THE 1993-94 BUDGET: PERSPECTIVES AND ISSUES

Report from the Legislative Analyst's Office to the Joint Legislative Budget Committee

California Legislature

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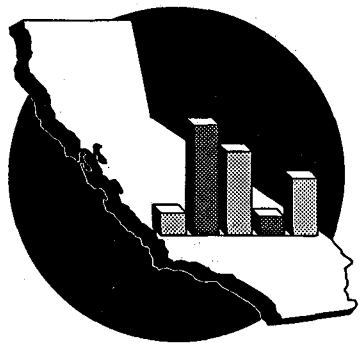


INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1993 Budget Bill and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 1993-94 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 1993-94 Budget Bill,* which contains our review of the Governor's Budget.

The *Analysis* continues to report the results of our detailed examination of state programs and activities. In contrast, this document presents a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the Legislature.

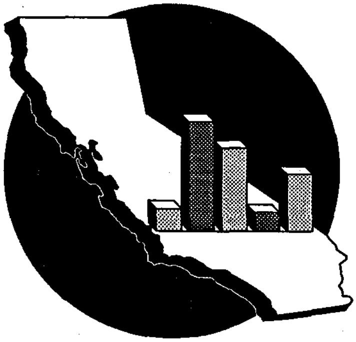
The 1993-94 Budget: Perspectives and Issues is divided into five parts:

- Part One, "State Fiscal Picture," provides an overall perspective on the serious fiscal problem currently confronting the Legislature.
- Part Two, "Perspectives on the Economy," describes the current economic situation and the Administration's forecast for the budget year.
- Part Three, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and an assessment of their reliability.

- Part Four, "Perspectives on State Expenditures," provides an overview of the state spending plan for 1993-94 and evaluates the major expenditure proposals in the budget.
- Part Five, "Restructuring California Government," discusses the issue of public sector restructuring and offers a model for fundamental change in state-local governmental responsibilities and financing.

I

State Fiscal Picture



State Fiscal Picture

As has been the case in each of the past four years, the *1993-94 Governor's Budget* recognizes a substantial decline in the state's fiscal fortunes. The continuing state recession has once again undermined the state's current-year spending plan, and will force the Legislature and the Administration into more painful choices as they struggle to balance the budget for the 1993-94 fiscal year. Even without attempting to provide for a prudent reserve, this task will require spending cuts or revenue increases conservatively estimated at $8.6 billion over the next 18 months. Given the magnitude of actions already taken in recent years, resolving this year's fiscal crisis requires a fundamental rethinking of governmental responsibilities in California.

The budget fully recognizes the magnitude of the crisis and proposes that the state respond with major changes in fiscal policy. However, the budget as presented does not realistically address the problem and could not be adopted as proposed. It provides little explanation of the policies inherent in its proposed changes or of the mechanics of implementing those changes. The budget also relies on overly optimistic assumptions about federal funding and the timing of statutory changes.

The budget essentially retains the same priorities for state spending as were followed in the adoption of the current year's budget. K-12 school funding and corrections spending receive the highest priorities, while major spending reductions are proposed in the health and welfare area. Local governments would take the largest cut, by means of a $2.6 billion shift of their local property taxes to school districts. The budget also calls on the federal government to assume $1.4 billion worth of responsibility for the impact of its immigration policy on the state's treasury. As was the case last year, the budget proposes to eliminate the renter's tax credit, but otherwise places no reliance on state-level tax increases to resolve the problem. However, tax increases at the local and federal levels are at least implicit in the budget.

In this part, we asses the state's current fiscal outlook and evaluate the Governor's response to the situation. We also examine the implications of the 1994-95 outlook on possible budget strategies for 1993-94.

THE 1993-94 BUDGET PROBLEM

Current Year Will End With Large Deficit

The 1992-93 budget plan adopted in September anticipated that the state would pay off its 1991-92 carry-over deficit and end the year with a small reserve of $31 million. This expectation was based on the Administration's May 1992 revenue estimate, which assumed that California's economy would resume moderate growth by the end of 1992. That assumption has proved overly optimistic, and the Governor's Budget now projects that the state's economy will remain mired in recession until late 1993. As a result, rather than ending 1992-93 in balance, the state now faces another multibillion dollar deficit at the end of the current year.

The Economy: A Weak Recovery in 1993-94

The Administration's forecast for the California economy assumes that the state's current recession will cause problems for the state in the budget year. Specifically, the recession is forecast to continue through the third quarter of 1993, followed by a relatively weak recovery continuing through 1994. Personal income is forecast to increase 3.5 percent in 1993 and 5.8 percent in 1994. Employment is expected to decline by 1 percent (120,000 jobs) in 1993 and increase by just 1.2 percent in 1994.

California's projected ongoing recession is the result of an expected weak national recovery and a number of other factors that will hit California especially hard, particularly the continuing declines in defense spending. California also has suffered more than most states from declines in residential and nonresidential construction and increasing competition in nondefense high-tech manufacturing, such as computers and commercial aircraft.

The Revenue Forecast

Due to the weaker-than-anticipated performance of the California economy, the Administration forecasts that current-year General Fund revenues will be $2.5 billion below the level anticipated by the 1992 Budget Act (that is, revenues will be approximately $40.9 billion). General Fund revenues are forecast to fall again in 1993-94 by almost $1.1 billion (-2.6 percent). This 1993-94 decline is entirely attributable to two major tax changes required by existing laws:

- The decrease in the state General Fund portion of the sales and use tax from 5.5 to 5 percent, effective July 1, 1993.
- Reintroduction of the net loss carry forward for businesses.

In the absence of these scheduled tax changes, General Fund revenues for 1993-94 would actually show a small increase of approximately $800 million (2 percent).

The Current-Year Deficit

Figure 1 compares the September 1992 budget estimates for 1992-93 with the January 1993 estimates in the *1993-94 Governor's Budget,* adjusted to exclude the spending and revenue changes proposed by the budget to mitigate the projected current-year deficit. As the figure

Figure 1

1992-93 General Fund Condition Deteriorates Rapidly Since Budget Enactment[a]

(In Millions)

	Estimate Date		
	September 1992	January 1993	Change
Prior-year balance	-$2,191	-$2,220	
Revenues and transfers	43,421	40,939[b]	
Total resources available	$41,230	$38,719	-$2,511
Expenditures	$40,792	$41,665[c]	873
Fund balance	$438	-$2,946	
Reserve	**$31**	**-$3,357**	**-$3,388**
Other obligations	$407	$410	$3

[a] Detail may not add to totals due to rounding.
[b] Excludes $3 million of new transfers proposed in the budget.
[c] Governor's Budget estimate adjusted to restore $843 million of proposed savings.

shows, the budget anticipates that, absent any corrective action, the state will end 1992-93 with a *deficit* of about $3.4 billion instead of the $31 million reserve originally planned. The $2.5 billion drop in estimated revenues discussed above accounts for most of this deterioration in the state's fiscal condition.Although weak revenues are the main problem, unbudgeted spending also contributes to the current-year deficit. General Fund expenditures in 1992-93 will exceed the previous estimate by $873 million (absent proposed spending reductions), according to the budget estimates. There are three major reasons for the increased spending. First, the federal government failed to provide all of the State Legalization Impact Assistance Grant (SLIAG) funds that were anticipated in the budget. Second, caseloads and costs increased over the amounts budgeted for Medi-Cal and prisons. Third, some of the savings that had been budgeted will not occur because of implementation delays or the need to enact enabling legislation.

