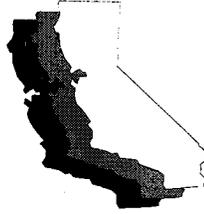


State Fiscal Picture

I

Part I



State Fiscal Picture

The *1990-91 Governor's Budget* reflects the two main constraints under which it was developed. First, the state's economy is expected to grow at a moderate pace, limiting the resources available to fund state spending requirements. Second, past state policy choices put in place by legislation and initiatives dictate to a large extent the allocation of available resources among state programs.

As it has in past years, the Governor's Budget offers as a starting point for negotiations a set of policy choices that only partially accepts these dual constraints. While the budget recognizes the need to restrain state expenditure growth to the level of available resources, it proposes changes in existing policies as to how those resources are allocated. In part, this reflects the administration's preferences as to how the state's money should be spent. Over the next four months, the Legislature and the administration will attempt to reconcile their preferences in developing a state budget for 1990-91. However, changes in the economy and in the state's past policy choices also may influence the budget that is ultimately signed into law.

In this part, 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.

State Fiscal Picture

OVERVIEW OF THE GENERAL FUND CONDITION

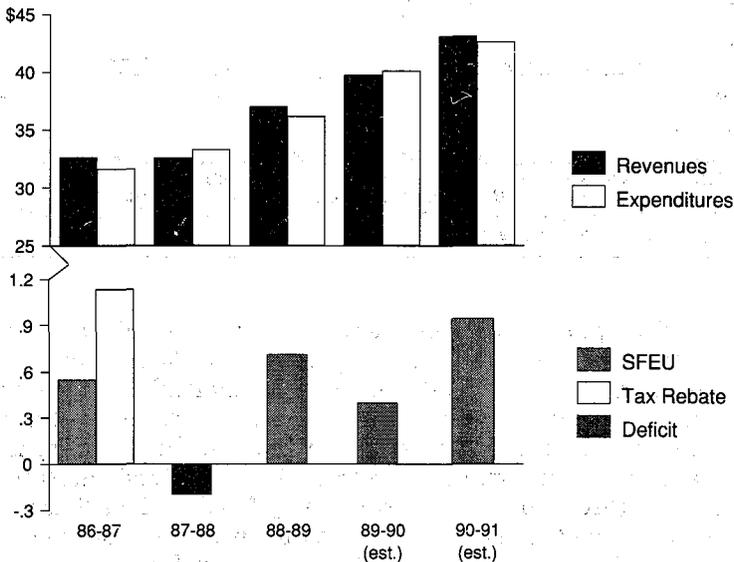
Figure 1 provides information on General Fund revenues, expenditures and the Special Fund for Economic Uncertainties (SFEU) from 1986-87 through the budget year. Figure 2 presents the same information in greater detail. Several of the numbers shown in Figure 2 differ from those in the Governor's Budget, for two reasons. First, consistent with existing law governing the transfer of funds to the SFEU, we reflect only the unappropriated

Figure 1

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

1986-87 through 1990-91

(dollars in billions)



balance of the General Fund as available for transfer to the SFEU. The budget, however, includes funds within the SFEU which are committed for continuing appropriations. Second, we have not reflected the administration's anticipated savings of \$50 million in 1989-90 from cancellation of encumbrances, because they are unlikely to occur and because the reduction of expenditures on this basis is not consistent with traditional accounting practices.

Figure 2

General Fund Revenues, Expenditures and the Special Fund for Economic Uncertainties

1986-87 through 1990-91^a
(dollars in millions)

	Actual 1986-87	Actual 1987-88	Actual 1988-89	Estimated 1989-90 ^b	Proposed 1990-91 ^b
Prior-year resources	\$711	\$680	-\$8	\$829	\$485
Revenues and transfers	32,614	32,579	36,983	39,775	43,102
Expenditures	<u>31,560</u>	<u>33,342</u>	<u>36,146</u>	<u>40,120</u>	<u>42,613</u>
General Fund balance	\$1,765	-\$83	\$829	\$485	\$974
Reserves ^b	(78)	(117)	(116)	(88)	(28)
Tax rebate	(1,138)	—	—	—	—
Special Fund for Economic Uncertainties	(549)	—	(713)	(396)	(946)
Deficit	—	-200	—	—	—

^a Source: State Controller. Data for 1986-87 and 1987-88 reflect adjustments to highlight funding provided for tax rebates. Detail may not add to totals due to rounding.

