The 1987-88 Budget : Perspectives and Issues

Report of the Legislative Analyst to the Joint Legislative Budget Committee

California Legislature

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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1987 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 1987–88 and (2) identifying some of the major *issues* facing the Legislature in 1987. Many of these issues are long-range in nature. Even in these cases, however, legislative action during 1987 is warranted since the Legislature generally will have a wider range of options for addressing these issues in 1987 than it will have in subsequent years. As such, this document is intended to complement the *Analysis of the 1987–88 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 generally cut across program or agency lines, and do not necessarily fall under the jurisdiction of a single fiscal subcommittee.

The 1987–88 Budget: Perspectives and Issues is divided into three parts.

Part One, "State Finances in 1987," provides a perspective on the state's current fiscal situation by discussing the state's General Fund condition in 1986 and 1987.

Part Two, "Perspectives on the 1987–88 Budget," presents data on the budget as a whole—expenditures, revenues, bonding activity, and the state's fiscal condition—to provide a perspective on the budget issues that the Legislature will face in 1987. It does so by detailing the total spending plan for the state from all funding sources and highlighting the major changes in program activities proposed by the Governor. It also discusses the various sources of income to the state, as well as the economic circumstances that will influence the level of revenues in the current and budget years. Finally, this part discusses the types and volume of borrowing being done by the state and local governments, and analyzes the reasons for changes in the state's work force in 1987–88.

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 1987–88. Wherever possible, our analysis identifies options which the Legislature may wish to consider in addressing these issues.

Most of the issues in this section fall into four categories. The first is the fiscal constraints facing the state and the counties. The second category deals with program changes that directly affect the state budget: the rising costs of incarceration, the AIDS epidemic, implementation of GAIN, financing community colleges, and California's long-term care system. The third category includes issues the Legislature needs to address in response to federal legislation: tax reform, revenue bond limitations, immigration reform and control, and early education for the handicapped. Finally, there are issues that arise from the growing deferred maintenance and capacity needs of the state's infrastructure systems: prisons, higher education campuses, state hospitals, state office buildings, highways, and sewage treatment facilities.

PART ONE

State Finances in 1987

- ***Fiscal Situation Facing the Legislature***

Part One

STATE FINANCES IN 1987

The Governor's Budget for 1987–88 reflects an anticipated temporary slowdown in the California economy. As a result, projected revenues will not be sufficient to fund both the current level of services and restore the reserve to a $1 billion level. Faced with this choice, the budget gives its highest priority to the restoration of the reserve. For example, about 50 percent of the growth in revenues between the current and budget years is earmarked for the restoration of the reserve, while the remainder would be used to fund changes in expenditure levels.

In terms of inflation-adjusted (real) purchasing power, the level of General Fund revenues is 0.5 percent lower than the level estimated for the current year, while the proposed level of General Fund expenditures is 2.4 percent lower.

Even though state revenues are projected to decline in "real" terms, the state's constitutional limit on appropriations could further restrain the state's ability to maintain the level of services provided to its citizens.

In this part, we provide a brief overview of the state's fiscal condition in 1986 and 1987. We also discuss the state's budget prospects beyond the upcoming year. A more-detailed examination of revenues and expenditures appears in Part Two of this volume.

Fiscal Situation Facing the Legislature

Table 1 provides information on annual General Fund revenues, expenditures and the end-of-year balance, beginning with 1981–82. Trends in General Fund revenues and expenditures are illustrated in Chart 1.

The chart shows that General Fund expenditures have exceeded General Fund revenues in four of the last six years. In 1985–86, expenditures exceeded revenues by almost $770 million, causing a large drop in the end-of-year General Fund balance. In the current year, estimates indicate that expenditures will again exceed revenues. In spite of this deficit, the state's Special Fund for Economic Uncertainties is projected to grow by $115 million, because the excess expenditures will be paid for by funds appropriated for these purposes in prior years. In 1987–88, however, the budget predicts a reversal of this situation. If the Governor's estimates of 1987–88 revenues and expenditures turn out to be accurate, General Fund revenues will exceed expenditures by $478 million.

Chart 1

Comparison of General Fund Revenues and Expenditures

1981-82 through 1987-88 (in billions)

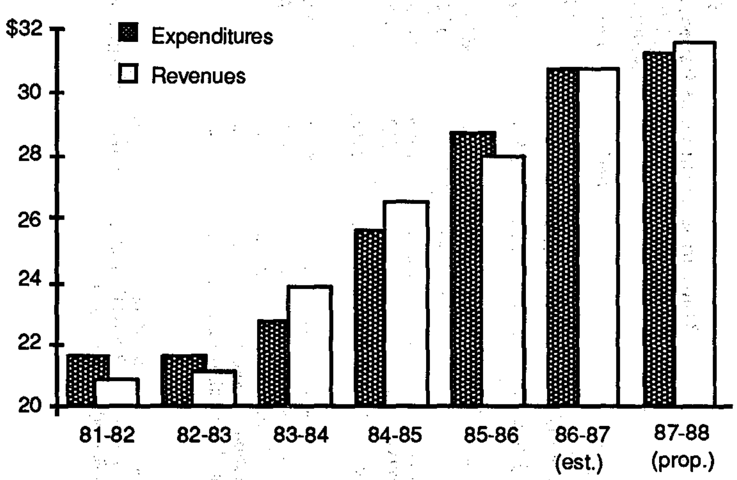


Table 1
Trend in General Fund Revenues, Expenditures and the Surplus [a,b]
1981–82 through 1987–88
(dollars in millions)

	1981–82	*1982–83*	*1983–84*	*1984–85*	*1985–86* [c]	*1986–87* [c]	*1987–88* [c]
Prior year resources	$681.0	–$30.8	–$521.3	$490.6	$1,400.2	$686.3	$561.3
Adjustments to prior year resources	50.0	7.0	57.7	40.1	55.1	—	—
Prior year resources, adjusted	$731.0	–$23.8	–$463.6	$530.8	$1,455.3	$686.3	$561.3
Revenues and Transfers	$20,920.6	$21,231.1	$23,822.1	$26,605.9	$28,072.2	$30,764.8	$31,742.0
Expenditures	$21,682.3	$21,728.6	$22,867.9	$25,736.4	$28,841.3	$30,889.8	$31,263.6
(Difference)	(–761.8)	(–497.5)	(954.2)	(869.5)	(–769.1)	(–125.0)	(478.4)
(Expenditures from reserves)	(274.2)	(–29.3)	(24.1)	(–0.1)	(–88.0)	(142.6)	(4.4)
(Annual surplus or deficit)	(–487.6)	(–526.8)	(978.3)	(869.3)	(–857.1)	(17.6)	(482.8)
General Fund balance	–$30.8	–$521.3	$490.6	$1,400.2	$686.3	$561.3	$1,039.7
Carry-over reserves	(57.8)	(87.1)	(63.0)	(63.1)	(151.1)	(8.5)	(4.1)
Reserve for Los Angeles County Grant Account	—	—	(100.0)	—	—	—	—
Disaster Response-Operations Account	—	—	—	—	(99.6)	(1.6)	(10.0)
Special Fund for Economic Uncertainties	—	—	(327.6)	(1,337.1)	(435.6)	(551.2)	(1,025.6)

[a] Source: State Controller.
[b] Detail may not add to totals due to rounding.
[c] Source: *Governor's Budget*. Data for 1985–86 through 1987–88 are not strictly comparable with prior years due to Generally Accepted Accounting Principles (GAAP)-related adjustments reflected in these years.

According to the budget document, the Governor's spending program for 1987–88 would leave the General Fund with an unrestricted balance of approximately $1.0 billion on June 30, 1988—up from about $551 million at the end of the current year. These funds would be retained in the Special Fund 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 affecting revenues and expenditures, it helps the state provide a continuous and more predictable level of services to its citizens.

General Fund Condition Deteriorates in 1986–87

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

Table 2
Change in General Fund Condition
1985–86 and 1986–87
(dollars in millions) [a,b]

	Condition of the General Fund in 1985–86 as Projected by Governor's Budget		*Effect on*	*Condition of the General Fund in 1986–87 as Projected by Governor's Budget*		*Effect on*
	January 1986	*January 1987*	*1985–86 Surplus*	*January 1986*	*January 1987*	*1986–87 Surplus*
Beginning resources	$1,386	$1,455	$69	$863	$686	−$177
Revenues and transfers	28,187	28,072	−115	31,024	30,765	−259
Expenditures	28,710	28,841	−131	30,699	30,890	−191
General Fund balance	$863	$686	−$177	$1,188	$561	−$627
Reserves [c]	46	251	−205	28	10	18
Unrestricted balance	$817	$436	−$381	$1,160	$551	−$609

[a] Detail may not add to totals due to rounding.
[b] Source: *Governor's Budget.*
[c] Includes unencumbered balance of continuing appropriations, and reserve for Disaster Response-Operations Account.

1985–86. Last year at this time, the Governor's Budget projected that the state would end 1985–86 with an unrestricted balance of $817 million in the General Fund. The 1987 Governor's Budget states that the balance is now expected to be $436 million, or $381 million less than what was estimated one year ago. This decrease results from both higher-than-anticipated expenditures and lower-than-anticipated revenues.

As shown in Table 2, expenditures in 1985–86 were $131 million higher than the amount predicted in last year's Governor's Budget. This change is the net effect of both increases and decreases to the expenditures projected in the Governor's original spending plan. Expenditure increases were primarily the result of legislation ($120 million) and additional deficiencies ($206 million). Expenditure decreases were primarily the result of savings ($64 million) and the fact that $217 million of authorized expenditures—for example, spending for flood-related disaster assistance—did not occur in 1985–86. Most of these authorized expenditures will occur instead in 1986–87.

Table 2 also shows that actual revenues and transfers in 1985–86 were $115 million less than the amount predicted in last year's Governor's Budget. These decreased revenues primarily reflect lower-than-anticipated receipts from state taxes.

1986–87. Relative to estimates made one year ago, the General Fund balance is expected to decline by $627 million in 1986–87, instead of increasing by $325 million as the Governor originally proposed. This large decline is attributable to three factors:

- The General Fund began the current year with a balance which was $177 million lower than originally anticipated;
- Revenue projections are now $259 million lower than estimated in January 1986; and
- Expenditure estimates are now $191 million higher than estimated in January 1986.

Table 2 indicates that 1986–87 General Fund revenue projections have decreased by $259 million. This revenue decrease reflects large shortfalls in state tax receipts, the failure of the Governor's proposal to realize revenue from the sale of land at Agnews State Hospital, and revenue losses due to legislation. The budget anticipates that these decreases will be partially offset by legislation authorizing increased transfers of approximately $78 million.

Table 2 also indicates that 1986–87 General Fund expenditure estimates have increased by $191 million. This increase is the net effect of several large increases, partially offset by other expenditure decreases. Expenditure increases reflect legislation approved by the Legislature and the Governor (approximately $77 million), expenditures authorized in 1985–86 which are expected to occur in 1986–87 ($180 million), and an additional $378 million in expenditures for deficiencies. Anticipated expenditure decreases include $103 million from the Governor's 2 percent reduction in state operating costs, a savings of $159 million from the proposed reversion of funds appropriated for the school maintenance program and for unemployment insurance reimbursements, and an additional $129 million in other identified savings. To the extent that the anticipated state operating cost savings are not realized, or the proposed reversions are not approved, expenditures will be correspondingly higher.

General Fund Condition for 1987–88

If the budget's estimates of revenues and expenditures for 1987–88 turn out to be accurate, revenues will exceed expenditures by $478 million. These excess funds would bring the balance in the Special Fund for Economic Uncertainties up to $1.0 billion, or 3.3 percent of General Fund expenditures.

The 1987–88 budget contains one proposal which distorts the inter-year comparison of the growth in revenues and expenditures. This proposal calls for the elimination of state General Fund subventions to county governments for eight county-operated health programs, and the creation of a new state subvention of unrestricted funds as a replacement. Because the proposal would transfer existing General Fund sales tax revenues to a special fund from which the subventions would be paid, the proposal *reduces* both General Fund revenues and expenditures by $477 million, and increases special fund revenues and expenditures by the same amount. Table 3 shows that total General Fund revenues under current law are projected to increase by $1.5 billion or 4.7 percent, in 1987–88. On this same basis, General Fund expenditures would increase by $851 million, or 2.8 percent.

Table 3
Comparison of General Fund Revenues and Expenditures Adjusted for Proposed County Health Services Funding Shift (dollars in millions)

			Difference	
Revenues	*1986–87*	*1987–88*	*Amount*	*Percent*
Governor's Budget	$30,765	$31,742	$977	3.2%
Proposed sales tax transfer	—	477	477	—
Existing law	$30,765	$32,219	$1,454	4.7%
Expenditures				
Governor's Budget	$30,890	$31,264	374	1.2%
Proposed county health transfer	—	477	477	—
Existing law	$30,890	$31,741	$851	2.8%

Consistent with past years, the largest increase in 1987–88 is proposed for education, which would gain $452 million, or 2.7 percent, in additional General Fund support. However, this increase is much smaller than the current year's; 1986–87 saw education receive an additional $1.2 *billion,* or 7.5 percent, in General Fund support. The second largest increase is for youth and adult correctional programs, which would gain $162 million, or 9.5 percent, in additional General Fund support. This increase is also much smaller than the current year's; 1986–87 saw the correctional programs receive $272 million, or 19 percent, in additional General Fund support.

As we discuss in Part Two of this volume, the budget's estimate of 1987–88 expenditures understates the amount needed to provide the level of services proposed by the Governor. Our analysis also indicates that revenues could turn out to be higher than the budget projects, especially if the consensus view of the economy's behavior materializes. Given the considerable uncertainty that characterizes the proposed budget's estimates of revenues and expenditures and the potential for reductions in federal funding, the General Fund's end-of-year balance could vary considerably from the level estimated in the budget.

PART TWO

Perspectives on the 1987-88 Budget

- *Expenditures in 1987-88*
- *Revenues in 1987-88*
- *State and Local Borrowing*
- *The State's Work Force*

Part Two

PERSPECTIVES ON THE 1987-88 BUDGET

This part of our analysis provides perspectives on the Governor's Budget for 1987–88. It consists of four major sections:

- ***Expenditures.*** This section presents an overview of the spending plans proposed in the Governor's Budget. It discusses the level of proposed expenditures, the major components of the budget, and the major program changes proposed in the budget. It also identifies some of the likely state expenditures that are not funded in the budget.
- ***Revenues.*** This section provides a perspective on the state's economy in 1986, 1987, and 1988, and the outlook for the economy in succeeding years. It also includes an analysis of revenue collections in the 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 conducted by the state and local governments. It also includes a brief review of certain borrowing-related policy issues that will influence the level of borrowing in the current and budget years.
- ***The State's Work Force.*** This section analyzes the reasons for changes in the state's work force in 1987-88. It also examines historical trends that account for the changes in state employment in recent years.

Expenditures in 1987–88

TOTAL STATE SPENDING PLAN

The Governor's Budget for 1987–88 proposes total expenditures of $66.4 billion. This amount includes:

- $39.1 billion in *state expenditures,* consisting of $31.3 billion from the General Fund, $6.7 billion from special funds, and $1.1 billion from selected bond funds;
- $15.2 billion in expenditures from *federal funds;* and
- $12.1 billion in expenditures from various "*nongovernmental cost*" funds, including funds established for retirement, working capital, public service enterprise, and other purposes.

Table 4
Total State Spending Plan [a]
1985–86 through 1987–88

	Actual 1985–86	Estimated 1986–87 Amount	Estimated 1986–87 Percent Change	Proposed 1987–88 Amount	Proposed 1987–88 Percent Change	Proposed 1987–88 Dollar Change
General Fund	$28,841.3	$30,889.8	7.1%	$31,263.6	1.2%	$373.8
Special funds	5,190.3	5,949.8	14.6	6,665.5	12.0	715.7
Budget Expenditures	$34,031.6	$36,839.6	8.3%	$37,929.1	3.0%	$1,089.5
Selected bond funds	945.1	1,775.3	87.8	1,124.3	−36.7	−651.0
State Expenditures	$34,976.7	$38,614.9	10.4%	$39,053.4	1.1%	$438.5
Federal funds	14,280.3	15,350.6	7.5	15,160.5	−1.2	−190.1
Governmental Expenditures	$49,257.0	$53,965.5	9.6%	$54,213.9	0.5%	$248.4
Nongovernmental cost funds	10,420.8	11,556.3	10.9	12,143.6	5.1	587.3
Total State Spending	$59,677.8	$65,521.8	9.8%	$66,357.5	1.3%	$835.7

[a] Source: Governor's Budget. Detail may not add to totals due to rounding

Governmental Expenditures

The budget proposes expenditures from governmental funds—that is, total state spending less expenditures from nongovernmental cost funds—amounting to $54.2 billion in 1987–88. This represents a $248 million, or 0.5 percent increase from the estimated current year level. This increase is the net effect of a $1.1 billion increase in budget expenditures—General Fund and special funds, and an $841 million *decrease* in combined federal fund and selected bond fund expenditures.

Using this measure of expenditures, during 1987–88, the state will spend $1,980 for every man, woman and child in California, or $148 million per day.

State Expenditures

That portion of the state spending plan financed by state revenues deposited in the General Fund or state special funds is usually referred to as "state expenditures." As shown in Table 4, state expenditures are proposed to total $39.1 billion in 1987–88, which is 1.1 percent higher than state expenditures in the current year. This compares with an increase of 10.4 percent between 1985–86 and the current year.

General Fund Expenditures

The budget proposes General Fund expenditures of $31.3 billion—nearly one-half of all expenditures that will occur under the state's auspices.

Chart 2

Annual Growth in General Fund Expenditures
1981-82 through 1987-88 (in billions)

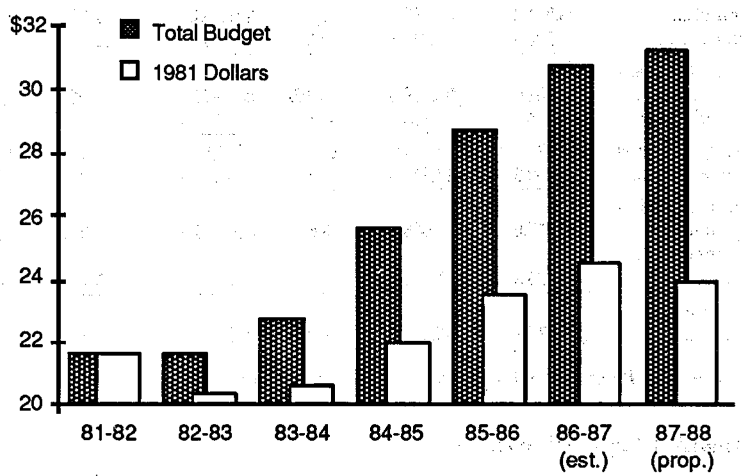


Chart 2 and Table 5 show the trend in General Fund expenditures since 1981–82. Chart 2 displays expenditures both on a "current dollar" and "real dollar" basis. Expenditures in "real dollars" represent expenditure levels as they appear in the budget (that is, "current dollars"), adjusted for the effect of inflation since 1981. Presenting the budget totals in terms of "real dollars" allows expenditure levels in different years to be compared on a common basis.

Table 5
Annual Change in General Fund Expenditures
1981–82 through 1987–88
(dollars in millions)

	Total General Fund Budget[a]			
	"Current Dollars"		*"Real (1981) Dollars"*	
	Amount	*Change*	*Amount*[b]	*Change*
1981–82	$21,682	—	$21,682	—
1982–83	21,729	0.2%	20,495	−5.5%
1983–84	22,868	5.2	20,618	0.6
1984–85	25,736	12.5	22,035	6.9
1985–86[c]	28,841	12.1	23,608	7.1
1986–87 estimated[c]	30,890	7.1	24,522	3.9
1987–88 proposed[c]	31,264	1.2	23,922	−2.4

[a] Source: State Controller.
[b] "Real dollars" equal current dollars deflated to 1981–82 dollars using the Gross National Product implicit price deflator for state and local purchases of goods and services.
[c] Source: *Governor's Budget*. Data for these years are not strictly comparable to data for the prior years due to the effect of accounting changes.

In current dollars, the proposed General Fund budget for 1987–88 is 44.2 percent greater than it was in 1981–82. In terms of "real dollars," however, the increase proposed in the General Fund budget is 10.3 percent.

As shown in Chart 2 and Table 5, between 1981–82 and 1982–83 total General Fund expenditures in "real dollars" actually *declined* by 5.5 percent, as the state experienced the effects of the nation-wide recession. In 1983–84 "real" General Fund expenditures increased by less than 1 percent. In 1984–85 and 1985–86, however, "real" General Fund expenditures headed upward, in line with the expansion of the state's economy. For these two years, total General Fund expenditure growth averaged over 12 percent in current dollars and 7 percent in real dollars. Estimated expenditures for the current year are expected to continue this growth trend, though at a much slower rate than during the preceding two years.

The level of General Fund expenditures proposed for 1987–88 would reverse the upward trend of real expenditure growth that began in 1983–84. In current dollars, the amount of General Fund expenditures proposed for 1987–88 is 1.2 percent greater than the current year amount, which represents the smallest year-to-year increase since 1982–83. In fact, this expenditure level translates into a *decrease* in purchasing power of 2.4 percent, based on an estimated inflation rate of 3.7 percent in the budget year.

The decrease in the rate at which General Fund expenditures are proposed to grow in the budget year reflects slower-than-normal growth in General Fund revenues, as well as the Governor's proposal to increase the balance in the Special Fund for Economic Uncertainties. The budget anticipates that revenues deposited in the General Fund will increase by only 3.2 percent, compared to the 9.6 percent growth estimated for the current year. In part, this reflects the Governor's proposal to deposit $477 million of state sales tax revenues in a special fund for distribution to county governments. Without this proposal, the General Fund revenue increase would be 4.7 percent. In order to restore the level of the state's Special Fund for Economic Uncertainties, the Governor's Budget proposes to use $475 million of the budget year revenue growth to raise the end-of-year balance in this fund to $1,026 million.

Federal Fund Expenditures

Federal fund expenditures account for 28 percent of the *governmental* expenditures (that is, total expenditures less nongovernmental cost funds) which the Governor's Budget proposes for 1987–88. As shown in Table 6, this percentage has been declining for the past five years. The level of federal fund expenditures anticipated in 1987–88—$15.2 billion—represents a decrease of $190 million, or 1 percent, below the estimated 1986–87 level. This decrease reflects the net effect of increases and decreases in federal receipts for several programs, as well as the accounting treatment of funds received in prior years.

Table 6
Federal Fund Expenditures as a Percent of Total State Expenditures [a,b]
1981–82 through 1987–88
(dollars in millions)

	General Fund	*Special Funds*	*Federal Funds*	*Selected Bond Funds*	*Totals*	*Federal Funds as Percent of Total*
1981–82	$21,682	$3,099	$10,863	$230	$35,874	30%
1982–83	21,729	3,180	12,255	399	37,562	33
1983–84	22,868	3,527	12,454	400	39,250	32
1984–85	25,736	4,651	13,372	588	44,348	30
1985–86 [c]	28,841	5,190	14,280	945	49,257	29
1986–87 estimated [c]	30,890	5,950	15,351	1,775	53,966	28
1987–88 proposed [c]	31,264	6,666	15,161	1,124	54,214	28

[a] Excludes nongovernmental cost funds. Detail may not add to totals due to rounding.
[b] 1981–82 through 1984–85 data from State Controller.
[c] Source: *Governor's Budget.*

While the projected decrease in total federal spending between the current and budget years is relatively small (1 percent), the budget reflects several major increases and decreases in individual program areas. These changes are shown in Table 7.

The most significant reduction—$125 million in health and welfare—is primarily due to a $188 million decrease in Job Training Partnership Act (JTPA) funds expended by the Employment Development Department. This "reduction" is somewhat misleading. This is because funds received in 1985–86 and earlier years were not expended until the current year, thereby artificially "inflating" the level of current year expenditures. This decrease in JTPA expenditures is partially offset by increased spending for other health and welfare programs, including an increase of $61 million

Table 7
Federal Funds Changes, By Program [a]
1986–87 and 1987–88
(dollars in millions)

Program	*Estimated 1986–87*	*Proposed 1987–88*	*Change Amount*	*Change Percent*
Legislative/Judicial/Executive	$39	$58	$19	49%
State and Consumer Services	22	21	−1	−5
Business, Transportation and Housing	1,472	1,380	−92	−6
Resources	202	167	−35	−17
Health and Welfare	9,065	8,941	−125	−1
Youth/Adult Corrections	1	1	0	0
K–12 Education	1,156	1,138	−18	−2
Higher Education	2,863	2,939	76	3
Other Governmental Units/Services	530	515	−15	−3
Totals	$15,351	$15,161	−$190	−1%

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.

due to cost-of-living adjustments and caseload increases. Federal fund expenditures for health programs would be even higher were it not for the Medi-Cal cost reduction program ($150 million in federal funds savings) reflected in the Governor's Budget.

The budget also anticipates large net reductions in federal spending for business, transportation, and housing programs. Table 7 shows a decrease of $92 million for these programs between the current and budget years. This figure primarily reflects a $102 million net decrease in federal funds expended by the Department of Transportation—a decrease of $67 million for capital outlay funds and a $53 million decrease in local assistance transportation programs, partially offset by an $18 million increase in federal funds for the support of engineering and design projects.

Federal expenditures for resources programs show a net reduction of $35 million. This change primarily reflects a reduction of $66 million in federal Outer Continental Shelf Lands Act (8g) funds, partially offset by an increase of $33 million in Petroleum Violation Escrow Account expenditures.

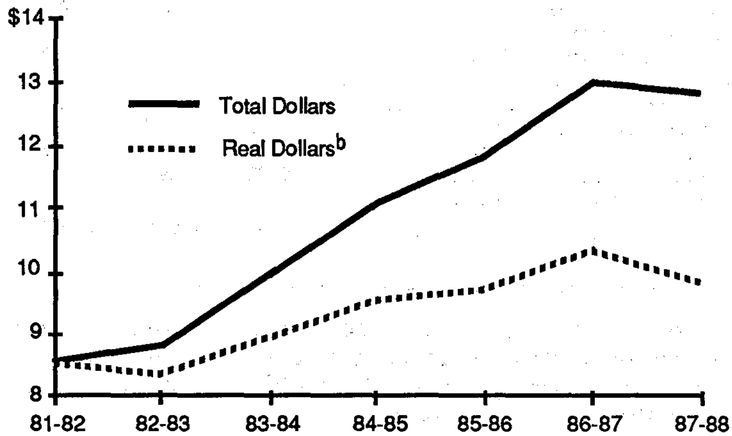
Table 7 also shows that the amount of federal funding provided to the state's higher education segments is expected to increase by $76 million in 1987–88. Three items account for this increase: (1) $87 million for Department of Energy laboratories at the University of California; (2) $17 million for federal research contracts at the University of California; and (3) $8.4 million for student aid at the California State University and the University of California. These increases are partially offset by a $36 million reduction in funds provided for the purchase of defaulted student loans under the Guaranteed Student Loan program.

Federal Aid Trends. The amount of federal aid to California has experienced expansions and contractions since 1981–82, as shown in Chart 3.

Chart 3

Expenditures of Federal Aid Granted to the State of California[a]

1981-82 through 1987-88 (in billions)



[a] Excludes federal expenditures for unemployment insurance and administration.

[b] "Real" dollars equal total dollars deflated to 1981-82 dollars using the GNP price deflator for state and local purchases of goods and services.

In order to give a truer picture of federal expenditures during the last six years, we have adjusted total federal fund expenditures by the state to *exclude* expenditures of federal unemployment insurance (UI) funds. These expenditures have been unusually volatile, ranging from a low of $2.3 billion to a high of $3.5 billion during the period. Changes in UI expenditures primarily reflect changes in economic conditions, and thus tend to obscure the underlying trends in federal grants-in-aid to California.

In terms of "current dollars," adjusted federal expenditures have grown from $8.5 billion in 1981–82 to $12.8 billion in 1987–88, an increase of approximately 50 percent. This represents a 7.1 percent average annual rate of growth over the six-year period. When expressed in "real dollars," however, the level of federal aid anticipated in 1987–88 (excludng unemployment insurance funds) is only 14 percent more than the amount of federal aid actually received by the state in 1981–82. This represents a 2.5 percent average annual rate of growth.

Impact of Current Efforts to Reduce Federal Spending

In December 1985, the President signed legislation containing the so-called Gramm-Rudman-Hollings (GRH) balanced budget amendment. The amendment requires a balanced federal budget by federal fiscal year (FFY) 1991, and requires automatic across-the-board spending reductions if deficit targets are not met. Federal grants-in-aid to state and local governments, with certain exceptions, are subject to these automatic provisions.

On February 1, 1986 the President issued an order to implement the automatic spending reductions required by the amendment. Shortly thereafter, the United States District Court for the District of Columbia declared the automatic deficit reduction process unconstitutional. In July 1986 this decision was affirmed by the United States Supreme Court. By invalidating the automatic reduction provisions of GRH, the amendment's ability to reduce the budget was significantly constrained. While the deficit maximums of $144 billion and $108 billion for FFYs 1987 and 1988 still exist in law, the achievement of these targets essentially rests with the budget process, as it did prior to GRH.

The *Budget of the United States Government,* submitted by the President to Congress on January 5, 1987, proposes to achieve the deficit reduction target for FFY 1988. Preliminary information indicates that major decreases in federal funding to California would result from the President's budget. The largest reductions would come in the areas of welfare and transportation. The Governor's Budget, however, does not reflect the cuts in federal funding that would occur if the President's budget were to be enacted as submitted.

Total State and Local Government Spending in California

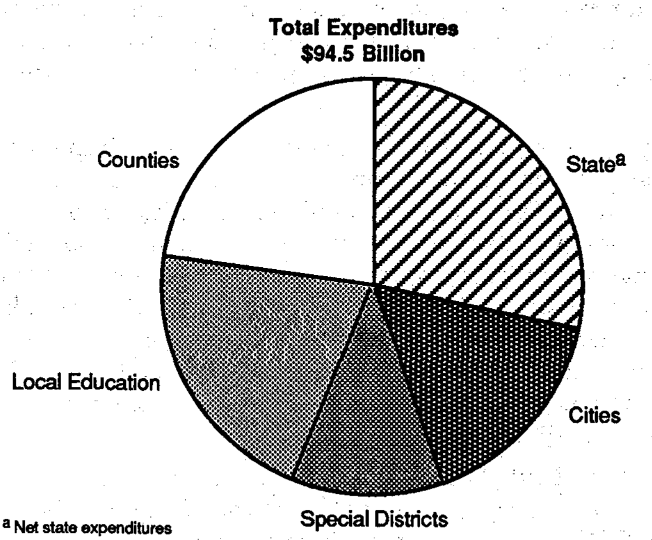
Local governments also are a significant contributor to public sector spending in California. Because local agencies receive a substantial portion of their resources from the state, however, their expenditures cannot simply be added to those of the state in order to determine aggregate government spending.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

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 1986–87 expenditures by each governmental category 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.

Chart 4

Total State and Local Government Expenditures 1986-87



[a] Net state expenditures

In the current year, expenditures for all services provided by state and local governments in California are expected to total approximately $94.5 billion. This amount consists of approximately $27 billion in net state expenditures (that is, state expenditures net of funds provided to local governments) and approximately $68 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.

Net state spending—$26.8 billion—amounts to only half of what the state spends from governmental sources ($52.9 billion) and indicates just how much "state money" actually is spent at the local level. These state funds, which total $26.1 billion in the current year, show up as local government spending in Table 8. About one-half of this amount is state aid to local school districts ($13.1 billion).

Table 8 provides a perspective on government sector spending in California over the past three years. It shows that the relative share of total state and local government expenditures accounted for by each level of government has remained virtually unchanged.

Table 8
Estimated Total State and Local Government Expenditures [a]
1984–85 through 1986–87
(dollars in millions)

	1984–85		1985–86		1986–87	
Government Entity	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*	*Expenditures*	*Percent of Total*
Counties	$16,800	21.7%	$18,865	21.9%	$21,284	22.4%
Cities	12,609	16.3	13,928	16.2	15,385	16.3
Special Districts	9,259	12.0	9,259	10.8	10,826	11.5
Local Education [b]	16,637	21.5	18,761	21.8	20,160	21.4
Subtotal, Local Government	($55,305)	(71.6%)	($60,813)	(70.7%)	($67,655)	(71.6%)
State [b]	43,745	—	49,208	—	52,895	—
Less: Amount expended by local governments	−21,781	—	−23,952	—	−26,061	—
Subtotal, State (net)	($21,964)	(28.4%)	($25,256)	(29.3%)	($26,834)	(28.4%)
Totals, state and local expenditures	$77,269	100.0%	$86,069	100.0%	$94,489	100.0%

[a] Local government expenditure data for 1984–85 are from *State Controller's Report on Financial Transactions.* Figures for 1985–86 and 1986–87 represent Legislative Analyst's Office estimates. All data include enterprise fund transactions. State government and local education data are taken from *Governor's Budgets.* Detail may not add to totals due to rounding.

[b] Includes spending attributable to state lottery operations, including administrative expenses.

TAX EXPENDITURES

In addition to the $39.1 billion in total state funds which the Governor's Budget requests for *direct* expenditure programs in 1987–88, the budget also proposes over $16.9 billion of *indirect* spending in the form of "tax expenditures."

Tax expenditure programs (TEPs) 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. These TEPs are provisions of the tax code which are used to either encourage specific types of economic behavior, or provide general or selective tax relief.

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

The Volume of Tax Expenditures. Table 9 shows our estimates of the revenue losses from state-level TEPs in 1987–88. These estimates are contained in our report entitled *Analysis of the 1987–88 Tax Expenditure Budget* (January 1987), which was prepared in response to Assembly Concurrent Resolution 17 (1985). This measure also established a tax expenditure budget review process, and requires us to report on the costs and effectiveness of TEPs on an ongoing basis.

The table indicates that the cost of state-level TEPs (which are primarily General Fund costs) is estimated to total at least $16.9 billion in 1987–88, an increase of 7.8 percent. The full cost of TEPs is unknown, because insufficient data exist to measure the revenue losses from many of the programs. As a result, TEPs will reduce, by about 32 percent, the amount of revenues which otherwise would be collected from the state's "basic" tax structure. The largest single category of these TEPs, expected to total $12.2 billion in 1987–88, includes the various exemptions, deductions, and credits permitted under the personal income tax. The largest individual tax expenditure program is the deductibility of mortgage interest expenses ($2.5 billion), followed by the nontaxability of employer contributions to pension plans ($2.1 billion), and the exemption from the sales tax of food products ($1.5 billion). Altogether, we estimate that there are over 230 other state-level TEPs which will be in effect during 1987–88, plus an additional 65 local property tax TEPs which the state partially funds through subvention payments.

Table 9
State Tax Expenditures [a]
1987–88
(dollars in million)

Tax Expenditure Category	*Amount*	*Percent of Total Identifiable State-Level Tax Expenditures*
Personal income tax	$12,241	73%
Sales and use tax	3,899	23
Bank and corporations tax	386	2
Other state taxes	331	2
Totals, all categories	$16,857	100%

[a] Source: Legislative Analyst's Office.

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 by 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 governments for the cost of certain mandates.

Impact of Article XIII B in 1987–88. Table 10 shows what the Department of Finance estimates the state's appropriations limit to be, as well as total appropriations subject to limitation from 1985–86 through 1987–88. It also shows our estimates of both the limit and the appropriations that are subject to it for 1986–87 and 1987–88. The department estimates that if the Governor's Budget is approved, the state would be $80 million below its limit for 1987–88. Our analysis indicates that the Governor's Budget, as submitted, calls for appropriations that exceed the appropriations limit by $587 million.

Table 10
Impact of Article XIII B on the State [a]
1985–86 through 1987–88
(dollars in millions)

		1986–87		*1987–88*	
	1985–86	*Department of Finance*	*Legislative Analyst*	*Department of Finance*	*Legislative Analyst*
Appropriations limit	$22,962	$24,159	$24,175	$25,273	$24,800
Appropriations subject to limitation	22,467	23,738	24,396	25,193	25,387
Difference	−$495	−$421	$221	−$80	$587

[a] Source: *Governor's Budget* and Legislative Analyst's Office.

Prior to the current year, there has been a large gap between the limit and appropriations subject to limitation. This has been the case for two reasons. First, the state appropriated more funds in the base year (1978–79) than it took in as tax revenue. Thus, under existing tax laws, the state was not in a position to continue spending up to its limit until revenues caught up. Second, during the early 1980s high rates of inflation caused the limit to rise rapidly, while the recession which began in 1981–82 restrained the growth in the state's tax revenues. Thus, during these years, the growth in the limit exceeded the state's ability to increase its expenditures.

During the current year, however, the appropriations limit and the state's appropriations which are subject to it have converged. We estimate that during 1986–87, *if current estimates of revenues and expenditures remain unchanged,* the state will exceed its limit by $221 million, unless the Governor and the Legislature take corrective action. As Table 10 indicates, we also expect the state to exceed its appropriations limit during the budget year, given the anticipated level of state revenues and the expenditure program proposed by the Governor's Budget.

The difference between our estimate and the Department of Finance's is primarily attributable to one issue: Do the state's payments to the State Teachers' Retirement System and to reimburse school districts for court-ordered desegregation costs qualify for exclusion from the limit under Article XIII B's definition of "court mandates"? The Legislative Counsel has issued opinions indicating that these payments do *not* qualify for exclusion. As a result, our estimates reflect these payments as appropriations subject to limitation. The Department of Finance, however, has excluded them.

If actual revenues differ from those projected in the budget, this will result in a dollar for dollar increase or decrease in the state's conformity with the limit. This is because at year end, all unappropriated revenues are automatically appropriated to the Special Fund for Economic Uncertainties, and appropriations into this reserve fund are required to be included in the amount of "appropriations subject to limitation." These issues are discussed more fully in Part Three of this volume.

Prediction or Plan?

It should be noted that the budget estimates are not *predictions* of how much ultimately will be spent in 1987–88, although these estimates reflect numerous 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, 1988, expenditures (and revenues) will be revised by the Governor, the Legislature, changing economic conditions, court orders, and other factors. Thus, as in past years, actual revenues and expenditures are likely to be substantially 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 of General Fund expenditures with actual expenditures during the past six years.

Table 11
Proposed and Actual General Fund Expenditures
1981–82 through 1986–87
(dollars in millions)

	Budget as Submitted [a]	*Actual Expenditures* [b]	*Change*	
			Amount	*Percent*
1981–82	$20,799	$21,682	$883	4.2%
1982–83	23,203	21,729	−1,474	−6.4
1983–84	21,677	22,868	1,191	5.5
1984–85	25,076	25,736	660	2.6
1985–86	27,864	28,841 [a]	977	3.5
1986–87	30,699	30,890 [a]	191	0.6

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

As Table 11 shows, actual expenditures exceeded the amount originally proposed by the Governor in five of the last six years—usually by substantial margins. Only once during this six-year period—in 1982–83—was the actual amount spent *less* than the amount initially proposed for expenditure. The large decrease in actual versus budgeted expenditures for 1982–83—$1.5 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.

In the current year, actual expenditures are projected to exceed the amount originally proposed in the Governor's Budget by $191 million. As a result, General Fund expenditures will exceed General Fund revenues by $125 million, making 1986–87 the second year in a row in which the General Fund has run a deficit. The deficit would be even larger than this amount but for the impact of several administrative actions taken to reduce expenditures in the current year. In addition, this estimate of the deficit reflects legislative proposals contained in the budget to further reduce expenditures and increase revenues in 1986–87.

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.

Table 12
General Fund and Special Fund Expenditures, by Function [a]
1985–86 through 1987–88
(dollars in millions)

		Estimated 1986–87		*Proposed 1987–88*	
General Fund	*Actual 1985–86*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State operations	$7,125	$7,778	9.2%	$8,188	5.3%
Capital outlay	67	15	−77.6	—	—
Local assistance	21,649	23,097	6.7	23,075	−0.1
Aid to individuals	(6,690)	(7,271)	8.7	(7,459)	2.6
Aid to local governments	(14,959)	(15,826)	5.8	(15,616)	−1.3
Totals [b]	$28,841	$30,890	7.1%	$31,264	1.2%
Special Funds					
State operations	$2,258	$2,516	11.4%	$2,692	7.0%
Capital outlay	362	469	29.6	581	23.9
Local assistance	2,558	2,952	15.4	3,380	14.5
Unclassified	12	12	0.0	12	0.0
Totals [b]	$5,190	$5,950	14.6%	$6,666	12.0%

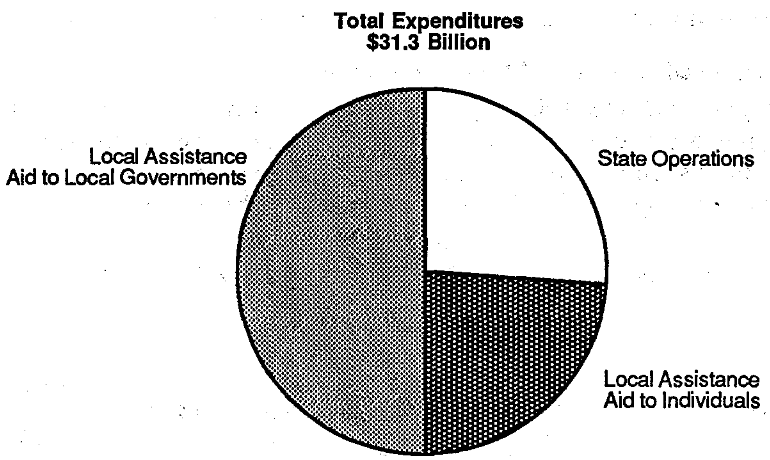
[a] Source: *Governor's Budget.*
[b] Detail may not add to totals due to rounding.

As Chart 5 illustrates, state operations make up 26 percent of total General Fund expenditures in the budget year, while local assistance, as defined in the Governor's Budget, makes up 74 percent.

State Operations

The budget proposes an increase from the General Fund of $410 million, or 5.3 percent, for state operations in 1987–88. General Fund expenditures proposed for state operations in 1987–88 are $8.2 billion, or 82 percent, above what they were six years ago (1981–82). When adjusted for inflation, however, expenditures for state operations have increased by $1.8 billion, or 39 percent, during this period.

Chart 5
1987-88 General Fund Budget Structure



Capital Outlay

The budget proposes no General Fund expenditures for capital outlay in 1987–88. General Fund capital outlay expenditures over the past six years have fluctuated between zero and $67 million. During this period, most capital outlay programs have been funded by bond revenues or tidelands oil revenues.

Local Assistance

The budget proposes General Fund expenditures of $23.1 billion for local assistance in 1987–88. This amount represents a decrease of $22 million from the current year level. The amount proposed for local assistance in 1987–88 is $5.9 billion, or 34 percent, higher than the amount expended for these purposes six years ago (1981–82). When adjusted for inflation, however, expenditures for local assistance have increased by only $472 million, or 2.7 percent, during this period.

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 programs which make payments through intermediaries are the Supplemental Security Income/State Supplementary Program (SSI/SSP), which is administered by the federal government, and the Aid to Families with Dependent Children (AFDC) program, which is administered by county governments.

Aid to Individuals. Table 13 identifies 10 General Fund-supported local assistance programs which our analysis indicates are appropriately categorized as "Aid to Individuals." Overall, the Governor's Budget proposes an increase of $188 million, or 2.6 percent, for these programs in the budget year. On a program-by-program basis, the Governor proposes increases for five of these 10 programs, no change in funding for two, and slight reductions for three.

Table 13
Major General Fund-Supported Local Assistance Programs Providing Aid to Individuals 1985–86 through 1987–88 (dollars in millions)

Program	*Actual 1985–86*	*Estimated 1986–87*	*Governor's Budget 1987–88*
Medi-Cal [a]	$2,306	$2,399	$2,391
AFDC [b]	1,790	1,952	1,985
SSI/SSP	1,408	1,638	1,768
Developmental Services	345	427	452
Renters' Tax Relief	453	466	475
Homeowners Property Tax Relief	334	338	343
Senior Citizens Renters' Tax Relief	29	25	20
Senior Citizens Property Tax Assistance	6	5	4
Senior Citizens Property Tax Deferral	5	7	7
Subventions for Open Space	14	14	14
Totals [c]	$6,690	$7,271	$7,459

[a] Excludes county administration.
[b] Grant payments only.
[c] Detail may not add to totals due to rounding.

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 a reduction in funding for these programs of approximately $210 million, or 1.3 percent, below current year levels. This decrease primarily reflects the proposed elimination of $477 million in state subventions for County Health Services programs. (These funds would be replaced by a new special fund subvention.) Adjusting for this change, funding for all other programs would actually increase by $268 million, or 1.7 percent, above current year levels. This change is primarily the result of a 2.2 percent funding increase proposed for K–12 education.

Table 14
Major General Fund-Supported Local Assistance Programs Providing Aid to Local Governments 1985–86 through 1987–88 (dollars in millions)

Program	*Actual 1985–86*	*Estimated 1986–87*	*Governor's Budget 1987–88*
Public Health Services	$1,039	$1,049	$591
California Children's Services	46	52	48
Department of Rehabilitation	57	62	66
Mental Health Programs	459	497	496
Alcohol and Drug Programs	70	72	72
Social Services—Programs	307	431	521
Social Services—County Administration	125	140	157
County Justice Subvention	67	67	67
K–12 Education	10,928	11,783	12,040
Community Colleges	1,165	1,195	1,213
Special Supplemental Subventions/Special District Loans	73	27	25
Local Streets and Roads	125	77	—
State Mandates	110	133	58
All Other	388	241	263
Totals [a]	$14,959	$15,826	$15,616

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

SPECIAL FUND FOR ECONOMIC UNCERTAINTIES

The Governor's Budget indicates that $1,040 million from the General Fund will be held in reserve during 1987–88. Of this amount, $1,026 would be in the Special Fund for Economic Uncertainties, $10 million would be set aside for the Disaster Response Operations Account, and $4 million represents funds which have already been appropriated but are not expected to be spent during the budget year.

The Special Fund for Economic Uncertainties provides a source of funds to meet General Fund obligations in the event of an unanticipated decline in revenues or increase 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. Normally, the balance in the reserve is invested and produces interest income for the General Fund.

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 22 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* basis, through the budget process.

In 1987–88, statutory COLAs range from 2 percent (K–12 instructional materials) to 7.5 percent (Medi-Cal noncontract hospitals). The statutory COLAs having the largest costs are those for K–12 apportionments ($253 million) and SSI/SSP grants ($84 million). The General Fund cost of fully funding *statutory* COLAs in 1987–88 is approximately $563 million, or $278 million more than the amount provided in the budget.

Governor's Budget Proposal

The budget proposes a total of $415 million from the General Fund for COLAs in 1987–88, including $285 million for statutory COLAs and $130 million for discretionary COLAs. These amounts reflect the Governor's proposal that existing law be amended to delay the effective date of most of these COLAs by six months. Thus, in most cases, the Governor proposes to provide one-half of the amount required by existing law. In three cases—court ordered and voluntary desegregation and gifted and talented education—the Governor proposes that no funds be provided for statutory COLAs. The amount provided for discretionary COLAs primarily reflects funding for changes in employee compensation; few other discretionary COLAs are funded. The specific increases proposed by the Governor are shown in Table 15.

Table 15
General Fund Cost-of-Living Increases
1986–87 and 1987–88
(dollars in thousands)

Department/Program	*1986–87 Budgeted Percent Increase*	*1987–88 1% Dollar Increase*	*1987–88 Statutory Percent Increase*	*1987–88 Statutory Dollar Increase*	*1987–88 Budget Percent Increase* [a]	*1987–88 Budget as Proposed*
HEALTH AND WELFARE						
Aging	—	$334	—	—	—	—
Alcohol and Drug Programs	—	718	—	—	—	—
Medi-Cal						
Noncontract Hospitals	6.0%	656	7.5%	$4,922	7.5% [b]	$4,922
Long-Term Care Facilities, excluding state hospitals	1.1–16.2 [c]	5,077	—	—	—	—
State Hospitals	8.4 [c]	1,573	—	—	—	—
OB/GYN Providers	26.5	193	—	—	—	—
Other Providers	—	5,770	—	—	—	—
Beneficiary Spin-off	5.1	2,228 [d]	3.6	7,293	1.8	2,791
Drug Ingredients	5.5	869	3.3	2,867	3.3	2,867
County Administration [e]	4.8	407	—	—	4.8	1,956
Health Services						
County Health (AB 8)	3.95	4,164	3.5	14,624	1.53	6,369
Medically Indigent Services	—	5,446	—	—	—	—
Public Health	—	937	—	—	—	—
Emergency Medical Services	—	17	—	—	—	—
Developmental Services						
Regional Centers:						
Out-of-Home Care	—	2,235	—	—	—	—
Other Client Services	—	1,651	—	—	—	—
Personal Services	6	922	—	—	1.5	1,383
Operations	1	112	—	—	—	—
Education Programs	1	56	—	—	—	—
Local Mental Health Programs	—	4,600	—	—	—	—
Social Services						
SSI/SSP	5.1	23,184	3.6	83,600	1.8 [f]	41,822
AFDC/FG & U	5.1	18,421	3.6	66,316	1.8	34,215
AFDC—Foster Care	1.0	2,982	—	—	—	—
County Administration—Grants [e]	5.0	1,452	—	—	1.8	5,398
Child Welfare Services	13.5	2,189	—	—	1.8	7,879
County Services Block Grant	—	634	—	—	—	—
IHSS Maximum Grant	5.1	142	3.6	511	1.8	256
IHSS provider	1.0	3,840	—	—	—	—
Deaf Access	—	34	—	—	—	—
Maternity Care	—	23	—	—	—	—
Employment Programs	—	150	—	—	—	—
Child Abuse Prevention	—	206	—	—	—	—
Adoptions	—	148	—	—	—	—
Community Care Licensing	—	84	—	—	—	—
Department of Rehabilitation	1.0	656	—	—	—	—
YOUTH AUTHORITY						
County Justice System Subvention Programs	1.0	673	—	—	—	—
Delinquency Prevention	1.0	23	—	—	—	—
K–12 EDUCATION						
Apportionments:						
K–12—District Revenue Limits	5.49	114,982	2.20	252,960	1.1	126,480
Meals for Needy Pupils	6.00	261	6.00	1,564	3.0	782
Summer School	5.49	693	2.20	1,524	1.1	762
Apprentice Programs	3.00	27	—	—	—	—
Small School District Transportation	1.00	100	—	—	—	—
Transportation	1.00	2,919	—	—	—	—

K–12—County Offices of Education	5.49	2,166	2.20	4,764	1.1	2,382
Regional Occupational Centers/Programs	3.00	2,118	—	—	—	—
Court-Ordered Desegregation	5.49	2,690	2.20	5,917	—	—
Voluntary Desegregation	5.49	550	2.20	1,210	—	—
Child Nutrition	3.30	386	3.86	1,486	1.93	743
American Indian Education Centers	1.00	9	—	—	—	—
Native American Indian Education [g]	1.00	4	—	—	—	—
Child Care Program	1.00	2,500	—	—	—	—
Special Education	5.49	15,925	2.20	35,034	1.1	17,517
Dropout Prevention	— [h]	148	—	—	—	—
Staff Development	1.00	213	—	—	—	—
Preschool	1.00	358	—	—	—	—
Libraries	1.00	75	—	—	—	—
Meade Aid [g]	1.00	52	—	—	—	—
Urban Impact Aid [g]	1.00	381	—	—	—	—
Gifted and Talented [g]	6.00	212	6.00	1,274	—	—
Instructional Materials (K–8)	3.60	731	2.00	1,462	1.0	731
Instructional Materials (9–12)	3.00	224	—	—	—	—
Demonstration Programs in Reading and Math	3.00	44	—	—	—	—
Educational Technology	1.00	262	—	—	—	—
Economic Impact Aid [g]	1.00	1,970	—	—	—	—
Adult Education	6.00	2,174	6.00	14,488	3.0	7,244
Adults in Correctional Facilities	6.00	19	6.00	116	3.0	58
School Improvement Program (K–6)	5.49	1,924	2.20	4,232	1.1	2,116
School Improvement Program (7–12)	1.00	325	—	—	—	—
Miller-Unruh Reading Program [g]	1.00	199	—	—	—	—
High School Pupil Counseling	1.00	78	—	—	—	—
Specialized Secondary Schools	1.00	21	—	—	—	—
Foster Youth Services	1.00	8	—	—	—	—
Opportunity Classes/Programs	—	8 [i]	—	—	—	—
COMMUNITY COLLEGES						
Apportionments	5.77	17,673	2.7	47,718	1.35	23,859
Community College Categoricals	1.0	551	—	—	—	—
Financial Aid Awards	5.0	1,029	—	—	—	—
ALL OTHERS						
State Contribution to STRS	3.50	2,342	3.85	9,015	3.85	9,015
Employee Compensation [j]						
Civil Service and Related	5.85	29,993	—	—	2.05	61,371
University of California	5.7	14,157	—	—	2.0	28,152
California State University	6.6	13,268	—	—	1.8	23,590
Totals	—	$326,575	—	$562,897	—	$414,660

[a] Generally, these increases are effective January 1, 1988.
[b] Effective July 1, 1987.
[c] These COLAs are funded through the proposed deficiency bill. There were no funds for these COLAs in the 1986 Budget Act.
[d] The effect of a given percent COLA cannot be calculated directly using this figure.
[e] The amount of funding included in the 1987–88 budget is to be used to reimburse counties for cost increases incurred during 1986–87.
[f] Effective April 1, 1988.
[g] The *Governor's Budget* proposes to eliminate all funding for Urban Impact Aid and Meade Aid. The budget also proposes to consolidate funding from Native American Indian Education, the Miller-Unruh Reading Program, the Gifted and Talented Program, and the Economic Impact Aid program into a Class Size Reduction/Educational Assistance Program.
[h] Program started in 1986–87.
[i] Funded by reappropriation of 1986–87 unexpended balance; dollar amount represents Legislative Analyst's Office estimate based on 1985–86 participation rates.
[j] Reflects a 1.5 percent adjustment in salary levels and funding to maintain health and dental coverages at present levels.

PROGRAM EXPENDITURES

We have discussed in some detail the 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 6 and Table 16 show the distribution of General Fund expenditures by major program category in 1987–88. These displays indicate the two largest budget categories are education, and health and welfare, which collectively account for $26.5 billion, or 85 percent, of total General Fund expenditures. The share of the budget devoted to each of these two categories is approximately the same as their shares in the current year. These shares would show declines, however, but for the effect of the Governor's county health services program shift proposal discussed earlier. This is because the proposal reduces the General Fund expenditure total by $477 million. The remaining $4.8 billion, or 15 percent of total expenditures, goes for tax relief, correctional programs, and all other programs of state government.

Chart 6

General Fund Expenditures Major Components 1987-88

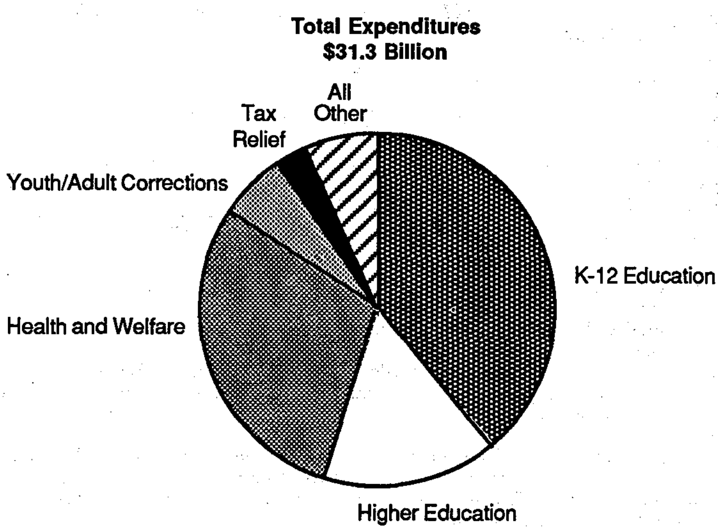


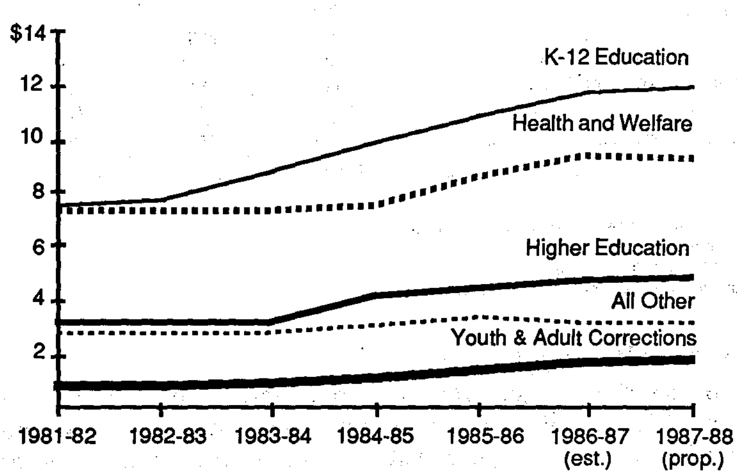
Table 16
Expenditures for Health, Welfare, and Education [a]
As a Percent of Total General Fund Expenditures
1987–88
(dollars in millions)

	State Operations	*Local Assistance*	*Total*	*Percent of General Fund Budget*
K–12 Education [b]	$205	$12,040	$12,244	39%
Higher Education	3,637	1,332	4,969	16
Subtotal, Education [c]	$3,842	$13,371	$17,213	55%
Health and Welfare	628	8,665	9,294	30
Subtotal, Education, Health and Welfare [c]	$4,470	$22,037	$26,507	85%
Other program areas	3,718	1,039	4,756	15
Total General Fund Budget [c]	$8,188	$23,075	$31,264	100%

[a] Source: *Governor's Budget.*
[b] Includes $507 million for State Teachers' Retirement System contribution.
[c] Detail may not add to totals due to rounding.

Education and youth and adult correctional programs have been the fastest growing components of General Fund expenditures in recent years. Chart 7 illustrates that since 1981–82, expenditures for these programs have increased significantly. Over the seven-year period, youth and

Chart 7
Trends in General Fund Program Expenditures
1981-82 through 1987-88 (in billions)



adult corrections expenditures have increased by 137 percent in current dollars, and by 81 percent in "real terms." Total education expenditures have increased in real terms by 20 percent, while spending on health and welfare expenditures has decreased in real terms by about 4 percent.

Overall, General Fund expenditures have increased by 44 percent in current dollars from 1981–82 through 1987–88, and by 10 percent in real terms.

Table 17
Estimated General Fund Program Changes [a]
1986–87 and 1987–88
(dollars in millions)

	Estimated 1986–87	*Proposed 1987–88*	*Change Amount*	*Change Percent*
Health and Welfare:				
Medi-Cal [b]	$2,461	$2,463	$2	0.1%
County Health [b]	959	545	−414	−43.2
SSI/SSP [b]	1,638	1,768	130	7.9
AFDC grants [b]	1,952	1,985	33	1.7
Social services programs [b]	431	521	90	20.9
Mental health	819	834	15	1.8
Developmental services	446	473	27	6.1
Other, health and welfare	768	705	−63	−8.2
Subtotals, Health and Welfare	$9,474	$9,294	−$180	−1.9%
Education:				
K–12	$11,497	$11,737	$240	2.1%
State teachers' retirement	465	507	42	9.0
University of California	1,788	1,859	71	4.0
California State University	1,626	1,690	64	3.9
California Community Colleges	1,195	1,213	18	1.5
Other, higher education	190	207	17	8.9
Subtotals, Education	$16,761	$17,213	$452	2.7%
Other:				
Youth and adult corrections	$1,711	$1,873	$162	9.5%
Resources	693	667	−26	−3.8
Tax relief	943	896	−47	−5.0
Bond interest and redemption [c]	(538)	(617)	(79)	(14.7)
Interest on General Fund loans	117	81	−36	−30.8
All other	1,191	1,240	49	4.1
Subtotals, Other	$4,655	$4,757	$102	2.2%
Total [d]	$30,890	$31,264	$374	1.2%

[a] Based on amounts shown in *Governor's Budget.*
[b] Local assistance only.
[c] Distributed to program categories.
[d] Detail may not add to totals due to rounding.

Summary of Major Program Changes

For 1987–88, the budget proposes a net increase in General Fund expenditures of $374 million, or 1.2 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. As was the case in the current year, the largest dollar increase is proposed for education—$452 million, or 2.7 percent. The next largest dollar increase—$162 million, or 9.5 percent—is proposed for youth and adult corrections. Within each expenditure category, significant program changes have been proposed. Some of the major General Fund changes include the following:

Medi-Cal local assistance expenditures are up by $2 million, or 0.1 percent. Expenditures would be higher were it not for the proposed cost reductions of $150 million reflected in the Governor's Budget. These consist of $125 million worth of savings due to "program restructuring" and $25 million in savings due to cost control measures. The budget does not contain a specific program to achieve these savings.

County Health is budgeted at $545 million, a $414 million, or 43 percent reduction from current year funding levels. This reduction is primarily the result of a proposal to eliminate the County Health Services (AB 8) program and to transfer the associated funds to the counties as "shared revenue."

SSI/SSP expenditures are expected to increase by $130 million, or 8 percent, above estimated current year expenditures. This increase is due primarily to four factors: (1) an increase of $96 million to fund the full-year cost of the 1986–87 COLA provided on January 1, 1987, (2) an increase of $42 million to fund a 3.6 percent statutory COLA effective April 1, 1988, (3) an increase of $42 million to fund an estimated 2.6 percent caseload growth, and (4) offsetting savings of $51 million due to an estimated 3.3 percent Federal COLA effective January 1, 1988.

AFDC grant costs are budgeted to increase by $33 million, or 1.7 percent, above estimated current year expenditures. This relatively low growth is due primarily to (1) an anticipated caseload increase of 0.8 percent ($40 million) even though actual growth has been about 3 percent, (2) increased costs of $34 million to provide a statutory COLA effective January 1, 1988, and (3) increased savings of $48 million from various fraud detection programs and the Greater Avenues for Independence (GAIN) program.

Social Services Program expenditures are up $90 million, or 21 percent, above estimated current year expenditures. This increase primarily reflects increased General Fund costs for: (1) the Child Welfare Services program ($46 million), (2) the In-Home Supportive Services program ($30 million), and (3) the Greater Avenues for Independence (GAIN) program ($27 million). These increased costs are partially offset by various savings totaling $13 million.

Developmental Services expenditures are budgeted at $473 million, an increase of $27 million, or 6.1 percent, over current year estimated expenditures. This increase is primarily the result of caseload increases at the regional centers.

Other Health and Welfare expenditures are expected to decrease by $63 million, or 8.2 percent, below estimated current year expenditures. This reduction is primarily due to the county health programs shift proposal, which involves $52 million included in this budget category.

K–12 Education expenditures are expected to increase by $240 million, or 2.1 percent, over estimated current year expenditures. The primary factors accounting for this increase are: (1) an increase of $260 million for increased enrollment in public schools; (2) an increase of $159 million to provide half-year funding for statutory COLAs: (3) an increase of $89 million to restore General Fund support for school deferred maintenance (the Governor proposes that a $90 million appropriation for this purpose be reverted to the General Fund in 1986–87); (4) an increase of $66 million to provide additional funding for special education services to handicapped students; and (5) an increase of $34 million to reflect the elimination of a one-time "loan repayment" (reduction in school apportionment funding) made during 1986–87. These increases are partially offset by (1) a $281 million reduction in General Fund requirements resulting from anticipated increases in school district property tax receipts; (2) the elimination of $43 million in funding for two programs providing state aid to school districts with high concentrations of disadvantaged students; and (3) a reduction of $40 million in funding for school desegregation.

Higher Education expenditures are proposed to increase by $170 million, or 3.5 percent. The primary factors accounting for this increase are: (1) $30 million due to enrollment increases; (2) $22 million for workload and cost adjustments; (3) $52 million for a 3 percent salary increase beginning January 1, 1988; and (4) program augmentations of $49 million, which include $12 million for instructional equipment replacement and library materials and $7.5 million for a teaching hospital subsidy.

Youth and Adult Corrections expenditures are proposed to increase by $162 million in the budget year. Most of this amount, or $130 million, will fund 2,126 additional personnel-years for the Department of Corrections and the increased operating expenditures needed to accommodate the growth in the prison population. The budget is based on a 12 percent growth rate in the inmate population between June 30, 1987 and June 30, 1988 and a 16 percent growth rate in the parole population over the same period.

Debt Service expenditures for bond interest and redemption are expected to be $79 million, or 15 percent, higher in 1987–88 than in the current year. This reflects the large volume of general obligation bonds approved by the voters in recent statewide elections.

Expenditures Not Recognized in the Budget

In preparing the Governor's Budget, the Department of Finance must estimate the impact of program caseload growth, court decisions, and other factors on expenditure levels in the current and budget year. Our analysis indicates that the Governor's Budget has underestimated expenditures for the two-year period (1986–87 and 1987–88) by $262 million. The components of this $262 million are as follows:

School Desegregation. The Governor's Budget contains insufficient funding to reimburse school districts for their allowable costs of operating court-ordered and voluntary desegregation programs, pursuant to the provisions of AB 38 (Ch 180/85). We estimate that the budget proposal would result in a cumulative deficit in funding for school desegregation reimbursement claims of $98 million by the end of 1987–88.

Child Care. The budget assumes that the state will receive federal reimbursements of $31 million annually in 1986–87 and 1987–88 for child care services provided to eligible participants in the Greater Avenues for Independence (GAIN) program. Recent information from the State Department of Education, however, indicates that the actual level of reimbursements in the current year is likely to be only $2 million. Should this estimate prove to be accurate, the child care budget could be underfunded by up to $29 million in the current year.

K–12 Education Apportionments. In contrast to other understated expenditures, the budget *overestimates* by a net $10 million the amount needed to fund K–12 school and special education apportionments in 1987–88. This is because of technical budgeting errors that (1) *overfund* special education by $16 million and (2) *underfund* school apportionments by $6 million. The budget, however, also overestimates by $19 million the amount of excess funding for school apportionments that will be available for reversion to the General Fund at the end of 1986–87. Recent information from the State Department of Education indicates that these funds have been used to pay school apportionments deficits remaining from 1985–86. Consequently, the amount of the 1986–87 General Fund ending balance assumed by the Governor is too high by $19 million.

AFDC. The Department of Social Services assumes that the 1987–88 caseload for the AFDC-Family Group program will grow at roughly half the existing rate of increase. If recent trends prevail, however, caseload growth will add $27 million to General Fund expenditures in the budget year. In addition, the budget assumes $23 million in General Fund savings from implementation of the Greater Avenues for Independence (GAIN) program because fewer persons will apply for aid. Because there is no empirical evidence that fewer persons will apply for aid once this program is in operation, costs for the AFDC program may be understated.

SSI/SSP. This program may be underfunded by up to $21 million from the General Fund. This consists of (a) $16 million due to underestimated caseload growth and (b) $5 million due to understated average grant costs.

Child Welfare Services. The budget probably understates the costs of this program for the budget year, since cost estimates are based on caseload trends dating back to the program's inception. The effect of this estimation procedure is that recent, dramatic caseload growth is not fully taken into account. If the most recent two year caseload trend continues, then the actual General Fund cost will be $7 million higher than budgeted in 1987–88.

Medi-Cal. As it did last year, the budget fails to provide for increases in Medi-Cal reimbursement rates for long-term care facilities and the cost of abortions, even though the likelihood of such costs is all but certain. The statutorily required increases for long-term care will cost $20 million in the budget year, and the General Fund's share of costs for Medi-Cal abortions will be $14.7 million.

Department of Forestry. Based on an average fire year, we would expect General Fund expenditures for emergency firefighting by the Department of Forestry and Fire Protection to total $13 million *more* than is included in the budget for 1987–88.

