

## An Overview of **THE GOVERNOR'S 2001-02 BUDGET PROPOSAL**

On Wednesday, January 10, 2001, Governor Davis unveiled his proposed budget for the 2001-02 fiscal year.

The budget is now in the hands of the Legislature to review, analyze, debate, revise, and return to the Governor. Assembly Bill 95 (Cardenas) and Senate Bill 75 (Peace) will serve as the budget bills for the Assembly and the Senate, respectively. Multiple "Trailer Bills" will also be introduced in both houses as vehicles for policy changes necessary to implement the final budget agreement.

The Governor's proposed 2001-02 budget reflects the California's strong growth in the current year, moderate growth in the budget year and corresponding economic increase in General Fund revenues that have outpaced previous projections. The proposed budget uses Department of Finance (DOF) projections that forecast General Fund revenues to increase by \$3.8 billion over the past and current budget years and to grow by \$2.54 billion, or 3.3 percent, in the budget year.

While General Fund revenues continue to grow, the growth has slowed from recent years when California's robust economy produced General Fund growth of 22.7 percent in 1999-00 and 6.9 percent in 2000-01. According to the Department of Finance, much of the recent surge in General Fund revenues resulted from extraordinary gains in the stock market. California taxpayers have realized capitol gains that have grown between 22 and 58 percent over the last five years. In addition, an increasing number of taxpayers receive stock option wage packages or receive income from Individual Retirement Accounts, which have benefited from gains in the stock market.

Revenues derived from capitol gains and stock options together contribute about 21 percent of the total General Fund. As recently as 1994-95, these two factors contributed less than five percent of the General Fund. With the increased importance of these two revenue sources and their dependence on the volatile stock market, the Governor's proposed budget forecast assumes the recent growth rates will not continue indefinitely.

The Governor's proposed expenditure plan includes significant one-time investments, on-going investments primarily in education initiatives, modest health access improvements, and various targeted tax cuts. In addition, the Governor's proposed budget meets all statutorily required obligations and most cost-of-living adjustments.

## **ECONOMIC OUTLOOK**

California's economy in 2000 continued its robust growth, significantly outpacing the strong national performance. Personal income rose more than 11 percent, the largest gain in 16 years, and non-farm employment increased 3.6 percent, the largest gain since 1985.

Though 2000 was a strong year for the California economy (as well as the national economy), the final weeks of the year revealed several troubling indicators for the national economy. According to the Department of Finance, retail sales declined, consumer confidence dropped, unemployment

claims rose from their near-record lows, factory orders declined, automakers cut back production, and California now faces an energy crisis.

While these factors could indicate significant economic concerns, most economic experts have concluded that the state's economy is now experiencing moderate growth that is healthy for long-term sustainment. In support of this, the Department of Finance points out that excluding auto sales, retail sales growth remains strong and that actions of the Federal Reserve have and can continue to respond to shifts in economic momentum.

The potential warning signs of the national economy have not been seen in the California economy. Job growth and retail sales have been particularly strong, and California continues to benefit economic growth in Mexico, Asia, and Europe with exports increasing by 21 percent in 2000.

Despite the continuing strength of California's economy, the Department of Finance projects that personal income growth will slow from 11.7 percent in 2000 to 5.7 percent in 2001 – based in part on the assumption that stock option values will decline by 10 percent.

In addition, the energy crisis poses a significant threat to the continued strength of California's economy. Not only does the interruption of energy services have severe impacts on households and businesses, final solutions to the crisis may require significant General Fund commitments.

## REVENUES

The Department of Finance forecasts General Fund revenues of \$79.4 billion for the budget year. This represents a 3.3 percent increase in revenues over the current year. Table 1 displays the composition of the General Fund.

