

INTRODUCTION

Today, California's economy is larger than all but four nations. In just eight years, the state budget has gone from perpetual multi-billion dollar annual deficits to being balanced and having a robust Rainy Day Fund. The Budget protects this hard-won recovery, continues to save and to address structural liabilities, prepares for uncertain times ahead, and meets the challenges of today so that all Californians can count on a measure of security and a real shot at opportunity. To achieve these goals, the Budget is centered on making necessary investments for an effective government, promoting affordability and opportunity, and supporting just and dignified treatment for all Californians.

EFFECTIVE GOVERNMENT

To promote a more effective government that can withstand downturns in the economy, as well as natural and man-made emergencies and disasters, the Budget makes unprecedented investments in budget resiliency. It makes historic payments to reduce the state's unfunded pension liabilities, pays off long-standing budgetary debts, continues to build and strengthen the state's Rainy Day Fund, and makes critical investments to improve California's emergency readiness, response, and recovery capabilities. The Budget also proposes a comprehensive approach to bringing government services into the digital age, and funds critical work to build a longitudinal data system to better track student outcomes and increase the alignment of our educational system to the state's workforce needs.

Maintaining a balanced budget and increasing budget resiliency is non-negotiable and a predicate for expanding programs, especially with growing risks facing the state and national economies, including the recent volatility of the stock market.

AFFORDABILITY AND OPPORTUNITY

While the Budget reflects prudent stewardship of taxpayer dollars, it is the responsibility of government to address the issues that are most trying for all those living in the state and to invest in California's future. The Budget does more than ever to address the fact that far too many Californians simply cannot pay their bills, afford health care, put a roof over their heads, or provide the opportunity for their children to thrive from cradle to career.

To provide immediate relief, the Budget more than doubles the existing Earned Income Tax Credit by investing \$1 billion in a new “Working Families Tax Credit” to help families—particularly those with young children—receive a bump in their income to address the costs of housing, rent, and child care.

To improve affordability and access to health care, the Budget addresses the rising cost of prescription drugs, makes critical investments to uphold and expand the Affordable Care Act by increasing subsidies to ensure that more middle-class Californians can afford health coverage through Covered California, and makes progress in providing universal coverage by expanding Medi-Cal to young adults ages 19 through 25 regardless of immigration status.

The Budget addresses the housing crisis in California head-on with a one-time investment to spur housing development, an expansion of state tax credits to further develop both low- and moderate-income housing, and an innovative proposal to plan for housing development on excess state property.

The Budget prioritizes cradle-to-career opportunities by recognizing the crucial investments needed for young children and their parents: creating a path for California to be the first in the nation to provide newborns with the opportunity to be cared for by a parent or close relative for the first six months of the child's life by expanding California's Paid Family Leave program; providing universal full-day, full-year preschool for all income-eligible 4-year-olds and increased funding so all children in California can attend full-day kindergarten; and making investments in critical child care workforce and facility infrastructure to improve quality, affordable child care.

The Budget builds on these early years by providing an historic level of funding for K-12 schools—with the per-pupil expenditure now nearly \$5,000 higher than just 7 years ago—and greater investments to assist students with the greatest needs.

So that colleges and universities remain engines of economic mobility, the Budget provides funding for two free years of community college tuition, and provides significant increases for the California State University and the University of California.

JUSTICE AND DIGNITY

California is simultaneously facing a homelessness epidemic across the state, a humanitarian crisis at the border, a health care system that does not adequately serve individuals with mental illness, and a criminal justice system that can do more to focus on rehabilitation and reentry. The Budget makes critical investments to address these gaps to ensure that all Californians have access to justice and dignity.