Impact on the 1987–88 General Fund Balance. Should expenditures materialize, as detailed above the amount which the Governor's Budget shows in the Special Fund for Economic Uncertainties on June 30, 1988 would be $262 higher than is likely to be available. Under these circumstances, with no changes in anticipated revenues, instead of increasing the state's reserve by $475 million, the Governor's Budget would increase the reserve by only $213 million, leaving it at $764 million at year-end.

Revenues In 1987–88

The various expenditure programs discussed in the *Analysis* are supported by revenues which come 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 into the General Fund, from which they may be appropriated to support the general activities of state government. (In most years, about 90 percent of General Fund revenues come from three large taxes—the personal income tax, the sales and use tax, and the bank and corporation tax.) The remaining portion of state revenues—normally about 15 percent of the total—is placed into special funds to support specific programs and activities, including highway maintenance and construction, and various education-related capital outlay projects.

In addition to the above revenues, the state collects certain other monies which are not included in the budget revenue totals as either General Fund or special fund revenues, because they are legally committed to specific purposes. Included in this category are state receipts from the California State Lottery, and monies to be deposited in certain bond and pension funds.

This section examines the Department of Finance's forecast for revenues, including the economic projections and other assumptions on which it is based.

SUMMARY OF THE REVENUE OUTLOOK

Table 18 summarizes the department's estimates of how much revenues will be generated in the current and budget years. It also shows, for comparison purposes, actual revenues received in the prior year. Chart 8 provides an historical perspective on these figures by showing the trend in state revenues over the past decade.

Moderate Revenue Growth Predicted

The budget predicts that revenue growth in both 1986–87 and 1987–88 will be moderate. This reflects the department's forecast that the current economic expansion will continue, though only at a modest pace. Table 18 indicates that:

- ***Budget year*** (1987–88) revenues will total $37.9 billion (5.4 percent growth), including General Fund revenues of $31.7 billion (3.2 percent growth) and special fund revenues of $6.1 billion.
- ***Current year*** (1986–87) revenues will total $35.9 billion (7 percent growth), including General Fund revenues of $30.8 billion (9.6 percent growth) and special fund revenues of $5.1 billion.

Table 18
Revenue Summary
General Fund and Special Funds
1985–86 through 1987–88
(dollars in millions)[a]

General Fund Revenues	Prior Year (1985–86)[b]	Current Year (1986–87)[c]	Budget Year (1987–88)[d]
—Amount	$28,072	$30,765	$31,742
—Dollar change	1,466	2,693	977
—Percent change	5.5%	9.6%	3.2%
Special Fund Revenues			
—Amount	$5,486	$5,149	$6,112
—Dollar change	442	−337	963
—Percent change	8.8%	−6.1%	18.7%
Total, General Fund and Special Fund Revenues			
—Amount	$33,558	$35,914	$37,854
—Dollar change	1,910	2,356	1,940
—Percent change	6.0%	7.0%	5.4%

[a] Source: *1987–88 Governor's Budget* and State Controller. Detail may not add to totals due to rounding. Figures include effects of various revenue-related law changes and shifts of revenues between special funds and the General Fund. Neither the General Fund nor special fund revenue totals include revenues from the California State Lottery, because the funds into which these lottery revenues are put have been classified as nongovernmental cost funds.

[b] Dollar and percent change figures may be distorted, due to accounting reclassifications of certain revenues and reimbursements made between 1984–85 and 1985–86.

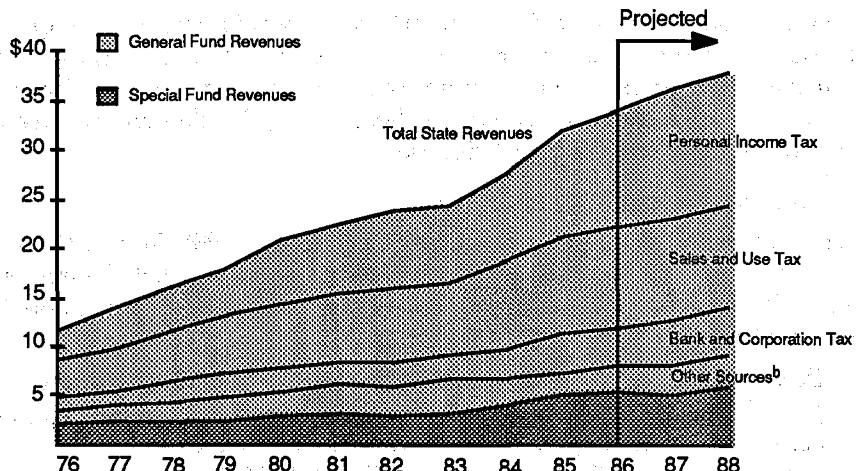
[c] General Fund revenue total includes a net gain of $425 million due to federal tax reform and $78 million in proposed transfers from special fund balances.

[d] General Fund revenue total includes a net loss of $250 million due to federal tax reform. In addition, the revenue figures shown incorporate the Governor's proposal to shift $477 million of state sales and use tax revenues from the General Fund to special funds for use by local governments.

Chart 8

Trends in State Revenues

1975-76 through 1987-88 (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 fund revenues reflect year-to-year shifts in revenues between these two categories.

The year-to-year revenue growth rates shown in Table 18 contain certain distortions, because they incorporate the effects of factors such as new legislation, one-time revenue effects, and shifts of revenues between the General Fund and special funds. Four factors are especially important. First, the federal Tax Reform Act of 1986 has caused changes in taxpayers' behavior, such as when they pay their state income taxes and report their capital gains income (these changes affect revenues in both 1986–87 and 1987–88). Second, the budget proposes to shift $477 million in General Fund sales and use tax revenues to local governments in 1987–88, in exchange for repealing existing state subventions that fund various county health programs. Third, the budget proposes to transfer $78 million from special fund balances into the General Fund in the current year, in order to improve the fund's condition. Fourth, the budget assumes that a $75 million one-time inheritance tax settlement will be received in 1987–88. In the absence of these four factors, a fairly level, moderate revenue growth pattern would exist—about 8 percent for General Fund revenues and 6 percent for total revenues in 1986–87, and approximately 7 percent for both General Fund revenues and total revenues in 1987–88.

Reliability of the Revenue Forecast

The department's revenue forecast appears to be somewhat on the *conservative* side, based on our review of the economic and other assumptions on which it is based. We estimate that revenues over the next 18 months would be $150 million higher than predicted if the department's economic forecast comes true, and $485 million higher than predicted if the consensus economic outlook of other forecasters prevails. As the box on the following page shows, however, there is a wide variety of factors which could cause economic performance to differ from the consensus forecast, and this could dramatically affect revenues. For example, revenues could range several billion dollars above or below the department's forecast, if the economy experienced a strong expansion or a moderate downturn. *Thus, even though the department's revenue forecast appears conservative, this bias is not nearly as large as the deviations which could occur due to the economy.*

We now take a closer look at the economic assumptions on which the budget's revenue forecast is based, followed by a more detailed discussion of the state revenue outlook.

Key Factors in the 1987 Economic Outlook

Positive Factors

- Continued moderate inflation
- Reduced interest rates
- Strength in service industries
- Improved corporate profits
- Continued growth in "real" personal income
- Accomodative monetary policy
- Absence of excessive inventories
- Reduced crude oil and fuel prices
- Expected decline in the value of the dollar
- Modest strength in housing sector
- Positive effects on consumer spending due to federal tax reform

Negative Factors

- Large foreign trade deficit
- Lower federal defense spending in California
- Weak business investment spending
- High levels of consumer debt
- Historically low savings rate
- Continued large federal budget deficit
- Softness in manufacturing employment
- International debt problems
- Negative effects on business investment due to federal tax reform
- Relatively weak overseas economies

Major Areas of Uncertainty

- To what extent will the dollar continue to depreciate, and by what amount will this reduce the foreign trade deficit?
- Will consumers retrench in their spending, due to their low savings rate and high debt levels?
- How will federal tax reform affect consumption spending and business investment?
- Will crude oil prices remain stable, or eventually trend upward due to output restrictions by OPEC members?
- By how much and in what areas will federal spending be trimmed to reduce the federal budget deficit?

THE ECONOMIC OUTLOOK

The economy's performance during 1987 and 1988 will be the prime determinant of state revenue collections during the latter half of 1986–87 and in 1987–88. Economic activity during calendar 1987 will account for about one-third of current year revenues and two-thirds of budget year revenues, while the remaining one-third of budget year revenues will depend on economic conditions in early 1988.

Continued Economic Expansion Expected

Table 19 summarizes the budget's economic forecast for 1987 and 1988, as well as the economy's performance during 1986. In a nutshell, the department expects that the current economic expansion will carry forward throughout the next two years at a moderate pace. Inflation is expected to remain under control, and neither a recession, slowdown nor economic boom is anticipated. The department's prediction of an unspectacular-though-sustained expansion is a "middle-of-the-road" forecast that pretty much reflects the current consensus views of economists generally. It also reflects the tendency of economists to predict "more of the same," once an economic recovery period has matured and there are no clear signals indicating when the next strong upturn or downturn will occur.

Table 19
Department of Finance Economic Outlook for California and the Nation 1986 through 1988 [a]

Economic Indicator	*1986 Estimated*	*1987 Projected*	*1988 Projected*
1. *National Economy*			
Percent change in:			
—Real GNP	2.5%	2.4%	3.4%
—Personal income	5.2	4.5	5.8
—Pre-tax corporate profits	3.9	10.4	23.4
—Wage and salary employment	2.5	2.0	2.3
—Civilian employment	2.3	1.4	1.9
—GNP prices	2.8	2.4	3.3
—GNP consumer prices	2.0	2.8	3.6
—Consumer Price Index	2.0	3.1	3.6
Unemployent rate (%)	7.0%	7.1%	7.0%
Savings rate (%)	4.1	3.3	3.2
Prime interest rate (%)	8.3	6.8	7.3
New car sales (millions of units)	11.2	10.0	10.7
Housing starts (millions of units)	1.84	1.72	1.86
Net exports (billions of dollars) [b]	−$147	−$133	−$125
2. *California Economy*			
Percent change in:			
—Personal income	7.0%	6.1%	7.2%
—Wage and salary income	7.8	6.9	7.7
—Wage and salary employment	2.8	2.3	2.8
—Civilian employment	3.6	2.9	3.3
—Consumer Price Index	3.3	4.0	4.6
—Key elements of the state's tax base:			
—Taxable personal income [c]	7.2	5.9	7.4
—Taxable sales	3.7	4.0	6.2
—Taxable corporate profits	5.5	12.0	12.6
Unemployment rate (%)	6.7%	6.9%	7.0%
New car registrations (thousands of units)	1,405	1,278	1,363
New building permits (thousands of units)	271	254	276

[a] Source: *1987–88 Governor's Budget* and Department of Finance.
[b] Defined as United States exports minus imports, measured in constant 1982 dollars.
[c] Defined as total personal income plus social security contributions, minus transfer payments and certain other nontaxable income components. This income concept historically has shown a strong correlation to adjusted gross income reported for tax purposes in California.

How 1986 Ended and 1987 Began

At this time last year, as much uncertainty about the economy existed as we see today. Thus, not surprisingly, the department also predicted in last year's budget an unspectacular-though-sustained low-inflation expansion period for 1986 (see Table 20). This prediction generally came true, although the overall strength of the economy was less than expected. For example, actual GNP growth (2.5 percent) fell short of the forecast (3.2 percent), partly because of a large foreign trade imbalance which saw our country importing far more goods than we were exporting. Likewise, Table 20 shows that even though California home building activity and car sales exceeded expectations in 1986, both taxable sales and corporate profits fell far short of their predicted levels. Similarly, as shown in Chart 9, California's employment growth, though continuing, tapered downward throughout the year. Manufacturing employment was especially weak, as it experienced an actual decline of about 1 percent, primarily due to softness in the electronics and computer industries. In addition, a number of uncertainties clouded the economic horizon at year-end (see box on page 46). The major uncertainties include the effects of federal tax reform on business investment decisions, the effect of high debt levels on future consumer spending, future prices for imported crude oil, and prospects for reducing both the federal budget deficit and the foreign trade deficit. It was on this note that 1986 ended and 1987 began.

Table 20
Accuracy of Economic Forecasts for California in 1986

	Original Forecasts				*Revised Department of Finance May 1986*	
Economic Indicator	*Department of Finance* [a]	*Other Forecasters* [b] *Lowest*	*Average*	*Highest*	*Forecast*	*Actual* [c]
Percent change in:						
—Personal income	7.1%	7.0%	7.7%	8.8%	7.3%	7.0%
—"Real" personal income [d]	2.4	1.9	3.0	4.3	3.5	3.6
—Wage and salary jobs	2.9	2.5	3.2	3.7	3.4	2.8
—Consumer prices	4.6	3.8	4.6	5.2	3.7	3.3
—Taxable sales	6.3	—	—	—	6.0	3.7
—Taxable corporate profits	13.7	—	—	—	10.4	5.5
Unemployment rate (%)	7.2%	6.8%	7.3%	7.8%	6.7%	6.7%
Residential building permits (thousands)	229	210	216	229	250	271
New car sales (thousands)	1,120	—	—	—	1,265	1,405

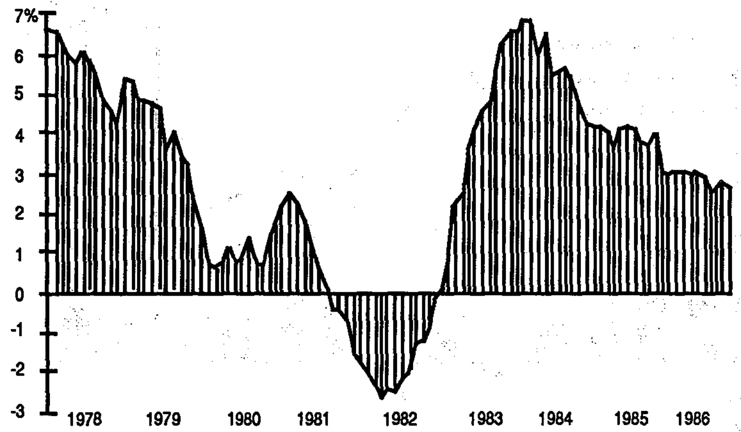
[a] *1986–87 Governor's Budget.*
[b] Includes First Interstate Bank, Security Pacific Bank, Bank of America, Crocker Bank, UCLA, Wells Fargo Bank and the Commission on State Finance. Forecasts are as of approximately year-end 1985, corresponding to when the Department of Finance constructed the economic assumptions contained in the *1986–87 Governor's Budget.* For detail on these forecasts, see *1986–87 Perspective and Issues,* Table 23, page 65.
[c] As estimated in the *1987–88 Governor's Budget.*
[d] Defined here as nominal personal income deflated by the California Consumer Price Index.

Key Aspects of the Economic Outlook

Table 19 and Chart 10 summarize the most critical features of the department's economic outlook for the nation and California in 1987 and 1988. They indicate that for the nation:

Chart 9

Year-Over-Year Percent Change in California's Wage & Salary Employment[a]
1978 through 1986



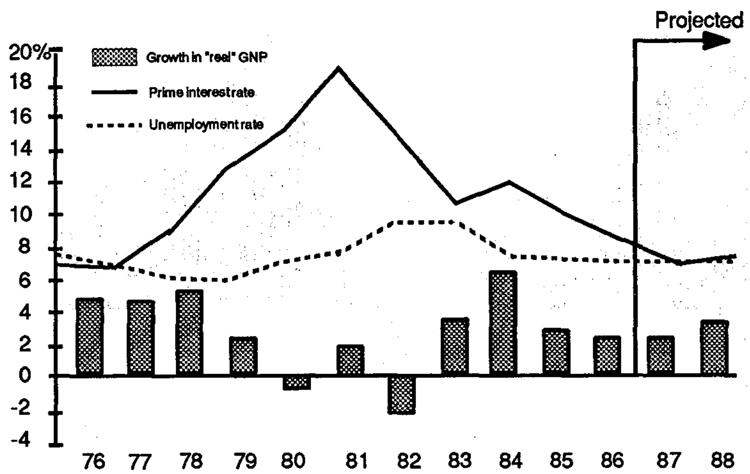
[a] Source: California Employment Development Department. Data shown are through November 1986, and represent percent changes in California's wage and salary employment over same month of prior year.

- ***GNP*** is projected to increase by 2.4 percent in 1987 and 3.4 percent in 1988. (Most economists view GNP growth of under 3 percent as unsatisfactory over the long term.)
- The ***unemployment rate*** is projected to remain basically unchanged from 1986, at about 7 percent.
- The ***prime interest rate*** is predicted to drop below its 1986 level (8.3 percent) in both 1987 (6.8 percent) and 1988 (7.3 percent). This reflects the combined effect of three expected factors: ***low economy-wide inflation, weak overall credit demands*** (due to the sluggish economy), and ***accommodative monetary policy.***
- The ***savings rate*** (that is, savings as a percent of disposable income) is predicted to drop to only 3.2 percent by 1988, as consumers attempt to support their spending habits through borrowing and by saving less of their income.

The 1987 forecast also calls for moderate growth in consumer spending and industrial production, no growth in business investment expenditures after adjusting for inflation, and a continuing large foreign trade deficit exceeding $130 billion. Other key factors in the economic outlook are identified in the box on page 46.

Chart 10

Trends in Key National Economic Variables
1976 through 1988[a]



[a] Source: Department of Finance.

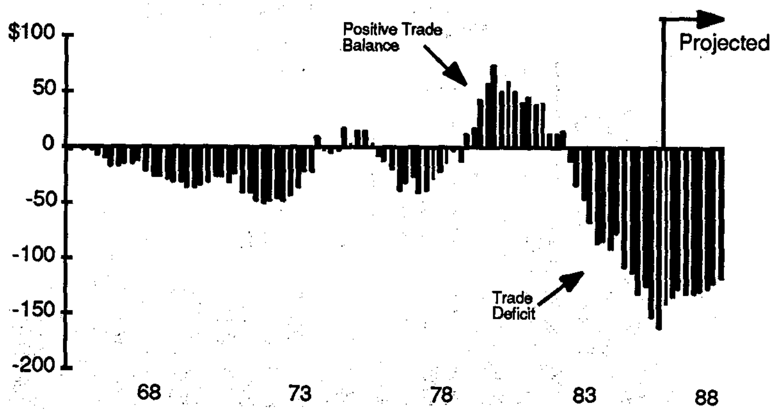
Will the Trade Deficit Improve? The prognosis for the nation's trade deficit, which Chart 11 shows emerged in 1983 and soared to a record $165 billion in late 1986, is the single greatest uncertainty in the economic outlook. The presence of the deficit acts as a continuing drag on the economy, since it means that we are purchasing more goods from other nations than they are buying from us. This, in turn, reduces our production and employment levels. While most economists believe that the deficit will shrink in 1987 in response to declines in the international value of the dollar, there is considerable uncertainty and disagreement about the likely magnitude of the improvement. The department subscribes to the consensus view that the improvement will be modest, which is a reasonable assumption at present.

California To Outperform Nation

Regarding California, Table 19 indicates that the state is forecast to experience the same general moderate economic expansion as the nation, although its performance will be a bit stronger in a number of areas. Specifically:

Chart 11

Trends in the United States Trade Balance
1965 through 1988 (in billions)[a]



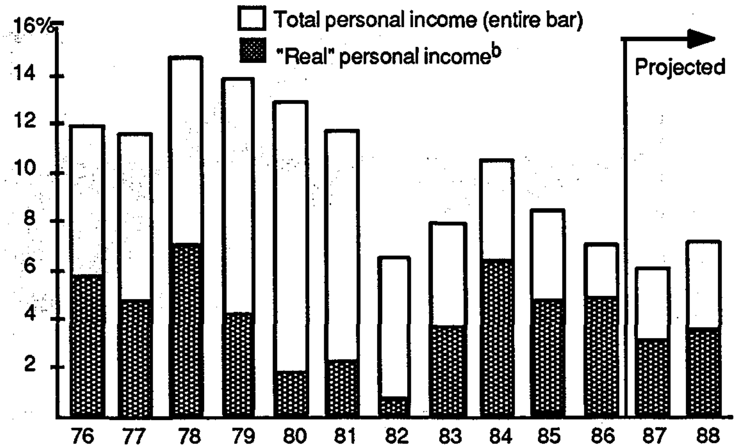
[a] Data shown represent the difference between annualized United States exports and imports, as measured quarterly in constant 1982 dollars. Projections for 1987 and 1988 are by the Department of Finance.

- California ***personal income*** is predicted to increase by 6.1 percent in 1987 and 7.2 percent in 1988 (see Chart 12). These growth rates are not high by historical standards, although they do exceed the national projections.
- ***Wage and salary employment*** is expected to grow by 2.3 percent in 1987 and 2.8 percent in 1988 (see Chart 13). Again, these increases are above the nation's, although historically low for a nonrecessionary period. In fact, because California's labor force is expected to increase by about 3 percent annually, the department predicts that the state's ***unemployment rate*** actually will rise slightly from its 1986 level.
- Both ***new building permits*** and ***new car sales*** are expected to weaken somewhat in 1987 from their exceptionally strong 1986 levels, and then turn up again in 1988. The department is assuming that these spending categories will do fairly well, despite the modest pace of the economy, due to low inflation, declining interest rates, and the willingness of consumers to maintain their current low savings rate.

Chart 12

Annual Growth in California Personal Income

1976 through 1988[a]

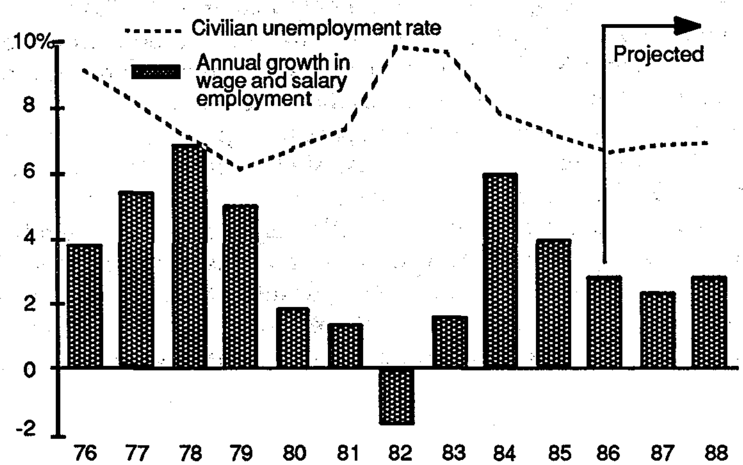


[a] Source: Department of Finance. Data are estimated for 1986.
[b] "Real" personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

Chart 13

Trends in California's Employment and Unemployment

1976 through 1988[a]



[a] Source: Department of Finance and Employment Development Department. Data are estimated for 1986.

Implications of the Economic Forecast for the Revenue Forecast

The implications of the department's economic outlook for state revenues most closely relate to how the economic forecast affects the tax bases for California's major revenue sources. The most important of these tax-base variables are "adjusted" personal income (derived from the forecast for personal income), taxable sales (derived from the forecast for expenditures made by consumers and businesses), and taxable corporate profits (derived from forecasts of business sales revenues and production costs). As shown in Table 19:

- ***"Adjusted" personal income*** (that is, personal income adjusted for transfer payments, social security contributions and certain non-wage income, so as to roughly approximate "taxable" personal income) is predicted to increase by only 5.9 percent in 1987, followed by 7.4 percent in 1988.
- ***Taxable corporate profits*** are predicted to rise by 12 percent in 1987 and 12.6 percent in 1988, following only a 5.5 percent gain in 1986.
- ***Taxable sales,*** which rose by only 3.7 percent in 1986, are predicted to increase by only 4 percent in 1987, followed by a 6.2 percent gain in 1988.

Is the Economic Forecast Reliable?

Based upon our own assessment of current economic conditions, we believe that the general thrust of the department's economic outlook—continued though moderate growth—is reasonable at this point in time. Table 21 shows that this general type of outlook is shared by most other economic forecasters, and that the department's *national* economic outlook is nearly identical to the consensus forecast in many respects. (One exception is corporate profits growth, for which the department's forecast is below the average.) In the case of California, however, the department is at the *low end* of the spectrum with regard to both employment growth and personal income, the single most important determinant of state revenues. For example, *the department's personal income growth forecast is almost one percentage point below the consensus.* This is an important difference, since each percentage point of income growth typically translates into at least $300 million in additional revenues, and we have found that the consensus forecast for personal income growth has been more accurate over the past decade than the predictions of any single forecaster, including the department. From this perspective, the department's *California* economic forecast is a bit *conservative*.

Of course, many things could occur during the next year that would dramatically alter the economic situation, including a reescalation of world oil prices, a retrenchment by consumers, and either a further deterioration or significantly greater-than-expected improvement in the foreign trade balance. Such developments obviously could require substantial revisions in the economic outlook.

Table 21
Comparisons of Different Economic Outlooks for 1987 [a]

	Percent Change In: Real GNP	GNP Prices	Pre-Tax Profits [b]	Unemployment Rate	New Car Sales (millions)	Housing Starts (millions)
A. *National Forecasts*						
Department of Finance	2.4%	2.4%	4.0%	7.1%	10.0	1.72
Blue Chip Survey: [c]						
—Concensus forecast	2.4	3.2	8.1	7.0	10.7	1.71
—Low-end average forecast [d]	1.0	2.5	−1.1	6.6	9.6	1.59
—High-end average forecast [d]	3.6	3.7	18.2	7.4	11.8	1.88

	Percent Change In: Personal Income	Consumer Prices	"Real" Personal Income [e]	Wage and Salary Jobs	Unemployment Rate	New Residential Building Permits (thousands)
B. *California Forecasts*						
Department of Finance	6.1%	4.0%	2.0%	2.3%	6.9%	254
Other Forecasters						
UCLA	5.9	3.8	2.0	2.8	6.7	245
Security Pacific Bank	7.5	4.1	3.3	3.0	6.9	225
First Interstate Bank	8.0	4.1	3.7	2.9	6.0	250
Bank of America	7.0	4.5	2.4	3.0	6.6	275 [f]
Wells Fargo Bank	6.7	4.0	2.6	2.3	7.0	240
Commission on State Finance	6.9	4.0	2.8	2.7	6.7	235
Average of "Other" Forecasters	7.0%	4.1%	2.8%	2.8%	6.6%	245

[a] Forecasts available as of approximately year-end 1986.
[b] Defined as pre-tax profits *with* inventory valuation and capital consumption adjustments. The Blue Chip Survey does not report pre-tax profits excluding these adjustments, which is the most relevant profit figure for revenue-estimating purposes. The department's 1987 projection for growth in this latter profit measure is 10.4 percent.
[c] Includes the projections of 50-odd economists as published in *Blue Chip Economic Indicators* for January 1987. Permission to reprint data granted by Capitol Publications, Inc.
[d] Represents average of the 10 lowest/highest forecasts for each variable as published in *Blue Chip Economic Indicators* in January 1987.
[e] Defined as personal income adjusted for consumer price inflation.
[f] Estimate by the Legislative Analyst's Office, based on the bank's forecast of 252,000 residential building *starts*. Building starts typically average slightly over 90 percent of building permits.

THE REVENUE OUTLOOK

Table 22 presents the department's forecast for state revenues, by source, for the current and budget years. These estimates are best discussed by distinguishing between General Fund revenues (about 85 percent of the total) and special fund revenues (about 15 percent of the total).

A. The Forecast for General Fund Revenues

General Fund revenues are projected to total $31.7 billion in 1987–88, an increase of $977 million over the 1986–87 estimate of $30.8 billion. Chart 14 shows that over 91 percent ($28.8 billion) of these revenues are to be

Table 22
State Revenue Collections
1985–86 through 1987–88
(dollars in millions) [a]

General Fund	*Actual 1985–86*	*Estimated 1986–87*	*Projected 1987–88*	*Change 1986–87 to 1987–88 Amount*	*Percent*
Taxes:					
Sales and use [b]	$10,202	$10,730	$10,898	$168	1.6%
Personal income [c]	11,419	12,800	13,200	400	3.1
Bank and corporation [d]	3,843	4,315	4,675	360	8.3
Estate, inheritance and gift [e]	253	270	367	97	35.9
Insurance	840	993	1,106	113	11.4
Cigarette	181	180	180	—	—
Alcoholic beverage	132	134	134	—	—
Horse racing	112	114	116	2	1.8
Subtotals, Taxes	$26,982	$29,536	$30,676	$1,140	3.9%
Other Sources:					
Interest on investments	521	450	380	−70	−15.6
California State University fees [f]	270	252	291	39	15.5
Other revenues [g]	317	318	328	10	3.1
Transfers	−18	209	67	−142	−67.9
Totals, General Fund	$28,072	$30,765	$31,742	$977	3.2%
Special Funds					
Motor Vehicle:					
Fuel taxes	1,194	1,238	1,252	14	1.1
License fees (in lieu)	1,522	1,688	1,891	203	12.0
Registration, weight and miscellaneous fees	998	1,012	1,051	39	3.9
Subtotals, Motor Vehicle Revenues	$3,714	$3,938	$4,194	$256	6.5%
Other Sources:					
Oil and gas revenues [h]	404	100	128	28	28.0
Sales and use taxes	116 [i]	—	477 [j]	477	NMF [k]
Interest on investments	135	112	108	−4	−3.6
Cigarette tax	81	77	77	—	—
Other	1,036	922	1,128	206	22.3
Totals, Special Funds	$5,486	$5,149	$6,112 [j]	$963	18.7%
Totals, State Funds	$33,558	$35,914	$37,854	$1,940	5.4%

[a] Source: *1987–88 Governor's Budget.* Detail may not add to totals due to rounding.
[b] The estimate for 1987–88 includes (i) a $24 million revenue gain from the Governor's *proposal* to increase audit staff at the Board of Equalization, (ii) a $477 million reduction due to the Governor's *proposal* to allocate these funds as general purpose revenues to local governments, and (iii) a $70 million net gain due to 1986 legislation.
[c] Includes the estimated effects of (i) federal tax reform (a $325 million net gain in 1986–87 and a $220 million net loss in 1987–88), (ii) the Governor's *proposals* to increase audit staff at the Franchise Tax Board (a $20 million gain in 1987–88) and provide an income tax deduction for respite care expenses (a reduction of $5 million in 1987–88), and (iii) legislation enacted during 1986 (a reduction of $9 million in 1986–87 and $22 million in 1987–88).
[d] Includes the estimated effects of (i) federal tax reform (a $100 million gain in 1986–87 and a $30 million loss in 1987–88), (ii) the Governor's *proposal* to increase audit staff at the Franchise Tax Board (a gain of $14 million in 1987–88), and (iii) 1986 legislation (a loss of $60 million in 1987–88, including $40 million due to Chapter 660, the "unitary reform" measure).
[e] The pattern of year-to-year changes in these revenues is partly due to Proposition 6 (June 1982), which repealed inheritance and gift taxes and, in their place, imposed an estate "pick-up" tax. Revenues in 1987–88 include $266 million in estate taxes, $100 million in inheritance taxes, and $1 million in gift

taxes. The 1987–88 inheritance tax estimate includes a $75 million payment from one large estate. The State Controller, however, has the option of accepting certain real property in lieu of this payment. Under this option, the revenues received would depend on when the property is sold by the state, and for what price.

[f] Includes various funds derived from nongovernmental sources, including the State University Fee, library fines, certain registration fees, and application fees.

[g] Includes revenues from various regulatory taxes and licenses, local agencies, user charges for services provided to the public, property-related income, and other miscellaneous revenues.

[h] Represents oil and gas royalties from state lands, about 80 percent of which come from the state's tidelands located adjacent to the City of Long Beach. Excludes royalties allocated to the General Fund to support the State Lands Commission, royalties allocated to nongovernmental cost funds, and federal lands royalties.

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

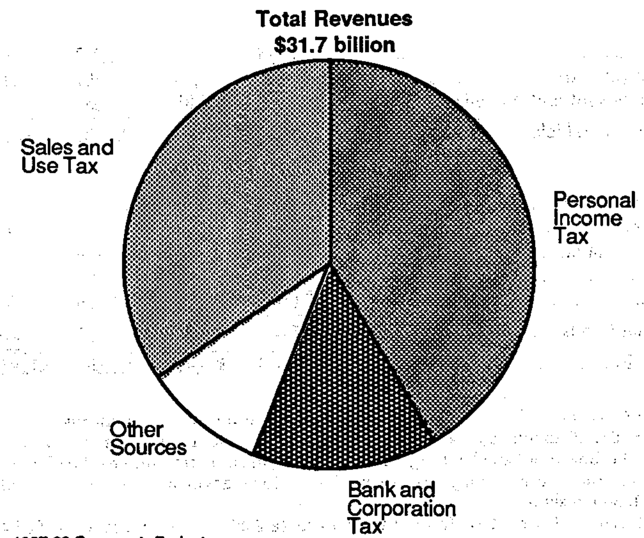
[j] Reflects the Governor's *proposal* to allocate a portion of state sales and use tax revenues as general purpose revenues to local governments, in exchange for eliminating certain subvention programs.

[k] Not a meaningful figure.

derived from three large taxes—the personal income tax, the sales and use tax, and the bank and corporation tax. The remaining 9 percent of revenues is attributable to the insurance tax, interest income from state investments, estate and inheritance taxes, and various other sources.

Chart 14

1987-88 General Fund Revenues, by Source[a]



[a] Source: *1987-88 Governor's Budget.*

Special Factors Distort Revenue Growth

Table 22 shows that projected 1987–88 General Fund revenue growth is only 3.2 percent, compared to 9.6 percent in the current year. These highly dissimilar growth rates reflect distortions due to a number of special factors, in whose absence these growth rates would be in a more normal 7-to-8 percent range. These distortions involve:

- ***Federal Tax Reform.*** Projected revenues have been increased by $425 million in 1986–87, and reduced by $250 million in 1987–88, to account for the effects on state tax collections of the federal 1986 Tax Reform Act (discussed later).
- ***Revenue Sharing Proposal.*** Sales and use tax revenues have been reduced in 1987–88 by $477 million, reflecting the Governor's *proposal* to replace certain local subvention programs with an allocation of general purpose revenues to local governments.
- ***Large Inheritance Tax Payment.*** A $75 million one-time inheritance tax payment is expected in 1987–88 from an unusually large estate.
- ***Proposed Transfers.*** The budget proposes to transfer $78 million in certain special fund balances to the General Fund in 1986–87, to help improve the fund's condition.

The combined effect of these factors is to make 1986–87 revenues over $500 million *greater* than otherwise, and 1987–88 revenues $650 million *less* than otherwise. Without these factors, General Fund revenue growth would be about 7.8 percent in 1986–87 and 7 percent in 1987–88.

The Forecast for Personal Income Taxes—Moderate Growth

The personal income tax is the single largest General Fund revenue source, accounting for over 40 percent of the total. The tax is imposed on income using a progressive tax rate schedule ranging from 1 percent to 11 percent, and includes a variety of income exclusions, deductions and credits.

Personal income tax (PIT) revenues are projected to total $12.8 billion in the current year and $13.2 billion in the budget year. There are two key assumptions behind these projections: the effects of federal tax reform, and the underlying rate of tax liability growth in the 1987 and 1988 income years.

State Revenue Effects of Federal Tax Reform. As summarized in Table 23, PIT revenues are projected to increase by $325 million in the current year, and then be reduced by $220 million in the budget year, due to the 1986 Tax Reform Act. (A detailed discussion of tax reform appears in Part Three.) The largest revenue effects involve sales of assets on which capital gains taxes must be paid. (The act encouraged taxpayers to sell such assets in 1986, by increasing the federal tax rate on capital gains beginning in 1987. The act also may affect the reporting of future capital gains.) Another large effect derives from the expected shift toward income-producing investments and away from loss-generating investments (the act limits taxpayers' ability to use loss-generating investments as tax shelters).

Although the department's assumptions regarding the state revenue effects from federal tax reform were as reasonable as anyone's at the time they were developed (December 1986), *no one* is in a position to accurately predict these effects, and *no consensus exists* as to what they eventually will turn out to be. For example, the Commission on State Finance assumes that the effect on PIT collections in 1987–88 will only be a $5 million reduction, compared to the department's assumed $220 million reduction. Given this, *a significant margin of error surrounds the department's assumptions, and this uncertainty will not be fully resolved until May 1988, when 1987 income tax returns have been processed.*

Table 23
Predicted State Revenue Effects Due to the Federal 1986 Tax Reform Act (dollars in millions) [a]

Type of Effect	*Predicted State Revenue Effect* 1986–87	*Predicted State Revenue Effect* 1987–88
A. Personal income taxes		
a. Changes in the timing and amount of reported capital gains	$350	–$350
b. Reduced investments in loss-generating tax shelters	—	100
c. Other effects [b]	–25	30
Subtotal, personal income tax	$325	–$220
B. Bank and corporation taxes		
a. Early audit-related payments	100	—
b. Increased incorporations by taxpayers with loss-generating investments	—	–30
Subtotal, bank and corporation taxes	$100	–$30
Total state revenue effect	$425	–$250

[a] Source: *1987–88 Governor's Budget* and Department of Finance.
[b] These "other effects" relate to changes in the amount and timing of charitable donations and consumer interest deductions, plus other factors.

Underlying Growth in Tax Liabilities. After removing the effects attributable to federal tax reform, PIT revenues are estimated to grow by 9.2 percent in 1986–87 and 7.6 percent in 1987–88. These estimates assume that the underlying growth in PIT income-year liabilities will be about 7.8 percent in 1987 and 7.9 percent in 1988.

Evaluation of the PIT Forecast. The department's estimated tax liability growth rate for 1987 is substantially *above* the department's projected growth rate in taxable personal income—only 5.9 percent (see Table 19). Ordinarily, tax liabilities can grow significantly faster than taxable income only when taxpayers move into increasingly higher income tax brackets.

This, in turn, requires the "real" average income of taxpayers to increase, after adjustment for inflation (this is because the state's income tax brackets are indexed for inflation). The department's own economic forecast does *not* suggest that this is very likely to occur, since its income growth forecast is not high enough to allow for an increase in income per employee after adjustment for inflation (see Table 19). We estimate that personal income tax revenues *generated by the department's economic forecast* will be less than predicted, by $50 million in 1986–87 and $130 million in 1987–88.

The Forecast for Sales and Use Taxes—Below-Average Growth

Sales and use taxes are the second largest source of General Fund revenues—around 34 percent of the total—and are projected to reach $10.7 billion in the current year and $10.9 billion in the budget year. These revenues are derived from a 4¾ percent levy on taxable sales, and are in addition to the sales and use taxes levied by local governments and transit districts.

Revenue Sharing Proposal To Reduce State Revenues. As noted earlier, the budget year estimate incorporates a $477 million reduction, reflecting the Governor's *proposal* to allocate a share of state sales tax revenues to local governments, in exchange for discontinuing certain subvention programs. (The Governor also proposes to give localities one-quarter cent's worth of state sales tax revenues on an *ongoing* basis, beginning in 1988–89.) After removing the distortions caused by the Governor's proposal, the projected increase for sales and use taxes is 5.2 percent in the current year and 6 percent in the budget year. This forecast is based on the department's projection of taxable sales.

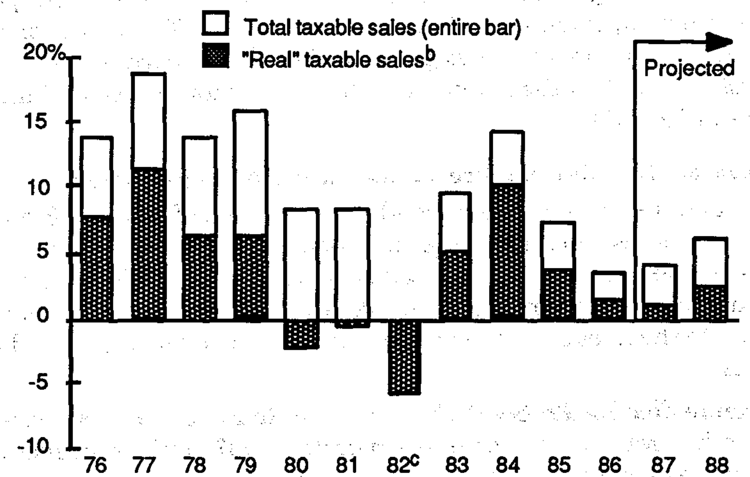
Weak Growth Projected for Taxable Sales. The department predicts that taxable sales, which increased by only 3.7 percent in 1986, will grow by only 4 percent in 1987 and 6.2 percent in 1988. Chart 15 shows that these increases are relatively low by historical standards, both before and after adjustment for inflation, and also are below the projected rate of personal income growth. As a result, the ratio of taxable sales to personal income is not only predicted to decline, but to reach its lowest level in over 20 years (see Chart 16). Taxable sales are predicted to be especially weak in 1987 for fuel (down nearly 6 percent, due to low gasoline prices) and motor vehicles (up only 1 percent, due to a fall-off in car sales from their 1986 level).

Evaluation of the Sales Tax Forecast. Taxable sales depend on such economic variables as income and employment growth, the unemployment rate, interest rates, inflation, and the willingness of consumers to

Chart 15

Annual Growth in California Taxable Sales

1976 through 1988[a]

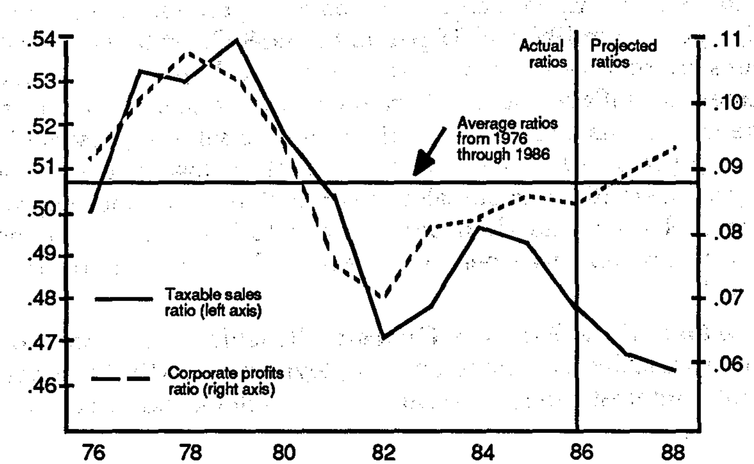


[a] Source: Department of Finance.
[b] "Real" taxable sales equal total taxable sales (current dollars) deflated by the GNP price deflator for consumption expenditures.
[c] Total taxable sales declined by 0.4 percent.

Chart 16

Ratios of California Taxable Sales and Corporate Profits to Personal Income

1976 through 1988[a]



[a] Source: Department of Finance. Data are estimated for 1986 and projected for 1987 and 1988.

borrow more and/or save less in order to finance their spending. Our revenue estimating model confirms that the department's economic assumptions, if realized, will produce relatively weak growth in taxable sales and a decline in the sales-to-income ratio. However, the actual dollar level of taxable sales that our model generates is somewhat higher than predicted by the department. This is because the department's projected decline in the savings rate and in interest rates will partially offset various other negative factors affecting taxable sales. We estimate sales tax revenues *generated by the department's economic forecast* will be greater than predicted, by $50 million in 1986–87 and $115 million in 1987–88.

Uncertainty Regarding Fuel Prices. The revenue projections also may require some upward revision if recent developments involving fuel prices are not reversed. The department has assumed that average gasoline prices will drop from 91 cents per gallon in 1986, to only 86 cents in 1987 and 1988, based on its forecast that crude oil prices will be averaging $15 per barrel. However, the Organization of Petroleum Exporting Countries (OPEC) recently announced it will attempt, through output restrictions, to move crude oil prices into the $18 per barrel range. Partly in response to this announcement, gasoline prices recently moved upward. Historically, each $1 increase in oil prices has tended to eventually increase average gasoline prices by about 2 cents per gallon, which in turn annually increases taxable fuel sales by $240 million and fuel sales tax revenues by about $12 million. *Thus, if oil prices averaged $18 per barrel rather than the $15 level estimated by the department, this could add over $35 million to the department's fuel sales tax forecast in the budget year.*

The Forecast for Bank and Corporation Taxes—Healthy Increase

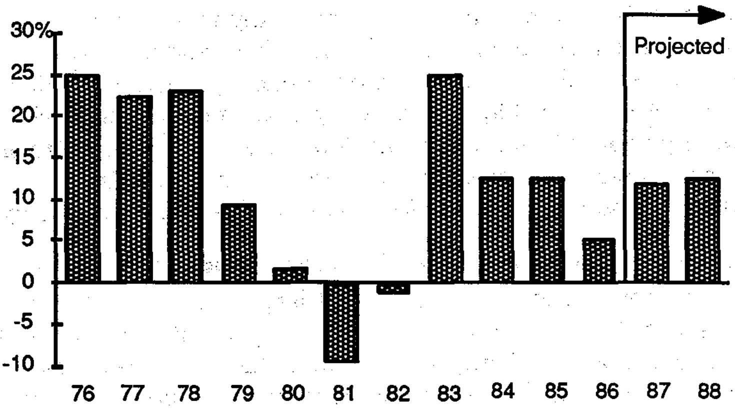
Bank and corporation taxes, the third largest source of General Fund revenues, are derived primarily from a 9.6 percent levy on the taxable profits of corporations doing business in California. These revenues are projected to total $4.3 billion in the current year and $4.7 billion in the budget year. The key assumptions behind these projections involve the effects of federal tax reform and the underlying forecast for taxable profits.

State Revenue Effects of Federal Tax Reform. As summarized earlier in Table 23, the federal Tax Reform Act of 1986 is projected to cause California corporate tax revenues to increase by $100 million in the current year, followed by a $30 million decrease in the budget year. The current year gain reflects the early payment by certain taxpayers of audit assessments, so as to allow them to be deducted on their 1986 federal tax returns. (The act reduces federal corporate tax rates in 1987, thereby making the savings from deducting state taxes less in 1987 than in 1986.) The budget year loss reflects a shift in the reporting of business losses, from the personal income tax to the corporate tax. (The act encourages certain taxpayers with losses to incorporate, since some losses that the act limits under the personal income tax still are allowed under the corporate tax.)

Upswing Predicted in Corporate Profits. After removing the distortions caused by tax reform, corporate tax revenues are projected to rise by 9.7 percent in the current year and 11.6 percent in the budget year. These healthy increases are attributable to the department's forecast that California corporate profits will rise by 12 percent in 1987 and 12.6 percent in 1988. Charts 16 and 17 show that these profit increases are reasonably strong by historical standards and will exceed personal income growth, thereby returning the ratio of profits-to-income to where it stood at the start of the decade.

Chart 17

Annual Growth in California Taxable Corporate Profits
1976 through 1988[a]



[a] Source: Department of Finance. Profit totals include a $967 million increase in 1978 due to Proposition 13. Preliminary 1986 estimate by Department of Finance and Franchise Tax Board.

Evaluation of the Bank and Corporation Tax Forecast. California corporate profits are related to such economic variables as the volume of business activity in California, interest rates, labor costs, and national corporate profits. The level of taxable profits that our revenue estimating model generates from the department's economic assumptions differs somewhat from the department's, although it confirms that these economic assumptions will indeed result in fairly strong profit growth and an increased ratio of profits to income. In addition, the current year revenue estimate should be increased by *$140 million,* due to certain audit-related payments that were received in January but were not included in the department's revenue forecast. Taking both of these factors into account, we estimate that bank and corporation tax revenues *generated by the department's economic forecast* will be greater than predicted, by $130 million in 1986–87 and $20 million in 1987–88.

Insurance Taxes—Continued Strong Gains

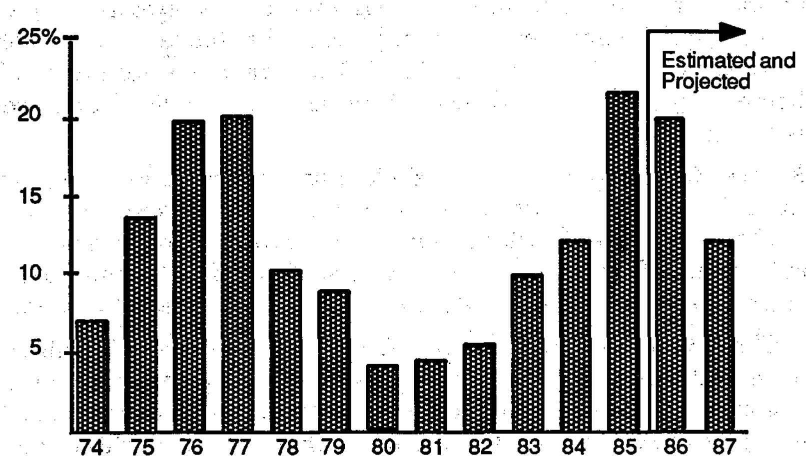
Insurance tax revenues, which primarily are derived from a 2.35 percent levy on taxable insurance premiums, are projected to reach nearly $1 billion (18 percent growth) in the current year, and more than $1.1 billion (over 11 percent growth) in the budget year. Given this strong growth, insurance taxes are predicted to account for 12 percent of new General Fund revenues in the budget year, even though they amount to less than 4 percent of total collections.

Above-Average Growth in Insurance Premiums. Because of the way in which insurance tax prepayments are computed, 1986–87 revenues primarily depend on 1986 premiums, and 1987–88 revenues will depend primarily on 1987 premiums. Chart 18 shows that the strong revenue in-

Chart 18

Annual Growth in California Taxable Insurance Premiums

1974 through 1987[a]



[a] Source: Department of Finance. Insurance tax revenues in 1986-87 primarily depend on 1986 premiums, while revenues in 1987-88 primarily depend on 1987 premiums.

creases predicted for 1986–87 and 1987–88 reflect the department's forecast that insurance premiums will rise by 20 percent (to $38 billion) in 1986 and 12 percent (to $42 billion) in 1987, or well above personal income growth. This forecast is based on survey information from firms collecting over one half of California's insurance premiums. Especially large premium increases are expected for liability insurance lines, especially commercial liability. The latter partly reflects the trend in recent years of increased liability claims and large monetary judgments to plaintiffs.

Evaluation of the Insurance Tax Forecast. Insurance tax premiums are only loosely related to the outlook for the economy. Chart 18 shows that growth in insurance tax premiums tends to follow a cyclical pattern over time. This is because the insurance industry tends to experience cycles of underwriting profits and losses, in response to which it continually adjusts its premium rates. Thus, periods of large underwriting losses are followed by periods of large premium increases, which in turn are followed by periods of improved underwriting profits and lower premium increases. Recent insurance industry data suggest that underwriting profits have been improving, and thus that we may be entering the downside of the premium-growth cycle. As Chart 18 shows, the department's forecast is consistent with this evidence. Therefore, *the forecast is reasonable.*

Death-Related Taxes—Large One-Time Gain Assumed

Death-related tax revenues are predicted to be $270 million in the current year and $367 million in the budget year. The budget year estimate includes $266 million from the estate tax and $100 million from the inheritance tax, including $75 million in inheritance taxes associated with one very wealthy decedent. (Although the inheritance tax was abolished and replaced with the estate tax in 1982, inheritance taxes are still being collected from the unclosed accounts of persons who died before the law was changed.)

Modest Underlying Growth. Excluding the large one-time payment, death-related taxes are projected to increase at a modest 7-to-8 percent pace. This is consistent with the state's death rate, and the rate of appreciation in values of real property and other assets on which death taxes must be paid. Thus, *the department's baseline revenue forecast is reasonable.*

Will the One-Time Gain Be Realized? Whether the $75 million one-time inheritance tax gain will be realized in the budget year depends upon decisions yet to be made by the State Controller. An existing legal settlement gives the Controller the option to either (1) accept this $75 million, or (2) take title to or realize the proceeds from the sale or other use of specified property belonging to the decedent's estate. If the second option is chosen, a state revenue gain may not materialize until *after* the budget year, in which case *1987–88 revenues would be reduced by $75 million.*

The Forecast for Other Taxes—No Growth

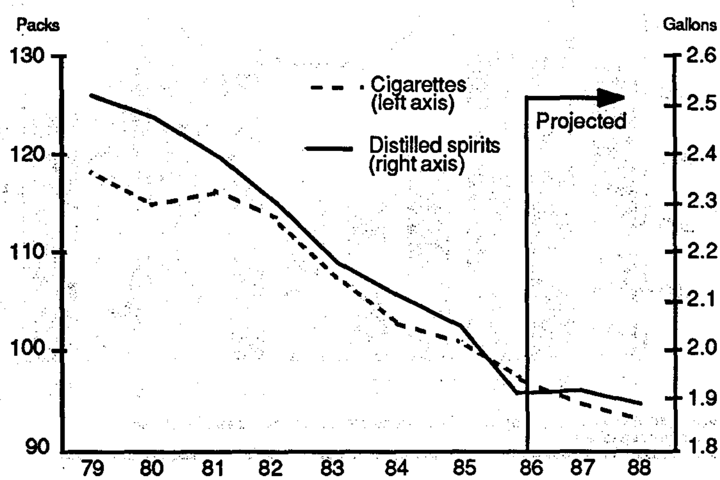
General Fund revenues from the state's remaining taxes are projected to total about $430 million in the budget year, or essentially to remain unchanged from the current and prior years. These taxes include the cigarette tax ($180 million), alcoholic beverage taxes ($134 million), and horse racing taxes ($114 million). The flatness in these revenues is due mainly to two factors:

- First, the "bases" on which the taxes are levied are not growing much. Chart 19, for example, indicates that per capita consumption of cigarettes and liquor have steadily declined in recent years. Per capita horse racing wagering also has fallen in the past couple of years.
- Second, both cigarettes and alcoholic beverages are taxed on a fixed "cents-per-unit-consumed" basis. Thus, taxes collected do not increase over time as the prices for these items rise.

The estimates for these revenues are consistent with the department's economic forecast.

Chart 19

California Per Capita Consumption of Cigarettes and Distilled Spirits
1978-79 through 1987-88[a]



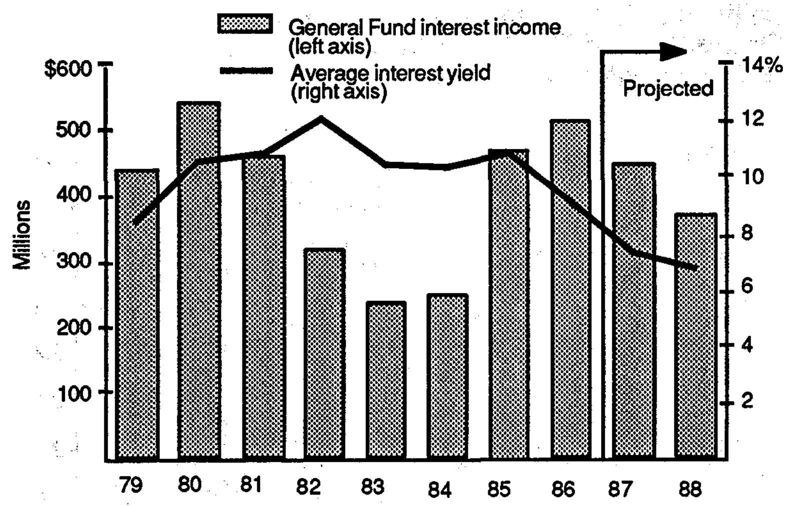
[a] Source: Department of Finance and State Board of Equalization. Data shown are for fiscal years ending in year specified.

The Forecast for Interest Income—Significant Drop Expected

General Fund interest income is predicted to total $380 million in the budget year, down from $450 in the current year and $521 million in the prior year (see Chart 20). This interest income is derived from four sources: (1) the investment of monies carried over from prior years (that is, monies in the Special Fund for Economic Uncertainties and other funds that have been appropriated but not yet spent); (2) earnings on certain special fund balances to which the General Fund is entitled; (3) the investment of incoming General Fund revenues that are temporarily not needed to pay for expenditures; and (4) "arbitrage income" from the short-term investing of temporarily idle monies that the General Fund has borrowed to handle its intrayear cash-flow imbalances. These monies are all invested through the state's Pooled Money Investment Account (PMIA).

Chart 20

General Fund Revenues From Interest Income
1978-79 through 1987-88[a]



[a] Source: *1987-88 Governor's Budget* and State Treasurer. Data shown are for fiscal years ending in year specified.

Key Assumptions. The interest income forecast primarily depends on projections of the General Fund's average investable balance, and the earnings yield of the PMIA. Both of these variables are projected to decline in the budget year—the former ($5.6 billion) due to a projected shrinkage in the General Fund surplus, and the latter (6.8 percent) due to declines in economy-wide interest rates. The reason interest income has not fallen off until the current year despite falling interest rates (see Chart 20), is that the investable PMIA balance was expanding.

Evaluation of the Interest Income Forecast. The department's assumptions regarding the PMIA's average yield are consistent with its economic forecast. However, the interest income projections require two adjustments:

- First, the estimated 1987–88 investable General Fund balance in the PMIA is low, by approximately $500 million. This is equivalent to about $30 million in interest income. The balance is understated because the estimate assumes that the General Fund will earn arbitrage interest for 10 months on $1.8 billion of externally-borrowed funds in 1987–88, whereas the Governor's Budget assumes that $2.4 billion will be borrowed.
- Second, it appears that the General Fund will have to return about $15 million in 1986–87 interest income to the Petroleum Violation Escrow Account (PVEA), in order to comply with federal requirements.

Given the above, *projected General Fund interest income should be reduced by $15 million in the current year and increased by $30 million in the budget year.*

B. Reliability of the General Fund Revenue Forecast

How Reliable Have Past Revenue Forecasts Been?

History shows that the reliability of the department's revenue forecasts has been variable. The primary problem has been accurately predicting how the economy will perform. Over the past decade, the estimating error for budget year revenues (after adjusting for noneconomic factors such as new legislation) has averaged over 5 percent, which in 1987–88 would amount to a revenue-estimating error of over $1.6 billion. In each of the past two years, however, the budget year forecasting error has been very small—only about 1 percent. Yet, even this small percentage error would translate into a dollar error of over $300 million in 1987–88. Thus, *it is only realistic to expect a revenue-estimating error of at least several hundred million dollars, and it is within this band of uncertainty that our assessment of the department's estimates should be viewed.*

How Reliable Are the Budget's Revenue Forecasts?

The reliability of the department's General Fund revenue estimates depends primarily upon two factors:

- First, the extent to which the revenue estimates are ***internally consistent*** with the department's economic forecast. This was discussed in the preceding section for each of the major revenue sources.

- Second, the reliability of the department's ***own economic forecast.*** It is impossible to know ahead of time how "reliable" an economic forecast will prove to be. However, since few individual forecasters consistently outperform the consensus, it makes sense to compare the department's revenue estimates to those which would result if the consensus economic outlook came true. As discussed earlier in the economic outlook section, the department's economic forecast, while very similar to the consensus forecast in its general thrust, is somewhat on the ***conservative side*** relative to the consensus view for California.

General Conclusion—Revenue Estimates Appear Low

Table 24 and Chart 21 show how the department's revenue estimates would change if they were adjusted to reflect (1) our earlier evaluation of the estimates for individual revenue sources, and (2) the consensus economic outlook. We estimate that:

- If the department's economic forecast comes true and all of the special adjustments we have identified are considered, revenues will be *higher* than predicted by $115 million in 1986–87 and $35 million in 1987–88.
- The consensus economic outlook, if it comes true, will *increase* revenues by an additional $85 million in 1986–87 and $250 million in 1987–88.

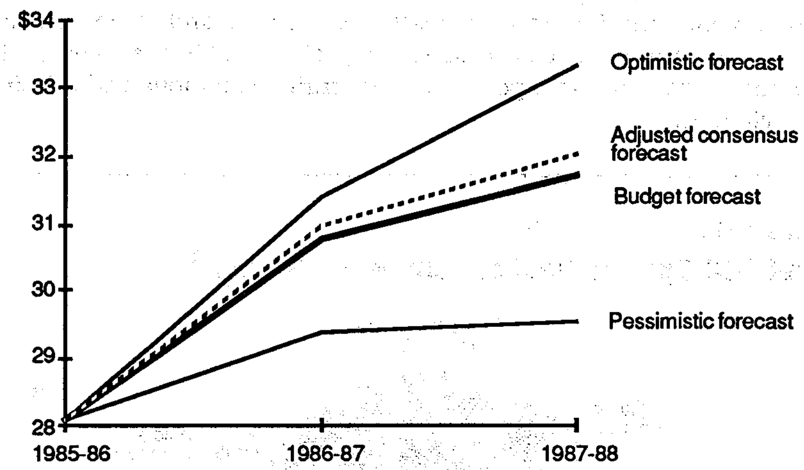
Thus, *these two factors together would increase General Fund revenues by $200 million in 1986–87 and $285 million in 1987–88, or $485 million for the two years combined.*

Table 24
Selected Adjustments to the Department of Finance's Revenue Estimates (dollars in millions)

Type of Adjustment	*1986–87*	*1987–88*	*Two-year Total*
A. Adjustments assuming the department's economic forecast comes true:			
1. Personal income taxes	–$50	–$130	–$180
2. Bank and corporation taxes	130	20	150
3. Sales and use taxes	50	115	165
4. Interest income	–15	30	15
Subtotal	$115	$35	$150
B. Additional adjustments, assuming the consensus economic forecast comes true	$85	$250	$335
Total revenue adjustments	$200	$285	$485

Chart 21

Alternative Revenue Forecasts for 1986-87 and 1987-88 (in billions)[a]



[a] Source: *1987-88 Governor's Budget* and Legislative Analyst's Office.

Significant Error Margins Exist

What if the economy's behavior during 1987 and 1988 differs significantly from both the department's economic forecast and the consensus economic outlook? In this event, Chart 21 shows that General Fund revenues could be either well below the department's projections, or well above that which the consensus outlook produces. Specifically, the chart shows the amount of revenues which the department estimates would be produced by either a strong 1987 economic expansion or a modest 1987 economic downturn. Under the *optimistic* alternative, revenues would exceed the budget forecast by nearly $2.3 billion over the next 18 months (not all of these funds could be spent, however, due to the state's appropriations limit); under the *pessimistic* alternative, revenues would fall short of the forecast by over $3.5 billion. *Thus, even though the department's revenue forecast appears conservative, this bias is not nearly as large as the deviations which could occur due to the economy.*

C. The Forecast for Special Fund Revenues

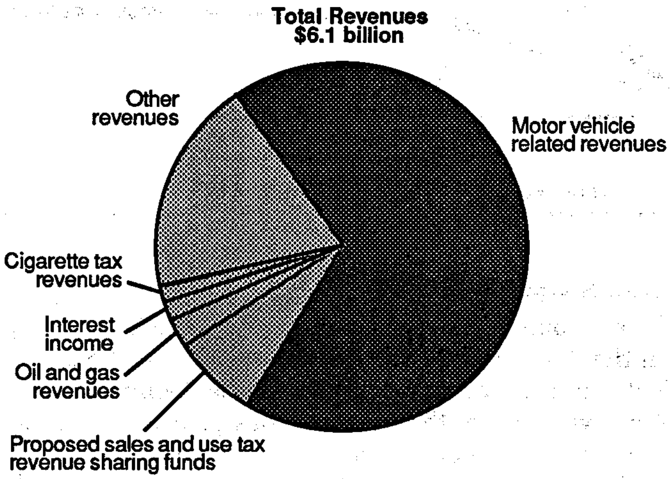
Special fund revenues are projected to total $6.1 billion in 1987–88, or 16 percent of total revenues. Table 22 and Chart 22 indicate that:

- Over two-thirds ($4.2 billion) of special fund revenues are derived from motor vehicle-related sources, including vehicle license fees ($1.9 billion), fuel taxes ($1.3 billion), and vehicle registration and related fees ($1.1 billion).

- The remaining one-third ($1.9 billion) of special fund revenues include oil and gas royalties, interest income, local governments' 30-percent share of cigarette tax collections, the proposed sales and use tax revenue-sharing monies discussed earlier, and other smaller sources including various business and professional license fees, utility surcharge receipts, and penalties from traffic violations and criminal convictions.

Chart 22

1987-88 Special Fund Revenues, by Source[a]



[a] Source: *1987-88 Governor's Budget*.

How Are Special Fund Revenues Used?

Special fund revenues are used for a wide variety of purposes. For example:

- Over half of motor vehicle-related revenues are returned to local governments for transportation-related and other purposes. The remainder is used for various state programs relating to transportation and vehicle use, including the support of the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), and the Department of Transportation (Caltrans).

- The local share of cigarette taxes is distributed between cities (83 percent) and counties (17 percent).
- Interest income generally is credited to various special funds, based on how much they have invested in the PMIA.
- Oil and gas revenues are used primarily to finance capital outlay projects.

Moderate Revenue Growth Expected

Table 22 indicates that special fund revenues are predicted to rise by 19 percent in 1987–88. The underlying growth rate, however, is a more-modest 8 percent after eliminating such distortions as the proposed revenue sharing program and changes in the amount of transfers from special funds to the General Fund. This moderate underlying growth trend, however, incorporates some very different trends for individual revenue sources.

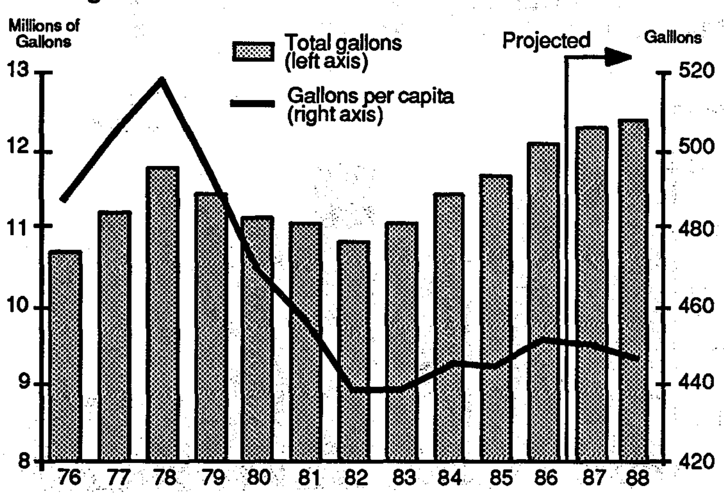
Mixed Growth Trends for Motor Vehicle-Related Revenues

These revenues are projected to grow by 6.5 percent in 1987–88, including strong growth for vehicle license fees (12 percent), very modest growth for registration fees (4 percent), and weak growth for fuel taxes (1 percent). Specifically:

Chart 23

California Gasoline Distributions

1976 through 1988[a]



[a] Source: *1987-88 Governor's Budget* and State Board of Equalization.

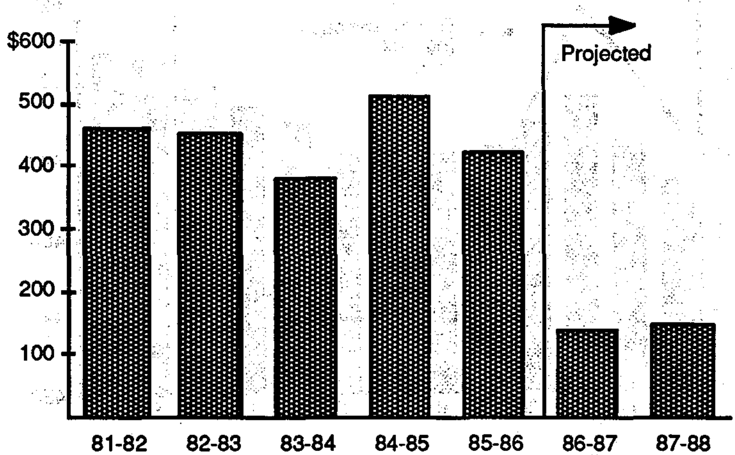
- *Vehicle license fees,* which are imposed for the privilege of operating vehicles on public roads in California and are in lieu of the personal property tax on vehicles, are the single largest special fund revenue source. Their expected strength in 1987–88 reflects two factors. First, the average market value of new cars continues to rise, and is expected to reach $15,000 in 1988 (higher-priced vehicles translate into more revenues, because a vehicle's license fee depends on its market value). Second, the number of registered vehicles continues to rise on a per capita basis.
- *Registration fees,* which are levied at a flat rate, are projected to grow only modestly because of fewer new vehicle sales than in 1986.
- *Fuel taxes,* which also are levied at a flat rate, are projected to increase hardly at all. This is because of weak growth in gasoline sales, due to declining per capita gasoline use. As shown in Chart 23, the per capita level of gasoline distributions remains well below its pre-1980 level.

