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.

Today, California has passed eight consecutive on-time budgets, kept its spending in line with revenues, and fully filled its Rainy Day Fund.

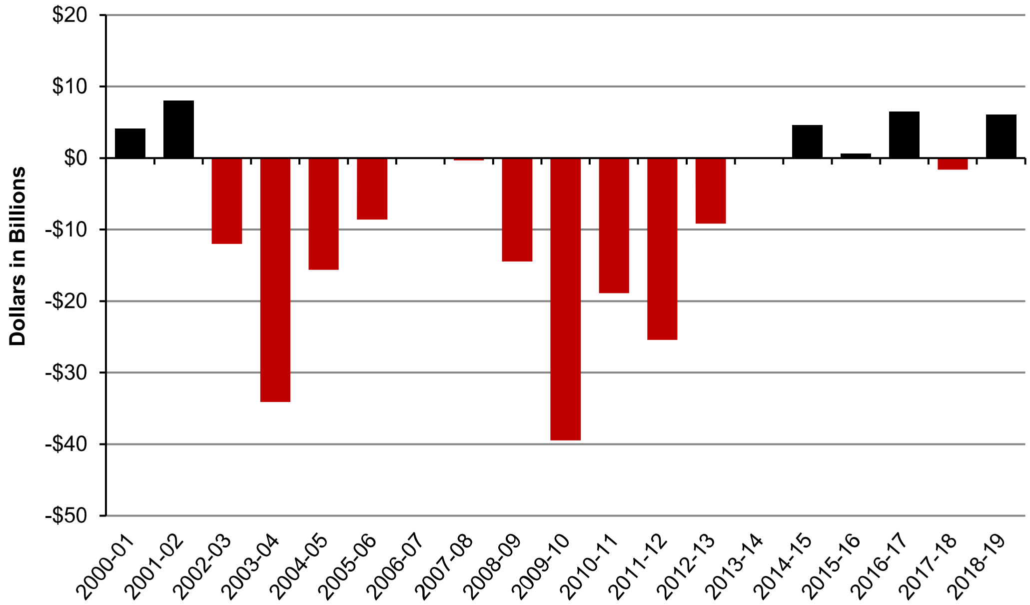
As the state's economy has recovered from the Great Recession, the past six budgets have significantly increased spending—through historic growth in education funding, the creation and expansion of the state's first Earned Income Tax Credit, a minimum wage that will increase to $15 per hour over time, 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 state must continue to plan and save for the next recession. By the end of 2018-19, the current economic expansion will have matched the longest in post-war history. To protect against future cuts, the Budget takes a prudent approach—fully filling the Rainy Day Fund and emphasizing one-time spending. While the state still faces large long-term risks, California is in better shape to weather a recession than at any other time in recent history.

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 (January).

Federal Government and Tax Bill

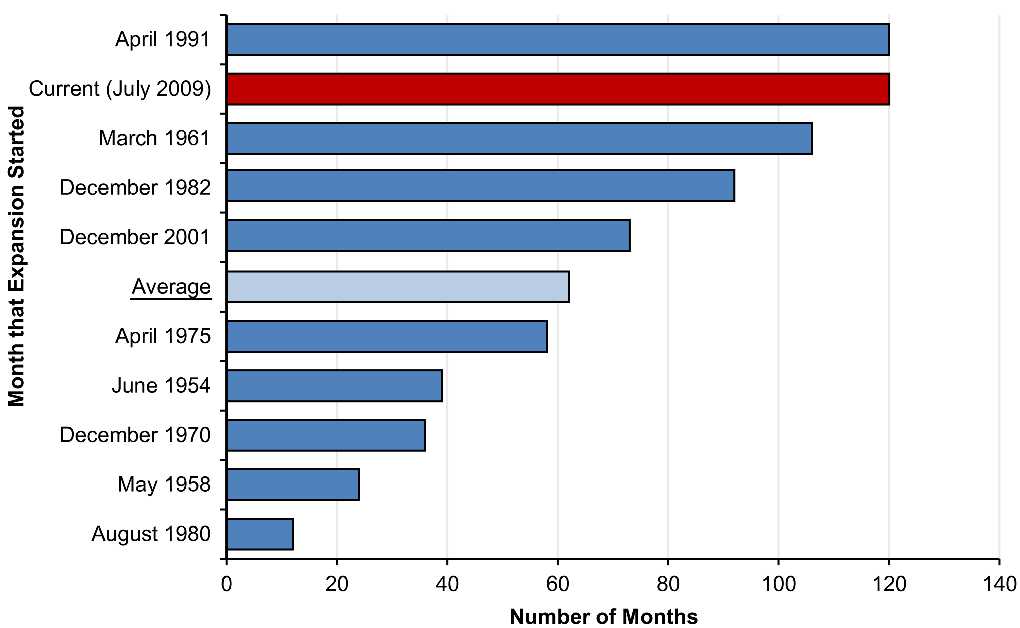
The economic forecast underlying the budget assumes the tax changes passed by the federal government in late 2017 will provide a temporary boost to the national economy and provide fiscal gains to many Americans, especially the wealthiest. However, this boost is likely to come at a long-term cost as it will take economic growth from future years and increase income inequality. By growing the federal deficit to more than $1 trillion each year, the tax package is essentially borrowing from the future to subsidize corporate stock buybacks and executive bonuses. However, the full implications to the state's taxpayers and federal-state programs will not be known for many years.

