The 1989-90 Budget Dilemma: Initial Comments

Statement to the Senate Committee on Budget and Fiscal Review

Office of the Legislative Analyst

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Senator Alquist and Members:

You have asked us to comment on the Governor's 1989-90 budget, which was released last week. Our comments today reflect our initial observations about the budget. In part, this is because much of the information in major areas became available to us just last week. We are also finding that the justification and supporting detail for many of the proposals are still in various stages of development. The long and short of our initial review is that you will have your hands full in crafting a budget that reflects *legislative* priorities. This is because:

- You cannot maintain current service levels and meet the requirements of existing law with the amount of revenues estimated to be available in the budget year.
- The interaction of the appropriations limit, funding of Proposition 98, statutory COLAs and the restoration of a reserve leave you limited options for balancing the state budget.
- The Governor's Budget is dependent on the adoption of six pieces of legislation, four of which are in the health and welfare area. Absent passage of these bills, the Governor has indicated that he will cut current services in specified areas.

Our preliminary comments on the Governor's Budget can be divided into three parts:

First, we examine the funding pressures faced by the Governor and the Director of Finance when they put this budget together.

Second, we summarize the major funding decisions made in preparing this budget.

Finally, we discuss some of our concerns with the spending proposals which have been submitted to you.

I. Problems in Crafting a 1989-90 Budget

The task of preparing a state budget is never easy. This year, the problems faced by the Department of Finance were more formidable than usual. Increased funding demands to maintain existing state programs and to restore the reserve totaled over $4.5 billion. The growth in available revenues, however, was less than $2.9 billion. As a result, there was an initial funding gap of $1.6 billion facing the budget preparers.

The increased funding demands are in four separate categories.

1. ***Workload and COLAs, $2.4 billion.***

   To maintain the "existing level of services" requires funding for workload ($1.3 billion) and COLAs ($1.1 billion). The latter includes both statutory ($935 million) and discretionary adjustments ($188 million), except for salary increases which we have treated separately. These are rough estimates, but they indicate the general magnitude of these two fundamental parts of the state budget.

2. ***Escalated costs of current-year commitments, $0.7 billion.***

   Several decisions were made during the current fiscal year which have escalated cost implications in the budget year. For example, the current-year cost of the Trial Court Funding Act is $205 million, but the budget-year cost is almost double this amount at $409 million. Salary increases for state employees were granted in the current fiscal year, but their effective date was postponed until June 1, 1989, which is the last month of the fiscal year. The General Fund costs of these increases will be only $27 million in 1988-89, but $324 million in 1989-90. The administration also signed multi-year collective bargaining contracts with many of the state employee unions. As a result of these actions, the administration has added $166 million for midyear (January 1990) employee and higher education salary increases. In total, these three commitments account for almost $0.7 billion of budget-year cost increases.

3. ***Increased budget-year cost of Proposition 98, $0.3 billion.***

   Last November the voters approved Proposition 98, which provides more funding for K-14 schools. As you recall from last week's hearing, the Department of Finance estimates the additional current-year cost of this measure at $116 million, and the additional budget-year cost--after workload and statutory COLA adjustments--$405 million.

4. ***Restoration of the General Fund reserve, $1.1 billion.***

   The Department of Finance estimates that the state's "uncommitted reserve" will be only $3 million at the end of the current fiscal year. It would take $1.1 billion to have a reserve equal to 3 percent of the General Fund expenditure level proposed in the budget.

The Department of Finance estimates that General Fund revenues will grow by $2,875 million, or 8 percent, in 1989-90. This revenue growth will not cover all of the funding demands mentioned previously. This is the dilemma that you face.

II. Decisions Made by the Governor in Preparing the 1989-90 Budget

At this point, we will examine how the administration allocated its resources to "balance this budget."

Table 1 shows that revenues are expected to grow by $2.9 billion in 1989-90. Expenditures, by contrast, will increase by less than $2.1 billion. The remainder of the revenues will be used to restore the reserve.