Oil and Gas Revenues To Remain Low

Chart 24 shows that state oil and gas royalty income is projected to drop dramatically from its level during the past few years. This reflects the early-1986 decline in world crude oil prices, which reduces the revenues derived from oil produced on state-owned lands. Total state oil and gas

Chart 24

State Oil and Gas Royalties
1981-82 through 1987-88 (in millions)[a]



[a] Source: *1987-88 Governor's Budget* and State Lands Commission. Data shown include oil, gas and mineral royalties collected by the State Lands Commission.

royalty income is projected to be only $140 million in the current year and $150 million in the budget year, compared to an average of $450 million during the preceding five years. As a result, the portion of oil and gas revenues distributed to special funds will represent only 2 percent of total special fund revenues in 1986–87 and 1987–88, compared to an average of nearly 10 percent over the prior five-year period.

D. The California State Lottery

The special fund revenue totals contained in the budget do *not* include any revenues derived from the California State Lottery, which first began operation in October 1985. This is because lottery revenues currently are classified as "nongovernmental trust and agency funds," and monies so classified normally are not reported in the budget. Nevertheless, because the lottery is a major source of state income, its revenue outlook is summarized below. A more detailed discussion of the lottery appears under Item 0850 in the *Analysis.*

Projected Lottery Sales—$1.8 Billion

Predicting lottery sales over the next 18 months is extremely difficult, both due to the relatively limited history of lottery wagering in California, and the continued phasing-in of electronic on-line lotto games which began in October 1986.

The budget projects that lottery sales will total $1.8 billion in the budget year. This is the same as in the prior year (which included 9 months of operation), and an increase over the current year's projection of $1.4 billion. Lotto games are expected to account for $1 billion of 1987–88 sales, compared to $750 million for instant ticket games.

Whether or not projected lottery sales will be realized depends primarily on whether lotto wagering, which is assumed to offset a declining trend in instant ticket game wagering, reaches expectations. In order for projected sales to be achieved, per capita lotto wagering will have to more than double from its current level (about 33 cents per week). It is possible that this increase will occur, as lotto receives greater publicity and more on-line terminals are installed. However, if it does not, lottery sales could easily fall several hundred million dollars below the projection.

How Lottery Proceeds Are Used

Chart 25 shows how the budget proposes to distribute the $1.8 billion of projected lottery receipts in 1987–88. Existing law provides that these proceeds must be distributed as follows:

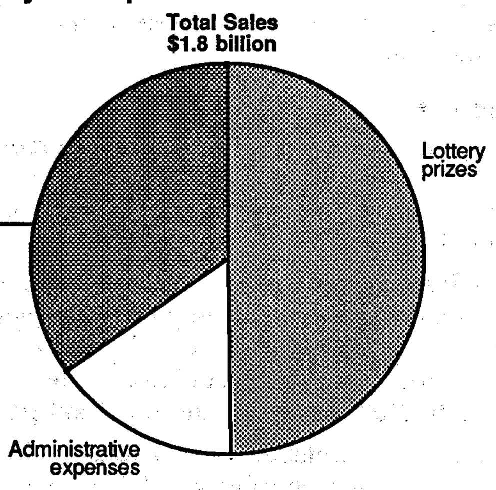
- 50 percent ($875 million) must be paid out to the public as prizes;
- Up to 16 percent ($280 million) may be used to cover lottery-related administrative expenses; and

- At least 34 percent (about $600 million), along with any unclaimed prize monies and unused administrative allotments, must be allocated to various levels of public education.

Chart 25 also shows how the monies going to education are to be allocated to different educational levels. Existing law provides that this be done on the basis of educational enrollments and attendance. Altogether, the 1987–88 lottery revenues earmarked for education amount to about 3.5 percent of total proposed General Fund educational expenditures.

Chart 25

Estimated Distribution of 1987-88 State Lottery Receipts[a]



Revenues to education (in millions)

K-12 Education	$493
Community Colleges	72
California State University	27
University of California	15
Other	1
Total	$608[b]

[a] Source: *1987-88 Governor's Budget*.
[b] Includes $595 million from 1987-88 lottery sales and $13 million in net interest income.

State and Local Borrowing

The Governor's Budget proposes to spend $1.1 billion in funds derived from the sale of state bonds that are supported by the General Fund. These funds will be used primarily for capital outlay programs.

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

- ***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 only by revenues from the projects which are financed from the bond proceeds. State revenue bonds must be authorized by a majority 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 the borrowing conducted by California's local governments. A discussion of the effect that the recently enacted Tax Reform Act of 1986 will have on California's state and local borrowing program appears in Part Three of this document.

STATE BORROWING

The state borrows money on both a long-term and a short-term basis. Long-term borrowing involves the issuance of general obligation and revenue bonds, which provide funds for a variety of state and state-assisted local capital outlay programs. Short-term borrowing is accomplished through the issuance of notes, such as revenue anticipation notes, which are repaid by the end of a given fiscal year. The funds obtained from the sale of short-term notes are used to meet the state's cash flow requirements.

State General Obligation Bonds

The general obligation bonds issued by the state support a range of programs, such as state construction projects, state parks and recreational facilities, new prisons and county jails, and cleanup of hazardous substances. These bonds also are issued to provide financial assistance for California veterans seeking to purchase homes as well as to first-time homebuyers.

During 1986, a record volume of new general obligation bond authorizations—over $3.4 billion—was approved by the voters. Most of this amount consisted of additional authorizations for existing state bond programs—those financing new state prisons ($500 million), county jails ($495 million), school building lease-purchase ($800 million), assistance to veterans ($850 million), clean water ($150 million), parks and recreational facilities ($100 million) and higher educational facilities ($400 million). The voters also approved funds for one *new* program: $100 million for safe drinking water.

Status of Bonds Authorized. Table 25 identifies, for the state's general obligation bond programs, the currently authorized amounts that are outstanding, redeemed, and unsold. The table shows that, as of December 31, 1986, the state had not sold $5.2 billion in authorized bonds, compared to $2.7 billion at the end of 1985. Of the authorized bonds already sold (approximately $14.6 billion), the state had retired $6.3 billion, leaving $8.3 billion (57 percent) still outstanding.

Table 25
General Obligation Bonds of the State of California [a]
As of December 31, 1986
(dollars in millions) [b]

Program	*Authorized*	*Unsold*	*Redeemed*	*Outstanding*
Beach, park, recreational and historical facilities	$400	—	$234	$166
Clean water	1,200	$375	300	525
Community college construction	160	—	91	69
Community parklands	100	100	—	—
County correctional facilities	495	495	—	—
County jail construction	530	255	13	262
First-time homebuyers	200	185	—	15
Harbor bonds	89	—	76	14
Hazardous substance cleanup	100	50	3	48
Health sciences facilities	156	—	74	82
Higher education construction	230	—	177	53
Higher education facilities	400	400	—	—
Junior college construction	65	—	51	14
Lake Tahoe land acquisition	85	55	1	30
New prison construction	1,295	500	58	738
Park and recreational facilities	370	275	4	92
Parklands acquisition and development	285	45	48	192
Recreation, fish, and wildlife	145	55	40	50
Safe drinking water	350	170	19	161
School building aid	2,140	40	1,649	451
School building lease-purchase	1,750	1,000	67	683
Senior centers	50	—	—	50
State construction	1,050	—	891	159
State, urban, and coastal park	280	25	84	171
Veterans farm and home loan	5,950	850	2,215	2,885
Water conservation and quality	150	150	—	—
Water resources development	1,750	180	195	1,375
Totals	$19,775	$5,205	$6,287	$8,283

[a] Source: State Treasurer's Office.
[b] Detail may not add to totals due to rounding.

General obligation bonds can be classified into two categories, depending upon the source of the funding used to pay their debt service costs. For *General Fund bonds,* the debt service is *fully* paid by the General Fund. These bonds account for 43 percent of the total amount of outstanding general obligation bonds. For *self-liquidating bonds,* the debt service costs are either partially or fully paid from project revenues. Should such revenue ever be inadequate to cover the required debt service, however, the General Fund would be obligated to pay for the shortfall. These bonds comprise 57 percent of the total outstanding amount.

Sales of General Obligation Bonds. In 1985–86, the State Treasurer sold $1.2 billion in general obligation bonds. The largest volume of bonds sold ($410 million) was for the new prison construction program. The Treasurer also sold large volumes of bonds for the veterans farm and home loan program ($340 million), the school building lease-purchase program ($205 million), and various state parks and recreational facilities ($125 million).

The State Treasurer's latest schedule calls for the sale of approximately $845 million of general obligation bonds in 1986–87. This amount is $355 million less than the volume of sales in 1985–86, due to a lower level of sales for the veterans program. Bonds for the school lease-purchase program ($250 million) and the county jail program ($200 million) account for about one-half of the sales planned for the current year. As of December 31, 1986, $250 million in bonds had been issued in 1986–87.

For 1987–88, the budget shows that a total of $855 million in general obligation bonds sales are planned, about the same as in the current year. The largest volume of bonds to be sold in 1987–88 is for the new prison construction program ($300 million). The next largest amount will be sold for county jail construction ($230 million), followed by higher education and state school lease-purchase programs ($100 million for each program). In addition, the budget anticipates the sale of bonds for clean water projects ($25 million).

General Fund Cost for Paying Off Bonds. The state's General Fund bears a significant portion of the costs resulting from debt service payments, both principal and interest, made on general obligation bonds. The debt service payments on bonds *fully* paid by the General Fund are shown for the period 1983–84 through 1987–88 in Table 26.

Debt service for the budget year is estimated to total $617 million. Of this amount, approximately $305 million is for payment of interest and $312 million is for repayment of principal. The total payments represent an increase of $79 million, or 15 percent, over estimated expenditures in the current year. While debt service represents a small percentage of total

Table 26
General Fund Debt Service [a]
1983–84 through 1987–88
(dollars in millions)

	Debt Service [b]	*Percent Change From Previous Year*	*Percentage of General Fund Expenditures*	*Total Bond Sales* [c]
1983–84	$318.7	21.6%	1.4%	$360
1984–85	378.6	18.8	1.5	740
1985–86	452.3	19.5	1.6	1,240
1986–87	537.9	18.9	1.7	845
1987–88	616.9	14.7	2.0	855

[a] Includes payment of interest and principal on bonds *currently authorized* by the electorate and fully supported by the General Fund.
[b] Interest rates of 7.0 percent and 7.5 percent are assumed for anticipated bond sales in 1986–87 and 1987–88, respectively.
[c] Source: State Treasurer's Office for actual bond sales from 1983–84 through 1985–86; *Governor's Budget* for 1986–87 and 1987–88.

General Fund expenditures, 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 budget.

The amount of debt service actually paid by the General Fund in 1986–87 and 1987–88 could differ from the amounts shown in the budget, for two reasons:

- ***Project Revenues May Offset Debt Service Costs.*** The authorizations for some bond programs, such as the programs to assist first-time homebuyers and to provide loans to water agencies for water supply improvements, call for project revenues to pay at least part of the costs of debt service. The budget, however, assumes that the General Fund will pay all of the debt service costs, even though some reimbursements are anticipated in the budget year. This assumption reflects uncertainties over the level and timing of these receipts.
- ***Changes in Bond Sale Schedules and Interest Rates Will Affect Debt Service Requirements.*** The debt service estimates in the budget are based on specific assumptions regarding future bond sales and interest rates. If the actual sales volume is greater (less) than the estimated volume, or if interest rates are higher (lower) than projected, the amounts needed from the General Fund to service the debt will increase (decrease) accordingly. For example, in January 1986, debt service for 1986–87 was projected at $525.7 million. As a result of changes in bond sales and the increases in interest rates that have occurred since then, however, the actual level of debt service now is estimated to be $537.9 million, or $12.2 million *higher* than projected.

How the Bond Proceeds Will Be Spent. Once the state's bonds are sold, the proceeds are allocated for expenditure on specific projects. Table 27 identifies these expenditures for the prior, current, and budget years, according to the source of the bond funding.

Table 27
Selected Bond Fund Expenditures
1985–86 through 1987–88
(dollars in million) [a]

Program	*1985–86*	*1986–87*	*1987–88*
Safe and clean water	$64	$172	$224
County jails	120	120	189
Fish and wildlife enhancement	17	28	28
Lake Tahoe land acquisition	2	27	27
New prisons	383	602	45
State construction	— [b]	1	—
School building lease purchase	250	400	400
State parks and recreational facilities [c]	109	192	56
Higher education capital outlay	—	233	157
Totals	$945	$1,775 [d]	$1,124

[a] Detail may not add to totals due to rounding.
[b] Less than $1 million.
[c] Includes expenditures for parklands acquisition, parks and recreational facilities, coastal conservancy programs, and urban and coastal parks.
[d] This amount differs from the amount shown in Schedule 1 of the *Governor's Budget,* due to an error made in the computation of that total.

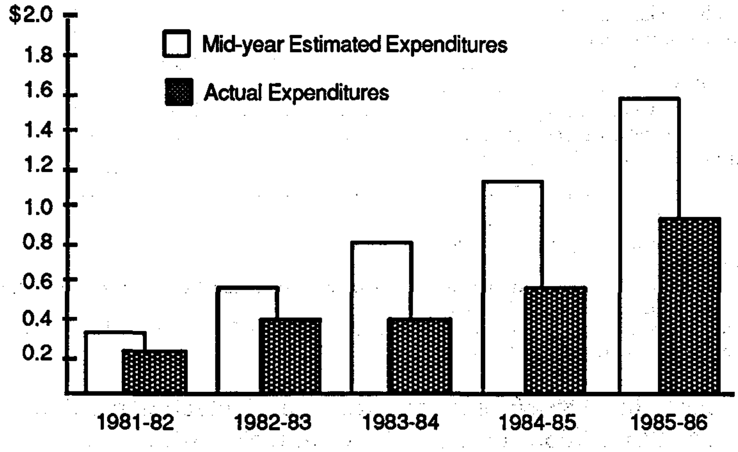
Past Year. In 1985–86, expenditures from selected bond funds totaled about $945 million. Last year, the midyear estimate of bond fund expenditures was $1.6 billion, or approximately $636 million *more* than the amount actually spent. Much of the shortfall was associated with the state's new prison construction program. Actual expenditures for this program were *$235 million less* than what had been estimated, due to delays in construction and the selection of prison sites. Delays in the county jail construction program accounted for an additional $189 million of the shortfall.

Current Year. In 1986–87, the budget indicates that bond fund expenditures will reach a record level of $1.7 billion. Table 28 shows that over 80 percent of the $830 million increase over the 1985–86 expenditure level can be attributed to four programs: new prison construction ($219 million increase), higher education capital outlay ($233 million), school building lease-purchase ($150 million), and safe and clean water ($108 million). The actual level of bond fund expenditures during the current year, however, is certain to fall short of the amount shown in the budget.

For example, the spending level shown in the budget assumes that $602 million in bond funds will be expended in the current year for the construction of new state prisons. Of this amount, however, approximately $200 million in construction funds for the Los Angeles and Riverside prisons will not be expended because the siting of these projects has not been resolved. Hence, it is clear that the level of expenditures projected for this program is overstated. Chart 26 shows a comparison of midyear estimated bond fund expenditures with actual expenditures for the period 1981–82 through 1985–86.

Chart 26

Selected Bond Fund Expenditures Estimated Versus Actual Expenditures
1981-82 through 1985-86 (in billions)[a]



[a] Source: *Governor's Budget*

As noted above, the midyear estimate contained in last year's budget exceeded the amount actually spend *by more than $636 million.* For 1984–85, the midyear estimate exceeded the actual level of expenditures by $542 million. As a result, the Legislature should not expect bond fund expenditures during the current year to come anywhere near the $1.7 billion estimated by the budget.

Budget Year. The level of bond fund expenditures are expected to return to a more normal level ($1.1 billion) for 1987–88. Four programs account for about two-thirds of these expenditures: school building lease-purchase ($400 million); county correctional facilities ($105 million); water conservation and water quality ($111 million); and prison construction ($157 million).

State Revenue Bonds

Various agencies of the state issue revenue bonds. These bonds are fundamentally different from general obligation bonds, in that only the revenue generated from the project is pledged as security and used to service the debt.

Revenue bonds traditionally have been used to finance the construction of such projects as state-operated bridges, fair facilities, and higher education dormitories. However, beginning in the 1970s the state expanded the scope of revenue bond programs to include financing for home purchases, pollution control, and health and educational facilities. In 1984, the Legislature created a new program which authorizes the California Industrial Development Financing Advisory Commission (CIDFAC) to issue revenue bonds in order to provide financial assistance for small business development. Most of the newer programs provide financing for projects (such as housing and alternative energy facilities) that actually are owned or operated by a *private entity,* rather than a state or local agency.

Table 28 identifies the 20 different types of state revenue bond programs and shows the current authorization for each. As of December 31, 1986, a total of $14.5 billion in state revenue bonds was outstanding. Three housing bond programs account for over $3.6 billion, or 31 percent, of the total outstanding amount: the California Housing Finance Authority ($2.5 billion), Veterans Revenue Debenture ($1.1 billion), and the California National Guard ($27 million). Bonds issued by the California Pollution Control Financing Authority ($2.7 billion) and the California Health Facilities Financing Authority ($3.5 billion) also account for significant portions of the outstanding revenue bonds. The table also shows that 12 of the 20 programs have statutory authorization limits, which together total $14.3 billion. Of this amount, approximately $6.1 billion (42 percent) was unused at the end of 1986.

Table 28
State Agency Revenue Bonds [a]
As of December 31, 1986
(dollars in millions)

Issuing Agency	*Authorization Limit, If Any*	*Out-standing*	*Remaining Authorization*
California Alternative Energy Source Financing Authority	$200	$116	$84
California Educational Facilities Authority	1,250	688	562
California Health Facilities Financing Authority	4,429	3,491	938
California Housing Finance Authority	3,750	2,536	1,214
California Industrial Development Financing Advisory Commission (Small business financing)	—	—	—
California National Guard	100	27	73
California Passenger Rail Financing Commission	1,250	—	1,250
California Pollution Control Financing Authority	—	2,675	—
California Student Loan Authority	300	102	198
California Transportation Commission	—	92	—
California Urban Waterfront Area Restoration Financing Authority	650	—	650
Department of Water Resources	—	1,522	—
Hastings College of Law	—	7	—
Regents, University of California	—	902	—
State Public Works Board	—	842	—
State Public Works Board (Energy Conservation and Cogeneration)	500	66	434
Trustees, California State University	—	224	—
Veterans Revenue Debenture	1,500	1,135	365
California School Finance Authority	250	50	200
Hazardous Substance Cleanup Financing Authority	100	—	100
Totals	14,279	$14,475	$6,068

[a] Source: State Treasurer's Office.

Revenue Bond Sales. Revenue bond sales have increased dramatically in the last five years. State financing authorities issued approximately $800 million in revenue bonds in 1980–81 and $1 billion in 1981–82. From 1982–83 through 1984–85, revenue bond sales were approximately $2 billion each year. In 1985–86, $4.8 billion in revenue bonds were sold—a new record.

Three authorities accounted for almost 75 percent of the 1985–86 sales: the California Housing Finance Authority ($0.6 billion), the California Pollution Control Financing Authority ($1.4 billion), and the California Health Facilities Financing Authority ($1.5 billion). As of December 1986, a total of $2.7 billion in revenue bonds had been sold in 1986–87.

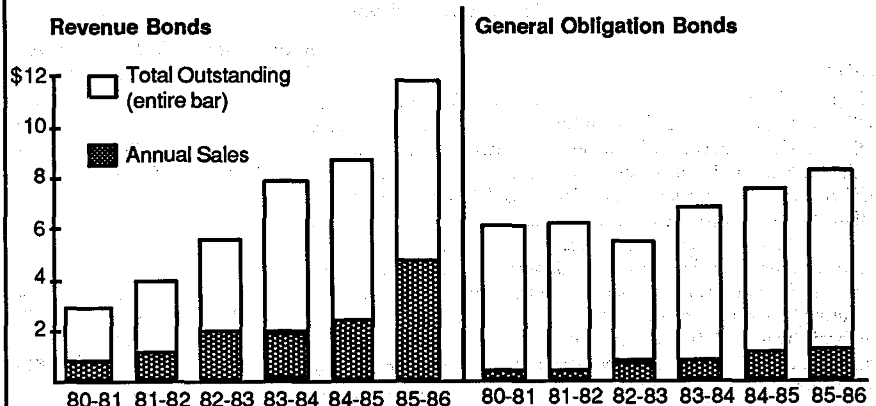
Use of General Obligation Versus Revenue Bonds

Chart 27 compares the sales and outstanding volumes of state general obligation and revenue bonds since 1980–81. It shows that revenue bond sales have significantly exceeded general obligation bond sales in each of the past six years.

Chart 27

State General Obligation and Revenue Bonds Annual Sales and Total Outstanding Volumes

1980-81 through 1985-86 (in billions)[a]



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

The increase in revenue bond sales, relative to general obligation bond sales, reflects several factors. First, revenue bonds generally are not subject to statutory interest rate ceilings. Under existing state law, the interest rate on general obligation bonds cannot exceed 11 percent. High interest rates, particularly during 1982 and 1983, have sometimes made it difficult to sell general obligation bonds at interest rates below this ceiling. Second, general obligation bonds are normally subject to specific authorization limits, which must be approved by the voters. As shown in Table 25, the limits for eight of these programs already have been reached. In contrast, there are no restrictions on sales under eight of the state's 20 revenue bond programs. Finally, the large increase in the volume of revenue bonds reflects the growing trend towards using this method of financing for "non-traditional" purposes. In fact, nearly 63 percent of the $9 billion increase in outstanding revenue bonds between 1980–81 and 1985–86 is due to two programs created within the past five years: those used to finance pollution control facilities ($2.8 billion) and private health facilities ($2.9 billion).

Additional Long-Term Borrowing

In addition to issuing general obligation and revenue bonds, the state also engages in other forms of long-term borrowing. These forms involve the issuance of *certificates of participation* (CPs) and *lease revenue bonds.* For example, in 1983 the state issued $42 million in CPs to fund the construction of the new headquarters facility for the Franchise Tax Board. In the following year, it issued $27 million to finance a telecommunications system for the University of California, Los Angeles. In addition, the Legislature has authorized the State Public Works Board to issue nearly $1 billion in lease revenue bonds for state prison construction projects, $0.5 billion for energy conservation and cogeneration projects, and $0.6 billion to provide financing for the construction of "high technology" educational facilities and libraries at the California State University and the University of California.

General Fund Debt Service Hidden in Agency Budgets. The funding needed to pay off the debt resulting from these types of long-term borrowing is provided by the General Fund and is subject to the state's appropriation limit. Repayment expenditures, however, are not included in the administration's estimate of debt service requirements. This is because for CPs and lease revenue bonds, "debt service" is budgeted in the individual agencies' support budgets as the cost of "facilities operations." These costs are approximately $20 million in the budget year. In future years, as currently authorized construction projects are completed and occupancy takes place, lease costs are expected to increase to approximately $150 million annually.

Short-Term Borrowing By the State

The state's General Fund often borrows money on a short-term basis to compensate for the differences in timing 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 cash needs were funded from internal sources, usually from the Special Reserve for Economic Uncertainties, from special funds, and from the Pooled Money Investment Account (PMIA). In recent years, the state has borrowed more from external sources. This type of borrowing was needed during 1982–83 and 1983–84 because sufficient funds were not available internally to meet the General Fund's cash needs.

In 1984 the Legislature authorized the use of external borrowing, even when sufficient internal funds are available. It did so 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 obtain funds from external sources at tax-exempt interest rates, while internal sources must be paid interest at rates comparable to the yield on taxable securities in which the funds normally are invested. Since the state can invest its externally borrowed funds at taxable interest rates when they are not being used to finance cash-flow shortages, the state can sometimes make a profit by borrowing.

For the current year, the state borrowed $2.6 billion through the sale of revenue anticipation notes in August 1986. These notes will be repaid by June 1987. For 1987–88, the budget shows that $2.4 billion in short-term notes will be sold in August 1987.

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 which can be paid on certain debt. In addition, the state has been required to implement recently enacted federal limits on certain types of borrowing for private purposes, including industrial development and housing. A discussion of the effect that the federal Tax Reform Act of 1986 will have on California's state and local borrowing program appears in Part Three of this document.

Regardless of the scope of its specific responsibilities for regulating local borrowing, the state has an important interest in the amount of debt issued by local governments. This is because the marketability of state debt can be affected by the total volume of tax-exempt local debt offered to investors.

Long-Term Local Borrowing—Increases

Long-term bond sales by local governments increased dramatically in 1985–86. According to information from the California Debt Advisory Commission, the volume of local bond sales exceeded $18.5 billion in 1985–86, which is $5 billion, or 37 percent, more than the amount of sales reported for 1984–85. Some of the overall increase is due to accelerated bond sales by local agencies that were attempting to avoid the tighter debt issuance restrictions of the federal Tax Reform Act of 1986.

A large portion of the sales increase, however, can be attributed to bonds for capital improvement projects. Between 1984–85 and 1985–86, sales of capital improvement bonds (primarily power generation and transmission projects) increased by 66 percent (from $6.1 billion to $10.1 billion). Finally, the increase in overall bond sales also reflects the general decline in interest rates, which have made more projects economically viable. In the future, local governments will once again be able to rely on general obligation bonds as a source of financing for these projects, due to the approval of Proposition 47 at the June 1986 statewide election. This measure restored the ability of local agencies to increase their property tax rates as security for the bonds.

Short-Term Local Borrowing

Local governments engage in short-term local borrowing for cash management purposes by issuing a variety of secured and unsecured debt instruments. Most of the borrowing is accomplished through the issuance of tax and revenue anticipation notes. In 1985–86, local governments issued approximately $3.3 billion in short-term debt, which is approximately $400 million more than the volume issued in 1984–85. These amounts, though large in volume, are considerably smaller than the $5.3 billion of debt issued in 1982–83, when the economic recession caused local governments to borrow heavily from outside sources to meet their cash-flow requirements.

The State's Work Force

The Governor's Budget proposes a state government work force of 240,527 personnel-years (pys) for 1987–88. Four functional areas account for 78 percent of the total: higher education (38 percent); health and welfare (15 percent); business, transportation, and housing (14 percent); and youth and adult corrections (11 percent).

THE PROPOSED WORK FORCE FOR 1987–88

The budget proposes to *increase* the size of the state's work force by 4,372 pys, or 2 percent, in 1987–88. The largest increases would occur in three program areas—youth and adult corrections (+2,195 pys), higher education (+1,220 pys), and business, transportation and housing (+520 pys). These increases would be partially offset by a decrease in health and welfare programs (−639 pys), as shown in Table 29.

Table 29
The State Work Force, By Function [a]
(in personnel-years)
1985–86 through 1987–88

	Actual 1985–86	*Estimated 1986–87*	*Proposed 1987–88*	*Change 1986–87 to 1987–88 Amount*	*Change 1986–87 to 1987–88 Percent*	*Change 1985–86 to 1987–88 Amount*	*Change 1985–86 to 1987–88 Percent*
Legislative, Judicial, Executive	9,995	10,405	10,666	261	2.5%	671	6.7%
State and Consumer Services	11,749	12,060	12,230	170	1.4	481	4.1
Business, Transportation and Housing	33,277	33,401	33,921	520	1.6	644	1.9
Resources	13,801	14,238	14,564	326	2.3	763	5.5
Health and Welfare	37,371	37,800	37,161	−639	−1.7	−210	−0.6
Youth and Adult Corrections	18,868	24,085	26,280	2,195	9.1	7,411	39.3
Education	2,474	2,725	2,736	11	0.4	262	10.6
Higher Education	92,133	91,202	92,422	1,220	1.3	290	0.3
General Government	9,974	10,240	10,548	308	3.0	574	5.8
Totals	229,641	236,156	240,527	4,372	1.9%	10,887	4.7%

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.

Table 29 indicates that the proposed state work force for 1987–88 is 10,887 pys higher than the actual number of personnel-years worked in 1985–86. Over the two-year period covered by the table, youth and adult corrections programs will increase by 7,411 pys, or 39 percent, while health and welfare will decrease by 210 pys, or 0.6 percent.

Proposed Budget Year Changes by Function

Health and Welfare. The budget proposes reductions of 639 pys for health and welfare programs. This proposed decrease is primarily due to a reduction of 425 pys in the Employment Development Department, and is attributable to a variety of factors. These include automation of the unemployment insurance (UI) and tax accounting programs, program transfers to other departments, workload changes in the UI program, and program terminations. Staffing cuts proposed for the state hospitals operated by the Department of Developmental Services account for an additional reduction of 360 pys, reflecting further implementation of the administration's efforts to "contract-out" laundry and housekeeping duties.

These decreases are partially offset by increases in two areas. First, the Department of Mental Health shows an increase of 217 pys, primarily due to the full-year effect of the Mentally Disordered Offender program added in the current year. Second, the Department of Health Services proposes to add 113 pys for toxics programs.

Business, Transportation and Housing. The budget proposes to increase staffing in this area by 520 pys, or 1.6 percent, over the estimated current year level. Most of this increase is due to an additional 510 pys in the Department of Transportation. Of these 510 pys, 395 pys are to increase the department's capability to plan, design and engineer highway capital outlay projects. The remaining 115 pys are for highway maintenance (43 pys), operations (28 pys), closing out the accounts of completed highway capital outlay projects (34 pys), and various other workload increases. The budget also proposes to add 110 pys to the California Highway Patrol for increased workload and program enhancements.

Higher Education. The budget proposes an increase of 1,220 pys, or 1.3 percent, above the current year level. The main factor pushing up staffing is increased enrollments. The University of California's (UC) budget proposes a net increase of 451 pys, due to enrollment growth of 2,900 full time equivalent (FTE) students. The budget for the California State University proposes a net increase in staffing of 751 pys, related to enrollment growth of 5,995 FTE students.

Youth and Adult Corrections. The state's correctional programs account for the most significant staffing increases in the budget year, as they have in the preceding four years. Since 1985–86, the last year for which actual data are available, staffing for this function has increased by 7,411 pys, or 39 percent. The budget proposes to increase the Department of Corrections' staffing by 2,126 pys, or 10 percent, in 1987–88. This increase is primarily due to significant increases in the adult inmate population and the opening of new facilities to accommodate the additional inmates. Similarly, the Department of the Youth Authority will have an increase of 58 pys in 1987–88, largely because of an increase in the ward population and the opening of new living units within existing facilities in the budget year.

Resources. The budget proposes to increase staffing in this area by 326 pys, or 2.3 percent, in 1987–88. Workload and implementation of legislation, rather than new initiatives in the budget, account for the bulk of these increases. For example, an additional 86 pys are allocated to the Department of Conservation to implement new container recycling legislation.

PERSONNEL-YEARS IN HISTORICAL PERSPECTIVE

As with last year's budget, the Governor's Budget for 1987–88 does not place a great deal of emphasis on limiting the size of the state's work force. Since the Legislature enacted the 1986 Budget Act, the size of the work force has grown by 6,515 pys in the current year and would grow by an additional 4,372 pys in the budget year if the Governor's proposals are approved. This amounts to a two-year increase of 10,887 pys, or 4.7 percent. Increases in just one department, the Department of Corrections, account for 6,940 pys, or 64 percent of the total two-year change.

Table 30 summarizes the trends in state staffing since 1981–82. The table shows that state staffing has experienced large decreases (1,794 pys in 1983–84), large increases (6,515 pys in the current year), and smaller changes (in other years). The state's work force will increase by 11,714 pys, or 5 percent, during the period 1981–82 through 1987–88, if the budget proposals are realized.

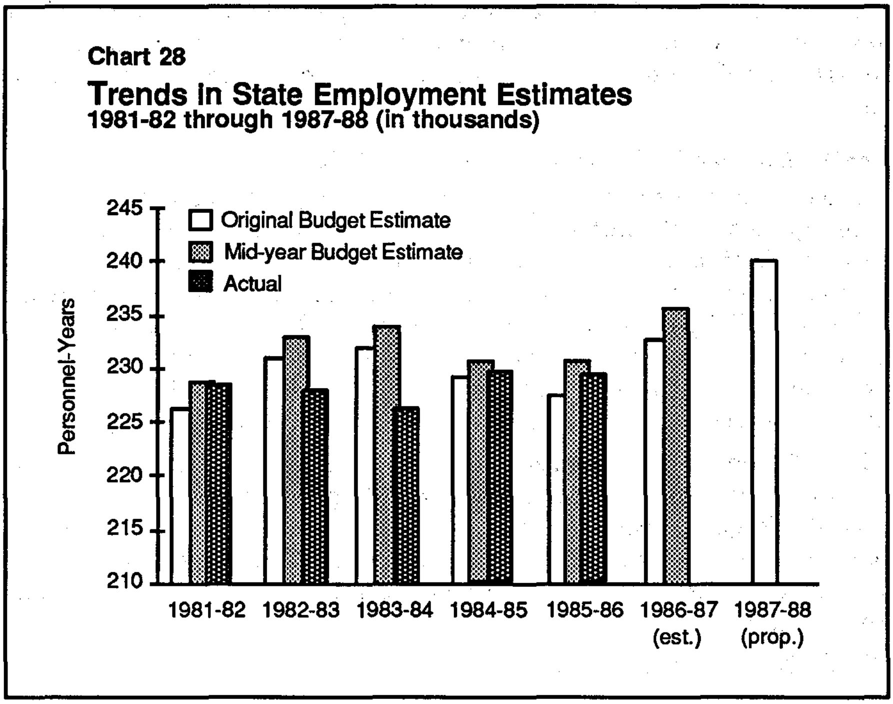
Table 30 also reveals that:

- The revised estimate of the state's work force in the current year is 6,515 pys larger than what the work force actually was in 1985–86.
- The staffing level proposed by the Governor for 1987–88—240,527 pys—represents the largest request for staffing during the past seven years, and, in fact, is the largest in the state's history.

Table 30
State Personnel-Years [a]
1981–82 through 1987–88

	Proposed in Budget	*Subsequent Change*	*Actual*	*Change From Prior Year*
1981–82	226,743	2,070	228,813	3,246
1982–83	231,375	−2,886	228,489	−324
1983–84	232,371	−5,676	226,695	−1,794
1984–85	229,540	305	229,845	3,150
1985–86	227,888	1,753	229,641	−204
1986–87	233,098	3,058 [b]	236,156 [b]	6,515 [b]
1987–88	240,527	—	—	4,372 [c]

[a] Source: *Governor's Budget*. Detail may not add to totals due to rounding.
[b] Estimated.
[c] Proposed.



Personnel-Year Estimates

Chart 28 illustrates that three patterns we identified two years ago with regard to state employment continue to hold: (1) midyear estimates of staffing levels typically are higher than the original budget estimates, (2) midyear estimates of pys in recent years tend to overstate the actual number of pys that will be worked, and (3) inflated midyear estimates make the number of pys proposed in the budget year look smaller.

Proposed Versus Midyear Estimates. Chart 28 shows that, in each of the last six years, the midyear estimate of the total state work force has been significantly higher than what the original budget for that year proposed. There are two reasons for this: (1) the administration and the Legislature typically increase staffing levels during the course of deliberations on the budget, and (2) the administration typically creates new positions administratively after the budget is enacted.

Midyear Estimate Versus Actual Staffing. Chart 28 shows that *every* year from 1981–82 through 1985–86 (the last year for which actual data are available), the state's actual staffing turned out to be below—in two of the five years, significantly below—the midyear estimate. As we predicted last year, the midyear estimate of 231,079 pys for 1985–86 (given in the Governor's 1986–87 budget proposal) exceeded the 229,641 pys actually worked in 1985–86 (according to the 1987–88 Governor's Budget). As in prior years, the unallocated cuts required by the administration in the 1986–87 fiscal year (absorption of merit salary adjustments, price increases, and the 2 percent cuts required by a December 1986 Executive Order) will translate for the most part into unallocated personnel reductions. Given the need for departments to intentionally hold positions vacant in order to generate additional salary savings to achieve these reductions, it is likely that the actual staffing level shown for 1986–87 in next year's budget will again be below the midyear estimate for 1986–87.

Inflated Midyear Estimates Make Budget Proposals Look Smaller. Chart 28 also shows that, from 1982–83 through 1984–85, midyear estimates for the budget just enacted have been higher than the personnel-year level proposed for the following year. This gave the appearance that the state work force was being pared back, when, in fact, the number of pys proposed for the budget exceeded the number of *actual* pys in the prior year. The Governor's last two budget proposals—1986–87 and 1987–88—have reversed this trend, by adopting a midyear estimate which is lower than the personnel level proposed for the budget year. In either case, however, the inflated midyear estimates make the budget year increase look smaller than it really is.

What Personnel-Year Changes Have Occurred Since 1983–84?

Table 31 shows the change in pys, by budget category, since 1983–84. It shows that the same four functional areas account for most of the state's work force today, just as they did in 1983–84: higher education; health and welfare; business, transportation, and housing; and youth and adult corrections. Over the four-year period, however, staffing for youth and adult corrections has grown by 71 percent, while staffing for health and welfare has decreased by 5 percent. Business, transportation and housing and higher education have remained relatively level.

Table 31

Comparison of Changes in the State's Work Force, By Function [a]
(in personnel-years)
1983–84 and 1987–88

Program	Actual 1983–84	Proposed 1987–88	Change 1983–84 to 1987–88 Amount	Percent
Legislative, Judicial, Executive	9,486	10,666	1,180	12.4%
State and Consumer Services	11,256	12,230	974	8.7
Business, Transportation and Housing	33,092	33,921	829	2.5
Resources	13,519	14,564	1,045	7.7
Health and Welfare	39,288	37,161	−2,127	−5.4
Youth and Adult Corrections	15,336	26,280	10,944	71.4
K–12 Education	2,548	2,736	188	7.4
Higher Education	93,092	92,422	−670	−0.7
General Government	9,079	10,548	1,469	16.2
Totals	226,695	240,527	13,832	6.1%

[a] Source: *Governor's Budget.* Detail may not add to totals due to rounding.

Unallocated Reductions Overstate Personnel-Year Totals

As in past years, this year's budget requires state agencies to absorb the cost of merit salary adjustments and general price increases through "unallocated reductions" in expenditures. For fiscal years 1986–87 and 1987–88, however, departments also must absorb "Special Adjustment" reductions in addition to these unallocated reductions. These "Special Adjustment" reductions amount to 2 percent and 1 percent, of most agencies' General Fund supported operating budgets (state operations) for 1986–87 and 1987–88, respectively. A large portion of both types of unallocated reductions will be realized through increases in salary savings, as new or vacant positions are left unfilled. The effect of the "Special Adjustment" reductions is not reflected in the personnel-year totals shown in the Governor's Budget.

The failure to fund salary and price adjustments in recent budgets has already led departments to fund unavoidable cost increases by keeping more positions vacant every year. Our analysis indicates that the statewide salary savings rate has increased from 2.8 percent, or 6,744 vacant positions, in 1983–84 to 3.8 percent, or 9,471 vacant positions, proposed for 1987–88. In dollar terms, the salary savings increase is even greater, growing from a $176 million savings in 1983–84 to a $320 million savings in 1987–88. This represents an 82 percent increase during the five-year period. The proposed increase in statewide salary savings from the estimated current year level is $53 million, or 20 percent.

Given the relatively high level of salary savings built into the budget, departments will have great difficulty in meeting their salary savings targets, achieving their "Special Adjustment" reductions, *and* providing the level of services anticipated by the budget. This has significant implications for the Legislature.

Specifically, what this means for the Legislature is that it will be asked to approve department budgets for 1987–88 which do not accurately reflect the level of services to be provided. Departments, rather than the Legislature, will decide which positions to leave open, and thus, which program activities will be cut back.

PART THREE

Major Fiscal Issues Facing the Legislature

Revenue Issue

- Conformity to the Federal Tax Reform Act

Expenditure Issues

- The State's Appropriations Limit
- State Bonds After Federal Tax Reform
- Rising Costs of Incarceration in California
- The AIDS Epidemic
- Implementing GAIN
- Financing Community Colleges
- Higher Education Facilities Planning
- California's Long-Term Care System
- State Regulation of the Trucking Industry
- Infrastructure--the Silent Cost
- Transportation and Waste Treatment Infrastructure
- County Finances
- State PERS Employer Contributions
- The New Federal Immigration Law
- Federal Initiative for Early Education for the Handicapped

Part Three

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

In addition to the major policy and funding issues identified in the *Analysis,* this part discusses some of the broader issues facing the Legislature in 1987. Many of these issues are closely linked to funding requests contained in the Governor's Budget for 1987–88; others are instances of the failure of the budget to address the state's response to new federal legislation. Still others are more long-range in nature and will, in all probability, persist for many years beyond 1987.

Most of the issues in this section fall into four categories. The first is the fiscal constraints facing the state and the counties. The second category deals with program changes that directly affect the state budget: the rising costs of incarceration, the AIDS epidemic, implementation of GAIN, financing community colleges, and California's long-term care system. The third category includes issues the Legislature needs to address in response to federal legislation: tax reform, revenue bond limitations, immigration reform and control, and early education for the handicapped. Finally, there are issues that arise from the growing deferred maintenance and capacity needs of the state's infrastructure systems: prisons, higher education campuses, state hospitals, state office buildings, highways, and sewage treatment facilities.

The most prominent theme that emerges from our discussions is the need for *long-range planning.* Decisions made in 1987 about many of these issues will determine budget requirements for years to come.

The second theme of this section is the importance of considering these long-range needs now, and determining what *priority* the state is to place on each of them in the future. This priority setting is especially critical because the state's appropriations authority under Article XIII B of the State Constitution is anticipated to grow more slowly than the economy and the cost of governmental services. By considering its options this year, the Legislature can design a long-range, coordinated approach for financing and providing these services in the future.

Revenue Issue

CONFORMITY TO THE FEDERAL TAX REFORM ACT

Should the Legislature Conform State Tax Laws to the Federal Tax Changes Enacted by the Tax Reform Act of 1986?

Summary

- *Given the many similarities between California's income tax and the federal income tax, there are strong reasons for conforming state law to the provisions of the federal Tax Reform Act of 1986.*
- *We recommend that the Legislature continue its policy of selective conformity, whereby individual tax provisions are reviewed on a case-by-case basis, and then action is taken to conform, partially conform, or not conform.*
- *Based on our review, conformity to the new federal law is desirable in several areas, including the new limits on deductions for medical expenses, business expenses, and consumer interest, the restrictions on tax shelters, and the repeal of the partial exclusion for capital gains and income averaging.*
- *However, conformity may not be desirable in other areas, including the federal taxation of unemployment benefits, deductions for contributions to individual retirement accounts, and certain new or extended tax expenditure programs.*
- *In the remaining areas, the decision to conform or not to conform will depend upon legislative tax policy preferences, including those relating to the distribution of the tax burden between businesses and individuals, the progressivity of the tax, and the need to provide tax preferences for certain types of economic and social activities.*

California's personal income tax was established in 1935. Today, it is the state's largest single source of General Fund revenue. In 1987–88, the amount of income taxes paid by almost 13 million taxpayers will total $13.2 billion, or 42 percent of total General Fund revenue.

The state income tax is based on the same principles and follows many of the same rules as the federal income tax. The Legislature, in fact, has enacted a series of measures in recent years which have conformed many features of California tax law to their federal counterparts. The interest in conformity is especially strong this year, because federal law has been substantially revamped by the Tax Reform Act of 1986. The new law was enacted partly to make the federal income tax more equitable. Thus, many would argue that the need for federal conformity is greater than ever.

This section evaluates whether the Legislature should conform the state income tax to the provisions of the Tax Reform Act. We first describe the major features of the Act and the reasons why it was adopted. Next, we evaluate what its adoption means for California's income tax system, and how the state might or might not benefit from conformity. We then evaluate the various approaches that the Legislature might wish to follow in addressing the conformity issue. Lastly, we offer recommendations as to whether the state should, or should not, conform to specific federal provisions.

What Does the Tax Reform Act Do?

The Tax Reform Act does not alter the basic concepts underlying the income tax or the manner in which individuals calculate their tax liability. It does, however, make a wide range of significant changes within the basic federal tax structure, affecting both individuals and corporations.

Base Broadening and Rate Reductions. The measure *broadens the tax base*—that is, it *increases* the amount of income subject to tax. At the same time, it sharply *reduces tax rates.* The base-broadening provisions and the rate reductions are intended to offset each other, so that the measure, in the aggregate, is estimated to be almost *revenue neutral.* Within the measure, however, are specific provisions which cause significant changes in the overall distribution of the tax burden.

Shift of Tax Burden from Individuals to Businesses. The Act's most important distributional effect is that, on the whole, it will reduce taxes for individuals and increase taxes for businesses. According to federal reports, individual income taxes will decrease by $122 billion between 1987 and 1991 (about 5 percent), while corporate income taxes will increase by $120 billion, or 22 percent, over the same five-year period.

The corporate tax increases are due mainly to the repeal of the investment tax credit, changes in accounting methods, restrictions on accelerated depreciation, and changes in other tax preferences. Again, however, not all corporate taxpayers will fare the same. Manufacturing companies in certain capital-intensive, "smokestack" industries will pay more taxes than otherwise, due to the elimination of various tax preferences that had been available to offset the costs of capital investments. However, other corporations will pay less, because they will benefit by reductions in the corporate tax rate.

Shift of Tax Burden from Lower to Higher-Income Individuals. Although taxes paid by individuals will be reduced overall, lower-income taxpayers will benefit relatively more than others, due to a combination of lower tax rates and increases in the standard deduction and personal exemption. On the other hand, many high-income taxpayers will end up paying more because of the repeal of certain deductions, restrictions on the use of tax shelters, and the higher effective tax rate on capital gains.

Why Tax Reform Was Adopted

The stated objective of Congress in enacting the tax reform measure was to promote tax equity, tax simplicity, and economic growth.

Tax Equity. Congress was concerned that many individuals had been able to avoid paying their "fair share" of taxes, through the use of tax shelters and certain tax preferences that produce large tax writeoffs. This, in turn, had contributed to an erosion of the federal tax base and resulted in inequitable tax burdens. The Congress also was concerned that other individuals, unable to claim these preferences, might lose confidence in the tax system and respond by trying to evade their tax liability. The Tax Reform Act attempts to improve the fairness of the tax system, by reducing the variability in tax liabilities between individuals with similar incomes.

The Act also abandons the use of highly progressive income tax rates. Instead, it establishes just two rates, which are considerably lower than before for most taxpayers. Despite the elimination of progressive tax rates, however, the Act is designed to have the *same* general progressivity as before. This is because the base-broadening provisions affect high-income taxpayers more than those at lower income levels.

Tax Simplicity. The Tax Reform Act also is intended to reduce the amount of recordkeeping, paperwork, and computations needed for filing tax returns. The federal tax law had become so complex that many taxpayers felt they had to pay tax preparers in order to prepare their tax returns. The Act lessens this likelihood by simplifying the system in some significant respects, such as decreasing substantially the number of households that itemize deductions and eliminating tax liabilities altogether for many low-income persons.

Economic Growth. The previous law caused many investment and consumption decisions to be based more on the value of the tax benefits associated with them than on their economic merits. The new plan lessens the role of taxes in economic decision-making by lowering marginal tax rates and eliminating tax preferences. In this sense, the new law attempts to provide more of a "level playing field" for businesses. Ideally, this will lead to a more efficient allocation of economic resources and promote economic growth in the long run.

How Federal Tax Reform Affects California's Income Tax Law

Reform of the federal tax code raises important policy issues for California, because the state personal income tax (PIT) law is modeled directly after the federal income tax. California is one of 40 states that has a broad-based personal income tax which conforms, to some degree, to the structure of the federal income tax. The state's long-standing policy has been to follow federal provisions as closely as possible, except in cases where there is good reason not to do so.

The state PIT law, in fact, is structured so that it simply makes direct reference to federal provisions, with only the *differences* specifically referred to in state statutes. The state PIT law is updated annually to account for changes in the federal law. Currently, where the state PIT law conforms to the federal Internal Revenue Code, it does so to the law in effect as of January 1, 1986.

The Legislature, however, has chosen *not* to follow federal rules in areas where its policy objectives differ from those embodied in the federal code. For example, unlike the federal government, California does not tax any portion of social security benefits or unemployment compensation. The state also has not fully conformed to certain federal provisions, such as accelerated depreciation or the deduction for contributions to individual retirement accounts, since the revenue losses would be substantial.

Given the high degree of conformity between state PIT law and the federal law in effect prior to 1987, the Tax Reform Act now places the state *out of conformity* with a number of significant federal provisions and rules. Conformity with these federal changes requires action by the Legislature.

Should the State Conform?

There are two primary arguments in favor of conforming state PIT law to the federal code. The first is simplicity. In the past, the Legislature has chosen conformance in order to make it easier for individuals to determine their state income tax liabilities. Conformity makes this a simply task because many of the necessary calculations—for example, adding up wages, interest income and expenses, and charitable contributions—are already required of taxpayers for federal tax purposes.

Second, conformity would help improve the fairness of the state's income tax. This is because many of the federal base-broadening provisions are intended to alleviate some of the differential treatment of taxpayers that arose under the prior law. For example, new restrictions on the use of tax shelters make it more difficult for high-income individuals to reduce their taxes.

However, whether conformity helps make the state income tax more fair depends, in part, on whether the Tax Reform Act achieves this goal at the federal level. In fact, there are a number of areas where the new federal law allows certain taxpayers to continue to receive special treatment. For example:

- ***Employee Fringe Benefits*** remain tax-exempt under federal law. This exemption is considered inequitable because taxpayers whose employers do not provide employee benefits, such as retirement and health insurance, are required to pay for them out of their wage or salary income, which is fully taxable when they receive it.

- ***Home Mortgage Interest*** remains fully deductible. This deduction usually is justified on the grounds that it encourages home ownership by reducing the cost of housing. However, the deduction provides tax savings only to those taxpayers who can afford to own (as opposed to rent) a home, and taxpayers who buy expensive homes receive the greatest tax benefits.

The Tax Reform Act makes changes which promote fairness in many areas, but falls short of this goal in others. Thus, we believe that the Legislature should approach the conformity issue from the standpoint of whether or not conformity in specific areas would change the state PIT law in a manner that is desirable or necessary. In other words, would conformity achieve its principal objective—tax simplification—without adverse effects on state tax policy?

How Might the Legislature Approach Conformity?

The Legislature will be required to decide whether the benefits of conformity, such as tax simplification and improved equity, exceed the disadvantages, such as reduced state control over the tax structure. In considering tax conformity, it must carefully choose which federal changes to incorporate, evaluate how the changes will affect state revenue, and decide how to distribute any resulting changes in the tax burden among different income classes and types of taxpayers. Generally, we recommend that the Legislature first establish what changes it desires to make in the state's tax base, and then determine what changes in the tax structure need to be made to distribute the tax burden equitably and to produce the desired level of revenues.

Approaches to Conformity. Three basic options exist for federal conformity of the state's PIT law.

- The Legislature could make a taxpayer's state liability a certain *percentage* of his or her federal tax liability;
- The Legislature could *adopt the federal definition* of adjusted gross income (AGI) or taxable income, and maintain the state's own set of tax rates and credits; or
- The Legislature could follow a *selective conformity approach,* whereby individual items are reviewed on a case-by-case basis, and then action is taken to conform, partially conform, or not conform. This is the policy that the Legislature has followed in the past.

The first and second options would provide the greatest simplification, in terms of taxpayer compliance with state tax laws. Option one could reduce the state tax form to just a postcard, or at most a couple of lines. Similarly, under option two, taxpayers would use their federal AGI or taxable income as a starting point for calculating their state tax liability, which also would simplify tax preparation.

Selective Conformity is Best. Despite the benefits of the first and second options, they still require the Legislature to give up some of its control over tax policy to the U.S. Congress and the federal Internal Revenue Service. Option 1, for example, requires the state to incorporate most federal adjustments, exemptions, deductions, credits, and the federal tax rate structure. Option 2 gives the state more flexibility to apply its own tax rates, deductions, and credits, but it still would adopt federal adjustments and exclusions. In either case, California would end up adopting many federal provisions that it has chosen not to conform to in the past. Moreover, if the Legislature wanted to ensure that the simplicity benefits would be retained over time, the state would be required to conform to all *future* federal tax law changes. This would leave the state vulnerable to the effects of future federal actions.

Given the above, we believe that the Legislature should adopt the third approach—selective conformity. This would enable it to adopt the federal provisions only in cases where conformity would change the income tax in a manner that is desired or necessary. It also gives the Legislature the opportunity to review whether the state should conform to, or maintain, certain preexisting differences.

Bank and Corporation Law Also Should Incorporate Changes to PIT Law. The state tax laws affecting individuals and corporations are contained in two separate parts of the California Revenue and Taxation Code—the PIT law and the bank and corporation (B&C) tax law. In most cases, it would be appropriate for the Legislature to continue its past practice of incorporating, into the corresponding sections of the B&C tax law, whatever changes that it makes to the PIT law. This will ensure that individuals and corporations are not treated differently for tax purposes, unless special circumstances warrant. It also will keep taxpayers from choosing one form of business organization over another simply for tax reasons.

Criteria for Evaluating Specific Provisions. In our view, the Legislature should consider three general criteria in deciding whether California should conform, partially conform, or not conform to individual federal changes. These include:

- Would conformity improve the *fairness* of the state tax burden?
- Would conformity be consistent with *state policy objectives*?
- Would the benefits of simplicity and improved tax equity outweigh any negative policy consequences of conformity?

In the sections that follow, we identify and make recommendations with respect to some of the major areas where California should or should not conform, based on these general criteria. In total, our analysis reviews 15 potential areas of conformity to new federal law. These items were selected because conformity would affect a large number of taxpayers, have a significant impact on state tax revenue, or have important implications for overall tax policy. There are, however, many more areas where the Legislature will be asked to conform state law to the new federal law, or to retain existing state law. In these cases, the Legislature's choices should be guided by the criteria discussed above, as well as the need to balance the aggregate fiscal and economic effects of state conformity legislation.

Major Provisions Where Conformity is Desirable

We recommend that the state conform to federal provisions which (1) repeal the deduction for consumer interest expenses, (2) limit the deduction for business expenses, (3) repeal the partial exclusion for capital gains, (4) restrict the use of tax shelters, (5) limit the deduction for medical expenses, and (6) repeal income averaging.

Our analysis indicates that the state law should conform to the following major provisions of federal law, as amended by the Tax Reform Act:

Repeal of Deduction for Consumer Interest Expenses. California conforms to pre-1987 federal law, which allowed taxpayers to deduct, as an itemized deduction, the amount of consumer interest expenses that they incur during the year. Such expenses include interest paid on credit cards and automobile loans. The new federal law phases out this deduction over a five-year period, beginning in 1987. Our review of this deduction indicates that it is not a cost-effective way of addressing certain policy objectives for which the deduction has been rationalized. For example, there is no evidence that it significantly stimulates economic activity. What it does provide are significant benefits to upper-income taxpayers who are capable of purchasing consumer goods without a tax subsidy. Accordingly, we recommend that the Legislature fully conform to the new federal provisions.

Limits on Deduction for Business Expenses. California generally conforms to pre-1987 federal rules, which allowed taxpayers to deduct, as an adjustment to income, certain unreimbursed business expenses, such as for travel and entertainment. The new federal law (1) allows these expenses to be deducted only as an itemized deduction, (2) limits the deduction for meals and entertainment to 80 percent, and (3) allows the deduction only to the extent that these expenses, together with certain other business expenses, exceed 2 percent of the taxpayer's AGI. The latter feature ensures that taxpayers who incur large unreimbursed business expenses still would be allowed to deduct them. Many of these expenditures—which ostensibly are for *business* purposes—also provide substantial *personal* benefits. The unlimited federal deduction also was felt to provide a substantial incentive for individuals and corporations to incur unnecessary business expenditures. For this reason, and in order to promote simplicity, we recommend that the state conform to the new federal law in this case.

Repeal of Partial Exclusion for Capital Gains. California law is similar to pre-1987 federal rules, which allow a partial exclusion for capital gains on the sale of assets. The new federal law requires taxpayers to report the full amount of capital gains as ordinary income. We believe that a state tax exclusion—by itself—provides taxpayers with little incentive to make longer-term investments, which is the primary policy justification for the exclusion. Since a partial tax exemption no longer will be allowed for federal purposes, taxpayers are likely to base their investment decisions more on *economic* rather than *tax* considerations. Thus, if the state continued to allow a capital gains exclusion, it would end up providing windfall benefits to individuals whose decisions would have been the same even without the exclusion. Conformity also would simplify the calculations needed to report capital gains income for state tax purposes. Accordingly, we recommend that California conform to the new federal law.

Restrictions on Tax Shelters. California generally follows pre-1987 rules which allow taxpayers to offset wage and salary income with losses from "passive investments." These are investments in business activities, such as limited partnerships, in which the taxpayer does *not* materially or actively participate. The new federal law allows taxpayers to deduct such losses only against income from passive investments. We believe that the ability of individuals to use losses from tax shelters to reduce their tax liabilities has allowed many to escape paying their "fair share" of California income taxes. This is because such taxpayers have been permitted to claim business deductions that bear no direct relationship to the amount of their investments or to their actual income-generating activities. Given the above, we recommend that California conform to the new federal provisions.

Deduction for Medical Expenses. California follows the pre-1987 federal rules, which allow taxpayers to claim an itemized deduction for the amount of their unreimbursed medical and dental expenses which exceed 5 percent of AGI. The new federal law raises the percent-of-AGI limit to 7.5 percent, thereby reducing the amount of such expenses that are tax-deductible. The deduction for medical expenses has been found by economists to create a number of inequities and undesirable incentives. For example, it provides an incentive for individuals to *not* carry their own health insurance because the government, in effect, provides a tax subsidy for a large portion of their medical costs. Also, taxpayers who have insurance end up subsidizing those who do not, by paying more in taxes to "cover" the revenue losses that result from the deduction. On this basis, we recommend that California conform to the new federal provisions. We recognize that the 7.5 percent-of-AGI threshold is somewhat arbitrary.

However, the use of a different percentage for state tax purposes probably would result in unnecessary taxpayer confusion.

Repeal of Income Averaging. California partially conforms to pre-1987 federal rules, which allowed taxpayers who experience large increases in income to determine their current year tax liabilities based on their "average income" over the prior three years. The new federal law repeals income averaging, partly to eliminate the need for many individuals to make a complex series of tax computations. However, it also is apparent that income averaging is a poorly targeted way of providing tax relief to taxpayers with fluctuating incomes (such as farmers), which was its underlying rationale. In fact, many taxpayers qualify for and receive benefits from income averaging even though their incomes do *not* fluctuate up *and* down, such as college graduates whose incomes rise rapidly during the first few years of their careers. Thus, we recommend that income averaging in its present form also be repealed for state tax purposes.

Major Provisions Where Conformity is Not Desirable

We recommend that the state not conform to federal provisions regarding (1) the taxation of unemployment insurance benefits, (2) the deduction for contributions to individual retirement accounts, and (3) certain new or extended tax expenditure programs.

Our analysis also indicates that the state should not conform to the following major provisions of federal law, as modified by the Tax Reform Act:

Tax Exemption for Unemployment Insurance Benefits. California currently does not tax any portion of unemployment insurance (UI) benefits. The Act repealed the previous partial federal tax exclusion, so that taxpayers are now required to include the full amount of UI benefits in gross income for federal tax purposes. The Congress made UI benefits fully taxable because it considers them to be wage replacement payments, and it therefore believes that they should be treated for tax purposes in the same manner as wages. However, this ignores the fact that legislatively provided social welfare benefits are structured to provide a certain amount of after-tax purchasing power to recipients. If the state were to tax UI benefits, it would end up reducing the amount of benefits to below these predetermined levels. Increasing the level of benefits to restore the purchasing power would increase employer costs, because they finance these benefits through UI taxes. For this reason, we recommend that the Legislature not conform to the federal treatment of UI benefits.

Deduction for Contributions to Individual Retirement Accounts. In 1982, Congress made *all* taxpayers eligible for the deduction for contributions to an individual retirement arrangement (IRA) account. Under the new federal law, taxpayers who do *not* belong to employer-sponsored pension plans will still be able to deduct up to $2,000 in IRA contributions. In addition, the full deduction still will be available to taxpayers with AGI below $25,000 ($40,000 for joint taxpayers), who *do* belong to an employer pension plan. California permits a lower deduction ($1,500), and it allows the deduction only for those who are not covered by an employer pension plan. In our view, the IRA deduction is intended mainly to provide an incentive for taxpayers who do *not* have a pension plan to save for their retirement. Moreover, when the Congress expanded the deduction in 1982 to include all taxpayers (to which California did not conform), it did so in response to concerns about the overall level of savings in the economy. However, there is no solid evidence that the federal change resulted in a net increase in savings, especially in a long-run sense. It is doubtful that expanding the state IRA deduction would have the effect that the Congress had hoped for in 1982. Given the above, we recommend that the state not conform to the federal provisions which enable taxpayers who belong to an employer pension plan to claim the deduction. We do, however, recommend that the state conform to the federal dollar limits, as this would alleviate a significant source of taxpayer confusion and errors.

New or Extended Tax Expenditure Programs. The Tax Reform Act establishes or extends a number of federal tax expenditure programs. For example, it provides a new tax credit for the costs of rehabilitating or acquiring low income housing. It also extends the federal targeted jobs tax credit and the special tax credits for research and development and business energy property, such as solar energy systems. We do not believe that a strong case can be made to conform to these provisions at this time. In some of these cases, the federal programs are not consistent with current state policy objectives. For example, the state recently terminated its special tax treatment for solar energy systems, on the basis that its objective of stimulating the development of the industry has been achieved. In other cases, there is little evidence that state tax expenditure programs of this sort would be a cost-effective means of achieving current objectives. Thus, we do not recommend that the state conform to these provisions.

Other Provisions Are Numerous But Important

The Legislature also will be asked to conform or retain existing law with respect to more than 100 additional individual provisions. These range from fairly minor issues, such as the tax treatment of imputed interest, to relatively major issues, such as the treatment of bad debt reserves and preference income. In these cases, we recommend that the Legislature be guided by the criteria discussed earlier.

Final Decisions Depend Upon Basic Tax Policy Issues

In the final analysis, the overall characteristics of California's new tax law will be highly influenced by how the Legislature resolves two basic tax policy issues:

- How should the state tax burden be distributed among individuals with different incomes?
- How should the state tax burden be distributed between individuals and businesses?

In both cases, specific conformity items should be evaluated using the same general criteria as the other items we have discussed thus far. However, the provisions identified in this section are subject to an additional consideration, namely that by its actions in these items the Legislature must offset the changes in state revenues caused by its decisions on issues involving the tax base, if it is to produce a "revenue neutral" measure.

In deciding how to distribute the tax burden among individuals with different incomes, the Legislature needs to determine whether the state needs to adopt changes in tax rates and brackets, exemptions and certain tax deductions as discussed below.

Reduced tax rates and brackets. Lower tax rates and fewer tax brackets are central features of the new federal tax law. These changes are intended to offset the increased amount of income that now is subject to tax. Given the base-broadening approach of the Tax Reform Act, the Legislature also would need to make significant reductions in California's tax rates if it adopted base-broadening provisions, presuming that it wants to maintain "revenue neutrality."

As noted above, the Tax Reform Act reduced both the number of tax brackets (from 14 to 2) and the level of tax rates (from 50 to 28 percent for taxpayers in the highest tax bracket.) California currently has 11 tax brackets, with a top rate of 11 percent. In our view, there are *no significant administrative advantages* from conforming to the use of fewer tax brackets. The overwhelming number of taxpayers would continue to use precomputed tax tables prepared by the Franchise Tax Board (FTB) in order to figure out the amount of taxes they owe.

From a "fairness" or tax equity standpoint, the use of fewer tax rates and brackets could have both good and bad side effects. For instance, it would make the dollar value of tax benefits from certain exemptions, adjustments, and deductions more equal for different taxpayers, since these benefits would be affected less by a taxpayer's marginal tax rate. On the other hand, eliminating the current use of multiple, progressive tax brackets also reduces the progressivity of the current system. Greater progressivity is consistent with the view that the more income a taxpayer has, the more he or she should be taxed in order to finance the public services that society as a whole needs.

In general, the changes to the state's tax rates should be made only after decisions have been reached regarding (1) how the base should be changed, (2) what the relative burden of taxes between individuals with differing incomes should be, and (3) how much revenue the personal income tax should raise. Once these issues are decided, it is a relatively simple step to set tax rates that both achieve the state's revenue targets and distribute the tax burden *across* income classes in a desirable manner.

Exemption Credits or Exemption Deductions. Both California and federal law provide for broad-based tax relief through the use of exemptions. California allows a personal exemption credit of $43 ($86 for joint taxpayers) and $14 for each dependent. The federal government allows an exemption deduction. The Tax Reform Act raised the amount for each exemption from $1,080 to $2,000 over a three-year period. This change poses two issues for the Legislature to resolve:

- ***First,*** should California conform to federal law by allowing an exemption deduction rather than a credit? An exemption credit with a fixed dollar amount is more equitable way of providing general tax relief, because each taxpayer would receive the same dollar benefit, regardless of income. In contrast, the actual benefit from an exemption deduction is dependent on a taxpayer's income level, due to the use of progressive tax rates. Thus, conforming to the federal use of an exemption deduction would make sense only if the current progressive tax rates were replaced with a flat rate structure. Under these circumstances, an exemption would provide all taxpayers with the same dollar amount of tax relief.
- ***Second,*** regardless of the mechanism, should the Legislature increase the level of benefits provided by the personal and dependent exemption? This depends on how the Legislature wants to change the overall tax burden. An increase in the exemption would benefit all taxpayers, but lower-income taxpayers benefit more than those at higher income levels. This is because the exemption offsets a relatively larger proportion of their tax liabilities. At the same time, the increase in the exemption presumably would be "paid for" through conformity to the federal base-broadening provisions, which have greater impact on higher-income taxpayers.

Deduction for Sales Taxes Paid. California conforms to pre-1987 federal law, which allows taxpayers to deduct the full amount of state and local sales taxes paid during a given year. The Tax Reform Act eliminates this deduction. The repeal of the state deduction would increase state tax revenues by about $270 million annually, based on existing PIT rates. Whether the state should conform to the federal change depends on how the Legislature wants to distribute the tax burden among income classes. The deductibility of sales taxes is often rationalized on the grounds that sales taxes reduce an individual's ability to pay income taxes and impose a relatively greater burden on taxpayers with lower incomes. However, the negative effects of repealing the deduction would be mitigated if the

Legislature increases the standard deduction, increases the personal exemption, or reduces the state income tax rates at low income levels.

Distribution of the Tax Burden Between Individuals and Businesses. There also are a number of significant provisions where federal conformity requires the Legislature to make policy decisions as to the distribution of the tax burden between individuals and businesses. Three of the most important are accelerated depreciation, carryover of operating losses, and "Subchapter S" rules. Federal law, as modified by the Tax Reform Act, continues to provide more generous depreciation methods compared to California law. Likewise, federal law permits businesses to carry forward net operating losses, which in effect allows businesses to use net losses in one year to offset taxable income in subsequent, more profitable years. California allows net operating losses to be carried forward in only a limited number of instances. Finally, the Act continues the preferential tax treatment for small businesses under Subchapter S rules, which enable the income earned by qualifying small corporations to be "passed through" to shareholders without being subject to tax.

