California Legislature

THE 1985-86 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 1985 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 1985–86 and (2) identifying some of the major *issues* facing the Legislature in 1985. As such, this document is intended to complement the *Analysis of the 1985–86 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 1985–86 Budget: Perspectives and Issues is divided into three parts.

Part One, "State Finances in 1985," 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 in 1984 and 1985, and
- *The Long-Term Fiscal Outlook,* which discusses the economic outlook for the state through 1987–88.

Part Two, "Perspectives on the 1985–86 Budget," presents data on the budget as a whole—expenditures, revenues and the fiscal condition of state and local governments—to provide a perspective on the budget issues that the Legislature will face in 1985. 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 year;
- *State and Local Borrowing,* which discusses the types and volume of borrowing being done by the state and local governments; and
- *The State's Work Force,* which analyzes the reasons for changes in the state's work force in 1985–86. It also examines historical trends that account for the current functional composition of state employment.

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 1985–86. Wherever possible, our analysis identifies options which the Legislature may wish to consider in addressing these issues. This part is divided into two sections:

- *Revenue Issues,* which includes issues involving the state's unitary method of taxation, the financial condition of the State Transportation Fund, and the Governor's recommendations concerning tax expenditures.
- *Expenditure Issues,* which includes issues dealing with statewide staffing reductions, the Governor's proposals to expand personal services contracting, and the condition of the state's infrastructure. This section also deals with information technology applications in state operations, state regulation of financial services, and comparable worth as a means of achieving state employment goals.

Part One

STATE FINANCES IN 1985

Fiscal Situation Facing the Legislature

The Long-Term Fiscal Outlook

STATE FINANCES IN 1985

Due to the continued expansion of the California economy, the Governor has been able to present the Legislature with a budget for 1985–86 that provides for both significant expansions in state-funded services *and* a healthy reserve for contingencies. In terms of purchasing power, the level of General Fund revenues projected for 1985–86 is 1.3 percent *higher* than the level of revenues estimated for the current year. Because a substantial portion of these revenues will *not* have to be used to replenish the reserve, as was necessary in the current year, expenditures (in inflation-adjusted dollars) can grow by even more—almost 3.9 percent. Thus, the short-term outlook for the state's General Fund is reasonably bright.

This part of the *Perspectives and Issues* provides a brief overview of the state's fiscal condition in 1984 and 1985. It also discusses the state's budgetary prospects beyond the upcoming fiscal year. A more detailed discussion of revenues and expenditures appears in Part Two of this document.

Fiscal Situation Facing the Legislature

Table 1 provides information on General Fund revenues, expenditures and the end-of-year balance for each of the last 10 years. Trends in General Fund revenues and expenditures are illustrated in Chart 1. If the budget estimates prove to be accurate, 1985–86 will be the third year in a row in which General Fund revenues have exceeded expenditures, after five years in which the reverse was true. It would also be the third year in a row that the General Fund ended the year in the black, rather than the red.

The Governor's spending program for 1985–86 would leave the General Fund with a positive balance exceeding $1 billion on June 30, 1986—up from $985 million at the end of the current year. These funds would be retained in the Reserve for Economic Uncertainties, in order to protect the General Fund from unanticipated declines in revenues and unforeseen increases in expenditures. Thus, the reserve serves a key purpose: by insulating the budget from adverse developments on the revenue and expenditure side, it helps the state provide a continuous and more predictable level of services to its citizens.

Chart 1

Comparison of General Fund Revenues and Expenditures

1977–78 through 1985–86 (in billions)

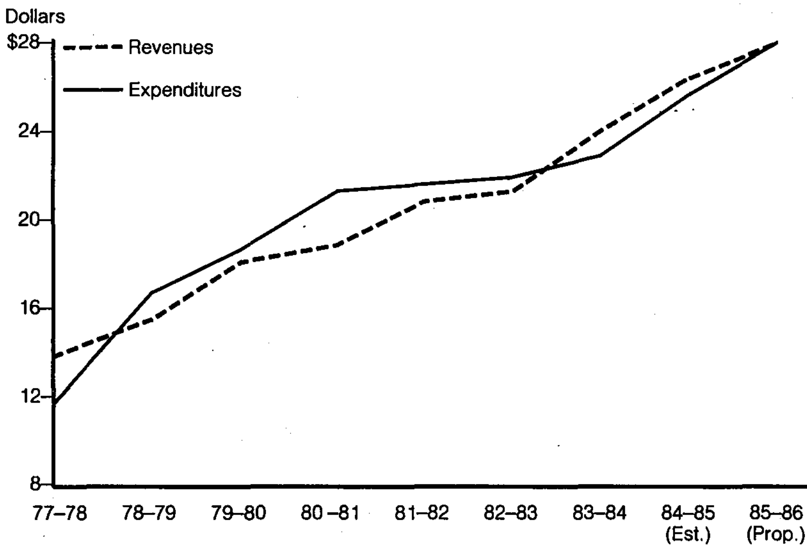


Table 1
Trend in General Fund Revenues, Expenditures and the Surplus [a, b]
1976–77 through 1985–86
(dollars in millions)

	1976–77	1977–78	1978–79	1979–80	1980–81	1981–82	1982–83	1983–84	1984–85 [c]	1985–86 [c]
Prior-year resources	$829.7	$1,839.1	$3,913.9	$2,905.4	$2,540.7	$681.0	−$30.8	−$521.3	$490.6	$985.3
Adjustments to prior-year resources	90.0	47.7	43.6	150.9	145.2	50.0	7.0	57.7	—	—
Prior-year resources, adjusted	$919.7	$1,886.7	$3,957.5	$3,056.4	$2,685.8	$730.9	−$23.9	−$463.6	$490.6	$985.3
Revenues and transfers	$11,405.5	$13,732.4	$15,217.4	$18,042.8	$19,047.5	$20,920.6	$21,231.1	$23,822.1	$26,076.9	$27,922.1
Expenditures	$10,487.8	$11,708.1	$16,272.0	$18,568.1	$21,065.5	$21,694.9	$21,755.1	$22,872.4	$25,582.2	$27,864.0
(Difference)	(917.6)	(2,024.2)	(−1,054.6)	(−525.3)	(−2,018.1)	(−774.3)	(−524.0)	(949.7)	(494.7)	(58.1)
(Expenditures from reserves)	(−28.5)	(−101.9)	(2.5)	(−317.4)	(210.7)	(274.2)	(−29.3)	(24.1)	(47.7)	(11.9)
(Annual surplus or deficit)	(889.2)	(1,922.3)	(−1,052.1)	(−842.8)	(−1,807.3)	(−500.0)	(−553.3)	(973.8)	(542.4)	(70.0)
Other surplus adjustments (+)	1.8	2.9	2.5	9.6	13.2	12.5	26.5	4.5	—	—
General Fund balance	$1,839.1	$3,913.9	$2,905.4	$2,540.7	$681.0	−$30.8	−$521.3	$490.6	$985.3	$1,043.5
Carry-over reserves	(125.9)	(227.8)	(225.3)	(542.8)	(332.0)	(57.8)	(87.1)	(63.0)	(15.3)	(3.4)
Reserve for Los Angeles County Grant Account	—	—	—	—	—	—	—	(100.0)	—	—
Reserve for Economic Uncertainties	—	—	—	—	(349.0)	—	—	(327.6)	(970.0)	(1,040.1)

[a] Source: State Controller.
[b] Details may not add to totals due to to rounding.
[c] Source: Governor's Budget.

General Fund Condition Improves in 1983–84 and 1984–85

Table 2 summarizes the changes in the condition of the General Fund that have taken place during the past year.

Table 2
Change in General Fund Condition
1983–84 and 1984–85
(dollars in millions) [a]

	Condition of the General Fund in 1983–84: As Projected in Governor's Budget January 1984	Condition of the General Fund in 1983–84: As Reported by State Controller January 1985	Effect on 1983–84 Surplus	Condition of the General Fund in 1984–85 as Projected by Governor's Budget: January 1984	Condition of the General Fund in 1984–85 as Projected by Governor's Budget: January 1985	Effect on 1984–85 Surplus
Beginning resources	–$521	–$464	$57	$205	$491	$286
Revenues and transfers	23,368	23,827	459	25,825	26,077	252
Expenditures	22,641	22,872	–231	25,076	25,582	–506
General Fund balance	$205	$491	$286	$954	$985	$31
Reserves [b]	105	163	–58	3	15	–12
Unrestricted balance	$100	$328	$228	$951	$970	$19

[a] Details may not add to totals due to rounding.
[b] Includes unencumbered balance of continuing appropriations, and reserve for Los Angeles County Medical Assistance Grant Account.

1983–84. One year ago, the Governor's Budget projected that the state would end fiscal year 1983–84 with a balance of $100 million in the General Fund. The State Controller now reports that the actual balance was $328 million. The increase resulted entirely from higher-than-anticipated revenues.

As shown in Table 2, revenues and transfers exceeded the initial budget estimate by approximately $459 million in 1983–84. These additional revenues were due almost entirely to the performance of the state's economy, which was considerably stronger than what the Governor's Budget for 1983–84 anticipated.

On the expenditure side, the budget estimate proved to be much more accurate. Almost the entire difference between projected and actual expenditures can be attributed to accounting adjustments made by the State Controller. These adjustments stem from the court's decision in a lawsuit filed against the state regarding the state's contributions to the State Teachers' Retirement System. The court ruled that the state could not legally defer its contributions to the system, which are specified in statute, and ordered the Controller to transfer the funds that were not provided in 1983–84 and previous years to the system. As a result, the Controller during the current year transferred $337 million from the state General Fund to the State Teachers' Retirement Fund, and reflected the transfer on his books as a 1983–84 expenditure.

Absent this adjustment, the surplus at the end of 1983–84 would have been $665 million, or $565 million more than what was projected six months earlier.

1984–85. The Department of Finance's current estimate of the unrestricted surplus at year-end 1984–85 is quite similar to the estimate that appeared in the Governor's Budget a year ago. At that time, it was anticipated that the state would end the fiscal year with a balance of $951 million, however, the balance is now expected to reach $985 million by year-end. Of this amount, $15 million will already have been committed by the Legislature (but not spent), leaving *$970 million* uncommitted.

Even so, there are some fairly significant differences between the latest revenue and expenditure estimates and last year's. As Table 2 shows, revenues are up $252 million, while expenditures are up $506 million. An increase in the amount carried over from 1983–84 ($286 million), however, offset the difference, leaving the General Fund balance about where it was estimated in January 1984.

The increased revenues are attributable to the effects of an improved economy ($138 million), the interest earnings associated with the external borrowing program ($84 million), and the anticipated collection of additional tax revenues under the tax amnesty program ($30 million).

The increase in expenditures is mainly due to a $161 million increase in payments to Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients and $223 million in additional expenditures for K–14 education.

General Fund Condition for 1985–86

In the budget year, revenues again are expected to exceed proposed expenditures, this time by a total of $58 million. These funds would be used to bring the balance in the Reserve for Economic Uncertainties up to $1,040 million, or 3.7 percent of General Fund expenditures.

General Fund revenues are projected to increase by $1.8 billion, or 7.1 percent, in 1985–86. In addition, due to the fact that approximately $642 million in 1984–85 General Fund revenues was put in reserve, rather than committed to the funding of ongoing expenditure programs, a corresponding amount of "base" revenue in 1985–86 is available to fund increases in expenditures.

The Governor's Budget proposes a total increase in General Fund expenditures of $2.3 billion, or 9 percent, over estimated expenditures in the current year. The largest increase is proposed for education, which would gain $1.3 billion, or 9.6 percent, in additional General Fund support above its 1984–85 funding level. This includes an increase of $896 million, or 9.5 percent, for K–12 education; an increase of $63 million, or 19 percent, in General Fund contributions to the State Teachers' Retirement System;

and increases for the University of California, the California State University, and California Community Colleges of 12 percent, 8.9 percent, and 4.5 percent, respectively.

The Long-Term Fiscal Outlook

The overall condition of the General Fund beyond the budget year will depend on three factors—future levels of state spending, future levels of state income (that is, revenues plus transfers), and the amount of reserves that the Legislature seeks to maintain.

The levels of income and expenditures beyond the budget year will be determined by a variety of factors, including economic conditions, judicial decisions, ballot initiatives, and 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 initiate 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 would be in future years if (a) no law changes are made that significantly affect state income, (b) the economy behaves in line with the Department of Finance's projections, and (c) the level of expenditures is maintained at the level proposed in the Governor's Budget, adjusted only for inflation and population growth.

General Fund Income

The most important factor determining state income in future years will be the economy's performance. Generally speaking, the state's revenue base appears to have sufficient "elasticity" to grow at a pace equal to, and probably slightly above, the rate of growth in California's personal income base—at least during normal years. Obviously, this relationship will not hold during periods when economic activity fluctuates. For example, when an economic slowdown occurs, corporate profits usually fall, and the percentage of income that consumers spend on taxable commodities can also decline. During economic expansions, the opposite usually occurs. Thus, on a year-to-year basis, the rate of growth in revenues can vary, depending on what the economy is doing.

It is not possible to predict with any confidence the economy's performance beyond the next 18 months. Indeed, no economist can say with any certainty 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 such factors as the unsettled conditions in the foreign trade sector, international debt problems, the inability of federal officials themselves to predict what future courses monetary and fiscal policies will take, the uncertain prospects for the federal deficit and the fact that the economy currently is in a "transition phase" during which it could either begin to expand or contract. Consequently, *any* estimate of General Fund revenues beyond 1985–86 depends heavily on what one *assumes* about the economy's performance beyond 1986.

The Governor's Budget contains a projection of General Fund revenues for 1986–87 and 1987–88. This projection is based on the Department of Finance's standard economic forecast for 1985 and 1986, and thereafter *assumes* that the economy will experience a mild recession in 1987 followed by recovery in 1988. The reason why the department chose to assume that a recession will occur in 1987 is that the average length of postwar economic expansions is 34 months, and the current expansion has already lasted 26 months. Should the department's assumptions come true, Table 3 shows that General Fund revenues would be $29.9 billion in 1986–87 and $30.6 billion in 1987–88.

We believe the department's assumption that a mild recession will occur before 1989 is reasonable, given past experience. Should the economy somehow "beat the odds" by expanding beyond 1986 and avoiding any type of downturn, however, General Fund revenues would be significantly higher than what is shown in Table 3—probably in the range of $30.2 billion for 1986–87 and $32.5 billion for 1987–88. Most economists do not put a very high probability on an uninterrupted economic expansion of this length.

General Fund Expenditure Growth

The Governor's Budget proposes General Fund expenditures in 1985–86 of $27.9 billion. In order to estimate the amount that would be needed to continue this level of state services in 1986–87 and 1987–88, two adjustments must be made. First, certain "one-time" expenditures must be removed in order to arrive at the ongoing "base" budget. Second, the adjusted base for 1985–86 must be increased for population growth and inflation, so as to hold "real" per capita expenditures constant over time. We have done this based on the assumption that inflation will average 5 percent per year and population growth will average 1.7 percent annually.

Table 3
Condition of the General Fund [a]
1985–86 through 1987–88
(dollars in millions)

	1985–86 [b]	*1986–87*	*1987–88*
Prior-year resources	$985	$1,043	$1,276
Income (as projected by DOF)	27,922	29,900 [b]	30,560 [b]
Expenditures	27,864	29,660 [c]	31,676 [c]
(Annual surplus)	(58)	(240)	(−1,116)
Year-end General Fund balance:			
Carry-over reserves	3	4	4
Reserve for Economic Uncertainties	1,040	1,276	156

[a] Details may not add to totals due to rounding.
[b] Source: 1985–86 Governor's Budget.
[c] Assumes 1985–86 expenditures are adjusted to reflect inflation and population increases.

The result is that actual expenditures grow by about 6.8 percent per year. Table 3 shows that the amount of funding needed to support a constant level of "real" per capita expenditures is $29.7 billion in 1986–87 and $31.7 billion in 1987–88.

General Fund Condition

Table 3 shows what the condition of the General Fund would be in 1986–87 and 1987–88, given these income and expenditure assumptions. The table indicates that:

- On an *annual* basis, General Fund income would exceed General Fund expenditures by approximately $240 million in 1986–87, but would fall short of these expenditures by $1.1 billion in 1987–88.
- The General Fund *balance*—that is, the total amount of unused funds "left over" at the end of the year—would rise from $1 billion in 1985–86 to $1.3 billion in 1986–87, and then fall to under $200 million in 1987–88.

Thus, a recession could quickly cause the General Fund balance to evaporate.

Part Two

PERSPECTIVES ON THE 1985-86 BUDGET

Expenditures in 1985-86

Revenues

State and Local Borrowing

The State's Work Force

Part Two

PERSPECTIVES ON THE 1985-86 BUDGET

This part of our analysis provides perspectives on the Governor's Budget for 1985–86. 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 1984 and 1985, 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.
- ***The State's Work Force.*** This section analyzes the reasons for changes in the state's work force in 1985–86. It also examines historical trends that account for the current functional composition of state employment.

Expenditures in 1985–86

TOTAL STATE SPENDING PLAN

The Governor's Budget for 1985–86 proposes total expenditures of $56.6 billion. This amount includes:

- $33.6 billion in *state expenditures,* consisting of $27.9 billion from the General Fund, $5.3 billion from special funds, and $0.5 billion from selected bond funds;
- $13.7 billion in expenditures from *federal funds;* and
- $9.3 billion in expenditures from various *"nongovernmental cost" funds,* including funds established for retirement, working capital, revolving, public service enterprise, and other purposes.

Table 4 presents the components of the state's spending program for 1983–84, 1984–85 and 1985–86.

Table 4
Total State Spending Plan[a]
1983–84 through 1985–86
(dollars in millions)

		Estimated 1984–85		*Proposed 1985–86*	
	Actual 1983–84	*Amount*	*Percent Change*	*Amount*	*Percent Change*
General Fund	$22,872.4 [b]	$25,582.2	11.8%	$27,864.0	8.9%
Special funds	3,527.4	4,952.2	40.4	5,266.7	6.4
Budget Expenditures	$26,399.8	$30,534.4	15.7%	$33,130.7	8.5%
Selected bond funds	399.9	1,130.1	182.6	469.1	−58.5
State Expenditures	$26,799.7	$31,664.5	18.2%	$33,599.7	6.1%
Federal funds	12,454.3	13,379.9	7.4	13,667.6	2.2
Governmental Expenditures	$39,254.0	$45,044.4	14.8%	$47,267.3	4.9%
Nongovernmental cost funds	7,789.6	8,715.9	11.9	9,348.6	7.3
Total State Spending	$47,043.6	$53,760.3	14.3%	$56,615.9	5.3%

[a] Source: Governor's Budget. Details may not add to totals due to rounding.
[b] Source: State Controller.

Governmental Expenditures

The budget proposes expenditures from governmental funds—that is, total state spending less nongovernmental cost funds—amounting to $47.3 billion in 1985–86. This represents a $2 billion, or 4.9 percent, *increase* from the current-year level, primarily reflecting increases in General Fund expenditures of $2.3 billion.

Using this measure of the budget, during 1985–86 the state will spend $1,814 for every man, woman and child in California or $129.5 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 4, state expenditures are proposed to total $33.6 billion in 1985–86, which is 6.1 percent higher than state expenditures in the current year.

General Fund Expenditures

The budget proposes General Fund expenditures of $27.9 billion in 1985–86, which accounts for nearly one-half of all expenditures under the state's auspices.

Chart 2
Annual Growth in General Fund Expenditures 1973–74 through 1985–86 (in billions)

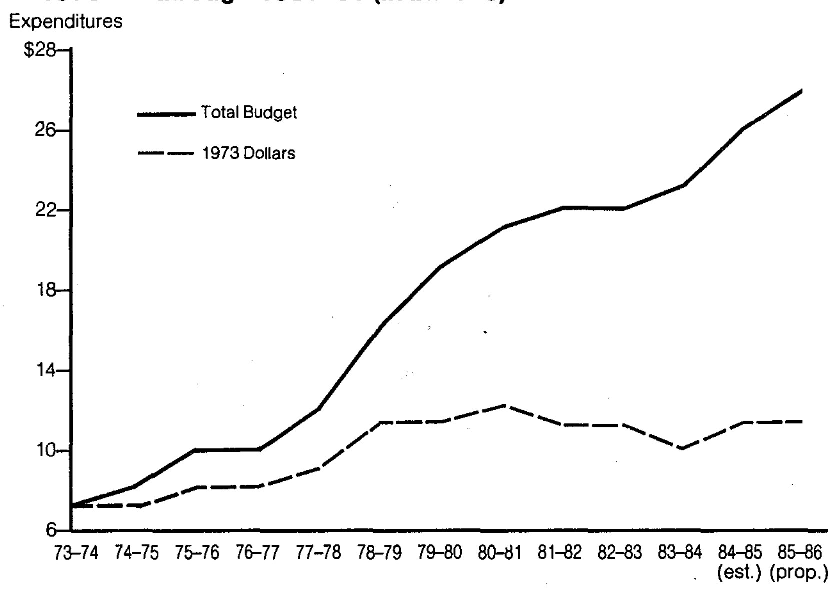


Chart 2 and Table 5 show the General Fund expenditure trend since 1973–74. Expenditures in Chart 2 and Table 5 are displayed both on a "current dollar" and "real dollar" basis. Expenditures in "real dollars" represent expenditure levels as they appear in the budget (that is, "current dollars") adjusted for the effects of inflation since 1973.

In current dollars, the proposed General Fund budget for 1985–86 is almost four times what it was in 1973–74. In terms of "real dollars," however, the proposed General Fund budget is only a little more than one and one-half times what it was in 1973–74.

As shown in Chart 2 and Table 5, between 1973–74 and 1980–81 total General Fund expenditures increased at an average annual rate of 17 percent in current dollars, and by 7 percent in "real dollars". The rate slowed considerably in 1981–82, as the state experienced the effects of the nationwide recession. Beginning in the current year, spending growth has resumed a more traditional course, in line with the expansion of the state's economy.

Table 5
Annual Change in General Fund Expenditures
1973–74 through 1985–86
(dollars in millions)

	Total General Fund Budget [a]			
	"Current Dollars"		*"Real (1973) Dollars"*	
	Amount	*Change*	*Amount* [b]	*Change*
1973–74	$7,302	—	$7,302	—
1974–75	8,325	14.0%	7,494	2.6%
1975–76	9,517	14.3	7,931	5.8
1976–77	10,488	10.2	8,194	3.3
1977–78	11,708	11.6	8,521	4.0
1978–79	16,272	39.0	10,928	28.3
1979–80	18,568	14.1	11,371	4.0
1980–81	21,066	13.4	11,775	3.6
1981–82	21,695	3.0	11,247	−4.5
1982–83	21,755	0.3	10,576	−6.0
1983–84	22,872	5.1	10,468	−1.0
1984–85 estimated [c]	25,582	11.9	11,055	5.6
1985–86 proposed [c]	27,864	8.9	11,392	3.0

[a] Source: State Controller.
[b] "Real 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.

The level of General Fund expenditures proposed for 1985–86 continues the upward trend in "real" expenditures begun in the current year, after three years of declining "real" expenditures. Total General Fund expenditures proposed for 1985–86 are 8.9 percent more than estimated expenditures for the current year, which translates into an increase in purchasing power of 3 percent.

Because significant *one-time* expenditures are included in the current-year total, the actual expansion of service levels proposed in the Governor's Budget is even greater than 3 percent. For example, General Fund expenditures for 1984–85 reflect a one-time $200 million loan repayment to Los Angeles County. We estimate that if adjustments are made for these and other one-time expenditures, the level of service proposed in the Governor's Budget for 1985–86 is 3.5 percent higher than the current-year level. Even so, proposed General Fund expenditures in 1985–86, expressed in "real dollars", are still $383 million below the pre-recession high reached in 1980–81.

Federal Fund Expenditures

Federal fund expenditures account for almost one-third of the expenditures in the state's 1985–86 budget (excluding nongovernmental cost and bond funds). As shown in Table 6, during the past 10 years federal funds have accounted for as much as 39 percent (1976–77) and as little as 28 percent (1979–80) of total state expenditures. Since 1982–83, federal expenditures have been declining as a percentage of total state expenditures.

Table 6
Federal Fund Expenditures as a Percent of Total State Expenditures [a]
1976–77 through 1985–86
(dollars in millions)

	General Fund [b]	*Special Funds*	*Federal Funds*	*Totals*	*Federal Funds as Percent of Total*
1976–77	$10,488	$2,041	$7,992	$20,521	39%
1977–78	11,708	2,161	7,239	21,108	34
1978–79	16,272	2,298	7,453	26,022	29
1979–80	18,568	2,760	8,160	29,489	28
1980–81	21,066	3,262	10,248	34,575	30
1981–82	21,695	3,099	10,863	35,657	31
1982–83	21,755	3,180	12,255	37,190	33
1983–84	22,872	3,527	12,454	38,854	32
1984–85	25,582	4,952	13,380	43,914	31
1985–86	27,864	5,267	13,668	46,798	29

[a] Excludes nongovernmental cost and bond funds. Details may not add to totals due to rounding.
[b] 1976–77 through 1983–84 data from State Controller.

The level of federal expenditures anticipated in 1985–86—$13.7 billion—represents an increase of $288 million, or 2.2 percent, over the estimated 1984–85 level. This relatively small increase in total federal funding masks several major increases and decreases anticipated in the budget year. These increases are shown in Table 7, by broad program area. The most significant reduction, $181 million in health and welfare programs, is primarily due to a decrease of $345 million in unemployment insurance (UI) benefits and administration, reflecting the assumption that the rate of unemployment in California will decline from 7.5 percent in 1984–85 to 7 percent in 1985–86. The decrease in UI is offset by various health and welfare increases, particularly in the Aid to Families with Dependent Children (AFDC), public health, social services and rehabilitation programs.

Table 7 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. This 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 ($189 million) for the University of California's Department of Energy laboratories.

In the event that the President and Congress take action in 1985 to reduce the federal budget deficit, total federal support received by California in the budget year could change dramatically. The programmatic distribution of these funds as outlined in Table 7 could also be changed significantly.

Table 7
Federal Funds Changes, By Program
1984–85 and 1985–86
(dollars in millions)

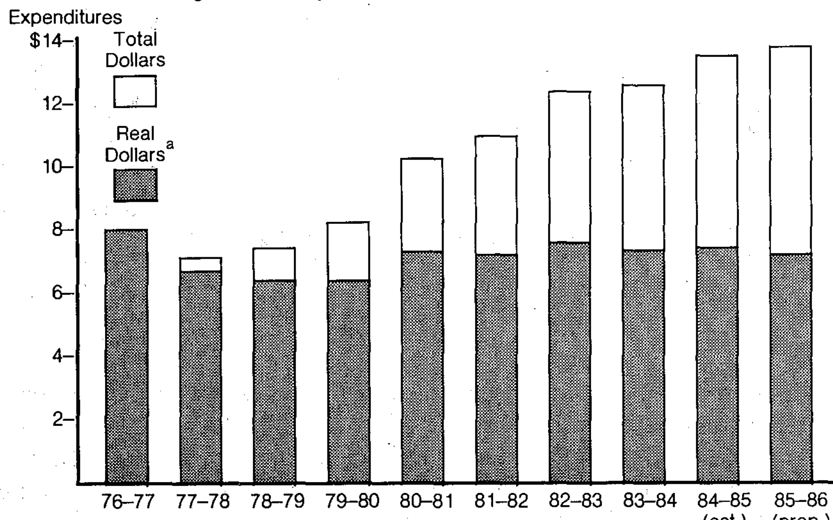
Program	Estimated 1984–85	Proposed 1985–86	Change Amount	Change Percent
Legislative/Judicial/Executive	$202	$175	–$27	–13.4%
State and Consumer Services	21	21	0	—
Business, Transportation and Housing	1,395	1,601	206	14.8
Resources	47	41	–6	–12.8
Health and Welfare	8,035	7,854	–181	–2.3
Youth/Adult Corrections	1	1	0	—
Education	3,357	3,635	278	8.3
Other Governmental Units	277	297	20	7.2
Other Governmental Services	45	43	–2	–4.4
Totals	$13,380	$13,668	$288	2.2%

As noted above, the amount of federal aid received by California has been somewhat volatile during the last 10 years. This volatility is illustrated in Chart 3. In terms of current dollars, federal expenditures have grown from just under $8 billion in 1976–77 to $13.7 billion in 1985–86, an increase of approximately 71 percent. This represents a 6.1 percent average annual rate of growth over this 10-year period. When expressed in "real dollars," however, the level of federal aid anticipated in 1985–86 is 11 percent *less* than the amount of federal aid actually received by the state in 1976–77.

One should be cautious in drawing conclusions from Chart 3 regarding the changes in federal expenditure levels, 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 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 significantly the total amount of federal aid received by the state, 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
1976–77 through 1985–86 (in billions)



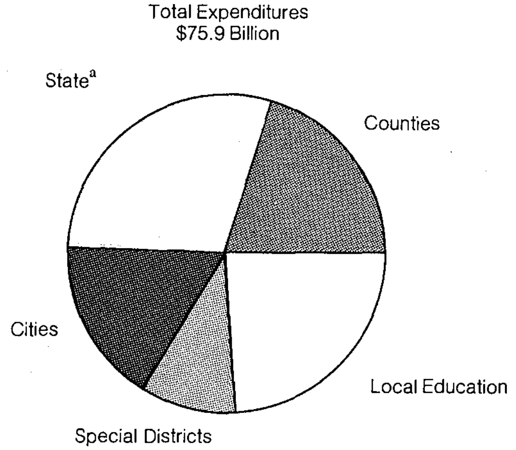
[a] "Real" federal dollars equal total federal dollars deflated to 1976–77 dollars using the GNP price deflator for state and local purchases of goods and services.

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.

Chart 4

Total State and Local Government Expenditures 1984–85



[a] Net state expenditures

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 4 displays 1984–85 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.

In the current year, expenditures for all services provided by state and local governments in California are expected to total approximately $76 billion. This amount consists of approximately $22 billion in net state expenditures (that is, state expenditures net of funds provided to local governments) and approximately $54 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—$21.9 billion—is only one-half of total General Fund, special fund and federal fund expenditures identified in the Governor's Budget ($43.9 billion) demonstrates how much "state money" actually is spent at the local level. These latter expenditures, which total $22 billion in the current year, are included in our estimate of local government spending. The principal component of this amount is state aid to local school districts ($12.1 billion).

Table 8 provides a perspective on government sector spending in California over the past three years. As Table 8 demonstrates, the relative share of total state and local government expenditures accounted for by the state and each of the four types of local jurisdictions has remained virtually unchanged during the past three years.

Table 8
Estimated Total State and Local Government Expenditures
1982–83 through 1984–85 [a]
(dollars in millions)

	1982–83		*1983–84*		*1984–85*	
Government Entity	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*
Counties	$13,467	20.7%	$14,426	21.0%	$15,550	20.5%
Cities	10,567	16.3	11,317	16.5	12,200	16.1
Special districts	6,989	10.8	7,513	10.9	8,400	11.1
Local education	14,272	22.0	16,155	23.5	17,835	23.5
Subtotal, Local Government	($45,295)	(69.8%)	($49,411)	(71.9%)	($53,985)	(71.2%)
State	37,186	—	38,851	—	43,914	—
Less: Amount expended by local governments	−17,563	—	−19,536	—	−22,032	—
Subtotal, State (net)	($19,623)	(30.2%)	($19,315)	(28.1%)	($21,882)	(28.8%)
Totals, state and local expenditures	$64,918	100.0%	$68,726	100.0%	$75,867	100.0%

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

TAX EXPENDITURES

In addition to the $33.6 billion in total state funds which the Governor's Budget requests for *direct* expenditure programs in 1985–86, it also proposes approximately $12.9 billion of *indirect* spending in the form of "tax expenditures".

These tax expenditures result from various tax exclusions, exemptions, preferential tax rates, credits, and deferrals, which reduce the amount of revenue collected from the state's "basic" tax structure—that is, the overall system of taxation, including those provisions, such as personal exemption credits under the personal income tax, which have general applicability. Thus, "tax expenditures" include those special provisions of the tax code which are used to achieve social policy goals or provide tax relief.

In terms of the state's overall fiscal condition, the fact that these monies are indirectly spent using the tax system as a distribution mechanism makes them no less "expenditures" than are monies which directly pass through the normal appropriation process. Thus, tax expenditures are appropriately viewed as part of the Governor's overall spending plan.

Table 9 shows the Department of Finance's estimate of state tax expenditures in 1985–86. The table indicates that tax expenditures are expected to total $12.9 billion in the budget year, which is equivalent to 46 percent of General Fund expenditures and 38 percent of total direct state expenditures. Of the $12.9 billion, about 70 percent is associated with various exemptions, deductions and credits permitted under the personal income tax, including the nontaxability of employer contributions to pension plans ($1.4 billion) and the deductibility of mortgage interest expenses ($1.3 billion). A third major tax expenditure is the exemption from the sales tax granted to food consumed at home ($1.3 billion).

(We believe the department's list of tax expenditures inappropriately includes some provisions of the tax code which are not really "tax expenditures." These provisions are so widely available and used by so many taxpayers that they really should be viewed as part of the state's basic tax structure itself.)

Table 9
State Tax Expenditures [a]
1985–86
(dollars in millions)

Tax Expenditure Category	*Amount*
1. Personal income tax	$9,009
2. Sales and use tax	3,327 [b]
3. Bank and corporation tax	368
4. Motor vehicle fuel taxes	110
5. Other taxes	103
Total, all categories	$12,917

[a] Source: Governor's Budget.
[b] In addition to the state tax expenditure shown for the sales and use tax, there is a comparable local government tax expenditure estimated at $876 million.

CONTROLLING EXPENDITURES

Control Through the Constitution

On November 6, 1979, California voters approved Proposition 4, the "Spirit of 13" Initiative. Proposition 4, which placed Article XIII B in the California Constitution, has three main provisions:

- It places a limit on the year-to-year growth in tax-supported appropriations of the state and individual local governments;
- It precludes the state and local governments from retaining surplus funds—any *unappropriated* balances at the end of a fiscal year must be returned to taxpayers within a two-year period; and
- It requires the state to reimburse local government for the cost of certain state mandates.

Table 10
Impact of Article XIII B on the State
1983–84 through 1985–86
(dollars in millions)

	1983–84	*1984–85*	*1985–86*
Appropriations limit	$20,368	$21,746	$23,095
Appropriations subject to limitation	17,737	20,629	21,323
Amount under the limit	$2,631	$1,117	$1,772

Impact of Article XIII B in 1985–86. Table 10 shows the Department of Finance's estimate of the state's appropriation limit under Article XIII B as well as the appropriations subject to limitation in 1983–84, 1984–85, and 1985–86. The department estimates that the state will be $1.8 billion below its limit in 1985–86.

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.

The gap between the limit and spending subject to limitation is expected to increase significantly in 1985–86. The Department of Finance expects that appropriations subject to limitation in 1985–86 will increase by 3 percent over the 1984–85 level, compared to a 16 percent increase during the previous year. The difference between these two rates of growth is due largely to a one-time factor: in the current year, $642 million was appropriated to the Reserve for Economic Uncertainties. In contrast, however, only $70 million is proposed for appropriation to the reserve in the budget year. If the appropriation to the reserve is excluded from both years' totals, appropriations subject to limitation are proposed to grow by 6.4 percent in the budget year.

The state's appropriations limit will *not* be a fiscal constraint in 1985–86. 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.

Prediction or Plan?

It should be noted that the budget estimates are not *predictions* of how much ultimately will be spent, although these estimates reflect countless predictions about expenditure rates and other factors that are in part outside of the state's control. Rather, the 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, 1986, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, the resolution of 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.

Budgeted Versus Actual Expenditures

The expenditure program proposed in the Governor's Budget invariably is changed during the 18 months following submission of the budget. Table 11 compares the original estimates with actual expenditures during the past 11 years.

Table 11
Proposed and Actual General Fund Expenditures
1974–75 through 1984–85
(dollars in millions)

	Budget As Submitted[a]	*Actual Expenditures*[b]	*Change*[c] *Amount*	*Percent*
1974–75	$7,812	$8,325	$514	6.6%
1975–76	9,170	9,517	348	3.8
1976–77	10,320	10,488	168	1.6
1977–78	11,822	11,708	–114	–1.0
1978–79	13,483	16,272	2,790	20.7
1979–80	17,088	18,568	1,480	8.7
1980–81	20,684	21,066	382	1.8
1981–82	20,770	21,695	925	4.5
1982–83	23,203	21,755	–1,448	–6.2
1983–84	21,677	22,872	1,195	5.5
1984–85	25,076	25,582[a]	506	2.0

[a] Source: Governor's Budget.
[b] Source: State Controller.
[c] Details may not add to totals due to rounding.

As Table 11 shows, actual expenditures exceeded the amounts originally proposed by the Governor in nine of the last eleven years—usually by significant margins. Only twice during this 11-year period—in 1977–78 and 1982–83—was the actual amount spent *less* than the amount initially proposed for expenditure. The large decrease in the budget for 1982–83—$1.4 billion—primarily reflects the severe recession that began in 1981. Revenues in that year were well below the level projected in the Governor's Budget, making it necessary for the Legislature to make large cuts in expenditures in order to minimize the end-of-year deficit.

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 12 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 1985–86 also includes "unclassified" General Fund expenditures of $75 million for legislative initiatives, and an additional $40 million for a loan guarantee.

Table 12
General Fund and Special Fund Expenditures, by Function [a]
1983–84 through 1985–86
(dollars in millions)

		Estimated 1984–85		*Proposed 1985–86*	
General Fund	*Actual [b] 1983–84*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State operations	$4,599.2	$5,782.8	25.7%	$6,502.9	12.5%
Capital outlay	0.1	8.0	— [c]	—	— [c]
Local assistance	18,172.0	19,791.5	8.9	21,246.1	7.3
Aid to individuals	(6,353.0)	(6,815.0)	7.3	(7,222.0)	6.0
Aid to local governments	(11,819.0)	(12,976.5)	9.8	(14,024.1)	8.1
Unclassified	101.1	—	— [c]	115.0	— [c]
Totals [d]	$22,872.4	$25,582.2	11.8%	$27,864.0	8.9%
Special Funds					
State operations	$1,786.8	$2,070.5	15.9%	$2,242.7	8.3%
Capital outlay	173.2	487.6	— [c]	534.3	9.6
Local assistance	1,555.4	2,393.8	53.9	2,478.2	3.5
Unclassified	12.0	0.4	−96.7	11.5	— [c]
Totals [d]	$3,527.4	$4,952.2	40.4%	$5,266.7	6.4%

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

As Chart 5 shows, state operations make up 23 percent of total General Fund expenditures in the budget year, while 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 proposed in the budget for 1985–86.

State Operations

The budget proposes an increase from the General Fund of $720 million, or 13 percent, for state operations expenditures in 1985–86. As shown in Chart 6, General Fund expenditures for state operations will have increased by $3.8 billion, or 144 percent, during the ten years from 1976–77 through 1985–86. When adjusted for inflation, however, expenditures have increased by only $738 million, or 28 percent, during this period.

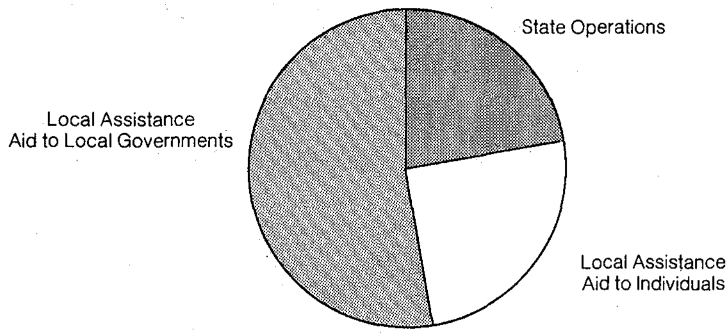
Capital Outlay

The budget proposes no General Fund expenditures for capital outlay in 1985–86. General Fund capital outlay expenditures over the past ten years have fluctuated from zero to a high of $151 million (in 1979–80). The Governor's Budget for 1984–85 proposed that $94.7 million be appropriated from the General Fund for capital outlay, but only $8 million was ultimately appropriated.

Chart 5

1985–86 General Fund Budget Structure

Total Expenditures[a]
$27.9 billion



[a] State operations and local assistance totals do not include $75 million (.3%) allocated to cover the cost of legislation approved in the budget year and $40 million (.1%) for state guarantee of loan.

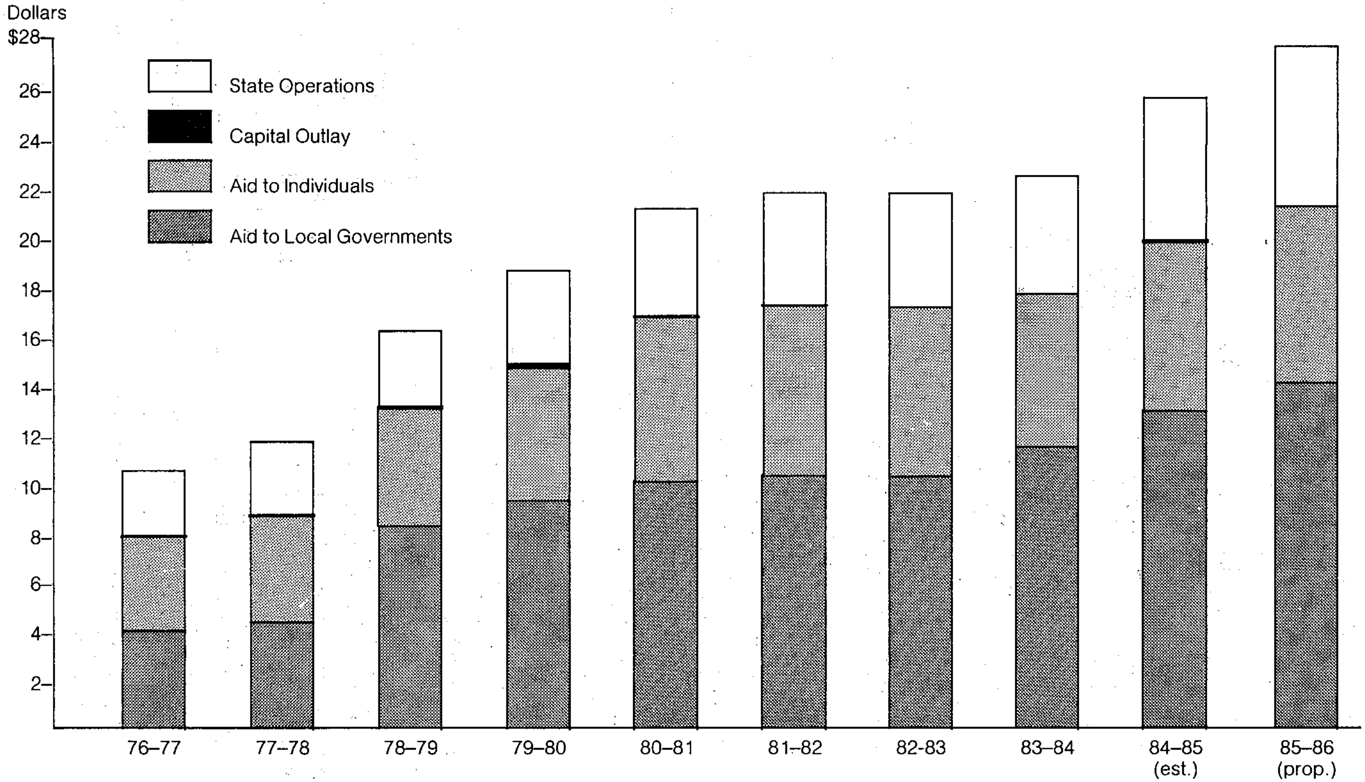
Local Assistance

As illustrated in Chart 6, General Fund expenditures for local assistance will have increased by $13.4 billion, or 171 percent, during the 10 years from 1976–77 through 1985–86. 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 12 displays local assistance expenditures, by funding source. It shows that the Governor's Budget proposes an overall increase of $1.5 billion, or 7.3 percent, in General Fund support for this category of expenditures.

