CALIFORNIA BUDGET PROJECT

BUDGET WATCH

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GOVERNOR RELEASES PROPOSED 2001-02 BUDGET

On January 10, Governor Gray Davis released his proposed Budget for the 2001-02 fiscal year. The Budget provides the framework for the Governor's policy initiatives for the upcoming year and serves as the basis of legislative debate over the upcoming weeks and months.

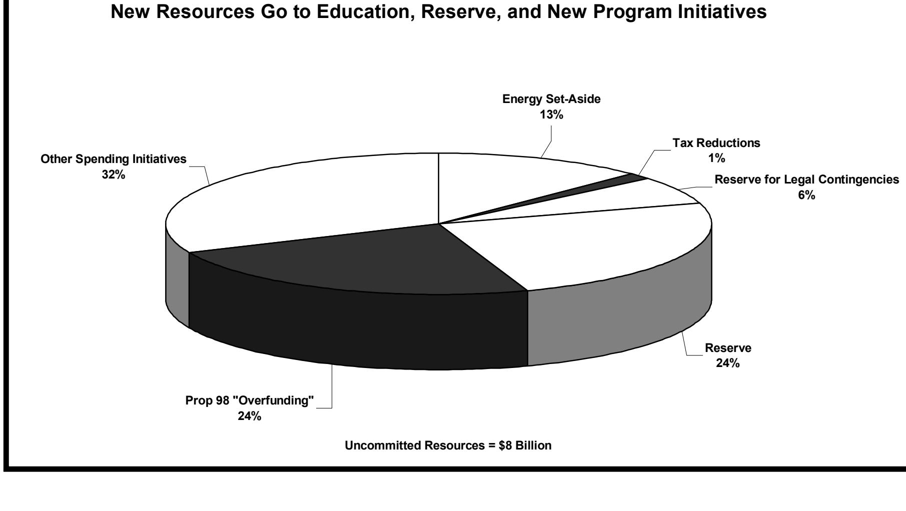
The Budget reflects continued growth in state revenues, with General Fund expenditures proposed to increase by $3.1 billion (3.9 percent) above 2000-01 levels. The Governor's Budget assumes that 2001-02 revenues will be $2.5 billion (6.9 percent) above 2000-01 levels and that current (2000-01) year's revenues will be $3.1 billion (4.2 percent) above the May 2000 forecast levels. However, the Governor's two-year forecast of revenues and expenditures results in $2.2 billion less in uncommitted resources than the forecast prepared by the Legislative Analyst in November. The difference reflects a more modest projection of economic growth based on the slowdown in the national economy and concern over the impact of the energy crisis on the state's economy.

Based on current revenue projections and program requirements under current law, lawmakers will have approximately $8 billion in new resources available to allocate through the budget process. The Governor allocates approximately 70 percent ($5.7 billion) of the available resources to one-time expenditures (including the reserve) and approximately 30 percent ($2.3 billion) to ongoing initiatives. The Budget provides a $1.9 billion reserve, equal to 2.3 percent of proposed General Fund expenditures, and a $500 million set-aside for legal contingencies. Major expenditures include $1.9 billion in education expenditures above the minimum required by the Proposition 98 school funding guarantee, a $1 billion set-aside to address the energy crisis, and $772 million in capital outlay expenditures.

