May Revision 2016-17

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State of California

Introduction

Since the January Budget, the state's revenues have lagged expectations while the Governor and the Legislature have made major new spending commitments:

- The tax revenue forecast has been reduced by $1.9 billion, reflecting poor April income tax receipts and more sluggish sales tax receipts than expected.
- The passage of the managed care organization financing package solidifies funding for Medi-Cal over the next three years.
- Additional funding was committed to developmental disability services, higher payments to Medi-Cal providers, and the reduction of debt.
- The passage of legislation that made California the first state in the nation to raise the statewide minimum wage to $15 per hour will eventually raise General Fund costs by an estimated $3.4 billion ($39 million in 2016-17).

As the economy has recovered since the Great Recession, the state has made additional dramatic increases in permanent spending obligations, particularly in programs to counteract the effects of poverty. Since 2012, the expansion of health care coverage, the Local Control Funding Formula, and other increases in safety net spending have committed over $19 billion in increased annual General Fund costs ($10.7 billion Proposition 98).

Barring any significant changes, the budget over the next two years is in balance. Proposition 2's required contributions to debt payment and the Rainy Day Fund have been reduced by a combined $1.6 billion since January. These reductions, based on declining revenues and reduced capital gains expectations, keep the budget from being worse off.

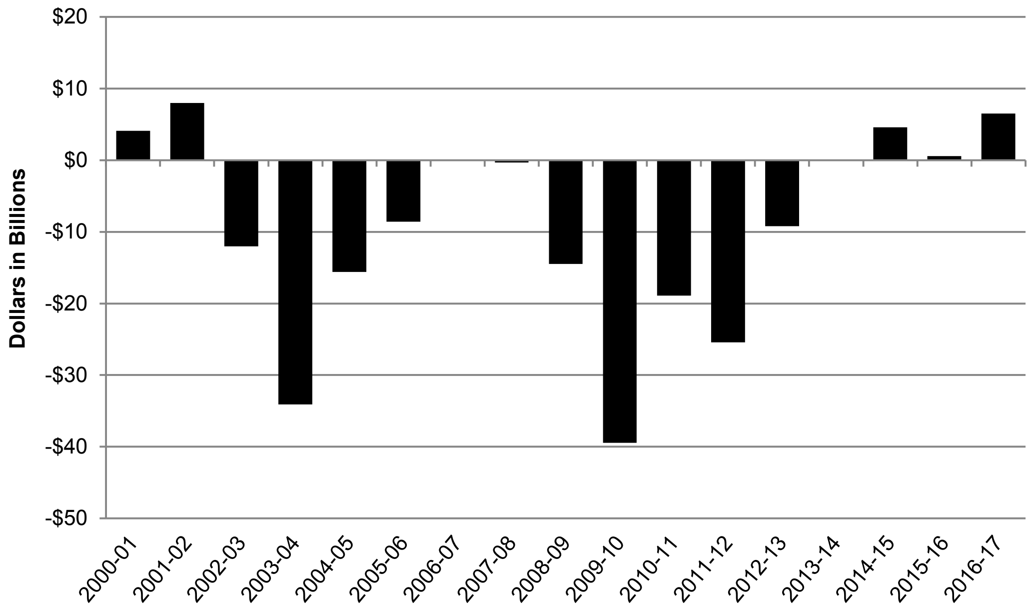
However, in the coming years, the state's commitments will exceed expected revenues. By 2019-20, the annual shortfall between spending and revenues is forecast to be over $4 billion. This shortfall does not take into account the likelihood of an economic slowdown or recession. The emerging shortfall is in large part—but not entirely—due to the expiration of the temporary taxes imposed under Proposition 30. This November, the state's voters will be given the choice whether to extend the Proposition 30 income tax rates for another 12 years. Even if the voters pass this extension of taxes, the longer-term budget outlook would be barely balanced. The cost of any additional new programs or obligations beyond the May Revision would need to be paid for through cuts in other programs or further tax increases beyond the Proposition 30 rates. If instead the voters do not pass the extension of taxes, the state will need to cut spending. Until the voters decide this important question, <u>no significant new ongoing spending commitments should be made</u>. The May Revision reflects this principle.

