

## Summary

Continued economic expansion and state General Fund revenue growth resulted in a major improvement in the state's budget outlook over the past year. The 1996-97 budget, signed into law by Governor Wilson on July 15, 1996, substantially increases funding for education, includes a bank and corporation tax rate reduction, and provides for a balanced budget at the close of the fiscal year. At the same time, the new budget continues several funding reductions made in past years, mostly to health and welfare programs.

The 1996 Budget Act, along with related implementing legislation, comprise a budget package authorizing \$59.8 billion in total state spending (budget-basis accounting), of which \$47.3 billion is from the General Fund and \$12.6 billion is from special funds.

Major features of the state budget include:

- ❖ ***Substantial Increases in K-14 Education Funding.*** Larger-than-expected revenue gains in 1995-96 and 1996-97 resulted in major increases in the Proposition 98 minimum funding requirement. The new budget includes the spending of Proposition 98 funds on class size reduction and a variety of related initiatives.
- ❖ ***Bank and Corporation Tax Cut.*** The new budget includes a 5 percent reduction in the bank and corporation tax rate, effective January 1997.
- ❖ ***Non-Proposition 98 Spending Reductions.*** The new budget contains a variety of reductions to non-

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education spending, totaling about \$1 billion. These include the extension of certain welfare grant reductions made in past years, and suspension of the Renters' Tax Credit for an additional year. These savings are partly offset by new initiatives in local law enforcement, family planning and teen pregnancy prevention, and new funds for higher education.

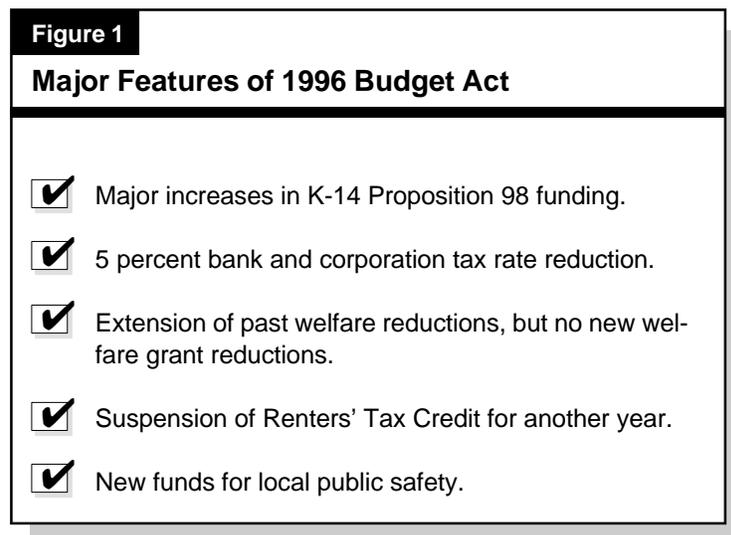
Since the state budget was passed, the President signed a federal welfare measure which will have significant implications in 1996-97, and potentially major effects in future years.

# Chapter 1

## The 1996-97 Budget Package

### INTRODUCTION AND OVERVIEW

Three years of moderate economic expansion and reasonably strong revenue growth have produced a significant improvement in the near-term fiscal outlook for California. The revenue gains enabled the Legislature and Governor to adopt a 1996-97 budget plan which eliminates the accumulated budget deficit carried over from the recessionary years, provides major funding increases for K-14 education, and includes a 5 percent reduction in the bank and corporation tax rate, as shown in Figure 1. At the same time, the new budget



does incorporate several important policy and fiscal tradeoffs, including the extension of temporary welfare grant reductions made in past years, as well as an additional one-year suspension of the renters' tax credit.

