



Overview of the 1999-00 Governor's Budget

Introduction

On January 8, 1999, the Governor submitted his proposed 1999-00 budget plan. This brief summarizes the proposal's main features, along with key considerations facing the Legislature as it develops its version of the 1999-00 budget.

LAO Findings

- ❖ **Workload Budget.** In general, the new proposal can be characterized as a "workload" budget, funding caseload and various inflationary adjustments.
- ❖ **New Initiatives Focused in Education.** Most of the budget's new initiatives are related to K-12 education, where the Governor has several proposals aimed at improving reading skills, improving teacher quality, and increasing school accountability.
- ❖ **Plan Relies on Certain Risky Budget-Balancing Proposals and Assumptions.** In order to eliminate a budget problem estimated to be in excess of \$2 billion, the plan includes several budget-balancing proposals and assumptions involving increased federal funds, asset sales, program cutbacks, and spending delays. Many of the budget's assumptions—particularly those related to federal funds—are subject to significant risk.
- ❖ **Higher Revenues May Offset Risks.** We believe that there is upside potential to the administration's revenue projections. This, in combination with lower Medi-Cal caseloads, could offset the risky expenditure assumptions included in the budget.
- ❖ **Higher Reserve Should Be a Priority.** If unanticipated revenues materialize again this year, we believe that an increase in the budget reserve should be a high priority, given the volatility in the state's revenue stream and the risks related to many of the budget-balancing actions included in this spending plan.



OVERVIEW OF THE GOVERNOR'S BUDGET

The Governor's budget proposes total state spending of \$76.2 billion in 1999-00 (excluding the expenditure of federal funds and selected bond funds), an increase of 4.1 percent from the current year. This total includes \$60.5 billion in General Fund spending and \$15.7 billion in special funds spending.

In general, the new spending plan can be characterized as a "workload" budget, funding caseload and inflationary adjustments for most, but not all, General Fund programs. Most of its significant programmatic initiatives are focused on K-12 education, with relatively few changes in other areas.

The plan's limited number of new initiatives reflects, in part, the fact that current-law commitments are expected to significantly exceed current-law resources in the budget year, leaving no funds for new or expanded programs. In fact, the budget avoids significant cutbacks only through increased reliance on federal funds, delaying certain expenditures to future years, and one-time asset sales.

THE GENERAL FUND BUDGET CONDITION

Figure 1 shows General Fund revenues, expendi-

tures, and the year-end reserve for 1998-99 and 1999-00. It shows that revenues in 1999-00 are projected to be \$60.3 billion, a 7.1 percent increase from the current year. Expenditures are proposed to be \$60.5 billion, a 3.8 percent increase from 1998-99. A slight operating deficit (that is, excess of expenditures over revenues) of about \$200 million occurs in the budget year, causing the reserve to decline from \$617 million in 1998-99 to \$415 million by the close of 1999-00. The reserve proposed for the budget year represents about 0.7 percent of General Fund revenues.

GENERAL FUND SPENDING BY PROGRAM

Figure 2 shows how spending from the state's General Fund is allocated among major program areas in the 1999-00 budget plan. It shows that

Figure 1

Governor's Budget General Fund Condition 1998-99 and 1999-00

(Dollars in Millions)

	1998-99	1999-00	Percent Change
Prior-year fund balance	\$3,075	\$1,097	
Revenues and transfers	56,293	60,272	7.1%
Total resources available	\$59,368	\$61,370	
Expenditures	\$58,271	\$60,475	3.8%
Ending fund balance	\$1,097	\$895	
Other obligations	\$480	\$480	
Reserve	\$617	\$415	

Detail may not total due to rounding.

education funding accounts for over one-half of the total. Health and social services accounts for slightly more than one-fourth, while spending on youth and adult corrections accounts for about 7 percent of the total. All other programs, including resources, debt service, retirement costs, local tax relief, and general government account for about 11 percent of the total.