^b Source: 1990-91 Governor's Budget. Data reflect LAO adjustments to exclude effect of accounting differences between the Department of Finance and the State Controller's Office and to include continuing appropriations.

The figures show that General Fund expenditures exceeded revenues in 1987-88 and are projected to do the same in the current year. 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 (based on traditional state accounting practices) indicate that expenditures will exceed revenues by \$345 million. These additional expenditures will be funded by drawing down the state's reserve fund, reducing it to \$396 million by June 30, 1990.

Based on the projected levels of revenues and expenditures for 1990-91 contained in the Governor's budget, we estimate that the Governor's proposed spending plan would leave the General Fund with approximately \$946 million in the SFEU on June 30, 1991. These funds serve to protect the state against unanticipated declines in General Fund revenues and unforeseen increases in expenditures.

Big Revenue Swings Dominate Budget Picture

Figures 3 and 4 summarize the changes in the condition of the General Fund for 1988-89 and 1989-90, respectively.

1988-89. As shown in Figure 3, it was anticipated in January of last year, using traditional state accounting practices, that the state would close 1988-89 with a *deficit* of \$83 million in the General Fund. When the revenue estimates were revised in May of 1989, however, the administration announced that the state would receive nearly \$1 billion more in 1988-89 revenues. This was the result of stronger-than-anticipated growth in personal income taxes, including capital gains. The projected additional revenue increased the 1988-89 ending General Fund balance to \$522 million, according to the estimates made in July 1989. The State Controller's final report for the 1988-89 fiscal year, however, indicates that the state actually finished 1988-89 with a General Fund balance of \$829 million. This increase in the fund balance was largely the result of lower-than-anticipated 1988-89 expendi-

Figure 3

Change in the 1988-89 General Fund Condition^a

(dollars in millions)

	January 1989 (Est.) ^b	July 1989 (Est.) ^c	January 1990 (Actual) ^d
Beginning resources	-\$83	-\$83	-\$8
Revenues and transfers	36,002	37,037	36,983
Expenditures	<u>36,002</u>	<u>36,432</u>	<u>36,146</u>
General Fund balance	-\$83	\$522	\$829

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

^b Source: 1989-90 Governor's Budget, adjusted to reflect traditional state accounting practices.

^c Source: 1989-90 Final Budget Summary, adjusted to reflect traditional state accounting practices.

^d Source: State Controller's Office.

tures, primarily in corrections and Aid to Families with Dependent Children (AFDC).

1989-90. As shown in Figure 4, one year ago the 1989-90 fiscal year was projected to close with a General Fund balance of \$784 million. Given the tight fiscal situation anticipated at that time, this \$784 million ending balance was predicated on achieving a number of significant program reductions proposed in the *1989-90 Governor's Budget*. Last year's May revision not only added \$1 billion to 1988-89 revenues, it also increased 1989-90 revenues by \$1.4 billion. This increase was attributable primarily to more optimistic assumptions about the economy and higher capital gains estimates. This projected revenue increase allowed the restoration of the expenditure reductions originally proposed in the budget, as well as several other spending increases. On the basis of the adopted budget, it was estimated that the state would close the 1989-90 fiscal year with a General Fund ending balance of \$1.2 billion.

Figure 4

Change in the 1989-90 General Fund Condition^a

(dollars in millions)

	January 1989 (Est.) ^b	July 1989 (Est.) ^c	January 1990 (Est.) ^d
Beginning resources	-\$83	\$522	\$829
Revenues and transfers	38,877	40,278	39,775
Expenditures	<u>38,010</u>	<u>39,608</u>	<u>40,120</u>
General Fund balance	\$784	\$1,192	\$485

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

^b Source: *1989-90 Governor's Budget*, adjusted to reflect traditional state accounting practices.

^c Source: *1989-90 Final Budget Summary*, adjusted to reflect traditional state accounting practices.

^d Source: *1990-91 Governor's Budget*, adjusted to reflect traditional state accounting practices.

A large portion of the anticipated revenue gain was wiped out, however, when the Governor's Budget was released this January. The 1990-91 budget reflects a *decrease* of \$875 million in the estimate of current-year General Fund revenues (exclusive of additional transfers proposed in the budget), relative to what was assumed at the time the 1989 Budget Act was enacted. This reduction occurred primarily because the May 1989 economic assumptions were determined to be overly optimistic. Since the

expenditure estimates have not been dramatically revised since the 1989 Budget Act was passed (exclusive of earthquake-related spending), the reduction in estimated revenues has had the effect of reducing the projected ending balance for the current year to \$485 million, \$299 million below the estimates of one year ago and approximately \$707 million below the balance projected at the time the 1989 Budget Act was adopted.

