

STATE'S ECONOMIC OUTLOOK HAS CHANGED DRAMATICALLY

The state appears to be on the verge of a significant budget deficit in the upcoming (2002-03) fiscal year. Concern over the state's deteriorating fiscal condition stems from lagging revenue collections and concerns that the economic downturn could be longer and more severe than initially anticipated. On October 11, Governor Davis ordered state agencies and departments to reduce their 2002-03 budget proposals by 15 percent. The Legislative Analyst previously told legislative leaders that the state's fiscal outlook had weakened significantly and that a continuation of recent revenue trends "would easily exhaust the \$2.6 billion reserve included in the 2001-02 Budget." Press reports suggest that the Governor may convene a "summit" to discuss the state of the state's economy and/or call the Legislature back into special session to address the expected deficit, as well as the economic slowdown.

Economy Slows and Revenues Decline

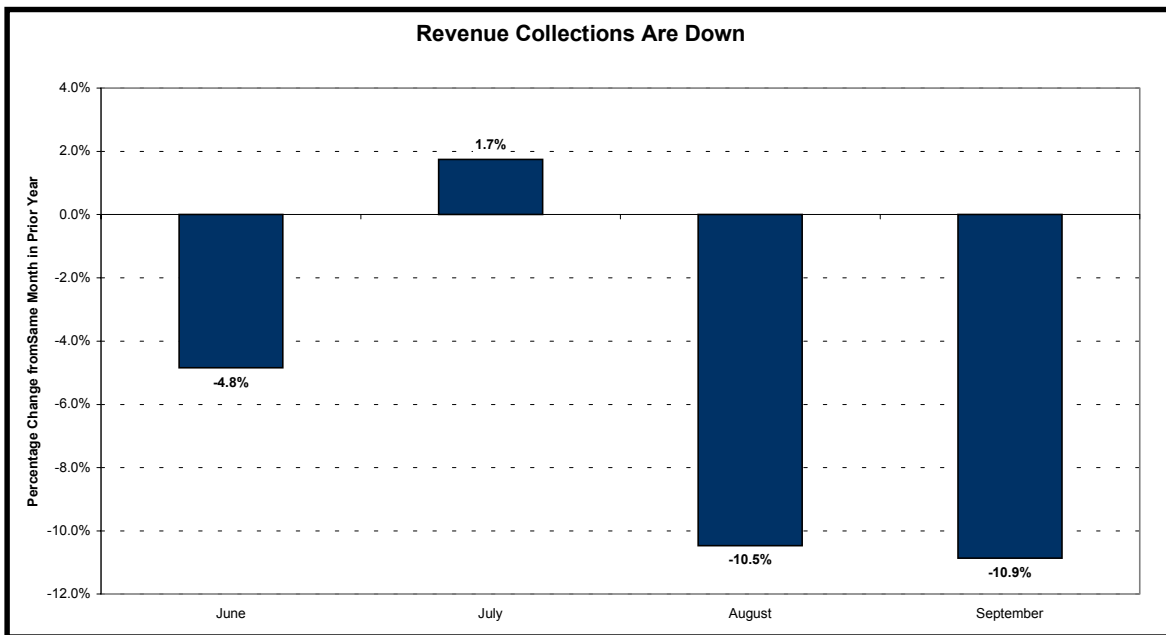
The California economy has undergone a marked slowdown since the adoption of the 2001-02 spending plan in July. The worsening economic situation has, in turn, depressed state revenue collections, leading forecasters to predict a widening budget gap in the upcoming fiscal years. September revenues were 6.3 percent (\$468 million) below the level forecast in May. Overall, revenues are down by \$1.1 billion since May, when the most recent budget forecast was prepared, including a \$466 million drop in the final two months of 2000-01. During the first three months of 2001-02, revenues were 7.9 percent (\$1.3 billion) lower than collections during the same months of the prior year. The Department of Finance noted that September revenue collections did not appear to reflect the dampening

effect of the September 11 tragedy on the economy and that the impact of the tragedy on consumer spending would be reflected in sales tax payments due at the end of October. The first indication of the prospects for the upcoming year will come in mid-November, when the Legislative Analyst's Office (LAO) releases its long-term forecast of both revenues and expenditures.