The increasing federal deficit caused by the tax bill will also create more pressure for the federal government to cut spending. Historically, this has meant shifting a greater cost burden to states. For instance, the congressional Medicaid proposals that have been debated over the past two years would have shifted tens of billions of dollars in permanent Medi-Cal costs to the state General Fund. Although they have been defeated to date, there is a major risk that they, or similar proposals, could reappear in future years.

Recession

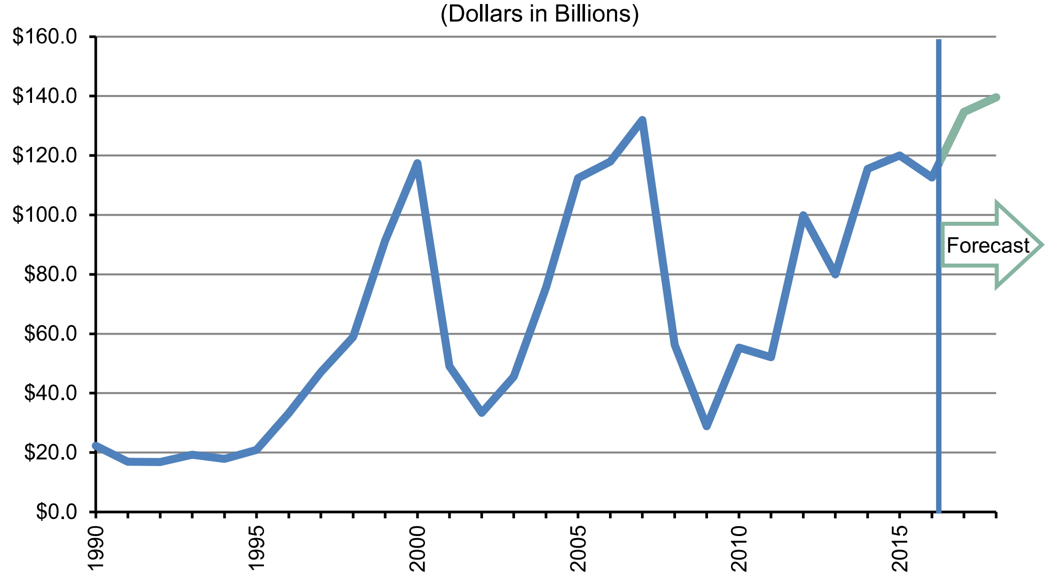
The Budget assumes the continued expansion of the economy and a balanced budget through the forecast period. But economic expansions don't last forever. In the modern era, the average expansion has lasted about five years. By the end of the 2018-19 fiscal year, as shown in Figure INT-02, the U.S. will have matched the longest recovery in modern history. In recent history, the state’s unemployment rate has dipped below 5 percent only twice, in 2000 and 2006. Each time, full employment was short-lived at 7 months and 11 months, respectively. The state's unemployment rate has fallen to an all-time low of 4.2 percent, and has been below 5 percent for more than a year.

Figure INT-02
Current Recovery Is Approaching The Longest Ever



The state’s most volatile revenue source—capital gains—is expected to reach all-time highs in 2017 and 2018 and is forecast to stay at levels never achieved previously as shown in Figure INT-03. To achieve these levels, the stock market would need to continue an unprecedented run.

