Budget Brief

An Overview of the 1995-96 Governor's Budget

SUMMARY

This brief provides an overview of the 1995-96 Governor's Budget. Its principal findings are that:

- *The plan adopted last July to pay off the 1993-94 budget deficit over a two-year period and achieve a balanced budget by the end of 1995-96 is now out of balance, by about $2 billion.*
- *The Governor proposes to eliminate the budget gap and end 1995-96 with a small surplus by taking several steps. These include $1.4 billion of program reductions (primarily welfare grant reductions) and savings, and shifting $0.9 billion of costs to the federal government and localities (through a state/county restructuring proposal).*
- *The Governor proposes a phased-in 15 percent reduction in income tax rates, in combination with leaving high-income tax brackets in place that are scheduled to expire in 1996. The estimated net revenue loss from this tax proposal is $225 million in 1995-96 and a cumulative $7.6 billion over four years.*
- *There are a number of major budget risks that could jeopardize achieving a balanced budget in 1995-96. These risks include pending budget-related litigation and reliance on future federal actions.*
- *If the Governor's fiscal policies for education, corrections, and tax reductions are projected over the next four years, it is probable that the remaining 40 percent of the budget would face program cutbacks (primarily health, welfare, and general government).*

ŸThe nation's economy experienced the best of both worlds in 1994—reasonably good growth with relatively modest inflation.

INTRODUCTION

The 1994-95 budget plan adopted last July was intended to pay off prior-year deficits over a two-year period and achieve a balanced budget in 1995-96. The 1995-96 Governor's Budget now indicates that the two-year plan adopted last July has fallen out of balance, and that significant budgetary adjustments must be made in order to restore the state's fiscal balance by the end of 1995-96.

The state's economic performance during 1994 is not to blame for the current budget problem. In fact, the state is experiencing a modest revenue increase due to improved economic growth, and caseload growth is moderating as well. Instead, the current budget problem reflects the large gap between the July plan's assumption that the state would receive $3.6 billion of federal funds for immigrant costs through 1995-96, and actual federal appropriations and authorizations to date, which will provide about $300 million.

NATIONAL ECONOMIC EXPANSION CONTINUES

The nation's economy experienced the best of both worlds in 1994—reasonably good growth with relatively modest inflation. Real Gross Domestic Product (GDP) rose by about 4 percent, and inflation was 3 percent. Labor markets reflected the strength in the economy, as the unemployment rate dropped to almost 6 percent.

The main concern about the nation's economy at present is that it is nearing the point at which inflationary pressures may take hold. The Federal Reserve (FED) has attempted to engineer a "soft landing" by raising interest rates, hoping to slow the economy down a bit without curtailing economic growth. Accordingly, the FED has taken action to raise interest rates six times since last February.

Although many economists expect the FED to raise interest rates again when it meets at the end of this month, some recent signs suggest that the economy may be slowing. For example, retail sales dipped in December, the first decline in eight months, and November retail sales growth was just revised down significantly. Additional evidence about the strength of the economy will be available shortly when new data are released regarding economic growth in the fourth quarter of 1994.

Figure 1

Comparative National Economic Forecasts

	Percent 1995	Percent 1996
Department of Finance		
Real domestic product growth	2.5	2.2
Unemployment rate	6.0	6.3
Inflation rate	3.5	3.6
Blue Chip Consensus[a]		
Real domestic product growth	3.1	2.2
Unemployment rate	5.6	5.7
Inflation rate	3.3	3.6

[a] As of January 1995.

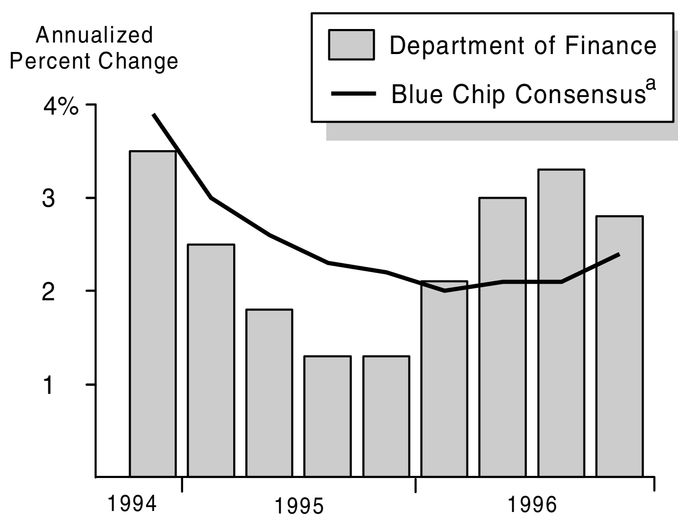
The Department of Finance's Outlook

Figure 1 shows that the Department of Finance (DOF) expects economic growth to slow to 2.5 percent in 1995 and 2.2 percent in 1996, with inflation in the mid-3-percent range in both years. Other elements of the forecast are for a slowing housing market, continuing gains in business investment, and ongoing strength in foreign trade.

As Figure 1 indicates, the DOF forecast is in general agreement with the consensus forecast, although the consensus forecast is stronger for 1995. This is especially true in the latter three quarters of 1995, as shown in Figure 2.

Figure 2

Comparative Patterns of Growth In National Gross Domestic Product



[a] As of January 1995.