Budget Situation Already Precarious

The state's fiscal situation was precarious even before the September 11 attack. Budgeted 2001-02 expenditures exceeded anticipated revenues by \$3.7 billion. The gap was made up by the sizeable \$7.1 billion balance carried forward from the prior year. The current year's spending plan includes a \$2.6 billion reserve, equal to 3.3 percent of budgeted expenditures. Expenditures also exceeded revenues in the prior year's budget (2000-01). Earlier this year, the LAO estimated that the state would face a \$1.4 billion 2002-03 budget gap. Moreover, these estimates do not take into account any increased expenditures related to the downturn in the economy or heightened security considerations.

The 1999-00 surplus (\$9.4 billion) was largely attributable to income taxes paid on capital gains and stock options. This surplus provided the funds needed to offset operating deficits in 2000-01 and 2001-02. In May, the Department of Finance estimated that the share of state revenues attributable to capital gains and stock option income would fall from 23.1 percent in 2000-01 to 16.8 percent in 2001-02, a drop of nearly \$5.5 billion. A substantially larger drop now appears likely in light of the continued slowdown in high technology industries, as well



as the sharp drop in the stock market after the September tragedy.

Energy Bonds: More Uncertainty

In January, the Department of Water Resources began to purchase electricity on behalf of customers of the state's investor-owned utilities. To date, the state has spent approximately \$6.2 billion out of the General Fund for power purchases. Plans for the state to issue bonds to repay the General Fund have been repeatedly delayed. On October 2, the Public Utilities Commission (PUC) refused to adopt a rate agreement necessary to move forward with the bond issuance, preferring an alternate approach outlined in SB 18XX (Burton). SB 18XX passed both houses of the Legislature by large majorities, but was not sent to the Governor at the end of the 2001 session. The Governor had publicly threatened to veto SB 18XX. The lack of action on SB 18XX, coupled with the PUC's objection to moving forward under the framework authorized by current law, leaves the timing of repayment of the General Fund in doubt.

The Governor and the Treasurer have voiced concerns that SB 18XX is unworkable and that its enactment would prevent or substantially delay the sale of bonds and repayment of the General Fund for power purchases. Senator Burton and a majority of the PUC members, on the other hand,

argue that SB 18XX would provide bond buyers with greater security and allow the state to renegotiate long-term energy contracts on terms that are more favorable. The state's fiscal condition would be substantially worsened if the General Fund is not repaid for power purchases. However, bonds are not the only mechanism available to ensure General Fund repayment. AB 1X, which authorized the state to purchase power on behalf of the state's investor-owned utilities, would also permit the PUC to increase electricity rates sufficiently to permit the General Fund to be repaid.

Moody's Investors Service, one of the major agencies that rate the creditworthiness of public debt, placed California's bond rating under review on October 5. The company cited the state's reliance on tax revenues attributable to capital gains and concerns over the issuance of the energy bonds as the rationale for its action.

Economic Data Fail to Reflect the Impact of the September 11 Tragedy

The most recent economic indicators for California are based on data collected before the September 11 tragedy. Available information suggests that the state's economy had weakened over the past year, but that some bright spots remained. Activity in the construction and real estate sectors, for example, actually improved in

August relative to recent months. However, most economists believe, and national data suggest, that the economy slowed in the wake of the September 11 attack.

California's unemployment rate has crept upwards in recent months, rising to 5.4 percent in September, as compared to 4.9 percent in the same month a year ago. The modest statewide increase, however, masks substantial increases in the Bay Area. Over the past year, unemployment rates nearly doubled in San Mateo County, climbing from 1.6 percent to 3.1 percent, and more than tripled in Santa Clara County, rising from 1.8 percent to 5.9 percent.

WHERE HAS ALL THE MONEY GONE?: THE DISTRIBUTION OF PROPOSITION 1A SCHOOL FACILITIES NEW CONSTRUCTION FUNDS

When the Legislature convenes in January, one of the first items of business will likely be a measure placing a state general obligation bond for school facilities on the November 2002 ballot. While there is general agreement on the need for a bond to finance school facilities, the issue of how to allocate the proceeds among districts is contentious. Under the current system, the State Allocation Board (SAB) allocates funds on a "first come, first served basis" until fund levels drop to a specified level or more districts apply for funding than there are funds available. Proponents of alternative approaches argue that the current system favors districts that are able to secure the required land and plan approvals quickly, rather than those with the greatest need.