1993-94 Budget Gap: $8.6 Billion

As shown in Figure 2, we estimate that the 1993-94 budget gap totals $8.6 billion. This amount consists of the carry-over deficit from 1992-93 ($3.4 billion) and the $5.2 billion operating shortfall between baseline spending and estimated revenue in 1993-94. For this calculation, we have used the Governor's Budget estimates of revenue (excluding proposed changes) as our base. On the expenditure side, our estimates recognize both increasing caseloads and the increasing costs of providing state services. Funding increases to offset one-time savings in 1992-93 are also included. This results in a baseline expenditure estimate of $44.7 billion for 1993-94, which is $3.0 billion, or 7.2 percent, more than current-year spending (excluding proposed changes). Our estimated budget gap does not include any funds to establish a prudent reserve. Including the creation of a prudent reserve would increase the size of the gap to almost $10 billion.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 3 shows the Governor's proposed amounts of spending and revenue for 1992-93 and 1993-94 and the resulting General Fund condition. Estimated General Fund revenues decline by 2.6 percent from the current year, while spending falls to $37.3 billion. This represents a reduction of $3.5 billion relative to estimated current-year spending (after taking into account the savings proposed in the budget). Although the budget is presented as balanced, the proposed $31 million reserve is much too small to cover the risk inherent in the budget plan.

Figure 2

1993-94 Budget Gap[a]

(In Billions)		
Pay off deficit from 1992-93		$3.4
1993-94 baseline spending	$44.7	
1993-94 estimated revenue[b]	-39.4	
Operating shortfall		$5.2
Budget Gap		**$8.6**

[a] Excludes Governor's Budget proposals. Details do not add to total due to rounding.
[b] Based on Administration's revenue forecast.

Figure 3

Governor's Budget General Fund Condition[a]

(Dollars in Millions)

	1992-93	1993-94	Percent Change
Prior-year balance	-$2,220	-$2,100	—
Revenues and transfers	40,942	39,875	-2.6%
Total resources available	$38,722	$37,774	-2.4%
Expenditures	$40,822	$37,333	-8.5%
Fund balance	-$2,100	$441	—
Reserve	**-$2,511**	**$31**	**—**
Other obligations	$410	$410	—

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

How the Budget Addresses the Spending Gap

Figure 4 shows how the budget proposes to address the $8.6 billion funding gap that we identified above. Half of the gap is addressed by shifting $4.3 billion of costs to other levels of government. Local governments would bear $2.7 billion of this burden, primarily through a shift of property tax revenue to schools and community colleges, where those revenues would replace state support. The budget also assumes that the federal government will provide $1.6 billion of additional federal funds, primarily to offset state costs of providing services to immigrants and their children.

Figure 4

Budget's Proposed Resolution Of the 1993-94 Spending Gap[a]

(In Billions)	
Cost shifts to other levels of government	
Reduced local government resources:	
Property tax shift to education	$2.6
Trial Court Funding and other	0.1
Increased federal funding:	
Reimbursements for health, welfare, and prison cost of immigrants	1.1
Additional SLIAG legalization aid	0.3
IHSS: shift to federal personal care program	0.2
Subtotal	$4.3
Program reductions	
Welfare proposals:	
Welfare reform/AFDC reductions	$0.5
No pass-through of federal SSI COLA	0.1
Shift special fund monies to General Fund programs	0.4
Unallocated cuts and other shortfalls at UC/CSU	0.4
Proposition 98:	
Reversion of K-12 funds in 1992-93	0.3
Unallocated CCC cut/fee increase	0.3
Eliminate Medi-Cal optional benefits	0.2
Downsizing state agencies, the Legislature and courts	0.2
Subtotal	$2.4
Cost deferrals	
Proposition 98:	
New K-12 loan for 1993-94	$0.5
Defer scheduled CCC loan repayment	0.1
Cash accounting for debt service	0.2
Defer repayment of 1992-93 loans from special funds	0.1
Subtotal	$0.9
Increased resources	
Tax expenditures:	
Repeal renters' credit	$0.8
Repeal small business health care tax credit	0.1
Subtotal	$0.9
Total	**$8.6**

[a] Figures reflect both 1992-93 and 1993-94 effects. Detail does not add to total due to rounding.

Program funding reductions account for $2.4 billion of savings. The largest savings come from the proposed AFDC grant reductions and related welfare reform proposals. Cost deferrals, including a loan to schools against their future Proposition 98 guarantees, provide about $900 million of savings. Other than the elimination of the renters' credit, the only tax-related proposal actually reflected in the budget is the repeal of the small business health care credit (which has never been implemented), for a savings of $110 million.

Major Budget Proposals

Property Tax Shift

The largest single feature in the budget proposal is the shift of $2.6 billion of property taxes and redevelopment funds from local governments to schools. This shift would reduce required state funding under Proposition 98 by a like amount, and would be in addition to the $1.1 billion permanently shifted to schools from cities, counties, and special districts in the current year.

The largest portion of the additional shift in 1993-94 consists of $2.1 billion that would be allocated among cities, counties, and special districts by an unspecified methodology that the budget proposes should be developed jointly by the state and local governments. The budget proposes to continue this year's one-time $200 million shift of redevelopment funds to schools, and to permanently restrict the allocation of property taxes to redevelopment agencies to generate another $100 million. In addition to the redevelopment funds, the shift also includes $150 million from enterprise special districts (other than hospital and transit districts) and a one-time diversion of $70 million to recapture savings from anticipated federal allocations to Los Angeles and certain other counties.

Increased Federal Funds

California has seen a massive influx of foreign immigrants over the last decade. The Administration indicates that it will seek $1.1 billion of increased federal funding for 1993-94 to reimburse the state for its ongoing costs of health and welfare benefits and services provided to refugees, immigrants, and their citizen children ($878 million), and for the costs of prison inmates who are undocumented immigrants ($250 million). The budget assumes that the federal government will provide these funds in 1993-94, and the Administration has requested that federal statutes and appropriations be enacted by May 15, 1993. The budget also includes savings of $314 million by assuming that the federal government will provide California with the full amount of remaining SLIAG funding owed for services already provided to newly legalized immigrants.

If this $1.4 billion of additional federal funds is not forthcoming, the budget presents a list of additional program reductions that the Administration would consider, including $809 million of additional Medi-Cal cuts. The Medi-Cal reductions would include eliminating additional optional benefits for adults (such as drugs and optometry) and optional eligibility categories for the medically needy and indigent. The list also includes $243 million from reducing the state's SSI/SSP benefits for elderly and disabled persons to the federal minimum amount.

Proposition 98

The budget reflects a downward revision in the level of K-12 enrollment for 1992-93. Combined with the reduction in estimated state revenues for the current year, this enrollment decline has lowered the Proposition 98 funding guarantee by $525 million. On this basis, the budget proposes to lower the amount appropriated for the 1992-93 guarantee by $437 million. More specifically, the budget proposes to lower K-12 school funding in the current year by $315 million, and to use $122 million of the $525 million "over-appropriation" to pay for outstanding Proposition 98 obligations from prior years. On a cash basis—what schools actually receive—total K-12 funding per pupil in the current year (from state and local sources) remains at essentially the same level contemplated in the 1992 budget agreement.

