Overview of the 1999-00 May Revision

Major Two-Year Increase in Revenues. Reflecting a stronger economic outlook and much higher-than-expected collections this spring, the May Revision shows increased revenues of $1.6 billion in 1998-99 and $2.7 billion in 1999-00, for a two-year increase of $4.3 billion.

Revised Proposals. Major spending increases are proposed for K-12 education and infrastructure. In other areas, the May Revision restores cuts that had been proposed in January and funds various increased costs and program augmentations. It also includes set-asides for employee compensation, litigation, health care costs, and a potential further reduction in the vehicle license fee in 2000-01.

Revised Plan Has Many Positive Features. These include major funding for infrastructure and deferred maintenance, restoration of commitments to local governments made last year, a general emphasis on one-time obligations, and an increase in the reserve.

Revenue Estimates Slightly Conservative. Our own updated forecast for the current year and budget year are higher than the administration’s estimates by a combined total of $360 million.

Budget Still Vulnerable to Threats. Although the May Revision fully funds caseloads and most other anticipated costs, it remains vulnerable to budget threats—particularly relating to federal funds.

Important Policy Issues Remain. In reviewing the proposal, the Legislature may wish to consider changes in at least two key areas:

- **State Control Versus Local Discretion.** In both his K-12 education and local government funding proposals, the Governor relies on a centralized approach. In both of these areas, the Legislature may wish to consider more decentralized approaches which recognize differing local needs.

- **Pay-As-You-Go Infrastructure.** The majority of funds targeted by the Governor for infrastructure projects will not be needed in 1999-00 for the purposes specified. Given this, and the vast number of infrastructure needs, the Legislature may wish to begin an ongoing commitment to a pay-as-you-go infrastructure program.

May 17, 1999
INTRODUCTION

The May Revision shows a major improvement in the General Fund revenue outlook, reflecting recent positive economic developments and much stronger-than-projected revenue receipts this spring. The budget’s updated revenue forecast anticipates a $1.6 billion increase in General Fund receipts in the current year, and an additional $2.7 billion increase in 1999-00, for a two-year gain of $4.3 billion.

As indicated in Figure 1, the Governor’s proposals for these new funds are focused in several key areas:

- **Proposition 98.** About $1 billion from the General Fund ($1.2 billion from all funds) is proposed for Proposition 98 education spending to cover costs associated with increased average daily attendance (ADA), as well as various initiatives for new textbooks, school safety, teacher bonuses, and deferred maintenance of school facilities.

- **Infrastructure.** About $1 billion is proposed for one-time infrastructure spending, including funds for a new prison, further capitalizing the infrastructure bank, transportation, and deferred maintenance for parks.

- **Other Program Costs.** Roughly $1 billion is proposed in other spending, about evenly split between (1) covering additional costs for Medi-Cal, corrections, and local mandates; and (2) restoring and augmenting programs in the areas of trial courts, local flood relief, and higher education.

- **Set-Asides.** Approximately $650 million is set-aside for employee compensation,
litigation, various health proposals, and the potential trigger of an additional vehicle license fee (VLF) tax reduction in 2000-01.

- **Budgetary Reserve.** Approximately $600 million is proposed to be added to the 1999-00 year-end budget reserve (up from slightly over $400 million in the January budget to slightly under $1 billion in the current proposal).

**Budget Emphasizes One-Time Commitments**

A key issue affecting California’s longer-term fiscal outlook is the balance between one-time and ongoing budgetary commitments made in the 1999-00 budget. In general, the greater the emphasis is on one-time commitments in the budget year, the less committed the state’s resources will be in the future. This, in turn, will afford the Legislature and Governor greater flexibility in subsequent years to deal with such developments as unanticipated revenue shortfalls, adverse court decisions, unforeseen spending requirements, and other such factors.

The administration has proposed to allocate about one-half of the new resources to one-time proposals, including infrastructure spending and an increase in the budgetary reserve. The remaining one-half is for ongoing commitments, primarily in the areas of education, trial court funding, Medi-Cal, and social services.

