The 1988-89 Budget: Perspectives and Issues

Report of the Legislative Analyst to the Joint Legislative Budget Committee

California Legislature

Hon. David Roberti
President pro Tempore of the Senate

Hon. Willie L. Brown, Jr.
Speaker of the Assembly

Members of the Committee

William Campbell, *Chairman*
Alfred E. Alquist
Robert G. Beverly
Bill Greene
Milton Marks
Nicholas C. Petris
Joseph B. Montoya

John Vasconcellos, *Vice Chairman*
William Baker
Robert Campbell
Robert C. Frazee
William Leonard
Maxine Waters
Vacancy

Elizabeth G. Hill, *Legislative Analyst*

STAFF

Elizabeth G. Hill—Legislative Analyst
John L. Vickerman—Chief Deputy
Thomas J. Dooley—Chief Deputy
Kenneth A. Carter—Deputy

Principal Program Analysts

Carol Bingham
Hal Geiogue
Michael Genest
Hadley Johnson, Jr.
Daniel P. Rabovsky
Peter W. Schaafsma
Cheryl Stewart
Mac Taylor

Gerald Beavers—Principal Capital Outlay Analyst
Randy Hodgins—Acting Principal Program Analyst
Jon David Vasche—Senior Economist

Program Analysts

Lisa Akeson
Danny Alvarez
Nancy Rose Anton
Nicholas Bartsch
Phyllis Bramson
Emily Burnstein
Marilyn E. Bybee
Laura J. Carter
Larry Castro
Gerald Concklin
Craig Cornett
Chi-Ming Dana Curry
Robert B. Egel
Susan P. Ehrlich
Judy A. Fitzgerald
Malcom H. Fleming
Jarvio Grevious
Kate W. Hansel
Julie K. Higgs
Molly Beth Hillis
David Illig
Carla Ida Javits
Andrea Kane
Joan Keegan
Wayne Keithley
Ann-Louise Kuhns
Charles Lieberman
Rachel D. Lodge
Robert Loessberg-Zahl
R. Stuart Marshall
Dana B. McPhall
Andrew Meyers
Paula A. Mishima
Robert Miyashiro
Ellen Moratti
Juliet Musso
Michael Nussbaum
Donna Watkins Olsson
Marianne O'Malley
Harry Osborne
Carlos J. Palacios
Sunghie Park
Rick Pratt
Susanne Ragen
Deborah A. Reidy
Raymond M. Reinhard
Sarah L. Reusswig
Vic Roberson
Steve Shea
Arnold M. Sowell, Jr.
Mark D. Taylor
Anna Trombettas
Robert Turnage
Gary L. Turner
Patricia Varga
Ellen Venturino
Paul Warren
Michael Zelner
Margaret Zentner

Information Processing

Wil Davies, Manager

Phillip R. Dyer
Suki O'Kane
Carol Johnson

Administrative Assistants

Helen Blanas
Jean Fernlund
Carol Perrin

Support Staff

Victoria Albert
Judy Cashner
Nancy Concklin
Marilyn J. Davis
Lyndall I. Duffy
Tanya Elkins
Kerryn Marie Fleeman
Susanne B. Fox
Lynn Kiehn
Nona Kimmel
Kimberly Lusk
Frank E. Marez
Monica M. Martin
Lenora Martinez
Maria Ponce
Michael Kent Read
Senita Robinson-Taylor
Ignacio Salinas
Patricia L. Skott
Kelly Smith
Jim Stahley
Diana L. Stuller

CONTENTS

	Page
TABLES	v
CHARTS	vii
INTRODUCTION	1
PART ONE:	
STATE FISCAL PICTURE	5
Revenues, Expenditures and the State's Reserve Fund	7
Turbulent General Fund Disguised by Smooth Bottom Line	8
General Fund Condition for 1988–89	10
Highlights of the 1988–89 Budget	11
PART TWO:	
PERSPECTIVES ON THE 1988–89 BUDGET	15
Expenditures in 1988–89	17
Total State Spending Plan	17
How is the Money Spent?	26
How Are Spending Levels Determined?	30
What Priorities Are Reflected in the Governor's Budget?	35
The State's Appropriations Limit	38
Resources in 1988–89	41
I. Revenue Resources in 1988–89	41
Summary of the Revenue Outlook	42
Economic Assumptions Underlying the Revenue Forecast	46
Detailed View of the Revenue Forecast	54
A. The Forecast for General Fund Revenues	56
B. The Forecast for Special Fund Revenues	70
C. California State Lottery Revenues	73
Reliability of the Revenue Forecasts	75
II. Borrowed Resources in 1988–89	78
Short-Term Borrowing in 1988–89	78
Long-Term Borrowing in 1988–89	80
III. Resources Foregone to Fund Tax Expenditures in 1988–89	86
PART THREE:	
MAJOR FISCAL ISSUES FACING THE LEGISLATURE	91
The Health Services "Safety Net"	93
State Programs to Help the Homeless	109
The Allocation of Home-to-School Transportation Funds	127
Funding for State-Mandated Local Programs	137
The Greater Avenues for Independence (GAIN) Program	143
Meeting the Costs of Federal Immigration Reform	161
A Status Report on Proposition 65—The Safe Drinking Water and Toxic Enforcement Act of 1986	177
The State Impact of Increasing the Minimum Wage	189
State Transportation Policies	194
The Impact of Demographic Changes on California	205
State Programs for Older Californians	217

TABLES

Part One: State Fiscal Picture — *Page*

1. General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties (SFEU), 1984–85 through 1988–89 8
2. Change in General Fund Condition, Governor's Budget Estimates, 1986–87 and 1987–88 8

Part Two: Perspectives on the 1988–89 Budget

3. Special Fund Expenditures by Function, 1986–87 through 1988–89 20
4. Selected Bond Fund Expenditures by Function, 1986–87 through 1988–89 21
5. General Obligation Bond Issues and Expenditures, Proposed in 1988–89 Budget 24
6. Federal Funds Changes, by Program, 1987–88 and 1988–89 25
7. The State's Work Force, by Function (All Funds), 1986–87 through 1988–89 27
8. Major Local Assistance Program, Providing Aid to Individuals, 1986–87 through 1988–89 29
9. Major Local Assistance Programs, Providing Aid to Local Governments, 1986–87 through 1988–89 30
10. General Fund Cost-of-Living Increases, 1987–88 and 1988–89 32
11. Estimated General Fund Program Changes, 1987–88 and 1988–89 35
12. State's Situation With Regard to Its Appropriations Limit, Governor's Budget Estimates, 1987–88 and 1988–89 39
13. Revenue Summary, General Fund and Special Funds, 1986–87 through 1988–89. 42
14. Department of Finance Economic Outlook for California and the Nation, 1987 through 1989 46
15. Accuracy of Economic Forecasts for California in 1987 47
16. Comparisons of Different Economic Outlooks for 1988 53
17. State Revenue Collections, 1986–87 through 1988–89 54
18. Potential Adjustments to the Department of Finance's Revenue Estimates 76

Part Three: Major Fiscal Issues Facing the Legislature

19. California's "Safety Net" Funding, 1985–86 through 1987–88 96
20. Characteristics of the Homeless Population, Three California Counties 110
21. State Programs for the Homeless, 1987–88 and 1988–89 114
22. Federal McKinney Act Allocations to California, FFY 1987 and FFY 1988 122
23. GAIN Expenditures and Funding Sources, 1987–88 and 1988–89 146
24. Comparison of GAIN Full Implementation Costs and Funding Sources in 1991–92, As Estimated in January 1986 and January 1988 149
25. Increase in Estimated Costs Per GAIN Registrant, At Full Implementation 150
26. GAIN Caseloads at Full Implementation, January 1986 and January 1988 Estimates 152
27. Increase in GAIN Unit Costs at Full Implementation 154
28. Federal SLIAG Funds, Availability and Proposed Expenditures, 1987–88 through 1991–92 164
29. Potential Costs Eligible for SLIAG Funding That Are Not Included in the Governor's Plan, 1988–89 Costs 168
30. Total SLIAG Funding, New Services and Base Funding, 1987–88 through 1991–92 169
31. Proposition 65, Funding by Agency and Activity, 1987–88 179
32. State Programs Affected by the Higher Minimum Wage, Potential 1988–89 General Fund Cost Impact 190

Page

33. Programs Available to Older Californians, By Eligibility Type, 1987–88 and 1988–89 220
34. Summary of Services Available to Older Californians by Program Type, 1987–88 and 1988–89 224
35. Real Expenditures for Major Programs Provided to Older Californians, Selected Years 225

CHARTS

Part One: State Fiscal Picture *Page*

1. Comparison of General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties (SFEU), 1984–85 through 1988–89 7

Part Two: Perspectives on the 1988–89 Budget

2. Total State Spending Plan 17
3. Annual Percentage Change in General Fund Expenditures, 1984–85 through 1988–89 18
4. 1988–89 General Fund Expenditures by Function and Category 19
5. 1988–89 Special Fund Expenditures by Function and Category 20
6. 1988–89 Selected Bond Fund Expenditures by Function and Category 22
7. Distribution of 1988–89 State Operations Budget, General Fund and Special Funds Only 27
8. Resources for Funding the 1988–89 Total State Spending Plan 41
9. Trends in State Revenues, 1976–77 through 1988–89 43
10. Key Factors in the 1988 Economic Outlook 45
11. Trends in U.S. Stock Market Prices, 1985 through 1987 48
12. Trends in Key National Economic Variables, 1977 through 1989 49
13. Trends in the U.S. Foreign Trade and Budget Balances, 1960 through 1989 50
14. Annual Growth in California Personal Income, 1977 through 1989 51
15. Trends in California's Employment and Unemployment, 1977 through 1989 52
16. 1988–89 General Fund Revenues, by Source 56
17. Estimated Revenue Effects of State Tax Reform 58
18. Annual Growth in Personal Income Tax Liabilities, 1985 through 1989 Income Years 59
19. California Profits from Sales of Capital Assets, 1976 through 1989 60
20. Annual Growth in California Taxable Sales, 1977 through 1989 62
21. Ratios of California Taxable Sales and Corporate Profits to Personal Income, 1966 through 1989 62
22. Annual Growth in Taxable Corporate Profits, 1977 through 1989 65
23. Annual Growth in California Taxable Insurance Premiums, 1974 through 1988 66
24. California Per Capita Consumption of Cigarettes and Distilled Spirits, 1978–79 through 1988–89 68
25. General Fund Revenues from Interest Income, 1978–79 through 1988–89 69
26. 1988–89 Special Fund Revenues, by Source 70
27. California Gasoline Distributions, 1977 through 1989 72
28. State Oil and Gas Royalties, 1981–82 through 1988–89 73
29. Estimated Distribution of 1988–89 State Lottery Receipts 74
30. Alternative General Fund Revenue Forecasts for 1987–88 and 1988–89 77
31. General Fund Revenues, Costs and Net Profits from Short-Term Borrowing 79
32. State General Fund Bonds 82
33. General Fund Debt Service and Related Borrowing Costs as a Percent of State Expenditures, 1980–81 through 1988–89 83
34. Identifiable Revenue Losses from State Tax Expenditures, 1988–89 87

Part Three: Major Fiscal Issues Facing the Legislature

35. Per Capita Inpatient/Outpatient Expenditures, Selected Counties, 1984–85 and 1986–87 100
36. Per Capita Net Inpatient/Outpatient Expenditures, Selected Counties, 1984–85 and 1986–87 100

	Page
37. Per Capita Expenditures for Health Services from County General Purpose Revenue, Selected Counties, 1984–85 and 1986–87	101
38. Percent of General Purpose Revenue Budgeted for Health Services, Selected Counties, 1983–84 and 1985–86	101
39. Home-To-School Transportation Program, Legislative Analyst's Rating of Alternative Funding Formulas, by Criterion	134
40. Status of GAIN Implementation by County, as of February 1988	144
41. Statutory Participation Restrictions for GAIN by Order of Exclusion	147
42. GAIN Costs Over Time, Initial and Current Estimates of Program Costs, 1986–87 through 1992–93	148
43. Uses of SLIAG Funds, Governor's "Total Cost" Proposal, 1987–88 through 1994–95	174
44. Uses of SLIAG Funds, "New Cost" Alternative, 1987–88 through 1994–95	174
45. California Population Totals and Average Annual Growth Rate, 1940–2000	207
46. California Population Growth by Region, 1980–2000	207
47. Population Increases by Ethnicity, 1980–1990 and 1990–2000	209
48. Population Changes by Age, 1980–1990 and 1990–2000	212
49. State Agencies That Provide Services and Benefits to Older Californians	218
50. Changes in Real Expenditures for Major Senior Programs Compared to Changes in Senior Population, 1980–81 through 1988–89	227

INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1988 Budget Act. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 1988-89 and (2) identifying some of the major issues now facing the Legislature. Many of these issues are long-range in nature. Even in these cases, however, legislative action during 1988 is warranted since the Legislature generally will have a wider range of options for addressing these issues now than it will have in subsequent years. As such, this document is intended to complement the *Analysis of the 1988-89 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 1988-89 Budget: Perspectives and Issues is divided into three parts.

Part One, "State Fiscal Picture" provides a perspective on the state's fiscal situation by discussing the state's current General Fund condition.

Part Two, "Perspectives on the 1988-89 Budget" presents data on both expenditures and the resources used to fund those expenditures. With regard to the state's spending plan, this part summarizes how funds would be allocated to various categories and how proposed spending differs from the current year. With regard to resources, it describes the state's major funding sources and evaluates the administration's economic and revenue forecasts.

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 1988-89. Wherever possible, our analysis identifies options which the Legislature may wish to consider in addressing these issues. The issues in this part fall into three categories: (1) reviews of specific programs or policy issues (such as, the state's health care "safety net" and the home-to-school transportation program); (2) issues requiring important budget-year implementation decisions (for example, the Greater Avenues for Independence (GAIN) program and the allocation of federal immigration reform monies); and (3) discussions of issues aimed at assisting the Legislature in its longer-range planning (such as, state transportation policies).

PART ONE

State Fiscal Picture

Part One

STATE FISCAL PICTURE

The Governor's Budget for 1988-89 anticipates continued moderate growth in the California economy. On this basis, the budget projects that revenue collections will be sufficient to fund normal workload increases and statutory requirements, as well as provide the funds to address certain other state priorities. As in recent years, the proposed revenue and expenditure programs would leave the state with an unrestricted reserve of about $1 billion.

In terms of inflation-adjusted (real) purchasing power, the level of General Fund revenues will be 3 percent higher than the level estimated for the current year, while the proposed level of General Fund expenditures will be 3.6 percent higher. The state's constitutional limit on appropriations will be 3.2 percent higher in real terms. The budget indicates that the projected level of state revenues will place the state $24 million below its appropriations limit for 1988-89.

In this part, we provide a brief overview of the condition of the General Fund in the current and budget years. We also discuss reasons for changes in the state's fiscal outlook since the last Governor's Budget. Finally, this section presents some highlights of the 1988-89 budget.

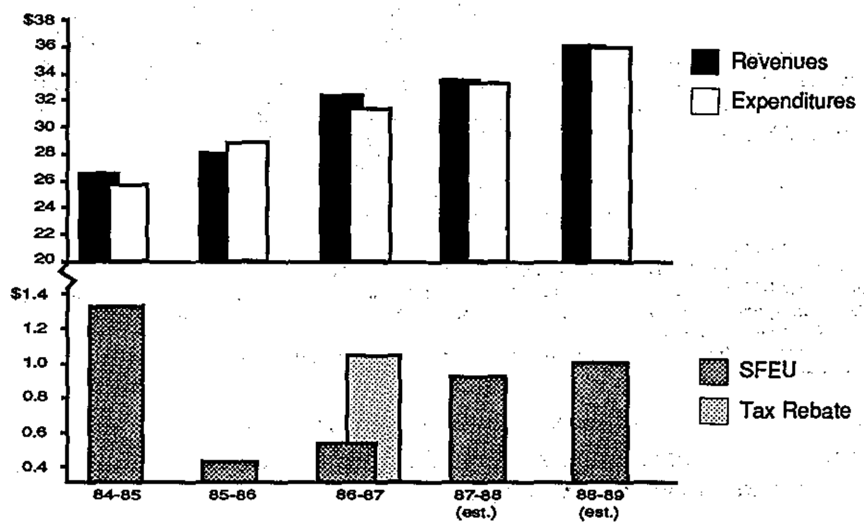
Revenues, Expenditures, and the State's Reserve Fund

Table 1 provides information on annual General Fund revenues, expenditures and the end-of-year balance, beginning with 1984-85. Trends in General Fund revenues, expenditures, and the state's reserve fund (the Special Fund for Economic Uncertainties [SFEU]) also are illustrated in Chart 1.

Chart 1

Comparison of General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties (SFEU)

1984-85 through 1988-89 (in billions)



The chart shows that General Fund revenues have exceeded General Fund expenditures in three of the last four years, and are projected to do so again in the budget year. In 1985-86, however, expenditures exceeded revenues by about $760 million. This required that the SFEU be drawn down to make up the difference. In 1986-87, the state collected approximately $1 billion more in General Fund revenues than was used to finance General Fund expenditures. As the state did not have "room" within its limit to spend these additional monies, it was constitutionally required to return these revenues to the taxpayers (the total tax rebate was $1.1 billion).

The Governor's Budget estimates that revenues will exceed expenditures by $335 million in 1987-88, producing a large increase in the SFEU. If the Governor's estimates of 1988-89 revenues and expenditures turn out to be accurate, General Fund revenues will exceed expenditures by $148 million.

According to the budget document, the Governor's spending program for 1988-89 would leave the General Fund with an unrestricted balance of approximately $1.1 billion on June 30, 1989—up from $935 million at the end of the current year. These funds would be retained in the SFEU as protection against unanticipated declines in General Fund revenues and unforeseen increases in expenditures (like the major earthquake which struck California in 1987).

Table 1
General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties (SFEU) [a,b]
1984-85 through 1988-89
(dollars in millions)

	Actual 1984-85 [c]	*Actual 1985-86*	*Actual 1986-87* [d]	*Estimated 1987-88* [d]	*Proposed 1988-89* [d]
Prior-year resources	$531	$1,448	$714	$626	$962
Revenues and transfers	26,606	28,227	32,519	33,678	36,249
Expenditures	25,736	28,988	31,469	33,343	36,101
General Fund balance	$1,400	$686	$1,764	$962	$1,110
Reserves [e]	(63)	(243)	(78)	(27)	(20)
Tax rebate	—	—	(1,138)	—	—
SFEU	(1,337)	(443)	(548)	(935)	(1,090)

[a] Source: State Controller.
[b] Detail may not add to totals due to rounding.
[c] Data for 1984-85 are not strictly comparable with subsequent years due to Generally Accepted Accounting Principles (GAAP)-related adjustments reflected in those latter years.
[d] Source: Governor's Budget.
[e] Includes unencumbered balance of continuing appropriations and Disaster Response-Operations Account.

Turbulent General Fund Disguised by Smooth Bottom Line

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
Governor's Budget Estimates
1986-87 and 1987-88
(dollars in millions) [a]

	1986-87 General Fund Condition			*1987-88 General Fund Condition*		
	January 1987 (Est.)	*January 1988 (Actual)*	*Effect on 1986-87 Balance*	*January 1987 (Proj.)*	*January 1988 (Est.)*	*Effect on 1987-88 Balance*
Beginning resources	$686	$714	$28	$561	$626	$65
Revenues and transfers	30,765	32,519	1,754	31,742	33,678	1,936
Expenditures	30,890	31,469	−579	31,264	33,343	−2,079
General Fund balance	$561	$1,764	$1,203	$1,040	$962	−$78
Reserves [b]	10	78	−68	14	27	−13
Tax rebate	—	1,138	−1,138	—	—	—
Unrestricted balance	$551	$548	−$3	$1,026	$935	−$91

[a] Detail may not add to totals due to rounding.
[b] Includes unencumbered balance of continuing appropriations and Disaster Response-Operations Account.

1986-87. Last year at this time, the Governor's Budget projected that the state would end 1986-87 with an unrestricted balance of $551 million in the General Fund. The 1988 Governor's Budget indicates that the actual balance was $548 million, or $3 million less than what was estimated one year ago. However, this apparently "on-target" projection disguises the major changes that took place in General Fund expenditures and revenues.

Specifically, Table 2 shows that General Fund revenues collected in 1986-87 were almost $1.8 billion higher than estimated in the budget one year ago. Over $700 million of this increase appears to be due to unanticipated gains from the federal Tax Reform Act of 1986. Among other things, this legislation gave taxpayers incentives to report capital gains income in 1986 that otherwise would not have been reported until 1987 or thereafter. Most of the remaining $1.1 billion of the 1986-87 revenue gain appears to have occurred because of stronger-than-expected economic performance during 1987 and a stronger underlying trend in the realization of capital gains income than was previously recognized.

Table 2 also shows why this substantial increase in General Fund revenues did not result in a large increase in the state's unrestricted balance. First, about $1.1 billion of the unanticipated revenue increase was declared "excess" under the terms of Article XIII B of the California Constitution, and returned to taxpayers. The Legislature passed and the Governor approved legislation in 1987 (Ch 908/87 and Ch 915/87) accomplishing this tax rebate.

Second, General Fund expenditures in 1986-87 were roughly $580 million *higher* than the level predicted in the Governor's Budget one year ago. These increases primarily reflect: (a) additional deficiencies of $135 million for Medi-Cal, $67 million for various social services programs, and $122 million for K-12 education; (b) lower-than-budgeted "unidentified" savings ($112 million); and (c) the cost of legislation ($53 million) to restore funding for Small School District Transportation, Urban Impact Aid, and Meade Aid.

Thus, the tax rebate and higher expenditures offset the large increase in General Fund revenues in 1986-87. Table 2 shows that the net result of these changes is that the unrestricted balance in the General Fund remained virtually unchanged.

1987-88. Last year at this time, the Governor's Budget projected that the state would end 1987-88 with an unrestricted balance of $1,026 million in the General Fund. The 1988 Governor's Budget now estimates the balance at $935 million, or $91 million less than what was projected one year ago. As in 1986-87, however, substantial changes in revenue and expenditure estimates have occurred since the Governor's last budget. Specifically, 1987-88 revenue projections are now $1.9 billion *higher* than projected in January 1987, and expenditure projections are now $2.1 billion *higher* than projected at that time.

The large increase in General Fund revenues primarily reflects: (a) significantly stronger-than-expected 1987 economic activity; (b) greater-than-expected reporting of capital gains, due both to an upward revision in the underlying trend for these gains and the large stock sell-off that occurred in October 1987; and (c) the Legislature's rejection of the administration's county health services disengagement proposal presented in last year's budget (if adopted, this proposal would have reduced 1987-88 General Fund revenues by $477 million).