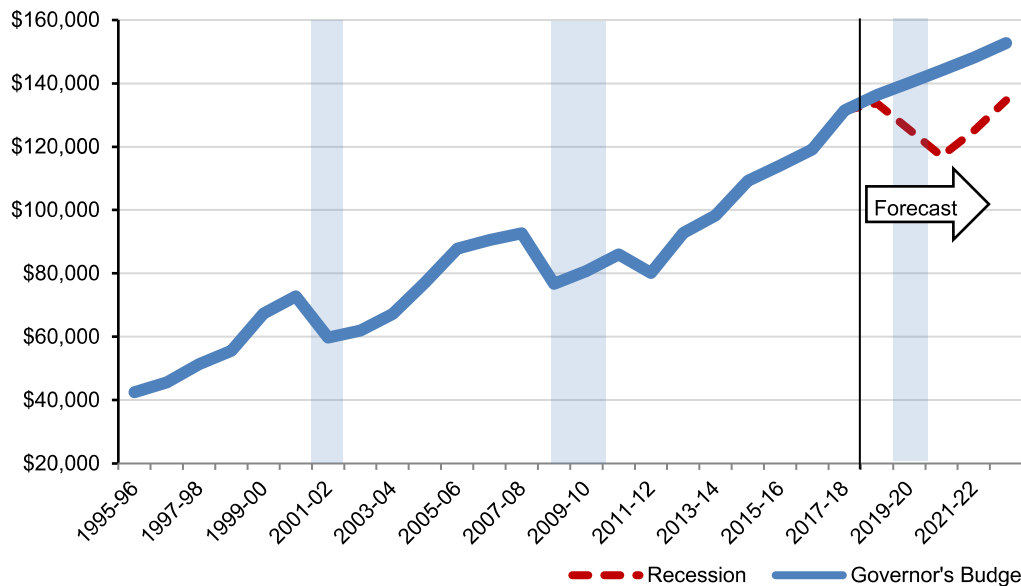
STRONG FOUNDATION, GROWING RISKS

The state has a strong fiscal foundation and has made significant progress in paying down debts and liabilities. The state has built up the Rainy Day Fund that will help to manage the effects of an economic downturn. The state is currently experiencing record low unemployment and has added hundreds of thousands of jobs each year since 2012.

While the state currently has a strong foundation, growing uncertainty related to the global political and economic climate, federal policies, rising costs, and the length of the current economic expansion require that the Budget be prudent. A trade war between the U.S. and China has materialized and the stock market ended 2018 with dizzying levels of volatility. Furthermore, relatively low interest rates and a growing federal deficit leave the federal government with fewer policy options to address an economic slowdown. By the time the budget year starts, the nation will have experienced 10 straight years of economic expansion—matching the longest economic expansion in modern history.

The Budget assumes moderate growth over the forecast period, but as shown in the figure below, even a moderate recession could result in significant revenue declines. A one-year recession in 2019-20 that is larger than the 2001 recession, but milder than the 2007 recession, could result in a nearly \$70 billion revenue loss and a \$40 billion budget deficit over three years.

Annual Revenue Could Drop by over \$25 Billion in a Recession
(Dollars in Millions)



Maintaining a balanced budget under the moderate recession scenario would be a challenge, even with the \$15.3 billion that will be saved in the Rainy Day Fund by 2019-20.

BUILDING BUDGETARY RESILIENCY AND PAYING DOWN UNFUNDED RETIREMENT LIABILITIES

Given federal uncertainty, the risks to the current economic forecast, and the need for a solid fiscal foundation, the Budget allocates \$13.6 billion (including debt payments and reserve deposits required by Proposition 2) to building budgetary resiliency and paying down the state's unfunded pension liabilities. This includes \$4 billion to eliminate debts and reverse deferrals, \$4.8 billion to build reserves, and an additional \$4.8 billion to pay down unfunded retirement liabilities. These investments will better enable the state to protect funding for schools and other core programs that serve the state's neediest individuals during the next economic slowdown.

