CALIFORNIA LEGISLATURE

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1977, to June 30, 1978

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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A. ALAN POST
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LETTER OF TRANSMITTAL

925 L Street, Suite 650
Sacramento, California 95814
February 14, 1977

THE HONORABLE DENNIS E. CARPENTER, *Chairman*
and Members of the Joint Legislative Budget Committee
State Capitol, Sacramento

Gentlemen:

In accordance with the provisions of Government Code, Sections 9140–9143, and Joint Rule No. 37 of the Senate and Assembly creating the Joint Legislative Budget Committee, defining its duties and providing authority to employ a Legislative Analyst, I submit an analysis of the Budget Bill of the State of California for the fiscal year July 1, 1977, to June 30, 1978.

The duty of the committee in this respect is set forth in Joint Rule No. 37 as follows:

> "It shall be the duty of the committee to ascertain facts and make recommendations to the Legislature and to the houses thereof concerning the state budget, the revenues and expenditures of the state, and of the organization and functions of the state, its departments, subdivisions and agencies, with a view of reducing the cost of the state government, and securing greater efficiency and economy."

I should like to express my gratitude to the staff of the Department of Finance and the other agencies of state government for their generous assistance in furnishing information necessary for this report.

Respectfully submitted,

A. ALAN POST
Legislative Analyst

BUDGET OVERVIEW

The Governor is proposing what is essentially a workload budget for 1977–78. Overall state expenditures at $14.3 billion are up $981 million or 7.4 percent from 1976–77. However, the Governor added to this proposal nearly $900 million in reserves for new programs—the details to be defined later—for school financing, property tax relief and other purposes. Including these reserves the increase would be $1,878 million or 13.1 percent.

In this Analysis of the Budget Bill, we have carefully examined each program indicating all areas in which we think appropriate reductions can be made. Conversely, we have recommended augmentations or policy review in certain programs where we believe the objectives presented in the budget are below or differ from those intended by the Legislature. We have also recommended increases where we believe the impact of inflation or workload elements are not sufficiently recognized in the budget.

The recommendations are not tailored to achieve any specific budget amount, but will effectively reduce many program expenditure levels and still, we believe, maintain levels of service required to achieve the basic objectives of the proposed budget.

The most significant feature of this budget is the magnitude of the projected surplus which in turn, reflects the economic assumptions underlying the proposed budget.

Economic Assumptions

In general, the economic forecasts for 1977 prepared by the Department of Finance are reasonable and compare favorably with the consensus of other economic forecasts we have reviewed. As noted in the budget document, the department views 1977 as a year of continued, though modest, economic recovery and growth. For the nation, the department estimates real growth at 5 percent, inflation at between 5 and 6 percent, and unemployment at 7 percent or less. For California, the forecast is for an unemployment rate of over 8 percent. On the other hand, healthy gains are anticipated for personal income, employment, consumer spending and residential construction. The continuing drought, however, creates some uncertainty and could influence farm income and food prices. Full economic implications are as yet unknown.

Revenue

The Department of Finance translates these economic assumptions into estimated General Fund revenues of $11 billion for the current year. This is, significantly, about $350 million above the estimate made last May.

Total income (including General Fund and special funds) for the budget year is estimated at $14.4 billion, an increase of 11.2 percent over 1976–77. General Fund income is forecast at $12.4 billion, up 12.6 percent over the current year. A detailed discussion of the economic assumptions and the revenue picture is presented later in this overview.

Expenditures

The budget proposes a combined 1977-78 expenditure program of $22,547 million. This is comprised of $11,855 million from the General Fund, $2,056 million from special funds, $388 million from bond funds, and $8,248 million in federal funds expended or subvened by the state.

Title II of the federal Public Works Employment Act of 1976 provides funds to state and local government to stimulate economic recovery. The Governor's Budget estimates that the State of California will receive a total of $50 million under this program; $20 million in the current year and $30 million in the budget year. Federal law stipulates that funds are to be used "for the maintenance of basic services customarily provided . . .". A detailed discussion of this program is contained in the analysis of the Employment Development Department (Item 257).

Table 1 presents a combined expenditure summary by funding source. Table 2 summarizes General Fund expenditures for state operations, capital outlay, and local assistance and Table 3 provides the same information for special fund expenditures.

Chart I shows estimated 1977-78 state revenues by source and state expenditures (excluding bond funds) by program.

Chart II shows the comparative magnitude of the various General Fund revenue sources and the distribution of these funds through the budget to the major program categories in 1977-78.

Table 1
State of California
Combined Expenditure Summary for Indicated Years

	1975-76	*1976-77*	*1977-78*
General Fund	$9,518,436,279	$10,889,681,293	$11,854,944,861
Special funds	1,678,832,232	2,023,042,938	2,056,377,647
State Budget Expenditures	$11,197,268,511	$12,912,724,231	$13,911,322,508
Bond funds	255,185,398	404,815,752	387,604,602
Overall state expenditures	$11,452,453,909	$13,317,539,983	$14,298,927,110
Expenditure of federal funds [a]	7,617,638,789	8,116,271,945	8,247,787,667
Combined Total Expenditures	$19,070,092,698	$21,433,811,928	$22,546,714,777

[a] Includes grants-in-aid, reimbursements and special projects.

Table 2
General Fund Budget Expenditures and Yearly Increases
(Millions)

	Actual 1975–76	*Estimated 1976–77*	*Change from 1975–76 Amount*	*Change from 1975–76 Percent*	*Proposed 1977–78*	*Change from 1976–77 Amount*	*Change from 1976–77 Percent*
State operations	$2,321.7	$2,651.8	$330.1	14.2%	$2,903.7	$251.9	9.5%
Capital outlay	21.5	100.1	78.6	365.6	132.6	32.5	32.5
Local Assistance	7,175.2	8,137.8	962.6	13.4	8,818.6	680.8	8.4
Totals	$9,518.4	$10,889.7	$1,371.3	14.4%	$11,854.9	$965.2	8.9%

Table 3
Special Fund Budget Expenditures and Yearly Increases
(Millions)

	Actual 1975–76	*Estimated 1976–77*	*Change from 1975–76 Amount*	*Change from 1975–76 Percent*	*Proposed 1977–78*	*Change from 1976–77 Amount*	*Change from 1976–77 Percent*
State operations	$631.9	$733.9	$102.0	16.1%	$783.7	$49.8	6.8%
Capital outlay	205.4	319.2	113.8	55.4	302.8	−16.4	−5.1
Local assistance	841.5	969.9	128.4	15.3	969.9	0.0	0.0
Totals	$1,678.8	$2,023.0	$344.2	20.5%	$2,056.4	$33.4	1.7%

Surplus

The budget document anticipates a General Fund unrestricted surplus of around $890 million in the current year. As shown in Table 4, this is expected to grow to $1,465 million by June 30, 1978. The addition of federal revenue sharing and tidelands oil money in the Capital Outlay Fund for Public Higher Education will provide an estimated total budget year surplus of almost $1,792 million.

CHART I

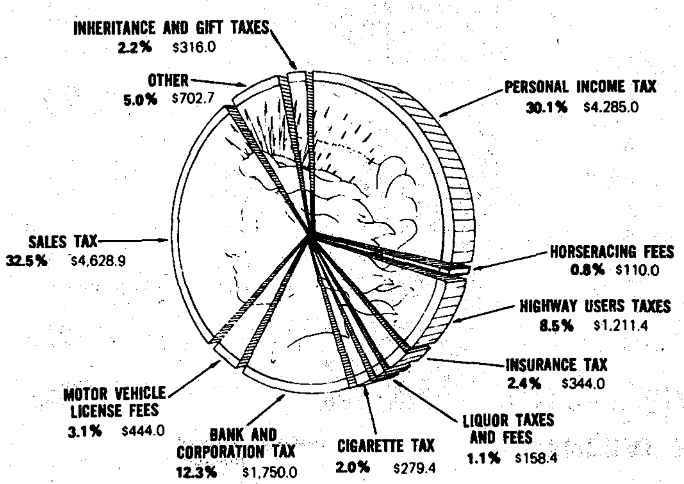
STATE BUDGET PICTURE

1977–78 FISCAL YEAR

(Dollars in Millions)

TOTAL REVENUES

$14,229.8	100.0%
215.3	(Transfers)
$14,445.1	(Total Income)



TOTAL EXPENDITURES

$13,911.3 100.0%

(Excluding Selected Bond Funds)

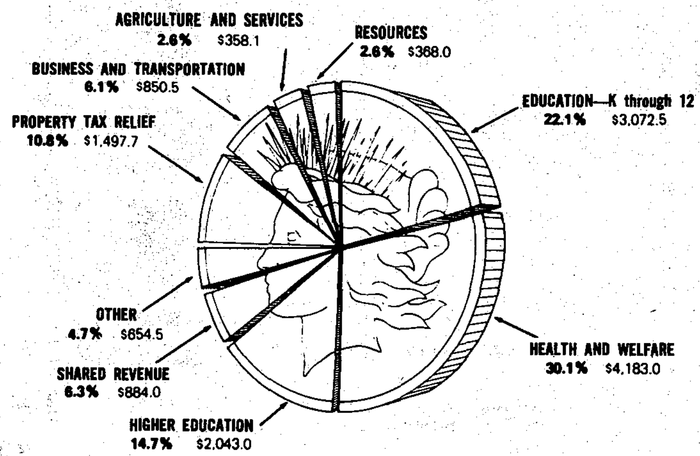
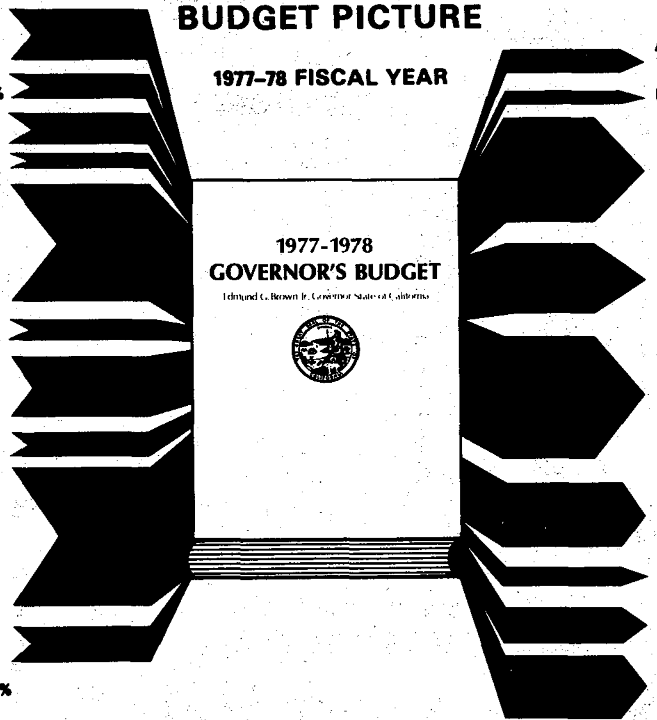


CHART II

GENERAL FUND

BUDGET PICTURE

1977–78 FISCAL YEAR



RESOURCES

	Amount (Millions)	Percent
Prior year Resources	$ (940.1)	(–)
Inher. & Gift Tax	316.0	2.6%
Insurance Tax	344.0	2.8
Horseracing	96.8	0.8
Personal Income Tax	4,285.0	35.2
Liquor Taxes and Fees	143.1	1.2
Bank and Corporation Tax	1,750.0	14.4
Cigarette Tax	195.6	1.6
Sales Tax	4,610.0	37.[illegible]
Other	440.5	3.6
Revenues	$12,181.0	100.0%
Federal Revenue Sharing, etc., Transfers	215.3	
Income	$12,396.3	

OUTGO

	Amount (Millions)	Percent
Agriculture and Services	$290.1	2.5%
Business and Transportation	35.7	0.3
Education K–12	3,037.1	25.6
Higher Education	1,973.6	16.7
Health and Welfare	4,176.0	35.2
Property Tax Relief	1,497.7	12.6
Resources	265.0	2.2
Other	579.7	4.9
Year-end Resources [a]	(1,490.4)	(–)
Expenditures	$11,864.9	100.0%

[a] Excludes $277.5 million available from Federal Revenue Sharing Fund.

Table 4
General Fund Surplus, Revenue Sharing and Tidelands Oil Revenues Available

	Amounts in Millions	
	1976–77	*1977–78*
Prior-year resources available	$808.8	$940.1
(Unrestricted surplus, prior year)	(731.8)	(890.4)
Income (adjusted to exclude special accounts)	10,986.2	12,357.0
Total Available	$11,795.0	$13,297.1
Expenditures (adjusted to exclude special accounts)	$10,854.9	$11,822.3
Carryover reserves	−49.7	−9.4
Current surplus (adjusted to exclude expenditures from carryover reserves)	(158.5)	(575.0)
Year-end General Fund Unrestricted Surplus	$890.4	$1,465.4
Other Funds Available:		
Federal Revenue Sharing balances available	$242.0	$277.5
Tidelands oil money in Capital Outlay Fund for Public Higher Education	78.6	49.0
Total Available Year-end	$1,211.0	$1,791.9

Reserves

As shown in Table 5, the Governor proposes to reserve almost $897 million of the surplus as follows:

Table 5
Governor's Proposed Reservations of 1977–78 General Fund Surplus

	Amounts in Millions
1. Homeowners' Property Tax Relief, Serrano Court Decision, and Senior Citizens' Renter Relief	$700.0
2. Prison Facilities for Additional 2,400 Inmates in Southern California	94.2
3. Reserve for Pending Court Cases	102.4
Total Proposed Reservations	$896.6
Total Funds Available	$1,791.9
Total Amount Available After Reservations	$895.3
General Fund Portion	(568.8)
Federal Revenue Sharing	(277.5)
Tidelands Oil Money in COFPHE	(49.0)

1. $700 million for Homeowners' Property Tax Relief, Serrano/school finance, and Senior Citizens' Renter Relief.

Many of the details of these plans have yet to be spelled out. Therefore, it is not possible to discuss specifics at this time. It is recommended, however, that in dealing with these major issues of property tax relief and school finance a comprehensive approach be followed which considers such factors as total tax burden, benefits and inequities of the present relief programs, the long-term funding capability of the revenue system, alternative revenue sources, and the state, local and federal distribution of funding and administrative responsibilities for all programs supported by the property tax.

It is important to note that since 1972–73, state expenditures for property tax relief and schools have increased by over $2 billion, but we are still confronted by fundamental issues such as equalization in terms of the Serrano decision. Along the way we have applied some expensive band-aids to both programs. It would seem that with this surplus we now have the opportunity and obligation to follow a comprehensive approach in seeking a long-term cure.

2. $94.2 million for new prison facilities.

The need for this amount is not clearly delineated in the budget. Moreover, we will not know the facility needs of the Department of Corrections until March when a departmental report will be completed. In any case, the time lag from preliminary budgeting to opening a new prison would be about five years. Therefore, the $94.2 million earmarked in the budget cannot be spent by the end of 1977–78. But it could be appropriated for the number of years covering the planning and construction period for the project. We believe the Legislature should have the policy for new prison programs and capacity well established before it commits itself to the appropriation of this amount.

3. $102.4 million for pending court cases.

The budget contains no backup information on this amount. The Legislature will have to be informed in some manner of the basis for the reservation.

Future Impact of Governor's Proposal

Our preliminary analysis of the Governor's Budget indicates that normal workload increases and a property tax relief/school finance program of the amount proposed in the budget can be funded within existing resources for the next two or three years if no other major expenditure programs are added. This conclusion, however, is based on preliminary data, and it will be impossible to determine the actual future costs until details of the proposal are spelled out completely.

Trends in General Fund Expenditures

General Fund expenditures are proposed to increase by about 8.9 percent or just under $1 billion in the budget year. If the reserves are included, the increase is 17.1 percent. The average increase during the past 10 years has been about 14 percent, as shown in Table 6.

Table 6
Growth in General Fund Expenditures From 1967–68 to 1976–77 (In millions)

Fiscal Year	*General Fund Expenditures*	*Percentage Change*
1967–68	$3,272.8	+ 8.5%
1968–69	3,908.8	+19.4
1969–70	4,456.1	+14.0
1970–71	4,853.9	+ 8.9
1971–72	5,027.3	+ 3.6
1972–73	5,615.7	+11.7
1973–74	7,299.4	+30.0
1974–75	8,348.6	+14.4
1975–76	9,518.4	+14.0
1976–77	10,889.7	+14.4

MAJOR GENERAL FUND PROGRAM ELEMENTS

This summary presents a brief overview of major expenditure programs such as health, education, benefit payments and property tax relief. These major programs comprise 87.3 percent of the $11,854.9 million in General Fund expenditures proposed for 1977–78.