CALIFORNIA'S ECONOMY IS CLEARLY RECOVERING

California's economy is strongly influenced by national economic performance. However, its unique characteristics also mean that its performance can differ significantly from the nation's. The state's recession was worse and its recovery has been slower than the nation's. California experienced relatively sluggish economic performance through the early part of 1994. A variety of indicators suggest, however, that the state's economy is now on a sustained recovery path.

Figure 3 shows that the DOF predicts that state personal income will increase by 6.6 percent in 1995 and 6 percent in 1996. Employment growth is expected to be in the range of 2 percent to 3 percent annually, and moderate growth is predicted for corporate profits and taxable sales. The department's forecast of ongoing expansion is shared by other forecasters.

Even though continued expansion is expected, the strength of the state's economy will be limited by continued cutbacks in defense spending, military base closures and industry restructuring. It also will depend on the strength of the export market and whether further interest rate increases occur, which could depress the recovering housing market.

Figure 3

Department of Finance
California Economic Outlook

	Actual	Projected	
	1994	1995	1996
Percent change in:			
Personal income	4.2%	6.6%	6.0%
Employment	1.3	1.8	2.5
Inflation	1.5	2.9	3.2
Taxable sales	5.2	6.0	6.0
Corporate profile	15.7	4.7	4.3
Unemployment rate	8.7%	7.8%	7.4%
New housing permits (000s)	97	109	153

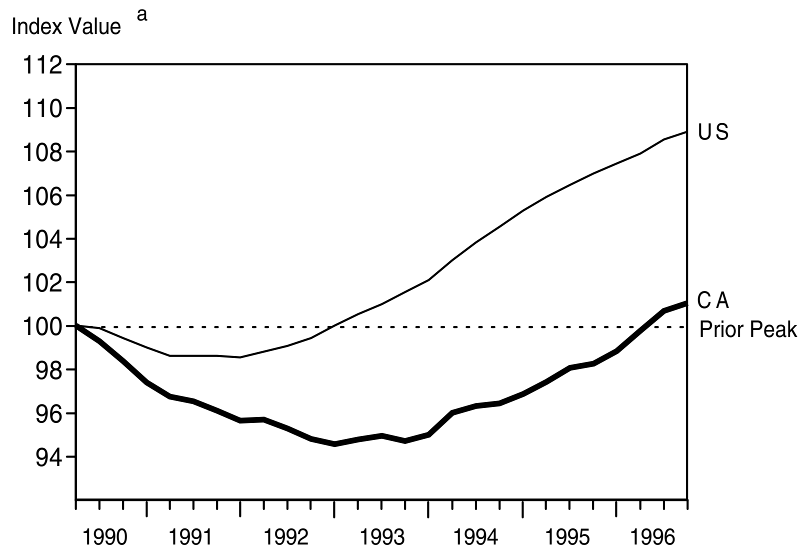
Employment Still Below Prior Peak

California employment is predicted to finally get back to its pre-recession level in the last half of 1996. Figure 4 shows that employment began declining in early 1990 and hit a low point in the first quarter of 1993. Job losses totaled nearly 700,000 during this period. Since then, employment has increased steadily, having risen by about 240,000.

ŸA variety of indicators suggest . . . that the state's economy is now on a sustained recovery path.

Figure 4

California Employment Rising But Still Trailing Nation



[a] Nonfarm payroll employment indexed to 100 in second quarter of 1990. Projections for 1995 and 1996 by Department of Finance.

Moderate Underlying Revenue Growth Expected

The budget forecasts General Fund revenues of $42.4 billion in the current year and $42.5 billion in budget year. Special fund revenues are forecast to be $12.2 billion in the current year and $13.5 billion in the budget year.

Budget Proposals Mask Revenue Growth

The budget contains two significant proposals which reduce General Fund revenues by over $1.2 billion. Specifically, the budget:

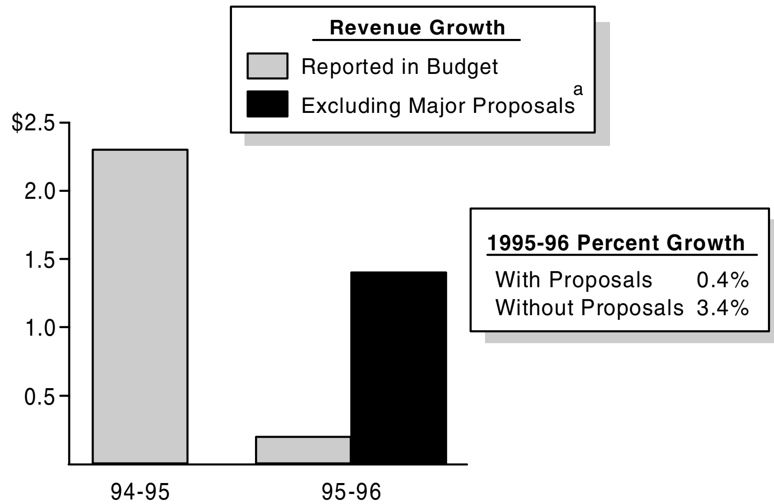
- Contains a state/local realignment proposal, which would shift close to one-quarter cent of the state sales tax ($710 million) and Trial Court Funding monies ($311 million) to localities.

Ÿ . . . the two-year budget plan adopted in July has fallen out of balance [by $2 billion].

Figure 5

Effect of Major General Fund Revenue Proposals On 1995-96 Revenue Growth

(In Billions)



[a] Major proposals include realignment and tax reduction.

