

STATEMENT BY THE LEGISLATIVE ANALYST TO THE
SENATE FINANCE COMMITTEE

MAY 14, 1984

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MR. CHAIRMAN AND MEMBERS:

THE DEPARTMENT OF FINANCE'S LATEST ESTIMATES OF GENERAL FUND REVENUES AND EXPENDITURES IN 1984-85 INDICATE THAT IF THE GOVERNOR'S BUDGET WERE APPROVED, \$412.7 MILLION WOULD REMAIN IN THE GENERAL FUND AND BE AVAILABLE TO THE LEGISLATURE FOR APPROPRIATION.

OUR ESTIMATE OF THE AMOUNT AVAILABLE BEYOND WHAT THE GOVERNOR PROPOSES TO APPROPRIATE IS \$678 MILLION--OR APPROXIMATELY \$265 MILLION MORE THAN WHAT THE DEPARTMENT OF FINANCE ESTIMATES. TABLE 1 SUMMARIZES THE DIFFERENCES BETWEEN OUR ESTIMATES OF GENERAL FUND REVENUES AND EXPENDITURES AND THE DEPARTMENT'S ESTIMATES.

Table 1

Difference Between the Department of Finance's
and the Legislative Analyst Office's Estimates
of the Unappropriated Balance in the General Fund
(in millions)

Department of Finance's Estimate (May 10, 1984)	\$413
Revenues	+140
Expenditures	<u>+125</u>
Legislative Analyst Office's Estimate	\$678

ATTACHMENTS I AND II PROVIDE OUR COMMENTS ON THE MAJOR CHANGES IN REVENUES AND EXPENDITURES REFLECTED IN THE DEPARTMENT OF FINANCE'S MAY REVISION. MY REMARKS THIS AFTERNOON WILL MERELY HIGHLIGHT THOSE AREAS WHERE OUR ESTIMATES DIFFER FROM THOSE OF THE DEPARTMENT.

GENERAL FUND REVENUES

OUR REVENUE ESTIMATES FOR THE CURRENT AND BUDGET YEARS, COMBINED, TOTAL \$140 MILLION MORE THAN THE DEPARTMENT OF FINANCE'S. TABLE 2 INDICATES THE SOURCE OF OUR DIFFERENCES.

Table 2

Differences Between the Department of Finance's and the Legislative Analyst's Office's Estimate of General Fund Revenues (in millions)

	<u>LAO Compared with DOF</u>
Differences, Assuming DOF's Economic Assumptions:	
Sales and Use Tax	-\$35
Personal Income	+30
Bank and Corporation Tax	<u>+45</u>
Subtotal, Assuming DOF's Economic Assumptions	+\$40
Higher Estimate of Wage and Salary Growth	<u>+100</u>
Net Effect on Revenues	+\$140

APPLYING OUR REVENUE ESTIMATING TECHNIQUES TO THE DEPARTMENT OF FINANCE'S ECONOMIC ASSUMPTIONS, WE ESTIMATE THAT REVENUES WILL BE \$40

MILLION HIGHER THAN THE REVENUE ESTIMATE CONTAINED IN THE MAY REVISION. OBVIOUSLY, THE DIFFERENCE BETWEEN OUR ESTIMATE AND THE DEPARTMENT'S IS EXTREMELY SMALL IN PERCENTAGE TERMS, GIVEN THAT GENERAL FUND REVENUES FOR THE TWO YEARS COMBINED IS ESTIMATED AT NEARLY \$50 BILLION.

WHILE WE FIND THE DEPARTMENT'S ECONOMIC FORECAST TO BE CONSISTENT WITH THOSE OF MOST OTHER FORECASTERS, WE BELIEVE THE ESTIMATES OF THE GROWTH IN AVERAGE WAGE AND SALARY INCOME ARE SOMEWHAT TOO CONSERVATIVE. ON THIS BASIS, WE BELIEVE IT WOULD BE PRUDENT TO INCREASE THE ESTIMATE OF REVENUES FROM THE PERSONAL INCOME TAX BY \$100 MILLION.

TOGETHER, THESE TWO FACTORS ACCOUNT FOR THE \$140 MILLION DIFFERENCE BETWEEN OUR REVENUE ESTIMATE AND THE DEPARTMENT'S. ATTACHMENT I EXPLORES THIS DIFFERENCE IN MORE DETAIL.

GENERAL FUND EXPENDITURES

OUR ANALYSIS OF THE EXPENDITURE ESTIMATES CONTAINED IN THE MAY REVISION ASSUMES THE SPENDING PROGRAM PROPOSED BY THE GOVERNOR. IN MAKING THIS ASSUMPTION, WE ARE NOT IGNORING THE CHANGES TO THAT PROGRAM WHICH ARE BEING CONSIDERED BY THE LEGISLATURE. THIS ASSUMPTION, HOWEVER, IS NECESSARY IN ORDER TO PROVIDE THE LEGISLATURE WITH AN ESTIMATE OF HOW MUCH "ROOM" IS LEFT IN THE BUDGET FOR LEGISLATIVE INITIATIVES, GIVEN THE REVENUE PROJECTIONS.

ON BALANCE, WE FIND THE DEPARTMENT'S ESTIMATES OF GENERAL FUND EXPENDITURES ASSOCIATED WITH THE GOVERNOR'S BUDGET TO BE \$125 MILLION TOO HIGH. TABLE 3 LISTS THE PROGRAMS FOR WHICH OUR ESTIMATE OF EXPENDITURES DIFFERS FROM THE DEPARTMENT OF FINANCE'S.

