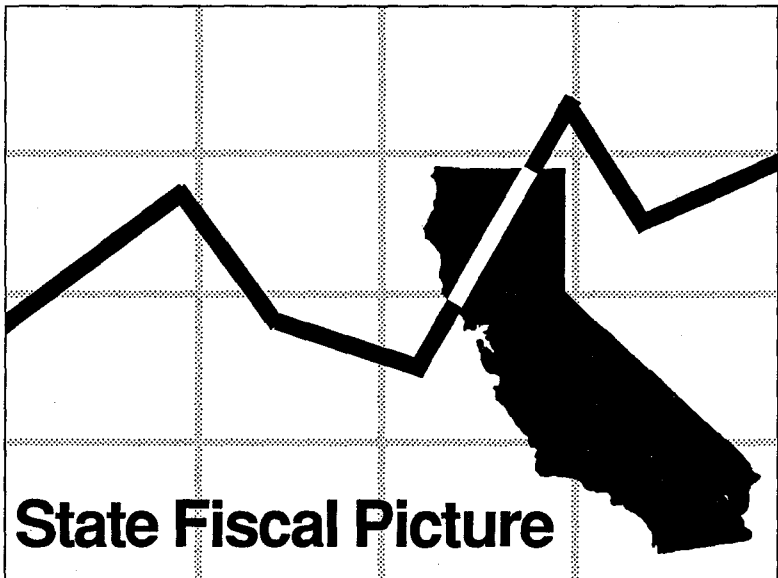


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State Fiscal Picture

Part 1



In beginning its work on the state budget for 1989-90, the Legislature faces the most adverse set of fiscal circumstances it has faced since the recession of 1981-82. The state's budget reserve has been completely depleted, and at this point a deficit in the current-year's budget appears likely. Based on the state's current levels of service, expenditure requirements for 1989-90 will exceed projected revenue growth by at least \$500 million, and the full restoration of the state's reserve fund would require another \$1.1 billion. This fiscal situation has come about despite the continued strength of the California economy.

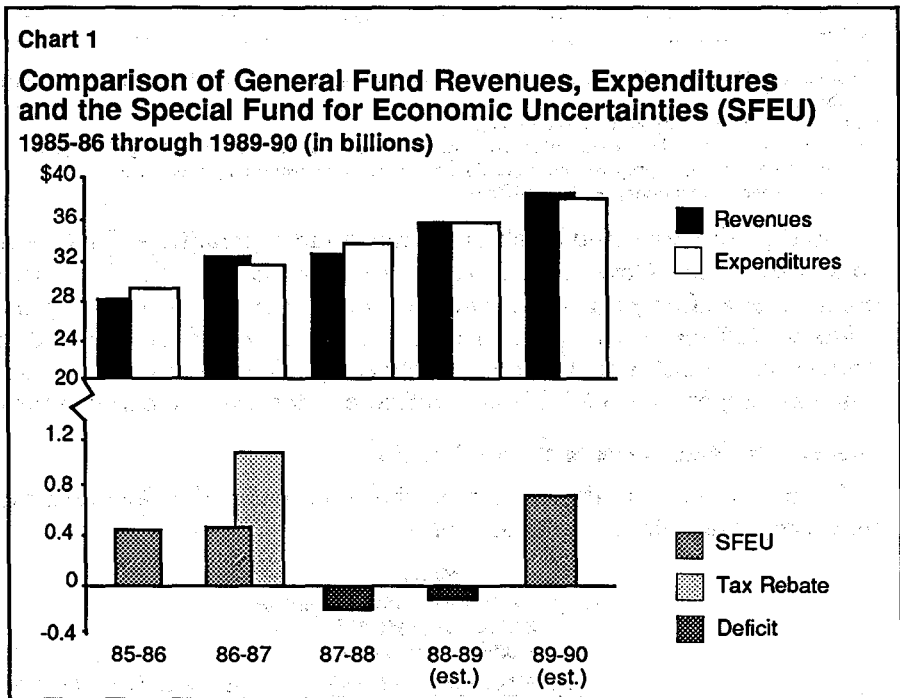
This set of adverse fiscal circumstances also comes at a time when state government faces a number of formidable challenges, such as the need to provide for the anticipated growth in the state's population. The state's success in addressing these issues will have a substantial effect on the health of the California economy and the quality of its citizens' lives in the coming decades.

