CALIFORNIA LEGISLATURE

An Overview of the State's Fiscal Condition in 1982–83

ANALYSIS OF THE BUDGET BILL

of the

STATE OF CALIFORNIA

for the

Fiscal Year July 1, 1982, to June 30, 1983

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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Speaker of the Assembly

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LETTER OF TRANSMITTAL

925 L Street, Suite 650
Sacramento, California 95814
February 24, 1982

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, 1982, to June 30, 1983.

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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INTRODUCTION

This *Analysis* reports the results of our detailed examination of the Governor's Budget. It also contains our recommendations on the budget, as well as our recommendations for new legislation.

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 or does not fall under the legislative mandate of a particular agency.

No attempt has been made, however, to tailor these recommendations in such a way as to achieve a specific overall spending level.

Organization of the *Analysis*

The *Analysis* is divided into three parts:

Part 1, "The Budget Overview," which begins on page A-2, presents data on the budget as a whole—expenditures, revenues, and the General Fund condition—for the purpose of providing a perspective on the budget issues that the Legislature faces in 1982–83. Part 1 of the *Analysis* is divided into seven sections:

I. Summary, which begins on page A-2, briefly discusses expenditures and revenues in 1982–83;
II. Background—the Rise and Fall of the Surplus, which begins on page A-3, traces historical trends in the surplus from 1973–74 to the budget year;
III. Expenditures, which begins on page A-6, details the total spending plan of the state, highlighting the major agencies and programs;
IV. Revenues, which begins on page A-24, discusses the various sources which supply revenues to the state, as well as the economic circumstances that will influence the level of revenues in the budget year.
V. Condition of the General Fund, which begins on page A-56, describes the condition of the General Fund at mid-year 1981–82, as well as pending and proposed actions which will have an impact on the fund in both the short- and long-run.
VI. State Borrowing, which begins on page A-57, discusses general obligation and revenue bonds.
VII. State Employment, which begins on page A-71, looks at trends in the number of state employees, highlighting the agencies that are growing rapidly.

Part 2, "The Major Fiscal Issues Facing the Legislature," which begins on page B-1, discusses the major issues we have identified in our review of the state's current fiscal condition and the Governor's Budget for 1982–83. This part of the *Analysis* is divided into five sections:

I. Revenue Issues, which begins on page B-1.
II. Expenditure Issues, which begins on page B-12.
III. Local Fiscal Relief Issues, which begins on page B-32.
IV. Broad Fiscal Issues, which begins on page B-42.
V. Collective Bargaining Issues, which begins on Page B-44.

Part 3, *The Analysis of Budget Requests,* which begins on page 1, presents a consecutive item-by-item analysis of specific budget issues. This part of the report includes our recommendations for legislative action, which are based on our analytical findings.

PART 1
BUDGET OVERVIEW
I. SUMMARY

Introduction

For the second year in a row, the Legislature faces a budget that does not contain sufficient funds to maintain the existing levels of service. In terms of real purchasing power, the Governor's Budget for 1982–83 is 3.5 percent *lower* than the budget for the current year.

The General Fund portion of the Governor's Budget will be in balance only if several critical assumptions underlying the budget are borne out. These assumptions are:

- The state's economy will improve by mid-1982,
- the Legislature will approve the $338 million in tax accelerations during the current year, and an additional $645 million in accelerations and revenue increases in the budget year—a total revenue package of nearly $1 billion,
- at the June 1982 primary election, the voters will approve the bond measure for state prison construction, and disapprove the initiatives relating to income tax indexing and inheritance and gift taxes,
- the Legislature will approve a number of reductions in the existing level of state operations and local assistance expenditures,
- further reductions in federal aid for entitlement programs such as Medi-Cal will not be made, and
- user-fee increases will be enacted and fully implemented by July 1, 1982, and implementation of program reductions will not be delayed by the courts.

If these assumptions are not borne out, then the General Fund portion of the Governor's Budget will be out of balance, and other actions will have to be taken to bring it back into balance.

Expenditures

The 1982–83 budget provides for expenditures of $27.0 billion in state funds. This amount includes:

- $23.2 billion from the General Fund. Of this amount, $4.9 billion is for state operations, $7.3 billion is for direct aid to individuals and $10.9 billion is for aid to local governments and school districts. The remaining amount, $100 million, has not been earmarked for specific budget items.
- $3.5 billion from special funds.
- $0.4 billion from selected bond funds.

In addition, the budget provides for $11.3 billion in expenditures from federal funds and $7.3 billion from various "nongovernmental cost" funds including retirement, working capital, revolving, and public service enterprise funds. Adding all of these components, the total spending program is $45.7 billion, of which $38.4 billion is from governmental funds. Using this latter measure we estimate that during 1982–83 the state will spend $1,543 for every man, woman, and child in the state, or $105 million per day. These represent increases of 2.3 percent and 4.0 percent, respectively, over the expenditure rate in the current year.

Revenues

The budget is supported from a variety of different revenue sources including taxes, fees, bond proceeds, service charges and intergovernmental transfers. In 1982–83, the state's revenue sources will provide:

- $23.6 billion to the General Fund.
- $3.4 billion to some 135 different special funds.
- $11.3 billion in federal funds for a myriad of purposes.

Income from state sources—that is, revenues to the General Fund and the special funds—is estimated to be $27 billion in the budget year. This is an increase of $2.7 billion, or 11.3 percent, over 1981–82, and 22.0 percent above 1980–81 revenues.

The Department of Finance's estimate of General Fund revenues—$23.6 billion for 1982–83—is $2.1 billion, or 9.8 percent, higher than estimated revenues in 1981–82. This estimate reflects the continued softness in the economy anticipated by the Department of Finance for the first half of calendar year 1982, followed by a relatively strong recovery. In addition, it includes $645 million in additional revenues which require legislative approval.

A detailed discussion of the revenue estimates and the economic assumptions on which the budget is based begins on page A-24 of this overview.

II. BACKGROUND—THE RISE AND FALL OF THE SURPLUS

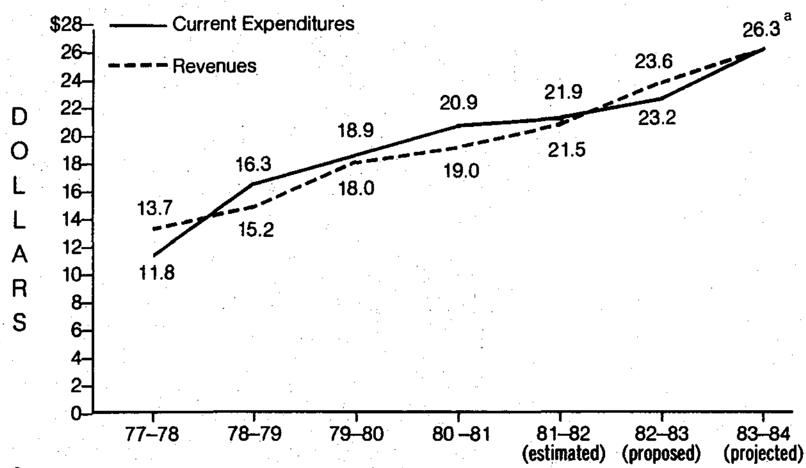
A. The Surplus—An Overview

The huge General Fund surpluses of past years have been used up. The only uncommitted resource shown in the budget as available to the General Fund on June 30, 1982, is the $116 million balance in the Reserve for Economic Uncertainties. This reserve started the year with a $658 million unobligated balance. Due to revenue shortfalls and expenditure overruns, however, the reserve will be fully depleted by year-end unless the Legislature accelerates revenues or reduces expenditures, as the Administration has proposed.

Chart 1

Comparison of General Fund Current Expenditures to Current Revenues

1977–78 through 1983–84 (in billions)



[a] Department of Finance projection.

B. Accumulation of the Surplus

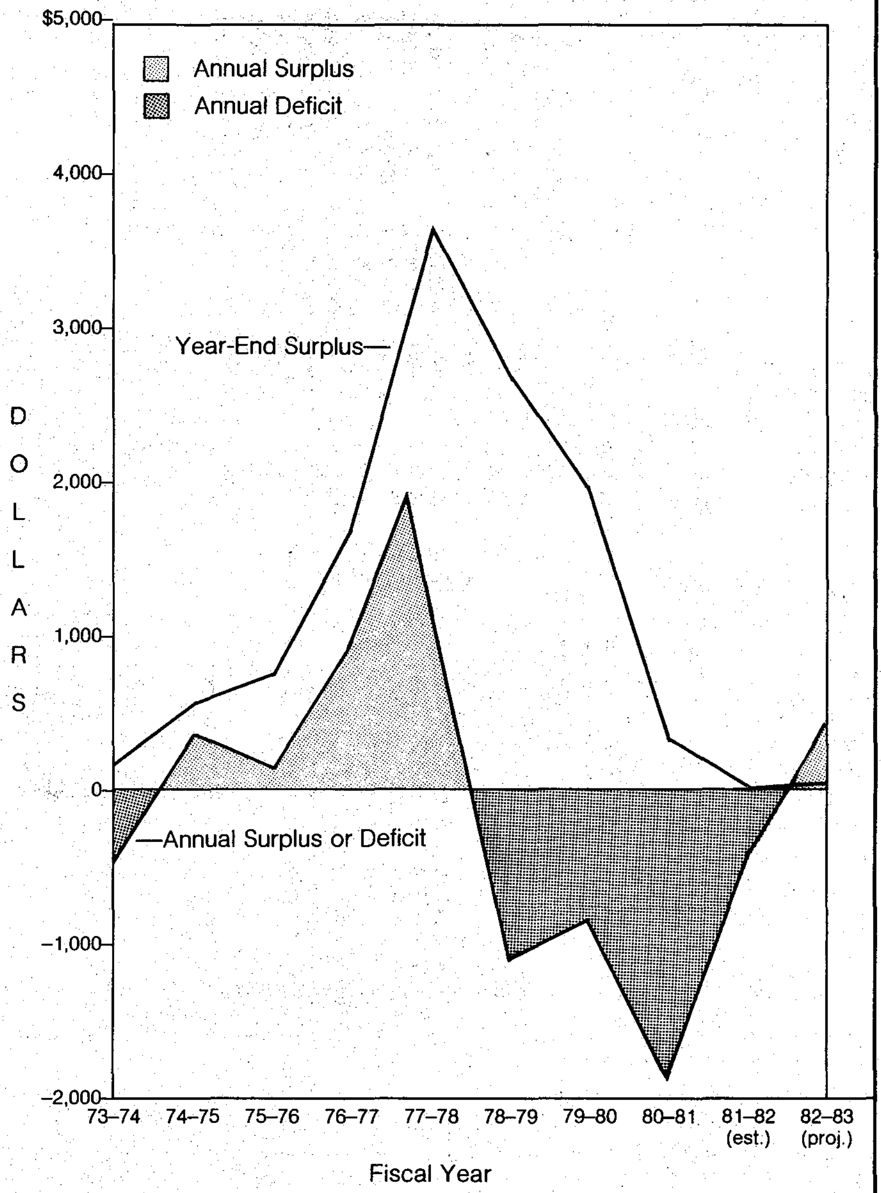
Table 1 and Charts 1 and 2 trace the history of General Fund expenditures, revenues, and the surplus since 1973–74. They indicate that the surplus reached a peak of $3.7 billion on June 30, 1978, shortly before Proposition 13 took effect.

Table 1
Trend in General Fund Unrestricted Surplus
1973–74 through 1982–83
(in millions)

	1973–74	*1974–75*	*1975–76*	*1976–77*	*1977–78*	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*1982–83*
Prior-year resources	$683.9	$358.3	$660.1	$808.8	$1,818.2	$3,886.9	$2,905.5	$2,540.7	$681.0	$123.5
Adjustments to prior-year resources	4.6	24.7	36.0	95.8	59.3	50.9	184.7	222.1	—	—
Prior year resources adjusted	$688.5	$383.0	$696.1	$904.6	$1,877.5	$3,937.8	$3,090.2	$2,762.8	$681.0	$123.5
Revenues and transfers	6,965.5	8,617.3	9,612.8	11,380.6	13,695.0	15,218.5	17,984.6	19,023.1	21,481.4	23,580.3
Expenditures (—)	7,295.7	8,340.2	9,500.1	10,467.1	11,685.7	16,250.8	18,534.1	21,104.9	22,038.8	23,202.9
(Expenditures from reserves)	(113.3)	(−72.8)	(−28.4)	(28.0)	(95.8)	(24.6)	(317.5)	(−210.8)	(−141.7)	(−7.2)
(Current Expenditures)	($7,409.9)	($8,267.4)	($9,471.7)	($10,495.1)	($11,781.4)	($16,275.4)	($18,851.6)	($20,894.1)	($21,897.1)	($23,195.7)
(Annual surplus or deficit)	(−443.5)	(349.9)	(141.1)	(885.5)	(1,913.6)	(−1,056.9)	(−867.0)	(−1,871.0)	(−415.7)	(384.6)
Carry-over reserves (—)	178.2	105.4	77.0	105.0	200.8	225.3	542.8	332.0	7.5	0.3
Reserve for economic uncertainties	—	—	—	—	—	—	—	349.0	116.0	500.0
Year-end Surplus	$180.1	$554.7	$731.8	$1,713.1	$3,686.1	$2,680.2	$1,997.9	$349.0	—	0.7

Chart 2

General Fund Unrestricted Surplus[a] 1973–74 through 1982–83 (in millions)



[a] Excludes Federal Revenue Sharing Fund.

C. What Happened to the Surplus?

The adoption of local fiscal relief in the wake of Proposition 13, together with income tax indexing, helped create the fiscal condition in which state expenditures exceeded current revenues for three years in a row. From 1978–79 through 1980–81, state expenditures exceeded revenues by a total of $3.8 billion, thereby completely wiping out the June 30, 1978 surplus.

During the current fiscal year, revenues would have been in balance with expenditures, had it not been for the recession. The economic slowdown reduced current year revenues by over $800 million. As Table 1 indicates, the shortfall between current revenues and expenditures in 1981–82 will be reduced to $416 million.

The budget projects that current revenues will exceed expenditures by $385 million in 1982–83. This, however, is contingent upon the enactment of $645 million in additional revenue accelerations and increases.

III. EXPENDITURES

A. TOTAL STATE SPENDING PLAN

Table 2 and Chart 3 present the principal categories of the state spending plan in the 1980–81, 1981–82 and 1982–83 fiscal years. Included are expenditures from the General Fund, special funds and bond funds, which total $27,045 million in 1982–83. When added to expenditures of $11,346 million from federal funds and $7,323 million from nongovernmental cost funds, the total state spending plan as proposed by the Governor amounts to $45,714 million.

Table 2
Total State Spending Plan [a]
(in millions)

	Actual 1980–81	Estimated 1981–82 Amount	Estimated 1981–82 Percent Change	Proposed 1982–83 Amount	Proposed 1982–83 Percent Change
General Fund	$21,104.9	$22,038.8 [b]	4.4%	$23,202.9 [b]	5.3%
Special funds	3,261.6	3,425.3 [c]	5.0	3,471.4 [c]	1.3 [d]
Budget Expenditures	$24,366.5	$25,464.1	4.5%	$26,674.3	4.8%
Selected bond funds	144.7	342.1	136.4	370.7	8.4
State Expenditures	$24,511.1	$25,806.3	5.3%	$27,045.0	4.8%
Federal funds	10,247.6	11,095.6	8.3	11.345.6	2.3
Governmental Expenditures	$34,758.7	$36,901.9	6.2%	$38,390.6	4.0
Nongovernmental cost funds	6,287.4	6.909.2	9.9	7,323.0	6.0
Total State Spending	$41,046.1	$43,811.1	6.7%	$45,713.7	4.3%

[a] Based on amounts shown in the Governor's Budget.
[b] Includes expenditures from reserves of $141.7 million in 1981–82 and $7.2 million in 1982–83.
[c] Includes expenditures from reserves of $212.0 million in 1981–82 and $18.4 million in 1982–83.
[d] Excluding the one-time reduction in shared revenues to local governments from the Vehicle License Fund, the increase in special fund expenditures is 14.5 percent.

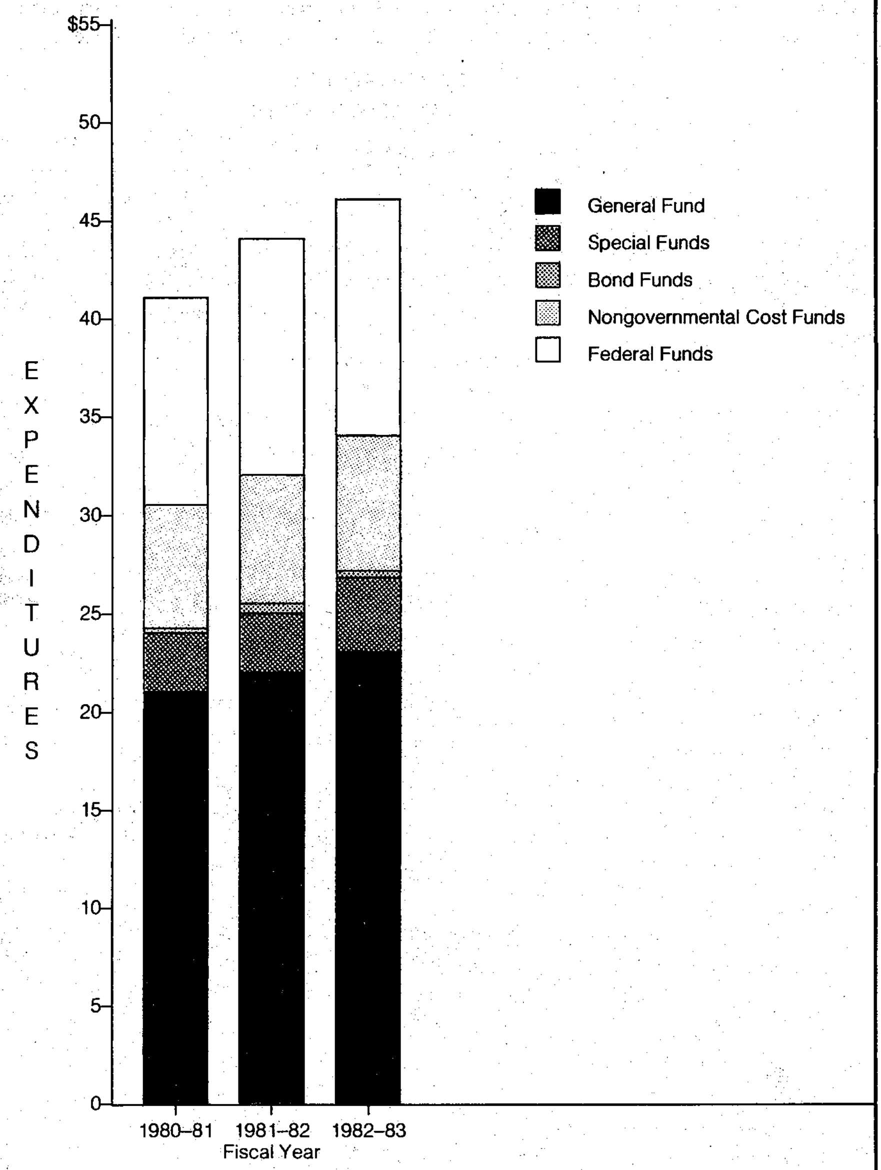
Governmental Expenditures

The budget proposes that expenditures from governmental funds—that is, state and federal funds—total $38.4 billion in 1982–83. The rate of increase in these expenditures—4.0 percent—is less than in either of two preceding years, due largely to the slow-down in federal aid to California (discussed below). Governmental expenditures in 1982–83 will average $1,543 for every man, woman and child in the state, or $105 million per day.

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." As shown in Table 2, budget expenditures are proposed at $26.7 billion in 1982–83. Budget expenditures in 1982–83 account for 58 percent of the $46 billion state spending plan, and 69.5 percent of total governmental expenditures.

Chart 3
Total State Spending 1980–81 through 1982–83 (in billions)



Growth in General Fund Expenditures

General Fund expenditures account for more than one-half of all expenditures under the state's auspices.

Historical perspective is a useful tool in analyzing trends in General Fund spending. Table 3 presents the amount and rate of increase in expenditures since 1973–74, in both actual dollars and real dollars. (That is, adjusted for the effects of inflation.) The proposed 1982–83 General Fund budget is more than three times what it was in 1973–74 in actual dollars. As shown on Chart 4, between 1973–74 and 1980–81, General Fund expenditures increased at an annual rate of 10 to 15 percent in actual dollars, and by 3 to 6 percent in real dollars. Beginning in 1981–82, however, the rate of growth in General Fund expenditures decreased dramatically. In fact, the rise in expenditures in 1981–82 was less than the rise in prices, causing real expenditures to decline. The budget projects the same situation to occur in 1982–83.

Table 3
Annual Growth in General Fund Expenditures
(in millions)

	Actual Dollars	*Percent Change*	*Real [a] Dollars*	*Percent Change*
1973–74	$7,295.7	29.9%	$7,295.7	—
1974–75	8,340.2	14.3	7,513.7	3.0%
1975–76	9,500.1	13.3	7,963.2	6.0
1976–77	10,467.1	10.2	8,254.8	3.7
1977–78	11,685.6	11.6	8,624.1	4.5
1978–79	16,250.8	39.1	11,070.0	28.4
1979–80	18,534.1	14.1	11,664.0	5.4
1980–81	21,104.9 [b]	13.9	12,227.6	4.8
1981–82 (estimated)	22,038.8 [c]	4.4	11,741.5	−4.0
1982–83 (proposed)	23,202.9 [d]	5.3	11,401.9	−2.9

[a] "Real" dollars equal actual dollars deflated to 1973–74 dollars using the Gross National Product price deflator for state and local puchases of goods and services.
[b] Includes $210.8 million in expenditures from reserves.
[c] Includes $141.7 million in expenditures from reserves.
[d] Includes $7.2 million in expenditures from reserves.

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 set either by statute or the Constitution, rather than by the Budget Bill.

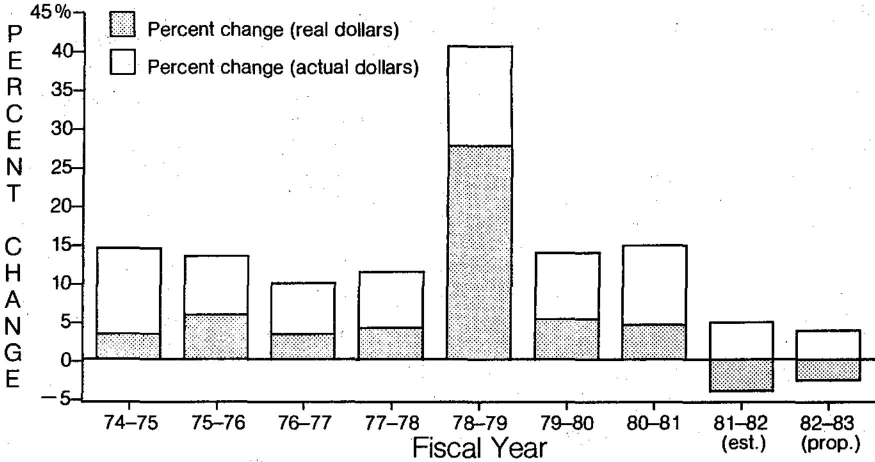
As Table 4 shows, expenditures of $23,150 million, or 99.8 percent of the $23,203 million in total General Fund expenditures proposed for 1982–83, are authorized in the Budget Bill. However, a significant portion of this amount—$11,615 million (or 50 percent), although included in the Budget Bill, is actually set by statute. This portion would be even higher if the budget requested funds to pay the full statutory cost-of-living adjustments.

Only $52 million, or 0.2 percent, does not appear in the Budget Bill. This is a net amount including $259 million for bond debt service payments, partially offset by "negative expenditures" of $207 million mainly reflecting General Fund credits from other funds (pro rata charges) and unidentified savings.

Chart 4

Annual Growth in General Fund Expenditures Comparison of "Real" and Actual Dollars[a]

1974–75 through 1982–83



[a] "Real" dollars equal actual dollars deflated to 1973–74 dollars using the Gross National Product price deflator for state and local purchases of goods and services.
[b] The large increase in 1978–79 is due primarily to the increase in local fiscal relief following the passage of Proposition 13.

Table 4
1982–83 General Fund Expenditures in the Budget Bill (in millions)

	Amount	Percent of Total Expenditures
1. *Expenditures in the 1982–83 Budget Bill:*		
Statutory authorizations also included in the Budget Bill:		
Education, K–12	$6,692.9	28.8%
Department of Social Services	3,017.7	13.0
Board of Governors—Community Colleges	543.2	2.3
Tax Relief	1,318.5	5.7
Legislature	3.9	0.02
Total, Statutory Authorizations	$11,576.2	49.9%
Expenditures authorized in the Budget Bill	11,574.4	49.9
Total, in the Budget Bill	$23,150.6	99.8%
2. *Expenditures Not in the Budget Bill*	*$52.2*	*0.2%*
Constitutional	(258.8)	(1.1)
Statutory	(−64.3)	0.3
Other	(−142.3)	(−0.6)
Total, Expenditures	$23,202.9	100.0%
Less Expenditures from reserves	7.2	
Current Expenditures	$23,195.7	

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 nine 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	20,683.9	20,894.1	210.2	1.0
1981–82	20,770.1 [b]	21,897.1 [c,d]	1,127.0	5.4

[a] Source: 1973–74 to 1982–83 Governor's Budget, Schedule 1.
[b] Excludes $28.5 million in expenditures from reserves.
[c] Midyear estimate.
[d] Excludes $141.7 million in expenditures from reserves.

Only once during this nine-year period—in 1977–78—was the actual amount expended less than the amount 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. Local fiscal relief added $4.4 billion to that budget, but reductions in other state programs held the net increase to $2,768 million. The increase of $1.1 billion for 1981–82 is attributable primarily to increases in expenditures for K–12 Education ($600 million) and SSI/SSP ($218 million). Both of these increases were caused by increased cost-of-living adjustments. In addition, estimated unidentified savings were reduced from $200 million to $100 million for the current year.

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, 1983, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, and many other factors. Thus, actual revenues and expenditures will be different from the estimates contained in the Governor's Budget.

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.

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 nontax 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.

Impact of Article XIII B in 1982–83

Table 6 shows the Department of Finance's estimate of the impact of Article XIII B on the state for fiscal years 1978–79 (the "base" year) through 1982–83. The department estimates that the state will be $1,723 million *below* its limit in 1982–83.

The large gap between the limit and spending subject to limitation results from the fact that the level of appropriations in the base year (1978–79) could not have been sustained indefinitely with the revenues produced by existing tax laws, even if there had been no limit on appropriations. This is because the state had a large portion of its base-year *limit* financed by *surplus* funds. Since the surplus is now depleted, 1982–83 appropriations can be financed only from *current* revenues. The large gap between the state's limit for 1982–83 and proposed expenditures reflects that portion of the state's limit originally financed by the surplus—and the year-to-year growth in that amount—which can no longer be financed because the surplus has been exhausted.

As a result, the state's appropriation limit will *not* be a fiscal constraint in 1982–83 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.

Table 6
Impact of Article XIII B on the State
1978–79 through 1982–83
(in millions)

	1978–79[a]	*1979–80*[b]	*1980–81*	*1981–82*	*1982–83*
Appropriations limit	$12,564	$14,194	$16,237	$18,085	$19,899
Appropriations Subject to Limitations	12,564	—	15,584	16,957	18,176
Amount Under Limit	—	—	$653	$1,128	$1,723

[a] For the base year, the appropriations limit is, by definition, equal to appropriations subject to limitation.
[b] Article XIII B was not effective until 1980–81. A 1979–80 limit is shown for illustrative purposes only.

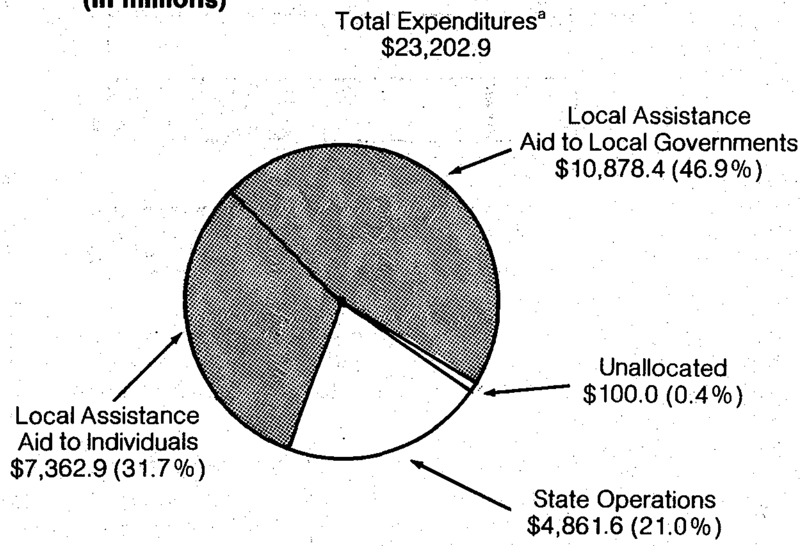
Establishing the 1982–83 Limit

The administration proposes to set the state's 1982–83 appropriations limit in Control Section 12.20 of the 1982 Budget Act. Although a 1982–83 limit of $19,899 million has been proposed, this number is subject to change, because the final inflation and population adjustments used to determine the 1982–83 limit will not be known until April of this year.

Chart 5

1982–83 General Fund Budget Structure

(in millions)



[a] Includes $7.2 million in expenditures from reserves.

B. MAJOR COMPONENTS OF THE BUDGET

State expenditures are traditionally divided into three categories: state operations, capital outlay, and local assistance. Table 7 presents the distribution of General Fund and special fund expenditures among these categories for the past, current and budget years. In 1982–83, the Governor's Budget includes $100 million in unallocated funds which have not been budgeted for any specific program or agency. Table 7 separately identifies expenditures from reserves (that is, from funds appropriated in prior years) in order to show expenditures from new appropriations (referred to as "current expenditures").

Chart 5 shows expenditures for state operations, capital outlay, and local assistance as a percentage of total General Fund expenditures. Local assistance, as defined in the Governor's Budget, accounts for 78.6 percent of total expenditures.

Chart 6

General Fund Budget Structure

1973–74 through 1982–83 (in billions)

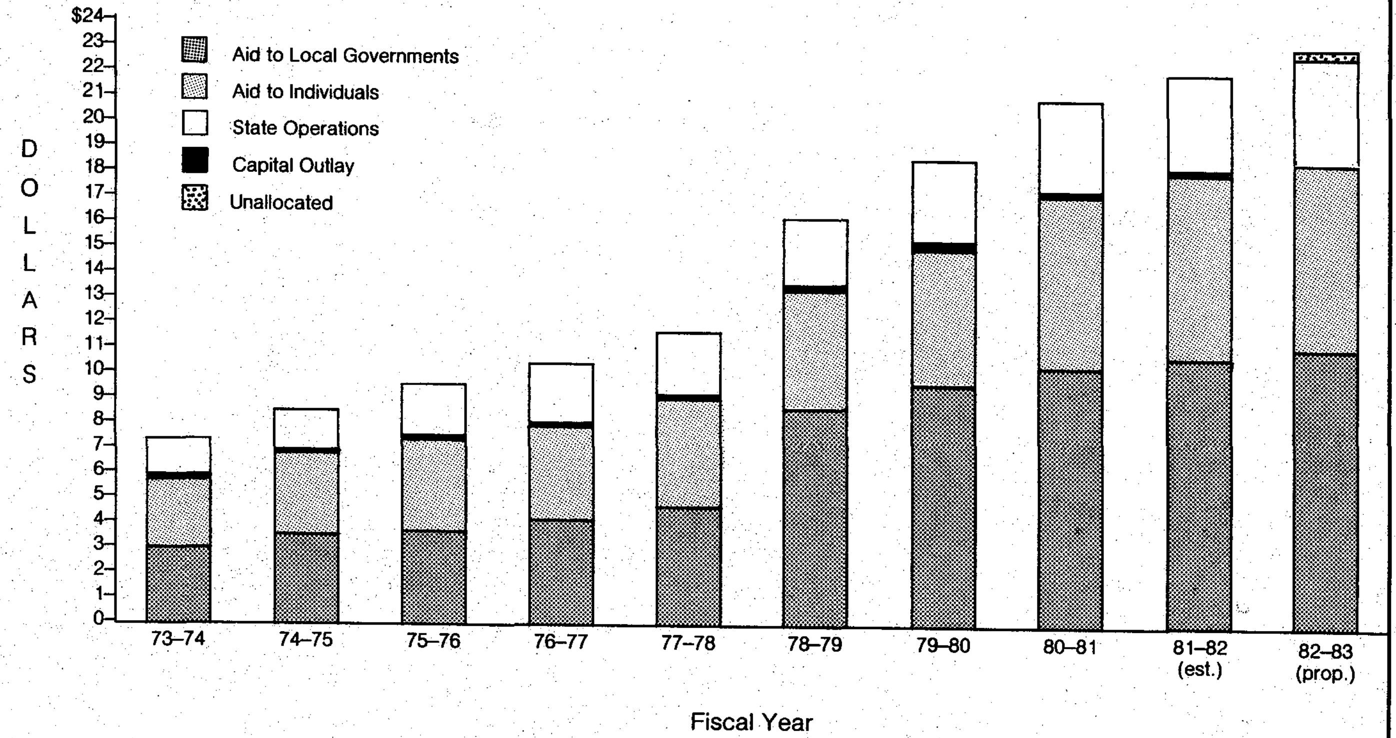


Table 7
General Fund and Special Fund Expenditures, by Function [a]
(in millions)

	Actual 1980–81	Estimated 1981–82 Amount	Estimated 1981–82 Percent Change	Proposed 1982–83 Amount	Proposed 1982–83 Percent Change
General Fund:					
State operations	$4,281.0	$4,592.8	7.3%	$4,861.6	5.8%
Capital outlay	53.6	38.5	−28.2	—	—
Local assistance	16,770.3	17,407.6	3.8	18,241.3	4.8
Aid to individuals	(6,677.0)	(7,101.6)	(6.4)	(7,362.9)	(3.7)
Aid to local governments	(10,093.3)	(10,306.0)	(2.1)	(10,878.4)	(5.6)
Unallocated	—	—	—	100.0	—
Totals	$21,104.9	$22,038.8	4.4%	$23,202.9	5.3%
Less expenditures from reserves	−210.8	−141.7	—	−7.2	—
Current Expenditures	$20,894.1	$21,897.1	4.8%	$23,195.7	5.9%
Special Funds:					
State operations	$1,362.9	$1,523.1	11.8%	$1,727.9	13.4%
Capital outlay	379.8	437.9	15.3	442.5	1.1
Local assistance	1,518.9	1,464.3	−3.6	1,301.0	−11.2
Totals	$3,261.6	$3,425.3	5.0%	$3,471.4	1.3%

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

Chart 6 shows the increase in expenditures for state operations, capital outlay and local assistance (which includes aid to individuals and aid to local governments) from 1973–74 through 1982–83.

State Operations

Expenditures for state operations during the period 1973–74 through 1982–83 have increased by $3.1 billion, or 178 percent. This growth is attributable mainly to increases in higher education and the state's corrections program.

The budget proposes an increase of $269 million, or 5.8 percent, for state operations in 1982–83. This reflects workload and salary increases, offset by a $115 million reduction in baseline budgets. Most General Fund-supported departments were subject to the baseline reductions mandated by the Governor, but in some cases, the required reductions were less than the standard 5 percent.

Capital Outlay

General Fund capital outlay expenditures over the past nine years have fluctuated from a high of $151 million in 1978–79 to a low of $17 million in 1974–75. The budget proposes no General Fund expenditures for capital outlay but does contain $442.5 million in capital outlay expenditures from special funds (mainly tidelands oil revenues). For a more detailed discussion of capital outlay, see page A-22.

Local Assistance

As shown in Chart 6, local assistance has increased by $12,712 million, or 230 percent, in the nine years from 1973–74 to 1982–83. The growth in state fiscal relief to local governments following the passage of Proposition 13 explains much of this increase. Additionally, direct benefit programs in local assistance have grown rapidly. The Governor's Budget proposes an increase in local assistance of $833.7 million in 1982–83, or 4.8 percent.

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, do not provide assistance to local government agencies; instead, it goes to *individuals*. Such 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, which are 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, we have divided the local assistance category into two new categories, one being "Assistance to Local Governments" and the other being "Assistance to Individuals."

Table 8
Major Local Assistance Programs More Appropriately Categorized as Assistance to Individuals
(in millions)

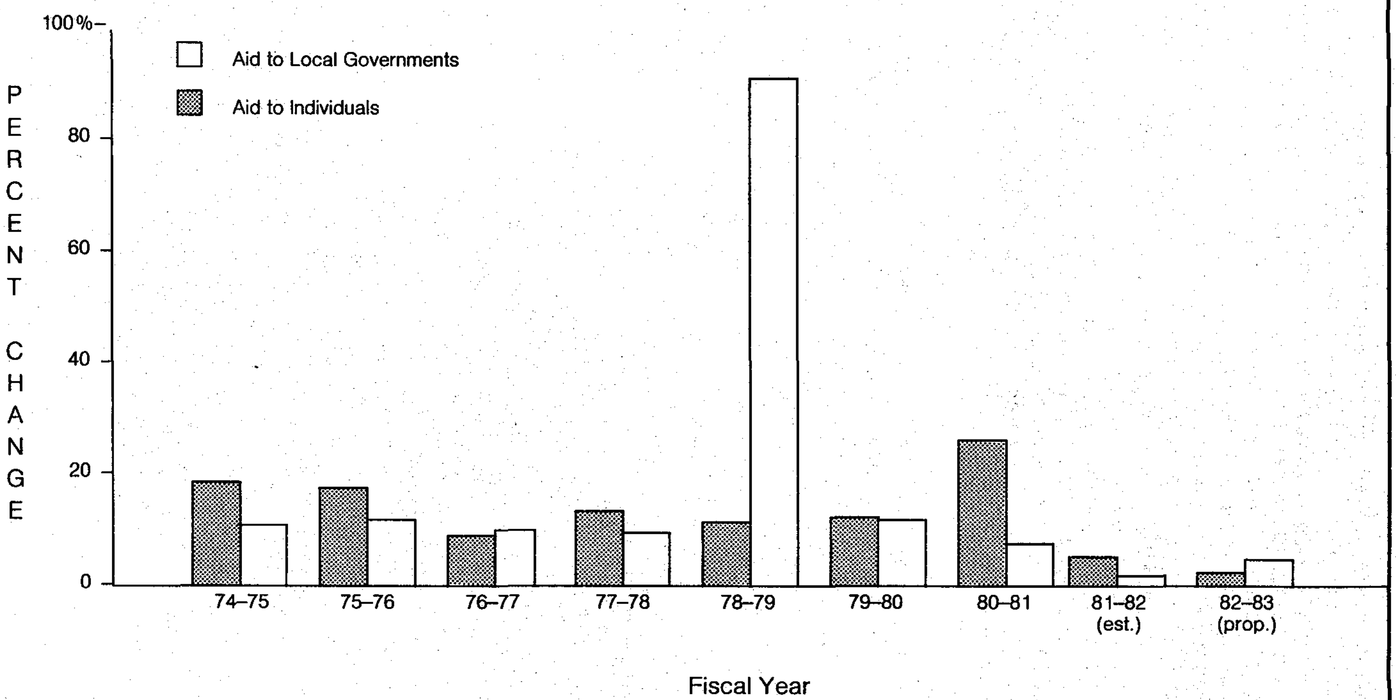
	1980–81	*1981–82*	*Governor's Budget 1982–83*
Medi-Cal [a]	$2,325.8	$2,609.4	$2,654.7
AFDC [b]	1,214.9	1,364.8	1,424.0
SSI/SSP	1,285.5	1,268.9	1,345.7
Developmental Services	513.1	521.2	540.9
Personal Property Tax Relief	496.8	467.3	537.2
Renters' Tax Relief	406.8	425.0	440.0
Homeowners' Property Tax Relief	333.7	335.0	338.0
Senior Citizens Renters' Tax Relief	49.6	48.0	46.0
Senior Citizens Property Tax Assistance	19.0	15.0	14.0
Subvention for Open Space	13.2	14.0	13.0
Senior Citizens Property Tax Postponement	4.2	5.0	6.1
Alternative Energy Tax Credit Refund	10.9	25.0	—
Payment to Local Governments for Sales and Property Tax Losses	3.5	3.0	3.3
Total	$6,677.0	$7,101.6	$7,362.9

[a] Excludes county administration.
[b] Grant payments only.

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 pro-

Chart 7

Expenditures for Local Assistance
Aid to Local Governments vs Aid to Individuals
1974–75 through 1982–83



vides *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 8 lists the major "local assistance" programs which our analysis indicates are more appropriately categorized as "Assistance to Individuals".