The budget package signed by the Governor in July authorizes total state spending of \$59.8 billion in 1996-97, of which \$47.3 billion is from the General Fund and \$12.6 billion is from special funds (budgetary accounting basis). The General Fund condition under the plan is depicted in Figure 2, which shows that revenues

**Figure 2**

**1996-97 Budget Plan  
Estimated General Fund Condition<sup>a</sup>**

(Dollars in Millions)

	1995-96	1996-97	Percent Change
Prior-year balance	-\$477	\$219	
Revenues and transfers	46,137	47,643	3.3%
<b>Total resources available</b>	<b>\$45,660</b>	<b>\$47,862</b>	
Expenditures	\$45,441	\$47,251	4.0%
Ending fund balance	\$219	\$611	
<b>Reserve</b>	<b>-\$87</b>	<b>\$305</b>	
<b>Other obligations</b>	<b>\$306</b>	<b>\$306</b>	

<sup>a</sup> Detail may not add to totals due to rounding. Data are on a budgetary accounting basis as reported by the Department of Finance.

are projected to grow by 3.3 percent in 1996-97, while expenditures are projected to grow by 4 percent. Under the plan, the General Fund would end 1996-97 with a reserve of slightly over \$300 million.

In the remainder of this chapter, we discuss the challenges and key developments associated with arriving at the new state budget, and provide a brief overview of the 1996-97 spending

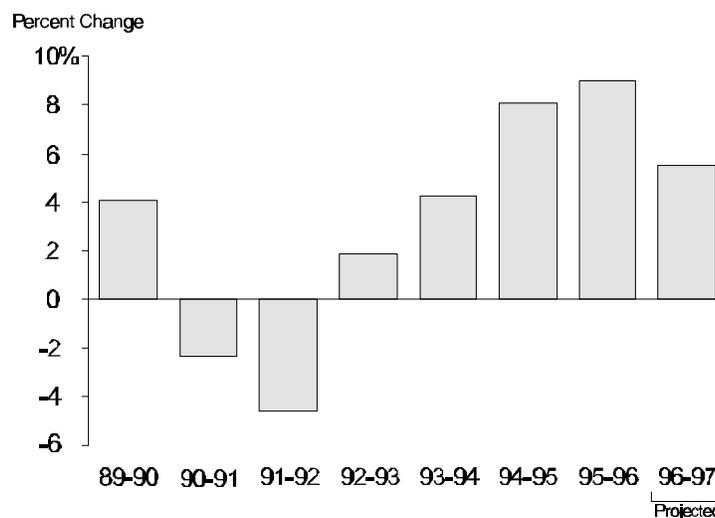
plan itself. Chapter 2 provides information on aggregate spending levels in the new budget, as well as a longer-term historical perspective on state expenditure trends. Chapter 3 discusses in more detail the major specific features of the new budget, by major program area.

## STATE REVENUE GAINS

As indicated above, a key factor behind the improvement in the state's fiscal picture has been the healthy growth in General Fund revenues. The extent of this improvement is depicted in Figure 3, which shows the year-to-year percent change over the past seven years in underlying revenues (that is, revenues adjusted to eliminate the effects of revenue-related law changes adopted in the 1990s).

**Figure 3**

### Underlying General Fund Revenue Growth<sup>a</sup> 1989-90 through 1996-97



<sup>a</sup> General Fund revenues excluding transfers and the effects of revenue-related legislation enacted in the 1990s.

The figure shows that revenues were growing modestly in 1989-90. They then fell during the early 1990s' recession, grew very modestly for a couple of years, and then rebounded strongly in both 1994-95 and 1995-96. Based on current projections, revenues will continue to grow at a moderate pace in 1996-97, resulting in the strongest three-year revenue growth (1994-95 through 1996-97) since the mid-1980s.

## 1996-97 BUDGET CHALLENGES

Partly as a result of the revenue improvement, the fiscal circumstances surrounding the development of the 1996 Budget Act were the most positive of the past five years. In contrast to the previous climate of weak revenue growth and major budget shortfalls, the Legislature was able to allocate increased funds among new programs and provide tax relief, while at the same time being able to balance the budget.

***Proposition 98 Versus Non-Proposition 98 Spending.*** Within the overall General Fund budget, however, there was a sharp contrast between the funding outlook for K-14 education under *Proposition 98*, versus that for *non-Proposition 98* program funding.

