California Legislature

THE 1983-84 BUDGET: PERSPECTIVES AND ISSUES

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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President pro Tempore of the Senate

HON. WILLIE L. BROWN, JR.
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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1983 Budget Act. It seeks to accomplish this purpose by providing (1) *perspectives* on the state's fiscal condition and the budget proposed by the Governor for 1983–84, and (2) identifying some of the major *issues* facing the Legislature in 1983. As such, this document is intended to complement the *Analysis of the Budget Bill,* which contains our traditional item-by-item review of the Governor's Budget.

The *Analysis* continues to report the results of our detailed examination of all programs and activities funded in the Governor's Budget. It also contains our recommendations on the various amounts proposed in the Budget Bill, as well as our recommendations for legislative changes in the statutory provisions governing individual programs and activities. In contrast, this document presents an analytical overview of the state's fiscal condition. The recommendations included herein cut across program or agency lines, and do not necessarily fall under the jurisdiction of a single fiscal subcommittee.

The 1983–84 Budget: Perspectives and Issues is divided into three parts.

Part I, "State Finances in 1983" (blue page), provides a perspective on the state's current fiscal situation, including options for addressing the deficit in the General Fund Budget for 1982–83.

Part I is divided into three sections:

I. *Fiscal Problems Facing the Legislature,* which discusses the state's cash flow and deficit problems, as well as current service level expenditure requirements for 1983–84.

II. *Alternatives for Legislative Action,* which examines options for addressing the current-year budget problem, including options for improving the state's ability to meet its cash needs, strategies for reducing expenditures, and strategies for increasing revenues.

III. *Long-term Fiscal Outlook,* which discusses the state's economic outlook through 1985–86.

Part II, "Perspectives on the 1983–84 Budget" (gold page), presents data on the budget as a whole—expenditures, revenues and the fiscal condition of state and local government—to provide a perspective on the budget issues that the Legislature faces in 1983–84. Part II is divided into five sections:

I. *Overview,* which provides a brief description of the purpose and components of this part;

II. *Expenditures,* which details the total spending plan for the state from all funding sources and highlights the major changes in program activities proposed by the Governor;

III. *Revenues,* which discusses the various sources of income to the state, as well as the economic circumstances that will influence the level of revenues in the current and budget years;

IV. *State and Local Borrowing,* which discusses short-term and long-term government borrowing, both by the state and by local governments; and

V. *The State's Workforce,* which looks at trends in the number of state employees and compares these trends to trends in the state budget.

Part III, "Major Issues Facing the Legislature" (green page), discusses major issues that have been identified in our review of the state's current fiscal condition and the Governor's Budget for 1983–84. Some of these issues involve matters over which the Legislature has little or no control, such as the amount and form of federal aid received by the state, and the cost of providing needed services to refugees who reside in California. In most cases, however, the issues fall well within the Legislature's purview. Wherever possible, our analysis identifies options which the Legislature may wish to consider in addressing these issues. This part is divided into six sections:

I. *Revenue Issues,* which include issues having to do with tax expenditures, the allocation of tidelands oil revenues and the viability of using one-time revenues.

II. *Expenditure Issues,* which include issues dealing with cost-of-living adjustments; statewide legal staff reductions; state block grants proposed by the Governor; federal aid to California; and the state's capital outlay needs.

III. *State Borrowing Issues,* which include issues that arise in connection with short-term and long-term borrowing by the state and its local governments.

IV. *Local Government Finance Issues,* which include issues involving local fiscal relief, the flexibility of local government financing, state mandates, and infrastructure needs at the local level.

V. *Legislative Control of the Budget,* which discusses issues dealing with collective bargaining for state employees, court decisions which have caused the state to incur additional costs or forego anticipated savings, the oversight role of the State Public Works Board, and the need for better information on state revenues, expenditures, and staffing levels.

VI. *Emerging Issues,* which discusses the impact of refugees on California and work for benefit programs.

Part I

STATE FINANCES IN 1983

Fiscal Problems Facing the Legislature

Alternatives For Legislative Action

Long-Term Fiscal Outlook

PART I

STATE FINANCES IN 1983

I. FISCAL PROBLEMS FACING THE LEGISLATURE

A. OVERVIEW

For the third year in a row, the Legislature faces a budget that does not contain sufficient funds to maintain the existing level of services provided to the people of California by the state. In terms of real purchasing power, the proposed level of General Fund expenditures in the budget year is 7.3 percent *lower* than estimated General Fund expenditures in the current year.

Table 1 and Chart 1 provide information on the trend in revenues, expenditures, and the General Fund condition for the last 10 years. As Chart 1 graphically illustrates, if the budget estimates turn out to be accurate, 1983–84 will be the first year since 1977–78 in which state revenues exceed state expenditures. Whether, in fact, these estimates do prove to be accurate will depend largely on three factors: (1) the performance of the state's economy, (2) policy decisions made by the Legislature, and (3) decisions handed down by the courts.

The Governor's Budget projects that General Fund revenues in 1983–84 will be $22.5 billion, and proposes that expenditures be limited to $21.7 billion. The difference—$800 million—would be retained in two reserves: the Reserve for Economic Uncertainties ($650 million) and a reserve for future legislation ($150 million).

The summary schedules contained in the Governor's Budget indicate that given the assumptions and proposals on which the budget is built, the General Fund would end fiscal year 1983–84 with a *surplus* of $4.8 million. This surplus, however, *assumes* that a $1.6 billion deficit in the 1982–83 budget will be eliminated between now and June 30, 1984. This, in turn, requires that either taxes be increased or expenditures reduced by an amount sufficient to produce an additional $1.6 billion. The Governor's Budget, however, proposes neither tax increases nor further expenditure reductions (although it does identify various "options" which might be employed to offset the deficit).

As time passes, it becomes more and more likely that the current year's budget will not be balanced. This is because the potential yield from the options now available to the Legislature will decline steadily as the state draws closer to June 30, 1983. This has significant implications for the Governor's Budget, because in the event that the state ends 1982–83 with a deficit in the General Fund, funds earmarked in the budget to support programs and activities in 1983–84 may have to be used instead to pay off the carry-over deficit.

In addition to the assumption regarding the current-year deficit, the budget for 1983–84 reflects a number of other critical assumptions. Specifically, it assumes that:

- The state's economy will improve, beginning in the first quarter of 1983, and that the pace of economic activity will accelerate throughout the year.
- The Legislature will approve a number of significant reductions in the level of services currently provided under various state programs.

Table 1
Trend in General Fund Unrestricted Surplus
1974–75 through 1983–84
(in millions)

	1974–75	*1975–76*	*1976–77*	*1977–78*	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*1982–83* [a]	*1983–84*
Prior-year resources	$358.3	$660.1	$808.8	$1,818.2	$3,886.9	$2,905.5	$2,540.7	$737.4	–$60.7 [a]	–$1,627.9
Adjustments to prior-year resources	24.7	36.0	95.8	59.3	50.9	184.7	222.1	—	—	—
Prior year resources, adjusted	$383.0	$696.1	$904.6	$1,877.5	$3,937.8	$3,090.2	$2,762.8	$737.4	–$60.7	–$1,627.9
Revenues and transfers	$8,617.3	$9,612.8	$11,380.6	$13,695.0	$15,218.5	$17,984.6	$19,023.1	$20,960.3	$20,489.7	22,479.4
Expenditures (–)	8,340.2	9.500.1	10,467.1	11,685.6	16,250.8	18,534.1	21,104.9	21,758.4 [b]	22,056.9	21,677.0
(Expenditures from reserves)	(–72.8)	(–28.4)	(28.0)	(95.8)	(24.6)	(317.5)	(–210.8)	(–274.2)	(–51.9)	(–2.4)
(Current expenditures)	($8,267.4)	($9,471.7)	($10,495.1)	($11,781.4)	($16,275.4)	($18,851.6)	($20,894.1)	($21,418.6)	($22,005.0)	($21,674.6)
(Annual surplus or deficit)	(349.9)	(141.1)	(885.5)	(1,913.6)	(–1,056.9)	(–867.0)	(–1,871.0)	(–523.9)	(–1,515.0)	(804.8)
Carry-over reserves (–)	105.4	77.0	105.0	200.8	225.3	542.8	332.0	57.8	5.9	3.5
Reserve for economic uncertainties	—	—	—	—	—	—	349.0	—	—	(550.0) [d]
Reserve for future legislation	—	—	—	—	—	—	—	—	—	150.0
Reserve for Los Angeles County Grant Account	—	—	—	—	—	—	—	—	—	100.0
Year-End Surplus/Deficit	$554.7	$731.8	$1,713.1	$3,686.1	$2,680.2	$1,997.9	$349.0	–$118.5 [b]	–$1,633.8 [c]	–$1,079.0

[a] Estimated expenditures for 1982–83 do not reflect the 2 percent unallotment directed by Executive Order D-1-83.
[b] Reflects 3rd District Court of Appeals decision in *Valdez vs. Cory* invalidating reallocation of $177.1 million to the General Fund.
[c] Governor's Budget assumes that legislative actions will produce the $1,634 million needed to balance the 1982–83 budget.
[d] Amount of uncommitted resources identified in Governor's Budget. Table 1 assumes these funds are used to reduce 1983–84 deficit to $1,079 million. Amount shown for information purposes only.

Table 2
Summary of General Fund Condition
1982–83 and 1983–84
(in millions)

	1982–83	*1983–84*
Funds Available, Start of Year:		
Prior Year Resources Available	–$118.5	–$1,627.9
Reserve for Economic Uncertainties	—	—
Revenues and Transfers	20,489.7	22,479.4
Current Expenditures	22,005.0	21,674.6
(Difference)	(–1,515.3)	(804.8)
Reserve for Future Legislation	—	150.0
Reserve for Los Angeles County Grant Account	—	100.0
Funds Available, End of Year:		
Reserve for Economic Uncertainties	—	(550.0) [a]
General Fund Surplus or Deficit	–$1,633.8	–$1,079.0

[a] Amount of uncommitted resources identified in Governor's Budget. Table 2 assumes these funds are used to reduce the 1983–84 deficit to $1,079.0 million. Amount shown for information purposes only.

As Table 2 indicates, estimated expenditures in 1982–83 are $1.5 billion greater than estimated resources available in the current year. Thus, unless actions are taken by the Legislature prior to June 30, 1983, or the economy (and hence revenues) performs better than anticipated, the state will end 1982–83 with a deficit of approximately $1.6 billion.

Causes of the Deficit in the Current Year

At the time the Legislature acted on the budget for 1982–83, the Department of Finance estimated that the General Fund would end the 1981–82 fiscal year with $228 million in the Reserve for Economic Uncertainties. As passed by the Legislature, the Budget Act for 1982 would have increased that reserve by $328 million, bringing the total to $556 million.

Table 3
Factors Causing the Deterioration in the State's Fiscal Condition
1982–83
(in millions)

Cause	*Amount*	*Percent of Total*
Economic factors	$1,409	64.3%
Court decisions	431	19.7
Increased workload	343	15.7
New legislation	90	4.1
All other factors	–83	–3.8
Total Change	$2,190	100.0%
Reserve for Economic Uncertainties	–556	
Budget Deficit	$1,634	

As Table 3 demonstrates, the *change* in the General Fund condition since the budget was enacted amounts to a decline of –$2,190 million. The factors contributing to this decline can be divided into five categories, as shown in Table 3. These include:

- ***Economic Factors (64 percent).*** Economic factors include revenue shortfalls ($1.4 billion) and other adjustments to revenues.
- ***Court Decisions (20 percent).*** Primary among these are the overturn of (a) the 6 percent cap on the increase in reimbursements to

hospitals for in-patient services under Medi-Cal ($176 million), and (b) the reallocation of $177.1 million from the Public Employees Retirement System to the General Fund.

- ***Increased Workload (16 percent).*** This consists primarily of deficiencies in Medi-Cal ($90 million) and the state's failure to achieve $150 million in unidentified savings.
- ***New Legislation (4 percent).*** This consists of the General Fund cost of legislation passed after the enactment of the 1982 Budget Bill.
- ***All Other (−4 percent).*** This category consists primarily of small expenditure and accrual adjustments, and adjustments in carry-over reserves.

The Department of Finance estimates that the reduction in the amount of funds carried forward from 1981–82 into 1982–83, coupled with the decline in estimated revenues and the increase in expenditures, results in an estimated *deficit* of $1,457 million on June 30, 1983. The PERS court decision increases this deficit to $1,633.8 million. This figure is, of course, only an *estimate* of the deficit, and will be revised once the State Controller issues his final report on fiscal year 1982–83. The Department of Finance also has identified $15 million in *likely* budget changes and $217 million in *potential* budget changes, which, if they materialize, would increase the deficit to $1,856 million as of June 30, 1983.

To make up this deficit, the Governor's Budget proposes a two-phase approach. The first includes transfers of special funds to the General Fund, deferments, and expenditure reductions of approximately $750 million to be accomplished in 1982–83. This would have the effect of rolling-over slightly more than one-half of the current year deficit, or about $884 million, into the budget year. The Governor proposes to then take further actions to balance the budget after the May revision.

Governor's Proposals with Regard to the Deficit

The Governor's Budget for 1983–84 was prepared on the assumption that the 1982–83 deficit would be eliminated by legislative action in the special session called in December. Because the deficit was not eliminated in the special session, the Governor's Budget, as submitted to the Legislature, is not viable. The budget acknowledges this, and lists options for reducing expenditures in both the current and budget years. This two-phase program calls for the projected $1.6 billion deficit to be eliminated by *June 30, 1984,* the end of the budget year. Phase 1 of the program initially consisted of a package of spending cuts, spending deferrals, funding shifts, and borrowing from special funds that would reduce 1982–83 expenditures by approximately $750 million. Phase 2 was not spelled out in the budget document. Instead, the budget listed a series of potential changes in the *administration's* proposals that could be made in order to reduce 1983–84 expenditures by $750 million.

General Fund Condition If No Action is Taken on 1982–83 Deficit. As noted earlier, the Governor's Budget estimates that the General Fund will end the current year with a deficit of $1,456.7 million, unless further action is taken by the Legislature. The Appeals Court decision invalidating the transfer of PERS funds to the General Fund increases the estimated deficit to $1,633.8 million. If no action is taken between now and June 30, 1984, either to increase revenues or to reduce expenditures below the levels proposed in the 1983–84 budget, the state would end 1983–84 with a deficit in the General Fund of approximately $1.1 billion, as shown in Table 1. This assumes that $550 million in the Reserve for Economic Uncertainties is used to reduce the size of the deficit. Although the budget states that $650 million would be available in the reserve for this pupose, $100 million of this amount is reserved by statute for the Los Angeles County Medi-Cal Assistance Grant Account, and as such, cannot be used to finance obligations of the state's General Fund.

General Fund Condition if the 1982–83 Budget is Balanced. If the Legislature acts to bring the 1982–83 budget into balance, the Governor's Budget could be enacted as proposed, leaving a nominal General Fund surplus of $4.8 million on June 30, 1984. This would be in *addition* to the $550 million in the Reserve for Economic Uncertainties.

C. CASH FLOW PROBLEMS—CURRENT YEAR AND BUDGET YEAR

Because of differences between when the state collects its revenues and when it must pay its bills, the state often finds itself without enough cash in the General Fund to cover the checks which must be drawn against it. When this happens, the Controller typically "borrows" temporarily idle money from the state's special funds in order to meet the General Fund's cash requirements. There is nothing unusual about this. In fact, such borrowing is usually anticipated at the time the Governor submits his budget to the Legislature.

Borrowing Sources

Under existing practices, when General Fund cash needs exceed existing resources, the balance is borrowed from other sources, according to the following priority sequence:

1. Reserve for Economic Uncertainties,
2. Pooled Money Investment Account (PMIA)—interest-free special funds,
3. Pooled Money Investment Account—interest-bearing funds, and
4. External sources.

1982–83 Cash Requirements

In the current year the amount that can be borrowed from special funds is not sufficient to meet General Fund cash requirements at those points in time when outflow significantly exceeds inflow. The last time the state was not able to meet its cash needs by borrowing from internal sources was in 1971–72, just prior to the adoption of income tax withholding. In response, the state issued revenue anticipation notes, a form of external borrowing secured by revenues not yet received.

Private Borrowing. In November 1982, the State Controller borrowed $400 million from the private sector to provide the funds needed to meet the General Fund's cash needs. Half of this amount must be repaid by February 22, 1983, and the remainder must be repaid by June 22, 1983. The Controller has estimated the *administrative* costs of borrowing these funds at $1.5 million. The cost of *interest* on the borrowed money is $8.1 million.

Due to the economy's failure to perform as expected and the resulting impact on General Fund revenues, the State Controller informed the Legislature in January that the state will have to borrow an *additional* $943 million from the private sector if no legislative action is taken to balance the current year's budget. This is the amount of cash necessary to cover payments through the end of the fiscal year without having to resort to the issuance of registered warrants (a warrant issued by the state in payment of obligations which cannot be cashed until funds become available). Of this amount, the state would need to borrow $718 million in March, and an additional $225 million in May.

If it becomes necessary to borrow these funds, the state will end the fiscal year with $300 million of outstanding external loans. If reductions totaling $750 million are made in current year expenditures (as the Governor initially proposed in Phase 1), the Department of Finance estimates that the state's cash needs would be reduced by some $250 million. Under these circumstances, the state could repay all but $50 million of this external borrowing by June 30, 1983.

1983–84 Cash Flow Situation

Even if actions are taken to balance the current year's budget by June 30, 1984, the Department of Finance estimates that the General Fund's cash needs will still exceed revenues for four of the first five months in 1983–84. The peak borrowing during this period will occur in August when the General Fund will have cash needs that are $700 million in excess of internal borrowing resources. Thus, to meet General Fund cash requirements in July, August, October, and November, the state again will be forced to borrow significantly from external sources.

Loan Interest

As we note in Item 9620 of the *Analysis* (Interest on General Fund Loans), the Governor's Budget proposes $1 million for payment of interest on General Fund loans that may be outstanding in the budget year. If the current estimate of General Fund borrowing needs remains constant, our analysis indicates that the interest costs on General Fund loans will be roughly comparable to the $53 million in costs incurred during 1982–83. This is $52 million more than the amount budgeted for 1983–84.

State's Credit Rating

In addition to the problems and costs associated with borrowing funds from external sources, the state's failure to come to grips with the deficit in the current year's budget caused one bond-rating firm to reduce the state's credit rating from "AA plus" to "AA." According to the State Controller, this rating will result in *additional* annual interest costs of approximately $3 million per year for every $100 million in bonds sold. The actual cost to the state, if any, resulting from the lower credit rating cannot be determined until the state's next bond sale.

D. CURRENT SERVICE LEVEL EXPENDITURE REQUIREMENTS

The Governor's Budget proposes General Fund expenditures of $21,677 million for 1983–84. This total amount reflects significant reductions in programs and funding relative to the *amount* necessary for the state to continue to provide the same level of service as it is providing in 1982–83—the "current service level." Our analysis indicates that the amount needed from the General Fund to finance a "current service level" budget is $23.2 billion, which is $1.5 billion, or 7.0 percent, more than the amount that the Governor proposes to spend.

The Governor's Budget, of course, does not simply fund each program at 93 percent of its current service level. The level of funding relative to the current service level varies for individual programs, depending upon the administration's priorities. Thus, the Governor's Budget proposes increases, as well as decreases, in funding, relative to the current service level. The net difference between our estimate of current service requirements in 1983–84 and the level of expenditures proposed for that year in the budget reflects the net impact of these increases and decreases (as well as various technical factors).

The $1.5 billion difference, however, does not reflect the impact of policy change proposals which would allow the state to provide the same level of service at a lower cost to the General Fund. For example, the Governor proposes significant increases in the fees charged students at the University of California, California State University, and the California Community Colleges. If these increases are approved, the reduction in service level resulting from enactment of the Governor's Budget would be considerably less than the $1.5 billion noted above, because the students themselves would pick up part of the cost of maintaining current services. (There would, however, be some reduction in services as a result of substituting student fees for General Fund support, since enrollment would decline in the three segments as a result of the fee increase.) If the fee proposal is approved by the Legislature, the cost to the state of maintaining current services would be approximately $1.3 billion, rather than $1.5 billion, more than the level of expenditures proposed in the Governor's Budget for 1983–84.

Methodology and Assumptions

The calculation of a current service level budget begins with a baseline 1982–83 expenditure figure for each department and agency. The baseline budget represents *total* expenditures, adjusted for one-time increases or decreases in funding, expired programs, and similar factors. To that baseline must be added 1983–84 costs associated with legislation passed in 1982–83, the budget-year costs of court decisions handed down in 1982–83, the costs associated with increased workload, increases needed to maintain the purchasing power of 1982–83 funding levels in 1983–84 and other non-policy adjustments. In making these calculations and adjustments, we have sought to approximate the amounts necessary to provide the citizens of California with the same level of service in 1983–84 that the state is providing in the current year. Consequently, the current service level budget calculations do not reflect *new program* proposals included in the Governor's Budget.

The current service level budget is based on a number of significant assumptions:

- All programs will be continued in the budget year at the same level of service, unless otherwise specified by *existing* law.
- Workload levels are calculated using workload estimates reflected in the Governor's Budget, whenever possible.
- Statutory cost-of-living increases are calculated at levels prescribed by current law.
- Discretionary cost-of-living increases are calculated at 5 percent.
- No adjustment is made for proposed shifts in funding sources (such as the proposal to increase student fees in higher education).

Comparison of the Governor's Budget Proposals With Current Service Level Requirements

As Table 4 shows, the level of expenditures proposed in the Governor's Budget is $1,515 million below the amount necessary for a current service level budget.

Table 4
Comparison of Governor's 1983–84 General Fund Budget Proposals With Current Service Level Requirements
(in millions)

	Governor's Budget (Proposed Expenditures)	*Current Service Level Requirements*	*Additional Amount Needed to Fund Current Service Level*
Health	$4,186	$4,356	$170
Welfare	2,717	3,081	378
Education:			
K–12	7,950	8,328	374
Higher Education	3,124	3,400	276
Resources	281	316	35
Youth and Adult Correctional	847	856	9
Tax Relief	1,390	1,418	28
All Other	1,182	1,447	265
Total	$21,677	$23,192	$1,515

Health. The Governor's Budget proposes General Fund expenditures of $4,186 million for health programs in 1983–84. This is *$170 million below* the amount required to maintain the current level of services in the budget year. This difference reflects (1) policy changes in numerous individual health programs, (2) cost-of-living adjustments (COLAs) that are less than statutory levels, and (3) discretionary COLAs of 3 percent, rather than the 5 percent that we assume is necessary to maintain purchasing power.

Specifically, the Governor's proposed expenditures for the Department of Mental Health, the Department of Developmental Services, public health local assistance programs, and the Department of Health Services (support), are $37 million below the funding level necessary to maintain the current level of service, primarily due to COLAs being limited to 3 percent rather than to 5 percent. The Governor's Budget proposes expenditures for Medi-Cal which are actually $69 million higher than the amount necessary to maintain the current level of service. This is because (1) the budget overestimates reductions in federal funds (−$94 million), (2) the budget does not reflect additional savings resulting from Ch 328/82 (AB 799) (−$13 million), (3) proposed COLAs are below statutory levels ($22 million), (4) discretionary COLAs are limited to 3 percent rather than to 5 percent ($16 million), and (5) other policy changes. (For a more detailed explanation, see Item 4260 of the *Analysis.*)

Finally, the Governor's Budget proposes expenditures for County Health Services which are $179 million below the amount needed to maintain the current level of services. This is primarily due to the fact that $100 million needed to repay a loan to Los Angeles County is not reflected as an expenditure in this item. Instead, the budget has included this $100 million in the Reserve for Economic Uncertainties. (See our analysis of reserves in Part II of this volume.)

Welfare. The Governor's Budget proposes General Fund expenditures of $2,717 million for welfare programs in 1983–84. This is *$364 million less* than the amount required to maintain the existing level of service. The shortfall is due primarily to the Governor's proposal that cost-of-living increases for SSI/SSP recipients be funded at less than the statutorily mandated levels and that AFDC recipients be given *no* COLA ($258 million). In addition, the Governor's Budget has proposed changes in the state/county sharing ratio under the foster care program, a change in the beginning date of cash grant assistance, and the establishment of a welfare fraud detection program. The budget estimates that these three policy changes will reduce General Fund expenditures by $90.5 million.

K–12 Education. The Governor's Budget proposes General Fund expenditures of $7,950 million for K–12 education in 1983–84, which is *$348 million less* than the amount required to fund the current level of services. This difference is primarily a result of (1) cost-of-living increases being proposed at less than the statutory levels ($270 million) and (2) the budget's failure to include funds for legislation passed in 1982–83 ($102 million). The primary components of this legislation are Ch 1498/82 (library fund), Ch 1619/82 (desegregation programs) and Ch 410/82 (State School Building Lease Purchase Bond Law).

Higher Education. The Governor's Budget proposes General Fund expenditures for higher education of $3,124 million. This is *$276 million less* than the amount required to maintain the current level of service if consideration is not given to the proposed increase in student fees. This reflects (1) the absence of funding for cost-of-living increases to California Community Colleges apportionments ($72 million), (2) the proposed elimination of state funding for the summer quarter at California State University ($14 million), and (3) the proposal to increase student charges at the University of California, California State University and the California Community Colleges in order to replace General Fund support ($198 million).

Resources. The Governor's Budget proposes $281 million in General Fund expenditures for resources programs in 1983–84, which is *$35 million less* than the amount needed to continue the current level of service. This difference is due primarily to reductions in various programs, including those administered by the California Energy Commission ($10 million), Air Resources Board ($5 million), California Conservation Corps ($3 million), and the California Water Management Board ($3 million).

Youth and Adult Correctional. The Governor's Budget proposes General Fund expenditures of $846.6 million for Youth and Adult Correctional programs. This is *$9.0 million below* current service level requirements as shown in Table 4. However, because the Governor's Budget is predicated on the assumption that the Department of Corrections can operate a Youth Authority facility at reduced costs, the budget does not acknowledge any reduction below current service levels in this functional area.

Tax Relief. The Governor's General Fund tax relief proposal is *$28 million less* than the amount required to maintain current levels of service. The difference results from (1) the proposal that funding not be provided for a statutory cost-of-living increase in Business Inventory Tax Relief ($32 million) and (2) an overestimate of workload in various other tax relief programs (−$4 million).

All Other. Included within the "all other" category are General Fund expenditures proposed for the legislative, judicial and executive branches; departments in the Business, Transportation, and Housing Agency; State and Consumer Services Agency; constitutionally appropriated items, such as debt service; and all other general government items. While many of these programs are special fund items, $1,182 million, or 5.4 percent of the Governor's proposed General Fund expenditures are included in this category.

The Governor's Budget proposes General Fund expenditures of $1,182 million for the maintenance of these programs. This is *$265 million less* than the amount required to maintain the current level of service. This difference is the result of reductions in (1) attorney positions throughout the budget ($12 million), (2) staffing for the Department of Industrial Relations ($8 million), and (3) staffing for the State Public Defender ($4 million). In addition, the Governor's Budget is predicated on the achievement of $260 million in *unidentified* savings for 1983–84. This reflects the Governor's estimate of savings to be achieved by the proposed private sector task force on efficiencies and economies ($200 million), as well as the unidentified savings historically reflected in the budget ($60 million). Finally, as we explain in our analysis of Item 9620-001-001 (Payment of Interest on General Fund Loans), the Governor's Budget proposes only $1 million for payment of interest on General Fund loans. This is significantly below anticipated expenditures for this item, which we estimate will be comparable to interest payments for current-year borrowing of $53 million.

Conclusion. Taking into account the factors discussed above, we estimate that proposed General Fund expenditures in the Governor's Budget are *$1,515 million below* what would be needed to maintain the current level of services provided by state programs that are financed from the General Fund. This difference primarily results from:

- Proposed cost-of-living adjustments below statutorily mandated levels,
- Proposed reductions in the level of service provided by specific state programs,
- Proposed policy changes regarding the nature and funding of services that would continue to be provided, and
- The budget's reliance on $260 million in unidentified savings.

II. ALTERNATIVES FOR LEGISLATIVE ACTION

A. IMPROVING THE STATE'S ABILITY TO MEET ITS CASH NEEDS

Cash Management

As discussed earlier, the collection of state revenues does not always match the timing of expenditures. Due to the scheduling of specific revenue collections, collections in one month may be significantly greater than collections in the next. For example, revenue collections in November 1982 exceeded collections for October 1982 by nearly $1.1 billion. Differences such as these result largely from statutory provisions regarding the due dates for personal income tax withholding payments, sales and use tax prepayments, and bank and corporation tax prepayments. Similarly, disbursements may vary by as much as $1 billion, on a month to month basis.

The Governor's Budget takes note of this imbalance in the flow of revenues and disbursements, and proposes to reduce the state's cash management problem by changing the timing of specific expenditure payments and revenue collections.

Specifically, the Governor's Budget proposes three changes in the scheduling of disbursements and revenue collections. These changes are as follows:

- ***Personal Property Tax Subventions.*** Under current law, these subventions are paid to counties in *one* lump sum on November 15 of each year. This payment is estimated to be $511.6 million in the budget year. Under the Governor's proposal, these subventions would be paid on a *monthly* basis in 12 equal disbursements of $42.6 million.
- ***Sales Tax.*** Under current law, business establishments with sales of over $17,000 a month are required, in the *second quarter* of the calendar year, to prepay two and one-half months of their quarterly liability. The Governor's proposal would extend this prepayment requirement to *all quarters* of the year.
- ***Motor Vehicle Fuel Tax and Use Fuel Tax.*** Under current law, these tax payments are required to be made one month and one day after the distribution of fuel by wholesalers. The Governor's proposal would accelerate these payments, requiring them to be made 15 days after the distribution of fuel by wholesalers.

Our analysis indicates that these proposals would ease the cash flow problems that we have described earlier, and *we recommend approval.* We further recommend that the Legislature consider adjustments to the payment schedule for K–12 apportionments so that these disbursements, which are estimated at $7.3 billion for 1983–84, will more closely match the timing of state revenue collections.

External Borrowing Procedures

Under existing law, legislative approval (two-thirds vote) of a new statute would be needed before the State Treasurer could issue conventional tax anticipation notes. The Controller, however, now has statutory authority to issue *unsecured* notes and warrants.

To meet the cash deficit in the current year, the Controller thus far has issued $400 million in "revenue anticipation warrants." Because these warrants do not carry the full faith and credit of the state, it was necessary for the state to have, in effect, a co-signer for the notes. The administrative costs associated with the sale are estimated by the Controller to be at least $1.5 million, including approximately $614,000 paid as a fee to the Public Employees Retirement System for providing the additional security needed to market the notes.

We believe that there are two problems with current law as it applies to short-term external borrowing for the purpose of meeting cash-flow needs:

- First, the State Treasurer, rather than the State Controller, probably should be the official who undertakes any such borrowing, since staff of the Treasurer's office have more day-to-day experience in borrowing activities than do staff of the Controller's office; and
- Second, a more flexible process is needed for enabling the state to issue conventional short-term debt in order to manage temporary cash-flow imbalances.

One means for addressing these problems would be to enact legislation permitting the Treasurer to sell conventional short-term notes for cash-flow management purposes. We discuss this option in Part III of this document.

B. STRATEGIES FOR REDUCING EXPENDITURES

During the past two fiscal years, the downturn in the economy and various other factors have necessitated reductions in the level of state General Fund expenditures, as well as the adoption of various revenue enhancements such as tax accelerations and General Fund transfers from special funds.

In this section, we briefly discuss some of the strategies that could be used to reduce expenditures, in the event the Legislature concludes that expenditures are too high. The next ensuing section discusses strategies for enhancing revenues.

Cost-of-Living Increases

One way in which expenditures can be lowered is through the reduction or elimination of cost of living adjustments (COLAs).

Existing law specifies that many programs are to receive COLAs each year, based either on an index of inflation or a specific estimate of what percentage increase will be needed to maintain purchasing power. Other programs traditionally have received COLAs through the Budget Act. In general, the purpose of cost-of-living adjustments is to maintain the purchasing power of program beneficiaries over time. To the extent that COLAs are reduced significantly below the rate at which the prices that must be paid by these beneficiaries are rising, the program or service level will have to be reduced, unless productivity improvements or other such savings can be made.

If fully funded, *statutory* COLAs would increase General Fund expenditures in 1983–84 by $1.1 billion above the 1982–83 level. The Governor's Budget, however, proposes to fund COLAs for some programs at less than the statutory maximum and to provide discretionary COLAs for selected other programs. The Governor's proposal is discussed in more detail in Part III of this volume.

Eliminating funding for COLAs was one method used by the Legislature to reduce General Fund expenditures in 1982–83. By withholding COLAs from most programs, the Legislature saved $1.4 billion, compared to the amounts proposed in the Governor's Budget for 1982–83.

Elimination of all COLAs proposed by the Governor in 1983–84 would reduce General Fund expenditures by $925.7 million, or 4.3 percent from the level proposed. In some cases, statutory changes outside the Budget Act would be necessary in order to reduce statutory COLAs below what existing law specifies. In other cases, federal law may limit the state's ability to withhold COLAs. The largest portion of the reduction, $543.9 million, would occur in the proposed budget for K–12 education.

Across-the-Board Reductions

Within the past two fiscal years, a number of across-the-board reductions have been implemented in order to reduce General Fund expenditures. In 1981–82, an Executive Order required a 2 percent across-the-board reduction in most state operations. This order resulted in a savings of approximately $68 million to the General Fund. These reductions subsequently were restored in the proposed 1982–83 budget.

Although the payoffs from these alternatives are not always immediate, these options may offer the potential for cost savings and expenditure reductions. As such, they merit further study.

C. STRATEGIES FOR INCREASING REVENUES

Currently, the Legislature has the dual problem of (1) eliminating a projected $1.5 billion General Fund deficit in the current year and (2) assuming that sufficient funds are available in the budget year to meet the needs of the state.

Most of the strategies employed in the Governor's Budget for balancing the budget and funding high-priority needs involve reductions in expenditures. The Legislature, however, should also consider the revenue side of the state's budgetary equation in developing its strategy for accomplishing these objectives.

If the Legislature concludes that temporary increases in General Fund revenues are needed, there are several alternative means for obtaining the additional revenues: (1) increase rates on existing taxes, (2) impose new taxes, and (3) accelerate the payment of existing taxes. We briefly describe below some alternatives in each of these three areas. Table 5 summarizes the fiscal effect of each alternative.

Increase Rates on Existing Taxes

The simplest administrative method for raising additional revenue is to increase the rates on *existing* taxes. A rate increase applied to any of the state's three major taxes—sales and use tax, personal income tax, and the tax on banks and corporations—would, of course, generate the largest amounts of new revenue. For instance:

- A one-time 10 percent surtax on 1983 taxable personal income would raise approximately $900 million ($225 million in 1982–83 and $675 million in 1983–84).

Table 5
Potential General Fund Revenue Sources
1982–83 and 1983–84
(in millions)

	Effective Period	*General Fund Revenue Gain* 1982–83	1983–84
Increasing Rates on Existing Taxes			
Personal income tax: 10% surtax	1983 tax year	$225	$675
Corporate income tax: 10% surtax	Income years ending in 1983	60	190
Sales tax: 1 cent increase	April 1, 1983–June 30, 1984	265	1,750
Alcoholic beverages: industrial state average	April 1, 1983–June 30, 1984	41	200
Cigarettes: industrial state average	April 1, 1983–June 30, 1984	46	225
New Taxes			
Severance tax	April 1, 1983 and thereafter	65	400
Accelerations			
Sales tax: prepayments	April 1, 1983 and thereafter	35	5
Personal income tax: withholding payments	April 1, 1983 and thereafter	38	5
Corporate income tax: prepayments	April 1, 1983 and thereafter	23	5
Repeal corporate letter refunds	April 1, 1983 and thereafter	14	[a]
Increase interest rate on late taxes	April 1, 1983 and thereafter	16	[a]
Totals		$828	$3,455

[a] Unknown.

- A one-time 10 percent surtax on 1983 bank and corporate income would raise approximately $250 million ($60 million in 1982–83 and $190 million in 1983–84).
- A 1 cent increase in the state sales tax rate from April 1983 through June 1984 would generate $265 million in 1982–83 and approximately $1.8 billion in 1983–84.

In addition to these major taxes, the state could increase the rates on excise taxes currently levied on such products as cigarettes and alcoholic beverages. For example, if California raised its tax rates to the average rates levied by other large industrial states, the state in 1983–84 would raise approximately $225 million in additional cigarette tax monies (assuming that all of the additional taxes went to the state), and $200 million in additional alcoholic beverage tax monies. It should be noted that, contrary to some assertions, increased excise taxes on these products would *not* place California manufacturers or distributors at a disadvantage relative to out-of-state competitors because these competitors would also be affected by the increased excise taxes.

New Taxes

The Legislature could also raise additional revenues by imposing *new* taxes. One such tax that already has been considered by the Legislature is a severance tax on oil. A severance tax levied at the rate of 6 percent on oil as it is removed from the ground would generate about $400 million in 1983–84.

Of course, the Legislature could levy new taxes on a number of items. For instance, it could tax tobacco goods (other than cigarettes) or certain luxury items (jewels, furs, etc.). The revenue, however, from taxing specific goods such as these would be small when compared to the funds that would be raised by a severance tax.

The major disadvantage of imposing a new tax is the administrative costs which must be incurred in collecting it.

Acceleration of Tax Payments

Finally, the Legislature can increase the amount of state revenues collected on a *one-time basis* by accelerating the payment of *existing* tax liabilities. For example, the state could increase 1982–83 revenues by having taxpayers make tax payments in 1982–83 that would otherwise have been paid in 1983–84. Each of the following accelerations has already been considered by the Legislature, but had not been enacted at the time this document was prepared:

- ***Sales Tax Prepayments.*** By raising from 90 percent to 95 percent the level of June sales tax liability due in that month, the state would increase 1982–83 revenues by about $35 million.
- ***Personal Income Tax Withholding.*** By subjecting additional employees to monthly, as opposed to quarterly, remittance of employer withholding payments, the state would increase 1982–83 revenues by approximately $38 million.
- ***Corporate Income Tax Prepayments.*** By conforming with federal law on the prepayment of state corporate income taxes, the state would increase current-year revenues by $23 million.
- ***Corporate Letter Refunds.*** By repealing provisions of state law per-

mitting corporations to receive tax refunds prior to filing final returns, the state would increase current-year revenues by $14 million.

- ***Increase Interest Rate on Late Tax Payments.*** By conforming to provisions of federal law regarding the determination of the interest owed on late tax payments, the state could raise $16 million in 1982–83. Gains or losses could result in subsequent years.

III. THE LONG-TERM FISCAL OUTLOOK

The overall condition of the General Fund *beyond* the budget year will depend upon three factors—future levels of state spending, future levels of state income (that is, revenues plus transfers), and the level of any carry-over surplus (or deficit) from 1983–84. If the General Fund is in balance at year-end 1983–84, the condition of the General Fund in subsequent years will be determined by the difference between rates of expenditure growth and income growth. Since the amount of state spending is ultimately limited by the amount of money the state has available to finance such spending, the long-term outlook for the General Fund can best be illustrated by considering what level of revenues the state can expect to collect in the future. This level of revenues, of course, will depend in part on actions taken by the Legislature in the future. The most important factor determining revenues in future years, however, will be the path taken by the economy and the underlying revenue growth trend that it produces under the state's current tax laws.

Obviously, it is not possible to predict economic performance beyond the next 18 months with any confidence. Indeed, no economist can say with *any* certainty at all what will happen to such key economic variables as interest rates, inflation, unemployment and corporate profits beyond the next several quarters (if that). This is especially true, given that not even governmental officials know at this time what future courses monetary and fiscal policies will take.

We can, however, offer an *illustration* of what the condition of the General Fund might be like in future years, *assuming* that the department's standard budget forecast of a moderate, sustained recovery in 1983 and 1984 carries forward into 1985 and 1986. This extrapolation suggests that revenues could reach approximately $24.7 billion (a growth of $2.3 billion, or about 10 percent) in 1984–85 and $27.6 billion (a growth of $2.9 billion, or 12 percent) in 1985–86. This is consistent with our view that, on an ongoing basis, the state's existing tax structure can be expected to generate revenue growth at least equal to and generally slightly more than state personal income growth.

This revenue growth would permit state General Fund expenditures to rise by almost 14 percent in 1984–85 over the level of 1983–84 expenditures proposed in the budget, *assuming that* the General Fund is in balance at year-end 1983–84, and that a Reserve for Economic Uncertainties equal to $650 million is maintained. Otherwise, some of the projected revenues will be needed to balance the 1983–84 budget and/or replenish the Reserve for Economic Uncertainties, leaving a smaller amount of new revenues available to fund increases in expenditures.

The level of 1983–84 expenditures proposed in the budget, however, is less than the level of "baseline" expenditures—that is, expenditures necessary to fully fund the state's programs at current year service levels. We estimate that, in order to fund these "baseline" or current service level requirements, some $23.3 billion in resources would be needed in 1983–84.

Relative to *this* level of spending, the resources available in 1984–85 would only permit a growth of 6 percent in baseline expenditures in that year. After 1984–85, however, the state's basic revenue structure could finance fairly significant levels of growth in expenditures.

Part II

PERSPECTIVES ON THE 1983–84 BUDGET

Overview

Expenditures

Revenues

State and Local Borrowing

The State's Workforce

PART II

PERSPECTIVES ON THE 1983–84 BUDGET

I. OVERVIEW

This part of our analysis provides perspectives on the Governor's Budget for 1983–84. It consists of four major sections, as follows:

- ***Expenditures.*** This section provides an overview of the expenditure side of the state's budget. It discusses the level of proposed expenditures, the major components of the budget, and the major program changes proposed in the budget.
- ***Revenues.*** This section provides a perspective on the state's economy in 1983 and the outlook for the economy in future years. It also includes an analysis of revenue collections in the prior, current, and budget years, and discusses how these revenue collections would be affected by alternative assumptions about economic growth.
- ***State and Local Borrowing.*** This section focuses on the types and volume of borrowing being done by the state and local governments, and the conditions which influence state and local borrowing.
- ***The State's Workforce.*** This section analyzes the reasons for changes in the state workforce since 1977–78.

II. EXPENDITURES

A. TOTAL STATE SPENDING PLAN

The Governor's Budget for 1983–84 proposes total expenditures of $45 billion. This amount includes:

- $21.7 billion in expenditures from the General Fund. Of this amount, $4.5 billion is for state operations and $17.0 billion is for local assistance. Of this latter amount, $6.1 billion is for direct aid to individuals and $10.9 billion is for aid to local governments;
- $3.5 billion in expenditures from special funds;
- $0.6 billion in expenditures from selected bond funds;
- $11.1 billion in expenditures from federal funds; and
- $8.2 billion in expenditures from various "nongovernmental cost" funds, including funds established for retirement, working capital, revolving, public service enterprise, and other purposes. Adding these components together, the total state spending program proposed for 1983–84 is $45.0 billion.

Table 6 and Chart 2 present the principal categories of the state spending plan in 1981–82, 1982–83 and 1983–84.

Governmental Expenditures

The budget proposes expenditures from governmental funds—that is, total expenditures less nongovernmental cost funds—amounting to $36.8 billion in 1983–84. This represents a 3.3 percent *decrease* from the current year level, reflecting (1) decreases in General Fund expenditures of $380 million, (2) decreases in special fund expenditures of $78 million, and (3) decreases in federal aid to California of $785 million.

Using this measure of the budget, the state will spend at the annual rate of $1,457 for every man, woman, and child in California, or $101 million per day, during 1983–84.

Chart 2

Total State Spending 1981–82 through 1983–84

(in billions)

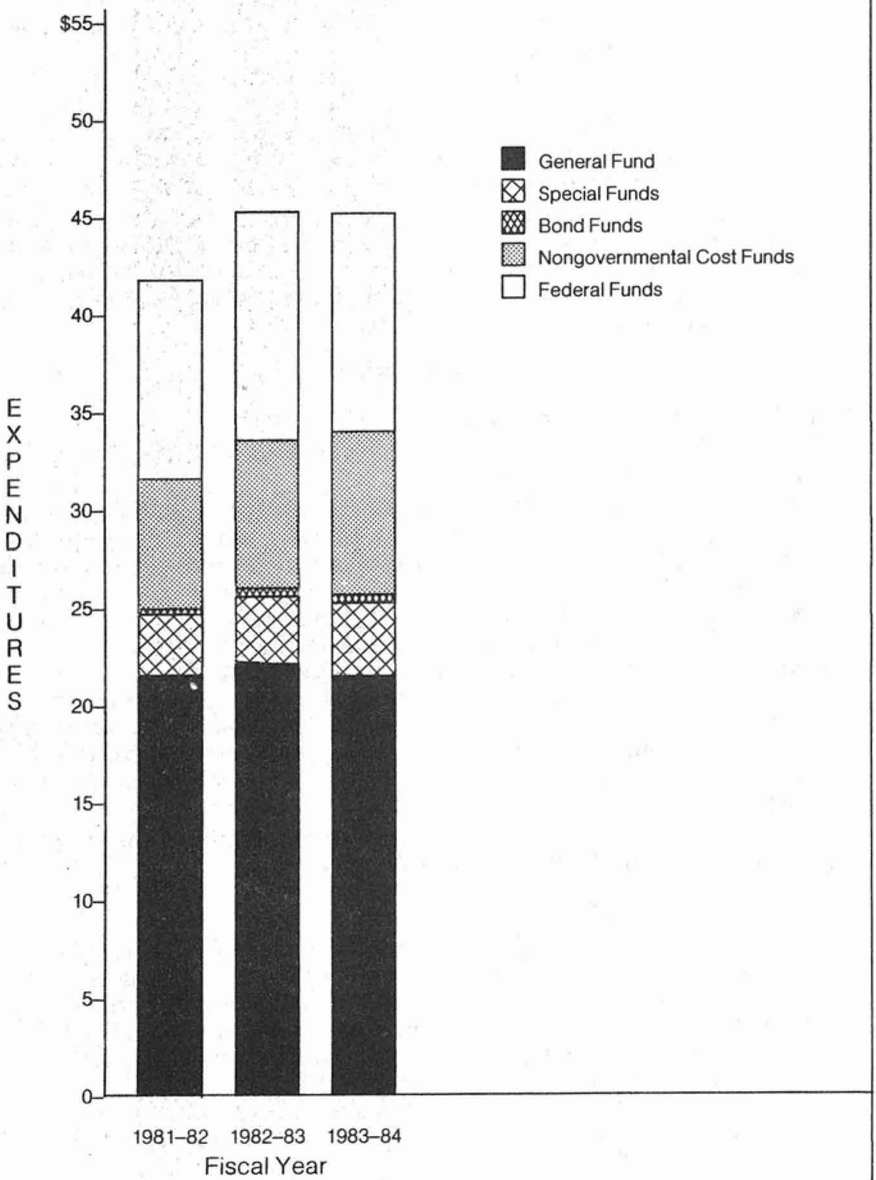


Table 6
Total State Spending Plan
1981–82 to 1983–84
(in millions) [a]

	Actual 1981–82	Estimated 1982–83[b] Amount	Estimated 1982–83[b] Percent Change	Proposed 1983–84 Amount	Proposed 1983–84 Percent Change
General Fund [c]	$21,758.4	$22,056.9	1.4%	$21,677.0	−1.7%
Special funds [d]	3,098.6	3,553.8	14.7	3,475.7	−2.2
Budget Expenditures	$24,857.0	$25,610.7	3.0%	$25,152.7	−1.8%
Selected bond funds	230.2	579.8	151.9	585.4	1.0
State Expenditures	$25,087.2	$26,190.5	4.4%	$25,738.4	−1.7%
Federal funds	10,863.2	11,850.9	9.1	11,065.7	−6.6
Governmental Expenditures	$35,950.4	$38,041.8	5.8%	$36,804.8	−3.3%
Nongovernmental cost funds	6,572.3	7,260.1	10.5	8,232.8	13.4
Total State Spending	$42,522.7	$45,301.5	6.5%	$45,036.6	−0.6%

[a] Based on amounts shown in the Governor's Budget.
[b] Estimated expenditures for 1982–83 do not reflect the 2 percent unallotment directed by Executive Order D-1-83.
[c] Includes expenditures from reserves of $51.9 million in 1982–83 and $2.4 million in 1983–84.
[d] Includes expenditures from reserves of $113.8 million in 1982–83 and $10.6 million in 1983–84.

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 6, budget expenditures are proposed to total $25.2 billion in 1983–84. Budget expenditures in 1983–84 account for 56 percent of the $45 billion state spending plan, and 68 percent of total governmental expenditures by the state.

Change in General Fund Expenditures

General Fund expenditures account for more than one-half of all expenditures under the state's auspices. Since 1978–79, General Fund expenditures have included significant amounts of money designated as local fiscal relief. The Governor's Budget proposes $5.8 billion in local fiscal relief in 1983–84, which is an increase of $104 million, or 1.8 percent above the 1982–83 level.

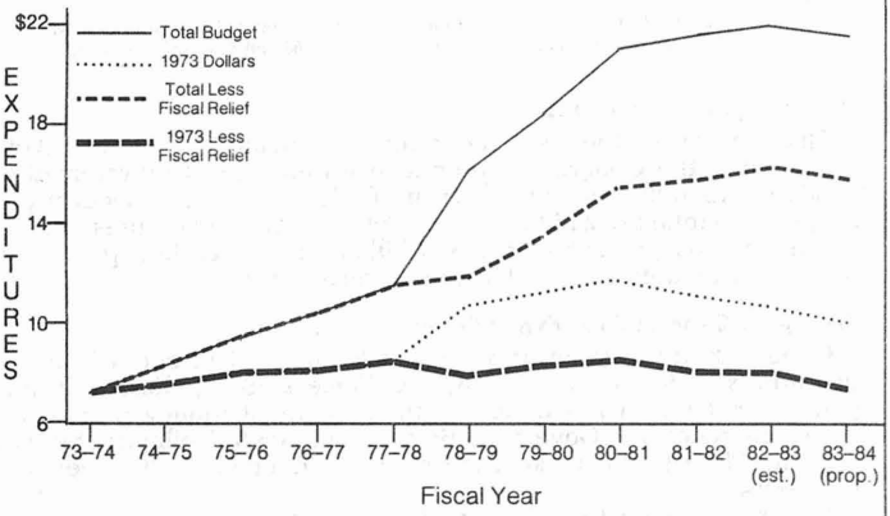
Historical perspective is a useful tool in analyzing trends in General Fund spending. Table 7 presents the amount and rate of increase in expenditures since 1973–74, both for total General Fund expenditures and total General Fund expenditures excluding local fiscal relief. Expenditures are displayed in the table both on a "current dollar" basis, and in "real dollars." "Real dollars" represent expenditure levels as they appear in the budget (that is, "current dollars") adjusted for the effects of inflation since 1973. In current dollars, the proposed General Fund budget for 1983–84 is almost three times what it was in 1973–74. As shown in Chart 3, between 1973–74 and 1980–81, total General Fund expenditures increased at an average annual rate of 11.5 percent in current dollars, and by 3.2 percent in "real" dollars.

Beginning in 1981–82, however, the rate of growth in General Fund expenditures dropped dramatically. In fact, the rise in expenditures in 1981–82 and 1982–83 was less than the rate of inflation, causing "real" expenditures to decline.

The level of General Fund expenditures proposed for 1983–84 is 1.7 percent less than estimated General Fund expenditures for the current year. This translates into a decrease in real purchasing power of 7.3 percent between 1982–83 and 1983–84. In fact, when the proposed 1983–84 General Fund expenditure level is adjusted for inflation, the purchasing power of the proposed budget is actually less than that of 1978–79.

Chart 3

Annual Growth in General Fund Expenditures
1973–74 through 1983–84 (in billions)



Changes in Federal Fund Expenditures

Federal fund expenditures account for almost one-third of the expenditures in the state's 1983–84 budget (excluding nongovernmental cost funds). As shown in Table 8, federal funds have accounted for as much as 40 percent (1975–76) and as little as 28 percent (1979–80) of total state expenditures during the past ten years. Since 1980–81, federal expenditures have represented approximately 30 percent of state government expenditures.

Table 7
Annual Change in General Fund Expenditures
1973–74 to 1983–84
(in millions)

	Total Budget				*Excluding Local Fiscal Relief*			
	Current Dollars	*Percent Change*	*1973 Dollars* [a]	*Percent Change*	*Current Dollars*	*Percent Change*	*1973 Dollars* [a]	*Percent Change*
1973–74	$7,295.7	—	$7,295.7	—	$7,295.7	—	$7,295.7	—
1974–75	8,340.2	14.3%	7,506.9	2.9%	8,340.2	14.3%	7,506.9	2.9%
1975–76	9,500.1	13.9	7,916.8	5.5	9,500.1	13.3	7,916.8	5.5
1976–77	10,467.1	10.2	8,177.4	3.3	10,467.1	10.2	8,177.4	3.3
1977–78	11,685.6	11.6	8,504.8	4.0	11,685.6	11.6	8,504.8	4.0
1978–79	16,250.8	39.1	10,913.9	28.3	11,891.8	1.8	7,986.4	−6.1
1979–80	18,534.1	14.1	11,349.7	4.0	13,654.1	14.8	8,361.4	4.7
1980–81	21,104.9	13.9	11,797.0	3.9	15,582.9	14.1	8,710.4	4.2
1981–82 [b]	21,758.4	3.1	11,260.2	−4.6	15,875.4	1.9	8,217.1	−5.7
1982–83 (estimated) [c]	22,056.9 [d]	1.4	10,780.5	−4.3	16,335.9	2.9	7,984.3	−2.8
1983–84 (proposed) [e]	21,677.0	−1.7	9,998.6	−7.3	15,852.0	−3.0	7,311.8	−8.4

[a] "1973" dollars equal current dollars deflated to 1973–74 dollars using the Gross National Product price deflator for state and local purchases of goods and services.
[b] Includes $274.2 million in expenditures from reserves.
[c] Includes $51.9 million in expenditures from reserves.
[d] The total estimated expenditures for 1982–83 do not reflect the 2 percent unallotment directed by Executive Order D-1-83.
[e] Includes $2.4 million in expenditures from reserves.

Table 8

Federal Fund Expenditures as a Percent of Total State Expenditures [a]

1974–75 to 1983–84

(in millions)

	General Fund	*Special Funds*	*Bond Funds*	*Federal Funds*	*Totals*	*Federal Funds As Percent of Total*
1974–75	$8,340	$1,689	$247	$6,482	$16,759	38.7%
1975–76	9,500	1,697	255	7,618	19,070	39.9
1976–77	10,467	2,041	123	7,992	20,623	38.8
1977–78	11,686	2,161	157	7,239	21,242	34.1
1978–79	16,251	2,298	196	7,453	26,198	28.4
1979–80	18,534	2,760	193	8,160	29,648	27.5
1980–81	21,105	3,262	145	10,248	34,759	29.5
1981–82	21,758	3,099	230	10,863	35,950	30.2
1982–83	22,057	3,554	580	11,851	38,041	31.2
1983–84	21,677	3,476	585	11,066	36,804	30.1

[a] Excludes nongovernmental cost funds. Details may not add to totals due to rounding.

The level of federal expenditures anticipated in 1983–84—$11.1 billion—represents a decrease in federally funded expenditures of $785 million, or 6.6 percent, from the estimated 1982–83 level. While the reduction reflects numerous adjustments, Table 9 shows that it is due primarily to reductions in health and welfare programs. These reductions, which total $852 million, have two primary components: (1) a decrease of $621 million in unemployment insurance benefits, reflecting the administration's assumption that the rate of unemployment in California will decline from 9.7 percent in 1982–83 to 8.5 percent in 1983–84 and (2) a decrease of $202 million in federal funding for the state's Medi-Cal program. The Medi-Cal reduction is due to reforms implemented by the Legislature in 1982–83, and to reduced federal sharing ratios instituted for this program in 1981.

Table 9 also shows that two significant increases will mitigate to some extent the reductions in health and welfare programs. First, business, transportation and housing programs are expected to receive additional federal support, principally in the form of federal transportation aid provided to the Department of Transportation. The increase in federal funding reflects the acceleration and continuation of the five-year highway capital improvement plan. Second, federal funding provided to the state's education agencies is expected to go up. Most of this increase, however, will not go for education per se. Instead, it reflects a significant funding increase for the University of California's Department of Energy laboratories.

Federal aid to California has experienced various expansions and contractions in both current dollars and real dollars during the last ten years, as shown in Chart 4. In terms of actual dollars, federal expenditures have grown from nearly $6.5 billion in 1974–75 to $11.1 billion in 1983–84, an increase of approximately 71 percent. This change represents a 6.1 percent annual average rate of growth over the 10-year period. When expressed in "real" dollars, however, the level of federal aid anticipated in 1983–84 is 12.5 percent *less* than the amount of federal aid actually received by the state in 1974–75.

Table 9
Federal Funds Changes, By Program
1982–83 and 1983–84
(in thousands)

Program	*Estimated 1982–83*	*Proposed 1983–84*	*Change Amount*	*Change Percent*
Legislative/Judicial/Executive	$161,951	$97,822	−$64,129	−39.6%
State and Consumer Services	11,738	10,821	−917	−7.8
Business, Transportation and Housing	773,939	836,404	62,465	8.1
Resources	41,556	30,961	−10,595	−25.5
Health and Welfare	7,936,027	7,084,090	−851,937	−10.7
Youth/Adult Corrections	952	977	25	2.6
Education	2,659,563	2,737,080	77,517	2.9
Other Governmental Units	241,613	240,798	−815	−0.3
Other Governmental Services	23,607	26,762	3,155	13.4
Totals	$11,850,946	$11,065,715	−$785,231	−6.6%

Caution should be used in drawing conclusions from the changes in federal expenditure levels shown in Chart 4, for two reasons. First, federal aid totals summarized in the Governor's Budgets have not included consistent categories over the 10-year period. For example, federal payments under the Supplemental Security Income (SSI) program were included in budget totals from 1974–75 through 1976–77, but have not been included since then because these payments do not actually flow through the state budget.

Second, changes in the level of payments to individuals meeting certain eligibility criteria (the so-called entitlement programs) can change the total amount of federal aid received by the state significantly, even though there may not have been a change in underlying federal policy or funding. For example, if in the budget year, the unemployment rate for 1984 is equal to the rate projected for 1983, and does not decline to the level anticipated by the administration, the state would receive approximately $648 million in additional federal funds beyond what is anticipated by the budget.

Federal Support of State Programs

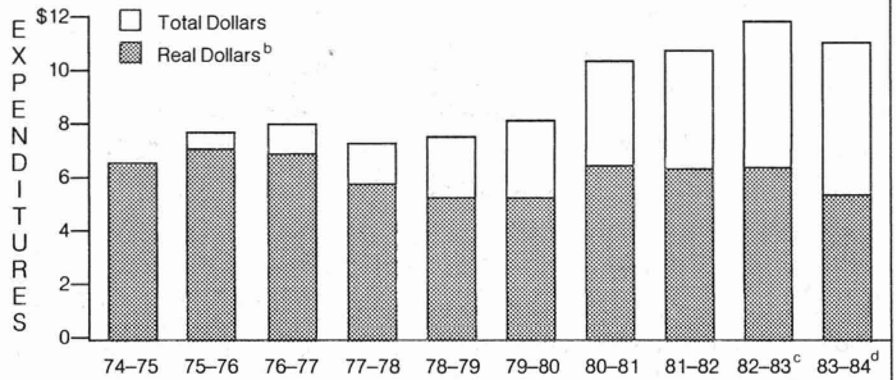
The percentage of total program activity supported by federal funds varies widely from one state agency to another. Chart 5 shows that of all the federal funds received by the state in 1983–84, $7.1 billion, or 64 percent, is expended for health and welfare activities. Education and business, transportation and housing programs also account for a significant portion of federal expenditures in California.

While the majority of federal funds received by the state are spent on health and welfare programs, this funding source accounts for only one-half of total expenditures proposed for these programs in 1983–84. Moreover, within the health and welfare area, federal fund levels vary widely, from a low of 34 percent for health programs to a high of 97 percent for employment programs. Similarly, while education receives 25 percent of total federal funds received by the state, federal aid supports just 19 percent of the state's education expenditures (less if local funds are included).

Chart 4

Expenditures of Federal Aid Granted to the State of California

1974–75 through 1983–84 (in billions) [a]



a Source: Governor's Budgets

b "Real" federal dollars equal total federal dollars deflated to 1974–75 dollars using the Gross National Product price deflator for state and local purchases of goods and services.

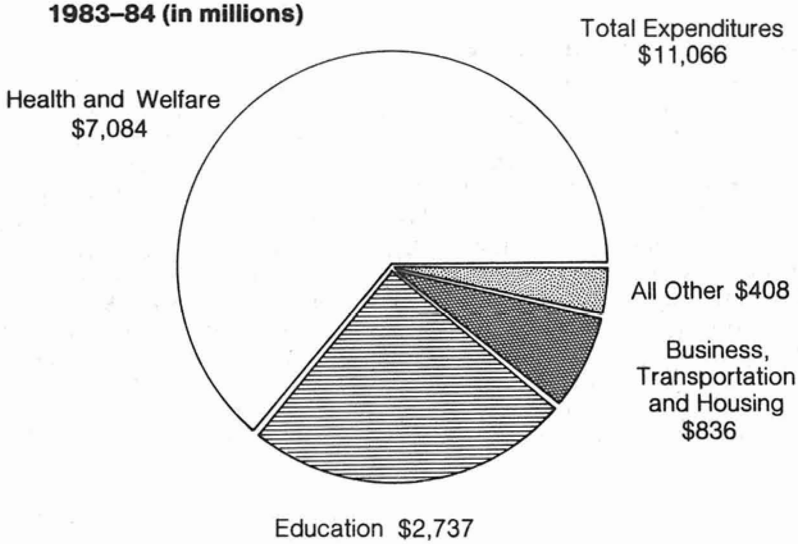
c Estimated

d Proposed

Chart 5

Program Distribution of Federal Aid Granted to the State of California

1983–84 (in millions)



On the other hand, as indicated in Table 10, business, transportation and housing agencies receive 8 percent of available federal aid, but support 34 percent of their total program activity from this funding source.

Table 10
Federal Aid to the State of California
Support of Budget Activites, by Program
1983–84
(in millions)

	General Fund	*Special Funds*	*Bond Funds*	*Federal Funds*	*Total*	*Percent Federal Funds*
Legislative/Judicial/Executive	$458	$36	—	$98	$592	16.6%
State and Consumer Services	159	121	—	11	291	3.8
Business/Transportation/Housing	38	1,596	—	836	2,470	33.8
Business/Housing	(38)	(48)	—	(40)	(126)	(31.7)
Transportation	([a])	(1,548)	—	(796)	(2,344)	(34.0)
Resources	281	213	141	31	666	4.7
Health and Welfare	6,903	60	—	7,084 [b]	14,047	50.4
Health	(4,188)	(49)	—	(2,149)	(6,387)	(33.6)
Human Services	(2,656)	(—)	—	(2,497)	(5,153)	(48.5)
Employment	(59)	(11)	—	(2,437)	(2,507)	(97.2)
Youth/Adult Corrections	846	24	245	1	1,116	— [a]
Education	11,074	114	200	2,737	14,125	19.4
K–12	(7,950)	(46)	(200)	(840)	(9,036)	(9.3)
Higher Education	(3,124)	(68)	([a])	(1,897)	(5,089)	(37.3)
Other Government Units/Services	1,918	1,311	—	268	3,497	7.7
Totals	$21,677	$3,475	$586	$11,066	$36,804	30.1%

[a] Less than $500,000.
[b] Details do not add to total due to rounding.