Changes in Reporting Categories

We recommend that the Legislature adopt supplemental report language requesting that the Department of Finance 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 questionable. These categories were established long ago, and have been maintained for purposes of year-to-year consistency. These categories, however, 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 those 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 1983–84 fiscal year, and provide new detail on historical expenditures consistent with this revision."

Chart 7 presents a comparison of the growth in these two categories of local assistance programs since the 1973–74 fiscal year. In six of the last nine years, 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 nine-year period. On a cumulative basis, aid to local governments grew by 265.5 percent during the period, while assistance to individuals increased by 188.5 percent.

Local Fiscal Relief

Table 9 summarizes our estimates of local fiscal relief from 1978–79 through 1982–83. For the budget year, the table shows estimates of fiscal relief under existing law (Chapter 282, Statutes of 1979 (AB 8)), as well as the amounts proposed by the Governor. The budget proposes to reduce motor vehicle license fee subventions to cities and counties in order to reduce local fiscal relief below the level called for by existing law. It also reduces funding for the county health services subvention by $55 million. In the absence of these proposals, local fiscal relief in 1982–83 would increase by $798 million, or 13.4 percent under existing law (without considering the AB 8 deflator). This increase is higher than it otherwise would be, due to the one-time reductions in fiscal relief made by Ch 101/81 (SB 102) during the current year.

Table 9
Summary of Local Fiscal Relief
1978–79 to 1982–83
(in millions)

					1982–83	
	1978–79	*1979–80*	*1980–81*	*1981–82*	*Under Existing Law*	*As Proposed by Governor's Budget*
Block grants to local agencies	$835	$14	—	—	—	—
Property taxes shifted from schools to local agencies	—	782	$921	$1,046	$1,172 [a]	$1,172 [a]
Business inventory reductions for cities and counties	—	−38	—	—	—	—
Health and welfare buyouts	1,079	1,288	1,529	1,747	1,957	1,904
SB 102 reductions	—	—	—	−181	−49	−49
Education [b]	2,453	2,813	3,050	3,322	3,652	3,652
Subtotals	$4,367	$4,859	$5,500	$5,934	$6,732	$6,679
Proposed vehicle license fee reductions	—	—	—	—	—	−450
Totals	$4,367	$4,859	$5,500	$5,934	$6,732	$6,229

[a] Assumes 12 percent increase in assessed valuation.
[b] Department of Finance estimates.

Table 10
Local Fiscal Relief by Type of Local Agency
1978–79 to 1982–83
(in millions)

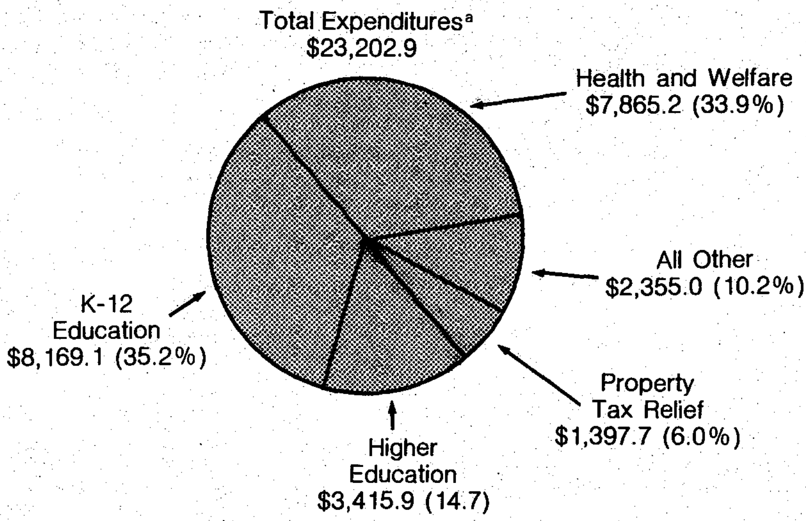
	1978–79	*1979–80*	*1980–81*	*1981–82*	*1982–83* [b]	*Percent Increase 1982–83 Over 1979–80*
Cities	$221	$224	$280	$171	$319	44.3%
Counties	1,504	1,614	1,927	2,166	2,452	63.0
Special districts	190	206	243	276	309	62.6
K–12 Education [a]	2,193	2,507	2,721	2,964	3,261	48.7
Community colleges [a]	260	306	329	358	391	50.4
Totals [c]	$4,367	$4,859	$5,500	$5,934	$6,732	54.2%

[a] Department of Finance estimates.
[b] Existing law; does not reflect reductions proposed in the budget.
[c] Details may not add to totals due to rounding.

Chart 8

General Fund Expenditures—Major Components

1982–83 (in millions)



[a] Includes $7.2 million in expenditures from reserves.

Table 10 presents information as to the *distribution* of fiscal relief by type of local agency under current law. These data indicate that K–12 school districts receive nearly half of total fiscal relief to local entities (48 percent), while counties receive the second largest share (36 percent). The table also indicates that, under current law, total fiscal relief costs in 1982–83 would be 54.2 percent above the orginal level established in 1978–79, with the largest relative increases in relief going to counties and special districts.

C. PROGRAM EXPENDITURES

Where Does the Money Go?

Table 11 and Chart 8 show the distribution of General Fund expenditures by major program categories in 1982–83. These displays indicate that the two largest categories in the budget are Education and Health and Welfare. If the $11.6 billion proposed for education is added to the $7.9 billion proposed for health and welfare, the total for these two categories is $19.5 billion, or 83.8 percent, of total expenditures. The remaining $3.8

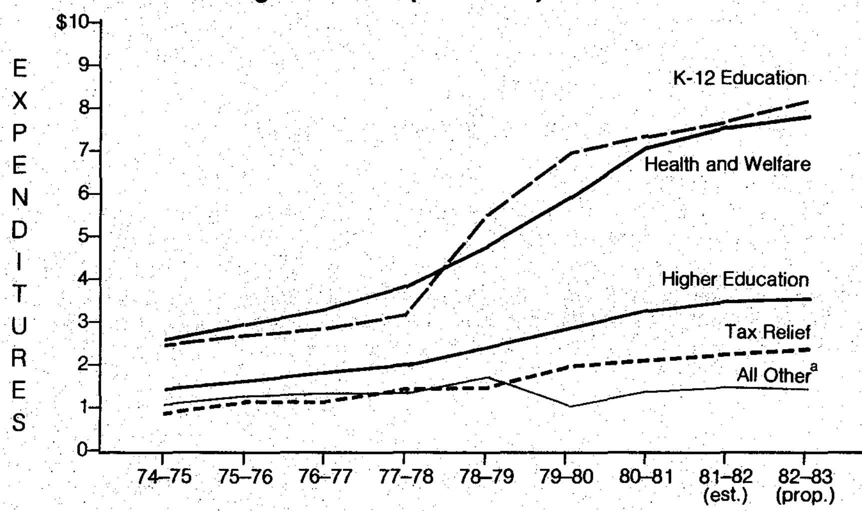
billion, or 16.2 percent, goes for tax relief and all other programs of state government, such as corrections and resources.

The so-called "people programs"—Education and Health and Welfare—have been the fastest growing components of General Fund expenditures in recent years. Chart 9 illustrates that since 1973–74 Health, Welfare, and Education have increased their share of the General Fund budget from about 75 percent to 83.8 percent. During the same period, expenditures on these programs have increased by more than 250 percent.

Table 11
Expenditures for Health, Welfare, and Education As a Percent of Total General Fund Expenditures 1982–83 (in millions)

	Amount	*Percent of General Fund Budget*
Health and Welfare	$7,865.2	33.9%
Education		
K–12	8,169.1	35.2
Higher education	3,415.9	14.7
Total, Education	$11,585.0	49.9%
Total, Health, Welfare, and Education	$19,450.2	83.8%
Other program areas	3,752.7	16.2
Total General Fund Budget	$23,202.9	100.0%
Less expenditures from reserves	7.2	—
Total, Current General Fund Expenditures	$23,195.7	100.0%

Chart 9
General Fund Expenditures By Major Program Categories
1973–74 through 1982–83 (in billions)



[a] Includes $100 million in unclassified funds for 1982–83.

Summary of Major Program Changes

The budget proposes an increase in General Fund expenditures of $1.3 billion for 1982–83. Table 12 shows that these increases are distributed among nearly all expenditure categories. There are, however, significant program changes within the broader categories. Some of the major shifts in historical trends include the following:

1. *Medi-Cal* expenditures from the General Fund in 1982–83 are budgeted at $2,817 million, which is $60.3 million, or 2.2 percent, above the current year expenditure level. In years past, Medi-Cal General Fund expenditures have grown at a rate of 3.5 percent to 22.2 percent. The principal reasons why the increase proposed for 1982–83 is so much smaller than the rate for recent years are:

- Provider reimbursement rate reductions offset almost all of the provider cost-of-living increases.
- Hospital inpatient reimbursement limitations (Ch 102/1980) which were applied during the current fiscal year are carried forward into 1982–83, for a savings of $56.1 million.
- The Governor's Budget proposes several restrictions in eligibility and scope of benefits.
- Cost savings changes enacted by recent legislation (AB 251) will become fully effective in 1982–83.
- Several administration cost control and anti-fraud projects approved for implementation in 1981–82 become fully effective in 1982–83.

2. *SSI/SSP Grants* are proposed to increase by $76.8 million in 1982–83. This increase reflects $211.3 million in increased expenditures and $134.5 million in offsetting savings. The major cost increases in the budget year are attributable to (a) an anticipated 1.2 percent increase in caseload ($16.7 million) and (b) an 8.8 percent cost-of-living increase ($170.3 million). The most significant reductions will result from increases in recipients' unearned income, such as social security payments. These income increases will reduce the size of the SSI/SSP grant, thereby resulting in overall program savings.

3. *AFDC Grants* are proposed to increase by $59.2 million in 1982–83. This reflects (a) savings of $83.7 million resulting from implementation of the federal Omnibus Reconciliation Act, and (b) the nonrecurring nature of one-time costs in 1981–82 ($43.7 million). The largest increase proposed in 1982–83 is $130.3 million to provide an 8.8 percent cost-of-living increase in aid payments.

4. *Special social service* programs are proposed to increase by 15.4 percent in the budget year. Because federal funding for these programs is capped, any increases provided as a cost-of-living adjustment to total program costs has to be borne by the state and counties. In effect, the state and counties must provide funds for a cost-of-living increase in federally supported activities because the federal government does not adjust its payments to the state for inflation.

5. *K–12 Education* increases by $460.6 million, or 6 percent in 1982–83. This amount includes $20 million in increased expenditures under the Governor's initiatives in mathematics and science. The budget does not, however, include $301 million in K–12 expenditures authorized under existing law. This is due to budget proposals that reduce transfers from the Tidelands Oil Fund (–$147 million), delete transfers of excess repayments of the State School Building Aid bond loans (–$83 million), and reduce cost-of-living adjustments in certain school apportionments (–$71 million).

6. *Community Colleges* expenditures are proposed to increase by close to $100 million in 1982–83. This reflects a 5 percent COLA ($67 million), replacement of one-time property tax revenues available during the current year ($60 million), savings from assessed property tax value growth (−$38.2 million), and the Governor's initiatives in Education ($10 million).

7. *Capital outlay* expenditures from the General Fund have been suspended in 1982–83. Capital outlay expenditures from all sources, including bond issues and Special Funds, however, total $632.1 million in the budget year.

8. *The Department of Corrections* expenditures are proposed to increase by $48 million in the budget year, primarily due to the growth in the state's prison population.

9. The Governor is also proposing $100 million in unallocated funds, which will be used to fund legislation and other expenditures, as directed by the Legislature.

Table 12
Proposed General Fund Program Changes
1981–82 to 1982–83
(in millions)

	1981–82 Estimated	*1982–83 Proposed*	*Change Amount*	*Change Percent*
Health and Welfare:				
Medi-Cal	$2,756.6	$2,816.9	$60.3	2.2%
SSI/SSP grants	1,268.9	1,345.7	76.8	6.1
AFDC grants	1,364.8	1,424.1	59.3	4.3
Mental health	590.3	618.0	27.7	4.7
Developmental services	536.8	558.2	21.4	4.0
Special social service programs	169.2	195.3	26.1	15.4
Other, health and welfare	872.1	907.0	34.9	4.0
Subtotals, Health and Welfare	$7,558.7	$7,865.2	$306.5	4.1%
Education:				
K–12	$7,708.5	$8,169.1	$460.6	6.0%
University of California	1,099.0	1,150.9	51.9	4.7
California State University	963.4	986.9	23.5	2.4
California Community Colleges	1,082.4	1,181.3	98.9	9.1
Other, higher education	96.8	96.8	—	—
Subtotals, Education	$10,950.1	$11,585.0	$634.9	5.8%
Property tax relief	$1,327.6	$1,397.6	$70.0	5.3%
Employee compensation	—	168.3	146.4	n/a
Capital outlay	27.7	—	−27.7	—
Unallocated	—	100.0	100.0	n/a
Debt service	221.7	278.8	57.1	25.8
All other	1,953.0	1,808.0	−145.0	−7.4
Totals	$22,038.8	$23,202.9	$1,164.1	5.3%
Less expenditures from reserves	−141.7	−7.2	134.5	—
Current Expenditures	$21,897.1	$23,195.7	$1,298.6	5.9%

D. CAPITAL OUTLAY

The Budget Bill includes $635.6 million from all sources for capital outlay in 1982–83. This is $232.6 million—58 percent—more than the appropriation for capital outlay contained in the 1981 Budget Act. The major changes from the current year appropriations are as follows:

	In Millions
State and Consumer Services	−$20.4
Business, Transportation and Housing	+95.0
Resources	+21.3
Health and Welfare	−43.2
Correctional Programs	+146.9
Postsecondary Education	+32.8

The most significant changes are in the areas of Business, Transportation/Housing and Corrections.

Business, Transportation and Housing. The $95.0 million increase for Business, Transportation and Housing reflects an increase of $82.3 million in Department of Transportation capital outlay, and increases totaling $12.7 million proposed by the California Highway Patrol and the Department of Motor Vehicles. The Department of Transportation's increase consists of $53.5 million in the highway program to pay the state's share of the State Transportation Improvement Program, and $28.8 million for the acquisition and improvement of intercity and commuter rail stations.

Correctional Programs. The $146.9 million increase in correctional programs reflects major appropriations from the proposed New Prison Construction Act of 1981 for new prison facilities. The majority of these appropriations is contingent on statewide approval of the bond program that will be on the statewide ballot in June 1982.

Other Programs. In general, the increases shown for other areas are not true increases. They reflect the administration's decision to defer capital outlay projects in 1981–82 and rebudget them in 1982–83. Thus, the proposed level of capital outlay includes both 1981–82 projects and new projects proposed for the budget year. In addition, the budget proposes an increase in appropriation from the Parklands Fund of 1980, for the Department of Parks and Recreation.

The $20.4 million reduction for State Consumer Services capital outlay is primarily a result of excluding construction funding for new office buildings. The budget indicates that the San Francisco office building, which was funded in the 1981 Budget Act ($34.4 million), may be constructed under a lease-purchase arrangement, rather than as a capital outlay project. The reduction shown for Health and Welfare reflects completion of the program to correct fire/life safety and environmental deficiencies at the state hospitals.

Distribution by Fund Source. Table 13 shows how the capital outlay amounts requested in the Budget Bill are distributed by fund among the major budget categories. The funds, if appropriated, will be available for expenditure over a three- to five-year period, and therefore do not represent the amount of expenditures to be made in the budget year.

As shown in Table 13, the capital outlay program is supported by special funds and bond funds exclusively. Approximately 48 percent ($201 million) of special fund appropriations are requested from the State Transportation Fund and various special funds in the Resources Agency. The remaining 52 percent ($220.1 million) is requested from tidelands oil revenues. The proposed bond fund appropriations are requested from the previously approved Parks and Recreation Bond Act, Health Science Facilities Construction Bond Act, and Community College Bond Act. The $161.8 million of bond funds for the Correctional programs, however, are contingent upon voter approval of the new Prison Construction Bond Act Program of 1981, which will be on the statewide ballot in June 1982.

Table 13
Summary of 1982–83 Proposed Capital Outlay Appropriations
(in thousands)

Category	*General Fund*	*Special Funds*	*Bond Funds*	*Total*
State and Consumer Services	—	$29,113	—	$29,113
Business and Transportation	—	188,031	—	188,031
Resources	—	65,190	$52,102	117,292
Health and Welfare	—	28,100	—	28,100
Correctional Program	—	22,316	161,800	184,116
Education	—	86,275	969	87,244
General Government	—	2,113	—	2,113
Totals	—	$421,138	$214,871	$636,009

IV. REVENUES

A. OVERVIEW

The various expenditure programs discussed in our *Analysis* are supported by revenues which are derived from many different sources. The 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 85 percent of all state revenues are deposited directly in the General Fund, from which they may be appropriated to support the general activities of state government. In most years, 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. Those state revenues that are not deposited in the General Fund are placed into special funds to support specific programs and activities, including highway maintenance and various construction projects.

Because the availability of revenues is the key determinant of how much the state can afford to spend on its programs, it is important to consider whether sufficient revenues will be collected to fund the Governor's proposed spending plan for 1982–83. The level of these revenues will be influenced by a variety of factors. These include the state's tax base under current law, the tax rates applied to this tax base, how future economic conditions will affect the size of this tax base, the time lags between when tax liabilities are incurred and when they are actually paid to the state, and the extent to which the Legislature chooses to enact the various income-enhancing measures which the budget proposes.

This section examines the Department of Finance's forecast for revenues from which the Governor's spending plan is to be funded, including the economic projections and other assumptions on which the revenue forecast is based.

Summary of the Economic Outlook

The single most important factor explaining the past and future performance of California state revenues is the behavior of the state's economy. Economic performance in 1981 was generally disappointing. Nationally, real Gross National Product (GNP) declined in two of the four quarters, both nominal and "real" interest rates were highly volatile and reached record levels, corporate profits fell for the second straight year, and unemployment climbed. California's economic performance in 1981 was also poor. For example, job growth in the state (1.1 percent) was lower than in any year since 1975, and new residential building permits (109,000) were at their lowest level since 1966. At year-end, the economy was in a recession.

The Department of Finance's economic forecast for 1982 and 1983 generally reflects the consensus of other economists in calling for a mixed performance. In the near term, the economy is expected to remain weak, with a continued fall in real GNP, employment and corporate profits in the first quarter of 1982. During this period, however, the forecast also assumes that inflation, interest rates, and excess inventories will be declining. These developments are expected to help halt the economic downturn by spring and put the economy into a recovery phase by mid-year. Further support for the recovery will be provided after July, when the second installment of President Reagan's tax reduction package goes into effect. However, the pace of recovery in the second half of 1982 is expected to remain quite moderate, largely because of upward pressures on interest rates due to the combination of a tight monetary policy, rising demand for credit by businesses and individuals, and federal government borrowing to finance a deficit of unprecedented proportions. These interest rate pressures will limit the near-term recovery, particularly in such credit-sensitive sectors as business investment and residential construction.

Nevertheless, the recovery is projected to continue beyond 1983. The department predicts that the rate of job growth in California will climb from only 1.1 percent in 1982 to 4.1 percent in 1983, 5.2 percent in 1984, and 4.1 percent in 1985, resulting in a steady fall in the unemployment rate from 8.1 percent in 1982 to 5.8 percent by 1985.

No one can say whether the department's economic forecast will prove to be accurate. Economic forecasters have had a very poor record in projecting the economy's performance in recent years, and we can have only limited confidence in the ability of the Department of Finance or any other forecaster to accurately foresee the future, even over a period as short as the next 12 months. This is particularly true at the present time, given the tremendous uncertainties characterizing the current economic environment. These uncertainties include the future course of federal monetary policies, the Reagan Administration's decisions during 1982 affecting taxes, spending and the federal deficit, and the reactions of businesses and financial markets to future trends in interest rates and inflationary expectations, which are themselves difficult to predict. We believe that because of these factors, and the precariousness with which the 1981–82 and 1982–83 budgets are balanced, the Legislature will need to keep a close watch on economic developments in the months to come and be prepared to revise the state's revenue outlook accordingly.

Summary of the Revenue Outlook

Table 14 summarizes the Governor's Budget estimates of total, General Fund, and special fund revenues. The table shows that:

- ***Prior year*** (1980–81) total revenues were $22.1 billion (a growth of $1.2 billion, or 5.7 percent, over the preceding year). This amount included about $19 billion in General Fund revenues (a growth of $1 billion, or 5.5 percent), and $3.1 billion in special funds revenues (a growth of $190 million, or 6.6 percent).

- *Current year* (1981–82) total revenues are estimated to reach $24.2 billion (a growth of $2.1 billion, or 9.7 percent), including revenues of $21.5 billion to the General Fund (a growth of $2.5 billion, or 12.9 percent). Revenues to special funds are estimated at $2.8 billion, or $325 million (10.5 percent) below the prior year amount. As discussed below, this decline results primarily from the one-time shift of certain special fund income directly into the General Fund.
- *Budget year* (1982–83) total revenues are projected at $27.0 billion ($2.7 billion, or 11.3 percent, above the estimated current-year level). This amount includes $23.6 billion in General Fund revenue (a growth of $2.1 billion, or 9.8 percent), and $3.4 billion in special funds revenue (a growth of $635 million, or 23 percent). The unusually large jump in special funds revenue occurs because special fund transfers to the General Fund are much larger in the current year than in the budget year.

Table 14

Summary of 1980–81, 1981–82, and 1982–83 General Fund and Special Funds Revenue Performance (dollars in millions) [a]

	Prior Year (1980–81)	*Current Year (1981–82)*	*Budget Year (1982–83)*
General Fund Revenue			
—Amount	$19,023	$21,481	$23,580
—Dollar change	$995 [b]	$2,458	$2,099
—Percent change	5.5% [b]	12.9%	9.8%
Special Funds Revenue			
—Amount	$3,081	$2,756	$3,391
—Dollar change	$190 [b]	–$325	$635
—Percent change	6.6% [b]	–10.5%	23.0%
Total, General Fund and Special Funds Revenue			
—Amount	$22,104	$24,237	$26,971
—Dollar change	$1,185	$2,133	$2,734
—Percent change	5.7%	9.7%	11.3%

[a] 1982–83 Governor's Budget. Detail may not add to totals due to rounding. Figures include effects of all revenue-enhancing measures proposed in the budget.

[b] 1979–80 base for computing changes has been adjusted to account for changes in the treatment of certain special fund transfer income.

By historical standards, revenue growth for these three years is low. For example:

- Growth in total ***current dollar*** revenues over the 10-year period preceding 1980–81 averaged over 15 percent per year, compared to 5.7 percent for 1980–81, 9.7 percent for 1981–82, and 11.3 percent for 1983–84;
- Growth in total ***constant dollar*** revenues (that is, revenues adjusted for inflation) averaged 7 percent over this 10-year period, compared to a decline of about 3 percent in 1980–81 and increases of only 1 percent in 1981–82 and 3 percent in 1982–83; and
- Growth in total ***constant dollar per capita*** revenues (that is, revenues adjusted for both inflation and population increases) averaged 5.2 percent over the 10-year period, versus declines of almost 5 percent in 1980–81 and 1 percent in 1981–82, and an increase of under 1 percent in 1982–83.

Of course, without tax enhancements proposed in the budget, the current and budget year revenue growth rates are even lower than those noted above.

The two main reasons for these historically-low rates of revenue growth are (1) the current weaknesses in the economy and (2) the fiscal effects of income tax indexing. The latter is projected by Finance to reduce 1982–83 General Fund revenues by over $3.1 billion below what it would have been without indexing. Our estimate of this effect is even larger—$3.6 billion. Current and budget year revenue growth, however, would be even weaker by historical standards were it not for the following factors:

- *First,* the budget revenue projections include the effects of a number of proposals to enhance revenues. These include accelerating the collection of certain taxes, increasing the interest penalties on late tax payments, and levying certain fees and user costs. These proposals amount to $338 million in 1981–82 (of which $233 million is a one-time gain) and $696 million in 1982–83 (of which $397 million is a one-time gain).
- *Second,* SB 215 (Ch 541/81) increased gasoline and diesel taxes, motor vehicle registration fees, truck weight fees, and driver's license fees. The result was to increase special fund revenues from motor vehicle user taxes and fees by $200 million in the current year and over $475 million in the budget year.

It is also important to recognize that the current and budget year revenue totals include significant redistributions of revenue from special funds to the General Fund. These redistributions, which are primarily one-time, are being proposed along with the other revenue-enhancing measures mentioned above in order to balance the General Fund budget. They total over $700 million in 1981–82 and $450 million in 1982–83. If the Department of Finance's economic forecast for 1982 and beyond comes true, a continuation of these transfers would not be necessary after 1982–83. This is because the regular General Fund tax base would generate enough revenues to fund the anticipated growth in future expenditures.

We now turn to a more detailed discussion of state revenues in the prior year (1980–81), current year (1981–82), and budget year (1982–83). First, however, it is important to look more closely at the economic assumptions on which the current and budget year revenue forecasts are based.

B. THE ECONOMIC OUTLOOK

1. THE 1981 ECONOMY IN RETROSPECT

On Balance, a Disappointing Year for California

For the second year in a row, the economy was a disappointment in many respects. Table 15 summarizes how the California economy fared during the year relative to Finance's projections. It indicates that:

- *Employment growth* fell below expectations. Civilian employment rose by only 1.1 percent, compared to the 4.5 percent increase expected one year ago. Wage and salary job growth was somewhat better (2.0 percent), although it, too, was less than predicted (2.4 percent).
- *Unemployment* averaged 7.4 percent compared to the 6.7 percent expected last year, and ended the year at 8.9 percent. This was the highest December rate in five years.

Table 15

Summary of 1981 Economic Performance for California [a]

Economic Indicators	*Original January 1981 Forecast* [b]	*Revised May 1981 Forecast*	*January 1982 Estimated Actual* [c]
Percent change in:			
—Personal income	11.9%	12.7%	12.1%
—Civilian employment	4.5%	2.5%	1.1%
—Wage and salary employment	2.4%	2.2%	2.0%
—Consumer prices	11.4%	10.3%	11.1%
Unemployment rate (%)	6.7%	7.6%	7.4%
Residential building permits (thousands)	175	155	109
New car sales (thousands)	975	1,015	930

[a] Forecasts and estimates by the California Department of Finance.
[b] 1981–82 Governor's Budget.
[c] 1982–83 Governor's Budget.

- ***Residential building permits*** were reported at only 109,000, compared to the predicted level of 175,000. This performance was the worst since 1966, when permits totaled about 100,000 but population was over 20 percent less than today.
- ***New car sales*** were 930,000, some 45,000 less than projected.
- ***"Real" personal income*** (that is, income adjusted for inflation) rose only 0.9 percent, if the Consumer Price Index (CPI) is used as a measure of inflation. This is because CPI inflation (11.1 percent) was very high relative to nominal personal income growth (12.1 percent). The CPI, however, has certain biases which appear to have overstated inflation. Depending on the extent of this bias, real income growth was probably somewhat more than 0.9 percent.
- ***Taxable sales*** rose 9.3 percent, well-below the 14.3 percent average from the preceding five years and much less than the increase in 1982 personal income.

Table 16 summarizes how successful forecasters other than Finance were in predicting California's economic performance. While the results are mixed, on balance these other forecasters appear to have expected somewhat better economic performance than occurred. For example, all but two forecasters overestimated personal income growth, everyone underestimated inflation and, as a result, all forecasters overestimated the state's growth in "real" personal income. Similarly, all but one forecaster overestimated employment growth. And as the last column in Table 16 indicates, no forecaster came even remotely close to foreseeing the collapse of the residential construction sector.

Economic Weaknesses a Nationwide Problem

California's economic problems in 1981 were, to a large extent, simply reflections of economic weaknesses affecting the nation generally. For instance:

- The ***nation's real GNP*** was only 2.1 percent higher in the fourth quarter of 1981 than in the first quarter of 1980, nearly two years earlier. On three occasions during this period, quarterly real GNP actually declined.

Table 16
Accuracy of 1981 Economic Forecasts for California[a]

Forecaster	*Personal Income Growth*	*Consumer Price Inflation*	*"Real" Personal Income Growth*[b]	*Wage and Salary Employment Growth*	*Unemployment Rate*	*New Residential Building Permits (thousands)*
Department of Finance	11.9%	11.4%	0.5%	2.4%	6.7%	175
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
UCLA	12.6	9.6	2.7	3.0	7.5	169
Crocker Bank	11.2	10.0	1.1	1.6	7.5	165
Average of All Forecasters	12.3%	10.3%	1.8%	2.6%	7.3%	173
Actual[c]	12.1%	11.1%	0.9%	2.0%	7.4%	109

[a] Forecasts as of approximately year-end 1980.
[b] Defined as personal income growth adjusted for consumer price inflation as measured by the California CPI. If the U.S. GNP Personal Consumption Expenditures (PCE) Deflator were used instead of the CPI to measure inflation, growth in "real" 1981 personal income would be 4.1 percent instead of 1.4 percent.
[c] As estimated in the 1982–83 Governor's Budget.

- U.S. before-tax ***corporate profits*** fell in each of the past two years.
- ***Housing starts*** in the fourth quarter of 1981 had fallen to an annual rate of only 870,000. For the year as a whole they averaged only 1.1 million, the worst performance since 1945;
- ***Capacity utilization*** averaged only 70 percent for the year, lowest in the postwar period.
- ***Interest rates*** remained high throughout the year, and were also quite volatile. Early in 1981, the prime rate reached 21.5 percent, then fell to 17 percent, rose again at mid-year to reach 20.5 percent and fell thereafter to end the year at 16 percent, slightly higher than it started 12 months earlier. Long-term interest rates, however, did not see an end-of-year decline. In fact, the corporate AAA bond rate had risen to 14.5 percent at year-end, while the average tax-exempt municipal bond rate exceeded 13 percent.

What Went Wrong?

Why did the economy perform so poorly in 1981? Some of the nation's leading economists openly disagree with one another about the exact causes of our current economic problems and the steps that are needed to overcome them. However, many economists share the belief that 1981's poor performance in terms of output and employment is most directly attributable to tight monetary policies pursued by the Federal Reserve Board (FED). These policies tend to restrict credit availability, put upward pressures on interest rates, and thereby discourage borrowing to finance home buying and business investment. However, the FED's purpose in attempting to reduce monetary growth stems directly from the need to lower inflation, which is ultimately caused by "too much money." Had more expansionary monetary policies been followed during 1981, it is possible that the economy might have performed better in terms of job growth and output, but at the cost of higher inflation in the future. Such inflation could, after a lag, result in even higher interest rates and a weaker economy than exists at present. Thus, selecting the proper policy prescription to rectify today's problems is a difficult and, as of yet, unresolved issue.

As 1982 begins, there is little data indicating that brighter days for the economy are immediately ahead. Indeed, softness in many underlying economic indicators, such as declining real income growth for consumers, excess inventories, and low capacity utilization rates, argue against any quick rebound in business activity. Because of preliminary data showing that real GNP declined at a 5.2 percent rate in the fourth quarter of 1981 and the high probability that there will be another (though probably smaller) decline in the current quarter, most economists concur that we are in the midst of a recession. Thus, the economy closed 1981 and began 1982 on a very negative note.

Table 17
Department of Finance Economic Outlook for California and the Nation (dollars in billions) [a]

	1981 Estimated		*1982 Forecast*		*1983 Forecast*	
	Level	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*
A. *The Nation*						
GNP in current dollars	$2,914.9	11.0%	$3,164.8	8.6%	$3,557.3	12.4%
GNP in 1972 dollars	$1,507.8	1.8	$1,502.5	−0.4	$1,561.9	4.0
Personal income	$2,406.0	11.4	$2,624.0	9.1	$2,913.7	11.0
Corporate profits (pre-tax)	$225.3	−8.2	$229.6	1.9	$282.3	23.0
Employment (in thousands)	98,439	1.2	98,750	0.3	101,301	2.6
Housing starts (millions of units)	1.12	−13.8	1.24	10.2	1.54	24.0
New car sales (millions of units)	8.7	−3.4	8.5	−1.6	9.4	9.6
GNP price deflator (1972=100)	193.3	9.0	210.6	8.9	227.8	8.1
Consumer price index (1967=100)	272.8	10.5	296.0	8.5	318.2	7.5
GNP consumption deflator (1972=100)	193.8	8.3	208.9	7.8	224.4	7.4
Unemployment (%)	7.5%	—	8.4%	—	7.6%	—
Savings rate (%)	5.3%	—	5.7%	—	6.4%	—
B. *California*						
Personal income	$291.1	12.1%	$321.1	10.3%	$358.1	11.5%
Employment (in thousands)	10,557	1.1	10,668	1.1	11,131	4.3
Residential building permits (in thousands)	109	−24.3	125	14.4	175	40.0
Consumer price index	277.0	11.1	308.2	11.3	333.7	8.3
Unemployment rate	7.4%	—	8.1%	—	7.1%	—

[a] Source: Department of Finance and 1982–83 Governor's Budget.

2. THE ECONOMIC OUTLOOK FOR 1982 AND 1983

Economic activity in calendar 1982 will account for about one-third of current year (1981–82) General Fund revenues and about two-thirds of budget year (1982–83) General Fund revenues. The remaining one-third of budget year revenues will be determined by 1983 economic conditions. Table 17 summarizes the Department of Finance economic projections for 1982 and 1983 for both the nation and California.

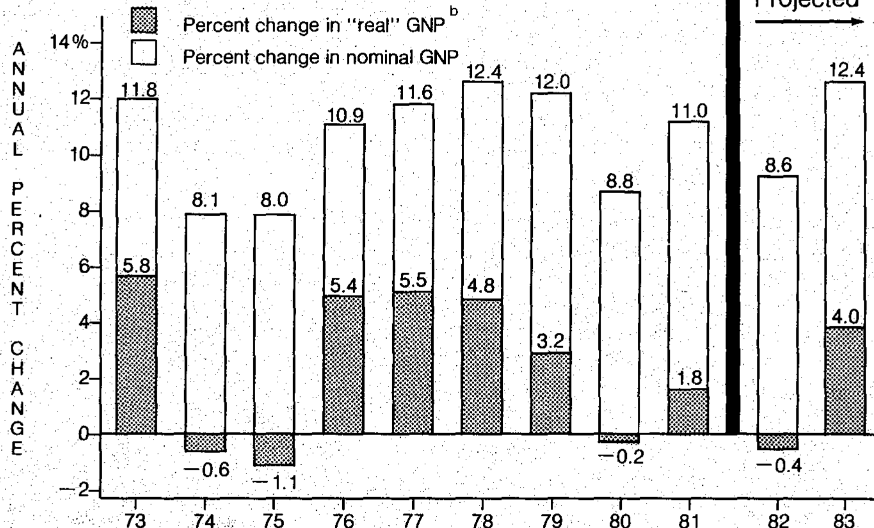
The Nation—From Recession to Recovery

The department predicts that the current recession will be over sometime in the spring months, and that economic recovery will be underway in the last half of 1982. The recovery is expected to be moderate, though sustained, carrying forward beyond 1983. As shown for the nation in Table 17:

- ***Real GNP*** is projected to decline by 0.4 percent for 1982 as a whole, and then rise by a strong 4.0 percent in 1983 (Chart 10).
- ***Pre-tax corporate profits*** are expected to post a very small gain in 1982, before rebounding to a 23 percent gain in 1983.

Chart 10

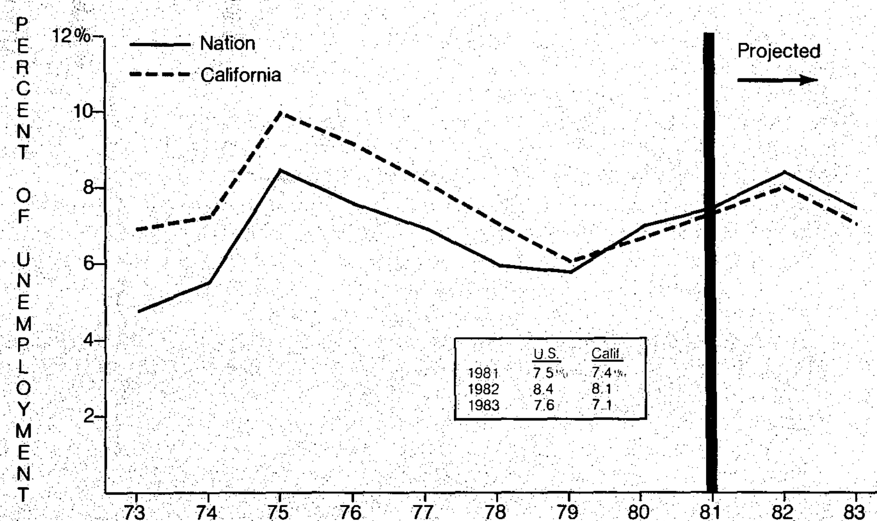
Annual Change in Gross National Product. 1973 through 1983[a]



[a] California Department of Finance. 1981 figures are preliminary.
[b] "Real" GNP is defined as current dollar nominal GNP deflated by the U.S. GNP price deflator.

Chart 11

Unemployment Rates for California and the Nation 1973 through 1983[a]



	U.S.	Calif.
1981	7.5%	7.4%
1982	8.4	8.1
1983	7.6	7.1

[a] California Department of Finance.

- ***Unemployment*** is expected to average 8.4 percent in 1982. In 1983, it is predicted to fall to 7.6 percent, which would still be above its 1981 level (Chart 11).
- ***Employment growth*** is expected to be negligible in 1982, rising only 0.3 percent versus the 1.2 percent gain of 1981. In 1983, a moderate gain of 2.6 percent is projected.
- ***Housing starts*** will remain weak in 1982 at 1.24 million units, and then rise to a modest 1.54 million units in 1983.
- ***Car sales*** will also remain weak in 1982, totaling only 8.5 million units, or even less than the 1982 level. In 1983, however, an increase to 9.4 million units is projected.

California—A Similar Recession-Recovery Outlook

Most economists who study the California economy believe that the state will fare better in the current recession than the nation. This is largely because California is less dependent than many other large industrial states on interest-sensitive heavy manufacturing industries (like the automobile industry), which are particularly vulnerable during recessions. Nevertheless, the recession clearly is expected to take its toll in the state. As shown in Table 17:

- ***Civilian employment growth*** in 1982 is projected to rise only 1.1 percent. As Chart 12 shows, California wage and salary job growth is also projected to be only 1.1 percent in 1982, representing just 114,000 new jobs. This would be the smallest number of new jobs created in any year since 1975.
- ***The unemployment rate*** is expected to rise from 7.4 percent in 1981 to 8.1 percent in 1982, or slightly below the nation's. As Chart 11 indicates, the state's unemployment rate is then expected to decline to 7.1 percent in 1983, or somewhat more rapidly than the nation's.
- California ***construction activity,*** like the nation's, is expected to improve only slightly in 1982. Building permits are projected to reach only 125,000 in 1982, before rising to 175,000 in 1983. Most economists believe that building permits in California need to average about 200,000 or more per year in order to meet the basic demand for new housing associated with natural population growth, new household formations and in-migration.

