Perspectives on the 1987 May Revision

Statement of the Legislative Analyst's Office to the Assembly Ways and Means Committee

Legislative Analyst's Office
May 26, 1987

Mr. Chairman and Members:

When the Director of Finance and I last appeared before this committee, the discussion focused on how projected revenues for 1987-88 would be insufficient to fund both a current services budget and restore the reserve to the $1 billion level. In the short time that has elapsed, the state's fiscal picture has been dramatically reversed. What you now have before you in the May Revision is essentially a new budget. This is a budget that:

- Funds current services in most program areas in both 1986-87 and 1987-88;
- Maintains the reserve at the $1 billion level;
- Chooses one of several options for complying with the terms of the state's appropriations limit; and
- Abandons most of the budgetary reductions proposed by the administration in January. The most notable reductions which remain in the budget include termination of the Cal-OSHA program, substitution of bond funding for General Fund support of school-deferred maintenance in the current year, and repeal of the state mandate for school collective bargaining.

In order to provide you with a framework for thinking about your choices in shaping this budget, my remarks this morning will focus on three areas:

1. ***General Fund Revenues*** — how much is available and how does the administration propose to allocate the funds?
2. ***Expenditure Changes*** — what are the administration's proposals and what are some of the issues facing the Legislature?
3. ***Appropriations Limit*** — where does the state now stand? What compliance options are available?

I. General Fund Revenues — Unprecedented Increases

The Department of Finance now estimates that General Fund revenues during the *current* fiscal year will be $1.7 billion higher than its January estimates. Table 1 shows that the personal income tax accounts for 70 percent of the total increase. This is, by far, the largest revenue adjustment ever made by the department in its May revisions. The enactment of the federal Tax Reform Act of 1986, which encouraged taxpayers to sell capital assets before the tax rate changed on January 1, 1987, obviously contributed to this revenue increase. But federal tax reform was not the only, or even the most dominant factor, explaining these revenue increases. A review of the department's working papers shows that, while about $800 million of the total increase is attributable to an upward revision of the estimated impact of *tax reform*, another $900 million is due to an underestimation of the *strength of the economy*. California was not the only jurisdiction which received an unanticipated surge in income tax revenues last month. The federal government and many states had similar experiences.

Table 1
Increases in General Fund Revenues
Department of Finance's May Revision
(dollars in millions)

Source	*1986-87*	*1987-88*	*Two-Year Total*
Sales tax	$160	$146	$306
Personal income tax	1,180	510	1,690
Bank and corporation tax	345	305	650
Other revenues and transfers	13	18	31
Totals	$1,698	$979	$2,677

The Department of Finance estimates that 1987-88 General Fund revenues will be $979 million above the budget figures. This total reflects a proposed $45 million transfer of sales tax revenues to the Transportation Planning & Development Account. It does not reflect the administration's proposal to shift a portion of the sales tax to a special fund to finance its health services disengagement proposal.

Our review of these budget-year revenue estimates indicates that:

1. In January, Finance's economic forecasts were clearly on the conservative side. The May Revision brought them more into line with the consensus outlook of other forecasters.
2. Finance's revenue estimates are generally consistent with its economic forecast.
3. The department's future estimates of income tax revenue face a wider than normal margin of error. This is because the department made the assumption that all of the additional federal tax reform-induced capital gains income reported in 1986 represents amounts that normally would have been reported in either 1987 or 1988.
4. Recent economic trends for inflation, interest rates, and the value of the dollar pose a downside risk that actual economic conditions in the future could be less robust than the consensus view of forecasters.
5. The volatility of income tax estimates will complicate your attempt to enact a "revenue neutral" California income tax reform measure.

How the Administration Allocates the Increased Revenues

Table 2 shows how the administration proposes to allocate the increased revenues identified in its May Revision.

In the *current* year:

- $514 million would be used to fund existing programs;
- $474 million would be used to build up the reserve to a billion dollar level;
- $8 million would be added to the Disaster Account; and
- $702 million would be used for income tax credits.

In the *budget* year:

- Total General Fund expenditures (disregarding the funding shift for disengagement) would increase by nearly $1.3 billion. The Governor's January Budget proposed to use part ($474 million) of the 1987-88 revenue growth to build up the reserve. With the May Revision, this diversion of budget-year funds is no longer needed because the reserve will be built up during the current fiscal year. As a result, these reallocated funds, plus those from the May Revision, will be used to finance the total expenditure increase.