Table 1

| <b>GENERAL FUND REVENUE</b>                     |                |                |                |
|---|----------------|----------------|----------------|
| <b>AS FORECAST BY THE DEPARTMENT OF FINANCE</b> |                |                |                |
| <b>1999-00 AND 2000-01</b>                      |                |                |                |
| <i>(Dollars in Billions)</i>                    |                |                |                |
|   | <b>1999-00</b> | <b>2000-01</b> | <b>2001-02</b> |
| Personal Income Tax (PIT)                       | \$39.6         | \$43.3         | \$44.8         |
| Sales and Use Tax                               | 21.1           | 22.0           | 23.4           |
| Bank and Corporation Tax                        | 6.6            | 6.9            | 6.9            |
| All Other                                       | 4.6            | 4.7            | 4.3            |
| Totals  | <b>\$71.9</b>  | <b>\$76.9</b>  | <b>\$79.4</b>  |
| Annual Percent Change                           | <b>22.7%</b>   | <b>6.9%</b>    | <b>3.3%</b>    |

**Proposed Reserves.** The Governor's proposed budget includes a General Fund reserve for economic uncertainties of \$1.9 billion, or 2.4 percent of total General Fund revenues. For the second year in a row, the Governor's proposed budget contains a prudent reserve. In the current year the Governor initially proposed a reserve of \$1.2 billion. Once enacted the Budget Act contained a reserve of \$1.8 billion (which has since grown to \$5.8 billion.)

Also for the second year in a row, the Governor's proposed budget includes a \$500 million set-aside for legal contingencies. Only \$7 million remains from the \$500 million set-aside for 2000-01.

**Targeted Tax Cuts.** The Governor's proposed budget includes a number of targeted tax initiatives that will reduce General Fund revenues by a total of \$108 million in 2001-02. (with increasing revenue reductions in subsequent years). The Governor's major new tax relief proposals are listed below:

- ◆ \$70 million to increase the manufactures' investment tax credit from six percent to seven percent and the budget also proposes to suspend the annual employment-growth test for continuing the credit until 2008.
- ◆ \$27 million for a one-time "back-to-school" sales tax "holiday" during the last three days of August 2001, during which purchases of apparel and footwear (costing up to \$200 per item) and computers (up to \$1,000) would be exempt from state and local sales taxes (subject to a local opt-out).
- ◆ Increase from 50 percent to 100 percent the capital gains exclusion for small business stock held five years or more, effective for stock purchased after January 1, 2001 (\$30 million annual cost beginning in 2006-07).
- ◆ \$6.3 million to expand the sales tax exemption for commercial "space launch" activities to include spaceport operations property and property used in assembly, launch or transport.
- ◆ \$3 million tax credits ranging from 20 percent to 80 percent of businesses' costs for employee transit passes.
- ◆ \$1 million for business tax credits of 50 percent of their cost to loan employees in public middle schools or high schools to teach math or science.
- ◆ \$500,000 to expand the sales tax exemption for new manufacturers to include software developers.

