Perspectives on the 1991-92 Budget

II

Part II

Perspectives on the 1991-92 Budget

This part provides a discussion of the state's revenues and expenditures in 1991-92 and the assumptions underlying them. The first section of this part describes California's current economic and demographic environment, which affects both revenues and expenditures. The second section presents the outlook for revenues and assesses the reliability of the revenue forecast. The third section summarizes the budget's spending plan, highlighting the major program changes and the factors driving program costs.

The major findings of this part include:

- The California economy is predicted to experience a brief and mild downturn, with recovery beginning by the latter half of 1991. The economic outlook, however, is characterized by considerable uncertainty.
- The state is experiencing rapid population growth, characterized by strong in-migration and shifts in the ethnic and age distributions of the population. These trends have a variety of implications for the state's spending programs.
- Because of the soft economy, underlying revenue growth is projected to be weak. Our assessment of the budget's revenue forecast is that the Legislature should not count on the $1.2 billion in economic recovery adjustment revenues assumed by the administration on top of its

standard revenue forecast. This is because its standard economic forecast already assumes an economic recovery. In addition, the revenue forecast is subject to unusually large error margins, given the uncertainties in the economic forecast.

- The Governor's Budget proposes a General Fund expenditure increase in 1991-92 totaling 3.7 percent. Expenditure growth is significantly below the amount needed to maintain current service levels and reflects several major proposals that reduce spending. These include suspension of Proposition 98, reductions in welfare grant levels, and reduced renters' tax relief payments. In addition, the Governor also proposes a major realignment involving health programs.

California's Economic and Demographic Environment

California's economic performance and the demographic trends occurring in the state are key determinants of both state revenues and expenditures. In the case of expenditures, for example, program needs are affected both by the rate of inflation and program caseloads, and the latter are influenced by such factors as overall population growth, the age characteristics of the population, and the unemployment rate. Likewise, revenues depend on such economic factors as income and job growth in the economy, which in turn are influenced by demographic variables such as the size of the labor force and number of people needing the various goods and services which businesses produce. This section discusses the basic economic and demographic forces operating in California which underlie the revenue and expenditure projections discussed later in this part.

THE CURRENT ECONOMIC CLIMATE

The current economic climate is fairly negative and full of uncertainties. The national economy is in the midst of a recession, and California's economy also has slowed markedly in recent months. The key question at the moment is how deep and lengthy the national recession will be, and to what extent California will share in the downturn.

The National Economy—Recession Has Arrived

The nation's economy weakened steadily throughout 1990, and is now in a recession which began in the latter half of last year. Recent economic data show that retail sales are soft, consumer confidence is weak, car sales and housing starts have fallen, industrial production and corporate profits have declined, business investment is down, manufacturing employment has contracted, and unemployment has been rising. Adding to these problems is the uncertainty regarding the war in the Persian Gulf, including how long it might last and its possible effects on oil prices. Also of concern is the renewed growth in the federal budget deficit and the ongoing foreign trade imbalance.

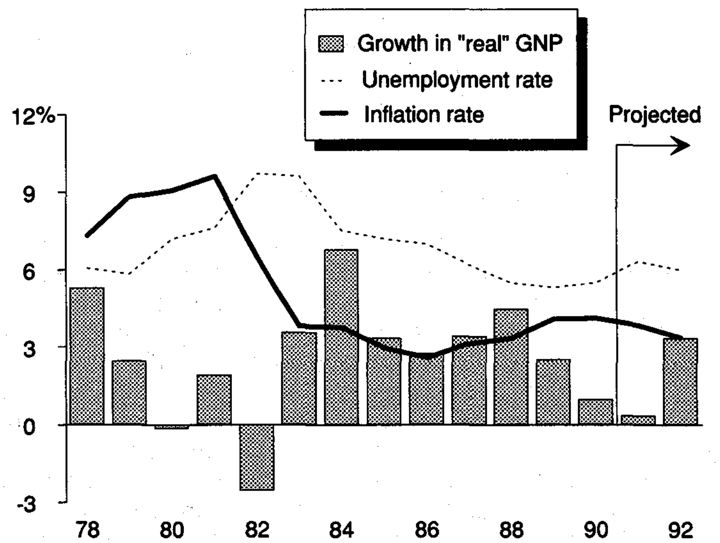
The Forecast—Moderate Downturn Followed by Recovery

Figure 1 shows what the Department of Finance is predicting for the nation's economy. It indicates that a moderate downturn is expected, with growth in "real" Gross National Product (GNP) of only 0.3 percent in 1991. Figure 2 shows the predicted quarterly time pattern of the downturn. It indicates that real GNP growth is expected to be negative in the first quarter of 1991, as it was in the last quarter of 1990. Then, beginning in mid-year 1991, a fairly strong "bounce back" is predicted for several quarters. This is to be followed by a return to sustained economic expansion in 1992, with 3.4 percent GNP growth for 1992 as a whole. Figure 1 shows that the unemployment rate is expected to rise through mid-1991 before turning back down, and inflation is expected to remain modest—around 4 percent. It also indicates that the recession is expected to be much less severe than the economic downturn of the early 1980s.

Figure 1

Trends in Key National Economic Variables

1978 through 1992

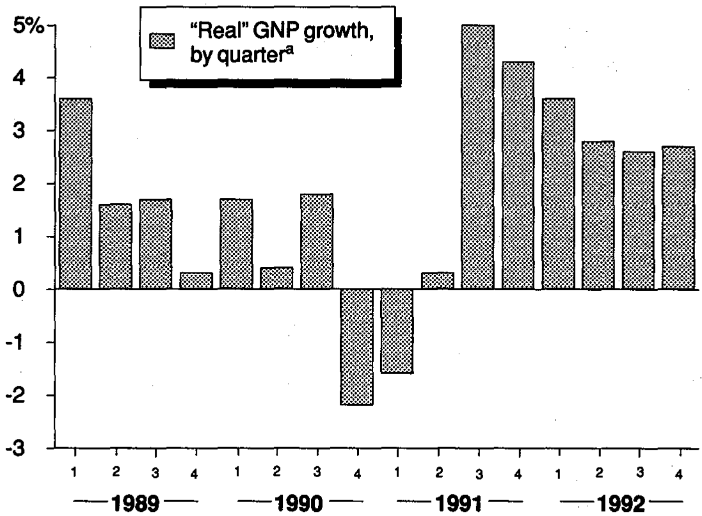


Source: Department of Finance.

Figure 2

The Recession's Projected Pattern

1989 through 1992



[a] Data reflect annualized quarterly rates of change.
Source: Department of Finance.

The California Forecast—Mild Downturn Anticipated

Figure 3 summarizes the department's economic forecast for California in 1991 and 1992, and compares it to the nation's. Like the nation, California is expected to experience a downturn, although the department predicts that the state will outperform the nation. For example, California's 1991 personal income growth is expected to be 6.3 percent versus the nation's 5.2 percent, while its job growth is expected to be 1.7 percent versus the nation's 0.8 percent.

As with the nation, California's downturn is predicted to be less severe than the early 1980's recession. For example, Figure 4 shows that, after adjusting for inflation, the expected slowing in personal income growth in this downturn is not as pronounced as during the previous recession. Likewise, Figure 5 shows that California is expected to at least experience some job growth in 1991, compared to the actual decline that occurred in 1982.

Figure 3

Department of Finance Economic Outlook for California and the Nation

1990 through 1992

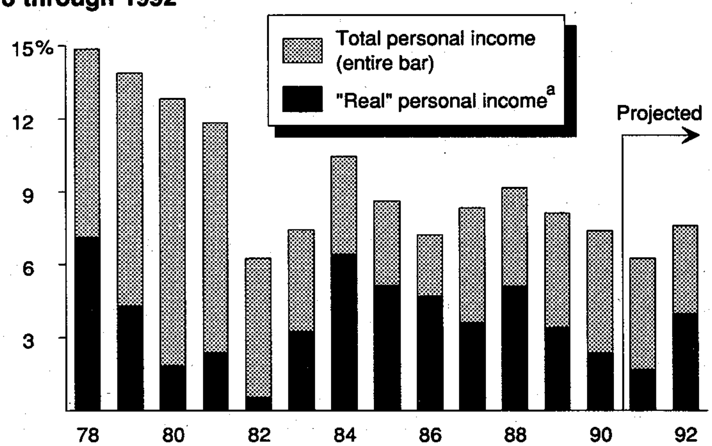
California Economic Indicators	1990 Estimated	1991 Projected	1992 Projected
Percent change in:			
Personal income	7.4%	6.3%	7.6%
Wage and salary employment	2.9	1.7	3.7
Consumer Price Index	5.5	5.0	4.0
Unemployment rate (%)	5.5	6.2	5.6
Residential building permits (thousands)	174	162	212
National Economic Indicators			
Percent change in:			
Real GNP	1.0%	0.3%	3.3%
Personal income	5.9	5.2	6.8
Wage and salary employment	1.8	0.8	2.6
Consumer Price Index	5.4	5.0	3.7
Pre-tax corporate profits	-0.4	-8.7	16.9
Unemployment rate (%)	5.5	6.3	6.0
Prime interest rate (%)	10.0	9.1	9.6
New car sales (millions)	9.5	9.1	9.8
Housing starts (millions)	1.23	1.17	1.42

Source: *1991-92 Governor's Budget* and Department of Finance.

Figure 4

Annual Growth in California Personal Income

1978 through 1992



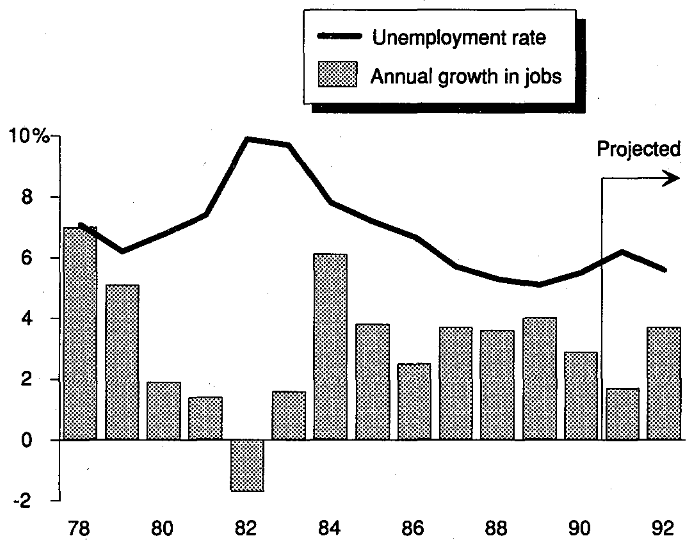
[a] "Real" personal income is defined as total personal income deflated by the GNP consumption expenditures deflator.

Source: Department of Finance. Data are estimated for 1990.

Figure 5

Trends in California's Employment And Unemployment

1978 through 1992



Source: Department of Finance and Employment Development Department. Data are estimated for 1990.

How Reliable Is the Economic Forecast?

