Governor's Budget **May Revision** 2014-15

Edmund G. Brown Jr. Governor   State of California

Introduction

The Governor's Budget—reflecting a modest surplus as a result of a temporary windfall in capital gains tax revenues—laid out a multiyear plan that was balanced, paid down budgetary debt from past years, saved for a rainy day, and increased spending for education, the environment, public safety, public works, affordable health care, and CalWORKs.

Under this May Revision, state revenues are forecast to increase by $2.4 billion. Nevertheless, the costs of health care, drought, and other programs have increased by essentially the same amount.

This May Revision maintains the Governor's Budget principle of paying down debt and reducing long-term liabilities. After years of discussion, the May Revision finally proposes a plan to shore up the teacher pension system.

Despite the state's achieving a solid balanced budget, there remain a number of major risks that threaten the state's fiscal stability, including the overhang of fiscal debts, growing long-term liabilities, and lingering uncertainties regarding the costs of the federal Affordable Care Act. The recent agreement between the Governor and legislative leaders to create a Rainy Day Fund will help the state minimize future boom-and-bust cycles.

Changes since the Governor's Budget

The May Revision reflects the net changes in the national and state economic outlook, the corresponding effects on revenues and the state's obligation to schools, increased costs for implementing federal health care reform and other spending adjustments.

The key developments and proposals reflected in the May Revision include:

- A net increase of $2.4 billion in expected revenues across 2012-13 through 2014-15. This increase is largely driven by higher than expected personal income tax withholding, partnership income, and dividend income. These revenues are associated with higher annual bonus payments and one-time shifts due to federal tax policy changes in 2012. Therefore, the higher revenues are largely a one-time bump in 2013-14.
- Due to the change in state revenues, lower property taxes, and higher enrollment in K-12 schools, state General Fund costs for the Proposition 98 minimum guarantee for education have increased by $659 million. The May Revision includes $10 billion in new Proposition 98 resources for schools this year, including $4.5 billion to continue the implementation of the Local Control Funding Formula.
- Last year, the state's adoption of the optional expansion of Medi-Cal under the Affordable Care Act represented a major new spending commitment in providing Californians with health care coverage. Compared to what was expected just a few months ago, implementation of federal health care reform will provide more than one million additional people with coverage through Covered California and Medi-Cal combined. Medi-Cal enrollment is now expected to rise from 7.9 million before implementation to 11.5 million in 2014-15.

  This is a <u>46 percent increase</u> and Medi-Cal will now cover about 30 percent of the state's population. This surge in coverage will bring significantly higher state costs. Although the federal government will pay the costs for the optional expansion for the next few years, approximately 800,000 individuals will receive Medi-Cal benefits under the current 50-50 state-federal cost sharing arrangement. As a result, General Fund Medi-Cal costs will rise by $2.4 billion over two years. This represents an additional General Fund cost of $1.2 billion compared to what was expected in the Governor's January Budget.
- On January 17, 2014, the Governor declared a state of emergency because of increasingly severe drought conditions. In February, the Governor signed Chapter 2,

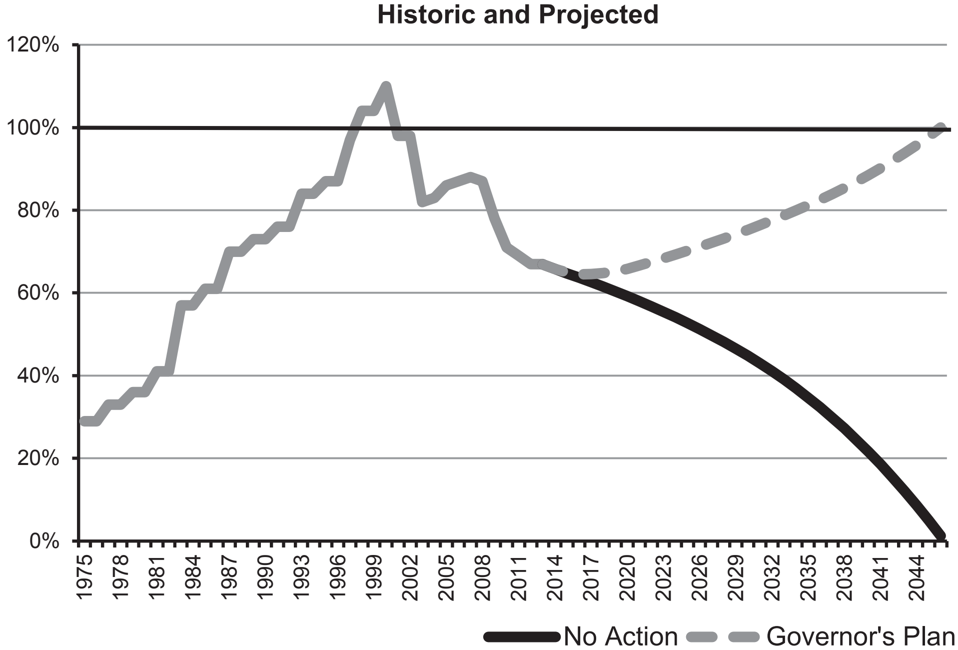
Statutes of 2014 (SB 103), appropriating $687 million in new expenditures. Additionally, the May Revision provides $142 million ($121 million General Fund) in drought-related expenditures to reflect higher costs in firefighting, emergency response, enforcement, monitoring, wildlife preservation, food assistance, and other critical activities.

