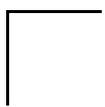
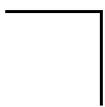
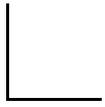
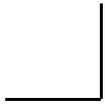


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**I**  
**State**  
**Fiscal Picture**



## *State Fiscal Picture*



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California's fiscal outlook is the brightest in over a decade. Substantial revenue growth in the current year, coupled with declining case-loads in the state's health and welfare programs, has enabled the Governor to propose a 1998-99 budget which is balanced, maintains the agreements reached last year in the areas of trial court funding and tax reductions, and covers funding for caseload growth and new education initiatives.

The January budget proposal reflects the Governor's priorities for 1998-99 regarding state revenues and spending. As always, the Legislature will have an opportunity to establish its priorities through the budget process over the next several months. In addition, based on our projections of revenues and expenditures, we believe that the Legislature will have discretion over more than \$1 billion in resources beyond those assumed in the Governor's proposal. This will provide the Legislature with an unusual opportunity to allocate a significant amount of unanticipated funds to meet its own priorities.

### **OVERVIEW OF THE GOVERNOR'S BUDGET**

The new budget proposes total state spending of \$70.6 billion (excluding the expenditure of federal funds and selected bond funds). As indicated in Figure 1 (see next page), this total includes \$55.4 billion in General Fund expenditures, nearly all of which are allocated through the budget process. It also includes \$15.2 billion in special funds spending, which are earmarked for specific purposes, such as highways, targeted health programs, and local governments. In terms of spending growth, the budget proposes a total spending increase of 4.7 percent, consisting

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of a General Fund increase of 4.5 percent, and a 5.3 percent increase from special funds.

<b>Figure 1</b>				
<b>Total Proposed Budgetary Spending<sup>a</sup></b>				
<i>1996-97 Through 1998-99 (Dollars in Billions)</i>				
	Actual 1996-97	Estimated 1997-98	Proposed 1998-99	
			Amount	Percent Change
General Fund	\$49.1	\$53.0	\$55.4	4.5%
Special funds <sup>b</sup>	13.3	14.4	15.2	5.3
<b>Totals</b>	<b>\$62.4</b>	<b>\$67.4</b>	<b>\$70.6</b>	<b>4.7%</b>

<sup>a</sup> Excludes selected bond fund expenditures.  
<sup>b</sup> Governor's budget presentation, which excludes Local Public Safety Fund expenditures. In 1998-99, these total \$1.9 billion.

### The General Fund's "Bottom Line" Condition

Figure 2 shows the Governor's estimated General Fund revenues, expenditures, and the year-end budgetary reserve for both 1997-98 and 1998-99. It shows that both the current and budget years are expected to end with a relatively modest reserve of around \$300 million—a bit over one-half of 1 percent of General Fund revenues.

### Two Perspectives on General Fund Spending

Figure 3 and Figure 4 (page 8) provide two alternative perspectives on how the Governor proposes to allocate General Fund expenditures in 1998-99.

**How Total Spending Is Allocated.** Figure 3 shows how spending from the state's General Fund is allocated among major program areas. It shows that education funding accounts for over one-half of the total budget, with K-12 education accounting for 42 percent, and higher education accounting for about 13 percent). Health and social services programs, including Medi-Cal, California Work Opportunity and Responsibility to Kids (CalWORKs) and Supplemental Security Income/State Supplementary Program (SSI/SSP), account for slightly more than one-fourth of the budget total. Spending on youth and adult corrections represents about 8 percent of the budget, and all other programs—including various state operations, retirement, and debt service—account for the remaining 10 percent of General Fund spending.

