Policy Brief
periodic analyses of issues before the Legislature

An Overview of the 1991-92 Governor's Budget

In order to provide the Legislature with a perspective on the 1991-92 Governor's Budget, we have prepared this brief overview. Our detailed analysis of the proposed budget will be released on February 27.

INTRODUCTION

Underlying structural budget problems and the onset of a national recession have combined to pose extremely difficult challenges for the 1991-92 state budget. The budget plan for the current year, adopted last summer, is now expected to leave the state with a large deficit on June 30, 1991. In addition, projected revenues for 1991-92 will fall far short of the level needed to both maintain current levels of services and restore the state's reserve fund.

The *1991-92 Governor's Budget* has as its most basic goal the resolution of the state's fiscal problems. It proposes increases in revenues to help fund state programs as well as reductions in existing state services in order to achieve this goal. It also contains a number of "prevention" proposals which are aimed at reducing the cost of existing services in future years.

The Governor's Budget provides a reasonable starting point for crafting a solution to the state's fiscal problems. However, whether the Governor's proposals are the best way to achieve this goal, versus other policy choices that will be considered in the coming months, is the key question facing state lawmakers in 1991.

This *Policy Brief* summarizes the nature of the state's budget gap in the absence of any corrective action, and the Governor's plan for bridging it. We also summarize the major proposals contained in the budget and provide our preliminary assessment of the extent to which the Governor's plan effectively addresses the budget gap for 1991-92 and in the longer term.

THE 1991-92 BUDGET PROBLEM

As has been typical of recent years, the 1991-92 budget must address not only the need to balance revenues and expenditures for the budget year, but also the imbalance that has arisen in the current year. According to the *administration's* calculations, the magnitude of this two-year fiscal problem amounts to $7 billion. This includes $1.9 billion to pay off the 1990-91 deficit, $3.7 billion to fund current levels of services in the budget year, and $1.4 billion to replenish the state's reserve fund. Our preliminary analysis suggests, however, that these estimates significantly *understate* the magnitude of the problem.

Specifically, as shown in Figure 1, we estimate that the total budget gap is closer to *$9.9 billion.* This includes $2.1 billion to pay off the 1990-91 deficit, $6.4 billion to fund current levels of services in the budget year, and $1.4 billion to replenish the state's reserve fund.

Why Do Our Estimates Differ?

Our figures differ from those of the administration primarily for three rea-

Figure 1

General Fund Budget Gap Preliminary LAO Estimates

(in billions)

1990-91 Budget Deficit		$2.1
1991-92:		
Base Expenditures	$48.1	
Base Revenues	41.7	
Difference		$6.4
Amount to Replenish Reserve		1.4
Two-Year Budget Gap		**$9.9**

sons.

First, the administration's estimate of 1991-92 General Fund revenues includes a special $1.2 billion "economic recovery adjustment." This adjustment reflects the administration's view that it is appropriate to anticipate certain events which would justify a more optimistic revenue outlook than implied by its economic forecast. We have excluded this upward adjustment on the basis of its relatively low probability and the fact that *the department's standard economic forecast already assumes a recovery in line with the consensus view of economists.*

Second, the administration's estimate of workload budget expenditures, such as AFDC costs, does not reflect the most recent trends in caseloads and unemployment, which we estimate will increase costs above the budgeted level by $300 million.

Third, our estimate of current services includes an additional $1 billion related to discretionary COLAs, Proposition 98 funding, and certain other factors.

