CALIFORNIA LEGISLATURE

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1979, to June 30, 1980

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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Legislative Analyst

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LETTER OF TRANSMITTAL

925 L Street, Suite 650
Sacramento, California 95814
February 15, 1979

THE HONORABLE ALBERT S. RODDA, *Acting 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, I submit for your consideration an analysis of the Budget Bill of the State of California for the fiscal year July 1, 1979, to June 30, 1980.

The purpose of this analysis is to assist the committee in performing its duties which are 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 am grateful to the staff of the Department of Finance and to the other agencies of state government for their generous assistance in furnishing information necessary for this report.

Respectfully submitted,

WILLIAM G. HAMM
Legislative Analyst

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THE BUDGET OVERVIEW

I. SUMMARY

Expenditures

The Governor has proposed a $33.7 billion spending plan for the State of California in 1979–80. It is the largest spending plan proposed by any Governor. Yet, it is a tight budget when considered in terms of the expenditure growth that it would allow.

The Governor's spending plan consists of:

- $17.3 billion from the General Fund (including reserves for housing and legislation);
- $2.6 billion from the various special funds;
- $0.2 billion from selected bond funds;
- $5.4 billion from nongovernmental cost funds (including various public service enterprise, working capital and revolving, and retirement funds); and
- $8.1 billion from the federal government.

In effect, the Governor proposes to spend about $1,470 for every man, woman, and child in California, or about $92 million per day. According to the budget document, the state spending plan calls for an increase of about 3.7 percent over estimated total expenditures in the current year (1978–79), or about 26 percent more than the state spent last year (1977–78).

Revenues

The revenues used to finance these expenditures come from a variety of different taxes, fees, charges, bond proceeds, and intergovernmental transfers. The most important of these revenue sources are:

- the General Fund, which will realize $15,995.3 million in 1979–80;
- some 113 special funds, which will realize $2,572.1 million; and
- the federal government, which is expected to provide $8,122.2 million.

In 1979–80, the Department of Finance estimates that income from state sources—that is, General Fund and special fund revenues—will total $18,567.4 million. This is an increase of 6.6 percent over estimated current year revenues, and 16.3 percent over actual revenues received last year.

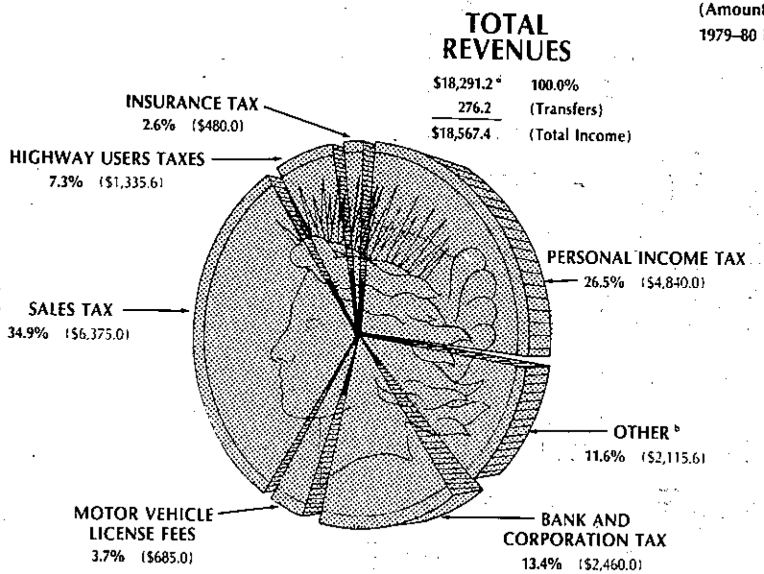
The revenue estimates contained in the budget reflect the Governor's proposals to reduce personal income taxes by $1.4 billion in the budget year. These reductions will require legislation. A more detailed discussion of the revenue estimates, and the economic and legislative assumptions on which they are based, begins on page A-26 of this overview.

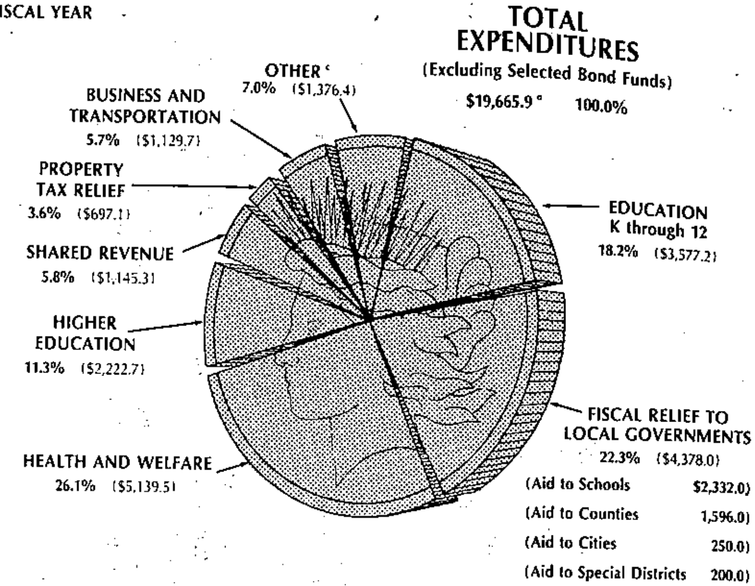
Charts I and II indicate the relative importance of the state's various revenue sources and show the primary categories in which these revenues are spent.

CHART I
STATE BUDGET PICTURE

(Amounts in millions)

1979–80 FISCAL YEAR





[a] Based on budget as submitted. Includes General Fund and special funds.

[b] Other Revenues include:
Inheritance and Gift Taxes 2.5% ($452.4)
Cigarette Tax 1.5% ($281.4)
Liquor Taxes and Fees 1.0% ($175.3)
Horseracing Fees 0.7% (126.0)
All Other 5.9% ($1,080.5)

[c] Other Expenditures include:
Resources 2.0% ($396.2)
State and Consumer Services 1.0% ($203.4)
All Other 4.0% ($776.8)

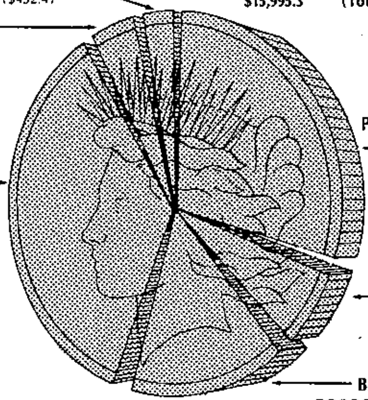
CHART II
GENERAL FUND BUDGET PICTURE

(Amounts in millions)

1979–80 FISCAL YEAR

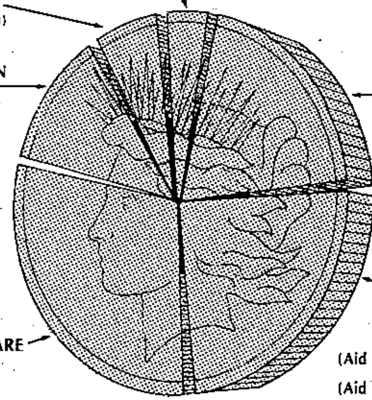
GENERAL FUND REVENUES

\$15,711.7[a]	100.0%
283.6	(Transfers)
\$15,995.3	(Total Income)



GENERAL FUND EXPENDITURES

\$17,088.1[a] 100.0%



(Aid to Schools	\$2,332.0)
(Aid to Counties	1,596.0)
(Aid to Cities	250.0)
(Aid to Special Districts	200.0)

[a] Based on budget as submitted.

[b] Other Revenues include:
Cigarette Tax 1.3% (\$197.0)
Liquor and License Fees 1.0% (\$161.3)
Horseracing Fees 0.7% (114.6)
All Other 4.0% (\$6,314)

[c] Other Expenditures include:
Resources 1.4% (\$247.7)
State and Consumer Services 0.9% (\$159.9)
Business and Transportation 0.3% (\$48.3)
All Other 4.0% (\$679.1)

Surplus or Deficit?

The budget estimates that the General Fund will have a surplus of $2,225.6 million at the beginning of fiscal year 1979–80 (that is, on July 1, 1979). However, during this 12-month period, the Governor's spending proposals (including the reserve for housing) would *exceed* current revenues by $1,152.5 million. This excess is called an annual deficit and it will reduce the carryover surplus from $2.2 billion to $1,073 million by June 30, 1980.

Prediction or Plan?

It should be noted that the estimates of both expenditures and revenues are not *predictions* of what ultimately will happen, although these estimates reflect countless predictions about expenditure rates, tax payments, and other factors that are in part outside of the state's control. Rather, these estimates reflect *the Governor's fiscal plan*—that is, what he thinks revenues and expenditures ought to be, given all of those factors that the state cannot control. It is certain that, between now and June 30, 1980, expenditures and revenues will be revised by the Governor, the Legislature, changing economic conditions, changes in the behavior of individuals and firms, and many other factors. Thus, actual revenues and expenditures are likely to be different from the estimates contained in the budget.

Our Analysis

In this Analysis, we report the results of our detailed examination of each item contained in the budget. Based on this examination, we recommend many reductions that we think are warranted and can appropriately be made—even to a generally tight budget. We also recommend augmentations to the budgeted amounts where factors of legislative intent, inflation or workload have not been fully recognized. We have made no attempt to tailor these recommendations to achieve any specific overall spending level.

II. EXPENDITURES

Table 1 summarizes the principal components of state expenditures in the prior, current, and budget years. The table displays expenditures from the General Fund, special funds and bond funds, and shows a 1979–80 overall expenditure total for state-funded programs of $19,834.9 million. Adding the $8,122.2 million in expenditures from federal funds, the $5,-458.7 million in nongovernmental cost funds and $250 million in reserves brings the state spending plan total to $33,665.8 million.

Table 1
Total State Spending Plan [a]
(dollars in millions)

	Actual 1977–78	Estimated 1978–79 Amount	Estimated 1978–79 Percent Change	Proposed 1979–80 Amount	Proposed 1979–80 Percent Change
General Fund [b]	$11,685.6	$16,508.5	41.3%	$17,088.1	3.5%
Special funds	2,161.1	2,662.8	23.2	2,577.8	−3.2
Budget Total	$13,846.7	$19,171.3	38.5	$19,665.9	2.6
Selected bond funds	156.6	426.9 [c]	172.6	169.0	−60.4
State Expenditures	$14,003.3	$19,598.2	40.0	$19,834.9	1.2
Nongovernmental cost funds	5,419.9	5,037.9	−7.0	5,458.7	8.4
Reserves	—	—	—	250.0	—
Federal funds	7,239.1	7,813.4	7.9	8,122.2	4.0
Total State Spending	$26,662.3	$32,449.5	21.7%	$33,665.8	3.7%

[a] Based on amounts shown in the Governor's Budget.
[b] Amounts shown for 1978–79 and 1979–80 include funds for fiscal relief for local government.
[c] This is the amount shown in the budget. It includes $20,467,000 which represents a federal reimbursement inappropriately included as a bond fund expenditure in the budget. Detail on bond fund expenditures by individual bond fund program are shown in Table 8 on page A-25.

Although the full amount of expenditures in each category is included in the state's spending plan, these amounts are by no means controlled through the budget. Significant expenditure authorizations are controlled directly by the Constitution or by specific statutes. Furthermore, federal funds often are not subject to control in the Budget Bill. Most state expenditures, however, are governed by budget decisions.

The total state spending plan includes some double-counting. For example: (1) revolving fund expenditures may also show up as expenditures in another budget item; (2) amounts spent from bond proceeds are counted again when debt service is paid; and (3) federal revenue sharing funds are counted before transfer to the General Fund and again after transfer. Nevertheless, the state spending plan gives a reasonably good estimate of spending under the state's auspices.

Local Assistance vs. State Operations

Table 2 shows the distribution of state expenditures among the categories of state operations, capital outlay and local assistance. General Fund expenditures are presented in two ways, with and without the $4,378 million proposed for local fiscal relief. As a result of the fiscal relief program, 80 percent of General Fund expenditures is earmarked for local assistance in one form or another. Only 18.8 percent is budgeted for state-operated programs, of which about one-half is for support of higher education programs, mainly for the University of California (UC) and the California State University and Colleges (CSUC). This is illustrated in Chart III.

Table 2
General Fund and Special Fund Expenditures by Function [a]
(dollars in millions)

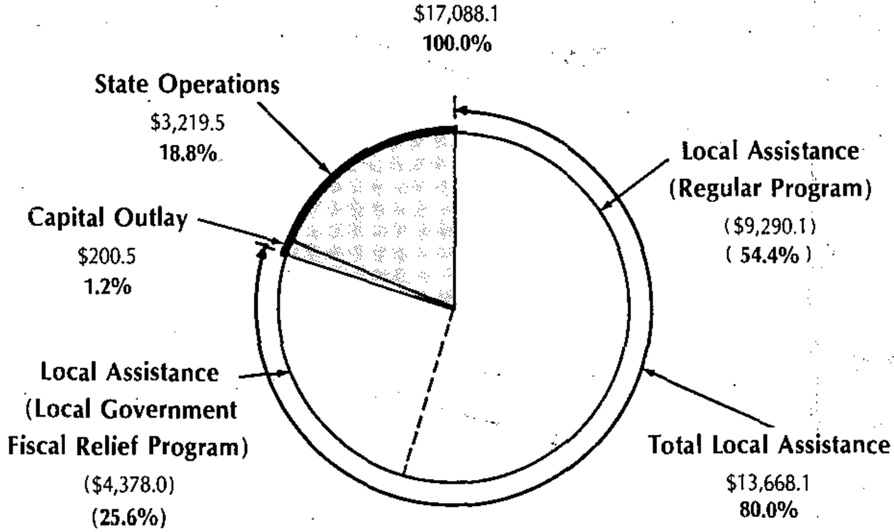
		Estimated 1978–79		*Proposed 1979–80*	
	Actual 1977–78	*Amount*	*Percent Change*	*Amount*	*Percent Change*
General Fund					
State operations	$2,953.0	$3,106.4	5.2%	$3,219.5	3.6%
Capital outlay	56.3	188.3	234.5	200.5	6.5
Local assistance	8,676.3	8,946.1	3.1	9,290.1	3.8
(including local fiscal relief)	(8,676.3)	(13,213.8)	(52.3)	(13,668.1)	(3.4)
Total	$11,685.6	$12,240.8	4.8%	$12,710.1	3.8%
(including fiscal relief)	(11,685.6)	(16,508.5)	(41.3)	(17,088.1)	(3.5)
Special Funds					
State operations	$804.7	$896.4	11.4%	$1,037.2	15.7%
Capital outlay	351.0	494.5	40.9	265.8	−46.2
Local assistance	1,005.5	1,272.0	26.5	1,274.8	0.2
Total	$2,161.1	$2,662.8	23.2%	$2,577.8	−3.2%

[a] Based on amounts shown in the Governor's Budget.

CHART III
1979–80 GENERAL FUND BUDGET STRUCTURE

(Based on Budget as Submitted)
(Dollars in millions)

Total Expenditures



A Tight Budget

By almost any yardstick, the budget proposed by the Governor is a tight one. The proposed growth in General Fund expenditures—which the Governor puts at 5 percent—is well below the 12.5 percent that budget increases have averaged during the past four years. Moreover, the regular General Fund budget is $2 billion below what the Department of Finance projected only one year ago.

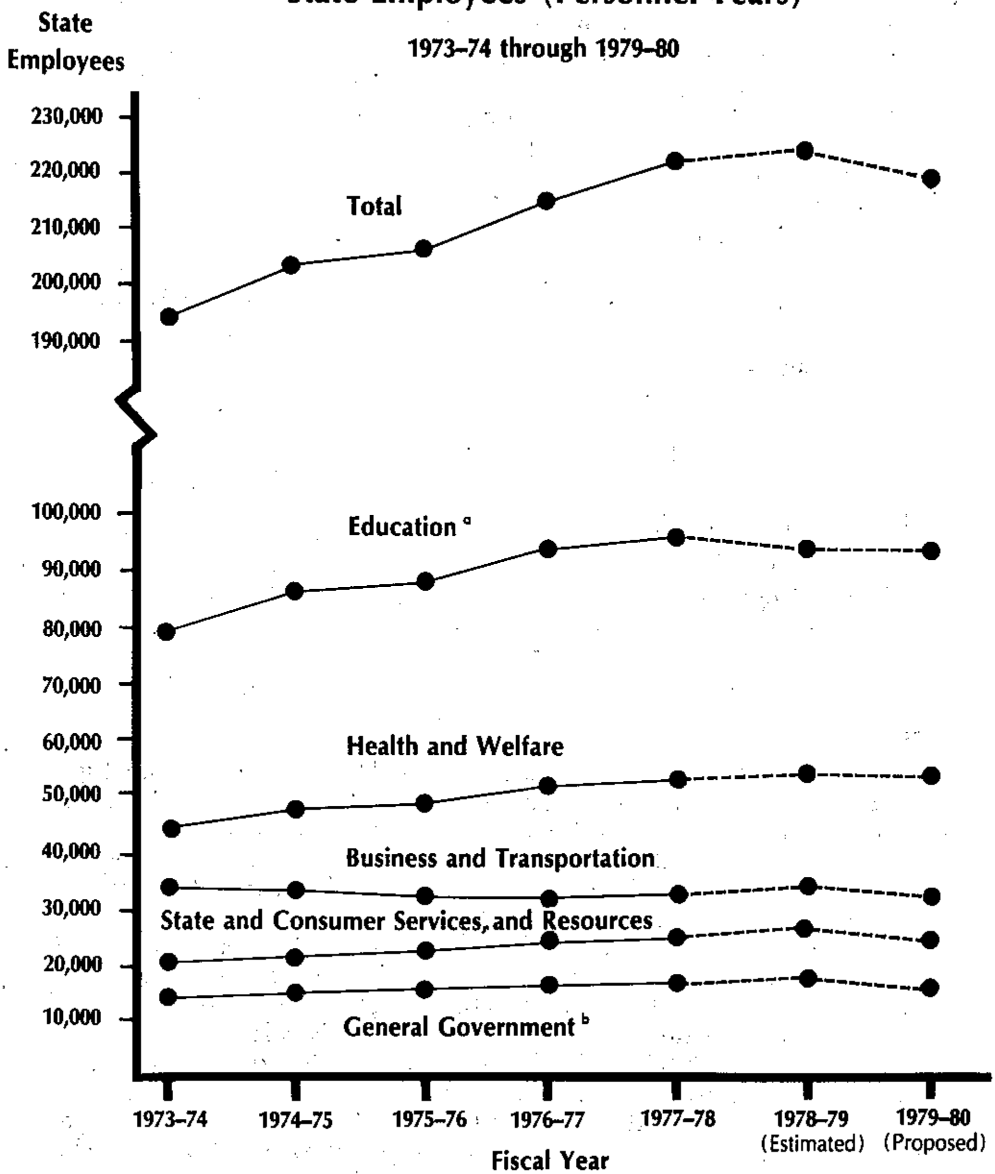
Some budgets, such as those for the Department of Conservation, EDY/Bilingual-Bicultural education programs, and the Coastal Commission, are relatively unchanged. Others, such as the budgets for the Department of Finance, the Energy Resources, Conservation and Development Commission, and the State Public Defender, have been reduced. And numerous regulatory boards are proposed for elimination.

Another indication of the budget's tightness is the unprecedented reduction of 5,141 state employee positions proposed by the Governor. The cuts are distributed throughout most functional categories, but are particularly severe in the Resources area, where employment would be reduced over 10 percent. In addition, a reduction of 3.6 percent is proposed for the Business and Transportation area, where the state's role in regulating businesses would be significantly reduced. Chart IV illustrates the trends in state employment since 1973–74, as well as the trends for specific functional areas.

CHART IV

State Employees (Personnel-Years)

1973–74 through 1979–80



[a] Approximately 97 percent of these personnel-years involve University of California or California State University and Colleges positions.

[b] The Department of Industrial Relations, State Board of Control, Compensation Insurance Fund and the Department of Food and Agriculture have been included in General Government for all years, even though they were under what is now State and Consumer Services prior to the 1978–79 fiscal year.

Some Programs Will Grow in Fiscal Year 1979–80

The budget does not merely cut, but also reallocates funds toward needs the Governor considers to have a higher priority. Specifically, the budget provides for:

- A new $100 million housing program;
- $100 million in capital outlay for new prisons;
- Increased funding for job training, social workers training, and in-home supportive services, and
- An increase of $110 million in fiscal relief for local government.

Potential Costs Not Funded in the Budget

The budget represents the Governor's expenditure plan for the forthcoming fiscal year. As an expenditure plan, however, it is incomplete and is contingent upon actions that may not be taken. Specifically:

1. No provision is made in the budget for the cost of:
   - A cost-of-living increase in state employee salaries (other than for judges);
   - Reorganizing the Health and Welfare Agency, which is required to occur on or before July 1, 1979 (This reorganization is supposed to spinoff the Departments of Corrections and the Youth Authority.);
   - Local government claims against the state approved or likely to be approved by the Board of Control;
   - Computer acquisition for the California State University and Colleges, which the Department of Finance intends to propose;
   - Transportation projects to be funded with approximately $254 million in new federal transportation aid which Caltrans will receive during the next five years;
   - The average daily population of Youth Authority wards likely in the budget year.

To the extent that the Governor proposed additional spending (or additional spending becomes inevitable), expenditures are almost certain to exceed the level proposed in the budget.

