Introduction

As the state's economy has recovered from the Great Recession, the past four budgets have significantly expanded government spending. The state has also paid down its budgetary borrowing and addressed some long-standing problems—such as implementing plans to restore fiscal health to its retirement benefit plans and making major improvements to the state's water system.

State revenues, which had surged during several years of the recovery, are now beginning to lag expectations. Consequently, the budget—which remained precariously balanced even in the strongest revenue years—now faces a deficit of almost $2 billion if action is not taken.

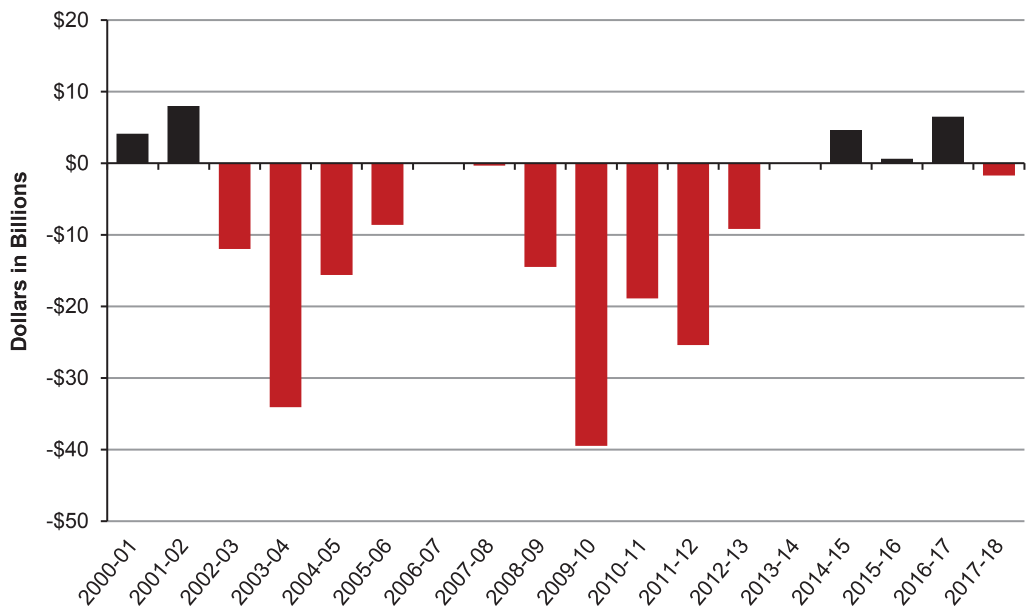
The Budget proposes a variety of solutions to bring the state's finances back into balance for 2017-18 and future years based on current projections. The Budget prioritizes the protection of the most significant accomplishments of the past four years—steady growth for education, the creation of the state's first earned income tax credit, a minimum wage that will responsibly increase to $15 per hour, and the expansion of health care coverage to millions of Californians. To protect these priorities, the Budget proposes to pull back on a variety of one-time spending commitments made in last year's budget and temper anticipated spending increases.

While rebalancing the budget is the immediate task at hand, the state must continue to plan for and save for the next recession. By the time the budget is enacted in June, the economy will have finished its eighth year of expansion, three years longer than the average recovery. The best way to protect against future cuts is to continue to build up the state's Rainy Day Fund. Under Proposition 2, the fund's balance will reach 63 percent of its constitutional target in the coming year.

Budget Would Fall Out of Balance without Corrective Action

The fiscal stability from a balanced budget and a recovering state economy has been a welcome reprieve from the prior decade's budget deficits. As shown in Figure INT-01, since 2000, the state's short periods of balanced budgets have been followed by massive budget shortfalls.

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.

