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2002-03: Overview of the Governor's Budget

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The *2002-03 Governor's Budget* lays out the administration's spending priorities and offers a plan for addressing the state's $12-plus billion budgetary shortfall. While "on paper" the plan appears to work, many of its assumptions are overly optimistic, it relies largely on one-time solutions, and it results in substantial long-term out-year costs. Moreover, the plan does not resolve the state's budgetary imbalance in subsequent years, thereby continuing the risk of future shortfalls. ■

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OVERVIEW OF THE GOVERNOR'S BUDGET

INTRODUCTION

The Governor's 2002-03 budget proposes a plan for addressing the state's multibillion dollar imbalance between General Fund revenues and expenditures. It does this through a variety of actions, including spending cuts and deferrals, revenue accelerations, asset sales, and loans from special funds. The budget's basic strategy reflects the assumption that the current imbalance between revenues and expenditures is primarily a *temporary* one, brought about by a drop in revenues resulting from a recession that itself is expected to be mild and short-lived. As a consequence, most of the budget's proposed solutions involve one-time savings or revenue accelerations, on the theory that the improved economic conditions associated with the projected economic recovery will keep the budget balanced over the longer term. As discussed below, while this strategy has enabled the administration to avoid deeper multiyear spending reductions or tax increases, its heavy reliance on one-time solutions and certain questionable assumptions raises the risk of substantial future budgetary imbalances emerging.

TOTAL STATE SPENDING

The budget proposes total state spending in 2002-03 of $97.9 billion (excluding expenditures of federal funds and selected bond funds). This represents a slight decrease of 0.4 percent from the current year. About 80 percent of total spending is from the General Fund, while the remainder is from special funds.

GENERAL FUND CONDITION

Figure 1 shows the General Fund's condition under the budget's assumptions and proposals. It shows that in the current year, revenues are projected to be $77.1 billion, expenditures are estimated to be $78.4 billion, and the year is expected to end with a negligible reserve of $12 million. In 2002-03, the budget projects that General Fund revenues will total $79.3 billion, an increase of about $2.2 billion (2.9 percent) from the current year, while expenditures are estimated to be $78.8 billion, a $400 million (0.5 percent) increase from the current year.

Figure 1

Governor's Budget General Fund Condition

(Dollars in Millions)

			Proposed 2002-03	
	2000-01	2001-02	Amount	Percent Change
Prior-year fund balance	$9,408	$2,783	$1,486	
Revenues and transfers[a]	71,428	77,083	79,305	2.9%
Total resources available	$80,836	$79,865	$80,790	
Expenditures	$78,053	$78,380	$78,806	0.5%
Ending fund balance	$2,783	$1,486	$1,984	
Encumbrances	$1,473	$1,473	$1,473	
Reserve	**$1,310**	**$12**	**$511**	

Detail may not total due to rounding.

[a] Reflects $6.2 billion General Fund loan to Electric Power Fund in 2000-01 with repayment in 2001-02.

Under the budget proposal, 2002-03 would end with a budgetary reserve of $511 million.

How the Budget Addresses the Shortfall

How Big Is the Problem? The budget identifies a cumulative budget shortfall of $12.5 billion in 2002-03, consisting of a current-year deficit of $3 billion, a budget-year imbalance between revenues and expenditures of about $9 billion, and the need to rebuild the reserve of $500 million.

The amount of the cumulative shortfall identified by the administration is similar in overall magnitude to our November projection of a $12.4 billion 2002-03 shortfall. However, its components are significantly different. Specifically, the administration is forecasting about $2 billion more in combined current-year and budget-year revenues than we had projected in November. These higher revenues are roughly offset, however, by (1) the costs of funding the reserve ($500 million) and (2) about $1.5 billion in net increases in the administration's definition of baseline expenditures relative to the current-law baseline used in our November report.

Key Solutions. Using the administration's estimate of revenues, expenditures, and the budget shortfall as the starting point, the budget proposes to close the $12.5 billion funding gap through a variety of measures. These are summarized in Figure 2 and include:

- ***Spending Reductions ($5.2 Billion).*** In November, the Governor proposed about $2.5 billion in spending reductions (current year and budget year combined) from program areas throughout the budget. The January budget assumes implementation of these reductions. The budget plan also contains an additional $2.7 billion in budget-year reductions, including such things as suspensions of cost-of-living adjustments (COLAs) in various social services programs, postponements of some recent health care expansions, reduced inflationary adjustments for higher education, and various other program reductions.

