CALIFORNIA LEGISLATURE

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1981, to June 30, 1982

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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LETTER OF TRANSMITTAL

925 L Street, Suite 650
Sacramento, California 95814
February 18, 1981

THE HONORABLE WALTER W. STIERN, *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, 1981, to June 30, 1982.

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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BUDGET OVERVIEW
I. INTRODUCTION

Our Analysis

This Analysis reports the results of our detailed examination of each item in the Budget Bill. It also contains our recommendations on the budget, as well as recommendations for new legislation and for legislative guidance to the departments and agencies in state government.

Based on our analysis we have recommended many reductions that appear to be warranted and can appropriately be made because:

- A program's objectives can be achieved at a lower cost to the state.
- Amounts requested have not been justified.
- A program or activity is not effective in achieving the purpose for which it was created.
- A program proposed for funding has not been authorized by the Legislature.

In addition, we have recommended augmentations to the proposed budget where factors of legislative intent have not been sufficiently recognized. No attempt, however, has been made to tailor these recommendations to achieve any specific overall spending level.

Organization of the Analysis

This Analysis is divided into two major components:

1. The A-pages present overall expenditure, revenue, surplus and economic data to provide perspective on budget issues faced by the Legislature in 1981–82. This overview contains both historical data and the outlook for the General Fund beyond 1981–82. Other sections of the A-pages discuss: (a) state and local borrowing through the issuance of bonds. (b) the major components of the budget, including information on state-operated programs, local assistance and fiscal relief, and capital outlay, and (c) a summary of the major issues facing the Legislature this year.
2. The body of the report presents a consecutive item-by-item analysis of the specific budget issues. Recommendations for legislative action are made relative to our findings on each budget issue.

Expenditures

The 1981–82 budget proposed by the Governor provides for expenditures of $24.7 billion. This amount includes:

- $20.8 billion from the General Fund, of which $4.3 billion is for state operations, $15.9 billion is for local assistance, and about $28 million is for capital outlay. The remaining amount, $0.5 billion, is proposed for cost-of-living adjustments. This amount has not been earmarked for distribution to specific budget items.
- $3.7 billion from special funds.
- $0.2 billion from selected bond funds.

In addition, the budget proposes expenditures of $10.6 billion from federal funds and $6.8 billion from various "nongovernmental cost" funds including retirement, working capital, revolving, public service enterprise, and others. Adding all these components, the total spending program proposed by the Governor is $42 billion, of which $35.2 billion is from governmental funds. Using this latter measure, the state will spend $1,443 for every man, woman, and child in the state during the budget year, or at the rate of $96 million per day.

Revenues

The budget is supported from a variety of different sources including tax fees, bond proceeds, service charges and intergovernmental transfers. In 1981–82, the most important sources will provide:

- $21,020 million to the General Fund.
- $3,340 million to some 133 different special funds.
- $10,586 million in federal funds for a myriad of purposes. The state will subvene most of these federal funds (54 percent) to local government.

Income from state sources—General Fund and special funds—is estimated to be $24,360 million in the budget year. This is an increase of $2,153 million, or 9.7 percent, over 1980–81, and 16.4 percent above 1979–80 revenues.

The Department of Finance's estimate of General Fund revenues—$21,020 million for 1981–82—is $1,964 million, or 10.3 percent, higher than estimated revenues in 1980–81. The percentage increase is on the low side because of changes in tax laws and in the budget year the continued softness in the economy that the Department of Finance anticipates in calendar year 1981.

A detailed discussion of the revenue estimates and the economic assumptions on which the budget is based begins on Page A-16 of this overview.

II. REVENUES, EXPENDITURES, AND THE SURPLUS

A. CONDITION OF THE GENERAL FUND—THE SURPLUS

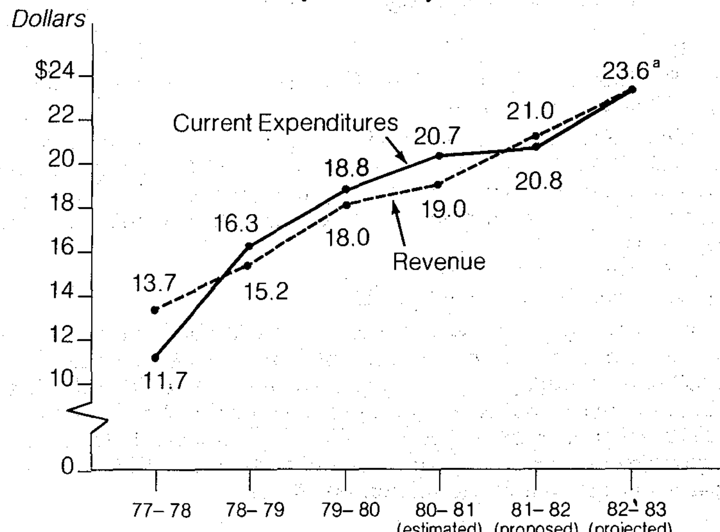
Overview

The budget problem facing the Legislature in 1981–82 is centered in the General Fund. Essentially, the challenge facing the Legislature in 1981–82 is how to avoid a deficit while providing for the needs of ongoing programs and activities in the face of high rates of inflation.

Chart 1

Comparison of General Fund Current Expenditures to Current Revenue

1977–78 to 1982–83 (in billions)



[a] Department of Finance projection.

Table 1
Trend in General Fund Unrestricted Surplus
1973–74 to 1981–82
(in millions)

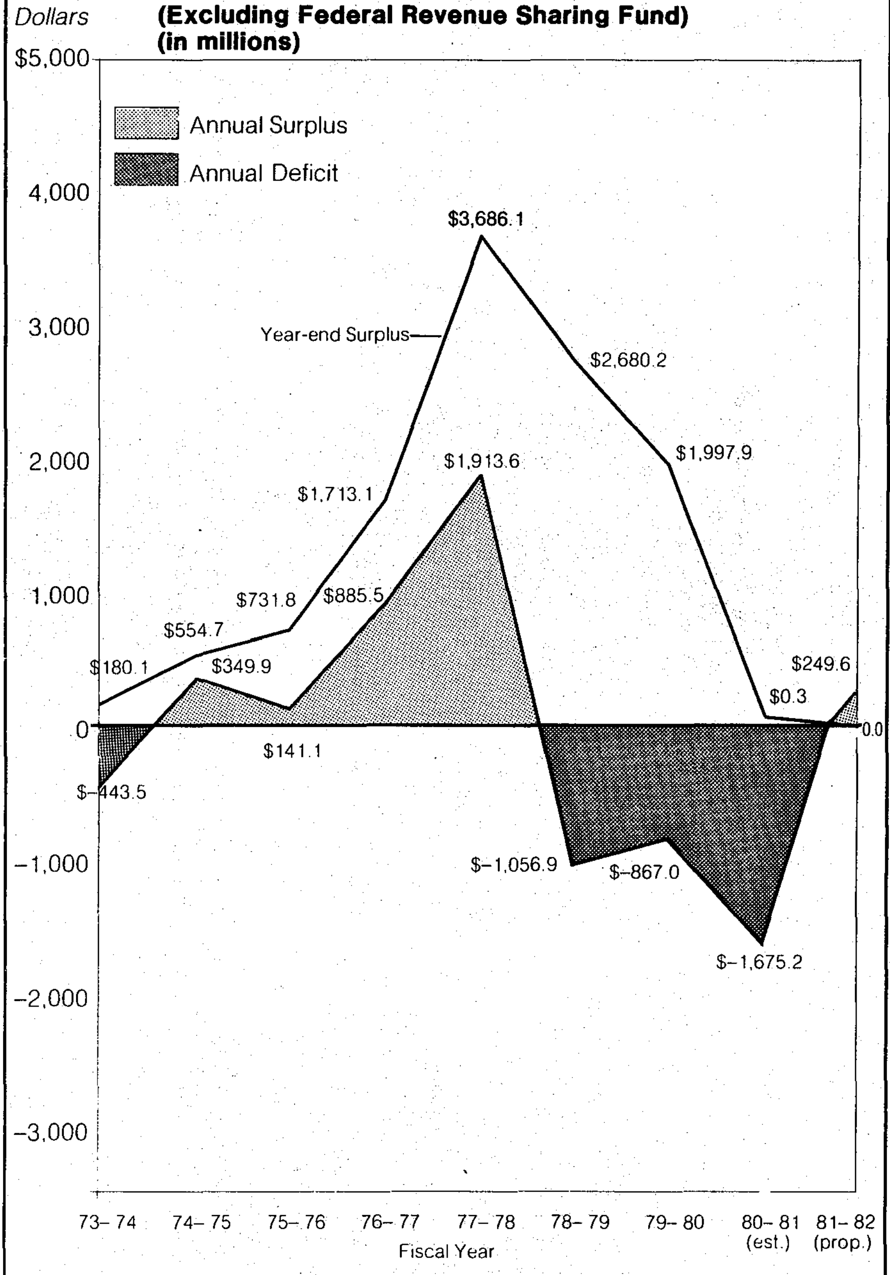
	1973–74	*1974–75*	*1975–76*	*1976–77*	*1977–78*	*1978–79*	*1979–80*	*1980–81*	*1981–82*
Prior year resources	$683.9	$358.3	$660.1	$808.8	$1,818.2	$3,886.9	$2,905.5	$2,540.7[a]	$399.1
Adjustments to prior-year resources	+4.6	+24.7	+36.0	+95.8	+59.3	+50.9	+184.7	(47.6)[a]	—
Prior year resources, adjusted	$688.5	$383.0	$696.1	$904.6	$1,877.5	$3,937.8	$3,090.2	$2,540.7	$399.1
Revenues and transfers	6,965.5	8,617.3	9,612.8	11,380.6	13,695.0	15,218.5	17,984.6	19,055.4	21,019.7
Expenditures (−)	7,295.7	8,340.2	9,500.1	10,467.1	11,685.6	16,250.8	18,534.1	21,197.0[b]	20,798.7[b]
(Expenditures from reserves)	(+113.3)	(−72.8)	(−28.4)	(+28.0)	(+95.8)	(+24.6)	(+317.5)	(−466.4)	(−28.6)
(Current Expenditures)	($7,409.0)	($8,267.4)	($9,471.7)	($10,495.1)	($11,781.4)	($16,275.4)	($18,851.6)	($20,730.6)	($20,770.1)
(Annual surplus or deficit)	(−443.5)	(+349.9)	(+141.1)	(+885.5)	(+1,913.6)	(−1,056.9)	(−867.0)	(−1,675.2)	(+249.6)
Carry-over reserves (−)	178.2	105.4	77.0	105.0	200.8	225.3	542.8[a]	28.0	0.1
Reserve for Economic Uncertainties	—	—	—	—	—	—	—	370.0	620.0
Year-End Surplus	$180.1	$554.7	$731.8	$1,713.1	$3,686.1	$2,680.2	$1,997.9	$0.3	-0-
Plus Federal Revenue Sharing Plan							302.9	179.0	—
Total Uncommitted Resources Available, including reserve for economic uncertainties							$2,300.8	$549.3	$620

[a] Includes (1) $38.5 million in General Fund capital outlay reappropriations that were made payable in 1980–81 from the Special Account for Capital Outlay (SAFCO) and (2) $9.1 million which will be reverted in 1980–81.

[b] After $180 million has been deducted in 1980–81 and $200 million in 1981–82 for Estimated Unidentifiable Savings (as shown in the 1981–82 Governor's Budget).

Chart 2

General Fund Unrestricted Surplus 1973–74 to 1981–82 (Excluding Federal Revenue Sharing Fund) (in millions)



If the Governor's estimate of revenues proves to be valid, and his expenditure proposals for 1981–82 are approved, the state will begin the budget year on July 1, 1981, with a surplus of less than $300 thousand, and will end the year, June 30, 1982, with a zero balance. The reserve for economic uncertainties will have a balance of $620 million on June 30, 1982.

Trends in the Surplus, 1973–74 through 1977–78

From 1973–74 to 1977–78, current revenues grew 97 percent as compared to an increase of 60 percent in expenditures. As shown in Table 1 and Chart 1, this more rapid growth in revenues caused year-end surpluses to accumulate rapidly, from a level of $180 million in 1973–74 to a peak of $3,686 million in 1977–78.

The year-end surplus is also a reflection of the *annual* General Fund surplus or deficit, which is the difference between resources received and funds expended during any one fiscal year. After incurring an annual deficit of $444 million in 1973–74, the state began accumulating large and growing annual surpluses. The annual surplus was $350 million in 1974–75, and reached $1,914 million in 1977–78. This was the largest annual surplus in the state's history, as illustrated in Chart 2.

What Happened to the Surplus?

In the three years subsequent to 1977–78, state expenditures exceeded revenues by a cumulative total of $3.6 billion. These spending levels will reduce the remaining General Fund surplus to $0.3 million by June 30, 1981. The state, however, will still have $370 million in a newly created Reserve for Economic Uncertainties.

The passage of Proposition 13 in 1978, a one-time income tax reduction and the ongoing income tax indexing program, are the major reasons why the state will end 1980–81 with a relatively insignificant surplus of $0.3 million and with a revenue base that is $1,675 million *below* the current expenditure level. Essentially, the problem in 1981–82 will be to hold back the growth in expenditures sufficiently to allow revenues to catch up. Table 2 summarizes the fiscal situation faced by the state in 1981–82.

Table 2
General Fund
Summary of Balances Available for Expenditure
During 1981–82
(in millions)

Prior-Year Funds Available			
Reserve for economic uncertainties, start of year			$370.0
Uncommitted General Fund surplus, start of year		$0.3	
Revenues and transfers	$21,019.7		
Expenditures	20,770.0		
Difference		$249.7	
Total—To Replenish reserve for economic uncertainties			$250.0
Total reserve for economic uncertainties, end of year			620.0
Uncommitted General Fund Surplus, end of year			0

As indicated earlier, revenues in 1980–81 will be $1,675 million below expenditures. The 1981–82 budget proposes to finance this gap by:

- Transferring to the state $500 million in local revenue from the unsecured property tax, by offsetting state costs for selected local assistance programs.

- Replacing $420 million in state educational aid with a like amount of property tax revenue from cities, counties, and special districts which would be redirected to local school districts.
- Reducing the costs of existing state programs by over $100 million.
- Replacing state funds with federal dollars to finance cost-of-living increases in SSI/SSP and other programs.

Through these measures, the Governor would hold expenditures during 1981–82 at $20,770 million, which is $250 million *below* revenues. The $250 million would be used to restore the Reserve for Economic Uncertainties to its original $620 million level. The end result is that there would be *no* General Fund surplus on June 30, 1982. Moreover, during 1981–82, the last portion ($179 million) of the Federal Revenue Sharing Funds will be used.

Is the Budget that Stringent?

The budget indicates that expenditures will only grow by $40 million (or 0.2 percent) in 1981–82. This figure does not count the $920 million in state expenditures which will be financed, in effect, from diverted property tax revenues. Therefore, it could be said that the total growth in state expenditures is closer to $960 million which is equivalent to an increase of 4.6 percent. This amount is still below the 8.6 percent inflation rate projected for state and local governments, but it indicates that the budget is not quite as stringent as it appears.

Underlying Assumptions

The condition of the General Fund on June 30, 1982, as shown in the budget, depends on a number of critical assumptions involving:

- The performance of the California economy.
- Whether the unidentified savings—$180 million in 1980–81 and $200 million in 1981–82—will be realized.
- Whether legislation is passed in the exact form proposed by the Governor to effect legislative and other changes in numerous programs that are needed in order to realize the savings reflected in the budget.
- Whether new fiscal legislation is passed increasing expenditures beyond the level proposed in the budget.

Outlook for the General Fund Beyond 1981–82

The longer-term outlook for the General Fund depends upon the relative rates of increase in future revenues and expenditures. Because the Legislature can pass laws which change the amount of revenues collected and expenditures made, there is really nothing automatic or inevitable about the future levels of these two variables. Nevertheless, some conclusions about the period beyond 1981–82 can be drawn by looking at revenues and expenditures under existing law.

Since the state cannot engage in deficit spending once the surplus is exhausted, as it is expected to be by the end of 1981–82, the main budgeting constraint will be the growth in General Fund revenues annually. Thus, the question becomes: Will General Fund revenues grow at a rate sufficient to cover the growth in the expenditure base, beyond the budget year, without further expenditure reductions or general tax increases?

We believe that the answer is yes. This is because:

- The state must align annual expenditures with annual revenues in 1981–82, so that new spending in the budget year will not exceed current income, and
- *After 1981–82,* we have estimated that General Fund revenues under current law will probably grow approximately in line with California personal income growth. This income growth averaged about 12.4 percent per year from 1974 through 1980.

- *Therefore,* given the realignment of annual expenditures and revenues in the budget year, annual expenditures after 1981–82 should be able to rise at a relatively good pace, in line with personal income growth.

The fiscal outlook for the state—where the near-term need for significant spending restraint is accompanied by the prospect of affordable expenditure growth in the future—is analogous to the situation in which many households find themselves from time to time. When consumers find themselves with large and unanticipated amounts of extra income or savings—as the state did after its surplus accumulated—they may increase their monthly spending for a period of time. Eventually, however, they must adjust their living standards to correspond to their monthly paycheck. This adjustment is more difficult to make when the temporarily higher spending is not on one-time purchases, but rather on items with the potential for ongoing financial commitments—as in the case of the state's increased spending for local governments following Proposition 13. As with the state government, however, such households must ultimately make this adjustment if they are to stay out of debt. Once this one-time adjustment is fully accomplished—as the state must do in 1981–82—spending can be increased as income rises in future years.

B. EXPENDITURES

Total State Spending Plan

Table 3 and Chart 3 present the principal categories of the state spending plan in the 1979–80, 1980–81 and 1981–82 fiscal years. Included are expenditures from the General Fund, special funds and bond funds totaling $24,653 million in 1981–82. When added to expenditures of $10,586 million from federal funds and $6,784 million from nongovernmental cost funds, the total as proposed by the Governor amounts to $42,024 million.

Table 3
Total State Spending Plan [a]
(in millions)

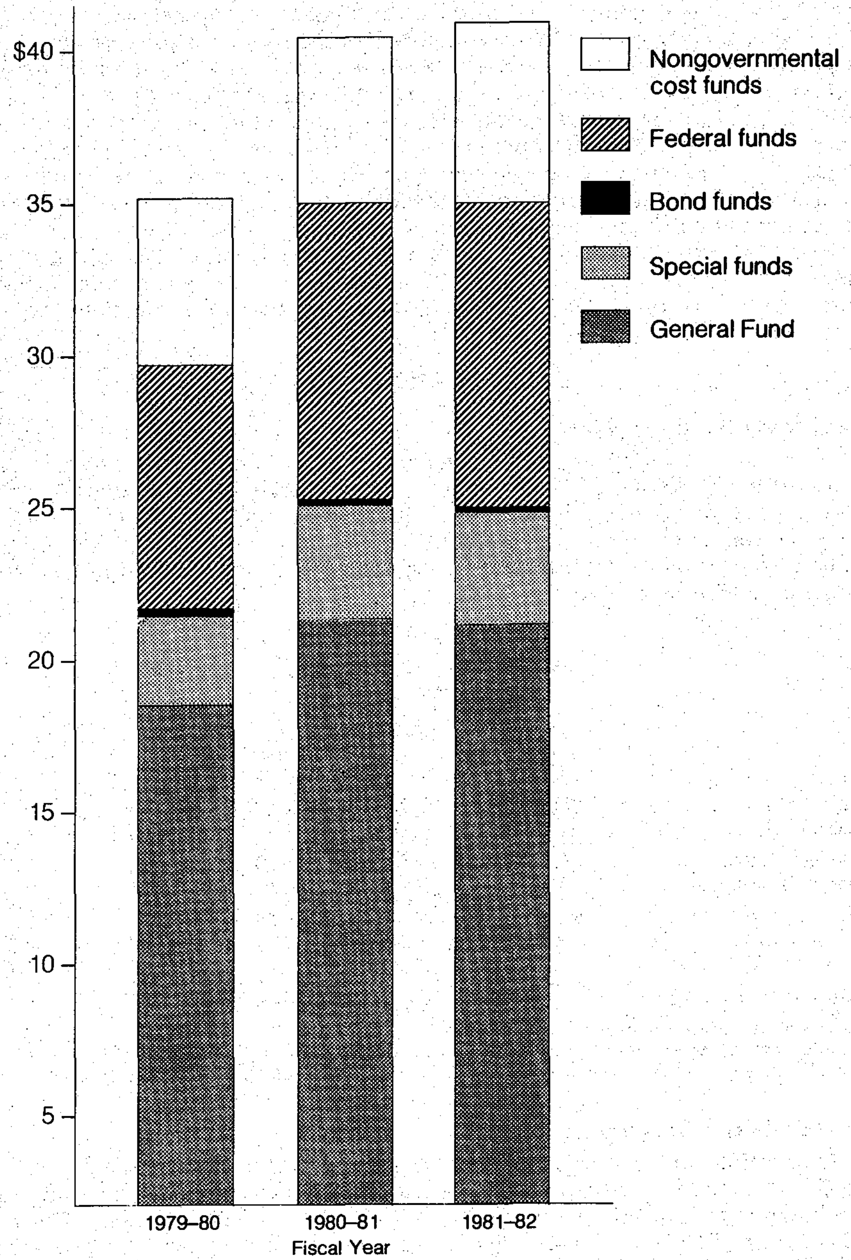
	Actual 1979–80	Estimated 1980–81 Amount	Estimated 1980–81 Percent Change	Proposed 1981–82 Amount	Proposed 1981–82 Percent Change
General Fund	$18,534.1	$21,197.0 [b]	14.4%	$20,798.7 [b]	−1.9%
Special funds	2,760.4	3,479.8 [c]	26.1	3,693.7 [c]	6.1
Budget Totals	$21,294.5	$24,676.8	15.9%	$24,492.4	−0.7%
Selected bond funds	193.0	272.6	41.2	160.6	−41.1
State Expenditures	$21,487.5	$24,949.4	16.1%	$24,653.0	−1.2%
Nongovernmental cost funds	5,658.0	6,544.4	15.7	6,784.4	3.7
Federal funds	8,160.2	10,445.2	28.0	10,586.3	1.4
Total State Spending	$35,305.7	$41,939.0	18.8%	$42,023.7	0.2%

[a] Based on amounts shown in the Governor's Budget.
[b] Includes expenditures from reserves of $466.4 million in 1980–81 and $28.5 million in 1981–82.
[c] Includes expenditures from reserves of $261.6 million in 1980–81 and $107.5 million in 1981–82.

State Budget Expenditures

That portion of the state spending plan financed by state revenues deposited in the General Fund or special funds is usually referred to as budget expenditures. The budget totals are shown in Table 3—$21.3 billion in 1979–80, $24.7 billion in 1980–81, and $24.5 billion in 1981–82. Budget expenditures account for 58 percent of the $42 billion state spending plan in 1981–82. General Fund expenditures alone are nearly one-half of the total.

Chart 3
Total State Spending 1979–80 to 1981–82 (in billions)



Growth in General Fund Expenditures

Historical perspective is a useful tool in analyzing trends in General Fund spending. Table 4 presents the amount and rate of increase in expenditures since 1973–74. The proposed 1981–82 General Fund budget is nearly three times what it was in 1973–74. During the last eight years, the average annual rate of increase was nearly $1.7 billion, or 18 percent. Thus, it is evident that the proposed increase between the current and budget years—0.2 percent—represents an abrupt halt to the expenditure trends of the past.

Table 4
Annual Growth in General Fund Expenditures
(in millions)

	Amount	*Percent Increase*
1973–74	$7,295.7	29.9%
1974–75	8,340.2	14.3
1975–76	9,500.1	13.3
1976–77	10,467.1	10.2
1977–78	11,685.6	11.6
1978–79	16,250.8	39.1
1979–80	18,534.1	14.1
1980–81 (estimated)	20,730.6 [a]	11.8
1981–82 (proposed)	20,770.1 [b]	0.2

[a] Not including $466 million in expenditures from reserves.
[b] Not including $29 million in expenditures from reserves.

Budgeted Versus Actual Expenditures

The expenditure program initially proposed in the budget, has invariably been changed—usually upward—during the budget process. Table 5 compares the magnitude of the original estimates with actual expenditures during the past eight years.

Table 5
Comparison of Budgeted and Actual General Fund Expenditures [a]
(in millions)

	Budget As Submitted	*Actual Expenditures*	*Change* Amount	*Change* Percent
1973–74	$7,151.1	$7,295.7	$144.6	2.0%
1974–75	7,811.9	8,340.2	528.3	6.8
1975–76	9,169.5	9,500.1	330.6	3.6
1976–77	10,319.7	10,457.1	147.4	1.4
1977–78	11,822.3	11,685.6	−136.7	−1.2
1978–79	13.482.5	16,250.8	2,768.3	20.5
1979–80	17,088.1	18,534.1	1,446.0	8.5
1980–81	20,748.4	20,730.6 [bc]	−17.8	−0.1

[a] Source: 1973–74 to 1981–82 Governor's Budget, Schedule 1.
[b] Midyear estimate.
[c] Excludes $466 million in expenditures from reserves.

In 1977–78 and 1980–81, the actual amount expended was less than initially proposed. The unusually large net increase for 1978–79 was mainly due to the fiscal relief program enacted in the wake of Proposition 13. This local fiscal relief added $4.4 billion to that budget, but reductions in other state programs held the net increase to $2,768 million.

Prediction or Plan?

It should be noted that the budget estimates are not *predictions* of how much ultimately will be spent, although these estimates reflect countless predictions about expenditure rates 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 expenditures *ought to be,* given all of those factors that the state cannot control. It is certain that, between now and June 30, 1982, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, and many other factors. Thus, actual revenues and expenditures are likely to be different from the estimates contained in the Governor's Budget.

Where Does the Money Go?

Table 6 and Chart 4 show the distribution of General Fund expenditures by major program categories. Adding the $10.2 billion for education to the $7 billion for health and welfare indicates that a total of $17.2 billion, or 82.7 percent of total expenditures goes to the so-called people programs. The remaining $3.6 billion, or 17.3 percent, goes for tax relief and other programs such as corrections and resources.

These "people programs" have been the fastest growing components in General Fund expenditures. Chart 5 illustrates the trends since 1973–74, when health, welfare, and education made up about 75 percent of the budget. These programs have moved up from around $5.5 billion in 1973–74 to more than triple that level in 1981–82—$17.2 billion.

Chart 4

General Fund Expenditures—Major Components 1981–82

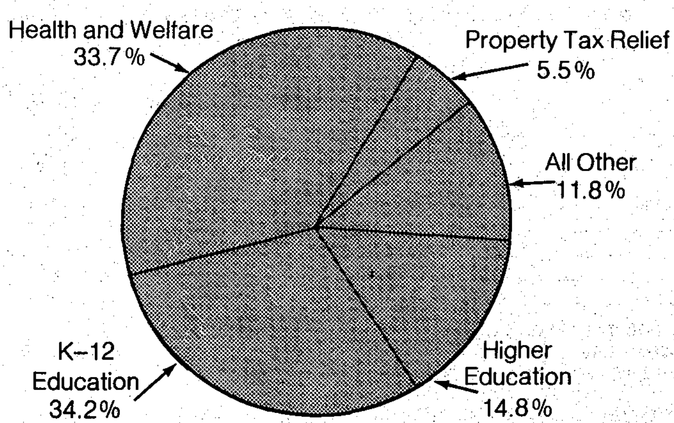
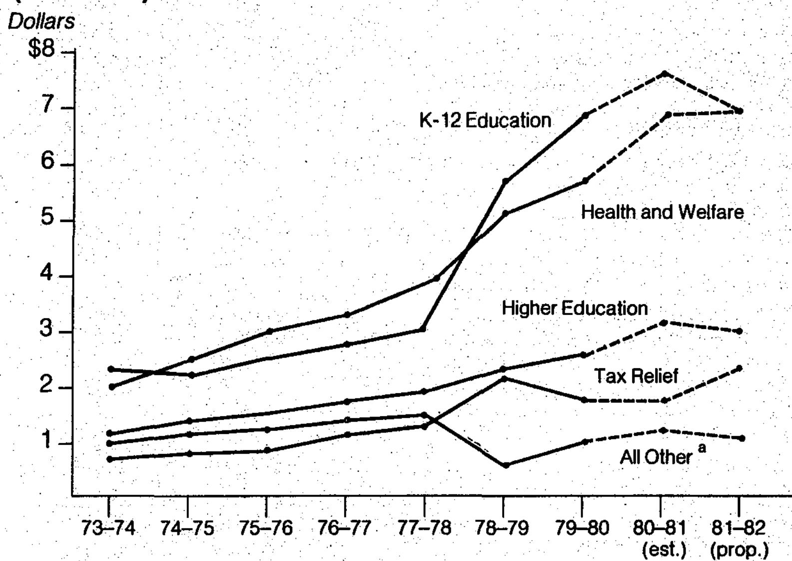


Table 6
Expenditures for Health, Welfare, and Education
As a Percent of Total General Fund Expenditures
1981–82
(in millions)

	Amount	*Percent of General Fund Budget*
Health and Welfare	$7,022.3	33.7%
Education:		
K–12	7,107.1	34.2
Higher education	3,076.8	14.8
Total, Education	$10,183.9	49.0%
Total, Health, Welfare, and Education	$17,206.2	82.7%
Other Program Areas	3,592.5	17.3
Total General Fund Budget	$20,798.7	100%
Less expenditures from reserves	−28.5	−1.4
Total, Current General Fund Expenditures	$20,770.2	98.6%

Chart 5
General Fund Expenditures By Major Program Categories 1973–74 to 1981–82
(in billions)



[a] Includes $509 million in 1981–82 for unallocated cost-of-living increases.

Summary of Major Program Changes

Although Table 7 shows that expenditures in total will increase by only $39.6 million, there are significant increases and decreases within individual programs that tend to offset each other. Some of these major changes are:

1. ***SSI/SSP grants*** will be reduced by $201 million, despite increased caseload. The overall reduction will occur because (1) recipient's unearned income such as social security will increase, (2) the federal government will provide

the entire amount needed to fund the 4.75 percent cost-of-living adjustments proposed in the budget, and (3) the mid-year change in grant levels during 1980–81 affects the growth rate for the budget year.

