

# California's Economic and Budget Outlook



**Legislative Analyst's Office**

**CASBO Annual Conference  
April 29, 2008**

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# Format of Presentation

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- ▶ **Economic Forecast**
- ▶ **State Budget Picture**
- ▶ **Education Funding Proposals**
- ▶ **What Next?**

# Economic Forecast



# LAO Assessment of Economy— February 2008

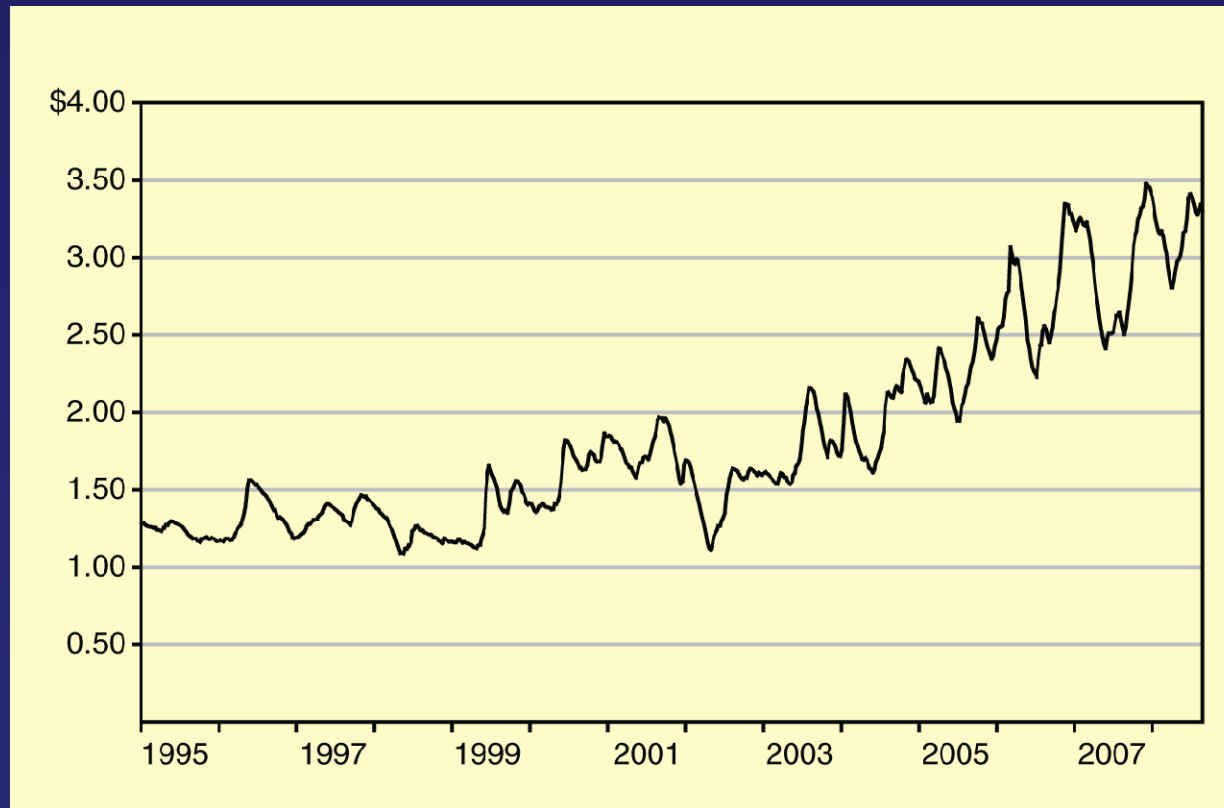
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- ▶ **Economy Still Growing Despite Major Problems**
- ▶ **Big Risks...**
  - Increase in energy costs
  - Downturn in housing market
- ▶ **...But Many Sectors Remain Strong**
  - Exports, agriculture, energy, computers