2. Spending levels below what existing law requires.

Existing law in many cases calls for a level of expenditure that is higher than what the Governor proposes in the budget. In these cases, the budget reductions assumed by the Governor are contingent on the passage of enabling legislation at either the state, federal or local level. According to the Department of Finance, 65 separate provisions of law would have to be changed at the state level alone in order to accommodate these reductions.

Examples of reductions requiring enabling legislation include the following:

- The budget does not include any General Fund support for the Indo-Chinese refugee assistance program on the assumption that the Congress will enact legislation halting the scheduled phase-out of federal support and re-establishing full federal funding for the program. At stake is $29 million in local aid costs and $14 million in county costs, just for those refugees now in California.
- In the business regulatory area, elimination of 132 positions will require enactment of legislation to change 23 separate provisions of law.
- Existing statutory provisions must be changed before benefits for AFDC and SSI/SSP recipients can be held to an increase of 6 percent (instead of the 15.2 percent they are entitled to now). At stake is $282 million from the General Fund plus $31 million in county costs.
- Finally, the budget assumes that the Orange County Board of Supervisors will elect to provide fire suppression on state-responsibility lands in the county, so that the number of state forestry employees can be reduced.

Impact of Cuts Not Identified

In a number of cases, the budget proposes program cuts without identifying where they would be made or what the resulting impact would be. For instance:

- The budget provides for a reduction of nearly 800 positions at the University of California (UC) and California State University and Colleges (CSUC) without specifying the specific positions to be cut.
- The personnel request for the Franchise Tax Board is 109 positions less than the numbers required based on historical workload-productivity standards.
- The Department of Justice's budget reflects a reduction of 100 positions that have not been identified.

How Much Will the Budget Really Grow?

The budget as submitted is usually the low point in the cycle of state expenditure projections. Subsequent to transmittal of the Governor's Budget, numerous factors cause individual expenditure estimates to rise or fall. On balance, however, the budget usually grows because:

- Additional spending is proposed by the administration;
- The Legislature adds more to than it subtracts from the budget;
- Other bills are enacted which add to state costs, and
- Expenditures are increased as a result of Emergency Fund authorizations by the administration using Sections 28 and 28.5 and California Government Code Sections 16352 and 16409.

Nevertheless, it is possible to draw some conclusions about the proposed level of expenditures for 1979–80 compared with the estimated level of expenditures in 1978–79. A meaningful comparison, however, requires that three adjustments be made in the expenditure estimates for these two years.

1. *The cost of providing cost-of-living increases to state employees and faculty members in 1979–80 must be recognized.* The budget document acknowledges the need to provide cost-of-living adjustments to state employees but does not include funding for such an increase. Thus, to compare expenditures in the current and budget years, some allowance must be made for the cost of that increase in 1979–80.

2. *The homeowners' property tax relief program must be treated the same way in both years.* The California Constitution exempts homeowners from paying property taxes on the first $7,000 of market value on their principal residence. The budget proposes to replace the homeowners' exemption with an $87 *income tax credit* or *rebate* in 1979–80. Under this proposal, about two-thirds of the cost of the tax relief program ($262 million) would be converted from an expenditure to a revenue loss. The remaining cost ($132 million, which is attributable to the direct rebate) would still be treated as an expenditure. Thus, the total cost of the homeowner tax relief program is counted as an expenditure in the current year, but only one-third of the cost will be so counted in the budget year, thereby distorting inter-year comparisons of General Fund expenditures (and revenues). To permit a meaningful comparison, either current-year

expenditures should be reduced, or allowance for the cost of this relief should be made in 1979–80 expenditures.

3. *The 1978–79 estimates of special fund and bond fund expenditures must be made more realistic.* Estimates of special fund and bond fund expenditures in 1978–79 are almost certain to be too high. Mid-year estimates of expenditures from these funds have been greatly overestimated during the last four years. In fact, actual bond fund expenditures have turned out to be about half of the midyear estimates, on the average. During this same period, special fund expenditures have been about 10 percent lower than midyear estimates.

If an amount equal to a 6 percent cost-of-living increase (a figure mentioned by the Administration) is added to 1979–80 expenditures, and an adjustment is made to treat homeowners' tax relief in the budget year on the same basis as in 1978–79, total state budget expenditures in 1979–80 would be increased from the $20.1 billion amount (including $250 million in reserves) shown in the budget to over $20.5 billion. The General Fund portion of these expenditures would be 7.5 percent higher than the prior year instead of only 5.0 percent higher as reflected in the budget. The effect of these adjustments is shown in Table 3.

Table 3
Comparison of State Expenditure Estimates and Resulting Growth Percentages in 1979–80
(amounts in billions)

	Department of Finance				*Legislative Analyst's Adjustments*	
	Budget Totals	*Percent Change*	*With Fiscal Relief and Reserves*	*Percent Change*	*Total*	*Percent Change*
General Fund	$12.71	3.8%	$17.34	5.0%	$17.75	7.5%
Special Funds	2.58	−3.2	2.58	−3.2	2.61	−1.9
Budget Totals	$15.29	2.6%	$19.92	3.9%	$20.36	6.2%
Bond Funds	0.17	−60.4	0.17	−60.4	0.17	−60.4
Total Expenditures	$15.46	0.8%	$20.08	2.5%	$20.53	4.8%

If a further adjustment is made in order to make the current year estimates of bond and special fund expenditures more realistic, the growth in total 1979–80 expenditures also becomes about 7.5 percent.

Finally, if recent experience is any guide, legislative augmentations to the state's spending program are likely to exceed the $150 million allowance suggested by the Governor. Between 1973–74 and 1977–78, legislative augmentations ranged from 2.9 percent to 6.4 percent of regular General Fund expenditures. Ignoring fiscal relief, these percentages translate into increased expenditure of $370 million to $800 million in 1979–80 (versus the $150 million reserved for the Legislature's use by the Governor).

SUMMARY OF MAJOR PROGRAM CHANGES

The State Budget has become increasingly dominated by programs in the areas of health, welfare and education. Chart V illustrates the growth in General Fund expenditures and the extent to which the General Fund has supported programs in these categories since 1973–74.

Not surprisingly, major program increases from the current year to the budget year also occur in the health, welfare and education categories. As Table 4 shows, two programs alone—Medi-Cal and K–12 Education—are responsible for 76 percent of the growth in General Fund expenditures (regular budget).

Table 4
General Fund Program Changes
1978–79 to 1979–80
(dollars in millions)

	Estimated 1978–79	*Proposed 1979–80*	*Change*	
			Amount	*Percent*
Health and Welfare:				
Medi-Cal	$1,604.5	$1,786.0	$181.5	11.3%
SSI/SSP grants	734.8	706.2	−28.6	−3.9
AFDC grants	612.4	662.0	49.6	8.1
Mental Health	404.7	438.1	33.4	8.3
Developmental Disabilities	365.7	380.5	14.8	4.0
Corrections	257.9	268.3	10.4	4.0
Special Social Service programs	132.1	177.1	45.0	34.1
Other, Health and Welfare	550.4	553.1	2.7	0.5
Subtotal, Health and Welfare	($4,662.5)	($4,971.3)	($308.8)	(6.6%)
Education:				
K–12	$3,400.4	$3,563.2	162.8	4.8%
University of California	767.0	797.1	30.1	3.9
CSUC	691.9	714.3	22.4	3.2
Community Colleges	557.2	592.4	35.2	6.3
Other, Education	84.9	87.0	2.1	2.5
Subtotal, Education	($5,501.5)	($5,754.1)	($252.6)	(4.6%)
Property Tax Relief	$803.9	$697.1	$−106.8	−13.3%
Employee Compensation	33.1	1.7	−31.4	−94.9
Capital outlay	188.3	200.5	12.2	6.5
All other	1,065.7	1,085.4	19.7	1.8
Total, Regular Budget	$12,255.0 [a]	$12,710.1	$455.1	3.7%
Local Government Fiscal Relief	4,267.7	4,378.0	110.3	2.6
Total	$16,522.7 [a]	$17,088.1	$565.4	3.4% [b]

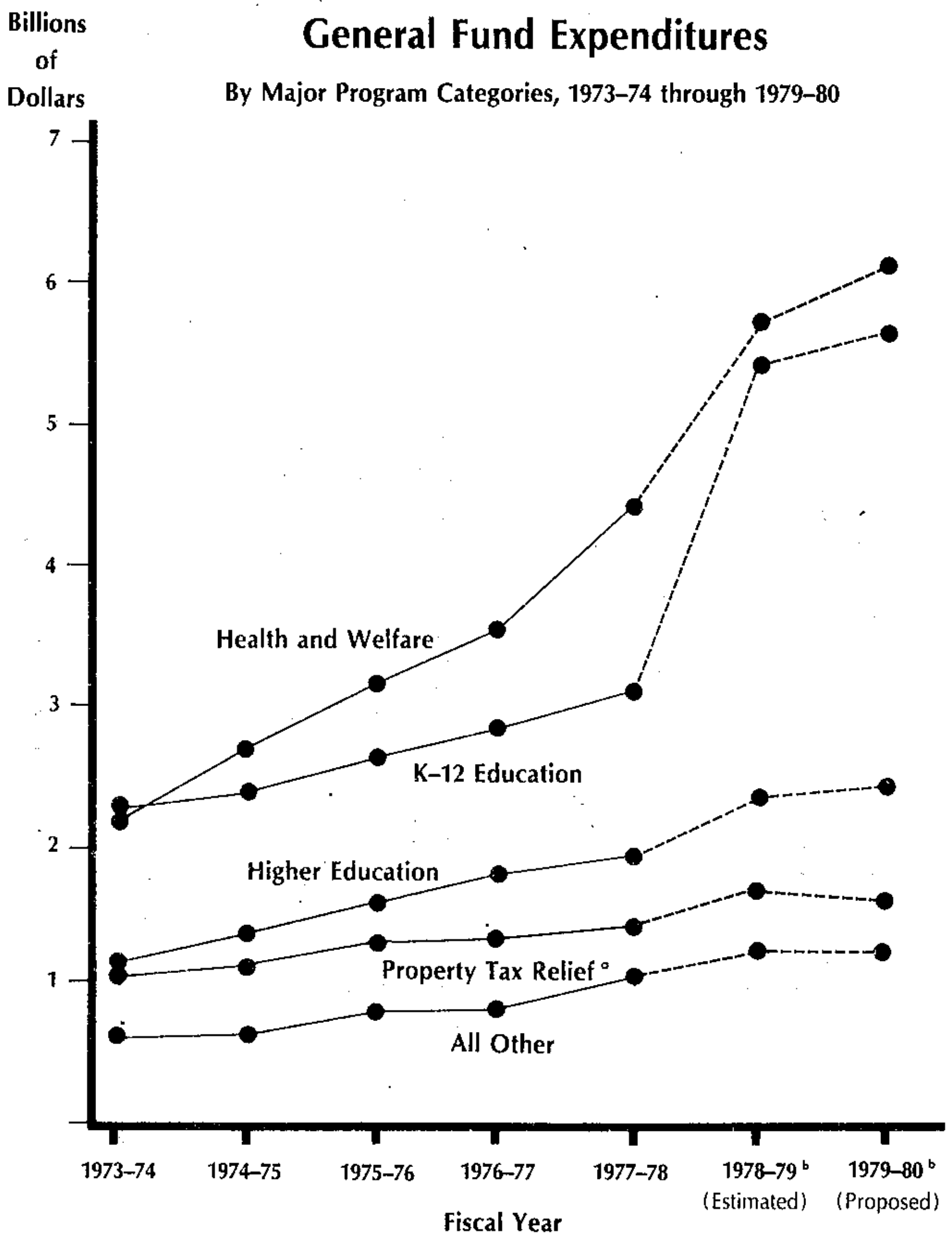
[a] This amount is $14.2 million greater than the total shown in the Governor's Budget, as small adjustments were made to "AFDC grants" and "Other, Health and Welfare."

[b] The Governor's Budget shows an increase of 3.5 percent. The difference is due to the higher 1978–79 General Fund expenditure total used in this table (see footnote a).

CHART V

General Fund Expenditures

By Major Program Categories, 1973–74 through 1979–80



[a] The expenditure total for 1979–80 homeowner tax relief conforms to the amount proposed in the budget.
[b] Fiscal relief for local governments is distributed in the categories as follows:

	1978–79	*1979–80*
Health and Welfare	$1,057.3 Million	$1,097.6 Million
K–12 Education	2,072.4	2,072.0
Higher Education	260.0	260.0
Property Tax Relief	878.0	948.4
Totals	$4,267.7 Millions	$4,378.0 Millions

In the sections that follow, we have noted the most significant expenditure changes for each of the programs listed in Table 4. Detailed information on every state program is contained in the body of the *Analysis.*

Local Government Fiscal Relief

	Estimated 1978–79	*Proposed 1979–80*	*Change*	
			Amount	*Percent*
General Fund (millions)	$4,267.7	$4,378.0	$110.3	2.6%

The passage of Proposition 13 on June 6, 1978, resulted in almost a $7 billion reduction in local property tax revenues. The state responded by providing local governments almost $4.3 billion in grants in 1978–79. This aid, as implemented through Chapter 292 (SB 154) and Chapter 332 (SB 2212), Statutes of 1978, was provided in the form of block grants to schools, cities, counties and special districts, as well as in the form of state "buy-outs" of local health and welfare program costs.

The Governor's Budget for 1979–80 proposes once again to provide fiscal relief to local governments using essentially the same approach as that used during the current year. As Table 5 shows, total fiscal relief proposed for the budget year is $4,378 million, which is $110.3 million or 2.6 percent more than the amount provided in 1978–79. Major increases in county Medi-Cal costs ($66 million) and greater assistance to special districts ($38 million) account for most of the change.

Table 5
Local Government Fiscal Relief
1978–79 and 1979–80
(dollars in millions)

	Estimated 1978–79	*Proposed 1979–80*	*Change Amount*	*Change Percent*
Education:				
K–12	$2,072.4	$2,072.0	–$0.4	—[a]
Community Colleges	260.0	260.0	—	0.0%
Subtotals, Education	($2,332.4)	($2,332.0)	($–0.4)	(—)[a]
Counties:				
Block grants	$436.0	$498.4	$62.4	14.3%
Medi-Cal share	418.0	484.0	66.0	15.8
AFDC share	257.0	256.2	–0.8	–0.3
SSI/SSP share	168.0	200.4	32.4	19.3
Boarding Homes and Institutions (BHI) share[b]	92.0	42.4	–49.6	–53.9
AFDC administration share	88.0	93.1	5.1	5.8
Food stamp administration	21.0	21.5	0.5	2.4
Mental health	13.3	—	–13.3	—
Subtotals, Counties	($1,493.3)[c]	($1,596.0)[d]	($102.7)	(6.9%)
Cities	$250.0	$250.0	—	0.0%
Special districts	162.0	200.0	$38.0	23.5
Loans	30.0[e]	—	–30.0	—
Totals	$4,267.7	$4,378.0	$110.3	2.6%

[a] Less than .05 percent.
[b] The Governor's Budget proposes an increase in the counties' share of this program from 5 percent in 1978–79 to 50 percent in 1979–80. Part of the proposed increase in county block grants is intended to pay for the higher county BHI costs.
[c] This is the total which appears in the Governor's Budget. However, December 1978 estimates of the component county costs by the Department of Social Services are slightly different from most of the figures shown above. Under these new estimates, total assistance to counties totals $1,515.1 million.
[d] The 1979–80 estimate of county AFDC costs has been revised to $271.8 million. This increases the county total to $1,611.6 million.
[e] These are three-year loans to local agencies with nonvoter-approved debt (e.g., redevelopment agencies). SB 154 also provided for $870 million in loans to local governments. All of these loans, however, are to be repaid by the end of fiscal year 1978–79.

Medi-Cal

	Estimated 1978–79 (millions)	*Proposed 1979–80 (millions)*	*Change Amount (millions)*	*Change Percent*
General Fund (includes price and provider rate increases)	$1,604.5	$1,786.0	$181.5	11.3%

The state's share of costs under the California Medical Assistance program, commonly referred to as Medi-Cal, is estimated at $1,786.0 million in 1979–80, which is a $181.5 million or 11.3 percent increase over the current year. The total cost of the program, including the federal government's share, is estimated at $4.1 billion, an increase of $441.3 million or 12.1 percent over 1978–79. This rise is primarily due to the higher cost of health care services. Inpatient hospital care, the single largest Medi-Cal component, is slated to increase 14.4 percent in 1979–80, and other medical care providers are scheduled to receive an average increase for cost of living of six percent.

A slightly expanded caseload will also contribute to the Medi-Cal expenditure rise. While the overall monthly caseload total is expected to increase only 0.5 percent, some of that increase will come in the medically indigent category. The health costs of most recipients in this category are fully funded by the state.

Average Monthly Medi-Cal Caseload

	Estimated 1978–79	*Estimated 1979–80*	*Change*	
			Number	*Percent*
Public assistance	2,152,800	2,145,200	−7,600	−0.4%
Medically needy	343,200	360,400	17,200	5.0
Medically indigent	419,300	425,600	6,300	1.5
Total	2,915,300	2,931,200	15,900	0.5%

Department of Social Services

	Estimated 1978–79 (millions)	*Proposed 1979–80 (millions)*	*Change*	
			Amount (millions)	*Percent*
SSI/SSP grants	$734.8	$706.2	$−28.6	−3.9%
AFDC grants	612.4 [a]	662.0	49.6	8.1
Special social service programs	132.1	177.1	45.0	34.1
County administration	71.4 [a]	79.0	7.6	10.6
All other (including support)	49.0	60.7	11.7	23.9
Total	$1,599.7	$1,685.0	$85.3	5.3%

[a] These amounts are slightly higher than those shown in the Governor's Budget. The budget has inappropriately applied cost savings in the counties' share of these two elements to the state's share.

Total 1979–80 General Fund expenditures for the Department of Social Services are proposed at $1,685.0 million, an $85.3 million or, 5.3 percent increase. Cash payments under SSI/SSP and AFDC, the state's major welfare programs, are estimated at $706.2 million and $662.0 million, respectively.

Expenditures under the SSI/SSP program are expected to decline by $28.6 million in 1979–80. The budget also anticipates a decline in the state share of SSI/SSP costs due to a greater-than-expected growth in assessed property values following the passage of Proposition 13. Because local government expenditures under the program are based on the growth in their assessed property value, their share will increase. Reduced state expenditures will occur despite a 6 percent cost-of-living increase and a caseload growth of 12,000.

Expenditures for AFDC are expected to rise by almost $50 million, reflecting a caseload rise of almost 22,000 and a 6 percent cost-of-living adjustment.

Finally, Special Social Services programs have been alloted a $45.0 million or 34.1 percent increase in budget year General Fund expenditures. This augmentation includes: (1) an increase of $41.1 million for the cost of caseload growth, cost-of-living adjustments and proposed regulations for the In-Home Supportive Services program; (2) an increase of $5 million for the Other County Social Services program for expanded services, and (3) minor offset costs and savings.

Department of Mental Health

	Estimated 1978–79	*Proposed 1979–80*	*Change*	
			Amount	*Percent*
General Fund (in millions)	$404.7	$438.1	$33.4	8.3%

Total General Fund expenditures in 1979–80 for the Department of Mental Health are proposed at $438.1 million, which is an 8.3 percent increase over current year expenditures of $404.7 million. Virtually all of the increase is in state assistance to local mental health programs: (1) $13.7 million to fund a 6 percent cost of living adjustment for community mental health programs, (2) $12.6 million to continue those programs started with 1978–79 monies provided by Chapter 332, Statutes of 1978, and (3) $3.0 million for local residential treatment programs begun under Chapter 1233, Statutes of 1978.

State programs for the mentally ill are estimated to increase only 3.9 percent, as increases in operating costs will be offset by a decline in patients and a corresponding reduction in personnel services. The cost to the General Fund of care for the mentally disabled in state hospitals is estimated at $152.4 million, or $30,000 per patient per year.

Department of Developmental Services

	Estimated 1978–79	*Proposed 1979–80*	*Change*	
			Amount	*Percent*
General Fund (millions)	$365.7	$380.5	$14.8	4.0%

The Governor's Budget proposes a 1979–80 General Fund expenditure of $380.5 million for the Department of Developmental Services, an increase of $14.8 million or 4.0 percent. The most significant change, a 12.2 percent growth in the caseload of the Regional Centers, accounts for $6.3 million of the increase. In state hospital programs for the developmentally disabled, however, caseloads are expected to decrease by 374 patients, allowing the department to reduce its hospital staff by 571 positions. The cost to the General Fund of care for the developmentally disabled in state hospitals is estimated at $233.4 million, or $26,000 per patient per year.

Department of Corrections

	Estimated 1978–79	Proposed 1979–80	Change Amount	Change Percent
General Fund (millions)	$257.9	$268.3	$10.4	4.0%

The Governor's Budget proposes a General Fund expenditure increase in the budget year of $10.4 million or 4.0 percent for the Department of Corrections. Over $2.9 million of the growth in expenditures is needed to provide and staff living quarters for the expected increase in the inmate population. The average number of persons in the state's prisons is anticipated to rise from 21,425 in the current year to 22,980 in 1979–80, a 7.3 percent increase. The budget also provides $2.6 million to increase the number of special housing units, which have been requested in order to help control prison violence. The incarceration costs to the General Fund per prisoner per year is estimated at $11,675.