Detailed information on each of the programs can be obtained by referring to the appropriate budget item in the following sections of this Analysis.

Table 7 indicates the major program changes in General Fund expenditures.

Table 7

1977–78 Selected General Fund Budget Program Changes From 1976–77 Expenditure Level (In Millions)

	Amount of Change	*Percent of Change*
Major Program Increases:		
Health (excluding Medi-Cal)	$143.7	18.8%
Medi-Cal	170.7	15.7
Benefit Payments	131.9	9.3
K–12 Education (total education) [a]	87.7	3.0
University of California	19.0	2.8
California State University and Colleges	25.3	4.1
California Community Colleges—apportionments	38.9	7.8
Property Tax Relief [a]	130.5	9.5
Capital Outlay [a]	32.2	32.1
Major Program Decrease:		
Employee Compensation	−55.4	−35.7

[a] Does not include amounts reserved by Governor.

Department of Health

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
Total Health	$1,853,482,560	$2,167,904,587	$314,422,027	17.0%
Medi-Cal	1,090,435,691	1,261,111,300 [a]	170,675,609	15.7
Other Health Services	763,046,869	906,793,287	143,746,418	18.8

[a] Includes $56.8 million for hospital cost containment lawsuit.

General Fund expenditures for the Department of Health are proposed at $2,167.9 million. This is an increase of $314.4 million or 17.0 percent over the current year. The largest part of this increase is in the Medi-Cal program.

California Medical Assistance Program (Medi-Cal)

The Governor's Budget proposes a General Fund expenditure of $1,-261.1 million for the Medi-Cal program. This represents an increase of $170.7 million or 15.7 percent over 1976–77. Significant increases include $56.8 million for the hospital cost containment lawsuit and $118.7 million for the medical services portion of the Medi-Cal program. Increases in the medical assistance program are due to higher use and utilization of services and the continued costs of part-year rate increases granted in 1976–77 which will be fully funded during 1977–78.

The average monthly Medi-Cal caseload is projected to increase by 2.6 percent during 1977–78. However, the individual components of this increase vary from a 12.6 percent increase for medically indigent to a 0.4 percent increase in cash grant eligibles.

Medi-Cal Average Monthly Caseload

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
Cash grant eligibles	2,219,000	2,228,800	9,800	0.4%
Medically needy	246,700	275,000	28,300	11.5
Medically indigent	273,200	307,600	34,400	12.6
Total	2,738,900	2,811,400	72,500	2.6%

Other Health Services

General Fund expenditures for all other health services in the Department of Health are budgeted at $906.8 million, an increase of $143.7 million or 18.8 percent over 1976–77. Medi-Cal is excluded from this total except $49.3 million for price and provider rate increases which will be transferred to it upon order of the Department of Finance.

Significant increases in the Department of Health include $31.5 million for the Mental Disabilities program, $38.2 million for the Developmental Disabilities program and $14.3 million for the Special Social Services program.

The increase in the Mental Disabilities program is primarily due to three factors: (1) a 6.0 percent cost increase in mental health services; (2) $10 million toward equity of county allocations for local mental health programs; and (3) 88 new positions for the second increment to comply with the 1973 staffing standards.

General Fund expenditures for the Developmental Disabilities program are proposed to increase as a result of the extension of services to an additional 8,500 clients and the implementation of the second increment of the 1973 staffing standards by 499.5 positions.

The largest General Fund increase in the Special Social Services program is $18.9 million for the Homemaker/Chore program. This increase is due to raises in the minimum wage, inclusion of homemaker/chore workers in the workers' compensation program and increases in caseload and levels of service.

The average population at the state hospitals is estimated to decrease by 680 or 4.4 percent between the current year and the budget year. It is estimated that the average population at the hospitals for the mentally disabled will decrease by 400 or 7.0 percent, while the average population at hospitals for the developmentally disabled will decrease by 280 of 2.8 percent. The following summary projects the anticipated changes in average population at the state hospitals between 1976–77 and 1977–78.

Average Population at the State Hospitals

	1976–77	*1977–78*	*Decrease*	*Percent*
Hospitals for the developmentally disabled	9,914	9,634	−280	−2.8%
Hospitals for the mentally disabled	5,698	5,298	−400	−7.0
Total	15,612	14,932	−680	−4.4%

A total of 1,894.5 new positions are proposed for the Department of Health during 1977–78. This includes 1,222.4 new positions for the state hospitals of which 634.9 are for continuation of positions administratively established in the current year as the first increment of the 1973 staffing standards and for other minor position changes and 587.5 positions for implementation of the second increment of the 1973 standards. An additional 672.1 positions are for other services within the Department of Health.

Department of Benefit Payments

	Estimated 1976-77	*Proposed 1977-78*	*Increase*	*Percent*
General Fund	$1,419,584,488	$1,551,453,593	$131,869,105	9.3%

The Governor's Budget proposes a General Fund expenditure of $1,551.5 million for the Department of Benefit Payments. This is an increase of $131.9 million or 9.3 percent over the current year and is primarily attributable to increased costs for aid to families with dependent children (AFDC) and adult welfare. It is anticipated that AFDC costs will increase by $48 million as a result of annual automatic cost-of-living payments and a 6 percent increase in AFDC grants provided by the Legislature in Chapter 348, Statutes of 1976 (AB 2601). Adult welfare costs will rise by $82 million due to automatic cost-of-living increases and the liberalization of benefits provided by AB 2601.

The following shows the state's local assistance payments for various public assistance programs.

Public Assistance Program Costs (General Fund)

	Estimated 1976-77	*Projected 1977-78*	*Change*	*Percent*
Payments for children	$585,166,500	$633,294,500	$48,128,000	8.2%
Payments for adults	742,278,300	824,341,300	82,063,000	11.1
Special adult programs	6,116,300	5,609,300	−507,000	−8.3
County administration	68,772,000	70,124,800	1,352,800	2.0
Federal Programs:				
WIN child care	—	327,803	327,803	
Total	$1,402,333,100	$1,533,697,703	$131,364,603	9.4%

The following table summarizes the average monthly caseload for public assistance programs in the Department of Benefit Payments. It is estimated that the average monthly caseload will increase by 0.5 percent during 1977-78. The largest increase is in the disabled category which is projected to grow by 23,500 recipients. However, it is anticipated that the number of persons receiving aid to families with dependent children will decrease by 20,430 or 1.4 percent.

Public Assistance Caseload Estimates

Monthly Average Number of Persons Aided:	*Estimated 1976-77*	*Proposed 1977-78*	*Change*	*Percent*
AFDC	1,456,450	1,436,020	−20,430	−1.4
Aged	334,600	339,300	4,700	1.4
Blind	16,900	18,800	1,900	11.2
Disabled	341,100	364,600	23,500	6.9
Total	2,149,050	2,158,720	9,670	0.5

The average monthly number of persons receiving food stamp assistance in 1977–78 is estimated at 1,472,900. This is a decrease of 17,900 or 1.2 percent from 1976–77.

Food Stamp Caseload Estimates

	Estimated 1976–77	*Proposed 1977–78*	*Decrease*	*Percent*
Total	1,490,800	1,472,900	–17,900	–1.2

Education (K–12)

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
Apportionments [a]	$2,378,939,246	$2,420,732,688	$41,793,442	1.8%
Total education [b]	2,939,337,971	3,027,070,483	87,732,512	3.0

[a] General Fund only.

[b] Excludes debt service on school building aid bonds, but includes state contribution to Teachers' Retirement Fund.

General Fund expenditures for K–12 education for 1977–78 are projected at $3,027.1 million, an increase of $87.7 million or 3.0 percent over 1976–77. Almost one-half of this increase is in apportionment of state aid which is proposed to increase by $41.8 million or 1.8 percent over 1976–77.

These budgeted expenditures, however, do not include the $220 million proposed by the Governor for reservation to equalize school financing as required by the California Supreme Court's recent Serrano decision.

The following is a comparison of the estimated average daily attendance (ADA) by school level during 1976–77 and 1977–78:

Estimated Average Daily Attendance

	1976–77	*1977–78*	*Change*	*Percent*
Elementary	3,038,010	2,967,789	–70,221	–2.3%
High school	1,476,999	1,487,576	10,577	0.7
Adults, high school	240,097	264,136	24,039	10.0
Total	4,755,106	4,719,501	–35,605	–0.7%

It is projected that total ADA will decrease by 35,605 or 0.7 percent between 1976–77 and 1977–78. However, the individual elements of this net decrease vary from a 2.3 percent decline in elementary school students to a 10.0 percent increase in the adults, high school program.

University of California

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
General Fund Appropriation	$681,161,895	$700,192,052	$19,030,157	2.8%

General Fund expenditures (excluding salary increases) for the University of California are proposed at $700.2 million for fiscal year 1977–78. This is an increase of $19.0 million or 2.8 percent over 1976–77. Significant increases include $10.8 million for merit salary adjustments, $3.3 million to assume the instructional laboratory costs heretofore funded from the education fee, $2.0 million for instructional equipment replacement, and $461,152 to convert 1976–77 temporary faculty positions to permanent positions.

Various criteria are used to determine the appropriate level of funding for each function of the University. One such criterion is the enrollment in terms of full-time equivalents (FTE). Universitywide FTE enrollment during 1976–77 and 1977–78 is shown as follows:

Estimated Full-Time Equivalent Enrollment

	1976–77	*1977–78*	*Increase*	*Percent*
General campus	108,311	108,374	63	0.1%
Health sciences	11,148	11,660	512	4.6
Total	119,459	120,034	575	0.5%

Total full-time equivalent enrollment is projected to increase by 575 or 0.5 percent during 1977–78. This includes an increase of only 63 or 0.1 percent for the general campuses and an increase of 512 or 4.6 percent in the health sciences.

California State University and Colleges

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
General Fund	$613,088,365	$638,392,003	$25,303,638	4.1%
Enrollment (Full-time equivalents)	233,786	236,370	2,584	1.1

The Governor's Budget proposes General Fund expenditures of $638.4 million (excluding salary increases) for the California State University and Colleges. This is an increase of $25.3 million or 4.1 percent over the current year. Significant increases include $6.5 million for merit salary adjustments; $6.4 million for an increase in Public Employees' Retirement System contributions, $7.5 million for price increases, $1.1 million for library development, and $2.8 million for instructional staffing. This latter increase is the result of a shift in student demand away from courses which are relatively less expensive to teach (e.g., social sciences) to those which are more expensive because of their low student-faculty ratio (e.g., engineering, health sciences).

The budget reflects a reduction of $1.9 million from the enrollment base. Originally, FTE was estimated at 239,410 for the current year, but this has been revised to 233,786. The 1977–78 budget was originally prepared on the basis of the prior enrollment figure but now has been adjusted downward by the above amount to reflect the reduced current year FTE base.

California Community Colleges

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
Apportionments	$501,426,256	$540,305,115	$38,878,859	7.8%

The budget proposes that expenditures for California Community College apportionments be increased by $38.9 million or 7.8 percent for fiscal year 1977–78. This increase is primarily due to an increase in average daily attendance (ADA) and a 6.0 percent inflation factor.

Total ADA at the California Community Colleges is projected to increase by 30,500 or 3.8 percent during 1977–78.

Estimated Average Daily Attendance

	1976–77	*1977–78*	*Increase*	*Percent*
Total ADA	793,600	824,100	30,500	3.8%

Property Tax Relief

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
Senior Citizens' Property Tax Assistance	$52,500,000	$78,000,000	$25,500,000	48.6%
Senior Citizen Renters' Tax Assistance	—	20,000,000	20,000,000	
Personal Property Tax Relief	409,000,000	430,000,000	21,000,000	5.1
Homeowners' Property Tax Relief	760,000,000	818,000,000	58,000,000	7.6
Open Space	19,500,000	21,000,000	1,500,000	7.7
Payments to Local Governments for Sales and Property Tax Revenue Loss	5,167,000	5,686,500	519,500	10.1
Renters' Tax Relief	121,000,000	125,000,000	4,000,000	3.3
Total	$1,367,167,000	$1,497,686,500	$130,519,500	9.5%

The state's Property Tax Relief program provides reduced property taxes to homeowners, personal property owners (business inventories), senior citizen homeowners, senior citizen renters and other renters. The subvention for open space and payments to local governments for sales and property tax revenue losses are also included as a category of property tax relief.

The Governor's Budget proposes a General Fund expenditure of $1,497.7 million for the Property Tax Relief program. This is an increase of $130.5 million or 9.5 percent over 1976–77. However, this proposal does not include the amount reserved by the Governor for a new Homeowners' Property Tax Relief program and additional relief for senior citizen renters.

The largest increase in the present programs is $58 million or 7.6 percent for homeowners' property tax relief. This increase is in part the result of Chapter 1060, Statutes of 1976 (AB 2972) which extended the homeowners' exemption to public assistance recipients. In addition, the Governor proposes that expenditures for the Senior Citizens' Property Tax Assistance program be increased by $25.5 million or 48.6 percent. This change reflects the effect of Chapter 161, Statutes of 1976, (SB 413) which increased the income limit for eligible recipients and Chapter 1060, Statutes of 1976 (AB 2972) which expanded the assistance levels.

Chapter 1060, Statutes of 1976, (AB 2972) established a new tax relief program for low-income renters who are at least 62 years of age. Expenditures for this program during 1977–78 are proposed at $20 million.

Capital Outlay

	Estimated 1976–77	*Proposed 1977–78*	*Increase*	*Percent*
General Fund capital outlay expenditures	$100,155,443	$132,319,766	$32,164,323	32.1%
Major Programs				
Department of General Services		91,706,700		
Department of Health.......................................		23,149,421		
Department of Forestry		1,538,408		
Department of Parks and Recreation..........		3,194,240		
Department of Water Resources		3,313,000		
Department of Corrections		2,741,088		
Department of the Youth Authority...........		3,982,900		

Expenditures for capital outlay for 1977–78 are estimated to increase by $32.2 million or 32.1 percent over the current year.

A General Fund expenditure of $91.7 million is proposed for capital outlay in the Department of General Services. The major component of this proposal is the construction of new state buildings in Sacramento, San Jose and Long Beach. Capital outlay expenditures for the Department of Health are proposed at $23.1 million, of which $21.3 million is for a fire and safety program at state hospitals. Capital outlay expenditures for the Department of Corrections are budgeted at $2.7 million for 1977–78. However, the Governor has proposed that an additional $94.2 million which is not included in these budget amounts be reserved for construction of new prison facilities.

Employee Compensation

	Estimated 1976–77	*Proposed 1977–78*	*Decrease*	*Percent*
Expenditures, all funds	$241,338,308 [a]	$162,700,000	−$78,638,308	−32.6%
Expenditures, General Fund	155,188,659 [b]	99,800,000	−55,388,659	−35.7

[a] Includes $188.7 million for salary increases and $52.6 million for employee benefits and special adjustments.

[b] Includes $120.4 million for salary increases and $34.8 million for employee benefits and special adjustments.

New expenditures (all funds) for employee compensation are budgeted at $162.7 million for 1977–78. This is a decrease of $78.6 million or 32.6 percent from 1976–77. While the budget does not specify how the increase will be distributed, it indicates that it is sufficient to provide for a 5 percent salary increase for most state employees except for a 2.2 percent increase for the academic staff of the California State University and Colleges. The General Fund portion of the increase is $99.8 million, a decrease of $55.4 million or 35.7 percent from 1976–77.

GENERAL OBLIGATION BONDS

State general obligation bonds outstanding on December 31, 1976 totaled $5,494,972,000, a decrease of $34,044,000 or 0.6 percent from December 31, 1975 when they totaled $5,529,016,000.

State general obligation bonds unsold on December 31, 1976 totaled $1,990,900,000 an increase of $695 million or 53.6 percent over the $1,295,900,000 unsold on December 31, 1975.

Bond Categories

General obligation bonds are those for which debt service (which includes interest and redemption payments) is either paid from the General Fund or the General Fund is pledged as a guarantee against a possible default in payment from program revenues.

There are three categories of general obligation bonds: (1) General Fund Bonds—those bonds for which the debt service is fully paid from the General Fund; (2) Partially Self-Liquidating Bonds—those bonds for which the debt service is partially paid from the project or program revenues and the remainder from the General Fund, and (3) Self-Liquidating Bonds—those bonds for which the debt service is entirely paid from the project or program revenues. If project or program revenues are insufficient to cover the costs of the partially self-liquidating bonds or self-liquidating bonds, the full faith and credit of the state is pledged to make payment from the General Fund.