Table 2
Administration's Proposed Allocation of May Revenue Increases
(dollars in millions)

Category	*1986-87*	*1987-88*
Increased General Fund expenditures	$514	$1,252
Increased disengagement funding	--	13
Economic Uncertainty Reserve	474	8
Reallocation of funds to replenish reserve	--	-474
Disaster Account	8	10
Tax credit proposal	702	170
Totals	$1,698	$979

II. Expenditure Changes

Under the administration's May Revision, General Fund expenditures in 1987-88 would be nearly $1.3 billion higher than those proposed in the Governor's Budget. This is, by far, the largest expenditure increase ever proposed by the administration.

Table 3 shows the composition of these expenditure changes. For example, total education expenditures would be increased by $526 million and health and welfare expenditures by $528 million. These two categories account for 83 percent of the total funding increases.

Most of the $599 million in May 11 changes consist of caseload and other workload adjustments. The May 19 changes include restoration of full-year cost-of-living adjustments (COLAs) for K-12 education, community colleges, and health and welfare programs. These adjustments also include a full-year (3 percent) increase in civil service salaries and the restoration of the 1 percent reduction in the state operations budget. There also are some program enhancements among these changes, including:

- $21 million added to community colleges as a special apportionment for growth in basic skill courses;
- $19 million added to community colleges to fund 1986-87 district ADA growth above the statutory enrollment cap, regardless of the type of program growth;
- $7.5 million for instructional computers at the University of California (UC), and another $5.2 million for those at California State University (CSU);
- $9.1 million for AIDS; and
- $3.3 million added to the Department of Alcoholic Beverage Control for increased enforcement activities.

The administration's spending program for the *current* year anticipates that the Legislature will approve the substitution of $90 million in bond funds, in lieu of General Fund support, for school- deferred maintenance. It is our understanding that the administration plans to drop its proposal to reimburse local governments for their unemployment insurance costs from the Unemployment Insurance (UI) Fund.

Despite the unprecedented magnitude of new expenditures proposed by the administration — $514 million in the current year and nearly $1.3 billion in the budget year — *the vast majority of this spending represents the restoration of current services budgets rather than program augmentations.*

Table 3
Department of Finance Revisions to the Governor's 1987-88 Budget
(dollars in millions)

	Net Increases			*% of Net Increase*
Category	*May 11*	*May 19*	*Total*	*Before Accounting Change*
K-12 Education	$117.9	$217.4	$335.3	26.5%
Community Colleges	-5.2	99.5	94.3	7.5
University of California	10.9	40.2	51.1	4.0
California State University		45.4	45.4	3.6
Sub-total Education	$123.6	$402.5	$526.1	41.6%
DHS Medi-Cal	202.6	33.9	236.5	18.7
DHS Public Health	9.6	7.0	16.6	1.3
Social Services/various	129.5	42.3	171.8	13.6
Social Services/GAIN	44.0		44.0	3.5
Mental Health	39.5	5.9	45.4	3.6
Developmental Services	7.8	-0.1	7.7	0.6
Rehabilitation	5.7		5.7	0.5
Sub-total Health & Welfare	$438.7	$89.0	$527.7	41.7%
Corrections	33.7		33.7	2.7
Youth Authority	5.8		5.8	0.5
State Mandates	46.9	47.1	94.0	7.4
Proposition 65		6.7	6.7	0.5
Employee Compensation/ Civil Service		46.2	46.2	3.7
Restore 1% reductions		69.4	69.4	5.5
Bond Interest	-66.3		-66.3	-5.2
Increases approved prior to May 11	16.6		16.6	1.3
All other		-7.7	-7.7	-0.6
Sub-total Others	$36.7	$161.7	$198.4	15.7%
Net Increase-General Fund	$599.0	$653.2	$1,252.2	98.9%
Increased Disengagement Funding		13.3	13.3	1.1
Net Increase Before Accounting Change	$599.0	$666.5	$1,265.5	100.0%
Accounting Change Health Services Disengagement (revised)		-457.0	-457.0	
Net Changes per Department of Finance	$599.0	$209.5	$808.5	

Highlights of Selected Spending Proposals

A number of the administration's program proposals raise issues that the Legislature may wish to address in its remaining budget deliberations. These include:

1. ***Academic Salaries.*** For most state programs which were budgeted at half-year COLAs, the administration now proposes full-year funding. The exception is academic salaries at UC and CSU. In January, the budget proposed a 3 percent faculty salary increase effective next January. Now the administration proposes higher rates of increase (5.7 percent at UC and 6.9 percent at CSU) but they still would be effective only for the last half of the budget year. Full-year funding, *to maintain parity with comparison institutions for each segment*, would require an *augmentation* of $27 million for CSU and a *reduction* of $6.1 million for UC.

