Overview of the 2001-02 Governor’s Budget

On January 10, 2001, the Governor released his proposed $100 billion plus state budget. This analysis briefly reviews the Governor’s budget plan and provides our preliminary reactions to it.

- The budget fully funds most existing state programs, covering costs for caseloads and inflation. It also provides for major new initiatives in the areas of education and energy. However, many initiatives will require further development, and additional spending beyond that proposed will be needed in some areas (such as employee compensation and retirement).

- The budget assumes $2.3 billion less in resources than the $10.3 billion in uncommitted funds we reported in November, primarily reflecting the recent slowing in the national economy. The budget proposal allocates the remaining $8 billion in uncommitted resources to finance increased spending ($5.5 billion), cut taxes ($0.1 billion), and provide for a budgetary reserve ($2.4 billion).

- Of the total $8 billion the Governor allocates, about 70 percent is for one-time purposes and the remainder is ongoing.

- In reviewing the Governor’s proposals in the coming months, the key challenge for the Legislature will be to identify its own spending and tax priorities for utilizing the available resources, and to determine how they compare to the Governor’s priorities and proposals.

- Other important challenges will involve achieving the proper balance between one-time and ongoing uses of funds, and developing effective proposals for addressing electricity-related problems.
OVERVIEW OF THE GOVERNOR’S BUDGET

THE BUDGET TOTALS
California’s strong economic and revenue performance have once again provided sufficient resources to both fund existing priorities and finance new ones. The Governor’s 2001-02 budget proposes total state spending of $102 billion (excluding expenditures of federal funds and selected bond funds). This represents an increase of $7.5 billion, or 7.9 percent, over the current year. Slightly over 80 percent of this total spending is from the General Fund, while the remainder is from special funds. As discussed below, the main focus of the Governor’s budgetary initiatives involves education and energy.

As shown in Figure 1, the budget projects that General Fund revenues will total $79.4 billion in 2001-02, an increase over the current year of $2.5 billion (3.3 percent). By comparison, budget-year General Fund expenditures are estimated at $82.9 billion, an increase of $3.1 billion (3.9 percent) over 2000-01. After accounting for various set-asides, the Governor’s estimated 2001-02 year-end General Fund budgetary reserve is $1.9 billion, or about 2.4 percent of expenditures.

HOW THE BUDGET ALLOCATES RESOURCES
The budget allocates approximately $8 billion in resources not committed for current-law requirements in 2001-02. This is about $2.3 billion less than the $10.3 billion in funds we had estimated would be available in our November report. The difference is primarily related to the effects of the recent national economic slowdown, partly offset by higher carry-in balances from 1999-00.

Figure 2 shows how the budget proposes to allocate the $8 billion. About $5.5 billion is for new spending initiatives, $0.1 billion is for tax reduction, $1.9 billion is allocated for the reserve, and $0.5 billion is set aside for litigation.

<table>
<thead>
<tr>
<th>Prior-year fund balance</th>
<th>1999-00</th>
<th>2000-01</th>
<th>2001-02</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues and transfers</td>
<td>$3,930</td>
<td>$9,367</td>
<td>$6,557</td>
<td></td>
</tr>
<tr>
<td>Total resources available</td>
<td>$75,861</td>
<td>$86,266</td>
<td>$85,991</td>
<td>3.3%</td>
</tr>
<tr>
<td>Expenditures</td>
<td>$66,494</td>
<td>$79,708</td>
<td>$82,853</td>
<td>3.9%</td>
</tr>
<tr>
<td>Ending fund balance</td>
<td>$9,367</td>
<td>$6,557</td>
<td>$3,139</td>
<td></td>
</tr>
<tr>
<td>Encumbrances</td>
<td>$701</td>
<td>$701</td>
<td>$701</td>
<td></td>
</tr>
<tr>
<td>Set-aside for legal contingencies</td>
<td>—</td>
<td>7</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>$8,666</td>
<td>$5,849</td>
<td>$1,937</td>
<td></td>
</tr>
</tbody>
</table>

Detail may not total due to rounding.
Of these uncommitted resources, about 70 percent ($5.7 billion) is for one-time uses (including funding reserves and supporting state programs), and the remainder ($2.3 billion) is for ongoing uses. The key issue that the Legislature faces in the coming months is identifying its own priorities for committing these funds, and determining how they compare to the Governor’s priorities and proposals.