By the time the Budget is enacted in June, the economy will have finished its seventh year of expansion, two years longer than the average recovery. The next recession is getting closer—even if we cannot tell exactly when it will hit. The outcome of the vote on the extension of Proposition 30 taxes will not change the need to plan for a recession. If the taxes are extended, the state will still need a sizable Rainy Day Fund given the volatility of the income taxes on the state's wealthiest residents. Without a tax extension, the state will have less ongoing tax revenues to support its current fixed commitments, meaning that a strong Rainy Day Fund is even more important to protect against devastating cuts.

Maintaining Fiscal Balance Is an Ongoing Challenge

The fiscal stability from a balanced budget and a recovering state economy has been a welcome reprieve from the prior decade's budget deficits. Yet maintaining a balanced budget for the long term will be an ongoing challenge—requiring restraint and prudence. As shown in Figure INT-01, since 2000, the state's short periods of balanced budgets

Figure INT-01
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1]

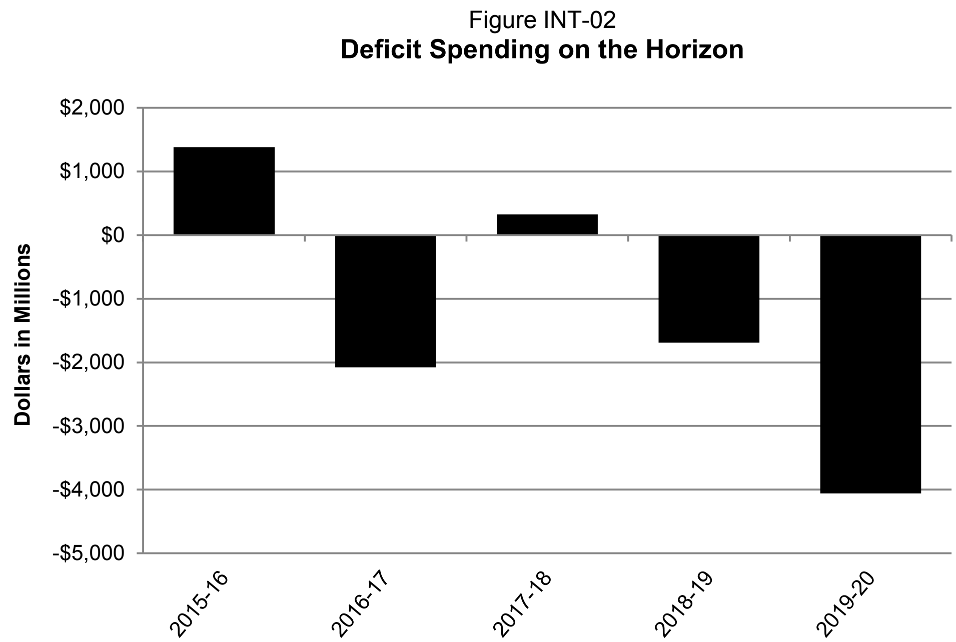


[1] Budget shortfalls or surplus, measured by the annual Governor's Budget.

have been followed by massive budget shortfalls. In fact, the sum of all the deficits during this period is <u>seven times</u> greater than the sum of all the surpluses.

With California's complicated budget, there will continue to be year-to-year fluctuations, risks and cost pressures, including from the federal government and ballot initiatives. Since January alone, forecasted revenues have dropped by nearly $2 billion and the federal government has issued managed care regulations that will likely drive up state Medi-Cal costs by hundreds of millions of dollars annually.

The current fiscal year is the last one with the full revenues of Proposition 30. Given that the state has added considerable ongoing commitments since its passage, the budget is currently projected to return to deficit spending when Proposition 30 revenues expire. As shown in Figure INT-02, without corrective action, the state will spend nearly $1.7 billion more than it receives in 2018-19 and $4 billion more than it receives in 2019-20 — the first year when no Proposition 30 revenues will be collected. If the voters choose to extend the taxes at the November election, the state's books will again come into balance but only by a few hundred million dollars each year.



