An LAO Report

Overview of the 2000-01 May Revision

The Governor's Plan

- ***Dramatic Two-Year Increase in Revenues.*** Reflecting the strong economy and higher-than-expected collections during the first half of 2000, revenues have been revised up by $5.8 billion for 1999-00 and $6.5 billion for 2000-01, or $12.3 billion overall.

- ***Main Uses of the New Resources.*** The $12.3 billion revenue gain is allocated across a variety of areas, led by Proposition 98 education programs ($3.9 billion), tax relief ($2.5 billion), and transportation ($1.9 billion). The tax relief includes a one-time personal income tax rebate ($1.8 billion).

- ***Other Uses.*** Other program areas receiving significant additional funding include health, social services, and housing. Additionally, the budgetary reserve has been augmented by half a billion dollars.

LAO Findings

- ***Revenues Reasonable, But Have Upward Potential.*** While reasonable, the Governor's revised revenue forecast has upward potential of about $500 million, largely associated with sales and corporate income taxes.

- ***Plan Has Positive Elements.*** The plan provides significant new funds for infrastructure (primarily one-time) and education. It also preserves the state's future fiscal flexibility by avoiding excessive ongoing commitments. Of the $12.3 billion in new resources, more than half—$7.2 billion—are for one-time purposes.

- ***But Significant Shortcomings Exist.*** Many proposals lack data and specificity, making it impossible to effectively evaluate them. In some areas, excessive delegation of authority to the administration threatens legislative oversight. Certain proposals do not appear cost efficient, like the teacher income exclusion.

- ***Missed Opportunities.*** Two areas not addressed in the May Revision are the creation of an ongoing infrastructure program and local fiscal reform. The Legislature may wish to set aside funding for (1) infrastructure, allowing time for a detailed review of proposals, and (2) long-term state-local reform, with the objective of providing greater local control and more balanced land-use incentives.

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INTRODUCTION

Once again, the May Revision reflects a dramatic improvement in the General Fund revenue outlook. The updated budget forecast estimates that revenues will exceed the Governor's January budget proposal by $5.8 billion in 1999-00 and by $6.5 billion in 2000-01, for a two-year increase of $12.3 billion.

Uses of New Resources

As shown in Figure 1, the budget proposes to use $7.2 billion of these new resources for one-time purposes and $5.1 billion for ongoing purposes. The bulk of the new funds is allocated to four key areas:

- ***Proposition 98 education,*** where the Governor proposes to spend an additional $1.5 billion in one-time funds and $2.4 billion in ongoing funds for general apportionments (deficit reduction), computers, performance bonuses, and other purposes.

- ***Tax relief,*** where the Governor proposes $1.8 billion for a one-time rebate, $154 million for one-time senior citizen homeowners' and renters' relief, and an ongoing exemption of K-12 public school teachers' salaries from state income taxation, which would reduce revenues by $545 million.

- ***Transportation,*** where the Governor proposes a $1.5 billion one-time General Fund appropriation plus an ongoing diversion for five years of $440 million in sales taxes to support various rail, mass transit, road, and street projects.

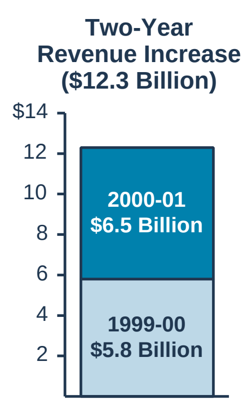
- ***Health and social services,*** where the Governor proposes about $100 million in one-time funds and $1.1 billion in ongoing funds for such purposes as provider rate increases, In-Home Supportive Services wage increases, and expansions to various mental health services.

In addition, the revised plan contains a major increase in spending for housing programs; various augmentations for resources, higher education, and public safety; a one-time subvention of $250 million

Figure 1

How the Governor Proposes To Allocate Additional Revenues

General Fund



Purpose	One-Time	Ongoing
Proposition 98	$1.5	$2.4
Tax relief	1.9	0.6
Transportation	1.5	0.4
Health/Social Services	0.1	1.1
Reserve/set-asides	0.6	—
Housing	0.5	0.1
All other[a]	1.1	0.5
Totals	**$7.2**	**$5.1**

[a] Includes higher education, resources, public safety, and local government.

to local governments; and a larger reserve.

The General Fund's Condition

Figure 2 summarizes the General Fund's condition, including expenditures, revenues, the reserve, and set-asides. Proposed expenditures total $67.3 billion in 1999-00 (16 percent growth) and $78.2 billion in 2000-01 (also 16 percent growth). The May Revision continues to include one-time set-asides for litigation ($500 million) and legislative initiatives ($200 million, up from $100 million in the January proposal). It also proposes a 2000-01 year-end reserve of $1.8 billion (2.2 percent), which is up $531 million from the January budget proposal.