Table 8

General Obligation Bonds of the State of California By Purpose as of December 31, 1976

Purpose	*Unsold*	*Outstanding*
General Fund Bonds:		
State construction	—	$606,400,000
Beaches, parks, recreational and historical facilities	$175,000,000	171,000,000
Higher education construction	—	159,410,000
Junior college construction	—	47,100,000
Community college construction	20,000,000	127,750,000
Clean water	300,000,000	170,000,000
Recreation and fish and wildlife	—	51,500,000
Health science facilities	100,900,000	50,750,000
California safe drinking water	175,000,000	—
State, urban and coastal parks	280,000,000	—
Total	1,050,900,000	1,383,910,000
Partially Self-Liquidating Bonds:		
School building aid [a]	$175,000,000	$1,222,425,000
Total	$175,000,000	$1,222,425,000
Self-Liquidating Bonds:		
Water resources development	$190,000,000	$1,543,800,000
Veterans' farm and home	575,000,000	1,304,050,000
Harbor implementation and India Basin	—	3,842,000
Harbor development	—	36,945,000
Total	$765,000,000	$2,888,637,000
Total, All Bonds	$1,990,900,000	$5,494,972,000

[a] School districts bear part of the debt service and the General Fund contributes the remainder.

Revenue bonds are also issued by state agencies. These bonds are for specific projects in which only the revenue generated from the program is pledged for payment of the bonds. Revenue bonds have been issued for the construction of dormitories and parking lots at the University of California and California State University and Colleges, Cal-Expo facilities, pollution control, bridges and other construction projects and purposes. Revenue bonds are not included in the totals of this summary but are mentioned merely to illustrate the different debt service instruments with which the state is involved.

Table 8 shows the amount of bonds by program which have been authorized but not sold and the amount of bonds sold and outstanding as of December 31, 1976. Each of the programs listed was approved by a majority of the electorate after having been passed by at least a two-thirds vote in each house of the Legislature.

Future Implications of 1976 Bond Changes

Experience in 1976 bond sales as well as new issues approved by the people during the year as indicated in Table 9 imply changes in future bond sales patterns.

Table 9
Changes in Bond Program Categories During 1976

In Millions

	Bonds Outstanding		*Unsold Bonds*	
	Amount	*Percent*	*Amount*	*Percent*
Total General Obligation Bonds	Down $34.0	−0.6%	Up $695.0	53.6%
General Fund Bonds	Down 89.7	−6.1	Up 455.0	76.4
Partially Self-Liquidating	Up 59.7	5.1	Down 150.0	−46.2
Self-Liquidating	Down 4.1	−0.1	Up 390.0	104.0

The data in Table 9 show a comparatively minor change in total bonds outstanding during 1976 resulting from sales of new bonds being $34 million less than repayments of old bonds. On the other hand, significant new bonding capacity was added during 1976 with the approval of new issues increasing the unsold bond total $695 million or 53.6 percent.

It is noteworthy that while the amount of General Fund bonds outstanding decreased during 1976, there was a large increase in the amount of unsold bonds indicating a more active sales program in the future.

On the other hand, sales in the partially self-liquidating (school building aid bonds) category will diminish in the future unless new issues are authorized by the people.

A steady continuation of sales in the self-liquidating category is indicated by the data.

It appears, therefore, that the portion of general obligation bonded debt borne directly by the General Fund will gradually increase during the next few years.

Bond Program Expenditures

Bond fund expenditures for those programs separately identified in Schedule 3 of the 1977–78 budget document are estimated at $387.6 million for the 1977–78 fiscal year. This is a decrease of $17.2 million or 4.3 percent from the estimated $404.8 million in expenditures for 1976–77.

Table 10
State of California
Bond Fund Expenditures
1975–76 through 1977–78 [a]

	1975–76	*1976–77*	*1977–78*
Water Resources Development	$109,105,392	$124,806,900	$127,045,700
Central Valley Water Project	12,180,038	5,199,700	16,609,600
Health Science Facilities	10,739,765	44,126,835	24,681,000
Recreation and Fish and Wildlife	6,227,377	11,414,820	2,324,433
Beaches, Parks, Recreational and Historical Facilities	65,860,011	119,819,121	18,977,079
Clean Water	47,460,109	68,370,944	103,146,587
State Construction Program	3,612,706	512,432	—
Safe Drinking Water	—	30,565,000	60,597,000
State Urban and Coastal Park Fund	—	—	33,996,672
Coastal Conservancy [b]	—	—	226,531
Total	$255,185,398	$404,815,752	$387,604,602

[a] Includes only expenditures from selected bond programs separately identified in Schedule 3 of the Governor's Budget.
[b] The State, Urban, and Coastal Park Bond Act of 1976 provided $10 million of its authorized $280 million for a separate State Coastal Conservancy Fund.

It should be noted that expenditures for the Water Resources Development Bond Fund and the Central Valley Water Project Bond Fund in 1976–77 and 1977–78 do not reflect bond sales, but will be mainly derived from project revenues. These funds will be used primarily to make interest payments on the bonds outstanding as well as to operate and maintain the water project.

Bond Program Actions By the Electorate in 1976

Three major General Obligation Bond issues totaling $955 million were approved by the electorate during 1976.

Legislation	*Program*	*Amount (In Millions)*
Chapter 982, Statutes of 1975 (AB 1782)	Veterans Bond Act of 1976	$500
Chapter 1008, Statutes of 1975 (AB 121)	California Safe Drinking Water Bond Law of 1976	175
Chapter 259, Statutes of 1976 (SB 1321)	State, Urban and Coastal Park Bond Act of 1976	280

Four General Obligation Bond issues totaling $875 million were rejected by the electorate during 1976.

Legislation	*Program*	*Amount (In Millions)*
Chapter 1007, Statutes of 1975 (AB 32)	School Building Lease-Purchase Bond Law of 1976	$200.0
Chapter 1066, Statutes of 1975 (SB 156)	Community College Construction Program Bond Act of 1976	150.0
Chapter 1, Statutes of 1975 (AB 1)	Housing Finance Bond Law of 1975	500.0
Chapter 264, Statutes of 1976 (SB 1524)	Residential Energy Conservation Bond Law	25.0

Bond Program Sales

Bond program sales totaled $295 million in 1975–76. Sales of $355 million in 1976–77 and $440 million in 1977–78 are anticipated for programs currently authorized as identified in Table 11.

Table 11

General Obligation Bond Sales
1975–76 through 1977–78
(In Millions)

	Actual 1975–76	*Estimated 1976–77*	*Estimated 1977–78*
Community colleges	–	$20	–
Health science facilities	–	–	–
Recreation and fish and wildlife	$10	–	–
Beaches, parks, recreational and historical facilities	50	50	$25
Clean water	–	50	100
State school building aid [a]	125	135	115
Veterans' farm and home [b]	100	75	200
Water resources development [b]	10	–	–
Safe drinking water	–	25	–
State, urban, and coastal parks	–	–	–
Totals	295	355	440

[a] Debt service partially paid by school districts.
[b] Debt service paid from project or program revenues.

General Fund Debt Service

Table 12 projects the total General Fund debt service for the period 1975–76 through 1979–80. This table includes both the bond debt service which is fully funded from the General Fund and the General Fund portion of the school building aid bond debt service. These estimates are based only on currently authorized issues. Should new issues be authorized and sold, the cost to the General Fund will increase accordingly.

Total General Fund debt service charges in 1977–78 are estimated at $176,170,717 and will increase to $201,051,962 in 1979–80. However, the total will decrease slightly between 1976–77 and 1977–78.

Table 12

Estimated Total General Fund Debt Service [a]

Fiscal Year	*General Fund Bonds*	*School Building Aid Bonds*	*Total Debt Service*
1975–76	$151,437,070	$32,034,417	$183,471,487
1976–77	152,993,864	24,869,702	177,863,566
1977–78	166,398,093	9,772,624	176,170,717
1978–79	176,326,449	7,613,109	183,939,558
1979–80	193,717,799	7,334,163	201,051,962

[a] Cash basis.

Tables 13 and 14 divide the General Fund debt service into its two major components. Table 13 projects the debt service on those programs which are fully funded from the General Fund. Table 14 projects the full debt service costs for school building aid bonds as well as the estimated portion projected to be contributed from the General Fund.

Table 14 shows that the General Fund portion for school building aid bonds has been decreasing significantly. In 1975–76, the portion borne by the General Fund was $32.0 million or 24.2 percent of the total school building aid debt service. It is estimated that in 1977–78 the General Fund portion will decrease to $9.8 million or 6.7 percent of the total debt service.

This decline is primarily due to the repayment formula for the debt service. The General Fund's contribution to the school program debt service is determined by the assessed value of property within local school districts. As the school districts' assessed property valuations have increased over the years, so too have their debt service repayments increased. In turn, the proportion paid from the General Fund has decreased as shown in Table 14.

Table 13

Estimated Interest and Redemption Charges on General Fund Bonds Fully Funded by the State 1975–76 Through 1979–80 [a]

Fiscal Year	*Total Debt Service*	*Debt Service on Bonds Sold as of Dec. 31, 1976*	*Debt Service on Anticipated Sales* [b]
1975–76	$151,437,070	$151,437,070	—
1976–77	152,993,864	152,993,864	—
1977–78	166,398,093	150,448,093	$15,950,000
1978–79	176,326,449	147,061,449	29,265,000
1979–80	193,717,799	144,262,799	49,455,000

[a] Cash basis. Includes state construction; state beach, park, recreational and historical facilities; clean water; state higher education; community colleges construction; recreation and fish and wildlife; health science facilities; and safe drinking water.

[b] Estimated debt service on anticipated sales of $145 million during the last half of 1976–77 fiscal year, $125 million in sales during 1977–78; $150 million during 1978–79; and $150 million during 1979–80. Assumes a 6.0 percent average interest cost on bonds sold.

Table 14

Estimated Interest and Redemption on State School Building Aid Bonds Partially Funded by the State 1975–76 Through 1979–80 [a]

Fiscal Year	*Total Debt Service*	*Debt Service on Bonds Sold as of Dec. 31, 1976*	*Debt Service on Anticipated Sales* [b]	*General Fund Portion of Total Debt Service* [c]
1975–76	$132,497,180	$132,497,180	—	$32,034,417
1976–77	140,873,807	140,873,807	—	24,869,702
1977–78	146,047,524	139,447,524	$6,600,000	9,785,184
1978–79	152,262,189	133,192,189	19,070,000	7,613,109
1979–80	146,683,259	128,138,259	18,545,000	7,334,163

[a] Cash basis.

[b] Estimated debt service on $60 million sales during last half of the 1976–77 fiscal year; and $115 million sales during 1977–78. Assumes a 6.0 percent average interest cost on bonds sold.

[c] General Fund portion of debt service is projected at 6.7 percent for 1977–78 and 5.0 percent for 1978–79 and 1979–80.

IMPACT OF SERRANO VS. PRIEST

The Governor's 1977–78 Budget proposes a $220 million allowance from the General Fund surplus to be utilized for "substantial compliance" with the California Supreme Court's Serrano school finance decision.

The Budget document does not discuss the details of the compliance plan. They are to be presented in separate legislation.

We believe it would be useful for this Analysis to present (a) the background of Serrano, (b) criteria for a solution, and (c) possible alternative forms of compliance. It is the purpose of such discussion to present a structure for evaluating the various plans, including the Governor's, which will be presented in 1977.

Background

The plaintiffs in Serrano were a group of Los Angeles County public school children and their parents who brought a class action suit for declaratory and injunctive relief against state and county officials who were charged with administering the financing of the California public school system. The plaintiffs alleged three causes of action:

(1) The public school system of which they are a part is maintained throughout California by a financing plan or scheme which relies heavily on local property taxes and causes substantial disparities among individual school districts in the amount of revenue available per pupil for educational programs. As a direct result of the financing scheme, substantial disparities in the quality and extent of availability of educational opportunities exist and are perpetuated among the several school districts of the state. Consequently, the educational opportunities made available to children attending public schools in some districts are substantially inferior to educational opportunities available to children attending public schools in many other districts of the state. The plaintiffs alleged that this financing scheme thus failed to meet the requirements of the equal protection clause of the 14th Amendment of the United States Constitution and the California Constitution in several specified respects.

(2) That as a direct result of the financing scheme they (the parents) are required to pay a higher property tax rate than taxpayers in many other school districts in order to obtain for their children the same or lesser education opportunities afforded in those other districts.

(3) That an actual controversy has arisen between the plaintiffs and the defendants as to the validity and constitutionality of the financing scheme.

A trial on the merits of the suit was ordered by the Supreme Court in August 1971, and the case was returned to the Los Angeles Superior Court. The trial ensued for three years following the 1971 ruling. During this time the issues in the original 1971 Serrano complaint were modified by two intervening events.

The first event was the ruling by the United States Supreme Court in the *San Antonio School District vs. Rodriquez* case that, in fact, there was no violation of the federal 14th Amendment equal protection provision in the Texas school financing system, which is very similar to that of California.

The second event was the enactment by the California Legislature of

SB 90 in 1972 and its trailer bill AB 1267 in 1973. These bills substantially increased the foundation program (guaranteed support per ADA) in California and made modifications to equalize school finance among districts. These modifications were incorporated into the Serrano suit at the Superior Court level.

On April 10, 1974, Judge Jefferson of the Los Angeles Superior Court issued a memorandum opinion concerning his intended decision on the Serrano case. This has become known as the Jefferson opinion. The lengthy memorandum of 106 pages in effect substantiated the plaintiffs' cause of action based on the California Constitution (Article 1, Sections 11 and 21).

Jefferson in effect, determined that the education of the plaintiffs was a fundamental interest which was suffering from discrimination on the basis of wealth. Such discrimination can only be justified on the basis of a compelling state interest which in this case the courts could not determine.

The current state financing system for K–12 education was held unconstitutional under the equal protection clauses of the California Constitution because the system denies the plaintiffs equal protection when it produces substantial disparities among districts (with comparable tax rates) in revenue available for the education of their children. The final Superior Court opinion, containing 299 findings of fact and 128 conclusions of law, was rendered on August 30, 1974, exactly three years after the original Serrano opinion.

Appeal

The Jefferson opinion was appealed by the defendants and a California Supreme Court review was granted to determine if there was prejudicial error at the trial. After rehearing and review the California Supreme Court upheld the Jefferson opinion on December 30, 1976.

What the Serrano-Jefferson Opinions Actually Require

The conclusion of law for which the court has mandated a remedy is simply "that equality of treatment means that the state may not provide for, or permit the development of, significant disparities in expenditures per pupil among school districts to be caused by or made possible by the irrelevant factor of significant disparities in assessed valuation of real property among school districts."

The current system of school finance which includes basic aid and the availability of unlimited overrides if chosen by the electorate does not meet this test. The state of California has been given six years from August 30, 1974 to solve the Serrano problem or else the court, which has retained jurisdiction in the case, may intervene.

The above conclusion of law appears simple enough on its face. However, many allegations of consequences have lead to confusion as to what can or cannot be done to resolve this matter.

1. A frequently mistaken interpretation of Serrano is that expenditures for all pupils in the California public schools must be substantially equal in all districts.

The court found that "an equal expenditure level per pupil throughout the state is not mandated by the California constitutional provision". Under Serrano there can be unequal expenditures per pupil derived by add-ons either through state categorical aids or school district impositions so long as the differences are not a direct function of differences in district wealth.

2. The Serrano opinion does not mandate that more money, either state or local, be raised for school expenditure purposes.

As pointed out in the Jefferson memorandum of April 10, 1974 "if uniformity of treatment were to result in all children being provided a low quality educational program, or even a clearly inadequate educational program, the California Constitution would be satisfied. This court does not read the Serrano opinion as requiring that there is any constitutional mandate for the state to provide funds for each child in the state at some magic level to produce either an adequate quality educational program or a high quality educational program. It is only a disparity in treatment between equals which runs afoul of the California constitutional mandate of equal protection of the laws".

3. The Serrano mandate does not terminate the use of property taxation as a method of school finance.

While some organizations and individuals may be opposed to property taxation, there is nothing in the Serrano decision which would mandate such a conclusion. Finding of Fact No. 198 states "potential various alternative plans of financing public education that do not produce wealth created spending disparities and that are workable, practical and feasible include: (1) full state funding, *with the imposition of a statewide property tax;* (2) consolidation of the present 1,067 school districts into about 500 districts, with boundary realignments to equalize assessed valuations of real property among all school districts; (3) retention of the present school district boundaries but the removal of commercial and industrial property from local taxation for school purposes and taxation of such property at the state level; (4) school district power equalizing. . . .; (5) vouchers; and (6) some combination of two or more of the above".

We will discuss several of these alternatives later. The point here is that property tax is not excluded as a source of revenue under the Serrano opinion.