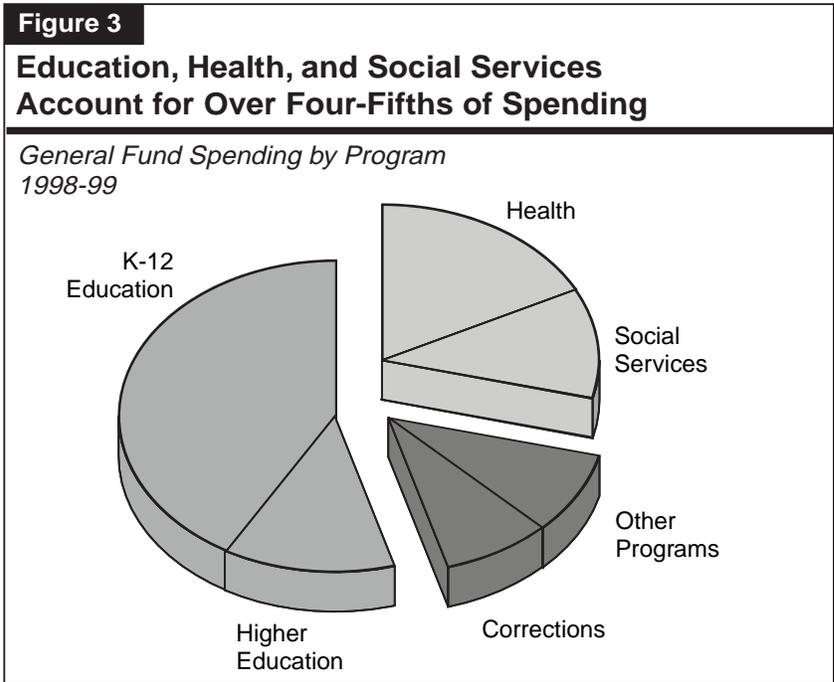
**Figure 2**

**Governor's Budget  
General Fund Condition**

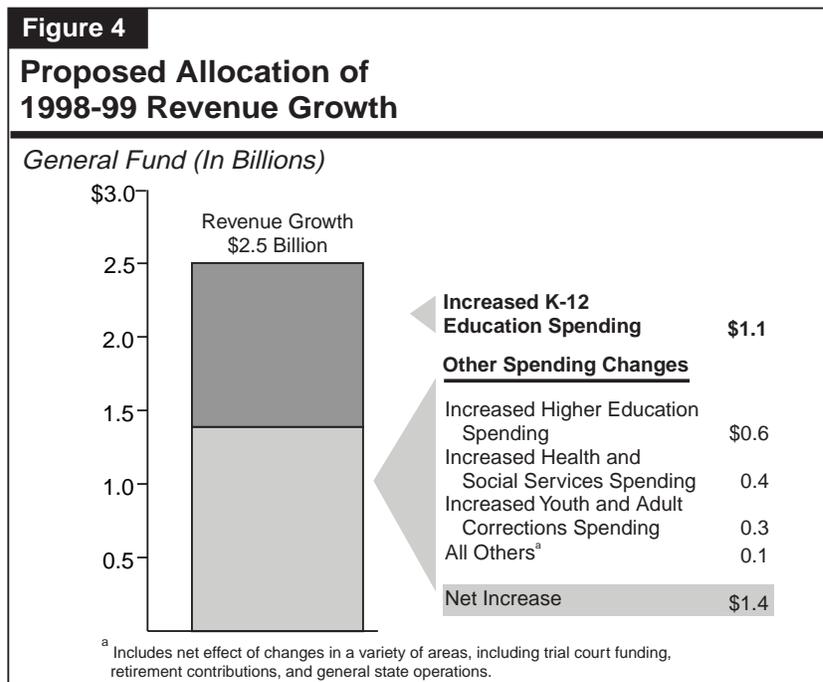
*1997-98 and 1998-99  
(Dollars in Millions)*

	1997-98	1998-99	Percent Change
Prior-year fund balance	\$906	\$774	
Revenues and transfers	52,890	55,383	4.7%
<b>Total resources available</b>	<b>\$53,796</b>	<b>\$56,157</b>	
Expenditures	\$53,022	\$55,416	4.5%
Ending fund balance	\$774	\$741	
Other obligations	\$445	\$445	
<b>Reserve</b>	<b>\$329</b>	<b>\$296</b>	

Detail may not total due to rounding.



**How Revenue Growth Is Allocated.** Figure 4 shows how the budget proposes to allocate the \$2.5 billion in projected 1998-99 revenue growth among major programs. Somewhat over 40 percent (\$1.1 billion) of the increase is for K-12 education, which is about in proportion to K-12 education's share of the total General Fund budget. Of the remainder, \$0.6 billion is proposed for higher education, \$0.4 billion goes to health and social services, and \$0.3 billion goes to corrections-related spending.



The final \$0.1 billion of 1998-99 revenue growth is a net figure which includes a variety of offsetting elements, including: (1) a drop of over \$0.7 billion in payments to the Public Employees' Retirement System (PERS), reflecting reduced payments in the budget year associated with the PERS court settlement; (2) an increase of \$0.5 billion for trial court funding (due to the financial restructuring agreement); (3) \$142 million for a 3 percent state employee pay increase; and (4) over \$100 million for state infrastructure.

### Key Features of the Governor's Budget Plan

Figure 5 summarizes the key features of the 1998-99 budget proposal. As noted above, the new budget plan reflects the major agreements reached last year in the areas of welfare reform, education, state tax relief, and the financial restructuring of California's trial court system. Most of

the budget's new proposals are in the areas of education and infrastructure. For example, the budget proposes funding to cover the costs of increasing the length of the K-12 school year to 180 days, as well as \$7 billion in bonds to finance capital outlay needs in the areas of education, prisons, and resources.