Figure 2

Governor's May Revision General Fund Condition

1999-00 Through 2000-01
(In Millions)

	1999-00	2000-01
Prior-year fund balance	$3,851	$7,512
Revenues and transfers	70,924	73,791
Total resources available	$74,775	$81,303
Expenditures	$67,263	$78,242
Ending fund balance	$7,512	$3,061
Encumbrances	592	592
Set-aside for legal contingencies	—	500
Set-aside for legislation	—	200
Reserve	**$6,920**	**$1,769**

Detail may not total due to rounding.

ECONOMIC AND REVENUE OUTLOOK

The Economy

The May Revision forecast reflects a much stronger near-term economic outlook than did the January budget. Underlying this stronger outlook are the recent positive national and state developments involving output, jobs, and income. The updated forecast foresees growth continuing in late 2000 and throughout 2001, although the pace of the expansion is expected to moderate.

With regard to key revenue-related variables, the administration forecasts that California personal income will increase by 7.4 percent in 2000, before slowing to 5.4 percent in 2001. It also projects that taxable sales growth will continue, but slow sharply from 6.9 percent in 2000 to 4.7 percent in 2001.

A key factor contributing to the expected moderating of growth is the administration's assumption that stock option-related wages will decline over the forecast period relative to their recent historically high levels. This is expected to result in slower personal income growth, as well as constrain taxable sales growth over the next 18 months.

GENERAL FUND REVENUES

As indicated above, the May Revision revenue forecast for both 1999-00 and 2000-01 is up sharply from January, reflecting recent positive economic and cash developments. The updated forecast assumes that General Fund receipts will total $70.9 billion in the current year (a 21 percent increase from 1998-99), and that revenues will increase further to $73.8 billion in 2000-01 (a 4 percent increase). The slower growth foreseen for 2000-01 is partly due to the proposed reduction in personal income taxes and the proposed redirection of sales taxes (discussed below). It is also due, however, to the administration's view that personal income, taxable sales, and corporate profits growth will be tapering off.

The LAO Assessment—Upside Potential Exists. The administration's updated economic and revenue projections are generally reasonable, in that they incorporate recent economic and cash trends, and the revenue projection itself falls near the middle of the range we provided in early May.

However, there is some upside revenue potential. This mainly relates to the outlook for taxable sales. We believe that historically high levels of consumer confidence, income, and accumulated wealth will remain positive forces in the outlook for consumer spending during the next year, and that taxable sales will grow significantly more rapidly than the May Revision forecasts. Primarily as a result of this difference, *our own two-year forecast is $500 million above the Governor's.*

TAX REDUCTION PROPOSALS

The Governor's revised budget plan includes several tax proposals that supplement certain tax proposals in the January budget. These total $2.5 billion in 2000-01, and include:

- ***One-Time Rebate.*** The largest proposal is a one-time personal income tax rebate, capped at $150 for single taxpayers and $300 for married couples. It would cost $1.8 billion in 2000-01 and benefit 12.3 million taxpayers.
- ***Exclusion for Teachers.*** The Governor also proposes exempting from income taxation the teaching-related income of certified K-12 public school teachers. This ongoing program would benefit over 280,000 teachers at a cost of $545 million in 2000-01.
- ***Other.*** These proposals include a one-time increase in the senior citizen homeowners' and renters' assistance programs ($154 million), an ongoing increase from 12 percent to 15 percent in the research and development tax credit ($16 million initially); and a future modest expansion in allowable net operating loss deductions beyond that proposed in the budget.

In addition to the above tax-reduction proposals, the Governor is also proposing a redirection of gasoline-related sales taxes to fund transportation. Specifically, a total of $440 million would be transferred each year for five years, beginning in 2000-01. The sales tax shift would thus provide funding for $2.2 billion of the Governor's $5.3 billion transportation initiative.

Legislative Considerations

In reviewing the Governor's tax-related proposals, the Legislature should ask how they stack up against its own tax policy priorities. Among the questions to ask are:

- Is the rebate the best form of broad-based tax relief—especially given that several hundred millions of dollars of it will end up with the federal government due to the federal deductibility of state income taxes?
- Is the teachers' income exclusion the most effective, efficient, and equitable approach to stimulating the supply of teachers—especially given that the dollar benefits to teachers with identical training, competency, and salary could differ markedly, due simply to their personal tax situations? Also, is it advisable to begin making occupation a basis for tax treatment?

