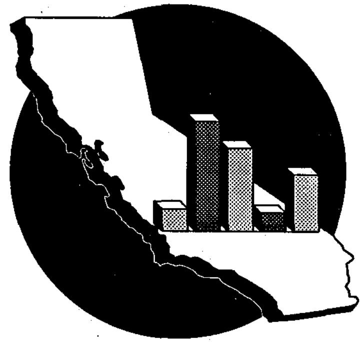
III

Perspectives on State Revenues



Perspective on State Revenues

State government revenues in California are divided into two broad categories: General Fund revenues and special fund revenues. As the name suggests, General Fund revenues are relatively flexible in terms of the purposes for which they can be used. Special fund revenues, on the other hand, tend to be earmarked for specific purposes. For example, motor vehicle fuel taxes are used primarily to fund highway construction and maintenance.

Figure 1 summarizes the major components of these two revenue categories and their relative sizes as proposed in the Governor's Budget. General Fund revenues are projected to be $39.9 billion for 1993-94, while special fund revenues are projected to be $12.1 billion. Thus, General Fund revenues are expected to account for 77 percent of the $52 billion state revenue totals.

The Forecast for General Fund Revenues

As shown in Figure 2, three main taxes comprise 90 percent of General Fund revenues, as projected in the Governor's Budget for 1993-94. The personal income tax (PIT) accounts for 42 percent of the total, followed by the sales and use tax at 36 percent, and the bank and corporation tax (B&C) at 12 percent. The next most important revenue source is the insurance tax, at 3 percent. Other sources of General Fund revenue are much smaller in terms of the share they contribute, but still provide important sources of state income. The larger of these include

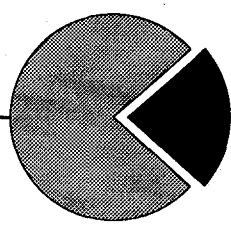
Figure 1

State Revenues in 1993-94

(In Billions)

General Fund Revenues	
Personal Income Taxes	$16.9
Sales and Use Taxes	14.3
Bank and Corporation Taxes	4.9
All Other	3.8
Total	**$39.9**

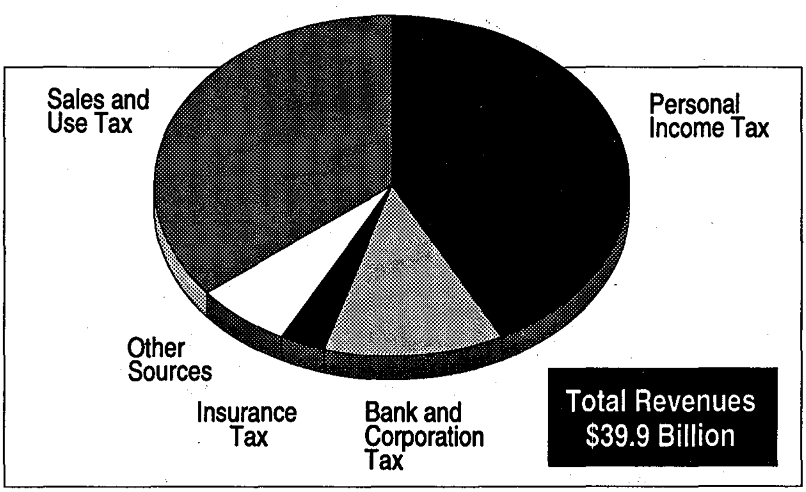
Total State Revenues $52 Billion



Special Fund Revenues	
Motor Vehicle-Related Taxes	$7.2
Sales and Use Taxes	1.6
Tobacco-Related Taxes	0.5
All Other	2.8
Total	**$12.1**

Figure 2

1993-94 General Fund Revenues by Source



the estate and inheritance taxes, alcoholic beverage and cigarette taxes, and interest income.

Figure 3 presents the budget's forecast for the primary sources of General Fund revenue. As the figure shows, General Fund revenues are expected to decrease by $1.1 billion in both 1992-93 and 1993-94. Most of this weakness in the performance of state revenues can be attributed to the weak performance of the state's economy. Several recent or pending tax changes also are contributing to these revenue reductions:

Figure 3

General Fund Revenues 1991-92 Through 1993-94

(Dollars in Millions)

Source of Revenue	Actual 1991-92	Estimated 1992-93	Projected 1993-94	Change From 1992-93 Amount	Change From 1992-93 Percent
Taxes					
Personal income	$17,240	$16,760	$16,900	$140	0.8%
Sales and use	16,146	15,110	14,256	-854	-5.7
Bank and corporation	4,494	4,850	4,900	50	1.0
Insurance	1,167	1,212	1,223	11	0.9
Estate, inheritance, and gift	447	540	608	68	12.6
Alcoholic beverage	321	307	291	-16	-5.2
Cigarette	169	178	192	14	7.9
Horse racing	88	80	75	-5	-6.3
Subtotals	$40,072	$39,037	$38,445	-$592	-1.5%
Other Sources					
Interest on investments	$322	$253	$268	$15	5.9%
Transfers and loans	689	795	371	-424	-53.3
Abandoned property	195	155	100	-55	-35.5
Other revenues	748	702	691	-11	-1.6
Subtotals	$1,954	$1,905	$1,430	-$475	-24.9%
Totals	**$42,026**	**$40,942**	**$39,875**	**-$1,067**	**-2.6%**

- The passage of Proposition 163 in November 1992, rescinding the 1991 application of the state's sales tax to "snack" foods and bottled water.

- The reinstatement of the net operating loss (NOL) deduction as of January 1, 1993.

- The termination of the state's temporary 1/2 cent sales tax on July 1, 1993.

In contrast to the Proposition 163-related revenue losses, which occur in both 1992-93 and 1993-94, the reinstatement of NOL deductions and the termination of the temporary sales tax rate primarily affect 1993-94 revenues. That is, the General Fund revenue estimates for 1993-94 have been reduced by approximately $1.8 billion to account for these tax changes, which more than explains the overall decline of $1.1 billion. In the absence of these scheduled tax changes, revenue collections would actually increase by about $700 million over 1992-93.

Tax Proposals in the Budget

The budget contains two proposals for legislation affecting state tax programs. First, the budget proposes that the existing renters' personal income tax credit be repealed, effective for the 1992 tax year. This change would raise approximately $840 million between the current and budget years, but it has no effect on reported levels of General Fund revenues because it is accounted for as an expenditure program. Second, the budget again proposes that the Small Business Health Care Tax Credit program be repealed. This program, which has never become operational, was suspended for the 1992 tax year by the 1992 budget agreement.

INDIVIDUAL GENERAL FUND REVENUE SOURCES

The Forecast for Personal Income Taxes

Background. California's personal income tax provides the largest single source of General Fund revenue. The structure of the tax is quite progressive, meaning that the proportion of income paid in taxes rises as income increases. This is illustrated by the fact that, in 1990, the top 4 percent of taxpayers in the state—those with over $100,000 in adjusted gross income (AGI)—paid 49 percent of the personal income tax collected, while accounting for 26 percent of AGI. The marginal tax rates range from 1 percent to 11 percent. The PIT tax base generally has conformed to the federal income tax laws since 1987 and includes a variety of deductions, credits, and income exclusions. The brackets and other basic elements are indexed for inflation.

The PIT is also the most sensitive of the state's taxes to changes in the rate of economic growth. The progressive structure of the personal income tax makes it highly "elastic" relative to personal income. In general, this means that income tax collections tend to rise by significantly more than 1 percent for every 1 percent increase in personal income, after accounting for inflation. The converse is also true, in that declines in "real" personal income in the state, as have occurred during the past two years, result in a more than proportionate decline in real income tax revenues.

The PIT Forecast. PIT collections are projected to reach $16.9 billion in the budget year, an increase of only 0.8 percent. Taking into account projected inflation as measured by the California Consumer Price Index (CPI), this translates into a decline in *real* income tax collections of 2.8 percent. The $16.9 billion is slightly *less* than the level of revenue the state received in 1990-91, which was prior to the addition of the 10 and 11 percent tax brackets. This illustrates the recession's severe impact on income tax revenues.

Proposed tax changes do not significantly influence the budget projections. The reinstatement of NOL deductions, required under existing law, reduces PIT collections by $86 million (the balance of the NOL effect is reflected in the B&C estimate). The net effect of other adjustments made to reflect 1992 legislation and other factors is essentially zero.

The "Clinton Factor." The forecast does include a small special adjustment, however, which is unrelated to state-level tax changes. Uncertainty over the potential for increases in federal tax rates on upper-income taxpayers has led the Department of Finance (DOF) to include an additional $220 million in the forecast for 1992-93 PIT revenues, partially offset by a reduction of $160 million in 1993-94 PIT revenues. In effect, the DOF anticipated that taxpayers would choose to accelerate the realization of some capital gains (including stock options) and other income into 1992, earlier than originally planned, in order to avoid the potentially higher 1993 federal tax rates. Based on information from December and January PIT collections, it appears that the acceleration adjustment was appropriate.

Salary and Wage Income Dominates PIT Base. Figure 4 indicates the relative importance of wages and various types of nonwage income in the PIT base. In 1990, the latest year for which final data are available, 63 percent of income was salaries and wages. Business and dividend income together accounted for 15 percent, while capital gains totaled 8 percent. As shown in Figure 5, however, the recession has taken a relatively greater toll on these latter sources of nonwage income than it has on income from salaries and wages. For example, the share of total taxable income attributable to salaries and wages is projected to

Figure 4

Personal Income Tax Liabilities By Source of Income, 1990

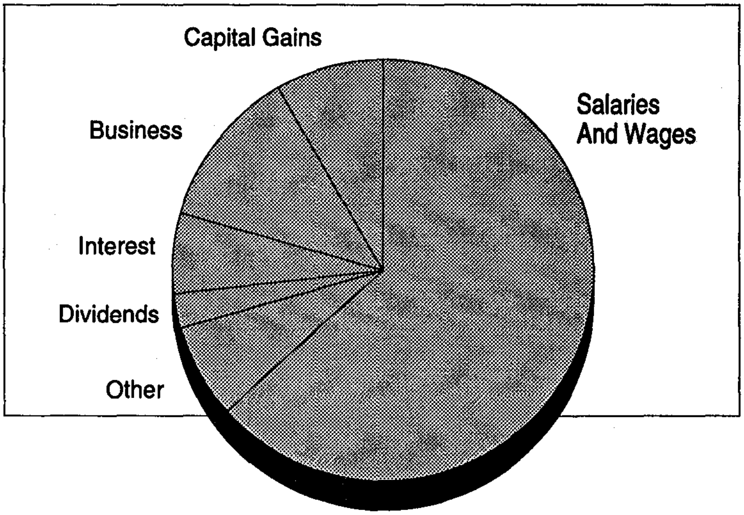
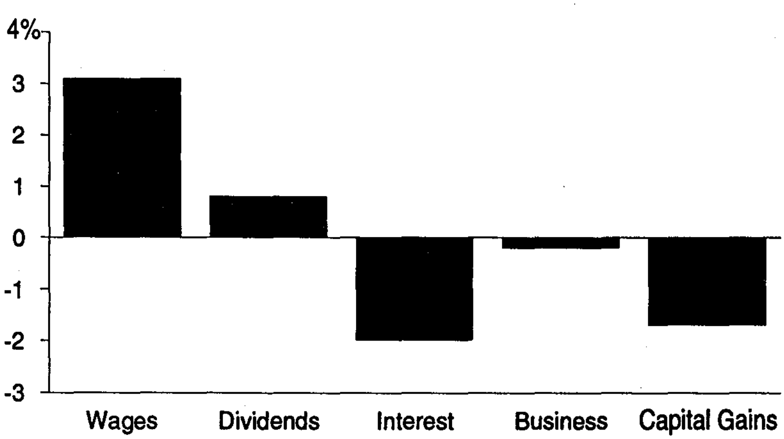


Figure 5

Changes in Shares of Taxable Income 1988 Through 1994

(In Billions)



increase by 3 percent between 1988 and 1994, while the shares attributable to interest and capital gains are projected to fall by about 2 percent each.

Capital Gains to Remain Weak. Capital gains have been one of the most volatile components of the income tax base in recent years. This results from changes in investor behavior in response to such factors as changes in tax rates, stock market fluctuations, and conditions in the real estate industry. The forecast assumes that capital gains realizations will fall by 10 percent in 1992 (to the lowest level in ten years), and then increase by 10 percent both in 1993 and 1994. In part, this projected weak performance reflects the fact that, although the share of total capital gains accounted for by sales of appreciated real estate has been increasing in recent years, the current declines taking place in commercial and residential asset values will dampen this increase.