As in recent years, the budget proposes the elimination of the renters' credit (which was suspended from 1993 through 1997), and also proposes to make permanent certain welfare grant reductions and suspensions in cost-of-living adjustments (COLAs).

**Figure 5****Key Programmatic Features of the Governor's 1998-99 Budget Proposal**

- Taxes**
  - Includes no new major tax-related changes.
- Education**
  - Provides funds for lengthened K-12 school year.
  - Proposes funds to higher education to cover fourth year of Governor's "compact" with CSU and UC, as well as enrollment growth.
- Welfare**
  - Makes permanent the CalWORKs 4.9 percent grant reduction and permanently suspends certain welfare COLA adjustments.
  - Uses federal funds to support a large increase in spending for CalWORKs job training and child care services.
- Infrastructure**
  - Proposes \$7 billion in bonds for K-12 school facilities, higher education, correctional facilities, local infrastructure bank, resources, and other purposes.
- Corrections**
  - Proposes full funding for caseload increases.
- Other Programs**
  - Eliminates renters' credit.
  - Provides funds for equivalent of 3 percent COLA for state employees.
  - Pays off interest relating to PERS lawsuit.

## Economic and Revenue Assumptions

Among the most important assumptions underlying the proposed budget are its economic and revenue projections. In both of these areas, moderate growth is assumed.

The budget assumes ongoing national economic expansion in 1998 and 1999, accompanied by continued, though tapering, economic growth with modest inflation in California. The state's personal income is projected to increase by 6.3 percent in 1998 and 6 percent in 1999, while wage and salary employment is projected to increase by 2.8 percent in 1998 and 2.3 percent in 1999. Although these projected gains represent a slowing from 1997's robust pace, solid economic performance is anticipated during the next two years. The administration indicates that it has lowered its projections of personal income growth by about one-half percentage point in both 1998 and 1999 in order to take into account the impacts of Asia's financial and economic problems.

**Moderate Revenue Growth in 1998-99.** After a healthy increase in the current year, the budget assumes that moderate revenue growth will occur in 1998-99, consistent with the moderate gains projected for the economy. As shown in Figure 2, the budget projects that General Fund revenues will total \$52.9 billion (7.5 percent growth) in the current year and \$55.4 billion (4.7 percent growth) in the budget year.

The budget does not contain any new tax-related proposals. However, the revenue forecast does incorporate the effects of the state's 1997 tax relief package, including an increased personal income tax dependent exemption credit. The fiscal effect of this package is to reduce revenues by \$189 million in 1997-98 and \$593 million in 1998-99 (reaching \$1.1 billion in 1999-00 when fully phased in). In the absence of this tax package, projected 1998-99 revenue growth would have been modestly higher—5.5 percent. The budget also assumes \$85 million in 1998-99 revenues from federal adoption of an "Internal Revenue Service tax offset" program (this program also has been assumed, but not adopted, in the last few years).

**Recent Cash Trends Have Been Strong.** In December, General Fund cash receipts exceeded the *1997-98 Budget Act* forecast by over \$700 million, more than offsetting the revenue softness that had occurred earlier in the year. These unanticipated tax payments were largely estimated payments on 1997 tax liabilities. Because these payments were not received until *after* the administration completed its revenue forecast, they were not directly incorporated into the forecast. The unexpected payments were primarily related to strong year-end personal income tax receipts. The strong year-end payments suggest that final payments made

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in April 1998 will be strong as well (given historical experience) and that the current revenue trend is above the budget forecast.

## GOVERNOR'S BUDGET PROPOSAL BY PROGRAM AREA

Figure 6 summarizes General Fund spending by major program area for 1996-97, 1997-98 (estimated), and 1998-99 (proposed).