EXPENDITURES

Figure 3 summarizes the Governor's revised spending proposals, by major program area. It shows that about half of 2000-01 spending is for K-12 and higher education, slightly over a quarter is for health and social services, and the remaining quarter is for corrections, transportation, housing, resources, and other programs. The Governor's funding proposals in some of these major individual program areas are discussed below.

Figure 3

Summary of May Revision Spending Proposal General Fund

(Dollars In Millions)

	1999-00	2000-01	
Program/Agency	**Amount**	**Amount**	**Percent Change**
Education Programs			
K-12 Education	$27,622	$30,492	10.4%
Higher Education	8,012	9,317	16.3
Health and Social Services	17,779	20,255	13.9
Youth and Adult Corrections	4,802	5,182	7.9
Business/Transportation/Housing	402	2,616	550.7
Resources/Environmental Protection	1,620	1,923	18.7
All Other	7,026	8,457	20.4
Totals	**$67,263**	**$78,242**	**16.3%**

Proposition 98—K-12 Education

The May Revision proposes over $3.7 billion in new General Fund spending for K-12 education, including $1.4 billion in the current year and over $2.3 billion in the budget year. In addition, the May Revision proposes exempting public school teacher earnings from state income taxation, at an estimated annual loss of revenue of about $545 million. Figures 4 and 5 display the major K-12 initiatives proposed in the May Revision for 1999-00 and 2000-01, respectively.

Figure 4

May Revision Increases in K-12 Proposition 98 Spending—One-Time

1999-00[a]
(In Millions)

Teacher performance bonuses	$500
Computers	325
English literacy program	250
Mandates—prior-year deficiencies	239
Teacher performance (low-performing schools)	50
Other	44
Total	**$1,408**

[a] Counts toward current-year guarantee.

Figure 5

May Revision Increases in K-12 Proposition 98 Spending—Ongoing

2000-01
(In Millions)

Deficit reduction	$1,840
COLA increase	114
Attendance increase	62
Teacher performance bonuses	50
School performance awards	40
Other	62
Total	**$2,168**

Legislative Considerations

Sheer Amount of "Deficit Reduction" Funds Could Pose Unanticipated Problems for School Districts. The May Revision proposes $1.84 billion for deficit reduction. This amount is sufficient to eliminate the so-called deficit in school district revenue limits that has existed since the early 1990s when the state withheld cost-of-living adjustments (COLAs). The large amount raises unanticipated, but potentially serious, budgeting problems for the many school districts with clauses in their collective bargaining agreements that trigger staff pay increases based on the percentage increase in revenue limits resulting from COLAs, equalization, and deficit reduction. Since this increase (averaging almost 11 percent statewide) would substantially exceed the 3.17 percent COLA that school districts will receive for most other state-funded programs, and since staff salaries are the largest item of expenditure in most of these programs, some school districts with such collective bargaining clauses may have to reduce programs in order to fund the salary increases.

This problem could be mitigated if the Legislature were to provide additional forms of discretionary funds. For example, the budget bill adopted by the Senate augments revenue limits by $495 million by deleting a provision of law that reduces revenue limits through a 13 percent "charge" against the amounts that districts spend on classified employee salaries. Including this Senate action in the "mix" of revenue limit augmentations would provide additional discretionary funds and help alleviate the problems noted above.

Block Grants for Current-Year Funds Would Better Meet Local School Needs. The May Revision proposes $1.4 billion of new current-year spending for K-12 education, as summarized in Figure 4. Although the amount appears reasonable in the overall budget context, the May Revision misses an opportunity to allocate the new spending in ways that permit local discretion. Instead, the new spending is characterized by narrowly specified purposes that are unlikely to match up with a given district's needs.

Some of the proposals raise further issues. For example, the May Revision proposes $500 million for certificated staff bonuses based on percentage increases in the academic performance index (API) of local schools. These percentage increases will be based on only one year's "improvement" in the SAT-9 standardized test because administration of the test on a statewide basis is so recent. As a consequence, it will not be possible to know to what extent any school's improvement is attributable either to better teaching, statistical "noise," or other extraneous factors. Moreover, teachers in schools without API scores—such as small rural schools—would be ineligible for bonuses. This is not a sound basis on which to grant or deny individual teachers rewards totaling $500 million.

The May Revision also adds $375 million of one-time funds for computer purchases, for a total of $500 million, despite the lack of evidence tying historically poor academic performance with lack of computers. We believe the Legislature could better match one-time funds with local needs through block grants that would allow school districts to pick from a relatively rich "menu" of high-priority purposes, which could include staff bonuses or computer purchases for those districts that regard those purposes as genuine priorities.