K–12 Education

General Fund	*Estimated 1978–79 (millions)*	*Proposed 1979–80 (millions)*	*Change Amount (millions)*	*Change Percent*
Regular Support:				
Block grants	$2,114.3	$2,214.7	$100.4	4.7%
All other	1,286.1	1,348.5	62.4	4.9
Subtotal, Regular Support	$3,400.4	$3,563.2	$162.8	4.8%
Proposition 13 fiscal relief	2,072.4	2,072.4	—	0.0
Total, General Fund	$5,472.8	$5,635.5	162.8	3.0%

The Governor's Budget proposes a $162.8 million or 3.0 percent increase in total K–12 Education General Fund expenditures. All of the increase is in the regular support budget; local fiscal assistance would be at the current year level of $2,072.4 million. The largest dollar increases are proposed for the block grant program and the Master Plan for Special Education.

Although General Fund support of K–12 Education is proposed to increase 3.0 percent in 1979–80, total K–12 expenditures—*on a per student basis*—are expected to rise 6.2 percent. As the following table shows, this is due to: (1) a continued decline in average daily attendance and (2) a 8.4 percent rise in per student expenditures from non-General Fund sources (primarily local property tax revenues).

Average Daily Attendance (ADA) and Per Student Expenditures

ADA	*Actual 1977–78*	*Estimated 1978–79 Total*	*Estimated 1978–79 Percent Change*	*Estimated 1979–80 Total*	*Estimated 1979–80 Percent Change*
Elementary	2,960,734	2,817,000	−4.9%	2,773,600	−1.6%
High School	1,449,983	1,380,600	−4.8	1,354,700	−1.9
High School, Adults	241,769	131,700	−45.5	133,400	1.3
Total	4,652,486	4,329,300	−6.9%	4,261,700	−1.6%
Per Student Expenditures					
General Fund [a]	$665	$1,264	90.1%	$1,322	4.6
All other sources	1,374	946	−31.1	1,025	8.4
Total	$2,039	$2,210	8.4%	$2,347	6.2%

[a] Includes local government fiscal relief to schools.

Postsecondary Education

	Estimated 1978–79 (millions)	*Proposed 1979–80 (millions)*	*Change*	
			Amount (millions)	*Percent*
University of California	$767.0	$797.1	$30.1	3.9%
California State University and Colleges	691.9	714.3	22.4	3.2
California Community Colleges:				
Regular program	557.2	592.4	35.2	6.3
Proposition 13 fiscal relief	260.0	260.0	—	—
Total, Community Colleges	$817.2	$852.4	$35.2	4.3%
Total, Postsecondary Education	$2,276.1	$2,363.8	$87.7	3.9%

The Governor's Budget proposes General Fund expenditures for the University of California of $797.1 million, an increase of $30.1 million or 3.9 percent. Most of the spending growth is due to merit increases ($12.4 million) and price increases ($11.2 million). Major program changes include: (1) $4.0 million for replacement of instructional equipment, (2) $1.9 million increase in the Student Affirmative Action Program, and (3) $1.5 million in library improvements.

The Governor's Budget proposes a $22.4 million increase in the California State University and Colleges (CSUC) budget, a 3.2 percent increase over 1978–79. Major augmentations include: (1) $10.1 million for additional retirement benefits, as required by Chapter 1180, Statutes of 1978 (AB 2582), (2) merit increases and salary adjustments of $6.2 million, (3) a $6.0 million revision in salary savings requirements, and (4) price increases of $6.0 million. These additions will be partially offset by an unidentified reduction equal to 1 percent of the 1978–79 budget, or $6.9 million.

Total 1979–80 General Fund expenditures for California Community Colleges are proposed at $852.4 million, a $35.2 million or 4.3 percent increase over the current year. A 6 percent cost-of-living adjustment is proposed for the community college apportionments program, while fiscal relief would be continued at the 1978–79 level of $260 million.

Enrollment
(Full-time Equivalents)

	Actual 1977–78	*Estimated 1978–79*		*Estimated 1979–80*	
		Amount	*Percent Change*	*Amount*	*Percent Change*
University of California:					
General campuses	106,543	107,909	1.3%	107,136	−0.7%
Health sciences	11,397	12,040	5.6	12,405	3.0
Total	117,940	119,949	1.7%	119,541	−0.3%
California State University and Colleges	234,074	229,958	−1.8%	230,510	0.2%
California Community Colleges (expressed in ADA)	718,303	678,200	−5.6%	678,200	0.0%

Enrollments in all three segments are projected at about the same levels as in 1978–79. However, whereas UC and CSUC enrollments changed only slightly between 1977–78 and 1978–79, average daily attendance (ADA) at community colleges fell over 40,000, or 5.6 percent. This was mainly due to the revenue reductions caused by Proposition 13, which necessitated program cuts.

Tax Relief

	Estimated 1978–79 (millions)	*Proposed 1979–80 (millions)*	*Change* Amount (millions)	Percent
Senior citizens' property tax assistance	$70.0	$39.0	$−31.0	−44.3%
Senior citizens' property tax deferral	10.0	12.0	2.0	20.0
Senior citizens' renters tax relief	5.5	101.0	95.5	1,736.4
Personal property tax relief	216.5	244.6	28.1	13.0
Homeowners' property tax relief	347.0	132.0	−215.0	−62.0
Open space	15.0	16.0	1.0	6.7
Subventions for tax losses	4.9	4.5	−0.4	−8.2
Renters' tax relief	135.0	148.0	13.0	9.6
Totals	$803.9	$697.1	$−106.8	−13.3%

In 1977–78 the state provided almost $1.5 billion in tax relief to homeowners, renters, and businesses. With the imposition of Proposition 13's 1 percent limit on property tax rates, state subventions for these eight programs in the current year were almost halved. For 1979–80 the Governor has proposed a General Fund expenditure of $697 million, which is $107 million, or 13.3 percent, less than expenditures in the current year. As was mentioned above, however, the decrease results from the Governor's proposal to change the homeowners' exemption to an income tax credit. As a result, approximately $262 million would be converted from an expenditure to a revenue loss. On an equivalent basis, the total cost of the homeowners' credit and rebate in 1979–80 would be approximately $374 million, a $27 million or 7.8 percent increase over the current year cost of the homeowners' exemption.

The major program increase in the tax relief category is in the senior citizens' renters program. Chapter 569, Statutes of 1978 (AB 3802), both increased benefit levels and expanded the program to include the disabled, changes which will add $95.5 million to expenditures in the budget year.

Employee Compensation

	Actual 1977–78 (millions)	*Estimated 1978–79 (millions)*	*Proposed 1979–80 (millions)*	*Change, 1978–79 to 1979–80* Amount (millions)	Percent
General Fund	$158.8	$33.2	$1.7	−$31.5	−94.9
Special funds	31.2	4.3	—	−4.3	—
Nongovernmental cost funds	46.0	5.5	—	−5.5	—
Total, All Funds	$235.9	$43.0	$1.7	−$41.3	−96.0

In 1977–78 most state employees received a 7.5 percent cost-of-living increase. When combined with the costs of other fringe benefit increases, the total augmentation for employee compensation in that year was $235.9 million. The current year budget, however, includes no cost-of-living adjustment for most state employees. The increase in compensation of $42.9 million shown for 1978–79 represents the cost of increased health benefits ($28.4 million), judicial salary increases ($2.6 million), legislative salary increases ($0.1 million) and special adjustments by the state.

The budget assumes that in 1979–80, employee compensation matters will be negotiated pursuant to the employee bargaining provisions of Chapter 1159, Statutes of 1977. The Governor has decided not to anticipate what these negotiations will produce in the way of compensation adjustments. Consequently, his budget does not include an appropriation for employee compensation increases other than $1.7 million for a statutorily mandated increase in judicial salaries. However, the Governor has indicated that he supports a cost-of-living adjustment for state employees.

In terms of the potential budget impact of a final negotiated agreement, each 1 percent salary increase granted will cost the state approximately $39.4 million: $25.6 million from the General Fund, $5.8 million from special funds and $8.0 million in nongovernmental cost fund expenditures.

Capital Outlay

	Estimated 1978–79 (millions)	*Proposed 1979–80 (millions)*	*Change*	
			Amount (millions)	*Percent*
General Fund	$188.3	$200.5	$12.2	6.5%
Special funds	494.5	265.8	−228.7	−46.2
Totals	$682.8	$466.3	−$216.5	−31.7%

Major Capital Outlay Programs: 1979–80
(millions)

General Fund		*Special Funds*	
Department of Corrections	$103.2	Department of Transportation	$177.6
Department of Developmental Services	43.8	Department of Water Resources	25.0
Department of General Services	37.6	Higher Education	31.4
All Other	15.9	All Other	31.8
Total	$200.5	Total	$265.8

General Fund capital outlay expenditures of $200.5 million are proposed for 1979–80, a $12.2 million or 6.5 percent increase. One-half of the total is designated for new prison facilities, while $43.8 million and $37.6 million are proposed for state hospital projects and state office buildings, respectively. Two-thirds of special fund capital outlay expenditures are for the Highway Transportation program.

The expected 31.7 percent decline in total capital outlay expenditures between 1978–79 and 1979–80 is unlikely to occur. As noted above, the midyear estimates of capital outlay expenditures historically have been highly inflated because the budget assumes that projects will proceed at a faster rate than realistic scheduling of projects would allow.

GENERAL OBLIGATION BONDS

Bond Categories

General obligation bonds are those debt instruments which are backed with the full faith and credit of the state. California's general obligation bonds are grouped into three categories, depending on the extent to which debt service is assumed by the state:

(1) *General Fund Bonds.* The debt service on these bonds is fully paid by the General Fund.

(2) *Partially Self-Liquidating Bonds.* The only program falling into this category is school building aid. Prior to the current year, debt service on these bonds was paid in part by the state and in part—depending on local assessed valuations—by local school districts. Assessed valuations have now reached such a level that the state is relieved of any debt service payments.

(3) *Self-Liquidating Bonds.* Redemption and interest costs are paid entirely from project revenues. However, should such revenues ever fail to cover the required debt service, the state would have to make up the difference.

Agencies of the state also issue revenue bonds. These are not, however, general obligation issues, as only the revenue generated from the financed project is pledged as security. This type of debt instrument has been used by the state to finance the construction of bridges, fair facilities, dormitories and parking lots. Revenue bond totals have not been included in this summary.

Table 6 provides detail on the three categories of general obligation

Table 6
General Obligation Bonds of the State of California
As of December 31, 1978

	Authorized	*Unsold*	*Redemptions*	*Outstanding*
General Fund Bonds:				
State construction	$1,050,000,000	—	$531,300,000	$518,700,000
Higher education construction	230,000,000	—	91,390,000	138,610,000
Junior college construction	65,000,000	—	24,300,000	40,700,000
Health science facilities construction	155,900,000	—	11,750,000	144,150,000
Community college construction	160,000,000	—	27,250,000	132,750,000
Beach, park, recreational and historical facilities	400,000,000	$85,000,000	78,600,000	236,400,000
Recreation and fish and wildlife	60,000,000	—	14,500,000	45,500,000
Clean water	875,000,000	510,000,000	54,500,000	310,500,000
Safe drinking water	175,000,000	145,000,000	—	30,000,000
State, urban, and coastal parks	280,000,000	195,000,000	1,500,000	83,500,000
Subtotal	($3,450,900,000)	($935,000,000)	($835,090,000)	($1,680,810,000)
Partially Self-Liquidating Bonds:				
School building aid	$2,140,000,000	$65,000,000	$931,405,000	$1,143,595,000
Self-Liquidating Bonds:				
Water resources development	1,750,000,000	180,000,000	39,100,000	1,530,900,000
Harbor bonds	89,303,000	—	54,474,000	34,829,000
Veterans' farm and home building	3,250,000,000	750,000,000	1,071,175,000	1,428,825,000
Subtotal	($5,089,303,000)	($930,000,000)	($1,164,749,000)	($2,994,554,000)
Total, All General Obligation Bonds	$10,680,203,000	$1,930,000,000	$2,931,244,000	$5,818,959,000

bonds. As of December 31, 1978, the state had over $1.9 billion in unsold bonds, an increase of $334.1 million or 20.9 percent from the total on December 31, 1977. During the 1978 calendar year, $540.9 million in bonds were sold and two new issues totaling $875 million were passed by a two-thirds vote of each house of the Legislature and approved by the electorate in the general elections.

Program	*Legislation*	*Election*	*Amount (in millions)*
Clean Water and Water Conservation Bond Law of 1978	Chapter 1160, Statutes of 1977 (AB 399)	June 1978	$375
Veterans Bond Act of 1978	Chapter 215, Statutes of 1978 (AB 340)	November 1978	$500

Of the authorized bonds already sold ($8.75 billion), $2.9 billion have been retired and $5.8 billion are still outstanding.

Bond Program Sales

Table 7 shows general obligation bond sales on a fiscal year basis for the past, current and budget years. For 1978–79 and 1979–80, two programs alone—clean water and veterans—will account for almost three-fourths of new general obligation bond indebtedness.

Table 7
General Obligation Bond Sales
1977–78 through 1979–80
(in millions)

	Actual 1977–78	*Estimated 1978–79*	*Proposed 1979–80*
Health science facilities construction	$60.9	—	—
Beach, park, recreational and historical facilities	25.0	$65	$45
Clean water	50.0	130	100
Safe drinking water	—	—	30
State, urban, and coastal parks	85.0	50	90
Subtotal, General Fund Bonds	($220.9)	($245)	($265)
School building aid [a]	50.0	65	—
Water resources development [b]	10.0	—	10
Veterans' farm and home building [b]	150.0	350	375
Total	$430.9	$660	$650

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

Selected Bond Fund Expenditures

Even after General Fund bonds are sold, the Legislature must still appropriate the proceeds from an issue for specific projects. These appropriations, referred to as selected bond fund expenditures, are identified in Schedule 3 of the Governor's Budget. Table 8 groups them according to the source of funding.

Table 8
Selected Bond Fund Expenditures
1977–78 through 1979–80

	Actual 1977–78	*Estimated 1978–79*	*Proposed 1979–80*
State construction	$682,800	$56,800	—
Higher education construction	—	11,880,166	—
Junior college construction	765,406	29,584	—
Health science facilities construction	22,151,043	21,332,906	$5,053,000
Community college construction	3,474,990	1,335,700	—
Beach, park, recreational and historical facilities	37,109,071	81,748,015	3,397,609
Recreation and fish and wildlife	1,473,916	7,330,572	36,372
Clean water	49,760,907	85,227,633	94,562,028
Safe drinking water	1,075,420	40,292,400	36,358,800
State, urban, and coastal parks	39,880,432	152,683,801	26,040,381
Coastal conservancy	177,018	4,482,309	3,538,110
Totals	$156,551,003	$406,399,886 [a]	$168,986,300

[a] This figure is less than the amount shown in Schedule 3 of the Governor's Budget by $20,467,000. This amount represents a federal reimbursement to the State, Urban, and Coastal Park Fund which was inappropriately included as a bond fund expenditure by the Department of Finance in the 1978–79 fiscal year.

It appears from Table 8 that bond fund expenditures will rise dramatically in 1978–79 (a 160 percent increase over 1977–78) and then drop precipitously in 1979–80 (a 58 percent decrease from 1978–79). By historical standards neither is likely to occur. Instead, it is almost certain that the midyear estimate for 1978–79, like previous midyear estimates, is greatly overstated.

Each of the last four midyear estimates of bond fund expenditures have turned out to be too high. On the average, actual expenditures recorded one year later have been about half of the midyear estimate. For example, the 1976–77 and 1977–78 midyear expenditure estimates were $405 million and $436 million, respectively, while actual expenditures in those years were $123 million and $157 million, respectively.

The failure of the budget to give a realistic picture of bond expenditures makes inter-year bond program comparisons invalid, and in turn distorts total expenditure comparisons. The distortion occurs because, at any one time, the state has a large backlog of projects—especially in the parks and recreation bond programs. More realistic scheduling of new projects and those already authorized would result in more accurate midyear estimates and, consequently, improved inter-year comparisons.

General Fund Debt Service

Table 9
General Fund Debt Service
1977–78 through 1981–82 [a]

Fiscal Year	*Debt Service* [a]	*Percent Change from Previous Year*	*Anticipated* [b] *Future Sales (millions)*
1977–78	$166,037,824	8.9%	—
1978–79	187,890,691	13.2	$145 (last half of fiscal year)
1979–80	210,385,746	12.0	265
1980–81	228,703,075	8.7	125
1981–82	235,656,091	3.0	125

[a] All figures are estimates except for 1977–78.
[b] An average interest rate of 5.5 percent is assumed on future sales.

Table 9 projects the amount of debt service to be paid on bonds fully supported by the General Fund through 1981–82. Debt service for the budget year will increase $22.5 million or 12.0 percent over the current year. All of the debt service estimates in Table 9 are based, of course, on specific estimates of anticipated future bond sales. If additional sales occur, the amounts needed to retire General Fund debt will increase accordingly.

III. REVENUES

Summary

The Governor's Budget estimates that General Fund revenues in the current year (1978–79) will total $15 billion, 9.5 percent ($1.3 billion) more than was collected in 1977–78. For the budget year (1979–80), General Fund revenues are projected to reach $17.4 billion *under existing law,* or 15.8 percent ($2.4 billion) more than estimated revenues in the current year. The Governor's Budget, however, also proposes $1.4 billion in tax reductions (including the conversion of $262 million in homeowners' tax relief from an expenditure to a tax credit). If approved, these reductions would lower the growth in General Fund revenues during 1979–80 to 6.6 percent.

Table 10 summarizes current year and budget year General Fund revenue projections, and shows the effects of the Governor's tax proposal and major 1978 income tax legislation on these revenue levels and yearly growth rates.

Table 10
Summary of 1978–79 and 1979–80
General Fund Revenue Growth Projections
(billions of dollars) [a]

	1977–78 Actual		*1978–79 Estimated*		*1979–80 Projected*	
	Amount	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
Revenues Under Laws in Effect in January 1978	$13.7	20.3%	$16.0	16.7%	$18.0	12.3%
Revenues Under Laws in Effect in January 1979 [b]	$13.7	20.3%	$15.0	9.5%	$17.4	15.8%
Revenues Under Current Law as Adjusted by the Governor's Tax Proposals [c]	$13.7	20.3%	$15.0	9.5%	$16.0	6.6%

[a] All figures rounded to nearest $100 million.
[b] Includes reduced revenues due to AB 3802 (Chapter 569) of $990 million in 1978–79 and $580 million in 1979–80. Of these reductions, the one-time provision of AB 3802 account for $647 million in 1978–79 and $34 million in 1979–80.
[c] The *1979–80 Governor's Budget* proposes $1.4 billion in reduced income tax revenues.

Current Year Revenues. The 1978–79 current year estimate of $15 billion in General Fund collections is about $160 million *less* than what the Department of Finance estimated a year ago. Since then, the economy has proven to be stronger than anticipated, thereby pushing up revenues, while new legislation (particularly AB 3802 which reduced income taxes by \$990 million) has had the effect of reducing revenues by an even larger amount. After adjustment for the effects of Proposition 13 and legislation, the current estimate is about \$590 million *more* than last year's May revenue revision. About \$365 million of this \$590 million increase reflects unexpectedly strong economic conditions, while \$225 million represents increased interest income. As of the end of December 1978, only about \$130 million of this \$590 million had actually been collected.

Budget Year Revenues. State revenues in fiscal year 1979–80 will depend on economic conditions in both calendar years 1979 and 1980. Given the Department of Finance's economic outlook, revenues under existing law are projected to increase more rapidly than in 1978–79. Revenues from all sources are projected to rise 14.5 percent versus 9.1 percent in 1978–79, while General Fund revenues are expected to rise 15.8 percent versus 9.5 percent in the current year. These trends, however, are distorted by one of the features in AB 3802—a \$680 million *one-time* increase in personal income tax credits that primarily affects 1978–79 revenues. Elimination of this one-time effect would indicate that both General Fund and total revenue growth will be slower in 1979–80 than in 1978–79. For instance:

- *Sales and use taxes*—the state's largest source of General Fund revenues—are expected to increase 11.9 percent in 1979–80 compared to 13.2 percent in the current year and 17.5 percent in 1977–78.
- *Bank and corporation taxes* in 1979–80 are projected to rise only 7.6 percent compared to 9.8 percent in the current year and 26.8 percent in 1977–78.
- *Personal income taxes* are projected to rise 30.9 percent in 1979–80 compared to 1.7 percent in 1978–79 and 24.1 percent in 1977–78. However, this strong 1979–80 increase and the sharp 1978–79 slowdown are eliminated when the distortions resulting from AB 3802 are removed.

Underlying Economic Assumptions. The Department of Finance's revenue projections are generally consistent with its underlying economic forecast. The department forecasts a slowing of economic activity in 1979 accompanied by continuing high inflation. This forecast appears to be reasonable at this time. However, because of the considerable uncertainty in the economic outlook—particularly for California—these economic projections will probably require reassessment as 1979 continues. The expectation of slowing economic activity in 1979 is evidenced in the forecasts for those key economic variables that have the most impact on state revenues:

- *California personal income growth* is forecast to taper from 14.0 percent in 1978 to 13.0 percent in 1979 and 10.5 percent in 1980.
- *Taxable sales* are predicted to rise 11.5 percent and 11.1 percent in 1979 and 1980, respectively, compared to 14.5 percent in 1978. In addition, the levels of both *new housing permits* and *new car sales* are expected to fall below those registered in 1978.
- *Corporate profits* are forecast to increase 7.7 percent in 1979 versus 19.9 percent in 1978.
- *Employment growth* is predicted to fall to 2.5 percent in 1979, versus

5.6 percent in 1978.

