

The Governor's May Revision to his proposed 2001-02 Budget assumes that revenue collections will be substantially lower than the levels assumed in January. The drop in revenues is attributable to a downturn in the economy and, in particular, weakness in the stock market. The Governor assumes that revenues will be \$3.4 billion lower in 2000-01 and 2001-02 combined. The Governor's forecast is approximately \$650 million lower than that of the Legislative Analyst's Office (LAO) over the same two-year period.

The Governor's forecast assumes that current (2000-01) year revenues will be \$1.144 billion above the January forecast, while budget (2001-02) year collections will be \$4.592 billion lower than the January forecast. On a year-to-year basis, the Governor estimates that available resources will decrease by \$3.2 billion. The substantial drop in revenues is related to overall weakness in the economy including:

- An assumption that tax revenues attributable to capital gains and stock options will fall from 23.1 percent of all General Fund revenues in 2000-01 to 16.8 percent in 2001-02;
- Weakness in sales tax collections;
- Lower bank and corporate income tax collections due to weaker profits and increased use of tax incentives; and
- A drop in personal income tax withholding.

#### **WHAT GOES UP....**

Approximately 57 percent of the state's 2000-01 General Fund revenues come from the personal income tax, up from 38 percent in 1980-81. Much of the increase comes from taxes paid on income from capital gains and stock options. Between 1995 and 1999, income attributable to stock options and capital gains rose from \$25 billion to \$130 billion, a more than five-fold increase. This rise translated into extraordinary revenue growth, with personal income tax collections rising by 90 percent between 1995-96 and 1999-00. The Department of Finance (DoF) estimates that nearly a quarter (23.1 percent) of current (2000-01) year General Fund dollars come from taxes paid on stock options and capital gains, up from 5.6 percent in 1995-96.

The downturn in the stock market, particularly technology driven sectors, is anticipated to significantly reduce both capital gain and option income. The May revenue forecast assumes that 2001 income from stock options will decline by approximately 37 percent, while capital gains will decline by about 27 percent. The misfortunes of a handful of individual companies will have a measurable impact on the state's finances. The DoF, for example, estimates that high-tech companies account for half the state's stock options income. The stock price of one company reputed to be on the list – Cisco Systems – has declined by approximately three-quarters over the past year.

#### **HOW WELL IS THE STATE PREPARED TO WEATHER A DOWNTURN?**

The answer is mixed. On the positive side, the 2000-01 Budget included a large amount of one-time expenditures, expenditures that do not create an ongoing demand for funds. Similarly, the Governor's January Budget included \$3.3 billion in proposed one-time spending (of this amount, approximately \$840 million has already been spent on energy conservation and supply efforts). The

large amount of one-time spending allowed the Governor to propose a revised spending plan that reduced spending by \$3.2 billion while making only modest reductions in ongoing programs. The proposed 2001-02 reserve is small, just 1.4 percent of proposed expenditures. While a larger reserve might be desirable in light of the uncertainty created by the energy crisis and a slowing economy, the \$1 billion in one-time energy spending and proposed continuation of the shift of \$1.2 billion of gas tax revenues to the General Fund, should provide a cushion for the 2002-03 Budget.

On the minus side, the last four budgets have included a total of \$6.5 billion in tax cuts, an amount larger than the deficit the state now confronts. In particular, a portion (\$1.2 billion) of the reimbursements to local governments for the 2001-02 Vehicle License Fee reduction was paid for out of the current year's budget. While this reduces the allocation needed in the budget year, the 2002-03 Budget will bear the full cost of the reduction. Moreover, the length and depth of the economic downturn is unknown, and it is unclear what long-term impact the energy crisis and rising energy prices will have on the state's economy and, in turn, state revenues.

## **PROPOSED POLICY CHANGES**

Proposed 2001-02 spending in the May Revision is \$3.177 billion below the level proposed in the Governor's January Budget, and spending in the current (2000-01) and budget (2001-02) years combined is \$2.6 billion below proposed January levels. Significant gap closing efforts include:

- Delaying the shift of sales taxes on gasoline from the General Fund to transportation for two years. This results in a \$1.3 billion increase in General Fund resources in 2001-02.
- Reducing the size of the proposed reserve from the \$2.4 billion proposed in January to \$1.1 billion (both figures include the set-aside for legal contingencies).
- Eliminating \$250 million in proposed discretionary aid to local governments.