In this part, we briefly review the challenges facing the Legislature and the state. We review the state's fiscal condition, the major areas where demand for state services is outstripping its ability to provide them, and the extent to which the state's existing revenue base is capable of supporting the delivery of existing and additional state services. Finally, we provide a brief examination of the strategies proposed in the Governor's Budget for resolving the state's fiscal dilemma.

Fiscal Dilemma Facing the Legislature

Overview of the General Fund Condition

Chart 1 provides information on annual General Fund revenues, expenditures and the Special Fund for Economic Uncertainties (SFEU) from 1985-86 through the budget year. Table 1 presents the same information in greater detail. (In both cases, the numbers are based on traditional state accounting practices, and do not reflect accounting changes contained in the Governor's Budget.)



The chart shows that General Fund revenues have exceeded expenditures in only one of the last four years. In that case, however, the excess of 1986-87 revenues over expenditures was returned to state taxpayers as a tax rebate, under the provisions of the state's constitutional limit on appropriations. In 1987-88, a significant shortfall in state income tax receipts late in the year wiped out the state's reserve fund, and ultimately resulted in a deficit. Projections for the current year indicate that revenues will be essentially equal to the level of estimated expenditures. Unless additional savings or revenues materialize, the state will not have enough money to pay off last year's deficit. As a result, it appears likely that the state will end 1988-89 in deficit as well.

Table 1
General Fund Revenues, Expenditures and the Special Fund
for Economic Uncertainties (SFEU) ^{a,b}
1985-86 through 1989-90
(dollars in millions)

	<i>Actual</i> 1985-86	<i>Actual</i> 1986-87	<i>Actual</i> 1987-88	<i>Est.</i> 1988-89 ^c	<i>Est.</i> 1989-90 ^c
Prior-year resources	\$1,448	\$710	\$680	-\$83	-\$83
Revenues	28,227	32,535	32,579	36,002	38,877
Expenditures	28,988	31,482	33,342	36,002	38,010
General Fund balance	\$686	\$1,764	-\$83	-\$83	\$784
Continuing appropriations	(243)	(190)	(117)	(43)	(30)
SFEU	(443)	(478)	—	—	(754)
Tax rebate	—	(1,096)	—	—	—
Deficit	—	—	-\$200	-\$126	—

^a Source: State Controller. Data for 1986-87 and 1987-88 reflect adjustments to highlight funding provided for tax rebates.

^b Detail may not add to totals due to rounding.

^c Source: Governor's Budget. Data reflect adjustments to exclude effect of accounting changes and to reflect continuing appropriations. Data do not reflect administration's anticipated savings from cancellation of encumbrances (\$80 million).

Based on the projected levels of revenues and expenditures for 1989-90 contained in the Governor's Budget, *we estimate that the Governor's proposed spending program would leave the General Fund with approximately \$750 million in the SFEU.* These funds would be retained as protection against unanticipated declines in General Fund revenues (such as happened in 1987-88) and unforeseen increases in expenditures.

Revenue Shortfall Leads to Budget Deficits

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
1987-88 and 1988-89 ^a
(dollars in millions)

	<i>1987-88 General Fund Condition</i>			<i>1988-89 General Fund Condition</i>		
	<i>January</i> 1988 (<i>Est.</i>) ^b	<i>January</i> 1989 (<i>Actual</i>) ^c	<i>Effect on</i> 1987-88 <i>Balance</i>	<i>January</i> 1988 (<i>Proj.</i>) ^b	<i>January</i> 1989 (<i>Est.</i>) ^d	<i>Effect on</i> 1988-89 <i>Balance</i>
Beginning resources	\$626	\$680	-\$54	\$962	-\$83	-\$1,045
Revenues and transfers	33,678	32,579	-1,099	36,249	36,002	-\$247
Expenditures	33,343	33,342	—	36,101	36,002	\$99
General Fund balance	\$962	-\$83	-\$1,045	\$1,110	-\$83	-\$1,193

^a Detail may not add to totals due to rounding.

^b Source: 1988-89 Governor's Budget.

^c Based on information provided by State Controller's Office.

^d Based on information provided by State Controller's Office and 1989-90 Governor's Budget.

