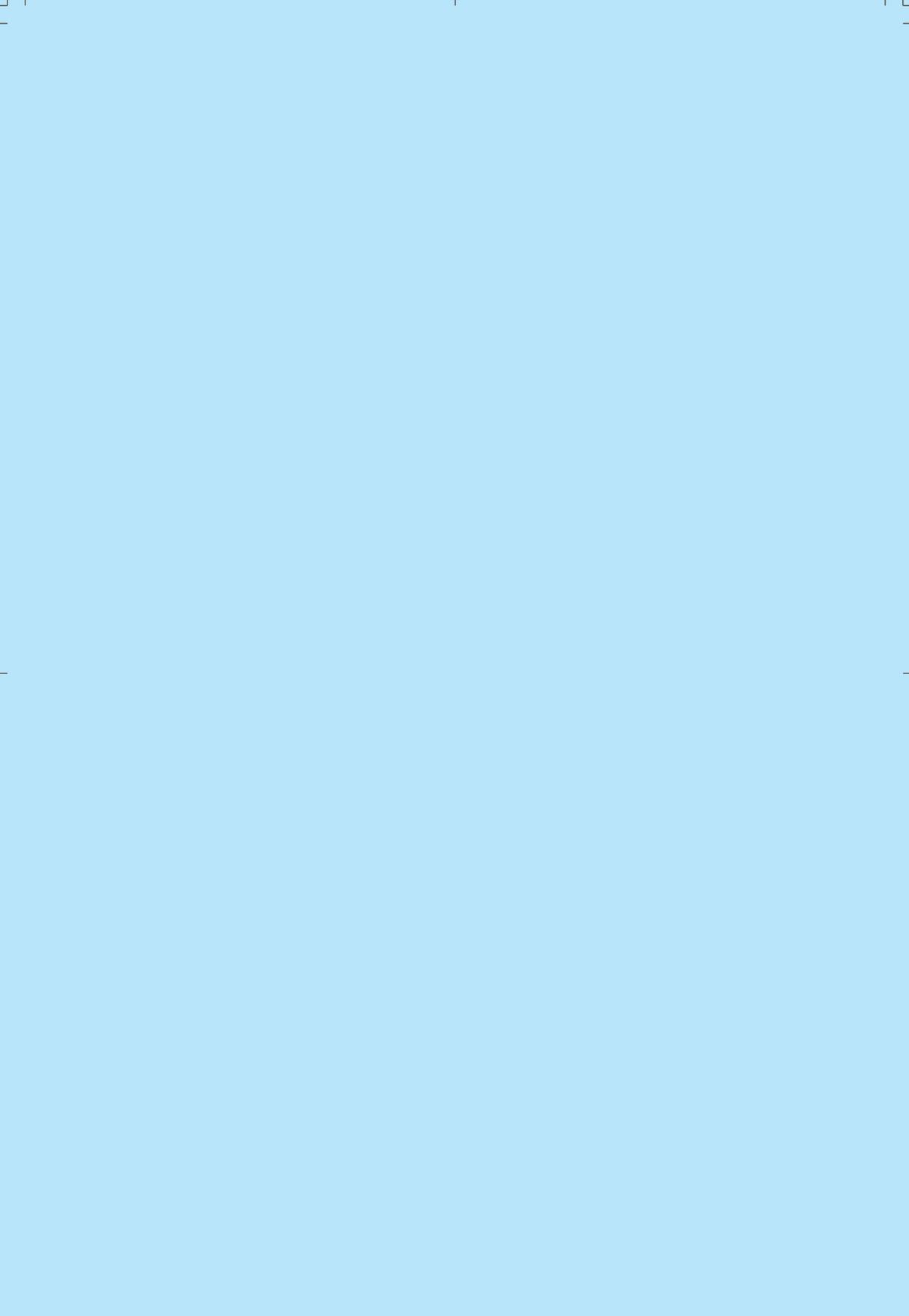




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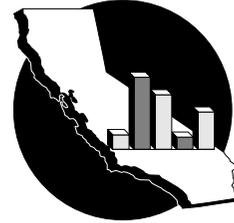
STATE
FISCAL PICTURE







State Fiscal Picture



The Governor has introduced a 1999-00 spending plan which can be characterized as a “workload” budget. For example, it provides funds for many (but not all) commitments adopted in the current year, as well as caseload growth and various statutory cost-of-living adjustments. Most of its significant programmatic initiatives are focused on K-12 education, with relatively few changes in other areas. In fact, the budget increases reliance on federal funds, delays certain expenditures to future years, and sells state assets to maintain fiscal balance by the end of 1999-00. The budget’s projections reflect expectations of continued, though slowing, economic and revenue growth.

