California Legislature

THE 1984-85 BUDGET: PERSPECTIVES AND ISSUES

Report of the Legislative Analyst

to the

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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 1984 Budget Act. It seeks to accomplish this purpose by (1) providing *perspectives* on the state's fiscal condition and the budget proposed by the Governor for 1984–85, and (2) identifying some of the major *issues* facing the Legislature in 1984. As such, this document is intended to complement the *Analysis of the 1984–85 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 1984–85 Budget: Perspectives and Issues is divided into three parts.

Part One, "State Finances in 1984," provides a perspective on the state's current fiscal situation. Part One is divided into two sections:

- *Fiscal Situation Facing the Legislature,* which discusses the state's General Fund condition, as well as current service level expenditure requirements for 1984–85.
- *The Long-Term Fiscal Outlook,* which discusses the economic outlook for the state through 1986–87.

Part Two, "Perspectives on the 1984–85 Budget," 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 will face in 1984. Part Two is divided into four sections:

- *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;
- *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;
- *State and Local Borrowing,* which discusses short-term and long-term government borrowing, both by the state and by local governments; and
- *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 Three, "Major Fiscal Issues Facing the Legislature," discusses major issues that we have identified in reviewing the state's current fiscal condition and the Governor's Budget for 1984–85. Wherever possible, our analysis identifies options which the Legislature may wish to consider in addressing these issues. This part is divided into four sections:

- *Revenue Issues,* which include issues having to do with tax expenditures and the level of taxation in California compared to the levels in other states.
- *Expenditure Issues,* which include issues dealing with cost-of-living adjustments, statewide staffing reductions, state program realignments proposed by the Governor, the level of funding for the Reserve for Economic Uncertainties, benefit funding for the state's retirement systems, and coordination of the state's hazardous substances control programs.
- *Local Government Finance Issues,* which include issues involving the Governor's local government finance proposal, the flexibility needed in trial court administration, and the financing of community redevelopment projects, state mandates, and the new supplemental property tax.
- *Legislative Control of the Budget,* which discusses issues dealing with collective bargaining for state employees, the need for better information on state revenues and expenditures, and the effect of adverse court decisions on the state's General Fund.

Part One

STATE FINANCES IN 1984

Fiscal Situation Facing the Legislature

The Long-Term Fiscal Outlook

STATE FINANCES IN 1984

For the first time in three years, the Legislature's budget choices are not limited to raising taxes or cutting into the base level of expenditures. Sufficient funds will be available in 1984–85 to maintain, and even expand, the existing level of services provided to the people of California. In terms of *real* purchasing power, the level of General Fund revenues projected for 1984–85 is 4.0 percent *higher* than the level of revenues estimated for the current year.

This part provides a brief overview of the state's fiscal condition during the current and budget years. It also contains estimates of what it would cost to maintain the existing level of services provided by the state in 1984–85 ("current service requirements"), and a brief look at the long-term fiscal outlook for the state. A more detailed discussion of revenues and expenditures follows in Part Two.

Fiscal Situation Facing the Legislature

Table 1 provides information on the trend in revenues, expenditures and the General Fund condition during the last 10 years. As Chart 1 graphically illustrates, if the budget estimates turn out to be accurate, 1984–85 will be only the second year since 1977–78 in which General Fund revenues *exceed* General Fund expenditures. In each of the other five years, the state spent more from its General Fund than it collected. The difference was financed by drawing down the large surplus that built up during the mid-1970's, and later by borrowing.

If the Governor's proposals for General Fund revenues ($25.8 billion) and expenditures ($25.1 billion) hold in 1984–85, the state will end the year with a surplus of $950 million in the General Fund. This amount, which consists of the difference between revenues and expenditures in 1984–85 ($750 million) and a $200 million balance to be carried over from 1983–84, would be retained in the Reserve for Economic Uncertainties. This reserve would be available to protect the General Fund from an unanticipated decline in revenues or increase in expenditures, and thus would help the state provide a continuous and more predictable level of service to its citizens.

Chart 1

Comparison of General Fund Revenues and Expenditures 1977–78 through 1984–85 (in billions)

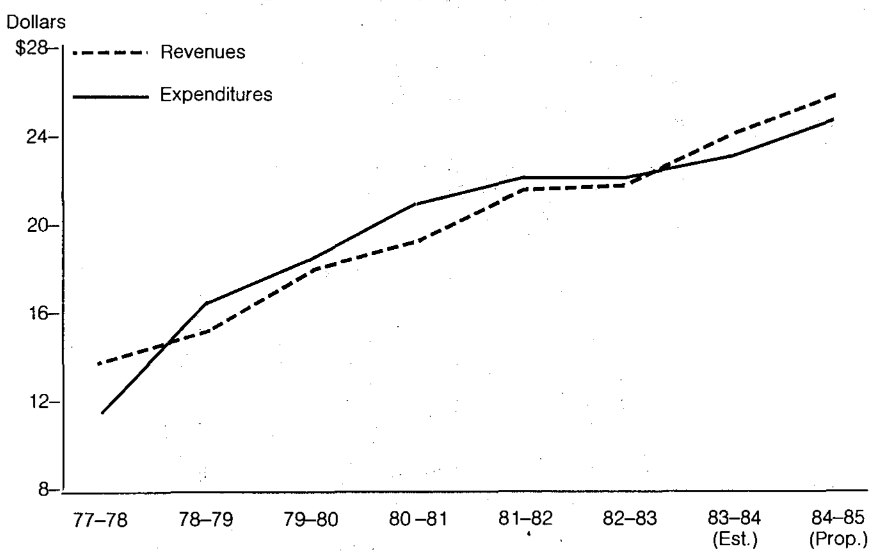

Table 1
Trend in General Fund Revenues, Expenditures and the Surplus [a]
1975–76 through 1984–85
(in millions)

	1975–76	*1976–77*	*1977–78*	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*1983–84* [b]	*1984–85* [b]
Prior-year resources	$673.7	$829.7	$1,839.1	$3,913.9	$2,905.4	$2,540.7	$681.0	–$30.8	–$521.3	$205.2
Adjustments to prior-year resources	28.7	90.0	47.7	43.6	150.9	145.2	50.0	7.0	—	—
Prior year resources, adjusted	$702.5	$919.6	$1,886.7	$3,957.5	$3,056.4	$2,685.8	$730.9	–$23.9	–$521.3	$205.2
Revenues and transfers	$9,642.1	$11,405.5	$13,732.4	$15,217.4	$18,042.8	$19,047.5	$20,920.6	$21,231.1	$23,367.6	$25,825.5
Expenditures (–)	$9,517.3	$10,487.8	$11,708.1	$16,272.0	$18,568.1	$21,065.5	$21,694.9	$21,755.1	$22,641.2	$25,076.4
(Difference)	(124.8)	(917.6)	(2,024.2)	(–1,054.6)	(–525.3)	(–2,018.1)	(–774.3)	(–524.0)	(726.5)	(749.0)
(Expenditures from reserves)	(–75.2)	(–28.5)	(–101.9)	(2.5)	(–317.4)	(210.7)	(274.2)	(–29.3)	(82.1)	(1.5)
(Annual surplus or deficit)	(49.6)	(889.2)	(1,922.3)	(–1,052.1)	(–842.8)	(–1,807.3)	(–500.0)	(–553.3)	(808.5)	(750.5)
Other surplus adjustments (+)	2.4	1.8	2.9	2.5	9.6	13.2	12.5	26.5	—	—
General Fund Balance [d]	$829.7	$1,839.1	$3,913.9	$2,905.4	$2,540.7	$681.0	–$30.8	–$521.3	$205.2	$954.2
Carry-over reserves	(97.5)	(125.9)	(227.8)	(225.3)	(542.8)	(332.0)	(57.8)	(87.1)	(5.0)	(3.5)
Reserve for pending litigation (PERS)	—	—	—	—	—	—	(65.6) [c]	—	—	—
Reserve for Los Angeles County Grant Account	—	—	—	—	—	—	—	—	(100.0)	—
Reserve for Economic Uncertainties	—	—	—	—	—	(349.0)	—	—	(100.2)	(950.7)

[a] Source: State Controller.
[b] Source: Governor's Budget. Does not reflect enactment of Ch 1xx/84 and Ch 3/84.
[c] This amount was disbursed in 1982–83.
[d] Details may not add to totals due to rounding.

CONDITION OF THE GENERAL FUND

Table 1 presents estimates of the General Fund condition in both 1983–84 and 1984–85. As Table 1 indicates, the state began the current year with a deficit of $521.3 million in its General Fund. Estimated revenues available in the current year, however, are expected to exceed expenditures by $726.5 million. This will be sufficient to wipe out the deficit and still leave an end-of-year balance equal to $205.2 million. This balance will consist of $100 million held in reserve for the repayment of a loan, $5 million for continuing appropriations, and surplus funds of $100.2 million.

For the budget year, revenues again are projected to exceed proposed expenditures—this time by a total of $749 million. When added to the $205.2 million beginning balance, this would leave a balance of $954.2 million in the General Fund at year-end. Of this amount, $950.7 would be held in the Reserve for Economic Uncertainties.

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

	1982–83 General Fund Condition			*1983–84 General Fund Condition as Projected by Governor's Budget*[a]		
	As projected in Governor's Budget[a] *January 1983*	*As reported by State Controller*[b] *January 1984*	*Effect on 1982–83 Surplus*	*January 1983*	*January 1984*	*Effect on 1983–84 Surplus*
Beginning Resources	–$61	–$24	$37	–$1,628[c]	–$521	$1,107
Revenues and Transfers	20,490	21,258	768	22,479	23,368	889
Expenditures	22,057	21,755	302	21,677	22,641	–964
General Fund Balance	–$1,628[c]	–$521	$1,107	–$826	$205	$1,031
Reserves[d]	6	87	–81	253	105	148
Unrestricted Balance[d, e]	–$1,634	–$608	$1,026	–$1,079	$100	$1,179

[a] Source: 1983–84 and 1984–85 Governor's Budget, Schedule 1.
[b] Source: State Controller.
[c] Reflects (1) 3rd District Court of Appeals decision in *Valdez* v. *Cory*, invalidating reallocation of $177.1 million to the General Fund, and (2) carry-over to 1983–84 of $1,458 million represented as "Anticipated Legislative Action" in the 1983–84 Governor's Budget.
[d] Includes unencumbered balance of continuing appropriations, reserve for Los Angeles County Medical Assistance Grant Account, and reserve for future legislation.
[e] Details may not add to totals due to rounding.

Dramatic Change in the General Fund Condition

One year ago, in January 1983, the state was looking at a lot of red ink in its budget. The estimates presented to the Legislature in that month anticipated a *deficit* in the General Fund of more than $1.6 billion on June 30, 1983 and almost $1.1 billion on June 30, 1984. Now, one year later, the picture is very different. The administration now expects that the state will end fiscal year 1983–84 with a *surplus* of $100 million in the General Fund.

What accounts for this $1.2 billion turn-around in the state's fiscal condition? As Table 2 shows, two factors are primarily responsible for the turn-around.

The Deficit in 1982–83 Was Considerably Less than Anticipated. At the time the 1983–84 Budget was submitted to the Legislature, we estimated that the deficit in the General Fund on June 30, 1984 would be just over $1.6 billion. The actual deficit, however, was much lower—$521 million. This $1.1 billion decline in the deficit for 1982–83 is due to three factors:

1. Action taken by the Legislature, which improved the General Fund condition by $697 million, consisting of $517 million in added revenues and $180 million in reduced expenditures.
2. An improving economy, which added $251 million to revenue collections.
3. Unplanned savings in various programs, which caused expenditures to be $122 million less than anticipated.

An Improving Economy Has Pushed Up the Estimate of Revenues in 1983–84. Revenue estimates for the current fiscal year are $889 million higher than the estimates made a year ago. Part of this is due to actions by the Legislature, which accelerated tax collections, transferred special funds to the General Fund, and made other changes having a favorable impact on revenues. Together, these changes will produce additional revenues of $1,072 million in 1983–84—or *$395 million* more than the $677 million in new revenues from legislation assumed by the administration in January 1983. The balance of the $889 million increase—*$494 million* —reflects the impact of an improving economy.

Partially offsetting these gains to the General Fund was an increase in expenditures during the current year of $964 million, due primarily to the passage of the school finance bill (SB 813).

Threats to the Projected Surpluses

As of February 1984, the prospects for the General Fund in both the 1983–84 and 1984–85 fiscal years are bright, with a substantial surplus projected for June 30, 1985. These prospects are particularly bright when one recalls that just a year ago, the state was faced with both a cash flow crisis and a large deficit in its budget. This rapid turn-around, however, should not be forgotten as the Legislature begins work on the budget for 1984–85. Just as the upturn in the economy restored the state to fiscal solvency, a downturn could bring forth fiscal problems similar to last year's. With the prospects of huge federal deficits continuing into the foreseeable future, there is a very real possibility that the competition for funds in the nation's financial markets will result in sharply higher interest rates that could ultimately lead to a downturn in the state's economy.

Of more immediate concern, however, are the threats to the General Fund in both the current and budget years.

Current Year Threats. Between January 1 and June 30, 1984, the administration anticipates that the General Fund will collect $12.6 billion in revenue. The projected year-end surplus of $100 million amounts to *less than 1 percent* of the revenues still to be collected—an extremely small margin for error.

Another potential threat to the General Fund in the current year is that counties will not be able to collect by June 30, 1984 the $258 million in additional property tax revenues expected from the newly enacted "floating lien date" provision and built into the budget estimates. The 1983 school finance bill (SB 813) earmarked all of these revenues for K–12 education. To the extent that the full amount does not materialize during 1983–84, the state's General Fund will have to fill the gap. Current indications are that the amount of additional property tax revenue that will be collected during 1983–84 could be as much as $150 million-to-$200 million *less* than what was assumed in the budget. If that happens and there are no other offsetting changes, the General Fund would—for the third year in a row—end the year with a deficit.

The Governor's Budget, however, anticipated this shortfall in collections, and includes $180 million in "unallocated expenditures"—another term for "reserves." These funds, if not committed to some other purpose, would protect the General Fund from the property tax shortfall and keep it out of the red.

Budget Year Threats. The main threat to the General Fund in 1984–85—as it usually is—is that the state's economy will not be as healthy as the Governor's Budget expects it to be. If, for example, the administration's "low economic forecast" were to materialize, General Fund revenues in 1984–85 would be $1.7 billion less than what the budget anticipates. This shortfall would completely wipe out the $950 million Reserve for Economic Uncertainties, and plunge the state back into deficit.

As we discuss in Part Two, it will be harder for the state in the future to accommodate major revenue shortfalls without tax increases or drastic spending reductions. This is because most of the less drastic alternatives for increasing revenues, such as tax accelerations, have already been employed. Consequently, the case for a large reserve is even stronger now than it was in the past. While, as a practical matter, it is not feasible to have a reserve large enough to protect the state against all contingencies, the reserve should be adequate to buy time for the Legislature and the Governor in the event that an unforeseen change in our volatile economy causes a deterioration in the state's fiscal condition.

CURRENT SERVICE LEVEL EXPENDITURE REQUIREMENTS

The Governor's Budget proposes General Fund expenditures of $25,076 million for 1984–85. We estimate this amount will allow the state to continue providing the same level of service in 1984–85 that it is providing in 1983–84. In fact, our analysis indicates that the amount needed from the General Fund to finance a "current service level" budget in 1984–85 is $24,814 million, which is *$262 million below* what the Governor proposes to spend.

This is not to say, of course, that the Governor's Budget simply funds each program at the current service level. Some programs are funded at higher levels, and others are funded at lower levels, depending upon the administration's priorities. *In the aggregate,* however, the level of services proposed by the Governor exceeds the level of services being provided in 1983–84.

Methodology and Assumptions

The calculation of a current service level budget begins with the 1983–84 baseline budget. (The figures shown for 1983–84 in the Governor's Budget for 1984–85 generally are used, except where we believe these figures do not properly represent "the base"). To this baseline are added the 1984–85 costs associated with legislation passed in 1983–84, the budget-year costs of court decisions handed down in the current year, the costs associated with changes in workload or caseload levels, the full-year cost of salary increases that were in effect for only part of 1983–84, increases needed to maintain the purchasing power of 1983–84 funding levels, and other non-policy adjustments. The baseline, however, is not adjusted to reflect new programs for which the Governor's Budget requests funding. (The new proposals are described in Part Two.)

The current service level budget is based on the following 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 generally are calculated at 6 percent, which is intended to maintain the purchasing power of the funds approved for 1983–84 (but not to restore purchasing power "lost" because increases in past years did not keep pace with inflation); and
- All funding sources for existing programs will remain the same.

Table 3
Comparison of Governor's
General Fund Budget Proposals for 1984–85
With Current Service Level Requirements
(in millions)

	Governor's Budget (Proposed Expenditures)	*Current Service Level Requirements*	*Amount Above (Below) Current Service Level*
Health	$4,521	$4,612	($91)
Welfare	3,236	3,403	(167)
Education:			
K-12 [a]	8,778	9,018	(240)
State Teachers' Retirement	536	301	235
Higher Education excluding Community Colleges	2,703	2,393	310
Community Colleges [b]	1,045	1,091	(46)
Youth and Adult Corrections	963	953	10
Resources	325	308	17
Tax Relief [a]	1,115	1,169	(54)
Capital Outlay	95	—	95
New Unallocated [c]	133	—	133
All Other	1,626	1,566	60
Totals	$25,076	$24,814	$262

[a] Adjusted for funding shift resulting from Governor's local government financing proposals.
[b] Reflects enactment of AB 1xx (Ch 1xx/84) and AB 470 (Ch 3/84).
[c] Includes funding for new legislation less $15 million for Community Colleges, a statewide telecommunications system, and information technology equipment.

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

As Table 3 shows, the level of expenditures proposed in the Governor's Budget for 1984–85 is *$262 million above* the amount necessary to fund a current service level budget. Nevertheless, a number of major programs are funded in the budget at levels that are less than what we estimate is needed to maintain the current service level. A comparison of the Governor's funding proposals with current service level requirements, for major program areas, follows:

Health Programs. The Governor's Budget proposes General Fund expenditures of $4,521 million for health programs in 1984–85. This is *$91 million below* the amount required to maintain the current level of service in the budget year. All major health programs, with the exception of the Department of Mental Health, are funded below current service requirements.

Specifically, *Medi-Cal* expenditures are *$66 million below* the current service level requirement. This is primarily because cost-of-living adjustments (COLAs) are funded below statutory levels and below the levels needed to maintain current services ($47 million). In addition, full funding for abortions *is not* provided in the budget ($14 million). Proposed expenditures for *county health* are *$42 million below* the amount needed to maintain the current level of service. Again, this is because the Governor proposes COLAs that are below the statutory level and does not propose any COLA for medically indigent services.

Net expenditures proposed for the *Department of Mental Health* are *$32 million above* the current service level, reflecting the $35 million augmentation for the Governor's mental health initiative.

Welfare Programs. The Governor's Budget proposes General Fund expenditures for welfare programs of $3,236 million in 1984–85. Overall, this is *$167 million less* than the amount required to maintain the existing level of services in the budget year. All major welfare services, with the exception of county administration, are funded below the amount necessary to provide the current level of service, primarily because COLAs are funded below the statutory level or below the amount needed to maintain current service levels. Thus, *Supplemental Security Income/State Supplementary Payment (SSI/SSP)* and *Aid to Families with Dependent Children (AFDC)* expenditures are, respectively, *$62 million* and *$51 million below* the current service level requirement, reflecting the fact that the budget proposes a 2 percent COLA for each program in lieu of the 5.5 percent statutory COLAs. Proposed expenditures for the *In-Home Supportive Services* program are *$33 million below* the current service requirement because the budget underfunds COLAs and does not provide for increased workload.

K–12 Education. In the case of K–12 education, comparing the Governor's Budget request to current service requirements is misleading. On the surface, it appears to provide *$47 million more* than current service requirements. However, when adjustments are made to reflect the shift in property tax revenues from K–12 districts to cities and counties that the Governor also proposes, we find that the level of funding provided in the budget actually is *$240 million below* the amount required to fund the current level of services.

The Governor's Budget underfunds various cost-of-living adjustments (COLAs) for K–12 education by $276 million. Specifically, the budget provides a 3 percent COLA for school district and county offices of education revenue limits in lieu of the 5.5 percent COLA specified in SB 813. In addition, the budget proposes to limit all discretionary and statutory categorical COLAs to 3 percent, which is less than the amount needed to fund the current level of service. Because other K–12 education requirements are overfunded, relative to current service requirements, by $36 million, however, the net result is that education programs receive $240 million less than what is required to maintain current services.

As the K–12 expenditure totals are reflected in the Governor's Budget, this $240 million shortfall is masked by a shift in *funding source* that has no impact on K–12 programs themselves. Specifically, the Governor proposes that $287 million in "floating lien date" property tax monies be shifted from schools to other local agencies. Under current law, these funds must be replaced by the state. Consequently, the General Fund ends up providing $287 million more for schools in 1984–85 as a result of this shift without actually increasing the aggregate amount of funds available to the school districts for expenditure. The figures in Table 3 have been adjusted to back out this increase in General Fund support made necessary by the funding shift, revealing the $240 million shortfall relative to current service requirements.

Higher Education. The Governor's Budget proposes General Fund expenditures for the *University of California* and the *California State University* of $2,703 million. This is *$310 million more* than the amount required to maintain the current level of service.

The additional funds reflect increased funding for employee compensation, the University of California Retirement System, instructional equipment replacement and deferred maintenance. *Community Colleges* expenditures, as shown in the Governor's Budget, do not reflect the impact of Ch 3/84 (AB 470) and Ch 1xx/84 (AB 1xx) which (1) restored $96.5 million to the 1983–84 base budget for the Community Colleges, (2) increased student fee revenue by approximately $75 million in 1984–85, and (3) appropriated $15 million from the General Fund in 1984–85 for financial aid. Based on these new laws, we estimate that the level of funding proposed in the Governor's Budget is approximately *$46 million less* than the amount required to fund the current service level in 1984–85.

Resources Programs. The Governor's Budget proposes $325 million in General Fund expenditures for resources programs in 1984–85, which is *$17 million more* than the amount needed to continue the current level of service. The increase represents funding augmentations for the Department of Forestry, the California Conservation Corps, the State Water Resources Control Board, and the Department of Boating and Waterways.

Tax Relief. As in the case of K–12 education, comparing the Governor's Budget request for tax relief to current service requirements is misleading. Therefore, we have adjusted the expenditure totals for tax relief to more appropriately reflect the Governor's proposed funding for this program. On this basis the Governor's General Fund tax relief proposal is *$54 million less* than the amount required to maintain the current level of service. The shortfall in funding relative to current service levels is attributable to the proposed repeal of the personal property tax relief subvention, which would cost $320 million to provide at current service levels. The Governor, however, proposes to replace these subvention funds with $266 million of the "floating lien date" property tax monies transferred away from schools, and causing total funding proposed for tax relief to be $54 million below current service requirements. This does not represent a decline in the level of tax relief provided to holders of business inventories; rather, it reflects a shift in the responsibility for funding this tax relief from the state to local governments.

Capital Outlay. The Governor proposes $95 million for General Fund capital outlay expenditures to fund the building of new prison facilities in the budget year. In the case of capital outlay, the current service level has little or no meaning because of the discrete nature of these projects, and the use of many different funding sources to finance them.

New Unallocated. For 1984–85, the Governor's Budget proposes $133 million to fund new "unallocated" items. Specifically, the Governor proposes funding for a statewide telecommunications system and for the management of information technology equipment. In addition, $125 million is set aside by the budget to cover the costs of legislation to be enacted during 1984–85. (We assume that $15 million of this is used to fund AB 1xx (Ch 1xx/84).) All of these items represent funding above the current service requirement.

Conclusion

Taking into account the factors discussed above, we estimate that the level of General Fund expenditures proposed in the Governor's Budget is *$262 million above* what would be needed to maintain, in the aggregate, the current level of services financed from the General Fund. This reflects funding *above* the current services requirement for UC, CSU, contributions to the State Teachers' Retirement Fund plus new monies for General Fund capital outlay ($95 million) and "unallocated" items ($133 million), partially offset by funding *below* the current services requirement for health and welfare programs, K–12 education, the Community Colleges, and tax relief.

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 amount of reserves carried over from 1984–85 into 1985–86.

The levels of income and expenditure growth beyond the budget year will be determined, in part, by the actions of the Legislature. The Legislature may, for example, enact legislation which changes tax rates or definitions of the tax base and thereby affects the level of revenue collections. It may also inititate new expenditure programs or modify existing ones. There is no way of predicting what the outcome of legislative action in the future will be.

One can, however, provide an *illustration* of what the condition of the General Fund might be in future years, *assuming* that (a) no law changes are made that significantly affect state income, (b) the department's standard economic forecast prepared for the budget holds true beyond 1985, and (c) the level of expenditures proposed in the budget is maintained in the future, adjusted for inflation and population growth.

GENERAL FUND INCOME GROWTH

The most important factor determining state income in future years will be the path taken by the state's economy. 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 federal governmental officials do not, themselves, know at this time what future courses monetary and fiscal policies will take, or what the effects will be in coming years of the federal government's $200 billion–$300 billion annual budget deficits.

By *assuming* that the department's standard budget forecast of an improving economy in 1984 and 1985 carries forward into 1986 and 1987—an optimistic assumption, to be sure, we can obtain some idea of what the general magnitude of potential income growth could be in the absence of another recession. As shown in Table 4, this type of extrapolation suggests that revenues could reach approximately $27.8 billion in 1985–86 (a growth of $2 billion, or close to 8 percent) and $30.2 billion in 1986–87 (a growth of $2.3 billion, or 8.4 percent). These projections assume that inflation stays in the moderate range—about 5 percent per year.

GENERAL FUND EXPENDITURE GROWTH

The Governor's Budget proposes General Fund expenditures in 1984–85 of $25.1 billion. In order to estimate the amount needed to continue this level of state services in 1985–86 and 1986–87, two things must be done. First, certain "one-time" expenditures proposed in the budget year, such as catch-up payments to the State Teachers' Retirement System ($211 million) and repayment of the Los Angeles County loan ($200 million), must be removed from the ongoing "base" budget. Second, the adjusted base for 1984–85—$24.5 billion—must be increased for population growth and inflation, so as to hold "real" expenditures per capita constant over time. In doing this, we have assumed that inflation will average 5 percent per year, population growth will be 1.7 percent yearly, and thus, the growth in actual expenditures consistent with constant "real" per capita expenditures would be about 6.8 percent yearly. Table 4 shows that the level of expenditures needed to fund the same level of services proposed for 1984–85 is $26.2 billion in 1985–86 and $27.9 billion in 1986–87.

Table 4
Long-Term Condition of the General Fund [a]
Assuming Continued Economic Expansion and 1984–85 Current Service Level Expenditures
1984–85 through 1986–87
(in millions)

	1984–85 [b]	*1985–86*	*1986–87*
Carry-in Balance from Prior Fiscal Year	$205	$954	$2,616
Income	25,826	27,830 [c]	30,175 [c]
Expenditures	25,076	26,168	27,943
(Annual Surplus)	(749)	(1,662)	(2,232)
Year-End General Fund Balance	954	2,616	4,848
Carry-Over Reserves	4	—	—
Reserve for Economic Uncertainties	951	1,308 [d]	1,397 [d]
Unrestricted General Fund Surplus	—	$1,308	$3,451

[a] Details may not add to totals due to rounding.
[b] Source: 1984–85 Governor's Budget.
[c] Projections for the bank and corporation tax, the sales and use tax, and the personal income tax by California Department of Finance. Projections of remaining revenue sources by Legislative Analyst's Office.
[d] Equal to 5 percent of expenditures.

GENERAL FUND CONDITION

Table 4 shows what the condition of the General Fund would be if these income and expenditure extrapolations for 1985–86 and 1986–87 were realized. It indicates that:

- On an *annual* basis, General Fund income would exceed General Fund expenditures by approximately $1.7 billion in 1985–86 and $2.2 billion in 1986–87, or $3.9 billion for the two years combined.
- The General Fund balance—that is, the total amount "left over" at the end of the year—would rise from $954 million in 1984–85 to $2.6 billion in 1985–86 and $4.8 billion in 1986–87.

- Of these amounts, the sum which we believe should be "set aside" as a reserve for economic uncertainties—5 percent of expenditures—equals $1.3 billion in 1985–86 and $1.4 billion in 1986–87.
- Therefore, the General Fund unrestricted surplus, after providing for a reserve for economic uncertainties, would amount to about $1.3 billion in 1985–86 and over $3.4 billion in 1986–87. These funds would be available for use by the Legislature in augmenting existing programs, expanding new programs, or financing tax reductions.

In summary, based on the Department of Finance's economic forecast, the state's current revenue structure, and the level of expenditures *proposed* for state programs in 1984–85, the General Fund would be in a position to both fund its existing programs *and* provide for a fairly significant growth in expenditures or further tax reductions. Thus, the long-term outlook for the General Fund under the department's economic scenario is healthy.

Of course, it is quite possible—even likely—that the economic assumptions underlying the department's forecast will not hold. Indeed, a sizeable group of economists do not believe that the economic expansion can continue beyond, or even through, 1985. Their view reflects the great concern they have regarding the effects which the federal government's large and continuing budget deficits will have in the future on interest rates and the ability of the private sector to obtain funds needed to finance investment, home purchases, and other items where credit is a necessity.

Should the large federal deficits eventually cause a downturn in the economy, revenue growth would be substantially below the levels indicated in Table 4 unless double-digit inflation also staged a come-back, and the General Fund's condition would be far less rosy than what is shown in the table. It is especially important to recognize how large the turnabout in the state's fiscal health could be under such circumstances. In fact, as we discuss in Part Two, a weaker-than-projected economy in 1984 and 1985 could reduce 1984 and 1985 revenues by a combined total of more than $2.2 billion. Continued weakness in the economy would take a similar toll on revenues beyond 1984–85. Given this possibility, a growing surplus beyond the budget year, although a nice prospect to contemplate, is by no means a certainty, and may not be a very good bet.

Part Two

PERSPECTIVES ON THE 1984-85 BUDGET

Expenditures

Revenues

State and Local Borrowing

The State's Workforce

Part Two

PERSPECTIVES ON THE 1984-85 BUDGET

This part of our analysis provides perspectives on the Governor's Budget for 1984–85. 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 1984, 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 revenues 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's workforce since 1978–79.

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Expenditures in 1984–85

TOTAL STATE SPENDING PLAN

The Governor's Budget for 1984–85 proposes total expenditures of $51.7 billion. This amount includes:

- $30.3 billion in *state expenditures* consisting of $25.1 billion from the General Fund, $4.8 billion from special funds, and $0.4 billion from selected bond funds;
- $13.6 billion in expenditures from *federal funds;* and
- $7.8 billion in expenditures from various *"nongovernmental cost" funds,* including funds established for retirement, working capital, public service enterprise, and other purposes.

Table 5 presents the components of the state's spending program for 1982–83, 1983–84 and 1984–85.

Table 5
Total State Spending Plan [a]
1982–83 through 1984–85
(in millions)

	Actual 1982–83	*Estimated 1983–84* Amount	*Estimated 1983–84* Percent Change	*Proposed 1984–85* Amount	*Proposed 1984–85* Percent Change
General Fund	$21,755.1 [b]	$22,641.2	4.1%	$25,076.4	10.8%
Special funds	3,180.0	3,769.3	18.5	4,781.4	26.9
Budget Expenditures	$24,935.1	$26,410.5	5.9%	$29,857.8	13.1%
Selected bond funds	398.5	824.4	106.9	414.8	−49.7
State Expenditures	$25,333.6	$27,234.9	7.5%	$30,272.6	11.2%
Federal funds	12,254.7	13,655.7	11.4	13,642.2	−.1
Governmental Expenditures	$37,588.3	$40,890.6	8.8%	$43,914.8	7.4%
Nongovernmental cost funds	6,695.7	8,377.7	25.1	7,805.8	−6.8
Total State Spending [c]	$44,284.0	$49,268.3	11.3%	$51,720.6	5.0%

[a] Source: Governor's Budget.
[b] Source: State Controller.
[c] This total does not agree with the total shown in Schedule 2 of the Governor's Budget due to an error in the reporting of nongovernmental cost funds which has been corrected here.

Governmental Expenditures

The budget proposes expenditures from governmental funds—that is, total state spending less nongovernmental cost funds—amounting to $43.9 billion in 1984–85. This represents a $3 billion, or 7.4 percent, *increase* from the current-year level, primarily reflecting increases in General Fund expenditures of $2,435 million, and increases in special fund expenditures of $1,012 million.

Using this measure of the budget, during 1984–85 the state will spend $1,717 for every man, woman and child in California or $120.3 million per day.

State 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 "state expenditures." As shown in Table 5, state expenditures are proposed to total $30.3 billion in 1984–85, which is 11 percent higher than state expenditures in the current year.

General Fund Expenditures

The budget proposes General Fund expenditures of $25.1 billion in 1984–85, which accounts for approximately 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 $7.1 billion in local fiscal relief in 1984–85, which is an increase of $919 million, or 15 percent above the 1983–84 level.

Chart 2
Annual Growth in General Fund Expenditures 1973–74 through 1984–85 (in billions)

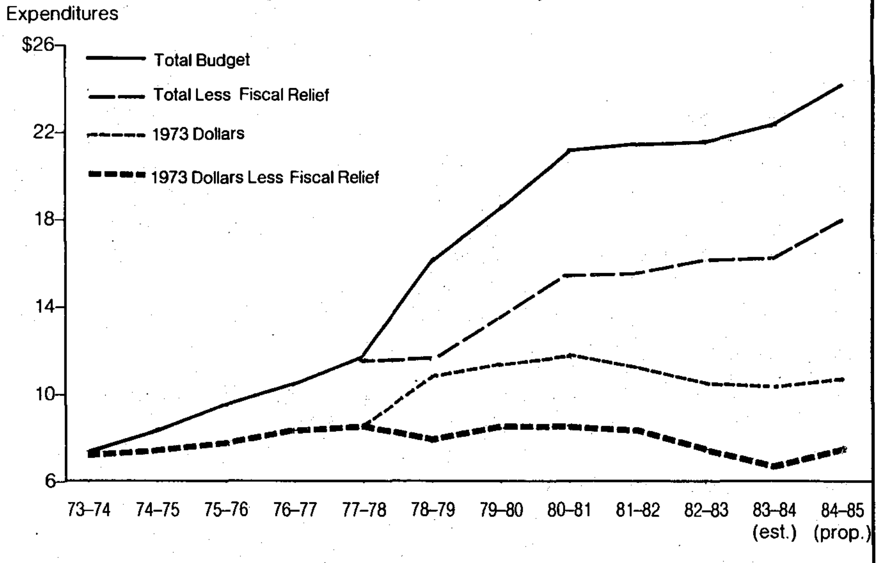


Chart 2 and Table 6 show the expenditure trend since 1973–74, both for the General Fund and for General Fund expenditures *excluding* local fiscal relief. The latter category depicts the trend for "traditional" state expenditures of the type that comprised total General Fund expenditures

Table 6
Annual Change in General Fund Expenditures
1973–74 through 1984–85
(in millions)

	Total General Fund Budget[a]				*Excluding Local Fiscal Relief*			
	Current Dollars	*Percent Change*	*1973 Dollars*[b]	*Percent Change*	*Current Dollars*	*Percent Change*	*1973 Dollars*[b]	*Percent Change*
1973–74	$7,302.1	—	$7,302.1	—	$7,295.7	—	$7,295.7	—
1974–75	8,325.4	14.0%	7,497.0	2.7%	8,340.2	14.3%	7,510.3	2.9%
1975–76	9,517.3	14.3	7,928.4	5.8	9,500.1	13.9	7,914.1	5.4
1976–77	10,487.8	10.2	8,196.2	3.4	10,467.1	10.2	8,180.0	3.4
1977–78	11,708.1	11.6	8,518.7	3.9	11,685.6	11.6	8,502.3	3.9
1978–79	16,272.0	39.0	10,929.6	28.3	11,887.0	1.7	7,984.3	−6.1
1979–80	18,568.1	14.1	11,368.5	4.0	13,723.1	15.4	8,402.1	5.2
1980–81	21,065.5	13.4	11,773.7	3.6	15,565.5	13.4	8,699.7	3.5
1981–82	21,694.9	3.0	11,247.9	−4.5	15,835.9	1.7	8,210.2	−5.6
1982–83	21,755.1	0.3	10,575.1	−6.0	16,110.1	1.7	7,831.1	−4.6
1983–84 estimated[c]	22,641.2	4.1	10,394.0	−1.7	16,478.2	2.3	7,564.7	−3.4
1984–85 proposed[c]	25,076.4	10.8	10,835.4	4.2	17,994.2	9.2	7,775.2	2.8

[a] Source: State Controller
[b] "1973" dollars equal current dollars deflated to 1973–74 dollars using the Gross National Product implicit price deflator for state and local purchases of goods and services.
[c] Source: Governor's Budget.

before the state came to the aid of local governments in the wake of Proposition 13. Expenditures in Chart 2 and Table 6 are displayed both on a "current dollar" basis, and in "real dollars." Expenditures in "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 1984–85 is almost three and one-half times what it was in 1973–74. In terms of "real dollars", however, the proposed General Fund budget is less than one and one-half times what it was in 1973–74.

As shown in Chart 2 and Table 6, between 1973–74 and 1980–81 total General Fund expenditures increased at an average annual rate of 16 percent in current dollars, and by 7 percent in "real" dollars. Much of the General Fund expenditure increase since 1978–79, however, is due to state funding for local fiscal relief. When local fiscal relief is *excluded* from the totals, we find that between 1973–74 and 1980–81 General Fund expenditures increased at an average annual rate of 11.4 percent in current dollars and 2.5 percent in "real" dollars.

For the past three years, from 1981–82 through the current year, the rate of growth in total General Fund expenditures has dropped dramatically, to an average annual rate of only 2.4 percent. The rise in expenditures in each of the past three years has, in fact, been *less* than the rate of inflation, causing "real" expenditures to go down, rather than up. General Fund expenditures in "real dollars" *declined* during this period at an annual rate of 4.2 percent.

The level of General Fund expenditures proposed for 1984–85 reverses the downward trend in expenditures witnessed during the last three years. Total General Fund expenditures proposed for 1984–85 are 11 percent more than estimated General Fund expenditures for the current year, which translates into an increase in purchasing power of 4.2 percent. Even with this increase, however, total 1984–85 General Fund expenditures, expressed in "real dollars" will be $938 million lower than the prerecession level achieved in 1980–81.

Federal Fund Expenditures

Federal fund expenditures account for almost one-third of the expenditures in the state's 1984–85 budget (excluding nongovernmental cost and bond funds). As shown in Table 7, federal funds have accounted for as much as 41 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 32 percent of state government's expenditures.

The level of federal expenditures anticipated in 1984–85—$13.6 billion—represents a decrease of $14 million, or 0.1 percent, from the estimated 1983–84 level. While the reduction in total federal funding is quite minor, the budget reflects several major increases and decreases, as detailed in

Table 7
Federal Fund Expenditures as a Percent of Total State Expenditures [a]
1975–76 through 1984–85
(in millions)

	General Fund[b]	*Special Funds*	*Federal Funds*	*Totals*	*Federal Funds As Percent of Total*
1975–76	$9,517.3	$1,678.8	$7,617.6	$18,813.7	40.5%
1976–77	10,487.8	2,041.4	7,991.7	20,520.9	38.9
1977–78	11,708.1	2,161.1	7,239.1	21,108.3	34.3
1978–79	16,272.0	2,297.8	7,452.6	26,022.4	28.6
1979–80	18,568.1	2,760.4	8,160.2	29,488.7	27.7
1980–81	21,065.5	3,261.6	10,247.6	34,574.7	29.6
1981–82	21,694.9	3,098.6	10,863.2	35,656.7	30.5
1982–83	21,755.1	3,180.0	12,254.7	37,189.8	33.0
1983–84	22,641.2	3,769.3	13,655.7	40,066.2	34.1
1984–85	25,076.4	4,781.4	13,642.2	43,500.0	31.4

[a] Excludes nongovernmental cost and bond funds. Details may not add to totals due to rounding.
[b] 1975–76 through 1982–83 data from State Controller.

Table 8. The most significant reduction, $222 million in health and welfare programs, is primarily due to a decrease of $290 million in unemployment insurance (UI) benefits, reflecting the administration's assumption that the rate of unemployment in California will decline from 8.3 percent in 1983–84 to 7.4 percent in 1984–85. The decrease in UI is offset by various health and welfare increases, particularly in the Aid to Families with Dependent Children (AFDC), Supplemental Security Income/State Supplementary Payment (SSI/SSP) and Medi-Cal programs.

Table 8 also shows that two significant increases in federally funded expenditures are anticipated in the budget year. First, business, transportation and housing programs are expected to receive increased support, principally in the form of more federal aid for transportation provided to California's 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 ($107 million) for the University of California's Department of Energy laboratories.

Federal fund expenditures in the current and budget years are not as level as they may appear at first glance, due to the influx of *one-time* funds from the federal emergency jobs bill (Public Law 98-8) during 1983–84. This measure, passed on March 24, 1983, resulted in approximately $239 million in additional federal funds flowing to state and local government

Table 8
Federal Funds Changes, By Program
1983–84 and 1984–85
(in thousands)

Program	Estimated 1983–84	Proposed 1984–85	Change Amount	Change Percent
Legislative/Judicial/Executive	$182,079	$162,780	–$19,299	–10.6%
State and Consumer Services	13,066	17,867	4,801	36.7
Business, Transportation and Housing	1,101,166	1,213,962	112,796	10.2
Resources	70,056	34,905	–35,151	–50.2
Health and Welfare	9,070,792	8,848,797	–221,995	–2.4
Youth/Adult Corrections	1,102	1,088	–14	–1.3
Education	2,931,055	3,068,200	137,145	4.7
Other Governmental Units	258,336	272,684	14,348	5.6
Other Governmental Services	28,094	21,889	–6,205	–22.1
Totals	$13,655,746	$13,642,172	–$13,574	–0.1%

in California. Of this amount, approximately $164 million flowed through the state's budget, as detailed in Table 9. Generally speaking, federal law required most of these funds to be obligated by September 30, 1983. As a result, federal fund expenditures in the current year tend to overstate the *ongoing* level of federal support received by the state.

Table 9
California's Allocation from Emergency Jobs Bill (PL 98-8) [a]
Federal Fiscal Years 1983 and 1984
(in millions)

Public Works	$36.2
Energy Conservation	2.8
Food and Shelter	27.3
Community Development/Services	5.8
Employment	56.2 [b]
Health and Welfare Block Grants	36.0
Total	$164.3

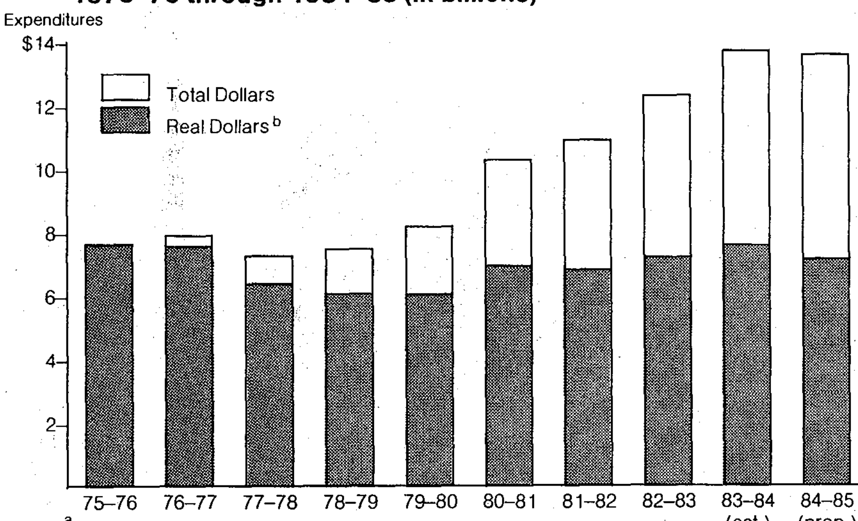
[a] Funds flowing through the state's budget. An additional $75 million was allocated to California and flowed directly to local entities.
[b] Includes $38.9 million for UI administration.

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 3. In terms of current dollars, federal expenditures have grown from $7.6 billion in 1975–76 to $13.6 billion in 1984–85, an increase of approximately 79 percent. This represents a 6.7 percent average annual rate of growth over the 10-year period. When expressed in "real dollars," however, the level of federal aid anticipated in 1984–85 is 7.1 percent *less* than the amount of federal aid actually received by the state in 1975–76.

Caution should be used in drawing conclusions from the changes in federal expenditure levels shown in Chart 3, for two reasons. First, the federal aid totals summarized in the Governor's Budgets have not included the same programs on a consistent basis during this 10-year period. For example, federal payments under the Supplemental Security Income (SSI) program were included in budget totals in 1975–76 and 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, when the Governor's Budget was submitted for 1982–83 it estimated that the state would receive $2.1 billion in federal funds for unemployment insurance. California, however, actually received $3.6 billion in that year, a difference of $1.5 billion, or 75 percent. The increase was due more to the effects of the recession on the number of persons eligible to receive UI benefits, than it was to any discretionary increase in federal support for the program.

Chart 3
Expenditures of Federal Aid Granted to the State of California 1975–76 through 1984–85 (in billions)[a]



[a] Source: Governor's Budgets

[b] "Real" federal dollars equal total federal dollars deflated to 1975–76 dollars using the GNP price deflator for state and local purchases of goods and services.

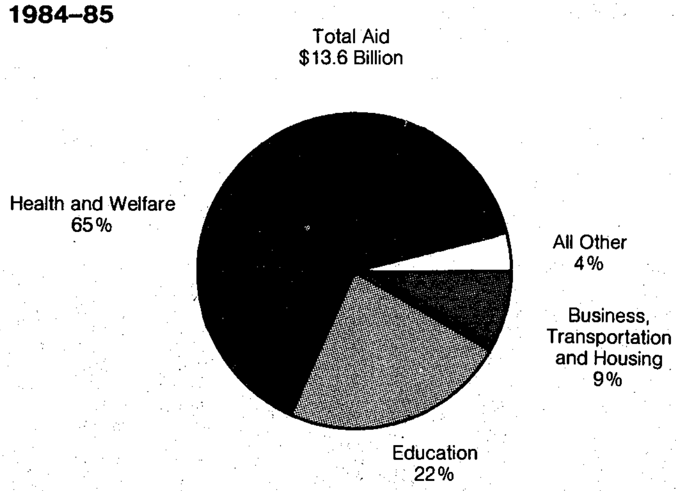
Federal Support of State Programs

The percentage of total program activity supported by federal funds varies widely from one state agency to another. Chart 4 shows that of all the federal funds received by the state in 1984–85, $8.8 billion, or 65 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 just slightly more than one-half of total expenditures proposed for these programs in 1984–85. Moreover, within the health and welfare area, federal fund levels vary widely, from a low of 35 percent for health programs to a high of 99 percent for employment programs. Similarly, while education receives 22 percent of total federal funds received by the state, federal aid supports just 18 percent of the state's education expenditures (less if local funds are included).

Chart 4

Program Distribution of Federal Aid Granted to the State of California 1984–85



On the other hand, as indicated in Table 10, business, transportation and housing agencies receive 9 percent of available federal aid, but support 39 percent of their total program activity from this funding source.

Table 10

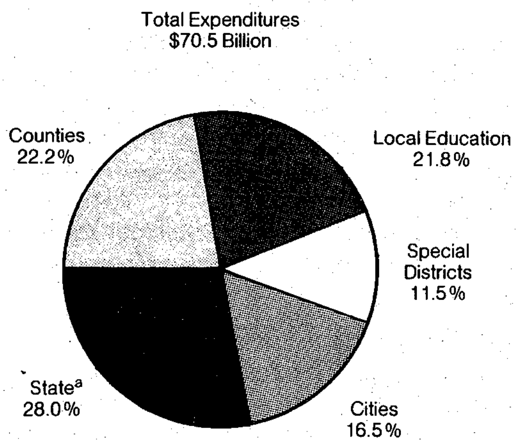
Federal Aid to the State of California
Support of Budget Activities, by Program
1984–85
(in millions) [a]

Program	*General Fund*	*Special Funds*	*Federal Funds*	*Total*	*Percent Federal Funds*
Legislative/Judicial/Executive	$512	$40	$163	$715	22.8%
State and Consumer Services	169	163	18	350	5.1
Business/Transportation/Housing	49	1,825	1,214	3,088	39.3
Business/Housing	(49)	(53)	(41)	(143)	(28.7)
Transportation	(-0-)	(1,773)	(1,173)	(2,946)	(39.8)
Resources	324	261	35	620	5.6
Health and Welfare	7,549	87	8,849	16,485	53.7
Health	(4,321)	(74)	(2,384)	(6,779)	(35.2)
Human Services	(3,190)	(-0-)	(2,817)	(6,007)	(46.9)
Employment	(38)	(13)	(3,647)	(3,698)	(98.6)
Youth/Adult Corrections	1,057	31	1	1,089	.1
Education	13,335	267	3,068	16,670	18.4
K-12	(9,602)	(151)	(924)	(10,677)	(8.7)
Higher Education	(3,733)	(116)	(2,145)	(5,994)	(35.8)
Other Government Units/Services [b]	2,082	2,107	295	4,484	6.6
Totals	$25,076	$4,781	$13,642	$43,500	31.4%

[a] Details may not add to totals due to rounding.
[b] Includes unclassified amounts in the General Fund and the special funds.

Chart 5

Total State and Local Government Expenditures 1983–84



[a] Net state expenditures.

Total State and Local Government Spending in California

Local governments are also a significant contributor to public sector spending in California. Because local agencies receive a good portion of their resources from the state, however, their expenditures cannot simply be added to those of the state in order to determine aggregate government spending. Instead, state expenditures that go to local government agencies must first be subtracted from the state totals, to avoid double-counting.

The discussion which follows provides a perspective on government sector spending trends 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 $71 billion. This amount consists of approximately $20 billion in net state expenditures (that is, state expenditures net of funds provided to local governments) and approximately $51 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.

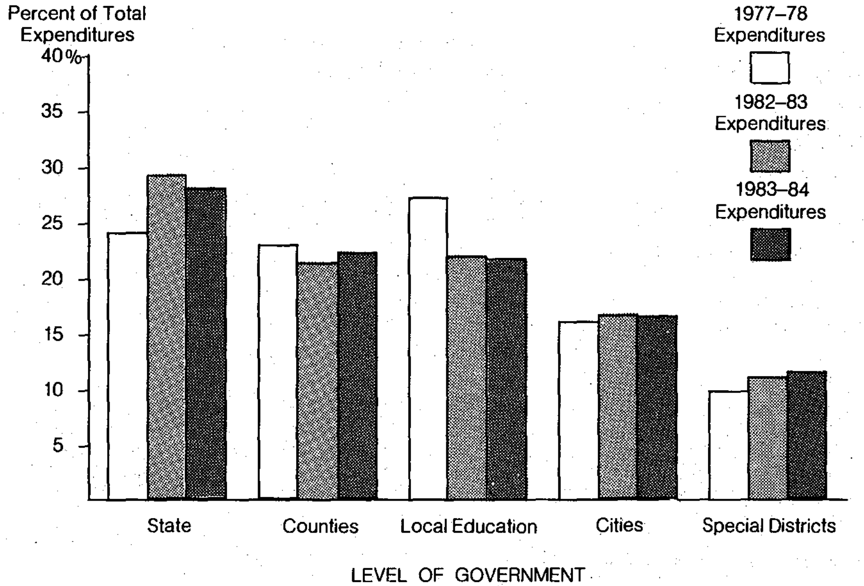
The fact that *net* state spending—$19,757 million—is less than half of total General Fund, special fund and federal fund expenditures identified in the Governor's Budget ($40.1 billion) demonstrates how much "state money" actually is spent at the local level. These expenditures, which total $20.3 billion in the current year, are included in our estimate of local government spending. The principal component of these funds is state aid to local school districts ($10.2 billion).

Local government expenditures consist of expenditures by four types of local jurisdictions: counties, cities, special districts and local education (K–14). The local education category includes expenditures for elementary and secondary schools (K–12), county offices of education, regional occupation centers and community colleges. Chart 5 displays 1983–84 expenditures by each government entity, as a portion of total state and local government expenditures. It shows that net state spending accounts for slightly more than one quarter of total state and local expenditures in the current year.

Total Spending Trends. Table 11 identifies the total expenditures by governments in each of these categories for three fiscal years: 1977–78, 1982–83 and 1983–84. Expenditures for fiscal year 1977–78 are included in the table to illustrate how the share of total spending accounted for by each category has changed since the passage of Proposition 13 in 1978. Chart 6 displays expenditures by each government entity as a percentage of total state and local government expenditures for these three years.

Chart 6

Total State and Local Government Expenditures 1977–78, 1982–83 and 1983–84



As shown in Table 11, total net state expenditures comprised approximately 24 percent of total state and local government expenditures in 1977–78 (the year prior to Proposition 13). They had increased to approximately 30 percent of the total by 1982–83, and have declined to approximately 28 percent in the current year. Local education's share of total state and local government expenditures has also declined—from 27 percent in 1977–78, to 22 percent and 21.8 percent in 1982–83 and 1983–84, respectively. Total expenditures for cities as a percentage of total state and local government expenditures have remained fairly constant—about 16 percent in all three years. The share of the total accounted for by counties dropped from 23 percent in 1977–78 to 21 percent in 1982–83, but has since risen slightly, to 22 percent in 1983–84. In summary, the chart indicates that the shares of total spending attributable to the state and to the K–14 school districts have experienced the most significant changes, with the decrease in the schools' share of the total mostly offset by an increase in the state's share.

Table 11
Estimated Total State and Local Government Expenditures 1977–78, 1982–83, and 1983–84 [a]
(in millions)

Government Entity	1977–78 Expenditures	1977–78 Percent of Total	1982–83 Expenditures	1982–83 Percent of Total	1983–84 Expenditures	1983–84 Percent of Total
Counties	$9,339	22.9%	$13,911	21.3%	$15,670	22.2%
Cities	6,499	16.0	10,860	16.6	11,620	16.5
Special Districts	3,948	9.7	7,162	11.0	8,085	11.5
Local Education	11,161	27.4	14,346	22.0	15,379	21.8
Subtotal, Local Government	($30,947)	(76.0%)	($46,279)	(70.8%)	($50,754)	(72.0%)
State	21,086	—	37,186	—	40,066	—
Less: Amount expended by local governments	−11,332	—	−18,103	—	−20,309	—
Subtotal, State (Net)	($9,754)	(24.0%)	($19,082)	(29.2%)	($19,757)	(28.0%)
Totals, State and Local Expenditures	$40,701	100.0%	$65,361	100.0%	$70,511	100.0%

[a] Local government expenditure data for 1977–78, and county data for 1982–83, taken from the State Controller's Report on Financial Transactions. Figures for 1982–83 and 1983–84 represent Legislative Analyst's Office estimates, except that 1983–84 county figure is taken from final county budgets. All local government data include enterprise fund transactions. State government expenditure data are taken from Governor's Budgets for 1979–80 and 1984–85. Details may not add to totals due to rounding.

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; and
- 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 that can be made 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, and for "transfers of financial responsibility." A "transfer of financial responsibility" occurs when the responsibility for providing a service is transferred from one entity to another. Adjustments must be made to the *state's* appropriations limit when such a transfer results in an increase or decrease in costs to the state. A corresponding change is made in the limit of the other party to the transfer. Hence, the limit can increase or decrease 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 1984–85. Table 12 shows the Department of Finance's estimate of the impact of Article XIII B on the state in 1982–83, 1983–84, and 1984–85. The department estimates that the state will be $3.0 billion and $1.6 billion *below* its limit in 1983–84 and 1984–85, respectively.

Table 12
Impact of Article XIII B On the State
1982–83 through 1984–85
(in millions)

	1982–83	*1983–84*	*1984–85*
Appropriations Limit	$19,580	$20,416	$21,967
Appropriations Subject to Limitation	16,268	17,380	20,367
Amount Under the Limit	$3,312	$3,036	$1,600

Since the voters approved Article XIII B, there has been a large gap between the limit and spending subject to limitation. This is because the state appropriated more monies in the base year (1978–79) than it took in as tax revenue. This resulted in the original "base" being larger than the amount of spending that could be sustained under existing tax laws. For the past two years, 1982–83 and 1983–84, the gap has been particularly large because of the recession, which has caused state tax revenues to grow more slowly than 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.

The gap between the limit and spending subject to limitation is expected to narrow in 1984–85. Due to the current economic recovery, state tax revenues are projected to fill depleted state coffers, allowing increased appropriations. The appropriations subject to limitation in 1984–85 are proposed to increase by 17 percent over the 1983–84 level, compared to a 7 percent increase between the years 1982–83 and 1983–84.

While the gap is expected to narrow in 1984–85, the state's appropriations limit will still *not* be a fiscal constraint. For the limit to be a constraint in future years, revenues would have to grow at rates significantly exceeding the annual adjustments to the state's limit. Based on the economic forecast prepared by the administration, this is not likely to occur. Rather, it appears that the rates of growth for both revenues and the limit will largely parallel each other. Hence, the limit probably will *not* be a constraint in the foreseeable future.

Adjusting the 1982–83 and 1983–84 Limits. For 1982–83 and 1983–84, the administration has identified two sets of financial responsibility transfers. These involve Public Utilities Commission (PUC) user fees and adjustments for increases or decreases in school district appropriations limits. The net result of these transfers is a *decrease* in the 1982–83 limit of $16.1 million, and a decrease in the 1983–84 limit of $24.2 million.

The administration, however, has not reflected the impact of at least two transfers of financial responsibility in its estimate of the appropriations limits. First, pursuant to Ch 327/82 (SB 1326), the state now *limits* benefits provided to federally ineligible AFDC-U recipients to a three-month period. This has resulted in a 1982–83 General Fund savings of $29.6 million. Our analysis indicates that this has also resulted in a corresponding increase in *federal* expenditures, as county governments have found ways to qualify these persons for federal benefits rather than placing them on county-funded general relief programs.

Second, pursuant to provisions of Ch 10x/83 (AB 28x), the state no longer reimburses cities and counties for the costs associated with providing mileage reimbursements to workers' compensation recipients. This has resulted in a 1982–83 General Fund savings of $18 million and a corresponding increase in costs to local agencies.

Because of these transfers of financial responsibility, the 1982–83 limit should be reduced by an additional $47.6 million, bringing it to $19,532 million. This adjustment, of course, affects all subsequent limit determinations, as well. Thus, the 1983–84 and 1984–85 limits should be adjusted downward to $20,366 million and $21,914 million, respectively.

The Proposed 1984–85 Limit. The administration proposes to set the state's 1984–85 appropriations limit in Control Section 12.00 of the 1984 Budget Bill. Although $21,967 million has been proposed as the limit in 1984–85, this number is subject to change because the final inflation and population adjustments used to determine the 1984–85 limit will not be known until April of this year. In addition, recognition of other transfers of financial responsibility, such as those described above, will have an impact on the 1984–85 limit.

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 Proposed and Actual General Fund Expenditures
1974–75 to 1983–84
(in millions)

	Budget As Submitted[a]	*Actual Expenditures*[b]	*Change* Amount	*Change* Percent
1974–75	$7,811.9	$8,325.4	$513.5	6.6%
1975–76	9,169.5	9,517.3	347.8	3.8
1976–77	10,319.7	10,487.8	168.1	1.6
1977–78	11,822.3	11,708.1	−114.2	−1.0
1978–79	13,482.5	16,272.0	2,789.5	20.7
1979–80	17,088.1	18,568.1	1,480.0	8.7
1980–81	20,683.9	21,065.5	381.6	1.8
1981–82	20,770.1	21,694.9	924.8	4.5
1982–83	23,202.9	21,755.1	−1,447.8	−6.2
1983–84	21,677.0	22,641.2[a]	964.2	4.4

[a] Source: Governor's Budget
[b] Source: State Controller

In eight of the last ten years, actual expenditures exceeded the amounts originally proposed by the Governor, usually 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.