2. ***Special Social Service programs*** appear to decline $37.2 million. The actual amount available for these programs, however, will actually increase in the budget year. Currently the Department of Education spends $52 million in federal funds to support child development programs. In the budget year, these federal funds will be shifted to Social Services and a corresponding amount of General Funds will be shifted from Social Services to the Department of Education. After accounting for these funding shifts, this program will experience a net funding increase of $14.8 million, rather than the reduction indicated in the budget.

Table 7
Estimated General Fund Program Changes
1980–81 to 1981–82
(in millions)

	Governor's Budget		*Change*	
	1980–81	*1981–82*	*Amount*	*Percent*
Health and Welfare:				
Medi-Cal	$2,493.0	$2,676.9	$183.9	7.4%
SSI/SSP grants	1,252.0	1,051.0	−201.0	−16.1
AFDC grants	1,195.9	1,215.0	19.1	1.6
Mental health	568.6	577.5	8.9	1.6
Developmental services	521.1	525.6	4.5	0.9
Special social service programs	187.9	150.7	−37.2	−19.8
Including federal buyout of General Fund program	—	(202.7)	(14.8)	(7.9)
Other, health and welfare	801.5	825.6	23.1	3.0
Subtotals, Health and Welfare	$7,020.0	$7,022.3	$2.3	0.03%
Adjusted, Health and Welfare	—	(7,074.3)	(54.3)	(0.7)
Education:				
K–12	$7,656.3	$7,107.1	−$549.2	−7.2%
Property tax shift	—	(361.2)	—	—
Unsecured roll	—	(228.0)	—	—
Adjusted K–12 Budget	—	($7,696.3)	($40.0)	(0.5%)
University of California	1,041.0	1,081.2	40.2	3.9
California State University and Colleges	932.6	928.7	−3.9	−0.4
California Community Colleges	1,088.8	969.0	−119.8	−11.0
Property tax shift	—	(58.8)	—	—
Unsecured roll	—	(37.0)	—	—
Adjusted CCC Budget	—	($1,064.8)	(−$24.0)	(−2.2%)
Other, higher education	93.7	97.9	4.2	4.5
Subtotals, Education	$10,812.4	$10,183.9	$628.5	−5.8%
Adjusted Education Budget	—	(10,868.9)	(56.5)	(0.5)
Property tax relief	1,327.2	1,144.2	−183.0	−13.8
Unsecured roll	—	(235.0)	—	—
Adjusted property tax relief	—	($1,379.2)	($52.0)	(3.9%)
Employee compensation	139.2	—	−139.2	N/A
Unallocated cost-of-living adjustments	—	509.1	509.1	N/A
Capital outlay	58.5	27.7	−30.8	−52.6
Debt service	212.0	231.3	19.8	9.1
All other	1,627.7	1,680.2	52.5	3.2
Totals	$21,197.0	$20,798.7	−$398.3	−1.9%
Less expenditures from reserves	−466.4	−28.5	437.9	N/A
Current Expenditures	$20,730.6	$20,770.2	$39.6	0.2%

3. ***K–12 education*** appears to decline by $549 million. This figure, however, makes no allowance for the $589 million in new property tax revenues these districts would receive under legislation proposed by the Governor. If these funds are included, the K–12 program shows an increase of $40 million.
4. ***Community Colleges*** appear to decline by almost $120 million, but this does not reflect the shift in property tax revenues. The net reduction, therefore, is closer to $24 million.
5. ***Property Tax Relief*** appears to decline by $183 million. However, this figure does not reflect the $235 million that cities, counties and special districts will receive from unsecured property taxes. The state, in effect, is capturing these funds by making offsetting reductions in state payments to these jurisdictions for Homeowners' Property Tax Relief ($209 million) and Personal Property Tax Relief ($16 million). If these adjustments are recognized, then expenditures for this category show a $52 million increase.
6. ***Unallocated cost-of-living adjustments*** show an increase of $509 million. The budget states that these funds can be used for cost-of-living increases in state programs, employees' compensation, or for other purposes. In addition to the $509 million in unallocated cost-of-living adjustment funds, the budget proposes $742 million for cost-of-living increases spread among the various programs. This amount would be in lieu of the statutory increases that these programs would otherwise receive. Existing *statutory* cost-of-living adjustments would cost $1.3 billion in 1981–82.

Controlling Expenditures Through the Budget Process

A large portion of the budget is not easily controllable through the budget process because funding for many programs is provided by statute or the constitution, rather than by the Budget Bill. As Table 8 shows, expenditures of $10.5 billion, or 50.6 percent of the $20.8 billion in total General Fund expenditures proposed by the budget, are authorized in the Budget Bill. A significant amount—$9.7 billion (or 46.9 percent), although included in the Budget Bill is really authorized by statute. (This figure would be higher if the budget requested funds to pay the full statutory cost-of-living adjustments.) Finally, $520 million, or 2.5 percent, does not even appear in the Budget Bill.

Table 8

1981–82 General Fund Expenditures in the Budget Bill (in millions)

	Amount	*Percent of Total*
Expenditures in the 1981–82 Budget Bill:		
Statutory authorizations also included in the Budget Bill:		
Education, K–12	$5,911.9	28.4%
Department of Social Services	2,272.8	10.9
Board of Governor's—Community Colleges	497.3	2.4
Tax Relief	1,063.2	5.1
Legislature	3.7	0.02
Total, Statutory Authorizations	$9,748.9	46.9%
Expenditures authorized in the Budget Bill	10,529.6	50.6
Total, in the Budget Bill	$20,278.5	97.5%
Expenditures *Not* in the Budget Bill	520.2	2.5
Constitutional	(231.3)	(1.1)
Other	(288.9)	(1.4)
Total, Expenditures	$20,798.7	100.0%
Less Expenditures from reserves	−28.5	
Current Expenditures	$20,770.2	

ARTICLE XIII B

On November 6, 1979, California voters overwhelmingly approved Proposition 4, the "Spirit of 13" Initiative. Proposition 4, which placed Article XIII B in the California Constitution, has three main provisions:

- It places a limit on the year-to-year growth in tax-supported appropriations of the state and individual local governments.
- It precludes the state and local governments from retaining surplus funds. Any *unappropriated* balances at the end of a fiscal year must be returned to taxpayers within a two-year period.
- It requires the state to reimburse local governments for the cost of certain state mandates.

Spending Limit

Article XIII B seeks to limit the spending of government entities by establishing a limit on the level of tax-supported appropriations in each fiscal year. The article establishes a base-year limit for 1978–79, and adjusts this limit in subsequent years for changes in inflation and population. Once established, the limit increases (or decreases) independently of actual government spending. The limits are effective beginning with the 1980–81 fiscal year.

Not all appropriations are covered by the article's provisions. The article limits only appropriations from tax revenues, such as revenues from property, sales, personal income and corporate franchise taxes. Appropriations financed from non-tax revenues—such as federal funds, user fees and oil revenue—are *not* limited by Article XIII B.

The article also exempts from the limits of both the state and local governments appropriations made for the following purposes: (1) debt service, (2) retirement benefit payments, (3) federal or court mandates, (4) investment funds, and (5) refunds of taxes. In addition, it exempts from the state limit state subventions to local governments. After allowing for these exemptions, the remaining appropriations of tax revenues are subject to the limit.

The ambiguity of certain provisions of Article XIII B led to much uncertainty as to how the article was to be implemented. In response to this problem, the Legislature passed and the Governor signed into law Chapter 1205, Statutes of 1980 (SB 1352). Among other things, Chapter 1205 clarified (1) the definition of "state subventions," (2) the method of calculating the annual adjustment factors, and (3) the process by which local government limits are established.

Impact of Article XIII B in 1980–81

Table 9 summarizes the impact of Article XIII B on the state in the current year, as estimated both by the administration and our office. The Department of Finance estimates that the state is $810 million *under* its appropriations limit in 1980–81, while we estimate that the state is $275 million *under* its limit. The difference between the two estimates—$535 million—is due to several factors.

- ***Base Year Limit Disparity.*** As Table 9 shows, our estimate of the 1978–79 or base-year limit ($12,422 million) is $276 million *less* than the Department of Finance's estimate ($12,698 million). This disparity is due to: (1) different methodologies on how to count appropriations financed by *non-tax proceeds* and (2) a disagreement on the calculation of the State Highway Account special reserve appropriation made in 1978–79. The Department of Finance's higher base-year limit translates into a higher 1980–81 limit than ours ($16,386 million versus $15,759 million), resulting in more "room" between the 1980–81 limit and appropriations subject to limitation.
- ***Annual Adjustment Factors.*** In calculating the annual adjustments to the limit for cost of living and population increases, we have followed the specific language contained in Chapter 1205, to arrive at a two-year adjustment factor of 26.3 percent. Finance, on the other hand, maintains that Chapter 1205 was not effective for setting the 1980–81 appropriations limits, and has used population and personal income figures which became available more recently. Thus, Finance is using a two-year adjustment of 28.4 percent. This difference alone accounts for approximately one-half of the disparity between the two estimates.
- ***Appropriation Updates.*** Finance's estimate of 1980–81 appropriations does not reflect revisions in current year continuous appropriations, nor does it include proposed deficiency appropriations. We have accounted for these updated appropriations figures in our estimate.

Table 9
Impact of Article XIII B on the State in 1980–81 (in millions)

	1978–79	*1980–81*
Department of Finance:		
Appropriations limit	$12,698	$16,386
Appropriations subject to limitation	12,698	15,576
Amount Under Limit	—	$810
Legislative Analyst's Office:		
Appropriations limit	$12,422	$15,759
Appropriations subject to limitation	12,422	15,484
Amount Under Limit	—	$275

Revisions to Earlier Legislative Analyst Estimates

In October 1980, we estimated that the state would be $122 million *over* its 1980-81 appropriations limit. The difference between this estimate and our new estimate of the state's position—$275 million *under* the limit—is due entirely to revised data presented in the 1981-82 Governor's Budget. The major changes are as follows:

- Estimates of nontax proceeds (especially federal Medicare receipts and oil revenues) have *increased* dramatically, thereby reducing the level of 1980-81 appropriations subject to limitation.
- Department of Finance has increased its estimate of state subventions to schools, which also reduces spending subject to the limit.
- The budget proposes to reduce the 1980-81 appropriation to the reserve for economic uncertainties by $250 million.

Impact of Article XIII B in 1981-82

Table 10 shows estimates of the impact that Article XIII B will have in the budget year. Finance projects that the state will be $1,790 million *under* its 1981-82 limit, while we estimate that the gap will be $1,136 million. The difference between the two figures is due principally to the same factors mentioned above in discussing the article's impact during the current year.

Table 10
Impact of Article XIII B
On the State in 1981-82
(in millions)

	Department of Finance	*Legislative Analyst*
Appropriations limit	$18,167	$17,472
Appropriations subject to limitation	16,377	16,336
Amount Under Limit	$1,790	$1,136

The large gap reflected in both estimates results from the fact that the level of appropriations in the base year (1978-79) could not be sustained indefinitely with the revenues produced by current tax laws. This is because the state had a large portion of its base-year *limit* financed by *surplus* funds. However, since the surplus is now depleted, 1981-82 appropriations can be financed only from *current-year* revenues. The large gap results from that portion of the state's limit originally financed by the surplus—and the year-to-year growth in this amount—which can no longer be financed in the budget year because the surplus has been exhausted.

As a result, the state's appropriation limit will *not* be a fiscal constraint in 1981-82 and, barring the enactment of a general tax increase, it will probably not be a constraint in the foreseeable future. Only if revenues grow for several years at rates higher than the annual adjustments to the state's limit will the state have adequate resources to spend up to its limit.

Return of Surplus

Section 2 of Article XIII B requires that all unappropriated revenues (that is, surplus funds) be returned to the people within the following two fiscal years. Legislative Counsel has interpreted this section as being applicable to both tax and non-tax revenues.

Section 2 will have little applicability to the General Fund in the current year, as the Governor's Budget estimates a 1980-81 year-end surplus of only $280,458. Special fund balances, on the other hand, are estimated at $860 million, an unknown portion of which is potentially subject to the return provisions of Section 2. We will have specific recommendations on this issue in our analysis of the general control sections, published subsequent to this *Analysis*.

C. REVENUES

1. Overview

California state government is supported by revenues which are derived from many different sources. The Governor's Budget identifies over 50 specific individual revenue categories, ranging from taxes levied on individuals and businesses, to income which the state derives directly from its own assets, such as oil-producing properties and financial investments.

About 86 percent of all revenues are deposited in the General Fund, where they may be appropriated for the support of general activities of state government. Nearly 90 percent of these General Fund revenues are derived from three specific sources: the sales and use tax, the personal income tax, and the bank and corporation tax. The remaining 14 percent of total state revenues are placed into special funds to support specific programs and activities.

What Determines the Level of Revenues?

The amount of revenues collected in any year depends primarily upon three factors:

- *First,* the *definition of the tax base* (such as taxable income, taxable corporate profits and taxable sales) and the *tax rates* applied to the various parts of this tax base;
- *Second,* the impact which *economic events* have on the *size* of the tax base; and
- *Third,* the *timing* of actual tax payments to the state.

The first factor is usually determined by either the Legislature or the voters. Tax rates and definitions of the tax base generally change relatively infrequently and, when they do change, there is often advance warning of how revenues will be affected, including the timing and magnitude of these effects.

However, the second factor—economic events—is often outside the direct control of both state policymakers and individual voters. These events are also very difficult to forecast accurately, particularly in today's highly uncertain economic environment. For these reasons, economic conditions are most responsible for year-to-year volatility in state revenue performance, and pose the single greatest barrier to accurate revenue forcasting.

The third factor—the cash-flow time pattern of tax payments—can also pose significant complications. This is because certain taxpayers—such as corporations—have considerable latitude regarding when they must submit their tax payments. As discussed later, California's personal income tax indexing provisions have also significantly affected the time pattern of income tax withholding payments and refunds. All of these factors make revenue estimating a very difficult task.

Errors in Revenue Forecasting

Table 11 summarizes the record of the Department of Finance in estimating General Fund revenues in recent years. Since 1973-74, these errors—*all underestimates*—have ranged from a low of 2.7 percent to a high of 7.6 percent, with the most recent error (for 1979-80) being the lowest in six years (3.2 percent).

Table 11
General Fund Revenue
Estimating Errors Made in May [a]

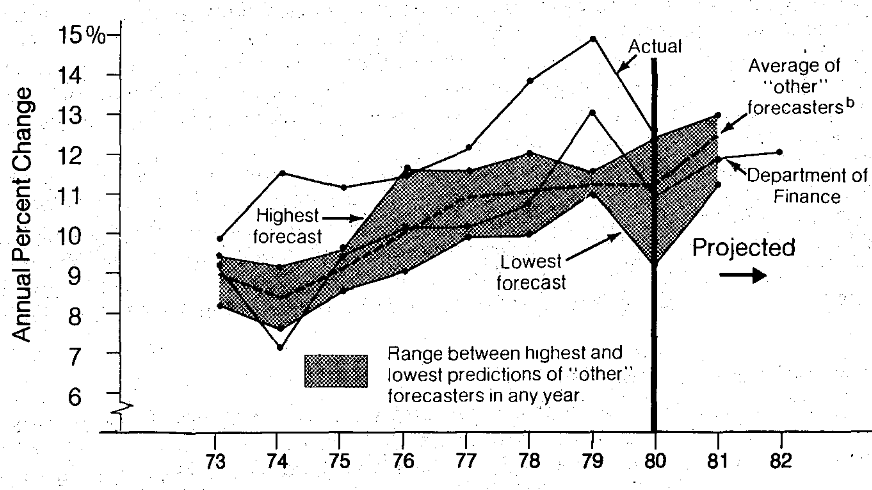
	Dollar Error (in millions)	*Percent Error*
1973–74	$184	2.7%
1974–75	322	3.9
1975–76	621	6.9
1976–77	726	6.8
1977–78	966	7.6
1978–79	780	5.4
1979–80 [b]	562	3.2

[a] Difference between actual receipts and receipts estimated in May prior to the start of the specified fiscal year.
[b] Error based on June 1979 forecast revision.

The fact that revenues have been consistently underestimated during this period is primarily explained by the inability of economists to fully anticipate the strength of the California economy and the high inflation rates which have occurred. Chart 6 shows the record of these forecasters in predicting California's personal income (the single most important determinant of state revenues) from 1973 to 1980, and indicates that income growth repeatedly exceeded the expectations of public and private sector economists alike. In fact, out of 44 separate forecasts which were available over this eight-year period, only *once* was income growth not underpredicted. The chart also indicates that the Department of Finance has performed neither worse nor better than other forecasters on average; rather, it has typically conformed to the concensus outlook.

Chart 6

Historical Accuracy of California Personal Income Forecasts, 1977 to 1982[a]



[a] Forecasts as of approximately year-end of each calendar year shown.

[b] "Other" forecasters include UCLA, Bank of America, United California Bank, Wells Fargo Bank, Crocker Bank, and Security Pacific National Bank.

This track record raises the question of whether, because of an inherent conservatism in the economic forecasting and revenue estimating process, revenues will again be significantly underpredicted this year. At the moment, this does not seem to be happening. In fact, cumulative revenue collections for 1980-81 are nearly $250 million *below* Finance's projections made last May, and $30 million *below* the budget forecast for the month of December alone. Whether this revenue shortfall will persist is unknown. However, its presence suggests that the state could be less likely to realize the unexpected revenue "windfalls" in 1980-81 that it realized in each of the prior seven years.

Table 12
HISTORICAL TRENDS IN STATE REVENUES [a]
1970–71 to 1981–82

General and Special Fund Revenue Growth

Fiscal year	Current Dollars (in millions) Dollar Amount	Current Dollars (in millions) Percent Change	Constant Dollars (in millions) Dollar Amount	Constant Dollars (in millions) Percent Change	Constant Dollars Per Capita Dollar Amount	Constant Dollars Per Capita Percent Change
1970–71	$5,919	3.1%	$5,919	−4.3%	$293.40	−5.3%
1971–72	6,897	16.5	6,514	10.1	318.42	8.5
1972–73	7,670	11.2	6,820	4.7	329.15	3.4
1973–74	8,715	13.6	7,182	5.3	342.12	3.9
1974–75	10,405	19.4	7,757	8.0	363.68	6.3
1975–76	11,567	11.2	7,991	3.0	368.13	1.2
1976–77	13,463	16.4	8,752	9.5	395.90	7.5
1977–78	15,962	18.6	9,715	11.0	430.79	8.8
1978–79	17,711	11.0	9,947	2.4	432.41	0.4
1979–80	20,919	18.1	10,852	9.1	462.24	6.9
1980–81	22,207	6.2	10,561	−2.7	440.92	−4.6
1981–82	24,360	9.7	10,668	1.0	436.81	−0.9
Total Increase	$18,441	311.6%	$4,749	80.2%	$143.41	48.9%
Average Increase	1,676	13.7	432	5.5	13.04	3.7

General Fund Revenue Growth

Fiscal year	Current Dollars (in millions) Dollar Amount	Current Dollars (in millions) Percent Change	Constant Dollars (in millions) Dollar Amount	Constant Dollars (in millions) Percent Change	Constant Dollars Per Capita Dollar Amount	Constant Dollars Per Capita Percent Change
1970–71	$4,534	4.7%	$4,534	−2.8%	$224.74	−3.8%
1971–72	5,395	19.0	5,095	12.4	249.08	10.8
1972–73	5,976	10.8	5,313	4.3	256.45	3.0
1973–74	6,978	16.8	5,750	8.2	273.91	6.8
1974–75	8,630	23.7	6,433	11.9	301.62	10.1
1975–76	9,639	11.7	6,659	3.5	306.77	1.7
1976–77	11,381	18.1	7,398	11.1	334.66	9.1
1977–78	13,695	20.3	8,335	12.7	369.61	10.4
1978–79	15,219	11.1	8,547	2.5	371.55	0.5
1979–80	17,985	18.2	9,330	9.2	397.40	7.0
1980–81	19,055	6.0	9,063	−2.9	378.35	−4.8
1981–82	21,020	10.3	9,205	1.6	376.91	−0.4
Total Increase	$16,486	363.6%	$4,671	103.0%	$152.17	67.7%
Average Increase	1,499	15.0	425	6.6	13.83	4.8

Special Fund Revenue Growth

Fiscal year	Current Dollars (in millions) Dollar Amount	Current Dollars (in millions) Percent Change	Constant Dollars (in millions) Dollar Amount	Constant Dollars (in millions) Percent Change	Constant Dollars Per Capita Dollar Amount	Constant Dollars Per Capita Percent Change
1970–71	$1,385	−2.0%	$1,385	−9.0%	$68.65	−9.9%
1971–72	1,502	8.4	1,419	2.4	69.34	1.0
1972–73	1,694	12.8	1,506	6.2	72.70	4.8
1973–74	1,738	2.6	1,432	−4.9	68.21	−6.2
1974–75	1,776	2.2	1,324	−7.6	62.06	−9.0
1975–76	1,928	8.6	1,332	0.6	61.37	−1.1
1976–77	2,082	8.0	1,354	1.6	61.24	−0.2
1977–78	2,267	8.9	1,380	1.9	61.18	−0.1
1978–79	2,493	10.0	1,400	1.5	60.86	−0.5
1979–80	2,934	17.7	1,522	8.7	64.84	6.5
1980–81	3,152	7.4	1,499	−1.5	62.57	−3.5
1981–82	3,340	6.0	1,463	−2.4	59.90	−4.3
Total Increase	$1,955	141.2%	$78	5.6%	−$8.76	−12.8%
Average Increase	178	8.3	7	0.5	−.81	−1.2

[a] Source: Governor's Budgets. Constant dollar amounts reflect current dollar amounts converted to 1970-71 dollars, using the Gross Natonal Product (GNP) implicit price deflator for state and local purchases of goods and services. Projections of the deflator for 1981 and 1982 are by Chase Econometrics, Inc., as of January 1981. Average annual percent changes are adjusted to reflect compounding, and all percentages are computed prior to rounding. Data is not adjusted for certain special fund accounts in the General Fund recorded under General Fund revenues prior to 1976-77.

Overview of the History and Outlook for Revenue

Table 12 summarizes the performance of state revenues in recent years, and presents the Governor's Budget estimates of total, General Fund, and special fund revenues for the current and budget years. The table shows that:

- *Prior year* (1979-80) total revenues were $20.9 billion, including about $18 billion in General Fund revenues (a growth of $2.8 billion, or 18.2 percent);
- *Current year* (1980-81) total revenues are estimated to reach $22.2 billion, including $19.1 billion for the General Fund (a growth of $1.1 billion, or 6 percent);
- *Budget year* (1981-82) total revenues are projected at $24.4 billion, including $21.0 billion in General Fund revenue (a growth of $1.9 billion, or 10.3 percent).

In order to provide perspective on the revenue outlook, Table 12 also shows what the average annual revenue increases have been over the past decade, and what the current and budget year changes would be if the forecasts are adjusted to account for inflation and population growth. Considering these factors, projected revenue growth is quite modest. For example:

- The estimated growth in current and budget year General Fund revenues (6.0 and 10.3 percent, respectively) are the *lowest* since 1970-71, and lie well below the 16.5 percent average for the preceding 10 years (1970-71 through 1979-80).
- After adjustment for *inflation,* General Fund revenues in constant dollars are projected to *decline* by 2.9 percent in 1980-81, and then rebound by only 1.6 percent in 1981-82. This compares to an average annual increase in "real" revenues over the preceding decade (1970-71 through 1979-80) of over 8.3 percent.
- After adjustment for *both* population growth and inflation, General Fund revenues are expected to *fall* in *both* the current and budget years, following nine years of increases (from 1971-72 through 1979-80) which averaged over 6.5 percent. In 1980-81, the drop in these constant dollar per capita revenues is particularly striking—4.8 percent.

Table 13
The Impact of Indexing on General Fund Revenues
(in millions)

		Growth Over Prior year			
		Under Existing Law		*Excluding Indexing and 1978 Special Credits*[a]	
	Dollar	*Dollar*	*Percent*	*Dollar*	*Percent*
1978-79	$15,219	$1,524	11.1%	$2,529	18.5%
1979-80[b]	17,985	2,766	18.2	2,484	15.3
1980-81[b]	19,055	1,071	6.0	2,307	12.3
1981-82[b]	21,020	1,964	10.3	2,706	12.9

[a] AB 3802 (Chapter 569, Statutes of 1978) provided that income tax brackets be indexed by the amount of inflation *above* 3 percent beginning in 1978, and also that the standard deduction, personal credits, and dependent credit be *fully* indexed beginning in 1979. In addition, AB 3802 provided for a special one-time increase in personal income tax credits for the 1978 income year, amounting to nearly $740 million. AB 276 (Chapter 1198, Statutes of 1979) provided that income tax brackets be *fully* indexed by the inflation rate, but only for the 1980 and 1981 income years. Revenue growth *without* the special one-time credit increases but *with* indexing would have been about 16.5 percent ($2,262 million) in 1978-79 and 12.7 percent ($2,028 million) in 1979-80.

[b] Transfers to special funds under AB 66 (Chapter 1150, Statutes of 1979) are treated here as direct *special* fund revenues, as they are in the 1981-82 Governor's Budget.

These trends in the revenue outlook are primarily explained by two factors: (a) the impact of California's personal income tax indexing laws, which were implemented in 1978 and 1979, and (b) the performance of the California economy.

a. The Impact of Personal Income Tax Indexing on Revenue Growth

Table 13 shows how the trend of revenue growth has been changed by personal income tax indexing.

- Without indexing, projected General Fund revenue growth in the *current year* (1980-81) would be 12.3 percent instead of only 6.0 percent. This would represent an *increase* of over $1.2 billion in the amount by which state revenue collections will grow during 1980-81. On a *cumulative* basis, the projected level of current year revenues is nearly $2 billion less than it would have been without indexing.
- *Without indexing, budget year* (1981-82) revenue growth would be 12.9 percent instead of 10.3 percent, causing the revenue increase to be over $740 million greater than currently projected. The level of General Fund revenues will be $2.7 billion lower in 1981-82 because of the cumulative effects of indexing.

Thus, after accounting for indexing, the projected rates of General Fund revenue growth are somewhat more in line with historical experience. Indexing has clearly caused a *permanent* reduction in the state's revenue growth trend.

b. The Economic Outlook

As always, economic conditions in California are the major determinants of the state's revenue position. We believe that the Department of Finance's revenue projections are generally consistent with its economic forcast, although we do not believe that any economist's projections for as far in advance as 1982 can be very accurate in today's highly unsettled economic climate.

The Department of Finance is projecting a year of slow-to-moderate economic performance for California in 1981, somewhat stronger than that expected nationally but still constrained by high interest rates, weak growth in real income, and continuing inflation. There is even some chance that an economic downturn could re-appear nationally in the first half of 1981, although California appears likely to escape any serious contraction because of its cyclically insensitive industry mix, and the current strength in electronics, aerospace, and agricultural-export industries.

Major uncertainties in the department's outlook include the prospects for federal tax cuts, the future course of monetary policies and interest rates, and the pricing and availability of gasoline, crude oil and other energy supplies. In addition, the federal government has recently completed a major revision of the nation's economic data, and these data revisions will change many of the historical relationships used in economic forecasting. For these reasons, the California economic outlook will necessarily be subject to revision in the near future.

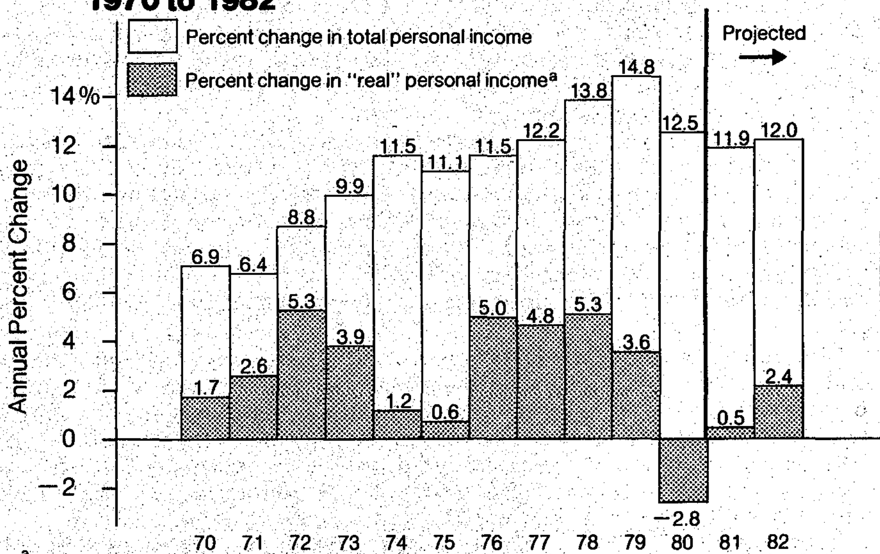
The implications of the current economic outlook for state revenues are best seen in the forcasts for those key California variables which most strongly affect the state's major revenue sources:

- *California personal income growth* (Chart 7) is projected to *decline* slightly from 12.5 percent in 1980 and the record 14.8 percent in 1979 to 11.9 percent in 1981. "Real" personal income growth (that is, growth adjusted for inflation) is expected to rise only 0.5 percent in 1981, an improvement over the 2.8 percent drop in 1980 but still the poorest performance of any other year in the postwar period.
- *Taxable corporate profits* (Chart 8) are forecast to rise 11.6 percent in 1981, following gains of only 5.1 percent in 1980 and 8.9 percent in 1979. However, this 1981 gain, while an improvement over 1979 and 1980, remains well below the 20-percent-plus increases experienced in 1976-78 after the previous recession had ended.
- *Taxable sales* (Chart 9) are predicted to rise 12.4 percent in 1981. While this exceeds the 8.8 percent gain of 1980, it is well below the increases of 14 percent to 19 percent experienced from 1976 to 1979. After adjustment for inflation, 1981 taxable sales are projected to rise only 1.5 percent.