The Legislature will have an opportunity in the coming months to establish its own priorities through the budget process. Our current assessment is that the state will end the budget year with a reserve which is at least \$500 million higher than identified in the budget. This reflects the net effect of increased revenues and expenditures.

OVERVIEW OF THE GOVERNOR’S BUDGET

The Governor’s budget proposes total state spending of \$76.2 billion in 1999-00 (excluding the expenditure of federal funds and selected bond funds), an increase of 4.1 percent from the current year. As indicated in Figure 1 (see next page), this total includes \$60.5 billion in General Fund expenditures, which are allocated through the budget process for education, health and social services, criminal justice, and various other programs. It also includes \$15.7 billion in special funds spending, which is earmarked for specific purposes, such as highways, targeted health programs, and local governments.

Figure 1				
Governor's Budget Total State Spending^a				
<i>1997-98 Through 1999-00 (Dollars in Billions)</i>				
	Actual 1997-98	Estimated 1998-99	Proposed 1999-00	
			Amount	Percent Change
General Fund ^b	\$52.9	\$58.3	\$60.5	3.8%
Special funds ^b	14.2	14.9	15.7	5.4
Totals	\$67.1	\$73.2	\$76.2	4.1%

^a Excludes selected bond expenditures and federal funds.
^b Governor's budget presentation, which excludes Local Public Safety Fund expenditures. In 1999-00, these total \$2 billion.

The General Fund Budget Condition

Figure 2 shows the budget's estimates for General Fund revenues, expenditures, and the year-end reserve for 1998-99 and 1999-00. It indicates that revenues in 1999-00 are projected to be \$60.3 billion, a 7.1 percent increase from the current year. Expenditures are proposed to be \$60.5 billion, a 3.8 percent increase from 1998-99. A slight operating deficit (that is, excess of expenditures over revenues) of about \$200 million occurs in the budget year, causing the reserve to decline from \$617 million in 1998-99 to \$415 million by the close of 1999-00. The reserve proposed for the budget year represents about 0.7 percent of General Fund revenues.

How General Fund Spending Is Allocated

Figure 3 shows how spending from the state's General Fund is allocated among major program areas in the 1999-00 budget plan. It shows that somewhat over one-half of the total budget is devoted to education, with K-12 education accounting for about 42 percent of the total. Health and social services programs, including Medi-Cal, California Work Opportunity and Responsibility to Kids (CalWORKs), and the Supplemental Security Income/State Supplementary Program (SSI/SSP), account for slightly more than one-fourth, while spending on youth and adult corrections accounts for about 7 percent of the total. All other programs, including resources, debt service, retirement costs, local tax relief, and general government account for about 11 percent of the total.