# California Gasoline Prices Have Tripled in Recent Years

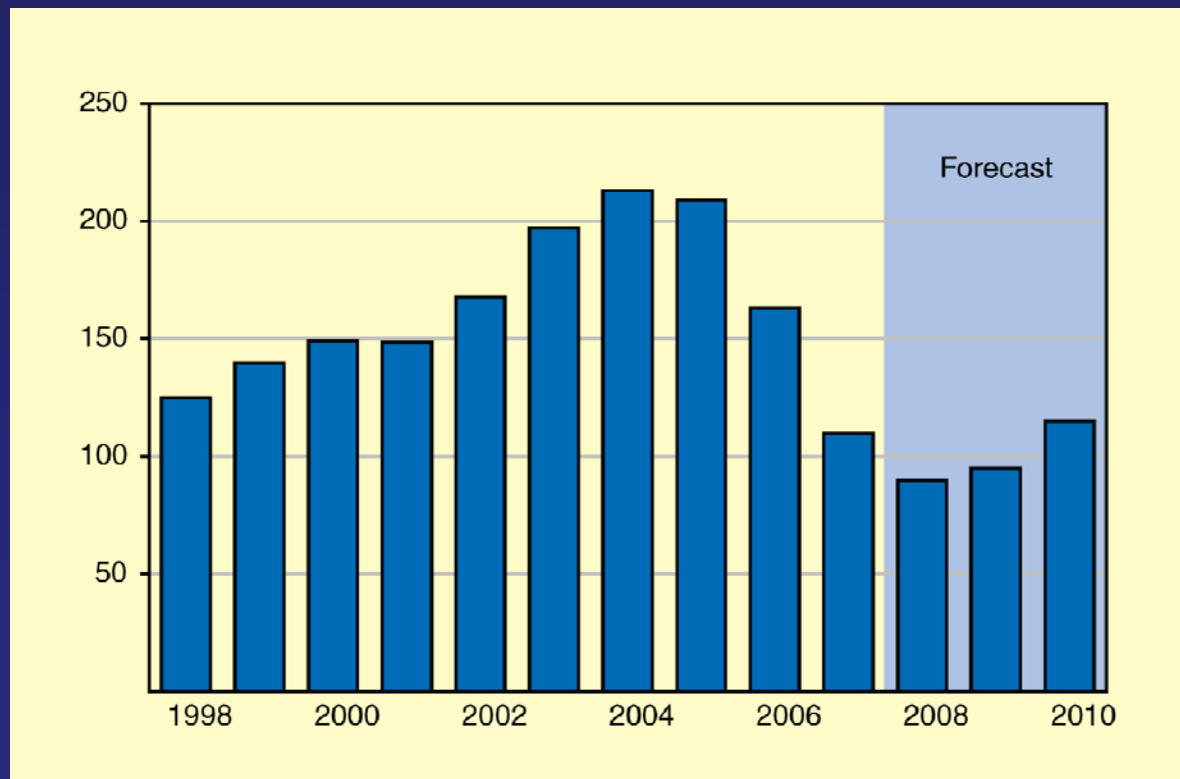
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Price Per Gallon



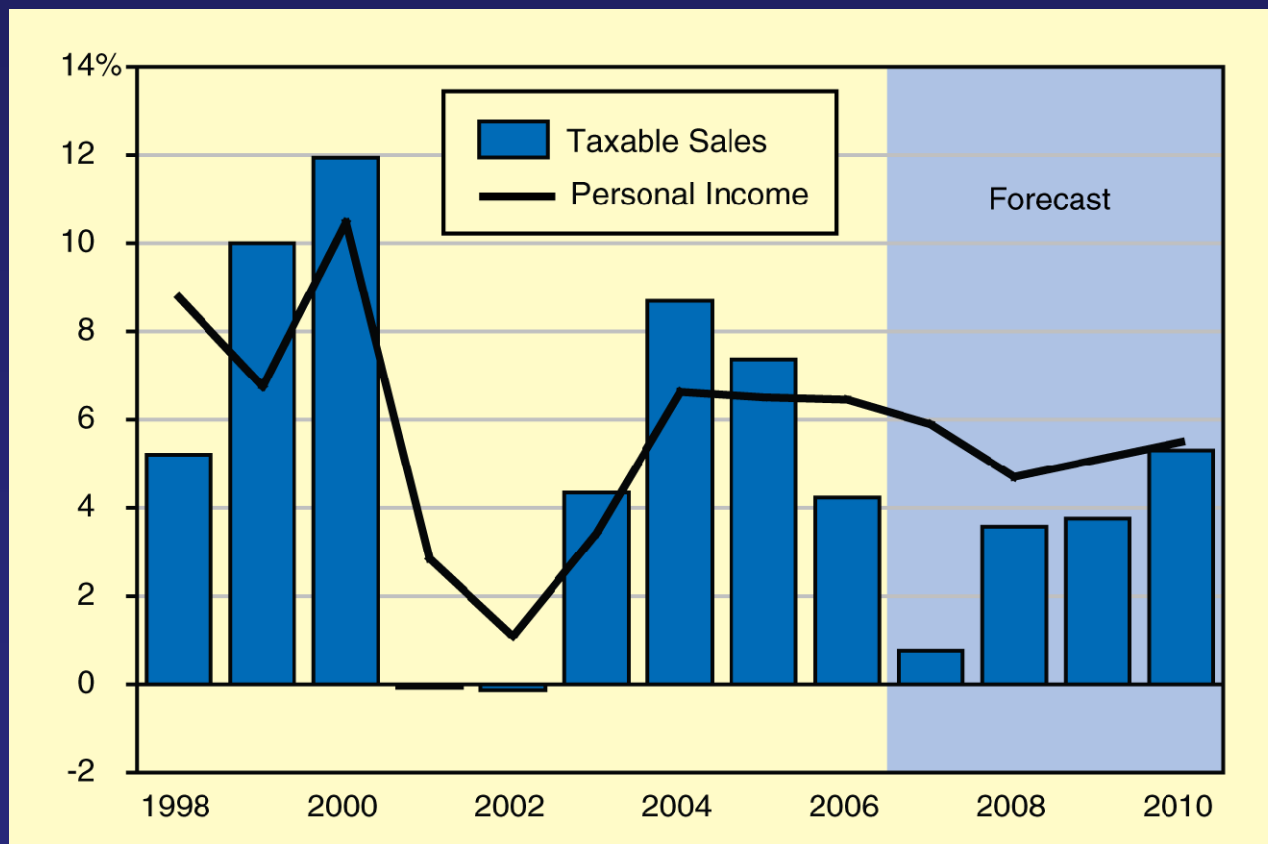
# Subdued Outlook for California Housing Activity