These projections are all consistent with the concensus view of economists that economic gains in 1981 will be unusually weak for a post-recession recovery year. It is primarily because of this sluggish economic recovery that only modest gains are anticipated for state revenues in 1980-81 and 1981-82.

Chart 7

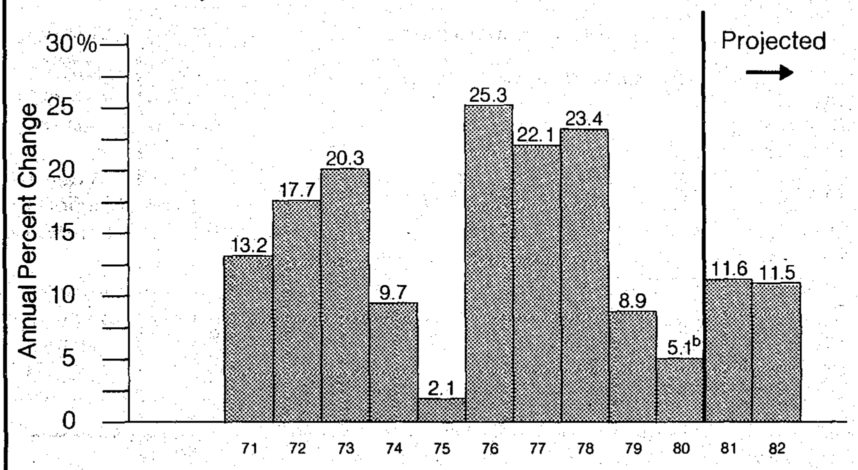
Annual Growth in California Personal Income 1970 to 1982



[a] Real personal income is defined as total personal income deflated by the California Consumer Price Index for all urban households. Estimates for 1980, 1981 and 1982 prepared by the Department of Finance. Had real personal income been computed for these latter three years using the GNP consumption expenditures deflator in place of the CPI, real income growth would be 2.0 percent (1980), 3.4 percent (1981), and 4.4 percent (1982).

Chart 8

Annual Percent Growth in California Taxable Corporate Profits, 1971 to 1982[a]



[a] California Department of Finance. Profit totals include a $335 million reduction in 1975 due to changes in depletion allowances, and a $967 million increase in 1978 due to Proposition 13..

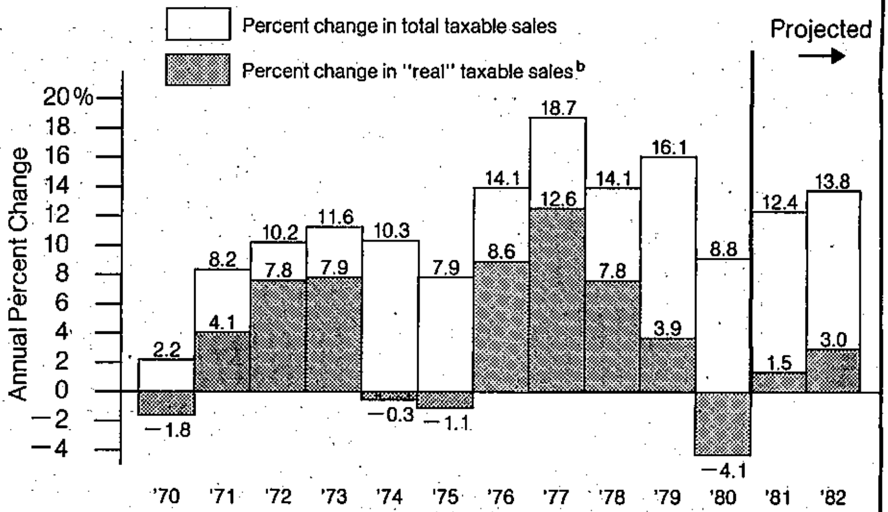
[b] Preliminary estimate by Department of Finance and Franchise Tax Board.

Alternative Revenue Forecasts

In view of both past revenue estimating errors, and the considerable uncertainty about exactly how the economy will perform in 1981 and 1982, it is important to make some estimate of the margin by which actual revenues in the current and budget years could differ from the forecast. This is especially important this year because of the unusually tight constrants on state and local spending.

Chart 9

Annual Growth in California Taxable Sales 1970 to 1982[a]



[a] Source: Department of Finance

[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the national CPI for all items less food.

We have constructed two alterative revenue scenarios, based on the range of economic forecasts available from a variety of private sector economists (these private sector forecasts are compared later in Tables 26 and 27). As detailed later, these scenarios suggest that actual *budget year* revenues could easily range from *$600 million below* to *$750 million above* the level which is currently predicted, *assuming that* the Department of Finance's projection for 1980–81 revenues is correct. However, when the possibility of errors in the revenue forecast for the current year is also considered, the error range for 1981–82 implied in these scenarios is closer to *$750 million (−3.6 percent)* on the low side, to *$900 million (+4.3 percent)* on the high side. As summarized in Table 14 below, this percentage error range is about the same on the low end as that presented in the budget. On the high end it is greater than Finance's range, although it is still well within the experience of most recent years (Table 11).

Table 14
Possible Changes in 1981–82 Budget Revenue Projections

	Difference from the Budget Estimate	
	High Revenue Scenario	*Low Revenue Scenario*
A. *Legislative Analyst*[a]		
—Amount (in millions)	+$905	−$762
—Percent difference	+4.3%	−3.6%
B. *Department of Finance*[b]		
—Amount (in millions)	+$769	−$771
—Percent difference	+3.7%	−3.7%

[a] Revenue estimates based on high and low economic forecasts of private sector economists. See Tables 26 and 27 below.

[b] Revenue estimates based on alternative economic forecasts in the 1981–82 Governor's Budget.

We now turn to a more detailed discussion of state revenues in the prior year (1979–80), current year (1980–81), and budget year (1981–82).

2. Prior Year Revenues

Table 15 summarizes 1979–80 General Fund revenue collections. These receipts totaled $18.0 billion, a dramatic increase of 18.2 percent ($2.8 billion) over 1978–79. However, revenue growth was a more moderate 12.7 percent ($2.0 billion) if adjustment is made for the distorting effects of the one-time special 1978 income tax credit increases under AB 3802 (see Table 13, footnote a). The actual 18.2 percent growth rate exceeded the predicted increase of 16.8 percent ($2.6 billion) made in January 1980.

As shown in Table 15, nearly 95 percent of this revenue increase came from three sources:

- *Personal income tax* collections increased by $1.7 billion (36.6 percent), or 65 percent of the entire gain. However, nearly $740 million of this increase was caused by the expiration of the one-time special 1978 increases in tax credits. Without this distortion, income tax revenues would have risen in 1979–80 by about $1 billion (18.3 percent), or about one-half of the overall revenue gain ($2 billion).
- *Sales and use tax* revenues rose by $743 million (12.9 percent), or about 37 percent of the overall revenue increase.
- *Interest income* rose by over 22 percent ($100 million), to $547 million.

In contrast, bank and corporation taxes rose only 3.6 percent ($85 million), and increases for the remaining major taxes and licenses were a modest 7.9 percent ($100 million combined.).

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Table 15
Growth of Prior Year General Fund Revenues by Type (in millions)[a]

	Actual 1978–79	Actual 1979–80	Change Amount	Change Percent
Three major taxes:				
Sales and use	$5,779	$6,522	$743	12.9%
Personal income[b]	4,762	6,506	1,744	36.6
Bank and corporation[c]	2,381	2,466	85	3.6
Other major taxes and licenses	1,266	1,366	100	7.9
Interest income	447	547	100	22.4
Other revenues and transfers[d]	584	578	−6	−1.2
Total General Fund[e]	$15,219	$17,985	$2,766	18.2%

[a] Detail may not add to total due to rounding.
[b] Includes revenue reduction in 1978–79 of approximately $1,005 million, $738 million of which is from a one-time increase in personal tax credits for the 1978 income year. The remaining $267 million is the revenue loss due to partial income tax indexing. Without the one-time credit, personal income tax revenue growth would have been 18.3 percent in 1979–80 (an increase of $1,006 million over 1978–79).
[c] Excludes $44 million in 1979–80 which is transferred to special funds under AB 66 (Chapter 1150, Statutes of 1979).
[d] Includes transfers from Federal Revenue Sharing Fund of $276.2 million in each year.
[e] Total revenue growth in the absence of the one-time 1978 personal income tax credit would have been 12.7 percent in 1979–80 (a gain over 1978–79 of $2,028 million).

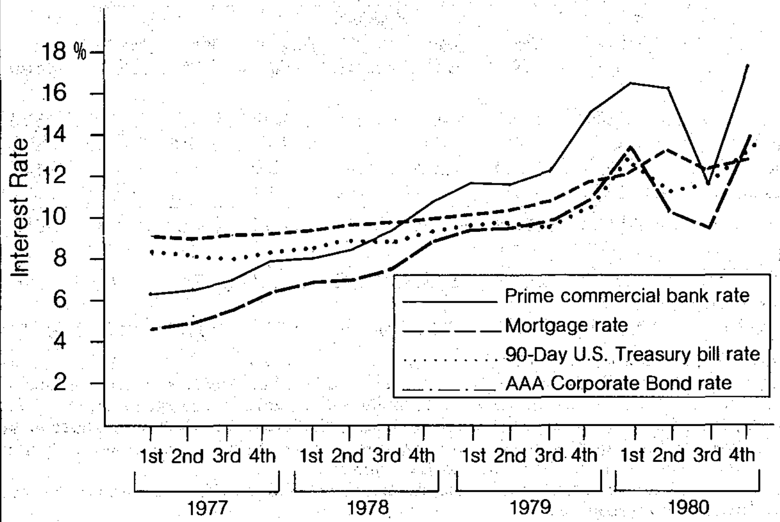
Revenue Gains Reflected Economic Developments

The difference in the rates at which revenues from these sources grew in 1979–80 is explained by the performance of the California economy in 1979 and early 1980:

- *Personal income*—the major determinant of personal income tax revenues—rose 14.8 percent in 1979 (Chart 7). This was an all-time record.
- *Taxable sales* gains, although very strong in 1979 (16.1 percent), weakened in early 1980 and ended 1980 up by only 8.8 percent (Chart 9).
- *Interest rates* climbed dramatically from the latter part of 1979 through the spring of 1980 (Chart 10). For example, the 90-day U.S. Treasury Bill rate rose from an average of 9.4 percent in the second quarter of 1979 to 13.5 percent in the first quarter of 1980. This rise in interest rates raised the return on the state's financial investments.
- *Corporate profits* rose only 8.9 percent in 1979 and remained weak throughout 1980 (Chart 8).

Chart 10

Quarterly Changes in Selected Interest Rates 1977 to 1980[a]



[a] National average interest rates as computed by Chase Econometrics, Inc.

Upward Revenue Revisions Continued to be a Problem

Table 16 shows how the Department of Finance revised its 1979–80 revenue forecast over the past two years:

- Actual revenues *exceeded* the *original* estimate presented in the 1979–80 Governor's Budget (January 1979) by $635 million, or 3.7 percent. This amount, which *excludes* the effects of 1979 legislation, included upward revisions of $193 million for the sales tax, $300 million for the income tax, and $222 million for interest income.
- Actual revenues *exceeded* the estimate made in June 1979 (the *latest estimate available* to the Legislature before it made budget decisions for 1979–80) by $562 million (Table 16), or 3.2 percent. Although significant, this underestimate was smaller in percentage terms than any May–June under-estimate in six years.
- Actual revenues *exceeded* the estimate presented in the 1980–81 Governor's Budget (January 1980) by $204 million (1.1 percent). In this case, however, there were offsetting errors. On the one hand, the sales and use tax, personal income tax, and interest income were revised *upward* by $62 million, $231 million, and $46 million, respectively. By contrast, corporate tax revenue was revised *downward* by $100 million, reflecting the slowing of profit growth as 1980 progressed.

In retrospect, it seems clear that these estimating errors primarily occurred because of inaccurate economic forecasting. For instance, few economists foresaw the dramatic explosion of interest rates in early 1980, the rate of 1979 personal income growth, or the extent of the slowdown which corporate profit growth would experience. In January 1980, for example, the Department of Finance thought that 1979 California profit growth would be 13.7 percent. It now estimates that the gain was only 8.9 percent, or $1 billion less than predicted before.

Clearly, unless economic forecasting improves, it is likely that significant revenue estimating errors will continue to occur.

Table 16

1979–80 General Fund Revenues
History of Department of Finance Estimates
(in millions) [a]

	Original Estimate January 1979	*Revisions: May 1979*	*June 1979*	*Adjustment for 1979 Legislation [b]*	*January 1980*	*May 1980*	*January 1981*	*Actual*
Taxes:								
Sales and use	$6,375.0	$+5.0	$−64.0 [c]	$−45.9	$+189.9	$+10.0	$+51.5	$6,521.5
Personal income [d]	6,213.0	−13.0	−150.0	−6.9	+231.9	+185.0	+46.0	6,506.0
Bank and corporation [e]	2,460.0	+180.0	+110.0	+44.1	−227.7	−99.0	−1.0	2,466.6
Other taxes	1,394.2	−22.8	-	−4.4	+9.4	−19.9	+9.5	1,366.0
Total Taxes	$16,442.2	$+149.2	$−104.0	$−13.1	$+203.5	$+76.1	$+106.0	$16,860.0
Interest income	325.0	+25.0	-	-	+150.2	+45.0	+1.4	546.6
Other revenues and transfers [f]	601.1	+2.8	-	−5.9	+5.0	+4.3	−29.2	578.1
Total General Fund Revenues and Transfers	$17,368.3	$+177.0	$−104.0	$−19.0	$+358.7	$+125.4	$+78.2	$17,984.6

[a] Detail may not add to total due to rounding.
[b] Major legislation included AB 66 (Chapter 1150) which, after special fund transfers, increased General Fund bank and corporation tax revenues by $54.1 million and sales and use tax revenues by $1.9 million. In addition, SB 620 (Chapter 161) reduced General Fund sales and use tax revenues by $46 million by increasing the estimated 1979–80 General Fund transfer to the Transportation Planning and Development Account from $64 million to $110 million.
[c] Transfer to the Transportation Planning and Development Account. This transfer was estimated to occur in 1980–81 in the May revision.
[d] All personal income tax figures have been adjusted to *exclude* the effect of legislation which was *proposed* in the 1979–80 Governor's Budget but which was not enacted by the Legislature. In January 1979, this amount totaled $1,373 million, including $1,125 million for an income tax cut and $248 million for a change in the tax treatment of the renters' credit.
[e] Beginning with January 1980, revenues shown are reduced by $43.6 million to reflect transfers to special funds under AB 66. Department of Finance intends to *propose* legislation to make these transfers appear as direct special fund income, and has treated them as such.
[f] Includes $276.2 million transfer from the Federal Revenue Sharing Fund.

3. Current Year Revenues

Table 19 presents the budget estimates of current year (1980–81) General Fund revenues. Before discussing these estimates, however, it is useful to briefly review the prime determinants of current year revenues—the pace of economic activity in California during 1980 and early 1981.

Overall 1980 Economic Performance was Disappointing

1980 was a year of negative real economic growth, rapid inflation, high and volatile interest rates, falling business profits, slow employment growth, and rising unemployment. Table 17 summarizes this economic performance for California and the nation:

- *U.S. GNP* declined in real terms by 0.7 percent, and its growth in current dollars sharply decelerated from 12.0 percent in 1979 to only 8.6 percent (Chart 11). This fall in real GNP was concentrated in the second quarter of 1980, when it contracted at an annual rate of 9.9 percent, a postwar record for a single quarter. Thus, although the 1980 downturn has been referred to as the shortest postwar recession on record, it was also one of the steepest.
- *Inflation* reached record rates. As illustrated in Chart 12, the Consumer Price Index (CPI) rose 15.7 percent in California and 13.6 percent nationally, both postwar highs. The GNP deflator for consumption expenditures increased 10.3 percent, second only to the 10.9 percent gain registered in 1974.

Table 17
Summary of 1980 Economic Performance for The U.S. and California[a]

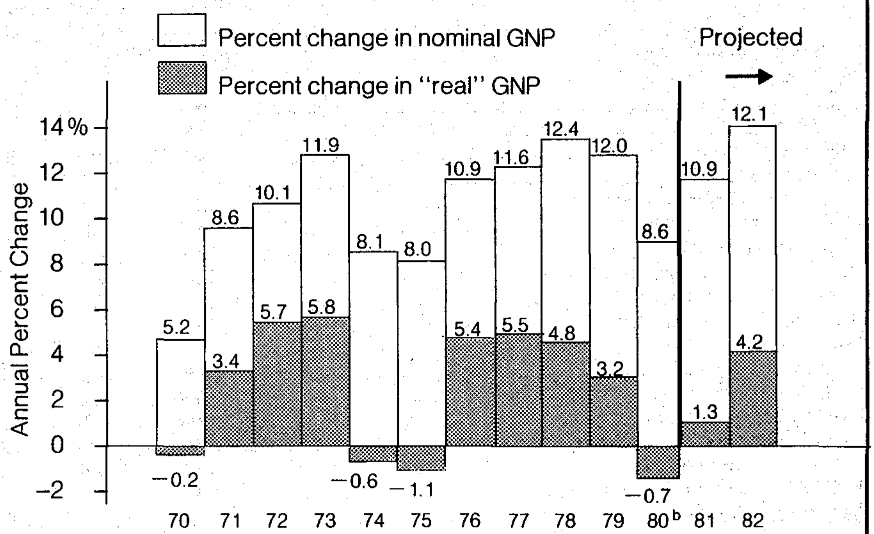
A. *Selected National Indicators*	*Original January 1980 Forecast*[b]	*Revised May 1980 Forecast*	*January 1981 Estimated Actual*[c]
Percent change in:			
—Real GNP	−1.8%	−1.1%	−0.7%
—GNP prices	10.3%	10.1%	9.3%
—Consumer prices	11.6%	14.0%	13.6%
—Personal income	10.4%	11.1%	10.3%
—Wage and salary employment	0.5%	0.6%	0.8%
—Pre-tax corporate profits	−8.3%	1.4%	−2.7%
Unemployment rate (%)	7.6%	7.4%	7.2%
Housing starts (millions of units)	1.32	1.01	1.28
New car sales (millions of units)	9.7	9.0	9.0
B. *Selected California Indicators*			
Percent change in:			
—Personal income	10.9%	12.4%	12.5%
—Civilian employment	1.9%	1.1%	1.4%
—Wage and salary employment	1.4%	2.1%	1.7%
—Consumer prices	11.7%	16.4%	15.7%
Unemployment rate (%)	7.6%	7.3%	6.8%
Residential building permits (thousands)	165	130	140
New car sales (thousands)	1,070	970	950

[a] Forecasts and estimates by the California Department of Finance.
[b] 1980–81 Governor's Budget.
[c] 1981–82 Governor's Budget.

- *California employment growth* was weak. Civilian employment increased by only 1.7 percent, the lowest rate since 1975. As shown in Chart 13, the rate of wage and salary employment growth in the state has steadily fallen since June 1978, when the year-over-year gain was 7.7 percent. In the third quarter of 1980, this gain was only 0.2 percent.
- *Personal income growth* slowed to 12.5 percent in current dollar terms, and declined by 2.8 percent in real terms (Chart 7).
- *Interest rates* followed an unpredictable, roller coaster pattern. As shown in Chart 10, they jumped in the first half of the year, dropped sharply in the middle, then exploded at the end. The prime rate continued rising to 22 percent in January 1981.
- These interest rate movements were accompanied and exacerbated by considerable volatility in the monthly rate of annualized *money supply expansion,* which ranged from a high of 24 percent in July to an actual contraction in April of 13 percent.
- *U.S. housing starts* plunged from over 1.7 million units in 1979 to under 1.3 million units in 1980, while *California building permits* dropped by 33 percent, from 208,000 to only 140,000. *Car sales,* which like housing starts were the victim of high interest rates and declining real incomes, dropped by 16 percent both nationally and in California.
- *The unemployment rate* drifted upward in California, from 6.2 percent in 1979 to 6.8 percent. As shown in Chart 14 however, the nation's unemployment rate rose much more, from 5.8 percent to 7.2 percent. Thus, 1980 was the first year in many years that the state's rate did *not* exceed the nation's. In fact, despite its rise, California's unemployment rate in 1980 was still the second lowest since 1969. However, this was not due to strong employment gains, but rather because of the *earlier* record job gains posted from 1976–1979, combined with the recession-induced slowing of underlying labor force growth and California in-migration in 1980.

Chart 11

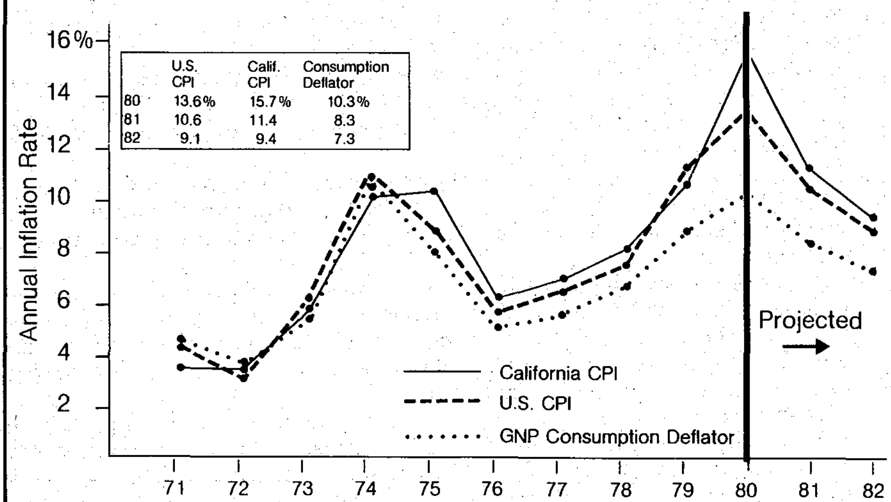
Annual Growth in Gross National Product 1970 to 1982[a]



[a] Estimates of 1980, 1981 and 1982 prepared by the Department of Finance.
[b] Since publication of the Governor's Budget, the U.S. Department of Commerce has released preliminary data suggesting that 1980 nominal GNP rose 8.9 percent and real GNP fell 0.2 percent.

Chart 12

Inflation Faced by Consumers in California and the Nation[a] 1971 to 1982

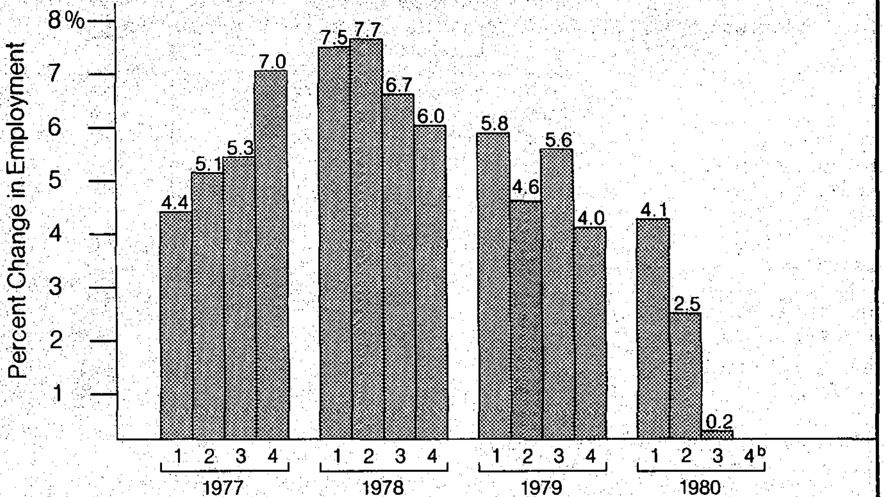


	U.S. CPI	Calif. CPI	Consumption Deflator
80	13.6%	15.7%	10.3%
81	10.6	11.4	8.3
82	9.1	9.4	7.3

[a] Annual average increases in the CPI for all urban households. Estimates for 1980, 1981 and 1982 provided by the California Department of Finance. Data on the Consumption Deflator is subject to revision for these years.

Chart 13

California Wage and Salary Employment Growth Over the Preceding Twelve Months, by Quarter[a] 1977 to 1980

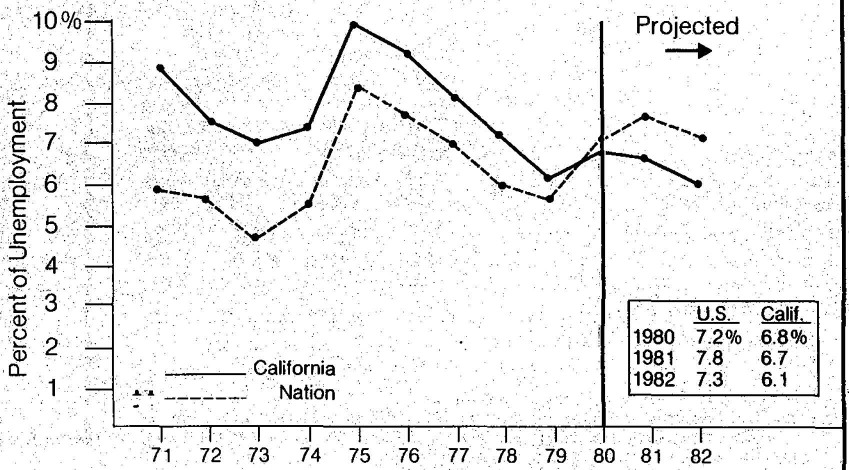


[a] Source: Interim employment data series reports from the California Employment Development Department. Quarterly data are averages of seasonally unadjusted monthly data, and percent changes are measured from the same quarter of the prior year.

[b] Not available

Chart 14

Unemployment Rates for California and the Nation 1971 to 1982[a]



	U.S.	Calif.
1980	7.2%	6.8%
1981	7.8	6.7
1982	7.3	6.1

a. Estimates for 1981 and 1982 by Department of Finance

Table 18 summarizes how well the Department of Finance and various other forecasters did in predicting the 1980 economy. Overall, Finance had a mixed track record. All forecasters, however, underprojected California personal income growth and CPI inflation, while overpredicting statewide home building activity.

Table 18
Accuracy of 1980 Economic Forecasts for California and the Nation[a]

	Nation			*California*			
Forecaster	*Real Economic Growth*	*General Price Inflation*	*Unemployment Rate*	*Personal Income Growth*	*Consumer Price Inflation*	*Unemployment Rate*	*Building Permits (thousands)*
Department of Finance	−1.8%	10.3%	7.6%	10.9%	11.7%	7.6%	165
United California Bank	0.5	8.6	7.1	12.3	9.5	6.7	190
Security Pacific Bank	−2.0	9.1	7.8	11.8	12.9	7.6	195
Wells Fargo Bank	−1.8	9.0	7.6	11.5	11.0	7.9	165
Bank of America	−2.1	9.0	7.4	11.5	10.9	7.7	200
UCLA	−1.7	8.4	7.4	9.1	11.6	7.3	186
Chase Econometrics	−1.8	8.2	7.7	—	—	—	—
Data Resources	−1.5	8.8	7.3	—	—	—	—
Average of All Forecasters	−1.5%	8.9%	7.5%	11.2%	11.1%	7.5%	184
Actual[b]	−0.7%	9.3%	7.2%	12.5%	15.7%	6.8%	140

[a] Forecasts as of approximately January 1980. Real economic growth is growth in total Gross National Product adjusted for general price inflation.
[b] As estimated in the 1981–82 Governor's Budget.

Revenues Revised Downward, Reflecting Troubled Economy

Table 19 shows that General Fund revenues are estimated to be $19.1 billion in 1980–81, a gain of only 6 percent ($1.1 billion) over 1979–80, and the smallest percentage increase since 1970–71 (Table 12).

Table 19
Comparison of General Fund Revenue Growth Estimates for 1980–81 Over 1979–80 (in millions)[a]

			Estimate of 1980–81 Revenue Growth			
			Last Year's Estimate (January 1980)[c]		*Current Estimate (January 1981)*	
	Actual for 1979–80	*Current Estimate for 1980–81*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
Sales and use tax	$6,522	$7,011	+780	+12.1%	+$490	+7.5%
Personal income tax	6,506	6,650	+525	+8.4	+144	+2.2
Bank and corporation tax[b]	2,466	2,676	+157	+6.1	+210	+8.5
Other taxes	1,366	1,545	+141	+10.2	+179	+13.1
Total Taxes	$16,860	$17,882	+$1,602	+9.6%	+1,022	+6.1%
Interest income	547	452	−100	−20.0	−95	−17.4
Other revenues and transfers	578	721	+1	+0.1	+144[c]	+24.9[d]
Total Revenues and Transfers to the General Fund	$17,985	$19,055	+$1,503	+8.5%	+$1,071	+6.0%

[a] Detail may not add to total due to rounding.
[b] Special fund transfers under AB 66 are treated as direct special fund revenues.
[c] These revenue increases are based upon the figures for 1979–80 and 1980–81 revenues published in the 1980–81 Governor's Budget (January 1980).
[d] Primarily reflects increased General Fund receipts from the Health Care Care Deposit Fund.

Table 20
1980–81 General Fund Revenues and Transfers
History of Department of Finance Estimates
(in millions) [a]

	Original Estimate in January 1980	Revisions: May 1980	Revisions: Adjustment for 1980 Legislation [b]	Revisions: January 1981	Current Estimate
Taxes:					
Sales and use tax	$7,240.0	—	−$3.5	−$225.3	$7,011.2
Personal income tax	6,800.0	−$130.0	−35.2	+15.2	6,650.0
Bank and corporation tax [c]	2,723.0	+83.0	−17.2	−112.8	2,676.0
Other taxes	1,517.1	−5.6	−14.7	+48.1	1,544.9
Total Taxes	$18,280.1	−$52.6	−$70.6	−$274.8	$17,882.1
Interest income	400.0	+25.0	−2.0	+28.6	451.6
Other revenues and transfers [d]	603.9 [e]	+37.4	+17.8	+62.7	721.8
Total General Fund Revenues and Transfers	$19,284.0	+$9.8	−$54.8	−$183.6	$19,055.4

[a] Detail may not add to total due to rounding.
[b] Department of Finance estimates, December 1980. Major fiscal legislation includes Chapter 29 (AB 325), which provides for changes in the timing of income tax withholding remittances from certain employers. This measure will reduce revenues by about $30 million in 1980–81. In addition, Chapter 1043 (AB 3383), which makes various changes in the horse racing statutes, will reduce 1980–81 revenues by about $15 million.
[c] Revenues shown in this table have been reduced by $77 million for January 1980, and by $48 million for January 1981, to account for transfers to special funds under AB 66 (Chapter 1150, Statutes of 1979). Finance is *proposing* legislation to treat these transfers as *direct* special fund income, and has treated them as such in the budget.
[d] Includes $276.2 million transfer from the Federal Revenue Sharing Fund.
[e] Excludes a transfer of $77.8 million in tidelands oil income to the General Fund, which was *proposed* in the 1980–81 Governor's Budget.