Table 3

Differences Between the Department of Finance's
and the Legislative Analyst Office's
Estimate of General Fund Expenditures
(in millions)

<u>Program/Reason for Difference</u>	<u>LAO Compared With DOF</u>
<u>Medi-Cal</u> - no allowance for cost of statutory rate increase endorsed by the administration	+24
<u>K-12</u> - overestimate of supplemental property tax allocations to K-12 districts in 1984-85	+36
<u>Tax Relief</u> - underestimate of 1984-85 expenditures, given adjustments made to 1983-84 estimate	+10
<u>Reimbursements for State Mandates</u> - identified cost of claims to be included in subsequent claims bills	+5
<u>Unidentified Savings</u> - underestimate of 1983-84 savings, given historical pattern	-100
<u>Unallocated Expenditures</u> - amount earmarked for legislative initiatives should not be treated as an expenditure until it has been allocated by the Legislature	-93
<u>AFDC</u> - overestimate of caseload	-4
<u>Corrections</u> - technical	-3
Net Effect on Expenditures	-\$125

THERE ARE THREE MAIN POINTS OF DISAGREEMENT BETWEEN THE DEPARTMENT
OF FINANCE AND THE ANALYST'S OFFICE REGARDING EXPENDITURES:

UNIDENTIFIED SAVINGS. WE AGREE WITH THE COMMISSION ON STATE FINANCE
THAT THE ALLOWANCE MADE FOR UNIDENTIFIED SAVINGS IN THE CURRENT YEAR (\$25

MILLION) IS TOO LOW BY HISTORICAL STANDARDS. WHILE IT IS VIRTUALLY IMPOSSIBLE TO PREDICT THESE SAVINGS WITH ANY CONFIDENCE, WE DO NOT FIND THE DEPARTMENT'S CASE FOR SUCH A LOW ESTIMATE CONVINCING. ACCORDINGLY, WE BELIEVE THE ESTIMATE CAN BE RAISED (THAT IS, EXPENDITURES CAN BE LOWERED) BY \$100 MILLION.

K-12. GIVEN THE DELAYS IN GETTING THE SUPPLEMENTAL PROPERTY TAX ROLL OFF THE GROUND, WE BELIEVE THE DEPARTMENT'S ESTIMATE OF THE AMOUNT TO BE ALLOCATED TO K-12 DISTRICTS IN 1984-85 IS TOO HIGH. IN ADDITION, WE FIND THAT THE DEPARTMENT'S ESTIMATE DOES NOT RECOGNIZE THE ALLOCATION OF SUPPLEMENTAL ROLL MONEY TO REDEVELOPMENT AGENCIES THAT CURRENT LAW APPEARS TO REQUIRE. ACCORDINGLY, WE ESTIMATE THAT GENERAL FUND EXPENDITURES FOR K-12 APPORTIONMENTS WILL BE \$36 MILLION HIGHER THAN WHAT IS REFLECTED IN THE MAY REVISION.

UNALLOCATED EXPENDITURES. A LARGE PORTION OF THE DIFFERENCE BETWEEN OUR ESTIMATE OF EXPENDITURES AND THE DEPARTMENT'S INVOLVES NOT HOW MUCH MONEY IS AVAILABLE FOR ALLOCATION BY THE LEGISLATURE, BUT RATHER HOW THESE FUNDS SHOULD BE SHOWN IN THE BUDGET TOTALS. THE DEPARTMENT CONTINUES TO INCLUDE ON THE EXPENDITURE LINE \$92.6 MILLION FOR LEGISLATIVE INITIATIVES. IT DOES SO ON THE GROUNDS THAT THIS MONEY ULTIMATELY WILL BE SPENT.

WHILE WE AGREE THAT THE LEGISLATURE IS ALMOST CERTAIN TO ALLOCATE THESE FUNDS AT SOME POINT, WE DO NOT BELIEVE THE FUNDS SHOULD BE CONSIDERED "SPENT" UNTIL THEY HAVE BEEN ALLOCATED. IN THIS REGARD, WE POINT OUT THAT THE \$92.6 MILLION ALLOCATED BY THE GOVERNOR FOR LEGISLATIVE INITIATIVES IS NO DIFFERENT FROM THE \$412.7 MILLION SHOWN BY THE DEPARTMENT OF FINANCE AS BEING "AVAILABLE FOR APPROPRIATION."

ACCORDINGLY, TO FACILITATE THE LEGISLATURE'S FISCAL PLANNING, WE SUGGEST THAT THE \$92.6 MILLION BE REMOVED FROM THE EXPENDITURE TOTAL AND ADDED TO THE UNAPPROPRIATED BALANCE.

OTHER DIFFERENCES. THE REMAINING DIFFERENCES BETWEEN OUR EXPENDITURE ESTIMATES AND THE DEPARTMENT'S ARE DISCUSSED IN ATTACHMENT II.

IN TWO CASES, THE LEGISLATURE MAY WISH TO MAKE FURTHER CHANGES TO THE EXPENDITURE TOTALS BEYOND THOSE THAT WE PROPOSE. ON THE ONE HAND, IT MIGHT WISH TO INCREASE THE ESTIMATE OF EXPENDITURES BY \$164.5 MILLION IN ORDER TO TAKE ACCOUNT OF THE APPELLATE COURT'S RECENT DECISION IN THE STRS CASE. WE DO NOT PROPOSE SUCH AN ADJUSTMENT AT THIS TIME BECAUSE THE AMOUNT OF THE STATE'S CONTRIBUTION TO THE STATE TEACHERS' RETIREMENT FUND (AS OPPOSED TO THE AMOUNT PAID FROM THE FUND TO MEMBERS WITH ACCRUED RETIREMENT BENEFITS) IS PROPERLY A POLICY MATTER FOR THE LEGISLATURE TO DECIDE.

ON THE OTHER HAND, THE LEGISLATURE MIGHT WISH TO REDUCE THE ESTIMATE OF EXPENDITURES BY \$98.9 MILLION TO REFLECT THE FACT THAT IT HAS CONSIDERED AND REJECTED CLAIMS FOR REIMBURSEMENT OF TWO STATE-MANDATED LOCAL PROGRAMS THAT ARE FUNDED IN THE GOVERNOR'S BUDGET. WE HAVE NOT PROPOSED SUCH AN ADJUSTMENT BECAUSE REIMBURSEMENT OF THESE CLAIMS IS STILL BEING PROPOSED BY THE ADMINISTRATION. IN ADDITION, COURT DECISIONS IN PENDING LAWSUITS INVOLVING STATE REIMBURSEMENT OF MANDATED COSTS, TOGETHER WITH THE COST OF CLAIMS NOW PENDING BEFORE THE BOARD OF CONTROL, COULD EASILY RESULT IN COSTS OF THIS MAGNITUDE DURING 1984-85, EVEN IF FUNDING FOR THE TWO CLAIMS IS NOT PROVIDED.