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—$1.4 billion—primarily reflects the fact that revenues did not come in as high as what had been projected in the Governor's Budget, making large cuts in expenditures necessary in order to minimize the end-of-year deficit. The increase of over $950 million in estimated expenditures during the current year is largely attributable to higher funding levels for K–12 education.

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 since the budget was enacted, which clearly are beyond either the Governor's or the Legislature's control, have reduced General Fund resources in the current year by approximately $46.8 million.) 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, 1985, 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.

Table 14
General Fund and Special Fund Expenditures by Function [a]
1982–83 through 1984–85
(in millions)

	Actual [b]	Estimated 1983–84		Proposed 1984–85	
General Fund	*1982–83*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State operations	$4,485.0	$4,729.1	5.4%	$5,705.5	20.6%
Capital outlay	−.8	1.1	— [c]	94.7	— [c]
Local assistance	17,180.6	17,730.9	3.2	19,151.3	8.0
Aid to individuals	(6,873.1)	(6,441.6)	−6.3	(6,619.0)	2.8
Aid to local governments	(10,307.5)	(11,289.3)	9.5	(12,532.3)	11.0
Unclassified	90.3	180.0	—	125.0	−30.6
Totals [d]	$21,755.1	$22,641.2	4.1%	$25,076.4	10.8%
Special Funds					
State operations	$1,774.3	$1,858.6	4.8%	$2,016.3	8.5%
Capital outlay	196.7	268.6	36.6	477.0	77.6
Local assistance	1,351.4	1,630.5	20.7	2,282.6	40.0
Unclassified	—	11.5	—	5.5	−52.2
Totals [d]	$3,322.4	$3,769.3	13.5%	$4,781.4	26.9%

[a] Source: Governor's Budget.
[b] Source: State Controller.
[c] Percentage change exceeds 100 percent.
[d] Details may not add to totals due to rounding.

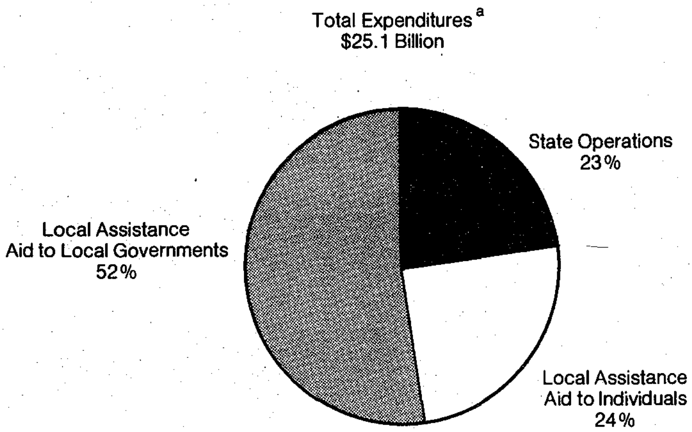
MAJOR COMPONENTS OF THE STATE BUDGET

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 1984–85 also includes "unclassified" General Fund expenditures of $125 million for legislative initiatives.

Chart 7 shows what portions of the General Fund budget local assistance and state operations represent. State operations make up 23 percent of total General Fund expenditures, and local assistance, as defined in the Governor's Budget, makes up 76 percent. Together, these components account for just over 99 percent of total General Fund expenditures.

Chart 7

1984–85 General Fund Budget Structure



[a] State operations and local assistance totals do not include $125 million (.5%) allocated to cover the cost of legislation approved in the budget year and $94.7 million (.4%) in capital outlay expenditures.

State Operations

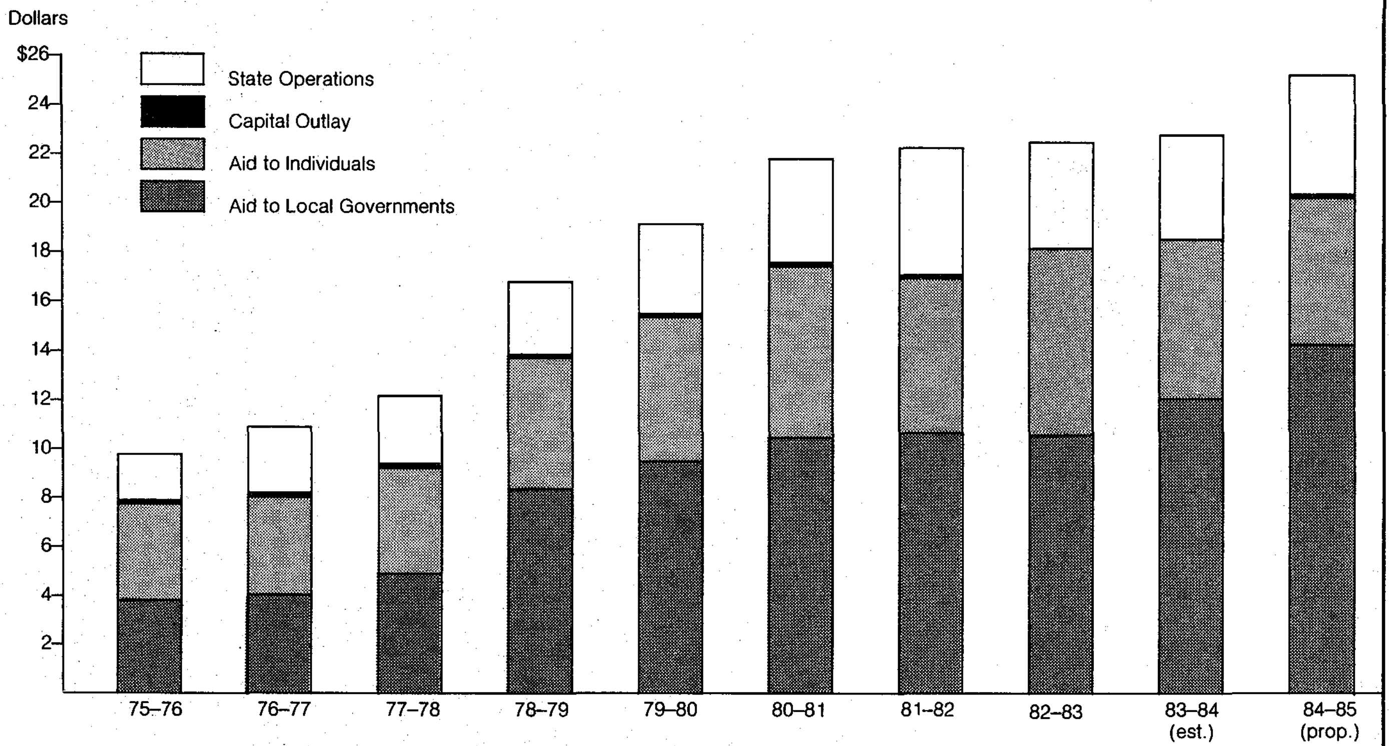
The budget proposes an increase of $976.4 million, or 21 percent, from the General Fund for state operations expenditures in 1984–85. As shown in Chart 8, General Fund expenditures for state operations will have increased by $3,412 million, or 149 percent, during the ten years from 1975–76 through 1984–85. When adjusted for inflation, however, expenditures have increased by only $666 million, or 29 percent, during this period.

Capital Outlay

The budget proposes $94.7 million from the General Fund for capital outlay expenditures in 1984–85. The entire amount will be used to fund part of the cost of building new prisons. General Fund capital outlay expenditures over the past ten years have fluctuated from a high of $151 million in 1979–80 to negative expenditures of $831,000 in 1982–83. This negative expenditure reflects the return to the General Fund of monies previously transferred to the Architectural Revolving Fund. The Governor's Budget for 1983–84 proposed no General Fund expenditures for capital outlay.

Chart 8

General Fund Budget Structure 1975–76 through 1984–85 (in billions)



Local Assistance

As illustrated in Chart 8, General Fund expenditures for local assistance will have increased by $12,014 million, or 168 percent, during the 10 years from 1975–76 through 1984–85. The growth in state fiscal relief to local governments, which began immediately 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 14 displays local assistance expenditures, by funding source. It shows that the Governor's Budget proposes an overall increase of $1,420 million, or 8 percent, in General Fund support. This increase, however, is larger than it would otherwise be due to the deferral from the current year to the budget year of the state's 1983–84 contribution to the State Teachers' Retirement Fund. If, instead of being deferred, this contribution had been made in the current year, the level of funding proposed for local assistance in 1984–85 would represent an increase of $999 million, or 5.6 percent, over current-year levels.

Aid to Individuals 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 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"—reflects the form in which assistance to individuals is provided. The former category includes *cash grants* to individuals, whereas the latter includes the cost of *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, "Aid to Local Governments" and "Aid to Individuals," as shown in Table 14.

Aid to Individuals. Table 15 identifies 12 General Fund-supported local assistance programs which our analysis indicates are more appropriately categorized as "Aid to Individuals." Overall, the Governor's Budget proposes a funding level increase of $177 million or 2.8 percent for these programs in the budget year. On a program-by-program basis, however, the Governor's Budget is proposing increases for seven of these 12 programs, decreases for two, no change in funding for two and transfer of funding for one.

Table 15
General Fund Supported Local Assistance Programs More Appropriately Categorized as Aid to Individuals 1982–83 through 1984–85 (in millions)

	1982–83	*1983–84*	*Governor's Budget 1984–85*
Medi-Cal [a]	$2,481	$1,984	$1,986
AFDC [b]	1,367	1,492	1,563
SSI/SSP	1,140	1,097	1,101
Developmental Services	527	559	592
Personal Property Tax Relief Subventions	517	293	—
Personal Property Tax Relief provided through other sources	11	235	528
Renters' Tax Relief	422	431 [c]	447
Homeowners' Property Tax Relief	334	334	335
Senior Citizens Renters' Tax Relief	42	36 [c]	33
Senior Citizens' Property Tax Assistance	11	9 [c]	8
Subventions for Open Space	13	13	13
Senior Citizens' Property Tax Postponement	6	7	9
Payment to Local Governments for Sales and Property Tax Losses	2	4	4
Totals [d]	$6,873	$6,442	$6,619

[a] Excludes county administration.
[b] Grant payments only.
[c] $51 million of the amounts shown for these three programs was funded from special fund sources; this amount is excluded in calculating General Fund total.
[d] Details may not add to totals due to rounding.

Table 16
Major General Fund Supported Local Assistance Programs More Appropriately Categorized as Aid to Local Governments 1982–83 through 1984–85 (in millions)

	1982–83	*1983–84*	*1984–85*
Public Health Services	$492	$905	$908
California Children's Services	38	38	42
Department of Rehabilitation	—	42	46
Mental Health	468	449	508
Alcohol and Drug Programs	62	62	64
Social Services Programs	154	169	196
County Administration	102	117	129
County Justice Subvention	63	63	64
K–12 Education	7,675	8,026	9,366
Community Colleges	1,055	990	999
All Other	199	429	472 [a]
Totals [b]	$10,308	$11,289	$12,532

[a] $262 million of the amount shown represents funding transferred to other state sources and is excluded in calculating General Fund totals.
[b] Details may not add to totals due to rounding.

Aid to Local Governments. Table 16 displays the major General Fund local assistance programs which our analysis indicates provide "Aid to Local Governments." Overall, the Governor's Budget proposes an increase in funding for these programs of $1.2 billion, or 11 percent, from current-year levels. This change is primarily the result of the funding increase proposed for K–12 education. The large increase between 1982–83 and 1983–84 in the "All Other" category reflects a change made in the accounting procedures for state-mandated local programs, and the $135 million in additional funding that the Governor proposes for these programs in the current year.

Local Fiscal Relief. Local assistance is a term which is often mistakenly confused with "local fiscal relief." The term fiscal relief refers to those funds which the state has provided to local government since the passage of Proposition 13 in order to compensate for a portion of the reductions in local property tax revenues brought about by that measure. Funding for fiscal relief cannot be identified simply by reviewing items in the budget. Rather, it can only be determined by measuring the increase in certain budget items which can be attributed to the provisions of AB 8 (Ch 282/79). That measure reduced the amount of property taxes received by school districts and redirected them to cities, counties and special districts. The recipient agencies experienced revenue gains from this redirection. Schools, however, did not experience any loss from the shift because the state replaced the redirected property taxes with additional state aid. Under AB 8, the state also "bought out" all or part of the locally-funded share of certain county health and welfare programs.

Table 17 summarizes our estimates of local fiscal relief from 1979–80 through 1984–85. For the budget year, the table shows what fiscal relief would be under existing law [Ch 282/79, (AB 8)] with one exception: the amounts shown do *not* reflect the effect of the AB 8 deflator, which we anticipate will be triggered for the budget year. This would result in a reduction of $364 million in the amounts of fiscal relief provided to cities, counties and special districts. The table also displays the amount of fiscal relief proposed to be provided under the Governor's Budget. Under the Governor's proposal, local fiscal relief would increase in 1984–85 by $919 million, or 15 percent from the estimated current-year level. The $31 million difference in the budget year between existing law and what the Governor proposes reflects the Governor's proposed reduction in the statutory cost-of-living adjustments for county health service subventions and AFDC grants (from 5.6 percent and 5.5 percent, respectively, to 2 percent). The Governor's Budget, while it would certainly have a fiscal impact on local agencies, contains no proposals to alter the level of *fiscal* *relief per se* (other than the repeal of the deflator and the reduction in the two statutory COLAs mentioned above). That is, the Governor's Budget generally proposes to *continue* the existing fiscal relief program.

Table 17
Summary of Local Fiscal Relief
1979–80 through 1984–85
(in millions)

	1979–80	*1980–81*	*1981–82*	*1982–83*	*1983–84*	*1984–85* Current Law[a]	*1984–85* As Proposed by Governor's Budget
Property taxes shifted from schools to local agencies	$781	$921	$1,024	$1,139	$1,230	$1,351 [b]	$1,351 [b]
Business inventory reductions for cities and counties	−38	—	—	—	—	—	—
Health and welfare buyouts	1,288	1,529	1,724	1,853	1,984	2,145	2,114
Ongoing reductions	—	—	−49	−49	−49	−49	−49
One-time reductions	—	—	−184	−290	−348	—	—
Local Agency Reimbursment Fund	—	—	—	10	—	—	—
Education [c]	2,814	3,050	3,344	3,002	3,346	3,666	3,666
Totals	$4,845	$5,500	$5,859	$5,665	$6,163	$7,113	$7,082

[a] Does not reflect deflator-related reductions.
[b] Assumes 9.5 percent increase in assessed valuation.
[c] Based on estimates from the Department of Finance.

Table 18 indicates that, under current law, fiscal relief would increase from $6.2 billion in the current year to $7.1 billion in the budget year. This increase is smaller than it otherwise would have been if the AB 8 deflator had been allowed to take effect in the current year. Instead, a one-time reduction in fiscal relief of $348 million was made during 1983–84. The table also indicates that in the seven years since the passage of Proposition 13 (1978–79 through 1984–85), the state has provided local governments with an estimated *$40 billion in fiscal relief.*

Cities would fare particularly well in the budget year as compared to the current year, because no one-time reductions in fiscal relief have been proposed. Although one-time reductions were made in the amount of fiscal relief provided to both cities and counties in each of the last three years, cities have borne the largest share of the reductions.

The fiscal relief estimates for community colleges in the budget year reflect a decline of $78 million, or 23 percent, from current-year levels. The Governor's Budget proposes that this reduction be offset by revenues resulting from the imposition of student fees.

The Governor's Budget contains other proposals intended to improve the relationship between the state and its local agencies. A discussion and fiscal analysis of these proposals appears in Part Three—Local Government Finance Issues.

Table 18
Local Fiscal Relief by Type of Local Agency
1978–79 through 1984–85
(in millions)

	1978–79	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*1983–84*	*1984–85*[a]	*Percent Increase 1984–85 Over 1978–79*
Cities	$230	$216	$280	$152	$99[b]	$63	$374	62.6%
Counties	1,512	1,609	1,927	2,095	2,264	2,432	2,717	79.7
Special districts[c]	190	206	243	268	300	323	356	87.4
K-12 education[c]	2,193	2,508	2,721	2,989	2,702	3,011	3,409	55.5
Community colleges[c]	260	306	329	355	300	335	257	−1.2
Totals[d]	$4,385	$4,845	$5,500	$5,859	$5,665	$6,163	$7,113	62.2%

[a] Existing law; does not reflect changes proposed in the budget, nor deflator-related reductions.
[b] Includes Local Agency Reimbursement Fund disbursements.
[c] Based on estimates from the Department of Finance.
[d] Details may not add to totals due to rounding.

RESERVES

The Governor's Budget holds $954.2 million from the General Fund in reserve for 1984–85. Of this amount, $950.7 million is proposed for the Reserve for Economic Uncertainties, and $3.5 million represents funds which have already been appropriated but are not expected to be spent during the budget year.

Reserve for Economic Uncertainties

The Reserve for Economic Uncertainties was created by the 1980 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 Bill. In addition, monies in this fund can be loaned, interest-free, to the General Fund in the event of a cash-flow shortage during the fiscal year. In the absence of such loans, the balance in the reserve is invested and produces interest income for the General Fund.

Reserve Proposed for 1984–85. Control Section 12.30 of the 1984 Budget Bill appropriates from the General Fund on the first day of the fiscal year, July 1, 1984, an amount necessary to bring the fund balance of the reserve up to $950.7 million. This amount is approximately 3.8 percent of proposed General Fund expenditures in 1984–85. On the last day of the fiscal year, June 30, 1985, the section provides for a transfer into or out of the reserve, depending on the status of the General Fund. Specifically, if the General Fund is in a *deficit* position, monies would be transferred out of the reserve to eliminate or reduce the deficit. If, on the other hand, there is a year-end *surplus*, additional monies would be transferred into the reserve, provided that the total amount in the reserve does not exceed five percent of General Fund appropriations. Therefore, on June 30, 1985, the reserve may be larger or smaller than what it was on July 1, 1984, depending on the condition of the General Fund.

PROGRAM EXPENDITURES

We have discussed in some detail total expenditures proposed for the budget year and their relationship to historical spending levels. In addition, we have examined the relationship of the three major components of the budget—state operations, local assistance and capital outlay. We now turn our attention to the distribution of expenditures on a programmatic basis.

Where Does the Money Go?

Chart 9 and Table 19 show the distribution of General Fund expenditures, by major program categories, in 1984–85. These displays indicate that the two largest budget categories are education and health and welfare, which account for $21.1 billion or 84 percent, of total General Fund expenditures. The remaining $4.0 billion, or 16 percent of total expenditures, goes for tax relief and all other programs of state government such as corrections and resources.

Chart 9

General Fund Expenditures—Major Components 1984–85

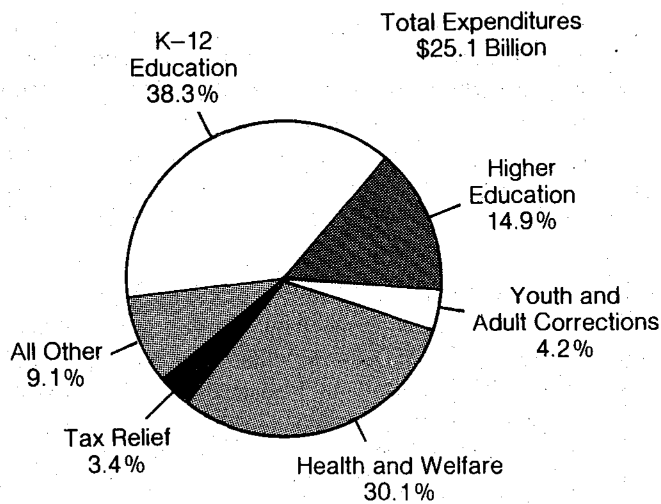


Table 19
Expenditures for Health, Welfare, and Education As a Percent of Total General Fund Expenditures 1984–85 (in millions) [a]

	Amount	*Percent of General Fund Budget*
K-12 Education [b]	$9,601.2	38.3%
Higher Education	3,732.8	14.9
Subtotal, Education	$13,334.0	53.2%
Health and Welfare	7,756.8	30.9
Subtotal Education, Health and Welfare	$21,090.8	84.1%
Other program areas	3,985.6	15.9
Total General Fund budget	$25,076.4	100.0%

[a] Source: Governor's Budget.
[b] Includes $536 million for State Teachers' Retirement contribution.

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 1975–76, these three components have increased their share of the General Fund budget from about 75 percent to 84 percent. During the same period, expenditures for these programs have increased by more than 184 percent, or at an average annual growth rate of 12 percent.

Chart 10
Trends in General Fund Program Expenditures 1975–76 through 1984–85 (in billions)

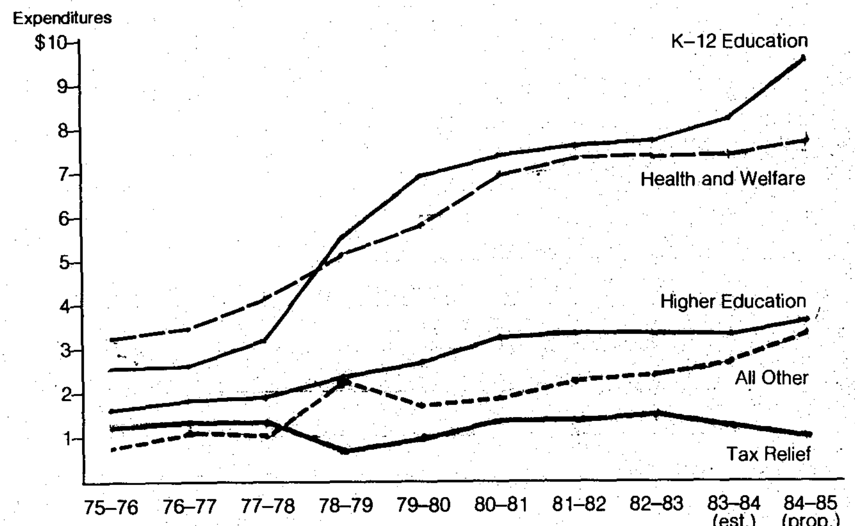


Table 20
Estimated General Fund Program Changes[a]
1983–84 and 1984–85
(in millions)

	Estimated 1983–84	Proposed 1984–85	Change Amount	Change Percent
Health and Welfare:[b]				
Medi-Cal	$2,019	$2,042	$23	1.2%
County health	846	854	8	.9
SSI/SSP	1,097	1,101	4	.3
AFDC grants	1,492	1,563	71	4.8
Social services programs	169	205	36	21.2
Mental health	556	613	57	10.2
Developmental services	576	608	32	5.5
L.A. County Medical Assist. Grant Program	—	200	200	—[d]
Other, health and welfare	545	570	25	4.7
Subtotals, Health and Welfare	$7,301	$7,757	$456	6.2%
Education:				
K-12	$8,239	$9,065	$827	10.0%
State teachers' retirement	21	536	516	—[d]
University of California	1,110	1,447	337	30.3
California State University	948	1,149	201	21.2
California Community Colleges[c]	1,021	1,030	9	.9
Other, higher education	94	107	13	13.8
Subtotals, Education	$11,432	$13,334	$1,902	16.6%
Other:				
Youth and adult correctional agency	$845	$963	$119	14.1%
Resources	289	325	36	12.5
Capital outlay	1	95	94	—[d]
Tax relief	1,077	848	−228	−21.2
Debt service	394	427	33	8.3
Unallocated	180	125	−55	−30.6
All other	1,123	1,203	80	7.1
Subtotals, Other	$3,908	$3,986	$78	2.0%
Totals[e]	$22,641	$25,076	$2,435	10.8%

[a] Based on amounts shown in Governor's Budget.
[b] Includes Secretary for Health and Welfare, and Office of Economic Opportunity. Does not include the Child Development Programs Advisory Committee.
[c] Does not reflect the enactment of AB 1xx (Ch 1xx/84) or AB 470 (Ch 3/84).
[d] Percentage change equals or exceeds 100 percent.
[e] Details may not add to totals due to rounding.

Summary of Major Program Changes

For 1984–85, the budget proposes a net increase in General Fund expenditures of $2,435 million, or 11 percent, from estimated current-year expenditures. Table 20 shows the primary factors that account for the proposed change in expenditures. It shows that the largest increase is proposed for education. The Governor proposes an increase in General Fund expenditures for education of $1,902 million, or 17 percent, above the 1983–84 level. The principal reduction included in the Governor's Budget for 1984–85 is a decrease of $228 million, or 21 percent, in tax relief. This reduction is primarily due to the proposed repeal of the Personal Property Tax Relief subvention. Within each major expenditure category, significant program changes have been proposed. Some of the major General Fund changes include the following:

Medi-Cal expenditures are up slightly, by $23 million or 1.2 percent, from estimated current-year expenditures. After more than a decade of steady growth, this will be the second year in a row in which Medi-Cal expenditures are either stable or lower than in the previous year, due primarily to the 1982 Medi-Cal reforms (Ch. 328/82, Ch 329/82 and Ch 1594/82). This legislation provided for: (1) termination of Medi-Cal eligibility for medically indigent adults and (2) establishment of hospital reimbursement rates on the basis of negotiated contracts. One indication of the fiscal restraint resulting from these reforms is that proposed General Fund expenditures in 1984–1985 are $525 million, or 22 percent, *less* than actual 1982–83 expenditures.

Social Services Programs expenditures are up $36 million, or 21 percent, in 1984–85. This increase primarily reflects increased General Fund monies requested to offset reductions in available federal funds and increased General Fund support for child welfare services and the In-Home Supportive Services program.

Mental Health expenditures are $57 million, or 10 percent, higher in 1984–85. The increase reflects the administration's proposed *mental health initiative,* which would modify the state's role and responsibilities in the administration of local community mental health programs, and upgrade the state hospital system.

K–12 Education expenditures are budgeted at $9,065 million in 1984–85. This is an increase of $827 million, or 10 percent, over estimated current-year expenditures. The major factor that accounts for this increase is second-year funding for major education reforms enacted in the current year by Ch 498/83 (SB 813). For 1984–85, the budget includes an additional $556 million for SB 813 implementation. These monies would fund the increased costs in the budget year of programs established in 1983–84, as well as the cost of new programs in 1984–85. Included in this amount are $257 million to provide incentive payments for increasing the length of the school day and school year and $145 million for additional equalization aid in order to bring expenditures per student in low-wealth districts closer to the statewide average.

State Teachers' Retirement Fund contributions from the General Fund are proposed to increase by $516 million. Of this amount, $211 million represents the statutorily-required contribution for 1983–84 which was vetoed by the Governor from the 1983 Budget Act.

Higher Education General Fund expenditures are proposed to increase by $560 million, or 18 percent. Expenditures for the University of California (UC) are budgeted to increase by $337 million, or 30 percent; expenditures for the California State University (CSU) are proposed to increase by $201 million, or 21 percent; and General Fund expenditures for the Community Colleges are budgeted to increase by $9 million, or 0.9 percent.

Accounting for a significant portion of the increase for higher education is $214 million in salary and benefit increases for UC and CSU faculty and staff. In addition, nearly $36 million in new funding is proposed at UC and CSU for high technology programs.

Youth and Adult Correctional Agency expenditures are proposed to increase by $119 million in the budget year. This will fund 546 additional personnel-year for the Department of Corrections and the increased operating expenditures needed to accommodate the 14 percent growth in the prison population projected by the end of 1984–85.

Capital Outlay expenditures are funded primarily from bond and special funds. In 1984–85, proposed capital outlay expenditures from all funding sources total $580 million, of which $95 million would be provided from the General Fund for building new prisons.

Tax Relief expenditures are budgeted to decrease by $228 million, or 21 percent. This decrease primarily reflects the administration's proposal to repeal the Personal Property Tax Relief subvention.

Unallocated funds contained in the 1984–85 Budget, $125 million from the General Fund, are earmarked to cover the costs of unidentified legislation enacted during the budget year. The $180 million in unallocated funds that are budgeted for 1983–84 are likely to be spent in order to cover anticipated expenditure increases, such as the expected increase in K-12 apportionments resulting from the failure of additional property tax revenues to materialize as projected.

All Other expenditures include $18 million for a statewide telecommunications system, and $5 million for information technology equipment management. In addition, the budget proposes $5 million for a state tourism advertising campaign and $2 million for a business marketing program.

Employee Compensation expenditures are proposed to increase from $121 million provided in the current year to $220 million for the budget year. This amount excludes funding for salary and benefit increases proposed for UC and CSU employees, which is included in the totals for higher education.

For 1984–85, the budget includes an employee compensation package of approximately 10 percent. This amount is set aside for bargaining purposes. The final decisions on employee compensation packages for various groups of state workers will be determined through the negotiation process.

Revenues

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 revenue categories, ranging from taxes levied on individuals and businesses, to income which the state earns 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 General Fund revenue is derived from three 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—normally about 15 percent of the total—are placed into special funds to support specific programs and activities, including highway maintenance and construction.

The availability of revenues is the key determinant of how much the state can afford to spend in providing goods and services to the public. It also determines how much money will be available to set aside in reserve for a "rainy day", so that the state can be reasonably confident of being able to pay its bills on time, even if economic conditions deteriorate unexpectedly. Thus, in analyzing the Governor's Budget for 1984–85, it is important to consider whether the state will collect sufficient revenues to fund the proposed spending plan, and at the same time make adequate provision for possible revenue shortfalls or unanticipated expenditures.

The level of revenues in any fiscal year will be influenced by a variety of factors. These include the state's *tax base* under current law, the *tax rates* that are applied to this tax base, the effect that *economic conditions* will have on 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* which affects the total amount of revenue collected.

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 revenues is the behavior of the state's economy.

For both the national and state economies, 1983 constituted the first year of economic recovery from the recession which plagued the economy in 1981 and 1982.

Nationally, real Gross National Product (GNP) expanded in each of the year's four quarters, and for the year as a whole it grew by 3.5 percent—the best performance since 1978. Likewise, the unemployment rate trended downward throughout the year, pretax profits rose 16 percent following three straight years of declines, and both new car sales and housing starts were at their highest levels since 1979.

California's economy also expanded, experiencing gains in employment, building activity, car sales, taxable sales and corporate profits, along with falling unemployment.

An especially welcome development for both the nation and the state was the low rate of inflation registered in 1983—3.3 percent nationally and only 1.8 percent in California, as measured by the Consumer Price Index. Because inflation was so low, California experienced strong gains in both "real" personal income (5 percent) and "real" taxable sales (5.2 percent).

Despite these improvements, however, a number of problems still confronted the economy at year-end, including historically high "real" interest rates, still-high unemployment levels, a persistent deficit in the nation's trade balance with other countries, and the specter of continuing huge federal budget deficits and the negative effects that these deficits could eventually have on financial markets and overall economic performance.

The Department of Finance's economic forecast for 1984 and 1985 generally reflects the consensus view that the economic recovery will continue, although at a slower pace relative to the quarterly gains realized in 1983. Solid improvements are projected for output and employment, which will reduce the unemployment rate. As the recovery progresses, however, the rate of inflation facing consumers is expected to return to the 5 percent to 6 percent annual range.

There is one significant difference between the department's economic outlook and that of many other forecasters. This difference involves the outlook for interest rates, given the large federal budget deficits that are projected "as far as the eye can see." The department forecasts that interest rates will trend downward throughout 1984 and 1985, reflecting its belief that the nation's financial markets will be able to absorb large federal deficits without having to dampen—through higher interest rates—other public and private demands for credit. In contrast, many other forecasters believe that a clash between the federal government and all other borrowers is inevitable, and therefore predict an eventual uptrend in interest rates which will "hold back" such interest-sensitive sectors as investment and housing. Because our economy has never before had to finance $200 billion per year federal deficits at the same time that the rest of the economy is increasing its demand for credit, no one really knows what to expect from interest rates in the years ahead. This, then, is *the* major uncertainty regarding the department's economic outlook for 1984 and 1985.

Will the Department of Finance's economic forecast prove to be accurate? No one can say. Given the very poor record economic forecasters have compiled in recent years, the Legislature can have only limited confidence in the ability of the department *or* any other forecaster to accurately foresee the future, even over a period as short as the next 12 to 18 months.

We believe the "confidence factor" associated with economic forecasts is especially low at this point in time. Although history suggests that an economic recovery such as the one we are now in the midst of should continue for some time, the ominous prospects of large and continuing federal budget deficits cloud the future as never before. Of particular concern is the effects which such deficits could have on interest rates, on investment spending and, if the deficits are financed through the creation of more money, on the rate of inflation.

Consequently, the Legislature will need to keep a close watch on economic developments in the months to come, and be prepared to revise its outlook for state revenues accordingly.

Summary of the Revenue Outlook

Table 21 summarizes the Governor's Budget estimates of total, General Fund, and special fund revenues. The table shows that:

Table 21
Summary of
General Fund and Special Fund Revenue Performance
1982–83 through 1984–85
(in millions) [a]

	Prior Year (1982–83)	*Current Year (1983–84)*	*Budget Year (1984–85)*
General Fund Revenues			
—Amount	$21,233	$23,368	$25,825
—Dollar change	$273	$2,135	$2,457
—Percent change	1.3%	10.1%	10.5%
Special Fund Revenues			
—Amount	$3,058	$3,792	$4,619
—Dollar change	$417	$734	$827
—Percent change	15.8%	24.0%	21.8%
Totals, General Fund and Special Fund Revenues			
—Amount	$24,291	$27,160	$30,444
—Dollar change	$690	$2,869	$3,284
—Percent change	2.9%	11.8%	12.1%

[a] Source: 1984–85 Governor's Budget. Details may not add to totals due to rounding. Figures include effects of all special revenue-enhancing measures in each year and include transfers between various special funds and the General Fund.

- *Prior year* (1982–83) total revenues were $24.3 billion (only $690 million, or 2.9 percent, above the previous year's level). This amount consists of about $21.2 billion in General Fund revenues (up $273 million, or 1.3 percent), and $3.1 million in special fund revenues (up

$417 million or 16 percent).

- ***Current year*** (1983–84) total revenues are estimated to reach $27.2 billion (up $2.9 billion, or 12 percent), consisting of $23.4 billion in General Fund revenues (up $2.1 billion, or 10 percent) and revenues to special funds of $3.8 billion (up $734 million, or 24 percent).
- ***Budget year*** (1984–85) total revenues are projected at $30.4 billion ($3.3 billion, or 12 percent, above the estimated current-year level). The total includes $25.8 billion in General Fund revenues (up $2.5 billion, or 11 percent), and $4.6 billion in special funds revenues (up $827 million, or 22 percent).

By historical standards, the growth in revenues projected for both the current and budget years is slightly above the norm, when the effects of inflation and population growth are eliminated. This is in contrast to the extremely poor revenue performance during 1982–83 that resulted from the recession. To illustrate:

- The annual growth in total *current dollar* revenues over the 12-year period from 1970–71 through 1981–82 averaged over 13 percent, compared to 2.9 percent for 1982–83, 11.8 percent for 1983–84, and 12.1 percent for 1984–85; and
- The annual growth in total *constant dollar* revenues (that is, revenues adjusted for inflation) averaged 4.9 percent over this 12 year period, compared to a decline of about 3.5 percent in 1982–83, and increases of 5.6 percent in 1983–84, and 5.4 percent in 1984–85.
- The annual growth in total *constant dollar per capita* revenues (that is, revenues adjusted for both inflation and population increases) averaged 3.1 percent over the 12-year period, compared to a decline of 5.1 percent in 1982–83, and increases of 3.8 percent in 1983–84 and 3.6 percent in 1984–85.

The decline in both constant dollar and constant dollar per capita revenues during 1982–83 was the worst decline since 1970–71, when these two measures of revenues fell by 4.3 percent and 5.3 percent, respectively.

It is important to recognize that the growth rates shown above for General Fund and special fund revenues during the prior, current and budget years have been significantly distorted by a number of factors. For example:

- ***General Fund*** revenue growth has been affected dramatically by revenue-reducing ballot measures, as well as by tax accelerations, other revenue enhancements, and special fund transfers to the General Fund that were enacted by the Legislature in 1981, 1982, and 1983.

Table 22
Effect of Selected Special Factors on General Fund Revenues 1981–82 through 1984–85 (in millions) [a]

	1981–82	*1982–83*	*1983–84*	*1984–85*
A. *Factors Which Increased Revenues*				
1. 1981 Budget Act and certain other legislation	$547	—	—	—
2. 1982 Budget Act and trailer bill	211	$903	$12	$151
3. 1982 legislation which accelerated taxes, raised interest penalties on delinquent taxes, and provided for certain transfers [b]	535	108	121	141
4. 1983 Budget Act and trailer bill [c]	—	—	647	193
5. 1983 education finance bill [d]	—	—	84	141
6. 1983 local finance bill [e]	—	—	388	210
7. 1983 special session measures to augment revenues through tax accelerations and transfers [f]	—	430	17	38
8. 1984–85 Governor's Budget [g]	—	—	66	152
9. Other factors	—	80	45	50
Subtotal, factors which increased revenues	$1,293	$1,521	$1,380	$1,076
B. *Factors Which Reduced Revenues*				
1. 1980 inheritance and gift tax changes [h]	−109	−203	−230	−262
2. Termination of federal revenue sharing	−97	−276	−276	−276
3. 1982 ballot initiatives [i]	—	−367	−900	−1,299
4. 1984–85 Governor's Budget [j]	—	—	—	−214
5. Other factors	−31	—	−8	−46
Subtotal, factors which reduced revenues	−$237	−$846	−$1,414	−$2,097
Totals	$1,056	$675	−$34	−$1,021 [k]

[a] Source: California Department of Finance and Legislative Analyst's Office.
[b] Ch 2x/82 (AB 6x), Ch 5x/82 (AB 8x), and Ch 115/82 (SB 1253).
[c] Includes $150 million in 1983–84 and $134 million in 1984–85 reflecting use of the "old" California Consumer Price Index in June 1983 for income tax indexing.
[d] SB 813 (Ch 498/83).
[e] Ch 983/83 (AB 895).
[f] Ch 10x/83 (AB 28x).
[g] Includes court cases, revenue gains from the 1984 Summer Olympics and Democratic National Convention, audit redirection, and tidelands oil revenues not statutorily earmarked for special funds.
[h] Ch 634/80 (AB 2092).
[i] Proposition 7 (income tax indexing) and Proposition 6 (inheritance and gift tax repeal).
[j] Elimination of transfer provided for under Ch 983/83 (AB 895), and audit redirection.
[k] Table does not show a $28 million revenue gain under Ch 1xx/84 (AB 1xx), which transferred these monies from the COFPHE Fund to the General Fund in 1984–85.

Of those actions which have increased revenues during this period, many were taken for the express purpose of balancing the state's budget. Table 22 summarizes those actions affecting General Fund revenues and shows the estimated fiscal effect of each. The table indicates that the *net* effect of these actions has declined from a *plus* $1.1 billion in 1981–82 to a *minus* $1 billion in 1984–85. This shift is partly due to the fact that no large General Fund revenue-enhancements have been proposed by the Governor for the budget year. (Such enhancements are not needed to balance the 1984–85 budget, as they were in the previous two years.)

- *Special fund* revenue growth has also been distorted in recent years, due to the transfers from special funds to the General Fund listed in Table 22. In addition, recent law changes raising fuel taxes and vehicle registration and license fees, increased special fund revenues by about

$205 million in 1981–82, $467 million in 1982–83, $859 million in 1983–84, and $876 million in 1984–85 (please see Table 43).

We now turn to a more detailed discussion of state revenues in the prior year (1982–83), current year (1983–84), and budget year (1984–85). The starting point for this discussion is a closer look at the economic assumptions on which the current and budget year revenue forecasts are based.

THE ECONOMIC OUTLOOK

Economic conditions in 1984 and 1985 will be the prime determinant of state revenue collections during the latter half of 1983–84 and in 1984–85. The economic outlook for these two years is discussed below, along with a review of how the economy performed during 1983.

The 1983 Economy In Retrospect

During 1983, the economy enjoyed a year of recovery from the 1981–82 recession. The economy reached a low point near the close of 1982, and since that time, has expanded. Most economists have characterized the 1983 recovery pattern as having been fairly strong and, on balance, similar to the average of other postwar recovery periods. Probably the most surprising aspects of the recovery were the unexpectedly sharp drop-off in inflation and the failure of interest rates to decline significantly. At year-end 1983, the recovery still appeared to be "on track," with further expansion expected throughout 1984. This is true both for California and the nation generally.

California's Report Card for 1983

Table 23 summarizes how the California economy fared during the year, relative to the Department of Finance's projections. It indicates that:

- *Employment growth* was pretty near expectations, which were not very high to begin with. Civilian employment rose by 1.3 percent, compared to the 1.5 percent gain expected one year ago. Likewise, wage and salary job growth was 1 percent, compared to last year's projection of 0.7 percent. These annual average rates of increase, however, obscure the improvement in employment which occured as 1983 progressed. For example, by December 1983, the number of jobs in the state was 3.4 percent higher than one year earlier.
- *Consumer price inflation* was only 1.8 percent, the lowest rate in 20 years and well below the 4.4 percent forecasted.
- *Unemployment* averaged 9.7 percent, below the original forecast of 10.2 percent, and ended the year at 7.9. This was a dramatic improvement over the 11 percent rate for December 1982, which had been a record high.
- *Residential building permits* were reported to be 162,000, or 30 percent above the predicted level of 125,000. *New car sales,* which reached over 1 million, also exceeded the department's projection.

Table 23
Summary of 1983 Economic Performance for California [a]

Economic Indicator	*Original January 1983 Forecast* [b]	*Revised June 1983 Forecast*	*January 1984 Actual* [c]
Percent change in:			
—Personal income	8.5%	6.6%	6.9%
—Civilian employment	1.5	0.7	1.3
—Wage and salary employment	0.7	0.7	1.0
—Consumer prices [d]	4.4	1.7	1.8
Unemployment rate (%)	10.2%	10.1%	9.7%
Residential building permits (thousands)	125	135	162
New car sales (thousands)	930	975	1010

[a] Forecasts and estimates by the California Department of Finance.
[b] 1983–84 Governor's Budget.
[c] Estimate contained in the 1984–85 Governor's Budget.
[d] Beginning in January 1983, the U.S. Bureau of Labor Statistics began publishing a "new" CPI which includes a revised treatment of homeownership costs. The CPI increase shown above for the June 1983 forecast used the "new" CPI; the projected increase for June using the "old" CPI was 0.7 percent. The "old" CPI is no longer published.

- ***Personal income*** expanded by 6.9 percent, or less than the projected 8.5 percent gain. This shortfall reflected lower-than-expected inflation.
- ***"Real" personal income*** (that is, income adjusted for inflation) rose by 5.0 percent, based on the Consumer Price Index measure of inflation. This was well above the projected 3.9 percent increase. The gain was only 2.9 percent using the GNP Consumption Deflator measure of inflation, however, or slightly less than the projected 3.2 percent gain. In either case, though, real per capita income rose.
- ***Taxable sales*** expanded by 9.3 percent, or close to last year's projected gain of 8.9 percent. For ***corporate profits,*** however, the current estimate of growth—21 percent—is more than twice that which was predicted—8 percent.

Thus, on balance, California's economic performance in 1983 met expectations and, in some cases, was considerably better than predicted.

Table 24 summarizes how successful various forecasters were in predicting California's economic performance during 1983. Like the Department of Finance, these forecasters as a group came quite close to projecting employment growth but, because they predicted too high a rate of inflation, they overestimated personal income growth. They also joined the department in overstating unemployment and understating building permits. Thus, on balance, the department's track record, though far from perfect, was at least as good as that of the other forecasters.

Economic Improvement a National Experience

The economic turnaround California experienced in 1983 was also experienced by the nation's economy generally. For instance:

- ***Real GNP*** in the fourth quarter of 1983 was 6.2 percent higher than it was one year earlier, and well above the pre-recession peak level reached in 1981.
- ***Pre-tax corporate profits*** surged by an estimated 16 percent, according to the department. Private-sector forecasters believe that the increase may have been even larger—about 20 percent. In contrast, the level of profits nationally declined in 1980, 1981 and 1982, even after adjusting for the effects on pre-tax profits of 1981 federal law changes regarding the treatment of depreciation allowances.

Table 24

Accuracy of Economic Forecasts for California in 1983 [a]

	Economic Variables						
Forecaster [b]	*Personal Income Growth*	*Consumer Price Inflation*	*"Real" Personal Income Growth* [a]	*Civilian Employment Growth*	*Wage and Salary Employment Growth*	*Unemployment Rate*	*Residential Building Permits (thousands)*
Department of Finance	8.5%	4.4%	3.9%	1.5%	0.7%	10.2%	125
First Interstate Bank	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
Actual	*6.9*	*1.8*	*5.0*	*1.3*	*1.0*	*9.7*	*162*

[a] Defined here as personal income growth adjusted for inflation as measured by the California Consumer Price Index. Actual 1983 "real" income growth is 2.9 percent (versus 5.0 percent) if the GNP Consumption Expenditures Deflator is used to measure inflation.

[b] Forecasts as of approximately year-end 1982.

- ***Housing starts*** in 1983 averaged 1.7 million units, or well above the postwar record low of 1.1 million units in 1982.
- ***Capacity utilization*** averaged slightly over 75 percent in 1983, up from 71 percent in 1982. The gain was especially dramatic if the two fourth quarters are compared—69 percent in 1982 versus nearly 80 percent in 1983.
- ***"Real" disposable personal income*** rose 3.3 percent in 1983, versus only 0.5 percent in 1982.
- ***Unemployment*** fell from 10.3 percent in December 1982 to 8.2 percent in December 1983.

Problems Still Remain

Despite the economic improvements which characterized 1983, the California and national economies were far from completely healthy by year-end. For example, real GNP was still only 3.2 percent higher than it was in mid-1981, and unemployment was still above the annual averages recorded during the late 1970's and early 1980's for both the state and nation. Especially disturbing were continuing high interest rates. At year-end, the prime rate was lodged at about 11 percent and the average mortgage rate was at near 13 percent. Combined with the recent low rates of inflation, this means that "real" interest rates were historically high, a situation which tends to limit the growth potential for interest-sensitive sectors of the economy such as housing and business investment. It is especially disturbing that interest rates are so high, first because they generally hit a low point at the close of a recession, and second because of the large federal budget deficits "waiting in the wings." Another problem facing the economy at year-end was the enormous foreign trade deficit, which tends to drain jobs and income away from our shores. Thus, although the economy ended 1983 apparently poised for continued expansion in 1984, many economic problems remain to be solved.

The Economic Outlook for 1984 and 1985

Economic activity in calendar 1984 will account for about one-third of current-year (1983–84) General Fund revenues and about two-thirds of budget-year (1984–85) General Fund revenues. The remaining one-third of budget-year revenues will be determined by economic conditions in 1985. Table 25 summarizes the Department of Finance's economic projections for 1984 and 1985, for both the nation and California.

The Nation—Expansion to Continue

The department's economic forecast reflects the consensus view among economists that the expansion of activity which began in 1983 will continue through 1984 and into 1985. The pace of expansion, however, is projected to taper off during this period. For the nation as a whole:

- ***Real GNP*** is projected to rise by 5.6 percent in 1984 and 3.2 percent in 1985. The projected increase in 1984, if realized, will be the largest increase since 1973 (see Chart 11).
- ***Pre-tax corporate profits*** are expected to post a 27 percent gain in 1984, followed by 16 percent rise in 1985.
- ***Unemployment*** is expected to trend downward, averaging 8.1 percent in 1984 and 7.7 percent 1985 (Chart 12). Despite this improvement, however, the unemployment rate in 1985 will still be above that experienced during the 1976-through-1981 period.

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

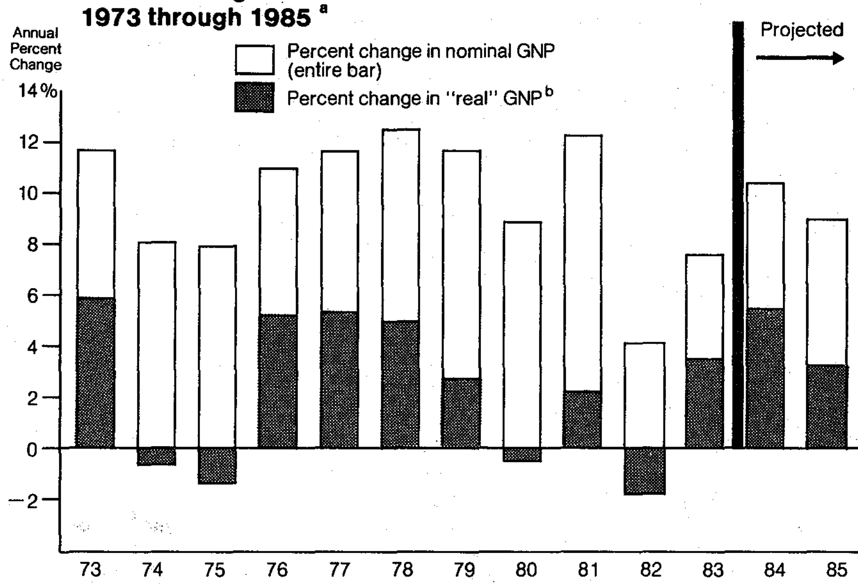
	1983 Estimated		*1984 Forecast*		*1985 Forecast*	
	Level	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*
A. *The Nation*						
GNP in current dollars	$3,309.8	7.7%	$3,647.5	10.2%	$3,974.5	9.0%
GNP in 1972 dollars	1,536.8	3.5	1,623.2	5.6	1,674.9	3.2
Personal income	2,740.4	6.3	2,993.1	9.2	3,242.6	8.3
Corporate profits (pre-tax)	202.1	16.0	257.4	27.3	299.7	16.4
Wage and salary employment (000)	89,985	0.4	93,540	3.9	95,691	2.3
Civilian employment (000)	100,744	1.2	104,393	3.6	106,599	2.1
Housing starts (millions of units)	1,711	61.6	1,730	1.1	1,632	−5.6
New car sales (millions of units)	9.1	13.9	10.4	14.5	10.8	3.4
GNP price deflator (1972 = 100)	215.3	4.1	224.7	4.3	237.3	5.6
Consumer price index (1967 = 100)	298.7	3.3	314.7	5.4	332.6	5.7
GNP consumption deflator (1972 = 100)	213.3	3.9	223.1	4.6	234.6	5.2
Unemployment rate (%)	9.6%	—	8.1%	—	7.7%	—
Savings rate (%)	4.9	—	5.2	—	5.0	—
Prime interest rate (%)	10.8	—	10.6	—	10.2	—
B. *California*						
Personal income	$332.1	6.9%	$364.4	9.7%	$394.9	8.4%
Wage and salary income	205.1	7.2	225.0	9.7	243.6	8.3
Wage and salary employment (000)	9,969	1.0	10,359	3.9	10,630	2.6
Civilian employment (000)	11,116	1.3	11,591	4.3	11,897	2.6
New car registrations (000)	1,010	18.6	1,110	9.9	1,155	4.1
Residential building permits (000)	162	93.5	170	4.9	155	−8.8
Consumer price index (1967 = 100)	299.8	1.8	317.8	6.0	337.0	6.0
Unemployment rate (%)	9.7%	—	7.9%	—	7.6%	—
Key elements of the state's tax base:						
—Taxable personal income [b]	$280.9	6.6%	$309.9	10.3%	$335.6	8.3%
—Taxable sales	168.9	9.3	190.7	12.9	207.8	9.0
—Taxable corporate profits	28.5	20.8	36.0	26.4	42.2	17.0

[a] Source: Department of Finance and the 1984–85 Governor's Budget.
[b] Defined as total personal income *plus* social security contributions *minus* both transfer payments and "other labor income." This income concept historically has shown a strong correlation to adjusted gross income reported for tax purposes in California.

- ***Employment growth*** in 1984 is expected to reach 3.6 percent for civilian employment and 3.9 percent for wage and salary employment, both strong gains compared to the slight increases seen in 1983. For 1985, milder gains of slightly over 2 percent are expected.
- ***Housing starts*** are projected to total 1.73 million units in 1984 and 1.63 million units in 1985. These levels are close to the 1983 rate (1.71 million units) and far in excess of the depressed levels achieved in 1980 (1.3 million units), 1981 and 1982 (1.1 million units in each year). However, they remain well below the levels reached in the strong housing years of the 1970's, when housing starts exceeded 2 million units on four different occasions.
- ***Car sales*** are forecast to reach 10.4 million units in 1984 and 10.8 million units in 1985. These levels compare favorably to those of the strong years of the late 1970's.

Chart 11

Annual Change in Gross National Product 1973 through 1985 [a]

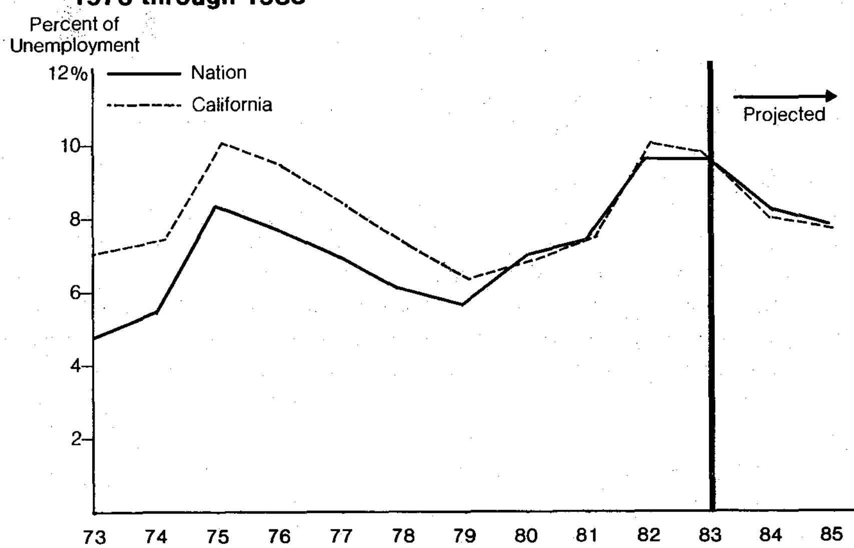


[a] Source: California Department of Finance. 1983 figures are preliminary

[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 1985 [a]



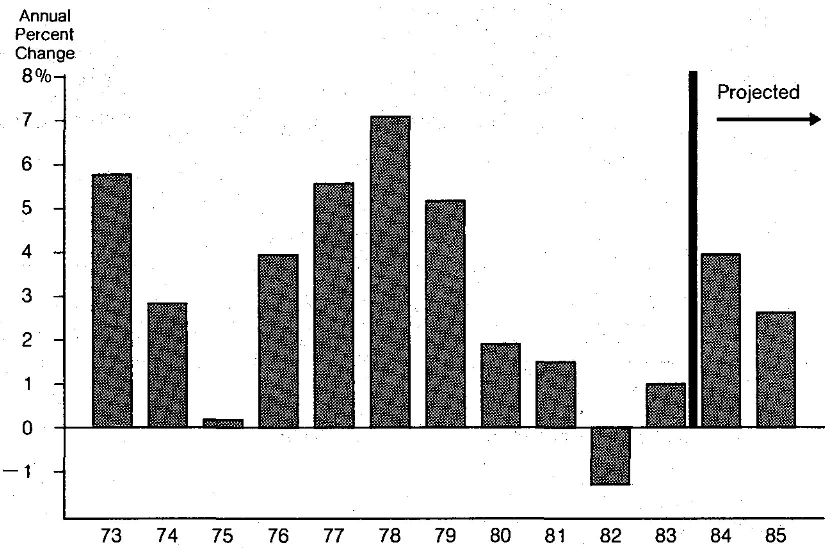
[a] Source: California Department of Finance

California—Similar Expectations of a Continuing Upturn

Economists who study the California economy generally agree with the department's belief that the economic expansion will continue throughout 1984 and into 1985. Indeed, there is a strong possibility that the state's performance could be better than the nation's, due to such factors as the benefits California is sure to realize from increases in federal defense spending. As shown in Table 25, the department's forecast for California indicates that:

Chart 13

Annual Growth in California Wage and Salary Employment 1973 through 1985 [a]



[a] Sources: Department of Finance and Employment Development Department. Data are estimated for 1983.

- ***Employment growth*** is projected to be 4.3 percent for 1984 and 2.6 percent for 1985, using the civilian employment series, and 3.9 percent for 1984 and 2.6 percent for 1985, using the wage and salary employment series. These rates exceed those projected nationally. As shown in Chart 13, the rate of growth projected for California wage and salary employment in 1984, if reached, would be the highest in five years, although well below the "boom" years of 1976 through

1979. The total number of new jobs projected for 1984 is 390,000, compared to the 446,000 that were created in 1977, 600,000 in 1978, and 465,000 in 1979.

- *Unemployment* is projected to fall from 9.7 percent in 1983 to 7.9 percent in 1984 and 7.6 percent in 1985. Chart 12 shows that California's improvement in this area will be slightly better than the nation's, reflecting the more rapid rate of job growth expected in the state. Even by 1985, however, unemployment still will lie above the levels that prevailed in the late 1970's.
- *Construction activity* is expected to improve slightly in 1984, with 170,000 new residential building permits issued. In 1985, however, the department predicts a softening of activity, partly due to the fact that interest rates will remain fairly high by historic standards. Again, while these permit levels are a welcome improvement over levels achieved in the 1980 through 1982 period, they are well below the average level of 225,000 permits for non-recession years since 1968.

The implications of the current economic outlook for state revenues are best seen in the forecast for those key California variables which most affect the state's major revenue sources. As shown in Table 25:

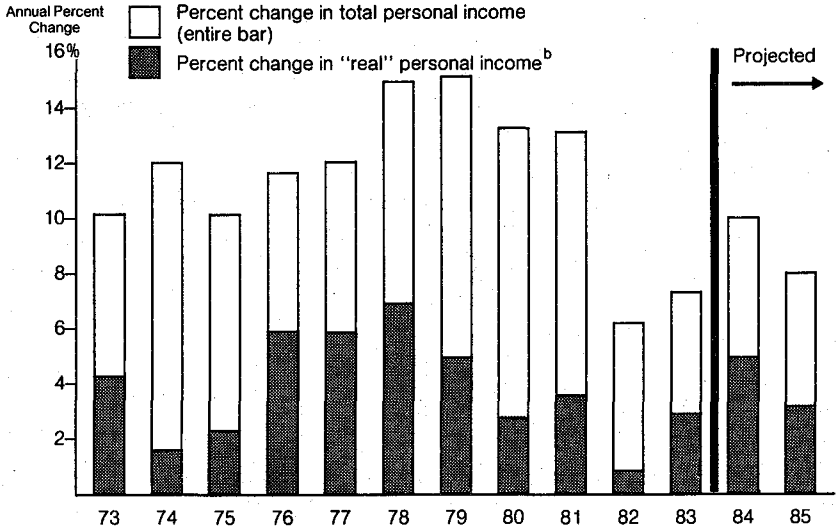
- *Personal income* is projected to rise by 9.7 percent in 1984 and 8.4 percent in 1985, as shown in Chart 14. When personal income is adjusted for transfer payments and social security contributions so as to roughly approximate "taxable" personal income, the increases become 10.3 percent in 1984 and 8.3 percent in 1985. "Real" personal income growth (that is, growth adjusted for inflation) is expected to be moderately strong—4.9 percent in 1984 and 3.0 percent in 1985.
- *Taxable corporate profits* are forecast to rise 26 percent in 1984 and 17 percent in 1985, following declines of 7 percent in 1981 and 1.3 percent in 1982, and a rise of 21 percent in 1983 (see Chart 18). The increases for these three years (1983, 1984 and 1985) are in sharp contrast to the preceeding four years, and compare favorably to the era of 20-percent-plus increases experienced from 1976 through 1978, after the last recession ended.
- *Taxable sales* are predicted to rise 13 percent in 1984 and 9 percent in 1985. Because of moderate inflation, these gains will allow for strong increases in "real" taxable sales, including 7.9 percent in 1984, which would be the highest rise since 1977 (see Chart 17).

Inflation—Moderate Increase Expected

Chart 15 shows the trend of inflation faced by consumers in the state and nation during the past ten years, and the department's projected rate of inflation for 1984 and 1985.

