The 1987-88 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 1987 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 1987–88 and (2) identifying some of the major *issues* facing the Legislature in 1987. Many of these issues are long-range in nature. Even in these cases, however, legislative action during 1987 is warranted since the Legislature generally will have a wider range of options for addressing these issues in 1987 than it will have in subsequent years. As such, this document is intended to complement the *Analysis of the 1987–88 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 legislative 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 1987–88 Budget: Perspectives and Issues is divided into three parts.

Part One, "State Finances in 1987," provides a perspective on the state's current fiscal situation by discussing the state's General Fund condition in 1986 and 1987.

Part Two, "Perspectives on the 1987–88 Budget," presents data on the budget as a whole—expenditures, revenues, bonding activity, and the state's fiscal condition—to provide a perspective on the budget issues that the Legislature will face in 1987. It does so by detailing the total spending plan for the state from all funding sources and highlighting the major changes in program activities proposed by the Governor. It also discusses the various sources of income to the state, as well as the economic circumstances that will influence the level of revenues in the current and budget years. Finally, this part discusses the types and volume of borrowing being done by the state and local governments, and analyzes the reasons for changes in the state's work force in 1987–88.

Part Three, "Major Fiscal Issues Facing the Legislature," discusses major issues that we have identified in reviewing the state's current fiscal condition and the Governor's Budget for 1987–88. Wherever possible, our analysis identifies options which the Legislature may wish to consider in addressing these issues.

Most of the issues in this section fall into four categories. The first is the fiscal constraints facing the state and the counties. The second category deals with program changes that directly affect the state budget: the rising costs of incarceration, the AIDS epidemic, implementation of GAIN, financing community colleges, and California's long-term care system. The third category includes issues the Legislature needs to address in response to federal legislation: tax reform, revenue bond limitations, immigration reform and control, and early education for the handicapped. Finally, there are issues that arise from the growing deferred maintenance and capacity needs of the state's infrastructure systems: prisons, higher education campuses, state hospitals, state office buildings, highways, and sewage treatment facilities.

PART ONE

State Finances in 1987

- ***Fiscal Situation Facing the Legislature***

Part One

STATE FINANCES IN 1987

The Governor's Budget for 1987–88 reflects an anticipated temporary slowdown in the California economy. As a result, projected revenues will not be sufficient to fund both the current level of services and restore the reserve to a $1 billion level. Faced with this choice, the budget gives its highest priority to the restoration of the reserve. For example, about 50 percent of the growth in revenues between the current and budget years is earmarked for the restoration of the reserve, while the remainder would be used to fund changes in expenditure levels.

In terms of inflation-adjusted (real) purchasing power, the level of General Fund revenues is 0.5 percent lower than the level estimated for the current year, while the proposed level of General Fund expenditures is 2.4 percent lower.

Even though state revenues are projected to decline in "real" terms, the state's constitutional limit on appropriations could further restrain the state's ability to maintain the level of services provided to its citizens.

In this part, we provide a brief overview of the state's fiscal condition in 1986 and 1987. We also discuss the state's budget 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 1981–82. Trends in General Fund revenues and expenditures are illustrated in Chart 1.

The chart shows that General Fund expenditures have exceeded General Fund revenues in four of the last six years. In 1985–86, expenditures exceeded revenues by almost $770 million, causing a large drop in the end-of-year General Fund balance. In the current year, estimates indicate that expenditures will again exceed revenues. In spite of this deficit, the state's Special Fund for Economic Uncertainties is projected to grow by $115 million, because the excess expenditures will be paid for by funds appropriated for these purposes in prior years. In 1987–88, however, the budget predicts a reversal of this situation. If the Governor's estimates of 1987–88 revenues and expenditures turn out to be accurate, General Fund revenues will exceed expenditures by $478 million.

Chart 1

Comparison of General Fund Revenues and Expenditures

1981-82 through 1987-88 (in billions)

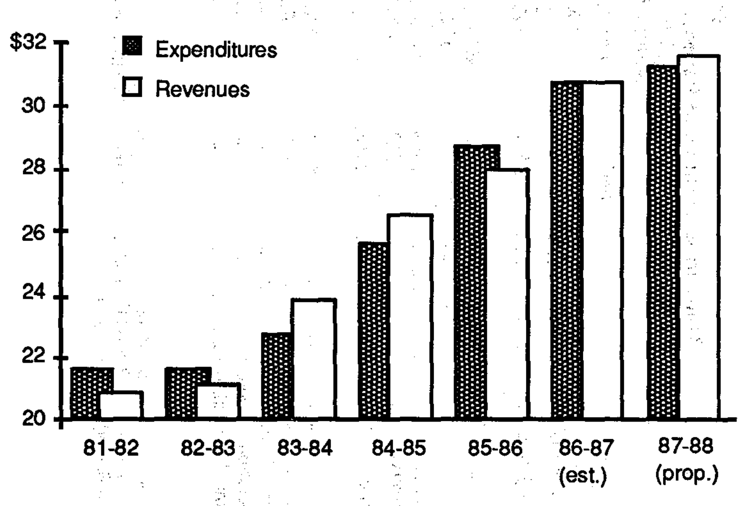


Table 1
Trend in General Fund Revenues, Expenditures and the Surplus [a, b]
1981–82 through 1987–88
(dollars in millions)

	1981–82	*1982–83*	*1983–84*	*1984–85*	*1985–86* [c]	*1986–87* [c]	*1987–88* [c]
Prior year resources	$681.0	–$30.8	–$521.3	$490.6	$1,400.2	$686.3	$561.3
Adjustments to prior year resources	50.0	7.0	57.7	40.1	55.1	—	—
Prior year resources, adjusted	$731.0	–$23.8	–$463.6	$530.8	$1,455.3	$686.3	$561.3
Revenues and Transfers	$20,920.6	$21,231.1	$23,822.1	$26,605.9	$28,072.2	$30,764.8	$31,742.0
Expenditures	$21,682.3	$21,728.6	$22,867.9	$25,736.4	$28,841.3	$30,889.8	$31,263.6
(Difference)	(–761.8)	(–497.5)	(954.2)	(869.5)	(–769.1)	(–125.0)	(478.4)
(Expenditures from reserves)	(274.2)	(–29.3)	(24.1)	(–0.1)	(–88.0)	(142.6)	(4.4)
(Annual surplus or deficit)	(–487.6)	(–526.8)	(978.3)	(869.3)	(–857.1)	(17.6)	(482.8)
General Fund balance	–$30.8	–$521.3	$490.6	$1,400.2	$686.3	$561.3	$1,039.7
Carry-over reserves	(57.8)	(87.1)	(63.0)	(63.1)	(151.1)	(8.5)	(4.1)
Reserve for Los Angeles County Grant Account	—	—	(100.0)	—	—	—	—
Disaster Response-Operations Account	—	—	—	—	(99.6)	(1.6)	(10.0)
Special Fund for Economic Uncertainties	—	—	(327.6)	(1,337.1)	(435.6)	(551.2)	(1,025.6)

[a] Source: State Controller.
[b] Detail may not add to totals due to rounding.
[c] Source: *Governor's Budget.* Data for 1985–86 through 1987–88 are not strictly comparable with prior years due to Generally Accepted Accounting Principles (GAAP)-related adjustments reflected in these years.

According to the budget document, the Governor's spending program for 1987–88 would leave the General Fund with an unrestricted balance of approximately $1.0 billion on June 30, 1988—up from about $551 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 in expenditures. Thus, the reserve serves a key purpose: by insulating the budget from adverse developments affecting revenues and expenditures, it helps the state provide a continuous and more predictable level of services to its citizens.

General Fund Condition Deteriorates in 1986–87

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
1985–86 and 1986–87
(dollars in millions) [a,b]

	Condition of the General Fund in 1985–86 as Projected by Governor's Budget		*Effect on*	*Condition of the General Fund in 1986–87 as Projected by Governor's Budget*		*Effect on*
	January 1986	*January 1987*	*1985–86 Surplus*	*January 1986*	*January 1987*	*1986–87 Surplus*
Beginning resources	$1,386	$1,455	$69	$863	$686	–$177
Revenues and transfers	28,187	28,072	–115	31,024	30,765	–259
Expenditures	28,710	28,841	–131	30,699	30,890	–191
General Fund balance	$863	$686	–$177	$1,188	$561	–$627
Reserves [c]	46	251	–205	28	10	18
Unrestricted balance	$817	$436	–$381	$1,160	$551	–$609

[a] Detail may not add to totals due to rounding.
[b] Source: *Governor's Budget*.
[c] Includes unencumbered balance of continuing appropriations, and reserve for Disaster Response-Operations Account.

1985–86. Last year at this time, the Governor's Budget projected that the state would end 1985–86 with an unrestricted balance of $817 million in the General Fund. The 1987 Governor's Budget states that the balance is now expected to be $436 million, or $381 million less than what was estimated one year ago. This decrease results from both higher-than-anticipated expenditures and lower-than-anticipated revenues.

As shown in Table 2, expenditures in 1985–86 were $131 million higher than the amount predicted in last year's Governor's Budget. This change is the net effect of both increases and decreases to the expenditures projected in the Governor's original spending plan. Expenditure increases were primarily the result of legislation ($120 million) and additional deficiencies ($206 million). Expenditure decreases were primarily the result of savings ($64 million) and the fact that $217 million of authorized expenditures—for example, spending for flood-related disaster assistance—did not occur in 1985–86. Most of these authorized expenditures will occur instead in 1986–87.

Table 2 also shows that actual revenues and transfers in 1985–86 were $115 million less than the amount predicted in last year's Governor's Budget. These decreased revenues primarily reflect lower-than-anticipated receipts from state taxes.

1986–87. Relative to estimates made one year ago, the General Fund balance is expected to decline by $627 million in 1986–87, instead of increasing by $325 million as the Governor originally proposed. This large decline is attributable to three factors:

- The General Fund began the current year with a balance which was $177 million lower than originally anticipated;
- Revenue projections are now $259 million lower than estimated in January 1986; and
- Expenditure estimates are now $191 million higher than estimated in January 1986.

Table 2 indicates that 1986–87 General Fund revenue projections have decreased by $259 million. This revenue decrease reflects large shortfalls in state tax receipts, the failure of the Governor's proposal to realize revenue from the sale of land at Agnews State Hospital, and revenue losses due to legislation. The budget anticipates that these decreases will be partially offset by legislation authorizing increased transfers of approximately $78 million.

Table 2 also indicates that 1986–87 General Fund expenditure estimates have increased by $191 million. This increase is the net effect of several large increases, partially offset by other expenditure decreases. Expenditure increases reflect legislation approved by the Legislature and the Governor (approximately $77 million), expenditures authorized in 1985–86 which are expected to occur in 1986–87 ($180 million), and an additional $378 million in expenditures for deficiencies. Anticipated expenditure decreases include $103 million from the Governor's 2 percent reduction in state operating costs, a savings of $159 million from the proposed reversion of funds appropriated for the school maintenance program and for unemployment insurance reimbursements, and an additional $129 million in other identified savings. To the extent that the anticipated state operating cost savings are not realized, or the proposed reversions are not approved, expenditures will be correspondingly higher.

General Fund Condition for 1987–88

If the budget's estimates of revenues and expenditures for 1987–88 turn out to be accurate, revenues will exceed expenditures by $478 million. These excess funds would bring the balance in the Special Fund for Economic Uncertainties up to $1.0 billion, or 3.3 percent of General Fund expenditures.

The 1987–88 budget contains one proposal which distorts the inter-year comparison of the growth in revenues and expenditures. This proposal calls for the elimination of state General Fund subventions to county governments for eight county-operated health programs, and the creation of a new state subvention of unrestricted funds as a replacement. Because the proposal would transfer existing General Fund sales tax revenues to a special fund from which the subventions would be paid, the proposal *reduces* both General Fund revenues and expenditures by $477 million, and increases special fund revenues and expenditures by the same amount. Table 3 shows that total General Fund revenues under current law are projected to increase by $1.5 billion or 4.7 percent, in 1987–88. On this same basis, General Fund expenditures would increase by $851 million, or 2.8 percent.

Table 3
Comparison of General Fund Revenues and Expenditures Adjusted for Proposed County Health Services Funding Shift (dollars in millions)

			Difference	
Revenues	*1986–87*	*1987–88*	*Amount*	*Percent*
Governor's Budget	$30,765	$31,742	$977	3.2%
Proposed sales tax transfer	—	477	477	—
Existing law	$30,765	$32,219	$1,454	4.7%
Expenditures				
Governor's Budget	$30,890	$31,264	374	1.2%
Proposed county health transfer	—	477	477	—
Existing law	$30,890	$31,741	$851	2.8%

Consistent with past years, the largest increase in 1987–88 is proposed for education, which would gain $452 million, or 2.7 percent, in additional General Fund support. However, this increase is much smaller than the current year's; 1986–87 saw education receive an additional $1.2 *billion,* or 7.5 percent, in General Fund support. The second largest increase is for youth and adult correctional programs, which would gain $162 million, or 9.5 percent, in additional General Fund support. This increase is also much smaller than the current year's; 1986–87 saw the correctional programs receive $272 million, or 19 percent, in additional General Fund support.

As we discuss in Part Two of this volume, the budget's estimate of 1987–88 expenditures understates the amount needed to provide the level of services proposed by the Governor. Our analysis also indicates that revenues could turn out to be higher than the budget projects, especially if the consensus view of the economy's behavior materializes. Given the considerable uncertainty that characterizes the proposed budget's estimates of revenues and expenditures and the potential for reductions in federal funding, the General Fund's end-of-year balance could vary considerably from the level estimated in the budget.

PART TWO

Perspectives on the 1987-88 Budget

- ***Expenditures in 1987-88***
- ***Revenues in 1987-88***
- ***State and Local Borrowing***
- ***The State's Work Force***

Part Two

PERSPECTIVES ON THE 1987-88 BUDGET

This part of our analysis provides perspectives on the Governor's Budget for 1987–88. It consists of four major sections:

- ***Expenditures.*** This section presents an overview of the spending plans 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 funded in the budget.
- ***Revenues.*** This section provides a perspective on the state's economy in 1986, 1987, and 1988, and the outlook for the economy in succeeding years. It also includes an analysis of revenue collections in the 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 1987-88. It also examines historical trends that account for the changes in state employment in recent years.

Expenditures in 1987–88

TOTAL STATE SPENDING PLAN

The Governor's Budget for 1987–88 proposes total expenditures of $66.4 billion. This amount includes:

- $39.1 billion in *state expenditures,* consisting of $31.3 billion from the General Fund, $6.7 billion from special funds, and $1.1 billion from selected bond funds;
- $15.2 billion in expenditures from *federal funds;* and
- $12.1 billion in expenditures from various "*nongovernmental cost*" funds, including funds established for retirement, working capital, public service enterprise, and other purposes.

Table 4
Total State Spending Plan [a]
1985–86 through 1987–88

	Actual 1985–86	Estimated 1986–87		Proposed 1987–88		
		Amount	Percent Change	Amount	Percent Change	Dollar Change
General Fund	$28,841.3	$30,889.8	7.1%	$31,263.6	1.2%	$373.8
Special funds	5,190.3	5,949.8	14.6	6,665.5	12.0	715.7
Budget Expenditures	$34,031.6	$36,839.6	8.3%	$37,929.1	3.0%	$1,089.5
Selected bond funds	945.1	1,775.3	87.8	1,124.3	−36.7	−651.0
State Expenditures	$34,976.7	$38,614.9	10.4%	$39,053.4	1.1%	$438.5
Federal funds	14,280.3	15,350.6	7.5	15,160.5	−1.2	−190.1
Governmental Expenditures	$49,257.0	$53,965.5	9.6%	$54,213.9	0.5%	$248.4
Nongovernmental cost funds	10,420.8	11,556.3	10.9	12,143.6	5.1	587.3
Total State Spending	$59,677.8	$65,521.8	9.8%	$66,357.5	1.3%	$835.7

[a] Source: Governor's Budget. Detail may not add to totals due to rounding

Governmental Expenditures

The budget proposes expenditures from governmental funds—that is, total state spending less expenditures from nongovernmental cost funds—amounting to $54.2 billion in 1987–88. This represents a $248 million, or 0.5 percent increase from the estimated current year level. This increase is the net effect of a $1.1 billion increase in budget expenditures—General Fund and special funds, and an $841 million *decrease* in combined federal fund and selected bond fund expenditures.

Using this measure of expenditures, during 1987–88, the state will spend $1,980 for every man, woman and child in California, or $148 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 $39.1 billion in 1987–88, which is 1.1 percent higher than state expenditures in the current year. This compares with an increase of 10.4 percent between 1985–86 and the current year.

General Fund Expenditures

The budget proposes General Fund expenditures of $31.3 billion—nearly one-half of all expenditures that will occur under the state's auspices.

Chart 2
Annual Growth in General Fund Expenditures
1981-82 through 1987-88 (in billions)

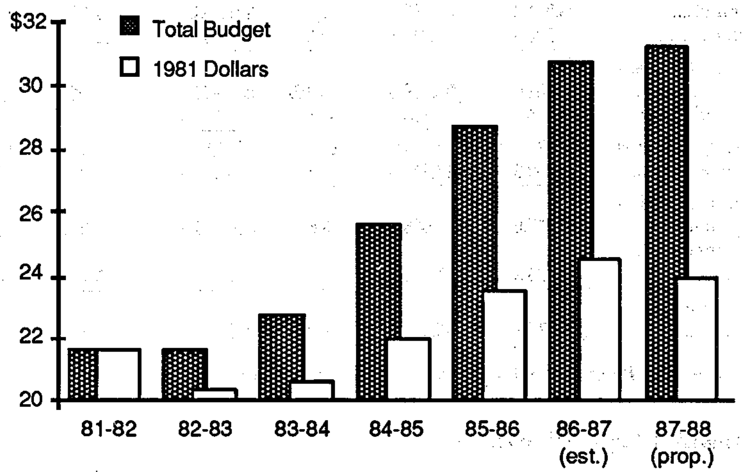


Chart 2 and Table 5 show the trend in General Fund expenditures since 1981–82. Chart 2 displays expenditures both on a "current dollar" and "real dollar" basis. Expenditures in "real dollars" represent expenditure levels as they appear in the budget (that is, "current dollars"), adjusted for the effect of inflation since 1981. Presenting the budget totals in terms of "real dollars" allows expenditure levels in different years to be compared on a common basis.

Table 5
Annual Change in General Fund Expenditures
1981–82 through 1987–88
(dollars in millions)

	Total General Fund Budget[a]			
	"Current Dollars"		"Real (1981) Dollars"	
	Amount	*Change*	*Amount*[b]	*Change*
1981–82	$21,682	—	$21,682	—
1982–83	21,729	0.2%	20,495	−5.5%
1983–84	22,868	5.2	20,618	0.6
1984–85	25,736	12.5	22,035	6.9
1985–86[c]	28,841	12.1	23,608	7.1
1986–87 estimated[c]	30,890	7.1	24,522	3.9
1987–88 proposed[c]	31,264	1.2	23,922	−2.4

[a] Source: State Controller.
[b] "Real dollars" equal current dollars deflated to 1981–82 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 are not strictly comparable to data for the prior years due to the effect of accounting changes.

In current dollars, the proposed General Fund budget for 1987–88 is 44.2 percent greater than it was in 1981–82. In terms of "real dollars," however, the increase proposed in the General Fund budget is 10.3 percent.

As shown in Chart 2 and Table 5, between 1981–82 and 1982–83 total General Fund expenditures in "real dollars" actually *declined* by 5.5 percent, as the state experienced the effects of the nation-wide recession. In 1983–84 "real" General Fund expenditures increased by less than 1 percent. In 1984–85 and 1985–86, however, "real" General Fund expenditures headed upward, in line with the expansion of the state's economy. For these two years, total General Fund expenditure growth averaged over 12 percent in current dollars and 7 percent in real dollars. Estimated expenditures for the current year are expected to continue this growth trend, though at a much slower rate than during the preceding two years.

The level of General Fund expenditures proposed for 1987–88 would reverse the upward trend of real expenditure growth that began in 1983–84. In current dollars, the amount of General Fund expenditures proposed for 1987–88 is 1.2 percent greater than the current year amount, which represents the smallest year-to-year increase since 1982–83. In fact, this expenditure level translates into a *decrease* in purchasing power of 2.4 percent, based on an estimated inflation rate of 3.7 percent in the budget year.