Chart 6

General Fund Budget Structure 1976–77 through 1985–86 (in billions)



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 provided to individuals. This treatment tends to ignore the issue of where the *responsibility* for providing the service lies. For example, the "payments to service providers"

Table 13
Major General Fund-Supported Local Assistance Programs Providing Aid to Individuals 1983–84 through 1985–86 (dollars in millions)

	Actual 1983–84	*Estimated 1984–85*	*Governor's Budget 1985–86*
Medi-Cal [a]	$1,893	1,929	$2,050
AFDC [b]	1,490	1,594	1,683
SSI/SSP	1,107	1,262	1,397
Developmental Services	559	659	703
Personal Property Tax Relief (subventions)	302	—	—
Personal Property Tax Relief (provided through other sources)	226	528	528
Renters' Tax Relief	423 [c]	441	460
Homeowners' Property Tax Relief	334	333	335
Senior Citizens Renters' Tax Relief	36 [c]	34	34
Senior Citizens' Property Tax Assistance	9 [c]	8	8
Subventions for Open Space	14	14	14
Senior Citizens' Property Tax Postponement	7	8	10
Payment to Local Governments for Sales and Property Tax Losses	4	5	—
Totals [d]	$6,353	$6,815	$7,222

[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.

category includes the state funds provided to county governments to assist the *counties* in providing a meaningful level of service for the alcohol and drug programs. Table 12 displays what we believe is a more meaningful division of local assistance expenditures: "Aid to Local Governments" and "Aid to Individuals."

Aid to Individuals. Table 13 identifies 12 General Fund-supported local assistance programs which our analysis indicates are appropriately categorized as "Aid to Individuals." Overall, the Governor's Budget proposes a funding increase of $407 million, or 6 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, no change in funding for four and transfer of funding for one.

Aid to Local Governments. Table 14 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 approximately $1 billion, or 8.1 percent, from current-year levels. This change is primarily the result of the 10 percent funding increase proposed for K–12 education. The decrease between 1984–85 and 1985–86 in the "All Other" category reflects the repayment, during the current year, of a $200 million loan to the General Fund under the Los Angeles County Medical Assistance Grant Program.

Table 14
Major General Fund-Supported Local Assistance Programs Providing Aid to Local Governments 1983–84 through 1985–86 (dollars in millions)

	Actual 1983–84	*Estimated 1984–85*	*Governor's Budget 1985–86*
Public Health Services	$904	$943	$950
California Children's Services	38	45	51
Department of Rehabilitation	45	58	65
Mental Health Programs	445	519	594
Alcohol and Drug Programs	62	69	72
Social Services—Programs	161	224	308
Social Services—County Administration	111	123	130
County Justice Subvention	63	64	67
K-12 Education	8,597	9,495	10,453
Community Colleges	1,036	1,084	1,134
All Other	357	353	200
Totals [a]	$11,819	$12,977	$14,024

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

RESERVE FOR ECONOMIC UNCERTAINTIES

The Governor's Budget holds $1,043.5 million from the General Fund in reserve for 1985–86. Of this amount, $1,040.1 million would be appropriated to the Reserve for Economic Uncertainties, and $3.4 million represents funds which have already been appropriated but are not expected to be spent during the budget year.

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.

The amount proposed for the reserve in 1985–86 is equal to about 3.7 percent of proposed General Fund expenditures.

COST-OF-LIVING ADJUSTMENTS (COLAs)

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

Discretionary and Statutory COLAs

Existing law authorizes *automatic* COLAs for 20 different programs, most of them in the health, education and welfare areas. These adjustments generally are referred to as statutory COLAs. Many other local assistance programs traditionally have received COLAs on a *discretionary* (or nonstatutory) basis, through the budget process.

In 1985–86, statutory COLAs will range from 3.8 percent (child nutrition in schools) to an estimated 10.7 percent (Medi-Cal noncontract hospitals). Those statutory COLAs with the largest costs are for K–12 apportionments ($580 million), SSI/SSP grants ($103 million) and Community College apportionments ($89 million). The General Fund cost of fully funding *statutory* COLAs in 1985–86 is approximately $1 billion.

Governor's Budget Proposal

The budget proposes a total of $1,587 million from the General Fund for COLAs in 1985–86, including $1,006 million for statutory COLAs (generally the full amount required by existing law) and $581 million for discretionary COLAs. The specific increases proposed by the Governor are shown in Table 15.

The table also includes one COLA-like adjustment: the $49 million increase proposed for state operating expenses in order to offset the effects of inflation on the budgets for 24-hour care institutions, state programs dedicated to fire and life safety, and programs involved with revenue production or the maintenance of classroom ratios. These adjustments generally are 5 percent.

Table 15
General Fund Cost-of-Living Increases
1984–85 and 1985–86
(dollars in thousands)

	1984–85	*1985–86*				
	Budgeted	*1%*	*Statutory*		*Budget*	
Department/Program	*Percent Increase*	*Dollar Increase*	*Percent Increase*	*Dollar Increase*	*Percent Increase*	*Budget as Proposed*
HEALTH AND WELFARE						
Alcohol and Drug Programs	3.0%	$640	—	—	4.0%	$2,560
Health Services						
County Health (AB 8)	4.2	3,847	5.35%	$20,582	5.35	20,582
Medically Indigent Services	3.0	4,930	—	—	4.0	19,720
Public Health	3.0	1,193	—	—	4.0	4,772
Medi-Cal						
Noncontract Hospitals (including PHPs and RHF)	10.4	460	10.7	4,916	10.7	4,916
PHPs, CDS, and RHF (nonhospital services)	3.0	1,184	—	—	4.0	4,736
Long-Term Care Facilities, including state hospitals	6.0	5,419	—	—	4.0	21,676
Providers, all others	7.6 [a]	3,672	—	—	4.0	14,768
Beneficiary ("Spin-off")	5.6	2,364	5.3	13,962	5.3	13,962
Drug Ingredients	7.5	451	6.8	3,065	6.8	3,065
County Administration	3.0	363	—	—	2.4	871
Developmental Services						
Regional Centers—Out-of-Home Care	12.5	1,875	—	—	4.0	7,498
Regional Centers—Other	3.0	1,399	—	—	4.0	5,601
State Hospital Education Programs	3.0	44	—	—	4.0	175
Local Mental Health Programs	3.0	3,644	—	—	4.0	14,576
Social Services						
SSI/SSP	5.6	19,476	5.3	103,224	5.3	103,224
AFDC	5.6	15,348	5.3	81,345	5.3	81,345
AFDC—Foster Care	4.0 [b]	1,497	—	—	4.0	5,988
IHSS—Statutory	5.6	105	5.3	557	5.3	557
IHSS—Nonstatutory	3.0	3,094	—	—	4.0	12,377
Community Care Licensing—Local Assistance	3.0	71	—	—	4.0	284
County Administration	3.0	1,272	—	—	2.4	3,053
Social Services—Other	3.0	2,336	—	—	4.0	9,343
Department of Rehabilitation	3.0	568	—	—	4.0	2,272
YOUTH AUTHORITY						
County Justice System Subvention Programs	2.0	641	—	—	4.0	2,564
EDUCATION						
Apportionments:						
K-12—District Revenue Limits	5.9	94,963	5.95	565,032	5.95	565,032
Meals for Needy Pupils	5.9	220	6.0	1,323	6.0	1,323
Summer School	5.9	606	5.95	3,605	5.95	3,605
Apprentice Programs	5.9	34	—	—	4.0	135

Small School District Transportation	3.0	191	—	—	4.0	765
Transportation	3.0	2,719	—	—	4.0	10,879
K-12—County Offices of Education	5.9	1,751	5.95	10,417	5.95	10,417
Regional Occupational Centers/Programs	5.9	1,877	—	—	4.0	7,508
Child Nutrition	5.9	284	3.8	1,079	3.8	1,079
American Indian Education Centers	3.0	8	—	—	4.0	33
Native American Indian Education	3.0	3	—	—	4.0	14
Child Care Program	3.0	2,459	—	—	4.0	9,834
Special Education	5.9	13,454	5.95	80,054	5.95	80,054
Staff Development	3.0	203	—	—	4.0	810
Preschool	3.0	338	—	—	4.0	1,355
Libraries	3.0	72	—	—	4.0	288
Meade Aid	3.0	99	—	—	4.0	397
Urban Impact Aid	3.0	725	—	—	4.0	2,902
Gifted and Talented	5.9	189	6.0	1,134	6.0	1,134
Instructional Materials (K–8)	5.9	635	4.3	2,731	4.4	2,766
Instructional Materials (9–12)	5.9	198	—	—	3.9	779
Demonstration Programs in Reading and Math	5.9	40	—	—	4.0	160
Education Technology	3.0	153	—	—	4.0	611
Economic Impact Aid	3.0	1,875	—	—	4.0	7,500
Adult Education	5.9	1,842	6.0	12,420	6.0	12,420
Adults in Correctional Facilities	5.9	13	6.0	81	4.0	54
Foster Youth Services	3.0	8	—	—	4.0	31
School Improvement Program	3.0	1,972	—	—	4.0	7,889
Miller-Unruh Reading Program	5.9	182	—	—	4.0	727
High School Pupil Counseling	—	66	—	—	4.0	264
Mathematics, Engineering, Science Achievement	—	14	—	—	4.0	56
Youth Suicide Prevention	—	3	—	—	4.0	12
Opportunity Classes	—	41	—	—	4.0	165
Specialized Secondary Schools	—	20	—	—	4.0	80
Board of Governors, California Community Colleges						
Apportionments	3.3	15,181	5.87	89,080	5.87	89,080
Handicapped Student Services	3.0	236	—	—	4.0	945
EOPS	3.0	267	—	—	4.0	1,069
Student Aid Commission—Awards	9.0	968	—	—	9.2	8,870
CSU-EOPS	3.0	78	—	—	4.0	311
ALL OTHERS						
State Contribution to STRS	5.5	2,165	5.1	11,039	5.1	11,039
Employee Compensation						
Civil Service and Related	10.0	22,355	—	—	6.5	162,308 [c]
University of California	11.0	12,130	—	—	8.8 [d]	89,339
California State University	10.5	10,960	—	—	10.5 [d]	82,043
Hastings College of Law	11.0	76	—	—	8.8 [d]	569
Inflation Adjustment (state support)	NA	NA	—	—	—	49,413
Totals	—	$267,566	—	$1,005,646	—	$1,586,549

[a] Those not affected by AB 799 reductions received a 3 percent COLA.
[b] Group homes received a 4 percent COLA; Foster family homes received none.
[c] Includes $17 million for annuitants.
[d] Faculty COLA; non-faculty COLA is 6.5 percent.

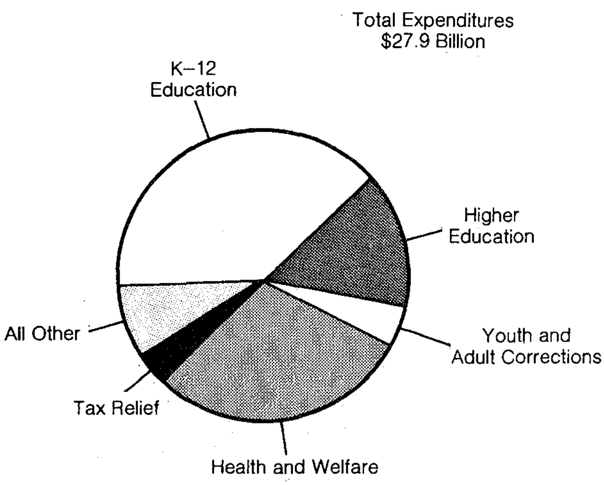
PROGRAM EXPENDITURES

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 7 and Table 16 show the distribution of General Fund expenditures, by major program categories, in 1985–86. These displays indicate that the two largest budget categories are education and health and welfare, which collectively account for $23.4 billion, or 84 percent, of total General Fund expenditures. The remaining $4.5 billion, or 16 percent of total expenditures, goes for tax relief and all other programs of state government, such as corrections and resources.

Chart 7
General Fund Expenditures—Major Components 1985–86



The so-called "people programs"—education, health and welfare—have been the fastest growing components of General Fund expenditures in recent years. Chart 8 illustrates that since 1976–77, expenditures for these programs have increased significantly. Over the ten-year period, higher and lower education expenditures have increased by $10.2 billion, or 219 percent, while health and welfare expenditures have grown by $5 billion, or 139 percent.

Table 16
Expenditures for Health, Welfare, and Education As a Percent of Total General Fund Expenditures 1985–86 (dollars in millions) [a]

	Amount	*Percent of General Fund Budget*
K-12 Education [b]	$10,697	38%
Higher Education	4,179	15
Subtotal, Education	$14,876	53%
Health and Welfare	8,509	31
Subtotal, Education, Health and Welfare	$23,385	84%
Other program areas	4,479	16
Total General Fund budget	$27,864	100%

[a] Source: Governor's Budget.
[b] Includes $400 million for State Teachers' Retirement System contribution.

Chart 8
Trends in General Fund Program Expenditures 1976–77 through 1985–86 (in billions)

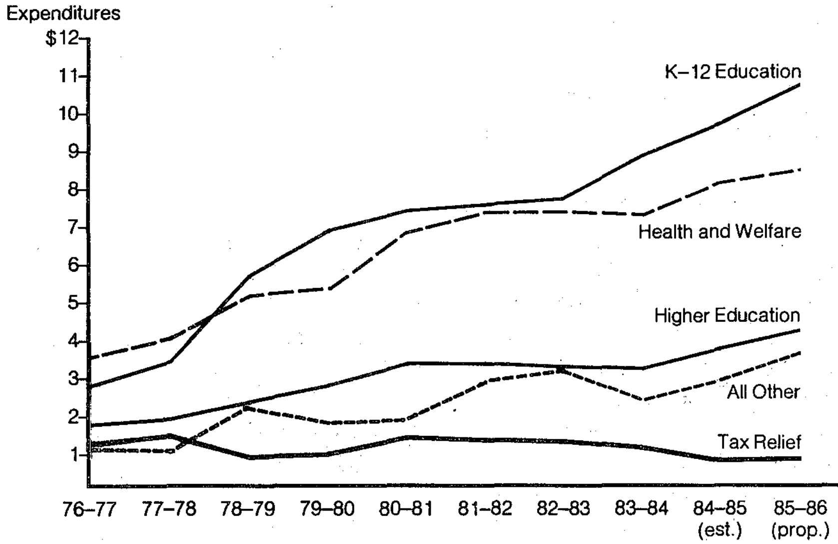


Table 17
Estimated General Fund Program Changes [a]
1984–85 and 1985–86
(dollars in millions)

	Estimated 1984–85	*Proposed 1985–86*	*Change Amount*	*Change Percent*
Health and Welfare:				
Medi-Cal	$1,978	$2,105	$127	6.4%
County health	877	920	43	4.8
SSI/SSP	1,263	1,398	135	10.7
AFDC grants	1,594	1,683	89	5.3
Social services programs	238	322	84	35.1
Mental health	640	715	75	11.7
Developmental services	676	721	45	6.6
L.A. County Medical Assist. Grant Program	200	—	−200	— [b]
Other, health and welfare	603	646	43	7.0
Subtotals, Health and Welfare	$8,070	$8,509	$439	5.4%
Education:				
K–12	$9,400	$10,297	$896	9.5%
State teachers' retirement	337	400	63	18.6
University of California	1,457	1,628	171	11.7
California State University	1,151	1,254	103	8.9
California Community Colleges	1,117	1,168	50	4.5
Other, higher education	109	130	22	19.9
Subtotals, Education	$13,571	$14,876	$1,305	9.6%
Other:				
Youth and adult corrections	$1,062	$1,183	$121	11.4%
Resources	393	398	5	1.4
Tax relief	930	978	48	5.2
Debt service	463	546	84	18.1
Unallocated	87	374	287	— [b]
All other	1,007	1,000	−7	−0.7
Subtotals, Other	$3,941	$4,480	$539	13.7%
Totals [c]	$25,582	$27,864	$2,282	8.9%

[a] Based on amounts shown in Governor's Budget.
[b] Percentage change equals or exceeds 100 percent.
[c] Details may not add to totals due to rounding.

Summary of Major Program Changes

For 1985–86, the budget proposes a net increase in General Fund expenditures of $2.3 billion, or 8.9 percent, above the level of expenditures estimated for the current year. Table 17 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 $1.3 billion, or 9.6 percent, above the 1984–85 level. 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 proposed to increase by $127 million, or 6.4 percent. Three factors primarily account for this increase: provider rate increases and a beneficiary cost-of-living adjustment ($71 million); increased expenditures to offset decreased receipts from the federal government ($93 million); and other changes in the cost per unit of service ($37 million). These costs partially are offset by an estimated decrease in caseload.

SSI/SSP expenditures are expected to be up $135 million, or 11 percent above estimated current-year expenditures. This increase primarily reflects a 5.3 percent cost-of-living increase for grants ($103 million) and increased caseloads.

Social Services Programs expenditures are up $84 million or 35 percent above estimated current-year expenditures. This increase primarily reflects increased General Fund costs to replace a net decrease in federal funds, ($11 million) as well as increases for cost-of-living ($27 million) and basic caseload growth ($39 million).

Mental Health expenditures are $75 million, or 12 percent, higher in 1985–86. The increase is primarily the result of $40 million in additional funding for local programs, a $15 million cost-of-living adjustment for local programs, and increased staffing in state hospitals, costing $5 million.

K–12 Education expenditures are budgeted at $10.3 billion in 1985–86. This is an increase of $896 million, or 9.5 percent, over estimated current-year expenditures. The primary factors accounting for this increase are: (1) $731 million for statutory and discretionary cost-of-living adjustments (COLAs); (2) $168 million for increased enrollment in public schools; and (3) $105 million to continue a program established by SB 813 (Ch 498/83) which provides fiscal incentives to school districts for increasing the amount of instructional time offered. These factors are partially offset by a $177 million reduction in General Fund requirements resulting from anticipated increases in school district property tax receipts.

State Teachers' Retirement Fund contributions from the General Fund are proposed to increase by $63 million. Of this amount, $31 million represents an increase in the state's basic contribution to the fund (for inflationary and special adjustments), and $32 million to increase the purchasing power protection for STRS retirees.

Higher Education General Fund expenditures are proposed to increase by $323 million, or 8.7 percent. Expenditures for the University of California (UC) are budgeted to increase by $171 million, or 12 percent; expenditures for the California State University (CSU) are proposed to increase by $102 million, or 8.9 percent; and General Fund expenditures for the Community Colleges are budgeted to increase by $50 million, or 4.5 percent.

Accounting for a significant portion of the increase for higher education is $171 million in salary and benefit increases for UC and CSU faculty and staff.

Youth and Adult Correctional Agency expenditures are proposed to increase by $121 million in the budget year. This will fund 1,906 additional personnel-years for the Department of Corrections and the increased operating expenditures needed to accommodate the 10 percent growth in the prison population projected by the end of 1985–86.

Debt Service is expected to be $84 million, or 18 percent, higher in 1985–86. This reflects the large volume of general obligation bond issues approved by the voters in the last two statewide elections.

Unallocated expenditures are budgeted at $374 million in 1985–86. Of this amount, $162 million is proposed for General Fund-supported civil service and related employee compensation increases, $75 million has been set aside to cover the costs of unidentified legislation enacted during the budget year, and $40 million is earmarked for legislation which would establish a state loan guarantee to the Thrift Guaranty Corporation for payments to account holders of an insolvent financial company.

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, and various education-related capital outlay projects.

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 its ability to pay its bills on time, even if economic conditions deteriorate unexpectedly. Thus, in analyzing the Governor's Budget for 1985–86, it is important to consider whether the state will collect sufficient revenues to (a) fund the Governor's proposed spending plan, (b) finance new legislation which the Legislature may choose to enact, and at the same time (c) set enough monies aside to adequately protect the General Fund against possible revenue shortfalls or unanticipated expenditures.

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 REVENUE OUTLOOK

The level of revenues that the state can expect to receive will be determined by a wide variety of factors. These include how the state's *tax base* is defined, 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, the extent to which the Legislature chooses to enact *legislation* which affects the total amount of revenue collected, and other factors such as court decisions and actions of the federal government which directly affect revenues. Of these, the single most important factor influencing the level of California state revenues in 1985–86 will be the behavior of the state's economy.

Continued Economic Expansion Assumed

The Department of Finance's economic forecast assumes that California's economy, like the nation's, will continue to expand throughout both 1985 and 1986, although at a much more moderate pace than the spectacular growth of 1984. Also projected are continued declines in the unemployment rate and relatively moderate inflation. The department's assumption that economic growth will moderate is consistent with the consensus views of economists generally and characteristic of what usually happens as an economic expansion matures.

Drop-Off in Revenue Growth Expected

Table 18 summarizes the budget's estimates of how much state revenues will be generated in the current and budget years if the department's economic forecast comes true. For comparison purposes, the table also summarizes how revenues performed during the prior year. Chart 9, on the other hand, shows the trend in state revenues, by source, over the past decade.

Table 18 indicates that:

- ***Prior-year*** (1983–84) total revenues were $27.6 billion ($3.3 billion, or 14 percent, above the previous year's level). This amount consists of about $23.8 billion in General Fund revenues (up 12 percent) and $3.8 billion in special fund revenues (up 25 percent). The largest single cause of the unusually rapid growth in prior-year special fund revenues was a 23 percent increase in motor vehicle-related revenues, brought about by legislation that increased vehicle-related licenses, fees and fuel taxes (discussed in more detail below).

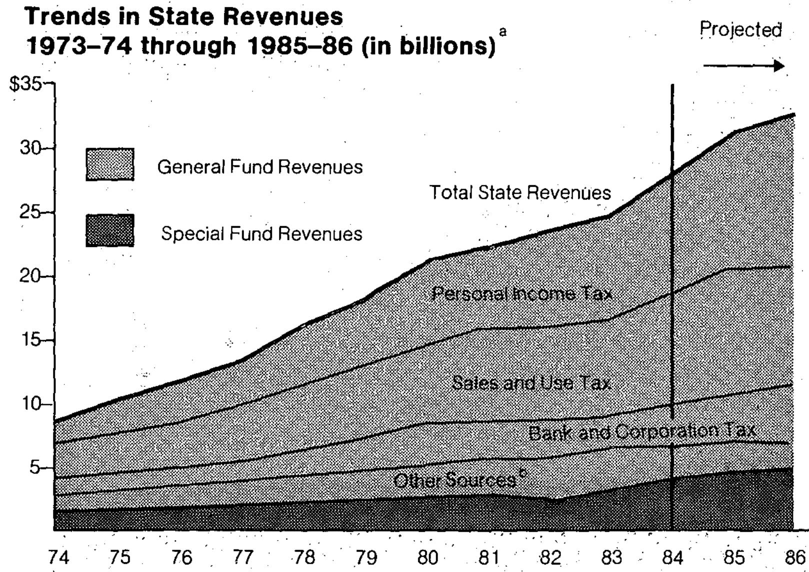
Table 18
Revenue Summary
General Fund and Special Funds
1983–84 through 1985–86
(dollars in millions) [a]

	Prior Year (1983–84)	*Current Year (1984–85)*	*Budget Year (1985–86)*
General Fund Revenues			
—Amount	$23,809	$26,077	$27,922
—Dollar change	2,578	2,268	1,845
—Percent change	12.1%	9.5%	7.1%
Special Fund Revenues			
—Amount	$3,816	$4,926	$4,999
—Dollar change	757	1,110	73
—Percent change	24.8%	29.1%	1.5%
Totals, General Fund and Special Fund Revenues			
—Amount	$27,626	$31,003	$32,921
—Dollar change	3,335	3,377	1,918
—Percent change	13.7%	12.2%	6.2%

[a] Source: Governor's Budget. Details may not add to totals due to rounding. Figures include effects of various revenue-enhancing measures and certain shifts of revenues between various special funds and the General Fund. General Fund revenue total for 1985–86 includes $137 million due to the Governor's *proposed* funding of energy-related tax credits through direct appropriations.

- *Current-year* (1984–85) total revenues are estimated to reach $31 billion (up $3.4 billion, or 12 percent), consisting of $26.1 billion in General Fund revenues (up 9.5 percent) and revenues to special funds of $4.9 billion (up 29 percent). The unusually rapid growth in current-year special fund revenues primarily reflects the discontinuation of large transfers from special funds to the General Fund. These transfers occurred in 1981–82, 1982–83 and 1983–84.
- *Budget-year* (1985–86) total revenues are projected at $32.9 billion ($1.9 billion, or 6.2 percent, above the estimated current-year level). The total includes $27.9 billion in General Fund revenues (up $1.8 billion, or 7.1 percent) and $5 billion in special fund revenues (up 1.5 percent).

Chart 9
Trends in State Revenues 1973–74 through 1985–86 (in billions)[a]



[a] Source: Governor's Budgets and State Controller's reports. Data are for fiscal years ending in years shown.
[b] Includes other taxes, licenses, fees, interest income, transfers, and other sources. Some of the year-to-year fluctuations in revenues in this category and in special funds revenues reflect year-to-year shifts in revenues between these two categories.

No Budget-Year Growth After Adjustments for Inflation and Population

Both by historical standards and relative to the current year, the revenue growth rate projected for the budget year is low. Growth in total state revenues averaged 12 percent over the period 1973–74 through 1983–84, and is projected to be 12 percent in the current year as well. This rate is nearly double the 6.2 percent growth rate projected in the budget year.

Likewise, revenue growth, after adjusting for the effects of population growth and inflation, averaged close to 1.9 percent during the prior 10 years, and is projected to be 4 percent in 1984–85. In contrast, inflation-adjusted revenues per capita are expected to *decline* by 1.3 percent in 1985–86.

While some of the drop-off in the revenue growth rate can be explained by "special" factors, such as the effects of past legislation and ballot initiatives, it primarily reflects the expected moderation in the pace of economic activity during 1985 and 1986. This is particularly true in the case of General Fund revenues. In addition, we believe that the department's budget-year General Fund revenue estimate is understated by about $345 million, relative to the amount of revenues that its economic assumptions should produce. If the $345 million is added to total revenues as displayed in the budget, the projected increase becomes about 7.6 percent in 1985–86. This increase would be just enough to offset the effects of inflation and population growth on current-year revenues. (General Fund revenue growth increases to around 8.7 percent when the $345 million is added in, or roughly in line with expected growth in personal income during 1985–86.)

Thus, while the department's economic assumptions produce a revenue growth rate for the budget year which is certainly well below the historical average, it is sufficiently high to at least keep total state revenues growing "in step" with inflation and population.

We now turn to a more detailed discussion of state revenues in the prior year (1983–84), current year (1984–85), and budget year (1985–86), following a closer look at the economic assumptions on which the current-year and budget-year revenue forecasts are based.

THE ECONOMIC OUTLOOK

Economic performance during 1985 and 1986 will be the prime determinant of state revenue collections during the latter half of 1984–85 and in 1985–86. Economic activity in calendar 1985 will account for about one-third of current-year (1984–85) General Fund revenues and about two-thirds of budget-year (1985–86) General Fund revenues. The remaining one-third of budget-year revenues will be determined by economic conditions in 1986.

The economic outlook projected by the department for 1985 and 1986 is a relatively favorable one. Most important, the economy is expected to continue expanding in both years, though at a slower pace than in 1984.

1984 Ends on a Strong Note

On balance, 1984's overall economic performance was very favorable. At the national level, real GNP grew by 6.8 percent, which was about 1 percentage point faster than the department had expected one year ago.

As shown in Chart 10 and Table 19, the year also saw a decline in the unemployment rate, a further downward-drift in inflation, and fairly strong performances for corporate profits, employment, car sales and housing starts.

Table 19
Department of Finance's Economic Outlook for California and the Nation [a]
1984 through 1986

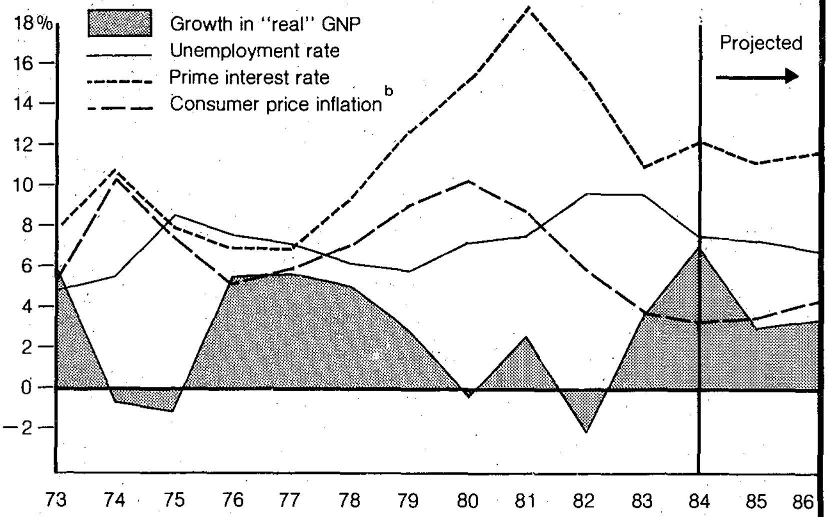
Economic Indicator	*1984 Estimated* [b]	*1985 Projected*	*1986 Projected*
1. *National Economy*			
Percent change in:			
—Real GNP	6.9%	3.0%	3.3%
—Personal income	9.9	7.5	7.4
—Pre-tax corporate profits	15.5	2.0	15.1
—Wage and salary employment	4.4	2.6	2.0
—Civilian employment	4.0	2.2	2.1
—GNP prices	3.8	4.0	4.3
—GNP consumer prices	3.3	3.6	4.2
—Consumer Price Index	4.4	4.4	4.9
Unemployment rate (%)	7.5%	7.2%	6.6%
Savings rate (%)	6.0	5.9	5.9
Prime interest rate (%)	12.1	11.2	11.8
New car sales (millions of units)	10.4	10.2	10.2
Housing starts (millions of units)	1.81	1.70	1.80
2. *California Economy*			
Percent change in:			
—Personal income	12.1%	8.6%	7.9%
—Wage and salary income	12.7	8.9	7.8
—Wage and salary employment	6.1	3.7	2.9
—Civilian employment	4.2	3.5	2.2
—Consumer Price Index	5.0	4.9	4.9
—Key elements of the state's tax base:			
—Taxable personal income [c]	13.4	9.1	7.9
—Taxable sales	15.9	8.4	7.9
—Taxable corporate profits	18.1	9.9	17.2
Unemployment rate (%)	7.8%	6.9%	6.4%
New car registrations (thousands of units)	1,180	1,155	1,165
New building permits (thousands of units)	218	185	195

[a] Source: Governor's Budget and Department of Finance.
[b] As estimated in December 1984 and published in the 1985–86 Governor's Budget.
[c] Defined as total personal income plus social security contributions minus 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.

California's performance in 1984 was even better, as the state registered a phenomenal 8.5 percent increase in "real" personal income (please see Chart 11) and an extremely strong 6.1 percent gain in wage and salary employment (please see Chart 12). As a result, California's unemployment rate declined by almost 2 percentage points, a record one-year drop.

Chart 10

Trends in Key National Economic Variables 1973 through 1986 [a]



[a] Source: California Department of Finance.

[b] Inflation as measured by the GNP consumption expenditures deflator.

Table 19 also indicates that the key elements of the state's tax base, including taxable sales and corporate profits, all registered strong gains. As shown in Table 20, California's economic performance was much stronger than predicted prior to the start of the year, especially in terms of the growth in personal income, wage and salary employment, and taxable sales.

Of course, the economy was not without its problems in 1984. These included persistently high interest rates (please see Chart 10), serious international debt problems, a record-high foreign trade deficit and, of course, a $200-billion-plus annual federal budget deficit with no near-term prospects for eliminating it. Likewise, the pattern of economic growth within 1984 was surprisingly uneven, with strong gains in the first two quarters of the year giving way to weakness in the third quarter. This raised concerns that the economy might be headed downward. However, the economy grew at a strong 4 percent annual rate in the fourth quarter, doing much to alleviate these concerns. Thus, despite its problems, the economy ended 1984 and began 1985 on a fairly strong note.

Table 20
Accuracy of Economic Forecasts for California in 1984

Economic Indicator	Original Forecasts: Department of Finance [a]	Other Forecasters [b]: Lowest	Average	Highest	Revised Department of Finance June 1984 Forecast	January 1985 Estimated Actual [c]
Percent change in:						
—Personal income	9.7%	10.2%	10.7%	11.3%	10.3%	12.1%
—Civilian employment	4.3	3.4	4.2	4.8	3.9	4.2
—Wage and salary jobs	3.9	3.5	4.2	4.8	5.5	6.1
—Consumer prices	6.0	4.6	5.1	5.8	5.1	5.0
—Taxable sales	12.9	—	—	—	13.9	15.9
—Taxable corporate profits	26.4	—	—	—	23.1	18.1
Unemployment rate (%)	7.9%	8.3%	8.5%	8.8%	7.6%	7.8%
Residential building permits (thousands)	170	143	169	191	189	218
New car sales (thousands)	1,110	—	—	—	1,195	1,180

[a] Source: 1984–85 Governor's Budget.
[b] Includes First Interstate Bank, Security Pacific Bank, Bank of America, Crocker Bank, UCLA, and the Commission on State Finance. Forecasts are as of approximately year-end 1983, corresponding to when the Department of Finance constructed the economic assumptions contained in the Governor's Budget for 1984–85. For detail on these forecasts, please see *1984–85 Perspectives and Issues,* Table 28, page 73.
[c] Source: 1985–86 Governor's Budget.

Continued Growth Expected

Table 19 summarizes the department's economic forecast for the nation and California. This forecast reflects the consensus view among economists that the current economic expansion, which began in 1983, will slow but nevertheless continue throughout 1985 and 1986. For the nation as a whole:

- ***Real GNP*** is projected to rise by 3 percent in 1985 and 3.3 percent in 1986. While well below the 6.8 percent gain in 1984, these are healthy, sustainable rates of growth.
- ***Pre-tax corporate profits*** are expected to post a relatively small 2 percent gain in 1985, followed by a 15 percent improvement in 1986.
- ***Unemployment*** is expected to drift downward to 7.2 percent in 1985 and 6.6 percent in 1986, reflecting modest gains in ***civilian employment*** of 2.2 percent and 2.1 percent in the two years, respectively.
- ***Housing starts*** (1.7 million units in 1985 and 1.8 million in 1986) are projected to hover at the same general level that was reached in 1984 (1.8 million). The same general leveling off is expected for ***new car sales***—10.2 million units in both 1985 and 1986, compared to 10.4 million units in 1984.

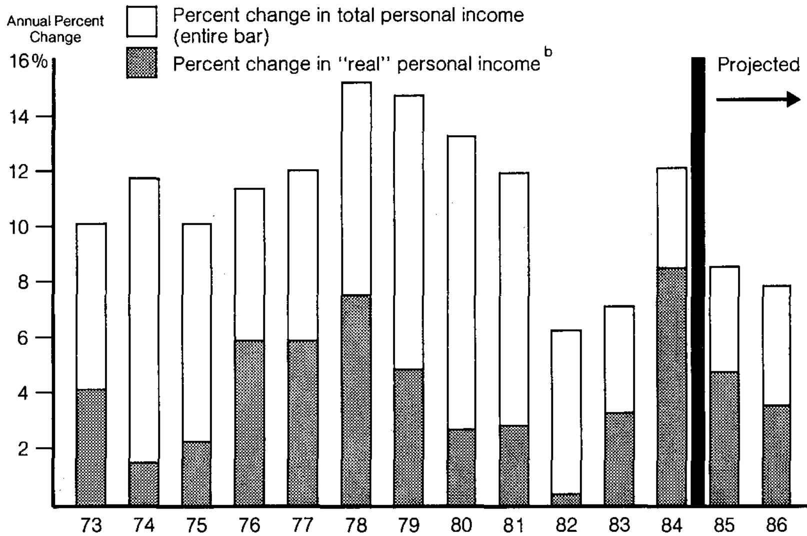
California To Outperform Nation

Table 19 also shows that, although the pace of economic activity in California is expected to slow from 1984, the state is still expected to outperform the nation. For example:

- ***Personal income*** in California is projected to rise by 8.6 percent in 1985 and 7.9 percent in 1986, versus 7.5 percent and 7.4 percent, respectively, at the national level. And, as shown in Chart 11, "real" personal income growth in the state (4.8 percent in 1985 and 3.6 percent in 1986) is expected to compare favorably with the growth rates realized during the past decade (an average of 3.8 percent for the 1973-through-1983 period).

Chart 11

Annual Growth in California Personal Income 1973 through 1986[a]



[a] Source: Department of Finance estimate for 1984 and projections for 1985 and 1986.
[b] Real personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

- ***Employment growth*** projected for California (3.5 percent in 1985 and 2.2 percent in 1986 for civilian employment; 3.7 percent in 1985 and 2.9 percent in 1986 for wage-and-salary employment) is expected to outdistance national employment growth rates. Although the state's employment growth rates are, from an historical perspective, relatively moderate (Chart 12), they translate into a very large number of new jobs—nearly 400,000 in 1985 and over 300,000 in 1986.
- The state's ***unemployment rate*** is expected to drop rapidly, as a result of these job gains, and fall below the national unemployment rate in both 1985 and 1986. As Chart 12 shows, the expected 6.9 percent and 6.4 percent unemployment rates forecasted for California in 1985 and 1986, respectively, would be amongst the lowest since 1973.

Chart 12

Trends in California Employment and Unemployment 1973 through 1986[a]

[a] Sources: Department of Finance and Employment Development Department. Data are estimated for 1984.

The implications of the current economic outlook for state revenues are best seen in the forecast for those key California variables which most directly affect the state's major revenue sources. As shown in Table 19:

- ***"Adjusted" personal income*** (that is personal income adjusted for transfer payments and social security contributions, so as to roughly approximate "taxable" personal income) is projected to increase by 9.1 percent in 1985 and 7.9 percent in 1986.
- ***Taxable corporate profits*** are forecast to rise 9.9 percent in 1985 and 17 percent in 1986, following 1984's gain of 18 percent and 1983's gain of 17 percent (please see Chart 14). The cumulative 78 percent increase for these four years (1983 through 1986) is in sharp contrast to the preceding four years, and compares favorably to the era of 20-percent-plus increases experienced from 1976 through 1978, after the 1973–75 recession ended.
- ***Taxable sales*** are predicted to rise 8.4 percent in 1985 and 7.9 percent in 1986. Because of continuing moderate inflation, these gains will allow for fairly good increases in "real" taxable sales, including 4.6 percent in 1985 and 3.6 percent in 1986 (please see Chart 13).

Inflation—Outlook Remains Good (For Now)

Chart 10 shows the trend of general inflation faced by consumers nationally since 1973 and the department's projected rate of inflation for 1985 and 1986.

The chart and Table 19 indicate that a major upswing in inflation is not expected during either 1985 or 1986. Some uptick is projected at the national level, both for GNP prices generally and GNP consumer prices. The same is projected in 1986 for the Consumer Price Index. However, the outlook for Consumer Price Index inflation shows relative stability for both 1985 and 1986 in California (4.9 percent in each year) and for 1985 nationally (4.4 percent). The general consensus among economic forecasters is that a major near-term escalation of inflation is not likely.

There are several reasons for this view. First, as shown in Table 21, unit labor costs (which are a prime determinant of the inflation rate) are expected to grow relatively slowly despite a projected drop-off in hourly labor productivity gains, reflecting moderate increases in hourly labor costs. Second, the softness in world oil prices is expected to keep gasoline prices low. A third reason is the currently high value of the dollar in international currency markets. While having the negative effect of drawing jobs and production away from the United States, the strong dollar allows consumption of more lower-cost foreign imports which both reduces costs to consumers directly and tends to hold down the prices of domestically-produced items.

Table 21
Trends in Factors Influencing National Inflation
1980 through 1986 [a]

				Inflation Rate			
				GNP Deflator			
Year	*Labor Productivity Growth*	*Growth in Hourly Labor Compensation*	*Growth in Unit Labor Costs* [b]	*Total*	*Consumption*	*CPI*	*"Core" Inflation* [c]
1980	−0.7%	10.4%	11.1%	9.2%	10.2%	13.5%	9.3%
1981	1.9	9.8	7.7	9.6	8.7	10.4	9.0
1982	−0.1	7.8	8.0	6.0	5.9	6.1	8.6
1983	3.4	4.8	1.3	3.8	3.7	3.2	6.6
1984 (estimated)	2.7	4.1	1.4	3.8	3.3	4.3	5.0
1985 (projected)	1.1	4.3	3.1	3.5	3.4	3.7	4.3
1986 (projected)	1.7	5.2	3.4	3.8	3.8	4.0	3.8

[a] Data for 1984, 1985 and 1986 from Data Resources, Inc., *Review of the U.S. Economy*, January 1985.
[b] The annual change in unit labor costs is approximately equal to the difference between growth in hourly labor compensation and productivity growth.
[c] This variable has been developed by Data Resources to reflect the "underlying" rate of inflation, which depends on such factors as unit labor costs and is free of transitory phenomena and temporary price shocks involving such commodities as food and fuels.

These factors are expected to offset any upward pressure on prices that usually occurs as continued economic expansion causes labor markets to tighten and the amount of "excess capacity" in the economy to decline.

Despite the relatively moderate rates of inflation projected for the next two years, we should *still* be concerned about the threat inflation poses to the economy. As we learned all too well during the 1970's, the rate of inflation can accelerate quickly if monetary growth is not controlled, or if outside shocks, such as disruptions in the supply of oil, occur. Furthermore, even a 5 percent inflation rate makes prices double in only 14 years, and can cause problems such as unintended income redistributions, instability in financial markets, and high interest rates. Thus, controlling and reducing inflation should remain a top priority of the nation's economic policymakers.

Interest Rates—Only Temporary Improvement Expected

The problem of high interest rates, which has plagued the economy since the late 1970's, is expected to lessen in 1985. The improvement, however, is only expected to be temporary, with rates drifting upward by 1986. Specifically, the department is projecting that:

- The *prime rate* will average 11.2 percent in 1985 and 11.8 percent in 1986, versus 12.1 percent in 1984; and
- The *average mortgage rate* will be 13.8 percent in 1985 and 13.9 percent in 1986, compared to 14.1 percent in 1984.

Current data suggest that the department's 1985 interest rate forecast could be a bit high, since the prime rate has been reduced seven times since September 1984 and now stands at 10.5 percent. In fact, UCLA currently projects that the prime rate will average 10.6 percent and mortgage rates will average 12.7 percent in 1985, while Data Resources, Inc. (DRI) predicts a 1985 average prime rate that is even lower—10.1 percent. Nevertheless, the department's assumption that interest rates will reverse course and drift upwards later in 1985 reflects the consensus among most economists, including UCLA and DRI. And, should 1984's strong fourth quarter economic performance carry into the first half of 1985, this could bring with it upward interest rate pressures.

In addition to their failure in accurately predicting future changes in interest rates, economists have been unable to fully explain why interest rates have been at such historically-high levels in recent years. This is especially true of "real" long-term 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 and, therefore, where these rates will head in the future.

What *is* clear is that continued high interest rates will tend to hurt 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 growth of the economy, such as business investment and homebuilding. Expenditure growth in both of these categories is expected to taper off in 1985, due to the combined effects of a more slowly growing economy and relatively high long-term interest rates. High interest rates also contribute to 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.

Federal Budget Problems Still Unresolved

Despite all of the attention directed at the federal budget deficit during the past several years, the deficit problem remains unresolved. Most forecasters expect the federal deficit to be in the $200-billion-plus range both this year and next and, if no action is taken, to remain at this level thereafter. These forecasters generally do not believe that the economy will be able to "grow itself out" of the deficit, since the federal government's expenditure *base* is simply out-of-line with its revenue *base*.