In an effort to inform the upcoming debate, the California Budget Project (CBP) examined the allocation of funds raised by Proposition 1A of 1998 for K-12 new construction in an effort to identify any relationships between funding and district characteristics such as district size, student demographics, and rankings on the 2000 Academic Performance Index (API). During the period examined by this analysis, 211 districts that include 37.1 percent of the state's schools and 46.2 percent of total state enrollment were apportioned new construction funds. In brief, the CBP found that:

- School districts that received state school construction funds were larger, served greater shares of low income and non-white students, and had a greater share of low-performing schools than districts that did not receive funds.
- School districts that received a disproportionately greater share of state school construction funds were smaller, served smaller shares of low income and non-white students, and had a smaller share of low-performing schools than districts that received a smaller share of state funds relative to their need.
- School districts where at least 50 percent of the schools scored in the bottom five deciles of the 2000 API served 49 percent of the state's students, but received only 36.8 percent of total state new construction apportionments.

Districts Eligible for New Construction Funds Face Multiple Challenges

Districts can be divided into those eligible for new construction funds and those not eligible. Under current law, a district is eligible for state new construction funds if it demonstrates that its projected enrollment five years into the future will exceed its current classroom capacity. While it is likely that many non-eligible districts have not applied for state funding eligibility because they do not have a projected need for new facilities, some may not have applied because they could not raise the required local funding match of 50 percent for new construction projects. Compared to non-eligible districts, the CBP analysis found that eligible districts, on average, had more schools, had a greater share of schools scoring in the bottom five and bottom two deciles of the 2000 API, and served greater shares of low income, non-white students.

Of Eligible Districts, Those that Received New Construction Funds Demonstrated Greater Need than Unfunded Districts

The current system for apportioning school facilities funds also requires eligible districts to have site and plan approval for new construction projects before applying to the SAB for funds from the School Facilities Program. Not all eligible districts have been apportioned funds.

This could be either because not all eligible districts have applied for new construction funds, or because districts have applied and received approval, but have not received an apportionment due to a lack of available funds. The CBP analysis found that the differences between funded and unfunded districts are similar to those between eligible and non-eligible districts:

- Funded districts were larger (199 schools) than unfunded districts (30 schools).
- Funded districts had a greater share of schools scoring in the bottom five deciles (49.3 percent) and in the bottom two deciles (25.1 percent) than unfunded districts (45.2 percent and 16.6 percent, respectively).
- Funded districts had a larger percentage of non-white students (69.9 percent) than unfunded districts (64.3 percent).
- Funded districts had a larger share of students enrolled in free or reduced priced lunch programs (53.9 percent) than unfunded districts (45.8 percent).

Among Funded Districts, Those that Were Smaller and Had Fewer Obstacles Fared Better

Funded districts can be further categorized into those whose share of total state apportionments is greater than their share of total state “unhoused” pupils (high-funded), and those whose share of total state apportionments is equal to or less than their share of total state “unhoused” pupils (low-funded). This permits an examination of the differences between districts receiving either more or less funding for new construction relative to their need. The CBP found that, on average:

- High-funded districts were smaller (20 schools) than low-funded districts (163 schools).
- High-funded districts had a smaller share of schools scoring in the bottom five deciles (37.4 percent) and in the bottom two deciles (13.7 percent) than low-funded districts (50.5 percent and 24.0 percent, respectively).
- High-funded districts had a smaller percentage of non-white students (59.3 percent) than low-funded districts (70.0 percent).
- High-funded districts had a smaller share of

students enrolled in free or reduced priced lunch programs (38.6 percent) than low-funded districts (54.1 percent).

Low-Performing Districts Served More of the State’s Students but Received Less of State New Construction Funds

The CBP also examined the distribution of state new school construction funds across districts that have a large share of schools that scored either in the top or bottom deciles of the 2000 API. The CBP found that districts in which at least 50 percent of the schools scored in the top five deciles of the API received more funds relative to their share of total state “unhoused” pupils. These high-performing districts’ percentage share of total state funding was 19.6 percent greater than their percentage share of the state’s “unhoused” pupils. Districts in which at least 50 percent of the schools scored in the bottom five deciles had a share of total state apportionments representing only 71.5 percent of their share of total state “unhoused” pupils. In other words, low-performing districts’ percentage share of state funding is 28.5 percent lower than their percentage share of state “unhoused” pupils.