**Main Features of the Governor’s Proposal**

**Focus Remains on Education.** For the third year in a row, the Governor’s proposal contains significant new ongoing funds for education. It proposes significant increases to support various K-12 initiatives directed at teacher and principal training, student achievement at middle schools, and settlement of a mandated cost claim for special education. In higher education, the budget includes significant ongoing increases for each of the three segments, as well as funds for increased financial aid, student outreach, and part-time instructor salary increases.

**Energy Also a Priority.** The budget also includes a $1 billion set-aside for energy-related initiatives, relating to the current electricity crisis facing the state. The funds would be available for programs directed at energy conservation and to increase supply. The administration indicates that specific proposals will be developed in consultation with the Legislature.

**Mostly One-Time Spending in Noneducation Areas.** With the exception of the expansion of the Healthy Families program, most of the policy-related increases in the noneducation portion of the budget are for one-time purposes. As shown in Figure 3 (see page 4), the budget is proposing about $3.3 billion in new one-time programmatic spending in 2001-02 (this one-time amount excludes the $2.4 billion noted earlier that is allocated to re-
This includes the $1 billion set-aside for various energy initiatives and $772 million in direct appropriations for capital outlay. The budget also includes significant one-time funds for local fiscal relief, new housing initiatives, and various environmental and resources-related purposes.

### Key One-Time Program Expenditures In the 2001-02 Budget

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy initiatives set-aside</td>
<td>$1,000</td>
</tr>
<tr>
<td>Capital outlay</td>
<td>772</td>
</tr>
<tr>
<td>Local government fiscal relief</td>
<td>250</td>
</tr>
<tr>
<td>New housing initiatives</td>
<td>220</td>
</tr>
<tr>
<td>Diesel replacement</td>
<td>100</td>
</tr>
<tr>
<td>Clean beaches</td>
<td>100</td>
</tr>
<tr>
<td>Law enforcement technology grants</td>
<td>75</td>
</tr>
<tr>
<td>Flood control subventions</td>
<td>74</td>
</tr>
<tr>
<td>River parkway initiative</td>
<td>70</td>
</tr>
<tr>
<td>Prison electromechanical doors</td>
<td>58</td>
</tr>
<tr>
<td>Zero-emission vehicle subsidies</td>
<td>50</td>
</tr>
<tr>
<td>Touch screen voting pilot project</td>
<td>40</td>
</tr>
<tr>
<td>Other</td>
<td>505</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$3,314</strong></td>
</tr>
</tbody>
</table>

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**THE BUDGET’S ECONOMIC AND REVENUE OUTLOOK**

**Underlying Economic Assumptions**

**Background.** The economic picture has been evolving rapidly during the past couple of months. Beginning in late November, there has been an almost uninterrupted string of reports indicating that the U.S. economy’s expansion is slowing. This is evidenced by reports of falling consumer confidence levels, weak Christmas retail sales, disappointing company profits, and scaled-back investment plans for 2001. The stock market also suffered significant losses late in the year, with the NASDAQ index falling by over 25 percent between the start of November and the end of December. At year’s end, it was clear that the U.S. economy was slowing sharply, although the effects of this slowdown in California remain to be seen.

**Slower Growth Expected.** The administration’s outlook calls for further slowing in the U.S. economy, which is expected to persist through most of 2001. A recession, however, is not anticipated. As indicated in Figure 4, U.S. real gross domestic product is projected to expand at an annual rate of about 2.5 percent in the first three quarters of 2001, reflecting sluggish growth in consumer spending and a marked slowdown in business investment, before rebounding late in the
year. California’s economy is expected to follow the same pattern as the nation, slowing in the first half of 2001 before rebounding late in the year. For example, the state’s personal income growth is projected to slow from 11.7 percent in 2000 to about 5.7 percent in 2001, before rebounding to 6.9 percent in 2002. The slowdown in 2001 relative to 2000 reflects reduced stock-option income as well as more moderate employment gains.