THUS, WE ESTIMATE THAT ENACTMENT OF THE GOVERNOR'S BUDGET, AS REVISED, WOULD LEAVE \$678 MILLION UNAPPROPRIATED IN THE GENERAL FUND. THIS AMOUNT WOULD BE AVAILABLE FOR ALLOCATION BY THE LEGISLATURE.

COST OF POTENTIAL CHANGES TO THE GOVERNOR'S BUDGET

TO FACILITATE THE LEGISLATURE'S FISCAL PLANNING, WE HAVE PREPARED A LISTING OF CHANGES TO THE SPENDING PROGRAM PROPOSED BY THE GOVERNOR THAT WOULD HAVE A MAJOR IMPACT ON GENERAL FUND EXPENDITURES. THE INDIVIDUAL CHANGES ARE DISCUSSED IN ATTACHMENT III. TABLE 4 SUMMARIZES THE EFFECT THAT THESE CHANGES WOULD HAVE ON THE GENERAL FUND.

Table 4

Impact of Potential Changes to the Spending
Program Proposed by the Governor for 1984-85
(in millions)

<u>Change</u>	<u>Effect on General Fund Expenditures</u>
A. Changes Being Considered by the Legislature	
1. <u>K-12 education--cost of fully funding COLA required by SB 813 as sent to the Governor</u>	+\$349.6
2. <u>Community Colleges--fully fund SB 851</u>	+101.0
3. <u>Welfare Programs--fully fund statutory COLA</u>	+113.3
4. Health Programs	
a. Fully fund statutory COLAs	+21.7
b. Provide 5 percent increase for all other health programs	+38.8
c. Provide funding for unrestricted abortions	+12.0
5. <u>Deficiency Claims for 1983-84--enact AB 3073 in its current form</u>	+54.9
6. <u>Local Government Finance--appropriate funds for infrastructure grants, per AB 2468</u>	+250.0
Subtotal, changes being considered by the Legislature	+\$941.3
B. <u>External Threats to the Budget</u>	
1. Jarvis initiative	
a. Make school districts whole	+\$500.0
b. Replace lost fee revenue with General Fund support	Major
2. Claims for Reimbursement of Mandated Costs	
a. Pending before Board of Control	Major
b. Pending before the Courts	Major
3. Court Decision in STRS case	<u>+164.5</u>
Subtotal, <u>identifiable</u> cost of external threats	+\$664.5

AS THE TABLE INDICATES, WE HAVE DIVIDED THESE CHANGES TO THE GOVERNOR'S BUDGET INTO TWO CATEGORIES:

- o CHANGES THAT ARE NOW BEING CONSIDERED BY THE LEGISLATURE, AND
- o EXTERNAL THREATS TO THE BUDGET.

THE FORMER TOTAL A LITTLE LESS THAN \$1 BILLION. FOR THOSE EXTERNAL THREATS ON WHICH WE CAN PUT A PRICE TAG, THE POTENTIAL COST IS ABOUT TWO-THIRDS OF A BILLION DOLLARS.

I AM PREPARED TO ANSWER ANY QUESTIONS YOU MAY HAVE ON OUR GENERAL FUND REVENUE AND EXPENDITURE ESTIMATES.

Attachment I

LEGISLATIVE ANALYST'S COMMENTS ON THE MAY REVISION

General Fund Revenues

The Department of Finance has revised General Fund revenues upward by \$263 million in the current year and downward by \$67 million in the budget year, for a net increase of \$197 million over this two-year period. This upward revision reflects the partially offsetting effects of numerous changes in the estimates. On the one hand, revenues have been revised upwards for the personal income tax (up \$320 million), the sales and use tax (up \$185 million), and interest income (up \$54 million). On the other hand, revenues have been revised downward for the bank and corporation tax (down \$370 million).

In evaluating the department's revenue forecast, we will separately discuss (1) the economic forecast on which the revenue forecast is based and (2) the consistency of the revenue forecast with this economic forecast.

1. The Economic Forecast

The department's latest forecast predicts that economic activity in both 1984 and 1985 will be generally stronger than what was assumed in January. For example, the forecast for such variables as GNP, employment, personal income, and housing activity has been revised upward, while the forecast for unemployment has been revised downward. A lower inflation

rate is also now expected. The one key economic variable which was not revised in a positive direction is corporate profits. The anticipated growth in corporate profits was revised downward, although reasonably strong gains are still expected.

These revisions are all consistent with recent economic developments and with the current views of the economic forecasting community generally. As a result, the department's forecast for the U. S. economy is very close to the average of the 1984 forecast made by the nation's 50 leading economic forecasters in April with respect to real GNP growth (5.9 percent for the department, versus an average of 5.7 percent for the 50 forecasters), consumer price inflation (5.0 percent versus 4.9 percent), housing starts (1.89 million units versus 1.85 million units), and the unemployment rate (both at 7.5 percent).

Given this, we believe that the department's economic forecast is reasonable.

2. The Revenue Forecast

We have applied our own revenue estimating techniques to the department's economic forecast, in order to determine whether the department's revenue estimate is consistent with its economic outlook. In general, we have found them to be compatible.

For the current and budget years combined, our revenue estimating methodology produces a revenue total which is about \$40 million more than the department's estimate (up \$45 million in the current year and down \$5 million in the budget year). This is a remarkably small difference, given the magnitude of the revenue totals--\$23.6 billion in 1983-84 and \$25.8

billion in 1984-85. I might also add that the department's May revenue revisions are in the directions which we indicated in January were appropriate--up for the personal income tax and sales and use tax, down for the bank and corporation tax, and up on a combined basis.

Our comments on the revised estimate for the main sources of General Fund income are as follows:

Sales and use tax. The department has revised sales and use tax revenues upward by \$185 million (\$75 million in 1983-84 and \$110 million in 1984-85). The revision in current-year revenues is consistent with the fact that the state has collected about \$50 million more in sales and use tax revenues during 1983-84 than what the January budget expected. The budget-year revision reflects the higher income and employment growth now forecast by the department.