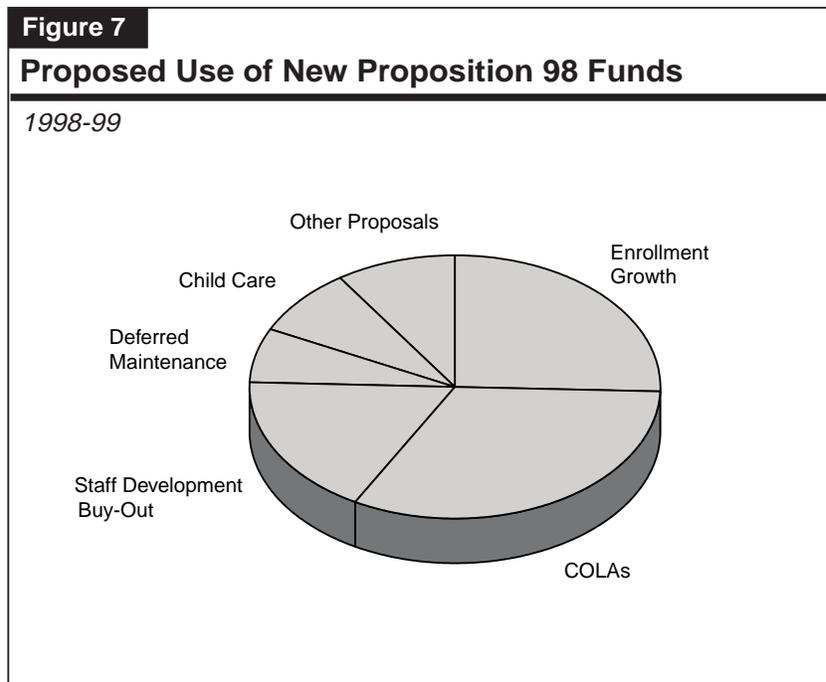
<b>Figure 6</b>				
<b>General Fund Spending by Major Program Area<sup>a</sup></b>				
<i>(Dollars in Millions)</i>				
	<b>Actual 1996-97</b>	<b>Estimated 1997-98</b>	<b>Proposed 1998-99</b>	
			<b>Amount</b>	<b>Percent Change</b>
<b>Education Programs</b>				
K-12 education	\$19,893	\$22,453	\$23,522	4.8%
Community colleges	1,872	2,095	2,276	8.6
UC/CSU <sup>b</sup> and other	4,308	4,545	4,916	8.2
<b>Health and Welfare Programs</b>				
Medi-Cal	\$6,838	\$6,780	\$6,820	0.6%
CalWORKs <sup>c</sup>	2,834	2,076	1,988	-4.2
SSI/SSP <sup>d</sup>	2,013	2,063	2,159	4.7
Other	3,163	3,778	4,103	8.6
<b>Youth and Adult Corrections</b>	\$3,805	\$4,074	\$4,399	8.0%
<b>All Other</b>	\$4,362	\$5,159	\$5,233	1.4%
<b>Totals</b>	<b>\$49,088</b>	<b>\$53,022</b>	<b>\$55,416</b>	<b>4.5%</b>

<sup>a</sup> Debt service and retirement contributions included within individual program areas.  
<sup>b</sup> University of California/California State University.  
<sup>c</sup> California Work Opportunity and Responsibility to Kids program.  
<sup>d</sup> Supplemental Security Income/State Supplementary Program.

### K-12 Education

The budget proposes moderate increases in K-12 education spending, consistent with Proposition 98's minimum funding requirements. Specifically, total K-12 education expenditures in 1998-99 are proposed to increase by over \$2 billion compared to the *1997-98 Budget Act* for the current year (of which \$1.7 billion would come from the General Fund).

Figure 7 shows that about one-third of the above increase—\$657 million—would go for providing a 2.2 percent COLA for district and county office revenue limits as well as for most categorical programs. General purpose and categorical program funding for the projected 1.7 percent growth in the student population accounts for about one-fourth of the increase (\$507 million). The proposal to increase the length of the school year to 180 days (also known as “staff development day buy-out”) accounts for another \$350 million, or 17 percent. Major increases for child care programs (\$168 million), deferred maintenance (\$135 million), and various other categorical programs use the remaining 25 percent of new K-12 funds.



The budget also includes several additional proposals which, although having only modest effects on General Fund expenditures, are significant from a policy perspective. These are shown in Figure 8.

### Higher Education

**Community Colleges.** The budget proposes total spending for community colleges of \$3.9 billion, of which \$2.3 billion would come from the General Fund. This is a 6.8 percent increase in total spending (an 8.6 percent increase in General Fund spending). The total increase includes \$90 million for enrollment growth, \$50 million in incentive funding

**Figure 8****Other Major K-12 Proposals**

- |                                     |   |
|-------------------------------------|---|
| <input checked="" type="checkbox"/> | <b>Opportunity Scholarships</b>   |
|                                     | <ul style="list-style-type: none"> <li>Allows 15,000 students attending the lowest performing schools in the state to attend a private school or other public school.</li> </ul>  |
| <input checked="" type="checkbox"/> | <b>Instructional Minutes</b>  |
|                                     | <ul style="list-style-type: none"> <li>Lengthens the school day at most middle schools and high schools by requiring schools to exclude the time between class periods (known as "passing time") from district calculations of instructional time.</li> </ul> |
| <input checked="" type="checkbox"/> | <b>Social Promotion</b>   |
|                                     | <ul style="list-style-type: none"> <li>Prohibits students who cannot achieve a passing score on a state assessment test to proceed to the next grade.</li> </ul>  |
| <input checked="" type="checkbox"/> | <b>Mandated Use of Lottery Funds</b>  |
|                                     | <ul style="list-style-type: none"> <li>Directs school districts to use the projected \$99 million increase in lottery funds for textbooks.</li> </ul>   |

based on specific performance measures for colleges, and funding for various investments in technology and infrastructure.

