California Legislature

THE 1985–86 BUDGET: PERSPECTIVES AND ISSUES

Report of the Legislative Analyst to the Joint Legislative Budget Committee

HON. DAVID ROBERTI
President pro Tempore of the Senate

HON. WILLIE L. BROWN, JR.
Speaker of the Assembly

Members of the Committee

SENATE	ASSEMBLY
Walter W. Stiern, *Chairman*	Richard Robinson, *Vice Chairman*
Alfred E. Alquist	Art Agnos
Robert G. Beverly	Ernest L. Konnyu
William Campbell	William Leonard
Bill Greene	John Vasconcellos
Milton Marks	Maxine Waters
Nicholas C. Petris	Phillip D. Wyman

WILLIAM G. HAMM
Legislative Analyst

STAFF

William G. Hamm—Legislative Analyst
John L. Vickerman—Chief Deputy
Thomas J. Dooley—Deputy
Kenneth A. Carter—Deputy

Principal Program Analysts

Carol Bingham
Hadley Johnson, Jr.
Peter W. Schaafsma
Hal Geiogue
Wayne Keithley
Cheryl Stewart
Elizabeth G. Hill
Daniel P. Rabovsky
Mac Taylor

Gerald Beavers—Principal Capital Outlay Analyst
Jon David Vasche—Senior Economist

Program Analysts

Nancy Rose Anton
Nicholas Bartsch
Phyllis Bramson
Craig Breedlove
Jocelyn Burton
Marilyn E. Bybee
Ann Carberry
Gerald Concklin
Craig Cornett
Chi-Ming Dana Curry
Wil Davies
John Decker
Lyle Defenbaugh
Robert B. Egel
Susan P. Ehrlich
Richard Figueroa, Jr.
Judy A. Fitzgerald
Michael Genest
Jarvio Grevious
Randy Hodgins
Richard J. Holden
Joan Keegan
Richard Keller
Charles Lieberman
R. Stuart Marshall
David Maxwell-Jolly
Paula A. Mishima
Robert Miyashiro
Karen Neuwald
Michael Nussbaum
Harry Osborne
Rick Pratt
Joseph Radding
Susanne Ragen
Raymond M. Reinhard
Sarah L. Reusswig
Michael Martin Reyna
Henry Sepulveda, Jr.
Jeffrey P. Shellito
Allan Solares
Pamela Spratlen
Mark D. Taylor
Titus S. Toyama
Robert Turnage
Paul Warren
Carol Wilkins
Kate Williams
Margaret Zentner

Program Technician

Phillip R. Dyer

Administrative Assistants

Helen Blanas
Jean Fernlund
Cheryl Firenze

Support Staff

Victoria Albert
Joanne Callaway
Judy Cashner
Nancy Concklin
Marilyn J. Davis
Tanya Elkins
Margaret Gipe
Helen Kiehn
Nona Kimmel
Kathie Lambert
Frank E. Marez
Lenora Martinez
Rosetta L. Morris
Elizabeth T. O'Neill
Carol Perrin
Maria Ponce
Senita Robinson-Taylor
Ignacio Salinas
Kelly Smith
Jim Stahley
J'Ann Wicks
Kathi Williams

CONTENTS

TABLES

CHARTS

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

Part One

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)