- On February 20, 2014, the California Public Employees' Retirement System Board adopted new assumptions regarding the longer life expectancy of state retirees. The impact of these assumptions will be $1 billion phased in over three years. The costs in 2014-15 will be $430 million ($254 million General Fund).
- The Governor's January Budget included an increase of $100 million for trial court operations. The May Revision increases this amount to $160 million as part of a two-year strategy to stabilize trial court funding and allow time for the Judiciary to pursue cost reduction strategies.

Shoring Up Teacher Pensions

In its 101-year history, the California State Teachers' Retirement System (CalSTRS) has rarely been adequately funded—meaning that expected contributions and investment returns have not been equal to expected pension payouts. As shown in Figure INT-01, the system was only 29 percent funded as recently as 1975. The system did reach full

Figure INT-01
STRS Funded Ratio
Historic and Projected



funding (100 percent) for a few years around 2000 because of exceptional investment returns and higher contributions in the preceding years. Yet, reduced contributions, benefit enhancements, and stock market crashes have reduced the system's funding status to its current 67 percent and set it on a consistent downward trajectory.

Unlike other pension systems, contributions to CalSTRS are set in state law, and contributions from school districts and teachers do not automatically adjust to ensure the system's revenues meet its required expenditures. If no action is taken, it is projected that the system will run out of money in 33 years.

To counteract this dire prospect, the May Revision sets forth a plan of shared responsibility among the state, school districts and teachers to shore up the teacher pension system. The first year's increased contributions from all three entities are modest, totaling about $450 million. The contributions would increase in subsequent years, reaching more than $5 billion annually. Total contributions today equal 19.3 percent of teacher payroll and will rise to 35.7 percent. This would eliminate the unfunded liability in approximately 30 years.

Paying Down Debts and Liabilities

The state's budget challenges have been exacerbated by the Wall of Debt —an unprecedented level of debts, deferrals, and budgetary obligations accumulated over the prior decade. The Governor's January Budget proposed to reduce the Wall of Debt by over $11 billion this year and fully eliminate it by 2017-18 (as shown in Figure INT-02).

Figure INT-02

Budget Plan Would Eliminate the Wall of Debt

(Dollars in Billions)

	End of 2010-11 [1/]	End of 2013-14 [2/]	End of 2014-15 [3/]	End of 2017-18 [3/]
Deferred payments to schools and community colleges	$10.4	$6.1	$0.0	$0.0
Economic Recovery Bonds	7.1	3.9	0.0	0.0
Loans from Special Funds	5.1	3.9	2.9	0.0
Unpaid costs to local governments, schools and community colleges for state mandates	4.3	6.7	6.6	0.0
Underfunding of Proposition 98	3.0	2.4	1.8	0.0
Borrowing from local governments (Proposition 1A)	1.9	0.0	0.0	0.0
Deferred Medi-Cal Costs	1.2	1.8	2.2	0.0
Deferral of state payroll costs from June to July	0.8	0.8	0.8	0.0
Deferred payments to CalPERS	0.5	0.4	0.4	0.0
Borrowing from transportation funds (Proposition 42)	0.4	0.2	0.1	0.0
Total	**$34.7**	**$26.2**	**$14.8**	**$0.0**

[1/] As of 2011-12 May Revision

[2/] Based on 2013 Budget Act policies

[3/] As of 2014-15 May Revision

Under the plan, all remaining deferrals to schools and the Economic Recovery Bonds would be completely paid off this year and early repayments to transportation and the Cap and Trade Program would allow accelerated investments in those areas.