Figure INT-03
Volatile Capital Gains on the Rise
(Dollars in Billions)



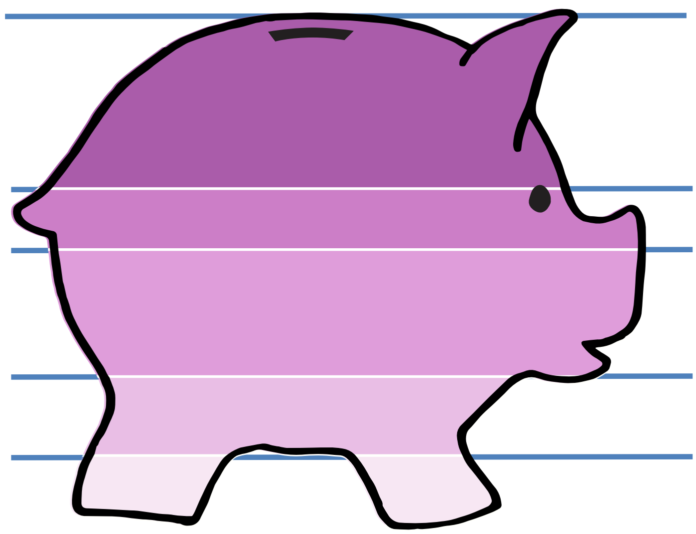
Planning for the Next Recession

The next recession will be upon California soon enough, so a full Rainy Day Fund and a commitment to prudent one-time spending are the best tools available to guide the state through a downturn.

Filling the Rainy Day Fund

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 increasing deposits in years with high capital gains. At the end of 2017-18, the state's Rainy Day Fund has a total balance of $9.4 billion (71 percent of the constitutional target). As shown in Figure INT-04, the state has quickly and aggressively filled the state's Rainy Day Fund in the past few years, including making optional supplemental deposits in 2016-17 and 2018-19, to fully fill the Rainy Day Fund before the next recession begins.

Figure INT-04
Filling Up the Rainy Day Fund Before the Next Recession



To address the inevitability of the next recession, the Budget adds two additional reserves to state law. The Budget Deficit Savings Account will facilitate the supplemental payment to fully fill the state's Rainy Day Fund, and the Safety Net Reserve Fund will protect against cuts to certain health and welfare programs during the next recession.

Focusing on One-Time Expenditures

After accounting for costs to continue existing programs, the Budget makes few new targeted ongoing commitments. Instead, in recognition of the growing risks that the state budget faces, the Budget commits $4 billion in one-time General Fund spending, focused on infrastructure, homelessness, and mental health.

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 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 $3.67 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 and provide nearly 1.0 percent growth on top of the fully implemented amounts.

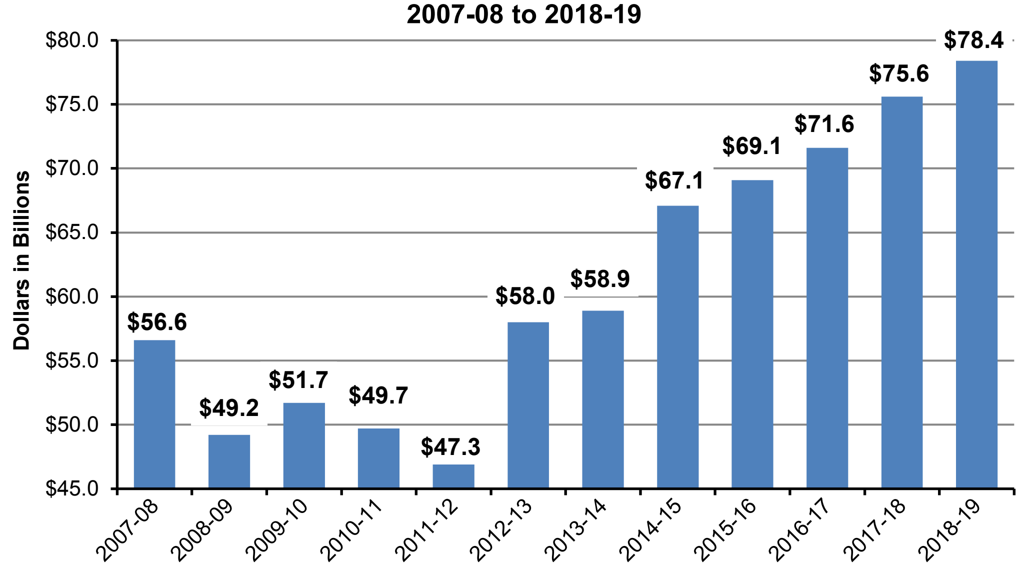
Increasing Money for Schools

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-05, 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 depth of the state budget crisis. From this recent low, funding has grown substantially, and will continue to grow to $78.4 billion in 2018-19—an increase of $31 billion (66 percent) in seven years.