Countless predictions have been made as to what the full economic implications of the deficit will be. Some economists believe that these deficits eventually will cause interest rates to rise to excessive levels, thereby stunting economic growth and investment and eventually leading to lower productivity and higher inflation. On the other hand, other economists maintain that much of the concern about deficits is overstated, and that the economy will somehow "learn to live with them." Last year at this time, for example, there was considerable concern that problems related to the deficit might abort the recovery; yet, the economy performed quite well in 1984 and interest rates actually fell. These economists also argue that in recent years, 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 why the deficits exist is the generous federal tax benefits that were enacted in 1981 and 1982, which themselves are aimed at aiding 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. What does seem clear, however, is that over time, the economy would be healthier without these deficits than with them. In any event, the implications of continuing federal budget deficits are a major cause of uncertainty regarding the economic outlook.

A second area of uncertainty related to federal budget policies involves exactly what expenditure and taxation policies Congress will adopt this year. While this is always a source of uncertainty, it is more so this year than normally, for two reasons. First, the federal government is considering expenditure cutbacks in a number of areas that would have direct implications for state governments—particularly with regard to their health and welfare programs. Second, the U.S. Treasury has proposed to completely overhaul the U.S. personal and corporate income tax system. Among other things, this proposal would lower tax rates, raise personal exemptions, and repeal or modify many existing deductions, exclusions, credits, and preferential treatments for certain types of income and expenses. The primary effects of this proposal would be to *redistribute* the tax burden away from individuals and toward businesses, and make the tax system more "neutral" in terms of its effects on taxpayers' decisions about how to spend and invest their money. This proposal could have a number of significant economic effects. It would *not*, however, have much of a near-term effect either on total federal revenues collected or on the federal budget deficit.

Finance Versus Other Forecasters

Table 22 compares the Department of Finance's national and California economic forecasts for 1985 with those which were made by other economists at approximately the same point in time (year-end 1984). Generally

Table 22
The Economic Outlook for 1985 [a]

A. *National Forecasts*	*Percent Change In:* *Real GNP*	*GNP Prices*	*Pre-Tax Profits*	*Unemployment Rate*	*New Car Sales (millions)*	*Housing Starts (millions)*
Department of Finance	3.0%	4.0%	2.0%	7.2%	10.2	1.70
Blue Chip Survey: [b]						
—Consensus forecast	3.3	4.1	3.6	7.2	10.6	1.72
—Low-end forecast [c]	2.2	3.0	−5.9	6.8	10.1	1.60
—High-end forecast [c]	4.5	5.0	12.5	7.6	11.3	1.90

B. *California Forecasts*	*Percent Change In:* *Personal Income*	*Consumer Prices*	*"Real" Personal Income* [d]	*Wage and Salary Jobs*	*Unemployment Rate*	*New Residential Building Permits (thousands)*
Department of Finance	8.6%	4.9%	3.5%	3.7%	6.9%	185
Other Forecasters						
UCLA	9.7	3.4	6.1	3.5	7.4	207
Security Pacific Bank	9.4	4.5	4.7	3.4	7.5	212
First Interstate Bank	10.0	4.6	5.2	3.9	—	199
Crocker Bank	8.9	5.2	3.5	3.6	7.4	218
Bank of America	11.0	4.5	6.2	—	7.5	—
Wells Fargo Bank	9.0	4.8	4.0	—	7.0	195
Commission on State Finance	8.7	4.8	3.7	3.7	7.5	204
Average of "Other" Forecasters	9.5%	4.5%	4.8%	3.6%	7.4%	206

[a] Forecasts prepared as of approximately year-end 1984.
[b] Includes the projections of 50-odd economists as published in *Blue Chip Economic Indicators* for January 1985. The consensus forecast for 1985 real GNP growth was increased to 3.7 percent in February 1985.
[c] Represents the lowest/highest forecast for each variable as published in *Blue Chip Economic Indicators* for January 1985, after eliminating the most extreme high and low forecast reported.
[d] Defined as personal income adjusted for consumer price inflation.

speaking, 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 1984). Since then, many forecasters have revised their projections upward a bit, based upon such factors as the greater-than-expected drop in the prime interest rate and the stronger-than-predicted real growth in GNP during the fourth quarter.

Nevertheless, the department's overall forecast is not fundamentally out of line. Most forecasters still envision the same general type of economic performance in 1985 that Finance does: fairly moderate inflation and homebuilding activity, healthy but reduced gains in output and employment, declining unemployment, and mild growth in national corporate profits.

However, if one were to characterize the department's 1985 forecast as being toward one end of the forecasting range or the other, one would put it toward the "low" end. As Table 22 shows, the department's forecast is a bit below the consensus for national real GNP growth, corporate profits, car sales, homebuilding activity, and both "nominal" and "real" California personal income growth. Even so, the general story told by *all* of the forecasters is pretty-much the same, and the differences between those stories are not such as to suggest the department's forecast is "out-of-line" or less reasonable than anyone else's.

PRIOR-YEAR (1983–84) REVENUES

General Fund revenue collections in 1983–84, the most recently-completed fiscal year, totalled $23.8 billion. This represents an increase of $2.6 billion (12 percent) over 1982–83.

Revenue Growth Rebounded From Recessionary Lows

The rate of growth in revenues during 1983–84 was about average by historical standards. For example, over the period 1970–71 through 1982–83, General Fund revenue growth averaged 14 percent per year. Prior-year revenue growth was also about average in "real" terms (that is, after adjusting for inflation)—5.5 percent, versus 5.4 percent for the 1970–71 through 1982–83 period. Revenue growth during the prior year, however, was extremely strong compared to growth during the 1980–81–through–1982–83 period, when the economy was in a recession. During this period, revenue growth averaged only 5.6 percent in nominal dollar terms and actually declined after adjusting the growth rate for inflation.

As for the performance of individual revenue sources in 1983–84:

- ***Sales and use taxes*** increased by 13 percent, or $996 million;
- ***Personal income taxes*** rose by 20 percent, or $1.6 billion (this abnormally high increase partly reflects cash-flow factors and the timing of income tax indexing adjustments to withholding tables);

- ***Bank and corporation taxes*** increased by 26 percent, or $664 million;
- ***Income from all other sources*** including investments, other taxes, special fund transfers, fees and royalties fell, by 21 percent, or $698 million.

Growth Would Have Been Even Higher Without Special Factors

The decline in General Fund income from "other sources" in 1983–84 is explained primarily by two special factors that were completely unrelated to the level of economic activity. First, revenues from death-related taxes fell by $324 million in 1983–84, due to the phasing-in of Proposition 6 (June 1982) and Ch 634/80 (discussed later). Second, Ch 327/82 increased insurance tax revenues by $227 million in 1982–83 and reduced them by $112 million in 1983–84. It did so by revising the due dates for insurance tax prepayments. The remaining decline in income from "other sources" reflects such factors as the decline in the amount of tidelands oil revenues transferred to the General Fund. In the absence of these special factors, revenues from "all other" sources would have risen in 1983–84, and total General Fund revenue growth would have exceeded 15 percent. This strong "underlying" growth trend reflects the strong economic performance that occurred, particularly during the first six months of 1984.

Improving Economy Caused Upward Revenue Revisions

Table 23
The Department of Finance's Track Record for Forecasting Revenues in 1983–84 and 1984–85 (dollars in millions) [a]

History of Changes	*Revenue Estimate For* *1983–84*	*1984–85*
A. Original budget estimate [b]	$21,802 [c]	$25,825
B. Revisions due to economic factors and technical reestimates		
—April 1983	−110	—
—June 1983	320	—
—January 1984	284	—
—May 1984	273	−67
—June 1984	68	−91
—July 1984	—	94
—January 1985	82	202
Subtotals	$917	$138
C. Revisions due to other factors, including legislation and court cases	$1,090 [d]	$114 [e]
D. Total revisions	$2,007	$252
E. Actual/estimate as reflected in the Budget for 1985–86 (January 1985)	$23,809	$26,077

[a] Information in the table was developed from Department of Finance data. For additional detail on this information, including the composition of economics-related revenue adjustments by type of tax, see *Perspectives and Issues* for 1983–84 and 1984–85, and *Why Aren't Revenue Estimates More Accurate?*, Legislative Analyst, Report 84-13, November 1984.

[b] Published in January preceding the start of the fiscal year.

[c] Excludes proposal contained in the 1983–84 Governor's Budget to raise revenues by $677 million.

[d] Includes $980 million from 1983 legislation associated primarily with various tax accelerations and the transfer of special fund monies into the General Fund. Also includes $18 million from 1984 legislation and $92 million from court decisions and federal law changes.

[e] Includes $84 million in interest income earnings from the state's short-term external borrowing program (this gain will be partially offset by the interest costs of short-term external borrowing). Also includes $30 million from 1984 legislation.

Table 23 summarizes the department's track record in estimating 1983–84 revenues. It indicates that actual 1983–84 revenues were more than $2 billion above the department's initial (January 1983) estimate for that year. Nearly $1.1 billion of the difference was due to such factors as legislation, court decisions and federal law changes. The remaining $917 million reflected the fact that the economy did not perform as the department forecast, as well as technical revenue reestimates.

As Table 23 shows, the department did not completely anticipate either the strength or timing of the economic recovery. For example, after the 1983–84 revenue estimate was first made, the department actually reduced it. Then, beginning in June 1983, it began revising its estimate upward, step-by-step.

Table 24 shows, however, that the magnitude of the difference between the department's revenue estimates for 1983–84 and actual revenues was considerably *less* than the average discrepancy in preceding years. Thus, from an historical perspective, the department's revenue estimating performance for 1983–84 was above average.

Table 24

Discrepancies Between Estimated and Actual General Fund Revenues Attributable to Economic and Technical Factors 1973–74 through 1983–84 [a]

	Percent Difference Between Actual Revenues and:		
Period	*Original January Budget Estimate*	*First May Estimate*	*Midyear Estimate (January)*
1. 1983–84	4.2%	3.2%	1.9%
2. Prior 10-year period (1973–74 through 1982–83)			
—Average discrepancy [b]	6.4	4.9	2.5
—Largest underestimate	10.8	7.5	4.9
—Largest overestimate	10.6	7.6	3.5

[a] Information in the table was developed by Legislative Analyst's office from Department of Finance historical revenue data. For year-to-year details on the department's revenue estimating discrepancies, see *1984–85 Perspectives and Issues* and *Why Aren't Revenue Estimates More Accurate?*, Legislative Analyst, Report 84-13, November 1984.

[b] Unweighted average of absolute values of percent revisions for individual years.

CURRENT-YEAR (1984–85) REVENUES

General Fund revenue collections in 1984–85 are projected to total $26.1 billion. If this level of collections is realized, it will represent an increase of $2.3 billion (9.5 percent) over the prior-year level. Although the pace of revenue growth expected in 1984–85 is well below that experienced in

1983–84, it is healthy. The slowdown merely reflects the economy's slowing from the extraordinary rapid pace it exhibited in early 1984. As for individual revenue sources:

- ***Sales and use taxes*** are expected to increase by 12 percent, or $1.1 billion.
- ***Personal income taxes*** are projected to rise by 13 percent, or $1.2 billion.
- ***Bank and corporation taxes*** are projected to rise by 9.1 percent, or $294 million.
- ***Income from all other sources,*** including investments, other taxes, special fund transfers, fees and royalties, are projected to decline by 11 percent, or $280 million.

Underlying Growth Trend Understated

As in the prior year, there are a variety of special factors which, taken together, have caused the rate of projected revenue growth for the current year to be artificially low. These factors include the continued phasing-in of death-tax reductions required by Proposition 6 and Ch 634/80 and, most significant, the absence in 1984–85 of over $650 million in General Fund income from vehicle license fees and tidelands oil revenues which is reflected in General Fund income for 1983–84. These factors more than offset the positive effects on 1984–85 revenue growth caused by the state's one-time tax amnesty program ($30 million), nearly $265 million in special fiduciary and death-related tax payments, "arbitrage" investment earnings associated with the state's new external borrowing program, and the $112 million reduction in insurance tax receipts during 1983–84 brought about by Ch 327/82. In the absence of these and various other special factors, current-year General Fund revenue growth would have been closer to 12 percent, than the 9.5 percent that is projected in the budget.

Net Revenue Revisions Minor

As shown in Table 23, the revisions to the department's revenue estimates during the past 12 months have added $252 million to the original estimate, of which only $138 million reflects economic forecasting revisions and technical reestimates. The $138 million net revision to date is much smaller than the mid-year revision for 1983–84 attributable to economic factors—$494 million. Since the department's revenue estimating record in 1983–84 was above average by historical standards, its record for 1984–85 thus far is all the more impressive.

BUDGET-YEAR (1985–86) REVENUES

Table 25 presents the department's estimates of state revenues for 1985–86. Total state revenues in the budget year are projected to reach $32.9 billion, a gain of 6.2 percent ($1.9 billion) over 1984–85. This gain repre-

Table 25
State Revenue Collections
1983–84 through 1985–86
(dollars in millions) [a]

General Fund	*Actual 1983–84*	*Estimated 1984–85*	*Projected 1985–86*	*Change 1984–85 to 1985–86 Amount*	*Change 1984–85 to 1985–86 Percent*
Taxes:					
Sales and use	$8,639	$9,705	$10,510	$805	8.3%
Personal income [b]	9,297	10,485	11,165	680	6.5
Bank and corporation [c]	3,231	3,525	3,950	425	12.1
Inheritance and gift [d]	109	100	34	−66	−66.0
Insurance [e]	457	635	675	40	6.3
Cigarette	185	183	180	−3	−1.4
Alcoholic beverage	137	137	140	3	2.3
Horse racing	125	120	122	2	1.7
Estate	128	175	159	−16	−9.1
Subtotals, Taxes	$22,309	$25,064	$26,935	$1,871	7.5%
Other Sources:					
Oil and gas revenues	287	24	22	−2	−9.1
Health Care Deposit Fund	301	336	345	9	2.7
Interest on investments	262	437	402	−35	−8.0
Other revenues	176	187	196	9	4.8
Transfers	475	28	23	−6	−20.5
Totals, General Fund	$23,809	$26,077	$27,922	$1,845	7.1%
Special Funds					
Motor Vehicle Revenues: [f]					
Fuel taxes	1,213	1,145	1,149	4	0.3
License fees (in lieu) [g]	1,047	1,220	1,349	129	10.6
Registration, weight and miscellaneous fees	860	905	930	25	2.8
Subtotals, Motor Vehicle Revenues	$3,120	$3,270	$3,428	$158	4.8%
Other Sources:					
Oil and gas revenues	143	500	448	−52	−10.3
Sales and use [h]	159	125	108	−17	−13.6
Interest on investments	112	137	123	−14	−10.2
Cigarette tax	78	78	77	−1	−1.5
Other	205	816	814	−2	−0.2
Totals, Special Funds	$3,817	$4,926	$4,998	$73	1.5%
Totals, State Funds	$27,626	$31,003	$32,921	$1,918	6.2%

[a] Source: 1985–86 Governor's Budget. Details may not add to totals due to rounding. Percent changes are computed prior to rounding.

[b] Includes $122 million in 1985–86 resulting from the Governor's proposal to fund energy tax credits through direct appropriations.

[c] Includes $15 million in 1985–86 resulting from the Governor's proposal to fund energy tax credits through direct appropriations.

[d] The decline in these revenues over time is due to Proposition 6 (June 1982), which repealed inheritance and gift taxes and in their place imposed an estate "pick-up" tax.

[e] Revenues were reduced by about $112 million in 1983–84 due to the tax acceleration provisions of Ch 327/82 (SB 1326), which also had increased revenues by about $227 million in 1982–83.

[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 but will expire after 1985. 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 $246 million for 1983–84, $236 million for 1984–85, and $260 million for 1985–86.

[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).

sents a sharp fall-off from the current-year's projected rate of increase, which is almost twice as large—12.2 percent. Of the total amount, about 85 percent represents General Fund revenues and 15 percent represents special fund revenues.

General Fund Revenues

As shown in Table 25, General Fund revenues in the budget year are forecast to reach $27.9 billion, a gain of $1.8 billion (7.1 percent). The 1985–86 amount includes nearly $11.2 billion in personal income taxes (a 6.5 percent gain), $10.5 billion in sales and use taxes (an 8.3 percent gain), and nearly $4 billion in bank and corporation taxes (a gain of 12 percent). These reasonably healthy growth rates reflect the department's forecast of a continued economic expansion throughout 1985 and the first half of 1986.

Revenue Trend Relatively Free of Distortions

The 7.1 percent growth in General Fund revenues projected for 1985–86 is relatively free of distortions from special factors. This is not to say that there are no such distortions at work in 1985–86. Indeed, there are four: (1) growing revenue losses from the phasing-out of inheritance taxes, (2) revenue gains from the tax amnesty program, (3) artifically high current-year revenue collections from unexpectedly large fiduciary tax payments and death-related taxes involving three extremely wealthy Californians (one of whom was Howard Hughes), and (4) the Governor's proposal to fund the state's current energy tax credit programs by direct appropriations instead of through tax credits. These factors, however, partially offset one another and the underlying revenue growth trend which emerges after adjusting for them—about 7.6 percent—is not dramatically different from the projected rate—7.1 percent.

Tapering Revenue Growth Due To Slower Economy

The projected growth rate in General Fund revenues during the budget year (7.1 percent, or 7.6 percent after adjustment for special factors) is decidedly below the projected rate for the current year (9.5 percent, or about 12 percent after adjustment for special factors). The reason for this sharp drop-off is that, although the California economy is expected to continue expanding during both 1985 and 1986, the pace of expansion is expected to be slower than in 1984. This reduced rate of general economic expansion will in turn slow the rate at which the major elements of the state's tax base, and thus revenue collections themselves, grow.

Moderate Gains For Personal Income Taxes

Personal income taxes are projected to rise by 6.5 percent in the budget year. This compares to a projected increase of nearly 13 percent for the current year. Thus, the rate of growth in personal income tax collections, while still fairly good, is expected to moderate sharply.

There are two reasons for this moderation:

- First, there is the anticipated slowdown in California personal income growth, from over 12 percent in 1984 to 8.6 percent in 1985 and 7.9 percent in 1986.
- Second, the "elasticity" of personal income tax collections is expected to be relatively low in both 1985 and 1986.

Income Tax "Elasticity" to Decline. The best way to understand the income tax projections for any fiscal year is to examine the projection of income tax *liabilities* for the calendar years which underlie the fiscal-year revenue estimates. Year-to-year growth in tax liabilities 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, which 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).

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 historically has resulted in about the same percentage increase in tax liabilities.

Table 26 shows those variables in the department's economic forecast that are the primary determinants of estimates of income tax liability growth and elasticity. The table also shows *our* estimates of income tax liability growth and elasticity, using these same economic assumptions and our own personal income tax revenue-estimating model. The table indicates that elasticity is expected to drop from about 1.75 in 1983 to 1.25 in 1984, and to 1.02 in 1985, before rising slightly to 1.04 in 1986. What this means is that a given percentage point of personal income growth produced fewer tax dollars in 1984 than in 1983, and will produce still fewer tax dollars in 1985 and 1986.

Table 26
Estimates of Income Tax "Elasticity" and Its Determinants 1983 through 1986

	Percent Change In:					Elasticity of Tax Liabilities with Respect to Income[e]
Calendar Year	Adjusted Personal Income[a]	Civilian Employment	Average Real Income Per Employee[b]	Indexing Adjustment Factor[c]	Implied Tax Liabilities[d]	
1983	7.2%	1.5%	6.9%	−1.2%	12.4%	1.75
1984 (estimated)	13.5	4.2	4.1	4.6	16.8	1.25
1985 (projected)	9.1	3.5	0.4	5.0	9.2	1.02
1986 (projected)	8.1	2.2	0.6	5.1	8.4	1.04

[a] Defined as personal income minus transfer payments plus social security contributions. This income concept historically has shown a strong correlation to adjusted gross income reported for tax purposes.
[b] Growth in average adjusted personal income per employee, adjusted for the indexing adjustment factor (the June-to-June change in the California Consumer Price Index).
[c] June-to-June change in the California Consumer Price Index (statutorily mandated).
[d] Estimated by Legislative Analyst's office using Department of Finance economic forecast. The department's own estimates of tax liability growth differ somewhat from these figures.
[e] Estimated by Legislative Analyst's office. Figures represent the ratio of tax liability growth to growth in adjusted personal income shown in the table, computed prior to rounding.

The principal reason for the decline in elasticity shown in Table 26 is the drop in the growth of average real income per employee. It is this variable, which the department projects to be negligible in both 1985 and 1986, that gives elasticity its "punch" by propelling taxpayers into higher tax brackets more rapidly than indexing shifts the boundaries of the individual tax brackets outward. Clearly, if the department's economic forecast comes true, there won't be any such "punch" in 1985 and 1986, and therefore, growth in income tax liabilities will be limited to approximately the rate of income growth.

Our estimate of how much personal income tax revenues the department's economic forecast should produce is a bit higher—by about $120 million for the current year and budget year combined—than the department's own estimate. This difference, which is concentrated in the budget year, is less than 1 percent of the nearly $22 billion to be collected in personal income tax revenues for the two years combined.

Special Revenue Adjustments. The personal income tax projection for the budget year includes $162 million from two special factors:

- ***Tax Amnesty.*** The projection assumes that $40 million will be received as a result of the tax amnesty program established by Ch 1490/84 (AB 3230). This program offers taxpayers a one-time opportunity to "come forward" and pay their back taxes without penalties, provided they do so prior to March 15, 1985, when the higher penalties and stricter enforcement procedures also established by Chapter 1490 take effect. This program also is expected to bring in $19 million in personal income tax revenues in the current year, or total revenues of $59 million for 1984–85 and 1985–86 combined. (An additional $11 million in current-year amnesty revenues is expected from the sales and use tax, making the total expected two-year revenue gain from the program equal to $70 million.)

- *Energy Tax Credit Proposal.* The revenue projection for the budget year also includes $122 million in personal income tax revenues that would result from the Governor's proposal to eliminate the state's current energy tax credit program. The administration proposes to replace the present tax credit mechanism with a direct annual appropriation to fund a portion of these credits. (An additional $15 million revenue gain is included in the budget-year revenue estimate for the bank and corporation tax, making the total revenue gain for the proposal equal to $137 million). The Governor's proposal is discussed in Part Three of this volume and under Item 9100 of the *Analysis.*

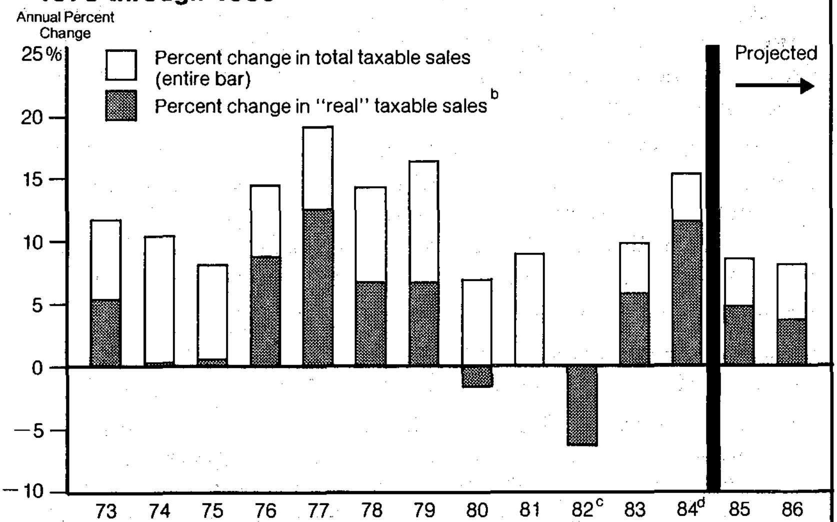
Taxable Sales—Unspectacular But Steady

As shown in Table 25, sales and use taxes are projected to increase by 8.3 percent in the budget year. While this increase is well below the 12 percent anticipated in the current year, it is still a good, solid increase.

The projected rate of growth in sales tax revenues during 1985–86 means that growth in taxable sales is expected to pretty-much mirror the growth

Chart 13

Annual Growth in California Taxable Sales 1973 through 1986[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.
[d] Taxable sales in 1984 include an estimated $630 million due to the Summer Olympics in Los Angeles and the National Democratic Convention in San Francisco.

in California personal income—both in the second half of 1985 and throughout 1986. This consistency shows up, regardless of whether growth is expressed in either nominal or "real" terms. This is confirmed by comparing Chart 11 and Chart 13, and by looking at the ratio of taxable sales-to-personal income contained in the department's economic forecast.

As Table 27 shows, the taxable sales-to-personal income ratio dropped for three consecutive years—from 57 percent in 1979 to under 55 percent in 1980, under 53 percent in 1981, and under 50 percent in 1982. Then, as the economic recovery set in in 1983, the ratio rose slightly to nearly 51 percent, and rose again in 1984 to slightly over 52 percent. As Chart 13 illustrates, taxable sales growth in "real" terms during 1984 was nothing short of spectacular—over 11 percent. For both 1985 and 1986, however, the department projects that the ratio will hold steady at 52 percent, or just a notch below the 1984 level. This assumes that taxable sales will rise by 8.4 percent in 1985 and 7.9 percent in 1986, or at a pace that is nearly

Table 27
Historical Trends in Taxable Sales in California
1968 through 1986 [a]
(dollars in millions)

		Percent Change in:		
Calendar year	*Total Taxable Sales*	*Total Taxable Sales*	*"Real" Taxable Sales* [b]	*Ratio of Taxable Sales to Personal Income*
1968	$41,582	NA	NA	.541
1969	45,428	8.5%	3.8%	.538
1970	46,429	2.2	−2.3	.514
1971	50,205	8.1	3.6	.525
1972	55,322	10.2	6.3	.531
1973	61,738	11.6	5.6	.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	.561
1979	131,678	16.0	6.4	.569
1980	142,759	8.4	−1.6	.545
1981	155,127	8.7	0.3	.529
1982	154,553	−0.4	−5.9	.496
1983	169,412	9.6	5.7	.508
1984 (estimated)	194,840	15.0	11.3	.521
1985 (projected)	211,300	8.4	4.6	.520
1986 (projected)	227,930	7.9	3.6	.520

[a] Source: Department of Finance and State Board of Equalization. Estimated (1984) and projected (1985 and 1986) data from Department of Finance. Historical taxable sales data have been adjusted by the department to account for changes over time in the definition of the taxable sales base, including inclusion of gasoline sales beginning in mid-1982.

[b] Defined as total taxable sales deflated by U.S. GNP consumption expenditures deflator.

identical to the projected rise in personal income (8.6 percent and 7.9 percent, respectively). The department's 1985 estimate assumes that particularly sharp drop-offs in taxable sales growth will occur in the building, automobile, general manufacturing, home furnishings, and services industries.

Revenues May Be Slightly Understated. Our own analysis indicates that, while the department's economic forecast offers no basis for expecting booming taxable sales growth or a dramatic rise in the sales-to-income ratio during 1985 or 1986, there are some grounds in the forecast for anticipating a better taxable sales performance than what the department expects. For example, the department's economic forecast assumes that California's unemployment rate will fall sharply over the next 18 months, that "real" interest rates will soften a bit, that the percentage of the population which is employed will be rising, and that 1985 expenditures on consumer durable goods and fixed nonresidential business investment will rise more rapidly than personal income. All of these factors historically have implied a rise in the taxable sales-to-personal income ratio, and are capable of offsetting such negative factors in the taxable sales outlook as declining gasoline prices and the moderating rate of housing starts.

Our own revenue estimating techniques suggest that, if the department's economic forecast comes true, the sales-to-income ratio would probably drift up to around 52.4 percent in 1985 and 53.6 percent in 1986, thereby generating about $105 million in additional sales and use tax revenues during the current and budget years, combined. Even if this turns out to be the case, the ratio of taxable sales-to-personal income would still remain well below its 1980 level.

Corporate Profits—Above Average Growth Anticipated

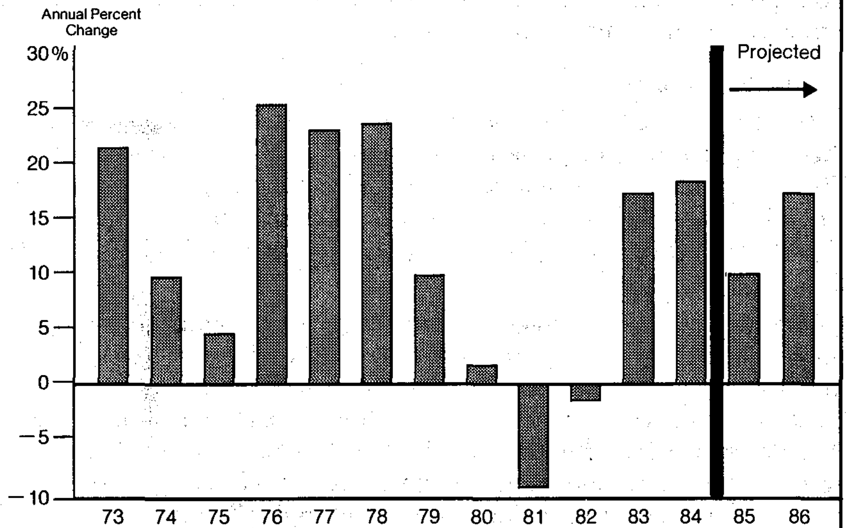
Revenues from the bank and corporation tax are more difficult to project from year-to-year than revenues from any other source. This is because of the inherent volatility of corporate profits, the wide variety of factors which influence profits, the complex prepayment patterns which firms use to remit 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 of these 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 federal tax purposes.

As Table 25 shows, the department projects that revenues from the bank and corporation tax will rise by over 12 percent in the budget year. Thus, the bank and corporation tax is projected to grow faster in 1985–86 than any other major revenue source. This rate compares to a healthy 9.1 percent rise in the current year and the enormous 27 percent increase in the prior year, which occurred as profits began recovering from their abnormally low recessionary levels during the 1980 through 1982 period.

The above-average growth projected for bank and corporation tax revenues reflects the department's projection for taxable corporate profits. As Chart 14 shows, California profits are estimated to have risen by 17 percent in 1983 and 18 percent in 1984. For 1985 and 1986, the department projects gains of nearly 10 percent and over 17 percent, respectively. This would represent four consecutive years of relatively strong profit growth.

Chart 14

Annual Growth in California Taxable Corporate Profits 1973 through 1986[a]



[a] Source: California Department of Finance. Profit totals include a $335 million reduction in 1975 due to changes in depletion allowances and a $967 million increase in 1978 due to Proposition 13. Preliminary 1984 estimate by Department of Finance and Franchise Tax Board.

The department's 1985 and 1986 corporate profit growth projections for California are noticeably stronger than its projection of corporate profits growth nationally (2 percent in 1985 and 15 percent in 1986). Nonetheless, our own revenue-estimating procedures indicate that the department's two-year estimates of California corporate profits and tax revenues are basically consistent with its overall economic forecast, after considering not only the relationship between national and California profit levels and state-federal depreciation differences, but also the unique effects that such variables as interest rates, inflation rates, and California taxable sales and employment have on California profits.

Specifically, we estimate that *if* the department's economic forecast comes true, bank and corporation tax revenues will be higher than the department's estimate by about $10 million in the current year and $30 million in the budget year, or $40 million for the two years combined. This is an extremely small difference—only about one-half of one percent of revenues for the two years combined. 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.

As evidence that the department's relatively strong projection for California corporate profits growth is not unreasonable, we note that projected profits relative to the state's personal income base amount to under 8.6 percent for 1985 and 9.3 percent for 1986. This compares to an average of over 9 percent for the entire 17-year period (including recession years) from 1968 through 1984, and 9.4 percent during the entire decade of the 1970's (again including recession years).

Other Major Taxes

Table 25 shows that General Fund revenues from taxes other than the three major taxes are projected to total $1.3 billion in the budget year. These taxes include the insurance tax ($675 million), the inheritance, gift and estate taxes ($193 million, combined), the cigarette tax ($180 million), alcoholic beverage taxes ($140 million), and horse racing taxes ($122 million).

The budget-year estimate for these taxes is $39 million (or 2.9 percent) below the current-year projected level of $1.3 billion. This decline is the net result of three distinctly different trends within this category of taxes—*growth* in insurance tax collections, *declines* in inheritance, gift and estate taxes, and *relative stability* in the remaining taxes. It should also be noted that, after adjusting for special factors affecting inheritance and estate taxes (discussed below), the "underlying" trend in budget-year collections within this "other major taxes" category shows a mild increase of 2.7 percent ($36 million).

Healthy Growth in Insurance Taxes. Insurance tax collections are projected to reach $675 million in 1985–86, a gain of 6.3 percent ($40 million). This estimate is based on the department's projections of insurance tax premiums, which in turn are derived from survey responses submitted by 150 California insurance companies that account for about 55 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 (under current law this rate will return to 2.35 percent in 1986) is expected to rise by about 11 percent in 1984 (the year on which 1985 tax prepayments are based), and 7.5 percent in 1985 (the year on which 1986 tax prepayments are based). Taxes on these premiums account for about 97 percent of all insurance tax collections.

The estimated increase in premiums during 1984—11 percent—represents a strong gain and is consistent with the healthy growth in the economy that characterized 1984. By comparison, premiums grew by slightly less—9.9 percent—during 1983, and by less than 5.5 percent in each of the three years before that, when the economy was in a downturn. The projected gain of 7.5 percent for 1985, while less than that for 1984, is still a reasonably good increase and is consistent both with the pace of personal income growth projected and the expectation that the economy will be less robust in 1985 than in 1984.

It should also be noted that the 39 percent ($178 million) increase in current-year receipts shown in Table 25 is unrelated to insurance tax premium growth, and instead reflects cash-flow shifts associated with Ch 327/82 (SB 1326). Among other things, this statute revised the timing of insurance prepayments and had the effect of raising revenues by $227 million in 1982–83, lowering revenues by $112 million 1983–84, and raising revenues by $8 million in 1984–85. Thus, the growth in current-year insurance tax coliections would have been a more-moderate 10 percent in the absence of these cash-flow distortions, and thus more in-line with estimates of 1984 and 1985 growth in insurance premiums.

Special Factors Distort Death-Related Taxes. Combined inheritance, gift and estate taxes are projected to be $193 million in the budget year—a fall of $82 million (30 percent) from the $275 million expected in the current year. This decline, as well as the 17 percent gain in current-year receipts, reflects distortions due to several special factors:

- ***First,*** Proposition 6 (June 1982) repealed the state's inheritance and gift taxes and established in their place 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. (Proposition 6 became effective for estates and decendents and for gifts made on or after June 9, 1982.) As a result, revenue losses from inheritance and gift taxes and revenue gains from the estate tax are being "phased-in".

  Table 28 summarizes what the estimated revenue effects of Proposition 6 and Ch 634/80 (which reduced inheritance taxes prior to Proposition 6) have been. It indicates that the net effect of these measures has been to reduce 1985–86 revenues by $966 million (83 percent), and to reduce revenues since 1980–81 on a cumulative basis by over $2.9 billion (57 percent).
- ***Second,*** several unusually large, one-time death-related tax payments were received in the current year. One was a $44 million inheritance tax payment from the Howard Hughes' estate. In addition, $35 million

in estate tax payments were made by two other large estates. The $79 million from these special payments is not part of the normal revenue trend line for these taxes. Had they not occurred, budget-year collections from death-related taxes would have been about unchanged (down $3 million) from the current year.

Although there will still be some inheritance and gift tax revenues collected after 1985–86, the revenue trend for death-related taxes beyond the budget year will increasingly be dominated by the estate tax. Based upon the state's experience with this tax so far, it appears that the "underlying" growth trend is between 10 percent and 12 percent per year. Thus, once inheritance and gift tax collections have been eliminated, a moderate annual growth trend in death-related taxes can be expected. This, in turn, will serve to boost the overall "elasticity" of the General Fund revenue base relative to what it has been during the Proposition 6 and Chapter 634 phase-in years.

Table 28
Effects of Tax Law Changes on Inheritance, Gift and Estate Tax Revenues
1980–81 through 1985–86
(dollars in millions) [a]

		Proposition 6 (June 1982)			Total Reduction	
Year	*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	128	−442	−672	−74.0
1984–85	−262	−720	175	−545	−807	−74.6
1985–86	−296	−829	159	−670	−966	−83.3
Cumulative Six-Year Totals	−$1,104	−$2,292	$490	−$1,802	−$2,906	−56.7%

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

No Growth in Other Taxes. The three remaining major taxes—the cigarette, alcoholic beverage and horse racing taxes—are projected to total $442 million in 1985–86. This is an increase of only $2 million over the current year and a decline of $5 million relative to the prior year.

There are two reasons why these taxes, taken together, are essentially a "no growth" revenue source:

- ***First,*** the "bases" on which these taxes are levied have not been growing much. For example, the dollar volume of parimutuel horse racing wagering (the main source of horse racing revenues) is essentially unchanged for the prior, current and budget years at a bit over $2.2 billion, while total consumption of cigarettes is expected to decline.

- ***Second,*** both the cigarette and alcoholic beverage taxes are selective excise taxes which are levied on a "cents-per-unit-consumed" basis. Thus, these revenues do not go up to reflect inflation as does a tax like the sales tax, which is levied as a percent of the amount spent for a commodity.

Regarding the cigarette tax, per capita consumption of cigarettes has fallen in all but one year (1981) since 1976. The decline was accelerated after January 1, 1983 when the federal excise tax on cigarettes was doubled, from 8 cents to 16 cents per pack. The federal rate is scheduled to return to 8 cents per pack on October 1, 1985.

If the higher federal rate is not extended, California will have an opportunity to raise its own cigarette tax rate without raising the total amount of taxes on cigarettes, and thus prices paid by cigarette users. For each 1 cent increase in California's per-pack cigarette tax above the current 10 cent level, about $25 million in revenues would be raised annually, assuming current per capita consumption levels.

Interest Income

The General Fund can earn interest income from four 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 is legally entitled to earn interest, (3) any General Fund monies that are idle because of the time lag between when revenues are collected and disbursements are made, and (4) "arbitrage earnings" on the short-term investment of temporarily-idle monies that the General Fund has externally borrowed to handle its intra-year cash flow imbalances. Of these four sources, the third—temporarily-unused General Fund monies—has been the single most important source of interest income in the past several years, partly because there have not been large surplus balances left over from prior years. Beginning with the current year, "arbitrage earnings" also have become significant. And, as the General Fund's fiscal condition has improved, the first source of interest income—the investment of surplus funds—has increased in importance.

The budget projects that General Fund interest on investments will be about $402 million in 1985–86, of which $395 million represents returns on the General Fund's share of PMIA balances. The level of General Fund investment income projected for 1985–86 compares to about $437 million (including $430 million from the PMIA) projected for 1984–85 and $262 million (including $255 million from the PMIA) in 1983–84, and assumes that:

- ***The average balance*** in the PMIA during 1985–86 will be in the range of $10.6 billion. This is less than the average balance of $10.9 billion for 1984–85, reflecting a combination of factors including anticipated reductions in non-General Fund monies held for local agencies and the State Teachers' Retirement System (STRS), plus a somewhat reduced volume of General Fund external borrowing.
- ***The General Fund share*** of monies in the PMIA will be slightly over 35 percent, or about the same as for 1984–85. Thus, the General Fund's PMIA balance is assumed to be a bit over $3.7 billion in the budget year versus close to $3.9 billion in the current year.
- ***The average interest yield*** on PMIA investments in 1985–86 will be about 10.4 percent. This compares to an actual average yield of about 11.5 percent at year-end 1984, 11.4 percent for the first half of 1984–85, and approximately 11 percent projected for the current year as a whole.

Our analysis of the department's interest income estimates has turned up several problems:

- On the one hand, the department appears to have double-counted the interest earnings from non-PMIA sources, thereby *overstating* interest income in both the current and budget years by over $7 million, or about $15 million for the two years combined.
- On the other hand, there appears to be an internal inconsistency between (1) the department's assumptions regarding the average General Fund balance in the PMIA, (2) its estimates of temporarily-idle cash balances available from external borrowing sources for investment in the PMIA, and (3) its projections of a growing General Fund surplus balance in both 1984–85 and 1985–86. In particular, the assumptions regarding the average balance in the account are too low to be consistent both with the department's expected volume of external borrowing and its surplus projections, thereby *understating* interest income. We anticipate that the amount of the revenue understatement is at least $15 million for the current and budget years combined (thus offsetting the overstatement identified above), and probably more. We understand that the department is in the process of reworking its figures.

Given the above, we believe that the department's interest income estimate is conservative, and that when the May Revise is released, the interest income estimates for 1984–85 and 1985–86 combined will be several tens of millions of dollars higher.

In any year, the estimate of interest income is quite susceptible to error. As a "rule of thumb," for each $100 million increase (decrease) in the average PMIA balance that is accounted for by the General Fund in 1985–86, interest income will be about $10 million higher (lower) than the amount forecast. Alternatively, for each 1 percentage point increase (decrease) in the average PMIA yield, relative to the forecasted rate, interest income will be about $40 million higher (lower).

Evaluation of General Fund Revenue Estimates

This section summarizes our evaluation of the department's General Fund revenue estimates. Our evaluation consists of two parts: (1) our analysis of whether the department's revenue projections are consistent with its economic forecast (internal consistency), and (2) our assessment of how alternative economic assumptions that are equally reasonable would affect revenues.

Internal Consistency: Two-Year Estimates On the Low Side

We have taken the *department's* economic assumptions for 1985 and 1986 and used *our own* revenue-estimating techniques to test whether Finance's revenue projections for the current and budget years are consistent with its economic assumptions.

Our analysis, which focused on the state's three major taxes, suggests that an economy along the lines projected by the department would generate somewhat *more* General Fund revenues in 1985–86 than what the department forecasts. We believe that this gain would be about $345 million. However, because our analysis also concludes that General Fund revenues in 1984–85 are likely to be about $80 million *less* than what Finance projects, the net difference for the current and budget years combined would be $265 million. Relative to the size of the tax revenue base (over $50 billion for the current and budget years, combined), this is a negligible difference—only one-half of 1 percent—especially when one considers the complexities and error margins involved in revenue estimating.

Nevertheless, the difference is significant enough in absolute dollar terms that the Legislature may wish to incorporate it in its own fiscal planning.

As shown in Table 29, the $265 million difference between our estimates and the department's is due primarily to differences in revenue estimates for the personal income tax ($120 million) and the sales and use tax ($105 million). There are a variety of reasons for these differences. In the case of the personal income tax, our income tax simulation model indicates that taxpayers will be pushed into higher marginal tax brackets at a somewhat more rapid pace than what the department assumes, thereby raising average tax rates. In the case of the sales and use tax, we believe that the ratio of taxable sales to personal income will be higher in both 1985 and 1986 than the department assumes, given such variables in its economic forecast as sharply falling unemployment rates, a downward drift in real interest rates, and a rise in the percentage of the population that holds jobs. All of these factors historically have been associated with increases in the taxable sales ratio.

Significant Statistical Error Margins Exist

Table 29 also shows our estimates of the statistical error margins that surround the revenue estimates. These margins provide a useful perspective on the basic reliability of revenue estimates, *independent* of the problems of accurately forecasting the economy. Simply stated, these margins indicate the band within which revenues could fluctuate *even if* the department's economic forecast comes true. As Table 29 shows, in the budget year this confidence interval is about $220 million for the personal income tax, $250 million for the sales and use tax, and $280 million for the bank and corporation tax. The reason why the error margin is largest for the bank and corporation tax, even though it raises much less revenues than either of the other two taxes, is that corporate profits are so volatile. In addition, because major changes recently were made in the federal tax treatment of corporate depreciation allowances to which California has not conformed, the exact statistical relationship between California taxable profits and national pre-tax profits is subject to greater uncertainties than previously.