These federal provisions have been rationalized as a way of providing an incentive for taxpayers to make capital investments or granting tax relief for businesses in certain situations. On the one hand, the state may not necessarily support the same policy objectives that underlie these federal tax provisions. On the other hand, conformity would simplify the state tax calculations for businesses.

If such conformity is desirable, the Legislature would have to address the loss in revenue which it would cause. According to FTB estimates, conformity in the three areas would *reduce* tax collections by the following amounts: (1) accelerated depreciation ($345 million), (2) net operating loss provisions ($212 million), and (3) Subchapter S rules ($220 million). Most of these tax reductions would benefit corporate businesses which file under the B&C tax law, although a portion of these losses would be attributable to personal income taxpayers. Clearly, if the state were to conform to these provisions, businesses would receive a substantial tax reduction. The Legislature would have the choice of simply accepting the revenue loss, increasing corporate tax rates to offset it, or increasing the amount of revenue to be raised from the personal income tax in order to "pay for" the tax reductions provided to businesses.

A "Revenue Neutral" Measure? Despite its numerous and complicated provisions, the federal Tax Reform Act was designed to be "revenue neutral." State conformity should have the same goal in mind, because the fundamental issues raised by tax reform—fairness, simplicity, and efficiency—are independent of how much revenue is needed in order to pay for state programs. This goal, however, will not be easy to achieve. As illustrated by the examples above, it will require the Legislature to make important decisions as to the overall distribution of the tax burden among individuals and between individual and business taxpayers.

The task also will be difficult because estimates by various state and private organizations of the revenue effects of certain important provisions probably will differ significantly. For instance, current estimates of the revenue gain which would result from repeal of the capital gains exclusion appear to vary by over $100 million, due to the use of different assumptions about the behavioral responses of taxpayers. Also, in many cases, the Legislature will have to rely on federal estimates which have been prorated to California, in order to evaluate the fiscal impact of conformity provisions. Given the amount of PIT collections—over $13 billion—an error margin of only 1 percent would translate into a tax increase *or* decrease of $130 million. The goal of "revenue neutrality" may be a very elusive one, and the Legislature will have to accept some level of uncertainty in the revenue estimates.

Conclusions

The enactment of the federal Tax Reform Act has provided a major impetus for revising and simplifying the state income tax. In the past, the state has conformed to many federal provisions in order to simplify tax computations. From this perspective, a strong case can be made for conforming state law. In addition, there are several areas where conformity would improve the fairness of the state tax. However, there also are certain provisions where conformity either would not be consistent with legislative policies or would not be an appropriate means of addressing them.

Given this, the answer to the question, "Should the State Conform to the New Federal Law?" is mixed. It can only be decided by the Legislature on a case-by-case basis. Otherwise, there is no way to ensure that the tax provisions it puts into place will be fair and equitable, raise sufficient amounts of revenue, and keep the tax simple enough so that it does not put an excessive compliance burden on taxpayers.

Expenditure Issues

THE STATE APPROPRIATIONS LIMIT

How Can the Legislature Maximize Its Flexibility Under the Impending Constraints of the State Appropriations Limit?

Summary

- *Article XIII B of the State Constitution sets a limit on the amount of tax funded appropriations the state can make.*
- *Based on the estimates of revenue and the spending plan contained in the Governor's Budget, we estimate that the state will exceed the appropriations limit in both the current and budget years.*
- *The Legislature can implement certain statutory changes and recognize specific "federal mandates" to bring the state into compliance with the limit, given the budget's estimate of state revenues in 1986–87 and 1987–88. These changes would have no effect on existing program commitments. We recommend that these changes and certain other provisions be adopted by statute prior to June 30, 1987.*
- *If the consensus view of the California economy held by private economists is realized, increased state revenues could still push the state over its 1987–88 appropriations limit by $252 million.*
- *In future years, the limited expenditure growth allowed by Article XIII B will force the budget to become practically a zero-sum process. The Legislature will be able to increase spending for higher priority programs or to add new programs only at the expense of other programs, or if it relies on sources of funds which do not constitute the "proceeds of taxes."*
- *The Legislature will be forced to consider the use of several options, including increased use of general obligation bonds and increased fees, to maximize the state's flexibility under the limit.*

As discussed in Part Two of this document, the Governor's Budget proposes that the state's constitutional appropriations limit for the 1987–88 fiscal year be established at $25.3 billion. According to the Department of Finance (DOF), the level of appropriations proposed by the Governor is $80 million less than the state's appropriations limit for 1987–88.

We estimate that the level of appropriations proposed in the budget actually *exceeds* the state's appropriations limit. Regardless of whose calculations are correct, however, the limitation on appropriations which the voters approved eight years ago has become an important factor which the Legislature must take into account in developing a budget for California.

This section provides background on the appropriations limit imposed by Article XIII B of the California Constitution. It also analyzes where the state stands in relation to the limit, given the spending plan presented in the Governor's Budget and the requirements of current law. In addition, this section discusses steps the Legislature can take to bring the state into compliance with the limit, and the long term effect on the budget process of operating under this constraint. Finally, this section provides the Legislature with options to maximize the state's flexibility with respect to the limit.

Background

Article XIII B was added to the State Constitution when the voters approved Proposition 4 on the November 1979 Special Election ballot.

Briefly, Article XIII B does three things:

- It limits the level of *tax-funded* appropriations which can be made by the state and individual local governments in any given year. The limit for each year is equal to the limit for the prior year, adjusted for changes in the cost-of-living and population, and other adjustments as required (e.g., transfers of financial responsibility).
- It requires state and local governments to return to the taxpayers any moneys collected or on hand that exceed the amount which can be appropriated in any given fiscal year.
- It requires the state to reimburse local governments and school districts for the cost of complying with state mandates.

The limit applies only to appropriations financed from the "proceeds of taxes," which include tax revenues, proceeds from the investment of tax revenues (interest earnings), and any revenues collected by a regulatory license fee or user charge in excess of the amount needed to cover the cost of providing the regulation, product, or service. Appropriations financed by other sources of revenue (e.g., tidelands oil revenues or federal funds) are not subject to the limit.

Certain specific categories of appropriations are also excluded from the limit. These include subventions to local governments, payments for interest and redemption charges on preexisting debt or voter-approved bonded indebtedness, and appropriations needed to pay the state's cost of complying with federal laws and court mandates. As defined in state law, subventions to local governments include only those monies provided by the state to local agencies which can be used for *any* purpose.

Article XIII B established the 1978–79 fiscal year as the "base year" for purposes of computing the initial appropriations limit. The initial appropriations limit in fiscal year 1978–79 is equal to the amount of "appropriations subject to limitation" for that year. This figure is basically the amount of appropriations financed by the proceeds of taxes, less:

- The amount of state subventions to local governments,
- The amount of appropriations for debt service, and
- The amount of appropriations for court and federal mandates.

The appropriations limits for subsequent years are calculated by adjusting the base year limit for cost-of-living and population changes, and for transfers of financial responsibility. A "transfer of financial responsibility" can occur when:

- The financial responsibility for providing a specific service is transferred from one governmental entity to another, or from a government to a private entity; and
- When the source of funds to provide a service is shifted from tax proceeds to user fees.

The Legislature enacted Ch 1205/80 (SB 1352) to clarify the meaning of certain terms (e.g., "state subvention") contained in Proposition 4. On the basis of this "implementing legislation," as well as opinions provided by the Legislative Counsel, the Legislative Analyst's Office and the Department of Finance developed the methodology needed to calculate the appropriations limit for 1980–81 and subsequent years.

Where Does the State Stand Now in Relation to the Limit?

In order to determine the state's position relative to the appropriations limit, two calculations must be made. These are the calculation of the appropriations limit itself, and the calculation of the appropriations which are subject to the limit. The computations required to determine where the state stands with regard to the limit are among the most complex in state government.

Limit Calculation

The Governor's Budget proposes that the Legislature take action in the 1987 Budget Bill to establish the state's appropriations limit for 1986–87 at $24,159 million, and at $25,273 million for 1987–88. Our analysis indicates that the 1986–87 limit should be set at $24,175 million, or $16 million *higher* than the budget proposal. Using the Governor's proposed appropriations as a base, our analysis indicates that the 1987–88 limit should be set at $24,800 million, or $473 million *lower* than the administration has requested. The following items account for these differences.

Administration Proposes Modifications. The 1986 Budget Act established the state's appropriations limit at $24,173 million for 1986–87. The administration proposes that five changes be made to the *current* year's appropriations limit, and that these changes be reflected in the 1987–88 appropriations limit to be adopted in the 1987 Budget Bill. Specifically, the administration proposes that:

- The limit be reduced to effect a recategorization of certain state revenue sources. Specifically, the Department of Finance contends that these revenue sources, primarily the state's proceeds under the Unclaimed Property Law, have been incorrectly treated as "proceeds of taxes." In order that they be correctly treated as nontax revenue, and to ensure consistent treatment between the base year and current year, the department *reduced* the state's 1986–87 appropriations limit by $68 million.
- A new interpretation be made of the 1980 statute which determines the amount of 1978–79 community college apportionments subject to the state's appropriations limit. This adjustment would *increase* the state's 1986–87 limit by $51 million.
- The appropriations limit be adjusted to correctly reflect the amounts transferred from the state's limit to school districts in prior years. This adjustment *reduces* the 1986–87 state appropriations limit by $4 million.
- The limit be adjusted to correct an error involving state Liquor License Fee revenues which was made in establishing the state's base-year appropriations limit. This adjustment *increases* the state's 1986–87 limit by $27 million.
- The limit be adjusted to account for transfers of a portion of the state's appropriations limit to school districts during the current year. This adjustment *reduces* the 1986–87 state appropriations limit by $21 million.

Taken together, these adjustments would reduce the adopted 1986–87 appropriations limit by $14 million, to $24,159 million.

The Governor's Budget estimates that the appropriations limit for 1987–88 will be $25,273 million. This estimate reflects the administration's proposed adjustments of the 1986–87 limit, as well as its assumptions about the cost-of-living and population adjustment factors for 1987–88. According to the Department of Finance, the 1987–88 cost-of-living and population adjustment will amount to 4.61 percent. This reflects an estimated 2.6 percent increase in the United States Consumer Price Index (USCPI), and an estimated 1.96 percent increase in the state's civilian population. Final data on these factors will be available in late April.

Two Adjustments Not Justified. Our analysis indicates that three of the five proposed adjustments to the 1986–87 limit are appropriate. With respect to the recategorization of revenues, however, the department has incorrectly assumed that these revenues were considered to be "proceeds of taxes" in determining the state's base year appropriations limit. Our records of the original computation indicate that these revenues were not so treated, and therefore no adjustment to the state's limit is necessary.

In the case of the community college funds, the department has recalculated the amount of state aid which was subject to the appropriations limit of community college districts. The department indicates that a portion of the state's funding should be treated as an appropriation subject to the state's limit, rather than of the community colleges. However, the department has not conducted its recalculation including all of the factors required by Chapter 1205. Specifically, the department did not consider prior year balances in determining the amount of local revenues available to community college districts in 1978–79. The financial reports of the community colleges demonstrate significant prior year balances for many districts. Due to the nature of the Chapter 1205 formula, the exclusion of these balances results in an understatement of the amount of state aid subject to local appropriations limits and an overstatement of the amount subject to the state's limit. Accordingly, this adjustment of the appropriations limit does not appear appropriate.

Taking into account the three adjustments which are appropriate, we estimate that the state's 1986–87 appropriations limit will be $24,175 million, or $16 million *more* than the amount indicated in the Governor's Budget.

1987–88 Limit Should Reflect Transfers Proposed in the Budget. Article XIII B requires the state's appropriations limit to be reduced in cases where the financial responsibility of providing services is transferred from one government entity to another, and in cases where the financial source for the provision of services is transferred from tax revenues to user fees. Our analysis identifies four such transfers which are proposed in the 1987–88 budget. These include:

- A $477 million transfer of the state's share of responsibility for financing county health service programs to the counties, thereby reversing the 1979 law establishing the state's participation; and
- Three shifts of funding from tax revenue to fee revenues totalling $12.6 million. The largest fee proposal is a $7.5 million shift of funding for certain programs administered by the Water Resources Control Board from the General Fund to user fees.

To the extent that these proposals are approved by the Legislature, the 1987–88 limit will need to be reduced accordingly. In the case of the county health services transfer, the state's withdrawal of funding leaves the counties 100 percent responsible for funding these programs, as they were prior to 1979. Neither the changes made in 1979, nor the changes now proposed by the administration, alter the counties' basic responsibilities under these programs—to provide health care to those in need. Because the state increased its appropriations limit in 1979 to reflect its assumption of partial responsibility for these programs, it is appropriate that this authority be transferred back to the counties if the responsibility for funding the programs is transferred. With respect to the shifts of funding from tax revenue to fees, our analysis indicates that the shifts have been proposed specifically to replace existing General Fund support with fee revenue—exactly the type of situation contemplated by Article XIII B. Incorporating all of these changes would produce a 1987–88 appropriations limit of $24,800 million, which is $473 million *less* than the amount proposed in the budget.

Calculation of Appropriations Subject to the Limit

The second item to consider in determining the state's position relative to the limit is the amount of appropriations subject to the limit. In past years, this calculation has generally involved (1) determining the total amount of *appropriations* made from both the General Fund and special funds, excluding appropriations from certain funds that do not receive any tax revenues, (2) subtracting exempt appropriations and nontax revenue sources, (3) subtracting the amount of appropriations financed by funds carried over from prior years, and (4) adding the amount of funds "left over" for appropriation to the reserve within each state fund. The amount of "appropriations subject to limitation" is the result.

This procedure has many inherent weaknesses, including its complexity and the fact that it relies on an accounting system which was not designed for this purpose. The use of the accounting system has led to many technical problems in past years, such as the "double counting" of non-tax revenues.

In order to provide the Legislature with a more reliable basis for the calculations, we developed a new system which uses the budget's estimates of *revenues* rather than appropriations as its starting point. Simply stated, this procedure determines: which funds contain tax proceeds covered by Article XIII B, and the total amount of tax revenues available to each fund, exclusive of their nontax revenues. It then subtracts the amount appropriated for exempt purposes, such as debt service and subventions to local agencies. Because of the provisions of state law which automatically appropriate to a reserve in each fund the amount of revenues not otherwise specifically appropriated, the result of these calculations equals the amount of appropriations "subject to the limit" for each fund.

The primary advantage of this revenue-based calculation is that it provides a more direct determination of appropriations subject to the limit, since it matches appropriations with the source of funds for those appropriations. Under the traditional methodology, it is also necessary to track the amount of appropriations financed by prior year receipts. The state's accounting system, however, has not provided completely adequate information for this purpose.

Reasons for Department of Finance and Legislative Analyst's Office Differences. The department estimates that 1986–87 appropriations subject to the limit will be $23,738 million. Our analysis indicates that the amount for 1986–87 is $24,396 million, or $658 million more than the department. The 1987–88 appropriations subject to the limit amount to $25,193 million by the department's estimate, whereas our procedure produces a figure that is $194 million higher—$25,387 million. Table 32 summarizes the reasons for the differences.

Table 32
Appropriations Subject to Limitation
Differences Between Governor's Budget and Legislative Analyst's Office Estimate
(dollars in millions)

	1986–87	*1987–88*
LAO Appropriations Limit	$24,175	$24,800
Appropriations Subject to Limitation Per 1987–88 Governor's Budget	23,738	25,193
LAO Changes		
Legal differences	535	642
Technical corrections	75	−28
Tax/nontax revenue differences	48	57
County health services transfer	—	−477
LAO Appropriations Subject to Limitation	$24,396	$25,387
Amount over limit	$221	$587

As shown in Table 32, the largest change is due to differences in legal interpretations. The largest of these include:

- ***STRS.*** The department considers the state's payments to the State Teachers' Retirement System (STRS) to be a "court mandate," and treats the appropriation as an exempt item on this basis. A 1983 court decision invalidated the state's attempt to suspend the payments to STRS required by 1979 legislation. The court held that the 1979 legislation represented a "contract" between the state and its school teachers to ensure the funding of teachers' retirement benefits, and the state did not have the power to, by itself, suspend the contract. On the basis of a Legislative Counsel opinion, we treat this as an appropriation subject to the limit ($354 million in 1986–87 and $383 million in 1987–88).
- ***Court-Ordered Desegregation.*** The department considers the state's payments to K–12 school districts for reimbursement of their costs to implement court-ordered desegregation programs as "court mandates," and treats the appropriation as an exempt item on this basis. The state's payments, which began in 1978–79, were *not required* by the terms of the court orders, but were provided voluntarily by the Legislature to assist the school districts to fund their costs of compliance. On the basis of a Legislative Counsel opinion, we treat this as an appropriation subject to the limit ($268 million in 1986–87 and 1987–88).

- ***Reappropriations.*** The department considers the reappropriation of funds to be an "appropriation subject to limitation." A recent Legislative Counsel opinion indicates that this treatment is unnecessary (−$87 million in 1986–87 and −$9 million in 1987–88).

"Technical corrections" refers to those situations where our review of the department's calculations turned up a procedural error. The largest of these was an understatement of the amount of State Highway Account appropriations subject to the limit which resulted from an error in determining how much of these appropriations was financed from reserve funds. The *"tax/nontax revenue differences"* category reflects the differing treatment of individual state revenue sources. Our review of each individual source of state revenue indicates that the department excludes some state tax revenue sources, such as the Employment Training Tax. On the other hand, the department also treats some nontax revenue sources as "proceeds of taxes." Finally our estimate reflects the proposed $477 million county health services transfer as an exempt subvention, rather than as an appropriation subject to the limit. This is consistent with our treatment of this issue in the appropriations limit calculation.

The 1987–88 Predicament

As shown in Table 32, our analysis indicates that the Governor's Budget proposes appropriations which exceed the limit imposed by Article XIII B. As submitted, appropriations subject to the limit will exceed the state's limit by $587 million in 1987–88.

What if revenue and expenditure estimates change? In general, changes in expenditures will have no direct effect on the amount of appropriations subject to the limit. This is because any increased expenditures will have to be paid for by revenues which the budget anticipates will be appropriated to the Special Fund for Economic Uncertainties. Thus, *increased appropriations* to pay for increased expenditures would be offset by *decreased appropriations* to this reserve.

However, if *actual revenues* exceed those proposed in the budget, as we expect (please see the discussion of revenues in Part Two of this volume), there will be a dollar-for-dollar increase in the amount of "appropriations subject to limitation." This is because at year end, all unappropriated revenues are automatically appropriated to the Special Fund for Economic Uncertainties, and these appropriations are subject to the limit.

If the consensus view of the California economy currently held by private economists is realized, the state will take in an additional $200 million of revenues in 1986–87, thereby increasing the amount that the state is over its limit to $421 million. Similarly, increased revenues in 1987–88 could increase appropriations subject to the limit by $285 million, thereby increasing the amount by which the state could exceed its limit in that year to $872 million.

Of course, legislative action on the budget and other factors can influence the appropriations limit estimates. For example, the provision of additional subventions to local agencies would reduce the amount of appropriations subject to the limit, as would higher estimated expenditures for debt service on voter-approved bonds. Additional shifts of General Fund program costs to user fee financing could lower the appropriations limit itself, as will the inevitable further shift of the state's limit to school districts under the provisions of existing law. Thus, the estimates are subject to considerable revision between now and the end of the 1987–88 fiscal year.

Legislature Can Bring Budget Into Compliance with Article XIII B

We recommend that legislation be enacted to modify the formula which determines what portion of the state's aid to school districts is counted against their appropriations limits. In addition, we recommend that the Legislature clarify its intent that state payments to the State Teachers' Retirement System are made for purposes of reducing that system's unfunded liability.

The Legislature can make two statutory changes to bring the state into compliance with Article XIII B in 1986–87. In addition, our review indicates that it may be possible to recognize certain federal and court mandates to further improve the situation.

K–12 Subventions. First, the Legislature could decrease the state's appropriations subject to the limit by changing the statutory definition of the term "subvention" as it applies to K–12 school districts, which determines the division of state aid between the state and local limits.

When the Legislature implemented Article XIII B in 1980 (Chapter 1205), it provided that about 60 percent of *state aid* to K–12 school districts would be counted against the state appropriations limit, while the other 40 percent would be counted against the local (K–12 school districts) appropriations limits. This division of state funds was intended to maximize the growth of the state's appropriations limit, and to minimize the amount of any unused appropriations capacity at the local level. Because of unforeseen circumstances, however, *it now appears that local school districts (rather than the state) have a sizeable amount (possibly $500 million) of unused appropriations authority.*

By changing the definition of the term "subvention," more state aid would be counted against the local limits, and less aid would be counted against the state's limit. As a result, the total amount of appropriations subject to the state's limit would decline, thereby "freeing up" appropriations authority for other state purposes. This change would have no effect on the amount of funds available to school districts.

STRS Payments Are Indebtedness. Second, the Legislature could clarify its intent that the state's payments to the State Teachers' Retirement System ($354 million), made pursuant to Ch 282/79 (AB 8), are made for purposes of reducing that system's "indebtedness existing or legally authorized as of January 1, 1979." Our analysis indicates that these payments were indeed authorized just for this purpose, as were similar payments made pursuant to provisions of laws in effect during the 1978–79 fiscal year. It would improve the state's position to change the way this appropriation is treated, although this requires that the initial state appropriations limit be reduced. This is because the amount expended for this purpose in 1986–87 ($354 million) *exceeds* the amount expended in 1978–79, as adjusted for the change in cost-of-living and population. In other words, the appropriation has grown faster than the limit. Because of the significance of the change, we recommend that it be accomplished by statute. This change would reduce the magnitude of the excess appropriations by about $70 million.

The enactment of these two statutory changes would have the effect of reducing the appropriations which are subject to the limit by $570 million in 1986–87 and a similar amount in 1987–88. To prevent the state from exceeding its limit in the current fiscal year, we recommend that these actions be made effective *prior to June 30, 1987.*

Federal Mandates. In addition to the two suggested statutory changes, it would appear that the state is entitled to treat certain existing appropriations as exempt pursuant to the federal mandate exception. The largest of these relates to the state's cost for Old Age, Survivors, and Disability Insurance (OASDI), more commonly referred to as social security and Medicare insurance. These costs have increased dramatically since 1978–79 due to changes in federal law. In 1978, the state paid 6.05 percent of the first $17,700 of employee earnings towards this program. Since then, the tax rate has gone up to 7.15 percent and the maximum wage base has increased to $43,800. Because these changes have "unavoidably increased the cost of existing programs," the state's cost of compliance can be considered to be required by a federal mandate. Our preliminary analysis indicates that the amount which could be regarded as exempt may be as high as $50 million in 1986–87, and a similar amount in 1987–88.

In addition, a recent state Supreme Court decision may allow the state to use a slightly more liberal interpretation of which programs qualify for the federal mandate exclusion. This decision, involving local governments' claims for reimbursement of state-mandated workers compensation costs, apparently overturns the relatively narrow interpretation of what constitutes a federal mandate which had been imposed by a 1984 state appellate court decision (City of Sacramento v. State of California). Several specific situations are currently being explored, and have been presented to the Legislative Counsel for opinion.

These changes would place the state under its limit for 1986–87 and for 1987–88, based on the budget's revenue estimates. However, if the consensus forecast of the economy proves correct, the General Fund will take in an additional $200 million in revenue during 1986–87, and an additional $285 million in 1987–88. Since these additional revenues would count towards the limit, *the state could still exceed its appropriations limit in 1987–88 by up to $252 million.*

What Will Happen in Future Years?

As discussed above, the Legislature can make statutory changes to stay under the limit in 1986–87, and it appears that these changes could also eliminate any problems in 1987–88, depending on the level of revenues collected. In future years, however, the appropriations limit will become a significant restraint on the state's ability to maintain its level of services.

Limit Will Become Increasingly Problematic

This is likely to be the case for three reasons: (1) the state's appropriations authority is likely to grow slower than both the economy and the cost of government services; (2) the growth provided by Article XIII B for population changes more than likely will not be enough to maintain a constant level of state services; and (3) the limit will make it more difficult to accommodate program growth and changes.

Appropriations Authority Will Grow Slower than the Economy and the Cost of Governmental Services. In periods of economic expansion, state revenue collections will expand at a rate faster than the state's ability to expend them. This is due to the fact that state revenue collections tend to grow at a rate which slightly exceeds the rate of growth in state personal income. The growth in state revenues reflects the growth in the state's economy (personal income), inflation, and population growth. The state appropriations limit, however, is tied to changes in the United States Consumer Price Index (USCPI) or per capita personal income, whichever is *lower.* Because the USCPI is anticipated to be lower than per capita income for the near term, the state appropriations limit, by definition, will not reflect the growth in the state's economy.

It is likely that the appropriations limit will restrain the growth in state spending for another reason. This is because the cost-of-living adjustment used in computing the allowed growth for the limit—the USCPI—does not reflect the increased costs faced by government agencies in providing services. The USCPI reflects the growth in prices faced by individual consumers, and is based on the types of products typically purchased by households. The growth in the costs of government goods and services is influenced by other factors, such as wage and salary payments for government employees and construction costs. As shown in Table 33, government cost increases, as measured by the Gross National Product (GNP) implicit price deflator for state and local purchases of goods and services, have generally exceeded consumer price increases as measured by the USCPI except during the exceptionally high inflation years of 1979 through 1982. Thus, as the "price" of government goods and services increases faster than the price factor recognized in the appropriations limit, the state would find it necessary to reduce services to compensate.

Table 33
Comparison of United States Consumer Price Index and Gross National Product Deflator for State and Local Governments 1978–79 through 1987–88

	USCPI	*GNP Deflator*
1978–79	6.5%	6.9%
1979–80	10.2	8.9
1980–81	14.7	11.6
1981–82	10.6	8.8
1982–83	6.8	7.2
1983–84	3.7	5.2
1984–85	4.7	5.0
1985–86	3.7	5.4
1986–87	2.3	3.9
1987–88	2.6	3.3

Population growth more than likely will be less than state workload growth. The population adjustment provisions of Article XIII B are intended to restrain state and local government to a constant, *per capita* level of spending. (This amount is roughly $550 in 1978–79 dollars.) However, this level of spending will probably not be sufficient to fund state services at their current levels. This is because the state provides services to certain populations which grow faster than the general population. Inmate populations in state prisons, children attending K–12 schools, and senior citizens relying on state services are examples of this phenomenon. The cost of providing the same level of these services rises faster than the appropriations limit, because there are more persons requiring these services than allowed for by the general population growth adjustment.

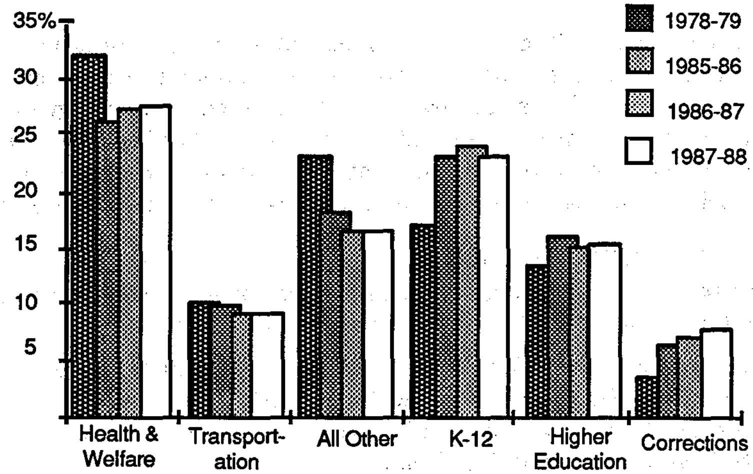
Conversely, some state programs grow more *slowly* than the population in general. For example, the state's expenditures for tax relief programs have actually been *declining* each year since Proposition 13 was approved by the voters in 1978. On balance, however, our review indicates that the state's expenditure base appears to require an expanding level of per capita expenditures in order to maintain the current level of services, even after adjusting for inflation.

Program Growth and Policy Changes Will Necessitate Reductions. In the past, executive and legislative policies and the availability of resources have been the major determinants in the funding levels of the various state programs. Chart 29 presents a comparison of spending for the major program areas between 1978–79 and the years covered in the Governor's Budget—1985–86 through 1987–88. As the chart shows, education and corrections programs now represent a larger proportion of the total amount of "appropriations subject to limitation" than they did in 1978–79. Health and welfare, transportation, and all other programs represent less. Another way of looking at this is that education and corrections expenditures have grown faster than the state's limit, while expenditures in the other programs have grown slower.

From the point of view of the limit, the higher relative growth rates for education and corrections are made possible by lower relative growth rates for the other programs. These lower rates of growth reflect state priorities to some extent, but they also reflect structural aspects of state programs. For example, the transportation program is constrained by its slow-growing source of funds—the tax on gasoline. Thus, to some extent, the more rapid rate of growth in education and corrections programs has not *forced* a correspondingly lower rate of growth in the other programs—it has simply taken advantage of that lower growth rate.

Chart 29

State Appropriations Subject to Limitation by Program Area, As Percent of Total
Selected Years



Ultimately, however, the constraint imposed by the limit causes the traditional budget process to become a zero-sum game. Increased spending beyond the cost-of-living and population threshold in one area will need to be accompanied by reduced spending in another area. This is because the continued growth in programs such as corrections and education which are growing faster than the limit will eventually outpace the slow growth in other programs.

The appropriations equation can also be unbalanced by changes in the state's priorities and responsibilities. As an example, many contend that the overcrowding of the state's streets and highways is reducing the quality of living in the state, and that this will become a major deterrent to the expansion of economic activity. As we discuss in other sections of this volume, the state faces not only large backlogs of maintenance work in several program areas, but also the need for increased construction to handle the growing demand for basic infrastructure. Similarly, changes in the level of federal funds available to the state, or the elimination of federal programs, could place additional pressures on the state's appropriations limit equation.

Circumstances outside the state's contol could also affect the equation, as they may force increases in some programs, or require *new* programs to be provided. The current emphasis on toxic substances control is a good example of a change in the scale of government services, as it requires the state to become familiar with new manufacturing processes and materials, to oversee new techniques for waste disposal, and to spend additional resources on monitoring the environment. The budget proposes to expend over $50 million of tax revenues to support these activities, which represents a substantial increase over the amount spent for this purpose in 1978–79.

In summary, the limit on appropriations will push the traditional budget into a zero-sum process, allowing growth or changes in some programs only at the expense of other programs. As the limit continues to grow more slowly than the cost of governmental services, the Legislature will have to make increasingly difficult choices about which programs to cut back, or alternatively, develop new sources of *nontax* revenues to finance them.

What Can the Legislature Do?

Under the terms of Article XIII B, the Legislature faces the challenge of providing an acceptable level of services in an environment where:

- The demand for services is likely to increase faster than the amount of resources the state is allowed to spend;
- The cost of these services will increase faster than the amount the state is allowed to pay for them; and
- A portion of the resources which otherwise would be used to respond

to these demands and costs will instead have to be returned to the taxpayers.

In this environment, the job of allocating available resources will become a difficult one. Not only will the Legislature be faced with the prospect of reducing services, it will be forced to consider taking actions on the basis of the *source* of funds. Some of the actions it will be asked to take would never be considered in the absence of Article XIII B. Obviously, Article XIII B contemplates that excess funds be returned to the state's taxpayers, and that the level of state spending be restricted. Article XIII B, however, does not require that the state proceed to this ultimate conclusion without considering actions which might be taken to lessen the impact. This section discusses options which are available to the state to maximize its flexibility. None of these options precludes the return of funds to taxpayers.

Evaluate budget to eliminate low-priority programs. One way the Legislature can increase its flexibility is to reduce the base of spending subject to the limit, so as to make room for future increases in programs that grow faster than the limit (such as corrections), or for new priorities (such as welfare reform). This can be done by eliminating low-priority programs.

Rely to a greater extent on voter-approved bonds. Under the terms of Article XIII B, only appropriations made from tax revenues are subject to the limit. In past years, the Legislature has relied to a limited extent on bonds for capital outlay projects, preferring to rely on a "pay-as-you-go" approach and to pay for the projects with tidelands oil revenue or other current revenue. To address the need for higher capital outlays, however, the Legislature will be forced to consider a greater reliance on voter-approved bonds to finance capital outlay projects.

Financing more capital outlay projects through voter-approved general obligation bonds would have three effects. First, because the debt service would be exempt from the limit, the state could pay these costs from revenues which otherwise might have to be returned to taxpayers. Second, in some cases the state's General Fund is the source of funds for revenue bond debt service payments. These include the state's lease-purchase bonds for prison construction and the University of California's and California State University's "high-tech" revenue bonds. "Inside-the-limit" appropriations authority currently used to service these revenue bonds could be made available for other state services if these issues were refunded using general obligation bonds. In other words, the state could issue voter-approved general obligation bonds to pay-off the revenue bonds, which is a technique commonly used by government agencies in times of declining interest rates. Finally, the state could use the tidelands revenues (approximately $150 million in 1987–88) to replace appropriations which currently count towards the limit, thereby freeing up additional appropriations authority.

The Legislature also will be asked to consider financing other programs using bond revenues rather than tax revenues. For example, certain transportation capital outlay projects are currently funded by gas tax revenues. The Legislature will be asked to consider using bonds to fund these projects because it would allow them to increase the overall level of expenditures in this area without requiring cutbacks in other areas. In addition, while a switch from revenue to debt financing would increase the cost of these projects, due to service payments on the debt, the cost of the programs would be spread more equitably over the life of the projects.

Rely to a greater extent on user fees, penalties, and permits. We recommend that the Legislature consider this option for *new* programs and for improvements to current programs. As an example, in our *Analysis of the Budget Bill,* we recommend approval of the budgets' proposal that a new optical disk storage and retrieval device for the Secretary of State's Office be financed by a surcharge on its users—businesses throughout the state. This approach is not recommended for existing programs, as Article XIII B requires that the state's appropriations limit be reduced when the cost of a program is shifted to user charges from tax revenues.

Give excess revenue to local agencies to help them increase services. To avoid appropriations in excess of the limit caused by excess revenues, the Legislature could investigate ways to increase subventions to local governments and school districts. It may be possible to do this in ways which further the Legislature's objectives, without imposing new mandates requiring state reimbursement. This could be accomplished through a general revenue sharing program accompanied by "bonus subventions" to be allocated to local agencies which expend their funds in specific areas.

Under a program of this type, any anticipated excess funds could be used to maintain services that cannot be funded within the state's appropriations limit. However, given the fact that local agencies are also covered by the appropriations limit, increasing subventions is feasible only to the extent that they have "room" within their limits to appropriate these funds, or to the extent that they can appropriate the funds for an exempt purpose.

Consider additional tax expenditure programs. Another option available to the Legislature is to consider additional tax expenditure programs. Because revenues which are not collected never need to be appropriated, the approval of new tax expenditure programs does not involve increased "appropriations subject to limitation." In our view, these programs are less efficient than direct spending programs, make legislative control of the budget more difficult, and add complexity to the tax system. Under the terms of Article XIII B, however, the Legislature must weigh the negative aspects of tax expenditure programs against the possibility that certain state goals will not otherwise be met.

Increase expenditures for debt service. Article XIII B exempts from the limit appropriations for debt service on voter approved bonds, or for indebtedness existing prior to January 1, 1979. If it appears likely that the state will exceed its appropriations limit because of excess revenues, the state could spend this excess on debt payments. It could, for example, decrease the unfunded liabilities of the state's retirement systems. Or, the Legislature could appropriate any excess revenues (in addition to the amount actually required in a given fiscal year according to the schedule of payments specified in the agreement with the holders of state bonds) to a reserve for the making of future interest and redemption payments. To the extent that the agreement with the holders of the bonds allows for the early redemption of the bonds, the state could also use excess revenues to redeem outstanding bonds in advance of their scheduled redemptions.

Summary

The appropriations limit required by Article XIII B of the State's Constitution has become a major factor for the Legislature to consider in providing a budget for California. The limited growth allowed under the terms of Article XIII B will force the budget into a zero-sum process. As such, the Legislature will be faced with difficult choices in the years ahead.

STATE BONDS AFTER FEDERAL TAX REFORM

What Action Does the Legislature Need to Take in Response to New Federal Tax Laws Regarding Bond Programs?

Summary

- *New federal law significantly limits the volume of tax-exempt bonds which California's governments will be able to issue in the future for "private activities," such as housing and industrial development. It also imposes new restrictions on how tax-exempt bond programs must be managed, including the investment of idle bond proceeds, the refinancing of bond issues, and how quickly bond proceeds must be spent.*
- *California's state and local governments will be required to dramatically reduce their future use of tax-exempt bonds for private activity purposes, in order to comply with the new volume limit. An average of about $8 billion annually of such bonds have been sold over the past three years. Now these sales must be limited to $2 billion in 1987 and $1.3 billion in 1988.*
- *In order to both maximize its financial interests and not jeopardize*

the tax-exempt status of its bonds, the state needs to improve its estimates of bond fund expenditures, improve its ability to track the use of bond proceeds, reconsider how its bond issues are structured, broaden the possible ways that idle bond proceeds may be invested, and consider using interim financing during the initial construction phases of capital outlay projects.

- *At present, the Legislature has no direct involvement in the debt limit allocation process. We therefore recommend that the Legislature enact legislation establishing specific statutory criteria to be used in making debt limit allocation decisions. We also recommend that the Legislature ensure that its views are represented during the allocation proceedings by enacting legislation which allows its members to participate on an ex-officio basis.*

The federal Tax Reform Act of 1986 contains a number of significant provisions involving the treatment of tax-exempt bonds issued by state and local governments. These provisions raise a number of important policy issues for the Legislature regarding tax-exempt bond programs, including the purposes for which tax-exempt bond proceeds should be used, and the way in which tax-exempt bond programs should be managed so as to maximize the state's financial interests. This section discusses these policy issues and how they might be addressed.

New Federal Tax Provisions Relating to Bonds

As discussed in Part Two, state and local governments issue billions of dollars worth of bonds annually to finance a wide range of activities. In the past, the interest income that these government-issued bonds pay to their owners has been exempt from federal (and state) income taxation. Since bond investors are willing to accept lower interest rates when their interest income is not taxable, the federal tax exemption has allowed state and local governments to borrow more cheaply than otherwise, thereby saving them money.

New Provisions. The new federal law does not eliminate the federal tax exemption for state and local bonds. However, it significantly restricts the purposes for which tax-exempt bonds may be issued, limits the sales volume of certain types of tax-exempt bonds, and imposes tight constraints on how bond programs are managed, including the ability of issuers to "make money" on tax-exempt bonds by temporarily reinvesting their proceeds elsewhere. The underlying rationale for these and many of the Act's other provisions is to broaden the federal tax base, thereby both allowing tax rates to be reduced, and making the tax system simpler and fairer. The most significant bond-related provisions of the Act are as follows:

1. Restrictions on Allowable Purposes for Tax-Exempt Borrowing

The Tax Reform Act places new restrictions on the types of projects that qualify for tax-exempt financing. These provisions generally continue the trend toward tighter restrictions on tax-exempt bonds used for private activity projects which began with the Mortgage Bond Subsidy Act of 1980 and the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1984. The intent of these restrictions is to limit federal revenue losses resulting from tax-exempt financing, and to restrict the amount of public subsidy for private activities.

Public Purpose Versus Private Activity Bonds. The new law creates two classifications for bonds: *public purpose bonds* and *private activity bonds.*

Federal Tax Treatment of Private Activity Bonds

Permitted Tax-Exempt Financings Under The Unified Volume Cap	Permitted Tax-Exempt Financings Outside The Unified Volume Cap	Financings That Are No Longer Treated As Tax-Exempt
• Multifamily rental housing (with stricter income targeting) • Mass commuting facilities (if owned by a governmental entity) • Local district heating or cooling • Local district gas and electricity • Facilities for furnishing water • Sewage and solid waste disposal • Hydroelectric facilities • Hazardous waste disposal facilities (new category) • Small issue IDBs (with a December 31, 1986 sunset for commercial and retail projects and a December 31, 1989 sunset for manufacturing) • Student loan bonds • Mortgage revenue bonds (with stricter income and purchase price limits) • Qualified redevelopment bonds (new category)	• Airports (if owned by a governmental entity) • Docks and wharves (if owned by a governmental entity) • Sewage and solid waste disposal (if owned by a governmental entity) • Qualified veterans mortgage revenue bonds • Nonprofit organizations (principally hospitals and universities)	• Air and water pollution control facilities • Sports stadiums • Convention and trade show facilities • Parking facilities • Industrial parks

- ***Public purpose bonds*** are those issued by or on behalf of state and local governments to finance *traditional capital outlay activities,* such as construction of highways, prisons, office buildings, parks, and dams. These bonds will *continue* to be federally tax-exempt.
- ***Private activity bonds*** are generally defined as those for which (a) more than 10 percent of the proceeds are used by a private entity, or otherwise secured by payments or property used in a trade or business-type activity, or (b) 5 percent or more of the proceeds are loaned to a private entity. The accompanying box shows that these private activity bonds are treated for federal tax purposes in one of three ways under the new law, depending on their purpose. Specifically, some will *continue* to be tax-exempt, some will *no longer* be tax-exempt, and some will be *tax-exempt but subject to a unified statewide volume limitation.*

2. The Volume Limitation for Private Purpose Bonds

The unified volume limitation applicable to this third category of private activity bonds applies to *combined* state and local bond issues, including mortgage bonds, student loan bonds, and industrial development bonds (IDBs). Prior federal law also limited the use of private activity bonds; however, the new law redefines the term "private activity," and is much more restrictive regarding the use of these bonds.

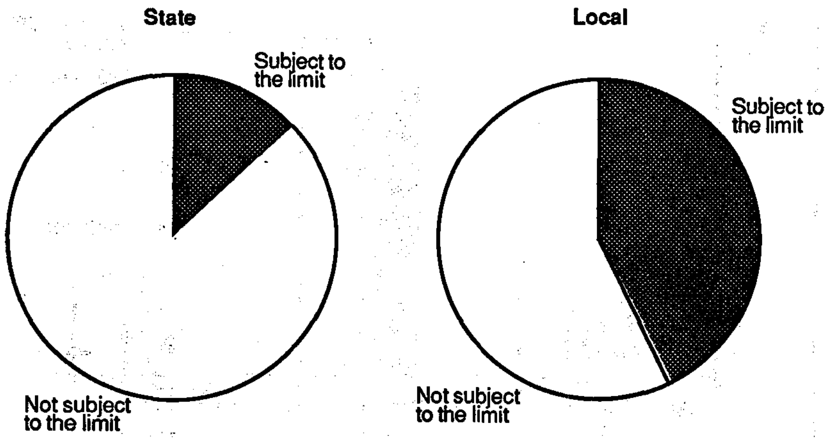
Prior law. Prior to federal tax reform, there were two separate volume limitations. First, bonds issued annually for industrial and commercial development projects, student loans, and certain educational and health facilities, could not exceed the greater of $200 million, or $150 per capita. (California's limits under this formula were $3.8 billion in 1985 and $3.9 billion in 1986; for 1987, the limit would have been $100 per capita, or $2.6 billion). Second, single-family mortgage revenue bonds had their own volume limit, which in 1985 equaled $2.5 billion. The ceiling for 1986 was never computed by the federal government, because enactment of the tax reform measure made the old formula obsolete.

New law. For the 1986 and 1987 calendar years, the new unified volume limitation on private activity bonds equals the greater of $250 million, or $75 per capita. Beginning in 1988, however, the limit is reduced to the greater of $150 million, or $50 per capita. In dollar terms, this statewide limit amounted to about $1.9 billion in 1986, and is projected to equal about $2 billion in 1987 and $1.3 billion in 1988. Given that the Tax Reform Act was passed in August of 1986, the 1986 limit applies only to bonds issued during the August through December 1986 period.

Chart 30 shows the proportion of state and local bond sales during the past three years that would have been subject to this new limitation. It indicates that about 13 percent of state issues and 43 percent of local issues would have been affected.

Chart 30

Proportion of State and Local Bond Sales Subject to Volume Limitation[a]

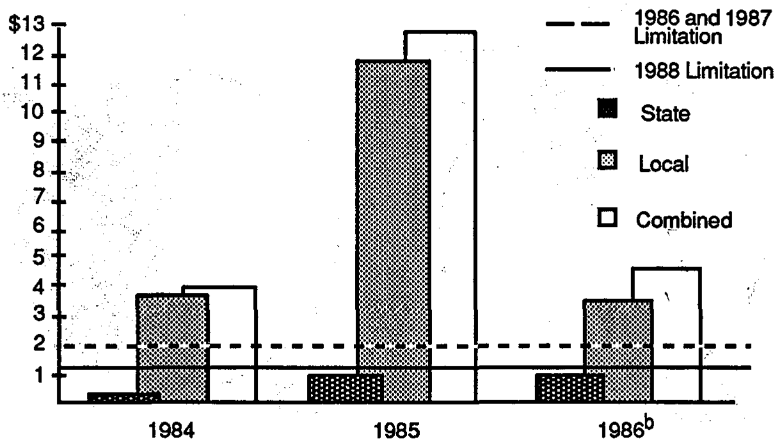


[a] Source: Estimate by Legislative Analyst's Office, based on data from the California Debt Advisory Commission for 1984 through 1986.

Chart 31 compares the projected limits for 1986, 1987 and 1988 to the dollar sales of the affected types of bonds over the past three years. It indicates that in each year these sales have far exceeded the limit, primarily because of local sales. *Given this, the new limit will require a dramatic cutback in the volume of private activity tax-exempt bonds issued in the future.* Thus, if state and local governments wish to continue to support their past levels of private activity projects, they will have to utilize taxable bonds or other means of financing. The largest reduction in tax-exempt bond financing clearly will be required at the *local* level, since even if the state had issued *no* such bonds, the limit still would have been exceeded by a significant margin. Chart 32, which shows the distribution of local bond sales subject to the allocation limit, indicates the different program areas from which these local bond reductions would have to be chosen. By far the largest category of past sales involves housing bonds, which by themselves would have exceeded the limit.

Chart 31

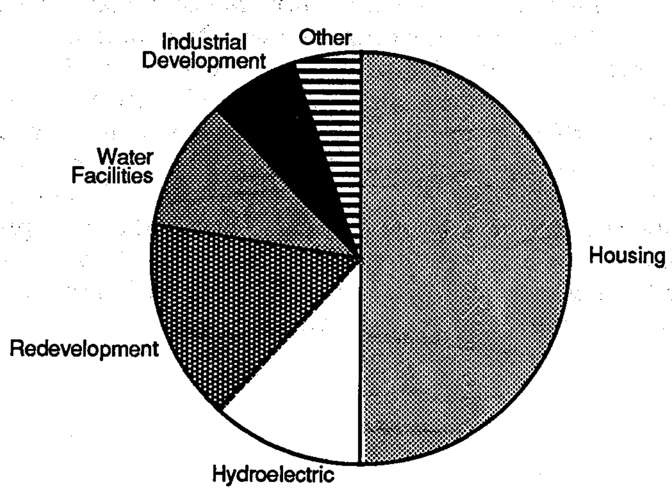
State and Local Bond Sales Affected by Volume Limitations
1984 through 1986 (in billions)[a]



[a] Source: Estimate by Legislative Analyst's Office, based on data from the California Debt Advisory Commission.
[b] Only bonds sold from August through December were subject to the limit.

Chart 32

Distribution of Local Bonds Sales Subject to Volume Limitation[a]



[a] Source: Estimate by Legislative Analyst's Office, based on data from the California Debt Advisory Commission for 1984 through 1986.

3. Other Provisions

The other major bond-related provisions of the Act involve restrictions on "arbitrage" interest earnings, on "advance refundings" of bonds, and on the "early issuance" of bonds.

Arbitrage Earnings. In the past, state and local governments issuing federally tax-exempt bonds have ordinarily been able to earn "arbitrage income" on their bond proceeds, by investing them before they are needed to be spent. This is because there is a "spread" between the tax-exempt interest rates that these governments must pay investors, and the higher interest rates that these governments can earn when they invest their bond proceeds in taxable securities. For example, if a tax-exempt state bond pays 7 percent and taxable U.S. Treasury securities pay 9 percent, the state can earn a spread of 2 percentage points on any of its tax-exempt bond proceeds that it invests temporarily. Prior federal law gave tax-exempt bond issuers several opportunities for earning such arbitrage income, including the investment of (1) bond proceeds held in reserve funds, and (2) proceeds derived from selling bonds far in advance of when the funds would actually be expended for capital projects.

Although the new law does not outlaw arbitrage income for tax-exempt issues, it sharply restricts it. (These restrictions on arbitrage income apply not only to tax-exempt *bonds,* but also short term tax-exempt *notes* such as the state issues under its external borrowing program.) For example, unrestricted arbitrage income from tax-exempt bond issues still may be earned if bond sale proceeds are used within six months, or are invested in tax-exempt securities. However, the Act: (1) provides that *no* arbitrage profits may be retained if an issue's proceeds are not used within six months, (2) reduces the allowable size of investable reserve funds, and (3) imposes a variety of other restrictions. The Act also provides that any unauthorized arbitrage profits must be *rebated* to the federal government, and that already-issued tax-exempt bonds can be *reclassified as taxable* bonds if the Act's bond-related requirements are violated.

Advance Refundings. The term "advance refunding" refers to the issuance of new bonds in order to pay off outstanding bonds, prior to when the outstanding bonds have matured or can be called-in by the issuer. This is usually done in order to replace high-interest bonds with lower-interest bonds. Ordinarily, the proceeds of the new issue are invested until the outstanding bonds are retired. Thus, such refunding operations enable issuers to earn additional income. However, they also impose additional costs on the federal government, because it is required to bear the revenue losses from allowing tax-exempt interest on a larger volume of bonds (that is, the outstanding bonds and the advance refunding bonds) than otherwise. The Act imposes tight restrictions on the number of times an original bond issue may be refunded, and also makes private activity refunding issues subject to the unified volume limitation.

Early Issuance. The Act requires that at least 5 percent of a bond issue's proceeds be spent within 30 days, and 100 percent within three years. This is intended to reduce the volume of idle tax-exempt bond proceeds, and thus the federal government's costs (that is, the revenue losses) from funding the tax exemption.

Reporting Requirements. The Act also requires bond issuers to file various new reports with the federal government regarding the volume and use (including investment income) of tax-exempt bonds.

Implications. Taken together, *the above provisions mean that tax-exempt bond programs will have to be very carefully managed in the future, in order to both preserve their tax-exempt status and maximize the state's financial interests.* The changes brought about by the 1986 Tax Reform Act will result in increased state costs for the administration of its bond programs, and losses of interest earnings due to the arbitrage restrictions. These adverse fiscal effects can be minimized to some extent by better management of the state's bond programs. Specifically, the state needs better information about, and control over, the amount, timing, and proceeds of its tax-exempt debt issues. The State Treasurer's Office, which is responsible for managing state bond programs, will be the key player in this process. Based upon our discussions with that office, we have identified five areas that will require a new approach:

- First, *more accurate estimates* of bond fund expenditures will be needed, so that bond sales may be timed more efficiently.
- Second, *improved reporting systems* will be needed to track the use of bond proceeds on an issue-by-issue basis. Information should be collected on exactly how these proceeds are invested and the income they generate.
- Third, in many cases it may make sense to *restructure bond issues,* so as to fund projects through a series of smaller bond issues spread over time, rather than relying on a few large issues. Although this would result in increased underwriting costs, these costs could be minimized by *pooled sales* of bonds for different programs.
- Fourth, *increased options* for investing temporarily idle general obligation bond proceeds may be necessary, in order to comply with new federal requirements that any investment earnings subject to rebate be maximized. (This would require legislation, because these proceeds must be invested in the PMIA under current law.)
- Fifth, there may be cases where the state should temporarily use *alternative funding* in lieu of tax-exempt bond proceeds for capital projects, until the projects have been completed. Potential sources of such funding might include short-term taxable bonds, and borrowing from the General Fund or PMIA (the latter requires legislation).

The Treasurer, in conjunction with the Department of Finance and representatives of various state bond programs, currently is in the process of exploring many of these issues and developing proposed legislation to address them. The Treasurer should be able to advise the Legislature about the fiscal effects of these requirements within the next few months, including reductions in interest income and increased administrative costs.

Policy Issues Facing the Legislature

We recommend that the Legislature enact legislation establishing specific statutory criteria that shall be used in making bond allocation decisions. We further recommend that the Legislature ensure that its views are represented during bond allocation proceedings, by enacting legislation which allows its members to participate on an ex-officio basis.

As shown earlier in Chart C, the federal government will now only permit California governments to issue a fraction of their past volume of tax-exempt private activity bonds. The federal government gives states the discretion to decide how this allocation is to be spread amongst different governmental levels and different bond programs. Given this, the major bond-related policy issue currently facing the Legislature as a result of federal tax reform is: How should California's limited private-activity tax-exempt bonding authority be *allocated,* between both different program areas and different levels of government?

The Present Allocation Method. Private-purpose tax-exempt bonding authority currently is allocated by the California Debt Limitation Allocation Committee (CDLAC), according to an executive proclamation of the Governor made in September 1986. The CDLAC, which was statutorily authorized by Ch 926/86, is comprised of the State Treasurer (the Chairman), the State Controller and, in the absence of the Governor, the Director of the Department of Finance. At present, any state or local agency wishing to issue a private activity bond subject to the allocation limit must apply to CDLAC. The CDLAC reviews and either approves or disapproves these requests on a case-by-case basis.

As indicated earlier, California's 1986 statewide bonding allocation was limited by the new law to about $1.9 billion. Of this amount, CDLAC delegated decisions regarding $700 million to the state's Mortgage Bond Allocation Committee (MBAC), for use in financing single and multifamily housing programs. *Because the Legislature is not represented on CDLAC and has not enacted statutory guidelines to govern bond allocations, it currently has no direct say regarding how California's limited bonding authority is allocated.*

Actions Which the Legislature Should Take. Given the important role that bond financing plays in many program areas, the significance of the new federal bond ceiling, and the Legislature's general responsibility for establishing and reviewing bond programs, we recommend that the Legislature take the following two steps:

- ***First, we recommend that the Legislature enact legislation which establishes specific statutory criteria for use in making bond allocation decisions.*** These criteria should reflect the Legislature's views regarding (1) how the total statewide limit shall be allocated between state and local projects, and (2) how the limit shall be allocated among different programs seeking tax-exempt bond financing. In developing such criteria, the Legislature may wish to consider a range of factors including the availability of alternative financing for different programs (including *taxable bonds,* which are not subject to federal restrictions), the direct and indirect economic benefits projects generate (such as new jobs), project readiness, and the extent to which projects offer public benefits.
- ***Second, we recommend that the Legislature take action to ensure that its own views regarding the use of tax-exempt bonds for specific projects are taken into account when bond allocation decisions are made.*** The most direct way for the Legislature to do this is to enact legislation which adds its own members to CDLAC, who would participate on an ex-officio basis during the proceedings.

RISING COSTS OF INCARCERATION IN CALIFORNIA

How Can the Legislature Control State and Local Spending for Correctional Programs?

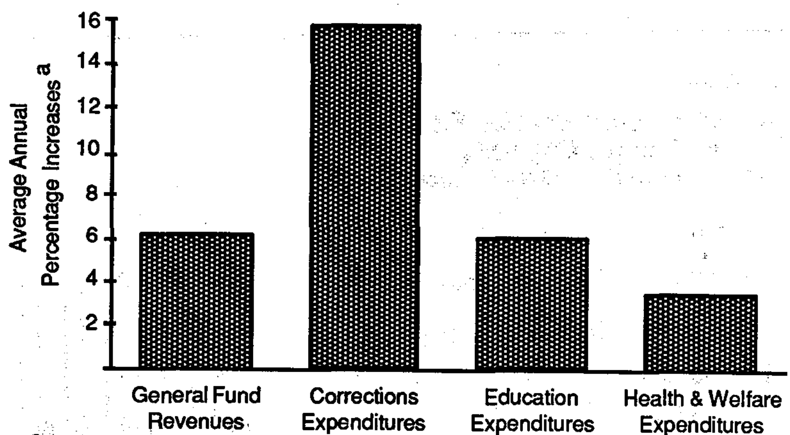
Summary

- *Despite spending more than $3.1 billion since 1981 for construction of new beds in state and local correctional facilities, more than 169,000 youth and adult offenders will be housed in space designed for 118,000 by 1990–91.*
- *Operating budgets for state and local correctional facilities are increasing rapidly. For example, annual spending to support the state Department of Corrections is growing faster than General Fund revenues and the state appropriations limit, and will exceed $2 billion by 1990–91.*
- *Without changes in policy, the Legislature will have to devote an increasing share of the state's General Fund budget to support the growing costs of state correctional programs. This may require that funds be redirected from education, health, and welfare programs. Furthermore, the Legislature may be asked to provide additional funds for local correctional facilities. There are alternatives to control these costs, although most entail difficult policy choices.*

In recent years, the number of persons incarcerated in California has increased dramatically. This growth has resulted in substantial increases in state and local costs for support and capital outlay for state prisons, facilities for youthful offenders, and local detention facilities. The increase in state General Fund spending for the Department of Corrections has been the most dramatic—it has far outpaced growth in state General Fund revenues and expenditures for other major General Fund programs. Chart 33 shows the average annual increases in spending to support the Department of Corrections, along with average annual increases for education, health and welfare.

Chart 33

Growth in General Fund Revenues and Expenditures for Corrections, Education, Health and Welfare
1980-81 through 1987-88



Source: *Governor's Budget* (1982-1987 editions)
[a] Support and local assistance budgets only

Given current policies, the upward trend in correctional costs can only continue. The number of incarcerated persons will grow, and the costs for the construction and operation of the new facilities needed to house the burgeoning population will continue to rise as well. Given, too, the spending limits imposed by Article XIII B of the Constitution, these increased costs will consume a growing proportion of existing state and local resources. To the extent that these increased costs cannot be accommodated by slower growth in other programs, funds will have to be diverted from other programs, such as education, health, and welfare. In order to lessen the fiscal pressure, the Legislature may wish to consider a variety of options to limit the growth in correctional costs at both the state and local levels.

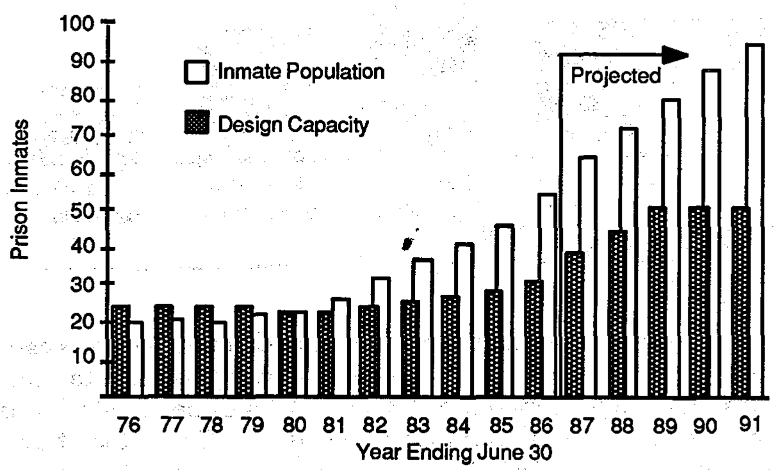
This section discusses population growth and projects the costs of incarceration at different levels in the criminal justice system—state prisons, Youth Authority facilities, and local detention facilities. The section also outlines alternatives to limit or reduce incarceration costs at the state and local levels.

State Prisons

The largest share of expenditures for correctional programs in California supports the ongoing operations of the Department of Corrections (CDC), which houses adult felons and narcotic addicts committed under civil authority. The costs of the prison system have risen sharply in recent years as the inmate population has climbed from about 20,300 inmates in 1976 to more than 55,000 ten years later—a 172 percent increase. The Department of Corrections estimates that the inmate population could reach almost 95,000 inmates by 1991 (please see Chart 34).

Chart 34

Inmate Population Far Exceeds Prison Design Capacity
1975-76 through 1990-91 (in thousands)



Source: *Governor's Budget* (1982-1987 editions) and Department of Corrections

Inmate Population Growth. Tougher laws, coupled with a stronger law enforcement climate and a larger state population, have brought about the growth in the inmate population. Increases in both the prison admission rate and length of prison sentences have caused the inmate population to swell. The admission rate has more than doubled in less than 10 years. In 1977–78, approximately 72 persons were admitted to prison per 100,000 of the state's population. By 1985–86, the number had increased to 155. The CDC projects that the rate will exceed 180 during the budget year.

At the same time, several statutes and ballot initiatives have resulted in longer prison sentences. In 1981, the average sentence for males and females in CDC institutions was about 3.7 years and 2.7 years, respectively. By 1985, the average sentence had increased to 4.1 years for males and 3.1 years for females.

In addition, the number of parolees returned to prison for violating conditions of their parole has increased dramatically. During 1985–86 more than 21,000 parolees either violated a condition of their parole or committed a new criminal offense. Sixty-four percent of parolees released that year were returned to prison, and the CDC anticipates that this rate will increase in the future. We discuss the problem of parole violators in more detail in our *Analysis* (please see Item 5240).

New Prison Construction Program. To accommodate the growing inmate population, California has embarked on the largest prison construction program in the nation, with plans to construct more than 25,000 beds at a cost of more than $2 billion. The department's current construction schedule shows that all construction (including construction of 11 new prisons, 10 new camps and the expansion of five existing prisons) should be completed by 1988–89. This will bring the prison system's design capacity to about 51,000.

At the beginning of the construction program in 1981, the prison system was operating at approximately 112 percent of its design capacity. Recent projections of the inmate population show that *by 1991 the inmate population will exceed by 44,000 the design capacity of the expanded prison system.* Thus, given existing trends and policies, the prison system will be operating at about 186 percent of its design capacity—far worse than when the building program began. Chart 34 contrasts the growth in the inmate population with the projected bed capacity of the prison system through 1991.

Although more than $2 billion has already been provided for construction of new state prison facilities, we estimate that an additional $3.5 billion would be needed to construct enough new prison beds to meet the department's projected 1990–91 population needs. If facilities are operated at 120 percent of design capacity, which the CDC considers a tolerable level of overcrowding, the additional need would be less—about $2.2 billion.

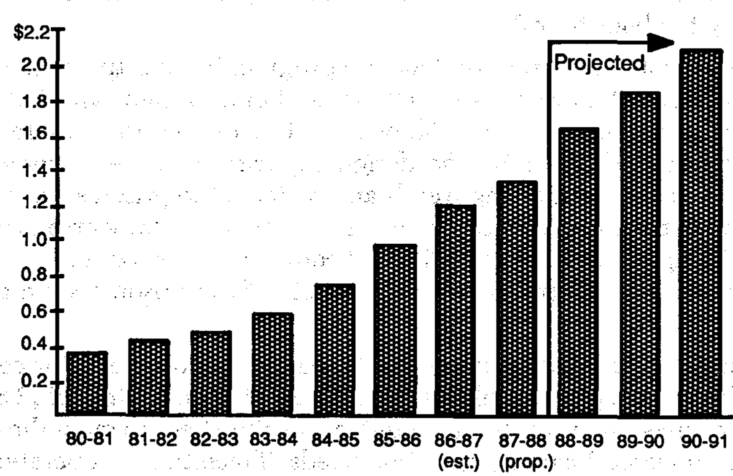
Operating Costs. The Legislature has traditionally funded about 95 percent of the CDC's support budget from the General Fund. The Governor's Budget for 1987–88 requests a General Fund appropriation of $1.36 billion for CDC support—an increase of 434 percent since 1977–78. Over the same 10-year period, General Fund revenues have increased by 131 percent. In addition, while the cumulative change in the state's appropriations limit is 72 percent since 1980, the cumulative change in the Department of Corrections' General Fund support budget is 306 percent.

We estimate that the annual General Fund support costs for the Department of Corrections will reach at least $2.1 billion by 1990–91. Chart 35 shows growth in the department's General Fund support budget since 1980–81, with our projections through 1990–91. These estimates are probably *minimum* costs, however, primarily because as new prison facilities are activated, per capita costs are likely to increase. This is because new prisons generally will have smaller housing units that are more staff-intensive than existing facilities. They also are designed to offer more work, training, and educational programs for inmates.

A number of other factors could increase support costs, such as costs imposed by court decisions. The *Toussaint v. McCarthy* court decision, for example, which required the state to reduce the inmate population at maximum security institutions and hire additional staff, increased costs by more than $10 million in 1986–87.

Chart 35

Department of Corrections Support Budget
1980-81 through 1990-91 (in billions)



Source: *Governor's Budget*, Department of Corrections, LAO estimates

Options to Reduce Costs of the Prison System. In order to reduce the pressure to finance the rising costs of the prison system by cutting back or slowing other state programs, the Legislature may wish to consider a number of options for controlling these costs. There are two basic catagories of options—those which reduce the inmate population, and those which reduce costs of inmate care once an inmate is in the prison system. Several of the options would require major policy changes and statutory authorization. Others could be implemented through the annual budget process.

Although the options to reduce the inmate population run counter to the trend of recent legislation, they would result in the greatest amount of savings. These options include selectively reducing prison terms, releasing selected inmates a short time prior to the end of their sentence, and modifying conditions for parole violation in order to reduce the number of parolees returning to prison. Options to reduce inmate population generally require statutory authorization.

The options to reduce the costs of inmate care generally could be implemented through the annual budget process. These options include: increasing inmate work/training assignments (work credits earned by inmates reduce their sentences); modifying the inmate classification system to place inmates at the lowest possible security level (consistent with public safety) in order to house inmates in less expensive institutions; increasing the use of less expensive community beds; and making greater use of privatization to carry out selected prison support functions. We discussed each of these options in more detail in *The 1986–87 Budget: Perspectives and Issues.*

Youth Authority Facilities

Like the state prison population, the population of the Department of the Youth Authority institutions continues to grow rapidly. The ward population increased by almost 88 percent between June 30, 1977 and June 30, 1986. Table 34 depicts the growth in ward population over the past 10 years, along with the Youth Authority's population projections through 1990–91.

Nature of the Youth Authority Population Problem. The recent increase in ward population is *not* primarily the result of an increase in juvenile and criminal court commitments to the Youth Authority. Since 1981–82, first commitments from juvenile courts have remained relatively stable and are projected to decline slightly for the remainder of the decade. In addition, first commitments from criminal courts have declined by over 80 percent during the same time period.

Table 34
Youth Authority Population Growth [a]
1976–77 through 1990–91

Year (As of June 30)	*Youth Authority Population*
1977	4,074
1978	4,324
1979	4,955
1980	5,207
1981	5,340
1982	5,763
1983	5,840
1984	6,035
1985	6,632
1986	7,650
1987 (projected)	8,335
1988 (projected)	8,570
1989 (projected)	8,780
1990 (projected)	8,930
1991 (projected)	9,015

[a] Source: Department of the Youth Authority

In part, the rapid increase in population in recent years is due to a large number of correctional inmates who have been transferred to the Youth Authority under the provisions of Ch 701/83 (SB 821). This measure specifies that in sentencing a person under the age of 21 to serve time in state prison, the court may order that person transferred to the custody of the Youth Authority to serve all or a portion of his or her confinement. At the beginning of 1984–85, a total of 206 of these so-called "SB 821" inmates were housed in the Youth Authority. As of June 30, 1986, however, the number housed in Youth Authority facilities had climbed to 1,320.

Ward population growth has also been partially fueled by an increase in the number of parole violators returned to Youth Authority institutions. Since 1981–82, parole violator admissions have increased by 41 percent. Almost one-half of these wards were returned for technical violations of the conditions of their parole, rather than for the commission of a new crime.

