California Legislature

THE 1984-85 BUDGET: PERSPECTIVES AND ISSUES

Report of the Legislative Analyst

to the

Joint Legislative Budget Committee

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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

Part One

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)

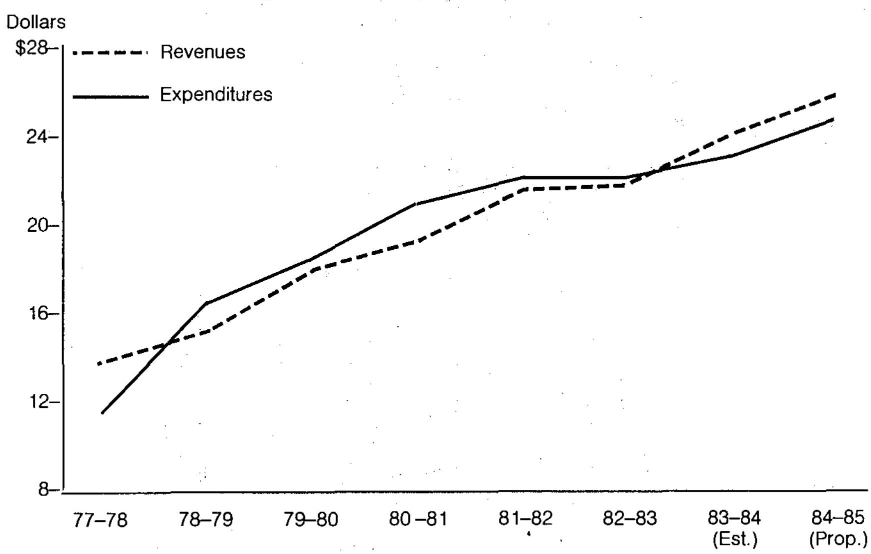

Table 1
Trend in General Fund Revenues, Expenditures and the Surplus [a]
1975–76 through 1984–85
(in millions)

	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

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)

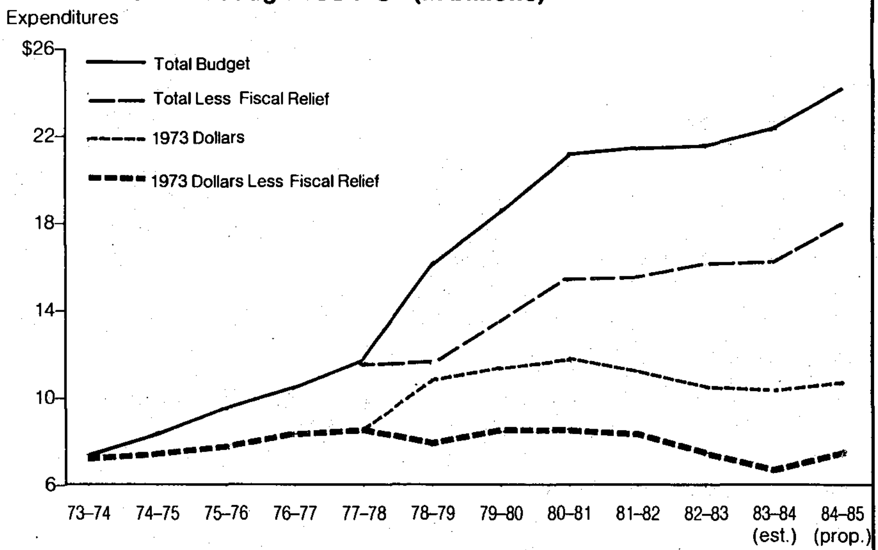


Chart 2 and Table 6 show the expenditure trend since 1973–74, both for the General Fund and for General Fund expenditures *excluding* local fiscal relief. The latter category depicts the trend for "traditional" state expenditures of the type that comprised total General Fund expenditures

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	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