The decrease in the rate at which General Fund expenditures are proposed to grow in the budget year reflects slower-than-normal growth in General Fund revenues, as well as the Governor's proposal to increase the balance in the Special Fund for Economic Uncertainties. The budget anticipates that revenues deposited in the General Fund will increase by only 3.2 percent, compared to the 9.6 percent growth estimated for the current year. In part, this reflects the Governor's proposal to deposit $477 million of state sales tax revenues in a special fund for distribution to county governments. Without this proposal, the General Fund revenue increase would be 4.7 percent. In order to restore the level of the state's Special Fund for Economic Uncertainties, the Governor's Budget proposes to use $475 million of the budget year revenue growth to raise the end-of-year balance in this fund to $1,026 million.

Federal Fund Expenditures

Federal fund expenditures account for 28 percent of the *governmental* expenditures (that is, total expenditures less nongovernmental cost funds) which the Governor's Budget proposes for 1987–88. As shown in Table 6, this percentage has been declining for the past five years. The level of federal fund expenditures anticipated in 1987–88—$15.2 billion—represents a decrease of $190 million, or 1 percent, below the estimated 1986–87 level. This decrease reflects the net effect of increases and decreases in federal receipts for several programs, as well as the accounting treatment of funds received in prior years.

Table 6
Federal Fund Expenditures as a Percent of Total State Expenditures [a,b]
1981–82 through 1987–88
(dollars in millions)

	General Fund	*Special Funds*	*Federal Funds*	*Selected Bond Funds*	*Totals*	*Federal Funds as Percent of Total*
1981–82	$21,682	$3,099	$10,863	$230	$35,874	30%
1982–83	21,729	3,180	12,255	399	37,562	33
1983–84	22,868	3,527	12,454	400	39,250	32
1984–85	25,736	4,651	13,372	588	44,348	30
1985–86 [c]	28,841	5,190	14,280	945	49,257	29
1986–87 estimated [c]	30,890	5,950	15,351	1,775	53,966	28
1987–88 proposed [c]	31,264	6,666	15,161	1,124	54,214	28

[a] Excludes nongovernmental cost funds. Detail may not add to totals due to rounding.
[b] 1981–82 through 1984–85 data from State Controller.
[c] Source: *Governor's Budget.*

While the projected decrease in total federal spending between the current and budget years is relatively small (1 percent), the budget reflects several major increases and decreases in individual program areas. These changes are shown in Table 7.

The most significant reduction—$125 million in health and welfare—is primarily due to a $188 million decrease in Job Training Partnership Act (JTPA) funds expended by the Employment Development Department. This "reduction" is somewhat misleading. This is because funds received in 1985–86 and earlier years were not expended until the current year, thereby artificially "inflating" the level of current year expenditures. This decrease in JTPA expenditures is partially offset by increased spending for other health and welfare programs, including an increase of $61 million

Table 7
Federal Funds Changes, By Program [a]
1986–87 and 1987–88
(dollars in millions)

	Estimated	Proposed	Change	
Program	*1986–87*	*1987–88*	*Amount*	*Percent*
Legislative/Judicial/Executive	$39	$58	$19	49%
State and Consumer Services	22	21	−1	−5
Business, Transportation and Housing	1,472	1,380	−92	−6
Resources	202	167	−35	−17
Health and Welfare	9,065	8,941	−125	−1
Youth/Adult Corrections	1	1	0	0
K–12 Education	1,156	1,138	−18	−2
Higher Education	2,863	2,939	76	3
Other Governmental Units/Services	530	515	−15	−3
Totals	$15,351	$15,161	−$190	−1%

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.

due to cost-of-living adjustments and caseload increases. Federal fund expenditures for health programs would be even higher were it not for the Medi-Cal cost reduction program ($150 million in federal funds savings) reflected in the Governor's Budget.

The budget also anticipates large net reductions in federal spending for business, transportation, and housing programs. Table 7 shows a decrease of $92 million for these programs between the current and budget years. This figure primarily reflects a $102 million net decrease in federal funds expended by the Department of Transportation—a decrease of $67 million for capital outlay funds and a $53 million decrease in local assistance transportation programs, partially offset by an $18 million increase in federal funds for the support of engineering and design projects.

Federal expenditures for resources programs show a net reduction of $35 million. This change primarily reflects a reduction of $66 million in federal Outer Continental Shelf Lands Act (8g) funds, partially offset by an increase of $33 million in Petroleum Violation Escrow Account expenditures.

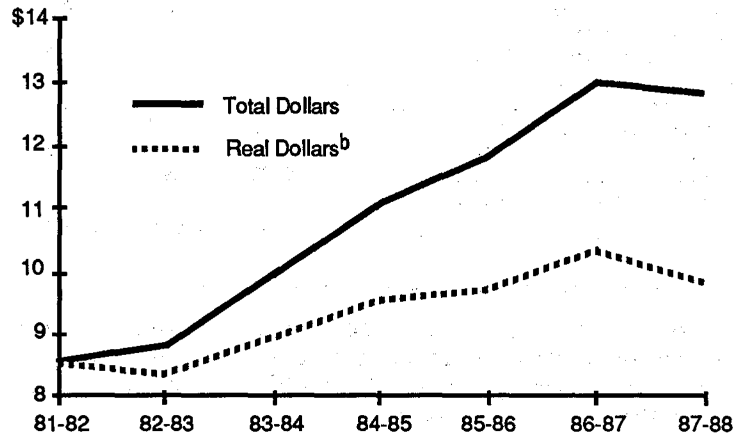
Table 7 also shows that the amount of federal funding provided to the state's higher education segments is expected to increase by $76 million in 1987–88. Three items account for this increase: (1) $87 million for Department of Energy laboratories at the University of California; (2) $17 million for federal research contracts at the University of California; and (3) $8.4 million for student aid at the California State University and the University of California. These increases are partially offset by a $36 million reduction in funds provided for the purchase of defaulted student loans under the Guaranteed Student Loan program.

Federal Aid Trends. The amount of federal aid to California has experienced expansions and contractions since 1981–82, as shown in Chart 3.

Chart 3

Expenditures of Federal Aid Granted to the State of California[a]

1981-82 through 1987-88 (in billions)



[a] Excludes federal expenditures for unemployment insurance and administration.

[b] "Real" dollars equal total dollars deflated to 1981-82 dollars using the GNP price deflator for state and local purchases of goods and services.

In order to give a truer picture of federal expenditures during the last six years, we have adjusted total federal fund expenditures by the state to *exclude* expenditures of federal unemployment insurance (UI) funds. These expenditures have been unusually volatile, ranging from a low of $2.3 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 $8.5 billion in 1981–82 to $12.8 billion in 1987–88, an increase of approximately 50 percent. This represents a 7.1 percent average annual rate of growth over the six-year period. When expressed in "real dollars," however, the level of federal aid anticipated in 1987–88 (excludng unemployment insurance funds) is only 14 percent more than the amount of federal aid actually received by the state in 1981–82. This represents a 2.5 percent average annual rate of growth.

Impact of Current Efforts to Reduce Federal Spending

In December 1985, the President signed legislation containing the so-called Gramm-Rudman-Hollings (GRH) balanced budget amendment. 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 governments, with certain exceptions, are subject to these automatic provisions.

On February 1, 1986 the President issued an order to implement the automatic spending reductions required by the amendment. Shortly thereafter, the United States District Court for the District of Columbia declared the automatic deficit reduction process unconstitutional. In July 1986 this decision was affirmed by the United States Supreme Court. By invalidating the automatic reduction provisions of GRH, the amendment's ability to reduce the budget was significantly constrained. While the deficit maximums of $144 billion and $108 billion for FFYs 1987 and 1988 still exist in law, the achievement of these targets essentially rests with the budget process, as it did prior to GRH.

The *Budget of the United States Government,* submitted by the President to Congress on January 5, 1987, proposes to achieve the deficit reduction target for FFY 1988. Preliminary information indicates that major decreases in federal funding to California would result from the President's budget. The largest reductions would come in the areas of welfare and transportation. The Governor's Budget, however, does not reflect the cuts in federal funding that would occur if the President's budget were to be enacted as submitted.

Total State and Local Government Spending in California

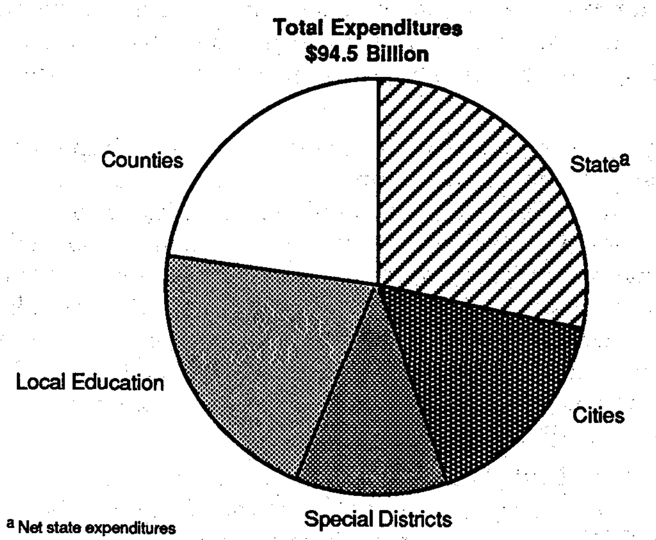
Local governments also are a significant contributor to public sector spending in California. Because local agencies receive a substantial portion of their resources from the state, however, their expenditures cannot simply be added to those of the state in order to determine aggregate government spending.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

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 1986–87 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.

Chart 4

Total State and Local Government Expenditures 1986-87



In the current year, expenditures for all services provided by state and local governments in California are expected to total approximately $94.5 billion. This amount consists of approximately $27 billion in net state expenditures (that is, state expenditures net of funds provided to local governments) and approximately $68 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.

Net state spending—$26.8 billion—amounts to only half of what the state spends from governmental sources ($52.9 billion) and indicates just how much "state money" actually is spent at the local level. These state funds, which total $26.1 billion in the current year, show up as local government spending in Table 8. About one-half of this amount is state aid to local school districts ($13.1 billion).

Table 8 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 each level of government has remained virtually unchanged.

Table 8
Estimated Total State and Local Government Expenditures [a]
1984–85 through 1986–87
(dollars in millions)

	1984–85		*1985–86*		*1986–87*	
Government Entity	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*
Counties	$16,800	21.7%	$18,865	21.9%	$21,284	22.4%
Cities	12,609	16.3	13,928	16.2	15,385	16.3
Special Districts	9,259	12.0	9,259	10.8	10,826	11.5
Local Education [b]	16,637	21.5	18,761	21.8	20,160	21.4
Subtotal, Local Government	($55,305)	(71.6%)	($60,813)	(70.7%)	($67,655)	(71.6%)
State [b]	43,745	—	49,208	—	52,895	—
Less: Amount expended by local governments	−21,781	—	−23,952	—	−26,061	—
Subtotal, State (net)	($21,964)	(28.4%)	($25,256)	(29.3%)	($26,834)	(28.4%)
Totals, state and local expenditures	$77,269	100.0%	$86,069	100.0%	$94,489	100.0%

[a] Local government expenditure data for 1984–85 are from *State Controller's Report on Financial Transactions.* Figures for 1985–86 and 1986–87 represent Legislative Analyst's Office estimates. All data include enterprise fund transactions. State government and local education data are taken from *Governor's Budgets.* Detail may not add to totals due to rounding.
[b] Includes spending attributable to state lottery operations, including administrative expenses.

TAX EXPENDITURES

In addition to the $39.1 billion in total state funds which the Governor's Budget requests for *direct* expenditure programs in 1987–88, the budget also proposes over $16.9 billion of *indirect* spending in the form of "tax expenditures."

Tax expenditure programs (TEPs) 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. These TEPs are provisions of the tax code which are used to either encourage specific types of economic behavior, or provide general or selective tax relief.

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

The Volume of Tax Expenditures. Table 9 shows our estimates of the revenue losses from state-level TEPs in 1987–88. These estimates are contained in our report entitled *Analysis of the 1987–88 Tax Expenditure Budget* (January 1987), which was prepared in response to Assembly Concurrent Resolution 17 (1985). This measure also established a tax expenditure budget review process, and requires us to report on the costs and effectiveness of TEPs on an ongoing basis.

The table indicates that the cost of state-level TEPs (which are primarily General Fund costs) is estimated to total at least $16.9 billion in 1987–88, an increase of 7.8 percent. The full cost of TEPs is unknown, because insufficient data exist to measure the revenue losses from many of the programs. As a result, TEPs will reduce, by about 32 percent, the amount of revenues which otherwise would be collected from the state's "basic" tax structure. The largest single category of these TEPs, expected to total $12.2 billion in 1987–88, includes the various exemptions, deductions, and credits permitted under the personal income tax. The largest individual tax expenditure program is the deductibility of mortgage interest expenses ($2.5 billion), followed by the nontaxability of employer contributions to pension plans ($2.1 billion), and the exemption from the sales tax of food products ($1.5 billion). Altogether, we estimate that there are over 230 other state-level TEPs which will be in effect during 1987–88, plus an additional 65 local property tax TEPs which the state partially funds through subvention payments.

Table 9
State Tax Expenditures [a]
1987–88
(dollars in million)

Tax Expenditure Category	*Amount*	*Percent of Total Identifiable State-Level Tax Expenditures*
Personal income tax	$12,241	73%
Sales and use tax	3,899	23
Bank and corporations tax	386	2
Other state taxes	331	2
Totals, all categories	$16,857	100%

[a] Source: Legislative Analyst's Office.

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 governments for the cost of certain mandates.

Impact of Article XIII B in 1987–88. Table 10 shows what the Department of Finance estimates the state's appropriations limit to be, as well as total appropriations subject to limitation from 1985–86 through 1987–88. It also shows our estimates of both the limit and the appropriations that are subject to it for 1986–87 and 1987–88. The department estimates that if the Governor's Budget is approved, the state would be $80 million below its limit for 1987–88. Our analysis indicates that the Governor's Budget, as submitted, calls for appropriations that exceed the appropriations limit by $587 million.

Table 10
Impact of Article XIII B on the State[a]
1985–86 through 1987–88
(dollars in millions)

		1986–87		*1987–88*	
	1985–86	*Department of Finance*	*Legislative Analyst*	*Department of Finance*	*Legislative Analyst*
Appropriations limit	$22,962	$24,159	$24,175	$25,273	$24,800
Appropriations subject to limitation	22,467	23,738	24,396	25,193	25,387
Difference	−$495	−$421	$221	−$80	$587

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

Prior to the current year, 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.

During the current year, however, the appropriations limit and the state's appropriations which are subject to it have converged. We estimate that during 1986–87, *if current estimates of revenues and expenditures remain unchanged,* the state will exceed its limit by $221 million, unless the Governor and the Legislature take corrective action. As Table 10 indicates, we also expect the state to exceed its appropriations limit during the budget year, given the anticipated level of state revenues and the expenditure program proposed by the Governor's Budget.

The difference between our estimate and the Department of Finance's is primarily attributable to one issue: Do the state's payments to the State Teachers' Retirement System and to reimburse school districts for court-ordered desegregation costs qualify for exclusion from the limit under Article XIII B's definition of "court mandates"? The Legislative Counsel has issued opinions indicating that these payments do *not* qualify for exclusion. As a result, our estimates reflect these payments as appropriations subject to limitation. The Department of Finance, however, has excluded them.

If actual revenues differ from those projected in the budget, this will result in a dollar for dollar increase or decrease in the state's conformity with the limit. This is because at year end, all unappropriated revenues are automatically appropriated to the Special Fund for Economic Uncertainties, and appropriations into this reserve fund are required to be included in the amount of "appropriations subject to limitation." These issues are 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 1987–88, although these estimates reflect numerous 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, 1988, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, court orders, and other factors. Thus, as in past years, actual revenues and expenditures are likely to be substantially 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 11 compares the original estimates of General Fund expenditures with actual expenditures during the past six years.

Table 11
Proposed and Actual General Fund Expenditures
1981–82 through 1986–87
(dollars in millions)

	Budget as Submitted[a]	*Actual Expenditures*[b]	*Change*	
			Amount	*Percent*
1981–82	$20,799	$21,682	$883	4.2%
1982–83	23,203	21,729	−1,474	−6.4
1983–84	21,677	22,868	1,191	5.5
1984–85	25,076	25,736	660	2.6
1985–86	27,864	28,841[a]	977	3.5
1986–87	30,699	30,890[a]	191	0.6

[a] Source: *Governor's Budget.*
[b] Source: State Controller.

As Table 11 shows, actual expenditures exceeded the amount 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 actual versus budgeted expenditures for 1982–83—$1.5 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 projected to exceed the amount originally proposed in the Governor's Budget by $191 million. As a result, General Fund expenditures will exceed General Fund revenues by $125 million, making 1986–87 the second year in a row in which the General Fund has run a deficit. The deficit would be even larger than this amount but for the impact of several administrative actions taken to reduce expenditures in the current year. In addition, this estimate of the deficit reflects legislative proposals contained in the budget to further reduce expenditures and increase revenues in 1986–87.

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 12 presents the distribution of General Fund and special fund expenditures among these categories for the past, current, and budget years.

Table 12
General Fund and Special Fund Expenditures, by Function [a]
1985–86 through 1987–88
(dollars in millions)

		Estimated 1986–87		Proposed 1987–88	
General Fund	*Actual 1985–86*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State operations	$7,125	$7,778	9.2%	$8,188	5.3%
Capital outlay	67	15	−77.6	—	—
Local assistance	21,649	23,097	6.7	23,075	−0.1
Aid to individuals	(6,690)	(7,271)	8.7	(7,459)	2.6
Aid to local governments	(14,959)	(15,826)	5.8	(15,616)	−1.3
Totals [b]	$28,841	$30,890	7.1%	$31,264	1.2%
Special Funds					
State operations	$2,258	$2,516	11.4%	$2,692	7.0%
Capital outlay	362	469	29.6	581	23.9
Local assistance	2,558	2,952	15.4	3,380	14.5
Unclassified	12	12	0.0	12	0.0
Totals [b]	$5,190	$5,950	14.6%	$6,666	12.0%

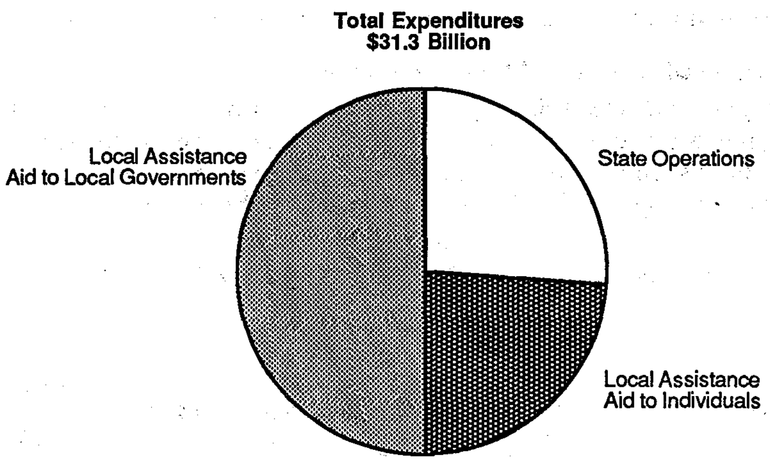
[a] Source: *Governor's Budget.*
[b] Detail may not add to totals due to rounding.

As Chart 5 illustrates, state operations make up 26 percent of total General Fund expenditures in the budget year, while local assistance, as defined in the Governor's Budget, makes up 74 percent.

State Operations

The budget proposes an increase from the General Fund of $410 million, or 5.3 percent, for state operations in 1987–88. General Fund expenditures proposed for state operations in 1987–88 are $8.2 billion, or 82 percent, above what they were six years ago (1981–82). When adjusted for inflation, however, expenditures for state operations have increased by $1.8 billion, or 39 percent, during this period.

Chart 5
1987-88 General Fund Budget Structure



Capital Outlay

The budget proposes no General Fund expenditures for capital outlay in 1987–88. General Fund capital outlay expenditures over the past six years have fluctuated between zero and $67 million. During this period, most capital outlay programs have been funded by bond revenues or tidelands oil revenues.

Local Assistance

The budget proposes General Fund expenditures of $23.1 billion for local assistance in 1987–88. This amount represents a decrease of $22 million from the current year level. The amount proposed for local assistance in 1987–88 is $5.9 billion, or 34 percent, higher than the amount expended for these purposes six years ago (1981–82). When adjusted for inflation, however, expenditures for local assistance have increased by only $472 million, or 2.7 percent, during this period.

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 the Supplemental Security Income/State Supplementary Program (SSI/SSP), which is administered by the federal government, and the Aid to Families with Dependent Children (AFDC) program, which is administered by county governments.

Aid to Individuals. Table 13 identifies 10 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 $188 million, or 2.6 percent, for these programs in the budget year. On a program-by-program basis, the Governor proposes increases for five of these 10 programs, no change in funding for two, and slight reductions for three.