Although SB 821 transfers and parole violators have increased significantly, the department's most recent population projections do not anticipate an increase in the rate of SB 821 and parole violator admissions during the next five years. Instead, the *primary* reason why the ward population is projected to continue to grow is a dramatic rise in the length of time that wards are committed to the Youth Authority.

Since 1981–82, ward length-of-stay has increased from 13.5 months to 17.4 months. The department's population projections now anticipate an additional 5.7 months increase in length-of-stay during the next five years, bringing the average Youth Authority ward's commitment term to almost two years by 1990–91. For the most part, length-of-stay is affected by two factors: parole consideration dates established for each ward and "time cuts" and "time adds," which are granted to wards based on program performance within the Youth Authority system.

In recent years, parole consideration dates granted by the Youthful Offender Parole Board have risen steadily. For example, a ward committed to the Youth Authority for murder prior to 1978 received a parole consideration date of three years from the date of commitment. Under current policies, the parole consideration date for this offense has increased to seven years.

In addition, there has been a distinct change in the pattern of time adds and time cuts granted by the board. For example, during most of fiscal year 1981–82, time adds and time cuts were granted at a rate which, in total, *reduced* a ward's average length-of-stay by approximately two weeks. The department's most recent population projections indicate that time adds and time cuts will be granted at a rate which will *add* more than *five months* to a ward's length-of-stay.

Growth in Youth Authority Support Costs. The rapid increase in ward population growth has fueled an increase in overall Youth Authority support budget expenditures, and will continue to do so given existing policies. Since the institutional ward population began to increase significantly in 1984–85, however, the growth rate of the Youth Authority's General Fund support expenditures has only slightly exceeded the rate of growth for total General Fund expenditures. This primarily is because the Youth Authority has accommodated the additional wards through overcrowding, which is a relatively inexpensive way to house additional population. How much these costs will grow in the future depends upon how the increase in ward population is accommodated.

The Youth Authority's Approach to Accommodating Population Growth. To accommodate the projected increase in wards, the Youth Authority has embarked on a major capital construction program which could have significant implications for the department's General Fund support budget. This program will not accommodate all of the growth, however, and the Legislature will be asked to make choices on how to manage and house the department's burgeoning population.

In the *Supplemental Report of the 1986 Budget Act,* the Legislature directed the Youth Authority to prepare a long-range ward population management report and evaluate various options for alleviating overcrowding of Youth Authority institutions. The department submitted its "Population and Facilities Master Plan" to the Legislature in December 1986. The report proposes a three-part solution to the population growth problem.

First, it calls for the construction of 1,718 new institutional bed spaces at a capital outlay cost between $122 million and $142 million. This amount includes 1,118 beds which will be constructed at new and existing institutions and for which partial funding has already been appropriated. It also includes construction of a new 600-bed facility with an estimated future cost of $57 million to $67 million, for which no funding is provided in the Governor's Budget. Second, the plan proposes continued overcrowding of 757 wards, or about 10 percent of the department's revised bed capacity.

Finally, the master plan proposes eight different alternatives to construction which it estimates will save approximately 625 institutional bed spaces. Three of the alternatives have already been implemented by the Youth Authority, and five others are new.

The alternatives that have already been implemented include:

- Expanding the number of formalized substance abuse programs at all Youth Authority institutions and camps.
- Rejecting juvenile court commitments that have one year or less of confinement time or have been committed for misdemeanor offenses only.
- Rejecting Department of Corrections' SB 821 transfers who previously have been committed to the Youth Authority.

The new alternatives outlined in the master plan include:

- Establishing disciplinary work crews at eight Youth Authority institutions.
- Expanding the department's existing parole re-entry programs and establishing a new parole readiness furlough program.
- Hiring half-time job developers from the Employment Development Department to assist Youth Authority parole officers in securing job placements for parolees.
- Increasing the use of community-based detention and temporary detention for parolees found guilty of minor violations.
- Establishing a parole violator program at the Youth Training School in Chino.

We discuss these alternatives more fully in Item 5450 of our *Analysis.* The Governor's Budget does not propose funding for the establishment of any new alternative program outlined in the master plan.

Other Options to Relieve Overcrowding. While the master plan suggests a number of alternatives to more buildings as an answer to overcrowding, it still calls for new construction to provide for more than one-half of all of the additional bed space required over the next five years. The Legislature, however, may wish to consider other options to reduce the Youth Authority ward population in order to reduce the need to construct this expensive institutional bed space. Such options range from releasing certain juvenile offenders prior to their established parole dates (please see *The 1986–87 Budget: Perspectives and Issues*) to restricting further increases in ward length-of-stay (this issue is discussed in greater detail in the *Analysis*—please see Item 5450).

Additionally, it should be noted that several of the options discussed in the Youth Authority master plan are suggested for implementation as "pilot projects." The Legislature may wish to expand these programs in order to provide additional institutional bed savings.

If the Legislature chooses to construct additional facilities, it could authorize different types of facilities than those outlined in the master plan. For example, facilities to house emotionally disturbed wards might be particularly useful, since the department estimates that 20 percent of new commitments suffer from some type of psychiatric disturbance. Other, less costly, specialized facilities could also be used to house special populations, such as sex offenders, substance abusers, SB 821 cases, or parole violators.

Data provided by the Youth Authority also suggests that a surplus of bed space may exist in various local juvenile facilities (camps, ranches, and juvenile halls). Such surplus space might be leased to provide additional capacity for Youth Authority wards.

Of course, the Legislature may choose to direct the department to overcrowd existing facilities to a greater extent. The department's plan allows for 10 percent overcrowding, although the Department of Corrections advises that 20 percent is an acceptable level of overcrowding in its institutions.

There are many other alternatives for coping with the Youth Authority's growing ward population; each entails different policy choices. The fiscal implications of such alternatives could vary widely and the final cost of the Youth Authority program will depend on the mix of options chosen.

Local Correctional Facilities

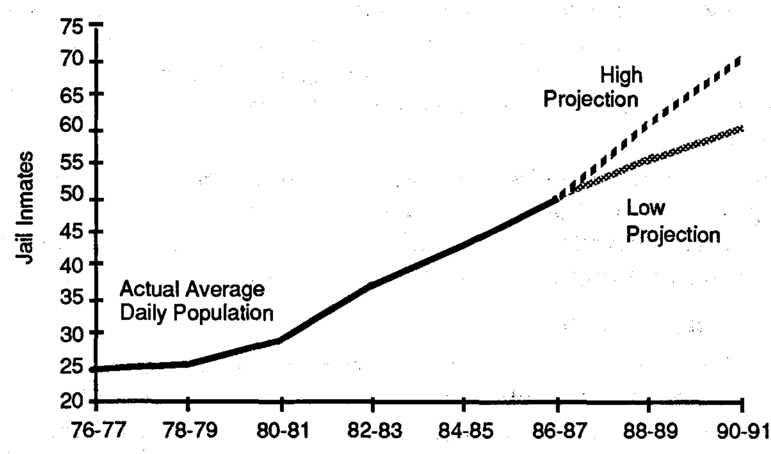
As in state prisons and Youth Authority facilities, overcrowding and rising costs are serious problems for many local correctional facilities in California. However, while local governments have primary fiscal responsibility for such facilities, other forces and institutions often set policies which affect their costs. For example, legislative actions to modify criminal penalties, as well as court sentencing decisions, affect jail population levels and have a major impact on local governments' costs for operating the facilities. In addition, in a number of jurisdictions, the courts have taken an active role in the oversight of county jails—in some cases imposing limits on jail population.

Although the state has provided primary funding for construction of local correctional facilities since 1981, the operating costs are borne by local governments. Furthermore, these operating costs are increasing more than three times faster than local government discretionary revenue. At the same time, spending limitations imposed by Article XIII B of the Constitution apply to local governments just as they do to state government.

Population Growth. The average daily population of county jails has doubled over the past 10 years, although most of the increase has occurred since 1980. Between 1980 and 1985, county jail population increased by 20,637, or 71 percent. The Board of Corrections (BOC) indicates that this trend in jail population growth is likely to continue. Chart 36 displays the historical growth in jail population and shows two population projections which were prepared by the board. The high projection is based on population growth over the past two years, while the low projection is based on growth trends over the past 10 years.

Chart 36

County Jail Population Growth
1976-77 through 1990-91 (in thousands)



Source: Board of Corrections

Since 1980, the population of county juvenile institutions such as juvenile halls, camps, ranches and homes has increased by 25 percent. However, current bed capacity for juvenile institutions is 9,329, or nearly 1,000 *more* beds than current population. As a result, there is no immediate systemwide overcrowding of these facilities.

Reasons for the Population Growth. In a November 1984 study, the BOC indicated that the substantial growth in jail populations results from (1) the general population growth of the state, (2) increased police activities, (3) more stringent law enforcement processing of felony arrests, and (4) recent legislation requiring mandatory jail terms and increasing sentence length.

The study indicated that only a small portion of the jail population growth can be attributed to the general increase in the state's population. For instance, while jail populations increased by about 100 percent in the past 10 years, the general state population increased by less than 20 percent.

Increased police activities may have contributed to the jail population. The board study showed that there has been an increase in jail bookings, partially because of increasing felony arrest rates over the past 10 years. Part of this increased activity can be attributed to a 14 percent increase in the number of local law enforcement personnel over a recent 10-year period.

While jail bookings have increased, the average length-of-stay per booking has also increased. The board found that the average stay increased from 10.5 days in 1981 to 14.9 in 1985. This is an increase of 4.4 days, or 42 percent. The board indicates that this probably results from more stringent law enforcement processing of felony arrests. For instance, a smaller percentage of accused felons are being released after arrest. Furthermore, the board suggests that a more stringent sentencing pattern by the judiciary has increased the length-of-stay.

The board also indicates that there is a consensus opinion among counties that recent legislation requiring mandatory jail terms has had a significant impact on jail populations. Legislation cited by the board established mandatory jail terms for residential burglary, second convictions for driving under the influence, and certain drug offenses.

Capital Outlay Costs for Local Facilities. Since 1980, the state has provided more than $1 billion to counties from three bond measures and a General Fund appropriation for jail design and construction. The bond measures generally provide that the state pay for 75 percent of the costs of constructing new facilities with a 25 percent match from counties. The board advises that the money from the General Fund appropriation and the first two bond measures has funded projects that, when completed, will add 11,138 new beds and 3,306 replacement beds to local correctional facilities. At the time this analysis was prepared, the board could not identify the number of beds that would be added from projects funded by the third bond measure. Based on the experience from previous bond issues, however, the board indicates that the third bond measure could add about 9,500 new beds.

In spite of the major construction program, population growth in local facilities will cause continual overcrowding of jails. Even when the new facilities that will be funded by the most recent bond measure are considered, jail population in 1990 will exceed projected capacity by 1,000 to 11,000 beds.

If the Legislature were to continue to assist local governments by providing about 75 percent of the funds needed for construction of new jail facilities, the state's costs to close the projected gap in 1990 would range between $50 million and $550 million. Local costs could range from $17 million to $183 million, assuming the 25 percent match requirement is maintained. Additional funding would be required if jail populations continue to rise after 1990.

County Jail Operating Costs. Although the cost of constructing new beds is substantial, the cost of maintaining them is far greater. For instance, the board indicates that the overall statewide average cost per prisoner is roughly $13,500 per year, and is increasing faster than inflation. Part of the cost increase is due to court orders requiring enhancements in maintenance, staffing, and support services in order to insure prisoner safety. Further, certain design features of the new jails may raise staffing costs.

Information collected by the County Supervisors Association of California shows that county costs for operating jails are growing at a substantially faster rate than discretionary revenue is growing. The data suggest that for the five years from 1980–81 to 1985–86, the average growth in county costs for operating jails was 153 percent. Over the same period, however, the average growth in discretionary county revenue was only 48 percent. These trends suggest that current funding patterns can continue only with substantial expenditure reductions in other local programs.

Alternatives to Reduce Overcrowding and Costs. There are a number of alternatives to alleviate overcrowding in county facilities and reduce their costs. Most of these alternatives are available to local governments already and would not require any action by the Legislature.

The most obvious way to reduce jail populations is make better use of alternatives to incarceration. The BOC made an extensive study of various local programs, which it released in December 1985. Generally, these programs fall into two categories: pretrial release programs and post-sentence release programs. Examples of pretrial release programs include: (1) a field or station citation in which a person accused of a misdemeanor can be released by the officer in the field on a promise to appear in court, (2) "own recognizance" release, (3) various bail programs, and (4) pretrial diversion, where persons are diverted from the criminal justice system by agreeing to participate in specialized treatment programs. Examples of post-sentence release programs are: (1) probation, (2) sheriff-initiated work projects in lieu of jail, (3) county parole, and (4) early release.

The board found that counties that make aggresive use of these alternatives have lower incarceration rates than counties that are less aggressive. As a result, better use of these alternatives by more counties could ease population growth. The board indicates, however, that even some of the most innovative counties will continue to have serious overcrowding in their jails.

There are also ways that the Legislature could assist local governments in reducing correctional costs or coping with increasing jail population. Although contrary to the trend of recent legislation, the Legislature could modify the laws imposing criminal penalties in order to reduce jail population pressures. As noted above, there is a consensus among local officials that recent legislation requiring mandatory jail terms and increasing sentence length for various crimes has resulted in population growth in local correctional facilities.

Another alternative would be for the state to provide major amounts of additional capital construction funds to counties in order to help them construct the facilities needed to house rising jail populations. The funds needed, however, could exceed $500 million.

Conclusion

As the populations of California's prisons, youth detention facilities, and county jails grow, costs for capital outlay and operating expenses will continue to increase. The Legislature, however, has options to control this growth and reduce fiscal pressures at both the state and local levels. Many of these options involve difficult policy choices, in which the cost implications must be weighed against the interests of public safety.

THE AIDS EPIDEMIC

What Will Be the Magnitude and Cost of the AIDS/ARC Epidemic During the Next Five Years? What Information Does the Legislature Need to Develop a Comprehensive, Targeted, and Efficient Approach to Addressing the Epidemic?

Summary

- *California has a cumulative total of 6,620 AIDS cases, which is about 23 percent of the national total. Currently, most of the cases involve homosexual and bisexual men. Medical experts expect that the proportion of AIDS cases among intravenous (IV) drug abusers will increase in the next few years. Because cases of AIDS among minorities, women, and children have generally been related to IV drug abuse, the proportions of AIDS cases in these populations are likely to increase as well.*

- *Medical care costs in California may range between $255 million and $406 million in 1991, an increase of over four-fold above the estimated costs in 1986. This estimate drastically understates the full cost of AIDS because it does not include certain medical care costs, supportive services, prevention and education, or indirect costs.*
- *Medi-Cal and county hospitals bear a large share—probably over 30 percent—of AIDS-related health care costs.*
- *Treatment of individuals with AIDS-Related Complex (ARC), more intensive treatments due to new drugs, increases in the IV drug abuse AIDS population, and costs of treating AIDS-related dementia may greatly increase costs above our estimates.*
- *Researchers are working on developing a vaccine and treatments for AIDS and examining less costly ways to care for people with AIDS. Currently, the best way to reduce future costs is to prevent the spread of the virus through education.*
- *In this volume and our Analysis, we make recommendations that several state agencies submit reports to the Legislature addressing (1) plans to curtail spread of the AIDS virus among IV drug abusers and sexually active heterosexuals, (2) alternatives to acute hospital care for AIDS patients, and (3) the extent to which AIDS victims are becoming eligible for disability payments.*

What is AIDS? What is ARC?

Acquired Immune Deficiency Syndrome (AIDS) is a disease that impairs the body's normal ability to resist harmful diseases and infections. The disease is caused by a virus known as Human Immunodeficiency Virus (HIV), which is spread through intimate sexual contact or exposure to the blood of an infected person. People who have AIDS are vulnerable to illnesses that would not be a threat to anyone whose immune system was functioning normally. These illnesses are referred to as "opportunistic" infections or diseases (OIs). To be diagnosed as having AIDS, a person must have immune system impairment, infection with the virus, and have certain identified OIs. Persons who are infected with the virus and who show signs of immune system impairment—but do not have one of the OIs associated with AIDS—have AIDS-Related Complex (ARC).

In order to transmit the virus, an infected person must have direct blood or semen contact with another individual. This may occur through sexual contact, use of contaminated hypodermic needles, blood or blood product transfusions, or exposure *in utero* or through breast feeding from a mother carrying the virus. Infection with the virus does not always lead to AIDS or ARC.

At present, there is no widely available method to detect whether or not a person actually carries the virus. A blood test can be performed, however, to detect antibodies to the virus. (Persons who test positive are termed "seropositive.") Antibodies are produced by the immune system in response to infection. Even though the blood test does not directly indicate the presence of the virus, medical experts generally assume that a positive test result means that the virus is present. The test does not detect whether an individual has AIDS or ARC, and it cannot be used to detect whether an individual will develop AIDS or ARC in the future.

At present, treatment for AIDS is limited to postponing the inevitable. AIDS is a fatal disease. Approximately 50 percent of all persons diagnosed with AIDS have died. Nearly 75 percent of persons with AIDS die within two years of diagnosis. There is no known cure for AIDS or ARC.

Researchers are currently trying to develop various treatments and a vaccine for AIDS/ARC. Experimental treatments range from reconstitution of the immune system through bone marrow transplants to medicinal agents directed against the virus itself. Some of the associated OIs, such as Kaposi's Sarcoma, can be treated with drugs. The National Academy of Sciences estimates that a vaccine for the HIV virus will not be available for at least five years, and probably longer.

The AIDS Population—California and the Nation

As of November 1986, there have been 28,246 reported cases of AIDS nationwide. California accounts for approximately 23 percent, or 6,620, of all reported cases. However, the Department of Health Services (DHS) has estimated that the official state counts of reported AIDS cases may understate the true number of AIDS cases by 17 to 25 percent. The DHS indicates that the strict standard for diagnosing AIDS established by the federal Centers for Disease Control (CDC) is the major reason for this problem. For example, a person could be infected with the virus, have opportunistic infections, and in the opinion of the treating physician have AIDS, yet still not meet the strict CDC case definition because certain laboratory tests were not performed. Variations in the numbers of AIDS cases reported illustrates the problems with reporting. For example, in November 1986, San Francisco County reported it had 2,654 cumulative AIDS cases, while the DHS estimated 2,370 cases.

Neither the DHS nor the CDC collect statistics on the number of individuals with ARC. Based on estimates that the ratio of ARC to AIDS cases is approximately 10 to 1, there are currently 66,000 ARC cases in California. Some of these individuals are leading relatively normal lives, while others are as disabled as those with AIDS. There is, however, no way to ascertain the distribution of ARC cases along the continuum of disability.

Cases by Population Group. Table 35 indicates the total number of reported AIDS cases in California and the country by population group. The distribution of California AIDS cases by group differs significantly from the distribution of AIDS cases nationwide. Ninety-two percent of California's AIDS cases occur among homosexual/bisexual men, while 2 percent are among intravenous drug abusers (IVDAs). Nationwide, 72 percent of reported cases occur among homosexual/bisexual men and 17 percent among IVDAs. The major reason for the difference is that in the states of New York and New Jersey, where approximately 40 percent of all AIDS cases have been reported, a large portion of the cases involve heterosexual IVDAs. In New York, 29 percent of all reported cases are IVDAs; in New Jersey, 47 percent. The difference between the east and the west coasts may be attributable to the relative concentration of IVDAs in those areas and different drug use behavior among addicts. The difference may also be somewhat overstated because 11 percent of the homosexual/bisexual men with AIDS in California also report using drugs intravenously. Thus, some of the homosexual/bisexual men with AIDS may have been exposed to the virus through IV drug use rather than through sexual contact.

Table 35
AIDS Cases by Population Group
California and the Nation
January 1981 through November 1986

	California				*United States*			
Population Group	*Male*	*Female*	*Total Cases*	*Percent of Total*	*Male*	*Female*	*Total Cases*	*Percent of Total*
Homosexual/bisexual[a]	6,059	0	6,059	92%	20,417	0	20,417	72%
Intravenous (IV) drug user	123	27	150	2	3,791	969	4,760	17
Hemophiliac	47	8	55	1	256	8	264	1
Heterosexual contact	29	23	52	1	542	518	1,060	4
Transfusion	97	35	132	2	357	203	560	2
Children with parents in risk groups	4	7	11	0	162	157	319	1
None apparent/unknown	141	20	161	2	658	208	866	3
Totals	6,500	120	6,620	100%	26,183	2,063	28,246	100%

[a] Eleven percent of homosexual men in California also reported having used IV drugs.
Source: Centers for Disease Control; Department of Health Services, Office of AIDS.

Primarily because California has fewer IVDA-associated cases than the nation, it also has fewer AIDS cases among minorities, women, and children. Table 36 shows the differences between California and the nation by race/ethnicity, sex, and age. Nationally, both blacks and hispanics represent over *twice* as many AIDS cases as their proportions of the general population. In contrast, whites in California are overrepresented in AIDS cases, and hispanics underrepresented by half, in relation to their proportions of the state's population.

Table 36
Proportion of AIDS Cases
by Selected Race/Ethnicity, Sex, and Age Categories
California and the Nation
January 1981 through November 1986

	California		*United States*	
	Percent of Total Population [a]	*Percent of AIDS Cases*	*Percent of Total Population* [a]	*Percent of AIDS Cases*
White	67%	79%	80%	61%
Black	8	9	12	24
Hispanic	19	10	6	14
Male	49	98	49	93
Female	51	2	51	7
Children under five	7	0.3	7	1

[a] Based on 1980 census data.

Cases by Geographic Area. Just as AIDS cases vary by age, sex, and other demographic factors, they vary by geographic area. Currently, AIDS cases are concentrated in urban areas. Los Angeles (2,419 cases) and San Francisco (2,370 cases) Counties accounted for approximately 72 percent of all reported cases in California. As of November 30, 1986, there were 12 counties, listed in Table 37, that had over 50 reported cases each. Forty-five out of 58 counties in the state have reported at least one case of AIDS.

Table 37
California Counties With
50 or More Reported AIDS Cases
January 1981 through November 1986

County	*Reported Cases*	*Reported Deaths*
Los Angeles	2,419	1,106
San Francisco	2,370	1,195
San Diego	341	174
Alameda [a]	276	108
Orange	238	124
Santa Clara	133	51
Riverside	103	69
San Mateo	102	47
Contra Costa	91	34
Sonoma	88	42
Sacramento	72	27
Marin	62	30

[a] Excluding Berkeley.
Source: Department of Health Services, Office of AIDS.

Growth Trends in AIDS Cases. Both nationwide and in California, the number of reported AIDS cases has been growing since 1981. However, the rate of increase in cases is declining. This is illustrated in California by a rate of increase of newly diagnosed AIDS cases between 1982 and 1983 of over 200 percent, as compared to a rate of increase between 1984 and 1985 of about 75 percent. This decline in the rate of increase largely reflects the experience in San Francisco and Los Angeles Counties. In counties with fewer cases, the rate of increase is still accelerating or, at best, holding steady.

Experts Estimate that the Number of AIDS Cases Diagnosed Will Quadruple by 1991

The Centers for Disease Control have developed projections of AIDS cases based on the number of cases reported by population group and other epidemiologic information. As of June 1986, the CDC estimated that there were 1 million individuals nationwide infected with the virus—although it also believes there could be as many as 1.5 million infected individuals. The CDC projects that approximately 18 to 29 percent of infected persons will develop AIDS, resulting in a total of 182,000 to 289,000 AIDS cases diagnosed by the end of 1991.

The CDC estimates that, nationwide, over 70 percent of the future cases will be diagnosed among homosexual/bisexual men, and 25 percent of the cases will occur among IVDAs. This represents an increase in cases among IVDAs relative to homosexual/bisexual men. Accordingly, we would expect to see an increase in the proportion of minorities, women, and children with AIDS.

The CDC did not develop projections of the number of ARC cases. Without a universal definition for or mandatory reporting of ARC, it is difficult to obtain accurate information about these individuals. Most experts estimate that, at any given time, the number of ARC cases is approximately 10 times the number of reported AIDS cases. Using this estimate, there would be 1.8 million to 2.9 million ARC cases nationwide by the end of 1991.

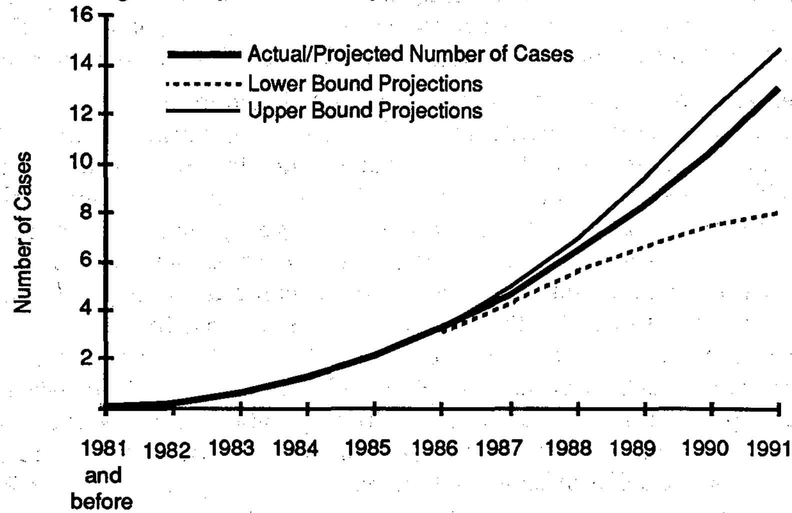
Projections of AIDS/ARC Cases in California. Because approximately 23 percent of all AIDS cases occur in California, CDC officials estimate that 23 percent of infected individuals also reside in California. This means that there are approximately 230,000 individuals in the state who have been infected with the virus, although there could be as many as 345,000. The majority of these persons are homosexual/bisexual men and IV drug abusers. However, any person who has been infected with the virus may be able to pass it on to others by exchanging blood or semen.

CDC officials have estimated the number of AIDS cases for California for the next five years. For each year, they also estimated an upper and lower bound for the number of cases. For example, Chart 37 shows that in 1991 CDC projects that approximately 12,900 new cases of AIDS will be diagnosed, but the range is between 8,100 and 14,600 cases. This variance in the range is due to uncertainty about the rate at which those with the virus develop AIDS. Again, we used the CDC's estimate of the probable range of these rates. By 1991, as Table 38 shows, the CDC estimates that a total of almost 50,000 individuals will have been diagnosed with AIDS. Of these individuals, approximately 34,000 will have died.

Chart 37

Actual and Projected Number of AIDS Cases Diagnosed During Year in California[a]

1981 through 1991 (in thousands)



[a] California estimates are based on projections by the Centers for Disease Control.

Table 38

Actual and Projected Number of AIDS Cases in California 1981 through 1991

Year	*Number of Cases Diagnosed During Year*	*Range of Case Projections* Lower Bound	*Range of Case Projections* Upper Bound	*Cumulative Number of Cases*
1981 and before (actual)	67			67
1982 (actual)	202			269
1983 (actual)	639			908
1984 (actual)	1,219			2,127
1985 (actual)	2,136			4,263
1986 (projected)	3,250	3,100	3,400	7,513
1987 (projected)	4,650	4,350	4,950	12,163
1988 (projected)	6,300	5,600	6,900	18,463
1989 (projected)	8,200	6,600	9,300	26,663
1990 (projected)	10,400	7,500	12,100	37,063
1991 (projected)	12,900	8,100	14,600	49,963

Source: Centers for Disease Control.

If there are 10 ARC cases for every AIDS case, in 1991 approximately 129,000 Californians will develop ARC. This will bring the total number of individuals who will have developed ARC to 500,000.

Projections of AIDS/ARC Among Population Groups in California. The CDC has not been able to estimate what percentage of cases in California will be diagnosed among the different population groups. Medical experts disagree about whether, over time, California's AIDS cases will match the nationwide demographic distribution. There is agreement, however, that the relative proportion of AIDS cases related to IV drug abuse and heterosexual contacts in California will continue to grow.

Some medical experts argue that the AIDS epidemic will occur in three stages corresponding to saturation of different population groups with the virus. According to this theory, the current decline in the rate of increase of AIDS cases represents saturation of the population of homosexual men. This means that the rate of increase may go up again when infection becomes widespread in the second population at risk—IVDAs and heterosexuals in sexual contact with them—and its members begin to develop AIDS more extensively. There is some evidence that this stage is already starting. In one methadone maintenance clinic in San Francisco, infection increased in 1986 from between 4 and 10 percent in April to between 18 and 25 percent in November. The third population at risk could be members of other sexually active groups. For example, the Infectious Disease Branch of the DHS informs us that blacks and hispanics in their 20s are a population in which other sexually transmitted diseases occur more frequently than average.

The Costs of AIDS and ARC

Costs related to AIDS and ARC fall into at least three different categories:

- ***Medical and Nonmedical Care Costs.*** The costs of caring for AIDS/ARC patients may include hospital costs, physician costs, in-home care costs, or any other type of supportive service.
- ***Prevention of HIV Infection Costs.*** The costs of preventing AIDS include costs incurred for testing for the virus, research, surveillance, and education.
- ***Indirect Costs.*** These costs include lost productivity or benefit to society from individuals who are sick or who die from AIDS or ARC.

Like projections of the number of AIDS cases, projections related to AIDS costs are highly speculative. We have no basis for projecting aggregate costs related to AIDS. We are able, however, to provide the Legislature an indication of the future cost of medical care alone for AIDS victims. The remaining sections discuss (1) our cost estimates for medical care and (2) other costs related to HIV infection.

The Annual Cost of Medical Care Per Case

We used three studies of the cost of care and the caseload projections discussed in the previous section to derive our cost range estimates.

The major components of medical care costs included in these studies are inpatient and outpatient hospital care, physician services, and drugs (both experimental and standard). These studies did not include other medical care costs such as outpatient drugs, hospice, skilled or intermediate nursing facilities, or in-home care. To some extent, this is because many of these services are not widely available for AIDS patients.

We adjusted the results of the studies so they reflected costs incurred in one calendar year per AIDS patient alive during the year. The adjusted costs derived from the three studies—in 1984 dollars—are:

- $15,955 by researcher Anne Scitovsky of the Palo Alto Medical Foundation/Research Institute. This estimate was based on 1984 charge data obtained from San Francisco General Hospital (SFGH). It represents a weighted average of Scitovsky's estimates for AIDS patients who received all inpatient and outpatient care at SFGH. However, individuals have widely varying cost histories. For example, Scitovsky's estimates ranged from $7,026 to $23,425 per case. The highest costs were for individuals who died during the year.
- $23,760 by the DHS. The DHS estimated individual lifetime costs by examining medical claims of AIDS patients who qualified for Medi-Cal. The DHS estimated the private-sector commercial equivalent of its costs would be approximately 54 percent higher than the amount that Medi-Cal reimburses.
- $25,350 by Blue Cross of California. Blue Cross estimated its medical expenses for AIDS patients based on its claims data. Individuals in this study were all employed at the time of diagnosis and worked for companies that provided health insurance.

The variation in the estimates is due to differences in the average number of hospitalizations, the average length of stay, and the cost per hospital day. The amount of time a person spends in the hospital is affected by the types of OIs that need to be treated, as well as the availability of alternatives to acute hospital care, such as in-home nursing. For example, someone with *pneumocystis carinii* pneumonia is usually hospitalized more frequently and for longer periods of time than someone with Kaposi's Sarcoma, who after a brief hospitalization can generally be treated on an outpatient basis.

The Estimated Cumulative Cost of Care Through 1991 Tops $1 Billion. The DHS estimates that, in 1984–85, the total amount paid in California for medical care provided to all confirmed AIDS patients amounted to approximately $55 million. The DHS is currently updating and revising these estimates; but, at the time we prepared this analysis, the revised figures were not available.

Table 39 displays our cost estimates for 1986 through 1991 in 1984 dollars. They are based on the estimated number of individuals who will be diagnosed with AIDS, adjusted for estimated deaths. The table shows the alternative costs of treating those individuals according to the three sources. The estimated cost of care in 1986 ranges between $56 million and $89 million. By 1991, the projected annual cost of care is between $255 million and $406 million, an increase of over four fold since 1986. The cumulative total cost from 1986 through 1991 could amount to between $870 million and $1.4 billion, in 1984 dollars. Assuming annual inflation of 5 percent, the cumulative total cost from 1986 through 1991 would be between $1.1 billion and $1.7 billion.

Table 39
Projected Medical Care Costs For AIDS Patients in California [a]
1986 through 1991

		Cost Estimates in 1984 Dollars (in millions)		
Year	*Number of AIDS Cases* [b]	*$15,955 Per Year (Scitovsky)*	*$23,760 Per Year (DHS)*	*$25,350 Per Year (Blue Cross)*
1986	3,500	$56	$83	$89
1987	5,200	83	124	132
1988	7,300	117	174	185
1989	9,800	156	233	248
1990	12,700	203	302	322
1991	16,000	255	380	406
Total costs 1986–1991		$870	$1,296	$1,382

[a] Assuming current medical technology.
[b] For each year, the number of individuals is calculated as follows: cases alive from previous year + cases diagnosed current year—projected deaths that year.

Medi-Cal's Share of AIDS Costs May Be Growing

Prior to 1985, only the DHS estimated source of payment for AIDS-related medical care. The DHS estimated that, from 1983 through 1985, Medi-Cal accounted for approximately 12 percent of total payments for AIDS-related care. The remaining costs, or 88 percent of total payments, were made by private third-party payors, counties, the state through county health services funds, or individuals. The DHS did not differentiate among payors other than Medi-Cal.

Since the beginning of 1985, two provider associations and Los Angeles County have also gathered data on payment sources for AIDS care in San Francisco and southern California. One provider group estimates that since 1985, private third-party payors have paid 58 percent—or the majority—of AIDS-related medical care costs in San Francisco hospitals. Medicare accounts for approximately 3 percent, and counties or individuals 6 percent. It estimates that Medi-Cal has paid approximately 30 percent of the costs since the beginning of 1985. This is over twice what DHS estimated prior to 1985. Preliminary information from the other provider group and Los Angeles County supports the newer estimate. According to the provider study, Medi-Cal's share of cumulative AIDS cost through 1991 could range from $261 million to $415 million.

At this time, there are no empirical data available to explain the significant difference between the studies of Medi-Cal reimbursement levels. One reason for the difference may be that in March 1985 the Supplemental Security Income/State Supplementary Program (SSI/SSP) established a policy of presumptive eligibility for AIDS patients. This means that a person diagnosed with AIDS is immediately eligible for Medi-Cal if he or she meets income and resource requirements. Prior to 1985, an individual would proceed through the normal disability evaluation process for determining eligibility for benefits. Another reason that Medi-Cal paid an increased share of costs in the later study may be that insurance companies are becoming more aware of AIDS and may be implementing policies that attempt to restrict payments for AIDS-related care. For example, the San Francisco District Attorney began an investigation of an Albany-based health care company based on complaints received that it was redlining San Francisco.

Counties, too, are feeling the impact of AIDS. County hospitals have been the primary providers of care for AIDS patients. In San Francisco and Los Angeles Counties, the county hospitals are treating especially large and growing numbers of AIDS patients. These institutions and the people that are served by them—mostly individuals who are on Medi-Cal or who have no public or private insurance—are being particularly hard hit by the AIDS epidemic for at least two reasons:

- ***AIDS patients represent a new population in an already overcrowded environment.*** These two hospitals were already at or near full capacity. AIDS patients represent a new population—otherwise healthy, employed males—that the counties would not otherwise have served.
- ***Any shift from private insurance coverage to Medi-Cal would represent a significant revenue loss to the two institutions that serve large numbers of AIDS patients.*** To the extent that these institutions must rely more on Medi-Cal than private insurance for payment in the future, they experience a revenue loss because Medi-Cal reimburses less than private insurance. For outpatient care, Medi-Cal reimbursement does not cover all costs.

The Cost Estimates Could be Significantly Understated

Changes in medical knowledge about AIDS/ARC and the way its victims are treated and cared for could result in future costs that are dramatically different from our estimates. Specifically:

Disabling Cases of ARC. No one has measured the number of debilitating and disabling ARC cases or even the number of ARC cases requiring some form of medical care, in part because there is no clear definition of ARC. Though the severity of ARC varies considerably, the number of cases severe enough to require extensive medical care, including acute hospital care, could be significant. There is no presumptive Medi-Cal eligibility for ARC as there is for AIDS. The DHS estimates that only between 5 and 10 ARC patients qualify for Medi-Cal monthly. Therefore, the bulk of ARC direct medical costs will fall on individuals, private third-party payors, and counties. Individuals with severe ARC may be too disabled to work regularly and thus lose health insurance benefits. However, these individuals may not be able to qualify for Medi-Cal because they may not be considered disabled under program rules. As a result, counties or the state, through county health services funding, may bear the costs for severe cases of ARC.

New (Experimental) Drugs. There is some indication that the availability of new drugs like azidodeoxthymidine (AZT) will increase total cost of care. AZT is the latest of several potentially effective antiviral drugs to be used as an AIDS treatment. First, because AZT is an FDA-approved experimental drug, clinical protocols must be stringently followed. Therefore, an individual taking AZT will require increased contact with the medical care system so that physicians may administer the drug and perform necessary tests. The cost of following the protocols prior to commercial approval falls on counties, private insurance, and individuals, since Medi-Cal does not reimburse for experimental treatment or drugs. Second, preliminary experience with AZT appears to indicate that individuals taking the drug need more lab tests and more blood transfusions than other AIDS patients. Finally, if the drug becomes commercially available, current law requires that it be placed on the Medi-Cal formulary, thus shifting some of the costs to Medi-Cal. We do not yet know what the costs of the drug or associated treatments will be.

Increase in the IVDA AIDS Population. The cost of care will probably increase as a result of increases in the proportion of IVDA AIDS cases. Some researchers believe that costs are higher on the east coast than the west coast because of the east's much higher proportion of IVDAs. IVDAs typically have pre-existing health problems that increase the length of hospitalization and the costs of care. Additionally, unlike the homosexual community, which has established numerous formal and informal networks of support and care for its AIDS victims, IVDAs lack social networks of support. As a result, IVDAs will probably stay longer in hospitals, because there are generally fewer out-of-hospital options available.

Dementia and Other Mental Health Problems. Mental deterioration, or dementia, is an increasingly recognized problem related not only to AIDS/ARC, but more generally to HIV infection. AIDS-related dementia is a condition characterized by cognitive, motor, and behavioral deficiencies. Physicians and researchers now recognize dementia in the absence of other OIs as a primary indicator of AIDS. Mental health problems may also accompany other OIs. Research indicates that as many as 50 to 70 percent of AIDS patients demonstrate certain aspects of dementia. There is even some indication of neurologic impairment in seropositive individuals, prior to the manifestation of any other symptoms. The stress of HIV infection may also affect the caregivers, family, and friends of those infected with the virus. The additional cost of dementia and other mental health problems related to HIV infection is unknown.

Other Costs Related to HIV Infection

The medical care costs cited in the three cost studies are only a part of the costs related to HIV infection. There are many other medical and nonmedical costs, which are briefly described below. For a more extensive analysis of issues related to medical and supportive care and prevention, please see Item 4260 in the *Analysis of the 1987–88 Budget Bill.*

- ***Other Medical and Nonmedical Care and Services.*** Individuals with AIDS/ARC are likely to require services other than inpatient, outpatient, and physician services. Examples include outpatient drugs, skilled nursing or intermediate care facilities, and homemaker services. To the extent that many of these other medical and nonmedical services provide alternatives to acute inpatient care, they may reduce the overall cost of caring for AIDS/ARC patients. The DHS is funding a number of pilot projects around the state, as well as a study to measure the cost of AIDS-related care, that will provide information regarding the efficiency and effectiveness of these services. For further description of these services, please see Item 4260 in the *Analysis of the 1987–88 Budget Bill.*
- ***Prevention of HIV Infection.*** Federal, state, county, and other municipal governments, as well as various private interests, incur costs related to prevention of AIDS. Obviously, to the extent HIV infection can be cured or its spread prevented, substantial direct and indirect costs that result from HIV infection will diminish. Prevention expenditures include research on treatments and vaccines, testing for HIV antibodies, epidemiologic surveillance, education, and training for people who work with AIDS patients.
- ***Indirect Costs.*** The estimated indirect costs due to HIV infection are far greater than the prevention and care costs combined. There is a significant indirect social cost associated with young men in the prime of their working years becoming disabled and dying. The costs are usually measured by the lost wages of those too ill to work and future earnings lost due to premature death.

If we assume California accounts for 23 percent of nationwide indirect costs (as calculated by Scitovsky), indirect costs were between $690 million and $851 million in 1985. *In 1991 the indirect cost to California could be between $7.1 billion and $9 billion.*

Prevention is the Most Effective Way to Reduce the Costs of HIV Infection

The Legislature may be able to reduce the costs of care somewhat through programs that provide alternatives to inpatient utilization. Many researchers believe that the low costs in San Francisco as compared to New York are partially due to the availability of these alternatives. However, the most effective way to reduce costs is to reduce the number of cases. At this time, the most effective way to reduce the number of cases is through prevention and education that is targeted towards individual groups, such as IVDAs who are not in treatment, sexual partners of IVDAs, and sexually active heterosexuals.

In this document and in the *Analysis of the 1987–88 Budget Bill,* we make several recommendations that should provide the Legislature with more information to assist it in developing a more comprehensive, targeted, and efficient approach to addressing the AIDS epidemic. Specifically, we recommend that:

- ***The Office of AIDS (OA) in the Department of Health Services, with the assistance of the Department of Alcohol and Drug Programs, provide a plan for a comprehensive strategy towards addressing intravenous drug abuse and AIDS.*** This plan would include information about what resources for treating and preventing AIDS will be available within a number of state departments and how those resources will be targeted towards specific groups. (Please see Item 4260 in the *Analysis.*)
- ***The OA provide a plan to address the spread of the AIDS virus among sexually active heterosexuals.*** This plan would comment on the OA's interface with public health clinics. (Please see Item 4260 in the *Analysis.*)
- ***The California Medical Assistance Commission include information about funding options for AIDS in its report on funding options for community-based long-term care services.*** This report would examine different ways to fund alternatives to acute care hospitalization for AIDS patients. (Please see our discussion of long-term care funding options in this volume.)
- ***The Department of Social Services implement a system to identify and track the growth in the Supplemental Security Income/State Supplementary Program (SSI/SSP) due to individuals with AIDS or ARC.*** This information would help in understanding how many people with AIDS and ARC are able to qualify for this program, as well as to improve the department's ability to estimate growth in the program. (Please see Item 5180 in the *Analysis.*)

What Actions Should the Legislature Take to Insure That the GAIN Program Operates in Accordance With Legislative Priorities?

Summary

Cost

- *Although the proposed budget for 1987–88 is 186 percent higher than expenditures in the current year, it is not sufficient to meet the identified number of GAIN program participants.*
- *We anticipate that GAIN expenditures will continue to accelerate during the next few years.*
- *We recommend the Legislature assert control over GAIN costs by limiting the average cost of county plans to the amount included in the Budget Act, while providing flexibility to the Department of Social Services to approve varying amounts as needed by specific counties.*

County Plans

- *The quality of county plans varies widely. In general, counties need to develop more sophisticated planning capabilities before GAIN planning will result in truly effective local strategies.*
- *We recommend that the Department of Social Services advise the fiscal committees of its plan to increase technical assistance to counties in order to improve the effectiveness of county planning activities.*

Remedial Education

- *The Department of Social Services should develop a general policy that identifies the circumstances under which counties may use community-based organizations to deliver remedial education services to GAIN participants.*
- *We recommend that the Legislature direct specified state agencies to collect data that would allow comparison of the cost-effectiveness of services that are provided by different types of education agencies.*

Child Care

- *For GAIN graduates who are single parents, affordable child care will play a crucial role in their ability to remain employed.*
- *We recommend the Department of Social Services take specified actions to collect data on the availability of child care for GAIN program graduates.*

The Greater Avenues for Independence (GAIN) program provides employment and training services to Aid to Families with Dependent Children (AFDC) recipients in order to help them find employment and become self-supporting. Under GAIN, the Department of Social Services (DSS) provides policy and coordination at the state level while county welfare departments administer local programs. Counties are allowed to phase in the program over a three-year period. At the time this analysis was prepared, DSS had approved the implementation plans of 9 counties, and anticipated that an additional 16 counties would begin operation before the end of 1986–87.

Once the GAIN program is fully operational statewide, county welfare departments will provide the following services to participants:

- ***Remedial Education.*** Counties must refer any participant who lacks a high school diploma or basic literacy to remedial adult education services.
- ***Job Search.*** Counties will offer training in job search techniques as well as a period of supervised job search.
- ***Assessment.*** An in-depth assessment of a participant's skills and aptitudes must precede any training or work program.
- ***Short-Term Training.*** A variety of training programs, requiring three to six months of classroom or on-the-job instruction, will be available to assist participants in gaining new job skills.
- ***Preemployment Preparation (PREP).*** Counties may require participants to work in a public-sector job for 3 to 12 months in order to acquire work behavior skills. The number of required hours is based on the size of the participant's AFDC grant.

This analysis consists of two sections. The first section analyzes the estimated costs of the GAIN program. The second section discusses the county planning process and the need for better information regarding specified adult education and child care issues.

How Much Will GAIN Cost During 1987–88?

Governor's Budget Proposes Major Funding Increases for 1987–88

Table 40 displays GAIN program expenditures for the current and budget years. As the table shows, GAIN expenditures in the budget year are projected to total $265.9 million, an increase of $172.8 million, or 186 percent, above the current-year level.

According to DSS, this increase is caused primarily by two factors. First, the budget projects that GAIN caseloads will increase by 131,510 participants, or 136 percent, above the current-year level. Second, the budget expects that many participants will use a higher proportion of more expensive program segments, such as education and training, during 1987–88.

Table 40
Greater Avenues for Independence
Budget Summary
1986–87 and 1987–88
(dollars in millions)

Component[a]	*Est. 1986–87*	*Prop. 1987–88*	*Change from 1986–87 Amount*	*Change from 1986–87 Percent*[c]
Registration	$4.8	$10.4	$5.6	116%
Education	22.8	66.6	43.8	192
Job search	12.8	34.6	21.8	170
Assessment	6.5	19.0	12.5	196
Training	32.4	105.3	72.9	225
Long-term PREP	0.2	6.8	6.6	d
90-day child care	2.5	8.0	5.5	230
Planning	10.6	13.8	3.2	30
Child Care Licensing	0.5	1.4	0.9	173
Totals	$93.1	$265.9	$172.8	186%
New Funding Sources				
General Fund	$37.5	$106.3	$68.8	183%
Dept. of Social Services	(22.5)	(55.5)	(33.0)	147
Dept. of Education				
Adult Education	(3.0)	(4.2)	(1.2)	40
Matching for JTPA Education Funds	(2.0)	(6.6)	(5.6)	565
Department of Finance[b]	(10.0)	(40.0)	(30.0)	300
Federal Funds	15.5	43.1	27.6	178
Existing Funding Sources				
State Funds				
General Fund	$12.1	$30.7	$18.6	157%
Existing ADA Funds				
Adult Education	(5.2)	(6.2)	(1.0)	19
ROC/P	(2.9)	(5.0)	(2.1)	72
Community Colleges	(4.0)	(16.5)	(12.5)	313
WIN/COD	—	(3.0)	(3.0)	—
Employment Training Fund	—	5.0	5.0	—
Federal Funds				
Job Training Partnership Act	$13.0	$52.3	$39.3	302%
(Training)	(11.0)	(36.0)	(25.0)	227
(Education)	(2.0)	(16.3)	(14.3)	d
Work Incentive (WIN)	15.0	10.5	−4.5	−30
Community Services Block Grant	—	3.0	3.0	—
Vocational Education Block Grant	—	10.0	10.0	—
Refugee Social Services	—	5.0	5.0	—

[a] Component costs include the direct costs of services plus participant support costs, such as transportation and child care costs.
[b] Control Section 22 of the Budget Bill appropriates $40 million to the Department of Finance to allocate to departments for as yet unspecified GAIN expenses.
[c] Percent change figures based on more detailed information than displayed in chart.
[d] Exceeds 1,000%.

GAIN Funding is Proposed from a Variety of Sources. There are two basic types of GAIN funding—existing and new. Existing funding is money that was budgeted in previous years to provide GAIN-type services to AFDC recipients, but was administered in an ad hoc fashion. Use of these funds is now supposed to be coordinated by DSS for the purposes of GAIN. "New" funds, on the other hand, represent *additional* resources allocated to the program from the General Fund and other sources.

Redirecting existing resources was a key element of the GAIN legislation. As Table 40 suggests, the proposed 1987–88 budget reflects that intent —it funds 44 percent of projected needs by redirecting existing resources for use by GAIN participants. The Job Training Partnership Act (JTPA) would provide $52.3 million in federal funds for training and education services, and state education agencies would contribute $37.7 million.

The 1987–88 GAIN budget also proposes to redirect funding from sources that are not being used specifically for the program during the current year. For example, the budget proposes spending $5 million from the Employment Training Fund (ETF) in order to support the training of individuals who receive both AFDC and Unemployment Insurance (UI) benefits, and $3 million in Work Incentive/Career Opportunity Development (WIN/COD) funds. The WIN/COD program uses a combination of federal and General Fund monies to train AFDC recipients for employment in state and local government.

General Fund Costs Are Increasing. Despite this redirection of funds, the budget proposes significant increases in "new" General Fund support for the GAIN program in 1987–88. The budget proposes new General Fund support of $106.3 million—an increase of $68.8 million, or 183 percent, over 1986–87. This increase is due to anticipated caseload increases and an increase in the General Fund's *share* of GAIN education and training costs. According to the department, the General Fund share of these GAIN costs is increasing for two reasons:

- Education costs are borne primarily by the General Fund, and the education segment of GAIN is projected to grow 3.2 percent faster than the overall program in the budget year. The budget proposes $66.6 million for basic education, English-as-a-second-language instruction and other remedial education.
- The General Fund represents the funding source of last resort. Any shortfall in the *share* of funding from existing resources will result in an increase in the General Fund share. For example, because training costs are expected to grow faster than the anticipated JTPA funds, the department expects the share of training costs supported through JTPA to fall 7 percent in 1987–88, resulting in a corresponding increase in General Fund monies.

The 1987–88 GAIN Budget Is Not Fully Funded

We recommend that the Department of Social Services submit a report to the Legislature's oversight and fiscal committees during the May revision identifying trends in approved GAIN programs that may affect their current- and budget-year costs.

Despite the significant increase in funding for the GAIN program, our analysis indicates that the proposed GAIN budget does not contain sufficient funding to meet the needs of the projected caseload in 1987–88. Specifically, the 1987–88 proposed budget estimate is based on a DSS model that does not recognize the following two developments:

- The average cost of approved county plans for 1986–87 are 35 percent higher than the amount included in the 1986 Budget Act.
- Serving the continuing caseload—a service which, in large part, will begin during the budget year—will be more expensive than serving this year's caseload of new applicants.

Each of these points is discussed separately below.

Approved Plans Suggest That DSS Underestimates Costs. The 1986 Budget Act assumed that 25 counties would begin GAIN operations in the current year. The DSS now estimates that up to 28 counties will start up before July 1, 1987. At the time this analysis was prepared, nine county plans were approved for operation by DSS: Fresno, Napa, San Mateo, Santa Clara, Butte, Stanislaus, Ventura, Kern and Madera. Detailed cost data, however, were available for only the first seven. Our review of the seven plans suggests that GAIN costs will be significantly *higher* than budgeted for 1986–87 and in turn the costs for 1987–88 will be higher than proposed. Table 41 compares, for the current year, the amounts budgeted for the program and an estimate of what *actual* costs will be during the year based on the average costs approved by the department for the seven counties. In order to compare these figures, we adjusted approved costs for the seven counties so that both budgeted and approved funding levels assume the same caseload projections.

Table 41
Approved GAIN Costs to Date
Compared to Amounts Budgeted for 1986–87
(dollars in thousands)

Component	*1986 Budget Act*	*Approved County Plans*[a]	*Difference*	
			Amount	*Percent*
Registration	$4,402	$4,795	$393	9%
Education	20,840	34,497	13,657	66
Job search	12,525	13,386	861	7
Assessment	6,448	6,849	401	6
Training	28,711	40,761	12,050	42
Long-term PREP	223	1,180	957	429
90-day child care	2,455	932	−1,523	−62
Totals	$75,604	$102,400	$26,796	35%

[a] Adjusted to reflect caseload assumptions used to estimate 1986–87 projections.

Table 41 shows that the cost of the seven approved county plans exceeded the budgeted amount by 35 percent. This implies that GAIN would incur a $26.8 million deficit in the current year if it served the number of participants assumed in the 1986 Budget Act. Costs would be higher in almost every category, the lone exception being transitional child care. Education and training costs account for most of the increase, rising 66 percent and 42 percent, respectively.

The department advises, however, that it does not expect to exceed its current-year appropriation. This is because counties are implementing GAIN more slowly than anticipated; fewer participants means enough funding is available to cover the higher average costs of approved plans.

Although this information was available to DSS, the proposed 1987–88 GAIN budget does not reflect it. If the cost trend for 1986–87 continues into the budget-year, the GAIN program would experience a funding shortfall totaling $94 million in 1987–88. While it seems unlikely that actual costs would exceed the proposed level by an amount of this magnitude, we believe that the 1987–88 GAIN budget should reflect some acknowledgment of the current-year cost experience. The department advises that its estimate of GAIN costs for the May revision will contain some adjustments based on the current-year experiences.

Volunteers and Continuing Caseload Will Need More Services Than New Applicants. Our analysis indicates that average 1987–88 GAIN costs will be higher than projected in the budget for a second reason as well; local programs will begin serving a more disadvantaged—and more expensive—type of AFDC recipient. During the first year of operation most GAIN participants are new applicants for AFDC who generally have recent work experience and basic job skills. During the second year, however, these programs will begin to serve volunteers (generally mothers with children under age six) and the continuing caseload, which is composed of recipients who may have been on aid for a considerable period of time and therefore may have fewer job skills than new applicants.

The difference in client characteristics means that the continuing caseload will require more education and training resources than new applicants. The DSS advises that it will incorporate available data concerning different program costs for the continuing caseload into the May revision.

Some Trends Will Reduce Costs. Although approved plans are more costly than anticipated, there are operational forces at work within the counties that may result in lower county costs. We have discussed these issues with a number of counties that are operating under approved plans. Even at this early stage of implementation, two general patterns are emerging:

- Participants often take significantly longer to progress through the program than assumed in the county plan because they frequently miss appointments.

- Some counties are finding that adult school ADA is available, even though local schools convinced the county and state social services departments during the plan approval process that no space existed in any adult educational classes.

We believe that as more data become available during the next few months, the department will be able to assess the caseload and cost implications of these findings. Therefore, we recommend that the DSS submit to the Legislature as part of the May revision a report identifying these trends and their impact on the current- and budget-year funding needs of the program. At a minimum this report should discuss (1) the impact of higher-than-expected 1986–87 approved county budgets on the 1987–88 funding needs of the program, (2) additional costs that reasonably can be expected during the budget-year due to an increase in the proportion of continuing AFDC cases in the GAIN program, and (3) the cost reduction attributable to county phase-in periods, unforeseen availability of existing resources and other local program trends.

The Department Needs a Plan for Monitoring Costs

We recommend that the Legislature adopt Budget Bill language requiring the Department of Social Services to keep average "new" GAIN General Fund costs to within the amounts appropriated in the 1987–88 Budget Act. We further recommend enactment of language requiring the department to submit quarterly reports to the Legislature on its progress in staying within Budget Act appropriations.

The DSS Budget Review May Result in Unintended Effects. The department does not merely rubber-stamp proposed county budgets—indeed our analysis indicates that DSS thoroughly reviews each county's budget. The department's review strategy—which is to minimize the "new" cost of the program—in fact resulted in significantly lower county costs. The department's approach, however, did not keep average county costs in line with budgeted amounts. As discussed above, average costs of approved county plans exceed by 35 percent the costs used to determine the 1986–87 GAIN budget.

Under the existing approval process, DSS is not accountable for potential cost overruns until the Budget Act appropriation is exhausted. However, even though the higher costs of approved plans may not increase current-year program costs, it will increase the base used to calculate budget-year program needs. Thus, because of the flexibility accorded to DSS in determining county GAIN budgets, the Legislature has little control over the growth in program costs.

In addition to the fiscal consequences for the state, the department's lack of overall expenditure control may have negative program impacts on county operations. For the most part, these problems will arise if state funding is not sufficient to support all approved county plans. Specifically, should the cost of approved plans exceed the amounts appropriated for GAIN, the following problems may occur:

- ***The department's first-come-first-serve approach to funding county programs may result in some counties receiving inadequate allotments while other counties are fully funded.*** With the approval of the first nine plans, the 1986–87 General Fund appropriation for GAIN is almost fully allocated. We estimate that only $7 million, or *16 percent*, of the $45.1 million appropriated to DSS for GAIN is left for the remaining 16 counties that plan to begin operation during the current year.
- ***The department's policy of reducing county funding, while promising to increase support if justified by actual experience, could result in counties exhausting GAIN funding before the end of the fiscal year.*** In some counties, the department reduced funding from levels proposed by the counties because DSS believed that the caseload projections were overestimated. The department has promised these counties, however, that full funding will be available should caseloads prove to be higher than approved by DSS. Because current-year funding is nearly exhausted, however, DSS may not be able to make good on this promise if caseloads exceed the department's estimate. Because the counties will serve a higher level of participants during the year in anticipation of additional state funding, the counties may run out of funds before the end of the fiscal year. As a result, counties could cancel programs in progress or ration services to compensate for the shortfall.

Controlling GAIN Costs Requires Reasonable Limits on County Budgets. Unless the Legislature is willing to place limits on the costs of county plans, the prospects for containing future GAIN costs are not good. Without some kind of limit, program costs will be driven by the design of county plans rather than legislative decision making. The Legislature has stated that it remains committed to fully funding the GAIN program. This commitment, however, does not necessarily translate into funding whatever plans counties propose. For this reason, we believe the Legislature should require that the average new General Fund cost of approved county plans not exceed the amount included in the Budget Act. This requirement would mandate that DSS control total program costs while providing it the flexibility to approve specific county budgets that are higher or lower than the average.

Setting absolute limits on average per-participant costs has a number of advantages, as well as some potential disadvantages. We believe the advantages are as follows.

- ***Setting limits will increase the Legislature's control of the General Fund cost of GAIN.*** By setting a limit on the average General

Fund costs of approved county plans, the Legislature will be able to control the increase in the new costs of the program.

- ***Limits provide additional incentives for counties to use funding efficiently and to take maximum advantage of other existing resources.*** For those counties that design expensive programs, additional funds would only be available by looking to sources other than DSS.

Limiting county funding, however, may have negative program impacts if the amounts budgeted are not sufficient. Funding caps might force counties to limit participation and ration services, despite program guidelines that direct counties to provide all services that participants *need* in order to become self-supporting.

We believe that a limit is only fair to the counties if (1) the Legislature appropriates sufficient funds to support reasonable county programs and (2) the department has the flexibility to permit county budgets that are higher or lower than the cap, so long as the average cost of all plans meets budget guidelines. Experience shows that some counties will have higher costs than others and therefore merit somewhat higher GAIN per-participant budgets. Our proposal would allow the department the flexibility to approve county budgets that deviate from the budgeted amount.

In order to provide the Legislature with some control over GAIN costs, we recommend adoption of Budget Bill language requiring the department to keep average "new" GAIN costs per participant to within the amounts appropriated in the 1987–88 Budget Act. In addition, we further recommend enactment of Budget Bill language requiring DSS to report each quarter to the Legislature on its progress in staying within Budget Act appropriations. Specifically, the department would be required to inform the Legislature about the impact of the limit on approved programs as well as on programs that are anticipated for approval during the fiscal year. The following language is consistent with this recommendation:

"The Department of Social Services shall ensure that the average new per-participant costs of approved GAIN budgets shall not exceed the amount included in this act. For the purposes of this section, new costs are defined as those costs that are funded through the department's budget and were not available to participants or counties prior to the approval of the GAIN program. The Department of Social Services shall submit quarterly reports to the fiscal committees of the Legislature, the Joint Legislative Budget Committee, and the Joint Oversight Committee on GAIN specifying (1) the total cost of county GAIN plans approved to date and (2) the average new per-participant costs of approved plans.

"If the average new per-participant cost exceeds the amount assumed in this act, the report shall specify how the department will revise its GAIN spending plan in order to accommodate the higher-than-anticipated county costs. The department shall also discuss (1) whether funding allotted for approved county plans shall be reduced, (2) whether the reduction in available funding will jeopardize the department's commitments to provide additional support to counties that have been promised such support if actual program experience warrants, and (3) whether the higher costs of approved plans will jeopardize the starting date for counties that are anticipated for approval during the fiscal year. If the potential shortfall necessitates reductions in approved county budgets or available funding for counties yet to be approved, the department shall advise the committees of how it proposes to achieve the reductions."

Are County Plans Serving As An Effective Tool For Devising Local Strategies for Implementing GAIN?

Understanding local labor market needs is crucial to the success of education and training programs such as GAIN. This is because counties that do not understand the needs of local employers may fall prey to a common training program malady—preparing people for jobs that do not exist in the area. In addition, in order to have a successful program it is essential to know what services will help AFDC recipients find and keep jobs. Without adequate information on client education and skill levels, local programs may provide services that do not address the deficiencies of potential participants.

To ensure that counties match services to needs, the GAIN legislation requires them to include the following information in their implementation plans:

- *Labor market analysis.* An assessment of the county's current and projected employment needs.
- *Client needs assessment.* The types and amounts of services needed by recipients in order to find unsubsidized employment.
- *Survey of available resources.* Existing resources that are available to help recipients find a job.

Using this information, counties must identify and explain how they will provide the services that participants need—but are not available in the county—in order to find a job.

Review of Two County GAIN Plans

We view the county planning process as *absolutely essential* to the success of GAIN. Because of the importance of these plans, we conducted an in-depth review of approved plans for two counties—one rural, one urban—to determine whether the plans effectively brought together the required information. We also reviewed selected parts of plans submitted by other counties in order to confirm our preliminary conclusions. On the whole, we think the counties made honest attempts at fulfilling the letter and spirit of the GAIN requirements. Most county welfare departments, however, have no experience in these types of analyses and we think most plans leave room for improvement.

Attributes of Two Review Counties. In order to understand the plans submitted by the two counties, some knowledge of their environments is helpful. Table 42 displays selected county attributes that are pertinent to the design of a local GAIN program. As the table suggests, there are substantial differences between these two counties. The rural county depends on one industry—agriculture—and has high AFDC and unemployment rates. The economy of the urban county is strong and more diversified. The economic make-up of the two counties results in different employment trends—the urban county's job growth is tied to the overall health of the national economy, while seasonal changes result in large fluctuations in employment in the rural county.

Table 42
Selected Attributes of Two GAIN Counties

	County Type		*State*
Attributes	*Primarily Rural*	*Primarily Urban*	*Average*
Unemployment rate in 1985	15.2%	5.8%	7.2%
Primary industry	Agriculture	Manufacturing	NA
Location	Central Valley	Large Urban Area	NA
Percent of county population receiving AFDC:	12.2%	4.0%	6.3%
Family Group	(8.5%)	(3.1%)	(4.9%)
Unemployed	(3.7%)	(0.9%)	(1.4%)

Labor Market Analysis

Urban County Survey is Exceptionally Good. The urban county's labor market assessment provides a central theme for a possible GAIN strategy: GAIN training should focus on the general traits desired by businesses, rather than providing vocational training in narrow skill occupations. The assessment concludes that employers value general job skills such as personal flexibility, customer awareness, ability and willingness to work together, and basic English and math skills. The plan further states that occupational skill training—such as vocational training—is not particularly valuable to employers because such training is often conducted using obsolete equipment or a different type of equipment than prospective employers use.

These conclusions are consistent with research which shows that short-term training programs generally do not help recipients by imparting specific occupational skills. Instead, they help by (1) bolstering students' confidence that they can find a job and (2) helping them understand what employers expect of workers.

We could find no evidence, however, that the county incorporated these findings into its GAIN plan. This is unfortunate, because we believe that GAIN is a perfect vehicle for testing innovative ideas that help AFDC recipients become self-supporting. We encourage the urban county to develop a GAIN strategy based on its analysis and, where appropriate, include it in future GAIN plans.

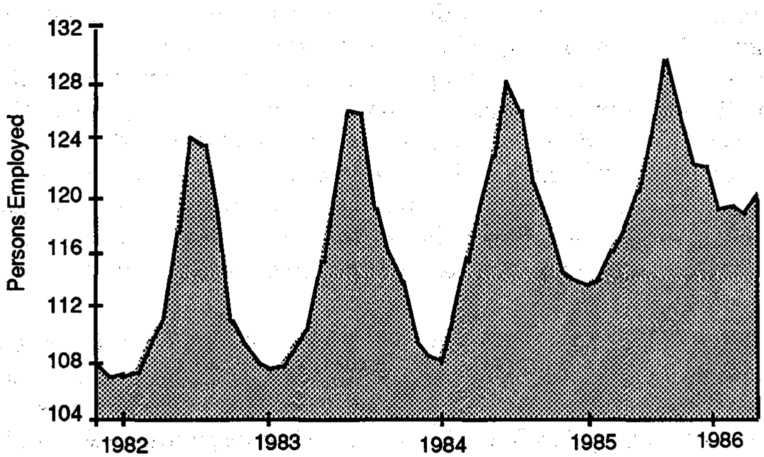
Rural County Labor Market Survey Is Inadequate. The rural county's labor market assessment concludes that the goal of placing GAIN participants into unsubsidized employment may be unrealistic. This conclusion is based on a labor market survey that focuses on job losses due to closing manufacturing plants and a lack of growth in the local economy. While local labor market conditions in the rural county are not as favorable as in the urban county, we feel that the survey does not present an accurate picture of the rural county job market.

There are two reasons for this. First, the county's characterization of the labor market as "no-growth" is clearly not correct, as Chart 38 shows. Base employment—the level of employment when seasonal hiring needs are at their lowest—increased 7.5 percent during 1984 and 3.5 percent during 1985. By most measures, this represents healthy job growth. Thus, despite the widespread impression that most rural areas are not generating new jobs, our analysis suggests that job growth may be occurring in many rural counties.

Chart 38

Rural County Employment

January 1982 through March 1986 (in thousands)



Second, the county underestimated the number of jobs that are available as a result of turnover among existing employees because it failed to investigate several occupations in the economy. For example, a labor market survey conducted by the Employment Development Department (EDD) in this county identifies 12 low- and semi-skilled occupations for which demand is moderate or high that are not identified in the county survey. The rural county recognizes the need for better data, and has requested $100,000 in additional funds from DSS in order to contract for a more complete labor market assessment for the second year of GAIN operation.

Additional Occupational Data Is Needed By Counties

We recommend that prior to budget hearings, DSS advise the Legislature's oversight and fiscal committees of the feasibility and costs or savings resulting from EDD providing technical assistance to counties in developing labor market assessments.

It would be unfair to criticize the rural county too much for its labor market survey. Most county welfare departments have not conducted labor market surveys before. As a result, they are not staffed with planners skilled in understanding labor market patterns. In addition, available data on local job demand usually are limited and out-of-date. (The EDD currently collects the best available county occupational data.)

We believe that the EDD can provide valuable assistance to counties in both of these areas. First, the department could provide technical assistance to counties during the development of the labor market assessment. Second, EDD could help counties establish occupational data collection systems so that they will have ongoing, in-depth sources of current data. For example, the department currently is developing a survey instrument for JTPA operators that facilitates the collection of useful labor market information. This tool could be easily adapted for use by county GAIN administrators.

The EDD advises that, while its staff offer assistance to all counties, such help is in addition to their other duties. Thus, since existing support levels do not permit EDD to devote substantial time to many counties, the department advises that the level of activities we have outlined would require additional resources.