The large increase in General Fund expenditures primarily reflects: (a) additional expenditures for health, welfare, and education programs totaling over $1 billion which were added to the budget at the time of the May revision; (b) the rejection of the Governor's county health services disengagement proposal (which would have reduced General Fund expenditures by $477 million); and (c) over $230 million in legislation passed by the Legislature and approved by the Governor in 1987.

General Fund Condition for 1988-89

The Governor's Budget projects that 1988-89 General Fund revenues and transfers will total $36.2 billion, which is an increase of $2.6 billion, or 7.6 percent, over 1987-88 estimated revenues. The budget proposes 1988-89 General Fund expenditures of $36.1 billion, which is an increase of $2.8 billion (8.3 percent) over 1987-88 expenditures. If the budget's estimates of revenues and expenditures for 1988-89 turn out to be accurate, the excess of revenues over expenditures ($148 million) would bring the balance in the Special Fund for Economic Uncertainties up to $1.1 billion, or 3 percent of General Fund expenditures.

Consistent with past years, the largest expenditure increase in 1988-89 is proposed for education, which would gain $1.3 billion, or 7.6 percent, in additional General Fund support. Of this amount, $918 million would go to K-12 educational programs. The budget also provides an additional $847 million for health and welfare programs, which represents an 8 percent increase over the amount provided for these programs in 1987-88. In addition, youth and adult correctional programs receive additional General Fund support of $237 million in 1988-89, which is a 12 percent increase over the amount provided in 1987-88 for these programs.

As we discuss in Part Two of this volume, there is a greater-than-normal amount of uncertainty about the future course of the economy. Our analysis indicates that this year's revenue estimates are subject to a much-larger-than-normal margin of error and could change significantly, depending on the performance of the economy. Further, the last two years show that major increases in expenditure levels can occur from one year's budget to the next. Given the considerable uncertainty that characterizes the proposed budget's estimates of revenues and expenditures, the General Fund's end-of-year balance could vary considerably from the level estimated in the budget.

Highlights of the 1988-89 Budget

The 1988-89 budget contains numerous proposals which will be of interest to the Legislature. The following are some highlights of the Governor's Budget by program area:

Education

- Fully funds workload growth for education programs, as measured by average daily attendance (ADA) for K-12 and community college programs, and by full-time equivalents (FTE) for the University of California (UC) and the California State University (CSU).
- Fully funds educational statutory COLAs.
- Funds half-year faculty salary increases — 3 percent at UC and 4.7 percent at CSU.
- Sets aside funds for the Urban Impact and Meade Aid programs, pending the report of the task force established pursuant to Ch 1137/87.
- Proposes a $700 million general obligation (GO) bond issue to finance capital improvements for the state's segments of higher education.
- Proposes two GO bond issues totaling $1.6 billion for construction and modernization of K-12 school facilities.
- Increases General Fund support for the Cal-Grant program by $15 million, providing a 24 percent increase in awards to students attending private colleges and universities.

Health

- Fully funds statutory and some discretionary COLAs.
- Expands the Alternative Rate Model (ARM) for residential care facilities serving the developmentally disabled.
- Proposes a $200 million GO bond issue for clean-up of toxic substances.

Welfare and Employment

- Increases General Fund support for the Greater Avenues for Independence (GAIN) program from $108 million in 1987-88 to $245 million in 1988-89, a 127 percent increase from last year's level of support, but does *not* fully fund the cost of this program in the budget year.
- Fully funds statutory COLAs.

Criminal Justice

- Includes new state funding for the Trial Court Funding Act of about $375 million.
- Is silent on the amount of a new bond issue for prisons.

Transportation

- Increases Caltrans work force by almost 1,200 personnel-years for various transportation projects.
- Proposes a GO bond issue of $1 billion for construction of transportation facilities.

Resources

- Proposes two GO bond issues totaling $400 million for clean water and safe drinking water.

General Government

- Proposes a general employee compensation increase of up to 4 percent, effective January 1, 1989.

PART TWO

Perspectives on the 1988-89 Budget

Part Two

PERSPECTIVES ON THE 1988-89 BUDGET

This part of our analysis provides perspectives on the Governor's Budget for 1988-89. It consists of two major sections:

- ***Expenditures.*** This section presents an overview of the spending plan proposed in the Governor's Budget. It discusses the level of proposed expenditures and the factors which determine this level, the major components of the budget, the priorities reflected in the budget, and the major program changes proposed in the budget. It also identifies some potential state expenditures that are not funded in the Governor's spending plan.
- ***Revenues.*** This section discusses where the money will come from that is needed to fund the expenditures proposed in the budget. Specifically, it reviews and evaluates the budget's revenue estimates and the economic assumptions underlying them, and discusses how revenues would be affected by alternative assumptions about economic performance. It also identifies the amount of money to be raised by selling bonds, and the amount of revenues that will be foregone in order to fund "tax expenditures."

Expenditures in 1988-89

TOTAL STATE SPENDING PLAN

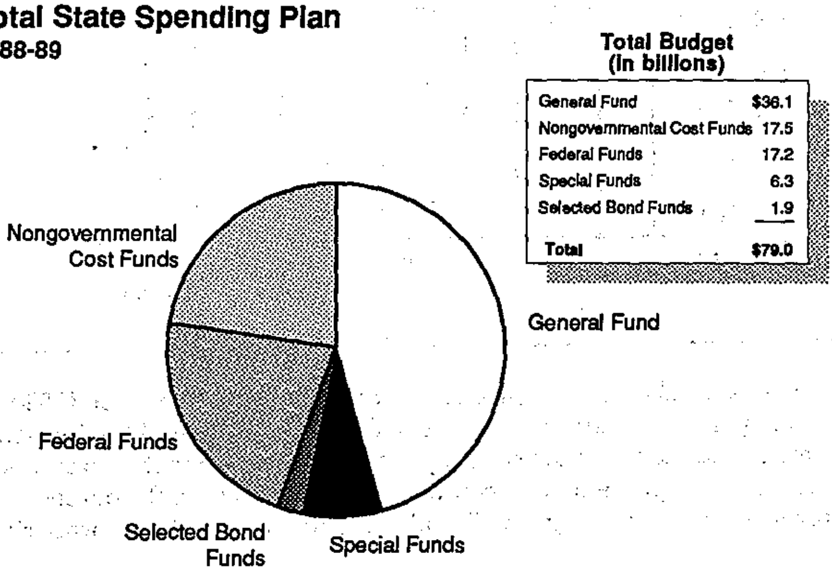
The Governor's Budget for 1988-89 proposes total expenditures of $79 billion. This amount represents a 4.9 percent increase over last year's total spending plan and includes:

- $36.1 billion in expenditures from the *General Fund*, which represents an increase of 8.3 percent over 1987-88;
- $6.3 billion in expenditures from *special funds*, which represents an increase of 1.7 percent over 1987-88;
- $17.2 billion in expenditures from *federal funds*, which represents an increase of 7 percent over 1987-88;
- $17.5 billion in expenditures from various *nongovernmental cost* funds, which include funds established for retirement, working capital, public services enterprise, and other purposes; and
- $1.9 billion in expenditures from *selected bond funds*.

Chart 2 shows the relative distribution of the $79 billion in total expenditures by funding source. As shown, expenditures from the General Fund amount to almost half (46 percent) of total state expenditures. Looking just at "governmental expenditures" (that is, spending from all fund types except nongovernmental cost funds), the General Fund's share is even higher—59 percent.

Chart 2

Total State Spending Plan
1988-89



Total Budget (In billions)

General Fund	$36.1
Nongovernmental Cost Funds	17.5
Federal Funds	17.2
Special Funds	6.3
Selected Bond Funds	1.9
Total	$79.0

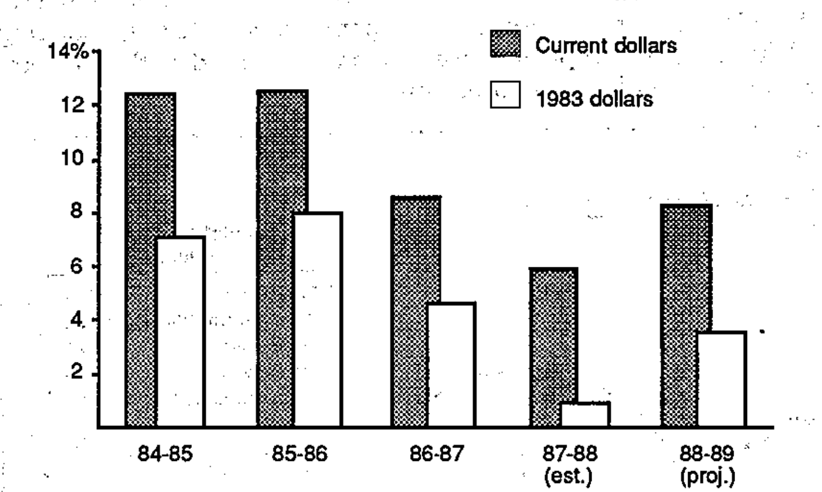
General Fund Expenditures

The state's General Fund receives the bulk of the state's tax revenues, and is the most sensitive to changes in economic conditions. The proposed increase of 8.3 percent for General Fund expenditures in 1988-89 reflects the budget's projection that the state's economy will continue to grow at a moderate pace, allowing significant "real" growth in the state's expenditures.

Chart 3 shows the growth trend in recent General Fund expenditures on an annual percentage basis, both in terms of "current dollars" (amounts as they appear in the budget) and "real dollars" ("current dollars" adjusted for the effect of inflation since 1983). Comparing growth rates in terms of "real dollars" allows expenditure growth rates in different years to be compared on a common basis.

Chart 3

Annual Percentage Change in General Fund Expenditures
1984-85 through 1988-89



As the chart indicates, the proposed General Fund budget for 1988-89 will be 8.3 percent greater in current dollars than estimated for 1987-88. In terms of real dollars, however, the General Fund budget is proposed to increase by 3.6 percent. This compares to an increase of 0.9 percent in real terms for the current year. This higher growth for 1988-89 primarily reflects two factors: (1) the relatively higher cost-of-living adjustments provided in the budget year; and (2) the implementation of the Trial Court Funding program, which involves approximately $375 million in new state monies for the superior, municipal, and justice courts.

General Fund Expenditures by Function and Category

Chart 4 shows the major components of the General Fund budget, by function and category.

As usual, more than half (53 percent) of the General Fund expenditures proposed in the budget are for educational programs and about one-third are for health and welfare programs (32 percent). The remaining expenditures are proposed in the areas of youth and adult corrections (6 percent), tax relief (2.5 percent), resources (1.9 percent), and all other (5.2 percent).

Chart 4

1988-89 General Fund Expenditures by Function and Category

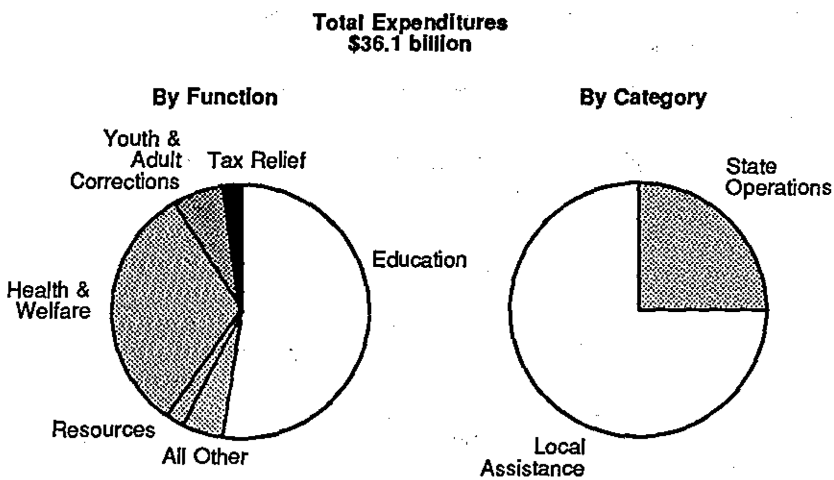


Chart 4 also shows the distribution of General Fund expenditures between state operations—25 percent, and local assistance—75 percent. In addition, a very small amount ($442,000, or about 1/1000 of 1 percent) is proposed for capital outlay projects. The budget proposes General Fund expenditures for state operations of $9.1 billion in 1988-89, which is $633 million, or 7.4 percent, greater than the level provided for this category in 1987-88. General Fund expenditures for local assistance are proposed at $27 billion in 1988-89, which is $2.1 billion, or 8.5 percent, greater than estimated 1987-88 expenditures.

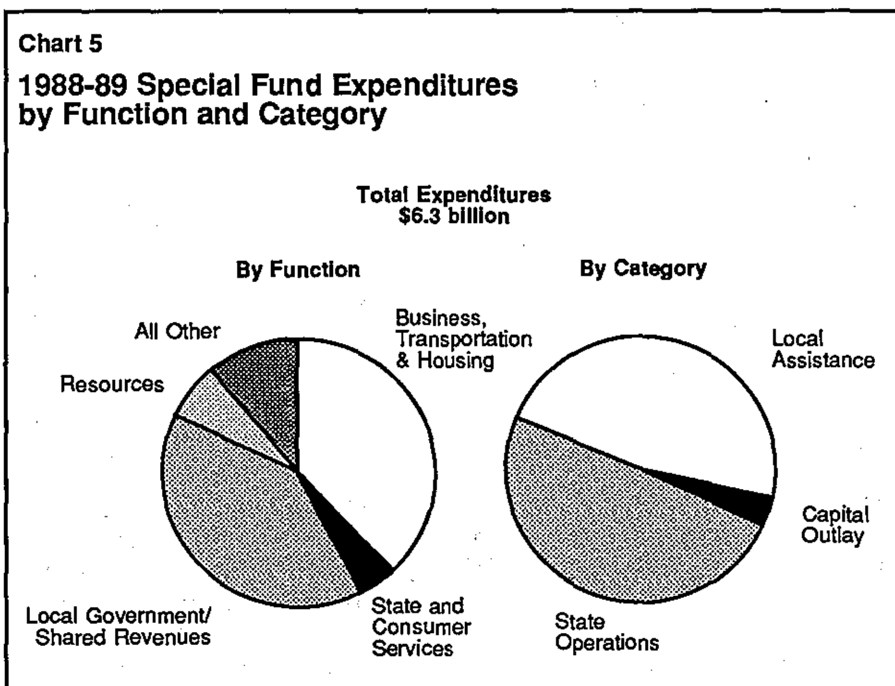
Special Fund Expenditures

The budget proposes special fund expenditures of $6.3 billion in 1988-89, which is an increase of $102 million, or 1.7 percent, over the current-year level. Table 3 shows the major components of the special fund budget, and Chart 5 shows the relative distribution of these funds by function and category.

Table 3
Special Fund Expenditures by Function [a]
1986-87 through 1988-89
(dollars in millions)

				Change From 1987-88	
	Actual 1986-87	*Estimated 1987-88*	*Proposed 1988-89*	*Amount*	*Percent*
Function					
State and consumer services	$206.5	$260.9	$282.5	$21.6	8.3%
Business, transportation, and housing	2,199.5	2,207.8	2,376.7	168.9	7.7
Resources	232.2	460.2	424.4	−35.8	−7.8
Local government/shared revenues	2,232.9	2,389.0	2,513.2	124.2	5.2
All other	778.3	839.8	663.1	−176.6	−21.0
Totals	$5,649.5	$6,157.6	$6,259.9	$102.3	1.7%

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



Local Government/Shared Revenues. The largest item in the state's special fund budget is the Shared Revenues program, which accounts for $2.5 billion (or 40 percent) of the $6.3 billion total. The revenues which support this program are derived primarily from taxes and fees levied on motor vehicles and motor vehicle fuels. These revenues are collected by the state and apportioned to local governments on the basis of statutory formulas.

The largest single source of shared revenues is the motor vehicle license fee (VLF), which accounts for $1.8 billion of the $2.5 billion in shared revenues. The VLF is imposed annually on motor vehicles on the basis of market value and is apportioned to cities and counties for general purposes according to population.

Business, Transportation and Housing. The second largest component of the 1988-89 special fund budget is for business, transportation and housing programs, which account for 38 percent of the total. The Governor's Budget proposes expenditures in this area of $2.4 billion, an increase of $169 million, or 7.7 percent, above the current-year level. Much of the proposed increase in expenditures is to fund additional state staff in the Department of Transportation for the planning, design and engineering of highway projects.

The bulk of these special funds comes from: (1) a nine cent per gallon tax on gasoline and diesel fuel; and (2) various user fees, primarily truck weight fees, motor vehicle registration fees, and driver's license fees. Most of these funds go to support the Department of Transportation, the California Highway Patrol and the Department of Motor Vehicles.

Selected Bond Fund Expenditures

The budget proposes selected bond fund expenditures of $1.9 billion in 1988-89, which is a decrease of $463 million, or 19 percent, from the current-year spending identified in the budget. Table 4 shows the proposed 1988-89 selected bond fund expenditures by function, and Chart 6 illustrates the relative distribution of these expenditures by function and category.

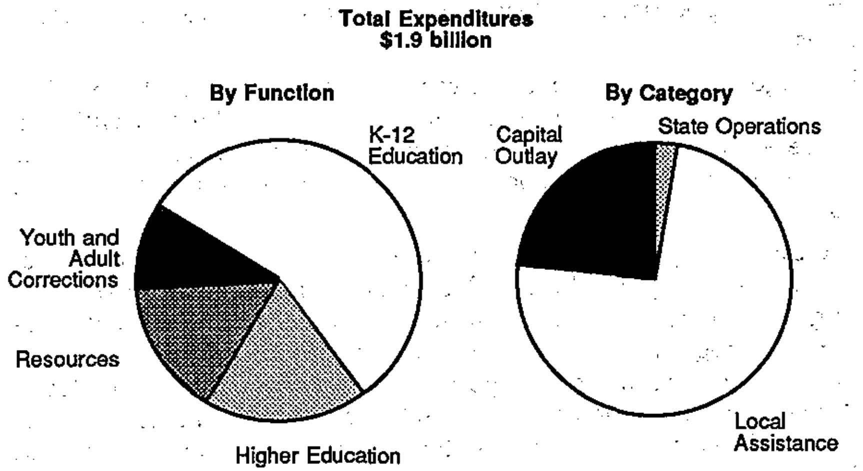
Table 4
Selected Bond Fund Expenditures by Function [a]
1986-87 through 1988-89
(dollars in millions)

Function	Actual 1986-87	Estimated 1987-88	Proposed 1988-89	Change From 1987-88 Amount	Change From 1987-88 Percent
K-12 education	$400.0	$600.0	$1,000.0	$400.0	66.7%
Higher education	0.6	386.0	345.7	−40.3	−10.4
Resources	186.3	474.2	302.2	−171.9	−36.3
Youth and adult corrections	374.4	938.3	288.3	−650.0	−69.3
Unallocated capital outlay	—	1.0	0.5	−0.5	−50.0
Totals	$961.3	$2,399.4	$1,936.7	−$462.7	−19.3%

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

Chart 6

1988-89 Selected Bond Fund Expenditures by Function and Category



As has consistently been the case in recent years, the budget overstates the amount of bond fund expenditures which are likely to occur in the current and budget years. The $2.4 billion estimated expenditure level for the current year would set a new record for bond fund expenditures, but this figure is not realistic. Given the delays which have been experienced by the state in bringing various bond-funded projects to the construction phase, it is not likely that this ambitious level of expenditure can be realized. Further, the estimate is based on an unrealistic assumption involving the prison construction program. As shown in Table 4, much of the increase in current-year expenditures is attributable to the prison construction program. Almost $300 million of the 1987-88 total reflects expenditures for two prisons in Los Angeles County, whose sites have not yet received final approval. One of these prisons and another in Madera County are proposed to be funded from a proposed June or November 1988 bond act, which means that expenditures from such bonds could not occur until the budget year at the earliest. Hence, the current-year total is clearly overstated.

The budget-year total is also overstated. For instance, the budget shows 1988-89 bond fund expenditures for the University of California and the California State University of $124 million each. These expenditures are proposed to be funded from 1988 bond acts, but no sales of these bonds are scheduled *until 1989-90*, and the budget does not propose to provide any short-term loans to fund the expenditures. This lack of budget-year funding means that the projects will have to be deferred until a later time. Thus, 1988-89 bond expenditures are seriously overstated.

In addition to being overstated, the budget-year total is not a good indication of the actual level of capital outlay activity which will occur in 1988-89. This is because, from an accounting perspective, certain "project commitments" are counted as bond fund expenditures even though projects will not actually commence in the budget-year (see the K-12 Education section, below).

The proposed budget-year bond fund expenditures are discussed in greater detail below.

K-12 Education. Over half of the proposed 1988-89 expenditures from selected bond funds are for K-12 education facilities. The Governor's Budget proposes that an $800 million general obligation (GO) bond authorization be placed on the June 1988 ballot and an additional $800 million be placed on the November 1988 ballot, for a total of $1.6 billion in new authorizations. Proceeds from these bonds would be deposited in the State School Building Lease-Purchase Fund for the construction, reconstruction and modernization of K-12 school facilities. The budget states that $1 billion of these funds would be transferred to eligible school districts in 1988-89. As noted earlier, however, the budget indicates that no funds will be available to finance these "expenditures" in 1988-89. Further, our analysis indicates that the "expenditures" reflected in the budget reflect only a *commitment* to provide funding for the school districts when they are ready to begin construction, rather than the actual transfer of funds. As of January 1988, no measure authorizing these bond sales had qualified for either the June or November 1988 ballot.

Higher Education. The Governor's Budget reflects 1988-89 selected bond fund expenditures for higher education totaling $346 million. These expenditures are to be funded by a proposed $700 million GO bond program to be submitted to the voters in 1988. The proposed spending includes $124 million each for the University of California and the California State University, and $51 million for the California Community Colleges. These funds would be used for several new buildings and various capital improvements. In addition, the budget also includes $24 million for removal of asbestos in various buildings at these institutions, and $23 million for instructional equipment at the California Community Colleges. Again, the budget document indicates that no funding will be made available for these "expenditures."

Resources. The Governor's Budget reflects selected bond fund expenditures for resources programs totaling $302 million for 1988-89. All of these expenditures would be made from previously approved GO bonds. Of the amount shown in the budget, $70 million would be used to provide a portion of the local match required for federal sewage plant construction funds, and $67 million would be used to assist small drinking water systems in meeting health standards. In addition, $55 million would be used to finance the acquisition and improvement of state and local parks.