Table 29
Legislative Analyst's Revenue Estimates Using Department of Finance Economic Assumptions 1984–85 and 1985–86 (dollars in millions)

	1984–85			*1985–86*			
Income Source	*LAO Estimate*	*Error Margin* [a]	*Difference From Finance*	*LAO Estimate*	*Error Margin* [a]	*Difference From Finance*	*Two-Year Revenue Difference*
Bank and corporation tax	$3,535	$130	$10	$3,965	$280	$30	$40
Sales and use tax	9,630	115	–75	10,690	250	180	105
Personal income tax	10,470	115	–15	11,178	220	135	120
Totals	$23,635	—	–$80	$25,833	—	$345	$265

[a] Amount by which revenues could differ from the estimate in *either* direction, based upon a 95 percent confidence factor.

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 and 1985–86 are subject to considerable revision during the next 18 months.

Alternative General Fund Revenue Scenarios

Given the ever-present uncertainty about 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 what the department projects if the department's *economic forecast* does *not* come true.

The department has constructed two alternative economic scenarios to show how economic conditions other than those assumed in its "standard" forecast would affect revenues. One scenario is based on a more optimistic set of economic assumptions than those used in preparing the 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 could easily depart from what the department forecasts for 1985 and 1986. These scenarios, however, by no means bracket the full range of possible outcomes.

Table 30 summarizes the key features of the department's alternative economic forecasts. The optimistic scenario for 1985 calls for a sharp rebound in economic growth from the drop-off experienced in the latter half of 1984, accompanied by higher inflation and interest rates. The department assumes that rising interest rates eventually would lead to a recession in 1987 or 1988; however, until that time, the state's economic pace would be above that of the standard forecast. In contrast, the pessimistic alternative calls for a recession during most of 1985 and early 1986, accompanied by weak personal income growth and declining employment.

Table 30
Alternative Economic Outlooks
Prepared by the Department of Finance
1985 and 1986 [a]

	Low Forecast		*High Forecast*	
Economic Variable	*1985*	*1986*	*1985*	*1986*
1. *National Data:*				
Real GNP growth	−0.1%	−0.5%	4.1%	4.4%
Pre-tax profits growth	−21.3	38.3	5.2	13.8
Unemployment rate	8.3	9.6	6.7	5.5
Wage and salary job growth	0.9	−1.6	3.4	2.9
Consumer price inflation	4.1	4.4	4.8	6.1
Car sales (millions)	9.7	9.5	10.8	11.2
Housing starts (millions)	1.42	1.44	1.87	2.03
2. *California Data:*				
Personal income growth	6.1%	3.2%	9.6%	9.8%
Wage and salary job growth	1.7	−1.6	4.7	4.4
Unemployment rate	8.1	9.9	6.4	5.6
Building permits (thousands)	153	169	215	226

[a] Source: Governor's Budget.

Table 31 shows that the department's alternative economic scenarios produce General Fund revenue estimates for 1984–85 which range from $418 million (1.6 percent) above, to $507 million (1.9 percent) below, the standard forecast. For 1985–86, the estimates range from $1.2 billion (4.2 percent) above to nearly $1.9 billion (6.8 percent) below the standard projection. (The revenue estimates prepared by the Commission on State Finance in December—$194 million above the department's current-year estimate and $181 million above its budget-year estimate, or $375 million above for the two years combined—fall well within these margins.) The potential error margins are not inconsistent with the actual error margins that have materialized in past years, as shown in Table 24, and it is likely that one could find economists at either end of the forecasting range defined by the department's two alternatives. In sum, the message given by Table 31 is that significant economics-related revenue estimating errors could occur in both 1984–85 and 1985–86. It is even possible that revenues could fall outside of these ranges.

Both Budget Surpluses and Deficits are Possible

Table 31 also shows that the General Fund balance would be dramatically affected if either of these alternative revenue scenarios were to materialize. Specifically:

- Were the "high" scenario to occur, the result would be a *two-year revenue improvement of nearly $1.6 billion.* This would leave the General Fund with a year-end 1985–86 *surplus* of over $2.6 billion, which would be enough to both fund a 5 percent reserve for economic uncertainties and still leave $1.2 billion to finance new programs, expansion of existing programs, one-time expenditures or a tax reduction.

Table 31
Revenue Effects of Alternative Department of Finance Economic Forecasts 1984–85 and 1985–86 (dollars in millions)[a]

	1984–85		*1985–86*		*Combined Two-Year Effect*	
	Low Forecast	*High Forecast*	*Low Forecast*	*High Forecast*	*Low Forecast*	*High Forecast*
1. Change from revenues in the standard forecast[a]						
Personal income tax	–$235	$265	–$805	$605	–$1,040	$870
Sales and use tax	–95	105	–820	440	–915	545
Bank and corporation tax	–150	25	–240	80	–390	105
Other revenues	–27	23	–32	28	–59	51
Totals, All Revenues[b]						
—Amount	–$507	$418	–$1,897	$1,153	–$2,404	$1,571
—Percent	–1.9%	1.6%	–6.8%	4.2%	–4.5%	2.9%
2. Unrestricted balance in the General Fund[c]	$463	$1,388	–$1,364	$2,611	–$1,364	$2,611

[a] Source: Governor's Budget and Department of Finance.
[b] These totals differ slightly from those shown in the budget because they represent the unrounded sums of the unrounded figures for each revenue source, whereas the figures shown in the budget are rounded sums.
[c] Computed by adjusting General Fund balances shown in the 1985–86 Governor's Budget for the department's standard economic forecast, to reflect the revenue effects shown in the table. These balances are $970 million for 1984–85 and $1,040 million for 1985–86, excluding estimated reserves for continuing appropriations of $15 million in 1984–85 and $3 million in 1985–86.

- Were the "low" scenario to occur, the result would be a *two-year revenue shortfall of over $2.4 billion*. Unless expenditures were reduced from the levels proposed in the budget, this would leave the General Fund in a *deficit* at the end of the budget year, amounting to nearly $1.4 billion.

What Will Happen?

Obviously, no one can say with certainty which of these (or other) alternative forecasts will come true. The department's feeling is that its standard forecast has a 50 percent chance of occurring, its optimistic alternative has a 15 percent chance, and its pessimistic alternative has a 35 percent chance. Thus, the department feels that the risks are primarily on the "downside."

We conclude that the department's forecast is somewhat pessimistic at this point, particularly given the recent favorable reports on the strength of economic performance in late 1984. Our own view is that the economy's performance, at least in California, is likely to be a bit *stronger* than what the department anticipates. Consequently, for planning purposes, the Legislature could reasonably add $200 million to the department's revenue projections to reflect a stronger-than-anticipated economy.

Summary

At the present time, the department's two-year revenue totals, although not unreasonable, appear to be somewhat on the low side. We believe that the department's two-year revenue projection appropriately could be raised by *$465 million*, including $265 million to bring revenues more in line with the department's economic forecast and $200 million to recognize the possibility of a stronger-than-projected economy.

We also, however, agree with the department that actual revenues during the two-year period covered by the Governor's Budget (1984–85 and 1985–86) could be from $1 billion to $2 billion higher or lower, depending on the particular path taken by the economy. Given this, it is inevitable that the revenue estimates will have to be revised during the next 18 months. And, because of the very real downside risks that are apparent in the economic outlook, it is imperative that the Legislature closely monitor the state's economic trends and revenue receipts throughout this period.

Special Fund Revenues

Table 25 shows that revenues to all state special funds, combined, are projected to reach $5 billion in 1985–86. Table 32 shows the share of special fund revenues accounted for by each of the major special fund revenue sources.

Table 32
Summary of Special Fund Revenues
1985–86
(dollars in millions) [a]

Revenue Source	*Amount*	*Percent of Total*
1. Motor Vehicle Taxes and Fees		
License fees	$1,315	26.3%
Fuel taxes	1,149	23.0
Registration and other fees	930	18.6
Trailer coach fees	34	0.7
Subtotals	$3,428	68.6%
2. Oil and Gas Revenues	448 [b]	9.0
3. Retail Sales Taxes ("spillover" revenues)	108	2.2
4. Interest on Investments	123	2.5
5. Cigarette Taxes	77	1.5
Subtotals	$4,184	83.7%
6. All Other [c]	814	16.3
Totals	$4,998	100.0%

[a] Source: Governor's Budget. Details may not add to totals due to rounding.
[b] Of this amount, $436 million represents tidelands oil and gas royalties from state lands. The remainder represents school lands royalties, primarily from geothermal sources.
[c] Includes such sources as fees to the Department of Consumer Affairs, electricity utility surcharge monies, Department of Fish and Game fees and licenses, and penalties on traffic violations and criminal convictions.

The major source of special fund income to the state is motor vehicle-related levies, which include taxes on gasoline and diesel fuel ($1.1 billion), vehicle license and trailer coach fees ($1.3 billion), and registration fees ($930 million). These vehicle-related levies are expected to total over $3.4 billion in the budget year, an increase of 4.8 percent ($158 million) over 1984–85. Other major sources of special fund income include oil and gas tax revenues ($448 million), "spillover" sales and use tax revenues ($108 million), cigarette tax receipts ($77 million), and interest on investments ($123 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.

At the outset of this discussion, it is important to note that Table 25 does *not* include any special fund revenues from the California State Lottery, which was approved by the voters in November 1984 (Proposition 37). The budget indicates that approximately $300 million in lottery revenues are expected during 1985–86, and that these funds will be distributed to various levels of education according to the provisions of the lottery law. *These funds, however, do not appear in either the expenditure or revenue totals shown in the budget.* This is because the department presently is classifying these monies as "nongovernmental trust and agency funds." As such, they fall outside of the umbrella of state funds whose income and spending activities are reported in the budget. The department adopted this classification on the theory that neither the Legislature nor the Governor has any authority regarding the appropriation of these monies (a theory with which we do not concur). A brief overview of the state lottery, including its revenue potential, is provided at the end of this section.

Slow Revenue Growth Expected

Table 25 shows that special fund revenues in 1985–86 are expected to be 1.5 percent above their 1984–85 level. This slow growth primarily reflects the fact that most special fund revenue sources are much less "elastic" than most of their General Fund counterparts with respect to economic growth. One reason for this is that a number of special fund revenue sources, such as the fuel tax and cigarette tax, rely on excise taxes that are levied *per unit of consumption* (for example, so much per gallon of gasoline or pack of cigarettes) instead of on an *ad valorem* basis (that is, as a percent of the dollar amount spent on the commodity). As a result, the growth in these revenues primarily depends on such factors as population growth, and does not reflect inflation. Other reasons for the slow growth projected in special fund revenues during 1985–86 include an expected decline in interest earnings, due to reduced interest yields and special fund balances in the PMIA, and a drop in sales and use tax "spillover" revenues associated with the current softness in gasoline prices.

Growth Trend Relatively Free of Distortions From Major Legislation and General Fund Transfers

In each of the previous three years, the rate of growth in special fund revenues has been severely distorted, either by the effects of major legislation or the transfer of special fund revenues to the General Fund.

The three most important specific causes of these distortions have included:

- Legislation which revised vehicle registration, weight and drivers' license fees, and fuel taxes;
- Transfers of funds from the Motor Vehicle License Fee (VLF) account to the General Fund, as a means of applying cuts in state spending to local governments; and
- The allocation of tidelands oil revenues to the General Fund on a one-time basis.

The first of these three distortions (legislation) is illustrated in Table 33.

In 1985–86, however, the growth in special fund revenues will be relatively free of these distortions.

Table 33
Effects of Recent Law Changes on Vehicle-Related Fees and Tax Revenues 1981–82 through 1985–86 (dollars in millions) [a]

Law Change [b]	*1981–82*	*1982–83*	*1983–84*	*1984–85*	*1985–86*	*Five-Year Totals*
A. *Licenses and Fees*						
1. Ch 541/81	$192	$362	$377	$398	$419	$1,748
2. Ch 933/81	10	20	20	21	10	81
3. Ch 323/83	—	—	140	205	230	575
Subtotals, Licenses and Fees	$202	$382	$537	$624	$659	$2,404
B. *Fuel Taxes*						
1. Ch 541/81	—	83	251	254	255	843
2. Ch 323/83	—	—	86	—	—	86
Subtotals, Fuel Taxes	—	$83	$337	$254	$255	$929
C. *Combined Licenses, Fees and Fuel Taxes*						
1. Ch 541/81	192	445	628	652	674	2,591
2. Ch 933/81	10	20	20	21	10	81
3. Ch 323/83	—	—	226	205	230	661
Totals	$202	$465	$874	$878	$914	$3,333

[a] 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.

Fuel Tax Revenues—Underlying Trend Remains Flat

Table 25 indicates that, 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 in 1983–84 (Ch 323), fuel tax revenues declined by $68 million in 1984–85. These revenues are projected to rise by $4 million in 1985–86. When fuel tax revenues are adjusted for these law changes, however, the year-to-year changes are dampened considerably. The underlying stability of fuel tax revenues 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 575 gallons in 1983–84 to 565 gallons in 1984–85 and to 550 gallons in 1985–86.

Vehicle-related registration and license fee revenues are projected at nearly $2.3 billion in the budget year. This is an increase of 7.2 percent. The projection assumes net increases in fee-paid vehicle registrations of 2.9 percent and 2.7 percent in 1985 and 1986, respectively. These relatively low rates of growth reflect the department's expectation that consumer purchases of new vehicles during the next 24 months will be lower in unit terms—by about 2.2 percent in 1985 and 1.6 percent in 1986—than their 1984 level.

Slow Revenue Growth Causing Highway Financing Woes

The vehicle-related special fund revenues discussed above provide the major source of financing for the construction and on-going maintenance of the state's transportation system. As noted earlier, the underlying growth trend for these revenues is relatively weak, primarily because these revenues are derived in large part from non-ad valorem excise taxes and are levied on such items as gasoline gallonage and vehicle registrations, which themselves have not been growing very rapidly. At the same time, however, highway construction and maintenance costs, as well as other transportation needs, continue to rise. As a result, it now appears that the state's transportation financing needs cannot be met unless changes are made to these vehicle-related funding mechanisms.

In Part Three we identify the transportation financing problems facing the state today, and discuss various options available to the Legislature for resolving these problems. These options include making changes in the manner and extent to which vehicle-related elements of the state's revenue base are taxed, such as gasoline sales, vehicle registrations, and license fees.

Tidelands Oil and Gas Revenues to Remain in Special Funds

Table 25 shows that a total of $471 million in oil and gas revenues will be collected by the state in the budget year, compared to $524 million in the current year and $430 million in the prior year. All but about $34 million of these funds (or $437 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). Of the $54 million decline in state oil and gas revenues projected for the budget year, about $18 million reflects a one-time revenue windfall resulting from the out-of-court settlement of the state's antitrust suit against ARCO (the state will receive about $20 million from this settlement in 1984–85 and about $2 million in 1985–86). The remaining $36 million decline reflects declines in gas production at the state's fields and soft oil prices in world markets.

Traditionally, the state's tidelands revenues have been used, along with bond proceeds, to finance state capital outlay projects. Large portions of these revenues were shifted on a "one-time" basis to the General Fund in 1981–82, 1982–83, and 1983–84, in order to help balance the state's budget. In both the current and budget years, however, about 95 percent of all state oil and gas revenues ($500 million in 1984–85 and $448 million 1985–86) will be retained by special funds for capital outlay purposes.

Additional Oil Revenues A Possibility

The state could receive additional oil revenues in 1985–86 beyond the revenues included in the Governor's Budget. These revenues could result from (a) settlement of outstanding antitrust litigation against six oil companies that produce oil from state tidelands and submerged lands in the Long Beach area and (b) consummation of an agreement with the U.S. Department of Interior over the state's share of federal revenues from offshore oil development. The exact amount and timing of any additional receipts that might occur, however, is very uncertain at this time. Potentially, the magnitude of these revenues could be in the range of several hundred million dollars.

The budget proposes to allocate these additional revenues, if in fact they are realized, for infrastructure financing purposes. The Governor's proposals for infrastructure financing are discussed in Part Three of this volume.

How Special Fund Revenues are Distributed

Table 34 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:

- Cities and counties will 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 distribution is the same as in the current year, but is in sharp contrast to what it was during the 1981–82 through 1983–84 period, 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 General Fund transfer amounted to $393 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 three special funds (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 "spillover" 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.

Table 34

Proposed Distribution of Special Fund Revenues From the Four Major Special Fund Sources 1985–86 (dollars in millions) [a]

Revenue Source	*Total Amount of Revenues*	*Distribution of Revenues: Recipient*	*Amount*
A. *Motor Vehicle Taxes and Fees*			
1. License fees	$1,331 [b]	To cities	$511
		To counties	738
		For DMV administration	81
		For Board of Equalization	1
2. Fuel taxes	1.154 [c]	For city streets	180
		For county roads	249
		To cities and counties for streets and roads	113
		To Caltrans for state highways	579
		Other	38
		Adjustment to fund balances	–5 [d]
3. Registration and other fees	934 [e]	To DMV	200
		To CHP	396
		To Caltrans	282
		To other state agencies	48
		Other	8
4. Trailer coach fees	34	To counties	11
		To localities generally	21
		To Department of Housing and Community Development	2
B. *Tidelands Oil and Gas Revenues*	436 [f]	California Water Fund	25
		COFPHE Fund	120
		Central Valley Water Project Construction Fund	5
		State School Building Lease-Purchase Fund	150
		SAFCO	122
		Other	14
C. *Retail Sales and Use Taxes* ("spillover" revenues)	112 [g]	State agencies, including support for mass transit	57
		Local agencies, including support for special transit programs	65
D. *Local Cigarete Taxes*	77	To cities	63
		To counties	14

[a] Source: Governor's Budget. Details may not add to totals due to rounding.
[b] Includes $16 million in interest income from prior-year fund balances.
[c] Includes $5 million in interest income from prior-year fund balances.
[d] Negative sign indicates expenditures from prior-year fund balances.
[e] Includes $4 million in interest income from prior-year fund balances.
[f] The distribution of revenues shown in the table is that which appears in the Governor's Budget. The distribution called for under existing law is shown in the *Analysis,* as part of our discussion of Control Section 11.50. That discussion also explains how our interpretation of the distribution proposed in Control Section 11.50 differs from the interpretation used in the budget.
[g] Includes $4 million in interest from prior-year fund balances. The $11 million difference between the revenues shown and the identified program expenditures will be financed through transfers from the State Highway Account.

THE CALIFORNIA STATE LOTTERY—AN OVERVIEW

As noted earlier, the special fund revenue totals contained in the budget do not include revenues associated with the California State Lottery. This is because the department presently is classifying these revenues as falling into the category of "nongovernmental trust and agency funds." Monies so classified are not normally reported in the budget. (Other revenues treated in this fashion include revenues to pension funds and certain bond funds.) In any event, because the new lottery does represent a major new source of special fund revenues, it is appropriate to briefly discuss here its provisions and revenue potential.

Basic Provisions of the California State Lottery

The California State Lottery was authorized and established by Proposition 37, which was approved by the voters in November 1984. The California State Lottery Act of 1984 provides for a state-operated lottery which will be administered, subject to certain restrictions, by a five-person commission appointed by the Governor and confirmed by the State Senate. The Legislature has the authority to amend the act if, by doing so, it furthers the purposes of the measure.

The act specifies that the proceeds of lottery ticket sales shall be distributed as follows:

- 50 percent shall be returned to the public in the form of lottery prizes;
- No more than 16 percent shall be used for administrative expenses of operating the lottery; and
- 34 percent shall be allocated to various levels of public education, plus any unclaimed lottery prizes and any portion of the amount by which actual administrative expenses fall short of 16 percent. (Based upon the actual experience of states with lotteries, education's share of lottery ticket sales eventually will be around 40 percent.)

The initiative provides that education's share of the lottery receipts shall be allocated on a "per capita" basis amongst K–12 education, the community colleges, the California State University (CSU) system, and the University of California (UC). The budget estimates that, based upon current average-daily-attendance and full-time-enrollment projections, the 1985–86 allocation of the state's share of lottery proceeds would be as follows:

• K–12	81.0%
• Community Colleges	12.0
• CSU	4.5
• UC	2.5
Total	100.0%

Projected Revenues

Projecting the volume of California lottery ticket sales and state lottery revenues for 1985–86 is extremely speculative, especially given that the lottery's commissioners were only appointed in late January and there has never been a statewide lottery before in California. Because the five commissioners have yet to decide the types of lottery games to be played, the frequency of lottery drawings, and the number and locations of ticket sales outlets, one can only speculate about how much lottery revenues will be realized.

Last year we estimated that a fully-operational lottery eventually could generate $500 million annually for public education. The amount of revenues that can be expected in 1985–86, however, is undoubtedly less than this amount, given that lottery games take considerable time to plan and implement properly. The lottery commissioners recently indicated that they plan to have the lottery operational before year-end 1985; however, no specific "timetable" has been developed.

As indicated above, the budget assumes that 1985–86 lottery revenues to education will be in the range of $300 million. This assumption could be optimistic, since the exact timing and nature of the state's lottery games have yet to be determined and, at the time this analysis was written, even the lottery director had not yet been named.

The Legislature Needs to Review Lottery Revenues and Expenditures

We recommend the Legislature require that: (1) the proceeds from the lottery earmarked for education be deposited in a special fund, (2) the proceeds from the lottery earmarked for the administration of the lottery be deposited in a separate special fund, and (3) expenditures from both lottery special funds be made subject to direct Budget Act appropriation.

As discussed above, state lottery revenues are not included in the budget totals because the Department of Finance has classified lottery-related monies as "nongovermental trust and agency funds," similar to pension funds and certain bond funds. For this same reason, most lottery-related expenditures do not appear in the budget, and are not subject to legislative review through the normal budget process.

The department has the authority to classify lottery funds in any manner it chooses. We believe, however, that the department's decision to keep lottery-related funds "outside" of the budget and the normal appropriation process is not warranted by the nature of these funds, nor is it appropriate, for two reasons:

- ***First,*** this decision means that the budget will fail to reflect the extent to which the state is supporting public education in California.
- ***Second,*** the decision makes it more difficult for the Legislature to monitor the use of lottery revenues and ensure that they are being

subjected to the same thorough review as the expenditure of other state funds.

For these reasons, we recommend that the Legislature:

1. Designate the California State Lottery Education Fund as a special fund,
2. Establish a second special lottery fund into which the share of lottery proceeds available for administrative costs is placed, and
3. Make the expenditure of monies from both of these special funds contingent on a direct Budget Act appropriation.

These actions would *not* conflict with Proposition 37's requirements regarding how lottery proceeds are to be spent, but *would* ensure that lottery-related expenditures are properly tracked, properly reviewed and subjected to necessary legislative oversight.

THE LONG-TERM REVENUE OUTLOOK

Accurately projecting what General Fund and special fund revenues might be beyond the budget year is always an extremely difficult undertaking, largely because it is impossible to guess with any confidence 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 available, so that the Legislature will have at least some general idea of what the prospects for General Fund and special fund revenues might be in the future. Such forecasts are prepared both at the federal level and by many economic consulting firms.

The most important factor determining state income in future years will be the path taken by the state's economy. Generally speaking, the state's revenue base appears to have sufficient "elasticity" to grow at a pace equal to, and probably slightly above, the growth rate of California's personal income base—at least during normal years. (This is pretty much the case for the budget year.) However, this relationship can be severely distorted during periods when economic activity fluctuates from the long-term trend. For example, when an economic downturn occurs, corporate profits usually fall in dollar terms, and the percentage of their income that consumers spend on taxable commodities can also decline. During strong economic expansions, the opposite usually occurs. Thus, on a year-to-year basis, the rate of growth in revenues can be higher or lower than the growth rate for the economy.

Obviously, it is not possible to predict the economy's performance beyond the next 18 months with any confidence. Indeed, no economist can say with any certainty 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 such factors as the unsettled conditions in the foreign trade sector, international debt problems, the inability of federal government officials themselves to predict what courses monetary and fiscal policies will take in the future, the continued prospects for large federal budget deficits and their potentially negative effects on the economy, and the fact that the economy currently appears to be in a "transition phase" during which it could either begin to expand or contract. Given this, any estimate of what General Fund revenues will be beyond 1985–86 depends entirely on what one wants to *assume* about the economy's performance beyond 1986.

The Department's Long-Term Revenue Forecast

The Governor's Budget contains projections of both General Fund and special fund revenues for 1986–87 and 1987–88. These projections are shown in Table 35. The projections assume that the department's standard economic forecast for moderate growth will come true in 1985 and 1986, and that the economy will experience a mild recession in 1987, followed by a post-recession recovery in 1988. The reason the department chose to assume a recession in 1987 is that the average length of postwar economic expansions is 34 months, and the current expansion has already lasted 26 months. Table 35 shows that, should the department's assumptions come true, General Fund revenues would total $29.9 billion in 1986–87 and $30.6 billion in 1987–88, while special fund revenues would total $5.2 billion and $5.4 billion in those two years. Thus, total state revenues would amount to $35.1 billion in 1986–87 and $36 billion in 1987–88.

The General Fund revenue growth rates implied by this projection are 7.1 percent for 1986–87 and 2.2 percent in 1987–88, when the "brunt" of the 1987 recession would be felt by the state's treasury.

It appears that the General Fund could weather this economic storm—although just barely—without having to either raise taxes or reduce "real" per-capita expenditures below projected 1985–86 levels. This would not be true, however, if either (a) a 1987 recession was more severe than what the department has assumed, or (b) the year-end General Fund balances projected for 1985–86 and 1986–87 were not put into the Reserve for Economic Uncertainties where they would be available to "bail out" the General Fund during such a recession.

Given the underlying "elasticity" of the state's revenue structure, we anticipate that the General Fund balance would again proceed to grow after 1987–88 as the economic recovery contained in the department's long-term projections took place.

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Table 35
Long-Term Revenue Projections
1985–86 through 1987–88
(dollars in millions)[a]

Revenue Source	*1985–86*	*1986–87* Amount	*1986–87* Change	*1987–88* Amount	*1987–88* Change
A. General Fund Revenues					
Personal income tax	$11,165	$12,000	7.5%	$12,400	3.3%
Sales and use tax	10,510	11,230	6.9	11,370	1.2
Bank and corporation tax	3,950	4,300	8.9	4,340	0.9
Other sources	2,297	2,370	3.2	2,450	3.4
Subtotals, General Fund Revenues	$27,922	$29,900	7.1%	$30,560	2.2%
B. Special Fund Revenues	4,999	5,200	4.0	5,400	3.8
C. Total Revenues, All Sources	$32,921	$35,100	6.6%	$35,960	2.5%

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

The "No Recession" Alternative

We believe the department's decision to assume a mild recession before 1989 is reasonable, given historical experience. However, should the economy somehow "beat the odds" by expanding beyond 1986 and avoiding any type of downturn, General Fund revenues would be higher than the levels shown in Table 35. As an illustration, for example, revenues could be in the range of about $30.2 billion for 1986–87 and $32.5 billion for 1987–88, if California's personal income growth rate during this period were to average between 7 percent and 8 percent.

In this event, the General Fund would continue to accrue a surplus throughout the entire forecast period, which would reach about $2.4 billion at the end of 1987–88. This would be sufficient to maintain a 5 percent reserve ($1.6 billion) and still leave about $800 million that could be spent on new programs, expansion of existing programs, one-time expenditures or tax reductions.

Most economists, however, do *not* believe the likelihood of an uninterrupted economic expansion like this is very high. Nor do we. It seems more reasonable to assume that even if the economy were able to avoid an outright economic downturn over the next few years, there would at least be some period of economic lethargy. Assuming this, even a no-recession long-term economic outlook might not result in much of a "discretionary" surplus in 1987–88.

State and Local Borrowing

In addition to the $33.1 billion in state expenditures which would be funded from state revenue collections in 1985–86, the Governor's Budget proposes that the state expend approximately $469 million in funds derived from the sale of bonds. Generally speaking, these funds will be used for capital outlay programs.

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

- ***General obligation bonds*** are backed by the state's full faith and credit. Thus, when the State of California issues a general obligation bond, the state pledges to use its taxing power, if necessary, 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.
- ***Revenue bonds*** are not backed by the full faith and credit of the state. Instead, they are secured—at least in theory—by revenues from the projects which are financed from 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.

This section provides information on borrowing by the state, including the sales and outstanding volumes of state general obligation and revenue bonds. It also contains a brief discussion of borrowing conducted by California's local governments.

STATE BORROWING

The state borrows money on both a long-term and short-term basis. Long-term borrowing provides funds for a variety of state and state-assisted local capital outlay programs. Short-term borrowing provides funds to meet the state's cash-flow requirements.

State General Obligation Bonds

General obligation bonds issued by the state are used to support a wide variety of programs, such as state construction projects, state parks and recreational facilities, new state prisons and county jails. These bonds also are issued to provide financial assistance for California veterans seeking to purchase homes.

During 1984, California voters approved a record $2.7 billion in additional bond authorizations. Most of this amount consisted of additional authorizations for *existing* state bond programs—those financing county jails ($250 million), new state prisons ($300 million), parks and recreational facilities ($370 million), clean water ($325 million) and safe drinking water projects ($75 million), school building lease-purchase ($450 million), assistance to veterans ($650 million), and fish and wildlife enhancement ($85 million). In addition, voters approved two *new* bond programs: $100 million for hazardous substance cleanup and $50 million for senior citizen centers.

Status of Bonds Authorized. Table 36 identifies for the state's general obligation bond programs the portion of the currently-authorized amounts that are outstanding, redeemed, and unsold. As the table shows, on December 31, 1984 the state had not sold $3.7 billion in authorized bonds, compared to $2.3 billion at the end of 1983. Of the authorized bonds already sold ($12.7 billion), the state had retired approximately $5.3 billion, leaving $7.4 billion, or 58 percent of the total, still outstanding.

Table 36
General Obligation Bonds of the State of California
As of December 31, 1984
(dollars in millions)

	Authorized	*Unsold*	*Redeemed*	*Outstanding*
State construction	$1,050.0	—	$810.8	$239.3
Higher education construction	230.0	—	157.6	72.4
Junior college construction	65.0	—	44.0	21.0
Health sciences facilities construction	155.9	—	58.5	97.4
Community college construction	160.0	—	75.3	84.8
Beach, park, recreational, and historical facilities	400.0	—	191.1	208.9
Recreation, fish, and wildlife	145.0	$85.0	32.5	27.5
State, urban, and coastal park	280.0	30.0	55.5	194.5
Parklands acquisition and development	285.0	95.0	20.1	169.9
Park and recreational facilities	370.0	345.0	—	25.0
Clean water	1,200.0	500.0	215.9	484.1
Safe drinking water	250.0	110.0	6.0	134.0
New prison construction	795.0	495.0	15.0	285.0
County jail construction	530.0	455.0	—	75.0
Lake Tahoe land acquisition	85.0	85.0	—	—
First-time homebuyers	200.0	185.0	—	15.0
School building lease-purchase	950.0	595.0	13.4	341.6
Hazardous substance cleanup	100.0	100.0	—	—
Senior centers	50.0	50.0	—	—
School building aid	2,140.0	40.0	1,485.8	614.2
Water resources development	1,750.0	180.0	148.4	1,421.6
Harbor bonds	89.3	—	71.3	18.0
Veterans farm and home	5,100.0	340.0	1,887.3	2,872.7
Totals[a]	$16,380.2	$3,690.0	$5,288.4	$7,401.8

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

Sale of General Obligation Bonds. In 1983–84, the State Treasurer marketed $810 million in general obligation bonds. Over half of this amount ($450 million) was sold for the veterans farm and home loan program. The next largest volume of bonds ($195 million) was sold for the school building lease-purchase program.

During the current year, over $1.3 billion in general obligation bond sales by the State Treasurer's Office are anticipated, an increase of approximately $500 million over the volume sold last year. Most of the increase—$350 million—is attributable to the state's new prison construction program.

For 1985–86, the budget shows that a total of $1.2 billion in general obligation bond sales are planned by the State Treasurer. A significant portion of these sales ($710 million) is attributable to the additional authorizations approved by voters in 1984. The largest volume of bonds to be sold in 1985–86 will be used to finance the new prison construction program ($345 million), followed by bond sales for the veterans farm and home building loan program ($340 million), the state school building lease-purchase program ($95 million), safe drinking water projects ($80 million), hazardous substance cleanup ($50 million), and various other programs ($280 million).

General Fund Costs for Paying Off Bonds. Table 37 shows projections of the debt service payments for principal and interest that will be made in 1985–86 on bonds *fully-supported* by the General Fund. Debt service for the budget year is estimated to total $486 million, of which $233 million is for repayment of principal and $253 million is for payment of interest. This is an increase of $108 million, or 28 percent, over estimated costs in the current year. Our analysis indicates that the repayment of state general obligation bonds continues to be one of the most rapidly growing General Fund "programs" in the state's budget, exceeding, for example, the rate of growth for K–12 education (9.5 percent) and mental health programs (12 percent).

Table 37
General Fund Debt Service
1982–83 through 1985–86
(dollars in millions)

	Debt Service [a]	*Percent Change from Previous Year*	*Total Bond Sales* [b]
1982–83	$262.0	19.8%	$435.0
1983–84	318.7	21.6	360.0
1984–85	378.7	18.8	905.0 [c]
1985–86	486.4	28.4	850.0 [c]

[a] Includes estimated debt service only on general obligation bond issues currently authorized by the electorate. Excludes debt service on short-term borrowing.
[b] Interest rates of 9.5 percent and 10.0 percent are assumed for anticipated bond sales in 1984–85 and 1985–86, respectively. Figures for 1982–83 and 1983–84 are actual bond sales.
[c] Source: 1985–86 Governor's Budget.

The amount of debt service actually paid by the General Fund, however, could be lower than the amounts shown in the budget. This is because the authorizations for some of the bond programs, such as the programs for hazardous substance cleanup and assistance for first-time homebuyers, call for project revenues to pay at least part of the debt service costs. The budget, however, shows that the General Fund will pay these costs because of uncertainties over when such revenues would be generated.

The debt service estimates are based on specific assumptions regarding future bond sales and interest rates. If the actual volume of sales is greater (less) than the estimated volume, or interest rates are higher (lower) than projected, then the amounts needed from the General Fund to service the debt will increase (decrease) accordingly.

How Bond Proceeds Will Be Spent. Once General Fund bonds are sold, the proceeds from the sales are allocated for expenditure on specific projects. Table 38 identifies these expenditures for the prior, current, and budget years, according to the source of bond funding.

Table 38
Selected Bond Fund Expenditures
1983–84 through 1985–86
(dollars in millions)[a]

Program	*1983–84*	*1984–85*	*1985–86*
Parklands acquisition	$45	$102	$37
Fish and wildlife	—[b]	15	17
Parks and recreational facilities	—	—	11
Safe drinking water	18	46	71
Clean water	57	72	82
County jails	—	51	125
Lake Tahoe land acquisition	—	5	26
Beach and park	5	5	—[b]
Urban and coastal park	13	23	—[b]
New prison	75	620	4
School building lease-purchase	185	190	95
Higher education construction	—[b]	—[b]	—
Unallocated capital outlay	—	—[b]	—
Totals	$400	$1,130	$469

[a] Details may not add to totals due to rounding.
[b] Less than $1 million.

Past Year. In 1983–84, the midyear estimate of bond fund expenditures was $824 million, or $424 million more than the actual amount spent. Most of this shortfall occurred in the new prison construction program. Actual expenditures under this program were $324 million less than what had been estimated.

Current Year. In 1984–85, the budget indicates that bond fund expenditures will reach a record level of $1.1 billion. This estimate assumes that $620 million of the $795 million authorized for new prison construction will be expended in the current year. As noted earlier, however, the budget indicates that $345 million of this authorization will not be marketed until the budget year. Thus, it is very unlikely that this level of expenditure could be reached.

Budget Year. In 1985–86, bond fund expenditures are expected to return to a more normal level ($469 million). As shown in Table 38, the two programs accounting for almost half of these expenditures are county jails ($125 million) and school building lease-purchase ($95 million).

State Revenue Bonds

Agencies of the state also issue revenue bonds. These bonds are fundamentally different from general obligation issues, in that, in theory, only the revenue generated from the financed project is pledged as security.

Traditionally, revenue bonds have been used by the state to finance the construction of such projects as toll bridges and higher education dormitories. Beginning in the 1970s, however, 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 39 identifies the 17 different state revenue bond programs and shows the current authorization, if any, for each. As of December 31, 1984, a total of $7.9 billion in state revenue bonds was outstanding.

Table 39
State Agency Revenue Bonds
As of December 31, 1984
(dollars in millions)[a]

Issuing Agency	*Authorization Limit, If Any*	*Outstanding*	*Remaining Authorization*
California Educational Facilities Authority	$750	$621	$129
California Housing Finance Agency	2,350	2,129	221
California Pollution Control Financing Authority	—	1,437	—
California Transportation Commission	—	118	—
Department of Water Resources	—	956	—
Trustees, California State University	—	174	—
Regents, University of California	—	203	—
State Public Works Board	—	44	—
State Public Works Board, Energy Conservation and Cogeneration	500	—	500
Hastings College of Law	—	7	—
Veterans Revenue Debenture	1,000	656	344
California National Guard	100	39	61
California Health Facilities Authority	2,409	1,404	1,005
California Student Loan Authority	300	118	182
California Alternative Energy Source Financing Authority	200	30	170
California Rail Passenger Financing Authority	1,250	—	1,250
California Urban Waterfront Area Restoration Financing Authority	650	—	650
Totals	$9,509	$7,936	$4,512

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

Three housing bond programs account for over $2.8 billion, or 36 percent, of the oustanding bonds: the California Housing Finance Agency

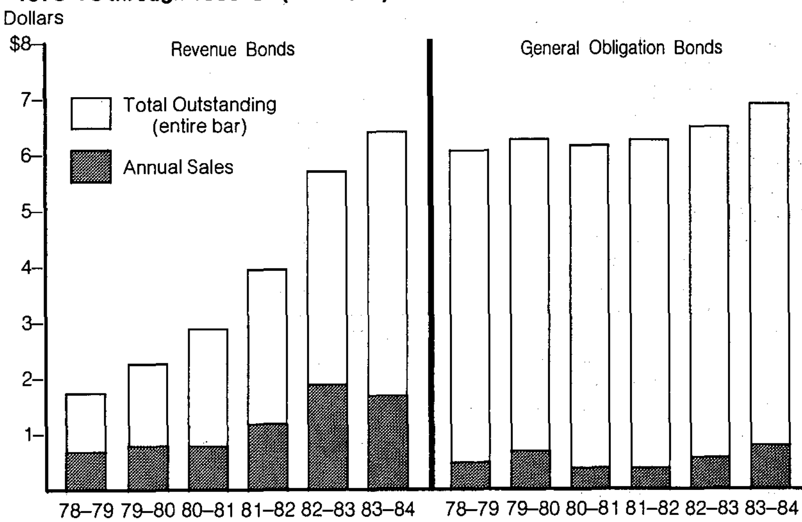
($2.1 billion), the Veterans Revenue Debenture ($656 million), and the California National Guard ($39 million). Bonds issued by two other authorities, the California Pollution Control Authority and the California Health Facilities Authority, also account for significant portions of the revenue bonds outstanding (about $1.4 billion each). The table also shows that 10 of the 17 programs have statutory authorization limits, which together total $9.5 billion. Of this amount, approximately $4.5 billion (47 percent) remained unused at the end of 1984.

Revenue Bond Sales. Revenue bond sales have increased dramatically in the last five years. In 1980–81, state financing authorities issued approximately $800 million in revenue bonds. For the last two years, however, sales have approached $2 billion. Three authorities accounted for over 80 percent of the sales in 1983–84—the California Housing Finance Agency ($438 million), the California Pollution Control Financing Authority ($452 million), and the California Health Facilities Authority ($561 million). These authorities also will account for over 75 percent of the estimated sales during the current year.

Use of General Obligation Versus Revenue Bonds

Chart 15 compares the sales and outstanding volumes of state general obligation and revenue bonds since 1978–79. It shows that revenue bond

Chart 15
State General Obligation and Revenue Bonds
Annual Sales and Total Outstanding Volumes
1978–79 through 1983–84 (in billions) [a]



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

sales have significantly exceeded general obligation bond sales in each of the past five years. As a result, the volume of outstanding revenue bonds has increased dramatically, in contrast to only a slight increase in the volume of general obligation bonds outstanding.

The increase in revenue bond sales, relative to general obligation bond sales, partly reflects the fact that revenue bonds generally are not subject to statutory interest rate ceilings. Under existing law, the interest rate on state general obligation bonds cannot exceed 11 percent. High interest rates, especially during 1982 and 1983, have sometimes made it difficult to sell general obligation bonds within these ceilings. In addition, general obligation bond sales for each of the state's programs are subject to specific authorization limits. The limits for six of these programs have already been reached. In contrast, there are no restrictions on sales under 7 of the state's 17 revenue bond programs.

Additional Long-Term Borrowing

In addition to the general obligation and revenue bond programs described above, the state also engages in other forms of long-term borrowing, mainly through the issuance of *certificates of participation* (CPs). For example, the state has borrowed $42 million through the issuance of CPs to fund the new headquarters' facility for the Franchise Tax Board. Up to $300 million in these instruments may also be used by the State Public Works Board to finance state prison construction projects. Finally, the Legislature has authorized the use of CPs, revenue bonds, and other debt instruments for the construction of "high technology" educational facilities, which would be leased to state postsecondary education institutions, such as the University of California.

Funding for the costs associated with these types of long-term borrowing is provided *by the General Fund.* These funds, however, are not included within the administration's estimate of debt service requirements. In the case of the CPs, the funding shows up (or will show up) in the individual agencies' budgets as the cost of "facilities operations". This is because the state's lease payments for use of the facilities are pledged to retire the debt. In the case of the "high technology" issues, the cost of the debt service is funded out of the state's annual appropriation for the particular educational institution.

Short-Term Borrowing by The State

The General Fund often borrows money on a short-term basis to compensate for the difference between when revenues are actually received and when the state must pay its bills. This type of borrowing for "cash management" purposes is a routine and integral part of managing the state's fiscal affairs.

In the past, most of the General Fund's short-term borrowing was done *internally,* usually from the Reserve for Economic Uncertainties, from special funds, or from the Pooled Money Investment Account (PMIA).

In 1983–84 and 1984–85, however, the state began to borrow from external sources. In 1983–84, for example, the state borrowed $1.2 billion from the private sector by issuing revenue anticipation notes. The balance of the state's cash flow needs for 1983–84 was met through loans from the PMIA ($1.3 billion) as well as from special funds and accounts ($772 million).

For the current year, the state borrowed $1.4 billion through the sale of revenue anticipation notes in August 1984. The Legislature authorized the use of external borrowing, even when sufficient funds are available internally, in order to take advantage of the fact that the state can borrow from external sources at a cost that is lower than the cost of borrowing from internal sources. This is because the state can borrow from external sources at tax-exempt interest rates, while internal sources must be paid interest at rates comparable to the yield on taxable securities.

The budget for 1985–86 shows that $1.3 billion in short-term notes will be issued in August 1985. The state's cash flow needs during the budget year also will be financed periodically from internal sources. Our detailed analysis of the external borrowing program proposed for 1985–86 appears in Item 9620 of the *Analysis.*

LOCAL BORROWING

The State of California does not directly regulate most types of borrowing by local governments. However, state law does govern such factors as the permissible types of borrowing that local entities can undertake and the maximum interest rates that can be paid on certain debt. The state also has been required to enforce recently-enacted federal limits on certain types of borrowing for private purposes, including housing. Regardless of its specific responsibilities for regulating local government borrowing, the state has an important interest in the amount of borrowing undertaken by local governments. This is because the marketability of state debt can be affected by the total volume of tax-exempt local debt offered for sale.

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. For example, 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. In 1983–84, with the economic recovery easing the cash-flow situations of local governments, the volume of short-term local borrowing fell to approximately $3 billion.