We believe that GAIN funds *will* be used to help counties obtain better occupational data. (We have already mentioned the rural county's request for $100,000 for this purpose.) Therefore, the issue is not whether funds should be spent, but whether they should be spent on private-sector consultants or EDD. The EDD should be able to provide data collection assistance at a lower cost than private firms. This is because the department receives federal funds to track employment trends and generate labor market information. As a result, most of the needed tools and information are already on hand and paid for.

For this reason, we recommend that DSS discuss with EDD the costs and feasibility of providing technical assistance to counties in (1) surveying local businesses to determine job demands and (2) assessing local labor markets for the purposes of the GAIN program. We further recommend that DSS report to the fiscal committees prior to budget hearings on (1) the progress of these talks and (2) the potential costs or savings of contracting with EDD rather than allowing each county to contract for private sector assistance.

Client Needs Assessments

Even though the economies of these two counties are very different, the counties' needs assessments revealed that the attributes of their respective AFDC populations are strikingly similar. For example, between 60 and 70 percent of the caseloads of both counties lack a high school degree or its equivalent. In addition, between 15 and 25 percent of recipients need instruction in English-as-a-second-language (ESL). About 60 percent of the mandatory GAIN participants have not worked within the previous two years (or never worked) and the remaining 40 percent have worked within the past two years (or are currently working).

Transportation poses a significant problem for this population—only half of all families own a car. The other half depend on public or other sources of transportation. Because many recipients live in relatively remote areas, simply reaching training and jobs is a problem. Child care is another major concern. Both counties indicate that existing licensed child care is not sufficient to meet the anticipated demand from GAIN participants. In addition, available child care may be located far from where participants live or train, further reducing the possibility that existing programs are accessible to GAIN clients.

Client Surveys Do Not Provide Adequate Planning Information

We recommend that prior to budget hearings, DSS submit to the Legislature's oversight and fiscal committees a plan for increasing technical assistance to counties in order to assure that assessments of participant needs provide a clear picture of client attributes and needs.

Our review of the counties' client needs surveys revealed two major problems. First, the surveys suffer from a variety of methodological problems that limit the validity of the results. For instance, questions may not provide mutually exclusive answers, and therefore counties cannot answer crucial questions about the characteristics of potential GAIN participants. A more serious problem is that many surveys did not obtain data on a representative cross-section of probable participants. For example, if a survey was conducted only in English, recipients who do not read English will not be adequately represented. If non-English readers are different in some systematic way from participants who can read English, the survey results will present an incorrect picture of all clients.

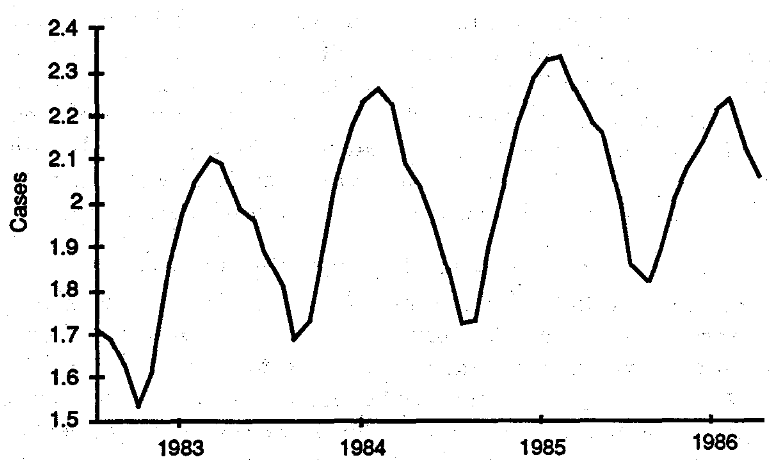
Second, both counties put together surveys that are not client assessments, but profiles. Profiles describe participant attributes; assessments identify problems that participants face in finding a job. Client profiles cannot address a number of questions essential for GAIN planning. For example, client profiles cannot identify what percentage of potential participants have serious drug or alcohol problems that might affect their job performance, or why some participants have such a hard time keeping a job, or whether refugee clients require different services—beyond ESL—than native-born participants.

Finally, assessments should attempt to understand why recipients currently go on and off of aid because such trends will affect county GAIN programs. For example, Chart 39 displays AFDC-U caseloads in the rural county from July 1982 through June 1986. As the chart illustrates, AFDC-U caseloads fluctuate greatly during the year, due primarily to agricultural demand for labor. Because of these fluctuations, the rural county will experience a large number of GAIN participants leaving the program

Chart 39

Rural County AFDC Caseloads

July 1982 to June 1986 (in thousands)



during the spring and summer—potentially in the middle of a training or education component. These same clients may reenter the GAIN program once labor demand declines. None of the plans reviewed recognize the problem of such short-term, recurring periods on aid.

Again, we do not want to be too critical of the counties. Welfare departments have little experience in conducting this type of assessment. We think that county plans would benefit greatly by improved participant assessments and that such data is relatively easily obtained. A county, for instance, could gain a wealth of data by thoroughly assessing a small random sample of potential GAIN clients. From this assessment, a realistic picture of client needs might emerge that would greatly alter county approaches to the program. For this reason, we recommend that DSS submit to the fiscal committees prior to budget hearings a plan for increasing technical assistance to counties in order to assure that participant needs assessments provide a clear picture of client attributes and needs.

Survey of Available Resources

Both counties did a reasonably good job of describing available services. The urban county inventory was excellent; the rural county inventory also was good, if a little less specific. The urban county, for example, examined the availability of specific types of education and training services that were identified as needed in the labor market and participant needs assessments. Because both counties expect transportation to be a major problem, their inventories examined where services were located with respect to the client population. The impact of GAIN's need for child care services also was assessed by both counties, in order to determine whether existing services could accommodate program needs.

We identified two areas, however, that warrant additional examination. First, counties need better data on the effectiveness of community-based organizations in providing remedial education services to GAIN participants. Second, county plans should include an assessment of the continuing child care needs of GAIN participants who find jobs, so that the state can act to remove any barrier to employment caused by the lack of affordable child care for GAIN graduates. Discussion of these issues follows.

Effectiveness of Community-Based Organizations is Unknown

We recommend that prior to budget hearings, DSS provide the Legislature's oversight and fiscal committees with criteria for determining when community-based organizations may be used to provide remedial education to GAIN participants. We further recommend that the Legislature adopt supplemental report language requiring DSS to (1) collect data on the relative cost-effectiveness of utilizing community-based organizations, versus public adult education programs, to provide these services, and (2) refine its criteria in light of its findings.

In a number of instances, county welfare departments have expressed a desire to contract with community-based organizations (CBOs), rather than public adult education programs, to provide remedial instruction in basic skills. At the present time, however, DSS has no consistent policy that specifies when it will approve the use of CBOs. Although the department has stated that it generally requires counties to first exhaust all available public adult ADA funds before contracting with CBOs, it also indicated that it reviews each request on a case-by-case basis, and may permit CBOs to be utilized in other instances as well.

Given the lack of any consistent policy on the part of DSS relative to CBOs, it is unclear what role, if any, CBOs will be allowed to play in the program.

Our review suggests that there may be some situations when using CBOs would increase county flexibility, and thus improve the quality of a local plan. Community-based organizations may be located closer to areas where low-income individuals reside, for example, thus making CBOs easier to reach than public institutions. Because transportation is a significant problem in many areas, easy access could mean the difference between participation and deferral for some clients. The CBOs *may* also be less intimidating because their often-informal environment is distinct from the public school atmosphere in which many GAIN participants have already failed.

On the other hand, there is little data which indicate that CBOs can provide services to GAIN clients as cost-effectively as public adult programs. The small amount of data that exists suggests that CBOs do tend to provide services at lower costs than public programs, primarily because of the extensive use of volunteer aides and tutors. However, in some instances, the use of inadequately trained and supervised volunteers has been shown to impede the ability of CBOs to deliver instruction effectively.

Because it is unclear when counties should be allowed to use CBOs, we recommend that DSS (1) develop criteria, for use during the 1987–88 fiscal year, for determining when CBOs may be used to provide remedial education to GAIN participants, and (2) submit these criteria, prior to budget hearings, to the legislative oversight and budget committees for review. The criteria developed should reflect the department's best appraisal, based on the data which are available to date, of when the use of CBOs would be desirable.

Because our review indicates, however, that only limited data are currently available, we recommend that the Legislature adopt supplemental report language directing DSS to gather representative statewide data on the relative cost-effectiveness of using CBOs and public adult programs to provide remedial education. The following language is consistent with this recommendation:

"The Department of Social Services shall collect data on the relative cost-effectiveness of public programs and community-based organizations in providing remedial education to GAIN participants. The data shall be collected for both types of providers, using the individual GAIN participant as the unit of analysis, and shall include measures of all of the following:

(1) Background characteristics of participants that might be expected to influence the individual's likelihood of success;

(2) Cost of educational services provided;

(3) Duration and type of services provided;

(4) Method of service delivery (including the use of alternative settings and techniques, and the use of volunteers); and

(5) Program outcomes (such as changes in academic skill levels and successful job placement).

The department shall then refine its criteria, in light of the data, for determining when counties may contract with CBOs, and submit these criteria, along with its findings, to the Legislature by March 1, 1989."

Continuing Child Care Needs Should Be Assessed

We recommend that the Legislature adopt supplemental report language that requires (1) the Department of Social Services (DSS), in conjunction with the State Department of Education (SDE), to collect data on the extent to which GAIN participants will be able to utilize SDE child care once they graduate from the program, and (2) the Department of Social Services to require future annual county plans to include assessments of the child care resources available to GAIN graduates.

All county plans that we reviewed indicate that the provision of child care services is an integral part of the GAIN program. Once AFDC recipients enter GAIN, DSS will pay for their child care (for any child under the age of 12), during the period of GAIN participation and for up to three months after they become employed. The type of child care arranged is at the participant's discretion, and can include care by a relative, private or nonprofit care, or care provided by child care agencies under contract with the State Department of Education (SDE).

The SDE administers several different child care programs which serve specific populations and/or address specific types of needs. Approximately 80 percent of the children served by these programs, which we refer to as "traditional" child care, are under the age of six. In addition, the SDE administers the new School Age Community Child Care ("Latchkey") program, which provides before- and after-school care for children in kindergarten through grade 9. Unlike traditional SDE child care (which is fully state-subsidized), only a portion of the Latchkey program's child care "slots" are state-subsidized. The remaining "slots" are reserved for fee-paying clients. In the discussion which follows, we refer to the state-subsidized portion of the Latchkey program, as well as traditional SDE child care, as "state-subsidized child care."

Because counties are not currently required to do so, neither county plan that we reviewed described the extent to which child care services will be available to GAIN participants *once they graduate from the program*. Our review indicates that, when the participants leave the program, many will remain low income and will thus be *eligible* for state-subsidized child care. (Because AFDC recipients with children under the age of 6 are not *required* to participate in GAIN, the primary impact of this demand for state-subsidized child care is likely to be felt in the Latchkey program. Voluntary participation in GAIN by persons with children under the age of 6, however, may also result in some impact on demand for traditional SDE child care programs.)

If such care is unavailable, however, these GAIN graduates may find that they are unable to continue working and will, instead, return to the welfare rolls. Thus, an assessment of the extent to which GAIN graduates are likely to be served by subsidized child care is crucial to ensuring the overall success of the program.

Currently, language contained in the 1986 Budget Act, and proposed in the 1987–88 Budget Bill, is intended to ensure that GAIN graduates have priority for state-subsidized child care. The language provides that:

- GAIN participants may remain "in line" for state-subsidized SDE child care programs while enrolled in the GAIN program.
- When GAIN participants whose children are being cared for outside an SDE program reach the top of an SDE waiting list, they will be placed on a deferral list (if they meet the other eligibility criteria).
- As soon as the parents become employed or separated from GAIN, they will have priority for the next available state-subsidized spaces. (This priority is only superseded by abused or neglected children.)

The deferral list process is suspended, however, if the level of AFDC recipients' participation in SDE child care programs falls below a base level. Then, GAIN participants are allowed to fill available SDE spaces immediately.

Generally, however, there are long waiting lists for state-subsidized child care. Because DSS believes that approximately 50 percent of GAIN participants will leave the program within 5 months, it is unclear how many will be high enough on an SDE waiting list, in such a relatively short time, to obtain subsidized care upon graduation. Accordingly, we recommend that the Department of Social Services, in conjunction with SDE, collect data that can be used to assess the extent to which GAIN participants will be able to utilize SDE child care (including Latchkey as well as traditional SDE child care programs) once they graduate. These data should include the number of GAIN graduates who are likely to qualify for SDE care, as well as the number that are likely to have SDE care made available to them upon graduation.

We further recommend that the Department of Social Services require future annual county plans to include assessments of the child care resources available to GAIN graduates. Specifically, we recommend that the Legislature adopt the following supplemental report language in Item 5180-151:

> "The Department of Social Services, in conjunction with the State Department of Education, shall collect data beginning July 1, 1987 on the extent to which GAIN participants will be able to utilize SDE child care once they graduate from the program. In addition, the Department of Social Services shall require that, beginning in 1987–88, annual county plans include assessments of the child care resources available to GAIN graduates."

DSS Needs Earlier Contact With Counties During Planning Process

We recommend that prior to budget hearings, DSS provide the legislative oversight and fiscal committees with a plan for providing additional technical assistance to counties to ensure that county plans are consistent with state policies and contain all necessary information for an appropriate plan review.

The county planning process serves a number of purposes. In addition to helping counties plan programs that respond to identified local needs, the plans also allow DSS an opportunity to review and comment on each county's proposal. The department reviews each plan to ensure that (1) all required information is contained in the plan, (2) county proposals are consistent with state policies, and (3) requested funding levels are necessary for program operation.

We found that department staff review county plans carefully in order to understand what counties are proposing. In the case of the two counties surveyed, the department posed a significant number of questions in order to clarify their proposals. This review obviously took substantial amounts of staff time and improved county plans in a number of ways. The state review, for instance, required the rural county to rework its labor market assessment so that a larger number of specific demand occupations were identified. Neither plan clearly described the proposed GAIN design, and the DSS review encouraged the counties to spell out certain details and eliminate inconsistencies.

In a sense, however, the department's review is too little and too late.

The review is too little because so much staff time was spent understanding the details of the plans that little review of the overall county strategy took place. We believe that the department would have more time to review the overall county strategy if plans contained all data needed by the department in its review. If proposed plans are seriously deficient in this respect, then it seems likely that the department has not clearly communicated its data needs to the counties.

The review also is too late. If the state is helping counties design workable programs, the plans should contain relatively few surprises by the time they are submitted to the state. The department's need for additional information concerning the two plans we reviewed indicates that counties would benefit from additional assistance during the planning process.

The DSS recognizes that additional state feedback would be useful both to the department and the counties. Accordingly, it recently issued a notice to counties identifying areas where plans usually require additional work. The notice also contains a checklist of information items frequently requested by the department during its reviews. The DSS also has hired additional staff to help counties with their GAIN plans.

This effort goes in the right direction. We believe, however, that these actions alone will not provide sufficient information to the counties about exactly what the department needs for its review. For instance, in its notice to counties, DSS discusses in one paragraph the need to link the labor market and participant needs assessments to specific skills that are needed in the area. Because the notice provides very little guidance to counties in how to achieve these linkages, we doubt that it is of much assistance.

We also question whether the department's budget-year staffing levels are sufficient to ensure ongoing assistance to counties during the planning process. This is because the 1987–88 budget does not propose staffing increases to (1) assist counties in refining future plans and (2) monitor the ongoing operation of county programs. At the time this analysis was prepared, we did not have adequate workload data from the department to determine the number of additional staff required. Therefore, we recommend that prior to budget hearings, DSS provide the fiscal committees with a plan for providing additional technical assistance to counties to ensure that county plans are consistent with state policies and contain all necessary information for the department's review. This plan should identify any staff increase required to provide this assistance.

Summary

In conclusion, we believe the Legislature needs to act in two general areas in order to ensure that the operation of the GAIN program conforms to legislative priorities:

- The Legislature should assert control over the GAIN budget so that program costs are determined by legislative priorities and decision-making and not driven primarily by the design of county plans.
- The Department of Social Services should be required to develop policies and provide assistance to counties in order to improve the effectiveness of the county planning process.

FINANCING COMMUNITY COLLEGES

What is the Appropriate Method for Financing the Community Colleges?

Summary

- *The current community college finance system will sunset on June 30, 1987.*
- *The current system does not adequately provide for changes in enrollment, equalization of revenues among districts, and revenue adjustments for long-run fixed costs. In addition, the current system does not provide community college districts a stable and predictable source of revenues.*
- *Differential funding, as outlined in the Chancellor's 1984 report, would not address the problems faced by districts under the current system and may create additional problems.*
- *We recommend that the sunset date for the current funding system be extended one year. During this time, the current system should be amended as prescribed.*

Senate Bill 851 (Ch 565/83) governs the allocation of state and local revenue to the California Community Colleges. The finance provisions of this measure will expire on June 30, 1987. As a result, this spring the Legislature will have to enact legislation providing for the allocation of apportionment aid to community college districts for 1987–88 and beyond.

The Legislature is faced with three basic options with regard to the SB 851 funding model: (1) leave the current model unchanged by simply extending the sunset provisions, (2) retain the structure of SB 851, but make specific changes to those provisions which are not working effectively, or (3) abandon the model and establish a new mechanism for allocating community college apportionments.

In this section, we offer several principles against which any community college finance system should be assessed. We also describe the current model, identify some of its most significant shortcomings, and recommend ways to address these problems. Finally, we evaluate a popularly discussed alternative to SB 851—differential funding.

Principles for Community College Finance

Before examining the current SB 851 finance model and the differential funding alternative, it is important to review some general principles against which these models can be assessed. We believe that the following criteria will assist the Legislature in evaluating any proposed finance system.

We have identified the principles as generally meeting either a state interest or a local interest, although these groupings are not mutually exclusive.

State Interest Criteria

- ***Equalization.*** Since the California Supreme Court ruled that funding for K–12 education could not be based, in large part, on district property tax wealth, the Legislature has maintained that equalization of per-ADA revenues among community college districts is a policy goal.
- ***Limiting General Fund Costs.*** Any community college funding mechanism should protect the state General Fund from unanticipated or uncontrollable expenditures. Funding levels for the community colleges should be determined by the Legislature and the Governor, not by local practices or decisions.
- ***Accountability.*** The recent failure of some districts to operate on a sound financial basis has prompted the Legislature, the Governor, and other parties to call for greater accountability within the community college finance system.

Local Interest Criteria

- ***Stability and Predictability of Revenues.*** Local administrators need to be reasonably certain about the level of funding their district will receive in order to establish reasonable expenditure targets and policies for the upcoming year. Moreover, in order to avoid disruptions of local program offerings, the level of revenues should not fluctuate wildly from year to year.
- ***Responsive to Workload Changes.*** Districts experiencing increases in enrollment should be provided additional revenues to serve these students. Conversely, the funding mechanism should reduce revenues of districts experiencing enrollment declines.
- ***Flexibility.*** The funding mechanism should also allow local administrators sufficient flexibility in the allocation of revenues to meet local needs.
- ***Equalization.*** Districts of similar size should be provided roughly equal revenues per unit of workload. Differences in per-ADA funding levels should be provided to address cost differences that are not under the control of the local administration.

- ***Ease of Administration.*** Finally, any funding mechanism should be simple to understand and administer. State policy makers should be able to understand the consequences of changes in the mechanism, and local officials should be able to determine the effect of state policy changes on their individual budgets. Data needed to determine district funding levels should be easy to collect and verify.

Community College Support Under SB 851

Under SB 851, community college districts receive support for the general operations of the district from three sources—the state General Fund (in the form of a state apportionment), the local property tax, and the mandatory student fee. (A district's state apportionment is that share of a district's general education budget provided from the state General Fund after deducting local revenues provided from the property tax and the enrollment fee.) Districts also receive funding for various categorical programs from both state and federal sources. Total community college support of $2.4 billion is proposed for 1987–88. Of this amount, the General Fund will provide $1.2 billion, or 51 percent. (For details, please see Item 6870 of the *Analysis.*)

The amount of funding a district receives under the SB 851 mechanism is dependent upon (1) base apportionment funding in the prior year, (2) the change in the district's workload as measured by average daily attendance (ADA), (3) the change in the adult population of the district, (4) inflation, and (5) equalization aid. Changes in these factors are combined to determine the district's total funding level. The state General Fund makes up the difference between the total funding level, as determined by the statutory formulas, and local revenues provided by the property tax and the student fee.

Below we discuss how each of the factors contributes to the determination of a district's total allocation.

Prior-Year Base Funding. The prior-year funding of a district is, of course, the result of the interaction of the factors discussed here. Much of a district's current funding level, however, is based upon historical expenditures that can be traced to expenditure and taxing decisions made by local districts prior to Proposition 13.

In general, districts that levied *special override taxes* to pay for adult education, community services, or facilities development tend to have a higher revenue base under SB 851 than districts that did not levy these taxes. In addition, *property tax wealth* continues to influence the amount of revenues a district receives under the current finance mechanism. Finally, *spending from district reserves* in 1977–78 also influences a district's base apportionment funding level. Districts that chose to spend from reserves in 1977–78, the base year which established post-Proposition 13 funding levels, rather than increase the tax rate, tend to have a lower revenue base than districts that increased their tax rate.

The revenues associated with these decisions are, in some measure, reflected in the district's base funding level to this day.

ADA Changes and Population Growth. The SB 851 mechanism recognizes that changes in district workload affect district costs. The workload measure for community college funding is average daily attendance (ADA). One ADA is defined as the equivalent of one student under the immediate supervision of a certificated instructor for a total of 525 hours per year. Because faculty costs at the community college level are more directly a function of contact with students, we believe that ADA, or some measure of contact hour, is a better measure of workload than one based on credits earned by students.

Inflation Adjustments. The current finance model also adjusts district revenues to offset the effects of inflation on purchasing power. Specifically, a district's general education apportionment is adjusted annually to offset inflation according to a specified index.

Equalization Aid. The SB 851 funding model also adjusts per-ADA revenues to reduce funding disparities among the 70 community college districts. The model provides low-revenue-per-ADA districts with additional state aid by (1) bringing all districts below the prior-year statewide average per-ADA up to 91 percent of the average in the current year, and (2) raising the revenue per ADA of the poorest districts "to the highest common level possible" after the first adjustment is made.

Other Funding Adjustments. The SB 851 finance mechanism also recognizes that small districts face higher per-ADA costs because they cannot take advantage of the economies of scale enjoyed by large districts. The model, therefore, provides a *small district factor* which increases the apportionments of qualifying districts. The size of the adjustment diminishes as district size reaches the threshold of 3,000 ADA.

The mechanism also provides a *marginal funding adjustment* to adjust district revenues for short-run expenditure changes attributable to marginal changes in workload. In general, for districts experiencing changing enrollments, the model adjusts the apportionment by only two-thirds of the per-ADA funding level for each student gained or lost.

Shortcomings of the Current Allocation Mechanism

The current community college funding model has been the subject of considerable criticism recently. Many have argued that it should be replaced by an alternate allocation mechanism. Some have argued that the current model "does not reflect the postsecondary nature of the community colleges" while others criticize the model for "failing to recognize costs other than instruction."

Our analysis of the SB 851 mechanism indicates that it suffers from four major weaknesses. Views expressed by community college district officials during our campus visits also support this assessment of the current model. Each of these shortcomings and a proposed solution is discussed below.

1. New Growth Factor Needed

We recommend that the community college finance mechanism consider the local unemployment rate, the number of high school graduates, and the adult population in determining the General Fund requirement for growth funding.

As discussed previously, the current model provides general education apportionments to community college districts based upon the number of students, as measured by ADA, attending classes. Districts receive additional funding if more students attend classes than the previous year and lose funding if enrollment declines. One shortcoming of the model is that budgeting for enrollment growth is based upon the statewide change in the adult population, with district-specific growth rates provided by the Department of Finance determining each district's entitlement to growth funds.

Numerous studies and historical evidence indicate that the change in the adult population is not a significant determinant of community college enrollments. During periods of enrollment decline—for example 1981–82 through 1985–86—the SB 851 funding mechanism required that the state appropriate funds for enrollment growth despite evidence that, on a statewide basis, the colleges would not require growth funding. As a result, General Fund support for growth that never materialized was needlessly appropriated in the state budget and thus was not available for other legislative priorities.

Conversely, the current-year budget provides funding for 1.9 percent growth in community college ADA statewide, based on the growth rate of the adult population. A survey conducted by the Chancellor's Office for the fall semester of 1986, however, indicates that statewide enrollment may be above 1985–86 levels by three percent, thus leaving approximately one percent of the ADA unfunded. Some districts indicate that enrollment growth may be as much as 10 percent above the prior-year level.

Our review indicates that factors in addition to the change in the adult population influence community college attendance. Creating a comprehensive model of the attendance decision would involve collection and verification of a vast array of data. A preliminary report of the impact of the enrollment fee prepared by the Chancellor's Office pursuant to Ch 1xx/84 (AB 1xx), however, suggests that reliance on just two additional factors—the local unemployment rate and the number of high school graduates in the district—would provide reasonably good and easily obtainable measures of probable community college workload. We concur with this conclusion. Use of these additional factors would result in a finance mechanism that is more sensitive to enrollment changes.

2. Equalization Equity

We recommend that the community college finance mechanism equalize per-ADA revenues by providing an adjustment to low revenue districts from funds that would otherwise be provided to districts with per-ADA revenues above the statewide average. We further recommend that the mechanism recognize cost differences attributable to differences in district size and provide a corresponding revenue adjustment.

The SB 851 funding mechanism was designed to promote the Legislature's policy goal of reducing per-ADA expenditure differences among districts that are wealth related. Our analysis indicates, however, that the mechanism has failed to achieve this goal. Left unchanged, the current mechanism would allow funding disparities between the highest and lowest revenue districts to increase.

Our review identified two primary reasons for the failure of the current mechanism to promote equalization. First, the mechanism interacts with the marginal funding adjustment of SB 851 by providing equalization funds to districts because of changes in ADA. Specifically, because districts retain one-third of their per-ADA revenues when enrollments decline, *average* funding per ADA for these districts increases, giving them the appearance of wealth. Conversely, districts experiencing increasing enrollments are funded at the marginal two-thirds rate for each additional ADA thus reducing their averge funding per ADA, and giving them the appearance of poverty. As a result, equalization aid is provided to districts because of changes in ADA rather than because of historically low expenditures stemming from wealth related differences among districts.

Second, the current mechanism does not reduce the relative revenue advantage of high revenue-per-ADA districts. Under the current formulas, a district receives a cost-of-living adjustment (COLA) equal to the percentage change in the Implicit Price Deflator multiplied by (1) the statewide average revenue per ADA or (2) the district's own revenue per ADA, whichever is *greater*. This application of the COLA ensures that the high revenue-per-ADA districts will always remain above the statewide average in per ADA funding. (Please see page 1480 of the 1986–87 *Analysis* for a more detailed discussion of these issues.)

In fact, the Legislature has already recognized the deficiencies in the current funding mechanism. In the 1986 Budget Act it directed the Chancellor to allocate equalization funds in a manner that would more effectively achieve this policy goal. The Chancellor's plan, however, has been held in abeyance by the Governor, who proposes to delete current-year equalization funds. The 1987–88 Governor's Budget proposes $2.3 million for equalization aid.

Any new funding system should contain an equalization mechanism that will (1) be insensitive to changes in ADA and the marginal funding provision, and (2) make revenue adjustments for districts both above and below the statewide average revenue level for districts of comparable size. To reduce disruption in existing programs, however, the mechanism should reduce per-ADA funding disparities gradually.

3. Aiding Funding Stability

We recommend that the workload measure for which districts receive state support be averaged over a three-year period to reduce the volatility in community college revenues and to allow districts to better plan for long-term expenditures.

During our visits to various community college districts, local administrators informed us of a recurring problem in funding the districts—instability and unpredictability of revenues to support district operations. This instability and lack of predictability in district revenues impairs local administrators' and boards' ability to adequately plan educational programs.

Our review reveals two reasons for the lack of stability and predictability in revenues for the community colleges: (1) the mechanism itself has undergone numerous changes in the last twelve years, and (2) the workload measure—ADA—is unstable and unpredictable.

Since 1973–74, there have been eight major changes to the community college finance model. Some of these changes have been prompted by court decisions, such as Ch 209/73 (SB 6) which attempted to reduce revenue disparities among districts in response to the *Serrano v. Priest* decision. Others have been prompted by voter initiatives, such as Ch 292/78 (SB 154) which established block grant funding for the community colleges in the wake of Proposition 13. And still others have resulted from legislative or gubernatorial policy initiatives. Regardless of the source of these changes, the frequent revision of the model itself has made local budget planning difficult. This uncertainty, for the most part, cannot be eliminated through the adoption of a new model.

A second source of instability and unpredictability, however, can be addressed directly through the finance model. A weakness of the current model is that the workload measure which generates each district's entitlement to state funds is inherently unstable. As discussed previously, many factors influence community college attendance, and precise predictions of attendance for a particular district in a given year is difficult at best.

In order to reduce the risk of budgeting for enrollments that are not realized and to provide a more stable source of funds from year to year, we recommend that the workload measure for which districts will receive funding be expanded to include the average workload over a three-year period: the past, current, and budget years. This system would promote two objectives not available under the current mechanism: (1) it would allow for more precise planning of local budgets because revenues generated by ADA, or whatever workload measure is established, could be predicted more accurately, and (2) it would reduce the volatility in the level of revenues a district receives from one year to the next by dampening the swings in the workload measure through the process of averaging.

4. Fixed Costs Should be Recognized

We recommend that the funding model explicitly recognize changes in fixed costs incurred by community college districts in the long run, while maintaining the marginal funding provisions for short-term changes in workload.

The SB 851 model recognizes that district costs do not change in direct proportion to changes in workload. For increases in workload, the model provides two-thirds of the average revenues per ADA for the district, rather than the average amount, in recognition of the fact that a district's fixed costs (plant, equipment, and core staff) do not change with marginal changes in workload. Conversely, the model allows districts to retain one-third of the average revenue per ADA associated with enrollment declines, again in recognition of the fact that fixed costs do not change in the short run.

The model, however, fails to consider the long-run implication of such a funding policy. Over time, districts will not be able to accommodate marginal increases in workload without incurring corresponding increases in fixed costs. Additional equipment must be purchased, more classroom space must be secured, and faculty and support staff must be hired. These costs cannot be accommodated at the marginal funding rate, and the model should recognize changes in fixed costs in the long run.

Our analysis indicates that the marginal funding policy under the current model is justified and should be continued. The model, however, should be amended to include an adjustment for long-run fixed costs as well. This change can be accomplished in a number of ways. For example, the per-ADA funding level for increases in ADA in a given year could be gradually increased from the marginal rate of two-thirds funding in the first year of the increase to three-quarters funding in the second year and 100 percent funding in the third year of the increase. Another approach would be to provide a single adjustment every third or fifth year from a base year workload level to fund changes in fixed costs. Regardless of the method chosen to allocate these funds, the model should recognize the need for adjusting revenues to account for changes in fixed costs that cannot be absorbed through marginal revenue adjustments alone.

The Popular Option for Funding Community Colleges—Differential Funding

As discussed previously, the current community college finance model is scheduled to sunset on June 30, 1987. The Governor's Budget proposes a one-year extension of the current model, with no significant policy changes. (See Item 6870-101-001 in the *Analysis* for a detailed discussion of the proposal.)

As we stated earlier, there are generally three policy options for funding the community colleges beyond the one-year extension of SB 851: (1) continue the SB 851 model in its current form, (2) modify and refine the SB 851 model to address specific shortcomings, or (3) abandon the current model and adopt a new method for allocating state apportionments to the community colleges.

We have discussed how the Legislature could modify the current model to address its shortcomings. In this and the following three sections, we analyze the benefits and weaknesses of the most-discussed alternative to the current model—differential funding.

Background. Senate Bill 851, in addition to establishing the current funding mechanism, required the Chancellor to prepare a plan for implementing a differential funding system to support the community colleges. This report was delivered to the Legislature in December 1984.

As outlined in the report, *A Plan for Implementing a Differential Cost Funding System for the California Community Colleges,* differential funding involves the provision of state apportionments to community college districts based upon a district's workload factors multiplied by support rates for various cost categories. The funding rates would be based upon the statewide average expenditures in specific cost categories.

The Chancellor's 1984 report proposes four cost categories for a differential funding model: (1) instruction, (2) student services, (3) general services, and (4) maintenance and operations. In addition, four corresponding workload measures are proposed: (1) Full-Time Student Equivalent, (2) Headcount Enrollment, (3) percentage of allocation in other categories or Full-Time Faculty Equivalent, and (4) assignable square feet.

Districts would receive state apportionments according to workload generated in the four major cost categories, with support rates adjusted for (1) programmatic cost differences in the instructional category, and (2) cost factors, such as district size and the makeup of the student body, that are outside of the control of the district. All other support rates would be based on total statewide expenditures in each cost category, divided by its corresponding workload measure.

The report further recommends, however, that in order to preserve local flexibility in the allocation of resources, districts not be *required* to expend revenues in the cost categories from which the revenues were generated. Thus, the model would be used only to allocate revenues; it would not be used to direct local expenditures.

Advantages of a Differential Funding System

The Chancellor's 1984 report identified a number of advantages of a differential funding system. It states that the model:

- Better matches funding to program offerings.
- Recognizes essential services other than instruction.
- Aids in cost comparisons among districts.
- Improves local planning.

Other advantags identified in the Chancellor's report include: greater focus on policy issues, greater funding equity across districts, and smaller impact of enrollment fluctuations on local budgets.

Needless to say, these proposed benefits have stirred up great interest in a differential funding system, and it is currently the most popularly discussed alternative to the SB 851 system.

The Differential Model Would Not Eliminate the Shortcomings of the Current Funding Mechanism

Our analysis of the differential funding mechanism indicates that it will make only small improvements in existing shortcomings. Specifically,

- ***Funding changes in enrollment.*** It does not address reliance on an inadequate measure—total population growth—as a predictor of community college attendance.
- ***Per ADA revenue equity among districts.*** In theory, differential funding based on statewide average expenditure rates for specified cost categories would result in immediate and absolute per-ADA revenue equity among communty college districts. The Chancellor's report on the alternative funding proposal, however, includes a buffer mechanism of $40 to $45 million which would level up funding of low spending districts to the statewide average while still allowing high spending districts to maintain their spending advantage. Thus, as proposed, differential funding would provide no more revenue equity than is available under the current system.
- ***Stability and Predictability of District Revenue.*** Differential funding would make revenues somewhat more stable, because allocations for plant maintenance and operations would be based on the relatively constant measure of assignable square feet. Allocations for instruction and overhead, however, would still be based on volatile, one-year measurements.

- *Adjustments for Fixed Costs.* Again, the differential funding system would rely on the current, inadequate method of adjusting revenue for additional workload. Marginal enrollment would be partially funded, with no recognition that districts must eventually come to terms with the need for additional plant, equipment, and support staff.

Other Consequences of Differential Funding

Our analysis of the differential funding proposal indicates that other consequences would result from allocating state apportionments differentially. While these may be unintended consequences, it is important to identify them before a specific funding model is adopted.

Greater Complexity. A differential funding system is dependent upon specific and reliable cost data for each cost category and various measures of workload—student attendance, headcount enrollment, faculty, and square footage of facilities—to allocate state dollars. These factors would have to be collected, compiled, and verified annually to maintain the integrity of the allocation process. Major new administrative costs would have to be funded, at both state and local levels.

This unintended consequence would, therefore, work against the criterion of providing a simple allocation mechanism which is easy to administer.

Shifts to High-Cost Programs. As mentioned, the current system funds districts for all aspects to district operations based on workload incurred in the classroom. There is no explicit differentiation between classroom and nonclassroom costs. Such differentiation is left to the discretion of local administrators and governing boards.

A differential funding model, on the other hand, explicitly recognizes costs other than costs incurred in the classroom, and different workload measures are required to generate revenues for different cost categories. It does not, however, require that funds be *spent* in accordance with the allocation method. Districts would have the incentive to shift offerings from low revenue cost categories, *relative to the particular district's actual costs,* to high revenue cost categories. Even within statewide and district-specific enrollment caps, there could be a shift to high-cost programs, resulting in an increase in statewide costs, with no corresponding increase in statewide enrollment.

This unintended consequence would work against the state's interest in controlling General Fund apportionments because district allocations would be determined by local program offerings.

Conclusions

In sum, our analysis indicates the following:

(1) The adoption of a differential funding model to allocate state General Fund apportionments is not warranted because it would not adequately address the problems faced under the current allocation system, and might create new funding and control problems.

(2) A modified version of the SB 851 model would provide the Legislature with equalization of per-ADA revenues and control over General Fund costs while at the same time meeting local needs for stability and predictability of revenues, flexibility, and ease of administration.

Given the limited time before the expiration of the current system, we do not believe that the modifications we have proposed can be developed and implemented in time for use during the budget year. Sufficient time must be provided to develop adjustments to the model and to allow local districts to prepare for any change in revenues resulting from these modifications.

We therefore recommend that the Legislature extend by one year the sunset date for the current community college finance model. During this time, the model should be amended to address the four problems identified earlier, with the intent that it then be adopted as the long-term community college finance mechanism.

HIGHER EDUCATION FACILITIES PLANNING

What Can the Legislature Do to Insure Higher Education Facilities Meet Future Enrollment Needs?

Summary

- *Demographic data indicate that California will have a dramatic increase in higher education enrollments toward the last half of the next decade. Capital planning to accommodate this growth must begin now.*
- *Planning for capital needs in higher education should take into account demographic trends of the areas served by the respective segments. The California State University capital planning does not reflect a consideration of these trends.*
- *Recently, the high cost research facilities at the University of California have overshadowed other capital needs in higher education.*
- *The Legislature needs to establish specific policies and funding priorities to correct these problems and guide future planning.*

Over the last few years, the Legislature has provided increasing amounts of funds for capital improvements for the higher education segments in California, primarily for the University of California and the California State University. At the same time, a special commission and a joint committee of the Legislature, have been reassessing California's higher education master plan. This analysis describes the outlook for higher education enrollment and identifies steps the Legislature needs to take to insure that California has an efficient system for planning and funding the facilities that will be needed to accommodate the state's future college and university students.

Demographic Factors Affecting Enrollments in California's Higher Education Institutions

In order to effectively plan capital outlay expenditures to meet future enrollments in higher education, the state relies on enrollment projections. The state Department of Finance (DOF) prepares enrollment projections for the University of California (UC), the California State University (CSU) and California's Community Colleges (CCC). These projections take into account:

- The relative participation rate in the various segments; that is, what percentages of the populace attend these institutions;
- Population changes within California;
- Enrollment trends;
- Changes in the admission standards of the segments.

The DOF projections become the basic tool for forecasting facility requirements for higher education. In the case of the community colleges, the DOF prepares an enrollment projection for each district. For UC and CSU, the projections are on a statewide basis. This is because community college enrollment is more closely aligned with the demographics of the area served, while UC and CSU serve broader areas. The UC and CSU are responsible for allocating the DOF statewide enrollment projections to the respective campuses. In recent years, however, the projected enrollment that has been allocated to the various campuses has exceeded the DOF projections.

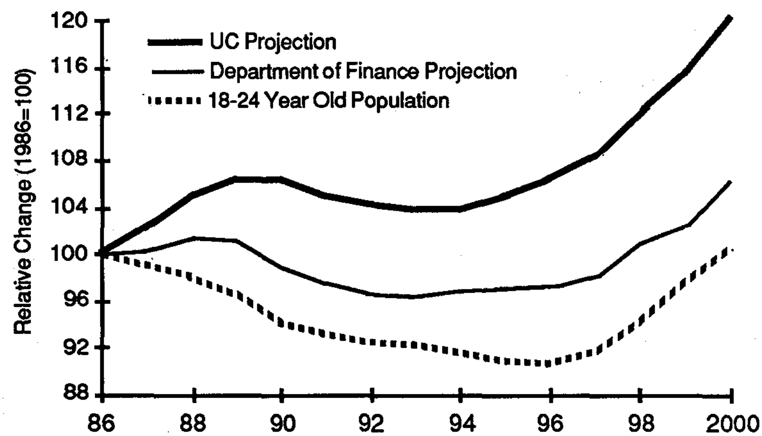
Projected UC Enrollment. Chart 40 compares the Department of Finance's UC enrollment projections to those prepared by UC, with the 1985 actual enrollment (135,720 students) indexed to a value of 100. Chart 40 also shows the DOF's projected change in the 18-to-24-year-old age group. This age group is generally accepted as being the traditional "college-age" population, and thus provides a point of reference for the two enrollment projections.

The Department of Finance projects that UC enrollment will decline slightly over the next ten years to a low of 133,900 students in 1995. The DOF indicates that while the proportion of the state's population enrolling at UC is expected to increase, the declining population trend among college-age individuals over the next ten years will more than offset that increase. In subsequent years, enrollment is expected to follow growth in the college-age group, reaching 146,800 by the year 2000.

As shown in Chart 40, the UC's enrollment projections exceed those developed by the DOF. For the year 2000, UC anticipates an enrollment of at least 162,000. This is about 10 percent higher than the DOF projection.

Chart 40

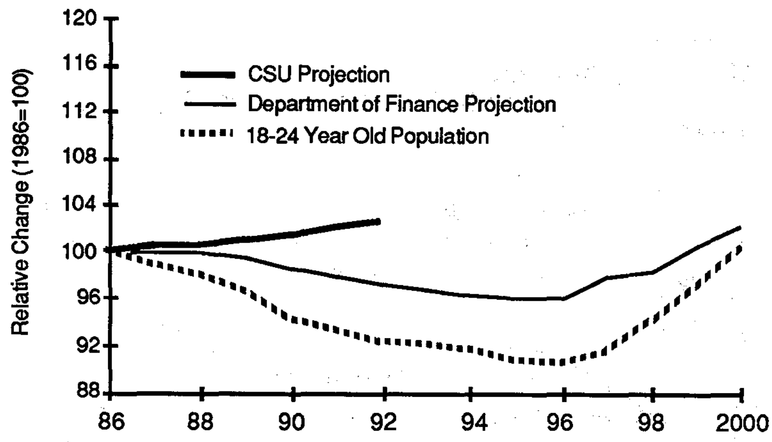
University of California
Projected Changes in Enrollments and Population
1986 through 2000



CSU Enrollment. Chart 41 compares DOF's and CSU's projections of CSU enrollment. It also displays the "college-age" group of 18-to-24 year olds. The DOF projects that total enrollment will increase from 322,626 students in 1985 to 337,200 students in the year 2000. This projections generally follows the same trend as UC enrollment, in which a decline in the prime age group is expected over the next ten years and an increase is expected between 1996 and the year 2000. Contrary to the modest decline projected by the DOF, the CSU Chancellor's Office, in preparing the five-year capital outlay program for 1987–88 through 1991–92, projects a moderate enrollment growth over the next five years. The CSU has not provided projections beyond 1991–92.

Chart 41

California State University
Projected Changes in Enrollments and Population
1986 through 2000

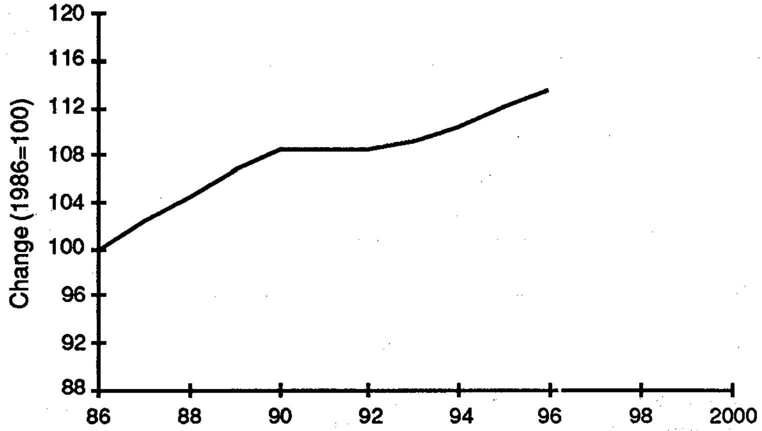


Community College Enrollment. Community college enrollment has fallen from a high of 750,715 average daily attendance (ADA) in 1981–82 to 639,074 ADA for 1985–86, the most recent year for which actual enrollment is available. Chart 42 shows the DOF enrollment projections for the community colleges for the next ten years. The projected increase of 13 percent would put the 1995–96 ADA at 726,000. Thus, projected enrollment is not expected to approach the previous peak enrollment for at least ten years. No projections are available for the years beyond 1995–96.

Regional Needs Vary From Statewide Needs. There are certain areas in the state which are currently experiencing rapid growth. These areas, which generally represent the rural or suburban areas of the state, are projected to continue to grow at a significant rate. They include San Bernardino, Riverside, San Diego and Sacramento Counties. At the same time, urban areas of the state, such as Los Angeles and San Francisco Counties are projected to decline in population, with a commensurate decline in the college-age population segment. Table 43 shows the projected 18-to-24-year-old population group for the ten counties with the most growth.

Chart 42

California Community Colleges Projected ADA
1986 through 1996



Source: Department of Finance data

Table 43
College-Age Population
Change from 1985 to 2000
Ten Counties with the Largest Increase

County	*18-to-24 Year Olds*
San Bernardino	39,800
Riverside	23,800
San Diego	20,100
Kern	14,200
San Joaquin	12,500
Solano	7,800
Sacramento	7,800
Tulare	7,700
Stanislaus	5,700
Fresno	4,800
Total	144,200

Source: Department of Finance and Legislative Analyst's Office.

Table 44 shows the same data for the ten counties with the greatest decline.

Table 44
College-Age Population
Change from 1985 to 2000
Ten Counties with the Largest Decline

County	*18-to-24 Year Olds*
Los Angeles	−87,700
Orange	−35,700
Alameda	−28,800
Santa Clara	−27,400
San Mateo	−13,000
Marin	−11,200
Contra Costa	−11,000
San Francisco	−8,300
Santa Barbara	−5,100
Napa	−2,300
Subtotal	−230,500
Ten Counties w/Largest Increase	144,200
Other Counties	43,200
Statewide total	−43,100

Source: Department of Finance and Legislative Analyst's Office.

Summary and Conclusions from Demographic Projections. Based on the projections prepared by the DOF, the general trend in enrollment shows little or no growth for UC or CSU until 1996, when enrollment growth is expected to increase substantially. The UC projections parallel those of the DOF but at a higher level throughout the study period. In the near term CSU also projects a higher level of enrollment than the DOF. No long-term projection is available from CSU. The CCC will have some growth but, because of recent enrollment declines, the enrollment is not expected to reach the level accommodated in 1981–82 in the foreseeable future. Available data also show that the college-age population is increasing in several suburban and rural counties, but *the increases will be more than offset by declines in the major urban counties through the year 2000.* Whether or not the geographic trend affects planning in higher education depends on the extent to which the respective missions of the three higher education segments are driven by regional needs.

The significant conclusion to be drawn from the demographic data is that California can expect a rather dramatic upturn in enrollment beginning in 1996. While there is disagreement over the exact numbers, the enrollment increase under either scenario means that the state will be faced with providing facilities for these additional students. Our analysis indicates, as we show in the next two sections, that the existing capital outlay process will not provide the Legislature with a coordinated, balanced approach to accommodate this growth.

Meeting Facility Needs in Higher Education

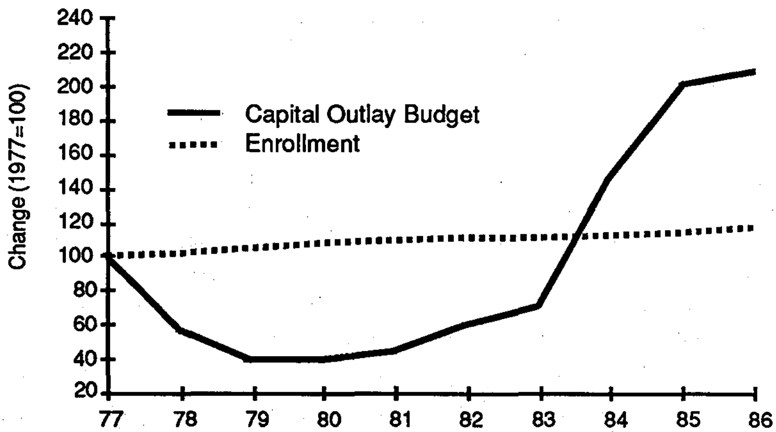
This section reviews the specific capital outlay budget themes for the three higher education segments.

University of California

Over the past ten years, the amount of funds budgeted for capital outlay for UC has ranged from a low of $19.7 million in 1979–80 to a high of $159.2 million in 1986–87. For 1987–88, the budget proposes nearly $140 million for new high-technology facilities, new libraries and various campus improvements. Chart 43 shows the recent history of UC's capital outlay budget and enrollment, with 1977 as the base year and data for all subsequent years indexed to 1977. The data show that while capital outlay expenditures declined significantly in the post Proposition 13 years, they accelerated dramatically beginning in 1983–84. Meanwhile, enrollment has grown moderately.

Chart 43

University of California
Capital Outlay and Enrollment Changes
1977 through 1986



Because of UC's research mission, a significant portion of recent capital outlay approriations has been for construction of research space for engineering and the natural sciences. Other recent capital outlay projects include additional library facilities. The UC's plans call for a continuation of these trends.

Why Is UC's Capital Program Costly? Changes in enrollment at UC have a far greater impact on facilties needs than they do at the other segments. This is because UC is the sole state-supported research institution. As new faculty positions are added to serve the increased enrollment in a program, so are additional needs for space to accommodate faculty research. In addition, UC is the state-supported institution in California that confers doctoral degrees, and has a large number of graduate students in attendance. The UC's relatively high concentration of graduate students means that it must maintain a significant amount of research space for them, as well.

As a result of these two factors—the faculty's research mission and the concentration of graduate students—a relatively small change in enrollment can generate significantly higher increases in the amount of space proposed for academic programs at UC than it would at either CSU or CCC. Moreover, the type of space constructed to house UC programs is more expensive to construct than space at CSU or CCC because research facilities typically cost more than classrooms.

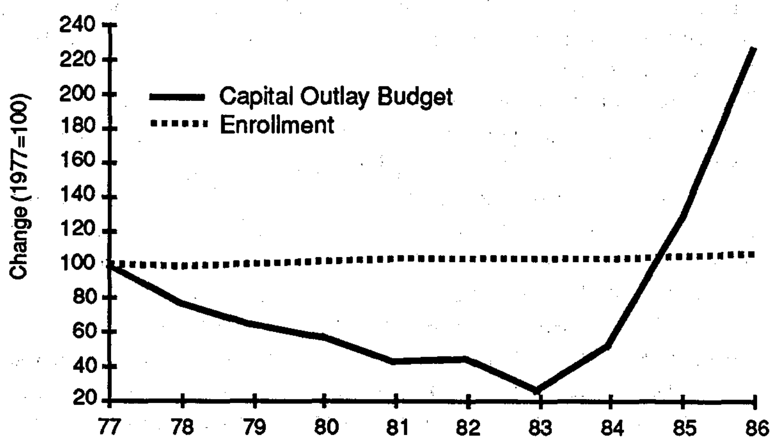
Building Is Not Driven by Regional Growth. The UC, with its emphasis on research and instruction at the graduate level, is a statewide and national resource. It has operated nine geographically dispersed campuses for a number of years. Regional demographics have a limited effect on university-wide planning. Consequently, the UC does not plan on establishing any new campuses even though it predicts growth in enrollment. Rather, the growth in UC enrollment will be accommodated by implementing the long-range development plans for the campuses that have room to grow.

California State University

The amount of funds appropriated for capital outlay for CSU has also substantially increased over the past few years. Chart 44 compares CSU capital outlay budgets to enrollment (again, with all data indexed to the base year, 1977). It shows that while spending decreased gradually from 1977 to 1983, it started increasing dramatically in 1984. The 1987 budget proposes an additional $108 million for CSU capital outlay.

The increased CSU capital budget has provided funds for construction of new high-technology facilities to accommodate expanding instructional programs in computer science, engineering and other fields. For the most part, these facilities include lecture rooms, class laboratories, faculty offices, and graduate student research space. In addition, funds have been provided for expansion of libraries on a number of CSU campuses. The increase in the amount of instructional space, however, has been modest because enrollment has grown only moderately over the past few years. The amount of research space is only a minor component of the space needed to support CSU programs because (1) CSU does not provide space for faculty research, and (2) the ratio of graduate to undergraduate students is low in comparison to UC.

Chart 44
California State University
Capital Outlay and Enrollment Changes
1977 through 1986



Options to Respond to Enrollment Growth in CSU. The 19-campus CSU system has a statewide mission that is influenced by regional demographics. With a few exceptions, most campuses primarily serve broad geographic areas. Consequently, the CSU plans assume that where there is growth in population, there will be increased demand for CSU services.

There are a variety of ways of meeting this demand.

1. ***Redirection.*** Previous legislative directives to CSU to consider the statewide capacity of all campuses, and "redirect" students to campuses that had sufficient space and appropriate programs to accommodate them, have not been implemented. In view of this, the Legislature has directed CSU to consider "regional" alternatives to redirection and report its findings to the Legislature. This report, due to the Legislature in October 1986, has not been received.

2. ***Off-Campus Centers.*** The CSU has a number of off-campus centers that operate as extensions of individual campuses. These centers have been established to meet upper division and graduate educational needs at the community level. The CSU has proposed that because of projected growth, several of the off-campus centers should occupy permanent state-owned facilities rather than leased facilities.

The three centers which are proposed for permanent facilities are:

- North San Diego County Center. The CSU plans to establish a permanent center on approximately 400 acres near San Marcos. The new center would initially accommodate 4,000 FTE students, and would replace an existing leased facility that can accommodate 800 FTE. The new center would be occupied in Fall 1992 according to CSU's current plan; CSU officials assume a development cost of over $100 million. (The California Postsecondary Education Commission (CPEC) has recommended approval of a permanent center at a significantly reduced enrollment).
- Ventura County Joint Center. The CSU also proposes establishing a permanent off-campus center located on 240 acres adjacent to the City of Ventura. The existing leased center, operated jointly by the Northridge campus and the University of California at Santa Barbara, has an enrollment of about 200 FTE students. The ultimate enrollment and cost to develop the permanent center is unknown at this time. (CPEC has not made a recommendation on this center.)
- Contra Costa Center. The CSU plans on relocating an existing off-campus center in Pleasant Hill, operated by the Hayward campus in leased space, to new facilities to be constructed on a 380-acre state-owned site acquired in 1969. This site was purchased to accommodate a full campus. The center currently enrolls about 500 FTE. The new facilities are to be available in Fall 1991 and serve 1,000 FTE, with an ultimate goal of 5,000 FTE at the site. The CSU estimates that the initial development for 1,000 FTE will cost $16 million. (CPEC has not made a recommendation on this center.)

The CSU points to regional growth as the driving force behind establishment of the permanent off-campus centers. The CSU plans, however, contradict its stated community service objective because a substantial portion of the projected enrollment at new permanent centers—up to 40 percent in one instance—is expected to come from outside the community service area.

An alternative means of providing adequate space for centers would be for the CSU to lease underutilized community college facilities, where regional needs and capacity make this possible. This would improve overall facility utilization and could reduce costs for both segments.

3. ***Expansion of Existing Campuses.*** Several of the existing campuses have not reached their master plan capacity. Therefore, CSU has the ability to expand most CSU campuses to meet anticipated *regional* needs for the foreseeable future without incurring the cost of developing new campuses. Table 45 shows the master plan capacity for each of the existing 19 campuses. The table indicates that the *systemwide master plan capacity could accommodate over 100,000 additional FTE students.*

Table 45
California State University
Comparison of Master Plan Capacity to Projected Enrollment
Existing CSU Campuses
1992–93

Campus	*Master Plan Capacity*	*CSU Planned Enrollment 1992–93*	*Difference*
Bakersfield	12,000	3,300	8,700
Chico	14,000	13,800	200
Dominguez Hills	20,000	5,450	14,550
Fresno	20,000	13,900	6,100
Fullerton	20,000	16,500	3,500
Hayward	18,000	8,950	9,050
Humboldt	10,000	5,770	4,230
Long Beach	25,000	23,000	2,000
Los Angeles	25,000	13,500	11,500
Northridge	25,000	20,500	4,500
Pomona	20,000	15,000	5,000
Sacramento	25,000	19,250	5,750
San Bernardino	12,000	7,210	4,790
San Diego	25,300	25,300	0
San Francisco	20,000	18,750	1,250
San Jose	25,000	19,200	5,800
San Luis Obispo	15,000	15,000	0
Sonoma	10,000	4,450	5,550
Stanislaus	12,000	3,400	8,600
Totals	353,300	252,230	101,070

The CSU, however, has not looked at campus growth planning from a system viewpoint, in which the needs *and resources* of a broadly defined region shape the development plans of all the campuses that serve it. Rather, each campus has been allowed to develop its own plan independent of the projected changes in enrollment at surrounding campuses. Specifically, these plans do not take into account that campuses in areas that are expected to decline in population could, by trying to attract students from a wider geographic area, minimize both their underutilized facilities and the need for new construction at neighboring campuses with projected enrollment increases.

Focusing on Individual Campuses Means CSU Will Overbuild Statewide. The ultimate result of planning on the basis of individual campus needs is evident in CSU's latest plan. The CSU's five-year capital outlay program proposes that new facilities be added to increase the statewide "on-campus" capacity from about 232,000 full-time equivalent (FTE) students to over 251,000 FTE students. At the same time, however, CSU projects an enrollment increase of about 9,000 FTE—from 228,000 to 237,000 FTE. Consequently, based on the current five-year program, CSU is planning construction of additional facilities that will result in an excess *systemwide* capacity of over 14,000 FTE by the year 1992–93. This would be equivalent to building a campus the size of CSU Chico and leaving it completely empty. Table 46 shows the amount of surplus capacity for each year if the five-year plan is implemented.

Table 46
California State University
Excess Instructional Capacity
(FTE Capacity)

Year	*On-Campus Capacity*	*Projected Enrollment*[a]	*Excess Capacity*
1987–88	232,236	228,335	3,901
1988–89	235,479	231,174	4,305
1989–90	236,756	233,369	3,387
1990–91	249,455	235,001	14,454
1991–92	251,057	236,576	14,481
1992–93	251,613	237,460	14,153

[a] CSU projected enrollment.

California Community Colleges

CCC Capital Outlay. The funds budgeted recently for capital outlay for the CCC have ranged from a low of $8 million in 1983 to a high of $39 million in 1986. The 1987–88 Governor's Budget includes $54.4 million for the CCC capital outlay program. The level of capital outlay has been relatively modest because of the recent decline in statewide enrollments. A substantial portion of the funds recently budgeted for the community colleges has been for replacement of temporary facilities that were installed at some of the colleges when enrollment was expanding. In addition, new capacity projects have been proposed by districts in growth areas of the state.

Regional Growth. The mission of the community colleges is to provide educational services, at the local level, to any high school graduate or citizen over the age of 18. The emphasis on local service, however, should not preclude the districts from cooperating among themselves to alleviate enrollment pressures. For instance, students that cannot be accommodated in the home district should be able to readily attend adjacent (and reasonably nearby) districts that have space available in the required programs. The sharing of facilities or the redirection of students to districts with adequate capacity would require cooperation. Such options, however, should be explored before state funds are approved for new capacity.

Where Is Higher Education Headed Given Current Plans?

Our analysis indicates that parochial rather than systemwide priorities are driving the capital outlay process for higher education. This focus will not help the Legislature make sound programmatic and fiscal decisions about how to address future enrollment needs. Specifically, we find that:

- The high cost research facilities at UC have overshadowed other capital needs in higher education.
- The CSU's planning is misdirected by focusing on individual cam-

puses rather than larger regional and statewide needs. This does not make efficient use of existing campuses.
- Options for meeting regional needs for community colleges should be assessed to make maximum use of existing resources.

What the Legislature Needs to Do to Address Future Needs

The state needs to initiate a planning process for higher education that will result in capital outlay expenditures that are cost-effective and consistent with priorities set by the Legislature. The intermediate steps in the process should identify:

- Options to be considered.
- Policies that need to be established.
- Financing methods that need to be evaluated in the context of long-range state budget plans.

Its end products would be the specific projects needed to meet enrollment growth.

Establish Legislative Policies and Funding Priorities. The Legislature can promote a rational planning process by establishing specific policies and funding priorities with regard to facilities needs. These policies should clearly state the Legislature's intent so that they will serve as a guide to the higher education segments in preparing their long-range plans. They will also assist the Legislature in evaluating capital construction requests from the segments.

The policies and funding priorities that we believe warrant legislative consideration include:

1. ***Instructional space needs shall be considered a high funding priority.*** The Legislature must be assured that California's universities and colleges will be able to accommodate the state's students. Establishing a policy that assigns a high (but not exclusive) priority to instructional space needs would recognize that it may not be financially feasible to finance all instruction and research space to the optimum level. This is not to say that new or high priority research needs must not be addressed. Rather, this policy would emphasize the instructional component of higher education.

2. ***Enrollment planning shall be consistent with the segment's mission—either statewide, regional or community-based.*** Clearly, UC has shown forethought in preparing enrollment plans to the year 2000. The UC has determined that regardless of the geographic location of the increases in the college-age population, existing campuses can be expanded to accommodate the anticipated statewide enrollment. The CSU however, has not adequately prepared a plan that takes account of the system's, as opposed to the campus's, ability to meet regional enrollment increases. Instead, CSU has simply consolidated separate campus and center proposals.

3. ***Existing capacity at CSU and CCC shall be evaluated for potential use to meet enrollment needs through redirection or intersegmental agreements before new facilities are requested.*** Where regional needs would indicate that additional space is needed to house campus programs, the community colleges should evaluate available options including the unused capacity at nearby districts. This could reduce the need for new construction. Moreover, if CSU centers are to meet upper division instructional needs on a community basis, then CSU should initially seek appropriate space at nearby community colleges to house the programs.

4. ***The UC, CSU and community colleges shall prepare long-range plans.*** Our analysis indicates that the Legislature needs to give direction to the planning process so that it will have the information it needs to make decisions about future facilities for higher education in California. Such a policy would require each segment to develop the information needed by the Legislature to make these decisions in accordance with Legislative priorities and policies. The segments must evaluate what new facilities, if any, are needed at existing campuses to meet enrollment growth. The Legislature could then evaluate specific capital outlay proposals, given the enrollment projections.

Summary and Recommendations

We recommend that the Legislature enact legislation (1) setting forth specific planning policies and (2) requiring the University of California, the California State University, and the California Community Colleges to prepare long range enrollment plans and capital improvement plans consistent with the Legislature's policies.

Based on our analysis of the projections of higher education enrollment to the year 2000, the Legislature needs to establish a policy framework that can be used by the three higher education segments to guide the development of efficient capital outlay plans. To begin this process, we recommend that the Legislature enact legislation requiring the higher education segments to prepare enrollment projections and capital outlay plans. We further recommend that the legislation specifically state the Legislature's policies on capital outlay planning for the segments, and that among those policies be the following:

1. Instructional space needs shall be considered a high priority for funding.
2. Enrollment and capital planning shall be consistent with the segment's mission.
3. The CSU and CCC shall evaluate existing capacity at both systems for its potential to meet enrollment needs through redirection or intersegmental agreements before new facilities are requested.

CALIFORNIA'S LONG-TERM CARE SYSTEM

How Can the Legislature Most Effectively Finance and Organize California's Long-Term Care Service Delivery System?

Summary

- *By the year 2020, the number of Californians over age 65 will grow by 111 percent and the number over age 85 will grow by 133 percent.*
- *This older population will create pressure on the Legislature to increase expenditures for long-term care services at a much faster rate than the growth in the overall appropriations limit.*
- *We recommend that the California Medical Assistance Commission (CMAC) evaluate several alternative approaches to funding and providing long-term care services, and report to the Legislature on the costs and benefits of those options.*
- *We further recommend that the Department of Finance prepare a long-term care budget, and submit it in a report to the Legislature.*

The Legislature is at the crossroads in developing a long-term care policy. California needs such a policy because between 1987 and the year 2000, unprecedented demographic shifts and other changes will create pressure on the state to accelerate its expenditures for long-term care services. This rising demand for services will result from a dramatic growth in the population age 65 and over, which currently consumes much of the state's expenditures on long-term care services. One out of every nine Californians, or 3.8 million persons will be age 65 and older by the year 2000. At the same time, the oldest portion of the population—those age 85 and older—which uses the most extensive services, is expected to grow more than *three times* faster than the total population. This growth rate does not diminish, but escalates between the years 2000 and 2020, when the *entire* population over age 65 will grow at three times the rate of the rest of the population.

A dramatic increase in demand for long-term care services would be particularly significant in light of the state's constitutional appropriations limit. This is because the appropriations limit is not adjusted to reflect the disproportionately higher growth in the elderly population.

Assuming that this segment of the population continues to demand extensive services which cannot be accommodated by decreased demands elsewhere, the Legislature will be faced with the following policy options:

- Increase funding for long-term care services by (a) redirecting funding from other public programs to long-term care, and/or (b) expanding the use of alternative sources of funding, such as federal funds or private health insurance.
- Limit the level of services to the population in need of long-term care.

This analysis describes the long-term care services currently available, identifies the factors that will drive future demand, and suggests what the Legislature can do to develop a plan to provide and finance services for a burgeoning clientele.

California Provides a Wide Range of Publicly Funded Long-Term Care Services

In general, California law defines long-term care as a coordinated continuum of services that:

- Addresses the individual's health, social and personal needs.
- Maximizes the individual's ability to function independently outside of an institution.

Long-term care services consist of two components: (1) institutional care (for example, nursing home care) and (2) community-based services. Community-based services include residential care facilities and services which assist individuals to remain in their home instead of being placed in an institution. (Residential care facilities are not classified as "institutional care" in state law. Their level of medical care and funding arrangements differ significantly from institutional care facilities.)

Long-term care services are provided not only to elderly people, but also to younger, chronically ill, developmentally, mentally or physically disabled people by several departments. These agencies include the Departments of Health Services (DHS), Mental Health (DMH), Developmental Services (DDS), Social Services (DSS), and the California Department of Aging (CDA).

Table 47 summarizes the major long-term care services provided in the state. The table demonstrates three important points regarding California's system of long-term care:

- ***Institutional and community-based care account for about the same amount of long-term care expenditures.*** California will spend approximately $3 billion (all funds) for long-term care services in 1986–87. Of this amount, about 50 percent will be spent for institutional care and a like amount for community-based services.
- ***More people use community-based services than reside in institutions.*** For example, 142,000 people annually use home health services—more than the number using any other long-term care service. Approximately 70,000 individuals reside in nursing homes, and 11,000 in state hospitals.
- ***In-Home Supportive Services (IHSS), residential care, and home health care services are the largest community-based services.*** Of the $1.5 billion (all funds) that California will spend for community-based services in 1986–87, 74 percent will be spent for three services. Of this amount, 28 percent will be spent for IHSS, 31 percent for residential care facilities, and 15 percent for home health care.