While the May Revision proposals raise a number of issues regarding the specific uses of the new resources, we believe that, in general, the emphasis on one-time spending is appropriate—especially in view of the uncertainties involving the future path of the financial markets, the economy, and therefore, state revenues.

**General Fund Condition—$1 Billion Reserve**

Figure 2 shows the May Revision’s estimates of revenues, expenditures, and year-end reserves for

### Figure 2

**1999 May Revision General Fund Condition**

<table>
<thead>
<tr>
<th></th>
<th>1998-99</th>
<th>1999-00</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior-year fund balance</td>
<td>$3,065</td>
<td>$2,361</td>
<td>8.7%</td>
</tr>
<tr>
<td>Revenues and transfers</td>
<td>57,927</td>
<td>62,985</td>
<td>8.7%</td>
</tr>
<tr>
<td>Total resources available</td>
<td>$60,992</td>
<td>$65,346</td>
<td>7.8%</td>
</tr>
<tr>
<td>Expenditures</td>
<td>$58,631</td>
<td>$63,223</td>
<td></td>
</tr>
<tr>
<td>Ending fund balance</td>
<td>$2,361</td>
<td>$2,123</td>
<td></td>
</tr>
<tr>
<td>Other obligations</td>
<td>$480</td>
<td>$480</td>
<td></td>
</tr>
<tr>
<td>Set-asides a</td>
<td>—</td>
<td>658</td>
<td></td>
</tr>
<tr>
<td><strong>Reserve</strong></td>
<td>$1,881</td>
<td>$985</td>
<td></td>
</tr>
</tbody>
</table>

Detail may not total due to rounding.

a Set-asides consist of $300 million for employee compensation and litigation, $248 million for potential vehicle license fee reduction, and $110 million for health and in-home services.
1998-99 and 1999-00. It shows that revenues are projected to increase by 8.7 percent between the current year and budget year, while expenditures would grow by 7.8 percent. Under the plan, the ending General Fund balance in 1999-00 would be $2.1 billion. However, this amount includes $1.1 billion in obligated encumbrances and various “set-asides.” After adjusting for these, the 1999-00 year-end unobligated budgetary reserve would be $985 million. This new reserve estimate is up by $570 million from the January proposal of $415 million.

**Set-Asides**

As noted above, in addition to the unobligated budgetary reserve, the budget includes various set-asides. These total $658 million, and include (1) $300 million to cover the potential costs of future state employee compensation increases and litigation settlements, (2) $248 million to cover the 2000-01 costs associated with the additional VLF rate reductions that, under the terms of last year’s legislation, will occur if revenues exceed a specified amount in 2000-01, and (3) $110 million to cover an expansion of the Healthy Families Program, rate increases for Medi-Cal managed care providers, and funding increases for a variety of other purposes. With regard to the VLF set-aside, a VLF rate reduction from the existing 25 percent to 35 percent would be triggered in 2000-01 if revenues in that year increased by slightly over 4 percent from the administration’s and Legislative Analyst’s Office (LAO’s) 1999-00 revenue projections.

**Budget Threats**

The May Revision is generally a realistic budget, in that it fully budgets for caseloads and other cost factors. However, while less vulnerable to shortfalls than the January plan, the updated proposal continues to face threats relating to lower-than-expected receipts of new federal funds, increased fire suppression costs, and local property tax reimbursements. These threats could result in over $400 million in additional expenditures in the budget year.

**THE ECONOMIC OUTLOOK**

The January budget was prepared in late 1998, when concerns about the negative effects of the Asian crisis on the financial markets and the U.S. economy were at their peak. Since that time, the economic picture has brightened considerably. It now appears that both the nation and California have avoided major adverse effects emanating from Asia’s problems, and in fact, economic growth has been unexpectedly strong. For example, growth in real U.S. gross domestic product (GDP) has far surpassed earlier economic projections. Similarly, recent revisions to California’s employment and income data indicate that economic growth in the state has been much stronger than previously thought, and that the economy currently continues to exhibit considerable vigor.
Outlook Revised Upward. The administration’s revised projections reflect the improved recent performance of the economy, and assume that these positive trends continue into the near-term future (see Figure 3). As a result, these revised projections are considerably stronger than those in the January budget.