Chart 14

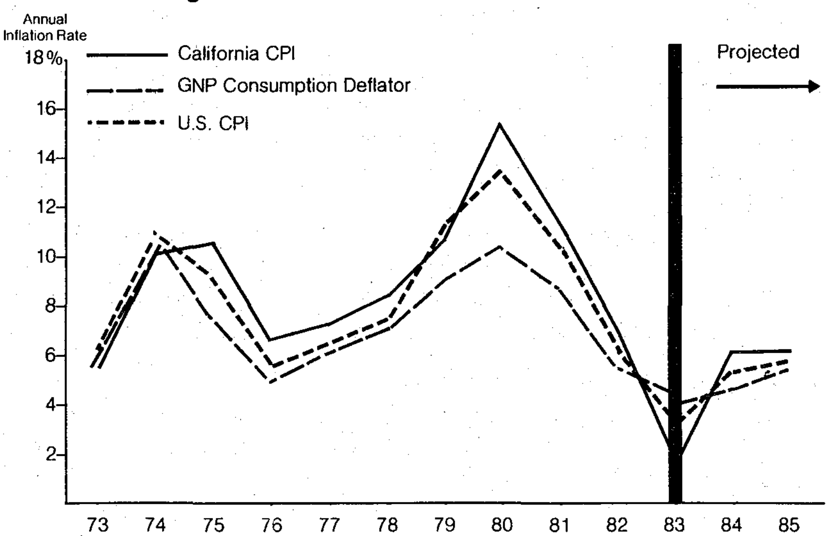
Annual Growth in California Personal Income 1973 through 1985[a]



[a] Source: Department of Finance estimate for 1983 and projections for 1984 and 1985.
[b] Real personal income is defined as total personal income deflated by the GNP Consumption Expenditures Deflator.

Chart 15

Inflation Faced by Consumers in California and the Nation 1973 through 1985[a]



[a] Source: 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.

As Chart 15 and Table 24 show, the rate of inflation in California during 1983 was far better than what the department envisioned 12 months ago—1.8 percent, versus 4.4 percent. The same good news occurred nationally as the rate of inflation, although higher than the state's, was at its lowest level in 10 years. The exact reason why the state's inflation rate was lower than the nation's is not yet completely clear, although a recent study by the Bank of America indicates that the state did experience lower inflation than the nation in such areas as transportation costs and home heating fuels. Some of the difference in inflation rates undoubtedly is due to the different weights which commodities get in the two consumer price indexes.

As Table 26 shows, a major reason accounting for the unexpectedly strong improvement in price stability during 1983 was the sharp decline in unit labor costs (which are a prime determinant of the inflation rate), brought about by the combination of improved labor productivity and reduced increases in hourly labor compensation.

Table 26
Trends in Factors Influencing National Inflation
1980 through 1983

Year	*Labor Productivity Growth*	*Growth in Hourly Labor Compensation*	*Growth in Unit Labor Costs*[a]	*Inflation Rate*	
				CPI	*GNP Consumption Deflator*
1980	−0.7%	10.4%	11.2%	13.5%	10.2%
1981	1.9	9.7	7.7	10.3	8.4
1982	0.0	7.9	7.9	6.2	5.8
1983	3.2	5.7	2.4	3.3	3.9

[a] The annual change in unit labor costs is approximately equal to the difference between growth in hourly labor compensation and productivity growth.

Chart 15 shows that the department expects consumer inflation to trend upwards a bit from here on out, averaging in the range of 4½ percent to 5½ percent nationally in 1984 and 5 percent to 6 percent in 1985, depending on the index used. For California, a 6 percent rate is forecast for each year. Most other forecasters expect inflation to be in this same basic range. The reasons why forecasters anticipate an upturn in inflation are (1) the demand-side pressures that are expected to accompany an expanding economy, and (2) somewhat smaller gains in labor productivity and thus larger increases in unit labor costs.

Although rates of inflation in the 5 percent to 6 percent range are relatively moderate—and far better than what the U.S. experienced several years ago—we should *still* be concerned about inflation. As we learned all too well during the 1970's, inflation can quickly accelerate if monetary growth is not carefully controlled, or if outside shocks, such as disruptions in the supply of oil, occur. Furthermore, a 6 percent inflation rate is not particularly low in an historical context. At this rate, prices will double in less than 12 years, and can result in problems such as unintended income redistributions, instability in financial markets, and high interest rates, especially if the inflation is not anticipated by workers, firms, investors and households. Thus, controlling and reducing inflation should remain a top priority of the nation's economic policymakers.

Interest Rates—Future Trend Uncertain

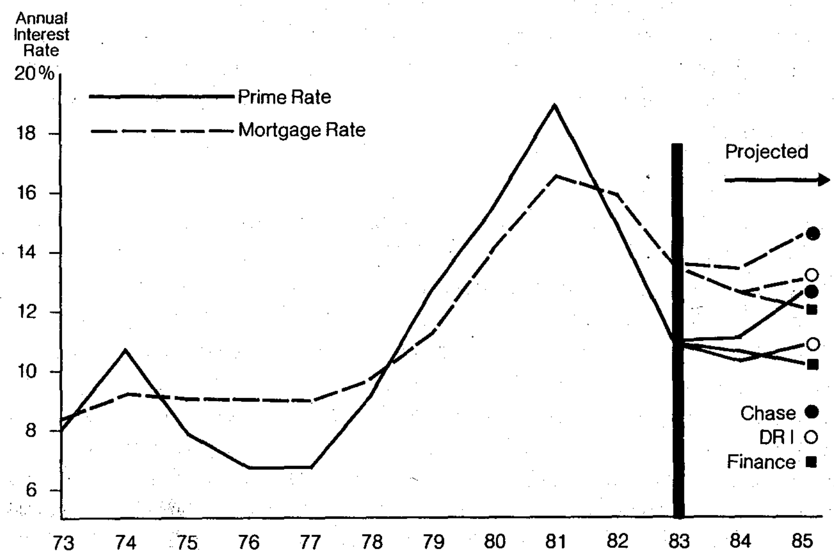
No two topics related to the economy have received greater attention during the past several years than interest rates and the federal budget deficit.

Chart 16 shows that interest rates fell during 1983 but still are at historically high levels. This is especially true of "real" interest rates (that is, interest rates adjusted for inflation). Most economists believe that interest rates currently are higher than they "should be", based upon such factors as demand and supply for credit and the rate of inflation. Although these economists have offered a variety of possible explanations for the high rates—including fears of a new inflation surge and the impact that federal budget deficits in the future are likely to have on the capital markets—there is no consensus as to exactly what the real causes of today's high interest rates are.

What is clear, is that continued high interest rates will result in less of certain types of economic activity. In many cases, the types of economic activity most affected by high interest rates are those very types that are important to the continued health of the economy, such as business investment. In addition, high interest rates are a major cause of our foreign trade problems, since they draw in foreign capital to the U.S., thereby raising the value of the dollar and reducing the demand for our exports.

Chart 16 shows that there is a lack of agreement regarding the likely course that interest rates will take in 1984 and 1985. The Department of Finance forecasts that rates will decline in both years, reflecting its assumption that financial markets can accommodate both the private sector's and the federal government's borrowing needs without a serious "clash" between the two. Certain other forecasters—such as Chase Econometrics and Data Resources—believe that interest rates will rise in 1985 and, in Chase's view, 1984 as well. Were this to occur, the department's economic forecast, and thus its revenue estimates, would probably have to be revised downward.

Chart 16
Trends in Interest Rates —1973 Through 1985[a]



[a] Projections by Chase Econometrics and Data Resources are as of approximately year-end 1983. Mortgage rate represents commitment rate series for conventional loans.

The question of what will happen to interest rates is <u>the</u> major element of uncertainty in the economic outlook.

Federal Budget Deficits Cloud the Future

The Congressional Budget Office recently reported that it expects the federal budget deficit to remain in the range of $200 billion to $300 billion through 1989. Countless predictions have been offered recently of what the economic implications of this unpleasant fact might be. As discussed earlier, some economists believe that these deficits eventually will cause interest rates to rise above their already-high levels, thereby stunting near-term economic growth and investment, which in turn could lead to an economy with lower productivity and higher inflation in future years. Other economists maintain that much of the concern about deficits is overstated, and that the economy will somehow "learn to live with them." These economists also argue that, thus far, the federal budget deficits may have actually benefitted the economy, by generating demand for production and jobs while the private sector was weakened by the recession. They also point to the fact that one reason for the deficits is the generous federal tax benefits that were enacted in 1981 and 1982, which themselves should aid the private sector.

The truth about the deficit problem is that no one really knows at this time exactly what these deficits will do to the economy. This is partly because we have never experienced a deficit problem of this magnitude and in these circumstances before. We are convinced, however, that as the recovery proceeds, the economy would be healthier without these deficits than with them. In any event, the implications of unprecedented federal budget deficits is a second major cause of uncertainty regarding the economic outlook.

Finance Versus Other Forecasters

Tables 27 and 28 compare the Department of Finance's national and California economic forecasts for 1984 with those which were made by other economists at approximately the same point in time (year-end 1983). The department's economic forecast is about where those of most other public and private forecasters were when the department prepared its forecast (November–December 1983). Since then, some forecasters have revised their projections downward a bit, based upon such factors as the greater-than-expected weakness in the U.S. trade balance and the lower-than-predicted real GNP growth in the fourth quarter. Nevertheless, the department's forecast is not out of line. Most forecasters still envision the same type of economic performance in 1984 that Finance does—fairly moderate growth in real output and employment, moderate inflation, large gains in corporate profits, a slowly but steadily declining unemployment rate, and moderately strong home building activity.

Table 27
Comparison of 1984 National Economic Outlooks of Selected Forecasters

	Percent Change in:							
	Real GNP	*GNP Prices*	*Consumer Price Index*	*Before Tax Profits*[a]	*Real Disposable Personal Income*	*Unemployment Rate*	*New Car Sales (millions of units)*	*Housing Starts (millions of units)*
Department of Finance	5.6%	4.3%	5.4%	27.3%	4.7%[c]	8.1%	10.4	1.73
Other Forecasters[b]								
Data Resources	5.4	4.7	4.9	23.0	4.4	8.1	10.4	1.73
UCLA	5.5	4.9	5.1	23.6	4.7	8.2	10.0	1.73
Evans Economics	4.4	3.9	3.9	19.6	4.8	8.0	9.9	1.61
Security Pacific Bank	5.6	4.7	5.4	28.5	4.7	7.8	10.3	1.76
Chase Manhattan Bank	4.8	5.4	5.6	32.0	2.7	8.1	10.0	1.68
Crocker Bank	4.5	4.9	4.9	—	4.1	8.7	10.3	1.68
First Interstate Bank	5.0	5.3	5.8	25.6	3.9	8.4	10.1	1.63
Conference Board	5.5	4.6	5.6	30.1	—	8.0	10.2	1.76
Chase Econometrics	5.2	4.9	4.9	23.0	4.4	8.0	10.3	1.71
Bank of America	5.6	5.1	4.9	27.4	4.5	8.2	10.4	1.75
Commission on State Finance	5.4	4.7	4.9	23.0	4.4	8.2	10.4	1.73
Blue Chip Consensus[d]	5.3	4.7	5.0	24.7	5.2	8.0	10.3	1.74
Average of "Other" Forecasters	5.2%	4.8%	5.1%	25.5%	4.3%	8.1%	10.2	1.71

[a] Most forecasters have reported this series as computed without the inventory valuation adjustment.
[b] Forecasts as of approximately year-end 1983.
[c] Computed by deflating total disposable personal income by the U.S. Consumption Expenditures Deflator. Real disposable income growth would be 3.9 percent using the Consumer Price Index.
[d] Consensus forecast for approximately 40 private sector forecasters collected monthly by Eggert Economic Enterprises, Inc.

Table 28
Comparison of 1984 California Economic Outlooks of Selected Forecasters

	Percent Change in:						
	Personal Income	*Consumer Prices*[a]	*Real Personal Income*[b]	*Civilian Employment*	*Wage and Salary Jobs*	*Unemployment Rate*	*Residential Building Permits (thousands)*
Department of Finance	9.7%	6.0%	3.5%	4.3%	3.9%	7.9%	170
Other Forecasters[c]							
First Interstate Bank	10.2	5.8[d]	4.2	—	3.9	—	143
Security Pacific Bank	11.3	4.6	6.4	3.7	3.5	8.7	146
Bank of America	10.3	5.3	4.8	4.5	—	8.8	191
Crocker Bank	10.8	5.1	5.4	4.5	4.5	8.3	175
UCLA	10.9	5.1	5.5	4.8	4.3	8.5	190
Commission on State Finance	10.4	4.7	5.4	3.4	4.8	8.4	166
Average of "Other" Forecasters	10.7%	5.1%	5.3%	4.2%	4.2%	8.5%	169

[a] As measured by the California Consumer Price Index (CCPI). Inflation projection comparisons show that the Department of Finance forecast is closer to the other forecasters when alternative consumer price measures are used. For example, if U.S. GNP Consumption Deflator is compared, the projections are 4.6% for the department, 4.7% for Crocker Bank, 4.6% for UCLA, and 4.5% for the Commission on State Finance.

[b] Defined as personal income growth adjusted for CCPI inflation. If the U.S. GNP Consumption Deflator is used to adjust personal income, the department's projected "real" personal income growth remains below that of most of the other forecasters, but by less than when using the CCPI. For example, the department's projection using the GNP measure is 4.9%, compared to 5.8% for Crocker Bank, 6.0% for UCLA, and 5.6% for the Commission on State Finance.

[c] Forecasts as of approximately year-end 1983, corresponding to when the Department of Finance constructed the economic assumptions on which its revenue projections are based.

[d] Consumer price inflation forecast unavailable for California; figure represents U.S. consumer price inflation.

The department's forecast for California does differ from what other forecasters are predicting in one important respect: the department expects a somewhat lower rate of personal income growth, reflecting a lower projected rate of "real" income growth. Even so, the department's projections for employment growth and housing activity in the state are comparable to those of the other forecasters. Thus, while there is some evidence that Finance's California forecast is a bit conservative when compared to those of other forecasters, we believe that the general story told by *all* of the forecasters is pretty-much the same, and that the differences are not such as to suggest the department's forecast is "out-of-line." This is especially so, given that a number of economists recently have revised their figures down a bit.

In short, we believe that the department's economic forecast at this point in time is as reasonable as anyone's. 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 any of the forecasts shown in Tables 27 and 28 will be exactly on target. There is simply too much uncertainty regarding the future for 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.

PRIOR YEAR (1982–83) REVENUES

Table 29 summarizes General Fund revenue collections in 1982–83. These receipts totaled $21,233 million, an increase of $312 million (1.5 percent) over 1981–82.

The rate of growth in revenues during 1982–83 was extremely weak by historical standards. For example, over the period 1970–71 through 1981–82, General Fund revenue growth averaged 15 percent per year, and was never less than 4.7 percent—more than three times the 1982–83 rate. As Table 29 shows, during 1982–83:

- ***Sales and use taxes*** increased 1.2 percent, or $94 million;
- ***Personal income taxes*** rose 3.1 percent, or $230 million;
- ***Bank and corporation taxes*** fell 4.3 percent, or $113 million;
- ***Interest income*** fell 25 percent, or $83 million;
- ***Transfer income*** to the General Fund fell 31 percent, or $337 million;
- Collections from ***all other sources,*** including the remaining taxes and licenses fees, rose 29 percent, or $521 million.

Revenue Enhancements ($1.5 billion) Exceeded Loss in Revenue Base ($850 million)

During 1982 and 1983, bills enacted by the Legislature, together with certain other factors, had the effect of increasing 1982–83 revenues by more than $1.5 billion over what they would have been otherwise. Specifically:

- ***Tax Collections Were Accelerated.*** These accelerations totaled about $574 million, including $227 for the insurance tax, $55 million for the personal income tax, $169 million for the sales and use tax, and $123 million for the bank and corporation tax.
- ***Interest Penalties on Delinquent Taxes Were Raised.*** These penalties brought in about $79 million in additional revenues from the personal income tax, the sales tax, and the bank and corporation tax.
- ***Revenues Were Transferred From Special Funds to the General Fund.*** As a result of actions taken in both 1982 and 1983, General Fund transfer income was raised by $746 million. The additional funds primarily came from the state's tidelands oil and gas revenues (which, prior to 1981–82, generally had been deposited in special funds to support a variety of capital outlay programs) and from the Vehicle License Fee Account (which normally would have gone to local governments).
- ***Other factors*** accounted for $122 million in additional revenues, in-

cluding $80 million from a change in the federal tax treatment of "cost recovery" oil.

Table 29
General Fund Revenues in 1982–83
By Source
(in millions) [a]

Income Source	*Actual 1981–82* [b]	*Actual 1982–83* [c]	*Change Amount*	*Change Percent*	*Percent Change in the Absence of Special Factors* [d,e]
Three major taxes:					
Sales and use tax	$7,549	$7,643	$94	1.2%	1.2%
Personal income tax	7,483	7,713	230	3.1	7.5
Bank and corporation tax	2,649	2,536	−113	−4.3	−7.9
Other major taxes and licenses	1,372	1,687	315	23.0	19.6
Total, major taxes and licenses	$19,053	$19,579	$526	2.8%	3.8%
Interest income	336	253	−83	−24.7	−24.7
Transfers	1,079	742	−337	−31.2	−5.6
Other revenues	453	659	206	45.5	16.3
Totals, General Fund Revenues and Transfers	$20,921	$21,233	$312	1.5%	3.5%

[a] Details may not add to totals due to rounding.
[b] *State of California 1981–82 Annual Report,* California State Controller.
[c] 1984–85 Governor's Budget.
[d] Special factors combined to produce a net revenue gain of about $1.1 billion in 1981–82. Of this amount, one-time transfers and revenue enhancements in 1981–82 totalled approximately $1.3 billion and included (1) $179 million increased transfers and other revenues associated with Ch 101/81 (SB 102), (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 Ch 2x/82 (AB 6x), Ch 4x/82 (AB 7x), Ch 5x/82 (AB 8x), and Ch 115/82 (AB 1253), and (5) $322 million in increased transfers under the 1982 Budget Act and trailer legislation. In addition, General Fund federal revenue sharing transfers declined from $276 million in 1980–81 to $179 million in 1981–82, or by $97 million and Ch 634/80 (AB 2092) reduced inheritance and gift tax receipts by approximately $109 million in 1982–83.
[e] Special factors combined to produce a net revenue gain of about $675 million in 1982–83. This gain includes about $1.5 billion in increased General Fund monies, including (1) $133 million in tax accelerations and $297 million in special funds transfers (primarily tidelands oil revenues) under Ch 10x/83 (AB 28x), (2) $449 million in special fund transfers and $454 million in tax accelerations and related provisions under the 1982 Budget Act and trailer legislation, (3) $108 million in continuing effects under Ch 2x/82, Ch 5x/82 and Ch 115/82, and (4) other factors worth $80 million. Offsetting these gains were revenue losses of $222 million due to full income tax indexing (Proposition 7, June 1982), $348 due to phase-out of the inheritance and gift taxes under Ch 634/80 and Proposition 6 (June 1982), and $276 million due to termination of the federal revenue sharing program for states. Percent changes shown in table do not fully account for certain reclassifications of revenues between the "other revenue" and "transfers" categories.

This $1.5 billion in 1982–83 revenue enhancements exceeded by nearly $230 million the $1.3 billion in revenue enhancements provided for in 1981–82 (See Table 22).

Partially offsetting these enhancements were three major factors which reduced the revenue base by nearly $850 million.

- ***Phasing-Out of Inheritance and Gift Taxes.*** Revenues from these taxes were reduced by $347 million under the provisions of Ch 634/80 (AB 2082) and Proposition 6 (June 1982).

- ***Permanent Full Income Tax Indexing.*** Proposition 7 (June 1982) indexed the state's marginal personal income tax brackets by the full change in the California Consumer Price Index each year. This resulted in a revenue reduction of $222 million.
- ***Termination of Federal Revenue Sharing.*** For the first time since 1972–73, the General Fund received no federal revenue sharing transfers, reflecting termination of the revenue sharing program for states. In 1981–82 the state received $179 million in shared revenues and, prior to that, nearly $280 million annually.

This $850 million paring of the 1982–83 General Fund revenue base exceeded by more than $600 million the paring that occurred in 1981–82.

The combined effect of the revenue enhancements and revenue base reductions in 1982–83 was a net gain to the General Fund of $675 million. Even so, the improvement was less than the $1.1 billion picked up in 1981–82 as a result of special factors.

Weak Underlying Revenue Growth Trend

When adjustments are made for special factors in both 1981–82 and 1982–83, Table 29 shows that the rate of growth in General Fund revenues during 1982–83 was 3.5 percent (over $700 million)— the lowest rate in over 12 years. The major factor responsible for this weakness in the underlying revenue growth trend was the recession, which did not "bottom out" until year-end 1982. Especially important in slowing the growth rate were 1982 drops in corporate profits (−1.3 percent) and taxable sales (−0.4 percent).

Poor Economy Caused Huge Downward Revenue Revisions

Table 30 shows how the Department of Finance revised its revenue forecast for 1982–83 between the initial forecast in May 1981 and the end of the fiscal year. The table indicates that:

- Actual revenues were nearly $3.9 billion *less* than the original estimate (May 1981) due strictly to weaker-than-expected economic performance.
- Actual revenues were *less* than the estimate presented in the Governor's Budget (January 1982) by over $2.3 billion, or 11 percent. This shortfall, which excludes the effects of law changes in 1982 and 1983, reflects the total downward adjustment of nearly $3.9 billion, minus the over $1.5 billion midyear adjustment for 1982–83. For individual taxes, the downward adjustments amounted to over $1.1 billion for the sales and use tax, $188 million for the personal income tax, and over $1 billion for the bank and corporation tax.
- Actual revenues were more than $1.1 billion, or 5.3 percent, *less* than

Table 30
General Fund Revenues and Transfers in 1982–83
History of Department of Finance Estimates (in millions) [a]

Revenue Source	Original Estimate in May 1981	Economics-related Revisions: Revisions during 1982[b]	Economics-related Revisions: Revisions during 1983[c]	Economics-related Revisions: January 1984	Economics-related Revisions: Totals	Revisions due to Law Changes: 1981 Legislation	Revisions due to Law Changes: 1982 Legislation[d]	Revisions due to Law Changes: 1982 Ballot Initiatives	Revisions due to Law Changes: 1983 Legislation[e]	Revisions due to Law Changes: Totals	Actual
Bank and corporation tax	$3,755	–$989	–$364	–$29	–$1,382	$34	$75	—	$54	$163	$2,536
Personal income tax	8,670	–894	–60	107	–847	–1	68	–$222[f]	45	–110	7,713
Sales and use tax	9,060	–795	–793	–3	–1,591	—	140	—	34	174	7,643
Other taxes	1,558	–56	86	–5	25	22	227	–145[g]	—	104	1,687
Total Taxes	$23,043	–$2,734	–$1,131	$70	–$3,795	$55	$510	–$367	$133	$331	$19,579
Interest income	375	–71	–48	–3	–122	—	—	—	—	—	253
Other revenue	397	139	2	–11	130	—	132	—	—	132	659
Total Revenues	$23,815	–$2,666	–$1,177	$56	–$3,787	$55	$642	–$367	$133	$463	$20,491
Transfers	60	–53	9	–20	–64	—	449	—	297	746	742
Totals, General Fund Revenues and Transfers	$23,875	–$2,728	–$1,168	$36	–$3,851	$55	$1,091	–$367	$430	$1,209	$21,233

[a] Details may not add to totals due to rounding.
[b] Revisions during 1982 included –$1,506 million in January 1982, –$805 million in March 1982, and –$408 million in May 1982.
[c] Revisions during 1983 included –$1,383 million in January 1983, and $215 million in June 1983.
[d] 1982–83 revenue effects from 1982 legislation included (i) $108 million from various tax accelerations and delinquent tax provisions under Ch 2x/82 (AB 6x), Ch 5x/82 (AB 8x), and Ch 115/82 (SB 1253), (ii) $903 million from tax accelerations ($377 million), transfers ($449 million) from sources such as the Vehicle License Fee Account and the California Water Fund, and other provisions ($77 million) of the 1982 Budget Act and Ch 327/82 (SB 1326), and (iii) $80 million from a change in the federal tax treatment of "cost recovery" oil.
[e] Revenue effects from Ch 10x/83 (AB 28x), including (i) $133 from tax accelerations and other tax enhancement provisions and (ii) $297 million from transfers (primarily tidelands oil related monies).
[f] Proposition 7 on the June 1982 ballot (permanent "full" income tax indexing).
[g] Proposition 6 on the June 1982 ballot (elimination of the inheritance and gift tax and imposition of the estate "pickup" tax).

the May 1982 revenue revision provided to the Legislature just before it acted on the 1982–83 budget.

- Actual revenues were $251 million, or 1.2 percent, *more* than the midyear estimate released in January 1983 as part of the 1983–84 Governor's Budget. This reflects the fact that economic activity finally started to "perk-up" in the first quarter of 1983, when the recovery began.

Table 31 compares the department's revenue estimating errors for 1982–83 to those over the preceding nine-year period, beginning with 1973–74. The table indicates that the revenue estimating error associated with the initial budget estimate for 1982–83 was the largest in history, both in dollar and percentage terms, while the estimating error in May was second only to the preceding year's revision in dollar terms.

The estimating error reflected in the May Revision is especially significant because the May estimate was the basis for legislative action on the 1982–83 budget. It was this inability in May 1982 to foresee the downward trend in revenues that, more than any other factor, necessitated the enactment in early 1983 of tax accelerations and special fund transfers in order to reduce the size of the June 30, 1983 General Fund budget deficit. The size of these downward revisions in the revenue estimate illustrate the tremendous impact which the recession had on the state's fiscal position.

Table 31
General Fund Revenue Estimating Errors Due to Economics Related Factors 1973–74 through 1982–83 [a]

	Errors made in Original January Budget [b]		*Errors made In May* [c]		*Errors Made in Midyear* [d]	
	Dollar Error	*Percent* [e]	*Dollar Error*	*Percent* [e]	*Dollar Error*	*Percent* [e]
1973–74	−$205	−2.9%	−$184	−2.6%	−$243	−3.5%
1974–75	−697	−8.1	−322	−3.7	−166	−1.9
1975–76	−459	−4.8	−621	−6.5	−451	−4.7
1976–77	−1,011	−9.8	−726	−6.4	−394	−3.5
1977–78	−1,339	−9.8	−966	−7.1	−331	−2.4
1978–79	−974	−6.4	−780	−5.1	−220	−1.4
1979–80	−680	−3.8	−502	−2.8	−204	−1.1
1980–81	283	1.5	277	1.5	80	0.4
1981–82	1,345	6.4	1,596	7.5	723	3.4
1982–83	2,345	11.0	1,132	5.3	−251	−1.2

[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 or June 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.

Prior to 1980–81, there was much concern in the Legislature over the department's persistent tendency to underestimate revenues—often by significant amounts. Some felt that these underestimates reflected an inherent conservative bias in the department's economic forecasting and revenue-estimating procedures. Given the record for 1980–81, 1981–82 and 1982–83, no such bias would seem to exist. Put another way, the state cannot count on any significant revenue "windfalls" as a result of any conservative bias in revenue estimates.

What does seem to have happened in the past is that the department has underestimated the economy's strength during economic upturns and its weakness during economic downturns. Thus, errors in revenue forecasts would appear to stem from the difficulty of accurately predicting the pattern and amplitude of the business cycle, rather than from any inherent revenue estimating bias. This difficulty, and the results that follow from it, are characteristic not only of forecasts made by the Department of Finance, but of those made by economic forecasters generally.

CURRENT YEAR (1983–84) REVENUES

Net Effect of Special Factors Turns Negative

Table 32 summarizes the Department of Finance's General Fund revenue projections for 1983–84. The table indicates that General Fund revenues in 1983–84 are estimated to total nearly $23.4 billion (a gain of $2.1 billion, or 10 percent). The total includes $8.6 billion from the sales and use tax (a 12 percent gain), nearly $9 billion from the personal income tax (a 16 percent gain) and $3.2 billion from the bank and corporation tax (a 28 percent gain). Partly offsetting the gains from these three main tax sources is a decline of $577 million (34 percent) in revenues from the remaining major taxes. As discussed below, however, this reduction is not indicative of any fundamental weakness in this revenue category.

As with both 1981–82 and 1982–83, the 1983–84 projections reflect a wide range of special revenue-influencing factors which produce a distorted picture of the underlying growth trend in the state's General Fund revenue base. The interesting thing about these special factors in 1983–84 is that their net impact on revenues is *negative* (by $200 million), as opposed to the positive net effects that special factors had on revenues in 1981–82 ($1.1 billion) and 1982–83 ($675 million).

The net effect of special factors on revenues in 1983–84 reflects:

- *Increases* in revenues of over $1.3 billion, due to such factors as ongoing and newly enacted tax accelerations, and transfers of special fund monies to the General Fund.
- *Decreases* in revenues of over $1.5 billion, due to the second year of the insurance tax acceleration, 1982 ballot initiatives which extended full income tax indexing and repealed the inheritance and gift tax, and the absence of federal revenue sharing monies.

Table 32
General Fund Revenues, by Type
1983–84
(in millions) [a]

Revenue Source	*Actual 1982–83*[b]	*Estimated 1983–84*[b]	*Change* *Amount*	*Change* *Percent*	*Percent Change in the Absence of Special Factors*[c]
Three major taxes:					
Sales and use tax	$7,643	$8,575	$932	12.2%	14.0%
Personal income tax	7,713	8,950	1,237	16.0	16.4
Bank and corporation tax	2,536	3,240	704	27.8	26.0
Other major taxes and licenses	1,687	1,110	−577	−34.2	4.8
Total, major taxes and licenses	$19,579	$21,875	$2,296	11.7%	15.5%
Interest income	253	240	−13	−5.1	−5.1
Transfers	742	443	−299	−40.3	5.1
Other revenues	659	810	151	22.9	−4.6
Totals, General Fund Revenues and Transfers	$21,233	$23,368	$2,135	10.1%	14.6%

[a] Details may not add to totals due to rounding.
[b] 1984–85 Governor's Budget.
[c] Special factors combined to produce a net revenue loss in 1983–84 of about $200 million. (This *excludes* a $166 million revenue gain under Ch 323/83 (AB 233) from using the "old" CPI instead of the "new" CPI in June 1983 for income tax indexing adjustments. The "old" CPI was the appropriate index to use from an economic perspective, and thus this law change had no impact on the underlying revenue growth rate.) The net loss was the combined effect of (1) a *revenue gain* of over $1.3 billion due to (a) $479 million under the 1982 Budget Act and trailer legislation, (b) $84 million under SB 813 (Ch 498/83), (c) $388 million under Ch 983/83 (AB 895), (d) $17 million under Ch 10x/83 (AB 28x), and $300 million from other factors, and (2) a *revenue reduction* of over $1.5 billion due to (a) $450 million from full income tax indexing (Proposition 7, June 1982), (b) $680 million from phasing-out the inheritance and gift taxes, (c) $276 million from termination of federal revenue sharing for states, and (d) $112 million for the second year effect of the insurance tax prepayment rule changes under Ch 327/82 (SB 1326). See footnote to Table 29 for a listing of special factors affecting 1982–83 revenues.

Underlying Growth Trend Strengthens

Table 32 shows that when an adjustment is made for the impact of special factors (special fund transfers, tax law changes, and so forth), the underlying trend in revenue growth during the current year is a healthy 14.6 percent, or well above the actual 10.1 percent rise. Two factors account for this strong underlying growth trend:

- ***First,*** and most important, the economy is once again expanding, and expanding with it are the major components of the state's tax base.
- ***Second,*** the California Consumer Price Index actually *declined* over the period June 1982 to June 1983, causing the indexing provisions of current law to have a "reverse" effect—*increasing* the income tax liabilities of taxpayers in 1983, relative to what they would have been in the absence of indexing. As a result, the growth of income tax collections relative to the growth of income itself is higher than normal.

Revenue Revisions Reversed Course, Turned Upward in June 1983

Table 33 presents the history of General Fund revenue estimates for 1983–84. The table shows that a weaker-than-expected economy caused revenues to be revised downward by nearly $2 billion between June 1982 and April 1983. Since that time, however, revenues have been revised upward by a total of $604 million, due to stronger-than-expected economic conditions. *This is the first time since January 1980 that the midyear revenue revision has been positive.* These recent upward revisions are especially good news, given that the department's January 1983 economic forecast for 1983 and 1984 had already assumed a moderate economic recovery and subsequent expansion.

Latest Cash Flow Data Support Economic Projections

January 1984 was the latest month for which data on General Fund revenue collections ("agency cash") were available before this analysis went to print. During January, preliminary data indicate that revenue collections for the major General Fund taxes and licenses were $53 million above the forecast for January contained in the 1984–85 Governor's Budget. Because receipts in December 1983 for these taxes were $62 million below the budget estimates, combined receipts for the two months were $9 million lower than projected. This represents a shortfall of only 0.2 percent. Combined December and January receipts for non-tax-revenue sources were also below the budget estimates. However, after taking account of a variety of cash-flow factors which affect the timing of revenue receipts, it appears that the performance of total revenues is thus far pretty much in line with the estimates. For example, the collective performance of sales tax receipts, combined income tax withholding and declarations, and profits tax prepayments is pretty much consistent with the department's economic forecast. Thus, while reported revenue collections were a bit below the projections, there is no evidence as yet to cast doubt on the projections themselves.

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 1983–84 is consistent with the department's economic forecast. In general, we conclude that it is. Our computations suggest that, *if* the department's economic forecast is accurate, current-year revenues could be a bit higher—perhaps $220 million—than what Finance estimates. This is not a significant difference (less than 1 percent of the revenue estimate), given the complications involved in estimating revenues and the fact that we are dealing with over $23 billion in collections during the current year.

The 1983–84 revenue picture, however, is still subject to change. Over

Table 33
General Fund Revenues and Transfers in 1983–84
History of Department of Finance Estimates (in millions)[a]

Revenue Source	Original Estimate June 1982[a]	Economics-Related Revisions: January[b] 1983	April[b] 1983	June[c] 1983	January 1984	Totals	1983 Legislation[d]	Others Factors	January 1984 Totals
Bank and corporation tax	$3,240	–$440	$55	–$40	$288	–$137	$45	$92[e]	$3,240
Personal income tax	8,810	–210	–56	310	–140	–96	236	—	8,950
Sales and use tax	9,475	–1,022	–103	51	150	–924	24	—	8,575
Other taxes	1,290	–170	–6	1	–13	–188	8	—	1,110
Total taxes	$22,815	–$1,842	–$110	$322	$285	–$1,345	$313	$92	$21,875
Interest income	350	–96	—	–19	5	–110	—	—	240
Other revenue	500	70	—	13	—	83	227	—	810
Total revenues	$23,665	–$1,868	–$110	$316	$290	–$1,372	$540	$92	$22,925
Transfers	5	—	—	4	–6	–2	440	—	443
Totals, General Fund Revenues and Transfers	$23,670	–$1,868	–$110	$320	$284	–$1,374	$980	$92	$23,368

[a] June 1983 estimate updated in November 1983 for law changes.

[b] Excludes the effect of General Fund revenue augmenting proposals contained in the 1983–84 Governor's Budget. These included (i) $10 million in bank and corporation taxes and $110 million in personal income taxes from repeal of the solar and energy conservation tax credits, (ii) $192 million in tidelands oil revenues, and (iii) transfers to the General Fund of $300 million from the Vehicle License Fee (VLF) Account, $42 million from the Transportation Planning and Development (TP&D) Account, and $23 million from the Driver Training Penalty Assessment Fund. In total, these proposals amount to $677 million.

[c] Excludes $380 million in increased revenues associated with the Governor's efficiency team recommendations, $149 million in additional gains from changes recommended in Finance letters, and $9 million for proposed sales tax acceleration and payment-due-date changes.

[d] See Schedule 2 in *Impact of Financial Legislation on Revenues and Expenditures, 1983–84 and 1984–85*, California Department of Finance. Revenue effects include (i) $17 million primarily in tax accelerations under Ch 10x/82 (AB 28x), (ii) $388 in VLF transfers under Ch 983/83 (AB 895), (iii) $84 million from state conformity to the 1982 federal TEFRA provisions, and (iv) $497 million under the 1983 Budget Act and trailer bill Ch 323/83 (AB 223). The latter amount includes $215 million in tidelands oil and gas revenues as a gain in the "other revenues" category. An additional $19 million in unanticipated tidelands oil revenues has been factored into the January 1984 economics revision column.

[e] Includes $47 million for court cases and $45 million for state revenue gains resulting from the 1982 federal TEFRA provisions regarding extended contract reporting.

$11 billion in revenue collections are needed between February and June in order to reach the total projected for 1983–84, and economic conditions during the first half of 1984 can exert a considerable influence on the level of collections. Thus, the development of alternative revenue estimates, based on different economic scenarios, is important in order to facilitate the Legislature's fiscal planning, especially given that the Governor's Budget projects only a $100 million unrestricted General Fund surplus for June 30, 1984 (or less than 1 percent of anticipated collections during the February-to-June period).

The budget suggests that current-year revenues could differ from the department's estimate by anywhere from plus 2.9 percent ($600 million) to a minus 2.7 percent ($550 million). This is certainly possible, given the size of past revisions to the midyear estimates, as shown in Table 31. The margin for error, coupled with the absence of any significant reserve for absorbing revenue shortfalls or expenditure overruns in 1983–84, makes it important that the department continuously review its 1983–84 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.

BUDGET YEAR (1984–85) REVENUES

Table 34 presents the department's estimates of state revenues for 1984–85. Total state revenues in the budget year are projected to reach $30,444 million, a gain of 12.1 percent ($3,284 million) over 1983–84, or about the same percentage gain as in the current year (11.8 percent). Of the revenue total, about 85 percent represents General Fund revenues and 15 percent represents special fund revenues.

General Fund Revenues

As shown in Table 34, General Fund revenues in the budget year are forecast to reach $25,826 million, a gain of $2,458 million (11 percent). The 1984–85 amount includes nearly $9.9 billion in personal income taxes (a gain of 10 percent), $9.6 billion in sales and use taxes (a gain of 12 percent), and nearly $4.3 million in bank and corporation taxes (a gain of 32 percent). These healthy growth rates reflect the department's forecast of an expanding economy throughout 1984 and the first half of 1985.

Actual Revenue Growth Understates Underlying Revenue Trend

Because of the numerous revenue-enhancing measures, special fund transfers, and various other special factors affecting revenues in recent years, the percentage rates of increase for 1984–85 revenues shown in Table 34 do not give a valid picture of the underlying growth in either the total revenue base or many of its individual components. To do so, one must adjust revenues for such factors as tax accelerations, special fund transfers, ballot initiatives, and other tax law changes, and determine what revenue growth would be like in their absence.

Table 34
State Revenue Collections
1982–83 through 1984–85
(in millions) [a]

General Fund	*Actual 1982–83*	*Estimated 1983–84*	*Projected 1984–85*	*Change 1983–84 to 1984–85 Amount*	*Percent*
Taxes:					
Sales and use	$7,643.1	$8,575.0	$9,600.0	$1,025.0	12.0%
Personal income [b]	7,712.7	8,950.0	9,860.0	910.0	10.2
Bank and corporation	2,536.0	3,240.0	4,290.0	1,050.0	32.4
Inheritance and gift [c]	489.6	107.5	46.5	−61.0	−56.7
Insurance [d]	736.9	442.0	615.0	173.0	39.1
Cigarette	190.6	185.5	180.0	−5.5	−3.0
Alcoholic beverage	136.2	137.3	136.8	−0.5	−0.4
Horseracing	105.3	118.0	114.0	−4.0	−3.4
Estate	28.3	120.0	140.0	20.0	16.7
Total Taxes	$19,578.8	$21,875.3	$24,982.3	$3,107.0	14.2%
Other Sources:					
Oil and gas revenues	148.2	258.6 [e]	16.9	−241.7	−93.5
Health Care Deposit Fund	292.5	308.0	314.8	6.8	2.2
Interest on investments	252.6	240.0	284.9	44.9	18.7
Other revenues	219.0	243.2	197.5	−45.7	−18.8
Transfers	742.1	442.6	29.1	−413.5	−93.4
Totals, General Fund	$21,233.2	$23,367.6	$25,825.5	$2,457.9	10.5%
Special Funds					
Motor Vehicle: [f]					
Fuel tax	928.6	1,174.0	1,097.0	−77.0	−6.6
License fee (in lieu) [g]	789.3	1,029.0	1,224.4	195.4	19.0
Registration, weight and miscellaneous fees	826.8	868.0	910.0	42.0	4.8
Subtotals, Motor Vehicle	$2,544.7	$3,071.0	$3,231.4	$160.4	5.2%
Other Sources:					
Oil and gas revenues	343.6	140.4	383.2	242.8	172.9
Sales and use [h]	152.3	159.0	133.0	−26.0	−16.4
Interest on investments	76.9	88.3	90.8	2.5	2.8
Cigarette tax	90.0	79.5	77.0	−2.5	−3.1
Other	−149.6 [i]	253.8	703.2	449.4	177.1
Totals, Special Funds	$3,057.9	$3,792.0	$4,618.6	$826.6	21.8%
Totals, State Funds	$24,291.1	$27,159.6	$30,444.0	$3,284.3	12.1%

[a] Details may not add to totals due to rounding. Figures for 1982–83, 1983–84 and 1984–85 include the effect of a variety of measures, enacted in 1981, 1982, and 1983 to augment General Fund revenues and transfers. These effects are summarized in Tables 22, 29, 32, and 35, and in the text which accompanies these various tables. The 1984–85 General Fund total also excludes $28 million in transfer income from the COFPHE Fund, under Ch 1xx/84 (AB 1xx), the 1984 community college funding bill.

[b] Includes revenue reductions of $222 million in 1982–83, $466 million in 1983–84 and $727 million in 1984–85 due to the full indexing provisions of Proposition 7 (approved in June 1982).

[c] Includes net revenue reductions (after taking account of the estate tax) of $348 million in 1982–83, $680 million in 1983–84, and $842 million in 1984–85, due to Ch 634/80 (AB 2092) and Proposition 6 (approved in June 1982). See Table 38.

[d] Revenues were increased by $227 million in 1982–83 and reduced by $112 million in 1983–84 due to the tax acceleration provisions of Ch 327/82 (SB 1326).

[e] Includes $19 million in revenues which were not statutorily allocated to special funds for 1983–84.

[f] Ch 541/81 (SB 215) increased the motor vehicle and diesel fuel tax rates from 7 cents to 9 cents per gallon

effective January 1983, and implemented substantial fee increases related to vehicle operation beginning in 1982. Ch 933/81 (AB 202) increased registration fees further. Ch 323/83 (AB 223) revised the methods of determining the "market value" of new vehicles and the depreciation schedule for existing vehicles, and also accelerated the payment of fuel tax revenues. The combined effect of these measures on vehicle-related taxes and fees is $205 million for 1981–82, $467 million for 1982–83, $859 million for 1983–84, and $876 million for 1984–85. For detail on these effects, see Table 43.

[g] Includes trailer coach fees.

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

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

Table 35 shows that, once these adjustments are made, budget year General Fund revenue growth becomes 14.5 percent, instead of the 10.5 percent shown in the table. Most of the adjustments used to derive the "underlying" rate of revenue growth in 1984–85 reflect the on-going effects of law changes made in 1981, 1982, and 1983. (The adjustments themselves are itemized in Table 22 and in the footnote to Table 35.) The budget, however, proposes to undo one of these effects by eliminating the $210 million transfer from the Vehicle License Fee Account to the General Fund which is provided for under AB 895 (Ch 983/83).

The "underlying" 14.5 percent growth trend for 1984–85 is about the same as that for 1983–84 (14.6 percent), and is over four times the underlying growth rate for 1982–83. The fact that the projected underlying growth rate in 1984–85 is about the same as the high growth rate forecast for 1983–84 reflects the department's prediction that the state's economy will experience a healthy, sustained expansion into 1985.

Table 35
Comparisons of Income Trends
1982–83 through 1984–85

	Percent Change in Revenues and Transfers					
	Change Published in Budget			*Change Adjusted for Special Factors*[a]		
Income Source	*1982–83*	*1983–84*	*1984–85*	*1982–83*	*1983–84*	*1984–85*
Sales and use tax	1.2%	12.2%	12.0%	1.2%	14.0%	11.6%
Personal income tax	3.1	16.0	10.2	7.5	16.4	13.7
Bank and corporation tax	−4.3	27.8	32.4	−7.9	26.0	32.4
Other major taxes	23.0	−34.2	11.0	19.6	4.8	9.1
Totals, major taxes and licenses	2.8%	11.7%	14.2%	3.8%	15.5%	15.0%
Interest income	−24.7	−5.1	18.8	−24.7	−5.1	18.8
Transfers	−31.2	−40.3	−93.5	−5.6	5.1	6.6
All other revenues	45.5	22.9	−34.7	16.3	−4.6	−6.8
Totals, General Fund Revenues and Transfers	1.5%	10.1%	10.5%	3.5%	14.6%	14.5%

[a] Removes the effects on revenue growth of such factors as one-time special funds transfers, tax accelerations, and ballot initiatives. See Tables 29 and 32 for a list of these factors for 1982–83 and 1983–84, respectively. For 1984–85, revenues are about $1.2 billion less than they would have been in the absence of special factors. This amount includes the effect of the June 1982 ballot initiatives (−$727 million for income tax indexing and −$842 million for inheritance and gift tax repeal), elimination of federal revenue sharing for states (−$276 million), the 1984 Summer Olympics in Los Angeles and the 1984 National Democratic Convention in San Francisco ($50 million), and all other factors including a variety of on-going tax acceleration measures ($632 million). Growth rates for 1984–85 do not include the effects of Ch 1xx/84 (AB 1xx), the 1984 community college funding bill, which increased transfer income to the General Fund by $28 million.

Strong Gains for Personal Income Taxes

Personal income taxes are projected to rise by 10 percent in the budget year. This increase is considerably less than the 16 percent gain estimated for 1983–84. However, as we discussed in last year's *Perspective and Issues* (pages 80–81), the exceptionally high rate of growth in 1983–84 is largely due to cash-flow factors and the timing of income tax indexing adjustments to withholding tables.

Income Tax "Elasticity" to Decline. The best way to understand the income tax projections for any fiscal year is to examine the projection of the calendar year income tax *liabilities* which underlie the fiscal year revenue estimates. As Table 36 indicates, the department projects that income tax liabilities will rise 9.1 percent in 1983, 12.1 percent in 1984, and 8 percent in 1985. These increases can be related to three factors—the growth in (1) the number of taxpayers (which is correlated with employment growth), (2) average taxable income per taxpayer (which is correlated with average personal income per employee), and (3) the June-to-June change in the California Consumer Price Index (the CCPI, is used under the income tax indexing law to annually adjust the state's marginal income tax brackets and various tax credits and deductions for inflation).

Table 36
Assumptions Underlying the Department of Finance's Estimate of Personal Income Tax Liabilities 1983 through 1985

	Percent change in:					
Calendar Year	*Adjusted Personal Income*[a]	*Civilian Employment*	*Average Income Per Employee*	*Indexing Adjustment Factor*	*Tax Liabilities*	*Elasticity of Tax Liabilities with Respect to Income*[b]
1983	6.6%	1.3%	5.2%	−1.2%	9.1%	1.38
1984	10.3	4.3	5.8	5.5	12.1	1.17
1985	8.3	2.6	5.6	6.1	8.0	0.96

[a] Defined as personal income minus transfer payments plus social security contributions. This income concept has historically shown a strong correlation to adjusted gross income reported for tax purposes.
[b] Ratio of tax liability growth to growth in adjusted personal income.

The percentage increase in tax liabilities which results from each 1 percentage point of income growth (that is, the "elasticity" of tax revenues) is influenced differently by each of these three variables. For example, (a) rapid growth in average income tends to produce a "high" elasticity, as taxpayers move into higher tax brackets, (b) rapid growth in the CCPI tends to produce a "low" elasticity as tax bracket boundaries are shifted outward, causing taxpayers to move back into lower brackets, and (c) growth in employment per se has historically resulted in about the same percentage increase in tax liabilities.

As Table 36 indicates, the department projects that the income tax elasticity will decline in both 1984 and 1985. This explains why the year-to-year differences in tax liability growth are not the same as the year-to-year changes in projected income. The principal reason for the decline in elasticity projected for 1984 is that the indexing adjustment factor is expected to be a *plus* 5.5 percent, versus a *minus* 1.2 percent in 1983. The 1.2 percent decline had the effect of "buoying up" tax liabilities in 1983. The decline in elasticity projected for 1985 reflects the fact that the indexing adjustment factor is expected to rise to 6.1 percent and, at the same time, growth in average income per employee is expected to drop below the indexing adjustment. As a result, fewer taxpayers will be moving into higher tax brackets and more will be moving into lower brackets.

Our estimate of how much personal income tax revenues the department's economic forecast could produce is a bit higher—by about $175 million for the current year and budget year combined—than the department's own estimate. This difference, which reflects our estimate of somewhat higher revenues for the current year and lower revenues for the budget year, is less than 1 percent of the $18.8 billion to be collected in the two years combined.

Special Revenue Adjustments. The budget year estimate incorporates revenue *gains* of about $336 million from such factors as the ongoing effects of past tax accelerations ($116 million), recent federal tax conformity law changes ($205 million), and the 1984 Olympics to be held in Los Angeles ($15 million). In addition, the estimates include revenue *losses* of about $84 million from revisions to the state's solar and energy conservation tax provisions (−$50 million), special tax treatment for IRAs and charitable deductions (−$30 million), and the Franchise Tax Board's redirection of audit resources toward the bank and corporation tax program (−$4 million). The budget estimate also reflects a revenue reduction of approximately $725 million due to Proposition 7 (June 1982), which permanently extended full income tax indexing. The total state revenue "loss" (or "savings" to taxpayers) due to indexing is about $3.9 billion in 1984–85, *and over $15 billion since the program first began in 1978.*

Taxable Sales to Outdistance Income Growth

As shown in Table 35, sales and use taxes are projected to increase by 12 percent in the budget year, or 11.6 percent when the distorting effects of such factors as tax accelerations and other legislation are eliminated. While the adjusted growth rate is somewhat lower than that for the current year, it still represents a healthy increase.

The projected rate of growth in sales tax revenues during 1984–85 means that growth in taxable sales is expected to outdistance the growth in personal income, both in the second half of 1984 and throughout 1985. This is confirmed by looking at the ratio of taxable sales-to-personal income contained in the department's economic forecast.

As Table 37 shows, the taxable sales-to-personal income ratio dropped for three consecutive years—from 57 percent in 1979 to 55 percent in 1980, to 53 percent in 1981, and to 50 percent in 1982. Then, in 1983, the ratio rose slightly to 51 percent. For 1984 the department projects a significant increase in the ratio, to 52.3 percent, followed by a subsequent improvement in 1985, to 52.6 percent.

Table 37
Historical Trends in Taxable Sales in California
1973 through 1985

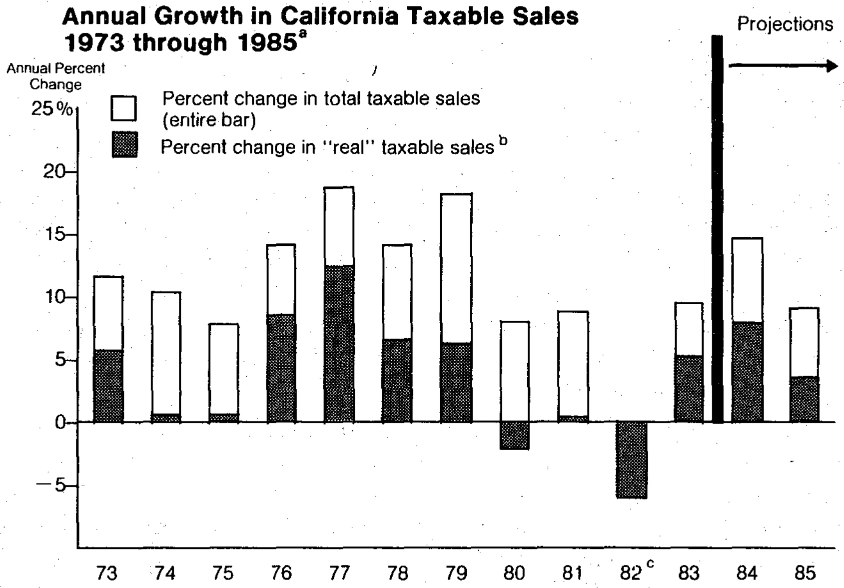
Calendar year	Total Taxable Sales (in millions)	Percent Change in: Total Taxable Sales	Percent Change in: "Real" Taxable Sales[a]	Ratio of Taxable Sales to Personal Income
1973	$61,738	11.6%[b]	5.6%[b]	.538
1974	68,071	10.3	0.2	.531
1975	73,476	7.9	0.3	.521
1976	83,822	14.1	8.6	.534
1977	99,482	18.7	12.2	.566
1978	113,468	14.1	6.6	.565
1979	131,678	16.0	6.4	.574
1980	142,759	8.4	−1.6	.550
1981	155,127	8.7	0.3	.531
1982	154,553	−0.4	−5.8	.497
1983 (estimated)	168,945	9.3	5.2	.509
1984 (projected)	190,705[c]	12.9	7.9	.523
1985 (projected)	207,780	9.0	3.6	.526

[a] Total taxable sales deflated by U.S. GNP Consumption Expenditures Deflator.
[b] Percent change for 1973 computed after adjusting 1972 actual taxable sales upward to the level which would have occurred had gasoline been taxable for all (as opposed to only the second-half) of the 1972 calendar year.
[c] Includes $630 million due to the 1984 Summer Olympics in Los Angeles and the 1984 National Democratic Convention in San Francisco.

As shown in Chart 17, taxable sales growth is expected to be especially strong in 1984 (up 13 percent), led by increases in sales tax receipts from such industries as motor vehicles (up 18 percent) and building materials (up 17 percent). Of course, the high rates of growth for the building and automobile industries are partly due to the fact that they were hit so hard during the past recession, and therefore are recovering from extremely depressed levels.

Chart 17 and Table 37 also indicate that the growth in "real" taxable sales has improved dramatically. "Real" taxable sales growth is estimated at 5.2 percent for 1983 and projected at 7.9 percent in 1984 and 3.6 percent in 1985. The 1984 rise would be the largest since the "boom" year of 1977, when nominal sales expanded by nearly 19 percent and "real" sales expanded by over 12 percent. It should be noted, however, that despite the taxable sales gains projected for 1984 and 1985, the ratio of taxable sales to personal income would still be lower than in all but one year during the 1973 through 1981 period.

Chart 17
Annual Growth in California Taxable Sales 1973 through 1985[a]



[a] Source: California Department of Finance

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

[c] Total taxable sales declined by 0.4 percent.

Our own analysis suggests that the department's projections of taxable sales, and thus of sales tax revenues, may be a bit low, based on the underlying economic assumptions contained in the budget. For example, using the budget's economic assumptions for such variables as employment, housing starts, real interest rates and unemployment, we believe that taxable sales could increase by closer to 14.7 percent in 1984 and 9.9 percent in 1985. This would raise the ratio of taxable sales to income to 53.2 percent in 1984 and 54 percent in 1985, and result in increased sales tax revenues compared to the budget projection of about $45 million in 1983–84 and $175 million in 1984–85. Even if this turns out to be the case, however, the ratio of taxable sales-to-income would still remain below its 1980 level.

The 1984–85 sales tax revenue estimate includes about $105 million in special adjustments, consisting of $30 million attributable to the 1984 Summer Olympics, $47 million from the on-going effects of previously enacted tax accelerations, and a $28 million net gain from 1983 legislation affecting certain sales tax exemptions.

Corporate Profits—Largest Gain in Recent History

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. The task of projecting these revenues has become even more difficult in the past several years because recent federal law changes have distorted the historical relationships between California and U.S. profits. The most significant federal law changes occurred as a result of the Economic Recovery Tax Act (ERTA) of 1981 and the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, which dramatically revised the rules governing depreciation allowances for tax purposes.

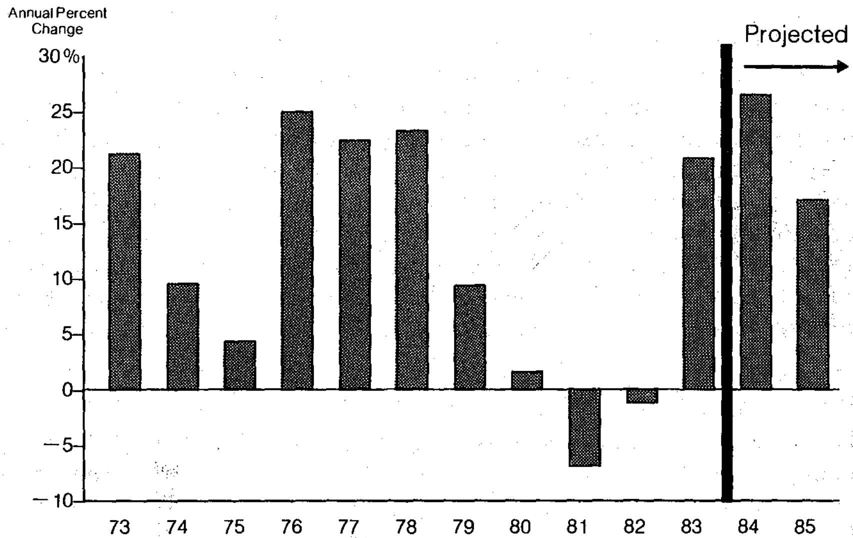
Table 35 shows that the department projects that revenues from the bank and corporation tax will rise by 32 percent in the budget year, following a strong 28 percent rise in the current year. After adjusting for special revenue factors, the bank and corporation tax is projected to grow faster in 1984–85 than any other revenue source. The 1984–85 revenue figure includes about $277 million from special revenue factors, reflecting audit redirections ($70 million), the on-going effects of previously enacted tax accelerations ($109 million), court cases ($32 million), the 1984 Summer Olympics ($5 million), and state conformity to certain federal TEFRA provisions ($61 million). However, because special revenue factors in 1983–84 also increased revenues from this source by more than $200 million, the underlying revenue growth trend for this tax in 1984–85 equals the projected growth rate—32 percent.

The extremely strong growth projected for bank and corporation tax revenues reflects the department's projection for taxable corporate profits. As Chart 18 shows, California profits are estimated to have risen by 21 percent in 1983, following declines in both 1981 and 1982. For 1984 and 1985, the department projects gains of 27 percent and 17 percent, respectively. The 1984 increase would represent the largest gain in recent history.

Review of Forecasting Procedures Needed. In Part Three, we discuss the alternative procedures which the Department of Finance currently uses in attempting to forecast California profits, and the reasons why we are recommending that the department conduct a thorough review of its methodology. It is especially important that the department evaluate its use of sampling techniques as a guide to projecting profits. In addition, the department needs to attempt to reconcile the differences between the corporate profits data published by the Franchise Tax Board,

Chart 18

Annual Growth in California Taxable Corporate Profits 1973 through 1985[a]



[a] Source: California Department of Finance profit totals include a $335 million reduction in 1975 due to changes in depletion allowances, a $967 million increase in 1978 due to Proposition 13, and a $630 million gain in 1984 due to the Summer Olympics and the National Democratic Convention. Preliminary estimate by Department of Finance and Franchise Tax Board for 1983.

and the level of corporate profits implied by cash revenue collections. It also should reexamine the recently changed relationship between U.S. and California profits that is so critical to forecasting state profits. The findings of such a study could result in more accurate forecasts of profits—and thus of state revenues.

Forecast Could Be High. Our review of the department's bank and corporation tax revenue projections leads us to conclude that, based on the department's overall economic forecast for the state and nation, its projections of revenues may be too high. There are two reasons for this. First, when using the department's economic assumptions, our estimating equation for California profits yields a lower level of profits than the department forecasts. Second, the department has added to its revenue totals a larger amount of collections not directly related to profits, such as audit monies and delinquent payments, than we think will materialize. For the current year and budget year combined, we believe actual revenues could be about $220 million to $425 million *below* the department's projections, assuming that the department's economic forecast comes true. This would imply a revenue growth of 23 percent in 1983–84 and 22 percent in 1984–85, reflecting growth in taxable profits of 18 percent in 1983, 26 percent in 1984 and 15 percent in 1985. While these growth rates are strong, they are also somewhat lower than what the department foresees. Of course, we are the first to admit that there is a fairly large error margin surrounding *anyone's* corporate profits estimates, especially estimates for California.