Table 1

An Overview of the General Fund Budget[a]
(dollars in millions)

	Revenues		Expenditures		
Fiscal Year	Amount	Growth From Prior Year	Amount	Growth From Prior Year	Rev. vs Expd.
1987-88	$32,534		$33,021		-$487
1988-89	36,002	+$3,468	35,922	+$2,901	+80
1989-90	38,877	+2,875	38,010	+2,088	+867

[a] These are Department of Finance estimates, which include the GAAP accounting changes which we will discuss later.

A discussion of the decisions made by the administration on this budget follows:

1. ***Proposition 98.*** Based on Department of Finance estimates, both the current-year and budget-year costs are fully funded.

2. ***Current-year commitments.*** The budget also fully funds the increases in trial court funding and the full-year effect of this year's salary increase costs. It also funds next year's salary increases.

3. ***Reserve.*** The General Fund's *uncommitted* reserve for contingencies and emergencies is *not* restored to the $1.1 billion level. *Based on Department of Finance figures,* this reserve will be $870 million, or about $230 million less than the 3 percent goal.

4. ***COLAs.*** Statutory COLAs would amount to about $935 million in the budget year. They are primarily in the education, health and welfare areas. The Governor's Budget funds the education COLAs (total funding was governed by Proposition 98), but law changes are proposed to suspend for one year the AFDC ($104 million), SSI/SSP ($138 million), and certain health COLAs ($30 million). These suspended COLAs amount to $272 million, or 29 percent of the total. The budget also states that if the Legislature does not concur with the suspension of these COLAs and other administration proposed reductions, then cuts will have to be made in certain local health and welfare programs.

5. ***Workload.*** For the programs included in the budget, our initial review indicates that most of the major workload increases are funded. For example, AFDC costs grow by $168 million. Most of this increase is attributable to higher foster care costs. K-12 education workload increases by $381 million. There also are substantial increases in corrections and higher education funding. The budget, however, continues the practice of requiring most departments to absorb the costs of merit salary adjustments (MSAs) and inflationary costs on operating expenses such as rent and utilities.

6. ***Program changes.*** The budget proposes a series of program changes which are designed to offset part of these workload increases. Some of these major changes are:

- ***In-Home Supportive Services (IHSS), -$64 million.***

  The state would impose limits on the reimbursement rates for providers and the hours of service clients receive in order to freeze the state's costs at the prior Budget Act level.

- ***Higher education fees, -$38 million.***

  Under existing formulas, resident fees for UC students would increase by 3 percent in the budget year. The budget, however, proposes fee increases of 10 percent for residents, and 17 percent for nonresidents. CSU will also have resident fee increases of 10 percent, but its nonresident fees will be increased by 21 percent. In total, these fee increases will offset state funding by $20 million at UC, and $18 million at CSU.

- ***UC pension costs, -$68 million.***

  The state provides the funding for the employer's share of these costs. The budget proposes to waive this funding in 1989-90, and instead have the state repay this obligation over a 30-year period.

- ***State teachers' retirement costs, -$164 million.***

  Currently the state funds, on a pay-as-you-go basis, a program to protect the purchasing power of retired teachers. The administration proposes: (1) to suspend the state payments for this program in 1989-90, thus avoiding a state cost of $164 million, (2) have the Teachers' Retirement Fund bear this cost in the budget year, and (3) adopt legislation which guarantees this benefit to *existing* and *future* retirees. The state would phase in, over a nine-year period, the funding for this new program which would cost the state about $450 million annually (in today's dollars) when fully implemented.

- ***Medically Indigent Program, -$360 million.***

  Last November the voters approved Proposition 99 which raised cigarette and tobacco taxes. This measure specifically stated that these revenues should be used to *supplement* rather than supplant funding for existing programs. The budget proposes to reduce medically indigent funding by $360 million, and creates a new program entitled California Healthcare for Indigents (CHIP) to expend $331 million from these Proposition 99 taxes in the budget year.