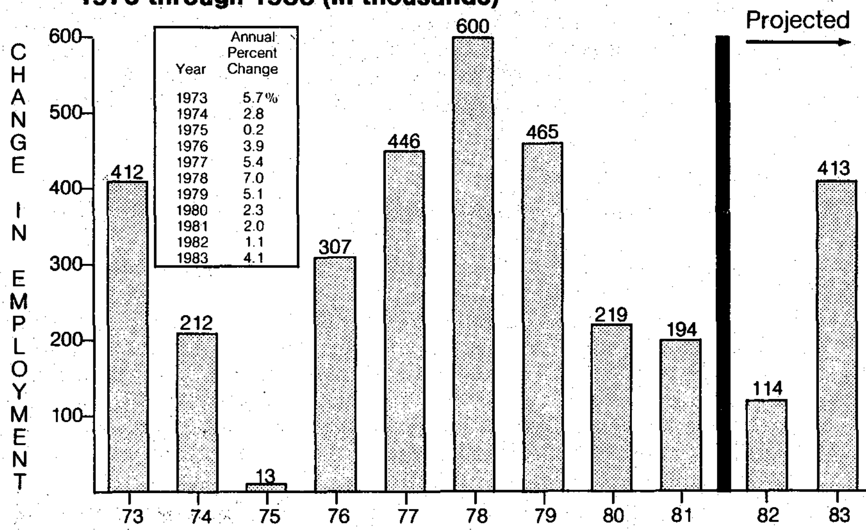
The implications of the current economic outlook for state revenues are best seen in the forecasts for those key California variables which most strongly affect the state's major revenue sources:

- ***California personal income growth*** (Chart 13) is projected to *decline* sharply from 12.1 percent in 1981 to only 10.3 percent in 1982, despite a projected rise in California inflation. As a result, "real" personal income growth (i.e., growth adjusted for inflation as measured by the CPI) is expected to fall by 1 percent in 1982.
- ***Taxable corporate profits*** are forecast to rise 10.8 percent in 1982 and 18.8 percent in 1983, following a gain of 11.9 percent in 1981. These 1982 and 1983 gains are below the 20-percent-plus increases experienced in 1976–78 after the previous recession had ended. However, they are still quite large, given the generally weak state of the economy. As discussed later, we believe that the growth in California corporate profits could easily fall below that projected by Finance.
- ***Taxable sales*** are predicted to rise only 9.6 percent in 1982. In 1983, however, the projected rise in nominal (15.7 percent) and real (8.6 percent) taxable sales is comparable to that of 1976, the first full year

Chart 12

Annual Growth in California Wage and Salary Employment

1973 through 1983 (in thousands)[a]

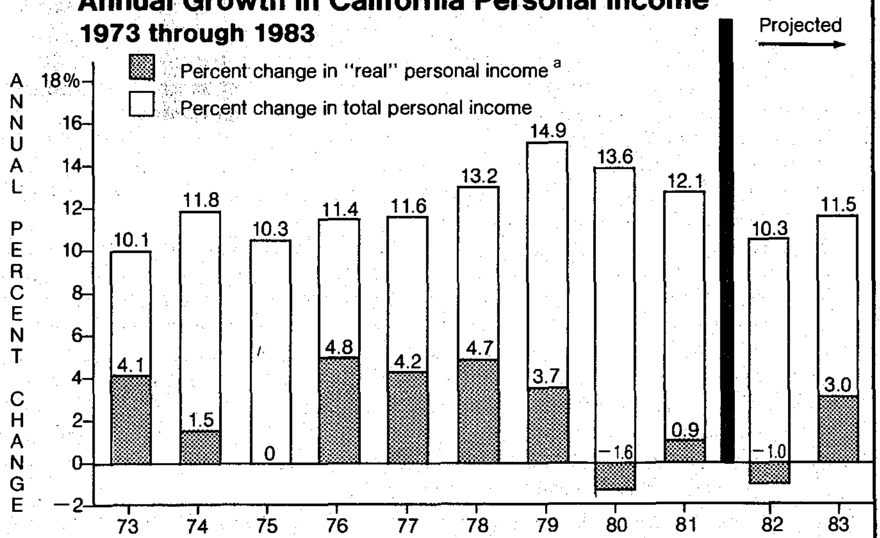


[a] Department of Finance and Employment Development Department. Data are estimated for 1981 and projected for 1982 and 1983.

Chart 13

Annual Growth in California Personal Income

1973 through 1983



[a] Real personal income is defined as total personal income deflated by the California Consumer Price Index for all urban households. Estimates for 1981, 1982, and 1983 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 3.5 percent (1981), 2.2 percent (1982) and 3.8 percent (1983).

of recovery following the 1973–75 recession. While the 1982 nominal gain exceeds the 9.3 percent gain of 1981, the increase, after adjustment for inflation, is only 2.5 percent.

These projections are all consistent with the concensus view of economists that the first half of 1982 will be a period of negative or flat growth, and that economic gains in the second half of 1982 will be only moderate. It is primarily because of this moderate economic recovery that only relatively modest gains are anticipated for state revenues in 1981–82 and 1982–83.

Inflation to Trend Downward

The outlook for inflation is moderately favorable. As shown in Table 17 and Chart 14:

- Inflation for the *nation* is expected to decline, though only slowly, through 1983. The nation's CPI is projected to fall to 8.5 percent in 1982 and 7.5 percent in 1983, and the GNP consumption deflator is projected to average 7.9 percent in 1982 and 7.4 percent in 1983.
- For *California,* the CPI is forecast to average 8.3 percent by 1983. Although this rate will exceed the nation's, primarily due to the state's tendency to record above-average increases in homeownership costs, this still represents a significant improvement over the average 15.5 percent inflation rate experienced in 1980.

Table 17 and Chart 14 indicate that the state's CPI increase in 1982 is expected to average 11.3 percent for the year as a whole, or slightly *above* the estimated 1981 rise of 11.1 percent. The higher *average* rate of inflation forecast for 1982 might appear to be inconsistent with the department's expectation of a declining *trend* in inflation during 1982. The explanation for the higher average increase lies not in the trend but in the monthly pattern which the CPI followed in 1981.

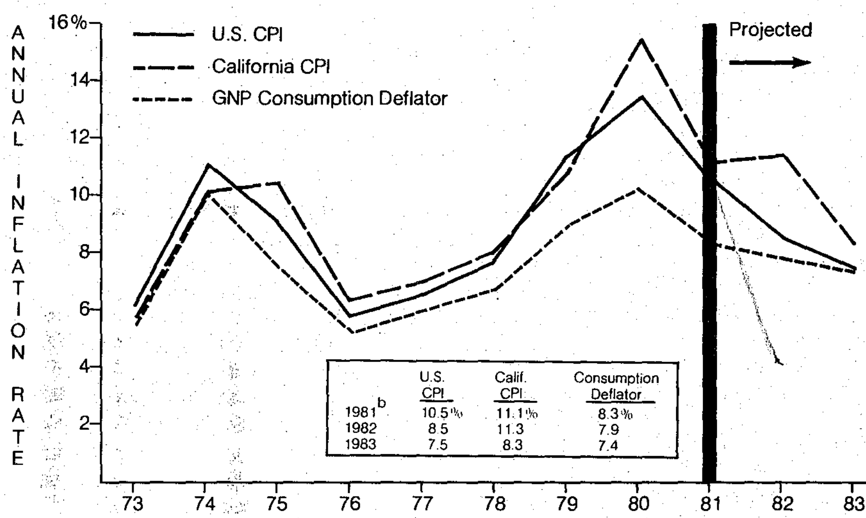
The outlook for a declining inflation trend in 1982 is supported by a number of fundamental inflation-determining factors. These include:

- Large amounts of *excess productive capacity* in the economy;
- A very favorable outlook for *food prices* in 1982 (projected to rise between 6 and 7 percent);
- The likelihood that *OPEC oil prices* will remain stable in 1982 and that petroleum demand may decline further, due to conservation efforts;
- Continued efforts by the Federal Reserve to avoid excessive rates of *money supply growth;* and
- Moderation in *collective bargaining wage increases.* In 1982, some 4.5 million workers will have new contracts negotiated, covering major industries like petroleum, rubber, electrical products, airlines, trucking and autos. In 1980 and 1981, wage increases averaged about 11 percent. Early evidence suggests that the average collective bargaining wage increase could drop into the 8 percent to 9 percent range, primarily because rising unemployment has weakened the bargaining power of unions. This moderation will help to reduce the growth in unit labor costs firms face, and enable them to achieve target profit margins with lower price increases.

Given these factors, it seems possible that the department's inflation projections could be on the high-side, since its predicted monthly inflation trend, though heading in a downward direction, declines at a mild rate. Some evidence that the department's inflation forecast may be too high appeared in late January, when the federal government reported that the increase in U.S. consumer prices from December 1980 through December 1981 averaged 8.9 percent, or about 1 percentage point below the department's budget estimate of 9.9 percent. Likewise, the December 1980 to December 1981 California CPI increase was 11.2 percent, compared to the department's estimate of 13 percent. As noted below, Finance's inflation projections are also on the high side relative to other forecasters.

Chart 14

Inflation Faced by Consumers in California and the Nation[a]
1973 through 1983



	U.S. CPI	Calif. CPI	Consumption Deflator
1981[b]	10.5%	11.1%	8.3%
1982	8.5	11.3	7.9
1983	7.5	8.3	7.4

[a] California Department of Finance. CPI figures are for all-urban index. Figures for the GNP Consumption Deflator are subject to revision for recent years, due to periodic GNP data adjustments.
[b] Preliminary estimates.

Federal Policies—Critical to the Outlook

There are two general categories of federal policies which can influence economic activity. First, there are the taxing and spending policies of the federal government, which are generally referred to as *fiscal policies*. And second, there are the policies regarding management of the nation's money supply and certain interest rates by the Federal Reserve Board, which are referred to as *monetary policies*. For 1982, the future course of these federal monetary and fiscal policies represents the single biggest uncertainty in the economic outlook, and will probably also exert the greatest influence on actual economic performance in the nation and state.

During 1981, the President developed and began implementation of a plan aimed at stimulating the economy, eliminating excessive inflation, encouraging productivity and investment, eliminating the federal deficit, and increasing the nation's defense capabilities. This plan has three major components:

- A significant *reduction* in the growth of *total federal spending;*
- A shift in the *mix* of federal spending, in favor of *defense-related* spending at the expense of nondefense spending; and
- Significant *tax cuts* for individuals and businesses, includng phased-in reductions in personal income tax rates and more liberal depreciation rules for plant, equipment, and residential and nonresidential properties. These tax cut provisions were enacted as the Economic Recovery Tax Act of 1981, which also included tax provisions to stimulate savings in the form of individual retirement accounts (IRA's).

In conjunction with these provisions, the administration expressed support for the Federal Reserve Board's current policy of limiting growth in the money supply so as to reduce inflation.

At present, the ability of the President to continue implementing his original plan is uncertain. He had hoped that the tax provisions would stimulate the economy and make up for the depressing effects of reduced federal spending. However, largely because of the recession, estimates of the federal deficit have risen dramatically in recent months to as high as $175 billion for fiscal 1983. Exactly how this might force the President to modify his current tax and spending plans is unknown. In addition, if the federal government is required to finance such a large deficit by borrowing, the effect could be to put increased pressure on the Federal Reserve Board to provide the economy with additional credit so that private sector borrowers are not "crowded out" by the federal government. The effect of this would be to increase the money supply and thereby possibly also increase inflation and interest rates in the future. Thus, the exact course which fiscal and monetary policies will take in 1982 and 1983 remains somewhat clouded.

Finance Versus Other Forecasters

Tables 18 and 19 compare the Department of Finance's national and California economic forecasts for 1982 with those of other economists. On balance, most of the forecasters envision the same general type of economy in 1982 as Finance does—weak economic growth, high inflation, and poor performance in terms of profits, home building, and car sales.

Table 18 indicates that Finance's *national* forecast is similar to the others in terms of real GNP growth and housing starts. However, Finance appears to be somewhat on the high-side regarding unemployment, inflation, and especially, profit growth. Regarding *California,* Table 19 suggests that Finance is on the high-side regarding personal income growth, inflation and employment growth, slightly optimistic regarding unemployment, and reflects the concensus regarding residential housing activity. The difference in inflation forecasts is particularly striking. Even if UCLA's low-end 1982 inflation forecast of 5.7 percent is excluded from the comparison, Finance's inflation forecast is still about three percentage points higher than the remaining forecasters'.

Our discussions with these forecasters indicate that they all exhibit considerable uncertainty about exactly what will happen over the next two years, and expect to have to revise their projections frequently in the months to come. Given this, we believe that the department's economic forecast is as reasonable as anyone's at this point in time, although the odds are low that it, or any of the other forecasts shown, will turn out to be on target.

Table 18
Comparison of 1982 National Economic Outlook for Selected Forecasters

	Percent Change in:						
	Real GNP	*GNP Prices*	*Consumer Prices*	*Before-Tax Profits*	*Unemployment Rate*	*New Car Sales (millions of units)*	*Housing Starts (millions of units)*
Department of Finance	−0.4%	8.6%	8.5%	1.9%	8.4%	8.5	1.24
Other Forecasters[a]							
First Interstate Bank[b]	2.5%	7.9%	8.2%	11.2%	7.1%	9.7	1.55
Security Pacific Bank	−0.3	7.9	7.8	−3.5	9.2	8.9	1.30
Wells Fargo Bank	0.1	7.8	8.3	N.A.	8.2	9.2	1.20
Bank of America	−0.9	7.7	8.2	−15.6	8.7	8.9	1.20
Crocker Bank	−0.5	7.5	7.6	N.A.	8.6	8.9	1.32
UCLA	−1.7	7.1	5.9	−15.9	8.9	8.3	1.32
Chase Econometrics	—	8.2	8.4	−7.0	9.0	9.4	1.26
Data Resources	−0.6	7.7	8.3	−7.1	8.6	9.1	1.28
Average of "Other" Forecasters	−0.2%	7.7%	7.8%	−6.3%	8.5%	9.0	1.31

[a] Forecasts as of approximately year-end 1981.
[b] Formerly United California Bank (UCB). Forecast as of October 1981.

Table 19
Comparison of 1982 California Economic Outlook for Selected Forecasters

	Percent Change in:					
	Personal Income	*Consumer Prices*	*"Real" Personal Income*[c]	*Wage and Salary Employment*	*Unemployment Rate*	*New Residential Building Permits (thousands)*
Department of Finance	10.3%	11.3%	−0.9%	1.1%	8.1%	125
Other Forecasters[a]						
First Interstate Bank[b]	11.0%	8.3%	2.5%	2.7%	6.9%	164
Security Pacific Bank	9.9	8.4	1.4	1.0	8.6	125
Wells Fargo Bank	11.0	8.0	2.8	1.0[d]	8.5	110
Bank of America	9.0	7.5	1.4	1.0[d]	8.0	135
Crocker Bank	9.0	7.8	1.1	0.2	8.4	138
UCLA	7.8	5.7	2.0	−0.5	8.8	133
Average of "Other" Forecasters	9.6%	7.6%	1.9%	0.9%	8.2%	134

[a] Forecasts as of approximately year-end 1981.
[b] Formerly United California Bank (UCB). Forecast as of October 1981.
[c] Defined as personal income growth adjusted for consumer price inflation. If the GNP consumption expenditures deflator were used instead of the CPI, "real" personal income growth would be somewhat higher.
[d] Civilian employment growth estimate.

C. PRIOR YEAR (1980–81) REVENUES

Smallest Increase in 10 Years

Table 20 summarizes 1980–81 General Fund revenue collections. These receipts totaled $19,023 million, or only 5.5 percent ($994 million) over 1979–80—a very modest increase. In fact, this was the smallest rate of increase in General Fund revenues since 1970–71. As Table 20 shows:

- ***Sales and use taxes*** increased 7.4 percent, or $484 million. This increase was much less than the rate of growth in state personal income, and reflects the depressing effect of high interest rates and declining real income on purchasing, especially of building supplies and consumer durables like automobiles.
- ***Personal income taxes*** rose only 1.9 percent, or $123 million. This extremely low growth is primarily due to income tax indexing, and reflects two factors. First, the June-to-June inflation rate, which is the basis for indexing, rose by 17.3 percent in 1980, or far in excess of 1980 personal income growth (13.6 percent). And second, the indexing of the marginal tax brackets in 1980 shifted from "partial" to "full" indexing. The net result of these two factors was that many taxpayers essentially moved "backwards" through the income tax structure in 1980, causing their tax liabilities to actually fall as a percent of their income.
- ***Bank and corporation taxes*** rose by 8.8 percent, or $221 million.

Table 20
Growth of Prior Year (1980–81)
General Fund Revenues by Type
(in millions)[a]

	Actual 1979–80	*Actual 1980–81*	*Change*	
			Amount	*Percent*
Three major taxes:				
—Sales and use	$6,522	$7,006	$484	7.4%
—Personal income[b]	6,506	6,629	123	1.9
—Bank and corporation	2,510[c]	2,731	221	8.8
Other major taxes and licenses	1,366	1,442	76	5.6
Interest income	547	464	−83	−15.2
Other revenues and transfers[d]	578	751	173[e]	29.9[e]
Total General Fund Revenues and Transfers	$18,029[c]	$19,023	$994	5.5%

[a] Detail may not add to total, due to rounding.
[b] Includes effect of moving from "partial" to "full" indexing of the personal income tax marginal rate brackets between 1979 and 1980.
[c] Includes $43.6 million shown in the 1981–82 Governor's Budget as bank and corporation tax special fund revenue associated with AB 66 (Ch 1150/79). The 1982–83 budget does not treat these transfers as direct special fund income.
[d] Includes transfers from Federal Revenue Sharing Fund of $276.2 million in each year.
[e] Primarily reflects increased receipts from the Health Care Deposit Fund.

- ***Interest income*** fell by $83 million, primarily because of the decline in the size of the General Fund budget surplus available for investment.

Weakening Economy Causes Downward Revenue Revisions

Table 21 shows how the Department of Finance revised its 1980–81 revenue forecast over the past two years:

- Actual revenues were *less than the original estimate* presented in the 1980–81 Governor's Budget (January 1980) by $283 million, or 1.5

percent. This amount, which *excludes* the effects of 1980 tax legislation, reflects downward adjustments of $231 million for the sales and use tax, $136 million for the personal income tax, and $52 million for the bank and corporation tax. The total downward revision would have been much larger were it not for greater-than-expected interest income of $66 million, caused by the upward surge in interest rates during 1980.

- Actual revenues were also *less than the May 1980 revenue revision* provided to the Legislature before its action on the 1980–81 budget, by $277 million (1.5 percent).
- Actual revenues were *less than the mid-year estimate* prepared in January 1981 for the 1981–82 Governor's Budget, by $80 million, or 0.4 percent.

Table 22 compares the department's revenue estimating errors for 1980–81 to those over the seven-year period since 1973–74. Two important points about the 1980–81 revenue estimates stand out:

- ***First,*** 1980–81 is the *only* year during this period when the department *overestimated* revenues; and

Table 21

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

		Revisions						Total
	Original Estimate in January 1980	*May 1980*	*Adjustment for 1980 Legislation* [b]	*January 1981*	*May 1981*	*January 1982*	*Actual*	*Total Revisions Adjusted for Legislation*
Taxes:								
Sales and use	$7,240.0	$—	−$3.5	−$225.3	$27.8	−$33.2	$7,005.8	−$230.7
Personal income	6,800.0	−130.0	−35.2	15.2	−35.0	13.7	6,628.7	−136.1
Bank and corporation [c]	2,723.0	83.0	−17.2	−112.8	50.0	4.6	2,730.6	−52.2 [f]
Other taxes	1,517.1	−5.6	−14.7	48.1	−88.2	−13.7	1,443.0	−59.4
Total Taxes	$18,280.1	−$52.6	−$70.6	−$274.8	−$45.4	−$28.6	$17,808.1	−$478.4 [f]
Interest income	400.0	25.0	−2.0	28.6	8.4	3.6	463.6	65.6
Other revenues and transfers [d]	603.9 [e]	37.4	17.8	62.7	5.2	24.4	751.4	129.7
Total General Fund Revenues and Transfers	$19,284.0	$9.8	−$54.8	−$183.6	−$31.7	−$0.6	$19,023.1	−$283.1 [f]

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

[b] Department of Finance estimates, December 1980. Major fiscal legislation includes Ch 29/80 (AB 325), which provides for changes in the timing of income tax withholding remittances from certain employers. This measure reduced revenues by an estimated $30 million in 1980–81. In addition, Ch 1043/80 (AB 3383), which makes various changes in the horse racing statutes, reduced 1980–81 revenues by about $15 million.

[c] Revenues shown in this table have been reduced by $77 million for January 1980, $61 million for May 1980, $48 million for January 1981, and $53 million for May 1981, to account for transfers to special funds under AB 66 (Ch 1150/79). During this period, Finance was *proposing* legislation to treat these transfers as *direct* special fund income. In the 1982–83 Governor's Budget, however, there are no such transfers excluded from General Fund revenues.

[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. This proposal was not enacted, although additional tidelands oil revenues were allocated to the General Fund at later dates.

[f] Adjusts for effect due to change in treatment of AB 66 transfers between January 1980 and January 1982. See footnote "c."

Table 22
General Fund Revenue Estimating Errors, 1973–74 Through 1980–81 [a]

	Errors Made in Original January Budget [b]		*Errors Made in May* [c]		*Errors Made in Midyear* [d]	
	Dollar Error (in millions)	*Percent Error* [e]	*Dollar Error (in millions)*	*Percent Error* [e]	*Dollar Error (in millions)*	*Percent Error* [e]
1973–74	–$205	–2.9%	–$184	–2.6%	–$243	–3.5%
1974–75	–697	–8.1	–322	–3.7	–166	–1.9
1975–76	–459	–4.8	–621	–6.5	–451	–4.7
1976–77	–1,011	–9.8	–726	–6.4	–394	–3.5
1977–78	–1,339	–9.8	–966	–7.1	–331	–2.4
1978–79	–974	–6.4	–780	–5.1	–220	–1.4
1979–80	–680	–3.8	–502	–2.8	–204	–1.1
1980–81	283	1.5	277	1.5	80	0.4

[a] Revenue effects of new legislation and changes in the treatment of special fund transfers over time have been removed. Negative numbers indicate that revenues were underestimated; positive numbers indicate that revenues were overestimated.
[b] Difference between receipts estimated in January prior to the start of the specified fiscal year and actual receipts.
[c] Difference between receipts estimated in May prior to the start of the specified fiscal year and actual receipts.
[d] Difference between receipts estimated in January of the fiscal year specified and actual receipts.
[e] Error as a percent of actual revenues.

- *Second,* 1980–81 shows the *smallest* percentage errors for any of these years.

Prior to 1980–81, there had been concern that the department's persistent tendency to underestimate revenues—often by significant amounts—reflected an inherent conservative bias in its economic forecasting and revenue estimating procedures. However, based upon the record of 1980–81 as well as the downward revisions that have been made thus far to the 1981–82 revenue estimate, no such bias is evident today. We see no reliable indications at this time that the state can count on any significant revenue "windfalls" during the current or budget years, relative to what the department is projecting.

D. CURRENT YEAR (1981–82) REVENUES

Revenues Include Over $1.1 Billion Due to Special Factors

Table 23 summarizes the Department of Finance projections for General Fund revenues in 1981–82. Before turning to these figures, however, it is important to note that these current year estimates include $1.1 billion in "new" and primarily one-time General Fund monies. Thus, *the published revenue figures in the budget provide a distorted and overly-optimistic picture of the underlying growth trend of the state's General Fund revenue base.*

This $1.1 billion, which is needed in order to finance 1981–82 General Fund expenditures without incurring a budget deficit, includes the following:

- ***A $338 million increase in tax receipts*** from accelerating the payment of income tax withholding funds to the state ($200 million), increasing

Table 23
Growth of Current Year (1981–82)
General Fund Revenues by Type
(in millions)[a]

Revenue Source	*Actual for 1980–81*	*Current estimate for 1981–82*	*Change* Amount	*Change* Percent	*Change Without One-time Transfers or Revenue-Enhancement Proposals* Amount	*Change Without One-time Transfers or Revenue-Enhancement Proposals* Percent
Sales and use tax	$7,006	$7,593	$587	8.4%	$569	8.1%
Personal income tax	6,629	7,575	946	14.3	721	10.9
Bank and corporation tax	2,731	3,055	324	11.9	259	9.5
Other major taxes and licenses	1,442	1,477	35	2.4	−25	−1.7
Total Major Taxes and Licenses	$17,808	$19,700[b]	$1,892	10.6%	$1,524	8.6%
Interest income	464	314	−150	−32.3	−150	−32.3
Other revenues and transfers	751	1,468[c]	717	95.5	−19	−2.5
Total General Fund Revenues and Transfers	$19,023	$21,481	$2,459	12.9%	$1,355	7.1%

[a] Detail may not add to total, due to rounding.
[b] Includes $338 million in tax revenue enhancements proposed in the 1982–83 Governor's Budget.
[c] Includes over $730 million in increased transfers to the General Fund resulting primarily from a combination of (1) 1981 legislation regarding the distribution of tidelands oil revenues, (2) SB 102 (Ch 101/81) and (3) proposals contained in the 1982–83 Governor's Budget and in the 1982 Budget Bill.

the interest due on delinquent tax payments ($125 million), and eliminating the 1981–82 transfer to the State Highway Account of certain gasoline sales tax receipts ($13 million). One portion of this plan—the acceleration of withholding receipts—was enacted in January after the budget was introduced (AB 6x, Ch 2/82). The revenue gain for this provision is now estimated at $180 million, or $20 million less than proposed in the budget.

- A one-time transfer of $131 million to the General Fund from the *Motor Vehicle License Fee Account* under SB 102 (Ch 101/81), plus over $35 million in additional General Fund revenues due to permanent elimination of three local subvention payments under SB 102.
- ***Additional one-time transfers*** of nearly $600 million into the General Fund from various special funds, including the Capital Outlay Fund for Higher Education, the Energy and Resources Fund, the Special Account for Capital Outlay, the State Parks and Recreation Fund, the State School Building-Lease Purchase Fund, the Transportation Planning and Developoment Account, and the Employment Development Contingent Fund.

Of the total $1.1 billion of these new General Fund receipts, about $960 million represents purely one-time revenues, of which over $700 million reflects a temporary shift of income from special funds.

Limited Strength in Underlying Revenue Trend

Table 23 indicates that 1981–82 General Fund revenues are estimated to reach nearly $21.5 billion, including $7.6 billion for both the sales and use tax and the personal income tax, and $3.1 billion for the bank and corporation tax. This represents a gain in General Fund revenues of almost

$2.5 billion (12.9 percent) over 1980–81, or an increase of 4 percent in constant dollars and 2 percent in constant dollars per capita.

However, the table also indicates that the *underlying* General Fund revenue growth, computed by excluding the $1.1 billion in new revenues due to special funds transfers and tax proposals, is only $1.4 billion, or 7.1 percent. Furthermore, even when the low-growth non-tax components of interest income and remaining transfers are omitted, the projected increase in baseline revenues from the major taxes is still only 8.6 percent, or well below the 12.1 percent increase in personal income recorded for 1981.

The limited strength in the state's 1981–82 underlying General Fund revenue trend can be traced primarily to five factors:

- ***First,*** revenue growth has slowed significantly due to the *recession.* For example, taxable sales grew only 9.3 percent in 1981, or less than both California personal income (12.1 percent) and inflation (11.1 percent).
- ***Second,*** the personal income tax rate brackets were *fully indexed* in 1981 for inflation. This has reduced the frequency and pace at which taxpayers move upward through the state's progressive income tax schedules.
- ***Third, inheritance and gift tax*** revenues are projected to *decline* in 1981–82, reflecting the continued phasing-in of AB 2092 (Ch 634/80), which exempted all spouses from inheritance and gift taxation and increased certain other exemptions. This legislation is estimated to reduce 1981–82 revenues by about $100 million.
- ***Fourth, interest income*** is projected to fall by $150 million in the current year, due to the decline in the General Fund surplus available for investment.
- ***Fifth,*** 1981–82 General Fund receipts from the Federal Revenue Sharing Fund total only $180 million, compared to $276 million in 1980–81. This decline is because the federal revenue sharing program for states has now terminated, and the 1981–82 transfer reflects only the remaining partial year monies left over from the final federal payment. Thus, in 1982–83, the General Fund will not receive any revenue sharing funds.

Current Year Revenues—Largest Downward Revision on Record

Table 24 presents the history of General Fund revenue estimates for 1981–82. Clearly, the current recession has had a tremendous negative impact on the current year's revenue outlook. The table indicates that:

- 1981–82 revenues were initially revised *upward* in *May 1981,* by over $250 million. This revision included offsetting effects. Upward adjustments were made to the bank and corporation tax ($245 million), personal income tax ($100 million), and interest income ($48 million), while downward adjustments were made to the sales and use tax (over $41 million) and the "all other" tax category ($98 million). The department made this net upward adjustment primarily based on the economy's performance in the first quarter of 1981, which was far stronger than had been expected. For example, in the first three months of 1981 the nation's real GNP rose at an annual rate of 8.6 percent, personal income rose by over 14 percent (annual rate), and before-tax profits rose by nearly 22 percent (annual rate).
- In *January 1982,* however, projected revenues have been revised *downward* from the May estimate by over $870 million. This revision,

which adjusts for the fiscal effects of legislation enacted in 1981 and assumes *current law,* is the *largest downward revision recorded at midyear for any fiscal year in history.* It includes downward adjustments for the bank and corporation tax ($228 million), the personal income tax ($184 million), the sales and use tax ($359 million), other taxes ($49 million), and interest income ($61 million). When this January 1982 downward revision is combined with the upward May 1981 revision, baseline January 1982 General Fund revenues total nearly $21 billion—about $620 million lower than originally projected 12 months ago (after adjustments are made for legislative changes).

- The 1981–82 General Fund revenue total appearing in the budget—nearly $21.5 billion—results from adding to the $21 billion baseline revenue figure approximately $520 million in tax enhancements and special fund transfers proposed in the budget. This latter amount, when combined with the $585 million in General Fund revenue gains from special funds transfers enacted earlier in 1981, accounts for the nearly $1.1 billion special General Fund revenue adjustments discussed earlier.

Latest Cash-Flow Data Indicates Continued Weakness

January 1982 was the latest month for which data on agency cash collections of General Fund revenue was available before our *Analysis* went to print. During January, these revenue collections were $129 million below the forecast for January contained in the 1982–83 Governor's Budget. Even after adjustment for cash-flow shifts, the shortfall was $108 million. The largest source of the shortfall was the sales and use tax—down $44 million.

January data also indicated a shortfall in withholding receipts of about $7 million. While this was a relatively small dollar shortfall, it was the sixth consecutive month that these receipts have fallen below the department's projections. Because withholding is a key barometer of economic conditions and a good indicator of the income base which supports future spending, January's revenue performance was not very encouraging.

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 the 1981–82 revenue forecast is consistent with the economic forecast. In general, we believe that it is, as our computations produce a level of current year revenues which is only $30 million below the Finance estimates.

However, the 1981–82 revenue picture is still far from certain. Economic conditions during the first half of 1982 will account for about one-third of total current-year revenues, and it is very likely that certain aspects of the economic forecast which are key to estimating revenues will prove to be inaccurate. January's revenue performance is certainly consistent with this possibility.

In discussing the problem of revenue estimating error margins, the budget suggests that current year revenues could differ from the department's estimate by as much as 3 percent, or about $650 million. This is certainly possible, based on the record of previous mid-year estimates, as Table 22 illustrates. Given this and the absence of any significant reserve for absorbing revenue shortfalls or expenditure overruns, it is imperative that the department continuously review its 1981–82 revenue forecast in the coming months as additional economic and revenue data are available, and alert the Legislature as to any significant changes in the outlook.

Table 24

1981–82 General Fund Revenues and Transfers
History of Department of Finance Estimates
(in millions) [a]

Revenue Source	Original Estimate in January 1981	Revisions: May 1981 Revision	Revisions: 1981 Legislation	Revisions: January 1982 Baseline Revision [e]	Total Revisions Adjusted for Legislation	January 1982 Baseline Revenues [e]	January 1982 Proposed Enhancements to Revenues & Transfers	January 1982 Budget Estimate
Bank and corporation tax [b]	$3,035.2	$244.8	$28.0 [c]	−$288.0	−$43.2	$3,020.0	$35.0	$3,055.0
Personal income tax	7,435.0	100.0	−0.8	−184.2	−84.2	7,350.0	225.0	7,575.0
Sales and use tax	8,000.7	−40.7	−26.3	−358.7	−399.4	7,575.0	18.0	7,593.0
Other taxes	1,563.7	−97.8	−0.3	−48.9	−146.7	1,416.7	60.0	1,476.7
Total taxes	$20,034.6	$206.3	$0.6	−$879.8	−$673.5	$19,361.7	$338.0	$19,699.7
Interest income	$326.6	$48.4	—	−61.3	−12.9	313.7	—	313.7
Other revenue	401.7	−4.0	17.4	95.0	91.0	510.0	—	510.0
Total, revenues	$20,762.9	$250.7	$18.0	−$846.2	−$595.5	$20,185.4	$338.0	$20,523.4
Transfers	256.8 [g]	—	546.6 [g]	−26.4	−26.4	777.0	181.0 [f]	958.0
Total, General Fund revenues and transfers	$21,019.7	$250.7	$564.6 [d]	−$872.6	−$621.9	$20,962.4	$519.0	$21,481.4

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

[b] Reduced by $27 million in January 1981 and $30 million in May 1981 for FALA Fund transfers under AB 66 (Ch 1150/79). Finance treated these monies as direct special fund revenues.

[c] Includes $30 million for elimination of FALA Fund transfers under SB 102 (Ch 101/81).

[d] Total legislation change of $564.6 million includes four main components: (1) revenues under SB 102, which Finance estimated in its *1981 General Fund Update and Financial Legislation Report* to total $179.1 million. This was comprised of (a) $130 million in General Fund transfers from the Motor Vehicle License Fee Account, (b) $30 million in bank and corporation tax revenues due to elimination of FALA fund transfers under AB 66, (c) $14.9 million in General Fund "other revenues" due to elimination of Liquor License Fee subventions and (d) $4.2 million in General Fund "other revenues" due to elimination of subventions for highway carriers; (2) $399.6 million in General Fund transfer income from special funds including (a) the Capital Outlay Fund for Higher Education ($53.6 million), (b) the Energy and Resources Fund ($24.0 million, (c) the Special Account for Capital Outlay ($47.0 million), (d) the State Parks and Recreation Fund ($41.0 million), (e) the State School Building-Lease Purchase Fund ($200.0 million), (f) the Transportation Planning and Development Account ($25.0 million) and (g) other miscellaneous special funds ($9.0 million). Provisions for transferring these funds, which represent tidelands oil revenues, were contained in the 1981 Budget Act; (3) increased sales and use tax transfers under SB 215 to the State Highway and Transportation Planning and Development Accounts. These combined transfers are currently estimated to total $26 million in 1981–82; and (4) miscellaneous other legislation enacted during 1981.

[e] Excludes proposed enhancements to revenues and transfers contained in the 1982–83 Governor's Budget and 1982 Budget Bill. Includes certain unidentified revisions to estimated fiscal effects of 1981 legislation.

[f] The 1982–83 Governor's Budget proposed transfers in 1981–82 of $128.2 million to the General Fund from the Capital Outlay Fund for Higher Education, the Energy and Resources Fund, the Parks and Recreation Fund, the Special Account for Capital Outlay, and the Employment Development Contingent Fund. In addition, General Fund transfer income of $52.8 million from the State School Building Lease Purchase Fund is proposed.

[g] The 1981–82 budget included a $10 million U.C. profit transfer to the General Fund for loan repayment. The 1981 Budget Act increased this transfer to $25 million.

E. BUDGET YEAR (1982–83) REVENUES

1. General Fund Income

Special Factors Again Critical—Total $1.2 Billion

Table 25 presents the department's estimates of budget year (1982–83) General Fund and special funds revenues and compares them with revenues for the current and prior years. As with current year revenues, the department's budget year estimates include a large volume of new General Fund revenues from special funds transfers and tax enhancements. These revenues, which are needed to balance the budget and replenish the Reserve for Economic Uncertainties, amount to about $1.2 billion and account for nearly 55 percent of the total dollar increase in 1982–83 General Fund income. Of this $1.2 billion, about $870 million (70 percent) represents "one-time" money. Specifically:

- The budget proposes to increase 1982–83 *tax revenues* by $645 million. Of this amount, $105 million represents ongoing effects of the tax revenue-enhancing proposals for the current year, while $540 million reflects new revenues. The two most important of these new revenues are the acceleration of sales tax payments (a gain of $300 million) and insurance tax payments (a gain of $120 million) to the state. Of the $645 million, about $400 million is "one-time."
- The budget proposes to transfer $450 million from the *Motor Vehicle License Fee Account* to the General Fund. This transfer is essentially local governments' share of the state's 1982–83 spending cuts. Normally, this $450 million would go to cities and counties. The General Fund transfer is being made in lieu of activating the "deflator" mechanism of AB 8 (Ch 282/79).
- $20 million in *tidelands oil revenues* are being provided to reimburse the General Fund for energy tax credits. This amount is in addition to the $42 million reimbursement for these tax credits already provides for under current law (Ch 899/80).

Table 25
Projected 1982–83 State Revenue Collections
(in millions) [a]

General Fund	Actual 1980–81	Estimated 1981–82	Projected 1982–83	Change: Amount	Change: Percent
Taxes:					
Sales and use	$7,005.8	$7,593.0	$8,900.0	$1,307.0	17.2%
Personal income	6,628.7	7,575.0	8,055.0	480.0	6.3
Bank and corporation	2,730.6	3,055.0	3,630.0	575.0	18.8
Inheritance and gift [b]	530.1	528.0	503.0	−25.0	−4.7
Insurance	460.9	496.0	660.0	164.0	33.1
Cigarette	196.4	202.0	207.0	5.0	2.5
Alcoholic beverage	142.9	143.0	147.2	4.2	2.9
Horse racing	112.7	107.7	117.3	9.6	8.9
Total Taxes	$17,808.1	$19,699.7	$22,219.5	$2,519.8	12.8%
Other Sources:					
Health Care Deposit Fund	$234.9	$288.8 [c]	$249.1 [c]	−$39.7	−13.7%
Interest on investments	463.6	313.7	303.8	−9.9	−3.2
Federal Revenue Sharing Transfer [d]	276.2	180.3	—	−108.3	−100.0
Other revenues and transfers	240.3	998.9 [e]	807.9 [f]	−191.0	−19.1
Total General Fund	$19,023.1	$21,481.4	$23,580.3	$2,098.9	9.8%

Special Funds					
Motor vehicle:					
Fuel tax [g]	$840.0	$834.7	$914.7	$80.0	9.6%
License fee (in lieu) [g]	693.7	735.0	804.0	69.0	9.4
Registration, weight and miscellaneous fees [g]	433.6	650.0	855.0	205.0	31.5
Other Sources:					
Oil and gas tax revenues	480.7	495.1	458.0 [h]	−37.1 [h]	−7.5
Sales and use [i]	125.7	152.0	155.0	3.0	2.0
Interest on investments	108.7	90.7	97.3	6.6	7.3
Cigarette tax	81.8	84.2	86.2	2.0	2.4
Other	316.5	−285.7 [j]	20.6	306.3	N.C.
Total Special Funds	$3,080.7	$2,756.0	$3,390.8	$634.8	23.0%
Total State Funds	$22,103.8	$24,237.4	$26,971.2	$2,733.8	11.3%

[a] Detail may not add to total due to rounding. Figures for 1981–82 and 1982–83 include the effects of a variety of measures, either enacted in 1981 or proposed in the 1982–83 Governor's Budget and the 1982 Budget Bill, to augment General Fund revenues and transfers. For *1981–82*, these factors amount to approximately $1.1 billion, including $338 million in measures to increase tax collections, and over $765 million in transfers from special funds. Approximately $960 million of these amounts constitutes one-time General Fund revenues. For *1982–83*, measures to increase tax collections account for $645 million in revenues, while special fund transfers to the General Fund will exceed $450 million. When combined with other revenue-enhancing proposals in the budget, these factors amount to approximately $1,220 million, of which about $870 million constitutes one-time revenues.

[b] The Department of Finance estimates that AB 2092 (Ch 634/80), which exempted all spouses from inheritance and gift taxation and increased certain other exemptions, has reduced inheritance and tax revenues by approximately $2.2 million in 1980–81, $100 million in 1981–82, and $150 million in 1982–83.

[c] Health Care Deposit Receipts in 1981–82 were unusually large, because certain time lags in reporting health-related claims and reimbursing the General Fund were eliminated between June and December of 1981. This accelerated receipts and produced a one-time General Fund revenue gain.

[d] Under current federal law, the General Fund will receive no additional revenue sharing funds after 1981–82.

[e] Includes primarily one-time transfers of $84.9 million from the Capital Outlay Fund for Public Higher Education, $89.8 million from the Energy and Resources Fund, $131.3 million from the Motor Vehicle License Fee Account, $80.5 million from the Special Account for Capital Outlay, $53.8 million from the State Parks and Recreation Fund, and $252 million from the State School Building Lease-Purchase Fund.

[f] Includes a one-time transfer of $450 million from the Motor Vehicle License Fee Account.

[g] Senate Bill 215 (Ch 541/81), which increased gasoline and diesel taxes, vehicle registration fees, weight fees, and drivers' license fees, is projected by Finance to increase motor vehicle user taxes and fees by $200 million in 1981–82 and by $478 million in 1982–83.

[h] Revenues reduced because the 1982–83 budget proposes a special one-time allocation of $61.7 million in tidelands oil receipts directly into the General Fund "other revenue" category.

[i] Reflects sales and use tax receipts to the Transportation Planning and Development Account in the Transportation Fund as specified under SB 620 (Ch 161/79) and SB 215 (Ch 541/81).

[j] Negative sign indicates net transfers to the General Fund.

The remainder of the $1.2 billion in revenue adjustments includes proposed increases in user fee assessments levied by the California Public Utilities Commission ($24 million) and savings under certain Department of Industrial Relations programs that would be achieved by putting the workers' compensation program on a self-supporting basis ($27 million). Both of these revenue effects would be ongoing.