- ***Fund Shifts ($586 Million).*** These include shifts of capital outlay support from the General Fund to lease-revenue bonds, and various spending shifts from the General Fund to special funds.

Figure 2

How the Governor "Bridges the Gap"

(In Millions)

	Amount
Major Spending Reductions	**$5,226**
November Revision reductions	2,449
Budget-year reductions	2,677
Reserve for litigation	100
Fund Shifts	**$586**
Shifts proposed in November Revision	152
Other shifts	434
Federal Funding Increases	**$1,066**
Medi-Cal FMAP offset	400
Security/bioterrorism funding	350
Child support system penalty relief	181
Undocumented felon incarceration (SCAAP)	50
All others	85
Loans/Accelerations/Transfers	**$5,624**
Securitization of tobacco settlement funds	2,400
Loan from Traffic Congestion Relief Fund	672
Loans from various special funds	579
STRS payment deferral/benefit improvement	508
PERS payment deferral/benefit improvement	371
All others	1,094
Total	**$12,502**

- ***Federal Funding Increases ($1.1 Billion)***. The budget assumes additional federal funds to offset state costs for Medi-Cal, undocumented felon incarceration, and security activities. It also assumes elimination of federal child support penalties.

- ***Revenue Accelerations, Spending Deferrals, Loans, and Transfers ($5.6 Billion).*** About $2.4 billion of this total would come from the sale of a revenue bond, which would be paid off using future tobacco settlement funds. These funds currently support a variety of recently adopted health expansions. Also included in this category are payment deferrals to the state teachers' and public employees' retirement funds, a loan from the Traffic Congestion Relief Fund, and various other special fund loans and transfers.

THE BUDGET'S ECONOMIC AND REVENUE PROJECTIONS

ECONOMIC ASSUMPTIONS

Economy Currently in Recession. Both the U.S. and California economies currently remain in the midst of a recession that began in the spring of 2001. This downturn was primarily caused by two factors:

- A retrenchment in business investment spending, particularly involving high-tech goods and related services.

- Declining exports to foreign nations, reflecting a weak international trade environment.

These and related factors have led to significant job losses in manufacturing in California, beginning in early 2001. This manufacturing downturn spread to other areas of the economy in the latter half of 2001, especially in the aftermath of the September 11 terrorist attacks. While recent economic data suggest that the downturn is nearing bottom, basic economic conditions remained relatively weak as of year end.

Personal Income Especially Hard Hit. It is important to note that California personal income has been especially hard hit during the recession, rising by only 1.4 percent in 2001 compared to the nation's 5 percent gain. This reflects not only the income losses from recession-induced job and production cutbacks, but also a dramatic reduction in the amount of bonuses and stock options paid by California employers.

Rebound Expected in Spring. The administration's forecast assumes that both the U.S. and California economies will stabilize in the first quarter of 2002 and then begin a sustained moderate expansion in the spring. The key forces behind the recovery forecast are recent interest rate cuts by the Federal Reserve, past federal tax reductions and spending increases, the observed rebound in consumer and business confidence from its post-September 11 low, and recent declines in business inventories (which mean that new spending will need to be matched by increased production).

Recovery to Accelerate Through 2003. As shown in Figure 3, California's downturn in jobs is expected to be more mild and short-lived than for the nation as a whole. The budget projects California wage and salary employment to start growing modestly late in the first half of 2002, and then steadily accelerate throughout the year's second half and thereafter. For 2003, job growth is projected to be a respectable 2.4 percent.

Although the state also is projected to experience moderate personal income growth in 2002 and 2003 on a par with the nation, this growth will be on a *significantly reduced base* given the dramatic 2001 falloff in bonuses and stock options. These two income sources will remain well below their previous levels. This, in conjunction with the reduced level of capital gains (which are not a part of personal income but nevertheless are taxed), will adversely affect income tax revenues.

