I want to begin with a true story from which we can draw a worthwhile lesson.

As you might guess, the Schwarzenegger household is something of a menagerie. An Austrian bodybuilder, a TV journalist, four children, a dog, the normal goldfish and hamsters and so forth -- and in recent years we added a miniature pony and a pot-bellied pig. It's not unusual for me to look up from working on the budget or something to find a pig and a pony standing there staring at me. Now, the dog's food, which we keep in a canister with a screw-on lid, sits on the top of the dog's kennel. The pony has learned to knock the canister off the top of the kennel, and then he and the pig wedge it into the corner. There's this ridge on the lid of the canister, and the pig with his snout pushes this ridge around and around until it loosens, and then they roll the canister around on the floor until the food spills out. I don't know how they ever figured all of that out. It's like humans figuring out how to create fire. But it is the greatest example of teamwork. I love it.

So one lesson to draw from the pig and the pony story is what we can accomplish when we work together. And last year we here in this room did some great things working together. We had a pig and pony year. Now before some reporter writes that I compared the legislature to a pig or a pony, which is not the message at all. Together, as a team -- as fractious, tentative and uncertain as it might have been -- together, we got California through the front end of the worst financial crisis since the Great Depression. Although not without pain, we closed a budget gap of 60 billion dollars! These decisions were very hard for both sides of the aisle.
On the Republican side, we had leaders who sacrificed their careers or put them at risk. On the Democratic side, we had legislators who were threatened by their own interest groups. To those on both sides of the aisle who took these risks for the good of the state, you have my deepest admiration. We did what we had to do. We made painful spending cuts. We passed temporary tax increases. We permanently eliminated COLAs for most state programs. We made major reforms in welfare and parole.

And there are two accomplishments in particular I want to recognize.

Just last night the Assembly passed major educational reform, reform that once seemed impossible, but now will become law as soon as it hits my desk. For too many years, too many children were trapped in low-performing schools. The exit doors may as well have been chained. Now, for the first time, parents -- without the principal's permission -- have the right to free their children from these destructive schools. That is a great freedom. Also in the past, parents had no power to bring about change in their children's schools.

But that will now change. Parents will now have the means to get rid of incompetent principals and take other necessary steps to improve their children's education. To increase accountability, we broke down the firewall so that teacher performance can be linked to student performance.

Another major accomplishment: for decades this state was in a literal war over water, with old and deep divisions, Northern California versus Southern California, Democrat versus Republican, farmer versus environmentalist, business versus labor. We here in this room made history with the most comprehensive water package in nearly half a century. Working together, we got it done. And now we must work to pass the 11 billion dollars in water bonds that will be on the ballot in November. Some people say... how can we afford these bonds in the current economic climate? I say, how can we not? It is the law that you cannot build a school; you cannot build a factory; you cannot build an office building or a housing development without identifying a source of water. As a result, huge projects with thousands of jobs have been put on hold. Our economy cannot grow without water. Our population cannot live without water. It is our state's lifeblood. Now is exactly the time to invest in it, so that when Californians turn on the faucet, there is safe, reliable and clean water coming out the tap -- not just five years from now but 30, 40 or 50 years.

Now, the coming year.

If I had to summarize in one word our focus for the coming year, it would be the word "priorities." We have to get them straight and we have to keep them straight. The first priority for the coming year is the economy and jobs. The people and businesses of California are an engine of self-betterment and progress. As long as government keeps the engine oiled with prudent policies -- and more importantly -- does not pour sand in its gears, this state will persevere and prosper.

I will come to the main thing we can do to help the economy in a moment, but there are four proposals to spur job growth that I will introduce. First, you will receive a $500 million jobs package that we estimate could train up to 140,000 workers and help create 100,000 jobs.
Second, you will receive a measure to streamline the permitting of construction projects that already have a completed environmental report. Third, to stimulate other construction jobs, you will receive a proposal for homebuyer tax credits of up to $10,000 for the purchase of new or existing homes. And fourth, since we want California to be the dynamo of green technology, I ask you to pass our proposal exempting the purchase of green tech manufacturing equipment from the sales tax. That, too, means jobs -- jobs for the new economy.