**Revenues**

**Modest Increases Anticipated.** Revenues during the first six months of 2000-01 were quite strong, with receipts from each of the major taxes exceeding by significant margins the 2000-01 budget forecast made last spring. In contrast, the administration currently forecasts that revenue growth will slow during the next 18 months, in line with the more subdued gains projected for the economy. Specifically, the forecast calls for General Fund revenues of $76.9 billion in 2000-01 (a 6.9 percent increase from 1999-00) and $79.4 billion in 2001-02 (a 3.3 percent increase from the current year).

The Governor’s budget forecast assumes that the quarter-cent sales tax reduction, certified by the Director of the Department of Finance (DOF) this past October, will be in effect for calendar year 2001, but not 2002. The forecast also includes proposed tax reductions totaling $109 million in the budget year. These include increases in the manufacturers’ investment credit, a three-day “sales tax holiday,” and various other targeted provisions. The revenue forecast also assumes various accounting changes affecting the tobacco settlement revenues and sales taxes allocated for transportation purposes.

**Initial LAO Assessment.** After adjusting for accounting changes and tax proposals, the budget forecast is down from our November projection by $3.1 billion in the current year and budget year combined. In light of the recent negative economic and stock market developments that have taken place, a downward revision
of this general magnitude is reasonable. The most recent revenue-related information available in early January has been mixed. On the positive side, personal income tax collections during the important year-end period (when taxpayers remit their final quarterly prepayments) modestly exceeded the new budget forecast (although by less than in past years). On the other hand, however, most U.S. economic news continues to be negative, suggesting that the U.S. slowdown could be significantly sharper than anticipated by the administration. We will continue to assess economic and revenue developments as they occur, and incorporate them into our own updated revenue projections which will be released with our publication entitled The 2001-02 Budget: Perspectives and Issues next month.

THE GOVERNOR’S BUDGET PROPOSALS BY PROGRAM AREA

Figure 5 shows the budget’s proposed General Fund spending by major program areas for 1999-00 through 2001-02. It shows that:

- All segments of education receive substantial funding increases.

- Medi-Cal shows a small decline in the budget year, which is due to various funding redirections. Without these shifts, Medi-Cal’s General Fund spending would show an increase of 6.7 percent over spending in 2000-01.

- The budget also proposes roughly a 10 percent increase for both the California Work Opportunity and Responsibility to Kids (CalWORKs) and the Supplemental Security Income/State Supplementary Program (SSI/SSP) programs. Most of the growth in CalWORKs is due to one-time savings in the current year related to the use of federal funds.

- Youth and Adult Corrections are growing 4 percent in the budget year, and “all other” programs are showing a collective decline of nearly 10.3 percent. The latter decline is primarily due to a large amount of one-time spending in 2000-01, and would be even larger without the funds provided in the budget year for electricity-related initiatives.

K-12 Education

Proposition 98 allocations (which include local property tax revenues) to K-12 schools total $41.3 billion in 2001-02. This represents an increase of over $3.2 billion, or 8.3 percent, over the current-year estimate. Per-pupil spending under Proposition 98 increases by $479, or 7.1 percent, to $7,174 per pupil. The budget proposes Proposition 98 spending that exceeds the estimated minimum funding guarantee by $1.9 billion.
Figure 5
General Fund Spending by Major Program Area
(Dollars in Millions)