For example, the May Revision calls for a 3.6 percent increase in real GDP in 1999, nearly double the 1.9 percent increase assumed in the January budget. For California, personal income is now projected to grow by 6.6 percent in 1999, up from the January forecast of 5.1 percent. However, the administration’s economic forecast continues to reflect a significant slowdown in economic growth during 2000, reflecting the constraining effects on future output and spending of such anticipated factors as increasingly tight labor markets and low savings rates.

The LAO Assessment—Economic Forecast Generally Reasonable

We believe that the administration’s updated economic forecast is reasonable in light of recent trends. In fact, the May Revision estimate for most economic variables is similar to our own updated outlook for the next two years. The one exception involves taxable sales, where the administration is assuming that growth in 1999 will be 7.6 percent. This would be the strongest increase of the current economic expansion, and more than 1.5 percent higher than our own projection (6 percent) for the year.
REVENUE FORECAST REVISED SHARPLY UPWARD

As indicated in Figure 4, the May Revision revenue forecast for 1998-99 is $57.9 billion, which is up 5.4 percent from 1997-98. The projection for 1999-00 is $63 billion, an 8.7 percent increase from the current year. Relative to January, the revised forecast is up $1.6 billion in the current year and $2.7 billion in 1999-00, for a two-year total increase of $4.3 billion.

Virtually all of the net increase in total revenues for the two years combined can be attributed to the personal income tax. The current-year increase from this source reflects stronger-than-expected April final payments on 1998 income tax liabilities, which the administration attributes largely to a continued surge in capital gains realized in 1998 and reported on 1998 income tax returns. To a lesser degree, stronger-than-expected withholding and quarterly estimated tax payments toward 1999 income tax liabilities have also contributed to the increase in the current-year revenue outlook.

The budget-year revenue increase largely reflects (1) the administration’s higher forecast for capital gains in 1999 and (2) the effects of the stronger economic forecast on both personal income taxes and sales and use tax liabilities.

A partly offsetting factor in both the current year and budget year is a downward revision in the administration’s forecast of bank and corporation tax receipts. This reduction reflects both lower-than-expected corporate prepayments toward their 1999 liabilities, and a downward adjustment to the outlook for corporate profits.

**Tax Relief Proposals.** The May Revision contains two new tax proposals. The first would eliminate the first two minimum tax payments for newly incorporated small businesses. This measure would result in a revenue reduction of $28 million in 1999-00, and about $60 million annually thereafter.

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**Figure 4**

May Revision Revenue Changes

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>1998-99</th>
<th>1999-00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>January</td>
<td>May</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>$28,526</td>
<td>$30,502</td>
</tr>
<tr>
<td>Sales and Use Tax</td>
<td>18,620</td>
<td>18,860</td>
</tr>
<tr>
<td>Bank and Corporation Tax</td>
<td>5,926</td>
<td>5,522</td>
</tr>
<tr>
<td>Other revenues and transfers</td>
<td>3,221</td>
<td>3,043</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$56,293</strong></td>
<td><strong>$57,927</strong></td>
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</table>
The second proposal would make permanent the 50 percent capital gains exclusion for small business stock held for more than five years, thereby conforming California to federal law. (Under existing state law, the exclusion applies to stock purchased before January 1, 1999.) This measure would reduce General Fund revenues by approximately $50 million beginning in 2004-05.

The LAO Assessment—Revenue Forecast Slightly Conservative

Given the uncertain outlook for the future of the stock market and capital gains, any revenue forecast being made at this time is subject to a large amount of uncertainty. While we believe that the general thrust of the administration’s forecast is reasonable, we also believe that its revenue projections are slightly on the conservative side. As shown in Figure 5, the LAO’s revised forecast for General Fund revenues is up from the administration’s by $137 million in the current year and $223 million in the budget year, for a two-year total of $360 million. Our two-year increase is the net result of two offsetting factors:

- Our estimate for the personal income tax is higher for the two years combined, by $493 million, due to our assumptions that refunds on 1998 liabilities will be somewhat lower than assumed by the administration, and that liability growth in 1999 will be slightly higher.
- Our higher personal income tax forecast is partly offset by our lower estimate of sales tax receipts, which is related to our assumption that taxable spending will increase by less than assumed by the administration during 1999.