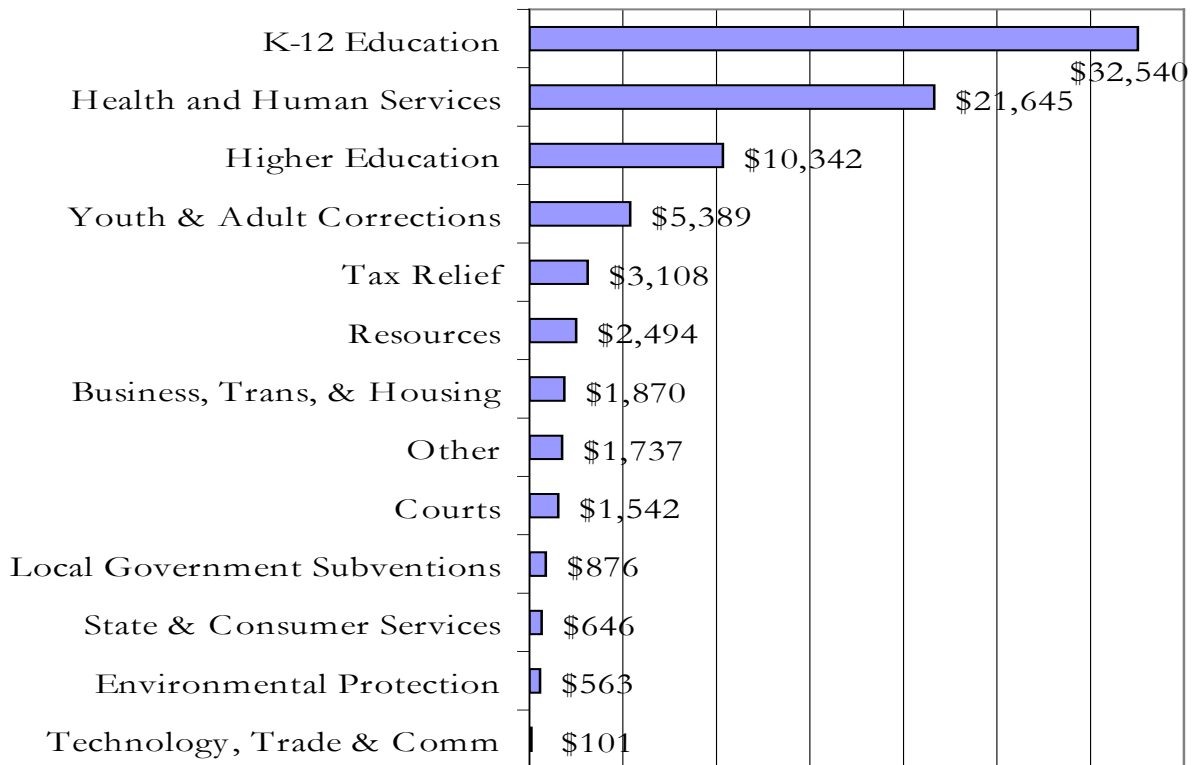
**Sales Tax Trigger.** The Governor's proposed budget reflects reduced revenues of \$553 million in the current year and \$630 million in the budget year as a result of the .25 percent reduction in the state sales tax rate (from five percent to 4.75 percent) that took effect January 1, 2001 and will remain in place for at least an entire calendar year. Under current law, when the General Fund surplus exceeds four percent of General Fund revenues during a two-year fiscal period, the "trigger" takes effect and the sales tax rate is reduced. The proposed budget contains a reserve of 2.4 percent, and should that level remain, then the "trigger" would again take effect and the sales tax rate will increase back to five percent. The proposed budget revenue forecast reflects this scenario.

## EXPENDITURES

The Governor's budget proposes to appropriate \$82.9 billion from the General Fund in 2001-02, an increase of \$3.2 billion over revised current year expenditures. Including General Fund, Special Funds and Bond Funds, the proposed budget contains expenditures of \$104.7 billion.

Of the General Fund expenditures, \$32.6 billion is proposed for K-12 education, 39.3 percent of the General Fund. Health and Human Services is proposed to receive \$21.6 billion, 26.1 percent of the General Fund. Higher Education (Community Colleges, the California State University, the University of California) is proposed to receive \$10.3 billion, 12.5 percent of the General Fund. Corrections, Courts, Business, Transportation and Housing, Tax Relief, State and Consumer Services, Environmental Protection and Resources are proposed to split the remaining 15 percent of the General Fund. Chart 1 graphs the Governor's budget proposal to display the relative appropriations in these major program areas.

2001-02 General Fund Expenditures  
(in Millions)



**Uncommitted General Fund Resources.** As a result of General Fund revenue growth projections outpacing the forecast used to implement the Budget Act of 2000, the Governor proposes \$5.5 billion in new expenditures, with the balance being proposed for reserves (\$2.4 billion) and new tax cuts (\$108 million). Of the funding for new expenditures, approximately \$2.2 billion is proposed for on-going expenditures – primarily education and Healthy Families increases. The balance of \$3.3 billion is proposed for various one-time investments, with the most significant of these being a \$1 billion set aside to address the current energy crisis. Table 4 lists proposed significant one-time investments.