Economic forecasts are subject to considerable error. This is especially true in transition periods such as this, when the pace of the economy is changing. As noted in the Governor's Budget, actual economic performance for 1991 and 1992 could end up being significantly different than predicted, especially given the considerable number of concerns and uncertainties in the outlook at this time. Some of these factors are itemized in Figure 6, including the war and California's drought.

At the time the budget was released, the department's economic forecasts for the nation and California both were reasonably consistent with the consensus views of economists. Since that time, however, most reports on the economy have been fairly negative. For example, California's unemployment rate reached 7 percent in January 1991, which was higher than most forecasters (including the department) had been expecting. Given such reports, many forecasters have recently revised their projections downward. As a result, the consensus forecast for the

Figure 6

Concerns and Uncertainties in the Economic Outlook

- ☑ ***War in the Persian Gulf.*** How long will it last, and what will be its effects in such areas as military spending and oil supplies and prices?
- ☑ ***Consumer confidence.*** When will it strengthen from its current low level, and what will be its effects on consumer spending?
- ☑ ***Federal monetary policies.*** Will federal monetary authorities be successful in providing enough credit to help stimulate the economy without setting the stage for a resurgence of inflation?
- ☑ ***California's drought.*** How severe and lengthy will the drought be, and what will be its impacts on agriculture, tourism, construction, and other areas of the economy?
- ☑ ***Federal budget deficit.*** What effects will the growing federal budget deficit have, such as in terms of constraining private sector business investment?
- ☑ ***Foreign trade activity.*** Will the economies of California's major trading partners remain healthy and keep the state's export markets strong?
- ☑ ***Defense spending.*** By how much will planned cutbacks in federal defense spending reduce employment and income in California?
- ☑ ***The housing market.*** What will happen to California housing prices and home sales over the next year, given the softness in the housing market that appeared in 1990?

California economy now is a bit *less optimistic* than the budget's forecast. This is not to say that the budget's economic forecast should not be used for preliminary budget planning purposes. What it does suggest, however, is that the Legislature needs to be especially mindful of the downside risks inherent in the budget's economic forecast. Thus, it will need to closely monitor the economy's performance in the months to come and, depending on what happens, be prepared to use revised estimates of state revenues and expenditures.

CALIFORNIA'S DEMOGRAPHIC ENVIRONMENT

California is in the midst of rapid changes in the size and composition of its population. These changes have many implications for the future course of California's economy and for the volume and mix of public services that will be needed in the budget year and beyond.

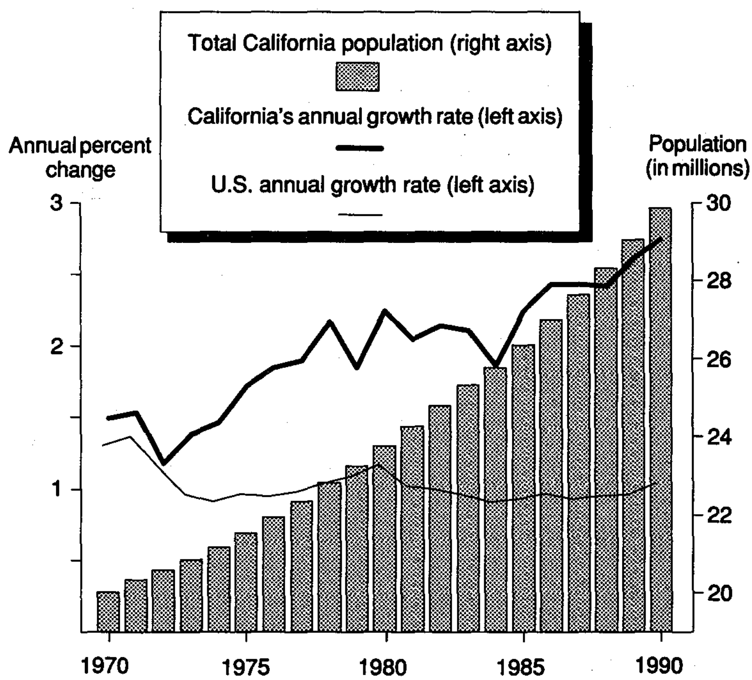
Rapid Population Growth

Figure 7 shows that the state's population has been growing about twice as fast as the nation's population since the late 1970s. Furthermore, the state's population growth rate accelerated after 1985, reaching 2.7 percent in 1990. This is the highest annual growth rate in the past 25 years, and compares to a national population growth rate in 1990 of only 1.1 percent. In numerical terms, California gained almost 800,000 new residents in 1990—a population greater than that of San Francisco.

Figure 7

California's Rapid Population Growth

1970 to 1990



Source: Department of Finance.

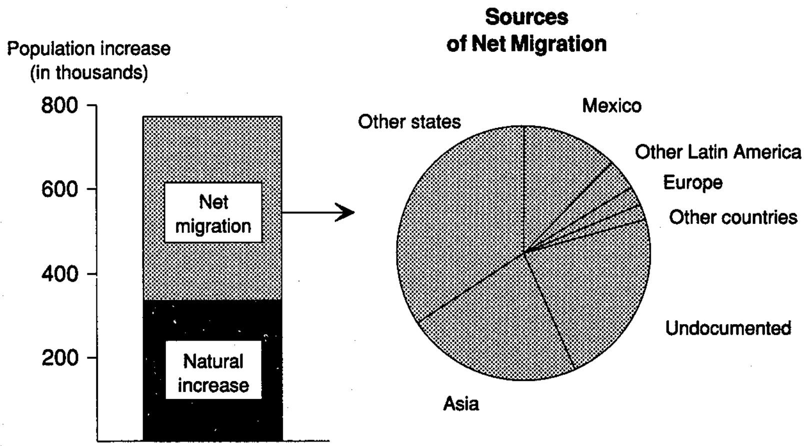
Immigration Spurs Population Growth

There are two sources of population growth: *natural increase*, which is the excess of births over deaths, and *net migration*, which is the difference between the number of people who come to California and the number of people who leave. Figure 8 illustrates the sources of California's population growth in 1989. It shows that more than half of the growth was attributable to net migration, a trend that most demographers expect to continue for at least several more years.

The figure also shows that more than half of the people migrating to California are immigrants from other countries. Mexico is the largest single source of immigrants to California, providing about 50,000 new legal immigrants annually and most of the estimated 100,000 undocumented annual immigrants to the state (these estimates exclude persons already residing in the state who are legalized under the federal Immigration Reform and Control Act of 1986). Asia is the second largest source of immigrants to California—particularly the Philippines, Southeast Asia, China, and Korea. Only about one-third of the people

Figure 8

More Than Half of California's 1989 Population Growth Was From Migration



Source: Legislative Analyst's estimates based on data from the Department of Finance and the U.S. Immigration and Naturalization Service.

who move into California are from other states. Given the above, federal immigration policies, along with the economic and political conditions in other countries, will be important determinants of the rate and composition of California's population growth in the budget year and beyond.

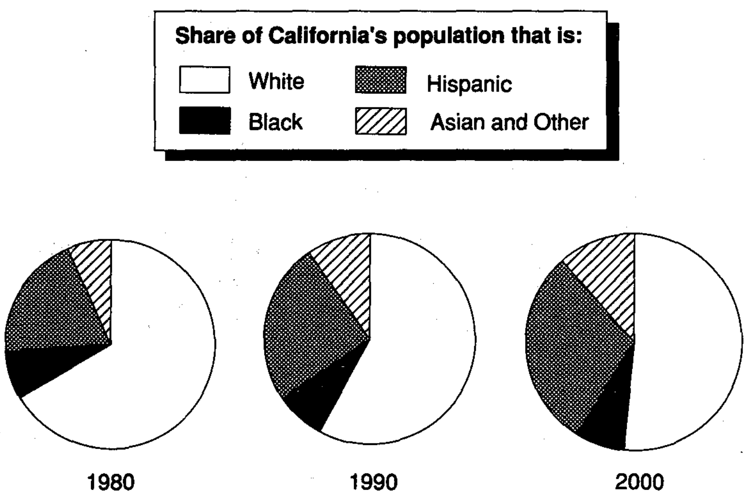
Increasing Ethnic Diversity

The large number of immigrants and the higher birthrates of many immigrant groups and ethnic minorities in California are rapidly changing the state's ethnic makeup. Figure 9 illustrates the evolution of the state's ethnic composition that has taken place over the last decade and that is projected to occur over the next decade. During this 20-year period, the non-Hispanic white portion of the state's population will shrink from about two-thirds to about one-half, while the black portion of the population will remain essentially constant. In contrast, the Hispanic portion of the population will grow from about one-fifth to close to one-third, and Asians will make up more than one-tenth of California's population by the year 2000. As a result of these trends, California is currently the most ethnically diverse state

Figure 9

California's Ethnic Makeup is Changing

1980 through 2000



Source: Department of Finance.

in the nation after Hawaii.

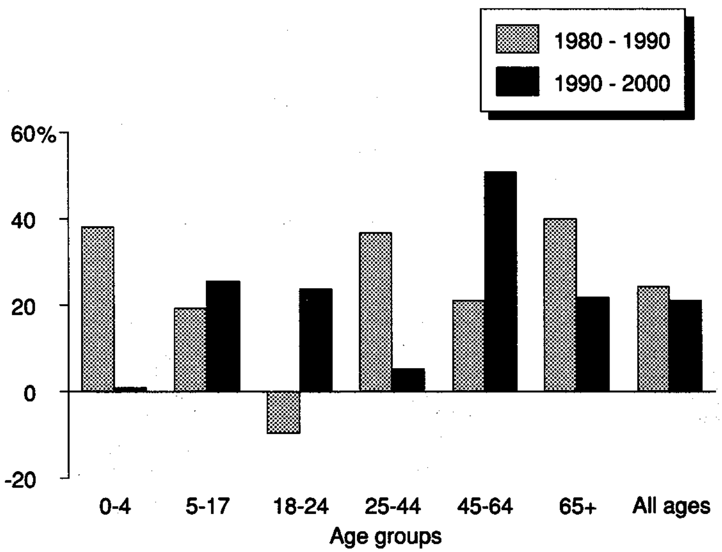
Changes in the Age Distribution of Californians

Rapid changes also are taking place in the age distribution of California's population. As shown in Figure 10, the decade of the 1980s saw rapid growth in the 25 to 44 age group (a key component of the workforce), as the postwar baby boomers matured. The 1980s, however, also saw strong growth among the very young and the elderly portions of the population. Meanwhile, the number of young adults aged 18 to 24 actually declined. During the decade of the 1990s, California's workforce will grow older on average as the baby boomers enter their late 40s and 50s. The decline in the young adult population will reverse, however, and growth in the 18 to 24 age group will provide increasing numbers of entry-level workers and potential college students during the 1990s. Growth in the K-12 school-age population will accelerate, as is already occurring, but the number of preschoolers will

Figure 10

Percent Increase in California's Population By Age Group

1980s versus 1990s



Source: Department of Finance.

change relatively little over the next decade. Although the elderly population will continue to grow in the 1990s, it will do so at a slower pace than during the 1980s.

What Effects Will These Trends Have?

