May 1997

California UPDATE

Legislative Analyst's Office

State's Fiscal Outlook Brightens

The administration is scheduled to release the May Revision to its January budget proposal for 1997-98 on May 14. The updated budget plan released each year in May traditionally contains revised revenue and expenditure assumptions reflecting such factors as economic developments and adjusted caseload projections. In this update we highlight some of the key non-policy-related factors that will affect the 1997 May Revision.

Based on revenue and expenditure trends through April, there has been a significant improvement in the state General Fund's outlook. There are three key factors involved. First, revenues for 1996-97 and 1997-98 will be up significantly, largely reflecting stronger economic performance. Second, Proposition 98 educational funding will be up significantly because of the increased revenues and revisions to population and enrollment estimates. The third factor is reduced caseloads in key health and welfare programs, which in turn will yield significant expenditure savings relative to the January budget estimates. These and other key factors which will affect the May Revision are shown in Figure 1 and discussed below. It should be noted that the fiscal estimates we provide below are preliminary, and will be refined following the formal release of the May Revision next week.

Figure 1

LAO Preliminary Assessment of Fiscal Developments

- State's economy—strong and outperforming previous expectations.
- Revenue outlook improving—two-year potential revenue increase of roughly $2 billion relative to January budget projections.
- Proposition 98 funding for education—sharp increase due to increased revenues and other factors, including demographic revisions.
- Caseload-related savings in health and welfare programs—approximately $700 million relative to the January budget estimate.
- Cost pressures—state continues to face potential costs related to federal actions and other cost pressures not recognized in the January budget.

Economy and Revenues—Improved Performance

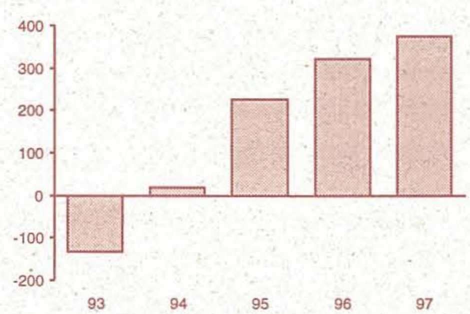
Strong Economic Growth Continues

California's economy in the first half of 1997 is experiencing strong economic growth with low inflation, and current signs are that healthy gains will continue in the coming months. As shown in Figure 2, the state added 374,000 jobs over the past year, including over 85,000 jobs in the past two months alone. Combined with other signs of economic strength—such as declining unemployment, increases in nonresidential construction, and healthy growth in state tax receipts (see below)—the current employment data suggest that California's economy is accelerating, rather than moderating as assumed in the earlier January budget forecast.

Figure 2

California Employment Growth Accelerating[a]

(In Thousands)



[a] Year-to-year change as measured from the first quarter of the year shown over the prior year's number.

Expansion Is Broad-Based. Economic growth is being led by a wide array of industries, including high-technology manufacturing and services, exports, tourism, and entertainment. In addition, some of the laggards in the current expansion—most notably aerospace and construction activity—are themselves starting to show signs of improvement. Given the strength and breadth of the economy's current expansion, we believe that healthy economic gains will continue through 1997 and into 1998.

Revenues Are Up

Healthy economic performance is translating into higher-than-expected General Fund revenues. Revenues from the state's three major taxes (which account for over 93 percent of General Fund revenues) were up about $520 million in April, primarily reflecting significantly higher-than-expected final payments on 1996 personal income tax returns. In addition, there were moderate gains in sales and use taxes and in corporate income taxes. Combined with the cumulative gain in revenues of $305 million relative to the budget estimate that was experienced through March, the April gain for the major taxes brought cumulative 1996-97 revenues to about $825 million above the January budget estimate.