Table 47
Long-Term Care Services in California
1986–87
(dollars in thousands)

Type of Service	Administrative[a] Agency	Number of People Served	Funding[b] General	Federal	Local	Total[c]
Community-Based Care						
Case Management						
Multipurpose Senior Services Program	CDA	5,400	$11,067	$10,431	—	$21,498
Linkages	CDA	2,500	4,388	—	—	4,388
Title IIIB—Case Management	CDA/AAA	9,200	123	1,583	$495	2,201
Direct Services						
IHSS	County Welfare	119,300	119,558	292,542	16,388	428,488
Title IIIB—In-Home Services	CDA/AAA	3,100	61	2,693	1,240	3,994
Home Health Care[d]	Private	142,000[e]	4,195	221,903	unknown	226,098
Aid and Attendance[f]	Veterans Admin.	unknown	—	30,000	—	30,000
In-Home Medical Care	DHS	100	4,838	4,838	—	9,676
Adult Day Health Centers	CDA	3,100	6,096	5,203	—	11,299
Independent Living Centers	Private	18,800	4,844	735	—	5,579
Rehabilitation Services	DOR	2,700	1,398	2,929	—	4,327
Home-Delivered Meals	CDA/AAA	54,800	6,630	9,914	8,334	24,878
Transportation	CDA/AAA	68,800	202	3,716	1,899	5,817
Housing	CDA/AAA	12,700	3	196	77	276
Adult Protective Services[g]	County Welfare	unknown	10,588	—	3,278	13,866
Alzheimers Day Care Centers	CDA	300	486	—	—	486
Mental Health Care[h]	Private/County	unknown				
Day Treatment		unknown	48,238	21,336	3,193	72,767
Outpatient Services		unknown	114,512	49,752	12,837	177,101
Brain-Impaired	Private	4,000	2,572	—	—	2,572
Residential Care	Private					
SSI/SSP[i]		67,700	200,898	150,787	—	351,685
DMH Supplement		—	13,944	—	—	13,944
DDS Supplement		—	103,176	—	—	103,176
Totals—Community-Based Care		unknown[j]	$657,817	$808,558	$47,741	$1,514,116
Institutional Care						
SNF/ICF[k]	Private	70,000	$521,470	$618,302	unknown	$1,139,772
State Hospitals[l]	DMH/DDS	11,000	184,421	184,421	—	368,842
Totals—Institutional Care		unknown	$705,891	$802,723	unknown[j]	$1,508,614
GRAND TOTALS		unknown[j]	$1,363,708	$1,611,281	$47,741[m]	$3,022,730[m]

[a] CDA=California Department of Aging; AAAs=Area Agencies on Aging; HCD=Department of Housing and Community Development; DMH=Department of Mental Health; DDS=Department of Developmental Services; DOR=Department of Rehabilitation.
[b] Estimates from 1987–88 Governor's Budget for 1986–87 unless otherwise noted.
[c] Totals do not include client share of cost where required.
[d] General Fund amount is Medi-Cal costs; Federal Fund amount includes federal portion of Medi-Cal, and Medicare funds. Medicare amount is projection for federal fiscal year 1985 (FFY 85); Health Care Financing Administration (HCFA) data.
[e] Medicare-funded services only.
[f] Estimate for FFY 85 based on information from Veteran's Administration.
[g] Estimate for 1986–87 based on proportion of Community Services Block Grant (CSBG) funding in 1980–81; includes cost of pilot projects in 1986–87.
[h] Estimate based on proportional funding in 1984–85.
[i] Actual SSI/SSP expenditures for residential care facilities December 1985 through November 1986.
[j] Most individuals use more than one service. Therefore summation does not provide an unduplicated count of total users.
[k] General Fund amount is estimated Medi-Cal costs for 1986–87; Federal Fund amount includes federal portion of Medi-Cal and Medicare funds. Medicare amount is for FFY 85; HCFA data.
[l] Estimated Medi-Cal costs for 1986–87 only. Excludes some additional support for state hospitals provided by DDS.
[m] Does not include unknown local expenditures.

The services shown in Table 47 are discussed in more detail in the *Analysis.* (Please see Items 4180, 4260, 4300, 4440, 5160, and 5180.) In addition to the services included in the table, several cash assistance programs, such as SSI/SSP, housing subsidies, and low-income home energy assistance, provide support to disabled and elderly recipients who live in the community.

Public Expenditures for Long-Term Care Services are Increasing

Table 48 highlights the increase in public expenditures for the four major long-term care services in California: home health care, IHSS, residential care facilities, and nursing homes. Between 1980–81 and 1986–87, total expenditures for these services increased by 57 percent. Federal Medicare and Medicaid funds account for more than half of total expenditures for these services in 1986–87.

Based on our review, we conclude that in general, expenditures for nursing homes and residential care are growing due to operating cost increases. Specifically, in the case of nursing homes, Medi-Cal costs increased by 38 percent, while the number of Medi-Cal recipients in nursing homes declined by 2 percent. These cost increases are primarily due to legislatively required changes, such as increased staffing ratios and annual rate increases. The cost increase may also result from the accelerated

Table 48
Increasing Expenditures for Selected Long-Term Care Services [a]
1980–81 and 1986–87
(dollars in thousands)

	1980–81			*1986–87*			*Percent Change from 80–81*		
	General Fund	*Federal Funds*	*Totals*	*General Fund*	*Federal Funds*	*Total*	*General Fund*	*Federal Funds*	*Totals*
Nursing Homes									
SNF/ICF									
Medi-Cal	$377,696	$370,345	$748,041	$515,901	$512,435	$1,028,336	37%	38%	37%
Medicare [b]........	—	51,883	51,883	—	104,147	104,147	—	101	101
State Hospitals	107,323	107,323	214,646	173,148	173,148	346,296	61	61	61
Residential Care									
SSI/SSP [c]	152,567	91,173	243,740	200,898	150,787	351,685	32	65	44
DDS Supplement	46,849	—	46,849	103,176	—	103,176	120	—	120
Home Health									
Medi-Cal	2,198	1,763	3,961	4,195	4,157	8,352	91	136	111
Medicare [b]...........	—	66,114	66,114	—	217,746	217,746	—	229	229
IHSS									
Services	159,500	103,700	263,200	119,558	292,542	412,100	−25	182	57
Totals	$846,133	$792,301	$1,638,434	$1,116,876	$1,454,962	$2,571,838	32%	84%	57%

[a] Estimates from 1987–88 Governor's Budget for 1986–87 unless otherwise noted.
[b] Medicare amounts are for FFY 80 and projection for FFY 85; Health Care Financing Administration (HCFA) data.
[c] Actual SSI/SSP expenditures for residential care facilities December 1985 through November 1986.

growth rate (16 percent between 1980 and 1985) in hospital-based nursing home beds which Medi-Cal reimburses at a higher rate than other nursing home beds.

Expenditures for home health care and IHSS on the other hand, are escalating due to increased use of services. Both the number of clients and the amount of care per client are climbing.

Demographic Trends and Other Factors Will Increase Demand for Services

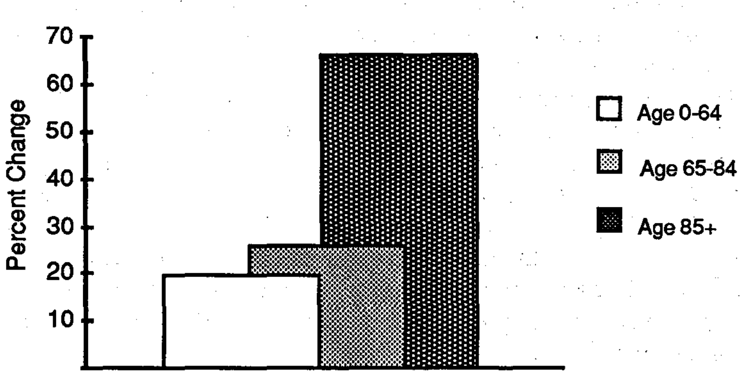
In the future, public expenditures for long-term care services may grow at an even faster pace than that experienced in the past due to the increase in the elderly population and to other trends which will boost the demand for services.

Chart 45 shows the Department of Finance's (DOF) projections of population growth, particularly the expansion of the elderly population. This chart illustrates that between 1986 and the year 2000, the population age 65 to 84 will grow by 26 percent, whereas the total population will increase by 21 percent. Furthermore, the population over age 85 will increase at the fastest rate of all groups—growing by 66 percent. By the year 2000, almost 4 million Californians will be over age 65, including approximately one-half million people age 85 and older.

Chart 45

Percentage Growth in California's Population

1986 through 2000



Greater Demand for Services by Those Over Age 85. The rising number of Californians who are age 85 or older is significant because these individuals are most likely to need long-term care services. In California, for example, about *23 percent* of those age 85 and older reside in nursing homes, compared to only about *3 percent* of those age 65 to 84, and less than one-half of 1 percent of those under age 65. About 6 percent of individuals age 85 or older receive IHSS, compared to about 2 percent of those age 65 to 84.

In addition to demographic trends, the following factors may increase the population in need of publicly funded community-based, as opposed to institutional, long-term care services.

- ***Individuals with chronic physical and mental illnesses are increasingly able to live at home with assistance due to advanced medical technologies and new drug therapies.*** For example, experimental drug treatments may prolong the lives of those with chronic diseases, such as Alzheimer's disease, thereby allowing them to live at home *with appropriate supportive services,* instead of in hospitals or nursing homes.
- ***The mushrooming Acquired Immune Deficiency Syndrome (AIDS) epidemic is placing rapidly growing demands on home and community-based services.*** As of November 1986, there have been 6,620 AIDS cases diagnosed in California. Experts estimate that the caseload will reach about 17,000 by 1991. These individuals, and those with AIDS-related conditions (ARC) will place additional demands on virtually the same home and community-based services utilized by the elderly and disabled, particularly as their lives are extended by new drugs. For further discussion of AIDS, please see Item 4260 of the *Analysis,* and the AIDS issue elsewhere in this part.
- ***Hospitals are reducing the average length of stay for patients because the government and private insurers are reducing reimbursement to hospitals. This results in increased referrals to home health agencies and IHSS by hospital discharge planners.*** For example, Medicare payments to hospitals have been curtailed by the new prospective payment system based on diagnostically related groups (DRGs). Under the DRG process, Medicare pays a fixed amount to a hospital for a particular "diagnosis," without regard to the actual cost of treating a particular patient. In some cases, this provides an incentive for hospitals to discharge patients quicker—and possibly sicker—than they might have in the past, so as to avoid spending more than the reimbursement allows.
- ***The Legislature has initiated a variety of programs which channel people into community-based long-term care programs.*** Public awareness of community-based long-term care services has grown as a consequence of outreach efforts and the proliferation of these services.

- ***Women are increasingly unable to provide free care.*** Women are the primary providers of free care in the community, but are less able to provide that care due to their increasing participation in the labor force.
- ***An increasing number of Medi-Cal beneficiaries will require community-based long-term care services to the extent that there are an insufficient number of nursing home beds for Medi-Cal recipients.*** Some estimates suggest that by the year 2000 California's population may need more than double the number of nursing home beds that currently exist, if admission rates and average lengths of stay do not change. The recent (January 1, 1987) suspension of the state's review process for approving new nursing home beds is likely to increase the total number of nursing home beds available. The extent to which the additional beds are available to Medi-Cal beneficiaries, however, will depend on a variety of market forces, including the Medi-Cal nursing home rate and the amount of private sector demand for beds.

Options for a Long-Term Care Delivery System

A significant increase in the demand for long-term care services is especially noteworthy in light of the state's constitutional appropriations limit. This is because the appropriations limit is not annually adjusted to reflect disproportionately higher growth in the elderly population, but is adjusted only to reflect the state's *total* population growth. To the extent that the demand for services by this segment of the population grows in proportion to its increasing share of total population, it is likely that the demand for long-term care services will grow faster than the appropriations limit. If this growth cannot be accommodated by slowdowns in other areas of the budget, the Legislature may be faced with a growing demand for long-term care services and a diminishing ability to appropriate funds to pay for them. In addition, initiatives by the federal government to limit its share of long-term care costs will increase the pressure on the state to resolve the funding dilemma.

The Legislature has responded to the increasing demand for services by expressing its intent to develop a comprehensive plan for long-term care. The Legislature enacted Ch 1637/85 in order to implement the first phase of "the incremental development of a long-term care service delivery system" by requiring the CDA to establish and coordinate specific community-based long-term care programs. Many of these programs have been implemented. The CDA also has initiated a project to develop local systems to deliver community-based long-term care services.

The state has not systematically analyzed the various alternatives for *funding* a comprehensive long-term care service delivery system in the context of increasing demand for services and potentially limited state and federal resources. To the extent that the state develops such a comprehensive system, it will be important to consider whether or not current funding sources are sufficient and appropriate for the development of an effective long-term care service delivery system. Due to the lack of adequate data, we have not been able to identify the most cost-effective and efficient approach to fund and organize the state's long-term care system. We have identified, however, several options that the Legislature may consider in conjunction or separately as the basis for funding long-term care services in California.

1. ***Medicaid Benefits: Personal Care and Case Management.*** Currently, the Medi-Cal program does not offer two optional federal Medicaid benefits that can be used to fund community-based long-term care services. These benefits are referred to as "personal care" and "case management." Personal care services—for example bathing or dressing—are ordered by a doctor to enable a recipient to be treated at home rather than in an institution. "Case management" is a Medicaid benefit which provides assessment of the individual's needs for services and coordinates the delivery of services to the individual. Federal legislation allows the state to target the case management benefit to specific population groups, but requires it to provide the personal care benefit to almost all Medi-Cal recipients.

Both of these services would be funded 50 percent by the federal government and 50 percent by the state. To the extent that the General Fund currently pays for more than 50 percent of similar services, providing these benefits could reduce the magnitude of the projected increase in General Fund costs for community-based long-term care services. On the other hand, these benefits could result in increased costs to the extent that the federal regulations require a higher level of service, or result in service to an increased number of clients. For example, federal regulations require that nurses supervise personal care service providers, whereas the state does not require such supervision in its IHSS program, which currently provides personal care services.

2. ***Waiver of Medicaid Regulations.*** As an alternative to providing personal care and case management as Medi-Cal benefits, the state could provide these and other services to certain *limited* populations by obtaining waivers of the federal Medicaid regulations. Federal law permits a state to obtain such a waiver to serve specified populations, rather than all Medicaid beneficiaries. For example, the state currently funds a full range of home- and community-based services for elderly persons who are at-risk of institutionalization through such a waiver. This waiver allows the state to use Medi-Cal funds to purchase services such as case management for these individuals. The state also could apply for a waiver specifically to provide services to persons with AIDS.

A waiver may be a cost-effective way to provide long-term care services. This is because federal law requires a state to prove that it is spending no more federal Medicaid funds with the waiver than it would without it, and also permits the state to limit the population that is eligible for services. The limited information available regarding the cost of care indicates that, *in general*, such a waiver would be a less expensive alternative than acute care hospitalization for persons with AIDS. (Please see Item 4260 of the *Analysis* for a further discussion of these options for persons with AIDS.) Waivers may be costly, however, to the extent that they result in programs that overlap with, or duplicate existing programs.

3. ***Social/Health Maintenance Organizations (S/HMOs).*** Currently, the state contracts with HMOs to provide medical services to some Medi-Cal recipients. Under these contracts, the Medi-Cal program pays the HMO a fixed monthly fee for each Medi-Cal beneficiary served by the HMO. This arrangement gives the HMO operator a strong fiscal incentive to control its costs of care, since the operator is "at risk" for cost overruns.

Long-term care services could be provided in a similar manner. Under such an arrangement, a provider (referred to as a S/HMO) would be paid a fixed monthly fee by the state to provide a range of health care *and* supportive social services, including case management and home care.

In 1980, Congress appropriated funds for demonstration projects in four sites to evaluate the costs and quality of care in S/HMOs. One site is in Long Beach, California. The University of California, San Francisco, is scheduled to complete an evaluation of the S/HMO demonstration projects by May 30, 1989. Prior to 1989, some information on costs for S/HMO members will be available. This information may indicate whether or not S/HMOs are likely to provide a cost-effective approach to providing long-term care services in California.

4. ***Additional Levels of Institutional Care.*** Some individuals who are in need of institutional services may require a less expensive level of care than that provided in skilled nursing facilities (SNFs) (nursing homes), which are the primary location of institutional care in California. These individuals may include those with Alzheimer's disease who cannot remain at home or in a residential care facility (RCF), but who do not need the level of medical care provided in a SNF. Such individuals may be more appropriately served in intermediate care facilities (ICFs)—which provide less intensive nursing home care than SNFs—or other kinds of facilities.

Currently, California has a significantly higher ratio of SNF to ICF beds (about 11 to 1) than the national average. Moreover, the average daily Medi-Cal reimbursement rate for SNFs is almost 25 percent higher than the ICF rate ($47.02 for SNFs versus $37.99 for ICFs).

To the extent that there are individuals who need less intensive care than a SNF provides, the state could provide incentives to increase the number of ICF beds or other facilities which provide a less intensive level of care than SNFs. The state already has taken some steps to expand the available levels of care. For example, the state provides supplemental rates for RCFs which serve developmentally disabled residents or those with specific mental health problems. In addition, the Department of Social Services (DSS) is currently preparing an implementation plan to establish a supplemental rate structure in residential care facilities for the elderly (RCFE), pursuant to Ch 1127/85 (SB 185). If the supplemental rates are implemented, RCFEs would provide a level of care that is higher than the traditional RCF, but lower than ICFs.

In addition to these efforts, there may be other steps which the state can take in order to encourage the development of facilities which offer a different level of care than SNFs. For example, some nursing home operators assert that the major barrier to the creation of more ICF beds is the cost of complying with licensing regulations that are virtually identical to those placed on SNFs, although the reimbursement rate for ICF beds is lower than that for SNFs. In order to address this issue, the state could modify the licensing regulations or increase the reimbursement rate for ICF beds.

5. ***Private Long-Term Care Insurance.*** To the extent that individuals purchase private insurance which covers the cost of long-term care services, public costs for those individuals can be avoided. Although private insurance companies offer long-term care policies in California, few people purchase the policies, and the services covered are generally limited. Pursuant to recent legislation, the Department of Insurance is preparing a report on the feasibility of offering private and public insurance for *community-based* long-term care services. The report is due to the Legislature by June 30, 1987.

Legislation in other states has focused on regulating insurance policies to protect the consumer, including the establishment of minimum benefit provisions, and implementation of consumer education programs to encourage the purchase of long-term care insurance. The Department of Insurance report in combination with the experience in other states may suggest options that the Legislature may pursue so as to expand the consumer market, by both assuring the purchase of minimum benefits and providing insurers incentives to market comprehensive long-term care policies.

California Needs to Evaluate Its Options for Financing and Organizing its Long-Term Care Service Delivery System

We recommend that the Legislature adopt supplemental report language which requires the California Medical Assistance Commission to submit a report to the Legislature by September 1, 1988 which analyzes the

potential costs, benefits, and impact on the service delivery system of several funding options for long-term care services.

Development of a long-term care policy would be facilitated by an analysis of the potential savings and costs of alternative methods of financing California's long-term care system, including the five options just discussed. Therefore, in order to provide the Legislature with a comprehensive review of this issue, we recommend that the California Medical Assistance Commission (CMAC) submit a report to the Legislature which analyzes the various options available for financing California's long-term care system. The commission's report should address the following issues:

- How will each alternative affect services and beneficiaries in the short and long-term?
- Will each alternative increase or decrease net costs in the short and long-term?
- How can the Legislature structure each alternative to maximize service coordination and minimize costs?

We recognize that CMAC will require some additional resources to prepare this report. At the time we prepared this analysis, the level of resources required was not known.

The following supplemental report language is consistent with this recommendation:

> "The California Medical Assistance Commission (CMAC) shall submit a report to the Legislature by September 1, 1988 which analyzes the potential costs, benefits, and impact on the beneficiary population and the service delivery system of various funding options for long-term care services. At a minimum, CMAC shall review the funding options identified in *The 1987–88 Budget: Perspectives and Issues*. The commission may include any additional funding options which it considers appropriate. The Departments of Health Services, Social Services, Aging, Developmental Services, Mental Health, and Insurance shall participate in the preparation of this report by providing to CMAC information and consultation, including data and data analysis, to the extent necessary to complete this report."

The Department of Finance Should Develop a Single Long-Term Care Budget Report

We recommend that the Legislature adopt supplemental report language which requires the Department of Finance, in consultation with various departments, to prepare a comprehensive long-term care budget report for 1988–89 and submit it to the Legislature by January 10, 1988.

Currently, it is difficult for the Legislature to determine how much state and federal money is spent on long-term care programs and the number of individuals who receive these services in California. This is because no one department administers all of the long-term care programs in California. Rather, various departments are responsible for different programs. In addition, expenditures for long-term care services are not identified separately from other expenditures in the various departments' budgets.

Although California has not consolidated all of its long-term care services in one department, it could, for budgetary purposes, consolidate all fiscal information concerning long-term care programs into one report. Such a report would offer the following benefits to the Legislature:

- The Legislature would be able to evaluate growth in program expenditures relative to growth in other related programs. For example, if the Legislature amends the state Medi-Cal plan to include the personal care benefit, the DHS could identify a resultant decrease in the projected growth in General Fund expenditures for existing, similar services under IHSS (in the DSS budget).
- The Legislature would be able to compare program expenditures—for example, expenditures on community-based versus institutional services—as a basis for its decisions about future expenditures.
- The Legislature could identify service duplication among different departments. For example, if three different departments reported expenditures for respite care services, the Legislature could evaluate whether or not it could reduce administrative costs by locating all the programs in one department.

Therefore, we recommend that the Legislature adopt supplemental report language which requires the Department of Finance, in consultation with various departments, to prepare a comprehensive long-term care budget report for 1988–89, and submit it to the Legislature by January 10, 1988.

The following supplemental report language is consistent with this recommendation:

"The Department of Finance shall prepare a comprehensive long-term care budget for 1988–89 and provide it in a report to the Legislature by January 10, 1988. The budget shall include, but not be limited to, the following information:

"1. Federal and state expenditures for long-term care services for 1986–87, 1987–88, and proposed expenditures for 1988–89. In departments which fund more than one service, each service shall be identified separately.

"2. The department that actually administers the funds.

"3. The number of persons receiving services including the extent of service to the target population (elderly, developmentally disabled)."

STATE REGULATION OF THE TRUCKING INDUSTRY

Is Continued Economic and Safety Regulation of the California Trucking Industry by the Public Utilities Commission (PUC) Necessary?

Summary

- *The PUC, after several years of relaxed regulation of the trucking industry, has recently increased its economic regulation of that industry.*
- *The increased oversight by the commission is intended to address concerns regarding profitability, safety and service.*
- *The evidence, however, indicates that the industry is highly competitive, and that economic regulation is not necessary. In particular, there appears to be little relationship between regulation and safety, indicating that this concern should be addressed through direct enforcement, where a strong relationship exists.*
- *We recommend that the Legislature enact legislation terminating the PUC's economic regulation of the trucking industry.*
- *We further recommend that the Legislature consider alternative means of improving safety in the trucking industry.*

In April 1986, the California Public Utilities Commission (PUC) issued a decision which provided for a significant increase in the commission's economic regulation of the trucking industry. That decision was completely contrary to the direction that both state and federal regulatory efforts had taken throughout the decade. As a consequence, the PUC's action raises fundamental questions regarding the need for continued state activity in this area. In this section, we reexamine the purported bases for economic regulation of motor carriers of freight and offer recommendations as to the level and provision of state regulatory efforts.

Profile of the California Trucking Industry

The trucking industry in California is large and diverse. Table 49 summarizes the number of motor carrier companies and vehicles found on California's highways, classified by their regulatory status. The table indicates that of the almost 770,000 trucks registered to operate in the state, only 300,000 are subject to economic regulation by the PUC. Also, a considerable portion of the 300,000 total consists of *exempt* trucks, which the commission has chosen to regulate in a limited manner only. All other trucks — the 306,000 interstate carriers which come under the jurisdiction of the federal government and the 160,000 unregulated private carriers (trucks hauling property solely for the company owning the trucks) — are not regulated by the PUC. Thus, the commission exercises rate regulation over a relatively small portion—less than 40 percent—of the state trucking industry.

Table 49
Motor Carriers of Property
Companies and Vehicles Operating in California
1985–86

	Companies	*Vehicles*
PUC Jurisdiction:		
Regulated	19,000	300,000 [a]
Exempt [b]	7,753	
Federal Jurisdiction [c]	14,673	306,069
Unregulated Private Carriers [d]	Unknown	160,000 [e]

[a] This number is a "best guess" estimate by PUC staff and includes all vehicles subject to PUC regulation regardless of size.
[b] For-hire carriers that must file for an authority to operate but are not subject to rate regulation.
[c] These carriers are not regulated by the PUC but are required to register with the PUC and purchase identification stamps for each vehicle that may operate in California. Some of these vehicles actually spend only a small amount of time in California.
[d] Vehicles that haul property only for the company owning the vehicle (for example, Safeway, Frito Lay or Longs Drugs). These carriers must register only their vehicles with the DMV. The DMV does not gather statistics on the number of vehicles belonging to particular companies; therefore, no accurate data exist for either the number of vehicles or companies.
[e] This estimate is based on the number of vehicles registered with the DMV in the "over 5,000 pound" weight class, and is consistent with estimates by individuals with industry experience.

Those motor carriers regulated by the PUC operate under one of two basic types of authority: (1) common carrier *certificates* of "public convenience and necessity" and (2) highway carrier *permits*. Common carriers must offer service to the general public in a nondiscriminatory fashion (that is, provide a given service to *all* comers). Highway permit carriers,

Table 50
Motor Carriers of Property
by Type of PUC Authority
1985–86

Carrier Classification	
Certificated Carriers:	
Highway common	5,500
Cement	179
Total Certificates	5,679 [a]
Permitted Carriers:	
Highway contract	17,436
Agriculture	6,528
Dump truck	5,923
Heavy-specialized	2,901
Household goods	1,401
Livestock	426
Tank truck	1,037
Vacuum truck	374
Cement	25
Agricultural, seasonal	188
Livestock, seasonal	3
Dump truck, temporary	331
Total Permits	36,573 [b]

[a] These 5,679 certificates are held by 5,427 carriers, with some truckers holding multiple authorities.
[b] These 36,573 permits are held by 22,040 carriers, with many truckers holding multiple authorities.

on the other hand, contract with a few shippers or with other trucking companies and serve them exclusively. They cannot accept freight from the general public. Table 50 provides detail on the number and types of certificated and permitted carriers.

Current Governmental Regulation of Trucks

Currently, state regulation of commercial motor carriers of freight is carried out by three state agencies: the PUC, California Highway Patrol (CHP), and the Department of Motor Vehicles (DMV). Table 51 provides an overview of the resources devoted to both bus and truck regulation by each of these agencies.

Table 51
State Motor Carrier Regulatory Programs[a]
Appropriations and Authorized Positions
(dollars in thousands)
1986–87

PUC	*Positions*	*Appropriations*
Licensing	132	$7,090
Regulation of Rates	126	10,997
Service and Facilities	12	1,368
Totals	270	$19,455
CHP		
Commercial Vehicle Inspections and Enforcement	336	$24,877
Motor Carrier Safety Operations	105	5,890
Totals	441	$30,767
DMV[b]		
Vehicle Registration	730	$34,994
Driver Licensing	45	1,934
Totals	775	$36,928

[a] Data include allocations for departmental overhead and include expenditures on both bus and truck regulatory activity.
[b] DMV does not account separately for the portion of its registration and licensing activities that are directed toward motor carriers and their drivers. These estimates are based on the ratio of commercial vehicles and licenses registered to total vehicles and licenses registered. Therefore, these figures cannot be considered precise expenditure levels or personnel allocations.

PUC. As noted above, the PUC regulates only "for-hire" motor carriers engaged in *intra*state commerce. It has no jurisdiction over *inter*state carriers or private, "company-owned" trucks. The PUC exercises its authority primarily through entry and rate regulation.

- ***Entry Regulation.*** The PUC establishes "fitness" criteria for the issuance of an operating authority (either a certificate or permit). These criteria include (1) proof of financial responsibility, (2) proof of liability insurance, (3) proof of residency in California, and (4) in the case of dump trucks and bulk dry cement carriers, proof of the need for the service. The commission historically has pursued a relatively open entry policy (with the exceptions of the dump truck and cement carrier segments of the industry), which remains in force today.

- ***Rate (or "Tariff") Regulation.*** More importantly, the commission has the authority to approve the rates trucking companies charge businesses to haul goods. In effect, the PUC determines appropriate *costs* for all carriers and then sets and approves rates needed to recover such costs and return a reasonable profit. In 1980, the commission initiated a less restrictive policy of rate regulation, with the goal to prepare the industry for further deregulation. In April 1986, however, the commission changed direction, ordering an immediate 10 percent increase for all filed tariffs. It also ordered (1) thorough cost justification for all tariffs outside a 10 percent "window" (5 percent above or below its baseline tariffs), and (2) annual adjustments in the baseline tariffs to reflect changes in the costs of providing trucking services. The commission's main justifications for this policy reversal were concerns over a perceived low level of carrier profits and the fear that low profits would have an adverse effect on vehicle and operator safety.

The PUC has no *direct* responsibility for motor carrier safety. Its involvement is limited to (1) suspending operating authority for persistent violations (most of which are identified by the CHP), and (2) verifying that carriers have met fitness requirements, such as the submission of signed statements that they will maintain their vehicles.

CHP. The CHP enforces vehicle and operator safety as defined in state and federal statutes. This enforcement activity is pursued through three major programs: (1) on-road inspections of documents and "critical" items, such as brakes and tires, (2) maintenance facility and records inspections, and (3) rules-of-the-road violation enforcement.

DMV. The DMV is responsible for licensing vehicles and operators. Drivers are issued licenses only after they successfully pass an administered written and practical driving exam and a physical exam. The driving exam takes place in a vehicle of the class for which the license is issued. The DMV can waive the practical exam if a driver provides certification of competence from a qualified employer. The DMV also maintains the operator records, including records of all rule-of-the-road violations.

Federal Regulation. Interstate motor carriers of freight or passengers are regulated by the Interstate Commerce Commission (ICC). Prior to 1978, the ICC pursued a very restrictive regulatory policy with regard both to entry and to rate competition. In 1978, the ICC began administratively to relax its regulatory oversight. This trend accelerated with the passage of the Motor Carrier Act of 1980 (P.L. 96-296), which partially deregulated the trucking industry. Today the ICC takes a very relaxed approach both to entry *and* rate regulation.

Arguments Made for Economic Regulation

Economic regulation is that set of policies adopted by government to control and oversee the structure and conduct of an industry for the benefit of all segments of society. Generally, regulation is necessary only in cases of severe "market failure," such as a lack of competition in the provision of a service (as with monopolies) or the inability to reflect in market prices the full costs of production (such as pollution costs). Over the years, several alleged problems with the trucking industry have been used to justify government intervention. These problems fall into the following three general areas.

Market Instability. Some have argued that the market for transportation services is in some way flawed, resulting in inefficiencies or inequities. The two major scenarios are:

- *Market Concentration.* This argument assumes that in the trucking industry there are both economies of scale (costs per unit of output that decline as output increases) and barriers to entry (high costs that face would-be entrants). As a consequence, "advantaged" firms can use predatory pricing (temporarily pricing below cost), price discrimination (varying the price of a service to exploit the individual customer's willingness to pay), or other strategies to drive out or prevent entry by other, less advantaged firms. Ultimately, a few firms become dominant and the industry becomes noncompetitive, resulting in higher prices and lower output than would exist in a perfectly competitive situation.
- *Market Chaos.* In this scenario, competition in the trucking industry leads to rampant, cut-throat pricecutting. The result is a volatile price environment, leading to excessively high rates of entry and exit as prices vary in cycles. Ultimately, society is harmed because the constant price changes and turnover cause such confusion in the market that shippers begin to choose less efficient transportation modes.

Quality of Service. Another argument in favor of regulation is the proposition that motor carriers prefer not to serve small shippers and remote, rural areas. If a carrier does offer service, it will only be at rates that are out of proportion to differences in the cost of providing the service.

Public Safety. Finally, it is argued that economic regulation is necessary to ensure an appropriate level of safety in motor carrier operations. Presumably, truckers can earn *higher* profits in a more regulated environment, with some of these added funds used to increase vehicle maintenance and enforce safe driving behavior. Absent regulation, any downward pressure on carrier profits leads to reduced vehicle maintenance and increased pressure on drivers both to speed and to drive for long periods without rest. The result, it is asserted, is equipment that is more prone to failure and drivers that are under greater stress and more fatigued.

The Evidence Does Not Support the Case for Regulation

The trucking industry has been heavily researched over the last 15 years. The vast majority of researchers examining this industry have concluded either that the problems discussed above do *not* exist or that economic regulation is not the means to address the problems. (For example, the *best* approach to addressing the safety issues which have concerned the Legislature in recent years is the *direct enforcement* approach, as shown below.)

No Reason to Expect Market Concentration. There has been considerable analysis on the issues of economies of scale and entry barriers in the trucking industry. With regard to the former, the consensus is that for most carriers—the "truckload" carriers—the economies are *small* compared to the size of the market. The story is somewhat different for "less-than-truckload" (LTL) carriers. These carriers, who combine relatively small shipments from several shippers, require more rolling stock, marketing skills, sophisticated operational controls and distribution centers. As this infrastructure is more costly, it is likely that the LTL market will be composed of fewer, but larger carriers than is the case for the truckload market. This is because large LTLs can spread the overhead cost over many more shipments. It appears, however, that even here economies are modest compared to the size of the market.

With regard to barriers to entry, the evidence indicates that there are no significant constraints. (The exception to this finding is cement carriers, where entry is effectively foreclosed by the PUC). Highways are available to all trucks and buses; therefore, terminal and right-of-way bottlenecks of the kind found in the airline and railroad industries are not relevant. Insurance has been an issue recently, but while expensive, it is generally available. The most significant cost for the truckload carrier is the truck, which seldom costs more than $100,000. This is a relatively low capital cost even for a small business. Entry into the LTL segment does require significantly more financial resources, but the requirements are not large relative to other industries. Even if it were difficult for new carriers to start LTL operations from scratch, there are many potential entrants from other transportation-related companies.

No Sign of Market Chaos. The past few years have been dynamic—and therefore unstable—ones for the trucking industry. Given governmental deregulation and a not-so-robust economy, motor carriers have had to adapt to the new environment and take steps to control costs. As a consequence, there *has* been increased entry and exit of firms in the industry and increased price volatility. But these should not be viewed as "market chaos." On the contrary, they indicate a movement toward a more efficient allocation of resources. The fact that entry is strong suggests that carriers see profit opportunities in the industry. At the same time, the exit of other carriers indicates that some firms have failed to adapt to changing market conditions. Our analysis indicates that what is occurring in the trucking industry is neither destructive nor in need of regulatory remedies.

No Denigration of Service. Our review of the studies on the impact of deregulation on service suggests that small and rural shippers generally are *not* disadvantaged because of geographic location or size. These studies identified isolated instances of reduced service and increased prices; however, for many shippers *more* service alternatives are available in a deregulated environment. This should not be surprising, as the level of competition both within the trucking industry and from other transportation modes works to assure some alternative transportation service to all shippers.

Little, If Any, Impact on Safety. The relationship between economic regulation and safety is more difficult to analyze, primarily because of the lack of data on this issue. What data does exist suggests that the connection is weak. On the other hand, 10 years of data supplied by the CHP demonstrate the dramatic reduction in accident rates that results from increased *direct* safety enforcement.

On a conceptual basis, it would appear that rate regulation could *not* be counted on to induce increased expenditures on maintenance or driver training. This is because increased initial profits generated by a rate increase would subsequently be dissipated by new entry into the industry. And, even if increased revenues failed to generate additional entry, empirical evidence suggests that there is a tendency for operating costs, such as wages and salaries, to drift upward, squeezing profits. In either case, higher initial profits provided through regulation would not *necessarily* translate into safer operations.

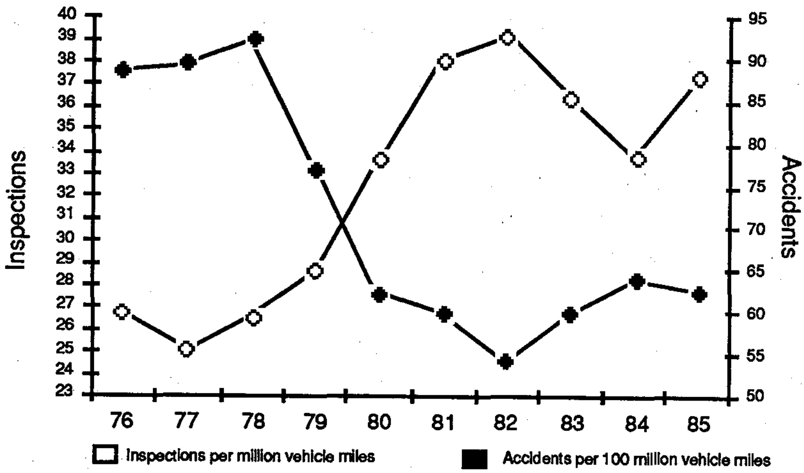
The evidence that is available on this issue bears out this conclusion. We reviewed three national surveys that attempted to identify differences in accident rates based on levels of regulation and ownership of vehicles. None of the three surveys found any significant differences in accident rates between unregulated carriers (private and exempt carriers) and regulated carriers.

While there is no demonstrable relationship between economic regulation and safety, there appears to be a strong relationship between *direct safety enforcement efforts* and safety. Chart 46 presents CHP data on (1) truck "at fault" accident rates and (2) CHP truck inspection rates for the

1976 through 1985 period. The chart shows a dramatic inverse relationship between inspection rates and truck accidents. This evidence suggests that direct field enforcement activity—as opposed to indirect regulatory efforts—is the more effective way of addressing safety concerns.

Chart 46

CHP Truck Inspection and Truck at Fault Accident Rates
1976 through 1985



Source: California Highway Patrol, "Critical Item Inspection Fact Sheet," State of California, Sacramento, 1986.

Experience With Trucking Deregulation. As the preceding discussion indicates, there appears to be little theoretical support for the need to regulate the trucking industry. Fortunately, there is also "real world" evidence in support of this conclusion from states which have recently deregulated their motor carrier industries. Since 1980, Wisconsin, Florida, Arizona, Alaska, Vermont and Maine have eliminated intrastate truck regulation. Studies that examined the results of deregulation in three of the states confirm that there has been no systematic degradation of service or "market chaos," and that motor carriers were providing *equal or better* service than before deregulation. In fact, shippers found many truck companies working harder to accommodate their needs and offering better service than previously.

Additional evidence comes from two PUC-commissioned studies designed to examine the impact of its regulatory policy since 1980. These studies found that:

- No general problems were created by the relatively relaxed regulatory environment;
- Service for most shippers either remained the same or improved; and
- Rates remained relatively stable but began to reflect the costs of service.

The studies did uncover some isolated examples of reduced service, but these instances were neither widespread nor sufficiently pervasive to suggest a need for increased regulatory oversight.

The Legislature Should End PUC Regulation Over the Trucking Industry

We recommend that the Legislature enact legislation terminating the PUC's economic regulation of the trucking industry because such regulation has not been shown to be necessary or productive. We further recommend that the Legislature consider alternative means of improving safety in the trucking industry.

Our analysis of the PUC's regulation of the trucking industry indicates that the commission's activities are unnecessary. The trucking industry is, in fact, an excellent example of a competitive market: many players, relatively low entry barriers and relatively small economies of scale. As such, the motor carrier market is unlike certain other recently deregulated industries (such as long-distance telephone and airline services), where vigorous debate as to the need for governmental regulation continues.

Accordingly, we recommend that the Legislature enact legislation which eliminates the PUC's authority to establish rates and entry requirements for motor carriers. This could be accomplished by eliminating many, and modifying certain, provisions of the Public Utilities Code.

We believe the complete deregulation of the industry would result in: (1) a reduction of about $17.5 million annually in the regulatory fees imposed on the industry; (2) a reduction in the regulatory-related administrative costs incurred by motor carriers, and (3) a more efficient, innovative, cost- and service-conscious industry. This is not to say the deregulation of the trucking industry would be a painless process. There would be some losers, dislocations, service reductions and price increases. The benefits to industry and consumers from deregulation, however, would greatly exceed the costs.

Safety Concerns. In recent months, there has been concern expressed by the Legislature about the growing number of truck accidents occurring in the state. In response to this trend—and to some specific, serious motor carrier accidents during 1986—the Legislature recently enacted laws which increased the PUC's and the CHP's ability to respond to motor carrier safety violations.

In light of this, it may seem ironic that we are recommending termination of the PUC's regulatory involvement with the trucking industry. As we discuss above, however, there is basically no evidence—conceptual or empirical—which indicates that economic regulation leads to improved safety. Consequently, we see no reason to continue such regulation simply on the *hope* that it will help address safety concerns. Economic regulation is an inefficient way to tackle a problem best addressed through *direct* safety requirements and enforcement. In fact, a reliance on PUC regulation may detract from other, more effective methods of addressing the safety problem.

Therefore, in conjunction with our recommendation regarding the PUC, we recommend that the Legislature consider the following safety-related actions:

- ***Codify Certain Existing PUC Requirements.*** Currently, the PUC requires, as part of its entry regulation, that carriers provide proof of insurance and certification that vehicles will be maintained and drivers monitored. In lieu of PUC regulation, the Legislature could place these requirements in statute and direct other entitites to enforce them. For instance, the CHP could check all driver and vehicle records whenever it stops a truck. CHP enforcement would be much less expensive than the PUC's current regulatory processes.
- ***Clarify and Strengthen the Role of the CHP.*** The CHP is currently the chief enforcement agency when it comes to ensuring truck safety. This role, however, could be clarified in statute, and then strengthened by: (1) empowering the CHP to "ground" all of the vehicles of any carrier found to have excessive safety violations, (2) increasing the penalties for vehicle code violations by motor carriers, and (3) adding field personnel to improve truck compliance with driver and truck maintenance requirements.

In short, we believe that reducing reliance on the PUC's paper-intensive, indirect safety role, and increasing on-the-road, direct enforcement by the CHP, would be the most effective way to promote safety.

INFRASTRUCTURE—THE SILENT COST

What Can the Legislature Do to Assure That the State's Infrastructure Meets the Needs of the People of California Now and In the Future?

Summary

- *California faces the combined problems of (1) an aging infrastructure which has not been adequately maintained, and as a result requires expensive "catch-up" deferred maintenance and (2) the need to expand several capital outlay programs to serve population increases.*
- *Both traditional and alternate sources of funds for infrastructure projects face constraints, due to falling oil prices and the appropriations limit.*
- *If the Legislature wants to meet its own priorities, rather than the administration's, with the limited funds available, the capital outlay budget process needs to be improved.*

The State's Infrastructure

The state's infrastructure consists of a wide range of facilities such as highways, campuses of our higher education institutions, prisons, hospitals, and office buildings, as well as their related utility systems. This discussion outlines an approach for protecting the investment in this system and ensuring that it meets the needs of the people of California, now and in the future. We devote special attention to (1) the lack of information about the state's overall infrastructure needs, (2) the lack of a plan to address and fund these needs, and (3) suggestions on how the administration and the Legislature can better address these issues.

Problems Among State Institutions

This section discusses some of the problems currently facing state institutions. (Infrastructure problems related to highways and water treatment are discussed separately in the following article.) These problems include "catch-up" or deferred maintenance, regular rehabilitation which preserves existing facilities, and demands for new or expanded facilities.

Regular versus Deferred Maintenance. Expenditures which maintain and preserve existing facilities are defined as regular maintenance. Whenever state agencies fail to maintain their facilities on a current basis, they incur a hidden cost which is shifted into the future. Addressing these "catch-up" costs is called deferred maintenance and, in most cases, it involves more expense than if the problems were addressed on a current basis. Unfortunately, nearly all state agencies have deferred maintenance problems due to past neglect and the diversion or absence of regular maintenance funding.

Higher Education. The three segments of higher education—the University of California, California State University, and the California Community Colleges—maintain a total of 86 million square feet of building space plus extensive institutional utility systems which serve their campuses.

A major portion of this infrastructure was constructed during the 1960s when there was a sharp increase in enrollments. Several campuses, however, have infrastructure elements which were constructed in the early part of this century. Regardless of age, these institutions have elements which are either obsolete or rapidly approaching obsolescence and are in varying stages of deterioration. The seriousness of this problem is illustrated by the growing demand for deferred maintenance funding. The respective segments of higher education now estimate that they have deferred maintenance "needs" of $282 million. This estimate has grown by $67 million over the last year, despite the provision of $41 million for this purpose in the 1986 Budget Act.

Compounding the maintenance problems for higher education are:

(1) Technological advances in sciences and engineering, and the increasing use of computers in these institutions which will necessitate major alteration and expansion or upgrading of utility systems, and

(2) The need to expand these facilities to accommodate a substantial increase in enrollment which is projected for the latter half of the next decade.

Correctional Facilities. California's adult correctional system includes 12 institutions constructed prior to 1960. As a result of age, general lack of proper maintenance and intense use (especially under the extreme overcrowding typical of the past several years) the condition of these infrastructure elements is nearing a critical stage. For example, in 1980 the California Department of Corrections (CDC) submitted a "Facilities Requirement Plan" to the Legislature which estimated that $368 million was needed to bring these institutions into compliance with fire, life/safety and seismic code requirements. Over the last six years, very few of these problems have been solved, and as a result, the cost to correct them today is over $500 million. In addition, substantial amounts will be needed to upgrade and correct deficiencies in the utility systems and security arrangements of these older institutions. An example is the court-ordered improvements at San Quentin prison. These changes, estimated to cost nearly $40 million, will make "temporary" improvements to a portion of this prison but will not address major deficiencies regarding seismic safety and the utility systems.

Overshadowing the problems at existing prisons is the need to provide new capacity. The problem facing the Legislature and the administration is the continuing upward spiral in the prison population. For example, in the spring of 1986 the CDC projected a population of 68,405 inmates by June 1990. Less than six months later, the CDC's projections for the same period had risen to 88,140 inmates—a 29 percent increase. Based on the latest population projections, the administration and the Legislature will be faced with providing at least $2.2 billion to construct more prisons. This is in addition to the $2 billion which has already been appropriated for expansion of the prison system.

To a lesser degree, the California Youth Authority (CYA) also is faced with an aging infrastructure and increasing population. To our knowledge, there has not been a comprehensive assessment of the infrastructure needs at the 11 CYA institutions. These institutions, however, are generally over 20 years old. It would be reasonable to expect them to have many of the same problems as the CDC institutions.

The Youth Authority is projecting a population of 9,015 youths by June 1991. This is 1,365 (18 percent) more youths than the June 1986 population. The CYA's construction plan (estimated to cost over $120 million) to accommodate this increased population includes expansion of existing institutions plus construction of two new ones. The source of funds for this expansion has not been identified.

Developmental Centers/State Hospitals. The state owns and operates seven developmental centers under the Department of Developmental Services and four state hospitals under the Department of Mental Health. These centers and hospitals provide 24-hour care to approximately 11,500 persons. The client living areas in the developmental centers have been upgraded recently to meet current code and licensing requirements. The Department of Mental Health is in the process of upgrading all patient living areas to meet similar code requirements. For the most part, however, the substandard conditions in the other areas of these facilities and in the utility systems have not been assessed.

State Office Buildings. Most state-owned office buildings have been adequately maintained over the years, but some have elements which are aging and deteriorating.

The state also leases about 12.6 million square feet of space. In Sacramento, the annual *cost* of this leasing has doubled over the last six years, from $21 million to $42 million, while the *amount* of leased space increased by less than 10 percent. Both our office and the Department of General Services have found that, in most cases, it is more economical for the state to occupy state-owned space rather than leased space. In view of the ever increasing annual lease payments (most of which are counted toward the state's appropriations limitation), the priority of financing state-owned space needs to be addressed.

Funding Problems

The state faces two major problems in attempting to meet its infrastructure needs over the next decade. These problems are:

1. Substantial funds will be needed each year for maintenance, alteration and expansion of facilities, and

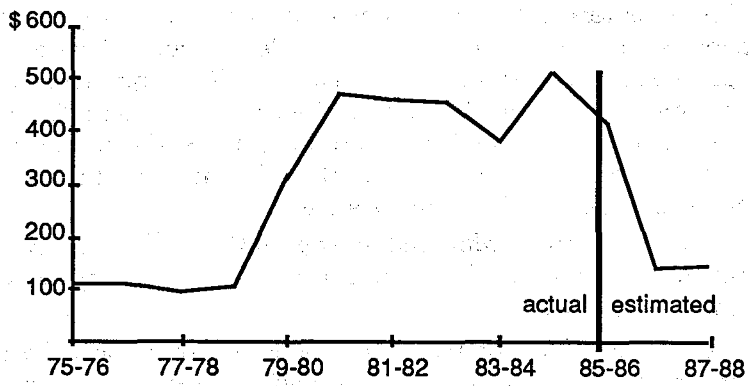
2. These demands will come at a time when traditional funding sources are less available, and alternative funding mechanisms are more limited.

For example, improvements and the expansion of state facilities have traditionally been financed by tidelands oil revenues and general obligation bonds. Both of these sources are "outside" of the appropriations limit imposed by Article XIII B of the State Constitution. In recent years, two other funding sources have been used, namely revenue bonds and lease-purchase arrangements. By contrast, these types of financing are subject to the appropriations limit.

Chart 47

State Tidelands Oil Revenues

1975-76 through 1987-88 (in millions)



Tidelands oil revenues have been the foundation for most of the state's capital outlay expansion funding, except for parks and prisons. The recent volatility in oil prices has significantly constrained this traditional funding source. As Chart 47 shows, these revenues reached a peak of $516 million in 1984–85, but fell by 70 percent, to $140 million, in the current fiscal year. The Governor's Budget anticipates a moderate improvement, to $150 million, in 1987–88. While the state can expect a continued flow of these revenues in the future, the instability of oil prices has disrupted any long-term planning which depends on predicting the magnitude of these revenues.

For a different reason—namely the state's appropriations limit—revenue bonds and lease-purchase arrangements are less desirable sources of funding. This is because the resulting annual costs will be counted against the appropriations limit. The Department of Corrections, for example, has authorization to finance nearly $1 billion of prison construction from these sources. The University of California and the California State University also are heavily involved in revenue bond financing. The annual servicing cost of these instruments will be about $140 million. As a result, this type of funding will compete with other state programs for unused appropriations authority. If the corrections and higher education programs had been funded by either tidelands revenues or general obligation bonds, by contrast, these costs would be outside the limit.

Maintenance expenditures at state institutions and in most state office buildings also will be competing for appropriations authority within the limit.

These funding and appropriations authority constraints make it more important than ever for the Legislature to develop an *overall* plan to meet the state's infrastructure needs. Unfortunately, the state's current capital outlay budget structure and the information available to the Legislature do not facilitate this type of review.

Ways to Improve Infrastructure Budgeting

Currently, budgeting for the state's infrastructure is fragmented. Some agencies prepare long-term plans which cover expansion needs, but few, if any, have systematic plans for addressing maintenance and eliminating deferred maintenance requirements. The Legislature's ability to address these issues would be enhanced if:

- Each department were required to prepare annual five-year capital outlay programs covering maintenance, alterations and expansion needs
- Standards were established for addressing both current and deferred maintenance problems,
- The Department of Finance were required to consolidate these departmental requests into an overall statewide program which could be evaluated by the Legislature, and
- Restrictions were placed to ensure that funds were expended as budgeted.

This type of information would give the Legislature better insight into the state's overall capital outlay needs—both for the budget year and the immediate future. As a result, the Legislature would be in a better position to establish its own goals and priorities rather than react to administration proposals.

TRANSPORTATION AND SEWAGE TREATMENT INFRASTRUCTURE

What Funding Options Are Available to the Legislature to Address the Funding Problems the State Faces in Rehabilitating and Improving the State's Highway System, and in Constructing Sewage Treatment Facilities?

Summary

- *More than $13 billion in highway system improvements would be required, in addition to currently programmed expenditures on highway and mass transportation programs, to expand the system's capacity to accommodate projected increases in highway traffic over the next decade. The system will also require increasing maintenance and rehabilitation funding as it gets older.*
- *Locally-owned sewage treatment facilities require about $5 billion in improvements in order to meet state and federal standards, and an additional $2 billion to $4 billion to accommodate growth to the year 2005.*
- *In both of these areas, the Legislature may wish to reexamine the traditional division of state and local responsibilities, particularly in light of declining federal assistance and the state appropriations limit.*
- *To increase transportation funding, the Legislature could rely on pay-as-you-go financing through raising highway user charges such as motor fuel excise taxes and weight fees. However, the use of these revenues could be constrained by Article XIII B of the State Constitution. The Legislature could also rely on debt financing through issuance of either general obligation bonds or revenue bonds. Bonds that are approved by voters provide funds which can be expended outside Article XIII B's appropriations limit.*
- *In the area of water treatment, various bond financing options are available to the Legislature to assist local agencies in raising the needed funds. The ability of localities to finance treatment plant construction is unclear. This information should be provided by the State Water Resources Control Board.*

California's infrastructure consists of elements that range in size and complexity from ranger stations to the state highway system. The previous section discussed prison, higher education, hospital and state office building infrastructure. This section addresses the state's highway system and local sewage treatment facilities. It does not, however, cover the areas of mass transportation or local streets and roads, which are primarily elements of local transportation infrastructures.

The state highway system and local sewage treatment facilities share the common themes of declining federal assistance and debate over the proper division of financial responsibility between state and local governments. Below, we discuss the condition of these facilities, the need for additional capacity and improvements, the problems faced in funding these needs, and options which the Legislature can consider to address the funding problems.

State Highway System

The state's highway system consists of approximately 48,000 lane miles of state highways, including nine toll bridges. These facilities represent a total investment of over $80 billion in current dollars. While the system comprises less than 9 percent of the total roadway mileage in California, it handles more than 107 billion vehicle miles of traffic a year, or about 52 percent of all traffic in the state. The bulk of the system was put in place in the 1950s, 1960s and 1970s. Only about 400 lane miles have been added since 1979.

The Current Situation

Projected Highway Needs are Substantial. The Department of Transportation (Caltrans) has projected that annual traffic on state highways will increase to more than 130 billion vehicle miles by 1995. The department estimates that, in addition to the current level of funding already programmed for construction in the five-year State Transportation Improvement Program, more than $13 billion (in 1984 dollars) would be needed to expand the system's capacity in order to accommodate this growth. The department's estimate assumes that the state's commitment to transit will continue, and transit improvements will be used as a supplement to meet traffic demand wherever feasible. We believe that the cost projection represents a reasonable estimate of the general magnitude of capacity improvements needed on the highway system.

Without the investment to increase capacity, vehicle operating speeds on the system would be significantly reduced. Additional funds also will be needed for increased maintenance and rehabilitation activities in order to prevent deterioration of the pavement in much of the aging system.

Current Funding. For 1986–87, Caltrans estimates that it will spend a total of $2.8 billion on the state highway system. Chart 48 shows the sources of funding and the activities these funds support. Resources include:

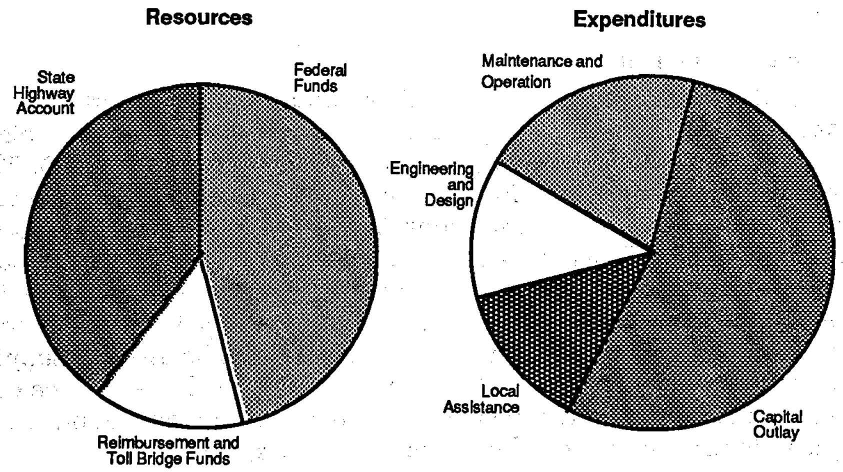
- $1.1 billion in State Highway Account money, generated mainly from

the motor vehicle fuel excise tax and truck weight fees,
- $1.3 billion in federal funds, and
- $400 million in toll bridge funds and reimbursements.

These resources are used as follows:
- $1.5 billion for capital outlay expenditures, including $920 million in federal funds, and $266 million in State Highway Account funds.
- $585 million for highway maintenance and operations, funded only by state funds and reimbursements, with no federal support.
- $417 million for engineering and design, of which about 30 percent is federally funded.
- $350 million to local governments for highway improvements, and for other department planning activities. About 78 percent of these activities are federally funded.

Chart 48

State Highway System Resources and Expenditures 1986-87



Source: *Governor's Budget*

Due to federal budget constraints, federal funds have been decreasing, and this trend is likely to continue. Thus, the state is bearing an increasing burden for the funding of transportation improvements. In the current year, $100 million in state funds will be used to make up for the loss in federal dollars, and the 1987–88 Governor's Budget proposes $250 million for the same purpose.

In addition to state and federal funds being expended on the state highway system, there has been an increasing use of local funds for state highway improvements. Certain counties have been given statutory authority to impose a local sales tax, when approved by the voters, to raise additional funds for transportation improvements, including improvements on the state highway system. Specifically, in Santa Clara, Alameda and Fresno Counties, voters have recently approved an additional one-half cent local sales tax to provide $2.4 billion over a 20 year period, about half of which will be used on state highways.

Funding Problem

State Highway Account revenues—which depend mainly upon the number of gallons (but not the price) of motor vehicle fuel sold—are not responsive to inflationary increases in highway maintenance and construction costs. (Please see Chart 23 and the accompanying discussion in Part Two of this volume.) They cannot, therefore, keep pace with funding demands to maintain and expand the system. By 1989–90 there will not be sufficient state funds both to maintain and operate the highway system, and to match federal funds for capital outlay expenditures. In fact, our analysis indicates that in order to fund all projects currently scheduled for construction, as well as department support activities from 1987–88 through 1991–92, $450 million more than the amount of resources estimated to be available over this period will be required. Even the $450 million, however, will not begin to fund any of the $13 billion in additional capacity needs, or to provide for the increasing maintenance and rehabilitation needs of the aging highway system.

Issues Facing the Legislature

Given the significant amount of funds estimated to be needed to improve the state highway system through 1995, the Legislature has to determine:

1. What level of highway improvements should be funded by the state? As part of this decision, the Legislature may want to reconsider the respective funding responsibilities of state and local governments. It may also want to consider the role of the private sector in paying for certain improvements and demands on the system.

2. Over what period of time should the improvements be undertaken?

3. What source of funds should be used to pay for these projects?

Funding Options

The Legislature has various options to raise state and local transportation funds. These include:

- Raising motor fuel excise taxes and other user fees, such as truck weight fees and tolls on bridges. The amount of any tax increase would depend on the amount of total improvements to be funded, and the time period within which the funds are to be generated. For instance, to raise an additional $13 billion over 10 years (at $1.3 billion annually) would require a motor vehicle fuel excise tax of 20 cents per gallon, an increase of approximately 11 cents per gallon above the current 9 cents.

- Providing additional transportation funding from other existing sources, such as the General Fund. For instance, this could be accomplished by an increase in the state sales tax dedicated to transportation improvements. An additional sales tax levy of one-half percent would generate about $1.2 billion in 1988. Over 10 years, a conservative $15 billion in additional revenues could be generated. By contrast, the use of existing sources of General Fund revenues for highway purposes would entail a reordering of overall state priorities among various programs which currently are supported by the General Fund, such as education, corrections, and health and welfare.
- Extending to all counties the authority to impose an optional local sales tax for transportation uses, including improvements on the state highway system. Currently, this authority is available only to certain counties. In addition, all counties currently have the authority to increase the gas tax.

In addressing this funding situation, the Legislature must also take the state's appropriations limit into consideration. Expenditures of funds raised through tax increases would be subject to the appropriations limit imposed by Article XIII B of the California Constitution. (Please see the discussion on the appropriations limit in Part Three of this document.) Under the terms of the appropriations limit, the Legislature's ability to expend funds derived from tax proceeds would be constrained and would have to be considered in relationship to other state expenditure priorities. Local governments, however, may not face the same constraints on raising funds from new taxes in the short-term because many of them are still below their appropriations limits.

Each of the above options is consistent with the Legislature's current policy of financing highway improvements on a "pay as you go" basis—through taxes. Appropriations from the General Fund, however, would deviate from another policy—that of relying on user fees and charges for highway improvements.

Debt Financing. There is an alternative to the pay-as-you-go approach, however, which would allow the Legislature to address highway funding needs more quickly. Improvements could be financed by debt instruments, such as:

- General obligation bonds which must be approved by the voters of the state, or

- Revenue bonds backed by an identified funding source other than the General Fund, such as motor fuel tax revenues. Revenue bonds can be, but do not need to be, approved by voters.

Bonds of either type, when *approved by the voters,* provide a means of raising funds which are not subject to the Article XIII B appropriations limit. Debt financing also enables substantial amounts of funds to be raised quickly to facilitate a significant increase in highway improvements, while allowing repayment to be spread over a later, longer period. To the extent these improvements benefit future generations of taxpayers, the deferred repayment will be borne by the beneficiaries of the improvements.

Designing a Solution. The Legislature must determine whether transportation improvements should be financed on a pay-as-you-go basis or through borrowing, or some combination thereof. To do that, it must evaluate (1) the amount of improvements to be funded, (2) the time period within which these improvements are to be made, (3) the cost of borrowing and the potential repayment period, and (4) who benefits and who should pay for the improvements. As part of this decision process, the Legislature will also need to identify the source(s) of funds for these highway improvements.

Sewage Treatment Needs

The state has approximately 1,800 publicly owned sewage treatment facilities. Since 1972, the state and federal government have provided $4.2 billion in grants to localities for sewage plant construction and renovation. Most of these plants treat both industrial and residential sewage and charge fees to cover operation, maintenance, and a portion of their construction costs. These plants treat up to 600 million gallons of waste water per day, and can serve from 500 to 6 million people each.

Estimates of Need

Both the U.S. Environmental Protection Agency (EPA) and the State Water Resources Control Board (SWRCB) have conducted surveys to estimate the cost of bringing California's existing publicly owned sewage treatment facilities into compliance with state and federal water quality laws and regulations. These surveys concluded that, as of 1986, from $4.5 billion to $5.2 billion would be needed for this purpose. These surveys also estimated that an *additional* $1.6 billion to $3.9 billion will be required by the year 2005 to meet California's additional sewage treatment needs, which will result primarily from population growth and the extension of sewage treatment service to a larger percentage of the population.

San Francisco, the City of Los Angeles, and Los Angeles County account for almost $2.3 billion, or about 51 percent, of the amount needed to improve existing sewage facilities. Providing secondary treatment to the City and County of Los Angeles' sewage will cost an estimated $683 million. In San Francisco, the estimated cost of systems to separate sewage and stormwater, and of completing other needed improvements, is $1.6 billion.

Funding Problems

The problem confronting local sewage treatment districts is similar to that challenging Caltrans: they must upgrade and expand capacity in the face of declining federal assistance and limits on their ability to raise funds by other means.

Federal Support Declining. Prior to October 1984, the federal government provided grants to local districts that usually paid for 75 percent of the cost of constructing sewage treatment plants. Responsibility for the remaining 25 percent generally was split equally between the state and the local agency. Beginning October 1984, however, federal construction grants were reduced to 55 percent of costs. Of the remaining 45 percent, the state now provides 25 percent—12.5 percent in grants, and 12.5 percent in loans—and the local agency generally pays the other 20 percent. For small communities with recognized financial hardships, however, the state provides a grant of up to 42.5 percent of the costs of the treatment works.

Existing State and Federal Funds Are Not Sufficient. Regardless of how funding is divided, the total amount of available state and federal funds falls short of the amount needed to upgrade systems. The SWRCB estimates that as of September 30, 1986, it had used all but approximately $200 million out of the total $1.2 billion of general obligation bonds authorized since 1970. These state funds will be used to match federal dollars that will flow to California as a result of the new federal Clean Water Act. The act will provide California with approximately $1 billion in federal funds—mostly as loans—for sewage facility improvements during the next nine years. Even with these funds and estimated interest from loan repayments during the next nine years, however, local sewage agencies will require an *additional $3.1 billion to $3.8 billion* to meet current treatment needs and regulatory requirements.

Funding Options

There are several options that the Legislature can consider to assist local governments in funding projects to upgrade and construct treatment facilities. The Legislature also may decide to use a combination of these options.

Rely on Local Fees and Revenues. Local governments may be able to finance their projects by issuing their own tax-exempt bonds, provided that they can generate sufficient revenues to repay the bonds. Large districts have a relative advantage in funding projects in this manner for two reasons. First, the economies of scale in large systems make them less expensive on a per-capita basis than small systems. Second, larger communities often have significant industrial or commercial developments that provide a substantial base of fee revenues.

Two California communities provide a dramatic example of the varying ability to pay for improvements. Residents of the San Jose/Santa Clara area currently pay $11.23 per month for sewage services. If there were no federal or state contribution to construction costs, the monthly fee would be about $2 higher—an increase of 18 percent. Households in Fall River Mills in Shasta County (population 650) currently pay almost the same amount—$11.85 per month—for services. These households, however, would have to pay approximately *$50* a month (more than a four-fold increase) if not for federal and state assistance.

Provide Additional State Assistance to Localities. The Legislature could place additional bond acts on future ballots to provide construction funds for local sewage treatment plants. If the state continues the current policy of providing 25 percent of construction costs (half through loans and half through grants), it would have to issue up to $900 million of new bonds, in addition to bond funds now available, to provide a 25-percent share of the $4.5 billion needed to bring existing plants up to standard.

Issue Self-Financing State Bonds. The Legislature could modify the current state assistance program to provide only *loans* (except in hardship cases) to localities whose loan repayments would be structured to reimburse both the state's debt service costs and administrative costs.

Under this option, local agencies would pay the *full* cost of sewage plant construction in excess of any federal contribution. However, local agencies would still be better off than if the state offered no financing help at all. They would benefit from being able to borrow money at the state's general obligation bond rate—which is lower than the rate most local agencies would pay if they had to issue their own bonds. In addition, the cost of underwriting for a large state bond issue would be less than for many smaller local issues.

More Information Needed

We recommend that the SWRCB report at the time of budget hearings on (1) the statewide priorities for funding sewage treatment improvements and (2) sewage fees currently charged by localities.

Unlike the case of transportation, where information on highway capital outlay improvement and annual maintenance needs is available annually in the State Transportation Improvement Program and the Governor's Budget, the Legislature does not receive information annually on the sewage plant construction and renovation needed in each community to meet existing standards. The Legislature generally has not reviewed detailed information on sewage treatment needs in the past because the federal government provided most of the funds that were needed to build sewage plants, and the state provided only a relatively small matching share. In the future, the federal government will provide less money and local agencies or the state will have to pay most of the cost of building sewage treatment plants. Local governments almost certainly will request additional state funds. Consequently, comprehensive information about statewide needs and priorities for sewage plant construction funds will become much more important to the Legislature.

Fortunately, the SWRCB has compiled a statewide priority list of local sewage treatment needs in the course of administering the federal grant program. The board's list, however, groups projects by water basin, rather than by the priority class assigned to each project. Moreover, the current board list totals only $2.6 billion, rather than the $5.2 billion that the board indicates is needed to meet current requirements. For these reasons, the list does not provide the kind of comprehensive overview that the Legislature needs to evaluate sewage plant funding options. In order to provide more useful information, the SWRCB should revise its list to (1) summarize funding needs by community within each priority category and (2) include all of the potential $5.2 billion in projects.

Our suggested revision of the board's list would make it a useful summary of each community's funding needs and the priority of its sewage treatment projects, but it would not address the ability of communities to fund those projects. As a first step in placing those funding needs in perspective, the board should compile (1) a listing of the typical fees currently charged by each community on the priority list for sewage treatment, (2) a brief summary of the statewide range of these fees and the statewide average fee, and (3) an explanation of the most significant reasons for differences in fees among communities. This information would provide the Legislature with a starting point in evaluating the ability of communities to finance their own sewage treatment improvements.