More Rapid Growth Expected in Underlying Revenue Trend

Table 25 shows that General Fund revenues in the budget year are forecast to reach nearly $23.6 billion, a gain of $2.1 billion (9.8 percent) over the current year. This amount includes $8.9 billion in sales and use tax revenues (a gain of over 17 percent), $8.1 billion in personal income tax revenues (a gain of only 6 percent), and $3.6 billion in bank and corporation tax revenues (a gain of nearly 19 percent). However, because of the large and primarily one-time revenue enhancing proposals and special funds transfers in both the current and budget years, the percentage rates of increase for 1982–83 shown in the table do not give a valid picture of the underlying growth in either the total revenue base or many of its individual components.

In order to identify the underlying revenue trend, it is necessary to make three types of adjustments:

- Revenues must be adjusted to exclude the tax revenue-enhancing proposals and one-time special funds transfers discussed earlier for both the current year ($1.1 billion) and budget year ($1.2 billion);
- The fiscal effects in 1981–82 (−$100 million) and 1982–83 (−$150 million) due to continued phasing-in of the inheritance provisions of AB 2092 must be removed; and
- The termination of federal revenue sharing must be accounted for.

Table 26 shows that once these adjustments are made, underlying revenue growth is 10.3 percent in the budget year, or equivalent to the projected rate of personal income growth in 1982. This compares to an 8.2 percent underlying revenue growth trend in the current year. If only the effects of the revenue-enhancements and special funds shifts are eliminated, underlying budget year revenue growth is 9.7 percent, compared to 7.1 percent in 1981–82. Thus, the underlying revenue trend in 1982–83 is forecasted to exceed that for 1981–82.

Table 26
Comparisons of Revenue Trends for the Current and Budget Years

	Percent Growth in Revenues					
	1981–82			1982–83		
		Increase Adjusted for:			Increase Adjusted for:	
Income Source	*Increase Published in Budget*	*Tax Enhancements and Special Funds Transfers*	*Plus: Revenue Sharing and Inheritance Tax Reduction*	*Increase Published in Budget*	*Tax Enhancements and Special Funds Transfers*	*Plus: Revenue Sharing and Inheritance Tax Reductions*
Sales and use tax	8.4%	8.1%	8.1%	17.2%	13.5%	13.5%
Bank and corporation tax	11.9	9.5	9.5	18.8	14.5	14.5
Personal income tax	14.3	10.9	10.9	6.3	9.0	9.0
Other major taxes	2.4	−1.7	5.1	10.7	5.2	8.1
All other revenues and transfers	46.7	−13.8	−5.9	−23.7	−20.4	−11.4
Total, General Fund Revenue and Transfers	12.9%	7.1%	8.2%	9.8%	9.7%	10.3%

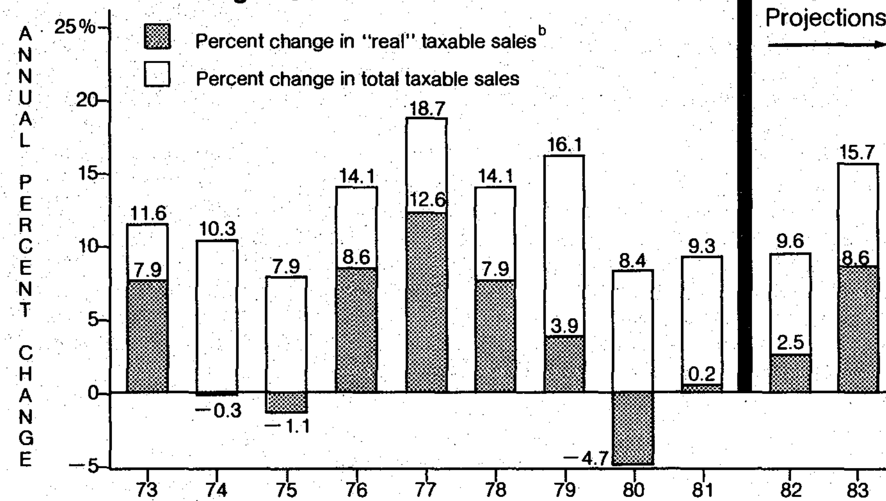
Taxable Sales to Spur Revenue Growth

As noted in Table 26, sales and use taxes are projected to increase by 17.2 percent when the Governor's proposed enhancements are included, and by 13.5 percent without these enhancements. This means that the growth in taxable sales is expected to exceed personal income growth during the second half of 1982 and thereafter. This is confirmed by the ratio of taxable sales-to-personal income contained in the department's economic forecast, which drops from 53.6 percent in 1981 to 53.3 percent in 1982, but then rises to 55.2 percent in 1983 and 56.2 percent in 1984. As shown in Chart 15, taxable sales growth in 1983 is expected to be especially strong (a 15.7 percent rise), led by increases in sales tax receipts from such industries as motor vehicles (22 percent) and building materials (21 percent). Of course, the high rates of growth for the building and automobile industries are largely due to the fact that they are expected to be recovering from extremely depressed recession levels.

Chart 15

Annual Growth in California Taxable Sales

1973 through 1983[a]



[a] California Department of Finance.
[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the national CPI for all items less food. Projections of the CPI are by Chase Econometrics as of January 1982.

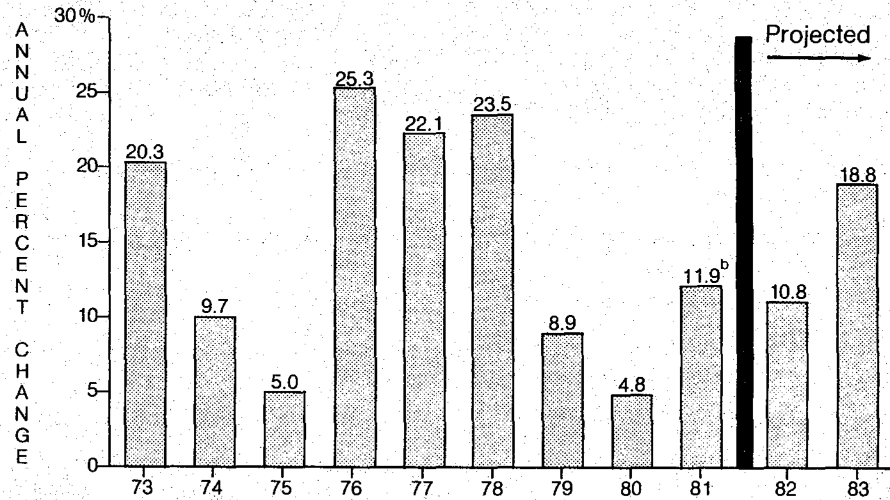
Optimistic Corporate Profits Outlook

Growth in 1982–83 corporate tax revenues—18.8 percent with revenue enhancements and 14.5 percent without such enhancements—reflects projected increases in corporate profits of about 11 percent in 1982 and 19 percent in 1983 (Chart 16). It is not possible to directly compare these profit growth assumptions with those of other forecasters, because private forecasters do not generally predict California corporate profits. However, one can compare the *U.S.* profits projections of these forecasters to the department's, in order to get a feel for how different their underlying profits growth outlooks are.

As shown earlier in Table 18, the department's forecast for U.S. corporate profits growth in 1982 (1.2 percent) is, on balance, an *optimistic* one relative to other forecasters. This is particularly true if the forecast by First Interstate Bank, which is about five months old, is excluded. The remaining forecasts show profits declining anywhere from −3.5 percent to −15.9 percent, or a downward differential of between about 5 and 15 percentage points relative to Finance's U.S. profit forecast. U.S. profit growth will automatically be higher in 1982 than profit growth for California, regardless of the forecaster, because of new federal tax law provisions. However, the U.S. profit growth forecasts may be compared as a means of shedding

Chart 16

Annual Growth in California Taxable Corporate Profits 1973 through 1983[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.

some light on the degree of optimism exhibited by the Department of Finance in its California profits forecast. If the department's *California* profits growth forecast for 1982 is reduced by the average differential between the department's *U.S.* profit growth forecast and these of other forecasts—about 10 percentage points—the revenue implications would be extremely significant. In fact, we estimate that General Fund revenues in 1982–83 and 1983–84 combined could be $735 million less than the amount shown in the budget. The exact distribution of the two-year loss between fiscal years would depend on decisions made by corporations regarding their tax prepayment patterns.

Effects of Income Tax Indexing Rapidly Growing

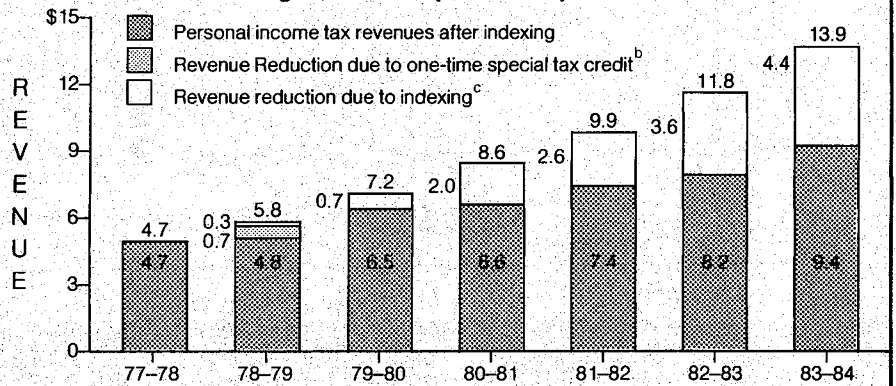
Personal income tax revenues are projected to increase by 6.3 percent in 1982–83, or 9 percent in baseline terms (that is, after excluding the tax revenue-enhancing proposals for both the current and budget years). This increase is less than the projected 1982 growth in personal income of 10.3 percent, even though under current law "full" indexing of the state's income tax brackets (that is, indexing using the full rise in the California CPI) will be replaced by "partial" indexing (using the CPI minus three percentage points) in 1982. Without the return to partial indexing, revenues from the personal income tax in 1982–83 would be about $230 million lower than projected. The reason why revenue growth is so low, despite a return to partial indexing, is that the department projects a June 1981-to-June 1982 CPI increase, which is used for indexing, of 12.8 percent, or far in excess of income growth. In fact, the tax bracket indexing adjustment factor projected under partial indexing in 1982 (12.8 percent minus 3 percent, or 9.8 percent) *exceeds* the factor used in 1981 for full indexing (8.3 percent), even though 1981 income growth exceeded the rate of growth projected for 1982.

Chart 17 summarizes the fiscal effects of income tax indexing from 1978–79 through 1983–84 (projected). It indicates that indexing reduced General Fund revenues by about $2 billion in 1980–81, and that it is projected to reduce revenues by $2.6 billion in the current year and $3.6 billion in the budget year. Thus, by 1982–83 the cumulative revenue reduction due to indexing will reach $9.2 billion.

Chart 17

Effects of Indexing on California Personal Income Tax Revenues.

1977–78 through 1983–84 (in billions)[a]



[a] Estimates by Legislative Analyst. Entire height of bars shows revenues without indexing.
[b] AB 3802 (Ch 569/80) increased the personal income tax credit for 1978 by $75 for single return taxpayers and by $150 for joint return taxpayers.
[c] AB 3802 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 (Ch 1198/79) 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, revenues would be reduced below those shown in the table by about $230 million in 1982–83 and $445 million in 1983–84. Revenues shown for 1981–82 through 1983–84 exclude the tax law changes proposed in the budget.

Other Major Taxes

Table 25 shows that General Fund revenues from taxes other than the three major levies are projected to reach $1.6 billion, an increase of $158 million (10.7 percent) over the current year. These taxes include the insurance tax ($660 million), the inheritance and gift taxes ($503 million), the cigarette tax ($204 million), alcoholic beverage taxes ($147 million), and horse racing-related revenues ($117 million). For two of these revenue sources—the insurance tax and inheritance and gift tax—the budget estimates reflect special factors:

- The *insurance tax* estimate for 1982–83 includes a proposed enhancement of $120 million that results from requiring insurers to make four tax prepayments per year instead of three. About $100 million of this amount is a one-time gain. After adjusting for this proposal, the insurance tax revenue increase in 1982–83 drops from over 33 percent in the budget to 8.9 percent.

- The *inheritance and gift tax* estimate for 1982–83 includes $25 million in revenues due to a proposal to increase the interest rate charged on delinquent tax payments. (In 1981–82, this proposal increases revenues by $60 million.) Secondly, 1982–83 revenues are $150 million lower because of the phasing-in of AB 2092 (Ch 634/80), which increased tax exemptions. (The revenue loss in 1981–82 is $100 million.) Thus, compared to the budget's growth of −4.7 percent shown for this source, revenue growth is 2.1 percent when the proposed interest penalty provision is excluded, and 10.6 percent when the effects of AB 2092 are also compensated for.

Revenues from the alcoholic beverage and cigarette taxes are expected to grow much more slowly—by under 3 percent. This is because the revenue base for these taxes tends to increase primarily as a result of population growth and is fairly insensitive to general economic conditions.

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 those balances in the Pooled Money Investment Account (PMIA) which are not General Fund balances per se but which the General Fund nevertheless earns interest income on, 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 importance source of interest income.

The budget projects that General Fund interest on investments will be about $304 million in 1982–83, of which $300 million represents returns on the PMIA. This investment income compares to about $314 million in 1981–82 and $464 million in 1980–81, and assumes that:

- ***The average fiscal year balance*** in the PMIA for 1982–83 will be somewhat over $4.6 billion. This average balance has declined in the past several years because the state has been spending more than it receives in current revenues. It should be more stable in the future, however, assuming that annual revenues and expenditures are brought into alignment.
- ***The General Fund share*** of funds in the Pooled Money Investment Account will be about 52 percent.
- ***The average interest yield*** on PMIA investments in 1982–83 will be about 11.75 percent. This compares to an actual average yield for the first half of 1981–82 of about 12.3 percent, and of about 11.9 percent as of year-end 1981.

Federal Revenue Sharing Has Ended

In September 1980, the federal revenue sharing program for states terminated. The General Fund received a transfer of $180.3 million from the state's Federal Revenue Sharing Fund in 1981–82, an amount which will exhaust the revenue sharing monies available to the state. Thus, the General fund will receive no revenue sharing transfers in the budget year. Since 1973–74, the state government has received nearly $2.2 billion under this program.

Estimates Consistent with Assumptions, but Future Revisions Inevitable

As with the current year revenue estimates, we have taken the department's economic assumptions and used our own revenue-estimating equations to determine whether Finance's budget year projections are consistent with its economic assumptions. Our analysis suggests that these assumptions could possibly generate an additional $200 million in 1982–83 General Fund revenues *above* what is forecast. However, because our analysis also results in about $100 million *less* in 1983–84 revenues than Finance projects, about half ($100 million) of the budget year difference could merely reflect cash-flow assumptions.

Given the extremely uncertain economic outlook, however, the closeness of our estimates to Finance's should not be interpreted as indicating that the outlook for revenues is at all certain. In fact, the outlook is quite uncertain. As evidence of this, the department's current law 1982–83 revenue estimate is approximately $1.5 billion lower than the original estimate made last May. Clearly, the department's 1982–83 revenue estimates will be subject to considerable revision over the next 18 months.

2. Special Fund Revenues

Table 25 shows that combined revenues to all state special funds are projected to reach nearly $3.4 billion in 1982–83, while Table 27 summarizes the relative shares of special fund revenues accounted for by the major special fund revenue sources.

Table 27
Summary of Special Fund Revenues in 1982–83

	Millions	*Percent*
1. *Motor Vehicle Taxes and Fees*		
License fees	$770 [a]	
Fuel taxes	915	
Registration and other fees	855	
Trailer coach fees	34	
Subtotal	$2,574	67.0%
2. *Tidelands Oil Revenues*	$458	11.9%
3. *Retail Sales Taxes* ("spill over" revenues)	$155	4.0%
4. *Cigarette Taxes*	$86	2.2%
Subtotal	$3,273	85.1%
5. *All Other*	571	14.9%
Totals	$3,844 [a]	100.0%

[a] Existing law; does not reflect budget proposal to reduce these transfers by $450 million.

The major source of special fund income comes from motor vehicle-related levies, which include gasoline taxes ($915 million), vehicle license and trailer coach fees ($804 million) and registration fees ($855 million). These vehicle-related levies are expected to total almost $2.6 billion in the budget year, for an increase of 15.9 percent ($354 million) over 1981–82. Other major sources of special fund income include tidelands oil and gas tax revenues ($458 million), sales and use tax revenues ($155 million), cigarette tax receipts ($86 million), and interest on investments ($97 million). The special fund sales and use tax revenues reflect monies which go to the Transportation Planning and Development Account, while the cigarette tax monies represent local governments' statutory 30 percent share of collections.

Revenue Trends Distorted by Major Legislation and General Fund Transfers

Table 25 shows that special funds revenues in 1982–83 will increase 23 percent over 1981–82. This growth rate is distorted by the following special factors:

- *First,* major legislation was enacted in 1981 which increased motor vehicle-related receipts in both 1981–82 and 1982–83. This legislation included (a) SB 215 (Ch 541/81), which increased vehicle registration, weight and drivers license fees (as of January 1, 1982), and increases the fuel tax from 7 cents to 9 cents per gallon (as of January 1, 1983) and (b) AB 202 (Ch 933), which provided for further increases in vehicle registration fees. Together, these measures will increase motor vehicle-related collections by $200 million in 1981–82 and $475 million in 1982–83.
- *Second,* the 1982–83 budget proposes to transfer $450 million out of the Motor Vehicle License Fee Account and into the General Fund on a one-time basis, as a means of applying state spending cuts to local governments. This transfer is in lieu of activating the AB 8 deflator mechanism. A similar type of one-time transfer was made in 1981–82 by SB 102 (Ch 101/81) in lieu of activating the deflator, although it is smaller than the 1982–83 transfer—$131 million.
- *Third,* the General Fund is to receive special one-time tidelands oil revenues in both the current and budget years. The budget year amount is about $20 million (excluding a $42 million reimbursement provided in current law for energy tax credits), while the current year amount is much larger—over $400 million.

Fuel Tax Revenues—Underlying Trend is Level

Because of the 1983 increase in the fuel tax from 7 cents to 9 cents per gallon under SB 215 (Ch 541/81), fuel tax revenues will be increased by $78 million in 1982–83. As shown in Table 25, budget year fuel tax revenues are essentially unchanged in the current year after adjusting for this legislation. This represents the fifth year in a row that the underlying revenue trend has not been upward. This failure of gasoline consumption to rise reflects such factors as changes in the automobile mix, increasing fuel economies, reduced demand due to slow economic growth, and the impacts of gasoline prices on consumption. The department's fuel tax estimate assumes that average gasoline consumption per vehicle will drop from 590 gallons in 1979–80 and 570 gallons in 1980–81 to 565 gallons in 1981–82 and 555 gallons in 1982–83. Vehicle-related registration and license fees are projected at almost $1.7 billion in the budget year, including the effects of new legislation. This projection assumes 5.9 percent and 11.8 percent increases in vehicle registrations in 1982 and 1983, respectively.

Oil and Gas Revenues—A Potentially Important Balancing Factor

Total oil and gas tax revenues are projected in the Governor's Budget to reach $542 million in 1981–82, up 5.3 percent from the current year. Although this is a relatively small increase, it still is an improvement over the projection for the current year that shows a *dip* in these revenues below the 1980–81 level. This modest growth rate reflects in part the recent softness in prices due to excessive stocks in the world's crude oil markets.

Most of these revenues represent direct earnings received by the state from the sale of oil and gas produced from tidelands (principally located adjacent to the City of Long Beach). Tidelands oil revenues are expected to total $510 million in 1982–83.

These funds have traditionally been used along with bond proceeds to finance state capital outlay projects. As discussed earlier, tidelands oil revenues are expected to pay a major role in achieving a balanced General Fund budget in 1981–82. In 1982–83, their role in this regard is not as significant. However, given the state's tight fiscal situation, these monies could be called on again to assist the General Fund. In the B-pages of this analysis, we discuss the issue of whether these tidelands revenues should be shifted on a permanent basis to the General Fund to help support the overall programs of the state government.

Table 28
Distribution of Special Fund Revenues From Four Major Sources 1982–83 (in millions)

Source		*Distribution*	
I. *Motor Vehicle Taxes and Fees*			
		To cities	$370
1. License fees	$770	To counties	$370
		For DMV administration	$30
		For city streets	$132
		For county roads	$206
2. Fuel Taxes	$915	To cities and counties for streets and roads	$106
		To Caltrans for state highways	$443
3. Registration and other fees	$855	To DMV	$184
		To CHP	$337
		To Caltrans	$322
		To other state agencies	$12
		To cities	5
4. Trailer coach fees	$34	To counties	15
		To schools	14
		Energy and Resources Fund	$120
		COFPHE	$116
		School Lease Purchase Fund	$100
		SAFCO	$78
II. *Tidelands Oil and Gas Revenues*	$458	Energy tax credits	$62
		Parks and Recreation Fund	$11
		All other	$23
		State agencies	$76
		Support for mass transit, etc. ($47)	
		Capital outlay/mass transit ($29)	
III. *Retail Sales (spillover) Taxes*	$155	*Local agencies*	$116
		Mass transit ($35)	
		Special transit ($75)	
		Others ($6)	
IV. *Local Cigarette Taxes*	$86	To cities	$71
		To counties	$17

How Special Fund Revenues are Distributed

Table 28 shows how special fund revenues from the four major sources are allocated among different programs and levels of government. The table indicates that cities and counties receive all of the proceeds from vehicle license fees, after DMV deducts its administrative costs. Cities and counties also receive about half of the motor vehicle fuel tax revenues. Motor vehicle registration fees are used to support the Department of Motor Vehicles, the California Highway Patrol, with the remainder going to the Department of Transportation for highway maintenance and construction.

Tidelands oil revenues are allocated mainly for capital outlay purposes. Most of these revenues are divided among five special funds (ERF, COFPHE, SAFCO, etc.). The 1982–83 budget proposes that a portion ($62 million) of these revenues be transferred to the General Fund to offset the revenue loss from the energy and solar tax credits. The distribution of oil revenues is based on the proposals in the budget, and does not reflect the distribution called for by existing law.

The "spill over" sales tax revenues are used mainly for mass transit and special transportation programs, and are allocated to both state and local agencies.

F. ALTERNATIVE GENERAL FUND REVENUE FORECASTS

Because of the history of revenue estimating errors, and the considerable uncertainty about exactly how the economy will perform in 1982 and 1983, it is important to make some estimate of the margin by which actual revenues in the current and budget years could differ from the department's forecasts. This is especially important this year because of the tight state and local fiscal picture.

In the *1982–83 Governor's Budget,* the Department of Finance indicates that revenues could be between *$1.2 billion less* and *$1.1 billion more* than projected in 1982–83. This range is based on the *assumption* that there could be an error in the budget year revenue forecast of up to 5 percent. The department also indicates that it is reasonable to assume that an error of up to 3 percent (or about $650 million) could be made in the current year revenue forecast. As shown in Table 22 earlier, errors of these magnitudes have occurred in previous years, and certainly could be repeated.

What would it take to produce such errors? Revenue estimating errors can result from a variety of causes. For example, the underlying data on which forecasts are based are often revised at later dates. Thus, had the "true" data been known earlier, the forecasts themselves would often have been different to begin with. In addition, there are normal errors of a statistical nature that accompany all estimates, and thus estimates generally are understood to be within a certain *range* of possible values, any of which could occur. However, it appears that the most important cause of revenue estimating errors involves errors in *economic forecasting.*

Given this, we have constructed two alternative revenue scenarios which can provide some insight as to the type of revenue estimating errors which could currently occur due to wrong economic forecasts. One scenario is based on more optimistic and the other on more pessimistic groups of economic assumptions than Finance used in the budget. In structuring these scenarios to be as realistic as possible, we examined the range of actual 1982 forecasts reported by different economists in Tables 18 and 19 above, identified the optimistic and pessimistic extremes, and then projected each into 1983. This projection into 1983 was necessary because most outside forecasters do not themselves project that far into the future, at least not publicly. We also made assumptions about certain economic variables—such as California taxable sales and corporate profits—which are not generally predicted by most private economists.

- The ***high revenue scenario*** assumes that California personal income growth will reach 12 percent in 1982 and 13 percent in 1983, that California corporate profits will rise at rates of 15 percent in 1982 and 20 percent in 1983, and that the ratio of taxable sales to statewide income will expand from 53.6 percent in 1981 to 55 percent in 1982 and 57 percent in 1983. Thus, by 1983, the taxable sales ratio would be nearing the levels it had achieved in 1978 and 1979.
- The ***low revenue scenario*** assumes that California personal income will grow by only 8 percent in 1982 and 9 percent in 1983, that the state's profits will experience no growth in 1982 and rise by a modest 10 percent in 1983, and that the ratio of taxable sales to income will further erode to 52.5 percent in 1982 before rising modestly back to 54 percent in 1983.

Table 29 shows that these economic scenarios produce 1981–82 General Fund revenue estimates for the three major taxes which range from $325 million (1.5 percent) *above* to $250 million (1.2 percent) *below* Finance's forecast. For 1982–83, the estimates range from $1.2 billion (5.1 percent) *above* to $1.2 billion (4.9 percent) *below* Finance's projection. These error margins are consistent with the historical errors reported earlier in Table 22. It is probably possible to find economists to support either end of this range. In addition, it is of course possible that actual economic performance could be such that revenues could fall *outside* of these ranges. The scenarios do illustrate, however, that significant revenue estimating errors in dollar terms could easily occur for both 1981–82 and 1982–83.

Table 29
Effects of Alternative Revenue Scenarios
(dollars in millions)

	1981-82		1982-83	
Revenue Source	*High Revenue Scenario*	*Low Revenue Scenario*	*High Revenue Scenario*	*Low Revenue Scenario*
Personal Income Tax	$85	−$85	$490	−$330
Sales and Use Tax	100	−65	250	−430
Bank and Corporation Tax	140	−100	460	−400
Total Revenue Difference, Major Three Taxes	$325	−$250	$1,200	−$1,160
Difference as a Percent of Finance Estimates	1.5%	1.2%	5.1%	4.9%

V. CONDITION OF THE GENERAL FUND

Table 30 presents the budget estimates of the General Fund condition in both 1981–82 and 1982–83.

As Table 30 indicates, revenues in 1981–82 will be $415.7 million less than expenditures, after adjusting for the revenue enhancements and capital outlay transfers proposed by the administration. For 1982–83, the *baseline* budget gap widens to $1.8 billion, because (1) revenue growth is adversely affected by the recession, and (2) approximately $777 million of the revenue enhancements and expenditure savings reflected in the 1981–82 estimates are one-time.

Table 30
Summary of General Fund Condition
During 1981–82 and 1982–83
(in millions)

	1981–82	*1982–83*
Funds Available, start of year:		
Reserve for economic uncertainties	$349.0	$116.0
Uncommitted General Fund surplus	—	—
Revenues and transfers	21,481.4	23,580.3
Current expenditures	21,897.1	23,195.7
(Difference)	(−415.7)	(384.6)
Funds available, end of year:		
Reserve for economic uncertainties	116.0	500.0
Uncommitted General Fund Surplus	—	$0.7

The 1982–83 budget proposes to close this gap between baseline expenditures and revenues by:

1. Increasing revenues on an ongoing basis ($299 million)
2. Accelerating revenue collections from 1983–84 into 1982–83 (one-time revenue increase of $397 million)
3. Transferring special fund resources to the General Fund on a one-time basis ($450 million)
4. Limiting expenditure growth to 5.3 percent ($1,497 million)

In effect, the budget reduces the level of expenditures in real terms (that is, expenditures adjusted for inflation), and thereby provides for a reduction in state-funded services below 1981–82 levels. In the aggregate, the reduction in real General Fund expenditures is about 3 percent. If the Governor's $696 million revenue enhancement program is not enacted, the reduction in real expenditures would be 4.4 percent.

As a result of the revenue enhancements and expenditure reductions, the budget makes $730.6 million available for the following purposes:

- $246 million in budget change proposal augmentations for existing programs;
- $100 million in unallocated funds which have not been budgeted for any specific program or agency; and
- $384.6 million to partially replenish the Reserve for Economic Uncertainties, bringing it up to $500 million. This is $200 million less than the 3-percent-of-appropriations minimum established by the Legislature in both the 1980 and 1981 Budget Acts.

The budget shows a nominal General Fund surplus of $0.7 million on June 30, 1983.

VI. STATE BORROWING

Overview

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

- ***General obligation bonds*** are backed by the full faith and credit of the state. That is, when it issues a general obligation bond, the state pledges to use its taxing power to pay off the bond (both principal and interest). These bonds must be authorized by a two-thirds vote of both houses of the Legislature, and then must be approved by a majority of the voters at a statewide election. Under existing law, the interest rates on state general obligation bonds cannot exceed 11 percent.

- *Revenue bonds* are *not* backed by the full faith and credit of the state. Instead, they are secured by the revenues from the projects which are financed by the bond proceeds. Revenue bonds must be authorized by a majority vote of both houses of the Legislature, but they do not require voter approval. Some revenue bonds have interest rate ceilings, while others do not.

This section provides information on the sales and outstanding volumes of these two types of state bonds. In addition, this section discusses bond sales by California's local governments, with particular emphasis on the rapidly growing volume of housing bonds. Lastly, this section discusses some of the problems currently facing state and local governments who wish to finance projects by issuing tax-exempt municipal debt.

A. GENERAL OBLIGATION BONDS

Bond Categories

California's general obligation bonds are grouped into three categories, depending on the extent to which debt service (that is, payment of interest and repayment of principal) is assumed by the state. These categories are:

(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 by local school districts, depending on local assessed valuations. Assessed valuations have now reached such a level, however, that the state has been relieved of any debt service payments.

(3) ***Self-Liquidating Bonds.*** Redemption and interest costs on these bonds are paid *entirely* from project revenues. However, should such revenues ever be inadequate to cover the required debt service, the state would be obligated to make up the shortfall.

Status of Bonds Authorized

Table 31 provides detail on these three categories of general obligation bonds. As of December 31, 1981, the state had over $1.4 billion in unsold bonds, compared to over $1.8 billion at the end of 1980. Of the authorized bonds already sold ($10.3 billion), the state has retired nearly $4.0 billion, leaving $6.3 billion outstanding. During the 1981 calendar year, no new state general obligation bond issues were approved by the voters. However, the Legislature did authorize a $495 million state general obligation bond issue for the purpose of financing new prison facilities in California. This issue will be voted upon by the electorate at the June 1982 election.

Bond Program Sales

Table 32 provides data on general obligation bond sales in 1979–80 through 1981–82. Of total sales in 1980–81 ($385 million), almost 80 percent ($300 million) were made under the Veterans' Farm and Home Building program. This program is also expected to account for nearly 65 percent ($450 million) of total general obligation bond sales in 1981–82 ($715 million). The Treasurer will attempt to market the remaining volume of

Table 31
General Obligation Bonds of the State of California
As of December 31, 1981
(in millions) [a]

	Authorized	*Unsold*	*Redemptions*	*Outstanding*
General Fund Bonds:				
State construction	$1,050.0	—	$668.1	$381.9
Higher education construction	230.0	—	124.1	105.9
Junior college construction	65.0	—	34.1	30.9
Health science facilities construction	155.9	—	35.1	120.8
Community college construction	160.0	—	51.2	108.8
Beach, park, recreational, and historical facilities	400.0	$20.0	130.2	249.8
Recreation and fish and wildlife	60.0	—	23.5	36.5
State, urban, and coastal parks	280.0	90.0	19.3	170.8
Parkland acquisition and development	285.0	255.0	—	30.0
Clean water	875.0	360.0	114.3	400.8
Safe drinking water	175.0	125.0	0.2	49.8
Subtotals	($3,735.9)	($850.0)	($1,200.1)	($1,685.8)
Partially Self-Liquidating Bonds:				
School building aid	$2,140.0	$40.0	$1,212.5	$887.5
Self-Liquidating Bonds:				
Water resources development	1,750.0	180.0	86.9	1,483.2
Harbor bonds	89.3	—	63.3	26.0
Veterans' farm and home building	4,000.0	350.0	1,424.1	2,225.9
Subtotals	($5,839.3)	($530.0)	($1,574.2)	($3,735.1)
Totals	$11,715.2	$1,420.0	$3,986.9	$6,308.4

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

Table 32
General Obligation Bond Sales
1979–80 Through 1982–83 [a]
(in millions)

	Actual 1979–80	*Actual 1980–81*	*Estimated 1981–82* [b]	*Proposed 1982–83* [b]
Beach park, recreational and historical facilities	$30	$10	$15	$10
Clean water	100	—	100	100
Parklands acquisition and development program	—	—	60	70
Safe drinking water	—	20	50	25
State, urban, and coastal parks	20	30	40	45
Subtotals, General Fund Bonds	($150)	($60)	($265)	($250)
School building aid [c]	—	$25	—	—
Veterans' farm and home building [d]	$475	300	$450	—
Totals	$625	$385	$715	$250

[a] 1982–83 Governor's Budget and California State Treasurer.

[b] Estimates by California State Treasurer. Through December 1981, $225 million in bonds had been sold during 1981–82, including $100 million in veterans' bonds. The remaining $490 million in anticipated 1981–82 sales, including $350 million in veterans' bonds, were expected to be sold between January and June 1982. However, financial market conditions could limit the actual amount of future 1981–82 bond sales to less than this amount.

[c] Debt service presently paid entirely by school districts.

[d] Debt service paid from program or project revenues.

unsold bonds authorized under the Veterans' Bond Act of 1980 during the current year.

The additional sales estimated in 1981–82 and 1982–83 are associated with five programs: beach park, recreational and historical facilities (totaling $25 million in the two years); clean water ($200 million); parklands acquisition and development ($130 million); safe drinking water ($75 million); and state, urban and coastal parks ($85 million). Of course, whether the proposed bond sales actually occur will depend on financial market conditions.

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. Debt service for the budget year ($259 million) will increase by $40.1 million (or 18.3 percent) over the current year. All of the debt service estimates in Table 33 are based on specific estimates of anticipated future bond sales. If the volume of sales is greater (less) than the estimated level, the amounts needed to service General Fund debt will increase (decrease) accordingly. Also, interest rates paid on future bond sales are very difficult to predict at this time, due to the uncertainty about the course of future federal monetary policies, the impacts of President Reagan's tax plan on the market for municipal debt, and the path of the economy generally. In Table 33, we have assumed that interest rates for new bond sales will be 10 percent. It is very possible, however, that rates could be higher than this. Whether interest rates on state bonds will exceed the current statutory ceiling of 11 percent if economy-wide interest rates trend upward will, in part, depend on how the bond issues are structured. In November 1981, for example, a $100 million general obligation issue which had been turned down the month before sold at about 10.2 percent after a number of modifications had been made in the terms of the bond, such as the removal of "call provisions" and a shortening of the maturity structure.

Table 33
General Fund Debt Service
1980–81 to 1984–85
(in millions)

	Debt Service [a]	*Percent Change from Previous Year*	*Anticipated Future Sales* [b]
1980–81	$210.5	6.9%	—
1981–82	218.7	3.9	$135.0
1982–83	258.8	18.3	250.0
1983–84 [c]	291.8	12.8	350.0
1984–85 [c]	308.1	5.6	350.0

[a] Includes estimated debt service *only* on bond issues presently authorized by the electorate. Figures through 1982–83 from Governor's Budget.

[b] An average interest rate of 10.0 percent is assumed on anticipated future sales. Projected sales for 1981–82 and 1982–83 from the 1982–83 Governor's Budget. Projections for 1983–84 and 1984–85 from California State Treasurer.

[c] Projections reflect interest paid on anticipated future sales and service on existing debt. Data assume that an average of one-half year's interest is paid on bonds during their year of sale.

Selected Bond Fund Expenditures

After General Fund bonds are sold, the proceeds from the sales are allocated to be spent on 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 for the prior, current, and budget years.

Each of the last six 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. In 1980–81, the estimate ($273 million) was $128 million over the actual ($145 million). The single largest component of the 1980–81 difference involved the state, urban, and coastal parks program, where estimated expenditures were more than $66 million above actual expenditures.

The failure of the budget to give a 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 projects already authorized, particularly those in the parks and recreation area, would result in more accurate midyear estimates and, consequently, improved interyear comparisons.

Table 34
Selected Bond Fund Expenditures
1980–81 Through 1982–83 [a]
(in thousands)

	Actual 1980–81	*Estimated 1981–82*	*Proposed 1982–83*
Higher education construction	$8	—	—
Health science facilities construction	1,340	$4,009	$542
Community college construction	—	664	427
Beach, park, recreational, and historical facilities	21,408	14,749	176
New prisons	—	—	161,800
Recreation and fish and wildlife	38	575	3,866
State, urban, and coastal parks	35,795	70,746	6,627
Parklands acquisition and development	—	142,725	74,983
Clean water	57,533	71,755	96,389
Safe drinking water	28,549	36,925	25,906
Totals	$144,672	$342,148	$370,716

[a] 1982–83 Governor's Budget, Schedule 3. Includes bond fund expenditures for state operations, local operations and capital outlay. Detail may not add to totals due to rounding.

B. STATE REVENUE BONDS

Bond Categories

Agencies of the state also issue revenue bonds. These are fundamentally different from general obligation issues, because 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 been increasing the use of revenue bonds, especially to finance housing, pollution control, and health facilities.

Table 35 provides detail on the fourteen different types of state revenue bonds and their current authorizations. As of December 31, 1981, there were $3,636 million in state revenue bonds outstanding. As shown in the table, three housing programs account for $1,446 million, or 40 percent, of the outstanding bonds: California Housing Agency ($936 million), Veterans Revenue Debenture ($485 million), and California National Guard ($25 million). Seven of the fourteen bond programs in Table 35 have no statutory limitation as to the amounts that can be issued.

Table 35
State Revenue Bonds
As of December 31, 1981
(in thousands) [a]

Issuing Agency	*Authorization Limits—If Any*	*Outstanding*	*Remaining authorization*
California Education Facilities Authority	$300,000	$286,190	$13,810
California Housing Finance Agency	1,500,000	935,805	564,195
California Pollution Control Financing Authority	(no statutory limits)	615,662	N/A
Transportation Commission	(no statutory limits)	129,282	N/A
Department of Water Resources	(no statutory limits)	695,840	N/A
Trustee's California State Colleges and Universities	(no statutory limits)	140,838	N/A
Regents University of California	(no statutory limits)	165,200	N/A
State Public Works Board	(no statutory limits)	15,587	N/A
Hastings College of Law	(no statutory limits)	—	N/A
Veterans Revenue Debenture	1,000,000	485,000	515,000
California National Guard	100,000	25,000	75,000
California Health Facilities Authority	767,000	141,245	625,755
California Student Loan Authority	150,000	—	150,000
California Alternate Energy Source Financing Authority	200,000	—	200,000
Subtotals:			
Bonds With Statutory Authorization Limits	$4,017,000	$1,873,240	$2,143,760
Bonds Without Statutory Authorization Limits	N/A	$1,762,409	N/A
Totals, All State Revenue Bonds	N/A	$3,635,649	N/A

[a] California State Treasurer.

Growth in Revenue Bonds

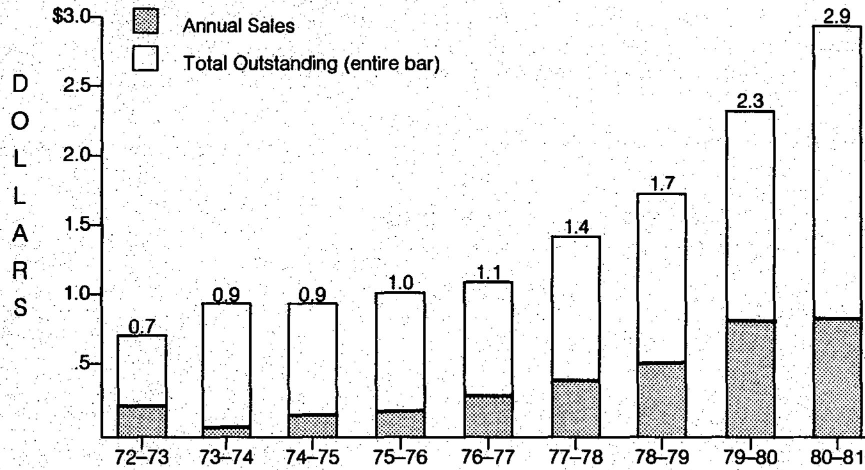
In recent years, the outstanding volume of revenue bonds has risen dramatically. Chart 18 shows the increase in revenue bonds outstanding from 1972–73 through 1980–81. The volume of these bonds has risen from $0.7 billion in 1972–73 to $2.9 billion in 1980–81. Between the end of 1980–81 and January 1982, the total rose an additional $740 million, to over $3.6 billion.

Bond Sales

Table 36 shows revenue bond sales for the past four years. Estimates of current- and budget-year sales are not available at this time. This is primarily because revenue bond issues are not scheduled as far in advance as are general obligation bond sales.

Chart 18

California State Revenue Bonds
Annual Sales and Total Outstanding Volume
1972–73 through 1980–81 (in billions)[a]



[a] California State Treasurer.