The state's rapidly growing and changing population will have many implications for California, including for its economy and state and local governments. For example:

- Continued population growth will generate increased economic activity, while at the same time imposing additional infrastructure demands on state and local governments.
- Growth in the school age and young adult populations will place greater demands on K-12 and higher education, job training programs, and possibly the criminal justice and correctional systems.
- The rapid changes taking place in the state's ethnic composition will place many public institutions, especially schools, under increased stress as they attempt to serve a public that speaks a multitude of languages, and that has a wide diversity of educational and cultural backgrounds.

The effects of demographic factors on individual state expenditure programs are discussed further in the remainder of Part Two and in Part Three of this document.

Revenues in 1991-92

This section reviews the budget's estimates of state revenues, including our evaluation of the reliability of the revenue forecast. These revenues are divided into two general categories: General Fund revenues and special fund revenues. Figure 1 summarizes the relative size of these revenue categories and their major components. We first discuss the General Fund revenue forecast followed by a discussion of the forecast for special fund revenues.

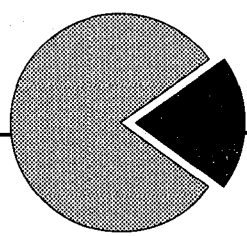
Figure 1

State Revenues in 1991-92

(in billions)

General Fund Revenues	
Personal Income Taxes	$20.0
Sales and Use Taxes	16.8
Bank and Corporation Taxes	5.5
All Other	3.5
Total	**$45.8**

Total State Revenues $57 billion



Special Fund Revenues	
Motor Vehicle-Related Taxes	$7.3
Tobacco-Related Taxes	0.6
Sales and Use Taxes	0.2
Alcoholic Beverage Taxes	0.2
All Other	3.0
Total	**$11.3**

Source: 1991-92 Governor's Budget.

THE FORECAST FOR GENERAL FUND REVENUES

General Fund revenues account for approximately 80 percent of all state revenue collections. Figure 2 presents the department's forecast for General Fund revenues, by source, for the prior, current, and budget years.

Figure 2 shows that General Fund revenues are expected to total $40.4 billion in 1990-91 and $45.8 billion in 1991-92. Figure

Figure 2

General Fund Revenues

1989-90 through 1991-92
(dollars in millions)[a]

Source of Revenue	Actual 1989-90	Estimated 1990-91	Projected 1991-92	Change 1990-91 to 1991-92 Amount	Change 1990-91 to 1991-92 Percent
Taxes:					
Personal income[b]	$16,903	$17,620	$20,034	$2,414	13.7%
Sales and use[c]	13,473	13,830	16,780	2,950	21.3
Bank and corporation[d]	4,927	5,370	5,535	165	3.1
Insurance[e]	1,168	1,270	1,325	55	4.3
Estate, inheritance and gift	389	442	487	45	10.2
Cigarette	153	147	158	11	7.5
Alcoholic beverage	129	127	135	8	6.3
Horse racing	107	111	113	2	1.8
Subtotals, taxes	$37,249	$38,917	$44,567	$5,650	14.5%
Other Sources:					
Interest on investments[f]	$390	$365	$390	$25	6.8%
Transfers[g]	477	590	338	-252	-42.7
Abandoned property[h]	249	218	70	-148	-67.9
Oil and gas revenues[i]	60	67	14	-53	-79.1
Other revenues[j]	325	281	392	111	39.5
Totals, General Fund	$38,750	$40,438	$45,771	$5,333	13.2%

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

[b] Estimates include net downward adjustments of $35 million in 1990-91 and net upward adjustments of $1.8 billion in 1991-92 due to adjustments and augmentations relating to proposals for legislation, changes in accounting methods, the Franchise Tax Board "trigger" reduction, and economic recovery.

[c] Estimates include net upward adjustments of $98 million in 1990-91 and $2.1 billion in 1991-92 due to adjustments and augmentations relating to previously enacted and proposed legislation, changes in accounting methods, the Board of Equalization "trigger" reductions, and economic recovery.

[d] Estimates include net upward adjustments of $435 million in 1990-91 and $233 million in 1991-92 due to adjustments and augmentations relating to legislation and changes in accounting methods.

[e] Estimate includes an upward adjustment of $7 million due to legislation accelerating "retaliatory" tax payments.

[f] Includes gross interest income earnings under the state's external borrowing program, which are partially offset by borrowing costs on the expenditure side of the budget.

[g] Includes transfers from the Disaster Relief Fund of $254 million in 1990-91 and $135 million in 1991-92. These amounts are to reimburse the General Fund for expenditures and revenue losses associated with the Loma Prieta earthquake.

[h] Includes a revenue increase of approximately $137 million in 1990-91 due to Ch 450/90 (SB 57, Lockyer), which shortened the time period from five to three years after which unclaimed property escheats to the state.

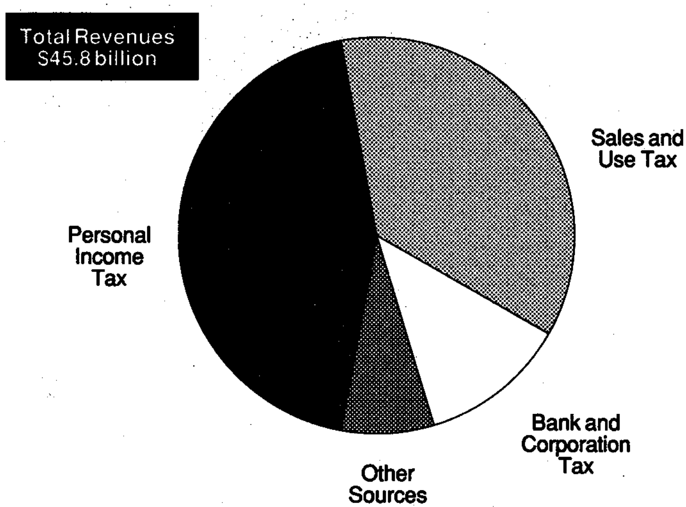
[i] Represents oil and gas revenues from state lands. Excludes royalties allocated to other funds and federal land royalties.

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

3 indicates that over 92 percent of these revenues will come from three large taxes—the personal income tax ($20 billion), the sales and use tax ($16.8 billion), and the bank and corporation tax ($5.5 billion). The remaining 8 percent of General Fund revenues ($3.5 billion) is derived from the insurance tax, interest income from investments, death-related taxes, and various other sources.

Figure 3

1991-92 General Fund Revenues, By Source

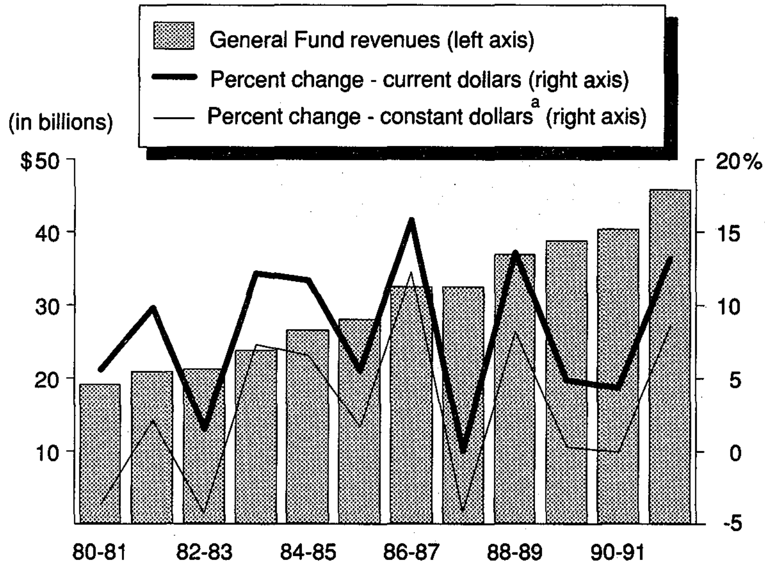


General Fund revenues are expected to grow by approximately 4.4 percent ($1.7 billion) in 1990-91 and 13 percent ($5.3 billion) in 1991-92 (see Figure 2). Figure 4 compares the predicted budget-year revenue growth with prior years, both before and after adjusting for inflation. The apparently strong *revenue* increase contrasts sharply with the department's forecast for sluggish growth in key *economic* variables. For example, the forecast predicts depressed growth rates in 1991 for personal income, taxable sales, and corporate profits, the bases from which the state's major tax revenues are generated.

Figure 4

Annual Growth in General Fund Revenues

1980-81 through 1991-92



[a] Revenue growth adjusted for inflation using the GNP state and local government price deflator.

Source: Governor's Budgets and State Controller's reports.

Revenue Adjustment Proposals Mask Underlying Trend

As is true in most years, the projected current-year and budget-year revenue growth rates incorporate various special factors and distortions which cause them to differ from the *underlying* growth in the revenue base. In the budget year, however, the magnitude of the special factors—$4 billion—is several times as large as the $1.3 billion baseline revenue growth which would be generated by the department's economic forecast in the absence of these special adjustments (see Figure 5).

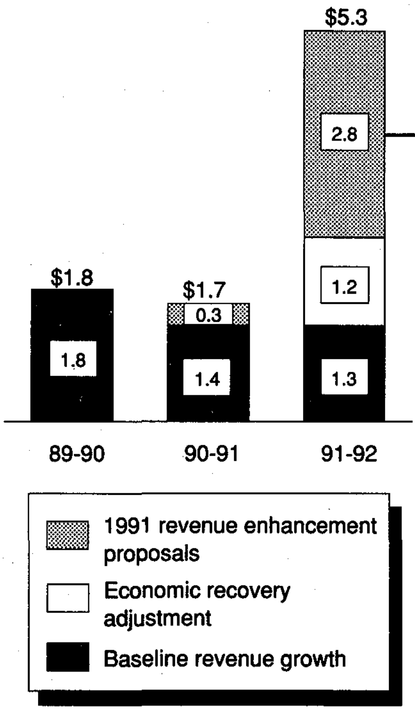
What Are the Revenue Adjustments Proposed in the Budget?

Figure 5 indicates that, of the $5.3 billion revenue growth expected in the budget year, $1.2 billion is attributable to a special economic recovery adjustment, which reflects the administration's view that the state will experience a stronger recovery from the current recession than is reflected in its economic fore-

Figure 5

General Fund Revenue Growth

1989-90 through 1991-92 (in billions)



Revenue Enhancement Proposals in the 1991-92 Governor's Budget

(in millions)	1991-92 Amount
Accounting Practices	
Accrual Accounting	$1,702
Withholding Proposals	
Independent Contractors	290
Estates/Trusts	42
Lump-Sum Payments	80
Tax Expenditures	
Repeal Sales Tax Exemptions:	
Candy/Snack Foods	200
Newspapers/Periodicals	83
Delay Health Care Tax Credit	97
Other Proposals	
Miscellaneous changes	345
Total Changes	$2.839

cast. An additional $2.8 billion is due to the administration's revenue enhancement proposals. These proposals include a change in accounting methods, which produces a net gain of $1.7 billion in 1991-92. In addition, the budget proposes legislation which would (1) require withholding on certain kinds of income not presently subject to withholding, (2) eliminate sales tax exemptions on candy and periodicals, (3) delay implementation of a health care tax credit, and (4) enact a number of smaller proposals affecting minor revenues and transfers. This latter group of proposals increases revenue by $1.1 billion in the budget year.