- ❖ On one hand, rising state revenues were resulting in a major increase in the state's projected minimum funding guarantee for K-14 education. As a result, the Governor and the Legislature were able to consider allocating additional spending for class-size reduction and other education-related initiatives.
- ❖ On the other hand, the non-Proposition 98 share of the budget—which funds such program areas as health and welfare, higher education, and criminal justice—was continuing to face major projected funding pressures for 1996-97. These pressures were partly due to the large share of new revenues mandated by Proposition 98 to be spent

on K-14 education, and thus would not be available for other programs. However, they also reflected significant anticipated cost increases in health and welfare programs stemming from the lack of federal actions that had been assumed in previous state budgets. In addition, temporary budget reductions enacted in past years were scheduled to be restored in 1996-97, putting additional projected pressures on state spending. These included previously enacted welfare grant reductions and the Renters' Tax Credit suspension.

Given the above, the central challenge facing policymakers as they approached developing the 1996-97 budget was twofold—how to allocate the new Proposition 98 resources expected to be available for education, and how to allocate the non-Proposition 98 portion of the budget among the many spending areas competing for the scarce resources available.

## DEVELOPMENT OF THE BUDGET

In this section, we provide a brief chronology of the development of the 1996-97 budget, which began with the introduction of the Governor's initial budget proposal in early January 1996, and concluded with the enactment of the budget package in early July.

### The Governor's January Proposal

The Governor's January budget proposal for 1996-97 contained many of the same priorities as his original proposal for 1995-96. It included a 15 percent cut in personal and corporate income tax rates phased in over three years, and modest increases in K-14 education funding consistent with the requirements of Proposition 98. The Governor's proposal addressed the tightness in the non-Proposition 98 portion of the budget primarily by making permanent both the elimination of the Renters' Tax Credit and past temporary welfare reductions. It also targeted health and welfare programs for new reductions, including a 4.5 percent cut in grant levels for Aid to

Families with Dependent Children (AFDC). These proposed reductions were partly offset by new health and welfare initiatives in the areas of family planning and teen pregnancy prevention, as well as an income tax “check-off” to provide funds for local law enforcement. The proposal also included funds for the state to “buy out” student fee increases for higher education in 1996-97. Finally, the budget included full funding for criminal justice programs, and contained a proposal for a significant restructuring of the trial court program. The budget proposal did not include a general salary increase for state employees.

The Governor’s January budget proposal was dependent on federal actions to achieve approximately \$2.6 billion in state budget savings, mostly in the health and welfare program areas.

### The May Revision

The May Revision to the Governor’s 1996-97 budget proposal reflected a major increase in both revenues and expenditures. On the revenue side, the administration raised its forecast by \$1.2 billion for 1995-96 and \$1.6 billion for 1996-97 (after adjusting for changes in the estimated cost of the tax cut pro-

**Figure 4**

#### Changes in Projected Baseline Revenues During 1996

(In Millions)	Department of Finance Projected Revenues	
	1995-96	1996-97 <sup>a</sup>
January Budget	\$44,991	\$46,143
May Revision	46,137	47,694
<b>Change from January</b>	<b>1,152</b>	<b>1,551</b>
Final Budget	46,137	47,728
<b>Change from May</b>	<b>—</b>	<b>34<sup>b</sup></b>

<sup>a</sup> Data adjusted to exclude the effects of proposed and adopted income tax rate reductions.

<sup>b</sup> Net effect reflects upward adjustment of \$55 million due to stronger economy, partially offset by \$21 million reduction due to other factors.

posal), or approximately \$2.7 billion for the two years combined (see Figure 4). When combined with a prior-year upward revision of \$100 million, the three-year increase in revenues totaled about \$2.8 billion.

On the expenditure side, K-14 spending increased by \$1.9 billion over the two years in the May Revision, primarily reflecting the impact of higher revenues on the Proposition 98 minimum funding guarantee. The Governor proposed to spend these funds on a variety of new education-related initiatives, including class-size reduction.

The May Revision also included a net of \$800 million in new expenditures in other program areas. The majority was for health and welfare expenditures needed to “backfill” savings that were dependent on federal actions which did not occur. To keep the budget in balance, the Governor also proposed new reductions, including a 3.4 percent cut in Supplemental Security Income/State Supplementary Program (SSI/SSP) grants.

Aside from these major changes, the Governor’s May Revision retained most of the same priorities as the original January proposal, including the 15 percent income tax rate reduction.

### **Legislative Actions**

The version of the budget passed by the Assembly in late May contained most of the Governor’s key May Revision proposals, including the tax cut, the welfare reductions (except for the 3.4 percent SSI/SSP grant reductions), increased funding for higher education, and full funding for corrections.