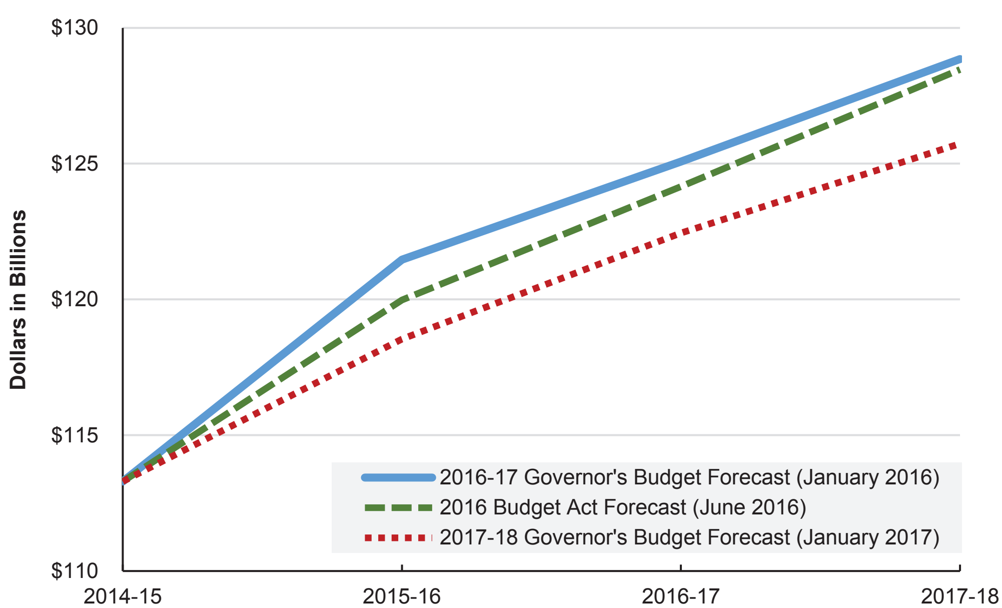
The past four years have been the longest stretch of balanced budgets in recent memory. With a volatile revenue structure and limited spending flexibility, the California budget demands constant attention to stay in balance. Without corrective action, this year's budget would face a deficit of $1.6 billion, or 1.3 percent of annual spending. Without action, the state would face annual deficits into the future of about $1 to $2 billion.

Compared to the 2016 Budget Act signed last June, the two main factors causing this deficit are a revenue forecast that is $5.8 billion lower than expected and a current-year shortfall in the Medi-Cal program. The deficit would be billions worse if not for the passage of a number of ballot measures at the November election, including Proposition 52 (hospital fee), Proposition 56 (tobacco tax), and Proposition 57 (prison reform). Proposition 55's extension of temporary income tax rates on the wealthiest Californians will begin to help balance the budget in 2018-19.

Revenues Below Forecast

As the economy and revenues were surging in recent years, budgets consistently upgraded revenue forecasts from the prior year. Yet, now, as shown in Figure INT-02, the January Budget is the second straight downgrade of revenue expectations over the past 12 months. The Budget reflects a revised revenue forecast that is $5.8 billion lower for 2015-16 through 2017-18. This represents a modest adjustment to expectations compared to the 2016 Budget Act—1.6 percent lower over the three years of revenues. Across the board, each of the state's "big three" revenues—the income, sales, and corporation taxes—are showing weakness. The two main reasons for the drop in revenue expectations are:

Figure INT-02
Tide of Revenues Has Begun to Turn



- Cash Trends—Since the enactment of the budget, five of the past seven months have fallen short of monthly revenue estimates—June revenues alone were $788 million below forecast. Although November revenues exceeded expectations, this was due to a timing issue of receiving funds earlier than expected as a consequence of an early Thanksgiving.

- Lower Wage Growth—Much of the employment growth since the budget signing has come from workers newly entering or reentering the labor force. Combined with the recent increases in the minimum wage, this means a greater share of wages is now going to lower-income workers. For example, over the last four years, the percentage of wage and salary growth from high-wage sectors dropped from 50 percent to 36 percent of total growth. From an income distribution standpoint, this is a positive development. From a revenue standpoint, however, this is negative due to California's progressive tax structure.