Revenue Gains Will Likely Continue. Based on current healthy economic trends, we believe that revenues will continue to outpace the January projection through the balance of this fiscal year and in 1997-98 as well. Our own initial assessment—which we will refine as we complete work on our updated economic and revenue projections shortly—is that *revenues over the current* *year and budget year combined will exceed the January budget estimate by roughly $2 billion. Accordingly, we expect that the May Revision will show a significant upward adjustment to revenues.*

Proposition 98 Funding—Significant Increase

Based on our review of the various factors that determine the minimum funding guarantee under Proposition 98, we conclude that about 80 to 100 percent of the new revenues will go to K-12 schools and community colleges. This large increase is due to three changes that have occurred since the Governor's Budget was issued in January:

- ***Interaction of Higher Revenues With Proposition 98 Guarantee.*** The upward adjustments to General Fund revenues, discussed above, will result in an increase in Proposition 98 funding. In general, the Proposition 98 formula calls for 40 percent to 60 percent of additional General Fund revenues to go to K-14 education.
- ***State Population Revisions.*** The Department of Finance recently reduced its estimate of the state's civilian population for 1996 and 1997. This change, in effect, raises the per-capita revenue increase for 1995-96, which in turn acts to increase the Proposition 98 minimum guarantee.
- ***Higher School Attendance.*** Preliminary reports show 1996-97 school attendance is up significantly from the January estimate. This will increase the Proposition 98 guarantee in both the current and budget years.

Health and Welfare Caseloads—Down Sharply

Our preliminary estimate is that sharper-than-expected declines in health and welfare caseloads could yield a reduction in General Fund expenditures of $700 million in the current and budget years combined relative to the Governor's January Budget proposal. The key elements here involve:

- ***AFDC Caseloads—$525 Million in Savings.*** Caseloads in California's Aid to Families With Dependent Children (AFDC) program have been declining sharply over the past year. We estimate that 1996-97 caseloads will be down by nearly 6 percent from the prior year—compared to the January budget estimate of a 2 percent year-to-year decrease. Based on current economic and demographic trends, we believe that caseloads will continue to fall in the budget year, yielding a two-year savings relative to the January budget of about $525 million.
- ***Medi-Cal Caseloads—$150 to $200 Million in Savings.*** The number of AFDC-linked Medi-Cal eligibles has declined by more than 3 percent over the last twelve months. This compares with a budget estimate of only about a 1 percent decline in the current year. Furthermore, the number of eligibles in most other Medi-Cal categories is growing more slowly than the budget had estimated. Over

the current and budget years combined, General Fund caseload savings should easily exceed our estimate of $108 million in the *Analysis* (which was based only on declining AFDC-linked eligibles), and could approach $200 million.

Other Fiscal Developments

Beyond the changes in revenues, Proposition 98 funding, and health and welfare caseload reductions discussed above, there are a variety of other factors that could affect the fiscal outlook. On the up side, there are potential savings related to hospital construction costs and drug-related expenses in the Medi-Cal program. However, the state continues to face significant unbudgeted costs in a variety of areas. For example, as indicated in our February analysis of the budget, the state is dependent on federal actions for $636 million in budgetary savings—mostly in the health and welfare programs. All of these savings are subject to considerable risk, and at least half of the total—over $300 million—appears unlikely to materialize at this time.

Moreover, some provisions of the recent budget agreement between the President and Congressional leadership, particularly in Medi-Cal and public assistance, could result in additional state and local costs. The state also faces significant costs related to disaster relief expenses and the local property tax administration loan program. As we indicated in our February *Analysis*, these latter costs could total $125 million in 1996-97 and 1997-98 combined.

Finally, major court cases relating to Medi-Cal rates, reimbursement of counties for indigent care costs, and state pensions are pending that could have significant General Fund implications. While the fiscal impacts are most likely to occur after the budget year, it is possible that early settlement of one or more of the cases could have fiscal impacts on 1997-98.

Summary

Factors affecting the state's fiscal outlook include significantly higher revenues, substantially higher Proposition 98 funding, and significant savings in non-Proposition 98 programs related to caseload reductions. While some of the caseload-related savings could be offset by higher costs related to federal assumptions and other factors, it appears that the General Fund condition has improved significantly since January. We will provide a review of the May Revision following its release next week.

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