Table 13
Major General Fund-Supported Local Assistance Programs Providing Aid to Individuals 1985–86 through 1987–88 (dollars in millions)

Program	*Actual 1985–86*	*Estimated 1986–87*	*Governor's Budget 1987–88*
Medi-Cal [a]	$2,306	$2,399	$2,391
AFDC [b]	1,790	1,952	1,985
SSI/SSP	1,408	1,638	1,768
Developmental Services	345	427	452
Renters' Tax Relief	453	466	475
Homeowners Property Tax Relief	334	338	343
Senior Citizens Renters' Tax Relief	29	25	20
Senior Citizens Property Tax Assistance	6	5	4
Senior Citizens Property Tax Deferral	5	7	7
Subventions for Open Space	14	14	14
Totals [c]	$6,690	$7,271	$7,459

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

Aid to Local Governments. Table 14 displays the major General Fund local assistance programs which our analysis indicates provide "Aid to Local Governments." Overall, the Governor's Budget proposes a reduction in funding for these programs of approximately $210 million, or 1.3 percent, below current year levels. This decrease primarily reflects the proposed elimination of $477 million in state subventions for County Health Services programs. (These funds would be replaced by a new special fund subvention.) Adjusting for this change, funding for all other programs would actually increase by $268 million, or 1.7 percent, above current year levels. This change is primarily the result of a 2.2 percent funding increase proposed for K–12 education.

Table 14
Major General Fund-Supported Local Assistance Programs Providing Aid to Local Governments 1985–86 through 1987–88 (dollars in millions)

Program	*Actual 1985–86*	*Estimated 1986–87*	*Governor's Budget 1987–88*
Public Health Services	$1,039	$1,049	$591
California Children's Services	46	52	48
Department of Rehabilitation	57	62	66
Mental Health Programs	459	497	496
Alcohol and Drug Programs	70	72	72
Social Services—Programs	307	431	521
Social Services—County Administration	125	140	157
County Justice Subvention	67	67	67
K–12 Education	10,928	11,783	12,040
Community Colleges	1,165	1,195	1,213
Special Supplemental Subventions/Special District Loans	73	27	25
Local Streets and Roads	125	77	—
State Mandates	110	133	58
All Other	388	241	263
Totals [a]	$14,959	$15,826	$15,616

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

SPECIAL FUND FOR ECONOMIC UNCERTAINTIES

The Governor's Budget indicates that $1,040 million from the General Fund will be held in reserve during 1987–88. Of this amount, $1,026 would be in the Special Fund for Economic Uncertainties, $10 million would be set aside for the Disaster Response Operations Account, and $4 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.

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 1987–88, statutory COLAs range from 2 percent (K–12 instructional materials) to 7.5 percent (Medi-Cal noncontract hospitals). The statutory COLAs having the largest costs are those for K–12 apportionments ($253 million) and SSI/SSP grants ($84 million). The General Fund cost of fully funding *statutory* COLAs in 1987–88 is approximately $563 million, or $278 million more than the amount provided in the budget.

Governor's Budget Proposal

The budget proposes a total of $415 million from the General Fund for COLAs in 1987–88, including $285 million for statutory COLAs and $130 million for discretionary COLAs. These amounts reflect the Governor's proposal that existing law be amended to delay the effective date of most of these COLAs by six months. Thus, in most cases, the Governor proposes to provide one-half of the amount required by existing law. In three cases—court ordered and voluntary desegregation and gifted and talented education—the Governor proposes that no funds be provided for statutory COLAs. The amount provided for discretionary COLAs primarily reflects funding for changes in employee compensation; few other discretionary COLAs are funded. The specific increases proposed by the Governor are shown in Table 15.

Table 15
General Fund Cost-of-Living Increases
1986–87 and 1987–88
(dollars in thousands)

	1986–87	*1987–88*				
	Budgeted	*1%*	*Statutory*		*Budget*	
Department/Program	*Percent Increase*	*Dollar Increase*	*Percent Increase*	*Dollar Increase*	*Percent Increase* [a]	*Budget as Proposed*
HEALTH AND WELFARE						
Aging	—	$334	—	—	—	—
Alcohol and Drug Programs	—	718	—	—	—	—
Medi-Cal						
Noncontract Hospitals	6.0%	656	7.5%	$4,922	7.5% [b]	$4,922
Long-Term Care Facilities, excluding state hospitals	1.1–16.2 [c]	5,077	—	—	—	—
State Hospitals	8.4 [c]	1,573	—	—	—	—
OB/GYN Providers	26.5	193	—	—	—	—
Other Providers	—	5,770	—	—	—	—
Beneficiary Spin-off	5.1	2,228 [d]	3.6	7,293	1.8	2,791
Drug Ingredients	5.5	869	3.3	2,867	3.3	2,867
County Administration [e]	4.8	407	—	—	4.8	1,956
Health Services						
County Health (AB 8)	3.95	4,164	3.5	14,624	1.53	6,369
Medically Indigent Services	—	5,446	—	—	—	—
Public Health	—	937	—	—	—	—
Emergency Medical Services	—	17	—	—	—	—
Developmental Services						
Regional Centers:						
Out-of-Home Care	—	2,235	—	—	—	—
Other Client Services	—	1,651	—	—	—	—
Personal Services	6	922	—	—	1.5	1,383
Operations	1	112	—	—	—	—
Education Programs	1	56	—	—	—	—
Local Mental Health Programs	—	4,600	—	—	—	—
Social Services						
SSI/SSP	5.1	23,184	3.6	83,600	1.8 [f]	41,822
AFDC/FG & U	5.1	18,421	3.6	66,316	1.8	34,215
AFDC—Foster Care	1.0	2,982	—	—	—	—
County Administration—Grants [e]	5.0	1,452	—	—	1.8	5,398
Child Welfare Services	13.5	2,189	—	—	1.8	7,879
County Services Block Grant	—	634	—	—	—	—
IHSS Maximum Grant	5.1	142	3.6	511	1.8	256
IHSS provider	1.0	3,840	—	—	—	—
Deaf Access	—	34	—	—	—	—
Maternity Care	—	23	—	—	—	—
Employment Programs	—	150	—	—	—	—
Child Abuse Prevention	—	206	—	—	—	—
Adoptions	—	148	—	—	—	—
Community Care Licensing	—	84	—	—	—	—
Department of Rehabilitation	1.0	656	—	—	—	—
YOUTH AUTHORITY						
County Justice System Subvention Programs	1.0	673	—	—	—	—
Delinquency Prevention	1.0	23	—	—	—	—
K–12 EDUCATION						
Apportionments:						
K–12—District Revenue Limits	5.49	114,982	2.20	252,960	1.1	126,480
Meals for Needy Pupils	6.00	261	6.00	1,564	3.0	782
Summer School	5.49	693	2.20	1,524	1.1	762
Apprentice Programs	3.00	27	—	—	—	—
Small School District Transportation	1.00	100	—	—	—	—
Transportation	1.00	2,919	—	—	—	—

K-12—County Offices of Education	5.49	2,166	2.20	4,764	1.1	2,382
Regional Occupational Centers/Programs	3.00	2,118	—	—	—	—
Court-Ordered Desegregation	5.49	2,690	2.20	5,917	—	—
Voluntary Desegregation	5.49	550	2.20	1,210	—	—
Child Nutrition	3.30	386	3.86	1,486	1.93	743
American Indian Education Centers	1.00	9	—	—	—	—
Native American Indian Education[g]	1.00	4	—	—	—	—
Child Care Program	1.00	2,500	—	—	—	—
Special Education	5.49	15,925	2.20	35,034	1.1	17,517
Dropout Prevention	—[h]	148	—	—	—	—
Staff Development	1.00	213	—	—	—	—
Preschool	1.00	358	—	—	—	—
Libraries	1.00	75	—	—	—	—
Meade Aid[g]	1.00	52	—	—	—	—
Urban Impact Aid[g]	1.00	381	—	—	—	—
Gifted and Talented[g]	6.00	212	6.00	1,274	—	—
Instructional Materials (K–8)	3.60	731	2.00	1,462	1.0	731
Instructional Materials (9–12)	3.00	224	—	—	—	—
Demonstration Programs in Reading and Math	3.00	44	—	—	—	—
Educational Technology	1.00	262	—	—	—	—
Economic Impact Aid[g]	1.00	1,970	—	—	—	—
Adult Education	6.00	2,174	6.00	14,488	3.0	7,244
Adults in Correctional Facilities	6.00	19	6.00	116	3.0	58
School Improvement Program (K–6)	5.49	1,924	2.20	4,232	1.1	2,116
School Improvement Program (7–12)	1.00	325	—	—	—	—
Miller-Unruh Reading Program[g]	1.00	199	—	—	—	—
High School Pupil Counseling	1.00	78	—	—	—	—
Specialized Secondary Schools	1.00	21	—	—	—	—
Foster Youth Services	1.00	8	—	—	—	—
Opportunity Classes/Programs	—	8[i]	—	—	—	—
COMMUNITY COLLEGES						
Apportionments	5.77	17,673	2.7	47,718	1.35	23,859
Community College Categoricals	1.0	551	—	—	—	—
Financial Aid Awards	5.0	1,029	—	—	—	—
ALL OTHERS						
State Contribution to STRS	3.50	2,342	3.85	9,015	3.85	9,015
Employee Compensation[j]						
Civil Service and Related	5.85	29,993	—	—	2.05	61,371
University of California	5.7	14,157	—	—	2.0	28,152
California State University	6.6	13,268	—	—	1.8	23,590
Totals	—	$326,575	—	$562,897	—	$414,660

[a] Generally, these increases are effective January 1, 1988.

[b] Effective July 1, 1987.

[c] These COLAs are funded through the proposed deficiency bill. There were no funds for these COLAs in the 1986 Budget Act.

[d] The effect of a given percent COLA cannot be calculated directly using this figure.

[e] The amount of funding included in the 1987–88 budget is to be used to reimburse counties for cost increases incurred during 1986–87.

[f] Effective April 1, 1988.

[g] The *Governor's Budget* proposes to eliminate all funding for Urban Impact Aid and Meade Aid. The budget also proposes to consolidate funding from Native American Indian Education, the Miller-Unruh Reading Program, the Gifted and Talented Program, and the Economic Impact Aid program into a Class Size Reduction/Educational Assistance Program.

[h] Program started in 1986–87.

[i] Funded by reappropriation of 1986–87 unexpended balance; dollar amount represents Legislative Analyst's Office estimate based on 1985–86 participation rates.

[j] Reflects a 1.5 percent adjustment in salary levels and funding to maintain health and dental coverages at present levels.

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 6 and Table 16 show the distribution of General Fund expenditures by major program category in 1987–88. These displays indicate the two largest budget categories are education, and health and welfare, which collectively account for $26.5 billion, or 85 percent, of total General Fund expenditures. The share of the budget devoted to each of these two categories is approximately the same as their shares in the current year. These shares would show declines, however, but for the effect of the Governor's county health services program shift proposal discussed earlier. This is because the proposal reduces the General Fund expenditure total by $477 million. The remaining $4.8 billion, or 15 percent of total expenditures, goes for tax relief, correctional programs, and all other programs of state government.

Chart 6
General Fund Expenditures Major Components 1987-88

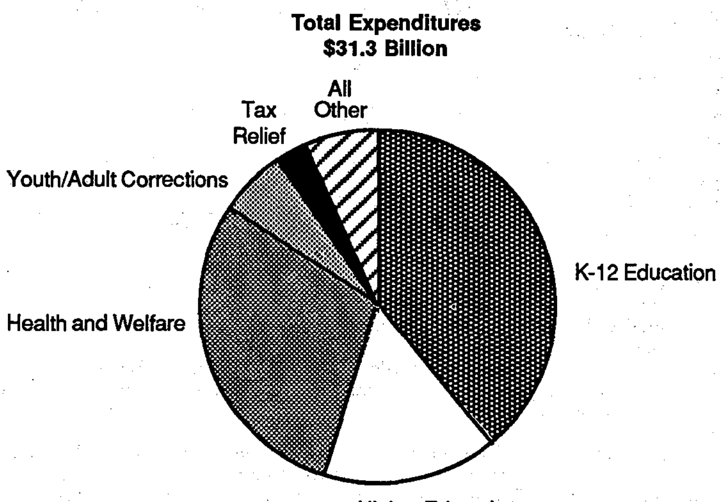


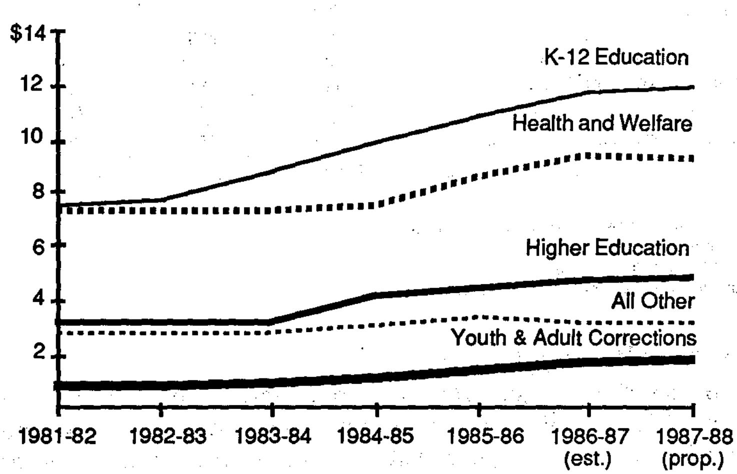
Table 16
Expenditures for Health, Welfare, and Education [a]
As a Percent of Total General Fund Expenditures
1987–88
(dollars in millions)

	State Operations	*Local Assistance*	*Total*	*Percent of General Fund Budget*
K–12 Education [b]	$205	$12,040	$12,244	39%
Higher Education	3,637	1,332	4,969	16
Subtotal, Education [c]	$3,842	$13,371	$17,213	55%
Health and Welfare	628	8,665	9,294	30
Subtotal, Education, Health and Welfare [c]	$4,470	$22,037	$26,507	85%
Other program areas	3,718	1,039	4,756	15
Total General Fund Budget [c]	$8,188	$23,075	$31,264	100%

[a] Source: *Governor's Budget.*
[b] Includes $507 million for State Teachers' Retirement System contribution.
[c] Detail may not add to totals due to rounding.

Education and youth and adult correctional programs have been the fastest growing components of General Fund expenditures in recent years. Chart 7 illustrates that since 1981–82, expenditures for these programs have increased significantly. Over the seven-year period, youth and

Chart 7
Trends in General Fund Program Expenditures
1981-82 through 1987-88 (in billions)



adult corrections expenditures have increased by 137 percent in current dollars, and by 81 percent in "real terms." Total education expenditures have increased in real terms by 20 percent, while spending on health and welfare expenditures has decreased in real terms by about 4 percent.

Overall, General Fund expenditures have increased by 44 percent in current dollars from 1981–82 through 1987–88, and by 10 percent in real terms.

Table 17
Estimated General Fund Program Changes [a]
1986–87 and 1987–88
(dollars in millions)

	Estimated 1986–87	*Proposed 1987–88*	*Change Amount*	*Change Percent*
Health and Welfare:				
Medi-Cal [b]	$2,461	$2,463	$2	0.1%
County Health [b]	959	545	−414	−43.2
SSI/SSP [b]	1,638	1,768	130	7.9
AFDC grants [b]	1,952	1,985	33	1.7
Social services programs [b]	431	521	90	20.9
Mental health	819	834	15	1.8
Developmental services	446	473	27	6.1
Other, health and welfare	768	705	−63	−8.2
Subtotals, Health and Welfare	$9,474	$9,294	−$180	−1.9%
Education:				
K–12	$11,497	$11,737	$240	2.1%
State teachers' retirement	465	507	42	9.0
University of California	1,788	1,859	71	4.0
California State University	1,626	1,690	64	3.9
California Community Colleges	1,195	1,213	18	1.5
Other, higher education	190	207	17	8.9
Subtotals, Education	$16,761	$17,213	$452	2.7%
Other:				
Youth and adult corrections	$1,711	$1,873	$162	9.5%
Resources	693	667	−26	−3.8
Tax relief	943	896	−47	−5.0
Bond interest and redemption [c]	(538)	(617)	(79)	(14.7)
Interest on General Fund loans	117	81	−36	−30.8
All other	1,191	1,240	49	4.1
Subtotals, Other	$4,655	$4,757	$102	2.2%
Total [d]	$30,890	$31,264	$374	1.2%

[a] Based on amounts shown in *Governor's Budget.*
[b] Local assistance only.
[c] Distributed to program categories.
[d] Detail may not add to totals due to rounding.

Summary of Major Program Changes

For 1987–88, the budget proposes a net increase in General Fund expenditures of $374 million, or 1.2 percent, above the level of expenditures estimated for the current year. Table 17 shows the primary factors that account for the proposed change in expenditures. As was the case in the current year, the largest dollar increase is proposed for education—$452 million, or 2.7 percent. The next largest dollar increase—$162 million, or 9.5 percent—is proposed for youth and adult corrections. Within each expenditure category, significant program changes have been proposed. Some of the major General Fund changes include the following:

Medi-Cal local assistance expenditures are up by $2 million, or 0.1 percent. Expenditures would be higher were it not for the proposed cost reductions of $150 million reflected in the Governor's Budget. These consist of $125 million worth of savings due to "program restructuring" and $25 million in savings due to cost control measures. The budget does not contain a specific program to achieve these savings.

County Health is budgeted at $545 million, a $414 million, or 43 percent reduction from current year funding levels. This reduction is primarily the result of a proposal to eliminate the County Health Services (AB 8) program and to transfer the associated funds to the counties as "shared revenue."

SSI/SSP expenditures are expected to increase by $130 million, or 8 percent, above estimated current year expenditures. This increase is due primarily to four factors: (1) an increase of $96 million to fund the full-year cost of the 1986–87 COLA provided on January 1, 1987, (2) an increase of $42 million to fund a 3.6 percent statutory COLA effective April 1, 1988, (3) an increase of $42 million to fund an estimated 2.6 percent caseload growth, and (4) offsetting savings of $51 million due to an estimated 3.3 percent Federal COLA effective January 1, 1988.

AFDC grant costs are budgeted to increase by $33 million, or 1.7 percent, above estimated current year expenditures. This relatively low growth is due primarily to (1) an anticipated caseload increase of 0.8 percent ($40 million) even though actual growth has been about 3 percent, (2) increased costs of $34 million to provide a statutory COLA effective January 1, 1988, and (3) increased savings of $48 million from various fraud detection programs and the Greater Avenues for Independence (GAIN) program.

Social Services Program expenditures are up $90 million, or 21 percent, above estimated current year expenditures. This increase primarily reflects increased General Fund costs for: (1) the Child Welfare Services program ($46 million), (2) the In-Home Supportive Services program ($30 million), and (3) the Greater Avenues for Independence (GAIN) program ($27 million). These increased costs are partially offset by various savings totaling $13 million.

Developmental Services expenditures are budgeted at $473 million, an increase of $27 million, or 6.1 percent, over current year estimated expenditures. This increase is primarily the result of caseload increases at the regional centers.

Other Health and Welfare expenditures are expected to decrease by $63 million, or 8.2 percent, below estimated current year expenditures. This reduction is primarily due to the county health programs shift proposal, which involves $52 million included in this budget category.

K–12 Education expenditures are expected to increase by $240 million, or 2.1 percent, over estimated current year expenditures. The primary factors accounting for this increase are: (1) an increase of $260 million for increased enrollment in public schools; (2) an increase of $159 million to provide half-year funding for statutory COLAs: (3) an increase of $89 million to restore General Fund support for school deferred maintenance (the Governor proposes that a $90 million appropriation for this purpose be reverted to the General Fund in 1986–87); (4) an increase of $66 million to provide additional funding for special education services to handicapped students; and (5) an increase of $34 million to reflect the elimination of a one-time "loan repayment" (reduction in school apportionment funding) made during 1986–87. These increases are partially offset by (1) a $281 million reduction in General Fund requirements resulting from anticipated increases in school district property tax receipts; (2) the elimination of $43 million in funding for two programs providing state aid to school districts with high concentrations of disadvantaged students; and (3) a reduction of $40 million in funding for school desegregation.

Higher Education expenditures are proposed to increase by $170 million, or 3.5 percent. The primary factors accounting for this increase are: (1) $30 million due to enrollment increases; (2) $22 million for workload and cost adjustments; (3) $52 million for a 3 percent salary increase beginning January 1, 1988; and (4) program augmentations of $49 million, which include $12 million for instructional equipment replacement and library materials and $7.5 million for a teaching hospital subsidy.

