

# State Fiscal Picture

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# I

## Part I



# State Fiscal Picture

The Legislature faces an enormous task as it begins its deliberations on the 1991-92 budget. The combination of underlying structural imbalances and a downturn in the California economy has resulted in an estimated two-year budget funding gap of almost \$10 billion.

The Governor's Budget seeks to address the budget problem through a combination of proposals to reduce existing state services and increase revenues. It also contains a number of "prevention" proposals aimed at reducing the cost of existing services in future years.

The Governor's plan is but one approach for addressing the budget problem and providing for the state's service needs. This plan has within it much to commend, especially given the adverse fiscal situation facing the state. However, the budget does not fully address the funding gap and also raises concerns regarding its impacts on health and welfare program users, schools, and other affected groups.

Thus, although the Governor's plan provides a reasonable starting point for the Legislature in its deliberations, it is but one of a wide variety of "solutions" available. Ultimately, the Legislature must craft a plan that balances the need for state services with the need to address the state's underlying structural budget problem.

# State Fiscal Picture

The presence of underlying structural budget problems and the onset of a national recession have combined to pose extremely difficult challenges for the 1991-92 state budget. The budget plan for the current year, adopted last summer, is now expected to leave the state with a large deficit on June 30, 1991. In addition, projected state revenues for 1991-92 will fall far short of the level needed to both maintain current levels of services and restore the state's reserve fund, absent corrective action.

The 1991-92 Governor's Budget has as its most basic goal the resolution of the state's fiscal problems. It proposes increases in revenues to help fund state programs as well as reductions in existing state services in order to achieve this goal. It also contains a number of "prevention" proposals which are aimed at reducing the cost of existing services in future years.

The budget provides a reasonable starting point for crafting a solution to the state's fiscal problems. If adopted, the Governor's proposals would go a long way toward addressing the funding gap which the state faces. However, whether the Governor's proposals are the best way to achieve this goal, as opposed to the other policy choices that will be considered in the coming months, is the key question facing state lawmakers in 1991.

In this part, we review the nature of the state's budget funding gap, both in the absence of any corrective action and assuming that the Governor's plan for bridging the gap is adopted. We also summarize the major proposals contained in the budget and examine how they affect different program areas. Finally, we provide our overall assessment of the extent to which the Governor's Budget effectively addresses the budget gap for 1991-92 and beyond.

## THE 1991-92 BUDGET PROBLEM

As has been fairly typical in recent years, the 1991-92 Budget must address not only the need to balance revenues and expenditures for the budget year, but also the imbalance that has arisen in the current year. According to the *administration's* calculations, the magnitude of this two-year fiscal problem amounts to \$7 billion. This includes \$1.9 billion to pay off the 1990-91 deficit,

\$3.7 billion to cover the difference between “workload budget” expenditures and baseline revenues anticipated for the budget year, and \$1.4 billion to replenish the state’s reserve fund.

Our analysis suggests, however, that these estimates significantly *understate* the true magnitude of the underlying budget funding gap. Specifically, as shown in Figure 1, our estimate of the total budget funding gap for 1991-92 is \$9.9 billion. This consists of \$2.1 billion to pay off the 1990-91 deficit, \$6.4 billion to fund current levels of services in the budget year, and \$1.4 billion to replenish the state’s reserve fund. As discussed later, about half of the \$2.9 billion by which our funding gap estimate exceeds the administration’s estimate translates into a reduction in the General Fund balance as of June 30, 1992.

Figure 1

### General Fund Budget Gap LAO Estimates

(in billions)

1990-91 Budget Deficit	\$2.1
1991-92:	
Base Expenditures	\$48.1
Base Revenues	41.7
Difference	\$6.4
Amount to Replenish Reserve	1.4
<b>Two-Year Budget Gap</b>	<b>\$9.9</b>

### Why Do Our Estimates Differ?

Our estimate of the budget funding gap differs from that of the administration for four primary reasons.