Other Major Taxes

Tables 34 and 35 show that General Fund revenues from taxes other than the three major levies are projected to reach $1.2 billion in the budget year, an increase of $122 million (11 percent) above the current year. These taxes include the insurance tax ($615 million), the inheritance, gift and estate taxes ($187 million), the cigarette tax ($180 million), alcoholic beverage taxes ($137 million), and horse racing-related revenues ($114 million). For two of these revenue sources—the insurance tax and the inheritance and gift taxes—the budget estimates reflect special factors that are discussed below. After adjusting for these and certain other special factors, Table 35 shows that budget-year revenues from other major taxes are projected to be 9.1 percent above the current-year level.

Insurance Taxes—Strong Growth Reflects Improved Economy and Cash-Flow Shifts

Insurance tax collections are projected to reach $615 million in 1984–85, a gain of $173 million (39 percent) from the estimated 1983–84 level of $442 million. This strong growth reflects two factors.

First, Ch 327/82 (SB 1326) made a number of changes in the statutory provisions governing the collection of this tax. This statute:

- Increased the number of annual tax prepayments required of insurers from three to four, 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 $227 million in 1982–83, lower them by $112 million in 1983–84, and raise them by $8 million in 1984–85. Thus, the growth in insurance tax revenues has been very uneven—up 52 percent in 1982–83, down 40 percent in 1983–84, and up 39 percent in 1984–85. Without these cash-flow shifts, the underlying revenue growth trend looks quite different—up 5.2 percent in 1982–83, up 8.6 percent in 1983–84, and up 9.6 percent in 1984–85.

The underlying growth trend is indicative of the second reason causing budget-year insurance tax collections to grow—the strengthening economy and the increased volume of insurance purchases which are expected to accompany it.

The department's revenue projections for the insurance tax are based on survey responses from 145 California insurance companies that account for 62 percent of all insurance premiums written in the state. According to the survey, the amount of insurance premiums subject to the 2.33 percent gross premiums tax is expected to rise by 8 percent in 1983 (the year on which 1984 tax prepayments are based), and 9.4 percent in 1984 (the year on which 1985 tax prepayments are based). Taxes on these premiums account for about 97 percent of all insurance tax collections.

The estimated increase in premiums during 1983—8 percent—represents a sharp rebound from the disappointing gains in each of the three preceding years, none of which exceeded 5.5 percent. And, the projected 1984 gain of 9.4 percent would be the strongest annual increase in taxable premiums since 1978.

Phasing-Out of Inheritance and Gift Tax Continues

Combined inheritance, gift and estate taxes are projected to be $187 million in the budget year, a fall of $41 million (18 percent) from the $228 million expected in the current year. This decline, as well as the 56 percent decline in current-year receipts, is due to two law changes:

- ***First,*** revenues have been reduced by Ch 634/80 (AB 2092), which increased inheritance tax exemptions.
- ***Second,*** revenues have been reduced by 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 38
Effects of Tax Law Changes on Inheritance, Gift and Estate Tax Revenues
1980–81 through 1984–85
(in millions) [a]

		Proposition 6 (June 1982)			*Total Reduction*	
	Ch 634/80	*Loss from Inheritance and Gift Taxes*	*Gain from Estate Tax*	*Net Effect*	*Amount*	*As Percent of Prior Law Revenues*
1980–81	–$2	—	—	—	–$2	0.4%
1981–82	–111	—	—	—	–111	18.0
1982–83	–203	–$173	$28	–$145	–348	40.2
1983–84	–230	–570	120	–450	–680	74.9
1984–85	–262	–720	140	–580	–842	81.8

[a] Estimates by California Department of Finance and Legislative Analyst.

Table 38 shows that the combined effect of Ch 634 and Proposition 6 is a net revenue reduction of approximately $111 million in 1981–82, $348 million in 1982–83, $680 million in 1983–84, and $842 million in 1984–85. Thus, by the end of the budget year, over 80 percent of the prior-law tax base will have been eliminated. The budget-year revenue total includes $47 million from the inheritance and gift tax, and $140 million for the "pick-up" estate tax established by Proposition 6.

Interest Income to Rise

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 on which the General Fund nevertheless earns income, and (3) any 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 has been the most important source of interest income in the past several years, since there have been no surplus monies left over from prior years. Of course, in future years the first source of interest income could become more important if the Legislature rebuilds the Reserve for Economic Uncertainties.

The budget projects that General Fund interest on investments will be about $285 million in 1984–85, of which $280 million represents returns on the General Fund's share of PMIA balances. The level of investment income projected for 1984–85 compares to about $240 million projected for 1983–84 and $252 million in 1982–83, and assumes that:

- ***The average balance*** in the PMIA during 1984–85 will be somewhere in the vicinity of $7 billion. This average balance represents an increase from $6.6 billion in 1983–84, and reflects the projected gap between revenues and expenditures which is expected to materialize.
- ***The General Fund share*** of funds in the PMIA will be about 40 percent, up from 36 percent in 1983–84.
- ***The average interest yield*** on PMIA investments in 1984–85 will be in the general range of 10 percent. This compares to an actual average yield of 10.2 percent in December 1983, 10.1 percent for the first half of 1983–84, and 10 percent projected for the fiscal year as a whole. Thus, no significant change in the PMIA yield is anticipated between the current year and budget year.

Interest income is extremely difficult to predict with any precision, given the number of assumptions that must be made in preparing an estimate. Interest rate forecasts have often proved wrong in recent years, due to the difficulties involved in accurately predicting the course of the economy and the paths that federal monetary and fiscal policies will follow. Likewise, as shown below in Table 41, the General Fund balance in 1984–85 could experience a swing of several *billion* dollars, either upward or downward, if one of the alternative economic forecasts published in the budget materializes in place of the standard forecast. Such a swing would affect the PMIA balance, and thus the amount of interest income earned by the General Fund. For each $100 million increase (decrease) in the average PMIA balance during 1984–85 that is due to changed General Fund conditions, interest income will be $10 million higher (lower) than the amount forecast.

Evaluation of General Fund Revenue Estimates

This section summarizes our evaluation of the department's General Fund revenue estimates. This evaluation has two aspects: (1) our analysis of whether the department's revenue projections are consistent with its economic forecast, and (2) our assessment of how the department's revenue figures would change under alternative economic assumptions.

Two-Year Estimates Consistent with Assumptions, but Future Revisions Inevitable

We have taken the *department's economic assumptions* for 1984 and 1985 and used *our own* revenue-estimating equations to test whether Finance's budget-year revenue projections are consistent with its economic assumptions.

Our analysis suggests that an economy along the lines projected by the department would generate somewhat *less* General Fund revenue in 1984–85 than what the department forecasts. We believe that this shortfall would be about $150 million. However, because our analysis also concludes that General Fund revenues in 1983–84 are likely to be about $220 million *more* than what Finance projects, the net difference for the current and budget years combined would be only $70 million. This is a negligible difference, given the size of the revenue base and the complexities involved in revenue estimating.

Table 39
Legislative Analyst Revenue Estimates Using Department of Finance Economic Assumptions 1983–84 and 1984–85 (in millions)

	Low	*Most Likely*	*High*
Bank and corporation tax	–$425	–$325	–$220
Sales and use tax	+200	+220	+240
Personal income tax	+95	+175	+250
Totals	–$130	+$70	+$270

As shown in Table 39, however, the closeness of our 2-year totals obscures differences between our estimates and the department's, for individual taxes. In addition, Table 39 shows that *even if* the department's economic forecast comes true, we believe that revenues could still fluctuate within a band of several hundred million dollars, due to uncertainties regarding the accuracy of the data provided by the Franchise Tax Board which shows us how much taxable income is earned by individuals and corporations. When statistical confidence intervals are also considered, the error margin surrounding the revenue estimate, even if the department's economic forecast is right on target, is *greater* still.

These considerations, coupled with the fact that the department's economic forecast itself could prove to be wrong, make it clear that the revenue estimates for 1984–85 are subject to considerable revision during the next 18 months.

Alternative General Fund Revenue Scenarios

Given the history of revenue estimating errors, and the ever-present uncertainty about exactly how the economy will perform in the future, 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 projections if the department's economic forecast does *not* come true.

Revenue-estimating errors can result from a variety of factors. For example, the underlying data on which forecasts are based often are revised later on. 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 single most important cause of revenue-estimating errors is the failure of the underlying economic forecast to hold up.

In view of this distinct possibility, the department has constructed two alternative economic scenarios which can show how different economic conditions would affect revenues. One scenario is based on a more optimistic set of economic assumptions than those which Finance used in preparing its standard budget forecast; the other is based on more pessimistic assumptions. These alternative forecasts illustrate the extent to which the paths followed by the national and state economies in 1984 and 1985 could easily depart from the department's forecast. These scenarios, however, by no means bracket the full range of possible outcomes.

Table 40 summarizes the key features of these alternative economic forecasts.

The department has taken the key variables in these economic scenarios and used them to project the main determinants of General Fund revenues—California taxable income, taxable corporate profits and taxable sales. Table 41 indicates what the effect on state revenues in the current and budget years would be if each of the department's alternative forecasts were borne out. We have reviewed these projections and have obtained results which are in the same general range as those obtained by

Table 40
Alternative Economic Outlooks
Prepared by the Department of Finance
1984 and 1985

Economic Variable	*Low Forecast* 1984	*Low Forecast* 1985	*High Forecast* 1984	*High Forecast* 1985
1. National Data:				
Real GNP growth	4.7%	−0.3%	6.0%	5.1%
Profits growth	22.8	−19.6	27.7	19.2
Unemployment rate	8.4	9.4	8.0	6.9
Wage and salary job growth	3.6	−0.1	4.1	3.5
Consumer price inflation	5.8	6.2	5.6	5.5
Car sales (millions)	10.0	8.6	10.5	11.6
Housing starts (millions)	1.51	1.26	1.78	1.87
2. California Data:				
Personal income growth	9.5%	7.0%	9.9%	9.6%
Wage and salary job growth	3.5	0.3	4.2	3.8
Unemployment rate	8.1	9.1	7.8	6.7
Building permits (thousands)	150	135	185	180

the department. We have also computed what the effect on the General Fund surplus would be in 1983–84 and 1984–85 if either of these alternative revenue scenarios occurred.

Table 41
Fiscal Effects of Alternative Department
of Finance Economic Forecasts
1983–84 and 1984–85
(in millions)

	1983–84 Low Forecast	*1983–84* High Forecast	*1984–85* Low Forecast	*1984–85* High Forecast
1. Change in Revenues From Standard Forecast[a]				
Personal income tax	−$350	$350	−$990	$980
Sales and use tax	−45	90	−250	290
Bank and corporation tax	−160	160	−430	430
Totals, Three Major Taxes				
—Amount	−$555	$600	−$1,670	$1,700
—Percent	−2.7%	2.9%	−7.0%	7.2%
2. Level of Unrestricted General Fund Surplus or Deficit Resulting from Alternative Revenue Forecasts[b]	−$455	$700	−$1,274[c]	$3,251[c]

[a] Estimates by California Department of Finance. These estimates were prepared only for the state's three major revenue sources. These sources account for 92 percent of General Fund income in the budget year.

[b] Positive sign indicates budget surplus and negative sign indicates budget deficit. The 1984–85 Governor's Budget projects an unrestricted General Fund surplus (excluding all reserves) of $100 million for 1983–84 and $951 million for 1984–85, based upon its standard economic forecast. Surplus and deficit figures shown for alternative revenue forecasts assume no change in expenditures from the levels proposed in the budget.

[c] Reflects the combined effect of 1983–84 and 1984–85 revenue changes. For the "low" forecast, the two-year revenue shortfall is $2,225 million, which reduces the projected surplus from $951 million to a deficit of $1,274 million. For the "high" forecast, the two-year revenue gain is $2.3 billion, which increases the projected budget surplus from $951 million to $3,251 million.

Table 41 shows that the department's alternative economic scenarios produce General Fund revenue estimates for the three major taxes in 1983–84 which range from $600 million (2.9 percent) above to $555 million (2.7 percent) below the standard forecast. For 1984–85, the estimates range from $1.7 billion (7.2 percent) above to nearly $1.7 billion (7 percent) below the standard projection. (The revenue estimates prepared by the Commission on State Finance in December—$203 million above the department's current-year estimate and $95 million below its budget-year estimate—fall well within these margins.) These margins are consistent with the error margins that have materialized in past years, as shown in Table 31, and it is likely that one could find economists at either end of this range. In sum, the message given by Table 41 is that significant revenue estimating errors could occur in both 1983–84 and 1984–85. It is even possible that revenues could fall outside of these ranges.

Table 41 also shows that the General Fund balance would be dramatically affected if either of these alternative revenue scenarios were to materialize. For example, were the "low" scenario to occur, the result would be a *two-year revenue shortfall of over $2.2 billion*. Unless expenditures were reduced from the levels proposed in the budget, this would leave the General Fund with deficits at the end of both the current year and the budget year amounting to $455 million and nearly $1.3 billion, respectively. Thus, it is imperative that the state's economy and revenue outlook be closely monitored over the next 18 months.

Special Fund Revenues

Table 34 shows that revenues to all state special funds combined are projected to reach over $4.6 billion in 1984–85. Table 42 shows the share of special fund revenues accounted for by each of the major special fund revenue sources.

The major source of special fund income is motor vehicle-related levies, which include taxes on gasoline and diesel fuel ($1,097 million), vehicle license and trailer coach fees ($1,224 million) and registration fees ($910 million). These vehicle-related levies are expected to total over $3.2 billion in the budget year, an increase of 5.2 percent ($160 million) over 1983–84. Other major sources of special fund income include tidelands oil and gas tax revenues ($383 million), "spillover" sales and use tax revenues ($133 million), cigarette tax receipts ($77 million), and interest on investments ($91 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 the total collections from this tax.

Revenue Trends Distorted by Major Legislation and General Fund Transfers

Table 34 shows that special fund revenues in 1984–85 are expected to be 22 percent above the 1983–84 level. This rate of growth is distorted by the following special factors:

Table 42
Summary of Special Fund Revenues
1984–85
(in millions) [a]

Revenue Source	*Amount*	*Percent of Total*
1. Motor Vehicle Taxes and Fees		
License fees	$1,192 [b]	25.8%
Fuel taxes	1,097	23.7
Registration and other fees	910	19.7
Trailer coach fees	32	0.7
Subtotal	$3,231	70.0%
2. Tidelands oil and gas revenues	383	8.3
3. Retail sales taxes ("spillover" revenues)	133 [c]	2.9
4. Interest on investments	91	2.0
5. Cigarette taxes	77	1.7
Subtotal	$3,915	84.8%
6. All other [d]	704	15.2
Total	$4,619	100.0%

[a] Source: 1984–85 Governor's Budget. Details may not add to totals due to rounding.
[b] Figure *includes* $210 million in license fee revenue which would have been transferred from the Motor Vehicle License Fee Account to the General Fund under Ch 983/83 (AB 895).
[c] Figure includes $12 million reduction for the partial sales tax exemption of gasohol. The Governor's Budget assumes that the exemption will be continued and that the Transportation Planning and Development Account, into which the sales tax "spillover" monies are put, will absorb the revenue loss.
[d] Includes such sources as fees to the Department of Consumer Affairs, electric utility surcharge monies, fees to the Department of Fish and Game, and penalties on traffic violations and criminal convictions.

- ***First,*** major legislation was enacted in both 1981 and 1983 which increased motor vehicle-related receipts in 1981–82, 1982–83, 1983–84, and 1984–85. This legislation included (a) Ch 541/81 (SB 215), 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), (b) Ch 933/81 (AB 202), which provided for further increases in vehicle registration fees, and (c) Ch 323/83 (AB 223), which changed the method for determining the "market value" of new motor vehicles, revised the depreciation schedule for license fee purposes, and provided for a one-time acceleration in fuel tax revenues. Table 43 shows the revenue effects of these measures and indicates that, taken together, they result in increases in motor vehicle-related collections of $205 million in 1981–82, $467 million in 1982–83, $859 million in 1983–84, and $876 million in 1984–85.
- ***Second,*** 1983–84 special fund revenues were reduced by $388 million, due to a one-time transfer of funds from the Motor Vehicle License Fee (VLF) Account to the General Fund pursuant to Ch 983/83 (AB 895). This statute was enacted as a means of applying cuts in state spending to local governments and allocating the increased revenues from the vehicle-related legislation described above. No such VLF

transfers are proposed in the 1984–85 budget.

- *Third,* 1983–84 special fund revenues were also reduced (as they were in 1982–83) by a special one-time allocation of tidelands oil revenues to the General Fund. This allocation totals $234 million for 1983–84. Again, no such redistribution of tidelands oil revenues to the General Fund is proposed in 1984–85.

Table 43
Effects of Recent Law Changes on Vehicle-Related Fees and Tax Revenues 1981–82 through 1984–85 (in millions) [a]

Law Change [b]	*1981–82*	*1982–83*	*1983–84*	*1984–85*	*Four year Totals*
A. *Licenses and Fees*					
1. Ch 541/81	$195	$364	$379	$405	$1,343
2. Ch 933/81	10	20	20	21	71
3. Ch 323/83	—	—	135	210	345
Subtotal, licenses and fees	$205	$384	$534	$636	$1,759
B. *Fuel taxes*					
1. Ch 541/81	—	$83	$240	$240	$563
2. Ch 323/83	—	—	85	—	85
Subtotal, Fuel taxes	—	$83	$325	$240	$648
C. *Combined Licenses, Fees and Fuel Taxes*					
1. Ch 541/81	$205	$447	$619	$645	$1,906
2. Ch 933/81	—	20	20	21	71
3. Ch 323/83	—	—	220	210	430
Totals	$205	$467	$859	$876	$2,407

[a] California Department of Finance estimates.
[b] Ch 541/81 (SB 215) increased gasoline and diesel taxes, vehicle registration fees, weight fees, and drivers' license fees, and Ch 933/81 (AB 202) increased registration fees further. Ch 323/83 (AB 223) changed the method for determining the "market value" of new motor vehicles, revised the depreciation schedule for valuing cars for license fee purposes, and provided for a one-time acceleration of fuel tax revenues to the state.

In the absence of these distortions, the growth in special fund revenues during 1984–85 would be only about $188 million (5.3 percent), instead of $827 million (22 percent) as reported in Table 34. This lower underlying revenue growth rate for special fund revenues is consistent with the fact that, in general, the special fund revenue base is less "elastic" than the General Fund revenue base.

Fuel Tax Revenues—Underlying Trend Remains Flat

Because of the increase in the fuel tax from 7 cents to 9 cents per gallon (Ch 541) that took effect on January 1, 1983 and the one-time acceleration of fuel tax collections (Ch 323), fuel tax revenues will go up by $245 million in 1983–84 and then decline by $77 million in 1984–85. However, when fuel tax revenues are adjusted for these law changes, we find that the resulting level of fuel tax revenues in the budget year ($857 million) is essentially unchanged from the current-year ($849 million) and prior-year ($846 million) levels. This stability reflects many different factors, such as changes in the automobile mix, increasing fuel economies, and the impact of gasoline prices on consumption. The department's fuel tax estimate assumes that average gasoline consumption per vehicle will drop from 570 gallons in 1982–83 to 557 gallons in 1983–84 and 545 gallons in 1984–85.

Vehicle-related registration and license fee revenues are projected at over $2.1 billion in the budget year, including the effects of new legislation. This is an increase of 13 percent, or 10 percent if the effects of new legislation are ignored. The projection assumes increases in new vehicle registrations of 11 percent and 4.8 percent in 1984 and 1985, respectively, following the strong 18 percent rise in 1983 associated with the first year of the economic recovery. These relatively strong rates of increase in vehicle registrations reflect the department's expectation that there will be a gradual up-swing in consumer spending on new automobiles during the next 24 months.

Tidelands Oil and Gas Revenues to Remain in Special Funds

Table 34 shows that a total of $400 million in oil and gas revenues will be collected by the state in the budget year, an amount essentially unchanged from the current year's level ($399 million) and about 19 percent below the prior year's level ($492 million). All but about $30 million of these monies (or $369 million in the budget year) represent revenues collected by the State Lands Commission from oil, gas, geothermal, and other sources. In turn, most of these State Lands Commission collections represent direct earnings received by the state from tidelands (principally located adjacent to the City of Long Beach). About $55 million of the $90-odd million by which 1981–82 revenues exceeded revenues in both the current and budget years is attributable to the effects of the federal Technical Corrections Act of 1982. This measure 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 reflects declines in gas production at the state's fields, and soft oil prices in world markets.

These tidelands revenues traditionally have been used, along with bond proceeds, to finance state capital outlay projects. As discussed above, however, large portions of these revenues were shifted to the General Fund in 1981–82, 1982–83, and 1983–84, in order to help balance the state's budget. In 1984–85, $383 million (96 percent) of all state oil and gas revenues will be retained by special funds for capital outlay purposes.

How Special Fund Revenues are Distributed

Table 44 identifies how the budget proposes to allocate revenues from the four major special fund sources among different programs and levels of government. Specifically, it shows that:

Table 44
Proposed Distribution of Special Fund Revenues From Four Major Sources 1984–85 (in millions) [a]

Source	Total Amount	Distribution	Amount
A. *Motor Vehicle Taxes and Fees*			
1. License Fees	$1,198 [b]	To cities	$469
		To counties	675
		For DMV administration	70
		Other	−16 [c]
2. Fuel Taxes	1,100 [d]	For city streets	172
		For county roads	233
		To cities and counties for streets and roads	107
		To Caltrans for state highways	546
		Other	42
3. Registration and Other Fees	918 [e]	To DMV	174
		To CHP	387
		To Caltrans	317
		To other state agencies	47
		Other	−6 [c]
4. Trailer Coach Fees	32	To counties	9
		To localities generally	22
		To Department of Housing and Community Development	1
B. *Tidelands Oil and Gas Revenues* [f]	383	California Water Fund	25
		COFPHE Fund	95
		Central Valley Water Project Construction Fund	5
		State School Building Lease-Purchase Fund	100
		SAFCO	134
		Other	24
C. *Retail Sales and Use Taxes (spillover)*	133 [g]	State agencies, including support for mass transit ($40)	67
		Local agencies, including support for special transit programs ($80) and other purposes ($2)	82
D. *Local Cigarette Taxes*	77	To cities	63
		To counties	14

[a] Details may not add to totals due to rounding.
[b] Includes $6 million in interest income from fund balances.
[c] Negative sign indicates expenditures from prior year fund balances.
[d] Includes $3 million in interest income from fund balances.
[e] Includes $4 million in interest income from fund balances and $4 million in transfers from the Environmental License Plate Fund.
[f] The distribution of these revenues under existing law is shown in Item 3560 of our *1984–85 Budget Analysis,* where the State Lands Commission budget is discussed.
[g] Includes $12 million reduction for the partial sales tax exemption of gasohol. The $16 million difference between the spillover and the identified program expenditures will be financed through transit station leases and certain transfers from other funds.

- Cities and counties receive almost half of the motor vehicle fuel tax revenues.
- Cities and counties are to receive all of the proceeds from vehicle license fees, after administrative and certain other costs are deducted.

This is in sharp contrast to the preceding three fiscal years, when substantial amounts of vehicle license fee revenues were transferred to the General Fund to help balance the budget. In 1983–84, for example, the transfer amounted to $388 million.

- Motor vehicle registration fees are used to support the Department of Motor Vehicles (DMV) and the California Highway Patrol (CHP) with most of the remainder going to the Department of Transportation (Caltrans) for highway maintenance and construction.
- As noted earlier, tidelands oil revenues are allocated mainly for capital outlay purposes. Most of these revenues are divided among five special funds (including the Capital Outlay Fund for Public Higher Education (COFPHE), the State School Building Lease-Purchase Fund, and the Special Account for Capital Outlay (SAFCO)).
- 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.
- Of the state cigarette tax levies which go to localities (30 percent of the total), approximately 80 percent goes to cities and 20 percent goes to counties.

THE LONG-TERM REVENUE OUTLOOK

Accurately projecting what General Fund and special funds revenues might be beyond the budget year is an extremely difficult undertaking, largely because it is impossible to guess exactly what path the economy will follow in the future. Nevertheless, it is important that long-term revenue projections be constructed using the most reasonable economic assumptions currently available, so that the Legislature will have at least some general idea of what the future revenue prospects for the General Fund and special funds might be. Such forecasts are prepared both at the federal government level and by many economic consulting firms.

The 1984–85 Governor's Budget contains no revenue forecasts beyond the budget year. However, the revenue estimating staff in the department did prepare revenue estimates for the state's three major General Fund taxes, for both 1985–86 and 1986–87, based on the department's forecast for the state's economy. These long-term revenue projections appear in Table 45. They indicate that revenues from the three major taxes are projected to grow in the range of 8 percent to 9 percent annually beyond the budget year. We expect that such a rate of revenue growth, if achieved, would produce enough income to fund the 1984–85 General Fund expenditure base adjusted for future population growth and inflation. That is, the rate of growth would be adequate to maintain the "real" level of services per capita beyond the budget year. However, the extent to which this rate of revenue growth would enable the Legislature to (1) expand existing programs, (2) initiate new programs, or (3) provide additional tax relief,

Table 45
Long-Term Revenue Projections
1984–85 through 1986–87
(in millions) [a]

Revenue Source	*1984–85*	*1985–86 Amount*	*1985–86 Percent Change*	*1986–87 Amount*	*1986–87 Percent Change*
Personal income tax	$9,860	$10,520	6.7%	$11,280	7.2%
Sales and use tax	9,600	10,400	8.3	11,370	9.3
Bank and corporation tax	4,290	4,700	9.6	5,200	10.6
Totals, Three Major Taxes	$23,750	$25,620	7.9%	$27,850	8.7%

[a] Revenue data for 1985–86 and 1986–87 were provided by the Department of Finance but are not published in the 1984–85 Governor's Budget.

cannot be determined without having projections of current program costs for future years. Because such projections are not published by the department, we have recommended in Part Three that the department's long-term projections of revenues be accompanied by similar projections for expenditures and for the General Fund surplus.

It must also be stressed that in deriving these long-term revenue figures, the department has assumed that the economic expansion forecast for 1984 and 1985 will continue onward in subsequent years. In order for this to make sense, however, the department has implicitly had to assume that the projected $200 billion annual federal budget deficits will not "stall" the economy. In our opinion, this implies either that some type of steps are taken to reduce the deficit, or that the nation's credit markets are somehow able to finance the deficits without hurting the private sector. Since it is not at all clear that either of these two conditions can be met, we believe that the department's assumption that an ongoing economic expansion beyond 1985 is likely should be treated with great caution. Many economists share this concern. For example, of the 400-plus members of the National Association of Business Economists who were polled at year end 1983 about the economic outlook, 72 percent believe that an economic downturn will occur in either 1985 or 1986, and most of these cite the federal budget deficit as their leading concern.

State and Local Borrowing

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.

STATE BORROWING

In this section, we describe the types of borrowing activities undertaken by the state. We first discuss how the state borrows in the short-term to meet its cash-flow requirements. Next, we describe the state's long-term borrowing activities, which provide funds for a variety of state capital outlay programs.

Short-term Borrowing by the State

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.

Traditionally, most short-term borrowing has been 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).

New Forms of Borrowing Authorized. In 1982–83, however, the state's cash flow needs could not be met from internal sources. As a consequence, the Legislature authorized the use of two new forms of external borrowing. Specifically, Ch 10x/83 (AB 28x) authorized the state to borrow externally by issuing (1) short-term debt instruments, such as revenue anticipation notes, commercial paper, and demand notes, and (2) "State of California" notes, which are short-term notes issued to provide funds for payment of registered warrants drawn by the State Controller. Prior to this legislation, the only authority for short-term borrowing involved the issuance of unsecured registered reimbursement warrants.

Internal vs. External Borrowing. Last year, the Legislature also addressed the issue of what *type* of borrowing—internal or external—should be done first. Specifically, it directed the administration to borrow funds from external sources, *even* if internal funds were available. The basis for this directive, which we had recommended, was that external funds often can be borrowed at *substantially* lower costs to the General Fund. This is because when the General Fund borrows externally, it does so at tax-exempt interest rates, whereas when it borrows internally it does so at taxable interest rates, since most of the state's resources are invested in taxable securities.

In the past and current years, the state has done some external borrowing. In November 1982, the state borrowed $400 million by issuing unsecured registered reimbursement warrants. This borrowing was necessary because of cash flow problems. Another $1.3 billion in State of California notes were issued in February and March of 1983. During the current year, the state thus far has issued $1.2 billion in these notes. The state has *not,* however, issued any other types of short-term instruments, and the Governor's Budget shows that no further external borrowing is planned for 1983–84.

In 1984–85, General Fund borrowing will vary from month-to-month, with the loan need reaching a maximum of $2.9 billion in October 1984. Of this amount, $986 million will be borrowed from the PMIA, $465 million will come from special funds, $950 million will come from the Reserve for Economic Uncertainties, $100 million will be borrowed from the reserve for Los Angeles County, and $350 million will come from external sources. We believe, however, that *more* of the borrowing for the budget year should be from *external sources*, because this would reduce the state's costs for short-term borrowing. Our detailed analysis of external versus internal borrowing appears in Item 9620 of the *Analysis*, where we review the administration's request for funds to pay interest on short-term loans to the General Fund.

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.*** Only part of the debt service on these bonds is 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.

Bond Programs. General obligation bonds are used to support a wide variety of bond programs, including general state construction, water treatment facilities construction, harbor development, post-secondary education facilities construction, development of parks and recreational areas, historical resources preservation, construction of county jails and state prison facilities, school facilities, and financial assistance for home purchasing.

During 1982, a record volume of new general obligation bond authorizations—over $2 billion—was approved by the voters. In 1983, no additional authorizations were voted upon. In 1984, however, voters will be asked to approve a number of new general obligation bond authorizations at both the June and November elections.

Status of Bonds Authorized. Table 46 identifies by general obligation bond program, the portion of the authorized amounts that are outstanding, redeemed, and unsold. As of December 31, 1983, the state had $2.3 billion in unsold bonds, compared to over $2.9 billion at the end of 1982. Of the authorized bonds already sold ($11.4 billion), the state has retired over $4.8 billion, leaving $6.6 billion outstanding.

Table 46
General Obligation Bonds of the State of California
As of December 31, 1983
(in millions)

General Fund Bonds:	*Authorized*	*Unsold*	*Redeemed*	*Outstanding*
State construction	$1,050.0	—	$764.5	$285.5
Higher education construction	230.0	—	146.1	83.9
Junior college construction	65.0	—	40.7	24.3
Health science facilities construction	155.9	—	50.7	105.2
Community college construction	160.0	—	64.8	95.2
Beach, park, recreational, and historical facilities	400.0	—	169.9	230.1
Recreation, fish, and wildlife	60.0	—	29.5	30.5
State, urban, and coastal park	280.0	$35.0	41.6	203.4
Parklands acquisition and development	285.0	130.0	9.0	146.0
Clean water	875.0	175.0	179.1	520.9
Safe drinking water	175.0	75.0	2.2	97.8
State prison construction	495.0	395.0	7.5	92.5
County jail construction	280.0	280.0	—	—
Lake Tahoe land acquisition	85.0	85.0	—	—
First-time homebuyers	200.0	185.0	—	15.0
School building lease purchase	500.0	300.0	—	200.0
Subtotals	($5,295.9)	($1,660.0)	($1,505.6)	($2,130.3)
Partially Self-Liquidating Bonds:				
School building aid	$2,140.0	$40.0	$1,396.5	$703.5
Self-Liquidating Bonds:				
Water resources development	$1,750.0	$180.0	$126.6	$1,443.4
Harbor bonds	89.3		68.9	20.4
Veterans' farm and home	4,450.0	400.0	1,731.4	2,318.6
Subtotals	($6,289.3)	($580.0)	($1,926.9)	($3,782.4)
Totals	$13,725.2	$2,280.0	$4,829.0	$6,616.2

Source: 1984–85 Governor's Budget.

Bond Program Sales. Table 47 displays general obligation bond sales, by program, from 1982-83 through 1984-85. The total volume of sales for 1982-83 ($635 million) is below the estimate of bond sales ($680 million) made in January 1983. The smaller-than-estimated volume of bond sales is due, in part, to the Treasurer's suspension of bond sales between December 1982 and April 1983. The Treasurer imposed this suspension because he feared that the projected 1982-83 deficit for the General Fund would lead to a reduction in the state's credit rating.

The Treasurer estimates that approximately $1.1 billion in general obligation bonds will be marketed in 1983-84, an increase of $415 million above the volume issued last year. Most of this increase—$300 million—is due to the Veterans' Farm and Home Building program. The remainder of the increase primarily reflects sales under the state's newest bond programs, including those for first-time home buyers ($15 million), Lake Tahoe land acquisition ($25 million), state school building lease purchase ($25 million), and county jail construction ($50 million).

For the budget year, the Treasurer plans to market $835 million in general obligation bonds. Nearly half of this amount—$400 million—will be issued for the Veterans' Farm and Home program. Bond sales will be larger if voters approve any additional bond authorizations proposed on the June and November 1984 ballots. At the time this analysis was prepared, the Legislature had approved four additional authorizations to be placed on the June 1984 ballot.

Table 47
General Obligation Bond Sales
1982–83 through 1984–85
(in millions)

	Actual 1982–83	*Estimated 1983–84*	*Proposed 1984–85*
Beach, park, recreational, and historical facilities	$5	$15	—
Clean water	—	20	—
Clean water and water conservation	95	80	$40
Parklands acquisition	75	40	25
Safe drinking water	30	25	25
State, urban, and coastal parks	5	30	20
New prison construction	100	100	100
County jail construction	—	50	50
Lake Tahoe land acquisition	—	25	25
School building lease purchase	125	150	150
First-time homebuyers	—	15	—
Subtotals, General Fund bonds	$435	$550	$435
Veterans' farm and home building	200	500	400
Totals	$635	$1,050	$835

Source: State Treasurer

General Fund Debt Service. Table 48 shows projections of the amount of debt service to be paid on bonds fully supported by the General Fund through 1985–86. Debt service for the budget year is estimated at $391.5 million, of which $212.2 million is for repayment of principal and $179.3 million is for payment of interest. This represents an increase of $67.7 million (or 21 percent) over the current year. Thus, the repayment on state general obligation borrowing is one of the most rapidly growing "programs" in the state's budget.

Table 48
General Fund Debt Service
1982–83 through 1985–86
(in millions)

	Debt Service [a]	*Percent Change from Previous Year*	*Anticipated Sales* [b]
1982–83	$262.0	19.8%	—
1983–84	323.9	23.6	$550.0
1984–85 [c]	391.5	20.9	435.0
1985–86 [d]	450.0	14.9	425.0

[a] Includes estimated debt service *only* on bond issues currently authorized by the electorate. Figures through 1984–85 are from the 1984–85 Governor's Budget.
[b] An average interest rate of 10 percent is assumed on anticipated future sales. Projected sales for 1983–84 and 1984–85 are from the 1984–85 Governor's Budget and the Treasurer's Office.
[c] The projection for 1984–85 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.
[d] Legislative Analyst's Office estimates.

All of the debt service estimates in Table 48 are based on specific estimates of future bond sales and conditions in the financial markets. If the actual volume of sales is greater (less) than the estimated volume, 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 48 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. Recent general obligation bond issues have been marketed at around 9 percent, but many economists are predicting that interest rates will shift upward in late 1984 or early 1985, partly in response to the large deficit financing requirements of the federal government.

Selected Bond Fund Expenditures. After General Fund bonds are sold, the proceeds from the sales are allocated for expenditure on specific projects. These bond fund expenditures are identified in Schedule 9 of the Governor's Budget, by administering agency. Table 49 groups these expenditures for the prior, current, and budget years, according to the source of bond funding. Two of the newest bond programs authorized by the voters in 1982—county jail construction and state school building lease-purchase—are expected to account for over three-fourths of all bond fund expenditures in 1984–85.

We have noted in past *Analyses* that midyear budget estimates of bond fund expenditures invariably turn out to be too high. For example, the 1980–81 midyear estimate of these expenditures was $273 million, while actual expenditures in that year were only $145 million.

In 1982–83, the midyear estimate of bond fund expenditures was $580 million, or $181 million more than the actual expenditure of $399 million. The programs primarily responsible for the shortfall in 1982–83 were the new prison construction program and the state parklands acquisition program. Estimated expenditures for these programs were over $70 million higher than actual expenditures.

The failure of the budget to give a realistic picture of bond expenditures distorts expenditure comparisons between years. More realistic scheduling of new projects and projects already authorized would result in more accurate midyear estimates and, consequently, improved inter-year comparisons.

Table 49
Selected Bond Fund Expenditures
1982–83 through 1984–85
(in thousands)

	Actual 1982–83	*Estimated 1983–84*	*Proposed 1984–85*
Higher education construction	—	$493	—
Health sciences facilities construction	$506	—	—
Community college construction	494	34	—
Beach, park, recreational and historical facilities	3,004	9,493	$398
New prison construction	72,765	399,203	—
State, urban, and coastal parks	17,890	31,201	4,970
State parklands acquisition and development	68,442	101,052	11,722
Clean water	69,067	71,578	71,879
Safe drinking water	40,495	58,419	359
State school building lease-purchase	125,000	150,000	225,000
County jail construction	—	—	100,498
Recreation, fish, and wildlife	858	2,960	—
Totals	$398,521	$824,433	$414,826

Source: 1984–85 Governor's Budget

State Revenue Bonds

Agencies of the state also issue revenue bonds. These bonds 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 to finance the construction of such projects as bridges, fair facilities, higher education dormitories, and parking lots.

Beginning in the 1970s, the state expanded the scope of revenue bond programs to include financing for home purchases, pollution control, and health and educational facilities. In 1983, the Legislature created a new revenue bond program which will provide financing for urban waterfront restoration projects.

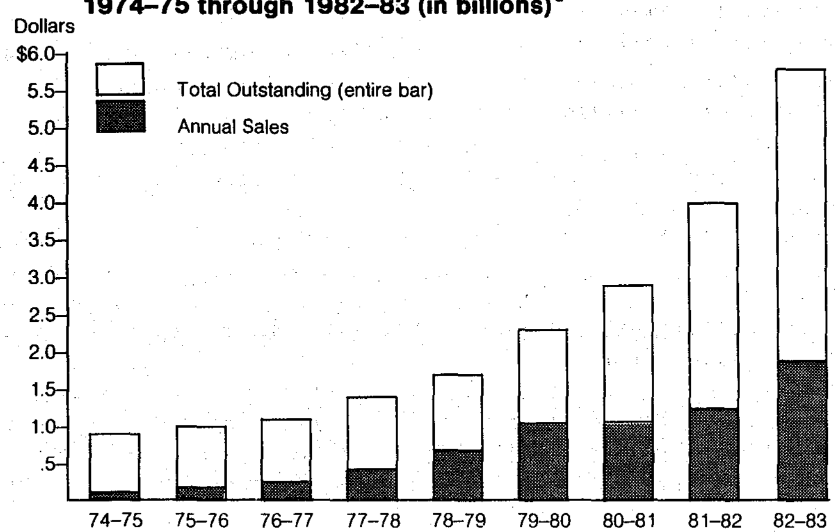
Table 50 identifies seventeen different types of state revenue bond programs and shows the current authorization for each. As of December 31, 1983, a total of $6.4 billion in state revenue bonds was outstanding.

Table 50
State Revenue Bonds
as of December 31, 1983
(in thousands)

Issuing Agency	*Authorization Limits —If Any*	*Out-standing*	*Remaining Authori-zation*
California Educational Facilities Authority	$500,000	$423,365	$76,635
California Housing Finance Agency	2,350,000	1,471,694	878,306
California Pollution Control Financing Authority	—	969,507	—
Transportation Commission	—	127,180	—
Department of Water Resources	—	1,325,245	—
Trustees, California State University	—	166,028	—
Regents, University of California	—	185,091	—
State Public Works Board	—	9,672	—
State Public Works Board—Energy Conservation and Co-generation	500,000	—	500,000
Hastings College of Law	—	7,280	—
Veterans Revenue Debenture	1,000,000	524,600	475,400
California National Guard	100,000	39,310	60,690
California Health Facilities Authority	1,534,000	996,835	537,165
California Student Loan Authority	300,000	121,475	178,525
California Alternate Energy Source Financing Authority	200,000	14,310	185,690
California Rail Passenger Financing Authority	1,250,000	—	1,250,000
California Urban Waterfront Area Restoration Financing Authority	650,000	—	650,000
Subtotals:			
Bonds with authorization limits	$8,384,000	$3,591,589	$4,792,411
Bonds without authorization limits	N.A.	2,790,003	N.A.
Totals, all state revenue bonds	N.A.	$6,381,592	$4,792,411

Source: State Treasurer

Chart 19
California State Revenue Bonds
Annual Sales and Total Outstanding Volume
1974–75 through 1982–83 (in billions)[a]



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

Three housing bond programs account for over $2 billion, or 32 percent of the outstanding bonds: California Housing Finance Agency ($1.5 billion), Veterans Revenue Debenture ($525 million), and California National Guard ($39 million). The table also shows that ten of the seventeen programs have statutory authorization limits, which together total $8.4 billion. Of this amount, $4.8 billion (57 percent) was unused at the end of 1983.

Growth in Revenue Bonds. In recent years, the outstanding volume of revenue bonds has risen dramatically. Chart 19 shows the increase in revenue bonds outstanding between 1974–75 and 1982–83. The volume of these bonds rose from $900 million in 1974–75 to $5.8 billion in 1982–83. In the six-month period from June 1983 to January 1984, the total rose by an additional $600 million, to almost $6.4 billion.

Table 51
State Revenue Bond Sales
1980–81 through 1984–85
(in millions)

Issuing Agency	*1980–81*	*1981–82*	*1982–83*	*Estimated 1983–84*	*Proposed 1984–85*
California Educational Facilities Authority	$114.7	$57.7	$71.2	$60.5	$80
California Housing Finance Agency	161.8	298.9	488.0	568.4	600
California National Guard	25.0	—	—	15.0	—
California Pollution Control Financing Authority	165.0	217.3	90.5	100.0	110
Transportation Commission	25.0	25.0	—	—	75
Department of Water Resources	—	250.0	600.0	—	50
Regents, University of California	—	17.8	56.2	20.0	30
Trustees, California State University	4.7	11.7	20.8	5.6	10
Hastings College of Law	—	7.3	—	—	—
Veterans Revenue Debenture	300.0	—	—	100.0	100
California Health Facilities Authority	—	339.6	506.8	587.1	650
California Alternative Energy Financing Authority	—	—	5.8	15.0	25
California Student Loan Authority	—	—	121.5	28.5	75
California Rail Passenger Financing Authority	—	—	—	—	100
California Urban Waterfront Authority	—	—	—	—	50
Totals	$796.2	$1,225.3	$1,960.8	$1,500.1	$1,955.0

Source: State Treasurer

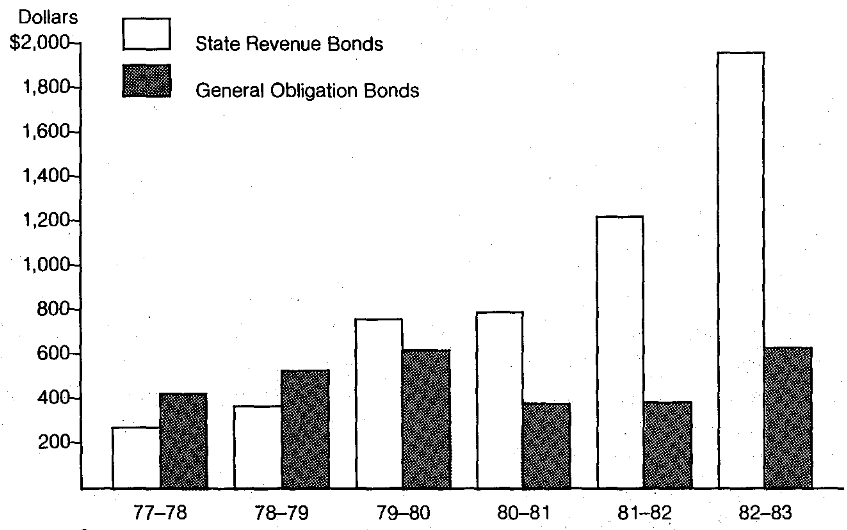
Bond Sales

Table 51 shows state revenue bond sales from 1980–81 through 1984–85. Revenue bond sales have increased dramatically in the last four years, with sales reaching almost $2 billion in 1982–83. Bonds issued by three authorities accounted for over 80 percent of the sales during that year: Department of Water Resources ($600 million), California Health Facilities Authority ($507 million), and California Housing Finance Agency ($488 million).

In 1983–84, another $1.5 billion in revenue bonds will be marketed. As in the prior year, health facilities and housing finance bonds will account for significant shares of the total. These programs also are expected to account for a large portion of 1984–85 revenue bond sales, which are expected to total almost $2 billion. The first revenue bond sales will also occur during the budget year under the state's newest programs: the California Rail Passenger Financing Authority ($100 million) and the California Urban Waterfront Restoration Financing Authority ($50 million), established by Ch 1553/82 (AB 3647) and Ch 1264/83 (SB 997), respectively.

Chart 20

Annual Sales of State Bonds 1977–78 through 1982–83 (in millions)[a]



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

Revenue Bond Sales Significantly Exceed General Obligation Bond Sales. Chart 20 compares the sales of state general obligation and revenue bonds since 1977–78. It shows that state revenue bond sales have significantly exceeded general obligation bond sales in each of the past four years. This is partly because the sale of most revenue bonds is not restricted by statutory interest rate ceilings. Because of high interest rates, especially during 1982 and 1983, these ceilings have sometimes made it difficult to sell general obligation bonds without restructuring the issues. Often, the restructuring results in terms that are less favorable to the state (such as the removal of "call" provisions and shorter maturities). In addition, general obligation bond sales for each of the state's programs are subject to specific authorization limits. The limits for seven of these programs have already been reached. In contrast, there are no restrictions at all on sales under seven of the state's 17 revenue bond programs.

LOCAL BORROWING

The State of California does not directly regulate most types of borrowing by local governments, although state law does govern such factors as the permissible types of borrowing and the maximum interest rates that can be paid on certain debt. 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.

Short-term Local Borrowing

Local governments 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 increased significantly in recent years. It appears that the various levels of local government in California issued over $5.3 billion in short-term debt obligations during 1982–83 alone. This is over $4 billion *more* than the volume issued in the previous year. The large increase appears to have been at least partly due to the recession, which caused local governments to borrow heavily from outside sources to meet their cash-flow requirements.

Local Bond Sales

Table 52 shows local bond sales for the last five years, by type of local government. The table indicates that between 1978–79 and 1982–83, the total volume of local bonds sold annually increased by approximately $4.2 billion. The table also indicates that a large share of this increase is due to the dramatic rise in housing bond sales (over 500 percent), especially housing bond sales by counties and cities. Between 1978–79 and 1982–83, housing bonds increased from 24 percent to 40 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.

Table 52
Annual Local Bond Sales
1978–79 through 1982–83
(in millions) [a]

Type of Local Government	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*1982–83*
1. Counties:	$13.7	$9.0	$214.1	$372.5	$1,000.7
Housing	(12.4)	(8.6)	(194.8)	(370.6)	(886.4)
Other	(1.3)	(0.4)	(19.3)	(2.0)	(114.3)
2. Cities:	$358.0	$488.9	$632.6	$341.2	$1,414.6
Housing	(111.2)	(211.9)	(124.1)	(73.3)	(713.9)
Other	(246.8)	(277.0)	(508.5)	(267.9)	(700.7)
3. School districts:	$58.7	$95.9	$52.6	—	$13.5
4. Redevelopment agencies:	$448.1	$1,150.4	$587.6	$741.1	$696.9
Housing	(241.3)	(948.3)	(446.7)	(349.7)	(321.4)
Other	(206.8)	(202.1)	(140.9)	(391.4)	(375.5)
5. Special districts:	$623.5	$814.0	$267.8	$569.2	$2,414.0
Housing	(—)	(—)	(27.0)	(193.4)	(372.6)
Other	(623.5)	(814.0)	(240.8)	(375.8)	(2,041.5)
6. Special Assessment Bonds	$14.9	$54.6	$77.3	$86.6	$149.7
Overall Totals	$1.516.9	$2,612.8	$1,831.9	$2,110.6	$5,689.6
Housing	*(364.9)*	*(1,168.8)*	*(792.6)*	*(987.0)*	*(2,294.3)*
Other	*(1,152.0)*	*(1,444.0)*	*(1,039.4)*	*(1,123.7)*	*(3,395.2)*

[a] Source: Data for 1978–79 through 1980–81 from Office of Planning and Research. Data for 1981–82 compiled by the Legislative Analyst's Office from the *Weekly Bond Buyer*, and for 1982–83 from the California Debt Advisory Commission *Calendar*. Special assessment bond data for 1982–83 compiled from *Weekly Bond Buyer* and Moody's *Municipal and Government News Reports*. Details may not add to totals due to rounding.

Different Data Sources Make Inter-Year Comparisons Difficult. Table 52 shows that the volume of local bond sales in 1982–83 increased dramatically from the previous year. A significant part of the increase shown, however, is *not* due to actual sales increases, but to more complete information on bond sales. The 1982–83 sales figures were compiled from data collected for the first time by the California Debt Advisory Commission (CDAC) which, under state law, must be notified of bond sales. The information on prior-year bond sales is based on sales reported in the *Weekly Bond Buyer*.

We believe that the CDAC data provide a much better indication of the actual level of local bond sales in the state than the data available for previous years. Consequently, inter-year comparisons of bond sales should be made with caution. Nevertheless, the CDAC data make one thing clear: the actual volume of debt issued by local agencies in prior years is *greater* than what was reported in the *Bond Buyer* for these years.

Trends in Local Public Debt

Local governments traditionally have relied extensively on bonds, long-term loans, and other forms of borrowing to raise funds for the construction of public facilities such as roads, water systems, sewers, and schools. Since the late 1970's, localities also have been issuing large volumes of debt for non-traditional purposes, particularly housing. As indicated above, housing bonds now account for a substantial portion of the growth in local bond sales in recent years.

Other important trends in local public debt also are emerging:

1. Local agencies are beginning to rely more heavily on *industrial development revenue bonds* (IDBs) to provide financing for *private* manufacturing and commercial facilities. These bonds, which must be approved by the California Industrial Development Financing Advisory Commission (CIDFAC), have been used to finance the construction of such facilities as food processing plants, furniture manufacturing facilities, office buildings, and shopping centers. In addition, IDBs also have been used to acquire buildings, machinery, and equipment for plant expansion. According to CIDFAC, approximately $230 million in IDBs have been issued in California since these bonds were first authorized.

2. Localities are issuing more debt to finance *infrastructure* (or public facilities) improvements. According to CDAC, $1.4 billion in debt was issued for such purposes during the first six months of 1983, compared to only $495 million issued during the same period in 1982. These amounts do *not* include special assessment district bonds, which are issued to finance capital improvements (sidewalks, gutters, lights, and so on) in specific areas. We estimate that nearly $150 million in special assessment district bonds were issued in 1982–83. Also, 1983 was the first year in which local agencies began to issue bonds under the Mello-Roos Community Facilities Act (established by Ch 1439/82 (SB 2001) and Ch 1451/82 (AB 3564)). These measures authorize local agencies to levy special taxes within "community facilities districts" to finance new capital construction.

3. Local agencies also are increasingly using various *"creative financing" techniques* to finance the construction of public facilities. Among these, the most popular technique involves the issuance of *certificates of participation (CPs)*. Between January and October 1983, over $637 million in CPs were issued. This method relies on an underwriter (such as an investment banker) to raise funds for the construction of a public facility through the sale of CPs to investors. The facility is then *leased* to the public agency. These instruments are called certificates of participation because they allow investors to *participate* in the lease arrangement. The financial transactions associated with this method are handled by a trustee, who collects lease payments and makes periodic payments of principal and tax-exempt interest to the holders of the certificates. From a public

agency's point of view, this method is attractive because CPs do not constitute indebtedness under the State Constitution or existing statutes. Thus, they do not require voter approval, nor are they subject to other restrictions, such as ceilings on interest rates.

COMBINED USE OF BONDS BY STATE AND LOCAL GOVERNMENTS

The combined volume of state and local borrowing in recent years is shown in Table 53. 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 $1.4 billion, or 56 percent. The largest relative increase was in the annual volume of state revenue bond sales, which increased by more than 170 percent.

In 1980–81, however, a sharp break occurred in the upward trend of bond sales. Total state and local bond 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. This drop in bond sales reflected unusually adverse conditions in the municipal markets during 1981—chief among them being exceptionally high interest rates. In 1981–82, the municipal bond market improved somewhat and, as a result, bond sales in that year reached more than $3.7 billion.

Table 53
Annual Sales of State and Local Bonds
1977–78 through 1982–83
(in millions)

		State of California[a]			
	Total All Bonds	*Total State*	*General Obligation*	*Revenue*	*Local Bonds*[b]
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
1982–83	8,285	2,595	635	1,960	5,690

[a] Source: California State Treasurer.
[b] Source: Data for 1977–78 from Office of Planning and Research. Data for 1981–82 and 1982–83 compiled by Legislative Analyst's Office.

In 1982–83, state and local bond sales rebounded dramatically. Total sales reached almost $8.3 billion, an increase of $4.6 billion compared to the previous year's level. As Table 53 shows, $980 million of the increase was due to state bond sales and $3.6 billion was due to bond sales by local agencies.

As indicated above, the *actual* increase in bond sales may be overstated because in 1982–83 a new and more complete source of data (CDAC) became available for use in determining the level of local bond sales. The significant increase in debt issues also is demonstrated, however, by data compiled by CDAC which compares the amount of bonds issued during the first six months of 1982 with the amount issued during same period for 1983. The data reported by CDAC show that the issuance of state and local bonds for this period in 1983 ($5.2 billion) was nearly 118 percent greater than the amount issued during the same period in 1982 ($2.4 billion).

The increase in bond sales during 1982–83 reflects the improved economy and more favorable conditions in the municipal debt market. Steady, and even declining, interest rates have made the issuance of long-term debt less costly than before. The improved economy, which has strengthened the financial condition of the state and local agencies, also has made debt-financed projects more feasible. Another reason for the increased volume of bond sales was that, beginning July 1, 1983, federal law required that tax-exempt bonds be issued in *registered form*. Under bond registration, records must be kept of who owns each bond and interest must be paid directly to that individual. It appears that issuers *accelerated* the sale of bonds in 1982–83 to avoid the additional administrative costs associated with bond registration in the future.

Housing Bond Sales

Table 54 shows 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. Between 1980–81 and 1981–82, total housing bond sales declined, due to the reduction in sales by the state.

Table 54
California State and Local Bond Sales
1977–78 through 1982–83
(in millions) [a]

	1977–78	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*1982–83*
State Bonds:						
Housing	$322.4	$625.0	$1,071.7	$861.8	$448.9	$688.0
Nonhousing	396.2	250.5	303.0	310.2	1,166.1	1,907.8
Subtotals	$718.6	$875.5	$1,374.7	$1,172.0	$1,615.0	$2,595.8
Local Bonds:						
Housing	$93.2	$364.9	$1,168.8	$792.6	$987.0	$2,294.3
Nonhousing [b]	1,766.9	1,151.1	1,444.0	1,039.3	1,123.6	3,395.3
Subtotals	$1,860.1	$1,516.0	$2,612.8	$1,831.9	$2,110.6	$5,689.6
State and Local Bonds:						
Housing	$415.6	$989.8	$2,240.5	$1,654.4	$1,435.9	$2,982.3
Nonhousing	2,163.1	1,401.7	1,747.0	1,349.5	2,289.7	5,303.1
Totals	$2,578.7	$2,391.5	$3,987.5	$3,003.9	$3,725.6	$8,285.4

[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 and 1982–83 compiled by Legislative Analyst's Office.

[b] Includes sales of special assessment bonds.

Housing bond sales increased dramatically in 1982–83, however, when over $2.9 billion in housing bonds were sold. Over three-fourths of this amount was attributable to local housing bond sales. Between July 1983 and October 1983, another $756 million in housing bonds were issued. The volume of housing bond sales was exceptionally large in 1983, because under current federal law this was the last year in which bonds issued to finance single-family home mortgages were eligible for the federal tax exemption.

This rise in housing bond sales in recent years can be attributed to several statutory changes:

- The Zenovich-Moscone-Chacon Housing and Home Finance Act (Ch 1x/75) established the California Housing Finance Agency and authorized a total outstanding amount 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 $1.4 billion in bonds were outstanding under this program. In 1983, the authorization was increased by $350 million, to $1.85 billion, and effective January 1, 1984, the limit was further increased by $500 million, to $2.35 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 Sales Uncertain

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.

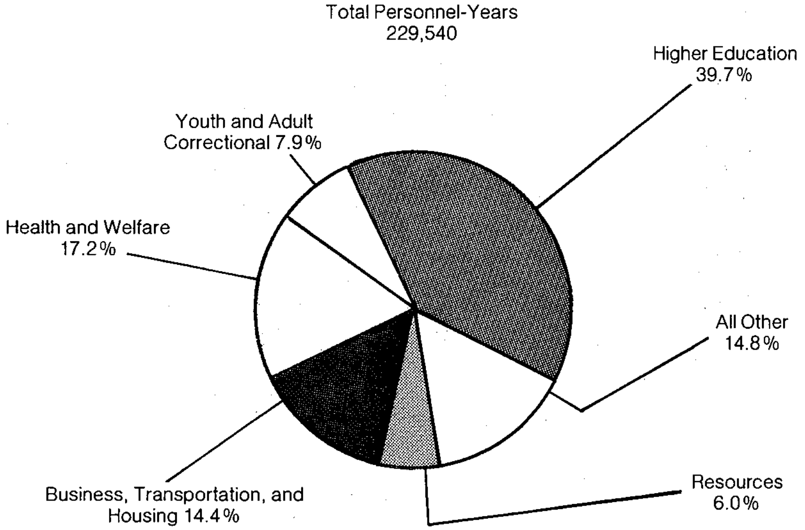
In December 1980, the U.S. Congress decided to stem the growth in housing revenue bonds by enacting the Mortgage Subsidy Bond Act of 1980. This act restricted the use of these bonds, and eliminated their tax-exempt status when sold to finance single-family housing, beginning December 31, 1983. The Congress considered proposals to extend the tax-exempt status of interest paid on these bonds beyond this date, but it failed to act before the exemption expired. There are indications, however, that Congress will reinstate the tax exemption for housing bonds. The level of housing bond sales in the future will depend on when and how Congress decides this issue.

The State's Workforce

PERSONNEL YEAR CHANGES IN THE BUDGET YEAR

As Chart 21 and Table 55 show, the Governor's Budget proposes a state government workforce of 229,540 personnel-years (pys) for 1984–85. The four functions accounting for the largest number of personnel-years are Higher Education, with 91,076 pys (40 percent of the total), Health and Welfare programs, with 39,593 pys (17 percent), Business, Transportation and Housing programs with 33,087 pys (14 percent), and Youth and Adult Correctional programs with 18,035 pys (8 percent).

Chart 21
Personnel-Years by Function 1984–85



The Governor proposes to reduce the size of the state's workforce in 1984–85 by 4,880 personnel-years, or 2 percent, below what the budget estimates to be the current-year level. From a program perspective, the budget proposes staffing level reductions for *all* functional areas with two *exceptions*—the Judiciary (+35 pys) and Youth and Adult Correctional programs (+157 pys). The largest reductions are proposed for Higher Education (−1,849 pys) and Health and Welfare programs (−1,780 pys).