Revenue Outlook

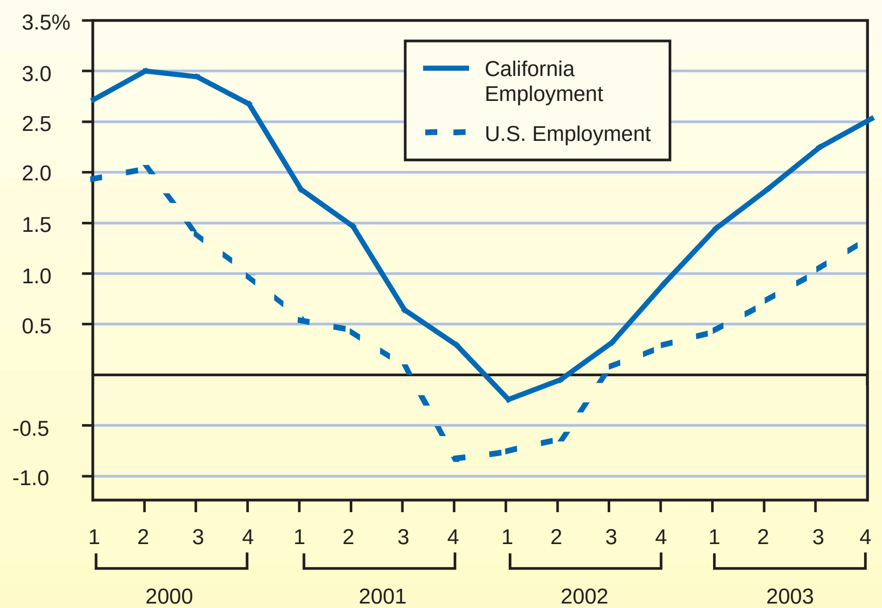
Revenues to Fall in 2001-02, Rebound in 2002-03. The budget forecasts that total General Fund revenues and transfers will grow from $71.4 billion in 2000-01 to $77.1 billion in 2001-02 and $79.3 billion in 2002-03. Numerous policy-related factors are embedded in these figures. These include:

- A transfer out of the General Fund of $6.2 billion in 2000-01 related to loans to the Department of Water Resources' Electric Power Fund.
- An offsetting transfer back into the General Fund of $6.5 billion in 2001-02 reflecting repayment of and interest on these electricity loans, financed from an assumed electricity revenue bond sale in June 2002.
- A $2.4 billion transfer into the General Fund in 2002-03 associated with the administration's tobacco settlement securitization proposal.

Figure 3

Budget Assumes Mild California Recession Ending by Spring 2002

Year-Over-Year Percent Change, By Quarter



- Numerous other transfers and loans to the General Fund from special funds during the three years.

- A net 2002-03 revenue gain of $180 million associated with various tax-related changes proposed in the budget (discussed below).

Eliminating the distorting effects of these factors, underlying General Fund revenues are projected to decline by 9.4 percent in the current year and increase by a moderate 7.2 percent in 2002-03.

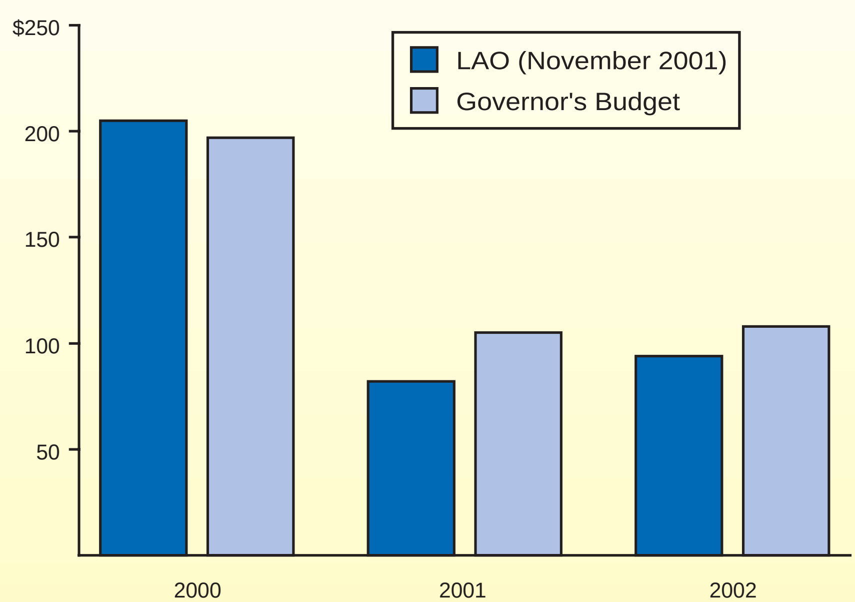
Revenue Estimate Is Far Above November Legislative Analyst's Office Projection. After adjusting for differences in policy assumptions, the 2002-03 budget revenue forecast is above our November projections by $1.7 billion in 2001-02 and about $300 million in 2002-03. While the administration's underlying assumptions for most economic and revenue variables are either similar to or slightly more conservative than our November figures, the administration is far more optimistic than us with regard to personal income tax (PIT) receipts.