Table 4

| <b>Key One-Time Program Expenditures<br/>In the 2001-02 Budget<br/>(In Millions)</b> |                |
|--|----------------|
| Energy initiatives set-aside   | \$1,000        |
| Capital outlay   | 772            |
| Local government fiscal relief   | 250            |
| New housing initiatives  | 220            |
| Diesel replacement   | 100            |
| Clean beaches  | 100            |
| Law enforcement technology grants  | 75             |
| Flood control subventions  | 74             |
| River parkway initiative   | 70             |
| Prison electromechanical doors   | 58             |
| Zero-emission vehicle subsidies  | 50             |
| Touch screen voting pilot project  | 40             |
| Other  | 505            |
| <b>Total</b>   | <b>\$3,314</b> |

Table 5

**Governor's Proposed Budget**  
**General Fund Spending by Major Program Area 2000-01 and 2001-02**

| (Dollars in Millions)                |                 |                 |                 |
|--------------------------------------|-----------------|-----------------|-----------------|
|                                      | <b>2000-01</b>  | <b>2001-02</b>  | <b>% Change</b> |
| K-12 Education                       | \$30,311        | \$32,540        | 7.4%            |
| Higher Education                     | 9,395           | 10,342          | 10.1            |
| Health and Welfare                   | 20,362          | 21,645          | 6.3             |
| Youth and Adult Corrections          | 5,181           | 5,389           | 4.0             |
| Resources                            | 2,040           | 2,494           | 22.3            |
| Environmental Protection             | 424             | 563             | 32.7            |
| General Government                   | 6,108           | 4,609           | -24.5           |
| Legislative, Judicial, Executive     | 2,669           | 2,654           | -.6             |
| State and Consumer Services          | 527             | 646             | 22.6            |
| Business, Transportation and Housing | 2,582           | 1,870           | -27.6           |
| Technology, Trade and Commerce       | 109             | 101             | -7.6            |
| <b>Total</b>                         | <b>\$79,708</b> | <b>\$82,853</b> | <b>3.9%</b>     |

Table 6

**GOVERNOR'S PROPOSED BUDGET**  
**ALL FUNDS SPENDING BY MAJOR PROGRAM AREA 2000-01 AND 2001-02**

| (Dollars in Millions)                |                     |                     |                  |                  |
|--------------------------------------|---------------------|---------------------|------------------|------------------|
|                                      | <b>General Fund</b> | <b>Special Fund</b> | <b>Bond Fund</b> | <b>Total</b>     |
| K-12 Education                       | \$32,540            | \$61                | \$863            | \$33,464         |
| Higher Education                     | 10,342              | 718                 | 556              | 11,616           |
| Health and Welfare                   | 21,645              | 5,024               | --               | 26,669           |
| Youth and Adult Corrections          | 5,389               | 19                  | --               | 5,408            |
| Resources                            | 2,494               | 1,049               | 740              | 4,283            |
| Environmental Protection             | 563                 | 615                 | 282              | 1,460            |
| Local Government Subventions         | 876                 | 4,624               | --               | 5,500            |
| Tax Relief                           | 3,108               | --                  | --               | 3,108            |
| State and Consumer Services          | 646                 | 531                 | 20               | 1,197            |
| Business, Transportation and Housing | 1,870               | 5,500               | 249              | 7,619            |
| Courts                               | 1,542               | 83                  | --               | 1,625            |
| Technology, Trade and Commerce       | 101                 | 7                   | --               | 108              |
| Other                                | 1,737               | 932                 | 1                | 2,670            |
| <b>Total</b>                         | <b>\$82,853</b>     | <b>\$19,163</b>     | <b>\$2,711</b>   | <b>\$104,727</b> |

Table 7

**2001-02 Governor's Budget  
General Fund  
Budget Summary  
(In Millions)**

|  | <b>2000-01</b>  | <b>2001-02</b>  |
|--|-----------------|-----------------|
| Prior Year Balance                         | \$9,366         | \$6,557         |
| Revenues and Transfers                     | \$76,899        | \$79,434        |
| <b>Total Resources Available</b>           | <b>\$86,265</b> | <b>\$85,991</b> |
| Expenditures                               | \$79,708        | \$82,853        |
| <b>Fund Balance</b>                        | <b>\$6,557</b>  | <b>\$3,138</b>  |
| <b>Budget Reserves and<br/>Set-asides:</b> |                 |                 |
| Reserve for Liquidation of<br>Encumbrances | \$701           | \$701           |
| Set-aside for Legal Contingencies          | \$7             | \$500           |
| Special Fund for Economic<br>Uncertainties | \$5,849         | \$1,937         |