- Proposes a tax reduction for personal income taxpayers and bank and corporation taxpayers. The revenue reduction in the budget year would be $225 million.

If these proposals are adopted, General Fund revenues will increase by $185 million, or 0.4 percent in the budget year as shown in Figure 5 (see page 6).

The figure also shows that without these proposals, underlying budget-year General Fund revenue growth is $1.4 billion, or 3.4 percent. Revenue growth is even somewhat higher if adjustments are made for a variety of special factors, such as the phasing-in of various previously enacted legislation.

The rate of special fund revenue growth also is distorted by proposals in the budget. The $1.3 billion (11 percent) increase in special fund revenues in the budget drops to $600 million (4.9 percent) after the sales tax shift to localities is removed.

Thus, in the case of both General and special fund revenues, underlying growth is moderate.

The department's revenue forecast is

generally consistent with its economic forecast. However, there are other reasonable economic forecasts which would result in somewhat greater or lesser revenues.

Two-Year Budget Plan Is Out of Balance

Despite the improvement in the state's economic and revenue outlook, the two-year budget plan adopted in July has fallen out of balance. This is because the budget's assumption of $3.6 billion of additional federal funding for immigrant costs far exceeds federal action to date.

Figure 6

Two-Year Budget Plan Out of Balance

(Dollars in Billions)

	General Fund Impact[a]
Reduced 1993-94 carryover deficit	$0.5
1994-95	
Improved revenues	$0.8
Spending increases	-0.4
1995-96	
Improved revenues	$0.6
Spending increases	-0.3
Reduced encumbrance obligations	$0.1
Underlying Improvement	**$1.3**
Federal immigrant funds[b]	
1994-95	-$0.7
1995-96	-2.6
Federal funds shortfall	**-$3.3**
Budget Gap	-$2.0

[a] Measures change between July 1994 and January 1995 budget estimates. Excludes Governor's proposed budget solutions and proposals, including realignment and tax reduction.

[b] Based on current federal appropriations and authorizations.

Figure 6 shows the changes to the July 1994 budget estimates for 1994-95 and 1995-96, based on the January 1995 estimates just released in the *1995-96 Governor's Budget*, adjusted to exclude new revenue and spending proposals in the budget. Thus, the changes shown in the figure reflect our estimate of baseline revenues and spending using the administration's latest revenue forecast and caseload projections. The federal funds shortfalls shown in the figure reflect the difference between the July budget estimates and our current estimate of California's share of federal appropriations and authorizations that have actually been approved by Congress to date.

State Faces $2 Billion 1995-96 Budget Gap

The budget plan adopted in July sought to eliminate an estimated $2 billion 1993-94 year-end budget deficit by the end of 1995-96, when the General Fund would achieve budgetary balance (with a minimal reserve of $29 million). As the figure shows, however, absent corrective action, the state's General Fund now faces a $2 billion budget gap, in

1995-96. While the state's underlying revenue and expenditure trends have improved by $1.3 billion, commitments

Ÿ . . . program reductions and savings fill most of the budget gap . . .

of federal immigrant funds fall $3.3 billion short of the July assumptions.

Underlying Trends Improve

In contrast with recent years, changes in the state's underlying revenue and spending trends (excluding federal immigrant funding) have been positive since enactment of the budget. Budget estimates indicate that underlying revenues and expenditures both have grown, but that the revenue increase is twice as much as the spending increase.

Revenues Are Up. Estimated General Fund revenues show improvement over the two-year period, reflecting the strengthened economic outlook. Compared with the July budget estimates, revenues (before the proposed tax reduction) increase by a total of $1.4 billion—$817 million in 1994-95 and $583 million in 1995-96. Improved revenue collections in the final months of 1993-94 also account for most of the $500 million reduction in the deficit carried over from 1993-94.

Revenue Gains Increase Proposition 98 Spending. Projected spending increases in 1994-95 and 1995-96 offset half of the revenue gain in each year. These spending increases primarily reflect the effect of the additional revenues in increasing the state's funding obligation to schools and community colleges under the Proposition 98. Other spending changes are roughly offsetting.

Federal Funds Shortfall. Of the total of $3.6 billion of new federal funds for the costs of illegal immigrants and refugees assumed in the July budget plan, we estimate that Congressional actions to date will provide about $300 million—all for incarceration costs of felons who are illegal immigrants. California will receive about $78 million over the two years from a current federal budget appropriation. The federal crime bill also authorizes an additional $300 million appropriation nationwide for the federal 1996 budget, of which California's share could be about $200 million. To date, however, Congress has not provided any of the new funding assumed in the July budget plan for education and health care costs of illegal immigrants or for refugee costs. Thus, there is a $3.3 billion federal funds shortfall in the two-year budget plan.

As a result of the changes discussed above, the Governor's 1995-96 budget proposal must address a $2 billion budget gap. The difference between the $3.3 billion federal funds shortfall and the $1.3 billion underlying improvement. The budget gap represents the minimum amount of savings or revenue from changes to existing laws and policies that is needed in order to achieve a balanced budget in 1995-96. As such, it is a useful measuring stick

Figure 7

**Governor's Budget
General Fund Condition
1994-95 and 1995-96**

(Dollars in Millions)

			Percent Change	
	1994-95	1995-96	As Presented	Adjusted for Realignment[b]
Prior-year balance	-$1,119	-$459		
Revenues and transfers	42,353	42,538	0.4%	2.8%
Total resources available	**$41,234**	**$42,078**		
Expenditures	$41,693	$41,726	0.1%	2.5%
Ending balance June 30, 1993	**-$459**	**$352**		
Reserve	-$740[a]	$92		
Other obligations	$281	$260		

[a] The budget shows a positive reserve of $285 million due to the inclusion of $1,025 million of deficit borrowing as a budget resource.