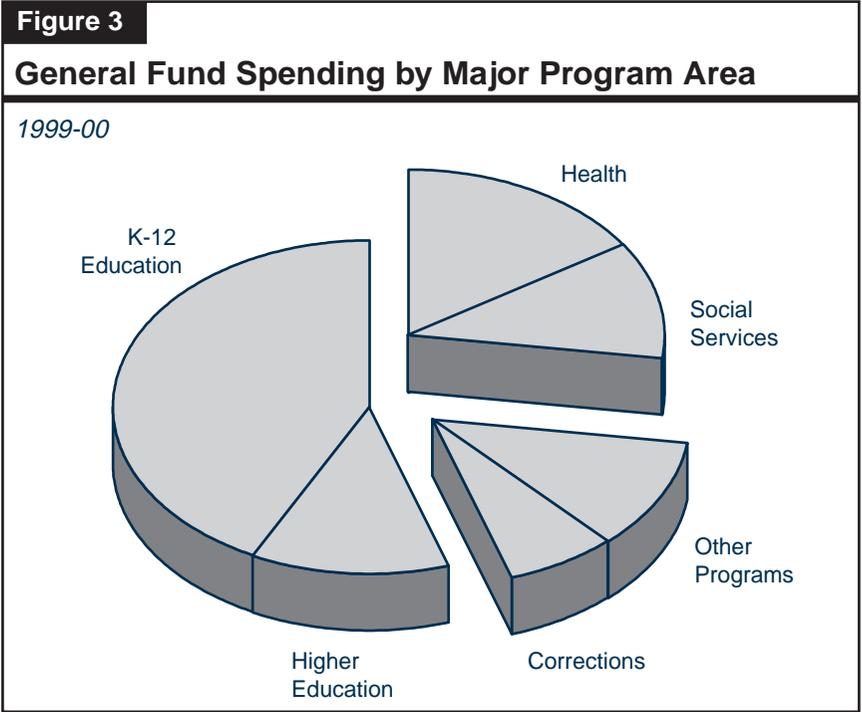
Figure 2

Governor's Budget General Fund Condition

*1998-99 and 1999-00
(Dollars in Millions)*

	1998-99	1999-00	Percent Change
Prior-year fund balance	\$3,075	\$1,097	
Revenues and transfers	56,293	60,272	7.1%
Total resources available	\$59,368	\$61,370	
Expenditures	\$58,271	\$60,475	3.8%
Ending fund balance	\$1,097	\$895	
Other obligations	\$480	\$480	
Reserve	\$617	\$415	

Detail may not total due to rounding.



Key Programmatic Features

New Initiatives. As indicated above, most of the policy initiatives in the budget are in the area of K-12 education. Specifically, the Governor proposes to use \$444 million—mostly from within the Proposition 98 guarantee—for initiatives aimed at improving reading skills, improving teacher quality, and increasing school accountability. In other areas, the budget contains relatively few programmatic initiatives.

Key Budget-Balancing Elements. The budget includes a number of proposals and assumptions to maintain fiscal balance in the budget year. As shown in Figure 4, the budget relies on:

- \$960 million in new resources, including the use of \$562 million in tobacco settlement funds for General Fund purposes, and \$261 million from the sale of state property.
- \$432 million in new federal funds associated with (1) an increase in the federal share of payments for the Medi-Cal program, (2) placing the state's family planning program into the Medi-Cal program, and (3) an increase in federal reimbursements for undocumented felons housed in state prisons.
- \$300 million in savings from the rescheduling of budget appropriations, so that they match the anticipated timing of outlays for the All American Canal and for local developer fee reimbursements.
- \$365 million in savings from not including funds to cover certain cost pressures that are likely to occur in such areas as Medi-Cal (for rate increases), fire suppression, and local property tax administration. The administration has also sharply increased its estimates of unidentified savings that will occur in the current and budget years, assuming an increase of \$200 million for the two years combined.
- \$92 million from spending cutbacks in the areas of trial court funding and local reimbursements for flood control.

Only the final category—spending cutbacks—involves *significant* changes to existing policy commitments. As such, savings related to this category depend primarily on actions by the Legislature. The majority of the remaining categories noted in Figure 4 are related to budgeting assumptions—some of which depend on factors which are beyond the direct control of the Legislature and Governor. These assumptions involve various degrees of risk. In our evaluation of the budget outlook (discussed below), we have made our own judgments about the likelihood of each of these assumptions materializing.

Figure 4	
Key Budget-Balancing Elements	
<i>(In Millions)</i>	
New Resources	
Tobacco settlement	\$562
New auditors in tax agencies	51
Asset sales	261
STRS ^a updated valuation	86
Subtotal	\$960
New Federal Funds	
Medi-Cal sharing ratio	\$210
Family Planning Program	122
Undocumented felons	100
Subtotal	\$432
Rescheduling of Expenditures	
All American Canal	\$200
Developer fees	100
Subtotal	\$300
Potential Underbudgeting	
Fire suppression	\$20
Property tax administration	50
Unidentified savings	200
Medi-Cal rate increases	95
Subtotal	\$365
Spending Cutbacks	
Trial courts	\$48
Local reimbursements for flood control	44
Subtotal	\$92
^a State Teachers' Retirement System.	

BUDGET'S ECONOMIC AND REVENUE OUTLOOK

The economic and revenue outlooks are key elements underlying the proposed budget. The budget forecast assumes that both the U.S. and California economies will continue to expand, but will slow markedly in 1999 and 2000 relative to the recent past. The slowdown in California's

economic growth will translate into a corresponding reduction in General Fund revenue growth.