The Gap's Cyclical and Structural Components

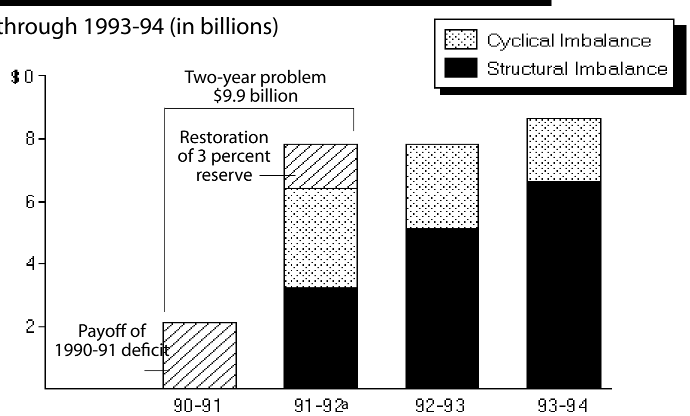
Our estimated $9.9 billion budget gap is the result of two fundamental factors. The first is the *current economic downturn,* which has the effect of depressing state revenue collections and increasing caseloads in state assistance programs. Because these effects should dissipate over time as the economy recovers, this part of the budget problem is *cyclical* in nature. The budget gap also reflects a substantial *structural* component, in that there is a significant imbalance between the levels of revenues and expenditures that would occur even in the absence of an economic downturn. Our estimates indicate that the $6.4 billion gap between revenues and expenditures for the 1991-92 fiscal year is almost equally attributable to these cyclical and structural factors.

Figure 2 shows our estimates of the budget gap, both for 1990-91 and 1991-92 as well as the following two years, including its cyclical and structural components. These estimates do not include any of the administration's budget proposals or any other corrective actions. They are based upon the budget's economic forecast for 1991 and 1992, our assumptions about economic performance in subsequent years, and our preliminary estimates of their associated revenue and expenditure levels. As this figure indicates, although the economy is assumed to strengthen by 1992 (see below), the *cyclical* imbalance still remains a factor in the out years. This is because of the time it takes to

Figure 2

Components of the State Budget Problem

1990-91 through 1993-94 (in billions)



[a] 1991-92 data reflect the second year effects of 1990-91 budget actions. These actions reduced expenditures and augmented revenues, thereby making the 1991-92 projected budget imbalance less than

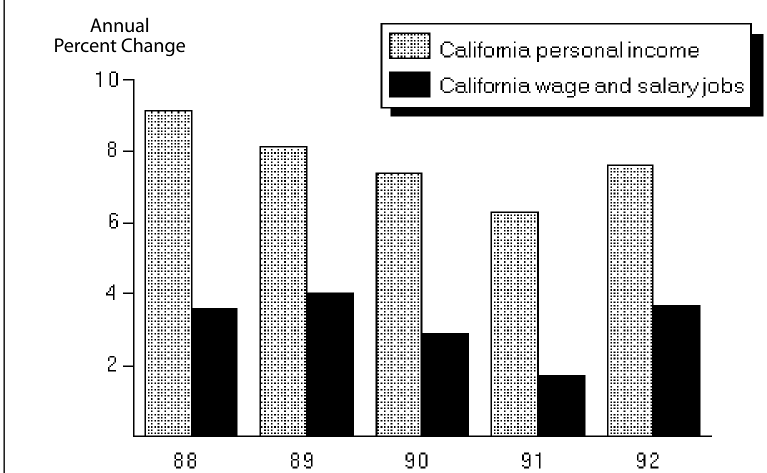
return to "normal" revenue levels, given the pace of economic recovery that most forecasters are assuming. *The structural component of the gap, however, is projected to increase substantially over time*, reflecting the continuing imbalance between annual revenues and expenditures. We now turn to an examination of these underlying trends.

The Economic Outlook

The Department of Finance's economic forecast assumes that the state will experience a brief and mild recession, with recovery beginning by the latter half of 1991. Figure 3 shows the projected growth rates in California personal income and employment which are reflected in this forecast. This forecast also assumes that a non-military resolution of the Persian Gulf crisis occurs by the spring of 1991, and that interest rates and oil prices will be declining through mid-1991. Beginning in 1992, it is assumed that the economy will return to a more normal pattern, with state personal income growth in the 8-percent range. This forecast is generally consistent with the consensus view of economists, although the situation in the Persian Gulf has obviously changed since the forecast was prepared.

Figure 3

The DOF Economic Forecast - Brief Recession Followed by Upturn



Source: 1991-92 Governor's Budget.