EXPENDITURES

Figure 6 (see page 8) shows the May Revision proposal for General Fund spending for 1998-99 and 1999-00, by major program area. It also shows the changes by program area from the January budget proposal. In general, the May Revision includes funding increases in a wide variety of programs throughout the budget. In dollar terms, the majority of the funding increases are in K-12 education, youth and adult corrections, and the “all other” category.
The additional spending for K-12 education largely reflects higher ADA, as well as the effects of higher per capita personal income on the Proposition 98 minimum funding guarantee. The Governor proposes to spend some of the additional funds on new initiatives in the areas of school safety, textbooks, teacher bonuses, and deferred maintenance.

The increase in youth and adult corrections reflects both the Governor’s proposed funding for a new prison as well as augmentations for various health and related costs. The major increase in the all other category includes increased infrastructure spending, additional local mandate claims, and funding for trial courts.

**PROPOSITION 98—K-12 EDUCATION**

**The Governor’s Proposal**

The May Revision proposes almost $1.2 billion in new spending for K-12 education, including $320 million in the current year and $866 million in the budget year. The General Fund provides $973 million of this total over the two fiscal years, with increased local property tax allocations accounting for the balance. In addition, the May Revision proposal redirects $114 million of current-year savings to various one-time purposes and redirects $128 million of savings resulting

<table>
<thead>
<tr>
<th>Figure 6</th>
<th>Summary of May Revision Spending Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General Fund</strong></td>
<td>(In Millions)</td>
</tr>
<tr>
<td><strong>Program</strong></td>
<td><strong>Proposed Spending</strong></td>
</tr>
<tr>
<td></td>
<td><strong>1998-99</strong></td>
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<tr>
<td><strong>Education Programs</strong></td>
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<tr>
<td>K-12 Education</td>
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<td>Community Colleges</td>
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<td>Higher Education</td>
<td>5,169</td>
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<td><strong>Health and Welfare Programs</strong></td>
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<td>Medi-Cal</td>
<td>$7,475</td>
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<td>CalWORKsa</td>
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<td>SSI/SSPb</td>
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<tr>
<td>Other</td>
<td>4,588</td>
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<tr>
<td><strong>Youth and Adult Corrections</strong></td>
<td>$4,552</td>
</tr>
<tr>
<td><strong>All Other</strong></td>
<td>$6,512</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$58,631</td>
</tr>
</tbody>
</table>

a California Work Opportunity and Responsibility to Kids.
b Supplemental Security Income/State Supplementary Program.
from a downward revision of the cost-of-living adjustment percentage for the budget year. Including these redirected funds, new spending proposals total $1.4 billion.

Figure 7 displays the major K-12 initiatives proposed in the May Revision for 1999-00.

**May Revision Over-Appropriates Proposition 98 Guarantee.** The Governor’s proposed spending level for K-14 Proposition 98 programs exceeds the calculation of the Proposition 98 minimum guarantee by $100 million in the budget year and by $42 million in the current year. As discussed below, the administration’s spending and minimum guarantee estimates appear to be too high in both fiscal years due to over-estimates of school attendance.

**Legislative Considerations**

**May Revision Over-Budgets for Additional ADA.** The state provides general purpose funding for school districts (so-called “revenue limits”) on the basis of ADA. The May Revision assumes that attendance for the 1999-00 school year will be almost 92,000 ADA higher than the January budget estimate, resulting in additional expenditures for revenue limits and special education apportionments of $406 million. The administration attributes most of this additional ADA (85,000) to an unanticipated jump in attendance in the 1998-99 school year. The Senate’s version of the budget assumes that this increase will be 60,000 ADA. Preliminary data from the recently completed “P-2” counts of 1998-99 ADA, however, indicate that the actual increase may be around 50,000 ADA.