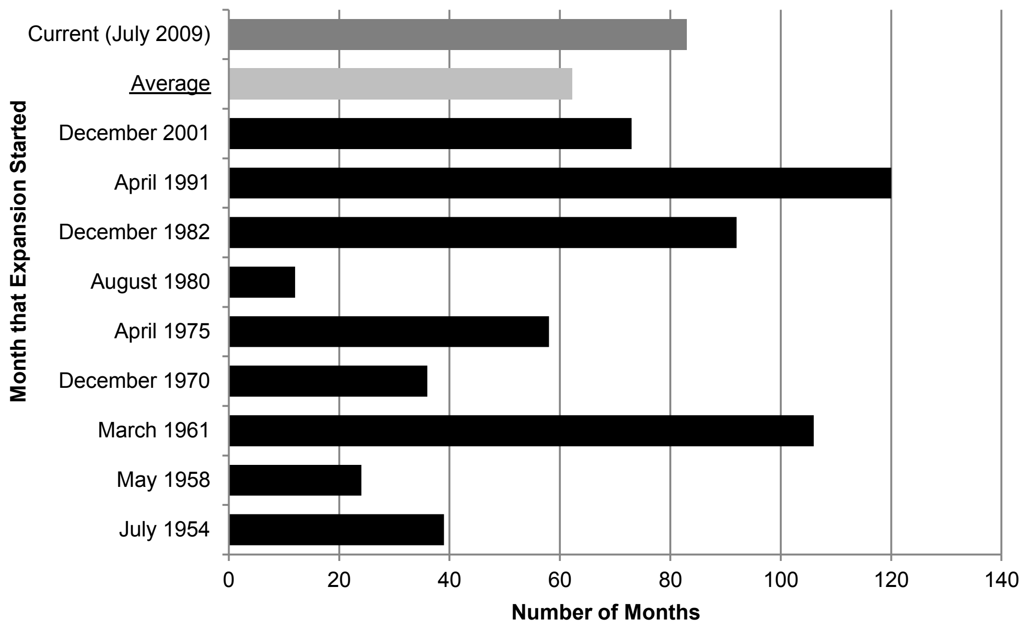
Planning for the Next Recession

The passage of Proposition 2 in 2014 gives the state an opportunity to mitigate the boom-and-bust cycle of the past two decades. Recent budget shortfalls have been driven by making ongoing commitments based upon temporary spikes in revenues primarily from capital gains. Under Proposition 2, these spikes in capital gains will instead be used to save money for the next recession and to pay down the state's debts and liabilities. Proposition 2 establishes a constitutional goal of having 10 percent of tax revenues in the Rainy Day Fund.

The budget assumes the continued expansion of the economy. There are few signs of immediate contraction at this point. Yet, economic expansions do not last forever. In the post-war period, the average expansion has been about five years. As shown in Figure INT-03, the current expansion has already exceeded the average by two years.

Prior to the start of the last two recessions (which began in 2001 and 2007), the state significantly increased its spending, had structurally imbalanced budgets, and had minimal reserves. As a result of paying off many of its budgetary debts and setting aside funds in the Rainy Day Fund, there is no doubt that California is better prepared for a

Figure INT-03
Current Recovery Already Two Years Longer Than Average



recession than it was for these last two. But that is hardly the standard to which the state should aspire.

Another recession is inevitable and the state must plan for it. To that end, in January, the Department of Finance modeled a recession of average magnitude to occur in 2017-18. Under this forecast, revenues from the state's "big three" taxes—the personal income, sales, and corporation taxes—dropped a total of $55 billion from the start of the recession through 2019-20.

In April, Moody's Investors Service released a report that assessed California's preparedness for the next recession compared to other larger states. Among 20 states, California was 19th in its preparedness, ahead of only Illinois. The state's key areas of vulnerability were:

- Revenue Volatility—California's heavy dependence on a progressive income tax makes it highly susceptible to stock market and other economic fluctuations. Proposition 30's higher income tax rates have temporarily made the state's taxes even more volatile. The top 1 percent of Californians account for 48 percent of the state's income taxes, which in turn accounts for two-thirds of General Fund taxes.