Table 36
State Revenue Bond Sales
1977–78 to 1980–81
(in millions) [a]

Issuing Agency	*1977–78*	*1978–79*	*1979–80*	*1980–81*
California Education Facilities	$45.3	$12.1	$24.5	$88.2
California Housing Finance Authority	172.4	250.0	371.7	161.8
California National Guard	—	—	—	25.0
California Pollution Control Financing Authority	40.2	107.8	44.5	165.6
Transportation Commission	20.0	—	—	25.0
Department of Water Resources	—	—	95.8	—
University of California Regents	2.6	—	28.8	4.7
Veterans Revenue Debenture	—	—	200.0	300.0
Totals	$280.6	$369.9	$765.3	$770.3

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

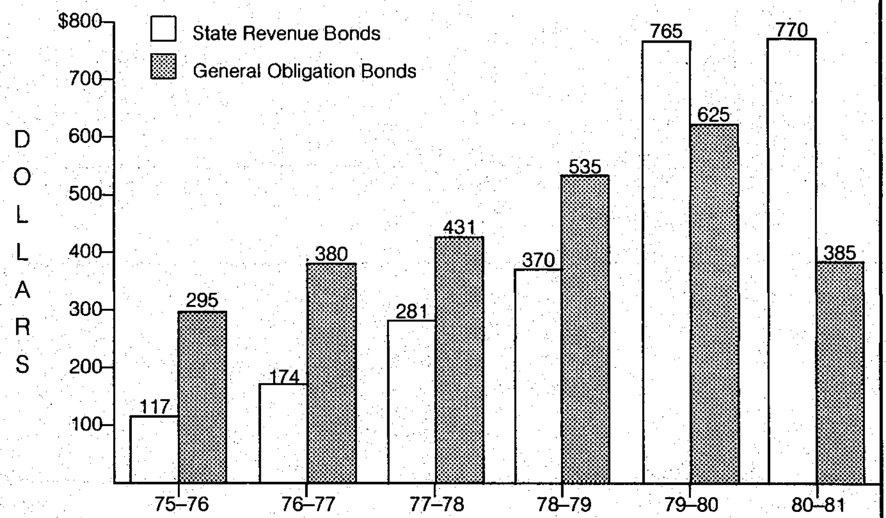
Two housing programs—California Housing Finance Agency and Veterans revenue bonds—accounted for 60 percent of 1980–81 sales. The remaining sales were accounted for primarily by the California Pollution Control Financing Authority. Since June 1981, there have been additional state revenue bond sales not shown in Table 36 of over $740 million. This upsurge appears to have partly reflected simply the timing of bond sales during calendar 1981. As discussed later, housing bond sales slowed in the first half of 1981 due to some uncertainty about exactly how new federal regulations affecting tax exempt housing bonds would be administered. When this uncertainty was removed later in 1981, bond sales accelerated.

Chart 19 compares the sales of state general obligation and revenue bonds since 1975–76. It shows that state revenue bond sales have significantly exceeded general obligation bond sales for the past two years. This is partly because the sale of most revenue bonds is not restricted by statutory interest rate ceilings. Because of high interest rates during the past year, these ceilings have often made it difficult to sell general obligation bonds.

Chart 19

Annual Sales of State Bonds

1975–76 through 1980–81 (in millions)[a]



[a] California State Treasurer. Data as of June 30 of each fiscal year.

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 state *and* local bonds offered for sale. Because of this, the state certainly has an interest in local borrowing activities.

Table 37 shows local bond sales for the last four years, by type of local government. The table indicates that between 1977–78 and 1980–81, the volume of local nonhousing bonds sold actually declined. The table also indicates, however, that a tremendous increase in housing bond sales, especially by redevelopment agencies, occurred between 1977–78 and 1979–80. During this period, housing bonds increased from 5 percent to 45 percent of total local bond sales. In 1980–81, however, housing bonds' share of the total stabilized, partly due to the effects of federal legislation (discussed below) limiting such housing bonds.

Table 37
Annual Local Bond Sales
1977–78 to 1980–81
(in millions) [a]

Type of Local Government	*1977–78*	*1978–79*	*1979–80*	*1980–81*
1 Counties:	$60.5	$13.7	$9.0	$214.1
Housing	(28.2)	(12.4)	(8.6)	(194.8)
Other	(32.3)	(1.3)	(0.4)	(19.3)
2. Cities:	462.9	358.0	488.9	632.6
Housing	(—)	(111.2)	(211.9)	(124.1)
Other	(462.9)	(246.8)	(277.0)	(508.5)
3. Special Districts:				
Schools	129.8	58.7	95.9	52.6
4. Redevelopment agencies:	507.3	448.1	1,150.4	587.6
Housing	(0.9)	(241.3)	(948.3)	(446.7)
Other	(506.4)	(206.8)	(202.1)	(140.9)
5. Other special districts	670.1	623.5	814.0	267.8
Housing	(64.1)	(—)	—	(27.0)
Other	(606.0)	(623.5)	(814.0)	(240.8)
Subtotals	*$1,830.6*	*$1,502.0*	*$2,558.2*	*$1,754.6*
Housing	(93.2)	(364.9)	(1,168.8)	(792.6)
Other	(1,737.4)	(1,137.1)	(1,384.4)	(962.1)
6. Special Assessments	29.5	14.0	54.6	77.3
Overall Totals	$1,860.1	$1,516.0	$2,612.8	$1,831.9
Housing	(93.2)	(364.8)	(1,168.8)	(792.6)
Other	(1,766.9)	(1,151.2)	(1,444.0)	(1,039.3)
Housing Bonds as a Percent of All Bonds	5.0%	24.1%	44.7%	43.3%

[a] Office of Planning and Research. Detail may not add to totals due to rounding.

D. COMBINED STATE AND LOCAL BORROWING

Chart 20 shows the composition of tax-exempt bonded municipal debt outstanding at the end of 1980–81, by level of government and by category of bonds. It indicates that state bonds accounted for about one-third and local bonds accounted for two-thirds of all bonds, while general obligation bonds accounted for 46 percent and all other bonds accounted for 54 percent.

Combined state and local borrowing undertaken in recent years is shown in Table 38. Between 1977–78 (the first year for which we have been able to obtain relatively complete data on local government bond sales) and 1979–80, the annual volume of state and local bond sales in California increased by $1,431 million, or 56 percent. The largest relative increase was in the volume of state revenue bonds, which increased over 170 percent. Although the volume of local bond sales remained much larger than combined state sales during this period, annual sales by the state grew much faster.

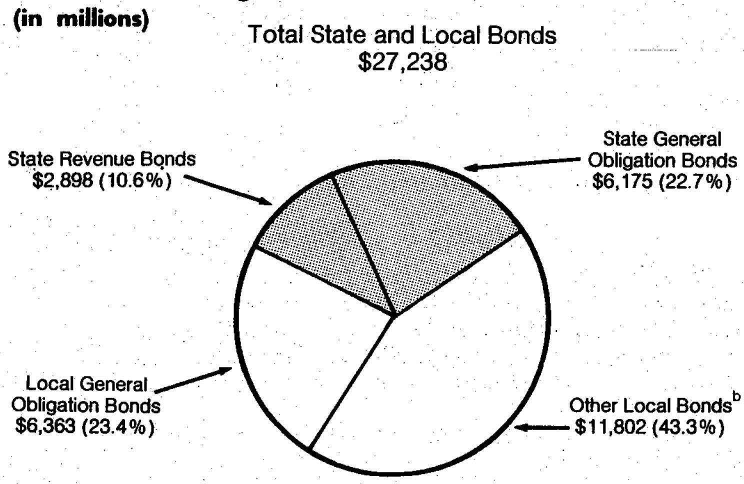
In 1980–81, however, a sharp break occurred in the upward trend of bond sales. Total state and local sales fell by 25 percent, or over $1 billion. This reflected declines of 17 percent for state sales and 30 percent for local sales. In the state's case, this was due to a 38 percent decline in General Obligation bond sales and essentially flat level of revenue bond sales. This drop off in bond sales reflected unusually negative financial conditions—especially high interest rates—in the municipal market during 1981.

Table 38
Annual Sales of State and Local Bonds
1975–76 to 1980–81
(in millions)

	Total All Bonds	*State of California*[a] *Total State*	*General Obligation*	*Revenue*	*Local Bonds*[b]
1975–76	$412[a]	$412	$295	$117	N.A.
1976–77	554[a]	554	380	174	N.A.
1977–78	2,572	712	431	281	$1,860
1978–79	2,421	905	535	370	1,516
1979–80	4,003	1,390	625	765	2,613
1980–81	2,987	1,155	385	770	1,832

[a] California State Treasurer.
[b] Office of Planning and Research. Data on local bond sales unavailable for years before 1977–78.

Chart 20
Total Outstanding State and Local Bonded Debt[a]
(in millions)



[a] California Municipal Statistics, Inc. Data as of June 30, 1981.
[b] Includes revenue bonds ($5,683), lease bonds ($2,273), mortgage revenue bonds ($2,247), redevelopment tax allocation bonds ($1,029) and 1915 Act special assessment bonds ($570). Data does not include (a) issues guaranteed by any branch of the Federal government (b) 1911 Act special assessment bonds (c) escrowed or pre-funded bonds or (d) industrial development bonds.

Housing Bonds Sales

Table 39 and Chart 21 show the sale of state and local housing and nonhousing bonds. From 1977–78 through 1979–80, combined state and local housing bond sales increased 439 percent. Local housing issues showed the largest increase—over 1,100 percent. In contrast, nonhousing bonds declined by 15 percent during this same period. In 1980–81, sales of both housing and nonhousing bonds fell significantly. However, housing bonds continued to maintain the same high share of total sales. As a result, the share of state and local bonds that are sold for housing rose from 5 percent in 1977–78 to 56 percent in 1979–80.

This rise in housing bond sales is attributable to several factors:

- Chapter 1, First Extraordinary Session-1975 (the Zenovich-Moscone-Chacon Housing and Home Finance Act), established the California Housing Finance Agency and authorized the sale of up to $1.5 billion in tax-exempt state revenue bonds. As of December 31, 1981, $936 million in bonds were outstanding under this program.
- Ch 1069/79 (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, although the State Housing Bond Credit Committee has the authority to review, disapprove, and/or reduce bond issues.

Table 39
California State and Local Bond Sales
1977–78 to 1980–81
(in millions) [a]

	1977–78	*1978–79*	*1979–80*	*1980–81*
State Bonds:				
Housing	$322.4	$625.0	$1,071.7	$861.8
Nonhousing	396.2	250.5	303.0	310.2
Subtotals	$718.6	$875.5	$1,374.7	$1,172.0
Local Bonds:				
Housing	$93.2	$364.9	$1,168.8	$792.6
Nonhousing	1,766.9	1,151.1	1,444.0	1,039.3
Subtotals	$1,860.1	$1,516.0	$2,612.8	$1,831.9
State and Local Bonds:				
Housing	$415.6	$989.8	$2,240.5	$1,654.4
Nonhousing	2,163.1	1,401.7	1,747.0	1,349.5
Totals	$2,578.7	$2,391.5	$3,987.5	$3,003.9

[a] Office of Planning and Research. State bond totals for 1980–81 are approximately $17 million more than estimated by the California State Treasurer.

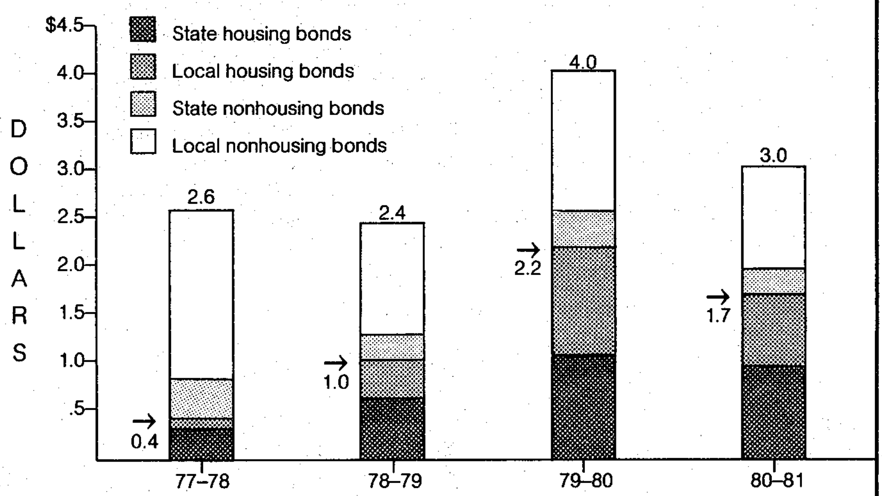
Future Housing Bond Growth

Both the state and federal governments have expressed concern about the rapid growth in the sale of housing revenue bonds, primarily out of fear that such bonds will increase the interest costs and limit the market for other tax-exempt bonds sold for more traditional purposes, such as to finance highway projects, construction of prisons, development of water projects, and so forth. In December 1980, the U.S. Congress decided to stem the growth in housing bonds when it enacted the Mortgage Subsidy Bond Act of 1980. This act restricts the use of these bonds, and eliminates their tax-exempt status when sold to finance single-family housing, beginning December 31, 1983. The threat of federal action and uncertainty about what its exact form might be, had caused a dramatic rise in the number of local housing bond issues proposed during late 1980. During this period, in fact, the State Housing Bond Credit Committee recommended postponement of several local housing bond sales in order to prevent a flood of issuances to the bond market.

Passage of the act also helps to explain why housing bond sales for 1980–81 as a whole dropped off so dramatically. Specifically, there was

Chart 21

California State and Local Bond Sales Highlighting Housing Bonds 1977–78 through 1980–81 (in billions)[a]



[a] Office of Planning and Research as published in "Mortgage Revenue Housing Bonds: California's 1980 Frenzy", November 1980, updated through December 1981 using data from Office of Planning and Research.

considerable uncertainty after December 1980 as to the conditions under which the tax-exempt status on housing bonds issued after that date could be voided due to the failure of housing agencies to adhere to the act's various regulations governing use of bond proceeds. This uncertainty was removed after mid-1981 when more detailed federal regulations were issued.

Between now and December 1983, there could be a resurgence of housing bond sales, subject to the contraints on volume imposed by the federal government, and assuming that conditions in the financial markets will permit bonds to be sold at reasonable interest rates. Beyond December 1983, however, the rate of growth in housing bonds will be less, because the tax-exempt status of issues used to finance single-family home purchases will be eliminated. How much this might reduce the future interest rates for other tax-exempt state and local debt is not known at present.

E. CURRENT PROBLEMS FACING THE STATE AND LOCAL TAX-EXEMPT BOND MARKET

1981—A Year of Setbacks

1981 was a disappointing year for the tax-exempt municipal bond market. While some of the problems facing the market are short-term in nature, a number are more fundamental, longer-term problems which may not disappear very quickly. Because of this, both the near-term and future outlook for tax-exempt bonds is quite uncertain at this time. Some of the major problems facing the market include the following:

- Because of current monetary policies and continuing inflation, *interest rates* have reached very high levels. This is especially true of municipal bond interest rates. In January 1982, for example, the widely-used 20-Bond Buyer Index of national municipal bonds stood at over 13.4 percent, compared to 9.6 percent 12 months before. Such high interest rates limit the ability of states and local governments to sell general obligation bonds because of statutory interest rate ceilings, and also impair the sale of revenue bonds because of the high debt servicing costs which governments must bear.
- Bond prices and interest rates have been negatively affected by both *basic supply and demand factors.* On the *supply side,* increased supplies of bonds, particularly bonds sold for "nontraditional" purposes, such as financing activities like housing that historically have been financed in the taxable market, have tended to drive prices down and yields up. On the *demand side,* organizations such as banks and insurance companies which traditionally buy tax-exempt bonds are not as active in purchasing these bonds because of reduced needs for tax-sheltered income. Casualty insurance companies, for instance, currently are at a low ebb of their earnings cycle. This, too, has driven prices down and yields up.
- The *Economic Recovery Tax Act of 1981* (ERTA) will exert a significantly negative impact on the tax-exempt bond market. For instance, ERTA reduces maximum individual marginal tax rates from 70 percent to 50 percent, thereby reducing the need by high-income individuals—who often buy municipal bonds—for tax shelters. ERTA also liberalizes the rules for tax-free retirement savings accounts and provides for tax-exempt "all savers" certificates.

The plight of the tax-exempt market, if not resolved, could result in very negative consequences for state and local governments. For most issuers, the sale of bonds represents the only feasible means for financing large capital outlay expenditures. There is evidence that the current state of the bond market has kept many governments from raising the funds they need. There is also evidence that, in order to sell bonds, some governments have had to shorten maturity structures and eliminate "call" provisions. This tends to reduce budgetary flexibility in the future.

Under such conditions, the bond-dependent capital infrastructure of governments may not only fail to keep pace with the needs of a growing population; it may actually erode. Ultimately, this could create significant economic and social problems for our society.

In California, the problems facing *local* governments in the municipal market are especially significant, because of the limitations which Proposition 13 placed on property tax revenues. Because these revenues traditionally have been pledged to service general obligation bonds, the ability of local governments to issue new general obligation debt has essentially been eliminated. No longer can a local government temporarily increase the property tax rate for the sole purpose of amortizing a bond. The reduction in the volume of local general obligation bond sales caused by the combination of negative conditions in the bond market and Proposition 13 has been partly offset, at least in the case of some localities, by increased use of revenue bonds, including those whose debt service relies on lease-purchase arrangements. Such revenue bonds, however, tend to impose higher interest costs on localities than do general obligation bonds.

What Can Be Done?

In 1981, several measures were enacted in California to address some of the problems the state and local governments face in raising money for capital outlay projects. These included:

- SB 121 (Ch 1098/81), which increases from 10 percent to 12 percent the maximum interest per year which can be paid on bonds issued by redevelopment agencies, housing authorities, industrial development authorities, and other local governmental agencies, unless otherwise excepted. The higher limit will expire on January 1, 1984, and revert to its original level.
- AB 176 (Ch 42/81), which increases from 9 percent to 11 percent the maximum interest per year which can be paid on state general obligation bonds.
- SB 152 (Ch 951/81), which gives cities the authority to share the city sales tax with redevelopment agencies. Sales tax revenues could then be pledged to support tax-allocation bonds for redevelopment purposes.

The overall issue of how best to deal with the underlying problems of tax-exempt bond financing, however, is the subject of considerable debate but little agreement. In general, some consensus has emerged that the market could benefit from restrictions on the proliferation of nontraditional uses of the tax-exempt borrowing privilege, such as the issuance of tax-exempt bonds to finance projects of private industry and housing. As noted earlier, the federal government has already enacted legislation to limit the use of tax-exempt revenue bonds for single-family housing. Exactly what the quantitative costs and benefits of such restrictions would be in terms of reduced government borrowing interest rates, however, remains unclear, although some reduction would be likely.

Other actions have been proposed which are much more controversial. Some economists and policy makers, for example, are in favor of eliminating tax-exempt bonds altogether, and replacing them with direct subsidies to issuers. This view is based on the well-known fact that the current exemption oversubsidizes high income investors to purchase tax-exempt bonds.

Another suggestion has been to have the state government become more involved in the capital outlay financing activities of local governments. This involvement could range anywhere from collecting and disseminating information on bond-related matters, to becoming directly involved in the approval and marketing of local debt issues. One step in the direction of greater state involvement in local debt was taken under AB 1192 (Ch 1088/81), which established the California Debt Advisory Commission for the purpose of providing *advisory* assistance on the marketing of bond issues for both the state and individual local governments. At present, this commission is still in a start-up mode, and it will be some time before its exact role is defined and the effects of its activities can be evaluated.

State and local government access to long-term financial capital through efficient bond markets is critical. While some of the markets' problems (such as the current state of the economy) are out of the state's direct control, others (such as state laws governing the conditions under which tax-exempt financing is used) are not.

We plan to provide the Legislature with a report later this year, which identifies the major problem areas in debt financing, and the policy options that are available to address these problems.

VII. STATE EMPLOYMENT

The budget estimates that there will be 231,375 state employees in 1982–83, an increase of 2,276 personnel-years, or 1.0 percent above the current-year level.

Table 40
Total Number of State Employees, by Function (in personnel-years) 1978–79 through 1982–83

Function	*1978–79* Actual Positions	*1979–80* Actual Positions	*1979–80* Percent Change	*1980–81* Actual Positions	*1980–81* Percent Change	*1981–82* Estimated Positions	*1981–82* Percent Change	*1982–83* Proposed Positions	*1982–83* Percent Change
Legislature	338.1	337.4	(−0.2%)	332.6	(1.4%)	361.8	(8.8%)	399.2	(10.3%)
Judicial	989.7	1,051.0	(3.3)	1,083.7	(3.1)	1,156.1	(6.7)	1,234.0	(6.7)
Executive	7,247.7	7,325.3	(1.1)	7,716.0	(5.3)	8,101.9	(5.0)	8,172.8	(0.9)
State and Consumer Services	10,402.7	10,671.3	(2.6)	11,023.2	(3.3)	11,721.1	(6.3)	11,917.2	(1.7)
Business, Transportation and Housing	30,867.6	31,293.4	(1.4)	31,955.0	(2.1)	32,200.4	(0.8)	33,365.3	(3.6)
Resources	14,167.9	13,779.5	(−2.7)	13,889.2	(0.8)	14,578.6	(5.0)	14,947.2	(2.5)
Health and Welfare	40,460.9	42,325.2	(4.6)	43,320.7	(2.4)	41,921.7	(−3.2)	41,493.7	(−1.0)
Education:									
Education	2,650.3	2,665.0	(0.6)	2,746.5	(3.1)	2,985.9	(8.7)	2,964.7	(−0.7)
Higher Education	90,152.0	89,840.5	(−0.3)	91,629.0	(2.0)	92,047.3	(0.5)	92,177.2	(0.1)
Youth and Adult Correctional	12,805.6	12,548.6	(2.0)	13,118.3	(4.5)	14,516.7	(10.7)	15,110.5	(4.1)
General Administration	8,447.6	8,355.3	(−1.1)	8,752.4	(4.8)	9,508.0	(8.6)	9,593.5	(0.9)
Totals	218,530.1	220,192.5	(0.8%)	225,567.4	(2.4%)	229,099.5	(1.6%	231,375.3	(1.0%)

As Table 40 shows, the major staffing increases for the budget year will occur in Business, Transportation and Housing, and in the Youth and Adult Correctional programs. In the former category, the budget proposes an increase of 1,165 personnel-years. Within this category, the major increases are in staffing for the Department of Motor Vehicles (414), the Department of Transportation (330) and the California Highway Patrol (458). The increase for the patrol results from Ch 933/80, which increase vehicle registration fees by one dollar to augment the patrol's staffing by 670 uniformed positions over a four-year period.

The increase in Youth and Adult Correctional programs, for which the budget proposes 594 new positions, is primarily due to the population increases in the state correctional system.

The only major reduction in state employees, 428 positions, will occur in the Health and Welfare Agency. This reduction reflects reductions in staffing at the state hospitals (−148), and transfers of state functions to regional developmental disability centers (−100). Federally funded positions are also included in these reductions. The Employment Development Department is proposing to eliminate 277.6 personnel-years, a reduction of 2.2 percent in 1982–83. This is a result of reductions in federal funded positions for administration of employment and unemployment insurance programs.

Table 40 shows an increase of 12,845, or 5.9 percent, personnel-years from 1978–79 through 1982–83.

During the past three years, the rate of increase has slowed from 2.4 percent in 1980–81 to 1.6 percent in 1981–82, to 1.0 percent in 1982–83. The major reduction during this period occurred in the Employment Development Department (Health and Welfare), which eliminated 1,000 positions (personnel-years not available) during the current year. This is a direct result of reductions in Federal funding to the department.

Table 41 shows the growth in the number of state employees from 1973–74 to 1982–83. While General Fund expenditures increased 185 percent during this period, the number of state employees increased 19.9 percent. The rate of growth in later years is much less than in earlier years.

A year ago, the budget estimated that there would be 226,743 positions in 1981–82, but the revised estimate shows a total of 229,100 positions, or 2,357 more than the budget forecast. Increases in corrections (608) and higher education (1,892) account for the growth during the current year.

Table 41
Trends in Total State Employee Growth
(in personnel-years)
1973–74 through 1982–83

	Employees	*Percent Change*
1973–74	192,918	2.4%
1974–75	203,548	5.5
1975–76	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	225,567	2.4
1981–82 (estimated)	229,100	1.6
1982–83 (proposed)	231,375	1.0
Increase from 1973–74 to 1982–83	38,457	19.9%

PART 2

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

This section contains a discussion of some of the broader issues facing the Legislature as it begins its deliberations on the Governor's Budget for 1982–83. We have grouped these issues into five major categories.

State Revenue Issues. The first category of issues relates to state revenues. Specifically, we discuss a number of tax policy issues, including tax expenditures and tax simplification procedures. We also present alternatives for increasing state revenues from existing sources, including tax increases, user charges, and transfers from special funds. Finally, we examine the existing system for earmarking the distribution of tidelands oil revenues, and explain how this system limits legislative flexibility.

State Expenditure Issues. The second largest category of issues relates to state expenditures. Here, we discuss the effects of the reduced rate of growth in federal aid to California, and the implications of shifting federal support for a number of program areas from a categorical to a block grant basis. In addition, we identify a number of issues relating to the allocation of funds for cost-of-living adjustments.

We also examine the Governor's proposals for reducing state operations budgets by 5 percent, controlling toxic substances, and the Investment in People Initiative. Finally, we discuss in this category various capital outlay issues, including those related to new prison facilities.

Fiscal Relief Issues. The third category of issues involves fiscal relief to local governments. Specifically, we analyze the Governor's proposed fiscal relief package which provides for a $503 million reduction in aid to cities and counties, as well as the proposal that would allow counties to recoup some of the loss by implementing a new procedure for reassessing property. We compare these proposed reductions with those that would occur under the AB 8 deflator, and identify other options for allocating reductions among local governments.

We also analyze the Governor's proposal for reforming procedures for reimbursing local agencies for state mandated programs, and recommend other options for evaluating the effectiveness of existing mandated programs.

Broad Fiscal Issues. The fourth category of issues involves broad fiscal trends. Here, we examine the ability of existing revenue sources to finance a "workload" budget in 1983–84. We also include a discussion of the Reserve for Economic Uncertainties, and point out the need to increase this reserve, if possible.

Collective Bargaining Issues. The fifth and last category consists of the issues the Legislature will face in implementing and funding the first collective bargaining contracts with state employees.

I. REVENUE ISSUES

A. Tax Policy Issues

The primary focus of our analysis of the Governor's Budget is on the direct expenditures which support both new and existing programs of state government. In addition, we attempt to identify various expenditure-related issues which may not involve specific funding requests at present, but which could be important from either a fiscal or policy perspective in the near future.

In acting on the Governor's Budget, however, the Legislature also needs to consider the "other half" of the administration's fiscal plan—the revenue side of the budget. By far the largest component of revenues is tax collections. Because the state's overall fiscal balance is dependent on *both* expenditures *and* revenues, the revenue side of the budget, in theory, should receive the same regular review as does the direct expenditure side. This review should include an evaluation of existing tax policies, as well as an identification of tax-related issues which have significant fiscal and/or policy implications.

In this section, we discuss several major issues regarding the tax revenue side of the budget. These are

1. "Tax expenditures," which are already embedded within the state's tax laws;
2. Tax simplification; and
3. Other taxation issues, including unitary apportionment, urban enterprise zones, windfall profits taxation, and indexing income taxes for inflation.

Tax Expenditures

The Governor's Budget for 1982–83 proposes an increase in General Fund expenditures that is just a little more than 5 percent above estimated current-year expenditures. That same budget, however, reveals a 24 percent increase in another "spending" category: General Fund *tax expenditures.*

The term tax expenditures refers to various tax exclusions, exemptions, preferential tax rates, credits, and deferrals, which reduce the amount of revenue collected from the basic tax structure. Although there are several reasons why tax expenditures may be enacted, the principal ones are: (1) to provide incentives for taxpayers to alter their behavior in certain ways (for example, tax deductions for mortgage interest is intended to encourage homeownership), and (2) to exempt certain types of income from taxation. The tax expenditure concept is used not to suggest that all income "belongs" to the government, but as a systematic means for identifying those revenues foregone by the state for policy reasons, in order that the "costs" of these policy decisions may be compared to the results.

In 1981–82, identifiable tax expenditures were estimated at $7.9 billion. For the budget year, however, the corresponding amount is $9.8 billion, or 24 percent more than the current-year level. This growth is explained in part by the large increase in tax expenditures through the inheritance and gift tax program which resulted from recent changes in law, and in part by rapidly increasing mortgage interest deductions by homeowners. As a result of the increase, total tax expenditures in 1982–83 are expected to be 41 percent of estimated General Fund expenditures in that year.

Although tax expenditures are an appropriate means of accomplishing legislative objectives, there are two basic reasons why their use needs to be closely monitored. First, tax expenditures may not be effective tools in influencing taxpayer behavior. For example, because California's income tax rates are low relative to federal tax rates, certain deductions allowed by California law do not result in large tax savings to individuals. It is doubtful that those state tax expenditures which provide a relatively moderate amount of tax relief per return have much impact on taxpayer behavior. These types of tax expenditures, however, can result in significant amounts of foregone revenue.

Second, tax expenditures weaken the Legislature's control of the budget. Once a tax expenditure has been established in law, the revenue loss occurs automatically thereafter. Unlike regular expenditure programs, funds for which must be appropriated annually in the Budget Act, tax expenditures need not come under annual legislative review.

Furthermore, tax expenditures are like entitlements in that there is no limit on the number of persons who can claim the corresponding benefits. While the Legislature can place a maximum "cap" on an otherwise open-ended appropriation, tax expenditures cannot be controlled in this fashion. In short, once a tax expenditure is enacted, the Legislature—for all practical purposes—loses control over the amount of state resources allocated to the accomplishment of the particular objective. In this regard, the unlimited deduction of mortgage interest payments is not unlike a direct housing subsidy program that provides grants to as many homeowners as file for them.

Reevaluation of Tax Expenditures. Because of the state's present fiscal condition, expenditure programs financed from the General Fund are undergoing a much more careful scrutiny than they have in the past. There are several reasons why the Legislature might also wish to give a more careful scrutiny to tax expenditures.

a. ***Windfall Benefits.*** Many tax expenditures provide benefits to taxpayers whose behavior is unaffected by the tax incentive. For instance, it is highly unlikely that the *state* tax deduction for charitable contributions affects many taxpayers' decisions on charitable donations, yet *everyone* claiming the deduction receives the benefits from the tax expenditure.

b. ***Tax Expenditures Contrary to Other State Goals.*** Some tax expenditures appear to be contrary to the objectives of other state programs. For example, the Legislature has made clear its intent to encourage energy conservation through both tax and regular expenditure programs. At the same time, the state continues to provide a partial subsidy to *consumers* of energy through the income tax deduction for gasoline taxes.

c. ***Tax Expenditures at Cross-Purposes.*** Some tax expenditures work at cross-purposes with each other. For instance, the state provides an income tax deduction for interest paid on consumer debt, which in effect subsidizes consumer *spending*. On the other hand, the state provides an income tax exemption for individual retirement accounts, which is intended to encourage *savings*.

d. ***Changed Priorities.*** Given the state's current fiscal condition, many tax expenditures may not have the same priority to the Legislature that they had when enacted. In this regard, the Legislature might want to consider eliminating such tax expenditures as:

- The sales tax exemptions for candy and periodicals.
- The income tax exclusion of up to $1,000 for military pay.
- The percentage depletion allowance under the income taxes (the state allows a flat percentage allowance, rather than a depletion allowance based on cost).

In addition to eliminating low-priority tax expenditures, the Legislature might also wish to limit certain tax expenditures. For instance, it is estimated that the tax expenditures for energy credits will cost the state in foregone revenues approximately $100 million in 1982–83. This cost could be reduced substantially by: (1) reducing the percentage credit allowed, (2) allowing a state credit only for expenditures *not* eligible for the federal credits, or (3) disallowing the credit for the purchase of those items which the taxpayer *already* has a strong economic incentive to purchase. The revenue loss from most tax expenditures can be reduced in similar ways.

Tax Simplification

One method of simplifying the state's tax structure is to make it conform with federal law. At present, state and federal income tax laws are generally comparable; however, there are still literally hundreds of differences between the two.

In past years, the Legislature has pursued conformity on a *selective* basis. That is, the Legislature has acted to conform specific provisions of state law with federal law. For instance, this past November the Senate and Assembly Revenue and Taxation Committees evaluated the extent to which the state should conform with the individual federal income tax changes made by the Economic Recovery Tax Act of 1981.

The Legislature, however, also has considered measures that would provide for *total* conformity with federal income tax laws. SCA 14 of the current session, for instance, would allow the state to bring its tax laws into conformity with federal laws on a prospective basis (that is, it would provide for *automatic* changes in state tax laws whenever federal tax laws change).

The advantages of either limited or widespread conformity are (1) reduced taxpayer compliance costs (in time and money) and (2) lower costs to the state for administering tax programs.

On the other hand, there are two major disadvantages to automatic conformity. First, with automatic conformity, the state loses control over its tax policy. In effect, the state must accept the federal government's judgment as to what is an equitable and efficient tax base. Second, the state may lose control over income tax revenues in the short run. For instance, had there been automatic conformity to the provisions of the Economic Recovery Tax Act of 1981, California would have lost hundreds of millions of dollars in 1981–82 unless an offsetting increase in the tax *rates* was enacted. The short-term loss of control can be a particular problem when the state is experiencing difficulties in balancing its budget.

Specific Tax Issues

In addition to questions involving tax expenditures and tax simplification, there are several specific tax policy issues which the Legislature is likely to face in the coming year.

a. ***Unitary Apportionment.*** In applying the bank and corporation tax to multinational firms, the Franchise Tax Board (FTB) allocates income to California through a unitary method of apportionment. This method uses three factors—sales, payroll and property—as a measure of a firm's California business activity relative to its total business activity. During the current session of the Legislature, several bills have been introduced which would prohibit FTB from applying unitary apportionment to *foreign-based* multinationals. In addition, a bill pending in the United States Congress would prohibit the application of unitary apportionment to *any* foreign operations.

b. ***Urban Enterprise Zones.*** The Reagan Administration has proposed the establishment of urban enterprise zones within economically depressed areas. Within these zones, various federal tax incentives would be provided in order to stimulate business development. State legislation providing comparable tax incentives has also been introduced during the current legislative session (AB 416).

c. ***Windfall Profits Tax.*** The state's existing Bank and Corporation Tax Law allows firms to deduct certain taxes (such as sales and property taxes) but not others (such as federal income taxes) in determining their taxable income. The Franchise Tax Board has issued a preliminary opinion holding that firms are permitted to deduct the federal windfall profits tax from income on their state returns. The administration has proposed legislation (AB 2361 and SB 1326) which would prohibit the deductibility of windfall profits taxes.

d. ***Indexing.*** The Legislature has provided for automatic annual adjustments to personal income tax brackets to offset the effects of inflation for increases in the California Consumer Price Index exceeding 3 percent. There remain, however, three major policy issues involving indexing which are still subject to legislative debate:

- What is the appropriate index to use for adjusting tax brackets—the California Consumer Price Index? the U.S. Consumer Price Index? the Wages and Salary Index? etc.
- Should the brackets be fully or partially adjusted to offset the effects of inflation?
- Should certain elements of the tax base (such as capital investments) also be indexed to avoid state taxation of inflation-induced gains that are not income in a real sense?

B. Alternatives for Increasing State Revenues

Given the uncertainty about the path of the economy in 1982 and 1983, it is possible that 1982–83 revenues could differ significantly from the budget's projections. To the extent revenues exceed the projections, additional funds would be available to (1) replenish the Reserve for Economic Uncertainties, (2) maintain existing service levels under various state programs, (3) fund new or expand existing programs, or provide additional tax relief. It is, of course, possible that actual revenues will exceed the forecast, as occurred in the middle and late 1970's.

On the other hand, should a revenue shortfall occur, the state would have to either reduce expenditures or augment its revenues in order to avoid a General Fund deficit.

There are several approaches the Legislature could consider if it is faced with the prospect of having to augment budget year revenues. For example:

The Legislature Could Enact a General Tax Increase

A general tax increase could be applied to one or more of the state's three major revenue producers—the sales and use tax, the personal income tax, and the bank and corporation tax. In most years, these taxes account for over 85 percent of total General Fund revenues.

The simplest way of implementing and administering a general tax increase would be to increase existing tax rates. For example:

- A quarter-cent increase in the state sales and use tax rate—currently 4¾ cents—would generate over $450 million in 1982–83.
- A one percentage point increase in the bank and corporation tax rate—currently 9.6 percent—would generate about $360 million in 1982–83.
- A 5 percent surcharge on marginal personal income tax rates—which presently range from 1 percent to 11 percent—would generate about $430 million in 1982–83.

It should be noted that the net cost to most California taxpayers from such revenue-raising measures would be *less* than the amounts of additional revenue received by the state, because state tax payments can be deducted when computing federal income tax liabilities.

The Legislature Could Increase Selective Excise Tax Rates

The state currently levies a variety of excise taxes, including taxes on cigarettes, horse racing wagering, and alcoholic beverages. In 1982–83, revenues from these items are projected to be over $530 million.

In last year's *Analysis* (pages A-85 through A-87) and in a subsequent report entitled *The Taxation of Cigarettes, Alcoholic Beverages and Horse Racing Activity in California* (Report 81-18, October 1981), we indicated that there are several reasons why the Legislature might wish to consider increasing these taxes. One reason is to adjust the tax rates to reflect inflation that has occurred, since these rates were last changed. Most of these rates have not been changed for many years. In the case of the taxes on alcoholic beverages and cigarettes, which are levied on a physical-unit basis, the passage of time effectively reduces the tax rate because inflation causes it to represent a smaller and smaller percentage of the taxed items' selling price.

SIN TAXES

Should the Legislature decide to increase these selective excise tax rates, the revenue gain would depend on the size of the increase. The potential yield from an increase in these taxes can be seen in the following examples:

- If these excise tax rates were increased to the average rates levied by other states, maximum additional revenues would total about $280 million.
- If these excise tax rates were adjusted for inflation since 1970–71, maximum additional revenues would total over $250 million.

Actual revenues could be somewhat less than these amounts if consumers reduced consumption of the taxed items in response to higher prices caused by the higher taxes.

The Legislature Could Increase User Charges

A third alternative for increasing revenues is to transfer the responsibility for supporting the cost of certain government services from the General Fund to those who benefit most directly from those services. For example, the administration has proposed to:

1. Extend the concept of user funding to all utilities under the jurisdiction of the California Public Utilities Commission (PUC). The 1982–83 budget indicates that the PUC will seek legislative approval to authorize assessments to offset the costs of regulating gas, electrical, water and sewer, and communication activities. These assessments, which would increase revenues by $24 million, are included in the budget's revenue estimates.
2. Save the General Fund approximately $27 million by shifting certain units in the Department of Industrial Relations to a self-funding reimbursement basis.

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Our analysis indicates that several other changes of this type are warranted, including the following:

- In our analysis of the Department of Forestry, we have recommended (a) that a system of graduated permit fees be used to finance the Forest Practice Act, and (b) that the Fire Protection program be made partially self-supporting through a system of landowner assessments. In addition, we have recommended that the Department of Fish and Game make its streambed alteration permit program self-supporting by levying fees. These three recommendations could save the General Fund close to *$35 million.*

- The Department of Food and Agriculture currently provides funds to cover county costs for issuing pesticides permits, for the operation of state veterinary labs, and for state inspection of fruits, nuts, and vegetables. General Fund support for these programs in 1982–83 will amount to over $9 million. Some portion of these costs could be offset by user fees and charges.
- The California Department of Transportation currently spends over $15 million for the operation and administration of inter-city rail service. Part of these costs, which presently are paid for by General Fund sales and use tax revenues transferred into the Transportation Planning and Development (TP&D) Account, could be offset by user charges.

The Legislature Could Transfer Special Fund Balances to the General Fund

In the 1981 Budget Act, over $700 million in special fund balances were transferred on a one-time basis to the General Fund, to help balance the current-year budget. Most of this money represented tidelands oil revenues.

In 1982–83, the Governor proposes a one-time transfer of over $450 million from special funds to the General Fund. This primarily represents monies in the Motor Vehicle License Fee Account. The budget, however, still shows special fund revenues totaling $3.4 billion in 1982–83, including $510 million in oil and gas revenue from state lands that would be spent through various special funds established in 1980.

In many cases, depositing revenues into special funds is desirable, particularly when these monies are collected to support specific programs, as they are in the case of most licensing and regulatory programs. In other cases, however, depositing monies into special purpose funds, though appropriate from a policy standpoint, tends to complicate the Legislature's review of state expenditures and narrow the Legislature's options in allocating state resources.

The Legislature may wish to consider transferring to the General Fund special fund balances that were not raised for the express purpose of financing specific activities. A prime candidate for such a transfer, should a 1982–83 revenue shortfall arise, is tideland oil revenue.