4. The Serrano opinion does not mandate an end to local control of educational programs.

In response to one of the defendant's points that local control is a compelling state interest which would tend to justify the existing school finance system, the Jefferson decision states "the California school finance system, as amended by SB 90 and AB 1267, is not necessary to further the state's interest in encouraging local responsibility for control of public education through local administrative control and through fiscal control over the amount of money to be spent on education. No matter how the state decides to finance public education, it can still leave local administrative control in the hands of local districts".

5. The Serrano opinion does not conclude that rich people necessarily live in wealthy school districts.

The court merely determined that there are school districts in the state which are substantially wealthier than others despite the characteristics of their citizens and that this is in fact primarily due to the fortuitous location of commercial and industrial property within district boundaries.

Criteria for a Serrano Solution

We believe there are general criteria to which any Serrano solution should adhere. These include:

1. The solution to Serrano must begin implementation by 1980 to comply with the mandate of the court.
2. The central issue of fiscal neutrality should be satisfied. This means that all districts in the state must be able to derive substantially equal revenue per ADA from the same property tax rate. The Jefferson decision permits a $100 per ADA revenue variation because perfect equality would be an unreasonable requirement.
3. Flexibility must be maintained to preserve special categories of expenditure such as special education, urban factors and local discretionary increases to the foundation program.
4. An adequate quality education should be assured for all students in California. While this is not a legal requirement of Serrano we believe it is a moral obligation of the Legislature in enacting any school finance program.
5. A constitutional amendment should be avoided if possible in the interest of achieving a solution which can begin a reasonable phase-in by 1980.
6. An inflation adjustment should be included in the basic funding formula and slippage eliminated.
7. There should not be a mandated reduction in revenue limits of any existing school program in the state. While the state cannot afford to bring all districts up to the highest expenditure level, existing high wealth districts should be allowed the opportunity to maintain current expenditure levels if they are willing to make the necessary tax effort.
8. The program should be designed for ease in administration by the Department of Education and the taxing agencies of our state and local governments.
9. A "circuit breaker" provision for low income taxpayers should be adopted if school property taxes are significantly increased.
10. Evaluation criteria should be included so that education administrators are held accountable for their use of school funds.
11. The policy of local control of educational program should be preserved.

Alternative Serrano Solutions

Four commonly discussed Serrano solutions include: (1) full state assumption with statewide imposition and control of real property taxes, (2) split assessment roll, (3) consolidation of school districts to minimize the present wealth disparities, and (4) power equalizing.

Statewide Property Tax

For a number of years our office has recommended that the Legislature adopt some form of a statewide property tax to achieve an equitable distribution of the property tax burden. Revenue from the statewide property tax could be distributed equally on a per pupil basis throughout the state regardless of the assessed valuation of any given school district.

As mentioned previously, neither the California Supreme Court nor the Jefferson decision prohibits the use of the property tax as a revenue source for schools. However, both decisions require that if property taxes are used as a revenue source, the tax effort in proportion to revenue must be distributed equitably. This requirement holds true for all revenue sources, e.g., a local income tax for school purposes.

A number of problems would have to be considered in moving to a statewide property tax. One administrative problem is the lack of uniformity in local assessment practices. In California, assessment ratios among counties vary widely. If these variations are not reduced, a statewide property tax for schools would have many inequities.

One way to improve assessment practices would be for the state to absorb the local assessment function and replace locally elected assessors with professionals. Proposition 8 on the November 1974 ballot provided that if a statewide property tax is enacted, then the state is required to make equalizing adjustments in tax rates to compensate for differences in local assessment ratios.

It must be mentioned that there may be additional state costs in the Homeowner's and Business Inventory Exemption Programs if a statewide property tax is imposed at the rate higher than the current average rate. It is estimated that an additional 10 cent tax rate would cost the state an estimated $12 million in these exemption programs.

Separate Tax on Non-Residential Property

A variation of a statewide tax on all property would be that the state could impose a statewide property tax on nonresidential property, i.e., commercial and industrial, for the purpose of supplying a portion of the educational program for all students in the state. School districts wishing to exceed the expenditure level financed from these taxes could be given authority to raise the necessary additional revenue by levying a local tax on their residential property under a power equalizing schedule.

A major advantage of this system is that it neutralizes the difference in property tax rates as a factor in the location of business, thereby giving greater weight to valid regional costs or market factors. In addition, local control is emphasized in this system in that the differential power equalized tax rates imposed on residential property would reflect differing evaluations on the part of local residents as to what should be spent for school purposes in their communities.

One problem associated with any split assessment proposal is the requirement of a constitutional amendment because Section 1, Article XIII of the California Constitution specifies that all property in the same taxable area must be taxed at the same rate.

Implementation of this plan could take several forms. One would maintain parity between the statewide average tax rate on non-residential property with the burden on residential property. The other would require non-residential property to bear a higher burden.

The first alternative is preferable. Under this concept, the statewide tax rate for commercial and residential property would be established each year by applying the prior year's statewide average rate on residential property. This is similar to the mechanism currently utilized to tax private railroad cars (i.e., The Private Car Tax). Under this procedure the owners of these properties would be assured that their tax rates would not be arbitrarily changed, an action which could result in an adverse effect on the state's business climate.

The second alternative contains numerous problems. One is that such a system is "unprincipled". By this it is meant that there is little logic with which to support a conclusion that one class of property should bear a heavier tax per dollar of value than another class similarly located and there is no means at all of determining how much higher the tax should be on one class of property than on another.

Another concern is that once the uniformity concept is abandoned, there is little resistance to the expansion of the classification concept. Minnesota started out with only four classes. However, it now has 30 classes of property separately assessed.

Finally, there remains the same problem previously cited in connection with a statewide property tax in that the state would have to resolve the lack of uniformity in local assessment practices.

School District Consolidation

Another method of equalizing the capacity of school districts to raise revenue would be to equalize school district property tax bases by means of district reorganization. Table 15 indicates the potential impact of district reorganization on equalizing the assessed valuation per unified district pupil in 1974–75. The table shows that under the current organization, the assessed valuation per unified district pupil ranges from a high of $127,793 to a low of $2,335. If, for example, California school districts were unified on a countywide basis, the range would be reduced from a high of $95,535 per pupil to a low of $8,535 per pupil. Alternatively, if the districts were reorganized into the twelve regions previously established in the state for vocational education planning, the range would be from a high of $27,283 per pupil to a low of $12,878 per pupil. These figures illustrate that it is possible to reduce significantly, but not eliminate, the differences in tax bases among school districts by means of district reorganization.

Table 15

Impact of School District Reorganization on Range in Assessed Valuation Per Unified District Average Daily Attendance (1974–75)

Range in Assessed Valuation Per Elementary Pupil	*Present District Organization*	*Countywide Unification*	*Regional Unification*
High	$127,793	$95,535	$27,283
Low	$2,335	$8,535	$12,878

While such reorganization would be in line with the traditional legislative policy towards unification, it would be impossible to completely equalize school district tax bases by 1980 through reorganization short of establishing one statewide district. As discussed previously, the Serrano rule is very strict in that wealth cannot have an effect of more than a $100 difference in revenue per ADA.

Power Equalizing

Another way to equalize the ability of school districts to fund an educational program would be the enactment of a guaranteed revenue-tax schedule which would provide each district a specified amount of revenue for each cent of property tax effort. This approach is called power equalizing.

Under a power equalizing system, each district could determine how much per pupil it wanted to spend. Districts which choose identical spending levels would have identical tax rates because the tax rate would be determined automatically by the expenditure level. Assume, for example, that a basic power equalizing schedule were enacted which permitted districts to spend $3 per pupil for each cent of property tax levied per $100 assessed valuation.

As shown in Table 16, Districts A, B, and C could all decide to spend $1,200 per pupil. The property tax rate for each district would then be $4 per $100 of assessed valuation. However, Table 16 shows that under the power equalizing schedule a one-cent tax would not raise enough revenue from the local property tax base to provide an expenditure of $3 per pupil in districts with an assessed valuation below $30,000 per pupil. In districts with an assessed valuation greater than $30,000 per pupil, a one-cent tax would produce excess revenue for redistribution to less wealthy districts. The $4 property tax rate would produce $800 more than the selected per pupil expenditure of $1,200 in District A, while in District C there would be a deficit of $800 per pupil.

Table 16

Redistribution of Funds Under Power Equalizing Schedule

District	*Per Pupil Expenditure*[a]	*District Tax Rate*	*Assessed Valuation Per Pupil*	*Revenue From Tax Per Pupil*	*Revenue Surplus (+) Deficit (−)*
District A	$1,200	$4.00	$50,000	$2,000	+$800
District B	1,200	4.00	30,000	1,200	None
District C	1,200	4.00	10,000	400	−$800

[a] Expenditure levels are determined by districts on the basis of a power equalizing schedule which provides revenue of $3 per pupil for each cent of property tax levied.

Thus, a major feature of the power equalizing system is that excess revenue from districts with high assessed valuation could be redistributed by the state to districts whose assessed valuation does not produce sufficient revenue to support the selected per pupil expenditure level. In the hypothetical case in Table 16, for example, the state would take the $800 revenue surplus in District A and redistribute it to District C in order to satisfy District C's revenue deficit.

It is difficult to estimate the cost to the state of basing the school finance system on a power equalizing schedule because the necessary variables to compute such a cost are unknown. The specific cost would be determined by the expenditure levels chosen by school districts. However, the greater the number of dollars that districts are allowed to spend per pupil for each cent of property tax they levy, the higher the potential state cost will be. This is because the number of districts with an assessed valuation per pupil sufficient to produce the guaranteed expenditure per pupil decreases as the level of guaranteed expenditure per pupil is increased.

From a budgetary standpoint, the power equalizing model poses problems in that the state would not know how much money it would have available for redistribution until local school districts set their expenditure levels. The magnitude of this problem can be extensive, particularly if districts are granted too much leeway in rate setting. This problem can be offset by limiting the state's participation or adjusting the guaranteed schedule to a lower level.

Another problem with the power equalizing model is the potential effect of such a system upon the choice between education and other public services. It is possible that if power equalizing applied only to education, local governments with high assessed valuations might be inclined to give education lower priority than other services for which they would not "lose" local revenue.

A Consolidated Approach

A combination of the various Serrano alternatives discussed previously could be utilized in meeting the judicial mandate. It is our continued opinion that for better administrative efficiency small school districts should be encouraged to combine and unify to the greatest extent that is possible. However, for the purpose of solving Serrano by 1980, a complete solution will not be found in unification programs.

We believe that a Serrano solution at a quality level will probably have to be a combination of the current state support with some form of a statewide property tax. Combined with this approach could be the continuation of state categorical aids and/or an add-on program level subject to local control and discretion and subject to power equalization in accordance with a schedule to be determined.

Governor's New State School Program (NSSP)

As mentioned previously, the Governor recently introduced a plan (NSSP) to address the Serrano mandate. Approximately $220 million of the General Fund surplus is designated in the Governor's proposed 1977–78 budget for this purpose.

The plan proposed by the Governor is primarily an upgraded SB 90. Serrano equalization is improved by increases in the foundation program while minor property tax relief occurs in some districts through the elimination of slippage and of state sharing in expenses incurred above the foundation program (Guaranteed Yield Program). These tax relief factors are offset by an end to basic aid and a freezing of high wealth districts' tax rates (prevention of rollback).

Because the plan is not in the budget and is subject to immediate changes, we will not analyze it here, but in a separate document.

PROPERTY TAX RELIEF

The Governor's budget proposes to reserve a portion of the General Fund surplus to finance a new program of property tax relief for homeowners, and some enhancement of the existing program for senior citizen renters. The proposed homeowners' program will provide for the state to reimburse homeowners for 75 percent of property taxes paid in excess of a specified percentage of their income. The percentages range from 3 percent for incomes below $10,000 to 5 percent for incomes over $30,000. The amount of the tax subject to assistance will be the amount paid on the first $60,000 of home value above the $7,000 homeowners' exemption. The maximum payment will be $700.

For renters over age 62, the existing program will be expanded by increasing the maximum income for eligible renters from $5,000 to $12,000, and increasing the property tax equivalent base from $220 to $300.

As a part of the tax relief program, a split assessment roll is proposed to provide a basis for equalizing growth in the residential and nonresidential components of the tax base. New property tax *revenue* limits (rather than the existing rate limits) for local governments are also proposed.

Of the $700 million proposed reserve for school finance and property tax relief, $365 million is earmarked for homeowners relief and $60 million for senior citizen renters.

Although the state is currently providing approximately $1.4 billion in property tax relief to taxpayers and local governments, strong pressures for additional relief have emerged in the last two years. The burden of the property tax has continued to grow despite the introduction of several major tax relief programs and the imposition of tax rate and revenue controls by the Legislature. It is also apparent that the unparalleled growth in aggregate taxable assessed values over the last three fiscal years has been the primary reason for the failure of tax rate controls to limit the growth in tax levies.

Role of the Property Tax in Local Government Finance

While the property tax may appear to the individual property owner to be a relatively simple tax it involves many complexities and provides revenue to over 6,000 individual taxing jurisdictions. The tax levied on any individual property is a composite of levies of all the taxing jurisdictions within whose boundaries the property is located.

Table 17 shows that property taxes are about $9.4 billion in 1976–77, an increase of over $1 billion, or 12.8 percent from the previous year. Because assessed values increased faster (13.3 percent) than total levies (12.8 percent), the statewide average tax rate declined by 14 cents. This table also indicates that schools accounted for over half of total property taxes.

Table 17

Comparison of the Growth in Property Tax Levies, Statewide Average Tax Rates, and Assessed Values

I. Property Tax Levies (in millions)

	1973–1974	*1974–75*	*Percent Change*	*1975–76*	*Percent Change*	*1976–77*[a]	*Percent Change*
Cities	$693	$770	11.1%	$865	12.3%	$960	11.0%
Counties	1,998	2,260	13.1	2,545	12.6	2,870	12.8
Schools	3,531	3,874	9.7	4,360	12.6	4,937	13.2
Special Districts	422	478	13.3	527	10.0	594	12.7
Total	$6,644	$7,381	11.1%	$8,297	12.4%	$9,361	12.8%

II. Statewide Average Property Tax Rates (per $100 of A.V.)

	1973–74	*1974–75*	*1975–76*	*1976–77*[a]
Cities	$1.16	$1.17	$1.18	$1.15
Counties	3.36	3.44	3.48	3.43
Schools	5.92	5.90	5.95	5.90
Special Districts	.71	.73	.72	.71
Total	$11.15	$11.24	$11.33	$11.19

III. Statewide Taxable Assessed Values[b] *(in millions)*

	1973–74	*1974–75*	*Percent Change*	*1975–76*	*Percent Change*	*1976–77*[a]	*Percent Change*
Total	$67,278	$74,299	10.4%	$82,692	11.3%	$93,717	13.3%

[a] Preliminary.
[b] Values are before the deduction of the homeowners and business inventory exemptions.

Growth in A.V. On a statewide basis, the growth in assessed values averaged about 7 percent annually prior to 1974–75. Since then these increases have been in the double digit range, primarily as a result of inflation. However, Table 18 shows wide variations in the rate of these increases among the larger counties. Some of our more rapidly growing counties such as Contra Costa, Orange, San Diego and Santa Clara had increases consistently higher than the statewide growth rate. Others such as Kern, Los Angeles, and San Francisco had growth rates which fluctuated substantially from year to year. For example, Kern County had a 2.6 percent increase in 1973–74, followed by a 34.3 percent increase in 1974–75 (due to a reevaluation of oil properties) and a 20.4 percent growth in 1975–76. Los Angeles County had very modest growth rates in 1973–74 and 1974–75, but this rate jumped to 15.0 percent in the current year due to the assessor's reevaluation of a large portion of the county. San Francisco had a reevaluation in 1975–76, but its growth rates prior and subsequent to then were very modest.

There is considerable uncertainty over the future magnitude of these increases in assessed valuation. The Governor's new education program assumes these increases will be 9 percent in both 1977–78 and in 1978–79 which is substantially less than the 13.3 percent increase during the current year.

Table 18

Percentage Change in Assessed Values by County
1973–74 to 1976–77

	1973–74	*1974–75*	*1975–76*	*1976–77*
Alameda	8.2%	7.1%	9.8%	10.7%
Contra Costa	11.1	12.6	13.6	13.5
Kern	2.6	34.3	20.4	7.5
Los Angeles	3.5	6.3	8.3	15.0
Marin	10.1	15.3	9.7	17.6
Orange	8.5	17.2	13.9	18.7
Sacramento	8.6	9.0	11.5	10.8
San Diego	13.6	15.0	13.3	12.9
San Francisco	4.4	3.3	21.5	5.6
San Mateo	9.7	8.7	16.2	4.1
Santa Clara	7.5	11.3	15.8	13.9
Statewide	7.1%	10.4%	11.3%	13.3%

Comparison of Property and State Taxes. Table 19 compares the magnitude of local property tax levies, State General Fund taxes and State property tax relief payments. This table shows: (1) during the last two years State General Fund taxes have grown faster than local property taxes, and (2) General Fund taxes exceed local property taxes by about $1 billion in the current year. (1973–74 General Fund tax revenues are about $725 million below normal because Chapter 396, Statutes of 1973–74, temporarily reduced income and sales taxes. These reductions distort comparison between property and General Fund taxes in that year, and they also distort the growth rate of General Fund taxes between 1973–74 and 1974–75).

