May 9, 2001

Hon. Dave Cox
Assembly Minority Floor Leader
Room 3104, State Capitol
Sacramento, California 95814

Dear Assembly Member Cox:

We were asked by a Member to develop updated information on the General Fund's projected condition. Given the significance of this information for the Legislature's budget-related deliberations, we are sharing this information with you. We also will be analyzing the May Revision when it is released by the administration next week. Below, we have updated our General Fund revenue projections and discuss their implications for the Governor's January budget proposal. In addition, we discuss the amount of one-time and ongoing spending reductions that would be needed to keep the budget in balance and the fiscal implications of funding Proposition 98 at the revised Test 2 level under our updated estimates. These estimates assume that the General Fund is reimbursed for its energy-related purchases.

Updated Estimates

We currently estimate that General Fund revenues will be $3.4 billion less than estimated by the Governor for the current and budget years combined. This two-year downward revenue adjustment reflects the net effect of a $1.4 billion *gain* in the current year and a $4.8 billion *reduction* in the budget year. The current-year increase primarily reflects the strong performance of final personal income tax payments on 2000 income-year liabilities. The budget-year reduction is due to a weaker near-term economic outlook, the decline in the stock market, and recent cash trends associated with 2001 economic activity (which are running well below projections).

Budgetary Implications. Our reduced revenue projections would cause the budget to fall significantly out of balance. Specifically, incorporation of our updated revenue estimates for both the current year and budget year would cause the January budget plan to fall into a deficit of $1.5 billion in 2001-02. This is in contrast to the January budget estimate of a $1.9 billion positive reserve balance.

The budget's condition would continue to deteriorate in 2002-03 using our updated revenue assumptions and extrapolating the Governor's spending plan into that year. Absent any budgetary adjustments, the deficit would reach nearly $6 billion in 2002-03. The growing deficit reflects the fact that, even though revenues are assumed to rebound, ongoing expenditures under the budget plan would still exceed receipts in that year by $4.8 billion. If the rebound in receipts we are assuming does not materialize, the shortfall would be even greater.

Given our updated projections, a comprehensive solution to the budget shortfall will necessarily require meaningful ongoing spending reductions in addition to one-time cuts. For example, if $2.5 billion in one-time reductions were to occur in 2001-02, ongoing reductions of about $1.7 billion in 2001-02 (continuing through 2002-03) would be needed to avoid a deficit at the end of 2002-03. It is important to remember that these estimates are based on the Governor's January spending projections, and thus, do not account for cost increases in such areas as Proposition 98 (see below), Medi-Cal, resources, and employee retirement.

Proposition 98 Spending

In discussing the cost of funding Proposition 98 at the Test 2 level using our revised economic and revenue projections, it is important to remember that this is a policy decision because Test 2 exceeds the required minimum funding level by a considerable margin. If funding at the Test 2 level were adopted, similar to the January budget, spending would increase by $810 million for the two years combined. The major factors behind these increased amounts are higher per-capita personal income, higher school enrollments, and lower local property taxes. The higher budget-year funding level would carryforward into 2002-03 and future years.

Should you have questions regarding this information, please feel free to contact Brad Williams of my staff at 324-4942.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

cc: Paul Navarro, Chief Consultant