Our own analysis, which accounts for the effects on taxable sales of such factors as income and employment growth, housing activity, interest rates, and the unemployment rate, suggests a two-year upward revenue revision from the budget of about \$150 million, or \$35 million less than the department's.

Personal Income Tax (PIT). The department has raised personal income tax revenues by \$180 million in the current year and \$140 million in the budget year, for a total of \$320 million. Given the department's economic forecast, we believe the upward revisions should be about \$175 million in each year, or \$350 million in total--\$30 million more than the department's.

These upward adjustments would have been even higher had it not been for the data on average income paid to California workers during the fourth quarter of 1983 released by the Employment Development Department on May 4. This data showed that average income in the last three months of 1983 was considerably lower than what virtually all forecasters anticipated. It is not clear why the average was so much lower than expected. Nor is it clear to what extent the new data provides an accurate indication of what is happening to the income base on which taxes are imposed.

Unfortunately, we do not know to what extent, if any, withholding receipts reflected the reported downturn in "average wages." This is because the due dates for first quarter withholding receipts recently was changed, and as a result, a large portion of the withholding receipts for the fourth quarter was co-mingled with withholding receipts for the first quarter. The department has not yet been able to determine exactly how much of total receipts should be allocated to each quarter's income.

Were it not for this shortfall in reported average income, we would have estimated income tax collections to be at least \$150 million higher over the two-year period.

A more definitive answer to the questions regarding California income in the fourth quarter will not be provided until August 1984, when the U. S. Department of Commerce releases its data on 1983 income levels. Until it becomes clear that fourth quarter withholding receipts actually weakened, we believe \$100 million should be added to the department's income tax revenue estimate. Such an adjustment might be warranted in any case on the basis that the growth in personal income will be larger than the department's estimate.

Bank and Corporation Tax. The department has left its bank and corporation tax revenue estimate unchanged for 1983-84, but it has reduced by \$370 million its estimate for 1984-85. Our own analysis suggests that bank and corporation tax revenues could be up by about \$75 million in the current year and down by \$400 million in the budget, for a net two-year reduction of \$325 million. Thus, our estimate is \$45 million higher than the department's. Whether current-year revenues will, in fact, exceed the budget estimate will depend on whether tax prepayments due in June--the largest month of the year for prepayments--exceed the estimate as they have done in recent months. (For example, in April prepayments exceeded the estimate by \$44 million.)

Despite the large downward revenue revision for the budget year, it is important to stress that relatively strong rates of profit growth are still assumed. For example, our estimates assume that California profits will rise by about 17 percent in both 1983 and 1984, and by 15 percent in 1985. The department's assumptions are generally similar.

Interest Income. The department has raised its estimate of interest income for the current and budget years combined by \$52 million. This revision reflects increases in both the level of interest rates in the economy and the projected amount of state funds available for investment. Although we believe that the revised interest income estimate is reasonable, the amount of interest income earned by the state could be higher if interest rates rise more sharply as a result of federal borrowing demands. For example, if the yield on state investments during 1984-85 rises to 12 percent, instead of to 11 percent as assumed by the department, the General Fund would realize an additional \$30 million in interest income.

Attachment II

LEGISLATIVE ANALYST'S COMMENTS ON THE MAY REVISION

General Fund Expenditures

This attachment provides our comments, by major program area, on the General Fund expenditure estimates reflected in the Department of Finance's May Revision.

Medi-Cal (Difference from DOF Estimate: +\$24 million)

1983-84. The May Revision projects that Medi-Cal local assistance expenditures in the current year will be \$104 million less than the amount appropriated in the 1983 Budget Act. Of the total, \$42 million represents savings to the General Fund. The principal reasons for the expenditure shortfall are (1) higher-than-anticipated savings from hospital contracting and (2) implementation of peer group rates for services provided by non-contracting hospitals. In addition, the May estimates identify \$12 million in federal reimbursements to the state for Medi-Cal payments made prior to 1983-84. This \$12 million will be deposited in the General Fund.

We agree with the department's estimate for 1983-84.

1984-85. The May Revision projects total expenditures under the Medi-Cal program in 1984-85 of \$3,967 million, with \$1,876 million of this amount to be financed from the General Fund. This amount is \$200 million (\$166 million General Fund) less than the amount proposed in the Governor's Budget. Of the \$166 million reduction in General Fund expenditures, \$62 million can be attributed to technical factors and funding changes recommended by the Legislative Analyst's Office. The remaining \$104

million is due primarily to reductions in utilization of high-cost care, such as hospital care--a phenomenon observed throughout the health care marketplace.

The May Revision contains \$21 million (\$11 million General Fund), for a 2 percent increase in nursing home rates. The rate study, which current law requires the increase to be based on, indicates that a 6.5 percent increase is warranted. The cost of this increase would be \$68 million (\$35 million General Fund). Although the Governor has endorsed the 6.5 percent increase, the Department of Finance has not formally requested an augmentation to the budget. Nor has it included the cost of a 6.5 percent increase in its estimate of expenditures.

Accordingly, we estimate that expenditures under the Governor's program will be \$24 million more than reflected in the May Revision.

California Children's Services (Difference from DOF estimates: None)

The May Revision reflects a \$3.5 million (all funds) reduction in 1984-85 expenditures under the California Children's Services (CCS) program. It also reduces the estimate of CCS expenditures in 1983-84 by \$4.2 million (all funds). The reductions primarily reflect a significant decrease in program utilization and costs in Los Angeles County. The net result of the proposed May Revision is to reduce General Fund costs by \$0.2 million in 1983-84 and \$4.5 million in 1984-85.

The CCS program is operated by counties. Because county decisions have a significant impact on program funding, the department includes county-specific assumptions in its estimating package.

Given the available information on program expenditure trends, we believe the estimates for CCS are reasonable.

AFDC Grant Payments (Difference from DOF estimate: -\$4.3 million)

The May Revision identifies a decrease of \$2.1 million in the General Fund costs for AFDC grants in 1983-84. The decrease is due primarily to small reductions in caseload in the Family Group and Unemployed Parent programs.