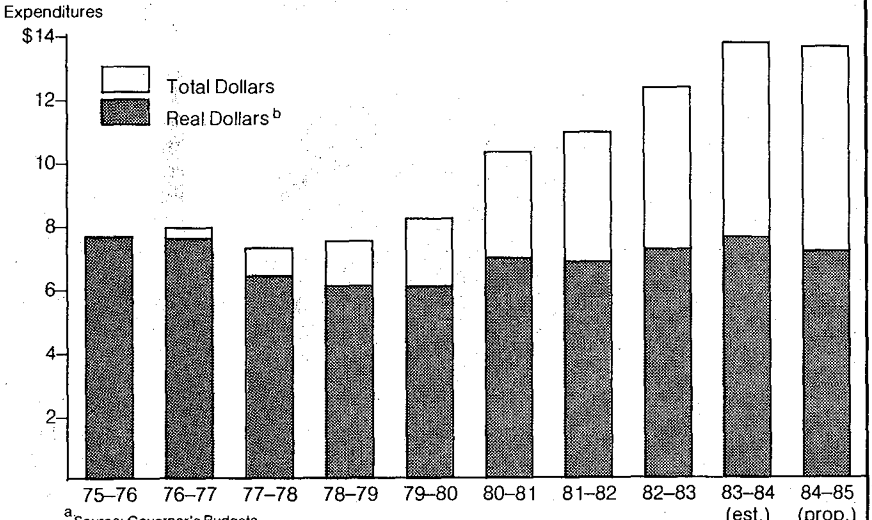
[a] Funds flowing through the state's budget. An additional $75 million was allocated to California and flowed directly to local entities.
[b] Includes $38.9 million for UI administration.

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.

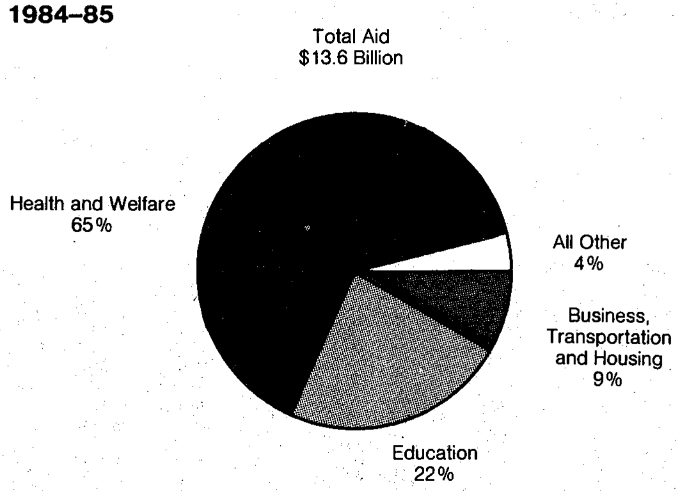
Federal Support of State Programs

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

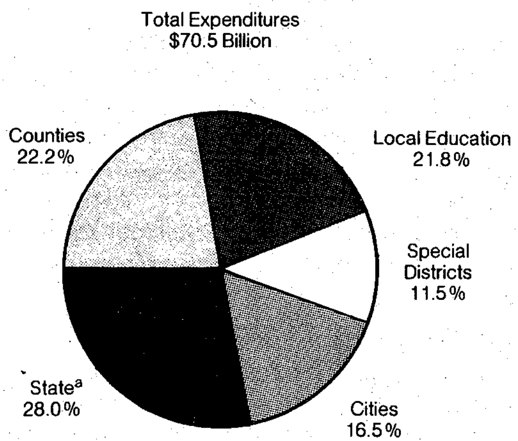
**Federal Aid to the State of California
Support of Budget Activities, by Program
1984–85
(in millions)[a]**

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.

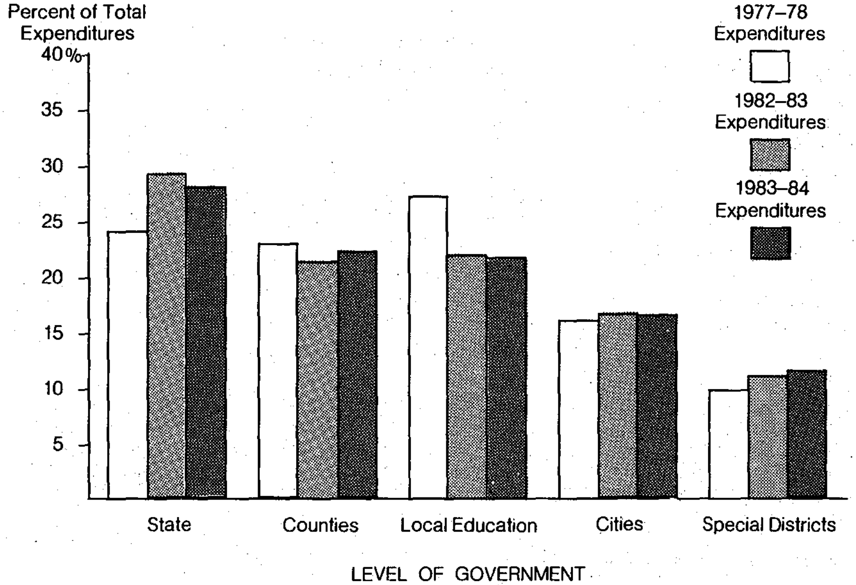
Current Year Spending. In the current year, expenditures for all services provided by state and local governments in California are expected to total approximately $71 billion. This amount consists of approximately $20 billion in net state expenditures (that is, state expenditures net of funds provided 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)

General Fund	*Actual[b] 1982–83*	*Estimated 1983–84 Amount*	*Estimated 1983–84 Percent Change*	*Proposed 1984–85 Amount*	*Proposed 1984–85 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.