Youth and Adult Corrections expenditures are proposed to increase by $162 million in the budget year. Most of this amount, or $130 million, will fund 2,126 additional personnel-years for the Department of Corrections and the increased operating expenditures needed to accommodate the growth in the prison population. The budget is based on a 12 percent growth rate in the inmate population between June 30, 1987 and June 30, 1988 and a 16 percent growth rate in the parole population over the same period.

Debt Service expenditures for bond interest and redemption are expected to be $79 million, or 15 percent, higher in 1987–88 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 current and budget year. Our analysis indicates that the Governor's Budget has underestimated expenditures for the two-year period (1986–87 and 1987–88) by $262 million. The components of this $262 million are as follows:

School Desegregation. The Governor's Budget contains insufficient funding to reimburse school districts for their allowable costs of operating court-ordered and voluntary desegregation programs, pursuant to the provisions of AB 38 (Ch 180/85). We estimate that the budget proposal would result in a cumulative deficit in funding for school desegregation reimbursement claims of $98 million by the end of 1987–88.

Child Care. The budget assumes that the state will receive federal reimbursements of $31 million annually in 1986–87 and 1987–88 for child care services provided to eligible participants in the Greater Avenues for Independence (GAIN) program. Recent information from the State Department of Education, however, indicates that the actual level of reimbursements in the current year is likely to be only $2 million. Should this estimate prove to be accurate, the child care budget could be underfunded by up to $29 million in the current year.

K–12 Education Apportionments. In contrast to other understated expenditures, the budget *overestimates* by a net $10 million the amount needed to fund K–12 school and special education apportionments in 1987–88. This is because of technical budgeting errors that (1) *overfund* special education by $16 million and (2) *underfund* school apportionments by $6 million. The budget, however, also overestimates by $19 million the amount of excess funding for school apportionments that will be available for reversion to the General Fund at the end of 1986–87. Recent information from the State Department of Education indicates that these funds have been used to pay school apportionments deficits remaining from 1985–86. Consequently, the amount of the 1986–87 General Fund ending balance assumed by the Governor is too high by $19 million.

AFDC. The Department of Social Services assumes that the 1987–88 caseload for the AFDC-Family Group program will grow at roughly half the existing rate of increase. If recent trends prevail, however, caseload growth will add $27 million to General Fund expenditures in the budget year. In addition, the budget assumes $23 million in General Fund savings from implementation of the Greater Avenues for Independence (GAIN) program because fewer persons will apply for aid. Because there is no empirical evidence that fewer persons will apply for aid once this program is in operation, costs for the AFDC program may be understated.

SSI/SSP. This program may be underfunded by up to $21 million from the General Fund. This consists of (a) $16 million due to underestimated caseload growth and (b) $5 million due to understated average grant costs.

Child Welfare Services. The budget probably understates the costs of this program for the budget year, since cost estimates are based on caseload trends dating back to the program's inception. The effect of this estimation procedure is that recent, dramatic caseload growth is not fully taken into account. If the most recent two year caseload trend continues, then the actual General Fund cost will be $7 million higher than budgeted in 1987–88.

Medi-Cal. As it did last year, 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 statutorily required increases for long-term care will cost $20 million in the budget year, and the General Fund's share of costs for Medi-Cal abortions will be $14.7 million.

Department of Forestry. Based on an average fire year, we would expect General Fund expenditures for emergency firefighting by the Department of Forestry and Fire Protection to total $13 million *more* than is included in the budget for 1987–88.

Impact on the 1987–88 General Fund Balance. Should expenditures materialize, as detailed above the amount which the Governor's Budget shows in the Special Fund for Economic Uncertainties on June 30, 1988 would be $262 higher than is likely to be available. Under these circumstances, with no changes in anticipated revenues, instead of increasing the state's reserve by $475 million, the Governor's Budget would increase the reserve by only $213 million, leaving it at $764 million at year-end.

Revenues In 1987–88

The various expenditure programs discussed in the *Analysis* are supported by revenues which come 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 into 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 revenues come from three large taxes—the personal income tax, the sales and use tax, and the bank and corporation tax.) The remaining portion of state revenues—normally about 15 percent of the total—is placed into special funds to support specific programs and activities, including highway maintenance and construction, and various education-related capital outlay projects.

In addition to the above revenues, 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. Included in this category are state receipts from the California State Lottery, and monies to be deposited in certain bond and pension funds.

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

SUMMARY OF THE REVENUE OUTLOOK

Table 18 summarizes the department's estimates of how much revenues will be generated in the current and budget years. It also shows, for comparison purposes, actual revenues received in the prior year. Chart 8 provides an historical perspective on these figures by showing the trend in state revenues over the past decade.

Moderate Revenue Growth Predicted

The budget predicts that revenue growth in both 1986–87 and 1987–88 will be moderate. This reflects the department's forecast that the current economic expansion will continue, though only at a modest pace. Table 18 indicates that:

- ***Budget year*** (1987–88) revenues will total $37.9 billion (5.4 percent growth), including General Fund revenues of $31.7 billion (3.2 percent growth) and special fund revenues of $6.1 billion.
- ***Current year*** (1986–87) revenues will total $35.9 billion (7 percent growth), including General Fund revenues of $30.8 billion (9.6 percent growth) and special fund revenues of $5.1 billion.

Table 18
Revenue Summary
General Fund and Special Funds
1985–86 through 1987–88
(dollars in millions)[a]

General Fund Revenues	*Prior Year (1985–86)*[b]	*Current Year (1986–87)*[c]	*Budget Year (1987–88)*[d]
—Amount	$28,072	$30,765	$31,742
—Dollar change	1,466	2,693	977
—Percent change	5.5%	9.6%	3.2%
Special Fund Revenues			
—Amount	$5,486	$5,149	$6,112
—Dollar change	442	−337	963
—Percent change	8.8%	−6.1%	18.7%
Total, General Fund and Special Fund Revenues			
—Amount	$33,558	$35,914	$37,854
—Dollar change	1,910	2,356	1,940
—Percent change	6.0%	7.0%	5.4%

[a] Source: *1987–88 Governor's Budget* and State Controller. Detail may not add to totals due to rounding. Figures include effects of various revenue-related law changes and shifts of revenues between special funds and the General Fund. Neither the General Fund nor special fund revenue totals include revenues from the California State Lottery, because the funds into which these lottery revenues are put have been classified as nongovernmental cost funds.

[b] Dollar and percent change figures may be distorted, due to accounting reclassifications of certain revenues and reimbursements made between 1984–85 and 1985–86.

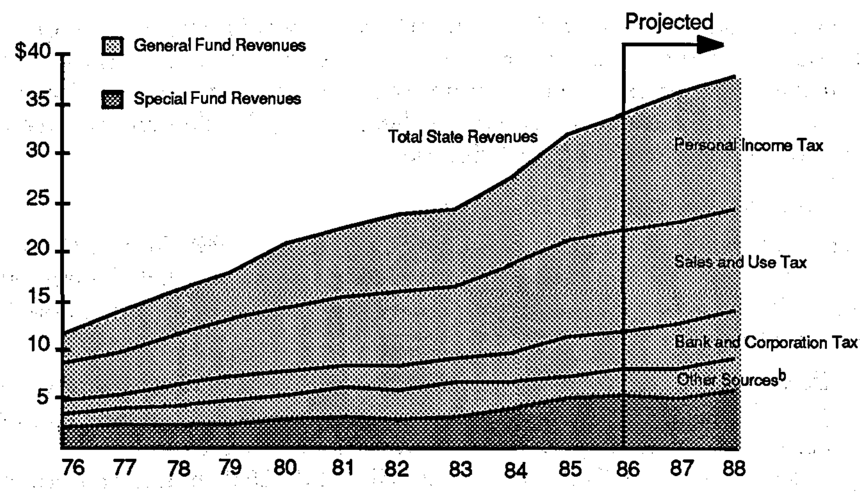
[c] General Fund revenue total includes a net gain of $425 million due to federal tax reform and $78 million in proposed transfers from special fund balances.

[d] General Fund revenue total includes a net loss of $250 million due to federal tax reform. In addition, the revenue figures shown incorporate the Governor's proposal to shift $477 million of state sales and use tax revenues from the General Fund to special funds for use by local governments.

Chart 8

Trends in State Revenues

1975-76 through 1987-88 (in billions)[a]



[a] Source: *Governor's Budgets* and State Controller's reports. Data are for fiscal years ending in years shown.

[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.

The year-to-year revenue growth rates shown in Table 18 contain certain distortions, because they incorporate the effects of factors such as new legislation, one-time revenue effects, and shifts of revenues between the General Fund and special funds. Four factors are especially important. First, the federal Tax Reform Act of 1986 has caused changes in taxpayers' behavior, such as when they pay their state income taxes and report their capital gains income (these changes affect revenues in both 1986–87 and 1987–88). Second, the budget proposes to shift $477 million in General Fund sales and use tax revenues to local governments in 1987–88, in exchange for repealing existing state subventions that fund various county health programs. Third, the budget proposes to transfer $78 million from special fund balances into the General Fund in the current year, in order to improve the fund's condition. Fourth, the budget assumes that a $75 million one-time inheritance tax settlement will be received in 1987–88. In the absence of these four factors, a fairly level, moderate revenue growth pattern would exist—about 8 percent for General Fund revenues and 6 percent for total revenues in 1986–87, and approximately 7 percent for both General Fund revenues and total revenues in 1987–88.

Reliability of the Revenue Forecast

The department's revenue forecast appears to be somewhat on the *conservative* side, based on our review of the economic and other assumptions on which it is based. We estimate that revenues over the next 18 months would be $150 million higher than predicted if the department's economic forecast comes true, and $485 million higher than predicted if the consensus economic outlook of other forecasters prevails. As the box on the following page shows, however, there is a wide variety of factors which could cause economic performance to differ from the consensus forecast, and this could dramatically affect revenues. For example, revenues could range several billion dollars above or below the department's forecast, if the economy experienced a strong expansion or a moderate downturn. *Thus, even though the department's revenue forecast appears conservative, this bias is not nearly as large as the deviations which could occur due to the economy.*

We now take a closer look at the economic assumptions on which the budget's revenue forecast is based, followed by a more detailed discussion of the state revenue outlook.

Key Factors in the 1987 Economic Outlook

Positive Factors

- Continued moderate inflation
- Reduced interest rates
- Strength in service industries
- Improved corporate profits
- Continued growth in "real" personal income
- Accomodative monetary policy
- Absence of excessive inventories
- Reduced crude oil and fuel prices
- Expected decline in the value of the dollar
- Modest strength in housing sector
- Positive effects on consumer spending due to federal tax reform

Negative Factors

- Large foreign trade deficit
- Lower federal defense spending in California
- Weak business investment spending
- High levels of consumer debt
- Historically low savings rate
- Continued large federal budget deficit
- Softness in manufacturing employment
- International debt problems
- Negative effects on business investment due to federal tax reform
- Relatively weak overseas economies

Major Areas of Uncertainty

- To what extent will the dollar continue to depreciate, and by what amount will this reduce the foreign trade deficit?
- Will consumers retrench in their spending, due to their low savings rate and high debt levels?
- How will federal tax reform affect consumption spending and business investment?
- Will crude oil prices remain stable, or eventually trend upward due to output restrictions by OPEC members?
- By how much and in what areas will federal spending be trimmed to reduce the federal budget deficit?

THE ECONOMIC OUTLOOK

The economy's performance during 1987 and 1988 will be the prime determinant of state revenue collections during the latter half of 1986–87 and in 1987–88. Economic activity during calendar 1987 will account for about one-third of current year revenues and two-thirds of budget year revenues, while the remaining one-third of budget year revenues will depend on economic conditions in early 1988.

Continued Economic Expansion Expected

Table 19 summarizes the budget's economic forecast for 1987 and 1988, as well as the economy's performance during 1986. In a nutshell, the department expects that the current economic expansion will carry forward throughout the next two years at a moderate pace. Inflation is expected to remain under control, and neither a recession, slowdown nor economic boom is anticipated. The department's prediction of an unspectacular-though-sustained expansion is a "middle-of-the-road" forecast that pretty much reflects 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.

Table 19
Department of Finance Economic Outlook for California and the Nation 1986 through 1988 [a]

Economic Indicator	*1986 Estimated*	*1987 Projected*	*1988 Projected*
1. *National Economy*			
Percent change in:			
—Real GNP	2.5%	2.4%	3.4%
—Personal income	5.2	4.5	5.8
—Pre-tax corporate profits	3.9	10.4	23.4
—Wage and salary employment	2.5	2.0	2.3
—Civilian employment	2.3	1.4	1.9
—GNP prices	2.8	2.4	3.3
—GNP consumer prices	2.0	2.8	3.6
—Consumer Price Index	2.0	3.1	3.6
Unemployent rate (%)	7.0%	7.1%	7.0%
Savings rate (%)	4.1	3.3	3.2
Prime interest rate (%)	8.3	6.8	7.3
New car sales (millions of units)	11.2	10.0	10.7
Housing starts (millions of units)	1.84	1.72	1.86
Net exports (billions of dollars) [b]	−$147	−$133	−$125
2. *California Economy*			
Percent change in:			
—Personal income	7.0%	6.1%	7.2%
—Wage and salary income	7.8	6.9	7.7
—Wage and salary employment	2.8	2.3	2.8
—Civilian employment	3.6	2.9	3.3
—Consumer Price Index	3.3	4.0	4.6
—Key elements of the state's tax base:			
—Taxable personal income [c]	7.2	5.9	7.4
—Taxable sales	3.7	4.0	6.2
—Taxable corporate profits	5.5	12.0	12.6
Unemployment rate (%)	6.7%	6.9%	7.0%
New car registrations (thousands of units)	1,405	1,278	1,363
New building permits (thousands of units)	271	254	276

[a] Source: *1987–88 Governor's Budget* and Department of Finance.
[b] Defined as United States exports minus imports, measured in constant 1982 dollars.
[c] Defined as total personal income plus social security contributions, minus transfer payments and certain other nontaxable income components. This income concept historically has shown a strong correlation to adjusted gross income reported for tax purposes in California.

How 1986 Ended and 1987 Began

At this time last year, as much uncertainty about the economy existed as we see today. Thus, not surprisingly, the department also predicted in last year's budget an unspectacular-though-sustained low-inflation expansion period for 1986 (see Table 20). This prediction generally came true, although the overall strength of the economy was less than expected. For example, actual GNP growth (2.5 percent) fell short of the forecast (3.2 percent), partly because of a large foreign trade imbalance which saw our country importing far more goods than we were exporting. Likewise, Table 20 shows that even though California home building activity and car sales exceeded expectations in 1986, both taxable sales and corporate profits fell far short of their predicted levels. Similarly, as shown in Chart 9, California's employment growth, though continuing, tapered downward throughout the year. Manufacturing employment was especially weak, as it experienced an actual decline of about 1 percent, primarily due to softness in the electronics and computer industries. In addition, a number of uncertainties clouded the economic horizon at year-end (see box on page 46). The major uncertainties include the effects of federal tax reform on business investment decisions, the effect of high debt levels on future consumer spending, future prices for imported crude oil, and prospects for reducing both the federal budget deficit and the foreign trade deficit. It was on this note that 1986 ended and 1987 began.

Table 20
Accuracy of Economic Forecasts for California in 1986

	Original Forecasts					
Economic Indicator	*Department of Finance* [a]	*Other Forecasters* [b] *Lowest*	*Average*	*Highest*	*Revised Department of Finance May 1986 Forecast*	*Actual* [c]
Percent change in:						
—Personal income	7.1%	7.0%	7.7%	8.8%	7.3%	7.0%
—"Real" personal income [d]	2.4	1.9	3.0	4.3	3.5	3.6
—Wage and salary jobs	2.9	2.5	3.2	3.7	3.4	2.8
—Consumer prices	4.6	3.8	4.6	5.2	3.7	3.3
—Taxable sales	6.3	—	—	—	6.0	3.7
—Taxable corporate profits	13.7	—	—	—	10.4	5.5
Unemployment rate (%)	7.2%	6.8%	7.3%	7.8%	6.7%	6.7%
Residential building permits (thousands)	229	210	216	229	250	271
New car sales (thousands)	1,120	—	—	—	1,265	1,405

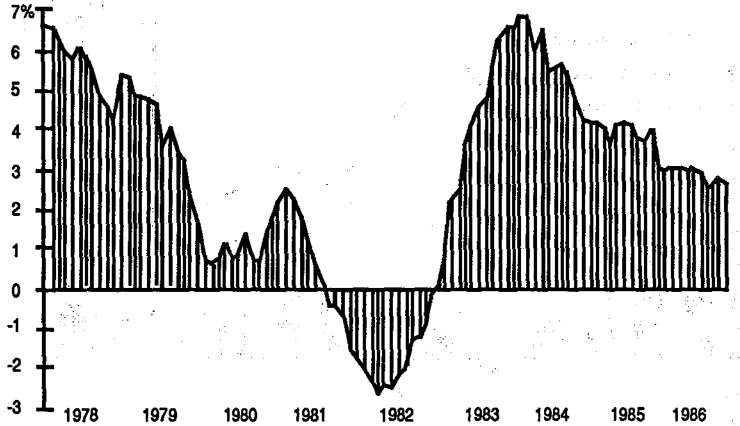
[a] *1986–87 Governor's Budget.*
[b] Includes First Interstate Bank, Security Pacific Bank, Bank of America, Crocker Bank, UCLA, Wells Fargo Bank and the Commission on State Finance. Forecasts are as of approximately year-end 1985, corresponding to when the Department of Finance constructed the economic assumptions contained in the *1986–87 Governor's Budget*. For detail on these forecasts, see *1986–87 Perspective and Issues*, Table 23, page 65.
[c] As estimated in the *1987–88 Governor's Budget.*
[d] Defined here as nominal personal income deflated by the California Consumer Price Index.

Key Aspects of the Economic Outlook

Table 19 and Chart 10 summarize the most critical features of the department's economic outlook for the nation and California in 1987 and 1988. They indicate that for the nation:

Chart 9

Year-Over-Year Percent Change in California's Wage & Salary Employment[a]
1978 through 1986



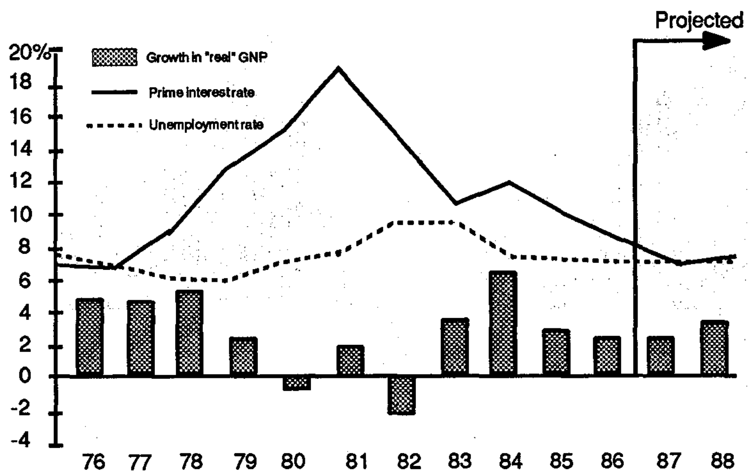
[a] Source: California Employment Development Department. Data shown are through November 1986, and represent percent changes in California's wage and salary employment over same month of prior year.

- ***GNP*** is projected to increase by 2.4 percent in 1987 and 3.4 percent in 1988. (Most economists view GNP growth of under 3 percent as unsatisfactory over the long term.)
- The ***unemployment rate*** is projected to remain basically unchanged from 1986, at about 7 percent.
- The ***prime interest rate*** is predicted to drop below its 1986 level (8.3 percent) in both 1987 (6.8 percent) and 1988 (7.3 percent). This reflects the combined effect of three expected factors: ***low economy-wide inflation, weak overall credit demands*** (due to the sluggish economy), and ***accommodative monetary policy.***
- The ***savings rate*** (that is, savings as a percent of disposable income) is predicted to drop to only 3.2 percent by 1988, as consumers attempt to support their spending habits through borrowing and by saving less of their income.

The 1987 forecast also calls for moderate growth in consumer spending and industrial production, no growth in business investment expenditures after adjusting for inflation, and a continuing large foreign trade deficit exceeding $130 billion. Other key factors in the economic outlook are identified in the box on page 46.

Chart 10

Trends in Key National Economic Variables
1976 through 1988[a]



[a] Source: Department of Finance.

