California Legislature

THE 1986-87 BUDGET: PERSPECTIVES AND ISSUES

Report of the Legislative Analyst to the Joint Legislative Budget Committee

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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1986 Budget Act. It seeks to accomplish this purpose by (1) providing *perspectives* on the state's fiscal condition and the budget proposed by the Governor for 1986–87 and (2) identifying some of the major *issues* facing the Legislature in 1986. As such, this document is intended to complement the *Analysis of the 1986–87 Budget Bill*, which contains our traditional item-by-item review of the Governor's Budget.

The *Analysis* continues to report the results of our detailed examination of all programs and activities funded in the Governor's Budget. It also contains our recommendations on the various amounts proposed in the Budget Bill, as well as our recommendations for changes in the statutory provisions governing individual programs and activities. In contrast, this document presents an analytical overview of the state's fiscal condition. The recommendations included herein generally cut across program or agency lines, and do not necessarily fall under the jurisdiction of a single fiscal subcommittee.

The 1986–87 Budget: Perspectives and Issues is divided into three parts.

Part One, "State Finances in 1986," provides a perspective on the state's current fiscal situation. Part One is divided into two sections:

- *Fiscal Situation Facing the Legislature,* which discusses the condition of the state's General Fund in 1985 and 1986, and
- *The Long-Term Fiscal Outlook,* which discusses the economic outlook for the state through 1988–89.

Part Two, "Perspectives on the 1986–87 Budget," presents data on the budget as a whole—expenditures, revenues and the fiscal condition of state and local governments—to provide a perspective on the budget issues that the Legislature will face in 1986. Part Two is divided into four sections:

- *Expenditures,* which details the total spending plan proposed for the state and highlights the major changes in program activities proposed by the Governor;
- *Revenues,* which discusses the various sources of income to the state, as well as the economic conditions that will influence the level of revenues in the current and budget year;
- *State and Local Borrowing,* which discusses the types and volume of borrowing being done by the state and local governments, as well as the factors, such as federal tax reform, which may affect borrowing levels in the future; and
- *The State's Work Force,* which analyzes the reasons for changes in the state's work force in 1986–87 and puts these changes in an historical context.

Part Three, "Major Fiscal Issues Facing the Legislature," discusses major issues that we believe warrant the Legislature's attention in 1986. This part is divided into two sections:

- *Revenue Issues,* which includes issues involving California's income tax system and the shortfall in the Motor Vehicle Account.
- *Expenditure Issues,* which includes issues dealing with the state's appropriations limit, the substantial growth in the population of the Department of the Youth Authority's facilities, and the rising cost of the state's prison system. This section also includes issues dealing with new prison construction, the financing of school facilities, the state's community-based long-term care system, and a cleanup strategy for hazardous waste sites. The section closes with a review of transportation programming, the increasing costs of tort liability, and management of the state's telecommunications system.

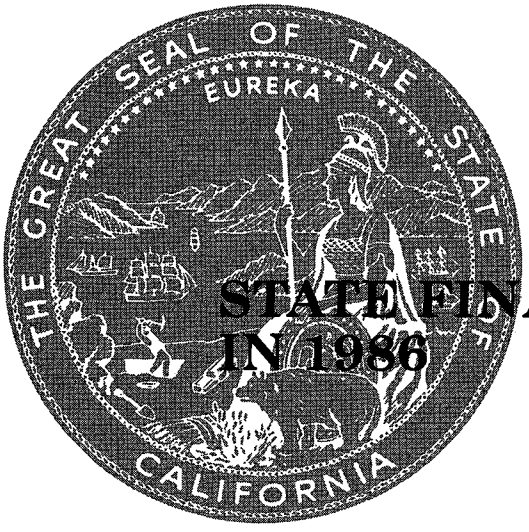
Part One

STATE FINANCES IN 1986

Fiscal Situation Facing the Legislature

The Long-Term Fiscal Outlook

Part One



STATE FINANCES IN 1986

The Governor's Budget for 1986–87 reflects the continuing expansion of the California economy as well as the need to provide for less-certain times. The budget provides for significant expansions in state-funded services, a modest expansion in the number of employees needed to provide those services, and the restoration of the state's "rainy day" fund.

In terms of purchasing power, the level of General Fund revenues is 4.1 percent *higher* than the level estimated for the current year. The level of General Fund expenditures proposed in the budget, however, is only 1.1 percent higher in inflation-adjusted (real) dollars than the level estimated for the current year. This is because (1) a substantial portion of the projected revenue growth must be used simply to fund *current* expenditures, and (2) the budget proposes to increase the balance in the state's reserve fund.

Even without these checks on expenditure growth, however, the state's ability to expend funds at a rate comparable to the growth in revenues would be limited in 1986–87 by the state's constitutional limitation on appropriations.

In this part, we provide a brief overview of the state's fiscal condition in 1985 and 1986. We also discuss the state's budgetary prospects beyond the upcoming year. A more detailed examination of revenues and expenditures appears in Part Two of this volume.

Fiscal Situation Facing the Legislature

Table 1 provides information on annual General Fund revenues, expenditures and the end-of-year balance, beginning with 1980–81. Trends in General Fund revenues and expenditures are illustrated in Chart 1.

The chart shows that General Fund revenues and expenditures have exhibited a fairly close relationship since 1983–84, when the state's large recession-caused deficit was eliminated. In the current year, the estimates indicate that expenditures will again exceed revenues. While this discrepancy is not of the same magnitude as in earlier years, it will cause a reduction of over $500 million in the state's Special Fund for Economic Uncertainties. If, however, the Governor's estimates of revenues and expenditures turn out to be accurate, revenues will *exceed* expenditures by $325 million in 1986–87.

According to the budget document, the Governor's spending program for 1986–87 would leave the General Fund with a positive balance of approximately $1.1 billion on June 30, 1987—up from about $800 million at the end of the current year. These funds would be retained in the Special Fund for Economic Uncertainties in order to protect the General Fund from unanticipated declines in revenues and unforeseen increases

Chart 1
Comparison of General Fund Revenues and Expenditures 1980–81 through 1986–87 (in billions)

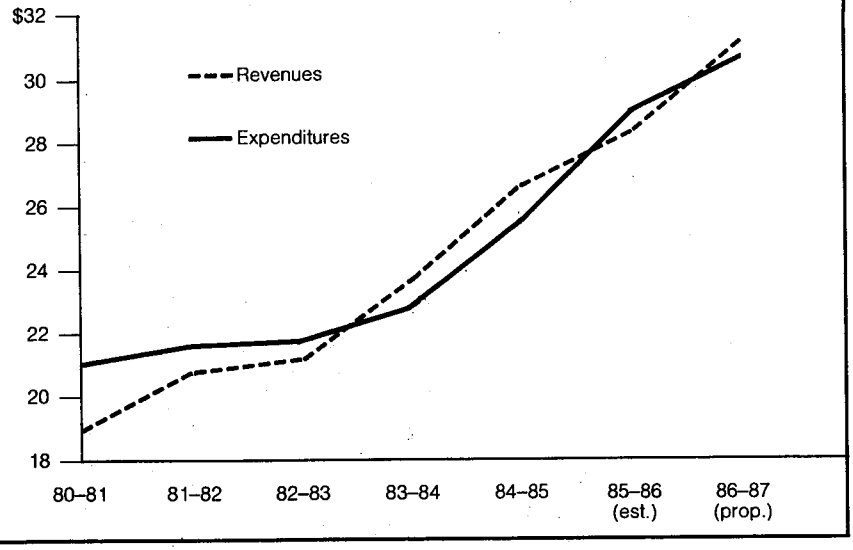


Table 1
Trend in General Fund Revenues, Expenditures and the Surplus [a, b]
1980–81 through 1986–87
(dollars in millions)

	1980–81	*1981–82*	*1982–83*	*1983–84*	*1984–85*	*1985–86* [c]	*1986–87* [c]
Prior-year resources	$2,540.7	$681.0	−$30.8	−$521.3	$490.6	$1,366.6	$843.3
Adjustments to prior-year resources	145.2	50.0	7.0	57.7	37.4	—	—
Prior-year resources, adjusted	$2,685.8	$730.9	−$23.9	−$463.6	$528.0	$1,366.6	$843.3
Revenues and transfers	$19,047.5	$20,920.6	$21,231.1	$23,822.1	$26,605.9	$28,186.6	$31,023.6
Expenditures	$21,052.3	$21,682.4	$21,728.6	$22,867.9	$25,767.3	$28,709.0	$30,698.9
(Difference)	(−2,004.8)	(−761.8)	(−497.5)	(954.2)	(838.6)	(−523.3)	(324.7)
(Expenditures from reserves)	(210.7)	(274.2)	(−29.3)	(24.1)	(−0.3)	(37.3)	(18.4)
(Annual surplus or deficit)	(−1,794.1)	(−487.6)	(−526.8)	(978.3)	(838.2)	(−486.0)	(343.1)
General Fund balance	$681.0	−$30.8	−$521.3	$490.6	$1,366.6	$843.3	$1,168.0
Carry-over reserves	(332.0)	(57.8)	(87.1)	(63.0)	(63.3)	(26.1)	(7.7)
Reserve for Los Angeles County Grant Account	—	—	—	(100.0)	—	—	—
Disaster Response-Operations Account	—	—	—	—	—	(20.0)	(20.0)
Special Fund for Economic Uncertainties	(349.0)	—	—	(327.6)	(1,303.2)	(797.2)	(1,140.3)

[a] Source: State Controller. The 1984–85 data represent the State Controller's January 1986 estimate of the 1984–85 final accrual-basis totals, but is subject to potential revision for final audit adjustments of the Auditor General.

[b] Details may not add to totals due to rounding.

[c] Source: Governor's Budget. Data for 1985–86 and 1986–87 are not strictly comparable with prior years due to Generally Accepted Accounting Principles (GAAP)—related adjustments reflected in the 1985–86 and 1986–87 budget data. General Fund balances in 1985–86 and subsequent years have been adjusted to reflect State Controller's January 1986 estimate of the 1984–85 General Fund balance.

in expenditures. Thus, the reserve serves a key purpose: by insulating the budget from adverse developments on the revenue and expenditure sides, it helps the state provide a continuous and more predictable level of services to its citizens.

General Fund Condition Deteriorates in 1985–86

Table 2 summarizes the changes in the condition of the General Fund that have taken place in the last year.

Table 2
Change in General Fund Condition
1984–85 and 1985–86
(dollars in millions) [a, b]

	Condition of the General Fund in 1984–85			*Condition of the General Fund in 1985–86, as Projected by Governor's Budget*		
	As Projected in Governor's Budget January 1985	*As Reported by State Controller January* [c] *1986*	*Effect on 1984–85 Surplus*	*January 1985*	*January 1986* [c]	*Effect on 1985–86 Surplus*
Beginning resources	$491	$528	$37	$985	$1,367	$382
Revenues and transfers	26,077	26,606	529	27,922	28,187	264
Expenditures	25,582	25,767	−185	27,864	28,710	−846
General Fund balance	$985	$1,367	$381	$1,043	$843	−$200
Reserves [d]	15	63	−48	3	46	−43
Unrestricted balance	$970	$1,303	$333	$1,040	$797	−$243

[a] Details may not add to totals due to rounding.
[b] Data for 1985–86 are not strictly comparable, due to GAAP-based budgeting changes reflected in the 1986–87 Governor's Budget.
[c] The 1984–85 data represent the State Controller's January 1986 estimate of the 1984–85 final accrual-basis totals, but is subject to potential revision for final audit adjustments of the Auditor General. The 1985–86 data have been adjusted to reflect the change in the 1984–85 General Fund balance indicated by the Controller's report.
[d] Includes unencumbered balance of continuing appropriations, and reserve for Disaster Response-Operations Account.

1984–85. Last year at this time, the Governor's Budget projected that the state would end the 1984–85 fiscal year with an unrestricted balance of $970 million in the General Fund. The Governor's Budget states that the balance is now expected to be $1,320 million. Based on the State Controller's preliminary figures, however, it appears that the actual balance will amount to $1,303 million, or $333 million more than what was estimated one year ago. The increase resulted entirely from higher-than-anticipated revenues.

As shown in Table 2, revenues and transfers in 1984–85 were $529 million higher than the amount predicted in last year's Governor's Budget. These increased revenues were due entirely to the performance of the state's economy.

The budget's estimate of expenditures in 1984–85 was much closer to the mark than the revenue estimate. Table 2 indicates that 1984–85 expenditures came in $185 million more than estimated six months earlier.

1985–86. The General Fund balance declined by a substantial amount in 1985–86, instead of increasing moderately as the Governor originally proposed. This large decline occurred *despite* two factors that tended to *increase* the balance:

- revenues are $264 million higher than estimated in January 1985, and
- the beginning General Fund balance was $382 million higher than originally anticipated.

Although Table 2 indicates that expenditures increased by $846 million, the actual increase was much larger—$1,140 million. The difference reflects certain accounting changes that mask the actual increase in spending. The higher-than-anticipated expenditures more than offset the upward adjustment in available resources, thereby reducing the year-end unrestricted balance by $243 million.

The increased revenues ($264 million) were attributable to the effects of a stronger-than-anticipated economy ($359 million), and legislation which expanded the state's external borrowing program ($81 million). These gains were partially offset by two accounting changes and legislation which transferred funds to the newly created Industrial Loan Fund for loan guarantees to a financial institution.

The increase in expenditures primarily reflects the additional expenditures approved by the Legislature and the Governor in the Budget Act ($273 million) and subsequent legislation ($571 million). The approval of deficiency requests, and the incorporation of revised estimates for other expenditure items, added $296 million to the expenditure total.

General Fund Condition for 1986–87

If the budget's estimates of revenues and expenditures for 1986–87 turn out to be accurate, revenues will exceed expenditures, and by a comfortable margin—$325 million. These excess funds would bring the balance in the Special Fund for Economic Uncertainties up to $1,140 million, or 3.7 percent of General Fund expenditures. As we discuss in Part Two of this volume, however, the budget's estimate of expenditures significantly understates the amount needed to provide the level of services proposed by the Governor. As a result, it is unlikely that the reserve balance can be increased to the level identified by the budget document, and may even decline further.

General Fund revenues are projected to increase by $2.8 billion, or 10 percent, in 1986–87. Because approximately $525 million of expenditures

in the current year are being funded from the reserve, only about $2.3 billion of the additional revenues will be available for increasing expenditures, reducing tax collections, or increasing the amount in the state's reserve fund.

The Governor's Budget proposes an increase in General Fund expenditures of almost $2 billion, or 6.9 percent, above the level of estimated expenditures in the current year. Consistent with past years, the largest increase is proposed for education, which would gain $1.4 billion, or 9.3 percent, in additional General Fund support. This includes increases of $1 billion (9.9 percent) for K–12 education and $48 million (12 percent) in contributions to the State Teachers' Retirement System, as well as increases for the University of California, the California State University, and the California Community Colleges of 8.5 percent, 7 percent, and 7 percent, respectively.

The Long-Term Fiscal Outlook

The condition of the General Fund beyond the budget year will depend on several factors—the level of services to be provided by the state, the level of state income (that is, revenues plus transfers), and the size of the reserve that the Legislature and the Governor decide to maintain.

The levels of income and expenditures beyond the budget year will be influenced by a variety of factors, including economic conditions, judicial decisions, ballot initiatives, and actions taken by the Legislature. The Legislature may, for example, enact legislation which changes tax rates or the definition of the tax base and thereby affects the level of revenue collections. It may also initiate new expenditure programs, modify existing programs, or transfer the responsibility for providing a particular service from one level of government to another. There is no way of predicting what the outcome of legislative actions in the future will be.

Another factor—one which has not played any significant role in the state budget process to date—will also help shape the level of expenditures in future years: the Constitutional limitation on appropriations that was approved by the voters as Proposition 4 in 1979.

In this section, we provide an *illustration* of what the condition of the General Fund would be in future years:

- if no law changes are made that significantly affect state income,
- if the economy behaves in line with the Department of Finance's projections, and
- if the state-funded services are maintained at the levels proposed in the Governor's Budget, adjusted for inflation and population growth.

General Fund Income

The most important factor determining state income in future years will be the economy's performance. Generally speaking, the state's revenue base appears to have sufficient "elasticity" to grow at a pace equal to, and probably slightly faster than, the rate of growth in California's personal income base—at least during normal years. From time to time, however, this relationship will break down. For example, when an economic slowdown occurs, corporate profits usually fall, and the percentage of income that consumers spend on taxable commodities can also decline. During economic expansions, the opposite usually occurs. Thus, on a year-to-year basis, the rate of growth in revenues, relative to the rate of growth in personal income, can vary considerably, depending on what the economy is doing.

It is not possible to predict with any confidence what the economy's performance will be beyond the next 18 months. Indeed, no economist can say with any certainty what will happen to the key economic variables

beyond the next several quarters—if that. This is partly because of the economy's sensitivity to external influences, such as unsettled conditions in the foreign trade sector, international debt problems, and pricing/output conditions in the world's crude oil market. Equally important are certain major policy decisions yet to be made by the U.S. Government, which will exert a strong influence on the economy. For example, the major cuts in federal expenditures contemplated by Congress in enacting the Gramm-Rudman-Hollings deficit reduction measure would certainly affect key economic variables, but these reductions could be superseded by action to raise taxes or reduce spending through more selective techniques.

Consequently, *any* estimate of General Fund revenues beyond 1986–87 depends heavily on what one *assumes* about the economy's performance beyond 1987.

The Governor's Budget contains a projection of General Fund revenues for 1987–88 and 1988–89. This projection is based on the Department of Finance's standard economic forecast for 1986 and 1987, which *assumes* that the economy will continue to expand at a "steady" pace through 1988 and 1989. That is, the department assumes that there is no recession in the cards for the state's economy for the foreseeable future. Should the department's assumptions prove to be correct, Table 3 shows that General Fund revenues would reach $34.2 billion in 1987–88 and $37.6 billion in 1988–89.

From our perspective, the department's projection of income to the General Fund is optimistic indeed. The economy has moved through the expansionary portion of the business cycle, and it is not clear whether or for how long continued economic expansion will take place. In fact, 85 percent of the nation's business economists expect a recession to begin sometime before 1988. This is not surprising since, even though economists have a poor record of forecasting recessions, the current expansion has already lasted longer than the average for postwar economic expansions. History suggests that periodic episodes of slow economic growth, though not always predictable, are to be expected. Given this, it seems reasonable to assume that at some point before the end of this decade, economic activity will slow from the current pace.

General Fund Expenditure Growth

The Governor's Budget proposes General Fund expenditures in 1986–87 of $30.7 billion. In order to estimate the amount that would be needed in future years to continue the level of state services proposed by the Governor, four adjustments must be made. First, certain "one-time" expenditures must be removed to reflect the fact that they are not part of the ongoing "base" budget. Second, the 1986–87 base must be adjusted to reflect the full-year costs of programs which are being "phased in" during the budget year. Third, the 1986–87 base must be increased to reflect the

funds needed to provide the level of services *proposed by the Governor.* (Our analysis indicates that the proposed budget underfunds the proposed level of services by approximately $384 million.)

Finally, the adjusted base for 1986–87 must be increased for population growth and inflation, so as to hold "real" per capita expenditures constant over time. We have done this, based on the assumption that inflation will average 6 percent per year and population growth will average 1.7 percent annually. The result is that estimated expenditures grow by about 7.8 percent per year. Table 3 shows that the amount of funding needed to support a constant level of "real" per capita expenditures is $33.5 billion in 1987–88 and $36.2 billion in 1988–89.

Table 3
Condition of the General Fund [a]
1986–87 through 1988–89
(dollars in millions)

	1986–87 [b]	*1987–88*	*1988–89*
Prior-year resources	$843	$1,168	$1,853
Income (as projected by DOF)	31,024	34,230 [c]	37,555 [c]
Expenditures	30,699	33,545 [d]	36,162 [d]
(Annual surplus)	(325)	(685)	(1,393)
Year-end General Fund balance:			
Carry-over reserves	28	28	28
Special Fund for Economic Uncertainties	1,140	1,825	3,218

[a] Details may not add to totals due to rounding.
[b] Source: Governor's Budget, adjusted to reflect the State Controller's estimate of the 1984–85 General Fund balance.
[c] Source: Governor's Budget.
[d] Assumes 1986–87 expenditures are adjusted to reflect inflation and population increases.

General Fund Condition

Table 3 shows what the condition of the General Fund would be in 1987–88 and 1988–89, given these income and expenditure assumptions. The table indicates that:

- On an annual basis, General Fund income would *exceed* General Fund expenditures by approximately $685 million in 1987–88 and $1.4 billion in 1988–89.
- The General Fund *balance*—that is, the total amount of unused funds "left over" at the end of the year—would rise from $1.1 billion at the end of the budget year to $3.2 billion at the end of 1988–89.

Thus, the expanding economy assumed by the Department of Finance would provide a considerable amount of resources for funding additional programs or tax relief.

Implications of the State's Appropriations Limit

The provisions of Article XIII B of the State Constitution, approved by the voters in 1979, set a "lid" on the amount of General and Special Fund

revenues which can be appropriated in a given year. The lid is increased each year by the product of the percentage change in population and either (a) the increase in the U.S. Consumer Price Index, or (b) the increase in California per capita personal income, whichever is lower. For 1986–87, this adjustment increases the state's limit by 5 percent.

Based on the Department of Finance's long-range projection for the state and national economies, it appears that the growth rate for the appropriations limit over the two years beyond the budget year will be substantially less than the rate of growth in General and Special Fund revenues. On this basis, it does *not* appear that the state could appropriate, for state purposes, all of the uncommitted resources identified in Table 3. This issue is discussed more fully in Part Three of this volume.

Part Two

PERSPECTIVES ON THE 1986-87 BUDGET

Expenditures in 1986-87

Revenues

State and Local Borrowing

The State's Work Force

Part Two

PERSPECTIVES ON THE 1986-87 BUDGET

This part of our analysis provides perspectives on the Governor's Budget for 1986–87. It consists of four major sections, as follows:

- ***Expenditures.*** This section presents an overview of the spending plan proposed in the Governor's Budget. It discusses the level of proposed expenditures, the major components of the budget, and the major program changes proposed in the budget. It also identifies some of the likely state expenditures that are not provided for in the budget.
- ***Revenues.*** This section provides a perspective on the state's economy in 1985, 1986, and 1987, and the outlook for the economy in succeeding years. It also includes an analysis of revenue collections in the prior, current, and budget years, and discusses how revenues would be affected by alternative assumptions about economic growth.
- ***State and Local Borrowing.*** This section focuses on the types and volume of borrowing conducted by the state and local governments. It also includes a brief review of certain borrowing-related policy issues that will influence the level of borrowing in the current and budget years.
- ***The State's Work Force.*** This section analyzes the reasons for changes in the state's work force in 1986–87. It also examines historical trends that account for the changes in state employment in recent years.

Expenditures in 1986–87

TOTAL STATE SPENDING PLAN

The Governor's Budget for 1986–87 proposes total expenditures of $62.5 billion. This amount includes:

- $36.7 billion in *state expenditures,* consisting of $30.7 billion from the General Fund, $5.5 billion from special funds, and $0.5 billion from selected bond funds;
- $14.7 billion in expenditures from *federal funds;* and
- $11 billion in expenditures from various *"nongovernmental cost"* funds, including funds established for retirement, working capital, revolving, public service enterprise, and other purposes.

Table 4
Total State Spending Plan [a]
1984–85 through 1986–87
(dollars in millions)

		Estimated 1985–86		*Proposed 1986–87*	
	Actual 1984–85	*Amount*	*Percent Change*	*Amount*	*Percent Change*
General Fund	$25,767.3[b]	$28,709.9	11.4%	$30,698.9	6.9%
Special funds	4,651.4	5,592.1	20.2	5,514.5	−1.4
Budget Expenditures	$30,418.7	$34,302.0	12.8%	$36,213.4	5.6%
Selected bond funds	588.4	1,580.8	168.7	525.4	−66.8
State Expenditures	$31,007.1	$35,882.7	15.7%	$36,738.9	2.4%
Federal funds	13,371.6	14,864.5	11.2	14,742.8	−0.8
Governmental Expenditures	$44,378.7	$50,747.3	14.4%	$51,481.7	1.4%
Nongovernmental cost funds	8,916.7	10,297.8	15.5	11,016.4	7.0
Total State Spending	$53,295.4	$61,045.1	14.5%	$62,498.1	2.4%

[a] Source: Governor's Budget. Details may not add to totals due to rounding.
[b] Source: State Controller.

Governmental Expenditures

The budget proposes expenditures from governmental funds—that is, total state spending less expenditures from nongovernmental cost funds—amounting to $51.5 billion in 1986–87. This represents a $734 million, or 1.4 percent increase from the current-year level. This increase is the net effect of a nearly $2 billion increase in General Fund expenditures, partially offset by a more than $1 billion decrease in selected bond fund expenditures.

Using this measure of expenditures, during 1986–87, the state will spend $1,950 for every man, woman and child in California, or $141 million per day.

State Expenditures

That portion of the state spending plan financed by state revenues deposited in the General Fund or state special funds is usually referred to as "state expenditures." As shown in Table 4, state expenditures are proposed to total $36.7 billion in 1986–87, which is 2.4 percent higher than state expenditures in the current year.

General Fund Expenditures

The budget proposes General Fund expenditures of $30.7 billion in 1986–87—nearly one-half of all expenditures that will occur under the state's auspices.

Chart 2

Annual Growth in General Fund Expenditures 1980–81 through 1986–87 (in billions)

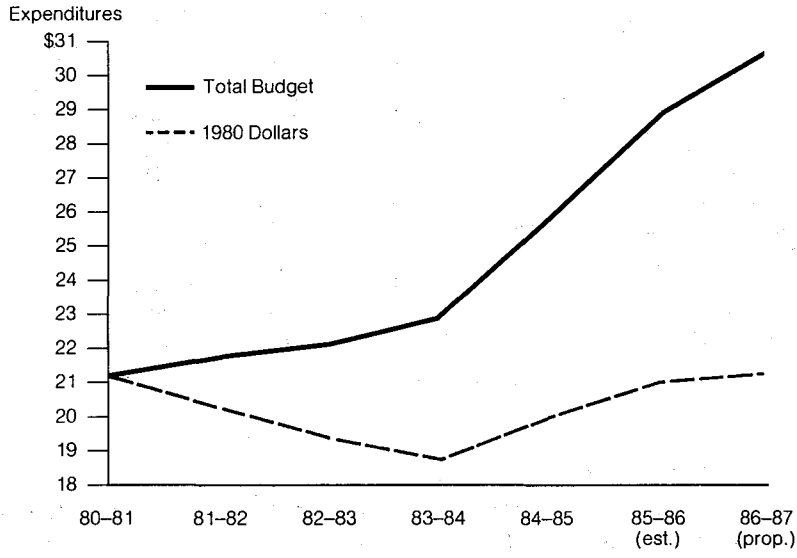


Chart 2 and Table 5 show the trend in General Fund expenditures since 1980–81. Chart 2 displays expenditures both on a "current dollar" and "real dollar" basis. Expenditures in "real dollars" represent expenditure levels as they appear in the budget (that is, "current dollars"), adjusted for the effects of inflation since 1980. Presenting the budget totals in terms of "real dollars" allows expenditure levels in different years to be compared on a common basis.

In current dollars, the proposed General Fund budget for 1986–87 is 46 percent greater than it was in 1980–81. In terms of "real dollars," however, the increase proposed in the General Fund budget is less than 1 percent.

As shown in Chart 2 and Table 5, between 1981–82 and 1983–84 total General Fund expenditures in "real dollars" actually *declined* at the rate of 3.5 percent per year, as the state experienced the effects of the nationwide recession. In 1984–85, however, "real" General Fund expenditures headed upward, in line with the expansion of the state's economy. For the past two years, total General Fund expenditure growth has averaged over 12 percent in current dollars and nearly 6 percent in real dollars.

Table 5
Annual Change in General Fund Expenditures
1980–81 through 1986–87
(dollars in millions)

	Total General Fund Budget [a]			
	"Current Dollars"		*"Real (1980) Dollars"*	
	Amount	*Change*	*Amount* [b]	*Change*
1980–81	$21,066	—	$21,066	—
1981–82	21,695	3.0%	20,129	−4.4%
1982–83	21,755	0.3	18,917	−6.0
1983–84	22,872	5.1	18,726	−1.0
1984–85	25,767	12.7	19,888	6.2
1985–86 estimated [c]	28,710	11.4	20,978	5.5
1986–87 proposed [c]	30,699	6.9	21,219	1.1

[a] Source: State Controller.
[b] "Real dollars" equal current dollars deflated to 1980–81 dollars using the Gross National Product implicit price deflator for state and local purchases of goods and services.
[c] Source: Governor's Budget. Data for these years is not strictly comparable to data for the prior years, due to the effect of two accounting changes reflected in the Governor's Budget.

The General Fund expenditures proposed for 1986–87 would continue the upward trend of real expenditure growth that began in 1984–85, but the rate of growth would be much slower. In current dollars, total General Fund expenditures proposed for 1986–87 are 6.9 percent greater than they are expected to be in the current year. This translates into an increase in purchasing power of 1.1 percent, based on an estimated inflation rate of 5.8 percent in the budget year.

The decrease in the rate at which General Fund expenditures are proposed to grow in the budget year primarily reflects the relationship between revenues and expenditures in the *current* year. In 1985–86, General Fund expenditures are expected to exceed revenues by over $500 million. This deficit is being funded by drawing down the Special Fund for Economic Uncertainties. In order to prevent further depletion of the state's reserves in 1986–87, a portion of the revenue growth which would otherwise be available to fund additional expenditures must instead be used to fund *existing* expenditures.

Federal Fund Expenditures

Federal fund expenditures account for almost one-third of the *governmental* expenditures (that is, total expenditures less nongovernmental cost and bond funds) which the Governor's Budget proposes for 1986–87. As Table 6 shows, federal funds have accounted for as much as 33 percent (1982–83) and as little as 29 percent (1986–87) of total governmental expenditures during the past seven years. Since 1982–83, however, federal expenditures as a percentage of total state expenditures have been declining. The level of federal expenditures anticipated in 1986–87—$14.7 billion—represents a decrease of $122 million, or 0.8 percent, below the estimated 1985–86 level.

Table 6
Federal Fund Expenditures as a Percent of Total State Expenditures [a]
1980–81 through 1986–87
(in millions)

	General Fund [b]	*Special Funds*	*Federal Funds*	*Totals*	*Federal Funds as Percent of Total*
1980–81	$21,066	$3,262	$10,248	$34,575	30%
1981–82	21,695	3,099	10,863	35,657	31
1982–83	21,755	3,180	12,255	37,190	33
1983–84	22,872	3,527	12,454	38,854	32
1984–85	25,767	4,651	13,372	43,790	31
1985–86	28,710	5,592	14,865	49,167	30
1986–87	30,699	5,515	14,743	50,957	29

[a] Excludes nongovernmental cost and bond funds. Details may not add to totals due to rounding.
[b] 1980–81 through 1984–85 data from State Controller.

Federal Escrow Funds. One factor accounts for the drop in federal expenditures that is anticipated between the current and budget years: the decline in expenditures of federal escrow funds. The budget estimates that the expenditure of these funds will be approximately $290 million in the current year and $83 million in the budget year.

The escrow funds are available to states pursuant to Section 8(g) of the federal Outer Continental Shelf Lands Act. The act requires that the federal government share with affected states the revenue that it receives from oil and gas development on federal submerged lands. To date, none of this money has been released to California. In the event these funds are not received, federal expenditures will be less than what is shown in the budget. More importantly, the failure of these funds to materialize would leave a large number of projects and activities underfunded. Undoubtedly, the Legislature would be asked to support these activities from other funding sources.

Table 7
Federal Funds Changes, By Program [a]
1985–86 and 1986–87
(in millions)

Program	Estimated 1985–86	Proposed 1986–87	Change Amount	Change Percent
Legislative/Judicial/Executive	$91	$53	−$38	−42.3%
State and Consumer Services	28	25	−3	−12.5
Business, Transportation and Housing	1,405	1,460	55	3.9
Resources	61	113	52	86.4
Health and Welfare	8,793	8,707	−86	−1.0
Youth/Adult Corrections	1	1	0	—
K–12 Education	1,198	1,100	−98	−8.2
Higher Education	2,630	2,774	144	5.5
Other Governmental Units/Services	657	510	−147	−22.4
Totals	$14,865	$14,743	−$122	−0.8%

[a] Details may not add to totals due to rounding.

While the projected decrease in total federal funding between the current and budget years is relatively small, the budget reflects several major increases and decreases in individual program areas. These changes are shown in Table 7.

The most significant reduction—$147 million in "other governmental units/services"—is primarily due to a $125 million decrease in the amount of federal 8(g) funds available for local streets and roads. During the current year, funds were appropriated for this purpose in Item 9675 of the 1985 Budget Act and by Ch 1600/85. The 1986 Budget Bill reverts these funds and instead proposes to borrow from the State Highway Account in order to finance the local streets and roads expenditures, pending the receipt of 8(g) monies.

Similarly, K–12 education shows a decrease of $98 million, primarily because escrow funds were appropriated for various child development, instructional materials, and school facilities purposes in the current year.