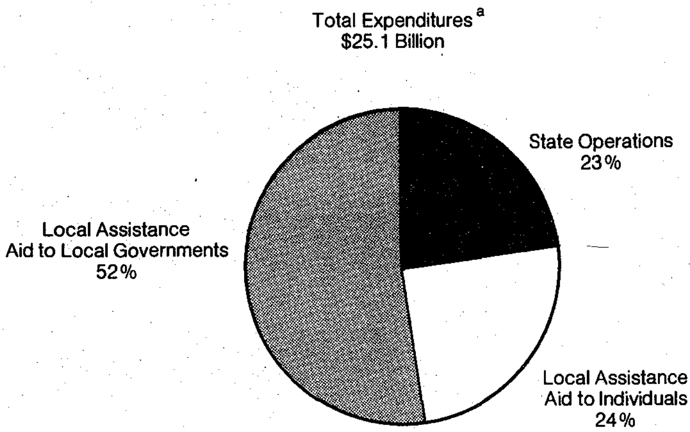
MAJOR COMPONENTS OF THE STATE BUDGET

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

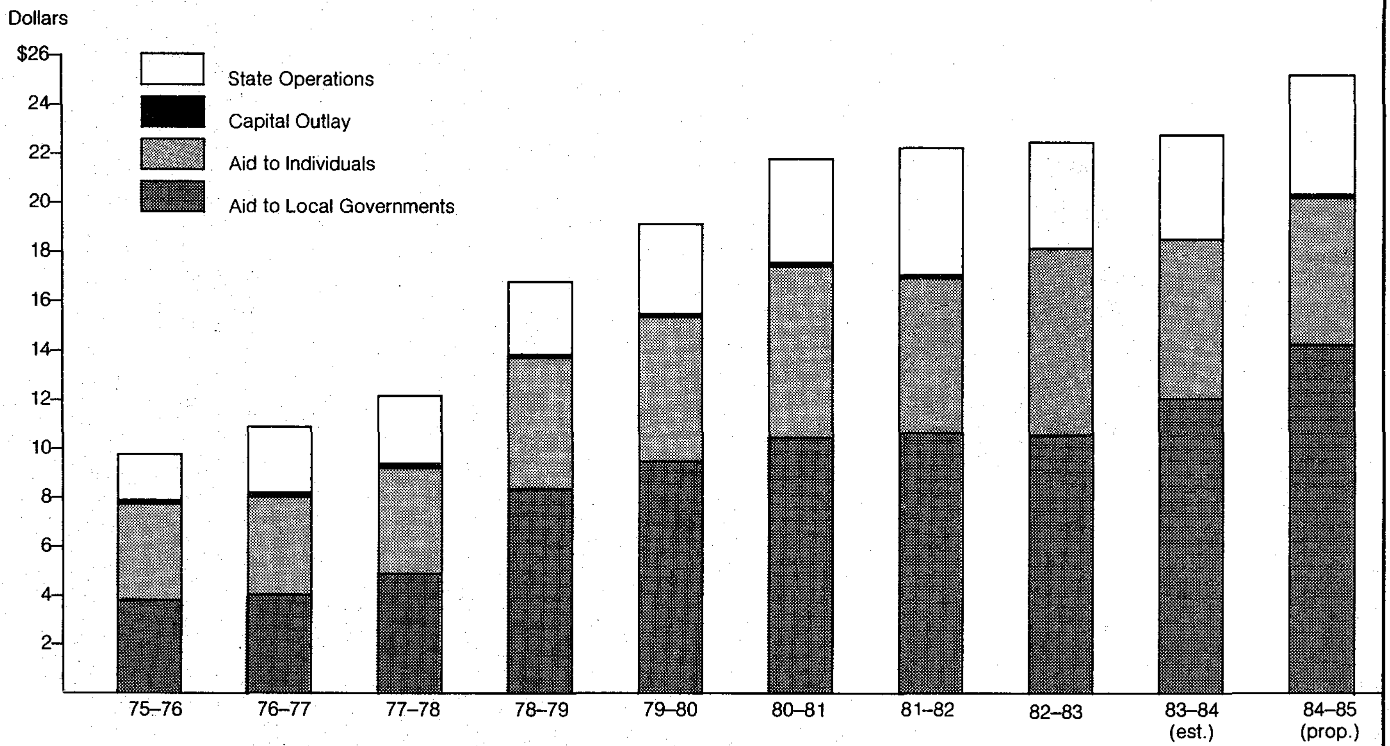
The budget proposes an increase of $976.4 million, or 21 percent, from the General Fund for state operations expenditures in 1984–85. As shown in Chart 8, General Fund expenditures for state operations will have increased by $3,412 million, or 149 percent, during the ten years from 1975–76 through 1984–85.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