2. ***K-12 Education.*** As shown in Table 3, K-12 received the largest increase, in absolute terms, of any state program. This amount, however, reflects enrollment increases and statutory requirements. It does not include any programmatic enhancements. Moreover, neither the original budget nor the May Revision proposes to fund Urban Impact Aid ($76.2 million) and Meade Aid ($10.4 million) in the budget year.

   The original budget proposed a 2.2 percent COLA for K-12 which would be effective in January 1988. The May Revision (a) proposes a 2.5 percent COLA for the full year, (b) provides a $10 million augmentation to restore full-year funding for Small School District Transportation, and (c) proposes a $57 million augmentation to fully fund school desegregation reimbursements.

   The current intent of the administration regarding the proposal to eliminate four categorical programs and reduce class size is unclear.

3. ***Community Colleges.*** The original budget proposed a 2.7 percent COLA for half of the year. The May Revision proposes a 3.4 percent COLA for the full year. Community colleges would receive program enhancement funding totaling approximately $56 million under the administration's proposal.

4. ***AIDS.*** The administration proposes to spend an additional $12.6 million on AIDS ($9.1 million General Fund and $3.5 million in federal funds). By contrast, the AIDS budget task force proposes an additional $59.5 million ($54.5 million General Fund). The main differences between these two spending proposals are shown in Table 4.

Table 4
AIDS Funding Proposals, By Expenditure Category
1987-88
(dollars in millions)

Category	*Administration*	*AIDS Task Force*
Treatment	$1.1	$6.9
Diagnostic services	—	1.0
Case monitoring	—	3.2
Testing	6.1	4.0
Information and education	1.2	23.5
San Francisco General Hospital AIDS facility	—	8.5
Department of Alcohol and Drug Programs	3.5	6.0
Department of Mental Health	—	3.2
Department of Education	—	1.0

5. ***Proposition 65.*** The administration proposes $11.7 million and 134 personnel-years for the implementation of Proposition 65. Three agencies would receive 93 percent of the total funding: the Department of Food and Agriculture (29 percent), the State Water Resources Control Board (21 percent), and the Department of Health Services (43 percent). The administration has not proposed funding for the Department of Industrial Relations, or another agency, to monitor and enforce industrial and occupational exposures. We are unable to advise you at this time if the workload estimates for the implementation proposal are based on the administration's list of 29 chemicals or the 200-plus listing of chemicals referenced in Proposition 65.

6. ***Disengagement.*** The administration has changed the composition of affected programs and increased the amount of funds involved in its local health disengagement proposal. The original proposal consisted of shifting $477 million of funding for AB 8 and eight public health categorical programs to the counties. The new proposal does not include the public health categorical programs. Instead, it includes the Medically Indigent Services Program (MISP). The total amount of discretionary funding to be shifted now amounts to $938 million in the budget year. Of this amount, $12.5 million represents partial restoration of the 1986-87 MISP funding reduction. In subsequent years, counties would receive revenues from 2/5 of one cent of the state sales tax rate. This would yield about $1 billion in local revenues.

7. ***State Highways.*** The original budget proposed to augment state staffing (395 personnel-years) and contract-out funding (equivalent of 155 personnel-years) to expedite state highway projects. Now the May Revision proposes *additional* contracts to work on locally funded (sales tax) projects in Alameda, Fresno, and Santa Clara Counties. These local projects will require the support of up to 150 personnel-years in the Department of Transportation. These personnel-years would be redirected from their regular work on state highway projects. Consequently, development of state- and federally funded projects in the highway system could be delayed.

   While the May Revision is silent on additional transportation enhancements, the Governor has suggested a $2.3 billion General Obligation Bond proposal to fund state highway projects (75 percent) and local roads (25 percent). At this time, however, it is unclear how the debt service on these bonds would be funded, and what impact that may have on other state programs.

Administration's Tax Credit Proposal

The administration contends that current-year revenues exceed the state appropriations limit by $700 million. It proposes that this "excess" be returned to the state's income taxpayers in the form of a credit on their 1987 returns which are due in April 1988. The implementation of this credit requires legislation.