The budget indicates that a strictly enforced hiring freeze and a subsequent management review showed that the 4,880 personnel-years could

Table 55
Total Number of State Employees, by Function [a]
(in personnel-years)
1978–79 through 1984–85

	1978–79	*1979–80*	*1980–81*	*1981–82*	*Estimated 1982–83*	*Proposed 1983–84*	*1984–85*	*1983–84 to 1984–85 Change Number*	*1983–84 to 1984–85 Change Percent*	*1978–79 to 1984–85 Change Number*	*1978–79 to 1984–85 Change Percent*
Legislative, Judicial and Executive	8,575.5	8,713.7	9,132.3	9,418.3	9,289.9	9,812.2	9,811.4	−.8	— [b]	1,235.9	14.4%
State and Consumer Services	10,402.7	10,671.3	11,023.2	11,325.3	11,378.2	12,177.6	12,102.3	−75.3	−0.6	1,699.6	16.3
Business, Transportation and Housing	30,867.6	31,293.4	31,955.0	31,859.4	32,181.5	33,699.3	33,086.5	−612.8	−1.8	2,218.9	7.2
Resources	14,167.9	13,779.5	13,889.2	14,373.0	14,141.0	14,293.6	13,758.3	−535.3	−3.7	−409.6	−2.9
Health and Welfare	40,460.9	42,325.2	43,320.7	41,589.7	40,931.0	41,372.7	39,592.8	−1,779.9	−4.3	−868.1	−2.1
Youth and Adult Correctional	12,805.6	12,548.6	13,118.3	13,934.6	14,673.7	17,878.3	18,035.3	157.0	0.9	5,229.7	40.8
K–12 Education	2,650.3	2,665.0	2,746.5	2,796.1	2,666.0	2,737.7	2,691.9	−45.8	−1.7	41.6	1.6
Higher Education	90,152.0	89,840.5	91,629.8	93,988.5	94,188.0	92,924.7	91,075.9	−1,848.8	−2.0	923.9	1.0
General Government	8,447.6	8,355.3	8,752.4	9,528.5	9,040.0	9,523.9	9,385.3	−138.6	−1.5	937.7	11.1
Totals	218,530.1	220,192.5	225,567.4	228,813.4	228,489.3	234,420.0	229,539.7	−4,880.3	−2.1	11,009.6	5.0

[a] Source: Governor's Budgets
[b] Less than .01 percent decrease.

be eliminated due to *increased efficiencies.* While a portion of this reduction can legitimately be attributed to "efficiencies", we find that other factors play a large role in explaining this reduction. As we discuss in Part Three, the personnel-year reduction can also be explained by:

- Inflated current-year estimates of staffing against which the level proposed for the budget year is compared;
- The termination of a significant number of authorized positions, including "limited-term" positions that had been authorized by the Legislature through 1983–84 and will terminate *automatically* at the end of the year; and
- The assumption that salary savings will *increase* in the budget year (this is to say, the budget assumes that the time positions will be vacant due to such factors as turnover and delays in hiring will be higher in 1984–85 than during 1983–84 when the hiring freeze was in effect).

The following discussion details, on a program basis, the significant personnel changes proposed in 1984–85.

Higher Education. The largest total staffing reduction, 1,849 personnel-years, is proposed in higher education. The budget indicates that the University of California (UC) will lose 1,116 personnel-years and the California State University (CSU) will lose 720 personnel-years. In the University of California's case, the major portion of the reduction will occur in the primarily fee-supported UC hospitals, where workload reductions are anticipated due to changes in Medi-Cal reimbursement policies enacted by the Legislature two years ago. The largest staffing reduction for the CSU will occur in the Independent Operations program due, according to the administration, to fewer federal grants and a trend toward using contracts to perform the work related to those grants.

Health and Welfare. The budget proposes to reduce overall staffing for this functional area by 1,780 personnel-years, or 4.3 percent. Within this area, the largest single staffing reduction is a decrease of 1,132 personnel-years in the Employment Development Department (EDD). EDD's staffing levels are heavily dependent on the unemployment rate in California, and these levels, for the most part, are adjusted upward or downward *automatically,* depending on the number of unemployment claims to be processed. In the budget year, 76 percent of the staffing reduction proposed for EDD (and 49 percent of the reduction proposed for the entire health and welfare agency) is attributable to the expected continued upturn in the economy and a decrease in the unemployment rate from 8.3 percent to 7.4 percent. In addition, the termination of the federal Comprehensive Employment and Training Act (CETA) program will result in 56 personnel-years being eliminated.

Overall staffing for the Department of Health Services will decline by 159 personnel-years. This primarily reflects reductions in department administration, partially offset by 57 personnel-years added to the Toxic Substances Control program for increased permit, surveillance and enforcement activities. A net reduction of 122 personnel-years for the Department of Mental Health includes reduced staffing for department support, partially offset by increased staffing for the state hospitals.

Resources. The budget proposes to reduce overall staffing for resources programs by 535 personnel-years, or 3.7 percent, from estimated current-year levels. The major components of this reduction are decreases in the Departments of Parks and Recreation and Water Resources (210 pys and 205 pys, respectively). These reductions are primarily due to workload-related factors: fewer capital outlay projects, and slippage in the schedules for completion of state water projects. These personnel reductions are partially offset by an increase of 38 personnel-years requested for the State Water Resources Control Board, which proposes to augment its efforts to locate and mitigate leaking underground tanks.

Business, Transportation and Housing. In 1984–85, the budget proposes to reduce the workforce in these programs by 613 personnel-years, or 1.8 percent. Reduced staffing levels in two programs, the Department of Transportation (Caltrans) and the Department of Motor Vehicles (DMV), account for most of the reduction. Caltrans will experience a net loss of 410 personnel-years, primarily in the Highway Transportation program, reflecting an increase in contracting with the private sector and use of alternative work methods. The Department of Motor Vehicles will lose a net total of 243 personnel-years, primarily as a result of increased automation.

Youth and Adult Correctional Agency. The budget proposes to *increase* Youth and Adult Correctional Agency staffing in 1984–85 by 157 personnel-years, or about 1 percent. This is one of only two functional areas in which *additional* staffing is proposed. The largest single increase within the agency, an *increase* of *546 personnel-years,* is proposed for the Department of Corrections in order to meet the demands of a projected growth in inmate and parolee populations. This increase is partially offset by the effect of Ch 956/83 which removed the Prison Industries program from the budget process and resulted in the elimination of 327 personnel-years from the budget totals, but not the elimination of the positions themselves.

HISTORICAL CHANGES

It is particularly useful to analyze changes in the state's workforce from a historical perspective. Personnel-year changes during the period from 1978–79 through 1982–83 have been quite modest, increasing at an average annual rate of 1 percent. As noted above, the Governor proposes what appears to be a sharp reduction in staffing from the current-year level. When the staffing level proposed for 1984–85, however, is compared to the *actual* staffing level in 1982–83, the trend goes in the opposite direction: there is an *increase* in personnel-years of 1,051, amounting to one half of one percent.

Table 56
Ratio of the State's Workforce To Total Population [a]
1978–79 through 1984–85

	State Workforce (in thousands)	*California's Population [b] (in thousands)*	*State Workforce As Percent of Total Population*	*State Operations Expenditures In Constant Dollars (in millions) [c]*
1978–79	218.5	22,839	0.957%	$3,909
1979–80	220.2	23,255	0.947	4,362
1980–81	225.6	23,771	0.949	4,697
1981–82	228.8	24,212	0.945	4,596
1982–83	228.5	24,628	0.928	4,437
1983–84	234.4	25,152	0.932	4,503
1984–85	229.5	25,576	0.897	4,968
Percentage change (1978–79 through 1984–85)	5.0%	12.0%	−6.3%	27.1%

[a] Source: Governor's Budget.
[b] Population as of July 1, the beginning of the fiscal year.
[c] Includes General Fund and special fund expenditures. Current dollars are deflated to 1978–79 dollars using the Gross National Product implicit price deflator for state and local purchases of goods and services.

Ratio of State Workers to Total Population Declines

Table 56 shows that between 1978–79 and 1984–85, California's population will have increased by 12 percent, while the state's workforce will have increased by only 5 percent. As a result, the ratio of state employees to the state's population has *declined* by 6.3 percent over the seven-year period. During the same period, state operations expenditures, adjusted for inflation, will have increased by 27 percent.

Increase in Correctional Staffing Accounts for Major Share of the Increase

If the staffing levels proposed in the Governor's Budget are achieved, the state's workforce will increase by 11,010 personnel-years between 1978–79 and 1984–85. Nearly one-half of the increase during this period will occur in a single program area: Youth and Adult Correctional programs. Staffing increases for this program, which total 5,230 personnel-years during this seven-year period, are due to the dramatic growth in the prison population, particularly during the past three years. For example, current-year staffing for these programs is estimated to exceed actual 1982–83 levels by 3,205 personnel-years.

During the past seven years, 2,219 personnel-years have been added to Business, Transportation and Housing programs, accounting for 20 percent of the total increase for the state. This increase is primarily attributable to growth in the Department of Transportation, the California Highway Patrol, and the Department of Motor Vehicles.

State and Consumer Services programs have grown by 1,700 personnel-years, accounting for 15 percent of the total increase. Staffing increases in this area relate to increased workload in the Franchise Tax Board, the Bureau of Automotive Repair, and the Department of General Services.

Overall *reductions* since 1978–79 have occurred only in two areas: Health and Welfare programs and Resources programs. Overall staffing for Health and Welfare programs has declined by 868 personnel-years, or 2 percent, and staffing for Resources programs has gone down by 410 personnel-years, or 3 percent during this six-year period. For both of these functional areas, however, the overall staffing reductions for the period as a whole are largely a result of the personnel decreases proposed for the budget year.

Part Three

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

Revenue Issues

Expenditure Issues

Local Government Finance Issues

Legislative Control of the Budget

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

This part discusses some of the broader issues facing the Legislature in 1984. Many of these issues are closely linked to proposals contained in the Governor's Budget for 1984–85. Others are more long range in nature and will, in all probability, persist for many years beyond 1984. Even in these cases, however, legislative action during 1984 is desirable because the Legislature generally will have a wider range of options for addressing these issues in 1984 than it will have in subsequent years.

We have grouped the issues discussed in this part into four major sections.

State Revenue Issues. The first section identifies issues related to state revenues. Specifically, we discuss options for increasing legislative oversight of *tax expenditures*—an increasingly significant portion of the state budget. We also discuss the *tax burden* in California, and analyze how the level of taxation in California compares with the levels in other states.

State Expenditure Issues. The second section identifies issues related to state expenditures. Here, we discuss the allocation of funds for *cost-of-living adjustments,* the effect of the Governor's proposed *staffing reductions* on state programs and operations, the state's "rainy day" fund which is formally known as the *reserve for economic uncertainties,* the proposed *realignment of state/county responsibilities* in four health and welfare areas, funding for benefits provided through the state's various *retirement systems,* and ways the Legislature can improve the effectiveness and coordination of the state's *hazardous substances* control programs.

Local Government Finance Issues. The third section identifies issues related to local government finance. In this section, we discuss the Governor's *local government finance proposal.* We also discuss the ways in which the Legislature can help counties control the rising costs of operating the *trial courts.* In addition, we discuss issues related to funding for *state-mandated local programs, community redevelopment projects,* and the new *supplemental property tax program.*

Legislative Control of the Budget. The fourth section identifies issues that involve the Legislature's ability to monitor and control state spending. One of these issues concerns the Legislature's role under those state laws that grant to state employees the right to bargain collectively over the terms and conditions of their employment. Other issues discussed in this section involve the availability, comprehensiveness and reliability of data on revenues and expenditures, and the effect of adverse court decisions on the state's General Fund.

In addition to the issues discussed in this part, a number of major policy and funding issues are discussed in the *Analysis.*

Revenue Issues

TAX EXPENDITURES

How Can The Legislature Ensure That its Priorities are Addressed by Tax Expenditure Programs?

This section examines ways in which the Legislature might improve its ability to review the state's multitude of tax expenditure programs. Annual review of the costs and benefits associated with tax expenditure programs is justified on the very same basis that annual review of direct expenditure programs is—namely, that these programs represent a commitment of state resources to achieve state objectives, and the priorities associated with these different objectives change over time.

Tax Expenditures Defined

The term tax expenditures refers to a number of tax exclusions, exemptions, preferential tax rates, credits, and deferrals, which reduce the amount of revenue collected from the state's basic tax structure.

The Legislature has enacted tax expenditure programs for a variety of reasons. First, tax expenditures provide taxpayers with *incentives* to alter their behavior in certain ways which further the goals of state policy in areas such as economic and industrial development, housing, transportation, energy and resources development, health and education. For example, the income tax deduction for mortgage interest is intended to encourage homeownership and promote the development of the housing industry. Tax credits for solar energy systems are designed to promote the growth of a new industry, reduce consumption of energy from traditional sources, and foster technological innovation. Tax expenditures also provide tax *relief or aid* to particular groups or classes of individuals, in order to further the goals of the state's social policies. For example, the sales tax exemption for prescription medicines is intended to lessen the financial burden on those who must purchase medication.

Because tax expenditures are described in terms of revenues *foregone,* some who oppose the use of the concept claim that it implies that all income belongs to the government, and that therefore all income *not* collected by the government is a tax expenditure. The problem with these critics' reasoning is that tax expenditures are not measured against a base of *all income,* but rather against the revenues which would have been collected under the basic system. Consequently, use of the term "tax expenditure" does not imply that "all income belongs to the government."

As instruments of state policy, tax expenditure programs differ from *direct* expenditure programs only in that they are "funded" through provisions of the tax code instead of through the annual Budget Act. The "costs" of tax expenditure programs are measured in terms of revenue losses, instead of budget expenditures. The revenue losses associated with existing tax expenditure programs are sufficiently large to constitute a substantial portion of the state's total spending plan.

Table 57 compares direct expenditures with major tax expenditures for the period 1981–82 through 1983–84. The table shows that the "cost" of tax expenditures has risen 22 percent since 1981–82, while the cost of direct expenditure programs has risen 4 percent during the same period. The relatively low rate of growth in direct expenditures, of course, was a direct consequence of the recent recession and the devastating impact it had on revenues. As Table 57 indicates, tax expenditure programs in no way bore a comparable share of the burden imposed on the General Fund by the recession. Instead, these programs continued to grow—and grow rapidly—throughout the period.

Table 57
Major General Fund
Tax Expenditure Costs and
Direct Expenditure Costs
1981–82 through 1983–84
(in millions)

				Change 1981–82 to 1983–84	
	1981–82	*1982–83*	*1983–84*	*Amount*	*Percent*
Tax expenditures:					
Personal income tax	$4,600	$5,443	$5,732	$1,132	24.6%
Sales and use tax	2,300	2,566	2,724	424	18.4
Bank and corporation tax	200	222	229	29	14.5
Totals	$7,100	$8,231	$8,685 [a]	$1,585	22.3%
Direct expenditures:					
General Fund	$21,695	$21,755	$22,641	$946	4.4%

[a] Source: 1983–84 Governor's Budget, adjusted for 1983 legislation.

The Need for Legislative Oversight

Tax expenditure programs can be an appropriate means of accomplishing legislative objectives. In certain circumstances, they may even be superior to alternative direct expenditure programs because they are relatively simple to administer. Nevertheless, the Legislature needs to monitor these programs closely, for three major reasons.

First, *tax expenditures may not be effective in influencing taxpayer behavior.* This may be due to the fact that the incentive provided by certain tax expenditures is too small to make a difference or is overwhelmed by other incentives facing those whose behavior is intended to be influenced. For example, several sales and use tax exemptions have been established as a means of encouraging new businesses to locate or stay in California. In many of these cases, however, other factors, such as access to markets, skilled labor, transportation, or raw materials, may be much more important to firms making location decisions than the relatively small amount of tax relief provided by a sales tax exemption.

Second, *compared to most direct expenditure programs, tax expenditure programs are relatively uncontrollable.* Once a tax expenditure has been established in law, expenditures—that is, revenue losses—occur automatically. Unlike direct expenditure programs, for which funds must be appropriated annually, tax expenditures are not subject to annual legislative review or approval. Also, tax expenditures resemble entitlement programs, in that there is no limit on the number of individuals who can claim a benefit or on the total amount of the "expenditure." In short, once a tax expenditure is enacted, the Legislature—as a practical matter—loses control over the total amount of state resources devoted 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 particularly necessary during times of fiscal constraint.

Finally, *excessive use of tax expenditures may have an adverse impact on the tax system.* The proliferation of exemptions, credits, and exclusions is one of the primary reasons why taxpayers are confronted with such a complicated tax system. Adding another line or one more form to a tax return has little impact, but the cumulative burden carried by the tax system from all tax expenditures is heavy.

Better Information is Prerequisite for the Review Process

We recommend that the Legislature enact legislation requiring the Department of Finance to present specific information on tax expenditures as part of the annual budget.

Since 1975–76, the Department of Finance (DOF) has each year provided a brief presentation on tax expenditures in the budget's introductory (or 'A') pages. This presentation has included background information and a fiscal summary of the major identifiable tax expenditures. Ch 575/76 requires the department, in odd-numbered years, to include a detailed analysis and set of recommendations regarding these "costs" in the Governor's Budget.

The Governor's Budget for 1983–84 included a review of changes in tax expenditure programs which either had been recommended by the department in prior tax expenditure reports or were recommended for termination in 1983 (the Solar and Energy Tax Credit programs). In addition, the budget proposed that the tax expenditure report requirement be discontinued, on the basis that the report did not have sufficient impact to warrant the effort that went into it. The Legislature did not consider discontinuation of the report requirement.

In contrast to past years, the Governor's Budget for 1984–85 contains no information on the estimated cost of tax expenditure programs for the current and budget years. This is the first budget since 1975–76 in which the department has failed to provide the Legislature with any information on this subject.

In our judgment, information on tax expenditures is too important for the Legislature to do without. If anything, the Legislature's need for information on tax expenditures is greater today than it was in 1976 when the requirement for a biennial report was imposed on the department. As state and local resources are constrained by a sagging economy or voter-approved restraints on taxing powers, the Legislature finds it more difficult to maintain expenditures for what it deems high priority programs. In looking for ways to shore up funding for these programs, the Legislature needs a comprehensive picture of where funds are being spent and how effectively they are being used, regardless of whether the expenditures occur through the budget or through the tax code. Without information on the projected revenue loss from existing tax expenditure programs in the budget year, a substantial portion of the state's total spending plan is beyond the Legislature's effective review or control.

We conclude that the Legislature needs information on tax expenditures annually, not every other year. Moreover, to facilitate legislative review of tax expenditure programs, this information should include:

- ***A Comprehensive List of Tax Expenditures.*** The department's reports in the past have included only "major identifiable" tax expenditures, rather than a complete list of state tax expenditures. As a result, the listings have generally excluded those tax provisions for which the revenue loss may be significant but is difficult to estimate.
- ***More Detailed Information on Individual Categories of Tax Expenditures.*** Past tax expenditure reports have provided only fiscal estimates for aggregated categories of tax expenditures (for example, the revenue loss from mortgage and nonmortgage interest deductions combined) in a single year. 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 Governor's Budget for 1983–84 included, for the first time, a chronology of tax expenditures enacted and repealed since 1977. The department should continue to provide this type of information, in order to facilitate the Legislature's evaluation of changes to the tax expenditure budget.

Accordingly, we recommend that the Legislature enact the following statutory language in the *companion* legislation to the Budget Bill:

"The Department of Finance shall provide an annual report to the Legislature on tax expenditures, including (1) a comprehensive list of tax expenditures, (2) additional detail on individual categories of tax expenditures, and (3) historical information on the enactment and repeal of tax expenditures."

Procedural Options for Legislative Review and Oversight

We recommend that the Legislature consider establishing a formal process for review and oversight of tax expenditure programs.

Despite the large volume of legislation on and the high level of interest in tax expenditure programs, the Legislature does not have a formal process for considering the level of resources devoted to these programs on an ongoing basis. Given that a substantial amount of resources are devoted to tax expenditure programs in order to achieve the Legislature's policy objectives, and that these resources would otherwise be available for direct expenditures or broad based tax relief, there is no reason why they should not receive the same oversight as direct expenditures.

If the Legislature wishes to establish a formal review process for tax expenditures, it could consider the following options:

- Establish a budget subcommittee in each house whose sole function would be to review tax expenditures.
- Delegate to the existing budget subcommittees the responsibility for reviewing tax expenditures falling within their jurisdiction, in conjunction with their review of the Governor's Budget. For example, the resources subcommittees would review solar energy tax credits, and the health and welfare subcommittees would review the medical expense deduction.
- Require the Governor to submit a "Tax Expenditure Budget" to the Legislature. This budget would identify all tax expenditure programs and center the Governor's recommendations on those that warrant special legislative review. This proposal is somewhat similar to AB 1894 (Bates), which has already passed the Assembly. That measure goes one step further and requires the Legislature to repeal or modify specific tax expenditures if the projected growth rate for all programs exceeds an allowable rate.
- Make tax expenditure control a part of the existing budgetary process. In Canada, for example, direct and tax expenditures relating to each program function are analyzed in the same light and subjected to the same spending limitations. Under this so-called "envelope system," budget subcommittees are constrained by a ceiling on the sum of direct and tax expenditures.

In our opinion, a formal legislative process for reviewing and overseeing tax expenditure programs should be based on the ongoing need to evaluate whether these programs are meeting state objectives and legislative priorities.

An Agenda for Review is Critical

We recommend that the Legislature assign to the Legislative Analyst the ongoing responsibility to prepare in-depth reviews of selected tax expenditure programs.

Whatever process the Legislature may choose to enact, it is clear that not all tax expenditure programs need annual review. Some programs, such as the income tax deduction for local property tax payments, are so widely applicable and so ingrained in the tax structure that they may need legislative attention on a relatively infrequent basis. Other tax expenditure programs, however, may warrant more frequent or more thorough review. In particular, legislative review should focus on tax expenditure programs which can be shown to:

- Provide windfall benefits to individuals or groups whose behavior is unaffected by the tax incentive,
- Work contrary to the objectives of other state programs or other tax expenditures, and
- Have less priority to the Legislature than they did when originally enacted.

The 1983 Tax Expenditure Agenda. In 1983, the Legislature's fiscal committees considered 31 pieces of legislation affecting some 42 separate tax expenditure programs. Action on these bills resulted in increased state resources amounting to approximately $174 million. The changes in tax expenditure programs made in 1983 reflect the Legislature's *overall* priorities for these programs, relative to direct spending programs, as well as the Legislature's priorities among different tax expenditure programs.

The Legislature's deliberations on tax expenditure priorities during the last session was greatly facilitated by the existence of an *agenda for reductions.* This agenda, which was offered by the Governor, sought to *"free up"* General Fund resources for other uses.

Setting the Agenda After 1984. Information on the costs and benefits of individual tax expenditure programs should constitute the basis for legislative review of these programs on an annual basis, independent of the state's overall fiscal condition. Unfortunately, the Legislature currently does not have an ongoing procedure which establishes an agenda for reviewing tax expenditure programs at the outset of each legislative session, and provides information on those programs that appear on the agenda. Instead, the Legislature's agenda is usually a function of sunset dates attached to various programs when they are enacted. The number of programs with sunset dates, however, is relatively small, and these programs may not necessarily be the ones that are most deserving of legislative scrutiny. We believe that the Legislature needs a more flexible procedure for establishing its agenda for reviewing tax expenditure programs, and for assuring that analysis of these programs is available to it on a timely basis.

In order to ensure that the Legislature has adequate and timely information on which to base a review of tax expenditure programs in future years, we recommend that the Legislature assign an ongoing responsibility for the preparation of in-depth reviews covering selected programs to the Legislative Analyst. The selection of items for review in the upcoming year could be determined annually in the course of the regular budget process, or left to the discretion of the Legislative Analyst. These reviews would be presented to the Legislature in December of each year. They would then be available to the Legislature during budget hearings regardless of the process it selects to review the programs.

THE LEVEL OF TAXATION IN CALIFORNIA

Does the Legislature Need to Worry That the "Tax Burden" in California is "Too High" Relative to the Tax Burden in Other States, and Therefore a Threat to the Well-Being of the State's Economy and Its Citizens?

The level of taxes collected by California's state and local governments from individuals and businesses has been the subject of considerable discussion in recent years. Some have argued that California's taxes are high relative to other states and that, because of this, the state's business climate, and therefore its economic performance, have suffered. Recent ballot initiatives calling for tax reductions have been defended, in part, on the basis that California's taxes are "too high." These initiatives have provided for reductions in local property taxes (Proposition 13, approved in June 1978), reductions in state income tax rates (Proposition 9, defeated in June 1980), full indexing of the income tax (Proposition 7, approved in June 1983), and elimination of inheritance and gift taxation (Propositions 5 and 6, approved in June 1982).

The discussion below presents an overview of tax levels in California, focusing on four main questions:

1. What is the level of taxes collected by California's state and local governments, and how does this level compare to those imposed by other states?
2. How has the level of taxes in California changed over time?
3. What are the major tax relief programs that have caused the level of taxes in California to drop in recent years?

4. What are the economic implications of California's tax burden and of interstate differences in tax levels?

1. Tax Levels in California and the Nation

Table 58 shows the amount of taxes collected by state and local governments in California and in the nation as a whole in 1982–83. The table indicates that in 1982–83:

- State and local government tax collections in California amounted to nearly $33.6 billion. Of this amount, nearly $22.3 billion (66 percent) represented state taxes and $11.3 billion (34 percent) represented local taxes.
- Taxes per capita in California were $1,358, including $901 in state taxes and $457 in local taxes. By comparison, state and local taxes per capita for the nation as a whole were $1,226, including $738 in state taxes and $487 in local taxes.
- Taxes per $1,000 of personal income in California, were $108, including $72 in state taxes and $36 in local taxes. By comparison, state and local taxes per $1,000 of personal income nationally were $110, including $66 in state taxes and $44 in local taxes.

Table 58

Comparative Data on State and Local Tax Collections in 1982–83 [a]
California and the Nation as a Whole

	State Government Tax Collections	*Local Government Tax Collections*	*Combined State and Local Government Tax Collections*
A. *Amount of Taxes Collected*			
1. California (millions)	$22,265	$11,300	$33,565
2. All states (millions)	170,936	112,830	283,766
B. *Taxes Per Capita*			
1. California	$901	$457	$1,358
2. All states	738	487	1,226
C. *Taxes Per $1,000 Personal Income*			
1. California	$72	$36	$108
2. All states	66	44	110
D. *California's Tax Rank Relative to Other States* [b]			
1. Amount of taxes	1st	2nd	2nd
2. Taxes per capita			
—Measure 1	9th	22nd	11th
—Measure 2	9th	19th	10th
3. Taxes per $1,000 personal income			
—Measure 1	21st	32nd	23rd
—Measure 2	21st	29th	21st

[a] Figures based on data from various publications of the U.S. Department of Commerce, Bureau of the Census. Details may not add to totals due to rounding.

[b] Rankings reflect estimates by Legislative Analyst's Office of 1982–83 local tax collections, based upon preliminary U.S. Department of Commerce information for selected tax levies. Measure 1 assumes that 1982–83 local tax collections for individual states equal the same percentage of their respective state tax collections as in 1981–82. Measure 2 assumes that 1982–83 preliminary property tax collections estimates for major population areas in individual states are the same proportion relative to their respective statewide local tax collections as in 1981–82.

Table 58 also shows that California ranked first in the dollar amount of state tax collections, and second (to New York) in both local tax collections and combined state and local tax collections. This high ranking, for the most part, reflects California's population and income base, both of which are the largest in the nation. When interstate differences in population and personal income are adjusted for, California's tax ranking is much lower. Specifically, Table 58 shows that:

- In terms of *taxes per $1,000 of personal income*—which we believe is probably the best single broad measure to use in making interstate tax level comparisons (because it partially compensates for interstate differences in such factors as income levels and living standards)—California ranked only 21st for state taxes, between 29th and 32nd for local taxes, and between 21st and 23rd for combined state and local taxes.
- In terms of *taxes per capita,* California ranked 9th for state taxes, between 19th and 22nd for local taxes, and either 10th or 11th for combined state and local taxes.

Given these rankings, California's overall tax level does not appear to be unusually high relative to many other states. It is true that the state-local tax *mix* in California differs somewhat from the nation's—66 percent of all California collections represent state taxes, compared to only 60 percent nationally (prior to Proposition 13, state taxes were relatively *less* important in California than they were nationally). Nevertheless, California's share of total state and local taxes (11.8 percent) was actually below its share of total national personal income (12.8 percent) in 1982–83. Furthermore, the dollar differences separating California from some of the states ranked lower in terms of tax burden are not all that great. For example, the state's ranking in terms of total taxes per $1,000 of personal income would drop from the low 20's to 30th with only a $4 (3.7 percent) decline in this measure of tax burden. Thus, it would appear that the current level of taxes in California relative to the levels in other states can be best characterized as "relatively moderate."

This characterization is supported by a recent study of state tax burdens (see *1981 Tax Capacity of the Fifty States, September 1983)* conducted by the Advisory Commission on Intergovernmental Relations (ACIR). The approach which ACIR used to measure tax burdens was to first develop an index of relative *tax capacity* for each state, which measures the amount of taxes per capita which would be raised in each state if a nationally uniform set of tax rates for 26 commonly-used state and local taxes were applied to the various components of each state's tax base. The commission then developed an index of relative *tax effort* for each state, which measures each state's actual tax collections relative to its tax capacity.

The ACIR study found that while California's relative *tax capacity* ranked 8th and was 15 percent above the national average, its relative *tax effort* ranked only 19th and equalled the national average. Thus, the ACIR's findings are consistent with the view that California's tax burden is "middle-of-the road." The ACIR study also reported that California was one of only 15 states whose tax effort index fell between 1977 and 1981, and the magnitude of California's tax effort decline (14 percent) was the second largest of any state.

Table 59
Historical Trends in State and Local Government Tax Burdens
1972–73 through 1982–83

A. "Real" Taxes Per Capita [a]

	Total State and Local Taxes		State Taxes		Local Taxes	
Fiscal Year	*California*	*All States*	*California*	*All States*	*California*	*All States*
1972–73	$740	$579	$356	$325	$384	$253
1973–74	706	571	353	324	353	247
1974–75	723	552	376	313	347	239
1975–76	742	560	385	319	357	241
1976–77	785	584	415	336	371	248
1977–78	823	593	452	347	372	246
1978–79	653	574	444	349	208	225
1979–80	675	563	471	346	204	218
1980–81	648	556	446	340	203	215
1981–82	643	556	432	340	211	217
1982–83	610 [b]	551	405	332	205 [b]	219

B. Taxes Per $1,000 of Personal Income

	Total State and Local Taxes		State Taxes		Local Taxes	
Fiscal Year	*California*	*All States*	*California*	*All States*	*California*	*All States*
1972–73	$146	$128	$70	$72	$76	$56
1973–74	139	123	70	70	69	53
1974–75	144	122	75	69	69	53
1975–76	147	125	76	71	71	54
1976–77	152	127	80	73	72	54
1977–78	156	126	85	74	70	52
1978–79	120	119	82	72	38	47
1979–80	121	115	84	71	37	44
1980–81	115	113	79	69	36	44
1981–82	111	110	75	67	37	43
1982–83	108 [b]	110	72	66	36 [b]	44

[a] Per capita taxes adjusted for inflation, using the U.S. State and Local Government GNP Deflator and measured in 1972–73 dollars.
[b] Legislative Analyst's Office estimate.

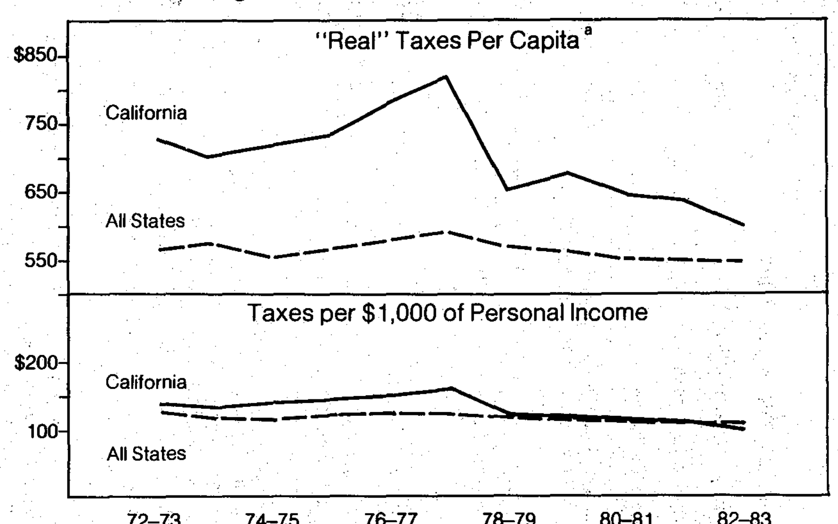
2. Changes in Tax Levels Over Time

Table 59 and Chart 22 show what the trends in tax collections were during the 1972–73 through 1982–83 period, both for California and for all state and local tax collections nationally. Two alternative tax measures are presented to illustrate these trends—taxes per $1,000 of personal income, and "real" (that is, inflation adjusted) taxes per capita. As shown in the table and chart, state taxes and combined state-local taxes in California rose from 1973–74 through 1977–78 regardless of which measure is used to indicate the tax burden. The rise, moreover, was considerably sharper than the rise in state and state-local taxes nationally.

Beginning in 1978, however, a number of tax-reducing measures were implemented in California, including a one-time personal income tax cut in 1978, income tax indexing, reductions in and eventually repeal of the inheritance and gift taxes, and, of course, property tax reductions. As a result, taxes per capita and per $1,000 of personal income fell in 1978–79 at both the state level and for California's local governments. By 1982–83, the tax burdens within the state had fallen even lower. Although tax burdens for the nation as a whole also fell during the past 5 years, the drop in California was relatively greater. As a consequence, California's tax ranking has improved (that is, dropped back from the high end of the spectrum) in recent years.

Chart 22

Historical Trends in State and Local Government Tax Burdens 1972–73 through 1982–83



[a] Per capita taxes adjusted for inflation, measured in 1972–73 dollars.

Table 60
State and Local Tax Relief Benefits
1977–78 Through 1984–85
(in millions) [a]

	1977–78	*1978–79*	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*1983–84*	*1984–85*	*Totals*
A. Tax Relief Measures Adopted Prior to June 6, 1978									
1. *Local Relief*									
Homeowner's Property Tax Exemption	$759	$337	$328	$334	$335	$334	$334	$335	$3,096
Senior Citizen's Property Tax Relief	98	78	74	73	68	59	52	48	550
Inventory Property Tax Exemption [b]	418	211	224	288	292	292	284	282	2,291
2. *State Relief*									
Low Income Income Tax Credit	23	25	15	5	2	1	1	1	73
Renter's Tax Credit	127	134	155	152	160	166	174	174	1,242
Subtotal, Measures Adopted Prior to June 6, 1978	$1,425	$785	$796	$852	$857	$852	$845	$840	$7,252
B. Tax Relief Measures Adopted On or After June 6, 1978									
1. *Local Relief*									
Proposition 13	—	$6,600	$7,300	$8,200	$9,000	$9,700	$11,000	$11,800	$63,600
Inventory Property Tax Exemption [b]	—	—	—	209	219	225	218	220	1,091
Senior Citizen's Property Tax and Renter's Relief	—	—	—	—	—	—	—	2	2
2. *State Relief*									
Personal Income Tax:									
—Indexing	—	$260	$688	$1,826	$2,323	$3,035	$3,012	$3,880	$15,024
—One-time 1978 Credit	—	720	—	—	—	—	—	—	720
—Elderly Tax Credit	—	8	8	8	8	8	8	10	58
—Sale of Home Exemption	—	25	25	25	25	25	25	25	175
Subtotal, Personal Income Tax	—	$1,013	$721	$1,859	$2,356	$3,068	$3,045	$3,915	$15,977
Renter's Tax Credit	—	—	$203	$253	$265	$256	$257	$273	$1,507
All other:									
—Unitary Treatment of In-state Businesses	—	—	—	14	16	18	20	68	136
—Inheritance and Gift Tax Phase-out	—	—	9	7	109	348	680	842	1,995
—Disability Insurance Provisions	—	—	354	48	9	1	1	1	414
—Unemployment Insurance Provisions	—	—	—	—	—	330	540	540	1,410
Subtotal, All Other	—	—	$363	$69	$134	$697	$1,241	$1,451	$3,955
Subtotal, Measures Adopted On or After June 6, 1978	—	$7,613	$8,587	$10,590	$11,974	$13,946	$15,761	$17,661	$86,132
Totals [c]	$1,425	$8,398	$9,383	$11,442	$12,831	$14,798	$16,606	$18,501	$93,384

[a] Estimates by Legislative Analyst's Office and California Department of Finance.
[b] Offset by increase in bank and corporation tax.
[c] Totals reflect the sum of individual program costs; however, the cost of individual programs may be affected by changes in other programs. For example, enactment of Proposition 13 reduced the cost of homeowner's property tax relief by reducing the property tax rate.

3. Tax Relief Measures

Table 60 shows the major tax relief measures which have been implemented in recent years and which are responsible for the decline in California's combined state and local tax burden. The table shows that from 1978–79 through 1982–83, the cumulative value of these measures totaled $52.7 billion, including $13.9 billion in 1982–83 alone. The single largest tax relief measure has been Proposition 13, accounting for a local property tax reduction of $9.7 billion in 1982–83 and $40.8 billion over the entire five-year period.

Table 60 also shows that the cost of California's Proposition 13-era tax relief programs will total an estimated $15.8 billion in the current year and $17.7 billion in the budget year. Thus, total tax relief provided from June 6, 1978 through 1984–85 is projected to reach $86.1 billion. Of this amount, $64.7 billion (75 percent) represents local tax relief.

4. Implications of Interstate Differentials in Tax Burdens

Although the tax burden data presented above provide a useful picture of the *level* of taxation in California relative to levels in other states, these data do *not,* contrary to what is often claimed, necessarily imply anything about the social and economic well-being of a state's residents and its economy. In drawing conclusions from the data, the following should be kept in mind.

- A state's ranking in terms of per capita taxes or taxes as a percent of personal income does *not* necessarily say anything about the relative well-being of taxpayers in that state. This is because such rankings do not compare the quality of the public services in different states which are paid for by taxes. Thus, it is possible that taxpayers in a state which ranks very high in terms of taxes collected could be much better off than taxpayers in other states *if* their tax payments provide high-quality public services like roads, schools, and sanitation facilities which they value very highly. What *is* important is that a state's citizens receive whatever amount of public services they are willing to pay for, and that these services are provided as efficiently as possible.
- Tax burden measurements and rankings also obscure important differences between states in the relative tax treatment of different taxpayers, such as individuals versus businesses and high-income taxpayers versus low-income taxpayers. California personal income taxpayers at different income levels, for example, fare very differently when compared to comparable taxpayers in other states. According to one recent analysis, estimated California personal income taxes for a family of four in 1983 rank 38th among all states when income is $15,000, 34th when income is $25,000, and 26th when income is $50,000. This variation occurs because California's personal income tax

structure has a fairly high income threshold which must be reached before *any* tax liability is due, and a highly progressive marginal tax rate structure thereafter.

- Most business location studies have not been able to provide any solid quantitative evidence that interstate tax levels per se are a significant determinant of business locational decisions. State and local tax levels can influence locational choices if interstate differences in other important determinants of business location are absent. Normally, however, this is not the case, and as a result, business locational decisions depend primarily on factors such as proximity to output markets, resource costs and availability, labor costs, and transportation requirements.

Given the above, care should be taken when drawing conclusions from tax collections measures and tax rankings regarding the effects of interstate differences in tax burdens on the relative well-being of taxpayers and on the general health of a state's economy.

Expenditure Issues

COST-OF-LIVING ADJUSTMENTS (COLAs)

How Should the Legislature Budget for Cost-of-Living and 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 20 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 traditionally have received COLAs on a *discretionary* (or nonstatutory) basis, through the budget process.

In 1984–85, statutory COLAs will range from 2 percent (Medi-Cal long-term care facilities) to 10 percent (Medi-Cal noncontract hospitals). Those statutory COLAs with the largest costs are for K–12 apportionments ($456 million), SSI/SSP grants ($97 million) and AFDC grants ($90 million). If fully funded, statutory COLAs would increase current General Fund expenditures by $884 million in 1984–85.

Governor's Budget Proposal

The budget proposes a total of $1,020 million from the General Fund for COLAs in 1984–85, including $428 million for statutory COLAs and $592 million for discretionary COLAs, including price adjustments for state operating expenses, as shown in Table 61. The amount requested for statutory COLAs is $456 million, or 52 percent, less than what would be needed to provide full increases for all programs with statutory COLAs.

Table 61 shows that only 5 of the 20 statutory COLAs are fully funded in the Governor's Budget. These include four components of the Medi-Cal program (noncontract hospitals; prepaid health plans and related nonhospital services; long-term care facilities; and drug ingredients) and the portion of the state's contribution to the State Teachers' Retirement System's unfunded liability that is adjusted annually by the change in California's Consumer Price Index. For the remaining 15 programs, the governor has sponsored provisions of SB 1379 and AB 2314 (the budget trailer bills) which would suspend the operation of statutory COLAs in 1984–85. In lieu of the statutory COLAs, the budget proposes a 2 percent increase for health and welfare programs and a 3 percent increase for K–12 education programs.

Two budget components would receive a discretionary COLA of approximately 10 percent—the Student Aid Commission's Cal grants and state employee compensation. Specifically, the budget reflects a total increase of 10 percent for student aid award programs operated by the commission. In addition, the budget includes funds for salary increases and improved fringe benefits for all state employees. According to the budget, sufficient funds are requested to increase state employee compensation as follows:

- University of California (UC) faculty 13%
- California State University (CSU) faculty 10%
- Other state employees (including nonacademic employees of UC and CSU) 10%

The budget does not request funds to provide COLAs for programs which traditionally have received discretionary COLAs. Specifically, as detailed in Table 61, no COLAs are proposed for the following four health and welfare programs: medically indigent services, Medi-Cal contract hospitals, Medi-Cal county administration, and welfare county administration. With regard to the county administration items, the Governor has proposed to reverse a three-year legislative policy aimed at limiting the cost of administering welfare and welfare-related programs. Specifically, the budget proposes that in lieu of a COLA for county administration in the budget year, $17.7 million be provided from the General Fund to fund cost-of-living increases granted by *counties* in excess of the increases that the Legislature agreed to pay for in the last three budget acts. Of this amount, $10.9 million is linked to administration of the AFDC program and $6.8 million is linked to Medi-Cal. Generally, the Legislature sought to limit the state's share of county-granted COLAs to an amount corresponding to the salary increase granted to state employees. Many counties granted salary increases well in excess of what the Legislature granted to state employees, and the budget proposes that the state pick-up a share of the costs attributable to the excess.

When the COLAs for county administration are included, the total amount proposed from the General Fund for COLAs in the budget year totals $1,038 million, or 4.1 percent of proposed General Fund expenditures.

Budgeting Errors. As a result of technical budgeting errors, the budget proposes more than a 3 percent increase for the summer school and California Children's Services programs, and less than a 2 percent increase for the In-Home Supportive Services and Primary Care Clinics programs. Moreover, our review indicates that the Governor's county administration proposal is overbudgeted by $1.6 million for Medi-Cal and underbudgeted by $2.3 million for AFDC (a difference of $700,000 which would have to be added to the budget if the Legislature decides to approve the Governor's proposal). Finally, the Governor proposes a $1.2 million COLA for the *supplemental* summer school program that will begin initial operations in July 1984 and therefore has experienced no purchasing power losses that need to be compensated for in the budget year. We discuss these issues under the appropriate budget items in the *Analysis.*

Table 61
General Fund Cost-of-Living Increases
1983–84 and 1984–85
(dollars in thousands)

	1983–84	*1984–85*				
	Budgeted	*1%*	*Statutory*		*Budget*	
Department/Program	*Percent Increase*	*Dollar Increase*[a]	*Percent Increase*	*Dollar Increase*	*Percent Increase*	*Budget as Proposed*
HEALTH AND WELFARE						
Alcohol and Drug Realignment	—	$626	—	—	2.0%	$1,252
Health Services						
County Health (AB 8)	0.53%	3,689	5.55%	$20,475	2.0	7,378
Medically Indigent Services	3.0	4,774	—	—	—	—
Public Health	—	1,022	—	—	2.0	2,038
Medi-Cal						
Contract Hospitals	—	524	—	—	—	—
Noncontract Hospitals (including PHPs and RHF)	8.2	909	10.0	9,086	10.0	9,086
PHPs, CDS, and RHF (nonhospital services)	10.0	1,321	2.0[b]	2,642	2.0	2,642
Long-Term Care Facilities, including state hospitals	1.9[c]	4,273	2.0[d]	8,546	2.0	8,546
Providers, all others	—	3,964	—	—	2.0	7,928
Beneficiary ("Spin-off")	4.0	2,347[e]	5.5	14,041	2.0	5,396
Drug Ingredients	8.0	435	7.4	3,216	7.4	3,216
County Administration	—	580	—	—	—	—
Developmental Services						
Regional Centers	—	3,328	—	—	2.0	6,656
State Hospital Education Programs	—	42	—	—	2.0	85
Local Mental Health Programs	—	3,172	—	—	2.0	6,344
Social Services						
SSI/SSP	4.0[f]	17,647	5.5	97,066	2.0	35,297
AFDC	4.0	16,362	5.5	89,861	2.0	32,723
IHSS—Statutory	4.0	170	5.5	912	2.0	326
IHSS—Nonstatutory	3.0	2,738	—	—	2.0	5,143[g]
Community Care Licensing—Local Assistance	—	75	—	—	2.0	150
County Administration	—	1,291	—	—	—	—
Social Services—Other	—	1,902	—	—	2.0	3,804
Department of Rehabilitation	—	446	—	—	2.0	893
YOUTH AUTHORITY						
County Justice System	—	628	[h]	—	2.0	1,256
EDUCATION						
Apportionments:						
K-12—Districts	8.0	82,833	5.5	455,580	3.0	250,880
Meals for Needy Pupils	6.0	201	6.0	1,209	3.0	604
Summer School—Base	8.0	176	5.5	966	3.0	527
Summer School—Supplement	—	410	—	—	3.0	1,231
Apprentice Programs	6.0	41	—	—	3.0	123
Small School District Transportation	6.0	186	—	—	3.0	557
Transportation	6.0	2,472	—	—	3.0	7,415

K-12—County Offices of Education	8.0	1,636	5.5	8,996	3.0	4,907
Regional Occupational Centers/Programs	6.0	1,650	—	—	3.0	4,949
Child Nutrition	6.0	268	4.1	1,099	3.0	804
American Indian Education Centers	6.0	8	—	—	3.0	24
Native American Indian Education	6.0	3	—	—	3.0	10
Child Care Program	6.0	2,313	—	—	3.0	6,939
Special Education	8.0	12,328	5.5	67,805	3.0	36,985
Staff Development	6.0	108	—	—	3.0	325
Preschool	6.0	322	—	—	3.0	965
Libraries	—	70	—	—	3.0	210
Meade Aid	6.0	96	—	—	3.0	289
Urban Impact Aid	6.0	615	—	—	3.0	1,844
Gifted and Talented	6.0	178	6.0	1,070	3.0	535
Instructional Materials (K–8)	—	590	3.3	1,948	3.0	1,769
Instructional Materials (9–12)	—	178	—	—	3.0	535
Demonstration Programs in Reading and Math	6.0	38	—	—	3.0	113
Educational Technology	6.0	12	—	—	3.0	35
Economic Impact Aid	6.0	1,820	—	—	3.0	5,461
Adult Education	6.0	1,627	6.0	9,761	3.0	4,881
Adults in Correctional Facilities	6.0	13	—	—	3.0	38
Foster Youth Services	6.0	8	—	—	3.0	23
School Improvement Program	6.0	1,725	—	—	3.0	5,174
Miller-Unruh Reading Program	6.0	172	—	—	3.0	515
Board of Governors, California Community Colleges						
Apportionments	—	14,119 [i]	5.7	77,828	[j]	9,961 [j]
Handicapped Student Services	3.0	219	—	—	3.0	656
EOPS	3.0	249	—	—	3.0	747
Student Aid Commission—Awards [k]	3.0	746	—	—	10.1	7,750
CSU-EOPS	—	69	—	—	3.0	207
ALL OTHERS						
State Contribution to STRS	—	2,097	5.5	11,523	5.5	11,523
Employee Compensation [l]	5.0 [m]	40,758	—	—	10.7	434,772
Civil Service and Related	—	(20,330)	—	—	(10.8)	(220,331)
University of California	—	(10,455)	—	—	(10.9)	(113,670)
California State University	—	(9,895)	—	—	(10.1)	(99,961)
Hastings College of Law	—	(78)	—	—	(10.4)	(810)
Price Adjustment (state support)	N/A	N/A	—	—	—	75,583 [n]
TOTALS	—	$242,619	—	$883,630	—	$1,020,025

[a] Figures have been rounded.
[b] Rates will be based on actuarial studies.
[c] Composite increase consisting of 2.9 percent for skilled nursing facilities and 1.1 percent for all other.
[d] Rates will be set on basis of rate studies.
[e] Approximate. COLA cannot be determined simply on a 1 percent basis.
[f] Annualized increase over the year.
[g] We estimate that the proposed two percent COLA is underfunded by $332,000 from the General Fund.
[h] Current law requires annual adjustment by same percentage given other local assistance programs receiving a discretionary COLA.
[i] One percent of revised 1983–84 base budget, per Ch 1xx/84 (AB 1xx).
[j] Due to enactment of Ch 1xx/84 (AB 1xx), proposed budget is no longer applicable.
[k] Reflects total increase in awards for all programs.
[l] Percentage increases reflect the level of salary and salary-driven benefits (such as social security) which could be provided by the budgeted amounts. Collective bargaining negotiations will determine final amounts.
[m] Total compensation package, including salary and benefits.
[n] Department of Finance planning estimates.

Purpose of COLAs

Most discussions of COLAs typically focus only on those programs listed in Table 61. 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 service providers (mostly in the health and welfare areas); and (4) to provide salary increases for state employees. In addition, COLAs are used to maintain the real value of (1) the state's contribution to the State Teachers' Retirement System (STRS), and (2) 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 6 percent increase in operating expenses was allowed by the Department of Finance. The second method involves providing 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 1984–85).

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 in 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.

There Is No Rationale for the Wide Variations in Statutory COLAs. Statutory COLAs in 1984–85 range from a low of 2 percent to a high of 10 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, which may be based on such measures as the manufacturers' direct list prices (Medi-Cal drug ingredients) or administratively determined "reasonable cost" guidelines (work activity services administered by the Department of Rehabilitation).

In past issues of the *Analysis*, we have noted that, although some variation in COLAs was warranted, we could find no analytic justification for the wide variations in statutory adjustments that currently exist. As a result, we have recommended that the Legislature use the Gross National Product (GNP) personal consumption expenditures deflator and the GNP deflator for state and local government purchases as the bases for judging how inflation affects the purchasing power of 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.

There Is No Rationale for the Variation in Discretionary Local Assistance COLAs. The Governor's Budget includes discretionary COLAs of *2* percent for 11 health, welfare, and correctional programs and *3* percent adjustments for 24 education programs. If these adjustments have a common objective, as stated earlier, of compensating for the effects of inflation on the purchasing power of the previous year's funding level, we know of no analytical reason to provide different COLAs to these local assistance programs.

Variations in COLAs Often Reflect Budget Accounting Concepts, Rather than Policy Considerations. The Governor's Budget for 1984–85 proposes that many of the programs categorized in the budget as local assistance receive either a 2 percent or 3 percent COLA, while programs categorized as state operations are recommended for a 6 percent (or larger) 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 proposed for the same purpose—that is, to maintain purchasing power at current-year 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 receive larger COLAs. Some examples of the haphazard treatment given by the budget to similar programs follow:

- The proposed budget for the *Department of Social Services* provides a 6 percent discretionary COLA for support of state-operated adoptions and community care licensing programs which are budgeted as state operations. Yet, the budget provides only a 2 percent COLA to the same programs operated by the counties on behalf of the state, which are budgeted as local assistance.

- The budget proposes a 2 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 10.7 percent COLA for employee compensation, and a price letter adjustment (maximum of 6 percent) for operating expenses, because these costs are classified as state operations.
- 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 2 percent COLA. Yet, the funding proposed for health services which the state provides directly, under contract with small counties, includes a 10.7 percent increase for employee compensation and a price letter adjustment (maximum of 6 percent) for operating expenses, because it is categorized as state operations.

County Administration COLA Proposal Raises Equity Questions. As discussed earlier, the Governor proposes to fund COLAs provided by *counties* to their welfare department employees in excess of the percentage increases specified by the Legislature in the Budget Acts for 1981–82, 1982–83, and 1983–84. Our review of this proposal (please see *Analysis*, Item 4260-101-001 (Medi-Cal) and Item 5180-141-001 (AFDC) for a detailed discussion) indicates that it would reward counties that chose not to support the Legislature's efforts to limit costs and penalize counties that attempted in good faith, to keep their salary and benefit increases within the limit set by the Legislature. Specifically, the Governor's proposal would (1) provide *no* additional funds for a county that limited salary increases for its employees to the legislatively established percentage (generally, the percentage increase granted to state employees), and (2) fund a portion of the increase granted by another county that was as much as 23 percentage points larger than the legislatively established limit.

There is another drawback to the Governor's proposal beyond the differential treatment of counties. Approval of the proposal would place the state in the position of paying for salary increases to *county* employees that exceed—often greatly exceed—the increases provided to its own *state* employees.

Conclusion

In order to ensure that the amounts of COLAs provided to individual programs are determined in a rational, equitable, and consistent manner that reflects the Legislature's priorities, we recommend that the Legislature establish at the outset of budget hearings a formal policy governing cost-of-living and inflation adjustments. This policy should call for the size of any COLAs awarded to 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.*

STATE WORKFORCE REDUCTION PROPOSAL

What Effect Will the Governor's Proposed Staffing Reductions Have on State Programs and Activities? How Much Money Will it Save?

As discussed in detail in Part Two, the Governor's Budget proposes a state government workforce of 229,540 personnel-years in 1984–85. This is a reduction of 4,880 personnel-years from what the budget estimates the current-year level to be, and a reduction of 3,520 personnel-years from the staffing level reflected in the 1983 Budget Act. The budget indicates that following a strictly enforced hiring freeze, a management review has found that these personnel-years can be eliminated due to "increased efficiencies." This section analyzes the Governor's staffing reduction proposal in an effort to evaluate its effect on state operations and expenditures.

Background

Since the passage of Proposition 13 in 1978, the state has operated under some type of hiring freeze almost continually, as shown in Table 62. Despite these restrictions, the state's workforce grew by 9,959 personnel-years between 1978–79 and 1982–83, the last year for which data on *actual* staffing levels are available. If the budget's estimate of the current-year staffing level is used, the increase in the state's workforce since 1978–79 is even larger—15,890. In other words, the budget indicates that there has been an *increase of 5,931 personnel-years* in the state's workforce since 1982–83 (which ended last June 30).

Table 62 shows that a hiring freeze in and of itself does not necessarily cause personnel-years to go down. For example, although hiring freezes were in effect during all of 1979–80 and 1980–81, the state's workforce actually grew by 1,663 personnel-years the first year and by 5,374 personnel-years the second year. Even in the current year, despite the freezes instituted by the administration, the workforce is estimated to be 2,026 personnel-years *larger* than what the *administration proposed* in the budget for 1983–84, and 5,931 personnel-years larger than what the workforce actually was in 1982–83. The increase in personnel-years shown for 1983–84 in the Governor's Budget represents the largest year-to-year increase, both in absolute and percentage terms, since Proposition 13.

Table 62
State Personnel-Years
1977–78 through 1984–85

	Proposed in Governor's Budget	*Actual*	*Difference Proposed/Actual*	*Change in Actual From Prior Year*	*Number of Hiring Freeze Months*
1977–78	215,796	221,251	5,455	—	—
1978–79	224,337	218,530	−5,807	−2,721	12
1979–80	218,619	220,193	1,574	1,663	12
1980–81	221,118	225,567	4,449	5,374	12
1981–82	226,743	228,813	2,070	3,246	4
1982–83	231,375	228,489	−2,886	−324	6
1983–84	232,394	234,420 [a]	2,026	5,931 [a]	12 [b]
1984–85	229,540 [c]	—	—	4,880 [c]	—

[a] Estimated.
[b] Beginning August 1, hiring limited to state layoff lists. Beginning January 31, departments can obtain freeze exemptions upon Department of Finance approval of a personnel management plan.
[c] Proposed.

There are a number of reasons why staffing levels can rise in the face of hiring freezes. For example, public safety, 24-hour care, and revenue raising activities usually are exempt from hiring freezes. In addition, exemptions from the freeze have often been allowed at the discretion of an agency secretary or the Department of Finance. This is not to suggest that such exemptions are inappropriate. In fact, quite the opposite is often true—staffing increases are needed to protect the public interest. What the trends shown in Table 62 do suggest is that the official policy toward staffing levels—for example, a hiring freeze—may not provide an accurate indication of what is happening "to the numbers"—that is, to the size of the workforce.

The reverse can also be true. A change "in the numbers" may not give an accurate indication of which direction state policy is actually heading, or what the implications are for state programs and expenditures. Such seems to be the case with respect to the staffing numbers contained in the Governor's Budget, and what has been said about the meaning of these numbers.

In the balance of this section, we consider the claims made in the Governor's Budget from five different perspectives:

1. What did the hiring freeze in 1982–83 accomplish?
2. How valid is the base against which the number of *personnel-years* proposed for 1984–85 is compared?
3. What changes in *positions* are proposed by the administration?

4. To what extent are personnel-year reductions the result of "increased efficiencies"?
5. How much has been saved as a result of the proposed reductions?

What Did the Freeze in 1982–83 Accomplish?

In the introductory ("A") pages to the 1984–85 Governor's Budget, the administration indicates that due to a strictly enforced freeze on new hiring, "approximately 6,700 personnel-years were vacant as of July 1983."

Our review indicates that no single state agency has comprehensive data on personnel-year savings attributable to the hiring freeze. This is because personnel data generally are kept for other purposes. Thus, although the State Controller's payroll-related data are extensive for most (but not all) state agencies and can identify the number of positions that did not receive a paycheck in June 1983, the data cannot identify *why* the positions were vacant. Similarly, although the State Personnel Board gathers statistics on state employees, not all employees are covered by these statistics nor are the data compiled on the basis of authorized positions.

Freeze Savings Unclear. While the administration's premise is sound that the state should employ no more staff than it really needs, our analysis indicates that the amount of staff savings attributable to the freeze at the end of 1982–83 is very unclear.

Because data cannot be obtained from any single state agency indicating the savings from or vacancies that can be attributed to the hiring freeze, the Department of Finance had to make an estimate of these variables. It did so relying primarily on data from the State Controller's office, and adjusting the data for various factors.

We have been unable to replicate the department's methodology because the 1982–83 payroll data on which it was based were purged in the fall of 1983. Through discussions with the department, however, we have identified a key assumption made by the administration that we believe casts considerable doubt on the reliability of the department's estimate of freeze-related vacancies and savings. Specifically, the department assumed that *the number of state employees working in June 1983 represented the staffing level for the state as a whole throughout 1982–83.*

We question the validity of assuming that the number of positions vacant in June is representative of vacancies throughout the year. This is because departments may be forced to hold more positions open in the last month of the fiscal year than at other times, particularly in a tight budget year, in order to live within their budgeted levels.

Moreover, the department failed to compare its estimate of vacancies in June 1983 with the normal vacancy rate at the end of a fiscal year. Only this incremental amount—vacancies in excess of the normal vacancy factor—can properly be attributed to the administration's hiring freeze.

For these reasons, we question whether the state's hiring freeze actually resulted in 6,700 personnel-year vacancies at the end of 1982–83.

How Valid Is the Base Against Which the Number of Personnel-Years Proposed for 1984–85 Is Compared?

The budget states that due to "increased efficiencies" the administration determined that 5,900 personnel-years could be abolished. The administration proposes to transfer 1,000 of these personnel-years to high priority programs (including prisons, highway patrol, and Caltrans), for a net savings of 4,880 personnel-years in 1984–85, compared to current-year staffing estimates. It is the basis for this comparison—the current-year staffing estimate—to which we now turn.