Proposed 2001-02 spending for K-12 Education and Health and Human Services increased between the Governor's January and May proposals. Most of the education increase reflects higher than anticipated enrollment, while the Health and Human Services increase is attributable to a delay in a payment made as part of a settlement of litigation over Medi-Cal reimbursement rates from the current to the budget year. The May Revision does not include funds for families entering Stage 3 of CalWORKs child care after July or extension of the sunsets in the Cash Assistance Program for Immigrants (CAPI) and California Food Assistance Program (CFAP) programs for immigrants who entered the US after August 22, 1996. Selected proposals contained in the Governor's May Revision are detailed below. A full description of proposed policy and budget changes is available at [www.dof.ca.gov](http://www.dof.ca.gov).

## **TAXES**

The May Revision eliminates several of the tax cuts proposed in the Governor's January Budget, including a three-day sales tax "holiday," an expansion of the manufacturers' investment credit (MIC) to software developers, expansion of the space launch sales tax exemption, and tax credits for businesses that provide employees with transit passes or loan employees to schools as math or science teachers. The May Revision retains an expansion of the MIC from 6 to 7 percent of qualified expenses and doubles the small business capital gains exclusion from 50 percent of qualified gains to 100 percent. The latter provision has no impact in the budget year, but a significant cost in future years.

## **ENERGY**

The May Revision describes the \$6.7 billion spent thus far out of the General Fund for electricity purchases as a “loan” to the Electric Power Fund from the General Fund, to be repaid as soon as revenue bonds are issued. The May Revision assumes that the bonds will be sold by the end of August. Other energy-related expenditure proposals include: \$39.2 million in 2001-02 and \$11.9 million in 2000-01 to cover higher utility costs for state agencies; \$5 million for urban and agricultural water and energy efficiency programs; and \$5.5 million for development and enforcement of electricity generation plant performance standards.

The May Revision also includes a \$95 million increase in internal borrowing costs attributable to a combination of energy purchases and declining revenues, and cautions that borrowing estimates are preliminary, pending updated cash flow estimates and anticipated August bond sales to repay electricity debts. On May 15, the credit agency Moody’s lowered the state’s bond rating citing “increasing financial risks associated with the continuing energy crisis, as well as those related to trends in the broader US and California economies.” Moody’s specifically cited the delay in securing legislation needed to issue the energy revenue bonds as a factor leading to the lowering of the state’s credit rating.

## **CalWORKs and CHILD CARE**

The Governor reduces current year CalWORKs spending by \$179.1 million as compared to the January Budget. The May Revision states that \$78.7 million of this decrease results from lower than projected caseload. Elimination of county performance incentive payments, which reward counties for lower caseload rolls and moving recipients into employment, accounts for approximately \$100 million in current year reductions. Since the state was expected to meet, but not exceed, its maintenance of effort (MOE) spending requirement, these reductions will not affect the General Fund, but should increase the amount of money from California’s Temporary Assistance for Needy Families (TANF) block grant that will be carried over to the budget year.

- The Governor proposes to meet the \$2.7 billion dollar MOE requirement in the budget year, in part by using funds from the California Children and Families (Proposition 10) Commission for Stage 1 child care (\$25 million) and transferring an additional \$46.7 million from the Employment Training Fund (ETF) to CalWORKs employment services.
- Funding for Stage 1 child care is increased by \$10.7 million and Stage 2 child care funding is increased by \$121.6 million in the budget year. The funds for increasing Stage 2 come primarily from additional federal Child Care Development Fund (CCDF) dollars that were received after the release of the Governor’s January Budget. The Child Care Reserve is increased by \$53 million. However, the Governor does not specify the level of funding for Stage 3 child care. Stage 3 is intended for former CalWORKs recipients whose incomes are low enough to make them eligible for state subsidized child care and is intended to be part of the larger subsidized child care system. The Governor’s comprehensive child care policy review, originally due last spring, was to provide the basis for Stage 3 budgeting but has not yet been released. The Governor notes that the estimated need for child care for families exhausting their two-year post-CalWORKs limit is \$280.5 million in the current year, growing to \$628.9 million in 2004-05. The identified demand for Stage 3 services is \$123.1 million above the funds provided in the Governor’s January Budget.
- The revised Budget freezes funding for employment services, the core CalWORKs program that helps support and prepare recipients for jobs, at the current year level. This results in a \$25.7 million reduction in the budget year, and the May Revision proposes requiring counties to use