C. Allocating Tidelands Oil Revenues

Allocation Priorities Under Current Law

Chapter 899, Statutes of 1980, provided for the redistribution of tidelands oil and gas revenue that under prior law would have been deposited in the Capital Outlay Fund for Public Higher Education (COFPHE).

Prior to 1980–81, California received approximately $110 million in tidelands oil revenue annually. About $70 million of that amount went to the COFPHE. Unprecedented increases in the price of oil, however, resulted in an almost five fold increase in tidelands oil revenues. Thus, in 1982–83, California will receive approximately $510 million in new revenues from this source.

In enacting Chapter 899, the Legislature established a priority sequence for the distribution of tidelands oil revenues. Under this measure, six special funds are recognized as eligible to receive the funds. Rather than distribute a fixed amount or a fixed percentage of available money to each of these six special funds, Chapter 899 arranges the funds in descending order of priority and establishes a target funding level for each. Under this arrangement, no fund gets *any* allocation of tidelands oil revenues until all funds having a higher priority get their *full* target amounts. Put another way, a shortfall in revenues is not appportioned among all six funds, but instead is borne by one or more funds at the bottom of the list. The existing priority sequence and the target distributions for each fund are shown below.

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

In the case of the COFPHE and ERF, any unused balances remaining in the fund from the prior year are deducted from the target amount. In the case of the other funds, however, no such deductions are made. Thus, for example, the State School Building Lease/Purchase Fund may have available more than $200 million in any year, if balances are carried over from the previous year.

Legislative Flexibility Restricted

From an analytical standpoint, tidelands oil revenues are indistinguishable from General Fund revenues. They are not raised for a particular function of state government, and may be used for any public purpose. Depositing tidelands oil revenue into special purpose funds tends to limit the Legislature's options in allocating available state resources among state-supported programs and activities. Our analysis suggests that there are two major weaknesses in the existing distribution of these revenues:

1. The priority sequence arrangement implies that the *lowest* priority capital outlay project funded in any one of the top five tiers is needed more than the highest priority project in the next lower tier. Thus, for example, the logic of the allocation mechanism implies that the lowest priority at, say, the community colleges, is more important than the energy and resources project offering the most dramatic energy savings to the state. Similarly, the energy and resources project with the lowest pay-off is given a higher priority than fire, life safety and environmental improvements at a state hospital.

2. Capital outlay projects financed from tidelands revenues are given a higher priority than all other state programs because they are funded from dedicated revenues, and need not compete for funding with these other programs. In contrast, state operations and local assistance must compete with each other for funding.

The Legislature recognized these problems in acting on the 1981 Budget Act and provided for the transfer of balances from the tidelands oil special funds to the General Fund. The Governor proposes to make a much smaller transfer in the 1982–83 Budget Bill.

While such transfers offer a way of overcoming the weaknesses in the existing distribution of tidelands oil revenues, they are not easily accomplished once specific projects are proposed for funding from individual special purpose funds.

To improve the Legislature's fiscal flexibility in responding to the fiscal problems facing the General Fund, we recommend that either:

1. Tidelands revenues be deposited directly into the General Fund, or

2. These revenues be deposited into a single capital outlay fund from which all capital outlay needs would be funded on a statewide-priority basis.

Governor's Proposed Distribution of Tidelands Revenue

Table 1 shows the distribution of tidelands oil revenue under existing law, as well as the distribution proposed in the Governor's Budget. Implementation of the Governor's proposal is provided for in Section 90 of AB 2361 and SB 1326.

Table 1
Distribution of Tidelands Oil Revenue
Existing Law Compared to Governor's Budget
(in thousands)

	1982–83	
	Existing Law	*Governor's Budget*
Revenues:		
Current estimate	$510,000	$510,000
Distribution:		
State Lands Commission and refunds to local governments	8,050	8,050
Water Fund	25,000	14,710
Central Valley Water Project	5,000	—
Sea Grants	500	475
Capital Outlay Fund for Public Higher Education (COFPHE)	125,000	116,000
State School Building Lease-Purchase Fund	247,200 [a]	100,000 [a]
Energy and Resources Fund (ERF)	98,250 [b]	120,000
State Parks and Recreation Fund (SPRF)	— [c]	11,000
Transportation Planning and Development Account (TPDA)	— [c]	—
Special Account for Capital Outlay (SAFCO)	— [d]	78,000
Off-Highway Vehicle Account	1,000 [e]	—
Reimbursement to General Fund for Energy Tax Credits	— [f]	61,740

[a] Includes repayment of $47.2 million loan pursuant to Ch 998/81.
[b] Based on Governor's Budget, this fund has a balance of $3,957,000 June 30, 1982. Thus, under existing law $116,043,000 would be deposited if there were sufficient tidelands oil revenues. Revenues, however, coupled with other commitments would leave $98,250 available for the Energy and Resources Fund.
[c] Revenues will not be sufficient to provide the $35 million and $25 million prescribed by existing law for the SPRF and TPDA, respectively.
[d] SAFCO receives balance of revenues not deposited in the other funds. Estimated revenues in 1981–82 are not sufficient to reach the SAFCO.
[e] Repayment of loan pursuant to Ch 998/81.
[f] Under existing law, reimbursements of up to $42 million and $3 million are to be made from the SAFCO and from the ERF, respectively, not from undistributed tidelands oil revenue.

As shown in Table 1, under the Governor's proposal the ERF, SPRF, and SAFCO would receive tidelands oil revenue at the expense of the state water projects, K–12 school construction, higher education, and transportation. The ERF, however, is the only fund that would receive *more* tidelands oil revenue than existing law would provide. This reflects the priority which the administration places on energy and resource conservation capital outlay projects. In fact, the Governor's Budget also includes $3.7 million from the COFPHE and $10.9 million from the SAFCO for energy conservation projects, in addition to the $103.7 million proposed from the Energy and Resources Fund for these projects. Thus, a total of $118.2 million is budgeted for energy/resource conservation projects in 1982–83. If transportation funds and bond funds are excluded, this amounts to 51 percent of the $233.1 million proposed in the Governor's capital outlay program.

Table 2 summarizes the appropriations from the tidelands oil special funds proposed in the Governor's Budget, and the balances that would be available in each fund on June 30, 1983 if the budget were approved as submitted.

Table 2
Appropriations and Amounts Available
Special Funds Receiving Tidelands Oil Revenues
As Proposed in Governor's Budget
(in thousands)

	1982–83
Capital Outlay Fund for Public Higher Education (COFPHE):	
Carry-over from previous year	—
Tideland oil revenue	$116,000
Budget Bill appropriations	−114,180
Balance available for appropriation	$1,820
State School Building Lease-Purchase Fund (SSBLPF):	
Carry-over from previous year	$1,000
Tideland oil revenue	100,000
Balance available (continuously appropriated)	$101,000
Energy and Resources Fund (ERF):	
Carry-over from previous year	$3,957
Tideland oil revenue	120,000
Budget Bill appropriations	−103,654
Balance available for appropriation	$20,303
State Parks and Recreation Fund (SPRF):	
Carry-over from previous year	$607
Tideland oil revenue	11,000
State Park System Revenues	7,500
Transfer from Highway Users Account, State Transportation Fund	1,500
Budget Bill appropriations	−19,937
Balance available for appropriation	$670
Transportation Planning and Development Account:	
Carry-over from previous year	$13,205
Retail Sales and Use Tax	155,000
Surplus Money Investment	17,200
Transfers	4,970
Budget Bill appropriations	−191,122
Reserve for Unified Trans Fund (locals)	−13,000
Balance available *(deficit)*	*−$13,747*
Special Account for Capital Outlay (SAFCO):	
Carry-over from previous year	$23,954
Tidelands oil revenue	78,000
Budget Bill appropriations	−72,712
Balance available for appropriation	$29,242

The distribution of funds proposed by the budget bill may cause the SAFCO to be oversubscribed. There are two reasons for this.

SAFCO Funds May be Needed for New Prison Construction. The budget includes $161.8 million for the Department of Corrections' New Prison Construction Program. These funds, however, will be available *only* if the voters at the June 1982 election approve the New Prison Construction Bond Act of 1981. The Budget Bill contains language specifying that, if this bond program is not approved, $69.3 million for a new prison at Tehachapi is to "be recognized as a priority project and shall be available from the Special Account for Capital Outlay." Should these funds have to be used for the Tehachapi prison, the capital outlay program proposed to be supported from the Special Account for Capital Outlay would be virtually eliminated, since the entire program funded from the SAFCO totals only $72.7 million—$3.4 million more than the cost of the prison.

Problems With Energy Tax Credit Funding. A further complication resulting from the distribution of tidelands oil revenue proposed by the Governor has to do with energy tax credits. The budget proposes to transfer $61.7 million in tidelands oil revenues *directly* to the General Fund for reimbursement of solar and other energy tax credits which are estimated to cost $100 million in 1982–83. Existing law (Ch 904/80), however, requires $42 million to be transferred *from SAFCO* to the General Fund as a reimbursement for energy conservation tax credits. As AB 2361 is drafted, the $61.7 million would be in addition to the statutory allocation of $42 million. Thus, the entire estimated cost for solar and other energy tax credits would be paid from tidelands oil revenue if AB 2361 is approved as introduced. (It is possible that the budget may have intended that $61.7 million come from the SAFCO.)

Taking both of these factors into consideration, the budget envisions commitments of $184 million against the SAFCO. According to the Governor's Budget, however, the SAFCO has a balance available of $101.9 million—$82.1 million less than the maximum potential commitment.

Legislative Priorities

We recommend that the Legislature make an early decision regarding the relative priority of the various claims on tidelands oil revenues. In lieu of the allocation of tidelands oil revenues proposed in the budget, the Legislature may chose to (1) redirect a larger portion of these revenues to the General Fund where they would be available to fund legislative priorities in all program areas, or (2) place a higher priority on capital outlay in such areas as state office buildings, higher education, or K–12 school construction. In any case, we urge the Legislature to make a decision on the allocation of these funds at the outset of the budget process so that (1) individual capital outlay projects proposed in the budget and other statewide needs can be evaluated on a consistent basis during budget hearings, and (2) funds are not committed to individual projects before the overall needs of the state are identified.

In our analysis of the various departmental capital outlay programs, we have divided those projects funded from tidelands oil revenues, which our analysis indicates are justified, into seven descriptive categories. These categories are provided as an aid to the Legislature in evaluating capital projects in the event (1) the Tehachapi project must be funded from SAFCO and the balance of the state capital outlay program must be reduced significantly, or (2) the Legislature decides to restructure the priorities for tidelands oil revenue, either by increasing the transfer to the General Fund or by modifying the emphasis on the type of capital outlay projects funded.

In addition, wherever we have recommended reductions to capital outlay programs funded with tidelands oil revenue, we have recommended that the resulting savings be transferred to the General Fund. We have made this recommendation with the intent of increasing the Legislature's fiscal options. Any unappropriated balance remaining in the tidelands oil special funds would be available only to finance programs and projects of a specific nature. By transferring these balances to the General Fund, the Legislature would broaden its options in meeting high-priority statewide needs.

II. EXPENDITURE ISSUES

A. Federal Budget Reductions

During recent years, the task of preparing a budget for the state has become increasingly difficult because of the uncertainties regarding fiscal and economic policy at the federal level. The state's experience in adopting and implementing a budget for the current year is a case in point.

Uncertainties Surrounding the Federal Budget for 1982

The Governor's Budget for 1981–82 was prepared in the fall of 1980 and submitted to the Legislature on January 10, 1981. The Legislature enacted the budget on June 15, 1981, and it became law on June 28. This budget assumed that the amount of federal aid provided to California would be at a certain level.

Six weeks later, however, major changes in federal expenditures and revenues were signed into law by President Reagan. These changes invalidated a number of key assumptions underlying the state's budget for 1981–82.

The Omnibus Budget Reconciliation Act of 1981 revised maximum authorizations for a large number of federal programs in 1982, 1983, and 1984, and provided for spending cuts in many of these programs. These cuts were made in response to President Reagan's economic plan. The President's original economic plan proposed to reduce the rate of growth of total federal spending over the next five years, and to shift federal priorities from nondefense to defense-related spending. The President's plan proposed net spending reductions of $270 billion during the five-year period 1981 to 1984. A portion of these reductions would be offset by spending increases, for a net reduction of $201 billion.

Spending decreases were spread across a variety of programs, but tended to fall disproportionately in a few areas—particularly federal grants to state and local governments.

The Omnibus Reconcilation Act established revised authorization levels for most programs in 1982, 1983, and 1984. These authorization levels, however, do not make funds available for distribution to the states. They merely establish the *maximum* amount that may be appropriated for a particular program in a given year. The Congress must then pass specific appropriation bills to determine the level of funds that will be available to programs within the maximum authorization.

Because Congress failed to enact appropriation bills by the beginning of federal fiscal year (FFY) 1982, it passed a series of continuing resolutions—on October 1, 1981, November 21, 1981, and December 11, 1981—to provide short-term funding for federal programs and activities. Continuing resolutions authorize spending for specific programs, pending enactment of an appropriation measure, at one of the following levels: (a) the level authorized in the previous fiscal year, (b) the level authorized in the Reconciliation Act, or (c) the level in the appropriation bill being consdered by each house of Congress—whichever is lower. The effect of the latest continuing resolution was to make further reductions in program spending levels, bringing them below the levels authorized by the Reconciliation Act. Once an appropriation bill is enacted, the funding level it contains supersedes that provided for in the continuing resolution, retroactive to the beginning of the federal fiscal year.

Since October 1981, 10 of the 13 appropriation bills have been signed into law. The three appropriation bills which remain to be approved, however, account for a significant portion of the federal budget, and well over half of the money provided by the federal government to the state. These three bills include funding for labor, health, human services, and education programs; state, justice, and commerce activities; and treasury and postal service operations.

The current continuing resolution expires March 31, 1982, with six months left in FFY 82. We are unable to predict whether Congress will pass the three remaining appropriation bills by that time or whether a fourth continuing resolution will be needed. Nor are we able to predict what the spending levels authorized in those measures will be. As a result, the level of federal spending for many programs in FFY 82 still remains uncertain. Since approximately 75 percent of federal aid provided in FFY 82 will be allocated by the state during its current fiscal year (which ends June 30, 1982), the difficulties presented by these uncertainties are easy to see.

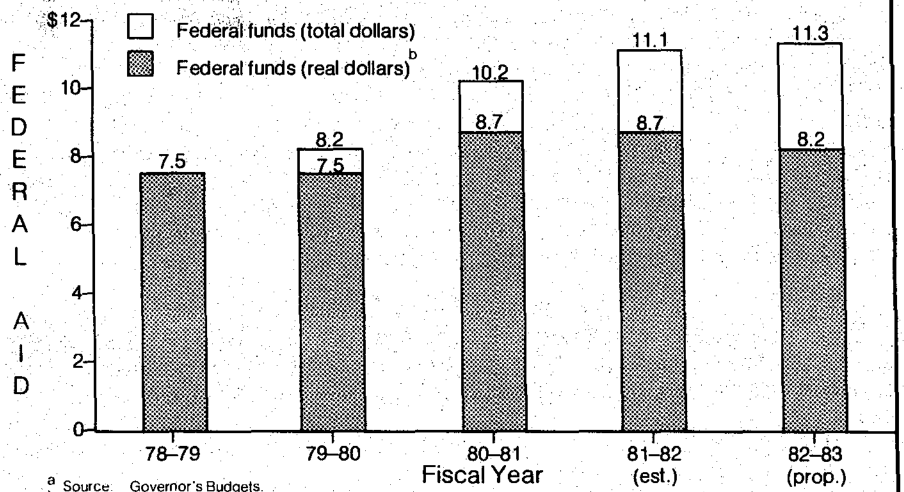
Recent Trends in Federal Aid to California

Chart 1 identifies the changes in total federal aid to California during the period 1978–79 through 1982–83. The amounts in this chart are based on estimates presented in the Governor's Budget for 1982–83. Because the budget in some cases assumes that federal funding will be provided at the

Chart 1

Expenditures of Federal Aid Granted to the State of California

1978–79 through 1982–83 (in billions)[a]



[a] Source: Governor's Budgets.
[b] "Real" federal dollars equal total federal dollars deflated to 1978–79 dollars using the Gross National Product price deflator for state and local purchases of goods and services.

levels authorized in the Omnibus Reconciliation Act, rather than at the lower levels provided for in the continuing resolutions, the levels of aid shown in the chart for 1981–82 and 1982–83 are likely to be optimistic.

A review of this chart indicates two things:

1. The rate of growth in federal aid to California is expected to be minimal in the budget year.

2. In terms of purchasing power, there has been relatively little growth in federal aid since 1978–79.

The chart shows expenditures in total actual dollars as well as in "real" dollars (that is, actual dollars deflated to reflect changes in purchasing power). In terms of total actual dollars, federal expenditures have grown from nearly $7.5 billion in 1978–79 to $11.3 billion in 1982–83. During the first two years of that four-year period, total federal expenditures grew at an average annual rate of 16.9 percent. During 1981–82 and 1982–83, however, total federal expenditures are expected to grow at an average annual rate of only 5.3 percent.

In terms of "real" or deflated dollars, federal expenditures have grown from $7.5 billion in 1978–79 to $8.2 billion in 1982–83. Real federal expenditures grew at an average annual rate of 8.8 percent during the two-year period 1978–79 to 1980–81. During 1981–82 and 1982–83, however, they are expected to *decrease* by 3.1 percent.

The Prospects for Federal Aid in the Future

State and local governments can expect further cutbacks in federal aid in the years ahead. The spending reductions proposed by the President and enacted by the Congress cannot be viewed as one-time occurrences. Nor is it likely that federal grants to state and local governments will begin rising once again in the near future. The Omnibus Reconciliation Act proposed spending reductions of $38 billion in FFY 82 and $105 billion in FFY 83 and FFY 84, for a total of $143 billion during the five-year period from 1981 to 1984. This still leaves an additional $127 billion in spending reductions which must be implemented if the President wishes to achieve his goal of $270 billion in total reductions by 1984.

Furthermore, the Economic Recovery Tax Act of 1981 will all but force further spending reductions to be made. We estimate that this act will reduce total federal tax revenues by $38 billion in FFY 82, $93 billion in FFY 83, and $150 billion in FFY 84, for a total revenue reduction of $282 billion over the entire 1981 to 1984 period.

Most of the growth in federal expenditures which may occur in the future is likely to be absorbed by the entitlement programs and, to a lesser extent, by the federal defense budget. Any growth in federal grants to state and local governments, however, is likely to fall far short of the amount needed to offset the effects of inflation.

B. Federal Block Grants

The Omnibus Budget Reconciliation Act of 1981 (PL 97-35), in conjunction with the Education Consolidation and Improvement Act of 1981, collapsed 57 federal categorical programs into the following nine block grants.

1. Title XX Social Services—includes social services, day care, and related training.

2. Low-Income Home Energy Assistance (LIHEA)—restructures the low-income energy assistance program.

3. Alcohol, Drug Abuse, and Mental Health—combines alcohol abuse and drug abuse categorical programs with the community mental health centers program.

4. Community Services—restructures the community action program which provides anti-poverty services.

5. Maternal and Child Health (MCH)—combines the maternal and child health, crippled and disabled children, lead-based paint poisoning prevention, sudden infant death syndrome, hemophilia, adolescent pregnancy, and genetic disease programs.

6. Preventive Health Services—combines the health incentive grants, risk reduction and health education, rodent control, fluoridation and hypertension, home health services, rape crisis services, and emergency medical services programs.

7. Primary Care Services—restructures the community health centers program.

8. Community Development—restructures the existing small cities community development block grant program.

9. Education—consolidates 31 educational programs authorized in six separate federal acts.

Federal Requirements

Federal law established procedures that states must follow in order to assume responsibility for administering block grants. Federal law also identifies matching requirements for program and administrative funding (if any), formulas for distributing funds to various states, restrictions on the use of funds, and provisions for the transfer of funds from one block grant to another.

In most cases, federal law establishes a transition period during which responsibility for the administration of block grants is to be shifted from the federal government to the states. States, however, were required to assume administrative responsibility for the Social Services and LIHEA block grants by October 1, 1981. They are required to take over the following block grants not later than October 1, 1982, or forego federal funding: Alcohol, Drug Abuse, and Mental Health; Community Services; MCH; and Preventive Health. Federal law regarding the education block grant becomes effective October 1, 1982, but requires the states to assume responsibility for that block grant retroactive to July 1, 1982, when payment of federal funds would begin. Finally, federal law *permits* but does not require states to assume responsibility for the Community Development block grant in FFY 82 and the Primary Care block grant in FFY 83. In the event the state chooses not to directly administer either of these block grants, the federal government is authorized to continue direct administration of the programs.

Federal Funding Impact

Table 3 identifies the impact of the federal funding changes that accompanied the switch from categorical to block grants. This table is based on information presented in the A-pages of the Governor's Budget.

As the table indicates, program funding under the federal block grant arrangement in 1981–82 will be 9.3 percent below what was anticipated before the federal reductions were made. The federal level will be *further reduced* by 7.9 percent in 1982–83.

4—75056

Table 3
Federal Funding Changes
For Block Grant Programs
1981–82 and 1982–83 [a]
(in thousands)

Funding Level	*Dollars*	*Percent Change*
A. 1981–82—anticipated before federal reductions	$634,136	—
B. 1981–82—anticipated following federal reductions		
1. Community provider share	134,392	
2. State share	440,820	
3. Subtotal	$575,212	−9.3%
C. 1982–83	$529,817	−7.9%

[a] Source: 1982–83 Governor's Budget.

Table 3 identifies general trends in funding under the block grants. Funding levels for individual block grants, however, should be viewed with a great deal of caution. In our discussions of the individual block grants later in this *Analysis,* we point out a number of errors or overly-optimistic assumptions reflected in the amounts estimated for the block grants in the Governor's Budget. For example:

- The amount of funds proposed for the Maternal and Child Health, Preventive Health Services, and Alcohol, Drug Abuse and Mental Health block grants for 1982–83 is based on the amounts *authorized* in the Omnibus Budget Reconciliation Act. The most recent continuing resolution, however, *appropriated* from 6.8 percent to 15.1 percent less money for these programs than the amounts authorized in the Reconciliation Act. As a result, the level of anticipated federal funding shown in the budget may be too optimistic.
- The administration counted a portion of block grant funds for Preventive Health twice, thus overstating the total level of federal funds available to the state by more than $1 million.
- The amount of funds budgeted for the Maternal and Child Health block grant fails to take into account the fact that the act allows the federal government to "set aside" up to 15 percent of total funds available nationwide to support special projects. The Governor's Budget anticipates receiving these funds for continuing activities which may not meet the federal criteria for special projects. As a result, the amount of funds budgeted for the Maternal and Child Health block grant in 1982–83 may be overstated by as much as $2.5 million.
- The Low Income Home Energy Assistance block grant amount includes $600,000 which will be allocated directly by the federal government to Indian tribes, rather than to the state, thus overstating the amount of funds actually available for direct state expenditure.

We also note several instances in which the information contained in the budget on block grant funding levels is either contradictory or incomplete:

- In the case of the Preventive Health, Maternal and Child Health, and Social Services block grants, the budget presents conflicting detail on the amount of block grant funding in its A-pages, the budget narrative, and individual back-up budget detail.
- The administration was unable to verify how it had estimated the amount of funding proposed in the Governor's Budget for the Mental Health block grant portion.

State Enabling Legislation

Chapter 1186, Statutes of 1981 (AB 2185), which became effective January 1, 1982, establishes provisions for state administration of the federal block grants during 1981–82 and subsequent years. It directs the state to assume administrative responsibility for the LIHEA and Social Services block grants during 1981–82. It also states that the following six block grant programs "shall not be assumed by the state until July 1, 1982": Preventive Health; MCH; Primary Care; Alcohol, Drug Abuse and Mental Health; Community Services; and Community Development. Another provision of Chapter 1186 requires the Governor to submit information for "all federal programs to be administered by the state as of July 1, 1982."

Because of the language contained in Chapter 1186, there is some confusion regarding when the six block grants must be taken over by the state.

Table 4
Implementation Dates for State Administration of Block Grant Programs, As Specified by Federal and State Law and the Governor's Budget

Block Grant Program	*Federal Law*	*State Law (Ch 1186/81)*	*Governor's Budget*
1. Social Services—Department of Social Services	10/1/81	1981–82	10/1/81
2. LIHEA—Office of Economic Opportunity	10/1/81	1981–82	10/1/81
3. Alcohol, Drug Abuse and Mental Health—Departments of Mental Health and Alcohol and Drug Abuse	No later than 10/1/82	7/1/82 [a]	10/1/82
4. Community Services—Office of Economic Opportunity	No later than 10/1/82	7/1/82 [a]	10/1/82
5. Maternal and Child Health—Department of Health Services	No later than 10/1/82	7/1/82 [a]	10/1/82
6. Preventive Health Services—Department of Health Services and Emergency Medical Services Authority	No later than 10/1/82	7/1/82 [a]	10/1/82
7. Primary Care	FFY 83 [b]	7/1/82 [a]	Allow federal government to continue to administer
8. Community Development—Department of Housing and Community Development	FFY 82 [b]	7/1/82 [a]	10/1/82
9. Education—Department of Education	7/1/82 [c]	Does not specify	10/1/82

[a] Legislative Analyst's assumption. We are awaiting an opinion from Legislative Counsel regarding the requirements of Chapter 1186.

[b] Federal law permits the federal government to continue to administer the Primary Care and Community Development block grants if the state opts not to assume direct administrative responsibility for them.

[c] Federal law becomes effective October 1, 1982, but its provisions regarding the payment of federal funds to the states are retroactive to July 1, 1982.

The administration is interpreting the provisions of Chapter 1186 to mean that the state must assume administrative responsibility for these block grants *no sooner than* July 1, 1982, rather than *on* July 1, 1982. As a result, the Governor's Budget proposes to let the federal government continue to administer the Primary Care block grant and to have the state take over the remaining five block grants on October 1, 1982. We have requested a legal opinion from the Legislative Counsel to clarify this issue.

Table 4 compares the implementation dates for state administration of block grants under federal law, Chapter 1186 (assuming a July 1, 1982 implementation date for the six block grants), and the Governor's Budget.

Chapter 1186 does not specify the date on which the state must assume responsibility for administration of the education block grant. It does, however, require that a Governor-appointed advisory committee make recommendations on the allocation of education block grant funds by May 1, 1982. It also requires the Superintendent of Public Instruction and the State Board of Education to make recommendations by July 1, 1982.

Budget Reporting Requirements

Chapter 1186 requires all affected departments to report to the Legislature no later than October 15, 1981 on the new block grant programs. These reports are to include a summary of programs, funding levels, contracting progress, clients affected by funding reductions during 1981–82, and a description of transition programs.

The Department of Finance has indicated that because of federal delays and uncertainty regarding the federal budget for 1982, most departments do not have sufficient information to prepare the required reports. As a result, the Department of Finance has instructed individual departments to submit this information to the Legislature as it becomes available. The information will be submitted in the form of a letter prepared under the provisions of Section 28 of the Budget Act of 1981.

As of February 1, 1982, one Section 28 letter—covering the Social Services block grant—had been submitted by the Department of Finance to the Legislature. That letter addressed some, but not all, of the reporting requirements identified in Chapter 1186.

Chapter 1186 also requires the Governor to submit, as part of his proposed 1982–83 budget, the following information related to block grants: program identification, estimates and descriptions of clients affected, estimates of federal funding levels, and a proposal for the structural and administrative organization of block grant programs to be administered by the state as of July 1, 1982. The Governor's Budget acknowledges that due to uncertainties regarding federal funding and delays in federal rules and regulations governing the block grants, several of the proposals included in the budget are incomplete. The budget states that more specific information will be provided before or during budget hearings.

Below, we summarize our findings regarding the adequacy of information submitted in the Governor's Budget regarding the block grants, and our recommendations for requiring the submission of additional information. Detailed discussions of each recommendation are found in our analysis of individual budget items.

1. The administration is proposing to spend less than the full amount of the Community Services block grant allocation for the budget year. Because this will result in a reduction in available funds from prior year

levels, we recommend that the administration report on how funding priorities will be established and whether it will reduce the level or number of awards to local agencies.

2. Carry-over funds from Community Services block grant awards made in prior fiscal years are available to the state in the budget year. As a result, we recommend that the administration report on both the block grant amount as well as any carry-over amount available in the budget year to ensure legislative control over the expenditure of *all* block grant funds.

3. The administration has failed to meet many of the reporting requirements identified in Ch 1186/81 for the Preventive Health Services, Maternal and Child Health, and Alcohol, Drug Abuse and Mental Health block grants. As a result, we recommend that the administration submit the required information, including (a) a description of programs and clients affected, and (b) proposals for administering the block grants, including expenditure plans, staffing requirements, and a discussion of options for integrating federal and state programs.

4. The budget does not include adequate information on staffing requirements for the administration of (a) preventive health service funds by the Emergency Medical Services Authority, (b) community mental health centers funds by the Department of Mental Health, and (c) small cities community development grants by the Department of Housing and Community Development. In each case, California has not previously had a role in the administration of these funds.

The budgets for the Emergency Medical Services Authority and the Department of Mental Health do not explain how necessary staff and administrative resources will be provided. In addition, the budget for the Department of Housing and Community Development proposes $652,000 in state and federal funds for 15 positions to administer the block grants, but the department has been unable to provide workload estimates or other materials to justify the requested amount. In each case, we recommend that the necessary material be provided so that the Legislature can assure that adequate resources will be available to administer these new state programs.

5. Federal Funds for the education block grant are expected to be 35.4 percent *less* than funds for programs consolidated into the block grant. Yet the budget proposes a $1.6 million *increase* in funding for state operations. We recommend that the Legislature withhold action on total proposed funding for state operations, pending receipt of adequate justification from the administration and final action on allocations by the special advisory committee.

C. Cost-of-Living Adjustments

We recommend that the Legislature:

1. ***Repeal statutory COLAs and provide inflation adjustments through the budget process to all programs that warrant such adjustments.***

2. ***Base state employee salary adjustments for those employees not covered by memorandums of understanding on pay levels for comparable occupational groups in nonstate employment, rather than on changes in the cost-of-living indices.***

3. ***Use the two GNP price deflators, with certain exceptions, as a basis for judging how inflation is affecting private citizens generally and state and local governments.***

4. ***Give highest priority to programs which can demonstrate that a re-***

duction in state funding will lead to a direct and proportionate reduction in essential services.

5. ***Require that each program administrator identify (a) how COLAs will be used and (b) what program adjustments will be made if the COLA provided is not sufficient to maintain current services.***

Discretionary and Statutory COLAs

Existing law authorizes automatic cost-of-living adjustments (COLAs) for 17 different programs, most of them in the health, education, and welfare areas. These adjustments generally are referred to as *statutory* COLAs. In 1982–83, statutory COLAs will range from 4.6 percent (Medi-Cal drug ingredients) to 13.95 percent (teachers' retirement). Those COLAs with the largest costs are K–12 apportionments ($520 million), SSI/SSP ($170 million) and AFDC ($130 million). If fully funded, statutory COLAs would increase General Fund expenditures by $1.3 billion in 1982–83.

Many other local assistance programs generally have received COLAs on a *discretionary* basis, through the budget process. If these programs are provided increases sufficient to maintain service levels provided in the current year, General Fund expenditures would increase by an additional $0.7 billion in 1982–83.

Governor's Budget Proposal

The budget proposes full statutory COLAs for SSI/SSP, AFDC, In-Home Supportive Services, and apportionments for K–12 education, county offices of education, master plan for special education, and community colleges. The Governor has sponsored provisions of AB 2361 and SB 1326 that would suspend the operation of all other statutory COLAs in 1982–83.

The budget proposes to provide an increase of 5 percent to most of the remaining programs which have received statutory or discretionary COLAs in past years. The one exception is that the budget proposes no COLA for Medi-Cal hospital inpatient services, drug ingredients, and other Medi-Cal providers.

The budget proposes a total of $1.5 billion from the General Fund for COLAs. This is $523 million, or 26 percent, less than what would be needed to provide full increases for all programs with statutory COLAs and to maintain current services in programs which traditionally have received discretionary COLAs.

Legislative Issues Regarding Determination of COLAs.

There are a number of issues which the Legislature may wish to consider in deciding how much of a COLA to provide for individual programs.

1. ***Should COLAs be established by statute or through the budget process?*** Statutory COLAs are intended to give program recipients some degree of certainty regarding the level of state funds they will receive in a given year. In providing this assurance to certain groups, however, the Legislature necessarily reduces its ability to allocate funds to reflect its program priorities and available resources. During the last two budget cycles, the Budget Act has funded COLAs for many programs at less than the level authorized by statute. The result is that statutory COLAs have not provided the level of certainty intended. In order to preserve legislative budget options and flexibility, we continue to recommend that statutory COLAs be repealed and that inflation adjustments be provided to all programs that warrant such adjustments through the budget process. Such

adjustments should be based on program needs and the availability of funds to finance these needs.

2. ***Should the salaries of state employees be based on comparable salaries or cost-of-living considerations?*** In providing salary increases to those state employees not covered by memorandums of understanding, the Legislature may choose to base the increases on one of two primary standards: (a) salaries paid by the private sector or other governmental agencies or (b) changes in the cost-of-living.

In those years when private sector salaries fail to keep up with inflation, choosing between these goals will have significant cost implications. It will also have significant policy implications, since it raises the question of whether state employees should be protected against inflation to a greater extent than (a) the taxpayers who supply the funds to pay their salaries, (b) local government employees, or (c) other recipients of state funds such as medical providers or welfare recipients.

We continue to recommend that the Legislature base salary adjustments for state employees not covered by memorandums of understanding on pay levels for comparable occupational groups in nonstate employment, rather than on inflationary considerations.

3. ***What indices should be used in adjusting for the effects of inflation?*** Existing statutory COLAs range from a low of 4.6 percent to a high of 13.95 percent. We can find no analytic justification for such a wide variation in the adjustments provided to different programs. Many statutory COLAs are tied to a particular inflationary index such as the U.S. or California Consumer Price Index (CPI). Most welfare programs use a specially constructed California Necessities Index (CNI). Other programs are provided statutorily specified increases based on such measures as the manufacturers' direct list prices for Medi-Cal drug ingredients, administratively determined "reasonable cost" guidelines for Medi-Cal inpatient reimbursements, or legislatively established revenue limits for K–12 apportionments.

In last year's *Analysis,* we discussed five of the more commonly used indices: the U.S. CPI, the California CPI, the Gross National Product (GNP) personal consumption deflator, the GNP state and local government deflator, and the CNI. For each index, we identified its measure of the inflation rate over the last decade and some of its strengths and weaknesses.

Based on the measuring deficiencies in the CPI, we continue to recommend that the Legislature use the two GNP deflators as a basis for judging how inflation affects private citizens generally and state and local governments. In addition, we continue to believe that the CNI may prove to be a good measure of inflation's effect on welfare recipients if refinements in certain spending subcategories can be made.

4. ***How does the Legislature intend that COLA funds be used?*** Funds for COLAs generally are added to a program's total funding and may be used for any of the purposes for which program funds are provided. As a result, it is extremely difficult to track how such funds have been used in prior fiscal years, or to project how they will be used in the budget year. Our analysis indicates, however, that COLA funds will be used in one of four primary ways: (1) to increase salaries and operating expenses for employees of counties, schools and community college districts; (2) to increase the maximum grants paid to welfare recipients; (3) to provide rate increases for providers who contract with the state or counties to provide specified services (mostly in the health and welfare areas); and

(4) to provide salary increases for state employees.

In addition, COLAs are used to maintain the real value of (1) the state's contribution to the State Teachers' Retirement System (STRS) to offset a portion of the system's unfunded liability, (2) reimbursements to offset local property tax relief revenue losses, and (3) student grant levels provided under the Equal Opportunity Program.

Occasionally, programs have used COLA funds to finance one-time expenditures including capital improvements (alcohol and drug abuse programs), to increase service hours (in-home supportive services), and to provide additional service grants (youth authority county justice system).

Generally, it is the funding recipient who decides how the COLA funds will be used. These include county boards of supervisors, school district boards, private providers, and individual recipients. State agencies have placed very few administrative constraints on the use of COLA funds. A number of legislative constraints, however, have been placed on the use of COLA funds in specific programs. For example, budget act language or statutory provisions have been used to:

- set specific rate increases for different types of providers funded through the Medi-Cal program and regional centers,
- prohibit state payment for county employee salary adjustments which exceed the percent increase specifically authorized by the Legislature for county Medi-Cal and welfare program administration, and
- prohibit salary and benefit increases to regional center employees and providers which exceed 5 percent.

In addition, language in the 1982 Budget Act proposes a cap on COLAs for provider reimbursement rates in the Department of Rehabilitation's work activity program.

Generally, the Legislature does not have adequate information to indicate how programs will respond if they do not receive a COLA sufficient to maintain current service levels. As a result, it also is difficult to identify what effect such adjustments will have on the level and quality of services provided and the achievement of stated program goals.

Some recipients have a variety of options available to them if they do not receive a full COLA. For example, a program administrator may be able to increase workload or extend workload backlogs, increase fees, reduce the number of clients served, extend waiting lists, substitute alternative funds, defer certain projects or acquisitions, reduce or eliminate optional programs, lay-off staff, or freeze salaries and wages. Some agencies, because of the nature of the programs they administer, have few options. The STRS program, for example, has only one option when the state's contribution fails to keep pace with inflation—watch the unfunded liability grow. Still other programs are prohibited from taking certain action.

In order to assure that funds provided for COLAs are used in the most cost-effective manner, we recommend that the Legislature assign the highest priority to programs which can demonstrate that a reduction in state funding will lead to a direct and proportionate reduction in essential services. This includes programs or recipients which have few alternative means for adjusting the level of their expenditures or substituting alternative sources of funding. The programs which most clearly meet these criteria are the AFDC and SSI/SSP programs. Welfare recipients, for example, cannot make a fixed amount of money "go further" by increasing productivity or deferring certain purchases.

We further recommend that, in considering the level of COLAs provided to other programs, the Legislature require that such programs identify (a) how COLAs will be used and (b) what program adjustment will be made if the COLA provided is not sufficient to maintain current services. In certain cases, the Legislature may wish to add clarifying language to the Budget Bill to ensure that actual program expenditures or reductions are consistent with legislative program priorities.

D. Five Percent Reductions in State Operations Budgets

The Governor directed most state agencies and departments to reduce the General Fund portion of their 1982–83 baseline budgets for state operations budget by 5 percent. These reductions were not supposed to require a change in statute or regulation. In addition, the reductions were not to include savings in programs already scheduled for reduction or elimination.

The administration exempted all 24-hour facilities from the 5 percent reduction. This included state correctional facilities, the Veterans' Home, state hospitals, state special schools for the disabled, and the work activity program for the developmentally disabled. It also exempted all local assistance programs and all state operations financed with special fund revenues.

According to information provided in the A-Pages of the budget, 1982–83 General Fund reductions achieved as a result of this directive totaled $115.1 million. Our analysis, however, indicates that this total inappropriately includes reductions of $2.8 million for the Board of Equalization and $4.3 million for the Franchise Tax Board. Because the Department of Finance subsequently restored both these reductions, they should not have been counted in the total. Adjusting the total budget reduction to *exclude* these amounts leaves a revised total reduction of $108 million.

The Governor's Budget also exempted the Legislature from any reduction. The Legislature, however, independently adjusted its budget to reflect $5.1 million in unallocated reductions. These reductions are not included in the $108 million total.

Table 5 breaks out the General Fund 5 percent reductions by spending category. Each of these categories is described below.

Table 5
Governor's Budget
Five Percent General Fund Reductions
By Spending Category
(in millions)

Category	*Amount*	*Percent of Total*
1. Personal services	$18.8	17.4%
2. Operating expenses and equipment (not related to personal services)	22.5	20.8
3. State programs	9.0	8.3
4. Unallocated reductions	21.6	20.0
a. By program	(0.5)	(0.5)
b. By department	(21.1)	(19.5)
5. Reductions achieved by transferring costs to other funding sources	36.1	33.5
a. User fees	(30.2)	(28.0)
b. Federal funds	(4.9)	(4.5)
c. Reimbursements from other departments	(0.5)	(0.5)
d. Bond funds	(0.4)	(0.4)
e. Other state funding sources	(0.1)	(0.1)
Totals	$108.0	100.0%
Personnel-years—503		

1. Personal Services—includes reductions in authorized positions, staff benefits, and related operating expenses and equipment. It also includes reductions in temporary help, overtime, and savings resulting from holding current positions vacant (salary savings).

2. Operating Expenses and Equipment (OE&E)—includes OE&E reductions not specifically related to the elimination of positions. It contains such items of expenditure as general office expenses, travel, facilities operations, consulting and professional services, and training.