Table 20 presents the history of revisions in estimated revenues for the current year. It shows that the projected revenue level has fallen by $229 million since January 1980. *This represents the first time in six years that current year revenues have been revised downward.* Of this revision, $55 million is due to new legislation and $174 million reflects economic conditions and other factors.

However, the negative 1980–81 revenue adjustment strictly attributable to economic problems affecting the *current* year is actually much *larger* than $174 million. This is because:

- The *prior year revenue base* was revised *upward* in both May 1980 (by $125 million) and January 1981 (by $78 million). Thus, if this information had been available one year ago, last year's budget would have projected 1980–81 revenues at a level that was $203 million higher than the budget level.
- Estimated 1980–81 General Fund transfer income from the *Health Care Deposit Fund*—which is not particularly sensitive to economic conditions—was also revised *upward* in both May 1980 (by $41 million) and January 1981 (by $62 million).

After making all of these adjustments, weakened economic conditions appear to have caused downward 1980–81 General Fund revenue revisions of about $480 million (−2.5 percent) since January 1980, and about $324 million since May.

Dampening of Revenue Outlook is Broad Based

The downward revenue revisions for 1980–81 caused by economic events apply to each of the state's three major taxes:

- The ***sales and use tax***—the largest single tax—was revised downward from the May estimate by $225 million (Table 20). However, when revisions to the prior year's tax base are taken into account (+$52 million, Table 16), the reduction is closer to $277 million. When compared to the January 1980 estimate one year ago, this adjusted downward revision is even larger—over $290 million. This dampening has occurred because taxable sales have not lived up to expectations, due to weak real income growth, high interest rate, rising prices, and slowing employment gains. In addition, taxable sales were hurt earlier in 1980 when the federal authorities experimented with a credit controls program. One year ago, taxable sales for 1980 had been predicted to rise 11.7 percent in current dollars and zero in real terms. In actuality, they rose only 8.8 percent in current dollars and *declined* 4.1 percent in real terms (Chart 9).
- The ***personal income tax***—the second largest single tax—was revised downward from last January by $150 million, from $6.8 billion to $6.65 billion. After adjusting for changes to the prior year's collections, however, the reduction is $381 million (Table 19). As a result, personal income tax revenues are now expected to rise by only 2.2 percent from their 1979–80 level. The major cause of this downward revision and unusually low growth rate is *indexing*. For instance:
  —The budget estimate of the cost of indexing in 1980–81 is $270 million *greater* than the prediction which was made in January 1980. This is primarily because the inflation rate actually used for 1980 indexing adjustment purposes (17.3 percent) far exceeded the projected rate (10.1 percent). A higher portion of the income base thus was exempted from taxation than originally predicted.
  —Our own simulations suggest that the cost of indexing will reach nearly $2 billion in the current year (Chart 16, later). This is an increase of over $1.2 billion above the 1979–80 cost of the program. *Without* indexing, 1980–81 revenues would have increased by about 18.9 percent, compared to the expected 2.2 percent gain.

Table 21
California Taxable Corporate Profits [a]
(in millions)

		1979						
		Last Year's Estimate		*Current Estimate*		*Estimated 1980*		
Industry	*1978 Actual* [c]	*Amount*	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Share of Total*	*Percent Change*
Manufacturing	$7,937	$9,045	13.1%	$8,598	8.3%	$8,361	31.4%	–2.4%
Trade	4,891	5,545	13.0	5,509	12.6	5,499	20.7	–0.2
Mining and oil operations	1,344	2,143	57.8	2,413	79.5	3,400	12.8	40.9
Services	1,988	2,279	16.0	2,206	11.0	2,413	9.1	9.4
Real estate and other financials	1,669	1,766	13.2	1,895	13.5	1,819	6.8	–4.0
Banks [b]	2,452	3,011	21.6	2,133	–13.0	1,713	6.4	–19.7
Utilities	1,700	1,219	–25.8	1,050	–38.2	1,703	6.4	62.2
Construction	981	953	5.4	1,160	18.2	1,366	5.1	17.8
Agriculture	279	379	7.7	336	20.4	326	1.2	–3.0
Totals	$23,241	$26,340	13.7%	$25,300	8.90%	$26,600	100.0%	5.1%

[a] Income of corporations with accounting periods ending from August of the year shown through July of the following year. Data from Department of Finance. Detail may not add to total due to rounding.
[b] Includes all financial institutions subjected to the bank tax.
[c] One year ago the preliminary estimate of 1978 profits was $23,163 million.

- The ***bank and corporation tax***—the third largest single tax—has been revised downward by $30 million since last January, and $113 million since May, excluding the effects of 1980 legislation. When prior year revenue revisions are adjusted for, the downward revision from May remains about the same—$112 million. This reflects a significantly poorer corporate profit performance than initially anticipated. The May corporate profit estimate for 1980 was $27.5 billion, compared to only $26.6 billion in the budget.

As shown in Table 21, the main source of profit growth in 1980 was in the oil-related and utilities industry sectors, which accounted for a combined profit gain of over $1.6 billion (47.4 percent). In contrast, total profits increased by only $1.3 billion (or 5.1 percent). The level of profits actually *declined* in such sectors as manufacturing (by $237 million), trade (by $10 million), real estate (by $76 million), and agriculture. The banking industry, however, suffered worst of all—a loss of $420 million—due to reduced savings and loan home mortgage lending.

1980–81 Revenue Picture Still Uncertain

We have taken the Department of Finance's economic assumptions and inserted them into our own revenue estimating equations to determine whether they are consistent with the economic data. We believe that they are, as our computations produce a level of 1980–81 revenues which is only $25 million below the Finance estimate.

However, because the current fiscal year is only a little more than one-half completed, the potential for errors in the current year revenue estimate remains significant. This is particularly the case this year for two reasons:

- ***First,*** economic events in the first half of calendar year 1981 will determine about one-third of 1980–81 revenues, and the economic outlook for this period remains cloudy; and
- ***Second,*** the Finance forecast was prepared in November and December 1980 using economic data which has since been substantially revised by the U.S. Department of Commerce. These data revisions, which cover series in the National Income and Product Accounts on which economic forecasting relationships are based, reach back to 1968 in all cases and as far back as 1929 for some. All economic forecasting models—including Finance's—must now be re-estimated in order to incorporate the changes in these data series and their implications for forecasting relationships.

Recognizing these problems and uncertainties, the Governor's Budget suggests that 1980–81 revenues could be $573 million higher (+3.0 percent) to $597 million lower (−3.1 percent) than the budget forecasts. Our review of the alternative economic forecasts published in the budget on which this range is based, shows that the reported range far exceeds that suggested by the department's economic variables. However, as shown in Table 22, an error of 3 percent, at least on the upside, is not unreasonable based on historical experience. In three of the past seven years, current year revenues, as estimated in January, have been revised upward by *more* than 3 percent, whereas in four years (including the past three years), the upward revision has been *below* 3 percent. In *no* case did a downward revision occur, although that possibility should never be ruled out, especially in a period of fiscal stringency. This is particularly true this year because of indexing, which is changing the patterns of income tax withholding payments and tax refunds in ways which we have yet to fully understand.

Table 22
Midyear General Fund Revenue Estimating Errors [a]

	Dollar Error (in millions)	*Percent Error*
1973–74	$243	3.6%
1974–75	166	2.0
1975–76	451	4.9
1976–77	394	3.6
1977–78	331	2.5
1978–79	220	1.5
1979–80	204	1.1

[a] Difference between actual receipts and receipts estimated in January of the fiscal year specified.

Cash Trends Consistent with Downward Revenue Revision

Table 20 above shows that 1980–81 revenues for the *three major taxes* are expected to be $379 million below the May estimate. Through the month of December, about $243 million of this drop had *already* occurred. Furthermore, for the month of December alone, these receipts *fell below* the *new* budget estimate by $32 million. Although only time will tell if the remaining $135 million drop-off from the May estimate is realized, current cash collection trends are consistent in the aggregate with the downward revenue revision.

The Problem of Indexing-Induced Overwithholding

As mentioned earlier, interpreting current cash trends is complicated by the behavior of income tax withholding payments under our indexing law. Current law adjusts the withholding tables for indexing with a *one-year time lag*, resulting in *indexing-related overwithholding*. This causes *greater tax refunds* and *smaller final tax payments* in the future. We have *estimated* that this indexing-induced overwithholding could exceed $750 million for the 1980 income year, and the Department of Finance assumes an even larger figure. This amount is *in addition to* about $1.2 billion in overwithholding which would occur anyway. However, because the *actual* amount of the indexing-induced overwithholding is *unknown*, monthly errors in estimating income tax collections can easily occur. In December, for example, withholding payments were $38 million *below* the budget estimate, a development which could be consistent with *either reduced* tax liabilities, or with *over-predictions* by Finance about the degree of indexing-related overwithholding (despite *accurate* projections of tax liabilities). Unfortunately, issues of this type cannot be fully resolved until the end of the fiscal year, when data on tax refunds and final payments become available.

4. Budget Year Revenues

Table 23 presents the department's estimates of budget year (1981–82) General Fund and Special Fund revenues in 1981–82.

It shows that:

- ***Total*** General and Special Fund revenues are projected to reach $24.4 billion, an increase of $2.2 billion (9.7 percent) over 1980–81.
- ***General Fund*** revenues are predicted to total $21.0 billion, a rise of $2.0 billion (10.3 percent) over 1980–81, and
- ***Special Fund*** revenues are expected to reach $3.3 billion, a gain of $189 million (6.0 percent) over 1980–81.

The outlook for these budget year revenues is primarily based on forecasts of California and U.S. economic activity in calendar years 1981 and 1982. Therefore, before examining the components of the revenue outlook, we will discuss these economic forecasts.

Table 23
Projected 1981–82 State Revenue Collections
Under Existing Law
(in millions) [a]

General Fund	*Actual 1979–80*	*Estimated 1980–81*	*Projected 1981–82*	*Change Amount*	*Change Percent*
Taxes:					
Sales and use	$6,521.5	$7,011.2	$8,000.7	$989.5	14.1%
Personal income	6,506.0	6,650.0	7,435.0	785.0	11.8
Bank and corporation [b]	2,466.5	2,676.0	3,035.2	359.2	13.4
Inheritance and gift [c]	465.6	575.5	531.5	−44.0	−7.6
Insurance	446.2	520.0	565.0	45.0	8.7
Cigarette	204.7	198.8	203.6	4.8	2.4
Alcoholic beverage	139.0	145.5	149.5	4.0	2.7
Horse racing	110.5	105.1	114.1	9.0	8.6
Total Taxes	$16,860.0	$17,882.1	$20,034.6	$2,152.5	12.0%
Other Sources:					
Health Care Deposit Fund	$113.1	$227.6	$223.4	−$4.2	−1.8%
Interest on investments	546.6	451.6	326.6	−125.0	−27.7
Federal Revenue Sharing Transfer [d]	276.2	276.2	180.3	−95.9	−34.7
Other revenues and transfers	188.7	217.9	254.8	36.9	16.9
Total General Fund [b]	$17,984.6	$19,055.4	$21,019.7	$1,964.3	10.3%
Special Funds					
Motor vehicle:					
Fuel tax	$852.8	$830.0	$827.0	−$3.0	−0.4%
License fee (in lieu)	672.2	707.2	813.0	105.8	15.0
Registration, weight and miscellaneous fees	424.5	442.2	468.1	25.9	5.9
Oil and gas tax revenues	308.9	455.5	505.8	50.3	11.0
Sales and use [e]	102.0	123.8	139.3	15.5	12.5
Interest on investments	117.4	111.2	102.3	−8.9	−8.0
Cigarette tax	85.4	83.4	85.4	2.0	2.4
Bank and corporation tax [b]	43.6	48.0	41.8	−6.2	−12.9
Other	327.4	350.2	357.6	7.4	2.1
Total Special Funds [b]	$2,934.2	$3,151.5	$3,340.3	$188.8	6.0%
Total State Funds	$20,918.8	$22,206.9	$24,360.0	$2,153.1	9.7%

[a] Detail may not add to total due to rounding.
[b] AB 66 (Chapter 1150, Statutes of 1979) increased bank and corporation taxes and provides for transfers from the General Fund to local agencies and to the State Litter Control, Recycling and Resource Recovery Fund. These transfers totaled $43.6 million in 1979–80, and are estimated at $48 million in 1980–81 and $41.8 million in 1981–82. The Governor's Budget treats these transfers as *direct* special fund revenues from the bank and corporation tax, based upon *proposed* legislation.
[c] AB 2092 (Chapter 634, Statutes of 1980) reduced inheritance and tax revenues by approximately $2.2 million in 1980–81 and $127.1 million in 1981–82.
[d] Under current federal law, the General Fund will receive no additional revenue sharing funds after 1981–82.
[e] Transfers to the Transportation Planning and Development Account in the Transportation Fund, as specified under SB 620 (Statutes of 1979).

Economic Unknowns and Uncertainties are Pervasive, Dominate Outlook

As we have stressed earlier, economic forecasting is the main source of error in revenue forecasting. In turn, unknowns and uncertainties regarding political and economic events are the main obstacles to accurate economic forecasting. These uncertainties seem to have become an increasingly serious problem recently, and this year is no exception. They include:

- The future course of *federal monetary policy,* including the targeted rates of monetary expansion, the ability of the Federal Reserve to achieve these tar-

gets, and the effects of such actions on interest rates, credit availability and inflation.
- The prospects for a significant *federal tax cut* in 1981, including its overall magnitude, its timing, and its distribution between individuals and businesses.
- The *behavior of consumers,* including their decisions to spend more or save more in the face of continued high inflation and weakened real incomes.
- The willingness of businesses to *invest in plants and equipment,* given the conflicting incentives of weakened consumption spending, excess capacity and high borrowing costs on the one hand (which argue *against* investment spending), and poor productivity performance and aging facilities on the other (which argue *in favor* of investment spending).
- The prospects for the health of our *export markets* in *overseas economies,* many of which are also battling high inflation and recession problems.
- The outlook for *energy prices and supplies,* particularly imported oil from the OPEC nations.
- The effect which the recently released comprehensive *revisions in the nation's economic data* will have on our perceptions of recent economic performance and our outlook for the future. For example, it now appears that in 1980 inflation was lower, productivity and investment spending were better, profit margins were worse and consumer savings were higher than previously thought.

Given these factors, any economic forecast, especially one for as far in the future as 1982 (which will not come to an end until 22 months from now), has an excellent chance of having significant errors.

High Inflation and Sluggish Recovery Expected

Table 24 presents highlights of the Department of Finance's, economic outlook for 1981 and 1982, for both the nation and California. It is from these forecasts that the department's budget year revenue projections are derived. According to this forecast,

- The *national economy* will experience a year of *slow recovery* in 1981, with *real GNP* rising by only 1.3 percent. This is expected to be followed by a much stronger performance in 1982, when real growth is expected to be 4.2 percent. Most of 1981's modest expansion will be concentrated in the *second half* of the year.
- ***Corporate profits*** nationally will rise 11.1 percent in 1981 and 10.9 percent in 1982, following a decline of 2.7 percent in 1980. The 1981 profit rebound is *considerably less* than that which occurred after the 1973–73 recession, and reflects the expected sluggish nature of the recovery.
- ***California personal income*** is predicted to rise 11.9 percent in 1981 and 12.0 percent in 1982. These gains are the *lowest since 1977.* Income grew by 13.8 percent in 1978, 14.8 percent in 1979, and 12.5 percent in 1980. (Chart 7 above.)
- ***Consumer inflation*** is anticipated to *decline,* but nevertheless remain at *relatively high rates* (Chart 12 above). The US CPI is predicted to rise 10.5 percent in 1981 and 9.1 percent in 1982, while the California CPI increases are estimated at 11.4 percent and 9.4 percent, respectively.
- ***Employment gains*** are projected to be *only moderate* for a post-recession recovery year, reflecting the non-robust nature of the upturn. As shown in Table 25 and Chart 15, California wage and salary employment is expected to rise 2.4 percent (241,000 new jobs) in 1981, following only a 1.7 percent gain (165,000 new jobs) in 1980. Excluding 1980, this 1981 percentage increase is the lowest since 1975. The 1982 gain is projected at 3.7 percent (371,000 new jobs), also less than in any year from 1976 through 1979.

Table 24
Department of Finance Economic Outlook for California and the Nation
(dollars in billions) [a]

A. *The Nation*	*1980 Estimated* Level	*1980 Estimated* Percent Change	*1981 Forecast* Level	*1981 Forecast* Percent Change	*1982 Forecast* Level	*1982 Forecast* Percent Change
GNP in current dollars	$2,571.4	8.6%	$2,851.7	10.9%	$3,196.1	12.1%
GNP in 1972 dollars	$1,421.1	−0.7	$1,439.5	1.3	$1,499.4	4.2
Personal income	$2,122.1	10.3	$2,343.2	10.4	$2,610.3	11.4
Corporate profits (pre-tax)	$230.2	−2.7	$255.7	11.1	$283.6	10.9
Employment (in thousands)	97,246	0.3	98,617	1.4	101,815	3.2
Housing starts (millions of units)	1.28	−25.8	1.37	6.9	1.62	18.9
New car sales (millions of units)	9.0	−15.5	9.7	7.4	10.5	8.4
GNP price deflator (1972=100)	181.0	9.3	198.1	9.4	213.1	7.6
Consumer price index (1967=100)	246.9	13.6	272.9	10.5	297.8	9.1
GNP consumption deflator (1972=100)	180.2	10.3	195.1	8.3	209.4	7.3
Unemployment (%)	7.2%	—	7.8%	—	7.3%	—
Savings rate (%)	4.5%	—	4.1%	—	4.1%	—
B. *California*						
Personal income	$256.6	12.5%	$287.2	11.9%	$321.8	12.0%
Employment (in thousands)	10,432	1.4	10,897	4.5	11.378	4.4
Residential building permits (in thousands)	140	−32.8	175	25.0	215	22.9
Consumer price index (1967=100)	249.9	15.7	278.4	11.4	304.5	9.4
Unemployment rate (%)	6.8%	—	6.7%	—	6.1%	—

[a] Source: Department of Finance and 1981–82 Governor's Budget.

Table 25
California Employment Gains by Major Industry Sector[a]
1974–1980
(in thousands)

Sector	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*[d]	*1982*[d]
Manufacturing	40	−107	64	77	147	129	2	33	58
Construction	−10	−31	15	48	52	46	−32	−2	15
Trade	49	34	90	106	144	106	45	70	109
Services	54	42	85	118	166	149	78	103	146
Government	61	85	24	44	11	−21	33	6	10
Federal	8	4	−8	−1	4	2	2	−2	0
Other	52	81	32	45	8	−24	31	8	10
All other nonagricultural wage and salary employment[b]	19	−10	29	51	79	73	39	31	33
Total Nonagricultural Wage and Salary Employment	213	13	307	444	599	482	165	241	371
Total Civilian Employment[c]	328	−65	360	487	583	396	146	465	481
Percent change in:									
Wage and salary employment	2.8%	0.2%	3.9%	5.4%	7.0%	5.2%	1.7%	2.4%	3.7%
Total civilian employment	4.0%	−0.8%	4.3%	5.5%	6.3%	4.0%	1.4%	4.5%	4.4%

[a] Data from Department of Finance and Employment Development Department. Detail may not add to total due to rounding.

[b] Includes mining, transportation, communications, utilities, finance, insurance, and real estate.

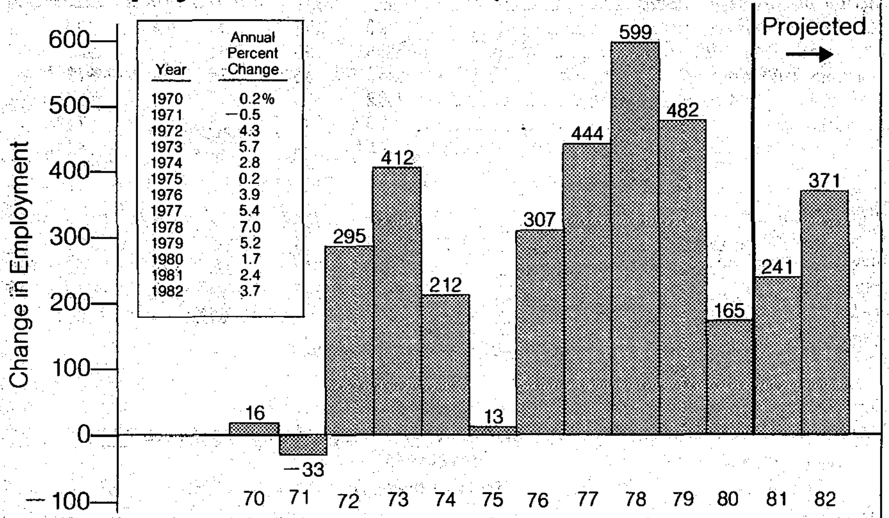
[c] Includes nonagricultural wage and salary employment *plus* (i) agricultural employment and (ii) nonagricultural employment which is not wage and salary employment (such as self-proprietors). In addition, the wage and salary data measures *jobs*, whereas the civilian employment data measures *persons working*.

[d] Department of Finance projections.

- *Weakness* will continue to characterize the housing markets, due to high mortgage interest rates and rising home prices. *U.S. housing starts* in 1981 are predicted to be only 1.4 million, a gain of only 6.9 percent over the depressed 1980 level of 1.3 million. In *California,* building permits are expected to reach only 175,000. While up 25 percent from the 140,000 level of 1980, the projected 1981 level remains well below the 200,000-plus rate which most economists feel is consistent with underlying housing demand in the state.

Chart 15

Annual Growth in California Wage and Salary Employment 1970 to 1982[a] (in thousands)



[a] Source: Department of Finance and Employment Development Department. Data are estimated for 1980 and projected for 1981 and 1982.

Finance Economic Outlook Reflects Concensus

Tables 26 and 27 show how the department's 1981 forecasts for key economic variables in the nation and California, respectively, compare to those made by other well-known forecasters. As is usually the case, Finance's predictions are generally consistent with these alternative outlooks. For example, Finance's projections for the state and nation are between the highest and lowest predictions shown for all but two variables (California CPI and "real" personal income growth). When compared to the *average* predictions made by the other forecasters for California, Finance is:

- Slightly *less* optimistic regarding California personal income growth (11.9 percent versus 12.4 percent) and employment growth (2.4 percent versus 2.6 percent).
- *Higher* on its California CPI estimate (11.4 percent versus 10.1 percent).
- *Lower* on its estimate of the state's *unemployment rate* (6.7 percent versus 7.4 percent), and
- *Almost identical* regarding residential homebuilding activity (175,000 versus 173,000 new building permits).

Despite these variations, however, all of the forecasters shown appear to agree that 1981 will probably be a year of continued high inflation and only modest economic expansion, with significant strength in the economy unlikely to appear until well after the first part of the year. Recent data are consistent with this prognosis for a slow recovery in 1981. For example, in December 1980, seasonally adjusted retail rates declined nationally by 1.3 percent from their November level, while a survey released by the U.S. Commerce Department suggested that 1981 capital spending by businesses might rise in real terms by only 1.5 percent.

Many economists have also stressed the possibility that real economic growth could briefly decline again in early 1981, although the chance of this happening has lessened somewhat, based on preliminary estimates from the Department of Commerce that real GNP rose at an annual rate of 5 percent in the fourth quarter of 1980. However, even if a decline occurs on a national basis, the odds are that California would escape such a downturn because of the current strength in its light manufacturing, aerospace, electronics, and other high technology industries.

Table 26
Comparison of 1981 National Economic Outlook for Selected Forecasters

	Percent Change in				*Unemployment Rate*	*New Car Sales (millions of units)*	*Housing Starts (millions of units)*
	Real GNP	*GNP Prices*	*Consumer Prices*	*Pre-Tax Profits*			
Department of Finance	1.3%	9.4%	10.5%	11.1%	7.8%	9.7	1.37
Other Forecasters[a]							
United California Bank	2.1%	8.5%	10.0%	4.9%	7.0%	10.2	1.55
Security Pacific Bank	0.5	10.2	10.4	3.5	8.1	9.4	1.40
Wells Fargo Bank	1.2	9.5	9.6	N.A.	7.8	9.3	1.56
Bank of America	0.5	9.6	9.7	−1.3	7.8	8.6	1.50
Crocker Bank	0.0	9.1	10.1	12.5	7.9	8.9	1.35
UCLA	1.3	9.8	11.0	−4.1	7.8	9.4	1.44
Chase Econometrics	0.6	10.2	11.6	0.5	8.1	9.2	1.40
Data Resources	0.8	9.8	11.0	−6.3	7.9	9.3	1.44
Average of "Other" Forecasters	0.9%	9.5%	10.4%	1.2%	7.8%	9.3	1.47

[a] Forecasts as of approximately year-end 1980.

Table 27
Comparison of 1981 California Economic Outlook for Selected Forecasters

	Percent Change in:				*Unemployment Rate*	*New Residential Building Permits (thousands)*
	Personal Income	*Consumer Prices*	*"Real" Personal Income*[b]	*Wage and Salary Employment*		
Department of Finance	11.9%	11.4%	0.5%	2.4%	6.7%	175
Other Forecasters[a]						
United California Bank	12.9%	11.0%	1.7%	3.4%	6.5%	185
Security Pacific Bank	12.5	10.2	2.1	2.7	7.6	170
Wells Fargo Bank	13.0	10.0	2.7	2.8	7.0	175
Bank of America	12.0	10.0	1.8	2.2	8.0	175
Crocker Bank	11.2	10.0	1.1	1.6	7.5	165
UCLA	12.6	9.6	2.7	3.0	7.5	169
Average of "Other" Forecasters	12.4%	10.1%	2.0%	2.6%	7.4%	173

[a] Forecasts as of approximately year-end 1980.
[b] Defined as personal income growth adjusted for customer price inflation. If the GNP consumption expenditures deflator were used instead of the CPI, "real" personal income growth would be somewhat higher.

a. General Fund Revenues in the Budget Year

General Fund income is projected to reach $21.0 billion in 1981–82, a gain of $2.0 billion (10.3 percent). These General Fund receipts can be separated into three broad categories: revenues from major taxes, interest income from investments, and various other income and transfers. As shown in Table 23, each of these categories is projected to perform differently in 1981–82:

- ***Major taxes***—which produce over 96 percent of General Fund income—are expected to *rise* by 12 percent ($2.2 billion), to $20 billion. This percentage gain is basically *identical* to the increase in California personal income—11.9 percent in 1981 and 12.0 percent in 1982. Thus, major tax revenues are projected to grow in step with income expansion. Revenue growth would have been even greater—12.7 percent—in the absence of a $127 million reduction attributable to changes in the inheritance and gift tax statutes.
- ***Interest income*** is expected to decline by $125 million, to a level of $327 million. This fall reflects the elimination of the state General Fund surplus, and the projected tapering in interest rate levels over the next 24 months.
- ***Other revenues and transfers***—about 3 percent of total General Fund receipts —are also expected to *decline,* from $722 million in the current year to $659 million in 1981–82, a drop of $63 million (−8.7 percent). This reduction is due to a $96 million fall in General Fund income from federal revenue sharing—a program which, though currently being considered for renewal, ended in September 1980. Omitting federal revenue sharing, this revenue category is projected to *increase* by about $33 million (7.3 percent).

Thus, if adjustments are made for the effects of reduced interest income and the termination of federal revenue sharing, the projected rate of growth in General Fund income rises to about 11.6 percent. This rate is a good general indication of the underlying growth trend in the 1981–82 General Fund revenue base.

Our review of the department's estimates shows that the projected General Fund revenues are generally consistent with the baseline economic forecast discussed earlier. For the *three major taxes,* for example, we estimate that revenue would be about $18.6 billion *using Finance's economic assumptions,* or $91 million more than the budget forecast. As shown below in Table 28, this difference is comprised of $58 million for the personal income tax, $30 million for the bank and corporation tax, and only $3 million for the sales and use tax.

Table 28

Comparison of Department of Finance and Legislative Analyst 1981–82 Revenue Estimates for Major Taxes, Assuming Finance's Economic Assumptions (in millions)

	Finance	*Legislative Analyst*	*Difference*
Personal Income Tax	$7,435	$7,493	+$58
Bank and Corporation Tax	3,035	3,065	+30
Sales and Use Tax	8,001	8,004	+3
Total, Three Major Taxes	$18,471	$18,562	+$91

Alternative Revenue Scenarios

As discussed in the introductory section (Table 14), we constructed two alternative revenue scenarios, based on a more optimistic and a more pessimistic group of economic assumptions than Finance used in the budget. In structuring these scenarios, we examined the range of *actual* 1981 forecasts reported by different economists in Tables 26 and 27 above, identified the optimistic and pessimistic extremes, and then projected each into 1982. This projection into 1982 was necessary because most outside forecasters do not themselves project that far into the future, at least publically. We also made assumptions about certain economic variables—like California taxable sales and California corporate profits—which are not generally predicted by most private sector economists.