The Forecast for Sales and Use Taxes

Background. Sales and use taxes are the second largest source of General Fund revenues. The tax is imposed primarily on retail sales of goods to consumers within the state. However, it also applies to many items purchased by businesses, such as capital goods or items consumed in the course of doing business. Examples include business machinery and equipment, stationery, and fixtures.

The "use" tax is imposed on products purchased by Californians from out of state for use and consumption within the state. Needless to say, many of the "use" items are difficult to track; a major exception is when automobiles purchased in another state are registered in California by either long-time residents or new immigrants.

Both the state and local governments levy sales and use taxes. The *state* tax rate is now 6.0 percent, including the temporary 0.5 percent rate scheduled to expire on June 30, 1993, and the 0.5 percent special fund rate levied to finance health and welfare program costs transferred to county governments under the 1991 program realignment legislation. A portion of the state's sales tax revenues—those generally derived from imposition of the sales tax on motor vehicles fuels—are deposited into special fund accounts for transportation purposes.

Local Sales and Use Taxes. Local governments also levy sales and use taxes, which are collected by the state on their behalf and are not included in the state revenue totals. These include the basic 1.25 percent Bradley-Burns tax rate levied by cities and counties, and a variety of other optional 0.5 and 0.25 percent tax rates levied for transportation, education, and general local government purposes. The maximum local tax rate may not exceed 2.75 percent in the aggregate, except in San Mateo County, which may levy an additional 0.5 percent if the proceeds are devoted to educational purposes. The actual local rates now imposed range from 1.25 percent to 2.5 percent, with the highest rate levied by the City and County of San Francisco.

The Sales Tax Forecast. General Fund sales tax collections are forecast to drop by approximately $850 million in 1993-94, following a fall of over $1 billion in 1992-93. The current-year decline reflects the recession's impact on taxable sales, as well as the voters' rejection in November 1992 of the so-called "snack tax" imposed in 1991. The budget-year decline, however, is entirely explained by the scheduled expiration of the state's temporary 0.5 percent tax rate, which reduces the 1993-94 forecast by slightly more than $1.4 billion.

Figure 6 illustrates the impact of the recession on sales tax collections by comparing changes in state personal income and taxable sales during the period 1990 through 1994. (For purposes of this figure, we have excluded those taxable sales associated with the "snack tax.") As these data indicate, total taxable sales generally move in step with personal income. Sales declined in response to the recession through the 1992 calendar year, but are expected to exhibit moderately strong growth (7.4 percent) in 1994, once the state's economy enters its projected recovery from the recession. This expected increase is less than the state has experienced during previous recovery periods, which reflects the relatively weak expansion projected by the DOF for the state and nation.

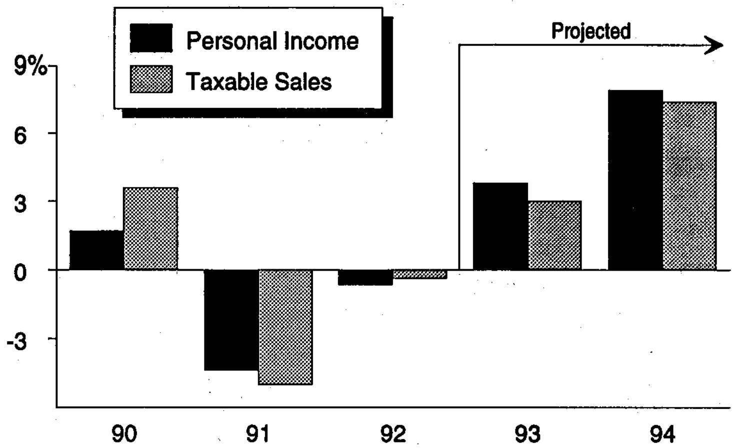
Figure 7 shows how two of the largest components of the sales tax base have been most affected by the recession. As these data indicate, the automobile and building materials categories have declined more drastically than total taxable sales, but are expected to rebound more strongly once the expansion begins.

The Forecast for Bank and Corporation Taxes

Background. Bank and corporation taxes are derived primarily from a 9.3 percent tax on taxable profits of corporations doing business in the state. This tax is projected to raise $4.9 billion in revenues in the budget year, which is a 1 percent increase over the projected 1992-93 level. In part, this low rate of increase reflects the effects of 1991 legislation suspending NOL deductions for 1991 and 1992 and reinstating them for 1993 and subsequent years. Adjusting for the effects of this legislation, 1993-94 B&C revenues would show a relatively strong rate of underlying growth—approximately 13 percent.

Figure 6

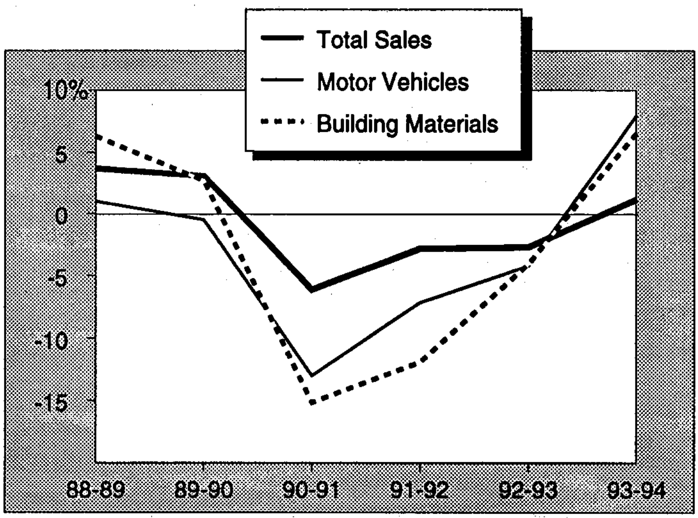
Comparison of Growth in Personal Income and Taxable Sales [a] 1990 Through 1994



[a] Excludes effect of "Snack Tax" in 1991 and 1992.

Figure 7

Growth in Real Taxable Sales 1988-89 Through 1993-94



Bank and Corporation Tax Collections Subject to Wide Fluctuations. Of the major state tax sources, the B&C tax is the most volatile and difficult to project. This is because of the economic and financial position of profits in business activity: they are the residual return to business owners after all business costs are paid. As such, they are influenced by a wide variety of factors, including contractual arrangements, market growth, competition from other firms, and investment decisions. During the past decade, B&C tax revenue growth fluctuated over a range between a minus 8 percent and a positive 27 percent.

Profits Expanding. The budget forecast anticipates that corporate profits will rebound strongly in 1992 and 1993, after declining in 1990 and 1991. This appears to reflect the expected recovery, as well as the combined effects of increasing productivity and a relatively low rate of growth in wages. Corporate staff downsizing programs, increased use of overtime, and other cost-cutting efforts do seem to be producing sizable productivity increases, according to recently released federal statistics. Nonfarm business sector labor productivity increased 2.7 percent in 1992, according to the U. S. Department of Labor, the highest rate of increase in 20 years.

Impact of NOL Deductions. The reinstatement of NOL deductions is projected to result in a $231 million reduction in B&C tax collections in 1993-94, which is about 5 percent of projected 1993-94 revenue. In years after 1993-94, revenue losses associated with the deduction are projected to increase substantially. This increase reflects a combination of factors, including:

- The ability of corporations to take the deduction was suspended during the past two years (1991 and 1992), so the deductions that otherwise would have been taken in these years will be taken in future years instead.
- Many businesses in the state have incurred large losses due to the long and serious state recession.
- The deduction is only available as an offset to future profits, so that the level of deductions claimed will rise as current profits recover from the recession.

The DOF estimates that B&C revenue losses due to the NOL deduction will climb from $231 million in the budget year to over $600 million by 1997.

Other General Fund Revenues

Other General Fund revenues are projected to decrease by $403 million (9.5 percent) in the budget year. This primarily reflects a drop in the amount of special fund monies to be transferred to the General Fund, following a large shift of these funds in 1992-93 for General Fund budget-balancing purposes. The budget anticipates that these transfers in 1993-94 will be about $371 million—less than half the amount transferred in 1992-93.

Reliability of the General Fund Revenue Forecast

As has been the case for several years now, the accuracy of the budget's revenue forecast hinges on one key question—when will California's current recession end? Job losses, personal income declines, and revenue shortfalls in the state are the worst since the Great Depression of the 1930s. It cannot be overemphasized that the most critical factor in making accurate forecasts of state revenues is making accurate economic forecasts. This is always the most difficult at turning points in the economy—when the state moves from expansion to recession or, as in the present case, from recession back to expansion. The past two years have been the most difficult for making such forecasts for California in the past half century.

The Past Two Forecasts Were Far Too Optimistic

Over the past several years, the economic forecasts contained in the Governor's Budget, and those developed for the May Revision, have been consistently wrong as to the timing of the state's recovery from recession. In each case, recovery was projected to have already begun or be "just around the corner," and the budget's revenue forecasts were based on this assumption.

As shown in Figure 8, there have been substantial downward revisions to the state's initial estimates of total General Fund revenue in each of the last three years. The shortfalls for 1990-91 and 1991-92, however, are actually *greater* than indicated in the table. Specifically:

- For 1990-91, the initial revenue estimate proved to be over $5 billion too high, after accounting for revenue legislation enacted along with the budget.
- For 1991-92, the budget forecast that General Fund revenues would total $45.8 billion, including approximately $2.8 billion of

revenue enhancements. Actual revenues for 1991-92 amounted to $42.0 billion, including about *$6 billion* of major revenue enhancements. Thus, this initial estimate was about $7 billion too high.

For 1992-93, General Fund revenues were initially projected at $45.7 billion, and now are forecast to come in at $40.9 billion, or $4.8 billion lower. (No major revenue enhancements were included in either figure.)

Figure 8

History of Governor's Budget Revenue Forecasts 1990-91 Through 1993-94

(In Billions)

Estimate Date	1990-91	1991-92	1992-93	1993-94
January 1990	$43.1	—	—	—
January 1991	40.4	$45.8	—	—
January 1992	38.2	43.6	$45.7	—
January 1993	—	42.0	40.9	$39.9

1993-94 Budget Takes a Conservative Approach

This year's economic and revenue forecasts in the Governor's Budget are more conservative than the initial forecasts made in the prior two years. The current forecast recognizes that the state's economy has been battered by the recession to an unprecedented and unforeseen extent and, despite signs of a national economic recovery, anticipates that the state's recovery will be slow in coming. In the longer run, however, the budget anticipates that the inherent strengths of the California economy will generate economic performance on a par with that of the nation.

Given the conservative nature of the budget's economic forecast, we believe that the major risks to the revenue forecast lie in three key areas.

Could the Recovery Be Delayed Beyond Late 1993? The budget anticipates that the state's employment losses will continue until the third quarter of 1993 and show modest gains thereafter through 1994. Because the state's 1993-94 fiscal year revenues are primarily derived from 1993 economic activity, any delay in the onset of recovery would cause significant reductions in state revenues.

Has the Recession Reduced the Predictive Power of Revenue Forecasting Models? The state's revenue forecasting models, which are based primarily on historical relationships between economic variables and tax receipts, are currently subject to greater-than-normal error margins. In part, this reflects the fact that the state has no relevant historical experience to guide it in forecasting revenues under severe recessionary conditions. In addition, there are concerns about the accuracy of federal data and economic statistics upon which the state's models must rely. Of special concern is the B&C forecasting model, where the reconciliation of actual tax receipts with reported profits data now requires extensive ad hoc adjustments.

What Impact Will Federal Policy Changes Have? Finally, there is substantial uncertainty as to the specifics of federal policy changes to be announced by the Clinton Administration. These policy changes could have both positive and negative effects in the short run. Among the more significant changes are the potential for further reductions in defense spending, the imposition of broad-based energy and other tax increases, and the possibility of increased federal assistance to state and local governments.

General Conclusion—Forecast is Reasonable

Based upon the most recent economic and revenue collection information available, we conclude that the budget's revenue estimates provide a reasonable basis for the Legislature to use in developing the 1993-94 budget. Although we have identified certain differences and potential risks associated with specific components of the forecast, these differences tend to be offsetting. Our findings include:

- ***Recent Improvements in PIT Collections.*** The performance of PIT collections in January was stronger than expected. Specifically, declarations of estimated taxes on 1992 income were about 8 percent higher than projected, and withholding was also up slightly. This performance may indicate that 1992 income tax liabilities were higher than forecast, which would tend to support a higher forecast of 1993 tax liabilities as well. Between the current and budget years, this stronger tax base could generate extra revenues, potentially in the $500 million range.

- ***B&C Estimates Too Strong.*** Our review of the B&C tax revenue estimate indicates that there is ample reason to be more cautious in this area. Specifically, we believe that the DOF's treatment of legislation enacted in recent years has led to an overstatement of actual profit levels. In addition, it is likely that the NOL deduction will reduce 1993-94 revenue collections by more than the budget estimates. These factors lead us to suspect that the forecast is at least $300 million too high.