The Energy Crisis

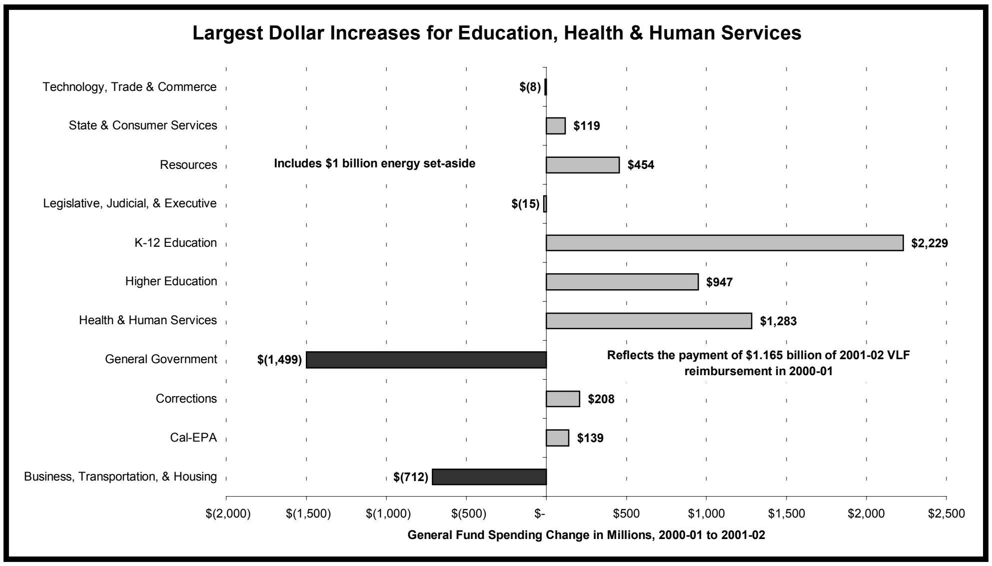
California's energy crisis has dominated debate during the first weeks of the new legislative session. On January 19, Governor Davis signed SB 7X (Burton) into law, authorizing the expenditure of $400 million in state funds to purchase electricity from power generators and sell it at cost to utilities, consumers, or the Independent System Operator (the body responsible for directing electricity distribution). The state was expected to spend the full initial authorization in a week to ten days. As this newsletter goes to print, the eventual cost of the energy crisis to the state's coffers in either the short or long term is impossible to predict. Budget related proposals range from

New Resources Go to Education, Reserve, and New Program Initiatives



Uncommitted Resources = $8 Billion

continued state electricity purchases on behalf of cash-strapped utilities to incentives for energy conservation to a state purchase of utility company assets. Specific proposals include $250 million in cash incentives aimed at reducing energy consumption and a $21.1 million allocation to expedite the process to bring power plants on-line, reduce electricity consumption, promote renewable energy sources, and provide energy and weatherization assistance to low income families. While the Budget augments funds available for low income energy assistance and weatherization by $4.7 million, it assumes a reduction of $21 million in federal funds available in 2001-02.



Revenue Trends Suggest Vulnerabilities in the State's Tax System

California's highly progressive personal income tax provides over half (56.5 percent) of state General Fund revenues and has provided most of the increase in state revenues in recent years. Several trends underlying the growth in total tax revenues could spell trouble for state revenues in the event of an economic downturn. A rising share of General Fund revenues come from taxes paid on non-wage income. Between 1998 and 1999, capital gains claimed by California taxpayers rose by 47 percent, while wage and salary income grew by just 10.3 percent. As a result of this disparity, an estimated 21 percent of all General Fund revenues will come from taxes paid on capital gains and stock options. Both of these sources of income are highly dependent on the stock market and are more prone to upswings and downswings than traditional wage and salary income.

Budget Proposes Modest Tax Cuts

The Governor proposes $108 million in tax cuts, including a three-day sales tax "holiday" for clothing and computer purchases, and a number of business tax incentives including $71 million in expansions to the manufacturers' investment tax credit. The $27 million estimated revenue loss for the sales tax holiday works out to a 76 cent per person tax savings.

The Budget reflects the pulling of a sales tax "trigger" enacted as part of 1991 budget-balancing efforts, effective January 1, 2001. The trigger reduces the state's sales tax rate by 1/4 percent in 2001, at a cost of $553 million in 2000-01 and $600 million in 2001-02. The Budget assumes that the 2001-02 reserve will be insufficient to trigger a continued reduction in calendar year 2002. However, the Republican budget plan released in December calls for making the sales tax reduction permanent, as well as a number of other tax reductions.

