Policy Brief

An Overview of the 1994-95 Governor's Budget

SUMMARY

The 1994-95 Governor's Budget recognizes that the two-year budget plan adopted last June has been undermined by the continuing stubborn state recession. Faced with an $8 billion budget funding gap for 1993-94, the Legislature and Governor adopted a two-year plan to achieve a balanced budget in 1994-95. That plan now is $4.9 billion out of balance based on the state's current revenue and spending trends identified in the 1994-95 Governor's Budget.

The success of the Governor's 1994-95 Budget proposal hinges on actions at the federal level to approve a multibillion dollar increase in federal funds and on a favorable decision by the U.S. Supreme Court in a pending case affecting state tax revenues. This represents a highly risky strategy that could result in a multibillion dollar budget hole if the federal government or the Court fail to live up to the budget's expectations. Furthermore, the budget presents the Legislature with a difficult timing problem because it must adopt the state budget before Congress completes action on the federal budget.

The proposal continues the same spending priorities that have characterized the state's budget for the past several years. K-12 school funding and corrections spending receive high priority, while the budget proposes $800 million of spending reductions in health and welfare programs. The budget proposes no tax increases.

Perhaps the most important policy proposal in the budget is one that has no net fiscal effect in 1994-95. This is the Governor's plan for restructuring the state/county fiscal relationship, which is intended to give counties a significant cost share in the health and welfare programs that they administer in order to provide appropriate incentives to make those programs more efficient and effective.

This policy brief provides an assessment of the state's current fiscal outlook and evaluates the Governor's response to the situation. It also examines the implications of the 199596 outlook on possible budget strategies for 1994-95.

THE FISCAL SITUATION

The budget plan adopted last June was intended to pay off prior-year deficits over a two-year period. Although this meant that the 1993-94 budget was not balanced, the plan indicated that, by the end of 1994-95, the state would have a small surplus of about $100 million. As has consistently been the case in recent years, this plan assumed that' economic recovery was imminent and it would improve the state's revenue outlook. Once again, however, the Governor's Budget reflects a lowering of expectations in this area. As a result, the budget plan adopted last summer will not restore the state's fiscal balance by 1994-95, and significant budgetary adjustments must be made.

The Economic Outlook

The administration's forecast for the California economy now assumes that the state's economic recession will extend well into 1994, with only a moderate recovery in 1995. Thus, the current budget forecast is significantly more pessimistic than the forecast underlying last summer's budget plan, which assumed a late-1993 turning point and a stronger recovery.

Figure 1 compares the forecasts for two of the state's critical economic indicators, payroll employment and personal income, made by the Governor's Budget, the UCLA Business Forecasting Project, and the consensus-based Western Blue Chip Economic

Figure 1

Comparisons of California Employment[a] And Personal Income Forecasts

	Percent Change	
	1994	1995
Department of Finance		
Employment	-0.6%	0.7%
Personal income	4.0%	5.0%
UCLA Business Forecasting Project		
Employment	-0.2%	1.3%
Personal income	3.6%	3.4%
Western Blue Chip Economic Forecast		
Employment	-0.2%	NA
Personal income	4.3%	NA

a Nonfarm, payroll employment.

Forecast. For 1994, the Governor's Budget forecasts a greater fall in employment, but is similar to the other two forecasts on personal income. Compared with UCLA, the Governor's Budget projects a slower recovery in jobs, but greater growth in personal income in 1995. (Western Blue Chip will not produce a survey for 1995 until late February.) Part of the explanation of this apparent anomaly in the two 1995 personal income forecasts is that the Governor's Budget projects significantly higher inflation in 1995 than the Forecasting Project (3.6 vs. 2.3 percent for the national Consumer Price Index). After adjusting for this difference, projected real income gains for Californians are nearly the same in the Governor's Budget and UCLA forecast:.