The Revenue Forecast

As shown in Figure 4, the budget forecasts General Fund revenue growth in 1991-92 totaling $5.3 billion, or 13 percent. This large increase is due primarily to a variety of revenue enhancements proposed in the budget, along with the optimistic $1.2 billion economic recovery revenue adjustment discussed earlier. The underlying rate of growth in revenues in the budget forecast is only 4 percent when these special factors are excluded, however, reflecting the forecast for generally slow economic growth. Our estimates of revenues beyond the budget year reflect a return to more-normal rates of growth in economic activity and underlying tax liabilities. In addition, these figures reflect none of the revenue proposals contained in the budget.

Figure 4

Components of General Fund Revenue Growth Anticipated in the 1991-92 Governor's Budget

(in billions)

Baseline Revenue Increase (Standard Economic Forecast)	$1.3
Additional Increase, Assuming Economic Recovery Adjustment	1.2
Accrual Accounting Proposal	1.7
Other Revenue Proposals[a]	0.8
[redacted]	

[a] Includes $400 million in withholding payments and $400 million from elimination or delay of certain tax expenditures.

Expenditure Growth Trends

Regarding expenditures, our estimates of the budget gap are based on

> ***"The Governor's proposals fall significantly short of eliminating the funding gap."***

calculations which attempt to measure the cost of providing 1990-91 levels of state services in 1991-92 and beyond. Thus, these calculations do not reflect the effect of the expenditure proposals contained in the Governor's Budget.

In the aggregate, we estimate that the cost of funding 1990-91 service levels amounts to $48.1 billion for 1991-92, an increase of 13 percent over 1990-91 expenditures (prior to the policy adjustments contained in the budget). Our estimates indicate that current services funding requirements will increase by 10 percent in both 1992-93 and 1993-94.

The Bottom Line

The state faces a multi-billion dollar funding gap in 1991-92 and beyond, *absent corrective action.* Although about half of the near-term funding gap may be ascribed to short-term cyclical factors, the underlying problem is predominantly structural. Dramatic action to either increase revenues and/or reduce expenditures on a continuing basis will be needed to permanently bring state revenues and expenditures into balance. In doing so, however, the consequences of both service reductions and tax increases need to be kept in mind.

WHAT DOES THE NEW BUDGET PROPOSE?

The *1991-92 Governor's Budget* contains a large number of major proposals to address the funding gap. Figure 5 shows that, in the aggregate, these proposals provide $5.4 billion in expenditure reductions and $3.1 billion in revenue enhancements. These proposals, combined with the added-on economic recovery revenue adjustment discussed earlier, total $9.7 billion. Thus, these proposals would have the effect of eliminating all but about $200 million of the $9.9 billion funding gap, and thus would leave the state budget in balance, but with a reserve slightly below the 3-percent target. Because the $1.2 billion economic recovery adjustment is unlikely to occur, however, the Governor's proposals fall significantly *short* of eliminating the funding gap. In fact, the state would be left with *no* reserve and a small *deficit* on June 30, 1992.

Specific Expenditure Proposals

The predominant themes of the *1991-92 Governor's Budget* have to do with correcting the budget's underlying structural problem and re-orienting certain state programs to focus on *prevention* of the social problems which in part are driving the state's fiscal problems. To these ends, the budget proposes the elimination or reduction of several specific state programs and the enhancement or creation of other programs thought to have preventive potential. In general, these program expansions are funded by redirecting resources from other existing programs. For example, the budget proposes to develop new public school programs to increase prevention-oriented services for children, and proposes that these efforts be funded by redirecting funds from other existing spending categories (primarily cost-of-living adjustments).

The budget's specific expenditure proposals to balance the budget are categorized in Figure 5 as follows:

Program Reductions. The budget proposes $5.0 billion in program funding reductions, including almost $700 million in current-year savings which are primarily due to reductions in Proposition 98-related education spending. Our estimate of budget-year Proposition 98 savings—$2.0 billion—is higher than the administration's $1.4 billion estimate. This is because our estimate of current service level requirements for 1991-92 is based on the amounts needed to fully fund Proposition 98—excluding the administration's proposal to reduce funding in

1990-91. The administration's estimate, in contrast, is based on the amount needed to fund the *reduced* current-year level of services in the budget year. Other major program reduction proposals include the suspension of cost-of-living adjustments ($0.4 billion), AFDC grant reductions ($0.2 billion), a reduction in the renters' tax credit ($0.2 billion), and reductions in support for higher education ($0.2 billion). The budget also achieves substantial savings by not funding normal cost increases (for example, price increases and merit salary adjustments) and through a variety of unallocated reductions in departmental budgets ($0.8 billion).