As noted earlier (and as Table 62 shows) when the *current-year* staffing level shown in the Governor's Budget is compared to the *actual* staffing level in 1982–83, we find the largest year-to-year *increase* since the voters approved Proposition 13—5,931 personnel-years. Our analysis indicates that an understanding of the 1983–84 staffing level estimated in the budget is crucial to understanding and evaluating the Governor's staffing proposal for the budget year.

Table 63 summarizes how the staffing levels for 1983–84 have changed since the Governor's Budget for that year was submitted to the Legislature in January 1983. It shows that *the administration has administratively established 2,213.2 new positions in the current year.* This is almost twice the number of positions eliminated from the 1983 Budget Act by gubernatorial vetoes. Because of increased salary savings, however, the net change between the budget as enacted and the revised midyear estimate is an increase of only 1,360.2 personnel-years.

Table 63

Changes in Personnel-Years for 1983–84, Between January 10, 1983 and January 10, 1984

Governor's Budget (January 10, 1983)	232,393.7	
Staffing added by Finance Letters	+951.1	
Governor's Budget (revised)	233,344.8	
Legislative changes	+847.6	
Staffing included in Budget Bill, as passed by the Legislature	234,192.4	
Staffing vetoed by the Governor	−1,132.6	
Staffing included in 1983 Budget Act, as chaptered	233,059.8	
Positions added by the administration *after* the budget was chaptered		2,213.2
Increase in estimated salary savings		−853.0
Net personnel-years added by the administration after the budget was chaptered		(1,360.2)
Revised estimate of personnel-years (January 10, 1984)	234,420.0	

Thus, by significantly increasing the number of positions in the current year (approximately 2,200 more than indicated in the 1983 Budget Act) the administration is able to take credit for "saving" positions that were never formally authorized by the Legislature. (We have not been able to resolve the apparent discrepancy between the administration's need to *add* significant numbers of staff in the current year after the budget was enacted and its proposal to reduce total staffing by 4,880 personnel-years in the budget year.)

What Changes in Positions Are Proposed for the Budget Year?

After examining how the base personnel level is adjusted, the next factor to consider is the changes in staffing levels that are proposed for 1984–85. To analyze these changes, two approaches can be followed. One looks at *positions*—what is happening to the number of "slots" (filled or unfilled) in state government? The other approach looks at personnel-years—how many years of staffing (filled positions) does the administration propose to "buy"?

While most of the data on the state's workforce is kept in terms of personnel-years, it is possible to estimate the change in positions proposed by the administration. To do this, we totaled the negative and positive position adjustments shown for each budget item in the Governor's Budget for 1984–85, *after* the adjustments which were made to the base and *before* salary savings were subtracted. Table 64 shows the results of these proposed changes. It indicates that rather than eliminating positions in the budget year, the budget actually proposes a net *increase of 588 positions.* (An unknown portion of the total positions added includes re-establishment of limited-term positions and continuation of administratively established positions.)

Table 64
Proposed Position Changes
Negative and Positive Adjustments, Excluding Base Adjustments and Salary Savings
1984–85

	Positive Adjustments	*Negative Adjustments*	*Difference*
Legislative, Judicial, and Executive	381.0	−74.7	306.3
State and Consumer Services	286.0	−303.0	−17.0
Business, Transportation, and Housing	997.8	−1,367.1	−369.3
Resources	411.5	−527.2	−115.7
Health and Welfare	778.7	−2,105.6	−1,326.9
Youth and Adult Correctional Agency	2,889.9	−753.2	2,136.7
Education	726.3	−1,172.2	−445.9
Other	538.9	−119.3	419.6
Totals	7,010.1	−6,422.3	587.8

To What Extent Are the Proposed Personnel-Year Reductions the Result of "Increased Efficiencies"?

Our analysis has found that while "increased efficiencies" will indeed enable the state to reduce staffing levels in 1984–85, the overwhelming majority of the reduction in personnel-years proposed by the administration for 1984–85 reflects other factors. Some of the more important of these factors are discussed below.

Positions Administratively Established Inflate Savings. State regulations require that administratively established positions cannot be continued beyond the year in which they are established unless authorization to do so is given by the Legislature. Thus, to the extent any of the 2,213 positions that were established administratively in 1983–84 (see Table 63) are among the 4,880 *proposed* for elimination, the proposal is redundant. That is to say, these positions would have been eliminated anyway. For example, the Department of Transportation (Caltrans) administratively established 244 personnel-years in 1983–84 to supplement its highway design and engineering staff over the level authorized by the Legislature in the 1983 Budget Act. The Governor then reduced the department's 1984–85 baseline level of operations by 250 personnel-years, as part of his program to reduce the number of state employees. Our review indicates that the department's "savings" of 494 personnel-years in the budget year is in fact only a reduction of 250 personnel-years compared to legislatively authorized levels, the difference being, the positions added by the administration in the current year.

Termination of Limited-Term Positions Not Due to Efficiencies. Similarly, when building the budget for 1984–85, the administration has to make adjustments for decreases in so-called "limited-term" positions that have been authorized by the Legislature for a specified length of time and are scheduled to expire at the end of the current year. Our analysis indicates that the number of authorized positions was reduced by approximately 600 between the current and budget years as a result of the expiration of limited-term positions in 1983–84. These positions, however, are counted by the administration as among the "savings" resulting from increased efficiencies. For example, the Department of Justice eliminated 81.5 limited-term positions because the project to automate the department's name index files will be finished at the end of the current year. Similarly, the Departments of Health Services, Mental Health, and Social Services combined eliminated 144.9 limited-term positions whose authority expires at the end of the current year.

Salary Savings Inflated. As noted earlier, personnel-years are different from positions authorized by the Legislature in that the former reflect the time that positions are expected to be vacant, due to such factors as staff turnover and delays in hiring. The difference between positions and personnel-years is known as "salary savings."

The administration estimates that 8,908.7 personnel-years will be saved as a result of position vacancies in the budget year. This is an increase of 1,177 personnel-years, or 15 percent, over estimated salary savings in 1983–84. This difference reflects an *increase* in the percentage of total positions that, on average, will be vacant during the year. Specifically, the administration expects this percentage to rise from 3.2 in 1983–84 to 3.7 in 1984–85.

Assuming that the state is no longer operating under a hiring freeze, it is unclear to us why the anticipated vacancy rate should be *higher* in the budget year. If the same salary savings rate used in 1983–84 were assumed for 1984–85, an estimated 7,613.4 personnel-years would be saved. Thus, 1,295.3 personnel-years of the 4,880 personnel-years to be eliminated are due to the assumed increase in *salary savings* in the budget year.

Personnel Reductions in Individual Program Areas Are Explained by Other Factors. Our review of the position reductions claimed in specific program areas indicates that, in many cases, the reductions are due to factors other than "increased efficiencies." For example, of the proposed reductions in personnel-years,

- 919.6 are in the *Employment Development Department* (EDD). The majority of these reductions (863.7), however, are due to anticipated decreases in *workload* for unemployment insurance claims processing caused by the expected decline in the rate of unemployment. The other 55.9 personnel-years are eliminated due to the termination of the federal Comprehensive Employment and Training Act (CETA) program.
- 442.7 are in the *Department of Motor Vehicles.* These reductions are due to increased automation, and were first identified in 1980 when the department's automation project began.
- 147.3 are in the *Department of Education.* In part, these reductions reflect the implementation of an unallocated reduction made in the 1983 Budget Act.
- 327.2 are in the *Prison Industries Authority.* This reduction is attributable to legislative action in Ch 956/83 (AB 436) which exempted this ongoing program from annual Budget Act appropriations. The positions are still there; they are just not counted in the totals for 1984–85.
- 1,116 are in the *University of California.* The largest component of the decrease, 957 personnel-years, was made in the teaching hospitals. A large portion of these reductions, however, were anticipated two years ago when the Legislature enacted Medi-Cal reform legislation.

Position Control Lacking. We note that 23 percent of the administration's total proposed savings in personnel-years occurs in the University of California. The state, however, does not have position control over the University. This means that the University is able to make position adjustments on its own during the course of the year without the approval of the applicable control agencies, principally the Department of Finance. Thus, if the teaching hospitals decide that some or all of the 957 personnel-years to be eliminated are needed, and sufficient funds are available to support them, the hospitals would be able to reestablish these positions administratively. This is true not only of the teaching hospitals, but for the University as a whole. As a result, the savings reported for the University may be more of a hope than a certainty.

In summary, our analysis of the Governor's personnel-year reduction proposal indicates that the administration has taken credit for "increased efficiencies" that simply do not exist. Statewide totals mask many of the changes that would have occurred regardless of administrative actions, as well as the effect that the Governor's addition of positions in the current year has on "savings" in the budget year.

Our review indicates that from the time the budget is enacted to the time that final staffing level data are available, such wide variations occur as to make statewide personnel totals, particularly midyear estimates, almost meaningless. From the Legislature's perspective, this necessitates a function-by-function review to ascertain whether an adequate staffing complement is available to carry out the program priorities of the legislative branch.

How Much Has Been Saved as a Result of the Proposed Reductions?

The Governor's Budget indicates (Schedule 4) that net salary and wages (that is, adjusted for salary savings) for state employees will increase from $5.7 billion in 1983–84 to $6.2 billion in the budget year, an increase of $534 million, despite the projected decrease of 4,880 personnel-years. The net average annual salary for a personnel-year in 1983–84 is $24,203. Assuming that the 4,880 personnel-years earned the average amount, the administration's staffing changes should have resulted in a net salaries and wages savings of approximately $118 million. Did they?

In order to evaluate the fiscal effect of the Governor's proposal, we derived a base level of salary expenditures by adjusting the net total salaries and wages figures reflected in the budget for both the current and budget years. Specifically, we subtracted from both figures the following factors: (1) unallocated employee compensation amounts, (2) the 6 percent salary increase provided effective January 1, 1984, and (3) special salary adjustments. Table 65 shows that when adjusted for these factors, "base" salary and wages are only $17 million *lower* in the budget year than the current-year level, or approximately $101 million less than the potential savings we derived assuming an average salary level.

In summary, despite projected staffing reductions in the budget year, we have been unable to identify dollar savings that in any way are commensurate with the personnel changes indicated in the budget.

Table 65
Adjusted Net Salaries and Wages
1983–84 and 1984–85
(in thousands)

	1983–84		*1984–85*
Salaries and wages	$5,842,680		$6,403,080
Salary savings	−168,945		−195,800
Net totals	$5,673,735		$6,207,280
Adjustments:			
Unallocated employee compensation	−96,849		−444,885 [a]
Six percent salary increase	−176,671		−354,327
Special salary adjustments	−12,856		−37,977
Base salaries and wages:	$5,387,359		$5,370,091
Difference:		−$17,268	

[a] Does not include higher education because amount has not been included in total salaries and wages.

Some Proposed Staffing Reductions are not Warranted on a Workload Basis

Our program review of personnel-year reductions reflected in the budget suggests that many of the staffing changes were made without a thorough review of what "inputs" are required in order to produce the "outputs" envisioned by the Legislature when the program was established. For example, in the budget year the administration is proposing to *reduce* positions in the Department of Industrial Relations' Division of Occupational Safety and Health at a time when programs within the division are experiencing serious backlog problems. Specifically,

- Approximately 13,600, or 40 percent, of the elevators in the state currently are overdue for the annual inspection required by law.
- At the present time, 2,255, or 7.5 percent, of the liquified petroleum gas (LPG) tanks in the state and 1,052, or 44 percent, of the boilers which are used to generate steam pressure are past due for inspection.

In view of these serious backlogs, it is unclear to us why staffing reductions have been made in this division. Moreover, as discussed in more detail in the *Analysis* (see Item 8350), these inspection programs are supported entirely by fee collections—thus, any "savings" to the state only result from fewer fees being collected.

Governor's Alternative to Using State Employees May be More Costly

It appears that there are a number of instances, such as the Department of Industrial Relations, where personnel-years have been reduced primarily for the sake of getting the staffing total down, rather than to reduce costs, because dollar savings commensurate with the reductions cannot be identified. In fact, in some instances, the budget proposes to spend *more* on contractual services to perform a function previously carried out by department staff than it would have cost to continue the existing program structure.

Some Proposed Contracts More Expensive Than the Staff They Would Replace. There are several instances in which the administration is proposing to replace departmental staff with outside staff at an increased cost to the taxpayers. For example, Caltrans proposes to rehabilitate 16 commuter rail stations between San Francisco and San Jose during the budget year. The department proposes to contract with the Office of State Architect in the Department of General Services for project design and construction engineering, at a cost of $1,625,000. Our analysis indicates that if departmental staff performed the same work, it could be completed for $1,121,000, for a savings of $504,000 or 31 percent.

Similarly, Caltrans is proposing to increase significantly the amount of highway maintenance work performed on a contract basis rather than by state staff. The budget for 1984–85 includes $2.9 million in additional contract funds for this purpose. The department advises that the amount requested for contracted work is calculated first by estimating the personnel-year equivalent and cost of the work if it were performed by department staff, *then multiplying by 1.25.* This increases the cost of contracting for the proposed maintenance work by $1.1 million in 1984–85.

We acknowledge that in many cases it is possible to reduce the cost of state programs by contracting with the private sector, and we have long recommended that greater use be made of private sector resources where doing so will result in savings to the state. However, contracting makes sense *only* if it is the more economical and cost-effective alternative, or if there are special circumstances such as a lack of expertise in a department to handle the particular task. The administration does not appear to have kept such factors in mind in some of its contract proposals. (For further discussion of these issues, please see the *Analysis*—Item 2660 [Caltrans], Item 3540 [Department of Forestry] and Item 1710 [State Fire Marshal].)

Conclusion

Our review of the administration's workforce reduction proposal found that:

- The administration's assertion that 6,700 personnel-years were vacant as a result of a strictly enforced freeze in 1982–83 cannot be substantiated;
- The administration's 1984–85 personnel-year savings are overstated as a result of significant personnel additions which have occurred since the enactment of the 1983 Budget as well as an increase in the salary savings rate assumed for 1984–85;
- The administration's personnel reductions attributable to "increased efficiencies" is overstated because many of the reductions would have

occurred in the absence of administrative actions or have been anticipated for several years;

- Dollar savings commensurate with the proposed staffing reduction cannot be identified; and
- In some instances, the administration is proposing to contract for ongoing state activities at a greater expense than continued use of state employees.

THE RESERVE FOR ECONOMIC UNCERTAINTIES

How Large Should the Reserve for Economic Uncertainties Be?

Beginning with the 1980 Budget Act, the Legislature established a Reserve for Economic Uncertainties within the General Fund. The purpose of this reserve is to provide a source of funds to meet state General Fund spending obligations in the event of an unexpected decline in revenues or an unanticipated increase in expenditures.

The establishment of this reserve by the Legislature was a wise move. Just as a household needs to keep some funds in its bank account at all times so that it can cope with an unforeseen financial emergency, the state needs to keep funds in *its* bank account.

In maintaining the Reserve for Economic Uncertainties, the most difficult question that the Legislature must answer is: How large should the state's reserve be? If the reserve is "too small," it may not be sufficient to protect the state's ability to provide needed governmental services to the people of California during periods of unanticipated revenue declines or program cost increases. On the other hand, if the reserve is "too large," expenditures for needed public services may be unnecessarily restricted or, alternatively, taxpayers may come to believe that they are giving up more of their income to pay taxes than is necessary.

Factors Affecting the Optimal Size of the Reserve

There is no simple formula for determining the "right" size of the reserve for uncertainties. There are, however, two general factors which the Legislature should consider in deciding how much of the state's revenues to earmark for the reserve.

- First, it should consider the potential effect of a downturn in the economy on revenues. As Table 31 in Part Two shows, General Fund revenues experienced shortfalls of well over 5 percent in both 1981–82 and 1982–83, due to weaker-than-expected economic performance.
- Second, it should consider the extent to which other means are available to help bridge an unanticipated gap between revenues and expenditures, such as increasing the amount of tax revenues collected or transferring monies from special funds to the General Fund.

These two considerations will indicate the magnitude of the "fiscal cushion" that might be needed in the event that the fiscal assumptions on which the state's expenditures and revenue estimates are based fail to come true.

How Fiscal Crises Have Been Dealt With in Recent Years

During the past three years, the state has managed to survive its fiscal problems in spite of *not* having a healthy reserve for uncertainties. In large part, it was able to do so by enacting legislation to enhance revenue collections.

Two primary methods have been used to enhance revenues when deficits in the state General Fund materialize:

1. The transfer of monies from special funds (primarily tidelands oil revenues and vehicle license fee collections) to the General Fund; and
2. Revising the due dates and delinquent penalties for tax payments, so as to accelerate revenue collections.

Table 66 shows that these steps, which are discussed in detail in the revenue section of Part Two, raised revenues by a total of over $950 million in 1981–82, nearly $1.4 billion in 1982–83, and about $760 million in 1983–84, or nearly $3.1 billion during the three years combined. While the absence of an adequate reserve to "lean on" during this three-year period made it necessary for the Legislature to reduce expenditures for many state programs when a deficit threatened the General Fund, the required cutbacks might have been much larger had these revenue enhancements not been available.

Clearly, the greater the potential availability of revenue enhancing mechanisms, the smaller the reserve that is necessary to deal with any particular fiscal emergency. The converse, however, is also true—namely, the more limited the set of revenue-enhancing opportunities available, the larger the reserve that is necessary to adequately protect the state from unanticipated fiscal problems.

Table 66
Primary Revenue Enhancement Methods
1981–82 through 1983–84
(in millions)

	1981–82	*1982–83*	*1983–84*	*Totals*
1. Revenue accelerations	$405	$620	$140	$1,165
2. Transfers from special funds to General Fund	550	750	619	1,919
Totals	$955	$1,370	$759	$3,084

The Reserve in 1984–85 and Thereafter

Unfortunately, the converse would seem to prevail as the state Legislature begins work on the Governor's Budget. Because of the heavy reliance placed on tax accelerations in combatting recession-induced revenue shortfalls in recent years, there is little more to be "milked" from these "revenue enhancements." Moreover, unless the Legislature decides to continue to use, for General Fund purposes, monies which traditionally have supported activities financed from special funds, "transfers" may not prove to be a reliable part of the state's "fiscal cushion" in the future. These considerations, coupled with the increasing volatility of the nation's economy, convince us that a substantial balance should be kept in the economic uncertainties reserve for the foreseeable future.

Size of the Reserve. As for the size of this "substantial balance," we repeat that there is no analytical basis for specifying a precise amount. In our judgment, however, we believe that a cushion equal to about *5 percent* of planned expenditures makes sense. For 1984–85, a cushion of this magnitude would amount to about $1.25 billion, or $300 million more than the $950 million reserve (3.8 percent of planned expenditures) provided for in the Governor's Budget. Based on recent history, a 5 percent reserve will give the state an "insurance policy" against a mild economic downturn, such as occurred in 1981–82 when revenues were about 6 percent below the original budget estimate. It will provide only partial protection against a more severe downturn such as that which caused 1982–83 revenues to come in 11 percent below budget estimates. Even under these circumstances, a 5 percent reserve can fulfill its "insurance policy" function by "buying time" for the Governor and the Legislature to seek and adopt other alternatives for keeping the budget in balance.

Providing for such a reserve in 1984–85 seems especially prudent in light of two factors:

- First, there is great uncertainty regarding how strong the economy will be by late 1984 and 1985. Should the economy weaken during 1984–85 due to the negative effects of such factors as large federal budget deficits and high interest rates, a 5 percent "fiscal cushion" could prove to be extremely valuable. As Table 41 in Part Two shows, General Fund revenues for 1983–84 and 1984–85 combined would fall short of the budget estimates by $2.2 billion if the Department of Finance's "low" economic and revenue scenarios occur, leaving the General Fund with a large deficit at the end of 1984–85.
- Second, if economic expansion continues through 1984–85, the revenues that the state's economy will yield would make it easier to establish an adequate cushion on which the state could fall back in subsequent years, when the business cycle turns down. In other words, while we believe that there is reason enough *in* the budget year to

> want an adequate reserve, the Legislature should also look *beyond* the budget year. Recognizing that over the longer-term there will be "good times" alternating with "bad times", the Legislature should take the opportunity presented by periods of economic prosperity to make provisions for the economic downturns to come, even though these downturns may be several years away.

In summary, our review indicates that a substantial balance should be established and maintained in the Reserve for Economic Uncertainties. For the budget year, we believe that this balance should be *at least* as much as that proposed by the Governor ($951 million, or 3.8 percent of proposed expenditures) and preferably $300 million larger.

PROPOSED STATE PROGRAM REALIGNMENTS

Should the Legislature Alter Program Administration Responsibilities for Four Health and Welfare Programs in Order to Give Local Government More Flexibility?

In the budget for 1983–84, the Governor proposed three state block grants—the Alcohol and Drug Block Grant, the Public Health Block Grant and the State Education Block Grant. The Legislature did not approve the administration's proposals and restored most state positions that had been designated for elimination in anticipation of these block grants.

In 1984–85, the administration is proposing to reduce state administrative staff and transfer various state responsibilities to the local level through four state/county program realignments. These realignments are proposed for the following areas: mental health, family planning, public health, and alcohol/drug programs. (For a detailed discussion of each of these proposals, see the following item discussions in the *Analysis:* Item 4440—Department of Mental Health, Item 4260—Department of Health Services, and Item 4200—Department of Alcohol and Drug Programs.) The administration's proposals will be embodied in five separate bills. Three of the five bills were in print when this was written; the remaining two—one each for alcohol and drug programs—will be introduced in the spring of 1984. The three pending bills are as follows:

1. AB 2381 (Mojonnier) which would implement the mental health initiative;

2. SB 1450 (Seymour) which would implement the new family planning grant program; and

3. AB 2450 (Stirling) which would implement the proposed Public Health Enhancement Program (PHEP).

Programmatic and Fiscal Overview of Proposals

The Governor's proposals and the programs they include are shown in Table 67. In total, 13 existing programs are included in the four program realignments.

Table 67
Program Realignments
1984–85

Proposal	*Administering Department*	*Consolidated/Transferred Programs*
Mental Health Initiative	Department of Mental Health	• Local Mental Health Programs
Family Planning Grant Program	Department of Health Services	• Family Planning
Public Health Enhancement Program	Department of Health Services	• Preventive Health Care for the Aging • Dental Health • Immunization Assistance • Infant Dispatch • Perinatal Access • High-Risk Infant Follow-up • Perinatal Health Services • Maternal and Child Health Grants • Child Health Disability Prevention
Alcohol and Drug Program Realignment	Department of Alcohol and Drug Programs	• Alcohol Programs • Drug Programs

Table 68 summarizes the proposed savings and transfers which are estimated to result from adoption of the four proposals in 1984–85 and 1985–86. Full-year effects would not be experienced until 1985–86, due to the phase-in of the proposals during the first six months of 1984–85. Thus, in the budget year, state savings in state operations would total approximately $9 million. Of this amount, $6.7 million is proposed for transfer to local assistance. Similarly, in 1985–86, the administration projects state operations savings of $20.6 million, of which $14.1 million would be transferred to local government.

The bulk of the savings in state operations is due to the elimination of 604 positions. Of the total proposed reduction, 415.9 positions, or 69 percent, are from the Department of Mental Health. Of this amount, 299 are proposed for transfer to 18 specified counties. Similar positions have been transferred in the past to the state's 40 other counties.

Table 69 puts the proposed savings into perspective. It identifies the state operations and local assistance budgets for the programs affected by the realignments. It shows that in 1984–85 state operations expenditures for these programs are proposed to *decrease* by $8.8 million and local assistance expenditures are proposed to *increase* by $51 million, compared to the current year. The differences in proposed savings and expenditures shown in the two tables are partially attributable to portions of the existing program which are not directly affected by the realignment proposal.

Table 68

Proposed Program Realignment Savings and Transfers (All Funds)
1984–85 and 1985–86
(in thousands)

	1984–85 (Six Months)	*1985–86 (Full Year)*
State Operations—Savings		
Mental Health	–$6,200	–$14,300
Family Planning	–445	–890
PHEP	–1,354	–3,381
Alcohol/Drug	–993	–1,986
Totals	–$8,992	–$20,557
Transfers to Local Assistance		
Mental Health	$5,100	$10,200
Family Planning	445	890
PHEP	822	2,318
Alcohol/Drug	324	648
Totals	$6,691	$14,056
Net Effect on All Funds	–$2,301	–$6,501
Positions [a]		
Mental Health	—	–415.9
Family Planning	—	–24.5
PHEP	—	–83.2
Alcohol/Drug	—	–80.0
Subtotals	—	–603.6

[a] Positions are phased out in 1984–85 resulting in full position savings in 1985–86.

Table 69

Proposed Funding Levels in Realigned Programs (All Funds)
1983–84 and 1984–85
(in thousands)

	1983–84 Estimated	*1984–85 Proposed*	*Change Amount*	*Change Percent*
State Operations				
Mental Health	$25,301	$19,498	–$5,803	–22.9%
Family Planning	1,002	603	–399	–39.8
PHEP	6,012	4,571	–1,441	–24.0
Alcohol/Drug	9,442	8,259	–1,183	–12.5
Subtotals	$41,757	$32,931	–$8,826	–21.1%
Local Assistance				
Mental Health	$317,152	$364,568	$47,416	15.0%
Family Planning	28,138	29,155 [a]	1,017	3.6
PHEP	26,772	28,473 [a]	1,701	6.4
Alcohol/Drug	93,864	94,682	818	0.9
Subtotals	$465,926	$516,878	$50,952	10.9%
Totals	$507,683	$549,809	$42,126	8.3%

[a] Represents half-year funding.

Incentive Funding. The Governor's Budget indicates (p. 31) that funding augmentations will be included in four of the five implementing bills "to provide local government with the ability to expand in areas of high need." Specifically, separate augmentations, totaling $11 million, are proposed as follows: (1) PHEP—$1.25 million, (2) Family Planning—$4.75 million, and (3) Alcohol and Drug Programs—$5 million (divided equally between the two programs). These incentive funds are not reflected in the funding totals included in the Governor's Budget, but instead will be incorporated in separate legislation. To the extent that incentive funding is provided, the administration's realignment proposal will result in a net cost, instead of a net savings, to the state.

Analysis of the Realignment Proposals

Our analysis indicates that the concept of program realignment for these particular programs has merit. Such proposals allow local governments increased flexibility in designing and funding local programs to meet local needs. Moreover, program realignment allows counties to integrate these programs more effectively with other local programs serving similar populations and/or clients. The realignment proposals generally have the advantage of increasing accountability by giving the level of government which spends the taxpayers' funds, in this instance, the counties, the greatest responsibility for program administration.

Despite these advantages, our analysis has identified various problems with each of the proposals. These crosscutting problems are summarized below and discussed in more detail in the individual item write-ups in the *Analysis.*

Potential Service Reductions. Our review has identified several instances where the proposals may result in service reductions to program clients. For example, the mental health initiative would eliminate existing county matching requirements (currently $30.8 million) for locally provided mental health services. Our review indicates that without effective maintenance of effort requirements, counties could replace county funds with state funds or reduce mental health services. In the case of both the family planning and PHEP proposals, it is unclear to us whether counties would experience increased costs to administer the grant program (negotiate contracts, establish claims payment systems, etc.), leaving less money available for services.

Audit Inconsistencies. One problem that we have identified in each of the administration's proposals has to do with the way that audits of state funds would be conducted. The administration has offered several alternatives ranging from no audit of state funds (alcohol and drug programs) to an independent audit arranged for by the county and subsequently forwarded to the state (mental health). Our review indicates that audits of state funds should continue on some sort of uniform basis.

Impact of Differential Standards. State-administered programs often offer the advantage of a consistent minimum service standard and consistent eligibility requirements. Our review indicates that the realignment proposals, because of increased flexibility at the local level, may have the unintended consequence of different minimum service and eligibility standards between counties. For example, because family planning services may be unpopular in some counties, more restrictive eligibility requirements may be imposed in these counties compared to the current state standard. Similarly, in alcohol programs, delegation of program review, approval and reapproval for the drinking driver program to the counties may result in inconsistent application of state standards for the program. In addition, it is unclear whether the delegation of responsibility to the counties for assuring the quality of alcohol and drug treatment and recovery programs may make it more difficult for these programs to receive reimbursement from insurance carriers and other so-called "third-party" payers, because of differential service quality standards from one county to another.

Funding Proposal Diminishes Local Control. Of the four proposals, two appear to contain aspects that diminish, rather than enhance, local control and thus run counter to the thrust of the proposals themselves. Specifically, the alcohol and drug program realignment requires counties to spend at least 35 percent of their combined alcohol and drug funds on alcohol programs and 35 percent on drug programs. The remaining 30 percent of the funds would be distributed on a discretionary basis between alcohol and drug programs. Our analysis indicates that five counties would experience funding shifts in their current programs if the 35/35/30 allocation process were adopted. Three counties would have to shift funds from drug programs to alcohol programs and two counties would have to shift funds from alcohol to drug programs.

In the case of the mental health initiative, the administration is proposing to transfer state staff who arrange essential community services for mentally disordered individuals released from state and local psychiatric hospitals to 18 counties who have been unwilling or unable to accept responsibility for these staff in the past.

Conclusion

At the time this review was prepared, specific legislation implementing the administration's proposals was being developed. In addition, in many instances, sufficient information was not available outlining the mechanics of the programs' operations. This information is needed before the Legislature can assess the specific merits of these realignment proposals.

How Should the Legislature Address Funding Shortfalls in State Retirement Systems?

Background

Currently, retirement benefits of state and many local government employees are provided through one of the following state pension programs: the Public Employees' Retirement System (PERS), the State Teachers' Retirement System (STRS), the Judges' Retirement System (JRS), the Legislators' Retirement System (LRS), and the University of California Retirement System (UCRS). The state actually *manages* all but one (the UCRS) of these systems, and it provides—directly or indirectly—a major portion of the funding for *all* of them.

Table 70 shows that in 1984–85, the state is expected to pay almost $1.5 billion *specifically* to finance retirement benefits provided by these systems. Of that amount, the state pays $560 million in "normal cost" contributions and $907 million toward financing unfunded liabilities (the terms "normal costs" and "unfunded liabilities" are discussed below). Table 70 also shows that in 1984–85 school districts and superintendents of schools are expected to pay $305 million in employers' PERS contributions for their nonteaching employees and $616 million in STRS contributions for their certificated (teaching) employees. A major portion of these contributions will be paid by the state indirectly, through apportionment aid to local school districts.

Table 70
State Retirement Systems
Selected Information
1984–85 (dollars in millions)

		Proposed 1984–85 State Contributions [a]			
Retirement Systems	*Current Membership*	*Toward the Normal Costs*	*Toward the Unfunded Liability*	*Total Contributions*	*Size of the the Unfunded Liability* [b]
Legislators'	400	$0.3	$0.4	$0.7	$25
Judges'	1,700	7.0	10.4	17.4	450
Public Employees'					
State members	264,000	485.0	331.3 [c]	816.3	6,000
School members	236,000	(208.0) [d]	(97.0) [d]	(305.0) [d]	1,500
State Teachers'	400,000	(616.0) [d]	555.4 [e]	555.4 [e]	13,200
University of California	85,000	73.4 [f]	9.5 [f]	82.9 [f]	395
Totals	987,100	$565.7	$907.0	$1,472.7	$21,570

[a] Based on current contribution rates and projected 1984-85 payrolls.
[b] As determined by the latest available actuarial valuation for each system.
[c] This amount includes $8.3 million in local mandate reimbursements.
[d] Amounts of total contributions paid by local school employers. A major portion of each of these amounts is indirectly financed by the state, in the form of apportioment aid to school districts and superintendents of schools.
[e] Includes: (1) $211 million in state contributions approved by the Legislature but vetoed by the Governor from the 1983 Budget Act, and (2) $43.4 million in local mandate reimbursements.
[f] Represents only the state's share of contributions (about 42 percent of total contributions) for UC employees whose salaries and benefits are paid from state funds. The balance of contributions comes from federal and private sources.

The Components of Retirement Costs

The state's contributions to retirement systems are used to pay one of two cost components associated with retirement benefits: (1) normal costs and (2) unfunded liabilities.

Normal Costs are the costs of financing the retirement benefits which are *being* earned in a given year. These costs are expressed in terms of a fixed percentage of an employee's salary that has to be paid annually over the employee's career, in order to fund his or her retirement benefits. For example, the normal cost of the Judges' Retirement System is 34 percent of payroll (please see Table 3, page 24, of the 1984–85 *Analysis*). This means that, as of the 1980 valuation date, annual payments equal to 34 percent of judicial payroll (or about $30 million in 1984–85) would be required to fully fund the retirement benefits being earned by active judges in a given 12-month period. (As noted below, current contributions total 30.3 percent, which is insufficient to fund the annual normal costs of the system.)

Normal costs are estimated in each actuarial valuation, based on the actuarial experience of the membership and specific assumptions about long-term salary increases and investment yields. These valuations usually are conducted at 2–4 year intervals for state systems.

Unfunded Liability Costs, on the other hand, are those obligations to pay retirement benefits earned in *prior* years which are not funded by current assets. These costs are also based on actuarial estimates, made at a given point in time. Unfunded liabilities exist because, in past years, normal costs were not covered by employee and employer contributions. Again, using the Judges' Retirement System as an example, it would take annual contributions equal to 42 percent of judicial payroll (or about $37 million in 1984–85) to amortize the $450 million accumulated unfunded liability of the system over a 30-year funding period (please see the *Analysis,* Item 0390, Table 3).

The Legislature Should Fully Fund Normal Costs

In past years, most of the discussion concerning the funding problems of individual state retirement systems has centered on unfunded liabilities. These liabilities, indeed, constitute a fiscal problem, particularly if (1) they are very large when compared to a retirement system's assets, and/or (2) they are growing rapidly.

In our judgment, however, the Legislature should look upon a shortfall in funding normal costs of state retirement systems as a more immediate and serious concern. It is this type of shortfall, after all, which brings about an unfunded liability and causes its continued growth.

Table 71 shows: (1) the current normal costs of the five state retirement systems, (2) the amounts of total contributions (from all sources) toward normal costs, and (3) the existing shortfall (if any) in funding these costs, expressed both in absolute terms for 1984–85 and as a percent of payroll.

As the table shows, there are normal cost shortfalls in three of the retirement systems—namely, the LRS, the JRS, and the STRS. A funding augmentation of $249.3 million would be required to eliminate these shortfalls.

Table 71
State Retirement Systems
Funding Requirements for Normal Costs [a]
1984–85

			Funding Shortfall	
Retirement Systems	*Normal Costs* [b]	*Current Contributions Toward Normal Costs* [b]	*Percent* [b]	*1984–85 Costs* [b] *(millions)*
Legislators'	21.3%	18.8%	2.5%	$0.1
Judges'	34.0	30.3	3.7	3.2
Public Employees'				
State Members	16.0	16.0	—	—
School Members	15.5 [c]	15.5 [c]	—	—
State Teachers'	19.2	16.0	3.2	246.0
University of California [d]	14.1	14.1	—	—

[a] As determined by the latest available actuarial valuation.
[b] Expressed as a percent of payroll of the respective systems, as indicated in the latest available actuarial valuation.
[c] A major portion of these costs are indirectly financed by the state through apportionment aid to school districts and superintendents of schools.
[d] This system is administered by the Regents, rather than by the state. It is shown here because about 42 percent of the system's total employer contributions is provided by the state.

Our review indicates that funding of normal costs should be the first step in addressing the funding problem of state retirement systems. Therefore, in our detailed analysis of the legislators', judges' and teachers' retirement systems (please see the *Analysis,* Items 0110–0150, 0390, and 6300, respectively), we are recommending that the Legislature place its highest priority on fully funding the normal cost shortfalls of these systems.

Total Compensation: A Guide to Selecting Funding Options

If the Legislature decides to eliminate the existing shortfalls in funding for normal costs of state retirement systems, it will need a basis for choosing among the various options for achieving this objective. These options involve: the employers' contribution toward benefits, the employees' contribution, the level of benefits themselves, and, where the state is not the employer (STRS), the state's contribution toward benefits.

When deciding what actions the *state* should take in eliminating any shortfall, we recommend that the Legislature base its decision on an analysis of the *total compensation* provided to employees. That is, the state's contributions toward funding employees' retirement benefits should be viewed as just *one* aspect of the employees' overall compensation—along with salary, other fringe benefits, and the general working environment. In the case of state contributions toward the JRS, for instance, we recommend that the Legislature consider this annual payment as part of the total compensation provided each year to judges.

If, in considering the various options for fully funding normal costs, the Legislature concludes that the level of total compensation for a particular employee (such as a judge or a state worker) is *not* adequate, the state would want to pick up part or all of the normal cost shortfall in that particular retirement system. If, on the other hand, the Legislature determines that the current level of total compensation *is* adequate, it would want to have the shortfall financed through increased employees' contribution rates, or through a reduction—on a prospective basis—of retirement benefits.

The Unfunded Liability Issue

Table 70 shows that state-administered systems have collective unfunded liabilities in excess of $21 billion, based on the latest available actuarial estimates. The magnitude of these liabilities is a problem which should not be ignored. The existence of this debt can harm the state's credit rating, and it certainly causes anxiety among existing employees as to the security of their future retirement benefits.

We find it difficult at this time, however, to make a recommendation as to how the Legislature should deal with the unfunded liability problem, for several reasons.

- ***Funding Responsibility.*** While the state has already assumed a role in funding unfunded liabilities, the Legislature may wish to reassess how that responsibility might be shared among employers, employees and the state, based on total compensation for current employees (or, in the case of the STRS, based on the adequacy of state contributions towards the cost of education at the local level).
- ***Intergenerational Equity.*** We can find no analytical basis for requiring one generation of taxpayers (such as the *current* one) to bear a greater burden in paying off an unfunded liability not of its own making, rather than requiring some other generation of taxpayers (that is, *future* ones) to do so. Therefore, it is impossible for us to recommend a level of contributions that the state *should* pay in any one year to help amortize this unfunded liability.
- ***Other Legislative Decisions Could Affect Contribution Level.*** Any decision the Legislature makes on other related compensation issues might affect how it would want to address the issue of unfunded liabilities. For instance, if the Legislature decides to provide for the

full funding of the STRS's normal cost, it would not be necessary to continue state contributions toward the unfunded liability of that system at the level proposed in the Governor's Budget.

Conclusion

In summary, we recommend that the Legislature (1) act first to fund the shortfalls in normal costs of state retirement systems; (2) use the concept of total employee compensation in determining what the state's role in eliminating such shortfalls should be; and (3) address the issue of unfunded liabilities by considering a collective funding approach, and by taking into account its decisions on related compensation issues, such as financing for normal costs.

HAZARDOUS SUBSTANCES CONTROL PROGRAMS

How Can the Legislature Improve the Effectiveness and Coordination of the State's Hazardous Substances Control Programs?

The budget proposes $105.7 million and 776 personnel-years in 12 state agencies for a wide range of regulatory functions related to hazardous substances. This is an increase of $6.3 million, or 6.3 percent, above estimated current-year expenditures, and an increase of 123 personnel-years, or 19 percent, above current-year staffing levels. The Department of Health Services accounts for 61 percent of the total funds budgeted for hazardous substance control, and the Department of Food and Agriculture's pesticide program represents an additional 19 percent of the total.

Table 72 provides an overview of hazardous substances control activities in state government. It briefly describes each program and shows estimated current-year and proposed budget-year expenditures, fund sources, and personnel-years.

Table 72
Hazardous Substances Control Expenditures, Fund Sources, and Staffing
1983–84 and 1984–85

			Amount (in thousands)		*Personnel-Years*	
Item	*Program*	*Fund*	*Estimated 1983–84*	*Proposed 1984–85*	*1983–84*	*1984–85*
0650	Office of Planning and Research					
	1. Hazardous Waste Management Council siting plan	Reimbursements	$225	—	5.0	—
0690	Office of Emergency Services					
	1. Hazardous material incident contingency plan	General, Reimbursements	$113	$118	3.0	3.0
0860	Board of Equalization					
	1. Collection of HWCA fees and HSA taxes	Reimbursements	$331	$346	8.1	8.1

2660 Department of Transportation					
1. Highway cleanup including toxic and nontoxic spills	SHA	$657 [a,b]	696 [a,b]	13.2	13.2
2720 California Highway Patrol					
1. Inspection related to transportation of hazardous materials	MVA, STF	$2,820	$2,874	60.1	60.1
2. Hazardous materials response training and equipment	Reimbursements	313	—	2.6	—
Subtotals		$3,133	$2,874	62.7	60.1
3400 Air Resources Board					
1. Research and support	MVA, General, APCF	$1,501	$2,480	17.5	22.5
2. Stationary source	MVA, General, APCF	616	1,001	12.9	13.9
Subtotals		$2,117	$3,481	30.4	36.4
3600 Department of Fish and Game					
1. Wildlife protection and management, and environmental services	Various	$626 [b]	$664 [b]	N/A	N/A
3940 State Water Resources Control Board					
1. Water quality regulatory activities, studies, and regional board assistance	General, CWBF	$3,724	$3,730	45.9	48.5
2. Hazardous waste permitting, enforcement, and site closure	HWCA, RCRA, Reimbursements	1,233	1,208	20.8	20.8
3. Underground tanks	General, UTS, UCIA	—	2,539	—	52.2
4. Underground injection control	Federal	258	114	4.3	—
Subtotals		$5,215	$7,591	71.0	121.5
4260 Department of Health Services					
1. Hazardous waste management	HWCA, RCRA, ERF	$8,436	$11,584	136.8	193.6
2. Superfund	HSA, HSCA, CERCLA, RP	49,600	48,100	45.5	62.5
3. Epidemiology, toxicology, and laboratory services	General, HWCA, RCRA, Reimbursements	5,034	5,118	67.2	69.4
Subtotals		$63,070	$64,802	249.5	325.5
8350 Department of Industrial Relations					
1. Cal-OSHA inspections and other support functions (includes both toxics- and non-toxics-related activities)	General, Federal	$8,000 [a]	$7,586 [a]	N/A	N/A

Table 72—Continued
Hazardous Substances Control Expenditures, Fund Sources, and Staffing
1983–84 and 1984–85

			Amount (in thousands)		Personnel-Years	
Item	*Program*	*Fund*	*Estimated 1983–84*	*Proposed 1984–85*	*1983–84*	*1984–85*
8570	Department of Food and Agriculture					
	1. Pesticide registration	General, Ag	$2,414	$2,563	72.4	72.4
	2. Pesticide use enforcement and worker health and safety	General, Ag, Federal	14,062	14,378	93.5	89.5
	3. Environmental monitoring	General, Ag, Reimbursements	2,623	3,264	42.8	44.9
	Subtotals		$19,099	$20,205	208.7	206.8
8700	Board of Control					
	1. Victims' compensation program	Reimbursements	$355	$355	1.0	1.0
	Totals		$102,941	$108,718	652.6	775.6
	Less reimbursements		3,490	2,996		
	Net totals		$99,451	$105,722		
	State funds:					
	Agriculture Fund (Ag)		*$9,279*	*$9,622*		
	Air Pollution Control Fund (APCF)		*106*	*174*		
	Clean Water Bond Fund (CWBF)		*1,335*	*1,129*		
	Energy and Resources Fund (ERF)		*439*	—		
	General Fund		*18,327*	*20,221*		
	Hazardous Substances Account (state Superfund—HSA)		*11,145*	*9,645*		
	Hazardous Substances Compensation Account (HSCA)		*355*	*355*		
	Hazardous Waste Control Account (HWCA)		*7,175*	*10,508*		
	Motor Vehicle Account (MVA)		*4,407*	*5,485*		
	State Highway Account (SHA)		*657*	*696*		
	Underground Tank Storage, Underground Container Inventory Accounts (UTS, UCIA)		—	*1,428*		
	Other		*267*	*283*		
	Subtotals		*$53,492*	*$59,546*		
	Federal funds:					
	Comprehensive Environmental Response Compensation, and Liability Act (federal Superfund—CERCLA)		*16,900* [c]	16,900 [c]		
	Resource Conservation and Recovery Act (RCRA)		*3,135*	*3,703*		
	Other		*4,724*	*4,373*		
	Subtotals		*$24,759*	*$24,976*		
	External sources:					
	Responsible parties (RP) [d]		$21,200 [c]	$21,200 [c]		

[a] Includes some proportion of nonhazardous substances activities.
[b] Estimate based on actual 1982–83 costs.
[c] These amounts probably exceed the amount that will actually be received.
[d] Responsible parties are private companies or individuals that reimburse the state for the cost of cleaning up hazardous waste sites.

Summary of Budget Changes

Below we summarize the amounts budgeted for those six departments accounting for 99 percent of hazardous substance control expenditures, as well as the major changes proposed for 1984–85.

1. *Department of Health Services.* The budget proposes $64.8 million for hazardous substances control functions performed by the department. The department's functions include (a) regulating hazardous waste management, cleaning up contaminated sites, and supporting the development of alternative technologies and (b) studying health effects, setting scientific standards, and consulting with other departments and local agencies. The budget proposes a net increase of $1 million and 73.8 personnel-years for hazardous substances control in 1984–85. This primarily reflects an increase of $2.6 million and 62 positions for permitting and inspecting hazardous waste facilities and a decrease of $1.5 million appropriated on a one-time basis for a site cleanup in the current year.

2. *Department of Food and Agriculture.* The budget includes $20.2 million and 207 personnel-years for the department's pesticide regulatory program, which includes pesticide registration, research on pesticide use, and monitoring exposure of persons handling pesticides. This is an increase of $1.1 million and a net decrease of 2 personnel-years from the current-year levels. The most significant change in the budget for this program in 1984–85 is the request for $334,000 and five positions to determine the dispersal of pesticides and their impact on the environment and agricultural productivity.

3. *State Water Resources Control Board.* The budget proposes $7.6 million and 121.5 personnel-years for hazardous substance control-related activities of the board in 1984–85. These funds will be used to (a) monitor ground water quality, (b) permit, inspect, and enforce waste discharge requirements, and (c) regulate underground tanks. The requested amount is $2.4 million (40 percent) above current-year levels, and will provide for 50.5 new positions (71 percent). Most of the increase is to implement new programs to identify, permit, and monitor underground tanks and to begin cleaning up leaks from these tanks.

4. *Department of Industrial Relations.* The budget includes $7.6 million for hazardous substance control-related workplace health and safety activities to be conducted by the department in 1984–85. This is a 5.1 percent reduction from estimated current-year expenditures. Most of the $7.6 million is for activities related to hazardous substances. These activities include workplace inspections, various research projects, enforcement of worker right-to-know laws, and the Hazard Evaluation System and Information Service (HESIS).

5. *Air Resources Board.* The budget proposes $3.5 million and 36.4 personnel-years for related activities to be conducted by the board in 1984–85. These funds will be used primarily to develop controls or standards for toxic air contaminants emitted by stationary (nonvehicular) sources. The requested amount is $1.4 million above the current-year level, and will fund six additional personnel-years, as well as increased extramural research and expanded sampling of ambient air and emissions.

6. *California Highway Patrol.* The budget proposes $2.9 million and 60.1 personnel-years for the patrol to use in inspecting and enforcing federal and state regulations for containers and vehicles carrying hazardous materials or wastes during the budget year. This is not a significant change from current-year expenditure and staffing levels.

Review of Hazardous Substances Control Programs

In the *Analysis,* we discuss numerous issues concerning individual hazardous substances programs in connection with our review of the departments' operating hazardous substances control programs. In this section, we review the current status of the state's program for controlling hazardous substances as a whole.

Our analysis indicates that the current mechanisms for planning and coordinating activities of the 12 departments operating hazardous substance control programs are not adequate. In the detailed analysis that follows, we (1) recommend immediate legislative action to strengthen the planning and coordinating functions of the existing system and (2) describe options for making further changes in the program.

Problems of Overlapping Authority and Coordination. Recognizing the need for greater control of hazardous substances, the Legislature has enacted numerous statutes to establish new hazardous substances control programs or expand existing authority. As a consequence, the number of statutes and hazardous substances control programs has increased tremendously since passage of the Hazardous Waste Control Act in 1972. In 1983, the Legislature established new programs to (1) identify and inspect underground tanks storing hazardous substances and (2) increase the monitoring of drinking water to detect contamination.

Some of the new laws enacted during the last 12 years have resulted in overlapping responsibilities among agencies. This has led to conflicts between agencies in regulatory development, standard-setting, and enforcement. For example, both the Department of Health Services (DHS) and the State Water Resources Control Board (SWRCB) regulate and issue permits to hazardous waste facilities. The board regulates hazardous waste disposal facilities that discharge waste to surface or ground water. The department regulates all hazardous waste disposal facilities, including facilities that generate, store, or treat hazardous wastes. Draft regulations developed separately by the two agencies in 1983 contained conflicting standards. Also in 1983, the department filed legal charges against wood treatment facilities that were negotiating with regional water boards to clean up contamination on a voluntary basis.

In addition, the proliferation of hazardous substances control programs in different departments has made it more difficult for the administration to coordinate plans and budgets for these programs. As a result, we have observed inconsistencies between budget requests for different agencies. For example, the budget proposes an increase of $889,000 and 5.7 personnel-years in the Air Resources Board (ARB) for improved regulation of toxic air contaminants. The statute authorizing these activities requires the DHS to analyze standards proposed by the ARB for their impact on public health. Although the ARB budget proposes a significant increase in staffing and workload that would presumably result in a larger number of proposed standards, the budget did not contain additional funds for the department to handle this additional workload.

Previous Efforts to Improve Coordination Between Agencies. The problems we identify have been recognized for several years, and efforts have been made on several occasions to improve interagency coordination. Our review indicates that at least three organizations have been established for this purpose over the years. They are as follows:

1. ***Toxic Substances Coordinating Council.*** In 1980, the Governor established, by executive order, the Toxic Substances Coordinating Council (TSCC), consisting of representatives from seven state agencies and departments that regulated hazardous substances. The Governor charged the council with developing policy recommendations, promoting consistency in regulations, encouraging cooperation between agencies, and coordinating research. The council's activities resulted in the development of numerous legislative initiatives and budgetary proposals. Our review indicates, however, that the council did not successfully address the problems of coordinating regulatory activities, planning, and budgeting in the state agencies involved with hazardous substances control.

2. ***Hazardous Waste Management Council.*** In 1982, the Legislature established the Hazardous Waste Management Council (HWMC) on a limited-term basis (until July 1984) to develop a plan for facility siting and permitting, and to make recommendations for legislative and administrative changes needed to improve hazardous waste management. The 16-member council is composed of key department heads, legislators, and representatives of local government, industry, and environmental organizations.

The draft *Hazardous Waste Management Plan,* issued by the council in January 1984, makes 79 specific recommendations for new legislation as well as changes in state and local government operating procedures, including some recommendations aimed at improving coordination between state agencies and between state and local agencies. The primary focus of the report, however, is on the facility siting process. The report recommends establishing a state appeals board to review certain local government decisions on facility siting requests. The council's report is the most comprehensive report produced to date that reviews state hazardous substances programs. We will be able to comment further on the report and the recommendations it contains at budget hearings.

3. ***Hazardous Substances Task Force.*** In April 1983, the Governor abolished the Toxic Substances Coordinating Council and created the Hazardous Substances Task Force (HSTF). The executive order creating the new task force charges it to "identify and address issues relating to radioactive, toxic, and other hazardous substances and have overall responsibility to formulate and oversee the implementation of a comprehensive program" through existing statutory authority. The Governor designated the Secretary of Environmental Affairs as task force chairperson. The membership of the task force is drawn from 16 state departments and agencies.

The task force is conducting a three-phase review to (a) identify issues, (b) adopt goals and priorities, and (c) develop specific implementation proposals. Staffing for the task force is provided through the Office of the Secretary of Environmental Affairs and through the loan of personnel from other departments. The task force hopes to complete its review by the end of 1984.

In October 1983, the task force issued a draft report, *An Identification of Issues,* that provides an overview of existing programs and examples of current coordination problems. The report does not identify priorities among the issues cited nor does it make recommendations to correct the problems. The task force indicates that priorities and recommendations will be covered in later reports. Although our review indicates that the task force is performing needed coordination, we identified a number of shortcomings, which are discussed below.

A Permanent Effort with Expanded Authority is Needed

We recommend that the Legislature enact legislation to establish the task force on a permanent basis and expand its responsibilities to include (1) the development of recommendations for legislation and organizational changes, (2) oversight of budgetary decisions involving hazardous substances control, and (3) reporting to the Legislature on a regular basis.

The Governor has established the Hazardous Substances Task Force (HSTF) to coordinate regulatory activities related to hazardous substances within the framework provided by existing law. The initial efforts of the task force have been aimed at identifying issues. In the future, the task force intends to establish priorities and plans for improving the state's hazardous substance control activities.

We see several shortcomings in the task force approach. Specifically, the task force (1) has no statutory authority and is therefore not accountable to the Legislature, (2) is not charged with reviewing existing statutes and organizational structures, (3) does not review budget proposals to insure that they are internally consistent, (4) has no line authority to resolve conflicts or direct departments to take specific actions, and (5) is not required to report to the Legislature or the public.

We believe that the enactment of legislation to establish the task force on a permanent basis would strengthen the efforts initiated by the Governor and, at the same time, improve legislative involvement in priority-setting for the hazardous substances control programs. The primary problems facing the state in coordinating its activities in this area are not likely to go away any time soon. In fact, we believe that a coordinating body of some sort will be needed as long as responsibilities in this area are shared by different agencies. From an organizational perspective, ad-hoc bodies established by executive order do not lend themselves to the same legislative review as similar organizations that have been established in statute. For this reason, we recommend that the Legislature enact legislation formally establishing and charging the task force (or some comparable body) with ongoing responsibilities in the hazardous substance control area. Specifically, this legislation should:

1. *Expand the task force's scope* to include the review of existing statutory provisions and organizational structures. The limitation on the task force's efforts imposed by the executive order's—acceptance of the existing statutes as immutable—is inappropriate because the state's efforts to control hazardous substances are still developing. Members of the task force are familiar with the existing statutes and should be encouraged to recommend changes where such changes will strengthen program performance.

2. *Expand the role of the task force chairperson* to include reviewing budget proposals in the hazardous substance control area. The current

budget development process does not ensure consistent decisions on related activities undertaken by different agencies. An effective way to ensure consistency would be to refer all budget requests to the task force and require the chairperson to submit written comments to the Department of Finance before these proposals are included in the budget. A unified presentation of the hazardous substance control program should be included annually in the introduction to the Governor's Budget.

3. *Require the task force to develop a comprehensive state plan* for the control of hazardous substances and to *report annually to the Legislature* on the administration's progress in fulfilling the plan's objectives. A comprehensive plan would represent a commitment by the administration to the Legislature to achieve concrete objectives and allow the Legislature to make changes in the priorities as necessary. The annual progress reports would form the basis for ongoing legislative oversight as well as for efforts by the public to hold the administration responsible for meeting the plan's commitments. The task force should solicit public input on the plan through hearings, workshops, or advisory committees.

Our analysis of the state's current efforts in the hazardous substance control area has identified two other program components that need immediate attention. These components involve data systems and scientific standard-setting. In the following sections, we discuss the problems in these areas that our analysis has uncovered and recommend supplemental report language requiring the administration to establish technical working groups to coordinate efforts in these areas.

Improved Data Systems Needed

We recommend that the Legislature adopt supplemental report language requiring the Hazardous Substances Task Force to establish a technical working group to review and coordinate data collection efforts and to recommend changes in current data collection efforts as appropriate.

Over the years, the departments regulating hazardous substances independently of one another, have developed mechanisms to collect data from the regulated industries and to use that data to monitor compliance with the law. Different data systems on hazardous waste generation currently are operated by the Department of Health Services (DHS), the Board of Equalization (BOE), and the State Water Resources Control Board (SWRCB). In addition, the Department of Food and Agriculture collects data on pesticide usage. These systems produce contradictory conclusions as to the amounts and types of hazardous wastes generated because of differences in definitions and methodology.

The draft report of the Hazardous Substances Task Force (HSTF) and the draft plan of the Hazardous Waste Management Council (HWMC) identify the lack of a statewide coordinated data base as a significant problem. The lack of data (1) impedes monitoring of compliance with permit requirements, (2) reduces the state's ability to encourage recycling and other alternatives to land disposal, (3) hinders program planning and facility siting decisions, and (4) makes evaluation of program effectiveness more difficult. The Hazardous Waste Management Council (HWMC) recommends that DHS (1) take the lead in coordinating and consolidating data and (2) provide data to counties to assist them in planning for facilities.

Our analysis confirms that the existing data systems are inadequate and uncoordinated, and that immediate steps are needed to improve these systems. We do not agree with the council's recommendation, however, that the Department of Health Services is the entity best able to design and operate a comprehensive data system. As we discuss in our analysis of the DHS budget (Item 4260 of the *Analysis*), implementation of the department's Hazardous Waste Information System is significantly behind schedule. In fact, the department currently is reviewing the system to identify changes in its design and operation that will allow full implementation. Given the problems that the department is having already, we do not believe it would be prudent to assign to it additional data management responsibilities.

We recommend instead that the HSTF establish a technical working group of staff currently responsible for collecting and managing hazardous substances data to (1) analyze existing data bases, (2) identify duplication or gaps in the information collected, (3) recommend system changes, and (4) estimate the cost of making these changes. Because of the importance of a functional data system to statewide hazardous waste management, we recommend that the Legislature adopt the following supplemental report language:

"The Hazardous Substances Task Force (HSTF) shall establish a technical working group to review the existing hazardous substances data systems and to recommend improvements. The group shall include representatives from the departments operating the existing systems and technical consultants experienced in electronic data processing. The working group should perform an inventory of existing data bases, identify duplication or gaps in the information collected, and make recommendations for system changes. The system changes may consist of alterations to existing systems or consolidating the systems into one. It shall also develop a feasibility study, an implementation schedule, and cost estimates for implementing the system changes. The HSTF shall submit a preliminary report of the working group's findings and recommendations to the chairpersons of the fiscal committees and the Joint Legislative Budget Committee by December 31, 1984, and a final report by March 31, 1985."

7—77959

Standard-Setting and Risk Assessment

We recommend that the Legislature adopt supplemental report language requiring the Hazardous Substances Task Force to establish a working group of departmental scientists to (1) coordinate current activities, (2) analyze ongoing risk assessment needs, (3) establish priorities among specific substances to be reviewed, and (4) recommend changes in funding, organizational structures, or statutory authority as appropriate.

The development of health effect standards is a major component of state hazardous substances regulatory activities. Current law authorizes at least five departments to develop and enforce exposure standards. The Department of Health Services (DHS) (1) sets and enforces standards for food and drinking water, (2) sets and enforces standards for hazardous waste disposal, (3) conducts studies of specific populations to determine health effects of hazardous substances, and (4) advises other departments on the medical and toxicological aspects of proposed standards. The Air Resources Board (ARB), State Water Resources Control Board (SWRCB), Department of Food and Agriculture (DFA), and Department of Industrial Relations (DIR) set and enforce standards for specific substances closely related to their program responsibilities.

The process of scientific standard-setting can be separated into two components: risk assessment and risk management. Risk assessment uses factual data to determine the effects of exposure to specific hazardous substances on the health of populations and individuals. Risk management develops regulatory standards using the information from the health risk assessment and other technical engineering and economic concerns.

Risk assessment has two phases (1) reviewing available scientific literature and conducting new studies to determine if a material poses a health risk and, if so, the total amount of exposure that is harmful and (2) applying that knowledge to the specific environmental medium or population covered by the particular department's jurisdiction. For example, acceptable exposure levels for ethylene dibromide (EDB) are different for drinking water, food products, and worksite exposure because the amount of the substance absorbed through each medium is different.

Differences in standards caused by the nature of the environmental medium are appropriate. Other differences in the risk assessment stage occur when the agencies use different approaches in determining whether a substance poses a risk and the total amount of exposure that is harmful. At worst, these inconsistencies in risk assessment can lead to conflicting state standards for the same chemical being set by the different departments. At best, where similar approaches are used by the different departments, the first phase of risk assessment, involving the basic scientific review, is duplicated in up to five departments. With the current backlog of substances suspected of being a threat to public health for which enforceable exposure standards have not been developed, the state cannot afford to waste scientific effort in duplicative activities.