The May Revision includes an additional $100 million to repay a portion of existing mandate reimbursement claims that have been owed to local governments since at least 2004. This payment will provide local governments with discretionary dollars that can be spent on their highest local priorities. The Administration expects that the majority of the dollars will be spent improving implementation of 2011 Realignment and public safety.

Keeping a Balanced Budget

When Governor Brown took office in 2011, the state faced a $26.6 billion immediate budget deficit and future annual deficits estimated to be roughly $20 billion. The state's annual deficits have been eliminated through voter-approved temporary taxes, spending cuts, and a recovering economy.

The state is now on its most stable fiscal footing in more than a decade. Maintaining this stability will require continued fiscal restraint. There are numerous risks—each of which could cost the state hundreds of millions, or even billions, of dollars. Since January, for example, the costs of implementing federal health care reform increased General Fund costs by $1.2 billion. The cost of our future health care commitments contains large unknowns.

On the other hand, some risks and pressures have been reduced (although not eliminated) since the release of the Governor's January Budget. In February, the federal court overseeing prison overcrowding granted the state a two-year extension to meet the previously ordered 137.5 percent of capacity population cap. Also in February, the federal government avoided causing economic turbulence by raising its debt ceiling without incident. In addition, the state has prevailed in several key court decisions regarding the dissolution of redevelopment agencies that threatened the loss of billions of dollars for core public services.

Other risks remain. The May Revision assumes the continued modest economic expansion of the past couple of years. This expansion has now reached the historical average length of five years. While there are few signs of immediate contraction, we know from history that another recession is inevitable, with the potential of huge revenue losses. The state has also accumulated more than $300 billion in retirement, deferred maintenance, and other long-term liabilities, as shown in Figure INT-03. These liabilities cannot be ignored and must be kept in mind as new spending needs and desires are identified and advanced.

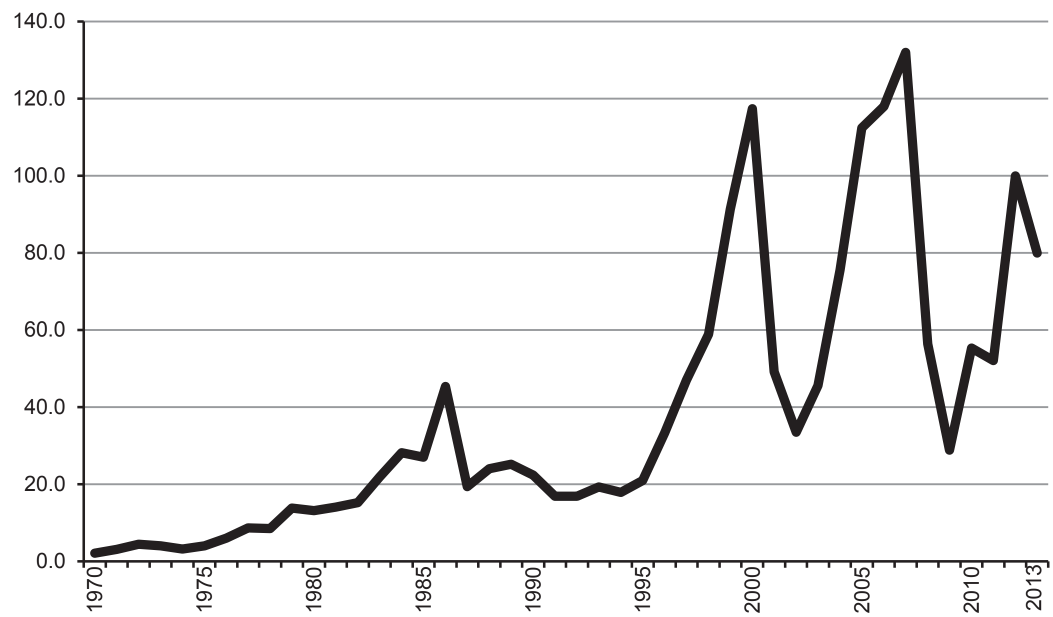
Figure INT-03
California's Long-Term Liabilities
As of 2014-15 May Revision

	($ in Billions)
Proposition 98 Maintenance Factor	$4.0
Unemployment Insurance Debt	6.8
Wall of Debt	14.8
Unfunded Retirement Liabilities	217.3
Deferred Maintenance	64.6
Unissued Bonds	30.0
Total	**$337.5**