Stock Options and Capital Gains Are the Issue. The budget's higher PIT forecast is due to its more optimistic assumptions about the stock market. As shown in Figure 4, the budget forecasts that income from stock options and capital gains will fall from $197 billion in 2000 to $105 billion in 2001—a decline of 47 percent—before growing slightly to $108 billion in 2002. In contrast, our November forecast assumes that the decline will be an even steeper 60 percent in 2001—to $82 billion—before rebounding by 15 percent (to $94 billion) in 2002. The difference in these assumptions translates into about $2 billion in PIT revenues in 2001-02 and about $1.3 billion in 2002-03, thus more than explaining our total revenue difference.

Figure 4

Budget's Forecast of Options and Gains Exceeds LAO's

California Income From Stock Options and Capital Gains (In Billions)



Administration Overly Optimistic. Weak year-end receipts from PIT taxpayers suggest that revenues from capital gains and options are below our November estimates, and thus, significantly weaker than the administration's higher projections. If recent negative collection trends continue, 2001-02 revenues could fall below the budget forecast by $3 billion or more.

Over the next month, we will be monitoring economic and revenue trends, and will incorporate these and other factors into our updated revenue projections in our publication entitled *The 2002-03 Budget: Perspectives and Issues.*

THE GOVERNOR'S MAJOR PROPOSALS BY PROGRAM AREA

Figure 5 shows the budget's proposed General Fund spending by major program areas for 2000-01 through 2002-03. It indicates that:

- ***K-12 Education.*** Total General Fund spending for K-12 education remains essentially flat, growing by 1.1 percent in 2002-03. This reflects a very small increase in the Proposition 98 minimum funding guarantee (2.2 percent, most of which is funded by growth in property tax revenues).

- ***Medi-Cal.*** This shows a 3.8 percent increase due in part to recent policy decisions to expand eligibility. This increase is offset by several spending reductions, including reforms in the way drugs are purchased and provided to patients, cuts in provider rates, and establishment of copayments for certain patients.

- ***Social Services.*** California Work Opportunity and Responsibility to Kids (CalWORKs) shows an increase of

Figure 5

General Fund Spending by Major Program Area

(Dollars in Millions)

			Proposed 2002-03	
	Actual 2000-01	Estimated 2001-02	Amount	Percent Change
Education Programs				
K-12 Proposition 98	$27,229	$28,270	$28,582	1.1%
Community Colleges Proposition 98	2,680	2,693	2,682	-0.4
UC/CSU	5,644	6,166	6,104	-1.0
Other	3,343	4,202	3,933	-6.4
Health and Social Service Programs				
Medi-Cal	$9,168	$9,705	$10,072	3.8%
CalWORKs	1,966	2,015	2,151	6.7
SSI/SSP	2,555	2,821	3,049	8.1
Other	6,121	7,181	7,169	-0.2
Youth and Adult Corrections	$5,298	$5,372	$5,274	-1.8%
All Other	$14,050	$9,956	$9,790	-1.7%
Totals	**$78,053**	**$78,380**	**$78,806**	**0.5%**

Detail may not total due to rounding.

6.7 percent, with total funding equaling the minimum level required by federal law. The Supplemental Security Income/State Supplementary Program (SSI/SSP) also shows an increase in the budget year (8.1 percent) mainly due to prior-year COLA adjustments and 2 percent caseload growth.

- ***Youth and Adult Corrections*** This shows a decline of 1.8 percent in the budget year, primarily reflecting declining inmate and ward caseloads.

- ***Other Programs.*** These show a collective decline of 1.7 percent, reflecting reductions in resources and environmental protection, as well as in general government programs.

K-12 EDUCATION

Proposition 98 allocations to K-12 schools (which include local property tax revenues) total $41.2 billion in 2002-03. This represents an increase of $1.2 billion, or 3.1 percent, over the Governor's current-year estimate. This current-year estimate includes significant reductions proposed by the Governor in November. Relative to the level of funding approved in the *2001-02 Budget Act*, the proposed spending level for 2002-03 represents an increase of $734 million, or 1.8 percent. The budget proposes Proposition 98 resources of $7,058 per pupil for 2002-03. This represents an increase of 2 percent relative to the revised current-year estimate and 0.8 percent relative to the *2001-02 Budget Act* amount.