***Economic Recovery Adjustment.*** The administration’s estimate of 1991-92 General Fund revenues includes a special \$1.2 billion “economic recovery adjustment.” This adjustment reflects the administration’s view that it is appropriate to anticipate certain events which would justify a more optimistic revenue outlook than is implied by its standard economic forecast. We have not included such an adjustment in our own estimates, on

the basis of its relatively low probability and the fact that *the department's standard economic forecast already assumes a recovery at least as strong as the consensus view of state and national economists.*

**Proposition 98.** Our estimate of 1991-92 Proposition 98 expenditures for K-14 schools is \$600 million higher than the administration's estimate. This is because the administration's estimate assumes that the 1990-91 funding level is reduced as proposed in the budget, and because it does not include funding for the restoration payments that would be required in 1991-92 as a result.

**Discretionary Colas.** Our estimate reflects the increased costs of maintaining current services in programs where cost-of-living adjustments are not required by statute. These adjustments, and certain other similar factors, add approximately \$400 million to our estimates.

**AFDC Caseloads.** Our expenditure estimates for 1990-91 and 1991-92 reflect a higher level of state costs for the AFDC program than is anticipated in the administration's workload budget figures. These estimates are based on recent trends in caseload and unemployment, and indicate that costs will be approximately \$300 million higher than the administration projects over the two-year period.

### The Gap's Cyclical and Structural Components

Our estimated \$9.9 billion budget gap is the result of two fundamental factors.

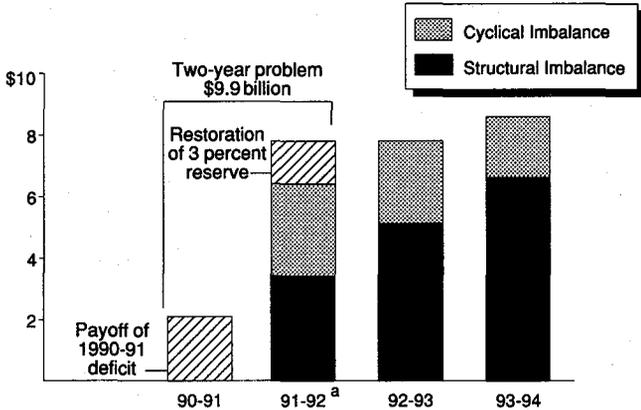
The first of these is the *current economic downturn*, which has the effect of depressing state revenue collections and increasing caseloads in state assistance programs. Because these effects should dissipate gradually over time as the economy recovers, this part of the budget problem is *cyclical* in nature. The budget gap also reflects a substantial *structural* component, in that there is a significant imbalance between revenues and expenditures that would occur even in the absence of an economic downturn. Our estimates indicate that the \$6.4 billion gap between revenues and expenditures for the 1991-92 fiscal year is almost equally attributable to these cyclical and structural factors.

Figure 2 shows our estimates of the budget gap, both for 1990-91 and 1991-92 as well as the following two years, including its cyclical and structural components. These estimates do *not* include any of the administration's budget proposals or any other corrective actions. They are based upon the budget's economic forecast for 1991 and 1992, our assumptions about the economic

Figure 2

**Components of the State Budget Problem**

1990-91 through 1993-94  
(in billions)



<sup>a</sup> 1991-92 data reflect the second-year effects of 1990-91 budget actions. These actions reduced expenditures and augmented revenues, thereby making the 1991-92 projected budget imbalance less than it otherwise would have been.

performance that would follow in subsequent years, and our estimates of the revenue and current-services expenditure levels that would be consistent with this outlook.

As this figure indicates, although the economy is assumed to strengthen by 1992, the *cyclical* imbalance still remains a factor in the out years. This is because of the time it takes to return to “normal” revenue levels, given the pace of economic recovery that most forecasters are assuming. *The structural component of the gap, however, is projected to increase substantially over time, reflecting the continuing imbalance between revenues and expenditures. These underlying trends, which are examined in greater detail in Parts Two and Three of this document, are briefly discussed below.*

**The Economic Outlook**

The Department of Finance’s economic forecast assumes that the state will experience a brief and mild downturn, with recovery underway in the last half of 1991. Figure 3 shows the projected growth rates in California personal income and employment that are reflected in this forecast. This forecast also

assumed that a nonmilitary resolution of the Persian Gulf crisis would occur by the spring of 1991, and that interest rates and oil prices will be declining through mid-1991. Beginning in 1992, it is assumed that the economy will return to a more normal pattern, with state personal income growth in the 8-percent range.