Youth and Adult Corrections. The budget proposes selected bond fund expenditures totaling $288 million in 1988-89 for youth and adult correctional programs. Of this amount, $163 million would provide assistance to local governments for construction of adult correctional facilities, and $11 million would provide assistance to local governments for construction of juvenile facilities. These funds would come from GO bonds approved in 1981, 1984, and 1986. In addition, the budget proposes support and capital outlay expenditures totaling $114 million in 1988-89 for projects at new and existing correctional facilities. Of this amount, $46 million would come from an unspecified GO bond issue. The Governor's Budget does not identify either the timing of this bond proposal or the total amount to be issued.

Budget Proposes New Bond Issues of $3.9 Billion

The Governor's Budget proposes several new GO bond issues, some of which have been identified above. Table 5 identifies the complete package of bond issues proposed in the budget, as well as the amounts which the budget proposes to spend from each in 1988-89.

Table 5
General Obligation Bond Issues and Expenditures Proposed in 1988-89 Budget
(dollars in millions)

Program	*Total Amount Proposed for New Bond Acts*	*Expenditures Reflected in 1988-89 Budget*
K-12 education (total)	$1,600	$1,000
Higher education	700	346
Clean water	200	—
Safe drinking water	200	—
Toxic cleanup	200	9
Transportation	1,000	—
Youth and adult corrections [a]	—	46
Totals	$3,900	$1,401

[a] Budget does not propose a total amount for this issue, although it includes expenditures of $340 million from this source in the current and budget years.

Although the budget indicates that $1.4 billion of the bond funds will be expended in 1988-89, it does not provide any funding for debt service on these bond issues. In fact, the Department of Finance indicates that none of the proposed 1988 GO bond issues will be marketed during 1988-89. This is because the department believes that only a small amount of cash will actually be needed to fund the projects proposed in the budget during 1988-89. This small cash need will require loans from the Pooled Money Investment Account (PMIA). It is our understanding that the administration will propose such loans in the May revision.

Federal Fund Expenditures

The budget proposes $17.2 billion in federal fund expenditures in 1988-89, which is 28 percent of governmental expenditures (that is, total expenditures less spending from nongovernmental cost funds). This level of federal fund expenditures is $1.1 billion, or 7 percent, higher than the current-year level. Table 6 shows federal fund expenditures by function for 1987-88 and 1988-89, as well as the increases and decreases occurring in the individual program areas.

Table 6
Federal Funds Changes, by Program
1987-88 and 1988-89
(dollars in millions)

Program	*Estimated 1987-88*	*Proposed 1988-89*	*Change* *Amount*	*Change* *Percent*
Legislative/judicial/executive	$62.1	$55.3	−$6.8	−11.0%
State and consumer services	20.2	20.1	−0.1	−0.4
Business, transportation and housing	1,464.1	1,745.0	280.9	19.2
Resources	151.3	350.5	199.2	131.6
Health and welfare	9,577.7	10,066.4	488.7	5.1
Youth/adult corrections	1.0	1.0	—	−1.5
K-12 education	1,270.9	1,262.6	−8.3	−0.7
Higher education	2,992.9	3,163.1	170.2	5.7
Other governmental units/services	557.9	567.9	10.0	1.8
Totals [a]	$16,098.0	$17,231.8	$1,133.8	7.0%

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

The largest dollar increase, $489 million, is shown for health and welfare programs. Of this amount, almost half ($236 million) is due to increased federal funding for the Medi-Cal program. This change primarily reflects increases in caseload and the cost of providing services. The remaining $253 million increase primarily reflects a $207 million increase in federal funding for social services programs.

The budget also anticipates large net increases in federal fund expenditures for business, transportation, and housing programs. Table 6 shows that the budget proposes expenditures of $1.7 billion in this area, which is an increase of $281 million, or 19 percent, above current-year expenditures. The bulk of these expenditures—$1.1 billion—are proposed for the construction of highway projects.

Table 6 also shows that the amount of federal funding provided to the state's higher education segments is expected to increase by $170 million in 1988-89. Two items account for this increase: (1) $146 million for Department of Energy laboratories at the University of California, and (2) $24 million for federal research contracts at the University of California.

Finally, federal expenditures for resources programs show a net gain of $199 million, or more than double the estimated current-year level. This large gain primarily reflects an increase of $173 million due to a change in the way that federal funds are provided for the construction of local sewage treatment plants. Previously, the federal government provided grants directly to local agencies. Beginning in 1988-89, the State Water Resources Control Board will receive the federal funds to capitalize a revolving loan fund to provide loans to local agencies for sewage plant construction. In 1994, all federal assistance for sewage plant construction is scheduled to end.

HOW IS THE MONEY SPENT?

The Governor's Budget proposes total "governmental" spending of $62 billion. Of this amount, $42.4 billion are expenditures made from the General Fund and special funds—commonly referred to as "state expenditures." These are the funds over which the Legislature exercises the most control in the budget. State expenditures have traditionally been categorized as spending for "state operations," "local assistance," and "capital outlay." This section takes a closer look at how these funds are proposed to be allocated.

State Operations

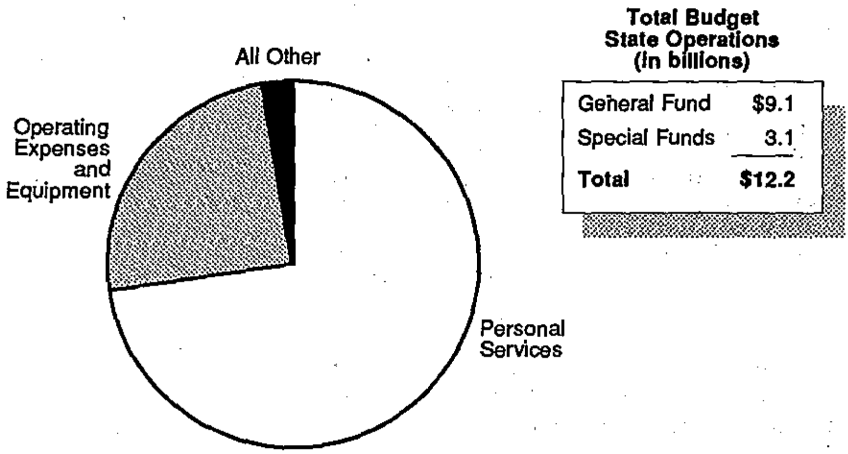
State operations refer to expenditures made to support state departments, boards, and commissions in their day-to-day operations. Chart 7 shows that General Fund and special funds expenditures for state operations are largely distributed between personal services and operating expenses and equipment (OE&E). As the chart indicates, about seven out of every ten dollars spent in this category (73 percent) are used to pay for personal services, which includes salaries, wages, and staff benefits.

The California State University and the University of California have the largest personal services budgets in the state, amounting to approximately $1.6 billion each (almost all General Fund). The Department of Corrections, the next largest budget in terms of personal costs, has a General Fund personal services budget in excess of $1 billion.

Special funds expenditures for personal services amount to approximately $2 billion. Of this amount, over half is spent for personal services for the Department of Transportation, the Department of Motor Vehicles, and the California Highway Patrol.

Chart 7

Distribution of 1988-89 State Operations Budget General Fund and Special Funds Only[a]



[a] Source: Legislative Analyst's Office estimates.

The bulk of the remaining General Fund and special funds expenditures for state operations is made for OE&E. This category includes all costs needed to support state employees—rent on facilities, phones, desks, etc.—as well as the costs of services contracted with the private sector. The "All Other" category shown in Chart 7 reflects special items of expense (such as one-time lease payments).

The State's Work Force. Table 7 shows trends in the total state employee work force (all funds) for 1986-87 through 1988-89.

As the table indicates, the Governor's Budget would increase the state's work force by 8,765 personnel-years (pys), or 3.6 percent, in 1988-89. This compares to a 4.4 percent increase from 1986-87 to 1987-88.

The following items account for most of the budget-year increase in pys:

- ***Youth and Adult Corrections*** programs are proposed to increase by 2,119 pys, 1,928 of which are budgeted for the Department of Corrections. The growth is primarily due to significant increases in the adult inmate population and the opening of new facilities to accommodate them.

Table 7
The State's Work Force, by Function (All Funds)
1986-87 through 1988-89
(in personnel-years)

	Actual 1986-87	*Estimated 1987-88*	*Proposed 1988-89*	*Change from 1987-88*	
				Amount	*Percent*
Function					
Legislative, judicial, executive	10,172	10,866	12,045	1,179	10.9%
State and consumer services	11,856	12,452	12,607	156	1.3
Business, transportation, and housing	32,990	34,154	35,799	1,646	4.8
Resources	14,130	14,676	14,992	316	2.2
Health and welfare	37,585	38,457	39,665	1,208	3.1
Youth and adult corrections	20,528	26,261	28,380	2,119	8.1
Education	2,498	2,716	2,748	32	1.2
Higher education	92,689	93,141	94,659	1,518	1.6
General government	10,479	10,447	11,038	591	5.7
Totals [a]	232,927	243,168	251,933	8,765	3.6%

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

- ***Business, Transportation, and Housing*** programs are proposed to increase by 1,646 pys. Of this amount, 1,161 pys are for the Department of Transportation, primarily to plan, design and engineer highway capital outlay projects.
- ***Higher Education*** programs would increase by 1,518 pys, primarily due to increased enrollment at the University of California and the California State University.
- ***Health and Welfare*** programs are proposed to increase by 1,208 pys. Of this amount, 676 pys are for the state's 24-hour care institutions. The largest single factor contributing to this change is an increase in the "coverage factor"—the number of backup staff hours that are budgeted for each staff position in order to cover sick leave and training-related absences.
- ***Legislative, Judicial, and Executive*** programs are scheduled to increase by 1,179 pys. Of this increase, 568 pys are attributable to the state's assumption of salary costs for municipal judges under the Trial Court Funding Act. Another 61 pys are attributable to the new superior court judgeships authorized by that measure.

Local Assistance

Local assistance, as the term is used in the budget, encompasses a wide variety of programs. As the name implies, these funds are generally provided to help carry out programs administered locally or for the support of local activities. Some of these programs, however, do not provide assistance to local government agencies; rather, their goal is to 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 8 identifies 12 local assistance programs which our analysis indicates are appropriately categorized as "Aid to Individuals." Overall, the Governor's Budget proposes a General Fund increase of $486 million, or 6.0 percent, for these programs in the budget year. Virtually all the growth takes place in the three largest programs: Medi-Cal, AFDC and SSI/SSP. The large reduction in the special funds budget for aid to individuals in 1988-89 reflects recent legislation which shifts the support for the Universal Telephone Service program from special funds to the private sector.

Table 8
Major Local Assistance Programs
Providing Aid to Individuals
1986-87 through 1988-89
(dollars in millions)

General Fund	*Actual 1986-87*	*Estimated 1987-88*	*Proposed 1988-89*	*Change from 1987-88*
Medi-Cal [a]	$2,515	$2,745	$2,890	$145
AFDC [b]	1,985	2,131	2,260	129
SSI/SSP	1,656	1,846	2,013	167
Renter's Tax Relief	472	480	490	10
Developmental Services	419	453	484	31
Homeowners Property Tax Relief	339	345	351	6
Senior Citizens Renters' Tax Relief	25	21	19	−2
Subventions for Open Space	15	15	15	—
Senior Citizens Property Tax Deferral	6	6	6	—
Senior Citizens Property Tax Relief	5	5	5	—
Subtotals, General Fund	($7,437)	($8,047)	($8,533)	($486)
Special Funds				
Universal Telephone Service Program	$72	$130	—	−$130
Developmental Services	4	4	$5	1
Subtotals, Special Funds	($76)	($134)	($5)	(−$129)
Totals [c]	$7,513	$8,181	$8,538	$357

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

Aid to Local Governments. Table 9 displays the major local assistance programs which our analysis indicates provide "Aid to Local Governments." Overall, the Governor's Budget proposes an increase in funding for these programs of approximately $1.8 billion, or 8.9 percent, above current-year levels. This compares with an increase of $663 million, or 3.5

percent in the current year. The General Fund budget-year increase primarily reflects: (a) increases in K-12 education funding for inflation adjustments and enrollment increases; (b) growth in social services programs due to increased GAIN funding; and (c) additional net costs to the state resulting from the Trial Court Funding Act. The special fund budget-year increase is due to increases in shared revenue programs.

Table 9
Major Local Assistance Programs Providing Aid to Local Governments 1986-87 through 1988-89 (dollars in millions)

General Fund	*Actual 1986-87*	*Estimated 1987-88*	*Proposed 1988-89*	*Change from 1987-88*
Public health services	$1,056	$1,096	$1,137	$41
California Children's Services	51	55	60	5
Department of Rehabilitation	64	74	81	7
Mental health programs	482	550	562	12
Alcohol and drug programs	72	72	72	—
Social services—programs	386	565	841	276
Social services—county administration	135	151	164	13
County justice subvention	67	67	67	—
K-12 education	12,071	12,377	13,324	947
Community colleges	1,220	1,317	1,400	83
Special supplemental subventions/special district loans	53	35	30	−5
Local streets and roads	77	—	—	—
State mandates	128	133	138	5
Trial court funding	—	—	335	335
All other	422	356	279	−77
Subtotals, General Fund	($16,284)	($16,848)	($18,490)	($1,642)
Special Funds				
K-12 education	$148	$86	$86	—
Shared revenues	2,233	2,389	2,514	$125
All other	327	332	322	−10
Subtotals, special funds	($2,708)	($2,807)	($2,922)	($115)
Totals[a]	$18,992	$19,655	$21,412	$1,757

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

HOW ARE SPENDING LEVELS DETERMINED?

The state's spending plan reflects a multitude of decisions made in the preparation of the proposed budget. However, most of the money that is proposed to be spent reflects the "baseline" cost of maintaining existing state programs. Most of the decisions made in the course of the normal budget process are focused on how *additional* resources will be allocated.

In distributing these additional resources to individual programs, the Legislature and the Governor must consider a variety of factors. These factors include statutory requirements which necessitate higher expenditures, as well as policy decisions to maintain, expand or cut back existing levels of state services. In the case of programs supported by special funds (whose revenues are usually dedicated to singular purposes), spending decisions are governed largely by the level of resources available, and the budget process focuses on how to set priorities for each individual program's additional spending needs. For programs supported by the General Fund, however, spending decisions also are influenced by competing demands from different program areas. The Governor's Budget reflects the administration's view as to how these competing demands should be accommodated.

This section discusses the major factors which influence *General Fund* spending decisions, and presents information as to how these factors have been addressed in the Governor's Budget.

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 attempt 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 25 different programs, most of them in the health, education and welfare areas. These adjustments generally are referred to as statutory COLAs. Many other programs traditionally have received COLAs on a *discretionary* basis through the budget process.

In 1988-89, statutory COLAs range from 2.9 percent (child nutrition) to 8.75 percent (Block Grants for Trial Court Funding). As in previous years, the statutory COLAs having the largest costs are those for K-12 apportionments ($526 million), SSI/SSP grants ($140 million) and AFDC grants ($107 million). The General Fund cost of fully funding *statutory* COLAs in 1988-89 is approximately $1.1 billion.

Governor's Budget Proposal. The budget proposes a total of $1.3 billion from the General Fund for COLAs in 1988-89, including $1.1 billion for statutory COLAs and $238 million for discretionary COLAs, which primarily reflects funding for increased employee compensation. The total COLA amount is equal to 47 percent of the total proposed increase in budget-year General Fund expenditures. The specific increases proposed by the Governor are shown in Table 10.

There are only two statutory COLAs not funded by the budget: Medi-Cal long-term care facilities and the trial court block grant ($69 million). The amount of funding required for the long-term care program will not be known until the new reimbursement rates for these facilities are adopted, and the Governor has traditionally not included any funds for this purpose in the budget. In addition, the administration indicates that it does not believe a 1988-89 COLA was intended for the trial court block grant and that clarifying legislation will be sought.

Table 10
General Fund Cost-of-Living Increases
1987-88 and 1988-89
(dollars in thousands)

Department/Program	1987-88 Budgeted Percent Increase	1988-89 1% Dollar Increase	1988-89 Statutory Percent Increase	1988-89 Statutory Dollar Increase	1988-89 Budget Percent Increase	1988-89 Budget Budget as Proposed
HEALTH AND WELFARE						
Aging	—	$317	—	—	—	—
Alcohol and drug programs	—	718	—	—	—	—
Medi-Cal:						
Noncontract hospitals	—	780	7.1%	$5,539	7.1%	$5,539
Long-term care facilities	5.7%	7,105	—[a]	—[a]	—	—
Obstetrical physicians	—	135	—	—	16.0	2,154[b]
Childrens' services	—	40	—	—	10.0	401
Home health	—	28	—	—	10.0	283
Portable X-ray	—	1	—	—	50.0	50
Other providers	—	6,466	—	—	—	—
Beneficiary spin-off	2.6	1,865	5.2	9,698	5.2	9,698
Drug ingredients	6.1	1,176	6.8	8,000	6.8	8,000
Health Services:						
County health (AB 8)	1.67	4,269	5.7	24,287	5.7	24,287
Medically indigent services	—	5,084	—	—	—	—
Public health	—	1,705	—	—	—	—
Emergency medical services	—	8	—	—	—	—
Developmental Services:						
Regional centers:						
Out-of-home care	—	2,322	—	—	5.0	9,869[c]
Personal services	4.0	1,015	—	—	2.5	2,538
Other	—	2,169	—	—	—	—
Education programs	—	56	—	—	2.5	141
Mental Health:						
Local mental health programs	—	4,814	—	—	—	—
Institutions for mental disease	4.7	662	—	—	—	—
Social Services:						
SSI/SSP	2.6	27,000	5.2[d,e]	140,400	5.2[d,e]	140,400
AFDC/FG&U	2.6	20,521	5.2[e]	106,700	5.2[e]	106,700
AFDC—foster care	—	3,905	—	—	—	—
County services block grant	—	667	—	—	—	—
IHSS maximum grant	2.6	177	5.2[e]	921	5.2[e]	921
IHSS provider	—	4,462	—	—	—	—
Deaf access	—	34	—	—	—	—
Maternity care	—	23	—	—	—	—
Child abuse prevention	—	201	—	—	—	—
Adoptions	—	182	—	—	—	—
Community care licensing	—	94	—	—	—	—
Department of Rehabilitation	—	807	—	—	—	—
YOUTH AUTHORITY						
County justice system subvention programs	—	673	—	—	—	—
Delinquency prevention	—	23	—	—	—	—

K-12 EDUCATION						
Apportionments:						
District revenue limits	2.5	120,151	4.37	525,932 [f]	4.37	525,932 [f]
Necessary small schools	2.5	682	4.37	2,981	4.37	2,981
Meals for needy pupils	6.0	304	6.0	1,824	6.0	1,824
Summer school	2.5	748	4.37	4,119 [g]	4.37	4,119 [g]
Apprentice programs	—	69	—	—	—	—
Small school district transportation	—	201	—	—	—	—
Transportation	—	2,931	—	—	—	—
County offices of education	2.5	2,342	4.37	10,234	4.37	10,234
Regional Occupational Centers/ programs	—	2,155	—	—	—	—
Court-ordered desegregation	2.5	3,831	4.37	16,742	4.37	16,742
Voluntary desegregation	2.5	487	4.37	2,130	4.37	2,130
Child nutrition	4.05	410	2.9	1,190	2.9	1,190
American Indian education centers	—	9	—	—	—	—
Native American Indian education	—	4	—	—	—	—
Child care program	—	2,813	—	—	4.37	12,292
Special education	2.5	17,122	4.37	74,824	4.22	72,285
Staff development	—	562	—	—	—	—
Preschool	—	358	—	—	4.37	1,565
Libraries	—	75	—	—	—	—
Meade Aid	—	104	—	—	—	—
Urban Impact Aid	—	762	—	—	—	—
Gifted and Talented Education	6.0	212	6.0	32	6.0	1,351 [h]
Instructional materials (K-8)	1.9	777	3.7	2,876	3.7	2,876
Instructional materials (9-12)	—	220	—	—	—	—
Demonstration programs in reading and math	—	44	—	—	—	—
Educational technology	—	131	—	—	—	—
Economic Impact Aid/bilingual education	—	1,970	—	—	—	—
Adult education	6.0	2,431	6.0	14,585 [i]	6.0	14,585 [i]
Adults in correctional facilities	6.0	21	6.0	127	6.0	127
School Improvement Program (K-6)	2.5	2,096	4.37	9,159	4.37	9,159
School Improvement Program (7-12)	—	325	—	—	—	—
Miller-Unruh Reading Program	—	193	—	—	—	—
High school pupil counseling	—	73	—	—	—	—
Specialized secondary schools	—	21	—	—	—	—
Dropout prevention	—	123	—	—	—	—
Opportunity programs and classes	—	28	—	—	—	—
Foster youth services	—	8	—	—	—	—
HIGHER EDUCATION						
Community Colleges						
Apportionments	3.4	18,863	4.79	90,354	4.79	90,354
Community college categoricals	3.4	581	—	—	4.79	2,783
Student Aid Commission:						
Cal Grant A and B (public, proprietary)	—	688	—	—	4.5	3,095
Cal Grant A and B (independent)	—	625	—	—	24.0	15,000

ALL OTHERS						
Trial Court Block Grants	—	7,892	8.75[j]	69,057	—	—
State contribution to STRS	3.3	2,419	5.1	12,336	5.1	12,336
Employee compensation:[k]						
Civil service and related	2.0[l]	32,283	—	—	2.00	105,075
University of California (faculty)	3.40[l]	8,800	—	—	1.5	19,617
University of California (staff)	2.60[l]	6,714	—	—	2.0	21,626
California State University (faculty)	3.80[l]	8,454	—	—	2.35	24,095
California State University (staff)	2.20[l]	5,719	—	—	2.0	17,339
Totals		$357,335		$1,133,997		$1,301,693

[a] Figures not yet available.
[b] Includes $20,000 for clinics, which will receive a 10 percent increase.
[c] Some providers will not receive the 5 percent increase, because they will receive larger increases under the department's Alternative Rate Model proposal.
[d] Effective January 1, 1989.
[e] The California Necessities Index change was estimated at 5.2 percent in the Governor's Budget; the Commission on State Finance announced in January 1988 that the actual figure was 4.7 percent. The lower costs for these COLAs will be reflected in the May Revision.
[f] COLA is calculated on a base that includes a proposed augmentation of $20 million for revenue limit equalization.
[g] COLA is calculated on a base that includes a proposed augmentation of $19.4 million for Supplemental Summer School expansion.
[h] The budget provides a 6 percent COLA for the entire program, although current law requires only that it be provided for approximately 3 percent of the program's funding base.
[i] Does not reflect the equalization adjustment of $725,000 included in this item in the budget.
[j] A new law requires that the trial court block grants provided in the budget year reflect a two-year cumulative adjustment: 5 percent for 1986-87 and 3.75% for 1987-88. The administration asserts that the provision of a COLA for 1988-89 was not intended when the law was enacted and that it will seek to modify this provision in clean-up legislation.
[k] Dollar increases for 1988-89 include changes in salaries and benefits. Percentage changes for 1988-89 reflect "annualized" increases for salaries only.
[l] Effective January 1, 1988.