The decline in health and welfare expenditures largely reflects a $243 million decline in spending by the Employment Development Department. This amount consists of (1) a $179 million drop in Job Training Partnership Act funds reflecting the availability of carryover funds in the current year and (2) a $63 million decline in the unemployment insurance (UI) program as the result of an anticipated decline in the unemployment rate (from 6.8 percent in 1985–86 to 6.6 percent in 1986–87). This decrease is offset by increases in other health and welfare programs, including Medi-Cal and the disability evaluation and employment services programs in the Department of Social Services.

Table 7 also shows that two significant increases in federally funded expenditures are anticipated in the budget year. First, the amount of federal funding provided to the state's higher education segments is expected to go up. Most of this increase, however, will not go for education

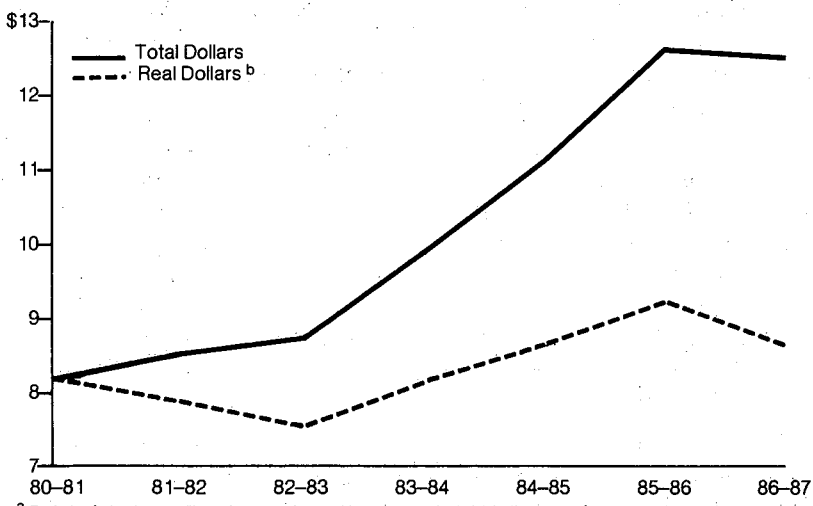
per se. Instead, it reflects a funding increase ($123 million) for the University of California's Department of Energy laboratories. Second, federal expenditures for resources programs are expected to nearly double in the budget year. This reflects the anticipated expenditure of nearly $70 million in federal 8(g) funds, which is partially offset by various decreases, including a decline in local assistance grants provided by the Department of Parks and Recreation.

Federal Aid Trends. The amount of federal aid to California has experienced expansions and contractions since 1980–81, as shown in Chart 3.

In order to give a truer picture of federal expenditures during the 1980s, we have adjusted total federal fund expenditures by the state to *exclude* expenditures of federal unemployment insurance funds. These expenditures have been unusually volatile, ranging from a low of $2.1 billion to a high of $3.5 billion during the period. Changes in UI expenditures primarily reflect changes in economic conditions, and thus tend to obscure the underlying trends in federal grants-in-aid to California.

In terms of "current dollars," adjusted federal expenditures have grown from $8.2 billion in 1980–81 to $12.5 billion in 1986–87, an increase of approximately 52 percent. This represents a 7.3 percent average annual rate of growth over the six-year period. When expressed in "real dollars," however, the level of federal aid (excluding unemployment insurance funds) anticipated in 1986–87 is only 6 percent more than the amount of federal aid actually received by the state in 1980–81.

Chart 3
Expenditures of Federal Aid Granted to the State of California[a]
1980–81 through 1986–87 (In billions)



[a] Excludes federal expenditures for unemployment insurance and administration
[b] "Real" dollars equal total dollars deflated to 1980–81 dollars using the GNP price deflator for state and local purchases of goods and services

Impact of the Gramm-Rudman-Hollings Amendment

Background. On December 12, 1985, the President signed the Gramm-Rudman-Hollings balanced budget amendment to the bill raising the nation's debt ceiling (Public Law 99-177). The amendment requires a balanced federal budget by federal fiscal year (FFY) 1991, and requires automatic across-the-board spending reductions if deficit targets are not met. Federal grants-in-aid to state and local government, with certain exceptions, are subject to these automatic provisions. Budget reductions made pursuant to the Gramm-Rudman-Hollings amendment must be distributed equally between defense and nondefense programs. A recent decision by a three-member panel on the constitutionality of the amendment, however, leaves its implementation status uncertain.

The Governor's Budget generally does not reflect the potential impact of the amendment.

Effects in 1986. The reduction procedures for FFY 1986 are different from those that will apply to subsequent years. This is because the amendment was enacted after the fiscal year was already underway. At the time this analysis was written, automatic spending reductions totaling $11.7 billion had been ordered. These cuts will go into effect automatically on March 1 unless Congress and the President take specific action to prevent this from happening. Table 8 lists 21 of the largest federal grant-in-aid programs in which California participates and shows the probable reduction for each one. It indicates that state and local governments in California are likely to lose $179 million in expenditure authority under these programs alone. Adding in reductions under other programs, the state stands to lose $263 million between now and September 30, 1986 (the last day of FFY 1986). Most of these programs would be reduced 4.3 percent below currently authorized levels.

While the state is the initial recipient of many of these grants-in-aid, much of the funding is passed on to local government in the form of local assistance. Thus, the real impact of these cuts will be felt primarily at the local level.

The effect of federal grant reductions may be mitigated somewhat to the extent that carryover money is available to support the currently authorized program level. There are strong indications, however, that the federal government will act to capture all or part of the carryover amounts before the state can use them. Several key state programs, such as Aid to Families with Dependent Children, Medi-Cal, and Food Stamps, are specifically exempt from the reductions called for by the Gramm-Rudman-Hollings amendment.

Table 8
Impact of Gramm-Rudman-Hollings on Selected State and Local Programs
Federal Fiscal Year 1986
(dollars in thousands)

Program	*Reduction in Budget Authority*
Community Development Block Grant	$13,600
Community Health	336
Community Services Block Grant	1,335
Compensatory Education	15,768
Energy Conservation Grants	402
Federal Aid Highways	46,777
Forest Service Revenues	1,531
General Revenue Sharing	20,471
Head Start	4,323
Health Block Grants	5,286
Job Training Partnership Act	11,731
Low Income Home Energy Assistance	4,627
Mass Transit	21,832
Migrant Health Centers	54
Mineral Leasing	1,666
Social Services Block Grant	12,412
Special Education	4,643
Urban Development Action Grants	249
Vocational & Adult Education	3,537
Wastewater Treatment Grants	7,523
Work Incentive Program	1,247
Total	$179,350

Source: Federal Funds Information for States, December 27, 1985, adjusted for Sequestration Report for Fiscal Year 1986 (Federal Register, January 15, 1986)

The reductions noted in Table 8 will have two immediate effects that the Legislature should recognize. First, under the state's funding formula for special education entitlements, the state is required to make up the difference between the amount of a school district's entitlements and the revenues it receives for this purpose from federal and local sources. Thus, the state will be required to make up most of the loss experienced by local special education programs as a result of Gramm-Rudman-Hollings. We estimate that this will cost the state about $3.5 million. Second, California currently budgets most of its Social Services Block Grant funds to support the In-Home Supportive Services (IHSS) program. A reduction of $12.4 million in federal funds in 1985–86, as called for by Gramm-Rudman-Hollings, would increase the current-year deficit in the IHSS program from $23.3 million to $35.7 million. The state could reduce the impact on the program by backfilling with state and county funds, reducing services as authorized by state law, or deferring the federal funds reduction until 1986–87.

Effects in 1987. The implications of Gramm-Rudman-Hollings for California in 1987 are far less certain, for three reasons.

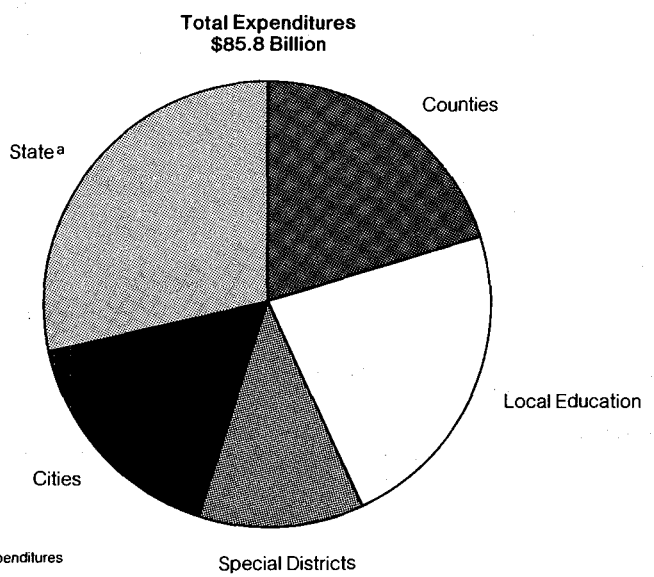
- The cuts required by the amendment will be considerably larger in 1987 than in 1986.
- These cuts will be more difficult to make because the base level of program activity in many areas will already be reduced as a result of the 1986 reductions.
- The President and the Congress may opt to stave off, or blunt the effect of the amendment in developing the 1987 federal budget.

The latest estimate of the reduction that Gramm-Rudman-Hollings will require in 1987 is $38 billion. This would require cuts in both defense and nonexempt domestic programs of $19 billion. While it is very difficult to speculate on the magnitude of the cut that California would experience in 1987 if action is taken to reduce the federal deficit, one thing is for sure. The Legislature will need a healthy reserve in the budget year in order to keep its options open when the new round of cuts takes place.

Total State and Local Government Spending in California

Local governments are also a significant contributor to public sector spending in California. Because local agencies receive a substantial portion of their resources from the state, however, their expenditures cannot simply be added to those of the state in order to determine aggregate government spending. Instead, state expenditures that go to local government agencies must first be subtracted from the state totals, to avoid double-counting.

Chart 4
Total State and Local Government Expenditures 1985–86



[a] Net state expenditures

Local government expenditures consist of expenditures by four types of local jurisdictions: counties, cities, special districts and local education (K–14). The local education category includes expenditures for elementary and secondary schools (K–12), county offices of education, regional occupation centers and community colleges.

Chart 4 displays 1985–86 expenditures by each governmental category as a portion of total state and local government expenditures. It shows that net state spending accounts for slightly more than one quarter of total state and local expenditures in the current year.

In the current year, expenditures for all services provided by state and local governments in California are expected to total approximately $86 billion. This amount consists of approximately $25 billion in net state expenditures (that is, state expenditures net of funds provided to local governments) and approximately $61 billion in local expenditures. These figures *include* federal funds expended by state and local governments, and *exclude* expenditures from bond proceeds and nongovernmental cost funds.

The fact that *net* state spending—$24.6 billion—amounts to only half of what the state spends from governmental sources ($49.2 billion) is impressive evidence of how much "state money" actually is spent at the local level. These state funds, which total $24.6 billion in the current year, show

Table 9
Estimated Total State and Local Government Expenditures [a]
1983–84 through 1985–86
(dollars in millions)

	1983–84		*1984–85*		*1985–86*	
Governmental Entity	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*
Counties	$14,887	21.6%	$16,535	21.1%	$17,567	20.4%
Cities	11,415	16.6	13,150	16.8	14,149	16.4
Special Districts	7,954	11.6	8,948	11.4	10,067	11.7
Local Education [b]	15,274	22.2	17,475	22.3	19,755	22.9
Subtotal, Local Government	($49,530)	(72.0%)	($56,108)	(71.6%)	($61,358)	(71.2%)
State [b]	38,851	—	44,003	—	49,395	—
Less: Amount expended by local governments	−19,548	—	−21,781	—	−24,555	—
Subtotal, State (net)	($19,303)	(28.0%)	($22,205)	(22.3%)	($24,840)	(28.8%)
Totals, state and local expenditures	$68,833	100.0%	$78,313	100.0%	$86,198	100.0%

[a] Local government expenditure data for 1983–84 are from State Controller's Report on Financial Transactions. Figures for 1984–85 and 1985–86 represent Legislative Analyst's office estimates. All data include enterprise fund transactions. State government and local education data are taken from Governor's Budgets. Details may not add to totals due to rounding.

[b] Includes spending attributable to state lottery operations, including administrative expenses.

up as local government spending in Table 9. About one-half of this amount is state aid to local school districts ($12.1 billion).

Table 9 provides a perspective on government sector spending in California over the past three years. It shows that the relative share of total state and local government expenditures accounted for by the state and each of the four types of local jurisdictions has remained virtually unchanged.

TAX EXPENDITURES

In addition to the $36.7 billion in total state funds which the Governor's Budget requests for *direct* expenditure programs in 1986–87, the budget also proposes approximately $14.9 billion of *indirect* spending in the form of "tax expenditures."

These tax expenditures result from various tax exclusions, exemptions, preferential tax rates, credits, and deferrals, which reduce the amount of revenue collected from the state's "basic" tax structure—that is, the overall system of taxation, including those provisions, such as personal exemption credits under the personal income tax, which have general applicability. Thus, "tax expenditures" include those special provisions of the tax code which are used to achieve social policy goals or provide tax relief.

In terms of the state's overall fiscal condition, the fact that these monies are indirectly spent using the tax system as a distribution mechanism makes then no less "expenditures" than the funds which pass through the appropriation process. Thus, tax expenditures are appropriately viewed as part of the Governor's overall spending plan.

Table 10 shows the Department of Finance's estimate of state tax expenditures in 1986–87. The table distinguishes between "general" and "special" tax expenditures. General tax expenditures are deductions or exclusions which are widely available and can be considered part of the state's basic tax structure. Special tax expenditures are more narrowly focused deductions or exclusions that are only available to specific groups of taxpayers.

The table indicates that tax expenditures are expected to total $14.9 billion in 1986–87. The largest single category of these expenditures, expected to total $10.7 billion in 1986–87, includes the various exemptions, deductions, and credits permitted under the personal income tax. Over 60 percent of this amount represents "special" tax expenditures, the largest of which is the nontaxability of employer contributions to pension plans ($1.9 billion). The deductibility of mortgage interest expense ($1.4 billion) and the exemption from the sales tax of food consumed at home ($1.4 billion) are the two other largest tax expenditures. They are considered general tax expenditures because they are widely available and used by most taxpayers.

The Department of Finance plans on excluding general tax expenditures from consideration in future tax expenditure reports. The department maintains that the general tax expenditures should be considered part of the basic tax structure for most Californians. While we agree with the distinction, we question whether the action proposed by the department is consistent with the statute which requires the report. Specifically, Ch 268/84 requires, among other things, that the department's report provide a *comprehensive* list of tax expenditures. Exclusion of general tax expenditures would provide the Legislature with a less-than-comprehensive picture of the expenditures made through the tax system.

Table 10
State Tax Expenditures [a]
1986–87
(dollars in millions)

Tax Expenditure Category	*Amount*		
	General	*Special*	*Total*
Personal income tax	$3,955	$6,781	$10,736
Sales and use tax	2,741	837	3,578
Bank and corporation tax	390	45	435
Motor vehicle fuel taxes	—	65	65
Other taxes	—	109	109
Totals, all categories	$7,086	$7,837	$14,923

[a] Source: Governor's Budget.

CONTROLLING EXPENDITURES

Control Through the Constitution

On November 6, 1979, California voters approved Proposition 4, the "Spirit of 13" Initiative. Proposition 4, which placed Article XIII B in the California Constitution, has three main provisions:

- It places a limit on the year-to-year growth in tax-supported appropriations by the state and individual local governments;
- It precludes the state and local governments from retaining surplus funds—any *unappropriated* balances at the end of a fiscal year must be returned to taxpayers within a two-year period; and
- It requires the state to reimburse local government for the cost of certain mandates.

Impact of Article XIII B in 1986–87. Table 11 shows what the Department of Finance estimates the state's appropriations limit under Article XIII B to be, as well as total appropriations subject to limitation, for 1984–85, 1985–86, and 1986–87. It also shows our estimates of both the limit and the appropriations that are subject to it for 1986–87. The department estimates that if the Governor's Budget is approved, the state would be $100 million *below* its limit for 1986–87. Our analysis indicates that the Governor's Budget, as submitted, calls for appropriations that *exceed* the appropriations limit by $238 million.

Table 11
Impact of Article XIII B on the State [a]
1984–85 through 1986–87
(dollars in millions)

	1984–85	1985–86	1986–87 Department of Finance	1986–87 Legislative Analyst
Appropriations limit	$21,740	$23,030	$24,205	$24,134
Appropriations subject to limitation	20,822	22,154	24,105	24,372
Amount under the limit	$918	$876	$100	−$238

[a] Source: Governor's Budget and Legislative Analyst's office.

In each of the years since the voters approved Article XIII B in 1979, there has been a large gap between the limit and appropriations subject to limitation. This has been the case for two reasons. First, the state appropriated more funds in the base year (1978–79) than it took in as tax revenue. Thus, under existing tax laws, the state was not in a position to continue spending up to its limit until revenues caught up. Second, during the early 1980s high rates of inflation caused the limit to rise rapidly, while the recession which began in 1981–82 restrained the growth in the state's tax revenues. Thus, during these years, the growth in the limit exceeded the state's ability to increase its expenditures.

The budget year marks the first year in which the state's appropriations limit will impose a constraint on state spending. Consequently, California has entered a new era of governmental finance. This issue is discussed more fully in Part Three of this volume.

Prediction or Plan?

It should be noted that the budget estimates are not *predictions* of how much ultimately will be spent in 1986–87, although these estimates reflect countless predictions about expenditure rates and other factors that are in part outside of the state's control. Rather, the budget estimates reflect the *Governor's fiscal plan*—that is, what he thinks expenditures *ought* to be, given all of those factors that the state can and cannot control. It is certain that, between now and June 30, 1987, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, court orders, and many other factors. Thus, as in past years, actual revenues and expenditures may be vastly different from the estimates contained in the Governor's Budget.

Budgeted Versus Actual Expenditures

The expenditure program proposed in the Governor's Budget invariably is changed during the 18 months following submission of the budget. Table 12 compares the original estimates of General Fund expenditures with actual expenditures during the past six years.

Table 12
Proposed and Actual General Fund Expenditures
1980–81 through 1985–86
(dollars in millions)

	Budget as Submitted[a]	*Actual Expenditures*[b]	*Change*[c]	
			Amount	*Percent*
1980–81	$20,684	$21,066	$382	1.8%
1981–82	20,770	21,695	925	4.5
1982–83	23,203	21,755	−1,448	−6.2
1983–84	21,677	22,872	1,195	5.5
1984–85	25,076	25,767	691	2.8
1985–86	27,864	28,820[a, d]	956	3.4

[a] Source: Governor's Budget.
[b] Source: State Controller.
[c] Details may not add to totals due to rounding.
[d] Adjusted to eliminate effect of accounting changes.

As Table 12 shows, actual expenditures exceeded the amounts originally proposed by the Governor in five of the last six years—usually by substantial margins. Only once during this six-year period—in 1982–83—was the actual amount spent *less* than the amount initially proposed for expenditure. The large decrease in the budget for 1982–83—$1.4 billion—primarily reflects the severe recession that began in 1981. Revenues in that year were well below the level projected in the Governor's Budget, making it necessary for the Legislature to make large cuts in expenditures in order to minimize the end-of-year deficit.

In the current year, actual expenditures are expected to exceed the amount originally proposed in the Governor's Budget by $956 million. As a result, General Fund expenditures will exceed General Fund revenues by approximately $523 million—making 1985–86 the first year since 1982–83 in which the General Fund has run a deficit.

MAJOR COMPONENTS OF THE STATE BUDGET

State expenditures traditionally are divided into three categories within the budget: state operations, capital outlay, and local assistance. Table 13 presents the distribution of General Fund and special fund expenditures among these categories for the past, current, and budget years.

As Chart 5 shows, state operations make up 25 percent of total General Fund expenditures in the budget year, while local assistance, as defined in the Governor's Budget, makes up 75 percent.

Table 13
General Fund and Special Fund Expenditures, by Function [a]
1984–85 through 1986–87
(dollars in millions)

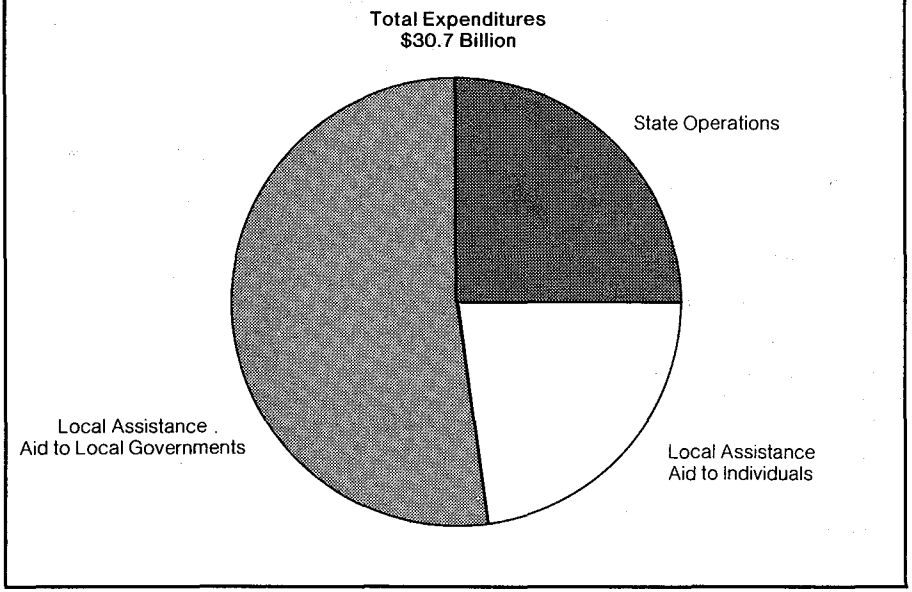
		Estimated 1985–86		*Proposed 1986–87*	
General Fund	*Actual 1984–85*	*Amount*	*Percent change*	*Amount*	*Percent Change*
State operations	$5,795.7	$7,103.8	22.6%	$7,666.0	7.9%
Capital outlay	9.2	79.3	—	0	—[b]
Local assistance	19,962.4	21,526.8	7.8	23,032.7	7.0
Aid to individuals	(5,987.0)	(6,688.0)	11.7	(6,991.0)	4.5
Aid to local governments	(13,975.4)	(14,839.0)	6.2	(16,042.0)	8.1
Unclassified	—	—	—	—	—
Totals [c]	$25,767.3	$28,709.9	11.4%	$30,698.7	6.9%
Special Funds					
State operations	$2,008.6	$2,328.8	15.9%	$2,473.8	6.2%
Capital outlay	281.8	561.1	99.1	458.9	−18.2
Local assistance	2,349.8	2,690.5	14.5	2,570.3	4.5
Unclassified	11.8	11.6	—	11.6	—[b]
Totals [c]	$4,651.5	$5,592.0	20.2%	$5,514.6	−1.4%

[a] Source: Governor's Budget.
[b] Percentage change equals or exceeds 100 percent.
[c] Details may not add to totals due to rounding.

State Operations

The budget proposes an increase from the General Fund of $562 million, or 7.9 percent, for state operations in 1986–87. As shown in Chart 6, General Fund expenditures proposed for state operations in 1986–87 are $3.4 billion, or 79 percent, above what they were six years ago (1980–81). When adjusted for inflation, however, expenditures for state operations have increased by only $1 billion, or 24 percent, during this period.

Chart 5
1986–87 General Fund Budget Structure



Capital Outlay

The budget proposes no General Fund expenditures for capital outlay in 1986–87. General Fund capital outlay expenditures over the past 10 years have fluctuated between zero and $151 million (in 1979–80).

Local Assistance

As illustrated in Chart 6, the budget proposes General Fund expenditures for local assistance in 1986–87 that are $6.3 billion, or 37 percent, higher than what they were six years ago (1980–81).

Table 13 displays local assistance expenditures by funding source. It shows that the Governor's Budget proposes an overall increase of $1.4 billion, or 5.7 percent, in General Fund support for this category of expenditures.

Aid to Individuals Versus Aid to Local Governments

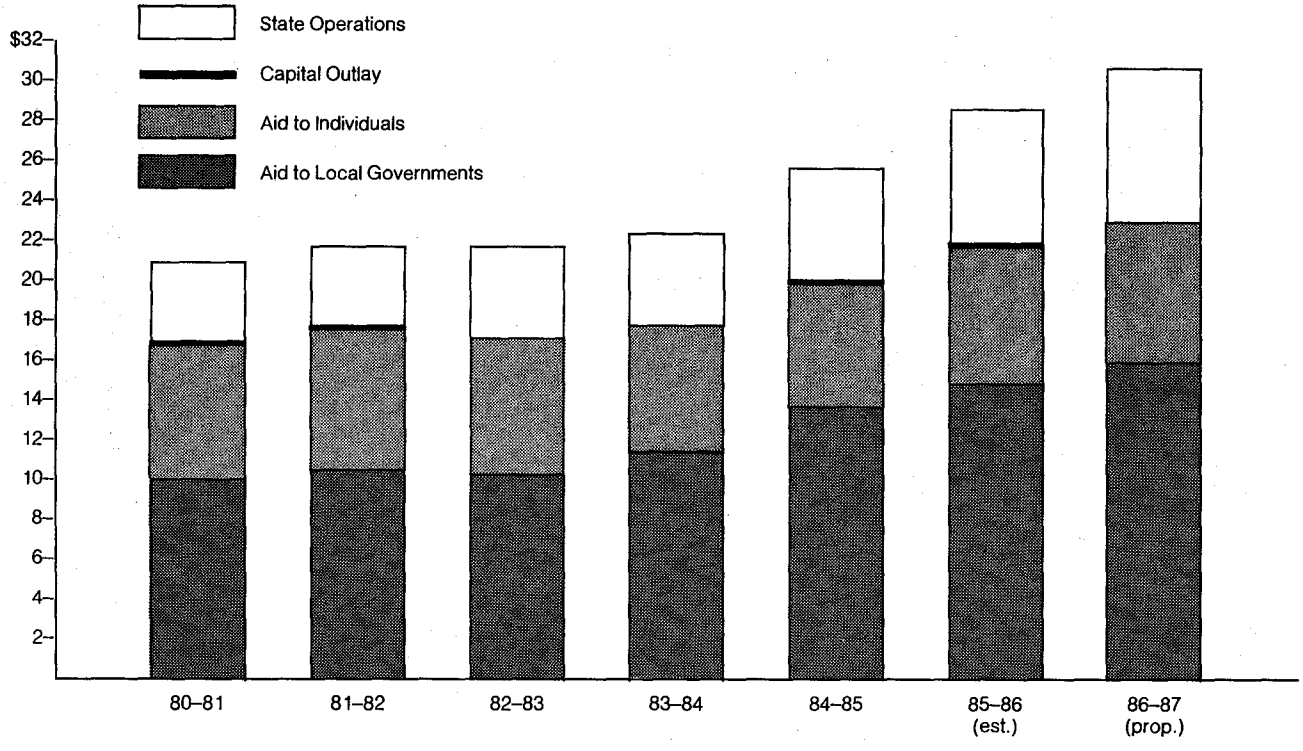
Local assistance, as the term is used in the budget, encompasses a wide variety of programs. Some of these programs do not provide assistance to local government agencies; instead, they provide assistance to individuals. Such payments may be made directly to individuals, as in the case of the Renters' Tax Relief program, or through an intermediary, such as the federal or county governments. Among the programs which make payments through intermediaries are Supplemental Security Income/State Supplementary Program (SSI/SSP), which is administered by the federal government, and Aid to Families with Dependent Children (AFDC), which is administered by county governments.

Table 14
Major General Fund-Supported Local Assistance Programs Providing Aid to Individuals 1984–85 through 1986–87 (dollars in millions)

	Actual 1984–85	*Estimated 1985–86*	*Governor's Budget 1986–87*
Medi-Cal [a]	$1,949	$2,221	$2,276
AFDC [b]	1,592	1,829	1,834
SSI/SSP	1,249	1,411	1,592
Developmental Services	352	374	424
Renters' Tax Relief	446	460	475
Homeowner Property Tax Relief	332	335	336
Senior Citizen Renters' Tax Relief	33	29	26
Senior Citizens' Property Tax Assistance	8	6	5
Senior Citizens' Property Tax Postponement	7	9	9
Subventions for Open Space	14	14	14
Payment to Local Governments for Sales and Property Tax Losses	5	0	0
Totals [c]	$5,987	$6,688	$6,991

[a] Excludes county administration.
[b] Grant payment only.
[c] Details may not add to totals due to rounding.

Chart 6
General Fund Budget Structure
1980–81 through 1986–87 (in billions)



Aid to Individuals. Table 14 identifies 11 General Fund-supported local assistance programs which our analysis indicates are appropriately categorized as "Aid to Individuals." Overall, the Governor's Budget proposes an increase of $303 million, or 4.5 percent, for these programs in the budget year. On a program-by-program basis, the Governor proposes increases for six of these 11 programs, no change in funding for three, and slight reductions for two (due to declining participation by individuals).

Aid to Local Governments. Table 15 displays the major General Fund local assistance programs which our analysis indicates provide "Aid to Local Governments." Overall, the Governor's Budget proposes an increase in funding for these programs of approximately $1.2 billion, or 8.1 percent, above current-year levels. This change is primarily the result of the 10 percent funding increase proposed for K–12 education. (The decrease between 1984–85 and 1985–86 in the "All Other" category, reflects the repayment, during 1984–85, of a $200 million loan to the General Fund under the Los Angeles County Medical Assistance Grant Program.)

Table 15
Major General Fund-Supported Local Assistance Programs Providing Aid to Local Governments 1984–85 through 1986–87 (dollars in millions)

	Actual 1984–85	*Estimated 1985–86*	*Governor's Budget 1986–87*
Public Health Services	$932	$1,038	$1,065
California Children's Services	45	51	56
Department of Rehabilitation	52	58	62
Mental Health Programs	364	458	499
Alcohol and Drug Programs	69	72	72
Social Services—Programs	234	328	394
Social Services—County Administration	123	129	134
County Justice Subvention	64	67	68
K–12 Education	9,870	10,882	11,972
Community Colleges	1,112	1,181	1,264
Special Supplemental Subventions/Special District Loans	122	37	23
Local Streets and Roads	—	125	90
State Mandates	97	160	124
All Other	891	253	219
Totals[a]	$13,975	$14,839	$16,042

[a] Details may not add to totals due to rounding.

SPECIAL FUND FOR ECONOMIC UNCERTAINTIES

The Governor's Budget indicates that $1,187.6 million from the General Fund will be held in reserve during 1986–87. Of this amount, $1,159.9 million would be appropriated to the Special Fund for Economic Uncertainties, $20 million would be set aside for the new Disaster Response-Operations Account, and $7.7 million represents funds which have already been appropriated but are not expected to be spent during the budget year.

The Special Fund for Economic Uncertainties provides a source of funds to meet General Fund obligations in the event of an unanticipated decline in revenues or increase in expenditures following enactment of the Budget Bill. In addition, monies in this fund can be loaned, interest-free, to the General Fund in the event of a cash-flow shortage during the fiscal year. Normally, the balance in the reserve is invested and produces interest income for the General Fund.

Prior to this year, the Special Fund for Economic Uncertainties was known as the "Reserve for Economic Uncertainties," and was located within the General Fund. Chapter 139, Statutes of 1985 (SB 1465), transferred the monies in the reserve from the General Fund to the Special Fund for Economic Uncertainties in order to facilitate the state's external borrowing program.

COST-OF-LIVING ADJUSTMENTS (COLAs)

Each year, the Governor's Budget typically includes funds for various cost-of-living adjustments, commonly referred to as COLAs. These adjustments generally have a common objective: to compensate for the effects of inflation on the purchasing power of the previous year's funding level.

Discretionary and Statutory COLAs

Existing law authorizes *automatic* COLAs for 22 different programs, most of them in the health, education and welfare areas. These adjustments generally are referred to as statutory COLAs. Many other local assistance programs traditionally have received COLAs on a *discretionary* basis, through the budget process.

In 1986–87, statutory COLAs will range from 3.1 percent (child nutrition in schools) to an estimated 7.3 percent (Medi-Cal noncontract hospitals). Those statutory COLAs having the largest costs are those for K–12 apportionments ($604 million) and SSI/SSP grants ($105 million). The General Fund cost of fully funding *statutory* COLAs in 1986–87 is approximately $1.1 billion.

Governor's Budget Proposal

The budget proposes a total of $1.5 billion from the General Fund for COLAs in 1986–87, including $1.1 billion for statutory COLAs and $412 million for discretionary COLAs. The specific increases proposed by the Governor are shown in Table 16.