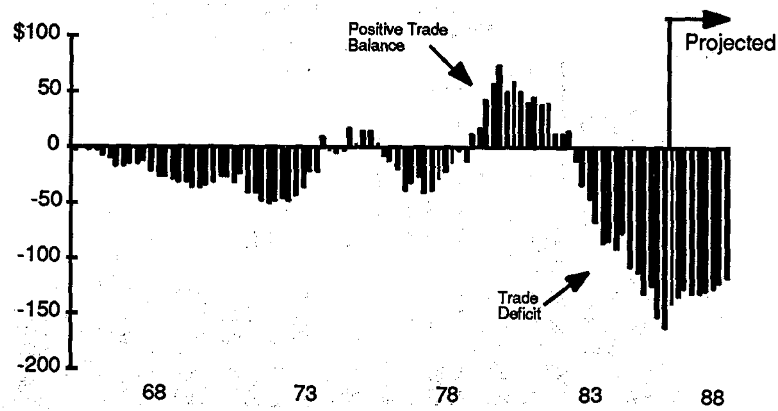
Will the Trade Deficit Improve? The prognosis for the nation's trade deficit, which Chart 11 shows emerged in 1983 and soared to a record $165 billion in late 1986, is the single greatest uncertainty in the economic outlook. The presence of the deficit acts as a continuing drag on the economy, since it means that we are purchasing more goods from other nations than they are buying from us. This, in turn, reduces our production and employment levels. While most economists believe that the deficit will shrink in 1987 in response to declines in the international value of the dollar, there is considerable uncertainty and disagreement about the likely magnitude of the improvement. The department subscribes to the consensus view that the improvement will be modest, which is a reasonable assumption at present.

California To Outperform Nation

Regarding California, Table 19 indicates that the state is forecast to experience the same general moderate economic expansion as the nation, although its performance will be a bit stronger in a number of areas. Specifically:

Chart 11

Trends in the United States Trade Balance
1965 through 1988 (in billions)[a]



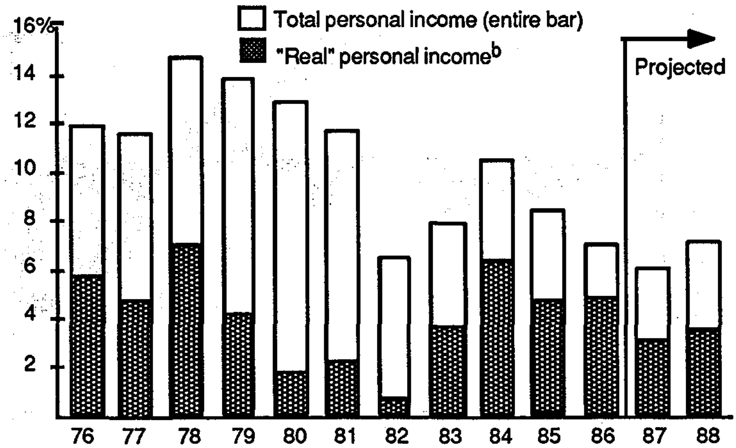
[a] Data shown represent the difference between annualized United States exports and imports, as measured quarterly in constant 1982 dollars. Projections for 1987 and 1988 are by the Department of Finance.

- California ***personal income*** is predicted to increase by 6.1 percent in 1987 and 7.2 percent in 1988 (see Chart 12). These growth rates are not high by historical standards, although they do exceed the national projections.
- ***Wage and salary employment*** is expected to grow by 2.3 percent in 1987 and 2.8 percent in 1988 (see Chart 13). Again, these increases are above the nation's, although historically low for a nonrecessionary period. In fact, because California's labor force is expected to increase by about 3 percent annually, the department predicts that the state's ***unemployment rate*** actually will rise slightly from its 1986 level.
- Both ***new building permits*** and ***new car sales*** are expected to weaken somewhat in 1987 from their exceptionally strong 1986 levels, and then turn up again in 1988. The department is assuming that these spending categories will do fairly well, despite the modest pace of the economy, due to low inflation, declining interest rates, and the willingness of consumers to maintain their current low savings rate.

Chart 12

Annual Growth in California Personal Income

1976 through 1988[a]

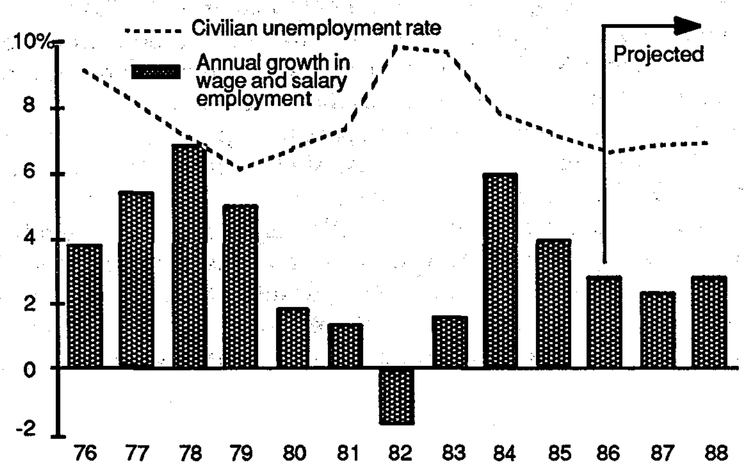


[a] Source: Department of Finance. Data are estimated for 1986.
[b] "Real" personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

Chart 13

Trends in California's Employment and Unemployment

1976 through 1988[a]



[a] Source: Department of Finance and Employment Development Department. Data are estimated for 1986.

Implications of the Economic Forecast for the Revenue Forecast

The implications of the department's economic outlook for state revenues most closely relate to how the economic forecast affects the tax bases for California's major revenue sources. The most important of these tax-base variables are "adjusted" personal income (derived from the forecast for personal income), taxable sales (derived from the forecast for expenditures made by consumers and businesses), and taxable corporate profits (derived from forecasts of business sales revenues and production costs). As shown in Table 19:

- ***"Adjusted" personal income*** (that is, personal income adjusted for transfer payments, social security contributions and certain non-wage income, so as to roughly approximate "taxable" personal income) is predicted to increase by only 5.9 percent in 1987, followed by 7.4 percent in 1988.
- ***Taxable corporate profits*** are predicted to rise by 12 percent in 1987 and 12.6 percent in 1988, following only a 5.5 percent gain in 1986.
- ***Taxable sales,*** which rose by only 3.7 percent in 1986, are predicted to increase by only 4 percent in 1987, followed by a 6.2 percent gain in 1988.

Is the Economic Forecast Reliable?

Based upon our own assessment of current economic conditions, we believe that the general thrust of the department's economic outlook—continued though moderate growth—is reasonable at this point in time. Table 21 shows that this general type of outlook is shared by most other economic forecasters, and that the department's *national* economic outlook is nearly identical to the consensus forecast in many respects. (One exception is corporate profits growth, for which the department's forecast is below the average.) In the case of California, however, the department is at the *low end* of the spectrum with regard to both employment growth and personal income, the single most important determinant of state revenues. For example, *the department's personal income growth forecast is almost one percentage point below the consensus.* This is an important difference, since each percentage point of income growth typically translates into at least $300 million in additional revenues, and we have found that the consensus forecast for personal income growth has been more accurate over the past decade than the predictions of any single forecaster, including the department. From this perspective, the department's *California* economic forecast is a bit *conservative.*

Of course, many things could occur during the next year that would dramatically alter the economic situation, including a reescalation of world oil prices, a retrenchment by consumers, and either a further deterioration or significantly greater-than-expected improvement in the foreign trade balance. Such developments obviously could require substantial revisions in the economic outlook.

Table 21
Comparisons of Different Economic Outlooks for 1987 [a]

	Percent Change In: Real GNP	Percent Change In: GNP Prices	Percent Change In: Pre-Tax Profits [b]	Unemployment Rate	New Car Sales (millions)	Housing Starts (millions)
A. *National Forecasts*						
Department of Finance	2.4%	2.4%	4.0%	7.1%	10.0	1.72
Blue Chip Survey: [c]						
—Concensus forecast	2.4	3.2	8.1	7.0	10.7	1.71
—Low-end average forecast [d]	1.0	2.5	−1.1	6.6	9.6	1.59
—High-end average forecast [d]	3.6	3.7	18.2	7.4	11.8	1.88

	Percent Change In: Personal Income	Percent Change In: Consumer Prices	Percent Change In: "Real" Personal Income [e]	Percent Change In: Wage and Salary Jobs	Unemployment Rate	New Residential Building Permits (thousands)
B. *California Forecasts*						
Department of Finance	6.1%	4.0%	2.0%	2.3%	6.9%	254
Other Forecasters						
UCLA	5.9	3.8	2.0	2.8	6.7	245
Security Pacific Bank	7.5	4.1	3.3	3.0	6.9	225
First Interstate Bank	8.0	4.1	3.7	2.9	6.0	250
Bank of America	7.0	4.5	2.4	3.0	6.6	275 [f]
Wells Fargo Bank	6.7	4.0	2.6	2.3	7.0	240
Commission on State Finance	6.9	4.0	2.8	2.7	6.7	235
Average of "Other" Forecasters	7.0%	4.1%	2.8%	2.8%	6.6%	245

[a] Forecasts available as of approximately year-end 1986.
[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 1987 projection for growth in this latter profit measure is 10.4 percent.
[c] Includes the projections of 50-odd economists as published in *Blue Chip Economic Indicators* for January 1987. 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 1987.
[e] Defined as personal income adjusted for consumer price inflation.
[f] Estimate by the Legislative Analyst's Office, based on the bank's forecast of 252,000 residential building *starts*. Building starts typically average slightly over 90 percent of building permits.

THE REVENUE OUTLOOK

Table 22 presents the department's forecast for state revenues, by source, for the current and budget years. These estimates are best discussed by distinguishing between General Fund revenues (about 85 percent of the total) and special fund revenues (about 15 percent of the total).

A. The Forecast for General Fund Revenues

General Fund revenues are projected to total $31.7 billion in 1987–88, an increase of $977 million over the 1986–87 estimate of $30.8 billion. Chart 14 shows that over 91 percent ($28.8 billion) of these revenues are to be

Table 22
State Revenue Collections
1985–86 through 1987–88
(dollars in millions) [a]

General Fund	Actual 1985–86	Estimated 1986–87	Projected 1987–88	Change 1986–87 to 1987–88 Amount	Change 1986–87 to 1987–88 Percent
Taxes:					
Sales and use [b]	$10,202	$10,730	$10,898	$168	1.6%
Personal income [c]	11,419	12,800	13,200	400	3.1
Bank and corporation [d]	3,843	4,315	4,675	360	8.3
Estate, inheritance and gift [e]	253	270	367	97	35.9
Insurance	840	993	1,106	113	11.4
Cigarette	181	180	180	—	—
Alcoholic beverage	132	134	134	—	—
Horse racing	112	114	116	2	1.8
Subtotals, Taxes	$26,982	$29,536	$30,676	$1,140	3.9%
Other Sources:					
Interest on investments	521	450	380	−70	−15.6
California State University fees [f]	270	252	291	39	15.5
Other revenues [g]	317	318	328	10	3.1
Transfers	−18	209	67	−142	−67.9
Totals, General Fund	$28,072	$30,765	$31,742	$977	3.2%
Special Funds					
Motor Vehicle:					
Fuel taxes	1,194	1,238	1,252	14	1.1
License fees (in lieu)	1,522	1,688	1,891	203	12.0
Registration, weight and miscellaneous fees	998	1,012	1,051	39	3.9
Subtotals, Motor Vehicle Revenues	$3,714	$3,938	$4,194	$256	6.5%
Other Sources:					
Oil and gas revenues [h]	404	100	128	28	28.0
Sales and use taxes	116 [i]	—	477 [j]	477	NMF [k]
Interest on investments	135	112	108	−4	−3.6
Cigarette tax	81	77	77	—	—
Other	1,036	922	1,128	206	22.3
Totals, Special Funds	$5,486	$5,149	$6,112 [j]	$963	18.7%
Totals, State Funds	$33,558	$35,914	$37,854	$1,940	5.4%

[a] Source: *1987–88 Governor's Budget.* Detail may not add to totals due to rounding.

[b] The estimate for 1987–88 includes (i) a $24 million revenue gain from the Governor's *proposal* to increase audit staff at the Board of Equalization, (ii) a $477 million reduction due to the Governor's *proposal* to allocate these funds as general purpose revenues to local governments, and (iii) a $70 million net gain due to 1986 legislation.

[c] Includes the estimated effects of (i) federal tax reform (a $325 million net gain in 1986–87 and a $220 million net loss in 1987–88), (ii) the Governor's *proposals* to increase audit staff at the Franchise Tax Board (a $20 million gain in 1987–88) and provide an income tax deduction for respite care expenses (a reduction of $5 million in 1987–88), and (iii) legislation enacted during 1986 (a reduction of $9 million in 1986–87 and $22 million in 1987–88).

[d] Includes the estimated effects of (i) federal tax reform (a $100 million gain in 1986–87 and a $30 million loss in 1987–88), (ii) the Governor's *proposal* to increase audit staff at the Franchise Tax Board (a gain of $14 million in 1987–88), and (iii) 1986 legislation (a loss of $60 million in 1987–88, including $40 million due to Chapter 660, the "unitary reform" measure).

[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 1987–88 include $266 million in estate taxes, $100 million in inheritance taxes, and $1 million in gift

taxes. The 1987–88 inheritance tax estimate includes a $75 million payment from one large estate. The State Controller, however, has the option of accepting certain real property in lieu of this payment. Under this option, the revenues received would depend on when the property is sold by the state, and for what price.

[f] Includes various funds derived from nongovernmental sources, including the State University Fee, library fines, certain registration fees, and application fees.

[g] Includes revenues from various regulatory taxes and licenses, local agencies, user charges for services provided to the public, property-related income, and other miscellaneous revenues.

[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, royalties allocated to nongovernmental cost funds, and federal lands royalties.

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

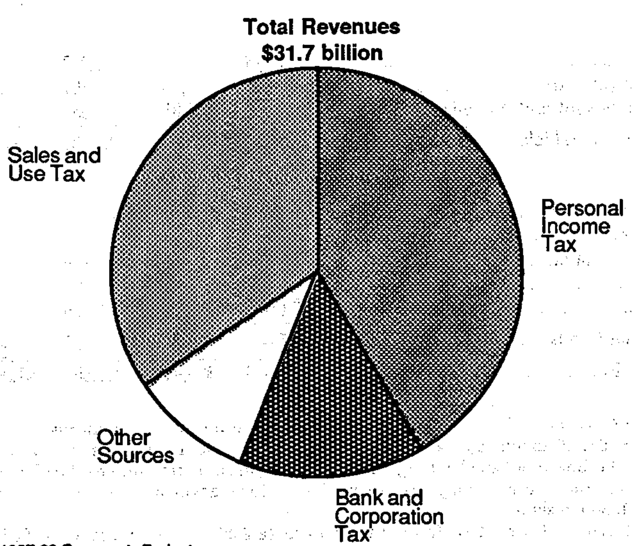
[j] Reflects the Governor's *proposal* to allocate a portion of state sales and use tax revenues as general purpose revenues to local governments, in exchange for eliminating certain subvention programs.

[k] Not a meaningful figure.

derived from three large taxes—the personal income tax, the sales and use tax, and the bank and corporation tax. The remaining 9 percent of revenues is attributable to the insurance tax, interest income from state investments, estate and inheritance taxes, and various other sources.

Chart 14

1987-88 General Fund Revenues, by Source[a]



[a] Source: *1987-88 Governor's Budget.*

Special Factors Distort Revenue Growth

Table 22 shows that projected 1987–88 General Fund revenue growth is only 3.2 percent, compared to 9.6 percent in the current year. These highly dissimilar growth rates reflect distortions due to a number of special factors, in whose absence these growth rates would be in a more normal 7-to-8 percent range. These distortions involve:

- ***Federal Tax Reform.*** Projected revenues have been increased by $425 million in 1986–87, and reduced by $250 million in 1987–88, to account for the effects on state tax collections of the federal 1986 Tax Reform Act (discussed later).
- ***Revenue Sharing Proposal.*** Sales and use tax revenues have been reduced in 1987–88 by $477 million, reflecting the Governor's *proposal* to replace certain local subvention programs with an allocation of general purpose revenues to local governments.
- ***Large Inheritance Tax Payment.*** A $75 million one-time inheritance tax payment is expected in 1987–88 from an unusually large estate.
- ***Proposed Transfers.*** The budget proposes to transfer $78 million in certain special fund balances to the General Fund in 1986–87, to help improve the fund's condition.

The combined effect of these factors is to make 1986–87 revenues over $500 million *greater* than otherwise, and 1987–88 revenues $650 million *less* than otherwise. Without these factors, General Fund revenue growth would be about 7.8 percent in 1986–87 and 7 percent in 1987–88.

The Forecast for Personal Income Taxes—Moderate Growth

The personal income tax is the single largest General Fund revenue source, accounting for over 40 percent of the total. The tax is imposed on income using a progressive tax rate schedule ranging from 1 percent to 11 percent, and includes a variety of income exclusions, deductions and credits.

Personal income tax (PIT) revenues are projected to total $12.8 billion in the current year and $13.2 billion in the budget year. There are two key assumptions behind these projections: the effects of federal tax reform, and the underlying rate of tax liability growth in the 1987 and 1988 income years.

State Revenue Effects of Federal Tax Reform. As summarized in Table 23, PIT revenues are projected to increase by $325 million in the current year, and then be reduced by $220 million in the budget year, due to the 1986 Tax Reform Act. (A detailed discussion of tax reform appears in Part Three.) The largest revenue effects involve sales of assets on which capital gains taxes must be paid. (The act encouraged taxpayers to sell such assets in 1986, by increasing the federal tax rate on capital gains beginning in 1987. The act also may affect the reporting of future capital gains.) Another large effect derives from the expected shift toward income-producing investments and away from loss-generating investments (the act limits taxpayers' ability to use loss-generating investments as tax shelters).

Although the department's assumptions regarding the state revenue effects from federal tax reform were as reasonable as anyone's at the time they were developed (December 1986), *no one* is in a position to accurately predict these effects, and *no consensus exists* as to what they eventually will turn out to be. For example, the Commission on State Finance assumes that the effect on PIT collections in 1987–88 will only be a $5 million reduction, compared to the department's assumed $220 million reduction. Given this, *a significant margin of error surrounds the department's assumptions, and this uncertainty will not be fully resolved until May 1988, when 1987 income tax returns have been processed.*

Table 23
Predicted State Revenue Effects Due to the Federal 1986 Tax Reform Act (dollars in millions) [a]

Type of Effect	Predicted State Revenue Effect 1986–87	1987–88
A. Personal income taxes		
a. Changes in the timing and amount of reported capital gains	$350	–$350
b. Reduced investments in loss-generating tax shelters	—	100
c. Other effects [b]	–25	30
Subtotal, personal income tax	$325	–$220
B. Bank and corporation taxes		
a. Early audit-related payments	100	—
b. Increased incorporations by taxpayers with loss-generating investments	—	–30
Subtotal, bank and corporation taxes	$100	–$30
Total state revenue effect	$425	–$250

[a] Source: *1987–88 Governor's Budget* and Department of Finance.
[b] These "other effects" relate to changes in the amount and timing of charitable donations and consumer interest deductions, plus other factors.

Underlying Growth in Tax Liabilities. After removing the effects attributable to federal tax reform, PIT revenues are estimated to grow by 9.2 percent in 1986–87 and 7.6 percent in 1987–88. These estimates assume that the underlying growth in PIT income-year liabilities will be about 7.8 percent in 1987 and 7.9 percent in 1988.

Evaluation of the PIT Forecast. The department's estimated tax liability growth rate for 1987 is substantially *above* the department's projected growth rate in taxable personal income—only 5.9 percent (see Table 19). Ordinarily, tax liabilities can grow significantly faster than taxable income only when taxpayers move into increasingly higher income tax brackets.

This, in turn, requires the "real" average income of taxpayers to increase, after adjustment for inflation (this is because the state's income tax brackets are indexed for inflation). The department's own economic forecast does *not* suggest that this is very likely to occur, since its income growth forecast is not high enough to allow for an increase in income per employee after adjustment for inflation (see Table 19). We estimate that personal income tax revenues *generated by the department's economic forecast* will be less than predicted, by $50 million in 1986–87 and $130 million in 1987–88.

The Forecast for Sales and Use Taxes—Below-Average Growth

Sales and use taxes are the second largest source of General Fund revenues—around 34 percent of the total—and are projected to reach $10.7 billion in the current year and $10.9 billion in the budget year. These revenues are derived from a 4¾ percent levy on taxable sales, and are in addition to the sales and use taxes levied by local governments and transit districts.

