

Overview of the 1997-98 May Revision

Sharply improving revenues, combined with large caseload-related budget savings, have enabled the administration to propose significant funding increases in the areas of K-12 education, welfare reform, and local government fiscal relief. This Budget Brief discusses the major changes in the May Revision to the Governor's 1997-98 budget proposal, and highlights some of the issues facing the Legislature as it considers the revised plan.

THE "BIG PICTURE"

\$3.4 Billion in Revenue Gains and Expenditure Savings. For the second straight year, the improving California economy has produced major upward revisions to state tax revenues. Along with major expenditure savings, this has enabled the administration to propose significant spending increases in the May Revision relative to the January budget proposal.

Figure 1 highlights the major features of the May Revision, which was released on May 14. It shows that higher revenues, lower health and welfare caseloads, and other savings have combined to produce \$3.4 billion in added budgetary

resources since January. Specifically, revenues are up \$2.3 billion over 1996-97 and 1997-98 combined, reflecting strong economic growth and higher-than-expected cash receipts

Figure 1

Key Features of the May Revision

- ✓ Significant two-year increase in General Fund resources—\$3.4 billion
 - Higher revenues—\$2.3 billion
 - Reduced health and welfare caseloads and other savings—\$1.1 billion
- ✓ How the added \$3.4 billion in resources is allocated:
 - Increased Proposition 98 funding—\$2.2 billion
 - Increased non-Proposition 98 spending—\$1.2 billion
- ✓ Budgetary reserve of \$580 million—essentially unchanged from January

in recent months. At the same time, caseload reductions in health and welfare programs, reduced debt-related expenses, and a number of smaller program savings, have combined to lower General Fund spending by about \$1.1 billion in the current and budget years combined.

Where Would the Money Go? Figure 1 also shows that \$2.2 billion of these new resources would go for K-14 spending, consistent with the Proposition 98 minimum funding guarantee, and \$1.2 billion would go toward increased spending on non-Proposition 98 programs. The revised spending plan includes significant new K-12 education funding for class size reduction and other initiatives, as well as new spending for welfare reform-related child care and local fiscal relief.

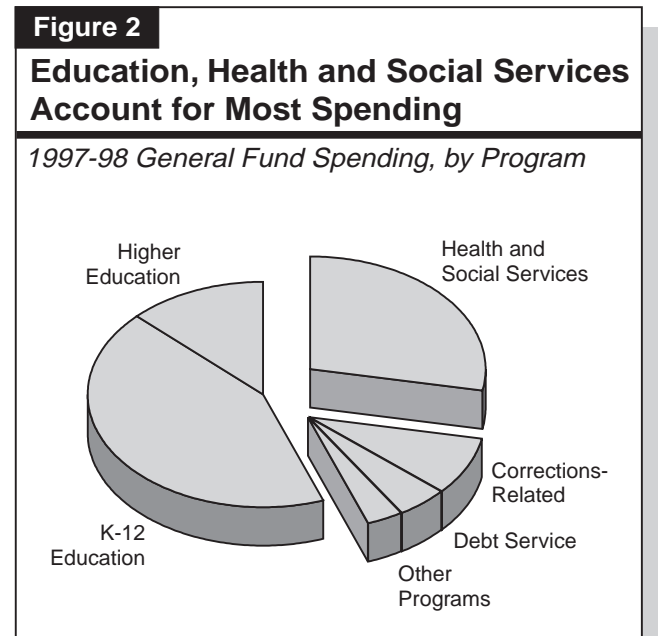
Because virtually all of the new resources are utilized for program spending, the revised budget proposal reflects only a slight net change to the 1997-98 year-end reserve. The revised budget plan would result in a reserve of \$580 million, up \$27 million from the January proposal.

Basic Budget Priorities Unchanged

Figure 2 shows the proposed break-out of General Fund spending for 1997-98, by major program area. It indicates that roughly 83 percent of the budget goes to fund education (55 percent, including 43 percent for K-12 education and 12 percent for higher education) and health and social services (about 28 percent). Youth and adult corrections account for an additional 8 percent, with the remainder for debt-service (5 percent) and all other programs (4 percent).

Since January, the “dollar size” of the expenditure pie has gotten bigger by \$2.3 billion. In

addition, the K-12 education share has gotten a bit bigger relative to the other pieces of the pie, due to the increased Proposition 98 funding.