Workload

Increased workload for state programs is another major factor contributing to the increase in spending from the current to the budget year. The major workload increases reflected in the budget are: (a) enrollment growth at educational institutions; (b) caseload growth for health and welfare programs; and (c) population growth at youth and adult correctional facilities. We estimate that these and other workload increases projected for the budget year account for approximately $1.1 billion, or about 40 percent, of the $2.8 billion in proposed additional General Fund expenditures.

Other Statutory Requirements

A third major factor contributing to the increase in spending from the current to the budget year are statutory requirements other than COLAs. For example, in 1988-89 the budget provides over $600 million from the General Fund to meet new state requirements for trial court funding, the continued phase in of the Greater Avenues for Independence (GAIN) program, and to pay increased state costs attributable to the increase in the minimum wage.

The cost of statutory COLAs, workload increases, and other legally required expenditures actually *exceeds* the $2.8 billion increase in total General Fund spending in the budget year. This is because the budget anticipates that expenditure decreases will partially offset the increases. For example, the increases in K-12 education funding for 1988-89 are partially offset by a $280 million reduction in the K-12 apportionments expenditure base which is attributable to increased local property tax revenues.

WHAT PRIORITIES ARE REFLECTED IN THE GOVERNOR'S BUDGET?

As noted earlier, most of the money provided by the state budget goes to fund the "baseline" cost of existing programs. Most of the decision making that occurs in the budget process involves how the additional budget-year revenues will be allocated. This section focuses on how the budget proposes to allocate the increased resources to specific programs.

Summary of Major Program Changes

For 1988-89, the budget proposes a net increase in General Fund expenditures of $2.8 billion, or 8.3 percent, above the level of expenditures estimated for the current year. Table 11 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 K-12 education—$918 million. The major General Fund changes are discussed below:

Medi-Cal local assistance expenditures are up by $150 million, or 5.3 percent. This increase is primarily due to increases in caseload and the cost of providing services. The budget reflects numerous major policy assumptions, including: (1) the state will win its suit regarding rate reductions proposed in 1986-87, allowing the department to collect $31 million in funds from providers; (2) legislation will be enacted in response to recent federal law changes, resulting in net costs of $25 million; and (3) various "program restructuring" proposals will be implemented, for net savings of $23 million.

Public Health is budgeted at $1.2 billion, an increase of $46 million, or 4 percent. This increase is due primarily to a 5.7 percent cost-of-living adjustment for the County Health Services program, workload increases in the County Medical Services program and various other programs, and increases in AIDS funding. The budget proposes no increased funding for the Medically Indigent Services program.

SSI/SSP is expected to increase by $168 million, or 9.1 percent, above estimated current-year expenditures. This increase is due primarily to: (1) an increase of $140 million to fund a 5.2 percent statutory COLA effective January 1, 1989; (2) an increase of $91 million to fund an estimated 4.9 percent caseload increase; and (3) an increase of $71 million to fund the full-year cost of the 1987-88 COLA provided on January 1, 1988. These increases are partially offset by savings of $77 million due to the 4.2 percent federal COLA effective January 1, 1988.

Table 11
Estimated General Fund Program Changes[a]
1987-88 and 1988-89
(dollars in millions)

	Estimated 1987-88	*Proposed 1988-89*	*Change Amount*	*Change Percent*
Health and Welfare:				
Medi-Cal[b]	$2,816	$2,966	$150	5.3%
Public health[b]	1,151	1,197	46	4.0
SSI/SSP[b]	1,846	2,013	168	9.1
AFDC grants[b]	2,131	2,260	128	6.0
Social services programs[b]	565	841	276	48.8
Mental health	891	926	35	3.9
Developmental services	475	504	29	6.1
Other, health and welfare	662	677	15	2.3
Subtotals, Health and Welfare	($10,537)	($11,384)	($847)	(8.0%)
Education:				
K-12	$12,079	$12,997	$918	7.6%
State teachers' retirement	500	559	59	11.8
University of California	1,906	2,038	133	7.0
California State University	1,743	1,862	119	6.8
California community colleges	1,191	1,279	87	7.3
Other, higher education	344	376	32	9.2
Subtotals, Education	($17,763)	($19,111)	($1,348)	(7.6%)
Other:				
Youth and adult corrections	$1,914	$2,151	$237	12.4%
Resources	698	685	−13	−1.9
Tax relief	872	885	13	1.5
Bond interest and redemption[c]	(521)	(568)	(47)	9.0
Interest on PMIA loans[c]	(81)	(77)	(−4)	−4.9
All other	1,558	1,885	327	21.0
Subtotals, Other	($5,042)	($5,605)	($563)	(11.2%)
Totals	$33,343	$36,101	$2,758	8.3%

[a] Based on amounts shown in Governor's Budget. Detail may not add to totals due to rounding.
[b] Local assistance only.
[c] Included in other items.

AFDC grant costs are budgeted to increase by $128 million, or 6.0 percent, above estimated current-year expenditures. This increase is due primarily to: (1) an increase of $107 million to provide a statutory COLA effective July 1, 1988; and (2) an increase of $87 million to fund an anticipated caseload growth of 2.4 percent. These increases are partially offset by higher anticipated savings of $34 million due to the Greater Avenues for Independence (GAIN) program.

Social Services Program expenditures are up $276 million, or 49 percent, above estimated 1987-88 expenditures. This increase is due primarily to: (1) an increase of $138 million, or 272 percent, in the costs to the Department of Social Services for the GAIN program in 1988-89, the third year of a scheduled five-year phase in; (2) an increase of $104 million, or 59 percent, in the cost of the In-Home Supportive Services program, primarily due to $63 million in additional costs arising from the increase in the minimum wage that will go into effect on July 1, 1988; and (3) an increase of $33 million, or 15 percent, in the cost of the Child Welfare Services program, primarily due to caseload increases.

K-12 Education expenditures are expected to increase by $918 million, or 7.6 percent, over the estimated current-year level. The primary factors accounting for this increase include: (1) $680 million for cost-of-living adjustments, most of which are required by statute; (2) $340 million for costs related to increased enrollments, including $64 million for growth in special education programs; (3) $96 million for growth in desegregation programs; and (4) $40 million to continue equalization of school district revenue limits ($20 million) and to expand summer school programs from 5 percent to 7 percent of enrollments ($20 million). These increases are partially offset by state apportionment reductions of $280 million due to increased local property tax revenues.

Higher Education expenditures are proposed to increase by $371 million, or 7.2 percent, over the estimated 1987-88 level. The primary factors accounting for this increase are: (1) $80 million for undergraduate enrollment growth at the University of California, the California State University, and the community colleges; (2) $83 million for faculty and staff salary and benefit increases; (3) $54 million for baseline budget adjustments, which include price increases and full-year funding; and (4) $51 million for new programs, including increased maximum Cal Grant awards for students at private colleges ($15 million).

Youth and Adult Corrections expenditures are proposed to increase by $237 million, or 12 percent, in the budget year. Most of this amount, or $199 million, will fund 1,928 additional personnel-years for the Department of Corrections to accommodate growth in the prison population. The budget is based on a 12.7 percent growth rate in the inmate population between June 30, 1988 and June 30, 1989 and an 11.2 percent growth rate in the parole population over the same period.

All Other expenditures increase primarily due to a net increase of approximately $375 million related to the Trial Court Funding Act.

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. While most of these factors have been accounted for, our analysis indicates that the Governor's Budget has potentially underestimated General Fund expenditures for the budget year by as much as $155 million. Whether the state actually realizes these expenditures in 1988-89 will depend on such factors as the outcome of certain legal issues and pending legislation. The components of this amount are:

Trial Court Funding. The Governor's Budget contains a net increase of about $375 million to implement the Trial Court Funding Act. Our analysis indicates that this level potentially understates the cost of this program by about $90 million. This figure is based on the law's requirement that cost-of-living adjustments be made to the block grant amounts for 1988-89. It also reflects the additional costs involved if legislation is not enacted to reduce the block grants for the City and County of San Francisco. The actual amount of funding required for this program will depend on the outcome of "clean-up" legislation to be considered by the Legislature in 1988.

Department of Forestry. Based on the state's experience over the last five years, we would expect General Fund expenditures for emergency firefighting by the Department of Forestry and Fire Protection to total $16 million more than the budget provides in 1988-89.

Medi-Cal. As in the last two years, the budget fails to provide for increases in Medi-Cal reimbursement rates for long-term care facilities. In the current year, these statutorily required increases resulted in net increases of $8 million, spread across various budgets. The budget-year requirement is not yet known. Further, the budget assumes that the department will prevail in a legal dispute over the 10 percent provider rate reductions imposed in 1986-87, resulting in savings of $62 million ($31 million General Fund) in 1988-89. If the state does not prevail, the budget would be underfunded by this amount.

Increased Minimum Wage. The minimum wage will increase from $3.35 to $4.25 on July 1, 1988. The budget includes funds in some departmental budgets to pay costs borne by private providers of state services. However, other programs (such as Medi-Cal and residential care programs) may require additional funds to meet these higher costs. (See *The 1988-89 Budget: Perspectives and Issues,* for an analysis of this issue.)

Interest on Pooled Money Investment Account (PMIA) Loans. The Governor's Budget proposes to submit a number of general obligation bond issues to the voters in 1988 and anticipates the expenditure of the proceeds of these bond issues in the 1988-89 budget. However, the budget does not reflect additional costs for debt service on the bonds, or for interest on PMIA loans which would be needed to fund the appropriations initially. These interest costs could amount to over $10 million in the budget year.

THE STATE'S APPROPRIATIONS LIMIT

In addition to the factors which help determine state spending mentioned above, the appropriations limit imposed by Article XIII B of the state's Constitution may also play a part in determining total spending levels. This would be the case whenever state revenues exceed the amount which can be appropriated, as occurred in the 1986-87 fiscal year. As Table 12 shows, the Governor's Budget indicates that the state will be $50 million below its limit in 1987-88 and $24 million below the limit in the budget year. Given the volatility of the economy and the large number of assumptions used in the appropriations limit calculations, the state could easily find itself with an appropriations limit problem for both years.

Table 12
State's Situation With Regard to Its Appropriations Limit
Governor's Budget Estimates
1987-88 and 1988-89
(dollars in millions)

	Estimated 1987-88	*Projected 1988-89*
Appropriations limit	$25,317	$27,306
Appropriations subject to limitation	25,267	27,282
Amount under limit	50	24

Current Year. The estimate for the current year is not significantly different than the one released by the administration in July, following enactment of the 1987-88 Budget. At that time, the administration estimated that the state would be $45 million below its limit for 1987-88. However, the administration now anticipates that General Fund tax revenues will be approximately $350 million higher than it estimated in July. According to the Department of Finance, this additional revenue did not push the state over its appropriations limit for three reasons. First, the original estimate had assumed that K-12 school districts would request transfers of the state's appropriations limit pursuant to Ch 134/87 (the 1987 Trailer Act) of $400 million in 1987-88. However, only $167 million in transfer requests have actually been received, and the department's 1987-88 limit is $233 million higher as a result. Second, the department indicates that its estimates of appropriations for *exempt* items, such as subventions to school districts, have increased over the earlier estimates. Finally, the department's estimates now treat the state's cost for interest payments on PMIA loans as an exempt appropriation, on the basis that they represent "debt service."

Budget Year. The estimates for 1988-89 reflect a 6.8 percent cost-of-living and population adjustment to the appropriations limit, and a $350 million increase in the limit for "transfers of financial responsibility" associated with the Trial Court Funding program. This latter adjustment is required to compensate for the state's assumption of financial responsibility for funding local trial courts, and has the effect of allowing the state to appropriate budget-year revenues that would otherwise have been potentially subject to the rebate requirements of the Constitution. The estimate also reflects a $70 million reduction in the limit for a transfer of financial responsibility related to the Universal Telephone Service program.

The estimates presented in Table 12 are potentially subject to significant revision over the next 18 months. These revisions could occur for several reasons, including:

- ***Changes in the state's economy,*** to the extent that growth is stronger or weaker than projected. To the extent that state revenues decline from the budget estimates, the state would be further below its limit than estimated. A stronger-than-projected economy could quickly push the state *over* its limit.
- ***Additional school district limit notifications,*** since the amount of the state's limit which has been transferred to school districts is much lower than anticipated. If school districts have simply been postponing their notifications pending their midyear financial reviews, or for other reasons, a further substantial reduction in the state's current-year limit may be required.
- ***Court decisions,*** to the extent they invalidate the state's present practice of excluding appropriations for certain court mandates. As discussed in last year's *The 1987-88 Budget: Perspectives and Issues* (please see p. 111), the administration assumes that the state's cost for STRS retirement contributions and desegregation-related payments to school districts can be treated as excludable "court mandates."
- ***County government decisions,*** since the number of counties which elect to participate in the Trial Court Funding program has a direct effect on the state's appropriations limit. As noted earlier, the budget assumes that the state's appropriations limit will be increased by $350 million on the basis that 54 counties will participate. This limit growth figure will decline if a smaller number of counties make the election.
- ***Other potential revisions,*** including changes needed to (1) address certain inconsistencies in the department's estimates uncovered by our review, (2) correct for changes in the estimates of expenditures for exempt items such as debt service, and (3) conform to changes in the projected rate of inflation.

Resources In 1988-89

The resources needed to fund the 1988-89 state spending plan come from a variety of different sources, including:

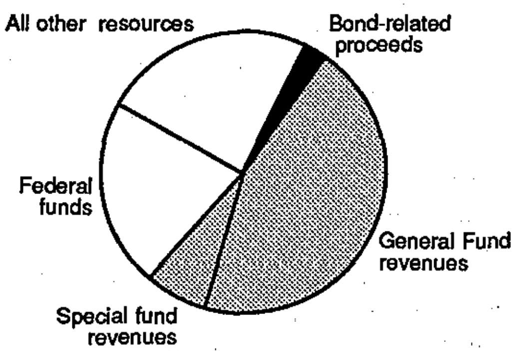
- Revenues from taxes, licenses, fees and investments;
- Transfers of previously accumulated monies out of funds that have been storing them;
- Borrowed money, such as proceeds from the sale of bonds; and
- Federal funds.

Chart 8 summarizes the relative importance of these different types of resources in funding the total 1988-89 state spending plan. It shows that over half of the resources are state revenues used to support the General Fund and special fund expenditures proposed in the budget.

This analysis reviews the budget's estimates of state revenues and borrowed resources. It also discusses the amount of revenues the state will forego in 1988-89 in order to indirectly fund so-called "tax expenditure" programs.

Chart 8

Resources for Funding the 1988-89 Total State Spending Plan



Total Funding (dollars in billions)

Funding Source	*Amount*
General Fund revenues	$36.2
Special fund revenues	6.0
State revenues	$42.2
Bond-related proceeds	1.9
Federal funds	17.2
Nongovernmental cost funds[a]	17.5
Other[b]	0.2
Total funding	$79.0

[a] Includes monies from public service enterprise funds, working capital and revolving funds, retirement funds and various other funds.
[b] Includes certain prior-year resources.

I. REVENUE RESOURCES IN 1988-89

The state's expenditure programs 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 funds and retirement 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 13 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 9 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 1988-89 will be moderate, following abnormally low revenue growth in 1987-88 caused by a number of revenue-related anomalies. The 1988-89 revenue estimates reflect the department's forecast that the current economic expansion will continue at a modest pace through mid-1989. Table 13 indicates that:

- ***Budget-year*** (1988-89) revenues will total $42.2 billion (7.5 percent growth), including General Fund revenues of $36.2 billion (7.6 percent growth) and special fund revenues of $6.0 billion (6.7 percent growth).
- ***Current-year*** (1987-88) revenues will total $39.3 billion (4 percent growth), including General Fund revenues of $33.7 billion (3.6 percent growth) and special fund revenues of $5.6 billion (6.7 percent growth).

Table 13
Revenue Summary
General Fund and Special Funds
1986-87 through 1988-89
(dollars in millions) [a]

	Prior Year (1986-87)	*Current Year (1987-88)*	*Budget Year (1988-89)*
General Fund Revenues [b]			
—Amount	$32,519	$33,678	$36,249
—Dollar change	4,292	1,159	2,571
—Percent change	15.2%	3.6%	7.6%
Special Fund Revenues			
—Amount	$5,248	$5,601	$5,977
—Dollar change	−238	353	376
—Percent change	−4.3%	6.7%	6.7%
Totals, General Fund and Special Fund Revenues			
—Amount	$37,767	$39,279	$42,225
—Dollar change	4,054	1,512	2,946
—Percent change	12.0%	4.0%	7.5%

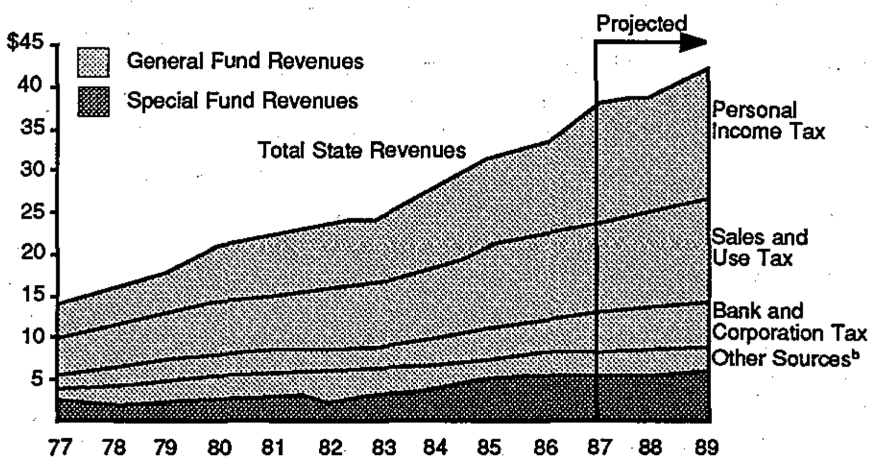
[a] Source: *1988-89 Governor's Budget* and State Controller. Detail may not add to totals due to rounding. Figures include effects of various revenue-related law changes and shifts of revenues between special funds and the General Fund. Neither the General Fund nor special fund revenue totals include revenues from the California State Lottery, because the funds into which these lottery revenues are put have been classified as nongovernmental cost funds.

[b] Revenue totals include the effects of federal tax reform, estimated to be a gain of $1.2 billion in 1986-87, and losses of approximately $270 million in 1987-88 and $320 million in 1988-89. In addition, the estimated effect of the 1987 stock market decline is a gain of $465 million in 1987-88 and a loss of about $185 million in 1988-89. See Table 14 and text for detail on these and other year-to-year distorting factors.

Chart 9

Trends in State Revenues

1976-77 through 1988-89 (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.

Removing Distortions Smooths Revenue Trend

The year-to-year revenue growth patterns shown in Table 13 are extremely volatile because of the distorting 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 affected both the amount and timing of capital gains reported for tax purposes (these changes affect revenues in 1986-87, 1987-88 and 1988-89);
- Second, taxable capital gains in both 1987-88 and 1988-89 have been affected by the stock market crash of October 1987;
- Third, budget-year revenues are assumed to increase by $110 million because of increased auditing activities by the state and federal governments; and
- Fourth, the budget assumes that a $75 million one-time inheritance tax settlement will be received in 1987-88.

In the absence of these and other distorting factors, a more level revenue growth pattern for total state revenues would exist between years than appears in Table 13 — about 8 percent in 1986-87, 6 percent in 1987-88, and 9 percent in 1988-89.

Reliability of the Revenue Forecast

All in all, the department's revenue forecast is reasonable (1) *if* the economy performs as predicted — namely, continued moderate economic growth, and (2) taxpayers respond to federal and state tax law changes as assumed. There is, however, a greater-than-normal amount of uncertainty about the future course of the economy. Also, the ability to predict taxpayer behavior due to changes in tax laws is very limited. As a result, there is a high probability that actual tax collections could be substantially different than the department's forecast. By the time of the May Revision, some of this uncertainty should be eliminated. However, a large element of uncertainty will still remain during the budget year.

General Fund Revenues. In the case of General Fund revenues, we estimate that revenues over the next 18 months would be $200 million *lower* than predicted if the department's economic forecast comes true. However, the department's forecast for certain revenue-determining economic variables is a bit conservative relative to the consensus economic outlook of *other forecasters.* If this consensus economic outlook prevails, revenues actually would end up $185 million *higher* than predicted by the department. This assumes that the department's optimistic assumption regarding growth in capital gains income proves correct; if it does not, there could be some revenue *shortfall.*

Special Fund Revenues. The forecast for special fund revenues appears reasonable with the exception of oil-related revenues. These are *overstated* by at least $50 million in the current year and $80 million in the budget year because crude oil prices have declined significantly since the revenue estimates were made.

Sizable Error Margins Exist. As Chart 10 shows, there is a wide variety of factors which could cause economic performance to differ significantly from the department's forecast, and this could dramatically affect revenues. For example, General Fund 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 is generally reasonable, there could be substantial deviations due to the economy.* Furthermore, revenue estimating has been complicated by the need to make assumptions about the revenue effects of factors like federal tax reform, state tax reform and the stock market crash. *Given this, the revenue estimates are subject to a much-larger-than-normal margin of error.*

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.

Chart 10

Key Factors In the 1988 Economic Outlook

+ Positive Factors

- Continued moderate inflation
- Accomodative monetary policy
- Further softening in the dollar's value
- Gains in business fixed investment
- Strengthening of exports
- Recent declines in crude oil prices
- Improved outlook for the California farm sector
- Strength in electronics industries
- Sharp interest rate increases unlikely in near term
- Some positive growth in "real" income

— Negative Factors

- Continued large foreign trade deficit
- Negative fallouts from stock market crash
- High consumer debt levels
- Softening of homebuilding and car buying
- Historically low savings rate
- Continued large federal budget deficit
- International debt problems
- Restrained defense spending in California
- Subdued consumer spending
- Slow growth in productivity
- Concerns at year-end about rising inventories

? Major Areas of Uncertainty

- To what extent will the stock market crash depress confidence and spending by individuals and businesses?
- Will world oil prices remain soft, or eventually trend upward again due to output restrictions by OPEC?
- What are the ongoing behavioral responses of taxpayers to federal and state tax reform?
- Will consumers retrench in their spending, due to low savings and high debt burdens?
- To what extent will the dollar continue to depreciate and the trade deficit improve?
- What will be the path of interest rates?

ECONOMIC ASSUMPTIONS UNDERLYING THE REVENUE FORECAST

The economy's performance during 1988 and 1989 will be the prime determinant of state revenue collections during the latter half of 1987-88 and throughout 1988-89. Economic activity during 1988 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 1989.