- ***Delaying the opening of CYA and correctional facilities, -$39 million.***

  As part of its budget balancing program, the administration is delaying the opening of two correctional facilities (Pelican Bay and Madera) to save $33 million, and delaying the activation of youth authority facilities to save $6 million.

- ***Medi-Cal, -$103 million.***

  The administration proposes to achieve $103 million in Medi-Cal savings by delaying a checkwrite ($40 million), adopting a new drug cost containment program ($40 million), and instituting new procedures on Medicare crossover claims ($23 million).

- ***Eliminate the Family Planning Program, -$36 million.***

  As a part of its legislative program, the administration is proposing to eliminate this program.

- ***Reduce General Fund support for local juvenile justice programs, -$67 million.***

  The administration proposes a one-time General Fund savings by shifting the cost ($30 million) of a local juvenile assistance program to the Restitution Fund. It also proposes to reduce the block grant funding ($37 million) of another juvenile program.

- ***Repeal various mandates, -$42 million.***

  There are 27 mandates which the administration proposes to repeal. They cover a wide range of subjects, from funding absentee ballots to missing persons' reports. The budget states that if the Legislature does not repeal these mandates, then other programs providing aid to counties would have to be reduced.

This is not a complete list of all of the administration's program reduction proposals. However, it does cover the major ones, and these 10 proposals would reduce General Fund costs by $981 million in the budget year.

III. Major Concerns We Have With This Budget

At this point, I would like to share with you some of the concerns that pose significant challenges for the Legislature which we have uncovered in analyzing this budget. Our discussion will focus on those issues where the policy or fiscal implications may not be readily apparent.

1. The Budget's Portrayal of the State's Fiscal Condition.

Table 2 presents the estimates of the General Fund condition as shown in the Governor's Budget. These estimates indicate that the General Fund is expected to complete 1987-88 and 1988-89 with a small amount in the Special Fund for Economic Uncertainties, and to finish the budget year with $870 million in this reserve.

Table 2

General Fund Condition -- Including DOF Accounting Changes
1987-88 through 1989-90[a,b]
(dollars in millions)

	Actual 1987-88	*Estimated 1988-89*	*Proposed 1989-90*
Prior-year resources	$662	$175	$254
Revenues and transfers	32,534	36,002	38,877
Expenditures	33,021	35,922	38,010
General Fund balance	$175	$254	$1,121
Reserves[c]	($171)	($251)	($251)
Special Fund for Economic Uncertainties	4	3	870
Deficit	--	--	--

[a] Source: Governor's Budget.
[b] Detail may not add to totals due to rounding.
[c] Includes reserve for liquidation of encumbrances.

Estimates Overstate True General Fund Condition. Our review of the figures in the budget indicate that they overstate the true condition of the General Fund for all three years. Included in the administration's estimates are the effect of two changes in the state's traditional method of accounting. The administration contends that these changes will eliminate the deficit that the Controller reported for the 1987-88 fiscal year, and the deficit that, at this point, appears likely to occur in the current fiscal year. Let me be more specific.

First, the budget indicates that the administration is taking another step towards conforming the state's books to what is known as "Generally Accepted Accounting Principles (GAAP)." In essence, this step requires that we change how accounts payable are treated. The effect of this change is that some transactions which are now treated as expenditures, thereby reducing the surplus, will instead be treated as "reserves." This change gives you a higher fund balance than you would have under traditional accounting practices.

Second, the budget does not set aside any funds to cover the cost of appropriations which have been made but not yet spent. The state's financial statements have traditionally included such a provision, in order to give a reliable view of the amount of funds which are on hand and available to be appropriated by the Legislature.

Table 3 presents estimates of the General Fund's condition prepared on the traditional basis. It shows that the General Fund had a negative fund balance of -$85 million for 1987-88. This ties to the figure reported by the Controller in November after the inclusion of certain corrections. In addition, provision is made for $117 million worth of appropriations that we consider still likely to be spent. On this basis, there is a total "deficit" of over $200 million in 1987-88.

