Part I

STATE FINANCES IN 1983

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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)

		General Fund Revenue Gain	
	Effective Period	*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.