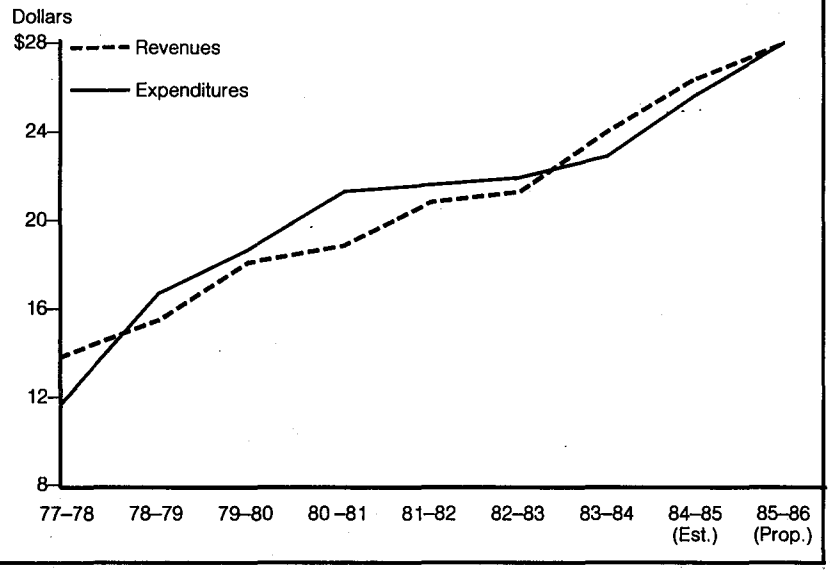


Table 1

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			*Condition of the General Fund in 1984–85 as Projected by Governor's Budget*		
	As Projected in Governor's Budget January 1984	*As Reported by State Controller January 1985*	*Effect on 1983–84 Surplus*	*January 1984*	*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)

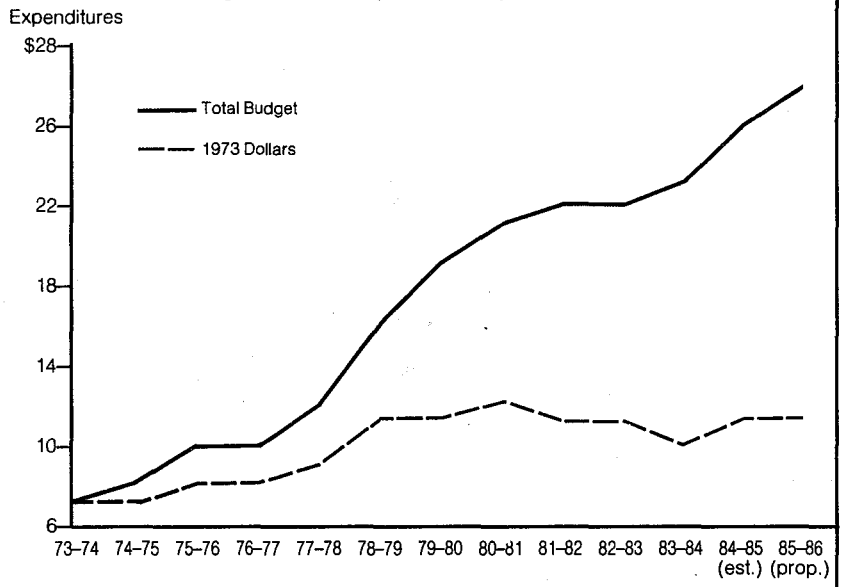


Chart 2 and Table 5 show the General Fund expenditure trend since 1973–74. Expenditures in Chart 2 and Table 5 are displayed both on a "current dollar" and "real dollar" basis. Expenditures in "real dollars" represent expenditure levels as they appear in the budget (that is, "current dollars") adjusted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

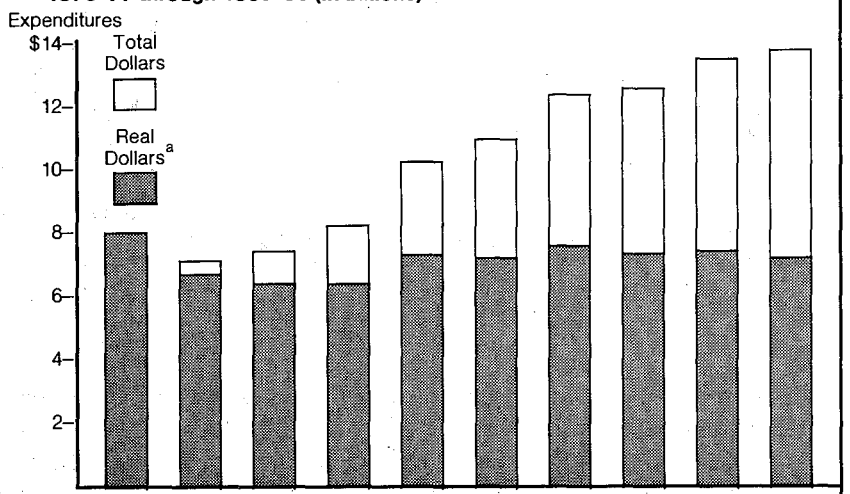
As noted above, the amount of federal aid received by California has been somewhat volatile during the last 10 years. This volatility is illustrated in Chart 3. In terms of current dollars, federal expenditures have grown from just under $8 billion in 1976–77 to $13.7 billion in 1985–86, an increase 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)



