Introduction

During the years leading up to 2011, California's fiscal troubles were monumental, with huge annual budget deficits and perennially late budgets. Many questioned whether California was governable at all, with the media calling the state "a fiscal basket case" and comparing it to insolvent nations like Greece. Seven years later, California passed seven consecutive on-time budgets, kept its spending in line with revenues, and built up a solid Rainy Day Fund.

As the state's economy has recovered from the Great Recession, the past five budgets have significantly increased spending—through historic growth in education funding, the creation and expansion of the state's first Earned Income Tax Credit, a minimum wage that will over time increase to $15 per hour, and the expansion of health care coverage to millions of Californians. The state has also paid down its budgetary borrowing and tackled such long-standing problems as restoring fiscal health to its retirement benefit plans and making major improvements to the state's transportation and water systems.

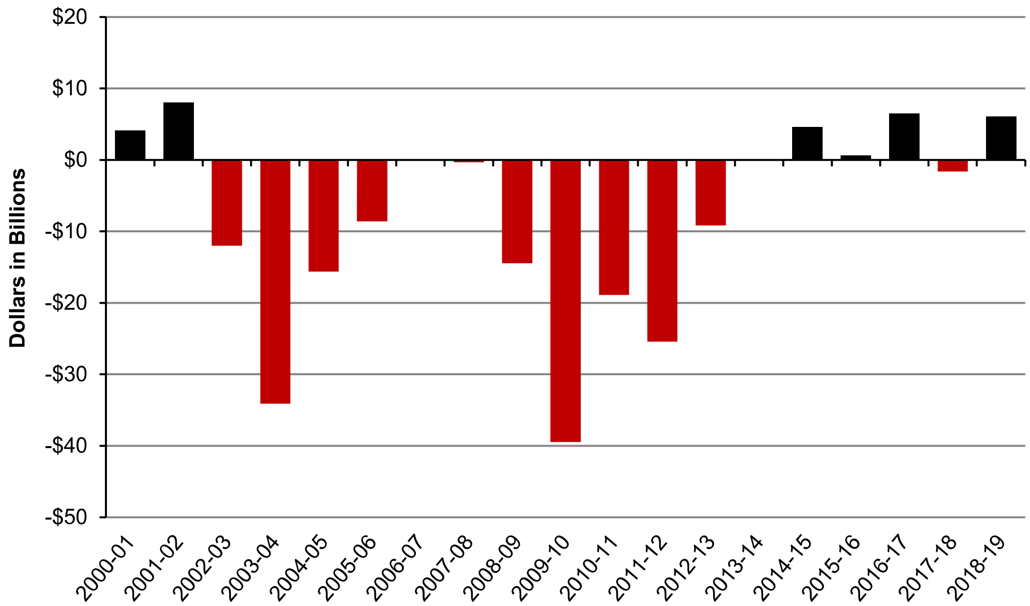
The 2018-19 Budget is projected to have a healthy one-time surplus. However, the state will continue to face uncertain times, including the ramifications of the recently enacted federal tax bill, which have not yet been factored into the Budget's economic or revenue forecasts.

The state must continue to plan and save for the next recession. By the end of 2018-19, the expansion will have matched the longest in post-war history. The best way to buffer against uncertainty and protect against future cuts is to continue building the state's Rainy Day Fund. Consequently, the Budget proposes to bring the Rainy Day Fund to 100 percent of its constitutional target.

Maintaining a Balanced Budget in Uncertain Times

California's fiscal stability—from a balanced budget and a recovering state economy—has been a welcome reprieve from prior budget deficits. As shown in Figure INT-01, the state's short periods of balanced budgets in the 2000s were followed by massive budget shortfalls. While each of these prior crises was preceded by a stock market crash, actions by the federal government could also easily overwhelm the fiscal capacity of the state. California's relationship with the federal government has never been more uncertain.

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.