						1984–85	
	1979–80	*1980–81*	*1981–82*	*1982–83*	*1983–84*	*Current Law* [a]	*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

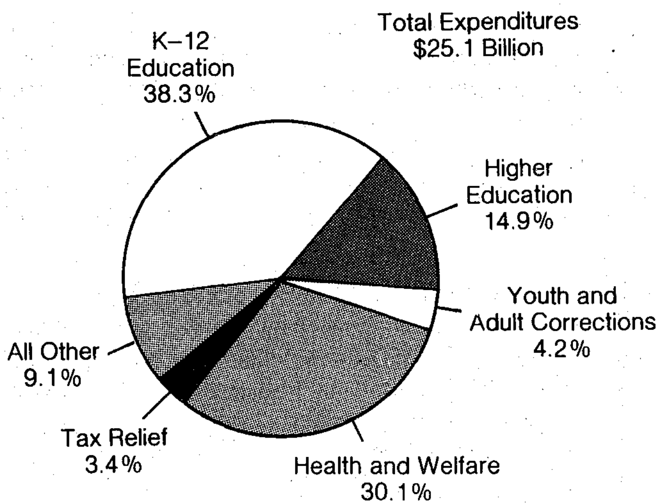


Table 19
Expenditures for Health, Welfare, and Education
As a Percent of Total General Fund Expenditures
1984–85
(in millions) [a]

	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)

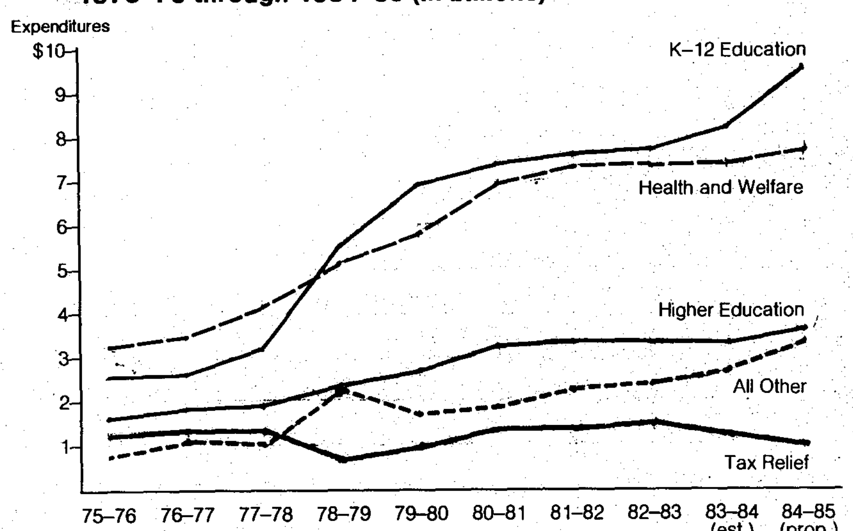


Table 20
Estimated General Fund Program Changes [a]
1983–84 and 1984–85
(in millions)

	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]

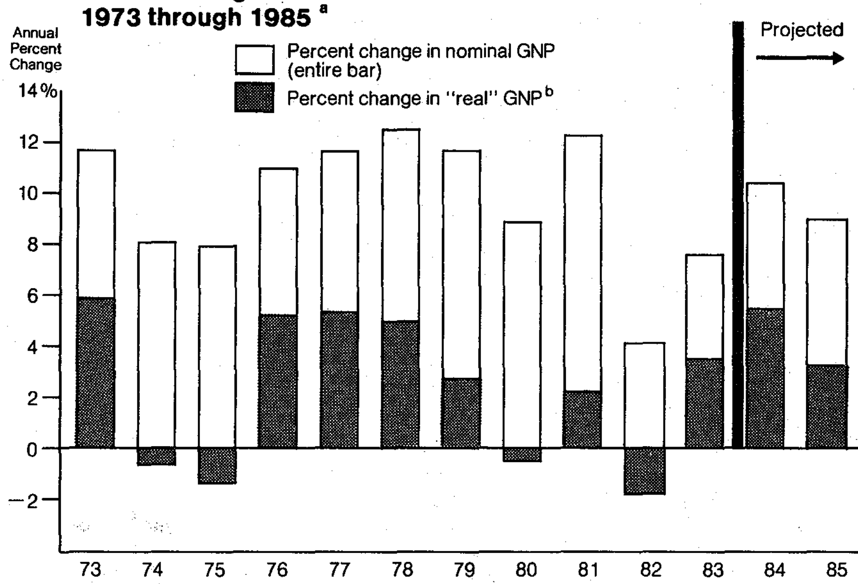
	1983 Estimated		*1984 Forecast*		*1985 Forecast*	
	Level	*Percent Change*	*Level*	*Percent Change*	*Level*	*Percent Change*
A. *The Nation*						
GNP in current dollars	$3,309.8	7.7%	$3,647.5	10.2%	$3,974.5	9.0%
GNP in 1972 dollars	1,536.8	3.5	1,623.2	5.6	1,674.9	3.2
Personal income	2,740.4	6.3	2,993.1	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]