Aside from the major changes in Proposition 98 funding, the May Revision retains most of the same priorities as the Governor’s January budget. Specifically, it includes the Governor’s corporate tax rate reduction proposal, his welfare reform plan, his proposals to make permanent certain welfare grant reductions, significant increases for higher education, full funding for the Department of Corrections, and no renters’ credit.

THE GENERAL FUND’S “BOTTOM LINE”

Figure 3 shows the May Revision General Fund condition statement, including carry-in balances, total revenues and expenditures, and the projected budgetary surplus.

Figure 3**General Fund Condition
May 1997 Revision***(In Millions)*

| | 1996-97 | 1997-98 |
|------------------------|-----------------|-----------------|
| Prior-year balance | \$564 | \$763 |
| Revenues and transfers | 49,365 | 51,960 |
| Total Resources | \$49,929 | \$52,723 |
| Expenditures | \$49,166 | \$51,692 |
| Fund Balance | \$763 | \$1,031 |
| Other Obligations | 451 | 451 |
| Reserve | 312 | 580 |

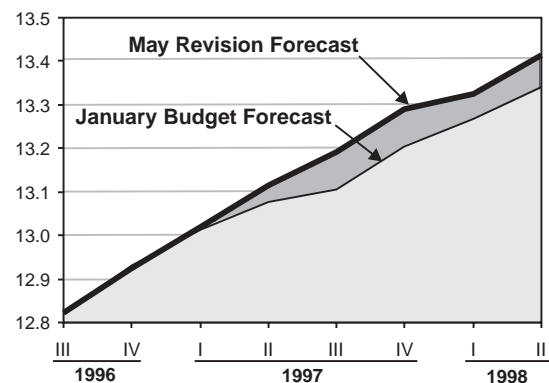
Revenues and Expenditures—Moderate Overall Growth. Revenues are projected to be \$49.4 billion in 1996-97 and \$52.0 billion in 1997-98, reflecting growth of 6.6 percent and 5.3 percent, respectively. Expenditures are projected to reach \$49.2 billion in 1996-97 and \$51.7 billion in 1997-98, reflecting growth of 8.0 percent and 5.1 percent. Budget-year expenditure growth (\$2.5 billion) is roughly in line with budget-year revenue growth (\$2.6 billion).

Modest Budget Surplus—Little Change. As Figure 3 indicates, the May Revision projects a 1997-98 year-end budgetary reserve of \$580 million. This is up slightly—by \$27 million—from the January budget projection, and is equivalent to about 1.1 percent of General Fund expenditures. On a cautionary note, such a reserve would provide the state with protection against relatively modest fiscal problems, but not more significant ones such as a material slowdown in the pace of economic growth. The projected reserve, however, is of better “quality” than January’s due to more realistic budgetary assumptions (see below).

THE ECONOMY AND REVENUES**Economic Performance—
Strong and Exceeding Expectations**

California’s economy in the first half of 1997 has been experiencing strong, broad-based economic growth with low inflation, and indications are that these positive trends will be continuing in the coming months. On the employment front (see Figure 4), the state added 374,000 jobs over the past year—a growth of 3 percent. Other signs of economic strength have included declining unemployment and increases in nonresidential construction.

The Economic Outlook—Revised Up. Reflecting current trends, the administration’s economic forecast has been revised up from January. As shown in Figure 4, for example, projected employment levels and job growth have increased. The department’s new economic forecast is similar to our own.

Figure 4**California’s Economic Outlook
Has Strengthened***Wage and Salary Jobs (In Millions)*

Revenues—Up Well Over \$2 Billion

The May Revision's two-year General Fund revenue forecast is up \$2.3 billion from January (including \$960 million for the current year and \$1.3 billion for the budget year). More than 95 percent (all but \$100 million) of this two-year revision is attributable to personal income taxes. The administration's revenue forecast incorporates the Governor's corporate tax reduction proposals (a combined fiscal effect of \$130 million in 1997-98, rising to over \$600 million by 2000-01 when fully phased in).