Permits for New Residential Construction  
(In Thousands)



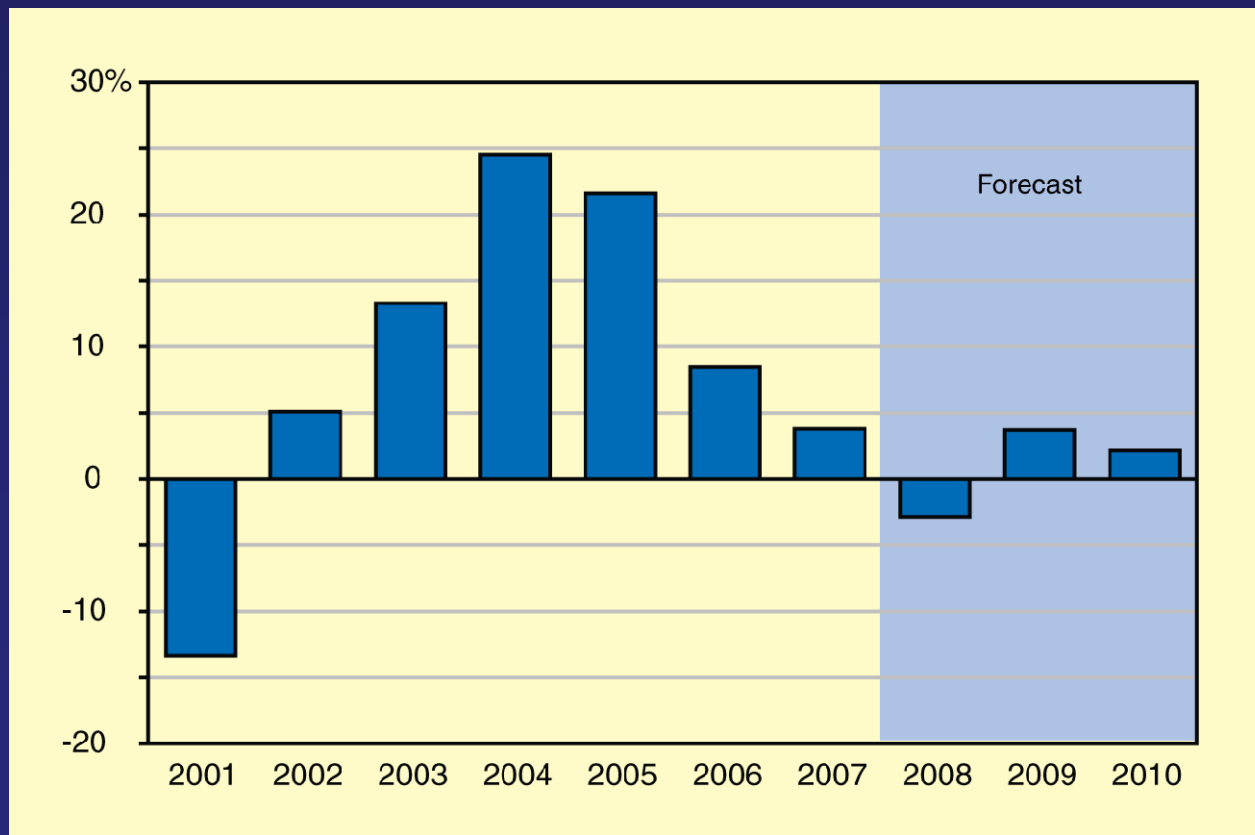
# Taxable Sales Growth to Trail Personal Income

Annual Percentage Change



# Weakness in California Corporate Profits Expected

Annual Percentage Change





# Update April 2008: Overall Economic Picture Worsening

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## ▶ Signs of Softening Economy

Revenue receipts trailing estimates

Unemployment rates increasing

Problems with housing market continue

## ▶ State Revenue Forecasts May Need to be Significantly Reduced

# Housing Is A Key Variable

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- ▶ **Problems Created by “Subprime” Loans are Peaking**