THE 1978 ECONOMY IN RETROSPECT

Table 11

Comparison of 1978 Department of Finance Economic Forecasts and Actual Results for Selected Variables (dollar amounts in billions)

	Original Budget Forecast for 1978[a]	*Revised Forecast for 1978*[b]	*Estimated Actual for 1978*[c]
A. *Selected National Indicators*			
Percentage Change in:			
-Real GNP	4.8%	3.8%	3.9%
-GNP price deflator	5.8	6.1	7.4
-Personal income	10.4	10.9	11.5
-Corporate profits (pre-tax)	11.9	9.6	15.6
-Employment (civilian)	N/A	3.6	4.1
-Consumer prices[d]	6.3	N/A	7.7
Unemployment Rate (%)	6.7%	6.2%	6.1%
Housing Starts (millions of units)	1.90	1.83	1.97
New Car Sales (millions of units)	11.20	11.00	11.30
B. *Selected California Indicators*			
Percentage Change in:			
-Personal income	10.7%	12.5%	14.0%
-Taxable corporate profits	10.0	10.4	19.9
-Taxable sales	10.7	12.3	14.5
-Employment (civilian)	3.4	6.4	5.6
-Consumer prices[d]	6.1	6.7	7.8
Unemployment Rate (%)	7.2%	7.4%	7.2%
Personal Income	$191.8	$193.9	$197.4
Taxable Corporate Profits	$20.0	$20.5	$22.6
Taxable Sales	$110.4	$111.7	$113.9
Residential Building Permits (000)	235	235	237
New Car Sales (000)	1,100	1,200	1,170

[a] 1978–79 Governor's Budget.
[b] Department of Finance, May 1978.
[c] 1979–80 Governor's Budget.
[d] Index for wage earners and clerical workers.

Inflationary Expansion Continued

At the national level, 1978 was a year of slowing economic expansion accompanied by high inflation. As indicated in Table 11:

- *Real Gross National Product* (GNP) rose by 3.9 percent. This compares to growth rates of 4.9 percent in 1977 and 5.7 percent in 1976.
- *General price inflation* soared to 7.4 percent (average annual rate), compared to only 5.9 percent in 1977 and 5.2 percent in 1976. However, this average annual rate was still below the 9.2 percent experienced in 1975.
- *Consumer price inflation* was even higher than general inflation—7.7 percent (average annual rate). This exceeded the rates of 6.5 percent in 1977 and 5.8 percent in 1976.
- The *employment* picture improved, with unemployment falling to 6.1 percent (average annual rate) compared to 7.0 percent in 1977, 7.7 percent in 1976 and 8.5 percent in 1975. This improvement was due to unexpectedly strong employment growth of 4.1 percent, versus only 3.5 percent in 1977.
- *Personal income* also increased at a rapid rate in 1978, rising 11.5 percent versus the 10.7 percent growth achieved in 1977. However, because of accelerating inflation, the growth in *real* personal income *declined.*
- *Corporate profits, housing* and *automobile sales* all had good years. Profits rose nearly 16 percent, compared to the 11.5 percent gain in 1977. Housing starts (1.97 million units) and automobile sales (11.3 million units) both registered 1978 performances which were on a par with 1977.

Table 12
Comparative Performance of Alternative National Forecasts for 1978 [a]

Real Gross National Product Growth		*General Price Inflation* [b]		*Unemployment Rate*	
Actual 1978 Value	3.9%	Actual 1978 Value	7.4%	Actual 1978 Value	6.1%
Forecasts:		*Forecasts:*		*Forecasts:*	
United California Bank	2.9%	Wells Fargo Bank	5.5%	Bank of America	6.5%
Chase Econometrics	3.9	Security Pacific Bank	5.8	Wells Fargo Bank	6.5
Security Pacific Bank	4.1	Department of Finance	5.8	Crocker Bank	6.5
Business Week Survey	4.3	Chase Econometrics	5.9	Security Pacific	6.6
Bank of America	4.4	Crocker Bank	5.9	UCLA	6.6
Wells Fargo Bank	4.4	United California Bank	5.9	*Times* Board of Economists	6.6
Times Board of Economists	4.6	*Business Week* Survey	6.1	Department of Finance	6.7
Department of Finance	4.8	*Times* Board of Economists	6.2	Chase Econometrics	6.7
Crocker Bank	4.9	UCLA	6.2	United California Bank	7.3
UCLA	4.9	Bank of America	6.5	*Business Week* Survey	7.6

[a] Forecasts dated approximately January 1977.
[b] Annual average percent change in the GNP deflator.

One year ago, the consensus of economic forecasters was that inflationary economic expansion would continue during 1978. However, economists generally overestimated the rates of real growth and unemployment, and underestimated the pace of inflation. Table 11, for instance, shows that the Department of Finance underestimated the inflation rate by about 1½ percentage points and overestimated the real growth rate by about 1 percentage point. These forecasting errors were made by most other forecasters. This can be seen in Table 12, which compares the 1978 national economic forecasts for inflation, real growth and unemployment made by a variety of forecasters. None of these forecasters accurately predicted all three of the main economic variables, and Finance's overall performance was no better nor worse than its competitors'. Thus, 1978 proved once again that economic forecasting remains more of an art than a science.

Employment Growth Maintained Vigor

Rapid employment growth has been a key characteristic of the nation's economy ever since the current expansion began in 1975. For the 12-month period ending in December 1978, preliminary data show that the number of persons employed nationally rose by 3.3 million, compared to increases of 4.1 million in 1977 and 3.0 million in 1976. Total employment in December 1978 reached a record 95.9 million while unemployment dropped to 5.9 percent (versus the 6.4 percent one year earlier). However, despite the improvement in the nation's overall unemployment picture, minority workers and teenagers continued to experience significant employment problems (Table 13).

Table 13
Unemployment Rates in the United States

	Unemployment Rates		
Group	*1976 Fourth Quarter*	*1977 Fourth Quarter*	*1978 Fourth Quarter*[a]
All workers	7.9%	6.6%	5.9%
Adult men	6.2	4.8	4.1
Adult women	7.6	6.8	5.8
Teenagers	19.1	16.7	16.5
White workers	7.2	5.8	5.2
Black and other minority workers	13.4	13.3	11.5
Full-time workers	7.5	6.2	5.3

[a] Preliminary data subject to revision.

Because labor force growth can be volatile and because unemployed workers can shift in and out of the labor force in a somewhat unpredictable fashion, many economists believe that the best general indication of employment strength is the ratio of employed persons to total working-age population, not the unemployment rate. The ratio of employed persons to working-age population for the nation as a whole reached a record level of 59.1 percent in December 1978. Thus, a higher proportion of the population is now working in the United States than ever before, despite the continuing high unemployment rate.

Disappointing Productivity Gains Intensified Inflationary Pressures

Real growth in the economy is heavily dependent upon increases in productivity of the labor force. This productivity is measured in terms of output of goods and services per hour of work. During 1978, there was a very strong increase in the total number of employees, but a weak increase in the output per worker. These conflicting trends partially explain the slowdown in total output last year. Worker productivity increased only 0.4 percent in 1978, compared to an average annual rate of 3.1 percent between 1947 and 1967 and about 1.6 percent over the past 10 years. This disappointingly low productivity gain, coupled with the average 9.3 percent increase in workers' hourly compensation in 1978, resulted in an 8.9 percent rise in unit labor costs—the second largest in history and well above the 6.5 percent recorded in 1977. This is an important factor in explaining inflation because the movement in unit labor costs is perhaps the single most important variable impacting on product prices.

To some extent, declining productivity growth can be explained by the rapid growth of employment in those sectors of the economy with lower levels of productivity—such as services and trade industries. Another factor is that certain industries are reducing their reliance on capital equipment and increasing their reliance on labor because of rising equipment and energy costs. Also, the failure of capital investment expenditures in the past several years to fully compensate for the reduced expenditure levels associated with the 1973–75 recession has adversely affected the overall stock of capital equipment. In addition, increasingly large amounts of investment monies have had to be spent on costly antipollution equipment and for compliance with health and safety regulations, rather than on more efficient machinery and production techniques. Finally, a growing minority of economists believe that the United States' economy is entering the downside of a long-run growth cycle, characterized by low rates of return on capital investment associated with declining labor productivity. Whatever the reason, the economy's continuing poor productivity performance, while somewhat conducive to employment growth, will significantly contribute to inflationary pressures and thereby reduce the growth rate of "real" income and output.

California Outperformed Expectations

Table 14 shows that California's 1978 economic performance was unexpectedly robust and inflation-ridden. For example:

- *Personal income* rose 14 percent, the strongest gain in 27 years.
- *Civilian employment* rose 518,000, or 5.6 percent, far exceeding the 3.4 percent initially forecast by the Department of Finance.
- *Consumer Price Inflation* rose 7.8 percent (average annual rate), versus the 6.1 percent forecast by Finance a year ago.
- *Unemployment* fell from 8.2 percent to 7.2 percent (average annual rate), largely due to the strong employment gains. This unemployment rate matched that forecast by Finance, because the department's initial estimates for both employment and labor force growth were conservative.

Because calendar 1978 economic performance is the prime determinant of current-year (1978–79) state revenues, the unexpected economic strength and inflation in 1978 largely explains the significant upward revisions in estimated current-year revenues which are discussed later in this section. For example, the three economic variables most directly tied to California's three major revenue sources all showed increases well above the rates forecasted at the start of 1978:

- *Personal income*—the prime determinant of personal income tax revenues—rose 14 percent compared to last year's forecast of only 10.7 percent.
- *Taxable sales*—which determine sales and use tax revenues—increased 14.5 percent versus the expected 10.7 percent increase.
- *Corporate profits*—which are the basis for bank and corporation tax revenues—experienced a 19.9 percent gain, or nearly twice the 10.0 percent forecast last year.

No private or public state-level forecaster predicted the strength of California's economic growth during 1978, and no forecaster even came close to anticipating the 14 percent increase in personal income. The data in Table 14 illustrate this fact.

Table 14

Comparative Performance of Alternative California Personal Income Forecasts for 1978 [a]

	Percent Change in Personal Income
Actual 1978 Value	14.0%
Forecasts:	
UCLA	12.0
Bank of America	11.2
Department of Finance	10.7
Crocker Bank	10.7
Security Pacific Bank	10.2
Wells Fargo Bank	10.0
United California Bank	9.9

[a] Forecasts dated approximately January 1977.

The reasons for California's very strong growth during 1978 are not fully understood—particularly those reasons responsible for the unusually large increase in employment which directly affects the growth in personal income. Some of the theories relied upon to explain these increases are: (1) growing in-migration, (2) increasing part-time employment, and (3) a large increase in the number of multiple job holders.

Whatever the explanation, California's 1978 economic performance has been extremely favorable both from an historical perspective and relative to the nation's. As evidence of the latter, California's personal income, employment and automobile sales gains all exceeded gains at the national level (Table 11). Although housing permits dropped to an annual average of 235,000 units, this still represented a strong performance given that the record 1977 level of 270,000 was clearly unsupportable for another year. Even the gap between the United States' and California's unemployment rates narrowed, although the state's rate remained higher due to factors such as strong in-migration, high rates of labor force participation and a mobile labor force characterized by high job turnover.

Year Ends on Strong Note

Recent national data indicate that real GNP rose in the last three months of 1978 at an annual rate of 6.1 percent, far exceeding expectations and suggesting that a significant economic slowdown is less likely to occur in the first half of 1979 than many economists anticipated. The GNP gain is particularly encouraging because it primarily reflected growth in final sales, while the rate of inventory accumulation declined. Strong year-end gains were also registered for industrial production, personal income and housing starts. California also maintained its economic strength in the latter part of 1978.

Unfortunately, the year-end data also indicate a worsening of inflation. For instance, at the national level general price inflation in the fourth quarter averaged 8.1 percent on an annual basis, up from 6.9 percent in the third quarter. Quarterly rates of general inflation during 1978 were as follows:

General Price Inflation in 1978 by Quarter (annual percentage rates)

First Quarter	*Second Quarter*	*Third Quarter*	*Fourth Quarter*	*Full Year*
7.2%	11.0%	6.9%	8.1%	7.4%

Consumer price inflation also remained undesirably high in the fourth quarter at 7.9 percent. Ominous signs of future inflation were also evident in the form of continued low productivity increases and rising rates of capacity utilization. In December, for instance, the overall capacity utilization rate rose to 85.9 percent versus 83.0 percent one year earlier, while the rate for industries in the basic materials inputs sector rose to 87.6 percent from 81.9 percent.

Thus, as 1978 ended and 1979 began, the term "inflationary expansion" still seems to best characterize the near-term economic outlook.

THE 1979 AND 1980 ECONOMIC OUTLOOK

Economic activity in calendar 1978 will account for about two-thirds of 1978–79 state General Fund revenues, while economic conditions in 1979 will account for the remaining one-third. Similarly two-thirds of budget year revenues will depend upon economic activity in 1979, while the remaining portion will reflect economic conditions in 1980. In this section, we discuss both the 1979 and 1980 calendar year economic forecasts, although emphasis is placed on the 1979 outlook because of its significance for revenues in both the current and budget years. A second reason for emphasizing the 1979 outlook is the fact that economic projections for periods beyond a year are much less reliable than those covering the period closer at hand.

The economic outlook for 1979 and 1980—both for the nation and for the State of California—is unusually difficult to establish at this time. Nearly all economists acknowledge the possibility that the economy could proceed along several different paths during the next 18–24 months. Some forecasters are anticipating that there will be a significant slowdown in the rate of economic activity later in 1979, leading to an outright recession. A much larger group of economists foresees a slowdown in the rate of economic activity later in 1979, but one that is not sufficiently pronounced to qualify as a recession. A third group is more optimistic, noting the absence of certain trends in selected economic indicators that normally precede recessions. Regardless of which forecast these economists believe is most likely to occur, most of them readily acknowledge that either one of the other scenarios is possible. Each scenario would have a significantly different impact on the State of California's revenues.

The Department of Finance has chosen the middle ground in making its economic and revenue forecast—a choice which we agree is the most reasonable at this time.

The National Economy

The department's economic forecast for the nation's economy in 1979 and 1980 is shown in Table 15. This forecast is based on the following key assumptions:

- *Real Gross National Product* will grow only 2.1 percent in 1979, a definite slowdown from the 3.9 percent and 4.9 percent growth rates achieved in 1978 and 1977, respectively. Moderate recovery from this slowdown is forecast for 1980, with a 3.7 percent rate of expansion.
- *General price inflation* in 1979 will average 7.4 percent, the same inflation rate as in 1978, but well above the 5.8 percent rate for 1977. General price inflation in 1980 is forecast to taper somewhat—to 6.5 percent.
- *Consumer prices* will increase 8.3 percent in 1979 (average annual rate), compared to increases of 7.7 percent in 1978 and 6.5 percent in 1977. In 1980, however, the inflation rate is expected to drop to 6.8 percent.

Table 15
National Economic Data
(dollars in billions) [a]

	Actual 1977		Estimated 1978		Budget Forecast 1979		Budget Forecast 1980	
	Level	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*
Gross National Product	$1,887.2	11.0%	$2,105.0	11.5%	$2,310.5	9.8%	$2,553.5	10.5%
GNP in 1972 Dollars	$1,332.7	4.9	$1,384.4	3.9	$1,413.9	2.1	$1,466.6	3.7
GNP Price Deflator (1972 = 100)	141.6	5.8	152.1	7.4	163.4	7.4	174.1	6.5
Personal Income	$1,529.0	10.7	$1,705.1	11.5	$1,883.0	10.4	$2,071.5	10.0
Disposable Personal Income	$1,303.0	10.0	$1,449.8	11.3	$1,605.0	11.1	$1,762.0	9.8
Personal Savings	$66.9	−1.8	$76.0	13.6	$91.7	20.7	$92.0	0.3
Savings Rate	5.1%	—	5.2%	—	5.7%	—	5.2%	—
Corporate Profits (pre-tax)	$173.9	11.5	$201.0	15.6	$209.0	4.0	$236.0	12.9
Consumer Price Index (1967 = 100)	181.5	6.5	195.4	7.7	211.6	8.3	226.0	6.8
Employment (thousands)	90,546	3.5	94,225	4.1	95,740	1.6	98,300	2.7
Unemployment (thousands)	6,855	−5.9	6,075	−11.4	6,960	14.6	6,950	−0.1
Unemployment Rate	7.0%	—	6.1%	—	6.8%	—	6.6%	—
Housing Starts (millions of units)	1.987	29.2	1.970	−0.9	1.750	−11.2	1.900	8.6
New Car Sales (millions of units)	11.2	10.9	11.3	0.9	10.4	−8.0	11.0	5.8
Net Exports	$−11.1	—	$−11.3	—	$−5.0	—	$−3.0	—

[a] Data from Department of Finance.

- *Unemployment* in 1979 will average 6.8 percent, a sharp rise from the 6.1 percent of 1978. This is expected to occur due to tapering employment gains caused by the economic slowdown. Furthermore, because employment growth in 1980 is forecast at only 2.7 percent, the unemployment rate is expected to improve only slightly in that year—to 6.6 percent.
- Corporate profit growth, personal income growth, gains in consumption and investment spending, new car sales and housing starts will all slow noticeably in 1979 relative to their 1978 performances.

The department's 1979 forecasts lie well within the range of those made by other economists. For example, a recent survey of approximately 30 leading private-sector economists and the nation's 10 major econometric forecasting models conducted by *Business Week* found that the average 1979 forecast expected real GNP growth to be slightly over 2 percent (with individual forecasts ranging from about 1 percent to about 3½ percent), general price inflation to be 7.6 percent (range: 7 percent to 8.5 percent), and unemployment to average 6.5 percent (range: 6 percent to 7 percent). Table 16 provides additional evidence that Finance's 1979 national forecast lies well within the range of forecasts made by private sector forecasters active in California.

It is difficult to compare Finance's 1980 forecast with those of other economists, because relatively few economists attempt to look that far into the future. Nonetheless, we believe that the department's 1980 forecast is a reasonable one, although it is subject to a much greater degree of error than the 1979 outlook because of the longer period of time covered.

Table 16
Comparison of 1979 National Economic Outlook For Selected Forecasters[a]

	Department of Finance[b]	*United California Bank*[c]	*UCLA*[d]	*Security Pacific National Bank*[c]	*Crocker Bank*[b]	*Wells Fargo Bank*[d]	*Bank of America*[d]	*Chase Econometrics*[d]
Percent Changes in:								
Gross National Product	9.8%	10.3%	9.4%	9.8%	10.7%	9.4%	9.5%	9.3%
Due to real growth	2.1	3.4	2.1	1.6	2.3	1.8	1.9	1.5
Due to price change	7.4	6.6	7.1	8.1	8.2	7.5	7.5	7.7
Personal Income	10.4	10.6	9.7	10.4	11.7	9.9	10.2	9.9
Consumer Prices	8.3	6.8	7.7	8.7	9.5	8.5[e]	7.6	8.5
Unemployment Rate (%)	6.8	6.3	6.6	6.6	6.4	6.7	6.6	6.6
Savings Rate (%)	5.7	6.2	6.3	5.5	6.0	6.0	6.2	5.2
Housing Starts (millions of units)	1.75	1.75	1.60	1.52	1.70	1.69	1.70	1.57
New Car Sales (millions of units)	10.4	10.8	10.2	10.0	10.6	10.5	10.5	10.3

[a] Not all percentage figures are based on identical 1978 data, due to differences in forecast dates.
[b] Forecast as of January 1979.
[c] Forecast as of November 1978.
[d] Forecast as of December 1978.
[e] Published forecast is 8 percent to 9 percent.

Consumer Spending in Question

Spending by consumers—which has played a key role in the recent expansion and accounts for nearly two-thirds of total GNP—is forecast to increase by only 10 percent in 1979 compared to 11.5 percent in 1978. However, because inflation is expected to worsen in 1979, the decline in real spending gains is even more pronounced. As is generally the case during economic slowdowns, the sharpest decline is forecast for the category of consumer durables (for example, automobiles and major appliances), from a 10.6 percent gain in 1978 to only a 6.8 percent gain in 1979.

Several indicators suggest that such a decline in consumer spending will occur. First, consumers saved only 4.8 percent of their after tax disposable income in the fourth quarter of 1978, the lowest level in nearly two years. Although some economists do not think such a low rate is cause for concern as yet, others believe that this low rate simply cannot be sustained and will soon rise, resulting in increased savings and reduced spending.

A second factor involves consumer debt. During 1978, total outstanding consumer debt rose about 20 percent, and the ratio of debt repayments to income continued to inch upward. There is some concern among economists that many consumers may have overextended themselves, thereby making a retrenchment probable. Critics of this view argue that increased borrowing can be largely explained by changes in the demographic age-mix of the population and increased household wealth associated with increasing values for homes and other property assets.

Although a clear slowing of consumer spending on items other than automobiles has not yet materialized, most economists agree that some tapering is inevitable. This is particularly true if a significant portion of recent consumer borrowing and spending has occurred because of inflationary expectations, thereby merely shifting future consumption into the present.

Declining Investment Expenditures

The growth in both real and nominal expenditures on business plant and equipment is expected to decline in 1979 despite relatively good business liquidity and rising rates of capacity utilization. For example, Finance projects current dollar expenditures to rise only 11.7 percent (versus the 16.2 percent growth achieved in 1978), or under 4 percent in real terms (versus about 7 percent in 1978). The cause for this projected slowing involves such factors as fear of an economic slowdown or recession, high interest rates, ongoing uncertainties involving federal energy and tax policies, environmental regulations, and the stability of the dollar in international financial markets.