The Budget, now more than ever, demands caution and prudence. Among the uncertainties are:

Federal Tax Changes—The Budget's economic and revenue forecasts were finalized prior to the enactment of the federal tax package at the end of December. The Budget forecasts assume no federal tax changes. While there are some aspects of the package that could temporarily benefit the national economy, millions of Californians will be hurt by the limitation of the ability to deduct state and local taxes from their federal filings. The May Revision will include a preliminary analysis of the projected impact of the changes on the state economy and revenues, although the effect from changed behavior of businesses and wealthy individuals will only be apparent after 2018 taxes are filed.

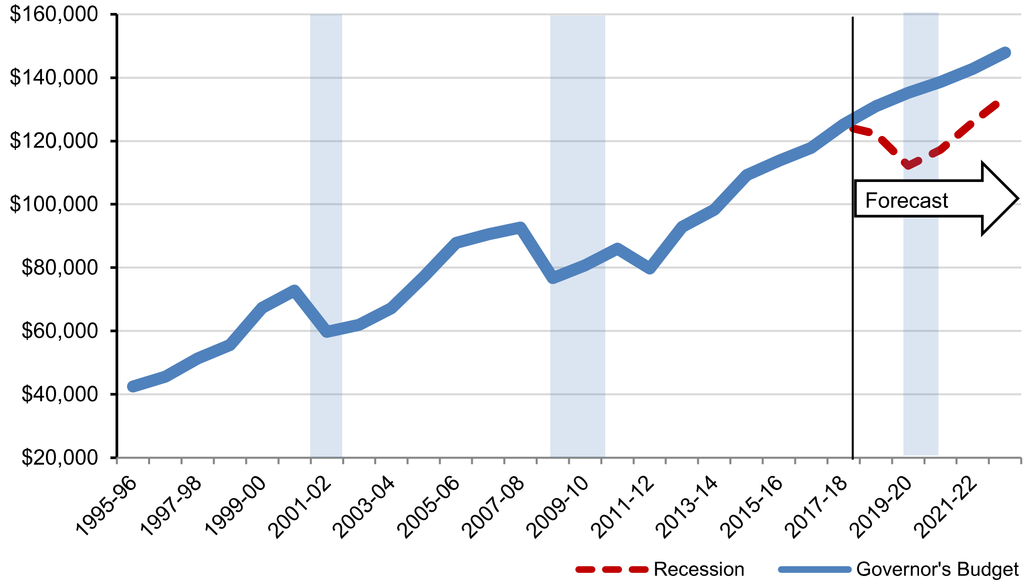
Children's Health Insurance Program (CHIP) Reauthorization—Congress acted in late 2017 to extend the federal cost sharing ratio for CHIP at an 88 percent federal match for several more months. The Budget was finalized before this action and instead assumes that the federal government will extend the CHIP cost sharing rate at a 65 percent level through 2018-19, consistent with the 2017 Budget Act. While the recent extension will lower budgeted state costs in the current year, failure by Congress to extend funding beyond March 2018 would increase state costs by hundreds of millions of dollars in 2018-19. The May Revision will include updated estimates based on federal action to date.

Federal Cost Shifting—In 2017, Congress attempted several times to repeal the Affordable Care Act and consequently drop health care coverage for millions of Californians. Such actions, if successful, would have cost the General Fund tens of billions of dollars annually—more than doubling the cost of Medi-Cal when fully implemented. While these recent efforts were defeated, Congress continues to indicate a willingness to shift health care and other entitlement program costs from the federal budget to states to address recent increases in the federal deficit.

Planning for the Next Recession

The Budget assumes the continued expansion of the economy. Yet, economic expansions do not last forever. In the post-war period, the average expansion has lasted about five years. By the end of the 2018-19 fiscal year, the expansion will have matched the longest in modern history. As shown in Figure INT-02, a moderate recession will drop state revenues by over $20 billion annually for several years.