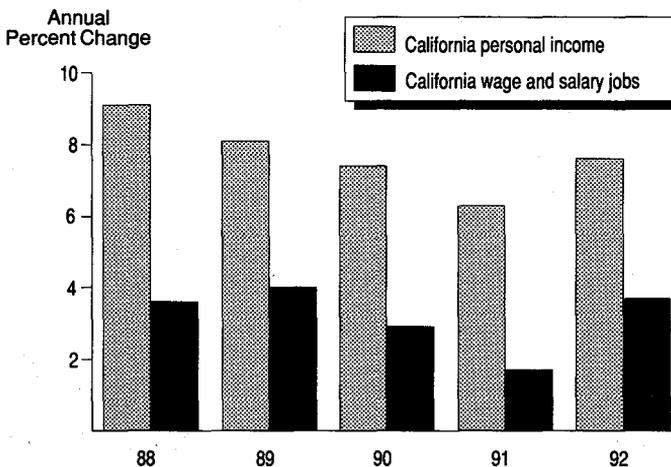
At the time this forecast was prepared, it was generally consistent with the consensus view of economists. Since that time, the situation in the Persian Gulf has obviously changed, however, and most reports on the economy have been fairly negative. Consequently, many economists have revised their projections downward, and the department's forecast for California now is a bit more optimistic than the consensus view.

### The Revenue Forecast

As shown in Figure 4, the budget forecasts General Fund revenue growth in 1991-92 totaling \$5.3 billion, a 13 percent increase over the current year. This large increase is primarily due to a variety of revenue enhancements proposed in the budget, along with the optimistic \$1.2 billion economic recovery adjust-

Figure 3

### The DOF Economic Forecast - Brief Downturn Followed by Upturn



Source: 1991-92 Governor's Budget.

Figure 4

### Components of General Fund Revenue Growth Anticipated in the 1991-92 Governor's Budget

(in billions)

Baseline Revenue Increase (Standard Economic Forecast)	\$1.3
Additional Increase, Assuming Economic Recovery Adjustment	1.2
Accrual Accounting Proposal	1.7
Other Revenue Proposals <sup>a</sup>	0.8
Transfer Proposals	0.3
<b>Total Revenue Growth</b>	<b>\$5.3</b>

<sup>a</sup> Includes \$400 million in withholding payments and \$400 million from elimination or delay of certain tax expenditures.

ment discussed earlier. The underlying rate of growth in revenues in the budget forecast is less than 4 percent when these special factors are excluded, however, reflecting the forecast for generally slow economic growth. Our estimates of revenues beyond the budget year reflect a return to more normal rates of growth in economic activity and underlying tax liabilities. In addition, these out-year figures reflect *none* of the revenue proposals contained in the budget.

### Expenditure Growth Trends

Regarding expenditures, our estimates of the budget gap are based on calculations which attempt to measure the cost of providing 1990-91 levels of state services in 1991-92 and beyond. Thus, these calculations do not reflect the effect of the expenditure proposals contained in the Governor's Budget.

In the aggregate, we estimate that the cost of providing 1990-91 service levels amounts to \$48.1 billion for 1991-92, an increase of 13 percent over estimated 1990-91 baseline expenditures. Our estimates indicate that these current services funding requirements will increase by 10 percent in both 1992-93 and 1993-94.

## The Bottom Line

The state faces a multi-billion dollar funding gap in 1991-92 and beyond, *absent corrective action*. Although about half of the near-term funding gap may be ascribed to cyclical factors, the underlying problem is predominantly structural. The Legislature will need to take dramatic action both to balance the 1991-92 budget and begin to permanently bring state revenues and expenditures into line. The Governor's Budget proposes one set of strategies for partially accomplishing this.

## WHAT DOES THE NEW BUDGET PROPOSE?

The 1991-92 Governor's Budget contains a large number of major proposals to bridge the funding gap. Figure 5 shows that, in the aggregate, these proposals provide \$5.4 billion in expenditure reductions and \$3.1 billion in revenue enhancements. These proposals, combined with the additional economic recovery revenue adjustment discussed earlier, total \$9.7 billion. Thus, these proposals would have the effect of eliminating all but about \$200 million of the \$9.9 billion funding gap, and would leave the state budget in balance and with a reserve slightly below the 3-percent target. Because the \$1.2 billion economic recovery revenue adjustment is unlikely to occur, however, we believe that the Governor's proposals fall significantly short of eliminating the