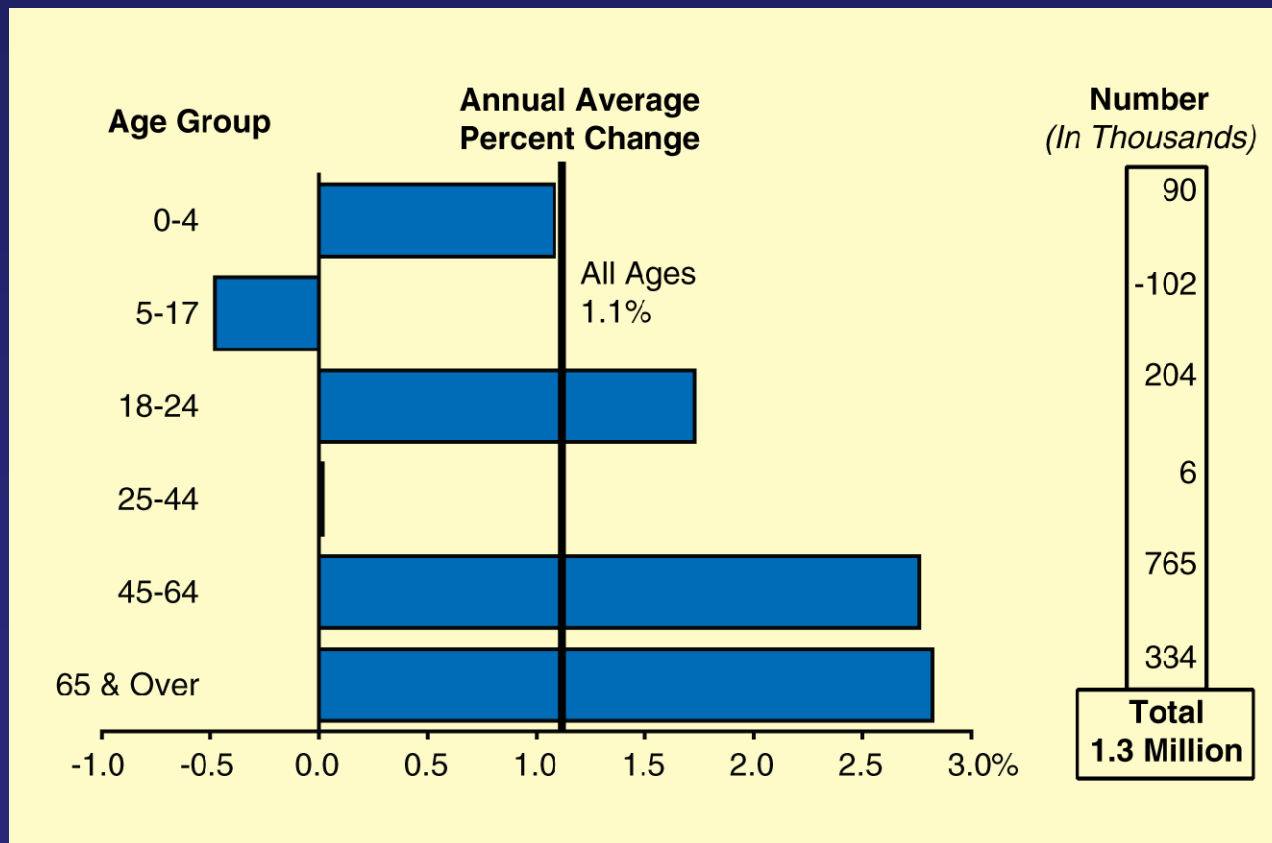
150,000 Variable Rate Loans Will  
“Reset” in 2008

Only About 70,000 Homes Will Reset in  
2009

- ▶ **Ripple Effects for Next Several Years**

# California's Population Outlook By Age Group

Population Change, 2008 Through 2010



# How Does a Downturn in the Economy Affect the Education Budget?

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- ▶ **Proposition 98 Formulas Drive Off of Changes in:**
  - General Fund Revenues
  - Per Capita Personal Income
  - K-12 Average Daily Attendance
- ▶ **Lower Growth Rates Generally Result in a Lower Proposition 98 Annual Funding Requirement**

# How Does a Downturn in the Economy Affect the Education Budget? (Cont.)

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- ▶ **Lower Local Property Tax Revenues Mean Greater State General Fund Obligation for Schools**