existing performance incentive funds to meet any shortfalls in employment services funding. Moreover, the Governor proposes a new methodology for budgeting for these services.

- The CalWORKs caseload is expected to increase in the budget year as compared to January projections. This is in part due to implementation of federal guidelines that require the state to exempt certain vehicles when determining eligibility for food stamps and CalWORKs, and a higher than projected cost of living adjustment (COLA).
- The Governor proposes a \$59.1 million 2001-02 General Fund reduction by spreading the state match for the Welfare-to-Work (WtW) Grant over the next three years. This reduction will be partially offset by \$44.3 million in TANF funds. The state's WtW Grant match is not applicable toward the MOE.
- A \$20 million expansion of the After School Learning Program in the Governor's January Budget was eliminated.

## **OTHER SOCIAL SERVICE PROGRAMS**

The May Revision:

- Does not extend the September 30, 2001 sunset date for CFAP and CAPI for immigrants who arrived in the US after August 22, 1996.
- Includes an additional \$57.0 million in the budget year as a continuation of a multi-year program to provide increased wages and benefits for In Home Supportive Services (IHSS) workers. This includes the state's share of cost for hourly wage increases up to \$1 per hour and benefits up to a cost of \$0.60 per hour in counties with public authorities. The May Revision also includes funds for wage increases for workers in counties without public authorities. The Governor includes this additional funding even though General Fund revenue growth will not reach the trigger specified in current law. The IHSS program provides in-home care to low income elderly and disabled individuals.
- Reduces the increased augmentations for Adult Protective Services proposed in January by \$13.3 million, eliminates discretionary COLAs for Child Welfare Services for a savings of \$4.3 million, and eliminates \$9.7 million in funding for Juvenile Crime Prevention Pilot Programs. Other savings come from a reduction in foster care caseloads (\$8.7 million over 2000-01 and 2001-02), increases in federal support for child support enforcement activities, and a reduction in federal penalties for the state's failure to implement a statewide child support collection system.

## **HEALTH**

Medi-Cal General Fund expenditures are estimated to increase by approximately \$100 million over the current and budget years combined. Caseload is forecast to grow more quickly than projected in January, due to a more rapid phase-in of eligibility expansions. The largest single change in health spending is a shift a \$175 million settlement payment from the current to the budget year. The payment is part of the settlement of a lawsuit regarding Medi-Cal reimbursement rates for outpatient services provided by hospitals. The May Revision also includes \$15.9 million for outpatient services rate increases above levels provided in the January Budget. Other changes include:

- One-time savings of \$44 million in Tobacco Settlement Funds attributable to a delay in the expansion of the Healthy Families Program to uninsured parents with incomes under 200 percent of the federal poverty level until October 1, 2001. Caseloads have been revised downward by 16,000 adults and 36,000 children compared to January estimates. However, General Fund expenditures are projected to increase by \$10 million due to higher than anticipated enrollment of children between 100 percent and 200 percent of the federal poverty level.

- \$18.3 million in reductions due to lower than anticipated tobacco tax revenues in the Proposition 99 account, including \$12.7 million in the California Healthcare for Indigents Program and \$3.1 million in breast cancer early detection funds. A number of proposed expansions contained in the January Budget are also scaled back, including \$10 million in media allocations for teen pregnancy and family planning programs and a \$5 million cost shift to counties in the County Medical Services program.