ELIMINATING DEBTS AND REVERSING DEFERRALS

The Budget includes \$4 billion to eliminate budgetary debts and reverse the deferrals of the past decades. Specifically, the Budget proposes:

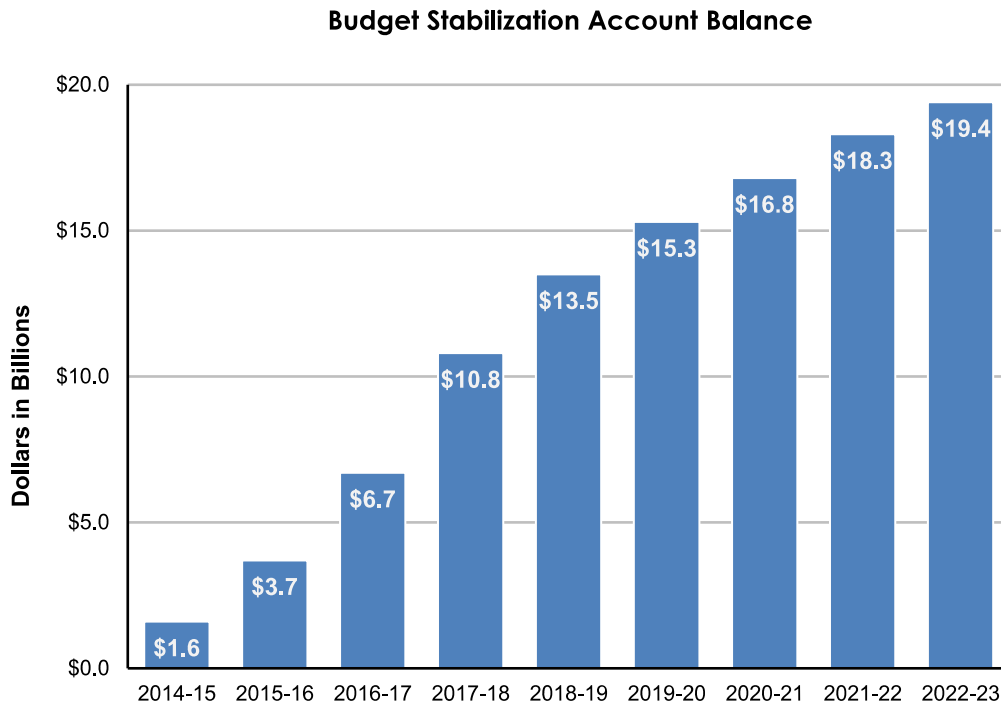
- \$2.4 billion to pay off the state's budgetary debts, including the elimination of all outstanding loans from special funds and transportation accounts. This marks the first time in over a decade that these debts have been completely paid off.
- \$1 billion to eliminate the annual payroll deferral. The one-month deferral of the June payroll provided a one-time budget savings that was used to help balance the budget nine years ago. The state has been deferring this payment ever since; this action eliminates this long-standing practice.
- \$700 million to eliminate the deferral of the fourth-quarter payment to the California Public Employees' Retirement System (CalPERS). Similar to the payroll deferral, this action reverses a one-time budget savings that was used to help balance the budget over a decade ago.

BUILDING RESERVES

The Budget continues to build additional reserves beyond the \$13.5 billion currently set aside in the Budget Stabilization Account (commonly called the Rainy Day Fund). The Budget assumes an additional \$1.8 billion transfer in the budget year and an additional \$4.1 billion over the remainder of the forecast period, bringing the Rainy Day Fund to \$19.4 billion by 2022-23, as shown in the figure below.

A recent opinion by the Legislative Counsel concluded that supplemental payments made in prior years do not count toward calculating the 10 percent of General Fund tax revenues target set in the Constitution. Consistent with this opinion, the Budget continues to make required deposits in the Rainy Day Fund.

The Budget also adds \$700 million to the Safety Net Reserve created in the 2018 Budget Act, bringing the total in this reserve to \$900 million. This reserve sets aside funds specifically to protect safety net services during the next recession.



Finally, the Budget reserves \$2.3 billion in the Special Fund for Economic Uncertainties to address emergencies and unforeseen events.