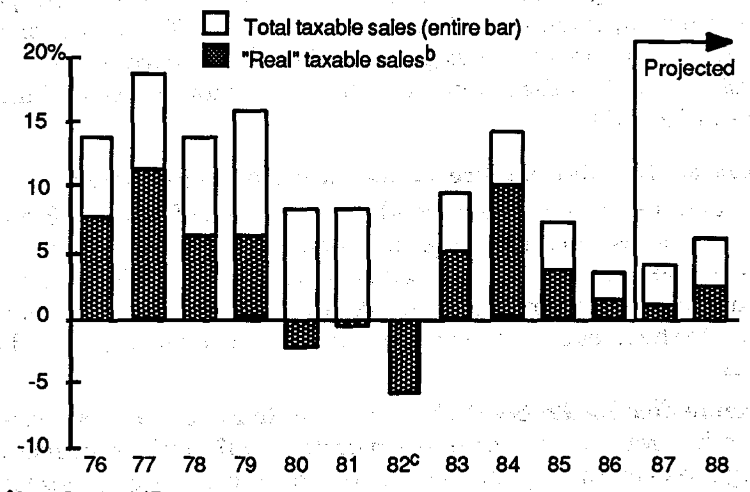
Revenue Sharing Proposal To Reduce State Revenues. As noted earlier, the budget year estimate incorporates a $477 million reduction, reflecting the Governor's *proposal* to allocate a share of state sales tax revenues to local governments, in exchange for discontinuing certain subvention programs. (The Governor also proposes to give localities one-quarter cent's worth of state sales tax revenues on an *ongoing* basis, beginning in 1988–89.) After removing the distortions caused by the Governor's proposal, the projected increase for sales and use taxes is 5.2 percent in the current year and 6 percent in the budget year. This forecast is based on the department's projection of taxable sales.

Weak Growth Projected for Taxable Sales. The department predicts that taxable sales, which increased by only 3.7 percent in 1986, will grow by only 4 percent in 1987 and 6.2 percent in 1988. Chart 15 shows that these increases are relatively low by historical standards, both before and after adjustment for inflation, and also are below the projected rate of personal income growth. As a result, the ratio of taxable sales to personal income is not only predicted to decline, but to reach its lowest level in over 20 years (see Chart 16). Taxable sales are predicted to be especially weak in 1987 for fuel (down nearly 6 percent, due to low gasoline prices) and motor vehicles (up only 1 percent, due to a fall-off in car sales from their 1986 level).

Evaluation of the Sales Tax Forecast. Taxable sales depend on such economic variables as income and employment growth, the unemployment rate, interest rates, inflation, and the willingness of consumers to

Chart 15

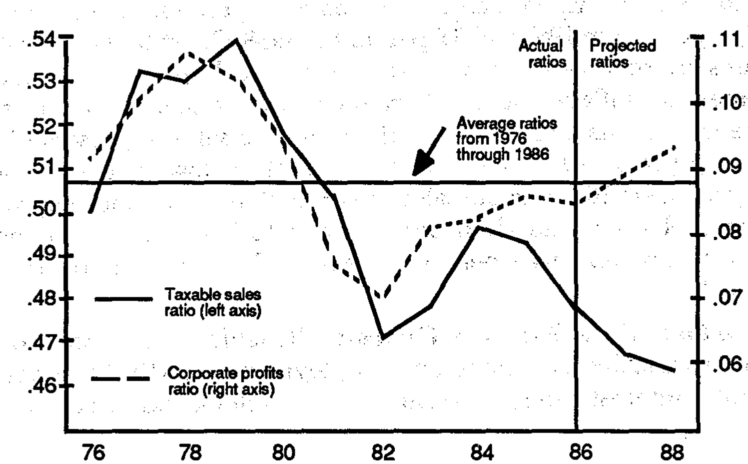
Annual Growth in California Taxable Sales
1976 through 1988[a]



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

Chart 16

Ratios of California Taxable Sales and Corporate Profits to Personal Income
1976 through 1988[a]



[a] Source: Department of Finance. Data are estimated for 1986 and projected for 1987 and 1988.

borrow more and/or save less in order to finance their spending. Our revenue estimating model confirms that the department's economic assumptions, if realized, will produce relatively weak growth in taxable sales and a decline in the sales-to-income ratio. However, the actual dollar level of taxable sales that our model generates is somewhat higher than predicted by the department. This is because the department's projected decline in the savings rate and in interest rates will partially offset various other negative factors affecting taxable sales. We estimate sales tax revenues *generated by the department's economic forecast* will be greater than predicted, by $50 million in 1986–87 and $115 million in 1987–88.

Uncertainty Regarding Fuel Prices. The revenue projections also may require some upward revision if recent developments involving fuel prices are not reversed. The department has assumed that average gasoline prices will drop from 91 cents per gallon in 1986, to only 86 cents in 1987 and 1988, based on its forecast that crude oil prices will be averaging $15 per barrel. However, the Organization of Petroleum Exporting Countries (OPEC) recently announced it will attempt, through output restrictions, to move crude oil prices into the $18 per barrel range. Partly in response to this announcement, gasoline prices recently moved upward. Historically, each $1 increase in oil prices has tended to eventually increase average gasoline prices by about 2 cents per gallon, which in turn annually increases taxable fuel sales by $240 million and fuel sales tax revenues by about $12 million. *Thus, if oil prices averaged $18 per barrel rather than the $15 level estimated by the department, this could add over $35 million to the department's fuel sales tax forecast in the budget year.*

The Forecast for Bank and Corporation Taxes—Healthy Increase

Bank and corporation taxes, the third largest source of General Fund revenues, are derived primarily from a 9.6 percent levy on the taxable profits of corporations doing business in California. These revenues are projected to total $4.3 billion in the current year and $4.7 billion in the budget year. The key assumptions behind these projections involve the effects of federal tax reform and the underlying forecast for taxable profits.

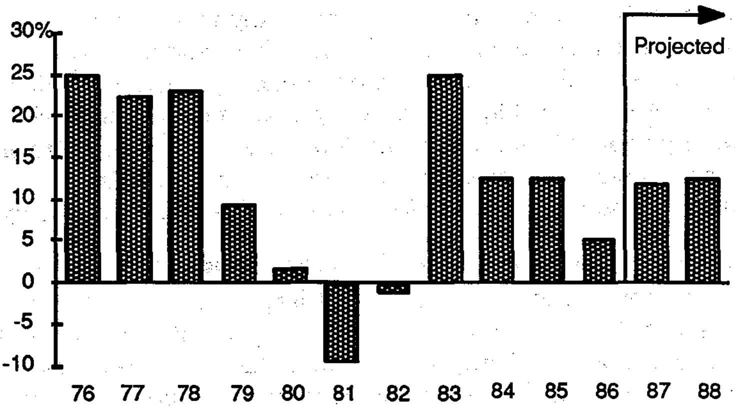
State Revenue Effects of Federal Tax Reform. As summarized earlier in Table 23, the federal Tax Reform Act of 1986 is projected to cause California corporate tax revenues to increase by $100 million in the current year, followed by a $30 million decrease in the budget year. The current year gain reflects the early payment by certain taxpayers of audit assessments, so as to allow them to be deducted on their 1986 federal tax returns. (The act reduces federal corporate tax rates in 1987, thereby making the savings from deducting state taxes less in 1987 than in 1986.) The budget year loss reflects a shift in the reporting of business losses, from the personal income tax to the corporate tax. (The act encourages certain taxpayers with losses to incorporate, since some losses that the act limits under the personal income tax still are allowed under the corporate tax.)

Upswing Predicted in Corporate Profits. After removing the distortions caused by tax reform, corporate tax revenues are projected to rise by 9.7 percent in the current year and 11.6 percent in the budget year. These healthy increases are attributable to the department's forecast that California corporate profits will rise by 12 percent in 1987 and 12.6 percent in 1988. Charts 16 and 17 show that these profit increases are reasonably strong by historical standards and will exceed personal income growth, thereby returning the ratio of profits-to-income to where it stood at the start of the decade.

Chart 17

Annual Growth In California Taxable Corporate Profits

1976 through 1988[a]



[a] Source: Department of Finance. Profit totals include a $967 million increase in 1978 due to Proposition 13. Preliminary 1986 estimate by Department of Finance and Franchise Tax Board.

Evaluation of the Bank and Corporation Tax Forecast. California corporate profits are related to such economic variables as the volume of business activity in California, interest rates, labor costs, and national corporate profits. The level of taxable profits that our revenue estimating model generates from the department's economic assumptions differs somewhat from the department's, although it confirms that these economic assumptions will indeed result in fairly strong profit growth and an increased ratio of profits to income. In addition, the current year revenue estimate should be increased by *$140 million*, due to certain audit-related payments that were received in January but were not included in the department's revenue forecast. Taking both of these factors into account, we estimate that bank and corporation tax revenues *generated by the department's economic forecast* will be greater than predicted, by $130 million in 1986–87 and $20 million in 1987–88.

Insurance Taxes—Continued Strong Gains

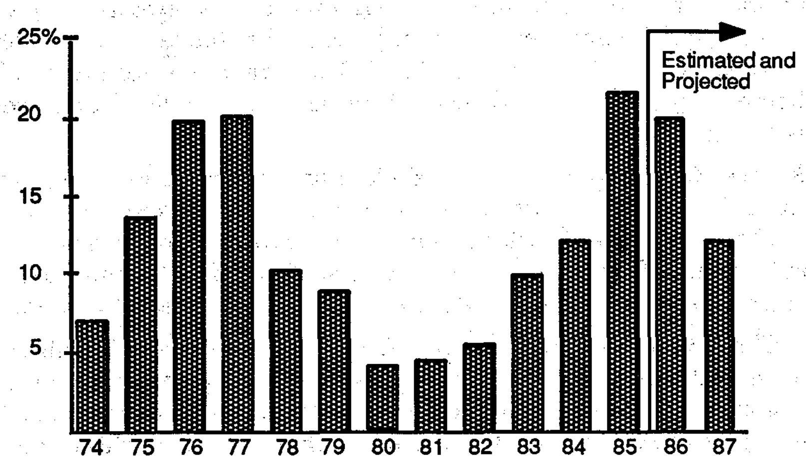
Insurance tax revenues, which primarily are derived from a 2.35 percent levy on taxable insurance premiums, are projected to reach nearly $1 billion (18 percent growth) in the current year, and more than $1.1 billion (over 11 percent growth) in the budget year. Given this strong growth, insurance taxes are predicted to account for 12 percent of new General Fund revenues in the budget year, even though they amount to less than 4 percent of total collections.

Above-Average Growth in Insurance Premiums. Because of the way in which insurance tax prepayments are computed, 1986–87 revenues primarily depend on 1986 premiums, and 1987–88 revenues will depend primarily on 1987 premiums. Chart 18 shows that the strong revenue in-

Chart 18

Annual Growth in California Taxable Insurance Premiums

1974 through 1987[a]



[a] Source: Department of Finance. Insurance tax revenues in 1986-87 primarily depend on 1986 premiums, while revenues in 1987-88 primarily depend on 1987 premiums.

creases predicted for 1986–87 and 1987–88 reflect the department's forecast that insurance premiums will rise by 20 percent (to $38 billion) in 1986 and 12 percent (to $42 billion) in 1987, or well above personal income growth. This forecast is based on survey information from firms collecting over one half of California's insurance premiums. Especially large premium increases are expected for liability insurance lines, especially commercial liability. The latter partly reflects the trend in recent years of increased liability claims and large monetary judgments to plaintiffs.

Evaluation of the Insurance Tax Forecast. Insurance tax premiums are only loosely related to the outlook for the economy. Chart 18 shows that growth in insurance tax premiums tends to follow a cyclical pattern over time. This is because the insurance industry tends to experience cycles of underwriting profits and losses, in response to which it continually adjusts its premium rates. Thus, periods of large underwriting losses are followed by periods of large premium increases, which in turn are followed by periods of improved underwriting profits and lower premium increases. Recent insurance industry data suggest that underwriting profits have been improving, and thus that we may be entering the downside of the premium-growth cycle. As Chart 18 shows, the department's forecast is consistent with this evidence. Therefore, *the forecast is reasonable.*

Death-Related Taxes—Large One-Time Gain Assumed

Death-related tax revenues are predicted to be $270 million in the current year and $367 million in the budget year. The budget year estimate includes $266 million from the estate tax and $100 million from the inheritance tax, including $75 million in inheritance taxes associated with one very wealthy decedent. (Although the inheritance tax was abolished and replaced with the estate tax in 1982, inheritance taxes are still being collected from the unclosed accounts of persons who died before the law was changed.)

Modest Underlying Growth. Excluding the large one-time payment, death-related taxes are projected to increase at a modest 7-to-8 percent pace. This is consistent with the state's death rate, and the rate of appreciation in values of real property and other assets on which death taxes must be paid. Thus, *the department's baseline revenue forecast is reasonable.*

Will the One-Time Gain Be Realized? Whether the $75 million one-time inheritance tax gain will be realized in the budget year depends upon decisions yet to be made by the State Controller. An existing legal settlement gives the Controller the option to either (1) accept this $75 million, or (2) take title to or realize the proceeds from the sale or other use of specified property belonging to the decedent's estate. If the second option is chosen, a state revenue gain may not materialize until *after* the budget year, in which case *1987–88 revenues would be reduced by $75 million.*

The Forecast for Other Taxes—No Growth

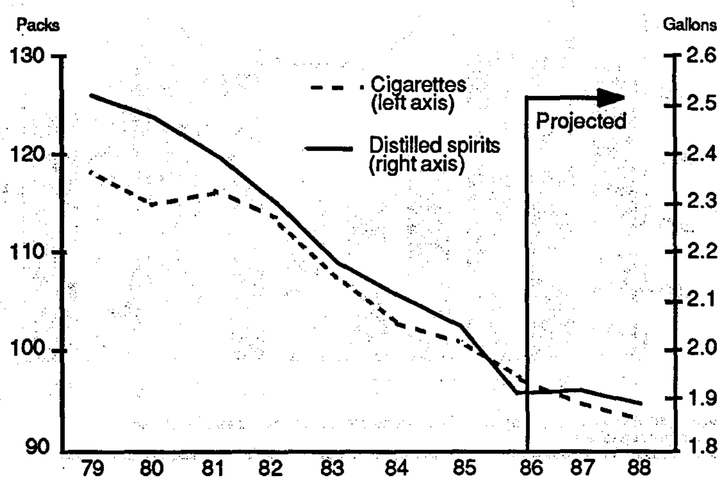
General Fund revenues from the state's remaining taxes are projected to total about $430 million in the budget year, or essentially to remain unchanged from the current and prior years. These taxes include the cigarette tax ($180 million), alcoholic beverage taxes ($134 million), and horse racing taxes ($114 million). The flatness in these revenues is due mainly to two factors:

- First, the "bases" on which the taxes are levied are not growing much. Chart 19, for example, indicates that per capita consumption of cigarettes and liquor have steadily declined in recent years. Per capita horse racing wagering also has fallen in the past couple of years.
- Second, both cigarettes and alcoholic beverages are taxed on a fixed "cents-per-unit-consumed" basis. Thus, taxes collected do not increase over time as the prices for these items rise.

The estimates for these revenues are consistent with the department's economic forecast.

Chart 19

California Per Capita Consumption of Cigarettes and Distilled Spirits
1978-79 through 1987-88[a]



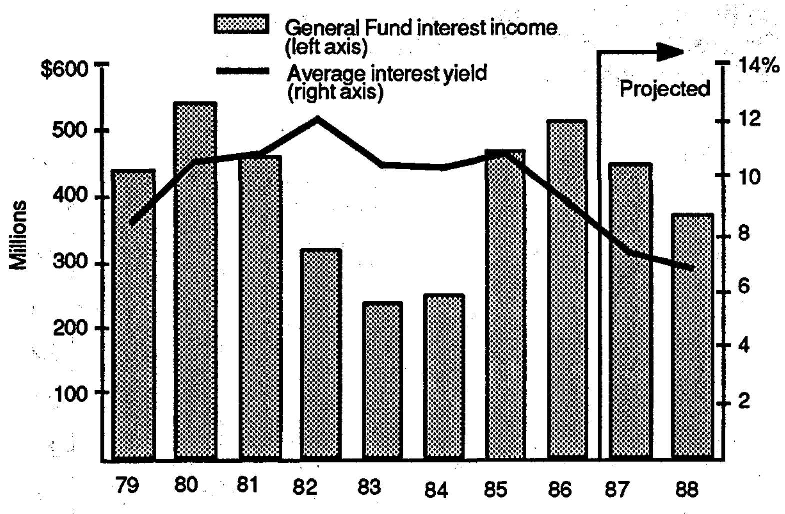
[a] Source: Department of Finance and State Board of Equalization. Data shown are for fiscal years ending in year specified.

The Forecast for Interest Income—Significant Drop Expected

General Fund interest income is predicted to total $380 million in the budget year, down from $450 in the current year and $521 million in the prior year (see Chart 20). This interest income is derived from four sources: (1) the investment of monies carried over from prior years (that is, monies in the Special Fund for Economic Uncertainties and other funds that have been appropriated but not yet spent); (2) earnings on certain special fund balances to which the General Fund is entitled; (3) the investment of incoming General Fund revenues that are temporarily not needed to pay for expenditures; and (4) "arbitrage income" from the short-term investing of temporarily idle monies that the General Fund has borrowed to handle its intrayear cash-flow imbalances. These monies are all invested through the state's Pooled Money Investment Account (PMIA).

Chart 20

General Fund Revenues From Interest Income
1978-79 through 1987-88[a]



[a] Source: *1987-88 Governor's Budget* and State Treasurer. Data shown are for fiscal years ending in year specified.

Key Assumptions. The interest income forecast primarily depends on projections of the General Fund's average investable balance, and the earnings yield of the PMIA. Both of these variables are projected to decline in the budget year—the former ($5.6 billion) due to a projected shrinkage in the General Fund surplus, and the latter (6.8 percent) due to declines in economy-wide interest rates. The reason interest income has not fallen off until the current year despite falling interest rates (see Chart 20), is that the investable PMIA balance was expanding.

Evaluation of the Interest Income Forecast. The department's assumptions regarding the PMIA's average yield are consistent with its economic forecast. However, the interest income projections require two adjustments:

- First, the estimated 1987–88 investable General Fund balance in the PMIA is low, by approximately $500 million. This is equivalent to about $30 million in interest income. The balance is understated because the estimate assumes that the General Fund will earn arbitrage interest for 10 months on $1.8 billion of externally-borrowed funds in 1987–88, whereas the Governor's Budget assumes that $2.4 billion will be borrowed.
- Second, it appears that the General Fund will have to return about $15 million in 1986–87 interest income to the Petroleum Violation Escrow Account (PVEA), in order to comply with federal requirements.

Given the above, *projected General Fund interest income should be reduced by $15 million in the current year and increased by $30 million in the budget year.*

B. Reliability of the General Fund Revenue Forecast

How Reliable Have Past Revenue Forecasts Been?

History shows that the reliability of the department's revenue forecasts has been variable. The primary problem has been accurately predicting how the economy will perform. Over the past decade, the estimating error for budget year revenues (after adjusting for noneconomic factors such as new legislation) has averaged over 5 percent, which in 1987–88 would amount to a revenue-estimating error of over $1.6 billion. In each of the past two years, however, the budget year forecasting error has been very small—only about 1 percent. Yet, even this small percentage error would translate into a dollar error of over $300 million in 1987–88. Thus, *it is only realistic to expect a revenue-estimating error of at least several hundred million dollars, and it is within this band of uncertainty that our assessment of the department's estimates should be viewed.*

How Reliable Are the Budget's Revenue Forecasts?

The reliability of the department's General Fund revenue estimates depends primarily upon two factors:

- First, the extent to which the revenue estimates are ***internally consistent*** with the department's economic forecast. This was discussed in the preceding section for each of the major revenue sources.

- Second, the reliability of the department's ***own economic forecast.*** It is impossible to know ahead of time how "reliable" an economic forecast will prove to be. However, since few individual forecasters consistently outperform the consensus, it makes sense to compare the department's revenue estimates to those which would result if the consensus economic outlook came true. As discussed earlier in the economic outlook section, the department's economic forecast, while very similar to the consensus forecast in its general thrust, is somewhat on the ***conservative side*** relative to the consensus view for California.

General Conclusion—Revenue Estimates Appear Low

Table 24 and Chart 21 show how the department's revenue estimates would change if they were adjusted to reflect (1) our earlier evaluation of the estimates for individual revenue sources, and (2) the consensus economic outlook. We estimate that:

- If the department's economic forecast comes true and all of the special adjustments we have identified are considered, revenues will be *higher* than predicted by $115 million in 1986–87 and $35 million in 1987–88.
- The consensus economic outlook, if it comes true, will *increase* revenues by an additional $85 million in 1986–87 and $250 million in 1987–88.