***University of California (UC) and California State University (CSU).***

The budget proposes General Fund spending of \$2.4 billion for UC and \$2.1 billion for CSU in 1998-99, representing increases of 8 percent and 8.6 percent, respectively, from the current year. The budget provides funding for the fourth year of the Governor's compact with higher education. It also provides funding for additional enrollment at both segments, and the "buy-out" of the 5 percent student fee reduction for UC and CSU required by legislation passed in 1997. The UC budget also includes planning funds for a tenth campus at Merced.

**Health and Social Services**

The budget proposes \$15.1 billion in General Fund spending for health and social services programs in 1998-99, a 2.5 percent increase from the current year. Figure 9 (see next page) summarizes the Governor's major health and social services proposals.

<b>Figure 9</b>	
<b>Major Health and Social Services Proposals</b>	
<i>(In Millions)</i>	
<b>Proposal</b>	<b>Fiscal Effect</b>
<input checked="" type="checkbox"/> Permanently eliminate CalWORKs and SSI/SSP COLAs	-\$123
<input checked="" type="checkbox"/> Make 4.9 percent CalWORKs grant reduction permanent	-151
<input checked="" type="checkbox"/> Fund new Healthy Families program	65
<input checked="" type="checkbox"/> Enhance services for developmental centers and regional centers	51

**California Work Opportunity and Responsibility to Kids.** The budget proposes \$5.9 billion from all funding sources for CalWORKs in 1998-99, including \$2 billion from the General Fund. This is an increase of \$307 million in total funds, but an \$88 million reduction in spending from the General Fund. The contrast between increased total spending and declining General Fund spending is due to the fact that a significant portion of CalWORKs spending in the budget year is funded by a large carryover balance of unexpended federal Temporary Assistance for Needy Families (TANF) block grant funds from the current and prior years. The budget proposes to: (1) make permanent the previous 4.9 percent grant reduction for recipients, resulting in a General Fund cost avoidance of \$151 million; and (2) permanently eliminate the statutory COLA, resulting in a General Fund cost avoidance of \$71 million (based on the administration's estimates).

**Supplemental Security Income/State Supplementary Program.** The budget proposes General Fund expenditures of \$2.2 billion in 1998-99, an increase of 4.7 percent over the current year. This includes funding to cover a 3.1 percent projected increase in caseload and an increase in the federal administrative fee. The budget proposes to make permanent the suspension of the state COLA, resulting in a General Fund cost avoidance of \$52 million in 1998-99 (based on the administration's estimates).

**Medi-Cal.** The budget proposes General Fund expenditures of \$6.9 billion for the Medi-Cal Program, a 0.6 percent increase over the

current year. This includes a current-year savings of \$238 million related to Medi-Cal benefits, primarily due to caseloads that are declining more rapidly than anticipated when the 1997-98 budget was enacted. An increase in the federal matching rate for Medi-Cal will save an additional \$66 million. However, these latter savings will essentially be offset by increases in the cost and utilization of services. The budget does not propose any major new changes in the Medi-Cal Program.

**Healthy Families Program.** The budget includes a total of \$65 million from the General Fund in 1998-99 for the first year of operation of the new Healthy Families program, which provides health care coverage to children in families with incomes up to 200 percent of the federal poverty level. Together with federal matching funds, the Governor's budget projects that total proposed spending for the Healthy Families program will be \$201 million. By the end of 1998-99, the budget estimates that the program will cover 201,000 children in the insurance program, and extend Medi-Cal coverage to an additional 101,000 children.

**Other Health and Welfare.** The budget proposes significant funding increases in several programs to fund caseload increases and enhanced services for developmentally disabled persons. This includes \$115 million for caseload and cost increases, \$40 million for regional center clients placed in the community, and \$31 million for the first year of a four-year expansion of staffing for the developmental centers.

### **Youth and Adult Corrections**

The budget includes \$4.4 billion from the General Fund for youth and adult corrections, an 8 percent increase from the current year. The largest part is for support of the Department of Corrections at \$3.9 billion, an increase of 7.2 percent. The budget provides full funding for caseload and workload changes in the department. The prison inmate population is projected to reach 171,610 by June 1999, a 6 percent increase from June of the current year. The budget proposes to significantly expand the state's use of contracting with private providers to house state prison inmates. Specifically, the budget proposes to contract for the first 5,000 beds out of a total of 15,000 beds in private corrections facilities in the budget year. The budget does not include any other significant new initiatives.