Table 16
General Fund Cost-of-Living Increases
1985–86 and 1986–87
(dollars in thousands)

Department Program	1985–86 Budgeted Percent Increase	1986–87 1% Dollar Increase	1986–87 Statutory Percent Increase	1986–87 Statutory Dollar Increase	1986–87 Budget Percent Increase	1986–87 Budget Budget as Proposed
HEALTH AND WELFARE						
Aging	4.0%	$161	—	—	—	—
Alcohol and Drug Programs	4.0	720	—	—	—	—
Health Services						
County Health (AB 8)	3.63	4,077	3.95%	$16,108	3.95%	$16,108
Medically Indigent Services	4.0	—	—	—	—	—
Public Health	4.0	—	—	—	—	—
Medi-Cal						
Hospital Outpatient	7.9	694	—	—	—	—
Noncontract Hospitals (including PHPs and RHF)	9.5	344	7.3	3,972	7.3	3,972
PHPs, CDS, and RHF (non-hospital services)	5.4	1,275	—	—	—	—
Long-Term Care Facilities, including state hospitals	5.4–17.5	6,730	—	—	—	—
Providers, all others	4.0–26.3	4,235	—	—	—	—
Beneficiary Spin-off	5.7	2,711	4.9	12,101	4.9	12,101
Drug Ingredients	6.2	712	3.6	3,985	3.6	3,985
County Administration	2.4	397	—	—	4.8	1,906
Developmental Services						
Regional Centers—Out-of-Home Care	4.0	2,277	—	—	2.0	4,554
Regional Centers—Other	4.0	1,527	—	—	2.0	3,054
State Hospital Education Programs	4.0	45	—	—	2.0	90
Local Mental Health Programs	4.0	4,601	—	—	2.0	9,201
Social Services						
SSI/SSP	5.7	21,374	4.9	104,732	4.9	104,732
AFDC-FG & U	5.7	16,965	4.9	80,678	4.9	80,678
AFDC—Foster Care	4.0	2,320	—	—	—	—
IHSS—Statutory	5.7	130	4.9	624	4.9	624
IHSS—Nonstatutory	4.0	3,599	—	—	—	—
Community Care Licensing—Local Assistance	4.0	84	—	—	—	—
County Administration—Grants	2.3	1,838	—	—	4.8	8,823
County Administration—Social Services						
Child Welfare Services	4.0	1,614	—	—	15.8	19,051
Adoptions	4.0	198	—	—	—	—
Other	4.0	864	—	—	—	—
Rehabilitation	4.0	615	—	—	—	—
YOUTH AUTHORITY						
County Justice System Subvention Programs	4.0	666	—	—	2.0	1,332
EDUCATION						
Apportionments:						
K–12—District Revenue Limits	6.19	104,499	5.78	604,006	5.78	604,006
Meals for Needy Pupils	6.0	239	6.0	1,433	6.0	1,433
Summer School	6.19	658	5.78	3,803	5.78	3,803
Apprentice Programs	6.19	26	—	—	5.78	151
Small School District Transportation	4.0	199	—	—	2.0	398
Transportation	4.0	2,856	—	—	2.0	5,712
K–12—County Offices of Education	6.19	1,973	5.78	11,405	5.78	11,405
Regional Occupational Centers/Programs	6.19	2,073	—	—	5.78	11,980
Court-Ordered Desegregation	—	2,140	5.78	12,367	5.78	12,367
Voluntary Desegregation	—	490	5.78	2,834	5.78	2,834

Child Nutrition	4.0	374	3.1	1,158	3.1	1,158
American Indian Education Centers	4.0	9	—	—	2.0	17
Native American Indian Education	4.0	4	—	—	2.0	7
Child Care Program	4.0	2,475	—	—	2.0	4,949
Special Education	6.19	14,595	5.78	84,361	5.78	84,361
Staff Development	4.0	211	—	—	2.0	421
Preschool	4.0	355	—	—	2.0	709
Libraries	4.0	110	—	—	2.0	220
Meade Aid	4.0	104	—	—	2.0	207
Urban Impact Aid	4.0	755	—	—	2.0	1,509
Gifted and Talented	6.0	200	6.0	1,202	6.0	1,202
Instructional Materials (K–8)	6.19	679	3.6	2,443	5.78	3,923
Instructional Materials (9–12)	6.19	215	—	—	5.78	1,242
Demonstration Programs in Reading and Math	6.19	42	—	—	5.78	245
Educational Technology	4.0	259	—	—	2.0	518
Economic Impact Aid	4.0	1,950	—	—	2.0	3,900
Adult Education	6.0	2,137	6.0	12,819	6.0	12,819
Adults in Correctional Facilities	6.0	18	6.0	107	6.0	107
School Improvement Program (K–6)	6.19	1,824	5.78	10,542	5.78	10,542
School Improvement Program (7–12)	4.0	322	—	—	2.0	643
Miller-Unruh Reading Program	6.19	193	—	—	5.78	1,115
High School Pupil Counseling	4.0	76	—	—	2.0	151
Youth Suicide Prevention	4.0	3	—	—	2.0	6
Specialized Secondary Schools	4.0	21	—	—	2.0	42
Foster Youth Services	4.0	8	—	—	2.0	16
Opportunity Classes Programs	6.19	8	—	—	5.78	44[a]
Board of Governor's, California Community Colleges						
Apportionments	6.19	16,284	5.84	95,100	5.84	95,100
Handicapped Student Services	4.0	247	—	—	2.0	497
EOPS	4.0	279	—	—	2.0	558
Student Aid Commission—Awards	9.2	1,036	—	—	8.9	9,220
ALL OTHERS						
State Contribution to STRS	5.1	2,275	4.5	10,237	4.5	10,237
Employee Compensation						
Civil Service and Related	7.5	28,000	—	—	5.9	163,805
University of California	8.8	13,091	—	—	5.7	74,152
California State University	10.5	12,075	—	—	7.0[b]	79,382
Hastings College of Law	8.8	82	—	—	5.7	464
Totals	—	$296,462	—	$1,076,017	—	$1,487,788

[a] Funded by reappropriation of 1985–86 unexpended balance, dollar amount represents Legislative Analyst's office estimate based on 1984–85 participation rates.
[b] Faculty COLA (including benefits). Nonfaculty COLA is 5.7 percent (including benefits).

PROGRAM EXPENDITURES

We have discussed in some detail the expenditures proposed for the budget year and their relationship to historical spending levels. In addition, we have examined the relationship of the three major components of the budget—state operations, local assistance and capital outlay. We now turn our attention to the distribution of expenditures on a programmatic basis.

Where Does the Money Go?

Chart 7 and Table 17 show the distribution of General Fund expenditures, by major program category, in 1986–87. These displays indicate that the two largest budget categories are education and health and welfare,

which collectively account for $26 billion, or 85 percent, of total General Fund expenditures. The remaining $4.7 billion, or 15 percent of total expenditures, goes for tax relief, correctional programs, and all other programs of state government.

Chart 7

General Fund Expenditures—Major Components 1986–87

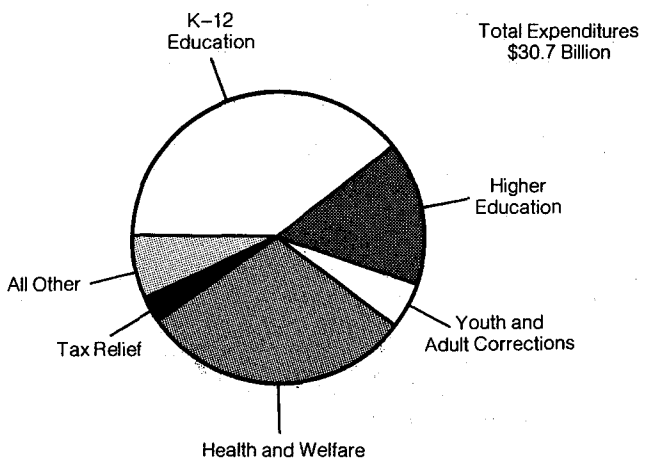


Table 17
Expenditures for Health, Welfare, and Education As a Percent of Total General Fund Expenditures 1986–87 (dollars in millions) [a]

	Amount	*Percent of General Fund Budget*
K–12 Education [b]	$12,060	39%
Higher Education	4,812	16
Subtotal, Education	$16,872	55%
Health and Welfare	9,158	30
Subtotal, Education, Health and Welfare	$26,029	85%
Other program areas	4,670	15
Total General Fund budget	$30,699	100%

[a] Source: Governor's Budget. Details may not add to totals due to rounding.
[b] Includes $467 million for State Teachers' Retirement System contribution.

The so-called "people programs"—education, health and welfare—have been the fastest growing components of General Fund expenditures in recent years. Chart 8 illustrates that since 1980–81, expenditures for these programs have increased significantly. Over the seven-year period, higher and lower education expenditures have increased by $6.2 billion, or 59 percent, while health and welfare expenditures have grown by $2.2 billion, or 31 percent. In terms of "real" dollars, spending for education has increased by $1 billion, or 9.7 percent, while spending for health and welfare has actually decreased by $660 million, or 9.5 percent.

Chart 8

Trends in General Fund Program Expenditures 1980–81 through 1986–87 (in billions)

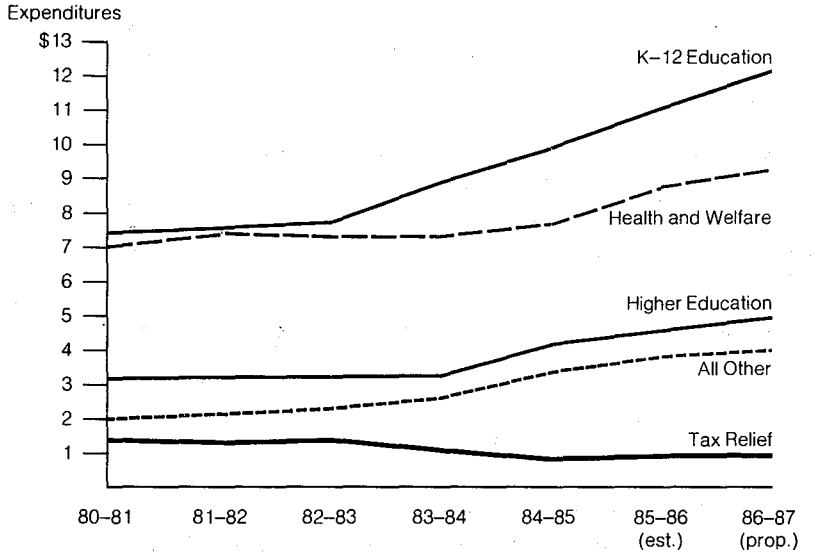


Table 18
Estimated General Fund Program Changes [a]
1985–86 and 1986–87
(dollars in millions)

	Estimated 1985–86	Proposed 1986–87	Change Amount	Change Percent
Health and Welfare:				
Medi-Cal	$2,274	$2,337	$63	2.8%
County health	885	976	91	10.3
SSI/SSP	1,411	1,591	180	12.8
AFDC grants	1,829	1,834	5	0.3
Social services programs	328	393	65	19.8
Mental health	755	835	80	10.6
Developmental services	392	443	51	13.0
Other, health and welfare	834	749	−85	−10.2
Subtotals, Health and Welfare	$8,708	$9,158	$450	5.2%
Education:				
K–12	$10,546	$11,593	$1,047	9.9%
State teachers' retirement	419	467	48	11.5
University of California	1,646	1,787	141	8.6
California State University	1,506	1,611	105	7.0
California Community Colleges	1,188	1,271	83	7.0
Other, higher education	132	142	10	7.6
Subtotals, Education	$15,437	$16,871	$1,434	9.3%
Other:				
Youth and adult corrections	$1,293	$1,516	$223	18.9%
Resources	459	453	−6	−1.3
Tax relief	855	865	10	1.2
Debt service	552	633	81	14.7
All other	1,406	1,203	−203	−14.4
Subtotals, Other	$4,565	$4,670	$105	2.3%
Totals [b]	$28,710	$30,699	$1,989	6.9%

[a] Based on amounts shown in Governor's Budget.
[b] Details may not add to totals due to rounding.

Summary of Major Program Changes

For 1986–87, the budget proposes a net increase in General Fund expenditures of $2 billion, or 6.9 percent, above the level of expenditures estimated for the current year. Table 18 shows the primary factors that account for the proposed change in expenditures. It shows that the largest increase is proposed for education—$1.4 billion, or 9.3 percent. Within each expenditure category, significant program changes have been proposed. Some of the major General Fund changes include the following:

SSI/SSP expenditures are expected to increase by $180 million, or 13 percent, above estimated current-year expenditures. This increase is due primarily to three factors: (1) an increase of $104.7 million to fund a 4.9 percent statutory COLA effective January 1, 1987, (2) an increase of $74.8 million to fund the full-year cost of the COLA provided on January 1, 1986, and (3) an increase of $45.3 million to fund a 2.7 percent increase in caseload. These increased costs are partially offset by a $33.9 million increase in federal funds.

AFDC grant costs are budgeted to increase by $5 million, or 0.3 percent above estimated current-year expenditures. The low rate of growth primarily reflects one-time costs incurred in the current year as a result of court orders ($52 million), and the increased savings anticipated in the budget year from the fraud detection and Greater Avenues for Independence (GAIN) programs ($20 million). It also reflects the budget's assumption that the growth in caseload will "flatten out" in the budget year.

Social Services Program expenditures are up $65 million, or 20 percent, above estimated current-year expenditures. This increase primarily reflects increased General Fund costs for: (1) the Child Welfare Services program ($22.9 million), (2) the In-Home Supportive Services program ($14.2 million), and (3) the Greater Avenues for Independence (GAIN) program ($15.4 million).

Developmental Services expenditures are up $51 million, or 13 percent, in 1986–87. This increase primarily reflects regional center caseload growth ($46 million).

Medi-Cal expenditures are expected to be up $63 million, or 2.8 percent, in 1986–87. The primary factors accounting for this increase are (1) the full-year cost of the 1985–86 COLA ($39 million), (2) a COLA for beneficiaries ($12 million), and (3) caseload growth ($26 million). These increases are offset by special one-time costs incurred in 1985–86 and other adjustments.

Mental Health expenditures are up $80 million, or 11 percent, above estimated current-year expenditures. This primarily results from increases of $26 million for local programs, $19 million for the first-year costs of the mentally disordered offender program, a $9.2 million cost-of-living adjustment for local programs, and a $10.4 million augmentation reflecting the transfer of Napa State Hospital from the Department of Developmental Services (DDS) to the Department of Mental Health (DMH).

K–12 Education expenditures are budgeted at $11.6 billion in 1986–87. This is an increase of $1 billion, or 10 percent, over estimated current-year expenditures. The primary factors accounting for this increase are: (1) an increase of $784 million for statutory and discretionary COLAs; (2) an increase of $214 million for increased enrollment in public schools; and (3) an increase of $107 million to continue a program established by Ch 498/83 (SB 813) which provides fiscal incentives to school districts for increasing the amount of instructional time offered. These increases are partially offset by a $151 million reduction in General Fund requirements resulting from anticipated increases in school district property tax receipts.

Higher Education General Fund expenditures are proposed to increase by $339 million, or 8 percent. The primary factors accounting for this increase are: (1) an increase of $95 million for a 5.8 percent statutory COLA for community colleges (offset by $37 million in increased property

taxes); (2) an increase of $150 million for salaries including 5 percent for faculty and staff at the University of California (UC), 6.8 percent for faculty at the California State University (CSU) and 5 percent for CSU staff; (3) an increase of $26 million to maintain annual student fees at the current-year level of $1,305 at UC and $573 at CSU; (4) an increase of $15 million for enrollment growth at UC and $14 million at CSU; (5) an increase of $60 million for instructional equipment and computers at UC; and (6) an increase of $3 million for CSU instructional supplies and services.

Youth and Adult Corrections expenditures are proposed to increase by $223 million in the budget year. Most of this amount, $203 million, will fund 2,049 additional personnel-years for the Department of Corrections and the increased operating expenditures needed to accommodate the 11 percent growth in the prison population projected by the end of 1986–87. Most of the remaining increase, $20 million, will finance staff and operating expense increases for the Department of the Youth Authority.

Debt Service is expected to be $81 million, or 15 percent, higher in 1986–87 than in the current year. This reflects the large volume of general obligation bonds approved by the voters in recent statewide elections.

Expenditures Not Recognized in the Budget

In preparing the Governor's Budget, the Department of Finance must estimate the impact of program caseload growth, court decisions, and other factors on expenditure levels in the budget year. Our analysis indicates that the Governor's Budget has underestimated expenditures over the two-year period from 1985–86 to 1986–87 by $495 million. The components of this $495 million are as follows:

Medi-Cal. In preparing the Governor's Budget, the Department of Finance arbitrarily reduced the estimate of Medi-Cal expenditures prepared by the Department of Health Services (DHS). This causes Medi-Cal expenditures in the current and budget years to be $95 million and $115 million lower, respectively, than they are likely to be based on historical patterns.

In addition, the budget fails to provide for increases in Medi-Cal reimbursement rates for long-term care facilities and the cost of abortions, even though the likelihood of such costs is all but certain. The Medi-Cal state plan *requires* the DHS to adjust reimbursement rates each year for skilled nursing and intermediate care facilities, as well as for state hospitals. The Department of Developmental Services' budget contains funds for a 5 percent increase in state hospital rates, but no increases are provided for long-term care facilities. General Fund costs will increase by $28 million if a similar COLA must be provided for these facilities. The General Fund cost for Medi-Cal abortions is estimated at $14 million for 1986–87, the amount needed to comply with existing court orders.

AFDC-Family Group. The Department of Social Services (DSS) assumes that the present upward trend in AFDC-Family Group caseload will level off, for the mere reason that it cannot find a satisfactory explanation for the increases which have occurred in recent years. If recent trends prevail, however, caseload growth will add $48 million to General Fund expenditures in the budget year.

AFDC-Foster Care. Caseload for the AFDC-Foster Care program grew from 32,000 in December 1984 to 37,000 in December 1985. The DSS assumes, however, that caseload will remain flat for the next 18 months. Recent trends indicate that caseload could grow to 43,000 by June 1987, requiring an additional $32 million in General Fund expenditures.

Simon v. McMahon. The budget does not recognize the full cost of the court's decision in the *Simon v. McMahon* case because the DSS plans to seek a federal waiver so federal costs will not be shifted to the state. If the waiver is not granted, General Fund costs will increase by $16 million in the current year and $24 million in the budget year.

In-Home Supportive Services. In the current year, the DSS has identified a deficit of $23 million (all funds) in the In-Home Supportive Services (IHSS) program, primarily because the 1985–86 budget did not allow for a growth in service hours. The budget for 1986–87 assumes that the trend in service hours will flatten at the June 1986 level. If current trends continue, an additional $8 million (General Fund) will be needed to fund this program in the budget year.

Child Welfare Services. The DSS is projecting that caseload for the Child Welfare Services (CWS) program will level off in 1986–87. Our analysis indicates that caseload for this program will continue to grow in the budget year, leaving the program underfunded by $5 million.

PERS Contributions. The budget assumes that the Board of the Public Employees' Retirement System (PERS) will recommend and the Legislature will enact changes in statutory PERS contribution rates that will reduce employer's retirement costs by 15 percent. The actuarial assumptions recently adopted by the board imply a reduction closer to 3.4 percent. This suggests that the amount budgeted for PERS contributions is $114 million too low.

Department of Forestry. The budget does not allocate sufficient funds for the Department of Forestry to comply with the Fair Labor Standards Act (FLSA) in the budget year. Our analysis of the duty week changes and overtime provisions negotiated between the state and the employees' association indicates that costs will exceed the amount budgeted by approximately $8 million if the 1986 fire season is "average."

State Mandated Local Programs. The current version of the local government claims bill contains $14 million to pay the costs of five state-mandated local programs. These funding requests have been approved by the Commission on State Mandates, but the budget does not contain any recognition of these costs.

Community Colleges. In contrast to these understated expenditures, the budget *overestimates* by $26 million the amount of money needed to fund community college apportionments in 1986–87. This is because the baseline budget has not been adjusted to reflect a decline in average daily attendance (ADA) during the current year.

Resources Overstated. In addition to understating expenditures by a net total of $495 million, our analysis indicates that the Governor's Budget has overstated the resources available in 1986–87 to fund expenditures by $92 million. The primary reason for this is that the budget assumes surplus lands at Agnews State Hospital will be sold and that the General Fund will receive $75 million from the sale during 1986–87. Legislation is needed to authorize this sale. It is highly unlikely that the revenue estimated in the budget can be collected prior to June 30, 1987. The other factor causing resources to be overstated is that the budget's estimate of the 1984–85 end-of-year balance exceeds by $17 million the actual figure released by the Controller subsequent to the budget's publication. As a result, the ending balance projected in the budget for 1986–87 is overstated by a corresponding amount.

Impact on the 1986–87 General Fund Balance. The net result of these miscalculations is that the amount which the Governor's Budget shows in the Special Fund for Economic Uncertainties on June 30, 1987 is $587 million more than what is likely to be available. Instead of increasing the state's reserve by $325 million, the budget as proposed by the Governor is likely to *reduce* the reserve by $244 million in 1986–87, leaving it at $573 million at year end.

Revenues

The various expenditure programs discussed in the *Analysis* are supported by revenues which are derived from many different sources. The budget identifies over 50 specific revenue categories, ranging from taxes levied on individuals and businesses, to income which the state earns from its own assets, such as oil-producing properties and financial investments.

About 85 percent of all state revenues are deposited directly in the General Fund, from which they may be appropriated to support the general activities of state government. In most years, about 90 percent of General Fund revenue is derived from three sources: the sales and use tax, the personal income tax, and the bank and corporation tax.

Those state revenues that are not deposited in the General Fund—normally about 15 percent of the total—are placed into special funds to support specific programs and activities, including highway maintenance and construction, and various education-related capital outlay projects.

In addition, the state collects certain other monies which are not included in the budget revenue totals as either General Fund or special fund revenues, because they are legally committed to specific purposes. Money deposited in "nongovernmental trust and agency funds," such as pension funds, certain bond funds and (at the present time) state receipts from the California State Lottery fall into this category.

The availability of revenues is the key determinant of how much the state is able to spend in providing goods and services to the public. It also helps determine how much money can be set aside in reserve for a "rainy day," so that the state can be reasonably confident of its ability to pay its bills on time, even if economic conditions deteriorate unexpectedly. Thus, in analyzing the Governor's Budget for 1986–87, it is important to consider whether the state will collect sufficient revenues to (a) fund the Governor's proposed spending plan, (b) finance new legislation which the Legislature may choose to enact, and at the same time (c) build a reserve that can protect the General Fund against possible revenue shortfalls or unanticipated expenditures.

It is also important to consider whether tax collections will yield more funds than can legally be appropriated under Article XIII B of the State Constitution (which establishes the state's appropriations limit). If this occurs, some of the excess tax revenues eventually might have to be returned to the public.

This section examines the Department of Finance's forecast for revenues in the current and budget years, including the economic projections and other assumptions on which the revenue forecast is based.

SUMMARY OF THE REVENUE OUTLOOK

The level of revenues that the state can expect to receive will be determined by a wide variety of factors. These include how the state's *tax base* is defined, the *tax rates* that are applied to this tax base, the effect that *economic conditions* will have on the size of the tax base, the *time lags* between when tax liabilities are incurred and when they are actually paid to the state, the extent to which the Legislature chooses to enact *legislation* which affects the total amount of revenues collected, and other factors such as court decisions and actions taken by the federal government which directly affect revenues. Of these, the single most important factor influencing the level of revenues in 1986–87 will be the behavior of the state's economy.

Continued Economic Expansion Assumed

The Department of Finance's economic forecast assumes that California's economy, like the nation's, will continue to expand at a moderate pace throughout both 1986 and 1987. The department also projects continued declines in the unemployment rate and relatively moderate inflation. Compared to 1985, the actual pace of growth in 1986 is expected to slow slightly before speeding up again in 1987. However, neither a recession nor a sharp growth slowdown is anticipated during this period. On the other hand, the forecast contains no prediction of a period of economic "boom", either.

On balance, the department's predictions of unspectacular-though-sustained growth is a "middle-of-the-road" forecast that is consistent with the current consensus views of economists generally. It also reflects the tendency of economists to predict "more of the same" once an economic recovery period has matured and there are no clear signals indicating when the next strong upturn or downturn will occur.

Moderate Revenue Growth Expected

Table 19 summarizes the budget's estimates of how much state revenues will be generated in the current and budget years if the department's economic forecast comes true. For comparison purposes, the table also summarizes how revenues performed during the prior year. Chart 9, on the other hand, shows the trend in state revenues, by source, over the past decade.

Table 19
Revenue Summary
General Fund and Special Funds
1984–85 through 1986–87
(dollars in millions)[a]

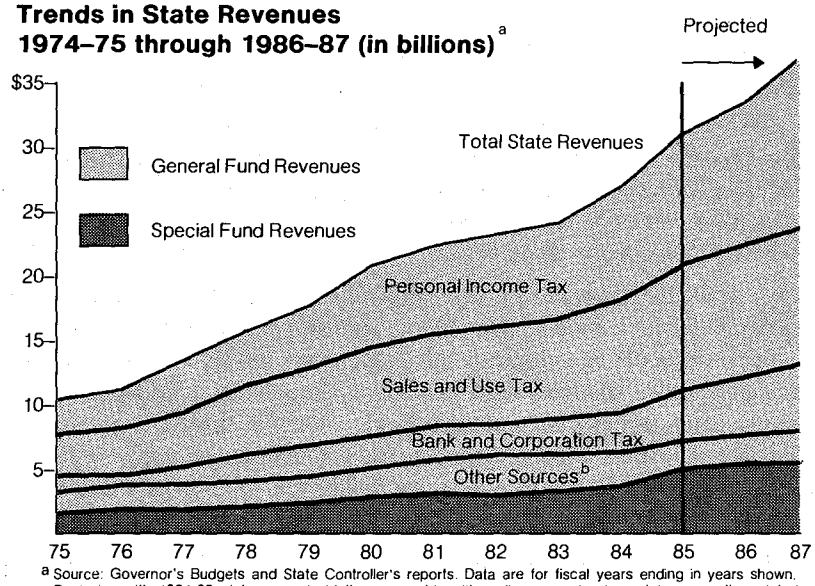
	Prior Year (1984–85) [b]	*Current Year (1985–86)*	*Budget Year (1986–87)* [c]
General Fund Revenues			
—Amount	$26,536	$28,187	$31,024
—Dollar change	2,714	1,651	2,837
—Percent change	11.4%	6.2%	10.1%
Special Fund Revenues			
—Amount	$5,034	$5,339	$5,324
—Dollar change	1,198	305	−15
—Percent change	31.2%	6.1%	−0.3%
Totals, General Fund and Special Fund Revenues			
—Amount	$31,570	$33,526	$36,348
—Dollar change	3,912	1,956	2,822
—Percent change	14.1%	6.2%	8.4%

[a] Source: Governor's Budget. Details may not add to totals due to rounding. Figures include effects of various revenue-related law changes and certain shifts of revenues between various special funds and the General Fund.

[b] Dollar and percent change figures may be distorted, due to two GAAP-related accounting reclassifications of certain revenues and reimbursements which have been made by the Department of Finance for 1984–85 but not for 1983–84.

[c] General Fund revenue total includes $127 million due to the Governor's *proposals* to sell certain state property ($75 million) and increase audit personnel at the state's major tax agencies ($52 million). Total for special fund revenues has been reduced by $20 million to account for a printing error in the Governor's Budget. Neither the General Fund nor special fund revenue totals include revenues from the California State Lottery, as the funds into which these lottery revenues are deposited have been classified as nongovernmental cost funds.

Chart 9
Trends in State Revenues
1974–75 through 1986–87 (in billions) [a]



[a] Source: Governor's Budgets and State Controller's reports. Data are for fiscal years ending in years shown. Beginning with 1984-85, data are not strictly comparable with earlier years due to certain accounting-related reclassifications of revenues and expenditure reimbursements.

[b] Includes other taxes, licenses, fees, interest income, transfers, and other sources. Some of the year-to-year fluctuations in revenues in this category and in special fund revenues reflect year-to-year shifts in revenues between these two categories.

Table 19 indicates that:

- ***Prior-year*** (1984–85) total revenues were $31.6 billion ($3.9 billion, or 14 percent, above the previous year's level). This amount consists of about $26.5 billion in General Fund revenues (up 11 percent) and $1.2 billion in special fund revenues (up 31 percent). The primary cause of the unusually rapid growth in 1984–85 special fund revenues was the transfer in 1983–84 of approximately $720 million from special funds to the General Fund to improve the General Fund's condition. (Because these transfers inflated the 1983–84 revenue base and were not repeated in 1984–85, they make the 1984–85 revenue growth rate artificially high.)
- ***Current-year*** (1985–86) total revenues are expected to reach $33.5 billion (up $2 billion, or 6.2 percent), consisting of $28.2 billion in General Fund revenues (up 6.2 percent) and revenues to special funds of $5.3 billion (up 6.1 percent).
- ***Budget-year*** (1986–87) total revenues are projected at $36.3 billion (up $2.8 billion, or 8.4 percent). This amount includes $31 billion in General Fund revenues (up $2.8 billion, or 10 percent) and $5.3 billion in special fund revenues (down 0.3 percent).

No Growth After Adjustments for Inflation and Population

Both by historical standards and relative to the prior year, the growth in total revenues projected for the current and budget years is low. Growth in total state revenues averaged more than 12 percent over the period 1973–74 through 1983–84, and 14 percent in 1984–85. Thus, the average rate of growth in revenues during the past decade is about twice the rate for the current year and well above the rate projected for the budget year.

Likewise, total revenue growth after adjusting for the effects of population growth and inflation averaged 1.9 percent during the past decade, and was 5.7 percent in 1984–85. In contrast, inflation-adjusted revenues per capita are expected to *decline* by 1.2 percent in 1985–86 and increase by only 0.9 percent in 1986–87.

Some of the flatness in total "real" revenue growth can be explained by "special" factors, such as the effects of past legislation and ballot initiatives. A sharp drop-off in tidelands oil and gas revenues, due to soft prices and excess supplies in the world's crude oil markets, is another contributing factor. An especially important factor in explaining the trend is the fact that the inflation rate for government-purchased goods and services is projected to be much higher than either the economy's overall inflation rate or inflation in California.

Thus, while the department projects a positive "real" growth in total revenues during the budget year, the rate is well below the historical average, and is not large enough to offset the decline in "real" per capita

total revenues anticipated during the current year. As a result, the purchasing power of total revenues projected for the budget year actually is *less* than it was in 1984–85.

We will now take a closer look at the economic assumptions on which the current-year and budget-year revenue forecasts are based, before turning to a more detailed discussion of state revenues in the prior year (1984–85), current year (1985–86), and budget year (1986–87).

THE ECONOMIC OUTLOOK

The economy's performance during 1986 and 1987 will be the prime determinant of state revenue collections during the latter half of 1985–86 and in 1986–87. Economic activity in calendar 1986 will account for about one-third of current-year (1985–86) General Fund revenues and about two-thirds of budget-year (1986–87) General Fund revenues. The remaining one-third of budget-year revenues will be determined by economic conditions in 1987.

The economic outlook projected by the department for 1986 and 1987 is a relatively favorable one. Nevertheless, while the economy is expected to continue expanding in both years, the pace of expansion in California is expected to be somewhat slower in 1986 than in 1985.

Economic Growth Continued Throughout 1985

On balance, the economy's performance in 1985 was one of unspectacular though sustained expansion. At the national level, real GNP grew by 2.3 percent according to the most recent estimates, which was about 0.7 percentage point slower than the department had expected one year ago. In comparison, real GNP expanded by 6.6 percent in 1984 and 3.4 percent in 1983. Thus, economic growth clearly slowed in 1985.

As shown in Chart 10 and Table 20, the year also saw a continued decline in the unemployment rate, a further downward-drift in inflation, reduced interest rates, and moderate employment gains and homebuilding activity. New car sales were one of the bright spots, reaching their highest level (11 million units) since 1978. On the other hand, corporate profits performed poorly, falling by 4.1 percent.

California's economy in 1985 performed somewhat better than the nation's in a number of respects. For example, the state's rate of personal income growth (8.1 percent) was a full 2.2 percentage points above the nation's (5.9 percent). California's civilian employment growth (2.7 percent) also exceeded the national figure (2.1 percent), and building permits (245,000) were at their highest level since 1977. In addition, California's "real" personal income growth (Chart 11) was a healthy 5 percent—well above the 4.1 percent average annual increase for the prior 12 years. Table 20 also indicates that the key elements of the state's tax base all registered reasonably strong gains in 1985, including taxable personal income, taxable sales, and especially corporate profits.