Long-Term Local Borrowing—Growth Eases

After increasing dramatically over the previous four years, the rate of growth in long-term bond sales by local governments appeared to ease slightly last year. Based on information provided by the California Debt Advisory Commission, we estimate that sales reached over $5.8 billion in 1983–84, up from $5.7 billion in 1982–83. Most of the growth in previous years was due to housing bond sales, which rose from $1.2 billion in 1979–80 to $2.3 billion in 1982–83. Last year, however, local housing bond sales fell to $1.8 billion, apparently in response to the temporary federal moratorium on the tax exemption for interest earned on housing bonds.

TRENDS IN STATE AND LOCAL BORROWING

The state and local governments traditionally have relied on bonds, long-term loans, and other forms of borrowing to raise funds for the construction of public facilities, such as roads, schools, water systems, prisons, and recreational facilities. In recent years, however, a number of trends and policy changes have emerged which affect the purposes, methods, and level of borrowing, as discussed in detail below.

New Federal Limits on "Private Activity Bonds"

State and local agencies have begun to rely heavily on tax-exempt bonds to provide financing for *private* projects. This includes, for example, *industrial development bonds,* which are used to finance private manufacturing and commercial facilities, and *revenue bonds,* which often are used to help finance private pollution control and alternative energy projects.

Concerned that such tax-exempt bonds frequently are used to finance projects that benefit private investors more than the general public, the federal government recently enacted limits on the volume of "private activity bonds" which state and local authorities could issue each year. These limits generally apply to bonds issued for industrial and commercial development projects, certain for-profit educational and health facilities, and student loans. The federal Tax Reform Act of 1984 set a limit on the issuance of private activity bonds for the state as a whole at $150 per resident or $200 million per calendar year, whichever is greater.

The Governor recently established the California Debt Limit Allocation Committee (CDLAC), which is responsible for determining the cap on such borrowing within California and allocating borrowing authority among state and local jurisdictions. Based on the state's population, CDLAC set the cap for 1985 at $3.8 billion. It appears, however, that the new federal limit will not pose any significant problems for California jurisdictions, because the volume of private activity bonds issued is likely to fall well below the limit.

Housing Bond Sales Remain Significant

Housing bonds account for a substantial portion of the growth in bond sales during recent years, particularly at the local level. In 1977–78, a total of $416 million in housing bonds were sold. In 1982–83, total housing bond sales reached almost $3.0 billion, with over 75 percent of this amount attributable to local sales. Housing bond sales in 1983–84 fell by approximately $150 million, although the volume remains significantly higher compared to what it was in previous years. In general, local authorities have been able to issue large volumes of housing bonds to make housing more affordable during periods of escalating home prices and mortgage interest rates.

Both the state and the federal government have expressed concern over the rapid growth in the sale of housing revenue bonds, primarily out of fear that such bond sales will increase the interest costs and limit the market for other tax-exempt bonds sold for more traditional public purposes. The federal government recently has taken actions to limit and regulate the issuance of housing bonds, particularly mortgage revenue bonds. These restrictions include annual limitations on the volume of mortage revenue bonds that may be issued in each state, and a sunset, effective December 31, 1987, on the federal tax exemption for interest earned on state and local bonds issued for such purposes.

The use of tax-exempt bonds to provide below-market financing for housing also presents major fiscal and policy issues at the state level. Our recent report, *The Use of Mortgage Revenue Bonds in California* (Report 85-7), discusses some of these issues and provides other information on the use of tax-exempt housing bonds within California.

Debt Financing for Infrastructure Continues on the Rise

State and local authorities continue to issue a significant amount of debt to finance "infrastructure"—capital improvements and public works. According to information from the California Debt Advisory Commission, approximately $1.4 billion was issued for such purposes between January and June of 1984, compared to less than $500 million for the same period in 1982.

The level of debt issued to finance infrastructure could increase if ACA 55 is approved by the voters in June 1986. This constitutional amendment, in effect, would restore local government's ability to issue general obligation bonds, as it would allow increases in local property tax rates to secure the bonds. (This ability was effectively removed by the passage of Proposition 13.) Contingent on the approval of two-thirds of the local jurisdictions' voters, local agencies would be able to issue general obligation bonds for any form of capital improvements needed locally.

Potential Impact of Federal Tax Reform

The U.S. Congress and the Reagan Administration currently are considering proposals for major reform of the federal income tax system. While the proposals under consideration vary, the underlying purpose of these proposals is tax simplification. To accomplish this, the options would eliminate many of the current tax deductions and credits that have made federal tax laws complicated. They also would revise tax rates, to ensure that individual tax liabilities remain essentially the same.

Federal tax reform potentially could have a significant impact on the market for tax-exempt debt. In particular, if federal tax rates are reduced, tax-exempt bonds would become less attractive, especially for individuals who currently are in high tax brackets. For example, from the standpoint of investors in the 40 percent tax bracket, a *taxable* security which earns 10 percent is equivalent to a *tax-exempt* security which earns 6 percent. If, however, the investor's tax bracket were reduced to, say 25 percent, the yield on the tax-exempt security would have to *rise* to 7.5 percent in order to remain competitive with the taxable security. Under these circumstances, a reduction in federal tax rates may narrow the "spread" between taxable and tax-exempt securities. As a result, issuers of tax-exempt debt, such as the state, may be required to offer or accept higher interest rates—which would increase debt service costs—in order to market their debt issues.

The State's Work Force

The Governor's Budget proposes a state government work force of 227,888 personnel-years (pys) for 1985–86. Four functional areas account for 79 percent of the total: higher education (40 percent); health and welfare (16 percent); business, transportation, and housing (14 percent); and youth and adult corrections (9 percent).

THE PROPOSED WORK FORCE FOR 1985–86

The budget proposes to reduce the size of the state's work force by 2,869 personnel-years, or 1.2 percent, in 1985–86. From a program perspective, the largest reductions would occur in three principal areas—health and welfare (−2,713 pys); business, transportation and housing (−880 pys); and state and consumer services (−654 pys). These reductions would be partially offset by a significant increase in the youth and adult correctional program (+1,830 pys), as shown in Table 40.

Table 40
The State Work Force, by Function
(in personnel-years)
1983–84 through 1985–86 [a]

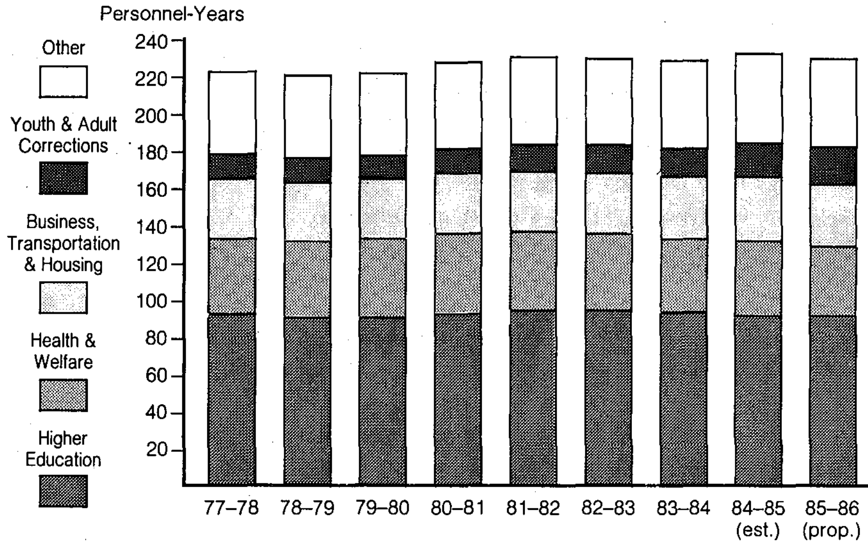
				Change 1984–85 to 1985–86		Change 1983–84 to 1985–86	
	1983–84	*Estimated 1984–85*	*Proposed 1985–86*	*Amount*	*Percent*	*Amount*	*Percent*
Legislative, Judicial, Executive	9,486	9,960	10,053	93	0.9%	567	6.0%
State and Consumer Services	11,256	12,196	11,542	−654	−5.4	286	2.5
Business, Transportation and Housing	33,092	33,528	32,648	−880	−2.6	−444	−1.3
Resources	13,519	13,842	13,723	−119	−0.9	204	1.5
Health and Welfare	39,288	39,680	36,967	−2,713	−6.8	−2,321	−5.9
Youth and Adult Corrections	15,336	18,154	19,984	1,830	10.1	4,648	30.3
K–12 Education	2,548	2,712	2,718	6	0.2	170	6.7
Higher Education	93,092	91,081	90,756	−325	−0.4	−2,336	−2.5
General Government	9,079	9,604	9,497	−107	−1.1	418	4.6
Totals	226,695	230,757	227,888	−2,869	−1.2%	1,193	0.5%

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

Table 40 indicates that when the budget proposal is compared to the actual number of personnel-years worked in 1983–84, the proposed state work force for the budget year is 1,193 personnel-years higher. Over the two-year period covered by the table, youth and adult correctional programs will increase by 4,648 personnel-years, or 30 percent, while health and welfare; higher education; and business, transportation and housing; collectively, will decrease by 5,101 pys, or 3.1 percent.

As shown in Chart 16, the trend identified in Table 40 is characteristic of state experience in recent years. Specifically, the total state work force dipped after the passage of Proposition 13 and has remained relatively steady since 1980–81. The composition of the state work force is changing, however, as health and welfare staffing is cut back while youth and adult corrections is expanding.

Chart 16
Historical Trends in the State Work Force, by Function 1977-78 through 1985-86 (in thousands)



As we discuss in detail in Part Three, the personnel reduction proposed for the budget year can be explained by a variety of factors, including the following:

- The staffing estimates for 1984–85 are higher than the state's actual work force in 1983–84 and represent the second largest year-to-year increase since Proposition 13. By comparing this estimated level to the proposed amount for 1985–86, the magnitude of the reduction is inflated.
- The 1984–85 estimate of the state work force is not a very reliable base against which the number of personnel-years proposed for 1985–86 should be compared. This is because the current-year estimate, more than likely, is overstated and, therefore, tends to exaggerate the size of the reduction proposed for the budget year.
- A large number of authorized positions are proposed for elimination in 1985–86. Some of these reductions are due to increased efficiencies.
- Many of the staffing reductions are attributable, however, to book-

keeping adjustments, unallocated reductions, position decreases which would have occurred in the absence of administrative actions, or staffing reductions which have been anticipated for several years.

- The budget contains numerous proposals to contract for personnel-related work currently performed by state employees or of the type generally done by state employees. We estimate that a minimum of 1,300 pys have been "saved" in this manner.

Proposed Changes by Function

Health and Welfare. The largest staffing reduction in absolute terms, 2,713 personnel-years, is proposed for health and welfare. A little more than one-half of these reductions are proposed for the Employment Development Department, where a total of 1,367 personnel-years would be deleted. This reduction can be attributed to a variety of factors, including administrative economies, automation of the unemployment insurance (UI) and disability insurance (DI) programs, transfers to other departments and levels of government, workload changes in the UI program, and program terminations. State hospitals operated by both the Departments of Mental Health and Developmental Services account for the other major reduction. These decreases are occurring due to population reductions, introduction of labor-saving equipment in kitchens and pharmacies, a transfer of laundry operations to the Prison Industry Authority, and a reduction of overhead costs at Stockton State Hospital pursuant to legislative direction.

Personnel reductions in the Departments of Health Services, Social Services, and Rehabilitation also are attributable to the transfer of various programs to local entities, including family planning and maternal and child health; adoption placements; and vocational rehabilitation services, respectively.

Business, Transportation, and Housing. The budget proposes to reduce staffing for this program area by 880 pys, or approximately 3 percent. Caltrans would experience the largest reduction (−543 pys) due to efficiency reductions, contracting for services, and increased salary savings. The California Highway Patrol would experience a net reduction of 129 pys, primarily due to the completion in the current year of the training phase of the AB 202 program. That program will have added approximately 670 uniformed officers to the department's operations over a three-year period. The Department of Motor Vehicles is also experiencing a contraction. The principal change in the department is due to an automation project that was initiated in 1978.

State and Consumer Services. Three departments account for the major portion of the changes in this area. The State Personnel Board is being reduced by 105 pys, or 25 percent, due to an acceleration of its decentralized personnel selection program to individual state departments, as well as the termination of the merit system and technical personnel work it currently performs for local government on a reimbursable basis. With regard to this latter activity, the budget proposes that a new Joint Powers Authority perform this function instead. The authority's staffing would not be counted in the totals for the state. In addition, the Franchise Tax Board will reduce its work force by 120 personnel-years, primarily due to improvements in tax return processing. The Department of General Services, meanwhile, will eliminate 219 pys due primarily to workload-related changes in the State Printing Plant, increased salary savings for the State Police, as well as reductions in janitorial personnel (50 pys) reflecting the policy decision to contract for such services.

Higher Education. The budget shows both the University of California (UC) and the California State University (CSU) experiencing net staffing reductions in the budget year. There is less here than meets the eye, however. Budgeted personnel-years generally are not as reliable in these two segments of higher education as they are elsewhere in state government. In fact, the state has no control whatever over UC's staffing level.

According to the budget, UC will experience a *net* decrease of 250 pys. As discussed in more detail in the *Analysis* (Item 6440), however, our review indicates that the net change in university personnel will actually result in *increased* costs to the state, rather than savings. This is because the majority of the 600 pys that the budget claims are being deleted are supported with nonstate funds, while the majority of the personnel added (350 pys) are supported by the General Fund.

The net reduction of 81 pys that the budget shows for the CSU will not result in any savings to the state. This is because the system has deleted 250 personnel-years in an unallocated reduction, but has retained the funding associated with these positions.

Youth and Adult Corrections. The state's correctional program accounts for the most significant staffing increases in the budget year. The budget proposes to increase the Department of Corrections' staffing by 1,906 pys, or 10 percent. This increase is due to the significant increases in the adult inmate population and the opening of new facilities to accommodate them. Partially offsetting the department's staffing increases are staffing reductions totaling 76 pys in the Youth Authority. These reductions primarily reflect what the budget terms "staffing efficiencies".

PERSONNEL-YEARS IN HISTORICAL PERSPECTIVE

The Governor's Budget for 1985–86 places a great deal of emphasis on trends in the size of the state's work force. For example, the budget document indicates that, during the last 20 years, "government clearly has grown faster than the population rate." It is particularly useful to analyze changes in the state's work force from a historical perspective. Our analysis indicates that personnel-year changes over the last two decades have been quite moderate, increasing at an average annual rate of 2.1 percent. During the same period, state population increased at an average annual rate of 1.7 percent.

As shown in Table 41, over two decades, the state work force will grow by 51 percent, while population will grow by 41 percent. It is not surprising, however, that the state's work force is growing slightly faster than the population over time. This is generally because of increased services provided by the state. For example, a larger percentage of the state's population is attending the University of California and California State University than it did in 1965–66. Similarly, the Department of Corrections is housing a larger portion of the state's citizens and the Department of Motor Vehicles is processing more vehicle registrations as a percentage of the state's population than it did two decades ago.

Table 41 also illustrates the trends in civilian employment over the period. Like the state's work force, this sector grew at a faster rate than the state's population. This also is not surprising, however, given two recent trends: (1) the influx of second wage earners into the labor force and (2) a higher percentage of the national and state population of working age due to demographic changes over the period.

Table 41
Trends in California Employment and Population
1965–66 through 1985–86 (selected years, in thousands)

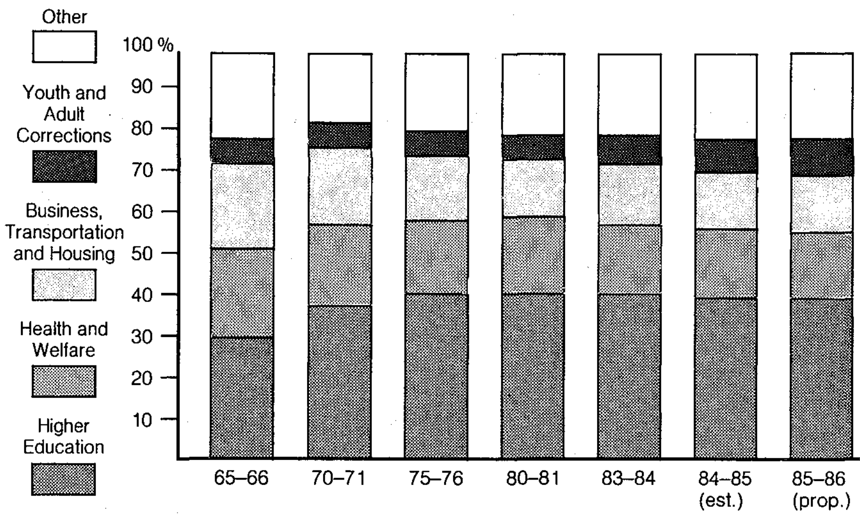
	State Work force [a]	*Civilian Employment* [b]	*State Population* [a]
1965–66	151	7,218	18,464
1970–71	182	7,668	20,039
1975–76	206	8,989	21,537
1980–81	226	10,937	23,771
1983–84	227	11,605	25,186
1984–85	231	12,013	25,622
1985–86	228	12,280	26,066
Difference:			
1965–66 to 1985–86	77	5,062	7,602
Percent change	50.7%	70.1%	41.2%
Average annual change	2.1%	2.7%	1.7%

[a] Source: Governor's Budgets and Department of Finance.
[b] Source: Department of Finance and Employment Development Department. Data reported on average employment over a calendar-year. Amounts reflected here are for the concluding year of each fiscal year.

Changing Distribution of the Work Force by Functional Area

Chart 17 illustrates how the percentage distribution of the state's work force, by functional area, has changed since 1965–66. What the chart shows is that higher education staffing, principally for the University of California and the California State University, is the *single largest component of the state's work force,* in both percentage and absolute terms. Its relative importance, moreover, has been growing in recent decades. From 30 percent of the state's work force in 1965–66, employment in higher education has increased to 41 percent of the state's total in 1983–84.

Chart 17
Historical Percentage Changes in the Functional Composition of the State Work Force Selected Years—1965–66 through 1985–86[a]



[a] Source: Governor's Budgets. Historical figures adjusted for comparability with the state's organizational structure in 1985-86.

Conversely, the relative importance of employment in both health and welfare and business, transportation and housing has been declining in recent years—from 22 percent and 21 percent of the total state's work force in 1965–66 to 16 percent and 14 percent in 1985–86, respectively. Changes in health and welfare staffing levels can be attributed to a number of factors, including major reductions in the state hospitals' mentally ill populations, beginning in the 1960s and extending to the mid-1970s. This led to the closing of three state hospitals and staffing reductions in the remaining 11 hospitals. Similarly, the developmentally disabled population in the state hospitals has been declining since the late 1960s. The decline in business, transportation and housing primarily reflects the reduction in the state's extensive highway capital outlay program from the peak levels in the early 1970s.

Youth and adult correctional programs accounted for 6 percent of the total state work force from 1965–66 through 1980–81. Since then, the programs' share of the total has steadily increased, reaching an all-time high of 9 percent in the budget year. This expansion has consisted almost exclusively of increases in the Department of Corrections to accommodate the influx of adult inmates.

Staffing for all other activities of state government, including general administration and revenue collection functions, consumer services, parks and other resource-related activities, has remained relatively stable, at approximately 20 percent of the state work force, despite significant changes in state services and operations during the last two decades.

Part Three

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

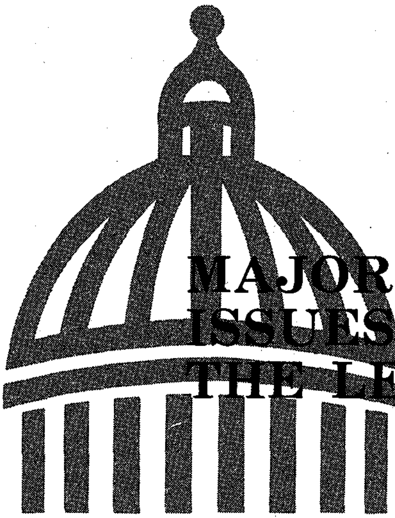
Revenue Issues

- California's Use of the Unitary Method
- Transportation Funding
- Tax Expenditures

Expenditure Issues

- State Work Force Reductions
- Expanded Personal Services Contracting
- The Condition of the State's Infrastructure
- Information Technology Applications
- Regulation of Financial Services
- Comparable Worth

Part Three



MAJOR FISCAL ISSUES FACING THE LEGISLATURE

This part discusses some of the broader issues facing the Legislature in 1985. Many of these issues are closely linked to proposals contained in the Governor's Budget for 1985–86. Others are more long-range in nature and will, in all probability, persist for many years beyond 1985. Even in these cases, however, legislative action during 1985 is desirable because the Legislature generally will have a wider range of options for addressing these issues in 1985 than it will have in subsequent years.

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

State Revenue Issues. The first section identifies issues related to state revenues. Specifically, we discuss California's use of the *unitary method* for taxing corporate profits and the potential consequences of changing from a worldwide combination approach to a water's-edge approach. We also discuss options available to the Legislature to ensure stable and adequate *funding for transportation* and the Governor's *tax expenditure* recommendations.

State Expenditure Issues. The second section identifies issues related to state expenditures. Here, we discuss the effect of the Governor's proposed *staffing reductions* on state programs and operations, the budget's proposals to expand *contracting out* for personal services, ways in which the Legislature could facilitate its review of the state's *infrastructure* needs, and the criteria that should be used to assure that state *automation* projects are soundly conceived and implemented. In this section, we also assess the state's regulation of financial services in the face of a deregulated environment, and the concept of comparable worth as a means of achieving state employment goals.

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

Revenue Issues

CALIFORNIA'S USE OF THE UNITARY METHOD

Should the Legislature Alter the State's "Unitary" Method of Taxing Corporate Profits, and If So, How?

The most controversial tax-related policy issue facing the Legislature today involves the so-called "unitary" method of establishing the corporate tax liabilities for those firms that conduct business both in and out of California.

This section discusses what the unitary method of corporate taxation is, why it is used, what its main advantages and disadvantages are, and what the potential consequences are if the Legislature determines that the method needs to be modified or replaced.

The Basic Problem: How to Tax Multijurisdictional Corporations

The State of California imposes a tax equal to 9.6 percent of the net income earned by banks and corporations that do business in the state. The key step in computing the amount of tax that an individual firm owes is determining its "net income" which, in simple terms, is its total income minus its costs.

For those banks and corporations that do business exclusively *within* the state, "net income" can be determined in a relatively straightforward manner. Since all of their business activities occur within the state, all the income and costs associated with these business activities can be totaled up and used to compute "net income."

Properly measuring "net income" for state tax purposes is not so simple, however, in the case of firms that have business activities both *within* and *outside* of California. This is because the state's tax is intended to apply only to income earned *within* California. Thus a corporation's income must be *apportioned* according to *where* it is earned, to ensure that only California-source income will be included as "net income" for state tax purposes.

As a practical matter, however, it has proven extremely difficult for either corporations or governments to devise a method for apportioning income to the state which is capable of accurately separating income associated with a firm's in-state operations from the income associated with its out-of-state operations. This is because a business's entire spectrum of management, production, accounting, marketing, and distribution activities may be spread around the country or the world, and each activity nonetheless plays a role in determining the overall profitability of the firm. It is the contribution to the firm's overall profitability made by activities within California to which, ideally, the state's tax should apply.

Allocation Methods. "Separate accounting," which is used by the federal government to distinguish between U.S. and foreign-source income for federal income tax purposes, is one way of allocating income according to where the income is earned. Under this method, all of the transactions between a U.S. firm and its foreign business partners are evaluated to determine whether the transaction prices are reflective of the typical "market" price for such a transaction. By restating these transactions at market or "arms length" prices, it is possible to approximate the true net income of the U.S.-based company. The success of this method, however, depends heavily on the amount of effort expended in evaluating a company's transactions, and the extent to which comparable transactions exist in the marketplace. The use of sophisticated accounting techniques and transfer pricing schemes, if undetected, can allow a firm to understate its net income for the U.S.-based company.

The other method of allocating income according to where it is earned in effect *apportions* the overall income of a company in relation to the level of business activity it conducts in different locations. Thus, this method, in effect, assumes that all activities of the firm are equally profitable, and that profits are a direct function of the level of business activity. Whether the results of using any single method to apportion corporate income to, say, California are "reasonable" will depend on the particular circumstances of individual corporate taxpayers—their environment (which involves factors such as labor costs, land values, access to raw materials, and energy supplies) and their organizational structure. Thus, *no single method of apportioning corporate income to an individual state* —no matter how sophisticated—will allocate profits accurately in all cases. The "apportioning" approach is simply a "second best" solution to an inherently complex accounting problem.

An Overview of the Unitary Method

The most popular "second best" solution to the problem of apportioning income geographically is the "unitary" apportionment method. Under this approach (which is used in varying forms by all 45 states that levy taxes on, or based on, corporate income, including California), the amount of a firm's total income subject to state taxation depends on how closely the firm's in-state activities are "unitary" (that is, unified or integrated) with its operations outside the state. The "unitary" concept can be applied to the activities of a *single* corporation operating in different geographic locations. It can also be applied to the activities of a *group* of corporations, such as a parent company and its subsidiaries and affiliates, by treating all members of the group as *one* unit for tax purposes. California is one of several states that uses the "worldwide combination" method, which requires corporations doing business in California to include *foreign* parent corporations, subsidiaries, and affiliates as part of their "unitary" business.

There are three basic steps involved in using the unitary method to determine a corporation's income for purposes of taxation in California:

- *First,* the Franchise Tax Board (FTB) must determine *which corporate or intercorporate activities* are sufficiently interrelated to be included as part of the corporate taxpayer's unitary business.
- *Second,* the board must determine the *type and amount of income* that is subject to formula apportionment.
- *Third,* the board must apply an *apportionment formula* to the taxpayer's unitary business income.

Determination of Unitary Activities. The FTB's general policy is to consider business operations to be "unitary" whenever there are *any* transactions or activities between corporate divisions or subsidiaries within and outside of the state. Such transactions and activities can include purchases of materials, advertising done on a cooperative basis, and centralized purchasing, marketing, and accounting. In some cases, the flow of goods or benefits between divisions and subsidiaries may not be significant, casting doubt on the existence of a "unitary relationship". The FTB maintains, however, that a unitary relationship cannot be measured with sufficient accuracy to enable such distinctions to be made on a case by case basis, and the flow of goods or benefits must therefore be regarded as presumptive of a unitary relationship.

Income Subject to Apportionment. Only a taxpayer's income from unitary business sources is apportioned to California for purposes of taxation. Thus, FTB must separate unitary business income from nonbusiness income. The latter, which includes interest, rents, royalties, and certain dividends, is allocated entirely to the state where the corporation is domiciled, and is not apportioned among its separate locations.

Once nonbusiness income has been removed from the corporation's income, the *taxable* amount of unitary business income must then be determined on the basis of California rules for deductions, exclusions and other factors which affect a taxpayer's liability.

The Apportionment Formula. As a general rule, the FTB uses a simple arithmetic average of three factors to allocate unitary business income to California. These factors are:

- ***The Property Factor.*** This includes all real and tangible personal property owned or rented and used to produce business income.
- ***The Payroll Factor.*** This includes all wages, salaries, commissions and other compensation paid directly to employees whose services are used to produce business income, and
- ***The Sales Factor.*** This includes all gross receipts less returns and allowances, from transactions and activities in the regular course of a firm's business.

These specific factors are used both because they generally bear some relationship to a corporation's overall income-producing ability, and because they are relatively easy to measure and assign to a specific geographic area such as a state.

For each factor, the taxpayer must calculate what its *worldwide total* is—that is, total property, payroll, and sales for all of its divisions and subsidiaries within and without the state that have been designated as part of the "unitary" business. Next, the percentages of its total payroll, property, and sales *within California* are determined. The *average* of these three percentages is then applied to the taxpayer's total taxable business income in order to determine the actual amount of income attributable to California for tax purposes.

The actual apportionment percentage may range from near zero, for a corporation with only minor business interests in California, to near 100 percent for a firm that is predominantly California-based. The statewide average for "unitary" corporations was about 14 percent in 1982. That is, on average, about 14 percent of the business income earned by corporations with unitary operations both inside and outside of California was subject to state taxation.

The Current Controversy Over the Unitary Method

The use of the unitary method by states like California has been controversial for some time. There has been considerable debate, for example, over such issues as exactly how a "unitary business" should be defined and whether specific types of income, such as dividends, should be subject to formula apportionment.

The greatest controversy, however, has arisen over California's and other states' designation of income associated with *foreign operations* as unitary business income—the "worldwide combination" element of the unitary method. To some extent, the controversy is inevitable since there is little agreement on the proper way to account for the multitude of factors that come into play when domestic-source income must be combined with foreign-source income. These factors include currency fluctuations, differences among nations in how taxable income is determined, and the role of foreign taxes and tax credits.

In addition, many multinational companies have contended that the use of "worldwide combination" causes more of their income to be taxed by California than is justified, given the extent and profitability of their business activities in the state. As a result, many argue that a large number of firms, especially foreign-based multinationals, choose to locate, expand or relocate outside of California.

In response, California tax administrators generally defend the unitary method, arguing that it is the fairest, simplest, and most practical way to tax the often complex and interconnected operations of multistate and multinational corporations. They also stress that despite its limitations, the unitary method is better than letting companies use sophisticated "separate accounting" techniques to avoid paying their "fair share" of California taxes.

The federal government attempted to assist states in dealing with the controversy over the unitary taxation method by establishing a working group in 1983, composed of representatives from the federal government, state governments, and the business community. The purpose of this group was to examine the unitary method and develop options for reform. However, the group was unable to reach agreement on many significant unitary-related issues, or recommend any specific reform option that states should adopt.

What Should the Legislature Do?

The choice facing the Legislature in 1985 is *not* between retaining the unitary method and abandoning it. Rather, the choice involves what, if any, changes should be made in the state's unitary method of taxing corporations.

This is an important distinction. Often, the debate over this issue is framed in terms of being "for" or "against" the unitary method. In reality, however, the unitary approach is *not* the issue. In fact, state tax administrators and businesses alike have come to accept the unitary approach as perhaps the only viable means for dealing with the complex problem of geographically apportioning the corporate income of multijurisdictional companies with interdependent business activities.

Rather, the issue is: *how far* should the unitary method extend? Should it apply to worldwide income, as it does under California law, or should it be restricted to U.S. businesses by abandoning the worldwide combination in favor of the "water's-edge" approach?

Water's Edge Versus Worldwide Combination

Under the water's-edge method, only the income associated with domestic business activity is considered in the apportionment process. This is in contrast to the *worldwide* unitary combination method, now used by California, which makes the income associated with *all* of a corporation's unitary operations—foreign and domestic—subject to apportionment.

Table 42 shows which elements of a unitary business are subject to taxation under the worldwide combination and water's-edge methods, for both domestic and foreign-based businesses. The table shows that in the case of worldwide combination, *all* multinational corporations—domestic and foreign—must include income and apportionment factors from parent corporations, subsidiaries operating in the U.S., and subsidiaries in other countries in determining their tax liabilities. In contrast, under the water's-edge approach, *foreign-based corporations* would only have to recognize income earned by their subsidiaries operating within the U.S. and include their apportionment factors. Transactions between domestic and foreign subsidiaries of a unitary corporation would have to be restated at market prices in order to determine the domestic subsidiaries' income, but the profits of the foreign subsidiaries would be ignored. Under the water's-edge approach, *domestic corporations* would continue to include domestic parents or subsidiaries, but would, in general, separately account for the activities of foreign subsidiaries.

Table 42
Apportionment Factors And Income Subject to Taxation Under The Unitary Method Water's Edge versus Worldwide Combination

Domestic-Based Corporations		
Worldwide Combination	*Water's Edge*	
Factors and Income from the following units are combined:	Factors and Income from the following units:	
	Combined:	Not Combined
Domestic Parent	Domestic Parent	Foreign Subsidiaries
Domestic Subsidiaries	Domestic Subsidiaries	
Foreign Subsidiaries		

Foreign-Based Corporations		
Worldwide Combination	*Water's Edge*	
Factors and Income from the following units are combined:	Factors and Income from the following units:	
	Combined:	Not Combined:
Domestic Subsidiaries	Domestic Subsidiaries	Foreign Parent
Foreign Parent		Foreign Subsidiaries
Foreign Subsidiaries		

If the Legislature were to adopt the water's-edge approach in place of worldwide combination, it still would be faced with a number of difficult implementation problems that could easily be as controversial as the worldwide combination approach has been. These problems have to do with what types of foreign-source business income should continue to be subject to apportionment for tax purposes. The two most important of these issues relate to the treatment of foreign dividends and "80/20" corporations.

1. Foreign Dividends

The water's-edge approach attempts to distinguish between a unitary business's domestic and foreign operations. There often are situations, however, where the domestic and foreign operations are closely related. For example, a domestic manufacturer may rely on a foreign-based sales subsidiary to sell its products in other countries. In such cases, the income from the foreign subsidiary normally comes back to the U.S. parent company in the form of *dividends.* An important issue for the Legislature to decide is whether such dividends should be treated as U.S. or foreign-source income.

Under worldwide combination, the treatment of dividends paid between members of a business family is not an important issue. This is because the worldwide combination method looks at the *total* income from all of the unitary family's businesses. Therefore, it does not matter whether a foreign subsidiary pays dividends to its domestic parent or keeps its income as retained earnings. In either situation, the income would still be reported for state tax purposes.

Under the water's-edge approach, the treatment of foreign-source dividends for apportionment purposes is a major issue. On the one hand, it can be argued that the treatment of such dividends as unitary business income is justified to the extent that the income which these dividends represent was derived from activities which constitute an integral part of the unitary business. This might be the case, for example, where the dividend paying foreign subsidiary sells raw materials to its domestic parent for use in manufacturing products within the United States.

On the other hand, a number of significant arguments can be raised against the treatment of foreign dividends as apportionable business income. The federal government and many states *exclude* dividends, including foreign dividends, paid to corporations on the basis that dividends are derived from income that already has been taxed in another jurisdiction. Moreover, including foreign dividends in apportionable income could work at "cross-purposes" to the objective of replacing the worldwide combination with the water's-edge approach. This is because, if dividends are included, it may be necessary for corporations to first "apportion" the dividend income between the U.S. and the foreign operation in much the same way as the net income of the foreign corporation is apportioned at present. Since the underlying purpose of the water's-edge approach is to account for *foreign* activities separately, a policy of taxing dividends paid by a foreign corporation from foreign earnings could be regarded as inconsistent with the new approach.

2. 80/20 Corporations

The treatment of "80/20" corporations under a water's-edge approach raises similar issues. The so-called "80/20" corporations either have at least 80 percent of their payroll and property outside the U.S. or receive at least 80 percent of their income from foreign sources.

Although incorporated within the U.S., such corporations conduct a substantial amount of business activity in other countries. On this basis, it often is argued that they are essentially foreign corporations, and thus, all of their income should be regarded as foreign-source income not subject to taxation by the state. On the other hand, a strong case could be made for including 80/20 corporations within the water's-edge, on the basis that they are managed in the U.S., they have some business activity in the U.S., and are incorporated in the U.S. to take advantage of beneficial federal tax laws.

If the Legislature chose to include 80/20 corporations within the water's edge, the business income of the 80/20 corporations would have to be apportioned between domestic and foreign sources. Thus, the state would find itself with some of the same problems that it hoped to avoid by abandoning worldwide combination.

What Factors Should the Legislature Consider in Deciding Whether to Modify the Unitary Method of Taxing Corporations?

We believe the Legislature should give consideration to four basic questions in deciding whether to retain the worldwide combination approach to unitary taxation or to adopt the water's-edge approach. These questions are identified and discussed below.

1. How Would Changes in the Unitary Method Affect Different Taxpayers? Changing the current method of apportioning income could have significantly different effects on different taxpayers. Some would benefit from the the change; others might be unaffected; and still others might find themselves paying higher taxes. The effects of the change on an individual corporation would depend on a variety of factors, of which three stand out: (a) the relative profitability of the firm's domestic and foreign operations, (b) whether a firm is foreign or domestically-based, and (c) how the firm is organized.

a. Relative Profitability of Domestic and Foreign Business Activities. Under the current method used by California to determine a unitary corporation's taxable income, the FTB *combines* the total worldwide business income of the corporation, and then uses the formula apportionment method to assign a share of this income to the state. This method, in effect, ignores differences in the profitabilty of the firm's various activities, because business income from *all* unitary activities—regardless of location—is combined for state tax purposes.

The water's-edge approach makes a clear differentiation between domestic and foreign operations. Thus, any differences in the profitability between domestic and foreign operations would be reflected in the amount of income assignable to California. Consequently, those businesses with more profitable foreign operations would pay *less* in bank and corporation taxes under the water's-edge approach than under worldwide combination.

Some businesses, however, would find themselves in just the opposite situation. These businesses would be unable to factor in their relatively unprofitable foreign operations in computing their total income for tax purposes in California, and would end up with larger state tax liabilities. It is possible, however, that such businesses still could continue to file on a worldwide combination basis, even if the state abandoned this approach in favor of water's-edge. Recently, the U.S. Supreme Court let stand a decision by the Illinois Supreme Court which held that a multinational corporation could use the *worldwide combination method* to account for operations outside of the state, even though the state allowed only the water's-edge method of recognizing income to be used. Thus, even if the Legislature repealed worldwide combination, the state potentially could find itself without the power to enforce a ban on worldwide combination.

b. Foreign-Based Versus Domestic Multinational Corporations. Current state law treats foreign-based and domestic-based multinational corporations the same—both must combine their worldwide business income in determining the amount of income subject to state tax. The water's-edge approach, however, could provide foreign and certain domestic multinationals with very different levels of tax relief, depending on how income from foreign operations is treated.

Consider, for example, the Governor's 1984 unitary reform proposal. This proposal would have moved California from the worldwide combination approach to a modified water's-edge approach. If it had been enacted, companies *electing* to file under the water's edge would have been required to include in domestic income the *apportioned* earnings of so-called "80/20" corporations, as well as certain foreign-source dividends. As a result, the reduction in taxes for domestic-based multinationals would have been, on average, about 5 percent. In contrast, foreign-based multinationals, which would not have been required to report income from non-U.S. business operations, would have realized a reduction in taxes averaging 25 percent.

In sum, *domestic* multinationals may *not* see any significant tax relief under the water's-edge approach, particularly in comparison with foreign multinationals, unless income from 80/20 corporations and dividends from foreign activities are treated as foreign-source income. If domestic firms are not able to exclude *non-U.S.* income, it could put them at a competitive *disadvantage,* relative to their foreign-based competitors, because their overall tax liability would be greater.

c. Organization of Unitary Business. Some domestic-based multinational corporations conduct their foreign activities through 80/20 corporations incorporated in the U.S. This allows them to take advantage of U.S. tax benefits and provides them with copyright, patent, and other protections under foreign-trade treaties. Other domestic multinationals find it advantageous to conduct their foreign activities through controlled foreign corporations (CFCs) incorporated outside the U.S. This allows them to defer paying taxes on foreign income until dividends are repatriated to the United States.

If a water's-edge unitary approach is adopted that includes the apportioned earnings of 80/20 corporations in the taxable base, domestic multinationals using CFCs would be better off than those using 80/20 corporations, solely because of where their subsidiary is incorporated.

2. How Would the Proposed Change Affect Business Investment and Overall Economic Activity in California? Critics of the unitary method argue that it represents a significant barrier to business investment in California by multijurisdictional corporations because such investment immediately subjects income earned outside of California to the state's bank and corporation tax. In some cases, new investment in California can increase the corporation's total tax bill, even though the investment itself has *not* generated *any* net income. Some foreign multinational corporations, particularly those from Japan, claim that they will restrict their investments in California for this very reason.

It is not surprising that multinational corporations make this threat. Clearly, a water's-edge or separate accounting approach would enable them to reduce their taxes, so that it is in their financial interest to "knock" the worldwide combination approach to unitary taxation. The key question, then, is: to what extent does the California unitary tax actually discourage investment in the state?

There is no substantive data that we know of which conclusively demonstrates that California's unitary approach has had a significant negative effect on the overall level of business investment in California. In fact a variety of economic and business indicators, taken together, tend to show that California continues to be an attractive place for business to expand or locate, notwithstanding the state's worldwide unitary approach to taxation. The available data indicate that California leads the nation in direct foreign investments and has far more new plants and plant expansions underway than any other state.

From an analytical standpoint, the unitary approach, by itself, should *not* have a particularly significant effect on the level of economic activity in California. This is because (1) state taxes are but one of many considerations facing firms planning to locate or relocate their operations, and (2) state taxes constitute a fairly small share of total business costs, and the bank and corporation tax is but one of many different state and local taxes levied.

Nevertheless, it is clear that California's current worldwide combination approach to taxation can have a negative impact on decisions by some businesses to locate or expand in the state, particularly if these businesses are foreign-based. Where this is true, the water's-edge method, by allowing a corporation's foreign source income to be excluded from the apportionment process, could make investments by multinationals in California more attractive.

For domestic-based multinationals, the impact on business investment of changes in the unitary method of taxing corporate income is less obvious. If income from foreign dividends and 80/20 corporations were *excluded,* thus providing domestic multinationals with significant tax relief, some firms could find investments in the state more attractive. At the same time, however, others could find it more attractive to invest in *foreign countries* rather than in California or other parts of the U.S. Since foreign income would not be subject to the apportionment process, some companies may find it attractive to shift operations to low tax foreign countries or tax havens, and thereby not be required to apportion the income to California. If, in contrast, income from foreign dividends and 80/20 corporations is not excluded from taxation, a move from the worldwide combination approach to water's edge probably will have little effect on investment incentives for domestic multinationals.

3. ***How Would Changes in the Unitary Method Affect State Revenues?*** Corporations subject to the unitary method account for over 75 percent of California's total corporate tax base. Thus, any changes in how the net income of these corporations is defined and apportioned to California can have a significant effect on state revenues. The FTB has estimated that a shift from worldwide unitary apportionment to a strict water's-edge unitary apportionment approach with *all* foreign income excluded, could result in a net annual General Fund revenue loss of $340 million. This revenue loss reflects reduced taxes of $560 million for one group of taxpayers and increased taxes of $220 million for another group. In evaluating FTB's estimates, the Legislature should keep in mind that the potential General Fund revenue loss could end up being $560 million, rather than $340 million. This is because, as noted above, the state may *not* be able to require all corporations to file on a water's-edge basis. If this turned out to be the case, the state would be unable to collect all or part of the $220 million in *increased* taxes resulting from the water's-edge approach, because companies which presently benefit from worldwide combination could still file on that basis, regardless of state law.

4. ***How Would Changes to the Unitary Method Affect Tax Administration?*** One key question for the Legislature to consider is whether a change from California's current worldwide unitary method to some alternative method would make it more difficult and costly for FTB to administer and enforce state tax laws. We believe that it *would.* This is because a change from worldwide combination would necessitate the use of separate accounting by corporations. For example, if a water's-edge approach were adopted, it would be crucial for FTB to conduct in-depth audits of income and expense transactions between domestic and foreign affiliates, including intercompany transfers and pricing arrangements which, if unchecked, could be manipulated to reduce income reported for U.S. tax purposes.

A recent report by the General Accounting Office concluded that the complexities of separate accounting impose considerable burdens on tax collectors and corporate taxpayers alike. The FTB has estimated that its increased audit costs under a water's-edge approach would be in the range of several million dollars per year. There would be some offset to these costs to the extent FTB received audit information, auditor training help, and other types of assistance from the federal government, which also audits multinational corporations. Even so, however, state tax administration costs would increase. These costs would show up either as a direct increase in the cost of audit activities, or as a reduction in audit revenues because FTB had to redirect resources from other audit areas to fund the separate accounting audits.