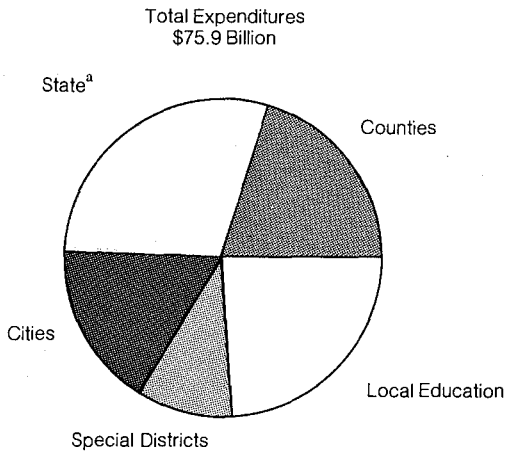
a "Real" federal dollars equal total federal dollars deflated to 1976–77 dollars using the GNP price deflator for state and local purchases of goods and services.

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*	*Change* [c] *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

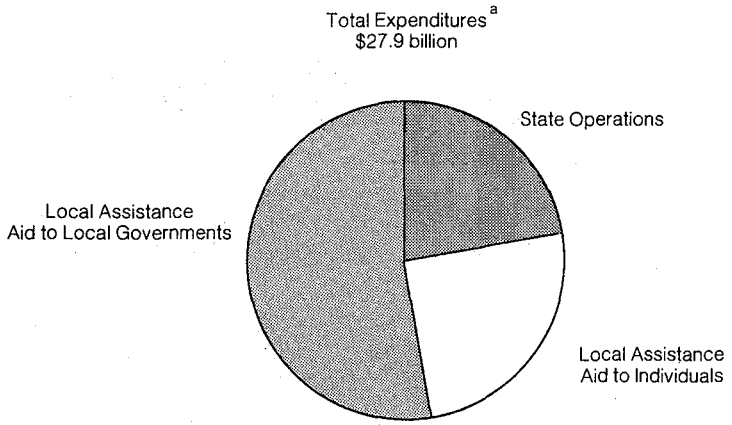
The budget proposes an increase from the General Fund of $720 million, or 13 percent, for state operations expenditures in 1985–86. As shown in Chart 6, General Fund expenditures for state operations will have increased by $3.8 billion, or 144 percent, during the ten years from 1976–77 through 1985–86.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



[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.