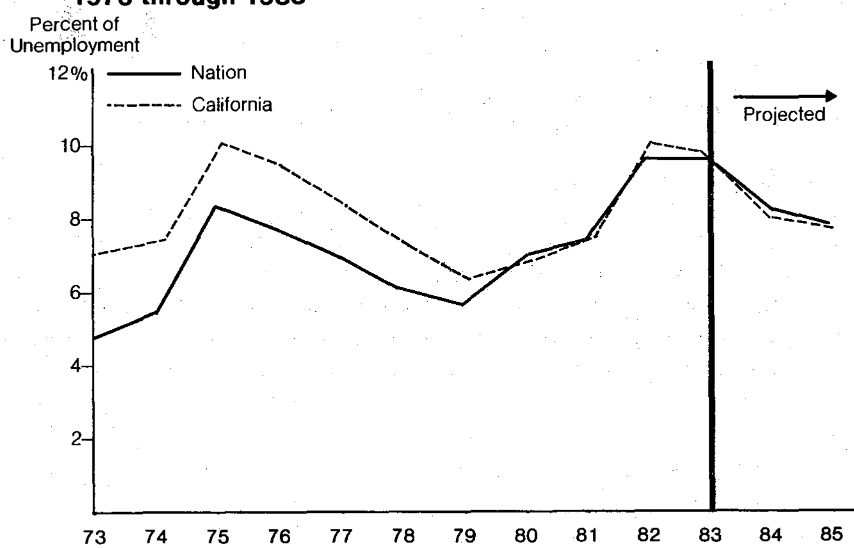


[a] Source: California Department of Finance. 1983 figures are preliminary

[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]



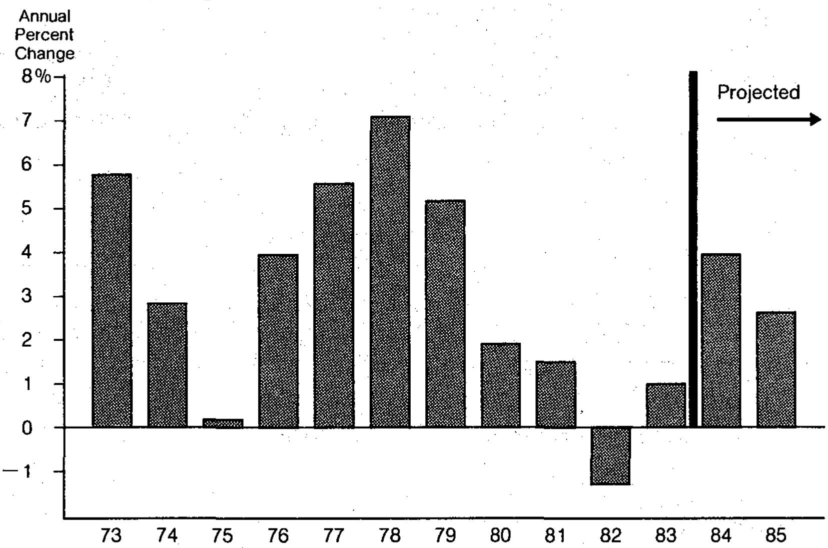
[a] Source: California Department of Finance

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:

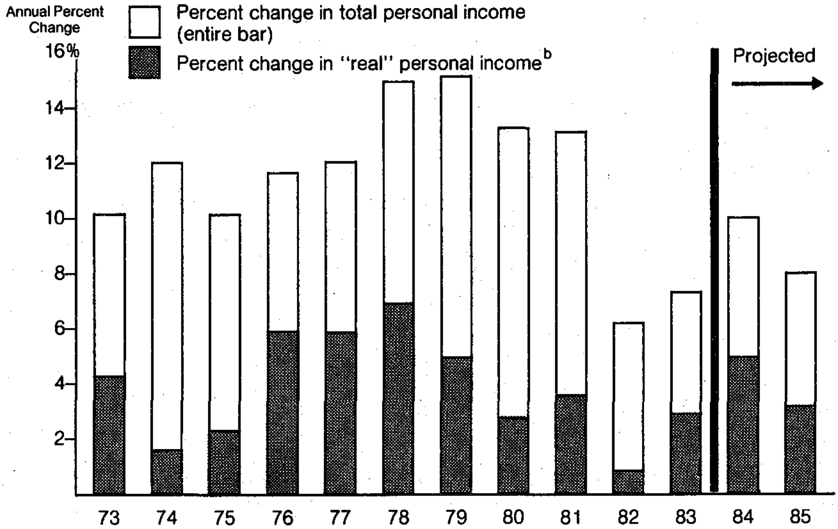
- *Personal income* is projected to rise by 9.7 percent in 1984 and 8.4 percent in 1985, as shown in Chart 14. When personal income is adjusted for transfer payments and social security contributions so as to roughly approximate "taxable" personal income, the increases become 10.3 percent in 1984 and 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

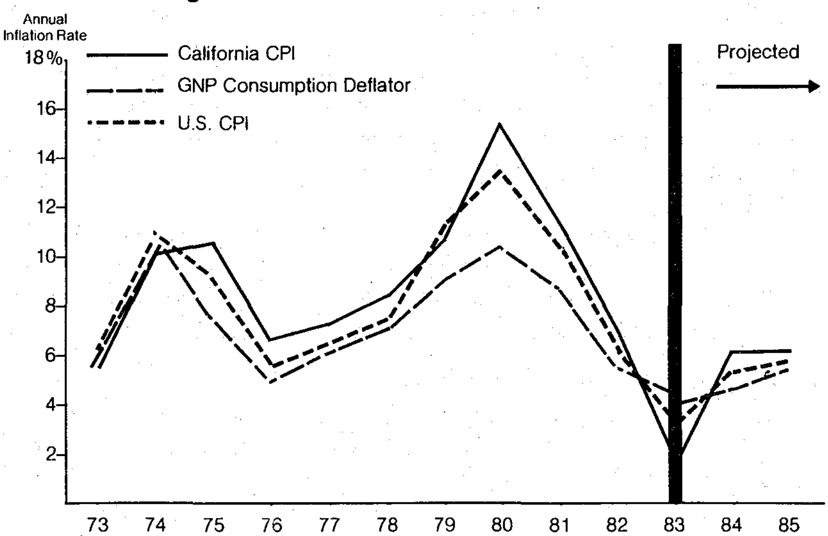
Annual Growth in California Personal Income 1973 through 1985[a]



[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

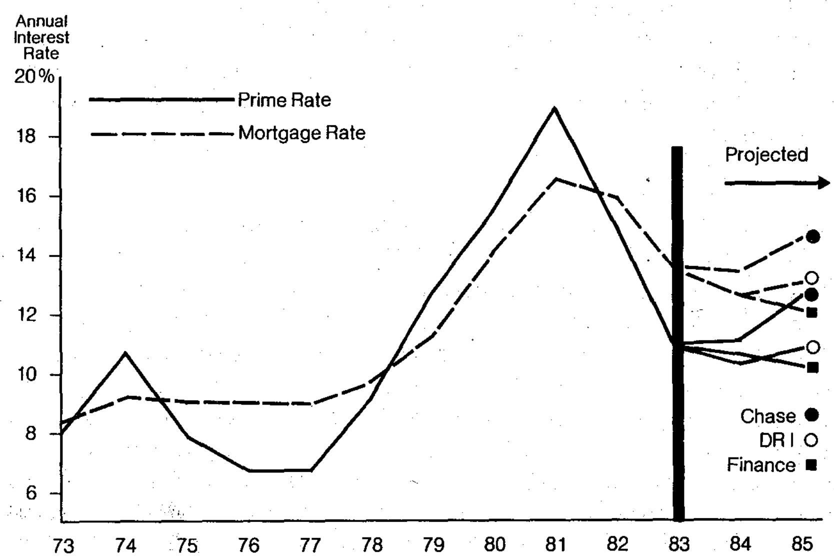
No two topics related to the economy have received greater attention during the past several years than interest rates and the federal budget deficit.