Based on this recent data, we believe the Senate’s planning assumption provides an adequate “cushion” for budget purposes. Using the Senate’s version as a benchmark, we estimate that the May Revision over-budgets for ADA by about $120 million in the budget year. (The amount of over-budgeting for the current year may be less than this amount due to a possible offsetting error in the May Revision’s proposed ADA payments for that year.) The Legislature should regard these funds as available for any of its budget priorities—including non-Proposition 98 purposes—because more realistic estimates of ADA would reduce the Proposition 98 minimum guarantee below the level calculated by the May Revision.

**Teacher Bonuses Proposal Lacks Important Details.** The Governor proposes $100 million for two new programs involving teacher bonuses. According to the administration, about two thirds...
of the money would be for a program granting performance bonuses to teachers at so-called low-performing schools (roughly half the state’s school sites). The proposal is not clear as to how teacher performance would be assessed or who would select the bonus recipients. The remaining one third of funds is intended for bonuses to attract credentialed teachers to schools with severe teacher recruitment problems (under the proposal, the lowest 10 percent of schools in terms of test scores). As proposed, qualifying teachers would receive a “signing bonus” of $4,000 for a commitment of at least three years at a qualifying school. The details of these two proposals, once finalized, merit careful and deliberate review by the Legislature. Accordingly, we recommend that the Legislature set-aside the $100 million for legislation that would specify the program details.

**Improve Local Incentives and School Outcomes.** Like the January budget proposal, the May Revision tends towards a centralized approach to K-12 problems, with the state mandating the use of specific improvement strategies applied more or less uniformly to all schools across the state. As we have emphasized before, we think a decentralized approach that recognizes differing local needs would be more effective. In that spirit, we recommend that the Legislature group the Governor’s various program proposals into one or more block grants. This would introduce vitally needed flexibility, improve incentives for good decision making at the local level, and as a consequence, improve the ultimate outcomes for schools and pupils.

Circumstances vary from district to district and from school to school. For example, not all schools need new metal detectors and security fences. The staff, parents, and pupils of these schools may place a higher priority on using funds proposed for that purpose instead for more counselors. A “school safety” block grant (or a broader school district block grant) would permit such flexibility.

**Potential Liability May Argue for a Proposition 98 Reserve.** Recently some education advocates circulated a proposal for the state to settle long-standing mandate claims by school districts regarding special education. At this time, it is not clear what the magnitude of the state’s liability is, if any. It could be substantial, however. As a precaution for this contingency, the Legislature may wish to consider setting aside a reserve within the Proposition 98 guarantee amount.

**Infrastructure Spending**

**The Budget Proposal**

In the May Revision, the Governor proposes to use $1 billion of the increase in General Fund revenues for infrastructure-related purposes. The $1 billion proposal in the May Revision includes the following elements.

**State Infrastructure and Economic Development Bank—$425 Million.** In the current year, the Legislature appropriated $50 million from the General Fund for the bank. Thus, the May Revision proposal would increase the amount in the bank to $475 million. Any subdivision of state or local government would be eligible to apply to the bank for financing assistance of infrastructure
projects. To date, however, none of the funds in the bank have been used and the bank has yet to establish policies or procedures for implementing a loan program.

**New Prison Construction—$355 Million.** This proposal provides design and construction funds ($335 million) for a new maximum security prison at Delano, Kern County, and design funds ($20 million) for a new maximum security prison on the grounds of the Richard J. Donovan prison at Otay Mesa, San Diego County. The estimated future cost to construct the San Diego prison is $320 million. Each prison would provide space for a total of 4,500 prisoners.

Given the existing prison population and capacity, a new prison will be needed within the next five years to accommodate inmate growth. The state does not, however, need to begin planning for a second new prison in the budget year. In addition, given the time required for designing a new prison, there is no need to appropriate construction funds for either prison in the budget year. We estimate the cost of planning one new prison in the budget year at approximately $10 million. Furthermore, we continue to recommend that in addressing prison system space needs, the state take a balanced approach of new prison space and policy changes to reduce prison population growth.