### **Infrastructure**

The budget proposes \$7 billion in bond sales over the next year to support infrastructure spending in several areas. This proposal includes \$2 billion for K-12 schools. (The K-12 bonds are proposed as part of \$8 billion in K-12 authorizations over the next four election cycles to cover

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capital outlay needs associated with enrollment growth and modernization of existing facilities.) The \$7 billion proposal also includes \$1 billion for higher education, \$1.4 billion for correctional facilities, \$1.3 billion for water projects, and \$1.3 billion for other purposes.

### Other Programs

**Trial Court Funding.** The budget provides increases involving trial court funding consistent with the restructuring measure passed last year. Total General Fund spending for trial courts would reach \$656 million in 1998-99.

**Public Employees' Retirement System.** Spending for PERS drops from \$1.7 billion in the current year to \$1 billion in 1998-99. Spending for both years includes the impacts of the PERS court settlement. The 1997-98 total includes the \$1.2 billion payment of deferred principal contributions to the fund, while in 1998-99 it includes \$310 million to cover the interest on these deferred payments.

**Renters' Credit.** This credit, which provides a refundable tax credit of \$60 to single renters and \$120 to married couples and heads of households, has been suspended in each year since 1993. Under existing law, the credit is scheduled to be reinstated in 1998. The budget proposes to permanently eliminate the credit, for a budgetary savings of \$540 million in 1998-99 and equivalent amounts annually thereafter.

**Local Government.** The budget proposes a \$200 million general obligation bond issue along with \$50 million in direct General Fund spending to fund an infrastructure bank. Other than this proposal, the budget does not include any major new initiatives relating to local governments.

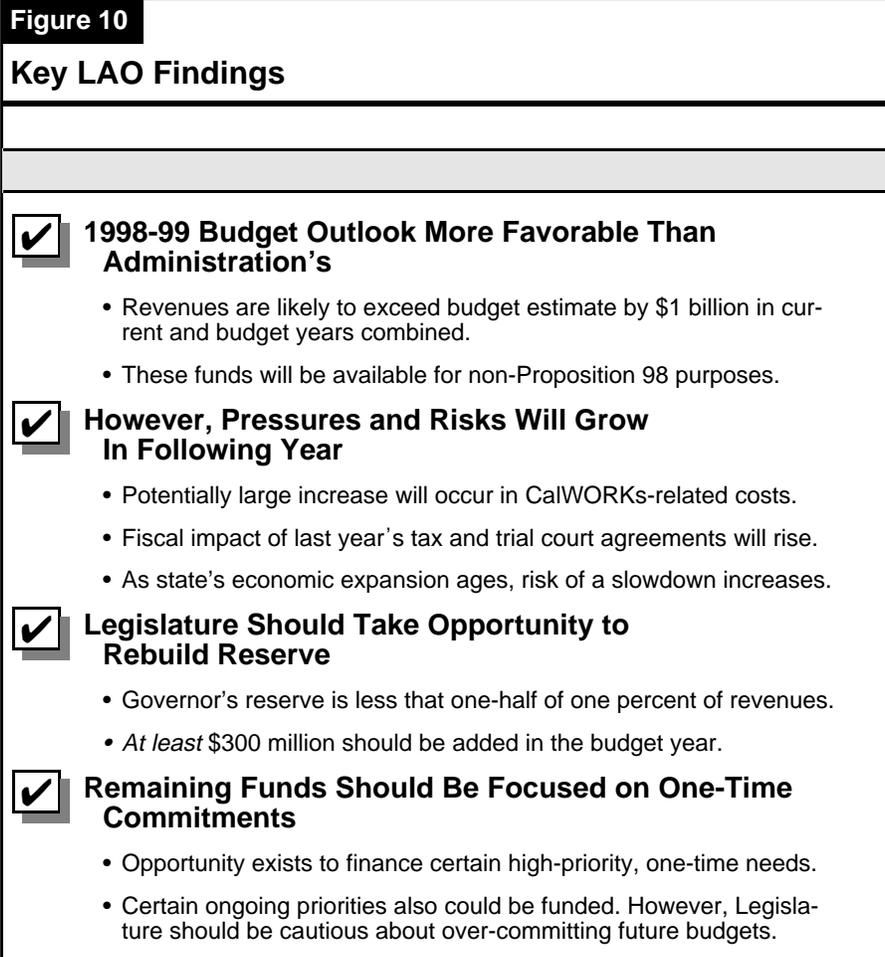
**Employee Compensation.** The budget includes sufficient funds for a 3 percent salary increase for state employees, effective July 1, 1998. The budget indicates that this money is to fund any forthcoming employee compensation changes arrived at for 1998-99 through the collective bargaining process.