Saving for a Rainy Day

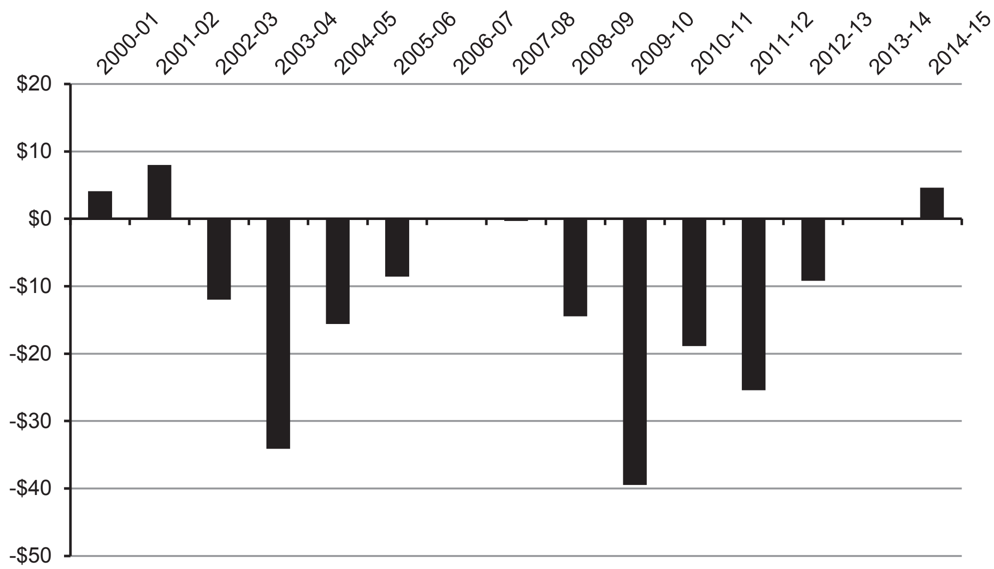
The state's current modest surplus is a welcome reprieve from recent budget crises. Nevertheless, the budget is heavily dependent on the performance of the stock market. Capital gains alone will provide 9.8 percent of General Fund tax revenues in 2014-15. Figure INT-04 illustrates the volatility of these revenues.

Figure INT-04
Unpredictable Capital Gains
(Dollars in Billions)



As shown in Figure INT-05, since 2000, the state has only had two short periods without budget deficits. During both periods, the state made big new ongoing commitments assuming that the economic growth would be permanent. Unfortunately, these periods of fiscal balance quickly turned into budget crises as the stock market plunged. Both times, the state encountered deficits of almost $40 billion, forcing the state to cut basic programs and raise taxes. The lesson is clear—during short spikes in revenues, the state should avoid new ongoing commitments.

Figure INT-05
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]
(Dollars in Billions)

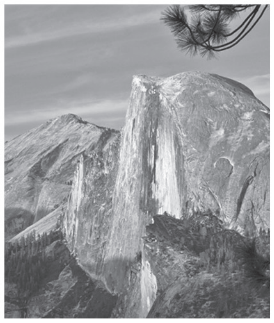


[1/] Budget shortfalls or surplus, measured by the annual Governor's Budget.

Learning from recent history and seeking to avoid the traps of the past, the Governor and legislative leaders recently announced a constitutional amendment for a strong Rainy Day Fund that requires both paying down liabilities and saving for a rainy day. Upon voter approval in November, this amendment would take effect for 2015-16, and its key components would be:

- Making deposits into the Rainy Day Fund whenever capital gains revenues rise to more than 8 percent of General Fund tax revenues. In addition, 1.5 percent of annual General Fund will be set aside each year.
- Setting the maximum size of the Rainy Day Fund at 10 percent of revenues.

GOVERNOR'S BUDGET **MAY REVISION** 2014-15

EDMUND G. BROWN JR. GOVERNOR STATE OF CALIFORNIA

Introduction

The Governor's Budget—reflecting a modest surplus as a result of a temporary windfall in capital gains tax revenues—laid out a multiyear plan that was balanced, paid down budgetary debt from past years, saved for a rainy day, and increased spending for education, the environment, public safety, public works, affordable health care, and CalWORKs.

Under this May Revision, state revenues are forecast to increase by $2.4 billion. Nevertheless, the costs of health care, drought, and other programs have increased by essentially the same amount.

This May Revision maintains the Governor's Budget principle of paying down debt and reducing long-term liabilities. After years of discussion, the May Revision finally proposes a plan to shore up the teacher pension system.