Table 20
Department of Finance Economic Outlook for California and the Nation [a]
1985 through 1987

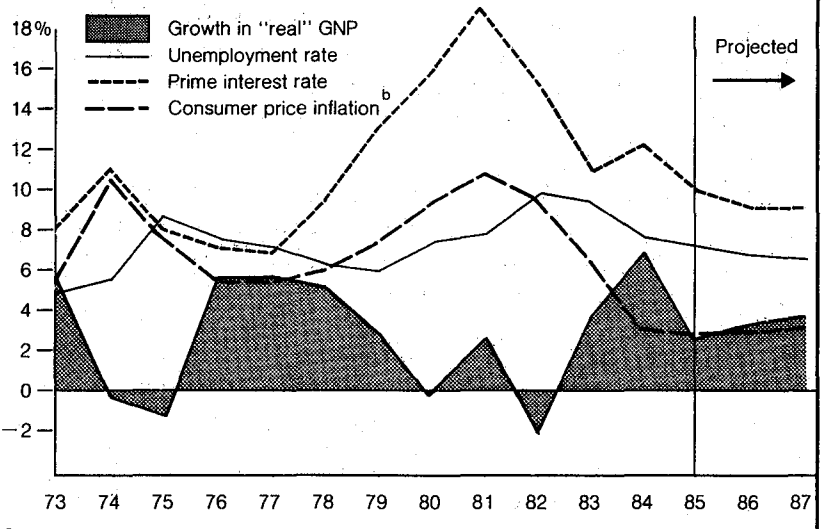
Economic Indicator	*1985 Estimated* [b]	*1986 Projected*	*1987 Projected*
1. *National Economy*			
Percent change in:			
—Real GNP	2.3%	3.2%	3.7%
—Personal income	5.9	5.9	8.0
—Pre-tax corporate profits	−4.1	4.4	9.2
—Wage and salary employment	3.4	2.6	3.0
—Civilian employment	2.1	2.1	2.2
—GNP prices	3.6	3.3	3.6
—GNP consumer prices	3.0	3.0	3.5
—Consumer Price Index	3.6	3.6	4.3
Unemployment rate (%)	7.2%	6.9%	6.6%
Savings rate (%)	3.8	2.9	3.7
Prime interest rate (%)	9.9	9.0	9.0
New car sales (millions of units)	11.0	10.7	11.0
Housing starts (millions of units)	1.76	1.82	1.90
2. *California Economy*			
Percent change in:			
—Personal income	8.1%	7.1%	9.1%
—Wage and salary income	9.4	7.8	9.1
—Wage and salary employment	3.4	2.9	3.8
—Civilian employment	2.7	2.2	2.9
—Consumer Price Index	4.6	4.6	5.1
—Key elements of the state's tax base:			
—Taxable personal income [c]	8.5	7.4	9.4
—Taxable sales	7.2	6.3	8.8
—Taxable corporate profits	17.0	13.7	13.8
Unemployment rate (%)	7.3%	7.2%	6.7%
New car registrations (thousands of units)	1,130	1,120	1,165
New building permits (thousands of units)	245	229	243

[a] Source: Governor's Budget and Department of Finance.
[b] As estimated in December 1985 and published in the 1986–87 Governor's Budget.
[c] Defined as total personal income plus social security contributions minus transfer payments. This income concept historically has shown a strong correlation to adjusted gross income reported for tax purposes in California.

As shown in Table 21, however, California's economic performance, like the nation's, was a bit weaker in a number of respects than what had been predicted prior to the start of the year. For example, although home building and corporate profits clearly were much stronger than anticipated, the growth in personal income, wage and salary employment, taxable sales, unemployment, and car sales was poorer than expected.

Chart 10

Trends in Key National Economic Variables 1973 through 1987 [a]



[a] Source: California Department of Finance.

[b] Inflation as measured by the GNP consumption expenditures deflator.

Table 21
Accuracy of Economic Forecasts for California in 1985

	Original Forecasts				*Revised Department of Finance January 1986*	
	Department of	*Other Forecasters* [b]			*May 1985*	*Estimated*
Economic Indicator	*Finance* [a]	*Lowest*	*Average*	*Highest*	*Forecast*	*Actual* [c]
Percent change in:						
—Personal income	8.6%	8.7%	9.5%	11.0%	7.7%	8.1%
—"Real" personal income [d]	3.5	3.5	4.8	6.2	3.1	3.3
—Wage and salary jobs	3.7	3.4	3.6	3.9	3.5	3.4
—Consumer prices	4.9	3.4	4.5	5.2	4.5	4.6
—Taxable sales	8.4	—	—	—	8.7	7.2
—Taxable corporate profits	9.9	—	—	—	17.1	17.0
Unemployment rate (%)	6.9%	7.0%	7.4%	7.5%	6.7%	7.3%
Residential building permits (thousands)	185	195	206	218	205	245
New car sales (thousands)	1,155	—	—	—	1,155	1,130

[a] Source: 1985–86 Governor's Budget.

[b] Includes First Interstate Bank, Security Pacific Bank, Bank of America, Crocker Bank, UCLA, Wells Fargo Bank and the Commission on State Finance. Forecasts are as of approximately year-end 1984, corresponding to when the Department of Finance constructed the economic assumptions contained in the Governor's Budget for 1985–86. For details on these forecasts, please see *1985–86 Perspectives and Issues*, Table 22, page 57.

[c] Source: 1986–87 Governor's Budget.

[d] Defined here as nominal personal income deflated by the California Consumer Price Index.

Expansion Still "On Track" At Year-End

As 1985 ended and 1986 began, the economic expansion that started three years ago in late 1982 was still intact. Real GNP growth in the fourth quarter of 1985 was not very stong—2.4 percent on an annual basis. However, this was partly due to a drop-off in consumption expenditures on durable goods, like cars, which had grown at an unbelievably rapid annual pace (24 percent) in the third quarter. The fall-off in growth at year-end fits the up-and-down pattern of quarterly growth that has been going on since late 1984.

This is not to say that there are no concerns about the health of the economy. Indeed, there are. In fact, the economy had its share of problems in 1985 and most of them still remain unsolved. These problems include persistently high interest rates (see Chart 10), serious international debt problems, a record-high foreign trade deficit, an ongoing $200 billion annual federal budget deficit, and high debt levels combined with a very low savings rate for consumers. Despite these problems and the relatively modest pace of recent economic growth, however, the economic expansion was still "on track" with no end in sight as 1986 began.

Continued Growth Expected

Table 20 and Chart 10 summarize the department's economic forecast for the nation and California. This forecast reflects the consensus view among economists that the current economic expansion, which began in late 1982, will continue throughout 1986 and 1987 at a moderate pace. For the nation as a whole:

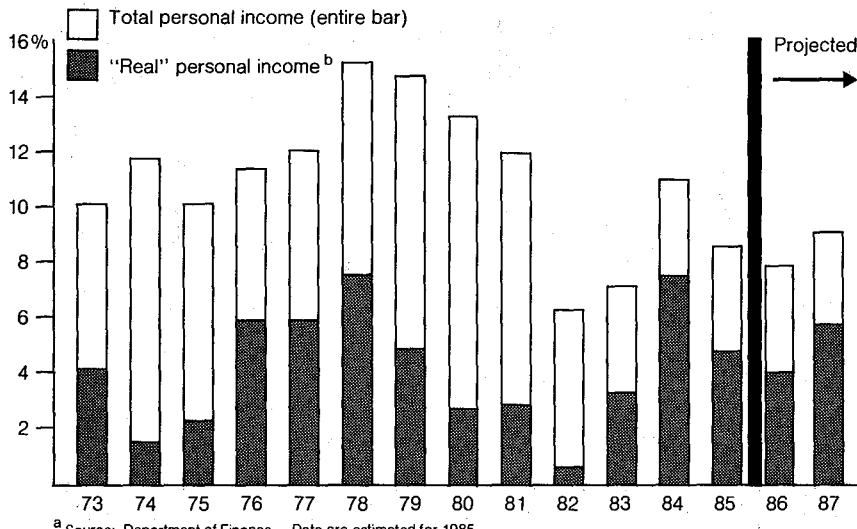
- ***Real GNP*** is projected to rise by 3.2 percent in 1986 and 3.7 percent in 1987. While well below the 6.6 percent gain in 1984, these are healthy, sustainable rates of growth and represent an improvement over 1985 (2.3 percent, according to the most recent estimate).
- ***Pre-tax corporate profits*** are expected to post a relatively small 4.4 percent gain in 1986, followed by a 9.2 percent improvement in 1987.
- ***Unemployment*** is expected to drift further downward, to 6.9 percent in 1986 and 6.6 percent in 1987, reflecting modest gains in ***civilian employment*** of 2.1 percent and 2.2 percent in the two years, respectively.
- ***Housing starts*** (1.8 million units in 1986 and 1.9 million units in 1987) are projected to hover at the same level reached in 1985 (1.8 million units). A similar trend is expected for ***new car sales***—10.7 million units in 1986 and 11 million units in 1987, compared to 11 million units in 1985.
- The ***prime interest rate*** is expected to drop to an average of 9 percent in both 1986 and 1987, compared to 9.9 percent in 1985.

California To Outperform Nation

Table 20 also shows that California is expected to experience continued moderate economic expansion during both 1986 and 1987, although the pace of economic activity is expected to slow in 1986 from 1985, before speeding up again in 1987. The table also shows that the state is expected to outperform the nation in a number of categories, just as it did in 1985. For example, the Department of Finance expects:

- ***Personal income*** in California to rise by 7.1 percent in 1986 and 9.1 percent in 1987, versus increases of 5.9 percent and 8.0 percent, respectively, at the national level. And, as shown in Chart 11, "real" personal income growth in the state (4.0 percent in 1986 and 5.4 percent in 1987) is expected to compare favorably with the growth rates realized during the past decade (an average of 4.1 percent for the 1973 through 1984 period).

Chart 11
Annual Growth in California Personal Income 1973 through 1987 [a]

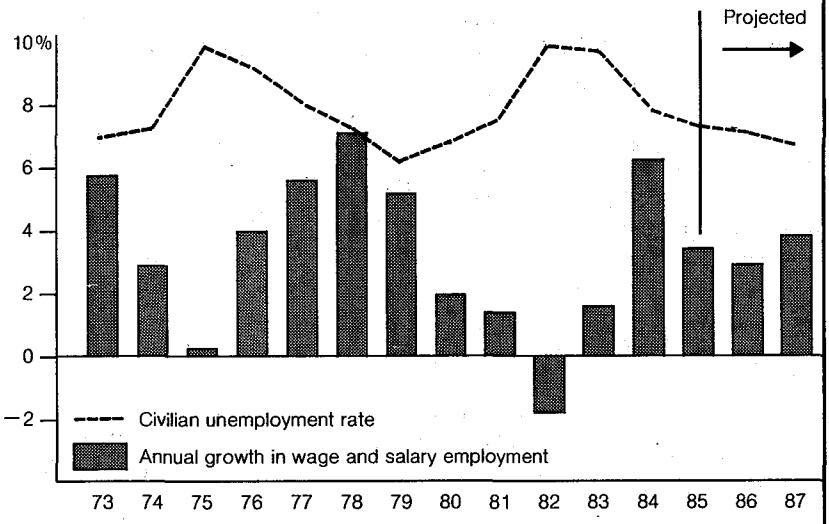


[a] Source: Department of Finance. Data are estimated for 1985.
[b] Real personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

- ***Employment growth*** projected for California (2.9 percent in 1986 and 3.8 percent in 1987 for wage-and-salary employment) to surpass employment growth nationwide. Although the state's employment growth rates are, from an historical perspective, relatively moderate (see Chart 12), they still translate into a very large number of new jobs—about 320,000 in 1986 and 425,000 in 1987.

- California's ***unemployment rate*** to lie a bit above the nation's rate in 1986 and 1987 because, despite the state's superior employment growth, its labor force also is expected to increase faster than the nation's. Nevertheless, the California unemployment rate is projected to drift down to an average of 6.7 percent by 1987, the lowest level since 1979.

Chart 12
Trends in California Employment and Unemployment 1973 through 1987 [a]



[a] Sources: Department of Finance and Employment Development Department. Data are estimated for 1985.

- ***Pre-tax corporate profits*** in California to rise by 13.7 percent and 13.8 percent in 1986 and 1987, respectively, compared to increases of only 4.4 percent and 9.2 percent, respectively, for the nation.

The implications of the current economic outlook for state revenues are best seen in the forecast for those key California variables which most directly affect the state's major revenue sources. As shown in Table 20:

- ***"Adjusted" personal income*** (that is, personal income adjusted for transfer payments and social security contributions, so as to roughly approximate "taxable" personal income) is projected to increase by 7.4 percent in 1986 and 9.4 percent in 1987.
- ***Taxable corporate profits,*** as indicated above, are forecast to rise by 13.7 percent in 1986 and 13.8 percent in 1987, following gains of 17

percent, 18 percent, and 22 percent in 1985, 1984, and 1983, respectively (see Chart 14). The cumulative 118 percent increase for these five years (1983 through 1987) is in sharp contrast to the preceding four years, and compares favorably to the era of 20-percent-plus increases experienced from 1976 through 1978, after the 1973–75 recession ended.

- ***Taxable sales*** are predicted to rise 6.3 percent in 1986 and 8.8 percent in 1987. Because of continuing moderate inflation, these gains reflect fairly good increases in "real" taxable sales of 3.2 percent in 1986 and 5.1 percent in 1987 (see Chart 13).

Continued Consumer Spending Is Critical

The levels of income and output that the economy generates are determined by four main types of spending—consumer spending on goods and services, investment spending on residential and nonresidential structures and equipment, government purchases of goods and services, and purchases by foreigners of the goods that we produce. Although each type of spending is important and affects the pace of overall economic activity, the single most important category is consumer spending. This is simply because consumer spending typically accounts for about two-thirds of total GNP. Thus, the economy's overall pace inevitably reflects, to a large degree, the pace of consumer spending. Episodes of weak consumer spending normally depress the economy's rate of expansion.

The department's forecast indicates that the correspondence between consumer spending and overall economic growth is expected to be especially close in 1986 and 1987. For example, the rates of consumer spending projected for the nation (6.7 percent in 1986 and 7.5 percent in 1987) are almost identical to nominal GNP growth (6.6 percent in 1986 and 7.5 percent in 1987). This is also true for the projected growth in "real" consumption spending (3.6 percent in 1986 and 3.8 percent in 1987) compared to "real" GNP growth (3.2 percent in 1986 and 3.7 percent in 1987). Thus, as consumer spending goes, so will the economy.

The department's projection that real consumer spending will advance at a moderate pace is consistent with its expectations regarding those variables that typically influence such spending. For example, it projects moderate growth in jobs and real incomes, moderate inflation, and a downdrift in real interest rates. An especially important factor behind the projection, however, is the department's view that the savings rate in the economy will remain relatively low. If this rate were to rise significantly, a smaller share of income would be entering the spending stream. The department, thus, assumes that what appears to be a relatively high level of consumer debt today will not result in a retrenchment of consumer spending tomorrow.

We believe the expectations of modest gains in real consumer spending are consistent both with the department's overall economic forecast and with the fundamental trends visible in the economy today. Nevertheless, because consumer spending is so important to the economy, the possibility that it might weaken at some point is probably the single greatest threat to the favorable economic outlook at this time.

Inflation—Outlook Remains Reasonably Good

Chart 10 shows the trend of general inflation faced by consumers nationally since 1973 and the department's projected rate of inflation for 1986 and 1987.

The chart and Table 20 indicate that a major upswing in inflation is not anticipated in 1986 or 1987. Inflation nationally is expected to remain in the general range of 3 percent to 4 percent, as measured by the GNP price indexes. Inflation as measured by the Consumer Price Index is expected to be somewhat higher—3½ percent to 4½ percent nationally, and 4½ percent to 5 percent for California. Thus, although inflation is generally expected to trend up a bit in 1987, the outlook can be described as "reasonably good."

The department's view is shared by most other economists. For example, there is some agreement that:

- ***Unit labor costs*** (which are a prime determinant of the inflation rate), are expected to hold steady at around 3 percent, due to restrained wage increases and a mild upturn in productivity (see Table 22);
- ***Food prices*** will rise by less than 2 percent in 1986;
- ***Gasoline prices*** will not rise at all; and
- The rate of ***capacity utilization*** of the nation's production facilities will hold steady and perhaps even decline slightly, as the capacity-augmenting effects of recent new investment in plant and equipment offset the increased needs for production facilities caused by the continued economic expansion.

Table 22
Trends in Factors Influencing National Inflation
1980 through 1987 [a]

Year	Labor Productivity Growth	Growth in Hourly Labor Compensation	Growth in Unit Labor Costs [b]	Inflation Rate GNP Deflator Total	GNP Deflator Consumption	CPI
1980	−0.7%	10.4%	11.1%	9.2%	10.2%	13.5%
1981	1.9	9.8	7.7	9.6	8.7	10.4
1982	−0.1	7.8	8.0	6.0	5.9	6.1
1983	3.4	4.8	1.3	3.8	3.7	3.2
1984	2.7	4.2	1.4	3.8	3.2	4.3
1985 (estimated)	0.4	3.6	3.5	3.4	3.1	3.5
1986 (projected)	1.8	3.7	2.8	3.1	3.0	3.3
1987 (projected)	2.2	4.9	3.1	3.7	3.8	3.9

[a] Data for 1985, 1986 and 1987 represent averages of estimates by Data Resources, Chase Econometrics and Wharton Econometrics, as of January 1986.

[b] The annual change in unit labor costs is approximately equal to the difference between growth in hourly labor compensation and productivity growth.

Furthermore, given that world crude oil prices have fallen substantially since mid-January when the department's economic forecast was released, the inflation outlook is even better—not just for gasoline prices but for all commodities whose production and distribution costs are affected by energy prices.

These factors are expected to outweigh those that are unfavorable to the inflation outlook. The latter include the possibility that further declines in the value of the dollar will make imports noticeably more expensive to Americans, and that the Federal Reserve may increase the money supply too fast in its effort to stimulate the economy (discussed below).

Despite the relatively moderate rates of inflation projected for the next two years, however, inflation still poses a threat to the economy. Even the 5 percent inflation rate predicted for California in 1987 would make prices double in only 14 years. This, in turn, can cause problems, such as unintended income redistributions, instability in financial markets, and high interest rates. Furthermore, of special interest to the Legislature is the fact that even in the moderate-inflation environment projected for 1986–87, the costs of state and local governmental purchases of goods and services still are projected to inflate at a nearly 6 percent rate in the budget year. At this pace, the "cost of government" would double in only 12 years. Thus, controlling and reducing inflation should remain a top priority of the nation's economic policymakers.

Interest Rates—Significant Near-Term Upswing Unlikely

The problem of high interest rates, which emerged in the late 1970s and remains with us, is projected by the department to lessen somewhat in 1986 and early 1987, as it did in 1985. Specifically, the department is projecting that:

- The ***prime rate*** will average 9 percent both in 1986 and 1987, versus 9.9 percent in 1985 and 12 percent in 1984; and
- The ***average mortgage rate*** will be 12.4 percent in 1986 and 12.2 percent in 1987, compared to 12.7 percent in 1985.

Forecasting interest rates is always a risky business, given the many factors that affect them and the need to predict not only the "real" component of interest rates, but also the "inflation premium" that becomes embedded in them. While interest rates certainly "can't fool all of the economists all of the time," few if any economists consistently make accurate interest rate predictions. (Indeed, if they could, they would retire as economists and spend full time amassing fortunes by speculating in the financial markets!)

Nevertheless, the department's predictions regarding interest rates are consistent with economic fundamentals and the other aspects of its economic outlook. These include:

- The expectation that inflation will not accelerate;
- The prediction that private-sector credit demands will moderate, due to a slowdown in business investment spending and efforts by consumers to avoid further increases in their debt levels; and
- The prospects for fairly "accommodative" monetary growth, given the possibility of a swing toward more conservative federal spending policies and thus the need for the Federal Reserve to "step in" and ensure that the current economic expansion will remain "on track."

Although many economists are forecasting that interest rates will turn upward at some point in 1987, the consensus view is that stable-to-declining rates will prevail over the next year and that, barring unforeseen events, a significant upswing in rates during 1986 is unlikely. Even if the department's forecast comes true, however, "real" interest rates will still be lodged well above where they were in the 1960s and throughout most of the 1970s.

Economy to Benefit From Oil Price Declines

During the latter half of January, after the department's economic forecast had been released, there was a dramatic drop in the price of crude oil. This drop was related to a variety of underlying supply and demand factors, but was actually triggered by a collapse of the pricing and production agreements between OPEC nations. Although most economists had been assuming that crude oil prices would be declining steadily throughout 1986 and 1987, few anticipated the magnitude of the early-1986 drop. For example, as of early February 1986 the open-market price of crude oil was below $20 per barrel, whereas Data Resources, the nation's largest economic forecasting firm, had been predicting that by year-end 1987 (nearly 24 months hence) the price would have declined only as far as $23 per barrel.

Substantially lower crude oil prices will produce a number of disruptions, especially to those economies that rely on crude oil exports. It also will reduce state revenue collections from gasoline sales taxes and tidelands oil production. Nevertheless, the overall effect on our economy should be very positive, just as the early 1970s run-up in oil prices hurt the economy. For example, lower oil prices will:

- ***Reduce inflation.*** This will occur both directly through lower gasoline prices, and indirectly by reducing production costs for goods that use oil as a direct input in the production process.
- ***Reduce the trade deficit.*** Economists have estimated that each $5 reduction in per-barrel crude oil prices has the potential to reduce the nation's $150 billion annual trade deficit by $9 billion.

- ***Stimulate business investment.*** This will occur because reduced energy costs will raise the rate of return on many types of projects, while at the same time reduced inflation will have a downward impact on interest rates and thus on financing costs.
- ***Raise overall economic growth.*** Data Resources has estimated that if oil prices remain at $20 per barrel, annual economic growth would rise about 2 percentage points by 1988.

Thus, although the sustainability and full economic implications of the recent crude oil price drop remain to be seen, the drop itself is a very positive development.

Continued Uncertainties Regarding Federal Budget Policies

During 1984–85, the federal budget deficit amounted to nearly $200 billion. Although economists continue to debate what the exact effects of such large deficits are on the economy, one thing is now clear—the economy *cannot* "grow itself out" of the deficit anytime soon. This is because the federal government's *expenditure base* is chronically out-of-line with its *revenue base.*

In an attempt to address the deficit problem, Congress enacted the Gramm-Rudman-Hollings Balanced Budget Amendment in late 1985. This measure requires that between now and 1991, the federal budget deficit be completely eliminated, either through spending cuts, tax increases, or a combination of the two. In order to accomplish this objective, the measure specifies a series of declining deficit targets for each year leading up to 1991. The maximum allowable deficit for 1986–87 is $144 billion. According to the President's 1987 Budget, achieving this target means that the deficit would have to be cut by about $38 billion from what it would be under current spending and taxation policies. This reduction, large though it is, understates the magnitude of the required change in federal program levels. This is because the base from which the $38 billion reduction has been measured already reflects cuts in program levels under Gramm-Rudman amounting to perhaps as much as $40 billion!

Should Gramm-Rudman be upheld in the courts and Congress not act on its own to achieve the deficit target, the amendment would require that both defense and nonexempt domestic spending programs each be trimmed by $19 billion across-the-board. Further cuts would be required in subsequent years to achieve the still-lower deficit targets set for those years. Since a wide variety of nondefense programs (including social security, Medi-Cal, AFDC, food stamps, and medicare) are either fully or partially exempt from the required spending cuts, the remaining programs would be especially hard hit by Gramm-Rudman.

Exactly what will happen to federal spending levels in federal fiscal year 1987 is perhaps the biggest imponderable facing California policymakers.

Generally speaking, however, economists believe that the effects of the Gramm-Rudman measure on the economy will, at least in the near term, be *negative*. For example, the *Blue Chip* forecasters rank the prospect of budget cuts and tax increases as the second most negative factor facing the economy today, only ranking below the uncertainty created by pending tax reform proposals. Economists have this view because of their belief that Gramm-Rudman, if implemented, would reduce the fiscal stimulus to the economy coming from government, and thus reduce economic growth. This, in turn, would place pressures on the federal monetary authorities to increase the money supply, which eventually could result in increased inflation. This concern is heightened by the fact that monetary growth in 1985 exceeded 11 percent, despite the existence of a fairly stimulative fiscal policy.

Of course, economists also recognize that eliminating the federal budget deficit probably would produce certain benefits in the long-run, such as lower real interest rates that would stimulate private sector investment spending. However, there is little consensus regarding the likely timing and magnitude of these benefits.

The second element of uncertainty in the area of federal policy involves *tax reform*. At the present time, the House Ways and Means Committee has passed a tax reform bill which would, among other things, reduce marginal income tax rates, increase personal exemptions, and make numerous other changes involving tax deductions. The Senate, however, has indicated that it may develop a proposal of its own. Thus, whether tax reform will occur and, if so, what form it will take, remains unclear at this time.

Finance Versus Other Forecasters

Table 23 compares the Department of Finance's national and California economic forecasts for 1986 with those which were made by other economists at approximately the same point in time (year-end 1985). Generally speaking, the department's overall forecast is not "out of line." Most forecasters envision the same general type of economic performance in 1986 that Finance does—fairly moderate levels of inflation and homebuilding activity, declining unemployment, and moderate though sustained real growth.

However, if one were to characterize the department's 1986 forecast as being toward one end of the forecasting range or the other, one would have to put it toward the "low" end—at least with respect to those variables most important in estimating revenues. For example, as Table 23 shows, the department's forecast is below the consensus for national corporate profits growth, as well as for growth in California nominal personal income, "real" personal income, and employment. Even so, the general story told by *all* of the forecasters is pretty-much the same.

Table 23
The Economic Outlook for 1986 [a]

A. *National Forecasts*	*Percent Change In: Real GNP*	*GNP Prices*	*Pre-Tax Profits* [b]	*Unemployment Rate*	*New Car Sales (millions)*	*Housing Starts (millions)*
Department of Finance	3.2%	3.3%	7.5%	6.9%	10.7	1.82
Blue Chip Survey: [c]						
—Consensus forecast	3.0	3.5	9.3	7.0	10.7	1.78
—Low-end average forecast [d]	1.8	2.9	2.5	6.6	9.7	1.65
—High-end average forecast [d]	4.1	4.2	17.4	7.3	11.7	1.90

B. *California Forecasts*	*Percent Change In: Personal Income*	*Consumer Prices*	*"Real" Personal Income* [e]	*Wage and Salary Jobs*	*Unemployment Rate*	*New Residential Building Permits (thousands)*
Department of Finance	7.1%	4.6%	2.4%	2.9%	7.2%	229
Other Forecasters						
UCLA	7.1	4.4	2.6	3.1	6.8	229
Security Pacific Bank	8.1	4.5	3.4	2.5	7.8	220
First Interstate Bank	8.8	4.3 [f]	4.3	3.7	—	211
Crocker Bank	8.0	5.2	2.7	3.4	6.8	210
Bank of America	7.5	5.0	2.4	— [g]	7.4	210
Wells Fargo Bank	7.0	5.0	1.9	— [g]	7.6	210
Commission on State Finance	7.4	3.8	3.5	3.1	7.4	219
Average of "Other" Forecasters	7.7%	4.6%	3.0%	3.2%	7.3%	216

[a] Forecasts available as of approximately year-end 1985.
[b] Defined as pre-tax profits *with* inventory valuation and capital consumption adjustments. The Blue Chip Survey does not report pre-tax profits excluding these adjustments, which is the most relevant profit figure for revenue-estimating purposes. The department's 1986 projection for growth in this latter profit measure is 4.4 percent, and we estimate that the comparable Blue Chip figure would be 6.7 percent.
[c] Includes the projections of 50-odd economists as published in *Blue Chip Economic Indicators* for January 1986. Permission to reprint data granted by Capitol Publications, Inc.
[d] Represents average of the 10 lowest/highest forecasts for each variable as published in *Blue Chip Economic Indicators* in January 1986.
[e] Defined as personal income adjusted for consumer price inflation.
[f] Forecast for U.S. consumer price inflation.
[g] Forecast for wage and salary employment growth not available. Forecast for growth in total civilian employment is 2.0 percent, compared to the department's forecast of 2.2 percent.

PRIOR-YEAR (1984–85) REVENUES

General Fund revenue collections in 1984–85 totaled $26.5 billion. This represents an increase of $2.7 billion (over 11 percent) from 1983–84.

Above-Average "Real" Revenue Growth Occurred

The rate of "nominal" revenue growth (that is, revenue growth before adjusting for inflation) during 1984–85 was a bit *below* average by historical standards. For example, over the period 1973–74 through 1983–84, General Fund revenue growth averaged about 13 percent per year. Revenue growth, however, actually was a bit *above* average in "real" per capita terms (that is, after adjusting for inflation and population)—3.2 percent, versus 2.7 percent for the 1973–74 through 1983–84 period. This anomaly

primarily reflects the fact that the 1984–85 inflation rate for the costs of government-purchased goods and services (6.1 percent) was well below the average for the prior decade (8.1 percent). The above-average "real" revenue growth is explained by the strong economic recovery that took place in 1984, a year that saw increases of 6.6 percent in real GNP and 6.2 percent in California employment.

As for the performance of individual revenue sources in 1984–85:

- ***Sales and use taxes*** increased by nearly 12 percent, or $1 billion;
- ***Personal income taxes*** increased by over 16 percent, or $1.5 billion (this abnormally high increase partly reflects large one-time fiduciary tax payments, without which revenue growth would have been a bit below 13 percent);
- ***Bank and corporation taxes*** increased by over 13 percent, or $434 million;
- ***Income from all other sources*** including investments, other taxes, special fund transfers, fees and royalties, fell by slightly under 10 percent ($265 million).

Growth Would Have Been Even Higher Without Special Factors

The observed 11 percent General Fund revenue gain in 1984–85 incorporates the distorting effects of a variety of "special" factors which affected revenues in 1983–84 and 1984–85. These factors include the phasing-out of inheritance and gift taxes and the phasing-in of the estate tax due to Proposition 6 (June 1982) and Ch 634/80, various tax accelerations and transfers of special fund monies to the General Fund, court cases, the state's tax amnesty program, new legislation, large one-time fiduciary tax payments and inheritance tax receipts, the 1984 Summer Olympics, implementation of the state's external borrowing program, and certain GAAP-related accounting reclassifications of revenues and reimbursements. In the absence of these "special factors", General Fund revenue growth in 1984–85 would have been almost 14 percent and "real" per capita growth would have been far above average—5.3 percent. This strong "underlying" growth trend reflects the strong economic performance that occurred during 1984.

Revenue-Estimating Accuracy Was Above Average

Table 24 summarizes the department's track record in estimating 1984–85 revenues. It indicates that actual 1984–85 revenues were $711 million above the department's initial (January 1984) estimate for that year. Of this difference, $455 million was due to such "special" factors as legislation, court decisions and one-time revenue windfalls. The remaining $256 million reflected the fact that the economy performed better than the department forecast, as well as technical revenue reestimates.

Table 24
The Department of Finance's
Track Record for Forecasting Revenues in
1984–85 and 1985–86
(dollars in millions)[a]

History of Changes	*Revenue Estimate For* 1984–85	1985–86
A. Original budget estimate [b]	$25,825	$27,922 [c]
B. Revisions due to economic factors and technical reestimates		
—May 1984	−67	—
—June 1984	−91	—
—July 1984	94	—
—January 1985	−63	—
—May 1985	392	244
—January 1986	−9	115
Subtotals	$256	$359
C. Revisions due to other factors including legislation, special one-time revenue collections, and accounting reclassifications	$455 [d]	−$94 [e]
D. Total revisions	$711	$265
E. Actual/estimate as reflected in the 1986–87 Governor's Budget (January 1986)	$26,536	$28,187

[a] Information in table was developed from published Department of Finance data. Additional details on this information, including data by type of revenue source, may be obtained from the Legislative Analyst's office.

[b] Published in January preceding the start of each fiscal year.

[c] Includes a $137 million revenue gain due to a proposal in the 1985–86 Governor's Budget to fund the state's solar and energy conservation tax credits through a direct appropriation.

[d] Includes (i) *gains* of $335 million in one-time fiduciary tax payments, $79 million in unexpectedly large estate tax payments (including $44 million from the Howard Hughes' estate), $84 million in increased arbitrage interest income related to external borrowing due to Ch 268/84, and $30 million from other 1984 legislation, and (ii) *losses* of $58 million from GAAP-related accounting reclassifications of certain revenues and reimbursements, and $14 million from General Fund repayments to the Emergency Telephone 911 Account.

[e] Includes (i) *gains* of $81 million in arbitrage interest income related to external borrowing due to Ch 139/85, $109 million from reduced solar and energy conservation tax credit costs (due to Ch 108/85, Ch 116/85, and Ch 1325/85) and $31 million from the DMV's Uncleared Collections Account, and (ii) *losses* of $137 million from failure to enact the Governor's January 1985 proposal to fund the solar and energy conservation tax credits through a direct appropriation, $110 million from GAAP-related accounting reclassifications of certain revenues and reimbursements, $63 million from a General Fund transfer to the Industrial Loan Special Fund due to Ch 142/85 and Ch 140/85, and $5 million from other 1985 legislation.

As Table 24 shows, the department's forecasts of the strength and timing of the economic recovery "flipflopped" throughout 1984 and early 1985. Table 25 shows, however, that the magnitude of the difference between the department's revenue estimates for 1984–85 and actual revenues was considerably *less* than the average discrepancy in prior years. Thus, from an historical perspective, the department's revenue estimating performance for 1984–85 was clearly above average.

Table 25
Discrepancies Between Estimated and Actual General Fund Revenues Attributable to Economic and Technical Factors 1973–74 through 1984–85 [a]

Period	Percent Difference Between Actual Revenues and Original Budget Estimate	First May Estimate	Midyear Estimate (January)
1. 1984–85	1.0%	1.3%	1.5%
2. Prior 11-year period (1973–74 through 1983–84)			
—Average Discrepancy [b]	6.2	4.7	2.4
—Largest Underestimate	10.8	7.5	4.9
—Largest Overestimate	10.6	7.6	3.5

[a] Information in table was developed by Legislative Analyst's office from Department of Finance historical revenue data. For year-to-year details on the department's revenue estimating discrepancies, see prior issues of the *Perspectives and Issues* and *Why Aren't Revenue Estimates More Accurate?*, Legislative Analyst, Report 84-13, November 1984.

[b] Unweighted average of absolute values of percent revisions for individual years.