The May Revision requests that the General Fund appropriation be increased by \$5.4 million for AFDC grant payments in 1984-85. This reflects the net impact of several adjustments, including decreases of \$5.1 million due to reduced caseload and \$5.7 million due to federal extension of unemployment benefits, and increased costs of \$9.0 million due to reduced child support collections and \$5.7 million in added costs resulting from a recent court decision.

In our analysis of the May Revision, we recommend a \$4.3 million reduction in the estimate of costs for AFDC grants, due to updated estimates of child support collections.

Supplemental Security Income/State Supplementary Payment

(SSI/SSP) Program (Difference from DOF estimate: None)

The May Revision shows a deficiency of \$8.3 million in General Fund expenditures for the SSI/SSP program in the current year. This deficiency is due primarily to a higher estimate of caseload. The May Revision also reflects an additional \$42.0 million in General Fund expenditures above the amount proposed in the Governor's Budget for 1984-85, due primarily to a higher estimate of caseload and average grant costs.

We believe the department's estimates are reasonable.

Social Services Programs (Difference from DOF estimate: None)

The May Revision adds \$4.5 million to expenditures for the Other County Social Services (OCSS) program. This increase primarily reflects an increased child welfare services (SB 14) caseload.

In addition, the May Revision requests a net increase of \$8.1 million in the In-Home Supportive Services (IHSS) program for 1984-85. This increase reflects the withdrawal of program reductions proposed by the administration.

Our review of the department's caseload projections and other budget assumptions indicates that the expenditure estimates are reasonable.

K-12 Education (Difference from DOF estimate: +\$36 million)

The changes in K-12 expenditures reflected in the May Revision are summarized in the following table:

	In Millions	
	<u>1983-84</u>	<u>1984-85</u>
Increased local property taxes:		
Regular	-\$67.8	-\$81.9
Supplemental roll	+238.0	-139.9
Increased State School Fund revenues	-3.9	-3.9
COLA funding requirements	-1.8	+1.9
Reduced home-to-school transportation entitlements	-6.4	-8.0
Increased ADA	+11.9	+42.2
Necessary small school adjustment	+10.3	+10.4
Other	+3.0	+1.3
Revised funding for longer school day/year	--	-10.6
Supplemental summer school	--	-3.8
Balance left in State School Fund	<u>+\$5.0</u>	<u>--</u>
Total changes	+\$188.3	-\$191.3

The factors primarily responsible for the change in the estimates are:

- o The slippage in supplemental roll property tax collections from 1983-84 to 1984-85.
- o The increase in "regular" property tax collections.
- o The increase in Average Daily Attendance.

Supplemental Roll Property Taxes. The Governor's Budget assumed that counties would allocate \$258 million in supplemental property tax revenues to school districts in 1983-84. This estimate was way too optimistic. The May Revision assumes that counties will levy \$210 million, and collect \$20 million during 1983-84, due to delays in billing taxpayers.

For 1984-85, the May Revision makes two adjustments in the supplemental roll revenue estimates:

1. It assumes that all of the taxes levied but not collected in 1983-84 (\$190 million) will be collected in 1984-85, and
2. It reduces the original estimate of collections for 1984-85 by \$51 million to reflect billing delays and other factors.

Our analysis indicates that further revisions in the estimate of supplemental roll allocations to schools are warranted, for three reasons. First, some of the supplemental property taxes levied in 1983-84 may not be allocated to schools until 1985-86. For example, Los Angeles County indicates that it will not be able to prepare 1983-84 assessments on multiple-ownership changes until late in 1984-85. This delay could reduce collections by at least \$10 million, and quite possibly by considerably more.

Second, given the delays in billings and collections experienced to date, we believe the Department of Finance's estimates of supplemental roll allocations to schools in 1984-85--\$98 million--should be reduced to \$87 million.

Third, the department assumes that redevelopment agencies will get none of the \$210 million in 1983-84 roll collections. Although this is consistent with the language proposed in the administration's local government finance bill, SB 1300, current law would appear to require that redevelopment agencies be allocated a share of these funds. We estimate their share at \$15 million.

Accordingly, we believe the department has underestimated General Fund expenditures in 1984-85 by \$36 million. (In recognition of this, both fiscal subcommittees have built a \$30 million "cushion" into 1984-85 apportionments, which the Director of Finance could reduce in the event that supplemental property tax revenues reach the May Revision target.)

Property Taxes--Regular Roll. The department's projection of local property tax revenues to be allocated to K-12 school districts for 1983-84 and 1984-85 is consistent with our own projections.

For 1983-84, the \$67.8 million increase over the budget estimate is attributable to:

- o An increase in the revenue growth rate from 7.5 to 7.9 percent, which is due to a change in DOF's method of accounting for the redevelopment agencies' share of revenues (\$8.5 million),
- o An increase in the amount of revenue received by schools in 1982-83, which serves as the basis for the 1983-84 projection (\$37.2 million), and

- o An assumed decrease in the property tax delinquency rate, which increases the amount of 1983-84 taxes levied that are actually collected (\$22.1 million).

Our analysis indicates that the entire \$67.8 million upward adjustment is reasonable.

For 1984-85, the increase primarily reflects the increase in 1983-84 revenues (in other words, the current-year increase raises the base for 1984-85). In addition, the revenue growth rate has been increased from 8.5 to 9.0 percent, on the basis of revised estimates of assessed value growth provided by county assessors and the Board of Equalization. Again, our analysis indicates that the increase is reasonable.

Changes in ADA. The Department of Finance estimates a net increase in K-12 education expenditure requirements of \$11.9 million in 1983-84 and \$42.2 million in 1984-85, resulting from changes in enrollment (ADA) in school districts and county offices of education. The changes are as follows:

- o 1983-84: Increased expenditure requirements of \$17.8 million, due to increased school district ADA, which is partially offset by decreased expenditure requirements of \$5.9 million, due to reduced county office ADA.
- o 1984-85: Increased expenditure requirements of \$46.6 million, due to a net increase of 19,297 ADA in school districts, which is partially offset by decreased expenditure requirements of \$4.4 million, due to reduced county office ADA (primarily in juvenile hall programs).

