An LAO Report

Overview of the 2001-02 May Revision

LAO Findings

- The May Revision reports a $5.7 billion deterioration in the state's fiscal condition that reflects a $4.2 billion downward revision to revenues, about $900 million in added budget costs in non-Proposition 98 programs, and $600 million in added Proposition 98 spending—mostly related to prior-year adjustments.

- The Governor's revenue forecast assumes a much sharper slowdown in California's economy than did the January projection. The administration's revenue estimate is about $650 million below our updated forecast for the current year and budget year combined.

- A critical assumption underlying the plan is that the General Fund will be reimbursed from revenue bonds for the $7 billion plus it has committed for purchasing electricity.

- The revised budget proposal addresses the imbalance by deferring the transfer of General Fund monies for transportation, eliminating or reducing many of the one-time expenditures proposed in the January budget, scaling back funding for other programs, transferring certain special fund balances into the General Fund, and reducing the reserve.

- Although some of the budgetary solutions are ongoing in nature, the vast majority are one time. Thus, while the Governor's plan would result in a balanced budget in 2001-02, we estimate that the state would likely face a further shortfall of roughly $4 billion in 2002-03.

Legislative Considerations

- Aside from determining the extent to which the May Revision matches its own budget priorities, the Legislature needs to decide whether to adopt deeper ongoing budget reductions this year in order to address the large ongoing imbalance between revenues and expenditures in the future.

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INTRODUCTION

In striking contrast to the past several years, the 2001-02 May Revision reflects a sharp deterioration in the state's fiscal picture. As we reported to the Legislature last week, slower near-term economic growth and recent weakness in the stock market have led to a sharp decline in the revenue outlook. This, coupled with added costs in a variety of budget areas, has necessitated significant changes to the Governor's January budget proposal. This report discusses the administration's new fiscal projections, the ways it proposes to address the state's multibillion dollar budgetary imbalance, and considerations for the Legislature as it evaluates the Governor's new plan.

THE MAY REVISION OVERVIEW

The administration estimates that its January budget plan has fallen out of balance by $5.7 billion. As shown in Figure 1, this is due to the combination of a net two-year *reduction* of $4.2 billion in revenues and a net two-year *increase* of $1.5 billion in the January plan's spending requirements. The expenditure increases are due to higher retirement costs, legal settlements, energy costs, and prior-year Proposition 98 requirements.

As indicated in the figure, the Governor proposes to solve the budgetary imbalance through a variety of measures, including:

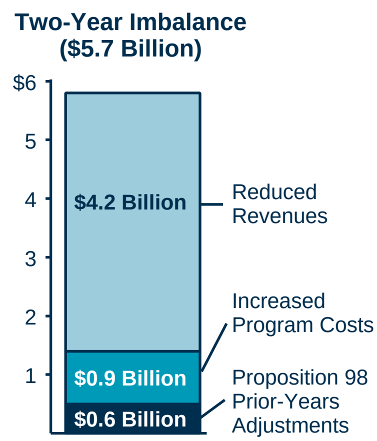
- Reduction in the budgetary and litigation reserves by a combined total of $1.4 billion.

- Redirection of monies from transportation funds into the General Fund, saving $1.3 billion in 2001-02 and $1.2 billion in 2002-03. These savings are achieved through a two-year postponement in the transfer of sales taxes on gasoline to transportation programs.

Figure 1

Budgetary Imbalance and Proposed Solutions

2000-01 and 2001-02, General Fund



Proposed Solutions

Reduced reserves	$1.4
Transportation funding shift	1.3
Reduced one-time spending proposals	1.3
Other special fund transfers	0.5
Reduced Proposition 98 ongoing spending	0.3
All other[a]	0.9

[a] Includes current-year adjustments.

- Reduction or elimination of $1.3 billion in one-time spending proposals in the areas of local fiscal relief, housing, clean beaches, and flood control. Also, there is a shift of $370 million in nontransportation capital outlay project funding from direct General Fund appropriations to debt financing.

- Transfer of about $500 million in non-transportation special funds to the General Fund in 2001-02.

- Reduction in ongoing Proposition 98 spending of about $255 million from January's proposed level.