- The *high revenue scenario* assumes that California personal income growth will reach 13 percent in 1981 and 14 percent in 1982, that U.S. corporate profits will strongly rebound at rates of 20 percent in 1981 and 15 percent in 1982, and that the ratio of taxable sales to statewide income will increase from 55.9 percent in 1980 to 57 percent in 1981 and 57.5 percent in 1982.
- The *low revenue scenario* assumes that California personal income will grow by 10.2 percent in 1981 and 11.7 percent in 1982, that U.S. corporate profits will decline by 5 percent in 1981 and rise by 15 percent in 1982, and that the ratio of taxable sales to income will further erode to 55.5 percent in 1981, before rising modestly to 56 percent in 1982.

As noted earlier in Table 14, these economic scenarios produce 1981–82 General Fund revenue estimates which range from $905 million (4.3 percent) *above* to $762 million (3.6 percent) *below* an amount consistent with Finance's baseline economic forecast. It is probably possible to find economists to support either end of this range.

Income Tax Collections to Rebound

Personal income tax receipts are projected to reach $7.4 billion in 1981–82, an increase of 11.8 percent ($785 million) over the current year. This growth far exceeds the 2.2 percent increase ($144 million) predicted for the current year. The main reason for this growth differential is indexing:

- In the *1980 income year*—which accounts for about two-thirds of *1980–81* revenues—the indexing adjustment factor applied to the tax brackets, credits and standard deduction will be 17.3 percent (the increase in the California CPI from June 1979 through June 1980). Because this adjustment is far in *excess* of 1980 personal income growth (12.5 percent), many taxpayers will in effect be "moved backwards" into lower marginal income tax rate brackets, and therefore be taxed at lower effective rates. We estimate that 1980 tax liabilities will rise by only 7 percent because of this.
- In the *1981 income year*—which accounts for about two-thirds of *1981–82* revenues—the indexing adjustment factor is projected to be only 10 percent. Because this factor is *less* than projected 1981 income growth (11.9 percent), less "backward movement" through the tax brackets will occur than for the 1980 income year. Tax liabilities should rise by about 10.8 percent.
- In the *1982 income year*—which accounts for about one-third of *1981–82* revenues—income growth (12.0 percent) is expected to stay about the same as in 1981, while the inflation rate used for indexing is expected to drop further (to 9.5 percent). The resulting faster growth in real income will tend to raise effective tax rates by pushing more taxpayers into higher brackets. This effect will be reinforced by the return to "partial" indexing in 1982, under the provisions of current law. Thus, 1982 tax liabilities will rise by about 13.6 percent.

Given the return to partial indexing and the expectation that the California economy will experience positive real growth in the years to come, *personal income tax revenues can probably be expected to grow an average of 10 to 20 percent more rapidly than income.*

Indexing Costs Rise Rapidly

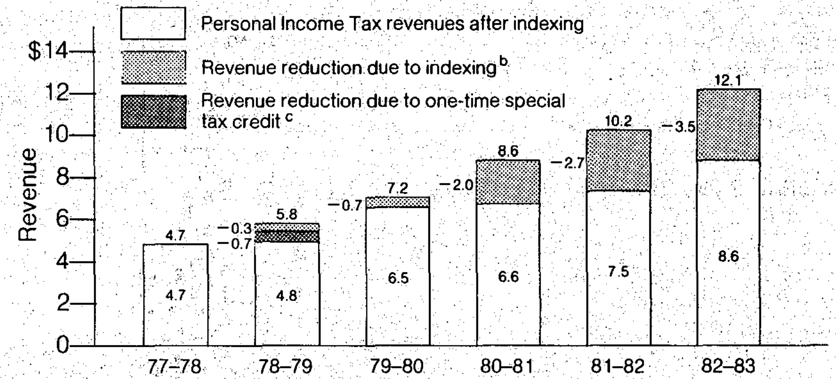
Chart 16 shows how indexing has affected personal income tax revenues:

- In 1981–82, income tax revenues will be $2.7 billion (26.3 percent) lower than without indexing.
- Income tax revenue growth in 1981–82 would be 18.7 percent without indexing, compared to the projected increase of 11.8 percent.
- The *cumulative* cost of indexing since 1977–78 will reach $5.7 billion by 1981–82.

In addition to these significant impacts on the level and rate of growth in income tax revenues, indexing has also made it more difficult to forecast accurately the personal income tax. This is because it makes the exact *mix* between inflation and real income growth more important than before, and this mix has been increasingly hard to predict. As a result, there is a greater potential now than ever before for errors in estimating current year and budget year income tax revenues. The errors could go in *either* direction.

Chart 16

Effects of Indexing on California Personal Income Tax Revenues[a] (in billions) 1977–78 to 1982–83



[a] Estimates by Legislative Analyst.

[b] AB 3802 (Chapter 569, Statutes of 1978) provided that income tax brackets be indexed by the amount of inflation *above* 3 percent beginning in 1978, and also that the standard deduction, personal credits and dependent credit be *fully* indexed beginning in 1979. AB 276 (Chapter 1198, Statutes of 1979) provided that income tax brackets be *fully* indexed by the inflation rate, but only for the 1980 and 1981 income years. If this full indexing were continued in 1982 and thereafter, 1982–83 revenues would be further reduced by about $235 million.

[c] AB 3802 increased the personal income tax credit for 1978 by $75 for single return taxpayers and by $150 for joint return taxpayers.

Stronger Sales Tax Growth

Revenue from the sales and use tax is projected to reach $8 billion, a rise of 14.1 percent ($990 million). In contrast, the estimated 1980–81 gain is only 7.5 percent ($490 million). The reason for this strengthening is not so much that taxable sales are expected to be abnormally strong in 1981 and 1982, as that taxable sales in 1980 were abnormally weak.

- Taxable sales in *calendar 1980* rose only 8.8 percent, as shown in Table 29 and Chart 9 earlier. This was the lowest increase since 1975 (7.9 percent) and was far below the average increase from 1976 to 1979 (nearly 15.8 percent).

- Taxable sales are expected to rise by 12.4 percent in *1981* and 13.8 percent in *1982*. Although these increases exceed projected personal income growth (11.9 percent and 12.0 percent, respectively), they are not so strong as to fully make up for the sharp 1980 fall-off in taxable sales growth. As shown in Table 29, the ratio of taxable sales to personal income in 1982 is expected to still be below its 1979 level.

The actual performance of taxable sales in the next two years will depend on such factors as how consumers adjust their spending and savings decisions in response to continued inflation, and whether developments affecting interest rates and credit availability will stimulate or depress the level of expenditures.

Table 29
California Taxable Sales
(in billions) [a]

	1979		*1980*		*1981*		*1982*	
Taxable Sales Category	*Amount*	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
—Retail stores (excluding motor vehicles and building)	$52.3	13.5%	$57.1	9.1%	$63.3	11.0%	$70.8	11.7%
—Motor vehicles and auto parts	16.6	4.1	15.3	−8.0	17.1	10.8	20.0	17.9
—Gasoline (service stations and refineries)	13.7	34.7	18.1	32.0	21.6	19.2	25.0	15.9
—Building activity	14.1	19.2	14.2	0.6	16.1	13.4	18.9	17.1
—Manufacturing and wholesaling	35.0	18.8	38.7	10.6	43.0	11.4	48.6	12.8
Total Taxable Sales	$131.7	16.1%	$143.3	8.8%	$161.0	12.4%	$183.2	13.8%
Total Taxable Sales Excluding Gas	118.0	14.2	125.2	6.1	139.4	11.3	158.1	13.4
Ratio of Total Taxable Sales to Personal Income	.578	—	.559	—	.560	—	.569	—

[a] Source: Department of Finance.

Gasoline Sales Taxes Increase Despite Volume Decline

As Tables 29 and 30 show, increased gasoline prices have made gasoline a key source of taxable sales growth. These gasoline sales—which include the taxable sales of both service stations and refineries—are projected to account for over 13.6 percent of total taxable sales by 1982, up from only 10.4 percent as recently as 1979. Without gasoline included, taxable sales growth is only 6.1 percent (instead of 8.8 percent) in 1980, 11.3 percent (instead of 12.4 percent) in 1981 and 13.4 percent (instead of 13.8 percent) in 1982.

Despite the growing importance of gasoline as a component of taxable sales, however, the annual percent growth in taxable gasoline sales appears to be slowing. As shown in Table 30,

- Retail gasoline sales rose by nearly 32 percent in both *1979* (a rise of $2.3 billion) and *1980* (a rise of $3 billion). However,
- The budget anticipates that sales will grow at slower rates in both *1981* (15 percent, or $1.9 billion) and *1982* (17 percent, or $2.5 billion).

This reflects a slowdown in the rate of growth in gasoline prices, accompanied by continued declines in gasoline consumption. For example, Table 30 shows that:

- The increase in the *average price per gallon* of gasoline was over 34 percent in 1979 and 36 percent in 1980. In 1981 and 1982, however, the increase is projected at only 17 percent to 18 percent; and
- Total retail gasoline *consumption* (measured in gallons) has fallen by 1.5 percent in 1979, 4 percent in 1980, 1.5 percent in 1981 (projected) and 1 percent in 1982 (projected). In 1980, the decline was so large that 1980 taxable gasoline sales were overestimated last January by $300 million *despite* higher

than predicted prices.

Table 30
Budget Assumptions Regarding Gasoline Prices and Consumption Levels

Calendar Year	*Gallons of Gasoline Sold (millions)*	*Average Price Per Gallon of Gasoline*[a]	*Dollar Amount of Retail Gasoline Sales (billions)*[a]
1978 (annual average)	11,387	$0.64	$7.3
1979 (annual average)	11,220	0.86	9.6
1980			
1st quarter	2,633	$1.14	$3.0
2nd quarter	2,714	1.19	3.2
3rd quarter	2,760	1.17	3.2
4th quarter	2,660	1.18	3.1
Total	10,767	$1.17	$12.6
1981			
1st quarter	2,580	$1.25	$3.2
2nd quarter	2,673	1.35	3.6
3rd quarter	2,719	1.40	3.8
4th quarter	2,633	1.48	3.9
Total	10,605	$1.37	$14.5
1982			
1st quarter	2,554	$1.54	$3.9
2nd quarter	2,646	1.59	4.2
3rd quarter	2,692	1.65	4.4
4th quarter	2,607	1.70	4.4
Total	10,499	$1,62	$17.0

[a] Before application of the sales tax. Detail may not total due to rounding.

Obviously, projections of retail gasoline sales must be highly qualified because of uncertainties regarding the impacts on gasoline prices, production, inventories and sales, of domestic oil price decontrol, "excess profits" taxation, future OPEC decisions, gasoline conservation by consumers, and the sensitivity of gasoline demand to future price increases.

Bank and Corporation Taxes Share in Recovery

Bank and corporation taxes are expected to rise by 13.4 percent ($359 million) in 1981–82, considerably above the 8.5 percent current year gain. This growth—which has been adjusted to *exclude* $48 million in transfers to special funds under the provisions of AB 66 (Chapter 1150, Statutes of 1979)—reflects both a mild strengthening of taxable California corporate profits, and the application of higher bank and corporation effective state tax rates under AB 66. These increased rates are projected to raise state General Fund revenues by at least $140 million, *net* of the AB 66 special fund transfers.

As shown in Table 21 and Chart 8 earlier, profit growth is projected to be 11.6 percent in 1981 and 11.5 percent in 1982. This is well above the 5.1 percent and 8.9 percent gains of 1980 and 1979, respectively, but far less than the gains of 1976 through 1978, which averaged nearly 24 percent.

There are a number of factors which complicate the projection of bank and corporation tax revenues this year. These include:

- The impact which general economic developments in 1981 will have on such profit-determining variables as sales volumes, borrowing costs for the financing of inventories and capital investments, and unit labor costs.

- The direct and indirect effects of oil price decontrol and "excess profits" taxation on energy-producing and energy-using industries, and
- The effect of economic conditions on the timing of corporate tax prepayments. Corporations are currently allowed considerable latitude in making these payments.

Other Major Taxes

Table 23 shows that General Fund revenues from taxes other than the three major levies are projected at about $1.6 billion, an increase of 8.3 percent ($120 million) over 1980–81. These taxes include the insurance tax ($565 million), the inheritance and gift taxes ($532 million), the cigarette tax ($204 million), alcoholic beverage taxes ($150 million) and horse racing-related revenues ($114 million). Because some of these taxes are more sensitive to economic conditions than others, their growth rates vary considerably. For example, cigarette tax revenues are expected to rise by only 2.4 percent, whereas the projected growth in insurance tax collections is 8.7 percent. The inheritance and gift tax is projected to decline by $44 million, or 7.6 percent, but this is due to the phasing-in of AB 2092 (Chapter 634, Statutes of 1980) which increased various tax exemptions for inheritees. Without these changes, projected 1981–82 inheritance and gift tax revenues would have been $127 million greater, resulting in a growth of 14.0 percent ($81 million) over the current year.

Continued Decline in Interest Income

The General Fund receives interest income from three primary sources: (1) the investment of surplus monies left over from the prior year, (2) earnings on balances in the Pooled Money Investment Account (PMIA) which are not General Fund balances per se but on which the General Fund nevertheless earns interest income, and (3) the balance of General Fund monies being held idle at any one moment because of the time lag between when revenues are collected and disbursements are made. Of these three, the last is currently the most important source of interest income.

The budget projects that General Fund interest income will be about $327 million in 1981–82, compared to about $547 million in 1979–80 and $452 million in the current year. This projection assumes that:

- *The average fiscal year balance* in the PMIA for 1981–82 will be $5.7 billion, a drop of $1.8 billion from the current year. The average balance has declined because the state has been spending more than it receives in current revenues.
- *The General Fund share* of funds in the PMIA will be about 56 percent.
- *The average interest yield* on PMIA investments in 1981–82 will be 10.25 percent. This compares to an actual average yield for the first half of 1980–81 of about 10.2 percent, and an estimated yield for the second half of about 11 percent.

Final Year for Federal Revenue Sharing

In September 1980, the federal revenue sharing program for states terminated. The General Fund will receive a transfer of $180.3 million from the state's Federal Reserve Sharing Fund in 1981–82, which will exhaust the revenue sharing monies currently available to the state. Since 1973–74, the General Fund will have received nearly $2.2 billion in federal revenue sharing monies.

Congress has enacted legislation authorizing funding for the program for federal fiscal years 1982 and 1983, but receipt of funds is contingent on a dollar-for-dollar reduction in categorical funds received by the state. In addition, no appropriation was provided for in the legislation, so funding is contingent on further congressional action.

Major 1980 Tax Legislation

Legislation enacted during 1980 will reduce General Fund revenues and transfers by nearly $218 million in 1981–82.

- *Personal income taxes* have been reduced by *$63 million.* This includes the effects of AB 2030 (a $40 million reduction), which provided a 40 percent tax credit for certain energy conservation expenditures, and AB 2036 (a $15 million reduction), which renewed the 55 percent solar energy credit for three years. The General Fund cost of AB 2030 is offset by a special fund transfer to the General Fund in 1981–82. In the case of AB 2036, a one-time special fund transfer was made into the General Fund in 1980–81 to partially compensate the General Fund for its revenue losses.
- *Horse racing revenues* have been lowered by *$30 million* under AB 3383, which extensively revised the statutes regarding horse racing and parimutual wagering activities.
- *Inheritance and gift taxes* have been revised downward by *$127 million* under AB 2092, which exempted spouses totally from this tax and substantially increased the exemptions for other categories of beneficiaries.
- *Bank and corporation taxes* were lowered by over $35 million. This includes a $10 million reduction under AB 2030 above, plus another $16 million decline due to AB 472, which made certain changes in the unitary method of taxing California-based corporations.

b. Special Fund Revenues in the Budget Year

Combined revenues from all state special funds are projected to reach over $3.3 billion in 1981–82, or 6.0 percent ($189 million) above the current year estimate (see Table 23).

About two-thirds 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 expected to rise by about $129 million (6.5 percent) in the budget year, to a level of about $2.1 billion. Of this total, nearly $830 million represents fuel taxes imposed on a per gallon basis.

As shown in Table 23, 1981–82 fuel tax revenues are projected to *decline* by 0.4 percent. This is the fourth year in a row that dollar revenues have fallen. This negative growth reflects the drop-off in gasoline consumption discussed earlier, which is due to the combination of changes in the automobile mix, increasing fuel economies, reduced demand due to the slowing in economic growth, and the impacts of higher gasoline prices on consumption. Thus, higher gasoline prices reduce the growth in fuel tax revenues, even though they tend to stimulate sales and use tax revenues. The fuel tax estimate assumes that average gasoline consumption per vehicle will drop from 590 gallons in 1979–80, to 561 gallons in 1980–81 and 542 gallons in 1981–1982. Vehicle registration and license fees are projected at almost $1.3 billion in the budget year, up 11.5 percent from 1980–81. This projection assumes a 3.7 percent and a 9.6 percent increase in vehicle registrations in 1981 and 1982, respectively, and a total stock of 20 million registered vehicles in California by the end of 1982.

Three other sources of special fund income deserve mention:

- The *Transportation Planning and Development Account* will receive $139 million in 1981–82 from sales and use tax collections because of both higher gasoline prices and the provisions of SB 620 (Chapter 161, Statutes of 1979), up from $124 million in the current year and $102 million in the prior year. Before 1979-80, the transfers into this account generally were negligible.
- *Oil and gas tax revenues* are projected in the Governor's Budget to reach $506

million in 1981–82, up 11.0 percent from the current year. (This estimate assumes that $50 million will be paid as federal windfall profits taxes. It now appears that some of this $50 million could be reimbursed to the state.) This amount primarily represents direct revenues received by the state from the sale of oil and gas produced from tidelands (principally located adjacent to the City of Long Beach). The continuing rise in these revenues is due to the federal decontrol of oil prices and the continuing escalation of crude oil and gas prices in domestic and world markets.

- Under the provisions of AB 66 (Chapter 1150, Statutes of 1979), the budget reports that special funds will receive income from the *bank and corporation tax* of $42 million in 1981–82, down from $48 million in the current year (Table 23). Of the budget year amount, $27 million will go to local governments as compensation for the loss of local revenue caused by the bill's tax provisions affecting bank and nonbank financial institutions. The remaining $15 million goes to the State Litter Control, Recycling and Resource Recovery Fund to replace revenues from the "litter tax", which AB 66 abolished. The budget shows the $42 million as special fund income *directly* from the bank and corporation tax. Under current law, however, these funds are technically General Fund *transfers*. The Governor intends to propose legislation to change this treatment.

III. STATE BORROWING

Overview

The State of California issues both general obligation and revenue bonds. These bonds have the following unique characteristics.

- General obligation bonds are backed by the full faith and credit of the state. This type of bond must be authorized by a *two-thirds* vote of both houses of the Legislature and then be approved by the voters at a statewide election. Existing law limits the allowable interest rate on these bonds to 9 percent.
- Revenue bonds are not backed by the credit of the state. Instead, they are secured by the revenues from the projects which are financed from these bond proceeds. This type of bond is authorized by a *majority* vote of both houses of the Legislature, and does not require voter approval. Some of these types of bonds have interest rate ceilings; others do not.

Over the last five years, the total volume of state bond sales has tripled (Table 38). Moreover, in 1979–80, the sale of revenue bonds, for the first time, exceeded the sale of general obligation bonds.

In the following sections, we discuss both types of state bonds, the increasing volume of local bond sales, and the combined effect of recent sales of both state and local bonds.

A. GENERAL OBLIGATION BONDS

Bond Categories

General obligation bonds are 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 1978–79, 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 has been 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.

Status of Bonds Authorized

Table 31 provides detail on the three categories of general obligation bonds. As of December 31, 1980, the state had over $1.8 billion in unsold bonds, $515 million, or 39 percent, more than the total at the end of 1979. Of the authorized bonds already sold ($9.88 billion), the state has retired $3.6 billion, leaving $6.3 billion outstanding. During the 1980 calendar year, two new general obligation bond issues—$285 million for Parklands acquisition and $750 million for veterans' farm and home building bonds—were passed by the Legislature and approved by the electorate.

Table 31
General Obligation Bonds of the State of California
As of December 31, 1980
(in millions)

	Authorized	*Unsold*	*Redemptions*	*Outstanding*
General Fund Bonds:				
State construction	$1,050.0	—	$621.5	$428.5
Higher education construction	230.0	—	113.2	116.8
Junior college construction	65.0	—	30.8	34.2
Health science facilities construction	155.9	—	27.3	128.6
Community college construction	160.0	—	43.3	116.7
Beach, park, recreational, and historical facilities	400.0	$35.0	111.5	253.5
Recreation and fish and wildlife	60.0	—	20.5	39.5
State, urban, and coastal parks	280.0	135.0	12.0	133.0
Parklands acquisition and development	285.0	285.0	—	—
Clean water	875.0	410.0	91.0	374.0
Safe drinking water	175.0	125.0	—	50.0
Subtotals	($3,735.9)	($990.0)	($1,071.1)	($1,674.8)
Partially Self-Liquidating Bonds:				
School building aid	$2,140.0	$65.0	$1,119.7	$955.3
Self-Liquidating Bonds:				
Water resources development	1,750.0	180.0	68.8	1,501.2
Harbor bonds	89.3	—	60.4	28.9
Veterans' farm and home building	4,000.0	600.0	1,289.4	2,110.6
Subtotals	($5,839.3)	($780.0)	($1,418.6)	($3,640.7)
Totals	$11,715.2	$1,835.0	$3,609.4	$6,270.8

Bond Program Sales

Table 32 shows general obligation bond sales on a fiscal year basis for the past, current, and budget year. Two programs—clean water and veteran's farm and home building—represented 76 percent of 1979–80 sales, and account for about 79 percent of the new general obligation bond indebtedness projected for both 1980–81 and 1981–82.

General Fund Debt Service

Table 33 projects the amount of debt service to be paid on bonds fully supported by the General Fund through 1983–84. During the budget year, debt service will increase $19.3 million, or 9.1 percent, over the current year. All of the debt service estimates in Table 33 are based on specific estimates of anticipated future bond

Table 32
General Obligation Bond Sales
1979–80 to 1981–82
(in millions)

	Actual 1979–80	*Estimated 1980–81*	*Proposed 1981–82*
Beach park, recreational and historical facilities	$30	$25	$10
Clean water	100	50	125
Safe drinking water	—	20	25
State, urban, and coastal parks	20	65	75
Subtotals, General Fund Bonds	$150	$160	$235
School building aid [a]	—	25	—
Veterans' farm and home building [b]	475	450	300
Totals	$625	$635	$535 [c]

[a] Debt service presently paid entirely by school districts.
[b] Debt service paid from program or project revenues.
[c] Department of Finance projections of $685 million include another $150 million in sales of veterans bonds not yet approved by the voters.

sales. If additional sales occur, the amounts needed to retire General Fund debt will increase accordingly. Also, interest rates paid on bond sales will tend to rise because both national rating services reduced the rating of state general obligation bonds from Aaa to Aa in 1980. In Table 33, we have assumed that interest rates will not exceed the current 9 percent statutory ceiling. However, recent Bond Buyers Index statistics have regularly exceeded 9 percent and two offerings have been delayed because of this.

Table 33
General Fund Debt Service
1979–80 to 1983–84 [a]
(in millions)

	Debt Service [b]	*Percent Change from Previous Year*	*Anticipated Future Sales* [c]
1979–80	$197.0	6.0%	—
1980–81	212.0	7.6	$140.0
1981–82	231.3	9.1	235.0
1982–83 [d]	251.0	8.5	200.0
1983–84 [d]	270.0	7.6	200.0

[a] All figures are estimates except for 1979–80.
[b] Includes estimates debt service *only* on bond issues presently authorized by the electorate.
[c] An average interest rate of 9.0 percent is assumed on future sales.
[d] Projections based on debt service for bonds now sold and on anticipated future sales.

Selected Bond Fund Expenditures

After General Fund bonds are sold, the proceeds from the sale are allocated to specific projects. These selected bond fund expenditures are identified in Schedule 3 of the Governor's Budget, by administering agency. Table 34 groups them according to the bond source of funding.

Each of the last five midyear budget estimates of bond fund expenditures has turned out to be too high. For example, the 1978–79 and 1979–80 midyear estimates were $406 million and $347 million, respectively, while actual expenditures in those years were $196 million and $193 million, respectively.

Table 34
Selected Bond Fund Expenditures
1979–80 to 1981–82
(in thousands)

	Actual 1979–80	*Estimated 1980–81*	*Proposed 1980–81*
Higher education construction	$373	$26	—
Health science facilities construction	5,279	1,340	$2,618
Community college construction	2,357	—	641
Beach, park, recreational, and historical facilities	37,558	36,488	1,267
Recreation and fish and wildlife	355	211	8
State, urban, and coastal parks	62,556	102,057	2,687
Parklands acquisition and development	—	—	22,925
Clean water	71,435	95,691	93,638
Safe drinking water	13,101	36,782	36,887
Totals	$193,014	$272,595	$160,671

The failure of the budget to give realistic picture of bond expenditures makes inter-year bond expenditure program comparisons invalid, and distorts total expenditure comparisons. More realistic scheduling of new projects and those already authorized, particularly in the parks and recreation area, would result in more accurate midyear estimates and, consequently, improved inter-year comparisons.

B. STATE REVENUE BONDS

Bond Categories

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 in the past to finance the construction of bridges, fair facilities, and higher education dormitories and parking lots. Recently, the state has made greater use of revenue bonds, especially to finance housing, pollution control, and health facilities.

Table 35
State Revenue Bonds
As of December 31, 1980
(in thousands)

Issuing Agency	*Authorization Limits—If Any*	*Outstanding*	*Remaining Authorization*
California Education Facilities Authority	$300,000	$130,415	$169,585
California Housing Finance Agency	1,500,000	761,985	738,015
California Pollution Control Financing Authority	(no statutory limits)	372,457	N/A
Transportation Commission	(no statutory limits)	113,210	N/A
Department of Water Resources	(no statutory limits)	45,725	N/A
Trustee's California State Colleges and Universities	(no statutory limits)	138,858	N/A
Regents University of California	(no statutory limits)	170,649	N/A
State Public Works Board	(no statutory limits)	19,330	N/A
Hastings College of Law	(no statutory limits)	—	N/A
Veterans Revenue Debenture	1,000,000	500,000	500,000
California National Guard	100,000	25,000	75,000
California Health Facilities Authority	767,000	—	767,000
California Student Loan Authority	150,000	—	150,000
California Alternate Energy Source Financing Authority	200,000	—	200,000
Totals	$4,017,000 [a]	$2,682,629	$2,699,600 [a]

[a] Totals include authorizations with statutory limits only.
Source: State Treasurer's office.

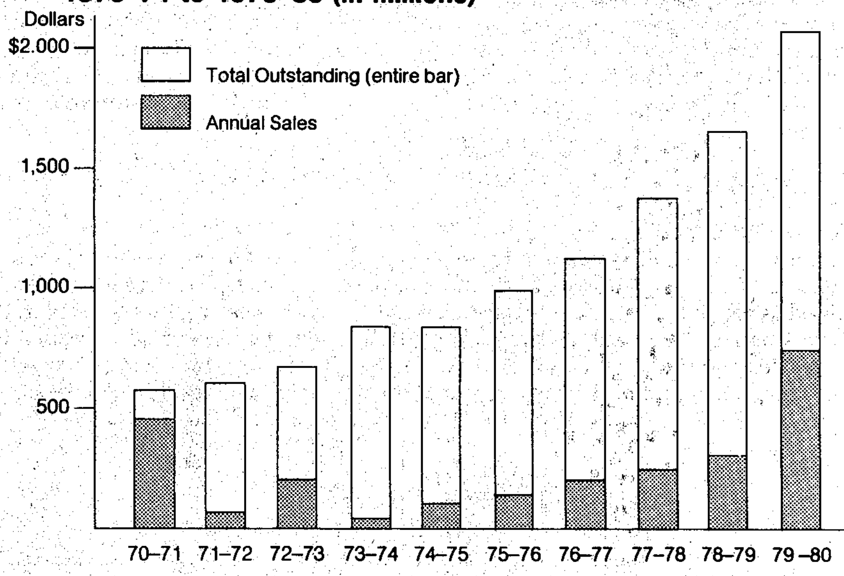
Table 35 provides detail on the fourteen different types of state revenue bonds and their current authorizations. As of December 31, 1980, there were $2,682.6 million in bonds outstanding. The three housing programs account for $1,287 million, or 48 percent, of the outstanding bonds: California Housing Agency, $762 million, Veterans Revenue Debenture, $500 million, and California National Guard, $25 million. Seven of the fourteen bond programs in Table 35 have no statutory limitations on the face value that can be issued.

Growth in Revenue Bonds

In recent years, the amount of revenue bonds outstanding has risen dramatically. Chart 17 shows the increase in outstanding revenue bonds from 1970–71 to 1979–80.

Chart 17

California State Revenue Bonds Annual Sales and Total Outstanding 1970–71 to 1979–80 (in millions)



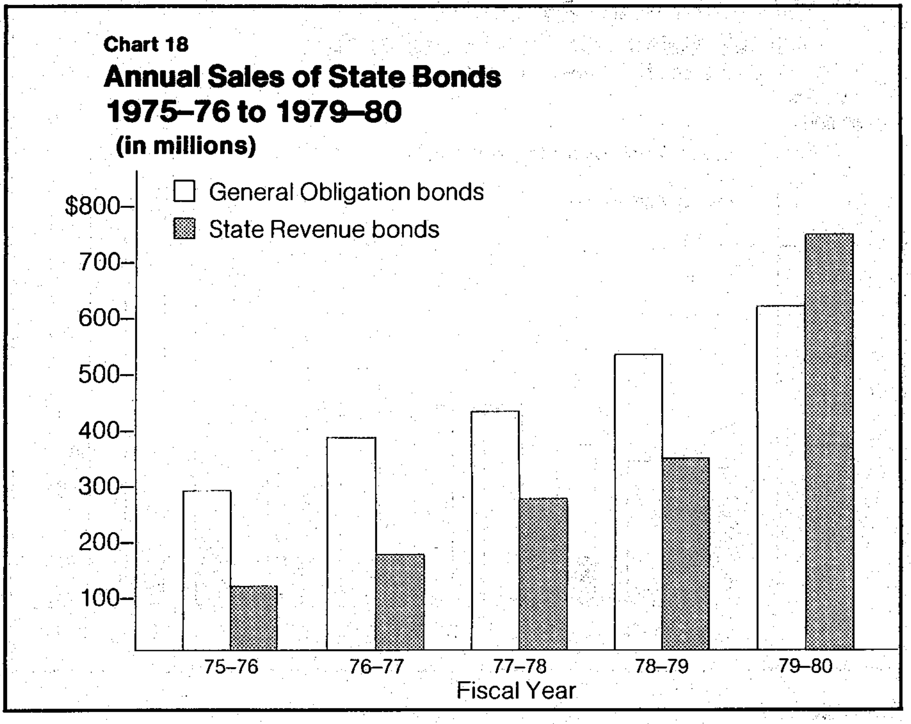
Bond Sales

Table 36 shows revenue bond sales for the past three years. Estimates of current and budget year sales are not available at this time. Revenue bond issues are not scheduled as far in advance as are general obligation bond sales. Two housing programs—California Housing Finance Agency and Veterans revenue bonds—accounted for 76 percent of 1979–80 sales.