Largest Share of New Funds Go to Education. K-12 education receives the largest dollar increase in the Proposed Budget ($2.2 billion). The increase translates into a $479 (7.2 percent) increase in per pupil spending over the current year. The proposed spending level is $1.9 billion above the minimum required by the state's Proposition 98 school funding guarantee.

New K-12 education initiatives include increasing the middle-school year by 30 days; increasing the number of students enrolled in algebra and the number of qualified algebra teachers; expanding teacher professional development programs; and training school site administrators.

Recent eligibility expansions and simplification efforts expected to boost Medi-Cal Enrollment. The Budget assumes that the number of people enrolled in Medi-Cal will increase by 12.3 percent, to 5.85 million, primarily due to expanded eligibility and simplified application processes. Recent expansions include extending eligibility to parents in families with incomes at or below 100 percent of the federal poverty line (FPL); the working disabled with incomes below 250 percent of the FPL; and seniors and disabled individuals with incomes below 133 percent of the FPL. Simplification measures include eliminating quarterly reporting, providing continuous eligibility for children, and continuing coverage for persons leaving CalWORKs until their annual Medi-Cal redetermination date. The Budget allocates $132 million less for Medi-Cal from the state's General Fund than the revised 2000-01 Budget. The reduction results from the substitution of Tobacco Settlement dollars for General Fund dollars to fund specified expansions in Medi-Cal eligibility. The Budget allocates $128.4 million ($64.2 million General Fund) to increase Medi-Cal reimbursement rates by 30 percent for outpatient services provided by hospitals, effective July 1, 2001. This augmentation is part of the settlement of litigation between the state and hospitals. Hospitals will also receive a one-time payment of $350 million ($175 million General Fund) as part of the settlement.

State Submits Request to Expand Healthy Families. AB 1015 (Chapter 946 of 2000, Gallegos) established the framework for the state to seek federal permission to use State Child Health Insurance Program (SCHIP) funds to cover uninsured parents of children eligible for the Healthy Families Program (HFP) or Medi-Cal. In late December, the Health and Human Services Agency submitted a proposal to cover parents in families with incomes of up to 200 percent of the federal poverty line (FPL) to the federal government. The Budget includes $201.5 million ($76.1 million Tobacco Settlement Fund) to cover the cost of the proposed expansion, which would cover an estimated 174,000 parents by June 30, 2002. While children in families with incomes of up to 250 percent of the FPL are currently eligible for the HFP, eligibility for parents under the proposed expansion would be capped at 200 percent of the FPL. There would be no limits on families' assets for the HFP, but the state would retain an assets test for Medi-Cal. The federal government must approve the proposed plan before its implementation. Most of the funding for the expansion comes from the unused portion of California's allocation of federal SCHIP dollars.

The Budget also includes $733.1 million ($125.2 million General Fund and $74.4 million Tobacco Settlement) for the Healthy Families Program (HFP). The Budget assumes that an additional 106,000 children will enroll in the HFP by June 30, 2002. The Budget also allocates an additional $7.8 million ($3.4 million General Fund) for HFP outreach activities in 2001-02.

Tobacco Settlement Funds Earmarked for Health Care. The Governor's Budget shifts $468 million in funds from the national tobacco settlement from the General Fund to a special fund for health care programs. The new fund will be used to support $244 million in previously enacted expansions of Medi-Cal and the Healthy Families programs, expanding the Healthy Families program to include parents ($76.1 million), cancer research and treatment ($40 million), youth smoking reduction efforts, and preventative health assessments and immunizations of low income children.

Benefits for recent immigrants to expire. The Budget does not extend the September 30, 2001 sunsets of the Cash Assistance Program for Immigrants (CAPI) and the California Food Assistance Program (CFAP) for immigrants who arrived in the US after August 22, 1996. The CAPI program provides cash assistance to low income elderly and disabled persons who are ineligible for the SSI/SSP program due to their immigration status. The CFAP program provides state-funded Food Stamps to immigrants who are ineligible for federal Food Stamps due to immigration status.