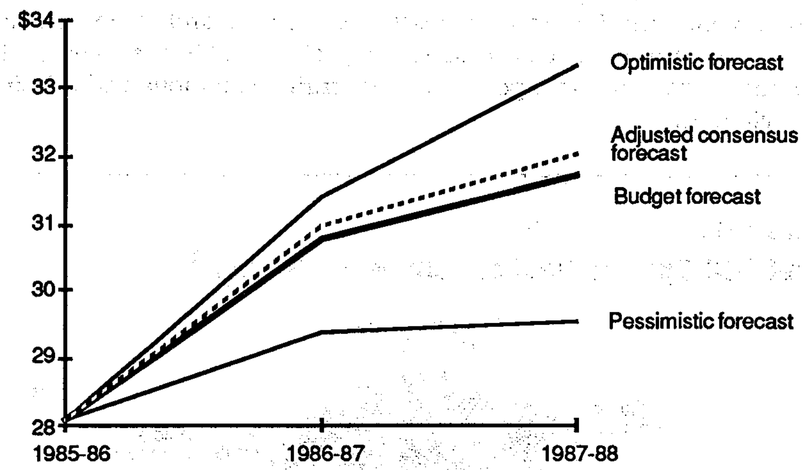
Thus, *these two factors together would increase General Fund revenues by $200 million in 1986–87 and $285 million in 1987–88, or $485 million for the two years combined.*

Table 24
Selected Adjustments to the Department of Finance's Revenue Estimates (dollars in millions)

Type of Adjustment	*1986–87*	*1987–88*	*Two-year Total*
A. Adjustments assuming the department's economic forecast comes true:			
1. Personal income taxes	−$50	−$130	−$180
2. Bank and corporation taxes	130	20	150
3. Sales and use taxes	50	115	165
4. Interest income	−15	30	15
Subtotal	$115	$35	$150
B. Additional adjustments, assuming the consensus economic forecast comes true	$85	$250	$335
Total revenue adjustments	$200	$285	$485

Chart 21

Alternative Revenue Forecasts for 1986-87 and 1987-88 (in billions)[a]



[a] Source: *1987-88 Governor's Budget* and Legislative Analyst's Office.

Significant Error Margins Exist

What if the economy's behavior during 1987 and 1988 differs significantly from both the department's economic forecast and the consensus economic outlook? In this event, Chart 21 shows that General Fund revenues could be either well below the department's projections, or well above that which the consensus outlook produces. Specifically, the chart shows the amount of revenues which the department estimates would be produced by either a strong 1987 economic expansion or a modest 1987 economic downturn. Under the *optimistic* alternative, revenues would exceed the budget forecast by nearly $2.3 billion over the next 18 months (not all of these funds could be spent, however, due to the state's appropriations limit); under the *pessimistic* alternative, revenues would fall short of the forecast by over $3.5 billion. *Thus, even though the department's revenue forecast appears conservative, this bias is not nearly as large as the deviations which could occur due to the economy.*

C. The Forecast for Special Fund Revenues

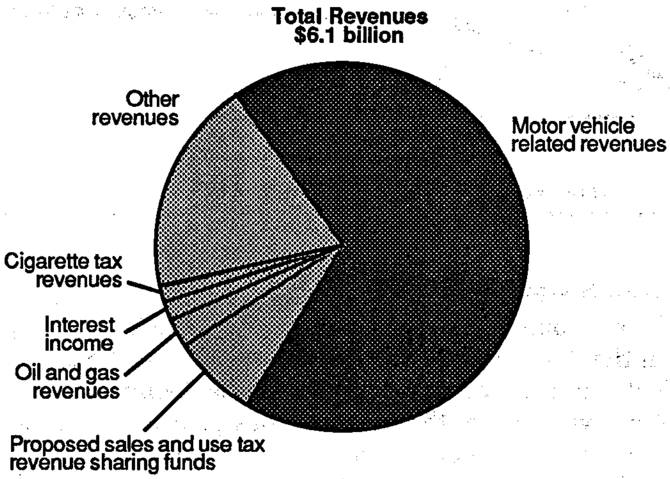
Special fund revenues are projected to total $6.1 billion in 1987–88, or 16 percent of total revenues. Table 22 and Chart 22 indicate that:

- Over two-thirds ($4.2 billion) of special fund revenues are derived from motor vehicle-related sources, including vehicle license fees ($1.9 billion), fuel taxes ($1.3 billion), and vehicle registration and related fees ($1.1 billion).

- The remaining one-third ($1.9 billion) of special fund revenues include oil and gas royalties, interest income, local governments' 30-percent share of cigarette tax collections, the proposed sales and use tax revenue-sharing monies discussed earlier, and other smaller sources including various business and professional license fees, utility surcharge receipts, and penalties from traffic violations and criminal convictions.

Chart 22

1987-88 Special Fund Revenues, by Source[a]



[a] Source: *1987-88 Governor's Budget*.

How Are Special Fund Revenues Used?

Special fund revenues are used for a wide variety of purposes. For example:

- Over half of motor vehicle-related revenues are returned to local governments for transportation-related and other purposes. The remainder is used for various state programs relating to transportation and vehicle use, including the support of the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), and the Department of Transportation (Caltrans).

- The local share of cigarette taxes is distributed between cities (83 percent) and counties (17 percent).
- Interest income generally is credited to various special funds, based on how much they have invested in the PMIA.
- Oil and gas revenues are used primarily to finance capital outlay projects.

Moderate Revenue Growth Expected

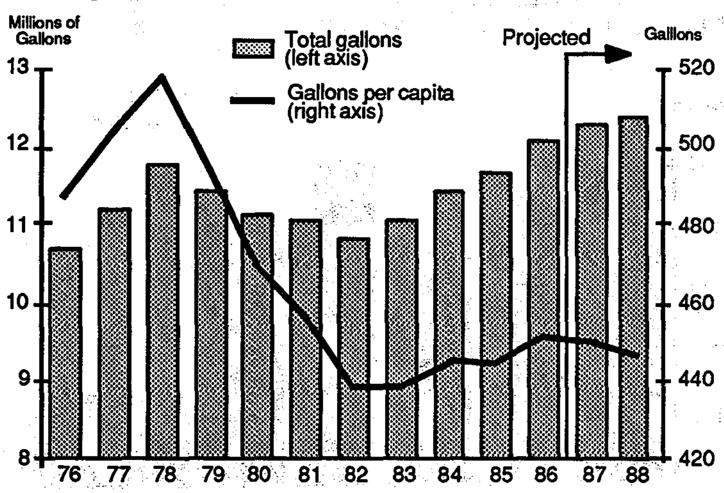
Table 22 indicates that special fund revenues are predicted to rise by 19 percent in 1987–88. The underlying growth rate, however, is a more-modest 8 percent after eliminating such distortions as the proposed revenue sharing program and changes in the amount of transfers from special funds to the General Fund. This moderate underlying growth trend, however, incorporates some very different trends for individual revenue sources.

Mixed Growth Trends for Motor Vehicle-Related Revenues

These revenues are projected to grow by 6.5 percent in 1987–88, including strong growth for vehicle license fees (12 percent), very modest growth for registration fees (4 percent), and weak growth for fuel taxes (1 percent). Specifically:

Chart 23

California Gasoline Distributions
1976 through 1988[a]



[a] Source: *1987-88 Governor's Budget* and State Board of Equalization.

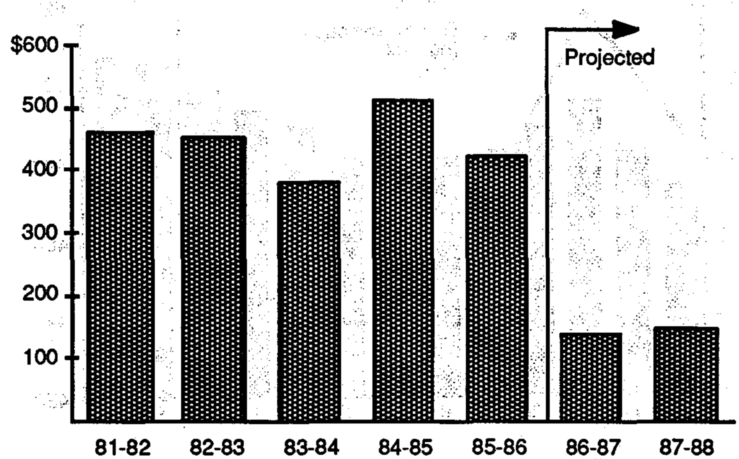
- *Vehicle license fees,* which are imposed for the privilege of operating vehicles on public roads in California and are in lieu of the personal property tax on vehicles, are the single largest special fund revenue source. Their expected strength in 1987–88 reflects two factors. First, the average market value of new cars continues to rise, and is expected to reach $15,000 in 1988 (higher-priced vehicles translate into more revenues, because a vehicle's license fee depends on its market value). Second, the number of registered vehicles continues to rise on a per capita basis.
- *Registration fees,* which are levied at a flat rate, are projected to grow only modestly because of fewer new vehicle sales than in 1986.
- *Fuel taxes,* which also are levied at a flat rate, are projected to increase hardly at all. This is because of weak growth in gasoline sales, due to declining per capita gasoline use. As shown in Chart 23, the per capita level of gasoline distributions remains well below its pre-1980 level.

Oil and Gas Revenues To Remain Low

Chart 24 shows that state oil and gas royalty income is projected to drop dramatically from its level during the past few years. This reflects the early-1986 decline in world crude oil prices, which reduces the revenues derived from oil produced on state-owned lands. Total state oil and gas

Chart 24

State Oil and Gas Royalties
1981-82 through 1987-88 (in millions)[a]



[a] Source: *1987-88 Governor's Budget* and State Lands Commission. Data shown include oil, gas and mineral royalties collected by the State Lands Commission.

royalty income is projected to be only $140 million in the current year and $150 million in the budget year, compared to an average of $450 million during the preceding five years. As a result, the portion of oil and gas revenues distributed to special funds will represent only 2 percent of total special fund revenues in 1986–87 and 1987–88, compared to an average of nearly 10 percent over the prior five-year period.

D. The California State Lottery

The special fund revenue totals contained in the budget do *not* include any revenues derived from the California State Lottery, which first began operation in October 1985. This is because lottery revenues currently are classified as "nongovernmental trust and agency funds," and monies so classified normally are not reported in the budget. Nevertheless, because the lottery is a major source of state income, its revenue outlook is summarized below. A more detailed discussion of the lottery appears under Item 0850 in the *Analysis.*

Projected Lottery Sales—$1.8 Billion

Predicting lottery sales over the next 18 months is extremely difficult, both due to the relatively limited history of lottery wagering in California, and the continued phasing-in of electronic on-line lotto games which began in October 1986.

The budget projects that lottery sales will total $1.8 billion in the budget year. This is the same as in the prior year (which included 9 months of operation), and an increase over the current year's projection of $1.4 billion. Lotto games are expected to account for $1 billion of 1987–88 sales, compared to $750 million for instant ticket games.

Whether or not projected lottery sales will be realized depends primarily on whether lotto wagering, which is assumed to offset a declining trend in instant ticket game wagering, reaches expectations. In order for projected sales to be achieved, per capita lotto wagering will have to more than double from its current level (about 33 cents per week). It is possible that this increase will occur, as lotto receives greater publicity and more on-line terminals are installed. However, if it does not, lottery sales could easily fall several hundred million dollars below the projection.

How Lottery Proceeds Are Used

Chart 25 shows how the budget proposes to distribute the $1.8 billion of projected lottery receipts in 1987–88. Existing law provides that these proceeds must be distributed as follows:

- 50 percent ($875 million) must be paid out to the public as prizes;
- Up to 16 percent ($280 million) may be used to cover lottery-related administrative expenses; and

- At least 34 percent (about $600 million), along with any unclaimed prize monies and unused administrative allotments, must be allocated to various levels of public education.

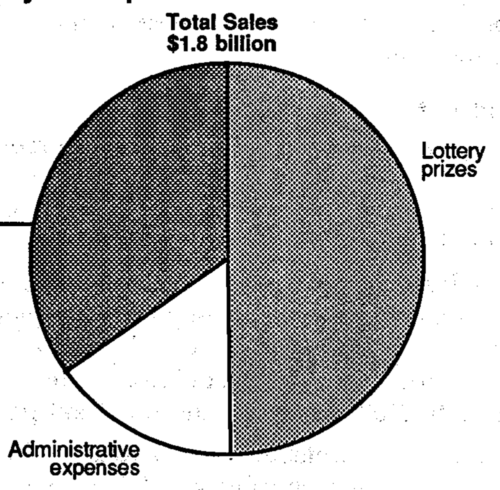
Chart 25 also shows how the monies going to education are to be allocated to different educational levels. Existing law provides that this be done on the basis of educational enrollments and attendance. Altogether, the 1987–88 lottery revenues earmarked for education amount to about 3.5 percent of total proposed General Fund educational expenditures.

Chart 25

Estimated Distribution of 1987-88 State Lottery Receipts[a]

Revenues to education (in millions)

K-12 Education	$493
Community Colleges	72
California State University	27
University of California	15
Other	1
Total	$608[b]



[a] Source: *1987-88 Governor's Budget*.
[b] Includes $595 million from 1987-88 lottery sales and $13 million in net interest income.

State and Local Borrowing

The Governor's Budget proposes to spend $1.1 billion in funds derived from the sale of state bonds that are supported by the General Fund. These funds will be used primarily 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. A discussion of the effect that the recently enacted Tax Reform Act of 1986 will have on California's state and local borrowing program appears in Part Three of this document.

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 1986, a record volume of new general obligation bond authorizations—over $3.4 billion—was approved by the voters. Most of this amount consisted of additional authorizations for existing state bond programs—those financing new state prisons ($500 million), county jails ($495 million), school building lease-purchase ($800 million), assistance to veterans ($850 million), clean water ($150 million), parks and recreational facilities ($100 million) and higher educational facilities ($400 million). The voters also approved funds for one *new* program: $100 million for safe drinking water.

Status of Bonds Authorized. Table 25 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, 1986, the state had not sold $5.2 billion in authorized bonds, compared to $2.7 billion at the end of 1985. Of the authorized bonds already sold (approximately $14.6 billion), the state had retired $6.3 billion, leaving $8.3 billion (57 percent) still outstanding.

Table 25
General Obligation Bonds of the State of California[a]
As of December 31, 1986
(dollars in millions)[b]

Program	*Authorized*	*Unsold*	*Redeemed*	*Outstanding*
Beach, park, recreational and historical facilities	$400	—	$234	$166
Clean water	1,200	$375	300	525
Community college construction	160	—	91	69
Community parklands	100	100	—	—
County correctional facilities	495	495	—	—
County jail construction	530	255	13	262
First-time homebuyers	200	185	—	15
Harbor bonds	89	—	76	14
Hazardous substance cleanup	100	50	3	48
Health sciences facilities	156	—	74	82
Higher education construction	230	—	177	53
Higher education facilities	400	400	—	—
Junior college construction	65	—	51	14
Lake Tahoe land acquisition	85	55	1	30
New prison construction	1,295	500	58	738
Park and recreational facilities	370	275	4	92
Parklands acquisition and development	285	45	48	192
Recreation, fish, and wildlife	145	55	40	50
Safe drinking water	350	170	19	161
School building aid	2,140	40	1,649	451
School building lease-purchase	1,750	1,000	67	683
Senior centers	50	—	—	50
State construction	1,050	—	891	159
State, urban, and coastal park	280	25	84	171
Veterans farm and home loan	5,950	850	2,215	2,885
Water conservation and quality	150	150	—	—
Water resources development	1,750	180	195	1,375
Totals	$19,775	$5,205	$6,287	$8,283

[a] Source: State Treasurer's Office.
[b] Detail may not add to totals due to rounding.

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 43 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 57 percent of the total outstanding amount.

Sales of General Obligation Bonds. In 1985–86, the State Treasurer sold $1.2 billion in general obligation bonds. The largest volume of bonds sold ($410 million) was for the new prison construction program. The Treasurer also sold large volumes of bonds for the veterans farm and home loan program ($340 million), the school building lease-purchase program ($205 million), and various state parks and recreational facilities ($125 million).

The State Treasurer's latest schedule calls for the sale of approximately $845 million of general obligation bonds in 1986–87. This amount is $355 million less than the volume of sales in 1985–86, due to a lower level of sales for the veterans program. Bonds for the school lease-purchase program ($250 million) and the county jail program ($200 million) account for about one-half of the sales planned for the current year. As of December 31, 1986, $250 million in bonds had been issued in 1986–87.

For 1987–88, the budget shows that a total of $855 million in general obligation bonds sales are planned, about the same as in the current year. The largest volume of bonds to be sold in 1987–88 is for the new prison construction program ($300 million). The next largest amount will be sold for county jail construction ($230 million), followed by higher education and state school lease-purchase programs ($100 million for each program). In addition, the budget anticipates the sale of bonds for clean water projects ($25 million).

General Fund Cost 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 the period 1983–84 through 1987–88 in Table 26.

Debt service for the budget year is estimated to total $617 million. Of this amount, approximately $305 million is for payment of interest and $312 million is for repayment of principal. The total payments represent an increase of $79 million, or 15 percent, over estimated expenditures in the current year. While debt service represents a small percentage of total

Table 26
General Fund Debt Service [a]
1983–84 through 1987–88
(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	452.3	19.5	1.6	1,240
1986–87	537.9	18.9	1.7	845
1987–88	616.9	14.7	2.0	855

[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 7.0 percent and 7.5 percent are assumed for anticipated bond sales in 1986–87 and 1987–88, respectively.
[c] Source: State Treasurer's Office for actual bond sales from 1983–84 through 1985–86; *Governor's Budget* for 1986–87 and 1987–88.

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 1986–87 and 1987–88 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 Schedules 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 are higher (lower) than projected, the amounts needed from the General Fund to service the debt will increase (decrease) accordingly. For example, in January 1986, debt service for 1986–87 was projected at $525.7 million. As a result of changes in bond sales and the increases in interest rates that have occurred since then, however, the actual level of debt service now is estimated to be $537.9 million, or $12.2 million *higher* than projected.

How the Bond Proceeds Will Be Spent. Once the state's bonds are sold, the proceeds are allocated for expenditure on specific projects. Table 27 identifies these expenditures for the prior, current, and budget years, according to the source of the bond funding.

Table 27
Selected Bond Fund Expenditures
1985–86 through 1987–88
(dollars in million) [a]

Program	*1985–86*	*1986–87*	*1987–88*
Safe and clean water	$64	$172	$224
County jails	120	120	189
Fish and wildlife enhancement	17	28	28
Lake Tahoe land acquisition	2	27	27
New prisons	383	602	45
State construction	— [b]	1	—
School building lease purchase	250	400	400
State parks and recreational facilities [c]	109	192	56
Higher education capital outlay	—	233	157
Totals	$945	$1,775 [d]	$1,124

[a] Detail 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.
[d] This amount differs from the amount shown in Schedule 1 of the *Governor's Budget,* due to an error made in the computation of that total.

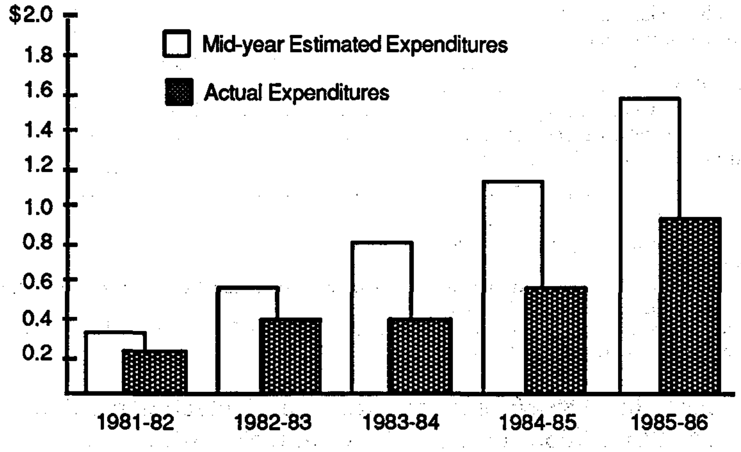
Past Year. In 1985–86, expenditures from selected bond funds totaled about $945 million. Last year, the midyear estimate of bond fund expenditures was $1.6 billion, or approximately $636 million *more* than the amount actually spent. Much of the shortfall was associated with the state's new prison construction program. Actual expenditures for this program were *$235 million less* than what had been estimated, due to delays in construction and the selection of prison sites. Delays in the county jail construction program accounted for an additional $189 million of the shortfall.

Current Year. In 1986–87, the budget indicates that bond fund expenditures will reach a record level of $1.7 billion. Table 28 shows that over 80 percent of the $830 million increase over the 1985–86 expenditure level can be attributed to four programs: new prison construction ($219 million increase), higher education capital outlay ($233 million), school building lease-purchase ($150 million), and safe and clean water ($108 million). The actual level of bond fund expenditures during the current year, however, is certain to fall short of the amount shown in the budget.