Total State and Local Government Spending in California

Current Year Spending. In the current year, expenditures for all services provided by state and local governments in California are expected to total approximately $72 billion, consisting of $20.2 billion in net state expenditures and $51.4 billion in local expenditures. These figures *include* federal funds expended by state and local governments, and *exclude* expenditures from bond proceeds and nongovernmental cost funds. Net state spending—$20,187 million—does not include $17,275 million in expenditures identified in the Governor's Budget as a *state* expenditure, because these funds actually are expended at the local level, and are included in our estimate of local government expenditures. The principal component of the excluded amount is state aid to local school districts ($9.6 billion).

Local government expenditures are categorized according to the four types of local jurisdictions: counties, cities, special districts, and K–14 education. As discussed here, the K–14 education category includes expenditures for elementary and secondary (K–12) schools, county offices of education, regional occupation centers, and community colleges (13–14).

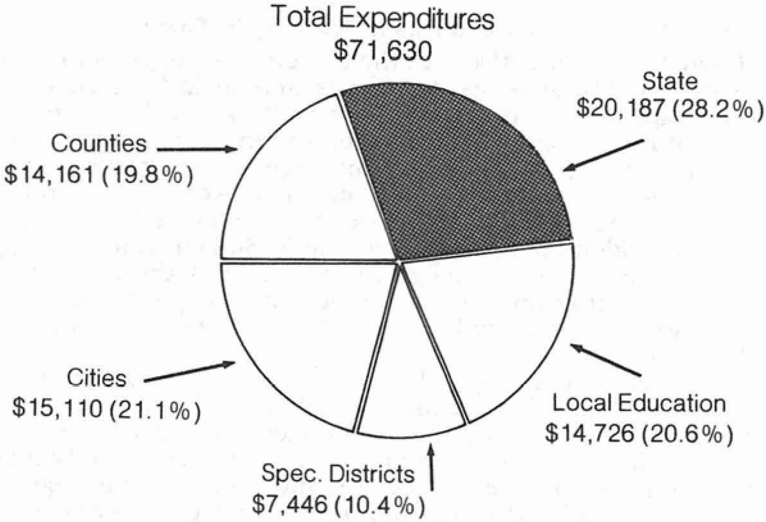
Table 11 identifies the expenditures by each category of government in the current year. Chart 6 displays expenditures by each government entity as a percentage of total state and local government expenditures. As shown in the chart, local government accounts for approximately 72 percent of total state and local government expenditures.

Table 11
Total State and Local Government Expenditures
1982–83
(in millions)

Government Entity	*Expenditure*	*Percent of Total*
Counties [a]	$14,161	19.8%
Cities [b c]	15,110	21.1
Special Districts [c]	7,446	10.4
Local Education [d]	14,726	20.6
Subtotal, Local Government [e]	($51,443)	(71.8)
State (As shown in budget)	$37,462	52.3
Less: Amount expended by local governments	17,275	24.1
Subtotal, State (Net)	($20,187)	(28.2)
Total, State and Local Expenditures	$71,630	100.0%

[a] From unaudited county budgets.
[b] Excludes bond funds. Includes city-owned enterprise expenditures.
[c] From Controller's 1980–81 financial transactions, increased by the average growth rate from preceding two years.
[d] Legislative Analyst's office estimate.
[e] Includes $17,275 million of state funds spent by local government.

Chart 6
Total State and Local Government Expenditures
1982–83 (in millions)



B. CONTROLLING EXPENDITURES

Control Through the Constitution

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 government 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 government 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 amount 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 tidelands oil revenues—are *not* limited by Article XIII B.

The article also exempts from the limits of both the state and local governments, appropriations made from tax proceeds but expended 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, Article XIII B 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 1983–84. Table 12 shows the Department of Finance's estimate of the impact of Article XIII B on the state in both 1982–83 and 1983–84. The department estimates that the state will be $2.6 billion and $3.3 billion below its limit in 1982–83 and 1983–84, respectively.

Table 12
Impact of Article XIII B
On the State in 1982–83 and 1983–84
(in millions)

	1982–83	*1983–84*
Appropriations Limit	$19,594	$20,822
Appropriations Subject to Limitation	16,971	17,480
Amount Under the Limit	$2,623	$3,342

There are two main reasons for the large gap between the limit and spending subject to limitation. First, the state appropriated more monies in 1978–79 (the base year) than it had in ongoing tax revenues. This resulted in the original "base" being larger than the amount of spending that could be sustained under existing tax laws. Second, because of the recession, state tax revenues have been growing very slowly, especially in comparison with the year-to-year growth in the state's appropriations limit. Thus, the state simply has not had the revenues to support the level of appropriations that would be allowed by Article XIII B.

As a result, the state's appropriations limit will *not* be a fiscal constraint in 1983–84, even if taxes are increased in the budget year by an amount necessary to eliminate the projected 1982–83 year-end General Fund deficit (approximately $1.5 billion). Furthermore, the limit will probably *not* be a constraint in the foreseeable future. Only if revenues grow for several years at rates exceeding the annual adjustments to the state's limit would the state have adequate resources to spend up to this amount.

Establishing the 1983–84 Limit. The administration proposes to set the state's 1983–84 appropriations limit in Control Section 12.00 of the 1983 Budget Bill. Although a 1983–84 limit of $20,822 million has been proposed, this number is subject to change, because the final inflation and population adjustments used to determine the 1983–84 limit will not be known until April of this year. In addition, certain actions taken in 1982 may have an impact on the 1983–84 limit, to the extent that they result in "transfers of financial responsibility" under Section 3 of Article XIII B. For instance, if the transfer of responsibility from the state to the counties for providing medical services to medically indigent adults (MIAs) results in costs to the counties in excess of the funds provided by the state for this purpose, an adjustment in the state's limit may be required.

Budgeted Versus Actual Expenditures

The expenditure program initially proposed in the budget has invariably been changed—usually upward—during the budget process. Table 13 compares the original estimates with actual expenditures during the past ten years.

Table 13
Comparison of Budgeted and Actual General Fund Expenditures [a]
1973–74 to 1982–83
(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	137.4	1.3
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	21,758.4	988.3	4.8
1982–83	23,202.9	22,056.0 [b]	−1,146.9	−4.9

[a] Source: Governor's Budgets, Schedule 1.
[b] Midyear estimate. This figure does not reflect the 2 percent unallotment directed by Executive Order D-1-83.

In several of the last five years, actual expenditures exceeded the amounts originally proposed by the Governor, by significant margins. The unusually large 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 the budget for that year, but reductions in other state programs held the net increase to $2.8 billion.

The increase of $900 million for *1981–82* is attributable primarily to increases in expenditures for K–12 Education ($600 million) and SSI/SSP grants ($218 million). Both of these changes were caused by larger cost-of-living adjustments than what the Governor had proposed.

Only twice during this ten-year period—in *1977–78* and *1982–83*—was the actual amount expended less than the amount initially proposed. The large decrease in the budget for 1982–83—$1.14 billion—primarily reflects the fact that the previous Governor did not propose a budget that was balanced, leaving it to the Legislature to make the necessary adjustments.

The midyear estimate for *1982–83* does not reflect the effect of the Governor's plan to reduce the projected year-end deficit of $1.6 billion by $750 million (Phase I), and therefore probably understates the extent of the likely reduction.

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. (For example, court rulings against the state, which are beyond the Legislature's control, are estimated to have reduced General Fund resources by approximately $431 million in 1982–83.) Rather, these budget estimates reflect the *Governor's fiscal plan*—that is, what he thinks expenditures *ought* to be, given all of those factors that the state can and cannot control. It is certain that, between now and June 30, 1984, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, the resolution of various court cases, and many other factors. Thus, as in past years, actual revenues and expenditures may be vastly different from the estimates contained in the Governor's Budget.

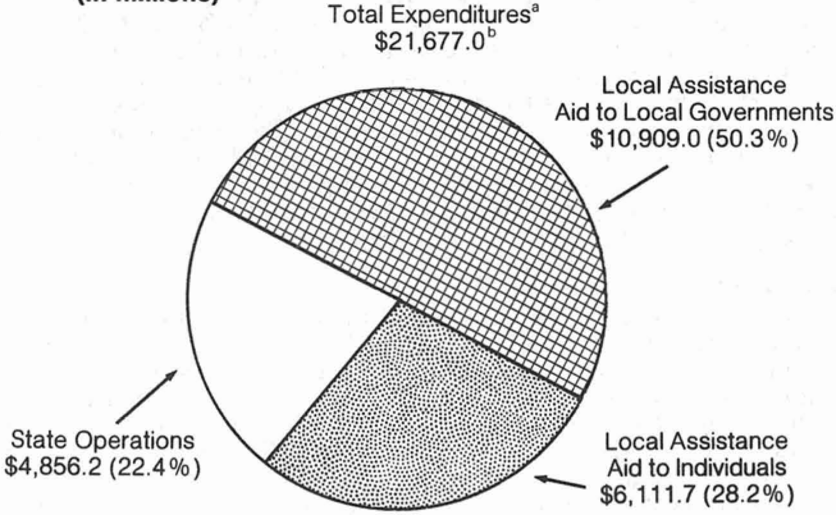
C. MAJOR COMPONENTS OF THE BUDGET

State expenditures traditionally are divided into three categories within the budget: state operations, capital outlay, and local assistance. Table 14 presents the distribution of General Fund and special fund expenditures among these categories for the past, current, and budget years. The Governor's Budget for 1983–84 introduces a new category of expenditures, which it labels "unclassified." This category consists of one "minus" expenditure, in the form of savings expected to result from the private sector task force which the Governor proposes to study efficiencies and economies in government. Specifically, the Governor asserts that the efforts of this task force will result in General Fund savings of $200 million during the budget year. Detailed reductions, however, are not identified for any specific program or agency. The Governor's Budget also sets aside $150 million from the General Fund for future legislative actions, and $650 million for the Reserve for Economic Uncertainties (although $100 million of this amount is already committed by law to another purpose.)

Chart 7 shows the local assistance and state operations portion of the budget as a percentage of total General Fund expenditures. Local assistance, as defined in the Governor's Budget, makes up 79 percent of total General Fund expenditures.

Chart 7

1983–84 General Fund Budget Structure
(in millions)



[a] Includes $2.4 million in expenditures from reserves.
[b] Pie chart state operations and local assistance totals do not include $200 million in "unclassified" reductions contained in Governor's Budget.

Table 14
General Fund and Special Fund Expenditures by Function [a]
1981–82 to 1983–84
(in millions)

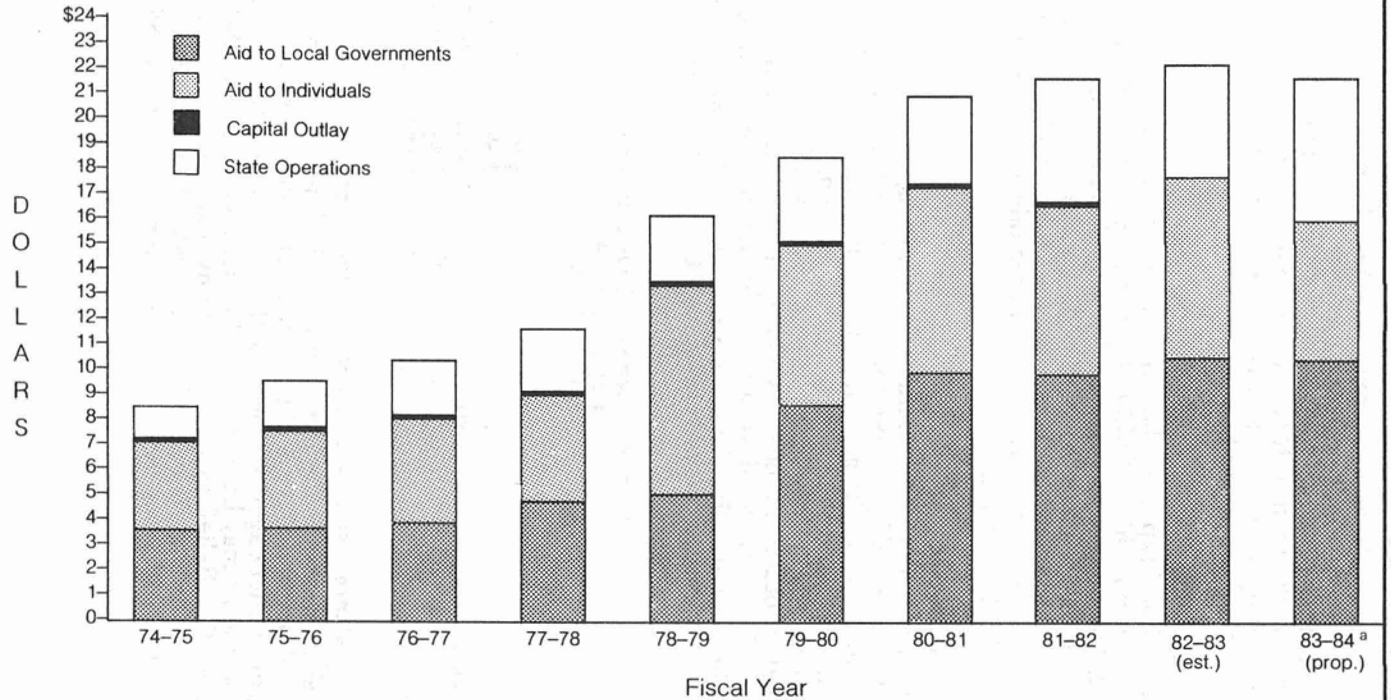
		Estimated 1982–83		*Proposed 1983–84*	
General Fund	*Actual 1981–82*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State operations	$4,497.5	$4,697.6	4.5%	$4,856.2	3.4%
Capital outlay	10.7	2.1	−80.4	–	–
Local assistance	17,250.1	17,357.2	0.6	17,020.7	−1.9
Aid to individuals	(6,898.5)	(6,903.5)	(0.1)	(6,111.7)	(−11.5)
Aid to local governments	(9,937.4)	(10,504.1)	(5.7)	(10,909.0)	(3.9)
Unclassified	–	–	–	−200.0	–
Totals [b]	$21,754.8	$22,056.9	1.4%	$21,677.0	−1.7%
Special Funds					
State operations	$1,457.0	$1,639.9	12.6%	$1,798.4	9.7%
Capital outlay	211.1	389.5	84.5	296.7	−23.8
Local assistance	1,422.3	1,515.0	6.5	1,369.8	−9.6
Unclassified	8.1	9.4	16.0	10.8	14.9
Totals [b]	$3,098.6	$3,553.8	14.7%	$3,475.7	−2.2%

[a] Based on amounts shown in the Governor's Budget. The amounts indicated for 1982–83 do not reflect the 2 percent unallotment directed by Executive Order D-1-83.
[b] Details may not add to total due to rounding.

Chart 8

General Fund Budget Structure

1974–75 through 1983–84 (in billions)



[a] Total includes $200 million in "unclassified" reductions contained in Governor's Budget

1. State Operations

The budget proposes an increase of $159 million, or 3.4 percent, in state operations for 1983–84. This figure, however, does not reflect approximately $70 million in proposed 1982–83 reductions scheduled to result from the 2 percent unallotment directed by Executive Order D-1-83. Hence, the increase in state operations between the current- and budget-years probably will exceed 3.4 percent.

2. Capital Outlay

General Fund capital outlay expenditures over the past nine years have fluctuated from a high of $15 million in 1978–79 to a low of $2 million in 1982–83. The budget proposes no General Fund expenditures for capital outlay in 1983–84, but does call for $297 million in capital outlay expenditures to be financed from special funds (mainly with tidelands oil revenues). For a more detailed discussion of capital outlay issues and financing, see Part III of this volume.

3. Local Assistance

As illustrated in Chart 8, General Fund expenditures for local assistance will have increased by $11,491 million, or 208 percent, in the 10 years from 1973–74 to 1983–84. The growth in state fiscal relief to local governments following the passage of Proposition 13 explains much of this increase. Additionally, direct benefit programs, such as AFDC grants, which are classified as local assistance, have grown rapidly during the past decade.

Table 15 displays local assistance expenditures by funding source. As shown in this table, the Governor's Budget proposes an overall decrease in local assistance of $481.7 million, or 2.6 percent, in 1983–84.

Table 15
Local Assistance by Source of Funds
1981–82 to 1983–84
(in millions)

				Change from 1982–83 to 1983–84	
	1981–82	*Estimated 1982–83*	*Proposed 1983–84*	*Dollars*	*Percent*
General Fund	$17,250.1	$17,357.2	$17,020.7	−$336.5	−1.9%
Special Funds	1,422.3	1,515.0	1,369.8	−145.2	−9.6
Totals	$18,672.4	$18,872.2	$18,390.5	−$481.7	−2.6%

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, they provide assistance to *individuals*. Such payments may be made *directly* to individuals, as in the case of the Renters' Tax Relief program, or individuals may receive assistance through an intermediary, such as the federal or county governments. Among the payments made through intermediaries are SSI/SSP payments, which are distributed by the *federal* government, and AFDC payments, which are distributed by *county* governments.

The Governor's Budget divides local assistance into three categories: (1) "Payments to Local Government," (2) "Assistance to Individuals," and (3) "Payments to Service Providers." The distinction between the second and third categories—"Assistance to Individuals" and "Payments to Service Providers"—is that the former represents *cash grants* to individuals whereas the latter represents *services* to individuals. Both, however, provide *aid* to individuals. In our opinion, combining these two categories allows for a more meaningful analysis of aid directed to individuals. Consequently, our presentation of local assistance expenditures displays only two categories, "Assistance to Local Governments" and "Assistance to Individuals," as shown in Table 14.

In dividing the existing local assistance programs between the two categories, it is important to keep in mind that some portion of "Assistance to Individuals" actually represents funds distributed to local governments. For example, the Homeowners' Property Tax Assistance program provides *reimbursements* to local governments for the property tax revenue losses attributable to the homeowners' property tax exemption. The reimbursements, however, do not *increase* the fiscal resources of the local governments; they 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

Table 16
Major General Fund Supported Local Assistance Programs More Appropriately Categorized as Assistance to Individuals 1981–82 to 1983–84 (in millions)

	1981–82	*1982–83*	*Governor's Budget 1983–84*
Medi-Cal [a]	$2,495	$2,576	$1,980
AFDC [b]	1,349	1,328	1,175
SSI/SSP	1,220	1,104	1,022
Developmental Services	522	524	545
Personal Property Tax Relief	467	504	512
Renters' Tax Relief	425	456	464
Homeowners' Property Tax Relief	334	335	336
Senior Citizens Renters' Tax Relief	48	44	43
Senior Citizens' Property Tax Assistance	15	12	11
Subvention for Open Space	14	13	13
Senior Citizens' Property Tax Postponement	6	6	7
Payment to Local Governments for Sales and Property Tax Losses	5	3	4
Totals [c]	$6,899	$6,904	$6,112

[a] Excludes county administration.
[b] Grant payments only.
[c] Totals may not add due to rounding.

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, these funds are provided by the state in an attempt to help local governments to fund these programs.

Table 16 identifies 12 major local assistance programs which our analysis indicates are more appropriately categorized as "Assistance to Individuals." The Governor's Budget proposes funding level increases for 6 of these 12 programs; decreases for five and no change for one. Overall, funding for "individual assistance" programs is proposed to decline by approximately $792 million, or 12 percent, in 1983–84. This results primarily from reductions in the Medi-Cal and AFDC programs, where the responsibility for serving certain categories of individuals (for example, medically indigent adults (MIAs) and nonfederally eligible AFDC-unemployed parents) has been transferred from the state to counties. Funds allocated to the counties for the MIA shift are included as "Assistance to Local Governments."

Local Fiscal Relief

Table 17 summarizes our estimates of local fiscal relief from 1978–79 through 1983–84. For the budget year, the table shows estimates of fiscal relief under existing law [Ch 282/79, (AB 8)], as well as the amounts proposed by the Governor. Under the Governor's proposal, local fiscal relief is estimated to increase in 1983–84 by $114 million, or 2.0 percent from the estimated current-year level. This low rate of growth reflects the Governor's proposal to reduce motor vehicle license fee subventions to cities and counties by $300 million. It also reflects the budget's proposals to delete statutory cost-of-living adjustments for county health service subventions and AFDC. In the absence of these proposals, local fiscal relief in 1983–84 would increase by $427 million, or 7.5 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 during the current year by Ch 327/82 (SB 1326).

Table 17
Summary of Local Fiscal Relief
1978–79 to 1983–84
(in millions)

						1983–84	
	1978–79	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*Under Existing Law*	*As Proposed by Governor's Budget*
Block grants to local agencies	$853	—	—	—	—	—	—
Property taxes shifted from schools to local agencies	—	$781	$921	$1,024	$1,140	$1,262[a]	$1,262[a]
Business inventory reductions for cities and counties	—	−38	—	—	—	—	—
Health and welfare buyouts	1,079	1,288	1,529	1,724	1,840	1,905	1,892
Ongoing reductions	—	—	—	−49	−49	−49	−49
One-time reductions	—	—	—	−184	−261	—	−300
Local Agency Reimbursement Fund	—	—	—	—	10	—	—
Education [b]	2,453	2,814	3,050	3,344	3,025	3,014	3,014
Totals	$4,385	$4,845	$5,500	$5,859	$5,705	$6,132	$5,819

[a] Assumes 10 percent increase in assessed valuation.
[b] Department of Finance estimates.

Table 18 presents information as to the *distribution* of fiscal relief under current law, by type of local agency. These data indicate that K–12 school districts receive nearly half of total fiscal relief to local entities (49 percent), while counties receive the second largest share (40 percent). The table also indicates that, under current law, total fiscal relief costs in 1983–84 would be 39.8 percent above the original level established in 1978–79, with the largest relative increases in relief going to special districts and counties.

The Legislature, in acting on the 1982–83 Budget, provided no specific explanation for the level of financing provided for education.The Department of Finance, however, *assumes* that the elimination of the cost-of-living adjustment (COLA) for school apportionments in 1982–83 was done with the objective of reducing fiscal relief to schools, in lieu of allowing the AB 8 deflator mechanism to become operative. Thus, the department asserts that the amount of fiscal relief proposed for education in 1982–83 was reduced by the amount of the COLA, reducing the amount of fiscal relief reported by the department for both 1981–82 and 1982–83. This reduction also affects the amounts shown for the budget year, as it reduces the base from which fiscal relief estimates are computed.

The Department of Finance's fiscal relief estimates for 1983–84 have also been reduced to reflect a $106 million reduction in state assistance to community colleges. The Governor's Budget proposes that this $106 million reduction be offset by the imposition of student fees. Thus, the level of *fiscal relief* going to community colleges in the budget year is 20.8 percent less than the level provided in 1978–79. The Governor proposes that student fees be increased to make up the difference.

Table 18
Local Fiscal Relief by Type of Local Agency
1978–79 to 1983–84
(in millions)

	1978–79	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*1983–84*[a]	*Percent Increase 1983–84 Over 1978–79*
Cities	$230	$216	$280	$152	$99[b]	$346	50.4%
Counties	1,512	1,609	1,927	2,095	2,280[b]	2,432	60.8
Special districts[c]	190	206	243	268	301	340	78.9
K–12 education[c]	2,193	2,508	2,721	2,989	2,692	2,808	28.1
Community colleges[c]	260	306	329	355	333	206	−20.8
Totals[d]	$4,385	$4,845	$5,500	$5,859	$5,705	$6,132	39.8%

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

D. RESERVES

The Governor's Budget holds $800 million from the General Fund in reserve for 1983–84. Of this amount, $650 million is proposed for the Reserve for Economic Uncertainties, and $150 million is earmarked for future legislation.

Reserve for Economic Uncertainties

Reserve Proposed for 1983–84. The Reserve for Economic Uncertainties was created by the 1981–82 Budget Act, and provides a source of funds to meet General Fund obligations in the event of an unanticipated decline in revenues or increases in expenditures following enactment of the Budget Act. Control Section 12.30 of the 1983–84 Budget Bill provides for the transfer of up to $650 million (approximately 3 percent of proposed 1983–84 General Fund expenditures) to fund this reserve in the budget year. Monies in this fund can also be loaned interest free to the General Fund in the event of a cash-flow shortage during the fiscal year.

The $650 million earmarked for the reserve in 1983–84 *overstates* the amount available. The Governor's Budget identifies $100 million of the $650 million as needed to repay a loan made to the state by Los Angeles County, pursuant to Ch 1594/82. This statute specifies that $100 million must be set aside in a special account in 1983–84 and used only for the purpose of repaying the county's loan. (The balance of the $200 million loan repayment must be set aside in the 1984–85 budget.) While these funds may be loaned to the General Fund, the special account must have a minimum balance of $100 million on June 30, 1984.

By counting this $100 million as part of the Reserve for Economic Uncertainties, the administration has overstated the size of the reserve by $100 million. For these reasons, we recommend that the Legislature *not* regard these funds as either available to eliminate the current year deficit or available to protect the General Fund against the type of uncertainties for which the reserve was created.

Use of the Reserve to Date. As Table 19 demonstrates, the reserve in 1981–82 and 1982–83 has not been sufficient to cover actual revenue shortfalls and expenditure overruns during these two fiscal years. The reserve has, however, helped to mitigate the problem, and has helped to moderate the severity of actions which have had to be taken to balance the budget in those years.

Table 19
Reserve for Economic Uncertainties
1981–82 and 1982–83
(in millions)

	Proposed in Budget Bill	*Included in Budget Act*	*Unanticipated Changes to General Fund Condition*	*Additional Amount Needed to Cover Shortfall*
1981–82	$620	$460	–$1,182	$722
1982–83	500	556	–2,190[a]	1,634

[a] Midyear estimate.

Should Next Year's Reserve be Used to Balance This Year's Budget? The Governor's Budget identifies $650 million budgeted for the Reserve for Economic Uncertainties in 1983–84 as a potential source of funds to reduce the $1.6 billion deficit in the current year's budget. To the extent that this is done, of course, these funds will not be available to fund unanticipated declines in revenue or increases in expenditure during the budget year.

The use of monies allocated to the Reserve for Economic Uncertainties for the purpose of funding *anticipated* expenditures defeats the very purpose of the reserve, and eliminates the state's ability to weather the types of fiscal setbacks that have plagued the state in recent years. For the state to *begin* the fiscal year without a reserve would be analogous to a homeowner suspending his casualty insurance in order to free up the funds needed to make his mortgage payments. It may turn out that the insurance wasn't needed after all. But, if the insurance *is* needed (if revenues do fall short of the level anticipated), the adjustment problem becomes much more difficult.

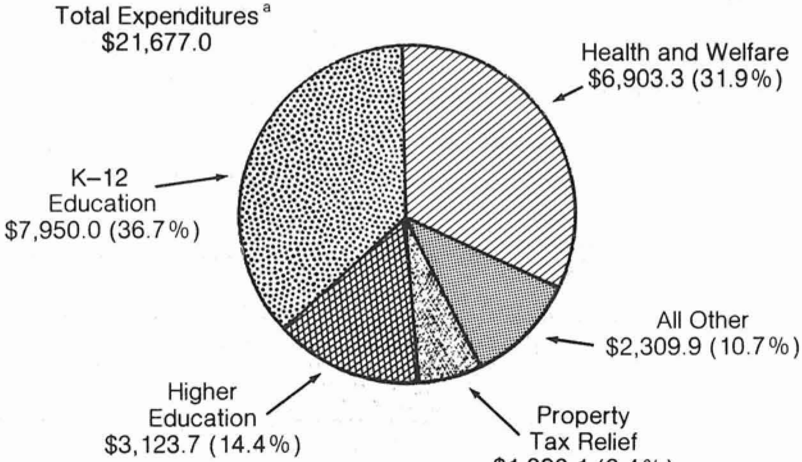
In summary, we believe that the option of using next year's reserve to balance this year's budget represents more of a *threat* to the maintenance of a balanced budget than it does a viable method for achieving one.

Accordingly, it should be viewed by the Legislature with great skepticism. In light of the state's experience in the past two years, we recommend that the Legislature retain a prudent reserve in an amount equal to *at least* 3 percent of anticipated expenditures for the budget year.

Chart 9

General Fund Expenditures—Major Components

1983–84 (in millions)



[a] Includes $7.2 million in expenditures from reserves

E. PROGRAM EXPENDITURES

Where Does the Money Go?

Table 20 and Chart 9 show the distribution of General Fund expenditures, by major program categories, in 1983–84. These displays indicate that the two largest budget categories are education and health and welfare, which account for $18.0 billion, or 82.9 percent, of total General Fund expenditures. The remaining $3.7 billion, or 17.1 percent, of total expenditures 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 10 illustrates that since 1973–74 health, welfare, and education have increased their share of the General Fund budget from about 75 percent to 83 percent. During the same period, expenditures for these programs have increased by more than 250 percent, for an average annual growth rate of 13.3 percent.

Chart 10

General Fund Expenditures By Major Program Categories

1973–74 through 1983–84 (in billions)

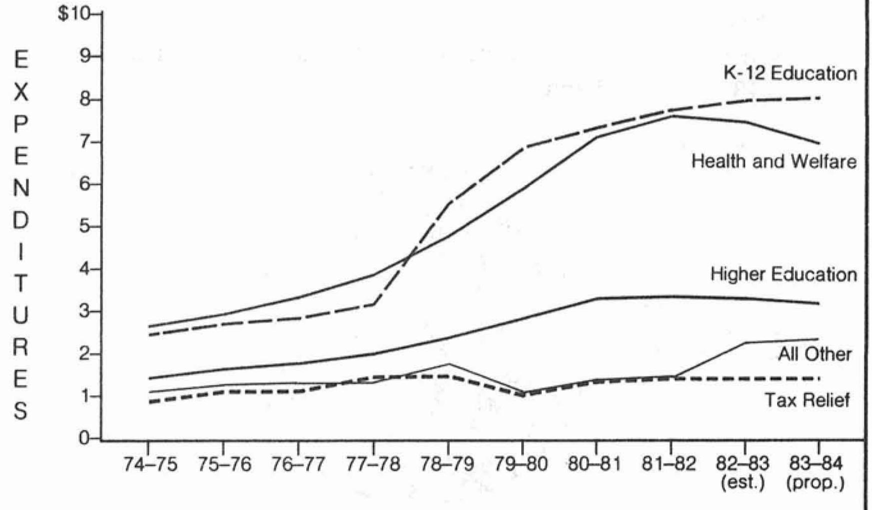


Table 20
Expenditures for Health, Welfare, and Education
As a Percent of Total General Fund Expenditures
1983–84
(in millions)

	Amount	Percent of General Fund Budget
Health and Welfare	$6,903.3	31.8%
K–12 Education	7,949.8	36.7
Higher Education	3,123.7	14.4
Subtotal, Education	($11,073.5)	51.1%
Subtotal, Health, Welfare, and Education	$17,976.8	82.9%
Other Program Areas	3,700.2	17.1
Total General Fund Budget	$21,677.0	100.0%

Table 21
Estimated General Fund Program Changes
1982–83 and 1983–84
(in millions)

	Estimated 1982–83	*Proposed 1983–84*	*Change*	
			Amount	*Percent*
Health and Welfare:				
Medi-Cal	$2,671	$2,040	−$631	−23.7%
County health	426	828	402	94.3
SSI/SSP grants	1,104	1,022	−82	−7.5
AFDC grants	1,328	1,175	−153	−11.6
Mental health	565	566	1	0.1
Developmental services	540	561	21	3.8
Social services programs	178	173	−5	−2.9
Other, health and welfare	547	538	−9	−1.7
Subtotals, Health and Welfare	$7,359	$6,903	−$456	−6.2%
Education:				
K–12	$7,838	$7,950	$112	1.4%
University of California	1,148	1,181	33	2.8
California State University	929	914	−15	−1.7
California Community Colleges	1,068	929	−139	−13.1
Other, higher education	95	98	3	3.1
Subtotals, Education	$11,078	$11,072	−$6	−0.1%
Other:				
Property tax relief	$1,371	$1,390	$19	1.3%
Employee compensation	—	211	211	—
Capital outlay	2	—	−2	−100.0
Debt service	332	344	12	3.6
All other	1,915	1,757	−158	−8.3
Subtotals, Other	$3,620	$3,702	$82	2.2%
Totals	$22,057	$21,677	−$380	−1.8%
Less expenditures from reserves	−52	−2	50	96.2
Current expenditures	$22,005	$21,675	−$330	−1.5%

Summary of Major Program Changes

The budget proposes a decrease in General Fund expenditures of $380 million for 1983–84. Table 21 shows the primary factors that account for the proposed change in expenditures. It shows that in the budget year, expenditures for health and welfare have been reduced by $456 million, education has remained relatively constant, and the "all other" category has increased, primarily due to the inclusion of $211 million for employee compensation. Within each of these categories, significant program changes have been proposed. Some of the major shifts include the following:

1. ***Medi-Cal*** expenditures from the General Fund in 1983–84 are budgeted at $2,040 million. This is a net reduction of $631 million, or 24 percent, from estimated current-year expenditures. After more than a decade of steady growth, the proposed level of Medi-Cal expenditures for 1983–84 is actually less than the amount spent in 1980–81. The major reasons for this dramatic reduction in expenditures are as follows:

- ***Full-year Effect of Terminating Medi-Cal Eligibility for Medically Indigent Adults (MIAs).*** The budget projects a decrease of $470 million in General Fund expenditures for Medi-Cal, due to the full-year effect of terminating eligibility for MIAs. The decrease in Medi-Cal expenditures is partially offset by a $415 million increase in AB 8 county health services subventions to counties, for the purpose of helping counties provide health care services to persons no longer eligible for Medi-Cal. Therefore, the net overall effect of the transfer in 1983–84 is a decrease in General Fund expenditures of $55 million.
- ***Previously Enacted Legislation.*** Changes in eligibility, benefit levels, and reimbursement rates were made by recently enacted legislation (Ch 328/82, Ch 329/82, and Ch 1594/82). These changes will become fully effective in 1983–84, resulting in additional savings beyond those reflected in the current-year estimates.
- ***Proposed Legislation.*** The Governor's Budget proposes several additional cost savings measures, including limitations on abortions and changes in reimbursements for county administration.
- ***Offsetting Increases.*** Increases in utilization of Medi-Cal benefits and a 3 percent provider rate increase will increase costs, thereby providing a small offset to the expected savings.

2. ***County Health Services*** expenditures are proposed to increase by a net of $402 million, or 94 percent, in 1983–84. This primarily reflects the increased subventions to counties intended to help them provide health care services to persons no longer eligible for Medi-Cal.

3. ***SSI/SSP Grants*** are proposed to decrease by $82 million. The decrease results primarily from two factors: (a) increases in unearned recipient income, which *decreases* the amount of the SSI/SSP grant, and (b) a projected decrease in caseload. The budget includes $72 million for a 2.1 percent COLA for these recipients.

4. ***AFDC Grants*** from the General Fund are proposed to decrease by $153 million. The decrease results primarily from (a) changes in the foster care sharing ratio between the state and counties, (b) savings anticipated from the welfare fraud early detection program, (c) changes in prorating shelter costs, and (d) a change in the beginning date of aid. These decreases are partially offset by a caseload increase. The Governor has not proposed a cost-of-living adjustment for this program in the budget year.

5. ***K–12 Education*** is budgeted to increase by $112 million. The major changes contributing to this increase are a one-time augmentation in-lieu of the 100 percent revenue guarantee to local school districts, local property tax revenue increases which offset the General Fund, enrollment increases, and K–12 education cost-of-living adjustments (COLAs).

6. ***Higher Education*** General Fund expenditures are projected to decrease by $118 million. The budget anticipates that this decrease will be offset by an increase in student fees for the University of California, California State University, and the California Community Colleges.

- ***University of California.*** Student fees would be increased by $150 per year (from $1,194 to $1,344), providing an additional $14.8 million in revenues.

- ***California State University.*** Student fees would be increased by $230 per year (from $441 to $671), providing an additional $73.6 million in revenues. In addition, the budget would eliminate General Fund support for summer quarters at the San Luis Obispo, Pomona, Los Angeles, and Hayward campuses, for a savings of $13.6 million.
- ***California Community Colleges.*** For the first time, community college students would be required to pay a statewide fee of $100 per year, which would provide $109.5 million in revenues. The budget does not provide for growth in average daily attendance (ADA) or a COLA.

7. ***Capital Outlay*** expenditures in 1983–84 are funded exclusively from bond and special funds. Proposed capital outlay expenditures from all sources total $568.4 million in the budget year.

8. ***Department of Corrections*** expenditures are proposed to increase by $114.6 million in the budget year, due primarily to the growth in the state's prison population.

9. ***Unidentified Savings*** of $260 million, primarily from the establishment of government efficiency teams, are proposed in the budget. These teams, composed of individuals from the public and private sectors, are expected to submit recommendations for inclusion in the budget before it is enacted. At the time this *Analysis* was prepared, however, no individuals had been named to serve on this task force. Due to the lack of specific information on these proposals, which the budget states will save $200 million, we recommend the Legislature *not* rely on the achievement of these savings, in doing its fiscal planning. In addition, the budget anticipates further unidentified savings of $60 million.

10. ***Merit Salary Adjustments*** for state employees are not funded in the Governor's Budget. Although funding for these adjustments (almost $60 million from the General Fund) is included within the individual appropriation requests, these funds are proposed for reversion by Control Section 9.25 of the 1983–84 Budget Bill. In addition, the budget proposes that $211 million be expended for additional employee compensation, but the administration has identified these funds as part of its Phase II options for use in eliminating the 1982–83 budget deficit.

III. REVENUES

A. OVERVIEW

The various expenditure programs discussed in the *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 is 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—15 percent of the total—are placed into special funds to support specific programs and activities, including highway maintenance and various construction projects.

The availability of revenues is the key determinant of how much the state can afford to spend in the budget year. Consequently, in analyzing the Governor's Budget for 1983–84, it is important to consider whether the state will collect sufficient revenues to fund the proposed spending plan. 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* affect the size of the 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 *legislation* to increase revenues in 1983.

This section examines the Department of Finance's forecast for revenues in the current and budget years, 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. In 1982, both the national and California economies were in the midst of a serious recession. Nationally, real Gross National Product (GNP) declined in two of the four quarters, "real" interest rates remained high throughout the year, unemployment reached record levels, housing starts sagged to a 36-year low, personal income grew at its slowest rate in 20 years, and corporate profits fell for the third straight year. California's economic performance in 1982 was also poor. Job growth in the state was negative for the first time since 1971, the unemployment rate at year-end was the highest in the postwar period, and new residential building permits (79,000) were at their lowest level in over two decades. At year-end, it appeared that the economy was still in a recession.

The Department of Finance's economic forecast for 1983 and 1984 generally reflects the consensus of other economists, in that it calls for a modest recovery. In the near term, the economy is expected to remain relatively weak, with only a very small increase in real GNP in the first quarter of 1983. As the year progresses, however, the forecast shows the economy improving gradually, led by consumer spending and improved levels of housing starts and car sales. On the positive side, inflation is expected to remain low (in the 4 to 6 percent range), and interest rates are anticipated to decline further from current levels.

As the economy moves into 1984, the recovery is projected to continue and pick up momentum. The department predicts that the rate of job growth in California will climb from only 0.7 percent in 1983 to 3.3 percent in 1984, resulting in a fall in the unemployment rate from 10.2 percent in 1983 to 8.5 percent in 1984.

No one can say whether the department's economic forecast will prove to be accurate. Economic forecasters have compiled 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; decisions by both the Reagan Administration and the Congress during 1983 and 1984 affecting taxes, spending and the federal deficit; and the reactions of businesses and financial markets to future trends in interest rates and inflationary expectations. We believe that because of these factors, and the precariousness with which the state's budget is to be balanced over the next 18 months, 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 22 summarizes the Governor's Budget estimates of total, General Fund, and special fund revenues. The table shows that:

- *Prior year* (1981–82) total revenues were $23.6 billion (a growth of $1.5 billion, or 6.8 percent, over the preceding year). This amount included about $21 billion in General Fund revenues (a growth of $1.9 billion, or 10.2 percent), and $2.6 billion in special fund revenues (a decline of $440 million, or 14.3 percent).
- *Current year* (1982–83) total revenues are estimated to reach $23.8 billion (a growth of $168 million, or 0.7 percent), including revenues of $20.5 billion to the General Fund (a decline of $471 million, or 2.2 percent). Revenues to special funds are estimated at $3.3 billion, or $638 million (24.2 percent) above the prior year amount.
- *Budget year* (1983–84) total revenues are projected at $26.0 billion ($2.3 billion, or 9.5 percent, above the estimated current-year level). This amount includes $22.5 billion in General Fund revenue (a growth of $2.0 billion, or 9.7 percent), and $3.5 billion in special fund revenues (a growth of $267 million, or 8.2 percent).

Table 22
Summary of General Fund and Special Fund Revenue Performance
1981–82 to 1983–84
(in millions)[a]

	Prior Year (1981–82)	*Current Year (1982–83)*	*Budget Year (1983–84)*
General Fund Revenue			
Amount	$20,960	$20,490	$22,479
Dollar Change	$1,937	−$471	$1,990
Percent Change	10.2%	−2.2%	9.7%
Special Fund Revenues			
Amount	$2,641	$3,279	$3,546
Dollar Change	−$440	$638	$267
Percent Change	−14.3%	24.2%	8.2%
Total, General Fund and Special Fund Revenues			
Amount	$23,601	$23,769	$26,026
Dollar Change	$1,497	$168	$2,257
Percent Change	6.8%	0.7%	9.5%

[a] 1983–84 Governor's Budget. Detail may not add to totals due to rounding. Figures include effects of all revenue-enhancing measures proposed in the budget.

As discussed later, the General Fund and special fund growth rates for the prior, current and budget years have been significantly distorted by a number of factors. These factors include tax accelerations, other revenue enhancements and special fund transfers into the General Fund that were enacted in 1981 and 1982, or have been proposed in the Governor's Budget for 1983–84. In our more detailed discussion of revenues which follows, we show what the "underlying" growth rate of General Fund revenues would be if these factors are excluded.

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

- Growth in total *current dollar* revenues over the 11-year period from 1970–71 through 1980–81 averaged over 14 percent, compared to 6.8 percent for 1981–82, 0.7 percent for 1982–83, and 9.5 percent for 1983–84; and
- Growth in total *constant dollar* revenues (that is, revenues adjusted for inflation) averaged 5.5 percent over this 11-year period, compared to declines of about 1.1 percent in 1981–82 and 4.9 percent in 1982–83, and an increase of 3.3 percent in 1983–84.
- Growth in total *constant dollar per capita* revenues (that is, revenues adjusted for both inflation and population increases) averaged 3.7 percent over the 11-year period, versus declines of 2.8 percent in 1981–82 and 6.5 percent in 1982–83, and an increase of 1.6 percent in 1983–84.

The two main reasons for these historically-low rates of revenue growth in the past three years are (1) the weaknesses in the economy in the past several years, and (2) the revenue effects of income tax indexing. According to the Department of Finance, the latter will reduce 1983–84 General Fund revenues by $3.5 billion below what revenues would have been without indexing. Our estimate of indexing's effect on revenues is even larger—$3.6 billion.

Revenue growth during the period covered by the budget would be even weaker, relative to historical standards, were it not for the following factors:

- *First,* total revenues over the period 1981–82 through 1983–84 reflect the effects of numerous enacted and proposed revenue enhancements. These enhancements were achieved by accelerating the collection of certain taxes, increasing the interest penalties on late tax payments, levying certain fees and user costs, increased tax auditing, and repeal of certain tax credits. These factors are detailed below.
- *Second,* SB 215 (Ch 541/81) and AB 202 (Ch 933/81) increased gasoline and diesel taxes, motor vehicle registration fees, truck weight fees, and drivers' license fees. The result was to increase special fund revenues from motor vehicle user taxes and fees by $205 million in 1981–82, $380 million in the current year and over $630 million in the budget year. In addition, the budget proposes to increase fuel tax revenues by $85 million in the budget year by moving-up the due dates for tax payments.

It is also important to recognize that the prior, 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, have been packaged with the other revenue-enhancing measures mentioned above in order to balance the 1981–82 General Fund budget, reduce the current year General Fund deficit and balance the 1983–84 General Fund budget. They total over $800 million in 1981–82, and over $550 million in both 1982–83 and 1983–84. If the Department of Finance's economic forecast for 1983 and beyond comes true, a continuation of these transfers would not be necessary after 1983–84. 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 (1981–82), current year (1982–83), and budget year (1983–84). 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 1982 ECONOMY IN RETROSPECT

A Bad Year for California

For the third year in a row, the economy performed very poorly in most respects. Table 23 summarizes how the California economy fared during the year, relative to the Department of Finance's projections. It indicates that:

- Employment growth fell below expectations, even though the original projections were not very high. Civilian employment rose by only 0.3 percent, compared to the 1.1 percent increase expected one year ago. Wage and salary job growth was even worse (a decline of 1.4 percent), and this was also a poorer performance than predicted (a gain of 1.1 percent).
- Unemployment averaged 9.9 percent compared to the 8.1 percent expected last year, and ended the year at 11.1 percent. The annual rate was as bad as that reached in 1975, during the last recession. The December rate, however, was the highest December rate on record for the postwar period, indicating that the unemployment situation was actually *worsening* at year-end.

Table 23

Summary of 1982 Economic Performance for California [a]

Economic Indicators	*Original January 1982 Forecast* [b]	*Revised May 1982 Forecast*	*January 1983 Estimated Actual* [c]
Percent change in:			
—Personal income	10.3%	8.5%	7.8%
—Civilian employment	1.1%	0.8%	0.3%
—Wage and salary employment	1.1%	0.3%	−1.4%
—Consumer prices	11.3%	7.5%	6.9%
Unemployment rate (%)	8.1%	9.1%	9.9%
Residential building permits (thousands)	125	86	79
New car sales (thousands)	975	890	840

[a] Forecasts and estimates by the California Department of Finance.
[b] 1982–83 Governor's Budget.
[c] 1983–84 Governor's Budget.

- Residential building permits were reported at only 79,000, compared to the predicted level of 125,000. This performance was the worst in decades, even though population has increased;
- New car sales totaled 840,000, some 135,000 less than projected;

- "Real" personal income (that is, income adjusted for inflation) rose only 0.8 percent using the Consumer Price Index (CPI) as a measure of inflation. Thus, per capita real income did not rise; and
- Taxable sales fell by 0.5 percent, the first time a decline has occurred since 1958.

Table 24 summarizes how successful forecasters other than Finance were in predicting California's economic performance. Like the department, these other forecasters all appear to have expected a better performance by the state's economy than the economy was able to achieve. For example, all but one forecaster overestimated personal income growth, all overestimated the level of employment, and no forecaster came even remotely close to foreseeing the collapse of the residential housing sector. Likewise, all forecasters underpredicted the unemployment rate, and all but the department overstated the growth of real personal income. The one bright spot in the state's economic performance during 1982 involved inflation (6.9 percent on an annual average basis), which was less than what all but one forecaster anticipated.

Table 24

Accuracy of 1982 Economic Forecasts for California [a]

	Economic Variables					
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	10.3%	11.3%	−0.9%	1.1%	8.1%	125
First Interstate Bank [c]	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
UCLA	7.8	5.7	2.0	−0.5	8.8	133
Crocker Bank	9.0	7.8	1.1	0.2	8.4	138
Average of All Forecasters	9.7%	8.1%	1.5%	0.9%	8.2%	133
Actual [e]	7.8%	6.9%	0.3%	−1.4%	9.9%	79

[a] Forecasts as of approximately year-end 1981.

[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" 1982 personal income would be 1.8 percent instead of 0.3 percent.

[c] Formerly United California Bank (UCB). Forecast as of October 1981.

[d] Civilian employment growth estimate.

[e] As estimated in the 1983–84 Governor's Budget.

Economic Weaknesses a Nationwide Problem

California's economic problems in 1982 were, to a large extent, reflections of economic weaknesses in the nation's economy generally. For instance:

- The *nation's real GNP* in the fourth quarter of 1982 was 1 percent *lower* than it was in the fourth quarter of 1979, three years earlier. On five occasions during this period, quarterly real GNP actually declined, including twice during 1982;
- U.S. before-tax *corporate profits* fell in each of the past three years,

even after adjusting for 1981 federal law changes regarding the treatment of depreciation allowances;

- ***Housing starts*** in 1982 averaged only 1.1 million for the year as a whole, the worst performance since 1945;
- ***Capacity utilization*** averaged only 70 percent for 1982, lowest in the postwar period. By December, the rate had slipped to only 67 percent, also a record low;
- ***Business investment expenditures*** on producers' durable equipment in 1982 fell by nearly 2 percent in current dollars, and by 6.5 percent in "real" terms. Adjusted for inflation, total nonresidential investment expenditures in the economy at year-end 1982 were 6.6 percent below their level three years earlier;
- ***Personal income*** increased only 6.4 percent in 1982, the smallest rise in 20 years; and
- ***Interest rates*** declined throughout the latter half of the year. However, although "real" short-term interest rates are now near normal historical levels, "real" long-term interest rates, which are important determinants of investment, continue to remain relatively high.

What Has Gone Wrong?

The economy's poor 1982 performance was essentially a continuation of a generally unhealthy performance by the economy in both 1980 (when real GNP fell by 0.4%) and 1981 (when real GNP rose by only 1.9 percent). Last year at this time, most economists expected a recovery from the recession to begin in 1982, but this did not happen. What has gone wrong?

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 1982's poor performance in terms of output and employment is most directly attributable to tight monetary policies pursued by the Federal Reserve Board (FED) in 1981. During 1981, these policies tended to restrict credit availability, put upward pressures on interest rates, and thereby discourage borrowing to finance home buying and business investment. Although nominal interest rates have since declined, the economy has yet to recover in terms of production and employment.

The FED's original purpose in attempting to reduce monetary growth in 1981 stemmed 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 in 1981, but at the cost of higher inflation in 1982. The monetary authorities feared that such inflation could, after a lag, result in an even weaker economy and stifle recovery. While the FED's monetary actions clearly succeeded in reducing inflation in 1982, the cost of this success was significant losses in production, income, and jobs.

Many economists question whether the benefits of past federal monetary policies have been worth the costs. Others maintain that the nation was destined to pay this price ultimately, due either to the FED's actions or the debilitating effects of inflation on the economy over time. At any rate, selecting the proper policy prescription to rectify today's economic problems is another difficult and, as of yet, unresolved issue.

As 1983 begins, it is not at all apparent whether brighter days for the economy are just ahead. There have been a number of positive developments recently, such as an upswing in housing starts, continuing declines in interest rates, and some improvements in consumer spending. These developments, by themselves, however, are not sufficient to guarantee a first quarter recovery. Indeed, softness in many other sectors of the economy, such as excess inventories, low capacity utilization rates, reduced spending by state and local governments, a deteriorating international trade situation, an increasing federal budget deficit, and declines in planned business investment spending, all argue against any quick rebound in business activity. Because of preliminary data showing that real GNP declined at a 2.5 percent annual rate in the fourth quarter of 1982, and the high probability that the current quarter will be weak, many economists believe that we may still be in the midst of a recession. Thus, the economy closed 1982 and began 1983 on a fairly negative note, and the outlook for recovery is still rather "iffy".

2. THE ECONOMIC OUTLOOK FOR 1983 AND 1984

Economic activity in calendar 1983 will account for about one-third of current-year (1982–83) General Fund revenues and about two-thirds of budget-year (1983–84) General Fund revenues. The remaining one-third of budget-year revenues will be determined by 1984 economic conditions. Table 25 summarizes the Department of Finance's economic projections for 1983 and 1984 for both the nation and California.

The Nation—From Recession to Recovery

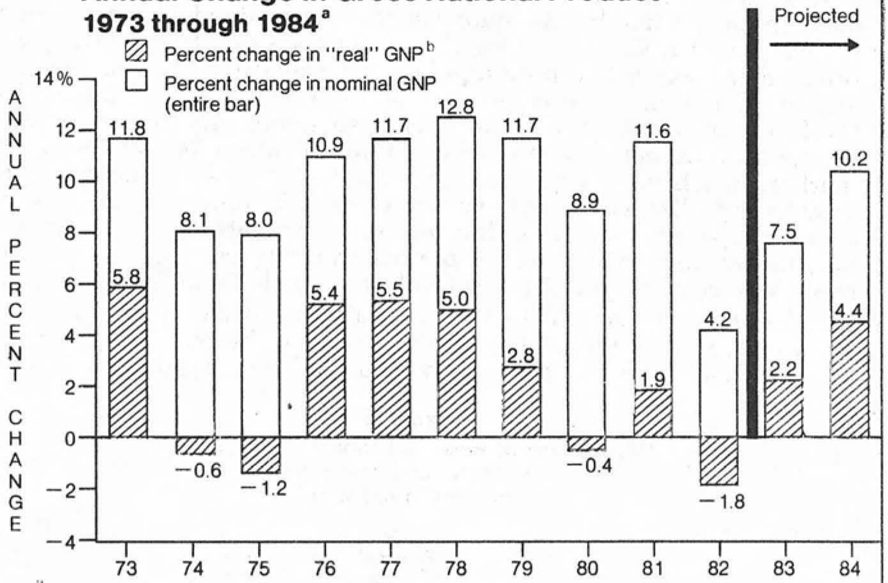
The department's forecast reflects the consensus view that the current recession will end sometime in early 1983, and that the recovery is expected to be moderate, though sustained, carrying forward beyond 1983 and throughout 1984. For the nation as a whole:

- ***Real GNP*** is projected to rise by a modest 2.2 percent in 1983, and then rise by a somewhat stronger 4.4 percent in 1984. This upswing, however, will be weaker than that which followed the 1973–75 recession (See Chart 11).
- ***Pre-tax corporate profits*** are expected to post a 10.7 percent gain in 1983. Despite this rise, however, the level of profits in 1983, after adjusting for recent federal tax law changes regarding treatment of depreciation allowances, will still be below that of 1978, even before adjusting for inflation. In 1984, profits are predicted to register a 17 percent gain.
- ***Unemployment*** is expected to average 10.0 percent in 1983, an increase over the record 9.6 percent rate of 1982. This rise will occur, despite the projected economic recovery, because businesses will add workers too slowly to offset the normal growth in the labor force and the reentrance into the job market of previously discouraged workers. In 1984, the unemployment rate is predicted to fall to 8.7 percent, which would still be above its 1981 level (See Chart 12).
- ***Employment growth*** is expected to be negligible in 1983, rising only 0.2 percent for wage and salary workers and 1 percent for all civilian workers. In 1984, moderate gains of about 3 percent for each employment category are projected.
- ***Housing starts*** will rise in 1983 to 1.34 million units. While this is an improvement over 1982, it is still a relatively depressed level. In 1984, starts are projected to rise to 1.63 million units.
- ***Car sales*** are projected to improve, reaching 8.6 million units in 1983. In 1984, a further increase, to 10.2 million units, is projected.

Chart 11

Annual Change in Gross National Product

1973 through 1984[a]



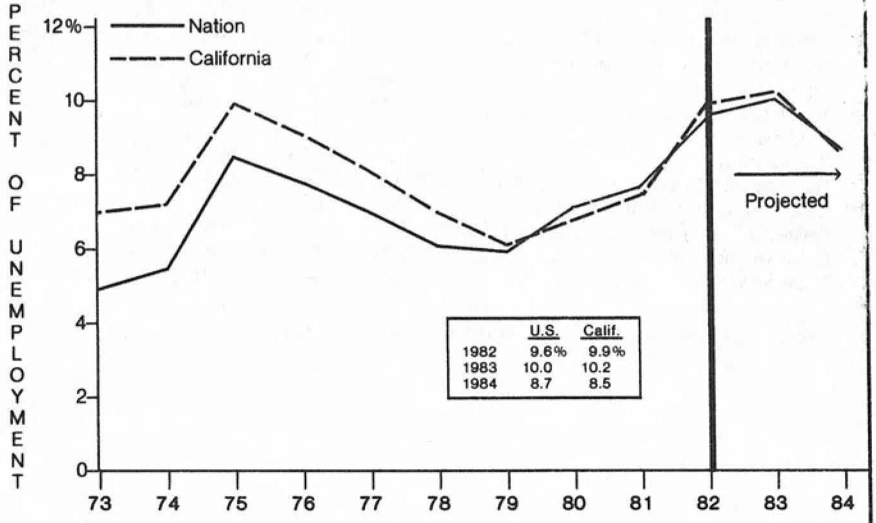
[a] California Department of Finance. 1981 figures are preliminary

[b] "Real" GNP is defined as current dollar nominal GNP deflated by the U.S. GNP price deflator

Chart 12

Unemployment Rates for California and the Nation

1973 through 1984[a]



[a] California Department of Finance

California—Similar Expectations for a Modest Recovery

Most economists who study the California economy agree with the department's belief that the state will begin a sustained period of economic recovery in 1983. In addition, the consensus is that this recovery could proceed at a somewhat more-rapid pace in California than for the nation at large. There are several reasons for this. One involves the benefits to California of increased federal defense spending. Another involves the improved prospects which declining interest rates offer for the housing market, which is an especially important sector of the economy in a growth state like California. Nevertheless, it is important to stress that economic performance in California, as for the nation, is expected to be only moderate over the forecast period, especially compared to past post-recession recovery periods. For California, Table 25 indicates that:

- ***Employment growth*** in 1983 is projected to rise only very slowly. Civilian employment growth is forecast to be only 1.5 percent. As shown in Chart 13, California wage and salary job growth is projected

Table 25
Department of Finance Economic Outlook for California and the Nation (dollars in billions) [a]

	1982 Estimated		*1983 Forecast*		*1984 Forecast*	
A. The Nation	*Level*	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*
GNP in current dollars	$3,060.1	4.2%	$3,288.4	7.5%	$3,623.9	10.2%
GNP in 1972 dollars	$1,475.9	−1.8	$1,508.0	2.2	$1,574.0	4.4
Personal income	$2,572.2	6.5	$2,763.2	7.4	$3,030.1	9.7
Corporate profits (pre-tax)	$176.9	−23.8	$195.8	10.7	$229.0	17.0
Wage and salary employment (in thousands)	89,686	−1.6	89,863	0.2	92,569	3.0
Civilian employment (in thousands)	99,605	−0.8	100,617	1.0	103,733	3.1
Housing starts (millions of units)	1.04	−5.3	1.34	28.7	1.63	21.3
New car sales (millions of units)	7.8	−8.8	8.6	10.9	10.2	18.2
GNP price deflator (1972=100)	207.3	6.0	218.0	5.2	230.2	5.6
Consumer price index (1967=100)	289.5	6.3	305.4	5.5	323.8	6.0
GNP consumption deflator (1972=100)	205.9	5.9	216.5	5.1	228.3	5.5
Unemployment (%)	9.6%	—	10.0%	—	8.7%	—
Savings rate (%)	6.7%	—	6.8%	—	6.4%	—
B. California						
Personal income	$311.0	7.8%	$337.6	8.5%	$370.3	9.7%
Wage and salary employment (in thousands)	9,901	−1.4	9,974	0.7	10,300	3.3
Civilian employment (in thousands)	10,940	0.3	11,110	1.5	11,579	4.2
Residential building permits (in thousands)	79	−25.8	125	58.8	150	20.0
Consumer price index	295.5	6.9	308.4	4.4	329.1	6.7
Unemployment rate	9.9%	—	10.2%	—	8.5%	—

[a] Source: Department of Finance and 1983–84 Governor's Budget.

to be even less—only 0.7 percent in 1983, representing just 73,000 new jobs. As a result, employment in 1983 will still be lower than it was in 1981.

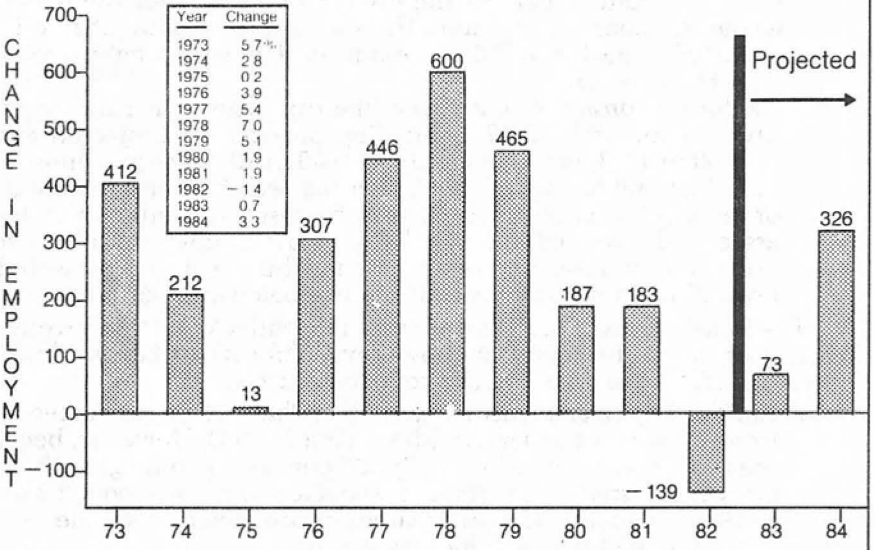
- ***The unemployment rate*** is expected to rise from 9.9 percent in 1982 to 10.2 percent in 1983, or slightly above the rate for the nation as a whole. As Chart 12 indicates, the state's unemployment rate is then expected to decline to 8.5 percent in 1984, or somewhat more rapidly than the nation's.
- California ***construction activity,*** like the nation's, is expected to improve moderately in 1983. Building permits are projected to reach 125,000 in 1983, before rising to 150,000 in 1984. 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, in-migration, and replacement. Thus, even the projected 1984 level of building permits represents a below-normal level.

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 14) is projected to rise from 7.8 percent in 1982 to 8.5 percent in 1983. However, because of the projected fall in inflation, "real" personal income growth (that is, growth adjusted for inflation) is expected to rise by about 3.2 percent in 1983, or about twice as great an improvement over the 1982 rate as for nominal personal income growth.
- ***Taxable corporate profits*** are forecast to rise 8.1 percent in 1983 and 15 percent in 1984, following declines of 3.6 percent in 1982 and 5.4 percent in 1981, and a rise of only 1.7 percent in 1980 (See Chart 19 on page 84). The projected 1983 gain is relatively mild, given the poor profit performance in the previous three years, and would leave the level of profits in 1983 only slightly above the 1979 level. The projected 1983 and 1984 gains are far below the 20-percent-plus increases experienced from 1976 through 1978, after the last recession ended, and indicate the generally poor state of corporate balance sheets.
- ***Taxable sales*** are predicted to rise 8.9 percent in 1983 and 13.6 percent in 1984. The 1983 increase, while in line with projected personal income growth (8.5 percent), is far from robust for a recovery year. For example, the 1983 increase in "real" taxable sales (that is, taxable sales adjusted for inflation) is 3.5 percent. This will not be sufficient to bring real taxable sales back to their 1979 level, since real sales fell by 1.7 percent in 1980, rose by only 0.1 percent in 1981, and declined by 6 percent in 1982 (see Chart 18 on page 82). By comparison, real taxable sales in 1976, the year following the 1973–75 recession, rose 8.6 percent, and in the subsequent year, they rose 12.2 percent.