Figure INT-05
Proposition 98 Funding
2007-08 to 2018-19

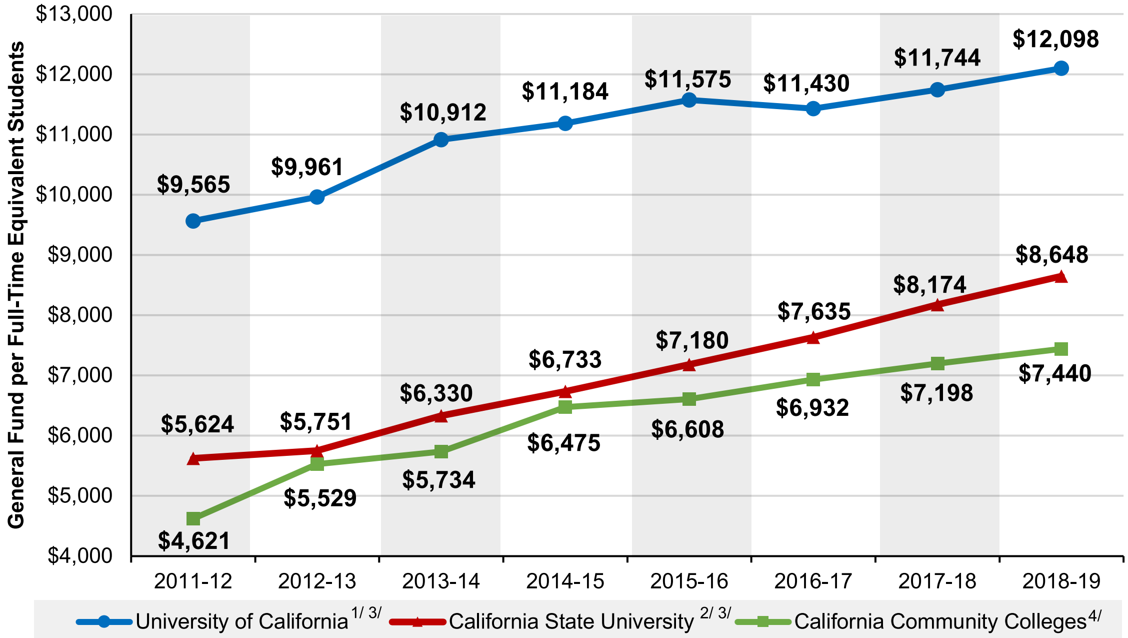


For K-12 schools, 2018-19 funding levels will increase by about $4,633 per student over 2011-12 levels. As noted above, available funding will allow the state to reach 100-percent implementation of the Local Control Funding Formula this year, correcting historical inequities in school district funding. 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 requires 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. The Budget also provides $300 million to districts to target improvements for the state's lowest performing students.

Higher Education

The Budget continues to keep student fees low, promote new technology and innovation, and improve graduation rates. The Budget provides each university system with an ongoing increase and the community colleges with a total increase of $609 million (4 percent). New funding is dedicated to the California State University to further improve its four-year graduation rates as laid out in its Graduation Initiative. As shown in Figure INT-06, per-student General Fund levels have increased 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 $1.7 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 $700 million, to a total of $2.4 billion.

Figure INT-06
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, $176.6 million in 2017-18, and $213.8 million in 2018-19.

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, $44.2 million in 2017-18, and $126.6 million in 2018-19.

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 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.

In 2010, through legislation (SB 1440), the state created the Associate Degree for Transfer—a process to simplify the transfer of community college students to the CSU system. Last year alone, over 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. Over the past few years, the state has made successful efforts to integrate both the University of California and the state's nonprofit colleges and universities into this transfer process.

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 their student achievement goals. Instead, the Budget adopts a new funding formula that provides supplemental funding to those districts that serve low-income students and provides funding to districts for each student who meets specified student success metrics, including completion of a degree or certificate with additional funding for low-income students. As the formula is implemented, no district will receive less funding than currently provided. The formula will be implemented over the next three years.

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 ending up buried in debt. To serve these workers—who lack the time and ability to enroll in traditional classes—the Budget creates 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, low-cost path to 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.

Affordable housing and Homelessness

Housing affordability for Californians continues to be a problem. Approximately one in five households in California in 2016 paid more than 50 percent of their household income toward housing costs. Over half of all California renters pay 30 percent or more of household income towards housing, with more than 25 percent paying 50 percent or more.