The more pessimistic outlook for the California economy relates in part to federal budget changes that have taken place since last summer, particularly in the critical defense-spending sector. The federal budget that was passed in August made additional cuts in projected military spending beyond those in the Bush Administration plans. These cuts will reduce defense procurement contracts in California, continuing the steep decline since the late 1980s. In addition, the third round of base closures was overwhelmingly directed at California military installations. High-income taxpayers, who represent an above-national-average share of California residents, will also be subject to significantly higher federal income taxes, which will reduce consumer spending and investment in California to some extent. The changed outlook also reflects an increased recognition of the structural changes that are occurring in the state's economy. Continued housing price declines have dampened construction activity and reduced consumer spending. Also, California is relatively dependent upon exports, and sales to foreign trading partners continue to be dampened by weak foreign economies.

National Forecast in Line With Consensus. At the national level, the Administration's forecast is for continued steady, but moderate, growth in real Gross Domestic Product (GDP)of around **3** percent per year through 1995. This is slightly weaker than the Forecasting Project's outlook for 1994, but essentially the same for 1995. It is also in line with other national forecasts, such as the consensus projections by Blue Chip Economic Indicators and the National Association of Business Economists.

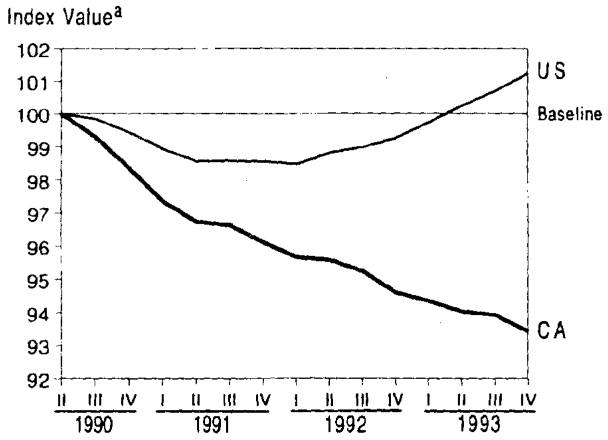
Until recently, the current national expansion has been termed a "jobless recovery" by many observers. As shown in Figure 2, U.S. nonfarm employment peaked in the second quarter of 1990 and did not fully recover until three years later. In the past, the usual recovery in jobs has taken 12 to 18 months. Furthermore, the national unemployment rate generally peaks near the end of a recession. In the present case, although the recession is officially dated as having hit bottom in the second quarter of 1991, the national unemployment rate continued to rise until June 1992, reaching a high of 7.7 percent.

Expectation of California's Recovery May Be Premature. Figure 2 also shows that California has not participated to date in the national economic recovery. Nonfarm payroll employment has fallen nearly 7 percent since its peak in May 1990, and shows no signs of turning up in the immediate future. The critical question for economic forecasters is exactly when these California employment losses will bottom out. The Governor's Budget assumes that will occur in late 1994.

Although the Governor's Budget forecast for California employment is weaker than the outlook of other economists, our preliminary review indicates that there is a significant possibility of continued declines in employment beyond those projected by the Governor's Budget over the next 12 to 18 months. This is because the state's dramatic losses of defense-related jobs have been compounded by severe problems in the construction industry. For example, home price declines, particularly in Southern California, accelerated in 1993, and high nonresidential vacancy rates have been stable at best in many of the state's metropolitan areas. Despite the record low mortgage interest rates that have increased home sales and construction in other parts of the nation, the expansion of building activity in California needed to stimulate the state's economy out of its recession is unlikely to occur until after home prices level off, and

Figure 2

California Employment Continues to Fall While U.S. Employment Grows



[a] Nonfarm payroll employment indexed to 100 in second quarter of 1990.

consumers regain confidence in the housing market. On the positive side, legislative actions in 1993 on a variety of tax and regulatory issues will likely improve the state's perceived "business climate," but these are also likely to take more than a year to have important effects on economic conditions.

The Revenue Forecast

Because the state's economy has generally not performed as well as was expected last May, current-year revenues are estimated to be somewhat weaker than projected when the 1993-94 budget was enacted. Revenues and transfers are now estimated to be $880 million (2 percent) below the budget estimates. In particular, sales tax revenues are now expected to be down approximately $400 million (3 percent), the largest single source of shortfall. Personal income tax revenues are expected to run approximately $100 million lower. The remainder of the shortfalls are accounted for primarily by minor revenues and transfers.