Continued Economic Expansion Assumed

Table 14 summarizes the budget's economic forecast for 1988 and 1989, as well as the economy's performance during 1987. The department expects that the current economic expansion will carry forward throughout the next two years at a moderate pace, though growth will be more

Table 14
Department of Finance Economic Outlook for California and the Nation 1987 through 1989 [a]

National Economic Indicators	*1987 Estimated*	*1988 Projected*	*1989 Projected*
Percent change in:			
—Real GNP	2.6%	2.1%	2.1%
—Personal income	5.7	5.1	5.7
—Pre-tax corporate profits	16.5	−6.1	4.8
—Wage and salary employment	2.5	2.1	2.1
—Civilian employment	2.6	1.8	2.1
—GNP prices	3.1	3.2	3.5
—GNP consumer prices	4.2	4.4	4.0
—Consumer Price Index	3.7	4.1	4.4
Unemployment rate (%)	6.2%	6.3%	6.4%
Savings rate (%)	3.3	3.2	2.7
Prime interest rate (%)	8.2	8.6	9.1
New car sales (millions of units)	10.2	9.6	10.0
Housing starts (millions of units)	1.66	1.65	1.60
Net exports (billions of dollars) [b]	−$131	−$89	−$80
California Economic Indicators			
Percent change in:			
—Personal income	7.8%	6.5%	6.7%
—Wage and salary income	8.5	7.2	7.2
—Wage and salary employment	3.9	2.6	2.8
—Civilian employment	4.0	2.0	1.4
—Consumer Price Index	4.2	5.0	4.8
—Key elements of the state's tax base:			
—Taxable personal income [c]	8.2	7.0	6.9
—Taxable sales	6.5	5.7	6.0
—Taxable corporate profits	21.2	7.1	6.6
Unemployment rate (%)	5.8%	5.8%	6.1%
New car registrations (thousands of units)	1,374	1,211	1,298
New building permits (thousands of units)	248	220	203

[a] Source: *1988-89 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.

subdued than in 1987. Inflation is expected to remain under control, and neither a recession nor strong upturn 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. It also reflects the tendency of economists to predict "more of the same" in cases where an economic recovery period has matured and there are no clear signals indicating when the next upswing or downturn will occur.

How 1987 Ended and 1988 Began

At this time last year, many of the same uncertainties about the economy existed as we see today. Thus, not surprisingly, the department predicted in last year's budget an unspectacular-though-sustained low-inflation expansion period for 1987 (see Table 15).

1987 Outperformed Expectations. Although 1987 was far from being a banner year, both the national and state economies did better than expected. While interest rates were higher than predicted, actual economic performance surpassed the department's projections for a wide range of variables, including GNP growth, employment growth, corporate profits, taxable sales, unemployment and personal income (see Table 15). This naturally resulted in more state revenues during the last half of 1986-87 and first half of 1987-88 than had been expected.

Table 15
Accuracy of Economic Forecasts for California in 1987

	Original Forecasts				*Revised Department of Finance May 1987*	
	Department of	*Other Forecasters*[b]				
Economic Indicator	*Finance*[a]	*Lowest*	*Average*	*Highest*	*Forecast*	*Actual*[c]
Percent change in:						
—Personal income	6.1%	5.9%	7.0%	8.0%	6.8%	7.8%
—"Real" personal income[d]	2.0	2.0	2.8	3.7	2.5	3.5
—Wage and salary jobs	2.3	2.3	2.8	3.0	3.0	3.9
—Consumer prices	4.0	3.8	4.1	4.5	4.2	4.2
—Taxable sales	4.0	—	—	—	5.3	6.5
—Taxable corporate profits	12.0	—	—	—	17.2	21.2
Unemployment rate (%)	6.9%	6.0%	6.6%	7.0%	6.3%	5.8%
Residential building permits (thousands)	254	225	245	275	280	248
New car sales (thousands)	1,278	—	—	—	1,278	1,374

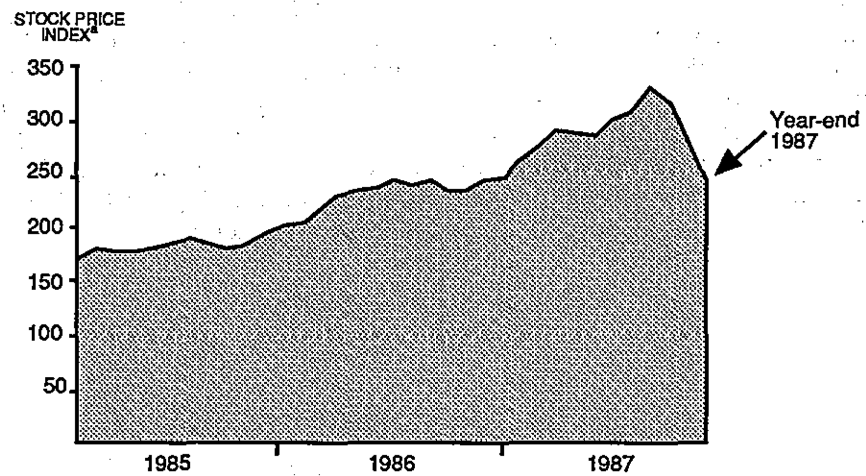
[a] *1987-88 Governor's Budget.*
[b] Includes First Interstate Bank, Security Pacific Bank, Bank of America, UCLA, Wells Fargo Bank and the Commission on State Finance. Forecasts are as of approximately year-end 1986, corresponding to when the Department of Finance constructed the economic assumptions contained in the *1987-88 Governor's Budget.* For detail on these forecasts, see *The 1987-88 Budget: Perspectives and Issues,* Table 21, page 54.
[c] As reported in the *1988-89 Governor's Budget.*
[d] Defined here as nominal personal income deflated by the California Consumer Price Index.

The Stock Market Crash. Undoubtedly, the most memorable economic event during 1987 was the spectacular 30-plus-percent plunge in the stock market in late October, which reduced the value of corporate equities held by investors by about *$1.5 trillion.* The magnitude of this decline, portrayed in Chart 11, is unprecedented. Predictions by some economists that the crash would immediately precipitate a recession proved incorrect. However, as 1987 ended the market had yet to rebound from the crash, and composite stock prices stood about where they had been one year earlier.

Chart 11

Trends in U.S. Stock Market Prices

1985 through 1987



[a] Data shown represent monthly averages of Standard & Poor's Index of 500 U.S. stock market prices. This index has a July 1, 1977 base value of 100.

Mixed Picture at Year-End. Both positive and negative factors characterized the economy at the end of 1987 (see Chart 10). *On the negative side* were concerns that the stock market crash had reduced confidence in the economy, that consumers might retrench because of high debt burdens, and that the persisting foreign trade deficit would cause further declines in the dollar's value and upward pressures on interest rates. In addition, there was a disturbing increase in business inventories and decline in total consumption expenditures in the fourth quarter of 1987, leading to concerns that business might respond by cutting production. *On the positive side,* however, the state's unemployment rate ended the year at only 5.2 percent (the lowest level in 19 years), both employment and business investment spending were doing okay, retail sales were expanding, the outlook was that oil prices would remain fairly soft, and the monthly trade-balance data were showing improvements. In addition, there was no conclusive evidence that the stock market collapse had thus far significantly damaged economic activity, giving credence to the view that the market's fall was an inevitable one-time technical correction to adjust for excessive price-earnings ratios. It was on this mixed note that 1987 ended and 1988 began.

Key Aspects of the Economic Outlook

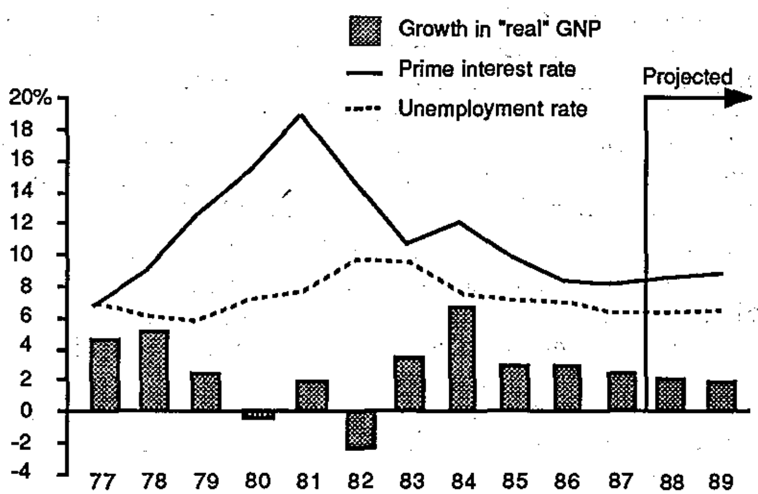
Table 14 and Chart 12 summarize the most critical features of the department's economic outlook for the nation and California in 1988 and 1989. They indicate that for the nation:

- ***Real GNP growth*** is projected to drop to 2.1 percent in both 1988 and 1989. (Most economists view GNP growth of under 3 percent as unsatisfactory over the long term.)
- The ***unemployment rate*** is projected to increase slightly from its 1987 level, to 6.3 percent in 1988 and 6.4 percent in 1989.
- The ***prime interest rate*** is predicted to rise from its 1987 level (8.2 percent) in both 1988 (8.6 percent) and 1989 (9.1 percent).
- The ***savings rate*** (that is, savings as a percent of disposable income) is predicted to drop to only 3.2 percent in 1988 and 2.7 percent by 1989, as consumers attempt to support their spending habits through borrowing and by saving less of their income.

Chart 12

Trends in Key National Economic Variables

1977 through 1989[a]

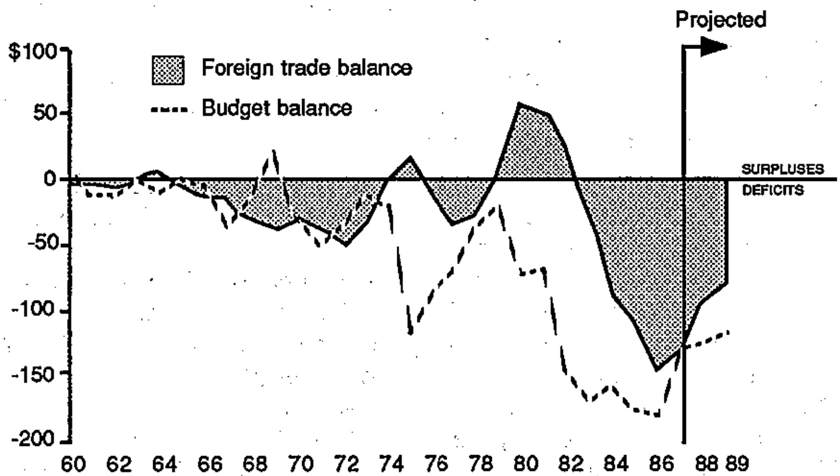


[a]Source: Department of Finance. Data are estimated for 1987.

The 1988 forecast also calls for slow growth in consumer spending, a strengthening of business investment expenditures after adjusting for inflation, and continuing large (though improving) federal budget and foreign trade deficits (see Chart 13).

Chart 13

Trends in the U.S. Foreign Trade and Budget Balances
1960 through 1989 (in billions)*



*Trade balance data shown represent the difference between annualized United States exports and imports, as measured in constant 1982 dollars. Federal budget balance data shown represent the difference between federal receipts and expenditures, as measured in constant 1982 dollars. Projections for 1988 and 1989 are by the Department of Finance.

Trade Deficit Improvement Is Key Assumption. The presence of the trade 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. Consequently, a reduction in the trade deficit generally tends to stimulate the economy. Chart 13 and Table 14 show that while the nation's trade deficit is projected to remain large, the department is counting on it to decline by over $40 billion (32 percent) in 1988. This accounts for over half of the department's projected growth in GNP.

While most economists agree that the trade deficit will shrink in 1988 in response to declines in the international value of the dollar, there is considerable uncertainty and disagreement about the likely timing and magnitude of the improvement. The department subscribes to the view that the 1988 improvement will be fairly substantial, led by increased exports. Although this outcome cannot be guaranteed, it is a reasonable assumption and is consistent both with basic economic theory and recent trade developments.

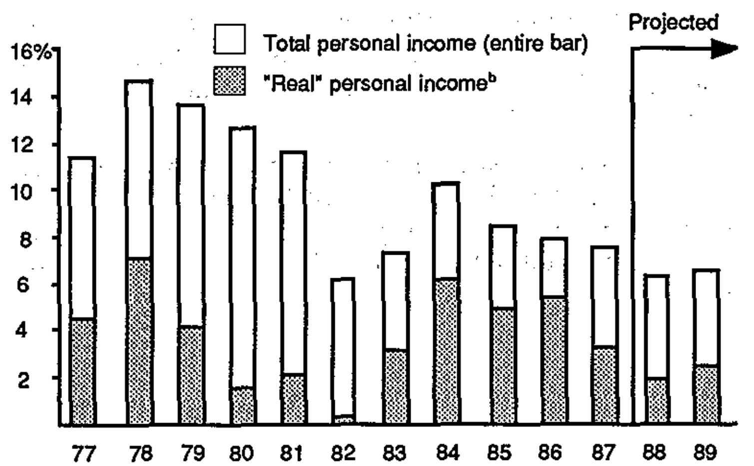
California To Outperform Nation

Regarding California, Table 14 indicates that the state is forecast to experience the same general moderate economic expansion as the nation. However, the state's performance is expected to be a bit stronger than the nation's in a number of areas. Specifically:

- California ***personal income*** is predicted to increase by 6.5 percent in 1988 and 6.7 percent in 1989 (see Chart 14). These growth rates are not high by historical standards, but they do exceed the national projections.
- ***Wage and salary employment*** is expected to grow by 2.6 percent in 1988 and 2.8 percent in 1989 (see Chart 15). Again, these increases are above the nation's, but are not particularly strong for a nonrecessionary period. In fact, given the rate at which California's labor force is expected to increase, the department predicts that the state's job growth will be insufficient to further reduce its ***unemployment rate***. The unemployment rate is projected to hold steady in 1988 and then drift upward slightly in 1989.
- Both ***new building permits*** and ***new car sales*** are expected to weaken somewhat in 1988 from their 1987 levels, with car sales turning up again in 1989 but building permits dropping further. The department is assuming that these spending categories will be constrained by the slow pace of the economy, upward-moving interest rates, and high consumer debt burdens.

Chart 14

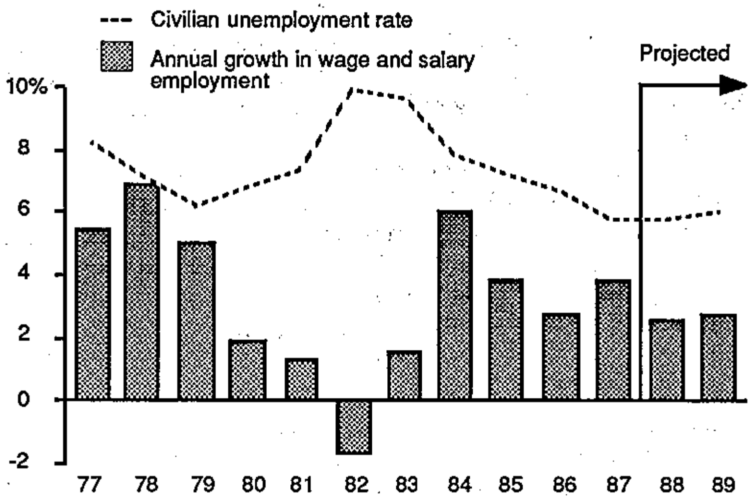
Annual Growth In California Personal Income
1977 through 1989[a]



[a] Source: Department of Finance. Data are estimated for 1987.
[b] "Real" personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

Chart 15

Trends in California's Employment and Unemployment
1977 through 1989[a]



[a] Source: Department of Finance and Employment Development Department. Data are estimated for 1987.

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 "taxable" 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 14:

- ***"Taxable" personal income*** (that is, personal income adjusted for transfer payments, Social Security contributions and certain non-wage income, so as to roughly approximate the portion of personal income subject to taxation) is predicted to increase by 7 percent in 1988 and 6.9 percent in 1989.

- ***Taxable corporate profits*** are predicted to rise by 7.1 percent in 1988 and 6.6 percent in 1989, following a strong 21 percent gain in 1986.
- ***Taxable sales*** are predicted to increase by 5.7 percent in 1988 and 6 percent in 1989.

Thus, all of the major tax bases are projected to experience *moderate growth.*

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 modest growth — is *reasonable* at this point in time. Table 16 shows that this general type of outlook is shared by most other economic forecasters, and that the department's *national* economic outlook is similar to the consensus forecast in many respects.

Table 16

Comparisons of Different Economic Outlooks for 1988 [a]

	Percent Change In:					
National Forecasts	*Real GNP*	*GNP Prices*	*Pre-Tax Profits* [b]	*Unemployment Rate*	*New Car Sales (millions)*	*Housing Starts (millions)*
Department of Finance.....	2.1%	3.2%	–2.5%	6.3%	9.6	1.65
Blue Chip Survey: [c]						
—Concensus forecast	2.2	3.6	2.9	6.2	9.9	1.54
—Low-end average forecast [d]	0.3	3.0	–10.9	5.7	8.8	1.41
—High-end average forecast [d]	3.3	4.3	13.5	6.8	11.0	1.70

	Percent Change In:					
California Forecasts	*Personal Income*	*Consumer Prices*	*"Real" Personal Income* [e]	*Wage and Salary Jobs*	*Unemployment Rate*	*New Residential Building Permits (thousands)*
Department of Finance.....	6.5%	5.0%	1.4%	2.6%	5.8%	220
Other Forecasters:						
UCLA..................	4.5	3.7	0.8	1.0	6.9	165
Security Pacific Bank.....	9.0	5.0	3.8	2.8	5.7	210
First Interstate Bank......	8.9	5.7	3.0	2.9	5.6	237
Bank of America	7.3	4.5	2.7	2.5	5.9	200
Wells Fargo Bank	7.5	4.5	2.9	2.7	5.7	230
Commission on State Finance................	6.7	4.5	2.1	2.4	6.2	216
Average of "Other" Forecasters	7.3%	4.6%	2.6%	2.4%	6.0%	210

[a] Forecasts available as of approximately year-end 1987.

[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 1988 projection for growth in this latter profit measure is –6.1 percent.

[c] Includes the projections of about 50 economists as published in *Blue Chip Economic Indicators* for January 1988. 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 1988.

[e] Defined as personal income adjusted for consumer price inflation.

In broad terms, the department's *California* forecast also is similar to the consensus. However, it is important to note that the department is toward the *low end* of the spectrum with regard to personal income, the single most important determinant of state revenues. For example, *the department's personal income growth forecast is almost 1 percentage point below the consensus, and lies beneath all but one of the other forecasts cited.* This is an important difference, since each percentage point of income growth typically translates into at least $300 million in additional revenues. 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 may be *somewhat conservative.* This proved to be the case last year also (see Table 15).

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, additional stock market disruptions, and either a further deterioration or significantly greater-than-expected improvement in the foreign trade balance. Such developments obviously would require substantial revisions in the economic outlook.

DETAILED VIEW OF THE REVENUE FORECAST

Table 17 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).

Table 17
State Revenue Collections
1986-87 through 1988-89
(dollars in millions) [a]

General Fund	*Actual 1986-87*	*Estimated 1987-88*	*Projected 1988-89*	*Change from 1987-88* Amount	*Change from 1987-88* Percent
Taxes:					
Personal income [b]	$13,922	$14,100	$15,428	$1,328	9.4%
Sales and use [c]	10,904	11,500	12,275	775	6.7
Bank and corporation [d]	4,801	5,000	5,415	415	8.3
Insurance	1,009	1,100	1,225	125	11.4
Estate, inheritance and gift [e]	273	380	345	−35	−9.2
Cigarette	179	177	176	−1	−0.6
Alcoholic beverage	131	130	129	−1	−0.8
Horse racing	111	112	114	2	1.8
Subtotals, Taxes	($31,331)	($32,499)	($35,107)	($2,608)	(8.0%)

Other Sources:					
Interest on investments	$447	$400	$450	$50	12.5%
California State University fees [f]	242	293	327	34	11.6
Oil and gas revenues [g]	33	101	16	−85	−84.2
Other revenues [h]	270	288	323	35	12.2
Transfers and loans	196	97	26	−71	−73.2
Totals, General Fund	$32,519	$33,678	$36,249	$2,571	7.6%
Special Funds					
Motor Vehicle Revenues:					
Fuel taxes	$1,250	$1,270	$1,300	$30	2.4%
License fees (in lieu)	1,665	1,819	1,938	119	6.5
Registration, weight and miscellaneous fees	1,025	1,070	1,108	38	3.6
Subtotals, Motor Vehicle Revenues	($3,940)	($4,159)	($4,346)	($187)	(4.5%)
Other Sources:					
Oil and gas revenues [g]	$131	$141	$177	$36	25.5%
Sales and use taxes [i]	—	20	49	29	45.0
Interest on investments	143	132	117	−15	−11.4
Cigarette tax	76	75	74	−1	−1.3
Other	958	1,074	1,214	140	13.0
Totals, Special Funds	$5,248	$5,601	$5,977	$376	6.7%
Totals, State Funds	$37,767	$39,279	$42,225	$2,946	7.5%

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

[b] Estimates include (i) the effects of Ch 1138/87, the federal conformity bill (see text discussion); (ii) a $7 million loss in 1987-88 and a $5 million gain in 1988-89 due to other 1987 legislation; (iii) gains of $53 million in 1987-88 and $80 million in 1988-89 due to reestimates of revenues produced by enforcement-related activities of the Franchise Tax Board (FTB); (iv) gains in 1988-89 of $25 million from the Governor's *proposal* to increase audit staff at the FTB and $30 million from increased federal auditing activity; and (v) net gains of about $1 billion in 1986-87 and $255 million in 1987-88, and a net loss of $415 million in 1988-89, from the combination of federal tax reform and the 1987 stock market decline (see text discussion).

[c] Estimates include (i) a $30 million gain in 1988-89 from the Governor's *proposal* to increase the audit staff at the Board of Equalization (BOE); (ii) a $7 million net loss in 1987-88 and an $85 million net gain in 1988-89 due to 1987 legislation; (iii) losses of $12 million in 1987-88 and $30 million in 1988-89 due to BOE regulatory changes involving the motion picture industry and master computer software programs; and (iv) a gain of $15 million in 1988-89 from the Governor's *proposal* to use Petroleum Violation Escrow Account (PVEA) monies to partially fund the statutorily required transfer of diesel fuel sales tax revenues to the Transportation Planning and Development (TP&D) Account.