Even with the reduced revenue forecast, revenues are expected to grow by almost 3 percent in the coming year and overall average more than 5 percent in annual growth since the 2012 Budget Act.

With California's volatile tax base, it is possible that revenues will recover in the coming months, particularly if final income tax receipts in April surge. If so, the May Revision will reflect that and the proposed cuts can be avoided. However, if the downward trends continue, additional cuts will be necessary.

Actions to Bring the Budget Back Into Balance

To close the budget deficit and rebuild the state's operating reserve, the Budget proposes $3.2 billion in budget solutions. These proposed actions put an emphasis on minimizing any negative effects on California residents. Rather than cut existing program levels, they temper spending growth based on the lower revenue projections.

- Adjust Proposition 98 ($1.7 billion)—Without action, appropriations made in 2015-16 and 2016-17 would overappropriate the Proposition 98 minimum guarantee. The Budget proposes adjustments designed to fund K-14 education at the guarantee for 2015-16 through 2017-18. With these adjustments, overall K-14 funding still grows by $2.1 billion for 2017-18.

- Recapture 2016 Allocations ($0.9 billion)—The 2016-17 Budget contained a large package of one-time spending. Much of that spending remains uncommitted at this point in time, and the Budget proposes to eliminate the authority to spend the dollars. The two largest components of this proposal are eliminating the $400 million set-aside for affordable housing that was never allocated and a $300 million transfer to modernize state office buildings planned for 2017-18.

- Constrain Spending Growth ($0.6 billion)—The Budget limits spending proposals to keep spending flat in 2017-18 compared to 2016-17, at about $123 billion. This involves pausing rate increases for child care, not providing Middle Class Scholarships to any new students, and not submitting a variety of spending proposals (including those to implement new legislation) from state departments that otherwise were justified.

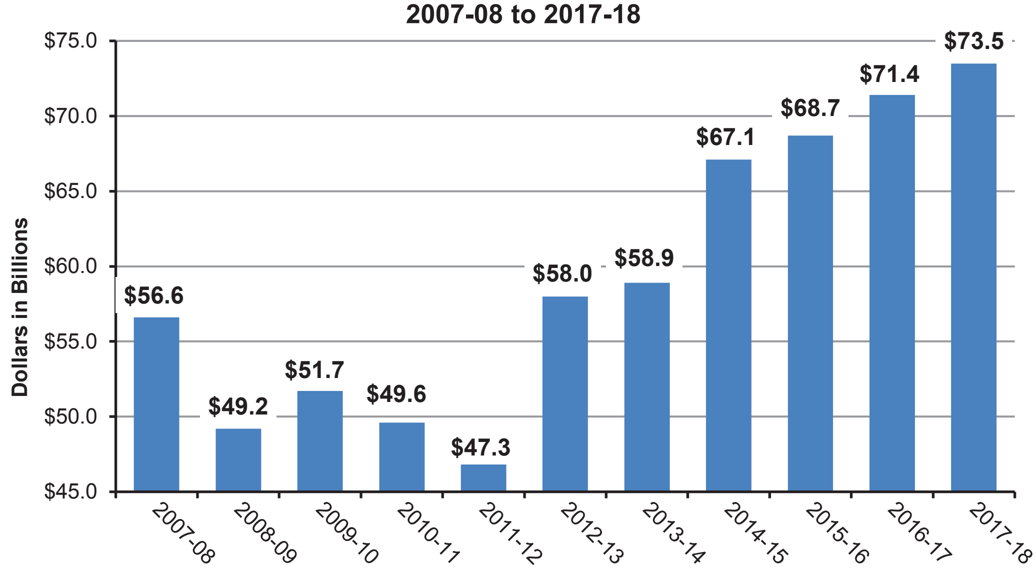
Preserving Core Achievements

The actions described above to bring the budget back into balance were chosen to maintain the state's core fiscal achievements from the past four years.