**Figure 5**

### Budget's Proposed Resolution of the 1991-92 Spending Gap<sup>a</sup>

(in billions)

Program Reductions	\$5.0	
Funding Shifts	1.2	
Cost Deferrals	0.1	
Cost Increases	-0.9	
Total, Expenditure Changes		\$5.4
Revenue Enhancements	\$3.1	
Economic Recovery Adjustment	1.2	
Total, Revenue Changes		\$4.3
<b>Total</b>		<b>\$9.7</b>

<sup>a</sup> Amounts reflect combined effect of 1990-91 and 1991-92 changes.

funding gap. In fact, the state would be left with *no* reserve and a small *deficit* on June 30, 1992. Given the considerable economic uncertainties facing the state today, it is highly desirable that an adequate reserve fund be available. Thus, even if the Legislature approved *all* of the Governor's proposals, additional actions totaling approximately \$1.4 billion would be needed to fully bridge the funding gap.

### Specific Expenditure Proposals

The predominant themes of the *1991-92 Governor's Budget* have to do with correcting the budget's underlying structural problem and re-orienting certain state programs to focus on *prevention* of the social problems which are in part driving the state's fiscal problems. Toward these ends, the budget proposes the elimination or reduction of several specific state programs and the enhancement or creation of other programs thought to have preventive potential. In general, these program expansions are funded by redirecting resources from other existing programs. For example, in the education area the budget proposes to develop new public school programs to increase prevention-oriented services for children, and proposes that these efforts be funded by redirecting funds from other existing K-12 spending categories (primarily cost-of-living adjustments).

The budget's specific expenditure proposals to balance the budget, as categorized in Figure 5, are as follows:

**Program Reductions.** The budget proposes \$5.0 billion in program funding reductions, including almost \$700 million in *current-year* savings, which are primarily due to reductions in Proposition 98-related educational spending. Of the \$4.3 billion in *budget-year* savings, \$2.0 billion is attributable to our estimate of budget-year Proposition 98-related savings. This is \$600 million higher than the administration's \$1.4 billion estimate, as discussed earlier. (For a thorough discussion of Proposition 98 and how it affects K-14 funding, please see our piece on Proposition 98 in Part Four of this document.)

Other major program reduction proposals include:

- Suspension of statutory cost-of-living adjustments (\$0.4 billion).
  - AFDC grant-level reductions (\$0.2 billion).
  - Reduction of the renters' tax credit (\$0.2 billion).
  - Reductions in specific higher education support items (\$0.2 billion).
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The budget also achieves substantial savings through a variety of unallocated reductions in departmental budgets (\$0.8 billion).

**Funding Shifts.** By shifting the responsibility of funding programs to other levels of government or to fees, the budget proposes to achieve savings of \$1.2 billion in 1991-92. The major item in this category is the budget's "program realignment" proposal, which would shift existing state responsibilities for funding local mental health and public health programs to county governments. State taxes on alcoholic beverages and automobiles would be increased and dedicated to counties to assist them with these or other responsibilities. The budget also funds a portion of the increased costs of operating the University of California (UC), the California State University, and the Community Colleges by imposing a 20 percent student fee increase.

**Cost Deferrals.** The budget contains two proposals that would result in the deferral of \$125 million of current costs to future years. Specifically, the budget proposes that \$55 million of 1991-92 UC expenditures be instead paid for in 1992-93, and that \$70 million in current state costs for the Public Employees' Retirement System (PERS) be deferred by accelerating the recognition of 1989-90 actuarial gains. (Subsequent to the introduction of the Governor's Budget, however, the PERS has indicated that there were no gains for 1989-90 and, in fact, the system sustained a loss. As a result, the savings from this proposal would not materialize.)

Partially offsetting these various expenditure reductions is an increase of about \$900 million due to an accrual accounting change involving Medi-Cal expenditures.