This table also indicates that: (1) state payments for the business inventory exemption have been the fastest growing component of property tax relief, (2) total property tax relief payments are about 15 percent of local property tax levies, and (3) these state payments consume about 14 percent of General Fund revenues.

If the state property tax relief payments are added to local property tax levies, then the combination ($10,724 million) is slightly in excess of total General Fund tax revenues. A comparison of these two major sources indicates that any substantial reduction in one source (i.e., property taxes) will probably necessitate a corresponding substantial increase in the other.

Table 19

Comparison of the Growth in Local Property Tax Revenues, State General Fund Taxes, and State Property Tax Relief Payments
(dollars in millions)

	I. Property Tax Levies and General Fund Taxes			
	1973–74	*1974–75*	*1975–76*	*1976–77*
Property taxes	$6,644	$7,381	$8,297	$9,361
Annual growth	(a)	11.1%	12.4%	12.8%
General Fund taxes	$6,379	$8,045	$9,069	$10,410
Annual growth	10.8%	26.1%	12.7%	14.8%

	II. State Property Tax Relief Payments			
	1973–74	*1974–75*	*1975–76*	*1976–77*
Homeowners	$657	$701	$757	$760
Business inventory	222	$296	363	409
Senior citizens	61	50	51	53
Renters	92	110	115	121
Open space	17	14	16	20
Total	$1,049	$1,171	$1,302	$1,363

	III. Property Tax Relief Payments as Percent of Local Property Taxes and State General Fund Taxes			
	1973–74	*1974–75*	*1975–76*	*1976–77*
Percent of local property taxes	15.8%	15.9%	15.7%	14.6%
Percent of General Fund Revenues	16.4	14.6	14.4	13.1

[a] Declined from the previous year's level due to the increase in the homeowners and business inventory exemptions and the increased school aid in SB 90 (Chapter 1406, Statutes of 1972).

Homeowners' Share of Property Taxes. Recently there has been a great deal of public interst in the proportion of property taxes paid by homeowners and other types of taxpayers. Table 20 shows that: (1) owner-occupied residences accounted for 29.7 percent of gross assessed values but this ratio declines to 24.8 percent after the homeowners exemption is deducted, (2) the state, through the homeowners exemption, pays about one-fourth of the property taxes on owner-occupied dwellings (i.e., $6,352 ÷ $24,550), (3) rental residential dwellings do not participate in the homeowners exemption and therefore their share of net assessed values increased to 20.0 percent, (4) the state, through the business inventory exemption, pays about seven percent of total non-residential property taxes (i.e., $3,094 ÷ $43,496), and (5) because tax rates in residential areas typically are higher than the statewide average, owners of residential properties paid $2.1 billion in net property taxes during 1975–76, which was 25.9 percent of total levies.

Other sources have quoted figures which indicate that single family dwellings pay about 35 percent of all property taxes. However, their figures include both owner-occupied and rental units. Rented single family homes account for 9.6 percent of all property taxes, and over a fourth of the taxes on single family dwellings.

There are about 3.7 million owner-occupied single family dwellings and they cover the spectrum from modest homes in rural areas with low tax rates to very expensive mansions in our metropolitan areas with high tax rates. There also are a multitude of other variations in both values and tax burdens.

Table 20
Distribution of Assessed Values by Type of Property
1975–76 Data [a]
(dollars in millions)

Property Type	*Gross Assessed Values*	*Percent Total*	*Homeowner and Inventory Exemptions*	*Net Assessed Values*	*Percent Total*	*Property Tax Levies*	*Percent Total*
Residential							
Owner-Occupied:							
Single family	$23,770	28.8%	$−6,038	$17,732	24.2%	$2,094	25.2%
Multiple family	780	0.9	−314	466	0.6	55	0.7
Subtotal	$24,550	29.7%	$−6,352	$18,198	24.8%	$2,149	25.9%
Renter-Occupied:							
Single family	$6,743	8.2%	-0-	$6,743	9.2%	$796	9.6%
Multiple family	7,903	9.5	-0-	7,903	10.8	933	11.2
Subtotal	$14,646	17.7%	-0-	$14,646	20.0%	$1,729	20.8%
Nonresidential							
Commercial	$16,600	20.1%	$−1,622	$14,978	20.4%	$1,745	21.0%
Industrial	13,066	15.8	−1,459	11,607	15.8	1,328	16.0
Other	13,830	16.7	−13	11,817	19.0	1,346	16.3
Subtotal	$43,496	52.6%	$−3,094	$40,402	55.2%	$4,419	53.3%
Total	$82,692	100.0%	$−9,446	$73,246	100.0%	$8,297	100.0%

[a] The percentage distribution is based on the Board of Equalization's most recently completed cycle of triennial equalization survey. Assessed value and tax levy amounts are 1975–76 data.

Although property taxes are the primary source of *locally raised* revenues for local governments, they represent about one-third of total revenues to counties and less than one-quarter of total city revenues. Table 21 shows that state and federal subventions have been the major component of total revenues for both cities and counties over the last three years. Property taxes have risen slightly as a percentage of total county revenues over this period, but increasing federal aid to cities, particularly in grants for employment related programs, has reduced the property tax share of city revenues.

Table 21
Sources of Revenue
Cities and Counties
1973–74 to 1975–76
(dollars in millions)

	1973–74		*1974–75*		*1975–76*	
Cities	*Amount*	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
Property tax[a]	$703	23.3%	$772	23.1%	$874	22.3%
Sales tax	520	17.2	576	17.2	643	16.4
State and federal	810	26.9	925	27.6	1,185	30.3
Service charge	268	8.9	291	8.7	332	8.5
All other	715	23.7	785	23.4	878	22.5
Total	$3,016	100.0%	$3,349	100.0%	$3,912	100.0%
Counties						
Property tax[a]	$1,985	32.6%	$2,235	34.7%	$2,531	35.1%
State and federal	2,936	48.3	2,919	45.4	3,334	46.3
Service charge	565	9.3	620	9.6	655	9.1
All other	594	9.8	659	10.3	687	9.5
Total	$6,080	100.0%	$6,433	100.0%	$7,207	100.0%

[a] Amounts shown here are collections, which include prior year collections and exclude delinquencies. Amounts shown on Table 17 are taxes levied in the year indicated.

Expenditure and revenue patterns vary widely between local government entities, with distinctly different trends for urban and rural areas. For the larger counties, Medi-Cal assistance and hospital care programs have been the most rapidly growing component of total expenditures, while smaller counties have experienced moderate growth in these areas. For metropolitan cities, law enforcement has been a major source of expenditure increases. Retirement costs for both city and metropolitan county employees have added significantly to rising levels of spending in recent years. Expenditure growth patterns in local government are not clearly related to changes in population or price levels, but appear to be influenced by many factors. City government costs for example, tend to increase on a per capita basis with the age of a city and its population density.

Trends in costs of special district services over time are obscured by the growing number of special districts and the increasing specialization of services. Table 22 shows the major categories of special districts and the amount of property tax levies in 1974–75.

Table 22

Special District Property Tax Levies in 1974–75

Type of District	*Property Tax Levies (millions)*	*Tax Levies Percent of State Totals*
Flood Control and Water Conservation	$120	23%
Fire Protection	107	20
Sanitation	75	14
Transit	62	12
All other	162	31
	$526	100%

Trends in Level of Property Taxes and Distribution of Burden

From 1965–66 through 1971–72 statewide property tax *rates* grew at an average annual rate of 5 percent, and this growth, coupled with the growth rate in assessed values of about 7 percent, produced an annual average rate of increase in *tax levies* of about 12 percent. Although population and incomes were also rising, the growth in property taxes was outpacing the growth in incomes. Over that same six-year period, property tax levies as a percent of personal income in California rose from about 5.6 percent to 6.7 percent, an increase of 20 percent in the share of income going to property taxes.

The upward trend in tax *rates* appears to have been brought under control since the passage of SB 90 (Chapter 1406, Statutes of 1972). The statewide average total property tax rate is $11.19 per $100 of assessed value in 1976–77, down from a high of $11.46 in 1972–73. Primarily as a result of the increased homeowners' exemption, property tax revenues as a percent of personal income dropped from the 6.7 percent level of 1971–72 to 5.8 percent in 1973–74. In the last three years, however, tax revenues appear to be on an upward trend once again due to the rapid growth in assessed values that has taken place since 1973–74.

Despite the apparent leveling off of statewide average tax rates, the real effectiveness of the SB 90 rate limits has yet to be tested. The revenue limits imposed on school districts appear to have achieved a degree of control over school tax rates. The evidence with respect to cities or counties, however, suggests that average rates have leveled off or declined for reasons other than the imposition of the SB 90 limits. In 1975–76, for example, there were *no* counties that had rates at the maximum level. Accelerated growth of assessed values coupled with lower welfare costs permitted counties to reduce tax rates from the high levels of 1971–72. The option of using the high 1971–72 base year plus the magnitude of the allowable CPI adjustment provided for in SB 90 gives counties substantial leeway for future rate increases.

Although the available data are not adequate to quantify precisely the source of the growth in assessments on a statewide basis, the evidence suggests that it has been concentrated in residential property, and in particular in single family homes. In Los Angeles County, for example, data from the assessor's office indicates that assessed value of all property in areas zoned for single family residences jumped from 31.4 percent of the total in 1975–76 to 35.1 percent for 1976–77. Single family residential property in Alameda County grew from 46.8 percent of total assessed value in 1974–75 to 50.2 percent in 1976–77. Similar patterns in growth are indicated by the data from other counties. On a statewide basis, estimates have been made from Board of Equalization survey data which indicate that the percentage of total assessed values represented by single family homes (including rented dwellings) has been rising since 1972–73.

The unprecedented increases in prices of both new and used homes, coupled with more frequent appraisals by assessors, appear to have increased the share of the total tax burden borne by residential property over the last three to five years. The outlook for housing prices in the future, however, is uncertain, and the recent trend may not continue beyond the near term.

The Issue of Additional Property Tax Relief

As noted earlier the state is currently providing approximately $1.4 billion in existing property tax relief programs. These programs are discussed further under Items 369 through 375 of this analysis. In the last year there has been a series of new tax relief proposals, incorporating various forms of assessment freezes or roll backs, tax shifts at the local level, assumption of local program costs by the state, and expansion or modification of state financed relief payments directly to taxpayers. Because of the substantial fiscal and economic implications of any major change in the structure of the property tax we believe several key policy questions should be addressed prior to the formulation of any new program, or even the expansion of existing programs. These questions are as follows:

(1) To which taxpayers should relief be provided, e.g., all property owners, all homeowners, low-income homeowners, homeowners and renters, or property owners with taxes determined to be "excessive"?

(2) What level of property tax relief should be provided, i.e., when do taxes become "excessive", and how much relief is "necessary"?

(3) What should be the source of funding for property tax relief?

(4) What should the policy be with respect to fiscal control and accountability relative to property tax funded programs, and what are the implications of property tax relief programs for state-local fiscal relations?

(5) What are the problems of implementation of new tax relief programs, e.g., "split roll" taxation, and what are the secondary consequences?

These issues are discussed in detail below:

1. *To which group or groups of taxpayers should relief be provided?* The premise that property taxes are generally "too high" appears to be almost universally accepted, although it cannot be supported on any particular theoretical grounds. Also, as Table 19 indicates, the recent growth in these levies has been slower than the growth in state General Fund taxes. An inter-state comparison shows that California ranks fourth highest in the nation in total property tax levies per capita, and that property taxes account for about 45 percent of total state and local tax revenues in California as contrasted with a 36 percent national average. Although this comparison, which includes taxes on both residential and nonresidential property, may lead to the conclusion that the tax is high relative to other states, it may not support the contention that it is "too high". A more relevant question may be whether the burden is uniformly and equitably distributed, or are particular groups of taxpayers burdened more severly than others.

The components of the property tax base can be categorized in a number of ways, the most common general classification being that of residential vs. nonresidential property. Within the first category are both owner occupied homes and rental property. With respect to taxpayers, classifications can be made on the basis of the amount of taxes paid relative to income. Of the two existing residential tax relief programs, one benefits all homeowners (the homeowners' exemption), and the other targets low income elderly homeowners and renters (the Senior Citizens' program). Further characteristics that could be considered are family size and geographical location, e.g., urban vs. rural.

Inter-jurisdicational differences in tax burdens are also an important factor which have not been explicitly recognized in existing programs. Tax relief is currently provided without regard to the level of taxation within particular jurisdictions. Average countywide tax rates vary considerably and the variation is even greater between tax code areas. In 1975–76, for example, four major metropolitan counties, Alameda, Contra Costa, Los Angeles and Sacramento had average total tax rates in excess of $12.00, while 10 rural counties had rates under $8.00. A taxpayer owning a home with a market value of $40,000 might pay property taxes of $550 in Colusa County while a taxpayer with the same income and home value would have a tax bill of almost $1,100 in Alameda County.

Within the nonresidential category we have targeted two particular types of property for property tax relief, i.e., business inventories and agricultural property. Further classifications might be examined to determine the existence of inequities in the taxation of nonresidential properties.

We noted earlier that the growth in aggregate assessed values in the last two to three years appears to be related to rapidly rising residential property values, particularly single family homes. Examples of assessed values on individual homes having been increased by substantial percentages in a single year are numerous and well documented. It is not clear, however, how widespread this problem is, how severe it is, or how many taxpayers are affected. Nor is it clear that a large percentage increase in the assessed value of a particular home in one year necessarily creates an excessive tax burden. Our office is continuing to conduct research in this area and we hope to provide the Legislature with more detailed information in the near future.

The question of the regressivity of the property tax is another aspect of the more general question of who should receive property tax relief. This issue of regressivity is subject to some dispute. It has been fairly well documented that the initial *impact* of the property tax (i.e., the amount actually paid directly by the taxpayer relative to his income) is greater for low-income homeowners. It has been argued, however, that the final *incidence* of the tax, i.e., the net effect of all property taxes on the individual, is progressive. This argument rests on the premise that the burden of the tax on income producing property is generally *not* shifted forward to consumers but falls on the owners of capital. Because these individuals tend to have higher incomes, the net result is progressivity in the property tax. Most property tax relief proposals, however, are concerned only with regressivity of the initial *impact* of the tax.

The mechanism chosen to provide relief will not only define the group of taxpayers to be recipients but will be a factor in determining the resulting proportions of income that are paid in taxes by persons at various income levels. A tax rate reduction, for example, will provide relief to all property owners in a taxing jurisdiction in proportion to taxes paid and will not affect regressivity. A reduction in the assessment ratio for a specified class of property ("split roll") will provide proportional relief to all property owners of the specified class. A flat exemption for homeowners or income tax credit for renters will provide the same dollar amount of tax reduction to all eligible taxpayers within a jurisdiction but will make the tax less regressive. Finally a circuit breaker type of program can be designed to provide a specific pattern of tax relief relative to income and tax liability, as is the case with the Governor's current proposals.

2. *What level of property tax relief should be provided?* This raises the related question of how "excess" property tax burdens should be measured. The conventional approach in the case of the individual homeowner or renter has been to relate taxes paid (or assumed paid in the case of the renter) to income. Again, no generally accepted standard or theoretical basis exists for determining an "excess" burden. States using either the constant or variable threshold type of circuit breaker provide relief on property taxes in amounts above specified percentages of income ranging from 1 percent (Arkansas; incomes below $1,500) to 13 percent (Kansas;

incomes above $8,000). As noted earlier, the Governor's announced program provides this type of assistance with thresholds ranging from 3 percent to 5 percent. A median measure of the level at which taxation becomes excessive, based on these programs, appears to be approximately 4 percent to 5 percent of income. The Advisory Commission on Intergovernmental Relations suggests that property taxes above 6 percent to 7 percent of income are excessive.

One possible basis for measuring excess taxation would be to relate current tax levels to a bench-mark year. The current gap in growth rates between household incomes and housing prices appears to have first become significant during 1972. Tax levies in 1973–74, the first fiscal year after the adoption of the $7,000 homeowners' exemption, and the last year before the onslaught of double digit rates of increase in assessed values, might be a suitable bench mark level.