THE STATE'S BUDGET DILEMMA FOR 1990-91

As has been the case for the last several years, the state faces a dilemma in putting together a balanced budget for 1990-91. This dilemma results from increased spending requirements which exceed the amount of new revenue available to meet those requirements.

How Much New Revenue Will Be Available?

Under the economic assumptions contained in the Governor's Budget, General Fund revenues are projected to increase by \$3.3 billion in 1990-91. Taking into account the distorting effect of earthquake-related tax revenues transferred to the General Fund, the increase in revenue actually amounts to almost \$3.5 billion. The first \$345 million of these new revenues, however, must be used to fund the *existing* level of state expenditures. This is because current-year expenditures are expected to exceed current-year revenues and are being financed in 1989-90 by drawing down the state's reserve fund, as described earlier. In addition, the budget proposes that \$489 million be used to restore the state's reserve fund in 1990-91. We estimate that this amount would bring the state's reserve to approximately \$946 million based on traditional accounting practices (as shown in Figure 2), or about 2.2 percent of proposed General Fund expenditures. These allocations leave approximately \$2.6 billion (equivalent to an increase of 6.7 percent in revenues) available to fund increases in state programs. Thus, almost one-quarter of the overall increase in revenues is not available to fund state spending in the budget year.

What Demands Will Be Placed on the Available New Revenue?

While the budget assumes that the state will continue to see moderate economic growth in the budget year, the \$2.6 billion available to fund expenditure increases is well below the amount needed to maintain current service levels. As discussed in more detail in Part Two of this volume, we estimate that nearly \$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 \$1.9 billion funding gap as it begins its deliberations on the state's budget for 1990-91.

What Factors Contribute to the Funding Gap?

As noted above, the demands for state funding increases exceed the amount of revenue that is available to pay for them. The higher growth rate for state expenditures stems from a variety of statutory and constitutional provisions and from past policy decisions which require growth in an increasing portion of the state's budget. For example, in the area of corrections, the state's prison inmate population has been increasing rapidly, in large part as a result of tougher statutory sentencing requirements, but also due to increased numbers of parole violations. This has led to a dramatic increase in corrections-related expenditure requirements to accommodate the additional inmates. The budget's growth also reflects the growth in entitlement programs in the health and welfare area such as AFDC, Supplemental Security Income/State Supplementary Program (SSI/SSP), and Medi-Cal. In addition, since the passage of Proposition 98 in November 1988, the state cannot reduce K-14 funding levels as part of an overall budget-balancing strategy.

In all of the cases cited above, increasing program expenditures are not subject to control through the budget process. In fact, by our estimates, more than 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 less than 30 percent of the budget that the Legislature can influence without changes to existing law. 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 or constitutional 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 not granting 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.

Thus, *without changes in existing law*, the Legislature would be faced with making \$1.9 billion in reductions to the 30 percent of the budget subject to discretion in the budget process. This is equivalent to an across-the-board reduction in this portion of the budget equal to 15 percent of proposed expenditures for 1990-91.

FUNDING PRIORITIES REFLECTED IN THE GOVERNOR'S BUDGET

Given the fiscal dilemma of expenditure requirements that are growing faster than available state revenues, the state is faced

with hard choices as to how the available resources should be allocated. The Governor's Budget proposes that the current growth rates be maintained in certain program areas, and reduced in others to make ends meet. Thus, it recognizes certain existing priorities and spending requirements, and proposes that others be changed. In general, the administration proposes to provide the necessary funding increases for K-14 education required by Proposition 98, and to continue the expansion of the state's correctional system. In addition, the Governor's Budget reflects the administration's general policy decision to fund workload and new legislative requirements.

Governor's Strategy for Balancing the Budget

The administration's strategy for closing the funding gap and balancing the budget can be categorized as follows:

Deferrals of State Costs (-\$197 million). The budget includes three proposals which would defer existing General Fund costs to future years. Specifically, the administration proposes to defer until 1991-92 the last Medi-Cal checkwrite of 1990-91 (\$48 million) and the state's 1990-91 contribution to the University of California Retirement System (\$50 million). In addition, the budget proposes to defer \$99 million in state costs for some existing state-mandated local programs from 1990-91 to future years.

Lower Reserve Funding (-\$330 million). We estimate that an additional \$330 million (above the amount provided in the Governor's Budget) would be required to fund the state's reserve at the 3-percent-of-expenditures level used in recent years as the state's funding goal.