- Size of Reserves — Proposition 2 has improved the state's ability to save. But even accounting for the Governor's proposed $2 billion supplemental deposit, the state's Rainy Day Fund would only reach 54 percent of its constitutional target this year.
- Revenue and Spending Flexibility — The state Constitution, combined with the extensive entitlements for poverty-focused programs, restricts the state's ability to react to worsening economic conditions as quickly as other states.
- Fixed Costs — Infrastructure debt and retirement obligations lock in more than 10 percent of General Fund spending, which can only be changed over many years. The state has issued tens of billions of dollars in infrastructure bonds in the past decade. In addition, as shown in Figure INT-04, the state has $232 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities — $228 billion — are related to retirement costs of state and University of California employees.

Figure INT-04

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2016-17	Proposed Use of 2016-17 Pay Down at Governor's Budget	Changes from Governor's Budget	Proposed Use of 2016-17 Pay Down at May Revision
Budgetary Borrowing				
Loans from Special Funds	$1,819	$955	-$263	$692
Underfunding of Proposition 98—Settle-Up	1,232	257	-39	218
Repayment of pre-Proposition 42 Transportation Loans	879	173	0	173
State Retirement Liabilities				
State Retiree Health	74,103	0	38	38
State Employee Pensions	49,592	0	0	0
Teacher Pensions [1]	72,626	0	0	0
Judges' Pensions	3,279	0	0	0
Deferred payments to CalPERS	570	0	0	0
University of California Retirement Liabilities				
University of California Employee Pensions	10,786	171	0	171
University of California Retiree Health	17,270	0	0	0
Total	**$232,156**	**$1,556**	**-$264**	**$1,292**

[1] The state portion of the unfunded liability for teacher pensions is $13.939 billion.

In recent years, the state has sought to enhance its future budget flexibility such as with the recently enacted minimum wage increase, which allows the Governor to pause future increases when faced with budget deficits or recessions. The state has also made great strides to reduce its fixed costs by avoiding excessive bond debt, implementing pension reform in 2012, and beginning to prefund retiree health benefits. Proposition 2 provides a dedicated funding source to help address retirement liabilities for 15 years, but that funding alone will not eliminate the liabilities.

In the short term, fully filling the Rainy Day Fund by the time the next recession begins should be the primary fiscal goal of the state. It is the only preparedness factor that can be improved quickly.

Counteracting the Effects of Poverty

For the last several years, the Census Bureau has reported that about 16 percent of California residents are living in poverty—slightly above the national average of 14.8 percent. The Census Bureau's supplemental measure of poverty, which considers broader measures of income and the cost of living, reflects an even higher poverty rate. While the state's economic condition has improved since the Great Recession, much of the gains are being made by the state's wealthiest residents.

California has an extensive safety net for the state's neediest residents who live in poverty, and the state maintained these core benefits despite the recession. Compared to other states, California provides broader health care coverage to a greater percentage of the population, including in-home care. California makes available higher cash assistance to families, continues that assistance to children after their parents lose eligibility, and provides extensive child care to working families with children up to age 13. Finally, the state provides generous financial aid to those seeking higher education.

In the past three years, the state has taken even greater steps to assist the state's neediest residents. The implementation of health care reform has increased coverage under Medi-Cal to an additional 6 million Californians in just four years. The Local Control Funding Formula is concentrating the greatest school funding to those students with the greatest needs. The state guaranteed that 6.5 million workers are eligible for sick leave. The 2015 Budget Act created California's first-ever earned income tax credit to help the poorest working families in California and encourage more families to claim the existing federal credit.

The January Budget proposed the first state cost-of-living increase for Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients since 2005. In April, the Governor signed legislation that will raise the minimum wage for all workers to $15 per hour as soon as 2023.

The full costs of many of these increases have already been built into the Budget. In the case of the Medi-Cal expansion and the minimum wage increases, however, the General Fund has only begun to pay the cost. The federal government will begin reducing its share of the Medi-Cal expansion costs beginning in 2017, and the costs of the minimum wage will hit the budget each year for higher in-home care and developmental disability costs as additional wage hikes occur. Accounting for the full implementation costs, the General Fund has incurred new obligations in the effort to counteract the effects of poverty totaling more than $19 billion (about $10.7 billion of which will be paid for through Proposition 98 funds). These costs are summarized in Figure INT-05.