PAYING DOWN UNFUNDED RETIREMENT LIABILITIES

Building and maintaining the fiscal health of the state's retirement systems is critical to ensuring the long-term security of the state's retirement benefits. Over the past several years, there have been significant strides in curbing the growing costs of the state's major retirement liabilities. These include enacting the California Public Employees' Pension Reform Act of 2013 (PEPRA) that capped benefits, increased the retirement age, and required employees to contribute more toward retirement; a statutory funding strategy to address the unfunded liability of the California State Teachers' Retirement System (CalSTRS); and a strategy to prefund retiree health benefits. Furthermore, both CalPERS and CalSTRS have adopted more realistic assumptions related to future investment earnings, more realistic life expectancy assumptions, and more responsible amortization schedules. Despite these actions, California continues to have considerable state retirement liabilities, as shown in the figure below.

The Budget makes an unprecedented \$3 billion supplemental contribution to pay down the state's share of unfunded liabilities within CalPERS. This investment is estimated to result in savings of \$7.2 billion over the next three decades.

Retirement Liabilities

(Dollars in Millions)

	Outstanding Amount at Start of 2019-20 ^{2/}
Retirement Liabilities	
State Retiree Health	\$91,008
State Employee Pensions	58,765
Teachers' Pensions ^{1/}	103,468
Judges' Pensions	3,277
Total	\$256,518

^{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.

The Budget makes it a top priority to pay down the state's retirement liabilities and proposes to dedicate all of the Proposition 2 debt payments—\$1.8 billion in 2019-20—toward paying down the state's retiree health and unfunded pension liabilities.

The Budget allocates \$1.1 billion of the aforementioned \$1.8 billion to CalSTRS in the budget year. The Budget will also dedicate an additional \$1.8 billion over the forecast period to pay down the state's share of the CalSTRS unfunded liability. Paying down this liability will result in estimated savings of \$7.4 billion over the next three decades.

EMERGENCY READINESS, RESPONSE AND RECOVERY

The state has faced unprecedented natural disasters over the past two years. By the end of 2018, wildfires in California killed over 100 people, destroyed more than 22,700 structures, and burned over 1.8 million acres. Emergencies of this magnitude are becoming a more regular occurrence and the impacts of these disasters are devastating to people and communities. The Budget proposes to bolster the preparedness of individuals and communities, makes additional investments in prevention and critical emergency response systems, builds up the state's firefighting capabilities, and provides critical relief to communities struggling to recover.

The Budget proposes to continue to support local areas devastated by the 2018 wildfires by backfilling wildfire-related property tax losses and waiving the local share of cost for debris removal. Funding for impacted schools is also backfilled.

The state must do more to help local governments and individuals be more prepared for the next emergency. The Budget proposes \$50 million General Fund one-time for local grants and to immediately begin a comprehensive, statewide education campaign on disaster preparedness and safety. The Budget also includes

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\$60 million General Fund one-time to jump-start upgrades to the 911 system, including an overhaul to the existing fee that will sustainably fund a modern, reliable system. The Budget includes \$16.3 million General Fund to finish the build-out of the California Earthquake Early Warning System.

To adjust to changing fire conditions, the Budget includes \$200 million General Fund to augment CAL FIRE's firefighting capabilities, adding 13 additional year-round engines, replacing Vietnam War-era helicopters, deploying new large air tankers, and investing in technology and data analytics that will support CAL FIRE's incident command in developing more effective initial fire suppression strategies. The Budget also continues \$25 million General Fund ongoing for pre-positioning local government fire engines to support the state's critical mutual aid system.

The Budget also provides a sizable investment in forest management—\$214 million—to increase fire prevention and complete additional fuel reduction projects, including increased prescribed fire crews.

PROVIDING SUPPORT FROM CRADLE TO CAREER

EARLY CHILDHOOD

The first five years of a child's life are the foundation for the child's future. The Budget contains a series of proposals to not only address early childhood education, but also focus on supporting parents to reduce child poverty and on improving early childhood health and wellness.