[d] Estimates include (i) gains of $113 million in 1987-88 and $96 million in 1988-89 from reestimates of revenues produced by enforcement-related activities of the FTB; (ii) a gain of $25 million in 1988-89 from the Governor's *proposal* to increase audit staff at the FTB; (iii) the estimated effects of federal tax reform (a gain of $240 million in 1986-87 and losses of $60 million in 1987-88 and $90 million in 1988-89); (iv) a loss of $40 million in 1988-89 due to Ch 660/86 (the "unitary reform" measure); and (v) the effects of Ch 1139/87, the federal conformity bill (see text discussion).

[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 1988-89 include $321 million in estate taxes, $23 million in inheritance taxes and $1 million in gift taxes. The 1987-88 inheritance tax estimate is $100 million, and 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] 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 other funds and federal lands royalties.

[h] 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.

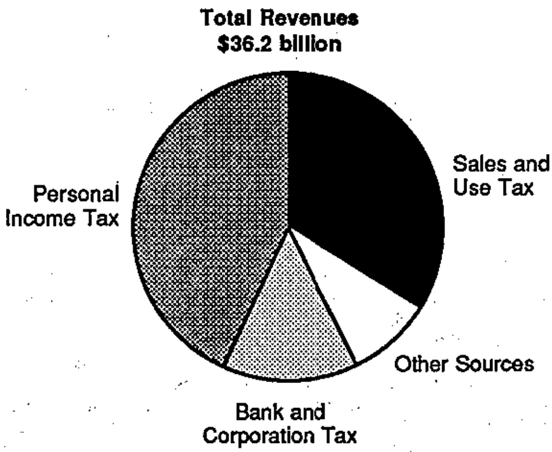
[i] Reflects sales and use tax receipts to the Transportation Planning and Development Account in the Transportation Tax Fund. The 1988-89 transfer is to be $64 million under current law. However, the Governor *proposes* that $15 million of this amount be funded from the Petroleum Violation Escrow Account.

A. The Forecast for General Fund Revenues

General Fund revenues are projected to total $36.2 billion in 1988-89, an increase of $2.6 billion over the 1987-88 estimate of $33.7 billion. Chart 16 shows that over 91 percent ($33.1 billion) of these revenues is to be 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 16

1988-89 General Fund Revenues, by Source



Special Factors Distort Revenue Growth

Table 17 shows that projected 1988-89 General Fund revenue growth is 7.6 percent, compared to only 3.6 percent in the current year and over 15 percent in the prior year. These highly dissimilar growth rates reflect distortions due to a number of special factors, in whose absence the growth rates would be closer. These distortions involve:

- ***Federal Tax Reform.*** Projected revenues have been increased by $1.2 billion in 1986-87, and reduced by about $270 million in 1987-88 and $320 million in 1988-89, to account for the effects of the federal Tax Reform Act of 1986 on state tax collections.

- ***The Stock Market Crash.*** Revenues have been increased by $465 million in 1987-88 and reduced by $186 million in 1988-89 in response to the crash's effect on reported capital gains.
- ***Increased Tax Auditing.*** Estimated revenues have been increased by $110 million in 1988-89, due to increased federal audit activity and the Governor's *proposal* to add to audit staff at the tax agencies.
- ***Large Inheritance Tax Payment.*** A $75 million one-time inheritance tax payment is expected in 1987-88 from an unusually large estate.

The combined effect of these and other factors (such as new legislation) is to make 1986-87 and 1987-88 revenues about $1.2 billion and $500 million, respectively, *greater* than otherwise and 1988-89 revenues about $250 million *less* than otherwise. Absent these factors, General Fund revenue growth would be about 10.9 percent in 1986-87, 6.2 percent in 1987-88 and 9.9 percent in 1988-89.

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 9.3 percent, and includes a variety of income exclusions, deductions and credits. Personal income tax (PIT) revenues are projected to be $14.1 billion in the current year and $15.4 billion in the budget year. These totals include about $50 million in the current year and $80 million in the budget year due to reestimates of revenues produced by enforcement-related activities of the Franchise Tax Board (FTB), plus another $55 million in the budget year for audit revenues related to federal audit activities and proposed staff increases at the FTB.

Tax Structure Has Been Revised. Legislation was enacted during 1987 which significantly restructured both the state's personal income tax (Chapter 1138—AB 53) and corporation tax (Chapter 1139—SB 572). These tax law changes are summarized in Chart 17. The state's personal income tax was revised to more closely conform with federal law, effective with the 1987 income year. Among other things, this legislation:

- Adopted most of the *base-broadening provisions* of the federal Tax Reform Act of 1986, including limiting or eliminating various tax deductions, making capital gains fully taxable, and restricting "passive losses."
- Conformed to the federal standard deduction and established a number of new tax credits, such as for low-income housing and certain research activities.

- *Reduced tax rates* (the maximum marginal tax rate was dropped from 11 percent to 9.3 percent) and increased the personal, blind and dependent credits.

Because of the complex assumptions needed to develop the estimated revenue effects of state tax reform, including the behavioral responses of taxpayers to the law changes, the department's estimates of these effects inevitably are subject to *fairly large error margins.*

Chart 17

Estimated Revenue Effects of State Tax Reform (In millions)[a]

PERSONAL INCOME TAX

	1987 EFFECT
Base-broadening changes:	
• Full taxation of capital gains	$764
• Passive loss limits and "at risk" rules	225
• Repeal of income averaging	180
• Other provisions, including elimination or reduction of various tax deductions and income exclusions[b]	770
Subtotal, base-broadening changes	**$1,939**
• Reduction of marginal tax rates and revisions to tax brackets	-1,512
• Conformity to the federal standard deduction	-50
• Increases in personal and dependent credits, and allowances for senior credit	-304
• Enactment/expansion of other credits	-94
• Provisions to encourage tax compliance	18
Total revenue effect	**-$3**

BANK AND CORPORATION TAX

	1987 EFFECT
Base-broadening changes:	
• Uniform capitalization rules	$381
• Limits on business and entertainment deductions	63
• Restrictions on long-term contract accounting methods	60
• Limits on cash-accounting methods	45
• Limits on expensing of intangible drilling costs	25
• Other provisions	48
Subtotal, base-broadening changes	**$622**
• Conformity to federal rules for taxing Subchapter S corporations, with a special 2.5 percent surtax	-249
• Partial carryover of net operating losses	-269
• Reduction in tax rate from 9.6% to 9.3%	-161
• Other provisions[c]	35
Total revenue effect	**-$22**

[a] Source: Assembly/Senate Conference Committee on Tax Reform, Department of Finance and Franchise Tax Board. Estimates are those used at the time tax reform was enacted and are subject to future revision.

[b] Affected areas include retirement contributions, pensions, moving expenses, alimony, charitable contributions, state and local taxes, consumer and investment interest, accounting methods, employee business expenses, business meals and entertainment, depreciation, and others.

[c] Includes increase in basic minimum tax ($28 million gain, increasing to $219 million by 1990), conformity to federal alternative minimum tax (no effect in 1987, but revenue gains thereafter beginning with $223 million in 1988), conformity to various federal tax credits (loss of $7 million), and tax compliance and other provisions (gain of $14 million).

Federal Tax Reform and Stock Market Crash Have Large Revenue Impacts. The department's estimated PIT revenues represent gains of 1.3 percent in the current year and 9.4 percent in the budget year, following a gain of nearly 22 percent in the prior year. This volatile growth pattern reflects very uneven growth rates for income-year tax liabilities (see Chart 18). In most years the growth in these tax liabilities runs slightly ahead of taxable personal income growth, due to the state's progressive marginal income tax bracket structure. This is not true for the period 1986 through 1989, however, primarily because of the distorting effects of federal tax reform and the stock market crash:

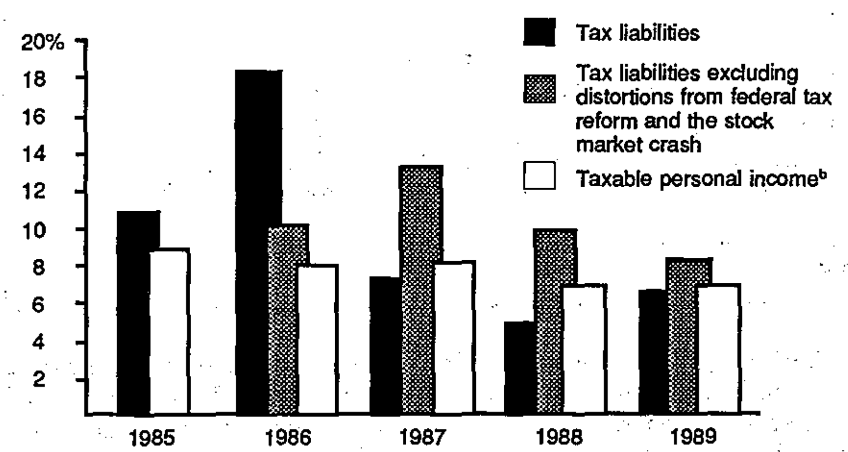
- ***Federal Tax Reform.*** The department estimates the effect of the federal Tax Reform Act of 1986 on state personal income tax revenues to be a gain of $980 million in 1986-87, and losses of about

$210 million in 1987-88 and $230 million in 1988-89. The largest revenue effects involve sales of assets on which capital gains taxes must be paid. (Because the act increased the federal tax rate on capital gains beginning in 1987, it affects both the timing and total volume of capital gains reported for tax purposes.) 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).

- *The Stock Market Effect.* The dramatic stock market crash in October 1987 has two main direct implications for personal income tax revenues. First, it "evaporated away" a large portion of the stock-related capital gains that otherwise would have been reported by taxpayers in the future. Second, the large stock sell-off that occurred increased the volume of capital gains reported in late 1987. The department assumes the net revenue effect of these opposing factors to be a $465 million *gain* in 1987-88 and a $186 million *loss* in 1988-89 (plus additional losses thereafter).

Chart 18

Annual Growth in Personal Income Tax Liabilities
1985 through 1989 Income Years[a]



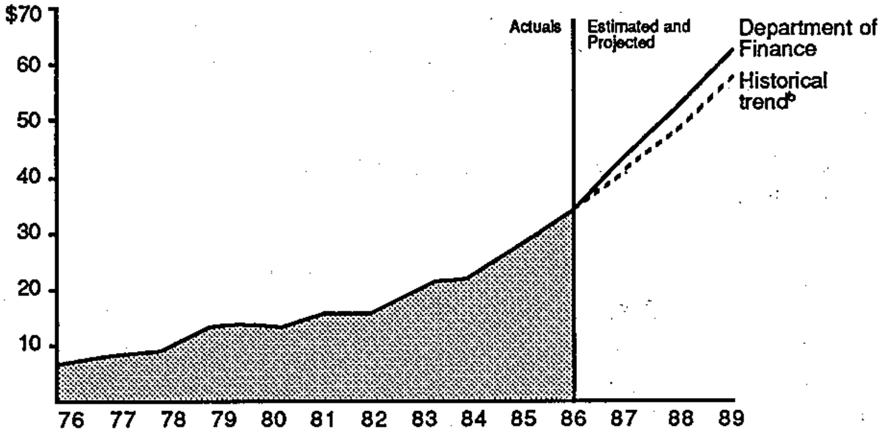
[a] Source: Department of Finance. Data are for income years and are estimated for 1986 and 1987 and projected for 1988 and 1989.
[b] Defined as total personal income plus Social Security contributions, minus transfer payments and certain other nontaxable income components.

Strong Underlying Growth in Tax Liabilities. Chart 18 shows that removing the above distortions results in the more traditional relationship of liability growth annually exceeding income growth. However, the chart also shows that the magnitude by which liability growth exceeds income growth in 1987 and 1988 is abnormally large. This is due to the department's *assumption* that the underlying baseline trend in capital gains (which are not included as part of personal income but yet are taxable) will be extremely strong. As shown in Chart 19, the assumed capital gains trend after 1986 is stronger than the average capital gains growth rate over the prior 10 years. In addition, the department's trend assumes a steady future growth rate even though historically, year-to-year volatility has been the norm (particularly in years following especially large increases—as in 1986).

Chart 19

California Profits from Sales of Capital Assets

1976 through 1989 (in billions)[a]



[a] Source: Department of Finance.
[b] Based on the annual average growth rate from 1976 through 1986.

Evaluation of the PIT Forecast. The PIT forecast for both the current year and budget year is extremely vulnerable to error. This is because of the numerous revenue-related *assumptions* which the department has had to make regarding such factors as tax reform, the stock market crash, and both the rate at which capital gains are being accrued (there are no good data to measure this) and when they are actually realized and reported for tax purposes. However, we believe that:

- The department's assumptions about tax reform and the stock market, while subject to great error, are *reasonable* — at least as much as anyone's could be at this point in time.

- The department's estimate of baseline tax liabilities (that is, liabilities excluding special distorting factors and capital gains) is a bit high. Specifically, we estimate that PIT revenues *generated by the department's economic forecast* will be lower than predicted, by about $55 million in 1987-88 and $85 million in 1988-89.
- Revenues could be even lower than this if the department's assumption about capital gains proves optimistic. The department assumes that the underlying baseline trend in reported capital gains will increase 25 percent in 1987 (these gains have yet to be measured) and 20 percent in both 1988 and 1989, compared to an average of 18 percent over the prior decade. No one has been able to accurately predict capital gains in the past. However, *should the long-term average growth prevail*, this would further reduce revenues, by more than $100 million in 1987-88 and $150 million in 1988-89.

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 total $11.5 billion in the current year and $12.3 billion in the budget year. These revenues are derived from a 4 3/4 percent levy on taxable sales and are in addition to the sales and use taxes levied by local governments and transit districts. Budget-year revenues include about $85 million due to newly enacted legislation.

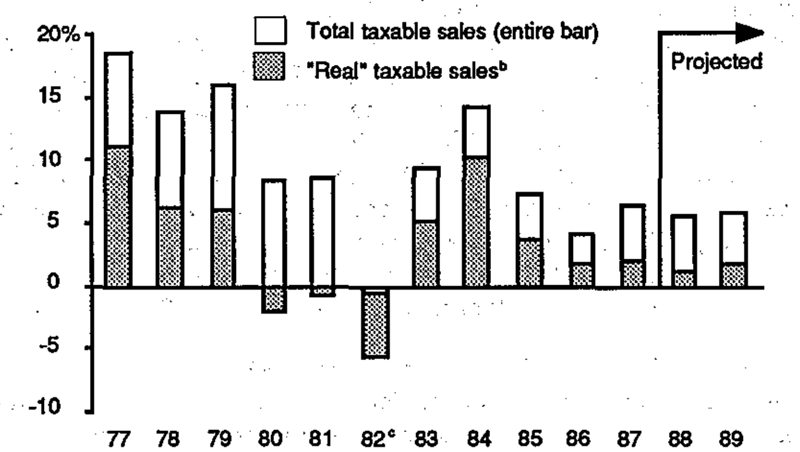
Soft Growth Projected for Taxable Sales. The department predicts that taxable sales will grow by 5.7 percent in 1988 and 6.0 percent in 1989. Chart 20 shows that these increases are relatively modest by historical standards, both before and after adjustment for inflation. For example, during the previous 10 years, taxable sales growth averaged nearly 9 percent. Projected taxable sales growth in 1988 and 1989 also is 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 21). Taxable sales growth is predicted to be especially weak in 1988 for building materials and motor vehicles (up only 4.3 percent), which reflects the department's projected drop-off in both California housing starts and car sales (see Table 14).

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 basic willingness of consumers to borrow more and/or save less in order to finance their spending. Our own revenue estimating model confirms that the department's economic assumptions, *if realized*, will produce relatively soft growth in taxable sales and a continued decline in the sales-to-income ratio. However, the

Chart 20

Annual Growth in California Taxable Sales

1977 through 1989[a]



[a] Source: Department of Finance. Data are estimated for 1987.

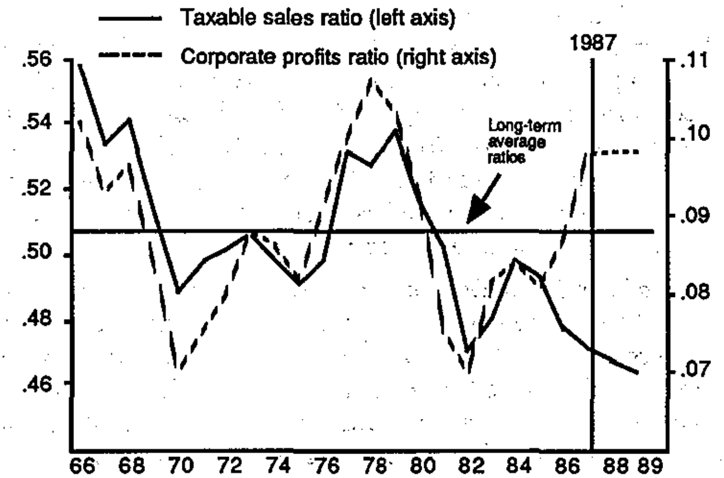
[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the GNP price deflator for consumption expenditures.

[c] Total taxable sales declined by 0.4 percent.

Chart 21

Ratios of California Taxable Sales and Corporate Profits to Personal Income

1966 through 1989[a]



[a] Source: Department of Finance. Data are estimated for 1987 and projected for 1988 and 1989.

actual growth rates for taxable sales that our model generates are slightly higher than predicted by the department — 6 percent (versus the department's 5.7 percent) for 1988 and 6.3 percent (versus 6.0 percent) for 1989. This is because the department's projected decline in the savings rate and increase in the employment-to-population ratio should partially offset various other negative factors affecting taxable sales. As a result, we estimate that sales tax revenues *generated by the department's economic forecast* will be greater than predicted, by $25 million in 1987-88 and $65 million in 1988-89.

Stock Market Damage Less Than Many Expected. Immediately following the October 1987 stock market crash, many economists predicted that consumers would retrench, leading to a recession. They felt that the market's record drop would make people lose confidence in the economy and financial marketplace, and therefore be more cautious about spending and prone to save. In addition, previous economic research has documented that consumers tend to reduce their spending when their overall wealth declines, and the value of stocks owned by individuals fell by around $1 trillion.

Consumer spending did *not*, however, "fall apart" following the crash. One partial explanation for this may be that many investors themselves may have suspected that stocks were significantly over-priced prior to the crash; another reason may be that monetary policy was eased after the crash in an attempt to provide economic stimulus. Granted, consumer spending was soft in late 1987 and is not expected to be very strong in 1988, and the crash has undoubtedly contributed to this; however, an environment of soft consumer spending also is supported by such other factors as high consumer debt burdens and the already-low savings rate.

The Forecast for Bank and Corporation Taxes — Moderate Increase

Bank and corporation taxes, the third largest source of General Fund revenues, are derived primarily from a 9.3 percent levy on the taxable profits of corporations doing business in California. These revenues are projected to total $5.0 billion (4.1 percent growth) in the current year and $5.4 billion (8.3 percent growth) in the budget year. The key assumptions behind these projections involve the effects of federal and state tax reform, and the underlying forecast for taxable profits.

State Revenue Effects of Federal Tax Reform. The federal Tax Reform Act of 1986 is projected to have caused California corporate tax revenues to increase by $240 million in 1986-87, followed by decreases of $60 million in the current year and $90 million in the budget year. These latter decreases reflect a shift in the timing of certain tax payments, plus 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.)

Revenue Effects of State Tax Reform. As shown in Chart 17, 1987 state tax reform legislation (Ch 1139—SB 572) made several significant changes to the Bank and Corporation Tax Law. Among other things, this legislation:

- Reduced the basic state corporate tax rate from 9.6 percent to 9.3 percent;
- Permits 50 percent of net operating losses to be carried forward for a 15-year period in order to offset taxable income;
- Conforms to federal provisions allowing Subchapter S corporations to "pass through" their income, losses, deductions and credits to shareholders; and
- Adopted a variety of other provisions to broaden the state's corporate tax base.

Because of the complex assumptions needed to develop the estimated revenue effects of state tax reform, including the behavioral responses of taxpayers to the law changes, the department's estimates of these effects inevitably are subject to *fairly large error margins.*

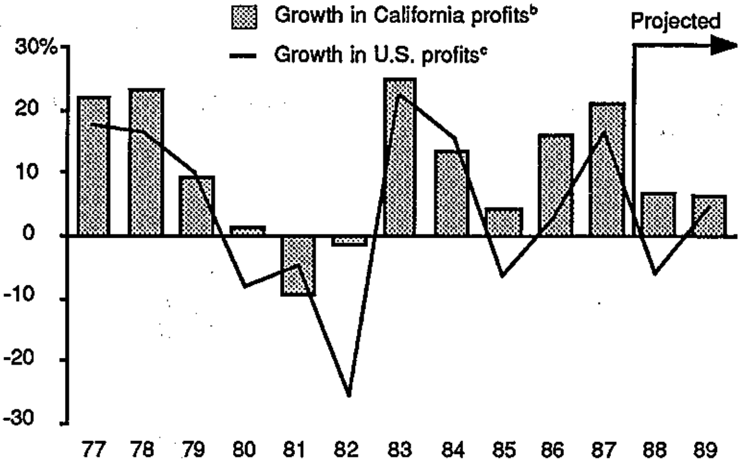
Moderate Growth Predicted in Taxable Profits. The department projects that after removing the distorting effects of tax reform, taxable California corporate profits will rise by 7.1 percent in 1988 and 6.6 percent in 1989. Chart 22 shows that although these profit increases are not particularly large by historical standards (the average growth over the past two decades has been well over 9 percent), California still is projected to outperform the nation. And because these projected profit increases closely parallel projected personal income growth, the ratio of profits-to-income will remain at a relatively high level (see Chart 21).

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, the level of business inventories, and national corporate profits. Our own revenue estimating model confirms the findings that the department's economic forecast, *if realized,* will generate moderate growth in taxable profits, that California will outperform the nation, and that the profits-to-income ratio will remain at an above-average level. However, the specific growth rates and profit levels that our model projects for California are *below* the department's. Further argument that the department's state profit forecast is somewhat overstated can be made based on the unusually large projected gap between California's and the nation's profit growth rates — 13.2 percentage points for 1988. There has been only one time in the past 20 years when this gap was greater.

Chart 22

Annual Growth in Taxable Corporate Profits

1977 through 1989[a]



[a] Source: Department of Finance.

[b] California profit totals include a $967 million increase in 1978 due to Proposition 13. Preliminary 1987 estimate by Department of Finance and Franchise Tax Board.

[c] California and U.S. profit data are not strictly comparable due to definitional differences. Data incorporate the effects of several major federal tax law changes during the 1980s which revised the definition of taxable U.S. corporate profits.

Given the above, we estimate that bank and corporation tax revenues *generated by the department's economic forecast* will be lower than predicted, by $30 million in 1987-88 and $120 million in 1988-89.