Reducing the Cost of Housing

California's housing costs are extremely high. Approximately 1.5 million low-income California households pay more than half their income in rent, straining their ability to pay for other household expenses. In addition, the state has a disproportionately high share of the nation's homeless and chronically homeless.

The May Revision reflects $3.2 billion in state and federal funding and award authority for various affordable housing and homelessness programs. This amount includes recently created programs that pay for affordable housing in sustainable communities and housing for veterans. There is increasing evidence that demonstrates the effectiveness of interventions such as rapid rehousing and permanent supportive housing in addressing chronic homelessness. The creation of a $35 million housing program within CalWORKs over the last two years, California Housing Finance Agency's Special Needs Housing Program established this year, and the new Emergency Solutions Grant regulations recently promulgated by Department of Housing and Community Development (HCD) are using this approach.

Building upon these current efforts, the May Revision endorses the Senate's concept of a $2 billion bond from a portion of future Proposition 63 mental health revenues. This funding would enable HCD to develop and administer homelessness and affordable housing programs through a Mental Health Services Act-Supportive Housing Program and Tenant-Based Rental Assistance Program, with a particular focus on

Figure INT-05
Major Poverty-Focused Budget Actions Since 2012

Minimum Wage	
• Increase from $8/hour to $10/hour	$208 million
• Increase from $10/hour to $15/hour and extend paid sick leave	$3.4 billion
Medi-Cal	
• Optional expansion under Affordable Care Act	$2.1 billion
• Exemptions from provider cuts	$387 million
• Adult Dental restoration	$170 million
• Full Scope Services for Undocumented Children	$229 million
CalWORKs	
• 11.4 percent in cost-of-living increases[1]	$362 million
• Enhanced employment and early engagement services	$288 million
• Creation of designated housing assistance	$35 million
CalFresh	
• Work Incentive Nutritional Supplement	$33 million
• State Utility Assistance Subsidy	$15 million
In-Home Supportive Services	
• Overtime	$468 million
• Restoration of 7 percent of hours	$266 million
Earned Income Tax Credit	
• Creation of California credit	$295 million
Child Care	
• Various increases to rates and slots	$289 million
Cal Grants	
• Various augmentations and restorations	$176 million
SSI/SSP	
• 2.76 percent cost-of-living increase	$74 million
Proposition 98	
• Local Control Funding Formula—Supplemental and concentration grants for low-income and English Learner students	$10.2 billion
• State Preschool—various increases to rates and slots	$307 million
• Community Colleges Student Equity funding increases	$155 million
• Community College Full-Time Student Success Grants	$41 million
Total:	**$19.5 billion ($10.7 billion Prop 98, $8.4 billion General Fund, $0.4 billion Local Realignment Fund)**

Note: Fiscal estimates reflect fully implemented costs.
[1] Funded by 1991-92 State-Local Realignment Revenues.

chronic homelessness. The May Revision proposes first-year funding of $267 million from the bond proceeds.

Local land use decisions surrounding housing production have contributed to low inventories—even though demand has steadily increased. Local land use permitting and review processes have lengthened the approval process and increased production costs. Ultimately, the state's housing affordability will improve only with new approaches that increase the housing supply and reduce its cost. The Legislature is currently considering a number of these approaches. The May Revision proposes additional legislation requiring ministerial "by right" land use entitlements for multifamily infill housing developments that include affordable housing. This would help constrain development costs, improve the pace of housing production, and encourage an increase in housing supply. It is counterproductive to continue providing funding for affordable housing under a system that slows down approvals in areas already vetted and zoned for housing.

Continuing to Invest in Education, Infrastructure, and Sustainability

The May Revision continues to prioritize funding for education, infrastructure, and sustainability.