1987-88. As shown in the table, last year's Governor's Budget anticipated that the state would close 1987-88 with a \$962 million General Fund balance. Shortly after the Legislature began its deliberations on the

budget proposed for 1988-89, however, a dramatic shortfall in personal and corporate income tax revenues occurred. This shortfall, which totaled \$1.1 billion, primarily reflected lower-than-anticipated levels of capital gains income realized by state taxpayers. Funds which had been appropriated to the SFEU were redirected to cover the shortfall, and several actions were taken by the administration to reduce or delay expenditures. It was anticipated that these actions would leave the state with a small amount of funds remaining in the SFEU at year's end.

When the state's books for 1987-88 were closed by the State Controller, however, it turned out that these actions had not been sufficient to avert a small deficit. Based on the state's traditional method of accounting, the Controller has reported that the state ended 1987-88 with a \$343 million deficit. This deficit consists of two parts. First, the Controller indicated that cash outlays and expenditure commitments exceeded available resources by \$83 million. Second, the Controller reported that \$260 million of appropriations were still available for expenditure at year's end. The reduced figure of \$117 million shown in Table 1 reflects our estimate of the amount of those appropriations which are likely to be spent.

1988-89. Table 2 also shows that last year's budget anticipated that the current fiscal year would end with a General Fund balance of about \$1.1 billion. Although the current projections of state revenues and expenditures are similar to those of a year ago, our current estimates indicate that a second deficit is now likely. This is primarily due to the loss of the carryover resources anticipated in last year's budget which, as mentioned above, were used to offset the 1987-88 revenue shortfall.

Averting this second-in-a-row deficit will be a difficult task. The administration has taken action to cancel some outstanding contracts and purchase orders issued in 1987-88 in order to save an estimated \$80 million, but our analysis indicates that the potential success of this effort is very limited. While actions which could be taken in the near future (such as a hiring freeze) may result in some additional savings, it is not likely that they will be sufficient to offset the cost of expected deficiency expenditures which have not been provided for in the budget (such as a \$27 million regional center deficiency). Finally, the state's appropriations limit and Proposition 98 reduce the prospect that higher-than-expected revenue collections in the current year will provide the necessary cushion. Because the administration calculates that the state is only \$134 million below the limit for 1988-89, the state could retain only this amount of any additional revenue. Furthermore, about 40 percent of this amount would have to be allocated to K-14 education under the provisions of Proposition 98, and could not be used to help reduce the deficit.

Budget Portrays Different Story. The Governor's Budget does not acknowledge the deficit that was reported by the Controller for 1987-88, nor the potential for a deficit in the current year. Instead, it shows a small amount of funds left over in the SFEU in each year. To achieve this result, the Department of Finance reduced the level of reported state spending by \$251 million in 1987-88 and by a net amount of \$80 million in the current year. The department has also eliminated the traditional set-aside for appropriated funds which have not yet been spent. The budget asserts that these changes were necessary to move the state towards greater conformity with "Generally Accepted Accounting Principles," and are consistent with state laws on this subject enacted in 1984. The data presented in this part do *not* reflect the department's adjustments, so that the Legislature can evaluate the state's fiscal condition as reflected by the traditional basis of accounting. In our judgment, this method gives the Legislature a more accurate picture of funds available for appropriation. We also note that the official records of the state prepared by the State Controller will reflect funds in this manner rather than the method proposed by the administration.

Budget Year Promises Hard Choices

The Governor's Budget proposes that \$870 million of the projected \$2.9 billion increase in General Fund revenues be used to restore the state's reserve fund. This policy choice leaves \$2 billion to fund expenditure increases, which is well below the amount needed to fund normal program growth and maintain the current level of state services. As discussed in more detail in Part Two of this document, we estimate that approximately \$4.5 billion in resources would be needed to accommodate the normal growth in state expenditures, and to restore the reserve to the 3-percent level. Thus, the Legislature faces a \$1.6 billion funding gap as it begins its deliberations on the state's budget for 1989-90.

Fiscal Pressures Increased by Additional Program Demands. In addition to the gap in normal funding requirements, the Legislature faces demands for increased state funding in a variety of program areas. In many cases these demands reflect requests for additional funds to offset declines in service levels that have been occurring over the past several years. In other cases, they simply reflect requests for funding to provide existing levels of service to an expanding population. More specifically:

- ***State and local health care programs*** for indigents have been unable to meet the demand for these services in recent years, and the idea of providing some form of insurance coverage is receiving greater attention.