Our analysis indicates that the state's current method of scientific standard-setting needs immediate improvement. We have identified two alternatives to addressing the problem: (1) consolidating all risk assessment functions in the Department of Health Services and (2) improving coordination between the departments.

Consolidation in the Department. In the past, before the other regulatory agencies were created, the department was responsible for all public health issues regardless of the type of exposure or environmental medium involved. Consolidation of scientific risk assessment into one organizational unit would tend to insulate the technical, scientific assessment of human health risk from the decisions of the regulatory agency managers, which must take into account political, economic, and technical considerations in addition to the potential effect on public health. The National Academy of Sciences recently recommended that the two functions of risk assessment and risk management be clearly separated.

Improve Coordination. At this time, we recommend that the Legislature opt for the improvement of coordination between the existing departments, rather than consolidation. Before a reorganization is contemplated, we believe that a technical working group of scientists from various departments should be established by the task force to coordinate activities, analyze ongoing risk assessment needs, and identify problems in existing organizational structures and funding. We further recommend that the working group specifically evaluate the advantages and disadvantages of consolidating risk assessment into one department.

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

> "The Hazardous Substances Task Force (HSTF) shall establish a technical working group of scientists representing the appropriate regulatory agencies to (1) coordinate current hazardous substances activities, (2) analyze ongoing risk assessment needs, (3) establish priorities among specific substances to be reviewed, and (4) identify problems in funding, organizational structures, or statutory authority as appropriate. The working group shall evaluate the advantages and disadvantages of consolidating all risk assessment activities into one department. Scientists employed outside of the state regulatory agencies should be consulted as needed. The HSTF shall submit a preliminary report and plan by December 31, 1984, and a final report by March 31, 1985."

Possible Organizational Changes

Our review indicates that the Legislature and the administration may wish to consider moving the hazardous waste regulatory activities currently located in the Department of Health Services (DHS) to the Environmental Affairs Agency. Under this option, other DHS functions related to hazardous substances—health effects studies, toxicology, and laboratory services—would remain in the department's Health Protection Division.

The majority of the state's hazardous waste management activities currently are performed by the Toxic Substances Control Division (TSCD) in the DHS. A portion of the activities of SWRCB and the ARB are also related to hazardous waste. Many of the coordination problems regarding data collection, regulations, permitting, and enforcement are between the department and SWRCB.

Our review indicates that the TSCD has more in common with the SWRCB than with other units in the department or in the Health and Welfare Agency. The division's personnel are primarily engineers or waste management specialists, classifications that are found in large numbers at the board but not frequently in the rest of the department.

Past evaluations conducted by the Auditor General, the Environmental Protection Agency, and the Legislative Analyst have criticized the department's management of the hazardous waste programs. One of the reasons for the department's poor performance in the past is the relative small size of the division compared to the department as a whole. In the budget year, the division's proposed expenditures of $58.1 million are 1 percent of the department's total expenditures of $5.6 billion. The division's 245.5 positions represent 6 percent of the 4,135 positions proposed for the department. Within such a large department, it takes more time to make decisions and to process administrative paperwork. In our analysis of the division's Superfund program, for example, we criticize the long time needed to develop and process contracts for remedial action. Each contract currently must pass through 45 steps of development or approval handled by 16 different units, of which 13 are in the department.

The advantages of establishing a separate Department of Hazardous Waste Management in the same agency as the SWRCB and the ARB are (1) the three major government units regulating hazardous waste would report to one agency secretary, thereby increasing cooperation and improving communications, (2) the number of layers of bureaucracy would be reduced, thereby speeding decision-making, (3) administrative staff would no longer be shared with other programs, and (4) administrative procedures would be tailored to the hazardous substances program's needs rather than those of other programs such as Medi-Cal or local assistance grants.

The disadvantages of such a proposal are that (1) the program may be less sensitive to public health concerns, (2) administrative disruptions and delays often occur during major reorganizations, and (3) a new department would increase, rather than decrease, the number of agencies involved in hazardous substances control because the DHS would continue to perform laboratory analyses and health effect studies. The Legislature needs more information before determining that reorganization is the best method of improving the performance of the state's hazardous substance control programs.

Local Government Finance Issues

THE GOVERNOR'S PROPOSAL FOR FINANCING LOCAL GOVERNMENTS

What Effect Will the Governor's Proposal for Financing Local Governments Have on the Ability of Local Agencies to Respond to the Needs of Those They Serve?

The voters' approval of Proposition 13 in 1978 brought about a distinct change in the way local government agencies operate. Prior to 1978, local governments had the ability to raise funds to maintain or expand local services, to add to their stock of capital facilities, and to provide in other ways for the needs of those residing within their boundaries. They were able to do this by increasing their property tax rates. Proposition 13, however, took away this ability, leaving most local agencies more dependent upon state aid to finance their programs. Furthermore, due to revenue shortages at all levels of government, local agencies have had to fund the growth in some programs by cutting back funding for other traditional services. Local governments contend that during the last five and one half years, they have lost a large part of their fiscal independence and fiscal stability.

The Governor's Proposal

The Governor's Budget proposes to restore, through the enactment of various statutory and constitutional changes, some of the fiscal stability which local governments enjoyed prior to Proposition 13. Specifically, the Governor proposes to:

- Repeal the AB 8 deflator;
- Repeal all statutory provisions for determining fiscal relief;
- Constitutionally guarantee vehicle license fee and cigarette tax subventions;
- Allocate the state's share of vehicle license fee revenues (18.75 percent of total collections, or $210 million) to *counties* ($208 million) and to the 31 "no property tax" *cities* ($2 million);
- Apportion the supplemental property tax proceeds (estimated at $422 million) among all local agencies, instead of only to K–12 schools, beginning in 1984–85 rather than in 1985–86 as provided by current law;
- Repeal the subvention for personal property tax relief (business inventories);
- Require counties to pay 20 percent of the estimated $5 million in costs arising under the Indigent Defense and Homicide Trials programs. (This proposal is discussed in greater detail in Items 8160 and 8180 of the *Analysis*);

- Restore local governments' access to the general obligation bond market by relaxing (through a constitutional amendment) the one percent limitation on the property tax rate;
- Provide additional unspecified revenues for counties;
- Make specified changes relating to state-mandated local programs. (This proposal is discussed in greater detail later in this part and in Item 9680 of the *Analysis.*)

Revenue Shifts

The Governor proposes to eliminate the personal property tax relief subvention for local agencies other than school districts. This would reduce state subventions to cities, counties and special districts by a total of $320 million in 1984–85. Schools would not be affected because business inventory subventions were folded into the regular school apportionments system beginning in 1983–84. In order to offset a portion of the revenue loss that local agencies would experience as a result of eliminating the subvention, the Governor also proposes to advance by one year, from 1985–86 to 1984–85, the date on which these agencies will begin to share in the proceeds of the supplemental property tax. Under existing law, all of the proceeds from this tax are allocated to K–12 school districts in 1983–84 and 1984–85. If the Governor's proposal is approved, cities, counties, and special districts would gain about $262 million from supplemental property taxes in 1984–85. K–12 schools would not be affected by the property tax shift because General Fund apportionments would increase automatically to offset any property tax revenue losses that they experience.

The Governor also proposes to allocate an additional portion of vehicle license fee (VLF) collections to counties. Under current law, 18.75 percent of these collections (an estimated $210 million in the budget year) are deposited in the state General Fund; the remaining 81.25 percent is apportioned among cities and counties on the basis of population. Under the Governor's proposal, most of the 18.75 percent designated for the state would be redirected to counties; a small portion ($2.1 million) would be allocated to the so-called "no property tax" cities—cities that existed but did not levy a property tax prior to the passage of Proposition 13. The $2.1 million is intended to restore the revenue loss incurred by these cities when three small subventions were repealed in 1981–82.

Fiscal Effect in 1984–85. Table 73 illustrates the effect of the individual components of the Governor's financing plan (other than the repeal of the deflator) in 1984–85. This table indicates that, overall, *counties* would fare the best under the Governor's proposal, as they would receive an estimated net increase in revenues of $191 million in 1984–85. Most of this increase is attributable to the additional vehicle license fee collections that would be redirected from the state to the counties.

Special districts would also fare well initially under the Governor's proposal, as they would receive an estimated $12 million increase in revenue in 1984–85. *Cities,* however, would experience a net loss of approximately $9 million, because they would lose more in revenue from the repeal of the business inventory subvention than they would gain in the form of supplemental property tax roll revenues. *Redevelopment agencies* would lose an estimated $43 million in revenue during 1984–85. This loss is attributable entirely to the repeal of the business inventory subvention.

Local school districts would experience no net change in revenue as a result of the Governor's proposal. This is because the state generally "guarantees" a specific level of funding (the "revenue limit") for all K–12 school districts. Consequently, the $284 million reduction in revenue to K–12 schools resulting from the revenue shifts would be offset by an increase in state General Fund apportionments. Similarly, the budget proposes to offset the $22 million revenue gain to community colleges by an equivalent reduction in General Fund apportionments.

Table 73
Fiscal Effect of Governor's Proposal [a]
by Revenue Source
1984–85
(in millions)

Revenue Source	*State*	*Counties*	*Cities*	*Special Districts*	*RDAs* [b]
Vehicle License Fees	−$210	$208	$2	—	—
Property Taxes—Supplemental Roll	—	165	61	$36	—
Offset to School Apportionments	−262	—	—	—	—
Business Inventory Subventions	+320	−181	−72	−24	−$43
Other [c]	+1	−1	—	—	—
Totals	−$151	$191	−$9	$12	−$43

[a] Does not reflect proposal to repeal deflator.
[b] Redevelopment agencies.
[c] Reflects counties' assumption of 20% of specified judicial programs.

As Table 73 indicates, the state would sustain a net loss of $151 million in the budget year as a result of the Governor's proposal.

The budget assumes that revenues from the supplemental property tax will total $422 million in 1984–85. As shown in Table 73, we estimate that if this assumption proves to be accurate, $262 million in additional property tax revenues would be allocated among cities, counties, and special districts. There is considerable doubt, however, as to whether the estimate of these property taxes contained in the budget is accurate. If it is not accurate, the net fiscal effect of the Governor's proposals on local governments will differ from what is shown in the table.

In this regard, we note that data compiled by the Board of Equalization from information submitted by the counties indicates that the level of supplemental property tax revenue in 1983–84 will be significantly less than what is anticipated by the Department of Finance. If the county estimates prove to be more accurate, the property tax estimates for 1984–85 probably are overstated as well. If that occurs, counties and special districts will not realize the full amount of the gains shown in Table 73, and cities will experience even greater net losses than those shown.

Fiscal Effect on Individual Local Agencies in 1984–85. The data in Table 73 display the fiscal effect of the Governor's proposal on the four categories of local agencies. The data, however, are not necessarily representative of how individual agencies within each category would fare. For example, Table 73 indicates that, overall, cities will sustain a loss of $9 million in the budget year. This $9 million loss, however, will not be spread evenly among cities. Some will come out ahead; others will lose a disproportionate amount.

Cities. The fiscal effect of the Governor's proposal on individual cities will depend on the relationship between each city's business inventory subventions (BIE) and what the city can expect to receive from the supplemental property tax. The amount of BIE received by any particular city depends on the value of business inventories located within that city's boundaries in 1979–80, and the city's share of the 1 percent Proposition 13 property tax rate. The amount of supplemental roll revenue that would be allocated to a given city would depend on assessed value within the city and, again, its share of the 1 percent Proposition 13 property tax rate.

The amount of business inventory value as a percent of total assessed value varies widely among cities, so that some cities would receive more in BIE than they would receive in proceeds from the supplemental property tax. Conversely, cities with a relatively small amount of BIE would probably realize a net gain in revenues.

Special Districts. Table 73 also indicates that, overall, special districts would realize increased revenues of $12 million. Again, this does not necessarily mean that each special district would come out ahead as a result of the Governor's proposal; some would and others would not.

Counties. No county would lose revenues as a result of the Governor's proposal, due to the way in which the increase in vehicle license fee subventions would be allocated. First, funds would be allocated to each county in an amount sufficient to replace the loss of business inventory funding. The remaining vehicle license fee funds (about $27 million) would be allocated to each county in proportion to its population.

Redevelopment Agencies. All redevelopment agencies would sustain a loss of revenue under the proposal. We estimate that these agencies would lose approximately $43 million, although the actual losses could be higher. Our estimate reflects the amount of the BIE subvention allocated to these agencies by county auditors. Current law, however, requires that an adjustment to the assessed value of redevelopment agencies be made to increase their property tax revenue, in lieu of allocating to them any of the proceeds from the BIE subvention. The Governor proposes to repeal this adjustment, and no information is available on what the fiscal effect of doing so would be.

Fiscal Effect After 1984–85. A significant feature of the Governor's proposal for 1984–85 is the transfer of supplemental property tax revenues from K–12 schools to other local agencies. Under current law, this transfer would occur in 1985–86. Consequently, the additional revenue that local agencies would receive from the supplemental property tax in 1984–85 as a result of the Governor's proposal represents a *one-time only* revenue gain. Table 74 displays the estimated effect of the Governor's proposal in 1985–86.

Table 74
Fiscal Effect of Governor's Proposal by Revenue Source 1985–86 (in millions)

Revenue Source	*State*	*Counties*	*Cities*	*Special Districts*	*RDAs* [a]
Vehicle License Fees [b]	–$230	$228	$2	—	—
Property Taxes—Supplemental Roll	—	—	—	—	—
Business Inventory Subventions	320	–181	–72	–$24	–$43
Other [c]	1	–1	—	—	—
Totals	$91	$46	–$70	–$24	–$43

[a] Redevelopment Agencies
[b] Assumes 10 percent growth in revenue.
[c] Reflects counties' assumption of 20% of specified judicial programs.

Table 74 indicates that under the Governor's proposal, the state and counties would realize net revenue increases in 1985–86 of $91 million and $46 million, respectively. Cities, special districts and redevelopment agencies, on the other hand, would sustain net revenue losses of $70 million, $24 million and $43 million, respectively.

Governor Proposes to Repeal the Deflator

At the same time that the Legislature committed itself to a permanent program of fiscal relief for local agencies, it also established a mechanism, commonly known as the "AB 8 deflator", that reduces the amount of this relief *automatically* in times when state revenues are not adequate to maintain the ongoing "baseline" level of state expenditures. (A more detailed discussion of fiscal relief appears in Part Two—Expenditures: Local Assistance).

The deflator becomes activated when projected state revenues fall below an inflation-adjusted base level of state expenditures. When the deflator is activated, the State Controller is required to reduce motor vehicle in-lieu subventions, cigarette tax subventions, and business inventory reimbursement subventions by an amount sufficient to make up one-half of the difference described above. Until recently, the other one-half would have come from apportionments to K–12 schools and community colleges. Ch 498/83, however, repealed the deflator for local education agencies.

Deflator in Effect for 1984–85. Based upon the most recent revenue and expenditure forecasts by the Department of Finance, the AB 8 deflator mechanism will be "triggered" for the 1984–85 fiscal year, and will require reductions of $364 million in aid to cities, counties and special districts. These reductions would be made in proportion to each local agency's share of the three subventions specified above.

The governor proposes that the deflator mechanism, which was suspended in 1981–82, 1982–83, and 1983–84, be repealed for 1984–85 and thereafter. Table 75 shows the effect that activation of the deflator would have in 1984–85, by type of agency;

Table 75
Effect of the AB 8 Deflator
Under Current Law
1984–85
(in millions)

	Counties	*Cities*	*Special Districts*	*RDAs*[a]	*Totals*
Vehicle License Fee Subvention	–$128	–$128	—	—	–$256
Cigarette Tax Subvention	–4	–17	—	—	–21
Business Inventory Subvention	–49	–20	–$6	–$12	–87
Totals	–$181	–$165	–$6	–$12	–$364

[a] Redevelopment agencies

Proposed Program Realignments Would Affect Local Agencies

In addition to the Governor's proposal for financing local government, the budget includes several other proposals which would significantly alter the existing relationship between the state and county governments. As discussed earlier in "Expenditure Issues", the five proposed program realignments generally would shift existing health-related responsibilities in community-based mental health services, public health, family planning, and alcohol and drug programs from the state to the counties. Local governments would be provided $53 million in additional revenues when these program responsibilities are transferred in 1984–85. This $53 million includes approximately (1) $7 million in existing state funds that would be "saved" as a result of transferring administrative responsibilities to the counties, (2) $11 million in new funds to be appropriated in the legislation introduced to accomplish the program transfers (these funds are *not* included in the budget), and (3) $35 million in new mental health services funds contained in the Governor's Budget.

Would the Governor's Proposal Increase the Fiscal Stability of Local Agencies?

The primary objective of the Governor's local government financing proposal is to restore fiscal stability at the local level. According to the budget, local governments do not enjoy fiscal stability at the present time because a large part of their basic revenue structure is vulnerable to change at the state level shortly before—or even during—the fiscal year to which the change applies. Thus, by eliminating the automatic annual adjustments *required* by the AB 8 deflator, by providing a constitutional guarantee for most shared revenues, and by redistributing certain other revenue sources between the state and local agencies, the Governor maintains that fiscal stability can be restored.

This section examines the major components of the Governor's local government financing proposal to determine whether, and to what extent, each would contribute to achievement of the Governor's stated objective.

Repeal of the AB 8 Deflator. The Governor's proposal to repeal the AB 8 deflator would, indeed, remove a major "threat" that each year confronts local governments as they prepare their budgets. If, for example, the Legislature allowed the deflator to take hold in 1984–85, as would occur *automatically* in the absence of legislative action, the deflator would reduce state aid to local governments by $364 million. This "threat," however, is more of a tactical, than a strategic, problem to local governments. The deflator has existed since 1979, but it has never been allowed to go into effect. Even last year, when the state faced fiscal problems of an unprecedented magnitude, other mechanisms were used to reduce fiscal relief in order to help balance the state's General Fund budget. The elimination of the deflator, therefore, would contribute to local governments' fiscal stability only by putting them in a better bargaining position in the event a deficit in the General Fund looms once again.

Constitutional Guarantee for VLF and Cigarette Tax Subventions. If a proposal to guarantee these subventions is approved by the voters in November 1984, cities and counties would have assurance, beginning in 1985–86, that *these* subventions could not be reduced by the state in the event of a prospective General Fund deficit. There can be no question that these subventions are particularly vulnerable to reduction. During the last three years, the state has reduced VLF subventions by significant amounts (39 percent in the current year) in order to help balance the state budget. Thus, this part of the Governor's program would indeed stabilize these particular revenue sources, by making the yield from them more predictable.

Here again, however, the advantage that would be gained by local governments is more tactical than strategic. Enactment of the Governor's proposal would in no way preclude the state from making changes in other local government revenue sources to achieve the same end as a reduction in the VLF would achieve. For example, the state is empowered to alter the distribution of property tax revenues between local agencies, and this could be used as a means of shifting resources from local agencies to the state.

Restoration of Local Governments' Access to the General Obligation Bond Market. Restoring the ability of local governments to issue general obligation bonds, which we have recommended since 1979, would provide important fiscal benefits to these governments. This change, however, would enhance local fiscal independence, rather than increase fiscal stability.

Revenue Shifts. As discussed earlier, counties would be net gainers from the revenue shifts proposed by the Governor. In the first year (1984–85), these gains could be as much as $191 million; by the second year, the increase would be reduced to $46 million. This feature of the Governor's proposal would add stability to county finances by removing the funding for BIE subventions from state control. It would also contribute to county fiscal independence in 1984–85 by increasing the level of resources available to counties. After the first year, however, the net revenue gain would be so small—less than 1 percent of county general purpose revenue—that the impact would not be very significant.

Both cities and special districts, after the first year, would be net losers under this part of the proposal. Relative to their general purpose revenue, however, the magnitude of the net losses in each case would be minor.

Conclusion. The Governor's proposal would improve the fiscal stability of local governments, but not in any fundamental or dramatic fashion. From a local perspective, the main attributes of the proposal are: (1) the increase in county revenues that would occur on a one-time basis in 1984–85, (2) the enhanced fiscal independence that would come from restored access to the general obligation bond market, and (3) the partial protection of the local revenue base if the voters approve the VLF and cigarette tax subvention guarantees. However, the proposal would *not* preclude the state from making adjustments in other local sources of funds, so local agencies would still be vulnerable to state-initiated, potentially abrupt changes in their revenues.

Issues Not Resolved by the Governor's Program

The Governor's program alludes to, but does not directly address, the other main concern of local governments (beside fiscal stability)—the ability to adjust local revenues to meet local needs. To us, this is the heart of the fiscal independence issue.

The budget mentions that the administration will work with the Legislature and local governments to review revenue alternatives for *county* governments. No details are given as to the types of alternatives which might be acceptable, nor is there any mention of a similar need for greater fiscal independence on the part of other types of local agencies. This section provides background on existing local revenue sources, and suggests ways in which the adequacy of local resources can be improved.

Review of Local Resources

Table 76 presents information on the total revenues received by local agencies in 1981–82, the last year for which actual data are available. These data indicate that 31 percent of total city revenues are derived from tax proceeds, while counties take in only 23 percent of their total revenues from this source. Special district tax proceeds amount to 32 percent of their total revenue. The table also indicates that state aid is relatively less important to cities and special districts than it is to counties, in terms of its contribution to *total* revenues. This reflects the large amounts of state aid provided for county-operated health and welfare programs.

Table 76
Local Government Revenues, By Source
1981–82 [a]
(in millions)

	Cities		Counties		Non-Enterprise Special Districts	
	Amount	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
General taxes	$3,222	31%	$2,994	23%	$619	32%
Charges for services	3,951	38	2,584	20	150	8
Aid from other government agencies:						
State	600	6	3,584	27	85	4
Federal	901	9	2,746	21	207	11
Other	99	1	59	— [b]	117	6
Other sources	1,522	15	1,107	8	744	39
Totals	$10,297	100%	$13,073	100%	$1,920	100%

[a] Source: State Controller. City and county data include enterprise activities. San Francisco is reflected as a county. County charges for services include state Medi-Cal funds. Details may not add to totals due to rounding.
[b] Less than 1 percent.

The data shown in Table 76 relate to total revenues, however, and these data do not provide a very definitive picture of the local resources that are available for local general purposes. This is because total revenues include revenues from sources, such as the gasoline tax and user charges, that must be used for *specific* purposes.

Table 77 presents information on the level of revenues available to local agencies for general purposes between 1981–82 and 1984–85. The data for 1984–85 reflect the effects of the Governor's proposal. These revenues exclude receipts over which local agencies have no control, and consequently these revenues provide a better (but by no means a precise) indicator of the relative extent to which local agencies can address local needs for services. The data in this table show that:

- Over the last three years, taxes have accounted for almost 74 percent of city general purpose revenue, and 63 percent of county general purpose revenue. Thus, the growth in total general purpose revenue for both types of agencies primarily depends on growth in tax revenues.
- Federal aid and other sources of both city and county revenue have been virtually static over the entire period.
- Cities experienced a modest increase (4.2 percent) in total revenues during 1982–83, reflecting the reduction in state vehicle license fee subventions. In the current year, the growth rate (8.9 percent) is more robust because higher tax receipts were not offset by significant increases in the amount of subventions withheld by the state. In the budget year, the restoration of "normal" VLF funding would raise state aid by 83 percent, which in turn would lead to a 14 percent increase in general purpose income.
- Counties also experienced modest revenue increases during 1982–83 (6.1 percent) and 1983–84 (6.1 percent). The Governor's proposal to shift additional VLF revenues to counties in the budget year would increase state aid by 23 percent, and contribute to a general purpose revenue increase of over 12 percent.

Table 77
General Purpose Revenues of Cities and Counties [a]
1981–82 through 1984–85
(in millions)

Cities	*1981–82*	*1982–83*	*1983–84*	*1984–85* [b]	*Percentage Change 1983–84 to 1984–85*
Taxes	$3,229	$3,484	$3,899	$4,359	11.8%
State aid	389	318	319	583	82.8
Federal aid	258	254	254	254	—
Other sources	640	648	651	657	0.1
Total	$4,516	$4,704	$5,123	$5,853	14.2%
Counties					
Taxes	$2,737	$3,020	$3,256	$3,710	13.9%
State aid	621	642	673	827	22.9
Federal aid	268	257	257	257	—
Other sources	895	880	903	930	3.0
Totals	$4,521	$4,799	$5,089	$5,724	12.5%

[a] Source: 1981–82 data for cities and counties, and 1982–83 data for counties, is from State Controller's Annual Report on Financial Transactions. All other data represent Legislative Analyst's Office estimates.

[b] Reflects Governor's local government finance proposal.

Adequacy of Local Revenue Base.

Even though it has been five and one-half years since Proposition 13 was approved by the voters, no consensus has formed regarding what constitutes an adequate local revenue base. Obviously, average trends in revenue growth do not reflect the experience of *every* city and county. Some communities have greater needs; others have more resources to draw on. As a result, estimates of general purpose revenues for cities and counties as a group illustrate broad trends in the fiscal health of local agencies, but they are not nearly precise enough to highlight the fiscal health of individual local entities.

If the Legislature wishes to increase the fiscal independence of local governments, it can do so in three ways:

- ***Authorize local agencies to impose additional local taxes.*** Cities presently have fairly broad authority to raise or levy virtually any type of tax not precluded by state law or city charter. County governments and special districts, however, do not have the same flexibility. There would appear to be little reason why the state would want to deny the voters of any local jurisdiction the right to tax *themselves* in order to maintain services in accordance with local priorities.
- ***Extend to local agencies a greater degree of flexibility in administering state-controlled programs.*** This can be done by eliminating unnecessary program requirements that are not closely related to program outputs. To the extent the state limits the options available to local agencies in carrying out their program responsibilities, it may prevent them from taking advantage of changes in technology which could result in the more efficient provision of public services.
- ***Provide additional funding to local governments whenever new program requirements are imposed by the state.*** Whenever the state mandates new or increased duties on local agencies and does not provide the necessary funding for these duties, it in effect requires local governments to redirect funds from existing local programs to the new state program. If local officials are to be held accountable by those they serve for how local resources are used, the state should fund the new requirements it imposes on local governments.

TRIAL COURT COSTS

How Can the Legislature Help the Counties Control Trial Court Costs?

The responsibility for the administration and financing of California's trial court system currently is shared between the state and local governments. State laws, and the rules of court adopted by the state Judicial Council, establish programs, procedures, and guidelines for the operation of these courts. Responsibility for the day-to-day administration of the trial courts, however, lies with the counties and the courts themselves.

California has three types of trial courts—superior, municipal, and justice courts. Superior courts are supported primarily by the counties, although the state (1) pays about 90 percent of each judge's salary, (2) provides an annual $60,000 block grant to offset a portion of county costs for certain judgeships, and (3) provides health and retirement benefits for judges. Municipal and justice courts are also financed primarily by the counties, except that the state provides retirement benefits for municipal court judges. In addition, the state reimburses counties for the costs of certain trial court activities, such as defending indigents in capital cases.

Trial Court Expenditures Increasing

Table 78 details the increase in state and county trial court expenditures from 1978–79 through 1982–83. It shows that during this period, state expenditures have been increasing at a rate of over 15 percent a year, while county expenditures rose at an annual rate of about 14 percent. During this five-year period, state trial court costs rose about 76 percent, and county costs rose about 68 percent. The actual increases in expenditures during this period were $32 million for the state and $218 million for the counties.

Table 78
Estimated State and County Trial Court Expenditures
1978–79 through 1982–83
(in millions)

	State		*County*		*Total Trial Court Costs*	
Year	*Amount*	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
1978–79	$42.3	—	$322.1	—	$364.4	—
1979–80	51.1	20.8%	370.5	15.0%	421.6	15.7%
1980–81	63.0	23.3	418.1	12.8	481.1	14.1
1981–82	62.7	−0.5	472.3	13.0	535.0	11.2
1982–83	74.5	18.8	540.4	14.4	614.9	14.9
Total Increase from 1978–79 to 1982–83	$32.2	76.1%	$218.3	67.8%	$250.5	68.7%
Average Annual Increase	—	15.2%	—	13.8%	—	14.0%

Sources: Governor's Budgets and the State Controller's office.

County expenditures for the trial courts rose at a rate significantly faster than overall county costs during the 1978–79 through 1982–83 period. As shown in Table 79, total county expenditures increased by an average of 8 percent annually between 1978–79 and 1982–83. Because trial court expenditures increased at an average annual rate of nearly 14 percent, these expenditures rose from 4.2 percent of county budgets in 1978–79 to 5.2 percent in 1982–83—a 24 percent increase. The data in Table 79 also demonstrate that state costs for the trial courts are rising faster than total state General Fund expenditures, although they still represent a very small percentage of the state's General Fund budget.

Table 79
Growth in County and State Expenditures
1978–79 through 1982–83
(in millions)

	Counties		*State General Fund*	
Year	*Amount*	*Percent*	*Amount*	*Percent*
1978–79	$7,618.7	—	$16,250.8	—
1979–80	8,148.4	7.0%	18,534.1	14.0%
1980–81	9,385.4	15.2	21,104.9	13.9
1981–82	9,783.7	4.2	21,692.8	2.8
1982–83	10,305.3	5.3	21,751.4	0.3
Total Increase, 1978–79 through 1982–83	$2,686.6	35.3%	$5,500.6	33.8%
Average Annual Increase	—	7.8%	—	7.6%

Sources: Governor's Budgets and the State Controller's office.

County representatives have expressed concern over the rapid rate of growth in trial court costs. Due to the restrictions imposed by Proposition 13 in 1978, counties generally are not able to increase taxes in order to cover the rising costs of providing government services. Because trial court costs are rising faster than the costs of other county services, counties are having to finance rising court costs by reducing expenditures for other programs which they believe to be of higher priority.

Legislature's Role in Controlling Court Costs

The largest component of *state* trial court expenses is the cost of salaries and retirement benefits for judges. Legislative attempts in recent years to control these costs have been frustrated by a series of court decisions which have ruled that limitations on salary increases or pensions may not be implemented during a judge's term in office. As a result, the Legislature's ability to control the state's share of trial court costs is limited, for the most part, to restricting the number of new judgeships authorized for the courts.

There are, however, a number of ways the Legislature can assist counties in controlling their costs. This is because, in many instances, *state law currently limits county flexibility to operate the trial courts in such a way as to control or reduce trial court costs.* Below, we identify several ways the Legislature can give counties more flexibility to administer the trial courts in a more cost-effective manner, or to impose more of the costs of providing court services on the users of those services. Each of these alternatives would require a change in state law.

Process Serving

In order to increase county control over the costs of serving civil process, we recommend that legislation be enacted to permit counties to (1) assess fees to cover their actual costs of serving process and (2) contract with private firms to serve process.

One way the Legislature can assist counties is to modify laws that limit local flexibility in utilizing court-related personnel. For example, counties use sheriff's and marshal's officers to serve civil process (such as a notification of a pending court action against a person). Private firms may also serve process except in specified instances (they may not serve certain writs). State law limits the ability of counties to control costs for process serving by setting a maximum fee counties may charge for this service, and by restricting counties from contracting with private firms, in lieu of using more expensive county personnel, to serve process.

Specifically, under Section 26721 of the Government Code, when a person decides to use a sheriff or marshal to serve process, the county may not charge the individual more than $14 for the service. The counties' actual costs for performing these duties often are significantly higher than the maximum allowable fee. This limit on fees makes it necessary for local taxpayers to subsidize users of public process servers. Los Angeles County estimates that its costs for process serving exceed fee revenues by about $9 million annually.

In addition, when individuals request counties to serve process for them, or when specified types of process must be served, the Government Code (Sections 26608, 71264, 71265) requires sheriff's or marshal's officers *themselves* to serve the process. As a result, a county generally may not contract with a private firm to serve process on the county's behalf, even where it would be cost-effective to do so. Because sheriff's and marshal's officers are trained and compensated as peace officers, a county's cost to serve process may be significantly higher than that of a private firm which does not use peace officer personnel for the task. San Diego County estimates that it could save $1 million annually by contracting with private firms for process serving.

By allowing counties to recover their actual costs in serving process, the Legislature would enable counties to shift the costs of providing these services from the general taxpayers to the users of the services. In addition, by allowing counties to contract with private firms to serve process, the Legislature would enable counties to reduce their costs.

Electronic Recording of Court Proceedings

In order to increase county control over the costs of court proceedings, we recommend that the Legislature enact legislation to permit counties to use electronic recording as an alternative to shorthand reporting when they determine it would be appropriate and cost-effective.

Various studies in recent years have found that major savings could be achieved by modernizing the method by which court and administrative proceedings are recorded and transcribed. In June 1982, the United States General Accounting Office (GAO) recommended increasing the use of electronic recording in the federal courts, as an alternative to shorthand court reporters. The GAO estimated that the annual savings from doing so would be about $10 million. In February 1982, the state Auditor General's office found that the Workers' Compensation Appeals Board, which conducts administrative hearings, could save about $1 million annually by using electronic recording. The studies also concluded that transcripts produced from electronic recordings could be as accurate, or more accurate, than shorthand reporters' transcripts.

Currently, many state agencies which conduct administrative hearings, such as the Public Employees' Relations Board and the Department of Motor Vehicles, rely on electronic recording devices in lieu of shorthand reporters. Moreover, the Office of Administrative Hearings indicates that the electronically recorded transcripts consistently have been accepted by the courts when decisions made by these agencies are appealed.

Despite strong indications that electronic recording devices can be as accurate as—and often significantly less expensive than—shorthand reporters, state law generally prohibits trial courts from using these devices or even experimenting with them to determine their usefulness. The Code of Civil Procedure (Sections 269 and 274c) *requires* superior, municipal, and justice courts to use shorthand reporters for court proceedings. The only exception to this requirement is that municipal and justice courts may use electronic recording devices for certain proceedings, in accordance with Judicial Council rules, if no reporter is available. Municipal courts in several counties currently employ these devices successfully when no reporter is available.

The Los Angeles County Superior Court Executive Officer estimates that the use of electronic recording in the 5–10 percent of the proceedings where it would be *most* cost-effective (for example, in certain family law hearings), would save the county over $400,000 annually. If the Legislature modified current law to give the counties more flexibility to use electronic recording devices in the trial courts, counties could reduce trial court costs by utilizing electronic reporting in those proceedings where it would be appropriate and cost-effective.

Fees for Civil Trials

In order to tie litigants' costs more closely to the costs they impose on the trial courts, we recommend the enactment of legislation to authorize all counties to assess litigants for the costs of court reporters in civil trials.

Courts traditionally have assessed fees to cover a portion of their operating costs. In recent years, the Legislature has authorized counties to offset rising costs by increasing fees charged to litigants in civil cases. As a result, court fee revenues were about $63 million, or 139 percent, higher in 1982–83 than in 1978–79. This represents an average annual increase of about 24 percent during the five-year period. As Table 80 demonstrates, because court fees rose faster than court costs during the period, the portion of costs covered by fees also increased. Nevertheless, fees still cover only about 20 percent of *total* county court costs.

It is important to note that this total includes costs for criminal, as well as civil actions. While no statewide data are available which separate the costs of these activities, two counties have performed studies indicating that costs for civil matters comprise about 50 percent of their total superior court costs. Based on these estimates, fee revenues may offset about 40 percent of county costs for civil matters handled by trial courts.

Table 80
County Trial Court Fee Revenues
1978–79 through 1982–83
(in millions)

	Fee Revenues		*Costs*		*Fees As A Percentage*
Year	*Amount*	*Percent*	*Amount*	*Percent*	*of Costs*
1978–79	$45.4	—	$322.1	—	14.1%
1979–80	46.3	2.0%	370.5	15.0%	12.5
1980–81	65.9	42.3	418.1	12.8	15.8
1981–82	87.2	32.3	472.3	13.0	18.5
1982–83	108.3	24.2	540.4	14.4	20.0
Total Increase, 1978–79 through 1982–83	$62.9	138.6%	$218.3	67.8%	—
Average Annual Increase	—	24.3%	—	13.8%	—

Source: State Controller's office.

Although much of the recent growth in court fee revenue has resulted from increases in filing fees, initial processing of filings is a relatively small proportion of total court costs. The costs of conducting trials accounts for a far greater portion of county court expenditures. Yet, in most counties, litigants must pay only a small share of county trial costs.

Counties currently have limited statutory authority to charge litigants for the costs of trials, which primarily result from the salaries and benefits of the court reporters, bailiffs, and clerks that attend trials. According to the Judicial Council, litigants in municipal and justice courts generally pay the full costs of court reporters. However, Government Code Section 269 prohibits superior courts from assessing litigants for a county's costs to retain a court reporter during a trial. The Legislature made exceptions to this provision in nine counties where the courts may charge litigants requesting trials for the costs of court reporters.

Our review suggests that the policy of allowing counties to charge litigants requesting trials for the costs of court reporters should be extended to the superior courts in all 58 counties. By enacting legislation to give counties the flexibility to charge civil litigants for an increased share of the costs of trials, the Legislature would tie the costs borne by litigants more closely to the costs they impose on county governments. While this approach clearly would shift more of the costs of the court system to litigants, it would not necessarily increase the financial burden on low or moderate income persons. This is because the California Rules of Court generally require courts to waive fees for persons who are not able to afford them.

Summary

The statutes discussed above are only several examples of the laws that the Legislature could modify in order to give counties more flexibility to cope with rising trial court costs. Elimination of such restrictions would enhance the ability of the counties to respond to the other demands for public services placed upon them by their residents. Accordingly, we recommend enactment of legislation to permit counties to: (1) assess fees to cover their actual costs of serving process, (2) contract with private firms to serve process, (3) use electronic recording as an alternative to shorthand reporting when the counties determine it would be appropriate and cost-effective, and (4) assess litigants for the costs of court reporters in civil trials.

FUNDING FOR STATE-MANDATED LOCAL PROGRAMS

Does the Legislature Need to Consider Changes in the Reimbursement Process?

Current statutory law (Chapter 3, Pt. 4, Div. 1, Revenue and Taxation Code), familiarly known as "SB 90", *requires* the state, under certain circumstances, to reimburse local governments for the costs of state-mandated programs. Article XIII B of the State Constitution (Proposition 4 on the November 1979 ballot) also requires the state to reimburse local governments for the costs of state-mandated programs. State reimbursement of these costs represents a significant annual expenditure. This section examines issues relating to the state's procedures for funding state-mandated local programs.

State Procedures for Reimbursing Mandated Costs

Under the existing reimbursement process, a local government may submit a claim to the State Board of Control in an attempt to obtain reimbursement for the state-mandated local costs associated with unfunded legislation. This first claim, known as a "test claim," forms the basis for the board's review. After a series of hearings and a review of documents submitted by local and state agencies, the board determines (1) if a mandate exists, (2) if the mandate is eligible for reimbursement, and (3) the amount of funding required to reimburse all local agencies for the costs incurred as a result of the mandate.

The amount of funding so determined reflects the costs incurred by all local agencies from the operative date of the mandate through the current year, which is usually a period of several years. The cost determination is based on "parameters and guidelines" developed by the board which delineate the types of costs which are eligible for reimbursement. Once adopted by the board, a report summarizing the board's findings is presented to the Legislature and a bill, known as a "claims bill," is introduced which appropriates funds sufficient to pay all claims approved by the board.

After the Legislature completes its deliberations on the claims bill and the bill is chaptered, local agencies then file "reimbursement claims" with the State Controller. The Controller disburses the funds appropriated by the Legislature to each claimant, after its claim is reviewed for consistency with the parameters and guidelines adopted by the Board of Control. In succeeding years, an appropriation for the ongoing costs associated with mandates initially funded in this manner is included in the Governor's Budget.

Legislative Action on Claims Bills

During the 1983 session, the Legislature considered two bills seeking appropriations to reimburse local governments for costs associated with what the Board of Control has deemed to be a reimbursible mandate. These bills, together with amendments requested by the board but not agreed to by the Legislature, would have provided a total of $219.7 million in funding for costs incurred by local agencies under 34 separate statutes.

As of this writing, one of these bills—SB 1274—has been chaptered. This act appropriated $157,800 for payment of claims relating to two statutes. The other claims bill, AB 504 (Vasconcellos), is still pending before the Legislature. In its current form (as amended February 13, 1984), the bill would appropriate a total of $52 million from the General Fund for payment of claims relating to 18 separate statutes.

Growth of State Mandates

Since 1975, when the state began keeping records on state-mandated local costs, approximately 2,800 bills have been enacted which contain a mandated local program. According to the Department of Finance, 108 of these bills contained an appropriation in the enabling legislation to pay for the mandated costs. In addition to the 108 bills which contained appropriations, the Board of Control has to date determined that another 52 statutes require reimbursement by the state. To date, 15 of these statutes have been funded by the Legislature.

Annual state General Fund expenditures for state-mandated costs have grown from $3.5 million in 1973–74 to an estimated $225 million in 1983–84. Table 81 details the total cost of state-mandated local programs from the inception of the program.

Table 81
State-Mandated Local Programs
Total General Fund Costs [a]
1973–74 through 1984–85
(in thousands)

	Appropriations Contained in Mandate Legislation	*Expenditures From Budget Act Appropriations*	*Claims Bills*	*Total*
1973–74	$3,538	—	—	$3,538
1974–75	2,655	$14,943	—	17,598
1975–76	1,376	17,963	—	19,339
1976–77	20,226	18,356	$523	39,105
1977–78	4,007	52,623	—	56,630
1978–79	21,443	54,434	1,203	77,080
1979–80	12,013	75,565	12,202	99,780
1980–81	9,947	105,377	7,572	122,896
1981–82	—	101,942	33,980	135,922
1982–83	610	92,886	24,183	117,679
1983–84	10,000	73,362	141,424 [b]	224,786
1984–85 [c]	—	82,042	29,550 [d]	111,592
Totals	$85,815	$689,493	$250,637	$1,025,945

[a] Includes funding from the Restitution/Indemnity Fund in 1982–83 through 1984–85 for Ch 1123/77.
[b] $157,800 of this amount has been approved by the Legislature, the remainder is pending. Does not reflect pending approval of $30 million for Ch 360/77 (liability limits).
[c] Department of Finance estimates.
[d] Pending approval by the Legislature.

Governor's Funding Proposals

Current Year. The Governor's Budget estimates that *General Fund* expenditures to reimburse local governments for mandated costs will be approximately $225 million in the current year, which includes: (1) $10 million to pay the costs of the first claims bill introduced in 1984, (2) $31 million in deficiencies from prior-year budget appropriations for mandated costs, (3) $84 million for reimbursement of the ongoing costs associated with existing mandates, and (4) $100 million for reimbursement of specific outstanding claims. This latter amount includes: (1) $21 million for AB 504, and (2) $79 million to fund two of the 13 claims which originally were recommended for payment by the Board of Control but were deleted from the bill in the Assembly. The Governor's Budget is silent regarding the $30 million appropriation in AB 504 for Ch 360/77. Assuming, however, that the administration would consent to the appropriation of these funds, approximately $130 million, or 60 percent of the $220 million originally requested by the Board of Control in 1983–84 may ultimately be provided.

Budget Year. The Governor proposes General Fund expenditures of approximately $112 million for reimbursement of mandate-related costs in the budget year. This includes: (1) $82 million for reimbursement of the continuing costs associated with existing mandates, and (2) $30 million to provide reimbursement for the ongoing costs of statutes funded for the first time in AB 504.

Expenditures for the budget year, however, could be significantly higher than the $112 million identified in the Governor's Budget, for two reasons. First, an unknown but probably major amount of funding will be required to reimburse local governments with respect to claims presently pending before the Board of Control. The board will introduce two claims bills during the 1984–85 fiscal year, one in July of 1984, and the other in January of 1985. No estimate of the amount of funds to be requested by the board in these claims bills is currently available. Second, the state could also incur additional funding liability for "prior year deficiencies." These deficiencies arise when the funding level provided for a mandate is insufficient, and an additional appropriation is needed to reimburse all local agencies with valid claims.

Governor's Proposal to Reform the Reimbursement Process

The Governor's Budget proposes two changes to the existing system for reimbursing approved state-mandated local costs. Specifically, the Governor proposes that legislation be enacted to (1) provide that mandates which are not accompanied by an appropriation shall be implemented only at the *discretion* of local agencies, and (2) allow the Controller to allocate funds to local agencies on a formula or "uniform allocation" basis, rather than on the basis of individual claims submitted by local agencies. The language to accomplish these changes is to be included in the budget companion bill, but as of this writing it was not available. Each of these proposals is discussed in more detail below.

Discretionary Mandates. The Governor's Budget proposes that legislation be enacted which provides that compliance with legislation which imposes new duties on local agencies without making an appropriation to fund the cost of carrying out those duties *shall be voluntary.* In contrast, the administration's local government finance package (SB 1300, Marks) provides that if the legislation imposes a mandate but does not appropriate an amount at least equal to the Department of Finance's statewide cost estimate, then the mandate *shall not be operative.*

Regardless of how the inconsistency between the two proposals is resolved, our analysis indicates that neither would accomplish its stated objective.

Specifically, according to Legislative Counsel, mandates cannot be made inoperative or discretionary in the manner suggested in either one of the administration's proposals. This is because the actions of one Legislature do not bind the actions of succeeding Legislatures. Any statute enacted *after* a statute making compliance with an unfunded mandate voluntary would not be bound by the earlier statute. Thus, if a subsequent bill placed a new requirement on local government but did not contain an appropriation to reimburse local government for these costs, local governments would be legally obligated to comply with the new statute, notwithstanding the previous statute making compliance voluntary.

Block Grant Funding. The Governor's Budget proposes that funding for most ongoing mandate programs be provided on a block grant basis. This would only apply to mandates which have been funded through the Budget Act for a period of several consecutive years. Presumably, this would result in funds for *individual* mandate programs being provided on an allocation formula or uniform allowance basis. The Department of Finance indicates, however, that this proposal is still being developed, and that the program ultimately proposed could be substantially different from that which is indicated by the language in the 1984 Budget Bill.

Our analysis indicates that the existing process for reimbursement of these mandates is, indeed, in need of revision. As the Governor points out, the process of developing complex procedures for computing the amount of allowable reimbursement, determining the actual amounts of costs eligible for reimbursement, and then verifying that the claimed amounts are appropriate, requires more effort than it is worth. The resources devoted to these unproductive activities could be better utilized in the delivery of services to the public at both the state and local levels. Accordingly, we endorse the thrust of the Governor's proposal and suggest that the Legislature and the administration work together to produce a new system for reimbursing local governments for such costs.

Payment options available to the Legislature range from the uniform allowance or allocation formula approach now in use for four mandates, to a broader "block grant" approach. Under the latter type of approach, all reimbursement funds for a particular type of agency might be "folded together," and allocated on the basis of population or some other variable. For example, each school district's revenue limit could be increased by the amount of its reimbursement under each of the 20 mandate programs currently funded for school districts.

In the *Analysis* (Item 9680, State-Mandated Local Programs), we recommend that the Department of Finance submit a detailed proposal for changing the funding of mandated local programs prior to the time of budget hearings, and address certain key administrative and policy issues associated with this suggested block grant approach.

Court Challenges to the Reimbursement Process

Within the past few years, several suits have been filed by local agencies against the state challenging various aspects of the existing mandated cost reimbursement process. These cases generally fall into one of two categories: (1) those challenging the authority of the Board of Control, and (2) those challenging the adequacy of the funding level provided. Several of these cases provide the courts the opportunity to significantly restructure the reimbursement process, and restrict the Legislature's ability to impose enforceable mandates. Following is a discussion of several of the cases which currently are pending and their potential impact on the reimbursement process.

Board of Control Authority. The County Supervisors Association and 38 counties have sued the state, alleging that the state has enacted 15 unfunded mandates in violation of Section 6, Article XIII B of the California Constitution. One of the more important issues in this case is whether the existing Board of Control reimbursement process provides an adequate administrative remedy for legislative mandates which are imposed without explicit provision for reimbursement. The counties contend that under Article XIII B, they may go directly to the courts to seek a remedy when mandates are imposed but reimbursement is not provided. The counties argue that the Board of Control does not have the authority to grant any relief from alleged violations of Article XIII B, and therefore it is not an administrative remedy that must be exhausted, per statutory law, prior to seeking judicial relief. A finding in favor of the counties would, in effect, shift from the Board of Control to the judicial system the responsibility for arbitrating disputes over funding for mandates. The case is currently pending in the Sacramento County Superior Court.

There have been at least four additional cases relating to 11 different statutes filed since March, 1983 which challenge the procedures used by the Board of Control when reviewing initial claims to determine if a mandate exists. Existing case law, commonly referred to as the "Topanga test," requires that findings of adjudicating boards must bridge an analytical gap between the evidence presented at an administrative hearing and the resulting decision or order of the board. In other words, the decision rendered by a board must bear a reasonable relationship to the facts and issues which were presented during the hearing. Compliance with the "Topanga test" serves several functions. Specifically, it (1) enables a reviewing court to trace and examine the decision-making board's analysis, (2) enables parties to the administrative decision to determine whether and on what basis to seek judicial review, and (3) demonstrates that the administrative decision is careful, reasoned and equitable.

In each of the 11 statutes cited in the four cases, the board found that no mandate existed. The local agencies subsequently filed suit alleging that the board's decision-making process did not meet the "Topanga test." The court found in favor of the local agencies and remanded each of the statutes to the Board of Control to be reheard.

As a result of the court's finding, the board implemented more formalized procedures, beginning at its December 1983 meeting. Specifically, the board revised its internal procedures to include sworn testimony, detailed written findings and a formal recording of all proceedings as documented by a court reporter. These changes were implemented too recently to know if they will meet the criteria of the "Topanga test." Further, it is unknown what effect, if any, these changes will have on the overall claim process. For example, the amount of time required to arrive at a determination could be increased, or these more formal proceedings could actually promote, rather than dispel, future litigation.

The significance of the court's decision, however, is not that it caused the board to change its procedures for hearing initial claims. Rather, the decision demonstrates that the court considers the board to be an adjudicating, rather than advisory body, thereby clarifying that the board's decisions are subject to judicial review.

Adequacy of Funding Level. On November 14, 1983, the City of Los Angeles filed an omnibus suit which, among other things, seeks to compel the state to pay the full costs, *as determined and approved by the Board of Control,* associated with reimbursable mandates. In this case, which relates to vocational rehabilitation (Ch 1435/74), the board found that a mandate existed, and fixed the level of reimbursement. The Legislature, however, did not provide the requested level of reimbursement. The city's suit seeks to compel the state to provide full reimbursement as determined by the board. The case raises the question as to how significant Board of Control findings are, and whether these findings can be used in court to force specific legislative action. Specifically, this case could allow the court to determine whether, through Article XIII B of the Constitution, the state can be compelled to provide funding for mandated local costs and whether the Legislature has any discretion over the level provided. This case is presently pending in the Sacramento County Superior Court.

In another case, the Sacramento County Superintendent of Schools, 84 other superintendents and the California School Boards' Association have filed a suit alleging that the Legislature has not provided a level of reimbursement sufficient to cover the full costs incurred by schools in complying with mandates relating to special education and bilingual/bicultural education. The significance of this case, again, is in the remedy being sought. The superintendents are not seeking full funding reimbursement. Instead, they are seeking a judicial declaration that absent (full) funding, a local agency need not comply with a mandate.

A finding in favor of the superintendents could reduce legislative control over the reimbursement process in two ways. First, it could establish the court's authority to determine exactly what constitutes "full" funding. Second, it could allow the court to determine what obligation, if any, there is for local agencies to comply with mandates for which full funding is not provided. The case is pending trial in Superior Court.

Recommended Changes to the Reimbursement Process

We recommend that the Legislature consider establishing a new adjudicative body to replace the State Board of Control for all matters relating to state-mandated local programs.

Our review of the existing system for reimbursing state-mandated local costs, along with our review of the number and breadth of reimbursement-related cases currently pending in court, indicates that the existing system needs to be altered. The Board of Control has functioned, since the time it was assigned its responsibility for SB 90 matters in 1979, as an *advisory* body. Its role has been to report to the Legislature its determinations as to which mandates qualify for reimbursement, and the amount of funding necessary to reimburse local agencies for carrying out these requirements. The board's approach to decision-making has not been constrained by the strict interpretation of legal issues which now appears to be necessary.

Our analysis indicates that the advisory role is no longer appropriate. Recent judicial decisions indicate that the courts will hold the board accountable to a *judicial* standard. Further, we believe that an adjudicative body's decisions would provide a better basis for legislative determinations as to its ultimate liability for reimbursement of mandates not currently funded and those not yet enacted. Such a body would, in the course of its operations, clarify many of the ambiguities which now exist as to what constitutes a mandate, and the circumstances under which reimbursement may be disclaimed. Finally, the creation of such a body might prevent the judicial system from subsuming the resolution of state-mandated local program issues within its ever-spreading jurisdiction. Accordingly, we recommend that the Legislature consider establishing an adjudicative body, along the lines of the Workers' Compensation Appeals Board, to replace the State Board of Control in all matters relating to state-mandated local programs.

FINANCING COMMUNITY REDEVELOPMENT PROJECTS

How Can the Legislature Assure that the Expenditure of State Funds for Redevelopment is Consistent with State Objectives?

Community redevelopment agencies are special districts established by local agencies, usually cities, to redevelop a community's blighted areas. Blighted areas are defined as property which suffers from economic dislocation or disuse due to faulty planning, inadequate public facilities, a high incidence of depreciated property values, impaired investments or social and economic maladjustment. Although local legislative bodies may appoint the members of the redevelopment agency's governing board, it is more common for the legislative body itself (usually a city council) to serve as the agency's governing board.

By 1981–82, local governments had created 160 redevelopment agencies, which constituted 3.2 percent of the state's 5,000 special districts. The relatively small number of redevelopment agencies, however, belies the size and scope of their financial operations. In 1981–82, redevelopment agency revenues exceeded $1.1 billion, which was 14 percent of all special district revenues. In the same year, redevelopment agencies spent over $885 million, which was slightly less than 14 percent of all special district expenditures.

As discussed in more detail below, redevelopment agencies derive most of their funding from the property taxes attributable to the *increase* in assessed valuation within project areas. Consequently, one might conclude that these agencies are supported entirely by local revenue sources. Such, however, is not the case. The state, through its General Fund, provides considerable financial support for redevelopment activities—albeit indirectly. The amount of this support, moreover, has increased rapidly in recent years. Because this support is provided indirectly, the amount of this support and the way it is used are not determined through the annual state budget process. Consequently, the Legislature should consider taking action to ensure that the amount and use of these funds are consistent with Legislative priorities.

Agency Funding Sources

Redevelopment agencies have five primary sources of revenue—tax increment revenues, bonds, other forms of long-term debt (usually loans), interest earnings and federal grants. Redevelopment agencies had been authorized to levy a 1 percent sales tax, but the statute authorizing this tax recently may have been invalidated by the First District Court of Appeals (*Huntington Park Redevelopment Agency vs. Martin,* 149 Cal. App. 3d 82). Table 82 summarizes redevelopment agencies' proceeds from each of these revenue sources and the major categories in which their expenditures fall, from 1976–77 through 1981–82.

As Table 82 indicates, not only is the scope of redevelopment agencies' activities broad; the level of these activities has grown rapidly. From 1976–77 to 1981–82, redevelopment agencies' gross revenues grew at an average annual rate of 13 percent. Tax increment revenues and interest earnings—which are redevelopment agencies' two primary sources of *operating* revenues—grew at annual rates of 21 percent and 35 percent, respectively. Gross expenditures over the same period grew at an annual rate of over 16 percent, while expenditures on current operations—project improvements, real estate purchases, administration and other operating expenses—grew at an annual rate of nearly 21 percent.

Table 82
Redevelopment Agencies
Revenue Sources and Objects of Expenditure
1976–77 through 1981–82
(in millions)

	Actual				Average Annual Change 1976–77 to 1981–82
Revenues	*1976–77*	*1979–80*	*1980–81*	*1981–82*	
Property Tax Increment	$106.6	$149.3	$205.1	$271.3	20.5%
Proceeds of Long-Term Debt	99.0	156.7	170.4	251.5	20.5
Sale of Bonds	229.2	445.5	66.1	237.8	0.7
Interest	34.0	119.6	119.2	153.2	35.1
Federal Grants	73.2	47.6	63.8	60.6	−3.2
Other	61.4	114.0	119.4	138.5	17.7
Totals	$603.4	$1,032.7	$744.0	$1,112.9	13.0%
Expenditures					
Debt Principal	$156.6	$181.2	$124.1	$222.6	7.3%
Project Improvement	67.5	315.8	162.8	150.3	17.4
Real Estate Purchases	58.7	79.9	104.5	199.7	27.7
Debt Interest	50.6	119.9	116.9	133.2	21.4
Administration	31.1	49.4	52.4	65.0	15.9
Other	49.7	59.7	107.0	116.1	18.5
Totals	$414.2	$805.9	$667.7	$886.9	16.4%
Net Income	$189.2	$226.8	$76.3	$226.0	3.6%

Source: State Controller's office

Tax Increment Financing

The most common form of funding for redevelopment agencies is property tax increment financing. After an agency is formed, the other taxing jurisdictions within the redevelopment project area (the county, cities, school districts, and other special districts) generally receive property tax revenue only from the amount of assessed valuation that existed within the project area at the time the agency was established. Property tax revenue attributable to any increase in assessed valuation subsequent to the agency's formation can be allocated to the redevelopment agency. These so-called property tax increment revenues are allocated to the redevelopment agency up to its level of certified debt, which can include bonded indebtedness, contractual agreements, payments to other agencies, or virtually any other form of financial obligation.

Although tax increment revenues constitute only about 25 percent of redevelopment agencies' revenues, these funds are far more important to the agencies. This is because the funds are used to leverage virtually all of the agencies' other revenues. Tax increment revenues are pledged to the retirement of tax allocation bonds, loans, and other debt instruments issued by the agency. This debt financing is used to support real estate acquisition, construction of public facilities, and other activities related to the redevelopment project. In 1981–82, the value of all outstanding debt issued by redevelopment agencies was nearly $2.2 billion, which represented over 20 percent of the debt issued by all special districts. Proceeds from bonds are also invested by redevelopment agencies. The yield from these investments has become a major source of operating funds for the agencies—now over $150 million per year.

State Bears Major Burden of Tax Increment

Except for a limited number of grants, the state does not support redevelopment agencies directly. The state, however, indirectly finances reedevelopment activities through the K–14 school district revenue limit apportionment mechanism. Under this mechanism, the state makes up the difference between what districts are authorized to spend by the revenue limit and what they receive in property tax revenues. Because the school districts' share of whatever growth in property taxes occurs within an agency's boundaries is allocated to the redevelopment agency, rather than to the districts, the state must allocate additional apportionment funds to the school districts to replace these foregone revenues. We estimate that in 1982–83, the state spent *$87.8 million* to replace the school districts' share of tax increment revenues.

Redevelopment agencies have argued that the state would have had to pay this amount anyway, because the assessed valuation growth that occurs in redevelopment project areas results primarily from the agencies' activities. This is partially true, because redevelopment agencies are indeed directly responsible for considerable growth in assessed valuation within project areas. Some of this growth, however, is due to inflationary adjustments and reassessments triggered by changes in ownership, which would have occurred even in the absence of a redevelopment project. Hence, the indirect cost to the state of supporting redevelopment agencies is equal to the school districts' share of tax increment revenues associated with assessed valuation growth that would have occurred without redevelopment activities. While we do not know what this amount is, it clearly is a substantial sum.

Table 83 shows that tax increment revenues received by redevelopment agencies more than doubled in the three years between 1979–80 and 1982–83, as did the school districts' share of the tax increment. This rapid rate of growth (over 30 percent annually) is not unexpected, because redevelopment agencies receive *all* of the property tax growth that occurs within existing project areas, and because they have usually been able to expand project areas by amending their redevelopment plans.

Table 83
Growth in Tax Increment Revenues
1979–80 through 1982–83
(in millions)

	1979–80	*1980–81*	*1981–82*	*1982–83*[a]
Total revenues	$149.3	$205.1	$271.3	$329.0
K–14 districts' share	39.7	54.6	72.2	87.8

Source: State Controller's office, Board of Equalization.
[a] The figures for 1979–80 through 1981–82 are actual revenues. The figure for 1982–83 is tax increment *levies* only. Levies exclude interest, penalties, delinquencies, and allocations from prior year levies. The 1982–83 figure probably understates by a considerable margin actual tax increment revenues.