Less Than Half of CalWORKs Dollars Go to Cash Assistance. The Budget provides $7.0

billion for the CalWORKs program, slightly above last year's $6.9 billion level, including $3.1 billion for cash assistance payments, $1.2 billion for child care, $112 million for substance abuse and mental health services, and an $84.9 million reserve. A cost of living adjustment (COLA) will bring the monthly grant level for a family of three from $645 to $676 in high cost counties and from $614 to $644 in low cost counties. The Budget assumes that a substantial portion of the caseload will reach the five-year time limit on federal assistance beginning in December 2001. Since families do not begin to reach the state time limit until January 2003, state, rather than federal, funds will be used to support these families.

The Proposed Budget also eliminates county performance incentive payments, a financial incentive provided to counties for reducing caseloads. The elimination of incentive payments is significant, in part, because a portion of these funds can be spent to assist working poor families with incomes up to 200 percent of the federal poverty level who do not qualify for other forms of assistance. The ability to use federal TANF and state matching funds to serve a broader definition of "needy families" was authorized by the federal regulations governing the use of welfare dollars and incorporated into state law in a measure passed as part of last year's budget agreement.

Child Care Policy Review Continues. The Budget includes a 3.91 percent cost of living adjustment for child care programs administered by the Department of Education ($45.5 million; $36.3 million General Fund and $9.2 million federal funds); $5.4 million to help child care contractors offset costs associated with the increase in the state's minimum wage; and $67 million to fund the full-year costs of expanding the State Preschool, General Child Care, and Migrant Child Care programs. The sole expansion in General Fund supported child care programs is $20 million for the After School Learning and Safe Neighborhoods Partnerships program.

Funding for CalWORKs child care remains essentially flat; however the Budget shifts $97.8 million from Stage 2 to Stage 1. Funding for Stage 3 increases by $41.7 million to serve families exhausting their two-year benefit after leaving cash assistance and families entering Stage 3 in July 2001. The Budget does not address families currently receiving Stage 1 or Stage 2 child care who will exhaust their two-year transitional benefit after July 2001. The Legislative Analyst has identified a shortfall of approximately $60 million in Stage 3 CalWORKs funding. The Budget Summary notes that additional funding for Stage 3 will be considered upon completion of a statewide child care policy review that is charged with developing recommendations designed to utilize "existing resources" to "more efficiently ... serve the State's neediest families."

Most Housing Programs Receive Baseline Allocations. The Department of Housing and Community Development's (HCD) total budget increases by $29.6 million (6 percent), from $501.7 million to $531.3 million. General Fund spending, however, drops from $560.7 million to $317.2 million (43 percent). The Proposed Budget continues the baseline funding levels established in last year's Budget for multifamily housing ($31 million), farmworker housing ($18.5 million), and emergency housing assistance ($14 million). However, the Cal-HOME homeownership assistance program receives no additional funds in the Proposed 2001-02 Budget.

Local Government. The Budget provides $250 million in one-time discretionary funding to local governments, to be allocated 50 percent on a per capita basis and 50 percent based on local governments' contributions to their counties' respective Educational Revenue Augmentation Fund. The Governor's Budget Summary included a lengthy discussion of state funding for locally administered programs and listed a number of state augmentations to programs administered at the local level.