Makes state budget crunch more difficult

- ▶ **K-12 COLA Based on Inflation in Government Costs**

Rising gasoline prices can have big effect

# State Budget Picture



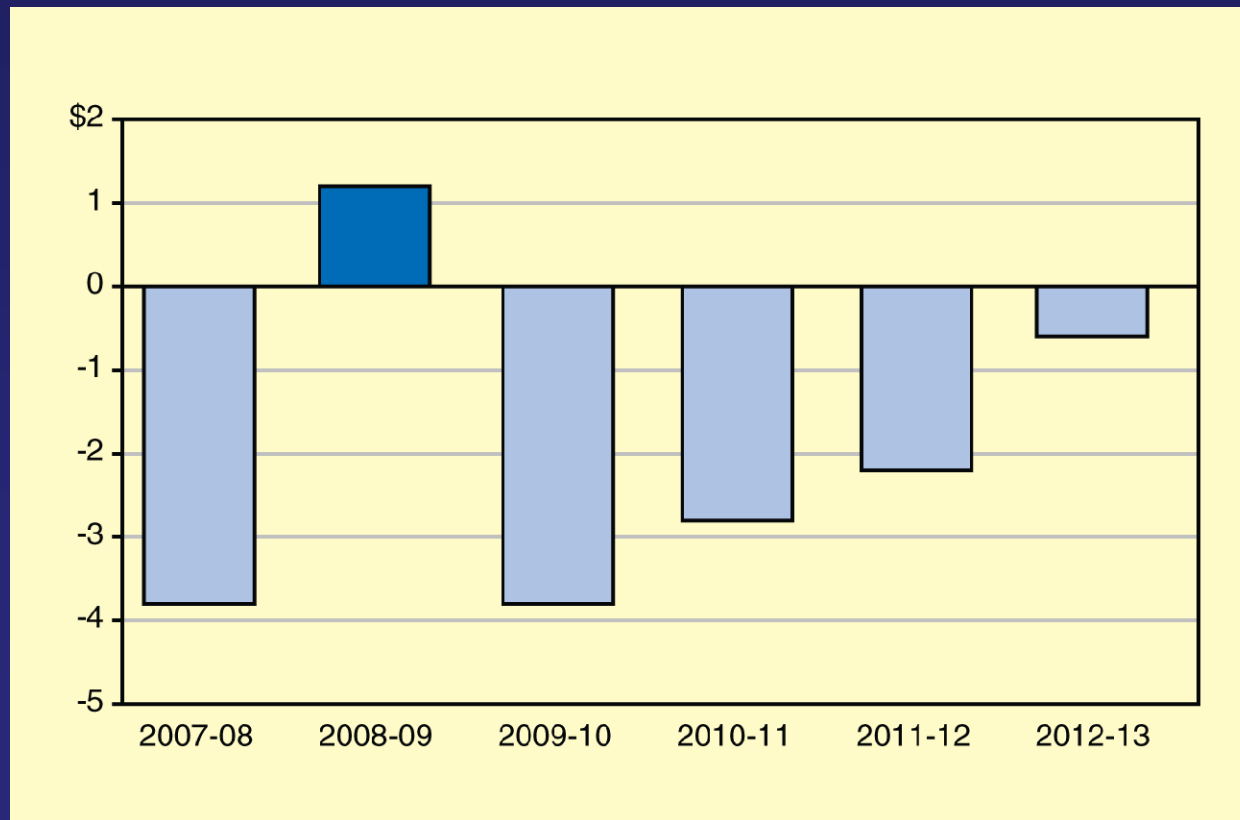
# Key LAO Findings on the Governor's January Budget

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- ▶ **February LAO Forecast: Lower Revenues of \$1.5 Billion**
- ▶ **Larger Budget Problem—\$16 Billion**
- ▶ **Failure to Set Priorities**

# Operating Shortfalls Return After 2008-09 Under Governor's Budget

General Fund (In Billions)





# Structural Budget Deficit Defies Easy Solution

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- ▶ **Chronic Budget Deficit Since 2001-02**
- ▶ **No Consensus on Program Cuts or Higher Taxes**
- ▶ **2008-09 Budget: Chronic Deficit Plus a Slowdown in the Economy**

# February Special Session Actions

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- ▶ **February Actions Reduce Deficit by About \$8 Billion; \$8 Billion Problem Remains.**

- ▶ **Actions Include:**

- Issuance of \$3.3 billion in additional debt

- Delay in supplemental debt payments

- Capturing unspent education funds

- Reducing Medi-Cal rates by 10 percent

# **LAO Alternative Budget Approach**

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- ▶ **Targeted Approach to Spending Reductions**
- ▶ **Balanced Approach Includes Revenues**
- ▶ **Balanced Budget Through 2012-13**

# Add Revenues in a Reasonable Manner

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## ▶ Reduce or Eliminate 12 Tax Credits, Deductions, and Exemptions