The budget proposes Proposition 98 spending equal to the minimum funding requirement. Within this amount, the budget provides $843 million for a 2.15 percent COLA for revenue limits and most categorical programs. The budget also provides $438 million for statutory growth, based on projected statewide attendance growth of 1.07 percent. The combined amounts for COLAs and statutory growth exceeds the total increase in Proposition 98 funds by about $60 million.

In addition, the budget proposes several program augmentations and also provides ongoing funds for various programs funded in the current year with one-time monies. To bridge the resulting funding gap, the budget for K-12 education depends on current-year and budget-year reductions to various existing programs.

Budget Risk Associated With Proposition 98. The minimum funding requirement for Proposition 98 programs in 2002-03 will depend largely on an estimate of the change in California personal income that itself will depend on an index of personal income to be published by the federal government in April or May 2002. (The use of this federal index is specified by state law.) The administration's estimate of the minimum funding requirement for Proposition 98 for 2002-03 assumes an estimated decline in California per-capita personal income of approximately 3 percent. In our November report, we forecast a 1 percent decline, and placed a 3 percent decline at the low end of a range of probable outcomes. If the federal government index is consistent with our 1 percent forecast, the General Fund would have to provide an additional $935 million for Proposition 98 programs in the budget year. (Each percentage point change in this factor means a General Fund change of almost $470 million.)

Concerns Regarding Current-Year K-12 Reductions. We also have concerns about the following three reductions proposed by the Governor for current-year K-12 education programs, totaling almost $143 million:

- Per-pupil block grant ($68 million).
- Revenue limit equalization ($40 million).
- Revenue limits: Public Employees' Retirement System (PERS) offset ($35 million).

School districts are well into the current fiscal year, having budgeted existing core programs on the assumed receipt of the above funds. Thus, loss of these funds could affect existing school operations and/or school district operating reserves. Moreover, the proposed budget plan does not utilize these three reductions for the purpose of addressing the General Fund's budget shortfall. Instead, it retains the $143 million in a special account (the Proposition 98 Reversion Account) and proposes to spend the freed-up funds on new one-time K-12 proposals. In our December report, *Addressing the State's Fiscal Problems*, we identified many alternative possibilities for current-year General Fund savings in K-12 education.

HIGHER EDUCATION

Community Colleges. The budget proposes $4.7 billion in Proposition 98 funding for California Community Colleges. This represents an increase of 3 percent over the current year. The increase includes support for 3 percent growth in enrollment and a 2.15 percent COLA. The budget makes reductions in various categorical programs and proposes some increases in spending to backfill ongoing programs that were funded with one-time funds in the current year. The General Fund component of Proposition 98 funding is reduced by 0.4 percent due to an anticipated increase in local property taxes.

University of California (UC) and California State University (CSU). Here, the budget proposal includes a combined 2002-03 General Fund reduction of 1 percent, comprised of a 2.5 percent reduction for UC and an increase of about 1 percent for CSU. These budgets support a 1.5 percent general increase and 3.9 percent enrollment growth for both UC and CSU. Funding is also included for increased state support of summer instruction and one-time funds to recruit faculty for UC Merced. In addition, reductions are proposed in various outreach and technology programs. The UC budget shows a reduction in the budget year due to the volume of one-time capital outlay projects in the current year.

STATE RETIREMENT CONTRIBUTIONS

The Governor's budget proposes to postpone payment of the state's retirement contributions to the PERS and the State Teachers' Retirement System (STRS) in exchange for the administration's support of particular retirement benefit increases. The administration has indicated that it will reassess these proposals for the May Revision in light of the state revenue picture at that time.

Public Employees' Retirement System. The PERS board has lowered the state contribution rates for the current and budget years by recognizing past investment returns more quickly. This results in a total General Fund savings of $496 million for state ($371 million) and non-teaching school employees ($125 million) in 2002-03. The state would have otherwise realized these savings in future years. As a result, the state would make up these lower contributions over 30 years by paying about $30 million to $40 million per year. These contributions would increase thereafter with the growth in payroll.