CURRENT-YEAR (1985–86) REVENUES

General Fund revenue collections in 1985–86 are projected to total $28.2 billion. If this level of collections is realized, it will represent an increase of $1.7 billion (6.2 percent) over the prior-year level. Thus, the pace of revenue growth expected in 1985–86 is well below that experienced in 1984–85. In fact, after adjusting for inflation and population growth, current-year General Fund revenues are projected to *decline* by 1.2 percent. This slowdown reflects a combination of factors, including a moderation in the pace of economic expansion in 1985 relative to 1984, and several special factors that had the effect of depressing revenue growth. As for individual revenue sources:

- ***Sales and use taxes*** are expected to increase by 6.3 percent, or $608 million.
- ***Personal income taxes*** are projected to rise by 5 percent, or $544 million.
- ***Bank and corporation taxes*** are projected to rise by nearly 12 percent, or $435 million.
- ***Income from all other sources,*** including investments, other taxes, special fund transfers, fees and royalties, are projected to rise by 2.7 percent, or $64 million.

Underlying Growth Trend Again Understated

As in the prior year, there are a variety of special factors which, taken together, have caused the rate of revenue growth projected for the current year to be distorted. These factors include the continued phasing-in of death-tax reductions required by Proposition 6 and Ch 634/80, expan-

sion of the state's external borrowing program, GAAP-related accounting changes, certain large one-time tax collections, a large General Fund transfer to the Industrial Loan Fund to support loan guarantees, delayed receipts from unprocessed tax payments on vehicle registrations, and new legislation. In the absence of these and various other special factors, current-year General Fund revenue growth would have been closer to 8.1 percent—well above the 6.2 percent rate projected in the budget. This adjusted "underlying" growth rate, although well below the prior year's rate, is roughly in line with projected income growth in 1985–86 (about 7.6 percent) and represents a small (0.5 percent) increase in "real" per capita General Fund revenues.

Revenues Revised Upward

As shown in Table 24, the revisions to the department's current-year revenue estimates during the past 12 months have added $265 million to the original estimate. This includes upward revisions of $359 million (1.3 percent) due to economic forecasting revisions and technical reestimates, partially offset by downward revisions of $94 million due to other factors.

The $359 million net revision includes gains of $169 million in bank and corporation taxes, $204 million in income taxes, and $256 million from other sources, partially offset by a $270 million shortfall in sales tax receipts. Key factors in the upward revision include stronger-than-expected levels of corporate profits and home building in 1985.

BUDGET-YEAR (1986–87) REVENUES

Table 26 presents the department's estimates of state revenues for 1986–87. Total state revenues in the budget year are projected to reach $36.3 billion, a gain of 8.4 percent ($2.8 billion) over 1985–86. This gain represents a modest acceleration from the current-year's projected rate of increase—6.2 percent. About 85 percent of total revenues goes to the General Fund and 15 percent represents special fund revenues.

General Fund Revenues

As shown in Table 26, General Fund revenues in the budget year are forecast to reach $31.0 billion, a gain of $2.8 billion (10 percent). This amount includes nearly $12.5 billion in personal income taxes (a 9.8 percent gain), $11.1 billion in sales and use taxes (an 8 percent gain), and nearly $4.7 billion in bank and corporation taxes (a gain of nearly 14 percent). These healthy growth rates reflect the department's forecast of a continued economic expansion throughout 1986 and the first half of 1987.

Table 26
State Revenue Collections
1984–85 through 1986–87
(dollars in millions) [a]

General Fund	Actual 1984–85	Estimated 1985–86	Projected 1986–87	Change 1985–86 to 1986–87 Amount	Change 1985–86 to 1986–87 Percent
Taxes:					
Sales and use [b]	$9,667	$10,275	$11,095	$820	8.0%
Personal income [c]	10,806	11,350	12,460	1,110	9.8
Bank and corporation [d]	3,663	4,100	4,655	555	13.5
Estate, inheritance and gift [e]	297	236	248	12	5.1
Insurance	643	745	840	95	12.8
Cigarette	185	175	175	—	—
Alcoholic beverage	136	134	134	—	—
Horse racing	118	119	120	1	0.1
Subtotals, Taxes	$25,515	$27,134	$29,727	$2,593	9.6%
Other Sources:					
Interest on investments	475	548	608	60	10.9
California State University fees [f]	255	241	251	10	4.1
Other revenues [g]	250	293	368	75	25.6
Transfers	41	−29	70	99	—
Totals, General Fund	$26,536	$28,187	$31,024	$2,837	10.1%
Special Funds					
Motor Vehicle:					
Fuel taxes	1,160	1,169	1,182	13	1.1
License fees (in-lieu)	1,240	1,393	1,474	81	5.8
Registration, weight and miscellaneous fees	894	952	965	13	1.4
Subtotals, Motor Vehicle Revenues	$3,294	$3,514	$3,621	$107	3.0%
Other Sources:					
Oil and gas revenues [h]	495	445	391	−54	−12.1
Sales and use tax [i]	131	114	90 [j]	−24	−21.1
Interest on investments	160	163	156	−7	−4.3
Cigarette tax	79	75	75	—	—
Other	875	1,028	991	−37	−3.6
Totals, Special Funds	$5,034	$5,339	$5,324 [j]	−$15	−0.3%
Totals, State Funds	$31,570	$33,526	$36,348 [j]	$2,822	8.4%

[a] Source: 1986–87 Governor's Budget. Details may not add to totals due to rounding.

[b] Includes (i) $31 million in 1985–86 from the Department of Motor Vehicles' Uncleared Collections Account, and (ii) $30 million in 1986–87 resulting from redirection of auditing activities at the Board of Equalization ($19 million) and the Governor's *proposal* to increase audit staff ($11 million).

[c] Includes (i) $335 million in one-time fiduciary payments in 1984–85, (ii) $105 million in 1985–86 and $110 million in 1986–87 due to Ch 116/85 (SB 125), Ch 108/85 (SB 1079), and Ch 1325/85 (SB 243), which reduced the costs of the solar and energy conservation tax credits, and (iii) $21 million in 1986–87 resulting from the Governor's *proposal* to increase audit activities at the Franchise Tax Board.

[d] Includes (i) $4 million in 1985–86 and $7 million in 1986–87 due to Ch 116/85, Ch 108/85, and Ch 1325/85, and (ii) $20 million in 1986–87 resulting from the Governor's *proposal* to increase audit activities at the Franchise Tax Board.

[e] The pattern of year-to-year changes in these revenues is partly due to Proposition 6 (June 1982), which repealed inheritance and gift taxes and in their place imposed an estate "pick-up" tax. Revenues in 1986–87 include $212 million in estate taxes, $35 million in inheritance taxes, and $1 million in gift taxes.

[f] Includes various funds derived from nongovernmental sources, including the state university fee, library fines, certain registration fees, and application fees. Prior to 1986–87, these funds were classified as "reimbursements" in the Governor's Budget and, therefore, were not shown as "revenues."

[g] Includes revenues from various regulatory taxes and licenses, local agencies, user costs for services provided to the public, property-related income, and other miscellaneous revenues. For 1986–87, also includes $75 million due to the Governor's *proposal* to sell surplus land at Agnews State Hospital. Data for *all* years reflect the reclassification of certain Health Care Deposit Fund receipts from "revenues" to "reimbursements," beginning with the 1986–87 Governor's Budget. The effect of this reclassification is to reduce revenues by $313 million in 1984–85, $351 million in 1985–86, and $350 million in 1986–87.

[h] Represents oil and gas royalties from state lands, about 80 percent of which come from the state's tidelands located adjacent to the City of Long Beach. Excludes royalties allocated to the General Fund to support the State Lands Commission and royalties allocated to nongovernmental cost funds.

[i] Reflects sales and use tax receipts to the Transportation Planning and Development Account in the Transportation Fund, as specified under Ch 161/79 (SB 620) and Ch 541/81 (SB 215).

[j] Figure reduced by $20 million from that shown in the budget, to correct for a printing error.

Revenue Trend Relatively Free of Distortions

The 10 percent growth in General Fund revenues projected for 1986–87 is relatively free of distortions from special factors. Nevertheless, the following factors cause the growth rate to be higher or lower than what the economic forecast would imply:

- The budget includes $75 million in revenues from the *proposed* sale of surplus land at Agnews State Hospital;
- The budget includes $52 million in revenues from increased audit collections anticipated to result from the *proposed* increase in audit staff at the Franchise Tax Board (FTB) and the Board of Equalization (BOE). The budget also assumes that another $19 million will be collected due to reallocations of existing audit staff at the BOE;
- The phasing-out of inheritance taxes and the phasing-in of estate taxes distorts the underlying revenue trend somewhat;
- The effects of GAAP-related accounting changes, the second-year effects of 1985 legislation, and the adjustments to the current-year revenue base required in order to reflect one-time transfers and revenues also influence the growth rate.

Taken together, however, these factors all pretty-much balance out, and the underlying General Fund revenue growth trend that emerges after adjusting for them—9.8 percent—is only slightly below the projected rate of 10 percent.

After adjusting for population growth and inflation, budget-year General Fund revenue growth amounts to 2.5 percent (2.2 percent after adjustment for special factors). This growth is only somewhat less than the average annual rate of increase during the past decade (2.7 percent).

Stronger Growth Despite More Moderate Economy in 1986

The growth rate in General Fund revenues projected for the budget year (10 percent, or 9.8 percent on an "underlying" basis after adjusting for special factors) is above the rate projected for the current year (6.2 percent, or 8.1 percent after adjusting for special factors). This uptick occurs *despite* the expectation that California's overall economic performance in 1986 will *not* be stronger than it was in 1985.

The explanation for this apparent anomaly involves a number of factors, including abnormally large increases in liability insurance premium rates, a projected rise in the interest yield on General Fund investments, and the partial-year revenue effects of the acceleration in economic growth forecast for 1987.

Personal Income Tax Gains to Parallel Income Growth

Personal income taxes are projected to rise by 9.8 percent in the budget year. This compares to a projected increase of only 5 percent for the current year. However, some of the apparent acceleration in these re-

ceipts is due to various one-time revenue collections and the effects of new legislation, which distort year-to-year growth patterns. These factors had the effect of raising revenues by $383 million in 1984–85, $131 million in 1985–86, and $133 million in 1986–87. After these effects are removed, the projected underlying personal income tax revenue growth becomes 7.6 percent in the current year and 9.9 percent for the budget year. As shown in Table 20, these rates are of the same general order of magnitude as the department's estimate of taxable personal income growth in 1985 (8.5 percent), 1986 (7.4 percent) and 1987 (9.4 percent).

One might expect that given California's highly progressive income tax rate structure, personal income tax collections should grow faster than the state's economy. The reason why this is not expected to happen is that the "elasticity" of tax collections is expected to be relatively low in 1986 and 1987.

Income Tax "Elasticity" to Remain Low. The best way to understand the income tax projections for any fiscal year is to examine the projection of income tax *liabilities* for the calendar years which underlie the revenue estimates. Year-to-year growth in tax liabilities can be due to three factors:

- Growth in the number of taxpayers (which is correlated with employment growth);
- Growth in average taxable income per taxpayer (which is correlated with average personal income per employee); and
- Growth on a June-to-June basis in the California Consumer Price Index (the CCPI, which is used under the income tax indexing law to adjust the state's marginal income tax brackets, as well as various tax credits and deductions, for inflation).

The percentage increase in tax liabilities which results from each 1 percentage point of income growth (that is, the "elasticity" of tax revenues) is influenced differently by each of these three variables. For example, (a) rapid growth in average income tends to produce a "high" elasticity, as taxpayers move into higher tax brackets, (b) rapid growth in the CCPI tends to produce a "low" elasticity, as tax bracket boundaries are shifted outward, causing taxpayers to move back into lower brackets, and (c) growth in employment per se historically has resulted in about an equivalent percentage increase in tax liabilities.

Table 27 shows those variables in the department's economic forecast that are the primary determinants of estimated income tax liability growth and elasticity. The table also shows *our* estimates of underlying income tax liability growth and elasticity, using these same economic assumptions and our own personal income tax revenue-estimating model. The table indicates that elasticity fell from over 1.8 in 1983 to 1.3 in 1984 and 1.1 in 1985 (estimated), and is projected to be slightly under 1.1 in 1986

and 1987. What this means is that a given percentage point of personal income growth produced considerably fewer tax dollars in 1984 than in 1983, fewer still in 1985, and will produce even fewer tax dollars in 1986 and 1987.

Table 27
Estimates of Underlying Income Tax "Elasticity" and Its Determinants
1980 through 1987

	Percent Change In:					
Calendar Year	*Adjusted Personal Income*[a]	*Civilian Employment*	*Average Real Income Per Employee*[b]	*Indexing Adjustment Factor*[c]	*Implied Tax Liabilities*[d]	*Underlying Elasticity of Tax Liabilities With Respect to Income*[e]
1980	12.3%	2.1%	−6.2%	17.3%	6.0%	0.49
1981	11.9	1.3	2.0	8.3	13.8	1.16
1982	5.9	0.3	−3.4	9.3	2.7	0.46
1983	7.1	1.5	6.8	−1.2	13.2	1.85
1984	12.1	3.5	3.5	4.6	15.3	1.27
1985 (estimated)	8.5	2.7	1.0	4.6	9.4	1.10
1986 (projected)	7.4	2.2	0.5	4.6	7.8	1.05
1987 (projected)	9.4	2.9	0.9	5.4	10.1	1.08

[a] Defined as personal income minus transfer payments plus social security contributions. This income concept historically has shown a strong correlation to adjusted gross income reported for tax purposes.
[b] Growth in average adjusted personal income per employee, deflated by the indexing adjustment factor (the June-to-June percent change in the California Consumer Price Index).
[c] June-to-June percent change in the California Consumer Price Index (statutorily mandated).
[d] Estimated by Legislative Analyst's office using Department of Finance economic forecast. The department's own estimates of actual tax liability growth differ somewhat from these "implied" tax liability figures, since the latter represent underlying liabilities prior to adjustment for such factors as new legislation, special one-time fiduciary tax payments, and changes in auditing activities.
[e] Estimated by Legislative Analyst's office. Figures represent the ratio of tax liability growth to growth in adjusted personal income shown in the table, computed prior to rounding.

The principal reason for the decline in elasticity since 1983 is the relatively slow growth in average real income per employee. It is this variable, which the department projects to be negligible in both 1986 and 1987, that normally gives elasticity its "punch" by propelling taxpayers into higher tax brackets more rapidly than indexing shifts the boundaries of the individual tax brackets outward. Clearly, if the department's economic forecast comes true, there won't be much of this "punch" in either 1986 or 1987, and therefore, the rate of growth in income tax liabilities will be only slightly above the rate of income growth.

Our estimate of how much personal income tax revenues the department's economic forecast should produce is a bit lower—by about $85 million for the current year and budget year combined—than the department's own estimate. This difference, which reflects a $130 million shortfall in 1986–87 partially offset by a $45 million gain in 1985–86, is well under 1 percent of the nearly $24 billion to be collected in personal income tax revenues for the two years combined.

Special Revenue Adjustments. The personal income tax projection for the budget year includes $133 million in *upward* adjustments for special factors. This is the net effect of:

- A gain of $110 million due to Ch 108/85 (SB 1079), Ch 1325/85 (SB 243), and Ch 116/85 (SB 125) which reduced the state's costs of providing the solar and energy conservation tax credits.
- A gain of $47 million from a *proposal* to increase audit staffing at the Franchise Tax Board ($21 million) and ongoing auditing of Individual Retirement Account (IRA) deductions on 1982 and 1983 California tax returns ($26 million). These IRA audits produced $80 million in audit revenues during the prior and current years combined.
- A reduction of $24 million due to other 1985 legislation ($8 million) and the state's tax-amnesty program established by Ch 1490/84 ($16 million). The amnesty-related losses partially offset a gain of $39 million from this program in the prior and current years combined, and reflect the fact that some of these amnesty tax payments ordinarily would have been received in 1986–87 in the form of late payments or audit receipts.

Taxable Sales to Lag Income Growth

As shown in Table 26, sales and use tax revenues are projected to increase by 8 percent in 1986–87, following a 6.3 percent rise in 1985–86.

The projected rates of growth in current-year and budget-year sales tax revenues are based on the assumption that growth in taxable sales will lag slightly behind the growth in California personal income during 1985, 1986 and 1987. This can be seen by comparing Chart 11 and Chart 13, and by looking at the ratio of taxable sales-to-personal income contained in the department's economic forecast.

As Table 28 shows, the taxable sales-to-personal income ratio dropped between 1979 (its all-time record) and 1982 (a recession year). Then, as economic recovery set in, the ratio drifted upward, propelled by a spectacular growth in "real" taxable sales of 11 percent in 1984 (see Chart 13). In 1985, however, the ratio fell again, and the department expects it to fall even slightly more in 1986 and 1987. This assumes taxable sales growth of 7.2 percent in 1985, 6.3 percent in 1986 and 8.8 percent in 1987, compared to personal income growth of 8.1 percent in 1985, 7.1 percent in 1986 and 9.1 percent in 1987.

Despite trailing income growth, however, Table 28 and Chart 13 reveal a healthy rate of growth in "real" taxable sales in all three years, due to continued moderate inflation. In 1986, the year in which taxable sales will exert the greatest influence on budget-year revenues, sales growth is projected to be strongest for the categories of services (9.6 percent), specialty items (8.4 percent) and building materials (8.2 percent), while the weakest growth is projected for the fuel category (1.4 percent).

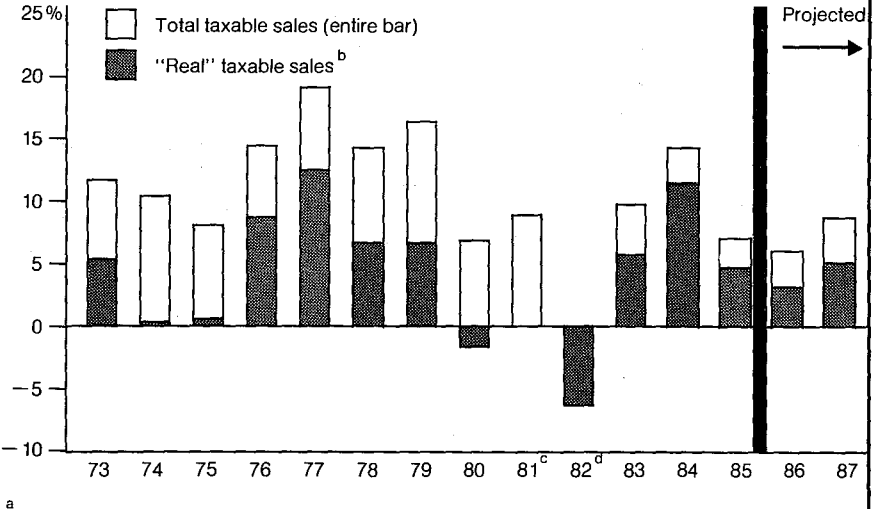
Table 28
Historical Trends in Taxable Sales in California
1968 through 1987 [a]
(dollars in millions)

Calendar year	Total Taxable Sales	Percent Change in: Total Taxable Sales	Percent Change in: "Real" Taxable Sales [b]	Ratio of Taxable Sales to Personal Income
1968	$41,582	10.8%	6.4%	.541
1969	45,428	8.5	3.9	.538
1970	46,429	2.2	−2.4	.514
1971	50,205	8.1	3.7	.525
1972	55,322	10.2	6.3	.531
1973	61,738	11.6	5.5	.538
1974	68,071	10.3	0.1	.531
1975	73,476	7.9	0.3	.521
1976	83,822	14.1	8.5	.534
1977	99,482	18.7	12.2	.566
1978	113,468	14.1	6.6	.561
1979	131,678	16.0	6.5	.569
1980	142,759	8.4	−1.6	.545
1981	155,127	8.7	0.0	.529
1982	154,553	−0.4	−5.9	.495
1983	169,412	9.6	5.8	.507
1984	194,012	14.5	11.0	.523
1985 (estimated)	207,980	7.2	4.1	.518
1986 (projected)	221,100	6.3	3.2	.514
1987 (projected)	240,550	8.8	5.1	.513

[a] Source: Department of Finance and State Board of Equalization. Estimated (1985) and projected (1986 and 1987) data from Department of Finance. Historical taxable sales data have been adjusted by the department to account for changes over time in the definition of the taxable sales base, including inclusion of gasoline sales beginning in mid-1972.

[b] Defined as total taxable sales deflated by U.S. GNP consumption expenditures deflator.

Chart 13
Annual Growth in California Taxable Sales
1973 through 1987 [a]



[a] Source: California Department of Finance.
[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the GNP price deflator for consumption expenditures.
[c] "Real" taxable sales were unchanged.
[d] Total taxable sales declined by 0.4 percent.

Revenues May Be Understated. Our own analysis indicates that, while there is no basis for expecting booming taxable sales or a dramatic rise in the sales-to-income ratio during 1986 or 1987, there is reason to believe that taxable sales in California will perform somewhat better than what the department expects. For example, the department's economic forecast assumes that California's unemployment rate will fall over the next 18 months, that "real" interest rates will soften a bit, that the percentage of the population which is employed will be rising, that annual housing starts will exceed the average level of the past decade, and that 1986 federal defense spending will rise more rapidly than personal income. All of these factors historically have implied a rise in the taxable sales-to-personal income ratio, and are capable of offsetting such negative factors in the taxable sales outlook as restrained growth in investment spending and flat expenditures on new automobiles and gasoline.

Our own revenue estimating techniques suggest that, if the department's economic forecast comes true, the sales-to-income ratio probably will drift up slightly, to around 52.9 percent in both 1986 and 1987. This would generate about $285 million in additional sales and use tax revenues during the current and budget years, combined. Even if this happens, however, the ratio of taxable sales-to-personal income would still remain well below its 1980 level (54.5 percent), and somewhat below the average for the past 20 years (53.5 percent).

Key Uncertainties Exist. Accurately predicting taxable sales is always difficult, given the many variables that influence spending decisions, and the lack of understanding about exactly how this spending is affected by such factors as high consumer debt burdens and increases in net worth caused by stock market upswings. It is especially hard at this point in time, however, for two reasons:

- ***Taxable Sales in 1985 Were Unexpectedly Weak.*** According to our statistical revenue-estimating models, the level of taxable sales in 1985 was approximately $4.3 billion *below* the level that would have occurred had normal historical relationships existed between taxable sales and those economic variables that traditionally have influenced them. As we discuss later, should 1985's experience be repeated, we estimate that 18-month sales tax revenues would be $15 million *below,* instead of $285 million above, the department's forecast.

- ***Imported Crude Oil Prices.*** As discussed earlier, crude oil prices dropped dramatically in the last half of January. To the extent that this translates into reduced retail gasoline prices without changing gasoline consumption, it will reduce sales tax revenues—by $5.5 million annually for each 1 cent-per-gallon price reduction. In addition, reduced fuel costs would reduce the inflation rate generally throughout the economy, thereby holding down the overall volume of taxable sales in nominal dollar terms. These effects, however, may not be fully realized. Some of the drop in crude oil prices probably will show up as increased profit margins for refineries and gasoline retailers, as opposed to lower retail gas prices. Moreover, producers may choose to restrict the supply of gasoline itself, in order to avoid sharp price drops. In addition, the savings realized by consumers as a result of lower gasoline prices will be partially redirected into other categories of taxable sales. Finally, reduced energy costs will tend to stimulate economic activity generally. On balance, we believe that because of these factors, the net effect of lower oil prices probably will be *positive* both for the economy and state revenues.

Special Revenue Adjustments. The sales and use tax revenue projection for the budget year includes a net gain of $41 million due to special adjustments. This amount consists of $11 million resulting from newly enacted 1985 legislation and $30 million from increased sales tax audits by the State Board of Equalization (BOE). The most important piece of revenue-affecting legislation was Ch 1446/85 (SB 1225), which is projected to raise $13 million in the budget year by subjecting mail-order transactions involving out-of-state retailers to the state sales tax. The $30 million audit-related revenue gain includes $11 million due to the *proposed* increase in BOE audit staffing, and $19 million due to a planned staffing reallocation within the BOE that will increase audits of high-yielding gasoline-retailer accounts.

Special adjustments in the current year include a one-time $31 million transfer to the General Fund from the Department of Motor Vehicles' Uncleared Collections Account, representing state use tax revenues belonging to the General Fund from yet-to-be-processed vehicle registration fees.

Corporate Profits—Strong Growth Projected

Revenues from the bank and corporation tax are more difficult to project from year-to-year than revenues from any other source. This is because of the inherent volatility of corporate profits, the wide variety of factors which influence profits, the complex prepayment patterns which firms use to remit tax liabilities to the state, and the lengthy time lags required before actual data on past corporate profits become available.

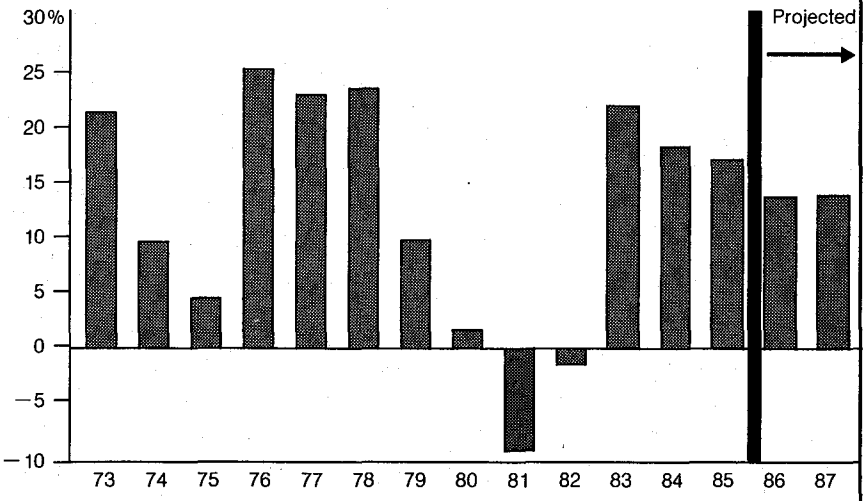
The task of projecting these revenues has become even more difficult in the past several years because recent federal law changes have distorted the historical relationships between California and U.S. profits. The most significant of these changes occurred as a result of the Economic Recovery Tax Act (ERTA) of 1981 and the Tax Equity and Fiscal Reponsibility Act (TEFRA) of 1982, which dramatically revised the rules governing depreciation allowances for federal tax purposes.

As Table 26 shows, the department projects that revenues from the bank and corporation tax will rise by nearly 14 percent in the budget year. Thus, the bank and corporation tax is projected to grow faster in 1986–87 than any other major revenue source. The projected budget-year growth compares to healthy increases of 12 percent in the current year (projected) and 13 percent in the prior year.

The above-average growth projected for bank and corporation tax revenues reflects the department's projection for taxable corporate profits. As Chart 14 shows, California profits are estimated to have risen by 22 percent in 1983, 18 percent in 1984, and 17 percent in 1985. For both 1986 and 1987, the department projects gains of nearly 14 percent. If achieved, this would represent five consecutive years of relatively strong profit growth in California.

Chart 14

Annual Growth in California Taxable Corporate Profits 1973 through 1987[a]



[a] Source: California Department of Finance. Profit totals include a $335 million reduction in 1975 due to changes in depletion allowances and a $967 million increase in 1978 due to Proposition 13. Preliminary 1985 estimate by Department of Finance and Franchise Tax Board.

Estimates Are Too High. The department's projections of California profit growth in 1986 and 1987 (nearly 14 percent for each year) are notably stronger than its projections of corporate profits growth nationally (4.4 percent in 1986 and 9.2 percent in 1987). Part of this disparity can be explained by the factors that cause California and national profits to grow at different rates year-in and year-out.

After adjusting for these factors, however, we find that the department's estimates of corporate growth are too high. Our own revenue-estimating procedures indicate that increases of about 9.6 percent in 1986 and 11.3 percent in 1987 are more consistent with the department's basic economic forecast. While these rates are well-below the department's projections, they exceed the rates projected for the nation as a whole, and would sustain the upward trend in the ratio of California profits-to-personal income that began after 1982 (see Chart 16). Nevertheless, they would translate into less revenues than what the department projects.

Specifically, we estimate that *if* the department's basic economic forecast comes true, bank and corporation tax revenues will be lower than the department's estimate by about $75 million in the current year and $180 million in the budget year, or $255 million for the two years combined. While this difference is fairly small in percentage terms—less than 3 percent of total revenues for the two years combined—it nevertheless is very significant in absolute dollar terms. Of course, we are the first to admit that there is a fairly large error margin surrounding *anyone's* corporate profits estimates, especially estimates for California.

Special Revenue Adjustments. The bank and corporation tax revenue estimate for the budget year includes a net gain from special adjustments of $23 million, including $3 million for the revenue effects of enacted 1985 legislation, and $20 million due to a budget *proposal* to increase tax audit staffing at the FTB. The revenue effects of legislation include an $8 million loss from several acts which provide corporations with special deductions and tax credits for donations of scientific equipment and computer programs to educational institutions, and a $7 million revenue gain from Ch 108/85 (SB 1079), Ch 1325/85 (SB 243), and Ch 116/85 (SB 125), which reduced the state's costs of providing the solar and energy conservation tax credits.

Other Major Taxes

Table 26 shows that General Fund revenues from taxes other than the three major taxes are projected to total $1.5 billion in the budget year. These taxes include the insurance tax ($840 million); the inheritance, gift and estate taxes ($248 million, combined); the cigarette tax ($175 million); alcoholic beverage taxes ($134 million); and horse racing taxes ($120 million).

The budget-year estimate for these taxes is $108 million (or 7.7 percent) above the current-year level. Nearly all of this increase is attributable to the insurance tax, with a small gain in death-related taxes accounting for most of the remainder. Revenues from the remaining taxes are projected to be flat.

Strong Growth in Insurance Taxes. Insurance tax collections are projected to reach $840 million in 1986–87, an increase of nearly 13 percent ($95 million). This estimate is based on the department's projections of taxable insurance premiums, which in turn were derived from survey responses submitted by 142 California insurance companies that account for about 51 percent of all insurance premiums written in the state. According to the survey, the amount of insurance premiums subject to the gross premiums tax (levied at a rate of 2.33 percent in 1985 and 2.35 percent in 1986 and 1987) is expected to rise by about 16 percent in 1985 (the year on which 1986 tax prepayments are based), and 12 percent in 1986 (the year on which 1987 tax prepayments are based). Taxes on these premiums account for about 97 percent of all insurance tax collections.

During normal times, the annual growth in taxable insurance premiums tends to run pretty much in line with growth in the state's personal income base. During the forecast period, however, expected premium growth (16 percent for 1985 and 12 percent for 1986) significantly exceeds income growth (8.1 percent for 1985 and 7.1 percent for 1986).

In part, this disparity is due to the ongoing economic expansion and the especially strong performance of the housing sector in 1985, which resulted in increased insurance coverage for automobiles and homes. By far the single most important factor pushing up insurance tax revenues, however, has been the dramatic growth in *premium rates* for *liability insurance.* These higher rates are attributable to such factors as expanded definitions of "liability" in the courts, a trend toward increased monetary settlements for insurance claims, and insurers' need to offset both large 1985 underwriting losses and unanticipated shortfalls in reserve-fund investment income (caused by reduced interest rates). As a result of these factors, taxable liability premiums are expected to rise by nearly 37 percent in 1985 and 16 perent in 1986.

Modest Growth For Death-Related Taxes. Combined inheritance, gift, and estate taxes are projected to yield $248 million in the budget year—a gain of $12 million (5.1 percent) from the amount expected in the current year. This gain is the net effect of two partially offsetting factors:

- A gain of $17 million (8.7 percent) in estate taxes, and
- A reduction of $5 million (12 percent) in inheritance and gift taxes.

These trends reflect, in part, the continued "phasing-in" of Proposition 6 (June 1982), which repealed the state's inheritance and gift taxes and established in their place a "pick-up" estate tax, which allows the state to

receive a portion of the revenue stemming from the federal estate tax, at no increased cost to taxpayers. (Proposition 6 became effective for estates and decedents and for gifts made on or after June 9, 1982.) Between 1980–81 and 1985–86, this measure has had the effect of reducing General Fund revenues by over $1.8 billion.

In the budget year, inheritance and gift taxes will amount to only $36 million, compared to $106 million as recently as 1984–85. The state will continue to collect inheritance and gift tax revenues in decreasing amounts for several years, after which time only estate tax revenues will remain. While the annual growth in these estate tax revenues will fluctuate from year to year, on the average they should run pretty much in line with growth in the state's overall income base.

No Growth in Other Taxes. The three remaining major taxes—the cigarette, alcoholic beverage and horse racing taxes—are projected to total $429 million in 1986–87. This is an increase of only $1 million over the current-year level and a decline of $10 million from the prior-year level.