Tax Increment Burden On Local Agencies

The balance of the tax increment financing, in effect, comes from cities, counties, and special districts. Cities, however, are the major direct beneficiary of redevelopment activity. These benefits come in the form of increased employment and retail trade within the project area, as well as the effect that the improved overall attractiveness and utility of the project area has on business and commerce in other areas of the city.

Redevelopment law has established two mechanisms to alleviate the financial burden caused by tax increment financing on local agencies:

1. Proposed redevelopment plans must be submitted to a fiscal review committee for review and comment. The committee consists of representatives from each of the local taxing jurisdictions affected by the proposal to establish tax increment financing.

2. Redevelopment agencies are authorized to make payments to local agencies to alleviate the effect of serious "financial detriment," as determined by the fiscal review committee, due to tax increment financing. The term "financial detriment" is not defined in current law.

It is not clear, however, how effective these mechanisms are in alleviating the burden that tax increment financing places on all affected entities. On the one hand, the structure of the fiscal committees does not appear to provide counties and special districts with much leverage on the development of redevelopment project plans. Committee members only have the power to advise the redevelopment agency of the detrimental effects that a proposed project would have, and they generally do not have sufficient information to adequately assess these effects. Counties and special districts have no authority to seek changes in a plan to ameliorate detrimental effects or to address other unmet needs. Fiscal review committees also have no authority to review proposed amendments to existing redevelopment plans, even though the amendments often are as significant as the proposals to adopt new plans.

On the other hand, while the financial detriment payments may alleviate the burden for some affected entities, they may *increase* the burden on others. To the extent, for example, that a payment is made to the county (perhaps as part of a negotiated settlement calling for the county to discontinue its efforts to block the establishment of a new agency or the expansion of an existing one), it increases the redevelopment agency's level of certified debt and consequently allows it to increase the amount of the tax increment it may claim. This will work to the further financial detriment of school districts—and therefore, to the state.

Use of Tax Increment Revenues for Purposes Other Than Redevelopment

The rehabilitation of blighted urban areas is an objective that serves both state and local interests. In recent years, however, some redevelopment agencies have served essentially as agencies of city governments, providing services that traditionally have been considered city responsibilities and providing capital that traditionally has been raised through the issuance of general obligation bonds.

For example, some redevelopment agencies have used tax increment revenues to secure indebtedness issued for the purpose of developing vacant and agricultural land, instead of rehabilitating blighted developed property. In certain extreme examples, redevelopment project areas consist almost exclusively of vacant property. In other cases, redevelopment agencies are using tax increment revenues to build freeway interchanges and support the ongoing maintenance and operation of *existing* public facilities, including buildings and even roads.

Cities concede that certain redevelopment activities do not serve the original objective which the agencies were created to achieve. They argue, however, that their existing general purpose revenues are inadequate to support the operation and maintenance of existing municipal facilities, necessitating the use of tax increment revenues for such purposes. They also argue that redevelopment projects are the only practical means available to cities to finance needed public facilities, infrastructure and maintenance, given the restrictions imposed by Proposition 13.

Legislature Needs to Reform Redevelopment System

We recommend that the Legislature enact legislation to reform the redevelopment plan adoption process, restrict the uses of tax increment revenues and limit the state's contribution to redevelopment projects.

We acknowledge the difficulties involved in issuing general obligation bonds, given Proposition 13's restrictions, and elsewhere in these pages we recommend that the voters be asked to approve a constitutional amendment relaxing these restrictions. Nevertheless, we see two defects in the cities' rationale for extending the use of tax increment financing beyond the traditional—and legitimate—use of rehabilitating blighted areas. First, it ignores the fact that both charter and general law cities are authorized by state law and the constitution to impose general purpose taxes with a simple majority vote of their legislative bodies. Given this flexibility, it seems inappropriate for cities to use tax increment revenues for operation and maintenance of existing facilities, especially when the activities are not directly related to the redevelopment of blighted areas.

Second, and more importantly, the current structure and operation of redevelopment agencies, in effect, requires the state to contribute major sums of *state* funds to achieve *local* objectives other than those which they originally were set up to achieve. In addition, redevelopment agencies, through tax increment financing, can dictate the amount of support provided by the state.

In order to assure that the state's interest is protected, we recommend enactment of legislation that would reform the redevelopment plan adoption process, restrict the uses of tax increment revenues, and limit the state's contribution. Specifically, this legislation should:

- Strengthen and clarify the responsibilities of the fiscal review committees;
- Prohibit the use of tax increment revenues to support traditional city services not directly related to the rehabilitation of blighted neighborhoods;
- Place limitations on the duration of redevelopment projects;
- Restrict the inclusion of vacant land in redevelopment project areas; and
- Limit the amount of tax increment available to redevelopment agencies to the growth in property tax revenues directly attributable to redevelopment project activities. At a minimum, legislation should require school districts, rather than redevelopment agencies, to receive their share of the assessed valuation growth resulting from the 2 percent inflationary adjustment allowed under Proposition 13.

THE SUPPLEMENTAL PROPERTY TAX

Should the Legislature Take Steps to Improve the Administration of the Supplemental Property Tax?

The cost of the various education reform programs enacted in SB 813 (Ch 498/83) was supported in part by the establishment of a supplemental property tax administered by county governments. The purpose of the supplemental tax program is to accelerate the collection of property tax increases caused by changes in ownership that occur, or new construction that is completed, on or after July 1, 1983.

At the time that SB 813 was enacted, it was estimated that this acceleration would yield additional property tax revenues of $272 million in 1983–84 and $444 million in 1984–85. SB 813 allocated all of these revenues, (also referred to as "floating lien date" funds) to K–12 school districts in 1983–84 and 1984–85, thereby reducing the General Fund cost of state aid provided to those districts by the amount of the supplemental property tax revenues. Beginning in 1985–86, the act provides that the supplemental revenues will be allocated to all local governments through the regular property tax allocation mechanism.

Following the passage of SB 813, the Legislature enacted AB 399 (Ch

1102/83), which made a variety of technical changes to SB 813 and established a mechanism to fund the counties' costs of administering the supplemental property tax program.

The supplemental property tax has a prominent role in the Governor's proposal for restructuring local government finance. Specifically, the Governor has proposed to allocate the supplemental property tax through the regular property tax mechanism in 1984–85 (one year earlier than required under current law), and to replace the schools' revenue losses in the budget year with increased General Fund aid.

Obviously, the attractiveness of this proposal to local governments and its fiscal impact on the state depend on how much revenue counties can be expected to collect in 1984–85. After reviewing the counties' progress in implementing the supplemental property tax, we have reached the following conclusions:

- Counties estimate that 1983–84 supplemental property tax *levies* will be about $50 million less than the amount assumed in the Governor's Budget;
- Supplemental property tax *collections* in 1983–84 probably will be substantially less than the amount assumed in the budget, resulting in a major unfunded current-year deficit in state aid to K–12 schools;
- If the counties' estimate of 1983–84 supplemental revenues is reliable, then the Governor's Budget probably overestimates 1984–85 revenues from this source by a significant amount.
- The Legislature needs to clarify whether redevelopment agencies are entitled to a share of supplemental property tax revenues.
- The amount of potentially reimbursable costs that counties will incur for administering the supplemental property tax is probably more than the amount of funds made available in AB 399 to cover those costs.

Property Tax Provisions of SB 813 and AB 399

Reassessment Prior to SB 813

Under the provisions of Proposition 13 (June 1978), increases in assessed valuation generally are restricted to increases in the cost of living, not to exceed 2 percent annually. Property which is newly constructed or changes ownership, however, is reassessed at its full market value as of the date the property is completed or transfered. Prior to SB 813, the county assessor did not conduct the reassessment until the first lien date (March 1) following the transfer or completion of contruction. The new assessed valuation became effective on the first day of the fiscal year following the lien date (July 1). Hence, under prior law, properties were subject to higher assessments no sooner than 4 months and as much as 16 months after the event which triggered the reassessment occurred.

How the Supplemental Property Tax Works

SB 813 established a "floating lien date" for reassessing property. Except for builders' inventories, property is now reassessed on the first day of the month following the date on which a transfer occurs or new construction is completed. The supplemental property tax has four major components: (1) making supplemental assessments, (2) determining supplemental tax liabilities, (3) billing and collecting taxes, and (4) allocating revenues to local agencies.

Step 1: Supplemental Assessments. SB 813 requires county assessors to prepare two supplemental assessment rolls in addition to the regular assessment roll—one for the current fiscal year and one for the upcoming fiscal year. Properties which change ownership or are newly constructed between March 1 and May 31 are placed on *both* supplemental rolls, because these transfers "missed" the lien date for the upcoming fiscal year. The first supplemental assessment equals the difference between the property's full market value as of the date of transfer or completion and the assessed value entered on the current roll. The second supplemental assessment equals the difference between full market value and the value entered on the roll being prepared. Properties which change ownership or are newly constructed between June 1 and February 28 are placed on the supplemental roll for the *current* year only. The supplemental assessment on these properties equals the difference between full market value as of the date of transfer or completion and the value entered on the current roll.

Step 2: Calculating Supplemental Tax Bills. After the deadline for claiming an exemption has expired (30 days after the assessor notifies the property owner that a supplemental assessment has been made), the assessor turns over the supplemental assessment rolls to the county auditor, who prepares the supplemental tax rolls. The tax liability on the supplemental assessment for the upcoming fiscal year equals the supplemental assessment for that year times the tax rate for the upcoming fiscal year. The tax liability on the supplemental assessment roll for the current year equals the supplemental assessment for that year, times the current tax rate, times a proration factor based on the number of months remaining in the fiscal year.

Step 3: Billing and Collecting Taxes. After preparing the supplemental tax roll, the auditor gives it to the county tax collector, who prepares and sends supplemental tax bills to the property owner. Supplemental bills for the current year are sent immediately, while supplemental bills for the upcoming fiscal year are combined with the property owner's regular tax bill.

Step 4: Allocating Revenues. After the tax collector receives payments on the supplemental tax bills, the county auditor deducts from the portion of the revenue attributable to the regular (1 percent) property tax levy an amount to cover the county's administrative costs. Under current law, the balance is allocated in 1983–84 and 1984–85 to each K–12 school district in the county in proportion to the district's average daily attendance. After 1984–85, these funds will be allocated through the regular property tax apportionment process. (That portion of the revenues attributable to the tax rate above 1 percent is allocated to various accounts used to retire voter-approved debt.)

Reimbursement of County Administrative Costs

SB 813 imposes major costs on county assessors, auditors, tax collectors and data processing departments to implement and administer the supplemental property tax. SB 813 itself provided no funds for county administrative costs. AB 399, however, authorized each county, prior to allocating revenues to school districts and debt accounts, to deduct from the supplemental property tax revenues it collects in 1983–84 and 1984–85 an amount to cover its administrative costs, not to exceed 5 percent of all the revenues collected, including debt levies. AB 399 also appropriated $10 million from the General Fund to reimburse counties for administrative costs in 1983–84 that exceed the amount that can be funded from the counties' share of the supplemental property tax.

Implementation Progress to Date

County Progress Varies Considerably

Shortly after SB 813 was enacted, forty-two county assessors filed suit against the state in San Francisco Superior Court (*Shafer* v. *State Board of Equalization*). The assessors have asked the court to invalidate the supplemental property tax primarily on constitutional grounds. First, the assessors have asserted that the supplemental property tax is a new ad valorem tax on real property which violates the prohibition on such taxes added to the constitution by Proposition 13. Second, the assessors have argued that the provisions of SB 813 exempting builders' inventories and trade fixtures from supplemental assessment are unconstitutional because classes of property may be exempted from property taxation only by constitutional provisions, not by statute. (A third cause of action—that SB 813 imposed an unfunded mandated program on counties, in violation of Article XIII B, Section 6—was dropped when AB 399 provided a funding source to defray the counties' costs for administering the tax.) As of February 1, 1984, the case had not yet been heard in court.

In spite of the lawsuit, it appears that every county has taken some steps toward implementing the tax. The progress made by individual counties to date, however, varies considerably.

By February 1, 1984, approximately one-half of the counties had sent out notices of supplemental assessment to owners of property that had debt accounts. The amount that would be allocated to school districts is $53.2 million less than the amount indicated in the budget. Any shortfall in such revenues would be reflected as an unfunded current-year deficit in state aid for K–12 school districts.

Collections Are Expected to Lag Behind Estimates. All of the figures displayed in Table 84 are estimates of *accrued revenues*—that is, taxes owed because of events that occur in each fiscal year. Because it is difficult to predict when counties will send out tax bills, there are no reliable estimates of actual *tax collections* in 1983–84. Collections probably will be *substantially less* than accrued revenues, because of the delays that counties have experienced in making supplemental assessments and collecting supplemental taxes. We estimate that actual collections could be as much as $150 to $200 million less than the estimate of accrued revenues contained in the budget. Because state aid to K–12 districts is calculated on the basis of property taxes *actually allocated* to school districts, a delay in collecting supplemental property taxes beyond June 30, 1984 would result in *increased* state aid to schools in 1983–84 and *decreased* state aid in 1984–85.

The budget estimates that these accrued revenues in 1984–85 will total approximately $500 million. Of this amount, $444 million would be allocated to various local agencies and the remaining $56 million would be allocated to debt accounts, as indicated in Table 84. Counties have not yet prepared their own estimate of 1984–85 revenues. If the counties' estimate of 1983–84 revenues is reliable, however, then the budget probably overestimates 1984–85 revenues.

Supplemental property tax *collections* in 1984–85 will be less than tax *levies*, because of delinquencies and delays in making assessments, billing taxpayers and collecting taxes. The shortfall in collections, however, will probably be less than the shortfall in the current year. This is because counties will be processing supplemental assessments and tax bills more quickly in 1984–85 than in the current year.

County Administrative Costs Could Exceed AB 399 Funding

On January 15, 1984, 47 counties submitted claims to the Board of Equalization for reimbursement of 1983–84 administrative costs which exceed 5 percent of 1983–84 supplemental tax revenues. These counties estimated total 1983–84 administrative costs of approximately $17.9 million. Based on discussions with Los Angeles, Santa Clara and San Francisco Counties, which did not file claims, we estimate that total county administrative costs will be about $22 million in the current year. This amounts to 7.1 percent of the 1983–84 supplemental revenues estimated by the Board of Equalization, and 8.8 percent of the revenues estimated by counties. About one-half of this amount will be funded from the 5 percent property tax allocation.

Under the claiming guidelines developed by the Department of Finance, the 47 counties will be required to support $10.9 million of these costs from the proceeds of the supplemental property tax. The remaining $11.1 million would be supported by funds appropriated in AB 399. Since the act appropriated only $10 million for this purpose, available funds probably will be prorated among certified claims. AB 399, however, permits counties to charge unpaid 1983–84 claims against 1984–85 supplemental property tax revenues.

In 1984–85, administrative costs for most counties will decline relative to supplemental tax revenues. This is because most counties will no longer incur one-time implementation costs, especially for modification of their data processing systems, and because 1984–85 supplemental tax levies will be larger than 1983–84 levies. There will be some exceptions, however. Several counties have deferred major modifications of their data processing systems until 1984–85 and will incur higher costs than they are incurring in 1983–84.

Even though counties' administrative costs will decline relative to supplemental tax revenues in 1984–85, it appears that the costs incurred by many smaller counties will exceed the funding currently available under AB 399. For example, in the current year, 18 counties have reported administrative costs in excess of 20 percent of tax levies. Although these counties' costs probably will decline in 1984–85 relative to tax revenues, their costs will exceed 5 percent of revenues in most cases. Any costs not supported by the counties' share of supplemental property tax revenues are potentially state-reimbursable.

Under the Governor's proposal, counties would receive, in addition to 5 percent of supplemental tax revenues, a portion of the remainder based on the regular property tax apportionment formulas. These funds could be used to support any county costs that exceed the amount available from AB 399.

Redevelopment Role Needs Clarification

We recommend that the Legislature clarify whether redevelopment agencies are entitled to a share of supplemental property tax revenues.

When a redevelopment agency is formed under current law, the other taxing jurisdictions within the redevelopment project area receive property tax revenue only from the amount of assessed valuation that existed in the project area prior to the agency's formation. Subsequent property tax revenue growth is allocated to the redevelopment agency.

The language of SB 813 is not sufficiently clear on the question of whether redevelopment agencies are entitled to the supplemental property tax levied on property within redevelopment project areas. Although current law does not distinguish supplemental property taxes from ordinary tax increment revenues, the Governor's Budget assumes that redevelopment agencies will *not* receive any supplemental revenues. This may not be a reasonable assumption. County auditors might be compelled to allocate to redevelopment agencies their share of the supplemental revenues. If all redevelopment agencies received these revenues, the amount remaining for allocation to all other agencies would be reduced by $19 million in 1983–84 and by $31 million in 1984–85.

Because of the magnitude of this potential revenue shift and because the ambiguity in SB 813 may result in different policies among the counties, the law should be clarified. We therefore recommend that the Legislature enact legislation specifying the allocation of supplemental property taxes levied in redevelopment project areas.

Legislative Control of the Budget

COLLECTIVE BARGAINING FOR STATE EMPLOYEES

What Role Does the Legislature Wish to Play in the Collective Bargaining Process?

Background

In 1983–84, the second round of collective bargaining negotiations took place within the framework established by the State Employer-Employee Relations Act (SEERA) and the Higher Education Employer-Employee Relations Act (HEERA).

In our *Analysis of the 1982–83 Budget Bill* (page B-44) and *The 1983–84 Budget: Perspectives and Issues* (page 185), we provided: (1) a detailed description of the bargaining process for state employees, (2) an analysis of what happened during the first year of collective bargaining, and (3) a number of recommendations intended to help the Legislature play a more meaningful role in the collective bargaining system. This year, our discussion of collective bargaining focuses on:

- The current status of collective bargaining within state government (1983–84), including the status of employees falling under SEERA and HEERA;
- The results of the second round of negotiations; and
- The Legislature's role in the collective bargaining process.

Employees Affected by Collective Bargaining

As Table 85 shows, most state civil service and related employees are now represented in collective bargaining with regard to the terms and conditions of their employment. Over 82 percent, or 112,890, of the state's 136,988 full-time employees have been assigned to bargaining units. The remaining 24,098 employees are not subject to collective bargaining, due to: (1) their responsibilities as managerial, supervisory or confidential employees, or (2) specific exemptions granted by law to (a) the staff of those 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.

Decisions regarding the terms and conditions of employment for those employees who are not covered by a collective bargaining agreement are made as follows:

- The Governor, through the DPA, proposes changes in existing conditions of employment for nonrepresented civil service and related employees.

Table 85
State Civil Service and Related Employees
Status Under the State Employer-Employee Relations Act (SEERA)
1983–84

Category	*Estimated Personnel-Years (As of July 1, 1983)* *Number*	*Percent*
Employees in bargaining units	112,890	82.4%
Employees not subject to bargaining:		
Managerial and supervisory	19,216	14.0
Confidential	1,356	1.0
Excluded specifically by SEERA	1,933	1.4
Statutory officers and exempt employees not in bargaining units	1,593	1.2
Total (excluding legislative staff)	136,988	100.0%

- The University of California (UC) Regents and California State University (CSU) Trustees propose such changes for UC and CSU non-represented employees, respectively.
- The Legislature then acts on the proposals, either:
  —Through the normal budget bill process (for provisions which require an appropriation), or
  —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 employees of the Legislature. Compensation increases for these employees are set by the Legislature, outside of the process established by SEERA.

State Employees Covered Under SEERA. The PERB has designated 20 separate bargaining units for state civil service and related employees. The exclusive bargaining representatives of these units have negotiated agreements on behalf of their members for each of the past two years. Table 86 shows the distribution of state civil service employees among bargaining units and the status of the memorandum of understanding (MOU) covering each unit. The table shows that:

- The vast majority of MOUs (17 out of 20) will expire at the end of 1983–84. Of the remaining three MOUs, two (units 8 and 18) will be operative until the end of 1984–85, and one (unit 13) will be in effect until the end of 1985–86.
- Almost one-half of the state civil service and related employees in bargaining units are part of either the administrative, financial and staff services group (unit 1) or the office and allied occupational group (unit 4).
- Ten of the 20 bargaining units, which cover two-thirds of those employees subject to bargaining, have the California State Employees' Association (CSEA) as their exclusive representative.

Table 86
Distribution of State Civil Service and Related Employees Among Bargaining Units and Current MOU Status 1983–84

Unit Number	Occupational Group	Estimated Personnel-Years As of July 1983 Number	Percent	Exclusive Representative	Term of Current MOU
1	Administrative, Financial and Staff Services	22,132	19.6%	California State Employees' Association (CSEA)	7-1-82 to 6-30-84
2	Attorney & Hearing Officer	1,858	1.6	Association of California State Attorneys, Inc.	7-1-82 to 6-30-84
3	Education and Library	2,044	1.8	CSEA	7-1-82 to 6-30-84
4	Office and Allied	29,770	26.4	CSEA	7-1-82 to 6-30-84
5	Highway Patrol	4,469	4.0	California Association of Highway Patrolmen	7-1-83 to 6-30-84
6	Corrections	7,271	6.4	California Correctional Officers Association	7-1-83 to 6-30-84
7	Protective Services and Public Safety	4,424	3.9	Coalition of Associations and Unions of State Employees	7-1-82 to 6-30-84
8	Firefighter	2,795	2.5	California Department of Forestry, Employees' Association	7-1-83 to 6-30-85
9	Professional Engineer	4,630	4.1	Professional Engineers in California Government	7-1-83 to 6-30-84
10	Professional Scientific	1,462	1.3	CSEA	7-1-82 to 6-30-84
11	Engineering and Scientific Technicians	2,731	2.4	CSEA	7-1-82 to 6-30-84
12	Craft and Maintenance	9,018	8.0	CSEA	7-1-82 to 6-30-84
13	Stationary Engineer	512	0.5	International Union of Operating Engineers, Stationary Engineers' Division	7-1-83 to 6-30-86
14	Printing Trades	685	0.6	CSEA	7-1-82 to 6-30-84
15	Custodial and Services	5,452	4.8	CSEA	7-1-82 to 6-30-84
16	Physician, Dentist and Podiatrist	802	0.7	Union of American Physicians and Dentists	5-1-83 to 6-30-84
17	Registered Nurse	1,570	1.4	CSEA	7-1-82 to 6-30-84
18	Psychiatric Technicians	7,000	6.2	Communication Workers of America, Psych Tech Union	7-1-82 to 6-30-85
19	Health and Social Services/Professional	3,000	2.7	American Federation of State County and Municipal Employees	7-1-82 to 6-30-84
20	Medical and Social Services/Support	1,265	1.1	CSEA	7-1-82 to 6-30-84
	Totals	112,890	100.0%		

California State University. The PERB has designated nine separate bargaining units for CSU employees. Exclusive representatives have been selected for each of these units. Table 87 shows the distribution of CSU employees among bargaining units and the effective period for each unit's current MOU. The table indicates that seven agreements cover both the current and budget years, while the remaining two agreements (for units 1 and 3) will expire at the end of 1985–86.

Table 87
Distribution of CSU Employees Among Bargaining Units and Current MOU Status
1983–84

Unit Number	*Occupational Group*	*Employees Number*[a]	*Employees Percent*	*Exclusive Representative*	*Term of Current MOU*
1	Physicians	139	0.4%	Union of American Physicians and Dentists	7-1-83 to 6-30-86
2	Health Care Support	399	1.2	California State Employees' Association (CSEA)	7-1-83 to 6-30-85
3	Faculty	19,690	58.0	Congress of Faculty Association	8-16-83 to 6-30-86[b]
4	Academic Support	1,357	4.0	United Professors of California	9-16-83 to 6-30-85[b]
5	Operations Support Services	1,966	5.8	CSEA	7-1-83 to 6-30-85
6	Skilled Crafts	782	2.3	State Employees Trades Council	7-1-83 to 6-30-85
7	Clerical Support	7,162	21.1	CSEA	7-1-83 to 6-30-85
8	Police	183	0.5	State University Police Association	9-16-83 to 6-30-85[b]
9	Technical Support Services	2,271	6.7	CSEA	7-1-83 to 6-30-85
	TOTALS	33,949	100.0%		

[a] Source: California State University
[b] Salary and benefit provisions effective July 1, 1983

University of California. Table 88 highlights the status of collective bargaining for UC employees. The table indicates that there are 26 bargaining units for UC employees, structured as follows: 8 are systemwide, 10 are confined to individual campuses, 4 are lab units, 3 are health-care units, and 1 unit (number 7) consists of printing trade employees working at three printing plants in the UC system. UC has filed a lawsuit challenging in the court the designation of unit 26, the house staff employees. UC questions whether the hospital interns and residents that comprise this unit qualify as employees under HEERA.

Contrary to the status of collective bargaining in state civil service and within the CSU system, exclusive representatives for 15 of these units were just selected during the past year, and most units are either just starting or still in the midst of negotiations with UC management regarding the terms of the initial MOUs. Eight of the 26 units have opted for no representation, and the question of representation for one unit is, as yet, undecided.

The HEERA provides that faculty units can be formed on either a single statewide basis or divisional units of the academic senate. The faculty employees at UC Berkeley and UCLA each voted for *no* representation in elections conducted by PERB. The only UC faculty that has opted for representation is one consisting of 267 members at the Santa Cruz campus. UC faculty employees at other campuses, estimated to number about 3,500, have not petitioned the PERB for an election.

Fiscal Impact of the MOUs In Effect During 1983–84

In order to identify the fiscal impact of the MOUs in effect during the current year, we asked the DPA and CSU to provide us with (1) a detailed cost accounting of all provisions of the MOUs to which they are a party and (2) detailed information on the cost of each new benefit provided to employees *not* covered by the collective bargaining process in 1983–84. We also asked DPA and CSU to designate whether each benefit required a new appropriation of funds or was considered "absorbable" within existing appropriations. Finally, we asked UC officials to provide us with information on what employee compensation adjustments were provided to their employees.

Based on our review of the information submitted by the Department of Finance (DOF), the DPA, CSU, and UC, we believe that 1983–84 employee compensation provisions can be divided into three fiscal categories:

- Provisions which received direct appropriations within the *1983* Budget Act;
- Provisions which will require *additional* (or incremental) funding from the *1984–85* budget; and
- Provisions considered by the administration to be *absorbable* within the current-year appropriations.

Provisions Having a Direct Fiscal Effect. In the 1983 Budget Act, the Legislature appropriated $338.8 million from all funds ($212.1 million from the General Fund) to finance employee compensation increases in 1983–84. The major provisions in this category provide for:

- A 6 percent salary increase, effective January 1, 1984.
- Continuation for six months of the $50 (or $100) reduction in the employee's contribution to the Public Employees' Retirement System (PERS) and the University of California Retirement System (UCRS).

Table 88
Distribution of UC Employees Among Bargaining Units And MOU Status
1983–84

Unit Number	Type	Occupational Group	Employees As of July 1, 1983 Number	Employees As of July 1, 1983 Percent	Exclusive Representative	MOU Status
1	Systemwide	Police	192	0.4%	Statewide University Police Associations	Currently in Negotiations
2	Campus	Faculty (Santa Cruz)	267	0.6	Faculty Association UC Santa Cruz	Effective July 1, 1983 to June 30, 1984
3	Lab	Lawrence Livermore National Laboratory (LLNL) Skilled Crafts	261	0.5	No Representation	Not Applicable
4	Campus	UC Berkeley/Lawrence Berkeley Skilled Crafts	222	0.5	Alameda County Building Trades Council	Currently in Negotiations
5	Campus	UC San Francisco Skilled Crafts	71	0.1	San Francisco Building Trades Council	Currently in Negotiations
6	Campus	UCLA Skilled Crafts	309	0.6	International Union of Operating Engineers (IUOE), Local 501	Currently in Negotiations
7	Printing Plants	Printing Trades	100	0.2	Printing Trades Alliance	Currently in Negotiations
8	Lab	LLNL Technical	1,653	3.5	No Representation	Not Applicable
9	Systemwide	Technical	4,083	8.5	No Representation	Not Applicable
10	Lab	LLNL Service	494	1.0	No Representation	Not Applicable
11	Systemwide	Service	6,320	13.2	American Federation of State, County and Municipal Employees (AFSCME)	Currently in Negotiations

12	Systemwide	Clerical and Allied Services	18,538	38.7	AFSCME	Currently in Negotiations
13	Health Care	Patient Care—Technical	3,914	8.2	AFSCME	Currently in Negotiations
14	Health Care	Residual Patient Care—Professional	1,462	3.1	No Representation	Not Applicable
15	Health Care	Registered Nurses	4,005	8.4	California Nurses Association	Currently in Negotiations
16	Lab	LLNL Professional Scientists and Engineers	3,205	6.7	No Representation	Not Applicable
17	Systemwide	Professional Librarians	381	0.8	American Federation of Teachers (AFT)	Currently in Negotiations
18	Systemwide	Nonacademic Senate Instructional	1,877	3.9	(AFT)	Currently in Negotiations
19	Systemwide	Research and Allied Professionals	Undetermined	—	Undecided	Not Applicable
20	Campus	UC Riverside Skilled Crafts	39	0.1	IUOE, Local 501	Currently in Negotiations
21	Campus	UC Irvine Skilled Crafts	81	0.2	IUOE, Local 501	Currently in Negotiations
22	Campus	UC Santa Barbara Skilled Crafts	49	0.1	IUOE, Local 501	Currently in Negotiations
23	Campus	UC Davis Skilled Crafts	205	0.4	No Representation	Not Applicable
24	Campus	UC San Diego Skilled Crafts	126	0.3	IUOE, Local 501	Currently in Negotiations
25	Campus	UC Santa Cruz Skilled Crafts	23	—[a]	AFSCME	Currently in Negotiations
26	Systemwide	House Staff Employees	Undetermined	—	No Representation	Not Applicable
	Total		47,877[b]	100.0%		

[a] Less than 0.05 percent.

[b] Does not include employees of either: Unit 19, whose membership would probably total less than 8,000 employees; or the employees of 8 faculty units (all campuses except for Santa Cruz), comprised of approximately 7,000 employees, which either have opted for no representation or have not petitioned the PERB for an election.

Table 89

1983–84 Employee Compensation Cost Provisions
1983–84 and 1984–85 Fiscal Impacts
All Funds
(in thousands)

	Civil Service and Related			*California State University*			*University of California*			*Total, All Employees*		
Provisions	*1983–84 Costs*	*1984–85 Costs*	*1984–85 Increment*	*1983–84 Costs*	*1984–85 Costs*	*1984–85 Increment*	*1983–84 Costs*	*1984–85 Costs*	*1984–85 Increment*	*1983–84 Costs*	*1984–85 Costs*	*1984–85 Increment*
General salary increase (6%)	$119,807	$239,614	$119,807	$27,415	$55,815	$28,400	$29,449	$58,898	$29,449	$176,671	$354,327	$177,656
Retirement offset	36,853	—	−36,853	7,521	—	−7,521	4,678	—	−4,678	49,052	—	−49,052
Special salary adjustments	7,161	28,645	21,484	1,350	2,400	1,050	1,333	5,332	3,999	9,844	36,377	26,533
Health insurance	44,480	44,480	—	3,386	3,386	—	12,140	13,870	1,730	60,006	61,736	1,730
Dental insurance	7,120	7,120	—	1,690	1,690	—	2,000	2,000	—	10,810	10,810	—
Shift differential	193	193	—	—	—	—	—	—	—	193	193	—
Work week group modification	800	1,600	800	—	—	—	—	—	—	800	1,600	800
Professional proficiency compensation	2,212	—	−2,212	—	—	—	—	—	—	2,212	—	−2,212
Health and welfare	300	300	—	—	—	—	—	—	—	300	300	—
Life insurance	177	707	530	—	—	—	—	—	—	177	707	530
Unfunded merit salary adjustments and faculty promotions	—	—	—	4,250 [a]	4,250 [a]	—	—	—	—	4,250	4,250	—
Other benefits	1,500	—	−1,500	1,911 [a]	1,349 [a]	−562	—	—	—	3,411	1,349	−2,062
Totals	$220,603	$322,659	$102,056	$47,523	$68,890	$21,367	$49,600	$80,100	$30,500	$317,726	$471,649	$153,923

[a] The 1983–84 costs of the (1) "Unfunded MSAs and Faculty Promotions" and (2) "Other Benefits" total $6.2 million. The 1984–85 cost of these two 1983–84 provisions is $5.6 million. Of the $5.6 million, the Governor proposes to fund only $1.1 million, leaving $4.5 million in unfunded costs for 1984–85.

- Special salary realignments and adjustments for specified classes of employees.
- An increase to maintain the state's percentage contributions toward the cost of employee health insurance premiums.
- An increase in the state's contributions for the employee dental care program.

Table 89 summarizes the fiscal impact of the employee compensation package in 1983–84, by type of employee. The table shows that the provisions will cost $317.7 million in 1983–84, which is $21.1 million, or 6.2 percent, less than the amount provided in the 1983 Budget Act. DOF officials maintain that the $317.7 million in identified expenditures represents the department's best estimate of the costs of the employee compensation package for civil service, UC, and CSU employees. Further adjustments may be needed, since the cost estimates are being refined.

Additional Costs of 1983–84 Provisions. Our review of the 1983–84 MOUs and cost estimates provided by the DPA, Department of Finance, UC, and CSU indicates that *the full-year cost of 1983–84 employee compensation increases is far greater than the amount allocated from the 1983 Budget Act appropriations.* These costs will be fully reflected in the 1984–85 budget. Costs will increase in the budget year because many salary and benefit increases provided in 1983–84 became effective *after* the start of the fiscal year. Thus, the *annualized* costs of these benefit increases greatly exceed current-year funding requirements.

For example, most state employees received a 6 percent salary increase, effective January 1, 1984. The total state cost of this provision in *1983–84,* as shown in Table 89, is $176.7 million. The full-year or annualized cost of this increase, as reflected in the budget for 1984–85, will be $354.3 million —double the amount provided in 1983–84. This annualized cost is shown in Table 89 in the column labeled "1984–85 Costs". The *additional* 1984–85 cost of providing the 6 percent salary increase is $177.7 million, as shown in Table 89 under "1984–85 Increment".

Table 89 shows that the cost of *all* 1983–84 provisions in fiscal year 1984–85 (that is, the "annualized" costs) will total $472 million. This is $154 million more than the amount allocated for employee compensation in 1983–84. Our review of the Governor's Budget for 1984–85 reveals that virtually all of the funds needed to cover the annualized costs of the 1983–84 employee compensation provisions have been included in the 1984–85 *baseline budgets* of departments. As a result, the additional incremental costs of these provisions are somewhat hidden from legislative review. We discuss the fiscal impact of "annualization" in greater detail in our review of the Governor's employee compensation proposal (See Item 9800 of the *Analysis*).

Provisions Considered Absorbable Within Existing Appropriations. As we pointed out in last year's *Perspectives and Issues* (p. 191), no money is specifically appropriated by the Legislature or allocated by the administration to fund those provisions of the employee compensation packages that impose costs which are considered to be "absorbable." The determination of what is and what is not "absorbable" is made by the administration through the fund allocation process.

The fact that a cost is deemed to be absorbable, however, does not mean that it is negligible or minor. It simply means that funding for the cost will not be provided to the department or agency. The department or agency, however, *will* have to find a way to fund the cost. Generally, it does so by redirecting funds from other activities, perhaps including those specifically approved by the Legislature, in order to finance the expenditure required by the MOU.

Our review of the employee compensation packages indicates that various provisions of the 1983 agreements will require the expenditure of $33.9 million in 1983–84 to cover costs for which no funds were specifically appropriated. This $33.9 million is on top of the $317.7 million in expenditures that *were* funded in the 1983 Budget Act.

Table 90 summarizes these "absorbable" costs for civil service and related employees, as identified by the DPA and the Department of Finance. CSU officials maintain that their employee compensation packages contain no provisions which will result in identifiable "absorbable" costs. (UC has completed only one MOU to date, and this MOU has no provisions with *fiscal* impact.) As Table 90 indicates, the employee benefit provision that results in the greatest "absorbable" costs is the one requiring merit salary adjustments ($28.8 million).

Table 90
Employee Compensation Costs "Absorbed" by State Agencies in 1983–84 Civil Service and Related Employees (in thousands)

Provisions	*Covered by MOUs*	*Not Covered by MOUs*	*Totals*
Merit salary adjustments	$24,014	$4,736	$28,750
Realignments	1,576	—	1,576
Adjustment of vacation accruals	947	—	947
Work week changes	556	—	556
Training	500	—	500
Professional fees	345	137	482
Uniform allowances	275	—	275
Safety equipment	213	—	213
Special pay	158	—	158
Pay differential	149	—	149
Increase in mileage rate	75	—	75
Bereavement leave	65	—	65
Special programs	60	—	60
Overtime	40	—	40
Counseling	29	—	29
Miscellaneous	57	—	57
Totals	$29,059	$4,873	$33,932

1983–84 Fiscal Effect Summary. Our analysis indicates that collective bargaining agreements signed in 1983–84, along with the compensation package for noncovered employees, resulted in ongoing costs of approximately $505.5 million (all funds)—$317.7 million in 1983–84 costs covered by a Budget Act appropriation, $153.9 million in 1984–85 incremental costs due to "annualization," and $33.9 million in "absorbable" costs (where the administration provided no allocations to fund the provisions).

Role of the Legislature in Collective Bargaining Under SEERA

At the present time, the Legislature has three main functions relevant to the process for setting the terms and conditions of state employment. First, the Legislature has an *oversight* role with regard to SEERA. As it gains experience with the act, the Legislature may choose to make changes in the law in order to increase its effectiveness.

Second, the Legislature considers legislation which affects the terms and conditions of state employment. In some cases, this legislation is needed to implement the provisions of a negotiated agreement (for example, under SEERA, the Legislature must implement any negotiated changes in retirement benefits). In other cases, the legislation may make *unilateral* changes in employee benefits, wages, and working conditions, even though these issues are bargainable and could be left to the parties to resolve at the bargaining table.

Finally, and most importantly, under SEERA, the Legislature must approve those provisions of MOUs that require the expenditure of funds. This responsibility was written into SEERA by the Legislature, presumably to maintain its control over expenditures, even while it delegates to the Governor the responsibility for reaching agreements with the exclusive representatives of state workers.

Legislative Review of MOU Provisions to Date

During the first two years in which bargaining took place under SEERA —1982 and 1983—the Legislature was not given an opportunity to conduct a meaningful review of MOUs prior to approving them. In fact, not one of the MOUs signed in either year was available to the Legislature or its staff for review prior to when the Legislature had to grant its approval in order for the agreements to take effect as scheduled. In some cases, MOUs were approved on the basis of a one-page summary of what the administration maintained were the major fiscal provisions.

Under these circumstances, the Legislature's ability to maintain control over state expenditures, as well as over the terms and conditions of state employment, is a far cry from what may have been intended by the Legislature when it enacted SEERA. In short, the approval of MOU provisions, as required by SEERA, has become a pro forma exercise.

To the extent the Legislature is *not* able to undertake a meaningful review of the MOUs, it will encounter a number of problems in performing its oversight and control functions. Specifically, without adequate legislative review:

- ***The Full Costs of the MOUs May Not Be Identified.*** For example, subsequent to legislative approval of the current contract covering the California Department of Forestry Employees' Association, we found that the contract provides for more than 1000 California Department of Forestry employees to receive a 7.5 percent salary increase during *non*fire mission periods. Despite its $800,000 price tag in 1983–84, this provision was *never brought* to the Legislature's attention before the MOU was approved. Full implementation of this provision in 1984–85 will cost $1,600,000.
- ***"Absorbable" Costs May Be Funded At The Expense of Legislative Priorities.*** As mentioned earlier, state agencies were required to "absorb" $34 million in costs resulting from MOUs negotiated for the 1983–84 fiscal year. MOUs negotiated for 1982–83 required state agencies to absorb $61 million in costs. Clearly, costs of this magnitude cannot be "absorbed" without cutting back agency activities in other areas. Consequently, it is likely that in order to absorb these costs, some agencies were forced to reduce activities *below* the levels funded by the Legislature. In other words, the benefits agreed to by the administration may come at the expense of *legislative* priorities.
- ***The Legislature Will Have No Opportunity to Compare the Provisions of MOUs for Consistency.*** To the extent the MOUs approved by the Legislature provide some employees with benefits that are not provided to employees in other units, state programs may be disrupted and the Legislature may find itself the target of criticism from the employees who come up short.
- ***The Legislature Will Have No Chance to Review Long-term Commitments Which It Will Be Expected to Fund in Future Years.*** Without copies of the MOUs and enough time to complete an adequate review, the Legislature has been asked to approve (and has approved) contracts which call for special adjustments to base salaries paid some employees costing more than $150 million, beginning in the *second* year of the contract.
- ***Finally, and Most Obviously, the Legislature Will Not Be Able to Confirm That the Costs of MOUs Fall Within the Amount Appropriated for Employee Compensation.*** During the past two years, the Legislature could assess the consistency of MOUs with the amount appropriated for employee compensation only *after*-the-fact.

What Role Does the Legislature Want to Play in the Bargaining Process?

These problems, and others like them, will continue to arise year-after-year if the Legislature's opportunity to review—not just approve—MOUs is cut short. These problems can be overcome or minimized if the Legislature wishes. Before addressing these problems, however, we believe the Legislature needs to make a basic policy decision as to what role it wants to play in the collective bargaining process.

The Legislature may wish to limit its role simply to controlling total expenditures in the budget year. If this is the role it wishes to play, the employee compensation item in the Budget Bill provides a reasonably effective means for doing so. This does not mean, however, that the Legislature should not consider making some changes in the existing collective bargaining process at the margin. If the Legislature chooses to play a more limited role in the process, it could, for instance, eliminate the requirement in SEERA that it approve *specific* provisions of MOUs.

If, instead, the Legislature wishes either to approve the *specific* provisions of MOUs—the role apparently envisioned at the time SEERA was enacted—or to control total expenditures *beyond* the budget year, far more dramatic changes in the existing process will have to be made. The current structure simply does not provide the Legislature with an opportunity to exercise these powers in a meaningful way.

This is a basic policy decision that the Legislature will have to make and it depends on:

- The confidence the Legislature has in this and future administrations to perform the role delegated to the Governor in an acceptable manner;
- The time the Legislature is willing to devote to the negotiating process;
- The extent to which the Legislature wants to be involved with the specific features of negotiated settlements; and
- The Legislature's willingness to set deadlines for the completion of negotiations and make them stick.

Alternatives to the Current Process

If the Legislature wishes to play a more active role in the bargaining process or address some of the problems identified above, there are a number of alternatives to the current system that it can consider. These alternatives can be divided into two categories: (1) those that retain the existing system, and (2) those that would make major changes in the existing system. None of these approaches, however, represents an absolute solution to the problems which have been identified.

First, these are several options which simply modify the *existing* collective bargaining process:

- ***Legislative Monitoring of Negotiations.*** The leaders of the Legislature could designate representatives to attend negotiations involving state employees. This would prevent last-minute surprises when the MOUs are presented to the Legislature.
- ***Require MOUs to Be Submitted by May 15.*** The Legislature, of course, would have a greater opportunity to consider and act upon the provisions of MOUs if they were available for review as part of the budget process. As the experience of other states has demonstrated, however, it is difficult to compel the parties to conclude negotiations by a fixed date if "late" decisions will still be considered by the Legislature. In the case of a May 15 deadline, the parties undoubtedly would recognize that most important budgetary decisions are made by the budget conference committee at a later date.
- ***Require MOUs to Be Submitted by June 30, and Become Effective October 1.*** If this alternative were adopted, legislative staff would have time to review the agreements during the summer recess and the Legislature could then consider and approve them in late August or September. Again, however, the problem of compelling compliance with an arbitrary deadline would remain.
- ***Provide Legislative Guidance at an Earlier Date.*** A joint committee could—through a resolution—provide the parties with a sense of legislative priorities on personnel needs and personnel policy for the upcoming year.

If, however, the legislature feels that the problems with the process are more serious, it could consider the following major changes to the collective bargaining structure:

- ***Delay the Onset of Bargaining Until the Amount Available for Enhancing Employees Wages, Benefits, and Working Conditions Has Been Decided.*** In this case, negotiations would occur during the fall—*after* an amount for employee compensation has been determined. The effective date of the new MOUs would also be delayed, giving the Legislature an opportunity to review and approve the MOUs when it reconvenes in January.
- ***Require Bargaining to Begin in the Fall and Conclude Before the Budget Process Begins.*** In this case, the amount of funds needed to implement the agreements could be included in the Governor's Budget in January. This would allow full legislative review and approval of the MOUs *prior* to the start of the new fiscal year.
- ***Fund MOUs Through Special Legislation.*** This alternative would enable the use of legislative committees to review the terms of negotiated settlements. The specific terms, however, would have to be available for legislative review. The legislatures in New York and Massachusetts use this approach.
- ***Create a Special Joint Committee.*** The committee would moni-

tor negotiations and/or review and approve MOUs. This approach, which would probably require the most legislative involvement in the bargaining process, is similar to that taken by the legislatures in Wisconsin and Minnesota.

In summary, our review of the Legislature's experience with collective bargaining during the first two rounds of negotiations has convinced us that the Legislature currently has the worst of all worlds. It has the statutory duty to approve the individual provisions of MOUs but does not have either the information or time needed to make the approval process meaningful. As a result, the Legislature is unable to exercise the control and oversight functions apparently envisioned by the drafters of SEERA, yet it may find itself held accountable for the specific features of individual MOUs that it has "approved".

While the Legislature has various alternatives for extricating itself from this bind, the first step must be to decide what kind of a role it wants to play in collective bargaining.

THE NEED FOR BETTER BUDGET INFORMATION

How can the Legislature Improve the Fiscal Information on Which it Depends for Making Informed Decisions on the Budget?

Our review of the fiscal information which traditionally has been presented to the Legislature indicates that certain improvements are needed in the timing, accuracy and comprehensiveness of this information. The Legislature must have good information on the state's economy, state revenues, and state expenditures in order to do an effective job in exercising its control of the state's budget. Our analysis indicates that these improvements are most needed in the area of fiscal forecasting, and can be achieved without a significant increase in cost.

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 at specified points in time during each fiscal year.

It is important that the Legislature have the most *current* and *accurate* picture possible of the state's fiscal situation in order to manage the budget in an effective manner. In last year's *Perspectives and Issues,* we identified a number of deficiencies in the state's current approach to fiscal forecasting, and recommended that certain statutory reporting requirements be enacted in order to remove these deficiencies. To date, no action has been taken either by the Legislature or the Department of Finance (DOF) in response to these recommendations.

Accordingly, we again recommend the enactment of legislation requiring the DOF, which has the leadership role in the budget process, to provide specified fiscal data to the Legislature. Specifically, we recommend that the DOF be statutorily required to do the following:

- ***Submit Periodic Fiscal Updates.*** The DOF should be required to provide estimates of General Fund revenues, expenditures, and surplus, at those points in time when updated information is needed for purposes of legislative decision-making or fiscal planning. Specifically, we believe updates should be submitted in January (Governor's Budget), March/April, May/June (May Revision), August, and November. These updates should also include revisions to the revenue estimates for the major sources of *special fund revenue* (such as vehicle-related fees and tidelands oil and gas revenues). Each update should reflect any significant fiscal developments which have occurred since the preceeding update such as changed economic conditions, legislation, court decisions, federal budget decisions, revised case load assumptions, and technical reestimates.
- ***Provide Explanations for Revisions in Fiscal Forecasts.*** The DOF should be required to itemize all factors responsible for significant changes in its estimate of the General Fund surplus, including economic factors, cash-flow factors, legislation, court cases, and so forth. It should also publish in the Governor's Budget each year a reconciliation table which documents the changes in the estimate of prior and current year General Fund surplus which have occurred since the previous year's budget.
- ***Indicate the Degree of Uncertainty Surrounding Fiscal Estimates.*** The DOF should be required to publish information on the degree of uncertainty surrounding its estimates of General Fund revenues, expenditures, and surplus, taking into account both economic forecasting uncertainties and error margins associated with statistical estimating techniques.
- ***Provide Alternative Fiscal Forecasts.*** The DOF should be required to publish, along with its regular fiscal estimates, fiscal estimates for alternative economic scenarios which the department and other economic forecasters feel have a reasonable likelihood of occurring.
- ***Publish Long-Term Fiscal Projections.*** The DOF should be required to publish, at least twice each year (in January and May), a projection of General Fund revenues, expenditures and surplus, and of special fund revenues, for *four years beyond* the budget year.

A detailed discussion of the basis for these recommended reporting requirements may be found on pages 204 through 206 of our 1983–84 *Perspectives and Issues.*

The reason why legislation to improve fiscal reporting is desirable is not that the DOF is unwilling to improve the fiscal information which it produces; indeed, the DOF has, itself, initiated a number of improvements in recent years. However, in the absence of a statutory obligation to upgrade the quality and frequency of its fiscal reports, there is no assurance that the DOF will adequately address all of the existing deficiencies on a continuing basis. Consider, for example, what happended during 1983:

- In April, the DOF revised downward its General Fund revenue estimates for 1982–83 and 1983–84 by a combined total of about $185 million. These reestimates, however, were *not* reflected in the DOF April General Fund surplus estimates.
- In October, the State Controller issued his preliminary estimate of the ending General Fund balance for 1982–83. This estimate—which had the effect of increasing the projected end-of-year surplus by several hundred million dollars—subsequently was published by the State Treasurer in October. The Legislature, however, was not formally notified of this significant change in the state's fiscal outlook until mid-December, when the DOF's report on 1983 financial legislation was published.
- Although the DOF stated in July 1981 that it would provide a complete fiscal forecast revision each November which would, among other things, take account of changed economic conditions (plus other factors) affecting revenues and expenditures, the department's revision for November 1983 was never released to the Legislature. Instead the department's reports to the Legislature continued to reflect the economic assumptions adopted in June 1983 right up to the publication of the Governor's Budget for 1984–85, even though these assumptions were over half-a-year old.
- The department also stated in July 1981 that it would provide, each year in the Governor's Budget, a projection of total and major categories of revenues and expenditures for two years beyond the budget year. This was done in 1982–83. These projections are absent, however, from both the 1983–84 and 1984–85 Governor's Budgets.
- Until 1984–85, the Governor's Budget has always included a table (labeled Schedule 1-A) which reconciles changes between the current and prior budget estimates of the General Fund's prior and current year surplus position. The 1984–85 Governor's Budget does not include this information.

To avoid situations such as these in the future, we believe it would be in the Legislature's best interest to require, through the enactment of legislation, any improvements it desires in the fiscal forecasting process.

Bank and Corporation Tax Forecasting Needs Study

We recommend that the Legislature adopt supplemental language directing the Department of Finance to conduct a thorough review of the

procedures which it uses to forecast bank and corporation tax revenues, and that it report the findings of this review to the Legislature by October 1, 1984.

Probably the single most difficult state revenue source to predict accurately is the bank and corporation tax. This is due to a variety of factors, including the inherent volatility of corporate profits, the complex prepayment patterns which firms use to remit funds to the state, the lengthy time lags before actual data on corporate profits become available, and recent federal law changes which have distorted the historical relationships between U.S. and California profits.

In forecasting California taxable profits, the Department of Finance utilizes several approaches. The first approach is to survey California's corporations to determine their profits in the most recent calendar year—in this case the 1983 calendar year. This is done because actual data on California profits in 1983 will not be available until later in 1984, when tax return data are available. The second approach involves the use of statistical multiple regression relationships between the past behavior of California profits and certain economic variables such as national corporate profits, state personal income and state taxable sales. These relationships are then applied to the forecast for these variables in order to project taxable profits in 1983, 1984, and 1985. Because each of these two procedures gives a different estimate of corporate profits for 1983, the department has to reconcile the two results and decide upon a single figure. It then uses the regression-based results to predict profits for 1984 and 1985, working from the 1983 figures selected as a base.

We believe that the department needs to conduct a thorough review of the procedures it uses to forecast the bank and corporation tax. There are several reasons why this should be done.

- *First,* the profit survey approach needs to be thoroughly evaluated in order to assess its usefulness and to identify how it might be improved. During the past several years, a number of problems regarding the sample have come to light. Although the department has gotten a relatively good response rate, the coverage of the survey is too small to provide a reliable measure of corporate profits in California. Moreover, the department has never "tracked" the actual profit performance of responding companies in order to determine how accurate the predictions of these companies are. Our review indicates that the survey responses need to be "validated." The department also needs to reevaluate the manner in which it conducts the survey, giving special attention to how firms are selected for the sample, and how much weight should be given to different categories of firms by industry type and firm size. The department may find that there are ways to improve the survey and its usefulness in forecasting revenue, or alternatively, that the resources spent conducting the survey could be better utilized in other ways.

- *Second,* the department has found that the data on California profits published by the Franchise Tax Board (FTB) are not always consistent with the level of profits implied by the actual bank and corporation tax collections. This is a potentially serious problem, because the FTB profits data provide the historical data used in the department's forecasting equations. If the data are wrong, then the resulting profits forecasts also will be wrong. In our judgment, the department needs to determine whether steps can be taken to reconcile these two types of data.
- *Third,* the relationship between U.S. profits and California profits has changed in recent years, due to the federal tax law changes cited earlier. Because the level of national profits is an important variable used in forecasting California profits (especially in light of unitary taxation), the department needs to review and restructure its state-national profits equations.

We believe that the department's review of its bank and corporation tax forecasting methodology should be conducted as a part of its normal fiscal forecasting responsibilities, utilizing existing resources. Accordingly, we recommend adoption of the following supplemental report language:

"The Department of Finance shall conduct a review of the methodology it uses to project bank and corporation tax revenues and report its findings to the Legislature by October 1, 1984. This review shall include (1) an analysis of the department's annual corporate profits survey, including its statistical reliability, steps which can be taken to improve the survey, and whether the costs of conducting the survey are justified, (2) an analysis and reconciliation of the differences between the profit data collected by the Franchise Tax Board and the profit data implied by actual cash revenue collections, and (3) an analysis of how the historical relationship between national and state profits has changed due to federal law changes, and how this change can best be incorporated into the department's revenue estimating models."

COURT RULINGS OVERTURN STATE BUDGET DECISIONS

What is the Impact of Recent Court Rulings on Policy and Funding Decisions Made by the Legislature?

A number of major court decisions issued since legislative action on the 1983 Budget Act was completed have had an adverse impact on the budget. These court decisions, and others like them in previous years, have two important implications for legislative control and priority setting. First, these decisions highlight the difficulties that the Legislature has in setting priorities through the budget and making these priorities stick during the course of the fiscal year. Second, these decisions make it difficult—sometimes very difficult—for the Legislature to control overall state expenditures.

The two problems tend to reinforce each other. To the extent the courts do not allow the Legislature to cut what it considers to be low-priority expenditures, the Legislature may have to reduce higher priority expenditures or, in some cases, raise taxes.

Recent Court Decisions Have Increased State Costs

Our review indicates that court decisions handed down since legislative action on the 1983 Budget Act was completed have increased General Fund costs by $42.1 million in 1983–84, and will further increase General Fund costs by $64.1 million in 1984–85. Table 91 displays the impact of these decisions.

Table 91
Increased General Fund Costs
Due to Court Decisions and Settlements
1983–84 and 1984–85
(in millions)

	1983–84	*1984–85*
I. Medi-Cal		
1. *Committee to Defend Reproductive Rights v. Rank*—payment for abortions	$15.7	—
2. *Beltran v. Myers*—property transfers	4.1	$7.6
3. *Lynch v. Rank*-effect of Social Security increases	1.5	1.3
4. *Lopez v. Heckler*—disability determinations on eligibility	0.7	4.3
Subtotal, Medi-Cal	$22.0	$13.2
II. Welfare		
1. *Lopez v. Heckler*—SSI/SSP disability determination	$0.8	$4.2
2. *Wright v. Woods*-AFDC retroactive supplemental benefits	—	20.4
3. *Wood v. Woods*—AFDC stepparent income	—	7.9
4. *Zapata v. Woods*—AFDC eligibility to children on SSI/SSP	5.8	1.3
5. *Miller v. Deukmejian*—AFDC emergency regulations	4.2	—
6. *Community Services for the Disabled v. Woods*—IHSS protective supervision by housemates	8.8	16.6
7. *Angus v. Woods*—AFDC collection of overpayments	—	0.5
Subtotal, Welfare	$19.6	$50.9
III. Judicial		
1. *Olson v. Cory*—interest on judges' back pay	$0.5	—
Totals	$42.1	$64.1

Excluded from the figures in Table 91 are the costs of those decisions which (1) find the state liable for personal injuries or property damage; (2) award attorney fees; (3) became final prior to July 1, 1983, even though these decisions also resulted in ongoing General Fund costs; (4) are under appeal; or (5) result in costs the magnitude of which is unknown (although possibly substantial).

Medi-Cal. The program area most affected by court decisions during the *current year* is Medi-Cal. A series of court decisions will increase General Fund costs under the Medi-Cal program by $22.0 million in 1983–84, and by $13.2 million in 1984–85.

These decisions (1) required the state to fund abortions for Medi-Cal recipients, despite limitations on these expenditures adopted by the Legislature in the 1983 Budget Act (*Committee v. Rank*); (2) ordered the state to reimburse Medi-Cal recipients who were penalized for transferring property to other individuals in order to qualify for Medi-Cal (*Beltran v. Myers*); (3) required the state to identify individuals disqualified from SSI/SSP because of social security benefit increases, and notify them that they may continue to be eligible for Medi-Cal benefits (*Lynch v. Rank*).

The court's decision in the *Lopez v. Heckler* case has increased General Fund costs under both the SSI/SSP program and Medi-Cal. This ruling prohibited the federal government from discontinuing payments to SSI/SSP recipients as a result of changes in disability criteria used in the program. Because SSI/SSP recipients are automatically eligible for Medi-Cal, the ruling also restores Medi-Cal benefits for these individuals. The decision will increase General Fund costs for both programs by a total of $1.5 million in 1983–84 and $8.5 million in 1984–85.

Welfare. Six other decisions affecting the AFDC, SSI/SSP, and In-Home Supportive Services programs will increase General Fund costs by $18.8 million in the current year and by $46.7 million in the budget year. In these cases, the courts (1) required the state to reimburse certain AFDC recipients denied supplemental payments between 1976 and 1981 (*Wright v. Woods*); (2) prohibited the state from automatically including stepparent income as part of the welfare family's income, without regard to other factors, in determining eligibility (*Wood v. Woods*); (3) required the state to provide AFDC benefits to needy parents or other relatives who are caring for children receiving SSI/SSP payments (*Zapata v. Woods*); (4) delayed implementation of emergency regulations affecting the beginning date for AFDC payments (*Miller v. Deukmejian*); (5) required the state to pay housemates for protective supervision they provide to aged, blind, or disabled individuals, regardless of their relationship to the individuals (*Community Services for the Disabled v. Woods*); and (6) required the state to consider the financial circumstances of AFDC recipients when reducing grants in order to collect previous overpayments. The decision further required the state to pay retroactive benefits to persons whose payments were reduced between 1977 and 1981 (*Angus v. Woods*).

Judicial. On December 30, 1983, the state Supreme Court ordered the state to pay judges elected before 1980, interest on the back pay they were awarded by the 1980 *Olson v. Cory* decision. (Chapter 1183, Statutes of 1976, limited judges' annual cost-of-living increases to 5 percent. The

1980 decision declared Chapter 1183 unconstitutional, and ordered the state to pay those judges back wages.)

Court Decisions Reduce the Legislature's Control Over State Spending

In summary, court rulings can have a significant effect on the policy and funding decisions made by the Legislature. As we indicated in last year's *Perspectives and Issues* (p. 203), decisions handed down after enactment of the 1982 Budget Bill imposed a net cost of $431.1 million on the General Fund in 1982–83. The second-year effect of many of those cases, plus the decisions handed down after the 1983 Budget Act was chaptered, have increased 1983–84 expenditures by an estimated $98 million. Clearly, these decisions not only reduce the Legislature's control over state spending but constrain its ability to achieve its priorities in the budget process.

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