Despite the state's achieving a solid balanced budget, there remain a number of major risks that threaten the state's fiscal stability, including the overhang of fiscal debts, growing long-term liabilities, and lingering uncertainties regarding the costs of the federal Affordable Care Act. The recent agreement between the Governor and legislative leaders to create a Rainy Day Fund will help the state minimize future boom-and-bust cycles.

Changes since the Governor's Budget

The May Revision reflects the net changes in the national and state economic outlook, the corresponding effects on revenues and the state's obligation to schools, increased costs for implementing federal health care reform and other spending adjustments.

The key developments and proposals reflected in the May Revision include:

- A net increase of $2.4 billion in expected revenues across 2012-13 through 2014-15. This increase is largely driven by higher than expected personal income tax withholding, partnership income, and dividend income. These revenues are associated with higher annual bonus payments and one-time shifts due to federal tax policy changes in 2012. Therefore, the higher revenues are largely a one-time bump in 2013-14.

- Due to the change in state revenues, lower property taxes, and higher enrollment in K-12 schools, state General Fund costs for the Proposition 98 minimum guarantee for education have increased by $659 million. The May Revision includes $10 billion in new Proposition 98 resources for schools this year, including $4.5 billion to continue the implementation of the Local Control Funding Formula.

- Last year, the state's adoption of the optional expansion of Medi-Cal under the Affordable Care Act represented a major new spending commitment in providing Californians with health care coverage. Compared to what was expected just a few months ago, implementation of federal health care reform will provide more than one million additional people with coverage through Covered California and Medi-Cal combined. Medi-Cal enrollment is now expected to rise from 7.9 million before implementation to 11.5 million in 2014-15.

  This is a <u>46 percent increase</u> and Medi-Cal will now cover about 30 percent of the state's population. This surge in coverage will bring significantly higher state costs. Although the federal government will pay the costs for the optional expansion for the next few years, approximately 800,000 individuals will receive Medi-Cal benefits under the current 50-50 state-federal cost sharing arrangement. As a result, General Fund Medi-Cal costs will rise by $2.4 billion over two years. This represents an additional General Fund cost of $1.2 billion compared to what was expected in the Governor's January Budget.

- On January 17, 2014, the Governor declared a state of emergency because of increasingly severe drought conditions. In February, the Governor signed Chapter 2, Statutes of 2014 (SB 103), appropriating $687 million in new expenditures. Additionally, the May Revision provides $142 million ($121 million General Fund) in drought-related expenditures to reflect higher costs in firefighting, emergency response, enforcement, monitoring, wildlife preservation, food assistance, and other critical activities.

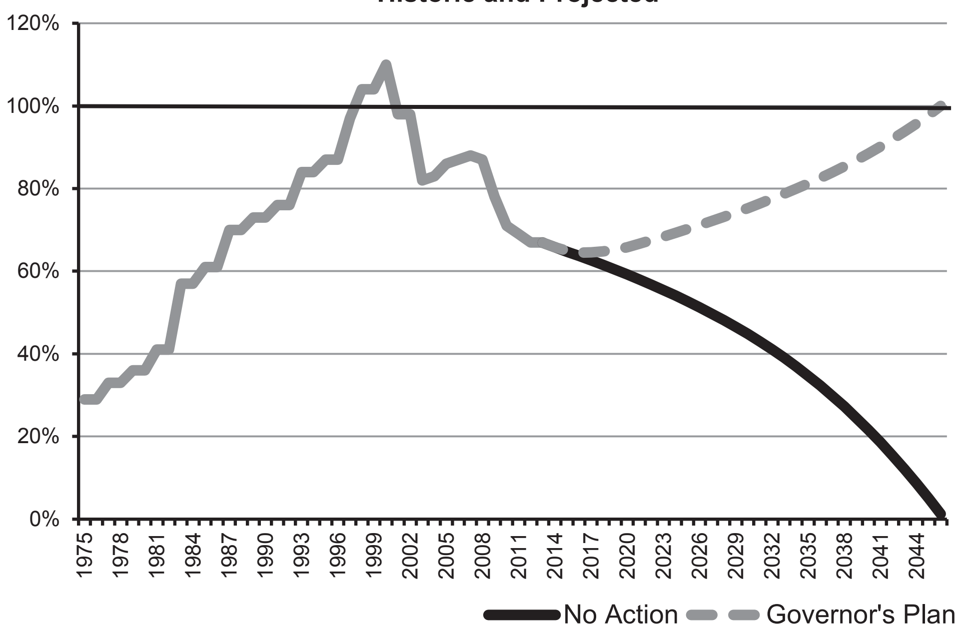
- On February 20, 2014, the California Public Employees' Retirement System Board adopted new assumptions regarding the longer life expectancy of state retirees. The impact of these assumptions will be $1 billion phased in over three years. The costs in 2014-15 will be $430 million ($254 million General Fund).