We have reviewed these revisions and concur that they are appropriate.

Unallocated Expenditures (Difference from DOF estimate: -\$92.6 million)

The Governor's Budget, as introduced in January, included \$305 million in unallocated expenditures--\$180 million for 1983-84 and \$125 million for 1984-85. The budget-year amount was set aside for legislative initiatives.

The May Revision does not include the \$180 million in Unallocated Expenditures for 1983-84; these funds have been allocated to cover the costs of (1) financial legislation enacted to date and (2) the slippage in supplemental property tax collections. We believe this adjustment is appropriate.

The expenditure totals for 1984-85 continue to include the \$125 million for the cost of new legislation in the budget year. The administration notes that, of the \$125 million, \$32.4 million has, in effect, been committed as a result of legislation enacted and chaptered since the introduction of the Governor's Budget.

While we recognize that legislation to be enacted during the balance of the 1984 session will almost certainly increase the expenditure totals beyond what the Governor proposes to spend, these expenditures should not be built into the totals at this point. The uncommitted balance of the \$125 million--\$92.6 million--is no different from the uncommitted balance of \$412.7 million reflected in the Department of Finance's May Revision.

Thus, to facilitate the Legislature's fiscal planning, we believe the expenditure totals should be reduced by \$92.6 million, and the

unappropriated balance in the General Fund should be increased by the same amount.

Tax Relief (Difference from DOF estimate: +\$10 million)

The May Revision indicates that tax relief payments will be \$18.3 million higher than the budget estimate in 1983-84. The Department of Finance's decision to allocate additional personal property tax subventions to Santa Clara and Orange Counties accounts for \$7.5 million of this increase. These higher allocations were made because the counties were "shorted" when the school's share of these subventions was eliminated. The remainder of the increase reflects more-recent information on program participation and county claims.

The Department of Finance, however, did not change the estimates of tax relief payments in 1984-85, despite the upward revisions made during the current year. Our analysis indicates a potential underfunding in the Renter's Credit program of at least \$10 million.

Unidentified Savings (Difference from DOF estimates: -\$100 million)

The Governor's Budget, as introduced in January, estimated that unidentified savings would be \$25 million in 1983-84 and \$100 million in 1984-85. These estimates, which reflect the difference anticipated between appropriations and expenditures in the current year, were not adjusted for the May Revision.

In a report published in April, the Commission on State Finance indicated that these estimates should be raised. The commission's analysis indicates that unidentified savings generally have amounted to about 1

percent of the expenditure estimate contained in the May Revision. In contrast, the estimates of unidentified savings reflected in the administration's expenditure totals are equal to 0.1 percent of estimated expenditures in 1983-84 and 0.4 percent of proposed expenditures in 1984-85. The commission, therefore, recommended that the unidentified savings estimates be revised upward by \$125 million and \$75 million in 1983-84 and 1984-85, respectively. These adjustments would bring the estimate of total unidentified savings in each year to 0.7 percent of estimated expenditures.

Department of Finance maintains that the commission's methodology incorrectly assumes that the full amount of unidentified savings will revert to the General Fund, and hence be available for allocation by the Legislature in the following year. According to the department, a large portion of the shortfall between appropriations and expenditures represents the unencumbered balances of continuing appropriations, which are not available for allocation.

Obviously, since they are unidentified, "unidentified savings" cannot be estimated with any precision. Moreover, during the last six years, the actual amount of unidentified savings has fluctuated widely. Nevertheless, we believe the department has underestimated unidentified savings in the current year. We note that:

- o Even when allowance is made for the unencumbered balance of continuing appropriations, the expenditure shortfall has averaged about double what the department has budgeted for unidentified savings in 1983-84.

- o Each year, the controller, in effect, reduces expenditures for one or more prior years after the books on these years have been "closed". This is another type of "unidentified savings"--one that is not reflected in either the commission's or the department's methodology.
- o The shift in capital outlay funding from the General Fund to special funds (principally, the Special Account for Capital Outlay), together with the hiring freeze that was in effect for part of 1983-84, should cause "unidentified savings" from one-year appropriations to be higher than the historical average.

For this reason, we believe the expenditure totals for 1983-84 should be reduced by \$100 million.

On the other hand, we do not believe a change in the estimate of "unidentified savings" for 1984-85 is warranted at this time. While it is true that the department's estimate--\$100 million--is low by historical standards, the expenditure totals currently make no allowance for the "unidentified expenditures" that will be reflected in the 1985 deficiency bill. These expenditures are likely to range from \$50 million to \$150 million.

State-Mandated Local Claims (Difference from DOF estimate: +\$5 million)

The Governor's Budget, as introduced in January, identified costs of \$225 million in 1983-84 and \$112 million in 1984-85 for reimbursing local agencies for state-mandated costs.

The \$225 million estimate for the current year includes \$78.7 million for two mandates--Vocational Rehabilitation (\$66.3 million) and

stray cats (\$12.5 million)--for which funding was included in the 1983 claims bill (AB 504), but subsequently deleted by the Legislature. The Governor's Budget for 1984-85 also included \$20.2 million to fund the ongoing cost of providing reimbursements for these two mandates. It is unlikely that either one of these claims will be paid in 1983-84.

The \$112 million estimate for 1984-85 does not include any funds for the support of the second claims bill, which will be introduced in July 1984, nor does it include funding for the first 1985 claims bill, which will be introduced in January 1985. The cost of claims already approved for inclusion in these bills should be recognized in the expenditure totals. Accordingly, we believe the estimate of General Fund expenditures should be increased by about \$5 million.

Since the Legislature has considered and rejected reimbursement for the two claims mentioned above, it could choose to reduce the estimated cost of the Governor's Budget for 1983-84 and 1984-85 by \$98.9 million (thereby increasing the unallocated balance by this amount). We do not propose such a reduction at this time for three reasons:

- o The Governor's Budget continues to propose reimbursement funding for these two statutes.
- o There are at least 28 suits pending against the state in which the plaintiffs are seeking a judgment that the state has failed to comply with its constitutional obligation to reimburse local governments for mandated costs. Decisions in these cases could increase state expenditures during the budget year by \$100 million.

