Chapter 1

The Budget Outlook

Over the past three years, California's fiscal condition has improved markedly, with the General Fund moving from a significant deficit position into rough fiscal balance. Our projections for 1996-97 through 1998-99 indicate, however, that budget shortfalls will reemerge, absent corrective action. Figure 1 summarizes our key findings.

For 1996-97, we estimate the state will end the current year with virtually no reserve. This is down from the *1996-97 Budget Act* reserve estimate of $305 million. The planned budgetary reserve has been nearly eliminated by higher costs, primarily in Proposition 98.

For 1997-98 and 1998-99, current-law spending requirements will grow faster than revenues, leading to a budget deficit in 1997-98 that will grow thereafter, reaching nearly $1 billion by 1998-99. Constitutionally required Proposition 98 spending will increase fairly rapidly, causing significant pressures on the non-Proposition 98 share of the budget. Our projection of the General Fund condition is summarized in Figure 2 (see next page).

Figure 1

Key Features Of LAO Outlook

✔ **Current-Year Budget Reserve Nearly Gone**

- Revenues are up.
- This is more than offset by higher spending, primarily in Proposition 98 funding.

✔ **Deficits Will Emerge by 1997-98 Absent Corrective Action**

- Economy and revenues to expand, but current-law spending to grow even faster.
- Proposition 98 spending will grow rapidly, leading to increased per-student funding.
- Remaining revenues would be inadequate, however, to fund current-law requirements of other programs.
- Left unchecked, budget deficit would continue to grow over time.

✔ **Implications of Our Projections**

- Corrective actions will be necessary to avoid a budget deficit in 1997-98 and beyond.
- Trade offs will be needed to balance the budget and fund any new initiatives.

KEY FEATURES OF OUTLOOK

The Economy and Revenues

Economy And Revenues Performing Well. Over the past several months, the economy and revenues have continued to outperform expectations. It now appears that personal income growth in 1996 will be 7.4 percent, the strongest gain since 1989. After adjusting for various cash-flow factors, underlying state revenues were up over $300 million during the first four months of 1996-97, with all three of the major taxes exceeding the *1996-97 Budget Act* forecast.

Figure 2

LAO Projections of General Fund Condition 1995-96 Through 1998-99

(In Millions)

	1995-96	1996-97	1997-98	1998-99
Prior-year fund balance	-$477	$45	$314	$39
Revenues and transfers	46,305	48,660	51,341	54,217
Total resources available	$45,828	$48,705	$51,655	$54,256
Expenditures	$45,783	$48,391	$51,616	$54,930
Ending fund balance	$45	$314	$39	-$674
Other obligations	$306	$306	$300	$300
Reserve	**-$261**	**$8**	**-$261**	**-$974**

Our forecast beyond 1996-97 assumes that these positive economic and revenue trends will continue, and that California's economy and state General Fund revenues will continue to grow at moderate rates through 1998-99. Specifically, we project that state revenues will increase by an annual average rate of 5.4 percent between 1995-96 and 1998-99.

Updated Budget Outlook for 1996-97

The *1996-97 Budget Act* enacted in July provided for major increases in education funding and a corporation tax cut, as well as a planned year-end reserve of $305 million. Since the budget was enacted, a number of revenue and expenditure developments have occurred which, on balance, have nearly eliminated the planned reserve. The major developments affecting 1996-97 include:

- ***Higher Revenues.*** Based on recent economic and revenue developments, we now estimate that revenues exceeded the budget estimate by $168 million in 1995-96, and will exceed the estimate by $723 million in 1996-97, for a two-year improvement of $891 million.

- ***Increased K-14 Education Funding.*** The increase in revenues has been completely offset by higher K-14 Proposition 98 funding of $900 million. This is due to upward revisions to average daily attendance figures for 1995-96 and 1996-97, coupled with the impact of the above-noted revenue increases on the Proposition 98 funding requirement. Under current law, the higher spending related to revenue growth is earmarked for local purposes.

- ***Federal Actions and Caseloads Affecting State Costs.*** The 1996-97 reserve will also be affected by several offsetting factors, mostly related to federal actions and caseloads. Factors *increasing* state costs (thereby reducing the reserve) include lower-than-expected increases in federal reimbursements and the lack of federal maintenance-of-effort (MOE) relief needed to implement certain welfare reductions in 1996-97. Factors *decreasing* state costs include projected savings relating to federal welfare reform and lower-than-expected caseloads in state health, welfare, and corrections programs.

Outlook for 1997-98 and 1998-99

Basis for Our Estimates. Our revenue and expenditure forecasts for 1997-98 and 1998-99 are based on the requirements of current law. Specifically, we have adjusted the 1996-97 spending plan for constitutional and statutory requirements as well as projected changes in prices and caseloads. In this regard, we have increased K-14 education funding in accordance with Proposition 98 minimum spending requirements. We have also provided for the restoration of the renters' credit in 1997, as well as the restoration of the welfare grant levels and cost-of-living adjustments to grants beginning in November 1997.

