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CALIFORNIA UPDATE

LEGISLATIVE ANALYST'S OFFICE

Per-Pupil Funding Under Proposition 98: What Do the Coming Years Hold?

One of the most important issues for the Legislature during the last three budget cycles has been the level of funding for K-12 education. Despite significant reductions in other programs, the state has been able to maintain per-pupil spending at about the 1991-92 level. This was accomplished by providing loans to school districts, which had the effect of funding schools at a level higher than the Proposition 98 minimum guarantee.

Future per-pupil funding under Proposition 98 will depend largely on the course of the California economy. In order to give the Legislature some idea of what this spending level would be, we projected growth in Proposition 98 funding through 1997-98 under two different assumptions about state General Fund revenue growth. The first is based on the Department of Finance's (DOF) baseline revenue forecast from last May (which now appears optimistic), and the second is based on a delayed economic recovery. Figure 1 (back page) shows the resulting per-pupil minimum funding levels under Proposition 98. The figure shows that, under either scenario, a combination of low revenue growth and required repayments of Proposition 98 loans is likely to (1) result in no appreciable growth in per-pupil spending in 1994-95 and (2) hold 1995-96 increases between 1 and 3 percent. Greater increases in funding levels per pupil would occur in 1996-97 and 1997-98, the years in which we estimate final payments on Proposition 98 loans would be made.

DOF Baseline

Under DOF baseline revenue assumptions, per-pupil spending grows each year without the need for additional loans. In 1994-95 and 1995-96, loan repayments would absorb half of the per-pupil increase in the Proposition 98

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Current Outlook for California Economy

The budget agreement adopted last summer was premised upon a set of assumptions about the performance of the California economy prepared by the DOF in May 1993. This economic forecast formed the basis for the estimates of state revenues that were an integral part of the state's budget plans. While the performance of the state's economy has been weaker than the DOF forecast, revenue collections have remained on track (see next section).

Nonfarm payroll employment is one of the best indicators of the economic condition of the state. The DOF's May 1993 forecast projected that California's nonfarm employment would continue to decline, on a year-over-year basis, to 12.1 million in 1993 (a 0.6 percent drop from 1992) and increase to an average of 12.2 million in 1994 (up 1.0 percent from 1993). On a quarterly basis, the forecast projected that the bottom would be hit in the first quarter of 1993, with small increases taking place through the rest of the year. Expansion would only take hold by the first quarter of 1994.

With three-fourths of the year's employment estimates now available from the Employment Development Department, it appears that 1993 employment levels have fallen more than anticipated by the DOF forecast. Specifically, employment losses appear to have continued with only minor interruption throughout 1993, and nonfarm employment is now slightly below 12.0 million. Based on an extrapolation of current trends, the year-over-year decline in employment amounts to 1.4 percent, as opposed to the 0.6 percent forecast decline. Since employment data are subject to revision going back a year or more, however, it is possible that the state's economy has performed slightly better than the currently available employment data suggest, but this will not be known for several months.

More worrisome is that, as of September, other forecasters were much more pessimistic about the state's outlook for 1994 than the DOF was in May. The Western Blue Chip Economic Forecast for California (an average of nine state forecasts by banks, utilities, and other major forecasters in the state) is that nonfarm employment will rise only 0.2 percent in 1994. The UCLA Business Forecasting Project, which has been the most pessimistic of state forecasters about the state's outlook for the past three years, now forecasts that employment will be essentially flat in 1994, with the state hitting bottom in the first or second quarter. If UCLA's forecast is correct, state employment levels will be *210,000* jobs below the DOF forecast as of the fourth quarter of 1994—with obviously significant implications for state revenue collections.

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Are Revenues Out-Performing the Economy?