For 1993-94, the budget proposes to maintain this same K-12 per-pupil funding policy, while at the same time achieving a savings of $3.6 billion. As discussed above, the property tax shift provides $2.6 billion of this savings. The remaining savings are achieved primarily in two ways. First, the Administration proposes to designate $540 million of 1993-94 K-12 funding as a loan against future state Proposition 98 requirements. (The Administration has revised the original loan figure of $375 million that appears in the budget document.) None of these "loaned" funds are counted as state expenditures in 1993-94. Second, the budget proposes an unallocated reduction to the community colleges of $266 million. The Administration supports legislation allowing the Board of Governors to make up for this reduction with increased fees.

Other Significant Proposals

Higher Education. The budget proposes unallocated General Fund reductions totaling $430 million for the University of California and the California State University. This represents a reduction of 7.2 percent and 4.5 percent, respectively. The budget document does not contain proposed 1993-94 student enrollment or student fee levels for the UC and CSU.

Welfare Proposals. The budget proposes immediate enactment of many of the AFDC grant reductions and welfare reform proposals that the Governor put forward last year in his 1992-93 budget and in Proposition 165, with certain modifications. These proposals account for a net savings of $499 million, including $32 million in the current year.

Medi-Cal Optional Benefits. The budget again proposes, with some modifications, to eliminate certain optional benefits that California provides under the Medi-Cal program. The benefits that would be eliminated include adult dental care, psychology, and podiatry. The proposal assumes enactment of legislation to eliminate these benefits in the current year. Net savings would total $202 million, including $43 million in 1992-93.

Renters' Credit. The budget proposes the immediate enactment of legislation to eliminate the renters' credit, effective with the 1992 tax year. The total savings from this action would be about $840 million for both the current and budget years.

State Operations Reductions. The budget includes savings of $197 million in 1993-94 from a proposed downsizing of state operations. Of this total, $150 million would be allocated among state agencies and programs by the Director of Finance. The budget documents contain a list of departments and programs that the Administration intends to review to identify opportunities to consolidate functions, reduce costs, and improve accountability. The budget also includes savings of $47 million from "voluntary" 15 percent reductions that the Administration is requesting from the Legislature and the judiciary.

New and Expanded Programs. Given the magnitude of the state's fiscal problems, the budget contains very few new spending proposals. The welfare reform proposal includes a $26 million expansion in state funding for the GAIN program (which provides education and training to welfare recipients). The budget also requests $8.2 million for a new Strategic Technologies program in the Trade and Commerce Agency and $5 million to implement a volunteer mentor program for school children. Within spending required to meet the Proposition 98 guarantee, the budget proposes to allocate $58 million to expand preschool services, the Healthy Start program, and the Early Mental Health program. These programs reflect the Governor's emphasis on prevention programs and children.

THE EFFECT OF OFF-BUDGET TRANSACTIONS

Another important consideration needs to be included in assessing the state's financial position. This concerns commitments that are being made against future-year resources, but which are not accounted for in the budget displays. The largest of these is the off-budget "loan" of $973 million that the state provided to schools and community colleges in the current year against future Proposition 98 requirements. The budget proposes a second off-budget loan of $540 million in 1993-94, which would bring the total amount of these loans to $1.5 billion.

In effect, the state has borrowed money from the future to maintain its current level of spending for schools and community colleges. This spending will have to be reflected in future budgets when the loans are "repaid" to the state, either by offsetting the repayments against the Proposition 98 guarantee at that time (a reduction in actual funding to education) or by forgiving the loans and reflecting the amounts as spending in the budget.

The state also has used an off-budget transaction to postpone its liability for a $600 million sales tax refund to federal contractors, pursuant to the *Aerospace* court decision. The state plans to pay off this liability (with interest) over ten years. The 1993-94 budget reflects only the $60 million first installment on this debt, leaving $540 million still owed. Including this amount, the General Fund would end 1993-94 with a total liability of more than $2 billion for off-budget financing of 1992-93 and 1993-94 spending.

The Growing Cash Gap

The use of off-budget transactions is one of several ways in which the state has used accounting techniques to balance its budget during the last few years of fiscal crisis. These accounting techniques have widened the gap between the budgetary and the cash position of the General Fund.

The Difference Between the Cash Balance And the Budget Balance

The reserve or deficit figures shown in the budget displays have little relationship to the amount of cash in the General Fund at year-end. Figure 5 illustrates the conceptual difference between the cash balance and budget balance of the General Fund at the end of each fiscal year.

Figure 5

Relationship Between General Fund Budget Balance and Cash Balance (End of Fiscal Year)

Budget balance[a]

– Net revenue accruals

\+ Net expenditure accruals

–/+ Adjustments for off-budget spending

= Cash balance

[a] Shown in budget as "Fund Balance."

The budget fund balance and the cash balance may be quite different, both in their amount and direction. Generally, the budget uses an accrual method of accounting. This means that the revenues shown in the budget include some money not yet in the state's possession on June 30, but owed to the state. Likewise, budget spending figures include amounts needed to pay outstanding bills for goods and services already provided to the state at year-end. As discussed above, the budget balance does not reflect off-budget spending, such as the Proposition 98 loans. In order to reconcile the actual cash balance to the General Fund "fund balance" that is shown in the budget displays, it is necessary to adjust for accruals and off-budget spending.

The Importance of the Cash Balance

Regardless of the budget's stated reserve, a cash deficit requires the General Fund to borrow money to cover current expenses, which results in interest costs. "Internal" borrowing (from other state funds) can provide some of these loans, but large cash deficits require the state to borrow externally from investors, such as by issuing revenue anticipation notes (RANs). Traditionally, California and most other state and local governments have issued RANs for cash-flow loans. These loans help pay expenses during the earlier part of the fiscal year when revenues are low, and are repaid later in the year when the revenue flow picks up. A year-end cash deficit that requires external borrowing creates difficulties, however. Investors are uncertain whether the state will have enough cash to repay them before the end of the fiscal year and, in the absence of an enacted budget, they may be willing to lend across fiscal years only at relatively high interest rates—or not at all.

Monitoring *changes* in the relationship between the cash balance and the budget balance over time also provides important information. If the cash balance worsens relative to the budget balance, this can indicate a growing imbalance between current revenues and spending that has been offset in the budget by accounting changes or other "paper" transactions. This type of situation signals increasing borrowing needs to finance current operations, and it also could signal an unsustainable level of spending.