Revisions Are Reasonable. The new revenue figures generally are consistent with current economic and revenue collection trends, and in this context appear reasonable. Prior to the May Revision, we reported preliminarily that two-year revenues would be up by roughly \$2 billion but that we would "fine tune" our estimates later in the month, once certain data became available. Having had a chance to do this, our revised revenue projections indicate increased revenues of \$2.5 billion – or about \$250 million more than the Governor's May Revision. While this difference is significant in dollar terms, it is relatively small given the magnitude of total revenues (over \$50 billion annually).

EXPENDITURE CHANGES— PROPOSITION 98 K-14 SPENDING

As discussed above, the May Revision proposes to increase General Fund Proposition 98 funding by \$2.2 billion. Of this amount, \$2 billion represents additional spending for K-12 schools and community colleges. An additional \$205 million is required in order to offset lower anticipated property taxes due to (1) a \$105 million reduction in the antici-

pated growth in property taxes and (2) a proposed \$100 million shift of property taxes from schools to local government.

It is unusual for the minimum guarantee under Proposition 98 to "use up" such a large percentage of new General Fund revenues – the May Revision estimates that Proposition 98 would use virtually 100 percent of the new tax receipts. This large increase is due to three changes that have occurred since the Governor's Budget was issued in January:

Higher Revenues. The higher General Fund revenues trigger an increase in Proposition 98 funding. Our calculations show that \$986 million of the new Proposition 98 funds (about 45 percent of the May Revision General Fund increase) results from the higher tax receipts.

State Population. The Department of Finance reduced its 1996 estimate of the state's population. This change, which also affects subsequent years, acts to *increase* the Proposition 98 minimum guarantee. Our estimates show that the population revision accounts for \$576 million of the new Proposition 98 funds.

School Attendance. Preliminary reports of 1996-97 school attendance are up sharply from the January estimate. The revised attendance figures require an additional \$443 million in Proposition 98 funds.

The Spending Plan for K-12 Education

1995-96 and 1996-97 Funds. Figure 5 shows the major uses of new funds from 1995-96 and 1996-97. Under an agreement made as part of the 1996-97 Budget Act, about half of the new 1996-97 funds are proposed to increase the level of local revenue limits to (1) equalize low-funded districts and (2) provide across-the-board increases for all districts. The May Revision also proposes \$159 million for school district

Figure 5**May Revision Increases in K-12 Proposition 98 Spending***1995-96 and 1996-97 (In Millions)*

| Purpose | Amount |
|--------------------------------|--------|
| Equalization/deficit reduction | \$ 384 |
| Attendance/property taxes | 191 |
| Mandates | 159 |
| Deferred maintenance | 100 |
| Special education deficiency | 60 |

mandate claims, \$100 million for a one-time increase in deferred maintenance funding, and \$60 million to fund a deficiency in special education.

1997-98 Funds. Figure 6 displays the major May Revision increases in K-12 funding for 1997-98. The budget proposes \$411 million to continue the revenue limit increases proposed with prior-year funds in the budget year. The May Revision also proposes to increase funding for a variety of other initiatives, including \$230 million for higher per-pupil funding for class size reduction (\$800 per pupil), a \$64 million increase in the subsidized child care programs operated by the state Department of Education, and \$59 million for a new statewide pupil testing program.

Figure 6**May Revision Increases in K-12 Proposition 98 Spending***1997-98 (In Millions)*

| Purpose | Amount |
|------------------------------------|--------|
| Equalization/deficit reduction | \$ 411 |
| Class-size reduction | 230 |
| Attendance/property taxes | 208 |
| Categorical program growth | 83 |
| Child development | 64 |
| New testing program (net increase) | 59 |
| Digital high school | 50 |

The Spending Plan for Community Colleges

1995-96 and 1996-97 Funds. The May Revision proposes to increase one-time spending for community colleges by \$93 million. This includes a \$65 million addition to the block grant proposed in the Governor's Budget (for a total grant of \$119 million), a \$20 million one-time increase in facility maintenance funding, and a \$4 million increase in the proposed community college child care facilities revolving loan program (to \$10 million).

1997-98 Funds. The May Revision includes a \$109 million increase for community colleges. The largest budget-year increases are proposed for instructional equipment (\$29 million), offsetting lower estimated property taxes (\$26 million), and enrollment growth (\$18 million).

