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The 1995-96 Budget Outlook

Overview

In July 1994, a two-year plan was adopted for eliminating the budget deficit carried over from 1993-94 and bringing the state's budget back into balance by year-end 1995-96. On January 10, 1995, the Governor is scheduled to release his specific budget proposal for 1995-96.

This update reviews the state's progress in implementing the budget plan based on recent developments. Currently, the state is running slightly ahead of schedule in its two-year plan to eliminate the budget deficit. However, there are a number of budget risks and uncertainties that could worsen the outlook considerably and jeopardize achieving a balanced budget in 1995-96.

The Two-Year Plan to Pay Off the Budget Deficit

The 1994-95 budget adopted last summer represents the first year of a two-year plan to pay off an estimated $2 billion budget deficit carried over from 1993-94. As shown in Figure 1, the plan calls for paying off half of the budget deficit in 1994-95 and eliminating the remaining $1 billion deficit in 1995-96, when the General Fund would end the year in balance, but essentially with no reserve.

Figure 1

Two-Year General Fund Budget Plan

(Dollars in Millions)

	1994-95	1995-96
Carryover deficit from prior year	-$1,971	-$1,019
Revenues and transfers	$41,892	$45,442
Expenditures	40,940	44,394
Operating surplus	$952	$1;048
Year-end deficit or reserve	**-$1,019**	**$29**
Federal immigrant funding assumed	($763)	($2,824)

Two major assumptions underlie the budget plan:

- ***$3.6 Billion of New Federal Immigrant Funding.*** The budget plan assumes that the federal government will provide $763 million in 1994-95 and $2.8 billion in 1995-96 to reimburse the state for costs related to illegal immigrants and refugees. To date, the federal government has committed to providing only about $100 million of this amount.

- ***Moderate Economic Growth.*** The budget's revenue projections assume that the state's severe and protracted recession has bottomed out and that 1995 will be a year of moderate economic growth in California. The budget's 1995 economic forecast calls for employment growth of 1.6 percent and personal income growth of 6.1 percent. Given recent improving economic trends, it is likely that these projections will be revised upward somewhat in January.

Current-Year Outlook Improves Modestly

Recent developments indicate that the anticipated 1994-95 year-end deficit has declined from $1 billion to roughly $800 million. As Figure 2 shows, this improvement is the net effect of a number of positive and negative developments.

Specifically, the 1994-95 shortfall in federal funds for immigrant costs has been more than offset by three other changes. First, the actual 1993-94 carryover deficit is less than the budget estimate, primarily because of higher- than-expected revenues at the end of that fiscal year. Second, the outlook for 1994-95 revenue growth is somewhat stronger. Finally, the growth of health and welfare caseloads and school enrollments has been slower than anticipated, which will result in savings.

Figure 2

Change in 1994-95 Budget Outlook [a]

(In Billions)

Factor	Effect on Budget Balance
Shortfall in budgeted 1994-95 federal immigrant funds	-$0.7
Reduction in 1993-94 carryover deficit	0.3
Improved 1994-95 revenues	0.4
Slower 1994-95 spending growth	0.3
Net Improvement	**$0.2**

[a] Detail does not add to total due to rounding. LAO estimates: November 1994.

Major Risks Cloud Two-Year Budget Outlook

The favorable revenue and spending trends in the current year may extend into 1995-96, thereby further improving the 1995-96 outlook. However, there are significant downside risks, which, if they materialized, would jeopardize the two-year spending plan. Figure 3 summarizes the major budget risks which could jeopardize the 1995-96 year-end balance. The amounts shown represent the likely maximum exposure.

Federal Actions Assumed in the Budget Plan. Risks associated with federal actions total at least $3.3 billion. The largest of these risks is the assumption of $2.8 billion of federal funding for immigrant costs in 1995-96. Congress has committed less than $100 million thus far, however, so the state could face a shortfall of up to $2.7 billion. A second major risk involves federal approval of county claims for Medicaid administrative and case-management funds. The budget plan counts on $400 million from these claims to offset state Medi-Cal costs over the two years. However, the federal government has deferred approval of these claims and has expressed significant concerns about whether they are appropriate.

Figure 3

Major Budget Risks

(In Billions)

	Potential Deterioration By End of 1995-96
Federal Actions Assumed In Budget Plan	
Additional immigrant funding	$2.7
Medicaid administrative/ case-management funds	0.4
Offset unpaid state taxes against federal refunds	0.1
Restrict legal immigrants' eligibility for welfare benefits	0.1
Pending Litigation	
CTA v. Gould invalidating Proposition 98 loans	$3.0
PERS v. Wilson requiring payment of deferred retirement contributions	1.0
Welch v. Anderson challenging AFDC welfare grant reductions	0.1
Clark v. Belshé overturning managed care requirement for Medi-Cal dental benefits	0.1

Pending Litigation. Four existing trial court decisions pose potential risks totaling $4.2 billion unless they are overturned or modified. The decision in *CTA v. Gould* poses a $3 billion budget risk by invalidating certain Proposition 98 loans provided to schools and community colleges by the state. Under the decision, the carryover deficit would increase by $1.8 billion in order to recognize past off-budget loan expenditures, and over the two-year period spending could increase by $1.2 billion because the past loans would increase the ongoing Proposition 98 base funding level. The decision in *PERS v. Wilson* involves a risk of $1 billion for the state to make up employee retirement contributions that were deferred by past budget-balancing actions.

Other Uncertainties. The state also faces other uncertainties that cannot be quantified at this time. One area of uncertainty involves potential Congressional actions to reform health and welfare programs, which could either impose costs or generate savings for the state. The recent bankruptcy of Orange County also could potentially result in some costs to the state to assist localities or school districts that have experienced significant financial losses.

Conclusion

Recent favorable economic, revenue and spending developments have combined to improve the 1994-95 budget outlook. It is likely that some of these recent developments will carry forward into 1995-96. Despite these developments, however, the two-year plan adopted last summer for balancing the budget faces a number of significant risks and uncertainties.

Assumptions about the continuation of recent spending and revenue trends, and whether budget-related risks and uncertainties are realistically addressed, will be the most important elements to evaluate in the Governor's 1995-96 budget proposal.

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