- o There are at least nine test claims for reimbursement of mandated costs currently being reviewed by the Board of Control. If the board adopts parameters and guidelines for these claims during 1984, the cost of the July 1984 and January 1985 claims bills would increase significantly.

Accordingly, we propose that the department's estimate of expenditures for reimbursement of mandated costs be increased by \$5 million to reflect the cost of claims already approved by the Board of Control.

Community Colleges (Difference from DOF estimate: -0-)

The Department of Finance's May estimates for community college apportionments reflect additional property tax revenue allocations to districts of \$12.0 million in 1983-84 and \$4.2 million in 1984-85. No adjustments have been made to General Fund expenditures for either year.

Given the funding level proposed by the administration, we have no disagreement with the expenditure estimates contained in the May Revision. (The cost of fully funding Community Colleges, pursuant to SB 851, is discussed elsewhere.)

Department of Corrections (Difference from DOF estimate: -\$3 million)

The May Revision proposes an increase of \$34,366,000 from the General Fund for the state's prison system in 1984-85. This reflects the net impact of several adjustments, including (1) increases of approximately \$14.4 million to staff new prison facilities that are expected to open during the next two years and increase crowding in existing facilities, (2) \$7.3 million to provide work or educational programs for all eligible

inmates, (3) \$1.2 million to increase departmental supervision of the prison construction program, (4) \$7.2 million primarily to reimburse counties for the costs of detaining parole violators, and (5) \$4.9 million to reimburse the Department of Forestry for its costs of establishing new conservation camps for inmates.

The department's actual funding needs could be significantly different from what the DOF now estimates if it is not able to construct new prison facilities according to its ambitious schedule. This schedule calls for the completion of housing space for over 10,000 additional inmates by the end of the 1985 calendar year. Because it is not clear that the department will be able to bring so many beds on-line so quickly, and because of the uncertainties regarding the level of staffing needed for the new prisons, we have no analytical basis for proposing major changes in the expenditure estimates. We believe, however, that a reduction of about \$3.0 million in the estimates is warranted on technical grounds.

Department of Rehabilitation (Difference from DOF estimate: -0-)

The May Revision proposes an \$8.7 million increase in expenditures by the Department of Rehabilitation to reflect increased caseload under the work activity program.

In our Analysis of the Budget Bill, we indicated that caseload could be underfunded by nearly this amount. Consequently, we believe the revised estimate is reasonable.

Court Decision in the STRS Cases (Difference from DOF estimate: -0-)

On May 7, 1984, the Third Appellate District of the Court of Appeals ruled for the plaintiffs in the case of CTA/STRS v. Cory (State of CA), affirming the state's obligation to contribute to the State Teachers Retirement Fund the amounts specified in Ch 282/79 (AB 8). The decision, however, did not provide for a specific dollar award.

The amount at issue in this case is \$375.8 million, which consists of (1) \$341.3 million in contribution deficiencies for the years 1980-81 through 1983-84 and (2) \$34.5 million for the interest that was "lost" by the STRF as a result of these deficiencies. Since the Governor's Budget for 1984-85 would pay back \$211.3 million of the \$375.8 million, the state's maximum potential liability would appear to be \$164.5 million.

The Governor has indicated that the state will petition the California Supreme Court for review of this decision.

In any event, we believe the amount which the state contributes to the fund (as opposed to the amount paid from the fund to those members of the retirement system with accrued retirement benefits) is properly a policy decision for the Legislature to make. Accordingly, we do not believe the expenditure estimates in the May Revision should be increased to reflect the appellate court's decision at this time.

Attachment III

COST OF POTENTIAL CHANGES TO THE GOVERNOR'S BUDGET

This attachment shows the effect that selected changes to the spending program proposed by the Governor would have on General Fund expenditures in 1984-85. We have divided these changes into two categories: (1) changes being considered by the Legislature, and (2) external threats to the budget.

Changes Being Considered by the Legislature

This section discusses major changes to the Governor's Budget that are actively being considered by the Legislature.

K-12 Education

The Governor's Budget includes a 3 percent Cost-of-Living Adjustment (COLA) for K-12 school apportionments, and a 3 percent COLA for categorical programs. The latest estimate of the increases that would have been required by SB 813 as sent to the Governor and subsequently amended by AB 2224 is 6.1 percent.

The following table shows that K-12 funding would have to be increased by \$349.6 million if both apportionments and categorical programs were given a 6.1 percent COLA in 1984-85:

Increases in K-12 Funding Necessary to
Provide a 6.1 COLA During 1984-85
(in millions)

	Cost of COLAs Provided in Governor's Budget (3%)	Cost of a 6.1% COLA	Difference
K-12 Apportionments	\$250.9	\$507.9	\$257.0
Categorical Programs With Statutory COLAs	54.1	110.0	55.9
Other Categorical Programs	<u>35.5</u>	<u>72.2</u>	<u>36.7</u>
Totals	\$340.5	\$690.1	\$349.6

Community Colleges

The Governor's Budget, together with AB 1xx, provides a total of \$958.4 million in General Fund support for community colleges in 1984-85. An additional \$111 million in apportionments would be required to fully fund the provisions of SB 851 as enacted by the Legislature last year. (However, the net General Fund cost would be only \$101 million due to excess funding for categorical aids in the budget.) Of this amount, \$6.6 million would be needed to fund in 1984-85 the 1983-84 COLA called for by SB 851. The balance--\$104.5 million--would be needed to fund the COLA, equalization, and growth authorized by SB 851 in 1984-85.

Welfare Programs

The Governor's Budget provides COLAs of about 2 percent for the state's principal welfare programs. This would be in lieu of the COLAs required by statute--5.6 percent.

The following table shows that General Fund costs would be \$113.3 million higher if COLAs were provided for these programs in 1984-85 in accordance with current law.