Chart 13

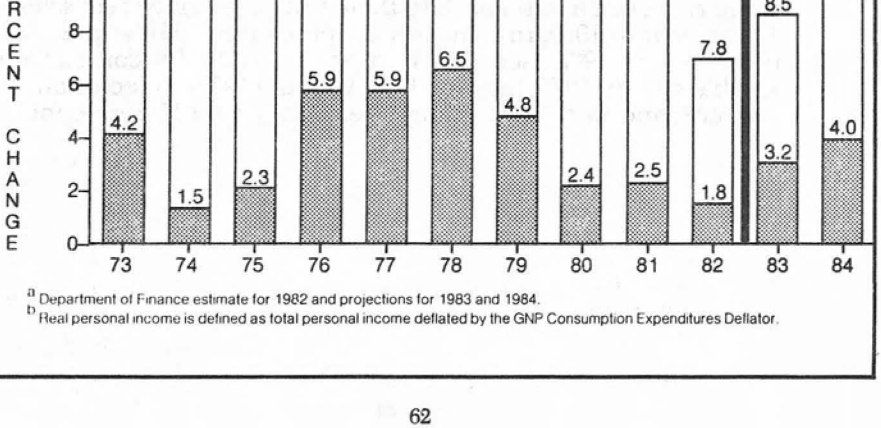
Annual Growth in California Wage and Salary Employment 1973 through 1983 (in thousands)[a]



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

Chart 14

Annual Growth in California Personal Income 1973 through 1984[a]



[a] Department of Finance estimate for 1982 and projections for 1983 and 1984.
[b] Real personal income is defined as total personal income deflated by the GNP Consumption Expenditures Deflator.

These projections are all consistent with the consensus view of economists that the projected recovery in 1983 will be relatively mild, and that although the recovery will gain momentum in 1984, it will still be only moderate by historical standards. It is primarily because of this moderate economic recovery that only relatively modest gains in state revenues are anticipated for 1982–83 and 1983–84.

Inflation Outlook Moderately Favorable

Chart 15 shows the trend of inflation faced by consumers over the past 10 years, and the department's projected rates of inflation for 1983 and 1984.

As Table 24 shows, California's inflation experience during 1982—an average rate of 6.9 percent—was far better than what the department projected 12 months ago—11.3 percent. In fact, most forecasters overestimated the rate of inflation in 1982. There were a number of reasons for this. The most important of these was the recession. The unprecedented level of excess productive capacity and the high rate of unemployment combined to lessen upward pressures on wage rates, input costs and the prices of final outputs. Other factors contributing to the surprisingly low rate of inflation were the oil surplus on world markets, which held down the rate of increase in petroleum and energy-related prices, declining interest rates, and only moderate increases in food prices. Also important was the reduction in the rate of monetary expansion in 1981.

For 1983, the department projects a further easing of inflation, due to the softness in the economy. In 1984, however, the rate of inflation is projected to rise somewhat, as the economy gains strength and begins to put pressure on the prices of certain inputs and outputs. The department's general inflation projection—between 4½ percent and 5½ percent in 1983 and between 5½ percent and 6½ percent for 1984, depending on the measure of inflation used—reflects the consensus view of economic forecasters at this time. This forecast assumes that the federal monetary authorities will "ease up" enough in controlling the growth rate of the money supply to accommodate a moderate recovery, but not so much as to rekindle inflationary expectations.

Interest Rates—Continued Declines Hoped For

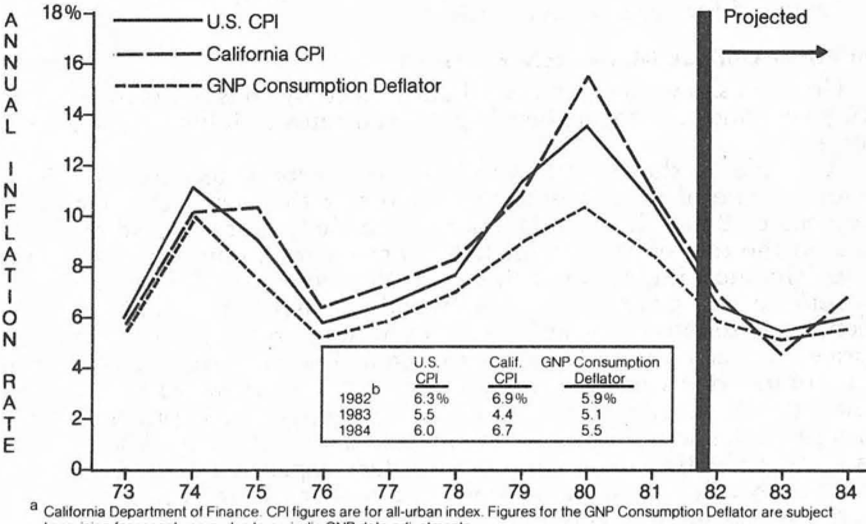
One of the most critical elements in the economic forecast for 1983 and 1984 is the behavior of interest rates. This is because the pace of economic activity is very much influenced by the behavior of credit-sensitive sectors—namely, housing, automobiles and business investment. Unfortunately, however, the future path of interest rates is subject to considerable uncertainty, especially in light of the need to finance a federal deficit exceeding $200 billion.

Chart 16 shows the pattern of short-term and long-term interest rates over the past 10 years and projections for 1983 and 1984. Beginning in about 1976, interest rates generally began an upward climb, peaking at record levels in 1981. The 1981 escalation was primarily due to a combination of restrictive monetary policies followed by the FED and high rates of inflation. During the first six months of 1982, neither short-term nor long-term rates changed much. After mid-year, however, less restrictive monetary policies, declining rates of inflation and a weak economy resulted in rather sharp drops in rates. As of year-end 1982, these declines already appeared to have given some boost to consumer purchases of

Chart 15

Inflation Faced by Consumers in California and the Nation

1973 through 1984[a]



	U.S. CPI	Calif. CPI	GNP Consumption Deflator
1982[b]	6.3%	6.9%	5.9%
1983	5.5	4.4	5.1
1984	6.0	6.7	5.5

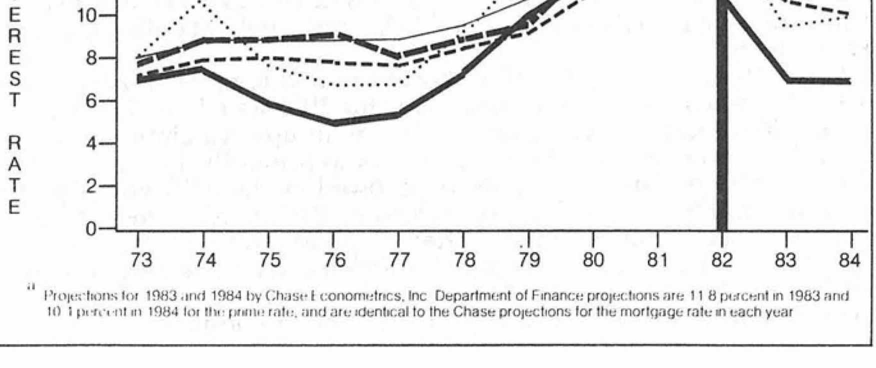
[a] California Department of Finance. CPI figures are for all-urban index. Figures for the GNP Consumption Deflator are subject to revision for recent years, due to periodic GNP data adjustments.

[b] Preliminary estimates.

Chart 16

Trends in Interest Rates

1973 through 1984[a]



[a] Projections for 1983 and 1984 by Chase Econometrics, Inc. Department of Finance projections are 11.8 percent in 1983 and 10.1 percent in 1984 for the prime rate, and are identical to the Chase projections for the mortgage rate in each year.

automobiles, and to housing starts.

The department predicts that interest rates will continue to drift downward in 1983 and 1984, with a prime rate of 10 percent and a mortgage rate of 12 percent at year-end 1984. This projection is shared by most other forecasters. Thus, the most common outlook for interest rates is a relatively favorable one which, if realized, will be a positive influence on both consumer and business spending decisions. The basis for this outlook is the belief that interest rate-reducing factors will be fairly strong in the months ahead. These factors include a very mild economic recovery, low inflation rates and weak private sector credit demands.

It must be stressed, however, that this optimistic forecast for interest rates could be "off target". Two factors, in particular, could cause interest rates to turn up and thereby jeopardize the recovery. These factors involve (1) the degree to which federal monetary authorities restrict the growth in the money supply, and (2) the impact on the credit markets of the federal government's need to finance an enormous deficit.

Federal Policies—More Important Than Ever

There are two general categories of federal policies that can influence the level and composition of economic activity. First, there are the taxing and spending policies of the federal government, which are generally referred to as *fiscal policies.* 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.* The future course of federal monetary and fiscal policies represents the single biggest uncertainty in the economic outlook for 1983 and beyond, and will probably exert the greatest influence on the economic performance of both the nation and California.

Monetary Policy: As discussed earlier, monetary policies exert an important influence on a great many economic variables, including inflation, interest rates and spending by consumers and businesses. Most economists share the department's assumption that the FED has somewhat changed its policy recently, by moving away from a strict focus on the rate of growth in various types of "money", and toward recognition that it must take specific actions aimed at reducing and stabilizing the level of interest rates. The challenge for the FED will be the same one that it always faces—can the money supply be increased at a rate which is high enough to accommodate a healthy pace of economic activity, and yet not so high as to ignite inflation? In past years, the FED's track record in achieving this goal has not been very good. Only time will tell if it will be more successful this time around. Its task will be more difficult than ever because of the need to help finance the huge federal deficit.

Fiscal Policy: The major fiscal policy issue is well-known—can the government control the size of the federal budget deficit, and can the deficit be financed without impeding the ability of the economy to recover from the recession?

In many respects, fiscal policy is "between a rock and a hard place." On the one hand, the federal government could attempt to reduce the deficit immediately by increasing taxes and lowering spending. This approach, however, could also slow the pace of economic activity in the near term by lowering total spending, and thereby reducing output and employment. On the other hand, the government could continue to follow the "supply-side" course of action espoused by the President in 1981, when he proposed a tax-reduction plan to stimulate private sector activities. While this approach has the potential to offer significant long-term benefits, it has had the effect in the short-run of enlarging the budget deficit.

Most economists agree that the federal deficit as a percentage of the GNP will reach unprecedented levels in the next several fiscal years, and that the deficit will not be eliminated easily. In the near term, financing the deficit may not significantly escalate interest rates, primarily because of the relatively weak demand for credit on the part of the private sector, due to the recession. Considerable uncertainty exists, however, over what the effects of financing these deficits will be in the last half of 1983 and beyond on monetary growth, inflation, interest rates, and consumer and business confidence. The worst case would be if financing the deficit "crowded out" private sector borrowing and thereby aborted the recovery.

One thing does appear clear—there is no simple, obvious, agreed-upon way out of the federal government's current budgetary problems. As a result, the exact course which fiscal and monetary policies will take in 1983 and 1984 remains rather clouded.

Finance Versus Other Forecasters

Tables 26 and 27 compare the Department of Finance's national and California economic forecasts for 1983 with those which were made at approximately year-end 1982 by other economists. The department's economic forecast is about where most other public and private forecasters were when the department prepared its forecast (November-December 1982). Since then, some forecasters have revised their projections downward. Nevertheless, the department's forecast is not out of line. Rather, most of the forecasters envision the same general type of economy in 1983 as Finance does—very modest economic growth, reduced inflation, and only moderate levels of profits, home building, and car sales. In the case of California, the department's projected 1983 personal income growth rate—8.5 percent—reflects the consensus, and is below that of some forecasters (Bank of America, for example, predicts a growth rate of 10.0 percent) and above that of others (UCLA, for example, predicts an increase of 7.4 percent).

Our discussions with these forecasters indicate that they all are considerably uncertain about exactly what will happen over the next two years, and expect that they will 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. This is *not* to say, of course, that the Legislature can be confident that the forecast will, in fact, prove to be accurate. In fact, the odds are low that it, or any of the other forecasts shown in Tables 26 and 27, will turn out to be exactly on target. There is simply too much uncertainty regarding the future to allow *anyone* to be confident about *any* forecast. What we are suggesting is simply that the department's economic forecast appears to be neither excessively optimistic nor excessively pessimistic, relative to the views of the economic forecasting community at large.

Table 26
Comparison of 1983 National Economic Outlook for Selected Forecasters

Forecaster	Percent Change in: Real GNP	GNP Prices	Consumer Prices	Before-Tax Profits	Personal Income	Unemployment Rate	New Car Sales (millions of units)	Housing Starts (millions of units)
Department of Finance	2.2%	5.2%	5.5%	10.7%	7.4%	10.0%	8.6	1.34
Other Forecasters[a]								
Date Resources	1.6	5.3	5.1	8.5	7.4	10.7	8.7	1.48
UCLA	1.9	5.1	3.9	7.0	7.1	10.9	8.9	1.41
Evans Economics	0.9	5.0	4.7	11.9	5.6	11.4	8.4	1.35
Security Pacific Bank	2.1[b]	5.3	5.1	22.2	7.3	10.6	8.9	1.48
Citibank	3.1	5.4	5.2	15.9	8.3	9.9	9.4	1.50
Crocker bank[c]	3.2	5.7	5.8	N/A	N/A	9.3	9.1	1.38
First Interstate Bank[c,d]	3.6	5.8	5.6	19.8[e]	9.5	9.5	9.0	1.31
Conference Board	2.4	5.2	5.3	23.1	6.8	10.5	8.9	1.33
Chase Econometrics	2.1	5.0	4.8	14.6	7.2	10.3	9.3	1.39
Wharton	2.4	5.2	4.9	10.2	7.1	10.5	9.6	1.47
Bank of America	1.3–2.5	5.3	4.9	2.0	6.8	10.3	8.5	1.39
Blue Chip Consensus[f]	2.5	5.1	5.0	17.5	7.6	10.3	9.2	1.45
Commission on State Finance	2.2	5.2	5.2	10.3	7.5	10.1	8.6	1.41
Average of "Other" Forecasters	2.3%	5.3%	5.0%	13.6%	7.4%	10.3%	9.0	1.41

[a] Forecasts as of approximately year-end 1982.
[b] In January 1983, this forecast was revised upward to 2.6 percent.
[c] Forecast as of October 1982.
[d] Formerly United California Bank (UCB).
[e] Projection of corporate operating profits.
[f] Consensus forecast for approximately 40 private sector forecasters collected monthly by Eggert Economic Enterprises, Inc.

Table 27
Comparison of 1982 California Economic Outlook for Selected Forecasters

	Percent Change in: Personal Income	Consumer Prices	Real Personal Income[a]	Civilian Employment	Wage and Salary Employment	Unemployment Rate	New Residential Building Permits (thousands)
Department of Finance	8.5%	4.4%	3.9%	1.5%	0.7%	10.2%	125
Other Forecasters[b]							
First Interstate Bank[c]	N/A	N/A	N/A	N/A	0.7	N/A	110
Security Pacific Bank	9.4	N/A	N/A	N/A	1.4	10.0	102
Bank of America	10.0	6.2	3.6	1.6	N/A	9.6	80
Crocker Bank	8.4	4.1	4.1	2.1	1.3	10.2	125
UCLA	7.4	2.9	4.4	0.6	0.2	11.6	114
Commission on State Finance	8.1	4.3	3.6	N/A	0.8	10.8	114
Average of "Other" Forecasters	8.7%	4.4%	3.7%	1.4%	0.9%	10.4%	108

[a] Defined as personal income growth adjusted for consumer price inflation.
[b] Forecasts as of approximately year-end 1982.
[c] Formerly United California Bank (UCB). Forecast as of October 1982.

C. PRIOR YEAR (1981–82) REVENUES

Table 28 summarizes 1981–82 General Fund revenue collections. These receipts totaled $20,960 million, an increase of $1,937 million (10.2 percent) over 1980–81. As Table 28 shows:

- ***Sales and use taxes*** increased 7.8 percent, or $543 million;
- ***Personal income taxes*** rose 13.0 percent, or $864 million;
- ***Bank and corporation taxes*** declined 3.0 percent, or $82 million;
- ***Interest income*** fell by $128 million, reflecting both the decline in the size of the General Fund budget surplus available for investment, and the tapering-off of market interest rates;
- ***Transfer income*** to the General Fund rose by $747 million, from $315 million to $1,062 million; and
- Collections from *all other sources,* including taxes and licenses, were essentially unchanged, declining by about $7 million.

Special Factors—Accounted for $1.3 billion or Two-Thirds of Revenue Growth

A number of special factors accounted for $1.3 billion, or two-thirds of the total growth in General Fund revenues during 1981–82.

- ***Tax Collections were Accelerated.*** These accelerations totaled $315 million, including $155 million for the personal income tax under AB 6x (Ch 2x/82), and $160 million for the sales and use tax under AB 1253 (Ch 115/82) and AB 8x (Ch 5x/82).
- ***Interest Penalties on Delinquent Taxes were Raised.*** These penalties brought in approximately $65 million in additional revenues from the personal income tax, the sales tax, and the bank and corporation tax (AB 8x).
- ***Revenues were Transferred from Special Funds to the General Fund.*** Because of legislative action taken in both 1981 and 1982, General Fund transfer income was raised by nearly $870 million. Most of these transfers (over $600 million) represented revenues from the state's tidelands, which are normally put into special funds to support

a variety of capital outlay programs. The General Fund also received approximately $150 million in transfer income from the Vehicle License Fee Account and other sources which normally would have gone to local governments.

Weak Underlying Revenue Growth Trend

Had these special factors not been present, General Fund revenue growth in 1981–82 would have been only 3.2 percent ($612 million). This would have been the *lowest* rate of growth in General Fund revenues since 1970–71.

The recession was the major factor responsible for this anemic underlying growth rate. Especially important in this regard was the drop in California corporate profits (−5.4% in 1981 and −3.6% in 1982), and the fall in the portion of personal income which consumers spent on taxable items (the ratio of taxable to personal income fell from over 55 percent in 1980 to under 50 percent in 1982).

Table 28

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

Income Source	*Actual 1980–81*	*Actual 1981–82*	*Change Amount*	*Change Percent*	*Percent Change Which Would Have Occurred in the Absence of Special Factors*[b]
Three major taxes:					
Sales and use tax	$7,006	$7,549	$543	7.8%	5.2%
Personal income tax	6,629	7,493	864	13.0	10.2
Bank and corporation tax	2,731	2,649	−82	−3.0	−5.4
Other major taxes and licenses	1,442	1,418	−24	−1.7	5.9
Total, major taxes and licenses	$17,808	$19,109	$1,301	7.3%	5.5%
Interest income	464	336	−128	−27.6	−27.6
Transfers	315	1,062	747	137.1	−10.8
Other revenues	436	453	17	3.9	−0.2
Total General Fund Revenues and Transfers	$19,023	$20,960	$1,937	10.2%	4.3%

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

[b] One-time transfers and revenue enhancements in 1981–82 totalled approximately $1.3 billion and included (1) $179 million in increased transfers and other revenues associated with SB 102 (Ch 101/81), (2) $400 million in transfers associated with the 1981 Budget Act, (3) $25 million in U.C. profit transfers, (4) $399 million in increased sales tax, personal income tax and bank and corporation tax revenues associated primarily with tax accelerations and interest penalties under AB 6x (Ch 2x/82), AB 7x (Ch 4x/82), AB 8x (Ch 5x/82) and AB 1253 (Ch 115/82), and (5) $322 million in increased transfers under the 1982 Budget Act and trailer legislation. In addition, General Fund revenue sharing transfers declined from $276.2 million in 1980–81 to $179.5 million in 1981–82, or by $97 million, and AB 2092 (Ch 634/80) reduced inheritance and gift tax receipts by approximately $1.2 million in 1980–81 and $109.3 million in 1982–83. The increase in 1981–82 revenues would have been $817 million instead of $1,937 million had none of these special factors occurred.

Other factors also contributed to the sluggish growth in revenues during 1981–82. They include the decline in interest income (brought about primarily by the decline in the General Fund surplus), the phasing-out of federal revenue sharing for state governments, and the phasing-in of AB 2092 (Chapter 634/80), which exempted spouses from inheritance and gift taxes. Table 28 shows that even if the effects of these factors are ignored, underlying revenue growth in 1981–82 is still less than 5 percent.

Weak Economy Caused Record Downward Revenue Revisions

Table 29 shows how the Department of Finance revised its original 1981–82 revenue forecast between January 1981 and the end of the fiscal year. The table indicates that:

- Actual revenues were *less* than the original estimate presented in the Governor's Budget (January 1981) by over $1.3 billion, or 6.4 percent. This amount, which excludes the effects of 1981 tax legislation, reflects downward adjustments of $605 million for the sales and use tax, $126 million for the personal income tax, and $450 million for the bank and corporation tax.
- Actual revenues were also nearly $1.6 billion, or 7.5 percent, *less* than the May 1981 revenue revision provided to the Legislature before it acted on the 1981–82 budget.
- Actual revenues were $723 million, or 3.4 percent *less* than the mid-year estimate prepared in January 1982 for the 1982–83 Governor's Budget.

Table 30 compares the department's revenue estimating errors for 1981–82 to those over the preceding eight-year period beginning with 1973–74. Several important points emerge from this table:

- ***First,*** in *dollar* terms, the 1981–82 errors were the *largest on record.*
- ***Second,*** in *percentage* terms, the error made in May 1981 was also the *largest on record.* This is especially significant because the May revision immediately preceding the start of the budget year provides the data used by the Legislature when it takes action on the budget (in this case, the 1981–82 budget). It was this inability in May to foresee the trend in revenues that, more than any other factor, necessitated the enactment in 1982 of tax accelerations and special transfers in order to balance the budget on June 30, 1982.

These record downward revenue revisions illustrate the tremendous impact which the recession had on the state's fiscal position.

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. Given the record for 1980–81 and 1981–82, and the downward revisions already made in the 1982–83 revenue estimate, no such bias is evident today. At this time, we see no indication that the state can count on any significant revenue "windfalls" as a result of an inherent conservative bias in estimating revenues.

D. CURRENT YEAR (1982–83) REVENUES

Special Factors Again Hold Up Revenues

Table 31 summarizes the Department of Finance's General Fund revenue projections for 1982–83. Before turning to a discussion of these figures, however, it is important to note that the current-year estimates include

Table 29

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	1981 Legislation	January 1982 Baseline Revision[b]	March Revision	May Revision	1982 Legislation[c]	January 1983[d]	Actual	Total Revisions Adjusted For Legislation
Bank and corporation tax[e]	$3,035.2	$244.8	$28.0[f]	−$288.0	−$255.0	−$50.0	$35.0	−$101.3	$2,648.7	−$449.5
Personal income tax	7,435.0	100.0	−0.8	−184.2	−97.0	65.0	185.0	−10.0	7,493.0	−126.2
Sales and use tax	8,000.7	−40.7	−26.3	−358.7	−140.0	−25.0	179.0	−40.3	7,548.7	−604.7
Other taxes	1,563.7	−97.8	−0.3	−48.9	17.3	—	—	−15.0	1,419.0	−144.4
Total taxes	$20,034.6	$206.3	$0.6	−$879.8	−$474.7	−$10.0	$399.0	−$166.6	$19,109.4	−$1,324.8
Interest income	326.6	48.4	—	−61.3	—	—	—	22.1	335.8	9.2
Other revenue	401.7	−4.0	$17.4	95.0	—	−$30.0[g]	—	−27.0	453.1	34.0
Total, revenues	$20,762.9	$250.7	$18.0	−$846.2	−$474.7	−$40.0	$399.0	−$171.5	$19,898.4	−$1,281.7
Transfers	256.8[h]	—	546.6	−26.4	—	—	322.0	−37.0	1,062.0	−63.4
Total, General Fund revenues and transfers	$21,019.7	$250.7	$564.6[i]	−$872.6	−$474.7	−$40.0	$721.0	−$208.5	$20,960.3	−$1,345.1

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

[b] Excludes proposed enhancements to revenues and transfers totaling $519 million contained in the 1982–83 Governor's Budget and 1982 Budget Bill, and includes certain unidentified revisions to estimated fiscal effects of 1981 legislation.

[c] Major items of legislation included accelerated sales tax receipts of $160 million (AB 8x and AB 1253), accelerated income tax receipts of $155 million (AB 6x), revenues from higher interest penalties on delinquent taxes of $65 million (AB 8x), and one-time transfers ($322 million), primarily associated with tidelands oil revenues ($211 million).

[d] Revenue receipts in May and June of 1982 fell short of projected receipts by $185.2 million. This shortfall accounts for most of the January 1983 revision.

[e] 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.

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

[g] Includes $29 million downward adjustment for accrued Health Care Deposit Fund receipts.

[h] 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.

[i] 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 were originally estimated to total $26 million in 1981–82; and (4) other legislation enacted during 1981 (−$3.1 million).

Table 30
General Fund Revenue Estimating Errors, 1973–74 through 1981–82 [e]

	Errors made in Original January Budget [b]		*Errors Made in May* [c]		*Errors Made in Midyear* [d]	
	Dollar Error	*Percent*	*Dollar Error*	*Percent*	*Dollar Error*	*Percent*
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
1981–82	1,345	6.4	1,596	7.5	723	3.4

[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.

over $1 billion in "new" and primarily "one-time" General Fund monies. *Thus, the revenue figures published in the budget for 1982–83, as was the case for 1981–82, provide a distorted picture of the underlying growth trend in the state's General Fund revenue base.*

This $1 billion in new or one-time revenues includes:

- Over $500 million in various types of *tax accelerations* due to revisions in tax prepayment dates and regulations, including a $230 million acceleration in insurance taxes, a $140 million acceleration in sales taxes, and a $40 million acceleration in bank and corporation taxes;
- Nearly $400 million in General Fund *transfers* from special funds, including $261 million from the Motor Vehicle License Fee Account and $80 million from the California Water Fund; and
- About $185 million in "other revenues," including over $130 million in tidelands oil revenues.

About $170 million of the $1 billion amount will be ongoing, representing primarily the permanent year-to-year gains in revenues from the revised tax payment dates and the increased penalties from delinquent tax payments. The remainder—nearly $830 million—represents "one-time" revenues.

Limited Strength in Underlying Revenue Trend

Table 31 indicates that General Fund revenues in 1982–83 are estimated to total about $20.5 billion, including $7.6 billion from the sales and use tax (a 0.4 percent gain), $7.3 billion from the personal income tax (a 2.9 percent reduction), and $2.6 billion from the bank and corporation tax (a 0.3 percent reduction). This represents a *loss* in General Fund revenues of almost $500 million (−2.2 percent) from 1981–82, or a decline of nearly

8 percent in constant dollars and 10 percent in constant dollars per capita. Had the special funds transfers and revenue enhancements provided for in both 1981–82 and 1982–83 not occurred, revenue growth still would have been *negative* (−1.1 percent), and General Fund revenues would have declined by over $200 million.

Part of the weak revenue performance in 1982–83 is explained by the phasing-out of inheritance and gift taxes and the termination of federal revenue sharing with the states. However, Table 31 shows that even after adjusting for all special factors—the special fund transfers, revenue enhancements, and the phasing-out of inheritance and gift taxes and federal revenue sharing—the underlying revenue growth trend for 1982–83 is still only about 1.2 percent.

Table 31
Growth of Current Year (1982–83)
General Fund Revenues by Type
(in millions) [a]

Revenue Source	*Actual 1981–82* [b]	*Estimated 1982–83* [c]	*Change*		*Percent Change in the Absence of Special Factors* [d]
			Amount	*Percent*	
Sales and use tax	$7,549	$7,578	$29	0.4%	1.1%
Personal income tax	7,493	7,275	−218	−2.9	−1.3
Bank and corporation tax	2,649	2,640	−9	−0.3	−0.7
Other major taxes and licenses	1,418	1,646	228	16.1	18.9
Total Major Taxes and Licenses	$19,109	$19,139	$30	0.2%	1.3%
Interest income	336	229	−107	−31.8	−31.8%
Other revenues	453	682	229	50.6	14.3
Transfers [e]	1,062	440	−622	−58.6	23.3
Totals General Fund Revenues and Transfers	$20,960	$20,490	−$470	−2.2%	1.2%

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

[b] Includes approximately $1.3 billion in revenue enhancements and special one-time General Fund transfers from special funds. Revenue enhancements include the acceleration of personal income taxes and sales and use taxes ($315 million) and increased revenues due to higher interest penalties on delinquent tax payments ($65 million). Transfers include nearly $870 million, composed of (1) nearly $550 million associated with 1981 legislation regarding the distribution of tidelands oil revenues and SB 102 (Ch 101/81), and (2) $322 million associated with the 1982 Budget Act, trailer bills and other 1982 legislation.

[c] Includes approximately $1 billion in enhancements, including accelerations of tax collections (over $500 million), General Fund transfers (about $400 million), and $156 million in tidelands oil revenues.

[d] Based upon data from Department of Finance and Commission on State Finance. Excludes one-time gains associated with "cost recovery" oil (see footnote e) and adjusts for one-time $31 million loss in insurance tax receipts due to court case involving principal office deduction. Other adjustments include the special funds transfers and revenue enhancements detailed in footnotes b and c, the decline in federal revenue sharing receipts from $180 million in 1981–82 to zero in 1982–83, and reductions in inheritance and gift tax revenues due to AB 2092 (Ch 634/80) and Proposition 6 (June 1982) of $109 million in 1981–82 and $348 million in 1982–83.

[e] General Fund "other revenues" from tidelands oil and gas receipts increased by approximately $139 million in 1982–83 over 1981–82. Included in this amount is an approximately $80 million one-time gain in state revenues due to federal tax law changes involving application of the windfall profits tax to "cost recovery" oil.

This weak revenue trend can be explained by three main factors:

- ***First,*** and most important, revenue growth in 1982–83, as in 1981–82, has slowed significantly due to the recession. For example, taxable sales actually *fell* in 1982—by 0.5 percent—for the first time since 1958. This occurred despite an increase of 7.8 percent in personal income.

- ***Second,*** the adjustment factor in 1982 for indexing the personal income tax brackets for inflation is 9.3 percent. Because this factor exceeds the average rate of income growth in 1982, this will have the effect of moving many taxpayers "backward" through the state's progressive income tax schedules, thereby limiting the growth in tax liabilities to only about 5 percent.
- ***Third,*** interest income is projected to fall by $107 million in the current year, due to the decline in the General Fund surplus available for investment and the fall in interest rates.

Current Year Revenues—Largest Downward Revision on Record

Table 32 presents the history of General Fund revenue estimates for 1982–83. The table clearly demonstrates the dramatic negative impact which the recession has had on the current year's revenues. It shows that:

- Since the *original* preliminary estimate of 1982–83 revenues was made approximately 21 months ago in May 1981, total General Fund revenues have been revised downward by nearly *$3.4 billion.* This reflects a $4.1 billion reduction due strictly to *economic factors,* plus reductions of $375 million due to the adoption of June 1982 ballot measures reducing personal income and inheritance and gift taxes, offset by $1.1 billion in revenue enhancements due to legislation enacted in 1981 and 1982.
- Since the *May 1982* revenue forecast, the last forecast available to the Legislature before it acted on the 1982–83 budget, revenues have been revised downward by over $1.3 billion. This January 1983 revision, which adjusts for legislation and initiatives, is the *largest downward revision recorded at midyear for any fiscal year in history.* It includes downward adjustments for the bank and corporation tax ($235 million), the personal income tax ($330 million) and, most importantly, the sales and use tax ($811 million). When this revision is combined with the downward revisions made in March 1982 ($805 million) and May 1982 ($408 million), the result is a drop in "baseline" revenues to about $19.8 billion, or nearly $2.6 billion below what was projected just 12 months ago in the 1982–83 Governor's Budget.

Latest Cash-Flow Data Support Revenue Estimates

January 1983 was the latest month for which data on General Fund revenue collections ("agency cash") were available before this *Analysis* went to print. During January, revenue collections were $24 million *above* the forecast for January contained in the 1983–84 Governor's Budget. Because December 1982 revenues were $103 million above the budget forecast, revenues are $127 million above the budget forecast for the two months combined.

It is difficult to be certain from January's revenue performance, however, the extent to which revenues are really running ahead of the forecast. This is because much of the money due in January was due on January 31, and thus "spills over" into February. Preliminary data for the first week in February gives a mixed picture, with income tax withholding collections running ahead and sales tax collections running behind the budget

Table 32

1982–83 General Fund Revenues and Transfers
History of Department of Finance Estimates
(in millions) [a]

	Original Estimate in May 1981	*Revisions*							*January 1983 Totals*
		1981 Legislation	*January 1982*	*March 1982*	*May 1982*	*1982 Legislation* [b]	*1982 Ballot Initiatives* [c]	*January 1983*	
Bank and Corporation Tax	$3,755.0	34.0	−$334.0	−$330.0	−$325.0	$75.0	$0.0	−$235.0	$2,640.0
Personal Income Tax	8,670.0	−1.0	−659.0	−195.0	−40.0	60.0	−230.0	−330.0	7,275.0
Sales and Use Tax	9,060.0	0.0	−465.0	−290.0	−40.0	124.0	0.0	−811.3	7,577.7
Other Taxes	1,558.0	22.0	−63.0	10.0	−3.0	199.0	−145.0	68.4	1,646.4
Total Taxes	$23,043.0	$55.0	−$1,521.0	−$805.0	−$408.0	$458.0	−$375.0	−$1,307.9	$19,139.2
Interest Income	375.0	0.0	−71.2	0.0	0.0	0.0	0.0	−74.3	229.4
Other Revenue	397.0	0.0	139.4 [d]	0.0	0.0	143.0 [e]	0.0	2.0	681.4
Total Revenues	$23,815.0	$55.0	−$1,452.8	−$805.0	−$408.0	$601.0	−$375.0	−$1,380.1	$20,050.0
Transfers	60.0	0.0	−53.2	0.0	0.0	436.0 [e]	−0.0	−2.8	440.0
Totals, General Fund Revenues and Transfers	$23,875.0	$55.0	−$1,506.0	−$805.0	−$408.0	$1,037.0	−$375.0	−$1,383.3	$20,489.7

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

[b] Major legislation affecting 1982–83 revenues included (1) AB 6x (Ch 2x/82), which accelerated personal income tax collections ($10 million); (2) AB 8x (Ch 5x/82) which in conjunction with AB 1253 (Ch 115/82) accelerated sales tax collections ($15 million) and imposed higher interest payments on delinquent tax payments ($65 million); (3) SB 1326 (Ch 327/82), which further accelerated sales tax collections ($125 million), (4) provisions in the 1982–83 Budget Act and trailer bills which increased General Fund transfers ($449 million), accelerated insurance tax collections ($230 million) and bank and corporation tax collections ($40 million), and raised Public Utility Commission assessments ($24 million); and (5) other legislation including miscellaneous sales tax exemptions enacted subsequent to the 1982–83 budget package (−$20 million). Adjustments shown in this column also include a $31 million loss in insurance tax revenues due to a court decision on the principal office deduction, plus various tidelands oil adjustments (see footnote e).

[c] Department of Finance estimates. Includes Proposition 6, which eliminated the current inheritance and gift tax and imposed a "pick-up" tax, and Proposition 7, which provided for permanent "full" indexing of the marginal personal income tax brackets.

[d] Includes effect of change in treatment of General Fund tidelands oil monies from "transfer income" to "other revenues". The "other revenues" category excludes what was a *proposed* increase of $20 million in General Fund income from tidelands revenues.

[e] Adjusts for change in treatment of $42 million in tidelands oil revenues, which in January 1981 were classified as "other revenues" but were reclassified as "transfers" in the Governor's budget. "Other revenue" changes include $80 million from a federal law change affecting tax treatment of "cost recovery oil", $53 million in additional tidelands monies and $52 million in other changes. Changes in transfers include $261 million in Vehicles License Fee transfers and $80 million in California Water Fund transfers.

estimate for that week.

It does appear, however, that on balance overall revenue collections currently are basically in line with—if not somewhat above—the estimate, thus giving some additional credibility to the department's forecast.

Revenue Picture Still Uncertain

We have taken the Department of Finance's economic assumptions and inserted them into our own revenue estimating equations in order to determine whether the revenue forecast for 1982–83 is consistent with the department's economic forecast. In general, we conclude that it is. Our computations produce a level of current-year revenues which is about $100 million below the Finance estimates. This is not a significant difference, given the complications involved in estimating revenues and the fact that we are dealing with over $20 billion in collections during the current year.

The 1982–83 revenue picture, however, is still far from clear. Approximately $9.0 billion in revenues must be collected between February and June in order to reach the total projected for 1982–83, and economic conditions during the first half of 1983 can exert a considerable influence on the exact amount actually collected. Thus, developing alternative revenue estimates based on different economic scenarios is important in order to facilitate the Legislature's fiscal planning, especially given the state's tight budget situation.

In discussing the problem of revenue estimating error margins, the budget suggests that current-year revenues could differ from the department's estimate by plus-or-minus 2 percent to 2.5 percent, or about $400 million to $500 million. This is certainly possible, given the size of revisions to the mid-year estimates shown in Table 30. In fact, the mid-year estimating error made 12 months ago with respect to 1981–82 revenues ($723 million, or 3.4 percent) exceeded this error range. 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 1982–83 revenue forecast in the coming months, as additional economic and revenue data become available, and alert the Legislature to any significant changes in the outlook.

E. BUDGET YEAR (1983–84) REVENUES

1. GENERAL FUND REVENUES

Special Factors Again Bolster Revenues

Table 33 presents the department's estimates of General Fund and special funds revenues for the budget year (1983–84), and compares these estimates with revenues for the current and prior years.

As with prior year and current year revenues, the department's budget-year estimates include certain General Fund revenues from special funds transfers and tax enhancements.

Specifically, the budget proposes to:

- Increase tax revenues by $120 million through *repeal* of the solar energy and energy conservation *tax credits* which are claimed by individuals ($110 million) and businesses ($10 million);
- Increase tax revenues by an additional $50 million by increased *tax auditing* activities;

- Transfer $300 million from the *Motor Vehicle License Fee Account* to the General Fund. This $300 million normally would go to cities and counties. As in both 1981–82 and 1982–83, transfers from this account are the means by which localities are sharing in the state's spending reductions in 1983–84.
- Increase in General Fund income through transfers of (1) tidelands oil revenues ($192 million), and (2) Transportation, Planning and Development Account revenues ($42 million).
- Continue approximately $100 million in on-going revenue gains from tax accelerations and other legislation enacted in 1982.

These special factors—which together are projected to raise revenues by over $750 million in 1983–84—though important pieces of the revenue picture, are less significant than they were in both 1981–82 and 1982–83.

More Rapid Growth Expected in Underlying Revenue Trend

Table 33 shows that General Fund revenues in the budget year are forecast to reach nearly $22.5 billion in 1983–84, a gain of $2.0 billion. Thus, the rate of revenue growth projected for 1983–84 (9.7 percent) dramatically exceeds that of 1982–83, when revenues actually declined by −2.2 percent. The 1983–84 revenue amount includes $8.5 billion in sales and use tax revenues (a gain of 11.6 percent), $8.7 billion in personal income tax revenues (a gain of 19.7 percent), and $2.8 billion in bank and corporation tax revenues (a gain of 6.4 percent). However, because of the various revenue-enhancing proposals, special funds transfers, and other special factors in both the current and budget years, the percentage rates of increase shown in the table for 1983–84 do not give a valid picture of the underlying growth in either the total revenue base or many of its individual components.

Computing the "underlying" revenue trend is difficult because of the many types of changes that have been made to the revenue base in recent years. Nevertheless, at least two types of adjustments clearly are needed to derive this trend:

- Revenues must be adjusted to exclude the tax revenue-enhancing proposals and one-time special funds transfers discussed earlier for both the current year (about $1 billion) and budget year (over $750 million);
- The fiscal effects in 1982–83 ($348 million) and 1983–84 ($680 million) of phasing out the inheritance and gift taxes must be removed.

Table 34 shows that once these adjustments are made, revenue growth amounts to 13.6 percent in the budget year. This compares to an adjusted rate of growth of only 1.2 percent for the current year, and is well in excess of projected personal income growth in both 1983 (8.5 percent) and 1984 (9.7 percent).

If only the effects of the revenue enhancements and special funds shifts are eliminated, underlying budget year revenue growth is 11.7 percent, compared to a 1.1 percent decline in 1981–82. Thus, by any measure the underlying revenue trend in 1983–84 is up.

One reason for this involves the extremely rapid projected growth rate for personal income tax receipts (19.7 percent), which even after adjustment for proposed tax law changes and recently enacted tax accelerations, is quite high (17.9 percent). As discussed below, there are several reasons for this high rate of growth, including the effects of indexing and shifts in cash-flow patterns. Because of these factors, the rate of personal income tax growth shown in Table 34 is not really an "underlying" rate, in that it doesn't represent a rate that can be sustained. Nevertheless, the budget year's "underlying" rate of revenue growth—however defined—is clearly stronger than in the preceeding several years. This reflects the department's projection that economic recovery will begin in the first half of 1983 and continue throughout 1984.

Table 33
State Revenue Collections
1981–82 to 1983–84
(in millions) [a]

General Fund	*Actual 1981–82*	*Estimated 1982–83*	*Projected 1983–84*	*Change 1982–83 to 1983–84 Amount*	*Percent*
Taxes:					
Sales and use	$7,548.7	$7,577.8	$8,453.1	$875.3	11.6%
Personal income	7,493.0	7,275.0	8,710.0 [b]	1,435.0	19.7
Bank and corporation	2,648.7	2,640.0	2,810.0 [c]	170.0	6.4
Inheritance and gift [d]	495.3	508.0	229.0	−279.0	−54.9
Insurance [e]	484.2	703.0	450.0	−253.0	−36.0
Cigarette	194.3	190.5	188.0	−2.5	−1.3
Alcoholic beverage	139.6	138.0	141.0	3.0	2.2
Horse racing	105.7	107.0	112.0	5.0	4.7
Total Taxes	$19,109.5	$19,139.2	$21,093.1	$1,953.9	10.2%
Other Sources:					
Oil and gas revenues	$18.5	$157.0	$215.7	$58.7	37.4%
Health Care Deposit Fund	250.3	309.8	342.0	32.2	10.4
Interest on investments	335.8	229.4	253.7	24.3	10.6
Federal revenue sharing transfer	179.4	–	–	–	–
Other revenues and transfer [f]	1,106.7	654.3	574.9	−79.4	−12.1
Totals, General Fund	$20,960.3	$20,489.7	$22,479.4	$1,989.7	9.7%
Special Funds					
Motor vehicle:					
Fuel tax [g]	$833.4	$900.3	$1,135.9	$235.6	26.2%
License fee (in lieu) [g]	706.4	741.0	815.0	74.0	10.0
Registration, weight and miscellaneous fees [g]	636.2	812.1	841.0	28.9	3.6
Other Sources:					
Oil and gas tax revenues	470.9	342.0	159.0	−183.0	−53.5
Sales and use [h]	140.3	152.3	162.9	10.6	7.0
Interest on investments	83.6	83.6	71.3	−12.3	−14.7
Cigarette tax	82.5	85.5	79.5	−6.0	−7.0
Other	−312.8 [i]	162.1	281.6	119.5	73.7
Totals, Special Funds	$2,640.5	$3,278.9	$3,546.2	$267.3	8.2%
Totals, State Funds	$23,600.9	$23,768.6	$26,025.6	$2,257.0	9.5%

[a] Details may not add to totals due to rounding. Figures for 1981–82, 1982–83 and 1983–84 include the effects of a variety of measures, either enacted in 1981 and 1982 or proposed in the 1983–84 Governor's Budget, to augment General Fund revenues and transfers. For *1981–82,* these factors amount to approximately $1.3 billion, and include provisions to accelerate tax collections (about $380 million) and to transfer monies to the General Fund from special funds (about $870 million). For *1982–83,* these factors amount to about $1 billion, and include about $400 million in tax accelerations and $450 million in special fund transfers to the General Fund. For *1983–84,* the budget proposes increases in tax revenues of $167 million from repeal of energy-related tax credits and increased auditing esti-

mates, a $300 million transfer to the General Fund from the Motor Vehicle License Fee Account, and placement of $192 million of tidelands oil revenues into the General Fund. For a more detailed explanation of these factors, see discussion in text.

[b] Includes $110 million for the proposed repeal of the solar energy credit and energy conservation credit, and $27 million for proposed audit activities.

[c] Includes $10 million for the proposed repeal of the solar energy credit and energy conservation credit, and $20 million for proposed audit activities.

[d] 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 $1.2 million in 1980–81, $109 million in 1981–82, $203 million in 1982–83, and $230 million in 1983–84. In addition, Proposition 6 (June 1982) is projected to reduce inheritance and gift tax revenues by $145 million in 1982–83 and $450 million in 1983–84.

[e] SB 1326 (Ch 327/82) changed prepayment dates for insurance companies and reduced the insurance tax rate for 1982 through 1986. This bill will have the effect of accelerating $230 million in tax receipts into 1982–83, and reducing 1983–84 receipts by $110 million.

[f] See text for a discussion of legislative action in the prior, current, and budget years to increase General Fund income from special fund transfers. The 1981–82 figure includes transfers of $84.9 million from the Capital Outlay Fund for Public Higher Education, $95.8 million from the Energy and Resources Fund, $131.6 million from the Motor Vehicle License Fee Account, $125.3 million from the Special Account for Capital Outlay (SAFCO), $53.8 million from the State parks and Recreation Fund, and $252 million from the State School Building Lease-Purchase Fund. The 1982–83 figure includes transfers of $261 million from the Motor Vehicle License Fee Account, $42 million from the SAFCO, and $80 million from the California Water Fund. The 1983–84 figure includes a proposed transfer of $300 million from the Motor Vehicle License Fee Account.

[g] SB 215 (Ch 541/81) increased gasoline and diesel taxes, vehicle registration fees, weight fees, and drivers' license fees, and AB 202 (Ch 933/81) increased registration fees further. These measures increased motor vehicle user taxes and fees by $205 million in 1981–82, an estimated $469 million in 1982–83, and a projected $633 million in 1983–84. The 1983–84 fuel tax revenue estimates also include a proposed one-time revenue increase of $85 million from accelerating the due date for fuel tax payments to the state. Trailer coach fees ("in lieu" tax) are included under "other" revenues.

[h] 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).

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

Table 34
Comparisons of Income Trends for the Current and Budget Years 1982–83 and 1983–84

	Percent Change in Revenues and Transfers			
	1982–83		*1983–84*	
Income Source	*Increase Published in Budget*	*Change Adjusted for Special Factors*[a]	*Increase Published in Budget*	*Change Adjusted for Special Factors*[a]
Sales and use tax	0.4%	1.1%	11.6%	13.2%
Bank and corporation tax	−0.3	−0.7	6.4	5.6
Personal income tax	−2.9	−1.3	19.7	17.9
Other major taxes	16.1	18.9	−32.0	12.5
Totals, Major taxes and licenses	0.2%	1.3%	10.2%	13.9%
Interest Income	−31.8	−31.8	10.6	10.6
Transfers	−58.6	23.3	−15.9	-
All other revenues	50.6	14.3	11.7	3.4
Totals, General Fund Revenue and Transfers	−2.2%	1.2%	9.7%	13.6%

[a] Removes the effects on revenue growth of all one-time special funds transfers, tax accelerations, one-time state revenue gains from federal tax law change involving "cost recovery oil," shifts in classification of certain tidelands oil monies from a "transfer" in 1982–83 to "other revenue" in 1983–84, and a $31 million insurance tax reduction in 1982–83 relating to a court case involving the principal office deduction.

Personal Income Taxes to Lead Revenue Growth

As noted above in Tables 33 and 34, personal income taxes are projected to rise by 19.7 percent when the Governor's proposals for increasing revenues are reflected in the estimates. These proposals include repeal of the solar energy tax credit and the energy conservation tax credit ($110 million), and increased auditing activities ($27 million). Table 34 also shows that revenue growth is 17.9 percent when these proposed changes and the tax accelerations enacted in 1982 are excluded. In contrast, anticipated receipts from this source in 1982–83 *declined* by 2.9 percent without adjustments for tax enhancements, and by 1.3 percent with such adjustments. As discussed below, this volatile pattern of revenue growth results from a combination of cash-flow factors and the impact of indexing.

The projection of personal income tax receipts involves two steps—projecting *calendar-year tax liabilities*, and allocating (or "cash-flowing") of these liabilities into *fiscal year receipts*.

1. ***Calendar Year Liabilities:*** The main determinants of calendar-year tax liabilities are growth in taxable income, the distribution of this income among tax brackets, and the inflation adjustment factors used to index the personal income tax. Table 35 shows both the department's estimates of these liabilities and our estimates of these liabilities (using the department's economic assumptions). The table indicates that personal income tax liabilities grew more slowly than personal income in 1982, and are projected to grow faster than personal income in 1983, and at about the same rate as income in 1984. One reason for these year-to-year differences involves the impact of indexing. For 1982, the tax brackets will be indexed by 9.3 percent (that is, by *more* than personal income growth), whereas the projected adjustment for 1983 is only 3.2 percent (that is, considerably *less* than projected personal income growth). In fact, recent trends in the California CPI suggest that the 1983 adjustment factor could be even less than the 3.2 percent assumed in the budget.

Table 35
Estimated Personal Income Tax Liabilities
Using Department of Finance Economic Assumptions
1982 to 1984
(in millions)

	Department of Finance		*Legislative Analyst*		*Percent Change in Personal Income*
Calendar Year	*Amount*	*Percent Change*	*Amount*	*Percent Change*	
1982	$7,318	4.1%	$7,389	5.2%	7.8%
1983	8,232	12.5	8,237	11.5	8.5
1984	9,120	10.8	9,055	9.9	9.7

Because the growth in tax liabilities is greater when the indexing adjustment factor is less, indexing served to depress personal income tax liabilities in 1982 to a much greater extent than it is expected to in 1983 or 1984. Growth in liabilities in 1982 was also slowed because the rate of income growth itself was relatively low, whereas it is expected to be higher in 1983 and 1984.

2. ***Fiscal Year Collections:*** Estimates of fiscal year collections are derived by apportioning income from adjacent calendar-year tax liabilities into different fiscal years, depending on (1) the pace of economic activity

throughout the year and (2) when taxpayers are required to make their payments. Normally, about 35 percent of an income year's liabilities (for example, the 1983 income year) are allocated to the first fiscal year (for example, 1982–83), with the remaining 65 percent showing up in the second fiscal year (for example, 1983–84). Thus collections in 1982–83 are derived primarily from the payment of 1982 liabilities and thus are heavily affected by the depressed level of activity in that year. In contrast, collections in 1983–84 are derived from the payment of 1983 and 1984 liabilities, and reflect a more-rapidly-growing level of economic activity. The relatively high rate of revenue growth that this produces for 1983–84 is further accentuated because the pace of income growth was slowing throughout 1982 and is expected to accelerate in 1983 and 1984, thereby pulling down revenues in 1982–83 and pushing them up in 1983–84. Thus, a variety of factors—proposed and enacted legislation, income tax indexing, the overall pattern and pace of economic activity, and cash-flow shifts—combine to explain the 19.7 percent growth projection for personal income tax collections in 1983–84.

Effects of Income Tax Indexing

Chart 17 summarizes the fiscal effects of income tax indexing in California. The chart shows that over the period 1978–79 through 1983–84, income tax indexing will have reduced personal income tax revenues by $12.1 billion, or over 22 percent of revenues which would have been collected without indexing during these years. Because indexing is cumulative, its effect on revenue increases over time. In 1982–83 and 1983–84, for example, indexing will reduce revenues by $3.1 billion and $3.6 billion, respectively, or by about 30 percent. These reductions include the effects of Proposition 7 (June 1982), which provided for permanent full indexing of the marginal income tax brackets beyond 1981. We estimate that Proposition 7 will reduce General Fund revenues by $210 million in 1982–83, and by $420 million in 1983–84.

Taxable Sales Also to Strengthen

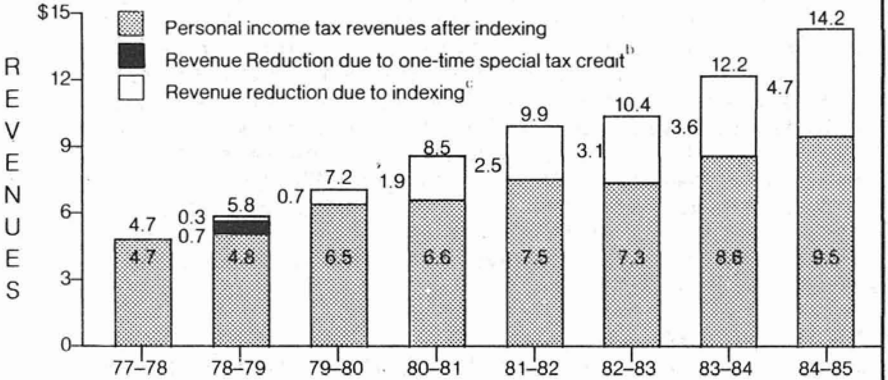
As shown in Table 34, sales and use taxes are projected to increase by 11.6 percent in the budget year, or 13.2 percent when the distorting effects of tax accelerations and other revenue-enhancing measures are eliminated. This is in marked contrast to 1982–83, when sales tax collections were essentially flat.

The projected rate of growth in sales tax revenues during 1983–84 means that growth in taxable sales is expected to out-distance growth in personal income in both the second half of 1983 and throughout 1984. This is confirmed by looking at the ratio of taxable sales-to-personal income contained in the department's economic forecast. As Table 36 shows, this ratio dropped from 53.8 percent in 1981 to 49.6 percent in 1982, but is predicted to rise slightly to 49.8 percent in 1983 and then increase to 51.6 percent in 1984. As shown in Chart 18, taxable sales growth is expected to be especially strong in 1984 (up 13.6 percent), led by increases in sales tax receipts from such industries as motor vehicles (up 22 percent) and building materials (up 24 percent). Of course, the high rates of growth for the building and automobile industries are partly due to the fact that they are expected to be recovering from extremely depressed recession levels.

Chart 17

Effects of Indexing on California Personal Income Tax Revenues.

1977–78 through 1984–85 (in billions)[a]



[a] Estimates by Legislative Analyst. Entire height of bars shows revenues without indexing.

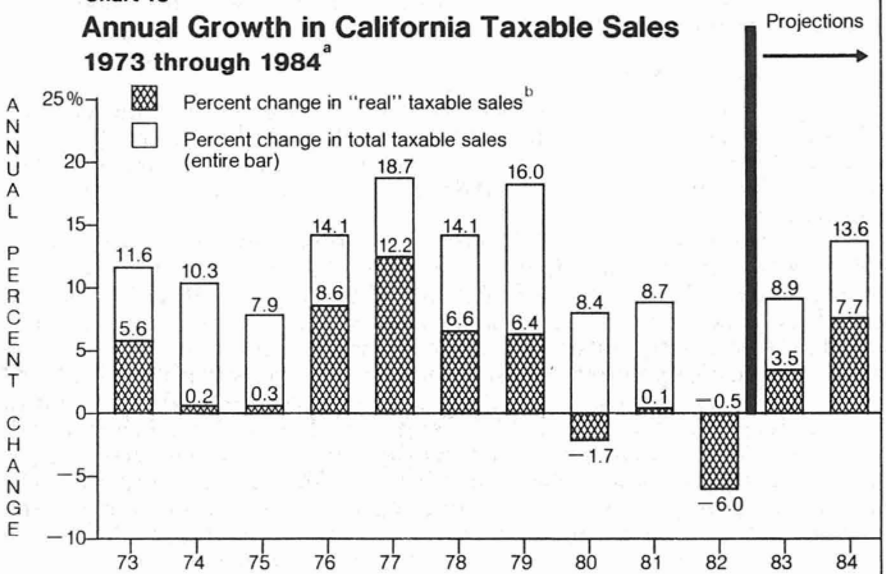
[b] AB 3802 (Ch 569/78) increased the personal income tax credit for 1978 by $75 for single return taxpayers and by $150 for joint return taxpayers.

[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. Proposition 7 (June 1982) provided for *permanent* full indexing of marginal tax brackets beyond 1981. Revenues shown for 1983–84 exclude the revenue increases proposed in the budget, which amount to approximately $140 million.

Chart 18

Annual Growth in California Taxable Sales

1973 through 1984[a]



[a] California Department of Finance

[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the GNP price deflator for consumption expenditures.

The upturn projected for taxable sales, while impressive in comparison to the growth in recent years, is *not* overly strong in light of the depressed level of sales that has prevailed during the recession. For example, the projected ratio of taxable sales-to-personal income in 1984 (51.6 percent) is considerably below what the department predicted 12 months ago (56.2 percent), and even further below the 1979 peak (57.5 percent), as shown in Table 36. In fact, the taxable sales-to-income ratio is even below what it was in 1975, during the low point of the 1973–75 recession.

Likewise, although the department forecasts growth in real taxable sales both in 1983 (3.5 percent) and 1984 (7.7 percent), the gains are not very robust given that real taxable sales fell by close to 8 percent between 1980 and 1982. The 1982 decline was especially deep—6 percent in real terms—because nominal dollar taxable sales *declined* for the first time since 1958.

Thus, although the growth in taxable sales is expected to play an important role in generating General Fund revenue gains during 1983–84, the rate of growth will be fairly modest given the extent to which consumers have cut back on their buying during the recession.

The budget proposes several changes in the collection dates for sales taxes. These proposals will enable the state to accelerate its collection of receipts from certain retailers. Thus, the state's cash position *within* the 1983–84 fiscal year will be improved if these measures are adopted. The proposals, however, will have no impact on sales tax receipts for the year as a whole.

Table 36
Ratios of Taxable Sales to Personal Income in California 1973 to 1984

Calendar Year	*Ratio of Taxable Sales to Personal Income*
1973	.538
1974	.531
1975	.521
1976	.534
1977	.566
1978	.566
1979	.575
1980	.552
1981	.538
1982 (Estimated)	.496
1983 (Projected)	.498
1984 (Projected)	.516

Moderate Corporate Profits Improvement to Produce Revenue Gain After Two Years of Declines

Revenues from the bank and corporation tax are more difficult to project from year-to-year than revenues from any other source. This is because of the inherent volatility of corporate profits, the wide variety of factors which influence profits, the complex prepayment patterns which firms use to remit funds to the state, and the lengthy time lags required before actual data on past corporate profits become available.

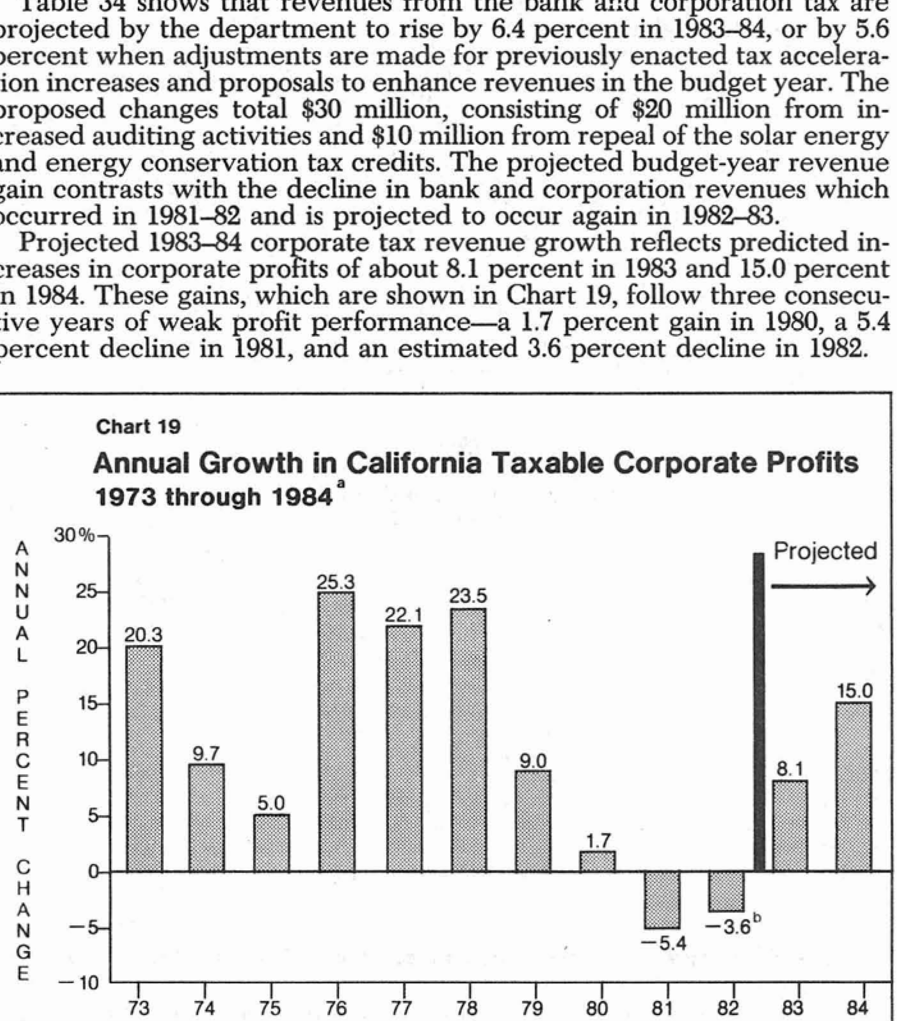
This year the problem of projecting corporate tax revenues is especially difficult because recent federal tax law changes have distorted historical relationships between California and U.S. profits. The problem has also been exacerbated by the recession, high interest rates, and the deterioration in corporate balance sheets, all of which affect profits.

Table 34 shows that revenues from the bank and corporation tax are projected by the department to rise by 6.4 percent in 1983–84, or by 5.6 percent when adjustments are made for previously enacted tax acceleration increases and proposals to enhance revenues in the budget year. The proposed changes total $30 million, consisting of $20 million from increased auditing activities and $10 million from repeal of the solar energy and energy conservation tax credits. The projected budget-year revenue gain contrasts with the decline in bank and corporation revenues which occurred in 1981–82 and is projected to occur again in 1982–83.

Projected 1983–84 corporate tax revenue growth reflects predicted increases in corporate profits of about 8.1 percent in 1983 and 15.0 percent in 1984. These gains, which are shown in Chart 19, follow three consecutive years of weak profit performance—a 1.7 percent gain in 1980, a 5.4 percent decline in 1981, and an estimated 3.6 percent decline in 1982.

Chart 19

Annual Growth in California Taxable Corporate Profits 1973 through 1984[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.

In developing its corporate profits forecast for 1983 and 1984, the department has relied on a survey of corporations to determine their 1982 profits. This is necessary because data on 1982 taxable profits in California is not yet available from any other source. In fact a solid estimate of taxable profits in 1982 will not be available until later in 1983, when tax return data become available. The department's survey covers firms which account for slightly over ⅓ of the corporate tax base. According to this survey, 1982 profits in the state were $1.4 billion (3.6 percent) lower than they were in 1981. With the single exception of utility companies, *every* industry grouping reported negative profit growth in the 1982 survey.

Exactly how accurate the 1982 profit survey—and thus the estimate of 1983 and 1984 profits, and of 1982–83 and 1983–84 revenues—will turn out to be remains to be seen. This is especially true because, although the department's survey has a relatively good response rate as far as surveys go, its coverage is far too small to determine the state's actual level of profits with any degree of certainty. Based on our examination of historical profit relationships between the nation and California, for example, there appears to be some possibility that California profits could be weaker in 1982 than the department is assuming. The department predicts that U.S. profits will fall by nearly 24 percent under current law, and by nearly 19 percent when adjusted for recent federal tax law changes regarding depreciation allowances. The department's resulting state-national profit growth rate differential for 1982—15.3 percentage points—is well in excess of any experienced in the past two decades.