3. *How should the cost of property tax relief be funded.* The options for financing relief programs are basically state funding, funding from local sources, or reductions in expenditures. State funding could take several forms, including (1) reimbursements to local governments for revenue losses resulting from exemptions, or rate or assessment reductions, (2) state assumption of local programs, or (3) state assistance payments direct to taxpayers.

Local government funding might be acomplished by creating a new local revenue source, such as a local income or payroll tax. Funding might also be generated by shifting the burden of the property tax from one class of property owners to another. Such a shift might be explicitly provided in a program through equalization of school tax rates for example, which would tend to shift a portion of the tax burden from low wealth school districts to high wealth districts.

The source of replacement revenues, either state or local, will have an effect on the net regressivity/progressivity impact of the program. A progressive source of replacement revenues could create an overall progressive net impact. A general property tax rate reduction (through state assumption of local costs), could have a net progressive effect if funded through income taxes, for example. Sales tax funding, on the other hand, might exacerbate the already existing regressivity.

Another significant concern related to funding sources is the outlook for future tax relief program costs and growth in the funding source. Care must be taken to avoid the adoption of a program with a growth in expenditures over time that will outstrip the growth in the revenues designed to finance the program.

4. *What is the goal with respect to fiscal control and accountability, and what are the implications of property tax relief programs for state-local fiscal relations?* A critical issue related to the general question of "who pays" is that of fiscal control and accountability. A principle of public finance that has wide support is that the governmental jurisdiction responsible for levying taxes should also be responsible for control of expenditures. Violation of this principle, it is argued, occurs when one level of government provides funding for programs controlled by a lower (or higher) level. This situation exists currently with respect to many pro-

grams carried out at the local level but funded through federal block grants or general revenue sharing. Other programs, although administered at the local level and partially funded through the local property tax, are basically controlled through state and/or federal regulations. The most notable examples are the Medi-Cal program and the adult caegorical welfare aids.

The specific questions to be addressed in this area are the following: (1) to what extent should the state assume full funding for programs already controlled at the state and/or federal level; (2) to what extent should the state assume control *and* funding for other programs which could be considered state government responsibilities (e.g., superior courts); and finally, (3) to what extent is the state willing to provide revenue for additional property tax relief while leaving program controls and expenditure level decisions in the hands of local government?

A related accountability issue is the possibility of reducing property taxes on residential property to the point where a majority of voters are in the position of being able to authorize tax increases which have little or no effect on their own direct tax liabilities.

The broader issue in state-local fiscal relations is the question of state imposed limitations on total revenues or total expenditures. As noted earlier, expenditure patterns over time at the local level demonstrate wide inter-jurisdictional variations and are not necessarily associated with population growth or inflation rates. Revenue or expenditure limits, if imposed, should be carefully designed to make appropriate allowances for other factors.

5. *What are the problems and consequences of implementation, and the secondary fiscal and economic implications?* The state already has in place two separate and distinct programs of residential property tax relief. Additional relief provided through expansion of one or both of these programs and funded through increases in existing state taxes would involve a minimum of administrative effort and cost. New relief programs or new sources of replacement revenues would add to the complexities of the existing tax structure and could require significant additional administrative costs. Programs involving a "split roll" for purposes of differential tax rates or assessment ratios would require a constitutional amendment and would complicate the assessment process.

Secondary fiscal effects must also be considered. Any program that would affect assessed values, e.g., assessment freezes, new exemptions, or reduced assessment ratios, would affect all state programs which incorporate assessed values in subvention or apportionment formulas. Such programs include school aid, Medi-Cal and adult welfare.

Secondary economic consequences must also be evaluated carefully. Substantial reductions in property taxes can be expected to increase property values, providing windfall gains to current property owners. Mechanisms which trigger the imposition of a new or higher level of taxation at the time of sale (e.g., transfer taxes or "unfrozen" assessed values) might have an adverse impact on the housing market.

ECONOMIC OUTLOOK AND REVENUE ANALYSIS

Summary

Overall, 1976 was a year of relatively strong economic expansion. Although growth rates declined toward the end of the year, 1977 began with a reacceleration of economic activity which suggested the continuation of recovery. Both California and the nation are expected to experience moderate expansion in 1977 and hopefully in 1978. The Department of Finance projections for 1977 generally compare favorably with those of other forecasters for such variables as real GNP growth (4.8 percent), consumer price inflation (5.4 percent), housing starts (1.75 million), California personal income growth (10.1 percent), California building permits (240,000), and California unemployment (8.4 percent). The department's forecast of the national unemployment rate (6.9 percent) is on the optimistic end of the concensus forecast range.

As was true last year, the key threat to continuing recovery remains a resurgence of inflation. Fortunately, the inflation outlook is quite optimistic, based upon forecasts for wage rate settlements, labor productivity gains and food prices. Interest rates, which declined throughout 1976, are expected to trend upward in later 1977, though not enough to threaten continued expansion. Additional strong spots include continued support from consumer spending, more stimulative federal policies and further expansion in the housing sector.

Business investment expenditures remain a major question mark. Strength in this sector, though questionable because of continuing excess capacity, could insure above-average performance for the 1977 economy. Continuing high unemployment remains the major disappointment; however, healthy 1976 actual and 1977 projected employment expansion indicates that the unemployment rate should steadily decline despite continuing labor force growth. Lastly, the California drought is increasingly more serious, and is expected to have potentially significant, though not yet fully known, negative consequences for the state.

Revenue estimates developed by the Department of Finance for 1976–77 and 1977–78 appear generally to be in line with the department's California economic forecast. Total projected revenues to all state funds of $14.2 billion in the budget year are $1.5 billion, or 11.5 percent, above the $12.8 billion expected in the current year. General Fund revenues are estimated to be $12.2 billion in 1977–78, 12.9 percent higher than the $10.8 billion estimated for 1976–77. Combined collections from the sales, income and corporation taxes, the state's three major sources of General Fund revenue, are expected to increase by 13.7 percent and to account for $1.3 billion, or 87 percent, of the total budget-year revenue growth.

Sales and use taxes are estimated to increase by over 11 percent in the budget year to $4.6 billion, reflecting expectations for a continued growth in disposable income. Total projected sales tax collections include an upward adjustment of $25 million to reflect the impact of an administrative change in procedures for taxing certain vehicle transfers. Personal income taxes are forecast at $4.3 billion in 1977–78, 17.6 percent above the current year. This includes an estimated $23 million revenue loss resulting from 1976 legislation which extended the 100 percent low-income tax credit.

Bank and corporation tax revenues—typically volatile and difficult to predict—are forecast at $1.8 billion in the budget year, an 11 percent increase over 1976–77.

Other significant General Fund revenue gains expected in the budget year include an 11 percent increase in insurance taxes (including $23 million due to the repeal of the principal office deduction) and a 17 percent increase in health care deposit fund receipts. Total *Special Fund* revenues will be up by an estimated 4.1 percent in 1977–78, consisting largely of increased motor vehicle fees and fuel taxes.

1976 IN RETROSPECT

Overall Performance Better Than Expected

Strong economic performance somewhat exceeding earlier anticipations was registered in 1976, with real growth in Gross National Product (GNP) above 6 percent. Table 1 shows that Department of Finance economic forecasts required generally favorable revisions during the year, as did those of many forecasters. Despite the lack of strong federal stimulus, favorable performance occurred for real GNP, durable goods including automobiles, housing construction, business inventory investment, corporate profits and employment. The rate of price inflation drifted downward, due in part to relatively stable food prices. Although unexpected, interest rates also declined moderately during the year.

Despite these positive factors, however, unemployment remains disturbingly high due to continued strong labor force growth, averaging 7.6 percent for 1976. Although many forecasters had hoped for strength in business investment expenditures, little materialized. For those industries where economists in late 1975 feared that insufficient productive capacity might exist by late 1976 and 1977, enough capacity has been added or remained available to alleviate the development of shortages or bottlenecks capable of bringing on a resurgence of strong inflation or a return of recession. The moderate level of interest rates pleasantly surprised most forecasters, and was due to a variety of factors. These included a moderating of output growth and inflation as the year progressed, and the lack of strong business loan demand for capital investment expenditures.

The disappointingly high national unemployment rate does *not* indicate weak employment growth during 1976. Quite the contrary, the national civilian employment growth in 1976 of 3.2 percent considerably exceeded the 2.2 percent annual average from 1964–1973. Rather, the rate remains high due to continued strong labor force growth, the severity of the 1973–75 recession, and the continuing shift in work force composition toward groups characteristically having high unemployment rates. The ratio of employment to population is itself at a record high.

The economy's improved 1976 inflation performance was assisted by moderating labor costs and continuing (though weakening) productivity gains. For the economy's business sector, for example, wages and fringe benefits averaged 8 percent growth in 1976, well down from over 9.0

Table 1
Comparison of Economic Forecasts and Actual Results for 1976
(dollar amounts in billions)

	Original Budget Forecast For 1976[a]	*Revised Forecast For 1976*[b]	*Estimated Actual For 1976*[c]
A. *Selected National Indicators*			
Percentage change in:			
Real GNP	5.4%	6.0%	6.3%
Personal Income	10.4%	10.9%	10.0%
GNP Price Deflator	6.0%	5.8%	5.1%
Corporate Profits	19.3%	26.4%	28.8%
Consumer Prices	6.9%	6.0%	5.9%
Employment	3.0%	3.2%	3.2%
Corporate Profits (before taxes)	$145.0	$148.0	$147.5
Unemployment Rate (%)	7.8%	7.3%	7.6%
Housing Starts (millions of units)	1.45	1.50	1.54
New Car Sales (millions)	10.0	10.2	10.2
B. *Selected California Indicators*			
Percentage change in:			
Personal income	10.2%	10.9%	10.6%
Taxable Corporate Income	13.2%	n.a.	19.0%
Taxable Sales	11.3%	12.4%	13.6%
Employment	2.9%	3.0%	1.7%
New Car Sales	13.3%	n.a.	12.6%
Building Permits	29.6%	43.9%	62.9%
Consumer Prices	7.6%	5.9%	6.1%
Unemployment Rate (%)	9.2%	9.0%	9.6%
Taxable Corporate Income	$12.9	n.a.	$14.4
Personal Income	$151.0	$153.4	$154.0
Residential Building Permits (000)	175	190	215
Taxable Sales	$82.0	$82.6	$83.5

[a] 1976–77 Governor's Budget.
[b] Department of Finance, May 1976
[c] 1977–78 Governor's Budget

percent in 1975. Moderating food prices, particularly in the grain, corn and beef markets, were an especially important factor in reducing overall inflation. The corn crop, for example, was the third largest in history.

Internationally, the U.S. led nearly all nations in 1976 performance. Net exports continued to show strength at $7 billion, though well down from the record $20 billion of 1975. Increases in exports were far from spectacular, partly due to lagging recoveries abroad, and were more than offset by increased import values for such commodities as petroleum and coffee.

Late Pause Gives Way to Resumption of Recovery

Despite relatively strong overall economic performance, 1976 experienced considerable disparity in its quarterly growth rates. Economic growth in the year's first half exceeded that of the second half, contrary to most predictions. First quarter real GNP growth soared to 9.2 percent, then steadily dropped in subsequent quarters to 4.5 percent, 3.9 percent and 3.0 percent, respectively. A major force behind these movements was inventory investment fluctuations, with 1976 inventory investment exceeding initial expectations. In addition, some economic punch was temporarily lost due to an unexpected shortfall in federal expenditures. As the economic slowdown continued late into 1976, concern developed that the fourth quarter "pause" might threaten further recovery prospects.

Recent data, however, suggest that the pause was short-lived and that the expansion is back on track. The federal sector had already moved back toward stimulus by late 1976. The fourth quarter's sluggishness was partly due to a "mini" inventory cycle, with unwanted stocks built up earlier in the year being adjusted back into balance and providing a basis for further inventory investment in 1977. Both November and December offered brighter economic signs for industrial production, employment, personal income and retail sales, even though the quarter overall was not particularly strong. Concerning consumer price inflation, *significant* price pressures should not materialize until later in 1977, if at all. On an annual year-end measurement basis, the 1976 rate of consumer price inflation of 4.8 percent provided a dramatic reduction relative to the 1974 and 1975 rates of 12.0 percent and 7.0 percent, respectively.

Thus, despite continued high labor unemployment and excessive productive capacity, the economy ended 1976 and entered 1977 on an upward trend.

General Outlook Favorable

We expect the economy to experience moderate growth during 1977, although some slowing could appear later in the year. As indicated above, 1977 has begun on an upward trend, enjoying good momentum from rising income and production, and a general re-acceleration of recovery. Continuation of this moderate expansion will hopefully extend into 1978. Some forecasters, unlike the Department of Finance and the consensus view, speak of a 1978 slowdown in growth due to such factors as rising inflation, higher interest rates, and "tight" productive capacity. However, past forecasts of a return to recession in 1978 have generally disappeared, probably due to current prospects for federal stimulus, accommodative monetary outlook, lack of pressing capacity constraints, and lower-than-expected OPEC (Organization of Petroleum Exporting Countries) oil price increases.

An indication of the consensus 1977 national outlook is given by *Business Week's* recent survey of forecasts by some 35 economists and econometric models. Forecasts of 1977 real GNP growth average slightly under 5.0 percent and range from about 4 percent to nearly 6 percent. The average projection for general price increases is about 5½ percent and ranges from 4½ percent to nearly 7½ percent. Unemployment forecasts range from 6.7 percent to 7.6 percent, with an average of 7.1 percent from economists and 7.4 percent from econometric models. This consensus suggests a small likelihood that average 1977 unemployment will fall much below 7.0 percent, or that real GNP growth will match the 1976 experience.

In general, the Department of Finance budget forecasts lie within the range of the *Business Week* survey, Table 2 compares the department's 1977 forecast with the two prior years. When compared with the forecasts for selected key variables made by leading California banks in Table 3, the department's projections are generally consistent.

Most economists believe that there is little, if any, chance of a 1977 downturn or recession, but that an inflation-constrained recovery will continue. Well-balanced growth is expected, thus picking up from the sluggish performance of late 1976. A *major uncertainty* in the overall outlook involves business investment expenditures. Although this sector may experience strengthening, a boom is unlikely. Even without strong business investment expenditures, however, the possibility of general capacity shortages and bottlenecks in 1977 appears remote. The various measures of current capacity utilization rates collectively suggest that considerable slack remains, with the possible exception of selected industries such as natural gas and paper.

Other factors characterizing the consensus outlook include the following:

1. Fiscal and monetary policy will be moderately stimulative, and more so than in 1976, particularly given the administration's interest in stimulative taxation and jobs-related expenditures programs. Such programs could raise real growth above current forecasts.

Table 2
National Economic Data
(dollars in billions)

	Actual 1975	*Estimated[a] 1976*	*Percent Change*	*Budget Forecast 1977[a]*	*Percent Change*
Gross National Product	$1,516.3	$1,693.1	11.7%	$1,868.0	10.3%
GNP in 1972 dollars	$1,191.7	$1,266.4	6.3	$1,326.7	4.8
GNP Price Deflator (1972=100)	$127.2	133.7	5.1	140.8	5.3
Personal Income	$1,249.7	$1,374.0	10.0	$1,513.0	10.1
Disposable Personal Income	$1,080.9	$1,181.5	9.3	$1,305.0	10.5
Savings	$84.0	$78.2	−6.9	$94.1	20.3
Corporate Profits (before taxes)	$114.5	$147.5	28.8	$167.0	13.2
Consumer Price Index (1967=100)	161.2	170.7	5.9	180.0	5.4
Employment (thousands)	84,783	87,500	3.2	90,100	3.0
Unemployment (thousands)	7,830	7,200	−8.1	6,700	−6.9
Unemployment Rate	8.5%	7.6%	-	6.9%	-
Housing Starts (millions of units)	1.16	1.54	32.8	1.75	13.6
New Car Sales (millions)	8.6	10.2	18.6	10.8	5.9
Savings Rate	7.8%	6.6%	-	7.2%	-
Net Exports	$20.5	$7.4	-	$5.5	-

[a] By the Department of Finance.

Table 3
Comparison of National Economic Forecasts for 1977

Percent Changes In:	*Dept. of Finance*	*UCLA*	*United Ca. Bank*	*Security Pac. National Bank*	*Crocker Bank*	*Chase Econ.*
— Gross National Product	10.3%	10.8%	11.1%	10.1%	9.3%	10.0%
Due to real growth	4.8%	5.2%	4.9%	4.7%	3.9%	4.6%
Due to price level	5.3%	5.3%	6.0%	5.1%	5.1%	5.1%
— Personal Income	10.1%	9.9%	10.3%	9.6%	n.a.	10.3%
— Consumer Prices	5.4%	5.1%	6.5%	5.3%	n.a.	5.8%
Unemployment Rate (%)	6.9	7.2	6.9%	7.3%	7.6%	7.9%
Savings Rate (%)	7.2%	6.7%	6.7%	n.a.	7.3%	7.2%
Housing Starts (millions of units)	1.75	1.86	1.60	1.81	1.81	1.60

[a] All forecasts as of December 1976.