### **Proposed Changes By Program Area**

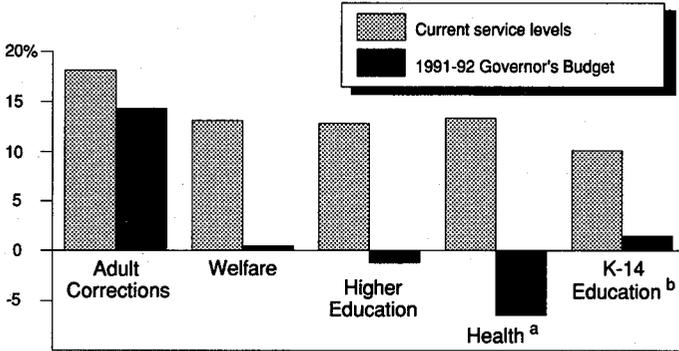
Figure 6 shows how most major program areas fare under the Governor's proposals relative to current services funding requirements. As the figure indicates, adult corrections programs are the most fully funded, while all other major program areas face significant reductions from current state-supported service levels. The level of funding for health programs is reduced dramatically, reflecting primarily the Governor's proposal to shift the state's existing local mental health and public health services funding responsibilities to county governments.

### **Revenue Enhancements**

The \$3.1 billion of revenue enhancements proposed by the budget include \$300 million of additional revenues for 1990-91 and \$2.8 billion of additional revenues for 1991-92. The major

Figure 6

**Expenditure Growth Rates by Program Area,  
Current Service Levels Versus Governor's Budget**



<sup>a</sup> Reflects the Governor's program realignment proposal.  
<sup>b</sup> 1991-92 Governor's Budget figure reflects proposed reductions in funding levels for 1990-91 and 1991-92.

changes for 1991-92 are summarized in Figure 7. As this figure shows:

- The bulk of this increased revenue (\$1.7 billion) is attributable to a proposed change in state accounting practices, whereby revenue is to be recognized as it is *earned* instead of generally when cash is *received* by the state. Thus, this proposal does not result in an actual increase in the tax liabilities of state taxpayers, and it would have only a small impact in subsequent years.
- The budget also proposes that state income tax withholding requirements be extended to cover independent contractors, estates and trusts, and that withholding requirements be increased as they apply to certain "lump-sum" payments. These proposals would raise about \$400 million in 1991-92, only a part of which would be ongoing.
- The state sales tax would be extended to candy, snack foods, newspapers and periodicals to generate about \$300 million in additional revenue. This gain would be ongoing.
- The state's health care tax credit, which becomes effective in 1992 under current law, would be delayed until

Figure 7

## Revenue Enhancement Proposals in the 1991-92 Governor's Budget

(in millions)

	1991-92 Amount
<b>Accounting Practices</b>	
Accrual Accounting	\$1,702
<b>Withholding Proposals</b>	
Independent Contractors	290
Estates/Trusts	42
Lump-Sum Payments	80
<b>Tax Expenditures</b>	
Repeal Sales Tax Exemptions:	
Candy/Snack Foods	200
Newspapers/Periodicals	83
Delay Health Care Tax Credit	97
<b>Other Proposals</b>	
Miscellaneous Changes	345
<b>Total Changes</b>	<b>\$2,839</b>

1993. This delay increases 1991-92 revenues by about \$100 million.

Figure 8 shows that, as was the case with the revenue changes adopted along with the 1990 Budget Act, the aggregate impact of the changes proposed in the budget would decline over time because of their one-time effects. In the case of the 1991 proposals, however, the one-time effects are particularly dominant. Thus, the budget in effect relies upon revenue changes primarily to address the *cyclical* (versus *structural*) portion of the budget problem, given that the long-term effect of these measures on state revenues is quite limited.

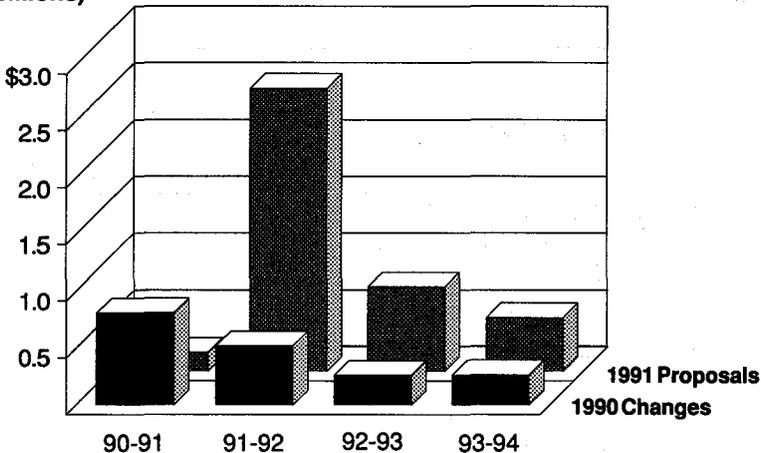
### DOES THE BUDGET WORK?

