

GENERAL FUND CONDITION

NOVEMBER 8, 1983

LEGISLATIVE ANALYST

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STATEMENT BY THE LEGISLATIVE ANALYST TO THE
SPECIAL COMMITTEE ON COMMUNITY COLLEGES
Sacramento, California
November 8, 1983

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

YOU HAVE ASKED THAT I PROVIDE THIS COMMITTEE WITH AN ASSESSMENT OF THE GENERAL FUND CONDITION -- WHERE THE GENERAL FUND STANDS THIS YEAR (1983-84) AND WHAT ITS PROSPECTS ARE FOR NEXT YEAR (1984-85).

BEFORE PROVIDING THIS ASSESSMENT, LET ME MAKE ONE THING VERY CLEAR: GIVEN WHAT WE KNOW ABOUT REVENUES AND EXPENDITURES, THERE IS NO \$1 BILLION SURPLUS -- AND I EMPHASIZE THE WORD "SURPLUS" -- IN THE WORKS FOR EITHER THE CURRENT OR BUDGET YEARS. WHILE THE NEAR TERM ECONOMIC OUTLOOK IS INDEED POSITIVE -- CONSIDERABLY MORE POSITIVE THAN WHAT IT WAS DURING EACH OF THE TWO PREVIOUS NOVEMBERS -- THE REPORTS OF A \$1 BILLION "SURPLUS" THAT KEEP CROPPING UP ARE DECIDEDLY PREMATURE. MOREOVER, IT IS SHORT-SIGHTED TO CHARACTERIZE AS A "SURPLUS" THE DIFFERENCE BETWEEN REVENUES AND BASELINE EXPENDITURES PROJECTED FOR 1984-85.

I WILL RETURN TO THIS IMPORTANT MATTER IN A FEW MOMENTS. BEFORE DOING SO, I WILL SUMMARIZE OUR ASSESSMENT OF THE GENERAL FUND CONDITION DURING THE NEXT 20 MONTHS.

I. THE CONDITION OF THE GENERAL FUND IN 1983-84

WE ESTIMATE THAT IN THE ABSENCE OF ANY CHANGE IN CURRENT LAW, THE GENERAL FUND WOULD END THE CURRENT FISCAL YEAR WITH \$444 MILLION IN THE RESERVE FOR ECONOMIC UNCERTAINTIES (THE STATE'S "RAINY DAY" FUND). THIS IS

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\$130 MILLION MORE THAN THE \$314 MILLION WE IDENTIFIED IN AUGUST. (SUMMARY OF LEGISLATIVE ACTION ON THE BUDGET BILL: 1983-84 FISCAL YEAR, REPORT 83-10).

THE INCREASE IN THE PROJECTED END-OF-YEAR BALANCE IS THE NET RESULT OF A VARIETY OF FACTORS, AND REFLECTS:

- A REDUCTION IN THE SIZE OF THE DEFICIT CARRIED OVER FROM 1982-83;
- RECENT LAW CHANGES;
- IMPROVED REVENUE COLLECTIONS;
- RECENT COURT DECISIONS; AND
- TECHNICAL REESTIMATES.

CARRY-OVER DEFICIT

THE SIZE OF THE GENERAL FUND DEFICIT CARRIED FORWARD FROM 1982-83 TO 1983-84 HAS BEEN REESTIMATED BY THE STATE CONTROLLER AT \$462 MILLION -- ABOUT \$201 MILLION LESS THAN WHAT WE ESTIMATED BACK IN AUGUST. THIS BIT OF GOOD NEWS PRIMARILY REFLECTS A SHORTFALL IN EXPENDITURES DURING THE PRIOR YEAR.

THUS, THROUGH A COMBINATION OF LEGISLATIVE ACTION, AN IMPROVING ECONOMY, AND LOWER-THAN-ANTICIPATED EXPENDITURES, THE PROJECTED DEFICIT AT THE END OF 1982-83 HAS BEEN REDUCED BY NEARLY 75 PERCENT, (FROM THE \$1.6 BILLION FORECAST IN JANUARY TO \$462 MILLION.)

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GENERAL FUND REVENUES

ALL TOLD, OUR ESTIMATE OF GENERAL FUND REVENUES AND TRANSFERS IS \$702 MILLION HIGHER THAN THE ESTIMATE USED IN OUR AUGUST REPORT. THE FACTORS ACCOUNTING FOR THIS CAN BE DIVIDED INTO THREE CATEGORIES.