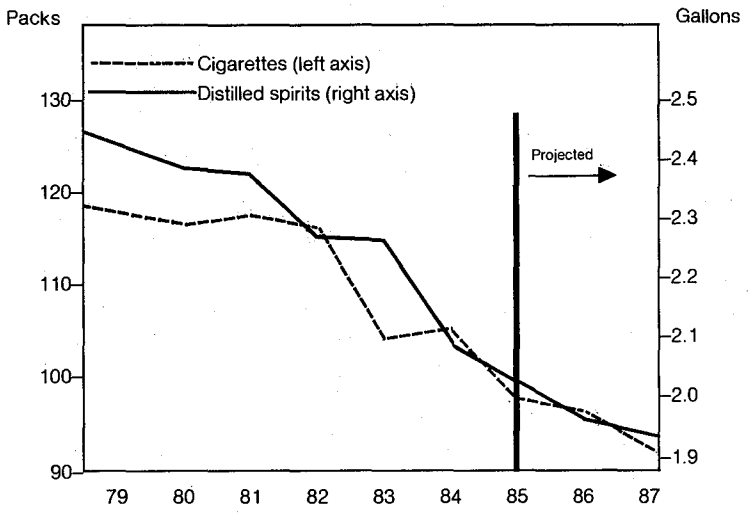
There are two reasons why these taxes, taken together, are essentially a "no growth" revenue source:

- ***First***, the "bases" on which these taxes are levied have not been growing much. For example, the dollar volume of parimutual horse racing wagering (the main source of horse racing revenue) is expected to inch upward by only about 2 percent in both the current year and budget year, and therefore, will remain essentially unchanged on a per capita basis. And, as shown in Chart 15, per capita consumption of both cigarettes and distilled spirits has been falling dramatically in recent years, and is expected to continue this trend through 1987.
- ***Second***, both the cigarette and alcoholic beverage taxes are selective excise taxes which are levied on a "cents-per-unit-consumed" basis. Thus, these revenues do not go up to reflect inflation as does a tax like the sales tax, which is levied as a percent of the dollar-amount spent for a commodity.

Regarding the ***cigarette tax,*** declining per capita consumption of cigarettes is attributable to a number of factors, including health-related concerns and smoking laws. The decline was accelerated after January 1, 1983 when the federal excise tax on cigarettes was doubled, from 8 cents to 16 cents per pack. The federal rate currently is scheduled to return to 8 cents per pack on March 15, 1986. It appears likely , however, that in light of the federal budget deficit and the Gramm-Rudman Amendment, the higher rate will be extended. In fact, the President has proposed this extension in his 1987 Budget.

Chart 15

California Per Capita Consumption of Cigarettes and Distilled Spirits, 1979 through 1987[a]



[a] Source: California Department of Finance and State Board of Equalization.

If the higher federal rate is not extended, however, California will have an opportunity to raise its own cigarette tax rate without raising the total amount of taxes levied on cigarettes, and thus prices paid by cigarette users. For each 1 cent increase in California's per-pack cigarette tax above the current 10 cent level, the state would raise about $25 million annually, assuming current per capita consumption levels.

In the case of ***horseracing taxes,*** some of the projected increase in total wagering is due to the implementation of intertrack simulcast wagering under Ch 1698/84 (SB 2150). The department estimates that this simulcast wagering will generate additional revenues of about $1.5 million in the current year and $3 million in the budget year. However, because most of this wagering currently is occurring at fair racing facilities, these revenues are expected to accrue to the Fair and Exposition Fund, not the General Fund.

Other legislation was enacted in 1985 which gave the California Horse Racing Board the option of licensing more harness racing weeks. However, the department has not incorporated any revenue effects for additional harness racing, partly because it believes that any added revenues from more racing weeks would merely serve to offset anticipated revenue losses due to various other factors, such as wagering competition from the California State Lottery.

Regarding ***alcoholic beverage taxes,*** the no-growth revenue outlook is in part due to the adverse effects on consumption of the $2-per-gallon increase in the federal excise tax on distilled spirits, which became effective on October 1, 1985. It is expected that this tax increase, by raising liquor prices, will help to sustain the downward trend in per capita consumption that has been in evidence since 1979 (see Chart 15).

Interest Income

The General Fund can earn interest income from four primary sources: (1) the investment of surplus monies left over from the preceeding year, (2) earnings on those balances in the Pooled Money Investment Account (PMIA) which are not General Fund balances per se, but on which the General Fund nevertheless is legally entitled to earn interest, (3) any General Fund monies that are idle because of the time lag between when revenues are collected and disbursements are made, and (4) "arbitrage earnings" on the short-term investment of temporarily idle monies that the General Fund has borrowed to handle its intra-year cash flow imbalances. Of these four sources, the third—temporarily unused General Fund monies—typically is the single most important source of interest income. Beginning in 1984–85, however, the importance of arbitrage earnings and income from investing surplus funds has increased significantly, due to expansion in the state's external-borrowing program and the General Fund's improved fiscal condition.

The budget projects that General Fund interest income on investments will be $616 million in 1986–87, of which $605 million represents returns on the General Fund's share of PMIA balances. The level of General Fund investment income projected for 1986–87 compares to about $556 million (including $545 million from the PMIA) projected for 1985–86 and $482 million (including $471 million from the PMIA) in 1984–85. As shown in Table 29, this projection assumes that:

- ***The average balance*** in the PMIA during 1986–87 on which the General Fund will earn interest will be about $6.4 billion. This is $420 million more than the average balance of $6 billion for 1985–86.
- ***The average interest yield*** on PMIA investments in 1986–87 will be about 9.5 percent. This compares to an actual average yield of about 10.8 percent in 1984–85, 9.4 percent for the first half of 1985–86, 9.3 percent at year-end 1985, and 9.2 percent projected for the current year as a whole.

As indicated in Table 29, over 30 percent of the PMIA balance on which the General Fund earns interest is attributable in both the current year and budget year to the state's external borrowing program, and represents temporarily idle monies that the General Fund has borrowed from non-state sources in order to handle intra-year cash flow imbalances. During periods when these external funds are idle, they are invested in short-term

securities paying market interest rates, thereby generating "arbitrage income" since the funds are borrowed at tax-exempt interest rates. Prior to 1984–85, the General Fund rarely engaged in short-term external borrowing. Because of legislation enacted in both 1984 and 1985, however, the General Fund now is undertaking as much external borrowing as the federal Internal Revenue Service (IRS) regulations permit, in order to minimize its net borrowing costs through the maximization of arbitrage earnings. The budget assumes that external borrowing will total $2.5 billion in 1986–87.

Table 29
Estimates of General Fund Interest Income
1985–86 and 1986–87
(dollars in millions)[a]

	1985–86	*1986–87*
A. Average Balance Available in the Pooled Money Investment Account (PMIA) for General Fund Investment Purposes		
1. Regular General Fund Balance	$4,073	$4,415
2. Balance from External Borrowing[b]		
a. Balance due to Ch 268/84	1,012	1,090
b. Balance due to Ch 139/85	875	875
Subtotals	$1,887	$1,965
3. Total PMIA Balance Available	$5,960	$6,380
B. Average PMIA Investment Yield	9.2%	9.5%
C. Resulting PMIA Investment Income	$545	$605
D. Additional Non-PMIA Interest Income[c]	11	11
E. Total General Fund Interest Income	$556	$616

[a] Source: California Department of Finance. Details may not add to totals due to rounding.

[b] The interest income associated with these balances is partially offset by the interest costs of external borrowing. Ch 10x/83 (AB28x) allowed the PMIA Board to authorize the State Treasurer to secure short-term external loans so as to satisfy the need of the General Fund to obtain borrowed funds at lowest cost. However, this measure required the exhaustion of all internal sources of funds prior to undertaking any external borrowing. Chapter 268, Statutes of 1984 (the 1984 Trailer Bill), subsequently eliminated the requirement of Chapter 10x that all internal sources of funds be exhausted prior to any external borrowing. Chapter 139, Statutes of 1985 (SB 1465), further expanded the state's ability to borrow externally by changing the Reserve for Economic Uncertainties from a General Fund special account to a special fund. This has the effect of increasing the measured amount of General Fund "borrowing needs" which the IRS uses in determining how much tax-exempt external borrowing it is permissible for California to undertake and earn "arbitrage" interest returns on.

[c] Includes interest income from surplus money investments, condemnation deposit investments, and other sources. Approximately $2.5 million of this income is specifically identified in the 1986–87 Governor's Budget as "interest income," while the remainder is classified as "other investment income."

Our analysis indicates that, relative to its economic forecast, the department's 1986–87 estimate of interest income may be a bit too high. This is because the department's assumption that the average PMIA interest yield will *rise* in 1986–87 conflicts with the assumption in its economic forecast that 1986–87 interest rates generally will be *stable-to-slightly-lower* than in 1985–86.

Of course, some divergence between market interest rates and the yield on PMIA investments could occur if the PMIA Board increases the importance of longer-maturity securities in its portfolio. These securities normal-

ly offer higher returns than shorter-maturity investments. If, however, the PMIA yield more-closely reflects the department's expectations for interest rates generally, interest income in 1986–87 could be as much as $20 million to $30 million *lower* than the amount projected in the budget.

Of course, the estimate of interest income in any particular year is quite susceptible to error. As a "rule of thumb," for each $100 million increase (decrease) in the average PMIA balance accounted for by the General Fund in 1986–87, interest income will be about $9 million higher (lower) than the amount forecast. Alternatively, for each 1 percentage point increase (decrease) in the average PMIA yield relative to the forecasted rate, interest income will be about $65 million higher (lower).

Evaluation of General Fund Revenue Estimates

This section summarizes our evaluation of the department's General Fund revenue estimates. Our evaluation consists of two parts: (1) our analysis of whether the department's revenue projections are consistent with its economic forecast (internal consistency), and (2) our assessment of how alternative economic assumptions that are equally or even more reasonable than the department's would affect revenues.

Internal Consistency: Two-Year Estimates On the High Side

We have taken the *department's* economic assumptions for 1986 and 1987 and used *our* own revenue-estimating techniques to test whether Finance's revenue projections for the current and budget years are consistent with its economic assumptions.

Our analysis, which focused on the state's three major taxes, suggests that an economy along the lines projected by the department would generate somewhat *less* General Fund revenues in 1986–87 than what the department forecasts. We believe that this shortfall would be about $130 million. However, because our analysis also concludes that General Fund revenues in 1985–86 are likely to be about $75 million *more* than what Finance projects, the net reduction for the current and budget years combined would be $55 million. Relative to the tax revenue base (nearly $54 billion for the current and budget years, combined), this is a negligible difference—only one-tenth of 1 percent.

As shown in Table 30, the $55 million difference between our estimates and the department's reflects reductions in both personal income taxes ($85 million) and bank and corporation taxes ($255 million), partially offset by a gain in sales and use taxes ($285 million).

Table 30
Legislative Analyst's Revenue Estimates Using Department of Finance Economic Assumptions 1985–86 and 1986–87 (dollars in millions)

	1985–86			1986–87			
		Statistical Difference			Statistical Difference		Two-Year
Income Source	LAO Estimate	Error Margin [a]	From Finance	LAO Estimate	Error Margin [a]	From Finance	Revenue Difference
Bank and corporation tax	$4,025	$200	−$75	$4,475	$445	−$180	−$225
Sales and use tax	10,380	210	105	11,275	450	180	285
Personal income tax	11,395	225	45	12,330	490	−130	−85
Totals	$25,800	$390 [b]	$75	$28,080	$840 [b]	−$130	−$55

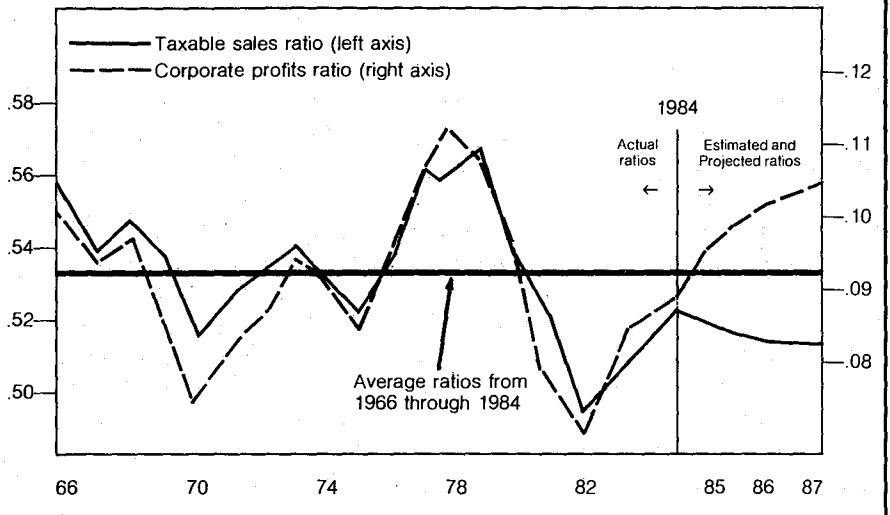
[a] Amount by which revenues could differ from the estimate in *either* direction, based upon a 95 percent confidence factor that takes into account statistical uncertainties in the revenue estimating models themselves. In percentage terms these margins are, for 1986–87, approximately 4 percent for both the personal income tax and sales and use tax, 10 percent for the bank and corporation tax, and 3 percent for the three taxes combined. For 1985–86, the *percentage* error margins are one-half of the 1986–87 margins. The margins do not take into account the effects of incorrect assumptions about exogenous economic variables used to forecast revenues.

[b] Total error margin is less than the sum of the error margins for the individual taxes because the probability is less than 95 percent that all three taxes will simultaneously experience errors in the same direction and equal to their maximum error margins. In statistical terms, the error margin for total taxes depends on the standard error of the forecast for total taxes, which equals the square root of the sum of the statistical *variances* for the individual tax forecasts, and *not* simply the sum of the *standard errors* for the individual tax forecasts.

There are a variety of reasons for these differences. In the case of the personal income tax, our income tax simulation model shows taxpayers being pushed into higher marginal tax brackets at a somewhat slower pace in 1986 and 1987 than what the department assumes, thereby resulting in smaller increases in average tax rates. In the case of the sales and use tax and the bank and corporation tax, however, where the larger estimating discrepancies occur, our revenue estimating models simply show the bases for these taxes—namely, taxable sales and corporate profits—behaving differently from what the department anticipates, both when looked at separately and relative to one another. For example, Chart 16 depicts how the ratio of both taxable sales and corporate profits relative to personal income have behaved over the past two decades. Almost without exception, these ratios have moved *together*. As shown in Chart 16, however, the department is predicting that during 1986 and 1987, the taxable sales ratio will decline while the corporate profits ratio will rise significantly. Thus, the department is predicting that these two ratios will increasingly *diverge*, to the point where the difference will be far greater than it has been at *any* time before. In contrast, our own revenue-estimating models suggest that:

Chart 16

Ratios of California Taxable Sales and Corporate Profits to Personal Income, 1966 through 1987[a]



[a] Source: California Department of Finance. Data are estimated for 1985 and projected for 1986 and 1987.

- The ***corporate profits ratio*** will indeed rise in 1986 and 1987, but to a much *lesser* degree than projected by the department. The department's projected rates of California corporate profits growth—nearly 14 percent in both 1986 and 1987—simply are inconsistent with many other aspects of its economic forecast that affect this variable, including its expectation for only moderate growth in national profits and in California employment, income and taxable sales.
- The ***taxable sales ratio,*** although it will still be below its long-term average, will be slightly *higher* in 1986 and 1987 than in 1984 and 1985. This is consistent with the department's forecast for falling unemployment rates, downward-drifting real interest rates, and a rise in the percentage of the population that holds jobs. All of these factors historically have been associated with increases in the taxable sales-to-personal income ratio.

As discussed earlier in the section on taxable sales, however, there is some downside risk to our estimate of how much taxable sales the department's economic forecast will produce. This is because 1985 taxable sales appear to have slipped about $4.3 billion below the level consistent with the 1985 economic performance in California. Our estimates assume that this unexplained shortfall, which is equivalent to about $200 million in

state sales tax collections, will not reappear in 1986 and 1987. Should our assumption not be correct, sales tax revenues would be up to $300 million less ($100 million in 1985–86 and $200 million in 1986–87) than the amounts shown in Table 30. This, in turn, would cause our two-year estimate of the revenues that should result from the type of economy forecast by the department to be about $355 million *below* the department's estimates.

Significant Statistical Error Margins Exist

Table 30 also shows our estimates of the statistical error margins that surround the revenue estimates. These margins provide a useful perspective on the basic reliability of revenue estimates, *independent* of the inherent problems encountered in trying to forecast economic performance. Simply stated, these margins indicate the band within which revenues could fluctuate *even if* the department's economic forecast comes true. As Table 30 shows, in the budget year this confidence interval is about $840 million (3 percent) for the three major taxes combined, including $490 million (4 percent) for the personal income tax, $450 million (4 percent) for the sales and use tax, and $445 million (10 percent) for the bank and corporation tax. The reason why the percent error margin is largest for the bank and corporation tax is that corporate profits are so volatile. In addition, because major changes were made in 1981 and 1982 to the federal tax treatment of corporate depreciation allowances to which California has not conformed, the exact statistical relationship between California taxable profits and national pre-tax profits is subject to greater uncertainties than ever.

All of these considerations, coupled with the fact that the department's economic forecast itself could prove to be wrong, make it clear that the revenue estimates for 1985–86 and 1986–87 could be subject to considerable revision during the next 18 months.

Alternative General Fund Revenue Scenarios

Given the ever-present uncertainty about how the economy will perform in the future, it is important to make some estimate of the margin by which actual revenues in the current and budget years could differ from what the department projects if the department's *economic forecast* does *not* come true.

Several approaches can be followed to develop these estimates. One can estimate the amount of revenues that would result if the "average" of other economic forecasts came true. Or one can develop optimistic and pessimistic revenue estimates based on economic scenarios that differ fundamentally from the "standard" economic forecast to which the department and most other forecasters publicly adhere. The results of each approach are presented below.

Revenue Estimates Based on the "Average" Economic Forecast

In order to estimate the amount of revenues that would result if the "average" of other economic forecasts came true, we used the average for two sets of "other" forecasters. For California, we used the forecasters listed in Table 23. For the national economy, we used the forecasters surveyed by *Blue Chip Economic Indicators*. We then used these assumptions to "drive" our own revenue estimating models. The results indicate that the "average" economic outlook would produce *$275 million more* in revenues than what the department projects, including $170 million in 1985–86 and $105 million 1986–87. This follows from the fact that, as discussed earlier, the department's economic forecast for certain key revenue-determining variables is a bit on the low end of the spectrum of published forecasts.

Revenue Estimates Based on Optimistic and Pessimistic Economic Scenarios

The department has constructed two alternative economic scenarios to show how economic conditions *other than* those assumed in its "standard" forecast would affect revenues. One scenario is based on a more optimistic set of economic assumptions than those used in preparing the standard budget forecast; the other is based on more pessimistic assumptions. These alternative forecasts illustrate the extent to which the paths followed by the national and state economies could depart from what the department forecasts for 1986 and 1987. (These scenarios, however, by no means bracket the full range of all possible outcomes.)

Table 31 summarizes the key features of the department's alternative economic outlooks. The *optimistic scenario* assumes that the Federal Reserve Board will follow an "easy" monetary policy, thereby stimulating strong economic growth in 1986 and 1987 in both the nation and California. If this scenario materialized, the state's current economic expansion would become one of the longest and most impressive on record. In contrast, the *pessimistic scenario* assumes that a recession starts in mid-1986, characterized by slow income growth, an eventual loss in jobs, declines in corporate profits, and a rising unemployment rate. The spread between the California personal income forecast under these two alternative economic scenarios is about $8 billion in 1986 and over $32 billion in 1987.

Table 32 shows that the department's alternative economic scenarios produce General Fund revenue estimates for 1985–86 which range from $634 million (2.2 percent) above to $776 million (2.8 percent) below the standard forecast. For 1986–87, the revenue estimates range from $1.1 billion (3.6 percent) above to $2.5 billion (8.2 percent) below the standard projection.

It is likely that one could find economists at either end of the forecasting range defined by the department's two alternatives. Moreover, these error margins are not inconsistent with the actual divergencies that have

Table 31
Alternative Economic Outlooks
Prepared by the Department of Finance
1986 and 1987 [a]

Economic Variable	Low Forecast 1986	Low Forecast 1987	High Forecast 1986	High Forecast 1987
1. *National Data:*				
Real GNP growth	2.4%	−1.0%	3.9%	5.4%
Pre-tax profits growth	−7.3	−20.8	9.2	13.0
Unemployment rate	7.3	9.2	6.7	5.7
Wage and salary job growth	2.0	−0.4	3.0	3.9
Consumer price inflation	3.3	3.3	3.9	5.0
Prime interest rate	9.9	10.8	8.7	8.1
Car sales (millions of units)	10.1	9.2	10.6	11.3
Housing starts (millions of units)	1.71	1.56	1.89	2.06
2. *California Data:*				
Personal income growth	6.0%	4.9%	7.9%	10.5%
Wage and salary job growth	1.6	−0.3	3.5	4.8
Unemployment rate	7.7	9.6	6.9	5.8
Building permits (thousands of units)	190	125	249	251

[a] Source: Governor's Budget and Department of Finance.

materialized in past years (see Table 25). In sum, the message given by Table 32 is that significant economics-related revenue estimating errors could occur in both 1985–86 and 1986–87. It is even possible that revenues could fall outside of these ranges.

Both Budget Surpluses and Deficits Are Possible

Table 32 also shows that the General Fund balance would be dramatically affected if either of these alternative revenue scenarios were to materialize. Specifically:

- Were the "high" scenario to occur, the result would be a *two-year revenue improvement* of over $1.7 billion. Ignoring the state's appropriations limit, this would leave the General Fund with a year-end 1986–87 *surplus* of nearly $2.9 billion, which would be enough to both fund a 5 percent balance in the Special Fund for Economic Uncertainties and still leave nearly $1.4 billion to finance new programs, expansion of existing programs, one-time expenditures, or a tax reduction. However, because the state's appropriations limit *is* expected to be a constraint in 1986–87, the Legislature probably would *not* be able to spend these funds for state programs or to "beef-up" the reserve. (The state's appropriations limit is discussed in Part Three.)
- Were the "low" scenario to occur, the result would be a *two-year revenue shortfall of over $3.3 billion.* Unless expenditures were reduced from the levels proposed in the budget or taxes increased, this would leave the General Fund in a *deficit* at the end of the budget year amounting to nearly $2.2 billion.

Table 32
Revenue Effects of Alternative
Department of Finance Economic Forecasts
1985–86 and 1986–87
(dollars in millions) [a]

	1985–86		*1986–87*		*Combined Two-Year Effect*	
	Low Forecast	*High Forecast*	*Low Forecast*	*High Forecast*	*Low Forecast*	*High Forecast*
1. Change from revenues in the standard forecast						
Personal income tax	−$350	$200	−$1,160	$320	−$1,510	$520
Sales and use tax	−105	155	−775	310	−880	465
Bank and corporation tax	−200	100	−460	225	−660	325
Other revenues	−121	179	−144	246	−265	425
Totals, all revenues						
—Amount	−$776	$634	−$2,539	$1,101	−$3,315	$1,735
—Percent	−2.8%	2.2%	−8.2%	3.6%	−5.6%	2.9%
2. Unrestricted balance in the General Fund [b]	−$41	$1,451	−$2,155	$2,895	−$2,155	$2,895

[a] Source: Governor's Budget and Department of Finance.
[b] Computed by adjusting baseline General Fund balances shown in the 1986–87 Governor's Budget for the department's standard economic forecast, to reflect the revenue effects shown in the table. These baseline General Fund balances are $817 million for 1985–86 and $1,160 million for 1986–87, excluding (i) estimated reserves for continuous appropriations of $26 million in 1985–86 and $8 million in 1986–87 and (ii) a $20 million balance in each year in the Disaster-Response Operations Account.

What Will Happen?

Obviously, no one can say with certainty which of the various alternative forecasts will come true. The department has not offered any specific probabilities as to the likelihood that its standard forecast will hold, or what the chances are that the pessimistic or optimistic scenarios will come to pass.

Many economists seem to feel that the downside risk is the most significant at this time, due to such factors as potential federal budget cuts, weak activity in the agricultural sector, high levels of consumer-debt burdens, the high value of the dollar, and international debt problems. For example, a nationwide poll of those belonging to the National Association of Business Economists (NABE) in late 1985 showed that over 40 percent expected a recession to begin sometime in 1986, and another 35 percent thought one would occur in 1987. Similarly, as of January 1986 Data Resources, the largest economic forecasting firm in the country, attached only a 10 percent probability to the economy significantly out-performing its standard, moderate-growth outlook, compared to a 35 percent probability that a recession will occur in either 1986 or 1987.

Nevertheless, it also is true that economists have developed a habitual tendency to predict recessions just because one has not happened for awhile. Furthermore, the expected date of the next recession emerging from the *Blue Chip* survey has now been stretched out all the way to fall 1987. Last year at this time, the percentage of NABE forecasters anticipating a recession within 24 months actually was greater than it is now.

Given this, our own view is that the consensus outlook of a continued moderate economic expansion is *reasonable,* despite the downside risks. This is especially so given the recent reduction in world crude oil prices, which on balance is a positive development for our economy. *Since the department's forecast for California is slightly conservative relative to the consensus, it appears that for planning purposes the Legislature can reasonably expect revenues to at least equal the department's forecast, and possibly exceed it by as much as $250 million if the behavior of taxable sales returns to its historical norm in 1986 and 1987.*

Special Fund Revenues

Table 26 shows that revenues to all state special funds, combined, are projected to reach $5.3 billion in 1986–87. Table 33 shows the share of special fund revenues accounted for by each of the major special fund revenue sources.

The major source of special fund income to the state is motor vehicle-related levies, which include taxes on gasoline and diesel fuel ($1.2 billion), vehicle license and trailer coach fees ($1.5 billion), and registration fees ($965 million). These vehicle-related levies are expected to total over $3.6 billion in the budget year, an increase of 3 percent ($107 million) over 1985–86. Other major sources of special fund income include oil and gas tax revenues from state lands ($391 million), "spillover" sales and use tax revenues ($90 million), cigarette tax receipts ($75 million), and interest

Table 33
Summary of Special Fund Revenues
1986–87
(dollars in millions) [a]

Revenue Source	*Amount*	*Percent of Total*
1. Motor Vehicle Taxes and Fees		
License fees	$1,440	27.0%
Fuel taxes	1,182	22.2
Registration and other fees	965	18.1
Trailer coach fees	34	0.6
Subtotals	$3,621	68.0%
2. Oil and Gas Revenues from State Lands [b]	391 [c]	7.3
3. Retail Sales Taxes ("spillover" revenues)	90 [d]	1.7
4. Interest on Investments	156	2.9
5. Cigarette Taxes	75	1.4
Subtotals	$4,333 [d]	81.4%
6. All Other [e]	991	18.6
Totals	$5,324 [d]	100.0%

[a] Source: Governor's Budget. Details may not add to totals due to rounding.
[b] Primarily represents oil and gas royalties from the state's tidelands located adjacent to the City of Long Beach.
[c] Excludes approximately $13 million in royalties allocated to the General Fund to support the State Lands Commission, and $20 million in royalties allocated to the California Housing Trust Fund (a nongovernmental cost fund).
[d] Figure has been reduced by $20 million from that published in the budget, to correct for a printing error.
[e] Includes such sources as fees to the Department of Consumer Affairs, electricity utility surcharge monies, Department of Fish and Game fees and licenses, and penalties on traffic violations and criminal convictions.

on investments ($156 million). The special fund sales and use tax revenues reflect monies which go to the Transportation Planning and Development Account, while the cigarette tax monies represent local governments' statutory 30-percent share of the collections from this tax.

At the outset of this discussion, it is important to note that Table 26 does *not* include any special fund revenues from the California State Lottery, which was approved by the voters in November 1984 (Proposition 37). This is because the department and State Controller are classifying all lottery revenues as "nongovernmental trust and agency funds." As such, they fall outside the umbrella of state funds whose income and spending activities are reported in the budget. This classification was adopted on the theory that neither the Legislature nor the Governor has any authority regarding the appropriation of these monies (a theory with which we do not concur). A brief overview of the state lottery, including its revenue estimates and spending activities, is provided at the end of this section.

No Revenue Growth Expected

Table 26 shows that special fund revenues in 1986–87 are expected to be slightly *below* their 1985–86 level. This reflects the fact that most special fund revenue sources are much less "elastic" with respect to economic growth than most of their General Fund counterparts.

One reason for this is that a number of special fund revenue sources, such as the fuel tax and cigarette tax, rely on excise taxes that are levied *per unit of consumption* (for example, so much per gallon of gasoline or pack of cigarettes) instead of on an ad valorem basis (that is, as a percent of the dollar amount spent on the commodity). As a result, the growth in these revenues primarily depends on such factors as population growth, and does not reflect inflation. Other reasons for the lack of growth projected in special fund revenues during 1986–87 include:

- A decline in interest earnings, due to reduced special fund balances in the PMIA;
- A drop in sales and use tax "spillover" revenues, as soft gasoline prices and declining average per-vehicle fuel use have kept gasoline sales from growing as fast as other categories of taxable sales; and
- Reduced oil and gas royalties from the state's tidelands, due to declining world oil prices.

Fuel Tax Revenues—Underlying Trend Remains Flat

As shown in Table 26, fuel tax revenues are projected to grow by only 1.1 percent in 1986–87, or about the increase recorded in 1985–86 (1 percent). The underlying stability of fuel tax revenues reflects many different factors, such as changes in the automobile mix, increasing fuel economies, and the impact of gasoline prices on consumption. The department's fuel

tax estimate assumes that average gasoline consumption per vehicle will drop from 582 gallons in 1984–85 to 565 gallons in 1985–86 and to 550 gallons in 1986–87.

Modest Growth for Vehicle-Related Fee Revenues

Table 26 also shows that vehicle-related registration and license fee revenues are projected at over $2.4 billion in the budget year. This is an increase of 4 percent. The projection assumes net increases in fee-paid vehicle registrations of 3.5 percent and 4 percent in 1986 and 1987, respectively. These rates of growth are about double that projected for population, and reflect the department's expectation that consumer purchases of new vehicles will total about 1.7 million units in both 1986 and 1987.

As shown in Table 26, the license-fee component of these revenues is expected to grow at a rate much faster (5.8 percent) than registration and weight fees (1.4 percent). This is because license fees are calculated based on vehicles' "market value" whereas the other fees are levied at a flat rate. In recent years, the *average* market value of new vehicles in California has been steadily rising, and is expected to reach $15,900 per vehicle in 1987.

Slow Revenue Growth Causing Transportation-Related Financing Woes

The vehicle-related special fund revenues discussed above provide the major source of financing for the construction and ongoing maintenance of the state's transportation system. As noted earlier, the underlying growth trend for these revenues is relatively weak, primarily because these revenues are derived in large part from non-ad valorem excise taxes and are levied on such bases as gasoline gallonage and vehicle registrations, which themselves have not been growing very rapidly. In contrast, highway construction and maintenance costs, as well as the costs of other transportation-related programs that are funded from these revenues, continue to rise.

The financing problems caused by slow vehicle-related revenue growth were temporarily addressed in 1981 and 1983, when fuel taxes and vehicle-related fees were raised by Ch 541/81 (SB 215), Ch 933/81 (AB 202), and Ch 323/83 (AB 223). As a result of these measures, over $3.3 billion in additional vehicle-related revenues were collected during the five-year period 1981–82 through 1985–86, and the ongoing *level* of annual revenues has been raised by over $900 million above what it otherwise would have been. However, because these measures did not significantly change the underlying revenue-growth *trend,* the imbalance between the growth in revenues and the growth in expenditures remains with us. As a result, it now appears that the state's transportation-related financing needs (as expressed in the State Transportation Improvement Program (STIP)) cannot be met unless changes are made to these vehicle-related funding mechanisms.

In Part Three we focus on the very significant financing problems facing the Motor Vehicle Account, which funds the operation of the Department of Motor Vehicles, the California Highway Patrol, and the Air Resources Board. We also discuss various options available to the Legislature for resolving these problems. These options include making changes in the extent to which vehicle-related elements of the state's revenue base are taxed, such as through vehicle registrations and license fees.

Tidelands Oil and Gas Revenues to Decline

A total of $429 million in special fund oil and gas revenues will be collected by the state in the budget year, compared to $478 million in the current year and $538 million in the prior year. All but a bit over $30 million of these funds (or $391 million in the budget year) represent revenues collected by the State Lands Commission from oil, gas, geothermal, and other sources. In turn, most of these State Lands Commission collections represent direct earnings received by the state from tidelands (principally located adjacent to the City of Long Beach).

Of the $60 million decline in state oil and gas revenues estimated for the current year, about $18 million reflects a one-time revenue windfall resulting from the out-of-court settlement of the state's antitrust suit against ARCO (the state received about $20 million from this settlement in 1984–85 and about $2 million in 1985–86). Most of the remaining decline in current-year revenues ($42 million), as well as nearly all of the $49 million decline in budget-year revenues, reflects declines in gas production at the state's fields and soft oil prices in world markets. Because of the significant declines in world crude oil prices that occurred in the last half of January, *actual oil and gas revenues in 1986–87 will probably be far below the budget estimate.*

Traditionally, the state's tidelands revenues have been used, along with bond proceeds, to finance state capital outlay projects. The budget proposes to use these funds not only for certain capital outlays, but also to pay for a variety of one-time equipment and operating costs. To the extent these revenues fall short of the budget estimates due to weak oil prices and reduced oil output, alternative financing will be required for some of these projects and costs.

Additional Oil Revenues a Possibility

The federal government receives revenues from oil and gas developments on federal submerged lands between three and six miles from a state's shoreline. Section 8(g) of the federal Outer Continental Shelf Lands Act provides that the federal government shall share these revenues with affected states. Federal revenues from "8(g)" lands currently are deposited in an escrow account pending an agreement between the federal Department of Interior (DOI) and the Governor of each affected coastal state regarding a revenue-sharing arrangement. No such agreement has been reached for California, and as a result the escrow account

currently contains approximately $1.4 billion from federal oil and gas leases on 8(g) lands off the shores of California.