Reduce dependent credit

Limit R&D credit and NOL carryforwards

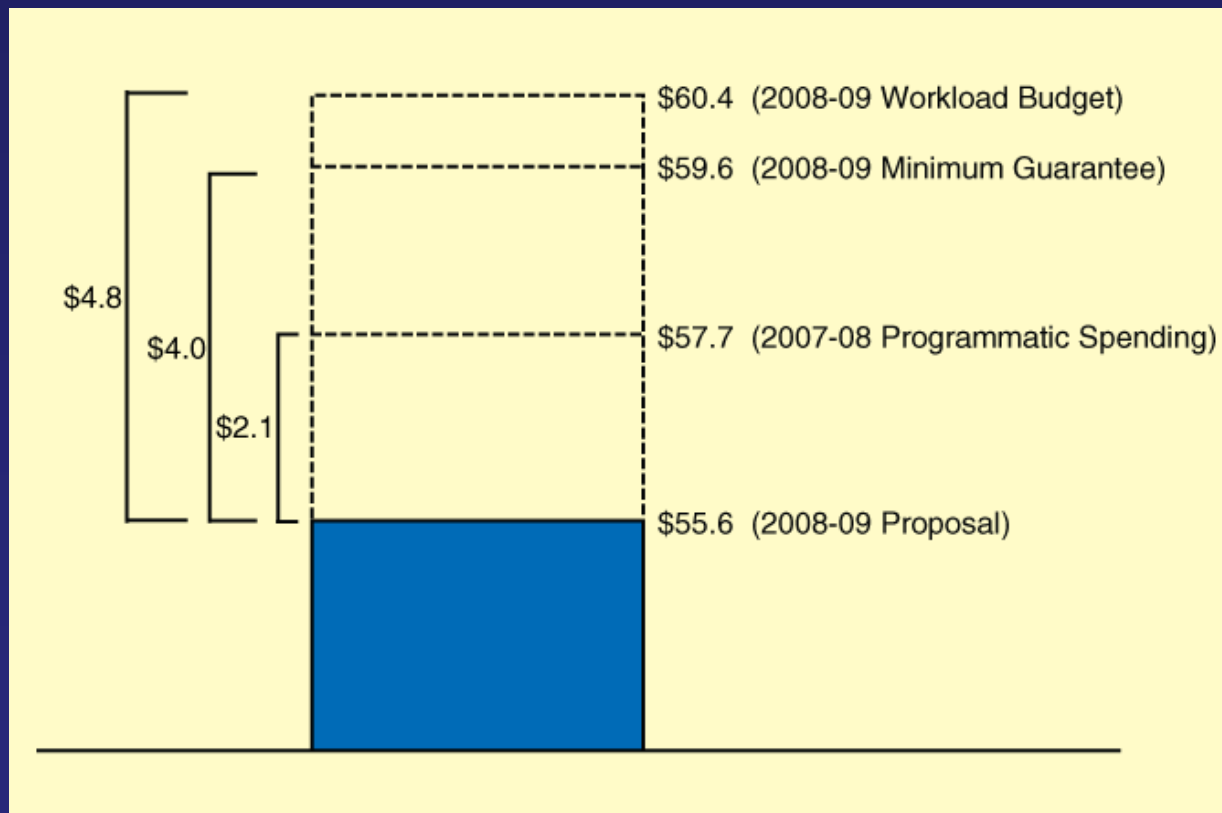
## ▶ No Broad-Based Tax Rate Increases

# Education Funding Proposals



# Three Perspectives on the Governor's Proposition 98 Reductions

(In Billions)



# Governor's Proposal for K-14 Education

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- ▶ **Suspends Proposition 98 Requirement by \$4 Billion**
- ▶ **Does Not Provide COLA and Reduces All From Current-Year Spending Levels**

Most programs experience 6 to 7 percent cut  
Revenue limits cut by 3 percent

# **LAO Alternative Provides \$57.7 Billion in Ongoing Proposition 98 Funding**

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- ▶ **Restores Ongoing Funding for Ongoing Programs Supported with One-Time Monies**
- ▶ **Makes Growth-Related Adjustments**
- ▶ **Does Not Provide COLAs**
- ▶ **Fully Funds Ongoing Costs of Mandates**
- ▶ **Makes Targeted Program Reductions**



# Alternative Makes \$179 Million in Targeted Reductions

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- ▶ **Eliminates Programs That Are:**
  - Poorly structured
  - Duplicative
  - Experiencing declines in participation
  - Technically overbudgeted

# LAO's 2008-09 Proposal Assumes Further Reductions in 2007-08

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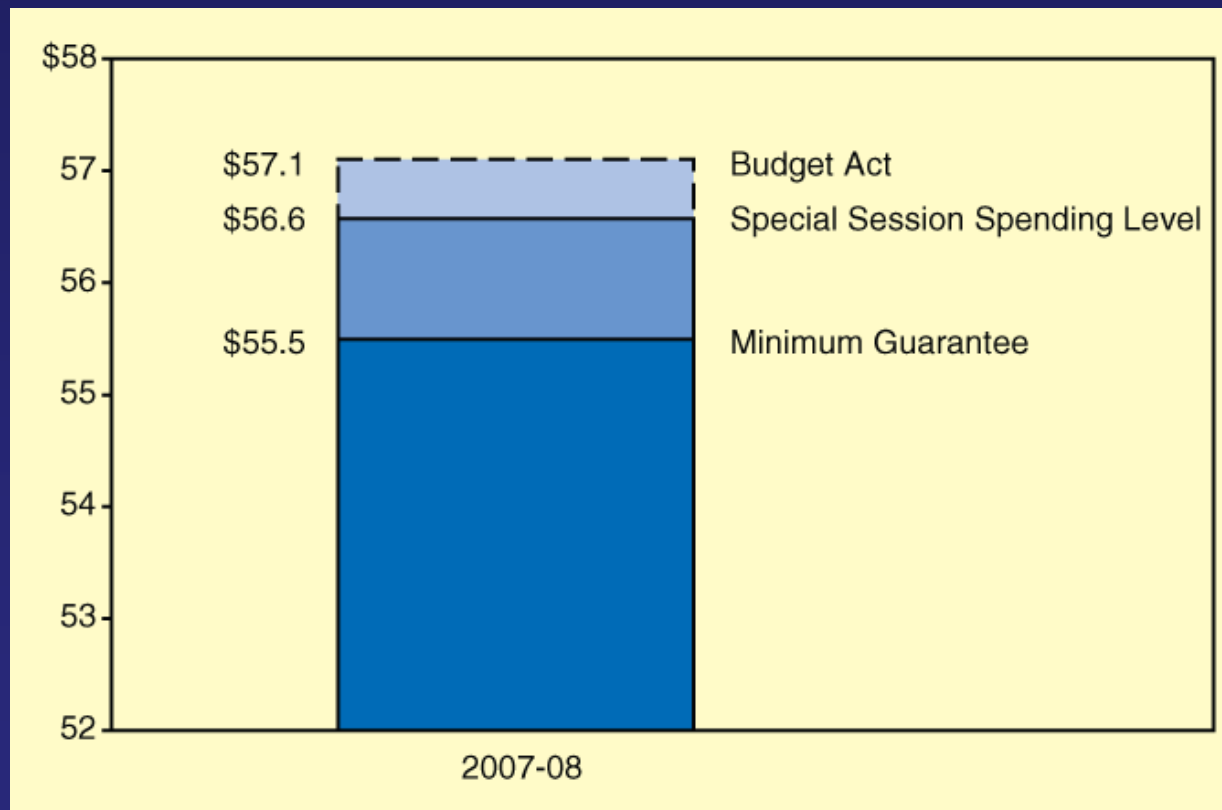
## ▶ Continue to Recommend Reducing Proposition 98 Spending to Minimum Guarantee in 2007-08