## **K-12 EDUCATION**

Proposition 98 provides a guaranteed pool of funds to be used for K-12 education, California Community Colleges, and child care programs. The May Revision increases General Fund spending subject to the Proposition 98 guarantee in both 2000-01 (\$53.7 million) and 2001-02 (\$285.7 million). However, the on-going portion of 2001-02 Proposition 98 allocation actually decreases by \$255.1 million from the January Budget. The net increase for 2001-02 is due to \$540.8 million in “settle up” adjustments to the constitutionally required minimum funding guarantee for prior years, and will be used to provide one-time block grant funds to K-12 school districts that have a plan to reduce energy consumption by 10 percent. Due to the decline in year-over-year General Fund revenue growth, the constitutionally required Proposition 98 minimum guarantee for 2001-02 decreased by \$2.9 billion, to a Test 3 level of \$28.0 billion.

The Governor’s May Revision states that K-12 education will receive \$341.4 million more than was provided in the January Proposed Budget over the current and budget years combined. The increase translates into a per pupil Proposition 98 spending level of \$7,168, lower than the \$7,174 per pupil level proposed in the January Budget, but 7 percent higher than the 2000-01 May Revision level. The decrease is primarily due to the fact that enrollment is approximately 30,000 students above the January forecast.

Proposition 98 created a funding guarantee for schools that is calculated using three tests that are based on the strength of the economy and state revenue growth. In years of average to strong revenue growth, Test 1 or Test 2 will apply. The Test 3 level is used in years with low growth or declines in General Fund revenues. However, if the minimum guarantee is reduced under Test 3, those funds must be restored in future years. A “maintenance factor” would be calculated as the difference between the amount of funding that would have been appropriated under Test 2 and the amount of funding actually appropriated to K-14 in that fiscal year. By funding the 2001-02 guarantee at level that is \$4.6 billion above the Test 3 minimum but \$861.1 million below the Test 2 level, the Governor proposes to minimize the required increase in future years. Specific changes include:

- A \$220 million allocation to create a High Priority Students Block Grant program that would provide schools in the lowest 2 deciles of the API with \$175 to \$200 per pupil in funds aimed at improving student achievement. Funds proposed for this program include \$35 million redirected from the Governor’s Middle School Extended Year proposal due to a reduction of the proposed school year extension.
- \$150 million in additional funds for revenue limits and categorical programs due to enrollment that is approximately 30,000 higher than previously anticipated.
- \$49.2 million to fully fund implementation grants for the second group of II/USP schools at the \$200 per pupil level and to bring implementation grants for the first group to the \$200 per pupil level.
- A reduction of \$123 million in the Governor’s Performance Awards. The reduced funding will limit the award to the current level of \$63 per pupil rather than increase the award to the maximum of \$150.

- A reduction of \$175 million from the Mathematics and Reading Professional Development Program.
- A reduction of \$9.5 million from the Deferred Maintenance Program.
- \$171.8 million in reductions for various programs due to revised participation estimates.

## **TRANSPORTATION**

One of the most significant changes proposed in the May Revision is a two-year delay in the transfer of the General Fund share of the sales tax on gasoline to the Transportation Congestion Relief Program (TCRP) resulting in an increase in 2001-02 General Fund resources of \$1.1 billion and \$1.2 billion in 2002-03. The proposal would add two years of funding at the end of the original plan (2006-07 and 2007-08). The Governor argues that the transfer will not delay specific projects since funds are available to support projects currently in the pipeline. The Governor proposes to hold local street and road maintenance and transit programs harmless by using uncommitted funds in the State Highway Account and Public Transportation Account, respectively. The LAO notes that the proposed transaction leaves the State Transit Assistance program, which provides assistance to transit operators, with \$38 million less than it would have under current law in 2001-02.

## **HOUSING**

The May Revision leaves intact core housing programs such as multifamily and farmworker housing, and protects baseline funding established in the 2000-01 Budget. 2001-02 reductions totaling \$348.3 million include:

- Eliminating the \$200 million augmentation proposed for the Jobs-Housing Balance Improvement Program (HCD).
- Eliminating the \$40 million proposed 2001-02 allocation for the School Facilities Fee Assistance Program (CHFA), transferring the \$86 million current balance to the General Fund, and eliminating the final scheduled allocation of \$20 million in 2002-03. The LAO recommends redirecting these funds to more effective programs in their February analysis of the Proposed 2001-02 Budget.
- Transferring \$18 million of the \$50 million allocated to the Down Payment Assistance (CHFA) program to the General Fund, based on the assumption that CHFA will be unable to spend the full allocation in the current year.
- Eliminating the \$4 million increase proposed in the Predevelopment Loan Program (HCD).
- Eliminating the \$200,000 proposed increase for the Statewide Housing Plan and the \$50,000 augmentation for the Employee Housing Program.