Sales of state revenue bonds, as shown in Chart 18, exceeded general obligation bond sales for the first time in 1979–80. Most revenue bonds are not subject to the 9 percent interest rate ceiling which has recently dampened the sale of general obligation bonds.

Table 36
State Revenue Bond Sales
1977–78 to 1979–80
(in millions)

Issuing Agency	*1977–78*	*1978–79*	*1979–80*
California Education Facilities Authority	$45.4	$12.0	$24.5
California Housing Finance Authority	172.4	250.0	371.7
California Pollution Control Financing Authority	47.3	78.5	32.8
Transportation Commission	20.0	—	—
Department of Water Resources	—	—	95.8
Regents University of California	2.6	—	25.0
Veterans Revenue Debenture	—	—	200.0
Totals	$287.7	$340.5	$749.8



C. LOCAL BORROWING

While the State of California does not regulate most local borrowing, the marketability of state bonds depends, in part, on the total volume of tax-exempt bonds offered for sale. Table 37 shows local bond sales for the last three years, by the level of government. It indicates a tremendous increase in housing bond sales, especially by redevelopment agencies, over the last three years. For example, in 1977–78, local housing bonds were $93.2 million, or about 5 percent of total local bond sales. In 1979–80, local housing bonds sales had increased to $1.2 billion, which was almost 45 percent of total local bond sales. This table also indicates that bond sales for other purposes have declined during this time period.

Table 37
Annual Local Bond Sales
1977–78 to 1979–80
(in millions)

	1977–78	*1978–79*	*1979–80*	*Housing as Percent of 1979–80 Total*
Counties:	$60.5	$13.7	$9.0	
Housing	(28.2)	(12.4)	(8.6)	95.6%
Other	(32.3)	(1.3)	(0.4)	
Cities:	$462.9	$358.0	$488.9	
Housing	—	(111.2)	(211.9)	43.3
Other	(462.9)	$246.8)	(277.0)	
Special Districts:				
Schools	$129.8	$58.7	$95.9	—
Redevelopment agencies:	507.3	448.1	1,150.4	
Housing	(0.9)	(241.3)	(948.3)	82.4
Other	(506.4)	(206.8)	(202.1)	
Other special districts	670.1	623.5	814.0	
Housing	(64.1)	—	—	—
Other	(606.0)	(623.5)	(814.0)	
Subtotals	$1,307.2	$1,130.3	$2,060.3	
Housing	(65.0)	(241.3)	(948.3)	46.0
Other	(1,242.3)	(889.0)	(1,112.0)	
Special Assessments	29.5	14.0	54.6	—
Totals	$1,860.1	$1,516.0	$2,612.8	
Housing	(93.2)	(364.8)	(1,168.8)	44.7%
Other	(1,766.9)	(1,151.2)	(1,444.0)	

D. COMBINED STATE AND LOCAL BORROWING

The combined state and local borrowing in recent years is shown in Table 38. Between 1977–78 and 1979–80, total bond sales in California increased by $1,409 million, or 54.6 percent. The largest relative increase was in the volume of state revenue bonds, which increased 160.4 percent. Local bond sales remained much larger than combined state sales during the period, although the rate of gain for state sales was much faster.

Table 38
Annual Sales of State and Local Bonds
1975–76 to 1979–80
(in millions)

		State of California			
	Total All Bonds	*Total State*	*General Obligation*	*Revenue*	*Local Bonds*[a]
1975–76	$413[a]	$413	$295	$118	N/A
1976–77	554[a]	554	380	174	N/A
1977–78	2,579	719	431	288	$1,860
1978–79	2,392	876	535	341	1,516
1979–80	3,988	1,375	625	750[a]	2,613
Percent Increase 1977–78 to 1979–80	54.6%	91.2%	45.0%	160.4%	40.5%

[a] Information on local bond sales is available only from 1977–78 to 1979–80.

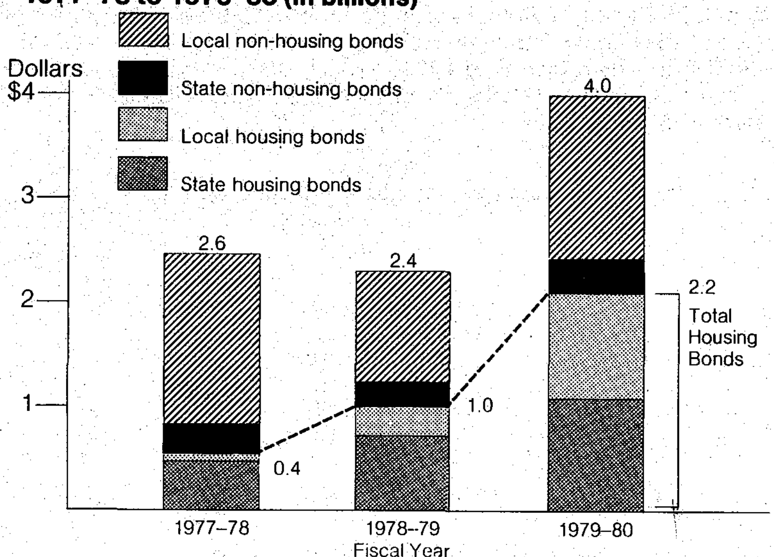
Housing Bonds Sales

Table 39 shows the sale of state and local housing and non-housing bonds during the past three years. Housing bond sales during this period increased 439 percent, with local housing issues showing the largest increase, 1,154 percent. Non-housing bonds declined by 19 percent during this same period.

Table 39
California State and Local Bond Sales
1977–78 to 1979–80
(in millions)

	1977–78	*1978–79*	*1979–80*	*Percent Change 1977–78 to 1979–80*
State Bonds:				
Housing	$322.4	$625.0	$1,071.7	232.4%
Non-housing	396.2	250.5	303.0	−23.5
Subtotals	$718.6	$875.5	$1,374.7	91.3%
Local Bonds:				
Housing	$93.2	$364.9	$1,168.8	1,154.1%
Non-housing	1,766.9	1,151.1	1,444.0	−18.3
Subtotals	$1,860.1	$1,516.0	$2,612.8	40.5%
State and Local Bonds:				
Housing	$415.6	$989.8	$2,240.5	439.1%
Non-housing	2,163.1	1,401.7	1,747.0	−19.2
Totals	$2,578.7	$2,391.5	$3,987.5	54.6%

Chart 19
California State and Local Bond Sales Highlighting Housing Bonds
1977–78 to 1979–80 (in billions)



Source: "Mortgage Revenue Bonds· California's 1980 Frenzy": Office of Planning and Research, November, 1980

This explosion in housing bond sales is attributable to two recent legislative acts:

Chapter 1, First Extraordinary Session—1975 (the Zenovich-Moscone-Chacon Housing and Home Finance Act) established the California Housing Finance Agency and authorized up to $1.5 billion in tax-exempt state revenue bonds. As of December 31, 1980, $762 million was outstanding.

Chapter 1069, Statutes of 1979 (AB 1355) authorized local housing finance agencies to sell tax-exempt revenue bonds in order to finance low-interest loans for low and moderate income housing. There is no statutory limit on the amount of bonds issued under this program. The State Housing Bond Credit Committee has the authority to review and disapprove or reduce bond issues.

Chart 19 shows the increase in housing bonds compared to other state and local bonds. In 1977–78, housing bond sales totaled $415 million, or 15 percent of the $2.6 billion in sales. By 1979–80, of $4 billion in total bond sales, $2.2 billion, or 55 percent, were housing bonds.

Future of Housing Bond Growth

Both the state and federal governments have recently expressed concern about the rapid growth in housing revenue bonds. The U.S. Congress has passed legislation limiting the uses of these bonds and eliminating their tax-exempt status as of December 31, 1983. The threat of such federal action led to a major increase in the number of local issues proposed during the last three months of 1980. The State Housing Bond Credit Committee recently recommended postponement of several of these local housing bond sales to prevent a flood on the bond market.

Impact on Interest Rates

Bond interest rates are functions of a number of factors including (1) the prime interest rate, (2) the volume of tax-exempt bonds on the market, (3) the type of security provided, in the case of revenue bonds, and (4) the rating of the issuing agency. There is no quantitative method to establish a relationship between any one of these factors and the interest rates on California bonds. However, the 439 percent increase in housing bonds during the last three years seems to have had an impact on interest rates.

Two recent state bond offerings—$100 million in State Water project bonds and $40 million in park bonds—were withdrawn because the bid interest rates exceeded the state general obligation bond ceiling of 9 percent. High interest rates have also affected local revenue bonds, some of which have been postponed or scaled back.

IV. MAJOR COMPONENTS OF THE BUDGET

A. Introduction

State expenditures are traditionally divided into three categories: state operations, capital outlay, and local assistance. Table 40 presents the distribution of expenditures among these categories, for the past, current and budget years, for the General Fund and Special funds. In 1981–82, the Governor's Budget contains an additional category for unallocated cost-of-living adjustments (COLA's) in the amount of $509.1 million. We have separately identified the expenditures from reserves in order to show the total current expenditure level.

Chart 20 shows these categories as a percentage of total General Fund expenditures. Local assistance, as defined in the Governor's Budget, makes up 76.6 percent of total expenditures. In addition, a significant part of the $509 million in unallocated funds for COLA's may be distributed to local assistance programs, further increasing its share of total expenditures.

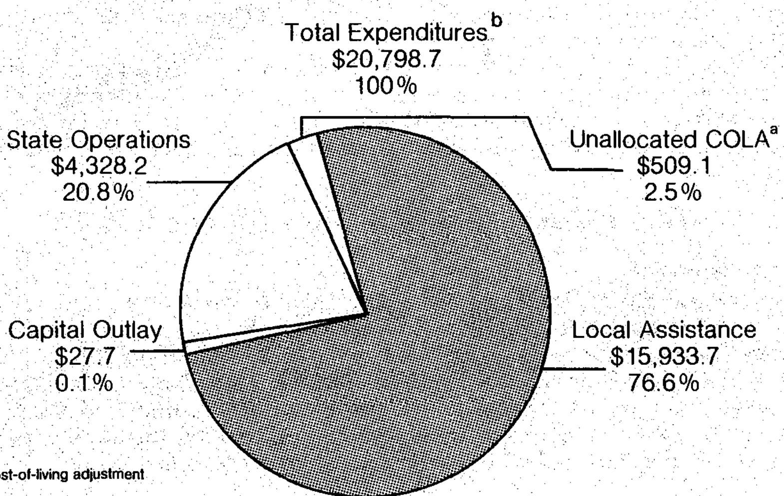
3—81685

Table 40
General Fund and Special Fund Expenditures by Function [a]
(in millions)

	Actual 1979–80	Estimated 1980–81 Amount	Estimated 1980–81 Percent Change	Proposed 1981–82 Amount	Proposed 1981–82 Percent Change
General Fund:					
State operations	$3,609.9	$4,310.8	19.4%	$4,328.2	0.4%
Capital outlay	150.6	58.5	−61.2	27.7	−52.6
Local assistance	14,773.6	16,827.7	13.9	15,933.7	−5.3
Unallocated COLA's [b]	—	—	—	509.1	N/A
Totals	$18,534.1	$21,197.0	14.4%	$20,798.7	−1.9%
Less expenditures from reserves	+317.5	−466.4	—	−28.6	—
Current Expenditures	$18,851.6	$20,730.6	10.0%	$20,770.1	0.2%
Special Funds:					
State operations	$1,175.0	$1,422.6	21.1%	$1,441.6	1.3%
Capital outlay	312.6	617.7	97.6	347.1	−43.8
Local assistance	1,272.8	1,439.6	13.1	1,905.0	32.3
Totals	$2,760.4	$3,479.9	26.1%	$3,963.7	13.9%

[a] Based on amounts shown in the Governor's Budget.
[b] Cost-of-living adjustments.

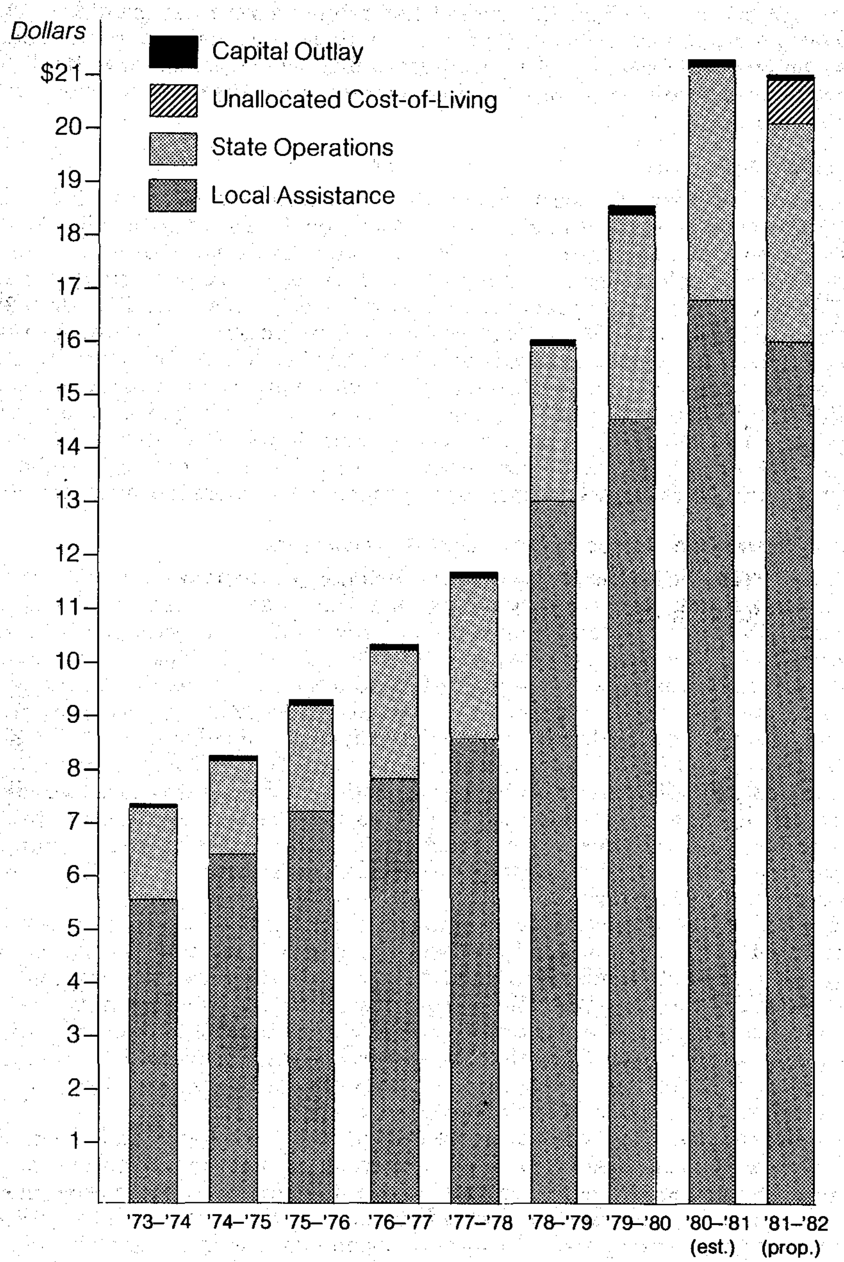
Chart 20
1981–82 General Fund Budget Structure
(in millions)



[a] Cost-of-living adjustment
[b] Includes $29 million in expenditures from reserves.

Chart 21

General Fund Budget Structure 1973–74 to 1981–82 (in billions)



From 1973–74 to 1981–82, local assistance has grown from $5.5 billion to $15.9 billion, an increase of 188 percent. State operations and capital outlay have increased from $1.8 billion to $4.4 billion, an increase of 146 percent. In effect, the

General Fund is becoming more of a funding mechanism for local assistance. Chart 21 shows the increase in local assistance and in total state expenditures.

B. State Operations

The budget proposes a minor increase, 0.4 percent, in General Fund-supported state operations. In effect, the budget has proposed zero net growth in state operations. Should any salary or staff benefit increase be approved for the budget year, however, this category of expenditures will show a larger increase. It is likely, therefore, that state operations will grow by more than the 0.4 percent shown in the budget.

C. Local Assistance

As shown in Chart 21, local assistance increased significantly from 1973–74 to 1980–81—by 204.4 percent in eight years. The growth in state fiscal relief to local governments following the passage of Proposition 13 explains some of this increase. In addition, benefit programs categorized as local assistance have grown rapidly.

The Governor's Budget proposes a decrease in local assistance in 1981–82 of $894 million, or 5.3 percent. This reflects a $500 million reduction in subventions to local governments and schools to offset the $500 million in additional revenue from the unsecured tax role that these entities will receive in 1981–82. Local assistance is also reduced by $420 million in state aid to schools which the budget proposes to replace with $420 million in property tax revenue shifted from cities and counties to schools. Additionally, state contributions to SSI/SSP payments will decline by $201 million. Most other local assistance programs will increase slightly.

Local Assistance Versus Aid to Local Governments

Local assistance, as the term is used in the budget, encompasses a wide variety of programs. Some of these programs, such as the Medical Assistance (Medi-Cal) program, do not provide assistance to local government agencies, but rather, to *individuals.* These payments may be made *directly* to individuals, as in the case of the Renters' Tax Relief program, or individuals may receive them through an intermediary, such as the federal or county governments. Examples of payments made through intermediaries are SSI/SSP payments distributed by the *federal* government, and AFDC payments, which are distributed by *county* governments.

Our analysis indicates that it may be more appropriate to categorize local assistance expenditures in a fashion which reflects the direct beneficiaries of the expenditure. Thus, the present local assistance category might be divided into two new categories, one being "Assistance to Local Governments" and the other being "Assistance to Individuals."

In dividing the present "local assistance" programs between these categories, it is important to keep in mind that some portion of "Assistance to Individuals" actually represents funds distributed to local governments. For example, the Homeowners' Property Tax Assistance program provides *reimbursements* to local governments for the property tax revenue losses attributable to the homeowners' property tax exemption. The reimbursements, however, do not *increase* the fiscal resources of the local governments, but merely replace the property taxes lost due to the provision of tax relief to homeowners.

Conversely, some of the funds distributed to local governments and categorized as "Assistance to Local Governments" represent the state's contribution for programs, operated locally, which provide *services* to individuals. These programs do, in one sense, provide assistance to individuals, but they are not distinguishable from other programs operated by local governments. This is because *all* programs operated by local governments are intended to provide assistance to individuals in one sense or another. Thus, for example, although the state's subvention of funds for County Health Services is expended for programs which assist individuals, the monies represent the state's attempt to help local governments to fund these programs.

Table 41 lists the major "local assistance" programs which our analysis indicates are more appropriately categorized as Assistance to Individuals.

Table 41
Major Local Assistance Programs More Appropriately Categorized as Assistance to Individuals
(in millions)

	Governor's Budget 1981–82
Medical Assistance [a]	$2,575.5
AFDC [b]	1,216.0
SSI/SSP	1,051.0
Developmental Services	512.2
Personal Property Tax Relief	493.2
Renters Tax Relief	425.0
Mental Health [c]	199.9
Homeowners Property Tax Relief	126.0
Senior Citizens Renters Tax Relief	51.5
Senior Citizens Property Tax Assistance	21.0
Subvention for Open Space	14.0
Senior Citizens Property Tax Postponement	5.0
Alternative Energy Tax Credit Refund	5.0
Payments to Local Governments for Sales and Property	3.4
Total	$6,698.7

[a] Excludes county administration.
[b] Grant payments only.
[c] State hospital portion only.

Changes in Reporting Categories

We recommend that the Legislature adopt supplemental report language directing the Department of Finance to revise its presentation of Local Assistance Expenditures.

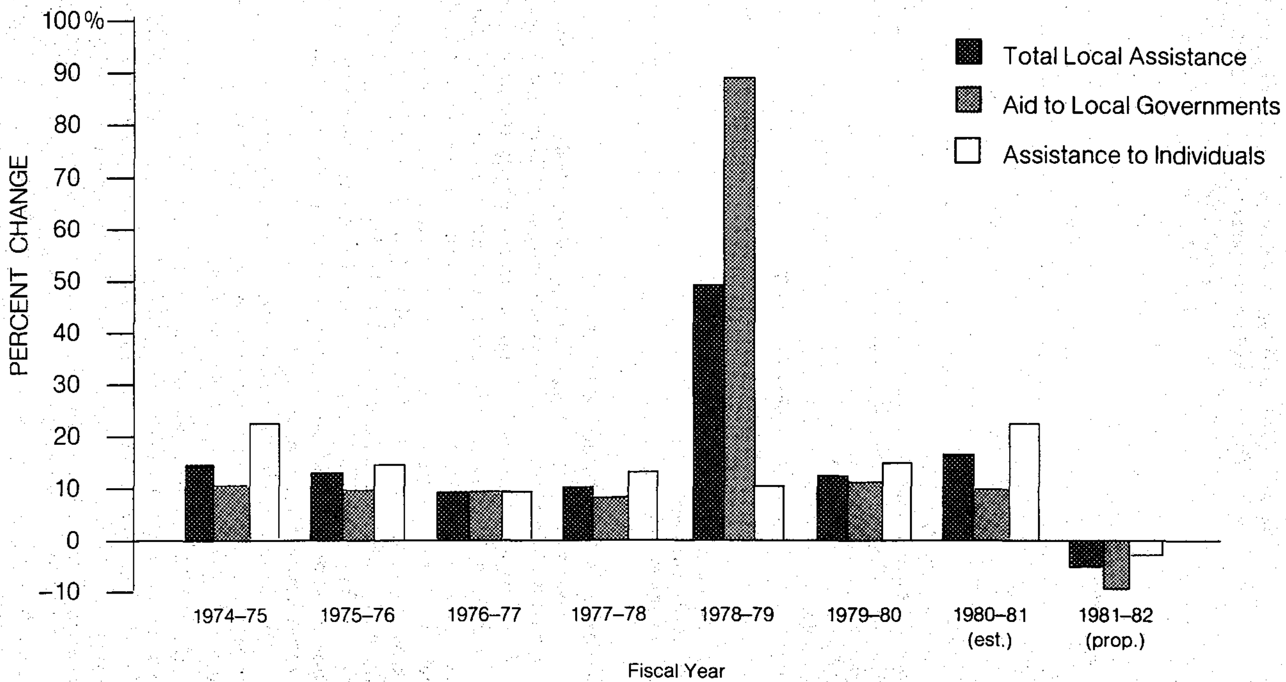
As interest in the distribution of state expenditures by function increases, the usefulness of the traditional reporting categories utilized in the Governor's Budget becomes more and more dubious. These categories were established long ago, and have been maintained for purposes of year to year consistency. Our analysis indicates, however, that these categories have become outmoded as a result of the dramatic shifts in state and local fiscal relationships that have occurred in the last decade. They would be more meaningful and useful if they were altered to reflect these changes. Therefore, we recommend that the Legislature adopt the following supplemental report language:

"The Department of Finance shall revise its presentation of Local Assistance expenditures beginning with the 1982–83 fiscal year, and provide new detail on historical expenditures consistent with this revision."

Chart 22 presents a comparison of the growth in these two categories of local assistance programs since the 1973–74 fiscal year. In six of the eight years shown, the growth in assistance to individuals has exceeded the growth in aid to local governments. Due to the provision of fiscal relief to local governments following passage of Proposition 13, however, aid to local governments increased dramatically in 1978–79—by 92.5 percent. As a result, the growth in aid to local governments exceeds the growth in assistance to individuals over the eight year period. On a cumulative basis, aid to local governments grew by 217.4 percent during the period, while assistance to individuals increased by 155.8 percent. The discrepancy is even larger if projected growth in the budget year is excluded. Through 1980-81, aid to local governments increased by 244 percent, while assistance to individuals grew by 160 percent.

Chart 22

Expenditures for Local Assistance: Aid to Local Governments Vs Assistance to Individuals 1974–75 to 1981–82



Local Fiscal Relief

Table 42 summarizes our estimates of local fiscal relief costs from 1978-79 through 1981-82 under the provisions of Chapter 292, Statutes of 1978 (SB 154), and Chapter 282, Statutes of 1979 (AB 8). These estimates differ somewhat from those in the budget. Our estimates are based on existing law, and do not reflect the effect of the Governor's proposed reductions in local fiscal relief in 1981-82. Existing law calls for fiscal relief in the budget year to increase by $669 million, or 12.3 percent. The table also displays the change in the *form* of fiscal relief to cities, counties, and special districts—from block grants in 1978-79 to property tax revenues shifted from school districts for 1979-80 through 1981-82.

Table 42
Summary of Local Fiscal Relief
1978–79 to 1981–82
(in millions)

	1978–79	*1979–80*	*1980–81*	*1981–82*
Block grants to local agencies	$835	14 [a]	—	—
Property taxes shifted from schools to local agencies	—	782	$923	$1,045 [b]
Business inventory reduction for cities and counties	—	−38	—	—
Health and welfare buy outs	1,079	1,284	1,472	1,673
Education	2,459	2,883	3,048	3,394 [c]
Totals	$4,373	$4,925	$5,443	$6,112 [d]

[a] AB 227.
[b] Assumes 13.2 percent growth in assessed valuation.
[c] Department of Finance estimate.
[d] The Governor's Budget proposes to reduce local fiscal relief to $5,612 million, with reductions primarily in fiscal relief to education and the amount of property taxes shifted to local agencies.

D. Capital Outlay

The Budget Bill includes $386.3 million from all sources for capital outlay. This is $79 million—17 percent—less than the appropriation contained in the 1980 Budget Act. The major changes from the current year appropriations are:

	In Millions
State and Consumer Services	+$26.0
Business, Transportation and Housing	−116.2
Resources	+24.5
Health and Welfare	−39.5
Correctional Programs	+16.9
Postsecondary Education	+16.7
General Government	−8.1

The $116.2 million reduction for Business, Transportation and Housing reflects a decrease of $109.1 million in Department of Transportation capital outlay, and reductions totaling $7.1 million in capital outlay expenditures by the California Highway Patrol and the Department of Motor Vehicles. The fall-off in Department of Transportation capital outlay is due to the fact that resources available to the State Highway account are not sufficient to continue construction at the 1980–81 level.

Table 43 shows how the capital outlay amounts in the Budget Bill are distributed among major categories by fund. These appropriations can be expended over a three to five year period and therefore, do not represent the amount of expenditures to be made in the budget year.

Table 43
Summary of 1981–82 Proposed Capital Outlay Appropriations
(in thousands)

Category	*General Fund*	*Special Funds*	*Bond Funds*	*Total*
Legislative/Judicial/Executive	—	$782	—	$782
State and Consumer Services	—	70,174	—	70,174
Business and Transportation	—	67,958	—	67,958
Resources	—	78,502	$8,288	86,790
Health and Welfare	—	47,695	—	47,695
Correctional Program	$27,669	15,275	—	42,944
Education	—	65,291	3,259	68,550
General Government	—	1,404	—	1,404
Totals	$27,669	$347,081	$11,547	$386,297

As shown in Table 43, the majority of the capital outlay program is supported by special funds rather than by the General Fund. Approximately 30 percent ($108.3 million) of the special funds amount is from the State Transportation Fund and various special funds in the Resources Agency. The remaining 70 percent ($238.8 million) of the special funds amount is from tidelands oil revenue. This is a result of Chapter 899, Statutes of 1980 (AB 2973), which redistributed the state's revenue from tidelands oil. Prior to enactment of Chapter 899, the income derived from tidelands oil revenue in excess of approximately $40 million went into the Capital Outlay Fund for Public Higher Education (COFPHE). In past years, when the price of oil was federally controlled, California received approximately $110 million in tidelands oil revenues annually. With the decontrol of oil prices, these revenues will increase to approximately $455 million in 1980–81 and $534 million in 1981–82. In our analysis of the State Lands Commission's budget we provide a detailed discussion of potential tidelands oil revenues and the effect that decontrol and changes in tax laws have had on this revenue.

Chapter 899 redistributes these revenues into five funds, in addition to the COFPHE. Table 44 shows this distribution, as well as the appropriations in the 1980 Budget Act plus the appropriations and transfers *proposed* in the 1981 Budget Bill. Table 44 also includes expenditure of amounts from the various funds as authorized by legislation other than the Budget Act.

Transfers to the Special Account for Capital Outlay (SAFCO). Control Section 19.18 and 19.19 of the 1981 Budget Bill would transfer $22 million from the COFPHE and $40 million from the State Parks and Recreation Fund to the SAFCO. These proposed transfers would leave a balance available for appropriation of $12.1 million and $7.9 million in the COFPHE and Parks and Recreation Fund, respectively. These transfers are necessary if all capital outlay projects in the 1981 Budget Bill, which are funded from the SAFCO, are to proceed.

General Fund Appropriations. The budget contains $27.7 million from the General Fund for capital outlay purposes. This entire amount is related to the planning of new state prison facilities at San Diego, and Folsom, and partial construction of the facility at Tehachapi. In view of the availability of funds in the various special accounts which receive tideland oil revenue—including $20.4 million in the SAFCO—the Legislature may wish to consider funding the $27.7 million from tidelands oil revenue rather than the General Fund. This would release the $27.7 million of General Fund monies which the Legislature could use for other priority needs.