Funding Shifts. By shifting the responsibility for funding programs to other levels of government or to fees, the budget proposes to achieve savings of $1.2 billion in 1991-92. The major item in this area is the budget's "program realignment" proposal, which would shift existing state responsibilities for funding local mental health and public health programs to county governments. State taxes on alcoholic beverages and automobiles would be increased and dedicated to counties to assist them with these or other responsibilities. The budget also funds a portion of the increased costs of operating the University of California (UC), the California State University, and the Community Colleges by imposing a 20 percent student fee increase.

Cost Deferrals. The budget contains two proposals that would result in a deferral of $125 million of current costs to future years. The budget proposes that $55 million of 1991-92 UC expenditures be instead paid for in 1992-93, and that $70 million in current state costs for the Public Employee's Retirement System (PERS) be deferred by accelerating the recognition of investment earnings.

Partially offsetting these various expenditure reductions is an increase of about $900 million due to an accrual accounting change involving Medi-Cal expenditures.

Proposed Changes By Program Area

Figure 6 shows generally how most major program areas fare under the Governor's Budget proposals, relative to current services funding requirements. As these data indicate, Adult Corrections programs are the most fully funded, while all other major program areas face significant reductions from current state-supported service levels. The level of funding for health programs is reduced dramatically, reflecting primarily the impact of the Governor's proposal to shift the state's existing local mental health and public health services funding responsibilities to county governments.

Figure 5

Budget's Proposed Resolution of the 1991-92 Spending Gap[a]

(in billions)

Program Reductions	$5.0	
Funding Shifts	1.2	
Cost Deferrals	0.1	
Cost Increases	-0.9	
Total, Expenditure Changes		$5.4
Revenue Enhancements	$3.1	
Economic Recovery Adjustment	1.2	
Total, Revenue Changes		$4.3
Total		**$9.7**

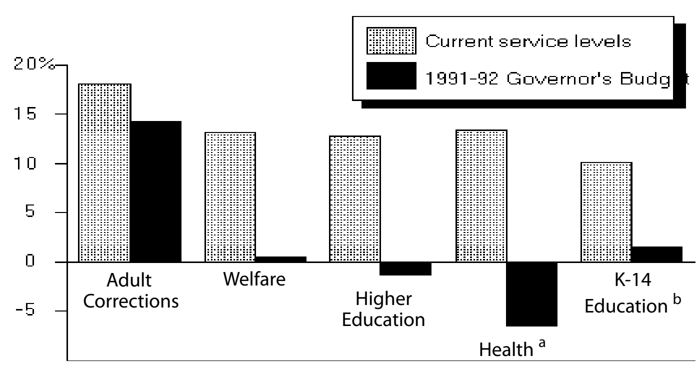
[a] Amounts reflect combined effect of 1990-91 and 1991-92 changes.

Revenue Enhancements

The $3.1 billion of revenue enhancements proposed by the budget include $2.8 billion in 1991-92. The major changes are summarized in Figure 7. As this

Figure 6

Expenditure Growth Rates by Program Area, Current Service Levels Versus Governor's Budget



[a] Reflects the Governor's program realignment proposal.
[b] 1991-92 Governor's Budget figure reflects proposed reductions in funding levels for 1990-91 and

figure shows:

- The bulk of this increased revenue ($1.7 billion) is attributable to a proposed change in state accounting practices, whereby revenue is to be recognized as it is *earned* instead of generally when cash is *received* by the state. Thus, this proposal does not result in an actual increase in the tax liabilities of state taxpayers, and it would have only a small impact in subsequent years.
- The budget also proposes that state income tax withholding requirements be extended to cover independent contractors, estates and trusts, and that withholding requirements be increased as they apply to certain "lump-sum" payments. These proposals would raise about $400 million in 1991-92, only part of which would be ongoing.
- The state sales tax would be applied to candy, snack foods, newspapers and periodicals to generate about $300 million in additional revenue. This gain would be ongoing.