The specific proposals are discussed further below under the individual taxes and in the section on the reliability of the revenue forecast.

How Does Projected Revenue Growth Compare to "Normal" Revenue Growth?

Although revenues *including the proposed augmentations* are expected to grow by 13 percent, baseline revenues excluding these proposals will increase by only 4 percent (or 7 percent if the economic recovery adjustment is included). This 4 percent underlying revenue growth rate is similar to revenue growth experienced in the last two years—3.6 percent in 1990-91 and 4.9 percent in 1989-90

In contrast, General Fund revenues grew at a much higher average rate of 8.2 percent over the last decade. Thus, the underlying revenue trend in 1991-92 is well below average historical levels, consistent with the weakness in the economic forecast.

As shown in Figure 4, General Fund revenues in individual years have grown at widely disparate rates in the past. This is partly because revenue growth rates are heavily influenced by the cyclical nature of economic activity. Lower-than-normal revenue growth periods tend to be associated with economic slowdowns, while greater-than-normal growth periods tend to be associated with economic expansions.

In addition, however, revenue growth rate fluctuations in recent years have been in part due to such factors as federal law changes and their effects on the magnitude and timing of certain types of tax payments, like capital gains taxes. This helps explain the revenue growth volatility shown in Figure 4 for the 1986-87 through 1988-89 period.

INDIVIDUAL GENERAL FUND REVENUE SOURCES

The Forecast for Personal Income Taxes

Background. The personal income tax (PIT) 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 9.3 percent, and includes a variety of income exclusions, deductions, and credits. In 1987, legislation was enacted which significantly restructured the tax to more closely conform with federal law. This included adopting most of the base-broadening provisions of the federal Tax Reform Act of 1986, including: limiting or eliminating various deductions, making capital gains fully taxable, restricting "passive losses," conforming to the federal standard deduction, and establishing a number of new tax credits (such as for low-income housing and certain research activities). These law changes have made it much more difficult to accurately forecast PIT revenues than previously.

The PIT Forecast. As shown in Figure 2, PIT revenues are projected to total $17.6 billion in 1990-91 (4.2 percent growth) and $20 billion in 1991-92 (14 percent growth).

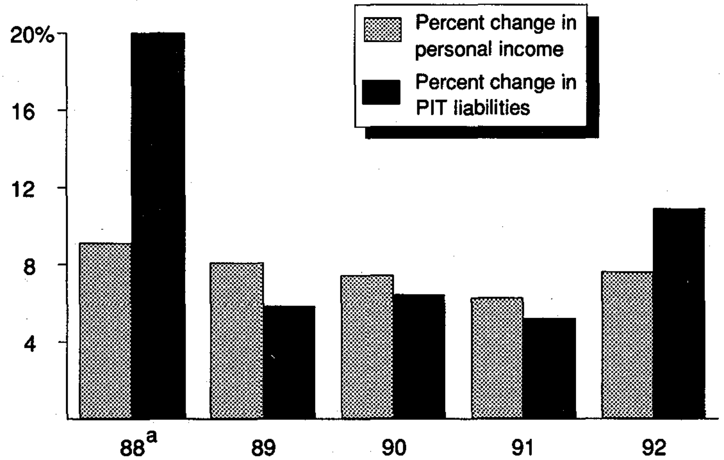
Figure 6 shows recent and expected future growth in PIT liabilities, and indicates that growth is expected to slow in 1991 and then strengthen in 1992, consistent with the projected pattern of economic activity.

As noted earlier, personal income is projected to increase by about 6.3 percent in 1991 and 7.6 percent in 1992, reflecting the department's forecast for a mild downturn followed by recovery. By comparison, personal income tax *liabilities* are expected to

Figure 6

Annual Growth in Personal Income Tax Liabilities and Personal Income

1988 through 1992



[a] Tax liability growth was unusually high in 1988 due to the effects of major changes to the income tax law at the federal level in 1986 and at the state level in 1987.

Source: Department of Finance and Franchise Tax Board. Data shown are on an income-year basis. Liability data shown are preliminary for 1989 and projected for 1990 through 1992.

increase by 5.2 percent in 1991, but by 11 percent in 1992. Although the state's progressive marginal tax bracket structure should enable 1992 tax liabilities to increase slightly faster than personal income growth, the 11 percent growth for 1992 is higher than would be expected from the economic forecast alone. Rather, this strong liability growth is heavily influenced by a 25 percent increase in capital gains in response to the expected economic recovery.

The growth in underlying tax liabilities only partially explains the department's estimate of the 14 percent PIT revenue growth in 1991-92. There are a number of special factors that complete the story. Specifically, the department has augmented its PIT revenue forecast by $1.4 billion for 1991-92, reflecting its proposed legislation and a special "economic recovery adjustment." Proposed legislation to (1) require withholding on payments to independent contractors, supplemental "lump-sum" wage payments, and estates and trusts, and (2) delay implementation of a health care tax credit, are estimated to bring in an additional $454 million in 1991-92. In addition, a proposed accrual accounting adjustment adds $270 million to the 1991-92 revenue forecast. Finally, revenues have been augmented by $700 million (an economic recovery adjustment) on the assumption that the economy will experience a stronger and swifter recovery than predicted in the economic forecast. Without the adjustments for legislation, 1991-92 PIT receipts would be reduced to $19.3 billion, an increase of 9.6 percent over 1990-91. Without the economic recovery adjustment, it would be further reduced to $18.6 billion, bringing the increase down to 5.6 percent.

Capital Gains Forecast Subject to Considerable Uncertainty. Figure 7 presents the historical trend and the department's forecast for capital gains tax liabilities. As this figure indicates, wide year-to-year swings in capital gains have been the norm in recent years. This partly reflects federal and state law changes regarding the tax treatment of capital gains (see below). In its forecast, the department estimates that capital gains liabilities fell by 6 percent in 1990, and projects them to remain flat in 1991 before increasing by 25 percent in 1992.

Capital gains liabilities have been more volatile in the past than other tax liabilities because taxpayers typically have great discretion over when to realize and report their gains. A 1987 change in the state tax treatment of these gains, making them fully taxable, increased their contribution to total revenues. As a result, the state became more "vulnerable" to potential revenue fluctuations caused by the volatility of capital gains taxes.

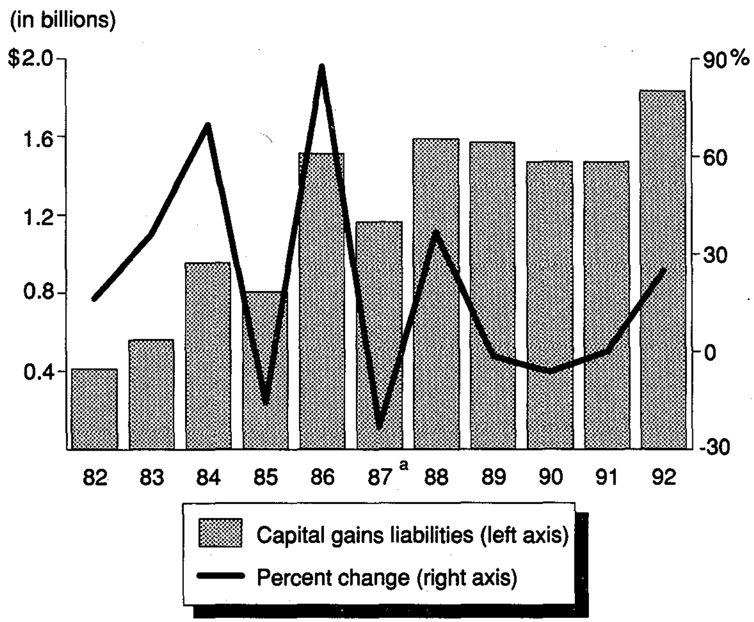
The department's forecast reflects the view that many taxpayers have delayed selling their assets because of uncertainty over the future federal tax treatment of capital gains and other factors such as soft real estate markets and the poor performance of the 1990 stock market. According to this view, the state will realize large increases in capital gains tax revenues as soon as the economy firms up and uncertainty about the federal tax issue disappears. It is this view that explains the department's assumption that capital gains activity will be strongly responsive to the economic recovery in 1992.

Although predicting capital gains is, to a large extent, guesswork, the department's capital gains forecast is a reasonable one and consistent with its economic forecast. It is important to note, however, the historical pattern of volatility in capital gains growth which illustrates the extreme sensitivity of this revenue

Figure 7

Capital Gains Tax Liabilities

1982 through 1992



[a] Federal tax reform and state conformity made capital gains fully taxable effective January 1, 1987.

Source: Department of Finance and Franchise Tax Board.

source to economic conditions. If the economic recovery is not as vigorous as the department forecasts, or is delayed, capital gains could be much weaker. In such a case, revenues from this source easily could vary from the forecast by several hundred million dollars in 1991-92.

The Forecast for Sales and Use Taxes

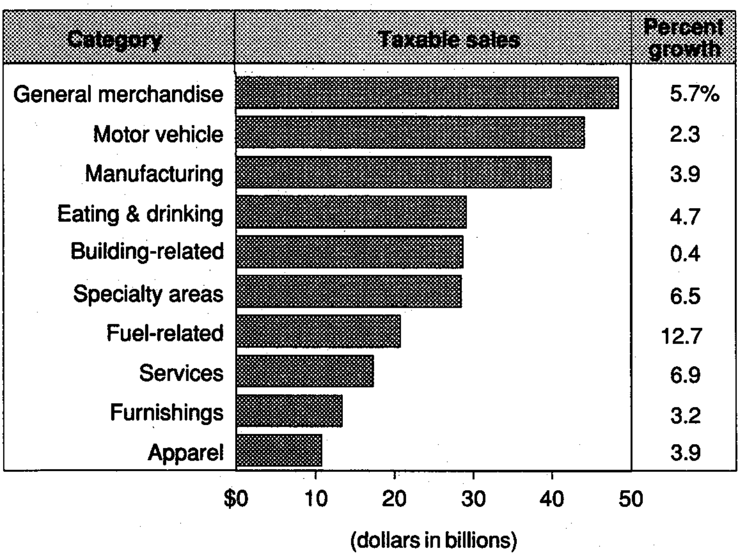
Background. Sales and use taxes are the second largest source of General Fund revenues, comprising about 37 percent of the total. Sales and use taxes are derived from the state's 4.75 percent levy on taxable sales. In addition, sales and use taxes of up to 2.25 percent are levied by local governments and transit districts. A temporary one-quarter-cent state sales tax was in effect from December 1, 1989 through December 31, 1990 to fund earthquake relief.

Taxable Sales Sluggish. The key to forecasting sales tax receipts is projecting the level of taxable sales in California. Figure 8 shows the major categories of taxable sales which comprise this tax base. It indicates that the department expects modest growth in many of the major categories of taxable sales.

Figure 8

Major Categories of Taxable Sales

1991



Fairly slow growth is predicted for those categories that are particularly sensitive to the economy, such as motor vehicles (2.3 percent), manufacturing (3.9 percent), and building-related materials (0.4 percent). The only area of strong predicted growth is in fuel-related sales, reflecting the budget's forecast for higher gasoline prices due to the Persian Gulf conflict.