The behavior of business investment continues to be cause for serious concern. It is true that business investment during the past several years has enjoyed a "boomless expansion", with the 1978 level of real business investment having exceeded its prerecession peak and with its ratio to real GNP topping 10 percent again—near its average for the decade preceding the recession. However, these recent investment gains have not made up for the loss in spending on new plant and equipment during the recession. Moreover, an increasingly significant amount of investment expenditures today are associated with government mandated environment and safety standards. Although the short-term effects of weak business investment primarily serve to reduce demand for goods and services in the economy —thereby affecting real GNP and employment—the long-term implications are probably the most crucial. These long-term impacts primarily involve the "supply side" of the economy, by reducing labor productivity and potential output and thus increasing unit labor costs and inflation rates. The 1979 investment outlook is thus a disappointment both from a short-run and longer-run perspective.

Inflation—A Critical Unknown

National inflation trends—which primarily determine California's inflation trends—continue to have a negative impact on economic activity. For example:

- The prime bank loan rate during the past 12 months has soared from 8 percent to close to 12 percent, partly in response to accelerating inflation. Likewise, short-term government securities yields have risen from 6.5 percent to 9.5 percent, and long-term corporate bond rates have drifted upward by nearly 1 percentage point, reflecting increasing inflationary expectations. Such increases hurt business investment, thereby slowing the future growth of labor productivity and thus rising production costs and inflation.
- Rising prices, by weakening the value of the dollar on foreign exchange markets, increase the price of imported goods and the size of the nation's balance of payments deficit.
- Inflationary expectations encourage the use of indexing provisions and cost-of-living escalator clauses in long-term contract agreements, thereby contributing to future inflation.

California's state revenue growth is also significantly impacted by inflation—although often in a positive way. Increased inflation—at least in the short-run—means higher taxable sales, personal income, corporate profits and interest yields on investments. Of course, higher inflation also raises state expenditures and, in the long-run, can inhibit "real" economic activity and thereby damage the California economy's revenue potential.

As indicated earlier, both general price inflation and consumer price inflation are expected to worsen in 1979. Economists generally agree that the worse inflation becomes, the greater will be the chance of a recession. This is because the federal monetary authorities will most likely respond to rapid inflation by tightening credit availability and raising interest rates, so as to "slow down" the economy and remove inflationary pressures.

The 1979 inflation performance will depend on several key factors:

- *Wage Price Guidelines*: The President's voluntary wage-price guidelines program calls for price increases limited to 5¾ percent and wage increases limited to 7 percent, subject to a growing list of qualifications, exceptions and adjustments. Whether the guidelines will be particularly effective in checking inflation is debatable. If they are not, many observers fear one of two extremes—even more rapid inflation, or mandatory price controls. History suggests that neither of these extremes is desirable or conducive to a smoothly functioning economic system.

- *Monetary Policy.* The Federal Reserve will once again be trying to walk a "tight rope" between excessive monetary stimulation (which supports high inflation) and excessive credit tightening (which, by raising interest rates and restricting credit availability, can generate a recession). The exact path the "FED" will choose—and its ability to stay on that path—remains to be seen, although a disciplined yet accommodative monetary expansion is hoped for.
- *Food Prices, and Energy Costs.* Food prices, which account for almost 20 percent of the CPI, are notoriously difficult to predict. In 1978 they rose slightly over 10.1 percent, compared to only 6.3 percent in 1977, 3.1 percent in 1976 and 8.4 percent in 1975. In 1973 and 1974, however, they rose over 14 percent. The Department of Finance currently expects a rise of 6 percent to 7 percent in 1979. Because the U.S. Department of Agriculture forecasts a rise of 7 to 8 percent and a number of private-sector economists foresee increases exceeding 8 percent, the department's inflation outlook for food prices could prove overly optimistic. This may also prove to be true in the case of energy prices. The prices of both gasoline and fuel oil will ultimately reflect the recently announced 14.5 percent rise in OPEC oil prices. About 10 percent of this 14.5 percent rise will show up in 1979, because of the way the increase is to be phased in. When it prepared its forecast, Finance—like most forecasters—assumed that the increase would be about 7.5 percent.

All in all, the behavior of inflation as 1979 progresses will be one of the most critical factors determining overall economic performance, the severity of the expected slowdown and the prospects for a recession in late 1979 or 1980.

The California Economic Outlook

California's economic performance for 1979 and 1980 is more difficult to predict than the nation's. This is because, in addition to the widely differing views on the national economic outlook, there is no concensus as to how California would fare relative to the nation if a recession should occur, or what California's underlying growth trend would be if a national recession did not occur. As discussed earlier, no forecaster fully understands why California's performance in 1977 and 1978 exceeded the nation's by so great a margin. This inability to explain the past impairs our ability to predict the future.

Tapering Gains for Key Revenue-Related Economic Variables

The most critical components of the California economic outlook from a revenue perspective are personal income, taxable sales and corporate profits. Table 17 presents highlights of the Department of Finance's forecast for California in 1979 and 1980, as compared to estimated 1978 performance and actual 1977 performance. The Department of Finance predicts that:

- *Personal income* will rise 13 percent in 1979 and 10.5 percent in 1980.

This is less than the extraordinary 14 percent growth in 1978, which we would not expect to continue. Given the recent and continuing strength in California employment, Finance's strong 1979 personal income projection is not unrealistic.

- *Taxable sales* growth is forecast to taper from 14.5 percent in 1978 to 11.5 percent in 1979, and to 11.1 percent in 1980. This slowdown is generally consistent with the projected slowing of personal income growth, and parallels the expected decline in consumption spending at the national level.
- *Corporate profits* are predicted to rise 7.7 percent in 1979, well below the 20 percent plus levels of 1977 and 1978. This reflects such factors as poor productivity improvements, generally increased labor costs and rapidly rising materials prices.

Table 17
California Economic Data
(dollars in billions)[a]

	Actual 1977		*Estimated 1978*		*Budget Forecast 1979*		*Budget Forecast 1980*	
	Level	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*
Personal Income	$173.2	11.5%	$197.4	14.0%	$223.2	13.0%	$246.5	10.5%
Taxable Corporate Profits	$18.8	22.2	$22.6	19.9	$24.3	7.7	$27.5	13.2
Taxable Sales	$99.5	18.7	$113.9	14.5	$126.9	11.5	$141.0	11.1
Employment (thousands)	9,306	5.6	9,824	5.6	10,074	2.5	10,501	4.2
Unemployment (thousands)	834	−6.1	761	−8.8	759	−0.3	769	1.3
Unemployment Rate (%)	8.2%	—	7.2%	—	7.0%	—	6.8%	—
Residential Building Permits (000)	270	21.8	237	−12.3	190	−19.8	215	13.2
New Car Sales (000)	1,123	22.5	1,170	4.2	1,080	−7.7	1,150	6.5
Consumer Price Index[b]	180.2	7.1	194.3	7.8	207.6	6.8	223.3	7.1

[a] Data from Department of Finance.
[b] Wage earner and clerical worker index. Includes adjustment for the effects of Proposition 13 on homeowner's costs.

Other highlights of the 1979 outlook include consumer price inflation of 6.8 percent, a persistently high unemployment rate of 7.0 percent, a sharp decline in civilian employment growth to 2.5 percent, and declines in new car sales and housing permits of 7.7 percent and 19.8 percent, respectively (all percentages on an average annual basis). Thus, as shown in Table 18, the 1979 economic outlook for the state—as for the nation—is for slowing real economic activity, declines in employment growth, and continued high unemployment.

Table 18
Selected Economic Indicators
California and the United States[a]

	1978		*1979 Forecast*	
	United States	*California*	*United States*	*California*
Percent change in:				
Labor Force	3.0%	4.4%	2.4%	2.3%
Civilian employment	4.1	5.6	1.6	2.5
New car sales	0.9	4.2	−8.0	−7.7
Personal income	11.5	14.0	10.4	13.0
Corporate profits	15.6	19.9	4.0	7.7
Housing activity[b]	−0.9	−12.3	−11.2	−19.8
Consumer prices	7.7	7.8	8.3	6.8[c]
Unemployment Rate (%)	6.1%	7.2%	6.8%	7.0%

[a] Source: Department of Finance.
[b] Data based upon national housing starts and California building permits.
[c] Includes effect of one-time decline in the Consumer Price Index due to Proposition 13.

Table 19 compares the 1979 Department of Finance forecast for California to those of private sector forecasters. Although the department's forecast is generally in line with the others, two important differences emerge from the table. *First*, Finance's forecast of personal income growth—13 percent—exceeds the other projections, which lie in a narrow range between 11.1 percent and 11.5 percent. This in part reflects the fact that not all forecasters have fully accounted for the effects of Proposition 13 on California personal income, as determined by the U.S. Department of Commerce. The adjustment for this effect, which involves raising rental and proprietors' income by $1.7 billion in 1978 and by $3.4 billion in 1979, raised Finance's underlying 1979 personal income growth forecast from about 12.3 percent to the higher figure. Even so, Finance clearly is more "bullish" than other forecasters about personal income growth.

The *second* major difference involves consumer price inflation, where Finance is relatively low with a 6.8 percent forecast. Again, the difference between this prediction and those of other forecasters (which range up to 9 percent) can be explained in part by Proposition 13 which produced significant property tax cuts. These cuts were officially incorporated into the state's consumer price index for December 1978, and caused Finance to reduce its 1979 California inflation projection by about 1.5 percentage points. It is our understanding that not all forecasters have fully accounted for this effect of Proposition 13.

Table 19

Comparison of 1979 California Economic Outlook For Selected Forecasters[a]

	Department of Finance[b]	UCLA[c]	United California Bank[d]	Security Pacific National Bank[b]	Wells Fargo Bank[b]	Bank of America[b]	Crocker Bank[b]
Percent changes in:							
Personal Income	13.0%	11.3%	11.3%	11.1%	11.1%	11.2%	11.5
Civilian Employment	2.5	1.5	4.0	2.8	3.0	5.0	2.7
Building Permits	−19.8	−21.7	6.4	−13.6	−16.3	−17.4	−12.2
New Car Sales	−7.7	N.A.	—	N.A.	−14.2	N.A.	N.A.
Consumer Prices	6.8	7.0	6.7	6.9	9.0	7.9	9.0
Unemployment Rate (%)	7.0	7.0	7.5	6.9	7.6	7.2	7.0
Building Permits (thousands of units)	190	188	250	203	195	200	205

[a] Not all percentage figures are based on equivalent 1978 data due to differences in forecast dates.

[b] Forecast as of January 1978.

[c] Forecast as of December 1978.

[d] Forecast as of November 1978.

We believe that the department's 1979 and 1980 state economic forecasts are reasonable. However, because economists have been unable to accurately project California's behavior in recent years, we must acknowledge the very real possibility that actual economic performance will be quite different from what is forecast.

Declines in Housing and Automobile Sectors Expected

The state's automobile and housing sectors, which together account for about one-third of the taxable sales base in California, are both forecast to weaken in 1979. New automobile sales, for instance, are forecast to fall from nearly 1.2 million units in 1978 to slightly below 1.1 million units in 1979, or by about 8 percent (Table 17). This in turn will reduce the growth in taxable sales from new car sales from 16.1 percent to 4.8 percent.

As for housing, 1978 was another strong year—both nationally and in California. Although California's new housing permits declined, as expected, from the unsustainable level of 270,000 units in 1977 to 237,000 units, new housing permits still reached the second highest level since 1972. The strength in this sector can be attributed to both supply and demand side factors, including healthy underlying housing demand, more two-income households, the willingness of families to devote higher shares of their income to housing, and the continued availability of mortgage money. The avoidance of "disintermediation" (that is, the flight of savings from mortgage-granting institutions during periods when high interest rates are available on other investment opportunities) in California is partly due to the popularity of certificates of deposit tied to the six-month Treasury bill rate. This program was initiated about seven months ago and since then has grown very rapidly.

The 1979 housing outlook is for a further decline in permits to 190,000 units. This level—although well below those of the past two years—still is on a par with those experienced in the 1965-through-1970 era and far exceeds the depressed 1973–74 levels of about 130,000 units. Most of the long-term positive factors accounting for housing market strength in 1977 and 1978 still exist, and the expected decline in 1979 partly reflects short-term cyclical factors such as the expected slowdown in general economic activity and the peaking of interest rates during the year. For 1980, Finance projects a 13.2 percent gain in new housing permits, to 215,000 units.

Employment Behavior Complicates Forecasting

The Department of Finance forecasts only moderate California employment growth in 1979 of 3.4 percent for wage and salary workers and 2.5 percent for total civilian employment. This forecast largely reflects the two-fold belief that a national economic slowdown is likely, and that California cannot realistically be expected to continue the very strong employment gains of the past two years. However, because these gains themselves were not foreseen nor are the factors responsible for these gains fully understood, the 1979 employment forecast is subject to considerable error. This qualification to the overall California economic forecast is significant, because employment projections are the basis for estimates of wage and salary income, and thus for personal income—the single most important determinant of state revenues.

Table 20 summarizes the past history of California's *civilian* employment, unemployment and labor force movements. Employment growth in 1978—nearly 520,000 new jobs—broke the record set in 1977. Unemployment, however, dropped only slightly, from 7.2 to 7.0 percent, due to the strikingly high 4.4 percent expansion in the labor force. Many believe that this labor force growth reflects higher rates of net in-migration to the state.

Table 20
Changes in California Civilian Labor Force, Employment and Unemployment
1971–1980
(in thousands)

Year	Labor Force	Change From Previous Year: Amount	Change From Previous Year: Percent Change	Employment	Change From Previous Year: Amount	Change From Previous Year: Percent Change	Unemployment	Numerical Change From Previous Year	Unemployment Rate
1971	8,389	260	3.2%	7,652	112	1.5%	737	148	8.8%
1972	8,589	200	2.4	7,937	285	3.7	652	−85	7.6
1973	8,811	222	2.6	8,194	257	3.2	617	−35	7.0
1974	9,181	370	4.2	8,512	318	3.9	669	52	7.3
1975	9,388	207	2.3	8,462	−50	−0.6	926	257	9.9
1976	9,702	314	3.3	8,814	352	4.2	888	−38	9.2
1977	10,140	438	4.5	9,306	492	5.6	834	−54	8.2
1978 [a]	10,584	444	4.4	9,824	518	5.6	761	−73	7.2
1979 [b]	10,833	249	2.4	10,074	250	2.5	759	−2	7.0
1980 [b]	11,270	437	4.0	10,501	427	4.2	769	10	6.8

[a] Department of Finance preliminary estimate.
[b] Department of Finance forecast.

The growth in *nonagricultural wage and salary employment* was even more spectacular in 1978 than civilian employment, rising by a record 7.6 percent, or by over 650,000 new jobs. The extent to which these jobs represent part-time workers and multiple job holders, however, is unknown.

Table 21 summarizes the employment picture in California's major industry sectors for 1978 and 1979 (projected), while Table 22 presents a more detailed picture of California's record 1978 employment gains. Services and trade industries are expected to provide the largest share of new jobs in 1979. Manufacturing will also contribute new jobs, although growth will be below overall wage and salary employment growth. Despite these job gains, growth rates in all nongovernment sectors—and particularly in construction—are expected to be less than in 1978. Furthermore, the level of government employment is expected to *decline* in 1979 by nearly 1 percent, following a modest 2.5 percent gain in 1978. This reflects the effects of Proposition 13 at the local level, budgetary tightening at the state level, and a concerted effort by the federal government to curtail its employment force.

The overall tapering of employment in 1979 serves as the basis for the projected slowing of California personal income, taxable sales and corporate profits. Therefore, it is the key ingredient in the projected tapering of current-year and budget-year revenue growth discussed in the following sections. To the extent that the employment forecast is incorrect—as it very well may be—the department's revenue estimates will also prove to be incorrect.

Table 21
California Employment by Major Sector
(in thousands) [a]

Industry Sector	*Level of Employment* *Estimated* *1978*	*Level of Employment* *Projected* *1979*	*Employment as a Share of Total Employment* *1978*	*Change in Employment as a Share of of Total Net Employment Changes* *1978*	*Change in Employment as a Share of of Total Net Employment Changes* *1979*	*Percent Change in Employment* *1978*	*Percent Change in Employment* *1979*
Mining	37	38	0.4%	0.2%	0.4%	2.8%	2.7%
Construction	421	426	4.3	10.6	2.0	15.0	1.2
Finance—Insurance—Real Estate	548	577	5.6	8.7	11.6	9.0	5.3
Transportation and Utilities	514	534	5.2	6.9	8.0	7.5	3.9
Government	1,779	1,765	18.1	8.5	−5.6	2.5	−0.8
Services	1,926	2,032	19.6	33.0	42.4	9.7	5.5
Trade	2,145	2,249	21.8	30.9	41.6	8.1	4.8
Manufacturing	1,869	1,929	19.0	26.6	24.0	8.0	3.2
Total Nonagricultural Wage and Salary Workers	9,239	9,550	94.0%	125.4%	124.4%	7.6%	3.4%
Other Workers [b]	585	524	6.0	−25.4	−24.4	−18.5	−10.4
Total Civilian Employment	9,824	10,074	100.0%	100.0%	100.0%	5.6%	2.5%
Civilian Labor Force	10,585	10,833				4.4	2.3
Civilian Unemployment	761	759				−8.8	−0.3
Unemployment Rate	7.2%	7.0%					

[a] *Source:* Department of Finance and Employment Development Department. 1979 data are projected and 1978 data are preliminary estimates subject to revision.

[b] This employment category includes civilian workers who are not nonagricultural wage and salary workers. It also is a reconciling factor between the wage and salary employment data collected from establishment surveys and the civilian employment data collected from household surveys.

Table 22
1978 California Employment Gains for Selected Industries (thousands of employees) [a]

Industry	Employment Level November 1977	Employment Level November 1978	Change in Employment Number	Change in Employment Percent
Contract Construction:	397.7	454.5	56.8	14.3%
—General building contractors	110.3	130.4	20.1	18.2
—Heavy construction contractors	77.9	87.0	9.1	11.7
—Special trade contractors	209.5	237.1	27.6	13.2
Manufacturing:	1,770.5	1,930.7	160.2	9.0
1. Nondurable goods:	608.5	627.3	18.8	3.1
—Food and kindred products	184.3	177.8	−6.5	−3.5
—Apparel and textiles	120.9	127.9	7.0	5.8
—Printing, publishing and paper	144.4	152.1	7.7	5.3
—Chemicals, petroleum and coal	88.0	90.8	2.8	3.2
—Rubber and plastics	59.8	66.1	6.3	10.5
2. Durable goods:	1,162.0	1,303.4	141.4	12.2
—Metal products	186.8	204.1	17.3	9.3
—Nonelectrical machinery	184.3	205.9	21.6	11.7
—Electrical equipment	265.1	307.2	42.1	15.9
—Transportation equipment	233.5	269.4	35.9	15.4
—Instruments	74.4	83.9	9.5	12.8
Transportation	279.3	303.8	24.5	8.8
Communications	148.6	157.8	9.2	6.2
Wholesale Trade	526.3	563.4	37.1	7.0
Retail Trade:	1,545.6	1,667.3	121.7	7.9
—General merchandise	244.5	253.7	9.2	3.8
—Food stores	219.4	232.4	13.0	5.9
—Other	1,081.7	1,181.2	99.5	9.2
Finance, Insurance and Real Estate	520.3	561.3	41.0	7.9
Services:	1,818.4	1,990.0	171.7	9.4
—Hotels and other lodging places	100.3	112.1	11.8	11.8
—Business services	361.7	415.8	54.1	15.0
—Health services	482.6	525.8	43.2	9.0
Government:	1,773.0	1,785.2	12.2	0.7
—Federal	312.6	313.6	1.0	0.3
—State and local:	1,460.4	1,471.6	11.2	0.8
(County)	228.2	228.6	0.4	0.2
(City)	190.9	187.4	−3.5	−1.8
(Public education)	826.8	834.4	7.6	0.9
(All other)	214.5	221.2	6.7	3.1
Total—all industries	8,881.4	9,520.1	638.7	7.2%

[a] Preliminary seasonally unadjusted interim data from the Employment Development Department which is subject to revision.

PRIOR YEAR REVENUES

Record Increases for 1977–78

General Fund revenues and transfers in 1977–78 totaled nearly $13.7 billion, an increase of $2.3 billion, or 20.3 percent, over the $11.4 billion recorded for 1976–77. Table 23 shows these figures.

This unusually strong growth reflected substantial gains in each of the state's major taxes and in interest income, which together accounted for over 96 percent of the total revenue increase. These gains largely are explained by the strong real economic growth, rapid inflation and high interest rates experienced in 1977 and 1978. In particular:

- *Sales and use taxes* rose by 17.5 percent (about $750 million), reflecting the unprecedented 18.7 percent growth in 1977 calendar year taxable sales and the strong 14.5 percent gain in 1978.
- *Personal income taxes* increased 24.1 percent (over $900 million), reflecting both the highly progressive rate structure of this tax and the strong personal income gains recorded during calendar years 1977 (11.5 percent) and 1978 (14.0 percent).
- *Bank and corporation taxes* expanded by an astounding 26.8 percent ($440 million), reflecting increases in calendar year taxable California corporate profits of 22 percent and 20 percent in 1977 and 1978, respectively.
- *Interest income,* although a relatively small component of total revenues, rose by nearly 90 percent (over $130 million), because of both the large General Fund surplus available for investment and the significant rise in interest rates in 1977 and 1978.

Table 23
Comparison of General Fund Revenue Growth for Selected Years (in millions)

Year	Actual Receipts	Growth Over Prior Year: Dollar Amount	Growth Over Prior Year: Percentage Change
1974–75 [a]	$8,617	$890	11.5%
1975–76	9,613	996	11.6
1976–77	11,381	1,768	18.4
1977–78	13,695	2,314	20.3

[a] In computing 1974–75 revenue growth, the 1973–74 revenue base has been adjusted to *exclude* the effects of the one-time six-month reduction in the sales and use tax, and the one-time 20 percent cut in the personal income tax. Without these one-time tax reductions, 1973–74 receipts would have been over $700 million more than the level actually realized.