Figure 7

Major Revenue Enhancement Proposals in the 1991-92 Governor's Budget

(in millions)

	1991-92 Amount
Accounting Practices	
Accrual Accounting	$1,702
Withholding Proposals	
Independent Contractors	290
Estates/Trusts	42
Lump-Sum Payments	80
Tax Expenditures	
Repeal Sales Tax Exemptions:	
Candy/Snack Foods	200
Newspapers/Periodicals	83
Delay Health Care Tax Credit	97

Figure 8 shows that, as was the case with the revenue changes adopted along with the 1990 Budget Act, the aggregate revenue impacts of the changes proposed in the budget would decline over time because of their one-time effects. In the case of the 1991 proposals, however, the one-time effects are particularly dominant. Thus, in effect, the budget relies on revenue changes primarily to address the *cyclical* (versus *structural)* portion of the budget problem, given that the long-term effect of these measures on state revenues is limited.

DOES THE BUDGET WORK?

The primary test of the desirability of the budget plan is the extent to which it can be relied upon to eliminate the budget funding gap, both in 1991-92 and for several years thereafter, while at the same time addressing the basic needs of Californians for public services.

Dealing With the Budget Gap

Figure 9 presents our estimates of the impact of the proposals contained in the budget on the budget funding gap from 1990-91 through 1993-94.

As noted earlier, *our analysis indicates that the proposed budget does not eliminate the budget funding gap for the 1990-91 fiscal year, and would leave the state with a small deficit and no reserve fund as of June 30, 1992.* This is primarily because we do not believe it is prudent to adopt the administration's optimistic premise that an additional $1.2 billion in revenue should be added to the revenue forecast. We also have identified several increased costs not addressed by the Governor's Budget, such as higher costs for public assistance stemming from the slowdown in the economy.

As Figure 9 indicates, the budget's proposals *do* make significant *headway* towards the elimination of the funding gap in the near term and reducing it in the longer term. It also indicates, however, that their effectiveness is expected to diminish over time, meaning that an underlying budget gap still will remain. In large part, this is attributable to the reduced level of ongoing revenue gains that result from the Governor's revenue proposals. However, it also reflects the budget's failure to deal fully with the underlying structural problems in the state budget. Although the budget makes some significant reductions in the levels of expenditures for state programs, these savings are not sufficient to permanently offset the increased costs of providing services to an ever-expanding population.

State Services

Another major consideration involved in assessing the budget's workability is whether its impact on state-supported services is acceptable. Among other things, the Legislature will need to evaluate the budget's proposal to substantially reduce funding for K-14 schools. Proposed levels of funding for both 1990-91 and 1991-92 are below the level of funding adopted in the 1990 Budget Act for the 1990-91 fiscal year. The Legislature will need to determine the impact that such reductions will have and whether they are acceptable. The same is true for such other major budget proposals as reductions in welfare grants, shifts of mental health and public health programs, reduced renters' credits, and funding for higher education.

Other Considerations

In assessing the budget's workability, the Legislature also must consider whether it provides adequate protection from economic and other types of uncertainties that could potentially affect state resources and spending requirements. In this regard, we note that the estimates of state revenues contained in the budget are subject to large dollar errors, even if the budget's economic forecast is basically correct. Given the substantial uncertainty over the course of events in the Middle East and the unknown duration and severity of the current economic downturn, these dollar error margins are considerably larger than normal.

State spending requirements also are subject to considerable uncertainty over the forecast period. Certainly, the budget's "prevention" proposals may result in savings beyond those reflected in our estimates, to the extent that they have a strong impact on the social problems

Figure 8

Fiscal Impact of 1990 and 1991 Revenue Adjustments

1990-91 through 1993-94 (in billions)