Welfare Programs - Amounts Needed to Fully Fund
Statutory COLAs in 1984-85
(in millions)

<u>Program</u>	<u>COLAs Proposed in the Governor's Budget</u>	<u>Statutory COLAs</u>	<u>Additional Amount Needed to Fully Fund Statutory COLAs</u>
AFDC	2.0%	5.6%	\$59.2
SSI/SSP	2.5 ^a	5.6	53.5
IHSS	2.0	5.6	<u>.6</u>
Total			\$113.3

a. Minimum weighted average COLA necessary to maintain July 1983 maximum SSP grant levels as required by federal law. Individual percentage increases would range from 2.0 percent to 5.3 percent.

Health Program COLAs

Statutory COLAs for the state's primary health programs range from 4.2 percent to 10.4 percent. In lieu of these increases, the budget provides funding for COLAs ranging from 2 to 10.4 percent, at a total cost of \$38.7 million.

A net additional \$45.7 million would be needed to fully fund these statutory COLAs in 1984-85, of which we have included \$24 million in our estimate of General Fund expenditures (see Attachment II). These increases are shown in the following table:

Amount Needed to Fund Statutory COLAs:
Health Programs
(in millions)

Program	<u>Governor's Budget Percent</u>	<u>Budget Amount</u>	<u>Statutory COLA Percent</u>	<u>Additional Amount Needed</u>
County Health Services	2.0	\$7.4	4.2	\$8.1
Medi-Cal Hospital Inpatient	10.4	9.1	10.4	--
Medi-Cal Drug Ingredient	7.5	3.2	7.5	--
Medi-Cal Spin Off	2.6	5.9	5.6	9.8
Prepaid Health Plans	2.0	2.5	5.0	3.8
Nursing Homes ^a	2.0	<u>10.6</u>	6.5	<u>(24.0)^a</u>
Totals		\$38.7		\$21.7

a. The amount needed to fund the statutory nursing home rate increase is not included in the budget as revised. However, in announcing his "Aging Initiative," the Governor stated that he intends to propose funding for the statutory increase. Consequently, we have included this amount in our estimate of the General Fund expenditures that would result from approval of the Governor's Budget.

The budget proposes a 2.0 percent increase for all but three other health programs. The exceptions are the Medically Indigent Adults (MIA) program and Medi-Cal county administration, for which the budget proposes no COLA, and the Regional Center program, out-of-home care, which has a 12.5 percent COLA. If a 5.0 percent increase is provided for all health-related programs that do not have statutory COLAs, the added General Fund cost would be \$38.8 million.

Abortions

The Governor's Budget contains (1) \$11.9 million for abortion-related services in 1984-85, including funds to pay the cost of (a) abortions performed in 1983-84, (b) abortions performed between July 1, 1984 and August 15, 1984, and (c) abortions that would be allowed after August 15, 1984 by the language contained in the Governor's Budget; and (2) \$3 million for other health services related to reductions in abortions.

To fund unrestricted abortion services, an additional \$12 million would be necessary (\$15 million for abortions less \$3 million saved for other health services).

Deficiency Claims for 1983-84

The Governor's Budget, as introduced in January, indicated that General Fund deficiencies during the current year would be \$100.4 million. The administration subsequently increased this amount to \$118 million. The May Revision reduces the estimate of the deficiency by \$39.3 million, to \$78.7 million.

In its present form, the deficiency bill (AB 3073 - Vasconcellos) contains \$54.9 million more than the \$78.7 million estimated by the Department of Finance. This amount consists of:

- \$39.3 million for special education;
- \$3.7 million for adult education;
- \$2.8 million for the Work Activity Program in the Department of Rehabilitation; and
- \$9.1 million for ROC/Ps.

(Note: the \$5 million balance projected for the state school fund on June 30, 1984 could be used to finance \$5 million of the special education deficiency.)

Local Government Finance

SB 1300 (Marks) and AB 2468 (Cortese)--the two competing bills that would revise the state's fiscal relationship with cities and counties--are similar in that both:

- Accelerate by one year the distribution of supplemental roll revenue to local agencies (cost to the state = \$220 million);
- Repeal the personal property tax subvention (savings = \$320 million);
- Allocate the state's share of vehicle license fee revenues to counties (\$208 million) and no-property tax cities (\$2 million); and
- Repeal the AB 8 Deflator (\$292 million).

The net effect of these provisions is built into the administration's expenditure estimates, as revised in May.

Each bill currently contains one major fiscal provision which is not reflected in the expenditure totals:

- SB 1300 contains a new subvention designed to offset net losses in excess of \$1 million that individual cities experience as a result of the Business Inventory Subvention/Supplemental Roll Transfer (net cost: under \$10 million).
- AB 2468 appropriates \$250 million for infrastructure grants, which would be passed out by the state to state and local agencies on a competitive basis.

External Threats to the Budget

The Jarvis Initiative

Howard Jarvis has qualified his "Save Proposition 13" initiative for the November ballot. If this measure is approved by the voters and allowed to take effect, it will have a major and immediate fiscal impact on both the state and local governments.

The provisions of the initiative that address the 2 percent inflation factor contained in Proposition 13 would require local governments (including schools) to refund \$1.3 billion to taxpayers. The school districts' share of these refunds would be approximately \$500 million.

In addition, the provisions of the measure that address fees and user charges would reduce the funds available to finance many General Fund programs by a major, but unknown, amount.

Claims for Reimbursement of Mandated Costs

Claims Pending Before the Board of Control. As noted in Attachment II, the Board of Control currently is reviewing local government claims for reimbursement of mandated costs under 19 statutes. In those cases where the board finds that these statutes contain a reimbursable mandate and develops parameters and guidelines for reimbursing the mandated costs, the Legislature will be asked to appropriate funds in a local government claims bill. It is not possible to estimate what these claims might be in 1984-85.

Claims Pending Before the Courts. As noted in Attachment II, at least 28 lawsuits have been filed by local agencies against the state seeking reimbursement of mandated costs. The amount at stake in these suits easily exceeds \$100 million.

Court Decision in the STRS Case

As noted in Attachment II, the Appellate Court's decision in the STRS case holds the state liable for up to \$164.5 million in contributions over and above what is proposed in the Governor's Budget.