Transportation

The May Revision includes some details related to the Governor's Transportation Congestion Relief Plan. The plan proposes $5.3 billion from the General Fund to be made available over the next five years, mainly for designated transportation projects. Specifically, the proposal would be funded with:

- $1.5 billion in one-time General Fund money in 2000-01.
- $440 million annually from sales tax revenues (General Fund) for five years, from 2000-01 through 2004-05 (for a total of $2.2 billion).
- A total of $1.6 billion (General Fund) from 2001-02 through 2004-05.

Of the $5.3 billion plan, $500 million is earmarked for deferred maintenance of local streets and roads ($400 million) and state highways ($100 million). The remaining $4.8 billion would be allocated to improvements of state highways, transit and rail improvements (including bus and train acquisition), and various transportation studies.

The plan would be administered by the California Transportation Commission, which would be responsible for reviewing project applications and allocating funds.

Figure 6

Governor's Transportation Congestion Relief Plan

(In Millions)

Types of Projects Funded	
Mass transportation improvements and studies	$3,312
High Occupancy Vehicle lanes	555
Highway improvements	650
Interchange improvements	312
Local streets and roads maintenance	400
Highway maintenance	100
Total	**$5,329**

About 70 Percent of New Capital Funds Proposed for Rail and Transit. As shown in Figure 6, about 70 percent ($3.3 billion) of the funds dedicated to new infrastructure (as opposed to maintenance) are proposed for rail and transit improvements, with about 30 percent proposed for highway improvements.

Over 1,500 New Caltrans Staff Proposed. The May Revision also requests 1,556 new positions in the Department of Transportation to deliver projects specified in the Governor's plan, as well as to handle current workload. This would bring total capital outlay support staffing in 2000-01 to approximately 11,781 personnel-years. Additionally, the administration requests funds for 567 personnel-year equivalents for various project-related work that would be contracted out to the private sector.

Legislative Considerations

While the May Revision provides some details on the Governor's transportation plan, many details remain to be specified in the separate legislation that would implement the plan. Figure 7 identifies several key issues that the Legislature should consider in assessing the Governor's proposal.

Other Programs

Health and Social Services

The Governor is proposing an increase of $1.3 billion in spending for health and social services programs relative to the January budget. This increase includes $460 million in Medi-Cal expenditures in the budget year, which would support:

- Currently required provider rate increases (long-term care facilities and managed care), and new increases for physicians and other providers ($388 million).
- Increased caseload costs ($115 million) associated with the elimination of quarterly status reporting requirements effective January 1, 2001.
- Increased costs associated with an additional $25 million reduction in the state's administrative fee paid by disproportionate share hospitals.

Figure 7

Governor's Transportation Congestion Relief Plan Issues for Legislative Consideration

- ***Ongoing Funding.*** Plan provides one-time funding over five years, but does not provide additional ongoing funding. How should the state address the unfunded statewide needs on an ongoing basis?
- ***Project Selection Process***. Plan designates funding for specific projects without using existing statutory process set up by Chapter 622, Statutes of 1997 (SB 45, Kopp). How do the proposed projects meet the stated goals of congestion relief, enhanced transportation connectivity, and improved goods movement in the most cost-effective manner?
- ***Local Match Requirement***. Plan only funds about 30 percent of projects' total costs. How would the requirements for local governments to match state funds affect the funding of other high-priority regional and local projects?
- ***Flexibility in Use of Funds***. Plan designates specific projects to be funded. Should local governments have the flexibility to redirect funds to higher-priority projects?
- ***Equity in Fund Distribution***. Plan concentrates funds in urban areas with many other counties (primarily rural counties) receiving minimal amounts for deferred maintenance. Are there needs in these areas that merit consideration?
- ***Project Delivery***. Will Caltrans and local agencies be able to deliver projects in a timely manner? How long will it take for specified projects to be constructed to achieve congestion relief goals?
- ***Ongoing Operating Costs***. How will the ongoing costs to maintain and operate the new facilities (such as intercity rail trains or additional local transit buses and trains) be funded?

These increases are partly offset by savings associated with antifraud efforts and higher drug rebates.

In other areas, the May Revision provides: $184 million (federal block grant funds) for employment services in the California Work Opportunity and Responsibility to Kids program; $63 million, assuming 100 percent participation in the Healthy Families Program; $101 million for mental health initiatives, including funds for services to homeless adults or those who are at risk of criminal involvement; $100 million in the In-Home Supportive Services program fund for increased wages and health benefits for public authority providers, and rate increases (COLA) for other providers; $80 million for Child Welfare Services, primarily to provide increased funding for social workers; and an increase of $150 million in the Department of Developmental Services, including various rate increases and renovations at developmental centers.