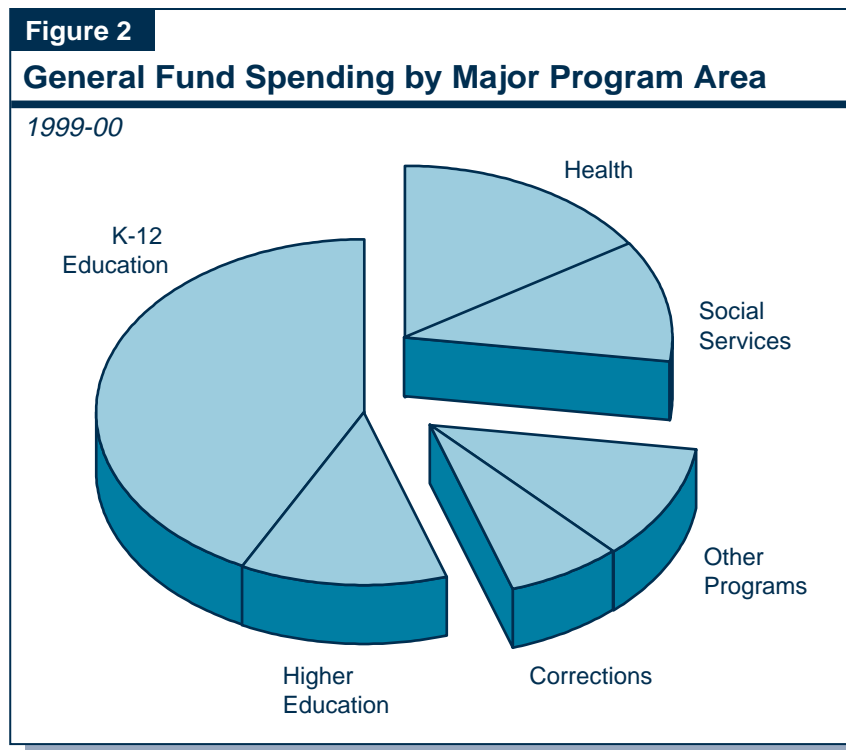
KEY PROGRAMMATIC FEATURES

As indicated above, most of the policy initiatives in the budget are in the area of K-12 education. Specifically, the Governor proposes to use \$444 million—mostly from within the Proposition 98 guarantee—for initiatives aimed at improving reading skills, improving teacher quality, and increasing school accountability.

In other areas, the budget proposes to bridge a funding shortfall—which the administration estimates in excess of \$2 billion—through a variety of proposals and assumptions. Figure 3 (see page 4) shows that these proposals and assumptions fall into five major categories.

Of the major assumptions and proposals, nearly \$900 million is related to new resources, including the use of \$562 million in assumed tobacco settlement funds for General Fund purposes, and \$180 million from the sale of state property. About \$432 million involves requests for new federal funds associated with (1) an increase in the federal share of payments for the Medi-Cal program, (2) placing the state’s family planning program in the Medi-Cal program, and (3) an increase in federal reimbursements for undocumented felons housed in state prisons.

The remainder is related to the stretching out of expenditures included in this year’s budget for the All American Canal and for the reimbursement of developers for local fees, and cutbacks in spending commitments made in this year’s budget for trial courts and local flood control reimbursements. Finally, the new budget does not include funds to cover certain cost pressures that are likely to occur in such areas as Medi-Cal, fire suppression, and local property tax adminis-





tration. The administration has also sharply increased its estimates of unidentified savings that will occur in the current and budget years, assuming total savings of \$300 million for the two years combined.

As discussed below, many of the assumptions and proposals shown in Figure 3 are subject to risk—particularly those related to federal funds, asset sales, and underbudgeting.