[b] Adjusted to include $1,021 million of revenues and costs that would be shifted to counties in 1995-96 under the Governor's realignment proposal.

for budget-balancing actions and provides a basis for comparing different approaches to resolving the budget problem.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 7 shows the Governor's proposed amounts of revenues and spending for 1994-95 and 1995-96 and the resulting General Fund condition consistent with traditional state accounting practices. Proposed revenues and spending in 1995-96 are almost unchanged from the estimated 1994-95 amounts. This lack of growth, however, reflects the effect of the Governor's realignment proposal, which shifts $1 billion of state revenues and equivalent expenditures to counties. Figure 7 also shows the percentage growth in spending and revenues adjusted to include these shifted amounts in order to place figures for 1994-95 and 1995-96 on a comparable basis.

Adjusted for realignment, proposed General Fund revenues and spending both increase modestly in 1995-96, with revenues growing slightly faster than spending—2.8 percent revenue growth versus 2.5 percent spending growth. For comparison, our estimate of baseline spending grows by 8 percent from 1994-95 to 1995-96. The budget projects a small reserve of $92 million at the end of 1995-96.

How the Budget Addresses the Gap

Figure 8 (see page 10) shows how the budget proposes to address the $2 billion budget gap noted above and allow for the $92 million reserve. Thus, the administration still proposes to eliminate the 1993-94 carryover deficit by the end of the budget year.

Spending. As shown in the figure, program reductions and savings fill most of the budget gap ($1.4 billion). The bulk of the proposed reductions are in health and welfare programs, and they generally reflect a continuation of proposals that the Governor made last year. The largest amounts of savings come from proposed welfare grant reductions and restrictions in the AFDC and SSI/SSP programs.

Federal Funds and Realignment. The budget continues to rely on additional federal funding to offset the state costs of providing services to illegal immigrants and to refugees. However, the amount of new federal funds is much less than the $2.8 billion assumed in the July budget estimate for 1995-96. The budget also includes a net state savings of $241 million from realignment. Resources provided to counties would fall short of costs shifted to them by this amount, which the budget proposes to offset with county savings from proposed mandate relief legislation.

Revenues. Budgeted revenues reflect a reduction of $225 million in 1995-96 due to the first year of a phased three-year reduction in personal and corporate income taxes. Approximately half of this revenue loss is offset by a reduction in education funding due to the resulting reduction in the Proposition 98 minimum funding guarantee.

MAJOR BUDGET PROPOSALS

Governor's Realignment Proposal. The budget proposes a significant shift of responsibility and funding from the state to the counties for certain welfare and social services programs. As detailed in Figure 9, the proposal shifts about $1.9 billion of state costs to the counties, along with $1.6 billion of state resources (a combination of state sales

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Figure 8

Governor's Proposed Resolution Of the 1995-96 Budget Gap[a]

(Dollars in Billions)

Program reductions/savings	**$1.4**
Welfare	
AFDC grant reductions and reforms	0.4
SSI/SSP grant reductions	0.4
Restrict eligibility	0.1
Medi-Cal	
Eliminate optional benefits and prenatal services for undocumented persons	0.2
Various cost containment measures	0.1
Proposition 98—tax cut reduces school funding guarantee	0.1
Other reductions/savings	0.2
Augment funding for disasters and emergencies	-0.1
Other augmentations, including REACH and AIM	-0.1
Shifts to other levels of government	**$0.9**
Federal Government	
Additional reimbursements for illegal immigrant costs	0.5
Increased refugee funding	0.1
Eliminate SSI/SSP administrative charge	0.1
Subtotal	**($0.6)**
Counties—unfunded realignment costs	**$0.2**
Taxes	**-$0.2**
Tax reduction proposal	-0.2
Total solutions	**$2.1**
Establish 1995-96 General Fund reserve	**0.1**

[a] Detail does not add to totals due to rounding.

tax revenue and increased state funding for local trial courts). The state would realize a net savings (and the counties a cost) of $241 million in 1995-96 under the proposal. The current realignment proposal contains some of the same elements included in the more extensive restructuring proposal presented in the 1994-95 Governor's Budget.

Budget Depends on Federal Actions. Federal actions to provide new funds or to change laws or waive existing program requirements are necessary in order to achieve $1.5 billion of the proposed savings in the budget. Figure 10 (see page 12) lists these budget proposals and categorizes them.

As shown in the figure, the budget assumes savings of $590 million in

ŸThe budget proposes legislation to enact various AFDC grant reductions and welfare reforms similar to proposals that the administration has put forward in previous budgets.

1995-96 from additional federal funds to offset the state costs of health and welfare services to illegal immigrants and to refugees. This amount is in addition to $245 million for incarceration costs that we estimate is the state's share from existing federal appropriations or authorizations. The January budget proposal, however, does not include $1.7 billion of federal reimbursements in 1995-96 assumed in the July budget plan for the education costs of illegal immigrant children. Figure 10 also shows that a total of $880 million of proposed savings in 1995-96 depend on the enactment of federal legislation or the approval of administrative waivers.