While we still have a long way to go, the worst is over for California's economy. And the really good thing is that we have the right economic mix going forward -- high tech, green tech, bio-tech, Hollywood-tech, farmer-tech and so forth. Our economy is well-positioned to take advantage of the future.

So let me tell you the main thing that we here in this chamber can do to help the economy and jobs. We can be a better partner to the economy. To strengthen the economy, which is the foundation of all jobs, we here in this chamber must reform California's budget and tax system. That would be a huge stimulus. The basic problem is that our tax system does not reflect our economy. In 2009, California's economic growth declined 2.8% ... but our tax revenues were down more than 8 times that much. Our economy is diverse, whereas our tax system is not. 144,000 taxpayers pay almost 50 percent of all personal income taxes. Think about it. 38 million Californians have to rely on 144,000 people for their schools, their fire protection, their health care, their public safety and many other services. That makes no sense. Here is what we need to accept: our economy is 21st Century, but our tax system is 20th Century. It's stuck in the wrong century.

The Tax Reform Commission did its work and came up with a plan for reform that was praised by both Willie Brown and the Wall Street Journal. How often does that happen? The Commission proposed major, radical reforms. Some people say they are too bold and thus they would be too hard to enact. What do they mean too bold? Bold is what we do in California. What do they mean too hard? If I had hesitated to attempt something because it was too hard, I'd still be yodeling in Austria. We must begin work on these tax reforms because we simply cannot wait for the rich to bounce back. State revenues are not expected to return to where they were until 2013 to 2014. I sent you the Tax Reform Commission's plan in late September, but it seems to have disappeared somewhere under this dome. Where is it? Maybe the pig and the pony have taken it.

But I am looking forward to working with the legislature to get this done. Budget reform is just as important. The budget crisis is our Katrina. We knew it was coming. We've known it for years. And yet Sacramento would not reinforce the economic levees. In addition to taking action on the Commission's plan, I ask you to also take action on the Best Practices Budget Accountability Act, which has been drafted by the reform group, California Forward. I especially support its proposals for performance-based budgeting and applying one-time spikes in revenues to one-time uses, such as debt reduction, infrastructure and the rainy day fund. The leaders of this body have said that the legislature should be given a chance to enact reforms before reforms go directly to the people. Here is that chance. I urge you to take it.
And as we struggle to overcome our differences, what I ask you to remember is that the current tax and budget system is cruel. It is cruel because it is forcing us to make a Sophie's choice among our obligations. Which child do we cut? The poor one? The sick one? The uneducated one? The one with special needs? That is cruel.

We overcame the divisions on water. We can do it on the tax system and budget systems. I will address our immediate budget situation more fully in a few days, but let me give you an overview. We face a $19.9 billion deficit -- $6.6 billion for the rest of this budget year and $13.3 billion for the upcoming budget year. Big picture, let me tell you what will be required. First, as bitter as the words are in my mouth, we face additional cuts. We know what that means. We know the pain it entails. What can we say at this point except the truth? That we have no choice.

But I am drawing this line. Because our future economic well-being is so dependent upon education, I will protect education funding in this budget. And we can no longer afford to cut higher education either. The priorities have become out of whack over the years. Thirty years ago 10 percent of the general fund went to higher education and 3 percent went to prisons. Today almost 11 percent goes to prisons and only 7 1/2 percent goes to higher education. Spending 45 percent more on prisons than universities is no way to proceed into the future. What does it say about a state that focuses more on prison uniforms than caps and gowns? It simply is not healthy.

I will submit to you a constitutional amendment so that never again do we spend a greater percentage of our money on prisons than on higher education. The way we get this done is to find more cost-effective ways to run our prison system and allows private prisons to compete with public prisons. Competition and choice are always good. California spends $50,000 per prisoner. By comparison, the ten largest states spend $32,000. They spend less, and yet you do not see federal judges taking over their prison health care. Why do we have to spend so much more than they do? If California's prisons were privately run, it would save us billions of dollars a year. That's billions of dollars that could go back to higher education where it belongs and where it better serves our future. Choosing universities over prisons: this is a historic and transforming realignment of California's priorities. If you have two states and one spends more on educating and one spends more on incarcerating, in which state's economy would you invest? I ask you to make the right choice for California.

