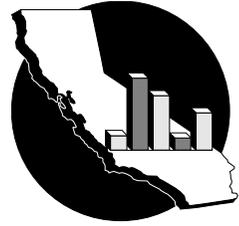

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STATE
FISCAL PICTURE

State Fiscal Picture



California's budget outlook continues to improve dramatically, boosted by robust economic growth and major increases in state revenues. The new budget reflects a much-improved outlook since the 1999-00 budget was enacted last summer. However, further significant gains in economic and revenue activity in December and January suggest that revenues will exceed the new budget's projections by a substantial margin—\$4.2 billion in the current and budget years combined. The improved picture provides the Governor and Legislature with the best opportunity in over two decades to strategically address major priorities in such areas as education, infrastructure, health care, local fiscal reform, and tax relief.

In this part, we first briefly review the *2000-01 Governor's Budget*. Next, we provide our own perspective on the budget outlook. Lastly, we highlight some of the major considerations and issues that will face the Legislature in the months to come as it evaluates the Governor's proposals, and develops its own fiscal priorities for the budget year and beyond.

OVERVIEW OF THE GOVERNOR'S BUDGET

The Governor's 2000-01 budget proposes total state spending of \$85.1 billion (excluding expenditures of federal funds and selected bond funds). This represents an increase of 3.7 percent from the current year. About 80 percent of this expenditure total is from the General Fund and 20 percent is from special funds.

Figure 1 summarizes the budget's projections for expenditures, revenues, and the General Fund's "bottom line" condition. It indicates the following:

- **Revenues.** These are projected to total \$65.2 billion in the current year, an 11.2 percent increase from 1998-99. The budget further assumes that revenues will grow at a more modest 4.7 percent in 2000-01, reaching \$68.2 billion.
- **Expenditures.** These are projected to total \$65.9 billion in the current year, a 13.9 percent rise from 1998-99. For 2000-01, the budget proposes total spending of \$68.8 billion, a 4.5 percent increase.
- **Budgetary Reserve.** The year-end reserve for 2000-01 is estimated to be \$1.2 billion, not including various set-asides. This is about 1.8 percent of total General Fund revenues.

Figure 1**Governor's Budget General Fund Condition**

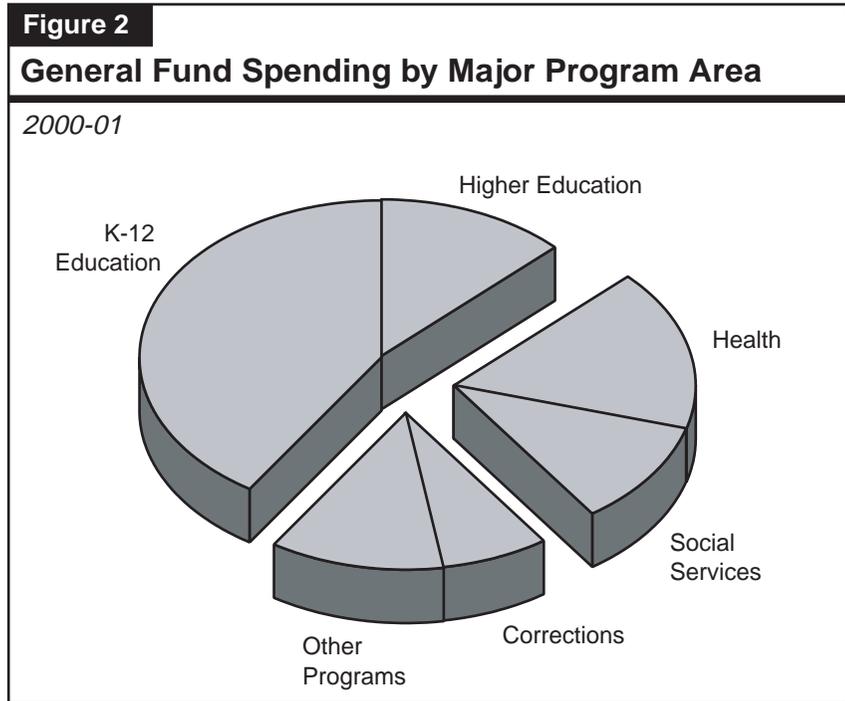
1998-99 Through 2000-01
(Dollars in Millions)

	1998-99	1999-00	2000-01	
			Amount	Percent Change
Prior-year fund balance	\$2,920	\$3,708	\$3,012	
Revenues and transfers	58,615	65,160	68,236	4.7%
Total resources available	\$61,535	\$68,868	\$71,249	
Expenditures	\$57,827	\$65,856	\$68,819	4.5%
Ending fund balance	\$3,708	\$3,012	\$2,430	
Encumbrances	\$592	\$592	\$592	
Set-aside for legal contingencies	—	—	500	
Set-aside for legislation	—	—	100	
Reserve	\$3,116	\$2,420	\$1,238	

Detail may not total due to rounding.