Conclusion

Clearly, the issues surrounding the debate over the unitary method of taxation pose a formidable challenge to the Legislature. What makes the issues particularly intractable is that no one, including tax administrators, accountants, auditors, and professional economists, knows the "right" way to resolve them.

Based on our review of these issues, we conclude that:

1. The Legislature should not abandon the current unitary method of worldwide combination. There is no solid evidence that worldwide combination has significantly reduced investments in California. Nor is there any evidence to support the belief that abandoning this method would result in a substantial *net* increase in economic activity within California. Furthermore, we believe that the alternative to worldwide combination—separate accounting—is likely to give multinational firms too many opportunities to avoid paying their fair share of California taxes. Thus, the state could easily experience significant losses of revenue from tax evasion over and above the $560 million revenue loss that could result if taxpayers were allowed to file their business and corporate tax returns on a water's-edge basis.

2. If the Legislature adopts the water's-edge approach, it should exclude from taxable income all income derived from 80/20 corporations and foreign dividends.

We recognize that the Legislature is faced with demands from many quarters to replace the worldwide-combination approach with the water's-edge approach. If it chooses to allow taxpayers to file their returns based on the water's-edge approach, it will have to resolve the difficult issue of how foreign-source income from 80/20 corporations and foreign dividends should be treated for California tax purposes.

In resolving this issue, we believe the Legislature should be guided by the principle that state tax policy should not discriminate in favor of either U.S. or foreign firms. In our view, the only way to achieve this objective is to *exclude* from taxable income, the income received from 80/20 corporations and foreign dividends.

If domestic multinationals are required to count this income in determining their California tax liabilities, they would be put at a competitive disadvantage, relative to foreign-based multinationals. This is because foreign-based multinationals would be allowed to *exclude* income from their non-U.S. operations, giving them a lower tax bill (other things being equal). This, in turn, might allow them to hold prices below their domestic counterparts, without having to sacrifice profits.

Moreover, if the Legislature required firms to include income from foreign dividends and 80/20 corporations in their taxable income, the need to consider foreign factors to *apportion* the income would continue. This would sacrifice some of the benefits anticipated from replacing worldwide combination with water's edge.

Thus, from a tax policy standpoint, we conclude that the water's-edge method would only make sense if income from foreign dividends and 80/20 corporations were excluded from the apportionment process. This option, however, carries a heavier price tag relative to water's edge with foreign income included.

3. If the Legislature chooses to retain the worldwide combination approach, it should direct the Franchise Tax Board to investigate alternatives to improve the apportionment of income.

The current method used to apportion income is not precise. In some cases, taxpayers probably are required to pay more than their fair share of California taxes. There also are numerous unresolved issues that should be addressed, such as how a "unitary business" ought to be defined, what kinds of income should be subject to apportionment, and what specific factors are appropriate for use in the apportionment formula.

These issues could be resolved through "fine tuning" the current method used to apportion income. For example, the FTB could allow businesses greater flexibility in the use of factors other than payroll, property, and sales, or in how these factors are weighted for apportionment purposes, in cases where this would improve the apportionment of income from an economic standpoint. We believe the Legislature should direct the board to explore the possibilities for fine tuning, if it decides to retain the worldwide combination approach.

TRANSPORTATION FUNDING

Will the Amount Available to Fund the State's Transportation Programs and Related Safety and Law Enforcement Activities be Adequate in the Years Ahead? What Options Are Available to the Legislature to Ensure Stable and Adequate Funding for These Programs and Activities?

California finances its transportation program and related activities with a combination of federal, state and local funds. These monies pay for the construction and maintenance of state highways and local streets and roads, the operation of and capital improvements to mass transportation systems, and the licensing and regulation of vehicular traffic. In general, funds are derived from a range of "user fees" that motorists and transit passengers are charged for the privilege of using the state's transportation network.

As we discussed in Part Two of this document, there is a significant imbalance between the fiscal health of the state's General Fund and that of many special funds. While General Fund revenues are expected to grow rapidly in the current and budget years, special fund revenues are not growing, and in some cases they are shrinking. This is particularly true with regard to those special funds that support transportation programs in California. Projections of state transportation fund balances during the period 1985–86 through 1989–90 indicate that the three major transportation accounts collectively are facing a potential shortfall relative to planned expenditures in excess of $1 billion. The Governor's Budget does not indicate whether the administration will seek revenue-raising legislation to resolve this problem, or seek to reduce services provided under these programs. One way or another, however, the Legislature will have to deal with this potential shortfall in the near future.

This section analyzes the condition of state transportation funding and identifies the options available to the Legislature to ensure a stable and adequate funding source for transportation programs and activities in the future.

Transportation Accounts Face Potential Shortfalls

Revenues derived from user fees charged to motorists are deposited in three separate accounts—the State Highway Account (SHA), the Transportation Planning and Development (TP and D) Account, and the Motor Vehicle Account (MVA). Together, these three accounts provide over 99 percent of state funding for transportation-related activities.

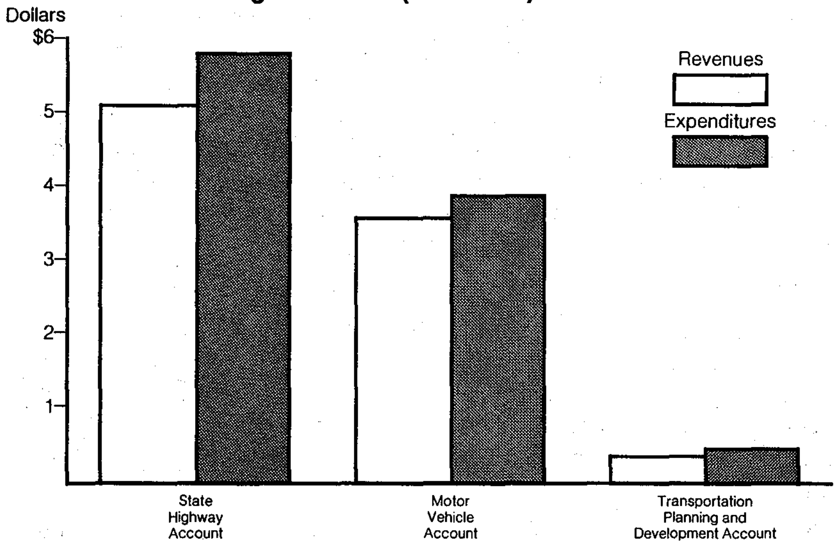
Our review of the condition of the three accounts shows a total shortfall of resources relative to expenditures over the five-year period of over $1 billion. These shortfalls will materialize at different times, as follows:

- *State Highway Account*—the shortfall will begin in 1987–88, and will likely be less than the $763 million currently projected.
- *Transportation Planning and Development Account*—the shortfall will begin in 1985–86 and reach $109 million for the five years combined. The administration proposes to cancel or postpone $34.7 million in previous local transit capital expenditure commitments in 1985–86 to keep the account in balance for the budget year.

- ***Motor Vehicle Account***—the shortfall will begin in 1987–88, and reach up to $327 million by 1989–90.

These shortfalls are illustrated in Chart 18.

Chart 18
State Transportation Program Cumulative Funding Condition[a]
1985–86 through 1989–90 (in billions)



[a] Sources: State Transportation Improvement Program (STIP) fund estimate. Secretary for Business, Transportation and Housing. Includes Legislative Analyst Office's estimate for the Motor Vehicle Account for 1989–90.

Table 43
State Transportation Program Fund Condition[a]
1985–86 through 1989–90
(dollars in millions)

	Total Resources All Funding Sources	*Expenditures* Support and Local Assistance	*Capital Outlay*	*Total*	*Fund Balances in June 1990*
State Highway Account	$5,086	$4,680	$1,169[b]	$5,849	–$763
Transportation Planning and Development Account	392	392	109	501	–109
Motor Vehicle Account[c]	3,582[d]	3,845[e]	64	3,909	–327
Totals	$9,060	$8,917	$1,342	$10,259	–$1,199

[a] Source: 1985 State Transportation Improvement Program (STIP) Fund Estimate, unless otherwise noted.
[b] Includes $719 million to match federal funds.
[c] Preliminary projections, for 1985–86 through 1988–89 only, based on estimates by the Secretary for Business, Transportation and Housing. For the four years, a total shortfall of $191 million is projected. We have extended the projections through 1989–90.
[d] Revenue projections do not include revenues from an extension of $1 vehicle registration surcharge, but include (1) $50 million to reflect revenues from legislation enacted in 1984, and (2) a carry-in balance which is $21 million higher than that projected by the Secretary to adjust for a lower transfer to the SHA.
[e] Includes support of the AB 202 program by the MVA from 1986–87 through 1989–90.

Table 43 shows the projected resources and expenditures of the three accounts from 1985–86 through 1989–90. Based on current assumptions regarding pertinent economic factors and the availability of federal funds, *the state will not have sufficient funds to maintain existing levels of operating support, local assistance and capital outlay expenditures for its transportation activities beyond the budget year.*

Because of the projected shortfall for the SHA and the TP and D Account, resources will not be adequate to fund all programmed highway and mass transit expenditures and previous commitments made by the California Transportation Commission (CTC) in the State Transportation Improvement Program (STIP). Similarly, shortfalls in the MVA will necessitate program reductions in the California Highway Patrol's traffic law enforcement programs and the Department of Motor Vehicles' vehicle registration and drivers' licensing programs.

Our analysis of the condition of each of the accounts follows.

State Highway Account (SHA). The main revenue source to the SHA is the 9 cents per gallon excise tax on fuel (gasoline and diesel) used by motor vehicles. Approximately 49 percent of these revenues are apportioned to local governments for use on local streets and roads. The SHA also receives truck weight fees, which account for approximately 30 percent of account revenues.

Activities funded by the SHA include (1) construction, maintenance, and rehabilitation of the state highway system, (2) matching of federal highway assistance funds, (3) operation of the Department of Transportation, and (4) construction and improvement of public mass transit guideways.

The Department of Transportation projects a potential shortfall in the SHA of $763 million by the end of the five-year period, with the shortfall first emerging in 1986–87. Because current state law requires that (1) state funds must first be used to match all available federal funds and (2) sufficient monies must then be set aside for the operation, maintenance and rehabilitation of the state highway system, our analysis indicates that *the potential shortfall probably will result in the elimination of funding for transit guideway projects and state-financed highway capital outlay projects.* The elimination of these two expenditure categories, however, will still leave a funding shortfall of $313 million, requiring further reductions in other highway expenditures, such as highway maintenance and the design and engineering of highway capital outlay projects.

Our review indicates that the five-year shortfall will likely be less than projected by the department. This is primarily due to the difficulty in predicting account expenditures with any certainty. The department's expenditure estimate assumes that the maximum amount of federal funds will be available. However, based on past experience and current efforts to reduce the size of the federal deficit, the amount the state will actually receive over the five-year period is likely to be less-than-projected, necessitating less state matching funds. Thus, depending on the amount of federal funds available, the magnitude of the shortfall could vary considerably from the $763 million estimate. To the extent that expenditure projections for the first two years of the STIP are reduced, the first occurrence of the shortfall could be delayed one year—to 1987–88.

Transportation Planning and Development (TP and D) Account. The TP and D Account depends primarily on the retail sales tax on gasoline for its revenues. Nearly all TP and D Account funds are expended on the following three programs: (1) operation of public mass transit systems by local transportation agencies (known as the State Transportation Assistance (STA) program), (2) the state's mass transportation program which includes local transit capital assistance, and (3) the transportation planning program in the Department of Transportation.

Retail sales tax transfers to the TP and D Account are determined by a formula using three variables—the level of retail sales, the level of gasoline consumption and the level of gasoline prices. Even small changes in any one of these variables can bring about a large change in the amount transferred to the account. Of the three variables, gasoline prices are potentially the most volatile and difficult to predict. Using alternative gasoline price assumptions, Table 44 shows the impact that either lower- or higher-than-expected gasoline prices would have on projected revenue transfers during the five-year period. While higher gasoline prices would increase revenue to the account, STA expenditures would also increase automatically. Therefore, increased revenues from higher gasoline prices are unlikely to eliminate the shortfall in the TP and D Account. To the extent that gasoline prices are lower-than-projected by the five-year estimate, the funding shortfall will be more pronounced. (The uncertainty of state funding levels takes on an even greater significance given recent federal proposals to reduce or eliminate federal transit capital and operating assistance.)

Programmatically, the shortfall would require postponement or cancellation of previous state funding commitments to local transit capital outlay projects such as Los Angeles Metro Rail, Santa Clara light rail, or the improvements to San Francisco Muni. Additionally, declining TP and D revenues would reduce transit operating assistance (STA) thereby requiring local transit operators to reduce services, increase fares, or secure additional local funding. This could have a particularly severe effect upon operators, such as Alameda-Contra Costa (AC) Transit, which have a limited local funding base.

Table 44
Transportation Planning and Development Account
Sales Tax Revenue Transfers
1985–86 through 1989–90

Revenue Transfers (dollars in millions)	*1985–86*	*1986–87*	*1987–88*	*1988–89*	*1989–90*	*Totals*
Five-year estimate	$109.3	$73.6	$59.9	$42.2	$19.9	$304.9
Low gas price	76.9	31.5	0.1	—	—	108.5
High gas price	136.7	118.9	101.2	83.7	66.5	506.9
Gas Price Assumptions: (dollar per gallon)						
Five-year estimate	$1.170	$1.215	$1.306	$1.404	$1.508	
Low [a]	1.112	1.139	1.197	1.278	1.335	
High [a]	1.219	1.297	1.381	1.480	1.594	

[a] Source: Chase Econometrics.

Motor Vehicle Account (MVA). The primary revenue sources to the MVA are (1) motor vehicle registration fees, (2) driver's license fees, and (3) collection costs for motor vehicle weight fees. The majority of these revenues (90 percent in 1984–85) support the activities of the California Highway Patrol (CHP) and the Department of Motor Vehicles (DMV).

Our review shows that because of a smaller transfer to the SHA—$29 million instead of the $50 million originally anticipated—there will be an additional $21 million available to the account at the beginning of 1985–86. Consequently, the shortfall will be delayed into 1987–88, and will be approximately $327 million over the five-year period. This shortfall will likely result in (1) a reduction of CHP traffic officers in the field, and (2) longer customer waiting times at DMV offices due to personnel reductions.

Causes of Potential Funding Shortfall

Several factors contribute to the funding shortfall projected in the state's principal sources of support for transportation programs. The most important of these are as follows:

1. The traditional measures of highway usage no longer accurately reflect the demands placed on the state's transportation system. In the past, changes in gasoline consumption have been used as the measure of changes in highway usage. As a result, the highway financing mechanism is based on the consumption of fuel. Because of the increasing fuel efficiency of motor vehicles in the state, however, changes in gasoline consumption *understate* the change in total vehicle miles travelled by the public. Thus, revenues to the State Highway Account have not kept pace with highway usage.

2. The structure of excise taxes and fees does not produce the revenues needed to compensate for the effect of inflation on the costs incurred in maintaining and expanding the state's transportation system. This is because the revenue sources that the state relies on to finance transportation programs—the fuel tax, weight fees, and registration and license fees—are fixed in dollar terms. As a result, inflation reduces the purchasing power of these tax and fee rates.

3. Revenue generation is not closely linked to funding needs. Because the bulk of the state's highway system was constructed about 20 years ago, many road segments are now or soon will be in need of major repairs and rehabilitation in order to maintain their serviceability. Revenues, however, do not recognize and respond to this aging of the state's transportation network.

4. Revenues to the TP and D Account are unstable, and are affected by nontransportation factors. While TP and D Account revenues also are based on *gasoline* sales, the account's funding mechanism, in effect, gives the General Fund the first call on these revenues. Revenues from the sales tax on gasoline are used to compensate the General Fund for the retail sales tax revenues that are shifted annually to local governments (under the Transportation Development Act (TDA) to fund local transportation activities), before any of these revenues are made available to the TP and D Account. Since the size of the payback to the General Fund depends upon nontransportation factors, namely, the level of nongasoline retail sales, growth in these sales reduces the funds available to the TP and D Account.

During the period 1979–80 through 1983–84, the sales tax on gasoline generated sufficient funds to repay the General Fund *and* support transportation program activities. Beginning in the current year, the combination of nongasoline retail sales growth, and lower gasoline prices will result in significantly less revenues flowing to the account. This trend is expected to continue through 1989–90.

Options For Eliminating the Shortfall in Transportation Funds

Given the prospect of transportation funding shortfalls exceeding $1 billion during the next five years, the Legislature must either reduce expenditures below current levels or increase revenues above projected levels. Potential options for addressing the shortfalls are discussed in more detail below.

Options for Reducing Transportation Expenditures

We have identified several alternatives which would enable the Legislature to reduce expenditures in each transportation account so as to avoid a funding shortfall.

1. Reduce SHA Expenditures by up to $763 Million. To avoid a shortfall and meet statutory requirements regarding account allocations, the CTC would have to eliminate $250 million in commitments for local transit guideways, and $200 million for state-funded highway projects. This would still leave a deficit, however, of over $300 million for the five-year period. In order to balance the account, our analysis indicates that expenditures on capital outlay project design and engineering, or the use of state funds to match federal funds for highway projects, or highway maintenance activities also would have to be trimmed.

2. Reduce TP and D Account Expenditures by $109 Million. In order to balance this account, the Legislature could direct the CTC to cancel or postpone all previous funding commitments ($109 million) under the transit capital improvement program. Alternatively, the shortfall could be partially offset by discontinuing rail operating subsidies ($73 million). Operating assistance to local transit operators under the STA program ($183 million) also could be reduced or eliminated to keep the account in balance.

3. Reduce MVA Expenditures by up to $327 Million. Because more than 70 percent of the California Highway Patrol's and Department of Motor Vehicles' total expenditures are for staffing services, personnel in both departments would have to be reduced in order to offset the shortfall. For the CHP, this would almost certainly mean fewer traffic officers in the field; for the DMV, it would mean a reduction in field office personnel handling registration and licensing work, resulting in longer waiting times for the public. In addition, the CHP's expenditures for airplane and helicopter operations might have to be reduced. Alternatively, capital outlay expenditures for the construction of new CHP and DMV field offices could be deleted in order to minimize the shortfall.

Options for Increasing Transportation Revenues

Transportation facilities do not directly benefit all Californians equally. Those who depend more heavily on these facilities benefit from them to a greater extent than those who "only drive their car on Sundays." For this reason, construction and maintenance of these facilities traditionally have been funded through "user charges" that seek to link the amount of support provided with the amount of benefits derived.

The Legislature recently reaffirmed this approach to financing transportation programs. In enacting Ch 541/81, it declared that the state should rely on user charges to finance transportation facilities, and that these user charges should be adjusted as necessary to maintain services at adequate levels.

We have identified four options for increasing transportation funding that are consistent with the user charge principle. Table 45 summarizes the potential revenue impact of each option, assuming it was implemented in 1985–86.

Table 45
Transportation Funding
Potential Revenue Generated by Various Options
1985–86 through 1989–90
(dollars in millions)

Options	*Additional Revenue Over 5 Years*	*Account*
1. Indexing		
a. fuel tax [a]	$154	State Highway Account
b. truck weight fees [a]	94	State Highway Account
2. One-time increases		
a. fuel tax: +1¢ [b]	308	State Highway Account
b. truck weight fees: +10%	164	State Highway Account
c. vehicle registration fee: +$1	100	Motor Vehicle Account
3. Increase sales tax on gasoline by 1 percent	532	Transportation Planning and Development Account
	12	State Highway Account
	544	
4. Restructure TP and D funding mechanism		Transportation Planning and Development Account
a. Option A [c]	274	
b. Option B [d]	277	

[a] 1985–86 tax rates are used as base rates. An additional $148 million would be available for local streets and roads if fuel taxes are indexed.
[b] An additional $293 million would be available to local streets and roads.
[c] This does not include an additional $62 million in combined STA and TDA local assistance.
[d] This does not include an additional $86 million in combined STA and TDA local assistance.

1. Index Fuel Tax and Various Fees, Based on Changes in Transportation Costs. One option to ensure that revenues grow in step with the cost of maintaining the state's transportation system is to build into the user charge structure an automatic adjustment that reflects changing costs. For instance, the fuel tax and truck weight fees could be linked to increases in the cost of building and maintaining the highway system. Vehicle registration fees could be tied to the cost of providing traffic regulatory services. Using the same inflation assumptions used in projecting highway capital outlay expenditures, we estimate that an "indexed" fuel tax would increase fuel tax revenues to the SHA by approximately $154 million between 1986–87 and 1989–90. In addition, local governments would receive approximately $148 million more for streets and roads, thereby meeting some of the unfunded maintenance that is estimated at $840 million annually. In the same period, revenues from truck weight fees would be $94 million higher.

2. Close Funding Gap Through a One-Time Increase in the Fuel Tax and Other Fees. Alternatively, the Legislature could adjust fuel tax and other fees by an amount needed to ensure an adequate level of funding for just the next five years. We estimate that an increase of 1 cent per gallon in the fuel tax, effective in 1985–86, would increase revenues to the SHA by approximately $308 million over the five-year period. Therefore, a 2½ cent per gallon fuel tax increase would be needed to avoid a SHA shortfall of $763 million. Local streets and roads also would receive an additional $293 million for every 1 cent per gallon increase in the fuel tax.

A one-time 10 percent increase in truck weight fees in all rate categories would generate $164 million from 1985–86 through 1989–90. Similarly, an increase of $1 per vehicle registration, beginning in 1985–86, would increase revenues to the Motor Vehicle Account by $100 million ($20 million annually). Thus, more than a $3 increase per vehicle registration would be necessary to avoid a MVA shortfall over the five-year period.

3. Increase the State's Retail Sales Tax Rate on Gasoline to Augment TP and D Account Funding. A one percent increase in the retail sales tax rate on gasoline (from 4.75 percent to 5.75 percent), everything else being equal, would generate additional revenues over the five-year period of approximately $532 million and $12 million to the TP and D Account and the SHA, respectively. (These estimates make no allowance for any reductions in gasoline consumption which might result from the sales tax increase.)

While this option would augment funding for the TP and D Account, it would not address the instability inherent in the TP and D funding formula.

4. Restructure TP and D Account Funding so that Account Revenues Depend Directly on Gasoline Retail Sales Tax Revenues. Financing the TP and D Account *directly* from gasoline retail sales tax revenues would eliminate revenue fluctuations caused by changes in non-transportation-related factors, and produce a more stable source of funds to the account. Table 46 summarizes the revenue impact of two options for accomplishing this.

Both alternatives would:

(a) Discontinue shifting a portion of retail sales tax revenues to local agencies for transportation activities (this raises the state's share of the 6 percent sales tax from 4.75 percent to 5 percent);

(b) Apportion revenues derived from the higher 5 percent rate on *gasoline* between local transportation funding (TDA) and the TP and D Account; and

(c) Make no change in the allocation of the TP and D Account in support of local transit operations (the current STA program).

Table 46
Revenue Impact
for Various TP and D Funding Options
1985–86 through 1989–90
(dollars in millions)

Current Law	*1985–86*	*1986–87*	*1987–88*	*1988–89*	*1989–90*	*Totals*[a]
(4.75% state gasoline sales tax)						
Local Share[b]	$611	$642	$693	$748	$810	$3,502
State TP and D	44	29	24	17	8	122
Option A						
(5% state gasoline and diesel sales tax)						
Local Share[b]	$646	$662	$706	$751	$799	$3,564
State TP and D	72	74	78	83	89	396
State General Fund	−63	−65	−67	−69	−72	−336
Option B						
(5.5% state gasoline sales tax)						
Local Share[b]	$648	$665	$710	$757	$809	$3,588
State TP and D	72	74	79	84	90	399
State General Fund	—	—	—	—	—	—

[a] Details may not add to totals due to rounding.
[b] Includes 75 percent apportionment to locals for TDA activities, and 60 percent of TP and D sales tax revenues for STA purposes.

Option A would expand the tax base to include gasoline *and diesel* fuel. Currently, revenues from the sales tax on diesel fuel are transferred into the General Fund. Consistent with the "user charge" principle, Option A would dedicate these revenues to transportation-related purposes. This option would reduce General Fund revenues by approximately $336 million over the five-year period, while increasing revenues for mass transportation programs by a corresponding amount including *$62 million more* for the local share of *combined* TDA and STA funds, and *$274 million more* for the state's share of TP and D Account funds.

Option B would retain the current (gasoline only) tax base but would increase the state's retail sales tax rate on gasoline to 5.5 percent. Over the next five years, this option would bring about a net increase of $86 million in the local share of retail sales tax revenues, while the state's share of TP and D Account funds would increase by $277 million. The state's General Fund would not be affected by this option.

Increased Resources Will Be Needed

We recommend the enactment of legislation to:

1. ***Link future increases in motor vehicle fuel tax rates and truck weight fees to increases in the cost of building and maintaining the highway system,***
2. ***Link future increases in vehicle registration fees to the cost of providing traffic regulatory services, and***
3. ***Raise motor vehicle fuel tax, truck weight fees and registration fees to increase transportation funds prior to 1987–88.***

Based on our review of the State Highway Account and the Motor Vehicle Account shortfalls, we conclude that, in order to ensure an adequate source of funding for transportation facilities and services, the state's user charge system should be restructured so that account revenues are more closely linked to the cost of maintaining transportation facilities and services. Accordingly, we recommend the enactment of legislation to (1) link future increases in motor vehicle fuel tax rates and truck weight fees to increases in the cost of building and maintaining the highway system, and (2) link the increases in vehicle registration fees to increases in the cost of providing traffic regulatory services.

In addition to ensuring future revenue increases commensurate with the increase in costs of transportation facilities and services, our analysis indicates that there is also a need to close the existing funding gap by 1987–88, *if the current level of services and expenditures are to continue.* This would necessitate an increase in the fuel tax and other fees. Accordingly, we recommend the enactment of legislation to raise motor vehicle fuel tax, truck weight fees, and vehicle registration fees to increase transportation funds prior to 1987–88.

Funding Mechanism Should Be Changed

We recommend that legislation be enacted to restructure the funding of the Transportation Planning and Development Account, and to extend the gasoline sales tax to diesel fuel.

Our review of the Transportation Planning and Development Account's current and projected condition indicates the need for legislative action. The instability generated by the existing funding formula creates too much uncertainty for transit operators, local transportation planning agencies and the California Transportation Commission, thus impairing their ability to effectively plan and implement their programs. The volatility of TP and D revenues makes it difficult for local agencies to forecast state apportionments from the account and makes the state's ability to fund past commitments for transit capital improvement projects highly uncertain. Consequently, we think that it is essential for the Legislature to provide a degree of stability in this account's funding comparable to that of other state accounts.

We also conclude that if previous local transit capital commitments are to be funded and current state mass transportation and planning activities maintained, the account will need more revenue in 1985–86.

We therefore recommend that legislation be enacted to restructure the TP and D funding mechanism by financing the TP and D Account directly from revenues generated by the retail sales tax on fuel, including gasoline *and* diesel. Implementation of this recommendation has three main advantages: (1) it would increase funding stability, (2) it would allocate costs between operators of gasoline and diesel powered vehicles more equitably, consistent with the "user charge" principle, and (3) it would provide a sufficient level of funding ($396 million over five years) to cover previous commitments made for transit capital projects, as well as maintain existing program levels.

More Equitable Truck Weight Fees Should Be Established

We recommend that the Legislature adopt a vehicle weight fee schedule based on vehicle laden weight and on miles traveled.

Currently, California's truck weight fee is based on the *unladen*, or empty, weight of the vehicle and makes no allowance for the mileage traveled by the vehicle during the course of a year. A vehicle's laden, or loaded weight, and distance traveled while loaded, however, better represent the vehicle's actual contribution to road pavement damage. Consequently, the current system fails to allocate equitably the cost of maintaining the state's highways in accordance with the actual use of, and damage inflicted on, those highways by various commercial vehicles.

Various federal and state studies have identified this bias in favor of heavy vehicles at the expense of light vehicles, and have recommended that the current system be changed to eliminate it. Because a laden weight-distance fee would establish more equitable user charges, we recommend that the Legislature adopt a truck weight fee structure which is based on vehicle laden weight and miles traveled. Such a fee structure would be a more effective means of allocating highway maintenance and construction costs to the users of the services. A more comprehensive discussion of the laden weight and distance concept of assessing truck weight fees is presented in our 1984 report entitled *Assessment of Weight Fees on Farm Vehicles in California.*

TAX EXPENDITURES

Should the Legislature Adopt the Department of Finance's Recommendations Regarding Tax Expenditures?

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

The Department's Tax Expenditure Recommendations

The Governor's Budget for 1985–86 contains a report on tax expenditures (pages 70–80), prepared by the Department of Finance. In addition to providing basic data on the state's current tax expenditures, the department's report contains three specific recommendations. The first two of these recommendations deal with tax expenditure reporting and review. Specifically, the budget proposes that:

1. The Legislature *reconsider the definition* of a tax expenditure, with

a view toward formulating a more "narrow and useful concept," and

2. Any legislation authorizing a new tax expenditure include a *three-year sunset provision,* so that the Legislature will have an opportunity to consider the costs of the tax expenditure and confirm that it is accomplishing its intended purpose.

The third recommendation set forth in the budget calls for a change in the way the state's tax expenditures for solar and energy conservation tax credits are treated. Specifically, the Department of Finance recommends that:

3. The solar and energy conservation credits be (a) funded directly, through a Budget Act *appropriation,* instead of indirectly, through the current tax expenditure mechanism, and (b) funded at only *50 percent* of what current law would allow for these credits in 1985–86.

Formal Process Needed for Review and Oversight of Tax Expenditures

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

As we discussed in last year's *Perspectives and Issues* (please see pages 132–137), tax expenditures should receive the same degree of legislative oversight as direct expenditures, especially given that such a substantial amount of resources is devoted to tax expenditure programs—resources that otherwise would be available to the Legislature either for use in accomplishing its policy objectives through direct expenditure programs, or for broad-based tax relief.

The department's recommendations to redefine tax expenditures and require an automatic three-year sunset for all newly-enacted tax expenditures would not, in our judgment, bring about a significant improvement in the Legislature's ability to review and oversee tax expenditure programs on a regular basis. This is because:

- The vast majority of items on the department's current listing of tax expenditures belong there,
- Although three-year sunsets may be appropriate for certain new tax expenditures, a mandatory three-year sunset is too mechanical to be appropriate for all new tax expenditures, and
- The proposed sunset for new tax expenditure programs does not improve the Legislature's ability to deal with the many *existing* tax expenditures.

This is not to imply that the inclusion of sunset provisions in legislation establishing new tax expenditures is necessarily a "bad" policy; in fact, in many cases sunsets may be the best policy. Sunsets, however, are best applied on a case-by-case basis, so that the need for a sunset and the appropriate length of time before a sunset review is conducted can be properly determined, based on the unique nature of the particular tax expenditure in question.

Last year, we indicated that what the Legislature *does* need is a *formal process* for reviewing and overseeing tax expenditure programs. We suggested several options for establishing such a process (please see *Perspectives and Issues,* page 135). During 1984, the Legislature enacted AB 1894, which would have implemented one of these options—a requirement that the Governor annually submit a "Tax Expenditure Budget." The Governor, however, vetoed this bill.

Given the administration's unwillingness to take the lead in reviewing existing tax expenditures, the Legislature may wish to proceed with one of the other three options that we suggested last year. Regardless of the exact approach which the Legislature chooses, however, we believe that a formal legislative process for reviewing and overseeing tax expenditure programs is needed if these programs are to be monitored properly.

Energy Tax Credits Should be Phased Out

We recommend that legislation be enacted which reduces the value of the solar and energy conservation tax credits by 50 percent.

Under current state law, individuals and corporate taxpayers are allowed to claim tax credits for the partial cost of both solar energy systems and energy conservation measures, subject to various limitations. In 1984, approximately 200,000 taxpayers claimed a total of $41.5 million in energy conservation credits, and 83,000 taxpayers claimed a total of $78.2 million in solar energy credits.

The Governor's Proposal. Item 9100 of the 1985 Budget Bill requests a direct General Fund appropriation of $68.5 million to fund the energy tax credit programs during the budget year. This appropriation would be in lieu of the open-ended tax credit now available to taxpayers when they file their tax returns. The proposed appropriation is equal to one-half of the $137 million in foregone revenues that would result from the current tax credit mechanism in 1985–86. Thus, the budget assumes that a 50 percent funding *reduction* for these credits could be achieved through the Budget Bill.

The Governor believes that a lower tax subsidy is justified because the solar energy and energy conservation industries have had sufficient time to establish themselves in the marketplace and no longer need as much state support in order to survive and prosper. In addition, the budget points out that the benefits from these subsidies have accrued primarily to higher-income taxpayers who are able to pay regular market prices for solar energy systems and energy conservation measures, without state tax subsidies. Finally, the Governor wants to begin a phase-out of these credits prior to the end of 1986, when they would be terminated under existing law, so as to provide a "clear signal" that the credits will not be extended.

Issues Raised by the Proposal. The Governor's proposal raises three separate policy issues, as discussed below.

1. Could the funding reduction be achieved through the Budget Bill? The department's aim in funding the tax credits through a direct appropriation is to reduce the level of state subsidies for solar energy and energy conservation. To do this, it simply proposes to make funds available, through the budget process, for one-half of the estimated level of credits that would otherwise be claimed. The proposal does not *limit* the amount of the credits which may be taken by taxpayers in filing their tax forms, which is a necessary step in order to reduce the level of credits paid.

At the time this analysis was prepared, however, the administration had not proposed the statutory changes needed to achieve the reduced funding level. Unless such new legislation is enacted, taxpayers in 1985–86 still would be allowed to deduct the *full amount* of the credits provided under current law, even if the funding for the credits were limited to a lesser amount in the Budget Act.

Our detailed analysis of the proposed appropriation appears under Item 9100 of the *Analysis,* where we recommend that it not be approved in its current form.

2. Should funding for the energy-related tax credits be appropriated in the Budget Act? We believe that using direct appropriations to fund individual state expenditure programs generally is the most desirable means for accomplishing the Legislature's objectives. Direct appropriations offer the Legislature the best opportunity to review and control individual spending programs, and to compare the costs and benefits associated with these programs to those associated with competing state programs.

Since the state does not appear to realize any significant administrative cost savings by funding energy-related tax credit subsidy programs through the tax expenditure mechanism, we believe that funding these programs through a direct appropriation makes sense. However, legislation would be necessary to restructure the program in a fashion compatible with direct Budget Act funding.

3. Should the funding for the tax credits be reduced? With regard to this last issue, we conclude that currently there is no analytical basis for setting the tax credits at *any* particular level. We are not aware of any evidence which demonstrates that a particular percentage credit is the most cost-effective, or that any "minimum percentage" credit is necessary to stimulate additional investment in energy conservation or solar devices. In fact, we doubt that any *single* credit level would be equally appropriate to the full range of potential solar and energy conservation applications and technologies.

On the other hand, it does appear that a reduction in the state subsidy for solar energy and energy conservation can be justified. It is not clear that state credits are still needed in order to help stimulate and develop the energy conservation and solar industries. In fact, a recent report by the California Energy Commission concludes that the solar industry has shown substantial growth over the past several years. This is based on evidence that 1,500 businesses directly work in the solar field and an additional 5,500 companies perform part-time work.

Tax return information from the state Franchise Tax Board (FTB) also shows that the benefits from the credit have accrued mainly to higher-income taxpayers, who do not need state subsidies to make solar and energy conservation investments affordable. According to FTB data, for example, nearly 70 percent of the amount of solar energy credit claims filed under the personal income tax in 1982 were claimed by taxpayers with adjusted gross incomes of over $50,000. Moreover, it appears that the credits are being used increasingly by high-income taxpayers for investments that serve mainly as tax shelters. Among these, one of the most popular is the solar windmill, which provides investors with state and federal tax credits, an accelerated depreciation deduction, and income from the sale of electricity to utilities. Between income years 1981 and 1982, the number of credit claims for solar windmills jumped from 122 ($2.6 million) to 1,894 ($25.6 million). For over one-half of the taxpayers who claimed this credit for the 1982 income year, the credit allowed them to reduce their net state tax payment to zero.

For these reasons, we agree that a reduction in the credit amount during 1985–86 would be warranted. Such a reduction could be achieved through an across-the-board reduction; by reducing the credit for taxpayers with higher incomes, as the Governor proposes; or even by repealing the credits one year prior to the scheduled sunset date of December 31, 1986. In our view, the most straightforward way to achieve the Governor's objective would be to simply reduce the value of the credits by 50 percent. Such a reduction would achieve the funding goal of the budget, and would also tend to phase-out, rather than abruptly cancel, a tax savings which is scheduled for termination on December 31, 1986. Accordingly, we recommend that the Legislature enact legislation which reduces the value of the solar energy and the energy conservation tax credits by fifty percent.

Expenditure Issues

STATE WORK FORCE REDUCTION PROPOSAL

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

As discussed in detail in Part Two of this document, the Governor's Budget proposes a state government work force of 227,888 personnel-years in 1985–86. This is a reduction of 2,869 personnel-years from what the budget estimates the current-year level to be. This section analyzes the Governor's staffing reduction proposal in an effort to evaluate its effect on state operations and expenditures.

Background

Table 47 summarizes trends in state staffing since 1977–78. It shows that, despite a significant decrease in the actual staffing level after the passage of Proposition 13, the state's work force grew by 5,444 personnel-years between 1977–78 and 1983–84, the last year for which data on *actual* staffing levels are available.

The budget shows that the state's work force in the current year is *4,062 personnel-years larger* than what the work force actually was in 1983–84. This is the second largest year-to-year increase, both in absolute and percentage terms, since Proposition 13. The current-year figures shown in the budget, however, are only *estimates* of the state's 1984–85 work force. The actual size of the work force may vary significantly from this level.

Table 47
State Personnel-Years
1977–78 through 1985–86

	Proposed In Budget	*Subsequent Change*	*Actual*	*Change From Prior Year*
1977–78	215,796	5,455	221,251	—
1978–79	224,337	−5,807	218,530	−2,721
1979–80	218,619	1,574	220,193	1,663
1980–81	221,118	4,449	225,567	5,374
1981–82	226,743	2,070	228,813	3,246
1982–83	231,375	−2,886	228,489	−324
1983–84	232,371	−5,676	226,695	−1,794
1984–85	229,540	1,217 [a]	230,757 [a]	4,062 [a]
1985–86	227,888	—	—	−2,869 [b]

[a] Estimated.
[b] Proposed.

One should view state personnel-year totals, such as those shown in

Table 47, with great caution, however. This is because a change "in the numbers" may not be a reliable guide to the direction in which state policy is actually heading, and may not give any indication as to the implications that changes in personnel-years have for state programs and expenditures. This certainly seems to be the case with respect to both the numbers on state employment that are contained in the Governor's Budget, and the interpretation put on these numbers in the budget document.

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

1. What can be concluded from budget estimates of the total state work force?

2. What personnel-year changes are occurring in 1984–85, and how do they affect 1985–86 staffing estimates?

3. To what extent are the proposed personnel-year reductions the result of "increased efficiencies and economies" ?

4. How much has been saved as a result of the proposed reductions?

5. What effect will the proposed reductions have on the quantity and quality of services provided to Californians?

What Can be Concluded From Budget Estimates of the Total State Work Force?

State work force reductions have been a central theme of the Governor's Budget for both 1984–85 and 1985–86. Most of the discussion in the budget pertaining to the state's work force revolves around the number of "personnel-years" worked by state employees.

As discussed below, this measure of the state's work effort is not entirely satisfactory. Unfortunately, other available methods are similarly flawed. What makes it difficult for the Legislature to evaluate the claims and counter-claims regarding changes in the state work force is the absence of a comprehensive statewide system for tracking the level of the state's work force.

Currently, the state's system of accounting for its staff is tied to the disbursement of paychecks. The system is geared to ensuring that a given individual is occupying a position authorized by the Legislature and is working the requisite number of hours. Thus, the State Controller, who issues the vast majority of these paychecks, is the main source of information about state personnel-years.

It is difficult, however, to use annual personnel-year data for more than general trend analysis. Two factors account for this. First, the "system" was essentially designed for payroll purposes and, therefore, lacks the standardization and comprehensiveness of a statewide position control system. Second, wide variations in personnel-year estimates occur between the time a budget is introduced and some 18 months later when the programmatic work envisioned in the budget is actually completed.

The following discussion outlines various aspects of the state's system in order to facilitate the evaluation of claims that are based on information from the system.

How does the state measure the size of its work force? There are three distinct ways that the level of state employment or staff effort can be expressed:

- The number of *employees*—the people performing the work,
- The number of *positions*—the slots authorized by the Legislature that individuals fill, and
- The number of *personnel-years*—the amount of time that slots are actually occupied by individuals.

For budget purposes, "personnel-years," or "pys," is used most often, because it represents the full-time staffing effort devoted to a particular function.

While the three terms may be synonymous, they often are not. For example, *two* individuals may fill *one* position, and each work a 10-hour week, thus yielding *one-half* a *personnel-year.*

Why is the staffing distinction important? The distinction between the various measures of the state's work force is important because the use of different measures can result in different answers to key questions about trends in the state's work force. For example, on a personnel-year basis, civil service staffing *declined* by 887 pys between 1982–83 and 1983–84. On an employee basis, however, there were 2,246 *more* full-time civil service employees at the end of June 1984 than there were at the same time one year earlier.

Are all state personnel reflected in the budget totals? No. Because the Controller does not process the payroll for all state employees, not all state personnel are reflected in the budget's work force totals. In addition, some employees have traditionally been excluded. Among those state employees not included are legislative staff (except those employed by the Legislative Counsel Bureau, who have civil service status), staff from certain district fairs that receive a state paycheck, and members of the national guard who are on active duty.

While staff of the University of California (UC) is reflected in the budget totals, the university is not part of the Controller's payroll system. The university prepares its own payroll and provides data concerning its staffing level directly to the Department of Finance. It is by no means clear just what the UC numbers mean—particularly estimates of these numbers—because the university does not have a position control system like the rest of state government. In the case of UC, it is *funding,* rather than authorized positions, that really determines staffing levels at the university. Because the university accounts for such a significant portion of the state's work force (25 percent in the budget year), however, a modest percentage change in the university's staffing level can have a significant effect on the statewide totals.

The personnel system used for the California State University (CSU), on the other hand, is more like the rest of the state's. Nevertheless, the state has delegated most of the personnel tracking function for CSU to the Chancellor's Office. Because the system also accounts for a large portion of the state's work force (14 percent in the budget year), modest percentage changes in CSU staffing can make a significant difference in the statewide totals.

Is all staffing effort reflected in the personnel-year totals? No. Both overtime and temporary help are important contributors to the state's work effort. Both of these categories, however, are controlled by the amount of *money expended* to pay staffing costs, rather than by the number of employees maintained or positions authorized. Although the budget contains an estimate of the personnel-years worked on a temporary help basis, it does not provide similar accounting for *overtime* work. Thus, if 10 full-time employees each work four hours of overtime each week so that an authorized position can be kept vacant, the number of personnel-years reported in the budget will go down, even though the work effort remains the same.

Personnel-Year Estimates

Chart 19 illustrates three common patterns that show up in state employment estimates: (1) midyear estimates of staffing levels typically are higher than the original budget estimates, (2) inflated midyear estimates make the number of personnel-years proposed in the budget year look smaller, and (3) midyear estimates of personnel-years in recent years tend to overstate the *actual* number of pys worked.

Proposed Versus Midyear Estimates. Chart 19 shows that, in five of the last six years, the midyear estimate of the total state work force has been higher than what the original budget for that year proposed. This is usually the case, for two reasons: (1) proposed staffing levels typically are increased by the administration and the Legislature during the course of deliberations on the budget and (2) new positions are created administratively after the budget is enacted, in order to provide sufficient staff to perform needed functions.