Figure 9

Governor's State/County Realignment Plan[a] 1995-96

(Dollars in Millions)	
State Costs Shifted to Counties	
Increase county share of AFDC costs	$1,157
Shift programs to counties	
Foster care	329
Child welfare and abuse prevention	298
Adoption	83
Total	**$1,868**
State Resources Shifted to Counties	
Shift state sales tax revenues	$710
Increase state trial court block grants	605
Return trial court fines and forfeiture revenues	311
Total	**$1,626**
Net State Savings	**$241**

[a] Detail may not add to totals due to rounding.

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 7.7 percent grant reduction effective September 1, 1995, 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 $254 million in General Fund savings from these actions in 1995-96.

The budget also proposes SSI/SSP grant reductions of 8 percent for individuals and 10 percent for couples, for a General Fund savings of $434 million in 1995-96.

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 $143 million in 1995-96.

Prenatal Services. The budget proposes to eliminate funding for a state-only program of prenatal services to undocumented immigrant women. This would reduce

Figure 10

1995-96 Governor's Budget Solutions Requiring Federal Action

(In Millions)	
Costs for Immigrants	
Pay full cost of Medi-Cal services to undocumented persons	$310
Reimburse state for incarceration of undocumented felons	177[a]
Fund 36 months of health and welfare benefits for refugees	103
Subtotal	**$590**
Other Proposals	
Federal legislation needed	
Eliminate federal administrative charge for SSI/SSP program	$50
SSI/SSP grant reductions	434
Bar sponsored immigrants from receiving Medi-Cal and AFDC benefits	64
Eliminate drug/alcohol abuse disability category for SSI/SSP program	52
Reduce Medi-Cal rates for "distinct part" nursing facilities	26
Waiver needed	
AFDC grant reductions	254
Subtotal	**$880**
Total	**$1,468**

[a] Amount budgeted in excess of estimated $245 million from existing authorizations and appropriations.

General Fund spending by $79 million in 1995-96. Undocumented women would remain eligible for federally required emergency and obstetric services under Medi-Cal.

Full Funding for Corrections. The budget proposes $3.5 billion ($3.3 billion from the General Fund) for support of the Department of Corrections (CDC). The budget proposal represents an increase of $374 million, or 13 percent, above estimated General Fund expenditures in the current year. The proposed increase will essentially provide *full funding* for workload growth in the department and provide augmentations for several policy changes.

Proposition 98. The budget proposes an additional $1.2 billion in Proposition 98 for K-12 and community colleges in 1995-96 due to strong General Fund revenue growth and a large anticipated increase in the K-12 student population. Consistent with existing statute, the budget proposes to deduct a total of $514 million (1994-95 and 1995-96) from the amount of funds distributed to school districts. The deductions would be partial repayments of past Proposition 98 loans.

Ÿ . . . about 70 percent of the net benefits of the tax proposal would go to individuals and 30 percent to corporations.

The additional funding increases average per-student support for K-12 to $4,292, an increase of $61, or 1.4 percent. The budget proposes a 2.2 percent cost-of-living adjustment, at a cost of $444 million in K-12 general purpose spending and special education and $55.2 million for community colleges. No cost-of-living adjustment is proposed for K-12 categorical programs.

Higher Education. The budget treats the University of California (UC) and the California State University (CSU) in a similar manner after adjusting for one-time expenditures at CSU. For each segment, the budget provides 2 percent increases for unspecified general purposes and funds increases in debt service costs for lease revenue bonds. The budget proposes a "four-year compact" with UC and CSU which includes a commitment to provide General Fund increases averaging 4 percent for the three fiscal years beginning in 1996-97. Among other things, the plan also calls for enrollment growth averaging about one percent annually, increases in faculty salaries, "productivity improvements," and reductions in students' time to obtain an undergraduate degree.

Department of Transportation Staff Reduction. The budget proposes to reduce the staffing level of Caltrans by over 1,200 personnel-years (PYs). This reduction is primarily due to a funding shortfall resulting from failure of various transportation bond measures. About one-third of these reductions are proposed in departmental administration and in highway project design and engineering.

Tax Proposal. As noted earlier, the budget contains a major tax reduction proposal. This proposal is discussed in the following section.

THE GOVERNOR'S TAX PROPOSAL

The Governor has adopted the recommendation of his Task Force on Tax Reform and Reduction that the state's income tax rates be reduced. The Task Force's view is that California's tax rates are too high, and that reducing them will stimulate economic activity, including attracting more businesses to California.

The Two-Part Proposal

The tax proposal has two parts:

- ***Continued high-income tax rates.*** The 10 percent and 11 percent personal income tax rates for high-income taxpayers would be continued. These rates have been in place since 1991 and were scheduled to return to 9.3 percent in 1996.

- ***Across-the-Board Tax Rate Reductions.*** Tax rates for both individuals and businesses would be reduced by a total of 15 percent from their 1995 level. The reduction would be phased-in evenly over three years—5 percent in 1996, 1997 and 1998.