## THE LAO'S BUDGET OUTLOOK

In this section, we provide our own perspective on the General Fund outlook for 1998-99. In addition, to assist the Legislature in its fiscal planning, we also provide our budgetary outlook for one year beyond the budget year—1999-00. In making these projections, we have used the LAO's economic and revenue forecasts which are described in Parts Two and Three of this volume. We have also developed our own projections

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of expenditures, assuming the policies embodied in the Governor's 1998-99 budget proposal. We have prepared these estimates to help the Legislature evaluate the impact of the budget proposal, and to shape its own priorities for next year. Our key findings are displayed in Figure 10.

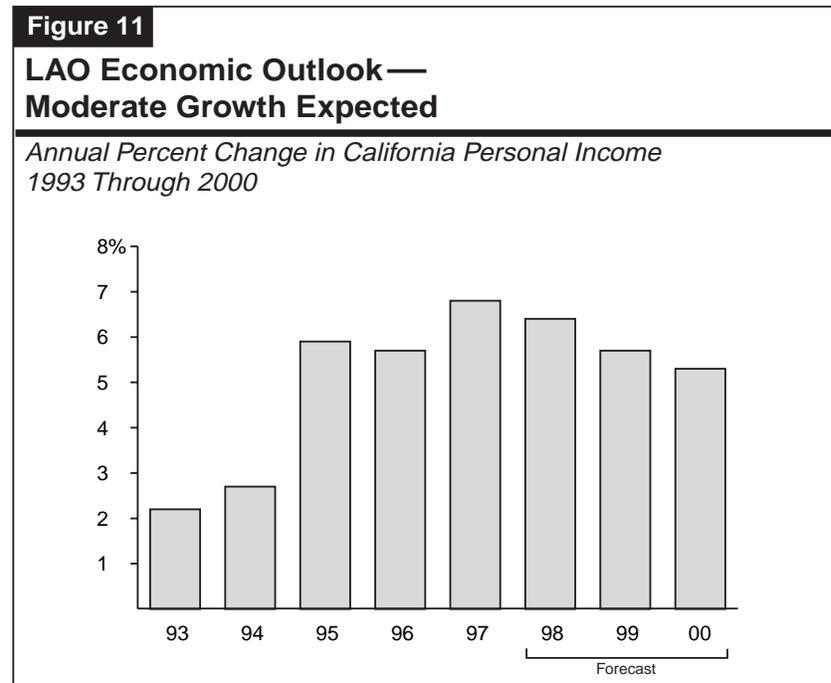


### Current-Year and Budget-Year Outlooks

We forecast significantly more revenues and somewhat lower expenditures than the administration. As a result, we believe that the Legislature will have discretion over \$1.2 billion of resources beyond those envisioned in the budget.

**Legislative Analyst's Office Economic Forecast.** In general, our economic forecast is similar to the administration's in that we expect moder-

ate economic growth during the forecast period (see Figure 11). California's economy has been experiencing healthy growth in recent months, and is beginning 1998 with considerable momentum. Although Asia's economic problems and other factors will cause some slowing over the next three years, we are projecting that the state's expansion will remain on track through 2000.



**Legislative Analyst's Office Revenues.** We project that General Fund tax receipts will be \$53.5 billion in the current year, or up \$645 million from the budget forecast. In the budget year, we project that revenues will be \$55.7 billion, or \$360 million above the budget forecast. Thus, for the two years combined, our revenue projections are slightly more than \$1 billion above the budget's. Our higher revenue estimates reflect recent healthy economic and cash-receipts trends, some of which were not available to the administration at the time its forecasts were prepared.

**Proposition 98 Interaction.** In contrast to the past two years, the additional revenues we foresee in the current and budget years will be available for non-Proposition 98 purposes. This is because, given the circumstances surrounding Proposition 98 this year, the additional revenues we are projecting for the current year will not raise the Proposition 98 guarantee. Moreover, the revenue growth we are forecasting for next year will result in slightly less 1998-99 growth in the Proposition 98 guarantee than

assumed in the budget. (A more complete discussion of the interaction between our higher revenue estimate and the Proposition 98 spending requirement is included in the K-12 Education chapter of the *Analysis*).

**Legislative Analyst's Office Expenditure Estimates.** We estimate that 1997-98 General Fund expenditures will be \$53 billion, or very similar to the budget estimate. In 1998-99, we estimate that expenditures will be \$55.2 billion, or \$206 million less than the budget estimate. The main cause of our budget-year difference involves our lower level of Proposition 98 spending. Other factors affecting our expenditure estimates include higher costs in Medi-Cal, fire suppression and local property tax administration, but lower costs for SSI/SSP.

It should be noted that our expenditure estimates do not take into account potential savings in the CalWORKs program. In the *Analysis*, we recommend actions that would result in CalWORKs savings of about \$350 million, of which we recommend \$126 million be put into a welfare reserve. The remainder could be available for legislative priorities.