Inflated Midyear Estimates Make Budget Proposals Look Smaller. The chart also shows that, beginning in 1982–83, midyear estimates for the budget just enacted have been higher than the personnel-year level proposed for the following year. This has the effect of making it look as though the state work force is being pared back, when, in fact, the number of pys proposed for the budget year exceed *actual* pys in the prior year. The Governor's Budget for 1985–86 provides a good illustration of this. While the proposal for 1985–86 (227,888 pys) is *less* than the midyear estimate (230,757 pys) for 1984–85, it is 1,193 pys *higher* than pys in the prior year (226,695 pys).

Midyear Estimate Versus Actual Staffing. A more recent phenomenon also is illustrated in Chart 19. In both 1982–83 and 1983–84, the state's actual staffing level turned out to be significantly below the midyear estimate (by −4,897.4 pys and −7,724.8 pys, respectively). Our review indicates that most of the difference can be explained by two factors: delays in the Department of Corrections' prison construction program and the hiring freeze at the Employment Development Department (EDD). Given the continuing delays in the prison construction program and the workload and organizational changes at EDD, the actual personnel-year totals for these two departments in 1984–85 also are likely to come in below the original and midyear estimates. Thus, it is probable, all else being equal, that the staffing level shown for 1985–86 in next year's budget will exceed, rather than be less than, the actual staffing level for 1984–85.

Chart 19

Trends in State Employment Estimates 1979–80 through 1985–86 (in thousands)

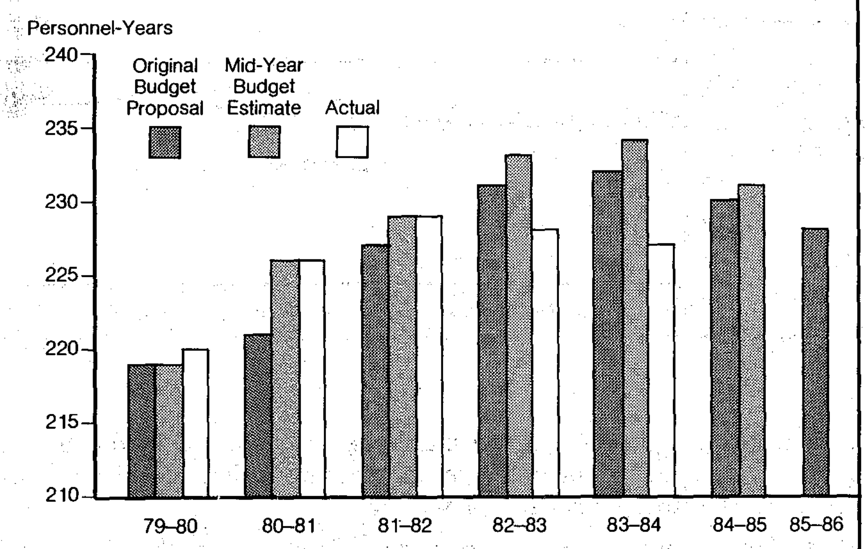
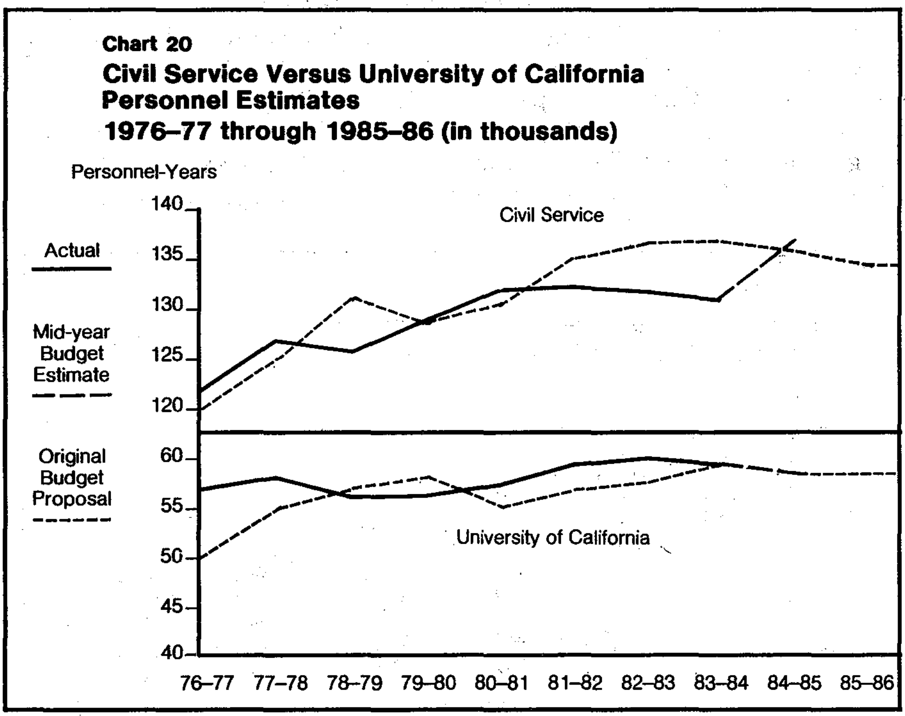


Chart 20 also illustrates the relationship between actual and estimated staffing for the two largest personnel classifications in the state's work force—civil service and the University of California. The chart shows that, between 1981–82 and 1983–84 (the last year for which actual data are available), there was a tendency to *underestimate* University of California staffing in the original budget, relative to actual staffing levels. The pattern for civil service staffing is the reverse—a tendency for the budget to *overestimate* staffing, relative to actual experience. Much of the civil service pattern can be attributed to staffing shortfalls for the Department of Corrections and EDD, as discussed earlier. With regard to UC, however, we assume that much of the explanation for the underestimates lies in the fact that the state has no position control over the university.



In summary, a change "in the numbers," as reflected in the budget document, generally does not give an accurate indication of what the trend in state staffing has been or will be.

With this in mind, we turn now to specific aspects of the Governor's proposals for the state work force in 1985–86.

What Personnel-Year Changes are Occurring in 1984–85, and How Do They Affect 1985–86 Staffing Estimates?

As noted in the previous section, midyear estimates of personnel-years are usually not reliable indicators of what the actual work effort for a given year will be. Our analysis indicates that this will turn out to have been the case with respect to the midyear estimate for 1984–85. Because the midyear estimate of the state's staffing level in 1984–85 is the base against which the proposed staffing level for 1985–86 often is compared, this estimate warrants a careful review.

As shown in Table 48, the revised estimate of total state personnel-years for 1984–85 is only 447 pys higher than what it was when the 1984 Budget Act was chaptered. This relatively modest increase, however, masks at least three significant changes: (1) an *accounting adjustment* that has reduced the staffing level reported for the California State University (CSU) by 477 pys, (2) a *workload* adjustment that allowed the Employment Development Department to reduce staffing by 276 pys, and (3) the *discretionary* increases in staff made by the administration that have added approximately 1,200 pys to the current-year staffing totals. Each of these changes is discussed below.

Table 48
Changes in Personnel-Years for 1984–85
Between January 10, 1984 and January 10, 1985

Staffing proposed in the Governor's Budget (1-10-84)	229,540	
Net staffing added by Finance Letters	+973	
Governor's Budget (revised)	230,513	
Legislative changes in staffing levels	+610	
Staffing included in Budget Bill, as passed by the Legislature	231,123	
Staffing vetoed by the Governor	−813	
Staffing included in the 1984 Budget Act	230,310	
Subsequent changes in staffing		
Accounting adjustment for CSU teaching		−477
Reduced personnel-years in Employment Development Department, due to workload decreases		−276
Personnel-years added *after* the budget was chaptered		+1,200
Total net personnel-years added by the administration		447
Current estimate of personnel-years	230,757	

1. Accounting Adjustment for CSU. The Department of Finance has adjusted the estimate of CSU's staffing level, presumably to avoid double-counting full-time faculty who teach in both daytime academic programs and extension classes at night or on weekends. The adjustment provides that this staffing effort will now be considered overtime, and therefore will no longer be reflected in statewide totals of personnel effort. This adjustment was made to the CSU's actual personnel-years for 1983–84 (−506 pys), as well as to the estimated level for 1984–85 (−477 pys), and the proposed amount for 1985–86 (−502 pys).

Thus, when the administration claims that it has reduced state employment, it includes in the reduction about 500 personnel-years that have simply been *defined* out of existence. In this case, there is no less work being done by state employees, nor is there less money being spent for this work; the work effort has merely been dropped from the total.

2. Employment Development Department. The Legislature included language in the 1984 Budget Act directing the department to review its staffing needs in administering the unemployment insurance and disability insurance programs. As a result of this directive and lower-than-anticipated unemployment rates, the department anticipates deleting 276 pys in the current year.

3. Administrative Adjustments in 1984–85. The nature of state operations is such that numerous staffing adjustments are required throughout the year in order to implement various state programs and respond to changing workload. Our analysis indicates that, disregarding the reductions noted above, the administration has added a net of 1,200 pys since the budget was enacted. This adjustment reflects the net effect of various position additions and deletions.

Thus, although the estimate of 1984–85 staffing levels has changed only slightly since the 1984 Budget Act was chaptered, the small change in the totals masks larger workload and policy changes that are occurring in the current year and are carried forward into the budget year.

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

Information provided to the Legislature in support of some position reductions proposed for 1985–86 documents that the reductions have been made possible by increased efficiencies and economies. While "increased efficiencies and economies" will indeed enable the state to eliminate some positions in the budget year, most of the reductions in personnel-years proposed by the administration reflect other factors. Some of the more important of these factors are discussed below.

Bookkeeping Adjustments Inflate Savings. There are a number of instances where personnel-year totals *appear* to be declining when, in fact, no change in work effort is being proposed. The reason for the apparent change is simply a change in bookkeeping. As discussed above, the apparent "savings" in CSU's staffing (502 pys in the budget year) falls into this category.

The Department of Corrections, for example, is "saving" 185 pys by eliminating officer positions and using the funding, instead, to pay for overtime work by the remaining employees. Thus, although there will be no reduction in work effort and no reduction in expenditures, the administration is able to report a reduction in state employment of 185 pys (since overtime work is not reflected in personnel-year totals).

The Health and Welfare Data Center, and the Departments of Food and Agriculture, Fish and Game, and Forestry, collectively, show a "savings" of 106 pys by changing the manner in which temporary help personnel is reflected in their respective budgets. Nevertheless, funding remains in these budgets so that state employees can perform the needed services.

Thus, our analysis indicates that the level of the state's work force in 1985–86 is at least 793 pys lower as a result of bookkeeping adjustments.

Unallocated Reductions Inflate Savings and Limit Legislative Control. The Governor's Budget for 1985–86 also proposes several unallocated personnel-year reductions. For example, the budget shows that 250 unspecified positions at CSU will be eliminated. The funding associated with the personnel, however, remains in the budget. The administration advises that a plan detailing these position reductions will be submitted during budget hearings. (If last year's pattern is followed, this reduction also may end up in the "bookkeeping change" category.)

Unallocated reductions take another form as well: an unreasonable increase in the salary savings rate (which reflects the period of time during which authorized positions are vacant). An artificially high salary savings rate will require the affected departments to purposely hold vacant positions open.

Our analysis indicates that both the State Personnel Board (SPB) and the Public Employees' Retirement System (PERS) will almost certainly have to hold positions vacant to achieve artificially high salary savings rates imposed on them by the 1985–86 budget. We estimate that the SPB will have to keep nine authorized positions vacant, while PERS will have to keep 22 authorized positions open. Similarly, Caltrans will have to hold enough authorized positions open to reduce personnel-years by 100. Our analysis indicates it would be very difficult for any of the three departments to meet the requirement without reducing departmental program activities.

These excessively high salary savings requirements mean that individual departments, rather than the Legislature, will decide which positions to leave open, and thus which program activities will be cut back.

Personnel Reductions in Individual Program Areas Are Explained by Other Factors. Our review of the position reductions proposed in the budget indicates that, in many cases, the reductions are due, not to "increased efficiencies," but rather to factors that are beyond the control of the administration. For example, of the proposed personnel-year reductions:

- 715 in the *Employment Development Department* result from (1) the scheduled termination of federal programs (292 pys) and (2) declining caseload in the unemployment insurance program, due to a projected decrease in unemployment (423 pys).

- 175 in the *Department of Motor Vehicles* are due to increased automation, and were first identified in *1978* when the department's automation project began.
- 350 in the *University of California's* teaching hospitals were anticipated *three years ago* when the Legislature enacted Medi-Cal reform legislation.
- 118 in the *California Highway Patrol* reflect the termination of the training phase of the AB 202 program, which added 670 new patrol officers.
- 1,200 are positions that were *administratively established* in 1984–85. Pursuant to state guidelines, these positions cannot continue beyond the current year, unless specifically authorized by the Legislature. (An unknown portion of these positions have been requested in 1985–86.)
- 872 are *limited-term positions* that are *automatically* deleted from the budget.

Summary. The administration's 1985–86 staffing proposal includes significant staffing reductions, along with some staffing increases (most notably in Youth and Adult Corrections, +1,830 pys). On balance, the budget claims that the administration is reducing the work force in 1985–86 by 2,869 pys from what it estimates the current-year staffing level to be.

Our analysis indicates that the administration has taken credit for reductions that are due to factors which either are not attributable to actions taken by the administration, or reflect bookkeeping changes or unidentified reductions—as well as "increased efficiencies and economies." Moreover, the size of the base from which the reduction is measured has been augmented by 1,200 personnel-years that were added administratively after the 1984 Budget Act was chaptered. Finally, the estimate of the base year (1984–85) staffing level is probably inflated, given the pattern reflected in Chart 19.

From the Legislature's perspective, however, the size of the reduction is not the real issue. Instead, the issue is: What effect will the elimination of *individual* positions have on the quality and cost of services provided by the state? This necessitates a function-by-function review to ascertain whether an adequate staffing complement is available to carry out the program priorities of the legislative branch.

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

The Governor's Budget (Schedule 4) indicates that, despite the projected elimination of 2,869 personnel-years, net salary and wages (that is, salary and wages adjusted for salary savings) for state employees will *increase* from $6.5 billion in 1984–85 to $7.0 billion in the budget year, an increase of $503 million, or 7.8 percent. Is such an increase reasonable, given the savings that should result from such a large reduction in personnel-years?

In order to determine the extent to which the Governor's proposed staffing reductions have produced savings, we derived a *base level* of salary expenditures. We did so by subtracting from the net total salaries and wages amount shown in the budget for both the current and budget year: (1) the unallocated employee compensation amounts (which include the proposed salary package for 1985–86) and (2) the incremental adjustment required in the budget year to pay midyear salary increases provided in 1984–85 to specified civil service, UC, and CSU employees. Table 49 shows that, when these adjustments are made, "base" salary and wages are $21 million *higher* in the budget year than in the current year. Assuming, however, that the 2,869 personnel-years earned the average state salary of $28,078, the administration's staffing changes *should have* resulted in a net salaries and wages savings of approximately $81 million. Thus, the budget requests approximately $102 million *more* than what we estimate would be saved if the 2,869 personnel-years were paid the average salary. (A part of this difference can be explained by the *additional* funding provided in the budget for merit salary adjustments. The Department of Finance advises that $35.1 million from the General Fund was added for this purpose.)

In summary, despite the staffing reductions proposed for the budget year, we have been unable to identify dollar savings that in any way are commensurate with the personnel changes indicated in the budget. Similarly, neither the Budget Bill nor the budget document appear to reflect this change. Where did the money go? What implications does the failure to reduce these funds have for the Legislature? We address these questions below.

Table 49
Adjusted Net Salaries and Wages
1984–85 and 1985–86
(dollars in thousands)

	1984–85		*1985–86*
Salaries and Wages	$6,677,739		$7,214,457
Salary Savings	−198,577		−232,789
Net Totals	$6,479,162		$6,981,668
Adjustments:			
Unallocated employee compensation	−32,828		−488,111 [a]
Special salary adjustments [b]	—		−26,672
Base salaries and wages	$6,446,334		$6,466,885
Difference		+$20,551	

[a] The amount set aside in the budget for salary and benefit increases for civil service and higher education employees.
[b] Reflects the increment required to fund midyear salary increases initiated in 1984–85 for specified civil service, UC and CSU employees.

We have identified numerous instances where (1) personnel-years have been reduced but funding for these pys has been left in the budget, (2) the salary and benefit costs associated with deleted positions have been underestimated, so that part of the funding for the deleted positions remains in the budget, (3) departments have redirected the savings from personnel cuts to other activities, and (4) the dollars associated with reduced state positions will be used to contract with the private sector for staffing services instead.

1. Staffing Reduced But Not Associated Funding. As discussed earlier, the budget proposes a number of personnel-year reductions without proposing any corresponding funding changes. The budget for the California State University, for example, shows a reduction of over 750 personnel, but *no dollar reduction* for these positions. Similarly, the budget for the University of California shows a reduction of 250 pys, but *no dollar reduction.* In addition, the budget for five entities (the Departments of Corrections, Food and Agriculture, Fish and Game, and Forestry, as well as the Health and Welfare Data Center) show a collective reduction of approximately 290 personnel-years but *no funding reduction.* Thus, the funds associated with more than 1,250 personnel-years proposed for elimination remain in the budget. This clearly is another case where a change "in the numbers" does not tell the whole story.

2. Savings Resulting from Reduced Staffing Has Been Underestimated. Our analysis has found that several departments propose to reduce funding for terminated positions on the assumption that these positions are budgeted at the minimum step of the salary range, when the positions actually are budgeted at higher levels. Table 50 shows that an additional $4.6 million could be saved in these five departments alone if salary and benefit reductions are made that more closely mirror actual salary levels.

Table 50
Funding for Salaries and Benefits That Should Be Reduced *If* the Legislature Approves Proposed Personnel Reductions (dollars in thousands)

Employment Development Department	$3,512
Department of Rehabilitation	536
Department of Social Services	245
Department of General Services	173
State Personnel Board	116
	$4,582

3. Redirected Savings. Several departments took the savings associated with staffing changes and redirected the funds to other activities. Thus, state expenditures remain unchanged. For example, the Department of Parks and Recreation realized a $415,000 savings by deleting 29 pys of seasonal staff in favor of utilizing California Conservation Corps

(CCC) personnel. The department proposes to use these funds to (a) purchase vehicles to transport corps members to job sites, (b) provide housing for corps members, and (c) fund additional operating expenses. The CHP, on the other hand, proposes to use $1.5 million of its savings to (a) purchase and operate four new airplanes and (b) pay for various staff-related costs, including relocation expenses.

4. Contracts for Staffing Services. As discussed in more detail in the next section, there are numerous examples of where the dollars associated with personnel-year reductions are proposed for use in contracting out for services. For example, the Department of Corrections proposes to eliminate 18 pys performing microfiche activities and instead use the $257,000 it would have cost to retain these staff to fund a contract for the needed services. Similarly, Caltrans proposes to eliminate 45 pys needed for right-of-way maintenance and instead use the $1.6 million it would have cost to retain these personnel to fund the needed work on a contract basis.

Failure to Reduce Funding Leaves Program Control in the Administration's Hands. Thus, our analysis indicates that an unknown, but significant, portion of the funding associated with the personnel reductions remains in the budget—either in the form of salaries and related expenses or as part of departmental support. To the extent extra money remains—the administration, rather than the Legislature—largely will be making the program-related decisions on how to use these funds.

What Effect Will the Proposed Reductions Have on the Quantity and Quality of Services Provided to Californians?

Of all the questions raised by the Governor's staffing proposal, this is the most difficult one to answer. This is because many of the proposals for reducing staff or contracting for personal services are still evolving. In many instances, the effects on programs of these proposed changes are, at best, unclear at this time. In several instances, however, the effects on services *are* apparent and warrant legislative consideration.

- ***The Office of Economic Opportunity (OEO).*** Pursuant to legislative direction in the 1984 Budget Act, the administration has reviewed OEO's organizational structure and reduced 26 pys. The savings associated with this change, $438,000, has been redirected to program activities which should result in increased local services for OEO clients.
- ***The Youth Authority*** is reducing 16 positions and $404,000 (federal funds) which are used to provide remedial reading, language development, and remedial math services to its wards. Twelve of these positions are teaching assistants who provide these services directly; the remaining four are related support staff. The proposed elimination of 12 teaching assistants represents a 22 percent reduction in the total number of teaching assistants in the department. We question

the budget's contention that elimination of the positions will not adversely affect the level of services provided to wards.

- ***Social Services.*** The budget proposes to transfer the responsibility of providing specified adoption services to the counties. Counties will receive $2.6 million to cover their costs. Our analysis indicates that the proposal would result in fewer children being adopted.
- ***Vocational Rehabilitation.*** The Department of Rehabilitation proposes to eliminate 88 personnel-years and instead contract for the provision of vocational rehabilitation services to disabled persons. No evidence has been submitted, however, to document that the needed services can be obtained from private providers on a cost-effective basis.
- The ***California Highway Patrol*** proposes to eliminate the traffic management helicopter in the Los Angeles area, in the hope that another agency will take over this service. At this point, however, no formal agreement has been signed that ensures continuation of this service.

In summary, it appears that a number of the Governor's personnel-year proposals would result, or potentially would result, in reduced services to the people of California.

Conclusion

In sum, our review of the administration's work force reduction proposal has found that:

- The 1984–85 estimate of the state work force is not a very reliable base against which the number of personnel-years proposed for 1985–86 should be compared. This is because the current-year estimate, more than likely, is overstated and, therefore, tends to exaggerate the size of the reduction proposed for the budget year.
- The administration's proposed staffing reduction for 1985–86 is attributable to increased efficiencies and economies, bookkeeping adjustments, unallocated reductions, and reductions which would have occurred in the absence of administrative actions or have been anticipated for several years.
- A large number of positions would be eliminated in the budget year, if the administration's proposals are adopted. The extent to which the total work force in 1985–86 will turn out to be lower than the work force in 1984–85, however, is unclear.
- Dollar savings commensurate with the proposed staffing reduction are not reflected in the budget. In fact, adjusted salary costs are up, not down, in the budget year.
- Several of the administration's personnel reduction proposals would result in reduced services to the people of California.

What Criteria Should the Legislature Use in Evaluating the Governor's Personal Services Contracting Proposals?

As discussed in the previous section, the budget includes a great deal of money that would be used to contract out for staffing services. Much of this money would be freed up by personnel reductions proposed in the budget.

Personal services contracting is not a new activity for state government. The state often has contracted for specialized staff who have a particular expertise. Departments also enter into contractual arrangements with each other when specialized services, such as data processing, are required. What is unique about the Governor's proposal is that a significant number of the proposed new personal services contracts would be let for the types of work currently performed, or traditionally performed, by state employees.

In many instances, it seems obvious that funding for a personal services contract has been proposed in the budget primarily for the sake of reducing the state's staffing level. Often, the proposal appears to have been developed without first ensuring the contract's actual viability—its legality, feasibility, cost-effectiveness, or program impact. This will make it exceedingly difficult for the Legislature to determine whether the proposal has merit.

Our analysis indicates that the Governor's Budget contains funds for more than 100 new personal services contracts in lieu of hiring state personnel. Table 51 provides our best estimate of the personnel replaced or avoided in the budget year as a result of these contracts. The table shows that approximately 1,300 state personnel-years are affected by the contracting proposals. This estimate, moreover, is conservative because (1) it only includes those instances where state staff are performing or traditionally have performed the function to be contracted out for the budget year, (2) it does not include ongoing contracts entered into in past years, and (3) it only includes those personnel which were clearly identifiable as a result of information provided by individual departments.

Not only are these new contracts significant from a personnel standpoint, they also involve a significant amount of money—at least $64 million (all funds). Contract amounts range from as little as $23,000 for the Public Employment Relations Board to obtain legal services to as much as $11 million for the Department of Rehabilitation to secure vocational rehabilitation services for its clients.

Table 51
Personnel-Years Replaced or Avoided in 1985–86 As a Result of New Contract Proposals

Legislative, Judicial, Executive	11.1
State and Consumer Services	194.9
Business, Transportation and Housing	369.4
Resources	70.4
Health and Welfare	406.9
Youth and Adult Corrections	18.0
K–12 Education	—
Higher Education	270.8
General Government	28.2
Total	1,369.7

We have long believed that the cost of state programs can be reduced by contracting for certain services with the private sector. In fact, in our *Analysis of the 1980–81 Budget Bill,* we recommended that the Legislature submit a constitutional amendment to the voters that would authorize the procurement of government services using independent contractors whenever it can be shown that the costs would be less than using state employees. We are the first to admit, however, that contracting does not make sense in all cases. Generally, it makes sense *only* if it is the more cost-effective alternative for providing a given level of service, or if there are special circumstances that warrant it, such as a lack of expertise in a department to perform a particular task.

This section analyzes the themes of the Governor's new personal services contracting proposals, and identifies the criteria that we believe the Legislature should use in evaluating these proposals.

Background

During the fall of 1984, the administration established a task force to review proposals for expansion and nontraditional uses of contracting out for personal services. Departments were not required to submit to the task force contracting proposals which essentially were continuations of past contracting practices. Proposals that were not submitted to the task force instead were reviewed by the Department of Finance prior to inclusion in the budget.

The task force requested that the following information be submitted with each proposal:

- The benefits of contracting out the work.
- A cost analysis of the contracting option versus current services, or for new activities, the projected costs if the work were performed by civil service employees.
- The data or background information needed to determine compliance of the proposal with contracting restrictions included in state law.
- The potential impact of the proposal on existing personnel (layoffs, for example).
- The likely impact of the proposed contract on quality of services.

The Administration's Proposals

The budget's new personal services contracting proposals generally fall into one of the following four categories:

- Contracts for functions *currently performed* by state employees.
- Contracts for *new functions.*
- Contracts where *additional* workload will be contracted out while *existing* workload continues to be performed by existing state staff.
- Contracts which *transfer* work currently performed by the state to another level of government, or another governmental entity.

In some instances, a contract may fall into more than one category. Examples of proposed contracts in each of these categories are listed below.

1. Contracts for functions currently performed by state employees.

- The *Department of Education* is proposing to spend $158,000 in 1985–86 to contract with other state agencies or private firms for the performance of unspecified, routine data processing tasks currently performed by the department's Education Data Management Systems division. This, in turn, will allow existing staff to undertake new projects related to the automation of school apportionment mechanisms.
- The *Museum of Science and Industry* proposes to eliminate 11.8 temporary-help personnel-years and contract ($265,000) for parking lot operations.
- The *Department of General Services* proposes to avoid hiring 69.3 personnel-years to provide janitorial and maintenance services in two new state office buildings. The money it would take to hire state personnel ($1.7 million) will be used to contract for the service instead.

2. Contracts for new functions.

- The *Department of Commerce's* California Film Office, established by Ch 1639/84, issues permits to filmmakers who wish to utilize state properties or facilities in commercial films. The department proposes to enter into a $40,000 contract to perform this activity in the budget year.
- The *Department of Health Services* proposes to contract for $1 million of laboratory work related to implementation of the Hazardous Substances Bond Act of 1984 passed by the voters in last November's General Election. The department also proposes to spend in excess of $3.5 million for a contract to develop drinking water standards. This proposal also includes funds to contract out the state's traditional function of contract management.

3. ***Contracts where additional workload will be contracted out, while existing workload will continue to be performed by existing state staff.*** The most common contracts of this type relate to janitorial services.

- The *Department of Parks and Recreation* uses state employees to provide janitorial and maintenance services at the Lake Perris State Recreation Area, but will contract for janitorial services at a new visitor center which will open in the area in 1985–86.
- The *California Highway Patrol* and the *Department of Motor Vehicles* have janitorial services contract proposals which together will result in the reduction or avoidance of approximately 67 personnel-years.
- The *State Library* will spend $56,000 on a contract to extend the Sutro Library's operating hours.
- The *Student Aid Commission* will undertake additional audits on a contract basis.

4. ***Contracts which transfer work currently performed by the state to another level of government or another governmental entity.*** The primary examples of transfers to another level of government occur in the health and welfare area.

- The *Department of Health Services* proposes to spend $841,000 to contract with county environmental health inspectors who would be on loan to the state for one year to enforce state and federal hazardous waste laws.
- The *Employment Development Department* proposes to contract ($7.4 million) with local training agencies throughout the state to provide job service activities.
- The *Department of Rehabilitation* is proposing to spend nearly $11 million on contracts with nonstate rehabilitation providers. The proposal consists of two components. The first component utilizes $6.6 million to fund rehabilitation services that will be provided to disabled students by local school districts and community colleges. The second component consists of $4.0 million, which the department will use to purchase services from other public or private rehabilitation providers.
- The *State Personnel Board's* Local Government Services Program traditionally has performed merit system and technical personnel services for local governments on a fully-reimbursable basis. The budget proposes that these services be provided, instead, through a Joint Powers Authority governed by local government officials and representatives of the board. The proposal allows the budget to show the elimination of all 55.4 personnel-years associated with the program.

- The *Department of Transportation (Caltrans)* has traditionally employed graduate and engineering students. The budget proposes, instead, to contract with California State University (CSU) for $959,000 to hire students (approximately 61 personnel-years) on a contract basis. This staffing level would not be reflected in either Caltrans' or CSU's personnel-year totals.
- The *state hospitals and the Veterans' Home* traditionally have utilized their own laundry facilities and staff (104 pys on a full-year basis) to launder residents' clothing. The budget proposes to contract ($1.5 million) with the Prison Industry Authority (PIA) to perform this function in the budget year. Because the contract will be phased in during 1985–86, the budget shows a reduction of 60 pys related to this proposal.

Cost Impacts of the Administration's Proposals

Our analysis indicates that the administration's contract proposals can be divided into three categories with respect to their cost implications—contracts that would cost the *same* as having state employees do the work, contracts that would cost *less* than the amount required to hire state employees, and contracts that would cost *more* than comparable services provided by state employees.

Equivalent Costs. Our analysis indicates that the amount of funding requested in the budget for nearly half of the more than 100 new personal services contracts was based on the costs of having state employees do the work. The $1.7 million contract for janitorial services that is funded in the *Department of General Services'* budget is a typical example of this equivalent-cost contracting. The same can be said for the $11 million contract for vocational rehabilitation services in the *Department of Rehabilitation* and the $7 million contract for job services in the *Employment Development Department.*

Cost Savings. Based on information currently available to the Legislature, we have been able to identify only two instances in which the administration's new contracting proposals will result in cost savings. The *Department of Motor Vehicles'* proposals to contract out for janitorial and key data operator services are estimated to save approximately $260,000 in 1985–86. This money has been deleted from the department's budget. Similarly, the *California Highway Patrol's* proposals to contract out for janitorial services should save approximately $397,000 in the budget year. These funds have been redirected, however, to fund other activities within the department.

Cost Increases. On the other hand, a number of the Governor's proposals will result in increased costs to the state. The *Energy Commission,* for example, is requesting $360,000 for a contract to analyze a backlog of energy use survey data. If the commission hires graduate student assistants to perform this task, as it has done in the past, the state could save $257,000. Similarly, the *Department of Food and Agriculture* proposes to contract with six counties for highway inspections of fruit and vegetables to assure that they meet specified quality standards. If state staff did the work, it would cost $138,000 less. The *Air Resources Board* also is proposing two contracts because its existing staff is either insufficient or too busy to do work related to (1) the development of control measures for air pollution and (2) the improvement of emission inventory estimates. The state could save $385,000, however, if state staff instead were hired to do this work.

Potential for Future Increased Costs Due to Contracting. Our analysis indicates that what may be presented as equivalent costs this year may turn out to be increased costs once the state department puts the contract out to bid.

For example, in the 1984–85 Governor's Budget, the *State Fire Marshal* proposed a contract of $298,000 to expand the office's fireworks program. The amount proposed was based on the office's estimate of what it would cost if in-house personnel were used. The State Fire Marshal assured the Legislature that the program contained in a draft request for proposal could be implemented fully within the requested amount, and with these assurances, the Legislature appropriated the full $298,000 requested in the budget. One year later, our analysis indicates that the costs in the current year for doing *less* than what originally was proposed is now nearly 12 percent higher.

Whether or not the administration encounters cost overruns in attempting to let the new contracts proposed in the budget, these contracts may prove more difficult to implement than it may appear. This is because the state has had limited experience with the type of expanded personal services contracting envisioned in the Governor's Budget for 1985–86. Consequently, implementation delays and narrowing of program scope could have a potentially significant impact on services as well as costs.

Impact on Services

Due to the lack of detailed information regarding how various contracts actually would be implemented, it will be difficult for the Legislature to identify the effect that many of these proposals will have on state services. For example, the *Employment Development Department's* proposal to contract with local training agencies to provide job service activities does not make clear what activities actually will be funded. As a result, we cannot determine the impact this contract would have on training services for the unemployed.

Similarly, the *Department of Rehabilitation's* proposal to eliminate field office staff and provide vocational rehabilitation services with nonstate providers may have a significant impact on disabled clients. As discussed in the *Analysis,* it is not clear that the proposed change will buy as much service as the state employees being replaced could provide. To the extent that it costs more to provide services to each client on a contract basis, fewer clients will actually receive services.

In order for the Legislature to evaluate the new personal services contracting proposals, the administration must provide sufficient data to permit an evaluation by the Legislature of the impact that the contract would have on the quality and quantity of services provided by the state. As discussed in detail below, this information, as well as other necessary documentation, had not been submitted at the time that this analysis was prepared.

More Documentation Needed

Based on our review of the supporting documentation accompanying the new personal services contracting proposals and discussions with the Department of Finance, we conclude that many of the approximately 100 contract proposals are still in the conceptual phase of their development. The administration simply has not met *its own* informational requirements, as set forth in a December 3, 1984, memorandum to agency secretaries and departmental directors. Specifically, for a large number of proposals, adequate information has not been provided on:

- The specific work to be contracted out;
- The cost impact of the contracting proposal in comparison with projected state costs using state employees to provide the service;
- The extent to which the contracting proposal complies with existing state law; and
- The impact of the contract on the quality of services provided.

As a general rule, supporting documents assert that the proposal is "efficient," "cost-effective," "legal," and "will not reduce the quality of services," but substantiating analysis and documentation of these assertions are often lacking.

This approach poses significant problems for the Legislature, since it will have to pass on the contract's appropriateness relative to the use of state employees, while the contracting proposal is still being developed. For this reason, we have recommended throughout the *Analysis* that the administration provide the Legislature with additional information concerning these contracting proposals.

The first step in ascertaining the viability of these proposed contracts should be an analysis to determine if the contract complies with the requirements of existing state law. It is to these legal requirements that we now turn.

Existing Law Governing Contract Services

Case Law. The California Supreme Court, in three decisions (dating back to 1937), has limited the ability of the state to use private contractors to perform state government support services. These decisions have been based largely on the presumption that the civil service, as established in the California Constitution (Article VII, Section 1), should perform most, if not all, state governmental functions.

Statutory Law. Chapter 1057, Statutes of 1982 (Government Code Sections 19130–19132), sets guidelines for state contracting of personal services. These guidelines essentially codify those established prior to 1982 by the State Personnel Board. The board based these contracting rules on the court decisions mentioned above. By enacting Chapter 1057, the Legislature apparently intended to clarify—and give more legal weight to—the rules governing contracting for services.

As specified in Chapter 1057, the general instances under which personal services contracting is *permissible* include the following:

- The service is not available within civil service (for example, the expertise of a private research consultant);
- The service is part of a new state function involving work authorized by the Legislature (for example, the translation of election materials into certain foreign languages); or
- The service is urgent, temporary, or occasional in nature, and timely delivery of the service is critical (for example, the use of private reporters and transcribers to handle peak workload for agencies which conduct administrative hearings).

Chapter 1057 also sets forth the specific conditions that govern personal services contracting to achieve *cost savings.* These conditions, *all* of which must be met, are as follows:

- The contractor has demonstrated that the proposed contract will result in savings;
- The savings are large enough to account for normal cost fluctuations and justify the size and duration of the contracts;
- The economic risk to the state from potential rate increases is minimal;
- The contractor's wages do not significantly undercut state pay rates;
- The contract does not cause the "displacement" (layoff, demotion, or involuntary transfer) of civil service employees;
- The contract satisfies the state's affirmative action standards; and
- The potential economic advantage of contracting is not outweighed by the public's interest in having a function performed directly by state government.

Summary. *Case law* regarding state contracting places the burden of proof on those agencies seeking to contract out state work. Recent legislation (Chapter 1057), however, suggests to us that the Legislature is willing to *expand* the practice of contracting for services, especially where potential cost savings are involved. It is hard to reconcile completely the cost-based contracting provisions of Chapter 1057 with a 1937 California Supreme Court decision which prohibited the consideration of economy or efficiency as a primary reason to contract out.

This legal question, as well as others, are likely to be tested in court. In fact, the California State Employees Association (CSEA) has recently challenged state personal services contracting proposals. Specifically, it has challenged the Employment Development Department's current efforts to contract out janitorial work in three of its field offices. Similarly, the state has been sued by the Professional Engineers in California Government regarding a Caltrans proposal to contract with private firms for certain design, materials testing, and other construction-related activities currently handled by state engineers. A suit also has been filed challenging the State Energy Commission's contract with a private firm to review proposed energy facility sites. The Legislature and the administration need to evaluate the risks of pursuing contract proposals that fall into legal gray areas. Such contracts may result in increased liabilities for the state.

What Criteria Can the Legislature Utilize to Evaluate These Proposals?

In order to evaluate the multitude of contracting proposals included in the Governor's Budget for 1985–86, the Legislature needs to assure itself that the administration can justify the proposal on a cost-savings, programmatic, and legal basis. The Governor's task force, in specifying the information it needed to evaluate contracts, outlined five of the criteria which we believe should be considered by the Legislature:

- Does the proposal conform to existing legal requirements?
- Are the estimated contract costs reasonable and verifiable? Is it cost-effective?
- What is the potential personnel impact (layoffs, transfers) of the proposal? Is the contract proposed simply as a substitute for using state personnel, rather than to achieve cost-savings or to improve program effectiveness?
- Is the contract service of equal or comparable quality to the same service if performed in-house?
- What benefits will the state derive from contracting?

In addition, we believe there are three other criteria the Legislature also should consider.

- Could short-term savings be offset by additional, unanticipated long-term contracting costs?
- Does the contract pose policy considerations by calling for identical

work to be performed by both contract and state personnel in a single program?
- Will the state be vulnerable or liable if the private contractor unexpectedly is unable to deliver the service?

Conclusion

The Governor's Budget contains a number of proposals to contract out personal services—many of which are innovative and nontraditional. Some of these proposals may well provide a means for delivering services or performing essential tasks at less cost to the taxpayer.

Unfortunately, many of the approximately 100 new personal services contracts are not well-defined and remain in the conceptual phase of their development. We suspect that this is because the decision to contract was based on the effect it would have on the size of the state's work force, rather than on a determination that this approach would be cost-beneficial or result in better delivery of services. As a result, in a significant number of cases, the Legislature has not been provided the information it needs in order to determine the contract's reasonableness, cost/benefit, or effect on the quality of service provided to the public.

Because these proposals have not been developed fully, the Legislature is placed in a position of trying to make the Governor's Budget whole. This, however, is appropriately the responsibility of the administration. The administration needs to determine the viability of its own proposals before deliberations on them can proceed.

THE CONDITION OF THE STATE'S INFRASTRUCTURE

What Can be Done to Facilitate the Legislature's Ability to Address the Need to Maintain and Expand the State's Infrastructure System?

What is Infrastructure?

There are many definitions of "infrastructure." For the purposes of this discussion, we have defined the term to mean investment in physical facilities. Investment in this context includes not only construction of new facilities, but also (and not secondarily) the alteration, repair and maintenance of existing assets.

In order to establish a statewide strategy to improve and sustain the state's infrastructure, the Legislature should consider the infrastructure system *as a whole*, rather than as individual elements or projects. In this way, the condition of the state's infrastructure can be identified in a manner which allows the Legislature to assure that these interrelated, yet competing, systems will serve the needs of the people of California, now and in the future. Unfortunately, the state's current capital outlay budget structure does not facilitate this type of review.

This section analyzes the administration's budget proposal for addressing the state's infrastructure needs, and makes recommendations for facilitating the Legislature's ability to act on the proposal and go beyond it.

The Condition of the State's Infrastructure Systems

Compared to eastern states, California has relatively new public facilities. Moreover, in most areas of the state, California is fortunate to have moderate weather conditions which extend the life of physical facilities. As a result, the deterioration of the state's infrastructure has not, in most cases, reached a crisis point. To avert a crisis in the future, is the challenge which the Governor and the Legislature now face.

Two studies of California's infrastructure were completed in 1984.

The Assembly Office of Research (AOR) completed a study in January 1984 which focused on "intrinsic infrastructure." This term was defined to include "eight infrastructure systems without which other vital public services and private commerce could not function—state highways, county roads, city streets, public transit, sewage systems, water systems, solid waste management, and flood controls/drainage systems." The AOR's report concluded that, during the next decade, there would be an estimated $24 billion funding shortfall for these systems under current policies.

The Governor's Infrastructure Review Task Force investigated a wider range of infrastructure than did the Assembly Office of Research. The task force defined infrastructure as the state's collective network of facilities (including maintenance) and divided it into three categories:

1. Intrinsic infrastructure (streets, highways, utility systems, etc.);

2. Protective infrastructure (police/fire facilities, prisons, hospitals, etc.); and

3. Enriching facilities (educational facilities and parks).

In April 1984, the task force reported that during the next decade, approximately $29 billion will be needed for deferred maintenance and $49 billion will be needed for new infrastructure. The task force indicated that ". . . while funding for some of these needs are already in place, an estimated $51 billion shortfall exists." The components of the $51 billion shortfall are shown in Table 52.

The financing shortfall identifed in these two studies reflects the estimated funding requirements for (1) eliminating deferred maintenance, and (2) meeting rehabilitation and expansion needs over the next decade. It is important to note that the identified needs and associated cost estimates were supplied by the affected entities themselves, and therefore may be biased in an upward direction. Nevertheless, the general magnitude of California's infrastructure financing needs certainly falls within the range identified in these two studies.

Table 52
Estimates of Ten-Year
Funding Shortfalls for California's Infrastructure
Compiled by the Governor's Task Force on Infrastructure Review [a]
(dollars in millions)

	Total Needs	*Estimated Funding*	*Funding Shortfall*
State-Supported Facilities			
State-maintained highway system	$26,500	$11,400	$15,100
State water project	1,268	1,268	—
State Universities	772	486	286
University of California	2,509	870	1,639
State hospitals	125	125	—
State prisons	2,135	600	1,535
State/Local-Supported Facilities			
Local streets and roads system	6,900	2,780	4,120
Bus and rail transit	9,600	728	8,872
Air carrier/commuter airports	1,600	1,600	—
General aviation airports	420	410	10
Domestic water systems	850	30	820
Wastewater treatment	12,500	406	12,094
Flood control and drainage	579	250	329
Solid waste disposal	3,000	3,000	—
Elementary and high schools	4,800	1,350	3,450
Community colleges	480	290	190
Local jails	2,700	—	2,700
Parks and recreation	250	250	—
Government buildings	633	633	—
Totals	$77,721 [b]	$26,576 [b]	$51,145

[a] Source: Infrastructure Report and Recommendations, April 15, 1984—Governor's Infrastructure Review Task Force, State of California. Figures based upon current revenue and taxation structure.
[b] We are unable to reconcile the difference between the detail and the estimated totals.

Recommendations Made by the Governor's Task Force

The report issued by the Governor's Task Force contained a series of recommendations for dealing with the infrastructure problem. Some of the task force's more important procedural and policy recommendations called for the state to:

- Initiate long-range strategic planning in each infrastructure element at the state level. This would set forth broad goals and objectives for meeting future statewide needs.
- Establish, as state and local government's highest infrastructure priority, the elimination of deferred maintenance.
- Establish the rehabilitation of existing facilities, and the construction of new infrastructure, as the state's next highest priorities.
- Terminate the practice of balancing budgets by deferring maintenance of infrastructure.
- Establish a separate, identifiable program in the Governor's Budget

that would include all major capital outlay proposals for the pending fiscal year.