Figure 3

Key Budget-Balancing Proposals and Assumptions

(In Millions)

New Resources

Tobacco settlement	\$562
New auditors in tax agencies	51
Asset sales	180
STRS ^a updated valuation	86
Subtotal	\$879

New Federal Funds

Medi-Cal sharing ratio	\$210
Family Planning Program	122
Undocumented felons	100
Subtotal	\$432

Rescheduling of Expenditures

All American Canal	\$200
Developer fees	100
Subtotal	\$300

Potential Underbudgeting

Fire suppression	\$20
Property tax administration	50
Unidentified savings	200
Medi-Cal rate increases	100
Subtotal	\$370

Spending Cutbacks

Trial courts	\$48
Local reimbursements for flood control	44
Subtotal	\$92

^a State Teachers' Retirement System.

HOW BIG IS THE PROBLEM THAT THE BUDGET ADDRESSES?

In November, our office estimated that there would be slightly more than a \$1 billion deficit in the 1999-00 budget, assuming current-law policies are followed. In his January 8 press conference on the 1999-00 budget, the Governor identified a \$2.3 billion budget shortfall.

In reality, the two figures reflect a very *similar* assessment of the underlying budget problem. The apparent difference merely relates to *how* the problem is portrayed. Specifically, our \$1 billion figure *did not* include funds to rebuild the reserve. In contrast, the \$2.3 billion shortfall identified by the Governor includes a provision of a \$1.2 billion reserve, which accounts for almost all of the difference between the two estimates.

BUDGET'S ECONOMIC AND REVENUE OUTLOOK

ECONOMY SLOWING

The economic forecast underlying the budget assumes that both the U.S. and California economies will slow markedly in 1999 and 2000 relative to the recent past. As shown in Figure 4 the budget assumes that U.S. real gross domestic product growth will slow from 3.6 percent in 1998 to 1.9 percent in 1999, before rebounding slightly to 2.2 percent in 2000. The slowdown is related to the continued economic and financial problems in Asia, and their associated effects on U.S. exports. The forecast also assumes consumer spending and business investment growth will subside in 1999, reflecting such factors as low savings rates, declining corporate profits, and more-sluggish gains in employment and personal income during the year.

As indicated in Figures 4 and 5 (see page 6), California's economy is also expected to slow in 1999, with wage and salary employment increasing by less than 300,000 jobs this year, compared to over 400,000 jobs last year. The problems in Asia are expected to hold down employment in the state's durable goods manufacturing sector. However, other sectors are expected to fare better, particularly those benefiting from the continued gains in residential and nonresidential construction activity.

REVENUES—MODEST UNDERLYING GROWTH

As shown in Figure 6 (see page 6), total General Fund revenues are projected to increase by

2.4 percent in 1998-99 and 7.1 percent in 1999-00. These growth rates are affected by a variety of factors, including tax reductions enacted in 1997 and 1998, the assumed receipt of tobacco settlement funds, and one-time asset sales. Adjusting for these factors, the budget's underlying revenue growth rates are about 5 percent in both the current year and budget year, or slightly less than the administration's forecast for California personal income growth.

Figure 4

Summary of Budget's Economic Outlook

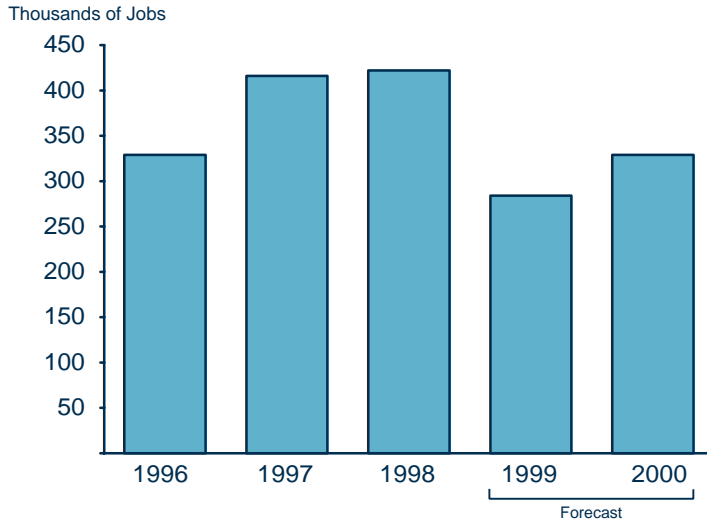
	Actual 1998	Projected	
		1999	2000
United States Forecast			
Percent change in:			
Real GDP	3.6%	1.9%	2.2%
Pretax corporate profits	-3.1	-5.2	0.5
Unemployment rate (%)	4.5	4.8	5.1
Federal funds interest rate (%)	5.4	4.6	4.3
California Forecast			
Percent change in:			
Personal income	6.3%	5.1%	5.5%
Nonagricultural employment	3.2	2.1	2.4
Consumer prices	1.9	2.4	3.0
Taxable sales	5.6	5.4	5.4
Unemployment rate (%)	5.8	5.8	5.8
New housing permits (000)	126	152	166