In 2017, the Legislature passed and the Governor signed a package of bills designed to increase housing supply and affordability. In the coming year, from that package, new revenues dedicated to addressing the rising cost of housing will begin to flow from a fee on real estate transactions and a $4 billion general obligation bond. The Budget includes $255 million from the real estate fee and $277 million from the bond, assuming voter approval in November 2018. In addition, the Budget includes $500 million to assist local governments in their immediate efforts to address homelessness. The Budget also anticipates placing the $2 billion No Place Like Home bond on the November ballot to accelerate the delivery of housing projects to serve individuals with mental illness. Altogether, the Budget includes $5 billion related to affordable housing and homelessness, across multiple state departments and programs.

Other Poverty-Focused Efforts

California has an extensive safety net for the state's neediest residents who live in poverty. Since 2012, the General Fund has newly committed more than $20 billion annually in poverty-focused programs (see Figure INT-07). 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 increases funding for programs designed to counteract poverty, focusing new efforts in CalWORKs and child care. In total, the Budget funds:

- 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 coverage, and expansion of full medical coverage to about 200,000 undocumented children.
- The restoration of various health benefits to low-income Californians that were eliminated during the recession, including adult dental services.
- The continuance of the state's Earned Income Tax Credit, which was created in 2015, and enhanced and expanded in 2017 and 2018.
- The increase in 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 elimination of the SSI/SSP "cash out" policy expanding federal funding for food assistance to approximately 370,000 households, while holding harmless households potentially affected by the change.
- The increases in child care and early education provider rates and the number of children served, totaling $1.3 billion.

Figure INT-07

Major Ongoing Poverty-Focused Budget Actions Since 2012

Minimum Wage	**Total Budget Impact**
• Increase from $8/hour to $10/hour	$173.3 million
• Increase from $10/hour to $15/hour and extend paid sick leave	$3.5 billion
Medi-Cal	
• Optional expansion under Affordable Care Act	$2.6 billion
• Exemptions from provider cuts	$213.8 million
• Adult dental restoration	$287.4 million
• Full Scope Services for undocumented children	$290.8 million
• Estate recovery limitations	$19.5 million
• Drug Medi-Cal Organized Delivery System Waiver[1]	$153.8 million
CalWORKs	
• 21.4 percent in cost-of-living increases[2]	$638.8 million
• Repeal Maximum Family Grant Rule[2]	$223.5 million
• Enhanced employment and early engagement services	$285.4 million
• Expansion of designated housing assistance	$95 million
• Elimination of once-in-a-lifetime restriction on homelessness assistance	$37 million
• Increase homelessness assistance daily rate from $65 to $85	$15.3 million
• Diaper assistance	$19.8 million
CalFresh	
• Work Incentive Nutritional Supplement	$29 million
• SSI Cash-Out Reversal (excludes one-time hold harmless benefits)	$22.3 million
• State Utility Assistance Subsidy	$11.1 million
SSI/SSP	
• 2.76 percent cost-of-living increase	$73 million
In-Home Supportive Services	
• Overtime	$311.5 million
• Restoration of 7 percent of hours	$311.7 million
Earned Income Tax Credit	
• Creation and expansion of California credit (includes administrative and outreach costs)	$445.9 million
Child Care	
• Various increases to rates and slots	$700 million
Cal Grants	
• Various augmentations and restorations	$183.7 million
Proposition 98	
• Local Control Funding Formula—Supplemental and concentration grants for low-income and English Learner students	$9.9 billion
• State Preschool—various increases to rates and slots and minimum wage costs	$599.5 million
• Community College Student Equity funding increases	$165 million
• Community College Student Success Completion Grant	$131.8 million
Total:	**$21.4 billion ($10.7 billion Prop 98, $10.3 billion General Fund, $0.4 billion Local Realignment Fund)**

Note: Fiscal estimates reflect fully implemented costs.

[1] Portions of the total costs are reflected under ACA optional expansion and existing Drug Medi-Cal base services.

[2] Funded by General Fund and 1991-92 State-Local Realignment Revenues.

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 $6.9 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 soils, recycling and home energy upgrades. Further, the state has prioritized the expenditure of these funds in disadvantaged communities.

The Administration worked with the Legislature last year to strengthen Cap and Trade by extending the program through 2030, The Budget includes a $1.4 billion Cap and Trade Expenditure Plan to invest in programs that further reduce emissions and support climate resiliency efforts, including $210 million for forest improvement and fire prevention projects that protect the state's forests from wildfires and $200 million to provide rebates for zero-emission vehicles to meet the Governor's Executive Order goal of 5 million zero-emission vehicles on the road by 2030.