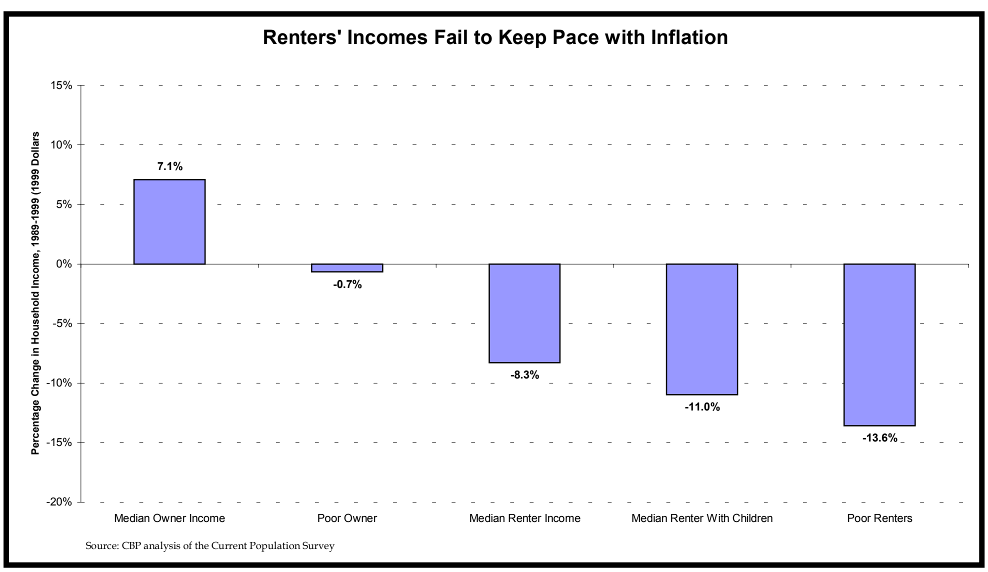
Hot Topics in the Budget Debate

In recent years, most of the controversial issues at stake in the Budget have been resolved after the release of the Governor's May Revision and its updated revenue and expenditure projections. In recent years, the May Revision has provided substantial increases in available revenues and enabled significant augmentations to proposed spending levels. At this point, it is uncertain whether the state can expect to receive a similar revenue bump when personal income tax receipts are tallied. The extent to which available resources will be used to address the state's energy crisis is also unknown at this time and could have a major impact on budget negotiations. That said, hot issues in this year's budget debate are likely to include the size and shape of the school funding package; the level of funding for housing, transportation, and local government; health coverage for the uninsured; and taxes.

CALIFORNIA'S HOUSING AFFORDABILITY CRISIS

In May 2000, the California Budget Project (CBP) published a comprehensive report on the state's housing problems, *Locked Out: California's Affordable Housing Crisis.* This report analyzed data from both the American Housing Survey (AHS) and the Current Population Survey (CPS), conducted by the US Census Bureau. Data released since the publication of *Locked Out* confirms that California's housing affordability crisis continues. The updated information shows that:

- ***Renters suffer the worst housing cost burdens.*** While the generally accepted standard is that households should spend no more than 30 percent of income on housing costs, nearly a quarter (23 percent) of metropolitan area renters spent more than half their income on shelter in 1999. Low income renter households, those with annual incomes under $15,000, fare even worse, with more than two-thirds (67 percent) paying more than half their income toward rent.
- ***Renters' incomes are not keeping pace with inflation.*** While the median income of homeowner households increased 7 percent between 1989 and 1999, after adjusting for inflation, the median renter income *dropped* by more than 8 percent. Household incomes for poor renters (those at the 20th percentile) fell by nearly 14 percent.
- ***Renter incomes lag housing costs.*** While the rental housing component of the Consumer Price Index rose 19 percent in the Los Angeles metropolitan area and 48 percent in the San Francisco metropolitan area between 1989 and 1999, the median income for poor renters rose by 14 percent and the median income of renters with children rose just 17 percent.
- ***Young families and nonwhite households struggle to achieve homeownership.*** The share of owner households headed by individuals in their twenties dropped 37 percent between 1979 and 2000, while the share headed by individuals in their thirties dropped 20 percent. Households headed by African-Americans and Latinos are significantly less likely to be homeowners; 65 percent of the state's white-headed households are homeowners, but fewer than half of Latino and African-American headed households (41 percent and 39 percent, respectively) own their own homes.
- ***Overcrowded and substandard housing is increasing as housing costs rise.*** More than one out of eight (13 percent) metropolitan area renter households lived in overcrowded conditions in 1999. In Los Angeles, the problem is even worse, with 17 percent of



renter households living in overcrowded conditions. Substandard housing is also a serious problem in Los Angeles, with 15 percent of metropolitan area renter households living in inadequate housing compared to 12 percent statewide. In addition, about a third (33 percent) of Latino households in the state lived in overcrowded conditions.