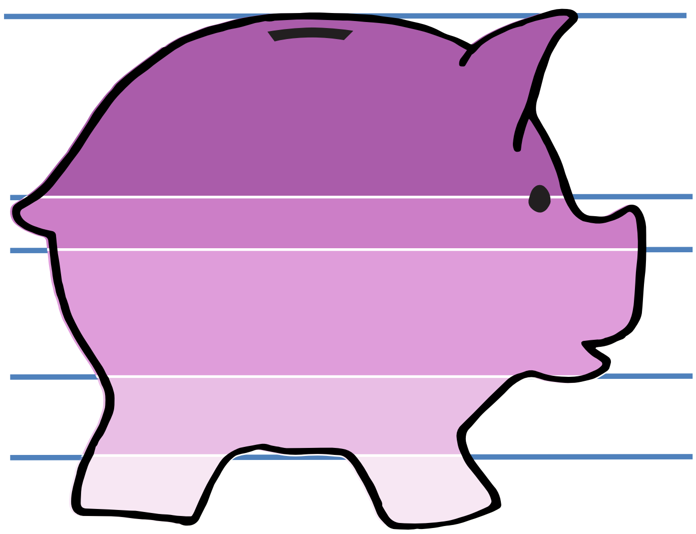
Figure INT-02
Annual Revenue Could Drop by over $20 Billion in a Recession
(Dollars in Millions)



Proposition 2, passed by the voters in 2014, establishes a constitutional goal of reserving 10 percent of tax revenues in a Rainy Day Fund. By the end of 2017-18, the state's Rainy Day Fund will have a total balance of $8.4 billion (65 percent of the constitutional target). The state's primary short-term fiscal goal should continue to be fully filling the Rainy Day Fund by the time the next recession begins. California's current fiscal position allows the state to achieve this goal, and the Budget proposes a $3.5 billion supplemental deposit to reach this milestone. See Figure INT-03 for a summary of the progress that the state has made in recent years.

While a full Rainy Day Fund might not eliminate the need for spending reductions in the case of a recession or major federal policy changes, saving now when budgets are good will allow the state to use its Rainy Day Fund later to soften the magnitude and length of any budget cuts. Not taking the opportunity to fully fill the Rainy Day Fund now will only heighten the risk that in the future the state will be unable to protect the vital public services it provides.

Figure INT-03
Filling Up the Rainy Day Fund Before the Next Recession



Moving Government Closer to the People

To both balance the budget and improve the state's ability to serve its residents, the state has taken major steps since 2011 to move government decision making closer to the people.

2011 Public Safety Realignment—The 2011 Public Safety Realignment shifted various public safety programs to local governments while providing an ongoing constitutionally protected funding source for these programs. The state began a major reduction in the size of the prison system due to federal court orders and the ability of counties to better serve lower-level offenders at a lesser cost. Since 2011, the state's prison population has been reduced by nearly 20 percent (from 162,000 in 2011 to 131,000 in 2017). As part of this realignment, roughly $8 billion in flexible funding will be distributed next year to local governments.

Local Control Funding Formula—In 2013, the state enacted the K-12 local control funding formula to enhance school district fiscal flexibility. By eliminating 43 discrete categorical programs and revamping state allocation formulas, school districts now have the freedom to innovate locally and focus improvement on English learners, students from low-income families, and youth in foster care. With a proposed $3 billion in new funding for the formula in 2018-19, the Budget will achieve full implementation of the formula two years earlier than originally scheduled.