- ***Effect of* Quill *Case Not Reflected.*** A recent U.S. Supreme Court decision (*Quill v. State of North Dakota*) has set back state efforts to require collection of sales taxes by out-of-state firms, particularly the rapidly growing mail-order industry. This court decision found that states have no authority to require firms without in-state premises to collect state sales taxes. Prior to the court's decision, the state had successfully persuaded a number of out-of-state firms to collect taxes on sales to California residents. The state had argued that these firms were in violation of its law, and the threat of legal action was sufficient to bring about compliance by many firms. At this point, in the absence of congressional action to prompt continued compliance (and the extension of collection responsibilities to other out-of-state firms), the existing collections of up to $100 million from out-of-state firms are at risk. Several small firms have already informed the state that they will no longer collect the tax, and others may do so as their current catalogs expire.

On the basis of the above factors, we conclude that the prospect of higher-than-expected PIT revenues generally offsets the risks associated with potential shortfalls in other areas of the forecast. Thus, for the Legislature's initial planning purposes, we conclude that the budget's forecast of current- and budget-year revenues provides a reasonable basis to proceed with the development of the budget plan. Revenue collections and economic data will need to be watched closely in the coming months, however, to allow for the early identification of significant deviations from these projections.

THE FORECAST FOR SPECIAL FUND REVENUES

Figure 9 presents the budget's forecast for special fund revenues in the prior, current, and budget years. These data indicate that special fund revenues are projected to total $11.5 billion in 1992-93 and $12.1 billion in 1993-94, which represents an increase of $0.6 billion, or 5.3 percent. Special fund revenues account for 24 percent of total state revenues in the budget year. The budget does not propose any major changes in special fund tax or fee structures for 1993-94. Under the terms of Proposition 111 (passed in 1990), however, a 1 cent increase in the motor vehicle fuel tax took effect on January 1, 1993, and a final 1 cent increase will take effect on January 1, 1994.

Figure 9

Special Fund Revenues 1991-92 Through 1993-94

(Dollars in Millions)

Source of Revenue	Actual 1991-92	Estimated 1992-93	Projected 1993-94	Change From 1992-93 Amount	Change From 1992-93 Percent
Motor Vehicle Revenues					
License fees (in lieu)	$2,943	$2,974	$3,041	$67	2.3%
Fuel taxes	2,458	2,428	2,625	197	8.1
Registration, weight, and miscellaneous fees	1,427	1,514	1,548	34	2.2
Subtotals	$6,828	$6,916	$7,214	$298	4.3%
Other Sources					
Sales and use taxes	$1,437	$1,546	$1,630	$84	5.4%
Cigarette and tobacco products tax	551	528	497	-31	-5.9
Interest on investments	109	85	79	-6	-7.1
Other	2,166	2,418	2,681	263	10.9
Subtotals	$4,263	$4,577	$4,887	$310	6.8%
Totals	**$11,091**	**$11,493**	**$12,101**	**$608**	**5.3%**

How Are Special Fund Revenues Used?

Figure 10 illustrates that motor vehicle license fees, fuel taxes, and other motor-vehicle-related fees are, by far, the largest category of revenues (60 percent). These funds primarily pay for transportation-related programs. Other sources of special fund revenues are earmarked for a variety of specific programs. Examples of special fund programs include the following:

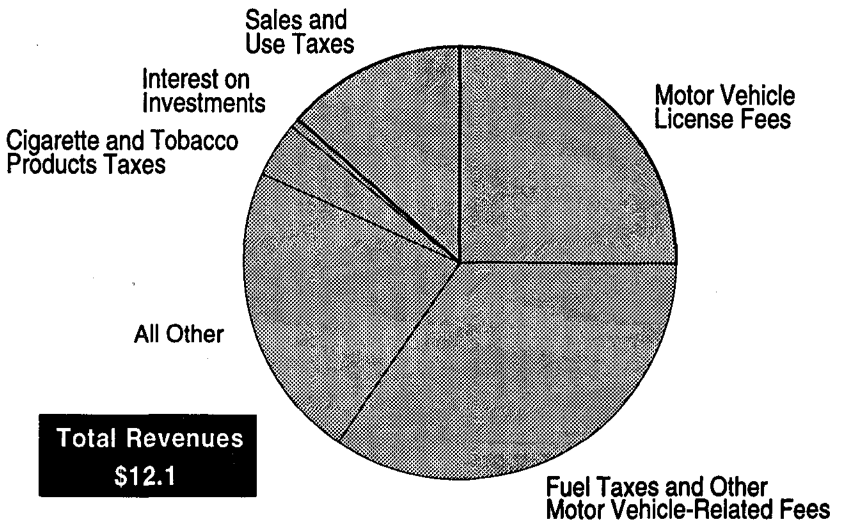
- Around half of motor vehicle-related revenues are transferred to local governments, in part for their general purposes and in part for such programs as road maintenance and mass transit. The remaining funds are used for state programs such as the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), the Department of Transportation (Caltrans), and the Air Resources Board (ARB).
- Tobacco-related taxes imposed by Proposition 99 (separate from those imposed for the General Fund) are distributed to various state accounts, usually for health and natural resources programs.

- Oil and gas revenues have generally been used to fund capital outlay projects.

Given the severe budget problems faced by the state the past three years, where legally possible, special fund revenues have been transferred and loaned to the General Fund, in effect to finance the general functions of state and local government.

Figure 10

1993-94 Special Fund Revenues By Source



Motor Vehicle Fee Revenues

Motor vehicle fee revenue grew a rapid 38 percent over the two years from 1989-90 and 1991-92 because of major increases in registration fees and changes in vehicle license fee depreciation schedules. In contrast to this rapid past-year growth, the budget forecasts a 1.1 percent increase in the current year and a 2.3 percent increase in the budget year. In part, this reflects the recession's impact on new auto sales. Sales of new autos are not expected to increase significantly in the state until 1994.

Motor Vehicle Fuel Taxes

Reduced travel during the recession, both by residents and visitors, has resulted in an estimated decline of $30 million (1.2 percent) in motor vehicle fuel tax revenues in the current year, despite the 1 cent rise in the fuel tax rate. This is in contrast with the 82 percent increase in these revenues from 1989-90 through 1991-92 that resulted primarily from Proposition 111's tax rate increases. The budget-year forecast is for a $0.3 billion (8.1 percent) increase in these revenues for 1993-94. This reflects both the recovery and the final scheduled 1 cent tax increase next January.

Realignment Revenues Sluggish

As shown in Figure 11, about $1.4 billion of sales and use taxes and $741 million of vehicle license fee revenues will be deposited into the Local Revenue Fund in 1993-94. This represents an increase of $72 million, or 3.4 percent, in 1993-94. This brings the amount of total revenues deposited in this fund to a level slightly below that originally forecast for 1991-92, when the program realignment legislation was first enacted.

Figure 11

Local Revenue Fund Tax Receipts 1991-92 Through 1993-94

(In Millions)

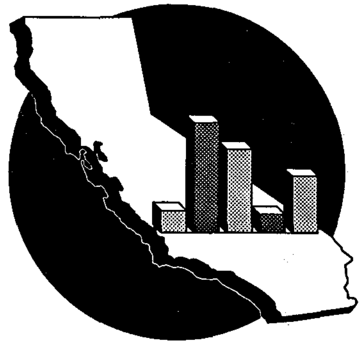
	1991-92	1992-93	1993-94
Sales and Use Taxes	$1,308	$1,366	$1,422
Vehicle License Fees	677	725	741
Totals	**$1,985**	**$2,091**	**$2,163**

Cigarette Tax Revenues Falling

The Cigarette and Tobacco Products Surtax is projected to decline 5.9 percent, to $497 million, in the budget year. In part, this reflects the large increase in the rate of the tax on tobacco products approved by the voters in 1988 (Proposition 99). The increased price, including federal as well as state tax increases, and continuing concern by the public over health effects have resulted in a pattern of declining consumption. On a per capita basis, consumption is expected to decline by approximately 4 percent in the current and budget years.

IV

Perspectives on State Expenditures



An Overview Of State Expenditures

State Spending Since 1982-83

Figure 1 illustrates the trends in state General Fund and special fund expenditures from 1982-83 through 1993-94. The figure shows expenditures in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars adjusted for the effects of inflation). This adjustment allows comparisons of the "purchasing power" of state spending over time.

As Figure 1 illustrates, state spending peaked in 1991-92 and is projected to decline in the current and budget years. This decline is without precedent in recent history—state spending has not registered a year-to-year reduction since the 1961-62 fiscal year. From 1982-83 through 1991-92, total spending increased at an annual rate of 8.1 percent (in current dollars) and, after adjusting for inflation, still grew by 5 percent annually.

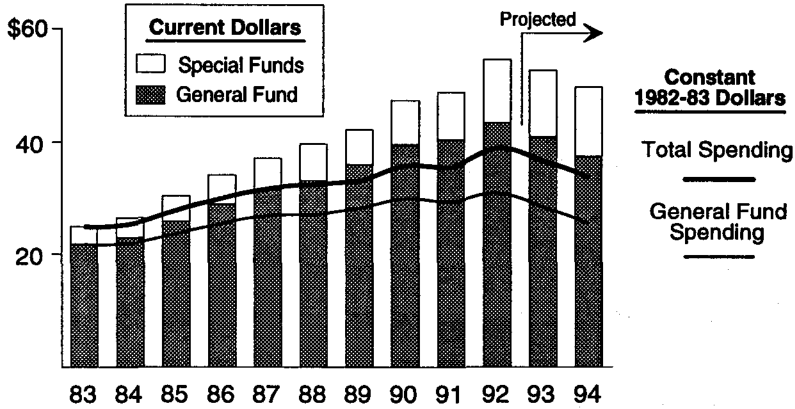
Proposed Current- and Budget-Year Spending

Figure 2 shows changes in the proposed level of spending for 1993-94. Total state spending is $49.7 billion, which is $3.0 billion, or 5.7 percent, *less* than estimated spending in 1992-93. This overall decline is the net result of a $3.5 billion reduction in General Fund spending, partially offset by an increase of $504 million in spending from state special funds.

Figure 1

State Spending[a]
Current and Constant Dollars
1982-83 Through 1993-94[b]

(In Billions)



[a] Excludes bond funds and federal funds.
[b] Data are for fiscal years ending in year shown.

Figure 2

Governor's Budget
Proposed and Adjusted Spending Changes
1992-93 and 1993-94

(Dollars in Millions)

			Change from 1992-93	
	1992-93	1993-94	Amount	Percent
Budgeted Spending				
General Fund	$40,822	$37,333	-$3,489	-8.5%
Special funds	11,854	12,358	504	4.2
Totals shown in budget	**$52,676**	**$49,691**	**-$2,985**	**-5.7%**
Proposition 98 loan adjustments	-$110[a]	$540[b]	—	—
Adjusted total spending	**$52,566**	**$50,231**	**-$2,335**	**-4.4%**

[a] Net General Fund adjustment from repayment of 1991-92 loan (-$1,083 million) and new 1992-93 loan ($973 million).
[b] Revised by the Administration from $375 million cited in the budget documents.

Adjustments for Proposition 98 "Loans"

The budget's proposed spending reduction in 1993-94 is somewhat exaggerated, due to the treatment of loans to K-14 school districts. Figure 2 shows the budget's proposed spending changes after adjustments for these "loans." These loans are an accounting mechanism that treat state funding in excess of Proposition 98's minimum funding guarantee as a loan against future state Proposition 98 requirements. The loaned funds are not counted as state expenditures in the year in which schools and community colleges actually receive the funds. Instead, the loan amount is counted as state spending when it is applied against the Proposition 98 minimum funding guarantee in a subsequent fiscal year. (Please see the Proposition 98 portion of "Major Expenditure Proposals in the 1993-94 Budget," later in this part, for a more detailed discussion of these loans.)

Adjusting for the effects of the Proposition 98 loans in the current and budget years lessens the proposed 1993-94 spending reduction by $650 million. Thus, on the adjusted basis, the spending decline amounts to $2.3 billion (4.4 percent) rather than the stated decline of $3 billion (5.7 percent). The budget proposes a significant drop in General Fund spending, even after these adjustments.

