

LEGISLATIVE ANALYST'S OFFICE

Budget Outlook Improves Substantially

On May 14, 1999, the administration is scheduled to release the May Revision to its January budget proposal for 1999-00. The updated budget plan will contain revisions to both the January proposal's revenue forecast and expenditure plan, taking into account such factors as recent positive economic developments, stronger-than-projected revenue receipts, and revised caseload projections. In this update, we discuss the brighter revenue outlook, along with some of the other developments potentially affecting the May Revision proposal.

Following the release of the May Revision, our office will publish its Overview of the 1999-00 May Revision, which will discuss the Governor's new proposals and provide our revised revenue projections.

For the fourth year in a row, California's budget outlook will show a major improvement in the May Revision. In particular, the revenue outlook is decidedly stronger. The improvement primarily reflects (1) a brighter near-term economic outlook than previously assumed and (2) higher-than-expected personal income tax receipts, especially

during the last month. A significant portion of the new revenues will be necessary to cover cost increases in Proposition 98 education and other state programs. Even after accounting for these new obligations, however, the Governor and Legislature will have discretion over a substantial amount of additional resources as they finalize the budget plan for 1999-00.

Economic Outlook Improves

The budget's economic forecast was prepared in late 1998 when it appeared that the Asian economic crisis was resulting in a significant slowdown in economic activity. Since that time, the economic picture has brightened considerably, as both the nation and California appear to have avoided a major slowdown emanating from Asia's problems. Based on continued growth in real gross domestic product (GDP), strong consumer confidence, and other factors, the consensus economic outlook for 1999 now calls for real GDP growth of over 3.5 percent, or nearly double the projection contained in the January budget forecast. In California, employment data revisions reveal that instead of slowing in late 1998 and early

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1999, as assumed in the January budget estimate, wage and salary jobs in the state continued to expand at a healthy pace (see Figure 1). This more positive trend is expected to continue through 1999.

Revenues up Sharply

The stronger economy, coupled with higher-than-expected tax receipts through April of this year, indicate that revenues will exceed the budget forecast by a substantial margin—probably in excess of \$2 billion in each of the current and budget years.

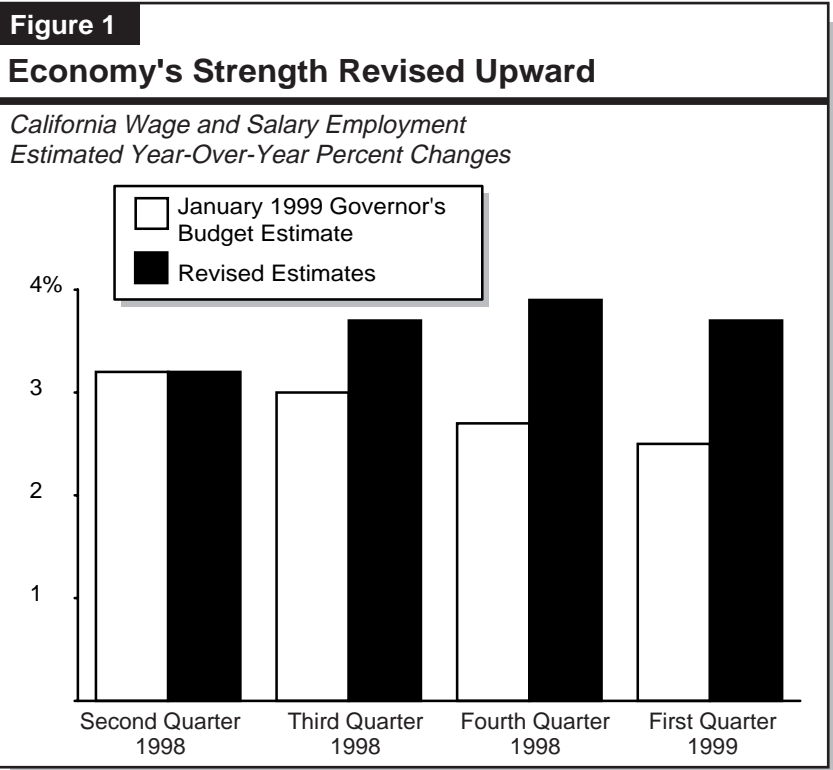
Current-Year Developments. General Fund revenues from the state's major taxes exceeded the January budget estimate by \$1.6 billion in April, bringing year-to-date collections about \$1.8 billion above the estimate. Most of the strength in April was related to final payments on 1998 personal income tax liabilities. However, revenues associated with economic activity in early 1999—namely, withholding, sales tax receipts, and quarterly estimated taxes—are also running ahead of estimates. Based on current trends, it would appear that revenues in May and June will continue to exceed the estimate. *As a result, revenues in 1998-99 are likely to exceed the January budget estimate by approximately \$2 billion.*