- *Prison inmate populations* are expanding faster than the state's ability to house them, and current estimates indicate that another \$1.6 billion will be needed to build additional prisons in the next five years.
- *Higher education enrollments* are increasing and new campuses and facilities are being sought to accommodate the additional students.
- *State transportation funds* are nowhere near the level needed to cover the projected expenditures outlined in the state's plan for transportation improvements.

While some of these demands may be addressed by the provision of additional bond act authority or from sources other than the state's General Fund, these mechanisms still would have an impact on the General Fund. Bond authorizations must ultimately be paid for by the General Fund in the form of debt service on the bond issues. Also, other potential funding sources, such as increased gasoline taxes, would be subject to the state's appropriations limit and require compensating reductions in General Fund appropriations for other programs.

State Budget Has a Structural Problem

As noted above, the demands for state funding increases exceed the amount of revenue that is available to pay for them. This imbalance between funding demands and revenues is largely the result of policy decisions made in past years. For example, today's rapidly increasing cost of building and staffing state correctional facilities is the result of decisions made several years ago to impose longer sentences as punishment for criminal activities. The budget's growth also reflects the growth of entitlement programs such as Aid to Families with Dependent Children (AFDC), Supplemental Security Income/State Supplementary Program (SSI/SSP) and Medi-Cal. Because of statutory requirements, these programs are not subject to legislative control *in the budget process*. The adoption of Proposition 98 by the voters in November places another 40 percent of the budget "off-limits" to legislative control of its funding level.

By our estimates, almost 70 percent of the state's General Fund budget is controlled by policies placed in statute or the state Constitution. As a result, there is only about 30 percent of the budget that the Legislature can influence without changes to existing law. Further, the programs which comprise this 70 percent of the budget are generally growing faster than the state's constitutional appropriations limit, thereby adding to the fiscal pressure placed on the remainder of the budget.

The portion subject to legislative control in the budget process includes state funding for higher education, public health, mental health and developmental disability programs, resources programs, and a variety of

social services programs. While these programs enjoy little statutory protection, they also reflect policy choices made in the past. The state has, however, used its control over these programs in past years to help balance the budget. By refusing to grant many of these programs additional spending authority to compensate for caseload growth and inflation, the state has required that fewer persons be served, that those served receive a lower level of service, or that new funding sources be found to support the programs.

While many state laws have been changed over the past 10 years to directly or indirectly require automatic program expenditure increases, the state's revenue base has not been altered to support these changes. In fact, largely because of voter-approved initiatives, the state's revenue base has actually been reduced. For example, voter-approved initiatives abolished the state's inheritance and gift tax, and required the adjustment of the personal income tax to compensate for inflation. Largely because of the "indexing" of the personal income tax, the state's revenue base will no longer grow at a rate significantly faster than the rate of growth in the economy.

The situation faced by the Legislature in preparing the budget for 1989-90 is more complicated than in prior years because it will not be possible to balance the budget by simply "freezing" spending on "controllable" programs. This is because existing expenditure commitments for the so-called "uncontrollable" programs exceed the growth in revenue. Thus, the Legislature has essentially three options. First, it can make significant reductions in the level of expenditures requested for those programs subject to control in the budget process. Second, it can make statutory changes or pursue constitutional changes to permit reductions in the 70 percent of expenditures not subject to control in the budget process. Third, the Legislature can pursue the statutory and constitutional changes which would be necessary to accommodate a higher level of state revenues.

Governor's Approach to Balancing the Budget

The Governor's Budget reflects one strategy that is available to the Legislature for resolving its fiscal dilemma. This strategy, however, does not reflect a long-term solution to the structural budget problem facing the state. Rather, the proposed budget reflects a short-term perspective, relying on one-time savings, deferrals of costs to future years and short-term funding shifts to achieve its results. Further, the budget makes little attempt to address policy challenges facing the state which will have a significant affect on the future of the state's economy. This section examines in more detail the key elements of the administration's budget-balancing strategy.