General Fund Cash Deficit Much Greater Than Budget Deficit

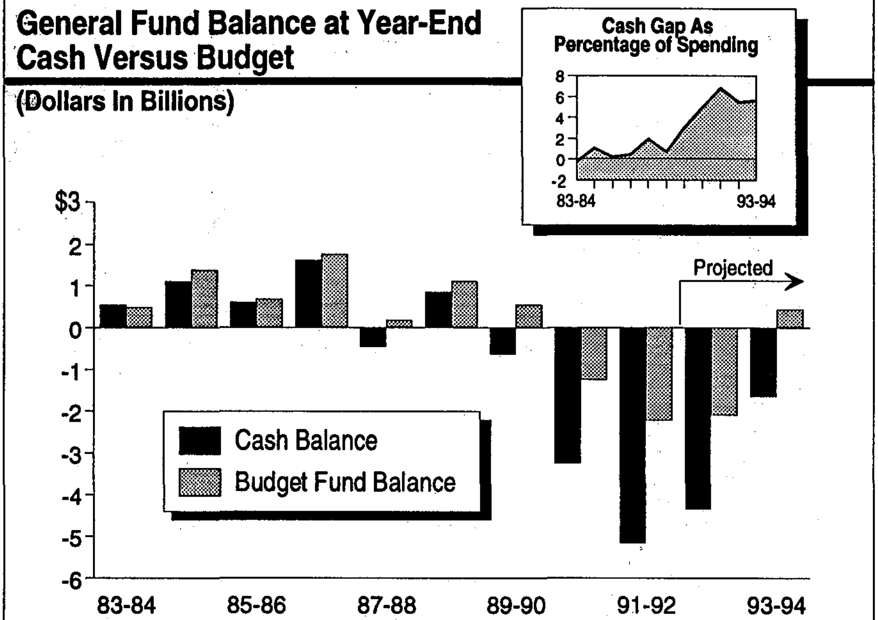
The cash-flow statement in the budget document indicates that the state ended 1991-92 with almost $5.2 billion in outstanding General Fund borrowing (excluding long-term debt, such as bonds). However, the deficit in the General Fund year-end fund balance displayed for budget purposes was much smaller—$2.2 billion. (The overall budget deficit, which was $3 billion in 1991-92, also includes reserves for obligated, but unspent, amounts.) Thus, the General Fund's cash borrowing exceeded the deficit shown in the budget fund balance by $3 billion, or 6.8 percent of General Fund spending that year.

Figure 6 compares the General Fund's year-end cash and budgetary position since 1983-84. The "gap" illustrated in the figure shows the difference between the budget fund balance and the year-end cash balance as a percentage of spending. Through 1988-89, there was relatively little difference between the General Fund's ending fund balance on a cash basis and its fund balance on a budget accrual basis—the differences amount to less than 2 percent of spending. Beginning in 1989-90, however, the General Fund's cash and budget positions began to diverge rapidly, as the figure illustrates. Although the budget's cash flow projections indicate that the gap will stabilize in the current year and 1993-94, those projections still indicate a need to borrow almost $1.7 billion at the end of 1993-94 in order to pay the state's current bills, despite a positive budget fund balance of $441 million.

Figure 6

General Fund Balance at Year-End Cash Versus Budget

(Dollars In Billions)



In addition to off-budget transactions, the widening gap between the General Fund's budget and cash positions reflects a variety of accounting changes used to improve the General Fund's budget position. For example, as part of the 1991-92 budget solution, budget revenues were increased by accruing revenue from taxes on sales that took place before the end of the fiscal year, but which retailers actually remit to the state during the first quarter of the next fiscal year. Similar types of accrual adjustments were made for several other taxes. Although the state took a partially offsetting action to accrue Medi-Cal expenses incurred before year-end, these accrual changes provided the General Fund with a net *one-time* gain of roughly $700 million to its budget balance. However, they also *permanently* widened the gap between the General Fund's budget balance and its cash balance.

The widening cash deficit means that the state must borrow substantial sums to carry it from one fiscal year to the next, even *without* a budget deficit—unless the budget generates a large reserve. This increased year-end borrowing has contributed to increased interest costs for cash-flow borrowing. These costs will have grown from $85 million in 1986-87 to $295 million in 1992-93 and 1993-94, according to budget estimates.

AVOIDING ANOTHER FISCAL CRISIS IN 1994-95

The current year will be the third consecutive year in which the state budget has had an ending deficit of more than a billion dollars, despite the fact that each of these budgets appeared to be balanced when they were adopted. In each of these years, the Legislature struggled to reconcile large operating shortfalls between spending requirements and ongoing revenues, as well as to find ways to pay off large carry-over deficits. Thus, the outlook for 1993-94 is essentially no different from recent years, except that prior state actions have shortened the list of available options. In this context, it is useful to examine whether the projected change in the state's economic fortunes next year could help to reverse this trend.

In order to examine the 1994-95 outlook, we have extended our baseline spending projection to that year. We also have projected ongoing revenues in 1994-95 based on the Department of Finance's economic forecast. Under these conditions, the fiscal picture does improve, in that revenues grow faster than spending (6.5 percent versus 5 percent). However, unless the existing 1993-94 operating shortfall of $5.2 billion is eliminated, this growth differential is not sufficient, by itself, to bring revenues and expenditures back into balance for 1994-95. In fact, it only reduces the operating shortfall to roughly $5 billion in 1994-95.

Our 1994-95 baseline projections have two implications for 1993-94 budget actions:

- At least $5 billion of the budget solutions adopted in 1993-94 must be ongoing in order to avoid another operating shortfall in 1994-95.
- No cushion is available in 1994-95 to absorb a carry-over deficit or cost deferrals from 1993-94. Risky 1993-94 solutions, especially

in the absence of a reserve, are almost certain to require more cuts in 1994-95.

There is another consideration for 1994-95 and beyond that our baseline projections do not address. This concerns the $2 billion of off-budget commitments against future-year resources that were discussed above. The expanded use of these practices will lead to further fiscal problems in the years ahead.

Does the Budget Work?

The Governor's January budget proposal does propose major policy changes and, in some cases, specific legislative proposals to accomplish them. Taken as a whole, however, it fails to provide a workable plan to resolve the state's fiscal problems. There are two reasons why the budget falls short. First, some major portions of the budget are presented only in outline form, with the substance to be filled in later. The most significant example of this is the proposed $2.1 billion property tax shift from local governments, where a methodology for allocating this massive shift is left to future negotiations, and the impacts on local governments have not been addressed.

The budget's second shortfall is that it entails a variety of large risks:

- There are a number of pending court cases that could have massive fiscal implications for the state. For example, up to $5 billion is at stake in one suite (*CTA v. Hayes*) that challenges the constitutionality of the Proposition 98 recapture and loans used to balance the current-year budget.
- Another large risk is the assumption that the state will receive $1.4 billion in federal immigration funding, most of it outside of any existing federal program.
- Savings from several major budget proposals—such as AFDC welfare reform, elimination of some Medi-Cal optional benefits, and repeal of the renters' credit—are likely to fall short of their targets because the budget unrealistically assumes that they will be enacted and implemented essentially immediately.
- We also have identified a number of costs not recognized in the budget, and costs that will likely exceed budget estimates. For example, the budget does not include funds for a rate increase for long-term care providers under Medi-Cal (potentially $73 million), which is required by federal law.

Together, these risks total roughly $8.5 billion.

Significant 1993-94 Deficit Likely. Of course, some of the risks discussed above probably will not materialize, and the spending for others may turn out to be different from the anticipated amounts. However, changing circumstances inevitably will add new risks as the year progresses. As a result, General Fund spending requirements are virtually certain to exceed the budget estimate, and probably by hundreds of millions to several billion dollars, by the end of 1993-94. Given that the budget as presented has no meaningful reserve, this additional spending would result in an equivalent deficit, absent correction action.