The outlook for 1994-95 has become significantly more pessimistic, however, relative to the forecast made last summer. Adjusting for policy changes incorporated into the Governor's Budget, 199495 revenues are approximately $1.8 billion lower than previously forecast. Almost half of this amount is attributable to lower expectations for sales tax collections. On this basis, revenue growth in 1994-95 is only $833 million, or 2.1 percent.

The revenue estimates contained in the Governor's Budget for 1994 95 reflect several assumptions or policy changes not contained in last summer's forecast. Discussed in greater detail later, these differences explain the somewhat higher rate of growth for revenues as stated in the budget—about $1.7 billion, or 4.2 percent.

Budget Plan Falls Out of Balance

Partially due to the state's continued economic misfortune, the state's two-year budget plan adopted in June now has fallen far out of balance. Figure 3 compares the June 1993 budget estimates for 1993-94 and 199495 with the January 1994 estimates just released in the 1994-95 Governor's Budget, adjusted to exclude the spending and revenue changes that are now proposed by the budget. Thus, the January estimates shown in Figure 3 incorporate the administration's latest revenue forecast and caseload projections. The budget plan adopted in June sought to reduce the General Fund deficit from $2.8 billion in 1992-93 to $540 million by the end of

Figure 3

Two-Year Budget Plan Falls Out of Balance
Change in General Fund Estirnates[a]
January 1994 versus June 1993

(In Millions)

	1993-94			1994-95		
	June	January	Change	June	January	Change
Prior-year balance	-52,233	-$2,289		-$130	42.073	
Revenues and transfers	40.623	39,743	-$880	42.418	40,576	-$I,842
Total resources available	$38,390	$37,454		$42.288	$38.503	
Expenditures	$38,520	$39,527	$1,007	$41.778	$43,04	$1.263
Ending balance	-$130	-$2,073		$510	-$4,538	
Reserve	-S540	-S2,466		S100	-S4,930	
Other obligations	$410	$393		$410	$393	

a Excludes Governors proposed budget solutions and restructuring proposal.

1993-94 and to achieve budgetary balance in 1994-95, ending the year with a small reserve of $100 million. As the figure shows, however, absent corrective action, the state's General Fund now faces a $4.9 billion deficit in 1994-95 that is attributable both to revenue shortfalls and spending increases.

Revenue Shortfalls. As we discussed above in our review of the current economic picture, the continued weakness in the California economy has reduced revenue estimates for the state's major tax sources. These changes reduce 1993-94 General Fund revenues by $880 million compared with the June estimate, and 1994-95 revenue estimates are reduced by $1.8 billion.

Spending Increases. As shown in Figure 3, our analysis indicates that spending is expected to increase by $2.3 billion over the two-year period covered by the budget plan. For 1993-94, this projection reflects current estimates of costs in major program areas, exclusive of solutions proposed in the budget. The 1994-95 baseline spending estimate shown in Figure 3 recognizes both increasing caseloads and the increasing costs of providing state services, except where existing law or policy requires otherwise. For example, our baseline estimate provides no increase in per-pupil K-12 education funding or in welfare grants. Our baseline includes funding increases to offset one-time savings in 1993-94 (such as the gain from adopting cash accounting for debt service), and it includes additional costs or savings associated with the full-year impact of changes that were in place for only a portion of 1993-94 (such as annualization of employee pay increases).

Several factors account for the increases in anticipated spending levels. The state's weak economy has reduced property tax receipts allocated to K-14 schools, and increased state spending will be needed to backfill these shortfalls in order to maintain per-pupil funding. In addition, county governments have implemented the property tax shift to schools adopted as part of the 1993-94 budget plan in a manner that reduces the amount shifted to the schools and in turn increases the state's liabilities (the budget proposes legislation to correct this problem). Together, these property tax shortfalls increase baseline spending by about $600 million over the two-year period.

A shortfall in previously expected federal funds accounts for $480 million of the spending increase. Specifically, the June budget plan included an annual savings of $240 million from federal funding to cover the state share of Medi-Cal costs for undocumented immigrants, but those funds were not approved by Congress. The remainder of the increase in the spending baseline primarily is due to a variety of shortfalls in savings anticipated from other actions in the June budget plan and some relatively minor caseload increases.