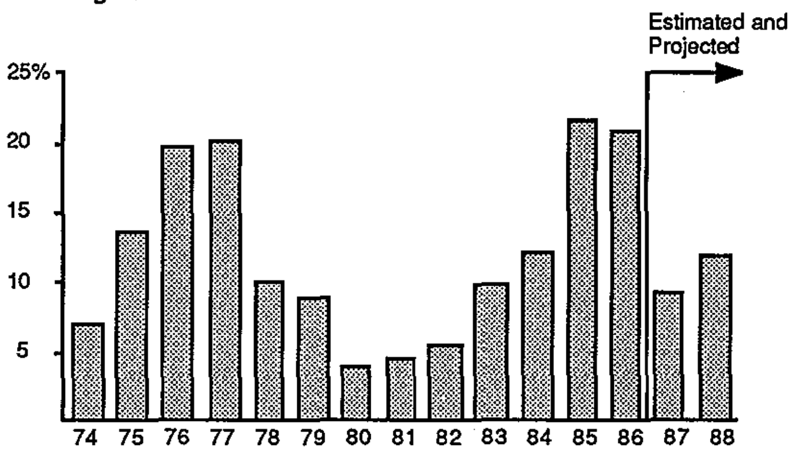
Insurance Taxes — Continued Healthy Gains

Insurance tax revenues, which primarily are derived from a 2.35 percent levy on taxable insurance premiums, are projected to reach $1.1 billion (9 percent growth) in the current year, and more than $1.2 billion (over 11 percent growth) in the budget year.

Moderate Growth in Insurance Premiums. Because of the way in which insurance tax prepayments are computed, 1987-88 revenues primarily depend on 1987 premiums, and 1988-89 revenues will depend primarily on 1988 premiums. Chart 23 shows that the healthy revenue increases predicted for 1987-88 and 1988-89 reflect the department's forecast that total insurance premiums will rise by over 9 percent (to $45 billion) in 1987 and nearly 12 percent (to $51 billion) in 1988. These increases are well above projected personal income growth, although below the average growth in premiums during the preceding 10 years — nearly 13 percent. The department's forecast is based on survey information from firms collecting about one half of California's insurance premiums. Especially large premium increases are expected for workers' compensation insurance and certain liability insurance lines, especially medical malpractice and nonauto liability. The latter partly reflects the trend in recent years of increased liability claims and large monetary judgments to plaintiffs.

Chart 23

Annual Growth in California Taxable Insurance Premiums
1974 through 1988[a]



[a] Source: Department of Finance. Insurance tax revenues in 1987-88 primarily depend on 1987 premiums, while revenues in 1988-89 primarily depend on 1988 premiums. Data shown are for premiums subject to the standard 2.35 percent tax rate, and exclude certain premiums for pension and profit sharing plans, surplus lines and ocean marine insurance, which are taxed at special rates.

Evaluation of the Insurance Tax Forecast. Insurance tax premiums are only loosely related to the outlook for the economy. Chart 23 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 are neither cyclically high nor low at present; therefore, premium increases probably will be mid-ranged. As Chart 23 shows, the department's forecast is consistent with this evidence. *Consequently, we believe the forecast is a reasonable one.*

Death-Related Taxes — Large One-Time Gain Assumed in Current Year

Death-related tax revenues are predicted to be $380 million in the current year and $345 million in the budget year. The budget-year estimate includes $321 million from the estate tax and $24 million from inheritance and gift taxes. The current-year estimate includes $75 million in inheritance taxes associated with one unusually 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.)

Well-Paced Underlying Growth. Excluding the large one-time current-year payment, death-related taxes in the budget year are projected to increase at about an 11 percent pace. This is consistent with the state's death rate, recent trends in revenue receipts, and the rate of appreciation in values of real property and other assets on which future 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 current year depends upon decisions yet to be made by the State Controller at the time this analysis was written. 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 at all until after the current year or perhaps even after the budget year, in which case *revenues would be reduced by $75 million.* On the other hand, revenues also could end up *exceeding $75 million* under the second option if the property is sold, since its current market value appears to exceed $75 million. The Controller must make his decision regarding this property by late February.

The Forecast for Other Taxes — No Growth

General Fund revenues from the state's remaining taxes are projected to total about $419 million in the budget year, or identical to the current year and down slightly from the prior year. These taxes include the cigarette tax ($176 million), alcoholic beverage taxes ($129 million), and horse racing taxes ($114 million). The flatness in revenues from the first two sources is due mainly to two factors:

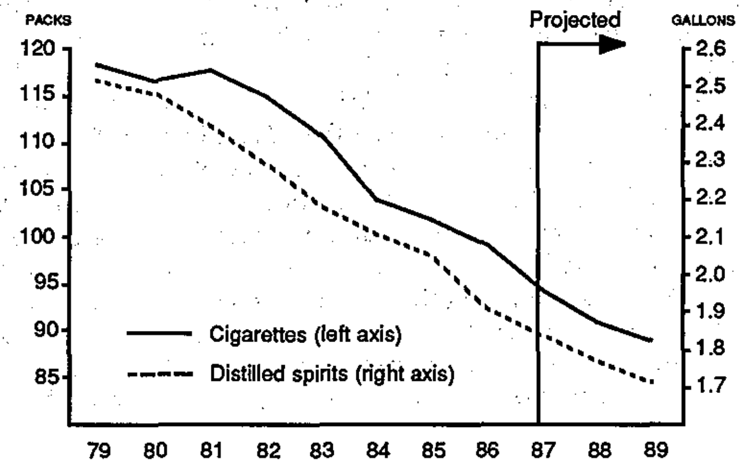
- First, both cigarettes and alcoholic beverages are taxed on a fixed "cents-per-unit-consumed" basis. Thus, taxes collected do not increase over time as the prices for these items rise.
- Second, the "bases" on which the taxes are levied are not growing much. This is because the effects of population growth have been offset by declining per capita consumption of both cigarettes and hard liquor (which accounts for three-fourths of alcoholic beverage taxes). These declines are illustrated in Chart 24.

In the case of horse racing, the total pari-mutuel wagering base on which state taxes are imposed is projected to *rise* by about 18 percent in 1987-88 and nearly 8 percent in 1988-89. However, most of this increase is due to 1987 legislation (Chapter 1273—SB 14) which expanded satellite wagering to fair locations in central and southern California and revised it in northern California. The primary effect of these changes is on special fund revenues, not General Fund revenues.

The estimates for the above revenues are reasonable.

Chart 24

California Per Capita Consumption of Cigarettes and Distilled Spirits
1978-79 through 1988-89[a]



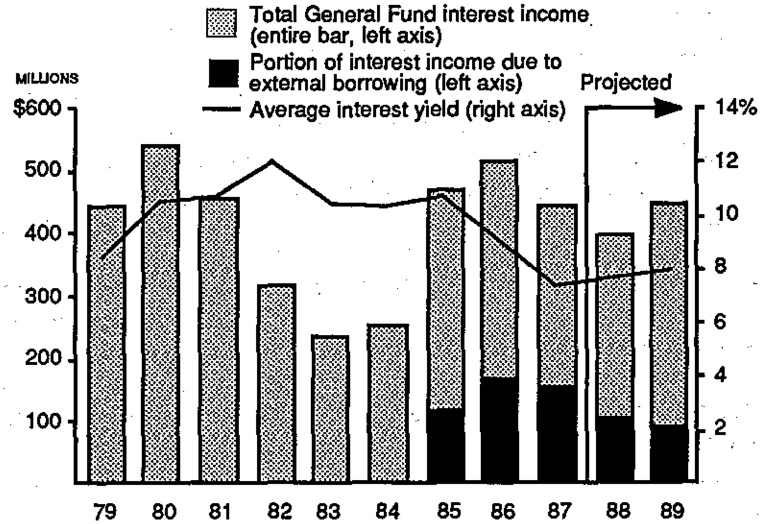
[a] Source: Department of Finance and State Board of Equalization. Data shown are for fiscal years ending in year specified.

The Forecast for Interest Income — Increase Expected

General Fund interest income is predicted to total $450 million in the budget year, up from $400 million in the current year and about the same as in the prior year (see Chart 25). This interest income is derived primarily 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 not been 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 intra-year cash-flow imbalances. These monies are all invested through the state's Pooled Money Investment Account (PMIA).

Chart 25

General Fund Revenues From Interest Income
1978-79 through 1988-89[a]



[a] Source: *1988-89 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 increase in the budget year — the former from $5.2 billion to $5.6 billion and the latter from 7.7 percent to 8.1 percent.

Evaluation of the Interest Income Forecast. The department's estimates of interest income are internally consistent with the assumptions in the *Governor's Budget* regarding the economy, the amount of external borrowing to be undertaken, and the General Fund's estimated expenditures and year-ending surplus balances. In particular:

- The assumed rise in the average PMIA earnings yield closely parallels the department's projected updrift in economy-wide interest rates.
- The projection of the General Fund's average investment balance correctly recognizes that the balance will *drop significantly* in 1987-88 and then *rise significantly* in 1988-89. This pattern is partly explained by the $1.1 billion current-year tax rebate that resulted

from the state's appropriation limit. The timing of this rebate had the distorting effect of "pulling down" the average 1987-88 PMIA investment balance.

Given the above, *we believe that the department's interest income forecast is reasonable.*

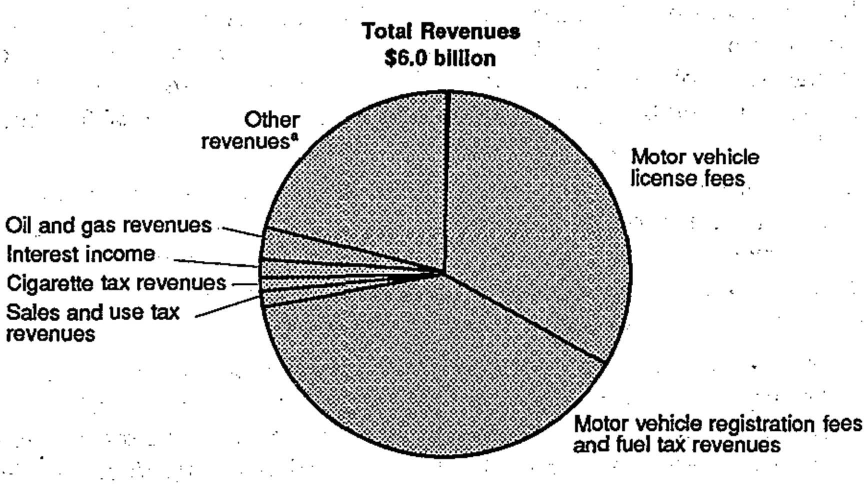
B. The Forecast for Special Fund Revenues

Special fund revenues are projected to total $6.0 billion in 1988-89, or 14 percent of total revenues. Table 17 and Chart 26 indicate that:

- Nearly three-fourths ($4.3 billion) of special fund revenues are derived from motor vehicle-related sources. These include those dedicated for transportation purposes, namely fuel taxes ($1.3 billion) and vehicle registration and related fees ($1.1 billion). Also included is the vehicle license fee ($1.9 billion), which is imposed on motor vehicles in lieu of the local property tax.
- The remaining one-fourth ($1.6 billion) of special fund revenues include oil and gas royalties, interest income, local governments' 30-percent share of cigarette tax collections, and other smaller sources, such as various business and professional license fees, utility surcharge receipts, and penalties from traffic violations and criminal convictions.

Chart 26

1988-89 Special Fund Revenues, by Source



[a] Includes a variety of sources such as regulatory taxes and licenses, fees and user charges, and penalty assessments.

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 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 17 indicates that special fund revenues are predicted to rise by about 7 percent in both 1987-88 and 1988-89. The table also shows, however, that the growth rates for individual special fund revenue sources differ considerably from one another.

Mixed Growth Trends for Motor Vehicle-Related Revenues

These revenues are projected to grow by 4.5 percent in 1988-89, including moderate growth for vehicle license fees (over 6 percent), very modest growth for registration fees (4 percent) and weak growth for fuel taxes (2 percent). Specifically:

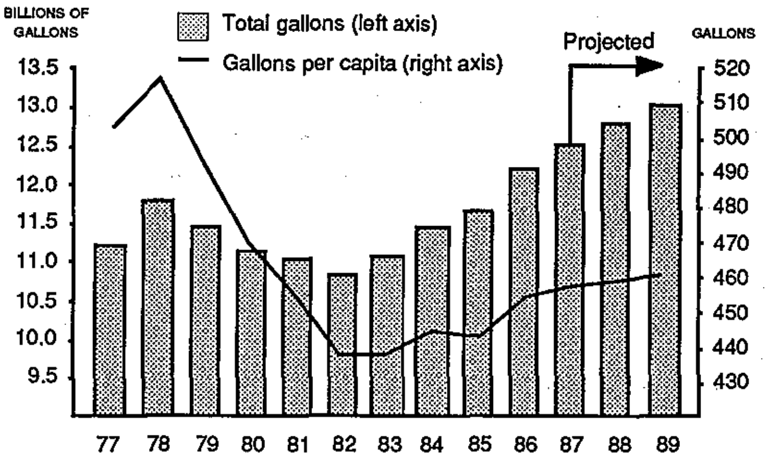
- ***Vehicle license fees,*** which are imposed for the privilege of operating vehicles on public roads in California and are in lieu of the local personal property tax on vehicles, are the single largest special fund revenue source. Their expected moderate growth in 1988-89 primarily reflects the fact that the average market value of new cars being registered is rising at about 5 percent annually and is expected to reach about $15,200 in 1988-89 (higher-priced vehicles translate into more revenues, because a vehicle's license fee depends on its market value). The reason why expected revenue growth is not as strong as in 1987-88 (over 9 percent) is that new car registrations are expected to drop in 1988 by nearly 12 percent (see Table 14).
- ***Registration fees,*** which are levied at a flat per-vehicle rate, are projected to grow only very modestly because of the fewer new vehicle sales in 1988 than in 1987.
- ***Fuel taxes,*** which also are levied at a flat rate, are projected to increase very little. This is because of projected weak growth in gasoline sales, due to very slowly rising per capita gasoline use. As

shown in Chart 27, the per capita level of gasoline consumption is still well below its 1978 peak, although it has been rising gradually since 1983.

Chart 27

California Gasoline Distributions

1977 through 1989[a]



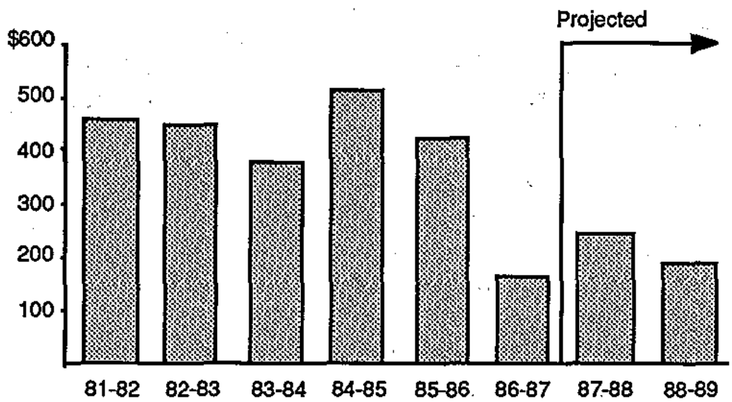
[a] Source: *1988-89 Governor's Budget* and State Board of Equalization. Data are estimated for 1987.

Oil and Gas Revenues To Remain Low

Chart 28 shows that state oil and gas royalty income is projected to remain well below its high levels experienced during the first half of the 1980s. This reflects the lower post-1986 level of world crude oil prices, which reduces the revenues derived from oil produced on state-owned lands. Total state oil and gas royalty income is projected to be $250 million in the current year and $195 million in the budget year. While this exceeds the $172 million collected in 1986-87, it is far below the average of $450 million for the preceding five years. And, as discussed later in the revenue reliability section, even these lower revenue figures now appear to be *substantially overstated* because of recent developments in world oil markets. The amount of the overstatement in each year appears to be at least $60 million and probably more.

Chart 28

State Oil and Gas Royalties
1981-82 through 1988-89 (in millions)[a]



[a] Source: *1988-89 Governor's Budget* and State Lands Commission. Data shown include oil, gas and mineral royalties collected by the State Lands Commission.

C. California State Lottery Revenues

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.

Projected Lottery Sales — $1.8 Billion

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

The budget projects that lottery sales will total $1.8 billion in both the current and budget years, or over $60 per capita. This represents an increase of about 25 percent over sales in 1986-87, the lottery's first full year of operation. Lotto games are expected to account for $1 billion of 1988-89 sales, compared to $750 million for instant ticket games.

Sales Forecast Is Reasonable

The lottery sales projection assumes that an increase in weekly per capita sales of on-line tickets will offset an anticipated decline in average weekly per capita sales of instant tickets. The trends assumed are based on the sales experience over time in other lottery states which operate both types of games, such as Michigan, Arizona, Pennsylvania and New Jersey. As of year-end 1987, estimated lottery sales were running somewhat ahead of expectations. Thus, based on the evidence to date, the sales projection is reasonable. In fact, if current trends continue, the projection could prove too conservative.

How Lottery Proceeds Are Used

Chart 29 shows how the budget proposes to distribute the $1.8 billion of projected lottery receipts in 1988-89. Existing law provides that these proceeds must be distributed as follows:

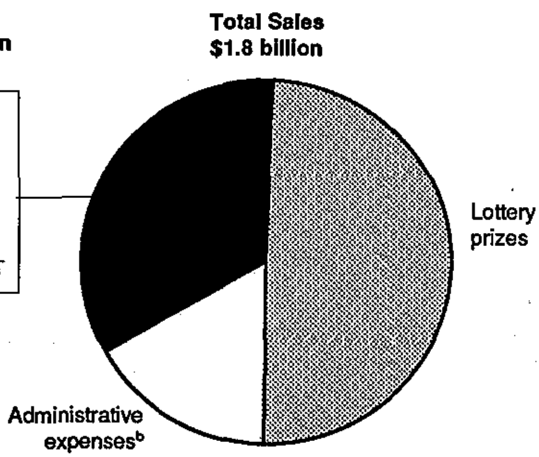
- 50 percent ($875 million) must be paid out to the public as prizes;
- Up to 16 percent ($280 million) may be used to cover lottery-related administrative expenses; and
- At least 34 percent ($595 million), along with any unclaimed prize monies and unused administrative allotments, must be allocated to various levels of public education.

Chart 29

Estimated Distribution of 1988-89 State Lottery Receipts

Revenues to Education (in millions)

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



[a] Includes $595 million from 1988-89 lottery sales and $13 million in net interest income.
[b] Includes commissions to retailers, instant-game ticket costs, on-line lotto-game costs, and general operating expenses.

Chart 29 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 1988-89 lottery revenues earmarked for education amount to about 3.2 percent of total proposed General Fund educational expenditures.

RELIABILITY OF THE REVENUE FORECASTS

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, for example, the estimating error for budget-year General Fund revenues (after adjusting for noneconomic factors such as new legislation) has averaged close to 5 percent, which in 1988-89 would amount to a revenue-estimating error of close to *$1.8 billion.* Over the past three years, the average budget-year forecasting error has been much smaller — under 2 percent. However, even a 1 percent error would translate into a dollar error of over $350 million in 1988-89. 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 earlier for each of the major General Fund 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 a bit on the *conservative side* relative to the consensus view for the most important revenue-determining variables.

Basic Conclusion — General Fund Revenue Totals Are Reasonable

Table 18 and Chart 30 show how the department's General Fund 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, General Fund revenues will be *lower* than predicted by $60 million in 1987-88 and $140 million in 1988-89.
- The *consensus* economic outlook, if it comes true, will *increase* revenues by $95 million in 1987-88 and $290 million in 1988-89. (The combined $385 million two-year effect includes about $165 million in personal income taxes, $130 million in sales and use taxes, $60 million in bank and corporation taxes, and $30 million from other sources.)

Thus, *these two factors together would increase General Fund revenues by $35 million in 1987-88 and $150 million in 1988-89, or $185 million for the two years combined.* However, Table 18 also shows that these revenue gains *could be more than offset* if the department's growth assumption for taxable capital gains proves optimistic and instead, for example, the average growth over the prior decade occurs.

Given that either of these outcomes could easily occur, and the small magnitude of the revenue differences in Table 18 relative to the large revenue base being estimated, *we conclude that the department's General Fund revenue totals are reasonable.* As noted earlier, however, there is a greater-than-normal amount of uncertainty about the future course of the economy, and the ability to accurately predict taxpayer behavior due to recent state and federal tax law changes is limited. As a result, *there is a greater-than-normal likelihood of revenue-estimating errors.*

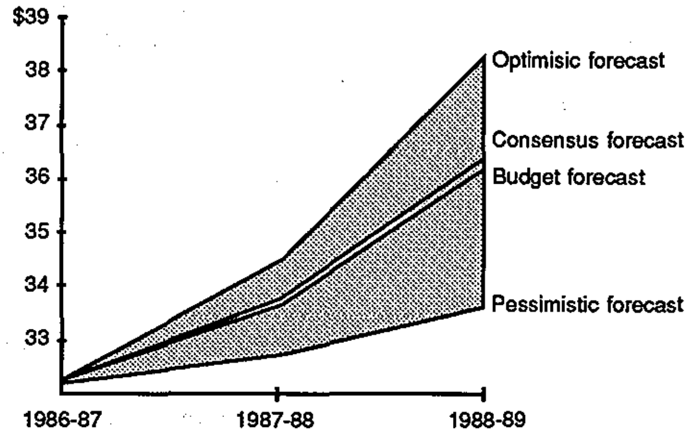
Table 18

Potential Adjustments to the Department of Finance's Revenue Estimates (dollars in millions)

Type of Potential Adjustment	*1987-88*	*1988-89*	*Two-year Total*
Adjustments assuming the department's own economic forecast comes true:			
—Personal income taxes	−$55	−$85	−$140
—Bank and corporation taxes	−30	−120	−150
—Sales and use taxes	25	65	90
Totals	−$60	−$140	−$200
Additional adjustments, assuming the consensus economic forecast comes true	$95	$290	$385
Total adjustments, assuming the consensus economic forecast comes true	$35	$150	$185
Additional adjustments if capital gains growth is less than predicted	−$100	−$150	−$250

Chart 30

Alternative General Fund Revenue Forecasts for 1987-88 and 1988-89 (in billions)[a]



[a] Source: *1988-89 Governor's Budget* and Legislative Analyst's Office.