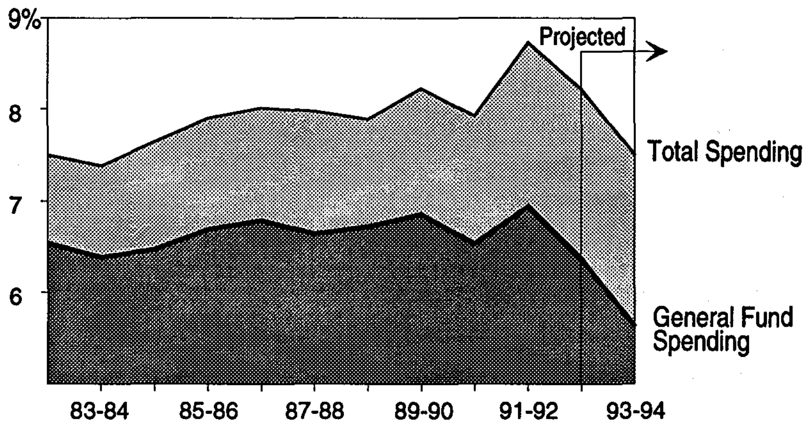
Spending in Relation to the State's Economy

Figure 3 shows how state spending has varied since 1982-83 as a percentage of personal income (which is an indicator of the size of the state's economy). From 1982-83 through 1989-90, total state spending generally increased as a percentage of personal income—from 7.5 percent to 8.2 percent. More than half of this growth was due to increased spending from special funds, which grew at an annual rate of almost 14 percent during the period.

Slow General Fund spending growth caused total spending to decline as a percentage of personal income in 1990-91. That decline was followed by a sharp rise in 1991-92 (to 8.7 percent). Two factors contributed to this rapid growth. First, tax increases and other actions taken to close the 1991-92 budget funding gap provided additional resources to finance rapidly growing program costs. Second, the recession had greatly reduced growth in personal income compared with past years. In addition, changes in accounting practices exaggerate somewhat the differences between 1990-91 and 1991-92. Spending in 1990-91 is understated because it excludes $1.2 billion provided to schools that year as an off-budget Proposition 98 loan, and 1991-92 spending is inflated by $1 billion due to a one-time accrual accounting adjustment for the Medi-Cal program. Taking all of these factors into account, the ongoing trend of state spending growing in proportion to personal income basically continued through 1991-92.

Figure 3

State Spending as a Percentage of Personal Income 1982-83 Through 1993-94



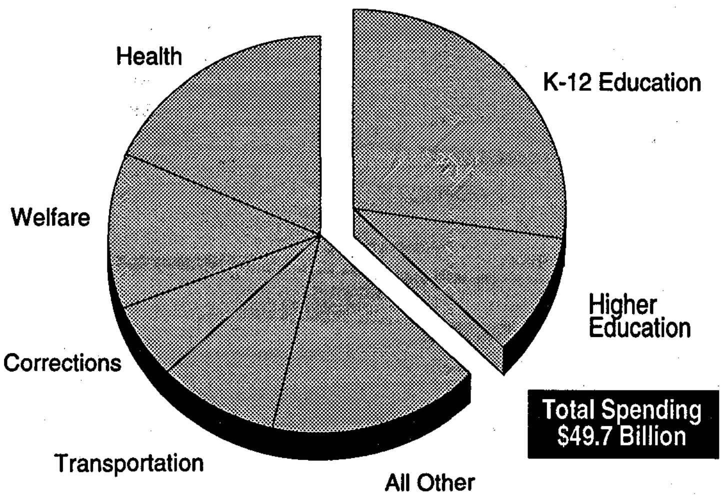
In the current year, as well as the proposal for 1993-94, state spending drops sharply as a percentage of personal income. Based on the budget's proposed spending and its projection of modest growth in personal income, total state spending in 1993-94 would fall to 7.5 percent of personal income—the same percentage as in 1982-83. This result, however, is attributable primarily to the budget's proposals to shift costs to the local and federal governments, as opposed to proposed reductions in programs.

State Spending By Program Area

Figure 4 shows the distribution of the proposed $49.7 billion of state spending in 1993-94 among the state's major program areas. The figure includes both General Fund and special fund expenditures in order to provide a meaningful comparison among program areas, since special funds provide the bulk of support in some areas (such as transportation). Also, including all state funds eliminates the distorting effects of past program funding shifts that have occurred between the General Fund and special funds.

Figure 4

Total State Spending By Major Program 1993-94



As Figure 4 shows, K-12 education receives the largest share of proposed state spending from all funds—28 percent. When higher education is included, education's share of total spending rises to 38 percent. The next largest shares of spending are for health programs (18 percent) and welfare programs (13 percent). The largest component of the "all other" category is $2.5 billion of general-purpose assistance provided to local governments in the form of vehicle license fee and homeowners' exemption subventions.

Spending from Federal Funds and Bond Proceeds

Debt service on general obligation bonds and lease-payment bonds is included in spending for the appropriate programmatic areas, as are direct expenditures on capital outlay projects from the General Fund and special funds. This gives a more complete picture of the current allocation of spending among programs. Spending from bond proceeds has *not* been included in these figures, however, because the spending of bond proceeds does not represent a *current* state cost. Instead, the cost of bond programs is reflected when the debt-service payments are made. The budget estimates that the state will spend $1.5 billion of general obligation bond proceeds in 1993-94. The majority of these bond fund expenditures are for transportation projects ($503 million), higher education facilities ($440 million), and prisons and jails ($276 million).

The budget also proposes to spend $29 billion of federal funds in 1993-94, including $1.4 billion that the Administration will seek from the federal government to offset state costs of services to refugees, immigrants, and their citizen children. The largest portions of these budgeted federal funds are for federal contributions to health and welfare programs ($19.1 billion), education ($6.2 billion), and transportation ($2.1 billion).

Including bond funds and federal funds, spending proposed in the budget for 1993-94 totals $80.2 billion—a decline of over $6 billion from the current year.

Spending Growth by Program Over Time

Figure 5 compares the annual growth rates of state spending for each major program area during the past ten years (1983-84 through 1992-93) and the proposed funding changes by program area for 1993-94. The figure reflects total spending from the General Fund and from state special funds. The difference between the trends of the last ten years and the current budget proposal is striking. Total state spending has grown at an annual rate of 8 percent during the last ten years, but the budget proposal would reduce overall spending by 5.7 percent in 1993-94. Further, the proposed reductions for several program areas contrasts sharply with their above-average historical growth rates.

Corrections

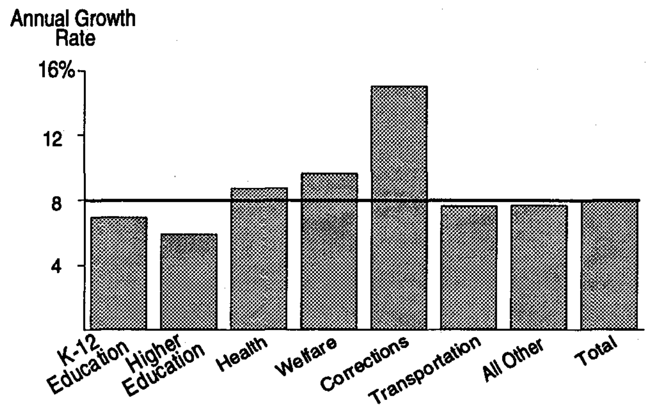
The most rapid growth among the major program areas has occurred in Youth and Adult Corrections, for which spending has grown at an annual rate of 15 percent since 1983-84. The growth in corrections spending reflects the costs of supporting an increasing inmate population, which has risen at an annual rate of almost 12 percent since 1983-84, and the cost of paying off bonds used to finance prison and jail construction. For 1993-94, the budget proposes a slight funding reduction of $18 million (0.6 percent). However, the principal reason for the reduction is the Administration's assumption that the state will receive $250 million in funding from the federal government to pay for the cost of inmates who are undocumented immigrants. Including these requested federal reimbursements, proposed funding for Youth and Adult Corrections would increase by 7.6 percent in 1993-94.

Figure 5

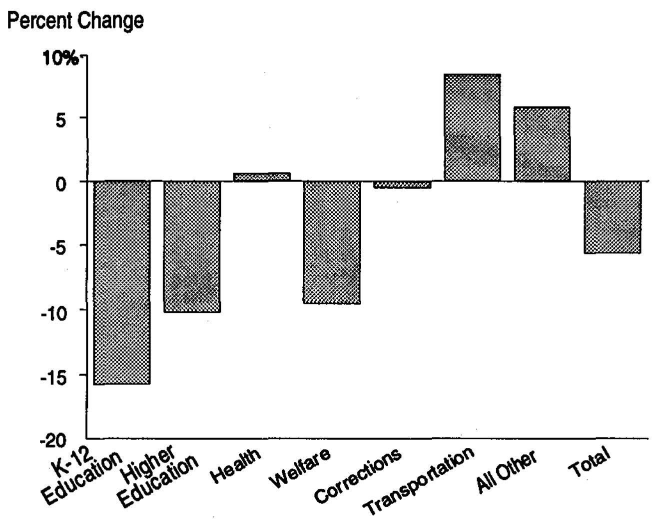
Spending Growth For Major Program Areas

All State Funds

Annual Growth Rates : 1983-84 Through 1992-93



Proposed Growth Rates for 1993-94



Health and Welfare

Spending on health and welfare programs (including state/local realignment funding and Proposition 99 funds) also has grown more rapidly than overall state spending. From 1983-84 through 1992-93, state spending for health and welfare has grown at annual rates of 8.8 percent and 9.7 percent, respectively, compared with the 8 percent overall rate of spending growth. A major reason for the spending growth has been an acceleration in caseloads. In 1984-85, for example, the number of persons receiving Aid to Families with Dependent Children (AFDC) benefits increased by 1.4 percent. In 1992-93, however, the budget estimates that the number of persons on AFDC will grow by almost 10 percent. Likewise, the growth in the number of Medi-Cal eligibles has risen from 3.6 percent in 1984-85 to an estimated 11.1 percent in 1992-93. Spending growth in health and welfare programs has a significant effect on budget totals, since these programs account for 30 percent of total state spending.

Figure 5 shows that, for 1993-94, the budget proposes essentially flat state funding for health programs (an increase of 0.6 percent) and a reduction of 9.6 percent for welfare spending. The budget also includes additional federal funding of $1.1 billion that the Administration is seeking from the federal government to cover state costs associated with providing health and welfare benefits to refugees, immigrants, and their citizen children. Including these additional federal funds in the year-to-year comparison results in health program spending increasing by 9 percent in 1993-94 and welfare spending declining by 4.4 percent (versus 9.6 percent for state funds only). If the additional federal funds are not forthcoming, the Administration proposes to make offsetting reductions, primarily in the health and welfare areas.

Education

During the past ten years, state funding for both K-12 education and higher education has grown somewhat more slowly than overall spending. The annual growth rates have been 7 percent for K-12 and 5.9 percent for higher education, compared with total state spending growth of 8 percent annually since 1983-84. This slower spending growth reflects the fact that, even though the number of students has increased faster than the state's total population, the number of students has grown relatively more slowly than has caseload in other programs. Over the ten-year period, K-12 average daily attendance (ADA) grew at an annual rate of 3.2 percent, and the number of students (full-time equivalents) at UC and CSU grew by only 1.2 percent annually. As discussed above, the numbers of prison inmates, Medi-Cal eligibles, and

AFDC recipients grew at much higher annual rates—11.6 percent, 6.7 percent, and 5.2 percent, respectively.

A funding shift also explains some of the slower apparent growth of education funding. As part of the 1992-93 budget solution, schools and community colleges received $1.4 billion of additional property tax revenue, which was diverted from local governments to offset state funding requirements.

For 1993-94, the budget proposes a reduction of $2.6 billion (15.8 percent) in state funding for K-12 education. The reduction in K-12 state funding, however, is more than offset by a $2.2 billion increase in the amount of property taxes shifted to K-12 schools from local governments, and by an off-budget Proposition 98 loan of $540 million in 1993-94. If these additional funds are included, then K-12 funding would *increase* by 2 percent in 1993-94 over comparably adjusted K-12 funding in 1992-93.

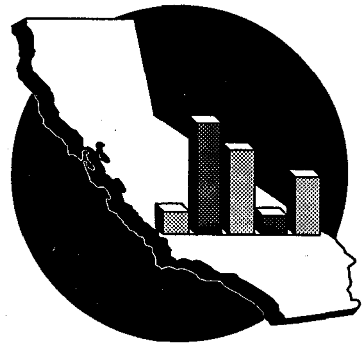
For higher education, the budget proposes a reduction of 10.3 percent in state funding in 1993-94. For the most part, this does represent a real funding reduction. Under the budget proposal, the community colleges also would receive an additional shift of property taxes from local governments ($400 million), but this gain is partially offset by the loss of $241 million from a one-time off-budget loan in the current year. The inclusion of these adjustments would still yield a reduction of 8.2 percent in higher education funding. The budget anticipates that a portion of this reduction may be offset by fee increases.