Considerations for the Legislature

The proposed 1997-98 K-14 budget as adjusted by the May Revision poses a number of significant policy and fiscal issues to the Legislature. These include:

- ❖ **Proposition 98.** The Legislature may want to assume our estimate of the Proposition 98 minimum funding guarantee, which is \$153 million higher than proposed in the May Revision. This higher estimate is due to (1) a higher General Fund estimate of revenues (\$250 million), (2) a higher estimate of K-12 attendance in 1997-98, and (3) a lower estimate of state population in the budget year.
- ❖ **K-12/Community College "Split."** We question the rationale for the large proposed increases in community college enrollment and expansion of an economic development program prior to its evaluation. The

Legislature should set its education priorities independent of a fixed ratio between K-12 and the community colleges.

❖ **Class Size Reduction.** The May Revision continues to propose full funding of four grades of class size reduction (Kindergarten through grade 3). Due to concern over an adequate supply of teachers and facilities to accomplish this proposal, the Legislature should delay implementation of a fourth grade.

EXPENDITURE CHANGES— NON-PROPOSITION 98 SPENDING

As noted previously, the May Revision shows non-Proposition 98 savings of \$1.1 billion, primarily due to health and welfare caseload declines and reduced debt-service costs. Essentially all of these savings are spent in the May Revision. Figure 7 summarizes the major new spending proposals involved. As shown, some of the savings are used for child care expenses related to welfare reform, and others for local government fiscal relief. The remaining savings are largely used in making budgetary assumptions more realistic.

More Realistic Budgetary Assumptions. The budget provides a \$216 million set-aside in the event that the federal government does not provide funding for emergency services for undocumented immigrants. It also increases state funding by \$47 million to reflect more realistic assumptions regarding federal reimbursements for the incarceration of illegal immigrant felons. These two factors reduce the General Fund's dependence on uncertain federal actions from \$636 million in January to \$373 million, the lowest in many years. Also included are \$60 million for local mandate claims (in

addition to those funded by Proposition 98), \$40 million for additional fire suppression costs, and \$20 million for disaster relief.

Developments Involving Health and Welfare

1. Medi-Cal

Caseloads and Average Costs. The May Revision estimates that Medi-Cal caseloads will decline by 1.4 percent in 1996-97 and 2.1 percent in 1997-98. Resulting savings, however, are largely offset by a projected increase in the average cost per eligible person—9.9 percent in the current year and 7 percent in the budget year (11 percent for AFDC recipients).

Figure 7

Non-Proposition 98 Spending Up \$1.2 Billion

| Major New Spending Proposals | (In Millions) |
|---|--------------------|
| AFDC/TANF | |
| • Child Care | \$213 |
| • Employment/training | 40 |
| Federal Assumptions | |
| • Emergency services to undocumented immigrants | \$216 |
| • Incarceration of illegal immigrant felons | 47 |
| • SSI/SSP for legal noncitizens | 153 |
| Local Government | |
| • Disproportionate share hospitals | \$75 |
| • ERAF property tax | (100) ^a |
| • Infrastructure bank | 50 |
| Other | |
| • Fire Protection | \$40 |
| • Office of Emergency Services | 20 |
| • Mandate claims | 60 |

^a This amount is a non-add as it is recorded as increased Proposition 98 spending.

We note that average costs per eligible person tend to rise in times of falling caseloads because persons who remain on the caseload tend to require relatively more care. The increases projected in the May Revision, however, appear to be larger than can be explained by this effect and anticipated inflation.

2. Temporary Assistance for Needy Families (TANF)

Caseloads. The May Revision estimates that AFDC/TANF caseloads will decline by 5.9 percent in 1996-97 and 10.1 percent in 1997-98. This would result in General Fund savings of about \$800 million over the two-year period, compared to the January budget estimate. The May Revision projection represents a significant acceleration in the declining trend in the caseload since 1994-95 (see Figure 8).

Based on *our* estimates, caseloads are projected to decline by 6 percent in the current year and 5.4 percent in the budget year. This would result in General Fund savings of about \$200 million *less* than the amount of savings estimated in the May Revision.