The Congress is considering provisions in the Budget Reconciliation Act that would establish a specific methodology for sharing the 8(g) funds with states. As currently drafted, these amendments would allocate to California approximately $380 million of the 8(g) funds in 1985–86, $22 million in 1986–87, and $23 million in 1987–88. Whether the state actually will receive these revenues will depend on whether Congress decides to divert some or all of them to help reduce the federal budget deficit.

It also is possible that the state could receive several hundred million dollars from settlement of outstanding antitrust litigation against six oil companies that produce oil from state tidelands and submerged lands in the Long Beach area. However, such revenues, were they to materialize, would not be received for at least three years.

Additional Refunds From Oil-Price Overcharges May Be Received

From September 1973 through January 1981, when federal price controls on oil were in effect, a number of oil companies violated these controls by overcharging customers. The Petroleum Violation Escrow Account (PVEA) is an escrow account maintained by the federal government, into which recovered overcharges from these companies are put so that states may provide restitution to the public when the courts are unable to attribute damages from overcharges to specific victims. To date, California has received about $26 million in such funds, which the Legislature has appropriated in prior years for various energy-related programs. In 1986–87, the budget estimates that an additional $207 million in PVEA funds will be received, and it proposes to appropriate these funds for a variety of purposes. These proposed appropriations are identified in the *Analysis,* as part of our discussion of Item 9895. The revenue figures in Table 26 do not include PVEA funds.

How Special Fund Revenues Are Distributed

Table 34 identifies how the budget proposes to allocate revenues from the four major special fund sources among different programs and levels of government. Specifically, it shows that:

- Cities and counties will receive almost half of the motor vehicle fuel tax revenues.
- Cities and counties are to receive all of the proceeds from vehicle license fees, after administrative and certain other costs are deducted.
- Motor vehicle registration fees are used to support the Department of Motor Vehicles (DMV) and the California Highway Patrol (CHP), with most of the remainder going to the Department of Transportation (Caltrans) for highway maintenance and construction.

Table 34
Proposed Distribution of Special Fund Revenues From the Four Major Special Fund Sources 1986–87 (dollars in millions) [a]

Revenue Source	Total Amount of Revenues	Distribution of Revenues: Recipient	Distribution of Revenues: Amount
A. *Motor Vehicle Taxes and Fees*			
1. License Fees	$1,459 [b]	To cities	$556
		To counties	806
		For DMV administration	96
		For Board of Equalization	1
2. Fuel Taxes	1,187 [c]	For city streets	187
		For county roads	252
		To cities and counties for streets and roads	116
		To Caltrans for state highways	593 [d]
		Other	40
		Adjustment to fund balances	−1 [e]
3. Registration and Other Fees	1,009 [f]	To DMV	199 [g]
		To CHP	484
		To Caltrans	291
		To other state agencies	61
		Other	−26 [e]
4. Trailer Coach Fees	35	To counties	12
		To localities generally	22
		To Department of Housing and Community Development	2
B. *State Lands Oil and Gas Revenues*	391 [h]	California Water Fund	25
		COFPHE Fund	126
		SAFCO	235
		Fisheries Restoration Fund	5
C. *Retail Sales and Use Taxes* ("spillover" revenues)	101 [i]	State agencies, including support for mass transit	45
		Local agencies, including support for special transit programs and other purposes	89
D. *Local Cigarette Taxes*	75	To cities	64
		To counties	13
		Adjustment to fund balance	−2 [e]

[a] Source: Governor's Budget. Details may not add to totals due to rounding. Revenue totals shown in this table may differ somewhat from those in Table 26, because this table is derived from individual fund-condition statements in the budget whereas Table 26 is based on Schedule 8 in the budget.

[b] Includes $19 million in interest income from prior-year fund balances.

[c] Includes $5 million in interest income from prior-year fund balances.

[d] Includes $66 million to be transferred for support of DMV.

[e] Negative sign indicates expenditures from prior-year fund balances.

[f] Includes $4 million in interest income from prior-year fund balances.

[g] Does not include $66 million to be funded from the State Highway Account.

[h] Excludes revenues of $20 million to the California Housing Trust Fund and $14 million for support of the State Lands Commission. The distribution of revenues shown is that which is *proposed* in the Governor's Budget. The distribution under *existing law* is shown in the *Analysis*, as part of our discussion of Control Section 11.50.

[i] Includes $11 million in interest from surplus money investments. The $33 million difference between the revenues shown and the identified program expenditures will be financed through transfers from the State Highway Account ($10 million), the General Fund as provided for under Ch 1600/85 (SB 300) ($20 million), and the prior-year fund balance ($3 million).

- As noted earlier, tidelands oil revenues are allocated mainly for capital outlay purposes. The Governor's Budget proposes to divide most of these revenues between the Capital Outlay Fund for Public Higher Education (COFPHE) and the Special Account for Capital Outlay (SAFCO).
- The "spillover" sales tax revenues are used mainly for mass transit and special transportation programs, and are allocated to both state and local agencies.
- Of the state cigarette tax levies which go to localities (30 percent of the total), approximately 83 percent goes to cities and 17 percent goes to counties.

THE CALIFORNIA STATE LOTTERY

As noted earlier, the special fund revenue totals contained in the budget do *not* include revenues associated with the California State Lottery. Likewise, expenditures of lottery revenues do not appear in the budget spending totals. This is because the department presently is classifying lottery revenues as falling into the category of "nongovernmental trust and agency funds," and monies so classified are not normally reported in the budget. (Other revenues treated in this fashion include revenues to pension funds and certain bond funds.)

Because the lottery represents a major new source of state revenues, it is appropriate to briefly discuss here its provisions, early experience, expected revenues, and spending activities.

Basic Provisions of the California State Lottery

The California State Lottery was authorized and established by Proposition 37 (November 1984), which enacted the California State Lottery Act of 1984.

The act provides for a state-operated lottery to be administered by a lottery commission, as specified, and requires that the proceeds of lottery ticket sales be distributed as follows:

- 50 percent shall be returned to the public in the form of lottery prizes;
- No more than 16 percent shall be used for administrative expenses of operating the lottery; and
- 34 percent shall be allocated to various levels of public education, *plus* any unclaimed lottery prizes and any portion of the amount by which actual administrative expenses fall short of 16 percent. (Based upon the actual experience of states with lotteries, education's share of lottery ticket sales eventually should be around 40 percent.) The initiative further provides that education's share of the lottery receipts shall be allocated on a "per capita" basis amongst K–12 education, the community colleges, the California State University (CSU) system, and the University of California (UC).

The Legislature has the authority to amend the act if, by doing so, it furthers the purposes of the measure. As of this date, however, no signifi-

cant amendments have been enacted. The Legislature did enact, as part of the 1985 Budget Act, language requiring the California State Lottery Commission's budget to be subject to annual legislative review. The Governor, however, vetoed this requirement.

Early History of Operations

California State Lottery ticket sales began in October 1985, with the sale of instant game tickets. As of January 1986, two instant games had been completed and a third was in progress. Approximately 800 million one-dollar lottery tickets had been sold by January 1, 1986. Additional instant games are scheduled throughout 1986, and the commission plans to introduce "on-line" games, such as "lotto," in mid-1986.

Instant lottery tickets currently are sold at some 21,000 retail business locations in the state. Computer terminals for the "on-line" games will be installed at four-to-five thousand locations during 1986.

Revenue Estimates

The budget projects that lottery ticket sales will be $1.2 billion in 1985–86 (all from instant games) and $1.25 billion in 1986–87 (including $650 million from instant games and $600 million from "on-line" games).

Obviously, projecting lottery revenue is not an easy task, for several reasons. First, because the California Lottery has been in existence for only a short time, one can only speculate about what per capita lottery ticket purchases will be in the future once the novelty of the lottery wears off. Second, lottery sales will depend on various yet-to-be-made decisions regarding the exact types of games to be offered over the next 18 months, including decisions on the prize structure of each one. Third, as noted in the budget, lawsuits by unsuccessful on-line vendors and/or technical problems involving computer equipment and security systems could delay implementation of "on-line" games beyond mid-1986.

Nevertheless, it appears that lottery sales most likely will *exceed* the budget's estimates, at least for 1985–86, given that sales already totaled $1 billion by February 1986.

Spending Activities

As noted above, the receipts from lottery sales that remain after prizes have been paid are used to offset lottery administrative and operations costs, and to support public education in California. Based on its projected lottery sales of $1.2 billion in 1985–86 and $1.25 billion in 1986–87, the budget estimates that administration and operations costs will be $192 million in the current year and $200 million in the budget year, leaving net revenues for education amounting to $408 million in the current year and $425 million in the budget year. When interest earnings on yet-to-be-paid disbursements are included, the totals become $416 million and $435 million, respectively.

Since the actual transfer of funds from the California State Lottery Education Fund to educational recipients occurs on a quarterly basis, after the lottery sales themselves have taken place, the budget estimates that the actual amount of lottery revenues turned over to public education will be $300 million in 1985–86 and $410 million in 1986–87. (The first payments were mailed out in early February.) Table 35 shows how the budget estimates these amounts will be distributed to various segments of public education in California, based on the lottery act's "per capita" formula. (To the extent that actual lottery sales exceed the budget's estimates, these dollar distributions would be larger than shown.) In the *Analysis,* we discuss any specific plans which these educational segments have for spending their anticipated lottery receipts.

Table 35
Estimated Distribution of Lottery Revenues to Education
1985–86 and 1986–87
(dollars in millions) [a]

	1985–86		*1986–87*	
Segment	*Amount*	*Percent*	*Amount*	*Percent*
K–12 Education	$241.8	80.7%	$330.0	80.7%
Community Colleges	37.0	12.3	50.3	12.3
California State University System	13.6	4.5	18.5	4.5
University of California	7.5	2.5	10.2	2.5
Other [b]	0.1	—	0.1	—
Totals	$300.0	100.0%	$410.0	100.0%

[a] Source: California Department of Finance and Governor's Budget. Details may not add to totals due to rounding.
[b] Includes Hastings Law School and the California Maritime Academy.

THE LONG-TERM REVENUE OUTLOOK

It is important to project revenues beyond the budget year. Such projections give the Legislature at least some rough idea of what the prospects for General Fund and special fund revenues might be in the future. This helps the Legislature develop its expenditure plans.

Unfortunately, however, projecting what General Fund and special fund revenues might be beyond the budget year is an extremely difficult undertaking. This is because the most important factor determining state income in future years will be the path taken by the state's economy, and making forecasts of economic behavior beyond the next 18 months inevitably involves a great deal of speculation. Not only must the forecaster accurately "model" the complex interactions within the economy that shorter-term forecasts require; he or she also must make assumptions regarding how the basic structure of the economy is slowly changing over time, and what types of decisions will be made at the federal level regarding monetary policies, defense and nondefense spending, and tax-law

revisions. Other factors that complicate long-term economic forecasting include international debt problems, imbalances in the foreign trade sector, and most recently, unsettled conditions in the world's oil markets.

Compounding these problems is the fact that the relationship between the growth in the state's revenue base and the pace of overall economic activity is not constant over time. For example, the single most important economic variable for revenue forecasting purposes is the level of California personal income. Generally speaking, the state's revenue base appears to have sufficient "elasticity" to grow at a pace equal to, and probably slightly above, the rate of growth in the personal income base—at least during normal years. During periods when economic activity fluctuates from the long-term trend, however, this relationship may break down. For example, when an economic downturn occurs, corporate profits usually fall in dollar terms, and the percentage of income that consumers spend on taxable commodities can also decline. During strong economic expansions, the opposite usually occurs. Thus, on a year-to-year basis, the rate of growth in revenues can be higher or lower than the growth rate for the economy generally.

Given these realities, any estimate of what General Fund and special fund revenues will be beyond 1986–87 primarily depends on what one wants to *assume* about the performance of the California economy and its tax base beyond 1987.

The Department's Long-Term Revenue Forecast

The Governor's Budget contains projections of both General Fund and special fund revenues for 1987–88 and 1988–89. The economic assumptions underlying these projections appear in Table 36, and the revenue projections themselves appear in Table 37.

As shown in Table 36, the revenue projections assume that the department's standard economic forecast for continued economic growth accompanied by modest inflation will *continue beyond 1987.* For 1988 and 1989, taken together, the department's forecast is for real GNP growth of 3.5 percent, inflation of 4.3 percent, California personal income growth of about 9 percent, and wage and salary employment growth of 3.5 percent.

Table 36
Selected Long-Term Economic Assumptions
1986 through 1989 [a]

Economic Variable	*Annual Percent Change in: 1986*	*1987*	*1988*	*1989*
U.S. real GNP	3.2%	3.7%	3.6%	3.4%
U.S. consumer prices	3.6	4.3	4.2	4.3
California personal income	7.1	9.1	9.1	8.8
California wage and salary employment	2.9	3.8	3.6	3.4

[a] Source: Department of Finance.

Table 37 shows that, should the department's assumptions come true, General Fund revenues would total $34.2 billion in 1987–88 (a 10 percent increase) and $37.6 billion in 1988–89 (a 9.7 percent increase), while special fund revenues would total $5.5 billion in 1987–88 and $5.6 billion in 1988–89. Thus, total state revenues would amount to $39.7 billion in 1987–88 and $43.2 billion in 1988–89.

Table 37
Long-Term Revenue Projections
1986–87 through 1988–89
(dollars in millions)[a]

		1987–88		1988–89	
Revenue Source	*1986–87*	*Amount*	*Change*	*Amount*	*Change*
A. General Fund Revenues					
Personal income tax	$12,460	$13,890	11.5%	$15,400	10.9%
Sales and use tax	11,095	12,130	9.3	13,190	8.7
Bank and corporation tax	4,655	5,335	14.6	5,930	11.2
Other sources	2,814	2,875	2.2	3,035	5.6
Subtotals, General Fund Revenues	$31,024	$34,230	10.3%	$37,555	9.7%
B. Special Fund Revenues[b]	5,324	5,480	2.9	5,600	2.2
C. Total Revenues, All Sources[b]	$36,348	$39,710	9.2%	$43,155	8.7%

[a] Source: Governor's Budget and Department of Finance.
[b] Figure for 1986–87 has been reduced by $20 million from that published in the Governor's Budget, to correct for a printing error.

Forecast Is Optimistic

Should the department's long-term economic forecast actually come true, the nation's economy will have expanded for seven consecutive years. This would represent the longest period of sustained economic growth since the 1960s. It also would represent seven straight years of inflation under 4.5 percent, and a record eight straight years in which California corporate profits expanded more rapidly than the state's personal income base. While this could occur, such a forecast must be viewed as optimistic. In fact, few economists believe that an uninterrupted period of economic growth and moderate inflation such as this is likely to occur, and the majority expect a recession to occur sometime before 1988.

What is more realistic to assume, in light of historical experience, is that even if an outright recession does not occur, there will be at least some period of economic lethargy prior to 1990. This would correspondingly reduce the revenue estimates shown in Table 37 for 1987–88 and 1988–89.

For example, we estimate that even if the economy "beats the odds" by continuing to expand through 1989 but revenues grow at rates that are just a bit lower than predicted (8.5 percent in 1987–88 and 8.0 percent in 1988–89), revenues for 1987–88 and 1988–89 would be more than *$1.7 billion below* what is shown in Table 37. As can be seen from Table 3, this would leave a reserve balance of $1.4 billion at the close of 1988–89, or less

than half of the reserve projected using the department's assumptions. (This assumes that *no* money is used beyond 1986–87 to fund either new programs, expansion of existing programs, or one-time expenditures. It also ignores the possible constraint imposed by the state's appropriations limit in 1987–88 and 1988–89 as discussed in Part Three.)

However, should a recession or period of economic lethargy set in prior to 1989, the reserve itself could easily disappear. For instance, we estimate that a moderate recession in 1988 followed by an upturn in 1989 could reduce two-year revenues by as much as *$3 billion* below the department's figures. In this event, Table 3 indicates that a balance of only about $200 million (or less than 1 percent of baseline expenditures) would remain in the reserve in 1988–89. Given this, if a deeper, full-blown recession were to occur, the General Fund would be in *deficit.*

State and Local Borrowing

The Governor's Budget proposes a total expenditure of $525 million in funds derived from the sale of state bonds that are supported by the General Fund. Generally speaking, these funds will be used for capital outlay programs.

The State of California issues both general obligation and revenue bonds. These two categories of borrowing instruments have the following general features:

- ***General obligation bonds*** are backed by the state's full faith and credit. Thus, when the State of California issues a general obligation bond, the state pledges to use its taxing power, if necessary, to pay off the bond (both principal and interest). These bonds must be authorized by a two-thirds vote of both houses of the Legislature, and then must be approved by a majority of the voters at a statewide election.
- ***Revenue bonds*** are not backed by the full faith and credit of the state. Instead, they are secured only by revenues from the projects which are financed from the bond proceeds. State revenue bonds must be authorized by a majority of both houses of the Legislature, but they do not require voter approval.

This section provides information on borrowing by the state, including the sales and outstanding volumes of state general obligation and revenue bonds. It also contains a brief discussion of the borrowing conducted by California's local governments, and reviews some of the recent policy issues involving state and local borrowing.

STATE BORROWING

The state borrows money on both a long-term and a short-term basis. Long-term borrowing involves the issuance of general obligation and revenue bonds, which provide funds for a variety of state and state-assisted local capital outlay programs. Short-term borrowing is accomplished through the issuance of notes, such as revenue anticipation notes, which are repaid by the end of a given fiscal year. The funds obtained from the sale of short-term notes are used to meet the state's cash-flow requirements.

State General Obligation Bonds

The general obligation bonds issued by the state support a range of programs, such as state construction projects, state parks and recreational facilities, new prisons and county jails, and cleanup of hazardous substances. These bonds also are issued to provide financial assistance for California veterans seeking to purchase homes as well as to first-time homebuyers.

During 1984, a record volume of new general obligation bond authorizations—over $2.7 billion—was approved by the voters. No additional au-

thorizations were presented to the voters in 1985, but it is likely that the voters will be asked to approve a number of new general obligation bond authorizations at both the June and November elections this year.

Status of Bonds Authorized. Table 38 identifies, for the state's general obligation bond programs, the currently authorized amounts that are outstanding, redeemed, and unsold. The table shows that, as of December 31, 1985, the state had not sold $2.7 billion in authorized bonds, compared to $3.7 billion at the end of 1984. Of the authorized bonds already sold (approximately $13.7 billion), the state had retired $5.8 billion, leaving $7.9 billion (58 percent) still outstanding.

General obligation bonds can be classified into two categories, depending upon the source of the funding used to pay their debt service costs. For *General Fund bonds,* the debt service is *fully* paid by the General Fund. These bonds account for 37 percent of the total amount of outstanding general obligation bonds. For *self-liquidating bonds,* the debt service costs are either partially or fully paid from project revenues. Should such revenue ever be inadequate to cover the required debt service, however, the General Fund would be obligated to pay for the shortfall. These bonds comprise 63 percent of the total outstanding amount.

Table 38
General Obligation Bonds of the State of California
As of December 31, 1985
(dollars in millions)

Program	*Authorized*	*Unsold*	*Redeemed*	*Outstanding*
Beach, park, recreational and historical facilities	$400.0	—	$212.3	$187.7
Clean water	1,200.0	$425.0	256.1	518.8
Community college construction	160.0	—	83.3	76.8
County jail construction	530.0	355.0	4.2	170.8
First-time homebuyers	200.0	185.0	—	15.0
Harbor bonds	89.3	—	73.5	15.8
Hazardous substance cleanup	100.0	50.0	—	50.0
Health sciences facilities	155.9	—	66.3	89.5
Higher education construction	230.0	—	168.8	61.2
Junior college construction	65.0	—	47.4	17.6
Lake Tahoe land acquisition	85.0	75.0	—	10.0
New prison construction	795.0	345.0	32.5	417.5
Park and recreational facilities	370.0	325.0	1.3	43.8
Parklands acquisition and development	285.0	70.0	33.6	181.4
Recreation, fish, and wildlife	145.0	55.0	35.5	54.5
Safe drinking water	250.0	90.0	11.8	148.2
School building aid	2,140.0	40.0	1,571.4	528.6
School building lease-purchase	950.0	450.0	36.5	463.5
Senior centers	50.0	45.0	—	5.0
State construction	1,050.0	—	852.8	197.2
State, urban, and coastal park	280.0	25.0	69.6	185.4
Veterans farm and home loan	5,100.0	—	2,046.2	3,053.8
Water resources development	1,750.0	180.0	171.0	1,399.0
Totals	$16,380.2	$2,715.0	$5,774.1	$7,891.1

Sales of General Obligation Bonds. In 1984–85, the State Treasurer sold nearly $1.2 billion in general obligation bonds. Over one-third of these bonds ($410 million) were issued for the veterans farm and home loan program. The next largest volumes were sold for the new prison construction program ($350 million) and the county jail construction program ($150 million).

The State Treasurer's latest schedule calls for the sale of approximately $1.1 billion of general obligation bonds in 1985–86. This amount is $70 million less than the volume of sales in 1984–85, due to a lower level of sales for the veterans program. Bonds for the school lease-purchase program ($355 million) and the veterans program ($340 million) each account for about one-third of the sales planned for the current year. By December 31, 1985, $585 million in bonds had been issued so far in 1985–86.

For 1986–87, the budget shows that a total of $808 million in general obligation bond sales are planned—$272 million less than the amount for the current year. The reduction is attributable to the veterans loan program, which had used up its total authorization of $5.1 billion by December 1985. The largest volume of bonds to be sold in 1986–87 is for the new prison construction program ($245 million). The next largest amount will be sold for the county jail construction and state school lease-purchase programs ($200 million for each program), followed by bonds for clean water projects and hazardous substance cleanup ($50 million each), senior centers ($45 million), and various other programs ($18 million).

Notwithstanding the State Treasurer's schedules, the volume of sales likely to occur during the rest of the current year and in the budget year is uncertain. This is because of concerns raised by tax reform proposals that are now before the U.S. Congress. These proposals would place limits on the volume of state and local bonds that can qualify for the federal tax exemption granted to interest on such bonds. These measures also would affect how quickly the proceeds of bond issues must be expended, alter certain disclosure requirements, and provide for the loss of an issue's tax exempt status in cases of noncompliance with the revised laws.

It is impossible to predict what changes, if any, the Congress will enact, or when these changes will take effect. Bond issuers, however, cannot write off the possibility that the new restrictions—whatever they are—will apply *retroactively* to *all* bonds sold this year. Given this possibility, bond counsels have been reluctant to issue opinions regarding whether certain new bond issues will be tax-exempt, and investors appear to be more cautious about investing in 1986-vintage bonds. This has caused the cancellation or postponement of many proposed bond sales, including some previously planned by California.

Given these circumstances, it is doubtful that the level of bond sales currently scheduled for both the current and budget years will be achieved. To the extent that bond sales are postponed, the levels of debt service payments and bond fund expenditures will be lower than the amounts reflected in the budget.

General Fund Costs for Paying Off Bonds. The state's General Fund bears a significant portion of the costs resulting from debt service payments, both principal and interest, made on general obligation bonds. The debt service payments on bonds *fully* paid by the General Fund are shown for 1983–84 through 1986–87 in Table 39.

Table 39
General Fund Debt Service[a]
1983–84 through 1986–87
(dollars in millions)

	Debt Service[b]	*Percent Change from Previous Year*	*Percentage of General Fund Expenditures*	*Total Bond Sales*[c]
1983–84	$318.7	21.6%	1.4%	$360
1984–85	378.6	18.8	1.5	740
1985–86	444.5	17.4	1.6	740
1986–87	525.7	18.3	1.7	808

[a] Includes payment of interest and principal on bonds *currently authorized* by the electorate and fully supported by the General Fund.
[b] Interest rates of 8.0 percent and 8.5 percent are assumed for anticipated bond sales in 1985–86 and 1986–87, respectively.
[c] Source: Actual bond sales for 1983–84 and 1984–85, Governor's Budget for 1985–86 and 1986–87.

Debt service for the budget year is estimated to total $526 million. Of this amount, approximately $264 million is for payment of interest and $262 million is for repayment of principal. The total payments represent an increase of $81 million, or 18 percent, over estimated expenditures in the current year. While debt service represents a small percentage of total General Fund expenditures, our analysis indicates that the repayment of state general obligation bonds continues to be one of the most rapidly growing General Fund "programs" in the state budget.

The amount of debt service actually paid by the General Fund in 1985–86 and 1986–87 could differ from the amounts shown in the budget, for two reasons:

- ***Project Revenues May Offset Debt Service Costs.*** The authorizations for some bond programs, such as the programs to assist first-time homebuyers and to provide loans to water agencies for water supply improvements, call for project revenues to pay at least part of the costs of debt service. The budget, however, assumes that the General Fund will pay all of the debt service costs, even though some reimbursements are anticipated in the budget year. This assumption reflects uncertainties over the level and timing of these receipts.

- ***Changes in Bond Sale Schedule and Interest Rates will Affect Debt Service Requirements.*** The debt service estimates in the budget are based on specific assumptions regarding future bond sales and interest rates. If the actual sales volume is greater (less) than the estimated volume, or if interest rates on new bond sales are higher (lower) than projected, the amounts needed from the General Fund to service the debt will increase (decrease) accordingly. For example, in January 1985, debt service for 1985–86 was projected at $486.4 million. As a result of changes in bond sales and the reductions in interest rates that have occurred since then, however, the actual level of debt service now is estimated to be $444.5 million, or $41.9 million *lower* than projected.

If *no* further bond sales occur between now and June 30, 1987, General Fund expenditures for debt service in 1986–87 would be $98 million less than the amount indicated in the budget ($526 million).

How the Bond Proceeds will be Spent. Once the state's bonds are sold, the proceeds are allocated for expenditure on specific projects. Table 40 identifies these expenditures for the prior, current, and budget years, according to the source of the bond funding.

Table 40
Selected Bond Fund Expenditures
1984–85 through 1986–87
(dollars in millions) [a]

Program	*1984–85*	*1985–86*	*1986–87*
Clean water	$52	$83	$73
County jails	175	309	84
Fish & wildlife enhancement	4	25	26
Health sciences facilities	— [b]	—	—
Lake Tahoe land acquisition	— [b]	25	20
New prisons	82	618	5
Safe drinking water	26	71	53
School building lease-purchase	190	250	200
State construction	—	— [b]	—
State parks and recreational facilities [c]	59	200	63
Total	$588	$1,581	$525

[a] Details may not add to totals due to rounding.
[b] Less than $1 million.
[c] Includes expenditures for parklands acquisition, parks and recreational facilities, coastal conservancy programs, and urban and coastal parks.

Past Year. In 1984–85, expenditures from selected bond funds totaled about $588 million. Last year, the midyear estimate of bond fund expenditures was $1.1 billion, or approximately $542 million *more* than the amount actually spent. Nearly all of the shortfall was associated with the state's new prison construction program. Actual expenditures for this program were *$538 million less* than what had been estimated, due to delays in construction and the selection of prison sites.

Current Year. In 1985–86, the budget indicates that bond fund expenditures will reach a record level of $1.6 billion. Table 40 shows that two-thirds of the $993 million increase over the 1984–85 expenditure level can be attributed to two programs: new prison construction ($536 million increase) and county jail construction ($134 million).

However, the actual level of bond fund expenditures during the current year is certain to fall *well short* of the amount shown in the budget. Part of the reason for this is all of the uncertainty surrounding federal tax reform, which could delay the sales of state bonds, and, therefore, the expenditure of bond proceeds.

Even if sales are not delayed, however, bond fund expenditures will be less—probably significantly less—than what the budget assumes. The spending level shown in the budget assumes that $618 million of the $795 million in bond sales authorized for the new prison construction program will be expended in the current year. Since the budget indicates that the bonds needed to fund $245 million of this spending *will not be sold until the budget year,* it is clear that the level of expenditures projected for this program is fallacious. Moreover, the midyear budget estimate of bond fund expenditures has proven to be *the* most unreliable number in the budget document, year in and year out. As we noted above, the midyear estimate contained in last year's budget exceeded the amount actually spent *by more than $0.5 billion.* For 1983–84, the midyear estimate exceeded the actual level of expenditures by $424 million. As a result, the Legislature should not expect bond fund expenditures during the current year to come anywhere near the $1.6 billion estimated by the budget.

Budget Year. The level of bond fund expenditures projected for 1986–87—$525 million—is much more realistic than the estimate for 1985–86. Two programs account for about half of these expenditures: school building lease-purchase ($200 million) and county jails ($84 million).

State Revenue Bonds

Various agencies of the state issue revenue bonds. These bonds are fundamentally different from general obligation bonds, in that only the revenue generated from the project is pledged as security and used to service the debt.

Revenue bonds traditionally have been used to finance the construction of such projects as state-operated bridges, fair facilities, and higher education dormitories. However, beginning in the 1970s, the state expanded the scope of revenue bond programs to include financing for home purchases, pollution control, and health and educational facilities. In 1984, the Legislature created a new program which authorizes the California Industrial Development Financing Advisory Commission to issue revenue bonds in order to provide financial assistance for small business development. Most

of the newer programs provide financing for projects (such as housing and alternative energy facilities) that actually are owned or operated by a *private entity,* rather than by a state or local agency.

Table 41 identifies the 18 different types of state revenue bond programs and shows the current authorization for each. As of December 31, 1985, a total of $11.5 billion in state revenue bonds was outstanding. Three housing bond programs account for over $3.6 billion, or 31 percent, of the total outstanding amount: the California Housing Finance Authority ($2.7 billion), the Veterans Revenue Debenture ($861 million), and the California National Guard ($38 million). Bonds issued by the California Pollution Control Financing Authority ($2.3 billion) and the California Health Facilities Financing Authority ($2.7 billion) also account for significant portions of the outstanding revenue bonds. The table also shows that 10 of the 18 programs have statutory authorization limits, which together total $11.1 billion. Of this amount, approximately $3.9 billion (35 percent) was unused at the end of 1985.

Table 41
State Agency Revenue Bonds
As of December 31, 1985
(in millions)

Issuing Agency	*Authorization Limit, If Any*	*Outstanding*	*Remaining Authorization*
California Alternative Energy Source Financing Authority	$200	$105	$95
California Educational Facilities Authority	750	703	47
California Health Facilities Authority	3,374	2,681	693
California Housing Finance Authority	2,950	2,693	257
California Industrial Development Financing Advisory Commission (Small business financing)	—	—	—
California National Guard	100	38	62
California Passenger Rail Financing Commission	1,250	—	1,250
California Pollution Control Financing Authority	—	2,345	—
California Student Loan Authority	300	110	190
California Transportation Commission	—	106	—
California Urban Waterfront Area Restoration Financing Authority	650	—	650
Department of Water Resources	—	1,200	—
Hastings College of Law	—	7	—
Regents, University of California	—	290	—
State Public Works Board	—	211	—
State Public Works Board (Energy Conservation and Cogeneration)	500	—	500
Trustees, California State University	—	197	—
Veterans Revenue Debenture	1,000	861	139
Totals	$11,074	$11,547	$3,883

Revenue Bond Sales. Revenue bond sales have increased dramatically in the last five years. State financing authorities issued approximately $800 million in revenue bonds in 1980–81 and $1 billion in 1981–82. In both 1982–83 and 1983–84, revenue bond sales approached $2 billion. In 1984–85, $2.4 billion in revenue bonds were sold—a new record.

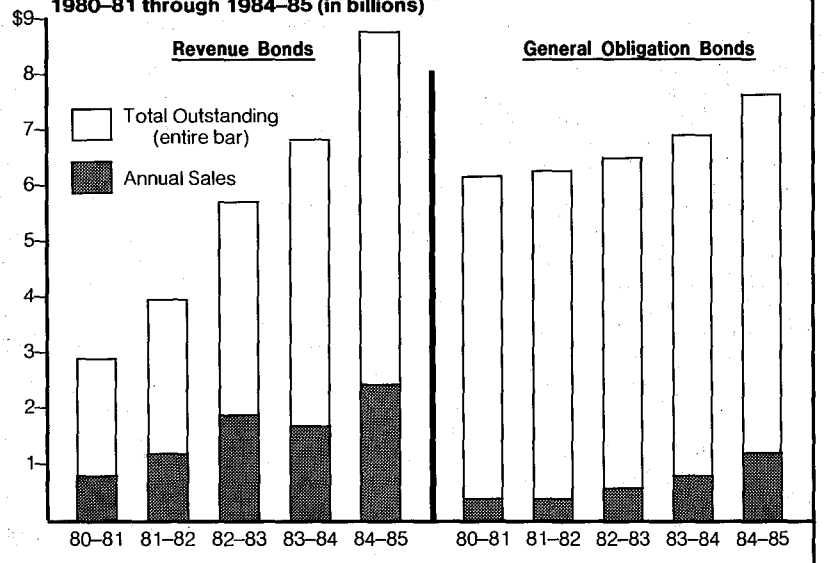
Three authorities accounted for over 68 percent of the 1984–85 sales: the California Housing Finance Authority ($727 million), the California Pollution Control Financing Authority ($255 million), and the California Health Facilities Financing Authority ($652 million).

As of October 1985, a total of $905 million in revenue bonds had been sold so far in 1985–86. As is the case for general obligation bonds, the volumes of state revenue bond sales during the rest of the current year and the budget year are impossible to predict, given the uncertainty surrounding federal tax reform proposals pending before the U.S. Congress.