- The Governor's January Budget included an increase of $100 million for trial court operations. The May Revision increases this amount to $160 million as part of a two-year strategy to stabilize trial court funding and allow time for the Judiciary to pursue cost reduction strategies.

Shoring Up Teacher Pensions

In its 101-year history, the California State Teachers' Retirement System (CalSTRS) has rarely been adequately funded — meaning that expected contributions and investment returns have not been equal to expected pension payouts. As shown in Figure INT-01, the system was only 29 percent funded as recently as 1975. The system did reach full

Figure INT-01
STRS Funded Ratio
Historic and Projected



funding (100 percent) for a few years around 2000 because of exceptional investment returns and higher contributions in the preceding years. Yet, reduced contributions, benefit enhancements, and stock market crashes have reduced the system's funding status to its current 67 percent and set it on a consistent downward trajectory.

Unlike other pension systems, contributions to CalSTRS are set in state law, and contributions from school districts and teachers do not automatically adjust to ensure the system's revenues meet its required expenditures. If no action is taken, it is projected that the system will run out of money in 33 years.

To counteract this dire prospect, the May Revision sets forth a plan of shared responsibility among the state, school districts and teachers to shore up the teacher pension system. The first year's increased contributions from all three entities are modest, totaling about $450 million. The contributions would increase in subsequent years, reaching more than $5 billion annually. Total contributions today equal 19.3 percent of teacher payroll and will rise to 35.7 percent. This would eliminate the unfunded liability in approximately 30 years.

Paying Down Debts and Liabilities

The state's budget challenges have been exacerbated by the Wall of Debt —an unprecedented level of debts, deferrals, and budgetary obligations accumulated over the prior decade. The Governor's January Budget proposed to reduce the Wall of Debt by over $11 billion this year and fully eliminate it by 2017-18 (as shown in Figure INT-02).

Figure INT-02

Budget Plan Would Eliminate the Wall of Debt

(Dollars in Billions)

	End of 2010-11 [1/]	End of 2013-14 [2/]	End of 2014-15 [3/]	End of 2017-18 [3/]
Deferred payments to schools and community colleges	$10.4	$6.1	$0.0	$0.0
Economic Recovery Bonds	7.1	3.9	0.0	0.0
Loans from Special Funds	5.1	3.9	2.9	0.0
Unpaid costs to local governments, schools and community colleges for state mandates	4.3	6.7	6.6	0.0
Underfunding of Proposition 98	3.0	2.4	1.8	0.0
Borrowing from local governments (Proposition 1A)	1.9	0.0	0.0	0.0
Deferred Medi-Cal Costs	1.2	1.8	2.2	0.0
Deferral of state payroll costs from June to July	0.8	0.8	0.8	0.0
Deferred payments to CalPERS	0.5	0.4	0.4	0.0
Borrowing from transportation funds (Proposition 42)	0.4	0.2	0.1	0.0
Total	**$34.7**	**$26.2**	**$14.8**	**$0.0**

[1/] As of 2011-12 May Revision

[2/] Based on 2013 Budget Act policies

[3/] As of 2014-15 May Revision

Under the plan, all remaining deferrals to schools and the Economic Recovery Bonds would be completely paid off this year and early repayments to transportation and the Cap and Trade Program would allow accelerated investments in those areas.

The May Revision includes an additional $100 million to repay a portion of existing mandate reimbursement claims that have been owed to local governments since at least 2004. This payment will provide local governments with discretionary dollars that can be spent on their highest local priorities. The Administration expects that the majority of the dollars will be spent improving implementation of 2011 Realignment and public safety.

Keeping a Balanced Budget

When Governor Brown took office in 2011, the state faced a $26.6 billion immediate budget deficit and future annual deficits estimated to be roughly $20 billion. The state's annual deficits have been eliminated through voter-approved temporary taxes, spending cuts, and a recovering economy.

The state is now on its most stable fiscal footing in more than a decade. Maintaining this stability will require continued fiscal restraint. There are numerous risks—each of which could cost the state hundreds of millions, or even billions, of dollars. Since January, for example, the costs of implementing federal health care reform increased General Fund costs by $1.2 billion. The cost of our future health care commitments contains large unknowns.