Figure 2 shows the distribution of General Fund spending by major program area that is proposed in the budget for 2000-01. Nearly 54 percent of total General Fund spending involves education, including roughly 41 percent for K-12 and 13 percent for higher education. About 28 per-

cent is for programs relating to health and social services, 7 percent is for corrections, and the remaining 12 percent covers general government and other programs.



MAIN FEATURES OF GOVERNOR'S PROPOSAL

The proposed budget is generally a fiscally prudent plan. On the whole, it relies on realistic assumptions about caseloads and federal funds, contains an increased reserve, sets aside significant funds for various contingencies, and reflects a mix of one-time versus ongoing commitments. Figure 3 (see next page) highlights the key programmatic elements of the proposal.

Budget's Focus Is on Education

As was the case last year, the Governor's budget proposal focuses on education.

K-12 Education. A 6 percent increase is included for K-12 education funding. Under the proposal, Proposition 98 per-pupil spending grows by 4.4 percent, from \$6,045 to \$6,313. The budget uses both Proposition 98 and non-Proposition 98 funds to support various K-12 initiatives directed at

Figure 3**Key General Fund Budget Proposals**

K-12 Education. Includes \$900 million for new initiatives targeting student achievement; teacher recruitment, retention, and training; and new technology. Almost two-thirds of the total counts toward Proposition 98 purposes, and the remainder is from non-Proposition 98 funds.



Higher Education. Provides significant funding increases for a new partnership agreement, acceleration of the opening of UC Merced, increases in Cal Grant awards, and teacher preparation initiatives.



Long-Term Care Initiative. Contains \$93 million in spending and \$47 million in tax credits for initiatives to improve senior care.



CalWORKs. Prohibits counties from earning new incentive payments in the budget year resulting in savings of \$496 million.



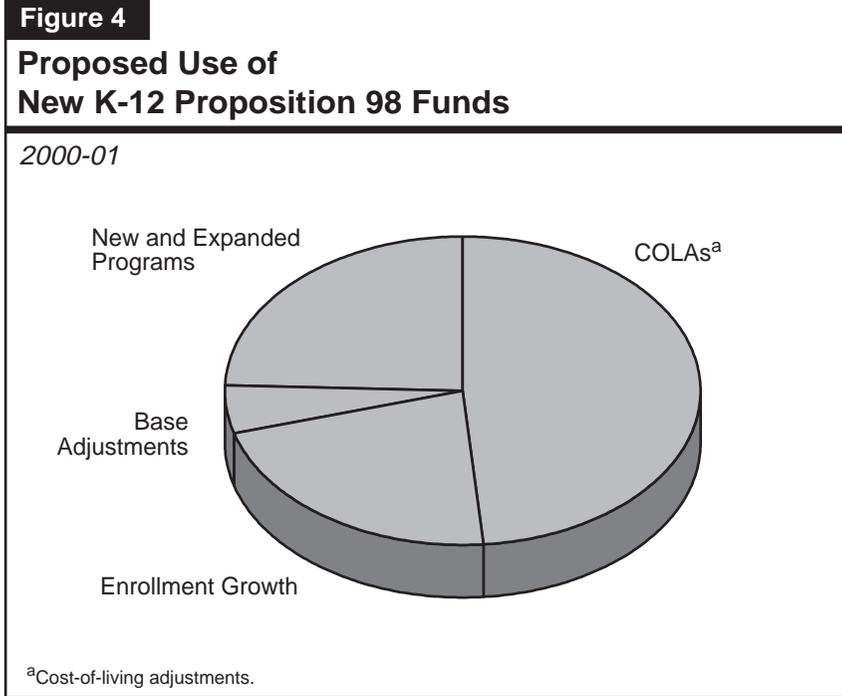
Tax Benefits. Contains \$167 million in tax benefits in 2000-01 (including the long-term care credit). Proposes increases in net operating loss deductions, expansion of the research and development credit, and a one-time tax credit for land donations.



One-Time Commitments. Contains about \$2.9 billion in one-time commitments and set-asides, including \$1.1 billion for litigation.

student achievement; teacher recruitment, retention, and training; and technology. Figure 4 shows how the \$1.9 billion in new K-12 Proposition 98 funds are allocated in 2000-01. The budget proposes Proposition 98 spending that exceeds the estimated minimum funding guarantee by \$257 million.