The Economy

The Nation's Outlook. The budget projects that U.S. real gross domestic product (GDP) will slow from 3.6 percent in 1998 to 1.9 percent in 1999, before rebounding slightly to 2.2 percent in 2000. The slowdown is partly related to the continued economic and financial problems in Asia, and their associated adverse effects on U.S. exports. The forecast also assumes consumer spending and business investment growth will subside in 1999, reflecting such factors as low savings rates, declining corporate profits, and more-sluggish gains in employment and personal income during the year.

California's Outlook. California's economy is also expected to slow in 1999, with wage and salary employment increasing by less than 300,000 jobs this year, compared to over 400,000 jobs last year. The problems in Asia are expected to hold down employment in the state's durable goods manufacturing sector. However, other sectors are expected to fare better, particularly those benefitting from the continued gains in residential and nonresidential construction activity that are anticipated.

State Revenues—Modest Underlying Growth

After growing strongly in each of the past three years, General Fund revenues are projected to increase by a modest 2.4 percent in 1998-99 before rebounding to a 7.1 percent gain in 1999-00. These growth rates are affected by a variety of factors. For example, revenues are being affected by tax relief enacted in 1997 and 1998, which is expected to reduce revenues by \$1.4 billion in both the current and budget years. The revenue totals in 1999-00 are also affected by the assumed receipt of tobacco settlement funds and one-time asset sales. Adjusting for these factors, the budget's underlying revenue growth rates are in the mid-5 percent range in both the current year and budget year, or roughly similar to the administration's forecast for California personal income growth.

Recent Developments Have Been Positive

Economic and revenue developments since the budget's forecasts were prepared have been positive. The U.S. and California economic growth in the fourth quarter was stronger than expected, and this has led many forecasters to raise their outlooks for 1999. In addition, the stock market ended 1998 on a strong note, which suggests that capital gains declared on personal income tax returns will be up again this year. Consistent with the stock market developments, 1998 year-end income tax prepayments by individuals were up by over 13 percent from the prior year. These pay-

ments are significant because they are related to capital gains and other investment-related earnings. In past years, strong year-end tax payments have been followed by strong final payments in April. If these trends hold, final tax payments in April 1999 will once again exceed the budget forecast, as discussed in more detail below in the section on the Legislative Analyst's Office's (LAO's) budget outlook.

GOVERNOR'S BUDGET SPENDING PROPOSALS

Figure 5 shows General Fund spending by major program for fiscal years 1997-98 through 1999-00. It shows that significant spending increases are proposed for K-12 education (including teacher retirement costs), community colleges, and SSI/SSP. Modest increases are proposed for both higher education and youth and adult corrections. Declines in General Fund spending are projected for Medi-Cal and CalWORKs and "all other" spending.

The year-to-year changes in many programs are affected by numerous special factors. For example, the increases for higher education reflect a drop-off of one-time expenditures included in these programs in the current year. Similarly, the General Fund growth for Medi-Cal and correc-

Figure 5

General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 1997-98	Estimated 1998-99	Proposed 1999-00	
			Amount	Percent Change
Education Programs				
K-12 education	\$22,080	\$23,648	\$25,642	8.4%
Community colleges	2,108	2,292	2,450	6.9
Higher education	4,516	5,185	5,276	1.8
Health and Welfare Programs				
Medi-Cal	\$6,759	\$7,399	\$7,330	-0.9%
CalWORKs	1,628	2,000	1,784	-10.8
SSI/SSP	2,025	2,256	2,439	8.1
Other	4,226	4,657	4,832	3.8
Youth and Adult Corrections	\$4,139	\$4,510	\$4,589	1.7%
All Other	\$5,392	\$6,325	\$6,133	-3.0%
Totals	\$52,874	\$58,271	\$60,475	3.8%



tions is held down by the assumed increases in federal funds for these programs in the budget year.