The details of this 1977–78 revenue growth by major revenue source are summarized in Table 24.

Table 24
Growth of 1977–78 General Fund Revenues (in millions)

	Actual 1976–77	Actual 1977–78	Change: Amount	Change: Percent
Major Taxes				
Sales and use	$4,281	$5,030	$749	17.5%
Personal income	3,761	4,668	907	24.1
Bank and corporation	1,642	2,082	440	26.8
Other Taxes	1,097	1,170	73	6.7
Interest income	152	283	131	86.2
Other revenues and transfers [a]	448	462	14	3.1
Total Revenues and Transfers	$11,381	$13,695	$2,314	20.3%

[a] Includes $215 million transfer from the Federal Revenue Sharing Fund in each year.

Revenues Far Exceeded Expectations

General Fund income in 1977–78 far exceeded expectations. Table 25, which traces the history of Department of Finance revenue estimates for 1977–78, shows that:

- Actual revenues exceeded the original estimate presented in the *1977–78 Governor's Budget* (January 1977) by over $1.3 billion, or 10.8 percent;
- Actual revenues exceeded the estimate made in May 1977 (the latest estimate available to the Legislature before it made budget decisions for the 1977–78 fiscal year) by nearly $1.0 billion, or 7.6 percent; and
- Actual revenues exceeded the estimate presented in the *1978–79 Governor's Budget* (January 1978) by $330 million, or 2.5 percent.

The unexpected strength in 1977–78 revenue growth primarily reflects the fact that Finance's estimates of such economic variables as California personal income, employment growth, taxable sales, corporate profits, and inflation rates in 1977 and 1978 were all too low. For instance, 1977 calendar year taxable sales growth was projected at only 10.8 percent in January 1977, but turned out to be 18.7 percent. Likewise, corporate profits and personal income were forecast in January, 1977 to rise by only 12.2 percent and 10.1 percent, respectively, but instead rose 20.3 percent and 11.5 percent.

Table 25
1977–78 General Fund Revenues
History of Department of Finance Estimates
(in millions) [a]

	Original Estimate	*Revisions*					
Taxes:	*January 1977*	*May 1977*	*Legislation [b]*	*January 1978*	*May 1978*	*January 1979*	*Actual*
Sales and Use	$4,610.0	$+90.0	$−1.0	$+316.0	—	$+15.4	$5,030.4
Personal Income	4,285.0	+215.0	+1.6	+83.4	$+20.0	+62.9	4,667.9
Bank and Corporation	1,750.0	+40.0	−2.0	+112.0	+155.0	+27.2	2,082.2
All Other	1,086.7	+29.4	−0.4	+65.7	−13.4	+2.0	1,170.0
Total Taxes	$11,731.7	$+374.4	$−1.8	$+577.1	$+161.6	$+107.4	$12,950.4
Interest income	$143.1	+6.9	—	$+75.1	$+9.9	$+47.8	$282.8
Other revenues and transfers [c]	482.2	−8.7	$+1.8	−16.5	−10.9	+13.9[d]	461.8
Total Revenues and Transfers	$12,357.0	$+372.7	—	$+635.7	$+160.6	$+169.0	$13,695.0

[a] Detail may not add to totals due to rounding.
[b] Major 1977 legislative changes included an increase in the solar energy credit, conformity of state tax laws to provisions of the Federal Tax Reform Act of 1976, and the exemption of certain medical devices from the sales tax.
[c] Includes $215 million transfer from the Federal Revenue Sharing Fund.
[d] Includes special fund transfer of $5.1 million to the General Fund under Sections 19.1 and 19.2 of Chapter 359, Statutes of 1978.

CURRENT YEAR REVENUES

Current estimates by the Department of Finance indicate that General Fund revenues and transfers in 1978–79 will total approximately $15.0 billion, an increase of 9.5 percent over actual receipts of $13.7 billion in 1977–78. Table 26 compares, by major source, revenues received in 1977–78 with those estimated for the current year. Table 27 provides an historical summary of revisions to the Department of Finance's 1978–79 General Fund revenue estimates.

Table 26

Growth of 1978–79 General Fund Revenues (in millions) [a]

	Actual 1977–78	*Estimated 1978–79*	*Change Amount*	*Change Percent*
Major Taxes:				
Sales and use	$5,030	$5,695	$665	13.2%
Personal income	4,668	4,747 [b]	79	1.7
Bank and corporation	2,082	2,287	205	9.8
Other Taxes	1,170	1,277	107	9.1
Interest Income	283	425	142	50.2
Other Revenues and Transfers [c]	462	568	106	22.9
Total	$13,695	$14,998	$1,303	9.5%

[a] Details may not add to totals due to rounding.
[b] Includes $990 million revenue reduction in 1978–79 due to AB 3802 (Chapter 569, Statutes of 1978).
[c] Includes transfer from the Federal Revenue Sharing Fund of $215 million in 1977–78 and $276 million in 1978–79.

Table 27

1978–79 General Fund Revenues
History of Department of Finance Estimates (in millions) [a]

	Original Estimate January 1978	*Revisions: May 1978* [b]	*Revisions: Adjustment for Proposition 13* [c]	*Revisions: Adjustment for Legislation* [d]	*Revisions: January 1979*	*Current Estimate*
Taxes:						
Sales and use	$5,515.0	$75.0	$–38.0	$3.0	$140.0	$5,695.0
Personal income	5,500.0	60.0	22.0	–1,010.0	175.0	4,747.0
Bank and corporation	2,120.0	60.0	87.0	–7.1	27.1	2,287.0
Inheritance and gift	392.0	–5.0	—	–5.0	23.3	405.3
Cigarette	198.0	–4.0	—	—	–2.0	192.0
Insurance	447.0	–5.0	—	—	–10.0	432.0
Alcoholic beverage	135.0	1.0	—	0.2	5.3	141.5
Horseracing	110.4	–3.0	—	–0.8	–0.4	106.2
Total Taxes	$14,417.4	$179.0	$71.0	$–1,019.8	$358.4	$14,006.0
Interest Income	190.1	9.9	—	—	225.0	425.0
Other Revenue and Transfers [e]	553.6	5.2	—	3.0	5.7	567.5
Total Revenues and Transfers	$15,161.1	$194.0	$71.0	$–1,016.8	$589.1	$14,998.5

[a] Detail may not add to totals due to rounding.
[b] Excludes estimated effects of SB 1 and AB 7X ($+34 million for the personal income tax and $+110 million for the bank and corporation tax), which were included in the Department of Finance's May revenue revisions. This legislation was enacted but did not become effective due to passage of Proposition 13 in the June 1978 election.
[c] Finance estimates as of June 1978.
[d] Major 1978 legislative changes included AB 3802 (Chapter 569), which reduces 1978–79 personal income tax revenue by $990 million. As discussed in the text, this measure contains one-time increases in the personal tax credit and partially indexes the personal income tax for inflation. Other major legislation involved the timing of refunds to bank and corporation taxpayers, the definition of retailers liable for sales tax payments, consideration of gifts when determining inheritance tax liabilities, expanded eligibility for the solar tax credit, and federal conformity provisions.
[e] Includes $276 million transfer from the Federal Revenue Sharing Fund.

Major Tax Legislation Distorts Historical Revenue Comparisons

As shown in Table 27, the budget estimates that 1978–79 revenues will increase by $1.3 million over the prior year. This estimate, however, reflects a $990 million reduction in personal income tax revenues resulting from AB 3802 (Chapter 569, Statutes of 1978). This tax cut, which is the largest in California's history, is discussed in some detail below. Had this legislation not been enacted, we estimate that personal income tax revenues would increase by almost $1.1 billion (22.9 percent) in 1978–79, as opposed to the $79 million (1.7 percent) increase shown in the *Governor's Budget* and in Table 26. Likewise, we estimate that total General Fund revenues would rise by nearly $2.3 billion (16.7 percent) in 1978–79, versus the currently estimated $1.3 billion increase (9.5 percent). Thus, although the estimated total revenue growth in the current year is well below the 20.3 percent increase experienced in 1977–78, this difference is substantially reduced when the effects of the tax cut are taken into account.

Tapering Gains in State Revenues

The 16.7 percent increase in 1978–79 General Fund revenues which we estimate would be recorded in the absence of AB 3802 represents a slight decline from the 20.3 percent increase in 1977–78. This decline in revenue growth primarily is attributable to the sales and use tax and the bank and corporation taxes. Specifically:

- *Bank and corporation taxes* are expected to increase only 9.8 percent in 1978–79, versus 26.8 percent in the preceding year. This difference is largely due to the anticipated sharp slowdown in corporate profit growth in 1979 (7.7 percent) relative to 1977 (22.2 percent) and 1978 (19.9 percent), and to the pattern of tax prepayments.
- *Sales and use taxes* are expected to rise by 13.2 percent, versus the 17.5 percent rise in 1977–78. This reflects the tapering of taxable sales growth from 18.7 percent in calendar 1977 to an estimated 14.5 percent in calendar 1978, and to only 11.5 percent projected for calendar 1979. The rationale for this tapering is that in the future, taxable sales will rise in rough conformity with personal income gains, due to the inability of consumers to continue to increase their borrowing and debt burdens at rates comparable to those experienced in the past several years.
- By contrast, *personal income taxes* show a 1978–79 rise of 22.9 percent if the effects of AB 3802 are excluded, or only slightly below the 24.1 percent increase realized in 1977–78. The remaining general revenue sources shown in Table 26 show higher growth rates in 1978–79 than in 1977–78, primarily due to increased interest income and a larger transfer of monies from the Federal Revenue Sharing Fund. However, these gains are not sufficiently large to outweigh the slowing growth rates of the major taxes.

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Revisions in the Estimates for 1978–79

The Department of Finance's current estimate of revenues in 1978–79 is $163 million *below* the revenue estimate contained in the Governor's 1978–79 Budget (January 1978), and $357 million below the estimate contained in the May 1978 revision. The revised estimate primarily reflects the combined effects of three factors: unexpectedly strong personal income gains, Proposition 13 and major tax cut legislation. Specifically:

- Proposition 13 *increased* estimated revenues by $71 million, according to June 1978 Department of Finance estimates. This is primarily because reduced property taxes result in reduced itemized deductions on income tax returns for individuals and businesses, thereby raising overall taxable income.
- The tax cut enacted under AB 3802 *reduced* estimated 1978–79 personal income tax revenues by $990 million.
- Unexpectedly strong gains in personal income, taxable sales and corporate profits, reflecting both high inflation and large employment gains, *increased* estimated revenues by $783 million over last year's budget estimate. In 1978, for instance, wage and salary income—the major single determinant of personal income tax revenues—rose 14.9 percent, compared to the Department of Finance's January 1978 forecast of 10.9 percent.

Other revisions to 1978–79 revenues involve reductions due to federal conformity legislation ($15 million), expanded eligibility for the solar energy device tax credit ($5 million), and changes in the timing of refunds to bank and corporation taxpayers ($7 million).

The Income Tax Cut: Provisions and Implications

Assembly Bill 3802 (Chapter 569) includes one-time and permanent tax reduction provisions which lowered estimated 1978–79 income tax revenues by $990 million. (The estimated reduction for 1979–80 is $580 million.) This legislation contains five key provisions:

- For the 1978 tax year only, the personal credit is increased from $25 to $100 for single persons and from $50 to $200 for married persons filing jointly.
- Effective for 1978 and thereafter, the personal income tax brackets are to be adjusted, or "indexed", each year by that portion of the annual percentage change in the Consumer Price Index (CPI) *exceeding 3 percent.*
- Effective for 1979 and thereafter, the personal credits, the dependent and blind credits, the standard deduction and the 100 percent low income credit also will be indexed, but by the *full* amount of the annual percentage change in the CPI.
- Taxpayers will be allowed to exclude from taxable income up to $100,000 of the capital gain on the sale of a personal residence. This exclusion may be taken only once in a taxpayer's lifetime.
- A state tax credit for the elderly will be provided which conforms to an existing federal tax credit for the elderly.

Table 28 details the effects of these provisions for calendar years 1978 and 1979.

Table 28
Calendar Year Effects of AB 3802 (Chapter 569)
(millions of dollars)

Type of Provision	*Revenue Effect* Calendar Year 1978	Calendar Year 1979
One-Time Increase in Personal Credit	$–681	$–0
Indexing [a]	–184	–431
Capital Gain Exclusion on Sale of Residence	–25	–25
Elderly Tax Credit	–8	–8
Total Effect	$–898	$–464

[a] Includes both the partial indexing of tax brackets beginning in 1978 and the full indexing of credits and of the standard deduction beginning in 1979.

In the short term, AB 3802's major impact on revenues results from the one-time personal credit increase. In the long-run, however, the measure's primary impact on state revenues will result from the indexing provisions. Indexing will substantially alter the relationship between changes in personal income components and the associated income tax liabilities. For instance, a 1 percent increase in personal income historically has produced, on the average, a 1.6 percent to 1.8 percent increase in personal income tax collections. The indexing provision of AB 3802 will reduce this revenue sensitivity. The extent to which it does so will depend on the share of personal income growth attributable to inflation in the future. The greater this share, the less sensitive revenues will be to income changes. Based upon current trends in inflation and income, we believe that indexing could result in a 1 percent change in personal income producing only a 1.3 percent to 1.4 percent increase in personal income tax revenues. Thus, in the future revenues will grow at a slower pace relative to income than they grew in the past.

Economic Strength Increases Revenue Estimates

Despite the tapering rate of overall revenue growth in 1978–79, revenues continue to run ahead of the Department of Finance's revenue forecast when adjustments are made for the revenue effects of new legislation (Table 27). This is primarily because real economic activity and inflation have exceeded the department's projections. As a result, the department's current revenue estimate for 1978–79 is nearly $590 million higher than the level forecast last May (after adjusting for the effects of legislation and Proposition 13). The increase in the estimate reflects three basic factors:

- The 1977–78 revenue base from which 1978–79 revenues are projected was found to be $170 million larger than preliminary data suggested in May. This is party because economic performance affecting 1977–78 revenues exceeded expectations.
- Economic performance in 1978, the major factor affecting 1978–79 revenues, also exceeded the level forecast in May. For example, the Department of Finance currently estimates 1978 personal income growth at 14 percent, but forecast only a 12.5 percent increase in May. Similarly, the estimate for taxable sales has been revised upward from 12.3 percent to 14.5 percent.

- Interest income is expected to total $425 million, or $225 million more than the May estimate.This revision reflects a combination of rising interest rates and a higher average balance in the State Treasury during the year than predicted earlier.

Whether the entire $590 million revenue gain expected by Finance will in fact occur remains to be seen. As of December 1978, only about $130 million of this amount had actually been realized by the state. However, based on the cash-flow patterns of revenue collections in prior years, we believe that the overall 1978–79 Finance revenue projection is reasonable.

Continued Strong Taxable Sales

Estimated current fiscal year sales and use tax receipts have been revised upward by $215 million over the estimate made in January 1978, after adjustment is made for Proposition 13 and new legislation. This revision is generally consistent with the revised economic forecasts. For example, the 3.8 percent upward revision in taxable sales estimated for calendar 1978 is only slightly higher than the 3.3 percent upward revision in estimated personal income (personal income growth for the year is estimated at 14.0 percent, or nearly the same as the estimated taxable sales growth rate of 14.5 percent). This situation is very different from the 1977 experience when personal income rose by 11.5 percent but taxable sales rose a record 18.7 percent. Because of this disparity in taxable sales growth relative to personal income growth during 1977, the ratio of taxable sales to disposable personal income in 1977 reached a record level of 65.7 percent (see Table 29).

Table 29
Comparison of Taxable Sales and Disposable Income
1973 Through 1978 Calendar Years [a]
(in millions)

	Taxable Sales	*Percent Change*	*Disposable Income*	*Percent Change*	*Taxable Sales As Percent Of Disposable Income*
1973	$61,738	—	$99,815	—	61.9%
1974	68,071	10.3%	110,220	10.4%	61.8
1975	73,476	7.9	123,396	12.0	59.5
1976	83,822	14.1	136,726	10.8	61.3
1977	99,481	18.7 [b]	151,322	10.7	65.7
1978	113,875	14.5	172,724	14.1	65.9

[a] Source: Department of Finance.
[b] Includes effect of one-time increase in taxable sales in 1977 due to (1) a significant shift from nontaxable to taxable fuels for energy production, and (2) a change in administrative procedures for taxing private transfers of automobiles. Excluding these effects would reduce the percentage change in 1977 to about 18 percent.

We suggested in last year's *Analysis* that this ratio might be expected to return to levels more in line with those of the past, partly because of concerns that the high levels of consumer borrowing which had helped to support 1977 spending could not be maintained indefinitely. However, this failed to occur in 1978. In fact, the ratio of taxable sales to income actually rose even further during 1978, to 65.9 percent. As a result, 1978–79 sales and use tax revenues are estimated to rise over the 1977–78 level by $700 million, or about 14 percent, excluding the effects of legislation and Proposition 13.

Bank and Corporation Tax Revisions

As shown in Table 27, the Department of Finance's current estimates of bank and corporation tax revenues for 1978–79 exceed its January 1978 estimates by nearly $90 million, excluding the revenue effects of new legislation and Proposition 13. This represents an upward adjustment of 4.1 percent, and produces a total increase in 1978–79 revenues of $205 million (9.8 percent) over 1977–78 revenues (Table 26). The Proposition 13 revenue effect—estimated in June 1978 as an increase of $87 million—reflects a significant increase in taxable corporate income caused by the reduction in deductible property tax payments.

Table 30 provides a breakdown by industry of estimated California corporate profits. Profits for all industries in 1978 are estimated to have increased by 19.9 percent ($3.7 billion) over the previous year, led by particularly large increases in manufacturing (25 percent, or $1.7 billion) and utilities (45 percent, or $530 million). Construction industry profits, by contrast, increased only 2.7 percent ($20 million), versus the gain of nearly 35 percent in 1977. This partly reflects the decline in 1978 California building activity relative to 1977 and the continuing increases in building materials costs. The 19.9 percent growth in profits for all industries represents a significant increase over the 10.0 percent gain originally expected, and is only slightly below the strong 22.2 percent gain registered in 1977. However, nearly $970 million of the $3.2 billion 1978 taxable profit gain is attributed to reduced property tax payments associated with Proposition 13. Without this effect, the 1978 profit increase would have been only 14.7 percent. The underlying growth in corporate profits, therefore, has clearly slowed from its 1977 pace.

Table 30
Calendar Year Taxable Corporate Income
(in millions)

Industry	*Actual 1976*	*Preliminary 1977*	*Percent Change*	*Estimated 1978*[b]	*Percent Change*
Agriculture	$289	$293	1.4%	$313	6.8%
Mining and Oil	1,388	1,150	−17.1	1,317	14.5
Construction	549	738	34.4	758	2.7
Manufacturing	5,463	6,579	20.4	8,225	25.0
Trade	3,301	4,095	24.1	4,686	14.4
Banking	1,304	2,008	54.0	2,270	13.0
Utilities	973	1,178	21.1	1,710	45.2
Other[a]	2,136	2,788	30.5	3,291	18.0
Total	$15,403	$18,829	22.2%	$22,570	19.9%

[a] Includes services, financial institutions not subject to the bank tax, and real estate.
[b] Includes $967 million due to Proposition 13.

BUDGET YEAR REVENUES

Total state revenues from all sources in the budget year are estimated by the Department of Finance at $18.6 billion. This estimate, however, incorporates the effects of a $1.4 billion revenue reduction associated with a tax cut *proposal* in the budget. Total state revenues under *existing* law are estimated at $19.9 billion in 1979–80—an increase of more than $2.5 billion, or 14.5 percent, over the $17.4 billion estimated in the current year. The growth of General Fund revenues, which represent over 85 percent of all state revenues, is expected to be 15.8 percent ($2.4 billion)—again excluding the effects of the proposed tax reduction. Revenues from all special funds are estimated to be nearly $2.6 billion in the budget year—up 6.2 percent over 1978–79.

Table 31 compares Department of Finance revenue estimates by source for the current and budget years.

Table 31

Projected 1979–80 State Revenue Collections Under Existing Law (in millions) [a]

General Fund	*Estimated 1978–79*	*Projected 1979–80*	*Change Amount*	*Change Percent*
Taxes:				
Sales and use	$5,695.0	$6,375.0	$680.0	11.9%
Personal income [b]	4,747.0	6,213.0 [c]	1,466.0	30.9
Bank and corporation	2,287.0	2,460.0	173.0	7.6
Inheritance and gift	405.3	452.4	47.1	11.6
Insurance	432.0	480.0	48.0	11.1
Cigarette	192.0	197.0	5.0	2.6
Alcoholic beverage	141.5	150.2	8.7	6.1
Horseracing	106.2	114.6	8.4	7.9
Total Taxes	$14,006.0	$16,442.2	$2,436.2	17.4%
Other Sources:				
Health Care Deposit Fund	$103.6	$140.9	$37.3	36.0%
Interest on investments	425.0	325.0	−100.0	−23.5
Federal revenue sharing transfer	276.2	276.2	-	-
Other revenues and transfers	187.7	184.0	−3.7	−2.0
Total General Fund	$14,998.5	$17,368.3	$2,369.7	15.8%
Special Funds				
Motor Vehicle:				
Fuel tax	$885.5	$913.0	$27.5	3.1%
License fee (in lieu)	555.0	635.0	80.0	14.4
Registration, weight and miscellaneous fees	400.7	422.6	21.9	5.5
Cigarette Tax	82.2	84.4	2.2	2.7
Oil and Gas Revenues	85.0	74.3	−10.7	−12.6
Other	413.1	442.8	29.7	7.2
Total Special Funds	$2,421.5	$2,572.1	$150.6	6.2%
Total State Funds	$17,420.0	$19,940.4	$2,520.3	14.5%

[a] Detail may not add to totals due to rounding.