Nevertheless, this budget does serve useful purposes. It does not attempt to hide the seriousness of the state's fiscal crisis. The magnitudes of the proposed local funding shifts and the amount of federal funds sought clearly point out the size of the state's fiscal problem and the difficulty of solving it. The inclusion of local governments and the federal government in the budget solutions also highlights the state's interdependence with them. They will have to play major roles in any realistic budget solution.

The Legislature's Dilemma

The state's fiscal problems present the Legislature with a threefold budget dilemma.

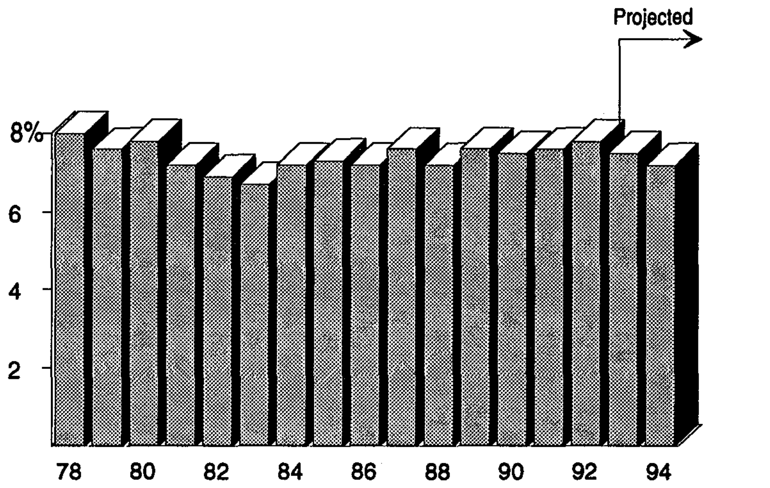
How Much Can Spending Be Cut? After several consecutive years of budget cuts, achieving significant additional savings will require deep and painful reductions in major programs. How deeply can *state and local* spending be cut without fundamentally damaging the state's social fabric, its ability to guarantee public safety, or its ability to retain and attract businesses and jobs?

Can the State Afford to Raise Taxes? The magnitude of the budget crisis and the pain of large spending cuts require consideration of tax increases and the modification of tax expenditures as part of a solution. One straightforward option is to extend the half-cent temporary sales tax rate that expires this year. As illustrated in Figure 7, the burden of state taxes (as a share of personal income) appears to be on the decline. However, the primary reason for the 1992-93 decline is the recession. As incomes fall, the state's progressive tax structure takes a smaller share of income in taxes. When economic recovery occurs and raises incomes, on the other hand, the tax burden will tend to rebound to former levels because of this progressive tax structure. The 1993-94 decline, however, is primarily attributable to the expiration of the one-half cent temporary sales tax rate and return of net operating loss deductions. This does represent an ongoing reduction in the state's existing tax burden.

Should state taxes be reduced in the face of the ongoing fiscal crisis? How much can state or local revenues be raised without overburdening taxpayers and discouraging economic growth and job creation? Can tax increases be structured to minimize the impact on those already hurt by the recession and to avoid negative economic consequences?

Figure 7

Forecast for California's State-Level Tax Burden Is Declining Due to Recession, Tax Changes[a]



[a] Data are for fiscal years ending in year shown; includes both General Fund and special fund taxes.

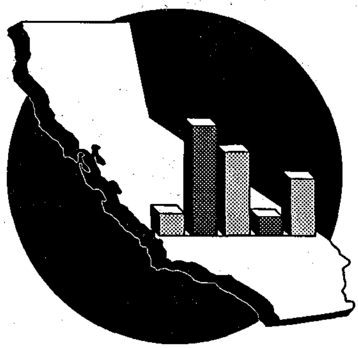
Can the State Afford to Roll the Deficit Over? The state will have what amounts to a rollover of more than $4 billion in the current year. This includes an ending deficit of at least $2.5 billion (assuming all of the budget's savings proposals are adopted), the off-budget Proposition 98 loan of $973 million provided to schools and community colleges in 1992-93, and the unpaid *Aerospace* refunds of $600 million. This rollover (most of which was not planned) has exacerbated the 1993-94 fiscal problem. Moreover, 1994-95 promises to be another difficult year, even if economic recovery does begin in 1993-94, as projected by the budget. Is it reasonable for the budget to borrow any more from the future to finance current spending?

Conclusion

The Legislature has an extremely complex task before it in developing a budget plan for next year. Difficult choices and legal constraints will make the task appear impossible, but a way out of the dilemma must be found. Rethinking the appropriate roles of government is critical to the ultimate resolution of this fiscal crisis. More fundamentally, all available options must be considered if a workable solution is to be put in place.

II

Perspectives on the Economy



PERSPECTIVES ON THE ECONOMY

The single most important factor that determines state government revenues from year to year is the performance of the state's economy. Major revenue shortfalls in each of the last three fiscal years have been caused by the unprecedented weakness of the California economy. Expenditures are also driven, in part, by the short- and long-term performance of the economy. For example, the recession has increased the need for government support of programs in such categories as welfare and medical care. In the long run, economic performance affects the overall level of services that can be provided for the state's citizens.

THE CURRENT ECONOMIC CLIMATE

According to the official statistics, the national economy hit the bottom of the most recent recession in the spring of 1991. Since then, the official measure of the nation's output of final goods and services, Gross Domestic Product (GDP), has increased in every quarter. This rate of expansion, however, has been extremely slow. The nation's unemployment rate continued to increase until its apparent peak in the third quarter of 1992. In contrast, the California economy has continued to sag, with declines in payroll employment and real (inflation-adjusted) personal income continuing through the fourth quarter of 1992.

The National Economy—Slow Recovery in Progress

During the first six quarters of the current expansion—through the third quarter of 1992—growth has been slow by historical standards. For example, real GDP increased at an annual rate of just 2 percent, well below the 4 to 6 percent experienced during the first two years of most post-recession periods in the past 50 years. Growth in output in the range of 3 percent is usually required to pull the nation's unemployment rate down in the early stages of a recovery. Because of slow growth in demand and output, the national unemployment rate continued to drift upwards from 6.8 percent in the second quarter of 1991 to 7.6 percent in the third quarter of 1992. In comparison, the national unemployment rate dropped by around one-third during the first six quarters following the end of the deep 1981-82 recession, when output expanded rapidly.

Why the Slow Recovery? A variety of factors have been suggested as causes of the slow national recovery to date. These include slow growth in basic money supply indicators; new regulatory constraints on the banking system; an accumulation of household, business, and government debt burdens; increased global competition; and major restructurings of several basic industries, including especially the defense sector. Neither the Bush Administration nor the Clinton Administration to date have undertaken a major fiscal stimulus effort, that is, tax cuts and/or expenditure increases. They have been constrained by the recent history of high annual federal budget deficits and the resultant accumulated debt.

Another underlying factor affecting the nation's growth potential is the fact that the economy has not done well for the past 20 years in terms of the most basic measure of economic progress: growth in labor productivity (output per worker). From 1952 to 1972, output per worker in the private sector rose nearly 3 percent per year, while increasing under 1 percent per year from 1972 to 1992. Although recently released statistics indicate that labor productivity rose by 2.7 percent in 1992, this is typical for the early stages of recovery and does not necessarily represent a fundamental change in labor productivity growth.