In any event, there is a fairly large error margin surrounding *anyone's* corporate profit estimates, especially those made for California.

Other Major Taxes

Tables 33 (page 78) and 34 (page 79) show that General Fund revenues from taxes other than the three major levies are projected to reach $1.1 billion in the budget year, a decrease of $526 million (32 percent) below the current year. These taxes include the insurance tax ($450 million), the inheritance and gift taxes ($229 million), the cigarette tax ($188 million), alcoholic beverage taxes ($141 million), and horse racing-related revenues ($112 million). For two of these revenue sources—the insurance tax and the inheritance and gift taxes—the budget estimates reflect special factors as discussed below. After adjusting for these factors, Table 34 shows that budget-year revenues from other major taxes are projected to rise by 12.5 percent over the current-year level.

Major Cash-Flow Shifts in Insurance Tax Collections

The *insurance tax* estimate for 1983–84—$450 million, a decline of $253 million from the 1982–83 estimated level—reflects a number of changes in the statutory provisions governing the collection of this tax that were made by SB 1326 (Ch 327/82). This bill:

- Increased the number of annual tax prepayments required of insurers from 3 to 4, and increased the total percent of prior year tax liabilities which must be remitted through prepayments from slightly under 80 percent to 100 percent;
- Raised the portion of each year's prepayments that are due in the first half of the calendar year from one-third to one half.
- Required an additional, one-time tax prepayment due on January 1, 1983; and
- For the years 1982 through 1985, reduced the insurance premiums tax rate from 2.35 percent to 2.33 percent.

The net impact of these provisions is to *raise* revenues by $230 million in 1982–83. In the budget year, the impact of the SB 1326 changes is to *reduce* revenues by $110 million. Thus, had these changes not been enacted, 1982–83 revenues would have been about $473 million and 1983–84 revenues would have been about $560 million, implying an underlying growth in revenues from this source of about $87 million (18.4 percent) in the budget year. The estimate of 1982–83 revenues, however, has been reduced by $31 million to reflect a recent court decision regarding the principal office deduction allowance that the voters repealed in 1976. Taking this one-time factor into account, underlying budget-year revenue growth is 11.1 percent over the current-year level.

The department's revenue projections for the insurance tax are based on a survey of California insurance companies that account for 55 percent of all insurance premiums written. According to the survey, insurance premiums subject to the 2.33 percent gross premiums tax are expected to rise by 3.9 percent in 1982 (the year on which 1983 tax prepayments are based), and 9.1 percent in 1983 (the year on which 1984 tax prepayments are based). Taxes on these premiums account for about 97 percent of all insurance tax collections.

The estimated 1982 premiums increase of 3.9 percent, which affects revenues in both the current and budget years, is the lowest annual increase in the past decade. For example, premiums during the mid-1970's rose by more than 20 percent in some years. The 1982 slowdown is attributable to the depressing effects of the current recession on income, employment, construction and car sales.

Phasing-out of Inheritance and Gift Tax Underway

Inheritance and gift tax receipts are projected to decline to $229 million in the budget year, a fall of $279 million (54.9 percent) from the current year. This decline, as well as the weak 2.6 percent growth in current-year receipts over prior-year receipts, is due to two law changes:

- ***First,*** revenues have been reduced because of the phasing-in of AB 2092 (Ch 634/80), which increased inheritance tax exemptions.
- ***Second,*** revenues have been reduced because of the phasing-in of Proposition 6 (June 1982), which repealed the state's inheritance and gift tax. (Proposition 6 became effective for estates and decedents and for gifts made on or after June 9, 1982. The initiative also established a "pick-up" estate tax, which allows the state to receive a portion of the revenue stemming from the federal estate tax, at no increased cost to taxpayers.)

Table 37
Effects of Tax Law Changes on Inheritance and Gift Tax Revenues 1980–81 to 1983–84 (in millions)

	Effects of		*Total Reduction*	
	AB 2092	*Proposition 6*	*Amount*	*As % of Prior Law Revenues*
1980–81	−$1	—	−$1	−0.2%
1981–82	−109	—	−109	−19.2
1982–83	−203	−$145	−348	−40.7
1983–84	−230	−450	−680	−73.4

Table 37 shows that the combined effect of AB 2092 and Proposition 6 is to reduce inheritance and gift tax revenues by approximately $110 million in 1981–82, $350 million in 1982–83, and $680 million in 1983–84. Thus, by the end of the budget year, nearly three-fourths of the prior-law tax base will have been eliminated. The budget-year revenue total includes $114 million from the inheritance and gift tax, and $115 million for the "pick-up" estate tax under Proposition 6.

Interest Income to Stabilize

The General Fund can receive 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 that are idle because of the time lag between when revenues are collected and disbursements are made. Of these three, the last currently is the most important source of interest income.

The budget projects that General Fund interest on investments will be about $254 million in 1983–84, of which $250 million represents returns on the PMIA. The level of investment income projected for 1983–84 compares to about $229 million projected for 1982–83 and $336 million in 1981–82, and assumes that:

- ***The average fiscal year balance*** in the PMIA for 1983–84 will be somewhere in the vicinity of $5.75 billion. This average balance has declined significantly in recent years because the state spent more than it received in revenues, causing the budget surplus to disappear. The average balance 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 PMIA will be about 44 percent.
- ***The average interest yield*** on PMIA investments in 1983–84 will be in the vicinity of 10 percent. This compares to an actual average yield for the first half of 1982–83 of about 11.4 percent, and of about 10.5 percent as of year-end 1982.

The estimates of interest income are subject to a large margin of error, due to the number of assumptions that must be made in preparing the estimate. The most obvious assumption involves the average balance in the PMIA during the year. The budget assumes that a $750 million deficit will be carried over from 1982–83 into 1983–84, and that by year-end 1983–84, the budget will be in balance. However, should the carryover deficit from 1982–83 exceed $750 million, or should the deficit not be completely eliminated in 1983–84, the average PMIA balance and thus interest income would be less. And, of course, the estimates are obviously at the mercy of conditions in financial markets that determine the rate at which the state will earn interest income. Our analysis indicates that the estimates of interest income do not appear to have explicitly incorporated the effects of the Governor's proposed cash management plan on the PMIA balance. Other things constant, this plan should increase the PMIA balance and thus raise interest earnings.

2. ALTERNATIVE GENERAL FUND REVENUE ESTIMATES

Estimates Consistent with Assumptions, but Future Revisions Inevitable

As we did 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 an economy along the lines projected by the department could generate an additional $230 million in 1983–84 General Fund revenues above what is forecast. Because our analysis also results in about $100 million less in 1982–83 revenues than Finance projects, the net difference for the current and budget years combined is only about $130 million. This is a very small difference, in light of the complexities of revenue estimating.

The closeness of our estimates to Finance's should *not* be interpreted as indicating that the outlook for revenues is predictable. It is not. In fact, the outlook is extremely *uncertain.* As evidence of the effect that economic forecasting errors can have on projected revenues, the department's current-law 1982–83 revenue estimate is $1.3 billion lower than the estimate made last May (Table 32, Page 75). Clearly the department's 1983–84 revenue estimates will be subject to considerable revision over the next 18 months.

Alternative General Fund Revenue Scenarios

Given the history of revenue estimating errors, and the considerable uncertainty about exactly how the economy will perform in 1983 and 1984, 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. It is especially important to do this now, given the extremely tight state and local government fiscal picture.

Revenue-estimating errors can result from a variety of factors. For example, the underlying data on which forecasts are based often are revised at later dates. It is likely that, had the "true" data been known earlier, the forecasts themselves would have been different. In addition, there are normal errors of a statistical nature that always accompany projections of future events. It appears, however, that the most important cause of revenue-estimating errors is errors in economic forecasting.

Given this, the department has constructed two alternative economic scenarios which can provide some insight into the type of revenue estimating errors which could show up if the economic forecast is wrong. One scenario is based on a more optimistic set of economic assumptions than Finance used for its standard budget forecast; the other is based on more pessimistic assumptions. We believe that these alternative forecasts provide a good illustration of how the paths taken by the national and state economies in 1983 and 1984 could depart from the department's forecast. These scenarios, however, by no means bracket the range of possible outcomes. Table 38 summarizes the key features of these alternative economic forecasts.

We have taken the key variables in these economic scenarios and used them to project the main determinants of General Fund revenues—taxable income, California taxable profits and taxable sales. Table 39 indicates what we estimate would be the effect on state revenues in the current and budget years if each of the department's alternative forecasts were borne out. These effects are in the same general range as are those estimated by the department and published in the budget.

Table 38
Alternative Economic Outlooks
Prepared by the Department of Finance
1983 and 1984

	Pessimistic Forecast		*Optimistic Forecast*	
Economic Variable	*1983*	*1984*	*1983*	*1984*
1. National Data:				
Real GNP growth	−0.2%	2.5%	3.2%	5.9%
Profits growth	−7.6%	16.7%	21.1%	18.5%
Car sales (millions)	8.0	9.1	9.1	11.3
Housing starts (millions)	1.12	1.34	1.38	1.76
Unemployment rate	10.5%	9.7%	9.8%	8.1%
2. California Data:				
Personal income growth	6.7%	7.4%	9.8%	11.9%
Wage and salary employment growth	−0.9%	1.7%	2.2%	5.6%
Building permits (thousands)	90	125	145	190
Unemployment rate	11.1%	9.4%	10.0%	8.0%

Table 39
Revenue Effects of Alternative Department of Finance Economic Forecasts
1982–83 and 1983–84
(in millions) [a]

	1982–83		*1983–84*	
Source of Income	*Pessimistic Forecast*	*Optimistic Forecast*	*Pessimistic Forecast*	*Optimistic Forecast*
Personal income tax	−$50	$50	−$235	$250
Sales and use tax	−215	150	−690	560
Bank and corporation tax	−50	50	−395	225
Total, Major Three Taxes	−$315	$250	−$1,320	$1,035

[a] Estimates by Legislative Analyst.

Table 39 shows that these alternative economic scenarios produce 1982–83 General Fund revenue estimates for the three major taxes which range from $250 million (1.4 percent) above to $315 million (1.8 percent) below Finance's forecast. For 1983–84, the estimates range from $1 billion (5.2 percent) above to $1.3 billion (6.7 percent) below Finance's projection. (The December revenue estimates prepared by the Commission on State Finance—$61 million above the department's current-year estimate and $715 million below its budget-year estimate—fall well within these margins.) These margins are consistent with the historical errors reported earlier in Table 30, page 72, and it is probably possible to find economists at 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 could occur in both 1982–83 and 1983–84.

3. SPECIAL FUND REVENUES

Table 33 (page 78) shows that combined revenues to all state special funds are projected to reach over $3.5 billion in 1983–84. Table 40 summarizes the share of special fund revenues accounted for by each of the major special fund revenue sources.

Table 40
Summary of Special Fund Revenues
1983–84
(in millions)

	Amount	Percent Of Total
1. *Motor Vehicle Taxes and Fees*		
License fees	$815[a]	23.0%
Fuel taxes	1,136	32.0
Registration and other fees	841	23.7
Trailer coach fees	27	0.8
Subtotal	$2,819	79.5%
2. *Tidelands Oil and Gas Revenues*	159[b]	4.5
3. *Retail Sales Taxes ("spill over" revenues)*	163	4.6
4. *Cigarette Taxes*	80	2.3
Subtotal	$3,221	90.8%
5. *All Other*	325	9.2
Total	$3,546[c]	100.0%

[a] Existing law; does not reflect budget proposal to transfer $300 million of this amount to the General Fund.
[b] This is the net amount after the budget proposal which would transfer $192 million of these revenues to the General Fund.
[c] Includes reduction of $300 million due to proposed transfer from the Motor Vehicle License Fee Account to the General Fund.

The major source of special fund income is motor vehicle-related levies, which include gasoline taxes ($1,136 million), vehicle license and trailer coach fees ($842 million) and registration fees ($841 million). These vehicle-related levies are expected to total over $2.8 billion in the budget year, an increase of 13.6 percent ($338 million) over 1982–83. Other major sources of special fund income include tidelands oil and gas tax revenues ($159 million), sales and use tax revenues ($163 million), cigarette tax receipts ($80 million), and interest on investments ($71 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 total collections from this tax.

Revenue Trends Distorted by Major Legislation and General Fund Transfers

Table 33 (page 78) shows that special fund revenues in 1983–84 are expected to be 8.2 percent above the 1982–83 level. This rate of growth is distorted by the following special factors:

- ***First,*** major legislation was enacted in 1981 which increased motor vehicle-related receipts in 1981–82, 1982–83 and 1983–84. This legislation included (a) SB 215 (Ch 541/81), which increased vehicle registration, weight and drivers license fees (as of January 1, 1982), and increased the fuel tax from 7 cents to 9 cents per gallon (as of January 1, 1983), and (b) AB 202 (Ch 933/81), which provided for further increases in vehicle registration fees. Together, the estimated effects of these measures are an increase in motor vehicle-related collections of $205 million in 1981–82, $469 million in 1982–83 and $633 million in 1983–84.

- ***Second,*** the budget proposes to change the date on which motor vehicle fuel tax collections must be remitted to the state. This, would produce a one-time revenue gain of $85 million in 1983–84.
- ***Third,*** the 1983–84 budget proposes to transfer $300 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 lieu of activating the deflator in both 1981–82 ($131 million) and 1982–83 ($261 million).
- ***Fourth,*** as in 1982–83, the General Fund is to receive a special one-time allocation of tidelands oil revenues. This amounts to $192 million in the budget year. The current-year amount is over $175 million, which includes a transfer for energy tax credit funding and an $80 million one-time tidelands oil revenue gain due to a recent federal law change regarding assessment of the windfall profits tax on "cost recovery" oil. By comparison, tidelands oil revenues transferred into the General Fund in 1981–82 totaled over $600 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, fuel tax revenues will go up by $79 million in 1982–83 and $233 million in 1983–84. As shown in Table 33 (page 78), when fuel tax revenues are adjusted for this legislation and the tax due-date changes proposed in the budget go into effect, resulting budget-year revenues ($818 million) are essentially unchanged from the current year ($821 million), and are actually *below* revenues in the prior year ($873 million). This represents the sixth year in a row that the underlying revenue trend has not been upward. This reflects such factors as changes in the automobile mix, increasing fuel economies, reduced demand due to slow economic growth, and the impact of gasoline prices on consumption. The department's fuel tax estimate assumes that average gasoline consumption per vehicle will drop from 595 gallons in 1981–82 to 585 gallons in 1982–83 and 570 gallons in 1983–84.

Vehicle-related registration and license fees are projected at almost $1.4 billion in the budget year, including the effects of new legislation. This projection assumes increases in new vehicle registrations of 12.3 percent and 16.3 percent in 1983 and 1984, respectively. These relatively strong rates of increase reflect the department's projection for an upswing in consumer spending on new automobiles during the next 24 months.

Tidelands Oil and Gas Revenues—A Potentially Important Balancing Factor

Total revenues collected by the State Lands Commission from oil, gas, geothermal, and other sources are projected in the Governor's Budget to reach $350 million in 1983–84, down $124 million (26 percent) from the current year. Of this decline, $55 million is due to the difference between the revenue-increasing effects of the Technical Corrections Act of 1982 in 1982–83 ($80 million) and 1983–84 ($25 million). This federal legislation revised the way in which windfall profit taxes are levied on oil produced on state-owned properties. The remaining decline in oil and gas and other revenues from state lands ($69 million) is in part due to declining oil and gas production at the state's fields. The most important factor in the decline, however, has been the drop in oil prices, due to excessive stocks in the world's crude oil markets.

Most of these oil and gas 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 $335 million in 1983–84.

These funds traditionally have been used along with bond proceeds to finance state capital outlay projects. As discussed earlier, however, tidelands oil revenues played a major role in balancing the General Fund budget in 1981–82, and are providing the General Fund with $175 million

Table 41
Proposed Distribution of Special Fund Revenues From Four Major Sources 1983–84 (in millions)

Source	*Amount*	*Distribution*	*Amount*
I. *Motor Vehicle Taxes and Fees*			
1. License fees [a]	$815	To cities	$125
		To counties	335
		For DMV administration	62
		To General Fund	300 [b]
2. Fuel Taxes	1,136	For city streets	177
		For county roads	243
		To cities and counties for streets and roads	113
		To Caltrans for state highways	570
		Other	33
3. Registration and other fees	841	To DMV	177
		To CHP	329
		To Caltrans	256
		To other state agencies	59
		Other	20
4. Trailer coach fees	27	To Counties	26
		Other	1
II. *Tidelands Oil and Gas Revenues* [c]	159	Energy and Resources Fund	31
		COFPHE	57
		SAFCO	38
		Parks and Recreation Fund	10
		All other	23
III. *Retail Sales (spill over) Taxes*	163	*State agencies*	27
		Support for mass transit, etc. (27)	
		Local Agencies	77
		Special transit ($75) [d]	
		Others ($2)	
		General Fund	42
		Other	17
IV. *Local Cigarette Taxes*	80	To cities	65
		To counties	15

[a] License fees generate an additional $7 million in interest income which support their proposed distribution.

[b] Proposed transfer. Under current law, these monies would be distributed to cities and counties.

[c] Total tidelands oil and gas revenues are projected to total $335 million in 1983–84. The budget proposes to put $192 million of the amount directly into the General Fund. Under current law, the General Fund would receive none of these monies.

[d] Under current law, this amount would be $103 million.

in revenues in the current year. In the budget year, the Governor proposes to place an additional $192 million of tidelands oil revenues into the General Fund. In Part III of this volume, we discuss the policy 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.

How Special Fund Revenues are Distributed

Table 41 identifies how the budget proposes to allocate special fund revenues from the four major sources among different programs and levels of government. Specifically, it shows:

- Cities and counties receive about half of the motor vehicle fuel tax revenues;
- Under current law, cities and counties receive all of the proceeds from vehicle license fees, after deduction of administrative and certain other costs. For 1983–84, however, the budget proposes to transfer $300 million of these funds to the General Fund to help balance the budget. Similar (although smaller) transfers occurred in both 1981–82 and 1982–83.
- Motor vehicle registration fees are used to support the Department of Motor Vehicles and the California Highway Patrol, with most of the remainder going to the Department of Transportation for highway maintenance and construction;
- Under current law, tidelands oil revenues are allocated mainly for capital outlay purposes. Most of these revenues normally are divided among six special funds (including ERF, COFPHE, and SAFCO). The 1983–84 budget, however, proposes that a significant portion ($192 million) of these revenues be transferred to the General Fund to help balance the budget. The distribution of oil revenues shown in Table 41 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.

IV. STATE AND LOCAL BORROWING

Overview

The State of California and its localities borrow monies in a variety of ways and for a variety of reasons.

One type of borrowing is short-term in nature, and is often used to cope with cash-flow problems caused by differences between when expenditures are made and when revenues are received. Such borrowing may take the form of temporary loans from the state's special funds, or may involve the issuance of short-term debt instruments such as secured or unsecured notes or warrants.

A second general type of borrowing is long-term in nature. This form of borrowing is accomplished through the issuance of long-term bonds. The State of California and its localities issue 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 issuing governments. Thus, when the State of California 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 issuing government. Instead, they are secured by the revenues from the projects which are financed by the bond proceeds. State 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 short-term and long-term borrowing by the state, including the sales and outstanding volumes of state general obligation and revenue bonds. In addition, this section discusses the use of short-term debt and long-term bonds by California's local governments, with particular emphasis on the volume of housing bonds. In Part III of this volume, we discuss some of the problems currently facing state and local governments who wish to finance projects through the sale of tax exempt debt, as well as legislative policy issues and recommendations regarding the use of tax exempt bonds.

A. STATE BORROWING

1. Short-term Borrowing by the State

As discussed in Part I, it is not uncommon for the General Fund to borrow monies on a short-term basis, to compensate for differences between when revenues are actually received and when bills must be paid. This type of borrowing falls under the heading of "cash management" and, when responsibly undertaken and monitored, is a routine and integral part of managing the state's fiscal affairs.

Normally, short-term borrowing is done *internally*. Whenever possible, the General Fund borrows from the Reserve for Economic Uncertainties, from special funds, and from the Pooled Money Investment Account (PMIA).

During 1982–83, however, it has not been possible to meet the state's cash-flow needs solely from internal sources, and the state has had to issue short-term debt instruments to private sector investors. At the time this *Analysis* was prepared, *external* borrowing during the current fiscal year had amounted to $400 million, in the form of unsecured "revenue anticipation warrants". We anticipate that further external borrowing will be necessary, both in the remainder of the current year and again during the budget year.

2. State 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.*** Debt service on these bonds is only partly paid by the General Fund. The only program falling into this category is school building aid. Although the debt service on these bonds is paid by the state, local school districts reimburse the state for these costs. The schedule for reimbursement, however, is different from the schedule used to retire the debt. As a result, in years prior to 1978–79, the state had to "subsidize" the debt service, because the reimbursement received from the school districts was less than the amount paid by the state to the bond holders. Since 1978–79, however, these reimbursements have *exceeded* the state's cost for servicing these bonds, in effect reimbursing the state for at least a portion of its earlier subsidies.

(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.

Table 42
General Obligation Bonds of the State of California
As of December 31, 1982
(in millions) [a]

	Authorized	*Unsold*	*Redemptions*	*Outstanding*
General Fund Bonds:				
State construction	$1,050.0	—	$716.0	$334.0
Higher education construction	230.0	—	135.0	95.0
Junior college construction	65.0	—	37.4	27.6
Health science facilities construction	155.9	—	42.9	113.0
Community college construction	160.0	—	59.3	100.8
Beach, park, recreational, and historical facilities	400.0	$15.0	149.8	235.2
Recreation and fish and wildlife	60.0	—	26.5	33.5
State, urban, and coastal parks	280.0	55.0	29.1	195.9
Parklands acquisition and development	285.0	195.0	2.3	87.8
Clean water	875.0	260.0	141.2	473.8
Safe drinking water	175.0	105.0	0.5	69.5
State prison construction	495.0	395.0	—	100.0
County jail construction	280.0	280.0	—	—
Lake Tahoe land acquisition	85.0	85.0	—	—
First-time home buyers	200.0	200.0	—	—
School building lease purchase	500.0	500.0	—	—
Subtotals	($5,295.9)	($2,090.0)	($1,339.9)	($1,866.0)
Partially Self-Liquidating Bonds:				
School building aid	$2,140.0	$40.0	$1,304.6	$795.4
Self-Liquidating Bonds:				
Water resources development	$1,750.0	$180.0	$106.1	$1,463.9
Harbor bonds	89.3	—	66.1	23.2
Veterans' farm and home building	4,450.0	650.0	1,571.9	2,228.1
Subtotals	($6,289.3)	($830.0)	($1,744.1)	($3,715.2)
Totals	$13,725.2	$2,960.0	$4,388.6	$6,376.6

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

Bond Programs. General obligation bonds are used to support a wide variety of bond programs, including general state construction, water treatment, harbor development, post-secondary education facilities construction, development of parks and recreational areas, historical resources preservation purposes, and financial assistance for home purchasing by war veterans. During the 1982 calendar year, California voters approved five new general obligation bond programs, totalling over $1.8 billion. These included: $495 million for financing new state prison facilities, $500 million for public school building lease-purchase, $280 million for county jail construction, $85 million to acquire undeveloped land in the Lake Tahoe Basin, and $200 million to provide assistance to first-time home buyers. In 1982 the voters also approved an addition of $450 million in bonds for the state's existing program to provide assistance to veterans for home buying.

Status of Bonds Authorized. Table 42 identifies these three categories of general obligation bonds, by bond program, and shows the portion of the authorized amounts that are outstanding, redeemed, and unsold. As of December 31, 1982, the state had over $2.9 billion in unsold bonds, compared to over $1.4 billion at the end of 1981. Of the authorized bonds already sold ($10.8 billion), the state has retired nearly $4.4 billion, leaving $6.4 billion outstanding.

Bond Program Sales. In December 1982, the State Treasurer told the Legislature that he was temporarily suspending the sale of general obligation and revenue bonds. This action was undertaken because the projected General Fund deficit in the state's 1982–83 budget threatened to erode the state's credit rating. This rating had been reduced in April 1980 by Standard and Poor's, from AAA (best quality) to AA-plus (high quality). Indeed, in late January, Standard and Poor's again reduced the state's rating (to AA). It appears that the state's credit rating is unlikely to be raised until the state's fiscal problems are resolved.

From our viewpoint, there is no logical reason why long-term state general obligation bond ratings should be lowered because of a short-term fiscal problem, especially in light of the constitutional guarantee regarding debt service payments to general obligation bond holders. Nevertheless, the rating agencies have chosen to reduce the state's credit standing, and this may hurt the state's ability to market debt.

Prior to the Treasurer's suspension of bond sales, a total of $280 million of general obligation bonds had been sold in 1982–83. Of the total, $100 million represented veteran's housing bonds, the sale of which had been postponed from 1981–82, and another $100 million represented bond sales under a new program—the new state prison construction program. The remaining $80 million represented bonds sold for state parklands ($25 million), clean water ($50 million) and state beaches and parks ($5 million).

Table 43 displays general obligation bond sales, by program, from 1980–81 through 1983–84. In 1981–82, over 60 percent ($240 million) of all general obligation bonds sold ($390 million) called for debt service to be paid by the General Fund, while about 40 percent ($150 million) represented self-liquidating bonds for housing. While housing bonds represented a substantial share of total bond sales in 1981–82, the amount of these sales was far less than originally anticipated. The Governor's Budget for 1982–83 had projected in January 1982 that housing bond sales would total $450 million in 1981–82.

Table 43
General Obligation Bond Sales
1980–81 Through 1983–84
(in millions) [a]

	Actual 1980–81	*Actual 1981–82*	*Estimated 1982–83*	*Proposed 1983–84*
Beach, park, recreational and historical facilities	$10	$5	$5	$10
Clean water	—	40	30	—
Clean water and water conservation	—	60	100	50
Parklands acquisition and development program	—	65	50	30
Safe drinking water	20	20	30	—
State, urban, and coastal parks	30	50	15	15
New prison construction	—	—	150	125
County jail construction	—	—	—	125
Lake Tahoe land acquisition	—	—	—	40
School building lease purchase	—	—	—	100
First-time home buyers	—	—	—	125
Subtotals, General Fund Bonds	$60	$240	$380	$620
School building aid [b]	25	—	—	—
Veterans' farm and home building [c]	300	150	300	250
Totals	$385	$390	$680	$870

[a] Source: California State Treasurer.
[b] Debt service currently paid entirely by school districts.
[c] Debt service paid from program or project revenues.

Table 43 also shows estimated bond sales for the current year. Given the Treasurer's suspension of bond sales, it is unlikely that the estimated level of sales will actually take place. As we noted above, $280 million in general obligation bonds have already been sold, or 41 percent of the bond sales scheduled for the current year. Other bonds sales scheduled for this year include: veteran's bonds ($200 million); prison construction ($50 million), clean water and water conservation ($80 million), safe drinking water ($30 million), state parklands ($25 million), and urban and coastal parks ($15 million).

For 1983–84, a total of $870 million in general obligation bond sales had been planned by the Treasurer, prior to his suspension of sales in December 1982. A significant portion of these bond sales are associated with the five new programs approved by the voters in 1982: state prison construction ($125 million); first-time home buyers ($125 million); state school building lease purchase ($100 million); Lake Tahoe land acquisition ($40 million); and new county jail construction ($125 million). How many of these planned bond sales actually occur will depend on (1) when the Treasurer lifts his suspension, and (2) the condition of the financial markets during 1983 and 1984.

General Fund Debt Service. Table 44 shows projections through 1983–84 of the amount of debt service to be paid on bonds fully supported by the General Fund. Debt service for the budget year is estimated at $343 million, of which $168.3 million is for repayment of principal and $174.8 million is for payment of interest. This represents an increase of $78.6 million (or 29.7 percent) over the current year.

General Fund debt service costs of $343 million compare to total *general* *obligation* debt service costs of approximately $780 million in 1983–84. Of the total, $340 million is for interest and $440 million is for repayment of principal. Thus, the debt servicing costs for self-liquidating bonds, such as veteran's mortgage revenue bonds, far exceed debt service costs for General Fund bonds. This reflects both the dramatic increase in sales of self-liquidating housing bonds in recent years, and the higher interest rates attached to these bonds, compared to bonds issued earlier.

All of the debt service estimates in Table 44 are based on specific estimates of future bond sales and conditions in the financial markets. If the volume of sales is greater (less) than the estimated level, the amounts needed to service General Fund debt will increase (decrease) accordingly. The estimates are also subject to error because the interest rates which will be paid on future bond sales are very difficult to predict at this time. The estimates in Table 44 assume that the yield paid on future tax-exempt bond issues will be 10 percent. The actual yields, however, will depend on the course of future federal monetary and fiscal policies, on the market for municipal debt specifically, and on the path of the economy generally.

Table 44
General Fund Debt Service
1980–81 to 1983–84
(in millions)

	Debt Service[a]	*Percent Change from Previous Year*	*Anticipated Sales*[b]
1980–81	$210.5	6.9%	—
1981–82	218.7	3.9	—
1982–83	264.5	20.9	380.0
1983–84[c]	343.0	29.7	620.0

[a] Includes estimated debt service *only* on bond issues currently authorized by the electorate. Figures through 1983–84 are from the 1983–84 Governor's Budget.

[b] An average interest rate of 10.0 percent is assumed on anticipated future sales. Projected sales for 1982–83 and 1983–84 are from the 1983–84 Governor's Budget.

[c] The projection for 1983–84 assumes that the level of sales projected in the budget occurs. Actual sales may be less, depending on bond sale decisions made by the Treasurer.

Selected Bond Fund Expenditures. After General Fund bonds are sold, the proceeds from the sales are allocated to be spent on specific projects. These bond fund expenditures are identified in Schedule 3 of the Governor's Budget, by administering agency. Table 45 groups these expenditures for the prior, current, and budget years, according to the source of bond funding. Two new bond programs authorized by the voters in 1982—new prison construction and state-school lease purchase—are expected to account for over three-fourths of all bond fund expenditures in 1983–84.

We have noted in past *Analyses* that midyear budget estimates of bond fund expenditures generally have turned out to be too high. For example, the 1979–80 and 1980–81 midyear estimates were $347 million and $273 million, respectively, while actual expenditures in those years were only $193 million and $145 million, respectively.

In 1981–82, the midyear estimate of bond fund expenditures was $342 million, or $112 million more than the actual expenditure of $230 million. The largest components of the 1981–82 difference involved two programs

—the state, urban, and coastal parks program, and the state parklands acquisition program. Estimated expenditures for each program were $42 million higher than actual expenditures.

The failure of the budget to give a realistic picture of bond expenditures makes inter-year bond expenditure program comparisons invalid and, in addition, 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 inter-year comparisons.

Table 45
Selected Bond Fund Expenditures [a]
1981–82 Through 1983–84
(in thousands)

	Actual 1981–82	*Estimated 1982–83*	*Proposed 1983–84*
Higher education construction	—	$493 [b]	—
Health science facilities construction	$4,009	506	—
Community college construction	649	494	$34
Beach, park, recreational, and historical facilities	7,814	12,407	189
New prisons	—	149,276	244,500
Recreation and fish and wildlife	371	1,988	694
State, urban, and coastal parks	28,124	45,500	8,446
Parklands acquisition and development	100,279	141,890	24,102
Clean water	69,468	76,311	81,456
Safe drinking water	19,511	25,964	26,041
School lease-purchase	—	124,985	199,985
Totals	$230,225	$579,814	$585,447

[a] Figures are derived from the 1983–84 Governor's Budget, Schedule 3. Includes bond fund expenditures for state operations, local operations and capital outlay.
[b] Includes unallocated capital outlay funds, as provided under the State Higher Education Construction Bond Act of 1966.

3. State Revenue Bonds

Bond Categories. Agencies of the state also issue revenue bonds. These are fundamentally different from general obligation issues, in that only the revenue generated from the financed project is pledged as security for the bond. This type of debt instrument has been used by the state in the past to finance the construction of such projects as bridges, fair facilities, and higher education dormitories and parking lots.

Beginning in the 1970's, the state expanded the scope of revenue bond programs to include financing for home purchases, pollution control outlays, and health and educational facilities. In 1982, the Legislature created the newest revenue bond program, which will provide financing for high speed rail passenger systems in California.

Table 46 identifies sixteen different types of state revenue bond programs and shows their current authorizations. As of December 31, 1982, a total of $4,986 million in state revenue bonds was outstanding. Three housing bond programs account for $1,927 million, or 39 percent of the outstanding bonds: California Housing Finance Agency ($1,447 million), Veterans Revenue Debenture ($455 million), and California National Guard ($25 million). The table also shows that nine of the sixteen programs have statutory authorization limits, which together total $7,084 million. Of this amount, $4,430 million (63 percent) was unused at the end of 1982.

Table 46
State Revenue Bonds
As of December 31, 1982
(in thousands) [a]

Issuing Agency	*Authorization Limits—If Any*	*Outstanding*	*Remaining Authorization*
California Education Facilities Authority	$500,000	$324,665	$175,335
California Housing Finance Agency	1,850,000 [b]	1,447,185	402,815
California Pollution Control Financing Authority	None	765,407	N/A
Transportation Commission	None	143,139	N/A
Department of Water Resources	None	1,077,820	N/A
Trustees California State University	None	148,798	N/A
Regents University of California	None	176,676	N/A
State Public Works Board	None	11,922	N/A
State Public Works Board—Energy Conservation and Cogeneration	500,000	—	500,000
Hastings College of Law	None	7,280	N/A
Veterans Revenue Debenture	1,000,000	455,000	545,000
California National Guard	100,000	24,920	75,080
California Health Facilities Authority	1,534,000 [b]	396,895	1,137,105
California Student Loan Authority	150,000	—	150,000
California Alternate Energy Source Financing Authority	200,000	5,810	194,190
California Rail Passenger Financing Authority	1,250,000 [b]	—	1,250,000
Subtotals:			
Bonds With Statutory Authorization Limits	$7,084,000	$2,654,475	$4,429,525
Bonds Without Statutory Authorization Limits	N/A	$2,331,042	N/A
Totals, All State Revenue Bonds	N/A	$4,985,517	N/A

[a] Source: California State Treasurer.
[b] Includes increases in statutory authorizations effective January 1, 1983.

Growth in Revenue Bonds. In recent years, the outstanding volume of revenue bonds has risen dramatically. Chart 20 shows the increase in revenue bonds outstanding from 1973–74 through 1981–82. The volume of these bonds rose from $0.9 billion in 1973–74 to $4.0 billion in 1981–82. In the six-month period from June 1982 to January 1983, the total rose by an additional $1.0 billion, to almost $5.0 billion.

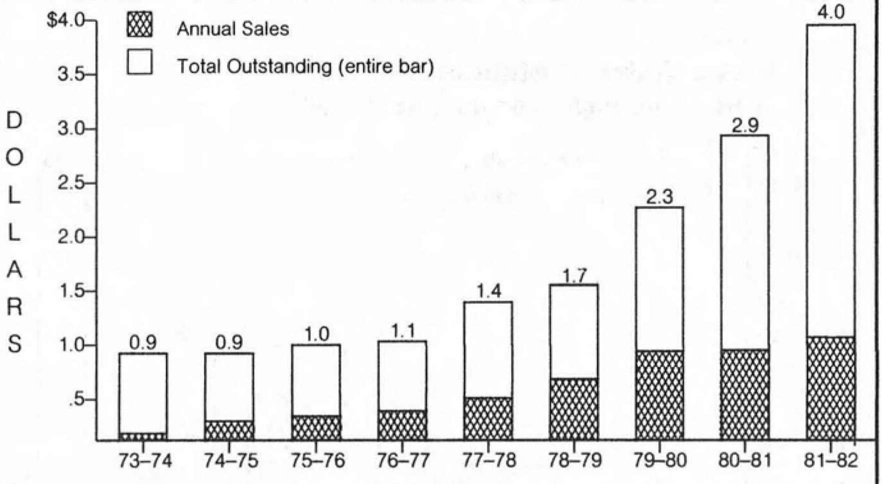
Bond Sales. Table 47 shows revenue bond sales for the past four years. Estimates of current-year and budget-year sales are not available at this time. This is primarily because revenue bond issues are not scheduled as far in advance as are general obligation bond sales.

Revenue bond sales have increased dramatically in the last four years, with sales exceeding $1 billion for the first time in 1981–82. The largest share (28 percent) of these sales was accounted for by the first issuance of California Health Facilities Authority revenue bonds. The remaining sales were accounted for primarily by bonds issued by the California Housing Finance Authority (24 percent), the Department of Water Resources (20 percent), and the California Pollution Control Financing Authority (18 percent). Since June 1982, there have been additional revenue bond sales of approximately $1 billion. Bonds for programs administered by two agencies—the California Housing Finance Authority and the Department of Water Resources—account for over 85 percent of these sales.

Chart 20

California State Revenue Bonds Annual Sales and Total Outstanding Volume

1973–74 through 1981–82 (in billions)[a]



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

Table 47

State Revenue Bond Sales

1978–79 to 1981–82

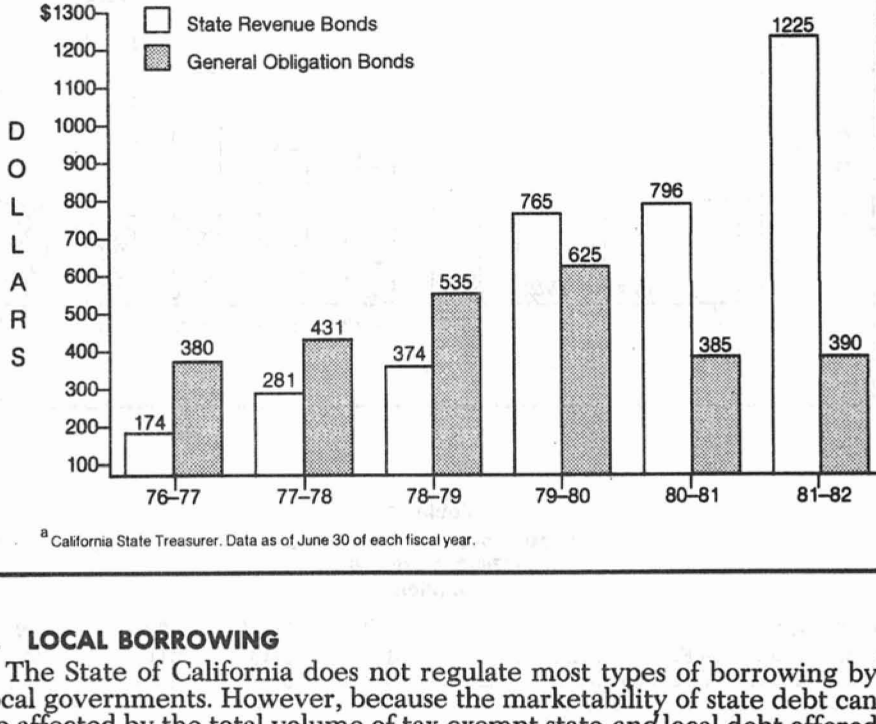
(in millions) [a]

Issuing Agency	*1978–79*	*1979–80*	*1980–81*	*1981–82*
California Education Facilities	$12.1	$24.5	$114.7	$57.7
California Housing Finance Authority	250.0	371.7	161.8	298.9
California National Guard	—	—	25.0	—
California Pollution Control Financing Authority	107.8	44.5	165.0	217.3
Transportation Commission	—	—	25.0	25.0
Department of Water Resources	—	95.8	—	250.0
University of California Regents	4.7	25.0	—	17.8
Trustees, California State University	—	3.8	4.7	11.7
Hastings College of Law	—	—	—	7.3
Veterans Revenue Debenture	—	200.0	300.0	—
California Health Facilities Authority	—	—	—	339.6
Totals	$374.6	$765.3	$796.8	$1,225.3

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

Chart 21 compares the sales of state general obligation and revenue bonds since 1976–77. It shows that state revenue bond sales have significantly exceeded general obligation bond sales in each of the past three 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 recent years, these ceilings have sometimes made it difficult to sell general obligation bonds.

Chart 21
Annual Sales of State Bonds
1976–77 through 1981–82 (in millions)[a]



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

B. LOCAL BORROWING

The State of California does not regulate most types of borrowing by local governments. However, because the marketability of state debt can be affected by the total volume of tax-exempt state *and* local debt offered for sale, the state has an important interest in local borrowing activities. Like the state, localities engage in both long-term borrowing through the issuance of bonds, and short-term borrowing.

Local Bond Sales

Table 48 shows local bond sales for the last four years, by type of local government. The table indicates that between 1978–79 and 1981–82, the total volume of local bonds sold annually increased by approximately 39 percent. The table also indicates that most of this increase is due to the dramatic rise in housing bond sales (170 percent), especially housing bond sales by counties and local redevelopment agencies. Between 1978–79 and 1981–82, housing bonds increased from 24 percent to 47 percent of total local bond sales. In 1979–80, however, the housing bond share of the total began to stabilize, partly in response to federal legislation limiting the sale of such bonds.

Another significant development shown in Table 48 is that no bonds were issued by local school districts in 1981–82. This is because voters in school districts have not authorized any new bond issues since the passage of Proposition 13 in 1978. The remaining authorizations for bond issues approved prior to Proposition 13 apparently were expended, for the most part, by the end of 1980–81.

Table 48
Annual Local Bond Sales
1978–79 to 1981–82
(in millions) [a]

Type of Local Government	*1978–79*	*1979–80*	*1980–81*	*1981–82*
1. Counties:	$13.7	$9.0	$214.1	$372.5
Housing	(12.4)	(8.6)	(194.8)	(370.6)
Other	(1.3)	(0.4)	(19.3)	(2.0)
2. Cities:	$358.0	$488.9	$632.6	$341.2
Housing	(111.2)	(211.9)	(124.1)	(73.3)
Other	(246.8)	(277.0)	(508.5)	(267.9)
3. School districts:	$58.7	$95.9	$52.6	—
4. Redevelopment agencies:	$448.1	$1,150.4	$587.6	$741.1
Housing	(241.3)	(948.3)	(446.7)	(349.7)
Other	(206.8)	(202.1)	(140.9)	(391.4)
5. Special districts:	$623.5	$814.0	$267.8	$569.2
Housing	(—)	(—)	(27.0)	(193.4)
Other	(623.5)	(814.0)	(240.8)	(375.8)
Overall Totals [b]	$1,516.0	$2,612.8	$1,831.9	$2,110.6
Housing	*(364.9)*	*(1,168.8)*	*(792.6)*	*(987.0)*
Other	*(1,137.2)*	*(1,389.4)*	*(962.0)*	*(1,037.1)*

[a] Source: Office of Planning and Research. Data for 1981–82 compiled by Legislative Analyst. Details may not add to totals due to rounding.

[b] Overall totals include sales of special assessment bonds. Such bond sales are not included in the detail, however, because data on these sales are unavailable by type of local government prior to 1981–82. Total sales of special assessment bonds were $14 million in 1978–79, $54.6 million in 1979–80, $77.3 million in 1980–81, and $86.6 million in 1981–82.

Short-term Local Borrowing

Local governments also engage in short-term borrowing by issuing a wide variety of secured and unsecured debt instruments. These include, among others, tax anticipation notes, revenue anticipation notes, certificates of participation, and tax-exempt commercial paper. The volume of such short-term borrowing, although not known with certainty, has significantly increased in recent years. Based on currently available data, it appears that the various levels of local government in California issued over $1.2 billion in short-term debt obligations during 1981–82 alone.

C. COMBINED USE OF BONDS BY STATE AND LOCAL GOVERNMENTS

Combined state and local borrowing undertaken in recent years is shown in Table 49. 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 sold annually, which increased by more than 170 percent. Although the outstanding volume of local bond sales remained much larger than combined state sales during this period, annual sales by the state grew much faster than local sales.

Table 49
Annual Sales of State and Local Bonds
1975–76 to 1981–82
(in millions)

		State of California[a]			
	Total All Bonds	*Total State*	*General Obligation*	*Revenue*	*Local Bonds*[b]
1975–76	N/A	$412	$295	$117	N/A
1976–77	N/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	3,013	1,181	385	796	1,832
1981–82	3,726	1,615	390	1,225	2,111

[a] Source: California State Treasurer.
[b] Source: Office of Planning and Research. Data on local bond sales unavailable for years before 1977–78. Data for 1981–82 compiled by Legislative Analyst.

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 more than $1 billion, from the previous year's level. This reflected a 17 percent decline in sales by the state, and a 30 percent decline in local sales. In the state's case, the decline was due to a 38 percent drop in general obligation bond sales, and an essentially flat level of revenue bond sales. This drop in bond sales reflected unusually negative conditions in the municipal markets during 1981—chief among them being exceptionally high interest rates.

In 1982, the municipal bond market improved somewhat and, as a result, bond sales in 1981–82 reached more than $3.7 billion. Although this level was still below that of 1979–80, it represented a 24 percent increase over the level of sales in 1980–81. Of the increase in total state and local bond sales between 1980–81 and 1981–82—$713 million—about 60 percent was due to increased sales of state revenues bonds ($429 million). State general obligation bond sales, in contrast, were essentially flat, while local bond sales rose by $279 million.

Housing Bonds Sales

Table 50 and Chart 22 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 19 percent during this same period. In 1980–81, the volume of both state and local housing bonds dropped by 26 percent, with about two-thirds of the decline due to local housing bond sales. In 1981–82, the total volume of housing bonds fell slightly. However, as a share of total sales, housing bonds fell significantly, from 55 percent in 1980–81 to 39 percent in 1981–82. Nonetheless, the share of state and local bonds that are sold to finance housing is still considerably higher than what it was in 1977–78 (16 percent).

Table 50
California State and Local Bond Sales
1977–78 to 1981–82
(in millions) [a]

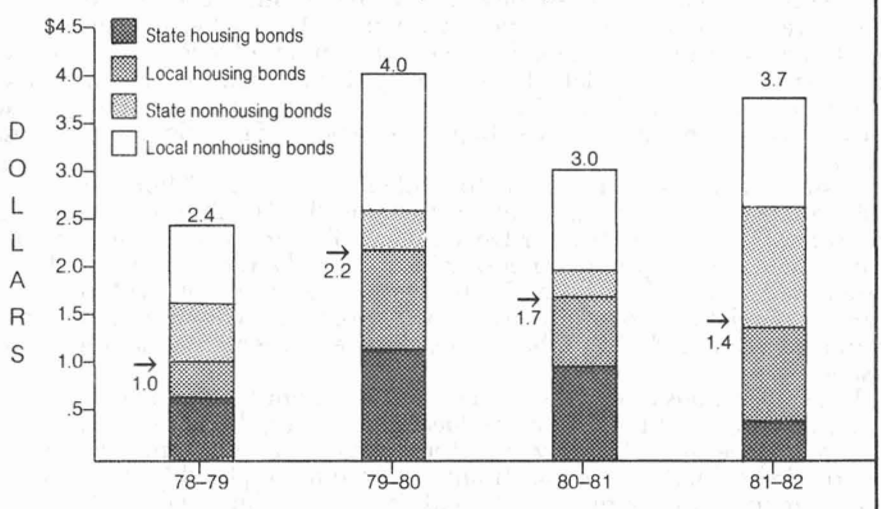
	1977–78	*1978–79*	*1979–80*	*1980–81*	*1981–82*
State Bonds:					
Housing	$322.4	$625.0	$1,071.7	$861.8	$448.9
Nonhousing	396.2	250.5	303.0	310.2	1,166.1
Subtotals	$718.6	$875.5	$1,374.7	$1,172.0	$1,615.0
Local Bonds:					
Housing	$93.2	$364.9	$1,168.8	$792.6	$987.0
Nonhousing [b]	1,766.9	1,151.1	1,444.0	1,039.3	1,123.6
Subtotals	$1,860.1	$1,516.0	$2,612.8	$1,831.9	$2,110.6
State and Local Bonds:					
Housing	$415.6	$989.8	$2,240.5	$1,654.4	$1,435.9
Nonhousing	2,163.1	1,401.7	1,747.0	1,349.5	2,289.7
Totals	$2,578.7	$2,391.5	$3,987.5	$3,003.9	$3,725.6

[a] Source: Office of Planning and Research. State bond totals for 1978–79 through 1980–81 differ slightly from those reported by California State Treasurer. Local bond data for 1981–82 compiled by Legislative Analyst.

[b] Includes sales of special assessment bonds.

Chart 22

California State and Local Bond Sales Highlighting Housing Bonds
1978–79 through 1981–82 (in billions)[a]



[a] Office of Planning and Research as published in "Mortgage Revenue Housing Bonds California's 1980 Frenzy", November 1980, updated through June 1982 using data from Office of Planning and Research Data as of June 30 of each fiscal year

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

- The Zenovich-Moscone-Chacon Housing and Home Finance Act (Chapter 1, First Extraordinary Session, Statutes of 1975) established the California Housing Finance Agency and authorized a total outstanding amounts of up to $1.5 billion in tax-exempt state revenue bonds. As of December 31, 1981, almost all of this authorization had been used, as $1,447 million in bonds were outstanding under this program. Effective January 1, 1983, the authorization was increased by $350 million, to $1.85 billion.
- 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 that may be issued under this program, although the State Housing Bond Credit Committee has the authority to review, disapprove, and/or reduce bond issues.

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 public purposes. These traditional purposes include the financing of highway projects, new prisons, water projects, and so forth.

In December 1980, the U.S. Congress decided to stem the growth in housing bonds by enacting 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 considerable uncertainty after December 1980 as to the conditions under which the tax-exemption for housing bonds issued after that date could be disallowed, due to the failure of housing agencies to comply with the act's various regulations governing use of bond proceeds. This uncertainty was removed after mid-1981, when more detailed federal regulations were issued.

In 1981–82, housing bond sales declined somewhat, both in dollar terms and as a percent of total state and local government bond sales. Between now and December 1983, however, there could be a resurgence of housing bond sales, subject to the constraints 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-exemption for issues used to finance single-family home purchases will be eliminated. We are not able to say how much this might reduce interest rates for other tax-exempt state and local debt.

D. PROBLEMS AND POLICY ISSUES

In last year's *Analysis,* we discussed a number of problems and questions regarding the use of debt, especially tax-exempt bonds, by state and local governments. We also indicated that given the importance of this subject area, we would prepare a report on the topic of debt financing. This report, entitled *The Use of Tax-Exempt Bonds in California: Policy Issues and Recommendations,* (Report #82-20), was published in December 1982. The report provides an extensive discussion of the nature of state and local tax-exempt bond markets, current problems facing the bond markets, and policy issues regarding the use of tax exempt bonds in California. In addition, the report offers a variety of recommendations to the Legislature regarding the use of tax-exempt bonds. These policy issues and our major recommendations are discussed in some detail in Part III.

V. THE STATE'S WORKFORCE

A. CHANGES IN THE CURRENT YEAR

As Table 51 and Chart 23 show, the Governor's Budget proposes a state government workforce of 232,370 personnel-years for 1983–84. The four largest components of this total are 93,334 personnel-years (40 percent) in Higher Education, 40,764 personnel-years (18 percent) in Health and Welfare programs, 33,530 personnel-years (14 percent) in Business, Transportation and Housing programs and 17,053 personnel-years (7 percent) in Youth and Adult Correctional programs.

Chart 23
Personnel-Years by Function
1983–84

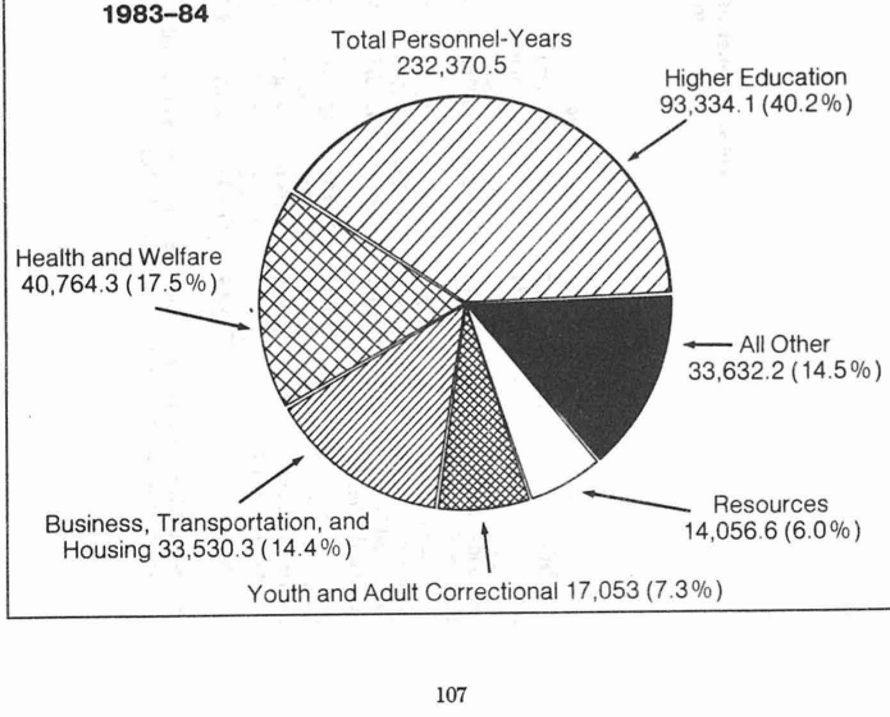


Table 51
Total Number of State Employees, by Function
(in personnel-years)
1977–78 through 1983–84

	1977–78	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*Estimated 1982–83*	*Proposed 1983–84*	*1983–84 Over 1982–83 Change*		*1983–84 Over 1977–78 Change*	
								Number	*Percent*	*Number*	*Percent*
Legislative	327.7	338.1	337.4	332.6	351.1	399.5	399.5	—	—	71.8	21.9%
Judicial	972.7	989.7	1,051.0	1,083.7	1,090.1	1,192.5	1,301.5	109.0	9.1%	328.8	33.8
Executive	7,349.5	7,247.7	7,325.3	7,716.0	7,977.1	8,149.3	7,968.7	−180.6	−2.3	619.2	8.4
State and Consumer Services	10,784.2	10,402.7	10,671.3	11,023.2	11,325.3	11,996.6	12,175.5	178.9	1.4	1,391.3	12.9
Business, Transportation and Housing	32,327.8	30,867.6	31,293.4	31,955.0	31,859.4	32,968.4	33,530.3	561.9	1.7	1,202.5	3.7
Resources	14,192.5	14,167.9	13,779.5	13,889.2	14,373.0	14,565.9	14,056.6	−509.3	−3.5	−135.9	−1.0
Health and Welfare	39,531.8 [a]	40,460.9	42,325.2	43,320.7	41,589.7	42,930.5	40,764.3	−2,166.2	−5.1	1,232.5	3.1
Youth and Adult Correctional	12,613.2 [a]	12,805.6	12,548.6	13,118.3	13,934.6	15,974.6	17,053.0	1,078.4	6.7	4,439.8	35.2
K–12 Education	2,673.7	2,650.3	2,665.0	2,746.5	2,796.1	2,941.1	2,851.6	−89.5	−3.1	177.9	6.7
Higher Education	92,394.6	90,152.0	89,840.5	91,629.8	93,988.5	92,971.7	93,334.1	362.4	0.3	939.5	1.0
General Government	8,173.7	8,447.6	8,355.3	8,752.4	9,528.5	9,296.6	8,935.4	−361.2	−3.9	761.7	9.3
Totals	221,341.4	218,530.1	220,192.5	225,567.4	228,813.4	233,386.7	232,370.5	−1,016.2	−0.5%	11,029.1	5.0%

[a] Youth and Adult Correctional programs were included in the Health and Welfare totals prior to 1978–79. Youth and Adult Correctional total in 1977–78 includes the Departments of Corrections and Youth Authority.

The size of the state's workforce proposed for 1983–84 is 1,016 personnel-years, or 0.5 percent, below the estimated number of personnel-years in 1982–83. The reduction reflects significant decreases in staffing for Health and Welfare (−2,166) and Resources (−509) programs, and a significant increase in staffing for Youth and Adult Correctional programs (1,078).

Health and Welfare

The largest staffing changes are proposed for this program area, a reduction of 2,166 personnel years, or 5 percent. Within this area, the largest single staffing reduction proposed in the budget year is a decrease of 1,506 personnel years in the Employment Development Department. A significant part of this reduction (1,170 personnel-years) is a result of an anticipated upturn in the economy, which will reduce the workforce necessary to process unemployment claims. The remaining reduction of 337 personnel-years, and a related decrease of 142 personnel-years in the Department of Rehabilitation, reflect anticipated declines in federal support. The budget also proposes significant personnel reductions in the following departments:

- Health Services, reflecting the proposed establishment of the state public health block grant,
- Social Services, reflecting the proposed elimination of family day-care licensing, and
- Developmental Services, reflecting caseload adjustments.

Resources

The budget proposes to reduce resources staffing by 509 personnel-years in 1983–84, a reduction of 3.5 percent from the estimated current-year levels. The major components of this reduction are decreases in the Energy Resources Conservation and Development Commission (−164), the Department of Parks and Recreation (−133), the California Conservation Corps (−48), the California Coastal Commission (−41), and the Air Resources Board (−30). Most of these reductions are associated with changes in service levels under various resources programs.

Youth and Adult Correctional

The budget proposes to increase Youth and Adult Correctional Agency staffing by 1,078 personnel-years in 1983–84, an increase of 6.7 percent. This is a net figure which reflects a special workload adjustment of 1,200 personnel-years in the Departments of Corrections and Youth Authority. However, because specific plans for operating and staffing temporary facilities to house the increased caseload have not been provided, and because the departments themselves did not request these new positions, we have no information on the allocation of the new caseload positions between the two departments.

Business, Transportation and Housing

The budget proposes to increase the workforce in these programs by 562 personnel-years in 1983–84, or by 1.7 percent. The most significant changes are increases of (1) 344 personnel-years for the California Highway Patrol, primarily to augment the number of traffic offices, and (2) 380 personnel years for the Department of Motor Vehicles, primarily to fund increased workload in vehicle registration and for issuance of reflectorized license plates. The budget also proposes significant personnel-year reductions in the Departments of Corporations and Transportation.

All Other

The Governor's Budget also proposes a number of other significant changes in staffing for 1983–84. These include increases for the Judiciary (94), the Department of Consumer Affairs (102), the University of California (252), and the California State University and Colleges (106), and decreases for the Department of Education (−83), the Agricultural Labor Relations Board (−58), and the Department of Industrial Relations (−214).

B. HISTORICAL CHANGES

Ratio of State Workers to Total Population Declines

Table 52 shows that between 1977–78 and 1983–84, California's population will have increased by 11.8 percent, and state operations expenditures, adjusted for inflation, will have increased by 12.2 percent. Both of these increases are larger than the growth in the state's workforce during the same period—5 percent. As a result, the ratio of state employees to the state's population has declined by 6 percent, or the equivalent of 15,000 state employees.

Table 52
Ratio of the State's Workforce To Total Population 1977–78 to 1983–84

	State Workforce (in thousands)	*California's Population (in thousands)*	*State Workforce As Percent of Total Population*	*State Operations Expenditures In Constant Dollars (in millions)* [a]
1977–78	221.3	22,600	0.979%	$3,758
1978–79	218.5	23,049	0.948	3,606
1979–80	220.2	23,534	0.936	4,024
1980–81	225.6	23,993	0.940	4,335
1981–82	228.8	24,423	0.937	4,235
1982–83	233.4	24,846	0.939	4,256
1983–84	232.4	25,263	0.920	4,217
Percentage Change (1977–78 to 1983–84)	5.0%	11.8%	−6.0%	12.2%

[a] Includes General Fund and special fund expenditures adjusted for inflation with 1977–78 as the base year.

Correctional Staffing Accounts for Major Share of Total Increase.

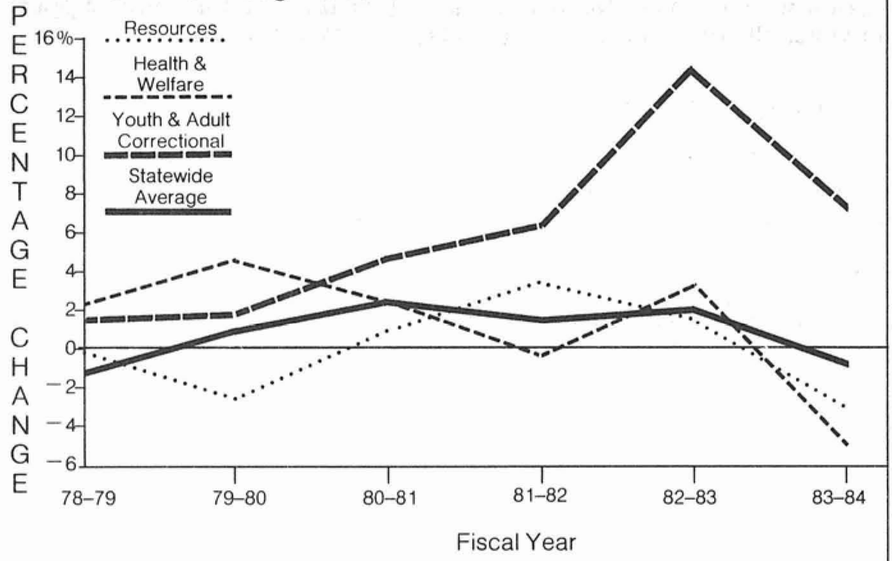
Overall, the state's workforce has increased by 11,029 since 1977–78. As Chart 24 shows, the *largest* percentage increases have occurred in Youth and Adult Correctional programs. These programs account for 40 percent (4,440 personnel-years) of the total increase. Increases in other programs areas are as follows: State and Consumer Services (1,391, or 12.6 percent of the total increase), Health and Welfare (1,232, or 11.2 percent), and Business, Transportation and Housing (1,202, or 10.9 percent). The only overall reduction since 1977–78 occurs in Resources (−136 personnel-years), largely as a result of decreases proposed for the budget year.

The primary components of the increases in staffing that have occurred since 1977–78 are described below:

Chart 24

Annual Percentage Change in Personnel-Years

1977–78 through 1983–84



- The increases in *Youth and Adult Correctional* are due to increased prison populations during the past two years. These increases are being funded primarily from the state's General Fund.
- Increases in *Business, Transportation and Housing* have occurred mainly in the Department of Transportation (270 personnel-years), the California Highway Patrol (327 personnel-years), and the Department of Motor Vehicles (236 personnel-years), none of which are General Fund supported agencies.
- Increases in *State and Consumer Services* can be attributed to (1) the creation of the Department of Fair Employment and Housing (257 personnel-years in 1983–84), (2) growth in the Franchise Tax Board (273 personnel-years), due to increased workload and the expansion of audit staff, and (3) a significant increase in the Department of Consumer Affairs (470 personnel-years, or 37.3 percent), due primarily to additional staff in the Bureau of Automotive Repair and the Contractors State License Board.

As Table 51 shows, increases over the period from 1977–78 to 1983–84 in all other departments (excluding the legislative, judicial, and executive branches) range from 3 percent to 7 percent. These increases reflect a normal growth in workload. Increases in general government are attributable primarily to the creation and expansion of small agencies.