Deferrals of State Costs (-\$349 million). The budget includes several proposals which would defer existing General Fund costs to future years, thereby increasing the structural imbalance that will have to be reckoned with later. These proposals include:

- **STRS COLA Funding (-\$164 million).** The Governor proposes to place in statute a guaranteed annual increase in benefits for retired teachers. In 1989-90, the cost of this benefit would be paid out of State Teachers' Retirement Fund assets, but it would subsequently be paid for by the state's General Fund. The annual state costs of this proposal, once fully phased in, would amount to approximately \$400 million in today's dollars.
- **UC Pension Costs (-\$68 million).** The state traditionally funds the employer's share of retirement costs for the University of California. The budget proposes to pay the state's 1989-90 contribution with accrued interest, over a 30-year period beginning in 1990-91.
- **Debt Service (-\$47 million).** The budget estimates of state costs for debt service on General Obligation bonds reflect the administration's assumption that the level of bond sales can be constrained below the level anticipated by the Treasurer's Office. The budget displays indicate a total volume of bond sales equal to \$2.2 billion over the next 18 months, but the budget actually provides enough funding to support only \$1.6 billion in sales. This slowdown reduces budget-year debt-service costs by approximately \$47 million.
- **Other deferrals (-\$70 million).** These include the administration's plan to delay one Medi-Cal check write from next June to next July, and to slow down the occupancy of new state correctional facilities in order to save on budget-year staffing costs.

Redirect Proposition 99 Revenues to Pay State Costs (-\$296 million). The new cigarette and tobacco products surtax imposed by Proposition 99 is expected to support about \$700 million worth of expenditures in the budget year. Despite language contained in the measure, the administration proposes to use a portion of these funds to replace existing state General Fund support for the Medically Indigent Services program. In addition, the administration proposes to use these monies to cover growth in Mental Health, Public Health, and certain other programs. Traditionally, these costs are borne by the General Fund.

Lower Reserve Funding Level (-\$230 million). The state's reserve fund is proposed to be funded at \$870 million, or \$230 million less than the 3-percent-of-expenditures level used in recent years as the state's funding goal.

Reductions in Services (-\$543 million). The budget proposes to provide reduced levels of services in a variety of areas. This occurs due to the proposed suspension of statutory cost-of-living adjustments for spec-

ified programs, and due to the reductions or outright elimination of funding for other programs. The most significant of these include:

- ***Suspension of Statutory COLAs (-\$272 million)***. A one-year suspension of statutory cost-of-living adjustments for AFDC, SSI/SSP, and certain health programs is proposed for 1989-90.
- ***Medi-Cal Program Changes (-\$63 million)***. A new drug cost-containment program, and new procedures to curb claims for services provided to persons eligible for both Medicare and Medi-Cal, are expected to reduce utilization of this program.
- ***Family Planning (-\$36 million)***. The budget proposes to eliminate all state support for family planning programs.
- ***Greater Avenues to Independence (GAIN) (-\$41 million)***. The administration plans to limit the planned expansion of the GAIN program and cut back on services offered.
- ***State Mandates (-\$42 million)***. The budget proposes to repeal 27 state mandates, ranging from funding absentee ballot costs to filing missing persons reports.
- ***In-Home Supportive Services (-\$64 million)***. Limits on provider reimbursement rates and the number of hours of service provided are expected to freeze state costs at the current-year level.

Shifting Costs to Counties (-\$137 million). The budget includes two proposals which will, at least in part, result in a shift of program costs to county governments. For example, the budget proposes a \$100 million reduction in General Fund support for the Medically Indigent Services program, and states that State Legalization Impact Assistance Grants (SLIAG) monies will be available to counties to replace these funds. Because of differences in the populations served by these programs, and the difficulties counties are expected to have in claiming the SLIAG funds, this proposal is likely to result in a higher funding burden for counties (or a reduction of services). The budget also proposes that the \$37 million share of state support for county juvenile justice systems be eliminated, so that counties will have to pay nearly all of these costs.

In summary, the Governor's Budget addresses the gap between available resources and program demands by (1) suspending statutory COLAs for one year in health and welfare programs, (2) reducing or eliminating state programs, primarily in the health area, (3) providing a smaller reserve, and (4) relying on other one-time savings or cost deferrals. The structural imbalance in the budget is yet to be addressed.

Conclusion

Clearly, the state must begin to address the budget's structural problem now. It may not be possible to resolve fully the dilemma in the coming year, as some changes may require a phase-in period and others may

require voter approval. We recommend, however, that the Legislature take a longer-term view of the state's needs and resources in the coming budget debate, so that the ultimate consequences of the short-term actions that may be necessary can be considered in the context of how the structural problem may ultimately be resolved.