Figure 5

Slowing Economic Growth Forecast

*Year-to-Year Increase in California Wage and Salary Employment
1996 Through 2000*



Upside Revenue Potential

Exists. The updated budget forecast for the current year and budget year combined is \$433 million below our November forecast (as adjusted for tobacco settlement funds and other special factors). Current positive trends in the economy and the stock market, coupled with strong year-end personal income tax receipts, suggest that revenues will at least meet our revenue forecast. We will be providing updated economic and revenue forecasts which take into account recent developments in our February *Perspectives and Issues*.

Figure 6

Governor's Budget Revenue Forecast

(Dollars in Billions)

Revenue Source	Actual 1997-98	Projected	
		1998-99	1999-00
Personal income tax	\$27.9	\$28.5	\$30.2
Sales and use tax	17.6	18.6	19.7
Bank and corporation tax	5.8	5.9	6.3
All other	3.6	3.2	4.1
Totals	\$55.0	\$56.3	\$60.3
Percent change	11.7%	2.4%	7.1%

Detail may not total due to rounding.

GOVERNOR'S BUDGET PROPOSALS BY PROGRAM AREA

Figure 7 shows General Fund spending by major program for fiscal years 1997-98 through 1999-00. It shows that significant spending increases are proposed for K-12 education, community colleges, and Supplemental Security Income/State Supplementary Program (SSI/SSP). Modest increases are proposed for both higher education and youth and adult corrections. Declines in General Fund spending are projected for Medi-Cal and CalWORKs and "all other" spending. The year-to-year changes in many programs are affected by numerous special factors. For example, the increases for higher education are understated, partly due to the drop-off of one-time expenditures included in these programs in the current year. Similarly, the General Fund growth for Medi-Cal and corrections is held down by the assumed increases in federal funds for the program in the budget year.

K-12 EDUCATION

The budget proposes moderate increases in K-12 education spending, consistent with the Proposition 98 minimum funding guarantee. Proposition 98 allocations (includes local property tax revenues) to K-12 schools total \$32.8 billion in

1999-00. This represents an increase of \$1.5 billion over the current-year estimate. The budget effectively augments these resources by \$191 million, for a total of almost \$1.7 billion, through various program redirections (discussed in more detail below).

How Are the New Monies Spent? Figure 8 (see page 8) displays the major proposed uses of the additional \$1.7 billion of Proposition 98 funds. The largest share—\$571 million (34 percent)—would provide a 1.8 percent cost-of-living adjustment (COLA) for district and county office apportionments (revenue limits) and categorical programs. General purpose and categorical program funding

Figure 7				
General Fund Spending by Major Program Area				
<i>(Dollars in Millions)</i>				
	Actual 1997-98	Estimated 1998-99	Proposed 1999-00	
			Amount	Percent Change
Education Programs				
K-12 education	\$22,080	\$23,648	\$25,642	8.4%
Community colleges	2,108	2,292	2,450	6.9
Higher education	4,516	5,185	5,276	1.8
Health and Welfare Programs				
Medi-Cal	\$6,759	\$7,399	\$7,330	-0.9%
CalWORKs	1,628	2,000	1,784	-10.8
SSI/SSP	2,025	2,256	2,439	8.1
Other	4,226	4,657	4,832	3.8
Youth and Adult Corrections	\$4,139	\$4,510	\$4,589	1.7%
All Other	\$5,392	\$6,325	\$6,133	-3.0%
Totals	\$52,874	\$58,271	\$60,475	3.8%