Use of General Obligation Versus Revenue Bonds

Chart 17 compares the sales and outstanding volumes of state general obligation and revenue bonds since 1980–81. It shows that revenue bond sales have significantly exceeded general obligation bond sales in each of the past five years. As a result, the volume of revenue bonds outstanding has increased dramatically—over 200 percent—in contrast to only a slight increase in the volume of outstanding general obligation bonds.

Chart 17
State General Obligation and Revenue Bonds
Annual Sales and Total Outstanding Volumes
1980–81 through 1984–85 (in billions) [a]



[a] Source: California State Treasurer. Data as of June 30 of each fiscal year.

The increase in revenue bond sales, relative to general obligation bond sales reflects several factors. First, revenue bonds generally are not subject to statutory interest rate ceilings. Under existing state law, the interest rate on general obligation bonds cannot exceed 11 percent. High interest rates, particularly during 1982 and 1983, have sometimes made it difficult to sell general obligation bonds at interest rates below this ceiling. Second, general obligation bonds are subject to specific authorization limits, which must be approved by the voters. As shown in Table 38, the limits for eight of these programs already have been reached. In contrast, there are no restrictions on sales under eight of the state's 18 revenue bond programs. Finally, the large increase in the volume of revenue bonds reflects the growing trend towards using this method of financing for "non-traditional" purposes. In fact, nearly 50 percent of the $5.9 billion increase in outstanding revenue bonds between 1980–81 and 1984–85 is due to two programs created within the past five years: those used to finance pollution control facilities ($1.4 billion) and private health facilities ($1.4 billion).

Additional Long-Term Borrowing

In addition to issuing general obligation and revenue bonds, the state also engages in other forms of long-term borrowing. These forms involve the issuance of *certificates of participation* (CPs), and *lease revenue bonds.* For example, in 1983 the state issued $42 million in CPs to fund the construction of the new headquarters facility for the Franchise Tax Board. In the following year, it issued $27 million to finance a telecommunications system for the University of California, Los Angeles. In addition, the Legislature has authorized the State Public Works Board to issue up to $300 million in lease revenue bonds for state prison construction projects, and to provide financing for the construction of "high technology" educational facilities.

The funding needed to pay off the debt resulting from these types of long-term borrowing is provided by the General Fund. Repayment expenditures, however, are not included in the administration's estimate of debt service requirements. For CPs and lease revenue bonds, the funding shows up in the individual agencies' budgets as the cost of "facilities operations."

Short-Term Borrowing by the State

The state's General Fund often borrows money on a short-term basis to compensate for the differences in timing when revenues are actually received and when the state must pay its bills. This type of borrowing for "cash-management" purposes is a routine and integral part of managing the state's fiscal affairs.

In the past, most of the General Fund's short-term cash needs was funded from internal sources, usually from the Reserve for Economic

Uncertainties, from special funds, and from the Pooled Money Investment Account (PMIA). In recent years, the state has borrowed more from external sources. This type of borrowing was needed during 1982–83 and 1983–84 because sufficient funds were not available internally to meet the General Fund's cash needs.

In 1984, the Legislature authorized the use of external borrowing, even when sufficient internal funds are available. It did so in order to take advantage of the fact that the state can borrow from external sources at a cost that is lower than the cost of borrowing from internal sources. This is because the state can obtain funds from external sources at tax-exempt interest rates, while internal sources must be paid interest at rates comparable to the yield on taxable securities in which the funds normally are invested. Since the state can invest its externally borrowed funds at taxable interest rates when they are not being used to finance cash-flow shortages, the state can sometimes make a profit by borrowing!

The state's ability to borrow from external sources was further enhanced by the enactment of Ch 139/85 (SB 1465). This measure reclassified the Reserve for Economic Uncertainties from a special account in the General Fund to a separate special fund (the Special Fund for Economic Uncertainties). This change was necessary because monies in the General Fund must be fully utilized to meet cash-flow needs before external sources of funds can be tapped. By moving the reserve out of the General Fund and making it a special fund, the General Fund balance is reduced accordingly, thereby increasing the amount of external borrowing that may be conducted by the state.

For the current year, the state borrowed $2.3 billion through the sale of revenue anticipation notes in August 1985. These notes will be repaid by June 1986. For 1986–87, the budget shows that $2.5 billion in short-term notes will be sold in August 1986.

LOCAL BORROWING

The State of California does not directly regulate most types of borrowing by local governments. However, state law does govern such factors as the permissible types of borrowing that local entities can undertake and the maximum interest rates which can be paid on certain debt. In addition, the state has been required to implement recently enacted federal limits on certain types of borrowing for private purposes, including industrial development and housing.

Regardless of the scope of its specific responsibilities for regulating local borrowing, the state has an important interest in the amount of debt issued by local governments. This is because the marketability of state debt can be affected by the total volume of tax-exempt local debt offered to investors.

Long-Term Local Borrowing—Sales Double

Long-term bond sales by local governments increased dramatically in 1984–85. According to information from the California Debt Advisory Commission, the volume of local bond sales exceeded $11.9 billion in 1984–85, which is over twice the amount ($5.8 billion) of sales reported for 1983–84.

Nearly all of the sales increase can be attributed to bonds for housing and capital improvement projects. Between 1983–84 and 1984–85, local housing bond sales increased by 150 percent (from $1.8 billion to $4.5 billion), while sales of capital improvement bonds increased by about 125 percent (from $2.5 billion to $5.6 billion). The increase in overall bond sales is due, in part, to declining interest rates, which has made more projects economically viable. The increase in housing bond sales also is due to a dramatic rise in the volume of mortgage revenue bonds sold for multifamily rental housing. This reflects the increases in the authorization limits passed by the Legislature for multifamily mortgage revenue bonds, as well as the wider use of the program by cities and counties.

Short-Term Local Borrowing

Local governments engage in short-term local borrowing for cash-management purposes by issuing a variety of secured and unsecured debt instruments. Most of the borrowing is accomplished through the issuance of tax and revenue anticipation notes. In 1984–85, local governments issued approximately $2.9 billion in short-term debt, which is approximately $100 million less than the volume issued in 1983–84. These amounts, though significant, are considerably smaller than the $5.3 billion of debt issued in 1982–83, when the economic recession caused local governments to borrow heavily from outside sources to meet their cash-flow requirements.

POLICY ISSUES IN STATE AND LOCAL BORROWING

The state and local governments traditionally have relied on bonds and other forms of borrowing to raise funds for the construction of public facilities, such as roads, schools, water systems, prisons, and recreational facilities. In recent years, however, a number of trends and policy changes have affected the purposes, methods, and level of borrowing. We discuss some of these issues below.

Federal Tax Reform Could Affect Bond Programs

As noted earlier, the U.S. Congress and the Reagan Administration are considering proposals that would make major changes in the federal income tax system. The options under consideration generally call for "base-broadening" and lower tax rates, in order to simplify the tax system. Such changes generally would increase the amount of an individual's taxable income by eliminating many current exemptions, deductions, and tax

credits. At the same time, a lower tax rate would be applied to the broadened tax base in order to keep individual tax liabilities essentially the same.

These two general features of federal tax reform could have a number of significant effects on the use of and market for tax-exempt debt.

First, the reform proposals would eliminate the federal tax exemption for the interest income on certain bonds issued by state and local agencies. (That is, the proposals would make the interest earned on these bonds taxable.) This would be accomplished by reducing the ceilings on the aggregate *amount* of tax-exempt bonds that may be issued in a state, or by limiting the *types* of nongovernmental projects or activities which may be funded with such bonds. These changes would have the greatest effect on state and local bond programs which provide financing for housing, commercial and industrial development, and other private projects.

Second, if federal tax rates are reduced significantly, tax-exempt bonds would become less attractive to investors, because the value of the tax exemption would be diminished. For example, to an investor in the 50 percent federal tax bracket, a taxable security which earns 10 percent is equal in value to a tax-exempt security which earns 5 percent. If, however, the investor's tax bracket is reduced to 35 percent (as proposed by the Reagan Administration), the yield on the tax-exempt security would have to rise to 6.5 percent in order to remain competitive with the taxable security. Thus, the proposed reductions in federal tax rates may cause the "spread" between the interest rates on taxable and tax-exempt bonds to narrow. As a result, issuers of tax-exempt securities, such as the state, may be required to pay higher interest rates—and thereby pay more in debt servicing costs—if their issues are to be marketable.

State Industrial Development Bond Law Expires in 1986–87

Industrial development bonds (IDBs) are bonds issued by local authorities on behalf of private businesses which use the proceeds to construct or purchase qualified industrial and commercial facilities. Current state and federal regulations provide a tax exemption for the interest on IDBs. This allows businesses to obtain financing for eligible projects at rates below conventional financing. The maximum amount of IDBs which may be issued in California is limited to $250 million each year. Before the bonds may be issued, they must be reviewed and approved by the California Industrial Development Financing Advisory Commission (CIDFAC). Between 1982 and 1985, $650 million in IDBs were approved by the CIDFAC and issued by local agencies.

Under existing law, Title 10 of the Government Code, which authorizes the issuance of IDBs, is repealed on January 1, 1987. Consequently, the Legislature will have to review the effectiveness and administration of this method of government-subsidized financing in order to determine if this

program should continue. In its review, the Legislature should examine a number of issues, including the kinds of projects that qualify for IDB financing, the volume of bonds that may be issued, and the types of review activities that are needed at the state level. The Legislature also must be mindful of pending federal actions which would place further limits on the use of IDBs. Clearly, these limitations would significantly alter the environment in which decisions concerning the continuation of the state's IDB program must be made.

ACA 55 Would Increase Local Ability to Finance Infrastructure

A significant amount of debt is issued each year by state and local agencies to provide funds for "infrastructure." This debt generally includes bonds issued for public works and capital improvements, such as streets, sewers, public buildings, and power generation facilities. Infrastructure bonds accounted for $2.4 billion, or 30 percent, of the total amount of debt issued by state and local governments between January and June of 1985.

The level of debt issued to finance infrastructure projects could increase if the voters approve ACA 55 in June 1986. This constitutional amendment would restore the ability of local governments to issue *general obligation bonds*, because it would permit temporary increases in local property tax rates in order to generate the additional revenues needed to secure the bonds. The ability of local governments to issue general obligation bonds was effectively removed by Proposition 13 in 1978. Under ACA 55, local agencies would be able to issue general obligation bonds for capital improvements needed locally, contingent upon the approval of two-thirds of the jurisdiction's voters.

The State's Work Force

The Governor's Budget proposes a state government work force of 233,098 personnel-years (pys) for 1986–87. Four functional areas account for 79 percent of the total: higher education (39 percent); health and welfare (16 percent); business, transportation, and housing (14 percent); and youth and adult corrections (10 percent).

THE PROPOSED WORK FORCE FOR 1986–87

The budget proposes to *increase* the size of the state's work force by 2,019 personnel-years, or 0.9 percent, in 1986–87. The largest increases would occur in three program areas—youth and adult corrections (+2,150 pys), higher education (+562 pys), and resources (+301 pys). These increases would be partially offset by a decrease in health and welfare programs (−1,478 pys), as shown in Table 42.

Table 42
The State Work Force, by Function
(in personnel-years)
1984–85 through 1986–87 [a]

	1984–85	Estimated 1985–86	Proposed 1986–87	Change 1985–86 to 1986–87 Amount	Change 1985–86 to 1986–87 Percent	Change 1984–85 to 1986–87 Amount	Change 1984–85 to 1986–87 Percent
Legislative, Judicial, Executive	9,686	10,104	10,275	171	1.7%	589	6.1%
State and Consumer Services	11,790	11,841	11,994	153	1.3	204	1.7
Business, Transportation and Housing	34,254	33,394	33,296	−99	−0.3	−959	−2.8
Resources	13,590	13,868	14,169	301	2.2	579	4.3
Health and Welfare	37,647	38,234	36,756	−1,478	−3.9	−891	−2.4
Youth and Adult Corrections	17,332	20,466	22,616	2,150	10.5	5,284	30.5
K-12 Education	2,476	2,732	2,721	−11	−0.4	245	9.8
Higher Education	93,524	90,605	91,167	562	0.6	−2,357	−2.5
General Government	9,546	9,834	10,106	272	2.8	560	5.9
Totals	229,845	231,079	233,098	2,019	0.9%	3,253	1.4%

[a] Details may not add to totals due to rounding

Table 42 indicates that, when the budget proposal is compared to the actual number of personnel-years worked in 1984–85, the proposed state work force for 1986–87 is 3,253 personnel-years higher. Over the two-year period covered by the table, youth and adult corrections programs will increase by 5,284 personnel-years, or 31 percent, while health and welfare; higher education; and business, transportation and housing; collectively, will decrease by 4,207 pys, or 2.5 percent.

Proposed Budget-Year Changes by Function

Health and Welfare. The largest budget-year staffing reduction in absolute terms, 1,478 personnel-years, is proposed for health and welfare

programs. Nearly one-half of these reductions are proposed for the Employment Development Department, where a total of 725 personnel-years would be deleted. This reduction can be attributed to a variety of factors, including automation of the unemployment insurance (UI) and tax accounting programs, program transfers to other departments, workload changes in the UI program, program terminations, and various administrative efficiencies. Staffing cuts proposed for the state hospitals operated by the Departments of Mental Health and Developmental Services also account for much of the reduction. These decreases reflect population declines, contracting out janitorial and laundry services, the introduction of labor-saving food preparation equipment, and reductions in nontreatment personnel.

These reductions are partially offset by staffing increases associated with the third phase of the Governor's mental health initiative and a new medically disordered offender program in the Department of Mental Health. This new program makes mental health treatment a condition of parole for specified inmates. The Department of Social Services also would receive staff increases for its disability evaluation program, as well as for employment services and community care licensing.

Business, Transportation, and Housing. The budget proposes to reduce staffing for this area by 99 pys, or 0.3 percent. This is primarily the result of reductions in the number of management personnel at the Department of Transportation, coupled with a slight decline in the Department of Motor Vehicles (45 personnel-years). After the 1985 Budget Act went into effect, the Department of Motor Vehicles added 635 personnel-years in order to reduce its processing backlog and waiting times, as well as to respond to chaptered legislation and delays in automation. Most, but not all, of these personnel are proposed for continuation in the budget year. Thus, while the department is showing a slight decline in 1986–87, it has added significant numbers of staff in the current year.

State and Consumer Services. Three departments principally account for the proposed increase (153 pys) in staffing for this area during the budget year. The Franchise Tax Board is adding 152 personnel-years, in order to increase its auditing and collecting functions as well as to keep pace with increased workload. The Department of General Services is increasing personnel for activities carried out by the Office of State Architect (84 pys), which are offset slightly by decreases in the state printing plant. These increases are partially offset by a decrease of 51 personnel-years in the State Personnel Board, which is continuing to decentralize the employee selection program to individual state departments.

Higher Education. The budget shows the University of California (UC) and the California State University (CSU) experiencing net increases in staffing during the budget year. In both instances, the main

factor pushing up staffing is increased enrollments. The increase at UC could have been larger were it not for the proposed reduction of 200 pys in the teaching hospitals. Unlike UC, the CSU is offsetting a portion of its enrollment-related increases with an unallocated reduction of 144 pys. As was the case in each of the last two years, the funding associated with the unallocated reduction has not been reduced.

Youth and Adult Corrections. The state's correctional program accounts for the most significant staffing increases in the budget year, as it has in the preceding three years. Since 1984–85, the last year for which actual data are available, staffing for this function has increased by 5,284 pys, or 31 percent. The budget proposes to increase the Department of Corrections' staffing by 2,049 pys, or 13 percent, in 1986–87. This increase is primarily due to significant increases in the adult inmate population and the opening of new facilities to accommodate the additional inmates. Similarly, the Department of the Youth Authority is experiencing an increase of 92 pys in the budget year, largely because of increased workload demands resulting from a major increase in the ward population.

Resources. The growth in resources programs is primarily accounted for by personnel increases in three constituent departments. The Department of Forestry is increasing by 128 pys as a result of three factors: (1) the 1985–86 collective bargaining agreement which reduced the work week for many departmental employees and thus required more personnel to be hired, (2) expansion of existing fire protection contracts, and (3) lower salary savings. The Department of Parks and Recreation, meanwhile, is growing by 69 pys as a result of new park acquisitions and increased visitors' services at Hearst Castle. The State Water Resources Control Board will increase by 59 pys, primarily as the result of increases requested for the toxic pit regulatory program as well as new activities to protect groundwater quality.

PERSONNEL-YEARS IN HISTORICAL PERSPECTIVE

In sharp contrast to the two preceding budgets, the Governor's Budget for 1986–87 does not place a great deal of emphasis on the size of the state's work force.

Since the Legislature enacted the 1985 Budget Act, the size of the work force has grown by 2,913 pys in the current year and would grow by an additional 2,019 pys in the budget year if the Governor's requests are approved. This amounts to a two-year increase of 4,932 personnel-years, or 2.2 percent. Increases in just one department, the Department of Corrections, account for 3,310 pys or 67 percent of the total change.Table 43 summarizes the trends in state staffing since 1980–81. It shows that, despite a sizable drop in staffing in 1983–84 (1,794 pys), the subsequent trend has been upward—increases totaling 6,403 pys in three years.

Table 43
State Personnel-Years
1980–81 through 1986–87

	Proposed In Budget	*Subsequent Change*	*Actual*	*Change From Prior Year*
1980–81	221,118	4,449	225,567	5,374
1981–82	226,743	2,070	228,813	3,246
1982–83	231,375	−2,886	228,489	−324
1983–84	232,371	−5,676	226,695	−1,794
1984–85	229,540	305	229,845	3,150
1985–86	227,888	3,191 [a]	231,079 [a]	1,234 [a]
1986–87	233,098	—	—	2,019 [b]

[a] Estimated.
[b] Proposed.

Table 43 also reveals that:

- The revised estimate of the state's work force in the current year is 1,234 personnel-years larger than what the work force actually was in 1984–85.
- The staffing level proposed by the Governor for 1986–87—233,098 personnel-years—represents the largest request for staffing during the past seven years, and, in fact, is the largest in the state's history.

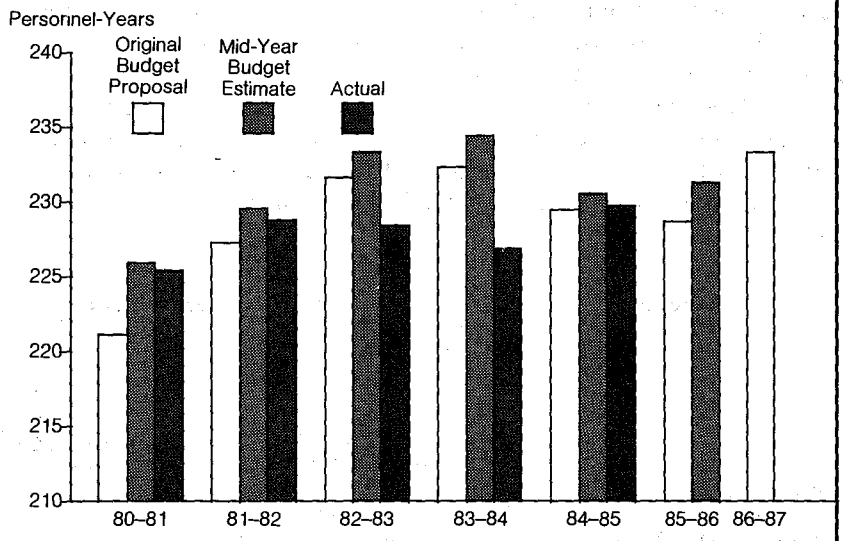
Personnel-Year Estimates

Chart 18 illustrates that three patterns we identified last year with regard to state employment continue to hold: (1) midyear estimates of staffing levels typically are higher than the original budget estimates, (2) midyear estimates of personnel-years in recent years tend to overstate the actual number of pys that will be worked, and (3) inflated midyear estimates make the number of personnel-years proposed in the budget year look smaller.

Proposed Versus Midyear Estimates. Chart 18 shows that, in each of the last six years, the midyear estimate of the total state work force has been markedly higher than what the original budget for that year proposed. This is usually the case, for two reasons: (1) the administration and the Legislature typically increase staffing levels during the course of deliberation on the budget and (2) the administration typically creates new positions administratively after the budget is enacted.

Midyear Estimate Versus Actual Staffing. A more recent phenomenon is also illustrated in Chart 18. From 1982–83 through 1984–85 (the last year for which actual data are available), the state's actual staffing turned out to be below—in two of the three years, significantly below—the midyear estimate. As we predicted last year, the midyear estimate for 1985–86 exceeds the actual staffing level for 1984–85. Given the continuing delays

Chart 18
Trends in State Employment Estimates 1980–81 through 1986–87 (in thousands)



in the prison construction program, the continuing workload and organizational changes in the Employment Development Department, and the need for some departments to intentionally hold positions vacant in order to free-up the funds needed to pay merit salary adjustments, we believe it is probable that the actual staffing level shown for 1985–86 in next year's budget will be below the midyear estimate.

Inflated Midyear Estimates Make Budget Proposals Look Smaller. The chart also shows that, from 1982–83 through 1984–85, midyear estimates for the budget just enacted have been higher than the personnel-year level proposed for the following year. This had the effect of making it look as though the state work force was being pared back, when, in fact, the number of pys proposed for the budget exceeded *actual* pys in the prior year. The proposed budget may mark a return to the trend in 1980–81 and 1981–82 when the midyear estimate was less than the personnel level proposed for the budget year. In either case, however, the inflated midyear estimates make the budget proposal look smaller than it really is.

What Personnel-Year Changes Have Occurred Since 1982–83 and How Do These Factors Affect the Estimates for 1986–87?

Table 44 shows the change in personnel-years, by budget category, since

1982–83. It shows that the same four functional areas account for most of the state's work force today, just as they did in 1982–83—higher education; health and welfare; business, transportation and housing; and youth and adult corrections. Over the four-year period, however, youth and adult corrections has grown by 54 percent, while health and welfare and higher education have decreased by 10 percent and 3.2 percent, respectively. Business, transportation and housing has remained relatively level. If one looks only at the last three years, the trends are roughly the same, though the total work force has grown by a somewhat larger amount—6,403 personnel-years. The main reason for the larger increase over a shorter period is the decrease in the statewide totals that occurred between 1982–83 and 1983–84.

Table 44
Historical Changes in the State's Work Force, by Function
(in personnel-years)
1982–83 through 1986–87 [a]

	1982–83	1983–84	Proposed 1986–87	Change 1982–83 to 1986–87 Amount	Change 1982–83 to 1986–87 Percent	Change 1983–84 to 1986–87 Amount	Change 1983–84 to 1986–87 Percent
Legislative, Judicial, Executive	9,290	9,486	10,275	985	10.6%	789	8.3%
State and Consumer Services	11,378	11,256	11,994	616	5.4	738	6.6
Business, Transportation and Housing	32,182	33,092	33,296	1,114	3.5	203	0.6
Resources	14,141	13,519	14,169	28	0.2	651	4.8
Health and Welfare	40,931	39,288	36,756	−4,175	−10.2	−2,532	−6.4
Youth and Adult Corrections	14,674	15,336	22,616	7,942	54.1	7,280	47.5
K-12 Education	2,666	2,548	2,721	55	2.1	173	6.8
Higher Education	94,188	93,092	91,167	−3,021	−3.2	−1,925	−2.1
General Government	9,040	9,079	10,106	1,066	11.8	1,026	11.3
Totals	228,489	226,695	233,098	4,609	2.0%	6,403	2.8%

[a] Details may not add to totals due to rounding

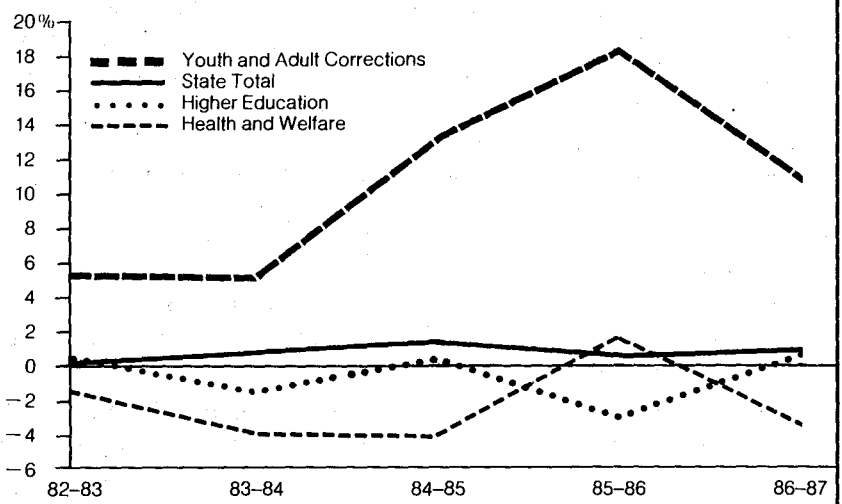
Chart 19 illustrates the percentage change in total personnel-years and the three most fluid functional areas since 1982–83. It shows that, despite significant percentage increases in youth and adult corrections, state totals have not changed much during the last four years. During the same time period, higher education staffing has declined slightly, while health and welfare generally has been on the decline, except during 1985–86 when it increased slightly.

As we have indicated the last two years, however, "a change in the numbers" may not be a reliable guide to the direction in which state policy is actually heading, and may not give any indication as to the implications that changes in personnel-years have for state programs and expenditures.

Since the 1984–85 budget was proposed in January 1984, there have been several changes which have occurred in the way that the state measures

Chart 19

Annual Percentage Change in State Personnel-Years 1982–83 through 1986–87



its work force. These changes have made it increasingly difficult to evaluate what the "numbers" mean. It is to an analysis of the numbers that we now turn.

Personnel Continue to Perform the Same Work But No Longer Appear in State Totals. As we have pointed out in past volumes of the *Perspectives and Issues*, the state no longer counts certain state employees in its statewide totals, even though they continue to perform the same work that they did in previous years. For example, last year the Department of Finance changed the way in which California State University (CSU) faculty members who teach in both daytime academic programs and extension classes are counted for budget purposes. Instead of converting instructional time in extension programs to a personnel-year equivalent, the budget now counts it as overtime. This lowers the reported size of the state work force by 495 pys, beginning in 1983–84, even though there may have been no change in the number of faculty members or hours worked.

Similarly, the Governor's Budget for 1985–86 required CSU to reduce 250 additional positions without specifying how it should be done. In April 1985, the system determined that it would make this "reduction" by removing two categories of staff—resident assistants who work for the

campuses in housing units and auxiliary organizations—from the statewide totals. Here again, the same staff will continue to perform the same duties for the university.

Legislative changes can have a similar effect. For example, in enacting Ch 956/83, the Legislature removed the Prison Industry Authority from the state budget and established it as an independent authority. In so doing, the state work force was "reduced" by 327 personnel-years, beginning in 1984–85.

We estimate, in the last two years alone, that approximately 1,350 personnel-years have been removed from statewide budget totals in this manner. Thus, it is not easy to draw meaningful conclusions from changes in statewide personnel-year totals over time. Fewer personnel-years does not necessarily translate into a reduction of services, a reduction in the number of employees, or even a reduction in the number of hours worked. One has to look behind the numbers to determine how program services are affected by staffing changes reported in the budget.

Contract Proposals Reduce Statewide Personnel Totals. Beginning last year, the administration substantially increased the state's efforts to contract with the private sector for staff services. What was unique about the Governor's proposal was not the emphasis on contracting but, rather, the types of work for which personal services contracts would be let. Much of this work was being performed, or traditionally was performed, by state employees. In February 1985, we identified funding in the Governor's 1985–86 Budget for more than 100 new personal services contracts in lieu of hiring state personnel. At that time, we also identified approximately 1,300 state personnel-years that were either replaced or avoided as a result of these proposals.

Personal services contracting does not have the same emphasis in this year's budget. In a report dated January 27, 1986, prepared pursuant to Control Section 29.5 of the 1985 Budget Act, the Department of Finance indicates that 616 pys were reduced or avoided in the Governor's Budget for 1986–87 as a result of contracting proposals. The largest proposals involve contracting for housekeeping services in the state hospitals (158 pys reduced), maintenance of increased highway inventory (70 pys avoided), expansion of California's birth defects and cancer registry programs (70 pys avoided) and verification of victims of crime claims by local centers (48 pys avoided).

Each of these proposed contracts will have to be evaluated on its own merits. Generally, contracting makes sense if it is the more cost-effective alternative for providing a given level of service, or if there are special circumstances that warrant it, such as a lack of needed expertise.

Personnel Changes Where There Are No Position Controls. As we indicated earlier, declines in higher education staffing amount to 3,021 pys

in the last four years. The University of California (UC) accounts for over half of that amount—1,704 personnel-years. As we have pointed out in past years, however, it is by no means clear just what the UC numbers mean—particularly estimates of these numbers—because the university does not have a position control system like the rest of state government. In the case of UC, it is *funding*, rather than authorized positions, that really determines staffing levels at the university. Because the university accounts for such a significant portion of the state's work force (25 percent in the budget year), however, a modest percentage change in the university's staffing level can have a significant effect on the statewide totals.

In last year's *Perspectives and Issues* we called the Legislature's attention to the tendency for the original budget to underestimate the University of California's actual staffing levels. This has happened in eight of the last 10 years—1978–79 and 1979–80 being the only exceptions. Thus, while UC personnel totals would appear to have declined over the period, when the final numbers are in for the current and budget years, the trend may be otherwise.

Program Changes Affect Statewide Totals. One of the main variables affecting statewide personnel totals is changes in programs and services delivered to California's citizens. These changes usually take one of four forms: new programs initiated by the administration and the Legislature, caseload-driven programs that expand and contract as caseload varies, program terminations, and program modifications that enable services to be delivered in a more efficient and effective manner.

A good example of the effect that a caseload-driven program can have on the state's work force is provided by the unemployment insurance (UI) program. In 1982–83, the state was experiencing the effects of the nationwide recession and had a 10.6 percent unemployment rate. In order to process checks and run the UI program in that year, the Employment Development Department had a UI work force of 6,739 pys. In 1986–87, a much smaller staff of 4,508 pys will manage the UI program—primarily because the state's unemployment rate is expected to be only 6.6 percent. The reduction of 2,231 pys did not result from any administrative actions to reduce the work force; it occurred automatically, in response to the reduced caseload attributable to the UI program.

Similarly, much of the reduction at the University of California can be attributed to a decline of 1,513 staff at the teaching hospitals since 1982–83. A large share of this reduction was anticipated four years ago when the Legislature enacted Medi-Cal reform legislation.

Finally, in recent years we have seen the decline of 118 pys in the California Highway Patrol, due to the termination of the AB 202 training program, and 618 personnel-years in the Department of Motor Vehicles as a result of anticipated automation savings. In the latter instance, howev-

er, our analysis indicates that automation-related personnel may have been eliminated too quickly, thus contributing to the need to add 635 pys in the current year to perform many of these same duties.

From the Legislature's perspective, the size of the state work force is not the real issue. Instead, the issue is: What effect does the proposed level of staffing for individual programs have on the quality and cost of services provided by the state? This necessitates a function-by-function review to ascertain whether an adequate staffing complement is available to carry out the program priorities of the legislative branch.

Unallocated Reductions Inflate Savings and Limit Legislative Control. The Governor's Budget for 1986–87 also proposes unallocated personnel-year reductions. For example, the budget shows that 144 unspecified positions at CSU will be eliminated. The funding associated with the personnel, however, remains in the budget. The administration advises, as it did last year, that a plan detailing these position reductions will be submitted during budget hearings.

Unallocated reductions take another form as well: an unreasonable increase in the salary savings rate (which reflects the period of time during which authorized positions are vacant). An artificially high salary savings rate will require the affected departments to purposely hold vacant positions open. Our analysis indicates that forced saving of this type will be necessary in the budget year because of the administration's decision not to fund merit salary adjustments (MSAs). This marks the third time in four years that General Fund-supported agencies have not received funds for these increases. As a result, many departments are proposing to fund the adjustments by increased salary savings. Our analysis indicates, for example, that the statewide salary savings rate has increased from 2.7 percent, or 6,480 vacant positions, proposed for 1982–83 to 3.7 percent, or 8,989 vacant positions, proposed for 1986–87. In dollar terms, the salary savings increase is even greater, growing from a $174 million savings in 1982–83 to a $285 million savings in 1986–87.

A number of departments plan to meet their merit salary adjustment costs in this manner. The Department of Parks and Recreation, for example, will fund $1.1 million of MSAs from forced salary savings. Similarly, the Board of Equalization will fund $1.9 million of MSAs by leaving 49 pys intentionally vacant. The Department of Industrial Relations is proposing to increase its salary savings requirement by $1.9 million. Of this amount, approximately $1 million is necessary to offset the costs of unfunded MSAs; the balance reflects an arbitrary increase in the salary savings requirement.

Excessively high salary savings requirements such as these mean that individual departments, rather than the Legislature, will decide which positions to leave open, and thus, which program activities will be cut back.

Conclusion

In summary, our review of historical trends in the state's work force has found that:

- The total work force has remained quite stable during the last five years.
- The recent growth in youth and adult corrections has been offset by declines in health and welfare and higher education, which, to a significant degree, are due to caseload changes, Medi-Cal reform, and accounting changes at CSU.
- Recent accounting changes and expanded contracting of functions traditionally performed by state employees make it increasingly difficult to evaluate the historical trends in the state's work force.