**Department of Parks and Recreation (DPR), Deferred Maintenance—$157 Million.** The DPR has identified nearly 3,800 deferred maintenance, repair, and minor capital outlay projects with an estimated $274 million total cost. The May Revision proposal would fund many of these projects. While there is a need to address the deferred maintenance problem in the park system, it is not clear that the department could commit more than about half of the proposed funds in the budget year.

**Acquire Additional Trains and Ferries—$75 Million.** This proposal includes $55 million to purchase five train sets for three intercity corridors—San Jose to Roseville; Los Angeles to San Diego; and Bakersfield to Sacramento. It also includes $14 million to purchase one locomotive and five coach cars for the Altamont Commuter Express and $6 million for competitive grants to provide additional ferries in the Bay Area.

While additional rail cars will be needed for future expansion of the state’s intercity rail service, the need for this level of additional funding in the budget year is questionable. Additionally, designating General Fund support for specific projects is not consistent with the existing statutory process for funding transportation priorities through the State Transportation Improvement Program (STIP). If the Legislature wants to use the General Fund for transportation rolling stock, it could provide a lump sum amount to be allocated by the California Transportation Commission in accordance with the existing STIP process.

**Legislative Considerations**

The Governor has committed a significant portion of the new revenues to infrastructure—on
a one-time basis. In reviewing the Governor’s proposal, the Legislature may wish to consider:

- How best to spend funds in the budget year on infrastructure.
- Whether the state should make an ongoing commitment to increased “pay-as-you-go” financing.

**Budget-Year Priorities.** As noted above, the Legislature would not need to appropriate in 1999-00 the level of funds proposed in the May Revision for various infrastructure projects. There are many other proposals the Legislature could fund instead. For instance, the budget has $280 million in capital outlay proposals to be funded from lease-payment bonds. These projects—as well as hundreds of millions of dollars in previously approved lease-payment projects—could be “bought out” by General Fund monies.

**Ongoing Commitment to Pay-As-You-Go.** The Governor has made a significant commitment of one-time funds to infrastructure in 1999-00. He has not, however, committed ongoing funds for pay-as-you-go capital outlay. That is, barring “unexpected” revenue growth in future years, there would not necessarily be monies available for direct funding of infrastructure projects in subsequent years. However, California’s strong economic and revenue growth provides an excellent opportunity for the state to establish an ongoing commitment to pay-as-you-go funding. We therefore recommend that the Legislature consider establishing an infrastructure account, funded each year with a given level of General Fund revenues (each 1 percent would provide about $630 million).

**OTHER PROGRAMS**

**Higher Education**

The May Revision proposes increases of $93 million for the University of California (UC) and $69 million for California State University (CSU). These increases would fund 10 percent student fee reductions for both segments. They also include funds for enrollment increases, various outreach and research programs, and the restoration of budget reductions made in the January budget proposal.

**Health and Social Services**

In the areas of health and social services, the May Revision’s changes primarily are related to caseload revisions and other workload and cost adjustments. Proposed General Fund expenditures for the Medi-Cal Program in the budget year are $185 million higher than in the January budget proposal, due to various caseload and cost changes. Proposed General Fund expenditures for the California Work Opportunity and Responsibility to Kids (CalWORKs) Program in the budget year are $209 million above the January budget, due primarily to a shift of federal Temporary Assistance for Needy Families (TANF) block grant funds from the CalWORKs Program to the Child Welfare Services and Foster Care programs, resulting in General Fund costs in CalWORKs and savings in the latter two programs. The May Revision also reflects a TANF reserve of $98 million.
Set-Aside for Health Proposals. The Governor’s budget in January included a $37.3 million General Fund set-aside to expand health coverage, pursuant to a plan to be developed by the Secretary of the Health and Human Services Agency.