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 Employ-ment*	*Wage and Salary Jobs*	*Unemploy-ment 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]

		Economics-related Revisions				Revisions due to Law Changes					
Revenue Source	*Original Estimate in May 1981*	*Revisions during 1982* [b]	*Revisions during 1983* [c]	*January 1984*	*Totals*	*1981 Legislation*	*1982 Legislation* [d]	*1982 Ballot Initiatives*	*1983 Legislation* [e]	*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*	*Change 1983–84 to 1984–85 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

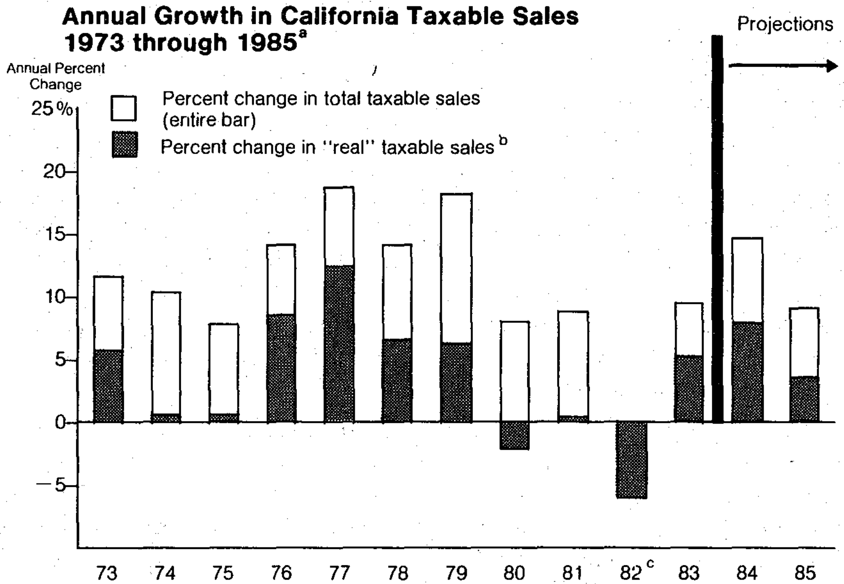
Calendar year	*Total Taxable Sales (in millions)*	*Percent Change in: Total Taxable Sales*	*Percent Change in: "Real" Taxable Sales*[a]	*Ratio of Taxable Sales to Personal Income*
1973	$61,738	11.6%[b]	5.6%[b]	.538
1974	68,071	10.3	0.2	.531
1975	73,476	7.9	0.3	.521
1976	83,822	14.1	8.6	.534
1977	99,482	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.

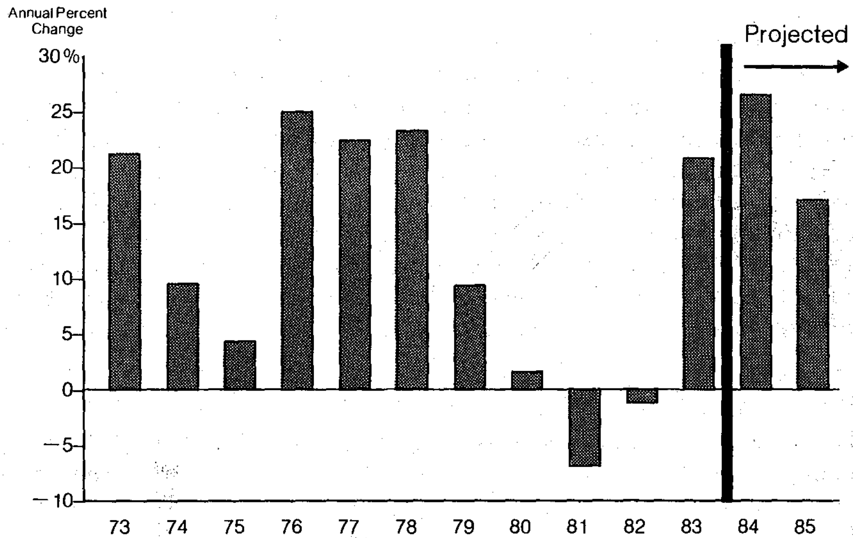
Table 35 shows that the department projects that revenues from the bank and corporation tax will rise by 32 percent in the budget year, following a strong 28 percent rise in the current year. After adjusting for special revenue factors, the bank and corporation tax is projected to grow faster in 1984–85 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*	*Out-standing*
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.