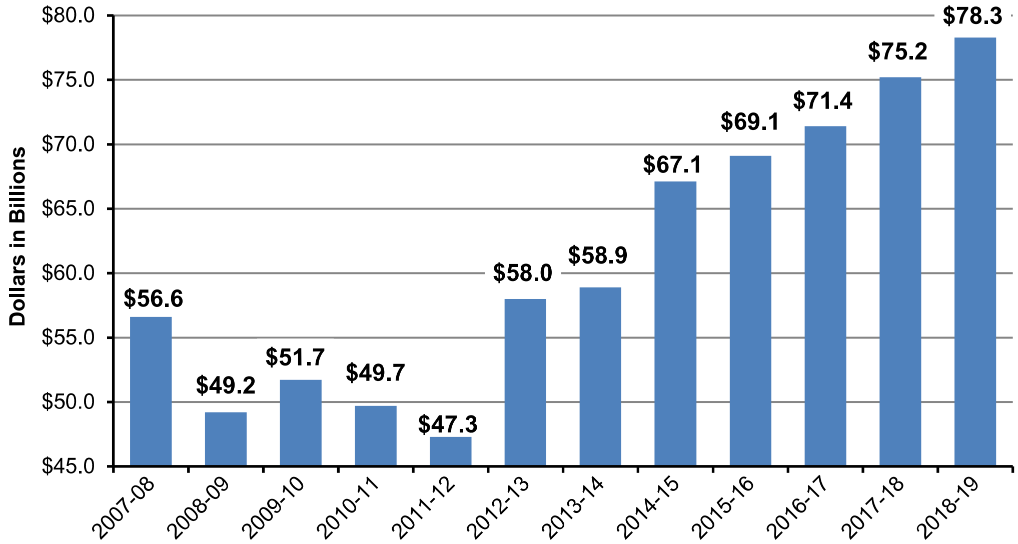
More Money for Schools

Proposition 30 in 2012 and Proposition 55 in 2016, as passed by the voters, increased funding for public education from their reduced levels during the Great Recession.

K-12 Education

As shown in Figure INT-04, the minimum guarantee of funding for K-14 schools in 2007-08 was $56.6 billion, dropping to $47.3 billion in 2011-12 at the peak of the state budget crisis. From this recent low, funding has grown substantially, and will continue to grow to $78.3 billion in 2018-19—an increase of $31 billion (66 percent) in seven years.

Figure INT-04
Proposition 98 Funding
2007-08 to 2018-19



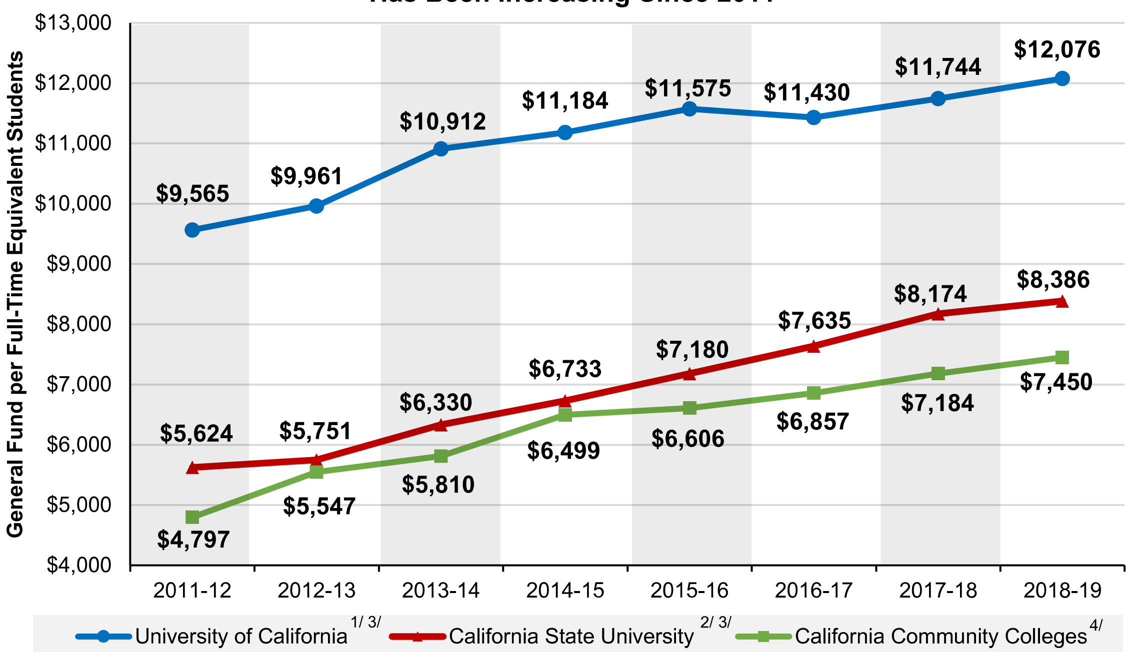
For K-12 schools, 2018-19 funding levels will increase by about $4,600 per student over 2011-12 levels. As noted above, available funding will allow the state to reach 100 percent implementation of the Local Control Funding Formula this year, correcting historical inequities in school district funding. While many districts have seized the opportunities offered under the formula to better serve their students, others have been slower to make changes. To improve student achievement and transparency, the Budget proposes requiring school districts to create a link between their local accountability plans and their budgets to show how increased funding is being spent to support English learners, students from low-income families, and youth in foster care.

