LAO
65 YEARS OF SERVICE

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To: Legislative Budget Staff

From: Mac Taylor
Legislative Analyst's Office

Subject: March 2010 Fiscal Update

Several of you have inquired about whether we plan to update our estimate of the size of the state's budget problem prior to the May Revision. In recent weeks, our staff has worked on a budget forecast that we were hoping to release publicly before the Legislature's spring recess and the all-important revenue collection month of April. The extended special session and the Governor's timing in acting on special session bills now make it impractical for us to complete a public document before the spring recess. We did, however, want to share some key thoughts resulting from our recent forecasting efforts.

As you are aware, the key developments in state finances in recent months have been the improvement in the economy and state revenues. We describe that improvement below, but caution the Legislature that it is unlikely that increased revenues will allow the state to avoid making the types of very difficult budgetary decisions for 2010-11 that we have identified as necessary in our recent publications.

Revenue Picture Looking Up

Near-Term Economic Outlook Improves Slightly. In November, we projected that the national and state economies would experience a modest recovery in 2010 and 2011 from the deep recession of 2008 and 2009. In January, the Governor's budget projected a similar path. Those forecasts are still on track, although the near-term outlook appears slightly better, with national gross domestic product growing 5.9 percent in the fourth quarter of 2009. The labor market appears to have stabilized after two years of massive job losses, and the state should start adding jobs on a net basis beginning in the second quarter of 2010. We expect wage and salary employment growth to turn positive on an annual basis in 2011, with California slightly trailing the rest of the nation in the coming years. We expect the lingering effects of the bursting of the housing bubble and the subsequent financial crisis to continue to dampen growth in California. In particular, relatively weak demand for new residential and commercial construction are leading us to have somewhat lower expectations of growth in the out-years compared to our previous economic forecasts.

Revenues Better Than Expected. Consistent with the near-term improvement in the economic outlook, we now expect that state revenues will be somewhat higher than estimated in the *2010-11 Governor's Budget* and our November 2009 fiscal forecast. Specifically, we project that current-law revenues will be about $2 billion higher than indicated in the Governor's budget for the three fiscal years 2008-09, 2009-10, and 2010-11 combined. (Our new outlook represents over $4 billion more revenue than indicated in our November forecast for the three fiscal years combined.) In particular, we foresee sales and use tax revenues rising above the levels assumed by the administration as consumers begin to spend again after three straight fiscal years of declines in taxable sales (through 2009-10).

Evaluating Recent Cash Receipts. Cash receipts have been particularly strong from December through February this year—pushing revenues $2 billion above the administration's monthly projections in the current fiscal year alone. Since our models are indicating an increase above the administration of $2 billion over the three fiscal years *combined*, there would have to be a modest reversal of the current-year revenue trend during the final four months of 2009-10 for our projections to be on track. We are concerned that the higher monthly revenue levels are not entirely consistent with the underlying economic indicators. In addition, with several mechanisms adopted in the past two budgets designed to accelerate revenues, it may be that the timing of the state's cash collections now follows a different pattern than assumed in the Governor's budget.

At the same time, it is possible that recent revenue collections indicate a relative strength not yet reflected in our updated numbers. Accordingly, there is a significant potential for further upward revenue adjustments. The state still has roughly 40 percent of this year's revenues to collect in the year's final four months. As always, the strength of the state's crucial net income tax receipts in April will solidify the numbers for this year and help illuminate the likely revenue trend for the budget year. At the time of the May Revision, we will be in a better position to advise you on a reasonable level of revenue to assume for the 2010-11 budget.

Over One-Half of the New Revenues May Have to Be Spent on Proposition 98. In considering how new revenues may affect the size of the state's budget problem, it is important to keep in mind that a large portion of each additional dollar in new state revenues will be required to go to current-law Proposition 98 school funding obligations. Specifically, we estimate that up to about 60 percent of the newly identified revenues above our current forecast will be required to go to these Proposition 98 obligations. While this helps schools, it means that "new" revenues provide much less budgetary solution than on first blush.