Transportation

Funding for transportation programs, including subventions to cities and counties for streets and highways, has grown at essentially the same rate as the overall budget since 1983-84. Unlike spending for most other programs, however, proposed state spending on transportation in 1993-94 continues to grow—increasing by 8.4 percent over estimated 1992-93 spending. The primary reason for this continued growth is that transportation spending is financed by its own revenue sources, including the gasoline tax. Proposition 111 authorized annual increases in the gasoline tax rate through 1994, so that transportation revenues have grown despite recession-caused declines in gasoline consumption.

Other Programs

Proposed spending for all other programs in 1993-94 appears to increase by 5.8 percent over 1992-93. This increase is misleading, however, because it reflects the budgeting practice of including in this category various statewide savings and costs that are not allocated among the individual program areas. For example, this spending category includes one-time savings in 1992-93 for retirement contributions for state employees in all program areas. In addition, proposed 1993-94 spending in this category includes funding for employee compensation increases required by bargaining agreements. These costs and savings will eventually be allocated to the other program areas when the final accounting for these years is completed. Excluding these statewide amounts, proposed funding for "other programs" falls by 3.9 percent in 1993-94.



MAJOR EXPENDITURE PROPOSALS IN THE 1993-94 BUDGET

As discussed in Part One, the state continues to face severe fiscal constraints due to the ongoing recession. Balancing the 1993-94 budget will require large spending cuts and/or revenue increases, and these decisions will be especially difficult because many of the available options already have been used in recent years. The budget's General Fund expenditure proposals primarily rely on shifts of program costs to local governments and the federal government. Figure 6 lists the major budget-balancing expenditure proposals in the budget and indicates whether legislation or federal action is needed to implement them, as well as the timing assumed by the budget. The amounts of savings shown in the figure are budget estimates.

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 1993-94 Budget Bill.*

PROPOSITION 98

Proposition 98 established minimum funding levels that the state must provide for K-14 education in each year. Generally, this is determined based on one of three so-called "tests." Specifically, the minimum funding level is equal to the greater of:

Figure 6

Summary of Major Budget-Balancing Proposals in the 1993-94 Governor's Budget

(In Millions)

Proposal	Legislation Required	Federal Action Required?	Effective Date	Savings 1992-93	Savings 1993-94
Property Tax Shift (Proposition 98)					
Cities, counties, special districts	Yes	No	7/1/93	—	$2,075
Redevelopment agencies	Yes	No	7/1/93	—	300
Enterprise special districts	Yes	No	7/1/93	—	150
Recapture of county SLIAG funds, one-time	Yes	No	7/1/93	—	70
Other Proposition 98					
K-12 loan for 1993-94	Yes	No	7/1/93	—	540
Current-year reversion	Yes	No	6/30/93	$315	—
Unallocated CCC cut/fees	Yes	No	7/1/93	—	266
Defer CCC loan repayment	Yes	No	7/1/93	—	121
Increased Federal Funding					
Reimbursements for state immigration-related costs	No	Yes	5/15/93	—	1,128
Provide remaining SLIAG funds	No	Yes	5/15/93	—	314
DDS regional centers: waiver for community-based service	No	Yes	1/1/93	18	28
Welfare Reductions					
AFDC grant reductions and other welfare reforms	Yes	Yes	3/1/93	32	467
SSI/SSP: no pass-through of federal COLA	Yes	No	1/1/94	—	69
Medi-Cal					
Eliminate some optional benefits	Yes	No	3/1/93	43	159
Higher Education					
Unallocated cuts and other shortfalls at UC/CSU	No	No	7/1/93	—	440
Trial Courts					
Shift additional funding to fees	Yes	No	7/1/93	—	71
Reduce funding	No	No	7/1/93	—	46
State Administration					
Downsize state agencies, Legislature, and courts	Possibly	No	7/1/93	—	197
Debt Service					
Cash accounting for bond interest payments	Yes	No	7/1/93	—	184
Special Fund Programs					
Special fund transfers to General Fund	Budget	No	7/1/93	—	226
Tax Expenditures					
Repeal renters' credit, starting 1992	Yes	No	Indefinite	395	445
Repeal small business health care credit	Yes	No	1/1/94	—	110

- ***Test 1—Percentage of General Fund Revenues.*** This is defined as the 1986-87 percentage of General Fund tax revenues provided K-14 education.

- ***Test 2—Maintenance of Prior-Year Funding Levels.*** This is defined as the prior-year level of total funding for K-14 education from state and local tax sources, adjusted for enrollment growth and for growth in per capita personal income.

In low revenue growth years, defined as years in which General Fund revenue growth, measured on a per capita basis, is more than one-half percentage point below the growth in per capita personal income, the minimum funding guarantee is based on:

- ***Test 3—Adjustment Based on Available Revenues.*** This is defined as the prior-year total level of funding for K-14 education from state and local sources, adjusted for enrollment growth and for growth in General Fund revenues per capita, *plus* one-half percent of the prior-year level. However, the increase in per-pupil funding must be at least equal to the increase in per capita expenditures for all other General Fund supported programs. This per-pupil funding floor (the so-called "equal pain, equal gain" or "Test 3b" provision) was intended to ensure that K-14 education is treated no worse, in years of low revenue growth, than are other segments of the state budget.

Other provisions of Proposition 98 allow the minimum funding level to be suspended by the Legislature and establish a "maintenance factor," which provides for restoration of funding levels in years following suspension or low revenue growth. These provisions ensure that any reductions in K-14 funding levels below those called for by the Test 1 or Test 2 formulas are only temporary in nature.

"Cash" Spending. In evaluating the effect of budget proposals, it is important to determine the amount actually available for K-14 programs ("cash" spending), as well as the Proposition 98 funding provided in a given fiscal year. Cash spending differs from Proposition 98 funding due to a variety of adjustments involving funding sources that are not recorded on the state's books at all or are not recorded in the fiscal year that the schools receive the funds. For example, community college fees are not shown in the state budget at all. In the case of loans, funds are received by districts in a different year than the expenditures are recorded on the state's books.

For a more complete discussion of Proposition 98 provisions and additional background on Proposition 98 funding levels, please see the "Overview of K-12 Education" in the ***Analysis of the 1993-94 Budget Bill.***

Proposal

The thrust of the Proposition 98 budget proposal is to maintain per-pupil K-12 funding at the 1991-92 level in both the current year and 1993-94.

Current Year

The Proposition 98 funding requirement (from the General Fund and local property tax sources) is at a Test 3 level of $23.8 billion. This is $725 million ($526 million General Fund) less than the level provided in the 1992 Budget Act because of a decline in state tax revenues and a reduced estimate of K-12 enrollment. The General Fund reduction is less than the total reduction because the state has to make up a $199 million decline in estimated local property tax revenues.

The Governor's Budget proposes to reduce current-year Proposition 98 spending below the 1992 Budget Act level by $637 million ($438 million General Fund). This is $88 million above the funding requirement.

The budget reflects a total of $24.1 billion in *cash* spending in the current year, a decrease of $460 million from the amount assumed in the 1992 Budget Act. This consists of the reduction of $637 million in Proposition 98 funding, offset by $177 million in changes involving non-Proposition 98 funding. Because of slower-than-expected growth in K-12 enrollment, this reduced level of cash spending would maintain K-12 funding at $4,187 per pupil, the same level as provided in 1991-92.

Budget Year

The DOF estimates that the Proposition 98 funding requirement for 1993-94 is at a Test 3 level of $23.5 billion, $390 million less than proposed current-year funding. This reduction is primarily the result of a projected decline in per capita General Fund tax revenues. The budget proposes to fund Proposition 98 at this level. Within the funding requirement, however, the budget proposes to shift $2.6 billion in property tax revenues from local governments to schools and community colleges. This shift would reduce the state funding requirement under Proposition 98 by an equal amount, assuming that proposed revisions are made to Test 3b to adjust for the property tax shift. The budget also proposes not to implement a provision stating legislative intent that 1993-94 funding exceed the Proposition 98 minimum funding level by $100 million.

The budget reflects Proposition 98 cash spending of $24.2 billion, an increase of $40 million from the proposed 1992-93 level of cash spending. The proposed level of spending would support K-12 schools at the same level of per-pupil funding as provided in 1992-93. Major budget proposals include (1) a new loan of $540 million for K-12 schools, (2) an unallocated reduction of $266 million in community college spending, and (3) deferral of a scheduled $121 million loan repayment from the community colleges.

We discuss issues affecting the community colleges under "Higher Education" and issues affecting property tax revenues under "Local Government."

Issues for Legislative Consideration

Our analysis indicates that there are several issues which the Legislature may wish to consider in evaluating the Administration's proposal for funding Proposition 98 programs. These include:

Reduced General-Purpose Spending

Although the budget maintains overall per-pupil funding levels for K-12 Proposition 98 programs, the budget proposal is about $260 million short of funding the per-pupil level of school district general-purpose spending supported by the 1992 Budget Act and related legislation. This is because the budget, in effect, proposes to fund categorical program growth, augmentations, and initiatives at the expense of per-pupil spending for general purposes. General-purpose spending represents around three-quarters of K-12 Proposition 98 spending.

New Loan

In order to maintain overall per-pupil funding levels for K-12 programs in 1993-94, the budget proposes a new loan of $540 million for K-12 schools. If added to the current-year $732 million K-12 loan, the new loan would result in total K-12 loans of $1.3 billion.

Our analysis indicates that borrowing an additional $540 million from future Proposition 98 funding to maintain spending during 1993-94 would place the state at risk of borrowing more funds in 1994-95 simply to maintain 1993-94 levels of per-pupil funding in Proposition 98 programs.

Categorical Mega-Item: Governor's Proposal Falls Short

The Governor's Budget proposes to continue funding most categorical programs through a single mega-item, and appropriates $3.7 billion for this purpose. The budget proposal differs from the current-year categorical mega-item, in that local education agencies (LEAs) would be permitted complete flexibility to redirect mega-item funding to any program that is funded in the item. LEAs would receive the same amount of funds for mega-item programs as they received in 1992-93, plus 1.55 percent growth.

As an alternative to the budget proposal, which does not simplify programs at the local level, the Legislature may wish to consider a more thorough reform of the current system of categorical programs. In our *Analysis of the 1993-94 Budget Bill,* we identify principles that we believe would be useful in guiding such a reform effort.

HIGHER EDUCATION

California's system of public higher education is the largest in the nation, and serves approximately 2 million students. This system is separated into three distinct segments—the University of California (UC) with 9 campuses, the California State University (CSU) with 20 campuses, and the California Community Colleges (CCC) with 107 campuses. The UC awards bachelor's degrees and a full range of graduate and professional degrees. It accepts students in the top eighth of high school graduates. The CSU primarily awards bachelor's degrees and accepts students from the upper third of high school graduates. The CCC offers a variety of academic and occupational programs, and basic skills and citizenship instruction.

Proposal

The UC and the CSU

General Fund support for the UC and the CSU will total $3.2 billion in 1993-94, a reduction of 6 percent compared with the current year. We estimate that this amount is $429 million less than the amount needed to fully fund salary and price increases, and to replace instructional equipment.

The budget document does not include any details regarding how the reductions would be implemented. It also does not include any information on projected enrollment or proposed student fees. It indicates that the segments will propose specific plans for consideration during spring budget hearings, and indicates the Governor's support for fee increases to offset at least part of the funding reduction.

Although the budget does not propose any specific fee increases related to the 1993-94 budget, the budget *does* reflect a fee increase of $605 at the UC in 1993-94 related to the current-year budget. The regents currently plan to borrow up to $70 million to balance the UC's 1992-93 budget. This loan would be paid off over a five-year period with student fee revenue. The $605 student fee increase scheduled for 1993-94 provides approximately $50 million in ongoing support in 1993-94 and sufficient funds over a five-year period to pay off the $70 million loan.

Community Colleges

The budget proposes $882 million in General Fund local assistance for the community colleges in 1993-94, of which $841 million counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 1993-94 General Fund request represents a reduction of $388 million, or 31 percent, from the amount of General Fund spending shown in the budget for the current year. Considering all funding sources available to the community colleges, including property taxes, fees, and loans, the net reduction is $297 million, or 11 percent.

The General Fund reduction is the net effect of a number of major changes, including (1) an increase of $224 million in budget spending to partially support services funded by an off-budget Proposition 98 loan in the current year (the proposed 1993-94 Proposition 98 loan would only be for K-12 schools), (2) a reduction of $367 million that is offset by a proposed shift of additional property taxes from local governments to the community colleges, and (3) an unallocated reduction of $266 million.