Higher Education. The budget includes substantial funding increases for higher education. It proposes a 6.7 percent increase for the California Community Colleges, including new funds for the Partnership for Excellence program, and for initiatives aimed at improving access for low-income students. It includes increases of 12.1 percent for UC and 8.7 percent for CSU in 2000-01. The new funds support a 6 percent base increase for both segments plus enrollment growth. They also support the various teacher-training costs associated with the Governor's K-12 education initiatives, and a variety of other costs related to research and new technologies.



Other Programs—Modest Changes

Outside of education, the new proposal is largely a workload budget, which funds existing programs and makes adjustments for caseloads and most cost-of-living (COLA) increases. It contains modest new spending initiatives and a tax credit relating to long-term care (the “Aging With Dignity” initiative), but no major new ongoing commitments elsewhere. Some significant programmatic features of the noneducation portion of the budget include:

- **CalWORKs.** The budget provides funds for the statutory COLA adjustment, as well as child care and employment services for CalWORKs recipients. It assumes enactment of legislation prohibiting counties from earning new performance incentive payments until the estimated prior obligation of incentive payments owed to the counties (approximately \$500 million) has been satisfied. This policy change results in General Fund savings of \$496 million in 2000-01.
- **Medi-Cal.** The budget proposes funding for a reduction in the state “takeout” from disproportionate share hospital (DSH) funding; a 5 percent increase in wages for nursing home workers

(which is part of the Governor's Aging With Dignity initiative); and some modest proposed increases in Medi-Cal eligibility.

- **Department of Corrections.** The budget includes funding to cover a modest 1.5 percent increase in the inmate population and a 2.6 percent increase in the parole population. It also includes augmentations for substance abuse treatment program expansion, and increased parole supervision for selected parolees.
- **Local Governments.** The budget includes some one-time funds for local law enforcement grants, and proposes to make permanent and provide new funds for the Citizen's Option for Public Safety program. However, the budget does not propose any fundamental fiscal reforms or fiscal relief in the area of local government.

Budget Includes Large Amount of One-Time Commitments

The budget anticipates a \$2.9 billion increase in prior-year and current-year revenues compared to the amount of two-year revenues estimated at the time the budget was enacted. It proposes to use these added resources for one-time commitments and set-asides in a number of areas. As shown in Figure 5, included among these are funds for the smog impact fee rebate, set-asides for legal contingencies and one-time legislative initiatives, grants for local law enforcement, rail projects, and a tax credit for land donations. In reviewing the budget, the Legislature will need to determine if these one-time expenditures are in line with its own priorities.

Recent Developments Render Revenue Forecast Conservative

The budget's economic and revenue forecast is considerably stronger than the forecast underlying the 1999-00 budget. It assumes that the state's economy will expand at a healthy pace through 2000, and is generally consistent with other forecasts made in November 1999. However, it has since been, in effect, superseded by the extraordinary economic and revenue developments that occurred at the end of 1999, *after* the budget forecast was completed. In particular, it does not incorporate the over 35 percent increase in year-end personal income tax estimated payments which suggests that the trend in personal income tax revenues is well above the budget forecast.

THE LAO'S OUTLOOK FOR THE BUDGET

This section provides our own perspective on the General Fund outlook for 1999-00 and 2000-01, based on the LAO's economic and revenue forecasts which are described in "Part Two" and "Part Three." Our ex-

Figure 5	
Key One-Time Commitments Proposed in Governor's Budget	
<i>(In Millions)</i>	
Purpose	Amount
Smog impact fee rebate	\$562
Set-aside for legal contingencies	500
Direct appropriations for capital outlay	383
Increase in budgetary reserve	358
Rail projects	121
Tax credit for land donations	100
Set-aside for legislative initiatives	100
Grants for local law enforcement	100
Fire suppression costs	71
School bus replacement	50
Down-payment assistance for teachers	50
UC teaching hospitals	25
Other	466
Total	\$2,886

penditure forecasts reflect our estimates of the level of spending that would occur if the Governor's budget proposals were fully adopted. Our estimates are intended to assist the Legislature in its review of the budget proposal and in shaping its own budget priorities.

More Good News

Our General Fund outlook for 1999-00 through 2001-02 is shown in Figure 6 (see next page), and our key outlook-related findings are highlighted in Figure 7 (see page 11). Our "bottom line" is that:

- The budget outlook has *improved dramatically* from what was assumed in the Governor's budget, due to \$4.2 billion more in projected revenues.
- In addition, the fiscal outlook beyond the budget year is *very favorable*, with revenues projected to exceed the ongoing costs of the Governor's budget plan by \$2.1 billion annually.
- This gives the Legislature a unique opportunity to both address major priorities and strengthen the state's underlying fiscal condition.