Very low-performing districts, those in which two-thirds or more of the schools scored in the bottom five deciles on the 2000 API, served 33.9 percent of the state’s students and received 23.6 percent of total new construction funds. These districts also received fewer funds relative to their share of total state “unhoused” pupils, with a share of total state apportionments representing 62.6 percent of their share of total state “unhoused” pupils. In other words, very low-performing districts’ percentage share of state funding is 37.4 percent lower than their percentage share of state “unhoused” pupils.

Other Proposition 1A Funding Was Better Aligned With District Needs

While the CBP analysis focused on new construction apportionments, an analysis of the apportionment of Proposition 1A’s modernization, financial hardship, and class size reduction funds suggests that the distribution of these funds was better aligned with district needs. Specifically:

- **Modernization Funding:** On average, districts with modernization funding were larger, had a greater share of schools in the bottom five deciles and the bottom two deciles, and had a greater share of non-white students and students enrolled in free or reduced priced lunch programs than those without funding.
- **Class Size Reduction Funding:** On average, districts with class size reduction funding were larger, had a greater share of schools in the bottom five deciles and the bottom two deciles, and had a greater share of non-white students and students enrolled in free or reduced priced lunch programs than those without funding.
- **Financial Hardship Funding:** On average, districts with new construction and modernization financial hardship funding were smaller, had a greater share of schools in the bottom five deciles and the bottom two deciles, and had a greater share of non-white students and students enrolled in free or reduced priced lunch programs than those without funding.

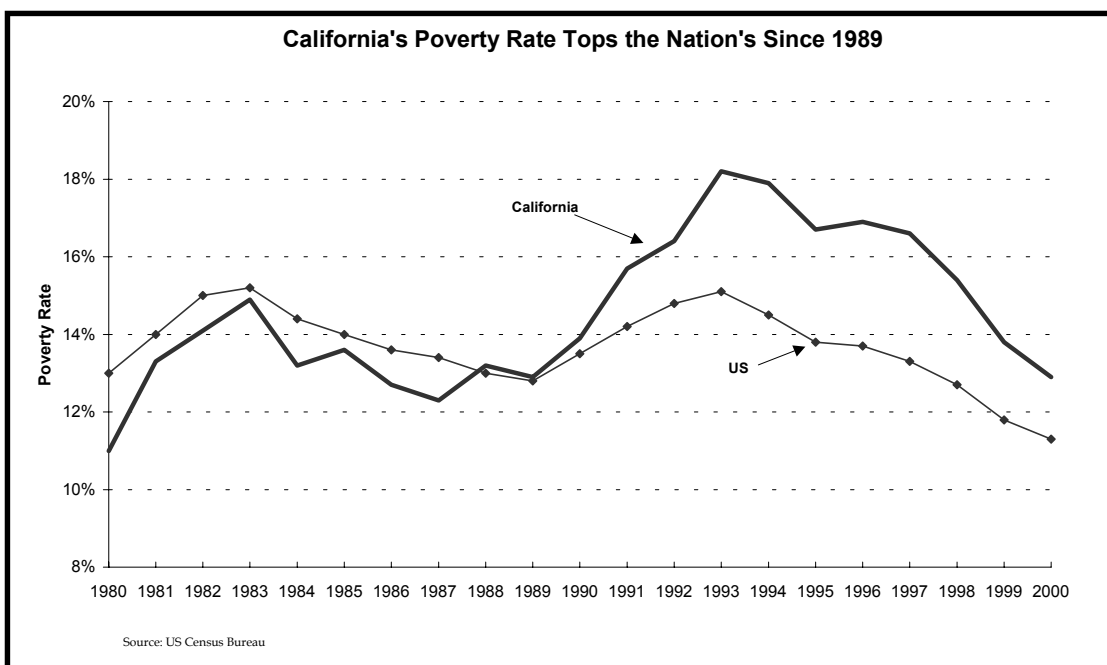
This analysis examined the differences between districts with demonstrated facilities needs that have received state school facilities funds and those that have not. Identifying these differences does not explain why some districts apply for funding and some do not, or why some districts

are able to secure land and construction plan approval faster, or at all, and others are not. It does, however, indicate that the current “first come, first served” system for distributing state school facilities funds may unintentionally favor one type of district over another, and so should be carefully considered when crafting the next state bond bill. This is especially true with regard to new construction funds appropriations, where districts with greater need and that serve greater shares of low income and non-white children have received a smaller share of state funds.

A more detailed explanation of the methodology and findings from this analysis are available on the CBP website at www.cbp.org.