It is important to note that our fiscal estimates are *not predictions* of what the Legislature and Governor will eventually adopt as policies and funding levels in coming budgets. Nor are they our recommendations as to what spending and tax policies should be. Rather, our estimates are a "baseline" projection of what would happen if current policies were allowed to run their course. We believe that by using this approach, our projections provide a meaningful starting point for the Legislature's evaluation of the state's fiscal condition, and its assessment of any necessary future changes to California's spending and taxing levels.

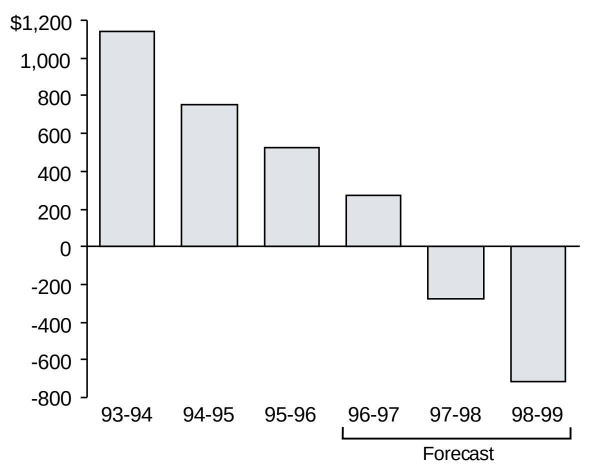
Future Budgets Face Deficits. We project that expenditure growth will exceed revenue growth during the next three years. As Figure 3 (see next page) shows, this will result in a declining operating surplus (that is, the excess of revenues over expenditures in a given year) in 1996-97 and increasingly large operating deficits thereafter. These operating deficits will emerge despite relatively good economic and revenue performance. During these years, revenues are projected to grow approximately in line with statewide personal income, while the overall gain in expenditures reflects divergent trends among the state's major program areas.

Faster-growing expenditure areas are led by K-14 education, which we project will increase by an average of slightly over 9 percent per year (reflecting particularly rapid growth in 1996-97). Programs experiencing slow or no growth include AFDC, Medi-Cal, and SSI / SSP, reflecting small or no growth in caseloads and projected increases in federal funds, partly resulting from federal welfare reform legislation.

Figure 3

Projected Spending To Exceed Revenues by 1997-98

Revenues Minus Expenditures by Year (In Millions)



As indicated above, our estimates assume the restoration of the renters' credit and certain welfare grant reductions and cost-of-living adjustments in 1997, as required by current law. These restorations are projected to result in about $775 million of additional state expenditures beginning in 1997-98.

IMPLICATIONS OF OUR PROJECTIONS

Our outlook for the General Fund indicates that—despite a generally positive economic environment—a serious budgetary imbalance will emerge absent corrective action. Our projections, however, reveal a significantly different outlook for the Proposition 98 portion of the budget. Namely, constitutionally required spending for Proposition 98 will experience significant increases. This will allow the Legislature to fund enrollment growth, maintain recent K-12 education initiatives, and provide significant funding for program increases and new school improvement activities.

Proposition 98 funding will take a growing share of the budget over this period, resulting in increasing pressures on the non-Proposition 98 portion of the budget. As noted above, there will be insufficient money to fully fund all of these programs and balance the budget. In addition, it should be noted that our projections assume no *new* spending initiatives in the non-Proposition 98 portion of the budget. Inclusion of new or expanded programs would add to the trade-offs the Legislature will face in developing its spending plans in 1997-98 and 1998-99. For example, with regard to implementation of federal welfare reform, our estimates imply that increases in funding for welfare-to-work programs, or other initiatives, would need to be financed from budgetary savings. Any increased funding for local governments or tax reductions would have to be financed similarly.

Lastly, it is important to emphasize that our projections are predicated on continued moderate economic growth, with no significant economic slowdown or recession in the next few years, and also embody various assumptions regarding program costs and federal funds. Our projections imply, however, the state would have *no meaningful reserve to cushion against unanticipated cost increases or shortfalls in revenues or federal funds.*

LONG-TERM CONSIDERATIONS

Making long-term fiscal projections is a difficult undertaking, yet it is important to be aware of the various factors which will influence the state's longer-term fiscal condition. This is especially important at this time given the budgetary imbalances we are projecting under current law absent corrective action. Looking beyond 1998-99, there are a variety of factors which will significantly influence the state's future fiscal position. These long-term considerations include demographic trends, economic and revenue performance, law changes, and trends in utilization of state programs. Areas of specific importance will be trends in educational enrollments and prison populations, how the state addresses its large and growing infrastructure needs, and how the state establishes its safety net as a result of federal welfare reform. These and other long-term budgetary considerations are touched upon in Chapter 5.