C. GENERAL FUND SHARE OF STATE WORKFORCE UNKNOWN

Because no requirement exists for statewide tabulations of personnel-years by funding source, it is impossible to distinguish staff supported from the General Fund from those supported by special funds. In some instances, programs are totally supported by *either* the General Fund *or* special funds, and in these cases it is easy to identify the funding source for personnel. In many cases, however, the funding of personnel-years cannot be directly correlated to funding source. Using the limited information which is available, we estimate that the General Fund supports between 50 and 60 percent of the state's workforce.

Part III

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

Revenue Issues

Expenditure Issues

State Borrowing Issues

Local Government Finance Issues

Legislative Control of the Budget

Emerging Issues

PART III

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

INTRODUCTION

This part discusses some of the broader issues facing the Legislature in 1983. Some of these issues are closely linked to the Governor's Budget for 1983–84. Others are more long range in nature and will, in all probability, persist for many years beyond 1983. Even so, however, legislative action to address these issues in 1983 generally will allow the Legislature to consider a wider range of options than it will have available to it in subsequent years. We have grouped these issues into six major sections.

State Revenue Issues. The first section identifies issues related to state revenues. Specifically, we discuss options for reducing tax expenditures and increasing legislative oversight of this significant portion of the state budget. We also discuss the allocation of tidelands oil revenues and how these funds can be used so as to give the Legislature the most fiscal flexibility in funding its priorities. Finally, we review the practicality of using one-time revenue sources to balance the state's budget.

State Expenditure Issues. The second section identifies issues related to state expenditures. Here, we discuss the allocation of funds for cost-of-living adjustments, and changes in the amount and form of federal aid to the state. We also identify the status of the legislatively approved capital outlay program for the current and budget years and suggest a way in which the Legislature can more effectively apply its priorities to the capital outlay program for 1983–84. Finally, we examine several of the Governor's cross-cutting budget proposals to reduce state legal staff and consolidate state funding for selected public health, substance abuse, and education programs into three state block grants to local governments.

State Borrowing Issues. In this section, we identify policy issues and make recommendation designed to improve the state's ability to borrow—both on a short-term basis, for cash management purposes, and on a long-term basis to finance capital projects.

Local Government Finance Issues. The fourth section identifies issues that involve the state's relationship with local governments. We discuss state fiscal relief for local governments and local fiscal flexibility. We also identify difficulties experienced by local governments in financing capital outlay projects, and the cost to the state of reimbursing local governments for implementing state-mandated programs.

Legislative Control of the Budget. The fifth category identifies issues that involve the Legislature's ability to monitor and control state spending. One of these issues has to do with the Legislature's role under those state laws that extend the right to collective bargaining to state employees. Other issues involve the availability, comprehensiveness and reliability of data on revenues, expenditures, and state employment.

In addition, we discuss options available to the Legislature for improving the oversight provided on behalf of the Legislature by the State Public Works Board, and options for reducing the extent to which the courts are able to thwart legislative priorities and policies.

Emerging Issues. The sixth and final section deals with issues which may have a significant effect on state programs and spending in the future. These include the increasing demand for state services on the part of California's growing refugee population, the performance record of four work-for-benefit programs and their potential applicability to California's welfare population.

I. REVENUE ISSUES

A. TAX EXPENDITURES—OPTIONS FOR THE LEGISLATURE

Should the Legislature Consider Reductions in Tax Expenditures as a Means for Minimizing Cuts in Direct Expenditure Programs?

In the Governor's Budget for 1983–84, the administration has provided its plan for two categories of General Fund "spending": (1) *direct* expenditures, which are made pursuant to appropriations contained in the Budget Act, and (2) *tax* expenditures, which are made pursuant to provisions of the tax code.

With regard to *direct* expenditures, the budget proposes to spend $21.7 billion from the General Fund in 1983–84, or $379 million (1.7 percent) less than estimated expenditures in the current year. Virtually all of the 1,350 pages in the budget document are devoted to detailed fiscal information supporting these expenditures as well as the direct expenditures from special and other funds. In the coming months, the members of the Legislature will spend hundreds of hours reviewing, debating, and approving the proposed items that will fix the level of direct expenditures for virtually every state program.

With regard to *tax* expenditures, the budget proposes to spend $8.9 billion in 1983–84. While the budget calls for direct expenditures to decline in 1983–84, it—in effect—proposes to increase tax expenditures by nearly 8 percent from the estimated current-year level.

In stark contrast to the attention that both the administration and the Legislature routinely give to direct expenditures, however, virtually *no* review is given to tax expenditures as part of the budget process. The budget devotes only nine pages to the subject, providing some historical background and some summary fiscal information. Moreover, little if any discussion of tax expenditures will occur during legislative budget hearings. As a consequence, the level of tax expenditures during 1983–84 will be set without benefit of legislative review or approval.

Tax Expenditures Defined

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 have been enacted, the principal ones are as follows: (1) to provide incentives for taxpayers to alter their behavior in certain ways (for example, the tax deduction for mortgage interest is intended to encourage homeownership), and (2) to provide aid or relief to a particular group or class of people (for example, the sales tax exemption for prescription medicines is intended to lessen the financial burden on those who must purchase such medication).

The "tax expenditure" concept provides a systematic means for identifying those revenues foregone by the state for policy reasons. Information on tax expenditures allows the state to compare the "costs" of these policy decisions with the results achieved by them.

Table 53 provides summary information on tax expenditures, by tax, from 1981–82 to 1983–84.

Table 53
Estimated Cost of General Fund Tax Expenditures 1981–82 Through 1983–84 (in millions)

	1981–82	*1982–83*	*1983–84*
Personal income tax	$4,600	$5,443	$5,890
Sales and use tax	2,300	2,566	2,733
Bank and corporation tax	200	222	236
Insurance tax	[a]	46	57
Cigarette tax	[a]	14	14
Horse racing	[a]	2	2
Totals	$7,100	$8,293	$8,932

[a] Less than $50 million.

Need for Legislative Control Over Tax Expenditures

Although tax expenditures are an appropriate means of accomplishing legislative objectives, there are three basic reasons why their use needs to be monitored closely. 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 (such as the deduction for charitable contributions) do not result in large tax savings to individual taxpayers. It is doubtful that those state tax expenditures which provide a relatively moderate amount of tax relief per return have much, if any, 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, for which funds must be appropriated annually in the Budget Act, tax expenditures do 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 benefits. In short, once a tax expenditure is enacted, the Legislature—for all practical purposes—loses control over the annual amount of state resources allocated to the accomplishment of the particular objective. This makes it extremely difficult for the Legislature to alter the allocation of existing resources to reflect changing priorities, as may be necessary in times of fiscal constraint.

Finally, *widespread use of the tax system to achieve public policy objectives may have an adverse impact on the tax system itself.* The proliferation of tax expenditures is one of the main reasons why the present tax system is so complicated. While the impact of adding one more line or one more form to a tax return packet may—by itself—be minor, the *cumulative* burden placed on the tax system by *all* tax expenditures is a heavy one. In fact, the plethora of special provisions (that is, tax expenditures) added to the tax system over the years has drastically increased the opportunities for tax evasion and cheating, and at the same time given many taxpayers the impression that the tax system is inequitable.

Tax Expenditures in 1983–84

The case for legislative review of tax expenditures, which is convincing in a "normal" year, is particularly convincing in 1983–84. It is by no means clear that the *Legislature's* priorities are best served by increasing the amount of tax expenditures by 7.7 percent, and reducing the amount spent directly through the state's General Fund by 1.7 percent.

Put another way, were the resources allocated to various policy objectives through the tax system subject to legislative review and approval through the budget process, the Legislature might choose to use some or all of the $639 million in increased tax expenditures to prevent or minimize cuts in direct spending programs. For example, the Governor's Budget proposes to spend $70 million to provide a tax exemption for interest earned on government bonds. This is an increase of $10 million, or 16.7 percent, over the amount provided in 1982–83. About two-thirds of this amount represents the cost of subsidizing bonds issued by local governments. This subsidy is available to all local governments, and the amount of the subsidy for any local government is not limited in any way. At the same time as the state is providing these subsidies, practically for the asking, it is at the same time undertaking extensive discussions over the amount of fiscal relief and other local aid to be taken *away* from cities and counties. Much of the aid to local governments that has already been reduced, or is under consideration for further reductions, is earmarked for programs in the health and welfare area, which have traditionally had a high priority for funding. Looked at in this light, the failure to review this tax expenditure in the same manner as a direct expenditure, in effect, gives local economic development a higher priority for funding than state health and welfare programs, as well as other basic local services.

Hence, a review of tax expenditures is particularly timely in 1983–84.

Options for Reducing Tax Expenditures in 1983–84

We suggest that the Legislature, in acting on the 1983–84 Budget, consider specific options for modifying state tax expenditure programs.

In our June 1982 report to the Legislature entitled *Options for Modifying State Tax Expenditure Programs: 1982–83* (#82-11), we provided a series of options for eliminating or modifying 17 existing tax expenditures. We selected existing tax expenditures for review based on the extent to which they satisfied one of the following criteria:

- Provides windfall benefits to taxpayers whose behavior is unaffected by the tax incentive.
- Appears to be contrary to the objectives of other state programs.
- Works at cross purposes with other tax expenditures.
- Has less priority to the Legislature than it had when enacted.

Of the options discussed in the report, some present legal, constitutional and/or administrative problems which might be difficult to resolve within a short period of time. Accordingly, we have selected from the 17 tax expenditures discussed in the report those 9 options which would involve a less dramatic departure from present tax policy. The Legislature could address these options in the 1983–84 budget process without lengthy hearings and debate. These options are summarized in Table 54, which also shows the 1983–84 General Fund revenue gain from implementing each option.

Table 54
Options for Eliminating or Modifying State Tax Expenditure Programs (in millions)

Sales Tax[a]	*1983–84 Revenue Gain*[b]
Exemption for candy and confectionary products:	
• Repeal exemption	$70
Exemption for items sold in vending machines:	
• Repeal exemption	17
Income Taxes	
Energy conservation credit:[c]	
• Repeal credit	20
• Reduce credit (from 40% to 20%)	15
• Make credit complementary to federal credit	15
Solar energy credit:[c]	
• Repeal credit	30
• Make credit complementary to federal credit	20
• Disallow credit for pool water heating	10
Itemized deduction for casualty losses:	
• Limit deduction to losses in excess of 10% of adjusted gross income (federal conformity)[d]	25
Itemized deduction for gas taxes:	
• Accelerate phaseout of deduction[e]	7
Itemized deduction for political contributions:	
• Repeal deduction	2
Military pay exclusion:	
• Repeal exclusion	4
Percentage depletion of minerals:	
• Repeal percentage depletion	8

[a] Modifications to the sales tax expenditures would also result in additional *local* sales tax revenue, equal to about one-third of the gains shown for the state.
[b] Effective date for options: (1) sales tax options: July 1, 1983; and (2) income tax options: tax and income years beginning on or after January 1, 1983 (except for the energy credits, see footnote "c").
[c] Effective date: July 1, 1983. Thus, the credit would be allowed for measures installed between January 1, 1983, and June 30, 1983, resulting in one-half year fiscal impacts for 1983–84.
[d] This option is slightly different from options presented in our report on tax expenditure. We have used the 10 percent threshold (instead of 3 percent and 5 percent), in conformity with recent changes in federal law.
[e] Chapter 1595, Statutes of 1982, provides for the phaseout of this deduction by 1984. Under this act, however, taxpayers may claim, in 1983, 25 percent of the deduction which would have been allowed under prior law. This option provides for the complete repeal of the deduction in 1983.

The only proposal regarding tax expenditures made by the administration in the 1983–84 budget is that the solar energy and energy conservation credits be eliminated. The justifications submitted by the administration on behalf of the proposal are virtually identical to those provided in our June 1982 report. We find that these arguments continue to have merit.

Treatment of Tax Expenditures in Future Years

As noted earlier, the Legislature currently has no way of reviewing the level of resources committed to tax expenditure programs on an ongoing basis. Because tax expenditures, just like direct expenditures, are undertaken to achieve state objectives, we see no basis for giving tax expenditures less legislative oversight.

If the Legislature considers it desirable to incorporate the review of tax expenditures into the budget process, there are several methods available to it for doing so. For example:

- The Legislature could establish a budget subcommittee in each house whose sole function is to review tax expenditures. In any year for which the existing tax system is not expected to provide adequate funding to meet the needs of the state, these subcommittees could be given revenue quotas by their respective houses, as a means of requiring the review and modification of tax expenditures.
- Alternatively, the existing budget subcommittees of each house could be given a list of tax expenditures falling within their jurisdiction. For example, subcommittees handling budget appropriations related to resources could review the energy tax credits. This would enable the subcommittees to assess the effectiveness of *all* state spending—both directly through appropriations and indirectly through tax expenditures. This would also assist the subcommittees in setting priorities for available funds, because they would be able to compare funding requests for *all* of the related programs in their jurisdictional area.
- The Legislature could also address the tax expenditure control issue in the context of overall reform of the budget process. The Legislature could, for instance, use a process similar to Canada's "envelope system," whereby direct and tax expenditures relating to a particular program function are analyzed in the same light and subjected to the same spending controls. Under this system, the budget subcommittees would be constrained by a ceiling on the combined amount of tax and direct expenditures that could be funded each year.

Department of Finance: Reporting Requirements

We recommend adoption of supplemental report language requiring the Department of Finance to expand its presentation of tax expenditures in subsequent Governor's Budgets.

Since 1975–76, the Department of Finance has provided a brief presentation on tax expenditures in the introductory (or "A") pages to the annual Governor's Budget. This presentation includes background information and a fiscal summary of the major identifiable tax expenditures. Chapter 575, Statutes of 1976, requires the department to include in the Governor's Budget, on a biennial basis, a more detailed analysis and recommendations.

The Governor's Budget for 1983–84 proposes that the Ch 575/76 reporting requirement be repealed (although the budget trailer bill, as introduced, does not reflect this proposal). The rationale for the department's recommendation is that the information provided in the report has not been used by the Legislature, nor have many of the recommendations made by the report since its inception in 1977–78 been implemented. While it is true that few tax expenditures have been modified or repealed as a result of the reports, we believe the department should continue to prepare the report required by Ch 575/76. We believe the main reason why there has not been more legislative action on tax expenditures is the absence of a mechanism for considering tax expenditures as part of the budget process (see prior discussion).

Because the annual tax expenditure report provides the Legislature with important summary information that otherwise would not be available, it is important that the department continue to include the report in the Governor's Budget document. Consequently, we recommend that the Legislature *not* repeal the reporting requirement of Ch 575/76.

In fact, we believe that the annual tax expenditure report in the Governor's Budget could be made much more useful to the Legislature if it were expanded and modified. Specifically, we believe that the following items be included in the annual tax expenditure report:

- ***Comprehensive List of Tax Expenditures.*** Currently, the report includes only "major identifiable" tax expenditures instead of a complete list of state tax expenditures. As a result, the listing fails to identify those tax provisions for which the revenue loss is difficult or impossible to estimate, even though it may be significant.
- ***More Detailed Information on Individual Categories of Tax Expenditures.*** Currently, the tax expenditure report provides only a one-year fiscal estimate for aggregated categories of tax expenditures (for example, the revenue loss from interest deductions is not broken out by mortgage and nonmortgage deductions). In order to facilitate legislative review, the department should include, for each tax expenditure, at least the following: (1) the authorizing section of the Revenue and Taxation Code, (2) a brief description, (3) the sunset date, if any, and (4) the estimated annual revenue loss.
- ***Historical Information.*** The 1983–84 Governor's Budget, for the first time, includes as part of the tax expenditure report, a chronology of tax expenditures enacted and repealed since 1977 (see Tables 2 and 3, pp. A-114 and A-115). The department should continue to provide this type of information, in order to facilitate an ongoing evaluation of changes to the tax expenditure budget.
- ***Proposals.*** For the budget year, the department has proposed changes to two tax expenditures: the solar energy and energy conservation credits. The department should, in future years, evaluate tax expenditure programs in the light of current priorities, fiscal realities and the accomplishments of these programs, and recommend the repeal or modification of those programs that the administration believes have a low priority for funding. These recommendations should be included in companion legislation to the Budget Bill.

Accordingly, we recommend that the Legislature adopt the following supplemental report language:

"The Department of Finance shall, in its annual report to the Legislature on tax expenditures, provide the following: (1) a comprehensive list of tax expenditures, (2) additional detail on individual categories of tax expenditures, (3) historical information on the enactment and repeal of tax expenditures, and (4) any proposals to repeal or modify existing tax expenditure programs that the department determines are warranted."

B. ALLOCATION OF TIDELANDS OIL AND GAS REVENUES

Should Tidelands Oil and Gas Revenues Be Earmarked for Specific Categories of Projects or Deposited in the General Fund?

History of Tidelands Revenues and Their Allocations

The state has received revenues from its tidelands oil and gas properties since 1929. Most of these revenues are secured from offshore areas along Santa Barbara and Ventura Counties, and adjacent to the Cities of Long Beach and Huntington Beach.

Prior to 1960, these revenues were allocated to the Investment Fund, the General Fund and to the Beach and Park funds. As the magnitude of these revenues increased, funds were allocated for other purposes such as financing a portion of the State Water Project. The bulk of these revenues, however, went for higher education capital outlay projects, primarily at the University of California and the California State University.

In the late 1960's, state tidelands revenues averaged about $47 million annually. During most of the 1970's, these revenues were over $100 million per year. Since 1979–80, they have averaged over $400 million per year.

Description of the Current Allocation Formulas

Chapter 981, Statutes of 1968, initiated the present system of allocating these revenues. This system was substantially revised, however, by Chapter 899, Statutes of 1980. These laws established a *priority sequence* for the distribution of the revenues. Under this arrangement, target amounts are established for four program areas, and six special funds. Those at the top of the priority list receive their full allocation before any revenues are allocated to the next lower priority. Put another way, a shortfall in revenues is not apportioned among all programs, but instead is borne by the funds at the bottom of the list.

Table 55 shows (1) the statutory target amounts to be allocated among the various tidelands oil claimants for 1983–84, (2) the allocations that would occur under existing law, based on the anticipated funding level, and (3) the changes in allocations proposed by the Governor's Budget. This comparison shows:

1. The state would have to receive $543 million in tidelands oil revenues in order to fund the "target amounts" for all claimants.
2. Because estimated revenues are more than $200 million *below* the "target" figure, the State School Building Lease Purchase Fund would, under existing law, receive only part of its target allocation, and no allocations would be made to the lower priority funds such as the Energy and Resources Fund (ERF), the State Parks and Recreation Fund (SPRF), the Transportation Planning and Development (TP&D) Account, and the Special Account for Capital Outlay (SAFCO).
3. The Governor's Budget proposes to change the allocation of these funds by (a) reallocating funds among the ten claimants, eliminating the allocation for some, reducing it for others, and increasing it for some of those who otherwise would receive nothing in 1983–84, and (b) diverting $192 million (57 percent of total tidelands revenues) to the General Fund to help balance the 1983–84 budget.

During deliberations on the last two Budget Acts, the Legislature reallocated tidelands oil revenues in a manner similar to what the Governor's Budget proposes. For example, the 1982 Budget Act reallocated $175 million to the General Fund to help balance the 1982–83 Budget, and reduced the targeted allocations for the Capital Outlay Fund for Public Higher Education (COFPHE) and the State School Building Lease-Purchase Fund, redirecting part of the money to the ERF and SAFCO.

Table 55
Allocation of Tidelands Revenues in 1983–84
(in thousands)

Priority Sequence	Existing Law: Target Amount	Existing Law: Reduced Funding Allocations	Governor's Budget
1. State Lands Commission	$7,500	$7,500	$7,498
2. California Water Fund	25,000	25,000	—
3. Central Valley Water Project Construction Fund	5,000	5,000	—
4. Sea Grant Program	500	500	400
5. Capital Outlay Fund for Public Higher Education (COFPHE)	125,000	125,000	56,715
6. State School Building Lease-Purchase Fund	200,000	172,000	—
7. Energy and Resources Fund (ERF)	120,000	—	30,098
8. State Parks and Recreation Fund (SPRF)	35,000	—	10,081
9. Transportation Planning and Development (TP&D) Account	25,000	—	—
10. Special Account for Capital Outlay (SAFCO)	Remainder	—	38,208
11. (General Fund)	None	None	192,000
Totals	$543,000	$335,000	$335,000

Analysis of Existing Allocation Formulas

When Chapter 899 was adopted, tidelands oil revenues were expected to total more than $500 million annually. As Table 55 illustrates, the "target allocations" depended on revenues being at or above this level. Actual revenues, however, have consistently fallen below expectations, due to a drop in oil prices. In fact, the gap between anticipated and actual revenues is widening. Thus, in 1980–81, tidelands revenues were $475 million, in the next two years they dropped to about $460 million, and the estimate for 1983–84 is only $335 million, or 60 percent of the target allocation.

These revenue shortfalls, plus changes in legislative priorities, have made the existing statutory allocations obsolete. Each year since Chapter 899 was adopted, the Legislature has made substantial changes in these allocations, often under circumstances where it must "take back" funds that have already been "given" for one specific purpose or another. As a result, the original purpose of Chapter 899—namely, that a fixed amount of revenue would be dedicated in advance for specific purposes—has never been achieved, and rather than make the Legislature's job in allocating these funds easier, Chapter 899 has actually made it more difficult.

Considering the volatility of this revenue source, it is doubtful whether the original goal can be achieved in the next several years. (For a discussion of future tidelands leasing operations see Item 3560 of the *Analysis,* the State Lands Commission.)

Tidelands Oil Revenues Should be Deposited Directly in the General Fund.

So as to maximize Legislative flexibility, we recommend that legislation be enacted requiring all tidelands oil revenues to be deposited in the General Fund for allocation based on legislative priorities as determined through the budget process, starting on July 1, 1983.

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 by the state for any public purpose. Depositing tidelands oil revenues into special purpose funds tends to limit the Legislature's options in allocating available state resources among state-supported programs and activities, and greatly increases the complexity of managing the money, thereby weakening legislative control of the budget. Earmarking these revenues for capital outlay projects gives such projects a higher priority because, having a dedicated revenue source, they do not have to compete for funding with other state programs.

Under existing law, the Chapter 899 allocation formulas sunset on July 1. Based on the Legislature's recent experience with this distribution mechanism, and the impact it has had on legislative decision-making, we believe it would be appropriate at this time to change these formulas. Accordingly, we recommend that legislation be enacted requiring all tidelands oil revenues to be deposited in the General Fund, starting on July 1, 1983.

C. VIABILITY OF USING ONE-TIME REVENUES

To What Extent Should "One-Time" Revenues Be Used to Balance the State's Budget?

As discussed in Part II of this document, a significant amount of General Fund expenditures in the prior, current, and budget years have been (or are proposed to be) financed with "one-time" revenues or "one-time" expenditure savings. These "one-time" funds primarily come from three sources: (1) tax collection accelerations, (2) tidelands oil and gas revenues which have been deposited into the General Fund instead of various special funds that, under existing law, are supposed to receive them and (3) transfers of monies from the Motor Vehicle License Fee Account to the General Fund which would otherwise go to local governments. To what extent is it viable to continue to rely on these types of "one-time" monies to pay for General Fund expenditures?

Tax Accelerations

There is a limit on the extent to which tax payment dates can be moved forward and prepayment requirements raised. Thus, a clear limit exists as to the amount of "one-time" revenue gains which are possible from this source. During the last two years, the Legislature has adopted many of the more feasible accelerations. As a result, there is limited potential for additional accelerations in the future.

Special Fund Revenues

In the case of special fund revenues, however, there clearly is an opportunity to use "one-time" monies on a *repeat* basis. Such monies are available each year, and the Legislature has the option of deciding whether or not these monies should go into the General Fund. This is true, for example, with respect to both Motor Vehicle License Fee Account funds and tidelands oil and gas revenues. In a sense, then, these monies are not strictly "one-time" in the same way that, for example, tax accelerations are "one-time".

The extent to which special funds should be used on a repeat basis to support the General Fund is a legislative policy issue. Deciding what to do with these monies involves weighing the benefits from using them for General Fund activities against the costs of not using them to support activities ordinarily financed by these special funds. This decision, however, should also take into account whether there are other, perhaps more feasible, ways of supporting the programs which in the past have relied on special fund monies. For example, higher education capital outlay projects could be financed through from the proceeds of bond sales, in recognition of their long life, rather than from tidelands oil and gas revenues.

In the preceding issue discussion, we recommended that one source of "one-time" monies—tidelands oil and gas revenues—be made "on-going" by the enactment of legislation requiring these funds to be deposited automatically into the General Fund, where they can be used for whatever programs the Legislature believes have the highest priority claim on the state's general purpose resources.

In the case of the Vehicle License Fee Account monies, however, each dollar transferred to the state reduces the income to localities by the same amount. Thus, in deciding whether to tap these monies repeatedly, the Legislature must also consider the impact of funding reductions on local government programs, especially given the property tax limitations imposed by Proposition 13.

Policy Considerations

As a general policy, the Legislature should fund *ongoing* expenditures from the *ongoing* revenue base. Reliance on one-time income from such sources as tax accelerations is *not* a viable means of funding *ongoing* expenditures. Only when it is *evident*—not merely hoped—that the state's fiscal condition will be better in the following year should the Legislature consider using one time resources to support on-going programs. Under these circumstances, use of one-time resources can minimize program disruptions that result from stop-and-go funding.

Otherwise, the Legislature should limit the use of one-time funding to one-time, or non-recurring purposes, such as building-up the size of the Reserve for Economic Uncertainties.

II. EXPENDITURE ISSUES

A. COST-OF-LIVING ADJUSTMENTS (COLAs)

What Policy Should the Legislature Adopt with Respect to the Provision of Cost-of-Living or Inflation Adjustments?

Each year, the Governor's Budget typically includes funds for various cost-of-living adjustments, commonly referred to as COLAs. These adjustments generally have a common objective: to compensate for the effects of inflation on the purchasing power of the previous year's funding level.

Discretionary and Statutory COLAs

Existing law authorizes *automatic* COLAs for 18 different programs, most of them in the health, education and welfare areas. These adjustments generally are referred to as statutory COLAs. Many other local assistance programs generally have received COLAs on a *discretionary* (or non-statutory) basis, through the budget process.

In 1983–84, statutory COLAs will range from 3.6 percent (county health services) to 10.9 percent (Department of Rehabilitation programs). Those statutory COLAs with the largest costs are for K–12 apportionments ($560 million), SSI/SSP grants ($230 million), and AFDC grants ($99 million). If fully funded, statutory COLAs would increase General Fund expenditures by $1.1 billion in 1983–84.

Governor's Budget Proposal

The budget proposes a total of $925.7 million from the General Fund for COLAs in 1983–84, including $580.8 million for statutory COLAs and $344.9 million for discretionary COLAs. The components of this proposal are highlighted in the table on page A-38 of the Governor's Budget. The amount requested for statutory COLAs is $553.7 million, or 49 percent, less than what would be needed to provide full increases for all programs with statutory COLAs.

The budget proposes that *none* of the programs with statutory COLAs receive the full COLA required by existing law. Instead, the Governor has sponsored provisions of SB 124 and AB 223 which would suspend the operation of statutory COLAs in 1983–84. In lieu of the statutory COLAs, the budget proposes a 3 percent increase for most (but not all) programs which normally receive a statutory or discretionary adjustment to offset the effects of inflation on what the prior year's funding level can buy.

Two programs would receive COLAs which are higher than 3 percent: K–12 apportionments (6 percent plus an additional variable increase for low wealth districts), and state employee compensation (5 percent). The SSI/SSP program would receive a 2.1 percent increase. The budget proposes no cost-of-living increase for a number of programs with statutory COLAs: Medi-Cal hospital inpatients, AFDC, teachers' retirement benefits, personal property tax relief, the Gifted and Talented Education program, and the Educational Instructional Materials program. (The administration proposes to include the latter two programs in the state education block grant.) In addition, the administration proposes no COLAs for several programs which had received discretionary COLAs prior to 1982–83. These include a number of health, substance abuse, and education programs which the budget proposes to incorporate in three new state block grants to local agencies.

As a result of technical budgeting errors, the budget proposes more than a 3 percent increase for the community care licensing program, the social services "other" program and the Student Aid Commission, and less than 3 percent for regional centers for the developmentally disabled. We discuss these budgeting errors under the appropriate budget items, in the *Analysis.*

Baseline Budget Reductions May Offset COLA Increases

A COLA does not necessarily result in a net increase in the amount of funds appropriated to a particular program. In many cases, the administration proposes to first reduce a program's budget base and then add a COLA to the lower base. Obviously, any baseline budget reduction will offset, in whole or in part, the increase intended as a COLA. For example, the budget proposes to reduce the budget base for county health services by $25 million and provide funds for a 3 percent COLA ($11 million). This results in a net reduction in program expenditures of $14 million below the estimated current-year level. We discuss each of these situations under the appropriate budget items in the *Analysis.*

Purpose of COLAs

Most discussions of COLAs typically focus only on those programs which are summarized in the COLA table on page A-38 of the Governor's Budget. Generally, these COLAs are 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 that is intended 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 California State University Educational Opportunity Program.

COLAs for State Operations

Any COLA discussion also should take account of COLA-type adjustments that are provided for the state operations portion of the budget. Budget items which are classified as state operations can receive an adjustment to compensate for inflation using one of two methods. The first involves applying an across-the-board percentage increase to funding for operating expenses. This year a 5 percent adjustment was allowed by the Department of Finance. The second is to provide specific percentage increases identified in the Department of General Services' Price Book for particular items of expense, and a fixed percentage increase for all other items that are not specifically identified (4 percent in 1983–84).

Need for a Consistent Policy in Awarding COLAs

The practice of awarding COLAs to different programs has developed in a piecemeal, haphazard manner. The result is that there is no consistent policy—either in the executive branch or the legislative branch—for deciding which programs get how much or for what purposes. Below we summarize some of the major inconsistencies in the ways in which COLAs currently are determined:

1. ***There is No Rationale for the Wide Variations in Statutory Colas.*** Statutory COLAs in 1983–84 range from a low of 3.6 percent to a high of 10.9 percent. This is due to differences in the base years and indices used in calculating the adjustment. For example, some statutory COLAs are tied to a particular inflation index, such as the U.S. or California Consumer Price Index. 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 work activity services administered by the Department of Rehabilitation, or legislatively established revenue limits for K–12 apportionments.

In past issues of the *Analysis,* we have noted that we could find no analytic justification for the wide variations in statutory adjustments. As a result, we have recommended that the Legislature use the Gross National Product personal consumption deflator and state and local government deflator as the bases for judging how inflation affects private citizens and state and local governments, respectively. In addition, we concluded 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.

2. ***Variations in COLAs Often Reflect Budget Accounting Concepts, Rather than Policy Considerations Categories.*** The Governor's Budget for 1983–84 proposes that many of the programs categorized in the budget as local assistance get a 3 percent COLA, while programs categorized as state operations are recommended for a 5 percent (or higher) increase. Yet there seems to be no analytic justification for awarding different increases to these two groups of state-funded programs. In most cases, the funding adjustment is awarded for the same purpose—that is, maintaining purchasing power at current levels. In addition, many spending items classified as local assistance are similar to state administrative activities, and some spending items classified as state operations actually are used to fund local programs. The result is that budgeting procedures, rather than policy considerations, determine which programs get larger COLAs. Some examples of the haphazard treatment given by the budget to similar programs follow:

a. The proposed budget for the *Department of Rehabilitation* provides a 5.7 percent discretionary COLA for grants to certain community rehabilitation facilities which are budgeted as state operations. Yet, the budget provides a 3 percent COLA to those community rehabilitation programs budgeted as local assistance.

b. The budget proposes no COLA for *emergency medical services* grants to local agencies which are budgeted as state operations. Elsewhere, the budget proposes a discretionary 3 percent COLA for selected other public health programs which are categorized as local assistance. Those public health programs incorporated in the new state block grant, however, would receive no COLA.

c. The budget proposes a 3 percent COLA for *regional centers* for the developmentally disabled, which is categorized as a local assistance item. Regional center staff are used, in part, to review regional center client utilization of services. Staff in the Department of Health Services perform a similar utilization review function for *Medi-Cal* clients, yet the budget proposes that department staff receive a 5 percent COLA for employee compensation, and a price letter adjustment (minimum of 5 percent) for operating expenses, because these costs are classified as state operations.

d. The Department of Health Services' budget proposes that *county health services* funded under the provisions of AB 8 and categorized as local assistance receive a 3 percent COLA. Yet, the funding proposed for health services which the state provides directly, under contract with small counties, includes a 5 percent increase for employee compensation and a price letter adjustment (minimum of 5 percent) for operating expenses, because it is categorized as state operations.

e. The proposed budgets for the *University of California* and the *California State University system,* which are categorized as state operations, contain 5 percent pay increases for their employees and price letter adjustments (minimum of 5 percent) for operating expenses. The proposed budget for the *California Community Colleges,* on the other hand, is categorized as local assistance, and includes no funds for a COLA on the apportionments portion of its budget and a 3 percent COLA for handicapped student and equal opportunity program activities.

f. The budget for the *State Department of Education* proposes a 5 percent increase for employee compensation and price letter adjustments (minimum of 5 percent) for operating expenses. Funding for K–12 educational programs, which are budgeted as local assistance, will provide for a 6 percent COLA on district apportionments, an additional variable increase for low wealth districts, a 3 percent COLA for selected program components, and no COLA for other components. Districts, in turn, will pool these funds before deciding how much cost-of-living adjustment to provide for their own staff and operating expenses.

g. Both the *Work Incentive (WIN) program* and the *Employment Preparation Program (EPP)* fund county social workers to provide supportive social services to applicants and recipients of AFDC. The social worker component of the WIN program is included in the Department of Social Services' local assistance budget item. The EPP is included in the Employment Development Department's state operations budget item. If EPP were categorized as local assistance, rather than as state operations, it would receive a 3 percent COLA rather than the 5 percent COLA proposed in the budget.

3. ***The Budget Proposes COLAs for Other Government Entities, but Doesn't Always Expect Them in Return.*** In one case, the budget proposes a COLA to protect the purchasing power of other governmental agencies from whom the state purchases services. The budget, however, does not provide comparable protection for the state when it acts as a seller, rather than as a buyer, of services. For example, the California Department of Forestry's budget proposes a 1 percent COLA for payments to the U.S. Forest Service and six counties which provide fire protection for state responsibility areas. Yet the budget does not propose that the state receive a similar COLA for the cost of fire protection services *it* provides the U.S. Bureau of Land Management (BLM) on BLM land in California.

Conclusion

In order to ensure that the amounts of COLAs provided to individual programs are determined in a rational, consistent manner, we recommend that the Legislature establish a formal policy governing cost-of-living or inflation adjustments. This policy should require that the size of any COLAs awarded be based on the extent to which a COLA is needed to protect and maintain the purchasing power of a program or activity, after giving due recognition to the options available to the recipient for improving productivity or reducing costs. The Legislature will want to adjust this basic policy from time to time to reflect changing legislative priorities and program needs. *Any variations in the level of COLAs awarded to different programs, however, should reflect specific legislative objectives, rather than historical spending differences or how the program is categorized in the budget.*

B. STATEWIDE LEGAL STAFF REDUCTIONS

Should the Legislature Reduce Legal Staffing in the Line Departments so that the Provision of Legal Services Can Be Centralized?

The Governor's Budget proposes to reduce the attorney staffing for 39 state departments, boards and commissions by approximately one-third. The reductions are designed to minimize the proliferation of individual departmental legal staffs which may duplicate centralized state legal services provided by the Attorney General's Department of Justice.

Generally, the budget suggests that the departments affected by the reduction should adjust workload to the reduced staffing level by performing only high priority legal work. Further, the budget indicates that, prior to reestablishing any of the deleted legal positions, the departments must justify the positions on a cost-benefit basis and provide reasons why centralized legal services should not be used instead of in-house staff.

In our review of the budget, we identified proposals to delete over 170 attorney positions and 82 related clerical staff. The budgets of the affected departments were reduced by approximately $11.7 million, including $4.4 million from the General Fund, $5.4 million from special funds, $1.2 million in federal funds and $0.7 million from other sources. Table 56 summarizes the proposed reductions in legal staff.

Table 56
Statewide Legal Staff Reductions

Agency	*Number of Departments Affected*	*1982–83 Authorized Attorney Positions*[a]	*1983–84 Proposed Reductions*		*Dollar Amount (in thousands)*	*Percent of Attorney Staff Deleted*
			Attorneys	*Clerical Staff*		
Business, Transportation and Housing	10	239.1	77	38	$5,808	32%
Health and Welfare	8	104.5	40	19	2,385	38
Resources	8	80.5	27	13.5	1,795	34
State and Consumer Services	5	39.6	13.6	6	848	34
Youth and Adult Corrections	3	7.0	3	—	167	43
Other affected departments	5	77.5	10.1	5.5	647	13
Totals	39	548.2	170.7	82	$11,650	31%

[a] Reflects authorized level only for affected departments.

Generally, we are unable to determine the impact of these reductions on state programs because the budget does not identify specific workload or activities that will be discontinued in 1983–84. In fact, most departments have not yet determined how they will absorb the staff reductions, or decided which legal services they will eliminate.

It is quite possible that some of the proposed reductions would have little or no adverse impact on state programs, because departments could eliminate non-essential services which currently are performed by in-house legal staff or requested from the Attorney General. Further, such reductions could result in cost efficiencies, to the extent that a larger percentage of the state's legal work is performed by the centralized legal staff at the Attorney General's office.

We are concerned, however, that some of the staff reductions could affect various departments in a way that might result in increased state costs. In the *Analysis,* we have identified a number of departments that could be affected adversely if they were unable to adjust to the cutbacks by eliminating low-priority legal work. Among these are the following:

- The Department of Veterans Affairs has a backlog in home loan foreclosure cases. Delays in resolving the cases could result in major revenue losses to the Cal-Vet Farm and Home Building Fund.
- The Department of Health Services legal staff (a) conducts administrative hearings on Medi-Cal provider audit appeals, disputes and suspensions, (b) represents the department in audit appeal hearings involving millions of dollars annually, and (c) provides general advice and consultation on recent Medi-Cal reform legislation, state and federal laws and regulations, and various preventive health programs. A reduction in some of these activities could result in additional Medi-Cal program costs.
- The State Lands Commission legal staff is involved in (a) the negotiation of tidelands oil leases and contracts which produce revenue for the state, and (b) litigation protecting the state's economic interests in disputes arising from the commission's revenue producing activities. A reduction in these activities may have an adverse impact on future state revenues.
- The State Teachers' Retirement System and the Public Employees' Retirement System are authorized by the Attorney General to provide their own legal representation in administrative and court proceedings involving retirement benefits. The loss of legal staff could cause the systems to forego or lose legal challenges, and result in additional retirement program costs in future years.
- The Department of Corporations Enforcement Division legal staff (a) conducts proceedings to suspend, revoke or deny licenses of securities brokers, dealers and investment advisers, (b) initiates civil litigation in cases of suspected investment fraud, (c) prosecutes complex cases of investment and financial crimes, in conjunction with district attorneys and (d) directs the investigative activities of the division's investigators and examiners. The loss of legal staff could reduce the department's ability to take action against licensees engaged in improper financial transactions, and initiate civil or criminal proceedings against suspected violators of state statutes under the department's jurisdiction.

Our analysis indicates that the amount of legal services available to the 39 affected state departments in 1983–84 will be significantly less than current-year levels, because the proposed staff reductions have not been offset by corresponding increases in staffing for the Department of Justice.

In order to assess the adequacy of the departments' budgets, it is important that the Legislature have an adequate description of the workload that will no longer be performed by in-house legal staff as a result of the cutbacks proposed in the budget. Only then will it be possible to identify the adverse fiscal effects or decreases in program activities that would result from the reductions in legal staff. Accordingly, we recommend in the *Analysis* that many of the affected departments report to the Legislature, prior to budget hearings, on the impact of the reductions on their operations.

C. FEDERAL AID TO STATE AND LOCAL GOVERNMENT

What Effect Are Recent Federal Funding and Program Changes Having on the Allocation of Funds Within the Budget?

Grants-in-aid to state and local governments consist of funds provided by the federal government in support of a state or local program of service to the public. This assistance is composed primarily of two components: (1) payments to individuals and (2) discretionary grants.

This section discusses the actual and potential impact of changes in the amount of federal funds available to California as well as the way in which these funds are provided. Specifically, it examines trends in national funding levels as well as amounts received in California, the effect of the 1981 Omnibus Budget Reconciliation Act on the state, the nine federal block grants established in 1981 and the state's response.

1. Federal Funding Changes

Importance of Federal Grants in Financing State Expenditures. Federal fund expenditures in California account for almost one-third of the governmental expenditures in the 1983–84 state budget. For each $10 proposed to be spent by the state in the budget year from governmental sources, $3.00 would be provided by the federal government. Thus, program and funding changes made by the federal government have a significant effect on the funding levels and program activities reflected in the state's budget. Moreover, as has been the case during the last two years, reduced federal funding for programs supported in whole or in part by the federal government puts presssure on the state to maintain programs at current operating levels.

Recent Trends in Federal Grants-in-Aid. Beginning in 1972, with the enactment of federal revenue sharing, the grant-in-aid portion of the federal budget grew steadily, reaching a high of $105.8 billion in 1981. Since then, this portion of the federal budget has been declining.

Chart 25 compares national grants-in-aid funding totals with the amounts received in California from 1977–78 to 1983–84. The chart shows that through 1980 grants to the state grew pretty much in line with total federal grants-in-aid. As a result, California's share of total grants-in-aid remained relatively constant at about 8 percent.

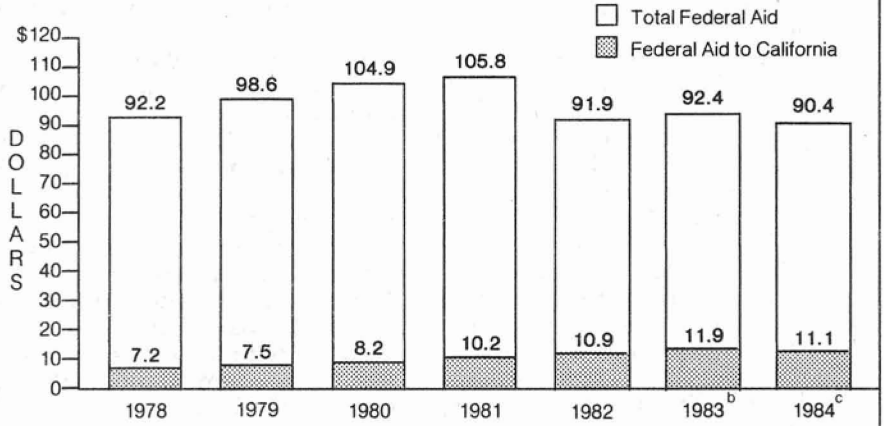
In 1981, the amount of federal funds received by the state increased by $2 billion, causing the state's share to increase sharply, reaching approximately 10 percent of the national total. In the following year—1982—federal grants-in-aid declined by 13 percent, but the amount received by the state continued to grow. As a result, the state's share of the total reached 12 percent in 1982, and increased to 13 in 1983. The President's Budget for 1984 shows a modest decline in federal grants, while the Governor's Budget anticipates an even sharper decline in state receipts from Washington. In part, this decline reflects the lag between when "budget authority" is provided and when grants are actually disbursed. California's receipts, like the national totals, remained relatively constant.

Changes in the Composition of Federal Expenditures

A closer look at the composition of the federal budget places the recent reductions in aid to state and local governments in better perspective.

Chart 25

Federal Aid to State and Local Governments National/California Comparison 1977–78 to 1983–84[a] (in billions)



Source: Office of Management and Budget's Special Analysis H/Governor's Budgets

[a] Federal data based on budget authority in federal fiscal years. State data shown in state fiscal years.
[b] Estimated
[c] Proposed

Categorizing Federal Expenditures. The federal budget can be divided into the following four categories:

- ***National Defense***—includes military and civilian salaries, operation and maintenance of military installations and the costs of procuring military hardware.
- ***Non-Means Tested Social Programs***—includes programs that provide benefits to individuals regardless of their income, such as social security, medicare and unemployment compensation.
- ***Interest on the Public Debt***—includes interest on the debt and tax refunds, adjusted for interest received by federal trust funds.
- ***Means-Tested Programs, Grants to State and Local Governments, All Other***—includes such income-based programs as Medicaid, Food Stamps, Aid to Families with Dependent Children, Supplemental Security Income, discretionary grants to state and local governments, and foreign aid.

Despite sizable cuts in the federal budget beginning in federal fiscal year 1982, total federal expenditures are expected to increase in the future. According to a 1982 report of the Congressional Budget Office analyzing the President's 1983 budget, if existing policies continued through 1985, federal outlays in 1985 will be $910 billion, or $232 billion above the 1981 level.

Expenditure Momentum in the Federal Budget. What explains the continued growth in federal spending, despite sizable cuts in the federal budget? The answer is the powerful momentum that has been built into the way in which the federal government spends the taxpayer's money. The source of this momentum is three-fold:

- First, the Congress has enacted a series of laws that create *entitlements* to benefits under certain federal programs, year-in and year-out. Under these laws, anyone who meets the qualifications for benefits gets those benfits, regardless of what is happening elsewhere in the federal budget. Medicare is a good example of an entitlement program.
- Second, the Congress has provided for *automatic cost-of-living adjustments* to benefit levels under a number of programs that automatically push expenditures up each year. In many cases, the way in which these adjustments are calculated causes benefits to rise faster than living costs. Social security is the prime example of a program with this type of adjustment mechanism.
- Third, the federal government utilizes a *budgetary accounting system* that gives an upward bias to spending. Because the federal budget is geared to cash disbursements, rather than spending commitments, it is possible under many programs, in effect, to buy now and pay later. The Department of Housing and Urban Development's subsidized housing programs provide a good example of how the federal system of accounting promotes expenditure momentum. Despite the fact that the President's 1983 budget called for a 78 percent *cut* in the volume of new commitments under these programs between 1981 and 1983, the budget projected a 28 percent *increase* in outlays during this two-year period. The increase in outlays reflects the cost of commitments made during the Carter (and perhaps even the Ford) administration.

Changes in the Mix of Federal Expenditures. As a result of these factors and certain policy proposals made by the President, major changes in the *composition* of the federal budget are taking place. In essence, the federal government is spending more on guns, more on certain types of butter, and a lot less on everything else. Specifically, the Congressional Budget Office's analysis of President Reagan's proposed 1983 budget showed that, between 1981 and 1985:

- The share of the federal budget going for *national defense* will increase from one-fourth to one-third.
- The share going for *non-means-tested social programs* —will increase from 38 percent to 39 percent.
- The share going for *interest on the public debt*—will increase from 10 percent to 12 percent; and
- The share going for *everything else*—largely the means-tested social programs, grants to state and local governments, and federal "overhead"—will drop from 28 percent to 16 percent.

These changes are displayed in Chart 26.

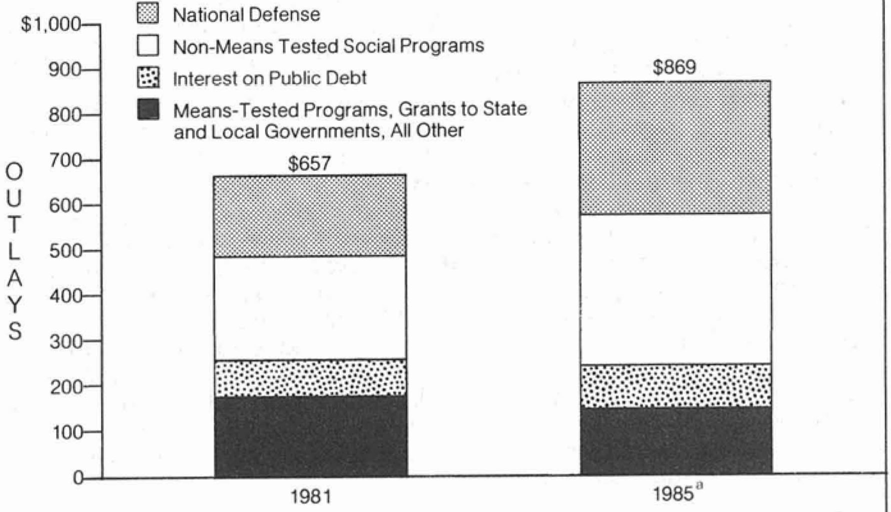
Status of Federal 1983 Appropriations

During recent years, the task of preparing a state budget that contains reliable estimates of the federal funds which California will receive in the budget year has become increasingly difficult for several reasons. First, the state budget must be enacted by July 1, when the state fiscal year begins. The federal fiscal year, however, does not begin until October 1, and the Congress usually is in the early stages of its budget deliberations at the time when the Legislature must conclude action on the state's budget.

Chart 26

Composition of Federal Outlays

1981 and 1985 (in billions)



Source: Congressional Budget Office (1982)

[a] As proposed by President Reagan in his 1983 budget

Second, the Congress must complete action on 13 separate appropriations bills before the federal budget is in place, rather than a single appropriation bill as in California.

In recent years, Congress has not come close to completing its work prior to October 1, and instead has come to rely on a series of continuing resolutions to authorize the expenditure of federal funds. These continuing resolutions are operative for whatever period of time within the fiscal year that the Congress designates. When there is a series of continuing resolutions for any one year, spending levels authorized for individual programs may change from resolution to resolution.

For federal fiscal year (FFY) 1983, the year which began October 1, 1982, the Congress enacted two continuing resolutions. The first, Public Law 97-276, was effective from October 1 through December 17, 1982 and was in lieu of 10 of the 13 appropriations bills. The second resolution, Public Law 97-377, provides funding through the end of the federal year. As of January 15, 1983, the following seven appropriation bills had been enacted: Agriculture; District of Columbia; Housing and Urban Development/Independent Agencies; Interior; Legislative Branch; Military Construction; and Transportation. Those that had not been enacted were: Labor, Health and Human Services, Education; Commerce, Justice, State and Judiciary; Defense; Energy and Water Development; Foreign Operations; and Treasury, Postal Service and General Government.

Nevertheless, the second resolution puts the state in a position where, unlike past years when a series of four or more resolutions were required, it should now be able to estimate the amount of federal funds it will receive through the first quarter of 1983–84. It may be as long as a year from now, however, before the state has any firm indication of how much it can expect to receive from the federal government during the last three quarters of 1983–84. By that time, of course, the Legislature will be considering the state's 1984–85 budget.

In 1982, congressional work on the federal budget focused on two major pieces of legislation in addition to the appropriations bills: The Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) and the Omnibus Budget Reconciliation Act of 1982 (Public Law 97-253).

P.L. 97-248 is expected to raise federal revenues by $98.3 billion over the next three years, and reduce spending—primarily under Medicare—by $17.5 billion over the same period. It is estimated that P.L. 97-253 will result in additional spending reductions of $13.2 billion over the 1983–85 period. These reductions, totaling $30.7 billion, are $111.8 billion, or 78 perent, *less* than the three-year expenditure reductions enacted by Congress in 1981. The Department of Finance estimates that the 1982 changes will result in a federal funds loss to California of $350 million. Approximately 78 percent of this amount represents a loss of support to individuals receiving Medicare, rather than a reduction of funds for programs financed in the state budget.

2. Federal Program Changes

Impact on California. During the 1970s, the fastest growing form of grants-in-aid to state and local governments was direct aid from the federal government to cities, counties and other *local* government entities. The Congress, in 1981, initiated a new era for federal/state relationships by establishing nine block grant programs that provide federal funding directly to states. These block grants encompassed a number of categorical programs which had not previously fallen within the state's purview. The Community Development Block Grant is a case in point. States are now authorized to design their own programs for assisting local development and redevelopment efforts, thus superseding a direct federal-local relationship that dates back to 1949 and the establishment of the urban renewal program.

Table 57 details the current federal block grant programs, the dates on which California assumed responsibility for them, and the funding levels for each in the current and budget years. Of the nine grants established by Congress in 1981, the Legislature assumed responsibility for two in 1981–82, and six in 1982–83. The Legislature declined to accept the ninth block grant—primary care—primarily because of state General Fund matching requirements.

Congress established one new block grant in 1982—the mass transit block grant, which will become effective in 1983–84. Congress eliminated the prior four-tiered capital and operating assistance transit program and replaced it with a formula-based block grant funded from general revenues. The formula provides for the following apportionments of funds: (1) approximately 88 percent to urban areas with populations exceeding 200,000, (2) approximately 9 percent to urban areas with populations up to 200,000, and (3) approximately 3 percent to nonurbanized areas.

Table 57
Federal Block Grants in California
1981–82 to 1983–84

Block Grant Program	*State Administering Agency*	*Starting Date in California*	*Funding Levels (in millions)*	
			1982–83	*1983–84*
1. Social Services	Department of Social Services	7-1-81	$253.4	$260.7
2. Low-Income Home Energy Assistance	Office of Economic Opportunity [a]	7-1-81	80.2 [b]	80.2
3. Alcohol, Drug Abuse and Mental Health	Departments of Mental Health and Alcohol and Drug Programs	7-1-82	40.3	46.7
4. Community Services	Office of Economic Opportunity	10-1-82	29.1 [c]	29.1
5. Maternal and Child Health	Department of Health Services	7-1-82	19.6	20.6
6. Preventive Health Services	Department of Health Services and Emergency Medical Services Authority	7-1-82	8.3 [d]	6.4
7. Primary Care	Department of Health Services	Not Accepted	—	—
8. Community Development	Department of Housing and Community Development	10-1-82	24.7	25.6
9. Education	Department of Education	7-1-82	41.3	41.5
10. Mass Transit	Department of Transportation	10-1-83	—	370.5 [e]

[a] Proposed by the Governor to be transferred to the Department of Social Services on October 1, 1983.
[b] Represents state's grant award for federal fiscal year 1983. Estimated expenditures will total $95.7 million in the current year due to prior year carryover.
[c] Of this amount, the federal government spent $15.1 million prior to January 1983 and OEO administered $14 million for the period January through June 1983.
[d] Includes two years of emergency medical services funding.
[e] Represents California's share of authorized funding in federal fiscal year 1984. Of this amount, the Governor's Budget only includes funds for state administration ($224,000).

Most of the transit block grant funds will flow directly from the federal government to regional transportation planning agencies. Funds for nonurbanized areas as well as urban areas with populations up to 200,000 will be administered by the state. The state anticipates receiving $224,000 in the budget year to cover the cost of administering this block grant, as shown in Table 57. A more detailed discussion of the transit block grant appears in our review of the Department of Transportation's budget, Item 2660 of the *Analysis.*

Proposed Block Grant Changes in 1983–84. The Governor's Budget proposes one significant change in the administration of federal block grant funds in the budget year. It proposes to transfer responsibility for state administration of the Low-Income Home Energy Assistance Program from the State Office of Economic Opportunity (OEO) to the Department of Social Services (DSS), effective October 1, 1983. OEO has administered the block grant since it was assumed by the state in 1981–82. DSS, however, administered the block grant's predecessor (the Low-Income Energy Assistance Program) in 1980–81.

Consistent with legislative policy direction in previous years, the administration proposes to transfer $8,022,000 from the energy block grant to the social services block grant administered by DSS. A more detailed discussion of the proposed transfer is included under Items 5180-136-866 and 0660-101-890 in the *Analysis.*

Impact of Federal Changes Enacted in 1981 on California

In President Reagan's first budget proposal, he sought spending reductions totaling approximately $270 billion over the four-year period 1981–84. Congress, in enacting the 1981 Omnibus Budget Reconciliation Act (Public Law 97-35), approved spending reductions totaling $143 billion over this same period, or slightly over one-half of the total reductions proposed by the President. What has been the effect of these reductions on California?

Several factors make this question very difficult to answer, and must be kept in mind when reviewing the level of program activity in California which is supported by federal funds.

Federal Funds Received in Prior Years Cushioned Reductions. A number of departments have been able to carry-over unspent federal funds received in prior years (so-called "carry-over funds") to cushion the initial effect of reduced federal funding. In 1981–82, for example, the first year in which the impact of significant federal funding cutbacks could be expected to appear, the Department of Rehabilitation spent $3.4 million in carry-over funds that originally became available in prior years. These carry-over funds helped to lessen the impact of program funding reductions totaling $14 million. Moreover, the department carried over $6.6 million from 1981–82 to 1982–83, which will lessen the effect of federal reductions in the current year. While the use of carry-over funds may cushion the effect of funding reductions on a short-term basis, support of ongoing activities in this manner merely postpones program adjustments. It does not prevent these effects unless federal funding levels for subsequent years are increased. In cushioning the effect, however, use of carry-over funds makes it difficult for the Legislature to assess the ongoing impact of federal funding reductions on particular state programs.

Forward Funding Delays Program Impacts. A number of federal programs, including those in the areas of housing, emergency medical services, and substance abuse, provide support for activities that will be undertaken *beyond* the year in which the funds are provided. In other words, 1983 activities are supported by funds appropriated in 1982. This is referred to as "forward funding". The forward funding method differs substantially from normal state budgeting practices, which support current-year activities with funds appropriated for the current year. Thus, in the case of programs supported by forward funding, changes made by the federal government which became effective in 1982 may not be felt by the state until 1983. The delayed effect of forward funding also makes it difficult to advise the Legislature regarding actual program changes resulting from reduced federal funding levels.

Funds That Previously Were Received Directly by Local Governments Now Flow Through the State Budget. As discussed earlier, the establishment of the federal block grants in 1981 reversed a long-standing federal policy of awarding federal funds directly to local governments. As a result, more federal funds now flow through the state budget.

While updated estimates are not available for each program, our analysis indicates that Public Law 97-35 redirected to the state more than $140 million that previously went directly to local governments. This change makes it difficult for the Legislature to determine, on a program basis, the extent to which the "new" funds offset federal reductions made elsewhere. Moreover, in terms of the total impact of federal changes on the state as a whole, this additional flow of funds through the state budget to local governments makes it difficult to account for total funding changes experienced by state and local government in California.

Fiscal Effect of Federal 1981 Reconciliation Act. Conventional wisdom holds that enactment of the federal budget reductions in 1981 resulted in program funding reductions averaging 25 percent. In order to evaluate the conventional wisdom with respect to California, we compared federal funding levels received by the state prior to the act, with funding levels received afterwards for the programs primarily affected by the federal changes. (All programs could not be compared over an identical time period because of implementation delays and/or data limitations.)

Our analysis of actual funding received before and after the act indicates that, on balance, California programs experienced less than a 25 percent reduction. In some cases, such as AFDC, a percentage change was impossible to calculate because other factors, such as additional caseload due in part to economic downturns, resulted in total program increases rather than decreases. Our specific findings with regard to federal reductions in 12 state programs totaling approximately $280 million are as follows:

- ***Community Development.*** Funding for the state-administered Small Cities Community Development Block Grant Program has remained essentially level from 1980–81 through 1982–83, at roughly $25 million.
- ***Education.*** California's share of funds for programs consolidated in the education block grant decreased from $57.2 million in 1981–82 to $41.3 million in 1982–83 (the first year of the block grant)—a drop of $15.9 million, or 28 percent.
- ***Social Services.*** Funds for the social services block grant, supported by appropriations under Title XX of the Social Security Act were reduced from $303.8 million in 1980–81 to $265.4 million in 1981–82—a drop of $38.4 million, or 13 percent. The Legislature offset a portion of these reductions by transferring various funds to the social services program. The largest component of the transfer was federal support received under the low-income home energy assistance block grant.
- ***Community Services.*** California programs consolidated in the community services block grant were reduced from $35.4 million in FFY 81 to $29.1 million in FFY 82—a drop of $6.3 million, or 18 percent.
- ***Energy Assistance.*** California's award of low-income home energy assistance block grant funds decreased slightly as a result of the 1981 Reconciliation Act, declining from $80.9 million in FFY 81 to $80.2 million in FFY 82—a difference of $700,000, or 0.9 percent. This reduction was significantly offset, however, by a supplemental congressional appropriation for energy crisis intervention assistance, from which California received $5.7 million.
- ***Preventive Health.*** California's share of the preventive health services block grant declined from $7.2 million in FFY 81 to $5.6 million in FFY 82—a drop of $1.6 million, or 22 percent. The program effect

of this reduction in the current state fiscal year, however, was minimized to a certain extent by carry-over funds and monies available for programs forward funded by the federal government, such as emergency medical services.

- ***Maternal and Child Health.*** Federal awards for programs consolidated in the maternal and child health block grant declined from \$21.0 million in FFY 81 to \$18.1 million in FFY 82—a reduction of \$2.9 million, or 14 percent. This decrease also was offset in the current year by federal carry-over funds.
- ***Alcohol and Drug.*** Alcohol and drug program funds decreased from a total funding level of \$35 million in FFY 81 to \$27.5 million in FFY 82—a reduction of \$7.5 million, or 21 percent over the period.
- ***AFDC.*** The first full-year effects of the 1981 Reconciliation Act on California's Aid to Families With Dependent Children (AFDC) program represent a 1982–83 savings of approximately \$204 million to all funding sources. Of this amount, savings of \$108 million, \$82 million and \$14 million will accrue to the federal, state and county governments, respectively.

  These savings are the result of increased grants in approximately 34,991 cases, and reduced grants in approximately 78,530 cases. Most of the savings, however, is due to the limitation placed on eligibility for grants. The Department of Social Services estimates that there are approximately 32,000 fewer cases per month in 1982–83 than there otherwise would have been without the 1981 federal changes.
- ***Employment Services.*** Federally funded employment services programs in California, a component of grants-in-aid to state and local governments, were reduced approximately \$53 million, or 23 percent between 1980–81 and 1981–82.
- ***Medi-Cal.*** Changes in federal sharing ratios in the Medi-Cal program are estimated to have resulted in state General Fund costs of \$44.8 million in 1981–82. As discussed in Item 4260 of the *Analysis,* we estimate that the state will be able to recoup these funds due to a provision in federal law which allows state recoupment under specified circumstances.
- ***Health Planning.*** The 1981 Reconciliation Act significantly reduced state health planning funds. Due to the structure of this program, these changes are being felt in the state for the first time during 1982–83, and represented a reduction of about \$890,000 or 34 percent compared to 1981–82. Increases in fee assessments due to increased health facilities operating costs, however, have maintained these programs at 1981–82 dollar levels.

In summary, our analysis of California's experience in selected program areas following enactment of the 1981 federal Omnibus Budget Reconciliation Act shows considerable variation in the size of program funding reductions. With few exceptions, however, the reductions have been less than 25 percent of pre-1981 Reconciliation Act *awards.* From the standpoint of purchasing power, however, the reductions have been more than 25 percent. Due to the existence of carry-over funds and allowable transfers under the federal block grants, however, the full effect of the federal changes has yet to be felt in many program areas.

Education Task Force

The education task force, established by the Legislature pursuant to federal requirements of the 1981 Omnibus Budget Reconciliation Act, is charged with advising the Superintendent of Public Instruction, the State Board of Education, the Legislature, and the Governor on the allocation of federal education block grant funds under Chapter 2 of the federal Education Consolidation and Improvement Act of 1981. The 32-member task force issued its recommendations in the spring of 1982. The Legislature followed the thrust of the task force's recommendations concerning the 1982–83 allocation of federal education block grant funds by appropriating 16 percent of total funds for state operations and the remaining 84 percent for local assistance. This action is consistent with federal requirements that (1) no more than 20 percent of the funds be retained for state operations, (2) at least 80 percent of the funds be allocated to local school districts, and (3) the state not direct how local districts may spend the local assistance funds.