Table 44
Appropriations and Amounts Available from Tidelands Oil Revenues Under Existing Law (in thousands)

	1980–81	*1981–82*
Revenues		
Balance available from prior year	$299,862	—
Current estimated tidelands oil revenues	455,000	$534,000
Prior expenditure authorizations	−88,827	−38,348
Revenue Available for Transfer	$666,035	$495,652
AB 2973 Transfers		
Capital Outlay Fund for Public Higher Education (COFPHE):		
Amount transferred	$125,000	$98,474
Carry-over from previous year	—	26,526
Amount appropriated	−98,474	−90,894
Amount transferred to SAFCO	—	−22,000
Balance Available for Appropriation	$26,526	$12,106
State School Building Lease-Purchase Fund:		
Amount transferred and continuously appropriated	$100,000	$200,000
Amount available for appropriation	—	—
Energy and Resources Fund (ERF):		
Amount transferred	$120,000	$58,521
Carry-over from previous year	—	61,479
Total Available	$120,000	$120,000
Amount appropriated	−58,521	−117,974
Balance Available for Appropriation	$61,479	$2,026
State Parks and Recreation Fund (SPRF):		
Amount transferred and continuously appropriated	$35,000	$35,000
Carry-over from previous year	—	28,900
Amount appropriated	−6,100	−23,216
Amount transferred to SAFCO	—	−40,000
Amount Available for Appropriation	$28,900	$684[a]
Transportation Planning and Development Account:		
Amount transferred and continuously appropriated	—	$25,000
Amount appropriated	—	—
Amount Available for Appropriation	—	$25,000[b]
Special Account for Capital Outlay (SAFCO):		
Amount transferred	$286,035	$140,657
Carry-over from previous year	—	28,222
Amount appropriated	−257,813	−148,483
Amount Available for Appropriation	$28,222	$20,396

[a] Does not include amount available from other revenue sources—Governor's Budget shows a $7,869,100 balance.
[b] Does not include amounts available from other revenue sources—Governor's Budget shows a $30,665,271 balance.

Capital Outlay Issues

The capital outlay proposals in the Budget Bill raise several major issues which we believe should be highlighted for legislative consideration. These are:

- ***Prison Facilities.*** The budget contains funds to continue planning prison facilities and provide for partial construction of the Tehachapi project. The anticipated completion of the new facilities, however, is behind the Department of Corrections' schedule by as much as one year. This delay, early in the planning process, conflicts with the Legislature's intent to expedite this program. The reasons for this delay and the measures required to expedite the program should be identified by the administration.

• ***Cogeneration Facililty.*** The budget contains several appropriations to develop cogeneration utility facilities at a number of state-owned locations. The expressed intent at many of these facilities is for the state to generate electricity *and sell the electricity to utility companies.* In effect, this puts the state in the utility supply business. We believe this is a major policy issue which should be considered in legislation other than the Budget Act.

• ***Replacement of Polychlorinated Biphenyls (PCB).*** The budget includes $30 million for the purpose of containment, replacement, storage, and disposal of hazardous electrical transformers and switches containing PCBs. The administration proposes to replace *all* such equipment, even though a large portion of the equipment may not have to be replaced under current federal environmental regulations. The administration is contracting with private consultants for the purpose of identifying the specific location of the PCB-filled electrical equipment. Until the consultant's study is completed and available for review, the magnitude of the problem of hazardous PCB equipment cannot be determined. However, from 1929 until 1971, PCBs were used in a high percentage of electrical transformers and capacitors. Thus, if the state is to replace all such state-owned equipment, it is almost certain that the proposed $30 million will not be adequate.

This program not only has significant cost implications, it may also represent a significant state liability with regard to replacing, storing and handling this equipment. The handling and storage of PCB is governed by strict federal environmental regulations, and if the state is to embark on this program, the Legislature should be advised of the potential state liability.

Transportation. The budget does not provide funding for Department of Transportation capital outlay expenditures of approximately $105 million which are programmed in the 1981 Proposed State Transportation Improvement Program. By June 30, 1982, all but $2.1 million of the remaining unrestricted reserve in the State Highway Account will be encumbered. This account balance, however, makes no allowance for approximately $13 million in lump-sum pay increases that are due the department's employees pursuant to Chapter 192, Statutes of 1979 (SB 91). When allowance is made for this obligation, it is apparent that *the department may be unable to match all federal funds currently budgeted for expenditure in 1981–82.*

E. Impact of Inflation and Population on Expenditure Growth

Table 45 shows the increase in General Fund and Special fund expenditures from 1970–71 to 1980–81. It attempts to explain the growth in expendures which can be attributed to inflation and population growth as opposed to other factors such as new programs.

During this 10 year period, General Fund expenditures increased by $15.9 billion. Of this total:

- $5.4 billion (or 33.7 percent), is due to *inflation.* This amount represents the extra funds needed during the current year to purchase the same level of total services purchased in the base year of 1970–71. This estimate was computed using the GNP price deflator for state and local governmental services as the measure of inflation. During the last three years, the GNP index has had lower rates of increase than the California Consumer Price Index.
- About $909 million of the increase (or 5.7 percent), represents the extra funds needed to maintain the same level of *per capita* expenditures as in the base year.
- An additional $1,003 million (or 6.3 prcent), was needed to offset the *inflation effect* on the growth in population.
- These three categories account for about 46 percent of the total increase in General Fund expenditures.

- Local fiscal relief provided in the wake of Proposition 13 accounts for $5.4 billion in the current year, or 34.3 percent of the total increase.
- The remaining $3.2 billion, or 20 percent, represents all other factors such as new programs and their increased costs due to inflation, increased levels of services and workload increases which exceed population growth. *In other words, four out of every five dollars of the total increase in General Fund expenditures during the last decade can be attributed to inflation, population growth or post-Proposition 13 local fiscal relief. Only one dollar represents new programs or increased levels of state governmental services.*

Table 45 also shows these same relationships for total state expenditures.

Table 45
Impact of Inflation and Population on Expenditure Growth
1970–71 to 1980–81
(in millions)[a]

	General Fund Expenditures		*Total General Fund and Special Fund Expenditures*[b]	
	Amount	*Percent of Total Increase*	*Amount*	*Percent of Total Increase*
A. Actual Total Increase in Current Dollar Expenditures	$15,876.7	100.0%	$17,735.7	100.0%
Minus:				
Increase Needed to Adjust 1970–71 Expenditure Base for:				
—*Only* population growth[c]	909.2	(5.7)	1,163.9	(6.6)
—*Only* inflation[d]	5,351.9	(33.7)	6,850.7	(38.6)
—Additional increase needed to adjust for *both* population growth and inflation simultaneously[e]	1,002.6	(6.3)	1,283.2	(7.2)
Subtotals, Increase Needed to Adjust for Both Population Growth and Inflation	$7,263.7	45.8%	$9,297.8	52.4%
Equals:				
B. Total Increase Remaining *After* Adjustment of 1970–71 Base for Inflation and Population Growth	$8,613.0	54.2%	$8,437.9	47.6%
Minus:				
—Increase due to AB 8 and SB 154	5,443.0	(34.3)	5,443.0	(30.7)
Equals:				
C. Remaining Increase Due to All Other Factors	$3,170.0	20.0%	$2,994.9	16.9%

[a] Detail may not add to total due to rounding. Expenditures *exclude* expenditure from reserves.
[b] Does not include bond funds.
[c] Adjusted to maintain the 1970–71 level of per capita expenditures. Does *not* adjust spending to account for changes in the age mix of the population.
[d] Using the implicit Gross National Product (GNP) price deflator for state and local government purchases of goods and services. Does *not* adjust the cost of *new* programs for inflation.
[e] This amount represents the increase in spending to offset the *inflation effect* on the 1970–71 expenditure base for amounts spent on *new* population.

F. Number of State Employees

The Governor's Budget proposes 226,743 state employees in 1981–82, an increase of 270 personnel-years, or 0.1 percent above the number of employees in the current year. The budget reflects a reduction of 629 positions caused by the "special adjustments" contained in the A-Pages of the Governor's Budget. Table 46 shows the adjusted number of employees, by function, for the past, current, and budget years.

Table 46
State Employees by Function
From All Fund Sources
(in personnel-years)
1979–80 to 1981–82

	Actual 1979–80	*Estimated 1980–81*	*Percent Change*	*Proposed 1981–82*[a]	*Change* Amount	*Change* Percent
Legislative/Judicial/Executive	8,714	9,508	9.1%	9,652	144	1.5%
State and Consumer Services	10,671	11,693	9.6	12,012	319	2.7
Business, Transportation and Housing	31,293	31,612	1.0	31,626	14	0.04
Resources	13,780	14,325	4.0	14,619	294	2.0
Health and Welfare	42,325	43,788	3.5	42,657	−1,131	−2.6
K–12 Education	2,665	2,998	12.5	3,001	3	0.1
Higher Education	89,841	89,989	1.7	90,155	166	0.2
Youth and Adult Correctional	12,549	13,503	7.6	13,908	405	3.0
General Government	8,355	9,057	8.4	9,113	56	0.6
Totals	220,193	226,473	2.9%	226,743	270	0.1%

[a] Reflects the special adjustment reduction of 629 personnel-years as described on page A-20 of the 1981–82 Governor's Budget.

The only function showing a decrease is Health and Welfare, where the budget proposes a 1,131 drop in the number of employees. Reductions are *proposed* in the Departments of Developmental Services and Mental Health through (1) "special adjustments" in non-level-of-care positions in the state hospitals, (2) staffing reductions in level-of-care positions due to a decline in client population, and (3) workload reductions in state operations resulting from private nonprofit corporations taking over social work functions. Workload reductions are proposed in the Employment Development Department because of a cut in federal funding. A federal funding shortage is also the cause of the reduction in the number of employees in the Department of Rehabilitation.

Trends in the Number of State Employees

Table 47 shows the growth in the number of state employees from 1973–74 to 1981–82. While General Fund expenditures increased 185 percent during this period, the number of state employees increased 17.5 percent. The rate of growth in the later years is much less than in earlier years.

It should be noted that a year ago the Governor's Budget proposed 221,118 positions in 1980–81. This year's Governor's Budget estimates that there will be 226,473 positions in 1980–81, an increase of 5,355. We are unable at this time to determine how many of these positions were administratively established, proposed by Department of Finance amendment letters, or added by the Legislature. Most of the changes are in Health and Welfare agencies (+2,647) and Higher Education (+1,750).

Employee Compensation

The budget contains no funds specifically for employee compensation. It does, however, leave $509 million available in the General Fund for unallocated cost-of-living adjustments, which may include salary increases. Each one percent increase in employee compensation generates $34 million in costs to the General Fund.

Table 47
Trends in State Employees Growth
From All Fund Sources
(in personnel-years)
1973–74 to 1981–82

	Employees	*Percent Change*
1973–74	192,918	2.4%
1974–75	203,548	5.5
1976–76	206,361	1.4
1976–77	213,795	3.6
1977–78	221,251	3.5
1978–79	218,530	−1.2
1979–80	220,193	0.8
1980–81 (estimated)	226,473	2.9
1981–82 (proposed)	226,743	0.1
Increase from 1973–74 to 1981–82	+33,825	17.5%

V. MAJOR ISSUES FACING THE LEGISLATURE

The budget leaves many issues unsettled that will require legislative action in 1981. For example, the Governor has established a $509 million allowance to fund cost-of-living increases, but has left it up to the Legislature to allocate these funds among various groups. Similarly, the Governor's Budget discusses the proliferation of tax exempt housing bonds, but proposes no remedy.

In the following sections, we discuss some of the major issues requiring legislative action during the current session.

A. Avoiding a General Fund Deficit in 1981–82

During each of the last three fiscal years, state expenditures have exceeded current revenues, and the differences were financed out of the $3.7 billion surplus which accumulated prior to the passage of Proposition 13. According to the Governor's Budget, the General Fund surplus will be virtually exhausted by June 30, 1981. Also, the 1980–81 revenue base is almost $1.7 billion *below* the level of expenditures during the current year, and this revenue gap will be carried over to the budget year. The primary budgetary problem facing the Legislature in 1981–82 is to limit the growth in expenditures so as to eliminate this revenue gap.

The Governor proposes to drastically cut the growth in expenditures by (1) not allowing full cost-of-living and other increases for state and local assistance programs—many of which are entitled to cost of living adjustments under current law, (2) shifting $420 million in property taxes from cities, counties and special districts to schools thereby reducing the need for state aid, and (3) holding-the-line on the growth in many other expenditure programs.

If the 1981–82 budget is enacted as proposed by the Governor, current revenues would *exceed* expenditures by $250 million. This excess would be used to restore the Reserve for Economic Uncertainties to its originally contemplated level of $620 million. Under these conditions the General Fund would avoid a deficit at the end of the budget year, and would have available an amount equal to about 3 percent of revenues.

B. Cost-of-Living Adjustments (COLA's)

Statutory versus Discretionary COLA's. Existing law provides for automatic cost-of-living adjustments for about 20 different programs, most of them in the health, education and welfare areas. These adjustments are generally referred to as statutory "COLA's". In 1981–82, statutory COLA's require increases ranging from 3.9 percent (Medi-Cal drug ingredients) to 16.6 percent (Personal Property Tax Relief). Those COLA's with the largest costs are K-12 education (7.2 percent and $506 million), SSI/SSP (11.2 percent and $349 million) and AFDC (11.2 percent and $153 million). If fully funded, these statutory COLA's would have a General Fund cost of $1.3 billion in 1981-82.

These 20 programs, of course, are not the only ones subject to inflationary pressures. Virtually all programs find that it costs more each year to provide a constant level of services. Most of these other programs historically have received cost-of-living adjustments on a *discretionary* basis, through the budget process. The same is true for state employee salary increases. If these discretionary categories were provided increases comparable to those called for by existing law in the case of programs with statutory COLA's, General Fund costs would increase by an additional $0.7 billion in 1981-82.

We can find no analytical justification for providing some programs with statutory protection from the effects of inflation while many other similar programs do not have this protection. For these reasons we have recommended that statutory COLA's be repealed and that inflation adjustments be provided to all programs that warrant such adjustments through the budgetary process. These adjustments should be based on (1) the best information available on the needs of each program, and (2) the availability of funds to finance such needs.

Governor's Budget Proposals. The Governor has sponsored the introduction of AB 251 and SB 111 which would suspend the operation of the statutory COLA's during 1981-82. This would allow the state to reduce the cost-of-living adjustments in the budget year. The budget provides increases of 4.75 percent for most statutory programs. The three exceptions are: (1) for Medi-Cal hospital inpatient services, which would receive a 15 percent increase as required by federal law, (2) K-12 apportionments and the Master Plan for Special Education, which would receive 5 percent increases and (3) Medi-Cal drug ingredients, which would receive the 3.9 percent statutory increase. These in lieu increases would cost $742 million in 1981-82, or about 56 percent of the amount required by the statutory COLA's.

The budget does not contain any specific funding for the other programs that generally have received discretionary COLA's. Instead, it sets aside $509 million in funds which it states are available to the Legislature to fund discretionary increases, employee salary increases, and additional increases for the programs with statutory COLA's. These funds, however, have not been allocated to specific programs!

The combination of the in lieu ($742 million) and unallocated ($509 million) funds totals $1.2 billion which is about 37 percent *less* than what would ordinarily be provided.

Possible Legislative Guidelines for Apportioning These Funds. We have identified three sets of considerations which the Legislature may wish to use as a basis for apportioning the unallocated funds among individual programs.

First, what is the Legislature's goal in providing cost-of-living adjustments?

Changes in state employee salaries provide a good example where alternative goals are possible for cost-of-living adjustments. For example, it has been the traditional policy of the state to pay salaries to its employees which are *comparable to those paid in the private sector and by other governmental agencies.* Employee groups have supported this concept when private sector salaries were increasing in *real* terms (that is, adjusted for inflation). However, when private sector salaries have failed to keep up with the rate of inflation, (for example in 1980 when average wages increased by 9 percent while the California CPI increased by 15.7 percent) some employee groups have advocated that state salaries should be increased by *the rate of inflation* in order to maintain existing purchasing power. The cost implications of choosing one rather than the other goal can be significant. Those alternative goals also raise the policy question of whether recipients of state funds should be protected against inflation to a greater extent than are the taxpayers who supply the funds to pay their salaries. This policy question has broad implications not only for state employees, but also for local employees and other recipients of state funds (e.g., medical providers, those receiving welfare grants, etc.).

Second, how can the Legislature best achieve its goals in providing cost-of-living adjustments?

Page A-31 of the Governor's Budget shows the wide variations in the size of statutory COLA's called for by existing law. They range from a low of 3.9 percent to a high of 16.6 percent. We find no analytical justification for such a wide variation.

Table 48
Inflation Rates for Different Measure of Inflation
1970 to 1980

	Measures of Annual Average Inflation				*Comparison of CNI and CPI Inflation (Dec. to Dec. basis)*	
	U.S. CPI	*California CPI*	*GNP Consumption Deflator*	*GNP State and Local Government Deflator*	*CNI*	*California CPI*
1970	5.9	5.1	4.6	8.0	—	—
1971	4.3	3.7	4.3	6.9	—	—
1972	3.3	3.4	3.6	5.6	—	—
1973	6.2	5.8	5.7	6.9	8.1	7.6
1974	11.0	10.2	10.0	9.8	9.3	12.1
1975	9.1	10.4	7.7	9.3	6.5	8.7
1976	5.8	6.3	5.1	6.8	4.8	5.4
1977	6.5	7.1	6.0	6.6	7.9	7.3
1978	7.7	8.1	6.9	7.5	8.7	7.5
1979	11.3	10.8	8.9	8.2	13.0	15.7
1980	13.6	15.7	10.3	8.9	12.0	12.7

Last year, the Legislature gave a great deal of attention to the various types of indexes used for COLA purposes, and to the limitations of these indexes. Table 48 shows the inflation rates over the last decade, as measured by five of the more commonly used indexes. The table shows that:

- Inflation during 1980 as measured by the California CPI, was 15.7 percent, which was 2.2 percentage points higher than the U.S. CPI. This difference in inflation rates was primarily due to the relatively more rapid increases in shelter costs in California than in the nation generally. However, many experts in and out of government have criticized use of the CPI to measure inflation for purposes of adjusting program/benefit levels because of the manner in which it measures a fixed market basket of goods and services, and especially for the way it treats homeownership costs. The published indexes do *not* present an accurate picture of the change in actual homeownership costs for the vast majority of families, namely those who have lived in their homes for more than a year. This is because the CPI reflects changes in prices and *interest costs* associated with home *purchases*—but only about 6 percent of the total number of homeowners buy a home in any particular year. During periods of high inflation and high mortgage interest rates, recent home purchasers are not representative of homeowners generally.
- The *GNP personal consumption deflator* is another index used to measure national inflation. It measures the change in prices for actual purchases of goods and services rather than for a fixed market basket. Also it is constructed

using the *rental* value of *all* types of homes, and not the prices and interest costs of newly purchased homes. In these two respects, this index is preferable to the CPI as an indicator of how inflation *currently* is affecting the vast majority of families. In 1980, this index showed an inflationary rate of 10.3 percent, which was 31 percent lower than the increase in the U.S. CPI, and 52 percent lower than the increase in the California CPI.

- The *GNP State and Local Government Deflator* is another national index which measures the change in prices paid by state and local governments. (There is no separate index just for state governments.) In 1980, this index indicated an inflationary rate of 8.9 percent, which was lower than the GNP personal consumption deflator.
- The *California Necessities Index* was specially constructed last year to serve as a basis for increasing SSI/SSP and AFDC welfare grants in California. It is constructed using certain components of the California CPI index that correspond generally to the necessities of life—food, clothing, shelter, transportation, and utilities. Its five spending categories, however, include many subitems which are not typically related to the spending patterns of welfare recipients, such as the new car purchase element in the transportation category, and restaurant meals in the food category. The index could be improved by redefining some of the spending subcategories. In 1980, this index showed an inflationary rate of 12 percent, which was only 0.7 percentage points lower than the California CPI for the same time period.

Due to the measuring defects in the CPI, we recommend that the Legislature use the two GNP deflators as a basis for judging how inflation is affecting private citizens generally and state and local governments. If refinements can be made in the CNI, this may prove to be a better measure of inflation's effect on welfare recipients.

Third, what would be the effects on recipients and programs of not providing full cost-of-living adjustments, and can these effects be measured?

The effects of inflation on state and local programs and activities will depend on two factors:

1. How much control does the recipient have over the level of its expenditures. One group of recipients may be able to change the way it spends its money so as to maintain (or nearly maintain service levels) without a full cost-of-living adjustment. It might do this by deferring capital expenditures, substituting one group of workers for another, or increasing productivity. Another group may not be able to make these adjustments. For example, welfare recipients may not be able to change suppliers, and cannot make a fixed amount of money "go further" by increasing productivity.
2. How important is state aid to the recipient? Those programs which traditionally have received most of their funds from the state are most likely to have to cut back service levels if the state fails to provide a cost-of-living adjustment. Other programs may be less vulnerable because they have access to local or federal funds or can increase fees to generate additional revenue.

Unfortunately, it will be impossible for the Legislature to determine the programmatic effects of providing less than a full cost-of-living adjustment to a particular program, in many cases. This is most likely where a program's goals are unclear, or where there is not adequate information on program performance or expenditures.

Conclusion and Recommendation. Clearly, there are not enough funds available under existing tax laws to provide full cost-of-living adjustments for all programs in 1981-82. Thus the Legislature will have to make a number of tough decisions in allocating the available funds among the many claimants for those funds. In making these decisions, we recommend that:

1. The Legislature defer a final decision on cost-of-living adjustments until after the Department of Finance has completed the May Revision to the budget, when better information on state expenditures and revenues will be available.
2. The Legislature utilize the GNP deflators as a measure of inflation for those programs affecting citizens generally, or state/local programs.
3. The Legislature base state employee salary adjustments on pay levels for comparable occupational groups in non-state employment, rather than on cost-of-living considerations.
4. The Legislature give its highest priority to those programs which can clearly demonstrate that a reduction in state funding will lead to a direct and proportionate reduction in essential service levels. Conversely, the Legislature should give its lowest priority to those programs which are unable to demonstrate that a reduction in funding will have a direct and proportionate reduction in essential service levels.

C. 1978-79 Unsecured Property Tax Collections

When Proposition 13 was adopted in 1978, it was not clear which tax rates should be applied to the unsecured property on the *1978-79 tax roll.* In an August 1980 decision, the California Supreme Court ruled that the pre-Proposition 13 rates should be applied to this property. This will result in a *one-time* increase in property tax because after 1978-79 the post Proposition 13 tax rates applied.

The Governor's Budget proposes that the additional local property tax collections attributable to the Supreme Court's decision on the 1978–79 unsecured property roll be, in effect, redirected to the state and used for specific, one-time, expenditures. These revenues, estimated in the budget to total $500 million statewide, would otherwise accrue to local governments and schools, once the current legislatively imposed freeze on their collection and distribution expires on July 1, 1981. It is important to note, however, that the school district portion of these revenues estimated at $265 million, would automatically accrue to the state under current law, because increases in local property tax revenues automatically offset a corresponding amount of school apportionments.

The budget proposes that the estimated $235 million which would otherwise accrue to cities, counties, and special districts be utilized instead for state purposes. This money would be redirected to the state by reducing the amount of reimbursements paid by the state to local governments to compensate them for the property tax revenue losses resulting from the homeowner's and business inventory property tax exemptions. According to the companion bills to the budget (SB 111/AB 251), however, the amount of the reduction for each local agency will be computed on the basis of the gross tax levels, rather than the amount actually collected and distributed to that local agency. Thus, *it is probable that more will be taken away than is distributed to these agencies.* This is illustrated in Table 49.

Table 49
Difference Between Amount of Reductions Proposed and Amounts Estimated in Governor's Budget (in millions)

	Based on SB 111/AB 251	*Based on Budget Estimates of Collections*	*Difference*
School districts	$265.1[a]	$265.1	—
Cities	57.7	50.0	$7.7
Counties	173.3	150.1	23.2
Special districts	40.4	35.0	5.4
Totals	$536.5	$500.1	$36.4

[a] Not applicable to school districts.

Another problem with the Governor's proposal relates to the state's ability to reduce the subventions for reimbursement of the homeowners' property tax exemption. Article XIII, Section 25, of the state Constitution requires that these *reimbursements* be paid in the same fiscal year as the revenue loss occurs, and Section 24 refers to the *subventions* made under Section 25. This language appears to preclude any reduction in these subventions.

Thus, all of the required reductions may have to be taken from business inventory exemption reimbursements under the language of the companion bills to the budget. This may cause additional problems, to the extent that an agency's share of the unsecured roll money exceeds its allocation of business inventory reimbursements. This would occur in areas with large amounts of business equipment but little inventory, and would mean that the agency's full share of the reduction could not be achieved.

D. Proposed Property Tax Shift

The Governor's Budget proposes to shift $420 million in property taxes from cities, counties, and special districts to K–12 school districts and community colleges. This is to be effected by reducing the local agency share of the existing 1 percent tax levy, and increasing the K–12 school district and community college district shares. In so doing, the amount of local property tax revenues available for support of schools increases, and the state's General Fund cost for school apportionments is reduced correspondingly.

Our analysis of this proposal indicates that several potential problems have not been addressed by either the Governor's Budget or the companion bills to the budget. First, the amount to be shifted will probably *exceed* the $420 million identified in the Governor's Budget. This is because the implementing language contained in the companion bills to the budget does not take into consideration the growth in assessed values projected for the 1981–82 fiscal year. Property tax allocations for any fiscal year are based on each agency's allocation from the prior year, plus a share of the *growth* in revenue generated by the growth in assessed values. The Governor proposes to adjust each local agency's share of the 1980–81 allocation, for purposes of computing the 1981–82 allocation, by its share of the $420 million to be shifted. However, an adjustment of $420 million to the 1980–81 allocations also affects the allocation of the revenue produced by the growth in assessed values for 1981–82. Based on the estimate of assessed value growth used in preparing the budget (13.2%), schools would stand to receive an increase of $475 million in 1981–82. Other factors, discussed below, however, would impinge on this.

Second, some county governments would be exempt from the property tax shift. This is because the reduction in property tax allocations for each type of local agency (cities, counties, special districts) is to be divided among all agencies of that type on the basis of the "state assistance payments" received by each agency under the provisions of AB 8 (Chapter 282, Statutes of 1979). In essence, "state assistance payments" are equal to the amount of property tax revenue transferred *to* each local agency from school districts as replacement for the block grant fiscal relief provided by SB 154 (Chapter 292, Statutes of 1979).

For counties, the calculation of "state assistance payments" involved two adjustments to the amount of their SB 154 block grants. First, the block grant was increased to reflect the increased county responsibility for the costs of the AFDC program imposed by AB 8, and secondly, it was reduced to reflect the new subvention of funds for county health services provided by the state. In the case of eight counties, the result of the computation was a *negative amount*, indicating that they should transfer some of their existing property tax revenues to schools in order to compensate for the increase in direct state assistance. It is not clear that any of the eight counties actually did this. Taking the Governor's proposal literally would require that school districts in these counties transfer funds *back to* the counties, which is clearly not in line with its intent. This problem raises a broader question, however, which is: to what extent does "state assistance payments" for counties constitute an appropriate means of allocating the $150 million reduction for counties? For example, Los Angeles County spends approximately 25 percent of the amount spent by all 58 counties, yet under the Governor's proposal it would have to absorb 53 percent of the reduction in county property tax revenues. Meanwhile, some counties would bear little or none of the reduction.

Third, because of the Governor's proposal to offset the 1978–79 unsecured roll collections by reducing homeowners and business inventory subventions, the share of property taxes transferred to schools will be *less* than the amount intended for transfer. This is because these subventions are treated just like property tax collections in distributing the funds. Thus, the share of property tax transferred also must be proportionately reduced for the reduction in subventions.

Fourth, in some counties the transfer of property tax revenues will exacerbate existing problems with respect to the appropriations limits of certain school districts. For example, some school districts are currently receiving levels of property tax revenue which exceed their appropriations limits for purposes of Article XIII B of the state Constitution. Any *additional* property tax revenues they receive must simply be rebated to local taxpayers, thus reducing the offset to state school apportionment costs.

Finally, the proposal requires that county auditors recompute local property tax allocations, and Legislative Counsel has identified this as a mandated local program. Although the companion bills to the budget contain language disclaiming the state's responsibility for reimbursing these costs, the state may nevertheless be obligated to provide for reimbursement under Article XIII B, Section 6 of the state Constitution. These costs may be significant, if experience with AB 8 can be used as a guide.

E. Reductions in Local Fiscal Relief and Other Local Aid

The Governor's Budget proposes that a total of $931 million in local aid be eliminated in the 1981–82 fiscal year, relative to the amounts that would be provided under current laws. These reductions consist of:

- A $472 million reduction in local fiscal relief. This amount consists of $420 million resulting from the shift in property taxes to schools, and $52 million resulting from the proposed reductions in cost-of-living adjustments for AFDC and County Health Services.
- Schools would experience a $165 million reduction because the COLA would be reduced from its statutory level of 7.2 percent to the budgeted level of 5 percent.
- Business inventory payments to local governments would be reduced by $59 million because the COLA would be reduced from the 16.6 percent statutory level identified in the Budget to the 4.75 percent level proposed in the budget our analysis indicates that this reduction would actually equal $42 million, as the budget overstates the actual statutory requirement of 13.1%.
- Homeowners and business inventory exemption payments to cities, counties and special districts would be reduced by $235 million to compensate for the increased revenues these governments will receive from the unsecured prop-

erty taxes on the 1978–79 tax roll. (There will also be a reduction of $265 million in school apportionment costs, but this will occur under the operation of current law and therefore is not counted as part of the Governor's proposed reductions.)

The distribution of these cuts in assistance among the different types of local jurisdictions is illustrated in Table 50.