Public health and economic research shows that providing up to six months of paid parental leave—the norm in most developed countries—leads to positive health and educational outcomes for children, greater economic security for parents, and less strain on finding and affording infant child care. To promote affordability and family bonding, the Administration is committed to expanding the Paid Family Leave program with the goal of ensuring that all newborns and newly adopted babies can be cared for by a parent or a close family member for the first six months. The Budget proposes to adjust the reserve requirement for the fund that supports the Paid Family Leave program. This change will enable the state to make a down payment in expanding Paid Family Leave in the upcoming budget year while maintaining an adequate reserve. During the year, the Administration will convene a taskforce to consider different options to increase participation in the program and to phase-in this program expansion. The Administration will also consider other changes—including better

alignment of existing worker protections and establishing non-retaliation protections for all workers—to increase the ability of all workers to access these important benefits.

The Budget includes funding for universal preschool for all income-eligible four-year-old children in the state, phased in over a three-year period. This funding will allow state preschool providers to offer full-day/full-year care to better accommodate working parents. The Budget proposes the development of a plan to achieve universal preschool for all children in California, including new revenue options to support increased enrollment. This plan will also include a framework to implement a comprehensive, high-quality child care system in the state—including simplifying the system, increasing access, and reflecting the principle of shared responsibility among government, businesses, and parents. The Budget includes \$500 million one-time General Fund to build child care infrastructure, including investing in the education of the child care workforce.

The Budget proposes to reduce health disparities in early childhood. The Budget includes additional funding to improve the detection of adverse childhood experiences and increase developmental screenings provided to children in Medi-Cal. The Budget also includes funding to expand existing home visiting programs with innovative new approaches to reach low-income young mothers, and an augmentation to the Black Infant Health program.

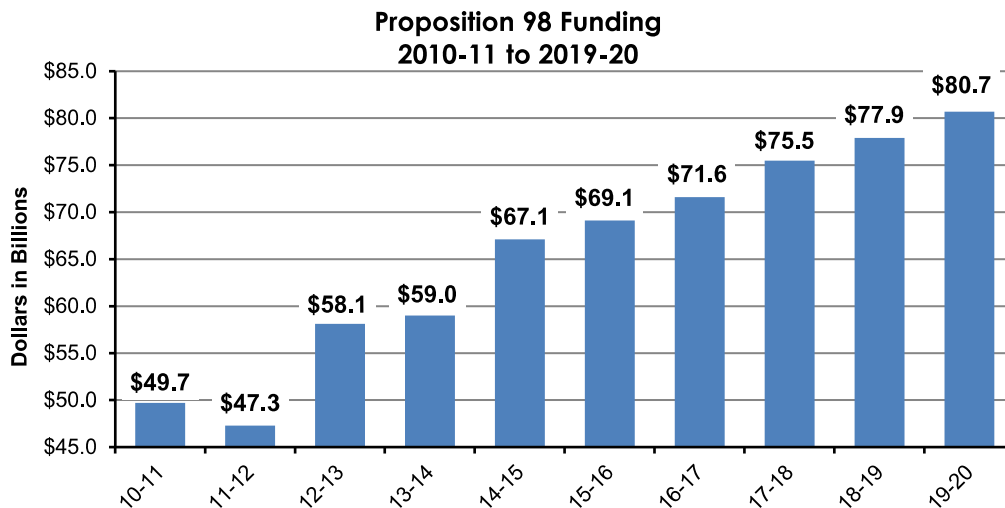
The Budget includes several proposals to directly address child poverty and support families in breaking the cycle of poverty through work and education. The Budget includes funding to raise grants for the lowest income families served by the CalWORKs program to 50 percent of the Federal Poverty level. The Budget also proposes a supplemental Cal Grant award of up to \$6,000 for student-parents with dependent children attending California's public colleges and an increased number of competitive Cal Grant awards to improve access to higher education. The Budget includes additional funding to aid local child support agencies in collecting and remitting millions in additional child support payments to families.