Higher Education

The Administration has consistently sought to keep student fees low, promote new technology and innovation, and improve graduation rates, all to support students' success in their educational goals. The Budget continues to provide each university system with an annual 3-percent increase and the community colleges with a Proposition 98 increase of $570 million (4 percent). As shown in Figure INT-05, per-student General Fund levels have been increasing significantly since 2011-12. Since their recent lows, the University of California has received $1.2 billion in new funding, the California State University (CSU) has received $1.6 billion, and the community colleges $2.4 billion. Over the same time period, funding for state financial aid that primarily supports low-income students has increased by $623 million, to a total of $2.3 billion.

Figure INT-05

Per Student Funding for Public Higher Education Has Been Increasing Since 2011



1/ Appropriations to the UC are adjusted to exclude one-time funds of $5 million in 2011-12, $5 million in 2012-13, $4 million in 2014-15, $122 million in 2015-16, $261.6 million in 2016-17, and $175.6 million in 2017-18.

2/ Appropriations to the CSU are adjusted to exclude one-time funds of $4.6 million in 2015-16, $48.3 million in 2016-17, and $44.2 million in 2017-18.

3/ Appropriations to the UC beginning in 2013-14 and the CSU beginning in 2014-15 are adjusted to exclude funds used to pay state general obligation bond debt service to allow for comparisons to earlier years.

4/ Community college funding reflects total Proposition 98 funding (including both General Fund and property taxes), excluding funding for adult education.

Given these recent and proposed funding increases, coupled with the current level of resources available to postsecondary education institutions, the Budget reflects flat tuition and expects the universities and community colleges to continue to improve their students' success with the proposed level of resources. With no tuition increases this year, university tuition, adjusted for inflation, will be below 2011-12 levels.

Since 2010, upon creation through legislation (AB 1440), the state has invested a great deal of effort and funding in the Associate Degree for Transfer—a process to simplify the transfer of community college students to the CSU system. Last year alone, 38,000 students earned an Associate Degree for Transfer from a community college and 18,000 of these students successfully transferred to the CSU for the 2017 fall term. To further expand transfer opportunities for students earning these transfer degrees, the Budget restores funding for Cal Grant scholarships used at private, nonprofit universities, contingent upon these institutions admitting at least 3,000 transfer students with these degrees in the coming years.

Among California's higher education institutions, community colleges serve by far the most students—2.1 million students, or three-quarters of all public higher education students. In the summer of 2017, the community college system released its *Vision for Success.* Much like the CSU Graduation Initiative released in 2016, the community college vision provides a strategic plan for the system to improve student outcomes. The plan calls on the colleges to significantly increase student completion and transfer rates, decrease excess units taken by students, increase the number of career technical education students who are employed in their field of study, and eliminate racial/ethnic and regional achievement gaps.