Figure 6

**The LAO's General Fund Condition
Assuming Governor's Policy Proposals**

*1998-99 Through 2000-01
(Dollars in Millions)*

	1998-99	1999-00	2000-01
Prior-year fund balance	\$2,920	\$3,708	\$5,011
Revenues and transfers	58,615	67,231	70,384
Total resources available	\$61,535	\$70,939	\$75,395
Expenditures ^a	\$57,827	\$65,928	\$68,860
Ending fund balance	\$3,708	\$5,011	\$6,535
Encumbrances	\$592	\$592	\$592
Set-aside for legal contingencies	—	—	500
Set-aside for legislation	—	—	100
Reserve	\$3,116	\$4,419	\$5,343

^a Assumes the LAO's estimates of caseload and costs.

The 1999-00 and 2000-01 Outlooks

Economy to Keep Humming. Reflecting positive year-end national and state economic trends, we forecast that economic growth will remain strong in 2000 and continue at moderate rates in 2001 and 2002. In 1999, we estimate that California personal income increased by 7 percent—the largest gain of the decade. Thereafter, we foresee personal income growing at 6.7 percent in 2000 and remaining near 6 percent in each of the subsequent two years. Our estimates for 1999 and 2000 are above the administration's estimates of 6.6 percent and 6.5 percent growth, respectively.

Revenues—Upward Revision of \$4.2 Billion. Reflecting positive developments regarding both economic growth and recent cash receipts, we estimate that General Fund revenues will exceed the budget forecast by \$1.9 billion in both the current and budget years. Over 80 percent of the cumulative two-year \$4.2 billion increase is related to the personal income tax, which in turn reflects our higher estimates of near-term basic economic growth and capital gains. We specifically estimate that revenues will be \$67.2 billion in 1999-00 (a 14.7 percent increase from the prior year), and \$70.4 billion in 2000-01 (a 4.7 percent rise).

Figure 7**Key LAO Findings Regarding the Budget Outlook****Budget Outlook Improves Dramatically**

- 2000-01 to end with a reserve of \$5.3 billion.
 - This is \$4.1 billion more than budget estimate.
- Improvement is due to revenues—up \$4.2 billion over two years.
 - Gain is largely from income taxes.
 - Total gain evenly divided between 1999-00 and 2000-01—\$2.1 billion each.
- Most of these funds will be available for any purpose.

Positive Fiscal Outlook Continues Beyond the Budget Year

- Absent a serious economic or revenue slowdown, revenues will continue to exceed expenditures by about \$2.1 billion annually.

Legislature Can Address Major Priorities

- Reserve should be increased to at least \$2 billion.
- Remaining funds should be used for a mix of one-time and ongoing purposes.
- New ongoing commitments should be limited to \$2.1 billion annually.

Proposition 98 Interaction. The higher revenues that we project will *not* add to the amount included in the Governor's budget for Proposition 98. Thus, these increased resources will be available for any purpose.

Expenditure Estimates. We estimate that expenditures under the Governor's budget proposal will total \$65.9 billion in the current year and \$68.9 billion in 2000-01. These estimates are above the Governor's budget amounts, but only slightly—by \$72 million in 1999-00 and \$41 million in 2000-01. The main factor responsible for these net increases involves expenditures for state subventions to backfill local vehicle license

fee (VLF) revenue losses associated with previously enacted rate reductions. We believe the state costs for this backfill will exceed the budget estimate by \$86 million in the current year and \$82 million in the budget year, for a two-year upward revision of \$168 million.

The General Fund Condition. Taking into account both our significantly higher revenues and slightly higher expenditures relative to the budget forecast, we estimate that the current year will end with a reserve of \$4.4 billion. This is \$2 billion more than the budget estimate. In the budget year, the reserve increases further, to \$5.3 billion. This is \$4.1 billion more than the Governor's \$1.2 billion 2000-01 reserve estimate.

What About After the Budget Year?

We forecast that the state's fiscal outlook beyond 2000-01 will remain positive. Specifically, our longer-term projections suggest that revenues will exceed expenditures by about \$2.1 billion during the subsequent two fiscal years. This implies that the state could provide an additional \$2.1 billion in ongoing commitments without diminishing the reserve over time. Of course, this scenario assumes that the California economy continues to be healthy, and that capital gains do not experience a major fall off.