3. State Programs—includes reductions in programs directly administered by state agencies.

4. Unallocated Reductions—consists of two components. The first includes reductions which are assigned to a specific program within a department or agency but which are unallocated within that specific program. The second includes reductions which are unallocated within a department or agency.

5. Reductions Achieved by Transferring Costs to Other Funding Sources—consists of General Fund reductions which are achieved by transferring the cost of an activity to (a) user fees, (b) federal funds, (c) reimbursements from other departments, (d) bond funds, or (e) other state funding sources.

Findings. Below, we describe our findings regarding how the 5 percent reductions were achieved by the individual departments and agencies.

1. ***The administration gave individual departments discretion in identifying which activities were to be reduced. As a result, there is no consistent pattern as to how the various departments applied these reductions.*** For example, the extent to which departments eliminated positions in order to achieve their budget reductions varies widely. Some departments, such as the Departments of Social Services and Justice, opted to take the majority of their reductions in authorized positions. Others, such as the Departments of Health Services and Education and the University of California, chose to take few or no position reductions, and instead achieved their reductions in other areas.

In one case, the administration allowed a department to apply a reduction to the local assistance portion of its budget. Specifically, the Department of Housing and Community Development reduced local assistance support for housing development loans to local agencies by $210,000.

2. ***The administration did not consistently apply the 5 percent reduction to all departments and agencies. In most cases, we are unable to identify the analytical basis for excluding certain departments from the full 5 percent reduction and not excluding others.*** The administration completely exempted the budgets of the Judiciary, the Department of Industrial Relations, and the California Conservation Corps. In other cases, the administration agreed to a reduction of less than 5 percent. Those departments receiving less than a full 5 percent reduction include the University of California (2.5 percent), the California State University (2.5 percent), the Department of Justice (3.7 percent), and the Department of Forestry (1.8 percent), among others.

In several cases, the administration rejected a department's proposal for achieving the intended reduction as programmatically unacceptable. Rather than requiring the department to submit an alternative proposal, however, the administration instead simply exempted the department from the reduction.

3. ***The budget reductions penalize those departments which rely heavily on General Fund support.*** For example, the State Personnel Board, which is supported almost entirely from the General Fund, was required to sustain substantial reductions. The Public Employees' Retirement System, on the other hand, is supported entirely by special funds and therefore was not subject to any reductions. In our judgment, decisions regarding budget reductions should be based on whether an activity or function is needed, rather than on whether or not it is supported from the General Fund.

4. ***The budget reductions penalize those activities or functions which are categorized as "state operations" rather than "local assistance." In many cases, we can identify little or no analytic difference among activities included in these two categories.*** A number of activities categorized as state operations actually provide funds to local governments and organizations or individuals. Examples include arts grants to local organizations provided by the Arts Council, grants to local youth employment programs provided by the Employment Development Department, recycling grants provided to local organizations by the State Solid Waste Management Board, grants to local agencies provided by the Emergency Medical Services Authority, and student grants awarded by the Student Aid Commission. Because these activities are budgeted as state operations, the agencies were permitted to reduce them in achieving the required 5 percent reductions.

On the other hand, items of spending classified as local assistance often include administrative operations comparable to those budgeted as state operations. An example is the review of client utilization rates which is performed both by staff in regional centers for the developmentally disabled and by Medi-Cal staff. Because support for regional center staff is budgeted as local assistance, it was exempted from the 5 percent reduction, whereas support for Medi-Cal staff was not exempted. Our analysis indicates that decisions regarding budget reductions should be based on the necessity of the function, rather than on how the function is identified in budget spending categories.

5. ***The total General Fund reduction of $108 million reflects only a $72 million reduction in the level of state government. One-third, or $36 million, of the reductions were achieved by shifting the cost of activities to other funding sources.*** A number of agencies maintained existing services but shifted the cost of these services to user fees. For example, the California State University achieved $13.1 million, or 52 percent, of its reduction by increasing student fees. Similarly, the Department of Parks and Recreation identified a reduction of $3.7 million but was able to offset this reduction and actually increase its baseline spending by 5 percent by increasing user fees and concession rental revenues at state parks for a total net increase of $2.3 million.

In most cases, we believe it is appropriate to require those who are the direct beneficiaries of state services to pay for these services when they are able. Allowing agencies to count those General Fund reductions which were offset by increased user fees, however, gives these agencies an advantage over other agencies which are unable to tap alternative revenue sources and thus must take "real" budget cuts.

In some cases, agencies merely transferred the cost of certain activities from the General Fund to other state funding sources. For example, the

Department of Justice achieved a $96,000 reduction by increasing its reimbursements from special fund departments. The Controller's Office achieved a $420,000 reduction by imposing a fee on other state agencies for processing certain payroll documents. The Water Resources Control Board achieved a $252,000 reduction by transferring the cost of contracts for toxic monitoring to the Clean Water Bond Fund, even though the General Fund ultimately is responsible for repaying the principal and interest on the bonds.

6. ***In a few cases, the administration included, as part of its special 5 percent reductions, those reductions which should have been incorporated as part of the normal budget preparation process.*** For example, the State Treasurer's reduction included $144,000 from increased reimbursements charged to various bond commissions and authorities, even though these reimbursements are required under provisions of existing law. Similarly, the Postsecondary Education Commission included a reduction of $64,000 achieved by eliminating a state match for a federal program which was terminated in FFY 81.

7. ***The budget fails to identify how almost $22 million in General Fund budget reductions will be achieved.*** For example, the budget for the California State University contains $12.1 million in unallocated reductions and the University of California's budget contains $8.7 million in unallocated reductions. Several other departments have identified reductions for specific programs but have not identified how these reductions will be achieved. The most significant of these is the Department of General Services, which has identified $354,000 in reductions for maintenance of the Capitol Complex but has not specified what activities will be reduced. In some cases, the budget indicates a spending plan for unallocated reductions will be provided prior to budget hearings. Without this information, the Legislature will be unable to determine how total funds for a department or program will be spent.

Summary of Recommendations. In our analysis of individual budget items, we identify the specific reductions applied to each department. In those items where our analysis indicates that funds requested in the Governor's Budget are less than the amount needed to accomplish the budget's stated objectives, we point this out. We also recommend that the administration be prepared to explain how it expects to carry out the program within the amount proposed. Where reductions are unallocated within departments or programs, we recommend that a spending plan be submitted to the Legislature prior to budget hearings. In several cases, we conclude that a program scheduled for elimination or reduction is performing a worthwhile or cost-saving activity and therefore recommend that the program be continued using an alternative funding source.

E. Governor's Proposal for Controlling Toxic Substances

For the past two years, the budget has proposed major increases in state efforts to control toxic substances, including hazardous wastes.

For 1982–83, the budget provides 773.8 positions and $47.6 million from various funds for toxic substances control activities in 11 state agencies. This is an increase of 204.9 positions, or 36 percent, above current-year authorized positions, and $18.2 million, or 62.2 percent, above estimated current-year expenditures. The increase consists of $24.5 million in new proposals, offset by $6.3 million in reductions to reflect one-time expenditures in the current year.

Table 6 provides an overview of the Governor's Toxic Substance Control program for 1982–83. It shows for each component of the program, funding source, estimated current-year expenditures, proposed budget changes, and our recommendations regarding the funding request. Each of these recommendations is discussed in our analysis of the individual budget items.

The three major proposals contained in the budget are as follows:

1. ***Superfund.*** The budget requests $10 million to implement Ch 756/81 (SB 618) for hazardous waste site clean-up and emergency response. Our analysis indicates that the proposed activities lack coordination and that the implementation schedule for a major portion of the proposal is unrealistic. Moreover, the detailed expenditure plan prepared by the Department of Health Services exceeds the $10 million available from the Hazardous Substances Account.

2. ***Polychlorinated Biphenyls (PCBs).*** PCBs are substances used in the manufacture of electrical equipment in past years which recently have been found to be highly toxic. The budget proposes the removal of equipment leaking PCBs in state-owned buildings, at a cost of $5.8 million. We recommend deletion of the funds because (a) the Department of General Services has not acted expeditiously to expend funds appropriated in the 1981 Budget Act for this purpose, (b) the expenditures should be supported by special funds, not the General Fund, and (c) a portion of the proposed expenditures is not adequately justified.

3. ***Occupational Health.*** The budget proposes 88 new positions and over $4 million in the Department of Industrial Relations to establish regulations, increase worksite inspections and develop voluntary compliance programs. We withhold recommendation on 12 of the proposed positions due to inadequate justification.

F. Governor's "Investment In People Initiative"

The Governor's Budget proposes to allocate a total of $49 million from the General Fund among six educational and employment-related activities as part of his "Investment in People" initiative. As summarized in Table 7, these proposals address (1) deficiencies in the training of math and science teachers and the relevance of the instructional materials provided for classroom use, (2) the adequacy of funding for engineering education in both the University of California and the State University system, (3) promotion of technical job training programs and establishment of grants for training programs in high technology fields, (4) training for welfare recipients, (5) assistance to displaced workers, and (6) strengthening the relationship between vocational education councils and the business community.

Conceptually, we believe that the Investment in People proposals represent a first step in identifying issues which merit the serious consideration of both the executive and legislative branches. We find, however, that many of the proposals, particularly those in the education area, are so lacking in program and budgetary detail that we have no basis for determining either their feasibility or the need for additional resources. Other proposals in the employment area would expand existing pilot projects begun on July 1, 1981, even though current law makes program expansions contingent on the demonstrated cost-effectiveness of these projects.

Accordingly, except in the case of two components—the Department of

Table 6
An Overview of Toxic Substances Programs [a]
Estimated and Proposed Expenditures
1981–82 and 1982–83
(dollars in thousands)

					1982–83			
			Estimated 1981–82		*Proposed Change [a]*		*Recommended Reductions*	
Item	*Agency*	*Fund*	*Amount*	*Staff*	*Amount*	*Staff*	*Amount*	*Staff*
0650	Office of Planning and Research	Reimb.	($473)	8.0	($132)	3.0	—	—
0690	Office of Emergency Services	General	108	1.5	—	—	—	—
		Reimb.	—	—	(83)	2.5	(−$30)	−1
0860	Board of Equalization	Reimb.	(357)	16.7	(−5)	−6.5	—	—
1710	Office of State Fire Marshal	General	200	1.0	−160	—	−37	−1
1760	Department of General Services	SAFCO	3,647	—	2,153	5.0	−5,310 [b]	−5
2720	California Highway Patrol	MVA	835	18.8	852	21.0	—	—
		Reimb.	(80)	1.0	(212)	1.5	Withhold	
3400	Air Resources Board	General	202	23.4 [c]	—	—	—	—
		MVA	891	N/A	287	7.0	—	—
		APCF	—	—	60	—	—	—
		ELPF	92	N/A	21	—	—	—
		Federal	101	N/A	—	—	—	—
3940	Water Resources Control Board	Various	4,380	74.5	−216	−8.1	Withhold	
4260	Department of Health Services							
	(1) Superfund Cleanup and Emergency Response	HSA	—	—	10,000	47.5	Withhold	
		General	2,000	10.0	−2,576 [d]	−10.0	—	—
	(2) Hazardous Waste Management	HWCA	2,909	67.0	2,358	31.0	Withhold	
		Federal	2,568	53.0	251	—	—	—
	(3) Siting and Abandoned Site Search	ERF	1,499	33.0	−363	−10.0	—	—
	(4) Laboratories, Epidemiology Studies, Occupational Hazards, and Research	General	1,628	40.0	1,408	17.0	—	—
		Reimb.	(3,473)	66.0	(398)	13.0	—	—

8250	Department of Industrial Relations	General	4,131	77.5	4,061	84.0	Withhold	
		Federal	4,131	77.5	—	—	—	—
		Reimb.	—	—	(157)	4.0	Withhold	
8710	Board of Control	General	—	—	6	—	−6	—
		Reimb.	—	—	89	3.0	(6)	—
	Totals	All	$29,322	568.9	$18,231	204.9	−$5,353	−7
	Totals, proposed budget, 1982–83				$47,553	773.8		

Fund Abbreviations:

MVA—Motor Vehicle Account
Reimb.—Reimbursements
SAFCO—Special Account for Capital Outlay
APCF—Air Pollution Control Fund
ERF—Energy and Resources Fund
HSA—Hazardous Substances Account
HWCA—Hazardous Waste Control Account
ELPF—Environmental License Plate Fund

[a] Change includes proposed new activities and the elimination of current-year, limited-term projects.
[b] Withhold recommendation on $490,000.
[c] The board was unable to identify positions by fund.
[d] Includes repayment of General Fund loan.
[e] Amounts in parentheses represent reimbursements from other state departments.

Employment Development Training for Welfare Recipients and Aid to Displaced Workers—for which we recommend limited approval, we are recommending that funding for the Investment in People Initiative be deleted from the budget. Each of the components is more fully discussed in our analysis of the respective budget items cited in Table 7. We will advise the fiscal committees if additional information becomes available before the budget hearings that would warrant a change in our recommendations.

Table 7
Investment in People Initiative
Proposed 1982–83 Expenditures
(in millions)

Item	*Agency and Program*	*General Fund Expenditure*[1]	
6100-189-001	*Department of Education*		
	1. Training for Math and Science Teachers—K–12		$19.6
	Replace and supplement instructional materials (math and science textbooks)	$8.6	
	Augment resource centers to upgrade the teaching skills of secondary math and science teachers	3.4	
	Staff development for secondary math and science teachers	7.6	
6440-001-001	*University of California (UC)*		
6610-001-001	*California State University System (CSU)*		
	2. Funding for Engineering Education		7.0
	UC: Research and education in engineering, computer sciences, and related basic sciences	4.0	
	CSU: Science and engineering enhancement	3.0	
6870-101-001	*Community Colleges*		
8350-001-001	*Department of Industrial Relations*		
	3. Technical Job-based Training		11.2
	Community Colleges: employment-based job training	7.5	
	Community Colleges: Institutes in high-technology jobs	2.5	
	Department of Industrial Relations: promote employment-based training	1.2	
5100-001-001	*Employment Development Department*		
	4. Training for Welfare Recipients		8.0
	Employment Preparation Program	6.5	
	Training for Welfare Recipients	1.5	
5100-001-001	*Employment Development Department*		
	5. Aid to Displaced Workers	2.0	2.0
5100-001-001	*Employment Development Department*		
	6. Strengthen Relations Between Vocational Education Councils and the Business Community	1.0	1.0
	Total Expenditure		$49.0

[1] Components do not add to total due to rounding.

G. Capital Outlay Issues

The capital outlay proposals in the Budget Bill raise the following major issues which the Legislature will need to consider.

Prison Facilities. The budget contains $161.8 million to continue planning for new prisons, to complete construction of the Tehachapi project and to construct temporary prison facilities. The budgeted amount is to be funded from the new Prison Construction Bond Act of 1981 that will be submitted to the voters for their approval in June 1982.

The administration proposes that 11,900 additional beds be constructed over the next five years to alleviate overcrowding in the prison system. It would cost about $800 million to finance these added facilities. The bond act would finance $495 million of this amount. The administration has not, however, identified a funding source for the remaining $305 million.

Moreover, the department estimates that even with these 11,900 new beds, the inmate population in 1987 will still be 6,800 above the system's designed capacity. It could cost an additional $640 million to eliminate this deficit. Thus, if the bond issue *is* approved by the voters and the Legislature decides to provide enough beds to eliminate overcrowding by 1987, the state will need to provide nearly $1 billion for prison construction *on top of* the $495 million proposed in the 1981 bond act. This estimate, moreover, *makes no allowance for the impact of pending legislation on the prison population* in 1987 or later years.

The Budget Bill indicates that in the event the bond measure is not approved by the voters, the Tehachapi project—$69.3 million—is to be considered a priority project and funding shall be available from the Special Account for Capital Outlay. Thus, the Tehachapi project, which provides 1,000 maximum-security beds, could proceed using tidelands oil revenues in the SAFCO (although it would proceed at the expense of virtually all other projects proposed for funding from the SAFCO in 1982–83). The other prison projects, however, could not proceed within the budgeted amounts, and the Legislature would be faced with funding new prison construction using additional tidelands oil revenue or the General Fund. The only other alternatives to proceeding with the state's prison construction program would be to (1) increase the number of inmates double-celled (two inmates in a cell designed for one inmate) or (2) commit fewer people to prison.

Cogeneration Facilities. The budget contains several appropriations to develop cogeneration utility facilities at a number of state-owned locations. Chapter 102, Statutes of 1981, states that:

> "It is the policy of this state to use available resources at state facilities which can substitute for traditional energy supplies or produce electricity at its facilities when use or production will reduce long-term energy expenditures. Criteria used in analysis of proposed actions shall include life-cycle cost evaluation, benefit to taxpayers, reduced fossil fuel and improved efficiency. Energy facilities at state-owned sites shall be scaled to produce optimal system efficiency and best economic advantage to the state. Energy produced in excess of state facility needs may be sold to nonstate purchasers."

Our review of the feasibilty studies submitted for proposed cogeneration facilities as part of the 1982–83 budget indicates that the policy established by the Legislature in Ch 102/81 has not been followed on a consistent basis. Most of these studies concentrate on *technical* feasibility, and place relatively little emphasis on the *economic advantage* to the state. Our analysis indicates that a more systematic approach to the evaluation of projects is needed. In order to ensure that the most cost-efficient cogeneration system is funded, the following information should be available to the Legislature before it is asked to appropriate funds beyond the preliminary planning stage:

- A reassessment and reconfirmation of the conclusions contained in the initial feasibility study should be performed by a consulting engineer.
- Each state facility where cogeneration is proposed should be the

subject of a comprehensive energy conservation plan to reduce overall energy consumption prior to the installation of a cogeneration facility.
- The cost-benefit analysis should be based on completed negotiations with the utility district.

Department of Energy (DOE) Consent Order Proceeds Account. In July 1981, the U.S. Department of Energy (DOE) and a major oil company entered into a proposed consent order concerning compliance with the federal petroleum and allocation statutes/regulations for the period January 1, 1973 through January 27, 1981. Under one provision of the consent order, the oil company agreed to pay $25 million to states and territories, based on the volume of products sold in those areas during 1980. California's share of this amount is $6.6 million. Under the consent order guidelines, the funds may be used for any of the following projects:
- Highway and bridge maintenance and repair.
- Ridesharing programs.
- Public transportation projects.
- Residential or commercial building energy audits.
- Grants or loan projects for energy conservation weatherization and equipment.
- Energy assistance programs.
- Airport maintenance or improvements.
- Reductions in airport user fees.
- Energy conservation or energy research offices and administration.

The Governor's Budget proposes to spend these funds for energy conservation projects in the Department of Developmental Services ($219,000) and cogeneration projects at two California State University campuses ($6.5 million). In view of the fiscal constraints facing the Legislature, there may be unmet needs which the Legislature may wish to fund from this source in lieu of the energy projects proposed by the administration. It would appear that a considerable amount could be reallocated from these projects to other program areas, particularly in view of the fact that (1) the Energy and Resources Fund is the only tidelands oil revenue fund which is budgeted to receive more than the amount allocated to it by current law, and (2) an additional $14.6 million in energy projects are to be funded from the Capital Outlay Fund for Public Higher Education and the Special Account for Capital Outlay.

III. LOCAL FISCAL RELIEF ISSUES

A. Alternatives for Reducing Local Fiscal Relief and Other Local Aid

Governor's Proposal

The budget proposes to reduce local fiscal relief and other local aid by a total of $569 million in 1982–83. To offset a portion of these reductions, the Governor is also proposing an optional program of selective property tax increases and a "speed-up" of sales tax collections, which the budget states could add $355 million in city, county, and special district revenues. Were this to happen, the net change in fiscal relief and other local aid would be a reduction of $214 million for local governments other than schools.

The reductions consist of:
- A $450 million reduction in vehicle license fee (VLF) subventions to

cities and counties, on a per capita basis. Cities would lose $250 million, while counties would lose $200 million.

- A $16.1 million reduction in business inventory payments to cities, counties and special districts. This would be achieved by reducing the COLA from the 10.0 percent statutory level to the 5 percent budgeted level.
- A $53 million reduction in funding for County Health Services, relative to the amount which otherwise would be provided under current law.
- A $50 million reduction in Medi-Cal reimbursements to county hospitals as a result of the proposed limit on hospital inpatient reimbursements.

The increases consists of:

- A $275 million increase in local property taxes (schools would receive an additional $205 million) to be implemented on an optional basis by county boards of supervisors. The increase would be achieved by changing the date on which property that is newly constructed or changes ownership is reassessed, so that additional revenue can be collected (this proposal is discussed more fully in the next section).
- An $80 million increase in sales tax receipts to cities, counties and transit districts resulting from an acceleration of sales tax collections from retailers.

The distribution of these reductions and increases among the different types of local agencies (excluding schools) is illustrated in Table 8.

Table 8
Proposed Changes in Local Fiscal Relief and Other Local Aid
1982–83
(in millions)

Reductions	*Cities*	*Counties*	*Special Districts*	*Total*
Fiscal Relief:				
Vehicle license fee subvention	−$250	−$200	—	−$450
County health services subventions	—	−53	—	−53
Subtotal, Fiscal Relief	−$250	−$253	—	−$503
Other Local Aid:				
Business inventory subvention	−$5	−$9	−$2	−$16
Medi-Cal hospital reimbursements	—	−50	—	−50
Subtotal, Other Local Aid	−$5	−$59	−$2	−$66
Totals, Reductions	−$255	−$312	−$2	−$569
Increases				
Property Tax Increase	$66	$179	$30	$275
Sales Tax Speed-up	51	13	16	80
Totals, Increases	$117	$192	$46	$355
Net Change in Local Resources	−$138	−$120	$44	−$214

As the table shows, the reduction experienced by cities and counties would be $258 million. Under the Governor's proposal, special districts would receive an additional $44 million. Thus, the net change for all three types of local governments is a reduction of $214 million. Under existing law, the Department of Finance estimates that county "discretionary revenues" will grow by 11.0 percent in 1982–83, while the "discretionary revenues" of cities will grow by 13.1 percent. According to the budget, the combined effect of the reductions and increases proposed by the Governor will be to reduce these growth rates to 10.5 percent for counties and 10.8 percent for cities. These estimates assume that all counties will adopt the proposed property tax reassessment procedure.

Offsetting Revenue Gains Unlikely to Materialize

Our analysis indicates that the property tax reassessment proposal and the proposed speedup may have little impact on local agencies in the budget year. This is because Legislative Counsel has indicated that the property tax proposal may be unconstitutional, and because it may not be administratively feasible for the Board of Equalization to transmit the sales tax funds to local agencies prior to July 1, 1983. Presently, the transmittal of sales taxes to local agencies occurs approximately one month after collections are received by the board.

AB 8 Deflator

Table 9 compares reductions in local government fiscal relief (excluding schools) that would occur under the Governor's proposal and those that would result from the AB 8 deflator.

Based upon the most recent revenue and expenditure forecasts by the Department of Finance, the AB 8 deflator mechanism will be "triggered" for the 1982–83 fiscal year. This mechanism, which was suspended for 1981–82, would require reductions of $793 million in aid to local agencies and school districts. Half of this amount ($396 million) would be taken from K–14 school district apportionments. The other half would be taken from cities, counties and special districts, in proportion to their share of four specific subventions.

Table 9
Changes in AB 8 Fiscal Relief:
Comparison of Governor's Proposal and AB 8 Deflator
1982–83
(in millions)

		Governor's Proposal		*AB8 Deflator*	
	Fiscal Relief Current Law	*Reduction*	*Percent Change*	*Reduction*	*Percent Change*
Cities	$319	−$250	−78.4%	−$181	−56.7%
Counties	2,452	−253	−10.3	−207	−8.4
Special Districts	309	—	—	−8	−2.6
Total	$3,080	−$503	−16.3%	−$396	−12.9%

The magnitude of the deflator reduction for 1982–83 will increase to the extent that (a) the Governor's proposals for increases in state revenues are not adopted, (b) the economy fails to perform as well as expected, (c) current year expenditures exceed estimated levels, and (d) the income tax indexing and inheritance tax initiatives on the June 1982 ballot are approved. The Commission on State Finance will make the final determination on the size of the deflator reduction on June 10, 1982.

In last year's *Analysis,* we recommended that the deflator mechanism be repealed. We continue to make this recommendation because our analysis suggests that the deflator restricts, rather than enhances, the Legislature's flexibility in responding to the problem of financing California government. Moreover, in its current form, the deflator would spread any reductions proportionately among local jurisdictions without taking into account the relative ability of local agencies to bear these reductions.

The Governor's proposal to reduce Vehicle License Fees (VLF) on a per capita basis has the same general shortcoming as the deflator, although this is mitigated to some extent by an exemption for low-growth agencies. We believe that many other options for reducing state aid to local governments are available that are preferable to either the deflator or the VLF reduction.

Factors the Legislature Should Consider in Providing Local Fiscal Relief

In considering the Governor's proposed reductions in fiscal relief, the Legislature needs to consider first the extent to which it wishes to establish priorities for expenditure in the *combined* state and local government sector. The answer to this question will, to a large extent, determine the best course of action for the Legislature to take.

Several other factors need to be considered in determining the level of fiscal relief for 1982–83. Specifically, the Legislature needs to consider:

- *The impact of reductions on essential local services.* In past years, service reductions have been made in police and fire protection services, although these reductions may be attributable to changes in local priorities rather than to a lack of resources available to support these services.
- *The extent to which local agencies can bail themselves out* through new local taxes or elimination of less essential services. The state is becoming the primary source of funding for more and more local programs. At some point, local taxpayers must be asked to support those local programs which they feel are worthwhile.
- *The extent to which reductions can be offset through elimination of unnecessary mandates on local agencies.* (See discussion of mandated programs on page (B-40).

The Legislature also needs to make decisions as to how the reductions are to be allocated among the different *types* of local agencies, and whether the mechanism selected for allocating the reductions among types of local agencies should take into account the relative ability of the local agencies to absorb these reductions.

Reductions in 1981–82 fiscal relief were made in proportion to the amount of property taxes transferred from schools to cities and counties in 1979–80. Because of the way this amount was determined, several county governments were exempt from the reductions, even though some of these counties were in better condition than counties which took reductions. We know of no analytical basis for allocating the cuts in this fashion. The Governor's proposal also ignores differences in local fiscal condition, except in the case of those cities and counties expecting less than 5 percent growth in their discretionary revenues.

From our perspective, the best measure of relative fiscal conditions (although a flawed one to be sure) is discretionary revenue growth. This measure excludes from consideration those receipts tied to programs over which local agencies have no control, and provides an indication of the relative extent to which local agencies are able to address local needs for services. In the case of county governments, the measure should be adjusted to account for the local resources which must be allocated to the major state mandated health and welfare programs, since these expenditures vary widely from county to county.

B. Governor's Property Tax Reassessment Proposal

The budget proposes to partially offset the $503 million reduction in local government fiscal relief by allowing counties to implement a new procedure for reassessing property which is newly constructed or changes ownership. Essentially, owners of such property would have their assessments and property taxes increased one year earlier than under existing law. The budget proposes to effect this change through the establishment of two supplemental property tax rolls. Legislative authority for the proposed change is contained in the companion bills (AB 2361 and SB 1326) to the Budget Bill.

Under existing law, property taxes are based on the assessed values established on the March 1 lien date. The taxes become a lien on the property as of that date, although the exact amount of taxes is not known until the tax rate is set by the county board of supervisors on or before September 1. The California Constitution, as amended by Proposition 13, provides that all property which changes ownership or is newly constructed during the year preceding the March 1 lien date shall be assessed at its full market value. Newly constructed property which is only partially completed as of the March 1 lien date is assessed at the full market value of the construction actually completed as of that date. All other real property is assessed at its value as recorded on the assessment roll for the *preceding* year, plus an inflationary adjustment not to exceed 2 percent.

The budget proposes giving local boards of supervisors authority to approve the preparation of two supplemental property tax rolls. The first of these rolls, which would be prepared after July 1, would consist of all properties which changed ownership or were newly constructed between March 1 and June 30. These properties would be enrolled at their respective full market values as of June 30. In the case of properties which were also included on the previous (March 1) roll, the new values would *supplant* their previously enrolled values.

The second supplemental roll, prepared after January 1, would consist of all properties which changed ownership or were newly constructed between July 1 and December 31. Properties on this roll would be valued in either of two ways: (1) those which changed ownership would be enrolled at 50 percent of the difference between their previously recorded assessed values and their full market values as of December 31, and (2) properties which were newly constructed would be enrolled at 50 percent of their full market values as of December 31. Values on this second supplemental roll would be in addition to, and not instead of, values already recorded on the previous rolls.

New construction which is only partially completed on either June 30 or December 31 would not appear on either supplemental roll. Instead, such property would continue to be enrolled only on the March 1 uniform lien date, the same as under existing law.

The budget estimates that *if all counties were to implement these changes*, the additional property tax revenues would total $480 million in 1982–83. Cities, counties and special districts would receive $275 million from these increased revenues, and schools would receive the remaining $205 million. Under existing law, increased property tax revenues for schools would be offset by an equal reduction in state school apportionments. Therefore, there would be no net increase in revenues for schools. The budget also proposes that counties be allowed to retain up to 2 percent of the additional property tax revenues for purposes of funding county assessors' costs of preparing two supplemental assessment rolls.

The budget estimates this amount to be almost $10 million.

Our examination of the Governor's property tax proposal identifies three major concerns.

1. Proposal May Be Unconstitutional

The Governor's proposal leaves the adoption of the reassessment changes to the discretion of county boards of supervisors. Thus, if some counties were to adopt the proposal, while others did not, identical types of property within the state could be assessed according to two different standards, depending on where they were located. The Legislative Counsel has advised us in a written opinion (# 599) that such assessment practices would be unconstitutional, as Article XIII, Section I of the California Constitution has been consistently interpreted to mandate the uniform assessment of property. Counsel also advises us that this proposal would be constitutional if it were applied uniformly throughout the state.

2. Budget Overestimates Potential State Cost Savings

Our analysis indicates that the budget estimates of the net additional revenues attributable to this proposal in 1982–83 are overly optimistic, for three reasons. First, the estimates assume that all counties will be willing and able to enact ordinances requiring their assessors to prepare the supplemental tax rolls. Given the differences in revenue sources and political climate among California's 58 counties, it is unlikely that all counties would opt for the Governor's proposal.

Second, the budget estimates implicitly assume that the total assessed value of California property will grow by 15.2 percent from March 1982 through February 1983, and that this growth will be spread relatively evenly over that period. This assumption is probably overly optimistic. Assessed values grew by 13. 4 percent between March of 1979 and the 1980 lien date, and by 13.6 percent in the 12 months preceding the 1981 lien date. Assessed values are estimated to increase by another 12 percent by the March , 1982 lien date. While some increase in the rate of assessed value growth during the period March 1, 1982 through February 1983 is possible, it is unlikely, given the current depressed state of the California real estate market, that the growth in assessed values will accelerate sufficiently to *average* more than 15 percent during this time period.

Finally, the budget estimate assumes that approximately $205 million (43 percent) of the increased local property tax revenues will be used to fund K–12 schools and community colleges, and that state apportionments for schools would be reduced by a corresponding amount. Our analysis indicates that the reduction in school apportionments is more likely to be only $150 million, as the actual proportion of existing property tax revenues devoted to school purposes is only 37 percent statewide.

Table 10 compares our estimate of the 1982–83 fiscal impact of the Governor's property tax proposal with the estimate presented in the budget. In developing our estimate, we have assumed that (1) assessed values will grow an average of 13 percent in 1982–83, and (2) the reduction in school apportionments would equal 37 percent of the increased property tax collections, not 43 percent as indicated in the budget.

3. Administrative Problems

The original reason for assessing property on the March 1 lien date and preparing the property tax bills several months later was to allow local governments time to calculate their respective tax rates based on a known amount of assessed value. The need for this time lag has largely disap-

Table 10
Estimated Impact of Governor's Property Tax Proposal 1982–83 (in millions)

Revenues	*Governor's Budget Estimate*	*Legislative Analyst Estimate*	*Difference*
Local government:			
Increased property tax collections	$480	$410	−$70
Decreased school apportionments	−205	−150	55
Totals	$275	$260	−$15
Costs			
State government:			
Decreased school apportionments	−$205	−$150	$55
Increased cost of homeowners' exemptions	—	4	4
Totals	−$205	−$146	$59
Local government:			
Assessors' administrative costs	$10	$8	−$2
Totals	$10	$8	−$2
Net Fiscal Impact, State and Local	$470	$398	−$72

peared as a result of the passage of Proposition 13. This is because most counties now levy the $1.00 maximum tax rate. Local governments, however, still rely on the known amount of assessed value to compute their tax rates for voter-approved debt. These rates, which will average about $0.125 per $100 of assessed value in 1982–83, vary significantly among local governments.

The enrollment of additional assessed value via the supplemental property tax rolls would greatly complicate the setting of tax rates for debt service. Under the Governor's proposal, local governments would face three choices. First, they could opt to tax property on the supplemental rolls at only the $1.00 basic rate, levying no tax for debt service on these properties. While this solution would be the easiest administratively, the taxation of identically situated properties at different rates may be unconstitutional. Second, the counties could opt to tax all property on the primary and supplemental rolls according to a debt tax rate based on the property values on the primary roll only. This approach, however, would result in local governments raising up to $50 million *more* than actually needed for debt repayment. Finally, counties could base the debt tax rate on the amount of assessed value on the primary assessment roll *plus* an estimate of the amount of assessed value expected to be added via the supplemental rolls. If the assessed value actually enrolled on the supplemental rolls turned out to be lower than anticipated, however, local governments could be forced to divert revenues earmarked for other operations to debt service.

C. Governor's Proposal to Reform Reimbursement Process for State Mandated Local Programs

Chapter 1406, Statutes of 1972 (SB 90), authorized the reimbursement of local governments for state mandated costs and lost sales and property tax revenues. Under Chapter 1406, local governments could submit claims for reimbursement only in cases where the mandating statute acknowledged an obligation on the state's part to cover the increased costs (or revenue loss) resulting from the mandate.

Chapter 1135, Statutes of 1977, significantly broadened the reimbursement program authorized by Chapter 1406. It allows local governments to appeal to the Board of Control for reimbursement where (1) legislation contains a section disclaiming any state obligation to reimburse mandate costs or (2) legislation does not disclaim the state's obligation to reimburse but fails to provide an appropriation.

Chapter 100 (AB 777), Statutes of 1981, further broadens the reimbursement program. It provides that costs mandated on school districts by the courts, federal government, and voter-approved initatives are also reimbursable through the Board of Control process.

The Governor's Budget is proposing several changes to this reimbursement process, all of which require the enactment of legislation.

Minor Cost Legislation

Currently, the state does not provide funding for most mandated local programs which impose relatively minor costs on local government. Legislation of this type typically includes a disclaimer recognizing that if local agencies incur additional minor costs, they may seek reimbursement through the Board of Control process. In 1980, 51 chaptered measures included disclaimers of this type.

The administration is proposing in the companion bills to the budget (AB 2361 and SB 1326) that minor cost bills be identified and that an estimate of their costs be made during the legislative review process. This identification would serve as the basis for a *statewide* annual cost estimate to be included in legislation introduced at the request of the Department of Finance. If an appropriation is made by the Legislature for this purpose, local agencies would be reimbursed on a predetermined formula basis.

The expense involved in preparing and submitting to the Board of Control minor cost claims, coupled with the uncertainty that reimbursement will be approved by the board or appropriated by the Legislature probably discourages many local agencies from filing claims. To the extent that such minor claims are submitted, it is doubtful that the cost of processing, auditing, and issuing the warants for reimbursements are justified by financial benefits to local agencies. Most of the resources devoted to accounting for and verifying these minor cost claims could probably be more productively used to meet other public needs. This conclusion would seem to apply equally to the reimbursements for sales and property tax revenue losses (Item 9100-101-001 (g)), which are budgeted at $3.2 million for 1982–83.

Crimes and Infractions Legislation

Section 2253.2 of the Revenue and Taxation Code specifies eight conditions under which mandated costs are not reimbursable. One of these conditions is when a chaptered bill creates, eliminates, or changes the penalty for a new crime or infraction. In 1981, over 100 bills were enacted which recognized additional costs associated with the mandate but disclaimed funding responsibility through a "crimes and infractions" disclaimer.

The budget proposes that the state recognize the impact of such legislation and provide funding to offset these costs. Specifically, it proposes that *any* measure which increases total local law enforcement costs by more than 5 percent of prior year expenditures be funded by the state. The most recently available expenditure data show that in 1979–80, cities and counties expended $2.9 billion for law enforcement activities. Table 11 identifies the components of these expenditures.

Table 11
1979–80 Local Agencies
Law Enforcement Expenditures
(in millions)

Program	*Amount*
Counties:	
Judicial	$566.5
Police protection	557.7
Detention and correction	510.8
Cities:	
Police protection [a]	1,299.1
Totals	$2,934.1

[a] Includes the cost of city detention facilities.

Using this amount as a base, a bill would have to raise expenditures by over $146 million (5 percent) statewide in order to qualify for state funding under the budget proposal. It is not likely that this proposal, as drafted, would result in the disbursement of any funds to local agencies.

Legislative Action on Claims Bills

Under the existing reimbursement process, the Board of Control reviews claims from local agencies which allege that chaptered legislation contains a state mandate. If the Board of Control determines that a mandate exists, it must develop parameters and guidelines which delineate allowable costs for which local agencies may claim reimbursement. Once adopted by the board, the approved claims are presented to the Legislature in a claims bill for an appropriation. In past claims bills, the Legislature has deleted some claims which were submitted for payment.

The administration is proposing legislation which would require that the Legislature issue a specific finding when deleting claims. This finding would have to indicate either that (1) the enabling legislation did *not* constitute a state mandate or (2) there are no reimbursable costs associated with the mandate. In the absence of such a finding, local agencies would not be required to continue to comply with these unfunded state mandates.

D. Procedures for Reevaluating Effectiveness of Existing State Mandated Local Programs

In 1972, the Legislature enacted Chapter 1406, which required the state to reimburse local governments for the cost of state mandated local programs. Since 1975, when the state began keeping records, almost 2,000 bills have been enacted which contained a state mandated local program. Only 111 of the bills, however, contained an appropriation to pay for the mandated costs.

In many of these cases, the state appropriately disclaimed responsibility for reimbursement. For example, where the statute also provided savings in an amount sufficient to offset the costs, there were no net increased costs to the local agency warranting reimbursement. In the bulk of these cases, however, we simply do not know whether any increased costs were incurred, or whether the statutes ever met their intended objectives. This is because, once a disclaimed state mandated program is enacted, its efficacy is usually not subject to review by the Legislature. The Legislature may have an opportunity to review some of these programs again, when local agencies seek to obtain reimbursement through the Board of Control. However, the number of such programs is limited relative to the number of outstanding mandated programs.

The Legislature has recognized the need for some review of these mandates. On two occasions, legislation has directed our office to examine specific state mandated local programs and make recommendations to the Legislature as to whether they need modification or should be repealed. In addition, our office has been given an ongoing responsibility to review annually all state mandated programs which receive state funding through the Board of Control process each year.

In our most recent report, "An Analysis of 21 State-Mandated Local Programs" (January 1982), we recommended that 12 of the 21 mandates examined be repealed or modified, in order to achieve a more efficient use of state and local funds. The specific mandates that we recommended be repealed or modified are as follows:

Statute or Regulation	*Analyst Recommendation*
• In-Home Supportive Services Regulations: MSW Requirement	Repeal
• Guardianship and Conservatorship	Modify
• Voter Registration Purge	Modify
• Voter Registration by Mail	Modify
• High School Proficiency Assessments	Modify
• Law Enforcement Records	Modify
• General Relief	Modify
• Benefits in Lieu of Temporary Disability for Safety Officers	Repeal
• Presumption of Work-Related Disability	Repeal
• Civic Center Act	Repeal
• Single Session Kindergarten Classes	Repeal
• Administrator-Teacher Ratio	Repeal

Some of these recommendations would increase state and local costs, and others would reduce costs. On balance, however, we believe the combined savings to the state and local governments would significantly exceed the costs.

From our perspective, the identification and repeal of existing state mandated local programs which are no longer justified can significantly reduce government expenditures at all levels. At the present time, however, there is no process for accomplishing such a review. The state is not in a good position to identify those mandates that are unnecessary or not constructive because it does not administer the programs or observe their results. Although local governments frequently testify on the problems caused by the imposition of these mandates, they generally refrain from offering any evaluations of *specific* mandates or presenting a case for eliminating them.

For this reason, we recommend that a process be established whereby the state and local governments, in a cooperative effort, seek to identify unnecessary mandates. This could be implemented by assigning this subject to a legislative committee with the responsibility for receiving evaluations of existing mandates from local agencies. This committee could review these evaluations and make recommendations to the Legislature as a whole. In this way, local governments could identify those programs with low priorities or inadequate accomplishments, and present a case for modification or repeal. Since, for the most part, these programs are currently financed by local governments, it should be in their interest to make recommendations for changes so the savings generated through this process could be put to other local purposes having a higher priority.