The May Revision replaces this specific set-aside with a more general set-aside of $110 million, to be used for: expansion of the Healthy Families Program, rate increases for Medi-Cal managed care providers, nursing home industry reforms, and wage increases for providers of In-Home Supportive Services.

Youth and Adult Corrections

The Governor proposes to increase youth and adult corrections spending by $42 million in the current year and by $499 million in 1999-00. Current-year increases are proposed primarily to cover deficiencies related to staffing costs and health care expenses in the Department of Corrections. The increases are partly offset by lower-than-expected growth in inmate populations. The budget-year increase also partly reflects increased staffing costs and related expenses (partly offset by lower inmate caseloads). It also includes $335 million for the future construction of a new maximum security prison which would house 4,500 inmates.

Employee Compensation

The January budget provided $162 million from the General Fund to pay for increased employee compensation, pending the completion of collective bargaining discussions (this amount does not include compensation increases in higher education, which are funded elsewhere in the budget). Since January, the state has reached agreements with all bargaining units for the current year, which generally provided for a 5.5 percent salary increase beginning this past April. After accounting for the budget-year costs associated with these agreements, there is about $50 million left over for any future agreements adopted in the budget year.

In addition to these funds, the May Revision includes a $300 million set-aside to cover the costs of both future collective bargaining agreements and potential court settlements. Future compensation increases will be tied to the provisions of future negotiated agreements. However, as an illustration, the combined $350 million (that is, the set-aside plus amounts left over from the January proposal) is approximately equivalent to the full-year costs of an average pay increase of 7 percent.

Retirement Fund Contributions

Due to continued favorable investment returns and revised assumptions by the Public Employees’ Retirement System (PERS), state retirement contributions will fall in 1999-00. These reductions will translate into General Fund savings of approximately $125 million in 1999-00.

Local Government Mandates

The administration proposes that $97 million be set aside to cover various local government mandate claims. This amount includes $37 million to cover reimbursement claims from local governments which have exceeded current-year appropriations, plus $55 million for claims approved for
new statutes recently determined to qualify for reimbursement as state-mandated local costs.

**Year 2000 Computer Costs**

The January budget includes significant appropriations throughout the budget for year 2000 (Y2K) remediation. The May Revision includes additional General Fund appropriations of $35 million in the current year and $44 million in the budget year to be allocated as needed to support century-change activities. Of this total, $14 million would be made available to the Department of Information Technology to fund Y2K oversight activities started in the current year. (The budget also includes $20 million in other funds for century-change activities.)

**Local Government Support**

In January, the Governor proposed a number of changes that would have negatively affected local governments. The May Revision reverses a number of these proposals, and also includes earmarked funds for local government in a number of areas. Figure 8 summarizes the Governor’s major proposals affecting local governments.

Aside from the major increase in funding for the State Infrastructure Bank (discussed previously), the May Revision restores prior-year commitments for trial court funding and flood control subventions, and provides new funds for local law enforcement grants.

**Trial Court Funding.** Under the trial court financial restructuring enacted last year, the state is scheduled to provide $98 million in additional fiscal relief to mid-size and large-size counties beginning in 1999-00. Due to the budget shortfall anticipated earlier this year, the Governor had proposed in January to postpone providing about one-half of this increase. The May Revision restores the funds needed to provide the full $98 million in additional relief, for a net cost of $46 million.

**Local Flood Control Reimbursements.**

Chapter 326, Statutes of 1998 (AB 2784, Strom-Martín), appropriated $132 million from the General Fund—$44 million annually for 1999-00 and the subsequent two fiscal years—to pay claims submitted by local agencies for the state’s share of costs for flood control projects. The Governor’s January budget proposal assumed enactment of legislation that would eliminate the appropriations made in Chapter 326, resulting in a $44 million savings in 1999-00. The May Revision continues to assume that legislation will be enacted eliminating the appropriations made in Chapter 326, but the updated proposal would separately appropriate $44 million in 1999-00 for flood control reimbursements.