The California Economy—Decline Continues

In contrast with the national economy, California's real income and employment has been in a continuous decline since May 1990. By the end of 1992, the state had lost over 800,000 nonfarm jobs (6 percent), according to the Department of Finance (DOF). Real personal income declined 3 percent between the third quarter of 1990 and the third quarter of 1992. The state's unemployment rate continued to rise through most of 1992, reaching an average of 9.9 percent in the fourth quarter of 1992, far above the national rate for the period, 7.3 percent.

Housing Hardest Hit. In percentage terms, California's construction industry has been hardest hit thus far, losing 29 percent of its jobs since the peak in mid-1990. Housing construction in the state—as measured by building permits—has always been extremely cyclical. Despite continuing population growth, however, building permits have averaged only around 100,000 units per year for the past two years, far below the 223,000 units that was the average in the 1980s.

National Recession and Defense Declines to Blame? The easiest factors to pinpoint in explaining California's economic woes are the national recession and slow recovery, plus the steep decline in defense spending. During the past 25 years, around 80 percent of the year-to-year variation in the state's employment growth could be explained by variations in national employment growth. Defense contract and military base spending is the largest single "industry" in the state. A wide variety of other factors, however, have converged to make the state's performance much weaker than these latter two factors can explain. These range from overbuilding of commercial structures to government regulatory and fee issues, such as air quality improvement programs and workers' compensation.

New Forecast—Moderate California Recovery Begins in Late 1993

Figure 1 shows the data from the DOF's economic forecast for the nation and California for 1993 and 1994 on a calendar-year basis. For both the nation and the state, the department projects extremely slow progress.

A Below-Consensus U.S. Economic Outlook

GDP is forecast by the DOF to increase only 1.8 percent from 1992 to 1993 (calendar-year basis) and 2.6 percent in 1994. These growth rates are well below those predicted in other national forecasts. For example, the consensus of 50 private forecasters surveyed for the December 1992 Blue Chip Economic Indicators is for 2.8 percent GDP growth in 1993. The December 1992 UCLA Business Forecast Project expects growth rates of 2.8 percent in 1993 and 3.0 percent in 1994.

The DOF forecasts the U.S. unemployment rate to fall only slightly, from an average 7.4 percent in 1992 to an average 6.9 percent in 1994.

Inflation (measured by the percentage change in the Consumer Price Index) and short-term interest rates (measured by the prime rate charged by banks) are forecast to stay close to their current levels.

Figure 1

Department of Finance Economic Outlook For California and the Nation 1992 Through 1994

	1992 Estimated	1993 Projected	1994 Projected
California Economic Indicators			
Percent change in:			
Personal income	2.6%	3.5%	5.8%
Wage and salary employment	-2.3	-1.0	1.2
Consumer Price Index	3.5	3.6	3.8
Unemployment rate (percent)	9.1	10.1	9.5
Residential building permits (thousands)	95	115	144
New car registrations (thousands)	1,227	1,269	1,445
National Economic Indicators			
Percent change in:			
Real Gross Domestic Product	1.7%	1.8%	2.6%
Personal income	4.4	4.0	6.0
Wage and salary employment	0.1	0.5	1.7
Consumer Price Index	3.0	3.2	3.3
Pre-tax corporate profits	9.1	11.3	8.3
Unemployment rate (percent)	7.4	7.2	6.9
Prime interest rate (percent)	6.2	5.6	6.5
Housing starts (thousands)	1,200	1,215	1,325
New car sales (thousands)	8,300	8,700	10,100

A Cautious California Economic Outlook

As shown in Figure 1, the basic economic indicators for California are also projected to be quite weak for the next two years. Personal income is forecast to rise just 3.5 percent in 1993, essentially the same rate as the California Consumer Price Index. This implies no growth in real income and a further decline in real income per capita because of continuing growth in the state's population. The budget forecasts 5.8 percent growth in personal income in 1994. While this translates into real growth, it is still significantly below the levels usually experienced in a "rebound" year.

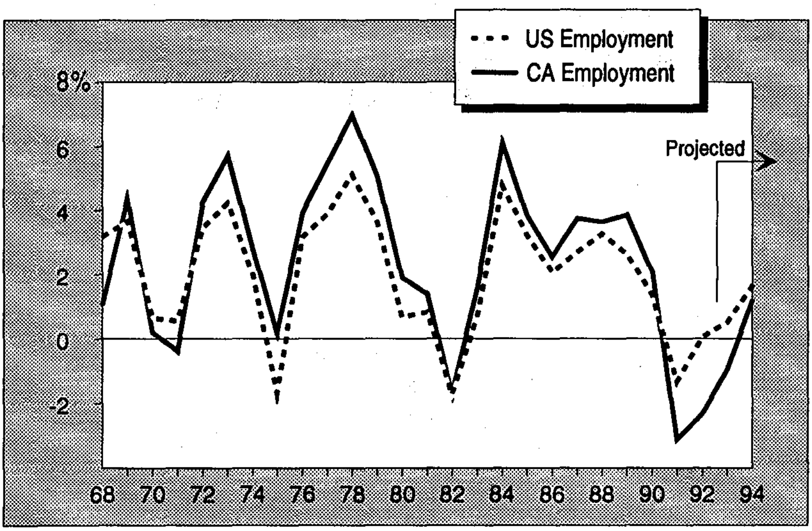
On a yearly average basis, employment is forecast to decline a further 1 percent in 1993. On a quarterly basis, the level of employment is expected to hit bottom in the third quarter of 1993. The state's unemployment rate is forecast to top out at 10.3 percent, over 3 percentage points above the national rate, in that quarter.

Unusual Recovery Pattern for Job Growth

Figure 2 graphically illustrates how California's rate of employment growth has paralleled the nation's during the past 25 years. In general, California's rate of expansion has exceeded the nation's, particularly during periods immediately following national recessions. The pattern that has occurred recently and is projected by the budget through 1994 is radically different. Even during a previous four-year period of rapid decline in defense spending (1967-71), California's employment grew by essentially the same percentage as the nation's. If the department's forecast for 1993 and 1994 is correct, the nation's employment will increase by 1 percent during the four years from 1990 to 1994, while California's employment will decline by 5 percent.

Figure 2

U.S. and California Nonfarm Employment Growth Rates 1968 Through 1994



Some California Weaknesses Have a Long History. Figure 3 illustrates that California has previously experienced large differences between its unemployment rate and the national unemployment rate. During the winding down from the Vietnam conflict in the early 1970s, California's unemployment rate averaged 2.2 percent above the nation's. For the five-year periods before and after 1970-74, the differential averaged 1.1 percent. The low and negative differentials that occurred during the 1980s (a California boom period) actually were unusual. The 1990-94 average differential is projected to be 1.6 percent by the department.