PRESIDENT TO SEND $1.6 TRILLION TAX PACKAGE TO CONGRESS

President Bush has promised that the $1.6 trillion tax cut he proposed during the fall campaign will be one of the first issues he takes to Congress. Debate over the tax cut is likely to center on the extent to which anticipated surpluses will be large enough to finance both the proposed tax cut and spending initiatives, such as Social Security reform, a Medicare prescription drug benefit, and education, as well as ongoing federal programs. The outcome of the debate will be critical, since the tax cut would consume a substantial fraction of the anticipated surpluses, leaving little room for other policy initiatives.

The Bush Tax Package

The major elements of the President's tax proposal include: a reduction in personal income tax rates; doubling the current $500 per child tax credit and making the credit available to high income families; allowing taxpayers who do not itemize deductions to deduct charitable contributions; providing an additional tax deduction for two-earner couples in order to reduce the so-called marriage penalty; repealing the federal estate tax; making the federal research and development tax credit permanent; and expanding education savings accounts. The President also proposed a package of tax measures aimed at expanding health coverage; however the cost of these proposals is not included in the $1.6 trillion estimate.

How Big is the Surplus Likely to Be?

The most recent projection by the Congressional Budget Office (CBO), released January 31, estimates that the on-budget surplus, which excludes the spending and revenues of Social Security and the Postal Service, will exceed $3.1 trillion between 2002 and 2011. The new forecast assumes that the economic downturn will be short lived and that growth will resume by the middle of 2001. The new forecast's estimate of the on-budget surpluses that would be generated between 2002 and 2011 under current policies and updated economic assumptions is approximately $1 trillion higher than the estimate released last July. The increase is attributable to more positive economic assumptions, along with a shift in the forecast period from 2001 to 2010 to 2002 to 2011.

However, a number of factors are likely to reduce the size of the surplus over the next decade. Recent analyses by the Center on Budget and Policy Priorities (CBPP) identify a number of factors that are likely to impact the size of the surplus. First, the CBO's projections assume that discretionary spending grows at the rate of inflation. This assumption does not take into account population growth or the fact that discretionary spending has grown at a higher rate during recent years. Second, the estimate excludes surpluses generated in the Social Security Trust Fund, but not those generated in Medicare. Finally, the CBO estimate reflects revenues and expenditures based on current law, but excludes the impact of items which are routinely reauthorized, such as the federal Research and Development Tax Credit. Maintaining current tax and budget policies, including items which are scheduled to sunset during the forecast period would also reduce available surpluses. The CBPP estimated that taking these factors in account would reduce the size of the surplus by approximately $1 trillion based on the July CBO forecast.

The CBO also notes that long-term forecasts are subject to considerable uncertainty. While the baseline forecast represents its best estimate of what is likely to occur, the CBO notes that "projections that are quite different from the baseline also have a significant probability of coming to pass." Using different economic assumptions, CBO estimates a range spanning from a $0.5

trillion deficit to a surplus approximately twice the size of that anticipated under the baseline projection.

How Much of the Surplus Would the Tax Cut Consume?

During the presidential campaign, analysts estimated the cost of the President's proposed tax plan at $1.3 trillion over the 2002 to 2010 period. The plan would also increase federal interest costs by $261.6 billion over the same period for a total cost of $1.6 trillion. However, analyses suggest that this cost estimate is understated in several important respects. First, the estimate fails to take into account the interaction between the plan's proposals and the alternative minimum tax (AMT, a provision designed to prevent taxpayers who claim various tax breaks from avoiding taxation). Unless adjustments are made to the AMT, the President's proposal would subject millions of middle income families to the AMT, an outcome that is widely regarded as politically untenable. Changing the AMT to prevent it from applying to middle income taxpayers would cost an estimated $192 billion over ten years. Second, the shift to a 2002-2011 forecast period will increase the cost of the tax cut, since it has no cost in 2001, but would have a sizeable cost in 2011. However, the cost of this adjustment is not factored into the cost of the Bush tax plan. When these factors are taken into account, the true cost of the tax cut is likely to exceed $2.1 trillion, potentially equaling or exceeding reasonable estimates of the available surplus.