- Establish a five-year capital outlay budget.
- Require each ensuing year's capital outlay budget display to identify the progress which has been made to reduce deferred maintenance backlogs.

Governor's Program For Rebuilding California

The Governor's Budget for 1985–86 (page 50) identifies a "Program for Rebuilding California." This program displays $25.1 billion in expenditures that will be made over the six-year period from 1984–85 through 1989–90. Most of these funds ($23.6 billion) would be expended under provisions of existing law, and, therefore, do not represent new funding to address the state's infrastructure needs.

The portion of the program that does reflect new funding, totaling $1.5 billion, consists of:

- $700 million from anticipated settlements of tidelands oil litigation and offshore oil negotiations;
- $650 million for local bond pooling to finance capital projects;
- $125 million for "privatization" (utilization of private-sector resources) in areas previously reserved for public entities.

Tidelands Oil Litigation. In 1975, the state and the City of Long Beach sued the consortium of oil companies (known as THUMS) that produce oil on state lands in Long Beach. The suit alleges that THUMS conspired to fix oil prices that were the basis for payments to the state/city for oil produced from 1962 through 1977. The state is seeking damages of up to $300 million, which could be tripled under antitrust law. In December 1984, the state settled with one of the companies for $21.5 million. This amount is included in the balance available for appropriation in the Special Account for Capital Outlay.

Offshore Oil Revenues. The federal Outer Continental Shelf Lands Act calls for the federal government to share with the relevant coastal state the revenue it derives from oil and gas operations conducted three to six miles offshore. The Department of Interior must deposit revenues from development of these resources off each state's coast into an escrow account until a sharing agreement has been reached with the Governor. The escrow account now contains approximately $1.6 billion in revenues from lands off the California coast.

In August 1984, the Department of Interior offered California nearly 17 percent (approximately $267 million) of the escrow amount, with the stipulation that California would *not* receive any future royalties. It is our understanding that negotiations with the Department of Interior are continuing, and that the state has neither accepted nor rejected this offer.

Local Bond Pooling. The Governor proposes a program under which local governments could realize "economies of scale" in raising money for infrastructure by "pooling" their debt issues. By issuing a few larger bonds in place of many smaller bonds to finance local projects, local agencies should be able to improve the marketability and reduce the costs of their debt issues. This portion of the Governor's program would require enabling legislation.

Privatization. Privatization envisions a partnership between the public and private sectors. The public sector receives the benefit of a facility without putting up the initial development cost, while the private sector secures profits and receives tax/investment credits by putting up the initial capital for the project. This concept is particularly suited to infrastructure elements that yield a regular income and are equipment-intensive. These elements would, for example, include waste water treatment, solid waste disposal, and hydroelectric facilities. This concept may also require legislation to allow such partnerships.

Analysis of the Governor's Infrastructure Program

We believe the Governor is to be commended for identifying, as a separate long-term program, the state's infrastructure needs. To our knowledge, this is the first time infrastructure has been separately addressed in the budget. Thus the Governor has taken an initial step toward facilitating legislative consideration of infrastructure improvement needs.

The Governor's program, however, is deficient in two key respects. First, it does not address the funding shortfalls identified in both the AOR's study and the report submitted by his own task force. Nearly 95 percent of the $25.1 billion that the budget "identifies" for meeting infrastructure needs would be spent under current policies—the policies that have been identified as insufficient to meet the state's needs. The main source of *new* funding, moreover, is at this point, far from certain.

The Governor is to be commended for advising the Legislature of his spending priorities for the $700 million in revenue that *may* be received from tidelands oil litigation and offshore oil negotiations, in advance of their being received (priorities include local streets and roads, cleanup of toxic sites, deferred maintenance at state-owned facilities, and construction of two prisons). Given the uncertain outcome of the litigation and negotiations, however, there is no basis for establishing either the amount or timing of any revenue that will be realized from these sources.

In sum, the first six years of the Governor's "Program for Rebuilding California" is basically a status quo program.

Second, the Governor does not propose any action to implement the recommendations made by his own task force. In our judgment, these recommendations would go a long way toward improving both the executive's and the Legislature's ability to oversee the financing of and progress made in addressing the state's infrastructure needs.

For example, the task force recommended that the budget include all major capital outlay proposals in a separate program, and display expenditures under this program for the next five years. This would provide the Legislature with a clear picture of the overall infrastructure program and facilitate meaningful legislative review of it. The Governor's Budget displays an overall broad program which lacks the specificity envisioned by the task force.

The task force also recommended that deferred maintenance be designated as the state's highest funding priority. The budget does not implement this recommendation. Nor does it contain the information that would permit the Legislature to implement this policy. In fact, it is difficult, at best, to identify in the budget those funds that are proposed for maintenance, special repairs, and other infrastructure-related items. Although these funds are separately displayed in the budgets for the University of California and the California State University, for most other departments they are simply lumped together in a single line item—"facility operations"—which includes funds for utilities and other costs that are not directly related to maintenance of infrastructure.

In addition, the task force recommended that (1) the rehabilitation and deferred maintenance allocation in each departmental operating budget be linked to the overall five-year capital budget plan and (2) each ensuing year's capital display identify progress in reducing the deferred maintenance backlog. This is an essential component for assuring that priority needs are funded and the amounts appropriated are spent as intended by the Legislature. Again, there is no indication in the Governor's Budget that this aspect of the task force's recommendations will be implemented.

In view of the pending shortfall in funding for needed infrastructure that now seems to be beyond contention, it is incumbent on the administration to advise the Legislature of its plans to address this shortfall. We also believe it is incumbent for the administration to address the recommendations made by the Governor's Task Force.

Recommendations for the Legislature's Consideration

As the Legislature awaits a complete program for meeting the state's infrastructure needs from the Governor, we believe there are several interim steps that the Legislature can take that would facilitate its ability to address the need for maintaining and expanding the state's infrastructure. Accordingly, we recommend that the Legislature:

- Identify funding for various elements of infrastructure, by line item, in the Budget Bill, and adopt budget language restricting the transfer of these funds for other purposes.

- Direct the administration to submit annually a five-year capital outlay budget.
- Set priorities for renovation, new construction, and increased maintenance of state facilities.
- Establish standards for appropriate maintenance of state facilities.
- Establish, as a high-priority goal, the elimination of deferred maintenance.
- Require departments with a responsibility for infrastructure elements to establish a preventive maintenance program.

We also recommend that the administration:

- Identify (1) the condition of the state's infrastructure on a department-by-department basis and (2) the current maintenance level of departmental facilities.
- Submit to the Legislature an annual post-audit report, identifying what has been accomplished with infrastructure funding provided in the annual Budget Act.

By taking these types of steps, the Legislature will be able to consider the infrastructure system as a whole and assure that these systems serve the needs of the people of California.

INFORMATION TECHNOLOGY APPLICATIONS FOR STATE OPERATIONS

How Can the Legislature Assure that the Automation Projects Proposed in the Budget are Soundly Conceived and Implemented?

During the last two years, the State of California has made a major effort to increase employee productivity through the use of modern information technology. Many agencies have replaced manual processes with automated systems; many others have begun to install office automation systems. Examples of large-scale information technology projects either underway or proposed for the budget year include (1) major office automation projects in the Department of Social Services and the Judicial Council, (2) enhanced telecommunications within the Department of Motor Vehicles and the California Highway Patrol, (3) information system projects within the Employment Development Department, and (4) replacement of large computers in the Board of Equalization.

Although no precise statistics are kept on state expenditures for informtion technology, the Governor's Budget estimates that the level of these expenditures proposed for the budget year exceeds $500 million. This, the budget estimates, is $45 million, or approximately 10 percent, above the current-year level.

Potential Benefits from Automation

Obviously, the use of modern information technology holds the potential to both reduce the cost of state government and improve the quality of services that the state provides. Many agencies are in the process of realizing these potential benefits. For example, automation projects are expected to result in savings of at least 475 personnel-years during the budget year, in four agencies or program areas alone: the Department of Motor Vehicles (175), the Employment Development Department (163), the state hospitals (105), and the Department of Social Services (32). Other automation proposals, such as the Board of Equalization's computer replacement project, will make existing programs more effective, regardless of whether they yield savings.

Automation Proposals Are Not Automatically Sound

While automation proposals offer the possibility for significant benefits to the state, they also carry with them large risks:

- The risk of large cost overruns;
- The risk that automation equipment either will duplicate or be incompatible with existing equipment;
- The risk that information systems will not work properly;
- The risk that information systems will work properly but fail to provide useful information; and
- The risk that automated systems will prove to be incompatible with programmatic objectives.

Perhaps the best example of how an automation project can go awry is the Statewide Public Assistance Network (SPAN) project, which was initiated in 1979–80 to assist in the delivery of benefits to various public assistance recipients. The project never became operational, despite the expenditure of *$19 million* (all funds), and was terminated in July 1982. There were many reasons why the project failed to yield any benefits to the state, not the least of which was the state's failure to plan the project effectively in both the long and short term. Specifically, the project never defined an appropriate system for the task at hand and presented three separate approaches in a 12-month period, *each* of which was labeled as the most cost-effective alternative. As these difficulties developed, projected expenditures increased and prospective savings grew increasingly uncertain.

Given the risks attached to automation projects and the amount of money at stake, the Legislature needs to carefully review those automation projects for which the budget requests funds.

Requirements for Success of an Automation Project

There exists no single approach that will assure the success of an automation project. Our analysis indicates, however, that several factors can improve the probability that an automation project will succeed. These prerequisites for success are as follows:

1. The department undertaking the project has a *strategic plan;*
2. Departmental *management is involved* in the project;
3. Departmental *users are involved* in the project;
4. A rigorous *feasibility study report* has been prepared and reviewed;
5. The department has *adequate staff* to carry out a project; and
6. A *pilot project* precedes full-scale implementation.

1. Strategic Plan. The State Administrative Manual *requires* that a feasibility study report be completed for most individual automation projects. Strategic planning of a department's overall information technology needs, however, is essentially an *optional* exercise. Nevertheless, it is important for each department to (a) develop a clear sense of direction for its programs, (b) develop an overall architecture for its information technology systems that is consistent with programmatic direction, and (c) assure that individual projects are consistent with both programmatic direction and system architecture. This approach was followed successfully last year by the Department of the Youth Authority, when it completed a comprehensive review of its automation needs. Similarly, the State Treasurer's Office currently is undertaking a thorough strategic planning effort that has the potential to increase the benefits from future investment in office automation.

In contrast, the Employment Development Department (EDD) is proceeding to automate a manual system *without* having first addressed the underlying program objective. The department is automating its job sharing system so that individuals seeking employment will have greater access to job openings in different geographical areas. This project, however, fails to take into account the fact that there already are sufficient applicants for existing job openings. The key problem facing those without jobs—a shortage of job openings—will not be ameliorated by the project. The Legislature recently addressed the need to strengthen the EDD's planning efforts by enacting Ch 1226/84 (AB 1654), which requires EDD to develop a strategic plan for all of its automation efforts.

2. Management Involvement. It is the responsibility of departmental management to assure that strategic planning occurs, and that each individual project developed is consistent with overall departmental goals and information processing architecture. The redesign of the Franchise Tax Board's personal income tax system and the Public Employees' Retirement System's automation project are two examples of projects that were successfully implemented, partly because of top-level management involvement. In each case, the project manager reported directly to the department's executive officer. Conversely, the Hazardous Waste Information System developed by the Department of Health Services has not been successful, in large part because system development efforts were not coordinated with departmental planning. This problem possibly could have been avoided had departmental management taken a more active interest in the project. Similarly, the Department of Consumer Affairs' distributed data processing project failed, at least in part, because it lacked sufficient top-level management involvement.

3. User Involvement. The success of many projects also is determined by the extent to which the ultimate users of the system are involved in its design. Data processing staff must understand the processes that are being automated, who will use the information, and how it will be used. In addition, early involvement of users is much more likely to assure their support of the new system once it is put in place. The California Fiscal Information System (CFIS), which has cost over $45 million to develop, failed in both its conception and design to account for the ultimate needs of its users. As a result, the central fiscal data base envisioned for the system rarely has been used, and two major components of this data base have been eliminated.

In contrast, the State Controller's Office established a user committee during the early stages of its current office automation project. This committee was responsible for determining the needs that would be served by the system. Implementation of the Department of Motor Vehicles' field office automation project also was characterized by a high level of user involvement.

4. Feasibility Study Report (FSR). The Office of Information Technology (OIT) requires and reviews an FSR for almost all proposed large automation systems. Creating an FSR does not, in and of itself, assure the success of an automation project. An FSR which *rigorously* identifies problems, specifies needs, addresses realistic alternatives, and assesses costs and benefits is much more likely to lead to a successful project. The FSRs prepared by many departments—for example, those prepared for the Department of Justice's Automated Child Abuse System and the State Controller's office automation system—exhibit this type of rigorous planning.

This was not the case, however, with the feasibility studies developed by the Employment Development Department (EDD) to support its unemployment insurance and disability insurance program automation proposals. Our analysis of these FSRs indicates that they do not adequately assess alternatives for setting up the system. In fact, the various FSRs prepared by EDD (a) discuss only the recommended alternative, (b) reject alternatives without explanation, and (c) rarely quantify benefits associated with alternatives. Without this type of information, it is difficult for anyone, in particular the Legislature, to be confident that the alternative chosen is the most cost-effective solution to a problem.

5. Staffing. Successful implementation of an automated system requires both adequate staffing and the proper mix of experienced and skilled technical personnel. Unfortunately, there currently is a shortage of such personnel in the state. One of our initial concerns regarding the SPAN project, for example, was that because there existed a serious shortage of qualified electronic data processing professional staff in state government, the Department of Social Services would experience difficulty in hiring an adequate number of skilled personnel for the project. Similarly, one of the reasons that the Department of Mental Health's Patient Care System has encountered difficulties is that the department has been unable to retain adequate levels of skilled personnel on the project.

On the other hand, the Department of Housing and Community Development, in redesigning its registration and titling system, followed suggestions made by OIT and redefined both its staffing levels and the mix of position types assigned to the project. This project appears to be successful, in part, because the staff necessary to carry out the project was put in place at an early stage.

6. Pilot Projects. A pilot project is a scaled-down version of a full automation project. It often is conducted within a subset of the areas that will be served by the full project—a regional office, or an office within a department—and is used to simulate the system as a whole. The pilot approach provides workload information which makes it possible to develop a realistic assessment of computing equipment requirements and other resource needs for the full system. Once again, our review of SPAN indicates that its chances of success might have been improved had a pilot project been undertaken to provide this type of information. Pilot projects have been used successfully in many instances, including the Medi-Cal Eligibility Determination System in the Department of Health Services. The Department of Social Services currently is overseeing the Food Stamp On-line Issuance System pilot program, which appears to be very successful.

Importance of the Office of Information Technology

Chapter 1327, Statutes of 1983 (AB 2074), made the Office of Information Technology (OIT) in the Department of Finance reponsible for statewide advocacy, planning, and policy setting in the area of information technology. OIT also is responsible for review and control of departmental plans and projects. (OIT's role is discussed more fully in our review of the Department of Finance's budget.)

In light of both the Legislature's mandate and the state's emphasis on increased automation, OIT's role is pivotal in assuring the success of automation projects and the wise use of statewide information technology resources. The OIT has taken some significant steps in its new role as advocate and statewide planner, and continues to perform a valuable service to the state in its traditional project review role. Our analysis indicates, however, that OIT could strengthen its effectiveness in both of these areas.

Statewide Planning and Analysis. The OIT has become much more active in advocating the use of information technology within the state. It also has developed various policies, such as a draft policy for purchasing microcomputers, and a draft revision of State Administrative Manual (SAM) guidelines related to information technology. Our analysis indicates, however, that the state continues to lack plans and policies in several areas such as office automation and the role of state data centers.

State policies in areas such as these would improve the ability of departmental managers to make informed decisions about information technology projects. This is particularly true in the area of office automation. Many managers don't understand the potential benefits of office automation and are not aware of the problems inherent in purchasing non-compatible equipment and software. The Department of Justice (DOJ), for example, proposes to spend $2 million in the budget year to implement an integrated office system. DOJ also is budgeting $438,000 to replace, upgrade, or expand *existing* word processing systems which are not compatible with its new system. The state needs to adopt policies which discourage duplicative and counterproductive proposals like this one.

In addition, our discussions with OIT staff and our review of its plans and policies indicate that OIT needs to devote more effort to policy *analysis.* By this, we mean additional discussion of statewide information technology objectives, problems limiting the achievement of those objectives, and alternatives to solving those problems. Specifically, OIT needs to address more forcefully:

- ***What are the ultimate goals of automation?*** To increase worker productivity? To provide information?
- ***What are the problems that keep the state from consistently achieving these goals?*** Poor project planning? A shortage of qualified personnel?
- ***How can the state solve these problems?*** Adopt policies to assure management and user involvement? Use new technology to reduce project backlogs? Increase the involvement of state or private sector consultants?

Additional critical analysis to support the policies that OIT has developed or is drafting would assist the state in solving the problems that cause information technology projects to fail.

Plan Review and Consulting Staff. The OIT has been charged with its new policy development role for only one year. Therefore it is understandable that many important plans and policies have not yet been implemented. It is more difficult to understand why the level of staff in OIT devoted to reviewing plans and projects—its traditional role—has not kept pace with the dramatically increasing workload. Between 1982 and 1984, OIT's workload more than doubled, while OIT's review staff decreased slightly. As a result, the number of projects that OIT does not review is on the rise.

OIT has begun to provide consulting support to state agencies that are preparing strategic plans and feasibility studies. This service is particularly crucial for those small- and medium-sized departments with little or no information technology expertise. Once again, however, our analysis indicates that the amount of consulting staff available is not adequate to meet the need for consulting services.

Guidelines for Legislative Deliberations.

By establishing as a high-priority goal the increased use of automation statewide, the administration is working to increase efficiency and productivity in state government. The Legislature, however, cannot assume that these benefits will be forthcoming from the projects proposed for funding in 1985–86. As a consequence, the Legislature, in considering individual funding requests for proposed automation projects, should confirm that:

- Departments have at least begun the process of developing a strategic plan for use of information technology *prior to requesting funding for individual projects,* and will have such a plan in place within a reasonable time;
- Departmental management and users are sufficiently involved in automation projects, and that departmental policy and management objectives are being considered in developing feasibility studies;
- Sufficient staffing has been provided to departments for the implementation of proposed projects.

Finally, the Legislature needs to assure itself that sufficient staffing resources have been provided to the Office of Information Technology so that it can (1) analyze and propose solutions to information technology problems, (2) quickly develop statewide plans and policies, (3) adequately review feasibility studies and strategic plans, and (4) provide necessary consulting support to state agencies.

REGULATION OF FINANCIAL SERVICES

Does the Legislature Have Sufficient Information to Determine Whether the State's Financial Regulatory System Should be Modified in the Face of Marketplace Changes Resulting from Deregulation?

For many years, financial institutions survived and profited in a very heavily regulated and stable marketplace. Banks, savings and loan associations, and credit unions were designed to serve different segments of the marketplace, and the federal and state regulatory structure evolved along these lines.

The industry changed during the latter part of the 1970s. Brokerage firms that offered money market accounts paying interest on a par with other market investments began draining billions of dollars in depositors' funds from the financial institutions.

Starting in 1980, Congress and many states acted to ease the plight of financial institutions through a series of steps designed to deregulate their activities. Deregulation effectively authorized banks, savings and loans, and credit unions to pay market interest rates on certain accounts and to increase interest rates significantly on other accounts. California went one step further by granting broad new investment authority to its financial institutions.

As a result of the dramatic changes which have taken place in the financial services marketplace, the state's financial institutions now are subject to a complex jurisdictional web of seven federal regulatory agencies and five state agencies. At a time when the marketplace is moving to a distribution of financial services on a functional basis, the state's financial regulators—the Departments of Banking; Savings and Loan; Corporations; Insurance; and Real Estate—remain organized along *institutional* rather than *functional* lines.

This section analyzes the problems deregulation poses for the state and whether the Legislature has sufficient information to determine whether the state's regulatory system should be modified as a result of these changes in the marketplace.

Background

Banks (including commercial, investment, savings, mortgage and cooperative), savings and loan associations, credit unions, and loan companies were heavily regulated in the 50 years following the Great Depression. During that period, regulation represented a deliberate effort on the part of federal and state government to reinstill public confidence and reestablish stability in the financial marketplace.

The various federal and state regulatory agencies accomplished their objectives, in part, by restricting the types of investments which financial institutions could make and limiting the interest paid to depositors and the interest charged to borrowers. Restrictions on the types of investments the financial institutions could make effectively prohibited them from using depositors' funds for speculative or high-risk purposes. Competition among the various financial institutions was limited by setting the maximum interest rates they could pay on depositors' time and savings accounts and by restricting their geographic scope of operations. Thus, the financial institutions were principally deposit takers and loan makers and each had its specified role.

Specifically, banks served the financial marketplace primarily by making personal, commercial and agricultural loans and providing checking account services. Savings and loans were earmarked as the nation's home mortgage lenders. In contrast, credit unions were set apart as cooperative savings and lending institutions serving groups of individuals having a common bond such as workplace or cultural heritage. Although the individual roles of the financial institutions were different, each faced similar types of risk.

In addition to these regulatory mechanisms, the federal government established deposit insurance funds for member banks, savings and loan associations and credit unions. These funds are backed with the full faith and credit of the United States' Treasury. As an added step, both the federal and state regulatory agencies have developed separate regulatory systems for each type of financial institution and conduct periodic, sometimes joint, financial examinations.

For the most part, federal deposit insurance, interest rate controls and federal and state regulatory oversight, worked well to instill public confidence in the financial institutions and to establish stability in the financial marketplace.

Changes in the Marketplace Brings About Deregulation

During the latter part of the 1970s, the financial marketplace began to change. Because inflation was high, financial institutions found themselves facing greater interest rate risk than ever before. Moreover, depositors grew increasingly more sophisticated and assertive in seeking the best return on their investment dollar. It was during this time that competition for depositors' money increased between the financial institutions and those brokerage firms offering money market accounts. These accounts drained billions of dollars out of the banks, savings and loans, and credit unions, because they could offer the depositor liquidity and a higher rate of return than traditional saving deposits. This process served to weaken the competitive stance of financial institutions because of their inability to pay the higher yields to depositors.

Federal Deregulation. Congress acted in 1980 and again in 1982 to ease the plight of financial institutions. It did so by enacting legislation which, among other things, eliminated most of the purely legal and functional distinctions between financial depositories and authorized them to offer a deposit account that was directly competitive with money market accounts offered by brokerage firms. Federal actions served to deregulate the liability side (interest payments to depositors) of financial institutions' balance sheets.

California Deregulation. California also took steps to deregulate its state-chartered financial institutions. California's actions, however, were focused on deregulation of the asset side (broadening the types of loans and investments which could be made), as well as the liability side of the financial institutions' balance sheets. These actions at the federal and state level were successful in reversing the outflow of funds from the banks, savings and loans, and credit unions. But these changes also raised new risks for these institutions and their depositors.

Institutions were allowed for the first time to make *equity* investments in real estate, insurance, commercial ventures, and corporate securities. This change provided the opportunity to earn a higher rate of return, but it also increased the potential for losses.

Depositors were offered a wide variety of new investment opportunities, some of which were insured, and many of which were not. Due to the multitude of new investment opportunities offered by these institutions, it is now likely that many unsophisticated account holders pay more attention to the promised rates of return without fully realizing that some of the "accounts" are uninsured equity investments subject to the risk of losses.

The sharp increases in competition within the financial service marketplace has produced an upturn in failures, mergers, and consolidations. California has seen a growing number of financial institutions encounter serious financial problems such as American Savings, Heritage Bank and the Western Community Money Center. The Bank of America also has been troubled with high risk loans which have become unproductive. These problems have reduced public confidence in financial institutions generally and raised questions as to the effectiveness of current regulatory controls. They also have called into question the reliability of public information released by the state's regulators regarding the financial condition of financial institutions.

Summary. Federal and state deregulation has (1) removed many of the legal and functional distinctions between banks, savings and loans and credit unions; (2) introduced a new element of risk by permitting financial institutions to take an ownership position in commercial and real estate ventures; (3) introduced a new element of risk for the account holders by offering investment opportunities which are not insured, and (4) intensified competition between the different types of financial institutions and full service financial firms.

Deregulation and the State's Regulation of Financial Services

Our analysis indicates that, as a result of deregulation, the Legislature may need to:

- Reorganize the state's financial regulatory structure;

- Alter the resources available to the state's financial regulatory agencies; and
- Redefine the role of the state's financial regulatory agencies.

Regulatory Structure. Currently, the state's financial regulatory agencies are independent of one another and, consequently, no effective mechanism exists to coordinate and harmonize their regulatory activities in a deregulated environment. Each agency maintains separate administrative, examination, legal, and enforcement staffs, and computer files on its licensees. Moreover, each agency has differing rules, regulations, field examination practices, and accounting and reporting procedures.

Fragmentation in the state's financial regulatory structure has existed for many years. As such, it was not uncommon, for example, to find a real estate development firm regulated by both the Department of Real Estate (because of its subdivision projects) and the Department of Corporations (because it had sold stock to the public). This situation did not post serious problems for the regulatory system because the activities were essentially separate.

In a deregulated environment, where the lines between previously separate industries have disappeared, a fragmented approach to regulation can lead to serious problems. Specifically, as a result of deregulation, the same real estate development firm also can form a savings and loan association to finance its projects. This makes it subject to regulation by a third state agency—the Department of Savings and Loan. Under such circumstances, serious regulatory problems could occur because the activities of the development firm and the savings and loan are so closely linked. If, for example, the development firm incurred a major loss on a subdivision financed by its savings and loan, the financial viability of the savings and loan could be impaired as well. Thus, deregulation appears to have increased the need for better coordination among the state's financial regulatory agencies.

Resource Needs. The current and future resource needs of the state's financial regulatory agencies are dependent on policy changes at the state and federal level brought about by deregulation. Specifically, deregulation has prompted a recent agreement between federal and state regulators that effectively results in a need for more state field examination staff. A further shift of federal regulatory responsibility to the state will occur if Congress approves the recommendations of a task force which was appointed by the President to study ways to simplify the federal regulatory structure and eliminate overlapping and duplicative regulatory effort. One major recommendation of the federal task force would shift—from federal regulators to state regulators—the responsibility for conducting field examinations of state-chartered financial institutions. This proposal, if implemented, could require the Legislature to increase significantly the examination staffs of the Departments of Banking and Savings and Loan. Thus, deregulation may alter the resource needs of the state's financial regulatory agencies.

Regulatory Role. In the past, the primary role of the state's financial regulatory system has been to protect the public from economic loss. To accomplish this objective, state regulators relied on periodic examinations to determine whether the operations of financial service providers were both safe and sound.

In a deregulated financial services marketplace, the role of the regulators may need to be redefined to include: (1) more in-depth evaluations of the soundness of these institutions' financial activities, and (2) expanded consumer protection.

Prior to deregulation, the typical types of assets held by financial institutions and evaluated by regulators included *secured* business, agricultural, consumer, and real estate loans plus U.S. government and municipal securities. Now regulators must evaluate *unsecured* equity investments made by these institutions. The complexity of these new types of investments raises the question of whether the regulators have the expertise, training and staff necessary to perform their new role. Also there is the question of how much information the regulators should publish on the financial condition of these institutions so that potential investors are adequately informed of the risks associated with each institution.

Consumers very often incorrectly assume that because they are dealing with traditional institutions, their investments are subject to traditional protections (that is, insurance). For many customers, the "jargon" used by these institutions does not clearly delineate between insured deposits and uninsured equity investments. Moreover, the various types of insurance now in effect are not standardized. For example, deposit insurance offered by the Federal Deposit Insurance Corporation (FDIC) and the state's Thrift Guarantee Corporation (TGC) differ significantly as to (1) the amount of deposit protection provided, (2) specific payout provisions if an institution should fail, and (3) the reliability of their ultimate financial backing (in the case of the FDIC and TGC, ultimate financial backing is provided by the U.S. Treasury and the thrift industry, respectively).

Thus, as a result of deregulation, the role of the state's financial regulatory agencies may need to be redefined.

The State's Financial Regulatory System In a Deregulated Environment

We recommend that legislation be enacted creating a blue-ribbon task force, consisting of industry, academic, administrative and legislative representatives, to reexamine the state's regulatory role pertaining to financial institutions. We further recommend that the task force submit periodic progress reports to the Legislature and the Governor, and that the final report, with its recommendations, be submitted in 1986.

Given the volatile changes that have occurred as a result of deregulation, it is becoming increasingly clear that the state's financial services regulatory system, which was designed for a marketplace that no longer exists, needs to be critically reexamined.

Budget Proposal. The Governor's Budget for 1985–86 recognizes that changes are needed in this area. The budget proposes $300,000 (Item 0520) to finance a private consultant's study of the state's existing financial regulatory structure and the changes in the financial services marketplace. We have evaluated the Governor's proposal (please see page 32 of the *Analysis*) and found that (1) the scope of the study is not clearly defined; (2) the cost estimate is not substantiated; and (3) no provision is specifically made to provide the Legislature with the results of the study.

Task Force Alternative. Our analysis indicates that additional information *is needed* regarding the effects of financial deregulation on the state's regulatory system. Specifically, the Legislature needs better information (1) to evaluate the impact of deregulation on the state's financial marketplace, (2) to analyze the state's current financial regulatory structure in light of recent developments, and (3) to develop alternatives which would streamline the regulatory structure and increase its efficiency and cost-effectiveness.

Due to the complexity of this issue and its impact on the private as well as public sectors, representative participation by the affected parties is essential. Therefore, in lieu of a private consulting contract, we recommend that the Legislature secure the needed information by enacting legislation creating a blue-ribbon task force, consisting of representatives of the financial industry, academic institutions, the administration, and the Legislature. The task force should be directed to submit periodic progress reports to the Legislature and the Governor and a final report during 1986.

Specifically, we recommend that the legislation direct the task force to:

- Conduct a comprehensive evaluation of the current and likely future effects of federal and state deregulation on California's financial service marketplace.
- Evaluate the state's current financial regulatory structure and determine what changes are needed in regulatory policies, programs and organizations vis-a-vis federal regulatory agencies. This review also should consider (1) the impact of potential changes in the roles of federal financial regulatory agencies on their state counterparts and (2) whether the state's existing decentralized regulatory structure should be replaced by a consolidated state regulatory organization.
- Determine what changes need to be made in the state's policies and procedures for examining and reporting on the financial condition of financial institutions.

- Ascertain what changes are needed to enhance consumer awareness of the risks involved in new types of investments, and what protections should be extended to traditional types of deposits.
- Provide the Legislature and the Governor with specific recommendations for legislation to implement such changes.

COMPARABLE WORTH

Is "Comparable Worth" an Effective and Efficient Means of Achieving State Employment Goals?

One of the most controversial issues in the area of public sector labor relations and compensation is the issue of "comparable worth." This concept envisions the payment of equal wages to different job classifications having comparable value.

Background

In California, the issue of comparable worth came to the forefront during legislative action on the 1984 Budget Bill. The Legislature augmented the 1984–85 employee compensation packages for state employees by \$76.6 million (\$46.3 million General Fund) in order to provide comparable worth pay adjustments to some of these employees. At the same time, the Legislature approved a bill (SB 1701) establishing a Commission on Pay Equity, which would have conducted a comparable worth pay study. The Governor vetoed both the pay increases in the Budget Bill and SB 1701.

The comparable worth issue was back in the headlines in November 1984, when the California State Employees' Association filed a sex-based wage discrimination lawsuit against the state on behalf of state employees in female-dominated job classifications. The lawsuit seeks, as relief for these employees, back pay to redress sex-based discrimination in wages.

The Concept of Comparable Worth. Comparable worth is a concept based on two related premises:

1. Jobs which are dissimilar in terms of both content and the demands they place on the worker may nonetheless be compared objectively in order to determine their *relative* value or worth.

2. Jobs which are approximately of the "same worth" should be compensated equally.

Conceptually, comparable worth can be used to address relative disparities between any job classifications. In practice, however, the concept has been used most often to highlight pay differentials between men and women.

Proponents of comparable worth argue that, because of both deeply ingrained sex-related cultural biases and outright sexual discrimination against women in employment practices, women have been restricted to lower-paying jobs. Because these discriminatory effects are so pervasive, they assert that an alternative to the "free market" determination of wages (such as comparable worth) is needed in order to counteract these effects.

Federal Anti-Discrimination Law. There are two main federal laws covering employment discrimination. The Equal Pay Act of 1963 established the doctrine of equal pay for work of equal value, and Title VII of the 1964 Civil Rights Act prohibits discrimination because of race, color, religion, sex, or national origin in all employment practices. The federal courts are in the process of interpreting the extent to which these anti-discrimination statutes are relevant to lawsuits involving comparable worth.

In one important case—*American Federation of State, County and Municipal Employees v. Washington State* (December 1983)—a federal district court judge found the State of Washington guilty of Title VII violations for failing to implement the results of a comparable worth study. This case is currently on appeal.

The U.S. Supreme Court, to date, has shied away from the issue of comparable worth. For example, the court recently refused to review an appellate court's decision in *Spaulding v. University of Washington,* which ruled that the university's nursing faculty could not bring a discrimination suit under Title VII solely because its members were paid less than faculty members with comparable duties at other schools within the university system.

State Employment Practices

In the past, the state generally has set salaries and wages on the basis of comparability with private sector compensation levels. Thus, the state has followed a "market" approach to setting pay levels.

The relatively recent passage of two measures, however, has significantly affected the state's traditional approach to compensating its employees. First, Ch 1159/77 (the State Employer-Employee Relations Act) made the determination of wages and salaries subject to collective bargaining.

Second, Ch 722/81, stated *legislative intent* that it is the state's policy to set salaries for female-dominated jobs on the basis of comparable worth. (Ch 641/83 established the same policy for California State University employees.) Prior to legislative action on the 1984 Budget Bill, however, there was little action by the state or employee unions to implement this policy.

Efforts to Alleviate Underrepresentation. Independent of the way in which state employee wages are set, the state has taken steps during the last decade to address the underrepresentation of females, minorities and disabled persons in the state workforce. The State Personnel Board (SPB), the agency which oversees the state's affirmative action program, has acted to:

- Provide extensive departmental affirmative action reviews;
- Expand recruitment activities targeted at underrepresented groups;
- Create and expand upward-mobility programs;
- Expand eligibility for certain exams in order to broaden participation;
- Use temporary appointments and training and development assignments to provide new job opportunities; and
- Create new apprenticeship programs.

Currently, SPB is involved in a special project designed to address the problems of recruiting, hiring, and retraining women in crafts and trades classifications. The board has provided specific recommendations to 13 departments to assist them in this regard. Furthermore, SPB is considering general recommendations on how to remove employment barriers in these trade occupations.

The Feasibility of the Comparable Worth Concept

Our review identifies three issues that should be addressed by the Legislature as it considers the comparable worth concept. These issues are as follows:

- Are the premises underlying the comparable worth concept valid?
- Would comparable worth help achieve the Legislature's main employment objectives?
- What are the implications of making the kind of drastic change in the way the state pays its employees that comparable worth envisions?

Are the Premises Underlying Comparable Worth Valid? Implicit in many of the arguments advanced on behalf of comparable worth are two premises: (1) the huge "wage gap" between men and women requires a radical departure from current compensation practices and (2) traditional efforts to correct "market imperfections" (such as affirmative action programs aimed at improving *access* to certain job classifications) are not sufficient to do the job.

The "wage gap" premise is based on the oft-quoted statistic that the average earnings of an American female is only three-fifths that of a male's. Many have wrongly assumed, however, that discrimination accounts for the entire difference. In fact, when differences in nondiscriminatory factors (such as length of workweek, education, and experience) are taken into account, the "unexplained" portion of the wage gap is typically in the 10 to 25 percent range. Economists assume that a good portion of this unexplained portion is, in fact, due to discrimination.

The need for comparable worth also seems to be based on the premise that the state has not acted effectively enough to address underrepresentation of females in the state work force. Currently, women comprise 44 percent of the state's work force, but tend to be concentrated in certain occupational classifications—particularly clerical-related jobs.

Table 53 shows the proportion of state jobs held by women in each of the twenty major categories covering all state employment. The table indicates that, with few exceptions, between 1975 and 1984 there were large percentage increases in the representation of women within each category. These gains have been realized, in large part, as a result of specific actions by the state to improve women's access to jobs. They also reflect the changing cultural mores which have dramatically affected women's work force participation.

Table 53 also clearly illustrates that, despite significant progress in the last 10 years, women still are underrepresented in most categories, especially in crafts and trades, law enforcement and management positions. It is not clear to us, however, that comparable worth in any way addresses this problem, as discussed below.

Table 53
Percent of Women in the State Work Force
By Major Job Categories
1975, 1981, and 1984

Job Categories	*Percent of Total Employees 1984*	*Percent Women In Each Category 1975*	*1981*	*1984*	*Percent Increase, 1984 Over 1975*
Office Support:					
Clerical	16.8%	88.6%	89.6%	89.2%	0.7%
Supervisory clerical	3.5	86.0	83.6	83.3	−3.1
Crafts and Trades:					
Semiskilled	2.8	0.3	5.8	7.3	—[a]
Crafts/trades	3.0	4.8	3.1	2.8	−41.7
Supervisory crafts/trades	3.7	0.3	0.6	1.5	400.0
Laborers	0.6	0.2	3.5	9.8	—[a]
Custodial:					
Janitor/custodian	2.7	32.6	39.4	38.4	17.8
Supervisory janitor/custodian	1.0	30.1	34.3	35.6	18.3
Professional and Technical:					
Professional	16.6	30.8	32.6	38.2	24.0
Supervisory professional	7.5	14.8	16.2	16.8	13.5
Sub-professional/technical	13.6	43.8	59.4	60.8	38.8
Supervisory sub-professional/technical	2.7	24.0	38.2	40.4	68.3
Field representative	2.3	12.0	31.0	40.6	238.3
Supervisory field representative	1.6	6.0	13.5	19.1	218.3
Law Enforcement:					
Line	8.7	3.0	8.9	12.3	310.0
Supervisory	1.8	2.1	3.1	5.7	171.4
Administrative:					
Administrative staff	5.3	30.5	54.8	54.9	80.0
Supervisory administrative staff	3.5	15.3	31.3	32.4	111.8
Administrative line	1.1	3.0	9.4	11.6	286.7
COD Classes	1.1	59.8	62.0	59.6	−0.3
Total employees	100.0%[b]	38.6%	44.1%	44.0%	14.0%

[a] Exceeds 2000 percent
[b] Details may not add to totals due to rounding.

Is Comparable Worth Aimed at the Right Objective? It is impossible to assess the concept of comparable worth as a means of achieving state employment goals without knowing the Legislature's objectives. Actions taken by the Legislature to date *suggest* (we can't be certain) that the Legislature's main objective is to improve women's *access* to all job classifications. That is, there should be no unnecessary barriers to the movement of individuals into whatever positions they are qualified to hold.

If this is the case, it does not appear that comparable worth is an appropriate or effective means to achieve this desired end. Comparable worth is aimed at changing the *relative* wage levels *among* job classifications, not in changing the male-female composition of existing classifications. This is because comparable worth does not in any way address barriers or restrictions which preclude women from entering certain classifications; rather, it addresses only what employees in existing classifications "should" be paid.

It may be, however, that the Legislature would want to implement comparable worth for *other* reasons. For instance, it could be used as a method for compensating female employees for past discrimination.

Thus, in considering whether to implement a comparable worth program, it is crucial that the Legislature specify what its objective is.

Comparable Worth Is a Drastic Change in Employee Compensation. Although comparable worth has been advanced as a means of addressing pay discrepancies between women and men, the concept has much broader applicability. If fully implemented, it would completely change the way wages for *all* classifications are determined.

Compensation levels currently are set through collective bargaining—presumably within the constraints imposed by the labor market. Under comparable worth, however, wages presumably would be established based on a consulting firm's judgment as to what the appropriate standards are for determining job worth within an organization (usually referred to as "point-factor" evaluations). There is no consensus, however, on what specific criteria should be used in setting these standards for determining job worth. Nor is it clear to us why the Legislature should be confident that the standards used by one group are "fairer" or "better" than those of another consulting firm.

Potential Negative Consequences of Implementing Comparable Worth

In addition to questioning the validity of the premises underlying comparable worth, we believe that implementation of a comparable worth program at the state level could have certain *adverse* consequences that the Legislature should keep in mind. Specifically,

- ***Comparable worth could discourage, rather than improve, the access of women to nontraditional jobs.*** If comparable worth were to achieve the intended effect of raising wages in female-dominated jobs, it would work at cross purposes to the goal of ensuring women's *access* to male-dominated jobs. This is because women would have less of an incentive to seek higher-paying and/or nontraditional jobs.
- ***Implementation of comparable worth can be very costly.*** Conceptually, comparable worth could be implemented at *no* cost to the state. Since the concept deals only with *relative* wage rates, any increased costs from raising wages in female-dominated classifications *could be* offset by *reducing* wages in other classifications. Practically, however, wages tend to *level up,* resulting in additional compensation costs to the implementing entity.
- ***Comparable worth could reduce employment opportunities for female workers now employed by the state.*** This is because a sharp rise in salaries for female-dominated occupational categories would tend to accelerate the search for less labor-intensive ways of providing these services. For example, a sharp increase in salaries for clerical workers would tend to make state office automation projects all the more attractive.
- ***Implementation of comparable worth could lead to shortages in certain occupational classifications.*** To the extent that a comparable worth assessment of a job's "value" is *less than* the market's, it will be difficult to fill these jobs at the "designated" salary. Thus, it is unclear how the state would be able to recruit and retain needed workers in all classifications if a comparable worth program were implemented.

Conclusion

In order to remove the remaining barriers confronting women who would like to move into male-dominated classifications, we recommend that the Legislature establish a special unit within the State Personnel Board devoted solely to improving access for women into nontraditional classifications.

There is no doubt that cultural biases and various forms of discrimination have affected the employment status of women in state government. Moreover, job barriers—both overt and subtle—remain which will preclude full and widespread participation of women in all categories of the state work force for many years to come.

Our review indicates, however, that the state has adopted the best policy direction for rectifying this problem by attempting to remove these barriers and to both encourage and assist women in pursuing nontraditional jobs. During the last decade, in fact, the state has achieved significant success in improving representation by women in virtually all job classifications.

Clearly, further success in this effort is needed if the state is to achieve its employment objectives. It is not at all clear to us, however, how a comparable worth program would contribute toward those ends. Our analysis indicates that implementation of the comparable worth concept: (1) would not help women in entering nontraditional occupations, (2) would probably be very costly (although *conceptually* there is no reason why its implementation has to result in *any* costs), and (3) could result in reduced employment of female workers and employee shortages in certain state classifications.

In short, it appears to us that comparable worth is neither an efficient nor effective means of achieving state employment objectives. Consequently, we recommend that the Legislature continue to rely on: (1) private sector comparability data in evaluating the compensation of state workers (within, of course, the context of collective bargaining), and (2) affirmative action efforts to improve access into nontraditional jobs.

With regard to the latter, however, we believe the state could do more than it is now doing to find and remove those remaining barriers confronting women who would like to move into male-dominated classifications. Currently, SPB does not have staff to thoroughly review departmental personnel practices in order to:

- Identify barriers preventing women from entering certain classifications,
- Promote upward mobility of women into male-dominated classes; and
- Assist departments in recruiting women in such classes.

Accordingly, we recommend that the Legislature establish a special unit within the SPB, devoted solely to improving access for women into nontraditional job classifications. While we have not received specific information from the board as to the number of staff needed to perform such a function, it appears to us that a five- to six-person unit (at an annual cost of approximately $250,000) could adequately perform this task.

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