On the other hand, some risks and pressures have been reduced (although not eliminated) since the release of the Governor's January Budget. In February, the federal court overseeing prison overcrowding granted the state a two-year extension to meet the previously ordered 137.5 percent of capacity population cap. Also in February, the federal government avoided causing economic turbulence by raising its debt ceiling without incident. In addition, the state has prevailed in several key court decisions regarding the dissolution of redevelopment agencies that threatened the loss of billions of dollars for core public services.

Other risks remain. The May Revision assumes the continued modest economic expansion of the past couple of years. This expansion has now reached the historical average length of five years. While there are few signs of immediate contraction, we know from history that another recession is inevitable, with the potential of huge revenue losses. The state has also accumulated more than $300 billion in retirement, deferred maintenance, and other long-term liabilities, as shown in Figure INT-03. These liabilities cannot be ignored and must be kept in mind as new spending needs and desires are identified and advanced.

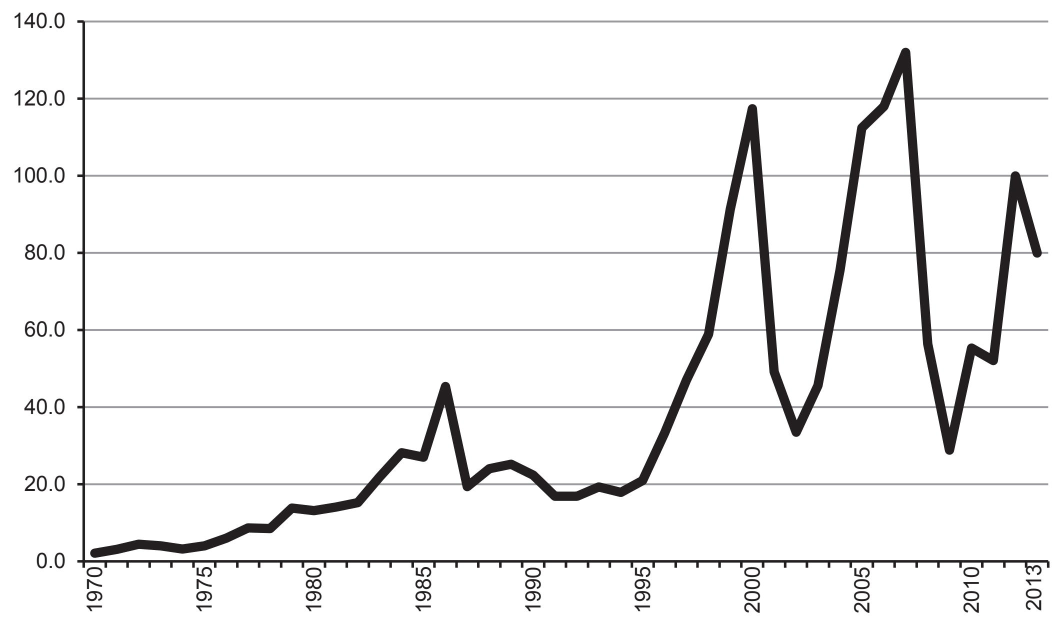
Figure INT-03
California's Long-Term Liabilities
As of 2014-15 May Revision

	($ in Billions)
Proposition 98 Maintenance Factor	$4.0
Unemployment Insurance Debt	6.8
Wall of Debt	14.8
Unfunded Retirement Liabilities	217.3
Deferred Maintenance	64.6
Unissued Bonds	30.0
Total	**$337.5**