State Block Grant Advisory Task Force

In response to the federal block grants created by the 1981 Omnibus Budget Reconciliation Act, the Legislature also established the 18-member state block grant advisory task force (hereafter referred to as the task force) to advise the Governor and the Legislature on the allocation, administration and use of block grant funds. The task force is authorized until July 1, 1984, and has jurisdiction over the following eight block grants: (1) social services, (2) low-income home energy assistance, (3) alcohol, drug abuse and mental health, (4) community services, (5) maternal and child health, (6) preventive health services, (7) primary care and (8) community development.

The task force issued its first report to the Legislature and the Governor on April 12, 1982. Its recommendations included the following:

- The primary care block grant should not be assumed by the state in federal fiscal year 1983.
- State and local administrative costs should be capped in the state-administered federal block grants.
- No funds should be transferred between or within block grants, except as authorized by existing state law.
- For the first year only (1982–83), existing projects should be funded on a pro rata basis, with specified exceptions such as rape crisis funds in the preventive health services block grant and the small cities portion of the community development block grant.

1982 Legislation. Chapter 1343, Statutes of 1982 (AB 3295), made various changes related to the federal block grants. The act (1) revised the state block grant advisory task force's duties, (2) appropriated $135,000 in federal funds during 1982–83 for task force activities and staff, and (3) established reporting and audit requirements applicable to each of the eight block grants operating in the state in 1982–83. Specifically, the act directed the state to assume five new block grants in 1982–83. The state had assumed the social services and low-income home energy assistance block grants in 1981–82. The following three new grants became operational on July 1, 1982: preventive health and health services; maternal and child health; and alcohol, drug abuse and mental health services. The community services and community development block grants became effective on October 1, 1982.

The task force is required by Chapter 1343 to issue two additional reports on February 1, 1983 and February 1, 1984, respectively. These reports shall discuss various issues including the following:

(1) Integration of block grant programs with existing state and local programs.
(2) Funding allocation methods.
(3) An analysis of which level of government can perform administrative functions most effectively in relation to the needs of the population served.
(4) Effective methods of monitoring state and local compliance with legislative intent.
(5) Options for transferring funds between and within block grants.

Administrative Support. Chapter 1343 appropriated $135,000 from a newly-created Federal Block Grant Fund. Pursuant to the act, the following state agencies each made available $27,000 in federal block grant administrative dollars to the fund during 1982–83: the Departments of Social Services, Health Services, Mental Health, Alcohol and Drug Programs and the Office of Economic Opportunity. No funds have been included in the 1983–84 Budget Bill for this purpose.

In order to prepare the required reports, the task force signed a $110,000 contract with a private consulting firm for 1983, following a competitive bid process. Pursuant to the contract, the consulting firm will prepare the following three reports:

1. A comprehensive review of the administration of federal block grant funds by the state for 1983–84. This is the 1983 report required by Ch 1343 and will include recommendations for legislative policy deliberations. (Due: April 1, 1983)
2. An analysis of the impact of block grants on California, including the task force's recommendations related to how implementation of the grants should be monitored. (Due: June 1, 1983)
3. A review of the impact of federal block grants in 1984 and future years, including recommendations on the state's response to these programs (Due: December 1, 1983)

Based on conversations with the Controller's office and the contractor, it is our understanding that staff support will be available to the task force through the first half of 1983–84. This will allow for completion of the task force's final report, as required by Ch 1343.

The balance of the $135,000 appropriation ($25,000) will be used for travel, per diem, and related expenses of the task force. Our analysis indicates that sufficient funds were appropriated by Ch 1343 to meet the task force's anticipated expenses in the current and budget years, because actual expenditures for this purpose totaled $2,000 in 1981–82.

Legislature's Information Needs on Federal Block Grants Unmet

We recommend that the Department of Finance ensure that state agencies administering federal block grants comply with the Legislature's information needs, as specified in Ch 1343/82 and the 1982 Budget Act, by April 15.

We further recommend that the State Controller report to the Legislature regarding the status of financial and compliance audits required by

the federal block grants by April 15.

Information Requirements. Ch 1343/82 recognized that the Legislature did not have adequate data on many of the programs consolidated in the federal block grants. As a result, the act requires:

- Establishment of fiscal reporting requirements by the Department of Finance.
- Development of standard definitions of units of service, costs per unit of service, citizen participation processes and due process notification procedures for each block grant.
- Annual reports by each administering department on current year funding and allocations, problems, and program options for block grant administration.
- Annual reports by the Health and Welfare Agency on options and recommendations for integrating the block grants.

In addition, the 1982 Budget Act requires that the Departments of Alcohol and Drug Programs, Health Services, and Mental Health make specific additional reports to the Legislature by specified dates in the current year. The departments are each required to (1) project state and local administrative costs for 1982–83, (2) propose definitions and limitations on all 1983–84 administrative expenses, and (3) report specified data related to clients, programs, and funding.

Timely Response Needed. Our analysis indicates that as of February 1, 1983, state agencies which administer the block grants, as well as the Department of Finance, were still in the process of addressing the Legislature's information needs.

In some cases, such as the community development block grant, current-year allocation decisions have yet to be made, and thus a report to the Legislature at this time would be meaningless. The Department of Housing and Community Development advises that final 1982–83 allocations are not expected for this block grant until April/May 1983. Thus, it is difficult for some of the administering agencies to provide the requested information at this time.

Furthermore, the Health and Welfare Agency's response to the requirements of existing law does not appear to be in conformance with legislative intent. Specifically, the agency's first report, submitted to the Legislature on January 25, 1983, is largely descriptive in nature and does not identify specific options and recommendations for integrating the block grants under its jurisdiction, as specified in Ch 1343/82.

In order to ensure that the Legislature's information needs are met, and to assist the Legislature in establishing its priorities for 1983–84, we recommend that the Department of Finance make certain that the seven state agencies administering the federal block grants provide the information prescribed in Chapter 1343 and the 1982 Budget Act to the Legislature by April 15, 1983.

Audit Requirements. Ch 1343/82 also established the state's policy with regard to audits of the federal block grants. State agencies are required by the act to rely on federally mandated audits arranged by local agencies. With regard to the state's role, the act requires the Controller to:

1) Review audit plans prepared by state agencies.
2) Provide local agencies federal financial and compliance audit guidelines.

3) Monitor and review audit findings to determine that both state and local entities have taken appropriate corrective action.
4) Report annually to the Legislature and the Governor on the status of federally mandated audits.

In addition, the act requires:

1) State agencies to develop audit plans based on audit plan guidelines.
2) The Governor's Budget to identify all planned disbursements for audit purposes to local agencies, as well as state audit costs for each block grant. The act authorizes up to 1 percent of the funds for each federal block grant for audit purposes.

Our analysis indicates that due to the effective date of the act (January 1, 1983), the Controller is still in the process of developing audit guidelines for local agencies. Moreover, the Governor's Budget does not separately identify any 1983–84 state or local costs related to audits.

Some progress, however, has been made. On December 23, 1982, the Department of Finance, the State Controller, and the Auditor General jointly issued "Guidelines for the Preparation of Audit Plans" to the seven state agencies administering the block grants (see Table 57 for an agency listing). State agencies in turn were required to submit their plans to the State Controller by February 1, 1983 for the current fiscal year. As of February 8, however, no plans had been received. In future years, such plans are required annually by August 1.

In order to ensure that audit plans and procedures for the eight block grants assumed by the state are proceeding in the manner intended by the Legislature, we recommend that by April 15, 1983 the Controller report to the Legislature regarding the status of financial and compliance audits required by the federal block grants. (For a related discussion on proposed positions in the State Controller's Office to administer this program, see Item 0840 of the *Analysis.*)

D. PROPOSED STATE BLOCK GRANTS

Should the Legislature Consolidate 21 Existing Categorical Programs Into Three Block Grants?

The Governor's Block Grant Proposals

In his budget, the Governor proposes to consolidate 21 existing programs into three state block grants. These proposed consolidations are shown in Table 58. Funds consolidated in two of the proposed block grants (alcohol/drug and public health) would flow from the state to counties, while education block grant support would be provided directly to local school districts.

The budget maintains that establishment of the three block grants would permit a reduction of $12.5 million in state operations from the current-year funding level (as shown in Table 59), and a $15.1 million decrease compared to what normally would have been budgeted for 1983–84 (as shown in Table 60). The anticipated savings result primarily from the proposed reduction of nearly 500 personnel-years, consisting of 101 personnel-years in the Department of Alcohol and Drug Programs, 321 personnel-years in the Department of Health Services and 71 personnel-years in the Department of Education.

While the state operations component of the budget for these programs would be cut sharply in 1983–84, the amount of local assistance funds would remain at about the 1982–83 level. This is shown in Table 59. However, the budget does not include state funds for a cost-of-living adjustment to the local assistance amounts included in the block grants.

Table 58
Proposed State Block Grants
1983–84

Proposal	*Administering Department*	*Consolidated Programs*
Alcohol and Drug Block Grant	Department of Alcohol and Drug Programs	• Alcohol Programs • Drug Programs
Public Health Block Grant	Department of Health Services	• Adult Health • Dental Health • Vector Biology and Control • Family Planning • California Children's Services • Child Health and Disability Prevention • Genetically Handicapped • Rural Health • Maternal and Child Health
State Education Block Grant	Department of Education	• Economic Impact Aid • School Improvement Program • Instructional Materials • Gifted and Talented Education • Miller/Unruh Reading Program • Staff Development • Demonstration Programs in Reading and Mathematics • Educational Technology • Native American Indian Education Program • Vocational Education (state administration)

Table 59
Proposed State Block Grant Funding Levels
All Funds
1982–83 and 1983–84
(in thousands)

	Estimated 1982–83	*Proposed 1983–84*	*Change*	
			Amount	*Percent*
Local Assistance				
Alcohol and Drug [a]	$91,147	$93,021	$1,874	2.1%
Public Health	123,688	123,128	−560 [b]	−0.5
Education	425,669	425,612	−57 [c]	[d]
Subtotals	$640,504	$641,761	$1,257	0.2%
State Operations				
Alcohol and Drug [a]	$9,290	$7,079	−$2,211	−23.8%
Public Health	16,641	9,813	−6,828	−41.0
Education	11,558	8,097	−3,461	−29.9
Subtotals	$37,489	$24,989	−$12,500	−33.3%
Totals	$677,963	$665,972	−$11,991	−1.8%

[a] Figures exclude reimbursements.
[b] Reflects deletion of $2.1 million in one-time funds partially offset by increases for California Children's Services.
[c] Reduction due to staff development funds carried over from 1981–82 to 1982–83.
[d] Less than 0.1 percent.

As noted earlier, the Governor's Budget indicates that 1983–84 state operations funding associated with these programs will be $15.1 million less than it otherwise would be *under existing law.* This is shown in Table 60. This amount assumes that in the absence of this program change state support for these programs would have received additional funding in the budget year for merit salary increases, higher retirement contributions and inflation adjustments. As a result, if the Legislature does not concur with the state block grant proposal *and* wishes to continue current staffing patterns in the budget year, it will have to augment the budget by $14.4 million from the General Fund.

Proposed Personnel Changes. Table 60 also shows the personnel-year reductions proposed in the budget, by department. The Governor proposes to eliminate 101 personnel years associated with the alcohol and drug programs, a reduction of 50 percent from currently authorized staffing levels. The public health block grant would result in the biggest staffing reduction—321 personnel years, or 87 percent of the Department of Health Service's authorized staffing level of 371 personnel-years for the categorical programs included in the block grant. The Department of Education would experience the smallest reduction, 71 personnel years out of a current-year total of 542 General Fund-supported personnel-years, a reduction of 13 percent.

Table 60
Governor's Proposed Savings
1983–84
(in thousands)

		State Operations		
Block	*Personnel years*	*General Fund*	*Federal Funds*	*Total*
Alcohol and Drug	101[a]	−$1,552	−$665	−$2,217
Public Health	321	−9,000	—	−9,000
Education	71	−3,859	—	−3,859
Totals	493	−$14,411	−$665	−$15,076

[a] The Governor's Budget inadvertently reflects a reduction of 108 positions. Funding savings, however, are based on a reduction of 106 positions, or 101 personnel years.

County Justice System Subvention Program Proposal

In addition to the three new block grants, the Governor has proposed a significant modification to the County Justice System Subvention Program (CJSSP) that currently operates in a manner similar to a block grant. CJSSP, established by Ch 461/78 (AB 90), makes funds available to counties on a per capita basis for expenditure on the local criminal justice system.

Historically, the state has allocated funds to counties (approximately $63 million in 1982–83) for expenditure in one or more of seven broad program categories, such as improving offender-centered services or operating crime and delinquency programs. In order to receive state funds, counties have had to maintain commitment rates to state correctional institutions below specified levels.

The Legislature modified the CJSSP program in the 1982 Budget Act by suspending the commitment rate targets, and instead requiring that counties spend their 1982–83 allocations in the same manner as in 1981–82.

In 1983–84, the Governor proposes that CJSSP become an unrestricted block grant for maintaining and improving local criminal justice systems. Specifically, the Governor proposes to repeal the program's enabling legislation and require that counties make applications for funding to the Secretary of the Youth and Adult Correctional Agency. Counties, in turn, could spend the money for activities that maintain and improve local criminal justice systems. Unlike the budget for the three newly proposed block grants, the administration proposes a 3 percent cost-of-living adjustment for the CJSSP.

Program Detail Not Yet Available

The administration's County Justice System Subvention Program proposal is contained in the budget companion bill (SB 124).

Detail on the statutory program and administrative changes for the three new block grants, however, is not yet available. According to the budget, program requirements and administrative responsibilities for each of the block grants will be specified in legislation to be introduced in the spring of 1983.

In two cases, the budget indicates that information on personnel reductions will be provided by the administering agencies to the Legislature, prior to legislative hearings on the budget. The 1983–84 Budget Bill indicates, however, that the plan for allocating state educational block grant funds will not be submitted to the Legislature until August 1, 1983, *one month after the new fiscal year begins.*

In the absence of this information on program requirements and administrative reponsibilities, we have no basis at this time on which to analyze the Governor's assertion that the proposed state grants would increase direct services at the local level without increasing cost to the taxpayers. In order to assist the Legislature in its deliberations, we have specified in the *Analysis* questions related to each of the block grants that should be addressed by the Departments of Alcohol and Drug Programs, Health Services, and Education prior to budget hearings.

Proposal Inconsistencies

Our review of the limited information available on the three block grant proposals, however, has turned up a number of inconsistencies. In order to assist the Legislature in its deliberations, we identify several of these inconsistencies below. Further discussion of these and other program issues is included in the *Analysis*, as part of our review of the budgets proposed for the three block grant administering departments.

Education Block Grant. The Governor proposes to consolidate nine local assistance programs and one state operations activity in the new block grant. The state operations component, state administration of vocational education, has a local assistance counterpart that is *not* included in the block grant, and that will continue to be allocated on the basis of federally-approved formulas. Furthermore, the proposed block grant does not include several categorical programs, such as Special

Education, that are similar to those programs which *have* been proposed for consolidation.

Alcohol and Drug Block Grant. Programs consolidated in the proposed state alcohol and drug block grant are part of the federal Alcohol, Drug Abuse and Mental Health block grant. The state block grant, however, would not include mental health programs. This would seem to ignore the fact that at the county level, alcohol and drug programs and mental health services frequently are administered by the same department.

Public Health Block Grant. Like the alcohol and drug block grant, the proposed state public health block grant would consolidate some programs that are already included in the federal Maternal and Child Health (MCH) block grant. Our analysis indicates, however, the following inconsistencies:

- The state block grant includes 98 percent of federal MCH block grant funds for local assistance, but excludes the remaining 2 percent, or $318,000.
- Five programs have not been included in the state block grant, even though closely related programs *have* been included. These programs include comprehensive public health services grants, health education, risk reduction and hypertension, urban rat control, and fluoridation.
- One of the components of the Adult Health program, which has been proposed for consolidation, is local assistance grants for medical research on the disease lupus erythematosus, a chronic disease which may affect the nervous system. Counties have never had a role in this activity, nor do they generally conduct or contract for medical research.
- The Governor proposes to delete 87 percent of the positions related to the consolidated categorical programs, but has reduced support funding from all sources, by 48 percent. Moreover, despite the fact that federal funds are used to support many of the consolidated programs, only General Fund monies have been deleted. Our analysis indicates that such a significant staffing reduction could not be accomplished without some federally funded positions being reduced.

Conclusion

At the time this review was prepared, there was not sufficient information on the three proposed block grants to permit legislative consideration of the proposals. Considerably more information—and perhaps a rationalization of the inconsistencies noted above—is needed before the Legislature can assess the merits of these proposals.

E. CAPITAL OUTLAY ISSUES

How Can the Legislature Assure that Limited Capital Outlay Funds Are Used to Meet the State's Most Urgent Capital Outlay Needs?

1. Status of Capital Outlay Funding for 1982–83

The 1982 Budget Act included $560.4 million from several funds for the state's capital outlay program in 1982–83. Table 61 shows the fund distribution for this program.

Table 61
1982 Budget Act—Capital Outlay Program
(in thousands)

Fund	*1982 Budget Act Amount*[a]
Capital Outlay Fund for Public Higher Education	$38,407
Energy and Resources Fund	20,268
State Park and Recreation Fund	14,273
Special Account for Capital Outlay	46,880
Subtotal (Tidelands Oil Revenue)	($119,828)
Transportation—Special Funds	$197,435
Other Special Funds	11,496
Park Bonds	81,365
Prison Bonds	149,276
Higher Education Bonds	1,000
Total	$560,400

[a] Does not include funds for support and operating expenses of administering departments.

Several problems have occurred during the current year which have affected the 1982 capital outlay program. The most important of these problems involve (1) the availability of resources (2) the allocation of funds by the State Public Works Board, (3) the deficit in the General Fund and (4) the State Treasurer's freeze on bond sales.

1. ***Resources Available At The Start of The Year Were Over-Estimated.*** Beginning in January 1982, the Department of Finance indicated to the State Public Works Board that the condition of those capital outlay funds supported by tidelands oil revenues was uncertain. During hearings on the 1982–83 Budget Bill, the Department of Finance testified that on June 30, 1982, the balance in each fund would be zero. On this basis, the Legislature deposited into each fund an amount equal to the total 1982 Budget Act appropriation from the respective fund.

These amounts, which for capital outlay totaled $119.8 million, are shown in Table 62.

Table 62
Tidelands Oil—Capital Outlay Funds
1982 Budget Act Appropriations Compared to
State Public Works Board Allocations
(in thousands)

	1982 Budget Act Amount	*Amount Allocated by Public Works Board*[a]	*Unallocated Appropriation*	
			Amount	*Percent*
Capital Outlay Fund for Public Higher Education	$38,407	$35,305	$3,102	8%
Energy and Resources Fund	20,268	7,516	12,752	63
State Park and Recreation Fund	14,273	12,478	1,795	13
Special Account for Capital Outlay	46,880	22,331	24,549	52
Totals	$119,828	$77,630	$42,198	35%

[a] As of December 1982

The State Controller, however, has indicated that the information which the Department of Finance provided to the Legislature during hearings on the 1982–83 Budget Bill was not correct. Instead, three of the four funds were *overcommitted* on June 30, 1982. Table 63 provides a comparison of the estimated balance as of June 30, 1982, as reported by the State Controller, and as reported by the administration in the 1981–82 column of the Governor's Budget for 1983–84.

Table 63

Selected Funds Receiving Tidelands Oil Revenue Comparison of State Controller's Balances and Governor's Estimated Balance as of June 30, 1982 [a] (in thousands)

Fund	*Controller's Balances*	*Governor's Estimate*	*Difference*
Capital Outlay Fund for Public Higher Education:			
1. Reserve for economic uncertainties	−$6,274	$523	$6,797
2. Reserve for unencumbered balances of continuing appropriations	4,405	1,452	−2,953
Energy and Resources Fund:			
1. Reserve for economic uncertainties	−8,998	−8,825	173
2. Reserve for unencumbered balances of continuing appropriations	5,483	2,315	−3,168
State Park and Recreation Fund:			
1. Reserve for economic uncertainties	12,602	−184	−12,786
2. Reserve for unencumbered balances of continuing appropriations	35,731	36,839	1,108
Special Account for Capital Outlay:			
1. Reserve for economic uncertainties	−40,260	12,612	52,872
2. Reserve for unencumbered balances of continuing appropriations	65,082	23,303	−41,779

[a] Sources: Controller's data as of 1/14/83. Governor's 1983–84 Budget.

Based on the Controller's data, it is evident that from the very beginning there has not been sufficient funds available to finance the 1982 capital outlay program approved by the Legislature.

The Governor's 1983–84 budget—prepared by the Department of Finance during November and December 1982—now reveals that in 1982–83, "unspecified savings" of $6.6 million from the Energy and Resources Fund and $10.5 million from the Special Account for Capital Outlay must be made in order to avoid a deficit in these funds on June 30, 1983. In addition, on January 18, 1983, the Governor issued an Executive Order freezing all capital outlay expenditures except under certain restricted conditions. The cumulative effect of all these factors on the state's 1982 capital program are unknown.

2. ***Allocation of Funds by the Public Works Board Has Not Reflected the Urgency of Individual Projects.*** In early 1982 and again in November 1982, we recommended that the State Public Works Board obtain a written fund status report from the Department of Finance, so that the board could (1) avoid over-committing any fund, and (2) ensure that available funds were used for those projects having the highest priority to the state. The department, however, chose not to provide written information on

the status of these funds.

As shown in Table 62, the 1982 Budget Act included \$119.8 million for capital outlay from funds which received tidelands oil revenue. At the time this was written, \$77.6 million (65 percent) had been allocated by the State Public Works Board.

In late 1982, the Department of Finance recognized that the balance available in each of these funds was uncertain. As a consequence, the department has deferred allocation of funds for most projects which had not been presented to the Public Works Board prior to November 1982. This deferral has affected security improvement projects for the Department of Corrections, and fire and life safety and environmental improvements for the state hospitals.

We discuss this issue further in our review of the State Public Works Board in Section V of this part where we recommend that the board receive funding status reports on a routine basis.

3. ***Projected Deficit in the General Fund May Affect Balances Available for Capital Outlay.*** Further compounding the uncertainty regarding the availability of funds for capital outlay in the current year is the condition of the state's General Fund. At the time this was written, the administration was projecting a deficit in the General Fund exceeding \$1.5 billion. One of the proposals that was being considered to remedy the problem was the transfer to the General Fund of \$37 million in unencumbered and uncommitted balances remaining from capital outlay appropriations made by the 1982 Budget Act and other acts. The proposal also included a requirement that the Director of Finance submit to the Joint Legislative Budget Committee a list of the projects from which funds would be transferred plus a list of projects which would proceed. If this proposal is approved by the Legislature, the information from the Department of Finance must be available prior to budget hearings, or the Legislature will have no basis for acting on the capital outlay portion of the Governor's Budget. This is because the impact of the freeze on capital expenditures coupled with the reversion of \$37 million in unencumbered funds will undoubtedly have an impact on the Legislature's priorities for 1983–84.

4. ***State Treasurer's Freeze on Bond Sales Contributes to Delays in New Prison Construction.*** The 1982 Budget Act appropriates \$149.3 million from the New Prison Construction Fund (bonds) for planning and construction of additional prison facilities. The Legislature appropriated this amount on the basis that (1) additional facilities were *urgently* needed and (2) the Department of Corrections' project schedule indicated that this amount of money could be encumbered in 1982–83.

The prior administration, however, chose to offer for sale in September 1982, only \$100 million of the \$495 million in bonds authorized by the electorate. Subsequently, the State Treasurer imposed a moratorium on issuing additional bonds for this program or any other bond program. As a result, implementation of the new prison program approved by the Legislature in 1982 will be delayed.

This delay compounds an already *critical* capacity problem in the state's correctional system. Currently, the state prison system has the capacity to house 25,600 inmates. In January 1983, there were 33,500 inmates in the system—131 percent of the system capacity—and the inmate population was increasing by about 100 inmates per week. Further, the Department of Corrections projects that the inmate population will be 71,000 by the year 1992—227 percent of the current capacity. If this inmate population is to be housed in appropriate facilities, the administration must start addressing the problem and implementing legislatively approved programs.

2. Funding For Capital Outlay

The state's capital improvement program is funded from various special funds and bond funds. Since the late 1960's, higher education capital outlay has been funded from the Capital Outlay Fund for Public Higher Education (COFPHE). State parks capital outlay generally has been funded from park revenues and bond funds. Prior to 1980–81, the capital programs for General Fund-supported departments, other than higher education and state parks, usually were funded from the General Fund.

Tidelands Oil Revenue. In 1980, unprecedented increases in the price of oil resulted in major increases in the state's tidelands oil revenues. In view of this increase, the Legislature enacted Chapter 899, Statutes of 1980, which provided for the redistribution of tidelands oil and gas revenues that, under prior law, would have been deposited in the COFPHE. Pursuant to this measure, six special funds are recognized as eligible to receive tidelands oil revenues.

Chapter 899 arranges these funds in descending order of priority and establishes a target funding level for each one. Under this arrangement, no fund receives *any* allocation of tidelands oil revenues until all funds assigned a higher priority receive their *full* target amounts. Put another way, a shortfall in revenues is not apportioned among all the programs, but instead is borne by the funds at the bottom of the list. The priority sequence and the target distributions for each are as follows:

Table 64
Distribution of Tidelands Oil Revenues
Comparison of Current Law with Actual and Proposed Distributions in 1982–83 and 1983–84
(in thousands)

Funds	*Chapter 899, Statutes of 1980*	*1982–83*	*Proposed 1983–84*
State Lands Commission	$7,498 [a]	$7,719	$7,498
California Water Fund	25,000	14,710	—
Central Valley Water Project Construction Fund	5,000	—	—
Sea Grant Program	500	400	400
Capital Outlay Fund for Public Higher Education	125,000	71,133 [b]	56,715 [b]
State School Building Lease/Purchase Fund	200,000	100,000	—
Energy and Resources Fund	120,000	64,081 [b]	30,098 [b]
State Park and Recreation Fund	35,000	12,417	10,081
Transportation, Planning and Development Account	25,000	—	—
Special Account for Capital Outlay	Remaining balance	54,725 [c]	38,208
Off-Highway Vehicle Account	—	1,000	—
General Fund	None	175,805	192,000 [d]

[a] This amount varies and is to meet State Lands Commission budget needs plus miscellaneous required payments to certain cities and counties.
[b] Total revenue deposit—does not bring fund balance to $125 million in COFPHE or $120 million EFR.
[c] $42 million of this amount is to be transferred to the General Fund to offset revenue losses due to energy tax credits (Ch 904/80).
[d] Includes the $42 million transfer required by Ch 904/80.

- $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 (SPRF)
- $25 million—Transportation, Planning and Development Account
- Remaining balance—Special Account for Capital Outlay (SAFCO)

In the case of the COFPHE and the ERF, any unused balances remaining in the fund from prior years are deducted from the target amount. In the case of the other funds, however, no deductions are made. Thus, for example, the SPRF may have available more than $35 million in any year, if balances are carried over from the previous year.

Funds Not Distributed According to Chapter 899/80. In recent years, the distribution of tidelands oil revenues has not been made in accordance with the provisions of Ch 899/80. Instead, the statutory distribution has been modified in response to changing priorities among these programs and the need to increase General Fund revenues so as to keep the budget in balance. Table 64 compares the distribution of tidelands oil funds under the provisions of Ch 899 with the actual distribution in 1982–83 and the proposed distribution in the Governor's 1983–84 Budget.

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. As a result, 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. While the Legislature has been able to overcome these limitations by overriding the provisions of Chapter 899 during the annual budget process, its task is made much more difficult by the fact that funds already "given" must be "taken back". The task becomes even more difficult once funds have been earmarked for specific projects.

To improve the Legislature's fiscal flexibility in responding to statewide programs and priorities (including capital outlay) supported by the General Fund, *we recommend that tidelands oil revenues be deposited directly into the General Fund.*

3. 1983–84 Demands on Capital Outlay Funding

As discussed earlier, the Governor's Budget includes a limited amount of funds for capital outlay. Moreover, there will continue to be limited amounts available from traditional capital outlay fund sources—tidelands oil revenues and bonds. There are however, several major capital improvement programs which, if funded in the budget year, will overburden these sources. In addition, there are continuing needs to repair and maintain the state's vast infrastructure. Examples of these major programs and repair/maintenance needs follow.

Higher Education—Capital Outlay. The 1983–84 budget includes $21.6 million for capital outlay expenditures in the three segments of higher education—the University of California, California State University, and the California Community Colleges. This amount provides for only a portion of the amount originally requested by the three segments. In fact, the segments submitted requests that, together, were more than seven times the amount budgeted for 1983–84 capital outlay—$160 million, compared with $21.6 million. The total three-year cost for the programs requested by the University of California and the California State University is $476 million. (The total three-year cost for the California Community College program was not available.)

Although our analysis indicates that some of the proposed projects are not essential and may not be warranted at all, the total amount requested provides an indication of the general magnitude of capital outlay needs, as seen by the respective system.

Some of the proposed prospects, if approved by the Legislature, will have implications for state expenditures in future years. For example, the University of California requests funding in 1983–84 to plan four projects that will cost nearly $140 million during the next three years. Moreover, the secondary effects of these projects (such as alterations of vacated space) could cost another $60 to $70 million after completion of the initial project.

Higher Education—Support Budget. The three segments of higher education have also identified ongoing problems in the areas of deferred maintenance and replacement of instructional equipment. The Legislature has recognized these problems, and since 1981, it has appropriated a total of $53 million from the COFPHE for deferred maintenance ($22.5 million) and instructional equipment ($30.5 million). The budget recognizes these support needs and requests $36 million from the COFPHE for these activities. This amount is divided evenly between maintenance and replacement of equipment.

This is the first year that the amount budgeted from the COFPHE for deferred maintenance/instructional equipment replacement ($36 million) exceeds the amount budgeted for capital outlay ($21.6 million). If this trend continues, funding for deferred maintenance and replacement of instructional equipment will continue to deplete the amount of funds available for statewide capital outlay programs.

Additional Prison Capacity. The Department of Corrections' *final draft* of its "1983 Facilities Master Plan" indicates that an additional $1,900 million (1983 costs) will be needed over the next eight years to provide additional prison capacity. This estimate is based on housing the anticipated 1992 male inmate population of approximately 71,000 in permanent beds (50,145), contract beds (1,910), and temporary compounds (7,200). This plan would leave a capacity deficit of 11,605 beds. To eliminate this deficit, an additional $900 million (1983 costs, based on average estimated cost per bed) would be required. Thus, the total costs to house the department's projected male inmate population in 1992, without double celling or overcrowding, would be $2,800 million beyond the amounts previously appropriated by the Legislature.

The 1982 Budget Act included $149.3 million from the New Prison Construction Fund (bonds) for additional prison capacity. A detailed discussion of the department's plan and the Governor's 1983–84 capital outlay program for additional prisons is included under Item 5240-301-723 in the *Analysis.*

Currently, there is a $345.7 million balance available for appropriation from the $495 million bond program approved by the electorate. This balance, however, will fund only 18 percent of the department's master plan and only 12 percent of the cost to house the department's projected population. Consequently, if the state's prison capacity is to be increased to meet the projected male inmate population, *an additional $1,500 million* *(with overcrowding) to $2,400 million (no overcrowding) will be needed over the next eight to ten years.*

Moreover, the department's master plan does not address either the ongoing capital improvement needs or the infrastructure renovation/repair needs of *existing* prisons. The state has not constructed a new prison since 1961, when the California Men's Colony at San Luis Obispo was completed. In addition, much of San Quentin State Prison is over 100 years old. The facilities in the state prison system are aging rapidly, and there will be a continuing requirement for capital improvements to meet both changing needs and renovations/repairs. The cost for these purposes has not been identified, but the department's "1980 Facilities Master Plan" included over $600 million (at 1980 costs) over a nine-year period for renovation of existing facilities. Although all of the work envisioned by the 1980 Plan probably is not necessary, the order of magnitude of anticipated costs is an indication of the problems that must be addressed over the next decade.

State Office Space. As of June 30, 1982, the state was leasing 8.1 million square feet of office space, at an annual cost of $61.3 million dollars. The largest share of this lease cost was in Sacramento County, where on June 30, 1982, the state was leasing 3.5 million square feet, at an annual cost of $25.3 million. In mid-1976, the lease space in Sacramento County totaled 2.1 million square feet, at a cost of $10.1 million per year. Thus, in six years, the state's leased cost has increased 150 percent, while the amount of space has increased 67 percent.

Our analysis indicates that the most cost-effective solution to the state's office space needs is to house ongoing functions of state government in state-owned buildings, rather than house these functions in privately owned space (assuming no difference in quality between a state-built facility and leased space). For the past several years, the Legislature has appropriated funds to construct state-owned space in Sacramento, as well as in other metropolitan areas. Nevertheless, the amount of and cost for space leased by the state continues to increase at a rapid rate. These costs reduce the amount of discretionary funds available to the Legislature for financing other statewide programs and needs. Consequently, the Legislature may wish to invest funds in constructing new state office buildings in order to—in the long term—increase the amount of state funds available for expenditure at the Legislature's discretion.

The capital outlay programs discussed above highlight some of the demands which will be placed on state funds. Other areas where major capital outlay programs have been identified include the Department of Forestry, the Veterans' Home in Yountville, the Department of Food and Agriculture, state hospitals, energy conservation, and others.

4. Priorities Need to be Established for the Statewide Capital Outlay Program

We recommend that each fiscal committee establish a subcommittee to consider all capital outlay programs so that (1) available funds can be used to support the Legislature's statewide capital outlay priorities, and (2) the Legislature can provide guidance to the administration for revising the capital outlay program in the event that cutbacks should be necessary during 1983–84.

The major capital improvement programs discussed above, coupled with the continuing needs to repair and maintain the state's vast infrastructure system that includes state office buildings, state hospitals, state prisons, and higher education facilities will overburden the current sources of capital outlay funding—tidelands oil revenues and bonds.

We believe the Legislature can ensure that such funds as are available are used in the most productive manner possible if it evaluates statewide capital outlay needs as a single program and establishes *statewide priorities,* instead of considering each proposed project on a department-by-department basis. Authorization of projects on a department-by-department basis may result in the funding of projects which the Legislature otherwise would consider to have a lower priority, in comparison with other statewide needs.

In contrast, if the Legislature were to consider *all* capital outlay requests as part of a single statewide program, it would result in (1) improved evaluation of individual projects, (2) more consistent application of legislatively established priorities to individual projects and (3) funds being committed to projects on the basis of statewide, rather than departmental needs.

Further, during the past two years it has been necessary to make mid-year adjustments to offset a General Fund deficit. Part of these adjustments has been the deferral or cancellation of capital outlay projects and the transfer of the associated funds to the General Fund. The Legislature has limited post-budget control and consequently, the decision, as to which projects are to proceed and which are to be deferred, has been left to the administration. The Legislature, however, can provide guidance to the administration by establishing the *Legislature's* statewide priorities for capital outlay. In this way, if mid-year adjustments are necessary, the administration will know the relative priority of projects in the Legislature's capital outlay program and will be able to identify those lower priority projects which, if necessary, could be deferred.

Given the limited resources available for all state programs, and capital outlay projects in particular, and the demands on these funds, a new approach to legislative consideration of capital outlay projects would appear to be warranted. Thus, in order to improve the Legislature's ability to review and control capital outlay programs, we recommend that each fiscal committee establish a subcommittee, to consider all capital outlay programs.

III. STATE BORROWING ISSUES

As discussed in some detail in Part II, the state borrows money for a variety of purposes. Some of this borrowing is short-term in nature, while other borrowing is long-term. Each type of borrowing raises policy issues of concern to the Legislature.

A. SHORT-TERM BORROWING

What Should Be the Legislature's Policy Regarding Short-term Borrowing?

With respect to short-term borrowing, we recommend that the Legislature:

(1) ***Designate the State Treasurer as the official statutorily responsible for managing all short-term General Fund external borrowing activities;***

(2) ***Limit the use of short-term external borrowing to borrowing within***

(as opposed to across) fiscal years, unless interyear borrowing is simply unavoidable;

(3) ***Establish a statutory ceiling on the amount of short-term external borrowing which can be undertaken without specific legislative authorization;***

(4) ***Authorize the issuance of secured, as well as unsecured, short-term debt for cash-management purposes; and***

(5) ***Authorize the Treasurer to borrow from external resources even if internal funds are available, whenever external borrowing is less costly.***

Background

It is not uncommon for the General Fund to borrow money on a *short-term* basis in the course of a fiscal year. This need arises because of differences between when revenues are actually received and when the state's bills must be paid. This type of borrowing, which can be necessary even when a year-end budget surplus is anticipated, is part of the cash management process and, when responsibly undertaken and monitored, it is a proper way of handling the state's short-run cash deficiencies. Of course, the use of short-term borrowing can be abused, such as when a government resorts to such borrowing in order to fund on-going operating costs without having any credible programs for repaying the debt. Such was the predicament which New York City put itself into some years ago.

Traditionally, California has been able to avoid issuing short-term debt instruments in order to satisy its short-term needs for cash. This is because the General Fund has several other sources of borrowable funds —namely, the Reserve for Economic Uncertainties, the state's various special funds, and the Pooled Money Investment Account (PMIA). It is only when these *internal* sources of borrowing are exhausted that the General Fund has had to engage in *external* short-term borrowing.

During 1982–83, exactly such a situation developed. Because the state's internal borrowing capacity was not adequate to meet its cash requirements, the Controller issued $400 million in unsecured "revenue anticipation warrants" to private sector investors. Both the Department of Finance and the Controller agree that additional external borrowing will be necessary in the current year. If there is no legislative action to balance the 1982–83 budget, external borrowing is expected to peak at over $900 million in May 1983. These borrowings will be accomplished by issuing secured or unsecured short-term notes, possibly in conjunction with "registered warrants" (that is, checks which cannot be cashed immediately) issued to those to whom the state owes payments, such as state employees and various program beneficiaries. The exact amount of external borrowing that will be needed prior to the end of the current year, and the exact form it will take, are not known at this time. It is clear, however, that a need to borrow significant amounts will confront the state prior to year-end.

Policy Issues

We believe that the Legislature may wish to consider and resolve a number of specific policy issues regarding short-term borrowing. These issues have not been resolved in the past primarily because the need for external borrowing has only developed recently. Five issues seem especially important:

1. ***Which state official should be responsible for managing short-term external borrowing?*** We recommend that the State Treasurer be designated as this official, given his office's experience in marketing debt. Currently, the State Controller is managing external short-term borrowing by the state.
2. ***Should short-term external borrowing for cash-management purposes be "rolled-over" between fiscal years?*** This issue involves the question of when short-term borrowing should be permitted to finance a year-end budget deficit, even if this financing is for only a "short period of time." We recommend that, in general, all short-term borrowing undertaken for cash management purposes be repaid by year-end, and that short-term borrowing across fiscal years *not* be allowed. Of course, there may be cases where borrowing to finance a deficit may be unavoidable, such as when a deficit is not anticipated early enough in the fiscal year to permit a realignment of revenues and expenditures, or when actions taken to eliminate a deficit are revealed to have been inadequate when the books on the fiscal year are closed. (This, in fact, is what happened in 1981–82.) In such cases, we recommend that the short-term borrowing be accompanied by a *specific plan* for repaying the debt, such as through a temporary increase in taxes.
3. ***Should there be a statutory ceiling on the amount of short-term external borrowing which can be undertaken without specific legislative authorization?*** Currently, the Controller is permitted to issue unsecured debt in whatever amounts are needed to pay the state's bills. We believe that the Legislature may wish to impose a ceiling on the amount of discretionary borrowing that may be undertaken. The ceiling should be set high enough to enable the official who manages short-term borrowing to have the flexibility necessary to handle *normal* cash-flow imbalances, but low enough to protect the state against excessive debt issuance in times when alternative approaches, such as revenue increases or expenditure decreases, are more appropriately pursued.

   Such a ceiling would improve legislative oversight over short-term borrowing activities. We therefore recommend that the Legislature enact such a ceiling in conjunction with any expansion of short-term borrowing authority.
4. ***What type of short-term debt should be issued for cash management purposes?*** Under current law, the Controller has standing authority to issue only *unsecured* debt in cases where external borrowing is necessary to address cash management problems. We recommend that the Legislature authorize the issuance of limited amounts of *secured* debt, such as tax anticipation and/or revenue anticipation notes, because secured debt might be more easily marketed, and might carry a lower interest cost to the taxpayers. Debt security could include anticipated revenues from one or more specified income sources.
5. ***Should the state be permitted to borrow externally before it has exhausted its internal borrowing capabilities?*** Current law does not require that General Fund borrowing from external sources occur only *after* all internal borrowing sources have been exhausted. In the past, however, the state's practice has been to use external borrowing as a last resort. Once the General Fund begins to borrow from the

PMIA, it must pay interest on the amount borrowed at a rate equal to the current PMIA yield. This yield can *exceed* the interest rate which must be paid on external short-term borrowing, largely because the PMIA holds many long-term, high-yielding financial assets. For example, in December 1982, the average yield on the pool was over 10 percent, whereas the revenue anticipation warrants marketed by the Controller in November carried an interest rate of approximately 5 percent. Thus, there are situations in which the state would be able to *reduce* borrowing costs by borrowing *externally instead of internally.* For this reason, we recommend that any legislation to expand the state's short-term borrowing capabilities explicitly provide that the Treasurer may borrow externally whenever he determines that it is a lower cost alternative to internal borrowing.

B. LONG-TERM BORROWING

What Should Be the Legislature's Policy Regarding Long-term Borrowing?

As discussed in Part II, the state undertakes borrowing through the issuance of long-term tax-exempt bonds. Unlike short-term borrowing, which is a tool for cash management, long-term bonds with maturities of up to 50 years are used to finance the acquisition of capital equipment and facilities, including highways, water systems, prisons, and office buildings.

In last year's *Analysis,* we indicated that there are a number of problems and policy issues regarding the use of tax-exempt bonds by governments to finance capital outlays. Given the importance of these issues, we prepared a report on the general subject of long-term borrowing. This report, entitled *The Use of Tax-Exempt Bonds in California: Policy Issues and Recommendations,* was transmitted to the Legislature earlier this session. The report provides an *overview* of tax-exempt borrowing, identifies *policy issues* regarding the use of tax-exempt bonds, and presents *recommendations* for improving state policy governing the use of tax-exempt financing.

Policy Issues Regarding Tax-Exempt Bonds

We believe that the major policy issues regarding tax-exempt bonds fall into five general categories:

- ***First, what programs*** should tax-exempt bonds be used to finance? Addressing this issue involves identifying (a) on what *basis* programs should be chosen as potential candidates for subsidies, (b) whether subsidies are actually *needed* for these programs to proceed, and (c) whether the tax exemption granted to interest on municipal bonds is the *best method* for providing these subsidies.
- ***Second, how much*** tax-exempt debt should be *issued* and how should it be *allocated* between different programs?
- ***Third,*** what *technical constraints* should the state impose on tax-exempt bond issues? Specific questions in this category involve (a) the bidding rules used to sell bonds, (b) the restrictions imposed on interest rates, price discounts, maturity structures, and call provisions, and (c) the method used to place bonds (competitive bids or negotiated sales).
- ***Fourth,*** what should be the *role of the state government in local*

borrowing activities? and

- ***Fifth,*** should California *continue to exempt* from state taxation the interest earned on state and local government bonds? This issue raises questions about (a) whether the state should subsidize capital outlay projects in the first place, (b) what the tax exemption actually does and does not accomplish, and (c) whether alternative approaches to subsidization might be preferable to exempting interest on government-issued bonds.

These policy issues all relate in one way or another to the ability of California's governments to market a sufficient quantity of long-term bonds to meet their capital outlay spending priorities, to minimize the costs to taxpayers of servicing this debt, and to structure debt issues in a manner which maximizes budgetary flexibility.

Recommendations Regarding Tax-Exempt Borrowing

We suggest that the Legislature consider the recommendations which appear in our December 1982 report entitled: "The Use of Tax Exempt Bonds in California: Policy Issues and Recommendations."

Our report, cited above, develops and presents 21 specific recommendations regarding tax-exempt borrowing in California. Because the subject of tax-exempt debt financing is an extremely broad and complex one, our recommendations by no means cover all of the issues involving tax-exempt borrowing which the Legislature might wish to consider. These recommendations, however, provide a starting point for addressing legislative policy issues related to tax-exempt financing.

The principal recommendations contained in our report are as follows:

- We recommend that the Legislature review existing state policies governing the *purposes* for which tax-exempt bonds may be issued, and develop a clearer picture of the state's overall capital outlay financing *needs* and the relative *priority* of each of these needs. This review could be accomplished through one or more oversight hearings conducted by the appropriate committees of the Legislature.
- We recommend that the Legislature amend existing law to (a) *remove open-ended bond authorizations* under the state's revenue bond programs, and (b) provide that unused bond authorizations *lapse automatically* after a specified period of time. Adoption of these recommendations would facilitate increased legislative control and oversight of the state's bond programs.
- We recommend that the Legislature adopt some form of state *debt ceiling.*
- We recommend that the Legislature place on the ballot for voter approval a constitutional amendment permitting localities to increase temporarily their *property tax rates* above the current 1 percent limit, for the express purpose of amortizing debt issued to finance voter-approved public facilities. The 1 percent limit on the property tax rate imposed by Proposition 13 (June 1978 ballot) has made new local general obligation bonds extinct, thereby creating many inequities with respect to how capital outlay projects in California are financed and raising the cost to the taxpayers of financing certain capital projects.
- We recommend that, if the Legislature decides to continue subsidizing governmental borrowing by exempting interest earned on state

and local government bonds from the income tax, it explore the advantages and disadvantages of extending this exemption to *businesses* subject to the California franchise tax. It may be in the state's best interest to extend the exemption to businesses because the market for its bonds would be broadened and its interest costs might be reduced. We also recommend that the tax exemption be extended to that portion of *capital gains* income on bonds which is anticipated when bonds are *purchased*, and therefore incorporated into bond prices. Such anticipated capital gains should be treated identically to normal interest income on bonds, which is exempt from taxation.

- We recommend that the Legislature require state authorities, whenever they sell a general obligation or revenue bond issue, to select the winning bidder using the true interest cost (TIC) criterion, *subject to* appropriate bidding constraints. Although the TIC criterion is now being used in awarding all state general obligation bond issues, apparently it is *not* minimizing interest costs to the state because of certain competitive imperfections in the underwriting industry. This problem, however, can be *lessened* by imposing certain *additional* constraints on the bidders. Therefore, state officials who sell bonds should design and utilize such constraints.
- We recommend that the Legislature (a) consider several options to revise those provisions of existing law that establish *interest rate ceilings* on certain types of bond programs, (b) allow *reasonable price discounts* when state bond issues are sold to underwriters (at present, price discounts are *not* permitted on most general obligation bond sales to underwriters), (c) amend existing law to require that, whenever possible, the maximum maturity on a bond issue approximate the *useful life* of the project or activity being financed, and (d) *standardize* the technical provisions applicable to state bond programs so that they are consistent with current legislative priorities. Currently, many of the differences in the technical provisions that apply to different state revenue bond programs appear to exist for no particular reason.
- We recommend that the Legislature reconsider the provisions of current law that require state general obligation bonds to be sold *competitively* in every instance as opposed to a *negotiated sale,* and that it amend state law to encourage underwriting of revenue bonds by commercial banks.
- Regarding the state's involvement in *local* government debt-related activities, we recommend that the Legislature (a) take various actions to improve the collection, tabulation, and dissemination of data regarding local government debt-related activities, and (b) explore ways in which the state can provide technical and administrative assistance on a *reimbursable* basis to local government borrowers, *when* they request such assistance. (We do *not,* however, believe that more direct forms of state involvement in local debt matters are warranted.)
- We recommend that the Legislature (as well as local governments) explore the potential economic benefits to be gained from *leasing* certain capital equipment and facilities instead of acquiring them through bond-financed construction or purchase.
- If the Legislature decides to continue subsidizing local borrowing, we recommend that it consider several options which are a more cost-

effective means of providing this subsidy. For example, a more *direct* form of subsidy would reduce the inefficiencies that are inherent in the tax exemption, and broaden the market for municipal debt. Such a change would require an amendment to the California Constitution.

- We recommend that the Legislature take action to eliminate the state tax exemption for interest earned on *state* bonds, because the revenues lost by the state as a result of attempting to "subsidize itself" through the tax exemption are larger than the savings the state achieves by borrowing in the tax-exempt market. Such a change also would require an amendment to the California Constitution.
- Lastly, we recommend that the Legislature establish a *formal mechanism for overseeing* on an ongoing basis all bond-related matters in a comprehensive and consistent fashion. One method of doing this would be for each fiscal committee to establish a subcommittee whose sole responsibility would be to review all bond-related matters coming before the full committee.

These and our other bond-related recommendations are discussed in more specific detail in our bond report.

IV. LOCAL GOVERNMENT FINANCE ISSUES

A. LOCAL FISCAL RELIEF ISSUES

To What Extent Should the Legislature Reduce the Amount of Fiscal Relief Provided to Cities, Counties, and Special Districts?

What is Fiscal Relief?

The term fiscal relief or "bailout" refers to the funds which the state has provided local government since the passage of Proposition 13 on account of the reductions in local property tax revenues brought about by that measure. With respect to city and county governments and special districts, this bailout corresponds to the increased share of ongoing property tax revenues given to these units of government by AB 8 (1979–80 session), less the ongoing revenue loss resulting from the repeal of three subventions by SB 102 in 1981–82. For county governments, fiscal relief also includes the amounts which would have been expended as the county share of health and welfare program costs under the formulas in effect prior to Proposition 13, plus the increase in state subventions for county health services.

AB 8 reduced, on an ongoing basis, the amount of property tax revenue received by school districts, and redirected these funds to cities, counties and special districts. School districts did not experience any loss of revenue, however, because under existing law the state "guarantees" a specific level of funds (the "revenue limit") for each school district. The additional local property tax revenues grow each year, in line with the growth of taxable assessed value.

A "reverse bailout" occurs when the amount of any funding reductions imposed on a local agency by the state exceeds the value of the fiscal relief it is receiving pursuant to AB 8. When this occurs, it is argued that local agencies actually are "bailing out" the state; hence, the derivation of the term "reverse bailout".

AB 8 Deflator

At the same time that the Legislature committed itself to a permanent program of fiscal relief, it also established a mechanism commonly known as the "AB 8 deflator." The deflator is intended to reduce the level of fiscal relief automatically in times when state revenues are inadequate to maintain the ongoing "baseline" level of state expenditures.

The deflator becomes activated when projected state revenues fall below an inflation-adjusted base level of state expenditures. As established in statute, when the deflator goes into effect, the State Controller is *required* to reduce motor vehicle in-lieu subventions, cigarette tax subventions, business inventory reimbursement subventions, and trailer coach subventions by an amount sufficient to make up one-half of the difference described above. The other one-half is taken from apportionments to K–12 schools and community colleges.

Deflator in Effect for 1983–84. Based upon the most recent revenue and expenditure forecasts by the Department of Finance, the AB 8 deflator mechanism will be "triggered" for the 1983–84 fiscal year. According to the Governor's Budget, this mechanism, which was suspended for both 1981–82 and 1982–83, would require reductions of $2,898 million in aid to local agencies and school districts. Half of this amount ($1,449 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 the four specific subventions.

Although the Governor's Budget identifies deflator reductions of $2,898 million, our analysis indicates that only $2,360 million in reductions could actually be made, because only $1,180 million in subventions to local agencies are available to be reduced. According to the statute, the reduction for school agencies cannot exceed the reduction for local agencies, even if funds are available. The $2,360 million is $538 million, or 23 percent, less than the amount identified in the budget.

Table 65 compares reductions in local government fiscal relief (excluding schools) that would occur under the Governor's proposal and those that would otherwise result from the AB 8 deflator.

Table 65
Changes in AB 8 Fiscal Relief:
Comparison of Governor's Proposal and AB 8 Deflator
1983–84
(in millions)

		Governor's Proposal		*AB 8 Deflator*	
	Fiscal Relief Current Law	*Reduction*	*Percent Change*	*Reduction*	*Percent Change*
Cities	$346	–$255	–73.7%	–$524	–151.5%
Counties	2,432	–47	–1.9	–605	–24.9
Special Districts	340	—	—	–51	–15.3
Total	$3,118	–$302	–9.7%	–$1,180	–37.8%

Governor's Proposal

The budget proposes to reduce local fiscal relief and other aid by $320 million. The budget contains no proposals which would increase the net fiscal resources available to local governments.

The $320 million in reductions reflect:

- A $300 million reduction in vehicle license fee subventions to cities and counties. Cities would lose $255 million, while counties would lose $45 million.
- An $18 million reduction in business inventory payments to cities, counties, and special districts. This would be achieved by eliminating the statutory COLA, estimated at 6.3 percent, for the budget year.
- A $2.2 million reduction in funding for County Health Services, due to a reduction in the statutory COLA from 3.6 percent to 3.0 percent.
- No identifiable fiscal impact from the Governor's proposals to replace specified categorical programs with block grant funding. (The proposal lacks sufficient detail for us to analyze its potential fiscal effect on either the state or local agencies.)

Table 66 illustrates the distribution of these reductions among the different types of local agencies (excluding schools).

The budget identifies a *potential* additional $100 million reduction in unspecified local subventions, to the extent that additional actions are necessary to balance the 1982–83 budget. The budget does not provide any details as to how this Phase 2 reduction, if approved, would be apportioned.

Table 66
Proposed Changes in Local Fiscal Relief and Other Local Aid
1983–84
(in millions)

Reductions	*Cities*	*Counties*	*Special Districts*	*Total*
Fiscal Relief:				
Vehicle License Fees	–$255	–$45	—	–$300
County Health Services	—	–2	—	–2
Subtotal, Local Fiscal Relief	–$255	–$47	—	–$302
Other Local Aid:				
Business Inventory	–$4	–$11	–$3	–$18
Total, Reductions	–$259	–$58	–$3	–$320

The budget proposes to apportion the reductions identified in Table 66 using the same formula which was used in the current year to reduce fiscal relief, with the following exceptions:

- No "special factors" funding is provided. In the current year, for example, the reductions computed for the Cities of Oakland and San Jose were mitigated by $3 million and $1.6 million, respectively, as a result of special factors.
- No funding is provided for the 31 "no property tax" cities. These are cities which existed but did not levy a property tax prior to Proposition 13. As a result of the repeal of three small subventions as part of the 1981–82 fiscal relief reductions, these cities lost some $2.2 million in subvention funds, although they had never received any fiscal relief from the state. In order to hold these cities harmless from this "reverse" bailout, approximately $2.2 million was distributed to the no property tax cities in 1981–82 and 1982–83. Under the Governor's proposal for 1983–84, they would not receive this assistance.

Proposed Formula Does Not Result in Proposed Savings. Although the Governor proposes a reduction of $300 million for cities and counties, our analysis indicates that the actual formula proposed in the budget companion bill—SB 124—to accomplish this reduction would yield a total savings to the state of only $287 million, or $13 million less than the budget indicates. The $287 million reduction consists of a $242 million reduction for cities and a $45 million reduction for counties.

Our analysis further indicates that under the Governor's proposal, 206 cities would lose an amount equivalent to their estimated net bailout for 1983–84. No city or county, however, would experience a reduction that exceeds the value of its net bailout. Table 67 identifies for cities and counties as a whole, the total value of fiscal relief in 1983–84, and the corresponding reduction that is reflected in the budget.

Table 67
Fiscal Relief to Cities and Counties in 1983–84
Before and After Governor's Proposal
(in millions)

	1983–84 Fiscal relief	*Reductions Per Governor's Budget*	*Remaining Fiscal Relief*	
			Amount	*Percent*
Cities	$346	$255	$91	26%
Counties	2,432	47	2,385	98
Total	$2,778.1	$302	$2,476	89%

Factors the Legislature Should Consider in Providing Local Fiscal Relief

In 1978–79, immediately following the adoption of Proposition 13, local governments were given one-time cash grants (SB 154). These funds were allocated generally in proportion to the amount of property tax revenues lost by each local government. Consequently, entities which lost the most as a result of Proposition 13 received the most block grant funding, regardless of their ability to adapt to these revenue losses. That is, this methodology did not consider the relative "fiscal status" of local governments.

In 1979–80, the cash grants were eliminated in favor of a permanent shift of property tax revenues to cities, counties, and special districts (AB 8) with the level of relief being determined based on the amount of relief the local entity had received under SB 154. In 1981–82 and 1982–83, the Legislature reduced the amount of fiscal relief below the level provided for by AB 8. In decreasing the amount of AB 8 fiscal relief, the Legislature generally made reductions based on the level of assistance each local entity was scheduled to receive. In short, the reductions from each entity was proportional to the amount of fiscal relief going to that entity.

The Governor's Budget proposes the reductions in fiscal relief for 1983–84 be made in the same way as they were made in 1981–82 and 1982–83: those agencies which benefitted the most from fiscal relief would experience the largest reductions.

The main difficulty with the approach proposed by the Governor is that the reductions are based on each agency's share of fiscal relief in 1978–79, and ignore any subsequent change in the agency's *relative* fiscal condition. To apportion the cuts according to grants initially received in 1978–79, therefore, could result in small cuts for cities and counties which are now relatively better off than others, and large cuts for less-well-off cities and counties.

It is our opinion that the existing system of apportioning reductions in fiscal relief does not provide for an equitable distribution of funds among local agencies. There is a substantial amount of evidence available today that we believe supports this conclusion. Some local governments, for example, have actually reduced their property tax rate and other tax rates, while continuing to receive fiscal relief from the state. Other local governments have never shared in the fiscal relief reductions made by the Legislature during the last several years, even though their budgets show significant surpluses. These and other circumstances document the need to reexamine the distribution of aid to local governments.

In considering the Governor's proposal to reduce fiscal relief, the Legislature needs to consider the extent to which it wishes to establish priorities for the *combined* state and local sector. Under the existing system of categorical programs, mandates, and restricted subventions, the Legislature, to a great extent, exercises control over the mix and level of services provided locally. Under alternative arrangments, the Legislature may not have this type of control, but the need for state assistance could be reduced.

B. REVENUE ENHANCEMENTS

Should the Legislature Give Local Government Greater Access to Revenues?

California Supreme Court Decisions Enhance Local Revenue-Raising Ability

As a result of three recent California Supreme Court decisions, the ability of local governments to raise additional revenues has been significantly enhanced. In the cases *LACTC v. Richmond, San Francisco v. Farrell,* and *Carman v. Alvord,* the California Supreme Court clarified several ambiguous phrases used in Article XIII A of the California Constitution, added by Proposition 13 in 1978. Public reaction to these decisions has varied widely. From one perspective, these decisions merely permit local governments to impose reasonable tax increases to maintain existing public services. Looking at the decisions from another perspective, however, the decisions have altered dramatically the ground rules under which Proposition 13 was conceived and implemented.

Article XIII A of the California Constitution places several limits on local taxes. Specifically, the measure limits increases in a property's assessed value for property tax purposes to no more than 2 percent annually, except in cases where a property is purchased or newly constructed. The measure also limits property taxes to 1 percent of assessed value; taxes in excess of the 1 percent limit may, however, be levied to pay interest and redemption charges on indebtedness approved by voters prior to June 1978. Finally, Article XIII A provides that cities, counties, and special districts may impose, by a two-thirds vote of the electorate, "special taxes." Such special taxes may not, however, consist of ad valorem property taxes or sales or transactions taxes on real property.

1. Special Taxes and the Two-Thirds Vote Requirement

Two of the court's decisions dealt with the two-thirds vote requirement for special taxes. In *LACTC v. Richmond,* the court held that an additional 0.5 cent local sales tax, levied by the Los Angeles County Transportation Commission for public transit purposes and approved by a 54 percent majority at a local election, was valid. In a divided opinion, the court reasoned that, because Proposition 13 was primarily concerned with property tax relief, the term "special district" as used by the measure applied only to those special districts which were empowered to levy property taxes. Because LACTC did not have such power, the court concluded, it did not constitute a "special district" within the meaning of Proposition 13 and, consequently, the two-thirds vote requirement did not apply.

In *San Francisco v. Farrell,* the court directly addressed the issue of what constitutes a "special tax" for purposes of Proposition 13. In another divided opinion, the court held that "special taxes" were distinguished from other taxes not by the type of tax nor by the object of taxation, but rather by the *uses* to which the tax revenues were put. Thus, the court held that the term "special tax" applies only to a tax whose proceeds are earmarked for a special purpose. Because San Francisco's payroll and gross receipts tax revenues were deposited in the city's general fund, the court concluded that an increase in that tax, approved by 55 percent of the city's voters at a local election, was also valid.

Both *Richmond* and *Farrell* increase the abilities of local governments to raise revenues from local sources. *Richmond* provides that any local government entity which does not have the power to levy a property tax is not bound by the two-thirds vote requirement of Proposition 13. *Farrell* provides that local governments may levy additional taxes (other than the prohibited ad valorem property taxes and real estate sales or transactions taxes), and that the levy of such taxes is not subject to the two-thirds vote requirement, provided that the tax proceeds are not earmarked for a special purpose.

While the *Farrell* decision appears, on its face, to offer local governments a wider range of possibilities for raising additional revenues, as a practical matter it will have a direct impact only on city governments. This is because other local government entities generally require *statutory authority* to raise additional revenues. Chartered cities have long enjoyed the ability to exercise independent taxing authority, as a result of the "municipal affairs" clause of the State Constitution. In 1982, the Legislature extended this taxing authority to general law cities as well. In effect, the Legislature empowered general law cities to levy the traditional charter city taxes—utility users taxes, admissions taxes, and parking taxes. General law cities already were authorized to levy business license and transient occupancy taxes, although they may now levy the latter at rates higher than those set by statute, as a result of the Legislature's action.

Perhaps more importantly, however, the Supreme Court's decision would seem to offer city government the opportunity to levy *new* types of taxes, such as per household or street frontage taxes, without the need for voter approval. It is uncertain the extent to which such taxes will actually be imposed, but they do represent a potentially significant source of additional revenue.

Counties, school districts, and special districts generally do not have statutory authority to levy new taxes at present, so the *Farrell* decision will have no impact on them in the absence of legislative action. Even with such action, however, the extent to which the *Farrell* decision might be applied to these units of government is unclear. As the court did not define what constitutes "revenue earmarked for a special purpose," there is some degree of uncertainty as to how specialized in function a governmental entity might be, yet still be considered to fulfill general purposes as well.

In October 1982, the Legislative Counsel stated in a written opinion (No. 16903) that a school district may take advantage of the *Farrell* decision to levy a tax for district general purposes, without specific approval by local voters:

> "We also note that the payroll and gross receipts tax considered in *Farrell* was levied by the City and County of San Francisco for the specific purpose of supporting the operations of the City and County of San Francisco, yet it was held not to be a special tax within the meaning of . . . Article XIII A. We think that a court would, by analogy, hold that a tax levied by a school district for deposit in the general fund of that district and for use for general purposes is not a special tax subject to the two-thirds vote requirement. . . . "

The opinion further states that, while school districts currently have the authority to *enact* a special tax without voter approval, they cannot *collect* such a tax until authorized to do so by the Legislature.