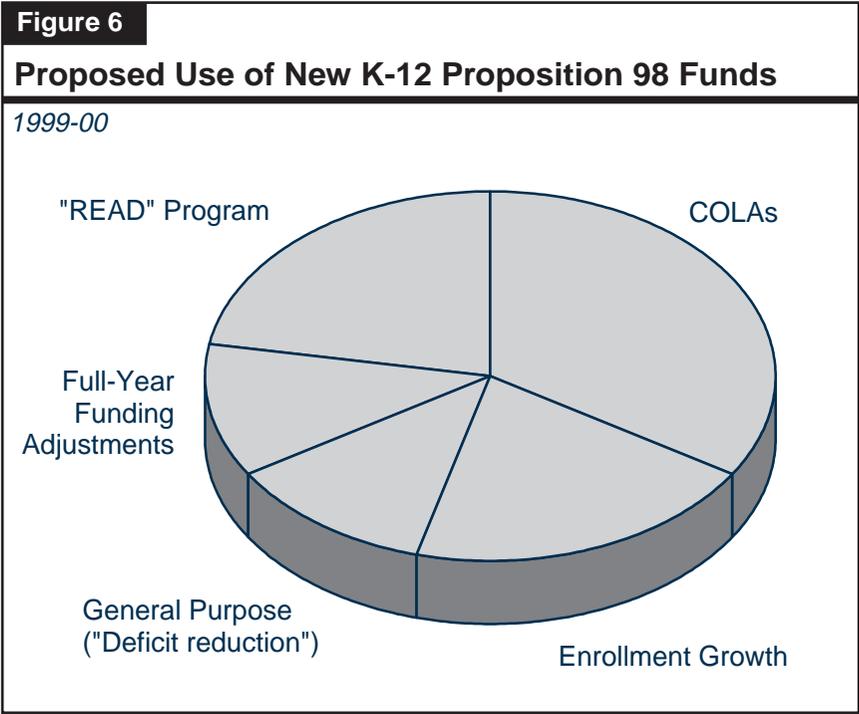
Part Four of this volume provides a discussion of expenditures for all program areas. K-12 education, which is the largest General Fund expenditure program and is the primary area in which the budget proposes new initiatives, is summarized below.

K-12 Education

The budget proposes moderate increases in Proposition 98 K-12 education spending, consistent with the growth in the minimum funding guarantee. Proposition 98 allocations to K-12 schools (including local property tax revenues) total \$32.8 billion in 1999-00. This represents an increase of \$1.5 billion over the current-year estimate. The budget effectively augments these resources through various program redirections (discussed below) by \$191 million, resulting in a total increase over the current year of almost \$1.7 billion.

How Are the New Monies Spent? Figure 6 displays the major proposed uses of the additional \$1.7 billion of Proposition 98 funds. The largest share—\$571 million (34 percent)—would provide a 1.8 percent cost-of-living adjustment (COLA) for district and county office apportionments (revenue limits) and categorical programs. General purpose and categorical program funding for the projected 1.4 percent growth in the student population accounts for another \$344 million (20 percent) of new Proposition 98 funds. Providing full-year funding for programs that began in the current year accounts for \$200 million (12 percent) of new funding. In addition, the budget provides another \$200 million for “revenue limit deficit reduction.” This proposed supplement of general purpose funding—which would continue in years after 1999-00—is intended to partly compensate school districts for prior years when the state did not fully fund statutory COLAs. Allocations for the above four expenditure categories combined with the proposed community colleges allocation, leaves \$365 million of Proposition 98 funds available for new K-12 programs.

New Programs. The budget allocates the entire \$365 million amount for a variety of new initiatives that the Governor groups together as his “READ” (Raising Expectations, Achievement and Development in Schools) program. These are subgrouped into three areas: (1) improving reading skills (\$176 million); (2) enhancing professional quality of teachers, principals, and other staff (\$29 million); and (3) school accountability (\$160 million). The budget proposes a total (all funds) of \$444 million for the READ program. This total includes both federal funds and allocations to the University of California and the community colleges.



Program Redirections. As mentioned above, the Governor effectively augments the amount of Proposition 98 funds available for new programs by redirecting \$191 million currently budgeted for four existing programs. The Legislature added \$115 million in the 1998-99 Budget Act to assist school districts in addressing a backlog of deferred maintenance of facilities. Although the Legislature intended that these funds be provided on an ongoing basis, the budget proposes to redirect this amount in 1999-00 and subsequent years. In addition, the budget proposes one-time redirections for the following three programs:

- \$50 million for after-school programs.
- \$16 million for the Beginning Teacher Support and Assessment program.
- \$10 million for the Healthy Start Pregnancy Prevention program.

Due to implementation delays in these three programs, the above amounts are expected to remain unspent at the close of the current year.

THE LAO'S BUDGET OUTLOOK

In this section, we provide the LAO's perspective on the General Fund outlook for 1999-00. We have also developed a forecast for 2000-01 in order to provide the Legislature with an indication of the implications of the Governor's spending plan. 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 prepared our own projections of expenditures that would occur *if the Governor's budget policies were fully adopted*. We have developed these estimates to help the Legislature evaluate the fiscal impact of the budget proposal, and to shape its own priorities for the 1999-00 budget.