CALIFORNIA'S POVERTY RATE DROPS TO 1989 LEVEL, WHILE INCOMES, HEALTH COVERAGE RISE

According to newly released Census data, the poverty rate both in California and the nation dropped in 2000, continuing a several year trend. The poverty rate for California fell by nearly a percentage point, from 13.8 percent in 1999 to 12.9 percent in 2000. The national poverty rate fell by half a percentage point, to 11.3 percent. Nationally, the poverty rate for African-Ameri-



cans and female-headed families reached all-time lows.

California's 2000 poverty rate was the same as it was in 1989, the peak of the last economic expansion. In contrast, the national poverty rate dropped 1.5 percentage points over the same period.

The current economic sluggishness, which many economists believe already constitutes a recession, will likely send poverty rates higher in 2001. Over 4.5 million Californians lived in poverty in 2000, about 100,000 fewer than in 1999.

While the decrease in poverty rates is good news, 2000 may be the economy's most prosperous year, at least in the short term. Unemployment rates in 2000 were the lowest since 1970 for both California and the US (4.9 and 4.0 percent, respectively). However, unemployment has been climbing in recent months. The national unemployment rate has increased from 4.2 percent in January of this year to 4.9 percent in September. California's unemployment rate inched up to 5.4 percent in September 2001 from 4.6 in January. The last time California's monthly unemployment rate was 5.4 percent was April 1999.

California's poverty rate increased by 3.8 percentage points between 1989 and 1995, followed by a drop of the same magnitude from 1995 to 2000. Nationally, the increase in the poverty rate between 1989 and 1995 was less (1.0 percent) and the decrease between 1995 and 2000 was more moderate (2.5 percent) than in California.

California's median household income, the point at which half the households have higher incomes and half have lower incomes, increased by \$1,804 from 1998-99 to 1999-00, from \$44,204 to \$46,008. The national median household income also increased, but by a smaller amount (\$558), from \$41,609 to \$42,168.

While many people prospered from the economic boom, the benefits were not equally shared. For example, more California workers earned poverty level wages in 2000 than in 1989. In 2000, 26.0 percent of the state's workers

earned wages that were insufficient to bring a family of four above the poverty level, two percentage points higher than in 1989 (24.0 percent). In contrast, the share of workers nationally who earned poverty level wages fell from 28.5 percent in 1989 to 25.1 percent in 2000, according to an analysis of Census data by the Economic Policy Institute.

Another sign that the boom economy of the late 1990s did not benefit everybody is that those who were poor in the US in 2000 were poorer than at any time since 1979. The average poor person was \$2,527 below the poverty line in 2000, as compared to \$2,116 below in 1989 and \$2,128 below in 1979, according to a recent analysis by the Center on Budget and Policy Priorities (CBPP). The CBPP analysis uses a broader definition of income that includes the Earned Income Tax Credit and food and housing benefits; this definition excludes federal income and payroll taxes.

At the same time, the safety net has weakened over the last several years. As a percentage of the population, Californians were much less likely to use welfare (CalWORKs, formerly AFDC) in 2000 than in 1989, even though the poverty rate was the same. The fraction of the population receiving welfare benefits dropped by a quarter (26.6 percent) over that time period. Since California's welfare caseload peaked in 1995, the share of the population receiving cash assistance has dropped by nearly half (45.8 percent).

The percentage of Californians without health insurance dropped by more than one point, from 19.0 percent in 1999 to 17.9 percent in 2000. The gains in California exceeded those nationally. However, California had the fifth highest percentage of uninsured residents among all states from 1998-2000. About 550,000 fewer people lacked health coverage nationally during 2000 as compared to 1999 (14.0 vs. 14.3 percent). The decrease in the percentage of uninsured stems primarily from an increase in job-based insurance, due to the strength of the economy, rather than increases in public health insurance such as Medicaid (Medi-Cal in California) or Medicare.

MANY CALIFORNIA FAMILIES LOST HEALTH COVERAGE WHEN THEY LEFT WELFARE FOR WORK

A new CBP report, *Losing Ground: Declining Medi-Cal Enrollment After Welfare Reform*, suggests that a number of California families may have unnecessarily lost health coverage when they left the welfare rolls. The report found wide variations in county efforts to extend Medi-Cal coverage to low income children and families, indicating that many Californians may have lost coverage for which they are eligible.