The budget document also states that the Governor supports legislation to authorize the Board of Governors to raise fees from $10 per credit unit to $30 per credit unit. A fee increase of this magnitude would raise sufficient funds to almost entirely offset the unallocated reduction.

Issues for Legislative Consideration

As we noted above, the Administration has not offered its view on major issues affecting the higher education segments. The Legislature will have to "start from scratch" in addressing those key issues. For instance:

Enrollment Levels. Perhaps the most important higher education issue for the Legislature to address is enrollment. While the budget contains no enrollment figures for 1993-94, it is clear that the segments are struggling to meet current Master Plan goals. For instance, CSU is serving at least 20,000 students fewer than called for by the plan, and many community colleges have been rationing their enrollments for years. The current situation raises the issue of the terms of the "contract" the state has with Californians who wish to pursue higher education goals. Put another way, what access should Californians have to public higher education?

Management of Resources. One way for the systems to accommodate more students for a given amount of money is to improve the way existing resources are managed. For instance, by increasing the percentage of time UC faculty spend on teaching (versus research and other activities), the UC can serve more students with the same number of faculty, with no impact on class size. Similarly, increased application of educational technology and improved course management can translate into higher productivity.

Fees and Financial Aid. While the budget does not propose any specific fee levels, it offers the prospect of potentially large fee increases. Coming on the heels of large increases in preceding years, these potential increases raise certain fundamental questions: (1) How much of the total education costs should be borne by students and their families? (2) How can the state provide more certainty as to fee levels and the rate of change in fees? On a related issue, the Legislature will face the issue of how to allocate a shrinking amount of financial aid monies to a growing number of eligible students.

Federal Reimbursement For Immigrant-Related Costs

California has experienced large amounts of foreign immigration over the last decade. The Administration estimates that about 2.3 million foreign immigrants (both legal and undocumented) came and stayed in California during the 1980s.

Immigration policy and enforcement is the responsibility of the federal government. The federal government also determines the eligibility of noncitizen immigrants for health and welfare benefits under programs such as Medicaid (Medi-Cal in California), AFDC, and SSI/SSP, which are supported jointly by federal and state funds. Thus, federal policies and laws that have allowed increased immigration and expanded health and welfare benefits to which immigrants are entitled have increased California's costs to provide the state's share of funding for these benefits. Furthermore, children born in the U.S. to immigrants (regardless of status) are automatically U.S. citizens, and are entitled to the full range of benefits available to any other citizen.

Proposal

The Administration is seeking a total of $1.6 billion of additional federal funds for services related to immigrants, refugees, and the citizen children of immigrants in 1993-94. Of this amount, $1.4 billion will offset state General Fund costs. These funds are included in the budget, which assumes that Congress will appropriate the funds by May 15, 1993, and that the state will receive the funds in 1993-94. Figure 7 lists the programs for which these federal funds are budgeted and the amount of General Fund savings that are assumed. The budgeted federal funds are related to a variety of federal requirements and past funding commitments that the Administration has identified.

State Legalization Impact Assistance Grants (SLIAG). Funding from SLIAG pays for services already provided to persons pursuant to the federal Immigration Reform and Control Act (IRCA) of 1986. That act established an amnesty program which allowed qualified undocumented immigrants to become legal residents. The act also established the SLIAG funding program to reimburse state and local governments for health, education, and public assistance grants and services provided to these legalized immigrants during the amnesty period. Through the current year, California has received a total of $1.63 billion of the $2.1 billion that the Administration estimates the state should receive as a minimum under the program. The budget assumes that California will receive the remaining $467 million of these funds in 1993-94, and that this will result in General Fund savings of $314 million (the remainder of the SLIAG funds will offset local costs or be used to provide discretionary services).

Refugee Act of 1980. The funding request includes $104 million to pay for the state's costs of providing Medi-Cal, AFDC, and SSI/SSP benefits for the first 36 months of residence by refugees, as required by the act. Federal funding for this purpose was provided at times in the past.

Figure 7

Federal Funding for State Immigration Costs 1993-94 Proposed General Fund Savings

(In Millions)

Program	Immigrant Categories	Amount
State Legalization Impact Assistance Grant (SLIAG)		
Medi-Cal	Legalized immigrants under the 1986 Immigration Reform and Control Act (IRCA)	$254
SSI/SSP		53
Food stamps		3
County Medical Services		2
AFDC		1
California Children's Services		1
Total SLIAG[a]		**$314**
Other Costs		
Medi-Cal	Citizen children, undocumented immigrants, legalized IRCA) immigrants, refugees	$574
AFDC	Citizen children, refugees	289
SSI/SSP	Refugees	15
Incarceration of undocumented felons	Undocumented immigrants	250
Total other costs		**$1,128**
Total budgeted federal funds		**$1,442**

[a] Excludes $153 million of unallocated SLIAG funds that do not offset required General Fund costs.

Citizen Children. The budget includes $240 million for the state's costs of providing AFDC benefits and Medi-Cal services to the citizen children of undocumented immigrants. No federal funding has been provided for this purpose in the past.

IRCA and Omnibus Budget Reconciliation Act of 1986 (OBRA) Medi-Cal Benefits. The budget includes $534 million for the state's costs of providing Medi-Cal benefits to newly legalized immigrants and to undocumented immigrants. The IRCA entitles newly legalized immigrants who are children, aged, blind, or disabled to full health benefits, and it entitles other newly legalized immigrants to emergency services, including labor and delivery, and prenatal and postnatal care. The OBRA requires states to provide emergency and labor/delivery services to undocumented immigrants.

Incarceration Costs. The budget assumes that the state will receive $250 million in federal funds for the cost of incarcerating undocumented immigrants who have been convicted of a felony in California. The IRCA authorizes federal reimbursement—subject to annual appropriations—for these state costs. However, Congress has never appropriated any funds for this purpose.

Alternative Program Reductions

In the event that the requested federal funds are not forthcoming, the Administration indicates that it would propose the following list of alternative reductions:

- ***Medi-Cal Optional Eligibility.*** Eliminate certain Medi-Cal optional eligibility categories, including medically needy adults and children (with some exceptions), and medically indigent children ($453 million).
- ***Medi-Cal Optional Benefits.*** Eliminate additional Medi-Cal optional benefits (beyond those already proposed for elimination in the budget), such as outpatient drugs and optometry ($356 million).
- ***Foster Care Rates.*** Delay foster care rate increases for group homes ($30 million).
- ***AFDC Homeless Assistance.*** Eliminate the AFDC Homeless Assistance Program ($31 million).

The Administration also states that it will seek to control Medi-Cal inpatient costs, for an $87 million savings. Furthermore, the Administration may seek additional reductions in other state services that are not federally mandated, such as services for developmentally disabled persons, rehabilitation services, nursing homes, and higher education.

Issues for Legislative Consideration

Unrealistic Deadline for Federal Action

The Governor's May 15 deadline for federal appropriations is not realistic. The next federal fiscal year does not begin until October, and Congress and the new Clinton Administration also face difficult budget decisions that will take time to resolve. Consequently, the Legislature almost certainly will have to make its budget decisions while the availability and amount of these federal funds remains uncertain.

This prospect necessitates a two-part strategy. First, the Legislature, along with the Administration, should continue to seek as early and as strong a commitment to funding as possible from Congress through the state's delegation. Second, the Legislature will need a contingency plan reflecting its priorities that it can put in place with the budget to make up for any shortfall in federal funding. Because the amount of federal funding is not likely to be certain until after the beginning of 1993-94, the contingency plan may require more solutions than the level identified by the Governor, in order to generate the same dollar savings during the remaining portion of 1993-94.

DEPARTMENT OF CORRECTIONS

The California Department of Corrections (CDC) is responsible for the incarceration, training, education, and care of adult felons and nonfelon narcotic addicts. It also supervises and treats parolees released to the community, as part of their prescribed terms.

Currently, the department operates 23 institutions, including a medical facility and a treatment center for narcotic addicts under civil commitment. The department also operates 38 fire and conservation camps. The department will activate two additional prisons before the end of the current year and a third new prison during the budget year. The Community Correctional Program includes parole supervision, operation of community correctional centers and facilities, outpatient psychiatric services for parolees and their families, and narcotic testing.

Proposal

The Governor's Budget requests $2.6 billion from the General Fund for support of the Department of Corrections (CDC) in 1993-94, an increase of 9.2 percent over the current year. This amount fully funds projected growth in the numbers of prison inmates and parolees, and provides an increase of 4.6 percent in funding per inmate. Moreover, the budget does not propose any significant policy or program changes to reduce inmate and parolee populations or to achieve savings in other ways in the budget year.

The budget's *total* spending figures assume that the CDC's General Fund costs will be reduced by $250 million in federal funds that the state is seeking to offset the cost of incarcerating undocumented immigrants who have been convicted of a felony in California (see our earlier discussion of the Governor's proposal for federal funds for immigration-related costs). However, the Budget Bill provides the full amount of General Fund support to CDC, so that the department's budget would be held harmless should the federal funds not materialize. In contrast, Budget Bill items for health and welfare programs already reflect the General Fund savings from the anticipated federal funds, and the Administration has proposed health and welfare program reductions to make up for any shortfall in federal immigration funding.

Issues for Legislative Consideration

The size of the 1993-94 budget shortfall will require the Legislature to consider budget-cutting options in *all* areas of the budget, including the CDC. Significant reductions in the CDC's budget would require reducing inmate and parole populations. In considering reductions to these populations, the Legislature should:

- Target reductions to nonviolent offenders.
- Target reductions to offenders incarcerated for very short periods.
- Consider greater use of enhanced community supervision (such as intensive parole or electronic monitoring) for offenders who would be redirected from the prison system.
- Consider greater use of other community-based sanctions in lieu of incarceration.
- Consider the impacts of any changes on local governments, particularly local law enforcement.
- Consider whether or how the reductions will affect crime in California.

In our *Analysis of the 1993-94 Budget Bill,* we offer a number of specific options for reducing the inmate and parole populations that we believe merit consideration.

TRIAL COURT FUNDING

The Supreme Court, the courts of appeal, and the superior, municipal, and justice courts make up the components of the California judicial system. The Supreme Court and the courts of appeal are entirely state-supported. The state and the counties share the costs of supporting the trial (superior, municipal, and justice) courts. State expenditures for trial court operations are partially offset by a portion of the fines, fees, and forfeitures collected by the courts. The fines, fees, and forfeitures transferred to the state pursuant to Ch 90/91 (AB 1297, Isenberg) are deposited into the General Fund, while the fees collected pursuant to Ch 696/92 (AB 1344, Isenberg) are deposited into the Trial Court Trust Fund. These fines, fees, and forfeitures, once collected by the trial courts and remitted to the state, are then redistributed back to participating counties.

Proposal

The Governor's Budget proposes total expenditures of $706 million for support of the Trial Court Funding Program. This amount is $45.7 million, or 6.1 percent, below estimated expenditures in the current year. The budget proposes significant shifts in funds to support the program, including a General Fund decrease of $125 million to trial court block grants and an increase of $71 million from fees deposited in the new Trial Court Trust Fund.

Issues for Legislative Consideration

There are a number of policy issues for the Legislature to consider regarding the Trial Court Funding Program.

Expenditure Level. For the second year in a row, the budget proposes to provide significantly less funding for the program than the amount needed to comply with previous statements of legislative intent. Specifically, existing law indicates that the state should support 60 percent of trial court costs, but the amount proposed in the budget would support only about 46 percent of these costs. In order to reach the 60 percent level, the budget would have to be augmented by $218 million.

Revenue Sources. The program has become increasingly dependent on revenues from fees and penalties generated at the local level, which are transferred to the state and used to finance trial court funding. As a result, the program has increasingly become a *redistribution* program.

Failure to Meet Expectations. The purposes of the Trial Court Funding Program are to (1) increase state funding for the trial courts, (2) transfer local court revenues to the state for a net benefit (at least in the short term) to the General Fund, and (3) improve the public's access to justice through the implementation of a number of court operating efficiencies and cost savings measures. In our view, the program has failed on the first two counts, and had mixed results on the third.

Please refer to the "Judiciary and Criminal Justice" section of our *Analysis of the 1993-94 Budget Bill* for a more complete discussion of these issues.

WELFARE REFORM

The bulk of the state's expenditures on welfare programs are for benefits in two programs known as AFDC and SSI/SSP. Both the state and federal governments fund these programs. In the current year, the budget estimates that the General Fund cost of these programs will be $2.9 billion for AFDC and $2.3 billion for SSI/SSP.