BASELINE REVENUES. WHEN THE BUDGET CONFERENCE COMMITTEE BEGAN ITS WORK IN JUNE, I TESTIFIED THAT THE DEPARTMENT OF FINANCE'S REVENUE ESTIMATES FOR 1983-84 APPEARED TO BE TOO LOW. I ADVISED THE CONFEREES THAT OUR ESTIMATES SHOWED AN ADDITIONAL \$200 MILLION COMING IN TO THE STATE TREASURY.

ACTUAL COLLECTIONS DURING THE FIRST FOUR MONTHS OF 1983-84 TEND TO CONFIRM THAT REVENUES WILL INDEED BE HIGHER THAN THE DEPARTMENT'S ESTIMATE. COLLECTIONS WERE \$203 MILLION HIGHER THAN ANTICIPATED DURING THE JULY - SEPTEMBER QUARTER, AND THE PRELIMINARY FIGURES INDICATE THAT THEY WERE MODESTLY HIGHER IN OCTOBER AS WELL. FOR THIS REASON, WE BELIEVE THE REVENUE FORECAST FOR THE FISCAL YEAR AS A WHOLE CAN BE RAISED BY A MINIMUM OF \$250 MILLION.

THE OBVIOUS QUESTION, OF COURSE, IS: IF GENERAL FUND REVENUES WERE \$200 MILLION HIGHER THAN EXPECTED DURING THE FIRST QUARTER OF THE YEAR, DOESN'T THAT SUGGEST AN INCREASE OF \$800 MILLION FOR ALL OF 1983-84? IF THE ADDITIONAL REVENUE COLLECTIONS TO DATE WERE LINKED WITH HIGHER LEVELS OF PERSONAL INCOME, TAXABLE SALES AND CORPORATE PROFITS, THE ANSWER WOULD BE "YES". MOST OF THE EXCESS COLLECTIONS (ABOUT 75 PERCENT), HOWEVER,

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REFLECT LARGER PREPAYMENTS UNDER JUST ONE OF THE STATE'S PRINCIPAL REVENUE SOURCES: THE BANK AND CORPORATION TAX. COLLECTIONS UNDER THE TWO LARGER REVENUE SOURCES -- THE PERSONAL INCOME TAX AND THE SALES AND USE TAX -- ARE PRETTY MUCH ON TRACK. WHILE COLLECTIONS DURING THE FIRST QUARTER MAY MEAN THAT THE ESTIMATE FOR THE BANK AND CORPORATION TAX DURING THE BALANCE OF 1983-84 IS ALSO TOO LOW, IT IS MUCH TOO EARLY TO COUNT ON THIS BEING THE CASE.

EFFECTS OF ENACTED LEGISLATION. IN ENACTING AB 895 TO SUSPEND THE AB 8 DEFLATOR AND CONTINUE SUBVENTIONS TO LOCAL GOVERNMENTS DURING THE LAST NINE MONTHS OF 1983-84, THE LEGISLATURE INCREASED TRANSFERS TO THE GENERAL FUND BY \$366 MILLION. (THIS INCREASE WAS MORE THAN OFFSET BY THE INCREASE IN SUBVENTIONS FROM THE GENERAL FUND.)

TECHNICAL REESTIMATES. FINALLY, WE HAVE INCREASED OUR ESTIMATE OF GENERAL FUND REVENUES BY \$85 MILLION TO REFLECT A LOWER-THAN-EXPECTED "INDEXING" FACTOR FOR THE PERSONAL INCOME TAX IN 1983 (\$40 MILLION), AND ADDITIONAL BANK AND CORPORATION TAX REVENUES RESULTING FROM PREVIOUSLY ENACTED LEGISLATION CONFORMING STATE LAW TO FEDERAL LAW (\$45 MILLION).

GENERAL FUND EXPENDITURES

WE HAVE INCREASED OUR ESTIMATE OF GENERAL FUND EXPENDITURES IN THE CURRENT YEAR BY \$943 MILLION. THIS, HOWEVER, DOES NOT REFLECT THE FULL IMPACT IN THE CURRENT YEAR OF ALL CHAPTERED LEGISLATION. WHEN THE DEPARTMENT OF FINANCE COMPLETES ITS REVIEW OF CHAPTERED BILLS LATER THIS MONTH, WE WILL PROBABLY HAVE TO RAISE OUR EXPENDITURE ESTIMATE SOMEWHAT.