K-12 EDUCATION

Education funding, including K-12 and higher education, is the largest share of the state's budget and the single greatest determinant of a strong workforce. The Budget proposes an historic level of funding for K-12 schools. Per-pupil funding has grown nearly \$5,000 more than 2011-12 levels from \$7,008 to \$12,003. The Budget proposes investing in all students with the greatest increases for the neediest students, including students with disabilities.

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As shown in the figure below, the minimum guarantee of funding for K-12 schools and community colleges in 2019-20 is \$80.7 billion, a new all-time high. This is compared to the recessionary low of \$47.3 billion in 2011-12.



The Local Control Funding Formula will grow to \$63 billion with a 3.46-percent cost-of-living adjustment (COLA) proposed in the Budget for 2019-20. School districts are experiencing relatively good fiscal health overall, but many school districts face significant long-term fiscal challenges. Statewide K-12 enrollment is declining and in some urban districts the declines are more significant because of decades of suburban flight and increased charter school enrollment. At the same time, districts have been facing increased costs related to health care and policy changes to address unfunded liabilities in CalSTRS and CalPERS.

To address the rising costs of CalSTRS pensions and provide immediate relief to districts, the Budget proposes a \$3 billion one-time non-Proposition 98 General Fund payment to CalSTRS on behalf of schools (the employers). Overall, this payment is expected to provide immediate relief to school districts and will reduce the out-year contribution rate by half a percentage point.

New statewide data shows that students with disabilities have the greatest need for improvement. The Budget reflects \$576 million in Proposition 98 General Fund (\$186 million is one-time) to support expanded special education services in school districts with a high concentration of special education students.

The Budget also includes \$750 million one-time General Fund to address barriers to full-day kindergarten. About one quarter of students enrolled in kindergarten do not have access to a full-day kindergarten program. This investment will put California on a path for all kindergartners to attend full-day kindergarten.

HIGHER EDUCATION

If colleges are to remain engines of economic mobility, they must evolve along with the state's changing population and economy. Colleges and training programs must prepare students with the skills needed by employers not only today but into the future. The Budget includes \$1.4 billion (\$942 million ongoing) for higher education to support increased enrollment, improved time to degree and a tuition freeze. Segments serving a higher number of students receive a greater amount of the increased resources. The Budget proposes funding for two free years of community college tuition.

- University of California—\$240 million ongoing General Fund for operational costs; student success, student hunger and housing initiatives; ongoing support for graduate medical education; and mental health resources. The Budget also includes \$138 million one-time General Fund for deferred maintenance.
- California State University—\$300 million ongoing General Fund for operational costs, increased enrollment, and for continued progress toward the equity goals of the Graduation Initiative 2025. The Budget also includes \$247 million in one-time General Fund for the expansion of on-campus child care facilities serving students and deferred maintenance, and \$15 million in one-time General Fund for student hunger and housing initiatives.
- Community Colleges—\$402 million ongoing Proposition 98 General Fund, including a 3.46-percent COLA, enrollment growth, legal services for undocumented students and families, and providing a second year of free tuition.

ADDRESSING AFFORDABILITY

The Budget creates a new "Working Families Tax Credit" by more than doubling the size of the state's Earned Income Tax Credit to \$1 billion. This tax break will support low-income families with young children by providing a \$500 credit for families with children under the age of six. The Administration will explore options to provide the credit on a monthly basis. Also, the credit will be expanded to reach full-time workers earning \$15 per hour—reaching 400,000 additional families. This expanded "Working

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Families Tax Credit" will be funded as part of a revenue neutral tax conformity package that will bring components of the state's tax policies in line with the new federal law and remove administrative burdens for small businesses.