Figure 12 shows that about 70 percent of the net benefits of the tax proposal would go to individuals and 30 percent to corporations. It also shows that corporations get a larger share of the tax benefits than their share of total income

Figure 11

State Revenue Effects of the Tax Reduction Proposal 1995-96 Through 1998-99

(Dollars in Billions)

State Revenue Effects	1995-96	1996-97	1997-98	1998-99	Four-Year Total
Personal Income Tax					
Continuation of high-income tax brackets after 1995	$0.3	$0.8	$0.9	$1.0	$3.0
Phase-in of 15 percent tax cut	-0.4	-1.5	-2.7	-3.6	-8.3
Net effect	**(-$0.1)**	**(-$0.7)**	**(-$1.9)**	**(-$2.7)**	**(-$5.3)**
Bank and Corporation Tax					
Phase-in of 15 percent tax cut	-$0.1	-$0.4	-$0.7	-$1.0	-$2.3
Total State Revenue Effect	**-$0.2**	**-$1.1**	**-$2.6**	**-$3.6**	**-$7.6**

[a] Source: Department of Finance. Detail may not add to totals due to rounding.

Total Benefits to Taxpayers

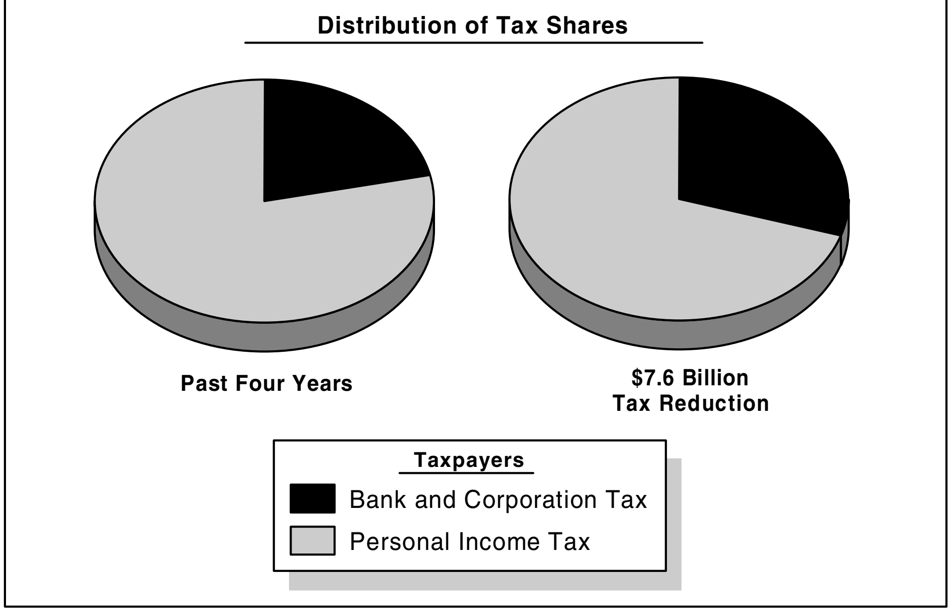
Figure 11 shows that, based on the budget display, tax reductions will total $7.6 billion over the first four years. This is the net effect of $3 billion more in taxes from continuing the high-income tax rates, offset by $10.6 billion in tax reductions due to the 15 percent across-the-board cut. The net reduction grows from $225 million in 1995-96 (a partial-year effect) to $3.6 billion by 1998-99.

taxes has been in recent years. This is largely because the proposal includes the continuation of the high marginal tax brackets for individuals. In the absence of these higher brackets, the distribution of tax benefits would be similar to the tax shares in recent years.

Federal Offsets Will Occur. Because state taxes are deductible on federal tax returns for corporations and for those individuals who itemize, part of the state

Figure 12

Distribution of Net Tax Reduction 1995-96 Through 1998-99



tax benefits will be offset by increased federal income taxes. The amount of the offset will depend on each taxpayer's federal marginal tax bracket. For many taxpayers, however, the offset will exceed one-fourth or even one-third of the state tax savings.

Effects on Individual Taxpayers

How the proposal affects individual taxpayers is shown in Figure 13. For illustrative purposes, the examples assume a married couple filing a joint return, with two children and tax deductions equal to the actual average for California taxpayers having their same income. These effects vary both by year and income level. For example:

- At an income of $40,000, savings would be $34 in 1996, $66 in 1997 and $96 in 1998.
- At an income of $250,000, savings would be $826 in 1996, $1,639 in 1997 and $2,441 in 1998.

High-Income Taxpayers. The bulk of the tax benefits go to these taxpayers

Figure 13

**Tax Reduction Proposal
Effects by Year and Income Level
1996 Through 1998**

Adjusted Gross Income	Tax Reduction by Year[a]		
	1996	1997	1998
$20,000	$0	$0	$0
40,000	34	66	96
60,000	74	142	206
80,000	130	252	365
100,000	210	407	593
150,000	410	807	1,193
200,000	628	1,244	1,849
250,000	826	1,639	2,441
500,000	384	2,562	4,666
1,000,000	-5,078	-175	4,673

[a] Data are for a married couple filing jointly, with two children and average itemized deductions for their income level. Negative amounts reflect tax increases.

ŸCalifornia's state and local tax burden is only 1 percent above the [national] average.

because they pay the bulk of taxes. (In 1992, the top 4.2 percent of taxpayers—those with income over $100,000—paid over 53 percent of personal income taxes). The share of benefits to these high-income taxpayers is less than proportional to their income, however. This is largely because of the continuation of the high tax brackets. Figure 14 shows tax savings by year and income level and indicates that:

- In 1996, taxpayers at all income levels would experience a tax reduction' except those with income over $500,000.