for the projected 1.4 percent growth in the student population accounts for \$344 million, or 20 percent, of new Proposition 98 funds. Providing full-year funding for programs that began in the current year accounts for \$200 million, or 12 percent, of new funding. The budget provides another \$200 million for “revenue limit deficit reduction.” This proposed supplement of general purpose funding—which would continue in years after 1999-00—is intended to partly compensate school districts for prior years when the state did not fully fund statutory COLAs.

Allocations for the above four expenditure categories (combined with the proposed community colleges allocation) leaves \$369 million of Proposition 98 funds available for new K-12 programs. The budget allocates this entire amount for a variety of new programs that the Governor groups together as his “READ” (Raising Expecta-

tions, Achievement and Development in Schools) program. These various programs are sub-grouped into three areas: (1) improving reading skills (\$180 million); (2) enhancing professional quality of teachers, principals, and other staff (\$29 million); and (3) school accountability (\$160 million). The budget proposes a total of \$444 million for the READ program. This total includes federal funds and allocations to the University of California and the community colleges.

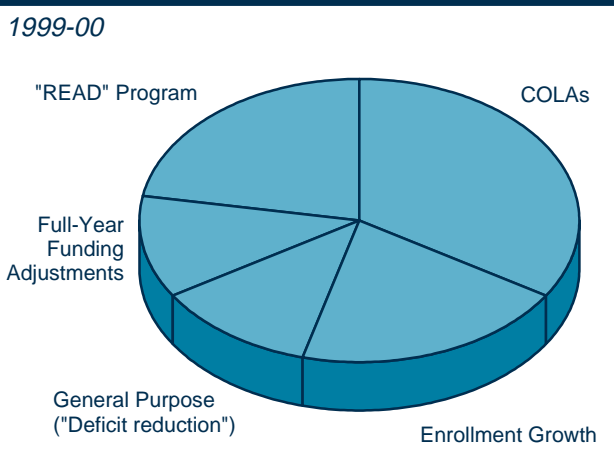
Program Redirections. As mentioned above, the Governor effectively augments the amount of Proposition 98 funds available for new programs by redirecting \$191 million currently budgeted for four existing programs. The Legislature added \$115 million in the *1998-99 Budget Act* to assist school districts in addressing a backlog of deferred maintenance of facilities. Although the Legislature intended that these funds be provided on an ongoing basis, the budget proposes to redirect this amount in 1999-00 and subsequent years. In addition, the budget proposes one-time redirections for the following three programs:

- ◆ \$50 million for after-school programs.
- ◆ \$16 million for the Beginning Teacher Support and Assessment program.
- ◆ \$10 million for the Healthy Start Pregnancy Prevention program.

Due to implementation delays in these three programs, the above amounts are expected to remain unspent at the close of the current year. The budget proposes to reappropriate these

Figure 8

Proposed Use of New K-12 Proposition 98 Funds



amounts for expenditure in 1999-00 in place of what the budget otherwise would have to provide for these programs out of the 1999-00 Proposition 98 "base." This action "frees up" a total of \$76 million in the 1999-00 base for new programs, but only on a one-time basis. Thus, if the Legislature were to adopt this approach, it would need to allocate an additional \$76 million from Proposition 98 resources in 2000-01 and subsequent years in order to fund the ongoing costs of these three programs.

HIGHER EDUCATION

University of California (UC) and California State University (CSU). The budget provides a General Fund increase of 1.8 percent for UC and a marginal 0.5 percent increase for CSU. After adjusting for one-time expenditures in the current year, however, the increases are 4.8 percent for UC and 4.3 percent for CSU. The budget includes funds for the buy-out of fee increases, pursuant to current law, and for enrollment increases of slightly more than 3 percent for both segments. It also includes \$12 million to UC for Reading Professional Development Institutes, which would provide staff development training for new teachers.