For example, the spending level shown in the budget assumes that $602 million in bond funds will be expended in the current year for the construction of new state prisons. Of this amount, however, approximately $200 million in construction funds for the Los Angeles and Riverside prisons will not be expended because the siting of these projects has not been resolved. Hence, it is clear that the level of expenditures projected for this program is overstated. Chart 26 shows a comparison of midyear estimated bond fund expenditures with actual expenditures for the period 1981–82 through 1985–86.

Chart 26

Selected Bond Fund Expenditures Estimated Versus Actual Expenditures 1981-82 through 1985-86 (in billions)[a]



[a] Source: *Governor's Budget*

As noted above, the midyear estimate contained in last year's budget exceeded the amount actually spend *by more than $636 million.* For 1984–85, the midyear estimate exceeded the actual level of expenditures by $542 million. As a result, the Legislature should not expect bond fund expenditures during the current year to come anywhere near the $1.7 billion estimated by the budget.

Budget Year. The level of bond fund expenditures are expected to return to a more normal level ($1.1 billion) for 1987–88. Four programs account for about two-thirds of these expenditures: school building lease-purchase ($400 million); county correctional facilities ($105 million); water conservation and water quality ($111 million); and prison construction ($157 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 (CIDFAC) 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 a state or local agency.

Table 28 identifies the 20 different types of state revenue bond programs and shows the current authorization for each. As of December 31, 1986, a total of $14.5 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 ($2.5 billion), Veterans Revenue Debenture ($1.1 billion), and the California National Guard ($27 million). Bonds issued by the California Pollution Control Financing Authority ($2.7 billion) and the California Health Facilities Financing Authority ($3.5 billion) also account for significant portions of the outstanding revenue bonds. The table also shows that 12 of the 20 programs have statutory authorization limits, which together total $14.3 billion. Of this amount, approximately $6.1 billion (42 percent) was unused at the end of 1986.

Table 28
State Agency Revenue Bonds [a]
As of December 31, 1986
(dollars in millions)

Issuing Agency	*Authorization Limit, If Any*	*Out-standing*	*Remaining Authorization*
California Alternative Energy Source Financing Authority	$200	$116	$84
California Educational Facilities Authority	1,250	688	562
California Health Facilities Financing Authority	4,429	3,491	938
California Housing Finance Authority	3,750	2,536	1,214
California Industrial Development Financing Advisory Commission (Small business financing)	—	—	—
California National Guard	100	27	73
California Passenger Rail Financing Commission	1,250	—	1,250
California Pollution Control Financing Authority	—	2,675	—
California Student Loan Authority	300	102	198
California Transportation Commission	—	92	—
California Urban Waterfront Area Restoration Financing Authority	650	—	650
Department of Water Resources	—	1,522	—
Hastings College of Law	—	7	—
Regents, University of California	—	902	—
State Public Works Board	—	842	—
State Public Works Board (Energy Conservation and Cogeneration)	500	66	434
Trustees, California State University	—	224	—
Veterans Revenue Debenture	1,500	1,135	365
California School Finance Authority	250	50	200
Hazardous Substance Cleanup Financing Authority	100	—	100
Totals	14,279	$14,475	$6,068

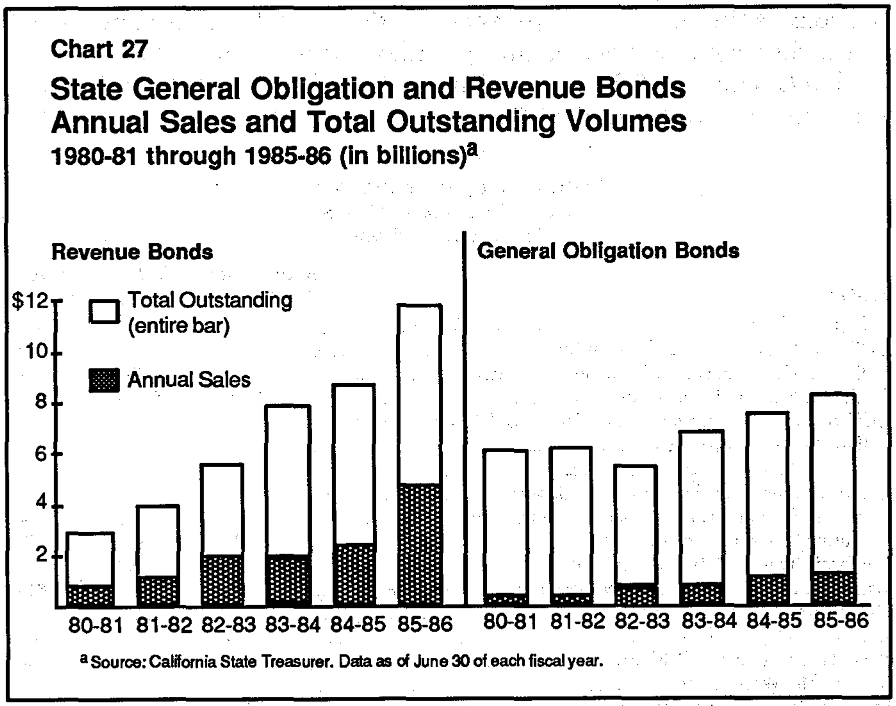
[a] Source: State Treasurer's Office.

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. From 1982–83 through 1984–85, revenue bond sales were approximately $2 billion each year. In 1985–86, $4.8 billion in revenue bonds were sold—a new record.

Three authorities accounted for almost 75 percent of the 1985–86 sales: the California Housing Finance Authority ($0.6 billion), the California Pollution Control Financing Authority ($1.4 billion), and the California Health Facilities Financing Authority ($1.5 billion). As of December 1986, a total of $2.7 billion in revenue bonds had been sold in 1986–87.

Use of General Obligation Versus Revenue Bonds

Chart 27 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 six years.



[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 normally subject to specific authorization limits, which must be approved by the voters. As shown in Table 25, 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 20 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 63 percent of the $9 billion increase in outstanding revenue bonds between 1980–81 and 1985–86 is due to two programs created within the past five years: those used to finance pollution control facilities ($2.8 billion) and private health facilities ($2.9 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 nearly $1 billion in lease revenue bonds for state prison construction projects, $0.5 billion for energy conservation and cogeneration projects, and $0.6 billion to provide financing for the construction of "high technology" educational facilities and libraries at the California State University and the University of California.

General Fund Debt Service Hidden in Agency Budgets. The funding needed to pay off the debt resulting from these types of long-term borrowing is provided by the General Fund and is subject to the state's appropriation limit. Repayment expenditures, however, are not included in the administration's estimate of debt service requirements. This is because for CPs and lease revenue bonds, "debt service" is budgeted in the individual agencies' support budgets as the cost of "facilities operations." These costs are approximately $20 million in the budget year. In future years, as currently authorized construction projects are completed and occupancy takes place, lease costs are expected to increase to approximately $150 million annually.

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 between 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 were funded from internal sources, usually from the Special 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.

For the current year, the state borrowed $2.6 billion through the sale of revenue anticipation notes in August 1986. These notes will be repaid by June 1987. For 1987–88, the budget shows that $2.4 billion in short-term notes will be sold in August 1987.

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. A discussion of the effect that the federal Tax Reform Act of 1986 will have on California's state and local borrowing program appears in Part Three of this document.

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—Increases

Long-term bond sales by local governments increased dramatically in 1985–86. According to information from the California Debt Advisory Commission, the volume of local bond sales exceeded $18.5 billion in 1985–86, which is $5 billion, or 37 percent, more than the amount of sales reported for 1984–85. Some of the overall increase is due to accelerated bond sales by local agencies that were attempting to avoid the tighter debt issuance restrictions of the federal Tax Reform Act of 1986.

A large portion of the sales increase, however, can be attributed to bonds for capital improvement projects. Between 1984–85 and 1985–86, sales of capital improvement bonds (primarily power generation and transmission projects) increased by 66 percent (from $6.1 billion to $10.1 billion). Finally, the increase in overall bond sales also reflects the general decline in interest rates, which have made more projects economically viable. In the future, local governments will once again be able to rely on general obligation bonds as a source of financing for these projects, due to the approval of Proposition 47 at the June 1986 statewide election. This measure restored the ability of local agencies to increase their property tax rates as security for the bonds.

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 1985–86, local governments issued approximately $3.3 billion in short-term debt, which is approximately $400 million more than the volume issued in 1984–85. These amounts, though large in volume, 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.

The State's Work Force

The Governor's Budget proposes a state government work force of 240,527 personnel-years (pys) for 1987–88. Four functional areas account for 78 percent of the total: higher education (38 percent); health and welfare (15 percent); business, transportation, and housing (14 percent); and youth and adult corrections (11 percent).

THE PROPOSED WORK FORCE FOR 1987–88

The budget proposes to *increase* the size of the state's work force by 4,372 pys, or 2 percent, in 1987–88. The largest increases would occur in three program areas—youth and adult corrections (+2,195 pys), higher education (+1,220 pys), and business, transportation and housing (+520 pys). These increases would be partially offset by a decrease in health and welfare programs (−639 pys), as shown in Table 29.

Table 29
The State Work Force, By Function [a]
(in personnel-years)
1985–86 through 1987–88

	Actual 1985–86	Estimated 1986–87	Proposed 1987–88	Change 1986–87 to 1987–88 Amount	Change 1986–87 to 1987–88 Percent	Change 1985–86 to 1987–88 Amount	Change 1985–86 to 1987–88 Percent
Legislative, Judicial, Executive	9,995	10,405	10,666	261	2.5%	671	6.7%
State and Consumer Services	11,749	12,060	12,230	170	1.4	481	4.1
Business, Transportation and Housing	33,277	33,401	33,921	520	1.6	644	1.9
Resources	13,801	14,238	14,564	326	2.3	763	5.5
Health and Welfare	37,371	37,800	37,161	−639	−1.7	−210	−0.6
Youth and Adult Corrections	18,868	24,085	26,280	2,195	9.1	7,411	39.3
Education	2,474	2,725	2,736	11	0.4	262	10.6
Higher Education	92,133	91,202	92,422	1,220	1.3	290	0.3
General Government	9,974	10,240	10,548	308	3.0	574	5.8
Totals	229,641	236,156	240,527	4,372	1.9%	10,887	4.7%

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.

Table 29 indicates that the proposed state work force for 1987–88 is 10,887 pys higher than the actual number of personnel-years worked in 1985–86. Over the two-year period covered by the table, youth and adult corrections programs will increase by 7,411 pys, or 39 percent, while health and welfare will decrease by 210 pys, or 0.6 percent.

Proposed Budget Year Changes by Function

Health and Welfare. The budget proposes reductions of 639 pys for health and welfare programs. This proposed decrease is primarily due to a reduction of 425 pys in the Employment Development Department, and is attributable to a variety of factors. These include automation of the unemployment insurance (UI) and tax accounting programs, program transfers to other departments, workload changes in the UI program, and program terminations. Staffing cuts proposed for the state hospitals operated by the Department of Developmental Services account for an additional reduction of 360 pys, reflecting further implementation of the administration's efforts to "contract-out" laundry and housekeeping duties.

These decreases are partially offset by increases in two areas. First, the Department of Mental Health shows an increase of 217 pys, primarily due to the full-year effect of the Mentally Disordered Offender program added in the current year. Second, the Department of Health Services proposes to add 113 pys for toxics programs.

Business, Transportation and Housing. The budget proposes to increase staffing in this area by 520 pys, or 1.6 percent, over the estimated current year level. Most of this increase is due to an additional 510 pys in the Department of Transportation. Of these 510 pys, 395 pys are to increase the department's capability to plan, design and engineer highway capital outlay projects. The remaining 115 pys are for highway maintenance (43 pys), operations (28 pys), closing out the accounts of completed highway capital outlay projects (34 pys), and various other workload increases. The budget also proposes to add 110 pys to the California Highway Patrol for increased workload and program enhancements.

Higher Education. The budget proposes an increase of 1,220 pys, or 1.3 percent, above the current year level. The main factor pushing up staffing is increased enrollments. The University of California's (UC) budget proposes a net increase of 451 pys, due to enrollment growth of 2,900 full time equivalent (FTE) students. The budget for the California State University proposes a net increase in staffing of 751 pys, related to enrollment growth of 5,995 FTE students.

Youth and Adult Corrections. The state's correctional programs account for the most significant staffing increases in the budget year, as they have in the preceding four years. Since 1985–86, the last year for which actual data are available, staffing for this function has increased by 7,411 pys, or 39 percent. The budget proposes to increase the Department of Corrections' staffing by 2,126 pys, or 10 percent, in 1987–88. 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 will have an increase of 58 pys in 1987–88, largely because of an increase in the ward population and the opening of new living units within existing facilities in the budget year.

Resources. The budget proposes to increase staffing in this area by 326 pys, or 2.3 percent, in 1987–88. Workload and implementation of legislation, rather than new initiatives in the budget, account for the bulk of these increases. For example, an additional 86 pys are allocated to the Department of Conservation to implement new container recycling legislation.

PERSONNEL-YEARS IN HISTORICAL PERSPECTIVE

As with last year's budget, the Governor's Budget for 1987–88 does not place a great deal of emphasis on limiting the size of the state's work force. Since the Legislature enacted the 1986 Budget Act, the size of the work force has grown by 6,515 pys in the current year and would grow by an additional 4,372 pys in the budget year if the Governor's proposals are approved. This amounts to a two-year increase of 10,887 pys, or 4.7 percent. Increases in just one department, the Department of Corrections, account for 6,940 pys, or 64 percent of the total two-year change.

Table 30 summarizes the trends in state staffing since 1981–82. The table shows that state staffing has experienced large decreases (1,794 pys in 1983–84), large increases (6,515 pys in the current year), and smaller changes (in other years). The state's work force will increase by 11,714 pys, or 5 percent, during the period 1981–82 through 1987–88, if the budget proposals are realized.

Table 30 also reveals that:

- The revised estimate of the state's work force in the current year is 6,515 pys larger than what the work force actually was in 1985–86.
- The staffing level proposed by the Governor for 1987–88—240,527 pys—represents the largest request for staffing during the past seven years, and, in fact, is the largest in the state's history.

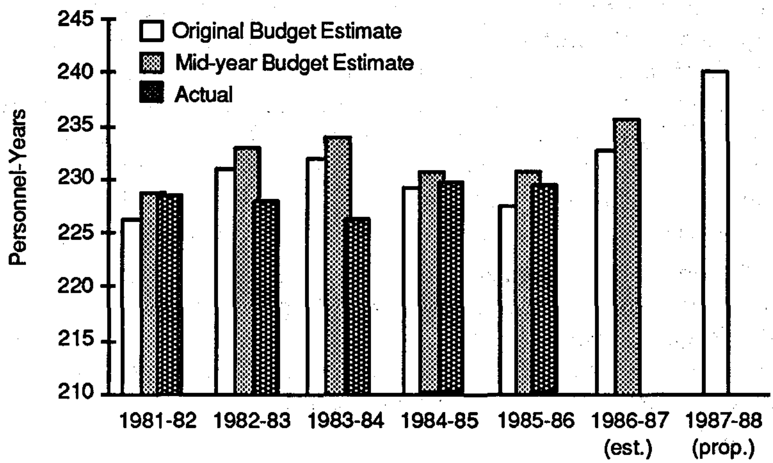
Table 30
State Personnel-Years [a]
1981–82 through 1987–88

	Proposed in Budget	*Subsequent Change*	*Actual*	*Change From Prior Year*
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	1,753	229,641	−204
1986–87	233,098	3,058 [b]	236,156 [b]	6,515 [b]
1987–88	240,527	—	—	4,372 [c]

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.
[b] Estimated.
[c] Proposed.

Chart 28

Trends in State Employment Estimates
1981-82 through 1987-88 (in thousands)



Personnel-Year Estimates

Chart 28 illustrates that three patterns we identified two years ago 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 pys in recent years tend to overstate the actual number of pys that will be worked, and (3) inflated midyear estimates make the number of pys proposed in the budget year look smaller.

Proposed Versus Midyear Estimates. Chart 28 shows that, in each of the last six years, the midyear estimate of the total state work force has been significantly higher than what the original budget for that year proposed. There are two reasons for this: (1) the administration and the Legislature typically increase staffing levels during the course of deliberations on the budget, and (2) the administration typically creates new positions administratively after the budget is enacted.

Midyear Estimate Versus Actual Staffing. Chart 28 shows that *every* year from 1981–82 through 1985–86 (the last year for which actual data are available), the state's actual staffing turned out to be below—in two of the five years, significantly below—the midyear estimate. As we predicted last year, the midyear estimate of 231,079 pys for 1985–86 (given in the Governor's 1986–87 budget proposal) exceeded the 229,641 pys actually worked in 1985–86 (according to the 1987–88 Governor's Budget). As in prior years, the unallocated cuts required by the administration in the 1986–87 fiscal year (absorption of merit salary adjustments, price increases, and the 2 percent cuts required by a December 1986 Executive Order) will translate for the most part into unallocated personnel reductions. Given the need for departments to intentionally hold positions vacant in order to generate additional salary savings to achieve these reductions, it is likely that the actual staffing level shown for 1986–87 in next year's budget will again be below the midyear estimate for 1986–87.

Inflated Midyear Estimates Make Budget Proposals Look Smaller. Chart 28 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 gave the appearance that the state work force was being pared back, when, in fact, the number of pys proposed for the budget exceeded the number of *actual* pys in the prior year. The Governor's last two budget proposals—1986–87 and 1987–88—have reversed this trend, by adopting a midyear estimate which is lower than the personnel level proposed for the budget year. In either case, however, the inflated midyear estimates make the budget year increase look smaller than it really is.

What Personnel-Year Changes Have Occurred Since 1983–84?

Table 31 shows the change in pys, by budget category, since 1983–84. It shows that the same four functional areas account for most of the state's work force today, just as they did in 1983–84: higher education; health and welfare; business, transportation, and housing; and youth and adult corrections. Over the four-year period, however, staffing for youth and adult corrections has grown by 71 percent, while staffing for health and welfare has decreased by 5 percent. Business, transportation and housing and higher education have remained relatively level.

Table 31

Comparison of Changes in the State's Work Force, By Function [a]
(in personnel-years)
1983–84 and 1987–88

			Change 1983–84 to 1987–88	
Program	*Actual 1983–84*	*Proposed 1987–88*	*Amount*	*Percent*
Legislative, Judicial, Executive	9,486	10,666	1,180	12.4%
State and Consumer Services	11,256	12,230	974	8.7
Business, Transportation and Housing	33,092	33,921	829	2.5
Resources	13,519	14,564	1,045	7.7
Health and Welfare	39,288	37,161	−2,127	−5.4
Youth and Adult Corrections	15,336	26,280	10,944	71.4
K-12 Education	2,548	2,736	188	7.4
Higher Education	93,092	92,422	−670	−0.7
General Government	9,079	10,548	1,469	16.2
Totals	226,695	240,527	13,832	6.1%

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.

Unallocated Reductions Overstate Personnel-Year Totals

As in past years, this year's budget requires state agencies to absorb the cost of merit salary adjustments and general price increases through "unallocated reductions" in expenditures. For fiscal years 1986–87 and 1987–88, however, departments also must absorb "Special Adjustment" reductions in addition to these unallocated reductions. These "Special Adjustment" reductions amount to 2 percent and 1 percent, of most agencies' General Fund supported operating budgets (state operations) for 1986–87 and 1987–88, respectively. A large portion of both types of unallocated reductions will be realized through increases in salary savings, as new or vacant positions are left unfilled. The effect of the "Special Adjustment" reductions is not reflected in the personnel-year totals shown in the Governor's Budget.

The failure to fund salary and price adjustments in recent budgets has already led departments to fund unavoidable cost increases by keeping more positions vacant every year. Our analysis indicates that the statewide salary savings rate has increased from 2.8 percent, or 6,744 vacant positions, in 1983–84 to 3.8 percent, or 9,471 vacant positions, proposed for 1987–88. In dollar terms, the salary savings increase is even greater, growing from a $176 million savings in 1983–84 to a $320 million savings in 1987–88. This represents an 82 percent increase during the five-year period. The proposed increase in statewide salary savings from the estimated current year level is $53 million, or 20 percent.

Given the relatively high level of salary savings built into the budget, departments will have great difficulty in meeting their salary savings targets, achieving their "Special Adjustment" reductions, *and* providing the level of services anticipated by the budget. This has significant implications for the Legislature.

Specifically, what this means for the Legislature is that it will be asked to approve department budgets for 1987–88 which do not accurately reflect the level of services to be provided. Departments, rather than the Legislature, will decide which positions to leave open, and thus, which program activities will be cut back.