Table 50
Distribution of Cuts in Local Aid
(in millions)

	Local Fiscal Relief	*Other Local Aid*[a]	*Unsecured Property Tax Offsets*	*Total*
Cities	$240	$8	$55	$303
Counties	202	20	150	372
Special districts	30	6	30	66
Schools	—	190	—[b]	190
Totals	$472[c]	$224	$235	$931

[a] Reflects reductions in statutory cost-of-living adjustments for school apportionments ($165 million) and Business Inventory Exemption Reimbursements ($59 million).
[b] A $265 million reduction in school apportionments occurs under operation of current law.
[c] Differs from figure implied in Governor's Budget (page A-19) of $572 million because the budget assumes that $100 million of the $165 million COLA reduction in school apportionments is allocated to fiscal relief.

It should be noted that a portion of the reduction in aid to counties, $23 million, is accompanied by decreases in expenditure requirements and thus has a net effect of zero on county budgets.

The budget documents assert that these cuts for agencies other than schools will require only a 3 percent reduction in local government expenditures. Our analysis indicates that these cuts are more likely to approximate 5 percent for cities and counties, and that the resources remaining after the cuts are implemented may permit only a 4 or 5 percent increase in expenditures.

F. Controlling the Proliferation of Tax-Exempt Bonds

In our earlier discussion on state borrowing, we noted that the volume of tax-exempt bond sales has dramatically increased during recent years. The issuance of tax-exempt revenue bonds, especially housing bonds, account for much of the growth. From 1977–78 to 1979–80, the annual sales of state and local housing bonds increased from $416 million to $2,240 million, or by 439 percent. In contrast non-housing bond sales *decreased* by 19 percent—from $2,163 million to $1,747 million. Local housing bond sales alone were up $1,075 million, or nearly 1,200 percent.

The increase in tax-exempt housing bonds represents a response to the high interest rates on conventional mortgage loans. The U.S. Congress recently approved legislation which eliminates the tax-exempt status of selected housing bonds as of December 31, 1983. This will eventually slow down the program, but the state needs to provide some control over the sales of these bonds in order to maintain a functioning bond market that is essential if public works are to be financed.

We also believe the growth in state non-housing revenue bonds is cause for concern. Seven of the fourteen authorized programs have no statutory limitation on the amount of debt that can be incurred. Most of the issuing agencies do not have to submit proposed sales to the Legislature for review.

Given that these state and local bonds (1) decrease state tax revenues and (2) tend to increase the interest rates for all public borrowing, we recommend that the Legislature reevaluate existing tax-exempt bond programs to establish statutory limitations on the amount of debt that can be incurred under each program.

G. Legislative Oversight of Capital Outlay Appropriations

The powers and duties of the State Public Works Board are defined in Government Code Section 15752 et. seq. The board consists of three voting members—the Directors of Finance, Transportation and General Services. Six legislative members act as advisors to the board but do not vote. The board's duties include determining if and when construction, improvements and the purchase of equipment shall be undertaken.

The Legislative Analyst's Office has traditionally served as staff to the legislative members of the board. In undertaking this responsibility, the Legislative Analyst's staff reviews proposals on the board's agenda and participates in the monthly meetings. During recent years, the Legislative Analyst's staff workload related to Public Works Board activities has increased significantly. This is because the Department of Finance is not adequately performing it's role of reviewing the details of projects proceding to the board. This results in board agendas which include projects for which (1) cost estimates are inadequate, (2) estimated project costs exceed the amount that the board can approve, (3) the scope differs from that approved by the Legislature and/or (4) features are proposed that were specifically denied by the Legislature or which are contrary to legislative intent.

In many cases, the board will defer action on such projects, after these issues have been raised. On other occasions, however, the board has approved projects which exhibit one or more of these problems. Projects with these problems should not be placed before the board prior to appropriate review and approval by the Department of Finance. Consequently, the process needs to be modified to assure that the Department of Finance effectively reviews projects prior to including them on the board's agenda.

In an effort to improve the Public Works Board process, we believe the following changes should be made:

- All administrative staff to the board should be located within the Department of Finance.
- All acquisition and development projects should be reviewed and approved by the Department of Finance prior to being included on the board agenda.
- The supplemental report of the annual Budget Act should include a description of the legislatively-approved project scope.
- Each month, prior to the board meeting, the Department of Finance should submit a letter to the chairperson of each fiscal committee, the Chairperson of the Joint Legislative Budget Committee and the legislative members of the board, indicating that the projects adhere to legislatively-approved scope and cost. If the Department of Finance approves changes, pursuant to Section 8 of the Budget Act, the department should indicate the changes and associated cost implications.

Many of these changes can be made administratively and/or through budget language under Control Section 8. In our analysis of the control sections, we will recommend specific budget language to implement these changes.

A brief discussion of the suggested changes follows

Staff changes. Currently, the secretary to the board is located in the Department of General Services, Real Estate Services Division. The chairperson of the board, however, is the Director of Finance. The staff to the board should be directly responsible to the chairperson—the Director of Finance. Moreover, the Department of Finance is the administration's fiscal control agency, and the responsibility for the Public Works Board agenda and cost controls should rest entirely within the Department of Finance.

Site acquisition. Currently, property acquisition projects are placed on the board agenda by the Department of General Services, Real Estate Services Division. These items are generally placed on the board agenda without being reviewed or approved by the Department of Finance. The Department of General Services, Real Estate Services Division, is a service organization which provides expertise in the purchase/selling of real estate. However, the policy and cost implications of proceding with an acquisition project should rest—as it does with respect to other capital expenditures—with the Department of Finance.

Supplemental report language. Except in the area of higher education, the Governor's Budget no longer includes a description of capital outlay projects. Moreover, many times during the course of legislative hearings, the Legislature approves a project which differs from the one proposed by the administration. After a project is funded in the Budget Act, it must be reviewed by the State Public Works Board before funds are released. Although there are legislative advisors on the board, the voting members of the board are part of the administration. Thus, the board is an arm of the administration and is outside the legislative process. Consequently, to assure that the board has a clear statement of legislative intent available at the time it considers projects, the supplemental report to the Budget Act should include a brief description of the scope of each capital outlay project as approved by the Legislature.

Department of Finance certification of project scope. Control Section 8 of the Budget Bill specifies that no changes shall be made in an approved project unless such changes are approved by the Department of Finance. We recommend that in the future, prior to each board meeting, the Director of Finance submit a letter to the chairperson of the two fiscal committees, and the chairperson of the Joint Legislative Budget Committee and the legislative members of the board, certifying that all projects on the board agenda are within the scope and cost approved by the Legislature. If any changes in the scope and cost are approved by the Department of Finance, the monthly letter should so indicate. Under these circumstances, we would review on behalf of the legislative members only those projects for which the Department of Finance has indicated that changes have been made.

In the past, we have recommended that Section 15770 of the Government Code be amended to revise the composition of the State Public Works Board by removing the Director of General Services and adding the Director of Housing and Community Development. We continue to recommend this change. The Department of General Services, by way of its "service agency" role to other state agencies, participates in the development of a substantial number of projects that the board must act on. Thus, many issues which arise at the board directly involve decisions made by Department of General Services. This places the Director of General Services in a position of constantly having to approve—or disapprove—proposals that are developed by the director's staff and in many cases have already been approved by the director himself. This puts the director in a difficult position by, in effect, giving him a direct stake in the outcome of the votes he must make.

The Director of Housing and Community Development would not be subject to the same conflicting pressures. The director would have no direct stake in the outcome of the board's action in a vast majority of cases. Furthermore, the director's interest in the state's acquisition and construction projects and their impact on community development would be an asset to the board. This change would require specific legislation and could not be made through the Budget Act.

H. Legislature's Flexibility Restricted by Special Funds and Accounts

Allocation of tidelands oil revenue. Chapter 899, Statutes of 1980, provided for the redistribution of tidelands oil revenue that would have otherwise been deposited in the Capital Outlay Fund for Public Higher Education (COFPHE). In past years, California received approximately $110 million in tidelands oil revenue. Of this amount, about $70 million went into the COFPHE. Current estimates, however, indicate that California will receive approximately $455 million and $534 million in 1980–81 and 1981–82, respectively. Because of the anticipated increase in revenues, the Legislature, under Chapter 899, redistributed the revenues in the following priority sequence, after accounting for prior expenditure authorizations:

- $125 million—COFPHE.
- $200 million—State School Building Lease/Purchase Fund.
- $120 million—Energy and Resources Fund.
- $35 million—State Parks and Recreation Fund.
- $25 million—Transportation Planning and Development Fund.
- Remaining balance—Special Account for Capital Outlay.

Legislative options limited. Depositing the tidelands oil revenue into special purpose funds tends to limit the Legislature's options in allocating state funds. The Legislature can take action to transfer amounts between funds—as the Budget Bill proposes under Sections 19.18 and 19.19—or into the General Fund. Such transfers, however, are not easily accomplished, however, once specific projects are proposed for funding from the special purpose fund. Thus, what the Legislature might consider to be a lower priority proposal may be approved simply because the proposal is funded from, say, the Energy and Resources Fund and did not have to compete with other statewide needs. At the same time, a General Fund program deemed by the Legislature to have a high priority may go unfunded because sufficient revenue is not available.

These special funds limit the Legislature's options in establishing priorities for expenditure of all state funds. To remedy this, the Legislature could:

- Insert a control section in the Budget Bill to transfer all tidelands oil revenue to the General Fund, and thus consider all needs on a priority basis from the same fund source.
- Enact legislation to modify the distribution of tidelands oil revenue and increase the Legislature's flexibility to fund state priorities.

Special accounts and funds in the Resource Agency. Departments, boards and commissions in the Resources Agency, and to a lesser degree those in other agencies, have been the recipients of substantial additional funding in recent years through the creation of special accounts and special funds. Most of the money in these accounts or funds is General Fund money or is a diversion of money that would otherwise be deposited in the General Fund. Many of these accounts and funds have been established for special purposes. The number of these accounts and funds has proliferated to the point that they greatly complicate the Governor's Budget and the Budget Bill. Some departments have had a doubling or tripling in the number of separate budget items on which they depend, in the last year or two.

These special accounts and funds sometimes confuse the evaluation of programs and cause the total available resources to be misunderstood. For example, the Department of Forestry has about $8 million for its traditional programs to administer the Forest Practice Act and to conduct other resource and management programs on forest lands. Last year the department initiated a new forest improvement program to finance the replanting of private timber lands. This was financed with approximately $7 million which was derived from a diversion of state forest timber sales revenues from the General Fund to a new Forest Resources Improvement Fund. For 1981–82, the Governor's Budget requests $4 million from the Energy and Resources Fund to undertake a new program of controlled burning on private lands.

These three programs take on an appearance of separateness because of the way they have been established. They would be much easier to evaluate, to place in a priority perspective and to manage if they were part of an integrated effort that is financed directly from the General Fund. In the present budget, program review, evaluation of accomplishments, determinations on the effective use of funds and staff, and simplified budgeting are all impeded by the unnecessary complexity of this type of budgeting.

I. Controlling Toxic Substances

Last year the Governor's Budget proposed a major increase in state efforts to control toxic and hazardous wastes in the environment. In the 1980 Budget Act, the Legislature authorized approximately $5.4 million in additional state expenditures and 126 new positions for toxic substances control.

This year the Governor's Budget indicates that the administration is proposing an increase of $35,102,643, from all funds, and 91 new positions to expand state efforts during 1981–82. This amount, shown in Table 51, includes $30 million from the General Fund to replace PCB-containing electrical transformers at state facilities.

Table 51
Total Funding California's Toxic Wastes Program
(in millions)

	Actual 1979–80	*Estimated 1980–81*	*Proposed 1981–82*
General Fund	$1.4	$4.6	$35.6
Special funds	2.3	3.9	7.1
Federal funds	2.4	3.0	3.2
Totals	$6.1	$11.5	$45.9

Our tabulation of the increases in individual items of the Budget Bill totals $35,654,007, and 98 new positions. Table 52 identifies, by department, (1) new positions and funding approved by the Legislature in the 1980 Budget Act, (2) proposed new positions and funding requested in the 1981–82 Governor's Budget, and (3) our recommendations on the requested increase, as set forth in this *Analysis*. We discuss each of these recommendations in detail in our analysis of the individual budget items.

As the table indicates, we are recommending approval of $1,749,597 and 42 positions, and a reduction of $2,484,627 and 32.5 positions. We have withheld recommendation on (1) the $30 million requested for removal of PCB-containing electrical equipment from state facilities, and (2) $1,419,783 and 23.5 positions requested for increased monitoring and enforcement of water pollutants. In addition, we are recommending in Item 338-001-001 that legislation be enacted repealing the statutory ban on Solid Waste Management Board participation in hazardous waste management.

Shortage of Qualified Personnel. People skilled in highly sophisticated toxics work currently are in great demand in private industry as well as in state and federal service. Our review of the implementation of staff increases approved for 1980–81 indicates that some state departments are having difficulty in recruiting qualified technical staff. For example, nine of the fifteen new technical positions authorized for the Air Resources Board in 1980–81 were vacant as of January 20,

Table 52
Toxic Waste Programs
1980–81 and 1981–82

Item	Agency	1980–81 Budget Act Authorization Amount	1980–81 Budget Act Authorization Staff	1981–82 Proposed Increases Amount	1981–82 Proposed Increases Staff	1981–82 Analyst's Proposal Amount	1981–82 Analyst's Proposal Staff
065	Office of Appropriate Technology	($242,725)[a, b]	—	($258,600)[a, b]	—	—	—
069	Office of Emergency Services	—	—	40,314	—	—	—
171	Office of State Fire Marshal	317,316[b]	3.0	302,872	3.0	—	—
272	California Highway Patrol	294,123	9.0	158,403	4.0	158,403	4.0
340	Air Resources Board	892,851	18.5	964,582	15.5	—	—
394	Water Resources Control Board	986,171	22.5	1,419,783	23.5	Withhold	
426	Department of Health Services						
	(1) Site Inspections	816,824	22.0	—	—	—	—
	(2) Abandoned Site Search	661,430[b]	23.0	1,115,019	33.0	506,352	23.0
	(3) Epidemiological Studies	442,164	9.0	81,341	1.0	—	—
	(4) Hazardous Waste Recycling	242,725[b]	—	497,185	4.0	454,306	3.0
	(5) Facility Siting	—	—	443,972	2.0	—	—
	(6) Implement AB 2370	—	—	387,859	7.0	387,859	7.0
	(Subtotals)	(2,163,143)	(54.0)	(2,525,376)	(47.0)	(1,348,517)	(33.0)
835	Industrial Relations	716,487	19.0	242,677	5.0	242,677	5.0
983	Statewide—Removal of PCB-containing equipment from state facilities	—	—	30,000,000	—	Withhold	
	Total Increases	$5,370,091	126.0	$35,654,007	98.0	$1,749,597	42.0
	Base Budget	6,100,000		10,300,000			
	Program Totals	$11,470,091		$45,954,007			

[a] Reimbursements from Department of Health Services.
[b] One-year funding and positions.

1981. The Water Resources Control Board was unable to hire enough additional staff to fill the 22.5 new positions authorized in 1980–81, so that existing staff have had to be diverted from other activities to perform toxics work. It thus appears that in some areas, the real constraint on the state's ability to expand these efforts is a shortage of qualified personnel, rather than lack of funding or positions.

J. The AB 8 Deflator

In 1978, following the passage of Proposition 13, the Legislature adopted a one-time package of fiscal relief to schools, cities, counties, and special districts. In 1979, local governments requested that the fiscal relief package be made a permanent feature of the state's program of assistance to local governments, so that they would have a better basis for fiscal planning.

In responding to this request, the Legislature recognized that, if local governments were guaranteed a certain level of funding, and state resources failed to materialize at expected levels, then other state programs would have to bear the brunt of the required cutbacks. In order to provide for this contingency, the Legislature added a provision to the permanent fiscal relief bill (AB 8, Chapter 282, Statutes of 1979) which would reduce state subventions to local governments and schools if state General Fund revenues and the carryover surplus fell below specified amounts.

Based on the Department of Finance's most recent estimates of revenue and the surplus, it is a virtual certainty that the deflator mechanism will go into operation in 1981–82 unless the Legislature acts to prevent it. As enacted, AB 8 contains a provision that allows the Legislature to suspend operation of the deflator through passage of a concurrent resolution. Legislative Counsel, however, has issued an opinion stating that the operation of law cannot be suspended by concurrent resolution, so it appears that urgency *legislation* is required to halt operation of the deflator.

We believe that the Legislature should act to repeal the deflator mechanism, for several reasons. First, it seems to us that the deflator mechanism restricts, rather than enhances, the Legislature's flexibility in responding to the problem of financing California government in the coming year. Many options for addressing the problem are available, and they should all be considered on their merits. Second, the reductions in local aid under the deflator mechanism would be administratively difficult to accomplish, but more importantly, these reductions would have widely varying effects on different local agencies. For example, many county governments would be exempt from the reduction, while others would experience large losses. We know of no analytical basis for allocating the cuts in this fashion. Third, the aggregate amount of the deflator reduction calculated for 1981–82 may bear no relation to the financing problem facing the state. Fourth, the deflator would, in effect, balance the state budget totally at the expense of local budgets. We do not believe that all state-operated programs necessarily have a higher priority than local programs.

In summary, we believe that other more equitable and administratively simpler options are available for dealing with the problem of financing California governments. Accordingly, *we recommend that the AB 8 Deflator be repealed.*

K. Budget Proposals Requiring Implementing Legislation

A significant portion of the Governor's Budget requires additional legislative action before it can be implemented. The following is a summary of budget proposals in this category. Collectively, these proposals involve in 1981–82 cost *increases* to all budget funds of $205 million and cost *savings* of $1,291 million. Not included in either of these totals is the $250 million proposed to be transferred from the Reserve for Economic Uncertainties to the General Fund in 1980–81.

Summary of Proposals in the Governor's Budget Requiring Implementing Legislation

Program	*Proposal*	*Fiscal Impact*
Driver Training	Eliminate support for regular driver training	Saves \$18.9 million (General Fund)
Child Nutrition	Eliminate state subsidy for non-needy meals	Saves \$12.5 million (General Fund)
Deferred Maintenance	Increase state funding for deferred maintenance on school facilities	Costs \$142.2 million (General Fund)
Career Criminal Prosecution Program (Office of Criminal Justice Planning)	(a) Transfer cost of program from the General Fund to Indemnity Fund	(a) Incur half-year costs of \$1.7 million to Indemnity Fund (July through December, 1981); Corresponding General Fund savings
	(b) Extend program past sunset of 1/1/82. Proposal to reauthorize program at a greater funding level	(b) Incur half-year costs of \$2.4 million to Indemnity Fund (January through June 1982)
Indemnification of Private Citizens		
(1) Payment of Victims' Claims (2) Local Assistance (3) Board of Control Services	Fund all of these programs from the Indemnity Fund and eliminate all General Fund support	(a) Requires Indemnity Fund to support an expenditure of \$11.9 million in budget year. Estimated Indemnity Funds available are approximately \$7.7 million. Net cost \$4.2 million. Corresponding General Fund savings.
Office for Citizens Initiative and Voluntary Action	Extend office past 12/1/81 sunset.	Costs \$89,769 (General Fund)
Office of Emergency Services	Enhance earthquake preparedness (legislation desirable; possibly could be implemented by executive order)	Costs \$4.6 million (General Fund)
Judicial	Add 15 judges and 45 related staff to the Courts of Appeal	Costs \$1.8 million (General Fund)
Overall Budget Plan	Shift property taxes from cities, counties and special districts to schools	Saves \$420 million in school apportionment costs; increases costs for local mandate reimbursements (disclaimed)
Overall Budget Plan	Capture Local Unsecured Property Tax Funds through reduction of Homeowners, Business, and Inventory and School Apportionment payments	Saves \$500 million in 1981–82 expenditures
Reserve for Economic Uncertainties	Reduce 1980–81 appropriation by \$250 million	Increases General Fund reserves by \$250 million
Financial Aid to Local Agencies Fund and Litter Tax Fund	Treat the transfer of General Fund monies to these accounts as reductions in Bank and Corporation Tax revenues rather than as General Fund expenditures	None

Program	*Proposal*	*Fiscal Impact*
Development of Information Technology	Establish an Information Technology Revolving Fund for distribution by the Department of Finance	Costs $5 million (General Fund)
Department of Insurance	Increase program activities	Requires increase in $500 maximum assessment paid by insurance companies
Department of Consumer Affairs		
Bureau of Automotive Repair	Maintain and expand activities	Automotive Repair Fund has projected June 30, 1982, deficit of $1.5 million; will require fee increase
Health Services		
Medi-Cal Beneficiary Cost-of-Living Adjustment	Provide a 4.75 percent increase rather than the 11.2 percent increase required by statute	If 4.75 percent can be given savings will be: $19.4 million General Fund $10.1 million Federal Funds $29.5 million Conversely, if current law is not changed, $19.4 million General Fund must be added
Medi-Cal Rate Increases Prepaid Health Plan (PHP)	No funds are budgeted in the Medi-Cal item of the Budget Bill even though state law requires rates based on actual cost adjusted for projected inflation. (The hospital inpatient componement of PHP rates is provided for in the budget.)	Assuming 12 percent projected inflation, PHP rate increases could cost $0.9 million ($0.5 million General Fund)
Medi-Cal Nursing Home and Intermediate Care Facilities, rate increases	No funds are budgeted in the Medi-Cal item of the Budget Bill even though there is federal law and a signed state plan which *may* mandate an increase for these providers	*If* it is determined nursing homes are mandatorily entitled to a rate increase which is based on changes in the CPI (as it has been in the last two rate increases), then an increase of 12 percent would cost approximately $72 million ($36.7 million General Fund)
Welfare Programs	Provide a 4.75 percent cost-of-living adjustment instead of the 11.2 percent statutory amount	Saves $296.4 million (General Fund)
AFDC-Unemployed Parent	Limit eligibility	Saves $30.0 million (General Fund)
SSI/SSP	Eliminate emergency loan program	Saves $1.7 million (General Fund)
Community Care Licensing	Impose licensure fees except for foster family homes and small family residential facilities	Saves $0.7 million (General Fund)
Department of Water Resources		
Weather Modification	Eliminate General Fund support, change to fee support	$64,500 General Fund reduction
Watermaster Service	Change funding from the existing equal sharing between the General Fund and local reimbursements to ⅓ General Fund and ⅔ local reimbursements.	$147,476 General Fund reduction

L. Raising the Yield from Existing Revenue Sources

The primary focus in our analysis is on the Governor's proposed *spending* plan. Our discussion of *revenues* has been confined to evaluating the consistency of the Department of Finance's revenue projections with its economic forecast, and estimating how alternative economic assumptions could affect revenue collections. However, because state government's overall fiscal health is determined by *both* expenditure decisions *and* the revenue structure, *each* of these variables should be carefully examined, particularly during periods of fiscal stringency.

One revenue-related issue the Legislature may wish to consider is whether the current revenue structure itself—which is *not* reviewed annually as are expenditures—is consistent with legislative intent and priorities. The key elements of this revenue structure include the *tax rates*, and the definition of the *tax bases* (including various exemptions) to which these rates are applied. We believe that there are two specific aspects of the tax structure which are particularly in need of review. They are:

- The *adjustment of certain tax rates to account for inflation;* and
- The *effectiveness and efficiency of various tax exemptions, credits, and other "tax expenditures"* in achieving legislative objectives.

1. Adjustment of Tax Rates for Inflation

Most state revenues are raised by applying *fixed* tax rates to various *dollar* tax bases. This means that when inflation occurs, state revenue collections automatically rise in direct proportion to the rise of these tax bases, thereby protecting the general purchasing power of the state's income. Examples of such taxes include the state sales and use tax (which is set at 4.75 percent of taxable sales), the corporation tax (which is set at 9.6 percent of taxable corporate profits), the personal income tax (whose marginal rates range from 1 percent to 11 percent of taxable personal income), and the insurance tax (which is set at 2.35 percent of taxable insurance premiums).

There are some revenue sources, however, which cannot keep pace either with general inflation or inflation in the specific programs which they support. This occurs because the tax base in these cases is measured *not* in dollar terms, but rather in *physical units.* Three common examples are:

- The *cigarette tax* (which is levied on a cents-per-pack basis),
- The *alcoholic beverage taxes* (which are levied on a cents-per-gallon basis), and
- The *motor vehicle fuel taxes* (which are also levied on a cents-per-gallon basis).

The only way that dollar revenues from these types of taxes can automatically rise is when the physical volumes of the taxed items increase. It is only coincidental if such revenue increases are enough to maintain the contribution to the state's purchasing power which these taxes were initially intended to make. Sometimes the physical volume of these taxed items actually *declines,* even though the *dollar* amounts spent on them *rises.* This has been true of gasoline sales during the past several years, because percentage declines in gallons consumed have been more than offset by percentage increases in prices per gallon. Thus, while *sales tax* revenues from gasoline have *risen, fuel tax* revenues have *fallen.*

There are two ways in which revenues from these taxes can be insulated, in whole or in part, from the distorting effects of inflation:

- *First,* the method of raising revenues from items like cigarettes, alcoholic beverages, and fuel taxes could be changed from taxing *physical* quantities to taxing *dollar* amounts sold. This would make these taxes similar to the current sales and use tax.
- *Second,* physical volume could continue to be taxed, but the tax rates could be adjusted for inflation in either the prices of the taxed items, the general costs of operating state government, or the costs of operating specific programs.

Revenue Potential. There have been no changes in the tax rates for cigarettes and alcoholic beverages over the past 10 years. If, however, these tax rates had been adjusted for the full amount of inflation which has occurred in the *prices* of these items during this period:

- *Cigarette tax* revenues would be $192 million higher in 1980–81, reflecting a rise in the cigarette tax rate from 10 cents per pack to 16.8 cents per pack, and
- *Alcoholic beverage taxes* would be *$118 million higher,* reflecting tax rate increases of $1.68 per gallon (from $2.00 to $3.68) for distilled spirits, 3 cents per gallon (from 4 cents to 7 cents) for beer, and up to 10 cents per gallon for certain types of wines.

Alternatively, if these tax rates had been adjusted for increased *general government costs* over the past 10 years—about 110 percent as measured by the GNP deflator for state and local government purchases of goods and services—these revenues would be *$311 million* higher in the case of the *cigarette tax,* and *$160 million* higher in the case of *alcoholic beverages.* These estimates assume that the consumption of cigarettes and alcoholic beverages would be relatively insensitive to the higher tax rates.

In the case of the *gasoline excise tax,* however—which also was not increased during the past decade—estimating the revenue potential of a higher tax rate is more difficult. This because higher gasoline prices would certainly occur if taxes were significantly raised, and there is evidence that gasoline demand *is* somewhat sensitive to higher gasoline prices. For example, gasoline prices have risen by about 285 percent since 1970–71, so a gasoline excise tax rate fully indexed to gasoline costs would have risen from the current 7 cents per gallon to 27 cents per gallon, an increase of 20 cents. *If* the quantity of gasoline sold in 1980–81 were unchanged, this tax increase would raise an additional $2.1 billion in 1980–81. The increase would be less—$825 million—if the tax rate was indexed to inflation in *general government costs,* which would have raised the tax rate to about 15 cents per gallon in 1980–81. In either case, however, there is little question that consumption would have experienced at least some decline, so that the revenue gain would be less than these amounts. It is also not clear that excise tax increases of these magnitudes would even be desirable. This is because the excise tax is intended partly to support highway construction activities, which have been declining in recent years.

Thus, the choice of which measure of inflation is best to use in adjusting tax rates depends upon the specific purpose of each tax. Regardless of which inflation index is used, however, adjusting these tax rates for inflation would significantly increase revenues from certain existing revenue sources which are currently insensitive to inflation. For instance, each 1 cent tax rate increase could raise up to $28 million in cigarette tax revenues, $570,000 for distilled spirits, $6 million for beer, and a maximum of $105 million for gasoline. Many other states have recently made such changes. For example:

- Over the past four years alone, 20 states increased their fuel taxes on gasoline, and as of October 1980 only three states had a rate lower than California's. The national average rate has now risen to 9 cents per gallon (compared to California's 7 cents per gallon).
- Thirty-seven states have increased their cigarette tax over the past decade, and the average tax nationally is now about 13 cents per pack (compared to California's 10 cents per pack).
- Nineteen states have increased their tax on distilled spirits since 1970–71, which now averages $2.71 per gallon nationally (compared to California's $2.00 per gallon).

2. Tax Exemptions, Tax Credits and Other "Tax Expenditures"

The Governor's Budget estimates that in 1981–82, the state will forego $7.9 billion in tax revenues because of various "tax expenditures." This term—tax expenditures—refers to various tax exclusions, preferential tax rates, exemptions, credits and deferrals, which reduce the amount of revenues collected from the basic tax structure. Unlike normal budgeted expenditures, these tax expenditures are not generally reviewed on an annual basis.

The Legislature may wish to examine some of these tax expenditures in order to determine if they are consistent with current legislative intent and priorities, as well as whether their track-record in meeting the Legislature's objectives merits continuing them. Many of the current tax expenditures enjoy widespread support and have fairly clear purposes, such as the personal income tax deduction for mortgage interest paid on principal residences, and the sales tax exemption for food. This is not the case for many other tax expenditures.

A review of the objectives and effectiveness of tax expenditures is particularly desirable at this time. This is because funds "spent" through tax expenditures may be used more effectively in other ways. In some cases, for instance, a tax expenditure may largely be subsidizing individuals or firms for some action which they would have undertaken anyway. In other cases, tax expenditures may be achieving an objective but are too costly relative to either the benefits they produce, or alternative ways of achieving the same objectives.

Examples of tax expenditures which the Legislature might wish to review for continuation or modification include, *among others:*

- Sales tax exemptions for:
  —candy ($55 million)
  —master tapes ($2 million)
  —newspapers and periodicals ($31 million)
  —prescription medicines (up to $75 million)
  —leases of motion pictures ($25 million)
  —vending machines ($16 million)
- Personal income tax deductions for:
  —meals furnished by employers ($12 million)
  —mortgage interest on a *second* home
- Broad-based personal and business tax expenditures on energy-related items ($70 million)
- Motor vehicle fuel tax exemption for aircraft ($45 million)
- Preferential tax rates and breakage treatment in the horse racing industry ($5 million).