The CBP study shows that while the number of Californians receiving non-cash-related Medi-Cal has increased substantially, the gain is less than the number of persons who lost Medi-Cal coverage when they left welfare. The study uses the concept of “replacement rates” to measure the movement of families from welfare-linked coverage to categories of Medi-Cal enrollment that are not based on the receipt of cash assistance. The study examines enrollment trends for the state and California’s 58 counties and suggests that variations reflect differences in local policies and outreach efforts.

The report’s key findings include:

- ***Family-based Medi-Cal enrollment declined by 194,029 between March 1995 and December 2000.*** Most of the drop occurred between the middle of 1996 and the beginning of 1998, with a partial recovery in 1999 and 2000.
- ***The decrease in coverage reflects fewer people enrolling in Medi-Cal as a result of receiving cash assistance through the CalWORKs program.*** Between March 1995 and December 2000, the number of persons receiving cash-related Medi-Cal fell by 1,268,050, while the number of persons enrolled in family-based Medi-Cal categories that are not linked to cash assistance rose by 1,074,021.
- ***Over the period studied, family-based enrollment shifted from being predominantly linked to cash assistance to predominantly non-cash-related.*** In March

1995, three-quarters (76.0 percent) of family-based Medi-Cal enrollment was cash-related, while in December 2000 less than half (42.8 percent) of family-based coverage was linked to cash assistance. Non-cash-related enrollment first surpassed cash-related enrollment in March 2000.

- ***Between March 1995 and December 2000, 84.7 percent of the decline in cash-related Medi-Cal enrollment was offset by an increase in non-cash Medi-Cal enrollment.*** The CBP calls this percentage offset a “replacement rate.”
- ***Replacement rates varied significantly during the three phases studied in this analysis (March 1995 to January 1998, January 1998 to April 1999, and April 1999 to December 2000).*** The three phases correspond to different policy frameworks for family-based Medi-Cal. The replacement rate for the period March 1995 to January 1998 was 6.8 percent. This is the period between the peak of welfare (then AFDC, now CalWORKs) caseloads and the implementation of welfare reform in California. In other words, only seven persons enrolled in non-cash-related Medi-Cal for every 100 persons who left cash-related Medi-Cal during this period. The replacement rate for January 1998 to April 1999 was 116.9 percent. This period covers the time from the “delinking” of Medi-Cal eligibility and cash assistance to the issuance of the final rules for the new 1931(b) category of Medi-Cal eligibility. The replacement rate for the final period was 163.0 percent. This period begins with the issuance of the final 1931(b) rules and ends in the final month for which data were available at the time of this analysis. (A replacement rate of more than 100 percent means that the increase in non-cash enrollment was larger than the decline in cash enrollment.)
- ***The increase in family-based coverage after the implementation of the policy changes related to the 1996 federal welfare law suggests that the “delinkage” of Medi-Cal and cash assistance, as well as measures taken to encourage Medi-Cal enrollment among individuals who are not receiving cash assistance, have helped to improve health coverage, particularly among children.*** However, the effectiveness of these policies

RETURN SERVICE REQUESTED

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- varies substantially among counties.
- ***Medi-Cal enrollment trends varied substantially among counties.*** Replacement rates for the March 1995 to December 2000 period ranged from a high of 134.1 percent in Los Angeles County to a low of 5.8 percent in Plumas County.
 - ***The magnitude of Los Angeles County's enrollment gain significantly affects the replacement rate for the state as a whole.*** If Los Angeles County is excluded, the overall replacement rate for the state is 66.9 percent (as compared to 84.7 percent); the replacement rate for the period of March 1995 to January 1998 excluding Los Angeles County is 21.3 percent (as compared to 6.8 percent); the replacement rate for the period of January 1998 to April 1999 excluding Los Angeles County is 81.3 percent (as compared to 116.9 percent); and the replacement rate for the
- period of April 1999 to December 2000 is 127.7 percent (as compared to 163.0 percent).
- ***Counties with high poverty rates tend to have higher replacement rates, while low replacement rates are associated with larger decreases in unemployment rates.*** The share of children enrolled in the Healthy Families Program is not statistically related to county replacement rates. The percentage of uninsured county residents is positively associated with replacement rates. In other words, counties with higher rates of uninsurance tend to have higher replacement rates. County policies and practices appear to be the most significant factor influencing family-based Medi-Cal enrollment trends.
- Losing Ground: Declining Medi-Cal Enrollment After Welfare Reform* is available from the CBP for \$3.23 (price includes tax).

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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