K-12 Education

As shown in Figure INT-03, 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. Despite the adjustments described above,

Figure INT-03
Proposition 98 Funding
2007-08 to 2017-18



funding is expected to grow to $73.5 billion in 2017-18—an increase of $26.2 billion in six years (55 percent). Under Proposition 55, funds for education are expected to continue to grow steadily in future years.

For K-12 schools, funding levels will increase by about $3,900 per student in 2017-18 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 Budget maintains the formula's implementation at 96 percent complete.

Higher Education

The Administration's higher education efforts—keeping student costs low, promoting new technology and innovation, and improving graduation rates—will support students' success in achieving their educational goals. The Budget reflects flat tuition and continues to provide each university system and the community colleges with annual General Fund growth. Since 2012-13, the University of California has received $818 million in new funding, the California State University has received $1.1 billion, and the community colleges $1.8 billion.

Counteracting the Effects of Poverty

California has an extensive safety net for the state's neediest residents who live in poverty. Since 2012, the General Fund has incurred new poverty-focused obligations totaling about $18 billion annually. The Budget continues to fund:

- The rising state minimum wage, which is scheduled to increase to $11 per hour in 2018 and to $15 per hour over time.
- The expansion of health care coverage under the federal Affordable Care Act, which provides millions of Californians with insurance.
- The first cost-of-living adjustment for Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients since 2005.
- The repeal of the maximum family grant rule in CalWORKs, which denied aid to children who were born while their parents were receiving aid.
- Increases in child care and early education provider rates and children served totaling $837 million.

Combatting Climate Change

California has acted decisively 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. In addition to the direct emission reductions required under the program, the state has appropriated $3.4 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 opportunities, and home energy upgrades. The state has prioritized the expenditure of these funds in disadvantaged communities.

Over the past year, however, auctions have experienced significant volatility, at least partially due to uncertainties about the program's future beyond 2020. To eliminate this uncertainty, the Administration proposes, through a two-thirds urgency vote, legislation to confirm authority for the program beyond 2020. Assuming the passage of this legislation, the Budget proposes $2.2 billion in expenditures from Cap and Trade auction proceeds.

Strengthening Infrastructure

The construction and maintenance of key physical infrastructure is one of the core functions of state government. Infrastructure allows for the delivery of public services and the movement of goods across the state. The deferred maintenance on existing state infrastructure is staggering—estimated to total $78 billion. The 2015 and 2016 Budgets contained a combined $960 million ($942 million General Fund) for levees and various state facilities to address the most critical deferred maintenance projects. The 2016 Budget also included $1 billion to support a major investment in renovating Sacramento's aged and inadequate state office infrastructure.

The state's largest deferred maintenance is on its highways, roads and bridges. Annual maintenance and repairs are billions of dollars more than can be funded annually within existing revenues. A recent study found that Californians spend on average $762 annually on vehicle repair costs due to poorly maintained roads. The Budget reflects the Governor's transportation package first proposed in September of 2015 that would provide $4.2 billion annually to improve the maintenance of highways and local roads, expand public transit, and improve critical trade routes. The package would measure and improve Caltrans' performance.

Paying Down Debts and Liabilities

As shown in Figure INT-04, the state has $240 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$236 billion—are related to retirement costs of state and University of California employees. Over the past several years, the Governor and Legislature have taken significant steps to address the long-term costs of its retirement programs. In 2012, the California Public Employees' Pension Reform Act was enacted to save billions of taxpayer dollars by capping 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 over three decades. In 2016, the state and its employees began to share equally in the prefunding of retiree health benefits to eliminate a $74 billion unfunded liability over three decades.

Figure INT-04

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2017-18	Proposed Use of 2017-18 Pay Down
Budgetary Borrowing		
Loans from Special Funds	$1,365	$252
Underfunding of Proposition 98—Settle-Up	1,026	400
Repayment of pre-Proposition 42 Transportation Loans	706	235
State Retirement Liabilities		
State Retiree Health	74,103	100
State Employee Pensions	49,592	0
Teachers' Pensions[1/]	72,626	0
Judges' Pensions	3,279	0
Deferred payments to CalPERS	627	0
University of California Retirement Liabilities		
University of California Employee Pensions	15,141	169
University of California Retiree Health	21,087	0
Total	**$239,552**	**$1,156**

[1/]The state portion of the unfunded liability for teachers' pensions is $14 billion.