<table>
<thead>
<tr>
<th></th>
<th>Proposed 2001-02</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual 1999-00</td>
</tr>
<tr>
<td><strong>Education Programs</strong></td>
<td></td>
</tr>
<tr>
<td>K-12—Proposition 98</td>
<td>$25,270</td>
</tr>
<tr>
<td>Community Colleges—Proposition 98</td>
<td>2,390</td>
</tr>
<tr>
<td>UC/CSU</td>
<td>4,891</td>
</tr>
<tr>
<td>Other</td>
<td>3,058</td>
</tr>
<tr>
<td><strong>Health and Social Service Programs</strong></td>
<td></td>
</tr>
<tr>
<td>Medi-Cal a</td>
<td>$8,065</td>
</tr>
<tr>
<td>CalWORKs</td>
<td>1,991</td>
</tr>
<tr>
<td>SSI/SSP</td>
<td>2,501</td>
</tr>
<tr>
<td>Other a</td>
<td>5,193</td>
</tr>
<tr>
<td><strong>Youth and Adult Corrections</strong></td>
<td></td>
</tr>
<tr>
<td>$4,748</td>
<td>$5,181</td>
</tr>
<tr>
<td><strong>All Other b</strong></td>
<td>$8,780</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$66,494</td>
</tr>
</tbody>
</table>

a The 2001-02 decline in “Medi-Cal” and increase in “Other” is due to a technical shift of $600 million to the Department of Developmental Services and the replacement of $170 million of General Fund spending with tobacco settlement funds.

b The 2001-02 decline is primarily due to the magnitude of one-time spending in 2000-01.

How Are the New Proposition 98 Monies Spent? Figure 6 displays the major proposed uses of the additional $3.2 billion of Proposition 98 funds. The largest share—$1.4 billion (45 percent)—would provide a 3.91 percent cost-of-living adjustment (COLA) for district and county office apportionments (revenue limits) and categorical programs. General purpose and categorical program funding for the projected 1.08 percent growth in the student population accounts for $463 million, or 15 percent, of new Proposition 98 funds. Providing full-year funding for programs that began in the current year and other net adjustments account for almost $400 million, or 13 percent of new funding.

The budget allocates the remaining funds (almost $900 million) for a variety of new and expanded categorical spending programs over which school districts would have minimal discretion (over $750 million) and for a proposed settlement of school district claims for mandated special education costs ($125 million). (In addition, the budget provides $270 million of one-time funds—attributed to 1999-00—for this proposed
settlement.) The largest of these programs in the budget year is a $335 million augmentation to provide intensive training to teachers in recently adopted academic content standards for mathematics and English language arts. The largest new program in terms of annual costs beyond the budget year is the Governor's proposal to add 30 instructional days to the academic year at middle schools. The budget provides $100 million for this purpose in 2001-02. The administration intends that the program reach virtually all middle schools in the state by 2003-04, at an estimated cost to the state exceeding $900 million annually.

Higher Education

Community Colleges. The budget proposes an 8.3 percent increase in California Community Colleges Proposition 98 funding (the General Fund share increases 8.4 percent). This increase includes money for a 3.9 percent COLA and 3 percent enrollment growth. The budget also proposes new funds to assist districts in making part-time faculty salaries more comparable to full-time salaries, and for helping students obtain Cal Grants.

The UC and CSU. The budget proposal includes increases in General Fund spending of 11.3 percent for the University of California (UC) and 7.8 percent for the California State University (CSU) in the budget year. The new funds support a 5 percent general increase in each budget, in addition to 3 percent enrollment growth for CSU and 3.5 percent enrollment growth for UC. The UC budget includes $308 million for capital outlay projects. Funding is also included for summer sessions, research, and student outreach and retention.

Other Programs

Medi-Cal. The budget proposes $9.3 billion in funding for Medi-Cal in 2001-02, a decline of 1.4 percent from the current year. However, the decline is entirely due to funding shifts. Specifically, about $600 million of expenditures have been shifted from Medi-Cal to the Department of Developmental Services, and about $170 million of General Fund expenditures are being replaced with tobacco settlement-related special funds. After adjusting for these factors, expenditures for Medi-Cal are up by 6.7 percent from the current year. The Medi-Cal budget proposal reflects an anticipated 12 percent increase in program caseload due to various changes in program eligibility rules enacted during the past two years.