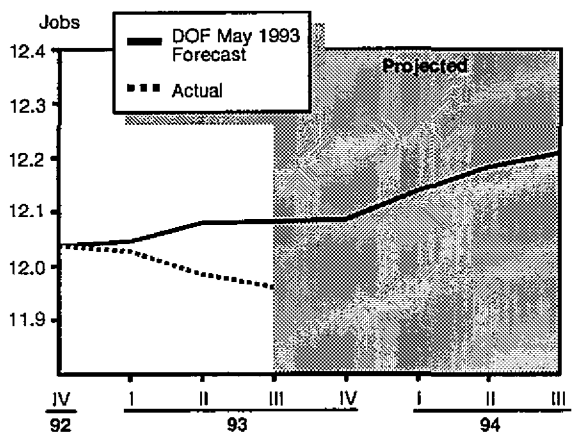
General Fund revenue receipts for September were approximately $65 million above the forecast of $4.2 billion, after adjusting for cash flow factors. On a cumulative basis, General Fund revenue for the current fiscal year continues to track the Department of Finance's latest revenue forecast.

Income Taxes Up. The most important developments in September were gains in estimated payments on personal income (PIT) and bank and corporation (B&C) tax liabilities. Estimated payments (declarations) for PIT were up $45 million (about 5 percent) and for B&C, up $29 million (roughly 4 percent). These gains would normally be positive developments since gains in estimated payments in September often indicate that the economic status of individuals and businesses is up, relative to the department's forecast. This is because quarterly tax payments are due in September for individual taxpayers who pay tax liabilities on a quarterly basis and for most business taxpayers.

Revenues and Economy Out-of-Sync? The relatively solid performance of General Fund revenues for the last three months seems to be at odds with the continued poor performance of the economy.

Employment in California Has Fallen Short of the Latest Forecast

(In Millions)



In particular, recent data show that California's employment level (which is a critical determinant for tax revenue) is worse than expected. As indicated in the prior section, the actual level of nonagricultural employment has declined during the past year, while the department's forecast expected employment to increase slightly after the first quarter. This divergence would normally result in revenue shortfalls relative to the forecast, especially from personal income taxes.

Outlook. There are no obvious reasons to explain the discrepancy between the current performance of revenues and the economy. If current employment trends continue, however, General Fund receipts are likely to fall short of the department's forecast over the upcoming months.

Specifically, the revenue forecast is based on light employment growth and moderate growth in taxable sales beginning this fall. The latest economic information, however, indicates that noticeable growth in employment and taxable sales is not likely to occur until well into 1994. As a result, General Fund receipts could fall short of the forecast, possibly as early as this December.

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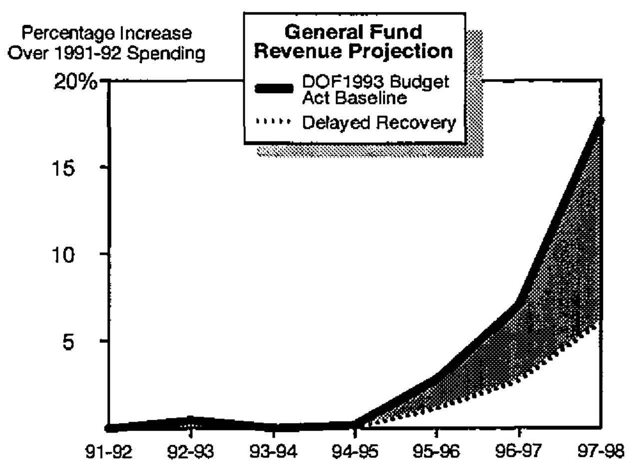
guarantee, thereby limiting growth in those years. The final payment on existing Proposition 98 loans would be made in 1996-97. As a result of projected economic growth and the end of loan payments, there would be significant growth in per-pupil spending in 1997-98 (about 10 percent).

Delayed Recovery

In order to assess the effects of a significant delay in California's economic recovery, we estimated the Proposition 98 minimum spending level assuming that General Fund revenues would be 2 percent less than projected by the DOF for each year. In this case, a new loan of about $300 million would be required to maintain the current-year level of per-pupil funding in 1994-95, and the Proposition 98 loans would not be fully repaid until 1997-98. As a result, growth in per-pupil spending in 1996-97 and 1997-98 would be considerably lower than under the DOF baseline revenue assumptions.

Figure 1

Proposition 98 Spending per K-12 Pupil— Little or No Growth Expected Through 1995-96



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