The LAO Assumptions. In preparing these estimates we have made a number of judgments regarding the key budget-balancing elements shown earlier in Figure 4. For purposes of our estimates, for example, we have *not* assumed the \$432 million in savings associated with the budget's federal assumptions. While California's requests for additional federal funds have merit, there are no indications of federal actions in these areas to date. For example, the President's new budget proposes *less* federal funds to states to cover the costs of undocumented felons than was appropriated in this year's budget.

In other areas, we have incorporated the budget assumptions in cases where we believe the budget savings or additional revenues involved have a *reasonable* chance of occurring—even though some risk remains. For example, we have accepted the administration's estimate of tobacco settlement funds and the majority of its assumptions about receipts from asset sales and new tax audit collections in 1999-00. On the other hand, we have increased the budget totals in areas where we believe additional costs will occur, such as fire suppression and Medi-Cal rate increases.

Our key findings are displayed in Figure 7.

Current-Year and Budget-Year Outlooks

We forecast that both revenues and expenditures will exceed the budget forecast. Taking into account the net effect of these factors, we believe that the General Fund will end the 1999-00 fiscal year with a reserve that is at least \$500 million *above* the \$415 million forecasted in the budget.

The LAO's Economic Forecast. Based on recent positive trends, we forecast more near-term growth in both the U.S. and California economies than does the administration. For example, we project that U.S. real GDP will increase 2.6 percent in 1999, compared to the budget forecast of 1.9 percent. In general, we expect that while problems in Asia will continue to

Figure 7

Key LAO Budget Outlook Findings

Additional Resources Likely

- Current economic and revenue trends are clearly stronger than assumed in the budget.
- Based on these trends, we estimate that General Fund revenues will likely exceed the budget forecast by more than \$1.3 billion in the current and budget years combined.
- Part of the revenue gain we forecast will be offset by nearly \$800 million in higher expenditures, reflecting lower federal reimbursements and a number of other unbudgeted costs.
- The additional revenues will not trigger an increase in the Proposition 98 minimum funding guarantee, and thus will be available for any purpose.

Budget Plan Remains In Balance Through 2000-01

- We project that revenues and expenditures—if the Governor’s budget policies were fully adopted—would increase about 5 percent in 2000-01, and that the budget would remain in balance.
- Our estimates assume continued moderate economic growth through 2001.

depress growth in California’s high-tech industries, widespread expansion will occur in other areas of the economy.

The LAO’s Revenue Forecast. We forecast that General Fund revenues will be \$57.1 billion in the current year, or \$758 million above the budget forecast. This increase relative to the administration is due largely to our estimate of higher personal income tax collections. We forecast that revenues in 1999-00 will total \$60.8 billion, or \$558 million more than the budget projection. Again, the increase is largely related to higher income tax collections. Thus, for the two years combined, we project \$1.3 billion more in revenue than the administration.

Proposition 98 Interaction. The higher revenues we forecast do not trigger an increase in the Proposition 98 guarantee. (This is because we are in a “Test 2” situation, where additional revenues do not necessarily

trigger an increase in the guarantee.) However, our projection of the guarantee is affected by our higher estimate of personal income growth. Specifically, we estimate that the total guarantee will be \$111 million higher than the budget estimate in 1999-00. Because of our slightly higher estimate of local property taxes, General Fund spending will be up by a somewhat smaller amount—about \$67 million.

The LAO's Expenditure Estimates. We estimate that General Fund expenditures will total \$58.2 billion in the current year, or just \$27 million less than assumed by the budget. We estimate lower General Fund costs in Proposition 98 (because of higher local property taxes) and in corrections (due to lower caseloads), but somewhat higher expenditures for trial court funding and resource programs.

In 1999-00, we estimate that General Fund expenditures will be \$61.3 billion. This is \$794 million higher than the budget estimate. Of this total increase, \$432 million is related to our assumptions about federal reimbursements for Medi-Cal and corrections. We also project slightly higher costs related to statutorily required COLAs for CalWORKs and SSI/SSP grants. We also have included additional funds to cover the likely costs associated with the property tax administration loan program. Our forecasts for caseloads in most of the state's major programs are similar to the administration's. The one exception is Medi-Cal, where we are projecting somewhat lower caseloads in the budget year, resulting in savings in excess of \$100 million.