California is facing a housing crisis. The median home price in 2017 was \$537,860, and was much higher in coastal areas. Meanwhile, median income is around \$72,000, and just surpassed the pre-recession level in 2017. These dynamics have resulted in many renters spending a relatively large share of their income on housing costs, and far too many cannot become homeowners. The Budget includes \$1.3 billion General Fund one-time and a new approach to spur housing development to address the state's affordability crisis and promote economic growth. The Budget also expands state tax credits to further develop both low- and moderate-income housing. Lastly, it proposes new innovative housing on excess state property.

California is a national leader in health care, but more needs to be done to advance health care affordability and universal access to health care for all Californians. Actions by the federal government threaten the Affordable Care Act and overall affordability of health care. The Budget proposes major steps to rein in the high cost of prescription drugs, provides expanded subsidies to individuals purchasing coverage through Covered California, and invests in more preventative services that will reduce overall health care costs. The Budget also makes progress in providing universal coverage by expanding Medi-Cal to serve approximately 138,000 young adults ages 19 through 25 regardless of immigration status. The cost of this expanded coverage will be offset, in part, by county indigent health savings.

JUSTICE AND DIGNITY

Political strife in Central America combined with inadequate federal immigration policies have created a humanitarian crisis at the state's border with Mexico. The Budget allocates \$25 million General Fund (including \$5 million to be made available in the current year) for an immigration rapid response program to assist qualified community-based organizations and non-profit entities in providing services to address this crisis. The Budget also includes \$75 million General Fund ongoing for immigration-related services, including assisting applicants seeking Deferred Action for Childhood Arrivals; naturalization; and other immigration remedies.

In any given year, one in four families deal with a mental health condition. An estimated one in 20 adults are living with a serious brain illness. Each year, thousands of young Californians will experience their first psychotic break, enduring the terrifying

delusions and hallucinations that are a hallmark of schizophrenia, bipolar disorder and some forms of depression. The Budget focuses on finding ways to improve brain health and improve care by investing in mental health workforce training, early psychosis research and treatment, and a Whole Person Care pilot program to coordinate health, behavioral health and social services, including supportive housing for people with severe mental illness.

A critical component of a well-functioning correctional system is providing offenders greater opportunity for rehabilitation. This starts with the youngest offenders. The Administration proposes to transform its youth correctional facilities to focus on rehabilitation and education. As part of this approach, the Budget proposes to move the Division of Juvenile Justice from the California Department of Corrections and Rehabilitation to a new department under the Health and Human Services Agency. This change will enable the state to better provide youth offenders with the services they need to be successful when released. The Budget also includes a major initiative to improve inmate literacy. To support more effective public safety, the Budget proposes an increase of \$35 million General Fund funding for local law enforcement training on use of force, de-escalation, and engaging with individuals experiencing a mental health crisis.

Homelessness pervades both urban and rural communities across the state and puts stress on local resources, from emergency rooms and mental health and social services programs to jails. The Budget includes \$500 million one-time General Fund for local governments to build emergency shelters and navigation centers, and \$25 million General Fund ongoing to assist homeless disabled individuals in applying for disability benefits.

Access to safe and affordable drinking water is a fundamental right. The Budget includes short-term measures to bring immediate relief to communities without safe drinking water and also proposes an ongoing sustainable funding source to address this problem into the future.

MAINTAINING BALANCE IS AN ONGOING CHALLENGE

Maintaining the fiscal health of the state is an ongoing challenge given its volatile revenue base and limited spending flexibility. The Budget demands constant attention to stay in balance. Vigilance is especially needed this year given the length of the current economic expansion and federal uncertainty. The Budget takes a careful approach by allocating \$13.6 billion toward building more budget resiliency through

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paying debts and saving. The Budget makes strategic investments, mainly one-time, to address affordability, expand opportunity, and strengthen the state's readiness and emergency response. It is possible that some of these decisions will need to be revisited this spring when more current information about the direction of the U.S. economy and state revenues is available. The Administration will closely monitor key economic and revenue indicators in the coming months and will make adjustments as needed to ensure the Budget plan continues to reflect the economic realities facing the state.