California Community Colleges (CCC). The budget proposes a 5.5 percent increase in funding for CCCs. The new funds cover a 2.5 percent projected increase in enrollment, a 1.8 percent COLA, and additional funds for lease payment costs.

HEALTH AND SOCIAL SERVICES

The budget proposes \$16.4 billion in General

Fund spending for health and social services spending in 1999-00, a 0.4 percent increase from the current year. It funds projected caseloads and provides statutory COLAs consistent with current law. However, the budget contains no major new initiatives.

CalWORKs

The budget proposes General Fund spending of \$1.8 billion, a 10.8 percent decline from the current year. The drop between the current year and budget year partly reflects continued caseload declines in the program. Specifically, the budget estimates that the caseload will fall 10.3 percent in 1999-00, following a 12.2 percent decline in 1998-99. General Fund spending for CalWORKs is held down in both 1998-99 and 1999-00 by the carryover of over \$800 million in unexpended federal Temporary Assistance for Needy Families funds from the prior year (of which \$400 million are spent in each of the current and budget years).

Budget Reappropriates Unexpended County Block Grant Funds. The budget also achieves General Fund savings in 1999-00 by reappropriating \$251 million in unexpended county block grant funds from the current year to help meet the estimated need for employment services in 1999-00. This represents a change in state policy from last year, when the state funded employment services and, *in addition*, provided counties with reappropriation authority to use unexpended funds from previous years. This change in approach has *not* been made to the CalWORKs child care program, however, where the budget proposes to



appropriate the full estimated amount needed for 1999-00, and provides the counties with an additional \$88 million in reappropriation authority.

SSI/SSP

The budget proposes \$2.4 billion in General Fund spending for the SSI/SSP program in 1999-00, an 8.1 percent increase from the current year. The increase is primarily related to modest growth in caseloads, and the effects of COLAs to the SSI/SSP grants that took effect in January 1999, and are scheduled to take effect in January 2000 pursuant to current law.

Medi-Cal

Spending for the Medi-Cal program is projected to fall slightly, from \$7.4 billion in the current year to \$7.3 billion in 1999-00.

Major Current-Year Deficiency. The revised current-year estimate reflects a deficiency of \$507 million, reflecting higher caseloads and costs per eligible recipient, increased drug costs, and funding for prenatal care for undocumented persons.

Increased Federal Funds Assumed in Budget Year. The slight decline in budget-year costs reflects the budget's assumption of \$332 million in savings related to increased federal funds. Specifically, the budget assumes an increase in the federal medical assistance percentage (FMAP) paid to California. The administration argues that the current FMAP is too low, due to underestimates by the federal government of population in this state. This FMAP change, if made by the federal government, would result in increased federal funding—and thus lower

General Fund costs—of \$210 million in 1999-00. The budget also proposes to shift the state-only portion of the existing family planning program to 90 percent federal funding as part of California's Medicaid program. This shift would reduce General Fund expenditures by \$122 million. There is considerable uncertainty about both of these assumptions.

The Medi-Cal estimate for 1999-00 assumes continuation of funding for prenatal services for undocumented persons. It does not include funding for rate increases for nursing homes or managed care plans in the budget year (typically the nursing home rate increase is included in the May Revision budget proposal). On the other hand, it appears that the budget's projections of caseloads in the Medi-Cal program are somewhat overstated.

YOUTH AND ADULT CORRECTIONS

The budget includes \$4.6 billion from the General Fund for youth and adult corrections, a 1.7 percent increase from the current year. The budget-year proposal covers inmate population increases and most other workload factors, along with the 1999-00 costs associated with policy actions taken in 1998-99. The budget assumes that inmate population in the Department of Corrections will reach 170,905 by June 2000, a 3.9 percent increase from June of the current year. The budget does not include any major policy changes, nor does it propose any new prison beds.