Aid to Families with Dependent Children (AFDC) provides cash grants to qualifying families with children whose incomes are not sufficient to provide for their basic needs. The largest component of the AFDC caseload is for the program component termed AFDC-Family Group (AFDC-FG), in which a family's financial need is related to the death, incapacity, or continued absence of one or both parents. Other program components provide for unemployed families with children and for children in foster care. The federal government shares the cost of AFDC grants with the state and (to a much smaller extent) the counties.

The Supplemental Security Income/State Supplementary Program (SSI/SSP) provides cash assistance to low-income persons who are elderly (age 65 or older), blind, or disabled, with the disabled being the largest group of recipients. The federal Social Security Administration, which administers the program, pays the cost of the SSI grant. California has chosen to supplement the federal payment by providing a state-funded SSP grant.

Proposal

The Governor's proposed welfare reform package generally consists of those components of last year's proposal (contained in the *1992-93 Governor's Budget* and Proposition 165) that were not enacted, with some modifications and additions. The net General Fund savings of the welfare reform proposals, as estimated by the budget, is $32 million in 1992-93 and $467 million in 1993-94, including related costs for administration and employment services programs. The major proposals are summarized below:

- ***Across-the-Board Grant Reductions.*** These account for the bulk of the savings. The budget proposes a 4.2 percent reduction in the AFDC maximum aid payment (MAP) and an additional 15 percent reduction for families that have an able-bodied adult and are on aid more than six months. The impact of the reductions would be primarily on nonworking recipients—those who currently get the maximum grants. The grant reductions would be partially offset by increases in federally funded food stamps. These grant reductions are proposed to take effect March 1, 1993, for a net savings (after administrative costs) of $40 million in 1992-93 and $367 million in 1993-94.

- *Maximum Family Grant.* Under this proposal, the MAP, which increases with family size, would not increase for a child born after the parent has been on aid for nine months. (In effect, the MAP would not increase for children conceived while the family is on aid.)

- *Expansion of Earned Income Disregard.* The budget proposes to remove the current four-month limit on the ability of working recipients to disregard about one-third of their earnings in calculating the amount of income that acts as an offset against their grant. This change would have the effect of increasing the grants for recipients who work for more than four months. The federal administration has approved a necessary waiver, contingent on funding the initial costs ($26 million), which are proposed in the 1993-94 budget.

- *Reduction in Pregnancy Benefits.* AFDC pregnancy-related payments would be eliminated, except for the federally assisted program, which provides payments during the last trimester of pregnancy.

- *Teen Parent Provisions.* The budget proposes to establish the Cal Learn Program, which would provide grant penalties based on secondary school attendance, and bonuses based on progress in school. The budget also proposes to require parents under age 18, with some exceptions, to reside with their parents, legal guardian, or adult relative in order to receive AFDC.

- *Expansion of the Greater Avenues for Independence (GAIN) Program.* The budget proposes to increase state funding for the GAIN Program, which provides employment training and education to AFDC recipients, by $15 million in the current year and $41 million in the budget year.

In our *Analysis of the 1993-94 Budget Bill,* we review these proposals in detail in our "Health and Social Services" section and offer several alternatives for legislative consideration, including proposals that have recently been implemented, on a demonstration basis, by other states.

Issues for Legislative Consideration

The goals of the budget proposal are to achieve current and future General Fund savings and to enhance the self-reliance of AFDC recipients so they can find jobs, improve their living standard, and contribute to the state's economic growth. The budget proposes to accomplish these goals by (1) reducing the size of grants, (2) increasing incentives and opportunities for AFDC recipients to work or continue their education, and (3) removing perceived incentives in the current system for women on aid to have more children. However, the proposal raises several significant issues.

Impact on Families. Will the reduced grant amounts be adequate to cover the basic living costs of families, especially in high-cost urban areas?

Effectiveness of Work Incentives. Will the grant reductions and the GAIN augmentation provide adequate incentives and opportunities for employment to AFDC recipients in order to achieve the dependency savings that are assumed in the budget? Also, employment may not be feasible or cost-effective for many recipients (for example, women with several young children requiring child care).

Timing and Feasibility. Many of the proposed AFDC changes require waivers of existing federal requirements. They also require enactment of state legislation to authorize the changes, and administrative and regulatory actions to implement them. The budget assumes implementation of the basic grant reductions by March 1, 1993, and implementation of the other proposals by July 1, 1993. This schedule appears to be too optimistic, given the number of steps involved, the complexity of some of the issues, and administrative requirements. Furthermore, court challenges could impose unanticipated delays. Consequently, the Legislature should take these factors into account in estimating the realistic level of savings that adoption of any of the AFDC proposals could achieve during the current and budget years.

MEDI-CAL

The California Medical Assistance Program is a joint federal-state program that is intended to assure the provision of necessary health services to public assistance recipients and to other individuals who cannot afford to pay for these services themselves. Federal laws establish a set of minimum eligibility criteria and the basic scope of benefits to be provided, and the states may provide for additional categories of eligibility and benefits at their discretion. Funding for most services provided under California's program is split equally between the state and federal governments. The budget estimates that the General Fund cost of the Medi-Cal Program will be $5.5 billion in the current year.

Proposal

The budget proposes the enactment of legislation, effective March 1, 1993, to eliminate 9 of the 28 optional service categories in the Medi-Cal program, for a General Fund savings of $47 million in 1992-93 and $172 million in 1993-94. These savings would be partially offset by additional costs of $3.7 million in the current year and $12.7 million in the budget year in the Department of Developmental Services, in order to maintain these services for Regional Center clients.

The services that would be eliminated are: adult dental; nonemergency transportation; medical supplies, excluding incontinence; speech and audiology; psychology; acupuncture; podiatry; chiropractic; and independent rehabilitation centers. Most of the savings would result from elimination of adult dental services. The budget proposes to continue these services for children under age 21, persons in long-term care facilities, and developmentally disabled clients.

Issues for Legislative Consideration

Potential for Cost-Shifting. In some cases, savings to the Medi-Cal program could result in shifting costs to other health programs. For example, elimination of adult dental care could result in untreated dental problems that later require more expensive emergency medical treatment. The Legislature should examine the cost-shifting potential for the optional services proposed for elimination, in order to determine the likely net savings and whether alternatives are needed to prevent shifts to higher-cost services.

RENTERS' TAX CREDIT

The renters' credit is a personal income tax credit that is available to low- and moderate-income Californians who are not homeowners.

Unlike other tax credits, however, the renters' credit is fully refundable—meaning that renters receive the full amount of the credit, even if their tax liability is less than the amount of the credit. Persons who have no tax liability may file a separate claim for the credit. For budgeting purposes, the entire cost of the credit, including the revenue loss, is counted as spending. Approximately two-thirds of the total cost of the credit is for the "refundable" portion (payments in excess of tax liability). The maximum credit is $120 (for a joint return).

Proposal

The budget proposes to eliminate the renters' credit program beginning in 1992-93. Elimination of the program would reduce General Fund expenditures for tax relief by $395 million in the current year and $445 million in 1993-94. The budget projects that, if the renters' credit is eliminated for tax year 1992, costs in 1992-93 to pay outstanding claims for preceding tax years will be $30 million. The proposal is contingent on the enactment of legislation, which is needed to eliminate the program.

Issues for Legislative Consideration

Retroactive Action. By proposing elimination starting with the 1992 tax year, the budget, in effect, is proposing a *retroactive* tax increase for those who qualified for the credit in 1992. This raises the general tax policy issue of the fairness of retroactive tax changes.

Proposal Unlinks Renters' Credit and Homeowners' Exemption. The Homeowners' Exemption and the predecessor to the renters' credit program were established simultaneously to mitigate rapidly rising property taxes in the late 1960s and early 1970s. The relative significance of the amount of relief provided to homeowners and renters has diminished over time, however. In addition, the passage of Proposition 13 in 1978 (1) has provided massive tax relief for both homeowners and renters and (2) prevents the rapid rise in property taxes that provided the original rationale for establishing these programs. Eliminating the renters' credit program would eliminate tax relief benefits for renters, while maintaining them for homeowners. The budget offers no policy justification for this choice. We believe that a better approach would be to seek the prospective elimination of *both* programs. This action would free up over $800 million annually to programs that are effective and are a higher priority to the Legislature. (Please see Item 9100 in the *Analysis of the 1993-94 Budget Bill* for a more detailed discussion.)

LOCAL GOVERNMENT PROPERTY TAX TRANSFER

Property taxes are the largest source of general purpose revenue available to local governments. Cities, counties, special districts, and redevelopment agencies depend upon these revenues to provide a wide variety of programs and services to California residents.

Recognizing the important role property tax revenues play in local government finance, the Legislature acted in 1979 to offset substantially the property tax losses local governments experienced as a result of Proposition 13. Specifically, the Legislature adopted a permanent fiscal relief mechanism which (1) shifted about $800 million of school and community college (K-14) district property tax revenues to cities, counties, and special districts (the so-called "AB 8" shift), and (2) assumed financial responsibility for approximately $1.3 billion of county health and welfare program expenses, thereby reducing financial strain on county general tax revenues. The property taxes shifted from schools to local governments were offset by higher allocations of state aid to K-14 education. Thus, the cost of the Proposition 13 "bailout" program for local governments (excluding schools) was about $2.1 billion in 1979-80.

Proposal

Due to the state's severe fiscal condition, the Administration indicates in the budget document that it is eliminating the Proposition 13 "bailout" of local governments. Specifically, the budget proposes to shift $2.6 billion in local government property tax dollars to K-14 districts in 1993-94. This shift would be *in addition* to the permanent redirection of $1.1 billion in property tax revenues to K-14 districts in the current year.

Figure 8 shows the allocation of property tax revenues between local governments and schools in 1991-92, 1992-93, and proposed in the budget for 1993-94. It is important to note that, although Figure 8 shows that K-14 districts would receive *more* property tax dollars under the budget proposal, total revenues for K-14 education *would not* increase. This is because the Administration proposes to *decrease* state funding for K-14 education on a dollar-for-dollar basis.

Figure 9 sets forth the details of the Administration's property tax shift proposal. As the figure indicates, the budget document does not state how almost $2.1 billion of the proposed $2.6 billion property tax shift is to be distributed or accomplished. Instead, the Administration intends that such a plan be developed collaboratively between the state and local governments.

Figure 8

Allocation of Property Taxes Between Local Government and Schools 1991-92 Through 1993-94

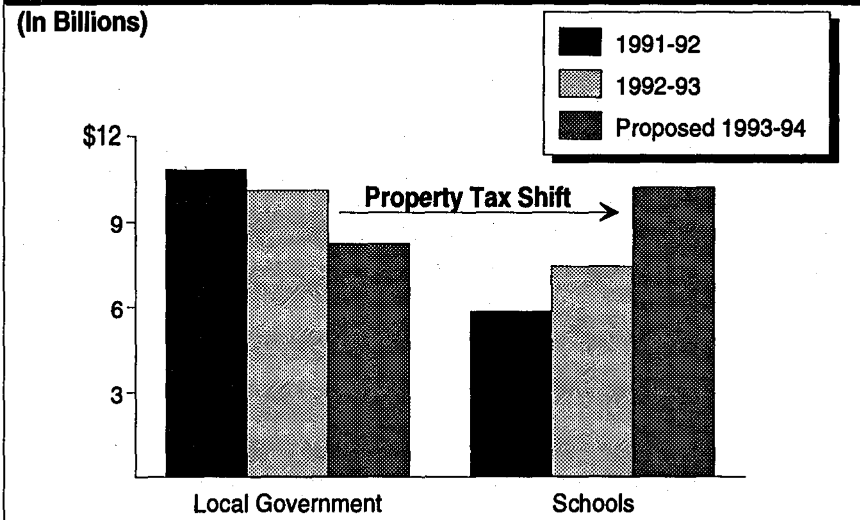


Figure 9

Components of the Proposed Property Tax Transfer

(In Millions)

Local Government Agency Affected	Amount Shifted to Schools	Methodology
Cities, counties, and special districts	$2,075	Unspecified.
Redevelopment agencies	200	Require transfer of funds in an amount equal to 16 percent of property tax increment.
Redevelopment agencies	100[a]	Limit allocation of property increment to amount needed to pay debt service.
Enterprise Special Districts	150	Eliminate entire property tax allocations for enterprise activities, except transit and hospitals.
Counties	70	One-time reduction in county property taxes to reflect projected increase in federal SLIAG monies.
Total	**$2,595**	

[a] This budget proposal would also shift $80 million from redevelopment agencies to counties, cities, and special districts.

Issues for Legislative Consideration

The magnitude of the proposed revenue transfer, the lack of a plan by the Administration, and the complexity of local government finance make this budget proposal one of the most difficult the Legislature will consider this year. We outline some of the important issues for legislative consideration below.

