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Overview of the 1994-95 May Revision

SUMMARY

On May 20, the Administration issued its May Revision of the 1994-95 Governor's Budget. This Budget Brief reviews the changes reflected in the May Revision and presents the following findings:

- The May Revision provides a technical update to the Governor's January budget, but it does not include any major new proposals. The Administration intends to reassess the likelihood of receiving federal funds assumed in the budget and will submit additional proposals to the Legislature in mid-June.
- The 1994-95 General Fund budget gap, which we estimated at $4.9 billion in January has declined by $0.3 billion—to $4.6 billion—while the value of budget "solutions" proposed in January has declined by about $100 million. As a result, the 1994-95 budget reserve increases to $472 million, compared to $260 million in January.
- The budget continues to rely on risky assumptions, the most significant of which is receipt of $3.1 billion of additional federal funds.
- The outlook for 1995-96 is not bright. The baseline operating shortfall increases to $4.4 billion, so that ongoing and growing budget solutions are needed rather than short-term savings.
- The Administration's timetable for a mid-June budget plan leaves the Legislature little time to consider major budget changes and still have a budget in place by the beginning of 1994-95.

May Revision: No Major Changes to January Budget

This year's May Revision essentially represents a technical update to the January budget. It does not include any major new proposals. Furthermore, the Administration's estimates of caseloads and its revenue outlook have changed only slightly since January, so that the May Revision changes are relatively small.

Figure 1 shows the May Revision changes to the Governor's January budget proposal for 1994-95. It differs from the Administration's presentation in two respects. First, it is presented according to the state's traditional budgetary accounting practices. Second, the 1994-95 expenditure amount includes $62 million to continue state support for local drug and alcohol programs that are no longer included in the Administration's state/county restructuring plan. Available resources increase by $451 million compared with the January budget, while spending increases by $238 million in 1994-95. As a result, the year-end reserve increases by $213 million—to $472 million compared with the reserve of $260 million in the January budget. This improvement in the General Fund condition is only marginal, and the larger reserve still represents only 1.2 percent of proposed spending in 1994-95. Much more important to the state's fiscal condition, however, is the continued reliance on $3.1 billion of new federal funds and other assumptions that were contained in the January budget to fund a significant portion of 1994-95 spending. The Administration has indicated that it intends to reassess the likelihood of receiving these federal funds and that, based on that reassessment, it will present a plan for a balanced budget to the Legislature in mid-June.

Figure 1

Governor's Budget
1994-95 General Fund Condition
May Revision Changes[a]

(In Millions)

	1994-95		
	January	**May**	**Change**
Prior-year balance	-$1,893	-$1,583	$310
Revenues and transfers	41,334	41,475	141
Total resources available	$39,440	$39,892	$451
Expenditures	$38,788	$39,026[b]	$238
Fund balance	$652	$865	$213
Reserve	**$260**	**$472**	**$213**
Other obligations	393	393	—

[a] Includes Governor's proposed budget solutions. Details may not add to totals due to rounding.
[b] Includes $62 million for drug and alcohol programs.

Budget Gap Declines to $4.6 Billion

Based on changes in the state's spending and revenue trends identified in the May Revision, we estimate that the 1994-95 budget gap has declined from $4.9 billion to $4.6 billion. Figure 2 shows that the gap reduction primarily results from a slight improvement in the budget's revenue estimate, a modest slowing of caseload growth and other savings in the Medi-Cal program, and a revised estimate of short-term borrowing costs. Partly offsetting these improvements is an increase in Proposition 98 education spending needed to backfill a decline in local property tax revenues.

1994-95 Baseline Operating Shortfall Unchanged. The budget gap that the state faces in 1994-95 consists of the carryover deficit from 1993-94 and the operating shortfall between baseline spending and revenues in 1994-95. As shown in Figure 2, the changes in the May Revision reduce only the carryover deficit from 1993-94. The $2.4 billion operating shortfall for 1994-95 remains unchanged from January, so that the reduction in the budget gap does not indicate any improvement in the

Figure 2

1994-95 Budget Gap[a]
May Revision Changes

(In Billions)

	January		May		Change	
Pay off deficit from 1993-94		$2.5		$2.2		-$0.3
1994-95 baseline spending	$43.0		$43.1		$0.1	
Less 1994-95 revenue[b]	-40.6		-40.7		-0.1	
1994-95 Operating shortfall		$2.4		$2.4		—
Budget Gap		**$4.9**		**$4.6**		**-$0.3**

a Detail may not add to totals due to rounding.
b Based on administrations's revenue forecast.