Federal Reimbursements. The budget assumes that federal reimbursements for incarcerating undocumented felons will increase from \$173 mil-

lion in the current year to \$273 million in the budget year. The administration indicates that current reimbursement levels fall well short of covering California's costs of incarcerating undocumented felons, and that California will work with other states to increase federal funds for this purpose. This estimate assumes that Congress will make a substantial increase in the national appropriation for state and local costs associated with undocumented felons.

OTHER PROGRAMS

Local Governments

Citizens' Option for Public Safety (COPS). This program, which was enacted in 1996, provides funds to local governments for law enforcement activities. Under current law, the program will sunset on June 30, 2000. The budget includes \$100 million for the program in 1999-00. The administration also indicates that proposed legislation will be introduced which makes the COPS program permanent.

Trial Court Funding. Under trial court financial restructuring legislation enacted last year, the state is scheduled to provide \$98 million in additional fiscal relief to mid- and large-size counties beginning in 1999-00. The budget proposes to postpone \$48.3 million of this scheduled increase.

Local Flood Control Reimbursements. Chapter 326, Statutes of 1998 (AB 2784, Strom-Martin), appropriated \$132 million from the General Fund—\$44 million annually for 1999-00 and the subsequent two fiscal years—to pay claims submitted by local agencies for the state's share of costs for

flood control projects. The 1999-00 Governor's Budget assumes enactment of legislation reverting the \$44 million appropriated by Chapter 326 for the budget year.

Child Support Enforcement. Federal law required that states have in place by October 1, 1997, a statewide automated child support enforcement system. California failed to meet this deadline and therefore, is subject to federal penalties in the form of reduced federal funds to administer the program. The budget assumes that these reduced federal funds—totaling \$37 million in the current year and \$53 million in the budget year—will be passed along to the counties which administer the program. It should be noted that recently enacted state law permits the administration to backfill the lost federal funds thereby holding the counties harmless from these reductions.

Capital Outlay

The budget proposes \$1.1 billion in capital outlay spending in 1999-00, excluding that for highways and K-12 schools. Slightly more than one-half of this total is for higher education, with the remainder divided between corrections, resources, state buildings, and a variety of other purposes. In terms of funding sources, about \$582 million comes from general obligation bond funds, \$262 million is from lease payment bonds, \$195 million is from direct appropriations from the General Fund, and \$60 million is from special and federal funds.

Employee Compensation

The Governor's budget includes \$162.3 million



from the General Fund in 1999-00 to provide increased compensation to state employees (not including those in higher education, which are funded elsewhere in the budget). The \$162.3 million consists of (1) \$62.3 million for the annual cost of any increases in employee compensation that are approved in the current year for employees currently in collective bargaining negotiations, and (2) \$100 million for employee compensation changes that may be agreed to through collective bargaining and become effective in the budget year.

Actual salary increases provided to employees by these funds are dependent on the terms of negotiated agreements. As an example, however, the \$62.3 million could cover the full-year costs of an average pay increase of 3 percent for those currently in collective bargaining. The \$100 million that would be available for the budget year could provide a salary increase of about 2 percent for all employees.

CONSIDERATIONS FOR THE LEGISLATURE

DOES THE BUDGET WORK?

On its own terms (that is, using the budget's revenue, caseload, and related assumptions), the budget plan may not "pencil out." It faces numerous risks associated with federal assumptions and potential underbudgeting. These risks could more than use up the budget's reserve. At the same time, however, we believe that there is upside potential for state revenues and the budget appears to overstate caseload-related costs in the Medi-Cal program. These factors could bring the budget plan back into balance.

WHAT IF UNANTICIPATED REVENUES MATERIALIZE?

In each of the past two years, the state has experienced major improvements in the revenue picture between the January budget and the May Revision, in part due to the stock market. If unanticipated revenues again materialize, we believe that an increase in the budget reserve should be a high priority. This is especially true given the volatility inherent in the state's revenue stream, and the uncertainty related to many of the budget-balancing actions included in this spending plan.

Acknowledgments

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