Impact of Budget Reduction On Total Local Government Revenues

The cumulative effect of the current-year and proposed budget-year property tax transfers would be to shift 31 percent of local government property tax revenues to K-14 districts. As Figure 10 indicates, this property tax shift represents a loss of about 4.1 percent of *total* local government revenues in the budget year—or a total of 5.8 percent over the two-year period.

While the percentage reductions shown in the figure may appear lower than reductions sustained recently by many state agencies, our analysis indicates that, in some cases, these funding reductions are *not* comparable. This is because the state has greater ability than some local governments to reduce expenditures. About 88 percent of all county expenditures, for example, are *required* by state or federal governments, and the counties have little control over this spending. Our analysis indicates that counties have discretion over the expenditure of only about $3.1 billion statewide. The current-year property tax shift, therefore, represents a 16 percent reduction in county discretionary spending. The proposed property tax shift (depending on the share allocated to counties) would bring the cumulative reduction in county discretionary spending to *50 percent or more.*

Role of Local Government in Resolving State's Fiscal Crisis. Despite the magnitude of this proposed local government revenue transfer, our review indicates that this does *not* constitute elimination of the Proposition 13 "bailout" to local government, as suggested by the Administration.

Specifically, the budget proposes to shift a total of $2.3 billion from agencies that benefitted from the Proposition 13 fiscal relief program (cities, counties, and special districts). As we show in Figure 11 (see page 84), however, the current value of the Proposition 13 bailout is approximately $6.1 billion. This estimate incorporates the current-year property tax shift and 14 years of growth in assessed value and health and welfare program costs. It does not, however, reflect other fiscal transactions between state and local government that have occurred since 1979-80—such as trial court funding changes and the transfer of financial responsibility to counties for medically indigent adults.

Figure 10

Local Government Impact of 1992-93 And Proposed 1993-94 Budget Cuts

(Dollars in Millions)

Type of Local Agency	Property Tax Shift	Total Revenues[a]	Percent Reduction
1992-93			
Counties[b]	$525	$25,036	2.5%
Cities	200	22,468	0.9
Special districts	375	14,504	2.6
Redevelopment agencies[c]	200	1,946	10.3
Totals	**$1,300**	**$63,954**	**2.0%**
1993-94 Proposed			
Counties, cities, and nonenterprise special districts (unallocated)	$2,075	$50,879	4.1%
Redevelopment agencies[d]	380	1,946	19.5
Enterprise special districts	150	11,129	1.3
Counties	70	—	—
Counties, cities, and nonenterprise special districts–unallocated tax gain[e]	-80	—	—
Totals	**$2,595**	**$63,954**	**4.1%**
Two-Year Totals	**$3,695**	**$63,954**	**5.8%**

a All revenue figures are 1990-91 data, except special districts (1989-90 fiscal year). Revenues include local taxes, state and federal aid, and user charges.
b City and County of San Francisco included in county totals.
c Redevelopment agencies funding reduction in 1992-93 was one-year only.
d Governor proposes to maintain the 1992-93 agency reduction ($200 million) and modify agency Statement of Indebtedness (SOI) calculations ($180 million). We estimate that modifications to the SOI will reduce agency funding by $300 million—or $120 million more than estimated by the Administration.
e Administration estimates that increases to city, county, and special district property tax revenues will be $80 million as a result of modifying agency SOI. We estimate that it will be $135 million.

The Administration's proposal, therefore, would take *more* than the estimated remaining value of the "AB 8" property tax shift, but *less than half* of the current value of the total Proposition 13 "bailout".

Our review also indicates that the budget proposal is inconsistent with its stated purpose of eliminating the bailout in two other ways:

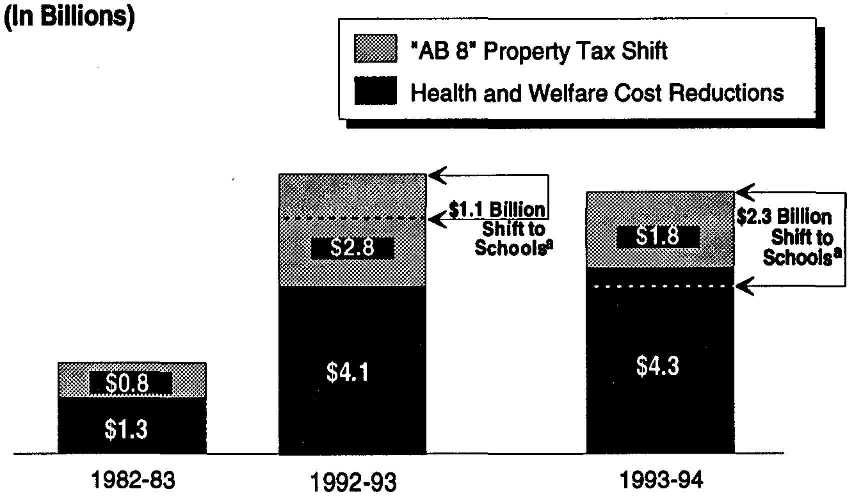
- It would take property taxes away from local agencies that did not benefit from the Proposition 13 fiscal relief package (such as redevelopment agencies).

- Local agencies that already lost all their Proposition 13 fiscal relief in the current year would face further property tax reductions.

Figure 11

Property Tax Shifts Reduce Value Of Proposition 13 Local Government "Bailout"

(In Billions)



[a] Excludes portions of property tax shifts relating to redevelopment agencies (which received no Proposition 13 bailout) and 1992-93 one-time related shifts.

Given the severity of the state's fiscal crisis, it is inevitable that some portion of the budget solution will be borne by local governments. Rather than considering this budget proposal in the context of a 14-year old fiscal relief program, however, we recommend that the Legislature consider this proposal in light of the relative need for state and local programs—and the appropriateness of the property tax to finance these needs.

Local Governments' Dependence Upon the Property Tax

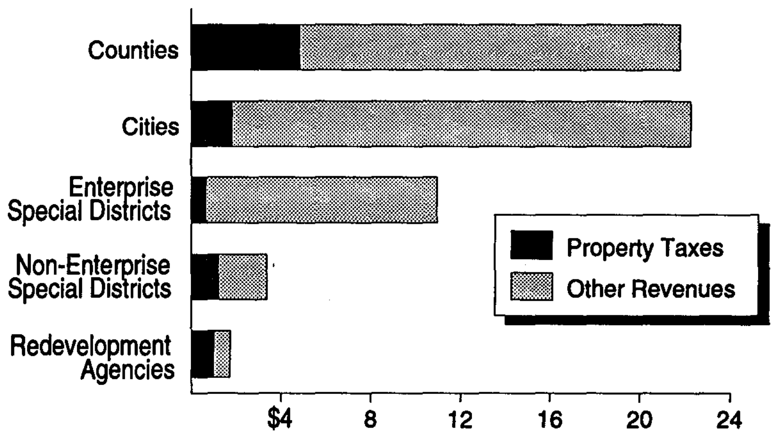
Local governments vary considerably in their dependence upon the property tax. This great variation will make the Legislature's task in allocating any property tax reduction much more complex.

Figure 12 shows the dependence on the property tax across local governments. Reliance upon the tax ranges from a high of about 61 percent for redevelopment agencies to less than 4 percent for enterprise special districts. There are also, however, very significant differences *within* groups of local government. Older cities, for example, tend to be much more dependent upon property tax revenues than newly incorporated cities (which receive relatively low allocations of property tax revenues). Similarly, counties without large retail establishments tend to depend more heavily upon property tax revenues than counties with auto malls and regional shopping centers in their unincorporated areas. Finally, fire protection, cemetery, flood, water conservation, and recreation and park districts depend on property taxes more than many other special districts.

Figure 12

Local Agency Dependence on Property Taxes
Property Taxes Relative to Other Revenues [a]

(In Billions)



[a] Excludes City and County of San Francisco. Data are for 1990-91 (1989-90 for special districts). Figures have been reduced to reflect the 1992-93 property tax shift.

Impact on Programs and Services

Almost all expenditures by special districts and cities are for traditional municipal programs, such as police and fire protection, and parks and recreation programs. Reducing one of the largest sources of general purpose revenues to these local agencies, therefore, inevitably will reduce the level of services provided under these programs.

The proposed property tax reduction for counties also would result in a decrease in funding for traditional municipal programs—although for somewhat different reasons. Unlike special districts and cities, counties provide a great variety of programs and services to California residents (from indigent health care to jails and elections). As we discussed above, however, about 88 percent of county expenditures are required by state or federal law, leaving counties direct control over the expenditure of only about $3.1 billion. These county discretionary funds are spent for public protection and other traditional municipal service programs. Unless the Legislature acts to give counties greater discretion over their budgets or access to other sources of funding, property tax losses will necessarily reduce county municipal service programs.

Finally, California's redevelopment agencies (RDAs) also would experience severe program reductions under the budget proposal. This is because the budget proposal (1) maintains the current-year requirement that RDAs transfer to schools an amount equal to 16 percent of agency property tax revenues and (2) further limits agency property tax revenues to the dollar amount needed to pay that year's debt service. Aside from the difficulties this may pose for existing RDA programs, it also raises the concern that RDAs will (1) cease all new urban revitalization and low-income housing construction activities and (2) shift costs to administer existing programs and repay debt service to cities and counties, requiring further cutbacks by these agencies.

Impact on New Development

Virtually all new developments—residential, commercial, and industrial— impose increased costs to local governments. New housing subdivisions, for example, enlarge the population needing public services. New manufacturing centers increase traffic and demand for water and solid waste disposal services.

Currently, many of these increased public costs are fully offset through the payment of property taxes by owners of new developments. By transferring a substantial amount of local government property tax revenues to K-14 districts as proposed, however, property tax revenues from new developments will offset *much less* of their public cost to local governments. As a result, local governments will have less incentive to rezone land or make other changes required in the process of approving new development projects.

Ability to Raise Revenues to Replace Loss of Property Taxes

While local governments have authority to levy assessments, charge fees, and impose a variety of taxes, our review indicates that these revenue sources will not be sufficient to offset the proposed property tax losses.

Most local governments, for example, have authority to levy benefit assessments and institute user charges. These revenue sources only can be used, however, to recapture the cost of providing a specific benefit to a group of property owners or service users. Thus, special districts may collect assessments or fees to cover the cost of providing flood protection, lighting services, or recreational programs, but counties may not use assessments or fees to pay for general governmental programs, such as elections, or for their required share of AFDC costs.

Cities and counties also have authority to institute a variety of taxes, including utility users', business license, property transfer, and transient occupancy taxes. These taxes raised a total of $2.4 billion in general purpose revenue for California's cities and counties in 1990-91. While cities and counties could increase the total revenues from these sources somewhat by raising the tax rates, many of the tax rates are at (or near) their practical or legal limit.

Finally, California counties have authority to impose a half-cent increase on the sales tax. While imposing such a tax could raise up to $1.5 billion for county programs in the budget year, our review indicates that counties cannot depend on this revenue source to replace their property tax losses for a variety of reasons. First, California voters have been reluctant to approve such measures by the requisite margins. (Tax increases for general governmental purposes require a majority vote; tax increases to fund specific programs require a two-thirds vote.) Second, imposition of the tax would require at least 120 days (to organize an election and to wait the statutorily required 90 days after the election before collecting the tax). Thus, even if a sales tax measure were to pass, it is unlikely that a county would receive substantial revenues from this source in the budget year. Third, some rural counties have few retail establishments. Increasing the sales taxes in these counties would not fully replace property tax revenue losses.

Fiscal Condition of Local Government

Like state government, the fiscal condition of many local governments in California has become strained and has resulted in significant program reductions. Given the continuing recession and increased demand for public services, many local governments would continue to experience significant fiscal difficulties—even without the proposed loss in property tax dollars.

Dubious Assumptions Included in Proposal

The Legislature's task in evaluating the proposed property tax transfer is further complicated by two unlikely assumptions included in the proposal. Specifically, the budget assumes that:

- Special districts will transfer $375 million in property taxes to schools again in the budget year, even though only a portion of these monies will be transferred in the current year, and court cases questioning the constitutionality of this transfer are pending.
- School districts in counties throughout the state can use the full amount of additional property tax revenues to replace state aid. Our analysis indicates that, in some counties, the amount of revenue proposed to be shifted could *exceed* the amount of state General Fund monies that could be freed up by the shift.

Finally, the budget includes very rough estimates of the amount of property tax revenues to be transferred by (1) modifying the Statement of Indebtedness (SOI) calculations by redevelopment agencies and (2) eliminating most property taxes to enterprise special districts. In the case of the SOI modifications, we estimate that the budget *understates* the amount of property tax to be transferred by $120 million. In the case of the enterprise special districts, we estimate that the budgeted amount could be in error in either direction by a range of tens of millions of dollars.