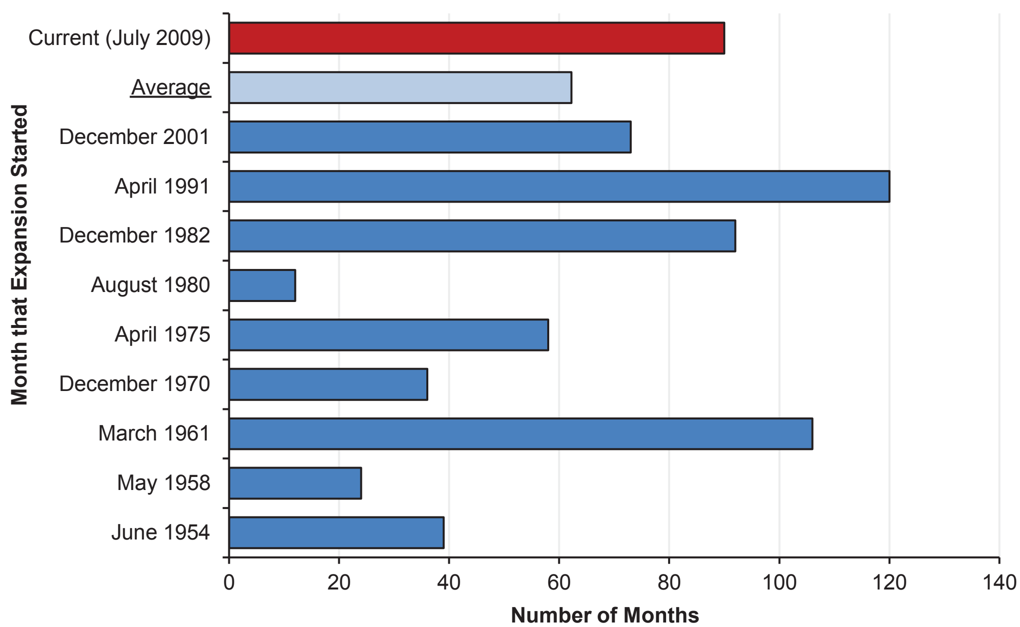
For 15 years, Proposition 2 provides a dedicated funding source to help address these debts, but that funding alone will not eliminate the liabilities. In December, the CalPERS

Board took action to reflect more realistic expectations for its investment returns —lowering its discount rate to 7 percent over the next three years. CalSTRS will consider the same issue in the coming months. The Budget includes $258 million from the General Fund to begin the additional payments required by these decisions. While the growing costs will be expensive, 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 a Balanced Budget in Uncertain Times

California faces uncertain times, with major potential risks threatening to drive the budget dramatically further out of balance. 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 been about five years. As shown in Figure INT-05, the current expansion is approaching three years longer than the average. A moderate recession will drop state revenues by about $20 billion annually for several years.

Figure INT-05
Current Recovery Is Approaching Three Years Longer than Average



The Budget also assumes the continuation of existing federal fiscal policy. The incoming presidential administration and leaders in Congress have suggested major changes to Medicaid, trade and immigration policy, and the federal tax structure. Many of the proposed changes could have serious and detrimental effects on the state's economy and budget. At this point, it is not clear what those changes will be or when they will take effect.

Proposition 2 establishes a constitutional goal of having 10 percent of tax revenues in the Rainy Day Fund. By the end of 2017-18, the state's Rainy Day Fund will have a total balance of $7.9 billion (63 percent of the constitutional target). While a full Rainy Day Fund might not eliminate the need for further spending reductions in case of a recession or major federal policy changes that trigger a budget crisis, saving now would allow the state to spend from its Rainy Day Fund later to soften the magnitude and length of any necessary cuts.