UC/CSU/Student Aid Commission

The May Revision proposes additional funds totaling $124 million in 2000-01 for University of California (UC) for expanded Internet access, deferred maintenance and instructional equipment, and other purposes. The California State University (CSU) system would receive an additional $42 million for development of the CSU Stanislaus Multi-Campus Regional Center in Stockton, the CSU Channel Islands campus, and other purposes. The revised proposal also includes an additional $42 million for the Student Aid Commission to support increases in the number of Cal Grant awards, and expanded outreach services for various financial aid programs.

Public Safety

The May Revision includes $256 million in new funds for various public safety initiatives, including $96 million for a Los Angeles City/County crime laboratory, $75 million for county juvenile detention facility construction, $50 million to provide local law enforcement agencies with resources to process evidence in unsolved sexual assault cases, and $25 million to augment the existing juvenile crime enforcement and accountability challenge grant program.

General Government

The May Revision provides $35 million in new funds to the Trade and Commerce Agency to support various initiatives aimed at retaining jobs and production in California's film industry, and to expand small business assistance programs. Increases are provided in a number of other areas including the California Arts Council, and online government services.

Local Government General Fiscal Relief

The May Revision provides $250 million in one-time discretionary funding to local governments. The funds would be allocated in the same manner as this year—50 percent based on population and 50 percent based on local governments' contribution to their counties' Educational Revenue Augmentation Fund.

Capital Outlay

In addition to the transportation program discussed above, the May Revision includes funding for nearly $620 million in capital outlay for non-Proposition 98 programs in 2000-01, an increase of about $220 million from the January budget proposal. Significant increases involve using $73 million for pay-as-you-go financing rather than lease-payment bonds and nearly $140 million for projects involving the UC and CSU systems. In addition to these General Fund proposals, the May Revision adds nearly $1.4 billion in general obligation bonds for resources (mostly for capital outlay) and $600 million in lease-payment bonds for seismic improvements to UC hospitals.

Housing

The Governor proposes $500 million in new General Fund spending on various housing programs ($50 million ongoing, $450 million one-time). Major proposals include:

- ***Local Infrastructure***. $200 million in grants for those local governments that increase the number of housing building permits issued and comply with state law on housing elements. Funds could be used for local capital outlay needs.

- ***Home Ownership.*** $150 million for programs designed to encourage home ownership.

- ***Multifamily Housing.*** $97 million for the construction, rehabilitation, and acquisition of multifamily housing, including a set-aside for housing in downtown areas.

- ***Special Needs.*** $47 million for programs that provide housing for the homeless ($17 million) and farmworkers ($10 million), and provide social services and housing in tandem ($20 million).

The State Appropriations Limit (SAL)

Last month, we reported that the state's strong revenue performance could make the SAL a budgetary issue this spring—which would happen if combined current- and budget-year appropriations exceed their combined SALs. The Governor's revised plan reduces this likelihood, since the combination of tax relief, capital outlay spending, and other SAL-exempt appropriations would reduce appropriations subject to the limit in 2000-01 by an amount sufficient to keep the state from exceeding its limit over the combined two-year period. Nevertheless, the Legislature could also keep appropriations under the SAL in the current year—by making sufficient SAL-exempt appropriations prior to the budget year.

CONSIDERATIONS

The revised budget plan includes many positive features. For example, it provides significant new funds in the areas of transportation and schools. It is also a prudent plan, which is based on reasonable revenue estimates, holds ongoing commitments significantly below ongoing revenues, and contains an expanded budgetary reserve.

However, the budget revision also raises a variety of significant issues and concerns. In addition to those we discussed previously in the areas of taxes, education, and transportation, the budget raises significant concerns in two general areas:

- First, it includes a number of proposals which would involve legislative delegation of authority to the administration. Examples include proposals to expend Proposition 13 bond funds, Cal-Fed related spending, and rehabilitation projects to conform with the Americans with Disabilities Act.
- Second, a closely related issue is that the budget lacks data and supporting detail in many areas. This is particularly true with regard to many of the capital outlay proposals.

To address these concerns, one option the Legislature may wish to consider is that, instead of considering the administration's long list of capital outlay proposals, it reserve a large amount of ongoing funding to support an ongoing capital outlay program. This alternative would enable the Legislature to more carefully prioritize and review capital outlay projects, and would provide an ongoing source of pay-as-you-go funds for infrastructure projects.

Finally the budget misses a significant opportunity to use newly available funds to undertake meaningful state and local fiscal reform—with the objectives of providing greater local fiscal control and correcting the skewed land-use incentives faced by local governments.

Acknowledgments

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