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THE NET INCREASE OF \$943 MILLION IN PROJECTED EXPENDITURES IS DUE TO THE FOLLOWING FACTORS:

- AN INCREASE IN EXPENDITURES DEFERRED FROM 1982-83 (\$73 MILLION);
- CHAPTERED LEGISLATION (\$711 MILLION). THE INCREASE IN THIS CATEGORY CONSISTS OF \$669 MILLION FROM AB 895 (LOCAL GOVERNMENT FINANCING), \$21 MILLION FROM AB 399 (PROPERTY TAX CLEAN-UP) AND \$26 MILLION FROM SB 1274 (LOCAL CLAIMS), PARTIALLY OFFSET BY A SAVINGS OF \$5 MILLION FROM AB 70 (EDUCATION FINANCE CLEAN-UP);
- COURT ORDERS (\$74 MILLION); AND
- MISCELLANEOUS FACTORS, SUCH AS DELAYS IN THE RECEIPT OF FEDERAL FUNDS AND PAYMENT OF LOCAL GOVERNMENT CLAIMS (\$85 MILLION).

GENERAL FUND BALANCE

OUR CURRENT ESTIMATE OF THE UNRESTRICTED GENERAL FUND BALANCE -- \$444 MILLION -- IS QUITE CLOSE TO THE ESTIMATE REPORTED LAST MONTH BY THE COMMISSION ON STATE FINANCE (COSF), ONCE THE COMMISSION'S ESTIMATE IS ADJUSTED TO REFLECT THE COST OF ANTICIPATED LEGISLATION AND THE SMALLER DEFICIT CARRIED OVER FROM 1982-83. (THE CONTROLLER HAD NOT REVISED HIS ESTIMATE OF THE DEFICIT BY THE TIME THE COMMISSION COMPLETED WORK ON ITS REPORT.) ON THE OTHER HAND, OUR ESTIMATE OF THE END-OF-YEAR BALANCE IS ABOUT \$171 MILLION MORE THAN THE MOST-RECENT DEPARTMENT OF FINANCE ESTIMATE: \$273 MILLION.

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IT IS CERTAINLY POSSIBLE THAT A STRONGER-THAN-EXPECTED RECOVERY FROM THE RECESSION COULD PUSH GENERAL FUND REVENUES EVEN HIGHER, CAUSING THE END-OF-YEAR BALANCE TO EXCEED \$444 MILLION. AT THE PRESENT TIME, HOWEVER, THERE IS NO OBJECTIVE BASIS FOR PREDICTING THAT THE SURPLUS WILL REACH \$1 BILLION IN THE CURRENT YEAR. IN FACT, WE HAVE IDENTIFIED OVER \$300 MILLION IN POTENTIAL EXPENDITURES BEYOND WHAT IS REFLECTED IN OUR ESTIMATES WHICH, IF THEY OCCUR, WOULD REDUCE THE END-OF-YEAR BALANCE WELL BELOW \$444 MILLION. AND, OF COURSE, THE END-OF-YEAR BALANCE WOULD BE REDUCED IN THE EVENT THE LEGISLATURE DECIDED TO PROVIDE ADDITIONAL FUNDS TO THE COMMUNITY COLLEGES IN 1983-84.

THE ONE THING OUR ANALYSIS DOES MAKE CLEAR IS THIS:

- IT IS MOST UNLIKELY THAT THE SECOND SALES TAX "TRIGGER" WILL BE "PULLED" ON JANUARY 10, 1984.

EVEN SO, THE GENERAL FUND WILL, IN ALL LIKELIHOOD, CARRY FORWARD A MODEST RESERVE FOR ECONOMIC UNCERTAINTIES INTO 1984-85. HOW BIG OF A RESERVE WILL DEPEND ON LEGISLATIVE ACTIONS, COURT RULINGS, PROPERTY TAX COLLECTIONS AT THE LOCAL LEVEL, AND ECONOMIC EVENTS THAT CANNOT BE PREDICTED AT THIS POINT IN TIME.

II. THE OUTLOOK FOR THE GENERAL FUND IN 1984-85

AT THIS POINT IN TIME, IT IS TOO EARLY FOR US TO MAKE A REVENUE ESTIMATE FOR 1984-85 THAT YOU COULD PLACE MUCH CONFIDENCE IN. IN FACT,

CONSIDERABLY MORE DATA ON CURRENT ECONOMIC CONDITIONS IS NEEDED BEFORE ANYBODY CAN HAVE MUCH CONFIDENCE IN THEIR NUMBERS.

WHAT WE CAN DO THIS MORNING, HOWEVER, IS GIVE YOU A PREVIEW OF WHAT THE BUDGETARY PICTURE FOR 1984-85 WILL LOOK LIKE, BASED ON (1) SOME REASONABLE ASSUMPTIONS ABOUT THE PERFORMANCE OF THE STATE'S ECONOMY AND (2) A VERY ROUGH ESTIMATE OF BASELINE EXPENDITURES. (BY "BASELINE EXPENDITURES," WE MEAN THE LEVEL OF EXPENDITURES NEEDED TO CONTINUE THE SERVICES THAT ARE BEING FUNDED BY THE STATE IN THE CURRENT YEAR -- GENERALLY, THIS YEAR'S EXPENDITURES ADJUSTED TO COMPENSATE FOR CASELOAD CHANGES, INFLATION, AND NONRECURRING FACTORS -- PLUS THOSE EXPENDITURES CALLED FOR BY EXISTING LAW.)