Major May Revision Changes in the Budget Gap[c]

(In Millions)

Increased revenue estimates	-$220
Proposition 98 property tax shortfalls partly offset by slower enrollment growth	164
Reduced caseload growth and other Medi-Cal savings	-102
Revised interest cost estimate for short-term loans	-102
Prior-year spending revisions	-76
Other changes (net)	15
Total	**-$321**

c Amounts show combined effects in 1993-94 and 1994-95.

ongoing imbalance between the state's spending and revenue trends.

Estimated Value of Budget Solutions Declines Slightly. The January budget proposal included $5.2 billion of budget "solutions" in order to fill the January budget gap of $4.9 billion and provide a small reserve of $260 million in 1994-95. The May Revision has reduced the estimated value of those budget solutions by about $100 million, leaving $5.1 billion of solutions against a reduced budget gap of $4.6 billion, which results in a larger year-end reserve of $472 million.

Revenues Up Slightly

The Department of Finance's revised revenue estimate for the current and budget years is up $220 million from the Governor's Budget forecast. This relatively small net adjustment primarily reflects *lower* estimates of personal income and bank and corporations taxes that are more than offset by a significant *upward* revision to projected sales and use tax revenues. The department attributes much of its downward revenue adjustments to the impact on 1993 income taxes of casualty loss deductions resulting from the Northridge earthquake and on largely unexplained shortfalls in corporation tax receipts. Upward adjustments to projected sales taxes and other revenue sources primarily reflect Finance's improved economic outlook for the nation and the state. The department currently expects the economic recovery in California to accelerate slightly over the next two years as a result of upward revisions to 1993 economic data, a tenuous improvement in employment trends in the first quarter of this year, and expectations for a mild construction stimulus from the earthquake rebuilding program. The principal *downside risk* to the department's current forecast is the potential for rising interest rates nationally to dampen consumer spending and impede California's incipient housing recovery.

The LAO Forecast. The Legislative Analyst's Office's current economic and revenue forecasts are not substantially different from the Department of Finance's May Revision. Our projections of combined current- and budget-year receipts from the state's three largest taxes are $210 million *lower* than the department's estimates, reflecting somewhat lower sales and corporation tax projections partially offset by moderately higher income tax estimates. We generally agree with Finance that the California economy appears to have improved in the past few months. The state's employment and income levels for 1993 were revised upward significantly, a stronger-than-expected national economy has helped to limit job losses in California's ailing manufacturing sector, existing home sales in the state have risen sharply, and there has been little evidence to date of serious short-term negative impacts from the Northridge earthquake on the overall California economy.

Although encouraged by these positive factors, we remain cautious about the economic and revenue outlook over the next two years. Increased activity in the home resale market has yet to translate into significantly higher construction levels, average monthly employment gains since the first of the year have been far below the levels of previous recoveries, and the state is continuing to cope with the effects of corporate downsizing and defense industry cutbacks. As noted above, the most immediate threat to California's modest recovery comes from higher interest rates. Our forecast simulations indicate, for example, that an increase in mortgage rates of from one-half to three-quarters of a percentage point above what we currently expect over the next two years could reduce combined revenues from the state's three major taxes in the current and budget years by $750 million or more from the Department of Finance May Revision estimates.

May Revision Maintains State/ County Restructuring Plan

The January budget contained a major proposal to shift about $3.3 billion of state costs for health and welfare programs to counties along with state resources to finance those costs. The May Revision removes drug and alcohol programs from the proposed shift (in order to address a recent federal court decision). Despite this change, the revised proposal remains roughly fiscally neutral due to other changes in the estimates of costs and revenues to be shifted to the counties. As we advised the Legislature in February, however, this neutrality also is dependent on adoption of other Administration proposals particularly in the Aid to Families With Dependent Children and Medi-Cal programs.