- At incomes over $1 million, taxes would be higher in both 1996 and 1997.

Even after the rate reductions are fully phased in, the proposal will make the tax structure more progressive than it otherwise would have been under current law, due to the extra brackets.

How High Are California's Current Tax Levels?

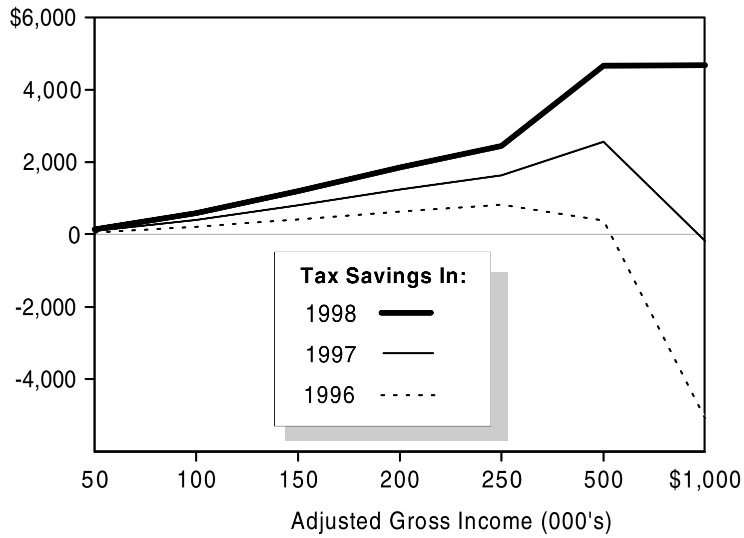
Given that the tax proposal reflects the view that California's tax rates are too high, the Legislature will want to consider when reviewing the proposal how California's tax burdens compare to other states.

- It is true that California's marginal income tax rates are relatively high compared to other states. In addition, state taxes per $100 of personal income are about 10 percent above the average for all states.

- However, California is near or below the average in various other respects. For example, its local tax burden is 12 percent below the national average, and its total state and local tax burden is only 1 percent above the average.

Figure 14

Tax Reduction Proposal— Effects on Individual Taxpayers By Income Year and Income Class 1996 Through 1998



Will the Proposal Spur the Economy?

The proposal undoubtedly would have stimulative effects on some elements of the California economy. However, what its net impact would be is unknown. This partly depends on the types of government spending that the tax reduction would displace, and how the resulting service cutbacks would be valued by the public. In addition, there is considerable debate among economists regarding the economic and fiscal effects of tax law changes, especially state-level changes.

At a minimum, however, the proposal would change the distribution of the tax burden and the mix of public versus private spending in California.

MAJOR RISKS POSE THREAT TO BUDGET

Because the projected budget reserve at the end of 1995-96 is only $92 million, any significant added spending or loss of revenue would throw the budget out of balance. Consequently, it is important to assess the major budget risks that could affect the state by the end of 1995-96.

Figure 15

**1995-96 Governor's Budget
Major Budget Risks**

(In Billions)

	Potential Deterioration By End of 1995-96
Federal Actions	
Welfare grant reductions and other savings dependent on federal legislation/waivers	$0.9
Additional immigrant/refugee funding	0.6
Medicaid administrative/ case-management funds	0.4
Local Actions	
AFDC grant savings to state from realignment	0.1
Pending Litigation	
CTA v. Gould invalidating Proposition 98 loans	3.0
PERS v. Wilson requiring payment of deferred retirement contributions	1.0
elch v. Anderson challenging 1994-95 AFDC welfare grant reductions	0.1

". . . the state faces budget risks totaling billions of dollars in 1995-96."

Figure 15 summarizes some of the major budget risks that could jeopardize achieving a balanced budget in 1995-96. The amounts shown represent the budget's *maximum* likely exposure. As Figure 15 shows, the state faces budget risks totaling billions of dollars in 1995-96. While it is unlikely that all of these risks will be realized, and any actual budget impacts may be less than shown in the figure, clearly the magnitude of these risks poses a significant threat to the budget.

Approximately $1.9 billion of budget savings depend on federal actions assumed in the budget, either to provide additional funds or to allow program revisions. This amount includes $400 million of Medi-Cal administrative/case-management funds assumed in the 1994-95 budget, but not yet approved by the federal government. The budget also depends on counties' improving AFDC administration to reduce state costs.

Pending litigation poses budget threats totaling billions of dollars. There have been initial trial court decisions adverse to the state in all of the cases cited in the figure, although they are subject to appeal and the actual fiscal impacts are still uncertain. Perhaps the most significant case is *CTA v. Gould,* which poses a $3 billion budget risk by invalidating certain Proposition 98 loans provided to schools and community colleges by the state. The decision would increase the carryover deficit by $1.8 billion to recognize spending for past off-budget loans, and it also could increase spending through 1995-96 by $1.2 billion by raising the base funding level for Proposition 98.

In addition to the litigation listed in Figure 15, another case that still is at the trial court level—*Orthopedic Hospital v. Kizer* challenging Medi-Cal outpatient rates—could impose substantial costs on the state.

THE STATE'S 1995-96 CASH POSITION

The "trigger" legislation enacted as part of the 1994-95 budget plan prohibits the 1995-96 budget from ending the year with a cash shortfall.