2. Inflation continues to remain the economy's *key threat.* Upward pressures, especially later in 1977, could arise due to declining post recession productivity gains, the heavy schedule of major labor contract negotiations, upward movements in food prices, and government fiscal stimulus.

3. Recent OPEC price increases should not severely harm the U.S. economy; however, smaller and lesser developed nations will continue to face serious damage.

4. Corporate profits will show healthy 1977 gains, though well below the near 30 percent increases of 1976.

5. Interest rates should drift upward by later 1977, due to increased need for external credit by businesses, borrowing by the federal govern-

ment, and possibly increased inflationary expectations. Monetary policy, however, should be sufficiently accommodative to restrict the tighter financial markets from producing "credit crunches".

6. Unemployment will continue to decline, but will be slowed by continued labor force expansion.

7. Residential construction activity will continue to expand in 1977, although at slower rates than in 1976. While single family units will continue to represent most of the activity, multifamily activity will produce most of the gains. Some slowing could occur later in 1977 as mortgage rates drift upward.

8. A merchandise trade deficit could occur in 1977, due to higher imported petroleum costs, coffee imports and values of farm exports.

9. A global lull in recovery may persist during at least part of the year. Real growth of the major western industrial nations has lagged since mid-1976. Many countries continue to have high inflation rates which constrain the use of stimulative measures, and look to the United States and other low-inflation nations to pull them into expansion through the trade sector.

Consumer Still Contributing

Performance of the consumer will be strongly supportive but not spectacular this year. In 1975, the consumer was the key to the recovery experience. In 1976, the consumer continued to "quarterback" the recovery, when both personal consumption expenditures and expenditures on consumer durables out-distanced the rise in disposable income. In 1977, however, the Department of Finance forecasts overall consumption increases to fall behind disposable income. Consumer durables, however, while well below their 1976 performance, will continue relatively strong (particularly automobiles and housing-related items).

Business Spending—Still Waiting in the Wings

Like most forecasters, the Department of Finance anticipates above-average gains in business investment expenditures, while noting the uncertainty surrounding the extent of capacity needs for plant and equipment investment at this time. In certain respects, this year is similar to the situation we outlined in last year's *Analysis.* Fixed capital investment disappointed many forecasters by expanding by only 4 percent in real terms in 1976, despite such factors as healthy profit expansion and improved financial positions which yielded strong internal financing potential. From 1965–1974, the annual ratio of real nonresidential fixed business investment to real GNP averaged nearly 10½ percent. This ratio declined in 1975 and remained low in 1976.

The main reason behind this sluggish performance involves currently existing and persisting excess productive capacity. Near term capacity shortages should not surface as a problem this year, although selective bottleneck problems could always materialize. General capacity ceilings should not emerge as a constraining factor before 1978 when utilization rates should approach 1973 levels.

Positive outlook factors in this sector include strong corporate finance positions, some spending backlogs from 1975–76 for plant modernization and compliance with governmental health, safety and environmental regulations, the presence of and potential for expanding federal investment tax credits, and increased demand for capital goods by OPEC nations. On the negative side, in addition to surplus capacity, are higher energy costs and cases of restricted availability. On balance, only moderate optimism seems justified for 1977.

Inflation—Down But Not Out

Inflation, still the economy's major threat, should remain at relatively moderate levels through 1977. The consensus view for 1977 consumer price inflation, for example, is a rate of 5 percent to 6 percent. Most of the near-term inflation declines we can expect have *already* occurred, and the rate in 1977 could increase moderately from late 1976 levels as the year progresses. Inflation pressures could include those due to raw materials, increased federal stimulus, possible future movements in OPEC prices, and food price increases. In addition, some concern exists that capacity constraints will emerge in 1978.

Food prices were an important factor in helping to moderate 1976 inflation, since only a minor rise occurred, and food prices represent 25 percent of the weight in the consumer price increase. In contrast, food prices rose over 40 percent in the 1973–1975 period. The U.S. Department of Agriculture predicts only moderate food price movements through mid-1977, although more noticeable increases could appear as the year progresses. As always, weather remains an uncertainty.

Another important element in the favorable inflation outlook is the movement of unit labor costs, which are based on the difference between wage increases and productivity gains. Unit labor costs should rise only a bit more rapidly in 1977 than in 1976. Athough productivity gains will be tempered, increases in wages and benefits will probably be similar to 1976, and could even moderate in the presence of continued high unemployment and reduced inflationary expectations. This is fortunate given the heavy schedule of 1977 labor negotiations. Nearly 5 million workers are involved in contract expirations and negotiations under major bargaining arguments including steel, communications and construction. About two-thirds of these workers are already covered under cost-of-living escalators negotiated mostly in 1974 in a year of 12 percent inflation and *following* termination of the Economic Stabilization Program.

Stimulative Government Policies Expected

In addition to accommodative 1977 monetary policies by the Federal Reserve, the administration is expected to propose a moderately stimulative fiscal policy. However, any abrupt change in fiscal policy during early 1977 is constrained by the procedures established by the 1974 Budget Act. Complementing increased federal stimulus in 1977 will be a modest expansion in state and local government outlays, financed by recovery-induced tax receipts and increased borrowings in financial markets.

A current argument favoring stimulatory federal policies involves the continuing sluggishness of capital expenditures as a demand factor. The Carter Administration has publicly referred to a two-year plan costing some $30 billion, including one-time tax rebates, permanent tax cuts for individuals, and tax incentives for businesses. Spending increases would also be proposed for public service jobs, public works projects and revenue sharing. Also providing some stimulating force is the nearly $4 billion in funding under the Public Works Employment Act, aimed at accelerating state and local public works programs, public service activities and water treatment projects.

Housing Sector Still Expansionary

Continued increases are anticipated for residential construction in 1977, though less than in 1976, with multiple family units providing most of the gains. Nevertheless, the expected 1.75 million units will still be well below this sector's peak performance in the early 1970's. Activity in the early half of the year will be encouraged by pent-up demand, lower mortgage rates and available mortgage financing. Later in the year, however, the possibility of somewhat increased inflation and the probability of somewhat higher interest rates could slow activity. In fact, some forecasters believe that 1977 mortgage rates will exceed late 1976 levels by year-end.

Energy Concerns Continue

Recent developments involving both natural gas and imported oil indicate that energy concerns will continue to characterize the economy in 1977. Serious natural gas shortages are now facing both industrial and residential users, especially in the east, intensified by extremely severe weather conditions. The Federal Power Commission noted in late January 1977 that several hundred thousand jobs have already been lost. Controversy about the merits of both oil and natural gas price deregulation continues.

Concerning imported oil, a two-tier OPEC price arrangement emerged at the start of the year, with the weighted price apparently increasing by about 8 percent. Although imported oil now provides over 40 percent of our consumption in the United States, the latest OPEC price increase should not significantly disrupt the economy's expansion. More noticeable is the *cumulative* effect of OPEC price increases from 1973 to the present. *Business Week* recently used data from the Brookings Institution and the Federal Reserve Board to indicate that, for 1977, the nation has lost 3 million jobs, more than $60 billion in real GNP, and more than $80 billion in real personal income. On the positive side, OPEC nations have developed strong effective demands for U.S. capital goods, and have invested large quantities of surplus oil receipts in various U.S. financial markets.

International Sector to Continue Sluggish

Continued softness in the international recovery is expected in the near term, with the possibility of even some further slowdowns for certain industrialized nations. Wide divergence in inflationary pressures presently characterizes industrial nations, thus making some less able to pursue stimulatory policies than others. Nations with high rates of inflation continue to be hurt by high interest rates which deter capital investment.

The U.S. experienced rather weak 1976 trade performance, partly because it led other nations in recovery and thus realized rather modest export growth. In addition, imports rose significantly, due to such commodities as petroleum and coffee. The Department of Commerce has indicated that the 1976 merchandise trade deficit of $5.5 billion could be exceeded in 1977, due to continuing increases in petroleum import costs and lowering of farm exports. However, some trade balance improvement could come later in 1977 if foreign recoveries strengthen.

1977 CALIFORNIA FORECAST

As with the nation, 1976 was a generally solid year of continued economic expansion for the California economy. Personal income rose by 10.6 percent, taxable corporate profits by nearly 20 percent and residential building permits by over 60 percent. Table 1 indicates that the state out performed the Department of Finance's initial expectations for personal and disposable income, corporate profits, consumer price inflation, retail sales and building permits. The housing sector's performance was particularly strong, with California out performing the nation. Although the state's 1972 record level of residential permits has not been approached, single-family permits reached a record 140,000. Multifamily permits, while far below 1972 peaks, did expand some 70 percent over 1975. Since mid-year, retail sales have also shown considerable strength. On the negative side, unemployment remained in a disturbingly high range. While somewhat over $500 million in farm receipts were lost to the drought, more substantial economic effects of this ongoing problem will be appearing in 1977.

The California economic outlook for 1977, and generally for 1978, is for continued expansion, steady though not spectacular. Growth in California could outpace that of the nation, particularly if current predictions for such sectors as aerospace and construction are realized. The 1977 pattern is expected to be similar to the nation's, with the possibility of some slowing later in the year if inflationary pressures strengthen and interest rates rise. Federal stimulatory policies, however, may limit such moderation. A significant improvement in capital spending nationally would help California's electrical equipment, electronics and nonelectrical machinery manufacturing industries; however, a boom in these areas is certainly not likely. Continued consumer support will help the expansion, although contributing less than in 1976. Likewise, profit increases will be healthy, though down from 1976 levels.

The housing sector continues to look quite promising. While financial markets are expected to tighten and interest rates rise later in 1977, ample funds should remain available to thrift institutions to supply home building, and only limited disintermediation can be expected. Housing demand remains strong. Single-family permits will continue at high levels, while the major increase should be in the multifamily subsector. As discussed below, negative factors for the California outlook include continued high unemployment, and the now-probable continuation of drought conditions into 1977.

Table 4 presents highlights of the Department of Finance forecast for California as compared with the prior two years. Table 5 indicates that the department's California outlook is generally compatable with those of other forecasters. Lastly, Table 6 compares selected economic indicators for the state to those of the nation.

Table 4
California Economic Data
(dollars in billions)

	Actual 1975	*Estimated 1976*[a]	*Percent Change*	*Budget Forecast 1977*[a]	*Percent Change*
Personal income	$139.3	$154.0	10.6%	$169.5	10.1%
Disposable income	$120.8	$132.8	9.9	$146.6	10.4
Taxable corporate profits	$12.1	$14.4	19.0	$16.2	12.2
Taxable sales	$73.5	$83.5	13.6	$92.5	10.8
Employment (thousands)	8,455	8,595	1.7	8,845	2.9
Unemployment (thousands)	925	915	−1.1	815	−10.9
Unemployment rate (%)	9.9%	9.6%	—	8.4%	—
Number of residential billing permits (thousands)	132	215	62.9	240	11.6
New car sales (thousands)	808	910	12.6	990	8.8
Consumer price index	158.5	168.2	6.1	178.1	5.9

[a] Estimate from 1977–78 Governor's Budget.

Table 5
Comparisons of California Economic Forecasts for 1977[a]

	Department of Finance	*UCLA*	*United California Bank*	*Security Pacific National Bank*[ab]	*Crocker Bank*[ab]
Percent change in:					
Personal income	10.1%	11.0%	11.6%	10.6%	9.9%
Employment	2.9	3.7	3.0	3.5	3.2
Building permits	11.6	12.7	17.1	14.2	3.9
New car sales	8.8	n.a.	5.1	n.a.	n.a.
Consumer prices	5.9	5.5	6.7	5.8	6.3
Unemployment rate (%)	8.4	8.1	8.9	8.2	8.9
Building permits (thousands)	240	231	240	217	216

[a] All forecasts as of December 1976 unless otherwise noted.
[b] November 1976.

Table 6
Selected Economic Indicators, California and United States[a]

	1976		*1977*	
	United States	*California*	*United States*	*California*
Percent Growth In:				
Labor Force	2.3%	1.4%	2.2%	1.6%
Civilian Employment	3.2	1.7	3.0	2.9
New Car Sales	18.6	12.6	5.9	8.8
Personal Income	10.0	10.6	10.1	10.1
Corporate Profits	28.8	19.0	13.2	12.2
Unemployment Rate (%)	7.6	9.6	6.9	8.4
Increase in Consumer prices (%)	5.9	6.1	5.4	5.9

[a] Department of Finance.

Unemployment—Still High But Improving

At year-end California's unemployment rate fell to 9.1 percent, the lowest since February of 1975, 22 months earlier. Unemployment had peaked at 10.5 percent in September of 1975, broke through the 10 percent barrier approximately one year ago, and has generally trended downward since that time. For all of 1976, unemployment averaged 9.6 percent for California, or 2.0 percent above the national figure. From 1975 to 1976 the *number* of California's unemployed fell by 10,000, while total civilian employment rose by 140,000 (1.7 percent). Nonagricultural wage and salary employment ended the year at a record level. In 1977, California unemployment is projected to approach 8½ percent, with moderate total employment growth of 3.0 percent, close to the national rate and substantially above the rate of projected California labor force growth. Table 7 shows changes in both California and U.S. labor force, employment and unemployment.

Table 7

Changes in Labor Force, Employment and Unemployment
1971 to 1977
(in thousands)

U.S.	*Civilian Labor Force*	*Change From Previous Year*	*Civilian Employment*	*Change From Previous Year*	*Unemployment*	*Change From Previous Year*
1971	84,113	1,398	79,120	493	4,993	905
1972	86,542	2,429	81,702	2,582	4,840	−153
1973	88,714	2,172	84,409	2,707	4,304	−536
1974	91,011	2,297	85,936	1,527	5,076	772
1975	92,613	1,602	84,783	−1,153	7,830	2,754
1976 (e)	94,700	2,087	87,500	2,717	7,200	−630
1977 (f)	96,800	2,100	90,100	2,600	6,700	−500
California						
1971	8,389	260	7,652	112	737	148
1972	8,589	200	7,937	285	652	−85
1973	8,811	222	8,194	257	617	−35
1974	9,181	370	8,512	318	669	52
1975	9,380	199	8,455	−57	925	256
1976	9,510	130	8,595	140	915	−10
1977[a]	9,660	150	8,845	250	815	−100

[a] Forecast

Table 8 summarizes the employment and unemployment picture in California industry sectors for 1976 and 1977. Particularly strong gains are foreseen for construction, services and trade, with a healthy 3.6 percent growth in nonagricultural wage and salary employment. Of special note is the switch from negative to positive aerospace employment growth, despite continuing weakness in commercial aircraft. Aerospace should benefit from increased prime contract awards from both NASA and the Department of Defense. Particular job strength is projected for the electrical equipment sector. Of special interest to California is the B-1 bomber project, whose future status is still undecided.

Table 8
California Employment by Type
(in thousands) [a]

	Level 1976	Level 1977	Percent Change 1976	Percent Change 1977
Mining	35	35	2.9%	-
Construction	312	335	2.6	7.4%
Finance-insurance-real estate	468	485	4.5	3.6
Transportation and utilities	461	470	0.2	2.0
Government	1,711	1,750	2.6	2.3
Services	1,629	1,710	5.1	5.0
Trade	1,875	1,950	4.9	4.0
Manufacturing	1,646	1,695	3.8	3.0
Aerospace	467	470	−1.5	0.6
Other Manufacturing	1,179	1,225	6.0	3.9
Total nonagricultural wage and salary workers	8,137	8,430	3.8%	3.6%
Other	458	415	−26.0	−9.4
Total civilian employment	8,595	8,845	1.7%	2.9%
Civilian labor force	9,510	9,660	1.4%	1.6%
Civilian unemployment	915	815	−1.1%	−10.9%
Unemployment rate	9.6	8.4	-	-

[a] Department of Finance.

California's employment/unemployment situation has been recently affected by federal legislation involving (1) expansion in the coverage of regular unemployment insurance, (2) the Public Works Employment Act for state and local government, and (3) extension of CETA-related provisions. Although such assistance is helpful, its job-providing potential is minor given the state's 800,000-plus unemployment figure.

Drought Becomes Increasingly Serious

California agricultural performance in 1977 was initially expected to have been better than 1976, a year disrupted by weather, strikes and commodity price declines. Unfortunately, the California drought (whose effects are not incorporated in the Department of Finance forecast) is anticipated to cause considerable problems for the state this year.