Enhancing Public Safety

The public safety goal of the Administration and the Legislature 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.

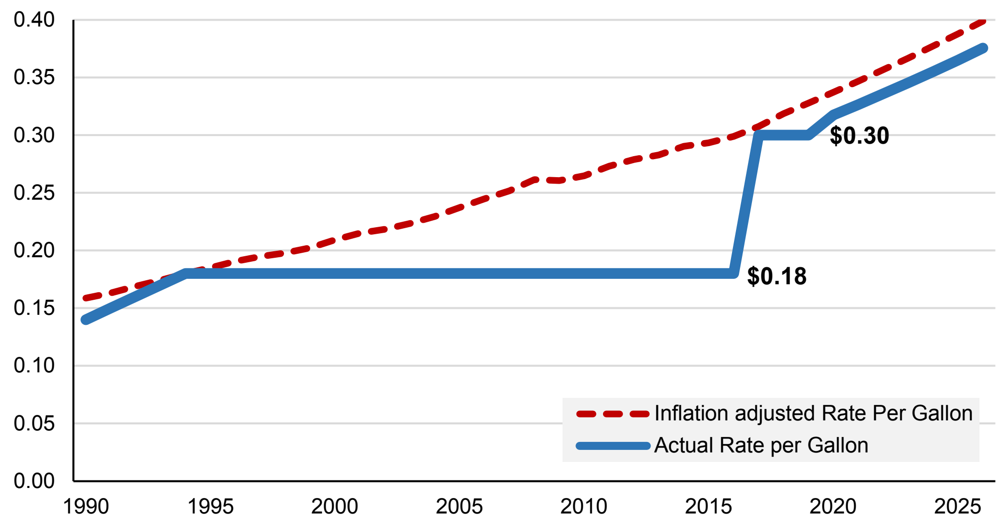
In contrast, over the past eight years, annual corrections spending growth has been reduced to 2.7 percent while focusing more dollars on health care and rehabilitation. While corrections spending represented 11.4 percent of 2011-12 General Fund spending, it now represents only 8.6 percent under the 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 hundreds of millions of dollars to begin addressing the most critical deferred maintenance projects. The Budget adds $333.5 million to this effort, with funding for the universities, courts, other state facilities, and flood control. The 2016 Budget also began a major investment in renovating Sacramento's aged and inadequate state office infrastructure including the state Capitol Annex, and the Budget provides $630 million to continue these efforts. Under the state Constitution, once the state's Rainy Day Fund is filled, the balance of deposits will be dedicated for infrastructure projects. The Budget allocates these future funds—providing the first $415 million annually to state government infrastructure costs with any remaining funds split evenly between high-priority housing and rail projects.

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-08) and provides $55 billion in new funding over the next decade, split evenly between state and local projects.

Figure INT-08
SB 1 Restored Lost Purchasing Power for the Gas Tax



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

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

In addition to significant transportation funding, the Budget also reflects the first $1.24 billion of expenditures from the recently passed natural resources bond (Proposition 68), and funding to restart the state's court construction program to complete ten courthouses.

Supporting Job Creation

Since January 2011, California has added 2.7 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 extends 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.

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 $5 billion after the appropriated payments in 2018-19. 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. The Budget provides $254 million, plus estimated interest, to repay counties for prior mental health mandated costs.

While short-term debts and budgetary borrowing have been largely eliminated, long-term liabilities remain. As shown in Figure INT-09, the state has $291 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$287 billion—are related to retirement costs of state and University of California employees.

Figure INT-09

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2018-19 [2/]	2018 Budget Act Pay Down
Budgetary Borrowing		
Loans from Special Funds	$1,248	$205
Weight Fees	1,150	382
Underfunding of Proposition 98—Settle-Up	440	100
Non-Proposition 98 Mandates (Pre 2004)	18	7
Pre-Proposition 42 Transportation Loans	471	235
State Retirement Liabilities		
State Retiree Health	91,008	195
State Employee Pensions	58,765	623
Teachers' Pensions[1/]	103,468	0
Judges' Pensions	3,277	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	**$290,709**	**$1,747**

[1/] The state portion of the unfunded liability for teachers' pensions is $35.3 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 multi-year 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 vigilance 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 next recession will be upon California soon enough, but a full Rainy Day Fund and a commitment to prudent one-time spending are the best tools available to guide the state through it.