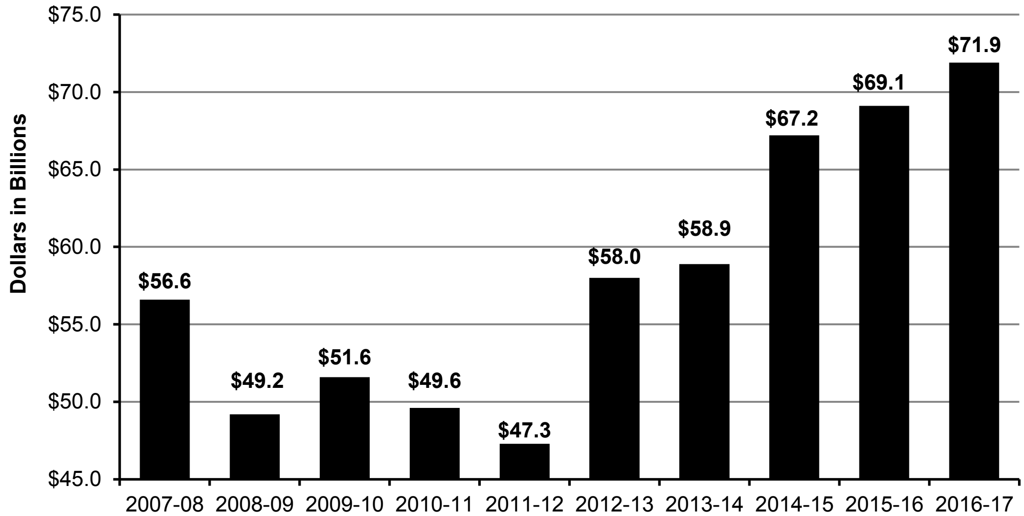
Investing in Education

The Proposition 30 temporary taxes were premised on the need to increase funding for education. As shown in Figure INT-06, the minimum guarantee of funding for K-14 schools was $56.6 billion in 2007-08 and sank to $47.3 billion in 2011-12. From this recent low, funding has been at all-time highs since 2012-13 and is expected to grow to $71.9 billion in 2016-17, an increase of $24.6 billion in five years (52 percent).

For K-12 schools, funding levels will increase by over $3,600 per student in 2016-17 over 2011-12 levels. This reinvestment provides the opportunity to correct historical inequities in school district funding with continued implementation of the Local Control Funding Formula. The May Revision provides $2.9 billion in new funding, bringing the formula's implementation to 96 percent complete.

The Budget also invests in the state's higher education system to maintain the quality and affordability of one of California's greatest strengths. The Budget keeps tuition at

Figure INT-06
Proposition 98 Funding
2007-08 to 2016-17



2011-12 levels. The May Revision commits $25 million in new funding for the California State University to reduce the time it takes a student to successfully complete a degree.

Strengthening Infrastructure

The construction and maintenance of key physical infrastructure is one of the core functions of state government. Infrastructure and capital assets allow for the delivery of public services and the movement of goods across the state—both essential components in fostering the state's long-term economic growth.

The May Revision continues to reflect the Governor's transportation package that would provide $36 billion over the next decade to improve the maintenance of highways and roads, expand public transit, and improve critical trade routes. The increased funding would be coupled with Caltrans efficiencies, streamlined project delivery, and accountability measures. The budget also includes $737 million ($500 million General Fund) for critical deferred maintenance at levees, state parks, universities, community colleges, prisons, state hospitals, and other state facilities, as well as a $1.5 billion General Fund down payment in improving Sacramento office buildings including the State Capitol Annex.

Addressing Climate Change

The California Global Warming Solutions Act of 2006 (AB 32) set California's initial greenhouse gas emission reduction goals, and directed the state to maintain and continue reductions beyond 2020. Last year, California adopted several ambitious policies that will further advance clean energy and significantly reduce greenhouse gas emissions. The Budget supports these efforts with a $3.1 billion Cap and Trade expenditure plan that will reduce greenhouse gas emissions through programs that support clean transportation, promote transformational sustainable communities, reduce short-lived climate pollutants, and protect natural ecosystems. Over multiple years, the Cap and Trade program gives the state the chance to transform its communities — particularly those disadvantaged ones — into innovative, sustainable economic centers.