**The "Bottom Line" General Fund Condition.** Figure 12 (see next page) summarizes our projections for the General Fund's condition. As noted above, our expenditure projections assume the policies embodied in the Governor's 1998-99 budget proposal, rather than current law, in order to assist the Legislature in evaluating its fiscal impact. We estimate that the current year will end with a reserve of \$1 billion, or \$674 million more than projected by the administration. We forecast that the budget year will close with a reserve of \$1.5 billion, which is \$1.2 billion more than the budget forecast.

### Budget Pressures to Grow in 1999-00

It is important that the Legislature be aware of *future* budgetary pressures that exist when developing its priorities for 1998-99. Figure 12 shows our projections for 1999-00, assuming the Governor's budget proposal. It indicates that:

- **Expenditures** will increase by over 6.1 percent—to \$58.6 billion. This increase reflects rising costs associated with agreements reached last year involving CalWORKs, financial restructuring of the trial courts, and the Healthy Families program.
- **Revenues** are projected to grow by a more modest 4.8 percent—to \$58.4 billion—reflecting the continued phase-in of last year's tax reduction agreement, and our assumption of tapering economic growth in 1999 and 2000.
- The **budgetary reserve** will decline slightly—from a bit over \$1.5 billion in the budget year to slightly under \$1.4 billion at the

end of 1999-00—due to a small operating deficit (that is, the excess of expenditures over revenues) that emerges in that year.

**Figure 12**

### LAO's General Fund Condition With Governor's Spending Proposals

1997-98 Through 1999-00  
(Dollars in Millions)

	1997-98	1998-99		1999-00	
		Amount	Percent Change	Amount	Percent Change
Prior-year fund balance	\$921	\$1,445		\$1,978	
Revenues and transfers	53,535	55,743	4.1%	58,435	4.8%
Total resources available	\$54,456	\$57,188		\$60,413	
Expenditures	\$53,011	\$55,210	4.1%	\$58,576	6.1%
Ending fund balance	\$1,445	\$1,978		\$1,837	
Other obligations	\$442	\$442		\$442	
<b>Reserve</b>	<b>\$1,003</b>	<b>\$1,536</b>		<b>\$1,395</b>	

Detail may not total due to rounding.

## CONSIDERATIONS FOR THE LEGISLATURE

As noted above, we project that the state would have a large budgetary reserve, both in 1998-99 and the year following. This raises the question—how should the Legislature respond to this more favorable budget outlook? Naturally, there are a great many competing demands and priorities facing the Legislature as it considers this issue.

### Augmenting the Governor's Proposed Reserve Should Be High Priority

The budgetary reserve proposed by the Governor for 1998-99 is \$296 million—only one-half of 1 percent of revenues. Put another way, it takes the state less than 50 hours to spend this amount of money to support its programs. Clearly, a “razor thin” reserve of this sort is not very prudent from a sound fiscal management standpoint. Thus, we recommend that it be augmented in 1998-99, by *at least* \$300 million. This would bring the reserve to a modest \$600 million—double the size proposed by

the Governor, but still just over 1 percent of revenues. If there ever was a good time to start to “beef up” the reserve, it is *now*, given the relatively good shape of the budget.

### **Remaining Funds Should Be Focused on One-Time Commitments**

With regard to the remainder of the additional resources we have identified, we believe that the Legislature will need to carefully weigh their allocation between one-time and ongoing commitments.

**Ongoing Commitments.** The reason why it is important to be cautious about committing to ongoing obligations is that they must be financed year after year. Thus, for example, a \$700 million ongoing commitment in 1998-99, whether a tax reduction or a spending increase, would require \$1.4 billion in resources by the end of 1999-00 compared to our budget condition estimates. This would eliminate the entire reserve we have projected. Moreover, an ongoing commitment of this magnitude could result in a significant deficit in the following year, given the emergence of the operating deficit we project for 1999-00 under the Governor’s budget proposal. The “bottom line” is that the Legislature should be cautious about over-committing future budgets to new ongoing fiscal obligations.

**One-Time Commitments.** In deciding about the use of additional resources, we believe that special attention should be given to certain high-priority, one-time needs facing the state. For example, in the *Analysis*, we have recommended that the Legislature:

- Increase the level of direct appropriations for capital outlay projects (\$165 million).
- Establish a reserve to assist state departments in meeting the year 2000 change for computer systems (at least \$25 million).

In addition, we believe it would be prudent to reduce the funds owed local governments for local flood control projects. These arrearages currently total approximately \$150 million.

### **Conclusion**

The additional resources we have identified provide the Legislature with an unusual opportunity to both meet some of its high-priority needs and further put the state’s “fiscal house in order.” We believe that these dual objectives can best be achieved if (1) some funds are set aside for building the reserve, and (2) the Legislature is careful to not over-commit future budgets to significant new or expanded on-going obligations.

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