1994-95 Budget Gap: $4.9 Billion

Over the two-year period, we estimate that baseline revenues have declined by $2.7 billion and that baseline spending has increased by $2.3 billion compared with the June budget plan. Taking into account the $100 million reserve in the June budget plan, these changes would result in a 199495 year-end deficit of $4.9 billion if no corrective action is taken (please see Figure 3). This amount represents the two-year budget gap that now faces the state. Figure 4 illustrates the components of the budget gap. The $4.9 billion gap consists of the estimated carryover deficit from 1993-94 (almost $2.5 billion) and a $2.4 billion operating shortfall between baseline spending and estimated revenue in 199495.

Figure 4

1 994-95 Budget Gap[a]

(In Billions)

Pay off def~c from 1993-94		$2.5
1994-95 baseline spending	$43.0	
1994-95 baseline revenue[b]	-40.6	
Operating shortfall		$2.4
Budget Gap		**$4.9**

a Excludes Governor's Budget proposals.
b Based on admincstration's revenue forecast.

While the state's weak economy constrains revenue growth, baseline expenditures increase by $3.5 billion, or 8.9 percent, in 1994-95compared with the current year. Two programs account for more than half of the baseline spending increase—Medi-Cal health services and Proposition 98 education funding. Medi-Cal baseline spending increases by $1.1 billion in 199495 because of the expected continued rapid. growth in caseload and costs and to replace expiring federal funds. Proposition 98 funding also increases by over $1 billion in order to maintain per-pupil funding levels, in part because $800 million of funding in the current year was provided by an off-budget loan.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 5 shows the Governor's proposed amounts of spending and revenue for 1993-94 and 1994-95 and the resulting General Fund condition. (These estimates differ from those printed in the Governor's Budget because they incorporate the administration's post-budget release adjustments for additional federal fund recoveries and tax reduction proposals. They also differ in that they present the annual budget deficits in line with traditional state accounting practices.) As shown in the figure, General Func

Figure 5

Governor's Budget General Fund Condition 1993-94 and 1994-95

(Dollars in Millions)

		1994-95			
	1993-94	As Proposed[a]	Percent Change	Adjusted for Restructuring[b]	Percent Change
Prior-year balance	-$2,289	-$1,893		-$1,893	
Revenues and transfers	39,743	41,334	4.0%	43,105	8.5%
Total resources available	$37,454	$39.441		$41.212	
Expenditures	$39,347	$38,788	-1.4%	$40,559	3.1%
Fund balance	-$1,893	$653		$653	
Reserve	-$2,286	$260		$260	
Other obligations	393	393		393	

a Includes post-budget adjustments to revenue totals

b Includes $1.8 billion of General Fund revenues and expenditures that are shifted to local governments under the Governor's restructuring proposal.

revenues are expected to increase by 4 percent from the current year, while spending is expected to fall by 1.4 percent. However, this comparison includes the effect of transferring $1.8 billion of General Fund revenues and costs to local governments under the Governor's state/county restructuring proposal. In order to facilitate comparisons between the two years, the figure also shows the 1994-95 General Fund condition adjusted to add back the revenues and costs shifted to local governments under the state/county restructuring proposal. This adjustment has no effect on the projected General Fund balance because it is fiscally neutral as presented. On this adjusted basis, proposed General Fund revenues increase by 8.5 percent (largely due to the assumed federal funds and Barclays victory) and proposed spending increases by 3.1 percent in 1994-95 compared with 1993-94. As presented, the budget would result in a modest reserve of $260 million at the end of 1994-95.

How the Budget Addresses the Spending Gap

Figure 6 shows how the budget proposes to address the *$4.9* billion budget gap that we identified above (and also create a reserve of $260 million). As shown in the figure, most of the budget gap ($3.5 billion) is filled by shifting costs to other levels of government. In contrast with last year's budget proposal, which primarily relied on shifting costs to local governments, the current budget proposal primarily relies on shifting costs to the federal government to gain $3.1 billion of budget solutions. Of this amount, $2.3 billion represents the Governor's request for federal funding of the state's education, health care, and incarceration costs related to undocumented immigrants. The other major increase in federal funding ($600 million) would result from increasing the federal match in the state's major health and welfare programs from the current 50 percent to 54.4 percent, based on one of several alternatives recommended by the U.S. General Accounting Office (GAO). Both of these budget proposals would require action by Congress and the President.