Expenditure Trends Mixed

Various Expenditure Changes Since Our November Forecast. As described above, we now estimate that current-law revenues will be over $4 billion higher for 2008-09, 2009-10, and 2010-11 combined, as compared to those projected in our November 2009 fiscal forecast. We have also reviewed current-law 2009-10 and 2010-11 General Fund spending. Our view is that General Fund expenditures for these fiscal years will be about $2 billion higher than we estimated in November—driven principally by (1) higher Proposition 98 spending obligations connected with the higher revenues, (2) higher spending due largely to court cases in the social services area, (3) lower spending in Medi-Cal due to a recent announcement of $680 million in one-time state relief from Medicare Part D "clawback" payments, (4) lower spending due to special session bills approved by the Governor, and (5) various other estimating differences which, on net, lower spending. Considering both updated revenue and expenditure trends, we estimate that the 2010-11 budget problem yet to be resolved by the Legislature is around $2 billion less than the $20.7 billion we estimated in November. This places the 2010-11 budget problem at around $19 billion—roughly the same as that indicated by the Governor in his January 2010 budget proposal.

Possible Fiscal Developments in the Coming Weeks

Below we discuss three key issues that will help define the size of the budget problem the Legislature will face after the May Revision.

What If Agreement Can Be Reached on a Gas Tax Swap? We estimate that the version of the swap approved by the Legislature would have reduced the 2010-11 budget problem by almost $2 billion—split between (1) reductions in transportation-related debt service costs for the General Fund and (2) reductions in current-law Proposition 98 funding obligations. (Under current law, we project that Proposition 98 will be in Test 2 in 2010-11, making the "Test 1 hold harmless" language approved as part of the gas tax swap not applicable.)

What If the Federal Government Sends More Funds to California? As we noted in our January 2010 publication, *Overview of the Governor's Budget*, we do not believe it would be prudent for the Legislature to pass a budget this year that assumes that the federal government will provide $6.9 billion in funding that can be used to address the state's budget problem, as the Governor proposed. There is, however, active discussion in Washington of several funding increases that could improve California's bottom line in 2010-11. While the federal government's strained finances are complicating these discussions, it still appears possible that somewhere around $3 billion more in federal funding could be forthcoming for various health and social services programs. (As noted above, our expenditure outlook already assumes receipt of the $680 million of Medicare Part D relief announced by the Governor on February 18.)

What If Revenues Are Much Higher Than Now Forecast in April, May, and June? As noted, we estimate that revenues over the three fiscal years will be higher than indicated in the Governor's budget by a combined $2 billion. If, however, General Fund revenues come in even higher, we estimate that nearly 60 percent of these higher revenues would have to be devoted to current-law Proposition 98 funding obligations. For example, assume a very optimistic scenario where revenues come in $3 billion higher in 2009-10 and $3 billion higher in 2010-11 compared to our updated estimates. In this case, the size of the state's budget problem would be reduced by only about $2.5 billion given the offsetting increase in Proposition 98 obligations.

Building the 2010-11 Budget

Adopting the Governor's Proposals Probably Not Enough to Close the Deficit. Even if everything breaks in California's favor in the coming weeks—a gas tax swap agreement is reached, revenues surge, and the federal government delivers more funds—the budget problem that the Legislature would need to address would only be reduced by about $7.5 billion. As we have discussed in our recent publications, there are numerous problems with achieving several of the major proposed savings in the Governor's proposals, and, in addition, about $2 billion of his proposals are unlikely to be achieved due to timing delays or the decision of the Legislature not to place proposed savings measures on the June 2010 ballot. As a result, if the Legislature hypothetically were to adopt essentially all of the Governor's remaining budget proposals (excluding his "trigger" proposal) by June, we do not believe the budget would fully balance. Therefore, in order to produce a credible balanced budget, the Legislature will need to develop even more revenue and expenditure solutions—whether drawing from the Governor's federal funds trigger proposals or from elsewhere.

Stubborn Out-Year Problem Still Indicated. The state continues to face a stubborn annual gap between current-law revenues and expenditures of about $20 billion for each year through at least 2014-15. With a fairly weak economic recovery expected, and the short-term nature of many federal relief funds and previous budget actions, the majority of the Legislature's budget-balancing decisions this year need to be ongoing or multiyear in nature in order to begin restoring state finances to a sound footing. As we recommended in January, lawmakers should aim for a mix of budget solutions that results in a much smaller structural deficit—preferably well under $10 billion per year in future years.

The Legislature still faces incredibly daunting challenges in balancing the budget this year. In the coming weeks, we will evaluate the administration's May Revision proposal and continue to assist lawmakers as they complete this year's budget process.