ASSUMPTIONS

GENERALLY, WE ASSUME THAT PERSONAL INCOME IN CALIFORNIA WILL GROW BY 9.5 PERCENT IN 1984 AND 8.5 PERCENT IN 1985, AND THAT INFLATION FACED BY CONSUMERS IN THESE TWO YEARS WILL AVERAGE ABOUT 5 PERCENT. FROM THESE ASSUMPTIONS, WE CAN DERIVE AN ESTIMATE OF REVENUES.

OUR ESTIMATE OF BASELINE EXPENDITURES ASSUMES:

- FULL FUNDING FOR SB 813;
- A 5.9 PERCENT INCREASE IN AFDC AND SSI/SSP GRANTS;
- THE LATEST CASELOAD PROJECTIONS FOR CASH GRANTS, SOCIAL SERVICES, AND K-12 APPORTIONMENTS; AND

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- A 7 PERCENT INCREASE FOR ALL DISCRETIONARY PROGRAMS, REFLECTING 5 PERCENT INFLATION AND 2 PERCENT POPULATION GROWTH.

THE FISCAL MARGIN PRODUCED BY OUR ASSUMPTIONS

WHEN THE REVENUES THAT WOULD BE PRODUCED BY THE ASSUMED LEVEL OF ECONOMIC ACTIVITY ARE COMPARED WITH BASELINE EXPENDITURES, WE FIND AN EXCESS OF REVENUES OVER EXPENDITURES AMOUNTING TO ABOUT \$1.2 BILLION IN 1984-85. CONSEQUENTLY, IF \$400 - \$450 MILLION IN UNUSED FUNDS WERE CARRIED OVER FROM 1983-84 TO 1984-85, THE UNCOMMITTED BALANCE IN THE GENERAL FUND DURING THE BUDGET YEAR COULD BE AS HIGH AS \$1.6 BILLION. THIS IS THE FISCAL MARGIN THAT WOULD BE AVAILABLE TO THE LEGISLATURE IN WRITING A BUDGET FOR 1984-85.

TO DESCRIBE THIS FISCAL MARGIN AS A "SURPLUS", AS MANY HAVE DONE, IMPLIES THAT THESE FUNDS ARE IN EXCESS OF WHAT STATE GOVERNMENT NEEDS TO OPERATE IN 1984-85. THIS IS SIMPLY NOT SO.

IF THE LAST TWO YEARS HAVE TAUGHT US ANYTHING, IT IS THAT YOU CANNOT RUN STATE GOVERNMENT IN CALIFORNIA WITHOUT A HEALTHY RESERVE FOR UNFORESEEN CONTINGENCIES. ABSENT SUCH A RESERVE, THE STATE'S BUDGET -- AND ALL WHO DEPEND ON IT -- ARE UNNECESSARILY VULNERABLE TO ANY UNANTICIPATED REDUCTION IN REVENUES OR INCREASE IN EXPENDITURES.

I SAY "UNNECESSARILY VULNERABLE" BECAUSE ULTIMATELY THE STATE'S ABILITY TO FINANCE EXPENDITURES DEPENDS ON THE STATE'S ECONOMY, AND WE ARE ALL VULNERABLE TO A DETERIORATION IN THE STATE'S LONG-TERM ECONOMIC

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FORTUNES. THE LEGISLATURE'S ABILITY TO RESPOND TO THESE CHANGES IN A CONSTRUCTIVE MANNER, HOWEVER, DEPENDS ON HOW MUCH NOTICE YOU GET, AND THAT'S WHERE HAVING A HEALTHY RESERVE IS VERY IMPORTANT. A RESERVE BUYS THE LEGISLATURE TIME, AND ALLOWS IT TO MAKE CHANGES IN THE BUDGET THAT REFLECT LEGISLATIVE PRIORITIES AND PROVIDE ENOUGH WARNING TO THOSE WHO RECEIVE STATE SERVICES SO THAT THEY CAN PREPARE FOR THESE CHANGES.