Who Would Benefit from the Bush Tax Package?

Over half of the benefits of the Bush tax package would go to the wealthiest 5 percent of households, according to an analysis by the Institute on Taxation and Economic Policy. Middle income taxpayers – those in the middle 20 percent of all households – would receive an average annual tax cut of $453 under the Bush proposal, while the poorest 20 percent would receive an average reduction of $42. In contrast, the wealthiest 1 percent would receive an average annual reduction of $46,072.

Who Would Benefit from the President's Proposed Tax Cut?
(Annual Effect at 1999 Income Levels)

Income Group	Income Range	Average Income	Average Tax Cut	Percent of Total Tax Cut
Lowest 20%	Less than $13,600	$8,600	($42)	0.8%
Second 20%	$13,600 - $24,400	$18,800	($187)	3.5%
Middle 20%	$24,400- $39,300	$31,100	($453)	8.4%
Fourth 20%	$39,300 - $64,900	$50,700	($876)	16.2%
Next 15%	$64,900 - $130,000	$86,800	($1,447)	20.1%
Next 4%	$130,000 - $319,000	$183,000	($2,253)	8.4%
Top 1%	$319,000 and above	$915,000	($46,072)	42.6%
ALL		**$50,800**	**($1,070)**	**100.0%**
Bottom 60%	Less than $39,300	$19,500	($227)	12.6%
Top 10%	$92,500 and above	$218,000	($6,410)	59.4%

Source: Institute on Taxation and Economic Policy

Proposal Would Reduce California Revenues

Repeal of the estate tax would have a direct impact on California's state budget. California, like most states, receives a portion of the revenues collected from the federal estate tax in the form of a "pick up" tax, which does not affect the amount of tax levied on an estate. The state expects to receive $1.0 billion in estate tax revenues in 2001-02. If the federal tax is repealed, the state would receive nothing.

What Would the Tax Cut Mean for Federal Budget Priorities?

The President's tax proposal would consume a substantial fraction, if not all, of the surpluses that are likely to be generated over the next decade. If Congress acts on the tax proposal first, its ability to consider other policy initiatives, such as education, a prescription drug benefit for Medicare recipients, and the long-term solvency of the Social Security system, will be severely limited. The debate over the tax cut will also have important implications for the reauthoriza-

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tion of funding for the Temporary Assistance for Needy Families (TANF) block grant, Child Care and Development Block Grant, State Children's' Health Insurance Program (SCHIP), and Food Stamp program which will come before Congress in the next several years.

NEW CBP PUBLICATIONS

Recent CBP publications include:

- *Winners and Losers: Where Has the Money Gone?* reviews spending and revenues trends in the first two budgets of the Davis Administration as compared to the final budget of the Wilson Era. The report helps set the stage for policy deliberations over the upcoming 2001-02 budget.
- *The Budget Unplugged: The Social and Economic Context of the Governor's Proposed 2001-02 Budget* provides a graphically oriented review of the Governor's Proposed 2001-02 Budget and the social and economic trends that provide the context for the Budget.
- *Reauthorization of the Temporary Assistance for Needy Families Block Grant: Issues and Options From A California Perspective* identifies critical issues at stake in the reauthorization of the federal Temporary Assistance for Needy Families (TANF) block grant and other programs forming the safety net for poor families.

Information on ordering publications can be found on CBP's web site (www.cbp.org).

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. General operating support for the California Budget Project is provided by foundation grants and individual donations and subscriptions.

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