IV. GENERAL FUND CONDITION, PRESENT AND FUTURE

A. Avoiding a Deficit

Fiscal Year 1981–82

Last July, after the 1981–82 budget was adopted, we estimated that the General Fund would have a surplus (uncommitted reserves) of about $475 million. In the intervening seven months, the condition of the General Fund has deteriorated markedly because:

- Revenue estimates for the current year have been revised downward by over $800 million—the largest downward adjustment in history.
- Expenditures are up over $300 million from the level estimated last July.

In the previous sections of this *Analysis*, we have described the actions proposed by the administration to keep the General Fund solvent during the current fiscal year. At the time this analysis was written, the Legislature was considering other alternatives, such as AB 7x and AB 8x which would increase current year resources by raising revenues or reducing expenditures. The fate of the state's General Fund during the current year depends upon what actions are taken by the Legislature to address the pending deficit, and especially what happens to revenue collections during the next five months.

Fiscal Year 1982–83

The Governor's proposed budget for 1982–83 will be in balance if the economy has a normal upturn from the current recession, and if several other assumptions, such as those regarding the voters' decisions at the June 1982 primary election, are borne out.

The principal fiscal problem facing the state in the budget year, as in the current year, is a sluggish economy. If the economic assumptions made in May 1981 had held up, General Fund revenues (under existing law) in 1982–83 would be $1.5 billion higher than currently estimated. This level of revenues would have provided funding that was almost sufficient to continue the original 1981–82 level of services into the budget year. The recession, however, has reduced revenues to the point where expenditures in terms of real purchasing power will be about 2.9 percent *lower* than those for the current year, assuming the Governor's revenue enhancements are approved. This decline in the level of services will be even larger if the voters in June 1982 approve the Jarvis full income tax indexing measure and repeal the inheritance and gift taxes.

Fiscal Year 1983–84

The budget estimates that General Fund revenues will be $26.3 billion in 1983–84—$2.7 billion, or 11.4 percent, over the estimated level for the budget year. Our analysis indicates that this is a reasonable figure, given what many private economists are predicting for the economy in 1982 and 1983, *provided* the ballot measures mentioned above are not approved by the voters.

We estimate that the levels of service proposed for the budget year could be financed in 1983–84 within the $26.3 billion projected to be available.

In summary, the condition of the General Fund and its ability to sustain current service levels depends primarily on:

1. what happens to the California economy, and
2. the voters' decision on three revenue measures on the June ballot.

Revenues are much more sensitive than expenditures to changes in economic conditions. If the expected upturn in the economy materializes, then the task of balancing the budget should be easier in the future.

B. Reserve for Economic Uncertainties

The Reserve for Economic Uncertainties was established in the 1980 Budget Act. It was designed to be an "insurance policy" to protect the solvency of the General Fund against declines in revenues and unanticipated increases in expenditures. This reserve was established at a *minimum* of 3 percent of total General Fund appropriations, with a goal of 5 percent.

In 1980–81, the reserve began the year with $620 million (3 percent of appropriations), but almost half of this amount was needed by the General Fund during the year to sustain the approved expenditure program. This was due to a decline in revenues, and some unanticipated increases in expenditures. The ending balance in the reserve was only $349 million.

In 1981–82, the reserve began the year with a balance of $658 million. Shortly after the budget was adopted, however, the reserve fell to $475 million because $183 million was needed to fund the expenditures in the budget and companion legislation. Without any action by the administration, this reserve would have been fully depleted during the current year because estimated revenues are down by over $800 million from the level estimated last May, and expenditures are up over $300 million. This $1.1 billion decrease in the resources available to the General Fund was more than double the size of the reserve after the adoption of the budget and its companion bills.

The administration's program for solving this funding problem consists of three parts.

1. Current-year expenditures would be reduced by $419 million, by cutting most General Fund-supported state operations budgets by 2 percent, and by freezing certain capital outlay appropriations.
2. Revenues would be accelerated by $338 million during the current year, and
3. The remaining reserve would be reduced to $116 million. This represents a total reduction of $542 million from the beginning balance.

Two important lessons can be learned from this year's experiences:

1. The solvency of the General Fund can be hurt more by a shortfall in revenues than from unanticipated increases in expenditures, and
2. A 3 percent reserve is only a *partial* "insurance policy." A 5 percent reserve (the ultimate goal of the 1980 and 1981 Budget Acts) would have been needed to absorb the $1.1 billion decline in General Fund resources.

In 1982–83, the budget proposes to restore the reserve to $500 million, or 2.16 percent of General Fund expenditures. This is *lower* than the 3 percent minimum target established by the Legislature in years past, and lower than the ratio at the beginning of either 1980–81 or 1981–82. This amount, moreover, would have to do double duty in 1982–83. Not only would it have to protect the General Fund against declines in revenue under existing law and increases in regular expenditures; it would also have to protect the General Fund against the following three unique contingencies which the budget assumes will *not* materialize.

1. The voters approve the Jarvis income tax indexing initiative on the June 1982 ballot (General Fund revenue loss of $230 million in 1982–83).

2. The voters approve one of the initiatives on the June 1982 ballot which repeals the inheritance and gift taxes (General Fund revenue loss of $130 million in 1982–83).

3. The voters reject the prison bond issue on the June 1982 ballot, which would eliminate $162 million in 1982–83 funding, which the budget anticipates will be available.

If all three of these contingencies materialize, the adverse affect on the budget would be $522 million, or more than the $500 million reserve.

We recommend the Legislature give high priority to increasing this reserve to the same ratio as existed in the prior two fiscal years, namely 3 percent. That would result in a starting balance of $700 million for 1982–83.

V. COLLECTIVE BARGAINING FOR STATE EMPLOYEES

New Collective Bargaining Provisions

In 1982–83, compensation increases for state employees will, for the first time, be subject to collective bargaining.

Collective negotiations over state employee compensation increases and other terms and conditions of employment were initiated during the current year under provisions of:

- The State Employer-Employee Relations Act (SEERA), which the Legislature enacted in 1977.
- The Higher Education Employer-Employee Relations Act (HEERA), which the Legislature enacted in 1978.

The SEERA provides for a formal, bilateral employee relations system for most state civil service employees. Under its provisions, the Governor or his designee is required to "meet and confer in good faith" with employee organizations which have been selected by a majority of employees within individual bargaining units in an effort to reach agreement relative to "wages, hours and other terms and conditions of employment." Such agreements are to be formalized in memorandums of understanding (MOU's). Any provision in such a memorandum requiring the expenditure of funds (for example, negotiated salary or benefit increases) is subject to approval by the Legislature. Mediation is required if the parties are unable to reach agreement.

The HEERA provides for a similar system with respect to both academic and nonacademic employees of the University of California (UC) and California State University (CSU).

Traditionally, state civil service salaries and benefits have been adjusted on the basis of (1) State Personnel Board (SPB) surveys of salaries and benefits received in nonstate employment, (2) salary and benefit increase recommendations contained in the board's annual report to the Governor and Legislature, (3) action by the Legislature and Governor on the Budget Act, and (4) SPB allocation of funds appropriated for salary increases, among occupational classes. (As we note in our analysis of the Department of Personnel Administration (DPA), all SPB functions involving salary administration and various other "nonmerit aspects" of personnel administration were transferred to the DPA effective July 1, 1981, pursuant to Governor's Reorganization Plan No. 1 of 1981.)

Under the prevailing rate system, salaries and benefits of academic employees of the UC and CSU were adjusted on the basis of (1) a report submitted to the Legislature by the California Postsecondary Education Commission (CPEC) comparing California faculty salaries to those in two groups of postsecondary education institutions that are comparable to the two California segments, and (2) action by the Legislature and Governor on the Budget Act.

In order to treat nonacademic employees of the UC and CSU equally, the Legislature traditionally has appropriated funds to provide the same salary increases for UC and CSU nonacademic employees as those received by civil service employees in comparable job classes.

Employees Not Covered by Collective Bargaining

Both the SEERA and HEERA exclude the following categories of employees from collective bargaining:

- ***Managerial employees,*** who are defined as those employees having significant responsibilities for formulating or administering policies or programs or for administering agencies.
- ***Supervisory employees,*** who are defined as those employees having the authority to hire, transfer, suspend, lay off, recall, promote, discharge, assign, reward, or discipline other employees, or responsibility to direct them or adjust their grievances, or effectively recommend such action.
- ***Confidential employees,*** who are defined as those employees required to develop or present management positions regarding employer-employee relations, or whose duties require access to confidential information contributing significantly to the development of management positions.

In addition to these categories, the SEERA also specifically excludes the following from collective bargaining:

- Employees of the Public Employment Relations Board.
- Employees of the Legislative Counsel Bureau.
- Nonclerical employees of the SPB engaged in technical or analytical personnel functions.
- Conciliators employed by the State Conciliation Service in the Department of Industrial Relations.

Also excluded are all statutory officers whose salaries are set by the Legislature and those employees in positions exempt from civil service who are not specifically designated by SEERA as being covered.

The total number of civil service and related personnel is estimated at 140,846 (full-time equivalent). Of the total, 118,570 employees, or 84.2 percent, have been assigned to specific bargaining units. This leaves 22,276, or 15.8 percent, of the employees not subject to collective bargaining. This is shown in Table 12, which displays the number and percent of employees in the categories not subject to collective bargaining.

The 18,222 managerial and supervisory employees group includes a variety of positions encompassing a wide range of salary levels and responsibilities. In many instances, an employee designated as a supervisor is excluded from bargaining while a higher salaried employee working in the same program area, in the same department, is subject to bargaining.

Table 12
State Civil Service and Related Employees Covered by State Employer-Employee Relations Act (SEERA)

Category	*Estimated Personnel (Full-Time Equivalent)* *Number*	*Percent*
Employees in bargaining units	118,570	84.2%
Employees not subject to bargaining:		
Managerial and supervisory	18,222	12.9
Confidential	833	0.6
Excluded specifically by SEERA	1,457	1.0
Statutory officers and exempt employees not in bargaining units	1,764	1.3
Total Personnel	140,846	100.0%

It should be noted that the totals in Table 12 do not include staff employed by the Legislature. Salaries and benefits of these employees will continue to be set by the Legislature outside the process established by the SEERA. The Legislature, however, may choose to coordinate its salary and benefit decisions for legislative staff with the decisions resulting from the collective bargaining process.

Issues Subject to Negotiation

The SEERA and HEERA both provide for collective bargaining over wages, hours and other terms and conditions of employment.

As a practical matter, virtually all conditions of employment are subject to collective bargaining. For example, the SEERA, identifies numerous negotiable issues which we have grouped in the nine major catgegories identified below:

1. Holidays, Vacation, Sick Leave, Leaves of Absence, Time Off.

- designated state holidays;
- the employee's personal holiday;
- the amount of vacation time which may be accumulated, and methods by which employees moving from one state agency to another may be compensated for, or otherwise receive credit for, their accumulated vacation privileges;
- the rate at which employees accumulate vacation credit;
- provisions for taking vacation time;
- the rate at which sick leave is accumulated;
- the amount of sick leave which may be accumulated;
- the provision of sick leave without pay for employees who have used all of the sick leave to which they are entitled;
- leaves of absence with pay for pregnancy, childbirth, or the recovery therefrom;
- authority of agency heads to grant educational leave with pay under specified conditions to state civil employees in positions requiring teaching certification qualifications;
- leaves of absence without pay;
- leaves of absence for jury duty;
- time off allowed during working hours to qualified employees for taking state civil service examinations.

2. Salaries, Compensation Levels, and Allowances and Payments for Work-Related Expenses

- salary increases including merit salary increases;
- compensation levels when the employee is paid a fixed amount per unit of work;
- payment above the minimum step of a salary range to meet recruitment problems, obtain employees of extraordinary qualifications or correct salary inequities;
- frequency of payments to state employees;
- intermediate steps within salary ranges;
- minimum and maximum salary limits for laborers, workers, and mechanics employed on an hourly or per diem basis;
- payment of a salary above the maximum of a range to employees moved to lower positions due to managment-initiated changes;
- provision of lump-sum payments upon separation for accumulated vacation or for compensating time off for previous overtime worked;
- payment for moving, traveling, lodging and meal expenses due to a required change in work location;
- payment of travel expenses of job applicants to fill positions for which there is a shortage of qualified applicants, and payment of moving expenses to persons accepting such positions;
- allowances paid to employees while traveling on state business;
- allowances provided to the employee for purchasing uniforms;
- the furnishing of work clothes to employees;
- the furnishing of safety equipment and police protective equipment to employees when such equipment is required by the employing agency;
- the replacement of employees' tools or equipment when stolen from the jobsite;
- the value of maintenance, living quarters, housing, lodging, board, meals, food, household supplies, fuel, laundry, domestic servants, and other services furnished by the state as an employer to its employees.

3. Overtime

- the designation of workweek groups and conditions for paying overtime for work performed after the normal scheduled workweek;
- the extent to which, and method by which, overtime work is compensated;
- the granting of compensating time off in lieu of cash for overtime;
- compensation provided to employees who are required to report back to work after completing the normal workday, workweek, or when otherwise off duty;
- payment to the employee of actual and necessary expenses when the employee is required to work overtime.

4. Health Insurance and Benefits, Life Insurance, Disability Benefits, and Rehabilitation Services

- the nature and extent of health insurance coverage for employees and their dependents;
- state's contribution toward employee health insurance;
- state payments into a private fund to provide health and welfare benefits to nonpermanent employees;
- health and safety programs for state employees;

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- the nature and amount of life insurance coverage provided for state employees;
- the nature, amount and conditions of nonindustrial disability coverage;
- the nature, amount, and conditions of industrial disability coverage;
- extension of benefits to a fireman who at the time of his injury, death, or disability is performing duties as a fireman, but not acting under the immediate direction of his employer;
- provisions requiring the DPA and Department of Rehabilitation to jointly formulate procedures for selecting and referring disabled state employees who can benefit from rehabilitation services and might be retrained for other appropriate positions in state service.

5. Employee Training

- provisions requiring the DPA to devise plans for, and cooperate with officials of the various agencies in training employees;
- conditions under which employees may be assigned to take out-service training;
- conditions under which employees may be reimbursed for tuition fees and other necessary expenses in connection with out-service training;
- conditions under which the employee may be required to reimburse the state for the cost of out-service training in the event the employee fails to remain in state service for a reasonable time after receiving the training;
- provisions requiring agency heads to arrange for counseling and training of employees in order to place them in other state civil service positions when their positions are to be changed substantially or eliminated by automation, technological changes, or other management-initiated changes;
- authority of the Commandant of the Veterans' Home of California to permit members of the medical staff to attend with pay medical and scientific meetings and medical and refresher courses under specified conditions.

6. Appointments, Transfers, Separations, Resignations, Reinstatements

- DPA's authority to temporarily restrict the methods of appointment available to the various agencies when necessary in order to place in other state civil service positions employees whose jobs have been substantially changed or eliminated;
- limited term appointments to education classifications to facilitate professional development of educators;
- authority of agency heads to transfer employees under various specified conditions;
- various provisions relative to separations from state service;
- the policy that when employees are separated from state service because of management-initiated changes, steps should be taken on an interdepartmental basis to assist such employees in locating, preparing to qualify for, and being placed in other state civil service positions;
- the provision that absence without leave for five consecutive working days constitutes an automatic resignation from state service;
- conditions under which an employee who formerly resigned from state service must be reinstated to his former position and paid his salary from the date of resignation;
- provisions under which an employee may be reinstated but *not* be

paid his salary from the date of resignation;
- DPA's authority to (1) establish a clerical pool in any location where the demand for temporary clerical help warrants it and (2) assign persons from the pool to agencies where they are needed.

7. Employee Performance Review
- employee performance standards and systems for rating employees' performance;
- rules under which unsatisfactory performance may lead to demotions or removal from service.

8. Retirement and Deferred Compensation
- the nature and extent of retirement benefits under the Public Employees' Retirement System (PERS);
- the state's contribution toward employee retirement benefits under the PERS;
- criteria for determining the application of the state safety category of membership in the PERS;
- DPA's authority to establish a deferred compensation plan and employees' authority to have deductions made from their wages in order to participate in such a plan.

9. Other Conditions of Employment
- credit for prior service;
- systems for adjusting employee grievances;
- provisions relative to prohibiting an employee from engaging in activities which are inconsistent, incompatible, or in conflict with his duties.

Issues Not Subject to Collective Bargaining

The SEERA and the HEERA both exclude from collective bargaining the basic functions of the employer—the merits, necessity, or organization of any service or activity provided by law.

The HEERA also excludes from the scope of bargaining (1) specified fees which are not a condition of employment; (2) admission requirements for students, conditions for awarding certificates and degrees to students, and the content and conduct of courses, curricula, and research programs; and (3) methods to be used for the appointment, promotion and tenure of academic employees.

Functions of the Executive Branch and the Legislature Under Collective Bargaining

Executive Branch Functions Under the SEERA. The Governor, or his representative, is to meet and confer in good faith regarding wages, hours and other terms and conditions of employment with representatives of recognized employee organizations, and consider fully presentations made by such organizations on behalf of their members. The parties are to attempt to reach agreement on matters within the scope of bargaining before the final state budget is adopted for the ensuing year. The negotiated agreements are to be formalized in MOU's and submitted "to the Legislature for determination."

Executive Branch Functions Under the HEERA. The "higher education employer" is defined as the (1) regents with respect to the UC, (2) Directors in the case of Hastings College of Law and (3) trustees in the case of the CSU.

The higher education employers, or their representatives, are to meet and confer with the employee organizations selected as exclusive representatives of the appropriate units of employees in all matters within the scope of representation. The negotiated agreements are to be prepared jointly by representatives of the higher education employers and the exclusive representatives and presented to the higher education employers for concurrence.

The higher education employer is to maintain close liaison with the Department of Finance and the Legislature in meeting and conferring on provisions which have fiscal ramifications. Following the execution of MOU's, the employer is to forward to the Legislature and the Governor or other funding agencies a request for funding for all state-funded employees or necessary proposed legislation.

If the Legislature or Governor fails to fund fully a MOU or take the necessary action, the entire MOU is to be referred back to the parties for further meeting and conferring. In that case, the parties may agree to provisions of the MOU which are nonbudgetary and do not require funding.

With respect to the CSU, the HEERA:

- Requires the Governor to appoint one representative to attend the meeting and conferring, including the impass procedure, to advise the Governor on matters requiring an appropriation or legislative action.
- Authorizes the Speaker of the Assembly and Senate Rules Committee each to appoint one representative to attend the meeting and conferring to advise the parties on the views of the Legislature on matters which would require an appropriation or legislative action.

Functions of the Legislature Under Collective Bargaining. Under both the SEERA and HEERA, the Legislature must approve MOU provisions which require either (1) the expenditure of funds or (2) a change in the law, before these provisions can be implemented.

As noted above, the HEERA specifically provides that if the Legislature or Governor does not fully fund a MOU, the *entire MOU* is to be referred back to the parties for further meeting and conferring.

Compensation Increases for Employees Not Covered by Collective Bargaining

It is our understanding that the procedure for providing compensation increases for state employees not covered by collective bargaining will probably operate as follows:

- The Governor, through the DPA, will propose increases for nonrepresented civil service and related employees, and the UC Regents and CSU Trustees will propose such increases for UC and CSU nonrepresented employees, respectively.
- The Legislature and Governor will act on such proposed increases through the normal Budget Bill process.

Implementing the Bargaining Process

The Public Employment Relations Board (PERB) is responsible, under the SEERA and HEERA, for:

- Determining appropriate bargaining units (that is, designating the specific job classes which are to be combined within separate units for representation by individual employee organizations).

- Conducting elections to determine which, if any, of the competing employee organizations will serve as the exclusive bargaining agent for each such unit.

Status of Implementing Collective Bargaining Under the SEERA. The PERB completed the bargaining unit determination process in November 1979 and designated a total of 20 separate bargaining units. Implementation of the SEERA was delayed to some extent by litigation testing its constitutionality. The California Supreme Court, however, has ruled that there is no basic conflict between the SEERA and the California Constitution.

Table 13

Distribution of State Civil Service and Related Employees Among Bargaining Units Created Under Provisions of the State Employer-Employee Relations Act (SEERA)

Bargaining Unit		*Estimated Personnel (Full-Time Equivalent*		
Unit Number	*Occupational Group*	*Number*	*Percent*	*Exclusive Representative*
1	Administrative, Financial and Staff Services	23,192	19.6%	California State Employees' Association (CSEA)
2	Attorney and Hearing Officer	1,842	1.5	Undecided
3	Education and Library	2,155	1.8	CSEA
4	Office and Allied	32,848	27.7	CSEA
5	Highway Patrol	4,179	3.5	California Association of Highway Patrolmen
6	Corrections	6,533	5.5	California Correctional Officers Association
7	Protective Services and Public Safety	4,492	3.8	Coalition of Associations and Unions of State Employees
8	Firefighter	3,150	2.7	California Department of Forestry Employees' Association
9	Professional Engineer	4,795	4.0	Professional Engineers in California Government
10	Professional Scientific	1,327	1.1	CSEA
11	Engineering and Scientific Technicians	3,092	2.6	CSEA
12	Craft and Maintenance	9,449	8.0	CSEA
13	Stationary Engineer	472	0.4	International Union of Operating Engineers, Stationary Engineers Division
14	Printing Trades	856	0.7	CSEA
15	Custodial and Services	5,690	4.8	CSEA
16	Physician, Dentist and Podiatrist	890	.7	Union of American Physicians and Dentists
17	Registered Nurse	1,608	1.4	CSEA
18	Psychiatric Technician	7,426	6.3	Communication Workers of America, Psych Tech Union
19	Health and Social Services/Professional	2,962	2.5	American Federation of State, County and Municipal Employees
20	Medical and Social Services Support	1,612	1.4	CSEA
	Total Employees	118,570	100.0%	

During June 1981, the PERB conducted unit elections, providing all eligible employees the opportunity to vote for the exclusive bargaining agent, if any, of their choice. At the time this analysis was written, 19 of the 20 units had selected an exclusive representative. The only unit remaining undecided with respect to exclusive representation was one consisting of attorneys and hearing officers which represents 1,842, or 1.5 percent, of the 118,570 civil service and related employees covered by collective bargaining. Therefore in the budget year, compensation increases for employees in 19—and possibly all—of the 20 bargaining units will be subject to the collective bargaining process.

Approximately 84 percent of state civil service and related employees are covered by collective bargaining under the SEERA. Table 13 indicates the distribution of these employees among the 20 bargaining units.

Steps Taken by the Administration to Prepare for Collective Bargaining. The Office of Employee Relations (OER) was established in the Governor's Office by Executive Order B7-75 to represent the administation in all matters concerning employer-employee relations. Pursuant to Governor's Reorganization Plan No. 1 of 1981, the OER was eliminated and its functions were transferred to the new Department of Personnel Administration (DPA). The new department, in addition to representing the administration in employer-employee relations, is responsible for managing the nonmerit aspects of the state personnel system.

Activities undertaken by the OER (now DPA) to prepare state management for collective bargaining include:

- Issuing guidelines to managers and supervisors for complying with the SEERA so that they may avoid committing unfair labor practices. (The guidelines cover such items as rights of employees and employee organizations, and procedures for complying with bilateral decisions.)
- Issuing to employees designated as "managers," "supervisors," and "confidential employees" information regarding their rights and role in the state management process.
- Issuing periodic reports informing state managers and supervisors of state plans for implementing collective bargaining under the SEERA.
- Conducting formal training for managers and supervisors in subjects such as grievance procedures and the administration of contracts executed pursuant to the collective bargaining process.
- Establishing a Management Relations Division to deal specifically with personnel issues related to those employees not covered by collective bargaining.
- Establishing steering committees consisting of departmental managers to assist the DPA in preparing for collective negotiations.

Status of Implementing Collective Bargaining for UC Employees. Faculty employees at UC Berkeley and UCLA each voted for no representation in the elections conducted by the PERB under the provisions of the HEERA. Therefore, at least for the budget year, those employees will *not* be covered by collective bargaining. Employees in two other UC bargaining units, however, have selected an exclusive bargaining agent, to represent them in collective negotiations in PERB-sponsored elections:

- A unit consisting of 295 faculty members at the Santa Cruz campus.
- A statewide university police unit consisting of approximately 200 employees.

Compensation and working conditions for these employees in 1982–83 will be subject to collective bargaining.

At the time this analysis was written, the unit determination process had not been completed for the balance of the UC employees and, therefore, it does not seem likely that the 1982–83 compensation increases for these employees will be determined by collective bargaining.

Status of Implementing Collective Bargaining for CSU Employees. The PERB designated a total of eight separate bargaining units for CSU employees. Each unit is structured on a statewide basis. At the time this analysis was written only the unit composed of university police (representing 185, or 0.5 percent of CSU employees covered by collective bargaining) had selected an exclusive bargaining representative. In the budget year, compensation increases and other terms and conditions of employment for these employees will be subject to collective bargaining.

Employees in the other seven units were in the process of voting to determine which, if any, of the competing employee organizations would represent them as their exclusive agents in collective bargaining negotiations. At this time it is uncertain whether or not compensation increases for employees in any or all of these seven units will be determined for the budget year through the collective bargaining process.

Table 14 shows the distribution of CSU employees among the eight bargaining units.

Table 14
Distribution of CSU Employees Among Bargaining Units Created Under Provisions of the Higher Education Employer-Employee Relations Act (HEERA)

Bargaining Unit		*Estimated Personnel (Full-time Equivalent)*		
Unit Number	*Occupational Group*	*Number*	*Percent*	*Exclusive Representative*
1	Physicians	140	0.5%	Undecided (election in progress)
2	Health Care Support	280	0.9	Undecided (election in progress)
3	Faculty	19,330	62.6	Undecided (election in progress)
4	Academic Support	1,335	4.3	Undecided (election in progress)
5	Operations Support Services	2,110	6.8	Undecided (election in progress)
6	Skilled Crafts	815	2.7	Undecided (election in progress)
7	Clerical Support	6,680	21.6	Undecided (election in progress)
8	Police	185	0.6	Statewide University Police Association
	Total Employees	30,875	100.0%	

Problems the Legislature Will Face as a Result of Collective Bargaining

Because 1982–83 compensation increases for many state employees will be subject to the collective bargaining process, the Legislature will face a number of new and perplexing problems. These problems will be particularly acute in this, the first year of bargaining because of uncertainty as to:

- Whether employees in certain bargaining units will be covered by collective bargaining.
- Whether negotiations in all of the bargaining units will be completed in time for the funding implications of the MOU's to be considered by the Legislature in acting on the 1982 Budget Bill.
- The procedure the Legislature will use in receiving, considering and acting on MOU's.
- The availability of adequate criteria and reliable cost data for evaluating MOU's.

Moreover, it is likely that the Legislature will have only a short time in which to act on MOU's, because employee compensation proposals probably will be submitted late in the 1982–83 budget process.

In the following pages we (1) identify and discuss some of these problems and (2) make recommendations for addressing them.

Problem No. 1: A Legislative Procedure Needs to be Established for Receiving, Considering, and Acting on MOU's.

Collective Bargaining Issues. There are essentially four types of issues which will arise out of collective bargaining: (1) direct fiscal issues involving such items as salaries, wages, and fringe benefits, (2) indirect fiscal issues involving working conditions, (3) issues requiring changes in existing law, and (4) issues which require neither legislative funding nor statutory changes. The latter category are those issues which either fall entirely within the discretion of management (including a wide range of working conditions) or are allowed to take precedent over specified sections of law, as permitted by both the SEERA and the HEERA. This category of issues does not require legislative approval.

Direct Fiscal Issues. The Legislature will have to act on any collective bargaining provision that requires the appropriation of state funds for employee salary, wages, or benefits. These provisions may be submitted to it in one of three ways. First, the Department of Finance may submit budget change letters to provide funding for MOU's. This is likely to be the case in 1982–83, due to delays in implementing the new collective bargaining process.

Second, funding for MOU's covering fiscal years beyond 1982–83 may be included in the Governor's Budget, if they are completed on time.

Third, where a MOU is agreed to after enactment of the Budget Bill, special legislation may be introduced to fund the direct fiscal provisions of these agreements. In all three cases, the Legislature could use the same hearing procedures that it uses in examining other fiscal issues.

Indirect Fiscal Issues. Negotiated changes in working conditions or other terms of employment could have an indirect fiscal impact. For example, a MOU might provide for changing employee workshifts from an 8-hour day, 5-day week to a 10-hour day, 4-day week. Such change could require additional staff resources if the normal workweek coverage is to be maintained. Ideally, such indirect costs should be identified in the MOU's and highlighted for legislative consideration in the same way as direct fiscal issues.

It is possible, however, that such indirect issues may not be raised at the time a MOU is submitted, particularly if the agency has not determined the full impact of the MOU on its operating requirements. If these indirect costs are not identified and highlighted for the Legislature, they could be overlooked, only to appear in future years in the form of Budget Change Proposals or baseline budget adjustments.

Statutory Changes. MOU's requiring changes in existing law will be presented to the Legislature in the form of special legislation. Here again, the Legislature could direct these measures through the regular policy committee/fiscal committee/floor route that other proposed fiscal measures must follow.

Most state legislatures have not found it necessary to establish special committees or procedures for dealing with collective bargaining issues. (One exception is Wisconsin, which we discuss below.) We believe that most collective bargaining issues can be handled within existing legislative organizational arrangements.

Accordingly, *we recommend that the existing committee structure which the Legislature uses for hearing budget items and bills be used for considering and acting on both MOU's and proposed increases submitted by the administration for employees not covered by collective bargaining.*

The Wisconsin Model. Although the Legislature probably does not need to establish any special committee structures for dealing with collective bargaining matters, the Wisconsin Model is an alternative that the Legislature may want to consider. Wisconsin is one of two states which has established a special committee structure for dealing with collective bargaining issues. Its Joint Committee on Employment Relations deals with all state-related collective bargaining matters. The committee is composed of the Speaker of the Assembly, the President of the Senate, the majority and minority leaders of both houses, and the chairpersons of the fiscal committees. The committee is authorized to meet with the Governor's negotiating team in executive session prior to the commencement of negotiations to help develop negotiation strategies, and to determine the budgetary amounts which can be made available to implement MOU's. The committee also holds hearings to approve or reject MOU's after they have been negotiated. Formal actions of this committee go directly to the floor of each house for final approval or disapproval.

Minnesota has recently enacted legislation creating a committee structure similar to the Wisconsin Model.

Problem No. 2 Criteria and Data Are Needed to Evaluate Proposed Compensation Increases

In the past, prevailing rates in nonstate employment have provided an objective basis for evaluating proposed compensation increases. In establishing collective bargaining in lieu of the prevailing rate system, the Legislature implicitly recognized that factors other than comparable pay are permissible standards for determining state employee compensation levels. While this opens up the wage-determination process to other considerations, it makes the Legislature's task in acting on MOU's that much more difficult, since the objective basis for evaluating increases (pay levels in comparable nonstate employment) is no longer definitive.

As a result, the Legislature must determine what criteria to use in evaluating compensation increases (a) negotiated by the administration and (b) proposed by the DPA for employees not represented in the collective bargaining process.

Negotiated Increases. Criteria which might be used for evaluating negotiated increases include:

- Prevailing salary rates in comparable nonstate employment.

- Increases in the GNP Personal Consumption Deflator (price index), the California Consumer Price Index (CCPI) or other indexes that measure inflation.
- Recruitment and retention problems which exist for individual state classifications.
- Cost-of-living increases granted by the state to other programs where a major share of the funding is used for salaries of local government employees.

Non-negotiated Increases. The DPA will be responsible for adjusting salaries of management, supervisory, and confidential employees as well as employees in units not represented by exclusive bargaining agents. Criteria which might be used by the Legislature for evaluating these proposals would be similar to those used to evaluate negotiated increases. For confidential employees and nonrepresented employees, an additional criterion would be the level of increases received by represented employees in comparable classes. For management and supervisory employees, an additional criterion might be the amount of increase required to maintain the same average percentage differential between their salaries and the salaries of the employees they supervise.

The information needed by the Legislature for evaluating compensation increase proposals will depend on which criteria the Legislature chooses to apply. Submission of this information to the Legislature in time to allow adequate review and evaluation is critical if the employee compensation proposals are to be coordinated with the 1982–83 Budget.

In order for the Legislature to have a basis for (a) evaluating negotiated increases for employees covered by collective negotiations and (b) determining appropriate increases for other state employees, *we recommend that the Department of Personnel Administration provide the following information to the Legislature by May 15 relative to each MOU or other proposed increase:*

A. *The projected percentage difference, as of the following July 1, between salaries of major state occupation groups and salaries paid in comparable nonstate employment. (In the case of managers and supervisors who are exempt from collective bargaining, the information should indicate the average percentage difference which would result between salaries of supervisors and managers and the salaries of those they supervise, assuming that all MOU's and proposed compensation increases are approved by the Legislature.)*

B. *The nature and extent of any significant recruitment and retention problems.*

Other Data

Another problem the Legislature will face will be evaluating one MOU against another. For instance, one unit may bargain for lower salary increases in favor of higher benefits or better working conditions, while another unit may bargain for higher salary increases with lower benefits. Some of the employee benefit provisions, such as retirement benefit changes, could have a significant future cost impact without affecting budget year costs.

To assist the Legislature in evaluating the total compensation package provided by each MOU, *we recommend that each MOU, or other proposed increase submitted to the Legislature be accompanied by information indicating the total cost expressed in terms of a percentage salary* *increase. This information should include long-range cost estimates for changes, such as increased retirement benefits, which would have a deferred cost impact.*

Problem No. 3 The Need for Reliable and Coordinated Cost Estimates

In order to determine the total amount of funds required for employee compensation and other employment related costs, the Legislature will need reliable and comprehensive cost estimates for each of the MOU's and other compensation proposals. Because the Legislature will be receiving numerous proposals from various sources (for example, the DPA, CSU, UC, and Hastings College of Law), it may be difficult for the Legislature to assess the accuracy and reliability of these estimates.

As noted above, MOU's also can have a substantial cost impact in ways other than straight-forward increases in salaries and benefits. For example, changes in work shifts, the definition of "overtime," productivity standards, and frequency of payments to state employees can have significant cost implications. As we noted earlier, (a) specific approval by the Legislature is needed to implement MOU provisions which require the expenditure of funds and (b) *virtually all conditions of employment are subject to negotiation.*

The reliability of the cost estimates for individual MOU's is particularly important for changes in benefits and working conditions because these costs are more difficult to estimate than salary increases. For instance, a proposal to add a new state holiday would add additional state costs for two reasons. First, there would be additional overtime relating to the staffing of functions that require 24-hour coverage, such as the state hospitals. Second, there would be a loss in productivity for those employees who are not replaced because they work one less day a year. The loss in productive time is difficult to measure objectively, and could result in a substantial variance in estimates between, say, DPA and CSU.

The Legislature needs to assure itself that the cost estimates submitted by the administration are complete, accurate and reliable. These estimates should be reviewed and coordinated by one central agency before being transmitted to the Legislature. The Department of Finance would be the logical agency to do this because it is designated by statute as having general supervisory responsibilities over all fiscal affairs of the state. Therefore, *we recommend that:*

(a) *The Department of Finance submit to the Legislature by May 15, 1982 a comprehensive cost summary of proposed and negotiated changes in compensation and working conditions for all civil service and related employees and employees of the UC and CSU. The summary should include long-range cost estimates for changes in benefits and working conditions, such as increased retirement benefits, which would have a deferred cost impact.*

(b) *The Department of Finance, in future years, include such a summary in the Governor's Budget.*

Problem No. 4: The Need to Treat Various Categories of Employees Equitably

Collective bargaining will make it more difficult to provide compensation increases in a consistent manner among the various classes and categories of state employees for the following reasons:

- Compensation increases contained in MOU's for the various bargaining units will be negotiated independently of one another.
- MOU's probably will be submitted to the Legislature at separate times.

- The magnitude of increases negotiated or proposed for nonfaculty employees of the UC and the *same classes* of nonfaculty employees at the CSU may differ significantly from one another and both may differ from increases negotiated for the same classes of civil service employees. Thus, it is possible that senior stenographers, for example, could be paid at different rates by the UC, CSU and the various state agencies.
- The magnitude of increases (a) negotiated for UC faculty employees in different units and (b) proposed for such employees who choose not to be covered under collective bargaining may differ significantly from one another.
- Disproportionate differences may result between (a) increases negotiated for represented employees and (b) increases proposed for the managers and supervisors to whom they report.

To enable the Legislature to act on negotiated and proposed increases in a consistent manner so that the various categories of employees are treated as equitably as possible, *we recommend that:*

A. *The administration submit to the Legislature a comprehensive summary showing the nature and amount of compensation increases negotiated or proposed for all categories of employees. Information on different units containing the same or similar classes of employees (UC faculty employees, for example) should be grouped together for comparative purposes.*

B. *The Legislature consider and act at one time on all compensation increases negotiated and proposed for all categories of employees.*

Problem No. 5: Need to Incorporate Employee Salary Provisions into the Budget Without Delaying the Budget Process

There are two main ways collective bargaining could delay the budget process:

- *Late submission of MOU's for consideration by the Legislature* due to the negotiating parties' failure to (a) commence negotiations sufficiently in advance of the budget hearing process, or (b) complete negotiations in a timely manner.
- *Negotiated increases might cost more than the amount the Legislature is willing to authorize.* It is important to note that MOU's submitted under the HEERA which are not approved by the Legislature must be returned to the parties for further meeting and conferring. The SEERA, however, is silent as to what the Legislature's options are with respect to MOU's it does not approve.

Under the HEERA, the Speaker of the Assembly and the Senate Rules Committee are each authorized to appoint a representative to attend negotiation sessions of the CSU. The SEERA, however, contains no similar provisions for such communication links between the Governor's negotiators and the Legislature.

In order to prevent collective bargaining from delaying enactment of the budget, we recommend that:

A. *The DPA, UC and CSU submit to the Legislature by May 15, 1982 all MOU's and other proposals for compensation increases for 1982–83.* This will provide time for the Legislature to consider and act on such proposed increases for 1982–83 as part of the regular budget process.

B. *Legislation be adopted to require that all MOU's and other proposals* *for compensation increases in future years be submitted to the Legislature by January 10, along with the Governor's budget. (Proposed compensation increases also should be submitted in situations where impasses have not been resolved.)* This would allow the amount of funds required to implement all employee compensation increases negotiated or proposed by the executive branch to be included in the Governor's Budget. This will enable the Legislature, in future years, to consider and act on employee compensation increases in the regular budget process.

C. *Legislation be adopted amending the SEERA and HEERA to designate November 15 as the date by which an impasse will be deemed to have been reached if the parties have not completed their negotiations.* This will give mediators and factfinders until early January to effect resolution of impasses and allow funding for the negotiated increases to be included in the Governor's Budget. (In order to *ensure* that impasses are resolved, the Legislature may want to adopt legislation to modify the SEERA and HEERA to provide for a final, binding arbitration procedure, whereby the last position proposed by either of the two parties is selected.)

D. *Legislation be adopted amending the SEERA to authorize the Speaker of the Assembly and the Senate Rules Committee to each appoint a representative to attend negotiation sessions relative to civil service and related employees.* This would allow for communication links between the Governor's negotiators and the Legislature, thereby increasing the likelihood that the types and amounts of increases negotiated would be within limits acceptable to the Legislature.

E. *Legislation be adopted amending the SEERA and HEERA to provide that if the Legislature disapproves an MOU because of the amount of funds required, it designate the amount of funds to be provided and return the MOU to the parties for meeting and conferring as to how the funds are to be allocated.* This will enable the Legislature to determine the amount of funds to be appropriated for compensation increases without interfering with the bilateral negotiations on how the funds are to be allocated. It will also avoid delaying completion of the final budget.

Problem No. 6. The Danger that the Negotiating Parties will Attempt to Circumvent the Collective Bargaining Process by Sponsoring Special Legislation

Collective bargaining considerations will be a primary concern for those legislative staff who prepare analyses of proposed legislation and budget requests for the various committees. Under the new collective bargaining policy, the Legislature has delegated the responsibility for determining "salaries, wages, working conditions, and other terms and conditions of employment" to the Governor and the two state university systems and appropriate employee organizations. Under the HEERA, the Legislature has retained the right only to approve or disapprove provisions of MOU's which require funding or statutory modifications.

It is likely that some of the parties involved in the meet and confer process will attempt to circumvent the collective bargaining process by sponsoring legislation which would *unilaterally* change provisions relative to employee wages, benefits, and working conditions.

The fiscal implications of granting some employee benefits through the collective bargaining process, and at the same time granting or taking away other benefits through the legislative process could be significant. This might make it difficult for the Legislature to evaluate the costs of salary and benefit improvements granted each year. Moreover, legislative proposals which unilaterally change employee wages, benefits, and working conditions could have the effect of undermining the collective negotiations process.