CONSIDERATIONS FOR THE LEGISLATURE

In light of the significant amount of new resources we project and the overall positive budgetary environment facing the state, we believe there are three key questions the Legislature should focus on during its forthcoming budgetary deliberations:

- First, what is the appropriate size of the reserve?
- Second, what are the Legislature's priorities for using the additional resources?
- Third, what is the appropriate mix to use in allocating these additional resources between one-time versus ongoing commitments?

Reserve Should Be Increased

We believe that some of the additional resources we have identified should be used to increase the budgetary reserve—to at least \$2 billion. Such a reserve would protect the state against moderate revenue shortfalls resulting from, for example, a pronounced slowdown in the economy or an unanticipated softening of capital gains. It also would soften the

adverse fiscal impacts of a more severe economic and revenue downturn, and “buy time” for effectively dealing with it.

What Are the Other Priorities?

The strengthened fiscal outlook provides the Legislature with a unique opportunity to strategically address a variety of issues and problems beyond the reserve. The key question for the Legislature in this regard is: *Which issues and problems are of the highest priority and greatest importance to address at this time?* We discuss some key areas below:

- **Education.** K-12 education is a high priority of both the Governor and Legislature. Added funds would help schools address current problems such as recruiting and retaining quality teachers. To the extent that the Legislature wishes to increase ongoing funding for K-12 education, we believe that the emphasis should be on *general purpose* funds, which would be available for locally determined purposes.
 - **Infrastructure.** Given the state’s documented infrastructure needs in the areas of transportation, water, school facilities, and other areas, we believe that both one-time and ongoing additional funds should be committed for capital outlay purposes. The Legislature could, for example, use some of the state’s increased resources to capitalize a state infrastructure fund whose balances would be available to finance projects as they come “on line.”
 - **Health Care.** The Legislature may wish to consider expanding efforts begun last year that address the lack of health care coverage available to California’s lower-income uninsured families. Problems also have been identified in the state’s mental health and substance abuse treatment systems that the Legislature may wish to address.
 - **Local Fiscal Reform.** As we indicate in Part Five, the current system of local finance lacks accountability. It also has the effect of skewing land-use incentives in favor of retail development at the expense of industrial and residential use. While there are a number of options available to improve the existing system, their implementation will require both one-time and ongoing resources.
 - **Tax Relief.** Under our revenue projections, all of the triggered VLF rate reductions that were enacted in 1998 will automatically occur as scheduled. However, given the state’s positive fiscal outlook and depending on its own priorities, the Legislature may wish to provide additional one-time or ongoing tax relief with some of the added resources we have identified.
-

Balancing One-Time Versus Ongoing Commitments

One of the key questions facing the Legislature is how much of the additional resources we have identified should be committed for one-time versus ongoing purposes. This is a critical issue because one-time commitments only draw down the reserve *once*, whereas ongoing commitments impose a cost *year after year*.

Ongoing Commitments Should Be Limited to \$2.1 Billion. In undertaking its budget-related decision making, we believe it is appropriate for the Legislature to view the \$2.1 billion in added resources we have identified for the *budget year* as available for *ongoing* commitments. This is because our projections indicate that revenues will be exceeding expenditures by approximately this amount not only in the budget year, but thereafter as well. Thus, ongoing commitments of this magnitude will be able to be paid for each year without drawing down the reserve.

One-Time Commitments. The remainder of the additional resources we have identified—also \$2.1 billion—are associated with the *current year*, and thus can be viewed as available for *one-time* purposes.

Matching Commitments With Priorities. Once its priorities are established, the practical challenge facing the Legislature will be to fashion a budget plan which not only meets these priorities, but also reflects an appropriate mix of ongoing versus one-time commitments that will keep the budget balanced. The Legislature has latitude in accomplishing this, as many of the potential priority areas we identified above have both one-time and ongoing elements.

CONCLUSION

The healthy budget outlook we see provides the Legislature with an opportunity to both strengthen the state's underlying financial condition, and address high priorities in a variety of areas. In doing so, we believe that the Legislature should take advantage of these "good times" to build up the reserve to help protect against an eventual downturn in the economy and revenues. Beyond this, the Legislature is in a position to allocate a substantial amount of additional resources to high-priority areas, whether these involve education, infrastructure, local fiscal reform, health care, tax relief, or other priorities.

In allocating these additional funds, however, it is important that an appropriate balance be struck in terms of ongoing versus one-time commitments. In particular, we believe that increased ongoing commitments from the additional resources we have identified should not exceed \$2.1 billion, given our current outlook for the General Fund in the budget year and thereafter.