Based on the two-year budget plan adopted in July 1994, a "cushion" of $1.3 billion was estimated.The 1995-96 budget now estimates a cash "cushion" of about $1 billion. Given the magnitude of the risks discussed above, this cushion does not provide a large margin for error.

The actual determination of whether the trigger is pulled will be made by the Controller in October 1995. That determination will depend primarily on the budget that is adopted and fiscal developments during the early part of the budget year.

LOOKING BEYOND THE BUDGET YEAR

Given the Governor's tax proposal and the tight budgets of recent years, it is important to know the implications of the Governor's budget proposals for the future. One natural question is what levels of funding for state programs would be possible, based on the revenues that would be available if the tax proposal is enacted.

The budget estimates that, assuming current tax laws, the state can expect to receive $28 billion in cumulative revenues from 1995-96 through 1998-99 beyond what would be received if revenues experienced *no growth.* The budget projects that, assuming its budget proposals, the distribution of this added revenue would be $7.6 billion to pay for the tax cut, $11.9 billion for Proposition 98 education funding, $2 billion for debt and the remaining $6.5 billion for "discretionary" spending.

In addition, the department's definition of discretionary spending includes such items as the homeowners' exemption (which is provided for constitutionally), debt service on lease-payment bonds, and interest costs on short-term cash borrowing. It also includes all remaining programs in the budget, including corrections, health and welfare, and higher education.

Things Will Be Even Tighter

Our preliminary estimates indicate

that, assuming a moderate economic and revenue growth scenario, the state can expect to receive about $24 billion in cumulative additional resources between 1995-96 and 1998-99 compared to the administration's $28 billion figure.

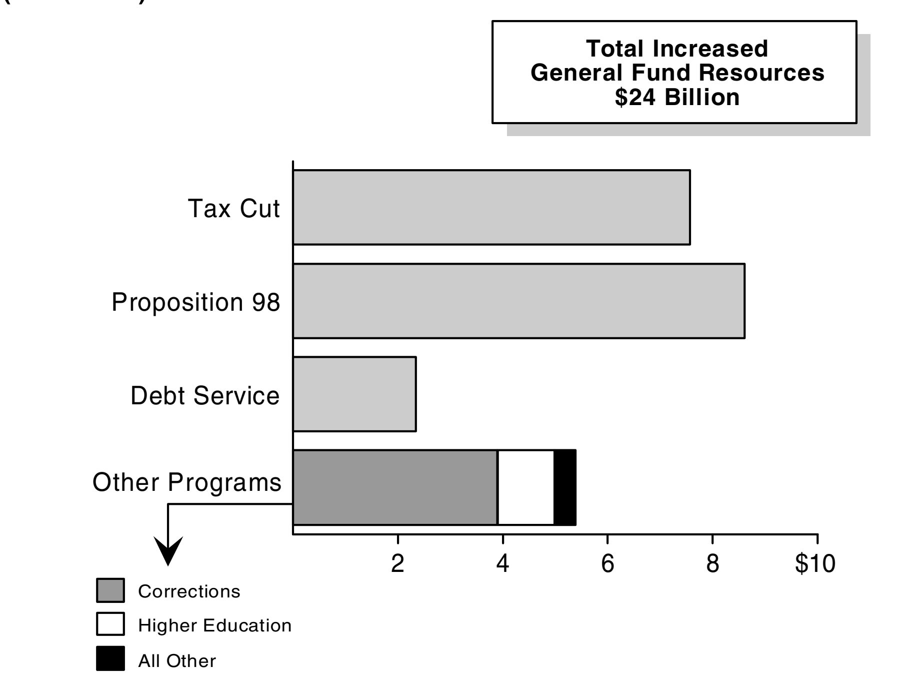
Figure 16 shows that the distribution of these revenues would be $7.6 billion for the tax cut, $8.6 billion for Proposition 98, $2.4 billion for debt service and employee retirement, and $5.4 billion for all other programs. This means that spending growth for all of these other programs could increase at an average annual rate of 3 percent.

Given other commitments, however, the spending situation is actually much tighter. For example, the Governor has been committed to full funding of corrections—which, if continued, would absorb $3.9 billion in increased revenues over the four-year period. In addition, the Governor has called for specific levels of funding for UC and CSU—which would absorb about $1.1 billion over the four years. Thus,

Figure 16

Use of Increased Resources 1995-96 Through 1998-99

(In Billions)



these two commitments alone would absorb virtually all the remaining resources available over the period. This would leave basically no room for growth in the remaining approximately 40 percent of the budget: primarily health, welfare and general government spending.

The above analysis probably overstates the actual level of resources available for other programs. For instance, there is no provision for a budget reserve. Normally, after several years of economic growth, the state would expect to have established at least a modest reserve. A 3 percent reserve would absorb about $1.5 billion.

In addition, the analysis implicitly assumes that the state will win on appeal several costly outstanding lawsuits. As noted earlier, the state's fiscal exposure in these cases is in the billions of dollars.

Finally, the analysis does not directly take into account the impact of certain provisions of law that are set to go back into effect in the future. For instance, the renters' credit is scheduled to go back into effect in 1996, resulting in cumulative costs over the remainder of the period of about $1.5 billion. Unless the credit were postponed again or repealed, these costs would have to be absorbed within available resources.

Thus, although the California economy is again experiencing moderate growth and the budget is on firmer ground than previously, the long term outlook suggests that, with a tax cut in place, the state will face continued program cutbacks and structural budget problems.

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