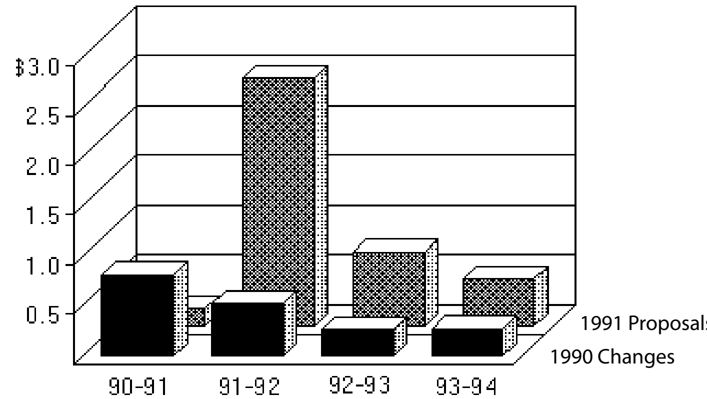
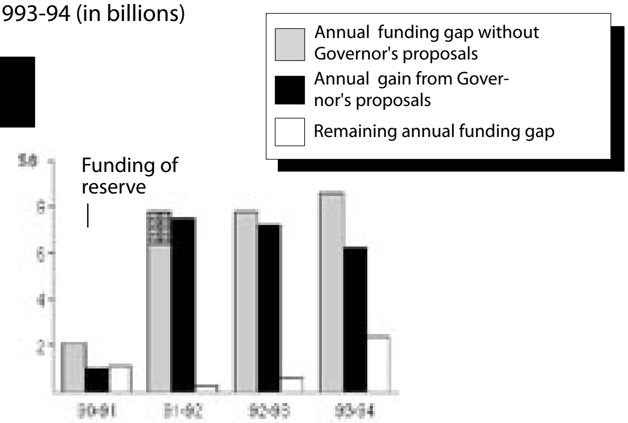


Figure 9

Impact of Governor's Budget Proposals on Budget Funding Gap[a]

1991-92 through 1993-94 (in billions)

Annual Funding Gaps



Year-End Deficits Assuming Governor's Proposals [b]

[a] Assumes that the $1.2 billion in economic recovery adjustment revenues included in the budget does not materialize.

they are intended to address. However, the budget also places great reliance on the use of unspecified reductions that may be restored as their impacts become apparent. Thus, there also is uncertainty as to whether these proposals can achieve the level of savings over the long-term that is reflected in our estimates of expenditures.

The other major source of uncertainty in our forecast is the potential impact of several outstanding lawsuits against the state in such areas as corporate taxation and indigent aid to counties. The combined impact of these lawsuits could exceed $7 billion initially, with substantial ongoing costs thereafter.

"Ultimately, the Legislature must agree on a plan that balances the need for state services with the need to address the state's underlying structural budget problem."

ARE THERE OTHER OPTIONS?

The plan proposed in the Governor's Budget is but one of a wide variety of alternative budget strategies available to the Legislature. For example, stategies could be developed that place a greater reliance on long-term revenue gains or a different set of reductions in state-supported services. All of these strategies, however, involve difficult decisions and impose burdens on those affected by them.

It is also important to note that the bulk of state spending is determined by existing federal, constitutional and statutory requirements. Thus, addressing the state's budget problems may necessitate modifying some of these requirements. Although the Legislature has only limited potential to change or limit the impact of federal requirements, it can seek voter approval of state constitutional changes and it can change existing statutory provisions where it believes such changes are necessary to effectively manage the budget.

The challenge for the Legislature in developing its budget strategy is to make the changes necessary for the state to best address the basic service needs of the population, while at the same time resolving the underlying budget gap.

CONCLUSION

The Governor's Budget offers *one approach* for addressing the budget problem and providing for the state's public service needs. This plan has within it much to commend, especially given the adverse fiscal situation facing the state budget. However, the Governor's plan also suffers from certain shortcomings that need to be addressed in order to make it workable. Most notable in this regard is its failure to fully address the budget funding gap. The budget also raises concerns regarding its impacts on health and welfare program users, schools, and other affected groups. As with the alternative strategies available to the Legislature, this plan will require the enactment of many pieces of legislation, and raises many important policy issues that will be difficult to resolve.

The Legislature faces an enormous task as it begins its deliberations on the 1991-92 Budget Bill. It must evaluate a wide range of potential budget strategies and determine their impacts on the achievement of state goals, as well as on the funding gap. Ultimately, it must agree upon a plan that balances the need for state services with the need to address the state's underlying structural budget problem. This problem, unless effectively addressed, will only become worse in the future. ❖

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