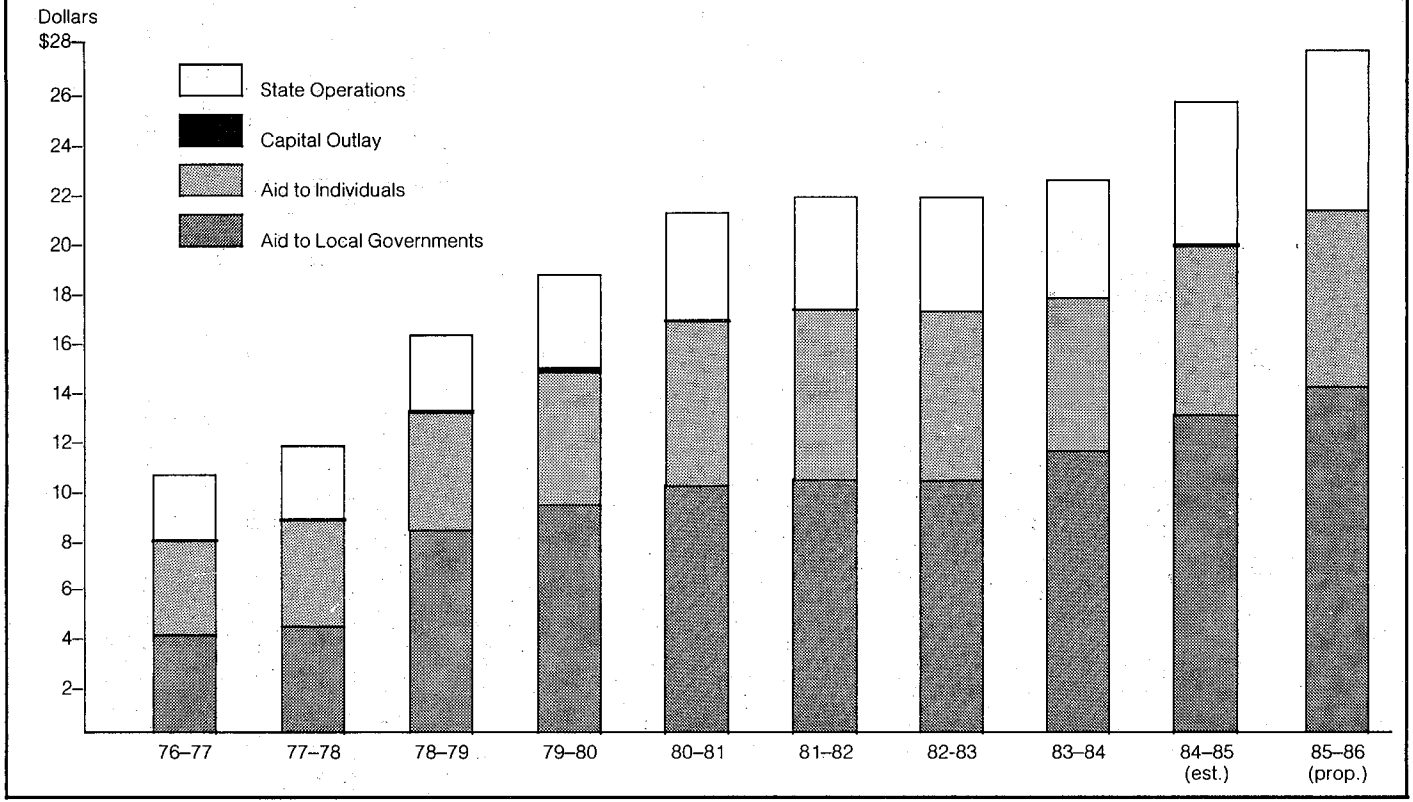
Local Assistance

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	
	Percent	Dollar	Percent	Dollar	Percent	Budget as
Department/Program	Increase	Increase	Increase	Increase	Increase	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.

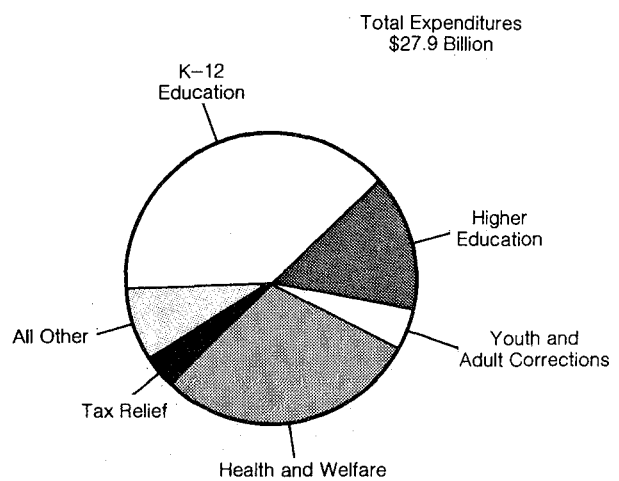
PROGRAM EXPENDITURES

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)

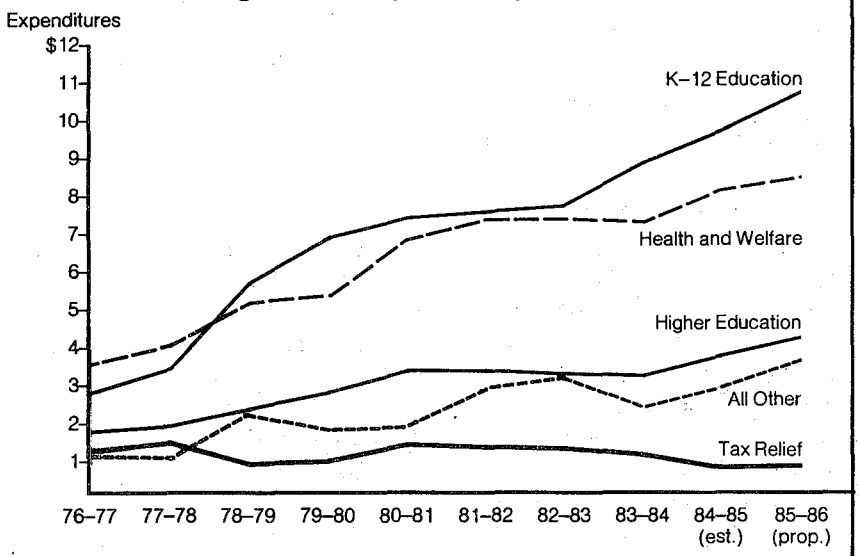


Table 17
Estimated General Fund Program Changes [a]
1984–85 and 1985–86
(dollars in millions)

	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).