Figure 3

Average Difference of California Unemployment Rate Over National Rate During Five-Year Periods 1965-69 Through 1990-94

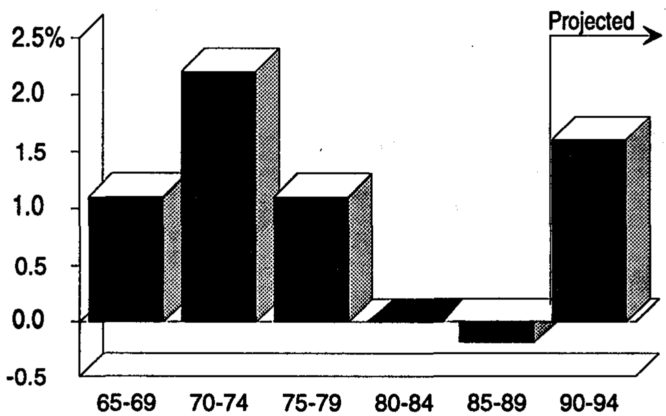
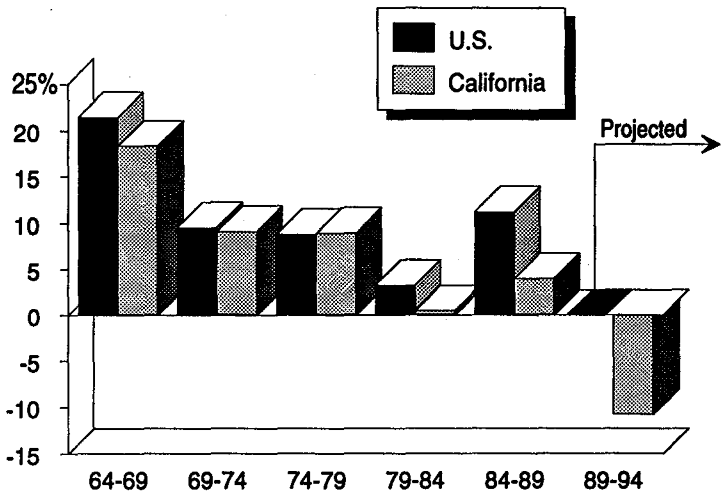


Figure 4 depicts a little-recognized fact about the California economy: the state's real per capita income growth did not keep pace with that of the nation during the 1980s, despite the boom in employment. Although the nation's real per capita income is projected by the department to show no growth from 1989 to 1994, the state is projected to experience an incredible 11 percent decline. This is the basic reason for the expected continuing squeeze on state revenues, particularly income and sales tax collections.

Figure 4

Average Annual Growth Rates in California and U.S. Real Per Capita Income During Five-Year Periods 1964-69 Through 1989-94



This startling change in the state's real income per person (in absolute terms and relative to the nation) is based on several factors, including:

- California inflation running around 0.4 percentage points above the national rate during the past 20 years.
- A changing labor force mix, with relatively fewer high-skill workers and more low-skill workers.
- A recent trend of losing high-paying jobs in such sectors as high-tech manufacturing and construction.
- The relatively severe continuing California recession compared with the nation.

Job Losses Vary Across Sectors

Figure 5 indicates the breakdown of job losses and gains by major sector projected for California by the DOF for 1993 and 1994. The largest absolute losses are forecast for manufacturing of durable goods, which includes defense and commercial aerospace products. Durable products manufacturing is one of the most important "basic" sectors in the California economy, in that most of its products are "exported" from the state to the rest of the nation and the world. As such, basic sector jobs tend to create higher levels of regional demand for nonbasic sector jobs, such as in trade and real estate. As Figure 5 shows, job losses in the basic sectors have been accompanied by job losses in the nonbasic sectors. This explains much of the state's current economic problems.

Figure 5

California Employment Gains and Losses By Industry 1992 Through 1993

(In Thousands)

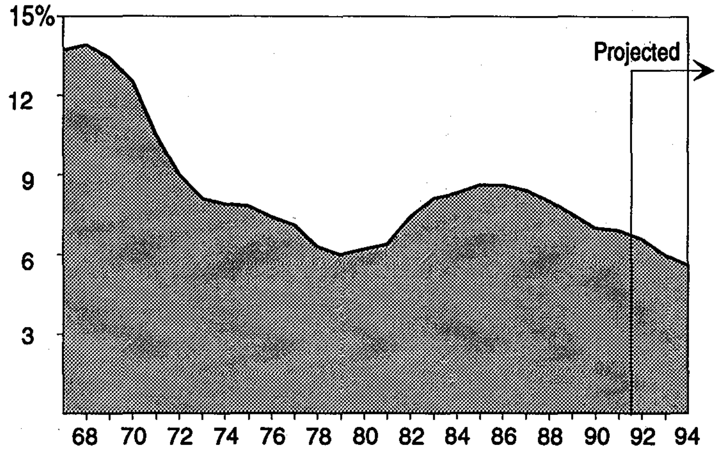
Industry	1992 Estimated	1993 Projected	1994 Projected
Mining	-5	—	1
Construction	-63	-36	20
Manufacturing—durables	-116	-64	-7
Manufacturing—nondurables	-11	-5	16
Transportation and utilities	-7	-6	2
Wholesale trade	-12	-7	10
Retail trade	-65	-20	36
Finance, insurance, and real estate	-28	-7	5
Services	19	58	93
Government	-1	-33	-27
Totals	**-289**	**-120**	**149**

Role of Defense Spending

Figure 6 indicates how the importance of defense spending in the California economy has changed during the past 25 years. At the peak of the Vietnam conflict in 1968, spending on military contracts and bases in the state accounted for 14 percent of the state's gross product, compared with a 9 percent share for defense spending in the nation's GDP. By 1991, the respective state and national shares had fallen to 7 percent and 6 percent. This supports the view that California is losing its share of the market for defense contracts. Although the California economy performed relatively well in the early 1970s despite the steep decline in defense spending, the state has performed poorly during the early 1990s defense retrenchment, which has been less severe in terms of percentage decline in spending than the early 1970s.

Figure 6

Defense Expenditures in California As Percent of Gross State Product 1967 Through 1994



Housing Has Been Particularly Volatile

Figure 7 illustrates the pattern of California single-family home prices relative to the nation, based on National Association of Realtors and California Association of Realtors median sales price data. In 1970, California's median home price was close to the national level. Since the state's household income and personal income per capita were around 15 percent above the national averages in the early 1970s, homes were just as affordable in California for the average family as they were in the rest of the country.

The home price differential rose rapidly between 1974 and 1982, reaching a new plateau of around 60 percent above the nation. California's family income differential from the nation fell during this same period, so that California homes became much less affordable for the average family. The second wave of absolute and relative home price appreciation took place in the late 1980s, as the California median home price reached 110 percent above the nation in 1989. This was a positive phenomenon for existing home owners, but a major problem for young families and those moving to California from other parts of the nation and the rest of the world. More recently, the home price differential has fallen to 90 percent in 1992. Absolute and relative declines in home prices are part of the economic adjustment process occurring in California. Given that the state is still far above the median, this process may not yet be complete.