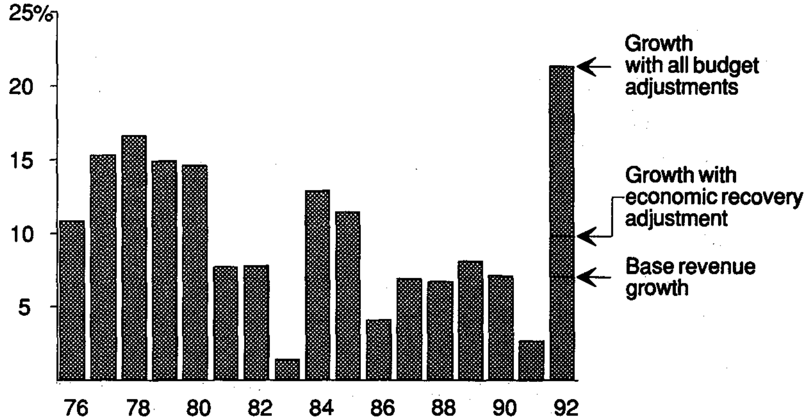
The budget forecasts that total taxable sales will increase by 6.3 percent in 1991 and 8.5 percent in 1992, compared to 4 percent in 1990. These growth rates reflect the department's forecast for a short and mild recession.

Strong Growth in Tax Receipts Due to Special Adjustments. The department expects sales tax revenues to reach $16.8 billion in 1991-92, a gain of 21 percent over the current year. As Figure 9 shows, the strong growth predicted for sales tax receipts is primarily attributable to various budget proposals. These include proposals to eliminate the tax exemptions for candy, snack foods, and periodicals ($283 million), and change accounting methods ($1.2 billion). In addition, the economic recovery adjustment adds $500 million to revenues over and above the amount produced from the projected underlying growth

Figure 9

Annual Growth in State Sales Tax Collections

1975-1976 through 1991-1992[a]



[a] Data are for fiscal years ending in years shown.

Source: Department of Finance. Tax collections data are preliminary for 1989-90 and projected for 1990-91 and 1991-92.

in taxable sales. This projected underlying growth is consistent with the department's economic forecast.

The Forecast for Bank and Corporation Taxes—Stagnation Continues

Bank and corporation taxes, the third largest source of General Fund revenues, are derived primarily from a 9.3 percent levy on the taxable profits of corporations doing business in California. These revenues are projected to total $5.4 billion (9 percent growth) in 1990-91 and $5.5 billion (3.1 percent growth) in 1991-92. As noted below, however, revenue growth in 1991-92 would be negative in the absence of the administration's proposed special adjustments.

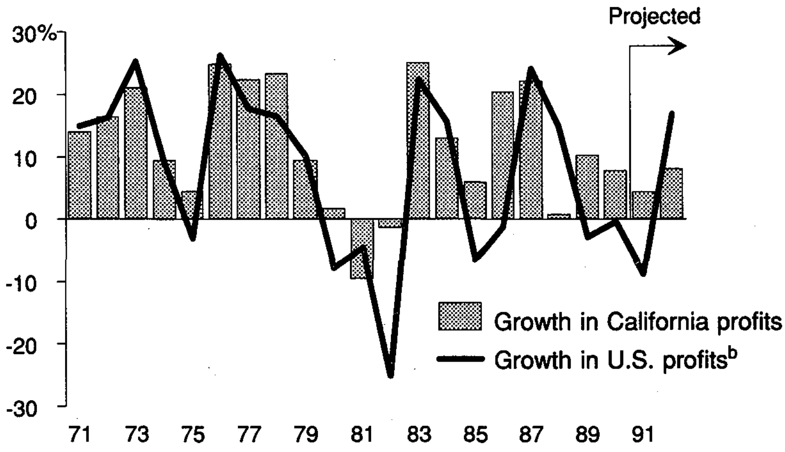
Department Predicts Modest Gains in Corporate Profits. The key to forecasting this tax is to predict the level of California's taxable corporate profits. California profits are related to national profits as well as to factors unique to California.

Figure 10 indicates that the department expects California profits to increase by 4.4 percent in 1991 and by 8.1 percent in

Figure 10

Annual Growth in Taxable Corporate Profits

1971 through 1992[a]



[a] California data for 1989 and 1990 are preliminary estimates by the Department of Finance.

[b] California and U.S. profit data are not strictly comparable in all years due to definitional differences. Data incorporate the effects of various federal and state tax law changes during the 1980s and 1990s which revised the definition of taxable corporate profits.

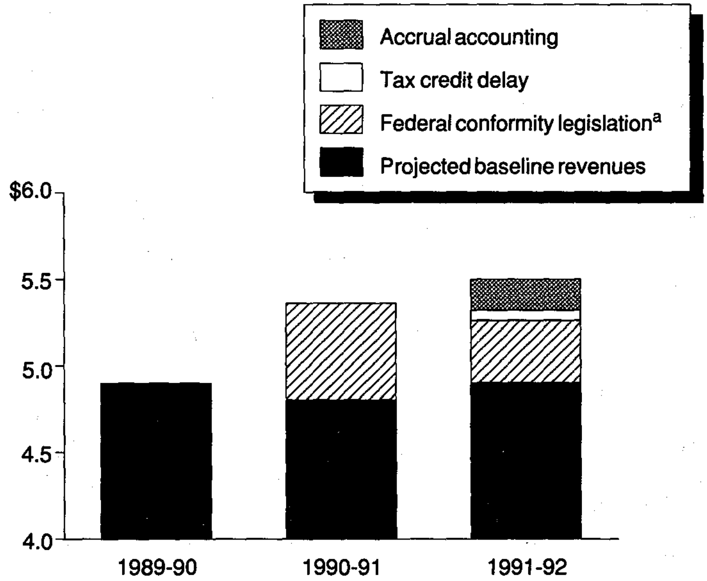
1992. In contrast, U.S. profits are expected to decrease by about 9 percent before rebounding by 17 percent over the same time period. Although there is a high degree of historical correlation between California and U.S. profits, the figure shows that California profits generally tend to be more resistant to economic slowdowns than do U.S. profits. This tendency of California to either match or "out perform" the nation as a whole (in good times as well as bad) is reflected in the department's forecast of California profits for 1989, 1990, and 1991. The higher growth rate estimated for U.S. profits in 1992 in part reflects the recovery from an especially depressed 1991 profit level.

Growth in Corporate Tax Receipts Is Due to Adjustments. Figure 11 shows the projected growth in corporate tax receipts for the prior, current, and budget years. As the figure indicates, projected growth in 1991-92 is due entirely to two proposed adjustments. These are the department's proposals to

Figure 11

Projected Corporate Tax Receipts

1989-90 through 1991-92 (in billions)



[a] Refers to federal conformity legislation enacted by California in 1990.

Source: Department of Finance.

change accounting methods ($180 million) and delay implementation of the health care tax credit for small employers ($55 million). Absent these adjustments, projected bank and corporation tax receipts would actually *decline* by $70 million in 1991-92.

This is the second consecutive year in which all of the projected growth in corporate tax receipts is due to proposed legislation. As Figure 11 shows, current-year growth in this tax is entirely attributable to the estimated revenue gain from "federal conformity" legislation enacted by California in 1990. The estimate of this revenue gain, made at the time this legislation was enacted—$525 million for 1990-91 and $363 million for 1991-92—has not yet been corroborated by actual collections data.

Other General Fund Revenues

Other General Fund revenues are expected to decline by $196 million in the budget year. This 5.4 percent reduction is due to the net effect of many factors. The most important of these are a reduction of $119 million in earthquake-related disaster relief transfers, a decrease of $148 million in revenues from the sale of abandoned property, a $78 million recovery of prior-year Department of Social Services costs from the federal government, an increase of $55 million in insurance tax revenues, and a $53 million decrease in oil and gas revenues. The latter decrease is primarily due to the expected decline of oil prices in the budget year over the current year. The increase in insurance taxes will actually be approximately $50 million more than is reflected in the revenue forecast (resulting in a total 1991-92 increase of $105 million) because the Board of Equalization recently increased the tax rate on 1990 premiums that will be collected in the budget year. This action was taken as a result of a provision in Proposition 103 (November 1988) which allows the state to be compensated for any decrease in revenues which result from the measure.

RELIABILITY OF THE REVENUE FORECAST

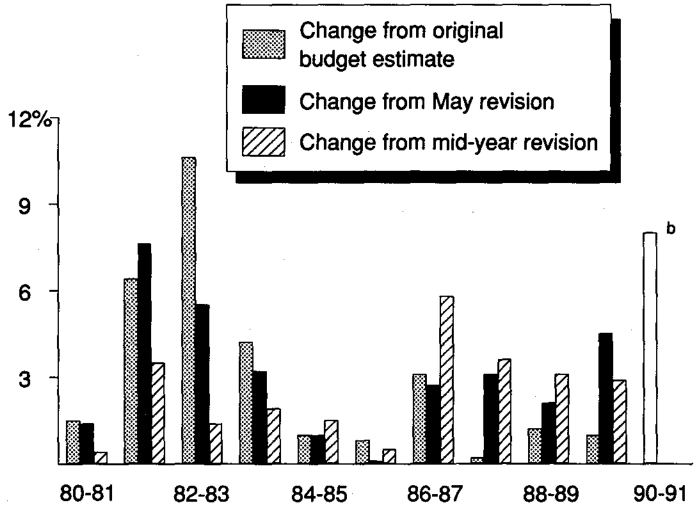
Figure 12 shows the discrepancies between past revenue forecasts—original budget estimates, May revise reestimates, and mid-year reestimates—and final receipts over the past decade. It demonstrates that there are significant margins of error underlying the revenue forecasts, and serves as a reminder that the budget-year forecast is subject to large margins of error as well.

Figure 12 also shows that revenue estimating errors over the past decade were at their largest during the early 1980's reces-

Figure 12

Discrepancies Between Actual and Estimated General Fund Revenues[a]

1980-81 through 1990-91



[a] Estimates by the Legislative Analyst, based on analysis of Department of Finance revenue estimates. Percentage discrepancies shown represent the average absolute values of discrepancies for the years specified that are attributable to economic forecasting revisions, taxpayer behavior and revenue estimating procedures. Data have been adjusted for the initial estimates of new legislation, budget actions, audit settlements and various other factors.

[b] Represents the discrepancy between the original *1990-91 Governor's Budget* forecast and the *1991-92 Governor's Budget* mid-year revision.

sion and subsequent recovery. This illustrates the fact that forecasting is most difficult at the peak or trough of an economic cycle, when economic trends are changing direction. The current period, in which California has moved into a downturn, is just such a case. The discrepancy between the original budget forecast for 1990-91 (made in January 1990) and the current reestimate is 8 percent (after adjustment for noneconomic factors). This discrepancy, due primarily to unexpected weakness in the economy, is significantly greater than those experienced in the past several years. The current downturn also adds to the difficulty in forecasting budget-year revenues, because both the 1990-91 base from which they will grow and the growth pace itself are uncertain. For this reason, the budget-year revenue forecast presents us with the potential for greater error than is the case when the economy is more stable.