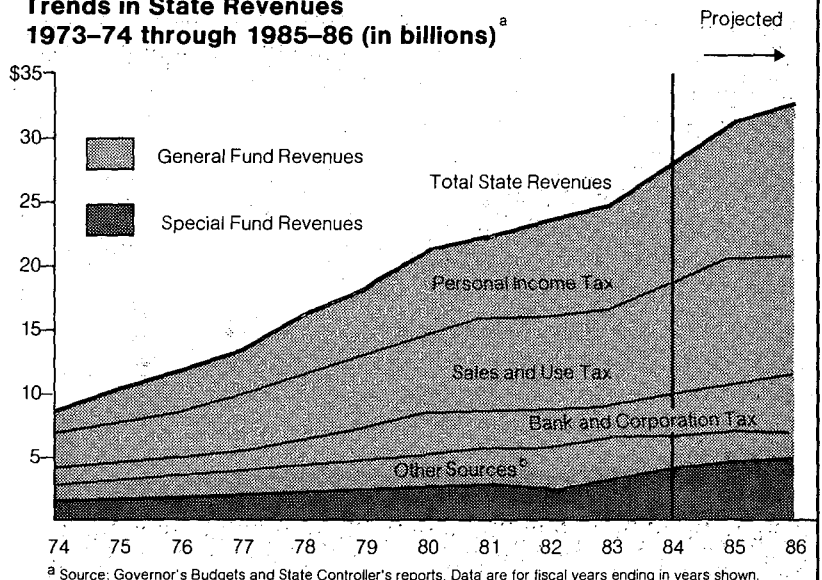
Table 18
Revenue Summary
General Fund and Special Funds
1983–84 through 1985–86
(dollars in millions) [a]

	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

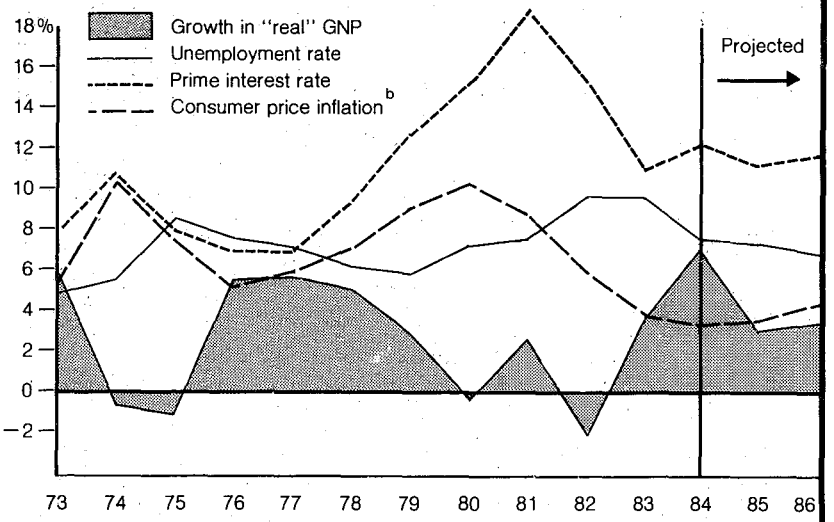
Economic Indicator	*1984 Estimated* [b]	*1985 Projected*	*1986 Projected*
1. *National Economy*			
Percent change in:			
—Real GNP	6.9%	3.0%	3.3%
—Personal income	9.9	7.5	7.4
—Pre-tax corporate profits	15.5	2.0	15.1
—Wage and salary employment	4.4	2.6	2.0
—Civilian employment	4.0	2.2	2.1
—GNP prices	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]	Original Forecasts: Other Forecasters [b] Lowest	Original Forecasts: Other Forecasters [b] Average	Original Forecasts: Other Forecasters [b] 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.