- Other reductions in the current year and budget year totaling $900 million.

The administration's proposal assumes that the General Fund outlays for the purchase of electricity will be reimbursed by the sale of the revenue bonds authorized by Chapter 4x, Statutes of 2001 (AB 1x, Keeley) and Chapter 9x, Statutes of 2001 (SB 31x, Burton).

General Fund Condition

Figure 2 shows the Governor's projections for the General Fund condition taking account of the above factors. It indicates that under his revised projections and proposed actions for dealing with the budgetary imbalance, the General Fund would end 2000-01 with a positive reserve balance of $5.9 billion and 2001-02 with a positive reserve of $1 billion—the latter being 1.4 percent of revenues. Both revenues and expenditures are anticipated to decline between the current year and budget year.

We now turn to a more detailed look at the May Revision's economic and revenue projections, spending proposals, and proposals to address the budgetary imbalance.

Figure 2

Governor's May Revision General Fund Condition

2000-01 Through 2001-02
(In Millions)

	2000-01	2001-02
Prior-year fund balance	$8,848	$6,645
Revenues and transfers	78,043	74,842
Total resources available	$86,891	$81,487
Expenditures	$80,246	$79,676
Ending fund balance	$6,645	$1,811
Encumbrances	701	701
Set-aside for legal contingencies	7	100
Reserve	**$5,937**	**$1,010**

Detail may not total due to rounding.

ECONOMIC AND REVENUE ASSUMPTIONS

Economic Outlook

The administration's updated economic outlook assumes a much sharper slowdown in California's economy than it did in its January projections. As shown in Figure 3, year-over-year increases in California's personal income are forecast to slow from nearly 12 percent in early 2000 to around zero percent in late 2001, before partly rebounding in 2002. A similar sharp slowdown in taxable sales is also projected for 2001. The decline in personal income partly reflects the general slowdown in employment anticipated for 2001. However, a major factor is also the expected sharp decline in stock option-related income this year.

Revenue Outlook

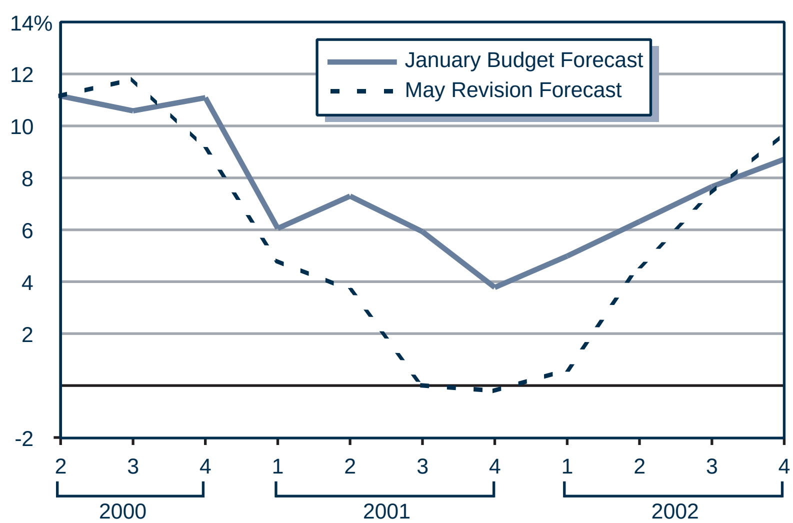
Consistent with the steeper slowdown in the California economy, and stock-market-related options and capital gains income, the administration forecasts that revenues for the current year and budget year combined will fall by about $4.2 billion relative to its January projection. This two-year revision reflects a $1.1 billion increase in 2000-01 revenues—due mostly to higher personal income tax payments attributable to 2000 liabilities—but a $5.3 billion decrease in 2001-02. The single largest source of the budget-year decline is the personal income tax, which is being adversely affected by falling stock options and capital gains. However, the administration's forecasts for sales and corporation taxes are also down sharply, reflecting much lower levels of personal spending, business outlays, and corporate profits during the next 12 months.