Cost shifts to local governments would provide a net $385 million of solutions, primarily through legislation to revise the 1993-94 property tax shift. This legislation would effectively reverse property tax allocation method changes adopted by county governments which have increased the state's liabilities for K-12 schools.

Figure 6

Governor's Proposed Resolution Of the 1994-95 Budget Gap[a]

(In Billions)	
Shifts to other levels of government	**$3.5**
Federal Government:	
Reimbursements for costs of undocumented immigrants	$2.3
Increased refugee funding	0.1
Raise federal health and welfare match to 54.4%	0.6
Other funding changes in IHSS and SSI/SSP programs	0.1
Subtotal	($3.1)
Local Government:	
Correct flaws in prior property tax shift to schools	$0.4
Subtotal	($0.4)
[illegible]	**$1.0**
Welfare--AFDC grant reductions and reforms	0.5
Medi-Cal: eliminate optional benefits and perinatal services for undocumented persons	0.3
Reduce management positions	0.1
Other General Fund reductions	0.3
Shift special fund monies to General Fund programs	0.1
Program augmentations, including Community Colleges, AIM, student aid, and Cal-Learn	-0.2
Cost deferrals	**$0.1**
Shift flood control costs to bonds	0.1
Increased resources	**$0.5**
Assumed victory in *Barclays* case	0.6
New tax credit	-0.1
Total solutions[b]	**$5.2**
Establish 1994-95 General Fund reserve	-0.3
Budget gap solutions	**$4.9**

a Figures reflect both 199594 and 1994-95 effecls.

b Details do not add to totals due to rounding.

Program funding reductions account for $1 billion of savings. The largest savings come from proposed AFDC grant reductions and related welfare reform proposals. The budget also includes substantial savings from the elimination of certain Medi-Cal optional benefits (services that are not required by federal law) and the elimination of funding for perinatal services for undocumented women.

The budget assumes that the state will be victorious in the *Barclays* and Colgate cases now before the U.S. Supreme Court, which challenge California's past unitary tax treatment of corporate income from national and worldwide operations. A favorable decision would allow collection of approximately $600 million of disputed tax assessments in 1994-95. The budget also proposes a new tax credit for low and moderate income taxpayers, which has an expected revenue loss of $95 million in 1994-95.

Major Budget Proposals

Governor's Restructuring Proposal. The budget proposes a major shift of program responsibilities and funding from the state to the counties. As detailed in Figure 7, about **$3.2** billion in existing state costs for health and welfare programs would be shifted to counties, in exchange for higher allocations of local property tax revenues, an additional shift of state sales taxes, and greater state support for local trial courts. The budget proposal also would significantly revise the 1991 realignment program, essentially consolidating its funding structure to accommodate the new program and funding shifts.

Figure 7

Governor's State/County Restructuring Plan 1994-95

(In Millions)

State Resources Shifted to Counties	
Shift state sales tax revenues	$1.409
Shift school property taxes to countles (state backfills school losses)	1.140
Increase state trial court block grants	386
Return trial court fines and forfeiture revenues	296
Return mental health patient revenues	15
Total	**$3,246**

State Costs Shifted to Counties	
Established county share of Medl-Cal costs	$1,353
Increase county share of AFDC costs	1,147
Shift IHSS program to counties	364
Shift foster care program to counties	324
Shift most drug and alcohol programs to counties	62
Eliminate county servlces block grant	16
Total	**$3,287**

Under the proposal, county governments' share of the nonfederal portion of costs of the AFDC program would be raised from 5 percent to 50 percent. They also would be required to pay a new 11.51 percent share of total costs under the Medi-Cal program. In addition, they would assume complete financial responsibility for the Foster Care, In-Home Supportive Services (IHSS), and most Alcohol and Drug programs. These changes are intended to increase the financial incentives of counties to make program investments and operating decisions in ways that improve program performance. To the extent that program performance improvements reduce program costs, counties would be entitled to use the savings for other local purposes. To the extent that program costs increase, counties would be at risk for the additional expenditures. The proposal also would increase county flexibility to make program decisions in these and other program areas, although no specifics are provided. Because the proposal assumes the receipt of additional federal funds and the proposed AFDC grant savings, it is revenue neutral only to the extent these funds and savings actually are realized.