Accordingly, we recommend that the SWRCB report at budget hearings on (1) the statewide priorities for funding sewage treatment improvements and (2) current sewage treatment fees.

CONCLUSION

Improvements in the state highway system and local sewage treatment facilities will require substantial funding increases. The issue facing the Legislature is how to ensure the availability of sufficient funds to (1) maintain, rehabilitate and improve the state's highway system, and (2) enable local agencies to construct and operate adequate sewage treatment facilities. Because federal participation in funding improvements to both highway and sewage treatment facilities has declined, the burden on the state and local governments to fund the needed facilities has increased.

In the transportation area, the Legislature needs to determine the respective responsibilities of state and local governments in funding improvements, and how it is to raise any additional funds it finds necessary. This involves identifying sources of funds, and determining whether improvements should be financed on a pay-as-you-go basis or through bond financing.

In water treatment, the Legislature needs to examine information about the relative priority and costs assignable to various projects, as well as what would be the effect of local financing on customer rates. Once it has this information, the Legislature needs to determine what share of the cost of upgrading and expanding sewage treatment facilities will be the state's responsibility, and what share the local district's.

COUNTY FINANCES

What Options Are Available to the Legislature to Improve the Fiscal Condition of California's Counties?

Summary

- *Due to the limitations put in place by Proposition 13, counties are no longer able to independently raise the revenues necessary to maintain service levels in both the programs required by the state and those desired by their citizens.*
- *The reforms to the state-county fiscal relationship proposed by the Governor would grant counties additional discretion in determining their own spending priorities. Their ability to exercise this discretion, however, would be limited by practical constraints. The proposal may also reduce the incentives for certain counties to provide basic health services.*
- *The Governor's proposal to "target" additional funds to those counties with relatively greater fiscal problems would provide little additional assistance to those most in need.*
- *In considering a program of fiscal relief for counties, the Legislature should seek to balance the need for local flexibility in determining expenditure priorities against the statewide interest in ensuring that a basic level of services is provided at the county level.*

Over the past few years, the Legislature has heard increasing complaints from county officials about their inability to fund both the programs required by state law and the traditional programs desired by their citizens. These complaints focus on two basic themes. First, counties are unable to increase revenues to a level commensurate with their expenditure requirements, because they lack access to a major independent revenue source. Second, they are unable to control the expenditure growth in programs required by state law—particularly in the areas of health, welfare and criminal justice. The remedies to this dilemma most frequently put forth by county officials are: (1) the statewide assumption of the full cost of basic human service programs; and (2) the transfer to the counties of an additional revenue source, such as a portion of the state's sales and use tax.

This section first examines the county budget structure in the post-Proposition 13 era. Next, we evaluate the proposals for addressing county fiscal problems included in the Governor's Budget. Finally, we discuss the need to balance local flexibility over expenditure priorities with the statewide interest in ensuring that a basic level of services is provided at the county level.

County Budget Structure in the Post-Proposition 13 Era.

The voters' approval of Proposition 13 in 1978 significantly reduced the proportion of total county revenues derived from the property tax. Table 52 presents the total revenues of the counties in fiscal years 1976–77 and 1984–85, as well as the proportionate amounts received from each source. As Table 52 illustrates, the share of total county revenues derived from the property tax declined from 35 percent in 1976–77 to 24 percent in 1984–85. State aid, which comprised 25 percent of total county revenues in 1976–77, increased to 35 percent of total county revenues in 1984–85. This largely reflects the additional funding for health and welfare programs pro-

Table 52
Sources of County Revenues [a]
1976–77 and 1984–85
(dollars in millions)

Revenue Sources	*1976–77*	*Percent of Total*	*1984–85*	*Percent of Total*	*Percent Change From 1976–77*
Taxes					
General Property	$2,604	35.4%	$2,980	23.8%	14.4%
Sales and Use	161	2.2	258	2.1	60.2
Other	47	0.6	139	1.1	195.7
Intergovernmental Aid					
State	1,821	24.7	4,394	35.1	141.3
Federal	1,759	23.9	2,692	21.5	53.0
Other	9	0.1	41	0.3	55.6
Charges for Current Services	657	8.9	994	7.9	51.3
Use of Money and Property	115	1.6	492	3.9	327.8
Other Revenue	192	2.6	529	4.2	175.5
Totals, Current Dollars [b]	$7,366	100.0%	$12,519	100.0%	69.9%
Totals, Constant Dollars [c]	$7,366		$6,860		–6.9%

[a] Source: State Controller. Excludes the City and County of San Francisco, and revenues from county-owned enterprises.
[b] Detail may not add to totals due to rounding.
[c] Adjusted by the GNP implicit price deflator for state and local governments.

vided by the state as part of the post-Proposition 13 "bail-out" legislation. There was also a slight decrease in the overall share of county revenues received from the federal government during this time period, from 24 percent in 1976–77 to 22 percent in 1984–85.

Perhaps the most significant consequence of Proposition 13 from the county perspective is that counties no longer have control over a "major" independent revenue source. Prior to the voters' approval of Proposition 13, county governments had direct control over their largest single revenue source, the property tax. Counties could independently raise the level of taxes necessary to finance both the programs desired by their citizens and the programs required by state law. Now, the only revenue source of any significance remaining under county control is charges for current services, which accounted for 8 percent of total county revenues in 1984–85.

The data in Table 52 also show that total county revenues, expressed in current dollars, increased by $5.2 billion, or 70 percent, between 1976–77 and 1984–85. After adjusting for inflation, however, total county revenues actually experienced a decrease of 7 percent during this time period. The current-dollar revenue growth of counties (70 percent) did not keep pace with that of cities (175 percent) or the state's General Fund (133 percent).

General Purpose Revenue Growth versus Growth in State-Required Program Expenditures. The data in Table 52 relate to total revenues and do not distinguish between the resources which are provided for specific purposes and those which are available for general purposes. Total revenues include both funds from state and federal sources that must be used for specific purposes, and monies which may be used for any purpose. Monies which are not restricted as to the purposes for which they can be expended are known as "general purpose" revenues. General purpose revenues are used to finance both the counties' cost for programs required by state law and those programs desired by local citizens. Table 53 presents estimates of the level of revenues available to counties for general purposes between 1983–84 and 1985–86, the most recent years for which data are available. In addition, Table 53 charts the growth of county expenditures for certain programs required by state law. Comparison of the two growth rates gives an indication of whether or not the amount of funds "left over" for local needs is expanding or contracting.

Table 53 indicates that county general purpose revenues have not kept pace with county costs for certain state-required programs over the past few years. Between 1983–84 and 1985–86, county general purpose revenues increased by 13 percent. During the same period:

- County costs for health and welfare programs increased by 27 percent;
- County trial court costs increased by 61 percent; and
- County jail costs increased by 30 percent.

Table 53
County General Purpose Revenues and Expenditures for State-Required Programs 1983–84 through 1985–86 (dollars in millions)

	1983–84	*1984–85*	*1985–86*	*Percent Change 1983–84 to 1985–86*
General Purpose Revenues [a]	$5,435	$5,810	$6,152	13.2%
Expenditures				
State-Required Programs [b]				
Health and Welfare	$994	$1,123	$1,266	27.3
Trial Courts	559	780	900	61.0
Jails	515	589	668	29.7
All Other Programs	3,367	3,318	3,318	−1.5

[a] Source: Department of Finance.
[b] Source: Legislative Analyst's Office estimates. These amounts are county costs net of specific state and federal assistance.

As Table 53 shows, the higher growth rates for state-required program costs, relative to the growth of general purpose revenue, means that other program requirements must be accommodated within a gradually shrinking pool of funds. Although greater efficiencies have mitigated this problem to some extent, our review indicates that in some counties, it has resulted in significant service reductions. County officials face pressures to avoid cuts in programs which are considered vital by the majority of their citizens, such as law enforcement activities. As a consequence, the cuts tend to fall on less-visible programs, such as probation, building maintenance and services to indigents.

Finally, the fiscal condition of counties is not uniform throughout the state. Certain counties are able to raise more tax revenue than others, due to regional variations in the state's economy. In addition, the proportion of persons requiring public assistance and health care differs significantly between counties. These "fiscal disparities" mean that some counties are less able to provide basic levels of services than other counties, and that to some extent, the state's objectives in some program areas are met to a greater or lesser degree depending upon geographic location.

How does the Governor's Proposal Affect Counties?

The Governor's Budget proposes that several changes be made to the state-county fiscal relationship. These include:

- the substitution of a share of the state's sales tax revenue for the existing County Health Services (AB 8) program subventions and five other categorical health programs,

- the provision of funds to help stabilize county matching fund requirements, and
- a proposal to repeal or change the funding source for some 50 existing recognized state-mandated local programs.

These proposals would both increase the amount of funds provided to the counties, and increase the amount of discretion that the counties have in determining how existing funds would be used.

Table 54
Effect of Governor's Proposal [a]
on County Revenues
(dollars in millions)

Revenue Source	*1987–88*	*1988–89*
State Subventions:		
County Health Services—AB 8	–$424	–$451
Public Health Categorical Programs	–53	–53
State Mandate Reimbursements	–31	–31
Shared Revenues	477	—
Sales Tax Transfer	—	640
County Match Requirements	8	4
Totals, (Net)	–$23	$109

[a] Source: Legislative Analyst's Office estimates.

Table 54 illustrates the net effect of the Governor's proposal on total county revenues. Overall, the Governor's proposal would reduce county revenue by $23 million in 1987–88, and increase county revenues by $109 million in 1988–89. The larger effect in 1988–89 occurs primarily because the sales tax transfer will exceed the existing health subventions by this amount. The ultimate effect of the Governor's proposal on the amount of county general purpose revenues left over for county programs, however, will depend on:

- The extent to which counties reduce the level of expenditures for health programs; and
- The extent to which the counties can realize expenditure savings due to the proposed repeal of state-mandated local programs.

We now turn to a more detailed examination of these proposals.

County Health Services. The Governor proposes to eliminate existing state subventions for County Health Services (AB 8) and several public health categorical programs, beginning in 1987–88. These subventions would be replaced by an allocation of state sales tax revenue of an equivalent amount in 1987–88, which could be used by the counties for general purposes. In 1988–89 and subsequent years, an allocation equivalent to the revenue produced by a ¼ cent share of the state's sales tax rate would be provided. The proposal would remove existing funding incentives for maintaining service levels and the requirement that counties notify the State Department of Health Services prior to closure of a county hospital or reducing services provided to indigents.

The Governor justifies this change on the grounds that it is inefficient and ineffective for the state to set priorities at the local level and that counties are in the best position to determine their spending priorities. The most obvious implication of the Governor's proposal is that counties would be able to reduce spending on the specified health programs, if they chose to do so, without losing state funds.

It is impossible to determine the extent to which counties would exercise this option. Some counties already "overmatch", or expend more local funds than is necessary to receive the full amount of their AB 8 allocation from the state. Because they have already chosen to provide a higher than required level of service, and to finance it with local general purpose funds, it would appear that this proposal alone would not result in their decision to reduce expenditures for these services in 1987–88. However, the elimination of the matching requirement could facilitate a reduction in service levels should this become necessary to overcome shortfalls in other areas of their budgets.

The counties which are currently undermatched (11 counties in 1985–86) expend a lower level of local funds than is necessary to receive their full allocation of AB 8 funds from the state. These counties might be tempted to reduce spending on county health services, because their spending levels may be higher than they would be in the absence of the matching requirement.

As a result, the increased discretion provided by the Governor's proposal would result in no change or in reduced spending for health services by the counties in the future.

Sales and Use Tax Transfer. The Governor also proposes to transfer a portion of the state's share of the sales and use tax, attributable to a 0.25 percent rate, to the counties beginning in 1988–89. As noted in Table 54, this transfer would decrease General Fund revenues by approximately $640 million and result in a corresponding increase in county revenues.

According to the Department of Finance, the funds would be allocated to the counties on the basis of their current allocation of county health services subventions and categorical program costs. In other words, each county would receive the same share of the new sales tax funds as they receive of the existing health program funds. Because the sales tax transfer would amount to roughly $640 million in 1988–89, rather than the $504 million we estimate would under current law be provided for health program subventions in that year, each county would also receive a proportionate share of the additional funds.

It is important to note that the existing distribution of health program funds is not based upon any objective measure of individual county fiscal strength. The AB 8 formula was designed to stabilize county health expenditures in the wake of the dramatic reduction in county property tax revenues caused by Proposition 13. The formula itself is based upon the counties' net costs for providing health services in 1977–78, the year prior to Proposition 13. For a variety of reasons, the counties which budgeted high net costs for health services in that year may not be the same counties which are experiencing the most fiscal constraints in 1987. As a result, the formula proposed for use in allocating the sales tax subventions does not consider existing differences in the fiscal capacity of the individual counties.

Mandate Reform. The Governor proposes extensive changes to the state's program of reimbursing local governments for costs mandated by the state. The fiscal effect of these actions would be to reduce county revenues by roughly $31 million, beginning in 1987–88. This revenue reduction would be offset by reduced costs to the extent that counties discontinue the activities which would no longer be mandated. In some cases, however, the administration indicates that it is "more than likely" that the counties would continue to carry out the mandated activities in the absence of either a specific statutory requirement or the existing funding. On this basis, our review indicates that it is not likely the counties will achieve savings comparable to the current level of reimbursements.

County Match Requirements. The Governor's Budget proposes to provide a new subvention to counties in 1987–88 and subsequent years which is intended to "stabilize" local matching requirements. Under a number of programs for which the state and the counties share the responsibility for funding, county costs are determined as a percentage of the total program cost. Thus, county expenditures increase in response to the growth in the program, and program growth may be outside of the county's control. The Governor's proposal would provide state funds to counties for specified programs where the cost to the county of fulfilling its state matching requirements for specified programs has increased more rapidly than its general purpose revenue. These programs include the Aid to Families with Dependent Children (AFDC), In-Home Supportive Services (IHSS) and Community Mental Health (CMH) programs. The budget proposes that the initial payment to be made in 1987–88 be based on county costs incurred during the period 1983–84 through 1985–86. In 1988–89, the payments would be based on the counties' experience in 1986–87. The budget indicates that the state's cost for this program in 1987–88 would be $7.6 million. The payment to the counties in future years would depend upon the growth in program costs and the fiscal condition of the individual counties.

Our analysis indicates that several counties, particularly the small rural counties, have experienced difficulty in meeting their state matching requirements over the past few years. Although the matching relief proposal would benefit many small rural counties, it is not clear that the benefit would represent a significant improvement over current conditions. Data provided by the Department of Finance indicates that in 1987–88, for example, Glenn County would receive a total payment of $114. Further, most of the counties which have received payments under the provisions of Ch 977/86 and Ch 1146/86 (Aid for Distressed Counties) would receive smaller allocations than in past years. Thus, it appears that even this proposal is not well-targeted to those counties experiencing the greatest fiscal distress.

Appropriations Limit Implications of the Governor's Proposal. The Governor's proposal to relieve the state of its funding responsibility for county health services would require a transfer of a portion of the state's appropriations limit to the counties. A more detailed analysis of this issue can be found in the discussion of the state's appropriations limit contained in this document.

Policy Consideration: Local Flexibility Versus Statewide Interest

Any attempt to reform the state-county fiscal relationship must address the question of *local flexibility* over expenditure decisions versus the *statewide interest* in ensuring that a minimal level of basic services is provided at the county level. The Governor's proposal clearly states its intention to increase the counties' discretion in determining their own spending priorities. This is the rationale behind eliminating the matching requirements associated with the County Health Services program (AB 8) and the various categorical public health programs.

The Governor's proposal, however, does not relieve the counties of their basic responsibility to provide health services. As a result, their ability to realize more discretionary income is dependent upon their willingness to cut back on these programs. These reductions would conflict with the state's interest in ensuring that a basic level of access to health care be available in all counties.

Other Alternatives. Options which provide a more direct approach to addressing these issues include:

- Altering the state's matching requirements in existing program areas to provide state funds in lieu of an increased local match, in those cases where fiscal distress can be demonstrated;
- Granting counties new revenue raising authority; and
- Investigating alternative program and revenue base alignments that would more closely match revenue and expenditure *levels* and *growth rates.*

The advantage of the first approach is that state funds can be targeted to those programs and counties with the most need. In addition, it would be easier for the state to control the overall cost of this approach. However, by itself, it does not address the need for additional local fiscal independence. The second alternative would provide more flexibility at the local level, but would not directly address the disparities in fiscal condition among the various counties. The third alternative has the most promise, at least from a theoretical perspective, as its objective is to correct the underlying reasons for the fiscal disparities. Its primary weakness is the fact that it is exceedingly difficult to accomplish this type of realignment without losing more of something else that is valued by the state—for example, the control over program service levels or state-collected revenues.

STATE PERS EMPLOYER CONTRIBUTIONS

How Should the Legislature Reflect Actuarial Gains in Employers' PERS Contributions?

Summary

- *Within the last few months, the Public Employees' Retirement System's (PERS) Board of Administration has considered three proposals which would produce large actuarial gains: (1) a reduction in the PERS' "reserve for deficiencies," (2) the "up front" reversion of Investment Dividend Disbursement Account (IDDA) monies, and (3) a shift from book to market value in determining "actuarial" assets.*
- *The Legislature considered, in the course of the 1986–87 budget process, the first two proposals, but ultimately did not pass implementing legislation. The third proposal, which was recently adopted by the PERS board, can be implemented administratively in the coming fiscal year.*
- *Our analysis indicates that: (1) the reserve for deficiencies can be eliminated, (2) reverted IDDA funds should not be recaptured "up front," and (3) the shift to market valuation of assets is appropriate.*
- *We therefore recommend that the Legislature: (1) enact legislation eliminating the reserve for deficiencies, and (2) set employer contribution rates such that all actuarial gains are recaptured over the long run.*
- *Enactment of these recommendations would have* no *effect on PERS benefits or the system's ability to pay off its liabilities.*

Recent Proposals Would Have Produced Actuarial Gains

In 1986, the Legislature and/or the PERS board considered the following three proposals which would have increased the asset value of the Public Employees' Retirement Fund (PERF) and reduced employer contribution rates.

Reduce the Reserve for Deficiencies. Current law requires that an amount equivalent to 1 percent of the PERF's assets be placed in a reserve for deficiencies, to be used for various one-time purposes. Currently, the reserve has a balance of about $300 million. The reserve funds, however, are *not* counted as assets for actuarial purposes. Consequently, the level of annual employer contributions is higher than if the reserve funds were considered assets.

In the 1986 Budget Act, the Legislature approved an administration proposal to reduce the reserve to 0.1 percent, thereby increasing fund assets, and "capturing " the increased assets by reducing 1986–87 employer contributions. The proposal, however, required implementing legislation, and the requisite bill (SB 566—Bergeson) was subsequently rejected by the Legislature.

Immediately Recapture the Money Reverted from the Investment Dividend Disbursement Account (IDDA). Generally, when investment earnings exceed the "actuarial earnings rate," the excess income attributable to *employee* contributions is placed in a special account, known as the IDDA. These funds are used to maintain the purchasing power of PERS retirees' benefits.

Current law limits the end-of-year account balance in the IDDA, and requires that any excess amounts be reverted to the main fund and counted as *employer* assets. Any reversions are used to reduce the annual rates charged employers. Thus, the money reverted in 1986–87—about $195 million—will result in slightly lower contributions paid by the state and local agencies to the PERS in future years.

The Legislature approved a provision in the 1986 Budget Act which would have recaptured the 1986–87 IDDA reversion "up front" (that is, in a lump-sum amount) by crediting the reversion against 1986–87 employer contributions. This proposal, which also required implementing legislation, was included in SB 566.

Change the Valuation of PERS Assets. On December 17, 1986, the PERS board voted to change the way it values assets in the PERF, by moving from book to market assessments. This change will result in an increase in actuarial assets of nearly 24 percent. This adjustment, however, will be phased in over five years in order to smooth out the impact on employer rates from going to market valuation.

Thus, all three of these proposals involve large actuarial gains to the PERF. Below, we examine both the merits of the proposals (that is, the need for a reserve for deficiencies and the proper way to value assets), and the appropriate way to realize actuarial gains (either "up front" in the form of employer contribution offsets, or over many years in the form of reduced annual employer rates).

Reserve for Deficiencies Is Unnecessary

Current law specifies that the PERF's reserve for deficiencies may be used only to cover: investment losses; court-mandated costs; actuarial losses resulting from terminations, mergers and dissolutions of contracting agencies; and prior-year interest deficiencies. Because the funds are set aside for these purposes, the monies in the reserve for deficiencies are not counted as assets for actuarial purposes (that is, for determining unfunded liabilities and employer contribution rates). As a result, PERS employers —the state and local agencies—pay higher annual contributions to the system than would be the case if there were no reserve.

The PERF's reserve for deficiencies does not serve the same function as most fund reserves. For instance, the General Fund's Special Reserve for Economic Uncertainties is used to cover actual current expenditures when fiscal projections are in error. The PERF's reserve, on the other hand, covers *actuarial* losses which otherwise would be accommodated through the system's annual determination of the long-run employer contribution rates. (The *purpose* of the annual determination is to adjust for such to-be-expected deviations from projected earnings and liabilities.) The PERF reserve is not needed to cover any particular liabilities in a given year. Indeed, the PERS board has not relied on the reserve to meet the system's funding obligations. According to PERS staff, the reserve has been used only *twice in the last 44 years.*

Our review indicates that the reserve is not needed to meet the system's unexpected liabilities and that maintaining the reserve increases employer costs. Based on this review, we find no fiscal rationale for maintaining the reserve. Accordingly, we recommend that the Legislature enact legislation eliminating the PERF's reserve for deficiencies. The PERS would then be treated similarly to all other state retirement systems, none of which has a reserve. This recommendation would result in about $300 million being credited to employer accounts, including about $180 million to state employer accounts (all funds). The state would realize first-year General Fund savings of about $6 million from reduced annual employer rates.

This action would have no effect whatsoever on the payment of benefits to members.

IDDA Reversions Available for Long-Term Rate Reductions

In 1986–87, about $195 million was reverted from IDDA to the PERF because of the "cap" on the fund balance in the account. While in IDDA, monies are not counted as assets; however, upon reversion, they are counted as actuarial assets. Under current law, the asset increase is reflected over many years through slight reductions in the annual contribution rates charged employers. The current-year reversion will result in 1987–88 General Fund savings of about $5 million.

Under the IDDA proposal considered by the Legislature in SB 566, employers would have realized all of the savings from the increased asset base in the current year, by offsetting the full amount of the reversion against current-year PERS employer contributions. The state would have realized savings in 1986–87 of about $141 million, including $94 million to the General Fund.

This proposal would have made no changes in current IDDA benefits, nor would it have changed the amount of money available for future IDDA benefits. Rather, the proposal simply would have changed the way reverted monies were used *after* they were no longer part of the IDDA program.

PERS Assets Should Be Assessed at Market Value

Each year, when employer contribution rates are set, the PERS actuaries estimate the value of the PERF's assets. They use this estimate, together with the system's estimated cost of future benefits, to determine the system's funding condition. Prior to 1987, the actuaries assessed investments at their *book value* to determine the level of actuarial assets. Under this method, the system values investments at their *original* cost, thereby ignoring all subsequent depreciation or appreciation in the asset price. The asset's gains and losses are recognized only when the assets are sold. The main justification for the use of book value is accounting convenience.

On December 17, 1986, the PERS board voted to change the method of valuing PERF assets by adopting a modified *market value* approach. Under this method, the PERS will determine the full market value of all investments, but phase in gains and losses from the prior year over five subsequent years. The phase-in period is intended to smooth market fluctuations in order to keep employer contribution rates steady. The new valuation method will result in an initial 4.2 percent (or $1.3 billion) increase in assets in 1987–88. (In subsequent years, there will be additional asset increases.) This, in turn, will reduce annual employer contribution rates over the long run, resulting in a General Fund savings of about $28 million in the budget year.

Our analysis indicates that the board's move to market value is appropriate, for two reasons.

Market Value Better Reflects the Value of PERF Assets. In performing its annual assessment of the PERF's condition, PERS staff must determine the cost—in *current* dollars—of future retirement benefits, and compare this with the value of assets on hand. There is no dispute that a market valuation gives a better assessment of the worth—in *current* dollars—of the fund portfolio. Thus, the market value method compares the amounts of assets and liabilities in the same "currency."

Market Value Eliminates Potential Biases in Investment Decisions.

When assets are valued at book, investment transactions affect the level of actuarial assets. For example, when an asset's market value is *higher* than book value, the sale of that investment increases the level of actuarial assets. This is because the system "captures" the unrealized gain inherent in the book value when the investment is sold. Conversely, when an investment's market value is *lower* than its book value, the level of actuarial assets will fall when the investment is sold.

Consequently, under the book value method, decisions about *when* to sell investments affect asset levels. For instance, the use of book value might encourage staff to: (1) hold a poorly performing investment too long, in order to keep the actuarial asset level artificially high, or (2) sell a good investment prematurely in order to capture the increased value in the actuarial asset level. Thus, book valuation of assets can lead to poor investment decisions and lower investment earnings.

In contrast, when assets reflect market value, unrealized gains and losses are included in the actuarial asset valuation. As a result, the prospect of a realized gain or loss—and its impact on actuarial levels—would not influence investment decisions.

Actuarial Gains Should Be Reflected in Long-Term Rates

All three of the proposals discussed above involve potentially large actuarial gains to the PERF. In each case, there is the issue of whether the gains should be captured "up front" or realized over time through slightly lower employer contribution rates. Our analysis suggests that the gains should be taken over the long run, for two basic reasons.

Gains and Losses Should Be Treated the Same. Currently, all changes in PERS liabilities (for example, longer annuitant life spans increase liabilities) are reflected in long-term rates. In other words, liabilities are amortized over the system's funding period. Similarly, the board has a policy of funding legislatively required increases in the unfunded liability over a 15-year period, spreading the costs over future years.

We believe that *gains* should be treated in the same manner as *losses.* In so doing, the true costs of the system are spread more evenly over time, so that taxpayers of a particular time period do not pay a disproportionate share of the system's costs. If, on the other hand, the system were to take all gains "up front" and defer all losses, current taxpayers would be subsidized by future ones.

Amortization of Gains "Smooths Out" Annual Contribution Rates. If gains were taken "up front," the state's employer contributions would be subject to considerable fluctuations. For instance, if the system did not phase in gains and losses in its market value assessment of investments, the level of actuarial assets could swing dramatically with changes in the financial markets. The variations in assets, in turn, would cause corresponding variations in contribution rates. A phase-in period provides a "smoothing" process that will tend to keep annual employer rates fairly steady. This stability would seem to be a benefit to the Legislature in its annual budget deliberations.

Summary of Findings and Recommendations

We recommend that the Legislature enact legislation eliminating the PERF's 1 percent reserve for deficiencies, for an annual General Fund savings of about $6 million.

We further recommend that the Legislature, when setting PERS employer contribution rates, capture actuarial gains over the long run.

In reviewing the three proposals involving actuarial gains to the PERS, we examined both the merits of the proposals and the manner in which any gains would be realized. As to the merits of the proposals, we conclude that: (1) the reserve for deficiencies is unnecessary, and therefore we recommend that the Legislature enact legislation eliminating it, and (2) the change to market value assessment of assets is appropriate.

Regarding the treatment of actuarial gains, we recommend that the Legislature set employer contribution rates such that all actuarial gains are recaptured over the long run. For the three proposals, this means:

- The gain from eliminating the reserve for deficiencies would be used to reduce the system's long-term employers' rates;
- Reverted IDDA funds would not be recaptured "up front" but realized over time, as required by current law; and
- Market value asset adjustment would include a phase-in period for gains and losses, as adopted by the board.

THE NEW FEDERAL IMMIGRATION LAW

What Steps Should the Legislature Take to Prepare for the Effects of the New Federal Immigration Law?

Summary

- *Fifty percent of all undocumented immigrants in the United States reside in California.*
- *The new federal immigration law creates certain rights to government services for those undocumented immigrants who achieve legal resident status.*
- *The Governor's Budget makes no provision for the expected major fiscal and program effects of implementing the new immigration law.*
- *We recommend that the Legislature require the administration to provide it with certain information so that the Legislature can make the program and fiscal decisions required for responsible implementation of the Immigration Reform and Control Act.*

After five years of debate, Congress passed legislation on October 17, 1986 that substantially amends federal laws governing legal and illegal immigration into the United States. The Immigration Reform and Control Act of 1986 (Public Law 99-603) was signed by the President on November 6, 1986.

The purpose of this analysis is to provide the Legislature with information that it can use to help shape implementation of the act in California. While we recognize that the act has implications for many policy areas, we have limited our discussion to the act's fiscal aspects. We begin by summarizing the major provisions of the act, and follow by evaluating its effects on California. We conclude by identifying those implementation issues that, in our judgement, warrant the Legislature's attention and action.

Major Provisions of the Act

The purposes of the Immigration Reform and Control Act (IRCA) are to control illegal immigration to the United States, make limited changes to the system for legal immigration, and provide a controlled legalization program for certain undocumented immigrants who entered this country prior to January 1, 1982.

Control of Illegal Immigration

The act contains three provisions intended to curtail the tide of illegal immigration to the United States.

Employer Sanctions. It is generally accepted that the principal incentive for illegal immigration is the availability of employment. Accordingly, the act seeks to reduce this incentive by imposing civil and criminal penalties for employers who knowingly hire, recruit, or refer an undocumented immigrant for employment. The act requires employers to ascertain the legal status of prospective employees by examining documents such as drivers' licenses, passports, or birth certificates.

Increased Enforcement. The act substantially increases the appropriations for the Immigration and Naturalization Service (INS) border patrol force and its other border enforcement activities.

Verification of Immigration Status. The act requires states to establish a system to verify with INS the immigration status of individuals applying for AFDC, SSI/SSP, Medicaid, food stamps, unemployment insurance, housing assistance, and federal student financial aid. The act also provides for full federal reimbursement for the costs of the system and authorizes federal agencies to waive the requirement for a separate system if the state has an acceptable existing system for verification.

Reform of Legal Immigration

The act increases the number of individuals who may lawfully immigrate to the U.S. particularly for the purposes of working in U.S. agriculture, as follows.

Temporary Agricultural Worker Program. Prior to IRCA, immigration law allowed the temporary admission of foreign workers if there was a shortage of U.S. agricultural workers. This act continues and enhances this program by expediting the process for granting authorization to employers to hire temporary foreign workers.

Special Agricultural Worker Program. In response to the special labor needs of western growers of perishable commodities, this act establishes an additional program to admit foreign workers *as legal immigrants* . The act authorizes undocumented immigrants to apply for temporary resident status if they worked in U.S. agriculture for a minimum of 90 days during the period May 1, 1985 to May 1, 1986. It also authorizes the admission of "replenishment workers" beginning in 1990 if the Secretaries of Labor and Agriculture determine that there is an agricultural labor shortage.

The IRCA disqualifies persons legalized under these provisions from receiving federal financial assistance—principally Medicaid and AFDC. The act, however, allows federally funded medical assistance for qualifying pregnant women, persons under 18 years of age, and in emergency situations. Qualifying aged, blind and disabled individuals would also be eligible for SSI/SSP, and Medicaid or Medicare benefits.

Legalization of Currently Undocumented Immigrants

The act recognizes that many undocumented immigrants have lived and worked in the U.S. for several years and that they have as a result developed strong social and economic ties to this country. The act, therefore, establishes a program to allow them to become legal residents.

Specifically, IRCA:

- Authorizes undocumented immigrants to apply for legal status if they have been living in the U.S. continuously since a date prior to January 1, 1982. The application period will be May 6, 1987 to May 5, 1988.
- Provides that eligible individuals will be granted temporary resident status and that they will be allowed 12 months to apply for permanent resident status.
- Requires temporary residents to demonstrate minimum competencies in English language skills and U.S. history and government, or be enrolled in the appropriate courses in order to become permanent residents.

- Authorizes the Attorney General to terminate an individual's temporary resident status if the individual commits specified crimes or does not apply for permanent status within 30 months.
- Disqualifies persons legalized under these provisions from receiving federal financial assistance—principally Medicaid, AFDC, and food stamps. The act, however, allows federally funded medical assistance for qualifying pregnant women, persons under 18 years of age, and in emergency situations. Qualifying aged, blind, and disabled individuals would also be eligible for SSI/SSP, and Medicaid or Medicare benefits.
- Authorizes states and local governments to disqualify legalized immigrants from their public assistance and medical assistance programs in a manner consistent with the federal disqualification provisions.

State Legalization Assistance Grants. The act provides for reimbursement of certain state and local government costs incurred in assisting legalized immigrants. The act appropriates $1 billion in each of four years beginning in federal fiscal year 1988 for this purpose. These funds, minus the federal share of costs (the "offset") for providing Medicaid, SSI, and food stamps to eligible legalized immigrants, will be allocated to states based on a formula to be developed by the U.S. Department of Health and Human Services (DHHS). Proposed regulations are expected in late February and final regulations are due by May 6. Table 55 shows the estimated amounts to be awarded to states for each of the four years.

Table 55
Legalization Assistance Grants
Federal Fiscal Years 1988 through 1991
(dollars in millions)

	1988	*1989*	*1990*	*1991*	*Totals*
Appropriation	$1,000	$1,000	$1,000	$1,000	$4,000
Offset *	72	305	410	445	1,232
Allocation	$928	$695	$590	$555	$2,768

* Congressional Budget Office estimates.

The act specifies that the formula for allocating these funds to the states will include the following factors:

- The number of legalized immigrants residing in the state.
- The ratio of the number of legalized immigrants in the state to the total number of residents in the state, and to the total number of all legalized immigrants in all states.
- Estimated state expenditures to provide assistance in that fiscal year.
- The ratio of the estimated expenditures of the state to the estimated expenditures of all states for assistance in that fiscal year.
- Adjustments for certain differences between estimated and actual expenditures for assistance in the previous fiscal year.

The allocations to the states are provided to support the costs of public assistance (including medical assistance), public health services, and educational services provided to newly legalized eligible immigrants. The act specifies that at least 10 percent of the allocation received by the state in each fiscal year shall be used for each of these three purposes. If a state cannot use a full 10 percent in any one of these assistance areas then it is required to allocate that amount equally to the two other assistance areas. The remaining 70 percent of the assistance grant may be allocated for related purposes at the discretion of the state.

The act also: (1) limits reimbursements to actual costs, (2) limits educational program cost reimbursements to $500 per pupil, and (3) restricts the use of reimbursements to existing programs—a state may not fund new programs from the assistance grants. The act authorizes states to carry over unused federal assistance funding from one fiscal year to the next. The funds may not be carried over past September 30, 1994.

To receive legalization assistance funding a state is required to apply to the federal government. The application must specify what assistance the state expects to provide and its estimated costs.

Potential Effects on California

While it is clear that the act will have a significant impact on California, attempts to evaluate its specific effects generate more questions than answers. Below, we identify several of these questions and discuss how the answers to them could affect the state's fiscal situation.

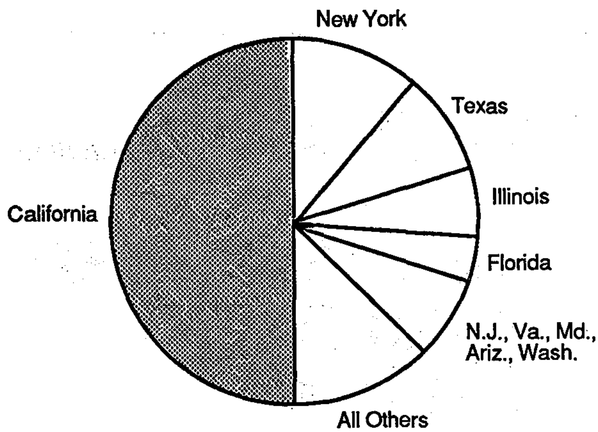
What Do We Know About the Undocumented Immigrant Population?

Using data provided by the U.S. Bureau of the Census and the Department of Finance we are able to provide some information about where the undocumented immigrants reside and in what numbers. The data we have used represents the low estimate of the numbers of undocumented immigrants. While there is no agreement on the exact numbers, the data are useful for analyzing the distribution among states and among California's counties. For example, Chart 49 shows that according to the 1980 census one-half of all undocumented immigrants counted reside in California.

Of the total number of undocumented immigrants counted in California in 1980 about 75 percent came from Mexico, 11 percent from other Latin American countries, 8 percent from Asia, 5 percent from Europe and Canada, and 1 percent from other countries.

Chart 49

Undocumented Immigrants Counted in the 1980 Census



Source: U.S. Bureau of the Census

How Many Undocumented Immigrants Reside in California Now? The Department of Finance estimates that California's population of undocumented immigrants grows by about 100,000 each fiscal year. This is a net number reflecting both entries and exits from the state. Based on this information, we estimate that about 1.6 million undocumented immigrants currently reside in California. This number, however, is the low estimate and, according to the Department of Finance, the actual number could be as high as 2.6 million.

Which Counties Have the Highest Numbers of Undocumented Immigrants? Using information supplied by the Department of Finance for July 1, 1985 we analyzed the distribution of undocumented immigrants by counties in California. Over 64 percent of the undocumented immigrants reside in Los Angeles County. Table 56 shows the five counties with the most undocumented immigrants.

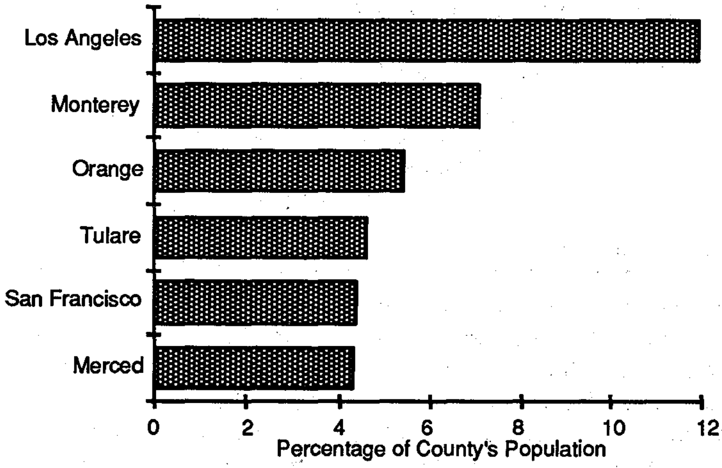
Table 56
Five Counties With The Highest Numbers of Undocumented Immigrants July 1, 1985

County	*Low Estimate*	*High Estimate*	*Percent of Total*
Los Angeles	964,000	1,600,000	64.3%
Orange	116,000	193,000	7.7
San Diego	73,000	122,000	4.9
Santa Clara	38,000	63,000	2.5
San Francisco	32,000	54,000	2.1
All Other Counties	277,000	468,000	18.5%
Total	1,500,000	2,500,000	100.0%

Another way to view the distribution of undocumented immigrants among counties is to compare the ratio of undocumented immigrants to total county populations. This ratio helps measure each county's ability to provide the support many legalized immigrants will seek. As Chart 50 shows, this presents a somewhat different picture.

Chart 50

Six Counties With the Highest Ratio of Undocumented Immigrants to Their Total Populations



Source: Based on data for July 1, 1985 supplied by Department of Finance

The chart shows that 12 percent of Los Angeles County's population, over 7 percent of Monterey County's, and 5 percent of Orange County's population is comprised of undocumented immigrants. If we use the high estimate of the undocumented population then the percentages are 20, 12 and 9 respectively. Thus, while Monterey County contains only 23,000 to 39,000 undocumented immigrants, or less than 2 percent of the state total, it may be affected to a greater extent by legalization, at least in relative fiscal terms, than a county such as Orange that has 117,000 undocumented immigrants, or nearly 8 percent of the total. The effect on a county also will depend, of course, on other factors such as the prevalence of existing public or private community and educational services and support groups that will be able to assist newly legalized immigrants.

How Many Undocumented Immigrants Will Be Legalized? This is a question which, at this point, we are unable to answer due to lack of information. The Department of Finance estimates that 1.3 to 2.0 million of the undocumented immigrants in California have been residing in the U.S. since prior to January 1, 1982. On that basis, they would be eligible for legal resident status. It cannot be estimated, however, how many of that number will apply for such status, or how many of the applications will be approved. The number that will be legalized depends to a large degree on the regulations yet to be adopted by the federal agencies. The regulations will specify requirements, such as the documentation required of applicants, which will determine how difficult or easy it will be to achieve legalization.

Will Legalization Result in Increased Demand for State Services?

Under previous law, undocumented immigrants were not entitled to most government benefits. Legalization will raise costs in federal and state entitlement programs because certain legalized immigrants will be newly eligible for assistance. The act, therefore, will increase state costs to some extent in the 1987–88 fiscal year and to a greater extent in subsequent years. The full program costs of legalization will be realized in the years beyond 1990–91 as (1) legalized immigrants begin to participate in programs closed to them during the first five years of implementation and (2) they become more familiar with the benefits available in all programs.

As noted earlier, IRCA authorizes states to disqualify newly legalized immigrants from eligibility for certain public and medical assistance services, and thereby limit additional costs. This step would, however, require state legislation.

Below, we summarize the major programs for which certain legalized immigrants will be eligible. We also cite some average cost data to provide a sense of the potential cost increases in these programs.

Medi-Cal. This program provides necessary health care services to public assistance recipients and to others who cannot afford to pay for these services. The IRCA allows qualifying children under 18, pregnant women, and aged, blind, and disabled individuals to receive services under Medi-Cal. Other individuals would be eligible for emergency services under Medi-Cal. To give some indication of the costs that might be incurred, we cite the costs of similar Medi-Cal services provided to medically indigent children and pregnant women. This category of Medi-Cal eligibles most closely approximates the demographic characteristics and expected service needs of the immigrants eligible for legal status. In 1986–87, the average monthly costs of Medi-Cal services provided to medically indigent children and pregnant women are about $140 and $600, respectively. The average cost of services provided to aged, blind, and disabled individuals in 1986–87 is about $300 per month.

SSI/SSP. This program provides cash assistance to eligible aged, blind, and disabled persons. The IRCA allows qualifying aged, blind or disabled individuals to receive SSI/SSP benefits. The maximum grants received by aged or disabled individuals in 1986–87 is $560 per month. Of this amount $220 is the state-funded SSP grant.

AFDC-U. The AFDC-Unemployed parent program provides cash grants to families who have financially needy children due to the unemployment of one or both parents. Legalized immigrant families are precluded by IRCA from participating in the *federal AFDC-U* program; however, they could be eligible for *state-only AFDC-U.* For a family of four, the average grant is about $711 per month. Of this amount $634 is funded by the state and $77 by the counties.

Food Stamps. This program provides assistance to eligible persons in need of a food allowance. The immigrants legalized under the Special Agricultural Workers provisions of IRCA could be eligible for food stamps, which would be funded almost completely through the federal offset deducted from the total assistance grant appropriation.

K–12 Education. The state's public education system provides educational services to children in grades K–12 and to adults in its adult education program. Because IRCA requires temporary legal residents to acquire minimum competencies in English language skills and U.S. government and history, or be enrolled in the appropriate courses, before they can be granted permanent legal resident status, additional demands will be made on the adult education component. Pursuant to a federal court decision in 1982 *(Plyler* v. *Doe)* the state has been providing educational services to children regardless of their immigration status.

Community Colleges. The community colleges will most likely experience some increased demand for the English language and citizenship courses that they offer.

Unemployment Insurance (UI). The UI program provides benefits to eligible unemployed individuals. The program is supported through payroll taxes levied upon employers. There would be a cost to the program to the extent that newly legalized persons become unemployed and draw benefits. A loss of savings would result to the extent undocumented immigrants whose employers were paying into the program but who were themselves unable to draw benefits are now able to draw them.

Disability Insurance (DI). The DI program provides cash benefits to individuals who are unable to work because of a physical or mental illness or injury. The program is supported through a payroll tax levied upon employees. There would be a cost to the program to the extent newly legalized persons become disabled and draw benefits and a loss of savings to the extent undocumented workers who were paying into the program but unable to draw benefits are now able to draw them.

In addition, the act specifies that newly legalized immigrants can, to the extent they are eligible, participate in the following federally funded programs: Headstart, the Job Training Partnership Act (JTPA), education financial assistance funded under Title IV of the Higher Education Act of 1965, county social services funded under Title XX, child welfare services, federal housing assistance programs and various federally funded education programs.

Will Legalization Result in Increased Demand for County Services?

State law requires counties to provide aid, including medical assistance, to residents who cannot care for themselves. While certain newly legalized immigrants will be eligible for the programs described above, IRCA makes *most* newly legalized immigrants ineligible for federally funded assistance. As a result, counties will incur costs to the extent that newly legalized immigrants require public or medical assistance not otherwise available to them. The amount of this new county cost is unknown at this time. The IRCA also authorizes counties to disqualify certain legalized immigrants from aid. This step would require state legislation.

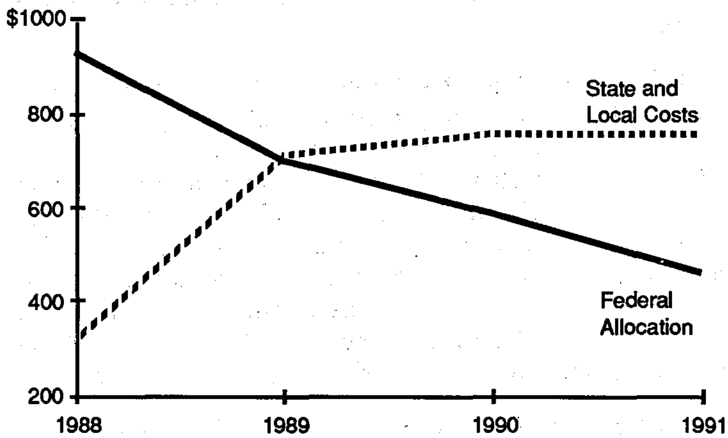
Will Federal Funding Levels Be Sufficient to Support Increased State and Local Costs?

The obvious question is whether state and local costs to serve newly legalized immigrants will exceed the federal assistance grant monies. At the time this analysis was prepared there was not sufficient information available to answer this question. Specifically, the administration had not prepared cost estimates for the various affected programs and the DHHS had not developed the formula which will determine California's share of the federal appropriation.

Still, we believe that the allocation *in the initial year* should be sufficient to cover the costs for two reasons. First, the federal, state, and local costs in the initial years of implementation are not likely to be as great as they are in subsequent years. This is primarily because (1) it will take some time to legalize eligible persons, and (2) the persons who are legalized are initially less likely to use as many services as the general population, as discussed earlier. Second, because the annual federal appropriation is constant but the offset for federal costs increases each year, the amount available for allocation to states decreases for each of the four years that federal funds are available. Chart 51 illustrates this relationship using estimates provided by the Congressional Budget Office.

Chart 51

State and Local Costs Compared to Federal Allocations 1988 through 1991 (in millions)



Source: Based on Congressional Budget Office estimates

Implementation Issues Facing the Legislature

While many of the decisions regarding implementation of IRCA in California will be made by federal agencies and, thus, are not subject to legislative control, the Legislature can influence certain aspects of its implementation. The Legislature can for example, help to shape the federally required state plan for assisting legalized immigrants, it can ensure that the Governor's Budget contains adequate funding for the expected additional costs, and it can require that appropriate data on service needs and expenditures are collected to assist in future policy deliberations.

The Legislature Should Review the Application for Legalization Assistance

We recommend that the Legislature adopt supplemental report language requiring the Department of Finance to (1) submit the state application for funds required by IRCA to the Legislature for review, (2) advise the Legislature on whether the expected amounts of federal funding will be adequate, and (3) advise the Legislature of the effect of the expenditure plan on state and local costs in years beyond 1990–91.

To be eligible for legalization assistance grants a state must submit to the Secretary of Health and Human Services, and have approved, an application that includes information on (1) the number of legalized immigrants residing in the state, (2) estimated state and local costs to provide assistance, and (3) state procedures and controls for allocating grant funds.

In order to provide the information required by DHHS, the administration will need to make several important policy decisions which we believe should be subject to legislative review. These decisions revolve primarily around defining which services will be available, which agency or level of government should provide them, and how funds will be divided among state and local agencies. The following list indicates just a few of the issues involved:

- Will medical assistance be provided through local county-operated medical assistance programs or through the state Medi-Cal program, or some combination of the two?
- What specific Medi-Cal services will be authorized for legalized immigrants eligible for Medi-Cal? For example, IRCA simply indicates that women are eligible for "pregnancy-related services."
- Which educational services will the state provide as assistance to newly legalized immigrants?
- What proportion of educational services to legalized immigrant adults will be provided by the K–12 adult programs and what proportion by community colleges?
- How much of the federal legalization assistance funding will the state allocate to each of the three broad categories of public assistance, public health assistance, and education?
- How much of the federal funds will the state allocate to county governments?
- Will the state make AFDC-U benefits available to eligible legalized immigrants?

Decisions regarding which services to provide, who will provide them, and how they will be funded need to take into account their implications for the state's *future* fiscal position. The future implications are important because the federal assistance funds will not be available after state fiscal year 1990–91. If adequate consideration has not been given to this question, state and local governments could suddenly face major "new" costs.

Because major policy and fiscal decisions must be made in the course of developing the application for a federal assistance grant, we recommend that the Legislature adopt supplemental report language requiring the Department of Finance to submit the application to the Legislature for review prior to its submission to DHHS. We further recommend that the Legislature direct the Department of Finance to consider and advise the Legislature on (1) whether the expected amount of federal funding will be adequate and (2) the effect of its expenditure plan on state and local program costs in years beyond 1990–91. The following language is consistent with this recommendation:

"The Department of Finance shall submit the state application for federal legalization assistance funding to the Legislature for its review prior to its submission to the United States Department of Health and Human Services. The Department of Finance shall also advise the Legislature on (1) whether the expected amounts of federal funding will be adequate and (2) the effect of its expenditure plan on state and local program costs in years beyond 1990–91."

Cost Estimates Should Be Included in the Governor's 1987–88 Budget

We recommend that the Legislature (1) direct the Department of Finance to include in its May revision, estimates of the fiscal effects of IRCA for state programs in 1987–88, (2) adopt a control section to appropriate the expected federal funding, and (3) adopt supplemental report language directing the Department of Finance to include the fiscal effects of IRCA in the 1988–89 Governor's Budget.

In addition to developing fiscal estimates for the state application, it is important to include the estimated cost to state programs in the 1987–88 state budget. The Governor's Budget does not include these expected costs even though they could be major for programs such as Medi-Cal and SSI/SSP. Additionally, the budget should include estimates of costs and savings associated with the verification systems required for public and medical assistance programs. We recommend, therefore, that the Legislature direct the Department of Finance to (1) identify the programs that will be affected, and (2) estimate the additional costs or savings by source of funds as part of the May revision. We also recommend that the Legislature include a Control Section in the Budget Bill to appropriate the expected federal assistance funding that will be received in 1987–88. The Control Section should include a schedule that allocates the funds to the programs designated by the Legislature.

In order to ensure future legislative review of these program expenditures, we further recommend that the Legislature adopt supplemental report language directing the Department of Finance to include the fiscal effects of IRCA in the 1988–89 Governor's Budget. The following language is consistent with this recommendation:

"The Department of Finance shall include in the 1988–89 Governor's Budget a discussion of the fiscal effects of the Immigration Reform and Control Act for affected state and local programs in 1988–89. The discussion shall include a table detailing each of the programs and the estimated fiscal effect for federal, state, and local funds."

The Legislature Should Continue to Monitor Implementation

We recommend that the Legislature direct the Department of Finance to submit to the Legislature its plan for collecting information on legalized immigrants. We further recommend that the Legislature adopt supplemental report language directing the department to collect the necessary data and report it to the Legislature.

The Legislature will need additional and more reliable demographic, service needs, and expenditure data to make future decisions about allocating resources for legalization assistance. The data can serve as the basis for requesting adjustments in the DHHS state allocation formula, if appropriate, or advocating for additional federal appropriations if the initial assistance grant proves to be inadequate. The data can also be used to guide the Legislature's decisions when it allocates resources for legalization assistance in the future.

Because so little is known about the undocumented immigrant population and because the funding decision for 1987–88 will be based on preliminary estimates, this information will be critical for evaluating and making modifications to the decisions made for the budget year. Consequently, we recommend that the Legislature direct the Department of Finance to prepare a plan for collecting the appropriate data concerning the numbers of undocumented immigrants that are and will be legalized, their service needs, their level of service utilization, and the costs of serving them in each of the affected programs. The plan should also comment on the need for a joint legislative-administrative task force or some other appropriate mechanism to oversee IRCA implementation. The Legislature should receive the plan as part of the May revision.

We recognize that this is a short time frame for preparing such a plan; however, in our view, the need to initiate the data collection effort is important enough to warrant this recommendation. Moreover, it is likely that the administration would be considering its data needs when preparing the application to DHHS for federal assistance funding.

In addition to reviewing the plan, we recommend that the Legislature adopt supplemental report language directing the Department of Finance to collect the information identified in its plan and submit it to the Legislature. The following language is consistent with these recommendations:

"The Department of Finance shall collect additional information on the immigrants legalized under provisions of the Immigration Reform and Control Act and report this information to the Legislature by January 1, 1988. The report shall include, but is not limited to, the following information:

(1) The number of undocumented immigrants who have been legalized.

(2) An estimate of the number who will be legalized in 1987–88.

(3) Demographic data (including income levels).

(4) The immigrants' service needs.

(5) Their level of participation in government programs.

(6) The costs of serving them in each of the affected programs."

By acting on these recommendations, the Legislature will be in a better position to shape California's implementation of IRCA and to address its fiscal implications.

FEDERAL INITIATIVE FOR EARLY EDUCATION FOR THE HANDICAPPED

Should the State Participate in New Federal Programs for Handicapped Children Under the Age of Five?

Summary

- *New federal legislation requires states accepting additional federal special education funds for handicapped children under age five to significantly expand services to children in this age group.*
- *Expanding services to preschoolers (three and four years of age) would cost the state an estimated $177 million over the next five years; expanding services to infants (under the age of three) would cost the state an estimated $206 million over the next five years.*
- *The long-term benefits of early intervention programs have not been well documented.*
- *We recommend that the Department of Finance clarify the administration's intent regarding California's participation in these programs.*

Recent federal legislation requires the state to assess the level of intervention services it wishes to provide for very young handicapped children. Choices made for the budget year will determine whether state expenditures and service levels remain relatively level, or increase dramatically, over the next five years.

Background

Under current state law, local education agencies (LEAs) are *mandated* to operate special education programs for severely handicapped preschoolers (three and four years of age) who require intensive special education and services. In addition, LEAs are *authorized* to provide special education services to severely handicapped infants (under the age of three) who require intensive services.

Although the state funds the majority of the cost of these programs, it receives some federal assistance. The state currently spends an estimated $46 million on preschool programs serving approximately 9,000 children. The state also spends $17 million for infant programs which serve approximately 4,000 children. These amounts include $4.9 million in federal funds for preschool programs and $2.3 million in federal funds for infant programs, or 11 percent and 14 percent of total program support, respectively.

Recent Federal Legislation Could Greatly Increase State Costs

Congress recently enacted P.L. 99-457, which changes both the scope and the funding arrangements for these early intervention programs. This measure creates new federal grant programs for special education programs serving preschoolers and/or infants. The act permits states to participate in the infant program without necessarily joining the federal preschool program, or, conversely, to participate in the preschool program without joining the infant program.

Any state accepting these grants would be required to significantly expand its infant/preschool programs. Because the federal grants would only fund a portion of the expansion, however, *participation in these programs would result in major additional costs to California.*

Furthermore, any state which does *not* participate in the *preschool* program would forfeit all federal special education funding for this age group. Some, if not all, of this funding would be lost in the budget year. P.L. 99-457 will thus have an impact on the amount of federal special education funding received by the state in the budget year, whether or not the state chooses to participate.

Because the decision whether or not to accept these funds will have major policy and fiscal implications, the specific terms of the federal act and more information on the details of this decision are described below.

Conditions of State Participation in Federal Programs

Preschool Provisions. Under the act's preschool provisions, states which elect to participate in the new program would be *mandated to serve all handicapped preschoolers by 1990–91.* (The mandate would be delayed until 1991–92, however, if Congress fails to appropriate the total amount of funding specified in the act.)

According to the State Department of Education (SDE), the new law requires states to use the same eligibility criteria for the preschool program as are used in the special education program for school-aged children. Since California's preschool program, unlike it's school-aged special education program, is currently restricted to children with relatively severe handicaps, the state would need to significantly expand its current preschool program to serve the *nonseverely* handicapped population as well, in order to retain eligibility for federal preschool funding. If the state were to choose not to continue to accept federal funds, however, it would be exempt from this requirement.

In Table 57, we compare the estimated costs associated with state participation in the new federal preschool program with the costs which would result if the state decided not to participate. (Our estimates are based on data from a variety of sources, including the Department of Education.) The table assumes that expansion of the preschool program would occur evenly over a five-year period, beginning in the budget year. It is possible, however, that the state would not begin to forfeit existing federal funds (P.L. 94-142) until 1991–92. This matter will depend on how the U.S. Department of Education chooses to interpret the new act, and should be clarified once the federal agency issues its administrative regulations.

As the table shows, the total state cost of participating in the preschool program in the budget year would be $47.8 million, versus total costs of $43.1 million if the state decided not to participate—a difference of $4.7 million. The difference, however, would increase over time, as the expansion of the preschool program was phased in, and would total $67 million annually beginning in 1991–92. *Total additional costs to the state over the next five years would equal $177 million.*

The table also displays the costs which would be financed with federal funds—$16.9 million in 1987–88, increasing to $29.6 million in 1991–92. These estimates assume that Congress will appropriate slightly less than the "full-funding" level specified in the act; it is possible, however, that Congress could appropriate *significantly less* than the amounts we have assumed, in which case state costs would increase. Congressional underfunding of the act is not unlikely, given the constraints on the federal budget associated with the deficit target provisions of the Gramm-Rudman-Hollings Act.

Infant Provisions. P.L. 99-457 also creates a new federal grant program for handicapped infants, under the age of three.

Under current *state* law, LEAs are generally free to determine the number of handicapped infants, if any, which they will serve. It is estimated that only about 15 percent of all handicapped infants in the state currently receive special education services.

Participation in the new federal infant program would require the state to expand services by 1990–91 to all handicapped infants manifesting "developmental delays." The state would have some discretion over how to define "developmental delay" and, thus, could determine to some extent how broad or restrictive to make eligibility for the program. Even assuming continued use of the state's existing eligibility criteria (which restrict services to infants with relatively severe handicaps), however, state costs would increase dramatically, since the state would be required to make services available to *all* handicapped children who meet the existing criteria.

Participation in the infant program, therefore, would have major fiscal implications for the state. On the other hand, the state would suffer no adverse consequences if it decided *not* to participate, since, unlike the preschool program, no existing federal funds would be lost.

Table 57
Costs Associated With Federal Early Education Program Participation versus Maintenance of Existing Effort 1986–87 through 1991–92

	Participate in Federal Program			*Do Not Participate Maintain Existing Effort*			
	Child-Years of Service	*State Cost (millions)*	*Federal Cost (millions)* [a]	*Child-Years of Service*	*State Cost (millions)* [b]	*Federal Cost (millions)* [c]	*Increased State Cost (millions)*
			I. Preschool				
1986–87	9,000	$41.0	$4.9	9,000	$41.0	$4.9	—
1987–88	14,123	47.8	16.9	9,000	43.1	—	$4.7
1988–89	19,246	62.1	21.4	9,000	43.1	—	19.1
1989–90	24,368	79.5	22.8	9,000	43.1	—	36.4
1990–91	29,491	92.9	28.2	9,000	43.1	—	49.8
1991–92	34,614	110.3	29.6	9,000	43.1	—	67.2
TOTALS	130,842	$433.6	$123.8	54,000	$256.5	$4.9	$177.1
			II. Infant				
1986–87	4,000	$14.7	$2.3	4,000	$14.7	$2.3	
1987–88	8,600	27.1	7.3	4,000	14.7	2.3	$12.4
1988–89	13,200	43.0	9.8	4,000	14.7	2.3	28.3
1989–90	17,800	58.9	12.3	4,000	14.7	2.3	44.2
1990–91	22,500	75.2	14.8	4,000	14.7	2.3	60.5
1991–92	22,500	75.2	14.8	4,000	14.7	2.3	60.5
TOTALS	88,600	$294.1	$61.3	24,000	$88.2	$13.8	$205.9

[a] Estimates are "midrange" between full-funding level and continuation of base. Includes potential increases in PL 94-142 funds.
[b] Includes replacement, beginning in 1987–88, of $2.1 million PL 94-142 funds for students ages three and four currently used for local assistance. Does not reflect replacement of $2.9 million in federal funding for children age five.
[c] Table assumes decrease in federal PL 94-142 funding begining in 1987–88; actual decrease may not commence until later.

As shown in Table 57, the total state costs of participating in the infant program in the budget year would be $27.1 million, versus total costs of $14.7 million if the state decided not to participate—a difference of $12.4 million. The difference would increase over time, as the expansion of the infant program is phased in, and would total $61 million annually beginning in 1990–91. *Total additional costs to the state over the next five years would equal $206 million.* (The estimates assume continued use of the state's existing eligibility criteria; costs would be higher if eligibility for services were broadened.)

Do the Benefits of Early Intervention Programs Exceed The Costs?

During the current fiscal year, the Legislature may be called upon to decide whether or not the state should participate in either or both of these federal programs. We believe that, when addressing this question, the Legislature should consider whether the benefits to the state from expanding early intervention programs would justify these major increases in costs.

Although SDE claims that current and past studies examining the efficacy of early intervention programs have consistently concluded that the provision of such services reduces the need for later special education services, our own review indicates that there is no consensus among experts on this issue. For instance, a recent comprehensive analysis of the literature by researchers at the University of Utah found that (1) most of the conclusions about the long-term effectiveness of early intervention have been based on studies of very poor methodological quality or on studies involving disadvantaged—rather than handicapped—children, and (2) long-term results from high-quality studies with handicapped children are virtually nonexistent. These authors conclude that, in the absence of valid data, it is not only difficult to determine whether or not early intervention is cost-effective, but if so, in what form and for what categories of children.

In order to gain more reliable data on these questions, the U.S. Department of Education is sponsoring a series of 16 longitudinal studies on various early intervention programs in various states. The results of these studies, however, will not be available for five years. Thus, the Legislature will have to make its participation decision without the benefit of conclusive information on the possible impact of early intervention on these youngsters.

Options for Legislative Action

Based on our analysis of the federal law, we believe that the state has the following three options in the area of early intervention:

- Participate in one or both of the federal programs;
- Do not participate and expand the current level of services; and
- Do not participate and maintain the current level of services.

(The state need not select the same option for preschoolers as for infants.)

Given the lack of reliable data on the effectiveness of early intervention programs, we are unable to advise the Legislature on the precise level of benefits associated with each option; we can, however, determine the number of children who would be served under each option, as well as the corresponding cost. The amount of services and costs associated with each option are shown in Tables 57 and 58, for the years 1986–87 through 1991–92.

Option One: Participate in the Federal Program. As shown in Table 57, over a period of six years, the state would provide a total of 130,842 child-years of service for preschoolers, and 88,600 child-years of service for infants, at total state costs of $434 million and $294 million, respectively. As noted earlier, however, state costs would be higher if the amount of federal funding provided is less than we have assumed. This may well be the case since the President has already requested that Congress (1) reduce the amount appropriated for both programs in 1987–88 by 56 percent, and (2) eliminate all funding for the infant program in the budget year.

Table 58
Early Education Programs
Nonparticipation/Expansion versus Maintenance of Existing Effort
1986–87 through 1991–92

	Do Not Participate; Expand Services			*Do Not Participate; Maintain Existing Effort*			
	Child-Years of Service [a]	*State Cost (millions)*	*Federal Cost (millions)*	*Child-Years of Service*	*State Cost (millions)* [b]	*Federal Cost (millions)* [c]	*Increased State Cost (millions)*
I. Preschool							
1986–87	9,000	$41.0	$4.9	9,000	$41.0	$4.9	—
1987–88	9,900	46.4	—	9,000	43.1	—	$3.3
1988–89	10,890	50.0	—	9,000	43.1	—	6.9
1989–90	11,979	54.0	—	9,000	43.1	—	10.9
1990–91	13,177	58.4	—	9,000	43.1	—	15.3
1991–92	14,495	63.2	—	9,000	43.1	—	20.1
TOTALS	69,440	$313.0	$4.9	54,000	$256.5	$4.9	$56.5
II. Infants							
1986–87	4,000	$14.7	$2.3	4,000	$14.7	$2.3	—
1987–88	4,400	15.3	2.3	4,000	14.7	2.3	$0.6
1988–89	4,840	17.1	2.3	4,000	14.7	2.3	2.4
1989–90	5,324	19.0	2.3	4,000	14.7	2.3	4.3
1990–91	5,856	21.1	2.3	4,000	14.7	2.3	6.4
1991–92	6,442	23.5	2.3	4,000	14.7	2.3	8.8
TOTALS	30,862	$110.6	$13.8	24,000	$88.2	$13.8	$22.4

[a] Assumes ten percent rate of expansion.
[b] Includes replacement, beginning in 1987–88, of $2.1 million PL 94-142 funds for students ages three and four currently used for local assistance. Does not reflect replacement of $2.9 million in federal funding for children age five.
[c] Table assumes decrease in federal PL 94-142 funding beginning in 1987–88; actual decrease may not commence until later.

In the absence of federal regulations, we do not know at this time whether the state could in the future withdraw from these programs after initially accepting P.L. 99-457 funds. Based on experiences with other federal programs, however, the state may be required to return federal funding associated with *all* years of participation which, as a practical matter, would make it extremely difficult for the state to withdraw. The state would thus essentially become "locked-into" the programs once it began to accept federal funds.

Option Two: Do Not Participate and Expand the Current Level of Service. Under this option, services would be expanded *without* the benefit of federal funds. Since the state would be exempt from the federal mandate, it could proceed with the expansion of the programs at whichever rate, and for whatever categories of children, it deemed best. Table 58 illustrates this option, assuming services were expanded at a rate of 10 percent annually. As shown in the table, a total of 69,440 child-years of services for preschoolers and 30,862 child-years of service for infants would be provided over the six-year period, at total state costs of $313 million and $111 million, respectively.

Option Three: Do Not Participate and Maintain the Current Level of Services. Under this option, the state would continue to serve approximately 9,000 preschoolers per year and 4,000 infants per year. Cumulative child-years of service provided would total 54,000 for preschoolers and 24,000 for infants over the six-year period; total state costs would be $256 million and $88 million, respectively.

Conclusion

We recommend that the Department of Finance clarify the administration's intent regarding California's participation in new federal grant programs for handicapped infants and preschoolers, because the budget is unclear regarding this matter.

The drastically different projections of state costs under these options, and the lack of data on the effectiveness of early intervention programs, point to the need for the Legislature to review whether the state should participate in either or both of these programs. This decision will begin to affect costs as early as the budget year. Specifically, compared to the level of state expenditures in the current year:

- If the state decides not to participate in the federal programs, but maintains existing service levels, it will cost the General Fund an additional $2.1 million in 1987–88 because the state would have to replace lost federal funds in this amount.
- If the state decides to participate in both federal programs, it will costs the General Fund an additional $19.2 million in 1987–88, as a result of increased program participation pursuant to federal eligibility requirements.

The Governor's Budget, however, neither specifically provides for California's participation in these programs, nor reflects any anticipated loss in federal funding associated with nonparticipation. Rather, the budget merely authorizes the same amount of federal funding for these age groups as was received in the current year (increased slightly for infants). The budget is therefore unclear as to whether it intends for California to accept P.L. 99-457 funds.

Because the decision whether or not to accept these funds will have major policy and fiscal implications, we recommend that the Department of Finance clarify the administration's intent, at the time of budget hearings, regarding whether or not California should participate in these programs.

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