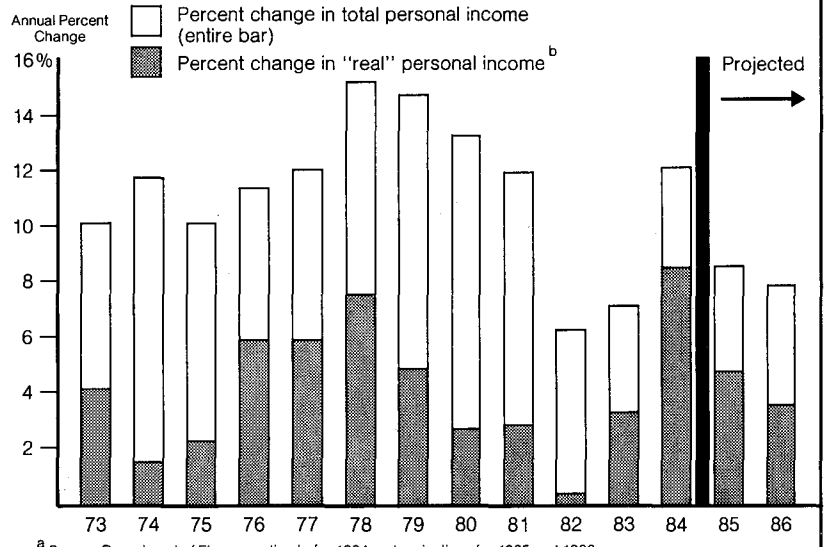
California To Outperform Nation

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

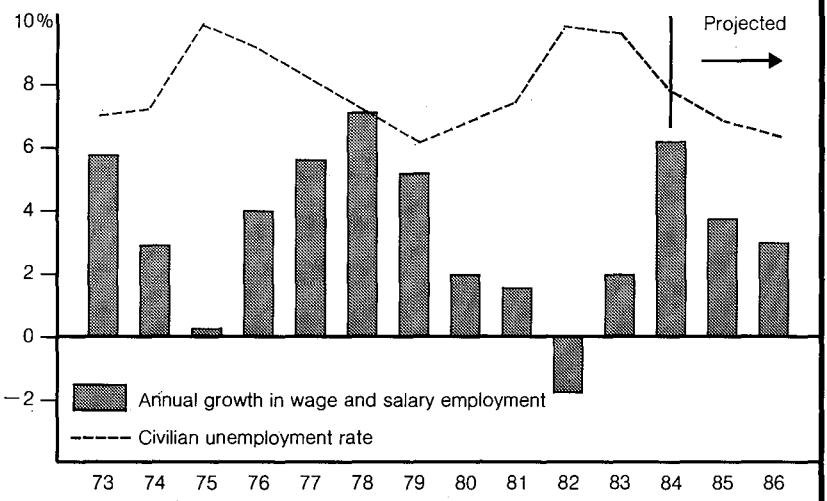
Annual Growth in California Personal Income 1973 through 1986 [a]



[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]

Year	Labor Productivity Growth	Growth in Hourly Labor Compensation	Growth in Unit Labor Costs [b]	Inflation Rate: GNP Deflator Total	Inflation Rate: GNP Deflator Consumption	Inflation Rate: 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]

Period	*Percent Difference Between Actual Revenues and:* 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

Calendar Year	Percent Change In: Adjusted Personal Income [a]	Civilian Employment	Average Real Income Per Employee [b]	Indexing Adjustment Factor [c]	Implied Tax Liabilities [d]	Elasticity of Tax Liabilities with Respect to Income [e]
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.)