Increased Federal Funds. Figure *8* details the major components of the $3.1 billion of increased federal funding sought in the budget. Reimbursement of state costs that the Department of Finance attributes to undocumented immigrants accounts for $2.3 billion of the total, and the largest share of that amount is $1.7 billion for the estimated cost of K-12 education for students who are undocumented immigrants. The budget treats this $1.7 billion as an addition to General Fund revenues, rather than as an offset to General Fund spending. The budget also treats the $300 million sought as reimbursement for incarceration costs of undocumented felons as a General Fund revenue, rather than using it to reduce General Fund support for corrections. In contrast, the budget reduces General Fund support for Medi-Cal to reflect the $300 million in federal funds sought to cover state costs of federally required Medi-Cal services to undocumented immigrants.

As discussed earlier, the budget assumes that Congress and the President will adopt one of the options that the U.S. General Accounting Office (GAO) has recommended to revise the formula that determines the share of cost that the federal government pays each state for Medicaid (Medi-Cal in California), including many services provided by the

Figure 8

Major Federal Funding Proposals In the 1994-95 Governor's Budget

(In Millions)	
Costs for Undocumented Persons	
Reimburse state for K-12 education costs of undocumented children	$1,700
Pay full cost of Medi-Cal services to undocumented persons	300
Reimburse state for incarceration of undocumented felons	300
Subtotal	($2,300)
Other Proposals	
Increase federal match for health and welfare from 50 percent to 54.4 percent	
Medi-Cal	$408
AFDC	170
IHSS/Personal Care	15
Fund 36 months of health and welfare benefits for refugees	111
Expand coverage of IHSS/Personal Care services	46
Eliminate federal administrative charge for SSI/SSP program	43
Total	**$3,093**

IHSS program in California, and for AFDC. The current formula is based on a state's per-capita personal income with the federal share increasing as per-capita personal income declines. California, which has a relatively large number of high-income individuals, currently receives a match of 50 percent—lower than many states. The GAO alternative uses the proportion of a state's population in poverty and the relative tax base in each state to determine the federal match—with the federal share increasing with the former and declining with the latter. This revision would increase the federal share of costs to 54.4 percent in California, saving almost $600 million in General Fund costs in 1994-95, based on implementation on October 1,1994. Most of these savings would be in the Medi-Cal program.

The budget also assumes other federal actions that would save the state a total of $200 million. The actions include funding up to 36 months of benefits to refugees, expanding Medicaid eligibility to include IHSS services provided by a parent or spouse, and eliminating the federal charge for administering state supplemental grants to the SSI/SSP program that Congress imposed on states as part of last year's federal budget agreement.

Welfare Proposals. The budget proposes legislation to enact various AFDC grant reductions and welfare reforms similar to proposals that the administration has put forward in previous budgets. These actions include a 10 percent grant reduction effective July 1, 1994, an additional 15 percent grant reduction after six months on aid, and a two-year time limit for aid to able-bodied adults. The budget estimates $460 million in General Fund savings from these actions in 1994-95.

Medi-Cal Optional Benefits. The' budget again proposes to eliminate certain optional benefits that California provides under the Medi-Cal program. The benefits that would be eliminated include adult dental care, psychology, and podiatry for a net General Fund savings of $154 million in 1994-95.

Prenatal Sewices. The budget proposes to eliminate funding for a state-only program of prenatal services to undocumented immigrant women, effective February 1, 1994. This would reduce General Fund spending by $14 million in 1993-94 and by $92 million in 1994-95. Undocumented women would remain eligible for federally required emergency and obstetric services under Medi-Cal. The budget indicates that $59 million of these savings will be used to expand the Access for Infants and Mothers (AIM) program that provides subsidized health coverage for pregnant women and infants with family incomes between 200 percent and 250 percent of the poverty level and who do not qualify for Medi-Cal.