The Senate version of the budget, however, contained numerous differences from the Governor’s original proposal. It rejected the Governor’s tax cut proposal, as well as the proposal to extend certain existing and all new AFDC and SSI/SSP grant reductions. It also rejected the Governor’s proposed income tax “check-off” for local public safety, and it reduced corrections’ funding. Finally, the Senate version funded the Renters’ Tax Credit.

## Final Budget

The Assembly and Senate versions of the budget were sent to Conference Committee for reconciliation in early June. Following four weeks of negotiations, the Conference Committee passed a budget which was approved by both houses of the Legislature on July 8, 1996. Before signing the bill, the Governor vetoed \$80 million in General Fund expenditures and \$2 million in special funds expenditures, eliminating some legislative augmentations for capital outlay.

***Comparison Between Final Budget and May Revision.*** The final budget package contains both similarities and differences from the May Revision. Revenues were adjusted upward slightly, by \$34 million. On the expenditure side, key similarities included major increases in K-12 education, full funding for corrections, and growth in funding for higher education sufficient to avoid student fee increases. Likewise, there was no general salary increase for state employees. Key differences (or modifications) included the adoption of a 5 percent bank and corporation tax rate reduction, the absence of new cuts to welfare grant levels, and a more limited extension of certain past welfare savings. The final budget also extended the suspension of the Renters' Tax Credit for one year, rather than permanently eliminating the credit, as was proposed in the May Revision. Finally, the final budget included a subvention of funds to local governments for public safety purposes, in lieu of the income tax "checkoff" program originally proposed for similar purposes.

## MAJOR FEATURES OF 1996-97 BUDGET ACT

Key features of the 1996-97 budget include a bank and corporation tax cut, major funding increases for K-14 education, and reductions in non-Proposition 98 programs.

### Tax Reduction

The budget package provides for a 5 percent reduction in the bank and corporation tax rate, from 9.3 percent to 8.84 percent, effective for income years beginning on or after January 1, 1997. This tax cut is in lieu

of the Governor's proposal for a phased 15 percent reduction in both personal and corporation income tax rates. The enacted tax cut is projected to reduce revenues by \$85 million in 1996-97, growing to \$290 million when fully implemented in 1998-99.

The Legislature also convened a Conference Committee to consider a variety of tax measures with the intent of enacting a revenue-neutral measure which would aid small businesses in California. Senate Bill 38, which was passed in late August, includes an increase in the research and development tax credit and a variety of other provisions, some of which involve conformity to federal tax law. These measures are described more fully in Chapter 3. Senate Bill 38, signed into law in late September, is projected to result in a \$10 million revenue reduction in 1996-97, and a combined revenue reduction of \$80 million during its first three years.

### **Proposition 98 Spending**

As indicated above, the major upward adjustments in revenues in 1995-96 and 1996-97 enabled the Governor and the Legislature to provide significant increases in K-12 per pupil funding in both years. The budget spends Proposition 98 funds on a variety of new initiatives, including class-size reduction in grades K-3 (\$771 million in 1996-97), one-time block grants (\$587 million), and portable facilities to accommodate class-size reductions (\$200 million). The budget also includes significant funding increases for the community colleges along with no student fee increases.

### **Non-Proposition 98 Programs**

Figure 5 (next page) summarizes the major budgetary actions affecting the non-Proposition 98 share of the budget. In contrast to the increases in Proposition 98 funding, the non-Proposition 98 portion of the budget includes significant reductions relative to prior-law spending requirements. As shown in Figure 5, the majority of the savings that were adopted in the budget related to the extension of past temporary grant reductions in the state's welfare programs and the continued suspension of the Renters' Tax Credit. Partly offsetting these savings were new initiatives in local law enforcement, family planning and teen pregnancy pre-

**Figure 5**

**Major Actions Affecting Non-Proposition 98  
Spending in 1996-97**

(In Millions)

**Extend Previously-Enacted Reductions**

AFDC grant reductions and COLA suspension	-\$209 <sup>a</sup>
SSI/SSP grant reductions and COLA suspension	-412 <sup>a</sup>
Medi-Cal drug rebates	-24
Renters' Tax Credit suspension	-520
<b>Subtotal</b>	<b>-\$1,165</b>