Major Budget Assumptions and Risks

The viability of the Governor's Budget plan, as presented in the May Revision, continues to turn on its extensive reliance on risky assumptions. If these assumptions do not hold up, the budget could be out of balance by billions of dollars, as shown in Figure 3.

No Commitment of Federal Funds. The most significant budget assumption continues to be that the federal government will provide $3.1 billion of additional funds to California in 1994-95, primarily to offset state costs related to immigrants ($2.4 billion). Recently, the President has requested that Congress

Figure 3

1994-95 Governor's Budget—May Revision
Major Budget Assumptions and Risks

(In Billions)

Risky Assumptions in the Budget	
New federal funds	$3.1
State victory in *Barclays* court case	0.6
Legislation to revise 1993-94 property tax allocations to schools	0.2
Immediate elimination of 10 percent of manager positions	0.1
Other Major Budget Risks	
CTA versus Gould court decision	$1.8
Failure to approve bond measure for earthquake costs	1.1

appropriate $350 million nationwide for incarceration costs for undocumented immigrants. The Governor's Budget assumes that California alone will receive $300 million in federal funds for such costs. Although the Congressional budget resolutions express intent to provide some assistance, no appropriations of these funds currently are pending in the Congressional budget process.

Barclays Court Decision Due Soon. The budget includes $600 million of revenue from an assumed state victory in the *Barclays* court case, which challenges California's past unitary tax treatment of corporate income from national and worldwide operations. The U.S. Supreme Court is expected to issue its opinion in June. An unfavorable decision could require tax refunds of up to $2.1 billion.

Revising 1993-94 Property Tax Allocations. The budget continues to assume savings from enactment of legislation to ensure that the property tax shifts enacted in 1992-93 and 1993-94 result in the full amount of state school apportionment savings intended by the Legislature and the Governor. This legislation is expected to generate over $400 million of state savings, of which about half represents current-year savings. Because local governments have already spent these current-year funds, it probably is not realistic to recover them at this late date.

"Flattening" the Bureaucracy. The May Revision assumes savings of $75 million in 1994-95 (up from $50 million in the January budget) from eliminating 10 percent of all state manager positions. However, the Administration has not yet delivered its plan for making these cuts or complying with complex civil service procedures in an expeditious manner. Savings are almost certain to be significantly less than budgeted.

CTA Versus Gould Court Decision. If this decision is upheld, it would relieve schools and community colleges from repaying the state for $1.8 billion of Proposition 98 loans, which would increase state expenditures by that amount. In addition, this decision could increase the state's Proposition 98 funding requirement in 1994-95 and subsequent years.

Financing the Cost of the Northridge Earthquake. The May Revision assumes the approval of Proposition 1A on the June 7 primary ballot authorizing bonds to pay for $1.1 billion of earthquake-related costs. The status of the earthquake bond proposal will be known in time for the Administration's mid-June budget reassessment. Failure of the bond measure could shift up to $1.1 billion in earthquake-related costs back to the General Fund.

Budget Outlook for 1995-96 Not Bright

Our projections of baseline revenue and spending indicate that the General Fund operating shortfall grows from $2.4 billion in 1994-95 to $4.4 billion in 1995-96. This accelerating imbalance reflects continued rapid growth in spending trends for some programs and the need to replace temporary savings and revenues that end or expire by 1995-96. Because the 1995-96 baseline operating shortfall is similar in size to the entire 1994-95 budget gap of $4.6 billion, any one-time budget solutions adopted for 1994-95 would have to be replaced with solutions yielding equivalent savings in 1995-96 in order to maintain a balanced budget.

Little Time for Considering Major Budget Changes

As noted earlier, the May Revision is essentially a technical update of the January budget estimates. The Administration has deferred any consideration of significant budget changes until after it has reassessed the likely amount of federal funds, and possibly other developments, in mid-June. This places the Legislature in a difficult bind.

As noted earlier, the Administration will not revise its spending plans until mid-June. Anticipated borrowing needs will require a timely budget in order for the state to have the cash needed to pay its bills in July. As a result, the Legislature would have very little time to consider major budget changes and still have a budget in place by the beginning of the 1994-95 fiscal year.

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