Saving for a Rainy Day

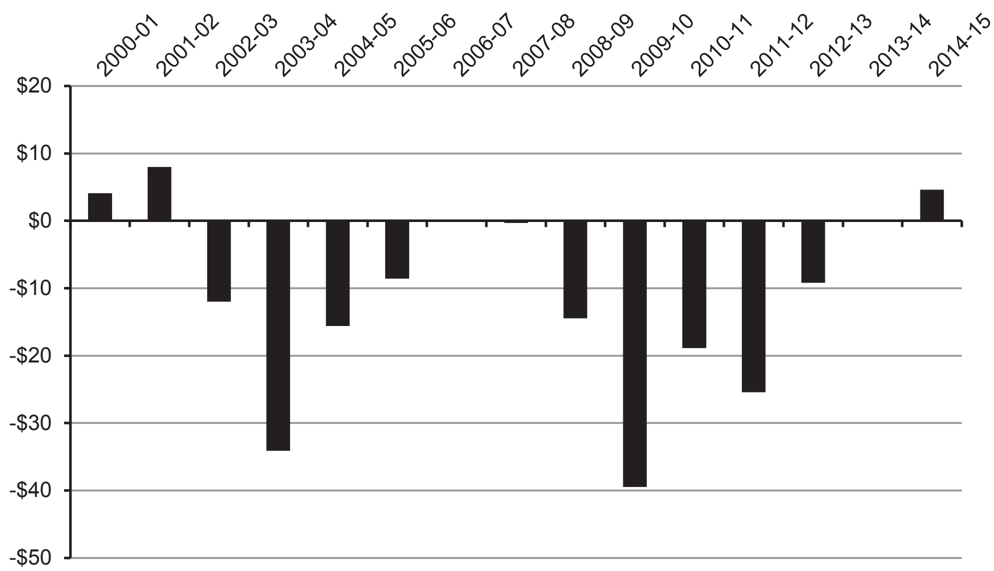
The state's current modest surplus is a welcome reprieve from recent budget crises. Nevertheless, the budget is heavily dependent on the performance of the stock market. Capital gains alone will provide 9.8 percent of General Fund tax revenues in 2014-15. Figure INT-04 illustrates the volatility of these revenues.

Figure INT-04
Unpredictable Capital Gains
(Dollars in Billions)



As shown in Figure INT-05, since 2000, the state has only had two short periods without budget deficits. During both periods, the state made big new ongoing commitments assuming that the economic growth would be permanent. Unfortunately, these periods of fiscal balance quickly turned into budget crises as the stock market plunged. Both times, the state encountered deficits of almost $40 billion, forcing the state to cut basic programs and raise taxes. The lesson is clear—during short spikes in revenues, the state should avoid new ongoing commitments.

Figure INT-05
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]
(Dollars in Billions)



[1/] Budget shortfalls or surplus, measured by the annual Governor's Budget.

Learning from recent history and seeking to avoid the traps of the past, the Governor and legislative leaders recently announced a constitutional amendment for a strong Rainy Day Fund that requires both paying down liabilities and saving for a rainy day. Upon voter approval in November, this amendment would take effect for 2015-16, and its key components would be:

- Making deposits into the Rainy Day Fund whenever capital gains revenues rise to more than 8 percent of General Fund tax revenues. In addition, 1.5 percent of annual General Fund will be set aside each year.
- Setting the maximum size of the Rainy Day Fund at 10 percent of revenues.

- Requiring half of each year's deposits for the next 15 years to be used for supplemental payments to the Wall of Debt or other long-term liabilities. After that time, at least half of each year's deposit would be saved, with the remainder used for supplemental debt payments or savings.
- Withdrawing funds only for a disaster or if spending remains at or below the highest level of spending from the past three years. The maximum amount that could be withdrawn in the first year of a recession would be limited to half of the fund's balance.
- Requiring in the Constitution that the state provide a multiyear budget forecast to help better manage the state's longer term finances.
- Creating a Proposition 98 reserve, whereby spikes in funding would be saved for future years. This would smooth school spending and thereby minimize future cuts. This reserve would make no changes to the Proposition 98 calculations, and it would not begin to operate until the existing maintenance factor is fully paid off.

As shown in Figure INT-06, under current projections, the proposed Rainy Day Fund would result in over $3 billion in savings and $3 billion in additional debt payments in its

Figure INT-06

Calculation of Rainy Day Amounts at 2014-15 May Revision

(Dollars in Millions)

	Fiscal Year		
	2015-16	**2016-17**	**2017-18**
Annual 1.5% of General Fund Revenues	$1,698	$1,773	$1,854
Capital Gains Tax Revenues in Excess of 8% of General Fund Taxes [1/]	$174	$233	$341
Total Rainy Day Amount	**$1,872**	**$2,005**	**$2,195**
Debt Repayment (50%)	$936	$1,003	$1,097
Deposit to Rainy Day Fund (50%)	$936	$1,003	$1,097

[1/] Net of amount of revenues attributable to Proposition 98.

Note: Numbers may not add due to rounding.

first three years of operation. If capital gains surge above normal levels during that period, even more money would go into the Fund. This May Revision sets aside 3 percent of revenues in 2014-15 as required by Proposition 58. Half of this deposit will go to make a supplemental payment to pay off the Economic Recovery Bonds and the other half—$1.6 billion—will be saved.

This page intentionally blank to facilitate double-sided printing.