Achieves greater budget savings while holding schools harmless from real cuts

Lowers requirement for 2008-09, resulting in lower suspension

# Current-Year Spending \$1.1 Billion Higher Than Funding Requirement

(In Billions)



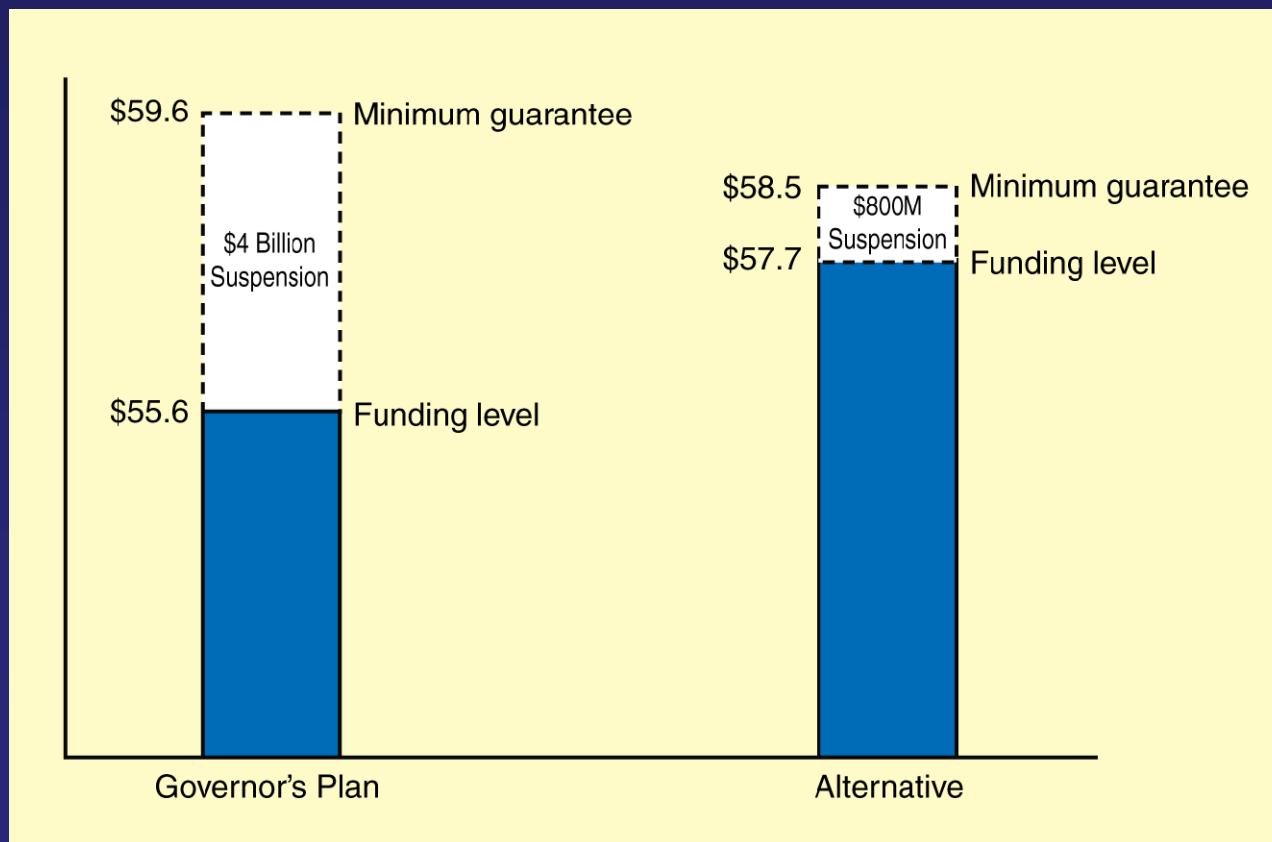
# Alternative Relies on Additional K-14 Savings

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- ▶ **Suspends Quality Education Investment Act in 2008-09 (\$450 Million Savings)**

Funding core programs that serve all schools is higher priority than expanding new program that serves small number of schools

# LAO Alternative's Funding Level Substantially Higher Than Governor's Level



# Reform Package Consolidates 43 Categorical Programs into 4 Block Grants

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(In Billions)