What Do These Error Margins Mean in Terms of Revenues? Even small percentage revenue estimating errors can produce large dollar discrepancies between forecasted and actual receipts. For example, a 1 percent error in the budget year would translate into a change of over $450 million. Thus, the "average" error for the previous 10-year period (3.1 percent) would amount to $1.4 billion.

Is the Revenue Forecast Reasonable? Assessing the reasonableness of the budget's revenue projections involves consideration of two main factors: (1) the reliability of the economic forecast on which the revenue forecast depends and (2) the consistency of the revenue projections with the economic forecast from which they are derived. Our analysis of these factors indicates the following:

- ***Economic reliability.*** As discussed in the preceding economic and demographic overview section, the consensus view of economic forecasters has become more negative since December when the economic forecast appearing in the budget was prepared. The consensus view still holds that the recession will be short and mild; however, its estimates of California personal income and employment growth for *both 1991 and 1992* have been adjusted downward so that they are now below those of the department. The net effect of using the less optimistic consensus forecast would be to reduce revenues below the budget forecast by several hundred million dollars.

  It also is important to recognize that the growing severity of the drought is another factor which has become more apparent since the department made its economic forecast. It will, in all likelihood, reduce tax revenues, both through (1) its *direct* negative effect on corporate profits and the income and sales of businesses such as farming operations, fisheries, and recreation-related businesses; and (2) its *indirect* effects on profits and employment in related business such as trucking companies, canneries, and chemical suppliers. It also may affect residential construction negatively. The extent to which revenues are affected by the drought will depend on many factors, including the extent to which farmers can adopt water-conserving technologies, move their operations to areas with adequate water, and convert to drought-resistant crops.

- ***Consistency.*** Our analysis indicates that the department's economic forecast would produce—on net—less revenues than the budget projects. The key difference between our own estimate and the department's is the $1.2 billion in economic recovery adjustments to personal income taxes and sales taxes. Apart from this factor, however, we believe the budget's revenue forecast is reasonably consistent with the department's economic forecast.

General Conclusion—Estimates Have Significant Downward Potential

Based on the most recent economic information available, it appears that the department's revenue estimates have significant downward potential. Specifically:

- Regarding the economic recovery adjustment, we see no basis for assuming that this $1.2 billion will be realized. Therefore, we recommend that the Legislature disregard this amount for its fiscal planning purposes.
- In addition, revenues could be several hundred million dollars lower if the latest consensus economic forecast proves more accurate than the department's, and if other factors like the drought further depress economic activity. This underscores the need for the state to have an adequate reserve in 1991-92.

April Will Provide Additional Information. During each of the past three years, the budget's revenue projections have been significantly revised in May, following the filing of personal income tax returns in April, and after other major tax payment dates have passed. This year, there again will be important revenue data available in the spring, as well as added information on the economy, which could significantly change the revenue estimates. More information will be available, for example, on the course of the current downturn, the severity of the drought, and the extent to which the budget's assumptions about oil prices are accurate. Depending on what these data show, the revenue estimates for both the current year and budget year may need to be significantly revised in May.

THE FORECAST FOR SPECIAL FUND REVENUES

As shown in Figure 13, special fund revenues are projected to be $9.0 billion in 1990-91 and $11.3 billion in 1991-92. This 27 percent increase is primarily due to administration proposals to (1) revise the motor vehicle depreciation schedule, (2) increase vehicle registration and driver's license fees, and (3) increase alcoholic beverage taxes, as well as the effect of fuel tax increases authorized by Proposition 111 (1990). These increases are

Figure 13

Special Fund Revenues

1989-90 through 1991-92
(dollars in millions) [a]

Source of Revenue	Actual 1989-90	Estimated 1990-91	Projected 1991-92	Change 1990-91 to 1991-92 Amount	Percent
Motor Vehicle Revenues:					
License fees (in lieu)[b]	$2,140	$2,262	$3,225	$963	42.6%
Fuel taxes[c]	1,349	2,018	2,537	519	25.7
Registration, weight and miscellaneous fees[d]	1,162	1,363	1,505	142	10.4
Subtotals, motor vehicle revenues	**$4,651**	**$5,643**	**$7,267**	**$1,624**	**28.8%**
Other Sources:					
Cigarette and tobacco products tax[e]	$634	$609	$644	$35	5.8%
Alcoholic beverage tax	--	--	190	190	--[f]
Sales and use taxes[g]	445	537	183	-354	-65.9
Interest on investments	202	171	170	-1	0.6
Oil and gas revenues[h]	84	170	149	-21	-12.4
Other	1,687	1,826	2,723	897	59.5
Totals, special funds	$7,703	$8,956	$11,326	$2,370	26.5%

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

[b] Includes revenues of $781 million in 1991-92 due to a proposed revision of the vehicle license fee depreciation schedule.

[c] Includes revenues of $687 million in 1990-91 and $970 million in 1991-92 due to a tax rate increase under Proposition 111 (June 1990).

[d] Includes revenues of $130 million in 1990-91 and $216 million in 1991-92 due to increased driver's license and vehicle registration fees.

[e] Includes revenues due to Proposition 99 (November 1988) of $569 million in 1989-90, $547 million in 1990-91, and $531 million in 1991-92, and an increase of $53 million due to a revision in the state's accounting methods.

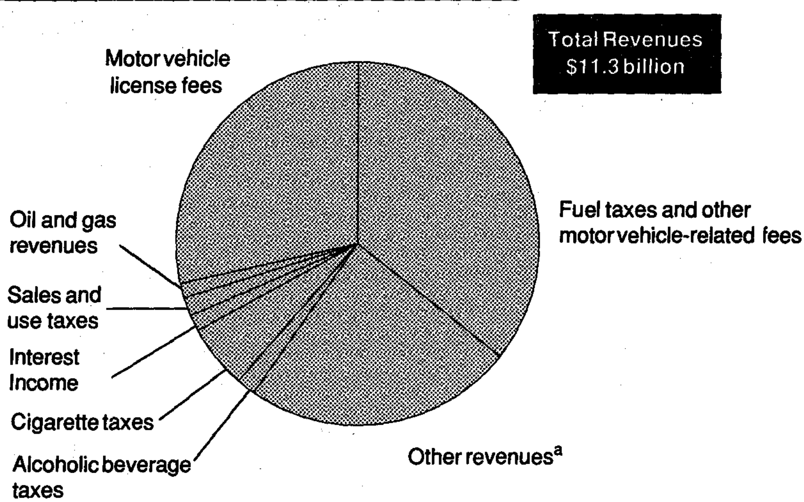
[f] Not a meaningful figure.

[g] Includes revenues of $353 million in 1989-90 and $422 million in 1990-91 due to a temporary one-quarter-cent tax increase enacted by the Legislature in 1989 to fund earthquake relief.

[h] Represents oil and gas revenues 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 other funds and federal land royalties.

Figure 14

1991-92 Special Fund Revenues, By Source



[a] Includes a variety of sources, such as property income, penalty assessments, and user fees.
Source: Department of Finance.

partially offset by the sunset of the one-quarter-cent earthquake tax implemented to fund disaster relief.

Figure 14 indicates that about two-thirds of all special fund revenues ($7.3 billion) are motor vehicle-related. These sources include vehicle license fees ($3.2 billion), fuel taxes ($2.5 billion), and vehicle registration, weight, and other fees ($1.5 billion). The other one-third of special fund revenues come from tobacco products taxes ($644 million), alcoholic beverage taxes ($190 million), sales and use taxes ($183 million), investment interest ($170 million), oil and gas revenues ($149 million), and a variety of other sources ($2.7 billion).

How Are Special Fund Revenues Used?

Special fund revenues are used for a variety of purposes. Many special fund revenues are dedicated to specific uses. For example:

- Motor vehicle-related revenues are used for various programs, many of which are related to transportation. Over one-half of these revenues are transferred to local governments for use in a variety of local programs, including street and road maintenance and mass transit purposes. The remainder is used for state programs relating to transportation and vehicle use, including support of the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), and the Department of Transportation (Caltrans).

- Revenues raised by the tobacco-related taxes imposed by Proposition 99 (1988) are distributed to various state accounts to be spent for health and natural resources-related purposes.
- The local 3-cent share of the basic 10-cent state cigarette tax in effect prior to Proposition 99 is distributed between cities (83 percent) and counties (17 percent).
- Oil and gas revenues are used primarily to fund capital outlay projects.

Major Increases in Motor Vehicle-Related Fees and Taxes

Motor Vehicle License Fees. Figure 13 shows that motor vehicle license fees are expected to total $2.3 billion in the current year and $3.2 billion in the budget year. The budget proposes to increase vehicle license fees primarily by revising the vehicle license fee depreciation schedule. Under current law, new car values are depreciated over a nine-year period, so their value for tax purposes declines from 85 percent in the first year to 5 percent by the ninth year. The new schedule would establish license fees instead based on 100 percent of purchase price for new vehicles, declining to a minimum of 15 percent over a 10-year period. These changes would increase vehicle license fee revenues by an estimated $781 million in the budget year. The budget proposes that these revenues be allocated to counties as part of its "program realignment" proposal. (For a discussion of this proposal, please see our county-state piece in Part Four of this document).

Vehicle Registration and Driver's License Fees. The department expects vehicle registration and other fees to be $1.4 billion in the current year and $1.5 billion in the budget year. The revenue forecast includes revenues from an administration proposal for legislation to increase vehicle registration fees by $5 and driver's license fees by $2 beginning January 1, 1992. Together, these increases would produce an additional $73 million in 1991-92 to be used for support of the DMV.

Fuel Taxes. Fuel taxes are expected to be $2 billion in the current year and $2.5 billion in the budget year. The forecast reflects fuel tax increases authorized by Proposition 111 (1990) to be used for transportation purposes. Proposition 111 increased fuel tax rates by 5 cents per gallon, effective August 1, 1990, with an additional 1-cent-per-gallon increase each January 1 thereafter for four years. The department expects these increases to produce $687 million in 1990-91 and $970 million in 1991-92.

Alcoholic Beverage Taxes. The budget forecast includes revenues generated from the administration's proposal to raise taxes on alcoholic beverages. The proposed rates are essentially the same as proposed by Proposition 126 on the November 1990 ballot, which was rejected by the voters. These increases would place the state's tax rates near the national average for all alcoholic beverages, with the exception of wine, for which the state tax rate would remain significantly below the national average.

The department estimates that these rate increases would raise approximately $190 million in additional revenues in the budget year. The administration has proposed to allocate most of these funds (together with the additional vehicle license fees from proposed fee increases) to counties, in lieu of General Fund support for public health services and local mental health programs. The remainder ($17 million) will be used for a program to educate women on the dangers of alcohol and drug abuse during pregnancy.

Tobacco-Related Taxes—Revenue Increase Due to Accrual Adjustment. Special fund revenues from tobacco-related taxes are estimated to be $609 million in 1990-91 and $644 million in 1991-92. Most of these revenues—$547 million in the current year and $578 million in the budget year—are due to Proposition 99, which levied an additional 25-cents-per-pack tax on cigarettes and an "equivalent" amount on other tobacco products, effective January 1, 1989. The remainder represents revenues distributed to local agencies.