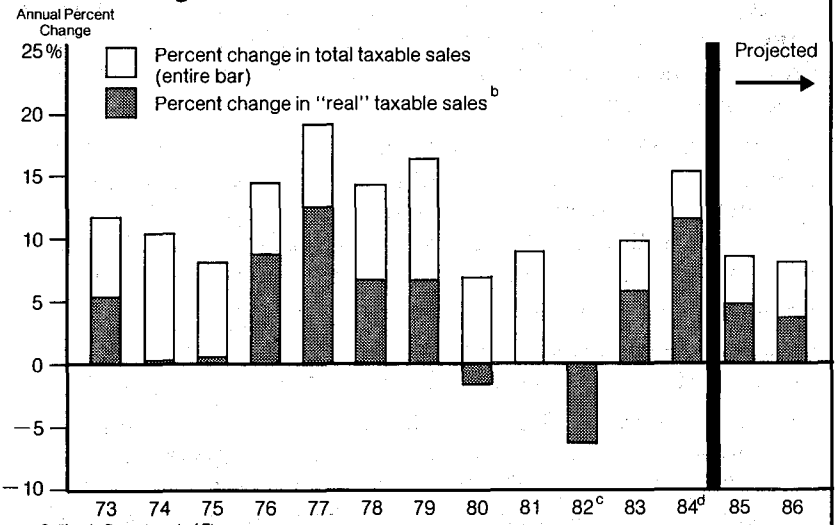
- ***Energy Tax Credit Proposal.*** The revenue projection for the budget year also includes $122 million in personal income tax revenues that would result from the Governor's proposal to eliminate the state's current energy tax credit program. The administration proposes to replace the present tax credit 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)

Calendar year	Total Taxable Sales	Percent Change in: Total Taxable Sales	Percent Change in: "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

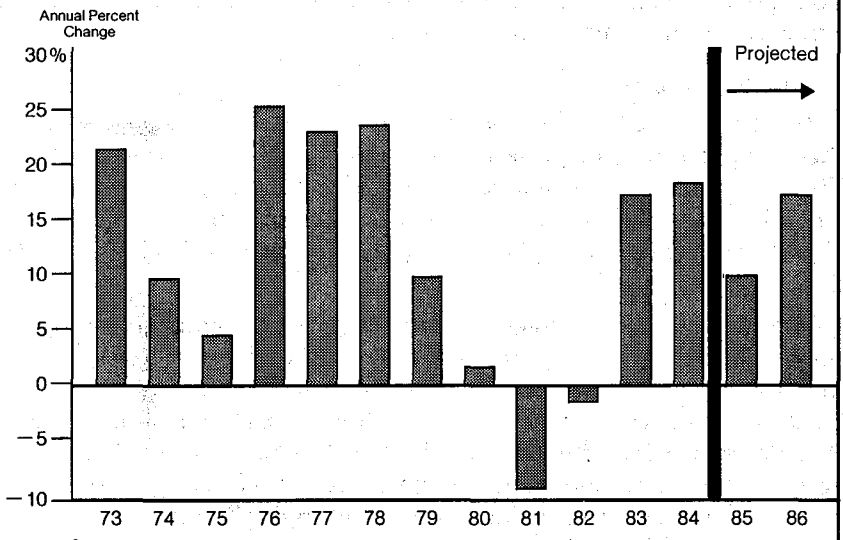
Revenues from the bank and corporation tax are more difficult to project from year-to-year than revenues from any other source. This is because of the inherent volatility of corporate profits, the wide variety of factors which influence profits, the complex prepayment patterns which firms use to remit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

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

Revenue Source	*1985–86*	*1986–87*		*1987–88*	
		Amount	*Change*	*Amount*	*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*	*Out-standing*	*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

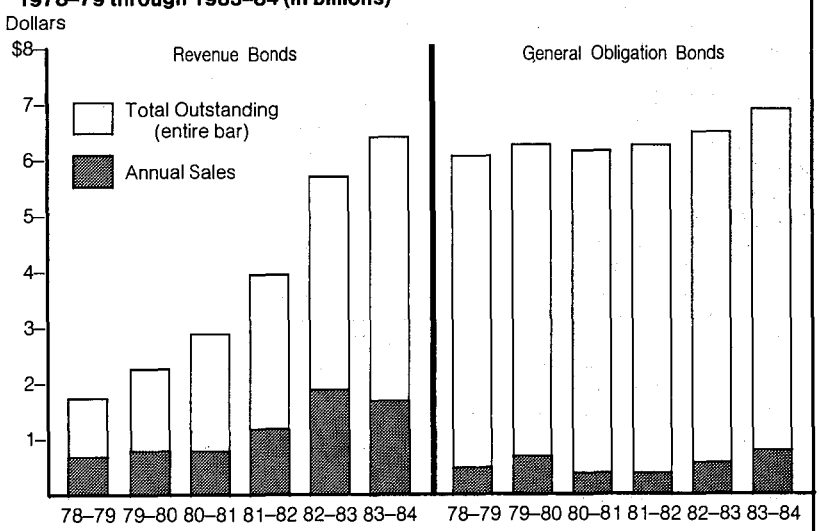
($2.1 billion), the Veterans Revenue Debenture ($656 million), and the California National Guard ($39 million). Bonds issued by two other authorities, the California Pollution Control Authority and the California Health Facilities Authority, also account for significant portions of the revenue bonds 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 obliga-