The third driest year in the state's history occurred in 1976, and 1977 appears to be a continuation of the trend. State agricultural authorities have estimated that 1976 losses of farm receipts exceeded $500 million, of which over 90 percent represented losses to livestock producers due to added input costs, loss in weight gain and premature marketing. In mid-January of 1977, 23 drought-stricken northern California counties were made eligible for $16.5 million in federal disaster relief for assistance in feeding nearly 1 million animals. In addition, significant losses in hydroelectric energy production were appearing by late 1976.

No reliable estimate is yet available of the drought's probable impact on the 1977 California economy. However, the effect could be significant, with California farm income seriously impacted. Actual 1977 economic losses will depend on availability of irrigation water, the extent to which less-water-intensive crops are relied on and possible implementation of more efficient water distribution facilities, such as sprinkler systems. More accurate projections will be available by May, since the Central Valley normally receives 70 percent of its precipitation between January 1 and April 1. Initial indications, however, are pessimistic.

State and federal water authorities have suggested that 25 percent to 50 percent cutbacks in irrigated water deliveries to agricultural users may be required in 1977. Thus, irrigated land users will be affected much more than in 1976. Additionally, cutbacks of up to 25 percent to certain industrial and municipal users are being discussed, increased water pumping is raising production costs due to falling water tables, certain water districts having debt-financed water distribution facilities may be financially pressed, and certain small and/or coastal communities will require residential water use rationing. Even more serious conditions will exist if the drought carries through 1977 and into 1978.

REVENUE ANALYSIS

Strong Revenue Gains Estimated for 1976–77

The Department of Finance currently estimates 1976–77 General Fund revenues at approximately $10.8 billion, representing a 14.5 percent increase over actual 1975–76 revenues of $9.4 billion. Table 9 shows the growth of estimated current-year revenues by major source both before and after adjusting for the revenue impact of legislation, administrative changes and court rulings.

Table 9

1976–77 General Fund Revenues
Growth Before Adjustments for Legislation and Court Rulings
(in millions)

	Actual 1975–76	*Estimated 1976–77*	*Growth*	
			Amount	*Percent*
Major Taxes:				
Sales and Use	$3,718	$4,177	$459	12.3%
Personal Income	3,090	3,670	580	18.8
Bank and Corporation	1,287	1,571	284	22.1
Other Taxes	909	1,003	94	10.3
Interest Income	139	139	–	–
Other Revenues	231	261	30	13.0
Total, Before Adjustments	$9,374	$10,821	$1,447	15.4%
Net Adjustments	50	−28[a]	−78	–
Total Revenues	$9,424	$10,793	$1,369	14.5%

[a] Major adjustments include sales and use tax refunds required under two U.S. Supreme Court decisions, the effect on personal income tax revenues of the extension of the low-income tax credit under Chapter 1060, Statutes of 1976, and the repeal of the principal office deduction for insurers as a result of the passage of Proposition 6 in the June 1976 primary election.

The strong growth forecast for 1976–77 revenues reflects expectations for substantial increases in personal income taxes and bank and corporation taxes. Income taxes in the current year are estimated to grow by $580 million, or nearly 19 percent. Although historical relationships of taxable personal income to annual tax liability suggest a somewhat smaller increase, actual collections of taxes withheld for the 1976 income year indicate this high growth rate may not be unreasonable.

Bank and corporation taxes in 1976–77 are estimated to increase by $284 million, or approximately 22 percent. This high growth rate is consistent with current projections of 1976 taxable corporate income, which the latest estimates show has rebounded from a relatively low level in 1975.

Substantial Revisions to Current-Year Estimates

Table 10 provides a history of Department of Finance estimates of 1976–77 General Fund revenues. Upward revisions to the department's original budget estimate of $10.2 billion total nearly $600 million, exclusive of adjustments for the effects of legislation, administrative changes and court rulings ($−28 million). Over $400 million of this change is attributable to increased estimates for income taxes and corporation taxes.

Table 10

1976–77 General Fund Revenues
History of Department of Finance Estimates
(in millions)

	Original Estimate January 1976	Revisions			Current Estimate January 1977
Taxes:		May 1976	January 1977	Legislation and Adjustments	
Sales and Use	$4,100.0	$38.0	$39.0	$−32	$4,145.0
Personal Income	3,455.0[a]	120.0	95.0	−25	3,645.0
Bank and Corporation	1,375.0	70.0	126.0	4	1,575.0
Inheritance and Gift	279.5	10.0	18.0		307.5
Cigarette	191.0	0.5	0.7		192.2
Insurance	254.0	10.0	21.0	25	310.0
Alcoholic Beverage	129.1	2.1	−1.7		129.5
Horse Racing	93.6	3.2	−7.9		88.9
Total Taxes	$9,877.2	$253.8	$290.1	$−28	$10,393.1
Interest Income	115.0	10.0	14.0		139.0
Other Revenues	233.9	12.7	14.2		260.8
Total Revenues	$10,226.1	$276.5	$318.3	$−28	$10,792.8

[a] Adjusted to exclude estimated revenue impact ($−50 million) of an extension of the 100 percent low-income tax credit *proposed* in the 1976–77 budget.

Estimated income tax revenues for 1976–77 were increased in May of 1976 by $120 million to reflect significantly revised forecasts of California personal income for 1976 and 1977. Revisions in January of this year further increased this estimate by $95 million, although personal income forecasts remained substantially unchanged. Realization of the January increase assumes that higher-than-anticipated withholding collections attributable to the 1976 income year reflect a more rapid increase in the "effective" tax rate (i.e., higher total income taxes as a percent of personal income) than is indicated by past experience. An alternative possibility is that higher collections merely represent a temporary shift in the relationship of taxes withheld to final tax liabilities and may be partially offset by higher refunds on 1976 tax returns and lower withholding in the first half of this year.

As shown in Table 10, current estimates of bank and corporation tax revenues for 1976–77 differ from those prepared in January of 1976 by a total of nearly $200 million, a change of about 14 percent. Because of the extreme volatility of corporate profits, revenues from this source typically are difficult to forecast. Based on data from a sample survey of corporations and an historical linkage to U.S. corporate profits, the original revenue estimates assumed a significant *decrease* in taxable corporate income in 1975. Table 11 provides a breakdown by industry of actual corporate income in California for 1974 and 1975 and estimates for 1976.

Table 11
Calendar Year Taxable Corporate Income
(in millions)

Industry	*Actual 1974*	*Actual 1975*	*Percent Change*	*Estimated 1976*	*Percent Change*
Agriculture	$226	$279	23.5%	$304	9.0%
Mining and Oil	1,148	946	−17.6	1,431	51.3
Construction	363	464	27.8	484	4.3
Manufacturing	4,236	4,376	3.3	4,979	13.8
Trade	2,555	2,886	13.0	3,164	9.6
Utilities	1,166	679	−41.8	998	47.0
Other[a]	2,159	2,513	16.4	3,082	22.6
Total	$11,853	$12,143	2.4%	$14,442	18.9%
Growth in National Corporate Profits			−10.3%		28.8%

[a] Includes services, financial institutions, and real estate.

Total corporate profits in 1975 are shown to have *increased* by 2.4 percent—although a substantial decline was reported in that year for mining and oil production (−17.6 percent) and utilities (−41.8 percent). This compares to an average *decrease* in corporate profits nationally of 10.3 percent in 1975. Current revenue estimates for 1976–77 are based on an estimated increase in California corporate income of nearly 19 percent in 1976. This assumes a resumption of the historical relationship between California profits and national corporate profits, which are estimated to increase by about 29 percent in 1976.

Continued High Revenue Growth in 1977–78

Total state revenues (all funds) are projected to be $14.2 billion in the 1977–78 budget year, up 11.5 percent from the $12.8 billion estimated for the current year. General Fund revenues, which will represent approximately 86 percent of the total, are forecast to be $12.2 billion in 1977–78, an increase of nearly 13 percent. Combined increases in sales, income and corporation taxes will account for $1.28 billion, or about 92 percent, of the total estimated General Fund revenue gain of $1.39 billion. The personal income tax, the second largest source of General Fund revenue, is expected to show the greatest increase—up an estimated 17.6 percent in the budget year. Total special fund revenues are estimated at $2.05 billion in 1977–78, representing a growth of 4.1 percent over the current year. Table 12 compares Department of Finance revenue estimates by source for the current and budget years.

Table 12
Projected 1977–78 State Revenue Collections
(in millions)

General Fund	*Estimated*	*Projected*	*Change*	
Taxes:	*1976–77*	*1977–78*	*Amount*	*Percent*
Sales and Use	$4,145.0	$4,610.0	$465.0	11.2%
Personal Income	3,645.0	4,285.0	640.0	17.6
Bank and Corporation	1,575.0	1,750.0	175.0	11.1
Inheritance and Gift	307.5	316.0	8.5	2.8

Insurance	310.0	344.0	34.0	11.0
Cigarette	192.2	195.6	3.4	1.8
Alcoholic Beverage	129.5	134.3	4.8	3.7
Horseracing	88.9	96.8	7.9	8.9
Total Taxes	$10,393.1	$11,731.7	$1,338.6	12.9%
Other Sources:				
Health Care Deposit Fund	101.5	119.0	17.5	17.2%
Interest on Investments	139.0	143.0	4.0	2.9
Other	159.3	187.3	28.0	17.6
Total General Fund	$10,792.8	$12,181.0	$1,388.2	12.9%
Special Funds				
Motor Vehicle:				
Fuel Taxes	804.6	838.6	34.0	4.2%
License Fee (In Lieu)	423.0	444.0	21.0	5.0
Registration, Weight, and Miscellaneous Fees	364.1	372.7	8.6	2.4
Cigarette Tax	82.4	83.8	1.4	1.7
Sales and Use Tax	13.3	18.9	5.6	42.1
Oil and Gas Revenues	83.9	72.5	−11.4	−13.6
Other	197.4	218.3	20.9	10.6
Total Special Funds	$1,968.8	$2,048.8	$80.0	4.1%
Total State Funds	$12,761.6	$14,229.8	$1,468.2	11.5%

Sales and Use Taxes Reflect Income Gains

Sales and use tax collections are forecast at $4.61 billion in the budget year, up 11.2 percent over revenues estimated for 1976–77. This reflects an expected growth in taxable sales of 10.8 percent and 9.6 percent, respectively, in the 1977 and 1978 calendar years. In "real" terms, taxable sales are estimated to increase by 5.5 percent in 1977 and 5.1 percent in 1978. Table 13 provides a breakdown of taxable sales by category as estimated for these years. This table also compares the growth in total sales with that of California disposable income, forecast at 10.4 percent in 1977 and 10.1 percent in 1978.

Table 13
Estimated Calendar-Year Taxable Sales
(in millions)

	1976	*1977*	*Percent Change*	*1978*	*Percent change*
Retail stores	$35,545	$38,630	8.7%	$42,325	9.6%
Autos, other vehicles and service stations	18,225	20,490	12.4	22,080	7.8
Building materials	7,880	9,000	14.2	10,075	11.9
Manufacturing, Wholesaling and miscellaneous	21,850	24,405	11.7	26,950	10.4
Total taxable sales	$83,500	$92,525	10.8%	$101,430	9.6%
"Real" growth			5.5%		5.1%
Growth in California disposable income			10.4%		10.1%

Although expected changes in disposable income are a good general indication of probable changes in taxable sales, the relationship of the two rates of growth can vary significantly from year to year to the extent (1) there is a shift in the composition of total expenditures (e.g., from nontaxable items, such as food and services, toward taxable commodities) and/or (2) more or less of disposable income is saved, and thus diverted from spending.

Estimates of sales and use tax collections for 1977–78 include an upward adjustment of $25 million to reflect a change in administrative procedures which will result in higher use tax payments on transfers of automobiles between private parties. The tax is now imposed on the actual sales price of such vehicles, which is typically higher than the value determined under the depreciation schedule formerly used. This adjustment will be partially offset by a $4 million loss of sales tax revenues due to the exemption of leases to the U.S. government, as required under a U.S. Supreme Court decision.

Personal Income Tax Growth Departs From Historical Pattern

State personal income taxes are forecast by the Department of Finance to be $4.29 billion in 1977–78, $640 million more than the 3.65 billion estimated for the current year. This 17.6 percent growth in fiscal-year collections assumes a 19.6 percent increase in 1977 calendar-year income tax liabilities and a 19.1 percent increase in calendar 1978. Estimated budget-year revenues show a lower growth rate than that forecast for self-assessed taxes in both 1977 and 1978 because of an expected cash-flow pattern which assumes collections attributable to the 1976 and 1977 calendar years will be concentrated in the current fiscal year. Table 14 provides a breakdown of calendar-year income taxes attributable to broad categories of income and compares the growth of total self-assessed taxes to that of California personal income.

Table 14
Estimated Calendar Year Self-Assessed Income Tax
(in millions)

	1976	*1977*	*Percent Change*	*1978*	*Percent Change*
Tax Attributable To:					
Wages and Salaries	$2,354	$2,848	21.0%	$3,432	20.5%
Other Ordinary Income [a]	856	995	16.2	1,147	15.3
Preference Income	28	31	10.7	34	9.7
Total Self-Assessed Tax	$3,238	$3,874	19.6%	$4,613	19.1%
Growth in California Personal Income			10.1%		9.8%

[a] Includes taxes on dividends, interest, business income and capital gains.

[b] Certain "preference" income items (e.g., accelerated depreciation and excludable capital gains) are taxed apart from "ordinary" income according to a separate rate schedule.

Personal income taxes tend to be highly responsive to changes in personal income because of the progressivity provided in the marginal tax rate structure. Past experience indicates a 1 percent increase in personal income will result, on the average, in a 1.6 percent to 1.7 percent increase in total income taxes. This relationship, however, can vary substantially from year to year because of shifts in the composition of personal income (e.g., toward a greater proportion of nontaxable income, such as social security and public assistance). Based on the historical relationship of changes in income taxes to changes in total personal income in periods of gradual economic recovery, we would expect self-assessed tax liabilities in 1977 and 1978 to be somewhat lower than assumed for purposes of the budget-year revenue projections. However, higher-than-anticipated collections in recent years suggest that past experience—especially data from years prior to the implementation of withholding in 1972—may have become somewhat less reliable as a basis for projecting income tax revenues. Thus, although we believe there exists some potential for lower-than-estimated income tax revenues in the budget year, we do not consider the department's estimates to be unrealistically high.

Personal income tax revenues forecast for the budget year include the estimated impact of Chapter 1060, Statutes of 1976 (a $23 million revenue loss). This act, which is effective for the 1976 income year and thereafter, extended the 100 percent low-income tax credit to married taxpayers with adjusted gross incomes between $8,000 and $10,000 and to single taxpayer with incomes between $5,000 and $6,000.

Bank and Corporation Taxes Follow Profit Forecasts

Bank and Corporation tax revenues are forecast at $1.75 billion in 1977–78, 11.1 percent higher than the $1.58 billion estimated for the current year. This estimate includes the effect of 1976 legislative changes which (1) denied interest on refunds paid to corporations within 90 days of the filing of a timely return (an additional $6 million) and (2) provided a tax deduction for the acquisition cost of solar energy devices (a $1 million revenue loss). The expected budget-year revenue increase reflects estimated gains in California corporate income of 12.2 percent and 8.9 percent, respectively, in the 1977 and 1978 calendar years. For the nation as a whole, corporate profits are forecast to increase by 13.2 percent in 1977 and by 8.7 percent in 1978.

Other General Fund Revenues

Combined General Fund revenues from sources other than the three major taxes are estimated at $1.54 billion for the budget year. This represents an increase of $108 million, or 7.6 percent, over 1976–77. Budget year revenues from these sources include a $22 million gain in gross premium taxes paid by insurance companies due to the repeal of the principal office deduction. Total insurance tax receipts are expected to be up by 11 percent in 1977–78, with significant gains also expected in Medi-Cal aid reimbursements to the Health Care Deposit Fund (up 17.2 percent).

Special Fund Revenues

Total special fund revenues are estimated to be $2.05 billion in 1977–78, a 4.1 percent increase over the current year. Motor vehicle taxes and fees account for $1.66 billion, or over 80 percent, of total special fund revenues. An expected 4.2 percent gain in fuel taxes, which are imposed on a per-gallon basis, assumes annual sales of 990,000 new cars in the 1977 and 1978 calendar years and an average gasoline consumption for all vehicles registered in the budget year of 637 gallons (up slightly from the previous year). Vehicle license and registration fees are estimated to be up in the budget year by 5 percent and 2.4 percent, respectively, and assume a total of 17.1 million vehicles will be registered in California at the end of calendar 1977.

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