**New Program Reductions**

Limit eligibility for state-only AFDC pregnancy benefits	-\$11
Other	-7
<b>Subtotal</b>	<b>-\$18</b>

**Program Enhancements**

Local law enforcement	\$150
Family planning and teen pregnancy prevention	65
Higher education—"buyout" of student fee increases	97
Trial courts—new judges	5
<b>Subtotal</b>	<b>\$317</b>

**Shifts To/From Other Levels of Government**

Assume federal funds for Medi-Cal services to undocumented persons	-\$216
County hospital funding	10
Increased funding for county juvenile camps	23
<b>Subtotal</b>	<b>-\$183</b>

**Other** **\$35**

**Total** **-\$1,014**

<sup>a</sup> Pursuant to Ch1/96 (4th extraordinary session), these reductions were to be restored on November 1, 1996. Amounts shown generally represent eight months of savings in 1996-97.

vention, as well as new funds for the General Fund “buyout” of higher education student fee increases.

**Health and Welfare.** The budget extends or makes permanent past grant reductions in the state’s AFDC and SSI/SSP programs, but does not adopt new cuts. Specifically, it makes the 1992-93 welfare grant reductions permanent and extends the statewide 1995-96 grant reduction through October 1997. The budget suspends state cost-of-living adjustments (COLAs) for AFDC and SSI/SSP through October 1997. However, it does provide the full federal SSI COLA to recipients.

With regard to the state’s health programs, the budget expands teen pregnancy prevention programs and extends the Medi-Cal Supplemental Drug Rebate Program until January 1, 1997, after which rebates could be negotiated with individual manufacturers.

**Higher Education.** The budget includes significant funding increases for the University of California and California State University, with no student fee increases.

**Corrections.** The budget includes close to full funding for corrections. It contains no policy changes and no funding for new prisons. The budget includes some reductions for caseload adjustments and administrative costs relative to the Governor’s budget proposal.

**Local Government.** In lieu of the Governor’s proposed income tax “checkoff” for local public safety, the budget provides a direct appropriation of \$100 million for local law enforcement and \$50 million to the Board of Corrections for juvenile justice grants. The budget also assumed the adoption of the Governor’s proposed changes to trial court funding, which would reduce both General Fund expenditures and revenues by \$3 billion in 1996-97. However, implementing legislation was not enacted.

**Renters’ Tax Credit.** The budget extends the suspension of the Renters’ Tax Credit for 1996. The Governor had proposed elimination of the credit.

**Figure 6**

**1996-97 Budget  
Major Implementing Legislation**

<b>Bill</b>	<b>Chapter</b>	<b>Author</b>	<b>Subject</b>
AB 2972	Ch 194/96	Olberg	Education: Home-to-school transportation equalization
AB 3137	Ch 187/96	Miller	Insurance: Escheated Proposition 103 rebates
AB 3229	Ch 134/96	Brulte, Lockyer	Local Government/Public Safety: Grants to local governments
AB 3369	Ch 195/96	Bordonaro, Wright	Corrections: "M" Cases
AB 3482	Ch 196/96	Davis	Education: Reading Initiative
AB 3483	Ch 197/96	Friedman	Health Services: Various (public health, drug rebates, etc.)
AB 3484	Ch 198/96	Friedman, Granlund	Health Services: Technical changes to AB 3483
AB 3487	Ch 199/96	Katz, Pringle	Health Services: Proposition 99
AB 3492	Ch 200/96	Frusetta	Education: School safety and training programs
AB 3493	Ch 201/96	Committee on Budget and Fiscal Review	General Government: Various (disaster relief, Museum of Science and Industry, budget information)
AB 3495	Ch 202/96	Kaloogian, Kopp	Resources: Various (cooperative fire fighting agreements, Fire Marshall, OHV fees)
AB 3497	Ch 203/96	Richter	Education: Revenue limit equalization
AB 3499	Ch 170/96	Pringle, Lockyer, Hurtt	Bank & Corporation Tax: 5 percent rate reduction
SB 1472	Ch 188/96	Solis	Social Services: County match relief
SB 1556	Ch 205/96	Johnston, Leslie	Social Services: Identification of persons in jail ineligible for aid
SB 1760	Ch 133/96	Lockyer, Goldsmith	Corrections: Juvenile justice
SB 1763	Ch 191/96	Committee on Budget and Fiscal Review	General Government: Performance budget contracts (Departments of Consumer Affairs and General Services)
SB 1770	Ch 193/96	Johnston	General Government: Surplus state property and Capitol Area Plan development
SB 1777	Ch 163/96	O'Connell, Peace, Wright, Baldwin, Alpert, Firestone, Machado	Education: Class-size reduction
SB 1780	Ch 206/96	Committee on Budget and Fiscal Review	Social Services: Various (grant reductions, etc.)
SB 1789	Ch 164/96	Greene	Education: Facilities for class-size reduction
SB 1794	Ch 192/96	Wright	Renter's Tax Credit: Suspension in 1996