In addition, the May Revision cuts \$5 million from the supportive housing program under the Department of Mental Health (DMH), leaving \$20.1 million. The May Revision retains the \$55.6 million proposed in January for Integrated Services for Homeless Adults (also under DMH).

## **HIGHER EDUCATION**

The May Revision reduces spending for the University of California (UC), California State University (CSU), and the California Community College (CCC) systems by a total of \$39 million. The May Revision includes \$244 million in cuts from January spending, \$210 million in augmentations, and \$5 million in savings and transfers. The augmentations are targeted almost entirely for natural gas and electricity costs and conservation programs in both the current and budget years.

The largest cuts are to the Partnership Agreement. As part of the 2000-01 Budget, UC and CSU agreed to a four-year partnership with the Governor in order to prepare for the expected “tidal wave” of enrollment in the coming decade. In the Partnership, the Governor agreed to provide UC and CSU with annual 4 percent base increases, plus annual one percent increases for shortfalls in areas such as building maintenance, instructional equipment, instructional technology, and libraries. In return, UC and CSU commit to meet accountability goals such as timely graduation, increased community college transfers, expanded teacher training, and continued collaboration with K-12 schools. The May Revise reduces the 4 percent base funding increase to 2 percent and eliminates the one percent increase for shortfalls.

Higher education reductions in the May Revise include:

- A net reduction of \$16.7 million for UC, reflecting \$113.4 million in augmentations, \$126.3 million in reductions, and \$3.8 million in savings and transfers. Augmentations include \$100.6 million for natural gas costs and conservation efforts in 2000-01 and 2001-02. Cuts include \$89.8 million from Partnership Agreement funding.
- A net reduction of \$58.8 million for CSU, reflecting \$34.1 million in increased spending for natural gas costs and conservation efforts in 2000-01 and 2001-02, \$92.2 million in reductions, and 0.7 million in savings. Cuts include \$70.2 million from Partnership Agreement funding.
- An increase of \$37 million for CCC in the budget year, \$4.6 million in the current year. Increased spending reflects \$62.4 million in augmentations and \$25.5 million in cuts to January proposals. Augmentations include \$49 million in one-time funds from the Proposition 98 Reversion Account to help colleges with natural gas and electricity costs and conservation efforts in 2000-01 and 2001-02. The \$4.6 million increase in 2000-01 funding reflects a General Fund backfill due to lower than anticipated local property tax collections.

The May Revise also reduces Student Aid Commission (Cal Grant program) spending by \$35 million in both 2000-01 and 2001-02 for a total of \$70 million, reflecting program savings due to factors such as “more students choosing lower cost public institutions.” Finally, the May Revise reduces spending for the Hastings School of Law by \$0.4 million, reflecting a reduction in Partnership Agreement funding.

## **LOCAL GOVERNMENT**

The May Revise reductions affecting local government include:

- Eliminating \$250 million in discretionary funding for local governments.
- Reducing technology grants to local law enforcement agencies from \$75 million to \$20 million.
- Eliminating the \$200 million augmentation for the Jobs-Housing Balance Improvement Program.
- Eliminating \$40 million for a touch screen voting project in three California counties.

## **OTHER**

- The May Revision transfers \$177 million in the Infrastructure Bank fund to the General Fund, stating that future lending by the bank could be financed by bonds backed by the Bank’s current loan portfolio.
- Benefit improvements in state employees’ retirement plans will increase 2001-02 General Fund costs by \$195.2 million, and rising health care costs will increase the cost of retiree benefits by \$32.4 million in 2001-02.

- The Governor proposes a 2.5 percent reduction (\$50 million) in operating appropriations for state agencies. The proposal exempts 24-hour care, public safety, higher education, and revenue producing departments.

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