Budget-Year Implications. The revenue picture for 1999-00 will be influenced by a number of factors, including the performance of the economy, the stock market, and

investment earnings over the next year. We are currently developing a revised economic and fiscal forecast, which we will present following the release of the May Revision. Our preliminary assessment, however, is that the additional current-year receipts are indicative of a higher economic and revenue trend which will carry into the next fiscal year. *This implies that revenues also will exceed the January forecast for 1999-00—by more than \$2 billion. Thus, we anticipate that the two-year revenue increase will be more than \$4 billion.*

Potential Expenditure Increases

A significant portion of the new revenues will be needed to fund higher state costs in education and other programs.



Proposition 98 Education

Two factors are contributing to a likely increase in the Proposition 98 minimum funding guarantee. Depending on various policy decisions, the increase could be anywhere from \$400 million to over \$1 billion in the current and budget years combined. Two factors are involved:

- *First*, based on actual economic data reported by the U.S. Department of Commerce in April, it appears that the per capita personal income factor used to adjust the minimum guarantee will be about 1.1 percentage points higher in 1999-00 than assumed in the January budget. This will result in an increase in the guarantee of approximately \$400 million in the budget year.
- *Second*, as we indicated in March, the State Department of Education's estimates of K-12 average daily attendance (ADA) for 1998-99 are up by 60,000 to 90,000 students. This, in turn, will increase required funding for "revenue limits" (that is, general purpose funding for schools) by between \$225 million and \$335 million in each of the current and budget years.

Most of the additional ADA spending in the current year could be funded through redirections from Proposition 98 savings in other areas. Indeed, the current Senate version of the budget relies to some extent on current year savings. Absent redirections in the final budget plan adopted by the state, the higher ADA will increase Proposition 98 spending in each year.

Other Expenditures

In February, our office identified approximately \$800 million in likely additional budget expenses in 1999-00, related to lower-than-expected federal funds, Medi-Cal rate increases, fire suppression activities, and other factors. The administration will be evaluating these and other expenditure-related factors—including current year deficiency requests—as it prepares its May Revision proposal.

Partly offsetting these potential increases is a rate reduction for the Public Employees' Retirement System (PERS). Based on revised contribution rates currently being considered by PERS, General Fund appropriations to the fund could be reduced by \$136 million in 1999-00 (state special funds and local agencies which contract with PERS would also experience contribution reductions). This would represent General Fund savings that would be available for legislative priorities in the budget year.

Conclusion

The May Revision will contain the Governor's updated budget plan for the current and budget years, including his proposals for allocating the substantial amount of new revenues. In the subsequent weeks, the Legislature will have an opportunity to decide how these resources should be allocated amongst such competing priorities as funding state programs and operations, enhancing infrastructure, assisting local governments, providing tax relief, and increasing the reserve. In making these decisions, we believe the Legislature should view the *current-year* revenue increase as being available for *one-time* purposes, while the *budget-year* increase is available for *ongoing* purposes.

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Property Tax Shift or “ERAF” Data On LAO Web Site

During the early 1990s, in response to significant state budget deficits, the state permanently shifted over \$3 billion of local property taxes from cities, counties, and special districts to schools. The purpose of this tax shift—commonly referred to as “ERAF,” after the fund into which the property taxes are deposited (the Educational Revenue Augmentation Fund)—was to offset, on a dollar-for-dollar basis, required state spending for schools.

Ever since the property tax shift was enacted, debate regarding the shift’s appropriateness, incidence, and mitigation has been a source of continual controversy between state and local govern-

ments. In order to provide the Legislature and the public information on the amount of property taxes shifted from specific local governments, we have placed two data sets on our web site. The data included on our web site was compiled by the State Controller’s Office and the California State Association of Counties.

While each of these data sets has limitations, we believe the information provides a reasonable approximation of the local impact of the property tax shift in 1998-99. To see the ERAF databases, go the LAO web site (www.lao.ca.gov) and click on “products,” “databases,” and “ERAF Database.”

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About the LAO

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