The primary test of the budget plan's effectiveness is the extent to which it can be relied upon to eliminate the budget funding gap in 1991-92 and make significant progress toward

Figure 8

## Fiscal Impact of 1990 and 1991 Revenue Adjustments

1990-91 through 1993-94  
(in billions)



doing so in subsequent years, while at the same time addressing the basic needs of Californians for public services.

### Dealing With the Budget Gap

Figure 9 presents our estimates of the impact of the budget's proposals on the funding gap from 1991-92 through 1993-94.

**1991-92.** As noted earlier, the budget goes a long way toward addressing the state's two-year funding gap. However, as Figure 9 indicates, *it does not fully eliminate the budget funding gap for the 1991-92 fiscal year, as the state would have a small deficit and no reserve fund as of June 30, 1992.* This is primarily because we do not believe it is prudent to adopt the administration's optimistic premise that an additional \$1.2 billion should be added to the revenue forecast. We also have identified several increased costs not addressed by the Governor's Budget, such as the higher costs for public assistance programs stemming from the slowdown in the economy.

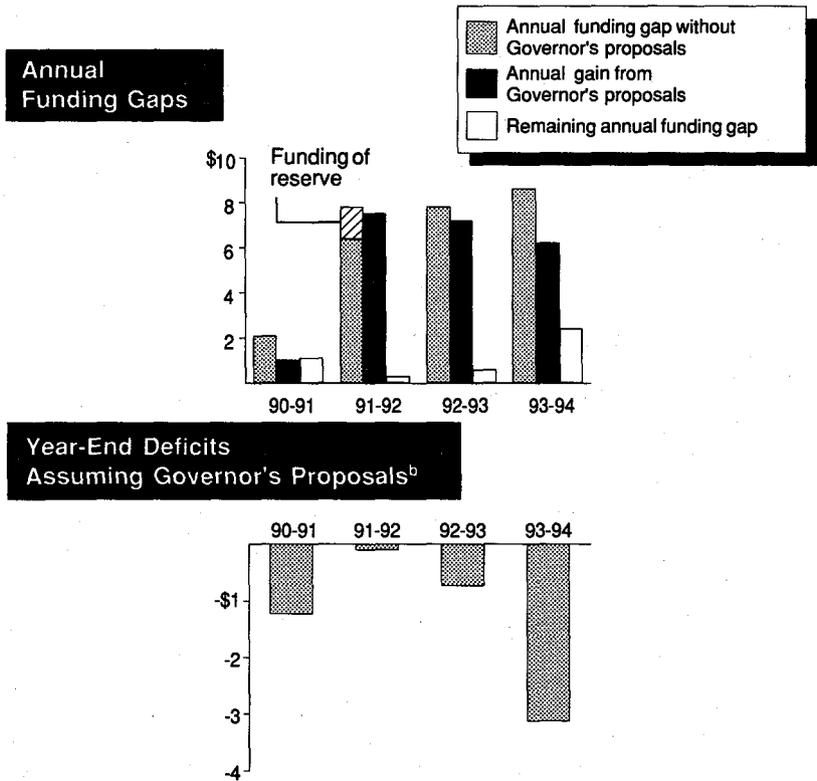
**Beyond 1991-92.** As Figure 9 indicates, the budget's proposals not only make significant headway toward the elimination of the funding gap in the near term, they also reduce it in the longer term. Figure 9 also indicates, however, that the effectiveness of

the budget proposals is expected to diminish over time, and the underlying budget gap will again become a major problem in the future. In large part, this is attributable to the one-time impacts of the Governor's revenue proposals. However, it also reflects the fact that the budget does not deal fully with the underlying structural problems. For example, fully half of the expenditure savings relied upon in the budget are attributable to Proposition 98 reductions, and these savings will disappear over time as the measure's funding-restoration provisions come into play. Thus, although the budget makes some significant reductions in the

Figure 9

### Impact of Governor's Budget Proposals on Budget Funding Gap<sup>a</sup>

1991-92 through 1993-94 (in billions)



<sup>a</sup> Assumes that the \$1.2 billion in economic recovery adjustment revenues included in the budget does not materialize.