The General Fund's Condition. Figure 8 summarizes our estimates of revenues, expenditures, and the year-end reserve, assuming the Governor's policy proposals. We project that the current year will close with a reserve of \$1.4 billion, which is up \$784 million from the budget forecast. We project that 1999-00 will conclude with a year-end reserve of slightly under \$1 billion, which is \$548 million more than the budget estimate.

Budget Remains in Balance in 2000-01

To help the Legislature with its fiscal planning, we have developed a projection of revenues and expenditures in 2000-01, assuming the policies and proposals embodied in the new budget. As shown in Figure 8:

- Revenues would increase from 1999-00 by about 5.1 percent, to \$63.9 billion. Our projections assume that moderate economic growth continues in California, and that the state receives additional amounts (albeit smaller than in 1999-00) from the tobacco settlement during 2000-01.
- Expenditures would also increase by 5.1 percent, to \$64.4 billion. This moderate increase reflects a 5 percent growth in the Proposi-

Figure 8

**The LAO’s General Fund Condition
Assuming Governor’s Policy Proposals**

*1998-99 Through 2000-01
(Dollars in Millions)*

	1998-99	1999-00		2000-01	
		Amount	Percent Change	Amount	Percent Change
Prior-year fund balance	\$3,075	\$1,882		\$1,443	
Revenues and transfers	57,051	60,830	6.6%	63,941	5.1%
Total resources available	\$60,126	\$62,712		\$65,384	
Expenditures ^a	\$58,244	\$61,269	5.2%	\$64,413	5.1%
Ending fund balance	\$1,882	\$1,443		\$971	
Other obligations	\$480	\$480		\$480	
Reserve	\$1,402	\$963		\$491	

^a The LAO estimates of caseload and costs. Excludes increased federal reimbursements proposed in the budget.

tion 98 minimum funding guarantee, as well as caseload and inflation-related increases in other state programs.

- Based on our revenue and expenditure estimates, 2000-01 would close with a budget reserve of just under \$500 million.

Given the imprecision in *any* long-term revenue and expenditure forecast, the 2000-01 budget picture we project could obviously change significantly, depending on such factors as the economy, caseload trends, lawsuits, and federal reimbursement levels. What our 2000-01 estimate does suggest, however, is that under a moderate economic growth scenario, the budget proposal would remain in rough fiscal balance in the near term.

CONSIDERATIONS FOR THE LEGISLATURE

For its planning purposes, we believe it is prudent for the Legislature to assume that about \$500 million in resources will be available in the budget year beyond those envisioned by the Governor’s budget. This consists of \$1.3 billion in higher revenues, partly offset by \$0.8 billion in



additional costs that will occur if the budget's assumptions about federal reimbursements and other savings-related factors are not realized.

Moreover, as this report is going to press, economic data continues to come in much stronger than anticipated. If these positive trends continue, the revenue outlook could improve further at the time of the May Revision.

Augmenting the Budgetary Reserve Should Be a Top Priority

If revenues come in at the level we forecast or above, the Legislature will again be faced with significant decisions about how the additional funds should be allocated. In the past, we have argued for an increased budgetary reserve, and we believe this is especially appropriate with regard to the 1999-00 budget.

California's revenue base is becoming increasingly sensitive to changes in economic and financial developments. In the past several years, the state has benefitted from this sensitivity, as stock market-driven increases in capital gains and healthy overall economic growth have translated into major revenue increases. However, at some point, the same sensitivity could result in sharp declines in revenues if the above factors soften or reverse themselves.

For example, a one percent decline in the rate of economic growth translates into as much as \$800 million in reduced revenues annually. Similarly, a 20 percent decline in capital gains declared on taxpayers' returns (resulting from, for example, a modest retrenchment in the stock market) would reduce personal income tax collections by more than \$1 billion. Thus, even a modest slowdown in the state's economy, or a moderate reduction in stock market valuations, would depress state revenues by potentially several billions of dollars.

With regard to expenditures, although we have not incorporated the budget's assumption regarding additional federal funds in 1999-00, we have accepted many of its other assumptions, including those concerning asset sales and tobacco tax settlement funds. As noted earlier, these remaining assumptions carry some risks.

For these reasons, we believe that the Legislature should take advantage of these "good times" to devote a significant portion of unanticipated revenues toward building up a meaningful reserve. Such a reserve would cushion the state from the adverse effects of a revenue slowdown, and enable the state to avoid the most disruptive and painful adjustments that might otherwise be required during a more serious decline.