Health Program Funding. The budget proposes to shift about $445 million from the General Fund to a special new trust fund supported from the tobacco settlement monies. Of this amount, $150 million would be used for caseload growth for children in the Healthy Families insurance coverage program and, for the first time, enrollment of their parents in this coverage. Another $170 million would be budgeted for Medi-Cal, $65 million for children’s medical services, and $60 million for other public health programs.

Social Services. The budget funds the 4.85 percent statutory COLAs for both SSI/SSP ($156 million General Fund cost) and CalWORKs ($128 mil-
lion combined from federal TANF and the General Fund). The budget also contains two proposals for modifying CalWO RKs county performance incentives. In the current year, the administration proposes urgency legislation to reduce these incentives by $153 million compared to the current appropriation. In 2001-02, the budget exercises the option, created in last year’s social services budget trailer bill, to spend less for performance incentives than the amount provided by the statutory formula. Specifically, the budget proposes no appropriation for county performance incentives, resulting in a General Fund savings of $244 million. Finally, we note that the budget assumes that California’s maintenance-of-effort requirements will effectively be reduced by $154 million on a one-time basis. The budget proposes to realize these savings in the current year by replacing $154 million in General Fund spending with TANF federal funds.

**Housing.** The budget proposes $200 million in 2001-02 for incentive payments to local governments to encourage the production of housing units. These funds, combined with $100 million appropriated in the current year, can be spent for any purpose by local governments.

**Capital Outlay.** The budget includes a total of $2 billion for capital outlay projects, of which $1 billion is financed from bonds, $780 million from direct General Fund appropriations, and $207 million from special funds and federal funds. Of the direct General Fund appropriations, about $308 million is for UC, including $150 million for the Merced campus and $108 million for four science and innovation centers. The remainder is for forestry and fire protection, corrections, and general state facilities.

**Electricity and Energy.** The budget includes a $1 billion set-aside for various electricity-related programs, most of which remains to be detailed. In addition, it provides $50 million to the DOF to allocate to state agencies for their higher energy bills. It also provides $16.1 million to various state agencies for such purposes as expediting the power plant siting processes, electricity-related forecasting and market monitoring, development of building efficiency standards to address peak electricity demand and transmission system reliability, electrical energy rate stability and conservation, and utility audits.
CONSIDERATIONS FOR THE LEGISLATURE

The Governor’s proposed budget fully funds most existing programs, covering caseloads and inflation. It also contains significant new funding for the Governor’s priorities in education and energy, as well as substantial amounts of largely one-time expenditures in a variety of other program areas.

Our initial review also indicates, however, that a number of the Governor’s proposals lack adequate detail and will require further development. For example, at this time, the Governor’s proposal to extend the school year in the state’s middle schools lacks (1) research data justifying this approach and (2) important detail as to how the program would be implemented by schools. The administration has also provided limited detail with its proposals relating to diesel emissions reductions, river parkways, clean beaches, and capital outlay for UC.

In addition, there are a number of areas of the budget in which additional funding will likely be necessary beyond that shown in the Governor’s proposal. These include:

- **Personnel Costs.** The budget includes no funds for potential increases in (1) employee compensation resulting from collective bargaining negotiations and (2) state employer retirement contributions.

- **Proposition 98.** The administration appears to have overstated local property tax revenues available to public schools. This could require up to $150 million from the General Fund to “backfill” this revenue shortfall.

- **CalWO RKs Child Care.** Based on current state practices, the budget underfunds the estimated child care needs for former CalWO RKs recipients by roughly $60 million.

In reviewing the Governor’s budgetary proposals in the coming months, the key challenge for the Legislature will be to identify its own spending and tax priorities for utilizing the available $8 billion in resources that the Governor has allocated, and determine how they compare to the Governor’s priorities and proposals. Another important challenge facing the Legislature will involve developing the proper balance between one-time and ongoing uses of funds to ensure that in meeting its priorities, the state’s fiscal resources will not become overcommitted in future years—especially given the uncertainties about the economy.
Acknowledgments
This report was prepared by Brad Williams, David Vasché, and Keely Martin Bosler with the assistance of many others throughout the office. The Legislative Analyst’s Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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