The state's decades-old community college apportionment formula—which favors counting the number of students at a desk at a particular point in time—is not the most effective way for community colleges to reach these ambitious goals. Instead, the Budget proposes a new funding formula that provides supplemental funding to those districts that serve low-income students and provides grants to districts for each student who completes a degree or certificate. As the formula is implemented, no district will receive less funding than currently provided.

Currently, public universities and community colleges are inadequately serving the 2.5 million Californians between the ages of 25 and 34 who are in the workforce but lack a postsecondary degree or credential. Consequently, these young adults lack the skills and education to succeed in the modern economy and, therefore, are particularly at risk of being laid off during a recession. Often, these individuals seek educational assistance outside of California or through for-profit institutions, paying tens of thousands of dollars to try to get ahead but too often just ending up buried in debt. To serve these workers—who lack the time and ability to enroll in traditional classes—the Budget proposes the creation of the California Online College. While this innovative new college will take time to get up and running, it will offer millions of state residents a new opportunity toward economic success by taking advantage of modern technology.

Counteracting the Effects of Poverty

The Census Bureau has reported that 14.3 percent of California residents are living in poverty—slightly above the national average of 14.0 percent. The Census Bureau's supplemental measure of poverty, which considers broader definitions of income and living costs, reflects an even higher poverty rate—primarily due to the state's high cost of housing. While California's economic condition has improved since the Great Recession, much of the gains have accrued to the state's wealthiest residents. The recently enacted federal tax package threatens to exacerbate this gap in wealth.

California has an extensive safety net for the state's neediest residents who live in poverty. Since 2012, the General Fund has newly committed approximately $20 billion annually in poverty-focused programs. In addition to full implementation of the K-12 local control funding formula—which heavily emphasizes services to the state's neediest students—the Budget continues to fund:

- The rising state minimum wage, which increased to $11 per hour in 2018 and is scheduled to eventually rise to $15 per hour.
- The expansion of health care coverage under the federal Affordable Care Act, which provides millions of Californians with insurance.
- The restoration of various health benefits to low-income Californians that were eliminated during the recession, including adult dental services.
- The state's first Earned Income Tax Credit and its recently expanded coverage.
- The increased CalWORKs grants and the repeal of the maximum family grant rule, which denied aid to children who were born while their parents were receiving aid.
- The increases in child care and early education provider rates and the number of children served totaling $1.2 billion.

Combating Climate Change

California has acted decisively and aggressively to reduce greenhouse gas emissions and address climate change, with a state goal to reduce emissions 40 percent below 1990 levels by 2030. The state's most cost-effective approach to meeting that target is the Cap and Trade Program, which allows the private sector to determine the most appropriate path for reducing emissions through the quarterly auction of pollution credits. In addition to the direct emission reductions required under the program, the state has appropriated $6 billion in auction proceeds to further reduce emissions by funding transit and high-speed rail, affordable housing near jobs and services, forest and watershed improvements, healthy soil, recycling opportunities, and home energy upgrades. The state has prioritized the expenditure of these funds to disadvantaged communities.

The Legislature recommitted to the future of Cap and Trade last year with an extension of the program through 2030. Since then, auction proceeds have stabilized and revenues have increased, resulting in $1.25 billion in Cap and Trade dollars being available for appropriation in 2018-19. The plan for these funds will be announced later in January as part of the Governor's annual State of the State Address.

Enhancing Public Safety

The public safety goal of the Administration has been to give offenders the greatest opportunity for rehabilitation—thereby reducing recidivism and increasing overall public safety in a cost-effective manner. Over the past seven years, both in response to a federally imposed population cap and voter directives, the prison population has been reduced by 20 percent.

Over the prior two decades, corrections spending was one of the fastest growing components of the state budget—averaging 12.5 percent annual growth. The department's budget was notoriously difficult to control, with spending exceeding budgeted amounts—often by hundreds of millions of dollars.