For 1988-89, the -$85 million fund balance is carried over from 1987-88. Reversing the effect of the GAAP-related accounting change results in an expenditure figure that is $80 million higher than indicated by the department. This corresponds to the savings that the administration asserts it will generate by forcing state agencies to cancel contracts and purchase orders issued in 1987-88. On this basis, the state again ends the year with an $85 million negative fund balance. Making provision for the $117 million in outstanding appropriations, leaves a deficit of over $200 million for the current year on a traditional accounting basis.

Table 3

General Fund Condition -- Traditional Basis 1987-88 through 1989-90[a,b]

(dollars in millions)

	Actual 1987-88	*Estimated 1988-89*	*Proposed 1989-90*
Prior-year resources	$662	-$85	-$85
Revenues and transfers	32,534	36,002	38,877
Expenditures	33,280	36,002	38,010
General Fund balance	-$85	-$85	$782
Reserves[c]	($117)	($117)	($117)
Special Fund for Economic Uncertainties	--	--	(665)
Deficit	$202	$202	--

[a] Source: LAO estimates based on prior-year data from the State Controller and the Governor's Budget.
[b] Detail may not add to totals due to rounding.
[c] Includes outstanding expenditure authorizations.

You should note that, even if the administration actually saves the $80 million it is counting on, the state will still end the current year with a deficit on the books of over $100 million unless there are other offsetting savings of equal magnitude. It would then take increased revenue collections of about $125 million--almost all the room you have left within the appropriations limit--to erase the current-year deficit.

The Savings Are Questionable. Our analysis indicates that it is not likely the administration can actually obtain the full $80 million it proposes to save by cancelling contracts. This is because indications are that much of the money accrued for these contracts has already been paid out, and because many of these committments will be difficult to eliminate. The administration contends that no additional corrective action is necessary to avert an additional deficit for the current fiscal year.

Budget-Year Reserve Less Than 3 Percent. In its discussion of the Special Fund for Economic Uncertainties, the budget states "the Administration believes that a reserve of less than $1.1 billion is simply not prudent." As shown in Table 3, our figures indicate that the reserve will be only $665 million, whereas the administration's estimate is $870 million. The difference again primarily reflects the $80 million savings from cancelled contracts assumed by the administration, and the $117 million we calculate is needed for the outstanding appropriations. In either case, the reserve does not meet the administration's goal.

2. Proposition 99 Funds for Indigent Care: Supplementary or Supplanting?

The Medically Indigent Services Program (MISP) is a General Fund-supported activity which provides block grants to counties to help them fund indigent medical care costs. The budget proposes to reduce General Fund support for this program by $360 million in the budget year. These funds would be "replaced" by $331 million in new Proposition 99 funds, and by a $108 million increase in federal State Legalization Impact Assistance Grant (SLIAG) funds.

We have the following concerns with this proposal:

1. Proposition 99 specifically stated that its new revenues should be used to supplement, not supplant, existing funding. The shifting of funding from MISP to the new California Healthcare for Indigents (CHIP) program raises the question of whether it meets this legal intent.

2. SLIAG and Proposition 99 funds are inappropriate *long-term* funding sources for county medical indigent costs. The former will expire in a few years, and cigarette and tobacco tax revenues are a declining revenue source that cannot support the ongoing costs of this type of program.

3. The budget is probably overly optimistic on the amount of SLIAG funds that California will receive, and on the amount of these funds the counties will be able to claim, especially in light of the funding proposed in the new federal budget.

3. Short-term Savings versus Long-Term Costs of the Governor's Teachers' Retirement Proposal.

Employer retirement rates would have to be increased by about 50 percent in order to fund the Governor's teachers' retirement proposal. Currently, the state has a pay-as-you-go system to maintain the purchasing power of retired teachers. The budget proposes to achieve a *short-term cost reduction* by having the state avoid its 1989-90 costs (i.e., $164 million). Instead, those costs would be funded out of the Teachers' Retirement Fund.