tion 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

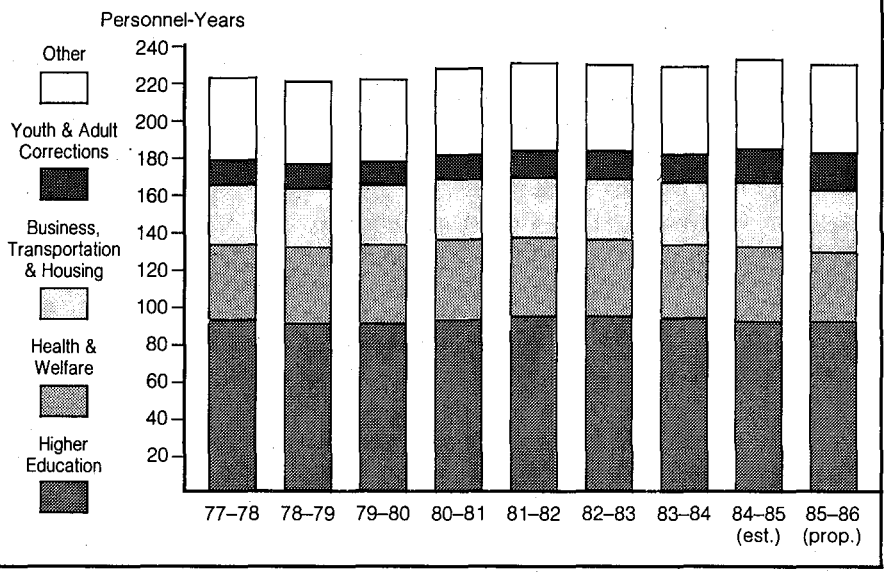
Table 40 indicates that when the budget proposal is compared to the actual number of personnel-years worked in 1983–84, the proposed state work force for the budget year is 1,193 personnel-years higher. Over the two-year period covered by the table, youth and adult correctional programs will increase 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 depart-

ments, 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%

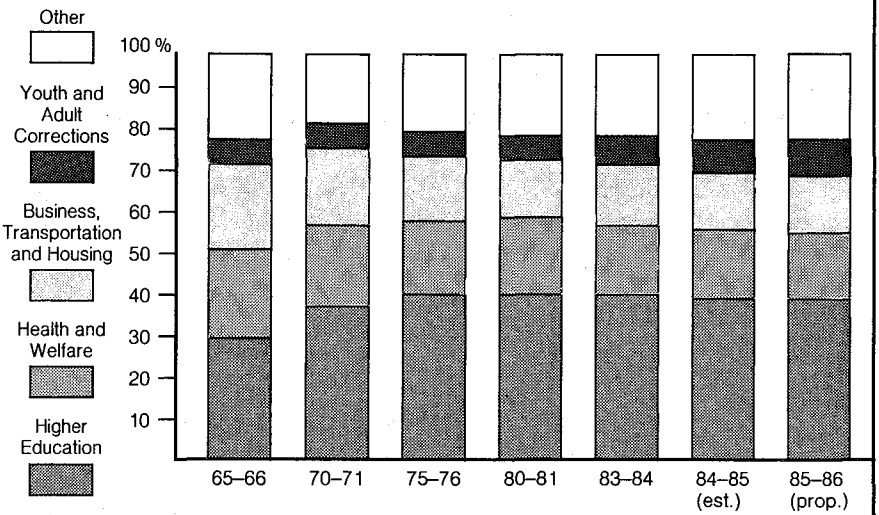
[a] Source: Governor's Budgets and Department of Finance.
[b] Source: Department of Finance and Employment Development Department. Data reported on average employment over a calendar-year. Amounts reflected here are for the concluding year of each fiscal year.

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 Califor-

nia 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.