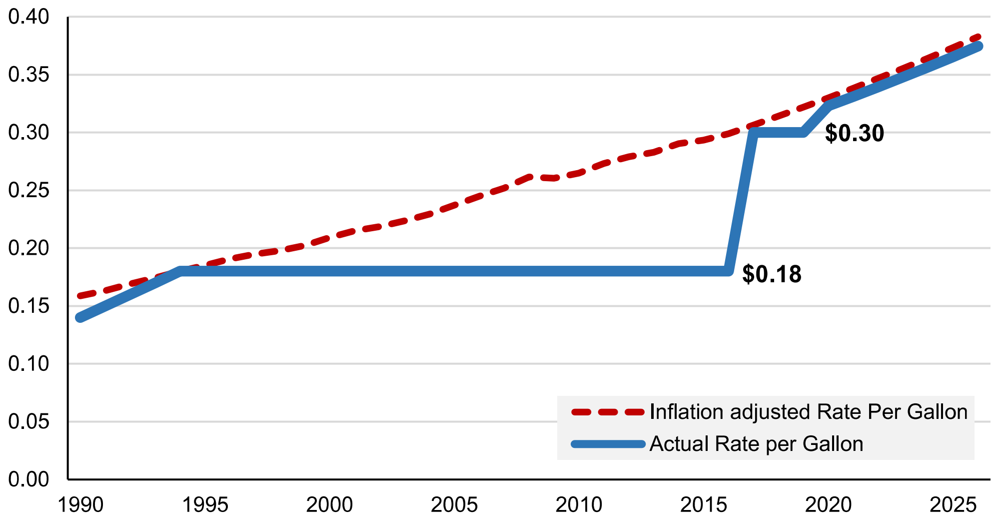
In contrast, over the past seven years, annual corrections spending growth has been reduced to 2.8 percent while focusing more dollars on health care and rehabilitation. While corrections spending represented 11.4 percent of 2011-12 General Fund spending, it now represents only 8.9 percent under the 2018-19 Budget.

Strengthening Infrastructure

The construction and maintenance of key physical infrastructure is one of the core functions of state government. Infrastructure allows for the movement of goods across the state and the delivery of public services. The deferred maintenance on existing state infrastructure is staggering—estimated to total $67 billion. The 2015 and 2016 Budgets contained a combined $960 million to address the most critical deferred maintenance projects such as levees and high-priority state facilities. The 2016 Budget also began a major investment in renovating Sacramento's aged and inadequate state office infrastructure, including the state Capitol Annex.

The Budget reflects the first full year of funding under the Road Repair and Accountability Act of 2017 (SB 1), which provides stable, long-term funding for both state and local transportation infrastructure priorities. California was facing the effects of inflation that had significantly eroded the purchasing power of the gas tax since the last time it was raised in 1994. The package reverses that trend (see Figure INT-06) and provides $55 billion in new funding over the next decade, split evenly between state and local projects.

Figure INT-06
SB 1 Restored Lost Purchasing Power for the Gas Tax



For 2018-19, the Budget includes $4.6 billion in new transportation funding, which includes:

- Focus on "fix-it-first" investments to repair neighborhood roads, state highways, and bridges ($2.8 billion).
- Make key investments in trade and commute corridors to support continued economic growth and implement a sustainable freight strategy ($556 million).
- Match locally generated funds for high-priority transportation projects ($200 million).
- Invest in passenger rail and public transit modernization and improvement ($721 million).

The Budget also reflects the first $1.3 billion in natural resources and housing infrastructure spending from the bonds passed by the Legislature last year, assuming passage by the voters in 2018. In addition, the Budget includes funding to restart the state's court construction program to complete ten courthouses.

Supporting Job Creation

Since January 2011, California has added 2.6 million jobs to the economy. While state government can only have a limited influence over the state's dynamic economy, the stability of a balanced state budget has given businesses the certainty and the reassurance they need to invest in California. In addition, the Administration redirected billions of dollars that were once spent ineffectively through the enterprise zone and redevelopment programs to more proven tools, like a sales tax exemption for manufacturing equipment and the California Competes tax credit program. To continue these efforts, the Budget proposes to extend the California Competes program for another five years with $180 million in credits awarded annually. An additional $20 million annually will directly assist small businesses.