Reductions in Services (-\$1.2 billion). The budget proposes to provide reduced levels of services in a variety of areas. It proposes the suspension of statutory cost-of-living adjustments for specified programs, and reductions in funding for other programs. Some of the most significant proposals include: cutbacks in a variety of welfare programs (-\$223 million) including Greater Avenues for Independence (GAIN) and the In-Home Supportive Services program, several changes in the Medi-Cal program (-\$98 million), and the elimination of funding for a variety of state-mandated local programs (-\$28 million). Of the proposed reductions, approximately \$500 million would require legislation in order for the proposed savings to be realized.

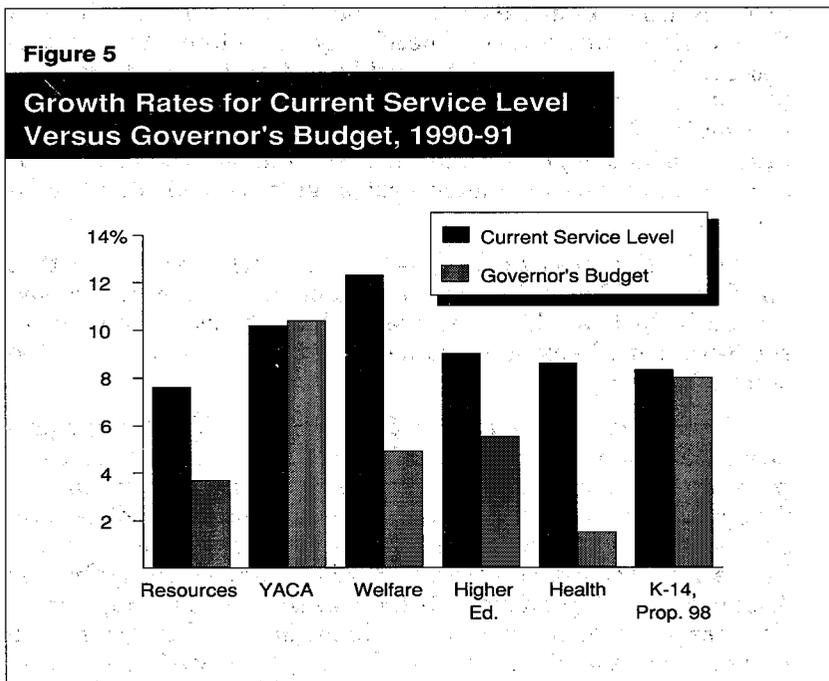
Shifting Costs to Counties (-\$157 million). The budget includes two proposals which will, at least in part, result in a shift of program costs to county governments. These include a proposed reduction of \$150 million in the AB 8 county health services

program (which would require legislation) and a shift of state costs for property tax programs to local funding sources.

Impact of Proposed Budget by Program Area

Another perspective on the Governor's strategy for balancing the budget can be gained by comparing the current service growth rates to the rates of growth provided in the Governor's Budget for the major program areas.

Figure 5 shows that the only major programs for which the current level of services is nearly or completely funded are K-14 education and Youth and Adult Corrections (YACA). The lower level of funding for K-14 education reflects the proposed diversion of Proposition 98 resources to other programs and certain technical factors. All other major program areas show significant short-falls.



CONCLUSION

Given the context in which the budget must be developed, the Legislature must begin its work with the majority of its effort focused on how to trim the state's spending requirements to match its available resources. The state's appropriations limit, at least

as it stands today, precludes the Legislature from proposing any significant increase in revenues for the budget year. The Governor's Budget estimates that the state would have less than \$150 million in room available under its appropriations limit to absorb additional tax revenues in the budget year. Thus, if the context of the budget four months from now remains as it is today, the Legislature will be faced with adopting a budget that makes significant reductions in existing programs and does not provide the traditional level of protection against economic uncertainties.

The context for the 1990-91 budget, however, could easily change over the next four months. The May revision could find the economy growing faster than anticipated, and provide the Legislature with more revenue to allocate (as occurred in the current year). A constitutional amendment which has been placed on the June 1990 ballot (SCA 1, Garamendi), if approved by the voters, could provide in the range of \$1 billion of increased room under the appropriations limit to absorb additional tax revenues. Under these circumstances, the Legislature would find its choices less difficult, but still not easy. At the same time, however, the budget's economic forecast is already somewhat more optimistic than that of other forecasters, and the state's economy could grow more slowly than anticipated. This could increase the magnitude of the budget problem.