In exchange for lowering the state's retirement contributions, the administration has agreed to support legislation that increases payments to retirees to provide purchasing power protection at 80 percent instead of 75 percent of the initial pension amount effective January 1, 2005. This would increase the state's General Fund retirement contributions by about $100 million annually for 20 years to pay for the unfunded cost of providing this benefit for state and school service already rendered. (These costs total $1.1 billion in today's dollars.) Additionally, beginning in 2006-07, the state's annual retirement contribution would be higher by an undetermined amount to pay for the cost of providing this benefit on an ongoing basis.

State Teachers' Retirement System. The provisions of the STRS agreement have not been finalized. Under the current tentative agreement, the state would not pay eight quarters of its contributions for retirement benefits. This results in current-year and budget-year General Fund savings of $508 million. The state would make up these payments by increasing the state's contribution to STRS in the future. In exchange, the administration has agreed to support an as-yet-undetermined increase in benefits.

OTHER PROGRAMS

Medi-Cal. The budget proposes $10.1 billion in funding for Medi-Cal in 2002-03, an increase of 3.8 percent above the proposed current-year spending level of $9.7 billion. These figures do not take into account an assumption in the budget plan that the state will receive $400 million in federal financial relief in the current year to offset a formula-driven reduction in the federal share of cost for support of the program.

The Medi-Cal budget reflects an increase of about 300,000 eligibles, or 4.9 percent, in the budget year. This is primarily as a result of recent policy decisions to expand eligibility and to make it easier to sign up and keep beneficiaries enrolled in the program. The spending level also reflects proposals for certain spending reductions, including reforms in the way drugs are purchased and provided to patients ($100 million), cuts in provider rates ($78 million), and establishment of copayments for certain patients ($31 million).

Other Health Programs. The budget assumes that expansion of the Healthy Families Program to parents, initially slated to start in the current fiscal year, will be postponed until 2003-04. The line-up of health programs supported from the new Tobacco Settlement Fund is proposed to change significantly, and about $62 million of the funds anticipated in the budget year will be diverted to pay the debt-service costs of a bond that will allow the state to accelerate its collection of $2.4 billion from this source. (In future years, the annual amounts diverted for debt-service payments will increase to $190 million.) The budget plan would also eliminate the Child Health and Disability Prevention program and shift eligible children to Medi-Cal, the Healthy Families Program, and the Expanded Access to Primary Care community clinics program. Significant reductions are also proposed for local assistance programs for the mentally ill, persons with drug and alcohol problems, and the developmentally disabled.

Social Services. The budget proposes to suspend statutory COLAs for CalWORKs and SSI/SSP, and does not provide the discretionary COLA for Foster Care and related programs. This results in a General Fund savings of $273 million. The budget also provides no inflation adjustment for county administration of CalWORKs, Foster Care, or Food Stamps, resulting in savings of $57 million. In order to maintain CalWORKs General Fund spending at the minimum level required by federal law, the budget proposes to redirect $189 million in county performance incentives to fund basic CalWORKs grants and services. Finally, the budget assumes General Fund savings of $226 million from federal law changes that (1) eliminate the federal child support automation penalty ($181 million) and (2) restore federal Food Stamp eligibility for noncitizens currently served in a state-only program ($35 million).

Child Care. The Governor proposes to reform California's subsidized child care system by modifying current eligibility rules, reimbursement rate limits, and family fees. Specifically, the proposal would eliminate eligibility for 13-year old children, reduce reimbursement rates, and increase fees for higher-income families. Additionally, former CalWORKs recipients would no longer be automatically eligible for child care services. The Governor proposes to reinvest the resulting savings, thereby increasing the availability of subsidized child care for approximately 100,000 children.

Youth and Adult Corrections. The budget proposes reduced General Fund spending for the California Department of Corrections and the Department of the Youth Authority due to reduced inmate and ward populations, respectively. In addition, the budget proposes savings from deactivating some community correctional facilities and shifting General Fund support for some programs to Workforce Investment Act funds. The budget also assumes that an additional $50 million in federal funds for undocumented felons will offset General Fund costs in the budget year.

Transportation. The budget proposes to loan $672 million from the Transportation Congestion Relief Fund (TCRF) to the General Fund. This amount is in addition to the $238 million transferred in the current year from the TCRF to the General Fund. The budget anticipates that the General Fund will repay the TCRF loans over a three-year period beginning in 2003-04.