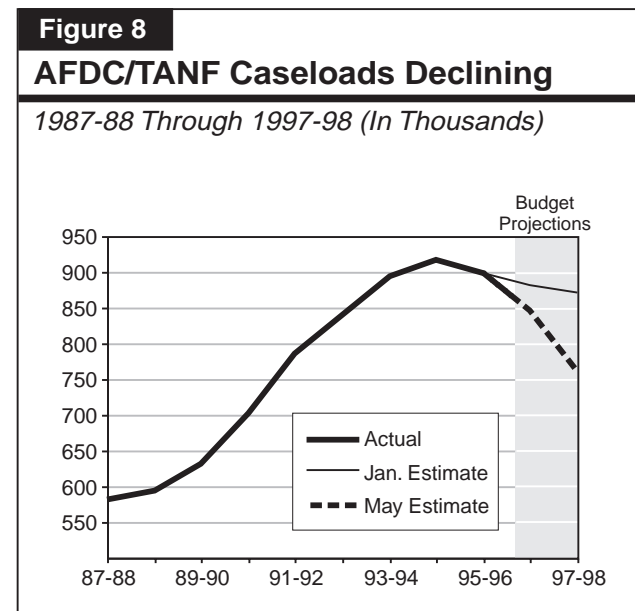
We note that there is considerable uncertainty in projecting AFDC/TANF caseloads. The May Revision estimate assumes continuation of the downward trend experienced over the last six months. While this estimate may not be unreasonable, it entails more risk than our projection. This is because it appears to rely heavily on a trend established over a relatively short period of time.

CalTAP. The May Revision proposes budget adjustments and an expansion of the Governor's welfare reform proposal (CalTAP). The major change consists of \$213 million in federal TANF block grant funds that would be allocated to the State Department of Education and then transferred to the Department of Social Services (DSS) to

provide child care for CalTAP recipients. This includes \$95 million to (1) correct a technical error in the January budget proposal, (2) adjust for an upward revision in the estimated costs, and (3) provide for additional child care due to a proposed change in the date of implementation of the services component of CalTAP for new applicants (from April to January 1998). Based on our preliminary review, however, the remaining \$118 million would not be needed to fund the direct child care requirements of CalTAP. The administration has not provided the Legislature with an expenditure plan for these funds. However, they could be used for CalTAP-related activities (for example, training new providers of child care).

3. SSI/SSP

Noncitizens. The January budget assumed General Fund savings of \$153 million due to elimination of SSI/SSP eligibility for legal noncitizens, pursuant to federal welfare reform legislation. Subsequently, Congressional leaders and the federal administration have agreed, in budget negotiations,



to continue eligibility for disabled noncitizens who were in the country prior to August 22, 1996. The May Revision restores these funds, as well as a related \$24 million in the In-Home Supportive Services program, on the assumption that the final federal budget agreement will restore eligibility.

Considerations For the Legislature

Most of the health and social services issues raised in the January budget, such as welfare reform, remain in the May Revision. Of the new issues associated with the May Revision, the following have the most significant fiscal and policy ramifications:

- ❖ What accounts for the large increase in average costs in the Medi-Cal Program?
- ❖ What caseload projections should the Legislature adopt for the AFDC/TANF Program?
- ❖ How does the administration plan to spend the \$118 million proposed for child care expansion?
- ❖ Should there be a contingency plan in the event Congress does not enact legislation to continue SSI/SSP eligibility for aged noncitizens who do not qualify under the disabled category?

Developments Involving Local Government

The Governor's Proposals. The May Revision proposes to return \$100 million of the approximately \$3.4 billion in property taxes that were transferred from counties, cities, and special districts to schools as part of previous budget agreements. The \$100 million is intended to be a permanent, ongoing reduction in the amount of the annual property tax shift. The allocation of the funds is yet to be determined; however, the administration has indicated that the allocation formula will take into account the funds that local entities receive from the ½ cent public safety sales tax.

The May Revision also proposes to provide \$75 million to certain counties under the Disproportionate Share Hospital Program and \$50 million to capitalize the California Infrastructure Bank.

Considerations for the Legislature. While the \$100 million property tax return will be available to local entities for general purposes, the \$75 million for the Disproportionate Share Hospital Program and the \$50 million to capitalize the California Infrastructure Bank are tied to specific programs. In addition, the May Revision includes \$100 million to continue the COPS program (also a targeted program) as proposed in January. The Legislature might want to consider combining funding from these and other proposals in order to provide a larger amount of discretionary resources to local governments.

Contact

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