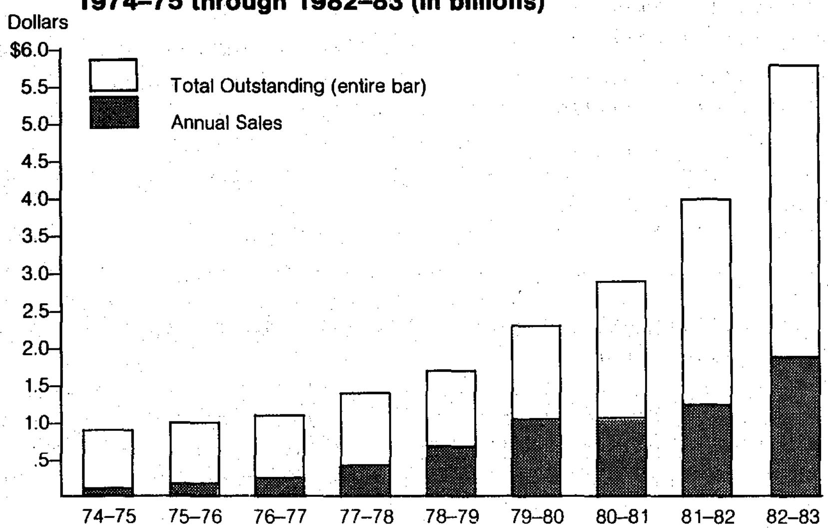
Table 50 identifies seventeen different types of state revenue bond programs and shows the current authorization for each. As of December 31, 1983, a total of $6.4 billion in state revenue bonds was outstanding.

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

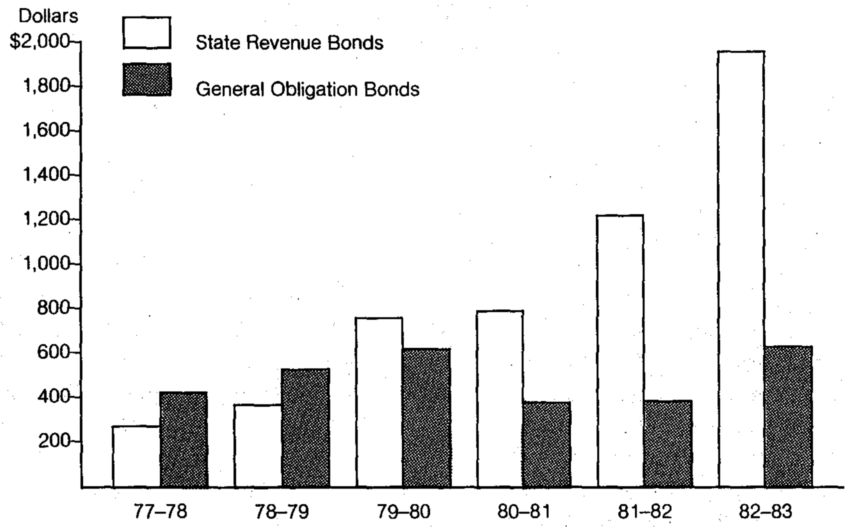
Bond Sales

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.

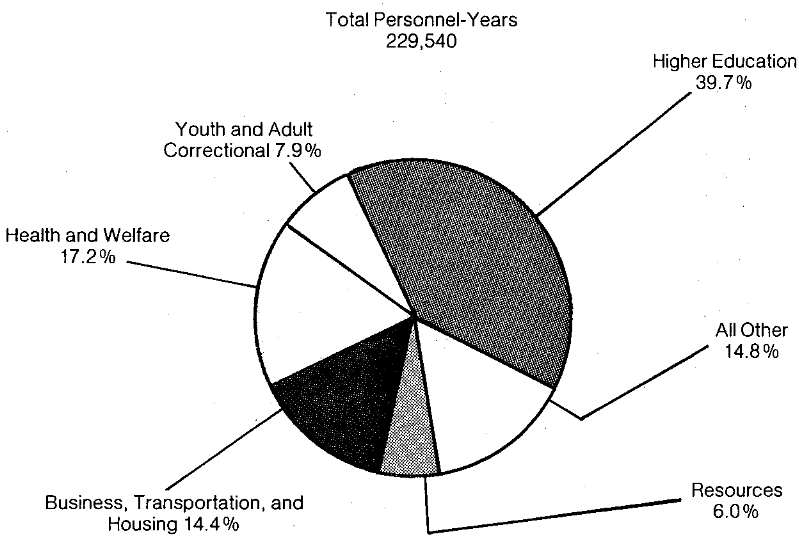
In December 1980, the U.S. Congress decided to stem the growth in housing revenue bonds by enacting the Mortgage Subsidy Bond Act of 1980. This act restricted the use of these bonds, and eliminated their tax-exempt status when sold to finance single-family housing, beginning December 31, 1983. The Congress 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.