Proposition 98. The budget does not propose any major policy changes to Proposition 98 funding for K-12 schools and community colleges. Spending per K-12 pupil would be maintained at the current level, which results in spending exceeding the minimum guarantee. Unlike past years, the budget does not propose any Proposition 98 loans or recaptures, so that 1994-95 budget expenditures reflect the actual amount of Proposition 98 funding that schools and community colleges will receive in 1994-95.

New Bond Proposals. The Governor has indicated his support for $5.1 billion of General Obligation bonds for the June or November ballots. (He has also proposed $1.1 billion in new lease-payment bonds for prisons.) These proposals include $1.6 billion for K-12 school construction, $1.4 billion for prisons and a variety of public safety projects, including assistance for local flood control projects that the state has budgeted on a pay-as-you-go basis previously, $1 billion in rail bonds (already scheduled for the November ballot), $900 million for higher education facilities, and $200 million to fund a state infrastructure bank that would assist local governments. These proposals would be in addition to $2.2 billion in other bond measures already placed on the ballot by initiative and prior legislative action.

Tax Reduction Proposals. The budget proposes legislation which would reduce income taxes for moderate-income individuals and newly established businesses. For individuals, the administration proposes to provide a nonrefundable income tax credit of $25 to most single taxpayers earning less than $25,000 per year. Most married couples earning less than $40,000 per year would be eligible for a $50 credit. Because the credit is not refundable, however, those persons with incomes too low to have a state tax liability would not benefit from the credit. These credits would result in annual revenue losses to the General Fund of approximately $95 million, beginning in 1994-95.

The administration also proposes to provide tax credits to businesses which are established and begin operations during the next two years. These businesses would receive a refundable credit of $1,000 for each new full-time job they create. Eligible businesses would receive the credit for up to two years following the date they begin operations. This proposal would result in annual revenue losses of approximately $50 million for four years, beginning in 1995-96.

State Agency Consolidations. The budget proposes several changes that would reorganize, consolidate, or potentially eliminate existing state agencies. Among these are a consolidation of existing commissions and authorities in the State Treasurer's Office. Some of these would be consolidated within a new Revenue Bond Financing Authority, while in other cases their functions would be assigned to other state agencies or eliminated. Two new state agencies are referenced in the budget: a Department of Energy and Conservation to absorb the functions of the existing Energy Commission, State Lands Commission, and Department of Conservation, and a Department of Waste Management to take over the functions of the existing Integrated Waste Management Board. The specifics of the administration's plan are not available at this time.

Flattening State Agencies. The budget proposes to reduce the number of managers and supervisors in state agencies by 10 percent by the end of 1994-95. This proposal is intended to improve the responsiveness and efficiency of state government agencies. The budget anticipates savings of $150 million (all funds) in 1994-95 from this reduction but specific departmental proposals are not yet available.

BUDGET'S BALANCING ACT IS PRECARIOUS

The Governor's Budget proposal involves major uncertainties and faces significant threats that easily could throw the budget several billion dollars out of balance.

Budget Balance Hinges on Actions by Others. Most of the budget solutions proposed by the Governor ultimately lie outside the control of the Legislature. All of the $3.1 billion of assumed additional federal funding requires action by Congress and the President, and most of the savings attributed to AFDC grant reductions and limitations will require federal law changes or waivers. The additional revenue assumed from a victory in Barclays relies on a future Supreme Court decision. We estimate that less than $1.5 billion of the $5.2 billion of proposed budget solutions can be accomplished directly by the Legislature.

Timing of Economic Recovery Uncertain. As we discuss earlier, the economic forecast on which the budget is based, although not rosy, still contains substantial downside risks. Continued employment losses beyond those anticipated in the budget could have significant adverse impacts on expected revenue collections.

Pending Lawsuits Threaten Budget. While the budget assumes a $600 million gain from a victory in Barclays, an adverse decision in that case could require the state to refund $2.1 billion of past tax collections, according to a preliminary estimate by the Franchise Tax Board. Such a result would reduce the anticipated ending balance by $2.7 billion in 1994-95. In addition, two other court cases could have substantial negative budget impacts by 1994-95.