## THE BUDGET "TRAILER BILLS"

In addition to the 1996 Budget Act, the 1996-97 budget package includes several related measures enacted to implement and carry out the budget's provisions. Figure 6 lists these budget "trailer bills."

## SAVINGS THAT DEPEND ON FEDERAL ACTIONS

Figure 7 shows that the budget relies on federal actions to achieve \$731 million in savings, mostly in health and welfare programs. Of this total, \$430 million is related to the elimination of federal maintenance-of-effort (MOE) requirements, which would allow California to implement previously enacted reductions to AFDC and SSI/SSP grant levels. The budget assumes that federal actions would be taken by August 1996 which would permit a reduction in AFDC grants effective in October 1996, and a reduction in SSI/SSP grants effective in November 1996. The main vehicle for state MOE relief

<b>Figure 7</b>	
<b>State Savings Dependent On Federal Actions</b>	
<b>(In Millions)</b>	
	<b>Amounts</b>
<b>AFDC</b>	
Maintenance-of-effort relief	\$162
<b>SSI/SSP</b>	
Maintenance-of-effort relief	\$268
<b>Medi-Cal</b>	
Federal funds for services to undocumented persons	\$216
<b>Other</b>	
IRS Tax Offset Program	\$85
<b>Total</b>	<b>\$731</b>

has been the federal welfare reform measure, which was pending in Congress when the state budget was passed in July, but has since been passed.

The remainder of the federal actions are primarily related to (1) new federal reimbursements for state costs of providing emergency Medi-Cal services to undocumented immigrants (\$216 million) and (2) the federal adoption of an Internal Revenue Service tax offset program (\$85 million), under which the federal government would collect for California delinquent state taxes out of the refunds owed to Californians on their federal income tax returns.

### Status of Federal Actions

Since the state budget was passed, Congress has passed and the President has signed measures enacting federal welfare reform and the 1997 federal budget. Based on these and related actions, most of the savings listed in Figure 7 will not be realized.

**Welfare Reform.** This measure will have a variety of state-level fiscal impacts—especially in future years. With regard to the estimates in Figure 7, the federal welfare measure has two implications:

- ❖ First, the federal measure does *not* provide MOE relief for the SSI/SSP program. Thus, the state will not achieve the \$268 million in savings related to SSI/SSP grant reductions, unless MOE relief is enacted in separate legislation.
- ❖ Second, the welfare reform measure *does* provide states with authority to lower AFDC grant levels, but only after the states have submitted a plan implementing the federal changes. (Alternatively, the state can also request a waiver of the MOE requirements from the federal government.) The timing of these changes in California is not clear at this time. Thus, at least some of the \$162 million in assumed state savings in AFDC is at risk.

More generally, the federal welfare reform measure could result in either cost increases or decreases in state welfare programs during 1996-97, depending on how it is implemented in California. These potential effects are not likely to be major in the current year. However, they could become substantial in the future. Some of the federal measure's potential effects on state spending are addressed in Chapter 3 of this report.

**Federal Budget.** Although funding was *authorized* in federal immigration reform legislation for Medi-Cal services to undocumented persons, the 1997 federal budget does not *appropriate* any of the additional federal funds assumed in the state's budget for this purpose.

**Internal Revenue Service Offset.** The main vehicle for the federal offset legislation (HR 757) was pending in the House Ways and Means Committee. However, it was not passed out of committee before Congress adjourned.

The 1996-97  
Budget Package