	2007-08 Amounts
Base grant	\$34.8
Special education block grant	3.2
Opportunity to learn block grant	3.1
Instructional improvement block grant	1.2
<b>Total</b>	<b>\$42.3</b>

# LAO Recommends Revising the K-12 COLA Factor

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- ▶ **Current Factor Not a Good Measure of Typical School Cost Pressures**

Overly influenced by changes in energy and construction costs

- ▶ **LAO Recommendation: Focus on Inflation in Employee Compensation Costs**

- ▶ **Governor's Proposal Would Focus on Increases in Consumer Prices**

# What Next?





# Budget Outlook Probably Worse Than in January

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- ▶ **Revenue Picture Is Uncertain**

  - Revenues in January through March are down by about \$1 billion

  - April income tax receipts are unpredictable

- ▶ **Costs Likely to be Higher Than Estimated**

- ▶ **Legislature Is Anticipating a Larger Gap**

# **No Consensus on Budget Plan**

- ▶ **Budget Committees Are Weighing Program Cuts**
- ▶ **Committees Are Making Some Cuts, Rejecting Others**
- ▶ **The “May Revision” Will Refine the Size of the Problem and the Governor’s Approach**

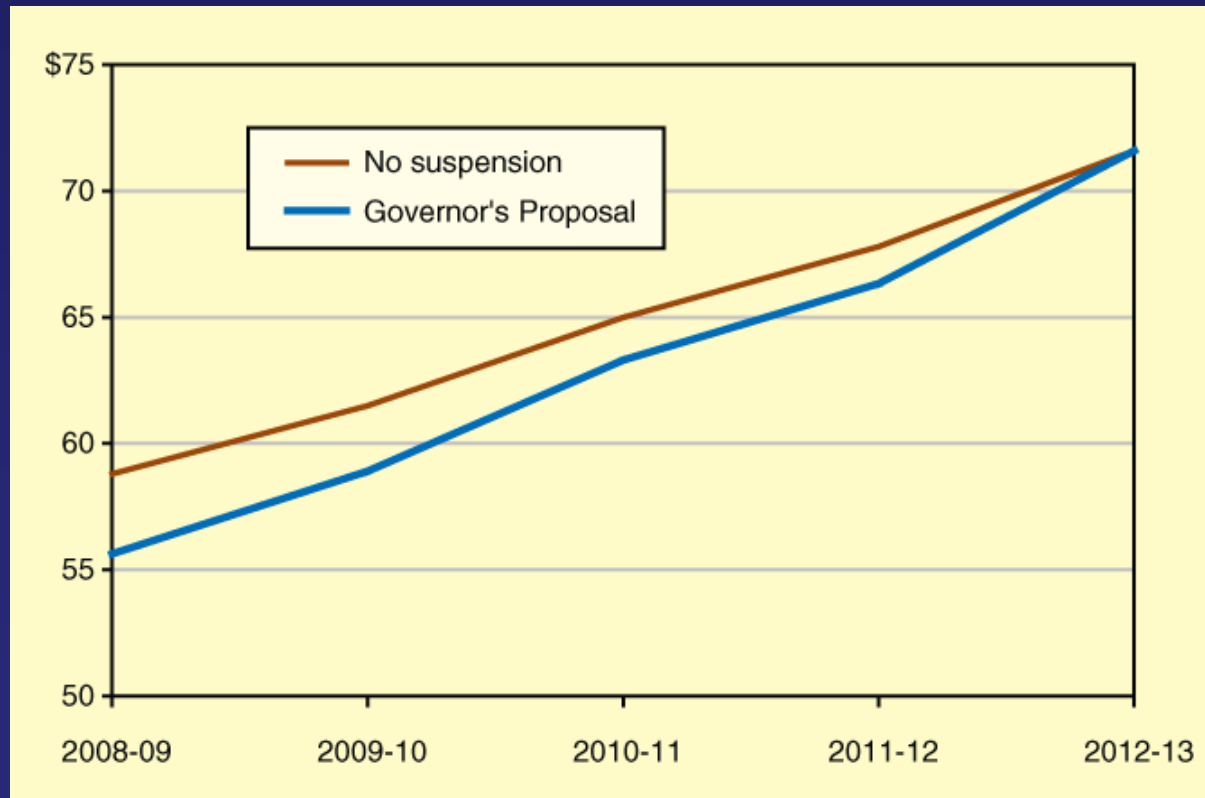
# Fundamental Debate Continues

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- ▶ **How to Pay For the Services Californians Enjoy?**
- ▶ **Higher Taxes Affect Economic Growth**
- ▶ **Lack of Investment in Education and Infrastructure Also Affects Long-Term Growth**

# Short-Term Proposition 98 Forecast Depends on 2008-09 Spending Level

(In Billions)



# New Discretionary Funds Still Expected in Out-Years

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- ▶ Lower COLAs and essentially no growth in number of K-12 students projected for out years.
- ▶ Results in low “baseline” costs and new discretionary funds.
- ▶ Between 2009-10 and 2012-13, total of around \$8 billion in new discretionary funds.

# Thank you!

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