<sup>b</sup> All years shown end up with zero balance in the reserve fund.

levels of expenditures for state programs in 1991-92, these savings are not sufficient to permanently offset the increased costs of providing services to an ever-expanding population. Figure 9 indicates that, assuming the Governor's proposals are adopted and assuming current service levels, 1993-94 state expenditures would exceed revenues by approximately \$2.4 billion, and the year-end deficit would total approximately \$3 billion.

### **Providing State Services**

Another major consideration involved in assessing the budget's workability is whether its impact on state-supported services is acceptable. Among other things, the Legislature will need to evaluate the budget's proposal to substantially reduce funding for K-14 schools. Proposed levels of K-14 funding for both 1990-91 and 1991-92 are below the level of funding adopted in the 1990 Budget Act for the 1990-91 fiscal year, and these reductions will result in lower funding levels than would otherwise be the case for several years to come. The Legislature will need to determine the impact that such reductions will have and whether they are acceptable. The same is true for such other major budget proposals as: reductions in welfare grants, shifts of local mental health and public health program responsibilities, reduced renters' tax credits, and funding for higher education.

### **Other Considerations**

In assessing the budget's workability, the Legislature must also consider whether it provides adequate protection from economic and other types of uncertainties that could potentially affect state resources and spending requirements. In this regard, we note that the estimates of state revenues contained in the budget are subject to large dollar errors, even if the budget's economic forecast is basically correct. Given the substantial uncertainty over the course of events in the Middle East and the unknown duration and severity of the current economic downturn, these dollar error margins for revenues are considerably larger than normal.

State spending requirements also are subject to considerable uncertainty over the forecast period. For example, the budget's "prevention" proposals may result in savings beyond those reflected in our estimates, to the extent that they have a strong impact on the social problems they are intended to address. However, the budget also places great reliance on the use of unallocated reductions that may be restored as their negative impacts on state programs become apparent. Thus, there also is

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uncertainty as to whether the budget can achieve the level of savings over the long term that is reflected in our estimates of expenditures.

The other major area of uncertainty in our forecast is the potential impact of several lawsuits against the state in such areas as corporate taxation, taxes on automobiles, and indigent aid to counties. The combined impact of these lawsuits, if decided against the state, could exceed \$7 billion initially, with substantial ongoing costs thereafter. It is unclear when these impacts would occur, although it appears that it would be primarily after 1991-92.

### **ARE THERE OTHER OPTIONS?**

The plan proposed in the Governor's Budget is but one of a variety of alternative budget strategies available to the Legislature. For example, strategies could be developed that place greater reliance on long-term revenue gains or a different set of reductions in state-supported services. All of these strategies, however, involve difficult decisions and impose burdens on those affected by them. The range of budget strategies available to the Legislature is discussed in Part Three of this document.

It also is important to note that the bulk of state spending is determined by existing federal, constitutional and statutory requirements. Thus, addressing the state's budget problems will necessitate modifying some of these requirements. Although the Legislature has only limited potential to change or limit the impact of federal requirements, it can seek voter approval of state constitutional changes, and it can change existing statutory provisions where it believes that such changes are necessary to effectively manage the state's budget.

The challenge for the Legislature in developing its budget strategy is to make the changes necessary for the state to resolve its underlying budget gap, while still addressing the basic service needs of the population.

### **CONCLUSION**

The Governor's Budget offers *one approach* for addressing the budget problem and providing for the state's public service needs. This plan has much within it to commend, especially given the adverse fiscal situation facing the state budget. However, the Governor's Budget also has certain shortcomings that need to be addressed in order to make it completely workable. Most notable in this regard is that it does not fully address the budget funding gap. The budget also raises concerns regarding its impacts on

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health and welfare program users, schools and other affected groups. As with the alternative strategies available to the Legislature, this plan will require the enactment of many pieces of legislation, and raises many important policy issues that will be difficult to resolve.

The Legislature faces an enormous task as it begins its deliberations on the 1991 Budget Bill. It must evaluate a wide range of potential budget strategies and determine their impacts on the achievement of state goals, as well as on the funding gap. Ultimately, it must agree upon a plan that balances the need for state services with the need to address the state's underlying structural budget problem. This structural problem, unless effectively addressed, will only become worse in the future.