Significant Error Margins Exist

What if the economy's behavior during 1988 and 1989 differs significantly from both the department's economic forecast and the consensus economic outlook? In this event, Chart 30 shows that General Fund revenues could be either far below the department's projections, or substantially 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 stronger-than-expected economic expansion in 1988 and 1989, or a modest 1988 economic downturn. Under the *optimistic* alternative, revenues would exceed the budget forecast by over $2.8 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 nearly $3.6 billion. *Thus, whatever biases exist in the department's revenue forecast are nowhere near as large as the deviations which could occur due to the economy.*

Special Fund Revenues — Oil Royalties Overstated

The department's estimates of special fund revenues appear reasonable with one notable exception — oil and gas revenues are overstated. This is because these estimates were prepared by the State Lands Commission

(SLC) prior to the OPEC-induced worldwide decline in crude oil prices that occurred near the end of 1987. This decline has had the effect of reducing the prices that California oil is sold for by over $3 per barrel. The SLC is expected to update its revenue estimates sometime in February. Given that each $1 fall in oil prices translates into a decline of over $20 million in state oil revenues, we expect that the estimates of state oil revenues will be revised downward by at least $50 million in 1987-88 and $80 million in 1988-89, and probably more.

Of course, errors will occur in the estimates for *all* special fund revenue sources if the economy performs much differently than predicted. In this event, the special fund revenue totals, like the General Fund totals, could be well off the mark.

II. BORROWED RESOURCES IN 1988-89

In addition to using revenues to fund its expenditure programs, the state also relies on borrowed resources. Two basic forms of borrowing are done:

- First, the state engages in *short-term external borrowing* in order to manage the intrayear cash-flow imbalances between its spending outflows and revenue inflows. This borrowing is usually done by issuing revenue anticipation notes, which are repaid at year-end. Thus, such borrowing is not carried over from one year to the next.
- Second, the state engages in *long-term borrowing* to help fund its capital outlay programs, primarily by issuing bonds.

SHORT-TERM BORROWING IN 1988-89

As noted above, the state routinely borrows money on a short-term basis for cash-management purposes, in much the same manner as do private businesses. While such borrowing helps the state to manage its fiscal affairs, it can also "make money" for the state. This is because the state is permitted to borrow at tax-exempt interest rates, yet can invest any temporarily idle borrowed funds at taxable interest rates. Thus, in years when borrowed funds sit idle for sufficient periods of time, the interest income generated by the program exceeds its costs. The federal government limits the amount of short-term tax-exempt borrowing which the state can undertake each year, according to a formula based on the pattern of its cash-flow imbalances.

Short-Term Borrowing to Decline. The budget shows that $1.3 billion will be borrowed in the budget year. This compares to borrowing of $2.1 billion in the current year and $2.6 billion in the prior year. Thus, the volume of external borrowing is expected to decline significantly.

The main reason for the reduced volume of short-term borrowing in the budget year involves the federal Tax Reform Act of 1986. Among other things, the act tightened the restrictions on the amount of tax-exempt cash-management borrowing which the state can engage in. The new law has the effect of reducing by about $1 billion the amount of tax-exempt short-term borrowing that the state will be able to undertake in the budget year.

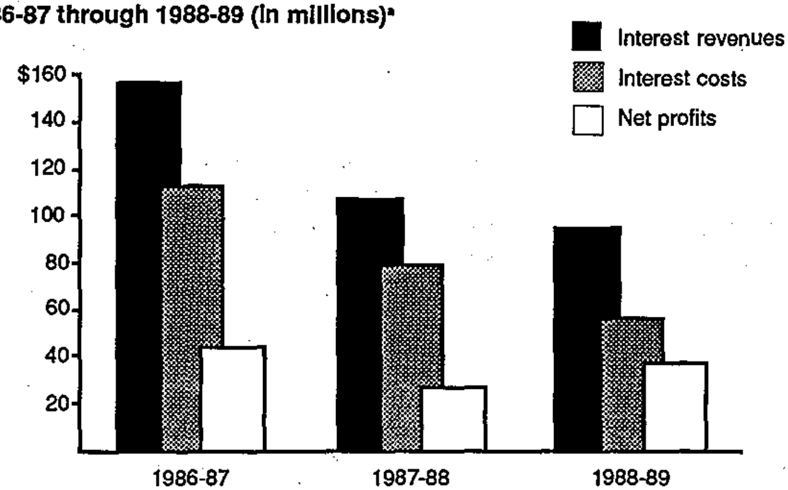
Net Profits From Borrowing to Rise. The profits which the state earns on its external borrowing depend on both the spread between taxable and nontaxable interest rates, and the average investable balance of borrowed funds. Chart 31 shows the costs, revenues (that is, interest income) and net profits from short-term borrowing in the prior, current and budget years. It indicates that the *net profit* from external borrowing is expected to total $38 million in 1988-89, up from $28 million in the current year.

One reason why the profits from borrowing are greater in the budget year than in the current year, despite the smaller volume of borrowing, is that the assumed spread between taxable and nontaxable interest rates is a bit higher in the budget year than in the current year. A second reason is that the money borrowed in the budget year will be available for investment earlier in the year than the money borrowed in the current year.

Chart 31

General Fund Revenues, Costs and Net Profits from Short-Term Borrowing

1986-87 through 1988-89 (in millions)[a]



[a] Source: *1988-89 Governor's Budget* and Department of Finance.

LONG-TERM BORROWING IN 1988-89

The state undertakes long-term borrowing primarily to finance its capital outlay needs. It does so by issuing two main types of bonds:

- ***General Obligation (GO) Bonds.*** These bonds are backed by the state's full faith and credit. Thus, the state pledges to use its taxing power, if necessary, to pay the debt-service costs (that is, principal and interest payments) on the bonds. These bonds must be approved by a majority of the voters at a statewide election. The General Fund directly pays the debt service only on "nonself-liquidating" GO bonds. In contrast, "self-liquidating" bonds usually impose no direct General Fund cost, since their debt service is paid from fees or other designated revenue sources.
- ***Revenue Bonds.*** These bonds are not backed by the state's full faith and credit or general taxing power. Rather, they normally are secured only by revenues from the projects which the bond proceeds finance, or by some other designated revenue source. There are, however, some revenue bonds whose debt service is paid directly by the General Fund, such as lease-revenue bonds issued for state prisons and higher education. Revenue bonds do not require voter approval, and usually sell at somewhat higher interest costs than GO bonds because of their greater risk.

The state uses bonds for a wide variety of purposes. For example, GO bonds are used for purposes like water treatment, environmental clean-up, parks, senior citizen centers, school construction, state prisons, county jails and home loans. Uses of revenue bonds include home loans, pollution control, health and educational facilities, state prisons and student dormitories.

How Much Bond-Related Resources Are to Be Used in 1988-89?

Our discussion of the use of bond resources in 1988-89 focuses on bonds supported by the General Fund, since it is these bonds that must be paid for using the state's general revenue base and therefore must compete for funding with other direct-expenditure programs.

The budget proposes $1.9 billion in 1988-89 "bond fund expenditures" associated with these types of bonds, compared to $2.4 billion in 1987-88 and $961 million in 1986-87. These amounts, however, do not represent the actual volume of bond-related "cash" that is spent in any particular year, because they include future "project commitments." The actual cash corresponding to these future commitments may not be needed for a number of years, depending on project completion schedules. Thus, money for only some of these spending commitments actually will go "out the door" in the current and budget years, while the remainder will be paid out later.

Where Will the Actual Money Spent Come From?

The actual dollars that go "out the door" as bond fund expenditures can come from one of four sources:

- Proceeds from old bond sales that are sitting in bond funds and have yet to be expended;
- The sale of bonds under previously voter-approved but unused authorizations;
- The sale of bonds under new voter-approved authorizations; and
- Loans from the Pooled Money Investment Account (PMIA) to enable programs funded by bond proceeds to "go forward" pending the actual sale of approved bonds.

For reasons related to the federal Tax Reform Act of 1986, the actual monies initially used for bond-funded expenditures now generally come from PMIA loans. Once a sufficient amount of such expenditures has occurred, the bonds themselves are issued, and their proceeds are used to repay the PMIA loans. This procedure is followed because the tax reform act imposes strict penalties if bond proceeds are not expended within six months of the sale of bonds, and requires detailed tracking of the investments of temporarily idle bond proceeds.

Loans From the PMIA. The budget estimates that expenditures of PMIA loans made to GO bond programs will total about $900 million in the current year and $1 billion in the budget year. This represents the money associated with bond programs that will actually go "out the door" in these years.

How Many New Bonds Are to Be Sold in 1988-89?

Bond Sales Under Existing Authorizations. The budget proposes General Fund bond sales under existing authorizations of $1.2 billion in the budget year, up from $300 million in the current year (current year sales were depressed because of uncertainties about how to manage bond programs under the new restrictions imposed by the federal Tax Reform Act of 1986). The proceeds of these sales will be used to pay-off most of the PMIA loans identified above. The budget also indicates that about $100 million of General Fund lease-revenue bonds will be sold in the current year.

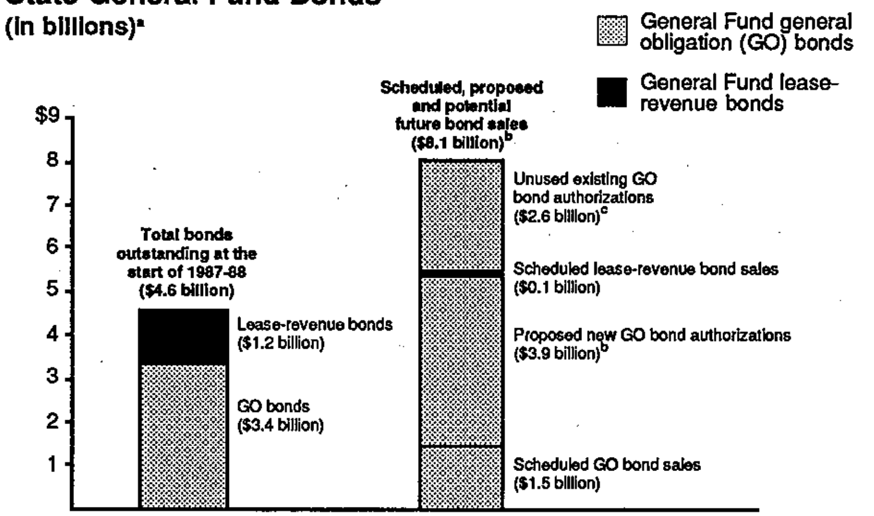
Bond Sales Under Proposed New Authorizations. As discussed in the expenditure section, the budget proposes that voters be asked to approve $3.9 billion in new GO bond authorizations during 1988. In addition, the Governor has indicated support for additional GO bonds to fund corrections-related capital outlay needs. However, *none* of these bonds are scheduled in the budget to be sold or result in PMIA loans until *after 1988-89,* and it is likely that their eventual sale and the expenditure of their proceeds will be spread over a number of years.

Will Selling More Bonds Pose Any Problems?

At the start of the current year about $23.1 billion in total state bonds were outstanding, or around $900 per person in California. Chart 32 shows that this total included about $3.4 billion in GO bonds directly serviced by the General Fund and another $1.2 billion in lease-revenue bonds directly serviced by the General Fund. Thus, long-term debt supported by the General Fund amounted to about $4.6 billion.

Chart 32

State General Fund Bonds
(In billions)[a]



[a] *1988-89 Governor's Budget*, State Treasurer and California Debt Advisory Commission. Includes bonds whose debt service is paid from the General Fund.
[b] Does not include any new authorizations approved after 1988.
[c] Spending commitments already have been made for some of these authorizations.

Chart 32 also shows that the level of long-term General Fund debt could increase significantly from its current level during the next few years, based on scheduled, proposed and potential bond sales. For example, the chart shows that the combination of scheduled sales in the budget for GO bonds ($1.5 billion) and General Fund lease-revenue bonds ($0.1 billion), plus the Governor's proposed new GO bond authorizations ($3.9 billion), total $5.5 billion. This total is more than the existing outstanding volume of General Fund-supported bonds. The total becomes even greater—$8.1 billion—when unused existing authorizations are added in. This raises several issues:

- ***Will this much new debt make the state overbonded?*** The answer is no. We believe that the state can sell the $5.5 billion in General Fund bonds over the next few years without becoming overbonded. In our recent report entitled *A Perspective on Bond Financing* (December

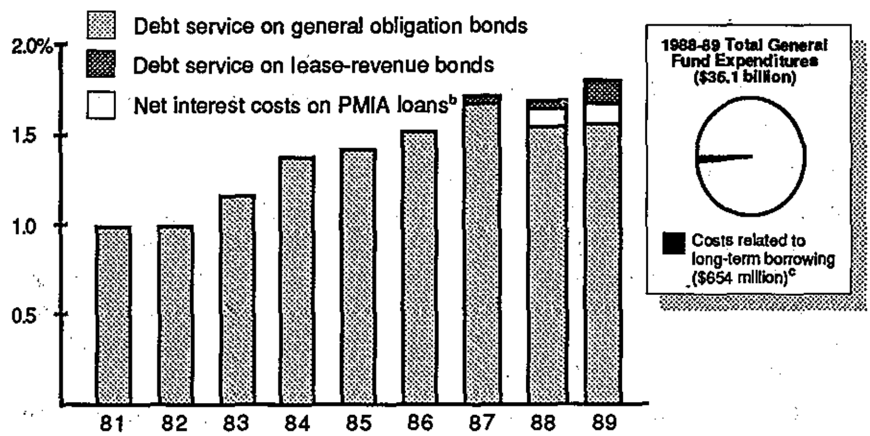
1987), we found that California is well below the average of other states in terms of debt per capita, debt relative to personal income, and debt-servicing costs as a percent of state expenditures. Selling another $5.5 billion in new bonds clearly will raise the state's indebtedness. However, on an interstate comparative basis it will only serve to make California closer to the average, particularly after adjusting for the fact that the outstanding volume of already-sold bonds will be shrinking as debt is continually retired.

- ***Will the added debt make debt-servicing costs excessive?*** As shown in Chart 33, General Fund debt-servicing costs were under 2 percent of General Fund expenditures in 1986-87, and are estimated to remain so in both the current and budget years. As the Governor's proposed new bond authorizations are marketed (assuming their approval by voters), this share will drift upward, to over 3 percent by the early 1990s if all of the bonds are sold within a couple of years and the state continues to also issue General Fund lease-revenue bonds. This still appears to be a tolerable share of total General Fund expenditures, although it would be well above the current share.

Chart 33

General Fund Debt Service and Related Borrowing Costs as a Percent of State Expenditures

1980-81 through 1988-89[a]



[a] Source: *1988-89 Governor's Budget*, State Treasurer and State Controller. Data are for fiscal years ending in years shown.
[b] Represents total interest charged minus revenues earned on temporarily idle bond-related borrowed funds.
[c] Includes about $568 million for debt service on general obligation bonds, $39 million for net interest on PMIA loans, and $46 million for debt service on lease-revenue bonds.

- ***Will there be problems in marketing such a large volume of new bonds?*** According to the State Treasurer, the more bonds the state tries to sell in any given year the greater risk it runs of having to pay higher interest rates due to "market saturation." That is, it takes time for the market to "absorb" the state's large bond issues. Pinpointing the level of annual bond sales beyond which the state might incur increased borrowing costs is difficult. However, the Treasurer's staff offers the view that an interest rate premium might be required if the state's total annual bond sales were to surpass, say, $5 billion to $6 billion. Given anticipated sales of revenue bonds, it appears that the state could market a couple billion dollars of General Fund bonds annually in a reasonably orderly fashion.
- ***How rapidly can the bond proceeds actually be spent?*** The budget has for many years overestimated the amount of bond-related proceeds that will actually be spent. This is because of slippage in the time schedules for beginning and completing capital outlay projects, and other administrative problems. As discussed in the expenditure section, it appears that bond fund expenditures have again been overstated in this year's budget. We believe that these practical constraints on how rapidly bond proceeds tend to be spent will probably keep future annual bond sales from exceeding levels that would create significant marketing problems, at least in the near term.

In summary, it appears that the state has sufficient bonding capacity to sell, and the financial marketplace has the ability to absorb, the bonds proposed in the budget, without incurring an excessive debt burden or insurmountable marketing problems.

Can Future Bond Needs Also Be Accommodated?

It is clear that as California continues to grow and urbanize, there will be ongoing additional capital outlay needs of a major magnitude. It therefore is very likely that a continuing stream of new bond authorizations will be proposed in future years. If this happens and the bonds are approved, the level of bonded indebtedness in California will rise, as will debt-servicing costs as a percent of total state expenditures.

This can be illustrated by considering what would happen to debt-servicing costs if, every two years beginning in 1988, an amount of new bonds about equal to that being proposed by the Governor in 1988 ($3.9 billion) was approved. If this happened, and the state continued to issue General Fund lease-revenue bonds as well, debt-service as a percent of General Fund expenditures would be close to 4 percent by the mid-1990s. According to the Treasurer's staff, the closer this ratio gets to 5 percent, the greater is the likelihood that the state's bond ratings and borrowing costs could be adversely affected.

Given this, it is especially important that future bond-financed projects be found worthy of spending taxpayers' money on, and that the increased costs that could arise if the state takes on more and more debt can be justified by the public benefits from the projects that bonds are used to finance.

A State Capital Outlay Plan Is Needed. Exactly how many and what type of bonds the state should issue in the future, and what share of its revenue base should be committed to paying debt service, are policy issues that only the Legislature can decide. No simple formulas exist for arriving at these decisions. However, in our above-cited report on bond financing we identified certain steps that can help the Legislature determine how much and what type of bond financing is warranted.

The principal finding of our report is that the state should develop a comprehensive multi-year capital outlay plan which identifies and sets priorities for capital outlay needs, and is used for developing a schedule of needed bond financing. We believe that implementing such a plan is the best way of improving the state's decision-making process for using bonds, and ensuring that the state's limited borrowing capacity will be used as effectively as possible in the future.

What About Revenue Bonds in 1988-89?

The budget does not contain a comprehensive schedule of proposed revenue bond sales for either the budget year or the remainder of the current year. According to the Treasurer's staff, no official schedule of this sort exists. However, one thing that we do know about revenue bonds is that future sales of private-purpose tax-exempt revenue bonds will be subject to sharp curtailment. This is because of new restrictions imposed by the federal Tax Reform Act of 1986 on the volume of such bonds that can be issued. Specifically:

- During 1987, federal law permitted California's state and local governments to issue a combined total of about $2 billion of such bonds.
- Beginning in 1988, the ceiling on such bonds will drop to about $1.3 billion, a 35 percent reduction.

How Will the Reduction Be Achieved? The California Debt Limit Allocation Committee (CDLAC) has responsibility for allocating California's limit on tax-exempt private-purpose bonds amongst the state and local governments, and different types of purposes. During 1987 the state received about 59 percent and local governments about 41 percent of California's $2 billion allotment. These bond allocations were used for: housing (46 percent of the limit); facilities related to furnishing gas, electricity, heating, cooling, hazardous waste disposal and mass commuting (32 percent); student loans (19 percent) and private manufacturing facilities (3 percent). It is currently unknown how much bond-issuing authority these issuers will request for 1988, or how CDLAC will allocate the reduced limit amongst different issuers and purposes.

1988 Bond Issuance May Not Decline. In 1988, the restrictive effects of the reduced limit will be mitigated by the fact that only $1.5 billion of private activity bonds subject to the 1987 limit were actually issued in 1987. The remaining portion of the 1987 allocation (approximately $500 million) was carried over into 1988 for eligible purposes or projects. This carryover allocation, combined with the reduced 1988 allocation of $1.3 billion, means that $1.8 billion in private-activity bonds actually can be issued in 1988. In addition, $800 million in 1986 allocations were carried over into 1987, and some of these amounts also remain unused. Thus, 1988 bond issuance may not be hurt by the lower limit.

Of course, once these carryover allocations are used up, the future issuance of private activity bonds will have to decline to a level corresponding to the reduced statewide allocation limit. At that point, competition for the available limit will intensify.

III. RESOURCES FOREGONE TO FUND TAX EXPENDITURES IN 1988-89

In addition to the $44.3 billion in total state funds which the Governor's Budget requests for *direct* expenditure programs in 1988-89, the budget also proposes $17.7 billion of *indirect* spending in the form of "tax expenditures."

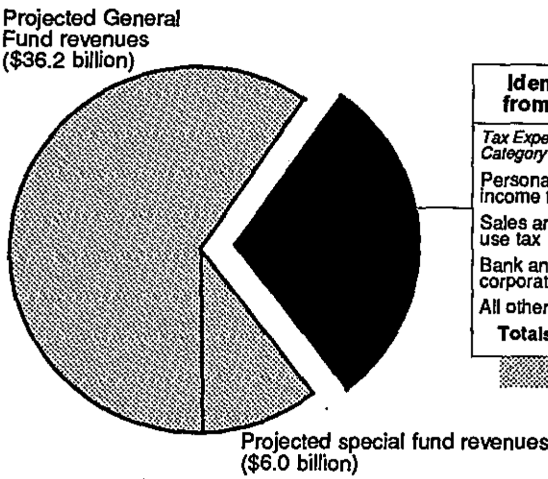
Tax expenditure programs (TEPs) result from various tax exclusions, exemptions, preferential tax rates, credits and deferrals which reduce the amount of revenue collected from the state's "basic" tax structure. These TEPs are provisions of the tax code which are used to either encourage specific types of economic behavior, or provide general or selective tax relief.

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 appropriations process. Thus, TEPs are appropriately viewed as part of the Governor's overall spending plan, and their costs therefore represent the use of state resources.

The Volume of Tax Expenditures. Chart 34 shows our estimates of the revenues foregone to fund state-level TEPs in 1988-89. These figures are preliminary summary estimates of the detailed information on tax expenditures which will be contained in our forthcoming report entitled *Analysis of the 1988-89 Tax Expenditure Budget,* which is being prepared in response to Assembly Concurrent Resolution 17 (1985). This measure established a tax expenditure budget review process, and requires our office to report on the costs and effectiveness of TEPs on an ongoing basis.

Chart 34

Identifiable Revenue Losses from State Tax Expenditures 1988-89



Identifiable Revenue Losses from State Tax Expenditures[a]

Tax Expenditure Category	*Amount (in billions)*	*Percent of Total*
Personal income tax	$12.2	69%
Sales and use tax	4.1	23
Bank and corporation tax	1.0	6
All other taxes	0.4	2
Totals	**$17.7**	**100%**

[a] Estimates by Legislative Analyst, based upon data from the Department of Finance, Franchise Tax Board, State Board of Equalization and other sources.

The chart indicates that the cost of state-level TEPs (which are primarily General Fund costs) is estimated to total at least $17.7 billion in 1988-89, an increase of 6.9 percent from the current year. (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 30 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 1988-89, 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 ($2.6 billion), followed by the nontaxability of employer contributions to pension plans ($2.1 billion), and the exemption from the sales tax of food products ($1.6 billion). Altogether, we estimate that there are over 200 other state-level TEPs which will be in effect during 1988-89, plus an additional 65 local property tax TEPs which the state partially funds through subvention payments.