2. Pension Obligations and Voter-Approved Indebtedness

In the third major decision relating to Proposition 13 rendered during 1982, the California Supreme Court held in *Carman v. Alvord* that a property tax rate in excess of 1 percent, which was imposed by the City of San Gabriel for the purpose of funding its employees' pension plan, was legal under the provisions of Article XIII A. As noted, Article XIII A excludes from the 1 percent property tax rate limitation "ad valorem taxes or special assessments to pay the interest and redemption charges on any indebtedness approved by the voters prior to the time [this section] becomes effective." In a unanimous opinion, the court held in *Carman* that, where a city's voters had approved, prior to June 1, 1978, a ballot measure authorizing the city (a) to join the State Employees' Retirement System (later PERS) and (b) to impose a special tax to meet its obligation to the system, a property tax levied for this purpose comes within this exclusion.

The Supreme Court's decision in *Carman* is not, however, without ambiguity. It is unclear, for example, whether the term "voter-approved indebtedness" extends only to pension plans in which *both* the plan and a specific tax levy to fund it were approved by voters, or whether voter approval of the plan *alone* is sufficient (as a literal reading of Article XIII A would appear to indicate). In addition, it is not entirely clear what constitutes "voter approval." For example, of California's 58 counties, 20 belong to the pension system created by the 1937 County Retirement Act. Amendments to the act, added in 1947, provided that counties could elect to join the system *either* by a popular vote *or* by a four-fifths vote of the county board of supervisors (Government Code Section 31500). Because the act makes no distinction among counties based on the manner in which they joined the 1937 Act system, it may be argued that membership by a vote of the board of supervisors is essentially equivalent to membership by a vote of the people, thereby meeting the test of voter approval. Similarly, California cities are authorized by statute to establish pension plans, subject to the approval of *either* a majority vote of the electorate *or* a two-thirds vote of the city's legislative body (Government Code Section 45306). A city council's authorization of a pension plan therefore may also, arguably, constitute "voter approval."

The court recognizes, but leaves unresolved, both issues—the necessity of voter approval of a special tax and the question of whether the approval of the pension system by a local governing body may ever constitute "voter approval"—as the following passage from the *Carman* opinion indicates:

> Plaintiff argues that [the court's] holding could create a "nonuniform" scheme of taxation, fortuitously protecting only those pension plans authorized by a vote of the public, *though voter approval never was required* (citation). As we have seen, there is a basis for distinguishing voter-approved debt (citation). In any event, in a single case we cannot resolve all article XIII A's anomalies (citation). *Nor need we decide how pension taxes authorized only by the governing body of a local agency might be treated.* Here we conclude only that section 1, subdivision (b) of article XIII A exempts from the tax limits those pensions *and corresponding tax levies* approved by the voters before the limitation became effective (31 Cal.3d 318, 333, emphasis added).

Fiscal Effect. We estimate that California cities and counties will expend approximately $1.5 billion to fund pension obligations in 1983–84. Of this amount, we estimate that approximately $850 million is associated with pension plans approved by voters prior to the enactment of Proposition 13 in 1978, and thus potentially could be funded through additional property taxes in excess of 1 percent as a result of the *Carman* decision.

Table 68 shows our estimates of the amount of annual pension costs in California's largest cities and counties which *probably* could be funded through additional property taxes. For purposes of the table, we have assumed that all cities and counties in which voters approved pension plans prior to June 1978 would be able to fund them through an additional property tax levy. Property tax rate increases would require only a simple majority vote of the city council or county board of supervisors. As shown in the table, five cities (Los Angeles, San Francisco, Long Beach, Oakland, and San Jose) have estimated annual pension-related costs in excess of $25 million each.

Table 68 also shows the increase in local property tax rates which would be required to fund these annual costs out of additional property taxes. These tax rate increases range from a low of only 2.6 cents per $100 of assessed value in Santa Clara County to 61.7 cents per $100 of assessed value in the City and County of San Francisco.

In the event the Legislature chooses to change the current system for allocating fiscal relief so as to give greater recognition to relative needs and relative fiscal capabilities, it might wish to consider reflecting the *Carman* decision in the new system. Taking account of the authority to fund pension obligations out of increased property tax levies to which certain cities and counties now have access may be justified for two reasons. First, state assistance payments to local governments are primarily intended to address revenue shortfalls which persist after all other local revenue-raising options are exhausted. Given the existence of this untapped revenue source, state assistance in helping cities and counties finance their local pension costs may no longer be justified. Second, by requiring local governments to finance pension-related indebtedness out of their own revenue sources, statewide tax equity would be enhanced. Under the present system, residents of cities and counties which have been unusually generous in granting pension benefits to their employees are able to export some of their pension-related costs to residents of those cities and counties which have kept their pension costs under control. Since most of the benefits associated with granting their public employees generous pension benefits (such as reductions in employee turnover) accrue primarily to residents of those localities, it would seem appropriate to expect those granting these benefits to pay the full costs using local (rather than state) resources. This would also, arguably, create a greater incentive for those jurisdictions which have been unusually generous to bring their pension costs under control in the future.

Table 68

Potential Impact of Supreme Court Decision Allowing Local Government to Fund Pension Indebtedness From Additional Property Taxes [a]

Cities	*Locally Fundable Annual Pension Cost (millions)*	*Assessed Value (millions)*	*Estimated Additional Tax Rate to Fund Pension Debt*
Los Angeles	$273	$81,447	$0.335
San Diego	18	25,061	0.072
San Francisco[b]	150	24,302	0.617
San Jose	26	17,811	0.146
Long Beach	43	10,897	0.395
Oakland	33 [c]	8,010	0.087 [d]
Sacramento	10	6,884	0.145
Anaheim	8	7,276	0.110
Fresno	4	5,809	0.069
Santa Ana	5	5,330	0.094
Counties			
Los Angeles	N.A.	$212,962	—
Orange	$35	71,304	$0.049
San Diego	35	56,041	0.062
Santa Clara	12	45,700	0.026
Alameda	N.A.	29,871	—
Sacramento	N.A.	19,695	—
San Bernardino	14	24,329	0.058
Contra Costa	24	24,768	0.097
Riverside	N.A.	22,260	—
San Mateo	14	23,669	0.059

[a] Based on 1982–83 data for 10 largest cities and 10 largest counties.
[b] City and county.
[c] $26 million currently funded by special property tax.
[d] Rate based on funding $7 million not currently funded by special property tax.
N.A.: Not applicable—pension plan not approved by voters prior to June 1978.

Providing Greater Local Flexibility

It is important that cities and counties have flexibility to respond to the demands put upon them by their residents. Currently, their opportunity to do so is severely restricted.

Cities. Historically, charter cities have had the authority to raise or levy virtually any type of tax not precluded by state law or city charter. In the current year, this authority has been extended to general law cities, as well. Both types of cities, however, are subject to the restrictions contained in Proposition 13—that is, they may not increase the ad valorem property tax rate and they cannot increase a "special tax" without two-thirds voter approval. Within these bounds, cities have wide flexibility to increase revenues.

Counties. On the other hand, counties do not enjoy the same authority as cities have to levy new taxes; they must first obtain specific statutory authorization from the Legislature. Further, in those program areas where counties do have the authority to levy fees to defray their costs, statutory limits often exist which either set specific fees or fee maximums, thereby limiting the amount of revenue that counties can raise. These statutory amounts often are not adequate to permit full cost recovery.

Given the limited fiscal flexibility available to counties, when the state imposes new requirements on counties without providing additional funding, counties have only a limited ability to augment their revenues in order to offset the additional costs. Consequently, these new costs must be funded through existing revenues, often to the detriment of other county-funded programs. In effect, the imposition of state requirements on the counties without the provision of additional funding is tantamount to the state appropriating local funds for state purposes.

Consequently, we conclude that if counties are to be able to respond to the needs and desires of their citizens, three policy changes are needed:

1. County voters should be given greater discretion to tax themselves in order to finance local services.

2. Legislation should be enacted removing statutory limits imposed on fees administered and collected by counties for services they perform. Alternatively, statutes regulating fees could be amended allowing counties to impose fees at levels sufficient to cover the cost of providing the services for which the fees are charged. For example:

- County boards of supervisors currently are not authorized to impose or collect fees for services provided by the county sealer of weights and measures. Our analysis indicates that, on a statewide basis, authorization to impose such fees could generate a revenue increase for counties of between $1 million and $3 million annually.
- Section 26721 of the Government Code specifies the fee ($14) for any legally required process or notice served by a public officer or employee. Specified private process servers, however, are authorized under Section 1032.8 of the Code of Civil Procedure to recover "such sums as are reasonably incurred in effecting service." This distinction between public and private process servers is estimated to cost local governments approximately $7 million annually in foregone revenues.
- The Government Code also provides the specific fee for numerous miscellaneous civil filing fees. We cannot estimate how much increased revenue could be generated from the fees. At a minimum, if fees could be set to cover costs it would not be necessary for local agencies to seek legislative authority each time a minor fee warrants adjustment.

3. New requirements imposed on counties by the state should be accompanied by funding support.

Impact of the Governor's Proposal on Local General Purpose Revenues

One measure of a local government's fiscal condition, although a limited measure at best, is the growth in its general purpose revenues. General purpose revenues are those revenues which are not tied to the support of any particular program or activity. They are "no strings attached" revenues that may be used by local government to fund locally determined priorities. By definition, therefore, general purpose revenues exclude receipts tied to programs over which local agencies have no control, and consequently, provide an indication of the relative extent to which local agencies can address local needs for services.

Specifically, general purpose revenues include the proceeds from local taxes, interest earnings, bailout monies, state discretionary subventions such as tax relief and shared revenues, and federal revenue sharing funds. They exclude local fees and charges for services provided, as these funds are authorized specifically to cover the cost of the particular service.

The Governor's Budget projects that general purpose revenues for cities will grow by 4.3 percent in 1983–84. This projection takes into account (1) the Governor's proposed $255 million reduction in vehicle license fees, and (2) the expiration of federal revenue sharing funds in October, 1983. For counties, the Governor's Budget projects an increase in general purpose revenues of 3.5 percent. Again, this projection allows for (1) the $45 million reduction in vehicle license fees proposed in the Governor's 1983–84 Budget, and (2) the expiration of federal revenue sharing effective October, 1983. The growth projections identified above do not reflect (1) the Governor's proposal to reduce subventions by $54 million each to cities and counties in the *current* year, or (2) the potential additional $100 million reduction the Governor has identified as an option for eliminating the current year deficit. Table 69 identifies projected general purpose revenue growth, under these alternative circumstances.

Table 69
Local General Purpose Revenue Growth
1982–83 and 1983–84

	1982–83 (Over Prior Year)		*1983–84 (Over Prior Year)* [a]		
	January 1982 Estimate	*January 1983 Estimate*	*With $300 Million Reduction in 1983–84* [b]	*With $400 Million Reduction in 1983–84* [c]	*Under Existing Law (No Reductions)*
Cities:					
If $54 million reduced in 1982–83	—	1.6%	5.5%	3.7%	—
If $54 million not reduced in 1982–83	10.5%	2.7	4.3	2.6	9.6%
Counties:					
If $54 million reduced in 1982–83	—	4.7	4.5	4.1	—
If $54 million not reduced in 1982–83	10.8	6.0	3.5	2.7	4.5

Source: Department of Finance.
[a] Assumes termination of federal revenue sharing effective October 1983.
[b] Assumes reductions of $255 million for cities and $45 million for counties.
[c] Assumes reductions of $340 million for cities and $60 million for counties.

Table 70 compares general purpose revenue growth for cities, counties, and the state over the period 1980–81 to 1983–84. During this time, the state's general purpose revenues increased at an average annual rate of 5.7 percent. Close behind were the counties,which realized an average annual increase in revenues of 5.1 percent. City general purposes revenues increased at an average annual rate of 3.9 percent during this period.

In the case of county governments, however, the comparison of general purpose revenue growth overstates the ability of counties to maintain local services. This is because some of the increase effectively *must* be allocated to state-mandated programs, in order to comply with state requirements. Consequently, these funds are not really available to support local programs. Approximately 85 percent of county budgets represent costs associated with state-mandated or controlled programs, although the counties have considerable discretion over certain components of these costs (such as salary increases).

Table 70
Comparison of General Purpose Revenue Growth
1980–81 Through 1983–84
(in millions)

	1980–81		*1981–82*		*1982–83*		*1983–84*	
	Amount	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State	$19,023.1	5.8%	$20,960.3	10.2%	$20,489.7	−2.3%	$22,479.4	9.7%
Counties	4,063.7	11.1	4,302.2	5.9	4,558.2	6.0	4,716.6	3.5
Cities	4,502.0	12.2	4,712.8	4.7	4,841.5	2.7	5,051.4	4.3

Source: Department of Finance.

Local Government Compensation and Employment

The ability of local government to increase the size and pay of its workforce is another measure of its fiscal health. In an effort to see how this ability has changed in 1982–83, we surveyed California's 8 largest cities and 14 largest counties. Information was collected from each jurisdiction to identify the current change in local compensation and employment. The analysis which follows is a *summary* of the major findings from our survey.

The data fall into three major categories:

Salary and Benefit Increases given to employees as a percent of base pay. These increases represent percentage adjustments in base salary. In a few cases, these increases also reflect employer retirement contributions previously deducted from an employee's salary.

Expenditures for Salaries and Benefits actually made in 1981–82 and budgeted for 1982–83. These expenditures represent the total cost to local jurisdictions to compensate employees for their work, including payroll-related benefits such as social security.The usefulness of the data on expenditure changes is limited by many factors, including (a) possible inaccuracy in reported data, (b) differences in the way similar items of expenditure are categorized by the jurisdictions in our sample, and (c) availability of *actual* expenditures for 1981–82.

Levels of Employment, reflecting the maximum number of positions authorized within local budgets for 1981–82 and 1982–83. Most of the jurisdictions include in their personnel figures both part-time and full-time permanent positions. A few cities and counties, however, express positions as full-time equivalents (FTE). FTE positions are simply the sum of all full-time positions, counted in whole numbers, and part-time positions, counted as fractions of full-time positions.

Changes in Employee Compensation

In order to obtain as representative information as possible, we requested salary and benefit data for the following three bargaining units which generally include the majority of each local government's employees: (1) *the largest nonsafety bargaining unit,* generally consisting of clerical workers; (2) *the nonsupervisory fire unit* for all cities and those counties which provide fire service; and (3) *the nonsupervisory law enforcement unit,* which is usually the deputy sheriff unit in counties and the police officer unit in cities. For our analysis, we consolidated this information so that our results distinguish only between two categories of personnel: safety (the fire and law enforcement units) and nonsafety (the largest unit).

Table 71
Local Government Survey

	Average Salary Increases Received During 1982–83 (percent change)		*Multi-Year Agreements (Yes or No)*
	Safety	*Nonsafety*	
Cities:			
Anaheim	6.0%	6.0%	Y
Fresno	12.5	7.9	N
Long Beach	8.3 [a]	7.0	Y
Los Angeles	6.0 [a]	8.0	Y
Oakland	6.5	7.0	Y [b]
Sacramento [c]	0	0	Y
San Diego	10.0	8.0	N
San Jose	9.0	8.0	Y
Total Average	7.3%	6.5%	
Counties:			
Alameda [a]	4.4 [d]	8.0 [e]	Y
Contra Costa	N/S	8.0	Y [b]
Fresno	N/S [d]	4.8	Y [b]
Kern	5.1	5.1	N
Los Angeles	10.2	8.1	Y
Orange	7.6 [d]	7.8	Y
Riverside	N/S [d]	0	N
Sacramento	9.6 [d]	5.0	Y [b]
San Bernardino	8.2 [d]	7.3 [e]	Y
San Diego	N/S [d]	6.5	N
San Francisco	5.9	10.1	N
San Mateo	6.1 [a]	1.7 [a]	Y
Santa Clara	9.5 [a]	8.0	Y
Ventura	5.9 [a]	7.3	Y
Total Average	7.2%	6.3%	

[a] Total increase by end of 1982–83 greater than average increase shown because of mid-year increases or negotiations settled on calendar year basis.
[b] Multi-year contract for nonsafety or safety but not both.
[c] The first year of the multi-year agreement calls for no increase. An 8 percent increase is scheduled for 1983–84.
[d] Increase given to deputy sheriff unit only either because fire unit is still in negotiations or county does not provide fire service.
[e] Effective June 1982.
N/S = No settlement to date.

As shown in Table 71 the *average salary increase* in 1982–83 for all of the cities in the sample was 7.3 percent for safety employees, and 6.5 percent for nonsafety employees. In the counties surveyed, salaries of safety employees increased an average of 7.2 percent, while other county employees received an average increase of 6.3 percent.

Sixteen of the twenty-two jurisdictions have granted multi-year increases to all or part of their employees. Multi-year contracts cover a period of years, specifying increases to be effective at future dates during those years. Once settled, multi-year increases are "automatically" triggered by the contract and cannot be reduced by action of the local governing body. Thus, an increase for 1982–83 granted pursuant to a multi-year agreement settled in 1980 may not be indicative of an agency's fiscal strength in 1982–83.

Of the 16 jurisdictions with multi-year agreements, 13 have contracts commencing in years prior to 1982–83. The size of current year increases then reflects:

- The fiscal strength of the local entity *at the time of settlement;* and
- The fiscal strength anticipated through the duration of the contract period, based on projections of future revenue and expenditure growth.

For the Cities of Los Angeles, Oakland, and Sacramento, 1982–83 marks the first year of their multi-year contracts. This is significant because these jurisdictions made salary commitments for 1982–83 and future years with complete cognizance of their current fiscal condition. Thus, the magnitude of these increases is a direct reflection of their current fiscal health and the bargaining strength of the local employee organizations.

Six of the local entities in our sample, as shown in Table 71, do not have multi-year contracts, and consequently have granted increases for 1982–83 only. As with the three cities discussed above, the size of increases granted by these jurisdictions may be used as an indicator of their fiscal strength.

Changes in Expenditures for Salaries and Benefits

Based on the amounts originally budgeted for 1982–83, expenditures for salaries and benefits increased over actual expenditures in 1981–82 by an average of 9.2 percent for the surveyed cities and 7.7 percent for the surveyed counties. The increase is probably higher for some jurisdictions, due to adjustments in expenditure levels following midyear negotiations. To the extent that increases in salaries and benefits are negotiated or phased-in after the budget has been adopted, the expenditure levels reported in the survey understate actual spending expected by the end of the year. Recognizing this possibility, most local jurisdictions, unlike the state, do not reflect salary savings from employee turnover and vacancies in their budgets. In addition, these figures are based on budgets as adopted, and many local jurisdictions have implemented midyear expenditure cutbacks in order to offset declines in revenue.

Of the total salary and benefit change in 1982–83, *salary* expenditures were budgeted to increase an average of 8.4 percent for the surveyed cities and 6.8 percent for the surveyed counties. Expenditures for all *fringe benefits,* including health insurance and retirement, are budgeted to increase an average 14.0 percent for cities and 7.0 percent for counties in the current year. This means that cities will have increased their spending for employee benefits roughly 6.0 percent over the increased spending for employee salaries. Counties, on the other hand, have increased spending for salaries and benefits at approximately the same rate. The fact that the increase in benefit expenditures exceeds the increase in salary expenditures underscores the growing significance of benefits in the collective bargaining process.

Changes in Employment

Changes in employee compensation do not occur in a vacuum. In fact, increases in salaries and benefits may be offset by reductions in personnel. Productivity gains, brought about in part by the increased salaries, may offset personnel reductions. To gain a better sense of local fiscal conditions, we have collected employment data for: (1) the cities and counties in our survey sample; and (2) all cities and counties in California. Taken together, this information provides a meaningful context for understanding the trends in local employment.

The Survey Sample. The changes in levels of employment authorized in each entity's budget between 1981–82 and 1982–83 indicate that for cities, the number of authorized positions (the ceiling on employment) has dropped an average of −0.4 percent from the 1981–82 level. Counties have experienced a sharper decline, with an average reduction of −2.8 percent in authorized positions from the prior year.

For comparative purposes, we have utilized data published by the U.S. Department of Commerce, Census Bureau to obtain the average rates of change in employment from 1978 to 1981 for all of the cities and counties in our sample. During this period, total employment in the surveyed cities dropped an average of −3.6 percent annually. Full-time equivalent employment declined less dramatically, at an average annual rate of −2.7 percent from 1978 to 1981. Total employment in the counties surveyed increased 2.1 percent during the same period. The average rate of change in county full-time equivalent employment also increased, though at a slower rate of 0.4 percent annually.

By comparing the rates of change reported in the survey for 1981–82 to 1982–83 with the trend from 1978 to 1981, we can draw the following conclusions:

- City employment has followed a continual downward trend from 1978 to the present.
- The trend in county employment has been less consistent, though the data indicate a small increase from 1978 to 1982.

All Local Jurisdictions in California. Data summarized from the Employment Development Department (EDD) for all cities and counties in California confirms our conclusions about the survey sample, by showing that from 1978 to 1982:

- All city employment has been *declining* at an annual rate of −1.5 percent.
- All county employment has been *climbing* at a slow pace of 0.4 percent annually.

Overall Trends in Local Government Employment. While the data presented so far seem to establish a consistent pattern of reductions in city employment and little growth in county employment during the post-Proposition 13 period, there is a major deficiency in the data. The information from the U.S. Census Bureau and the state Employment Development Department includes jobs created under the Comprehensive Employment and Training Act (CETA). As "work training" positions, these jobs, by definition, were temporary. Thus, the loss of CETA positions distorts the actual change in regular positions from 1978 to 1982.

Unfortunately data are not available which allows us to distinguish CETA positions from non-CETA positions for cities and for counties, in each year since 1978. Our review of all city and county employment, *including CETA,* suggests that CETA positions accounted for a greater proportion of city employment than of county employment.

By ignoring the reduction of CETA positions in *city and county employment combined,* the data shows that:

- On an annual basis, total city and county employment has *increased* at an average annual rate of 1.9 percent between 1978 and 1982.
- On an cumulative basis, total city and county employment in March 1982 is *up* 11.2 percent, or 40,000 employees from March 1978.

Our analysis indicates that most of this growth has occurred in county employment, while cities reflect stable to minor increases in employment over the post-Proposition 13 period.

C. FUNDING FOR STATE MANDATED LOCAL PROGRAMS

How Can the Legislature Assure that State-Mandated Programs Continue to Serve Statewide Objectives in a Cost-Effective Manner?

Chapter 1406, Statutes of 1972 (SB 90), required the state, under certain circumstances, to reimburse local governments for state mandated costs and lost sales and property tax revenues. Under this measure, local governments could submit claims for reimbursement to the state 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.

Legislation enacted since SB 90 has significantly broadened the reimbursement program. Local governments and school districts may now appeal to the state Board of Control for reimbursement of a wide variety of unfunded mandates, regardless of any prior legislative determinations on the issue. Even more significantly, the voters' approval of Proposition 4 on the November 1979 ballot has elevated the reimbursement principle to a constitutional guarantee. This guarantee is only now undergoing its first test in the California courts.

Legislative Action on Claims Bills

Under the existing reimbursment 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 the types of 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.

Changes to the claims bill process were made by the companion bills to the 1982 Budget Act, Ch 327/82 and Ch 1638/82. Chapter 327, Statutes of 1982, requires the Legislature to either provide the funding requested in the claims bill, or to include one of several specified findings.

The Legislature made several such findings in lieu of providing funds when it acted on the most recent claims bill, Ch 1586/82 (AB 2675). As a result, local agencies, the administration, and the parties involved in the mandate process were provided with specific reasons for the individual legislative actions. On the other hand, funding was not provided to reimburse local governments for mandated costs in connection with six programs, even though the claims would appear to be legitimate.

Ultimately, these and many other claims that previously were denied state reimbursement will have to be paid, because of the constitutional requirement for reimbursement. By not appropriating funds to reimburse local governments and school districts for mandated costs in the claims bill, the Legislature may delay, but probably cannot avoid providing reimbursement.

The lack of timely reimbursement for mandated costs may create problems for the programs mandated by the Legislature. In fact, the denial of funds could allow the courts to, in effect, repeal the program by enjoining the state from enforcing the mandated requirements. To the extent that the Legislature's action to deny funding for mandated costs reflects its priority regarding these programs, it would seem to be in the Legislature's interest to specifically repeal the requirements, thereby avoiding further claims and any litigations that may arise with respect to them.

Status of Counties' Law Suit Against the State

The County Supervisors Association of California and 38 counties have sued the state, alleging that the state enacted 15 unfunded mandates in violation of Section 6, Article XIII B of the California Constitution. The counties assert that these 15 statutes each mandate a new program or higher level of service to be performed by the counties. The counties maintain that in each instance, the Legislature has failed to provide the funds needed to cover the costs of performing these new functions. Based on the Legislature's action in denying reimbursement for other mandated costs, the counties maintain that the normal reimbursement process will not yield state reimbursement for these mandated costs. Therefore, they are asking the court to declare the statutes invalid and unenforceable.

In presenting the state's case, the Attorney General contends that the counties have failed to exhaust the administrative process for obtaining reimbursements, and therefore are obligated to continue complying with all statutes enacted by the Legislature. To further support the state's position, the Attorney General concludes that the State Constitution is silent on the question of whether the claims process must be followed, and therefore local governments are required to utilize the process completely before contesting a mandate in the court. Therefore, he believes that the counties must complete the claims process before they can challenge a legislative decision concerning funding for mandated costs. Opening arguments were made in November 1982 in the Superior Court. Final oral arguments were to be heard in January, with the court rendering a decision by the middle of February.

Growth of State Mandates

Since 1975, when the state began keeping records on state mandated costs, approximately 2,400 bills have been enacted which contain a mandated local program. According to the Department of Finance, however, 106 of these bills have contained an appropriation to pay for the mandated cost.

State expenditures for state-mandated costs have grown from \$2.9 million in 1973–74 to approximately \$90 million in 1982–83. The Department of Finance estimates that the local government claims bill to be introduced during the current session, for payment in the budget year, will include approximately $184.5 million in funds to pay mandated cost claims. In addition, the budget for 1983–84 proposes to appropriate $75.1 million for state-mandated program costs incurred in the budget year. Therefore, *total funding for state-mandated local programs could amount to $260 million for the budget year,* assuming that the claims bill is enacted as recommended by the Board of Control. Table 72 details the total cost of state-mandated local programs from the inception of the program.

Table 72

State-Mandated Local Programs
Total Costs
1974–75 to 1983–84
(in thousands)

Year	*Budget Appropriation*	*Claims Bill*	*Totals*
1974–75	$16,743	—	$16,743
1975–76	9,680	—	9,680
1976–77	18,356	—	18,356
1977–78	45,297	—	45,297
1978–79	48,749	—	48,749
1979–80	80,591	$8,207	88,798
1980–81	77,714	11,091	88,805
1981–82	69,913	21,576	91,489
1982–83	53,526	36,588	90,114 [a]
1983–84	75,112	184,500 [b]	259,612

[a] Based on claims approved by the Board of Control through December 1982.
[b] Based on Department of Finance Estimate.

Procedures for Reevaluating the Effectiveness of Existing State-Mandated Local Programs

As noted above, almost 2,400 bills containing a state mandated local program, have been enacted since 1975 but only 106 of these bills contained an appropriation to pay for the mandated costs.

In many cases, the state appropriately disclaimed responsibility for providing reimbursement of the mandated costs. Some of these statutes also provided *savings* to local government in an amount sufficient to offset the costs, so that there were no net increased costs to the local agency that warranted reimbursement. In the bulk of these cases, however, it was simply not possible to know in advance the extent to which any increased costs would be incurred.

The costs associated with state mandates, like the tax expenditures discussed earlier in this document, generally are insulated from the budget process and the trade-offs that characterize this process. This is because, once a state-mandated program is enacted, its efficacy usually is not subject to subsequent review by the Legislature. The Legislature *may* have an opportunity to review the performance of some of these programs when local agencies seek to obtain reimbursement through the Board of Control. The number of such programs reviewed in this manner, however, is limited, relative to the number of programs mandated to date.

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

In our most recent report, *State Reimbursement of Mandated Local Costs: A Review of Statutes During January 1978–June 1981* (April 1982), we recommended that four of the five mandates examined pursuant to the Legislature's directive be modified, in order to achieve a more efficient use of state and local funds.

We believe the identification and repeal of existing state-mandated local programs which are no longer cost-effective could significantly reduce government expenditures at all levels. The state, however, is not in a good position to identify those mandates that are unnecessary or are not constructive because it does not administer the programs directly or observe their results first hand. 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 that they administered or from presenting a case for eliminating these mandates.

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

Statutory Expenditure Requirements

Eliminating unnecessary program requirements which are *not directly related to the service provided* is another way the Legislature can reduce local expenditures and consequently free up local revenues. For example, the state mandates and counties provide a variety of public health services, such as family planning, maternal and child health and prenatal clinics. In general, each of these programs has its own specific eligibility requirements as prescribed by the state, and its own program for determining eligibility. If these eligibility requirements were made uniform and the eligibility determination processes consolidated, it would not be necessary to screen applicants separately for each program, thereby reducing administrative costs. Further, many of the community-health-related programs are required to provide to both the state and federal government statistical information on the services provided and the clients served. In addition to the federal information form, state administrative regulations prescribe a separate information form for each of the programs. To the extent that California used either (1) a uniform information form for all programs or (2) the federal form, administrative duties could be reduced and savings realized.

D. THE STATE AND LOCAL RELATIONSHIP: A NEED FOR REFORM

Does the Nature of the State's Relationship with Local Government Warrant a Reassessment?

The budget proposes that a new partnership be formed between the state and local government, with the goal of restoring to local government the position it held prior to the passage of Proposition 13.

The administration has developed two specific proposals in an effort to restore to local government the role it played prior to Proposition 13. The first proposal, as discussed earlier in this document, would consolidate funding for categorical programs into three state block grants in the following areas: education, public health, and alcohol and drugs. In addition, the Governor is proposing to modify an existing block grant program in county justice system subventions. Block grants *potentially* could reduce the costs to both the state and local governments of providing services in these and other areas. The block grant concept has another significant impact that does not show up in state or local budgets. It increases local control over how state funds are used, and thereby reduces the Legislature's control. Whether the savings from program consolidation and the increased responsiveness to local conditions and priorities are sufficient to offset the loss of control at the state level is something only the Legislature can determine.

The second proposal contained in the budget calls for the establishment of a task force to review the state and local relationship, and to propose a plan to implement a new partnership. This task force would be made up of representatives of both government and the private sector. The task force would not be unlike one established by the Legislature pursuant to Ch 831/82 (AB 3231) for the purpose of restructuring state and local program responsibilities. The final report from this effort is anticipated in February 1983.

We believe that it is both appropriate and desirable to review and evaluate the existing relationship between the state and local governments. While the budget does not contain any suggestions as to the specific changes in this relationship which might be sought, it does provide a platform on which the relationship can be reassessed. We believe this reassessment should specifically consider the following interrelated issues:

- ***Accountability for Program Costs and Benefits.*** Under the existing relationship, neither the state nor local governments are directly responsible for the results of many programs. The state promulgates the program requirements and provides much of the funding, while counties provide the service. The state is not directly accountable because it does not provide the service. The counties are not directly accountable because the program is state conceived and state mandated, and much of the financial support comes from state or federal funds. As a result, it is difficult for the public to hold anyone accountable for program performance.
- ***Incentives to Manage Resources Efficiently.*** Because those who actually disburse the funds under many state-local programs have only a modest stake in the cost of those programs, current funding arrangements do little to encourage cost-effective program administration. In fact, it may even have the opposite results in some cases. Often, the level of state and/or federal funds received by a county in one year

is dependent on the amount the county actually spent in the prior year. This creates an incentive to spend funds that may not be needed in one year, so that a subsequent years' funding will not be jeopardized.

- ***Accountability for Budgetary Decisions.*** The existing system also makes it difficult to pinpoint which agency—be it the state or local government—is accountable for budgetary decisions. For example, when the state reduces state support for a specific program operated by local governments, it is a local service that is reduced. Local governments must then bear the brunt of explaining the reduction in services. Conversely, some local governments that chose to maintain pre-Proposition 13 service levels, despite a lack of adequate funds on an ongoing basis, blame reductions in state assistance for the service reductions that ultimately must be made.
- ***Ability to Effect Economies and Efficiencies.*** The ability to effect economies and efficiencies is restricted by the current relationship, because the agencies providing the service, and consequently those best able to identify and implement changes to promote efficiencies and economies, are not the agencies with either the incentive or the authority to effect such changes. Meanwhile, the state is in a position of overseeing a single program implemented as many as 58 different ways.
- ***Ability to Set Priorities.*** The ability to set priorities and address local needs is all but lost under the existing system, given that many local agencies lack the ability to increase the resources available for responding to the needs of their residents.

E. LOCAL FINANCING OF CAPITAL IMPROVEMENTS

How Can the Legislature Help Local Government Obtain The Capital They Need to Provide and Maintain Public Facilities?

A growing concern among local governments is that their public works facilities—the systems of roads, bridges, sewers, water lines, transit facilities, and other capital projects on which community residents depend—have deteriorated to the point where they are badly in need of repair. Local governments are also concerned over the deterioration of public facilities because it is seen as posing a significant barrier to economic growth. This situation, referred to commonly as "the infrastructure problem," reflects many years of under maintenance and neglect of public facilities.

The concern about the condition of public facilities is not confined to California. Efforts are underway in other states and at the federal level to assess the magnitude of the infrastructure problem in the country, and to develop alternative means of financing public improvements.

Why Have Public Facilities Deteriorated?

The deterioration of public facilities can be traced mainly to (1) the reduction in funds available for *all* public purposes, and (2) decisions made by elected officials to limit funding for public works projects. Proposition 13 has sharply reduced revenues at the local level. This, coupled with public pressure to maintain existing social services, has led local government officials to postpone spending for the maintenance and construction of public facilities. Another important consequence of Proposition 13 that is relevant to the infrastructure problem is that the measure has eliminated the traditional local source of financing for public facilities improvements—general obligation bonds. Because of limits now placed on property tax rates, local governments are no longer able to sell general obligation bonds.

Reductions in state and federal aid to local governments have also contributed to the limitations on spending for public works. For example, while the federal government historically has financed 75 percent of the costs of sewage plants in California, it currently is providing virtually no funding for these facilities.

AOR Study of the Infrastructure Problem in California

Unfortunately, no reliable estimates are available which indicate how significant the infrastructure problem is in California. The Assembly Office of Research (AOR) currently is conducting an extensive study of the problem, and it hopes to produce a description of California public works and an inventory of capital replacement, repair, and rehabilitation needs. AOR plans to release its findings in the spring of 1983.

Methods Currently Available to Finance Infrastructure Improvements

In the *Analysis,* we discuss in several places issues regarding the "infrastructure" problem in California. In this section, we identify the various methods by which any needed improvements could be financed in the future.

Despite the loss of general obligation bond financing, there are a variety of financing tools which currently are available to assist localities in addressing the infrastructure problem. Some of these tools have only been developed recently, and are often referred to as "creative financing" techniques. More often than not, however, they are only variations of the traditional financing tools which have been available in the past. These traditional methods, all of which rely on tax-exempt financing, generally include special assessment bonds, revenue bonds, tax allocation bonds, and lease-revenue bonds.

Special Assessment Bonds. These bonds are sold by cities, counties, and special districts to finance public works projects, such as streets, sewers, storm drains, street lights, and sidewalks, which benefit particular properties that can be specifically identified. Assessments are then levied on the affected properties to generate the revenues needed to service the bonds. These assessments are based on the value of the benefits that each property receives, rather than on property values per se. For example, the bonds issued under the 1911 Special Assessment Bond Act are secured solely by fixed-lien assessments on property, which frees the issuing governments from any ultimate debt servicing obligations. While the volume of special assessment bonds still accounts for less than 10 percent of all nonhousing bonds issued by local agencies, the volume in absolute terms, has increased significantly in the last four years—from $14 million in 1978–79 to $87 million in 1981–82.

Assessments have several attractive features which highlight their usefulness as tools for financing public improvements. First, the courts repeatedly have ruled that assessments are not subject to either Article XIIIA of the Constitution (Proposition 13) or Article XIIIB (the so-called spending limitations). Moreover, a two-thirds vote is generally not required to levy an assessment. Finally, assessments are efficient, because the costs of the improvements are borne by those who directly benefit from them. The major disadvantage of assessments is that the limits on the purposes of assessments are unclear, particularly with respect to operation and maintenance of facilities.

Revenue Bonds. These are bonds sold by cities, counties, and special districts to pay for revenue-producing facilities, such as water and sewer systems, airports, parking facilities, and hospitals. The bonds are serviced by revenues generated from fees charged for the services provided by these services. Revenue bonds must be approved by a *majority* of the voters, and are sold competitively. Property taxes may not be pledged as revenues. The purposes for which these bonds may be used, however, are, of course, limited to revenue generating capital improvements.

Tax Allocation Bonds. These bonds are sold by redevelopment agencies to finance the acquisition of property in blighted areas, the demolition of deteriorated buildings, the relocation of existing residents and businesses, the preparation of land for redevelopment, and the provision of public improvements needed for redevelopment. Tax allocation bonds are financed and secured primarily by the "tax increment" revenues derived from a specific redevelopment project, and thus, are also sometimes referred to as tax increment bonds. Tax allocation bonds may be issued *without* voter approval.

These bonds are used extensively in California, and for a variety of projects, including shopping centers, commercial office space, and residential units. In addition, they are also used to construct public facilities needed for these redevelopment projects. For instance, one city has used tax allocation bonds to improve a freeway interchange which services a shopping mall, and another used this method to build schools and flood control facilities.

Lease-Revenue Bonds. These bonds—also called lease-purchase bonds, lease-rental bonds, or simply leasebacks—are sold by nonprofit corporations or joint powers authorities to pay for public facilities like hospitals, parking facilities, schools, and convention centers. A public agency then leases or rents the facility to provide the revenues necessary to service the bonds and to cover the operating expenses of the corporation. Normally, the lifetime of the lease or rental agreement corresponds to the maximum maturity of the bonds. The public agency finances its lease payments out of its operating budget. Once the lease or rental period has elapsed and the bonds have been repaid, the lessee normally becomes owner of the facility. In most cases, lease-revenue bonds are not voter approved.

Other Tools. There are also other new financing mechanisms, such as that authorized by the Legislature under the Mello-Roos Community Facilities Act. This measure authorizes local agencies to levy special taxes within "community facilities districts" for financing new capital construction. In addition, greater reliance can be placed on user fees or charges to generate the funds needed to finance public facilities. This may be an especially important source of financing for capital facilities in newly developed areas, where local governments may be able to increase or broaden the scope of facilities covered by fees, exactions, and other charges paid by developers. These and similar devices all have one feature in common which we believe commends them—they derive the funds needed to support capital facilities, not from general subsidies, but from fees and taxes paid by those who directly benefit.

Creative Financing Methods Inadequate—General Obligation Bonding Needed

We recommend that the Legislature present to the voters for their approval an amendment to the California Constitution that would give localities access to the general obligation bond market. Specifically, we recommend that the voters be asked to approve a constitutional amendment permitting localities to increase temporarily their property tax rates above the current 1 percent limit, for the express purpose of amortizing debt issued to finance voter-approved public facilities.

Financing methods which currently are available to local government could provide a significant portion of the funds needed for public improvements. *However,* we do not believe that the entire infrastructure problem can be solved without resort to general obligation bonds. General obligation bonds are a preferable means of financing many projects (and perhaps the only means for some) because (1) they are backed by the *full faith and credit* of the issuing agency; (2) they require approval by the voters; and (3) they generally provide for a better match between who pays and who benefits over the life of a project. Further, the use of general obligation bonds may permit some projects which could be financed under alternative financing mechanisms to be completed at lower cost, due to the superior security they offer.

Furthermore, we find no basis for precluding the use of general obligation bonds by local governments for projects which a majority of voters are willing to support. Accordingly, we recommend that the Legislature take action to give localities access to the general obligation bond market. Specifically, we recommend that voters be asked to approve a constitutional amendment permitting localities to temporarily increase property tax rates above the current 1 percent limit, for the express purpose of servicing debt issued to finance voter-approved public facilities.

V. LEGISLATIVE CONTROL OF THE BUDGET

A. COLLECTIVE BARGAINING FOR STATE EMPLOYEES

How Can the Legislature Carry Out Its Responsibilities Under the State's Collective Bargaining Laws in a Meaningful Way?

Background

In 1983–84, compensation increases for state employees will, for only the second year, be subject to determination through the collective bargaining process.

In this section, we focus primarily on the state's initial experience with collective bargaining—analyzing what happened and what can be learned from the process—in order to provide the Legislature with a framework for considering similar compensation matters in the budget year and beyond. Our *Analysis of the 1982–83 Budget Bill* (page B-44) contains a more detailed description of the bargaining process for state employees.

SEERA. The State Employer-Employee Relations Act (SEERA), Chapter 1159, Statutes of 1977, provides for a formal bilateral employee relations system for most 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 the "wages, hours, and terms and conditions of employment."

The negotiated agreements resulting from this process are to be formalized in memoranda of understanding (MOUs). Any provision in such a memorandum requiring the expenditure of funds (for example, negotiated salary or benefit increases) or a change in law must be approved by the Legislature. If provisions requiring the expenditure of funds are not approved or fully funded, either party *may* reopen negotiations on all or part of the MOU. Mediation is required if the parties are unable to reach agreement.

HEERA. The Higher Education Employer-Employee Relations Act (HEERA), Chapter 744, Statutes of 1978, established a similar system with respect to academic and nonacademic employees of the University of California (UC), including the Hastings College of Law, and California State University (CSU). Unlike SEERA, if the Legislature or Governor fails to fund an MOU fully, the entire MOU *must* be referred back to the parties for further meeting and conferring.

Employees Affected by Collective Bargaining

Most state civil service and related employees are covered by collective bargaining. Of the state's 142,213 full-time employees (excluding higher education), 115,882, or 82 percent, have been assigned to specific bargaining units. As shown in Table 73, the remaining 26,331 employees are not subject to collective bargaining, due primarily to (1) their responsibilities as managerial, supervisory or confidential employees or (2) specific statutory exemptions for (a) staff of state agencies with a direct role in the collective bargaining process, such as the Public Employment Relations Board (PERB) and the Department of Personnel Administration (DPA); and (b) statutory officers whose salaries are set directly by the Legislature.

Table 73

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

	Estimated Personnel Years	
Category	*Number*	*Percent*
Employees in bargaining units	115,882	81.5%
Employees not subject to bargaining:		
Managerial and supervisory	20,152	14.2
Confidential	1,186	.8
Excluded specifically by SEERA	3,825	2.7
Exempt employees not in bargaining units	1,168	.8
Total (excluding legislative staff)	142,213	100.0%

Decisions on compensation for those employees who are not covered by a collective bargaining agreement are made as follows:

- The Governor, through the Department of Personnel Administration, proposes changes in existing conditions of employment for nonrepresented civil service and related employees.
- The UC Regents and CSU trustees propose such changes for UC and CSU nonrepresented employees, respectively.

- The Legislature then acts on the proposals, either:
  (a) Through the normal budget bill process (for provisions which require an appropriation), or
  (b) By enacting a separate bill (for provisions which require changes to existing law).

Neither the provisions of the SEERA, nor the salary-setting procedure for non-covered employees apply to staff employed by the Legislature. Compensation increases for these employees are set by the Legislature, outside of the process established by SEERA.

Status of Collective Bargaining Implementation

SEERA. The PERB has designated a total of 20 separate bargaining units for state civil service and related employees. Exclusive bargaining representatives have been selected for each unit. Table 74 identifies the distribution of state civil service employees among bargaining units and the status of any MOU covering the members of each unit. It shows that:

- 14 of the 20 units are operating under MOUs that cover both the current and the budget years; the MOUs for 5 units will expire at the end of 1982–83; and 1 unit, the psychiatric technicians, will operate under the same MOU until the end of 1984–85.
- 45 percent of the state civil service and related employees in bargaining units are part of either the administrative, financial and staff services or office and allied occupational groups.
- 10 out of the 20 units have the California State Employees' Association (CSEA) serving as their exclusive representative.

Table 74
Distribution of State Civil Service and Related Employees Among Bargaining Units and Current MOU Status 1982–83

Unit Number	Occupational Group	Estimated Personnel Years: Number[a]	Estimated Personnel Years: Percent	Exclusive Representative	MOU Status
1	Administrative, Financial and Staff Services	22,156	19.1%	California State Employee's Association (CSEA)	Effective July 1, 1982 to June 30, 1984
2	Attorney and Hearing Officer	1,837	1.6	Association of California State Attorneys, Inc.	Effective July 1, 1982 to June 30, 1984
3	Education and Library	2,049	1.8	CSEA	Effective July 1, 1982 to June 30, 1984
4	Office and Allied	30,334	26.2	CSEA	Effective July 1, 1982 to June 30, 1984
5	Highway Patrol	4,252	3.7	California Association of Highway Patrolmen	Effective July 1, 1982 to June June 30, 1983
6	Corrections	7,548	6.5	California Correctional Officers Association	Effective July 1, 1982 to June 30, 1983
7	Protective Services and Public Safety	4,477	3.9	Coalition of Associations and Unions of State Employees	Effective July 1, 1982 to June 30, 1984
8	Firefighter	3,063	2.6	California Department of Forestry, Employees' Association	Effective July 1, 1982 to June 30, 1983
9	Professional Engineer	4,716	4.1	Professional Engineers in California Government	Effective July 1, 1982 to June 30, 1983
10	Professional Scientific	1,447	1.3	CSEA	Effective July 1, 1982

					to June 30, 1984
11	Engineering and Scientific Technicians	2,811	2.4	CSEA	Effective July 1, 1982 to June 30, 1984
12	Craft and Maintenance	9,723	8.4	CSEA	Effective July 1, 1982 to June 30, 1984
13	Stationary Engineer	499	0.4	International Union of Operating Engineers, Stationary Engineers' Division	Effective July 1, 1982 to July 1, 1984
14	Printing Trades	833	0.7	CSEA	Effective July 1, 1982 to June 30, 1984
15	Custodial and Services	5,745	4.9	CSEA	Effective July 1, 1982 to June 30, 1984
16	Physician, Dentist and Podiatrist	819	0.7	Union of American Physicians and Dentists	Effective July 1, 1982 to June 30, 1983
17	Registered Nurse	1,595	1.4	CSEA	Effective July 1, 1982 to June 30, 1984
18	Psychiatric Technicians	7,686	6.6	Communication Workers of America, Psych Tech Union	Effective July 1, 1982 to June 30, 1985
19	Health and Social Services/Professional	2,854	2.5	American Federation of State County and Municipal Employees	Effective July 1, 1982 to June 30, 1984
20	Medical and Social Services/Support	1,438	1.2	CSEA	Effective July 1, 1982 to June 30, 1984
	Total	115,882	100.0%		

[a] As of May 1982

California State University. The PERB has designated nine separate statewide bargaining units for CSU employees. Currently, exclusive representatives have been selected in eight of the nine CSU bargaining units. The undecided unit, consisting of CSU faculty, includes the majority (52 percent) of the system's employees. Table 75 shows the distribution of CSU employees among bargaining units and each unit's current MOU status. The table indicates that of the eight represented groups in the current year, four MOUs were finalized, one tentative agreement was reached, and three MOUs are still in negotiation.

Table 75
Distribution of CSU Employees Among Bargaining Units and Current MOU Status
1982–83

Unit Number	*Occupational Group*	*Employees* Number[a]	*Employees* Percent	*Exclusive Representative*	*MOU Status*
1	Physicians	119	0.4%	Union of American Physicians and Dentists	Effective July 1, 1982 to August 30, 1983
2	Health Care Support	264	0.9	CSEA	Currently in negotiations
3	Faculty	15,967	51.6	Undecided	—
4	Academic Support	1,365	4.4	United Professors of California	Currently in negotiations
5	Operations Support Services	2,192	7.1	CSEA	Effective July 1, 1982 to June 30, 1985
6	Skilled Crafts	940	3.0	State Employees Trades Council	Tentative agreement reached in November, 1982

7	Clerical Support	7,697	24.9	CSEA	Effective July 1, 1982 to June 30, 1985
8	Police	217	0.7	State University Police Association	Effective July 1, 1982 to June 30, 1984
9	Technical Support Services	2,163	7.0	CSEA	Currently in negotiations
	Total	30,924	100.0%		

[a] Source: California State University.

University of California. The PERB has designated 19 separate bargaining units for UC employees, 18 of which are structured on a systemwide basis. The remaining unit, number 7, consists of printing trade employees working at three printing plants in the UC system. Unlike the status of collective bargaining in state civil service and within the CSU system, exclusive representatives have been selected for only two of the UC units, as shown in Table 76. Thus, the UC system is still in the beginning stages of the collective bargaining process.

Table 76
Distribution of UC Employees Among Bargaining Units
1982–83

Unit Number	*Type*	*Occupational Group*	*Employees* *Number*[a]	*Employees* *Percent*	*Exclusive Representative*
1	Systemwide	Police	190	0.4%	Statewide University Police Association
2	Campus	Faculty (Santa Cruz)	292	0.6	Faculty Association, UC Santa Cruz
3	Lab	Lawrence Livermore National Laboratory (LLNL) Skilled Crafts	261	0.6	Undecided
4	Campus	UC Berkeley/Lawrence Berkeley Skilled Crafts	198	0.4	Undecided
5	Campus	UC San Francisco Skilled Crafts	86	0.2	Undecided
6	Campus	UCLA Skilled Crafts	380	0.8	Undecided
7	Printing Plants	Printing Trades	110	0.2	Undecided
8	Lab	LLNL Technical	1,653	3.6	Undecided
9	Systemwide	Technical	3,927	8.5	Undecided
10	Lab	LLNL Service	494	1.1	Undecided
11	Systemwide	Service	6,174	13.3	Undecided
12	Systemwide	Clerical and Allied Services	18,565	40.0	Undecided
13	Health care	Patient Care—Technical	4,214	9.1	Undecided
14	Health care	Residual Patient Care—Professional	1,539	3.3	Undecided
15	Health care	Registered Nurses	4,548	9.8	Undecided
16	Lab	LLNL Professional Scientists and Engineers	3,205	6.9	Undecided
17	Systemwide	Professional Librarians	552	1.2	Undecided
18	Systemwide	Nonacademic Senate Instructional	Undetermined	—	Undecided
19	Systemwide	Research and Allied Professionals	Undetermined	—	Undecided
Total			46,388	100.0%	

[a] Source: PERB and UC.

For those 17 UC units without exclusive representatives, elections are expected to be completed during 1983–84. Consequently, it is uncertain at this time how compensation increases for these UC employees will be determined for the budget year.

Table 76 indicates that of the 46,388 employees in the UC system that have been assigned to bargaining units, the largest single group is clerical and allied services (40 percent of the total).

Collective Bargaining During 1982–83

Civil Service Employees. Throughout 1981–82, the DPA (representing the Governor) met and conferred with those organization that had been recognized as the exclusive representative of employees in a specific bargaining unit. The parties' task was to negotiate a compensation package for 1982–83, in the form of an MOU. Once these negotiations had been completed, the Director of the Department of Personnel Administration presented to the members of the budget conference committee those MOU provisions which, in the director's judgment, required legislative action. This presentation was made orally; the MOUs themselves were not presented (in some cases, they had not even been reduced to writing).

While negotiations were in process for state employees covered under collective bargaining, DPA also was preparing a compensation package for those state employees *excluded* from the coverage of an MOU. This "management" compensation package encompassed many of the same benefits that ultimately were included in the negotiated MOUs.

The funds required for the fiscal provisions of the MOUs and the "management" compensation package were appropriated in Item 9800 (augmentation for employee compensation) of the 1982 Budget Act. The two companion bills to the 1982 Budget Act, Chapter 327 and 1125, Statutes of 1982, formally approved the fiscal provisions of (a) the MOUs, by reference to the agreement for each bargaining unit and (b) the management compensation package.

CSU Employees. Upon completion of negotiations for 1982–83 covering four of the system's eight units, CSU notified the Legislature, by letter, that the financial provisions included in the agreements contained the same increases as those provided to state civil service employees in Item 9800. The MOUs themselves, however, were not submitted for legislative review. Instead, CSU advised the Legislature that because no additional legislative action was required, the CSU letter fully satisfied the statutory notification requirements.

Even though CSU saw no need for any further action by the Legislature, the Legislature "approved" the MOUs, using a process similar to the one followed for the MOUs covering civil service employees. Chapter 1125, Statutes of 1982 (AB 1363), approved the fiscal provisions of the MOUs for CSU employees.

Changes in compensation for CSU employees not covered by MOUs were decided upon by CSU officials. Once the Legislature appropriated funds for employee compensation, CSU officials proposed, and the Board of Trustees approved, a benefit package that was consistent with the appropriations.

Fiscal Impact of the MOUs in 1982–83

Both the administration and CSU officials have assured the Legislature that the total fiscal impact of the MOUs agreed to for 1982–83 is reflected in the appropriations made explicitly for employee compensation in the 1982 Budget Act. Any additional benefits provided to state employees by the MOUs, these officials maintained, will be "absorbed" within existing appropriations, and thus do not represent an increase in costs to the state.

Subsequent to the ratification of the MOUs, we asked the DPA and CSU to provide a detailed cost accounting of all provisions of the MOUs, and to designate whether each provision required a new appropriation or was considered "absorbable" within existing appropriations. We also asked, for comparative purposes, that the DPA and CSU provide the same information on the costs of each new benefit provided to employees not covered by the collective bargaining process in 1982–83.

Based on our review of the information submitted by the DPA and CSU, we believe the provisions of the 1982–83 MOUs can be divided into the following three categories:

- Provisions with no fiscal effect;
- Provisions that received direct appropriations or consideration within the 1982 Budget Act;
- Provisions considered absorbable within the current-year appropriation.

Items with no Fiscal Effect. Most of the 1982–83 MOUs contain provisions that grant certain privileges and benefits but do not have any forseeable fiscal impact. For example, the agreements include provisions granting access to available bulletin boards for the posting of information and establishment of various committees. These provisions have little or no implications for state costs or legislative policy.

Provisions Having a Direct Fiscal Effect. In the Budget Act of 1982, the Legislature appropriated $93.9 million from all funds ($61.9 million from the General Fund) to fund the following collective bargaining provisions:

- A cost-of-living increase to maintain the state's percentage contributions for employee health insurance premiums.
- The continuation of an employee dental care program for civil service and related employees only. (Additional funds for this purpose were included in the support budgets of UC and CSU.)
- An increase in shift differential and certain overtime pay (for civil service and related employees only).

Our analysis indicates, however, that the actual cost of these provisions in the current year will be closer to $85.1 million or 9.4 percent less than the 1982 Budget Act appropriations. As seen in Table 77, this is because the appropriations for these provisions from the special funds and other funds were overestimated by $11.6 million.

The Governor's Budget for 1983–84, however, identifies a General Fund deficiency of $13.8 million in the current year for employee compensation. As shown in Table 77, the deficiency is caused by two factors: (1) an increase in expenditures beyond what was anticipated in the 1982 Budget Act ($2.8 million) and (2) the failure of the six-month reduction in employer contributions to the PERS to generate sufficient funds to support the employee compensation item ($11 million).

Provisions Considered Absorbable Within Existing Appropriations. Our review of the agreements and cost estimates provided by the DPA and CSU reveals that various provisions in the MOUs and noncovered

Table 77
Summary of Fund Adjustments
For Employee Compensation Increases
in 1982–83
(in thousands)

	General Fund			*Special Funds*			*Other Funds*			*Total, All Funds*		
Expenditures	*1982 Budget Act Amount*	*Estimated 1982–83*	*Change*	*1982 Budget Act Amount*	*Estimated 1982–83*	*Change*	*1982 Budget Act Amount*	*Estimated 1982–83*	*Change*	*1982 Budget Act Amount*	*Estimated 1982–83*	*Change*
Health Insurance	$43,707	$43,251	−$456	$9,438	$8,886	−$552	$8,846	$3,971	−$4,875	$61,991	$56,108	−$5,883
Dental Insurance	16,219	17,726	1,507	6,378	4,996	−1,382	6,186	2,360	−3,826	28,783	25,082	−3,701
Shift Differential and Overtime Pay	1,988	3,225	1,237	564	112	−452	528	43	−485	3,080	3,380	300
Employee Compensation for Legislature	—	510	510	—	—	—	—	—	—	—	510	510
Totals	$61,914	$64,712	$2,798	$16,380	$13,994	−$2,386	$15,560	$6,374	−$9,186	$93,854	$85,080	−$8,774
Funding												
Transfers From Departments for Retirement Adjustment of January 1, 1983	$61,914	$50,915	−$10,999	$16,380	$13,994	−$2,386	$15,560	$6,374	−$9,186	$93,854	$71,283	−$22,571
Deficiency Allocation Required	—	13,797	13,797	—	—	—	—	—	—	—	13,797	13,797
Totals	$61,914	$64,712	$2,798	$16,380	$13,994	−$2,386	$15,560	$6,374	−$9,186	$93,854	$85,080	−$8,774

employee compensation packages affecting various conditions of employment will require the expenditure of an *additional* $61.3 million from all funds in 1982–83. No funds have been *specifically* appropriated by the Legislature to cover these costs. Instead, funds appropriated by the Legislature for other purposes will be used to finance these benefits. It is in this sense that the $61.3 million in additional costs are considered absorbable within existing appropriations.

Table 78 shows the "absorbable" costs identified by the DPA, the Department of Finance, and CSU officials.

Table 78
Employee Compensation Costs Absorbed by State Agencies and CSU
1982–83
(in thousands)

	Employee Group			
Provisions	*Civil Service and Related Covered by MOUs*	*CSU Covered by MOUs*	*Excluded From Collective Bargaining or Not Covered by MOUs*	*Totals*
Special pay	$214	—	—	$214
Change in rest periods	14,717	—	—	14,717
Credit for Saturday holidays	10,152	1,924	3,552 [1]	15,628
Adjustment of vacation accruals	5,765	—	3,387 [1]	9,152
Sick leave (includes bereavement leave)	2,158	52	1,421 [1]	3,631
Uniform allowances	810	10	154 [2]	974
Changes in work week	3	—	—	3
Overtime	689	99	—	788
Overtime holidays	—	24	—	24
Training	686	—	—	686
Safety	—	6	—	6
Increase in per diem rate	8,191	15	3,505 [2]	11,711
Increase in mileage rate	1,744	—	811 [2]	2,555
Miscellaneous	1,175	—	—	1,175
Totals	$46,304	$2,130	$12,830	$61,264

[1] Includes costs for civil service and related employees only. Data are not available for CSU employees.
[2] Includes costs for civil service and related employees and CSU employees.

Table 78 shows the "absorbable" costs identified by the DPA, the Department of Finance, and CSU officials.

The $61 million in "absorbable" costs shown in Table 78 is a *minimum* estimate of these costs for 1982–83. This is because the costs of providing Saturday holiday credits, vacation accrual adjustments, and changes in sick leave benefits for CSU employees that are not covered by an MOU were not available at the time this *Analysis* was completed. As Table 78 shows, the three benefits for which full cost data are not available account for a significant portion of the "absorbable" costs incurred on behalf of excluded civil service employees. Thus, we anticipate the actual cost to the state of these benefits will be significantly in excess of $61 million.

Of the total cost to be absorbed in 1982–83, $48.4 million, or 79 percent, is attributable to the various provisions of the state civil service and CSU MOUs. The remainder is attributable to benefits provided for employees outside this year's bargaining process.

The employee benefit provisions which result in the greatest "absorbable" costs are:

- Changes in rest periods ($14.7 million);
- Credit for Saturday holidays ($15.6 million);
- Adjustment of vacation accruals ($9.2 million);
- Changes in sick leave provisions, including the provision of bereavement leave ($3.6 million) and
- Increases in per diem and mileage rates ($14.3 million).

Our review indicates that the size and nature of these "absorbable" costs raise three important issues, all of which have relevance for legislative control of the budget:

1. ***Absorption of Additional Costs May Subvert Legislative Priorities.*** Each year, the Governor submits to the Legislature a program budget setting forth each agency's programs and activities, and the costs associated with each. During its deliberations, the Legislature revises the budget to (a) establish its own priorities, and (b) eliminate any "slack" in the budget. Consequently, when agencies are directed to absorb costs for employee compensation provisions, programs or activities funded by the Legislature may be eliminated or cut back in order to free up the funds needed to pay for the employee compensation increases. The decisions as to *which* programs and activities will be cut back are made on the basis of the administration's priorities, rather than the Legislature's.

The specific effects of requiring departments to absorb significant unanticipated costs is unclear. Provisions deemed absorbable, such as higher per diem rates, additional time off for holiday credits and increased vacation accruals, will force departments to consider certain administrative options for keeping expenditures within the amount appropriated, such as:

- Reducing the amount of travel.
- Reducing staff.
- Modifying service levels, either by deleting functions or delaying service availability.

2. ***"Absorbable" Costs Increase General Fund Expenditures.*** Experience indicates that most departments will not spend all funds available to them in a given year. There are several reasons for this. On the one hand, needs for which funds have been budgeted may not arise. On the other hand, departmental budget control procedures designed to ensure that expenditures remain within budgeted levels may result in some appropriated funds being held back from obligation.

Using such unanticipated savings for other purposes, however, may still increase General Fund expenditure beyond the total shown in the budget. This is because *the Legislature counts on unidentified savings* in putting the budget together, and typically appropriates more money than it anticipates will be available for expenditure. For example, the 1982 Budget Act is premised on there being unidentified savings of at least $50 million, and the 1983–84 budget assumes similar unidentified savings of $60 million. Consequently, to the extent that what would otherwise turn out to be savings are instead used to fund additional employee benefits, state expenditures may exceed what the Legislature intended, or can afford. This, in fact, is what appears to be happening in 1982–83. Whereas the Legislature originally counted on unidentified savings of $50 million this year, the Department of Finance is now estimating that these savings will be only $20 million.

In this sense, then, the "absorbable" costs turn out to be *direct* costs. Put another way, what a department can absorb is *not* absorbable by the General Fund.

It may be that in the future, departments will request additional funds through the budget process to support these previously absorbed costs. This will put the Legislature in the difficult position of having to consider a request to fund something "which the Legislature itself has already approved."

3. ***The Legislature is Kept in the Dark About Significant Policy Changes Until After the Fact.*** For both civil service and CSU employees, information about the cost of the provisions itemized in Table 78 was not presented to the Legislature when it was asked to approve the MOUs in the budget companion bills. As a result, the Legislature was denied the opportunity to enforce its funding and policy priorities on decisions made by the administration.

In summary, the collective bargaining process, as conducted for 1982–83, (1) did not comply with the statutory requirement that the Legislature review and approve all MOU provisions requiring the expenditure of funds, (2) resulted in $61 million in state costs, in addition to the $85 million in so-called direct costs, which will continue in future years and (3) necessitated the diversion of existing program funds thereby circumventing the legislative process and reducing legislative control over the allocation of limited resources.

1982–83 Fiscal Effect Summary. Our analysis indicates that collective bargaining agreements and the compensation package for noncovered employees resulted in current-year costs of approximately $146 million, consisting of $85 million in costs reviewed by the Legislature (including recent adjustments) and $61 million in costs which were never presented to the Legislature for its consideration.

Problems With the Process for Legislative Review of MOUs

Under 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 the provisions can be implemented. Last year's experience indicates that the existing process for extending to the Legislature an opportunity to review and approve these features of MOUs is not satisfactory. Specifically, the Legislature was given only a short time in which to act on the MOUs, and was not given the information it needs in order for the review and approval process to be meaningful. Moreover, the process is too fragmented to allow adequate legislative review. This is because information on MOUs for state civil service and related employees, CSU employees, and eventually UC employees is submitted sequentially, using different formats, rather than concurrently, using the same format.