I HAVE LONG ADVOCATED THAT YOU MAINTAIN A RESERVE FOR ECONOMIC UNCERTAINTIES EQUAL TO 5 PERCENT OF GENERAL FUND EXPENDITURES. THUS, FROM THIS PERSPECTIVE, FULLY THREE-FOURTHS (\$1.2 BILLION) OF THE FISCAL MARGIN THAT COULD DEVELOP IN 1984-85 WOULD BE NEEDED TO OPERATE STATE GOVERNMENT. EVEN A 3 PERCENT RESERVE WOULD REQUIRE THAT \$700 MILLION OF ANY EXCESS REVENUES BE SET ASIDE FOR CONTINGENCIES.

IN SHORT, A LARGE PORTION OF WHAT MIGHT APPEAR TO BE "SURPLUS" FUNDS IN 1984-85 DOES NOT REPRESENT A SURPLUS AT ALL, IN TERMS OF WHAT STATE GOVERNMENT NEEDS TO HAVE ON HAND.

NONETHELESS, IF OUR ASSUMPTIONS HOLD, THE LEGISLATURE WOULD HAVE AVAILABLE CONSIDERABLY MORE REVENUES IN 1984-85 THAN IT WOULD NEED TO (1) MAINTAIN CURRENT SERVICES, (2) FUND THE SECOND YEAR OF SB 813, AND (3) PROVIDE FOR A PRUDENT RESERVE. THIS WOULD BE THE FIRST TIME SINCE 1980-81 THAT YOU WOULD BE FACED WITH THIS HAPPY PROSPECT. INSTEAD OF HAVING TO REDUCE THE EXPENDITURE BASE, AS YOU HAVE HAD TO DO IN EACH OF THE LAST THREE YEARS, YOU WOULD BE IN A POSITION TO EITHER RESTORE CUTS PREVIOUSLY MADE OR PROVIDE ADDITIONAL TAX RELIEF.

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AT THIS POINT, HOWEVER, I DO NOT EXPECT THAT YOU WILL HAVE \$1 BILLION IN SURPLUS FUNDS AVAILABLE TO RESTORE CUTS OR REDUCE TAXES UNLESS THE ECONOMY TAKES OFF. COULD IT HAPPEN? YES, IT COULD. BUT GIVEN THE DETERMINATION OF FEDERAL MONETARY OFFICIALS TO KEEP THE RATE OF GROWTH WITHIN THE BOUNDS OF WHAT IS SUSTAINABLE, AND GIVEN THE SERIOUS THREAT THAT A STRING OF \$200 BILLION FEDERAL DEFICITS REPRESENTS TO HOME BUYERS, CONSUMERS, EXPORTERS AND BUSINESSES WISHING TO INVEST IN NEW PLANTS AND EQUIPMENT, I DON'T SEE IT HAPPENING. MOREOVER, IT IS LIKELY THAT AN UNANTICIPATED INCREASE IN EXPENDITURES WILL CUT INTO THE GENERAL FUND BALANCE AS MORE COURTS HAND DOWN MORE DECISIONS THAT REORDER THE LEGISLATURE'S PRIORITIES.

III. CONCLUSION

IN CONCLUSION, LET ME REPEAT WHAT I SEE AS THE KEY FINDING FROM OUR PRELIMINARY ASSESSMENT OF THE GENERAL FUND'S PROSPECTS DURING THE NEXT 20 MONTHS:

- IT IS MOST UNLIKELY THAT THE SALES TAX "TRIGGER" WILL BE "PULLED" ON JANUARY 10.
- THE BUDGET FOR THE CURRENT YEAR HAS A BUILT-IN CUSHION OF ABOUT \$440 MILLION, SOME OF WHICH MAY BE NEEDED TO ACCOMMODATE IDENTIFIABLE BUDGET THREATS.

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- REVENUES IN 1984-85 SHOULD BE ADEQUATE TO MAINTAIN CURRENT STATE-FUNDED SERVICES, REBUILD THE RESERVE FOR ECONOMIC UNCERTAINTIES, AND PROVIDE A MODEST AMOUNT FOR NEW (OR RESTORED) SERVICES AND/OR TAX RELIEF.

BEYOND 1984-85, THE OUTLOOK IS NOT NEARLY AS FAVORABLE. AT SOME POINT -- PROBABLY IN 1985 OR 1986 -- PRIVATE INVESTMENT DEMAND WILL COLLIDE WITH THE FEDERAL GOVERNMENT'S DEMAND FOR FUNDS TO FINANCE THE DEFICIT IN ITS BUDGET. THE THREAT THIS POSES TO THE CALIFORNIA ECONOMY IS CONSIDERABLE . . . ALL THE MORE REASON FOR YOU NOT TO NEGLECT THE RESERVE FOR ECONOMIC UNCERTAINTIES IN DOING YOUR FISCAL PLANNING.

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