[b] Includes revenue effects of AB 3802 (Chapter 569, Statutes of 1978).

[c] Excludes personal income tax reduction *proposed* in the 1979–80 Governor's Budget and included in the Department of Finance's revenue estimates. If enacted, this proposal is estimated to reduce 1979–80 personal income tax revenues by $1,373 million.

Underlying Revenue Growth Trend Still Strong Yet Slowing

The underlying General Fund revenue growth trend is expected to taper significantly from that of the current year. Although Tables 26 and 31 indicate that the estimated General Fund growth in 1979–80 (15.8 percent) will exceed that for 1978–79 (9.5 percent), these figures are distorted by the tax reduction features in AB 3800.

In the absence of AB 3802, the Department of Finance data indicate that General Fund revenue growth would have tapered from 16.7 percent in the current year to 12.3 percent in the budget year. This slow down is reflected in the revenue estimates for each of the three major taxes:

- *Sales and use taxes*—the state's largest single source of General Fund revenue—are expected to increase 11.9 percent over 1979–80, compared to the 13.2 percent estimated for the current year.
- *Bank and corporation taxes* in 1979–80 are forecast to rise 7.6 percent, versus the 9.8 percent gain estimated for 1978–79.
- The Department of Finance's *personal income tax* estimates show that, in the absence of AB 3802, collections would rise 18.4 percent in the budget year, versus a 22.9 percent gain for 1978–79. This is a more realistic comparison than the one shown in Table 31.

This moderately strong, though slowing, underlying revenue trend reflects the Department of Finance's forecast for a tapering of economic activity in 1979 and 1980.

Personal Income Taxes Reflect Income Projections and New Legislation

The Department of Finance is predicting 1979–80 personal income taxes at $6.2 billion, *excluding* consideration of the $1.4 billion proposed tax program. The income tax estimate reflects a $580 million reduction resulting from AB 3802 (primarily the indexing provisions).

This income tax estimate is generally in line with projected income gains in California. However, in relating income tax revenues to income, it is important to recognize that both AB 3802 and Proposition 13 may significantly change the relationships that have been observed in the past.

In particular:

- Proposition 13, in addition to raising income tax revenues due to the reduction of property tax-related itemized income tax deductions, has significantly increased California personal income. This is partly because of substantially increased imputations to homeowners' rental income. These imputed income gains generally are not taxable until the property is sold.
- The large one-time personal income tax credit provided by AB 3802 for the 1978 income year produces an extremely large revenue growth in the budget year relative to income growth.
- The indexing provisions of AB 3802 will permanently change the sensitivity of personal income tax revenues to changes in personal income. As we have indicated earlier, we believe that the long-run effect of AB 3802 will be to reduce the "elasticity" of personal income tax revenues to changes in income from its current range of 1.6 to 1.8, down to a range of 1.3 to 1.4. However, because future rates of inflation are subject to great uncertainty, an accurate prediction of the long-run revenue effects of indexing is impossible.

Income Tax Reduction Proposed

The Governor's Budget proposes a $1.4 billion personal income tax reduction for 1979–80. As noted above, the Department of Finance's published revenue projections have been reduced so as to reflect this plan. As indicated in the budget, however, the Governor's plan is contingent upon a continued favorable economic and fiscal outlook during 1979. An economic downturn in the economy late in 1979, for instance, might cause such a proposal to be tabled or modified. We have eliminated the effects of this reduction from Table 31 in recognition of the fact that the reduction requires enactment of legislation.

The Governor's tax reduction proposal has three basic elements:

- The personal income tax exemption credit would be increased from $27 to $125 for single persons and from $54 to $250 for persons filing joint and head-of-household returns. This provision would reduce 1979–80 personal income tax revenues by *$915 million.*
- The treatment of the homeowner's exemption would be changed, from a $7,000 reduction in the market value of a home for tax purposes to an $87 refundable income tax credit. At present, the homeowner's exemption is treated as a state *expenditure* because the state reimburses localities for reduced property tax revenues caused by the exemption. For 1979–80, this expenditure is estimated to be $374 million under existing law. The budget proposal, however, would convert an estimated $262 million of this amount to a *revenue reduction* by allowing tax payers to reduce their income tax liabilities by up to $87 opposed to a state expenditure, because taxpayers with income tax liabilities would receive all or part of the $87 credit as an income tax reduction. Any unused part of the credit ($112 million) would be "paid out" as refunds to income tax filers, and thus would be classified as an expenditure.
- An additional personal income tax reduction of approximately *$200 million* is included for renters' relief or for other unspecified types of tax reductions.

The combined effect of these three income tax reduction provisions for personal income tax revenue in the budget year is nearly $1.4 billion. This represents 22 percent of the underlying 1979–80 personal income tax revenue estimate of $6.2 billion shown in Table 31.

Taxable Sales Maintain Strength

The Department of Finance forecasts that sales and use tax revenues will increase by 11.9 percent (to $6.4 billion) in fiscal 1979–80, reflecting a projected growth in taxable sales of 11.5 percent in calendar 1979 and 11.1 percent in 1980.

Table 32 provides a breakdown, by general category of sales outlet, of preliminary taxable sales data for 1978 and estimates for 1979 and 1980.

The anticipated slowing in economic activity later in 1979 explains the change in taxable sales. This slowdown will impact particularly on purchases of major consumer durables such as new cars. The department expects the growth in taxable new car sales to drop from 16.1 percent in 1978 to only 4.8 percent in 1979, before rebounding to an increase of 15.3 percent in 1980.

Table 32
Estimated Calendar Year Taxable Sales [a]
(in millions)

	Actual 1977	*Preliminary 1978*	*Percent Change*	*Estimated 1979*	*Percent Change*	*Estimated 1980*	*Percent Change*
Retail Stores	$40,565	$46,330	14.2%	$51,920	12.1%	$57,485	10.7%
Autos, Other Vehicles and Service Stations	23,387	26,175	11.9	28,020	7.0	31,160	11.2
Building Materials and Construction	10,202	11,835	16.0	13,490	14.0	15,135	12.2
Manufacturing, Wholesaling and Miscellaneous	25,327	29,535	16.6	33,495	13.4	37,250	11.2
Total Taxable Sales	$99,481	$113,875	14.5%	$126,925	11.5%	$141,030	11.1%
"Real Growth"	—	—	7.4%	—	4.0%	—	5.0%

[a] Source: Department of Finance.

The Department of Finance assumes that the ratio of total taxable sales to disposable personal income will remain near the high levels achieved in 1977 and 1978. Taxable sales averaged 61.1 percent of disposable income over the period 1973 through 1976. In 1977, however, this ratio soared from 61.3 percent to 65.7 percent, as taxable sales rose 18.7 percent and substantially exceeded the 10.7 percent increase in disposable income. The ratio rose even higher in 1978—to 65.9 percent (Table 20). To what extent this ratio will decline in the future is unknown.

Bank and Corporation Tax Revenues to Slow

The Department of Finance projects that bank and corporation tax revenues will total $2.5 billion in 1979–80, an increase of 7.6 percent ($173 million). This rate of increase is slightly below the 9.8 percent gain estimated for the current year, and substantially below the 26.8 percent gain in 1977–78.

The bank and corporation tax is consistently one of the most difficult revenue sources to project, because of both the general unpredictability of corporate profits and the technical problems of translating calendar year profits into fiscal year revenues. For example, complex cash flow patterns characterize the payment of estimated taxes, several different methods for computing tax prepayments may be chosen and a large portion of California's profits are taxed under the unitary method, which allocates profits of multistate and multinational firms to California on the basis of a statutorily-determined ratio capable of taking on different values in different years.

Nevertheless, broad trends in the growth of fiscal year corporate taxes are generally consistent with broad trends in calendar year corporate profits. Thus, the slowing rate of profit gain for 1979–80 largely reflects the sharp drop in 1979 taxable profit growth to 7.7 percent, followed by a moderate rebound to an increase of 13.2 percent forecast for 1980. The growth in California profits generally parallels the profit pattern projected nationally—a decline to 4.0 percent in 1979 followed by an increase of 12.9 percent in 1980 (Table 15). The accuracy of the department's bank and corporation tax estimate will depend primarily on the accuracy of the corporate profits forecast which, as indicated above, has typically been subject to substantial—although largely unavoidable—errors.

Other General Revenues

General Fund revenues from sources other than three major taxes are projected at slightly more than $2.3 billion in 1979–80, an increase of $50 million (or 2.2 percent) over 1978–79 (Table 31).

Inheritance and gift taxes are expected to increase 11.6 percent (a gain of $47 million), while insurance tax gains are expected to total $48 million (up 11.1 percent), reflecting a projected 11.1 percent growth in calendar 1979 taxable insurance premium volume.

Partially offsetting these and other gains, however, is a projected $100 million *decline* in interest income from state investments. This 24 percent reduction in interest income to a level of $325 million assumes that the average balance of surplus monies available for investment will decline from the current year, because of AB 3802, post-Proposition 13 local assistance, and the income tax reductions proposed in the budget. To the extent that these tax proposals are not enacted, the 1979–80 interest income projection might prove to be too low.

The interest income projection also assumes an average rate of return on investments in the budget year of 7¾ percent, down from an estimated 8¼ percent for 1978–79. However, because the inflation outlook is uncertain and inflation directly affects interest rates, projected interest rate movements may have to be revised, requiring revisions to the 1979–80 interest income forecast.

Special Fund Revenues

Combined revenues from all state special funds are projected to reach nearly $2.6 billion in 1979–80, or 6.2 percent ($150 million) above the current year estimate.

Over 75 percent of the revenues from these special funds come from motor vehicle-related levies, including gasoline taxes, license fees and registration fees. These vehicle-related levies are projected to rise by nearly $130 million in 1979–80 (7.0 percent), to a level of almost $2 billion. Of this total, over $900 million reflects fuel taxes imposed on a per gallon basis, which are projected to rise by 3.1 percent ($28 million) in 1979–80. This projection assumes that average gasoline consumption per vehicle will increase in 1978–79 (from 640.3 to 641.5 gallons) and decline in 1979–80 (to 638.0 gallons), the latter due to changes in the automobile mix and increasing engine fuel economies. The projection also assumes that California new car sales will decline by 7.7 percent in 1979 due to the economic slowdown, and then rebound with a 6.5 percent gain in 1980 (see Table 17). Vehicle registration and license fees are estimated at nearly $1.1 billion in the budget year, up 10.7 percent ($102 million) over 1978–79. This projection assumes a 3.1 percent average annual increase in registrations from 1978 to 1980 and a total stock of 19.3 million registered vehicles in California by the end of 1980.

Economic Outlook Uncertainties Qualify Revenue Projections

As indicated earlier, we believe that the Department of Finance's current year revenue revisions and budget year revenue projections are consistent with its economic forecasts for 1979 and 1980, and that these economic forecasts are themselves "reasonable". At the same time, however, these economic forecasts are subject to considerable uncertainty, particularly as one looks into late 1979 and 1980. These economic uncertainties apply to many of the economic variables which directly affect state revenues, such as inflation, interest rates, general consumer spending and automobile sales, employment and business profits.

Because of these uncertainties, actual revenues in 1978–79 and 1979–80 are almost certain to differ from projected revenues—perhaps substantially. The Department of Finance itself recognizes this, and has indicated that, depending on economic conditions, actual 1978–79 revenues could be $300 million higher or $500 million lower than what it estimates. The Department also has estimated that actual 1979–80 revenues could be $1.6 billion above to $1.7 billion below those it projects, a range of $3.3 billion. Our own analysis suggests that, based on the most probable economic scenarios, a more likely range would probably be less than one-half of this magnitude. In any case, even though the Department of Finance's revenue projections are "reasonable", they are also subject to considerable error in either direction due to inherent uncertainties in the economic outlook.

IV. TAX EXPENDITURES

Current law (Chapter 575, Statutes of 1976) requires the Department of Finance to include a report on "tax expenditures" in the Governor's Budget for each fiscal year beginning in an odd-numbered year. As part of this reporting responsibility, the department is required to:

- Identify all tax expenditures contained in California's state tax structure and in the property tax.
- Determine the amount of the revenue loss resulting from such tax expenditures.
- Make recommendations to eliminate or limit the duration of particular tax expenditures.
- Prepare any legislation required to implement its recommendations and present this legislation to the chairman of the revenue and taxation committee in each house of the legislature.

For 1979–80, the Department of Finance's report on tax expenditures is included in the Governor's Budget beginning on page A-81. The purpose of this discussion is to (1) provide background information on the tax expenditure concept, (2) review and comment on the findings and recommendations contained in Finance's tax expenditure report and (3) offer recommendations regarding possible modifications of the tax expenditure reporting process in California.

What is a "Tax Expenditure"?

The concept of "tax expenditures" originated in the late 1960's and has been used increasingly in recent years to identify—and, where possible, to quantify—those indirect government "costs" which result from tax revenue losses. "Tax expenditures" are defined generally as revenue losses resulting from tax provisions which are designed to encourage certain kinds of behavior by individuals or to aid taxpayers in special circumstances. The basic objective of the tax expenditure concept is to identify those revenue losses which result from the use of the tax system to achieve results commonly sought through direct government expenditure programs. Once identified, tax expenditures can be reviewed and evaluated on the same basis as direct expenditure programs. This review process might include:

- An assessment of the continued validity of the *basic goals* of and need for the tax expenditure (for example, to provide low-income tax relief or incentives to stimulate a new industry);
- A review of the costs and benefits of *alternative means* to accomplish these goals (for example, direct government grants or subsidies);
- Consideration of *revisions* to the tax expenditure provision the desired objectives being be accomplished at a lower level of revenue loss and/or administrative costs.

Basic Conceptual and Theoretical Issues

Despite the increasing use of the tax expenditure concept at both the federal and state levels, there remain important concerns as to (1) the basic validity of the concept, (2) the potential for translating what might be an acceptable theoretical concept into a practical budgeting tool, and (3) the implications of drawing a distinction between a "tax expenditure" and all other tax revenue losses.

1. *Validity of the Concept.* Some commentators have challenged the basic conceptual validity of the "tax expenditure" concept because, in their view, the logical extension of this theory implies that any income not collected by the government is in effect a government "subsidy". The proponents of the tax expenditure concept have attempted to deal with this concern by classifying as tax expenditures only those revenue losses resulting from provisions of the tax laws which are exceptions to a "normal" tax structure. Because, it is argued, such exceptions reflect a conscious decision to provide for specific exemptions from an otherwise uniformly applicable tax, the resulting revenue losses are appropriately considered as *tax reductions,* rather than as *income not collected.*

2. *Theoretical and Practical Problems.* Whether or not this approach is acceptable on a philosophical or policy level, serious theoretical and practical problems emerge in attempting to define a "normal" tax structure. For example, there are no purely theoretical grounds for including progressive rates in a "normal" income tax structure. However, because of their general acceptability, progressive tax rates are assumed as a starting point in estimating "tax expenditures" under both the state and federal income tax laws. Also, *imputed* income from owner-occupied homes (that is, the income which would be received by the owner if the home

were rented) typically is not considered a part of a "normal" income tax structure. This is because such income is difficult to measure and the concept is not generally understood and accepted. Therefore, although the exclusion from taxation of homeowners' imputed rental income theoretically results in a tax expenditure, practical considerations preclude it from being identified as such.

3. *Implications.* Although the term "tax expenditure" is used often, its exact meaning and intended applications may not be widely understood. One problem encountered in categorizing revenue losses as tax expenditures is the implication that all revenue losses *not* included result from tax provisions which are appropriately considered as part of the "normal" tax structure, and thus need not be subjected to review. For example, if progressive income tax rates are treated as being part of the "normal" tax structure for purposes of determining tax expenditures, this may be taken as an indication that the degree of progressivity provided by the existing structure is somehow "normal" or "acceptable".

The converse of this problem is that all revenue loss provisions placed in the "tax expenditure" category may take on the generally negative connotation of tax "loopholes", regardless of their appropriateness and effectiveness in accomplishing desirable social or economic goals.

The Federal Tax Expenditure Budget

The tax expenditure concept was first defined statutorily at the federal level in the Congressional Budget Act of 1974. This act, which requires a listing of tax expenditures in the federal budget, defines "tax expenditures" as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." This definition was narrowed considerably for purposes of implementing the federal tax expenditure reporting requirements by including as "tax expenditures" only those exceptions to the "normal structure" of the tax which reduce tax liabilities for a particular group of taxpayers.

Because of the theoretical problems in determining what constitutes a "normal" tax structure, tax provisions at the federal level are considered to result in tax expenditures if they depart from a "generally accepted" structure of an income tax. This "generally accepted" structure is frequently revised to incorporate various revisions to federal tax laws, such as those resulting from the Tax Reform Act of 1976 and the Tax Reduction and Simplification Act of 1977.

In preparing the federal tax expenditure budget, some of the provisions included as a part of the "generally accepted" federal income tax structure —and, thus, *not* considered a tax expenditure—are:

- Progressive tax rates;
- Separate rate schedules for single and married taxpayers, married taxpayers filing separately and heads-of-household;
- The zero bracket amount (formerly, the standard deduction);
- Personal exemptions;
- The deduction from gross income of business expenses (includes only

that portion of depreciation expenses reflecting a "reasonable" economic rate of depreciation);

- The exclusion from gross income of imputed "rent" on owner-occupied housing and "in-kind" income from the services of a nonworking spouse; and
- Itemized nonbusiness deductions, to the extent they do not exceed the standard deduction.

California's Tax Expenditure Reporting Requirements

California law defines "tax expenditures" to include *all* deductions, credits, exclusions, exemptions, and preferential tax rates contained in the state tax structure and in the local property tax. In preparing its required report on tax expenditures, it appears that the Department of Finance has applied a broad interpretation to this statutory definition and included estimates of the revenue losses resulting from *all* statutory state tax and local property tax deductions, credits, etc.—at least to the extent these losses can be quantified.

This represents a significantly different approach than that used at the federal level, where only variations from a "generally accepted" tax structure are shown as tax expenditures. For example, the Department of Finance has included in its report estimates of total income tax revenue losses due to the standard deduction, itemized deductions and personal and dependent credits. At the federal level, all or a portion of the equivalent deductions or credits—the zero bracket amount (formerly, the standard deduction), itemized deductions not exceeding the standard deduction, and the personal exemptions—are considered to be part of the "normal" federal income tax structure and, thus, are *not* considered tax expenditures.

Summary of 1979–80 "Tax Expenditures"

In the 1979–80 budget, the Department of Finance has identified state tax expenditures totaling $6.6 billion and local tax expenditures (under the sales and property taxes) of $2.7 billion. Table 33 summarizes Finance's tax expenditure estimates by tax.

Table 33
Summary of Identifiable "Tax Expenditures"
Department of Finance Estimates
1979–80

	Revenue Losses (In Millions)
State tax expenditures:	
Personal income taxes	$3,838
Retail sales and use taxes	1,835
Inheritance Tax	660
Bank and corporation tax	152
Motor vehicle fuel taxes	80
Insurance tax	40
Horse racing	5
Total State tax expenditures	$6,610
Local tax expenditures:	
Property tax	$2,144
Sales tax	514
Total local tax expenditures	$2,658
TOTAL	$9,268

As indicated in this table, the bulk of the identifiable tax expenditures, from the standpoint of revenue losses, occurs in the state personal income tax, the state and local sales and use taxes and local property taxes. Some of the major categories of tax expenditures are shown for each of these taxes in Table 34.

Table 34
Selected "Tax Expenditures"
Department of Finance Estimates
1979–80

	Estimated Revenue Loss (millions)
State Personal Income Tax	
Interest Expense	$735
Personal and Dependent Credits	450
Property, Sales and Vehicle Taxes	370
Capital Gains Exclusion	350
Charitable Contributions	215
Medical Expenses	130
Head-of-Household Status	115
Standard Deduction	90
Low Income Credit	30
Solar Energy Device Credit	15
State and Local Sales and Use Tax	
Food Consumed at Home	$1,024
Gas, Electricity and Water	672
Vessels and Aircraft	256
Cargo and Refundable Containers	141
Local Property Tax	
Government-owned Property	656
Household Furnishings	400
The Homeowners' Exemption ($7,000 full value)	354
The 50 percent Business Inventory Exemption	238
Bonds (and Intangibles)	200

A major portion (nearly $1.5 billion) of the tax expenditures identified under the *personal income tax* are the result of various nonbusiness itemized deductions. Chief among these are the deductions allowed for interest expenses, which Finance estimates will result in revenue losses of $735 million in 1979–80. Nonbusiness interest expenses are made up largely of interest paid on home loans and consumer credit. Other itemized income tax deductions shown as tax expenditures include those for property, sales and vehicle taxes ($370 million), charitable contributions ($215 million), and medical expenses ($130 million). Another major "tax expenditure" shown under the income tax is the $450 million revenue loss estimated for the personal and dependent credits.

Under *state and local sales taxes,* revenue losses from the exemption of food consumed at home ($1,024 million) represent the largest single tax expenditure category. The bulk of local property tax expenditures ($1,056 million) is estimated to result from the exemption of government owned property and household furnishings. Also included as a tax expenditure under the local property tax are the homeowners' property tax exemption ($354 million) and the 50 percent business inventory exemption ($238 million). (As discussed below, we question whether it is appropriate to classify such "reimbursable" local exemptions as "tax expenditures", to the extent that state subventions to replace these losses also are included as direct appropriations in the budget.)