In 1982–83, the Legislature received no written documentation that would enable it to determine the implications of the MOUs which it was asked to approve. Instead, the budget conference committee received only a brief oral presentation on what the administration claimed were the direct fiscal provisions of the MOUs, shortly before it completed its work on the 1982 Budget Bill. There were no detailed cost estimates—or even descriptions—of the provisions available to permit an evaluation of the MOUs by legislators and legislative staff. Even if this information had been available, there was virtually no time afforded the Legislature for review of the agreements.

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Written copies of the MOUs, with the complete package of provisions, were not submitted to the Legislature at the time of its deliberations because the MOUs had not been prepared. In fact, three months following legislative action on the MOUs, printed copies of some MOUs still were not available. As a result, the Legislature often learned about some of the specific provisions contained in the MOUs when legislation was proposed to provide similar benefits to employees excluded from the collective bargaining process. For example, during its deliberations on the management compensation package discussed earlier (Chapters 327 and 1125, Statutes of 1982), the Legislature learned that it had approved several new benefits for most state civil service employees, including bereavement leave (through a change in sick leave policy), increased vacations and vacation credit for Saturday holidays.

This clearly hampers the Legislature's ability to carry out its oversight functions in employment compensation matters.

Legislative oversight of contract provisions is further hampered by the lack of administrative guidance to state departments on how to budget for current and future contract provisions. This problem is compounded because agreements are developed on a unit, rather than an agency, basis. Agencies with employees in various bargaining units are likely to encounter difficulties in assessing their budget needs, since these needs are dependent on the fiscal effects of several agreements. In addition, a set of diverse administrative practices may arise as a consequence of agencies having to make budget adjustments in order to handle the cost of contract provisions. Central direction is needed to insure that all agencies implement the agreements consistently.

Legislative Control and Collective Bargaining

With collective bargaining, the Legislature is faced with a new process for determining the compensation levels for state employees. This process raises the important issue of how legislative review and control over contract provisions can be assured without hampering unduly the duties of the state's representative in the negotiations.

In summary, our review indicates that in 1982–83 the Legislature experienced three serious problems in carrying out its duties under collective bargaining:

- The Legislature had only a short time to review the contract provisions presented to it by administration and CSU officials.
- The information that was presented did not give a precise picture of the fiscal ramifications of the provisions within the MOUs.
- No process exists to ensure the consistent management and administration of the contract provisions.

In order that a collective bargaining system for state employees is managed consistently and with appropriate legislative oversight:

We recommend that legislation be enacted requiring that:

1. ***The DPA, UC and CSU submit to the Legislature by May 15 all MOUs and other proposals for compensation increases for 1983–84.*** This will provide the Legislature with an opportunity to consider and act on such proposed increases as part of the regular budget process.

2. ***The Department of Finance, UC and CSU annually submit a comprehensive cost summary of proposed and negotiated compensation changes for their respective employees.*** These cost summaries should be submit-

ted to the Legislature along with MOUs, and should include long-range cost estimates for changes in benefits and working conditions which would have a delayed cost impact.

3. ***The Department of Finance review all cost estimates prior to legislative budget hearings, to verify their reliability and consistency.*** This will provide the Legislature with cost estimates that are reviewed and coordinated by one central agency.

4. ***The Department of Finance provide guidance to agencies, in the form of management memos, as to standard procedures for implementing the various cost provisions contained in the MOUs.*** This will provide a consistent approach to implementing and budgeting the various provisions in the MOUs.

B. THE STATE PUBLIC WORKS BOARD

How Can the Legislature Assure that Capital Outlay Projects Are Carried Out in Accordance With Its Intent?

The State Public Works Board is charged with the responsibility for determining if and when site acquisition, improvements, and the purchase of equipment shall be undertaken for capital outlay projects approved by the Legislature. Specifically, it must approve preliminary plans before amounts appropriated by the Legislature for working drawings and construction can be allocated. Once the board approves preliminary plans, no further review or action—except to augment construction costs—is taken by the board. The board consists of three voting members—the Director of the Departments of Finance, Transportation, and General Services. Six legislative members act as advisers to the board, but do not vote.

Specific Authority for the Board

Legislative control and oversight of capital outlay appropriations is exercised through control Section 8.00 of the annual Budget Act and the Government Code (Section 15752, et. seq). Section 8.00 is not contained in the proposed Budget Bill, but its provisions are included in Section 44 of the 1983 budget trailer bill.

Chapter 808, Statutes of 1982, attempted to strengthen the board's process by establishing new oversight, review and reporting requirements for capital outlay projects. Specifically, the board's review of preliminary plans must ensure that the project is:

- consistent with legislatively approved cost and scope
- carried out with all due speed and diligence.

Moreover, as of January 1, 1983, the state agency conducting the capital outlay project must submit a quarterly report to the board detailing the project's progress. At the time this Analysis was prepared, however, the board had not identified administrative procedures to implement the act's requirements, despite the fact that the measure had been in effect for more than one month.

Legislators' Expectations versus Public Works Board Action

The board serves a useful purpose in that if its duties are properly executed, the Legislature's intent in appropriating funds for capital outlay will be implemented and capital expenditures will be undertaken in a timely fashion.

For the past few years, however, we have become increasingly concerned over the manner in which the state's capital outlay program is processed through the State Public Works Board. Although the Legislature has attempted to strengthen the process through various changes to Section 8.00 and the Government Code, our review indicates that the process continues to deteriorate rather than improve.

This problem is caused, in part, by the Department of Finance's failure to adequately review projects submitted to the board. Several years ago the Legislature attempted to improve the department's review of these projects by requiring (in Section 8.00) that the Department of Finance certify, in writing, to the chairperson of the Joint Legislature Budget Committee, the chairpersons of each fiscal committee and the legislative members of the board, that each project submitted to the board meets legislatively approved scope and cost.

The department, however, has not performed this responsibility as the Legislature intended. The prior director did not review or sign the letter of certification required by Section 8.00. Instead, she delegated this responsibility to staff. Frequently, the letter of certification failed to identify those projects which did not meet legislatively approved scope and cost. In many cases, for example, the certification failed to identify proposals which involved:

- augmentations to project costs
- changes to the project scope
- requests for allocation of funds prior to satisfying Budget Act language
- requests for approval of preliminary plans when the preliminary plans are neither complete nor available.

Moreover, in those instances where the Department of Finance identifies a change in scope or cost, the department generally does not comply with Section 8.00, because it does not detail either the change or the associated cost implication of the modification.

The board, itself, is no better in complying with legislative intent. Generally, unless the requested action is in direct conflict with *specific* budget act language, the board approves all requests submitted by the department, even when discrepancies of the type cited above are brought to its attention. Thus, neither the Department of Finance nor the board is providing the measure of control which the Legislature believes exists when it appropriates funds for capital outlay. In order to establish better control measures, ***we, therefore, recommend that the Director of Finance personally assume the responsibility of certifying in writing that the projects taken to the board meet legislatively approved scope and cost.***

Status of Capital Outlay Funds Needs Monitoring

The board's duties include determining if and when capital outlay projects shall be undertaken. Implicit in this responsibility is making the determination that funds are available to undertake the project. The board, however, has not met its obligations in this area.

As far back as January 1982, the Department of Finance indicated that the condition of these funds was uncertain. Accordingly, in April 1982, our office advised the Chairman of the Joint Legislative Budget Committee that the Department of Finance had placed projects on the board agenda with the stipulation that board approval was recommended, contingent on the availability of funds. At that time, we recommended that the Department of Finance provide a fund status report prior to board action.

The department chose not to provide any written information on the condition of these funds. Instead, department staff merely informed the board verbally that adequate funds were available for each project.

In November 1982, the Department of Finance staff, without explanation, began to withhold projects funded from the Special Account for Capital Outlay from the board's monthly agenda. In each of these months, our office advised the Chairman of the Joint Legislative Budget Committee of the department's action, and recommended that the board obtain a fund status report from the department. The board, however, chose to ignore this recommendation and a report has not yet been provided.

As we discussed earlier in this document, the Department of Finance's assurances of funding availability now appear to have been incorrect. Data from the State Controller's Office showing the fund balance for various tidelands oil funds differ significantly from the data shown in the Governor's 1983–84 Budget. Table 79 compares the estimates of fund balances obtained from these two sources.

Table 79
Selected Funds Receiving Tidelands Oil Revenue
State Controller's Balances and
Governor's Estimated Balance as of June 30, 1982 [a]
(in thousands)

Fund	*As reported by Controller*	*As estimated in the Governor's Budget*	*Difference*
Capital Outlay Fund for Public Higher Education:			
1. Reserve for economic uncertainties	−$6,274	$523	$6,797
2. Reserve for unencumbered balances of continuing appropriations	4,405	1,452	−2,953
Energy and Resources Fund:			
1. Reserved for economic uncertainities	−8,998	−8,825	173
2. Reserve for unencumbered balances of continuing appropriations	5,483	2,315	−3,168
State Park and Recreation Fund:			
1. Reserve for economic uncertainties	12,602	−184	−12,786
2. Reserve for unencumbered balances of continuing appropriations	35,731	36,839	1,108
Special Account for Capital Outlay:			
1. Reserve for economic uncertainties	−40,260	12,612	52,872
2. Reserve for unencumbered balances of continuing appropriations	65,082	23,303	−41,779

[a] Sources: State Controller (as of 1-14-83); Governor's Budget for 1983–84.

Table 79 shows that, according to the State Controller, three of the four capital outlay funds which receive tidelands oil revenue were overcommitted on June 30, 1982. The State Park and Recreation Fund was the only one with a positive year-end balance.

In view of the data discrepancies between the State Controller and the Governor, it is apparent that the board has been acting without sufficient information, and as a result may have overcommitted the various funds. To avoid this problem in the future, *we recommend that the State Controller provide to the board, on a quarterly basis, a written fund status report for each of the funds that provide financing for capital outlay.*

Board Membership Should Be Changed

In the past, we have recommended that Section 15770 of the Government Code be amended to revise the composition of the State Public Works Board by removing the Director of General Services and adding the Director of Housing and Community Development. In 1981, the Legislature approved SB 681 which would have made this change in the board's composition. The Governor, however, vetoed the bill.

We continue to believe this change is warranted. The Department of General Services, by way of its "service agency" role to other state agencies, participates in the development of a substantial number of projects on which the board must act. Thus, many issues which come before the board directly involve decisions made by the Department of General Services. This places the Director of General Services in a position of constantly having to approve—or disapprove—proposals that are developed by the Director's staff, and that in many cases have already been approved by the Director himself. This puts the Director in a difficult position by, in effect, giving him a direct stake in the outcome of the vote which he must make.

The Director of Housing and Community Development would not be subject to the same conflicting pressures. Further, the Director's interest in the state's acquisition and construction projects and their impact on community development would be an asset to the board. Accordingly, *we recommend that legislation be enacted to change the State Public Works Board membership by replacing the Director of General Services with the Director of Housing and Community Development.*

Staff Accountability Needed

The Director of Finance serves as chairman of the Public Works Board. The secretary to the board, however, is located in the Department of General Services, Real Estate Services Division. Staffing for the board is provided by two departments as follows: staff of the Department of General Services handle property acquisition matters and preparation of board agendas, while Department of Finance staff review capital improvement projects. The Legislative Analyst's office traditionally has served as staff to the legislative members of the board.

The division of duties between the Department of Finance and the Real Estate Services Division results in dual standards being applied to state capital outlay projects. Moreover, this arrangement, in effect, assigns to the Real Estate Services Division a responsibility for assessing the policy and cost implications of proceeding with an acquisition project. These statewide policy and cost matters are outside the division's normal real estate property purchase/management expertise. These matters more properly fall within the Department of Finance's area of statewide fiscal expertise. Consequently, *we recommend that the Legislature assign responsibility for providing staff support for the board exclusively to the Department of Finance.*

Summary of Proposed Changes

As discussed above, the Public Works Board serves a useful purpose. Its performance in carrying out its responsibilities, however, must be improved if the Legislature is to have any assurance that the capital program it funds is carried out in accordance with its intent. If the process is not improved to the point where it is able to provide this assurance, there is no point in having the board, and the Legislature should withdraw the board's authority to change or augment the capital program.

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

- The Director of Finance should be required to personally assume the responsibility for certifying in writing that the projects taken to the board meet legislatively approved scope and cost.
- The State Controller should be required to provide a written quarterly fund status report to the board.
- The composition of the board should be changed by removing the Director of General Services and adding the Director of Housing and Community Development.
- All administrative staff to the board should be located within the Department of Finance. In our review of the Real Estate Services Division, the Department of General Services (Item 1760-001-666 of the *Analysis*), we have recommended that this responsibility be transferred to the Department of Finance.
- The Legislature should provide clear direction on the scope and cost of each approved project. This can be accomplished through the budget act and by adopting supplemental report language.

Many of these changes could be made administratively. In the past, however, relying on administrative changes has not been successful. Consequently, we recommend that these changes, where appropriate, be made through specific legislation or Budget Act language.

C. COURT DECISIONS OVERTURN LEGISLATIVE ACTIONS

How Can the Legislature Protect Its Policy and Funding Decisions From Being Overturned by the Courts?

Recent Court Decisions Have Reduced Budget Savings

Over the last two years, estimates of General Fund revenues have been repeatedly reduced as the recession took its toll on the state's economy. Budgets, which initially were balanced were, by midyear, in deficit. In an attempt to keep the state solvent, the Legislature was forced to adopt numerous program reductions and reforms in the course of the fiscal year. Similarly, the state's deteriorating fiscal condition required the Legislature to make major reductions in baseline expenditures in preparing the annual budgets for 1981–82 and 1982–83.

Some of the anticipated savings from these legislative actions have been delayed, changed or reversed by the courts. Table 80 shows that during 1982–83, court decisions issued since legislative action on the 1982 Budget Act was completed have increased General Fund costs by $400 million, and reduced revenues by $31 million, *for a total negative impact on the state's General Fund of $431 million.* In 1983–84, these decisions will increase General Fund costs by $197 million.

Thus, as a result of the court's actions, even deeper reductions in other program areas will be necessary to keep the budget in balance.

Medi-Cal. The program area most affected by court decisions during the current year is Medi-Cal. Seven decisions will increase 1982–83 costs under the Medi-Cal program by $202.5 million. The one with the largest fiscal impact, handed down in the case *California Hospital Association v. Department of Health Services,* overturned the 6 percent cap imposed by AB 251 (Chapter 102, Statutes of 1981) on the increase in reimbursements for hospital inpatient services.

Three other court decisions have also thwarted the Legislature's effort to reduce the cost of the Medi-Cal program. In *Jeneski v. Myers,* for example, a superior court delayed implementation of drug formulary controls imposed by the Legislature in AB 799 (Chapter 328, Statutes of 1982), one of the Medi-Cal reform bills. Ultimately, the controls were implemented as provided in the legislation. The delay, however, increased General Fund costs by $6.4 million in the current fiscal year.

A court decision in the *Turner v. Woods* case has increased General Fund costs under both AFDC and Medi-Cal. SB 1X (Statutes of 1981) specified that the standard work expense deduction shall be in lieu of mandatory deductions, such as federal and state taxes, when calculating income for purposes of determining AFDC grants. To the extent that AFDC recipients were no longer qualified for aid as a result of this factor, Medi-Cal caseloads would also decline. In July 1982, a U.S. District Court ruled that this treatment of income deductions violated federal law. As a result, $14.1 million of anticipated General Fund savings will not be realized during 1982–83.

PERS Contributions. On February 9, 1983, the court of appeals, in deciding *Valdes v. Cory* overturned Ch. 115/1982, which withheld state employer payments to PERS during the last three months of 1981–82. This decision adds $177.1 million to the current-year General Fund deficit.

Other court decisions, unrelated to recent budget reforms, have had an impact on the General Fund condition. For example:

Principal Insurance Office Deduction. A recent appellate court decision overturned the Board of Equalization's interpretation of when the insurance tax principal office deduction was terminated. In June 1976, the voters adopted a constitutional amendment which repealed this deduction. A companion statutory measure, which took effect almost seven months later, also repealed this deduction. The court ruled, in effect, that the effective date of the statutory measure prevailed. As a result, insurance companies were able to claim this deduction for one additional year, and the state had to pay back $31 million to these insurance companies.

Destruction of Arrest Records. A superior court decision, in the case of *Hooper v. Deukmejian,* essentially voided the self-financing mechanism which the Legislature established in 1975 for the destruction of pre-1976 marijuana arrest records. As a result, the General Fund will have to bear the costs for this program, which are estimated at $1.4 million in 1983–84, and $5.6 million over a four-year period.

Number of Appeals Heard by Courts Likely to Increase

The large number of adverse court decisions on budgetary issues have two important implications for legislative control and priority setting. First, these decisions reflect the increasing difficulties that the Legislature is having in setting priorities through the budget and making its priorities stick during the course of the year. Second, these decisions make it difficult for the Legislature to control expenditures so as to keep the state's budget in balance.

The two problems reinforce each other. To the extent the courts do not allow the Legislature to cut low priority expenditures, the Legislature must reduce higher priority expenditures.

Table 80

Increased General Fund Costs/Revenue Losses Due to Court Decisions and Settlements 1982–83 and 1983–84 (in millions)

	1982–83	*1983–84*
I. *Medi-Cal*		
1. *California Hospital Association v. Department of Health Services*—6 percent hospital reimbursement cap (AB 251)	$175.6	$139.0
2. *Jeneski v. Myers*—drug formulary (AB 799)	6.4	—
3. *Richardson v. Myers*—nonemergency medical transportation (AB 799)	3.7	3.7
4. *Minor v. Myers*—maintenance need levels (AB 799)	5.3	16.3
5. *Turner v. Woods*—AFDC income deductions (SB 1x)	3.2	6.2
6. *Beltran v. Myers*—property transfers	6.5	11.0
7. *Ramos v. Myers*—beneficiary notification	1.4	1.4
8. Other cases	0.4	0.1
Subtotal, Medi-Cal	$202.5	$177.7
II. *Welfare*		
1. *Turner v. Woods*—AFDC income deductions (SB 1x)	$10.9	$13.3
2. *Lowry v. Woods*—costs of child care provided by household members not on AFDC	3.4	1.2
3. *Seibert v. Woods*—AFDC emergency shelter costs	0.2	0.4
4. *Green v. Obledo*—elimination of maximum limit on work-related transportation expenses for AFDC recipients	5.6	–
5. *Farias v. Woods*—placement of foster children with nonparent relations	0.4	2.8
Subtotal, Welfare	$20.5	$17.7
III. *Attorney General*		
1. *Hooper v. Deukmejian*—destruction of marijuana arrest records	—	$1.4
IV. *Insurance Tax*		
1. *California Compensation and Fire Company v. Board of Equalization*—timing of elimination of the principal office deduction	$31.0	—
V. *PERS*		
1. *Valdes v. Cory*—overturned the transfer of surplus reserve funds which were to replace General Fund	$177.1	—
Totals	$431.1	$196.8

Actions to Minimize Adverse Court Decisions

The Legislature could take several steps to minimize the potential for the courts to overturn legislative decisions and thus ensure that the state's expenditure program reflects *its* priorities. These steps include:

1. Defining more explicitly legislative intent in proposed statutes. Legislation containing general intent provisions and measures which delegate policy decisions to the administrative agencies leave more room for the courts to decide how acts of the Legislature should be implemented.
2. Reviewing the procedural requirements which administrative agencies must follow when implementing new statutes. Many of these requirements are designed to prevent precipitative action by administrative agencies. These same restrictions, however, impede the rapid implementation of legislative decisions and thus thwart legislative intent.

Recommendation

Court decisions are playing a bigger and bigger role in determining how—and how much—funds are spent by the state. Traditionally, this has been one of the most zealously guarded powers of the Legislature. ***As a result, we recommend that the fiscal committees of both houses hold oversight hearings on how the process for enacting and implementing legislation can be improved so as to prevent the courts from overturning legislative spending and policy decisions.***

D. THE NEED FOR BETTER BUDGET INFORMATION

How Can the Legislature Improve the Fiscal Information On Which It Is So Heavily Dependent?

Our review of the fiscal information which traditionally has been presented to the Legislature indicates the need for improvements in the timing, accuracy and comprehensiveness of this information. We believe that improvements are necessary and achievable in four specific areas:

(1) The preparation and reporting of *General Fund fiscal forecasts;*
(2) The updating of *revenue estimates for special funds;*
(3) The timely updating and accuracy of budget data in the *California Fiscal Information System* (CFIS); and
(4) The development and updating of information on *state personnel-years.*

1. Improvements in Fiscal Forecasts

We recommend that the Legislature enact legislation requiring the Department of Finance to include specific information in its fiscal forecasts, and to present these forecasts on four separate occasions during each fiscal year.

We believe that the state's current approach to fiscal forecasting has a number of limitations. These shortcomings become especially important when the state is operating close to the "fiscal margin" (that is, without a large General Fund surplus or reserve).

In our opinion, the single most important objective of fiscal forecasting is to provide the administration and the Legislature with the most *current* and *accurate* picture possible of the state's fiscal situation. Only then can the Legislature make informed decisions regarding the budget. The forecasting process should, in a sense, be "built around" the state's budget process, and should provide updated information precisely when the Legislature is making key budgetary decisions. In this way, fiscal forecasting can alert the Legislature promptly to the frequent and often unexpected changes in factors affecting state revenues and expenditures. These factors include new economic developments, revisions in existing economic data which change the economic outlook for the future, updated state revenue and expenditure information, and changes in federal government spending plans.

To achieve this objective, we believe that it is necessary for the Department of Finance to:

- Present *additional estimates* of revenues, expenditures, and the General Fund condition at *specified points in time;*
- Regularly prepare, in addition to the current-year and budget-year

fiscal estimates, *forecasts for the four-year period* following the budget year;
- Develop these forecasts in an *appropriate amount of detail,* including an itemization of specific *economic assumptions* and possible *error margins;* and
- Submit similar fiscal estimates for *alternative economic assumptions,* for the purpose of showing the *sensitivity* of the state's projected fiscal outlook to differing economic developments.

In some of these areas, the department already has taken steps to improve its reporting. During 1982, for example, it provided revised General Fund fiscal estimates in March and November, in addition to the normal May revision. In other areas, however, improvements are still needed. For example, the Governor's Budget for 1983–84 provides no long-term fiscal perspectives. There is no forecast of revenues beyond the budget year, nor any information on how projected expenditure trends beyond the budget year relate to projected trends for revenues.

To remedy these deficiencies in the forecasting process, we recommend that the Legislature enact legislation requiring the department to produce the four categories of information listed above. Specifically, we believe that legislation should be enacted containing the following provisions:

Timing of Forecast Revisions. In addition to the regular January and May estimates, the Department of Finance should provide fiscal forecasts at three other points in time: (a) in *early March* (when new data pertaining to the national economy and the federal budget are available); (b) in *early August* (following legislative and executive action on the budget, after state ballot measures have been decided in the primary election, and prior to legislative action on fiscal legislation; and (c) in *November* (after the books have been officially closed on the preceding fiscal year, so that the surplus estimates can be adjusted for revenue and expenditure revisions and fiscal legislation). These additional forecasts would not necessarily require the preparation of estimates from the "ground up", as is done for the January and May forecasts. In many cases, the Legislature's needs could be met if Finance simply provided *updates,* reflecting only the most relevant adjustments to the basic estimates. For example, the March update could selectively incorporate such factors as the effects on various state programs of changes in the proposed federal budget, cash flow developments, and new or revised economic data.

Causes for Revisions in Fiscal Forecasts. The Department of Finance should routinely prepare and publish an itemized list of the factors responsible for any change in the estimated year-end General Fund balance. Specifically, this report would *separately* identify any changes to the surplus estimates resulting from the following factors: changing economic conditions (including explicit reference to the forecasts for specific economic variables); changes in the underlying relationships between tax collections and economic conditions; cash-flow patterns in both the revenue and expenditure areas; actions by the Legislature; actions by the executive branch; actions by the judicial branch; and changing participation rates in entitlement programs.

This report would provide data similar to information currently published by the Office of Management and Budget, the Congressional Budget Office, and the Office of Tax Analysis (U.S. Department of Treasury) in their reports on federal government expenditures and revenues.

(See for example, *A Review of the Accuracy of Treasury Revenue Forecasts, 1963–1978,* Congressional Budget Office, U.S. Congress, February 1981.)

The Degree of Uncertainty Surrounding Fiscal Estimates. The Department of Finance should routinely provide the Legislature with more complete information about the degree of uncertainty surrounding its fiscal estimates. This might include providing estimates of the range within which the year-end General Fund balance will most likely fall, given economic forecasting uncertainties and error margins associated with the particular statistical estimating techniques being employed. It should also include information on the sensitivity of surplus estimates to changes in the rates of inflation, employment growth, and personal income growth, as well as to the approval of pending ballot measures and major financial legislation.

Alternative Fiscal Forecasts. The department should regularly prepare fiscal estimates, particularly for revenues, based on the economic scenarios envisioned by various *other* forecasters. These other forecasters could include the major California banks, leading econometric models (e.g., Chase Econometrics, Data Resources, and UCLA), and the federal authorities (e.g., Office of Management and Budget, Council of Economic Advisors, and Congressional Budget Office). The effect of "less likely" although still "realistically possible" economic scenarios should also be considered. One such possible scenario might be a recession which, although not actually predicted by any individual forecaster, is felt by many forecasters to have at least a 30 percent chance of occurring.

We believe that these steps would significantly improve the fiscal forecasting process in California and the ability of the Legislature to make informed decisions regarding the budget.

2. Special Funds Revenue Estimates

We recommend that legislation be enacted to require the Department of Finance to present updated estimates of major special funds revenues concurrent with the presentation of updates for General Fund revenues during the fiscal year.

In past years, the Department of Finance has generally provided a comprehensive estimate of special funds revenues only once a year—in January, as part of the Governor's Budget. As discussed in Part II, however, special funds revenues have played an important role in financing the General Fund budget in 1981–82, 1982–83, and 1983–84. Especially important has been the use of monies from two sources—the Motor Vehicle License Fee Account in the State Transportation Fund, and tidelands oil revenues. Because of this increased reliance on special funds revenues to help solve General Fund budget problems, and the fact that special funds revenue estimates are subject to the same forecasting errors as are General Fund revenue estimates, special funds revenue estimates for the major sources should be updated frequently.

Accordingly, we recommend that the department be statutorily required to present updates of the major special funds revenues several times each year. These revisions should be made at the same time that the department's General Fund revenue revisions are made. By having more timely estimates of special funds revenues, the Legislature will be in a better position to make decisions regarding the overall funding of state expenditures.

3. The California Fiscal Information System Needs Timely Budget Data

The California Fiscal Information System (CFIS) is intended to (a) provide a centralized fiscal and program data base for forecasting, modeling, and revenue monitoring of the state's budget, and (b) improve the availability of state expenditure and program performance data. In attempting to utilize CFIS, we have found three areas where improvement of the system could lead to better and more accurate information on which to base legislative policy decisions. They are (a) the timely updating of expenditure data, (b) the timely updating of the legislative information system, and (c) the presentation of summary by object data in a format which reflects the source of funds.

a. Budget Information

We recommend that supplemental report language be adopted directing the Department of Finance to update CFIS General Fund and special fund budget data for the prior year, current year, and budget year immediately following published revisions of expenditure data by the Department of Finance in May and November.

Budget data contained in CFIS could be used for two distinct purposes: analysis of historical trends in state expenditures and analysis of current-year and budget-year expenditures. Unfortunately, the data contained in CFIS are not updated during the fiscal year to reflect revisions in expenditure data published by the Department of Finance, or to reflect legislative action on the budget or other legislation. Due to these problems, CFIS is not capable of providing assistance in questions involving an up-to-date analysis of expenditures, which is one of the primary reasons the Legislature authorized the system in the first place. Accordingly, we recommend adoption of the following supplemental report language:

"The Department of Finance shall update CFIS General Fund and special fund budget data for the prior year, current year and budget year (when applicable), immediately following published revisions of expenditure data in May and November."

b. Legislative Information System

The CFIS Legislative Information System (LIS) is designed to produce up-to-date information on the location and fiscal effect of all legislation. Until recently, this system worked independently of the legislative tracking system used by the Department of Finance to prepare its annual financial legislation report. As a result of maintaining two parallel, yet distinct systems, fiscal estimates for legislation in one system often differ from the estimates entered in the other. The reconciliation of these two systems is a time-consuming process, and prevents the Legislature and the executive branch from relying on LIS for accurate up-to-date information.

Recently, the Department of Finance has taken steps to integrate these two systems as a means of avoiding the reconciliation problem and providing more accurate information on the fiscal effects of legislation.

Our analysis of the LIS, however, indicates that there is another problem which the system integration project will not resolve. Entries to the system often lag two to three days behind actions taken by the Legislature. This again results in the inability of the Legislature to rely on LIS for accurate, up-to-date information, particularly toward the end of the session. Accordingly, *we recommend that the Department of Finance act to insure the timeliness of information contained in the CFIS Legislative Information System.*

c. Summary by Object, by Fund Source

We recommend that supplemental report language be adopted directing the Department of Finance to include in CFIS expenditure data a summary by object schedule, categorized by funding source.

The Governor's Budget contains a schedule of expenditures, summarized by object, for each item. The schedule details operating expense and equipment expenditures, such as travel, data processing, and consultant services. In addition, it provides detailed information on each department's personal services, including positions, workload adjustments and salary savings. This object schedule, however, is not categorized by funding source. Thus, the system cannot be used to determine how much the *General Fund* is spending for statewide travel or consultant services—questions frequently asked by the Legislature.

It is our understanding that the Department of Finance has recently begun to categorize expenditures for operating expenses and equipment by funding source. So that the Legislature may have better information on which to base its decisions, we recommend that personal services also be categorized by funding source, and that the entire summary by object, categorized by funding source, be available on CFIS. Accordingly, we recommend the adoption of the following supplemental report language:

"The Department of Finance shall include, in CFIS expenditure data, a schedule categorizing objects of expenditure, including personal services, by funding source."

4. More Information Needed on State Personnel-Years

We recommend the adoption of a new control section in the 1983 Budget Act requiring the Department of Finance to publish the total number of personnel-years and estimated salary savings for each department and agency periodically during the year.

As we discuss in Part I of this document, the Legislature encounters great difficulty in tracking the number of state employees during the budget year. Once the Governor proposes his budget, there are four ways in which the proposed number of state personnel-years may be changed. First, the Governor may amend his proposal through the submission of a Department of Finance budget amendment letter. As a result, the number of state employees (personnel-years) proposed by the Governor invariably will differ from the number shown in the printed budget document. For example, our analysis indicates that the previous Governor submitted amendment letters to his original 1982–83 budget which increased the proposed number of personnel-years by 1,152.

Second, the Legislature may alter the number of personnel-years through its actions on the state budget. In 1982–83, for example, the Legislature reduced the number of personnel-years requested by the Governor by 1,505.

Third, after the Budget Bill is adopted, the executive branch may make changes in the number of state personnel by administratively establishing positions without legislative review. In most cases, the Department of

Finance will notify the Joint Legislative Budget Committee of these changes. This is not true, however, of all administratively established positions.

Finally, changes in employment will occur naturally due to vacant positions, leaves of absences, and delays in filling new positions. Because these vacancy factors are reflected in estimates of salary savings in the original Governor's Budget, the total number of personnel-years is affected only by the difference between these estimates and the actual level of salary savings realized.

Table 81
Changes in Personnel-Years
From Proposed Amounts to Actual Levels
1980–81 to 1982–83

	1980–81	*1981–82*	*1982–83*
Governor's Proposal [a]	221,117.8	226,743.3	231,375.3
Budget As Enacted [b]	221,158.0	225,984.0	231,022.3
Difference	40.2	−759.3	−353.0
Midyear Revision [a]	226,473.3	229,099.5	233,386.7
Change from Budget as Enacted	5,315.3	3,115.3	2,364.4
Actual [a]	225,567.4	228,813.4	— [c]
Change from Budget as Proposed	4,449.6	2,070.1	— [c]
Change from Budget as Enacted	4,409.4	2,829.4	— [c]
Change from Midyear Revision	−905.9	−286.1	— [c]

[a] Source: Governor's Budgets.
[b] Source: Department of Finance.
[c] 1982–83 actual will not be available until the submission of the Governor's 1984–85 Budget.

Table 81 compares the number of personnel-years originally approved by the Legislature with the *actual* number of personnel-years, for the last two years. It also shows the number approved by the Legislature and mid-year estimate for the current year. In each year, the actual number (midyear revision) is significantly higher than the number approved by the Legislature. For example, in 1981–82, actual personnel-years were 2,829 higher than the number approved. Part of this difference may be due to the effects of legislation enacted after the budget. The major portion of the increase, however, is attributable to administratively established positions and to revisions in salary savings estimates. The magnitude of these subsequent changes may indicate that the administration has more flexibility over the number of state employees than the Legislature intends.

To facilitate greater legislative control over the number of state employees, we recommend the establishment of a Control Section to require publication of an updated estimate of the total number of personnel-years four times during each fiscal year. This recommendation, along with proposed language, is also discussed in our analysis of general control sections (please see the concluding section of the *Analysis* "Analysis and Recommendations with Respect to General Control Sections".)

VI. EMERGING ISSUES

A. THE IMPACT OF REFUGEES ON CALIFORNIA

How Is the Influx of Refugees Affecting the State's Budget?

During the last few years, California has experienced a significant influx of refugees from around the world. Although since the end of the Vietnam war the majority of the refugees have come from Indochina, others have come from such diverse places as Cuba, Africa, and the Soviet Union. The large influx of refugees has led to considerable additional pressure on state and local resources and services, particularly medical services, cash assistance, education, and social services, as discussed below.

California has not been able to exert much control over the influx of refugees or the resulting impact of this influx on state and local programs and expenditures because immigration quotas and placement arrangements reflect decisions made by the federal government. In addition, the federal government limits the amount of funds it makes available for the support of refugees.

California's Disproportionate Share of Refugees

According to estimates prepared by the Department of Finance (DOF), as of October 1982 there were a total of 297,000 refugees living in California. Of this total, 230,000, or 77 percent, were Indochinese refugees; 54,000, or 18 percent, were non-Indochinese refugees; and 15,000, or 5 percent, were Cuban/Haitian entrants who did not have refugee status.

As regards the Indochinese refugees, California has a disproportionate share of the total residing in the United States. For example:

- California's Indochinese refugee population is larger than that of the eight states with the next largest Indochinese refugee populations *combined.*
- California has more Indochinese refugees per capita than any other state, and twice as many as Texas, which has the second highest per capita concentration of this immigrant group.
- There are more Indochinese refugees living in Los Angeles County than in any state in the union, and more in Orange County than in any state except Texas.

Within California, Indochinese refugees are concentrated in a few counties. Eighty-two percent of the Indochinese refugees live in the five counties of San Francisco, Orange, Santa Clara, San Diego, and Los Angeles, yet these counties make up only 56 percent of the state's total population.

Federal Support of Refugees

Federal policy recognizes that many refugees will require specialized services and support upon their arrival in this country and for a period of time to follow. These services include cash and medical assistance, social services, and educational assistance. Cash assistance consists of cash grants provided through various programs, such as Aid to Families with Dependent Children (AFDC). Medical assistance includes medical care provided through the Medi-Cal program. There are a wide range of social services available to refugees, including In-Home Supportive Services and child welfare services. Educational services encompass such programs as bilingual education and community and social orientation.

Table 82 shows the amount of federal funds budgeted for support of services provided to refugees in 1982–83 and 1983–84. As the table shows, federal support of $374.6 million is anticipated for services to refugees in 1983–84. This is $30.8 million, or 7.6 percent, *less* than current-year federal expenditures. This decrease reflects a reduction in the number of refugees on aid who are eligible for 100 percent federal funding.

Table 82
Federal Funds for Support of Refugees
1982–83 and 1983–84
(in thousands)

	Estimated 1982–83	*Proposed 1983–84*	*Change Amount*	*Change Percent*
Cash and Medical Assistance	$380,051 [a]	$349,634 [a]	−$30,417	−8.0%
Social Services	17,700	17,300	−400	−2.3
Education	7,710	7,715	5	0.1
Totals	$405,461	$374,649	−$30,812	−7.6%

[a] Does not include the federal costs of medical assistance for refugees who have been in this country for 36 months or more.

Federal Funds for Cash and Medical Assistance are Limited

The amount of federal funds available for the cash and medical assistance costs of a refugee depends on the length of time the refugee has been in this country. The federal government pays 100 percent of these costs for refugees who have been in this country for less than 36 months (referred to as "time-eligible"). The federal government, however, pays only a part of the cash and medical assistance costs of refugees who have been in this country 36 months or longer (referred to as "time-expired").

Cash assistance is available to time-eligible and time-expired refugees through the following programs:

- ***Aid to Families with Dependent Children (AFDC).*** The AFDC program provides cash grants to children and their parents or guardians whose income is insufficient to meet their basic needs. Eligibility is limited to families with children who are needy due to the death, incapacity, or continued absence or unemployment of the parents or guardians.
- ***Supplemental Security Income/State Supplementary Payment (SSI/SSP).*** The SSI/SSP program is a federally-administered program which is jointly funded by the federal and state governments, under which needy and eligible aged, blind, and disabled persons receive financial assistance.
- ***Refugee Cash Assistance (RCA).*** The Refugee Cash Assistance program provides cash grants to refugees who meet the income and need requirements of the AFDC program but who are ineligible for AFDC payments due to household composition (for example, the family has no absent or incapacitated parent). Only time-eligible refugees qualify for this program.
- ***County General Assistance.*** Needy California residents, including refugees, may receive aid through county general assistance programs. Eligibility criteria for these programs are established by each county.

Table 83 shows the number of time-eligible and time-expired refugees receiving aid in 1982–83 and 1983–84, under each of California's four cash assistance programs.

Table 83
Refugees Receiving Aid
Time-Eligible and Time-Expired
1982–83 and 1983–84

	1982–83	*1983–84*	*Change* *Amount*	*Percent*
Time-Eligible:				
AFDC	96,576	73,567	−23,009	−23.8%
SSI/SSP	8,074	5,986	−2,088	−25.9
Refugee Cash Assistance	15,595	12,042	−3,553	−22.8
General Assistance	5,895	3,983	−1,912	−32.4
Subtotals	126,140	95,578	−30,562	−24.2%
Time-Expired:				
AFDC	32,392	68,692	36,300	112.1%
SSI/SSP	2,637	5,882	3,245	123.1
General Assistance	3,114	7,282	4,168	133.9
Subtotal	38,143	81,856	43,713	114.6%
Totals	164,283	177,434	13,151	8.0%

Table 83 shows that:

- Approximately 177,400 refugees will receive some form of cash assistance in 1983–84. This is an 8.0 percent increase over the number of refugees receiving assistance in the current year.
- Of the 177,400 refugees on aid, approximately 142,300 (73,600 time-eligible and 68,700 time-expired) are receiving AFDC payments. As a result, refugees will make up 8.9 percent of the state's total AFDC caseload (1,601,459) in 1983–84.
- The number of refugees who are eligible for 100 percent federal funding will decrease in 1983–84, as increasing numbers of refugees reach their 36th month in this country. Accordingly, the number of time-expired refugees will increase significantly—by 115 percent—between 1982–83 and 1983–84.

Fiscal Impact on California of Limited Federal Funds

As a result of the 36-month time limit on federal funds, state and local costs for cash assistance will increase significantly between 1982–83 and 1983–84. Table 84 shows the costs of cash assistance provided to time-expired refugees in the current and budget years. The table shows that:

- General Fund costs for cash assistance to time-expired refugees will total $60.9 million in 1983–84, an increase of $31.3 million, or 106 percent above the current year.
- County costs will total $26.3 million in 1983–84, an increase of 126 percent over 1982–83.

The expenditures shown in Table 84 understate the total costs to the state and local governments because it does not include the cost of medical assistance provided to time-expired refugees. Because of the time limit on 100 percent federal funding, state and county costs will continue to increase in 1984–85 and beyond.

Table 84
Costs of Cash Assistance
For Time-Expired Refugees
1982–83 and 1983–84
(in thousands)

Program/Funding Source	*Estimated 1982–83*	*Proposed 1983–84*	*Change Amount*	*Change Percent*
1. AFDC [a]				
a. General Fund	$23,714	$48,972	$25,258	106.5%
b. County Funds	6,235	13,574	7,339	117.7
c. Federal Funds	25,829	56,215	30,386	117.6
Subtotals, AFDC	$55,778	$118,761	$62,983	112.9%
2. SSI/SSP				
a. General Fund	$5,874	$11,903	$6,029	102.6%
b. Federal Funds	7,865	18,758	10,893	138.5
Subtotals, SSI/SSP	$13,739	$30,661	$16,922	123.2%
3. General Assistance County funds	$5,437	$12,753	$7,316	134.6%
Totals	$74,954	$162,175	$87,221	116.4%
General Fund	*$29,588*	*$60,875*	*$31,287*	*105.7%*
County Funds	*$11,672*	*$26,327*	*$14,655*	*125.6%*
Federal Funds	*$33,694*	*$74,973*	*$41,279*	*122.5%*

[a] Includes grant and administrative costs.

Delays in Federal Funding to Pay for Refugee Cash and Medical Assistance

California has experienced significant delays in receiving federal funds for refugees whose cash grants and medical assistance are eligible for 100 percent federal support. Each quarter, the federal government advances refugee funds to the state based on a federal projection of eligible state spending during the upcoming quarter. The first quarterly advance to California for federal fiscal year (FFY) 1982 was received on November 10, 1981—more than half way through the first quarter of FFY 82. Subsequent advances were made in a more timely fashion, but were in amounts far less than the state's actual expenditures. As of December 31, 1982, California had submitted bills to the federal government totaling $281.4 million for cash and medical assistance for refugees during FFY 82. Of this amount, the federal government had paid $240.5 million, or $40.9 million, less than the amount billed. California is the only state which has not yet received an allocation sufficient to meet 100 percent of estimated expenditures for FFY 82.

Thus, at a time when California is facing a cash-flow crisis that is unprecedented in modern times, it is having to make interest free loans to the federal government from the General Fund.

Whenever the federal government fails to advance refugee funds in a timely manner, the state must temporarily use General Fund monies to pay the costs of cash and medical assistance provided to time-eligible refugees. This temporarily reduces the General Fund balances available for spending for other General Fund programs or for short-term investment. We estimate that the federal delays in advancing federal funds during FFY 82 resulted in a loss of $1.9 million in potential General Fund interest earnings.

In a letter dated November 2, 1982, the Secretary of the federal Department of Health and Human Services informed the Governor of California that no additional funds would be granted to California for expenditures made by the state during FFY 82 until the completion of an audit of the state's claim for the remaining $40.9 million. Normally, such audits are conducted after payments are made and any portion of the claim disallowed is repaid by the state. The Secretary's decision therefore casts some doubt as to whether the state will be fully reimbursed for costs incurred in FFY 82. Future delays, or even shortfalls, in federal funds seem likely. For example, as of December 31, 1982, California had yet to receive refugee funds adequate to pay for estimated spending during the first quarter of FFY 83.

There is nothing that the Legislature can do either to limit the number of refugees for which it bears a financial responsibility, or require the federal government to provide funds on a timely basis on behalf of those for which it is responsible. In our analysis of the State Supplementary Payment (SSP) Program *(Item 5180-111-001)*, we recommend adoption of Budget Bill language requiring that General Fund monies not be expended when the federal government fails to advance sufficient refugee funds on a timely basis.

B. WORK FOR BENEFIT PROGRAMS

Does "Workfare" Offer a Means to Increase Welfare Recipients' Earnings and Employment or Reduce State Costs?

Introduction

Work-for-benefit programs (referred to as workfare) require employable public assistance recipients to perform public service work without pay as a condition of eligibility for assistance. The purposes of such programs are many—to provide needed public services to the community, to provide on-the-job training and work experience for public assistance recipients, and to reduce the cost of welfare by enhancing the employability and earning power of recipients and by discouraging employable individuals from seeking assistance in the first place.

Workfare programs have existed in a number of states for over forty years. State and local agencies providing general relief to indigents have often required recipients to provide labor to public agencies as a condition of receiving cash assistance. Until recently, however, federal law prohibited establishment of workfare requirements for recipients of Aid to Families with Dependent Children (AFDC) or food stamps.

In 1971, Congress authorized demonstration projects for AFDC workfare. Several states, including California, established workfare programs under this authority. California's program, known as the Community Work Experience Program (CWEP), operated in 35 counties from 1972 to 1975. The Food Stamp Act of 1977 authorized local jurisdictions to operate food stamp workfare demonstration projects. Seven projects were established nationwide between July 1979 and November 1980, and an additional 14 projects, including one in San Diego County, were implemented in January 1981.

In 1981, Congress expanded its previous authorization and enacted legislation allowing states, at their option, to establish *statewide* workfare programs. The Omnibus Budget Reconciliation Act of 1981 (P.L. 97-35) permits states to establish workfare programs for recipients of AFDC. This program, like California's 1972–75 effort, is known as the Community

Table 85
Comparison of Program Structure WIN and CWEP (AFDC Workfare)

	WIN	CWEP
A. State Participation	Mandatory	Optional
B. Program Scope	Statewide or selected areas. 41 counties currently participate.	Statewide or selected areas.
C. Client Participation	Mandatory for all AFDC recipients and applicants in participating counties.	Mandatory for AFDC recipients only in participating counties.
	Exemptions:	*Exemptions:*
	1. Clients under age 16, over age 64.	1. Same.
	2. Clients age 16 to 19, if attending high school or secondary vocational education.	2. Same.
	3. Clients who are ill or disabled.	3. Same.
	4. Clients who are caring for an incapacitated member of the household.	4. Same.
	5. Parents of children under age 6 who provide full-time care.	5. Parents of children age 3 or under or under age 6 if no child care is available.
	6. Clients who work at least 30 hours per week in unsubsidized employment.	6. Clients who work at least 80 hours per month and earn at least minimum wage.
	7. Clients who are geographically remote from a WIN site.	7. Clients for whom AFDC grants would be less than $10 per month.
D. Client Responsibilities/ Available Services	Nonexempt participants must register for work, conduct a job search and accept suitable employment. Available services include job search assistance, on-the-job training (OJT), work experience, public service employment (PSE), and child care.	Nonexempt participants must work off AFDC benefits by providing public service work to a public or private nonprofit agency. Maximum monthly hours equal to monthly family grant divided by minimum wage. Federal law does not require states to provide any training or supportive services.
E. Wages/Benefits	*Wages:* Participants enrolled in OJT or PSE must receive at least minimum wage. If income disregard is not available, monthly wages must be at least as much as the monthly AFDC grant the participant would be entitled to receive.	*Wages:* None.
	Other Benefits: Job search expenses, work experience and training allowance (up to $30 per month), and relocation assistance.	*Other Benefits:* Client expenses (such as transportation and child care), up to $25 per month, and worker's compensation.
F. Noncompliance: Sanctions/Definitions	*Noncompliance:* Refusal to register or to accept suitable employment.	*Noncompliance:* Refusal to interview or to accept work assignment.
	Sanction: Loss of parent's share of AFDC grant for 3 months (first occurrence) or 6 months (subsequent occurrences).	*Sanction:* Same as WIN.
G. Funding	Federal funds cover 90 percent of program costs, including training, supervision, materials, administration, day care, and transportation. No federal funds for participant wages (except PSE).	Federal funds cover 50 percent of AFDC administrative and participant reimbursement costs (up to $25 per month). No federal funds for capital outlay, equipment, materials, or supervision of participants.

Work Experience Program (CWEP). (Hereafter, CWEP denotes the national program, unless otherwise indicated.) In addition, the Food Stamp and Commodity Distribution Amendments of 1981 (P.L. 97-98) authorizes states to establish workfare programs as a component of the Food Stamp program.

Through 1982, 23 states had established workfare programs authorized by P.L. 97-35 in at least one county. Six of these states—Idaho, Ohio, Oklahoma, West Virginia, Vermont, and Iowa—have chosen to establish the program statewide. In California, one county—San Diego—has established a CWEP demonstration project (September 1982) in conjunction with its state-funded Employment Preparation Program (EPP). (EPP provides job-search assistance and supportive services to AFDC applicants and recipients in selected counties throughout the state.)

Structure of Current Work Programs and Workfare Programs

The federal government currently requires the state to participate in two work programs for public assistance recipients. The Work Incentive (WIN) program provides job-search assistance, training, and supportive services to AFDC recipients and applicants, within the limits of the funding available. As a result, not all eligible clients receive employment-related services. The Food Stamp Recipient Registration program provides job-search assistance to food stamp recipients.

Table 85 displays the current structure of WIN, and compares it to the structure of the optional AFDC workfare program, CWEP. The most significant differences between WIN and CWEP are as follows:

- State participation in WIN is mandatory; CWEP is a state option.
- Nonexempt participants in WIN are required to register for work and accept suitable employment; those in CWEP are required to work without pay as a condition of eligibility.
- Federal funds cover 90 percent of WIN services, including training and supportive costs; federal funds cover 50 percent of CWEP administrative costs and participant costs of up to $25 per month, but do not cover training, supportive services, or supervision.

Table 86 shows the current structure of the Food Stamp Recipient Registration program and compares it to the structure of Food Stamp workfare. Food Stamp workfare is similar to CWEP because (1) it is an optional program, (2) it requires participants to work for their food stamp benefits, and (3) the federal government supports 50 percent of the program's administrative expenses.

Issues in Designing Workfare Programs

If the Legislature elects to establish either CWEP or Food Stamp workfare, it will be faced with a number of choices regarding the design of the programs. While federal regulations establish various requirements for client participation, work requirements, services, and funding of these programs (see Tables 85 and 86), the state retains some legislative and administrative flexibility, as summarized below.

Program Scope. The state may select participating counties for CWEP, although county cooperation is a practical prerequisite for successful implementation. Counties may establish their own Food Stamp workfare programs independent of the state.

Table 86
Comparison of Program Structure
Food Stamp Registration and Food Stamp Workfare

	Food Stamp Registration Program	*Food Stamp Workfare*
A. State Participation	Mandatory.	Optional.
B. Program Scope	Statewide or selected areas. 14 counties in California currently participate.	Statewide or selected areas. Local jurisdictions may establish program without state initiative.
C. Client Participation	Mandatory for all Food Stamp recipients in participating counties *Exemptions:*	Mandatory for all Food stamp recipients in participating counties. *Exemptions:*
	1. Clients under age 18 or over age 59.	1. Same.
	2. Students enrolled at least one-half time in school, training programs, or higher education.	2. Same.
	3. Unemployable due to physical or mental disability.	3. Same.
	4. Parent of child under age 6, or between ages 6 and 12 if no child care is available, or between ages 12 and 18 if another parent is registered for work or employed.	4. Same.
	5. Caretakers of incapacitated persons.	5. Same.
	6. Clients working at least 30 hours per week, or earning at least $100.50 per week.	6. Same.
	7. Regular participants in drug addiction or alcohol rehabilitation program.	7. Same.
	8. AFDC recipients participating in WIN.	8. Same unless client is enrolled in WIN training less than 20 hours per week.
	9. Clients receiving unemployment compensation benefits.	
D. Client Responsibilities/ Available Services	Nonexempt participants must register for work, conduct a job search, and accept suitable employment. Services are limited to job search assistance.	Nonexempt participants must work off food stamp benefits by providing public service work to a public or private nonprofit agency. Maximum monthly hours equal to monthly value of food stamps divided by minimum wage. Total hours, including CWEP hours, may not exceed 30 hours per week.
E. Wages	N/A. No training or employment services provided.	None.
F. Noncompliance: Sanctions/Definitions	*Noncompliance:* Refusal to register for work or accept suitable employment.	*Noncompliance:* Refusal to interview or to accept work assignment. Any eligible household member may complete the work obligation of another member.
	Sanction: Loss of entire household's food stamps for 2 months	*Sanction:* Same.
G. Funding	100% federally funded.	Federal funds cover 50 percent of administrative costs, including transportation and participant expenses (up to $25 per month). No federal funds for site equipment, training, materials, or supervision of participants.

Client Participation. State flexibility is limited to the exemption of clients in nonparticipating counties. Federal law specifies requirements for participating jurisdictions.

Work Assignments. State and local governments have discretion over most types of work assignments. Federal law, however, prohibits states from assigning workfare participants to jobs which (1) displace regular agency employees, (2) involve participation in political activities, (3) require unreasonable commute distances, or (4) violate labor agreements or health and safety standards.

Training and Supportive Services. Although state and local governments can provide training and supportive services to workfare participants, federal funding is not available for these purposes.

Funding. States are required to provide a 50 percent match for the administrative costs associated with workfare programs. The state must determine the extent to which local governments will share in these costs.

Effect of Similar Funding Arrangement on California CWEP. Like the national workfare program authorized in P.L. 97-35, the California CWEP program, which operated in 35 counties from 1972 to 1975, provided no financial assistance to counties and special districts for many costs they incurred in administering the program. For example, counties were not reimbursed for their costs related to training and supervision of CWEP participants, for purchasing additional equipment, or for providing required worker's compensation coverage to CWEP participants. These costs were an important factor in many counties' refusal to participate in the program, and in other counties' decisions to delay participation.

Effectiveness of Workfare Programs

The effectiveness of workfare programs is a controversial issue. Proponents assert that workfare programs provide needed work experience and training for welfare recipients, and discourage employable recipients from applying for aid. The result, they argue, has been to enhance welfare recipients' earning power, to reduce their dependence on aid, and to reduce the cost of public assistance. Opponents of workfare have criticized the program on grounds that it is used to punish and harass welfare recipients by forcing them into performing menial tasks in make-work jobs with no training or supervision. They argue further that workfare programs do not reduce welfare caseload or expenditures.

In actual practice, workfare programs have varied considerably in their primary objective, program design, and in the attitude of program administrators toward welfare recipients. As a result, individual examples can be found to support the assertions of both workfare's proponents and its critics.

Research on workfare programs is limited, and some of the available research suffers from methodological and data collection problems. Nevertheless, a discussion of the available literature on workfare may prove useful to the Legislature in considering this important policy issue. To provide a basis for such a discussion we examined evaluation research covering four workfare programs—the California Community Work Experience Program (California CWEP), the Food Stamp Workfare Demonstration Projects, the Utah Work Experience and Training Program (Utah WEAT), and the Massachusetts Work Experience Program (Massachusetts WEP)—as discussed below.

California CWEP. This program was established by the state Welfare Reform Act of 1971, and operated from 1972 to 1975 in 35 counties. The program design was similar to the CWEP program established by P.L. 97-35. We primarily examined an evaluation of the program prepared by the Employment Development Department (EDD), dated April 1976.

Food Stamp Demonstration. We examined an evaluation of the seven Food Stamp workfare demonstration projects published by the U.S. Department of Agriculture in June 1982, as well as an evaluation of San Diego County's program published by the county's Department of Social Services in September 1982.

Utah WEAT. This program was established in 1974. All able-bodied general assistance and AFDC clients in Utah's WIN unassigned recipient pool were required to work without pay for up to 96 hours per month. We reviewed an evaluation of this program conducted by the federal Department of Health, Education and Welfare in 1978.

Massachusetts WEP. This program was established in January 1978 and operated for 15 months. Technically, it was a WIN work experience demonstration project, not a workfare program. Nevertheless, its overall program design is similar to CWEP programs. We reviewed an evaluation of the program published by Brandeis University in October 1980, under contract with the U.S. Department of Labor.

In judging the performance of these four workfare programs, we focused on findings with respect to two broad issues—the impact of workfare on participants' employability and earning power, and the impact of workfare on welfare caseloads and costs.

Impact on Participant Employability and Earnings

Of the four evaluations we examined, only two—Food Stamp Demonstrations and Massachusetts WEP—collected and analyzed data regarding program impact on participants' employability and earning power. Table 87 summarizes these research findings.

Table 87

Effectiveness of Selected Workfare Programs
Impact on Participant Employment and Earnings

Program	*Employment*	*Earnings*
A. California CWEP	No data.	No data.
B. Food Stamp Workfare Demonstration Projects	Males—significant decrease in frequency of employment compared to control group. Females—significant increase in frequency of employment compared to control group.	No significant effect on wages. Because of effects of less frequent employment, total earnings of males were $152 less over a three-month period compared to the control group. Because of effects of more frequent employment, total earnings of females were $186 more over a three-month period compared to a control group.
C. Utah WEAT	No data.	No data.
D. Massachusetts WEP	No statistically significant effect on employment. 63 percent of participants had entered employment within 9 months after participation, as did 57 percent of nonparticipants.	No significant effect on wages or earnings.

The effect of these two workfare programs on the participants' employability and earning power was not significant. In the first year of the Food Stamp demonstration projects, the earnings of men actually declined after leaving workfare, compared to those in control groups. Women's earnings increased slightly, due to more frequent employment, but the average wage of both men and women was unchanged. In the Massachusetts Work Experience Program, there was no significant impact on the frequency of the participants' employment compared to that for a control group, and no significant impact on average earnings.

The absence of a significant positive impact on employment and earnings is not unexpected, given that the majority of workfare programs have placed participants in low-skill jobs with minimal training and supervision. In the Food Stamp workfare program, the primary jobs held by participants were in the clerical, maintenance and groundskeeping, laundry, and child care areas. In the Massachusetts WEP, 65 percent of the jobs were of the type that required minimal skills, such as janitorial and park maintenance positions.

Impact on Welfare Caseload and Costs

Reductions in AFDC and Food Stamp caseload and benefit payment costs attributable to workfare could reflect two separate factors:

1. For nonparticipants, workfare could establish a "deterrent" effect. Employable individuals would find the work requirement unattractive, and would be discouraged from applying for aid.

2. For workfare participants, increases in employment due to enhanced vocational and job-seeking skills could result in grant termination or reduction. Also, application of sanctions for failing to comply with program requirements would result in the loss or reduction of benefits.

Deterrent Effect. The question of whether workfare deters employable individuals from seeking public assistance is largely undocumented in available research. If workfare assignments consist of menial jobs without training or supervision, then participation may in fact be unattractive. The opposite effect is also possible. If a workfare program is operated in conjunction with training programs, then applying for aid may actually become attractive for some individuals who might not apply otherwise.

Participation Rates Limit Potential Caseload Impact. Table 88 shows that the level of participation in workfare programs has been very low. For example, in 1975, 8 percent of AFDC recipients in participating counties were eligible for the California CWEP program. Of this number, however, only 2.6 percent of the participants were actually placed in work assignments. In San Diego County's Food Stamp workfare program in 1981–82, 6 percent of the county's Food Stamp heads of households were affected by workfare registration, and 38 percent of those were actually assigned to work. During a 6-month period, 5.1 percent of the AFDC caseload was subject to the Utah WEAT program, and 44 percent of these persons were assigned to work. In Massachusetts, 2.5 percent of AFDC heads of household were subject to the WEP program in a 15-month period and 13 percent of those were assigned to work.

With such low participation rates, the potential effect of workfare programs on total caseload and costs cannot be large. Even if workfare participants were more successful in finding employment than nonparticipants (which, according to these studies, they are not), the absolute number of AFDC and Food Stamp recipients going off aid or having their grants reduced would not be large in relation to the total number of AFDC and

Food Stamp recipients at any one time. Also, even though workfare programs have applied financial sanctions more frequently than work registration programs, the absolute number of persons having their grants terminated or reduced would not be large.

Table 88
Participation Rates in Selected Workfare Programs

Program	Number of Public Assistance Recipients	Recipients Eligible for Workfare		Program Participants Actually Assigned to Work	
		Number	Percent	Number	Percent
A. California CWEP (1975)	2,277,000	183,000	8.0%	5,700	2.6%
B. Food Stamp Workfare Demonstration Projects					
1. Nationally, 1979–80	13,076	5,400	41.3	1,244	23.0
2. San Diego County, 1981–82	41,845	2,505	6.0	942	37.6
C. Utah WEAT (1977)	35,500	1,804	5.1	801	44.4
D. Massachusetts WEP (1978)	125,000	3,120	2.5	400	12.8

Welfare Savings. In fact, the workfare programs we reviewed have not resulted in decreased welfare caseloads or grant payments. Table 89 shows that, in the California CWEP, participating counties actually experienced *larger* caseload increases than nonparticipating counties. Further, there was no significant difference in the average AFDC grant between participating and nonparticipating counties. In the Food Stamp demonstrations, participating females experienced an average decline of $10 per month in Food Stamp grants, but males experienced none. The reduction

Table 89
Effectiveness of Selected Workfare Programs
Impact on Welfare Caseload and Costs

Program	Impact on Caseload	Impact on Welfare Grants
A. California CWEP	CWEP counties experienced a 7.5 percent increase in the number of AFDC applications, compared to a 1.7 percent increase in non-CWEP counties. There was no significant difference in the number of AFDC cases discontinued between CWEP and non-CWEP counties.	There was no significant difference in the average AFDC grant between CWEP and non-CWEP counties. No AFDC savings were identified, but both the state and counties incurred substantial administrative costs.
B. Food Stamp Workfare Demonstration Projects	No evidence was found of a decline in Food Stamp caseload attributable to workfare.	For females, the effects of increases in employment and increased sanctions resulted in an average reduction of $10 per month in Food Stamp grants. For males, the effects of decreases in earnings and increased sanctions were offsetting, resulting in no significant change in average Food Stamp grants. Net savings (grant savings less administrative costs) were not statistically significant.
C. Utah WEAT	27 percent of participants entered employment, but no data available on impact on caseload.	No data on grant reductions or AFDC savings.
D. Massachusetts WEP	No significant effect on caseload detected.	No significant reduction in average AFDC grants relative to a control group.

in grant amounts for women, however, did not result in a significant number of recipients going off aid. The evaluation of the Utah WEAT program provided no evidence of decreased AFDC caseload or grants attributable to the program. The evaluation of the Massachusetts WEP program concluded that there was no evidence of decreased participation in AFDC or average grant amounts compared to a control group.

Summary

We conclude that the effectiveness of past workfare programs in achieving their objectives has generally fallen short of expectations. None of the evaluations we examined provided clear evidence that workfare programs have enhanced clients' employability or earning power, or resulted in reduced AFDC and Food Stamp expenditures. To a great extent, the divergence of expectations and performance has been a result of inflated performance objectives rather than poor program performance. For example, the effect of the California CWEP on the AFDC caseloads between 1972 and 1975 fell far short of the administration's initial forecasts. The initial forecasts, however, were unreasonably optimistic given the low participation rates that occurred.

We also note that poor performance in some workfare programs is attributable to program design faults that are not necessarily inherent in all workfare programs. For example, workfare programs that provide participants with no training or supervision and place them in jobs performing menial tasks for which no labor market demand exists cannot be expected to enhance participants' employability and earning power. Workfare programs operated in conjunction with training programs may be more effective than those thus far evaluated.

In judging these results, it is important to remember that the federal government recoups 50 percent of any AFDC savings attributable to workfare. The state and counties recoup 45 percent and 5 percent, respectively. In the case of food stamps, the federal government recovers 100 percent of any savings attributable to workfare. For this reason, all research analyzing the cost effectiveness of Food Stamp workfare programs concludes that state and local governments do not benefit financially from the establishment of such programs. Because of the limitations of the research conducted thus far, it is more difficult to reach a conclusion regarding the fiscal effect of AFDC workfare programs. Nevertheless, no clear evidence has yet been established demonstrating that state or local governments benefit financially from the implementation of these programs.

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