Over the last 20 years, four temporary tax reductions have been enacted. They were:

1. SB 825 (Chapter 1464, Statutes of 1969) granted a 10 percent income tax credit on 1969 incomes. This credit had a cap of $200 for a married couple and $100 for a single taxpayer.
2. AB 1x (Chapter 1, 1971 First Extraordinary Session) granted a 20 percent forgiveness on 1971 income tax year liabilities. This credit was granted in conjunction with the state's adoption of withholding.
3. SB 90 (Chapter 296, Statutes of 1973) lowered the newly raised sales tax rate for six months and granted a variable (20 percent to 35 percent) income tax credit.
4. AB 3802 (Chapter 569, Statutes of 1978) increased, for the 1978 income year, the personal income tax credits for single taxpayers from $25 to $100, and for married couples from $50 to $200.

The administration has not spelled out how it proposes to distribute this credit. Taxpayers would receive about a 5 percent credit if it were applied across-the-board on 1987 tax liabilities. If, for example, the 1978 approach were used, single taxpayers could receive a $50 credit and married couples a $100 credit.

III. Where Does the State Now Stand Relative to Its Appropriations Limit?

In January, the Department of Finance contended that appropriations were $421 million below the limit in 1986-87. Since then it has made three adjustments to these figures:

1. Raised the limit by $158 million as a result of technical changes;
2. Reduced appropriations subject to the limit by $17 million as a result of technical changes; and
3. Reduced the amount of state appropriations subject to this limit by $400 million as a result of proposed legislation. This bookkeeping change (which would not affect the programmatic distribution of

funds) would shift a portion of state appropriations for schools from the state to the local limits, where there is unused appropriation authority.

According to the department, the combination of the original estimate of unused appropriation authority (i.e., $421 million), plus these three adjustments, allows the state to appropriate $996 million of the $1.7 billion in new revenues recognized in the May Revision. These new appropriations would consist of:

- $514 million to fund current-year spending deficiencies which were part of the May Revision;
- $474 million to build up the reserve to a billion dollar level; and
- $8 million to build up the Disaster Account.

The remaining portion (i.e., $702 million) of the current-year revenue increase, the administration contends, must be returned to the taxpayers.

While a rebate is a legitimate option for dealing with the increased revenues, it is not the only option. Two other options, which are equally consistent with the Constitution's language and intent, include:

- ***Subventions.*** The state could subvene additional funds to local governments which have unused appropriations authority. These state funds then would be subject to the appropriations limit at the local level. New state subventions could be grants for specific purposes, as long as the appropriation language specified that the grant was a subvention for purposes of Article XIII-B of the state's Constitution. In the aggregate, cities, counties, K-12 schools and community college districts are reported to have approximately $2 billion worth of unused appropriations authority. (This amount is before making any adjustment for the administration's $400 million shift in school appropriations limits.) Not all local agencies could accept funding from new state subventions, without approval of their voters, because they already are at their local appropriations limits.
- ***Revenue Transfers.*** This option involves passage of legislation to reallocate revenues between the state and cities and counties. In essence, the state could require that city and county receipts from vehicle code fines and forfeitures be deposited instead in the state General Fund, while providing a state subvention to offset the total revenue loss. In this way, the state could trade tax revenues subject to

the limit for non-tax revenues which are not subject to the limit.

Unless one or a combination of options is adopted before June 30, 1987, the state will have no alternative but to turn back a large portion of the $1.7 billion in additional current-year revenues to the taxpayers.

Our estimates of the calculations of the limit and the allowable appropriations differ from those of the Department of Finance. The main point of contention remains Finance's exclusion of over $600 million in appropriations on the basis that they are "court mandates." On the basis of opinions issued by Legislative Counsel, these appropriations are included in our calculations. Our review indicates that $1.3 billion, rather than $700 million, would have to be returned to the taxpayers in the current year under the administration's proposal. Without any law change to shift the school appropriation limit to the state, all $1.7 billion would have to be returned.

In 1987-88, Finance contends that revenues will exceed allowable appropriations by $170 million. This estimate assumes the adoption of the school appropriation shift in the current year. Our calculations, on the other hand, indicate that the department's estimates of revenues will exceed the limit by $800 million in the budget year, even with the school appropriation shift.

Conclusion

If I leave you with only one message today, it concerns the *timing* of your decision on the state's compliance with its appropriations limit.

Whether you favor a tax credit or another option that is consistent with the requirements of the Constitution, you must take action by June 30. In the absence of legislation by that date, the administration's proposed tax credit would grow from $700 million to $1.1 billion. Similarly, the administration's expenditure proposals for 1987-88 would be overstated by $400 million. ❖