Although the economy is near full employment, many Californians struggle to find work due to their personal history. As such, the Budget includes $50 million to provide credits for businesses that hire individuals who have employment barriers in the workforce, such as parolees, CalWORKs recipients, and veterans.

Paying Down Debts and Liabilities

In May 2011, Governor Brown identified a $35 billion Wall of Debt— an unprecedented level of debts, deferrals, and budgetary obligations accumulated over the prior decade. That debt has been substantially reduced, now standing at less than $6 billion. In addition to strengthening the Rainy Day Fund, Proposition 2 requires the state pay down a certain amount of debt in each budget. Additional Proposition 2 debt payments over the next few years for eligible components will further shrink this debt.

While short-term debts and budgetary borrowing have been largely eliminated, long-term liabilities remain. As shown in Figure INT-07, the state has $275 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$272 billion—are related to retirement costs of state and University of California employees.

Figure INT-07

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2018-19 [2/]	Proposed Use of 2018-19 Pay Down
Budgetary Borrowing		
Loans from Special Funds	$1,248	$205
Underfunding of Proposition 98—Settle-Up	440	100
Weight Fees	1,117	325
Repayment of pre-Proposition 42 Transportation Loans	471	235
State Retirement Liabilities		
State Retiree Health	76,533	195
State Employee Pensions	59,578	475
Teachers' Pensions[1/]	101,586	0
Judges' Pensions	3,489	0
Deferred payments to CalPERS	682	0
University of California Retirement Liabilities		
University of California Employee Pensions	10,851	0
University of California Retiree Health	19,331	0
Total	**$275,326**	**$1,535**

[1/] The state portion of the unfunded liability for teachers' pensions is $29.3 billion.

[2/] For retiree health and pensions, the amounts reflect latest actuarial report available.

Over the past several years, the Governor and Legislature have taken significant steps to address the long-term costs of retirement programs.

In 2012, the California Public Employees’ Pension Reform Act was enacted to save billions of taxpayer dollars by capping pension benefits, increasing the retirement age, stopping abusive practices, and requiring employees to pay at least half of their pension costs. In 2014, a funding plan was implemented to restore fiscal solvency to the state’s teacher pension system by 2046. In 2015, the state and its employees began to share equally in the prefunding of retiree health benefits to eliminate a then $72 billion unfunded liability in the coming decades. In 2017, the state made a $6 billion supplemental payment to CalPERS that is estimated to save a net $4.8 billion in required pension contributions over the next two decades.

Despite these efforts, California’s unfunded liabilities continue to rise. If not for the above-noted efforts, these liabilities would be billions of dollars higher. Accounting for all of these actions, and under current assumptions, the state now has plans in place to pay off these liabilities. The state’s multiyear spending forecast accounts for the expected increases in these costs while keeping spending in line with revenues. In other words, the state can continue to manage its retirement expenses while waiting for the long-term savings under 2012’s pension reform law to phase in. The growing costs will be expensive, but paying more now will reduce the liabilities and help preserve the ability of the state to keep providing these benefits over the long term.

Maintaining Fiscal Balance: An Ongoing Challenge

The past six years have been the longest stretch of balanced budgets in recent history. With a volatile revenue structure and limited spending flexibility, the California budget demands constant attention to stay in balance. These six years of relative fiscal stability illustrate the benefits of a prudent approach to budgeting—building up a Rainy Day Fund, avoiding overcommitting one-time revenues, and making tough decisions when necessary. These years provide a sharp contrast to the decade of budget crises that preceded it—a decade that was defined by using one-time revenues from capital gains for ongoing expenditures while deferring tough decisions through borrowing and gimmicks. The state’s next recession will be upon California soon enough, but a full Rainy Day Fund is the best tool available to guide the state through it.