Comparison to LAO's Forecast. After adjusting for such factors as transfers, fees, and tax-law changes assumed in the May Revision, the administration's forecast is below the estimate we provided to the Legislature last week by about $276 million in the current year and $373 million

Figure 3

Sharp Economic Slowdown Expected

Year-to-Year Percent Change in California Personal Income, By Quarter



in the budget year, or about $650 million total. Over the two years combined, the administration assumes higher personal income tax receipts, but lower revenues from sales and corporation taxes.

SPENDING BY MAJOR PROGRAM AREA

Under the proposed May Revision, General Fund spending would fall 0.7 percent in 2001-02. Underlying this modest decline in aggregate spending are sharply diverging trends among major program areas. As shown in Figure 4, spending in the single largest budget area—K-12 education—is proposed to increase by over 7 percent, while the spending areas of resources, transportation, housing, and the "all other" category are proposed to decline significantly, reflecting a sharply lower level of one-time budget-year spending. The Governor's funding proposals for two major areas are discussed below.

Figure 4

Summary of May Revision Spending Proposal General Fund

(Dollars in Millions)

Program/Agency	2000-01 Amount	2001-02 Amount	2001-02 Percent Change
Education Programs			
K-12-Proposition 98	$27,246	$29,229	7.3%
Community Colleges—Proposition 98	2,680	2,865	6.9
UC/CSU	5,824	6,138	5.4
Health and Social Services	20,128	21,852	8.6
Youth and Adult Corrections	5,199	5,300	1.9
Business/Transportation/Housing	2,579	746	-71.1
Resources/Environmental Protection	2,950	1,756	-40.5
All Other	13,640	11,790	-13.6
Totals	**$80,246**	**$79,676**	**-0.7%**

Transportation

The May Revision proposes to modify the financing of the Traffic Congestion Relief Program (TCRP) in order to free up a total of $2.5 billion for General Fund expenditures over the budget year and 2002-03. In 2000, the Legislature and administration enacted the TCRP, which provided $2 billion in General Fund monies to the Traffic Congestion Relief Fund (TCRF) in 2000-01. Additionally, the program transfers gasoline sales tax revenues that previously were deposited in the General Fund to transportation purposes for 2001-02 through 2005-06. Of the amount transferred annually, $678 million is deposited in the TCRF to fund 141 designated transportation projects, while the remainder of gasoline sales tax revenues is deposited in the Transportation Investment Fund (TIF) and distributed 40 percent to the State Transportation Improvement Program (STIP), 40 percent to local street and road repairs, and 20 percent to the Public Transportation Account (PTA). The proposal:

- Postpones the transfer of $2.3 billion in General Fund revenues for transportation purposes, including $1.1 billion in 2001-02 and $1.2 billion in 2002-03. Transfers would begin in 2003-04.

- Provides a $238 million loan to the General Fund from TCRF to be repaid beginning in 2004-05.

- Extends the program for two years—until 2007-08—providing an estimated $517 million above the estimated program total under current law to compensate for the postponement of the transfer of funds.

Proposal Intends to Meet Projects' Cash-Flow Needs. With regard to the 141 designated projects, the proposal is designed to meet their cash-flow and schedule needs by borrowing from other transportation funds—specifically the State Highway Account (SHA) and the PTA. These loans would then be repaid beginning in 2006-07. The proposal also anticipates an additional loan of $100 million from the Motor Vehicle Account in 2004-05.

Local Streets and Roads Held Harmless; PTA and STIP Take Short-Term Hit. The proposal affects the remainder of the TCRP as follows:

- Maintains local street and road funding at amounts specified in current law, but uses the SHA instead of TIF for 2001-02 and 2002-03.

- Eliminates the TIF transfer to PTA in 2001-02 and 2002-03 ($77 million and $100 million, respectively). As a result, the State Transit Assistance program, which funds transit operators, would receive $38 million less than under current law in 2001-02.

- Eliminates TIF transfer to STIP for 2001-02 and 2002-03 (a cumulative total of $354 million).

Issues for Legislative Consideration. Our preliminary review of the TCRP financing proposal raises the following issues:

- The proposal could negatively impact delivery of the STIP or the State Highway Operation and Protection Program in the next few years because SHA and PTA funds will be used to meet TCRP needs.

- There would be no uncommitted PTA funds available for new transit capital projects for 2001-02 and 2002-03. Earlier estimates projected an uncommitted PTA balance of $264 million in the budget year.