**Office of Criminal Justice Planning Grants.**

The May Revision provides $61 million to provide one-time grants to local law enforcement agencies. Under the proposal, the funds would be allocated to local agencies based on criteria which would be developed by the Office of Criminal Justice Planning.
## Major Proposals Affecting Local Governments

<table>
<thead>
<tr>
<th>Issue</th>
<th>January Proposal</th>
<th>May Revision Proposal</th>
<th>May Revision General Fund Fiscal Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure Bank</td>
<td>No proposal</td>
<td>Augment bank by $425 million to provide funding for state and local infrastructure projects</td>
<td>$425 million cost</td>
</tr>
<tr>
<td>Flood Control Subventions</td>
<td>Defer $44 million in payments to local agencies for state’s share of project costs</td>
<td>Restore $44 million in payments</td>
<td>$44 million cost</td>
</tr>
<tr>
<td>California Healthcare Indigents Program</td>
<td>Reduce funds by $54.5 million in budget year due to declining Proposition 99 revenues</td>
<td>Restore $4.6 million in current year; reduce $3.8 million in budget year</td>
<td>No General Fund impact</td>
</tr>
<tr>
<td>County Medical Services Program</td>
<td>Eliminate $20 million General Fund appropriation</td>
<td>No change</td>
<td>—</td>
</tr>
<tr>
<td>Child Support Enforcement Automation</td>
<td>Reduce federal reimbursements to counties by $90 million</td>
<td>Backfill $21 million to counties for lost federal funds</td>
<td>$21 million cost</td>
</tr>
<tr>
<td>Adult and Juvenile Detention Facilities</td>
<td>No proposal</td>
<td>Allocate $75 million in federal funds to local governments for construction or expansion of facilities</td>
<td>No General Fund impact</td>
</tr>
<tr>
<td>Office of Criminal Justice Planning Grants</td>
<td>No proposal</td>
<td>Provide one-time grants to local law enforcement agencies</td>
<td>$61 million cost</td>
</tr>
<tr>
<td>Citizens’ Option for Public Safety</td>
<td>Make $100 million program permanent with new restrictions on how funds can be used</td>
<td>No change</td>
<td>—</td>
</tr>
<tr>
<td>Trial Court Funding—County Share of Costs</td>
<td>Reduce by half the statutorily required “buyout” of county costs</td>
<td>Restore full amount of county buyout required by statute</td>
<td>$46 million cost</td>
</tr>
<tr>
<td>Department of Justice—Crime Labs</td>
<td>Charge local governments for use of state crime lab services</td>
<td>No change</td>
<td>—</td>
</tr>
</tbody>
</table>
CONSIDERATIONS FOR THE LEGISLATURE

The May Revision allocates the $4.3 billion in new resources among a wide variety of programs including education, infrastructure, and the restoration of commitments made to local governments last year. The proposal has many positive features. For example, it realistically budgets for caseloads and many other likely costs, it makes significant commitments to infrastructure and deferred maintenance, it contains a general emphasis on one-time obligations, and it makes provision for an enhanced reserve.

At the same time, the revised plan raises several important issues for the Legislature as it finalizes its decisions on the budget for 1999-00. In addition to the budget threats noted earlier, these include:

• **Central Statewide Control Versus Local Discretion.** In general, the Governor proposes a central approach toward dealing with both K-12 education and local government funding proposals. The Legislature may wish to consider a more decentralized approach that recognizes differing local needs.

• **Lack of Specificity.** The updated plan contains a number of proposals and set-asides in such areas as teacher bonuses, local law enforcement grants, and expansion of health care coverage, which do not include any detail. We believe it will be important for the administration to provide additional detail on these and other proposals to enable the Legislature to evaluate them.

• **Pay-As-You-Go Infrastructure.** Given that much of the $1 billion targeted for infrastructure will not be needed in 1999-00 for the purposes specified, the Legislature may wish to set up an infrastructure account within the General Fund, which would be used to support an ongoing pay-as-you-go infrastructure approach that augments the state’s bond approach. Such a commitment would raise out-year spending requirements. However, given the positive fiscal environment and the state’s vast infrastructure needs, we believe that an ongoing commitment in this area is appropriate.

Acknowledgments
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