An accrual accounting adjustment made by the department has increased the revenue estimate by $53 million for the budget year. Our analysis indicates, however, that these revenues *already* are accounted for on an accrual basis, so the adjustment is inappropriate. In the absence of this adjustment, total 1991-92 revenues from the cigarette tax would have been projected at $591 million ($531 million from Proposition 99), a 3 percent decrease from the current year. This decrease in underlying revenues is due to declining consumption of cigarettes. Because the cigarette tax is assessed on a flat rate-per-pack basis, declining consumption results in an absolute reduction in revenues. Price increases due to a recent federal surtax are expected to accelerate the trend of declining consumption of cigarettes, resulting in revenue decreases in the budget year.

Oil and Gas Revenues—Reduction Reflects Lower Oil Prices. Figure 13 shows that oil and gas revenues are expected to total $149 million in the budget year. This is a 12 percent ($21 million) reduction from the level in the current year. This reduction is primarily due to the department's expectation that the price of crude oil will remain below the recent high levels experienced immediately after the onset of the Persian Gulf conflict. Lower oil prices reduce both the revenues obtained per barrel from oil produced on state-owned lands, and the volume of oil it is profitable to extract. The amount of oil and gas revenues actually collected could differ significantly from the estimate, however, due to the uncertainty surrounding the war in the Persian Gulf and the potential volatility in oil prices.

Expenditures in 1991-92

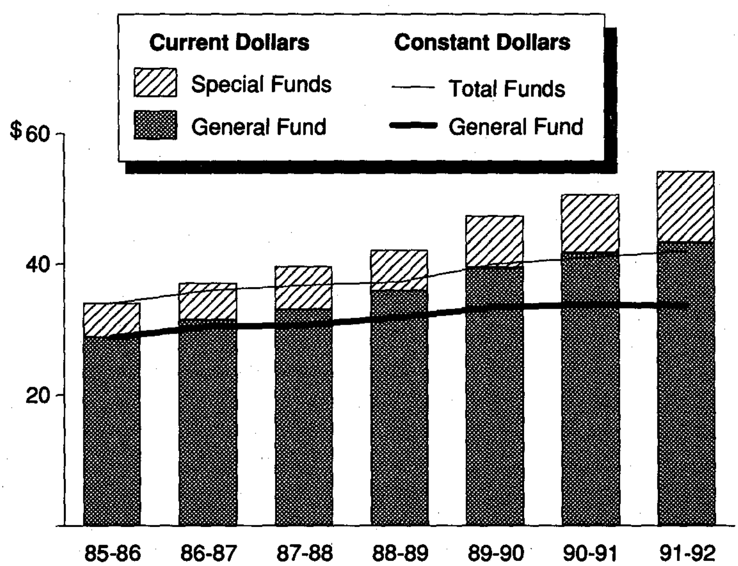
The Outlook for State Expenditures

Figure 1 shows state expenditures from 1985-86 through 1991-92 from the General Fund and special funds in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars adjusted for the effects of inflation). This adjustment relies upon the Gross National Product (GNP) implicit price deflator for state and local government purchases of goods and services. The GNP deflator is a good general measure of the price increases faced by state and local

Figure 1

Total State Spending
Current and Constant Dollars

1985-86 through 1991-92 (in billions)



governments, and allows comparisons of the "purchasing power" of state resource allocations over time.

Figure 1 shows that total state spending (in current dollars) increased from $34 billion in 1985-86 to a proposed level of $54.1 billion in 1991-92. This 1991-92 amount is $3.5 billion, or 6.9 percent, more than estimated total state spending for the 1990-91 fiscal year. The growth since 1985-86 amounts to an average annual increase over the period of 8.0 percent. Figure 1 also shows that, in constant dollars, total state expenditures have grown less rapidly, increasing at an average annual rate of 3.6 percent.

General Fund expenditures are proposed to total $43.3 billion in 1991-92, which is $1.6 billion, or 3.7 percent, more than estimated General Fund expenditures for 1990-91. In contrast, General Fund expenditures grew at an average growth rate of almost 8 percent between 1985-86 and 1990-91. Because we estimate that General Fund expenditures would need to grow by $6.4 billion in 1991-92 in order to maintain current levels of state-supported services, the budget reflects significant reductions in the level of services to be provided.

Special fund expenditures are proposed to total $10.8 billion in 1991-92. This amount is $1.9 billion, or 22 percent, higher than estimated special fund expenditures in 1990-91. This high growth rate reflects the budget's proposed increase in state taxes on vehicles and alcoholic beverages, which would be deposited in state special funds and distributed largely to counties.

State Spending by Program Area

Figure 2 shows the distribution of proposed 1991-92 expenditures from all state funds among different program areas. Both General Fund and state special fund expenditures are reflected in order to provide some perspective on total state spending on different programs. In some program areas (for example, resources), the exclusion of special fund expenditures would not permit a meaningful evaluation of funding and policy changes.

The program area groupings used in Figure 2 differ in three respects from the traditional groupings used in the Governor's Budget. Specifically, the criminal justice category includes spending on both the traditional Youth and Adult Corrections category as well as state expenditures for the judicial system, in order to recognize the linkage between these programs. The general government category includes not only most of the programs that traditionally are shown as general government in the Governor's Budget, but also includes all of the administrative functions traditionally included in the Legislative, Judicial and Executive; State and Consumer Services; and Business, Transportation, and Housing categories. This provides a better perspective as to the costs of running state government. Finally, the capital outlay category includes all of the direct capital outlay expenditures made from the General Fund and special funds, as well as state general obligation bond debt service, and expenditures associated with lease-payment bonds.

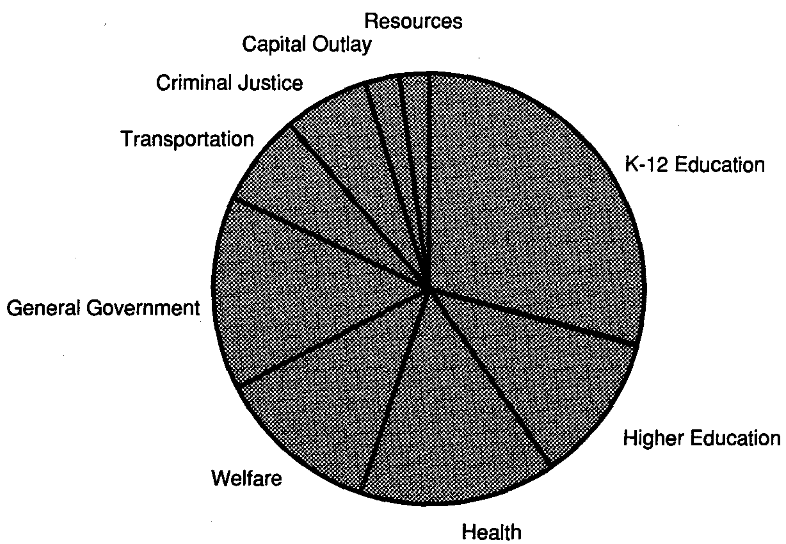
Figure 2 shows that slightly more than 40 percent of all expenditures from state funds is proposed for educational programs, and more than one-quarter for health and welfare programs. The remaining expenditures are in the areas of general government (13 percent), criminal justice (6.4 percent), transportation (7.9 percent), resources (2.0 percent) and capital outlay (2.6 percent).

Figure 3 compares the average annual growth rate for each program area during the 1985-86 through 1991-92 period with the overall rate of growth in expenditures from state funds. It

Figure 2

Total State Spending By Major Program

1991-92



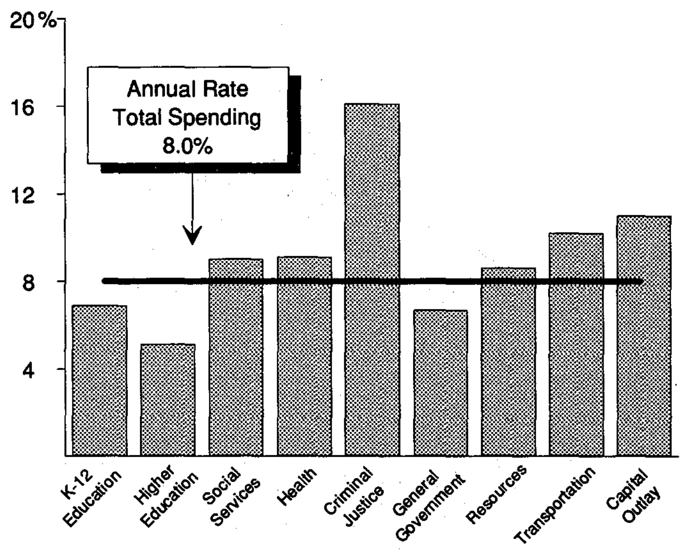
shows that criminal justice, transportation, and capital outlay expenditures have grown significantly faster than the budget as a whole. Taken together, however, these programs represented only 17 percent of state expenditures in 1991-92. By comparison, higher education programs have been growing significantly slower than total spending.

The next part of this section discusses this year's budget from a program area perspective. For each program area, we discuss the proposed level of expenditure for each major program, and the various factors which are "driving" program expenditures. In addition, we discuss the administration's major proposals for reductions in expenditures, as well as the new program initiatives proposed in the budget.

Figure 3

Comparison of Annual Average Growth Rates For Major Program Areas - All State Funds

1985-86 through 1991-92



K-12 EDUCATION

Funding for K-12 education from the General Fund for Proposition 98-eligible programs is proposed to total $15.1 billion, which is equal to approximately 35 percent of General Fund expenditures proposed in the Governor's Budget for 1991-92. (Over 90 percent of total General Fund support for K-12 education counts towards meeting Proposition 98's minimum funding requirements. The primary K-12 program areas which are not counted are contributions to the State Teachers' Retirement Fund, debt service on school facilities aid bonds, privately operated child care programs, and State Department of Education administration.)

The level of funding proposed in the budget represents an increase of $233 million, or 1.6 percent, over the level of K-12 education expenditures estimated for 1990-91. The 1990-91 expenditure level includes the impact of a $450 million reduction in Proposition 98 funding for K-12 schools which resulted from reduced General Fund revenues in the current year. (For a discussion of Proposition 98, please see our piece on this measure in Part Four.)

BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 4 shows General Fund spending levels for Proposition 98-eligible K-12 education programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. For purposes of this analysis, we define current service level as the Proposition 98 "full funding level" that would have been required in the absence of both the $450 million reduction in 1990-91 and the administration's proposal to suspend Proposition 98 in 1991-92.

As the figure indicates, the proposed budget would result in a $1.8 billion (10 percent) reduction in the overall level of funding for K-12 education programs relative to the current services funding level.