Figure 7

California Median Home Price Percent Difference From National Median 1970 Through 1992

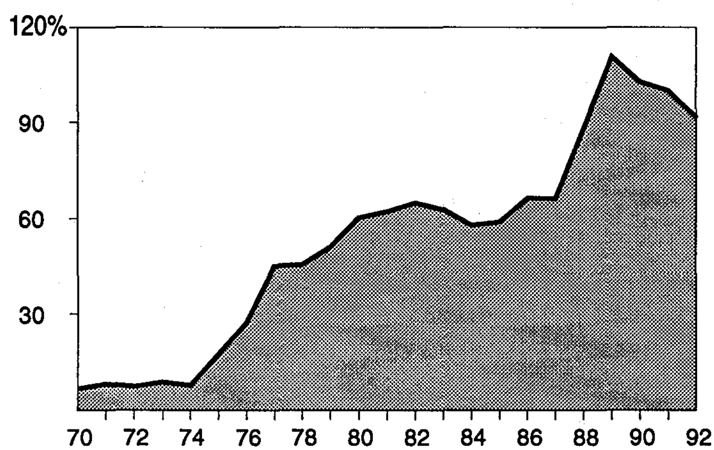


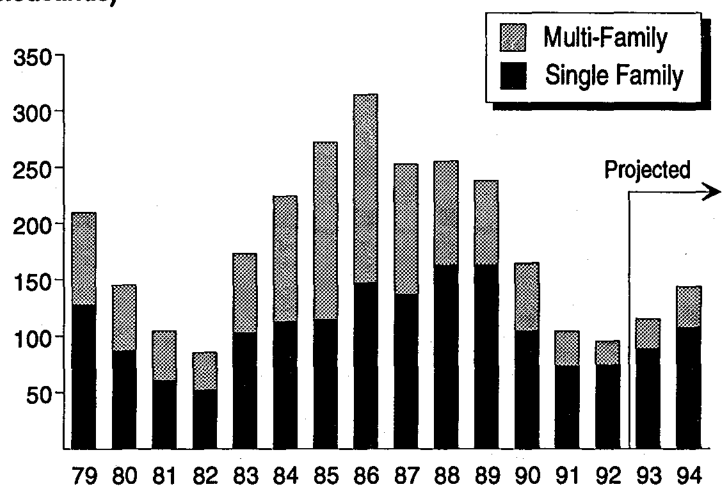
Figure 8 illustrates the high volatility of housing construction in California, with data from the late 1970s through the early 1990s. The lower part of the bars are single-family permits, which have held up much more than multi-family permits during the past several years. By 1992, single-family permits had dropped to just under half of their peak level in the most recent cycle, attained in 1988. In contrast, multi-family permits declined by nearly 90 percent from their peak in 1986 to the expected low in 1992. A precipitous decline in multi-family construction—around 80 percent—also took place at the national level after 1986, when federal tax reform sharply reduced the net financial returns to income property development, particularly for individual investors.

California's population has continued to increase at approximately a 2 percent annual rate, twice the national percentage increase, despite the state's recession and high housing prices. Low multi-family housing construction, which is primarily rental apartments, will eventually put pressure on the housing stock, particularly for the large number of lower-income residents. Recent construction rates of housing units amount to one housing unit per approximately six new residents, which is well below the one unit per three new residents built during the 1980s.

Figure 8

California Housing Permits 1979 Through 1994

(In Thousands)



The department's forecast for housing permits is for a relatively gradual increase in 1993 and 1994, well below the rapid rebound that took place in 1983 and 1984. Multi-family construction improvement is expected to be quite weak, whereas in past recoveries, this sector experienced much greater percentage improvement than single-family construction. Construction activity is an important factor in sales and use tax collections since building materials are subject to the tax.

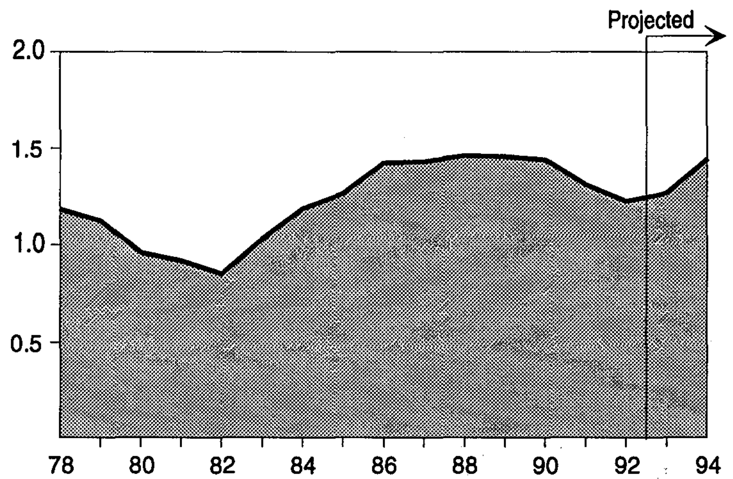
Auto Sales Have Been More Stable

Figure 9 illustrates the previous pattern and the DOF forecast for new motor vehicle registrations in California. Since the state is now down to one major automobile assembly plant (in Fremont), production jobs in this sector are not significant for the state. However, as with construction, new car sales are an important element in wholesale and retail jobs and sales tax collections, particularly during a time of economic recovery. Unlike housing and nonresidential construction, new car sales have held up relatively well in the state and give a significant boost to sales tax collections under the department's forecast.

Figure 9

California New Vehicle Registrations 1978 Through 1994

(In Millions)



HOW RELIABLE IS THE ECONOMIC FORECAST?

As with most other forecasters of the state's economy since late 1990, the Department of Finance has continually overestimated the outlook for the state's economy. The most bearish, widely publicized forecasts for the state for 1991 and 1992—therefore the most accurate, as it turned out—were by the UCLA Business Forecast Project. Yet, in both December 1990 and December 1991, even the Project's outlook was too optimistic. For example, in December 1991, the Project indicated that California nonfarm employment would decline 1.3 percent in 1992, while the actual decline is now estimated at 2.3 percent by the DOF. Although the Project's outlook for the national economy is more optimistic than the DOF's, the Project's outlook for California employment in 1993 and 1994 is essentially the same as the DOF's.

National Forecast Too Pessimistic. The DOF's forecast for the nation is likely too low. Their assumption for real GDP growth in 1993 is 1.8 percent. In contrast, most major national forecasters recently have been tending to boost their GDP projections for 1993 to 3 percent and above. In past years, at least, higher national growth in output and employment has meant higher growth for California.

California Forecast More Appropriate. Even if higher national growth than assumed by the DOF is factored in, however, a projection of continuing weakness of the California economy is likely justified. The accumulated problems of California—which were partially masked by the boom of the 1980s—are so severe that a cautious outlook is justified at this time. Because of factors such as those listed in Figure 10, it does not appear prudent to count on a major turnaround in 1993-94 in jobs, the unemployment rate, and personal income in California at this time.

Figure 10

Negative Factors Affecting California's Economic Outlook

Factors Cited by the Department of Finance:

- Further defense spending cuts, including base closures, are coming—and these may be accelerated by the Clinton Administration.
- The construction sector, particularly commercial real estate, is highly troubled.
- The state's commercial high-tech firms face increasing global competition.
- The state has an above-national-average dependence on international exports, and several major U.S. trading partners are in recession.
- Many California industries, such as financial services, utilities, and transportation, continue to pare employment.

Other Factors:

- Last spring's riots in Los Angeles have heightened investor uncertainty, which may retard rebuilding efforts.
- Conflicts are growing over the effects of continued heavy immigration, both legal and illegal, on the state's public service costs.
- State and local governments have been unable to resolve conflicting views and interests over such issues as workers' compensation and environmental regulation.
- Viewpoints over growth management policies, recently addressed in a report by the Governor, continue to be polarized.
- The housing market is in the midst of recovering from a speculative binge in the 1980s and may be moving toward a lower level relative to the national marketplace.