Technical Qualifications

Apart from concerns as to the appropriateness or significance of the tax expenditures shown in the Governor's Budget, Finance's estimates of these revenue losses are subject to the following important technical qualifications:

1. *Estimates Not Cumulative.* As Finance has indicated in its report, individual tax expenditure estimates cannot, in many cases, be added to provide an accurate estimate of total revenue gains resulting from the repeal of these provisions. This is because of the effect the elimination of one provision would have on the revenue gains resulting under another. For example, the repeal of the deductibility of interest expenses would increase income tax revenues by an estimated $735 million. At the same time, however, the resulting increase in taxable income would place taxpayers in higher marginal tax brackets, thus *increasing* the potential revenue gain from the repeal of *any or all* of the other income "tax expenditure" provisions.

2. *Data Limitations.* The lack of data frequently precludes precise estimates or, in some cases, even close approximations of tax expenditures. Many of the major tax expenditures shown result from exemptions of specified income, sales or property. Because these exempt items currently are not taxed, there is no reason to collect and maintain the information which is necessary to estimate the potential revenue loss (for example, due to the exemption from the sales tax of food consumed at home).

3. *"Second-Level" Effects Not Included.* The tax expenditure estimates shown reflect only the *direct* impact on revenues of repealing the various tax provisions. They do not take into account the largely unpredictable *"secondary* effects" which may result from consequent (a) changes in the behavior of individuals and/or (b) long-range impacts on the economy.

Tax Expenditure "Sunset" Provisions

In recent years, the Legislature has enacted several state and local tax reduction measures which have included "sunset" provisions. Under these provisions, a new exemption, credit, deduction, etc., is provided only for a specified period (usually five years), at the end of which time it automatically expires unless extended by direct action of the Legislature. Many of these sunset provisions have required this office to conduct and submit a study of, typically, the economic and revenue impacts of the tax reduction measure.

The Department of Finance has recommended in its tax expenditure report that (1) the process of reviewing tax reduction measures containing sunset provisions should include *interim legislative hearings* on such measures and (2) every study conducted on the impact of these measures should include a *firm recommendation as to continuation or curtailment.*

We agree that interim hearings could facilitate legislative consideration of the merits of extending limited-term tax reduction measures. Based on our experience in conducting studies on these measures, however, we believe it may not be possible to include a firm recommendation on continuation or curtailment in every such study for two basic reasons.

First, the Legislature's *objectives* in enacting tax reduction measures generally are not specified in the enabling legislation. Accordingly, it can not always be determined to what extent a tax reduction is intended, say, to provide for taxpayer equity or to stimulate an infant industry. Second, and more significantly, even if the objectives of a tax reduction measure are known or can be assumed, it is frequently not possible to isolate and quantify the effects of the tax reduction for purposes of measuring its benefits.

Tax Expenditure Reporting Modifications

In its report on tax expenditures, the Department of Finance makes the general recommendation that the "Legislature should review all existing tax expenditures in order to identify the beneficiary, and to determine if the original objectives are still deserving of the subsidy." While we agree with the basic goals of this recommendation, our general concern is that the "tax expenditures" identified in the Governor's Budget may be too comprehensive and too broadly defined to permit a selective review of particular beneficiary groups and any tax "subsidies" these groups may receive. Some of our specific concerns and suggestions are summarized below.

1. *Narrower Definition of "Tax Expenditure" Needed.* We believe that the Department of Finance should review the federal approach to identifying and estimating tax expenditures in order to determine its applicability to California's state and local tax structure. As discussed above, the federal tax expenditure budget includes only *exceptions* to a "normal" or a "generally accepted" tax structure. Although we recognize the considerable theoretical and practical difficulties in determining what the "normal" tax structure should be, we believe this approach is essential to a meaningful application of the tax expenditure concept.

For example, the standard deduction and the personal and dependent credits might appropriately be considered as an integral and generally accepted part of the California income tax structure. Classifying these as "tax expenditures", as is now done, suggests that large numbers of California taxpayers are the recipients of substantial income tax "subsidies".

2. *Avoid Overlapping Direct Appropriations and Tax Expenditures.* We do not believe that local revenue losses should be shown as "tax expenditures" to the extent that state subventions for the reimbursement of such losses are appropriated directly in the budget. This practice not only results in the "double counting" of the costs of state tax relief programs, but it is unnecessary, considering that direct appropriations for tax

relief are subject to the normal budgetary review process.

The principal examples of local revenue loss included in the Governor's Budget both as "tax expenditures" and direct expenditures are shown in Table 35.

Table 35
Illustration of Overlapping Tax Relief Costs Shown in the 1979–80 Budget (in millions)

Program	*Amount Shown As Tax Expenditure*	*Amount Shown as Direct Appropriation*	
		Amount	*Item Number*
Homeowners' Property Tax Exemption	$354	$132	428
Business Inventory Exemption	238	238	427
Open-space property	50	16	429
Livestock	6	2.2	427
Ground-time exemption for aid carriers	3.6	3.6	430

3. *Reimburse Certain Revenue Losses.* We also suggest that the Legislature consider appropriating funds directly in the budget for "reimbursement" of revenue losses resulting from tax law provisions which are clearly designed to accomplish goals unrelated to state tax policy. This is essentially done now for the local tax relief programs discussed above and for renters tax relief, which is provided as a $37 refundable income tax credit (see analysis of Item 431).

The solar energy devices income tax credit probably provides the best example of an existing program which is funded indirectly through the tax system, but clearly was not intended to further tax policy goals. We believe that the "reimbursement" by direct appropriation of revenue losses resulting from programs such as this would (a) provide for a truer picture of total state revenues and total state expenditures and (b) subject the actual costs of obvious subsidy programs to annual legislative review and action.

V. THE LEVEL OF STATE TAXES IN CALIFORNIA

Table 36 presents the relationship shown in the Governor's Budget between personal income and state tax collections in California from 1966–67 through 1979–80 (projected). During this 14-year period, total state taxes (General and special funds) have increased from $5.92 per $100 of personal income in 1966–67 to a peak of $8.56 in 1977–78. The principal cause of this increase is the progressive nature of California's income tax structure, which taxes additional increments of income at increasingly higher marginal rates up to a maximum of 11 percent.

In 1978–79, however, the ratio of state taxes to income is estimated to *decline* to $8.10 per $100. This reflects the one-time increases in income tax credits and the indexing provisions of Chapter 569, Statutes of 1978 (AB 3802). In 1979–80, these indexing provisions and the income tax reductions proposed in the Governor's Budget are projected to reduce state taxes to $7.70 per $100 of personal income.

These figures provide an indication of the general trends in total state taxes in California. However, for the reasons cited below, care must be taken in using these ratios as a basis for (1) judging the total state and local tax *burden* in California, (2) measuring the change in California's state tax *burden* over time, or (3) making comparisons of tax *burdens* between California and other states.

Table 36
Relationship of State General and Special Fund Taxes to California Personal Income 1966–1967 Through 1979–80 Fiscal Years

Fiscal Year	*California Personal Income*[a] *(millions)*	*Total State Tax Collections (millions)*	*State Taxes Per $100 of Income*
1966–67	$64,848	$3,838	$5.92
1967–68	69,492	4,676	6.73
1968–69	76,085	5,173	6.80
1969–70	82,799	5,409	6.53
1970–71	88,554	5,599	6.32
1971–72	94,206	6,599	7.00
1972–73	102,539	7,229	7.05
1973–74	112,366	7,877	7.01
1974–75	125,563	9,574	7.63
1975–76	139,371	10,710	7.68
1976–77	155,374	12,525	8.06
1977–78	173,214	14,825	8.56
1978–79 (est.)	197,415	15,992	8.10
1979–80 (est.)	223,150	17,186	7.70[b]

Source: 1979–80 Governor's Budget, Page A-108.
[a] Calendar-year basis, 1966 through 1979.
[b] This includes the effect of the Governor's proposed tax reductions totaling $1.4 billion in 1979–80. Excluding these reductions would increase state taxes to $8.32 per $100 of personal income.

Problems in Determining State Tax Burden.

Table 36 gives an incomplete picture of the total tax *burden* actually imposed by California on its residents for two reasons. First, these figures exclude local tax revenues. In 1976–77, the most recent year for which data are available, the combination of state and local tax revenues resulted in a burden of $15.49 per $100 of personal income compared with $8.06 for state taxes alone. Second, even if local taxes are included, the level will not necessarily coincide with the state and local tax burden on California residents. This is because a large share of state taxes is paid by corporations and out-of-state residents, and conversely, California residents—in their roles as tourists, corporate stockholders and owners of out-of-state property—pay taxes imposed in other states.

Changes in Tax Levels Over Time.

Several complications exist in attempting to evaluate the movements of state tax levels in California over time. These include the existence of interrelationships between state, federal and local taxes, and changes in the tax base. For example:

- Changes in state tax levels are sometimes directly related to changes in the level of federal and local taxes. Focusing only on the growth of state government taxes, therefore, may prove very misleading when comparing tax levels over time. For example, the Governor's Budget proposes to replace the current homeowners' property tax exemption with an $87 income tax credit for homeowners. Because this proposal would reduce state income taxes, it implies a decrease in the state tax burden. This decrease in state taxes, however, would be offset by an increase in local property taxes because of the elimination of the homeowners' property tax exemption. Thus, in this case, focusing on state government tax levels would be misleading in that it would exclude the increase in direct local tax collections.

- A substantial proportion of California's tax base is attributable to sources other than California residents. The California bank and corporation tax is based on corporate profits which, in the case of multistate corporations, are a computed share of the total U.S. profits of these companies. Fluctuations in total U.S. corporation profits over time can therefore influence the level of state taxes relative to personal income, without necessarily changing the tax load directly borne by residents of California.
- The sales and use tax is partially borne by nonstate residents to the extent that goods and services are sold to tourists and businesses from other states. Fluctuations in interstate trade also change the level of taxes relative to personal income without directly affecting the tax load of California residents.

Interstate Tax Level Comparisons

There are several problems associated with making meaningful comparisons of California tax levels with those of other states. For example:

- Substantial differences exist in legal, industrial and natural resource characteristics between states. Because of these differences, various states may impose different tax burdens on their own residents but realize similar levels of total revenues. For example, Nevada and New Jersey are able to raise substantial revenues through legalized gambling. States such as Texas and Louisiana, which have extensive natural resources, can rely on severance and export taxes on petroleum and natural gas to raise revenues. Similarly, Delaware and other states with a large number of corporations can rely more heavily on corporation taxes to raise revenues than states with smaller industrial bases. These taxes shift the tax loads from residents of these states to (a) residents of other states and (b) businesses and corporations.
- Variations in economic characteristics among states makes interstate comparisons of tax burden difficult. Public preferences in states with high levels of personal income may favor high levels of government services and thus higher tax levels than will areas with below-average personal income. Accordingly, comparison of state tax levels must be viewed in conjunction with the level of services desired by and provided to residents of the respective states. Thus, California—with its high average personal income—might be expected to desire more public services and thus have a higher state tax rate than states with lower income levels and less wealth.

VI. STATE SURPLUS

Trend in the Surplus Since Fiscal Year 1973–74

In order to provide perspective on the financial condition of the General Fund in 1979–80, it is useful to see how and why the surplus has grown. Table 37 and Chart VI show the year-to-year changes in the *year-end* surplus since 1973–74. The 1973–74 fiscal year is chosen as the beginning year because it marks the start of the period during which the General Fund surplus accumulated.

The year-end surplus at the end of 1973–74 was $180.1 million. It grew continuously through 1977–78, reaching $3,686.1 million on June 30, 1978. With the passage of Proposition 13, however, the state began spending more than it was receiving and the upward trend was reversed.

Changes in the year-end surplus, of course, reflect the *annual* General Fund surplus or deficit for each fiscal year. The annual surplus or deficit is the difference between resources received and funds expended during any one fiscal year. After incurring an annual deficit of $443.3 million in 1973–74, the state began realizing large and growing annual surpluses. The annual surplus was $349.9 million in 1974–75 and reached a high of $1,913.6 million in 1977–78. In response to the passage of Proposition 13, state General Fund expenditures increased sharply. As a result, the budget estimates that the state will incur an annual deficit of $1,460.5 million in 1978–79. This and any succeeding annual deficits must be financed with the year-end surplus, causing it to decline over time.

The Surplus in Fiscal Year 1979–80

On July 1, 1979—the first day of the budget year—the state is expected to have $2,225.6 million remaining from the surplus that built up over the 1973–74 through 1977–78 period.

If the Governor's expenditure and tax proposals for 1979–80 are approved, the state will once again spend more than it receives, resulting in a deficit as follows:

	(Millions)
General Fund revenues and transfers	$15,995.3
General Fund expenditures (excluding $250 million in proposed reserves)	17,042.8
Deficit	$−1,052.5

This deficit would further deplete the year-end surplus as follows:

	(Millions)
Surplus on hand, July 1, 1979	$2,225.6
1979–80 annual deficit	$−1,052.5
Surplus on hand, June 30, 1980	$1,173.1

The budget estimates are based on the following assumptions:

1. Income tax revenues will be reduced by a total of $1,111 million—$915 million for a new tax credit and $196 million for additional tax relief, possibly for renters. (The budget document quotes a figure of $210 million for the latter relief.)

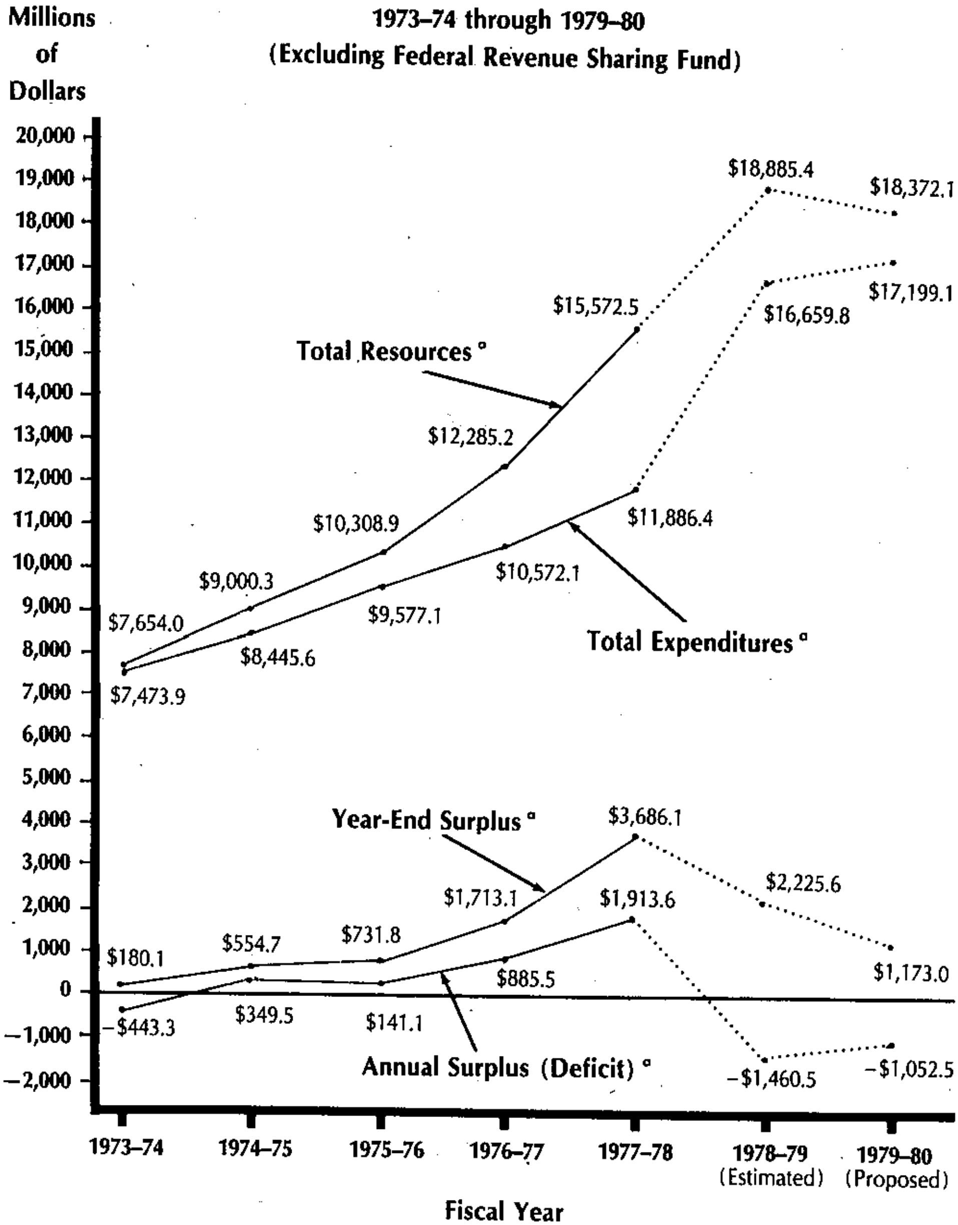
2. Regular budgeted expenditures will increase by 3.8 percent to $12,-

Table 37
Trend in General Fund Unrestricted Surplus
1973–74 through 1979–80
(in millions)

	1973–74	*1974–75*	*1975–76*	*1976–77*	*1977–78*	*1978–79*	*1979–80*
Prior-Year Resources	$683.9	$358.3	$660.1	$808.8	$1,818.2	$3,886.9	$2,376.8
Adjustments to Prior-Year Resources	+4.6	+24.7	+36.0	+95.8	+59.3	—	—
Total	$688.5	$383.0	$696.1	$904.6	$1,877.5	$3,886.9	$2,376.8
Revenues and Transfers	$6,965.0	$8,617.3	$9,612.8	$11,380.6	$13,695.0	$14,998.5	$15,995.3
Expenditures (−)	7,295.7	8,340.2	9,500.1	10,467.1	11,785.6	16,508.5	17,088.1
(Expenditures from Reserves)	(+113.1)	(−72.8)	(−28.4)	(+28.0)	(+95.8)	(+49.5)	(−40.3)
(Net Expenditures)	($7,408.8)	($8,267.4)	($9,471.7)	($10,495.1)	($11,781.4)	(16,459.0)	($17,047.8)
(Annual Surplus or Deficit)	(−444.3)	(+349.9)	(+141.1)	(+885.5)	(+1,913.6)	(−1,460.5)	(−1,052.5)
Carry-Over Reserves (−)	178.2	105.4	77.0	105.0	200.8	151.3	111.0
Year-End Surplus	$180.1	$554.7	$731.8	$1,712.1	$3,686.1	$2,255.6	$1,173.0
Less Reserves for:							
Housing							$100.0
Prudent Reserve							480.0
Adjusted Surplus							$593.0 [a]
Plus Federal Revenue Sharing Fund							274.9
Total Available (Governor's Budget)							$867.9 [a]

[a] The Governor proposes setting aside $150 million of this for legislation and legislative augmentations, leaving $443.0 million (or $717.9 million if federal revenue sharing funds are added.)

CHART VI
General Fund Unrestricted Surplus



[a] Terms are defined as follows:

(1) Total Resources consists of prior-year surplus plus revenues and transfers received during the year.
(2) Total Expenditures consists of funds expended during the year plus reserves carried over into the following year.
(3) Year-End Surplus is the difference between Total Resources and Total Expenditures. It represents the amount of unrestricted funds available at the beginning of the subsequent fiscal year.
(4) Annual Surplus (Deficit) is the difference between current year income and expenditures.

710 million in 1979–80. This amount does not include any allowance for state employee salary increases.

3. Local fiscal relief is increased by 2.6 percent to $4,378 million.

As noted in Part II of this overview, however, some of these assumptions may not prove to be valid. Table 38 summarizes how changes *in individual assumptions* would affect the annual and year-end surplus projected for the budget year.

Table 38

Estimates of 1979–80 Annual and Year-End Surplus Under Various Assumptions (in millions)

	Annual Surplus (Deficit)	*Year-End Surplus (Deficit)*
Governor's Budget	$−1,052.5	$1,173.0
Surplus Estimates Assuming: [a]		
(1) All budget reductions dependent on legislation are rejected	−1,341.6	883.9
(2) The Governor's tax package is not enacted	58.5	2,284.0
(3) The General Fund regular budget grows by 10 percent over 1978–79 (instead of the proposed 3.8 percent increase)	−1,807.3	418.2
(4) A 6 percent cost-of-living adjustment for state employees is granted	−1,206.1	1,019.4
(5) Legislative augmentations as a percent of regular General Fund expenditures total:		
a. 2.9 percent (the smallest increase in the past five years)	−1,421.1	804.4
b. 4.1 percent (the average increase for past five years)	−1,573.6	651.9
c. 6.4 percent (the largest increase in the past five years)	−1,865.9	359.6
(6) The $100 million reserve for housing is accepted	−1,152.5	1,073.0
(7) Local fiscal relief is increased to offset fully the effects of inflation	−1,240.9	984.6

[a] Only the impact of single assumptions is reflected in the pairs of surplus estimates. The impact is *not* cumulative.

To the $1,173.0 million year-end surplus projected in the Governor's Budget, $274.9 million in federal revenue sharing funds should be added, in order to show the uncommitted resources available to the state at the end of the budget year. This results in total uncommitted resources of $1,447.9 million. Of this amount, the Governor proposes to set aside $480 million (3 percent) of General Fund revenues as a prudent surplus.