Proposition 98—K-12 Education

The May Revision proposes a complicated set of adjustments to General Fund spending for Proposition 98 programs. For the current year, the May Revision proposes a net General Fund increase of $54 million, primarily to (1) offset a downward revision in estimated property tax allocations to local education agencies and (2) cover an average daily attendance (ADA) increase of about 12,000 pupils. For the budget year, the May Revision proposes a net General

Fund decrease of $255 million. This change includes increases for higher ADA growth (about 30,000 more pupils than estimated in January) and a new block grant proposal for low-performing schools ($220 million). It also includes numerous other augmentations and reductions, the most significant of which are listed in Figure 5.

In addition to the above changes to current-year and budget-year Proposition 98 appropriations, the May Revision proposes a one-time General Fund allocation of $541 million for energy conservation investments and energy costs at K-12 schools. This allocation is needed to meet Proposition 98 minimum funding requirements for 1995-96 through 1997-98 that have been revised as a result of new census data. Because these funds would be distributed to school districts in the budget year, the Governor counts these funds as part of his Proposition 98 per-pupil estimate of $7,168 in 2001-02. If the $541 million is counted on an appropriations basis rather than a cash-flow basis, the May Revision Proposition 98 amount is $7,075 per pupil. This is $99 less than the $7,174 proposed in the January budget and $397 (5.9 percent) more than the $6,678 revised per-pupil amount for the current year.

Considerations for the 2002-03 Fiscal Year. The Governor's revised spending proposal for Proposition 98 programs raises potential concerns for the 2002-03 fiscal year. Our preliminary analysis indicates that the minimum amount (General Fund and local property tax) that will be required for allocation under Proposition 98 in 2002-03 will be approximately $2.4 billion higher than the amount proposed for expenditure in 2001-02 by the May Revision. We estimate that *at least* this amount will be needed in 2002-03 to fund (1) enrollment growth and cost-of-living adjustments, (2) planned increases in the Longer Middle School Year program and the Math and Reading Professional Development Program, and (3) program requirements being met in the budget year by one-time monies. Thus, the Governor's revised spending plan leaves essentially no room for error or for new programs or program expansions in K-12 education,

Figure 5

May Revision Changes in K-12 Proposition 98 Spending—Ongoing Funds

2001-02
(In Millions)

	Augmentation	Reduction
High priority students block grant	$220	—
Property tax backfill	108	—
Attendance increase	102	—
Immediate intervention/underperforming schools	49	—
Math and reading professional development	—	$175
Caseload decreases (voluntary programs)	—	162
Shifts to one-time funds	—	140
Governor's performance awards	—	123
High school exit exam	—	46
Longer middle school year	—	35

unless the Legislature modifies the budget year spending plan or "over-appropriates" the Proposition 98 guarantee in 2002-03.

One-Time Expenditures

The May Revision eliminates or reduces many of the one-time spending proposals included in January, for a savings of roughly $1.3 billion. Key proposals affected include housing incentives ($200 million), local fiscal relief ($250 million), Clean Beaches ($90 million), and River Parkway initiatives ($35 million). The plan also reduces direct appropriations for capital outlay by about $460 million, by deferring some projects and shifting support for others to bond proceeds.

THE OUTLOOK BEYOND THE BUDGET YEAR

While the May Revision proposal would eliminate the estimated 2001-02 shortfall, it is not a comprehensive solution to the budget problem that has emerged. This is because the May Revision relies most heavily on *one-time* solutions, even though the revenue shortfall in the budget year is *ongoing* in nature. Specifically, even if the economy and state revenues rebound in 2002, revenues in 2002-03 would likely fall below expenditures by roughly $4 billion. This implies that the Governor and Legislature would need to make substantial budgetary reductions in future years. Thus, in considering the May Revision the Legislature will need to decide not only whether it agrees with the Governor's basic spending priorities, but also whether it agrees with the Governor's proposed mix of one-time versus ongoing budgetary solutions.

Acknowledgments

This report was prepared by Brad Williams and Jon David Vasché, with contributions from others in the office. For questions, contact the authors at 324-4942. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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