Another major item is this: federal funds have to be part of our budget solution because the federal government is part of our budget problem. When President Clinton was in office, California got back 94 cents on the dollar from the federal government. Today we get only 78 cents back. Texas gets 94 cents. Pennsylvania gets $1.07. Alaska, with all its oil, gets back $1.84 for every dollar. New Mexico gets $2.03. This should be more fair and equitable. We are not looking for a federal bailout, just federal fairness. Californians carry a special burden since we are a border state. The federal government alone controls immigration policy. It alone controls border security.

While acknowledging its responsibility, the federal government is not even funding a 50-50 split of the costs of undocumented immigrants. We can no longer ignore what is owed to us, or what
we are forced to spend on federal mandates. We are currently owed billions of dollars by the federal government for various programs. We need to work with the feds so that we can fix the flawed formula that demands that states spend money they do not have. Now Congress is about to pile billions more onto California with the new health care bill. While I enthusiastically support health care reform, it is not reform to push more costs onto states that are already struggling while other states get sweetheart deals. Health care reform, which started as noble and needed legislation, has become a trough of bribes, deals and loopholes. You've heard of the bridge to nowhere. This is health care to nowhere. California's congressional delegation should either vote against this bill that is a disaster for California or get in there and fight for the same sweetheart deal Senator Nelson of Nebraska got for the Cornhusker State. He got the corn; we got the husk.

Now, another priority relating to the budget is **pension reform**. The cost for state employee pensions is up 2,000 percent in the last ten years, while revenues have only increased by 24 percent. The pension fund will not have enough money to cover this amount, so the state -- that means the taxpayer -- has to come up with the money. This is money that is taken away from important government services. This is money that cannot go to our universities, our parks and other government functions. Now, for current employees these pensions cannot be changed -- either legally or morally. We cannot break the promises we already made. It is a done deal. But we are about to get run over by a locomotive. We can see the light coming at us. I ask the legislature to join me in finding the equivalent of a water deal on pensions, so that we can meet current promises and yet reduce the burden going forward.

These are serious issues we face.

Every year, in spite of whatever challenges are before us, I stand up here and tell you how much I believe in California's future. I tell you how much I believe in the dream. Some people think, "Ya, ya, ya, that's just Arnold being optimistic." But I am not alone in believing these things. Time magazine recently did an article about California that sounded like one of my speeches. I would like to read you a few sentences. Time wrote:

"(California) is still a dream state. In fact, the pioneering megastate...is still the cutting edge of the American future -- economically, environmentally, demographically, culturally, and maybe politically. It is the greenest and the most diverse state, the most globalized...when the world is heading in all those directions. It's also an unparalleled engine of innovation, the mecca of high tech, biotech and now clean tech. In 2008, California's wipeout economy attracted more venture capital than the rest of the nation combined."

So... now do you believe me?

California has the means and the mindpower to solve its problems. Sometimes we are just too close to the problems to see the positives, and we need to step back. A couple months ago I was in Iraq visiting our men and women in uniform, and of course many of them were from California. They have seen and experienced some hard things. Many have served tour after tour after tour. As a result, some have lost homes, spouses, limbs and lives. Too often our soldiers bring back the enemy with them in their heads. We are seeing a lot of post traumatic stress syndrome. The suicide rate is disturbing. California has more returning veterans than any other
state, so our state, as well as the federal government, has a special responsibility. You will see that in our agenda.

We have a fundamental obligation to anyone who has shed or risked blood for this country. That is a priority. Their sacrifice is extraordinary and never fails to inspire me. And if you look to the gallery, you will see some Californians wearing the uniform of our country who have just returned from Iraq and Afghanistan. To each of you, I say, "Welcome home."

No matter how big the problems are that this state faces, no matter how harsh things may seem to us in the months ahead those Californians in uniform will tell you that this is still the greatest place to come home to, the greatest place to pursue a better life.

Just ask them how often they dreamed of being back home here in the Golden State.

Ladies and gentlemen, in closing, we in this chamber must fulfill our sacred trust to keep California a great place to come home to, for our men and women in uniform and for generations of Californians yet to come.

Thank you very much.