In the first court case---California Teachers' Association v. Gould—a recent Superior Court decision appears to relieve K-12 schools and community colleges from repaying $1.8 billion of state Proposition 98 "prepayment" loans. These loans were to be repaid as offsets against the state's future Proposition 98 funding requirements. If this decision (which is not yet in writing) is upheld, it could require the state to show these loans, which currently are carried off-budget, as on-budget expenditures, which would worsen the stated General Fund condition by $1.8 billion. Furthermore, it appears that the decision could increase the state's ongoing Proposition 98 obligations by hundreds of millions of dollars annually because the loans would be rolled into the schools' permanent funding base.

In the second court case, Orthopedic Hospital v. Kizer, Medi-Cal providers contend that the state's payments for hospital outpatient services are too low and constrain access to care, in violation of federal law. The court has found that the current rates are arbitrary and has ordered the Department of Health Services to review its rate-setting methodology and report its findings in April 1994. We believe that the potential cost of increasing provider rates could easily be in the range of several hundred million dollars annually, in part because a decision to increase reimbursement rates for outpatient services provided in hospitals would effectively require a similar increase for all outpatient services.

THE OUTLOOK FOR 1995-96

The economic forecast on which the budget is based projects a resumption of modest job growth in California by the end of 1994. If the budget's economic forecast is accurate, we estimate that revenue growth would pick up in 1995-96, so that baseline revenues would increase by 4.6 percent. Whether this projected improvement in the state's economy next year is sufficient to pull the state out of its fiscal crisis depends upon the expected rate of growth for state spending.

In order to examine the 1995-96 outlook, we have extended our baseline spending projection to that year. This projection does not provide any basis for an optimistic outlook, because baseline spending grows almost twice as fast as revenues. As a result, the baseline operating deficit in 1995-96 would be $4.1 billion-significantly larger than our estimate of the baseline operating deficit of $2.4 billion in 1994-95. Continued rapid growth in costs for Medi-Cal and corrections are a major reason for the large baseline spending increase. The other major reason for the fiscal deterioration is the need to replace roughly $1 billion of temporary budget savings and revenues. These expiring budget solutions include the deferral of the state's PERS retirement contribution, the suspension of the renters' tax credit, and the expiration of the temporary 10 percent and 11 percent top personal income tax brackets.

DOES THE BUDGET WORK?

If the federal government, the courts, and the economy fulfill all of the budget's expectations, the state would regain fiscal balance in 1994-95 and (if this fulfillment is ongoing) remain in balance through 1995-96. However, we believe that it is much more likely that events will fall short of these expectations. In that event, the Legislature will once again face a multibillion dollar hole in the budget early in the 199495 fiscal year, at a point in time when it is difficult to make modifications. This would result, once again, in a large carry-over deficit to be dealt with in the next fiscal year.

As discussed above, the outlook past 199495 indicates that the' state's ongoing shortfall between revenues and spending will worsen, even with a modest recovery in place. This situation requires a budget strategy that looks beyond 199495 and achieves ongoing and growing savings over the next several years. We offer the following guidelines for the Legislature to use in developing a long-term budget strategy:

- One-time savings actions can buy time to implement ongoing savings; they should not be adopted as a substitute for them.

- Actions that produce significant future savings should be adopted even if they yield little or no savings in 1994-95, because the need for future savings will grow.

- Similarly, actions which result in significant future costs should be avoided.

- Existing laws that end savings, reduce revenues, or restore spending during the next few years should be reviewed.

- Federal health care reform efforts should be closely monitored since Medi-Cal cost increases are a major factor driving state spending growth. The Legislature should encourage Congress and the President to adopt reforms that help to bring the state's Medi-Cal costs under control.

- Efforts should be made to evaluate potential savings in corrections' programs that will reduce the rapid growth in those costs and focus resources on protecting the public from violent crime.

CONCLUSION

As we have discussed above, the state's economy has continued to undermine the Legislature's and the Governor's best efforts to bring the ongoing fiscal crisis under control. We do not expect this situation to be reversed in the near future, as it is unlikely that an improved economic outlook will prevent the need for significant and painful reductions in state spending. Rather, the use of optimistic expectations for the budget would be likely to merely defer the day of reckoning and make the reductions ultimately required all the more severe. The Legislature's best strategy is to focus on putting into place the types of changes that will produce the long-run savings that are needed.

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