As originally established in 2000, the TCRF received $2 billion from the General Fund in 2000-01, including $1.6 billion to fund 141 specific projects. The budget estimates that expenditures for these projects will total $820 million in 2002-03. In order to both make the General Fund loan and at the same time pay for the estimated project expenditures, the budget proposes to backfill the TCRF with $474 million from the State Highway Account (SHA). The SHA funds would be freed up, in part, by deferring their use for toll bridge seismic retrofit in the current and budget years. Rather, the budget proposes to issue $210 million of short-term bonds to fund anticipated toll bridge seismic retrofit expenditures in 2002-03.

Local Government. The budget does not change major local government revenues, including the property tax and vehicle license fee. Existing criminal justice grant programs, such as the Citizens' Option for Public Safety and technology grant programs, are continued.

Certain proposals of the Governor regarding state-county health and social services programs may increase county costs.

Capital Outlay. The budget includes $2 billion for capital outlay projects, of which the vast majority are financed from bonds. Included in this total is over $670 million in new lease-revenue bonds, which are part of the Governor's Economic Stimulus Package to accelerate new public works projects. Direct General Fund appropriations for capital outlay total $66 million, and are for funding projects at various correctional institutions, and new armories and other projects for the Military Department.

Tax-Related Proposals

The budget proposes that the state conform to the recently enacted federal increases in retirement fund contribution limits. It also would increase, from 80 percent up to the federal requirement of 90 percent, the amount of annual tax liabilities that must be paid in the form of withholding and estimated tax payments. Finally, it would require that corporations elect the same corporate tax status on both state and federal returns. The net impact of these measures is a revenue gain of $180 million in 2002-03, revenue reductions of about $59 million in 2003-04, and $75 million in 2004-05.

CONSIDERATIONS FOR THE LEGISLATURE

As it reviews the Governor's budgetary proposals in the coming months, the Legislature may find it helpful to focus on several key budget-related considerations. Specifically, there are several principles that merit attention in crafting an overall budget solution. As discussed in our recent report entitled *Addressing the State's Fiscal Problem*, these are:

- A wide range of alternative individual budget solutions should be considered.
- The out-year repercussions of solutions should be assessed.
- Individual solutions should "make sense" and not be counterproductive.
- Current-year solutions should play a key role.

Focusing on these principles will help ensure that the overall budget solution ultimately adopted will both (1) reflect the Legislature's priorities and (2) be effective from both a near-term and longer-term perspective.

How Does the Governor's Plan "Stack Up?"

We will be reviewing and evaluating the various elements of the Governor's plan in the weeks to come and presenting our findings in our February *Analysis of the 2002-03 Budget Bill*. However, several things immediately stand out about the plan that will merit the Legislature's attention.

Budget Plan Contains Numerous Risks. The budget proposal for dealing with the shortfall contains a number of optimistic assumptions that are subject to considerable risk. These risks fall into several key areas:

- ***Revenues.*** As noted previously, we believe that revenues are likely to be substantially below the administration's forecast due to its optimistic assumptions regarding stock options and capital gains.

- ***Federal Funds.*** While it is likely the state will receive some additional federal support, it is unlikely to meet expectations.

- ***Proposition 98.*** The minimum funding requirement could prove to be up to $900 million above the budget forecast.

In addition, the General Fund faces a cash-flow risk associated with the assumed repayment of the $6-plus billion in General Fund loans to the Electric Power Fund. The revenue bond sale to finance the repayment cannot occur until certain issues are resolved affecting its marketability.

Budget Plan Does Not Eliminate Out-Year Deficits. In our November report, we indicated that the state faces both a near-term budget shortfall *and* an ongoing operating deficit (that is, expenditures in excess of revenues). The latter, if not addressed, will result in large budget deficits in future years.

The Governor's plan does not address this out-year problem. This is because it relies heavily on one-time as opposed to multiyear solutions. Indeed, many of the budget's proposals, such as the securitization of future tobacco settlement revenues, the delay in retirement fund contributions, and the borrowings from special funds, would increase out-year expenditures and thus, aggravate the already-projected future imbalances between revenues and expenditures.

As a result, even though the year-end 2002-03 budget would be balanced under the Governor's assumptions, we estimate that an operating deficit of nearly $4 billion would emerge in 2003-04. Thus, it is important that the Legislature weigh the future costs of the Governor's proposed deferrals against these near-term benefits.

Additional Solutions Should Be Considered. Given the above, and the risks inherent in the Governor's plan, an important legislative consideration is what additional budget-related solutions should be adopted to ensure that a balanced budget is both achieved in the near term and maintained in the future.