The budget proposes a law change which would *guarantee* these COLAs to all retired teachers, both current and future retirees. The cost of the new program would be phased in over a nine-year period, by having employer contribution rates increased a half of a percent per year. At the end of the phase-in period, *employer* retirement contribution rates would be about 50 percent higher than currently, and the annual cost to the state in *1989 dollars* would be about $450 million.

We have two main concerns with this proposal:

First, it creates a new "vested right" which the *state* would be obligated to maintain in the future. This approach appears to run contrary to the Governor's other recommendations which would eliminate statutory COLAs and other restrictions which obligate budgetary expenditures. Moreover, unlike statutory COLAs which can be changed by the Legislature, this benefit would be guaranteed in perpetuity.

Second, this is a very expensive proposal, and no justification has been submitted to the Legislature to date which would justify the long-term phase-in of these costs. The Teachers' Retirement Fund has an unfunded liability of over $10 billion because prior costs were not funded on a timely basis.

4. Decline in Resources Available to Fund State Capital Outlay Projects.

Tidelands oil revenues have been a very important source of funding for state capital outlay projects. Three years ago (in 1985-86), the state received over $426 million in these revenues. The budget estimates that these revenues will total only $50 million in 1989-90, and most of these funds will be needed to cover a shortfall in current-year funding.

The absence of tidelands revenues means that the state's capital outlay needs now are dependent upon bond proceeds or special funds. Over 60 percent of higher education capital outlay will be financed by "revenue bonds," (which will be paid off by the General Fund in future years) while the remainder will be funded from General Obligation bonds. The budget proposes to fund $18 million of Department of Mental Health capital outlay projects from Proposition 99 funds.

Moreover, there is a funding backlog of over $100 million for the planning and construction of state buildings which have previously been approved by the Legislature. No source of funding to meet these requirements is readily available.

The fiscal restraints applied to the rest of the budget leave very little flexibility to address future capital outlay needs.

5. State's Highway Funding in Jeopardy.

The budget document acknowledges that the state highway program has a $666 million funding shortfall in 1989-90. It proposes to bridge this funding gap by:

- Making one-time transfers of $166 million from other funds.
- Changing the accounting system to achieve one-time savings of $70 million.
- Deferring construction of $600 million in highway projects to achieve $360 million of savings in cash outlays in the budget year.
- Reducing highway maintenance by $74 million and other support activities by $43 million.

These are essentially stop-gap measures. Even if they were all adopted, the State Highway Account would run out of cash in mid-1990-91. In the absence of new revenues, the Legislature will have to make further, substantial cuts in the state transportation program in 1990-91.

This budget does not address long-term highway funding issues. This is our main concern. Stop-gap measures simply will not solve the funding problem which is becoming more critical each year.

6. Higher Revenues Will Not Solve Budgetary Problems Because of Gann Limit.

The Department of Finance estimates that there is only $128 million of unused state appropriations authority in 1989-90. As a result, an upward revision in revenue estimates, or the adoption of new tax sources, will not solve the state's budget dilemma. The Legislature's ability to reverse the aggregate effect of some of the administration's spending reductions or funding shifts is restricted by this limit. For example, if the Legislature cut back on trial court funding, a corresponding reduction in the state's appropriations limit would be necessary.

Conclusion

Let me conclude by saying that, as difficult as this budget is, all indications are that next year's budget will be even worse. Frankly, the state does have a structural problem in its budget--existing revenues cannot sustain current service levels under existing constitutional limits. You are faced with the choice of doing less than the state is doing now (as the Governor proposes in many areas in the budget year) or altering these limits to meet a program level that can accommodate more of the demands being placed on the state by its citizens.

I recommend that you look beyond this year's budget deliberations--which may of necessity require some short-term solutions--and initiate plans for accommodating the state's future economic growth. As we reported to you last month in our report *A Perspective on the California Economy*, California's future economic growth and quality of life are dependent on how a number of key problem areas and policy issues are addressed.