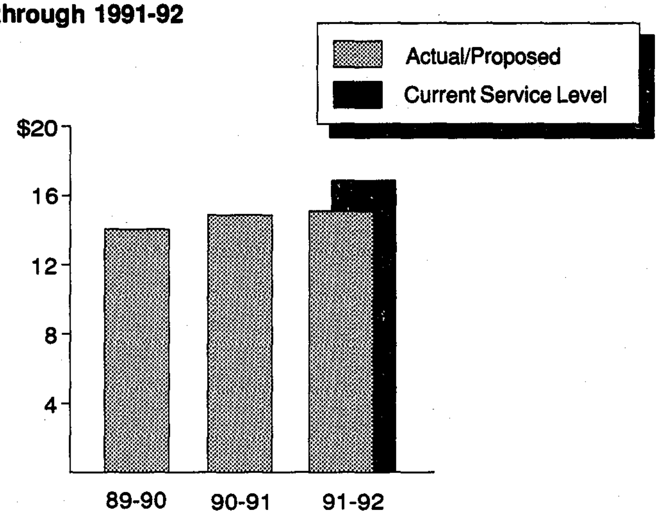
SPENDING BY MAJOR PROGRAM

Figure 5 shows General Fund expenditures for the major K-12 education programs from 1985-86 through 1991-92. The decrease in 1991-92 general-purpose apportionments is due to the Governor's proposals to: (1) not fund a COLA and (2) impose strict attendance accounting procedures.

Figure 4

Growth in K-12 Education Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



[a] Covers Proposition 98-eligible programs only (over 90 percent of total General Fund expenditures for K-12 education).

FACTORS DRIVING PROGRAM COSTS

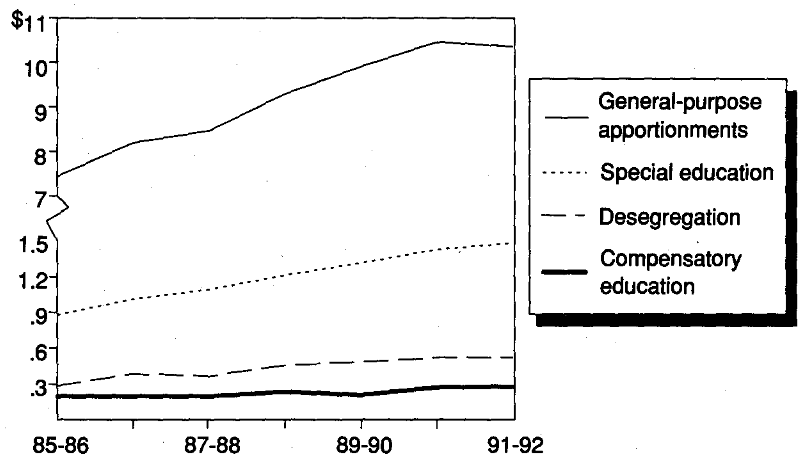
The primary factors driving K-12 education program costs are specified in the California Constitution, as amended by Proposition 98 and Proposition 111. These measures generally require that total funding for K-12 schools and community colleges from state and local sources be no less than the amount provided in the prior year, as adjusted for enrollment growth and growth in California per capita personal income. The measures also provide for the minimum funding requirement to be based on K-14 education's 1986-87 share of General Fund revenues, if this would result in a higher amount, and provide for an automatic reduction to the minimum funding level in years of low General Fund revenue growth.

Under the basic Proposition 98 minimum funding guarantee formula, therefore, the level of General Fund support required for K-12 education is based on three factors: (1) K-12 enrollment growth, (2) per capita personal income growth, and (3) local property tax growth. Other things equal, increases in the first two factors increase the required level of General Fund support,

Figure 5

K-12 Education Expenditures By Major Program

General Fund (in billions)
1985-86 through 1991-92



while increases in local property taxes *reduce* General Fund requirements on a dollar-for-dollar basis.

K-12 Enrollment Growth. The budget estimates K-12 enrollment growth of 4.3 percent, which increases the amount of General Fund support needed in order to maintain current service levels by $871 million.

Per Capita Personal Income Growth. The budget estimates growth in California per capita personal income of 5.3 percent, which increases the amount of General Fund support needed by $1.1 billion.

Property Tax Growth. The budget estimates growth in school district property tax revenues of 9.1 percent, which *decreases* the amount of General Fund support needed by $454 million.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for K-12 education is to significantly reduce the growth in program expenditures.

(As noted above, cuts in K-12 education funding can be accomplished only by suspending Proposition 98.) This is achieved through a variety of proposals, which in the aggregate would result in a funding level that is approximately $1.8 billion less than the amount needed to fund the 1990-91 level of services in these programs.

Cost Reduction Proposals

The major cost-cutting proposals contained in the budget are:

- ***Suspension of statutory K-12 education COLAs ($991 million).*** The budget eliminates funding for all statutory COLAs.
- ***Continuation of current-year funding reductions ($450 million).*** The budget continues in the K-12 funding "base" the reductions made in the current year.
- ***Strict attendance accounting requirements ($250 million).*** The budget reduces funding for school apportionments, on the assumption that strict adherence to current-law attendance accounting requirements will reduce the level of reported ADA by 2 percent.
- ***Suspension of Mentor Teacher Program ($66 million).*** The budget eliminates funding for the Mentor Teacher Program in 1991-92. The administration suggests that, when restored, the program should be restructured to emphasize merit pay.
- ***Elimination of funding for class size reduction ($31 million).*** The budget proposes no funding to continue the process of reducing class sizes, begun in the current year pursuant to Ch 1147/89 (SB 666, Morgan).

New Initiatives

The budget also contains $95 million in new initiatives, as follows:

- ***Preschool expansion ($50 million).*** The budget proposes a five-year program to extend the availability of preschool to all low-income families. The administration also proposes changing staff-to-child ratios for all state-funded programs serving preschool-aged children from 1:8 to 1:10, in order to serve more children.
- ***"Healthy Start" pilot program ($20 million).*** The budget proposes a pilot program to coordinate social services through specified elementary school sites.

- ***Early mental health ($10 million).*** The budget proposes a new program to provide mental health counseling services at elementary schools.
- ***Revised assessment system ($10 million).*** The budget proposes to restore a revised version of the California Assessment Program, allowing the reporting of individual student scores.
- ***Volunteer and mentor corps ($5 million).*** The budget proposes to train local community members as volunteers in schools and mentors for "at-risk" children.

Funding for these initiatives is not included in the Budget Bill, but is instead shown in the Governor's Budget as a General Fund "set-aside" for pending legislation.

HIGHER EDUCATION

Funding for higher education programs is proposed to total \$6.1 billion from all state funds, which is equal to approximately 11 percent of total expenditures proposed in the Governor's Budget for 1991-92. This level represents a decrease of \$27 million, or 0.4 percent, from the level of expenditures estimated for 1990-91.

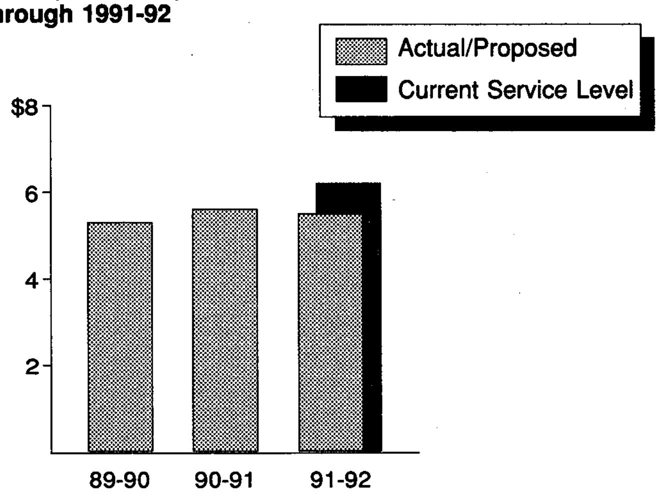
BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 6 shows combined General Fund spending for the University of California (UC), the California State University (CSU), and the California Community Colleges (CCC) for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. As the figure indicates, the proposed budget would result in significant reductions in the overall level of higher education programs relative to the current services funding level.

Figure 6

Growth in Higher Education Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



[a] Includes expenditures for UC, CSU, and the CCC. Includes 97 percent of total General Fund expenditures for higher education.

SPENDING BY MAJOR PROGRAM

Figure 7 shows General Fund expenditures for the UC, CSU, and the CCC from 1985-86 through 1991-92. It shows that the CCC have experienced a greater rate of growth than the UC or the CSU. This is partially explained by a slightly higher enrollment growth for the CCC and increased funding as the result of Proposition 98. We also note that the UC's somewhat lower rate of growth is explained by reductions in the state's contribution rate for the UC's retirement plan. CSU has experienced the lowest rate of growth.

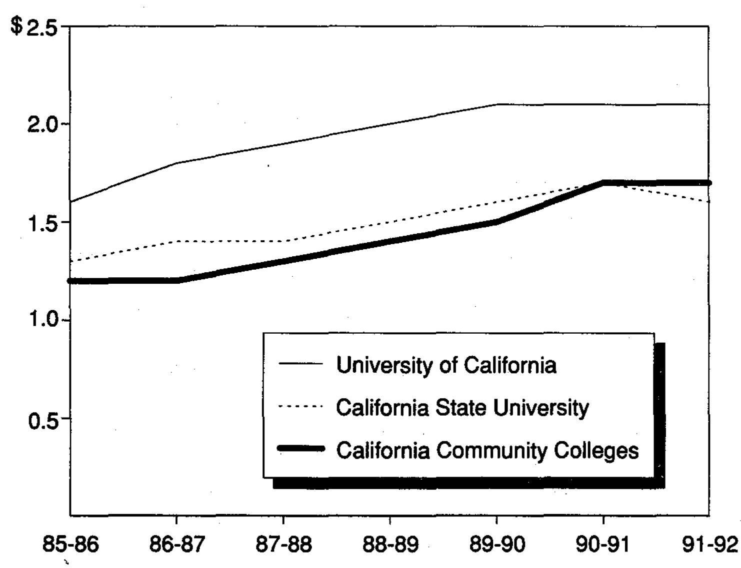
FACTORS DRIVING PROGRAM COSTS

In addition to salary and price increases, two main factors account for expenditure growth in higher education: (1) enrollment growth and (2) Proposition 98. Between 1985-86 and 1991-92, enrollment at UC, CSU, and the CCC increased at annual

Figure 7

Higher Education Expenditures By Segment

General Fund (in billions)
1985-86 through 1991-92



rates of 2.2 percent, 2 percent, and 2.3 percent, respectively. Proposition 98 generally requires that total funding for community colleges and K-12 schools from state and local sources be no less than the amount provided in the prior year, as adjusted for enrollment growth and growth in California per capita personal income. (For a discussion of Proposition 98, please see our piece on this measure in Part Four.)

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for higher education is to reduce the growth in program expenditures. This is accomplished through a variety of proposals which, in the aggregate, would result in a funding level that is approximately $764 million less than the amount required to continue funding the 1990-91 level of services in these programs.

Cost Reduction Proposals

Figure 8 shows the $764 million current services level shortfall by segment ($225 million for CCC, $227 million for CSU, and $312 million for UC). As the figure shows, the budget proposes to offset part of the shortfall with (1) additional fee revenue and (2) a $55 million deferral of payments for UC budget-year costs. The budget proposes a 20 percent increase in student fees at all three segments, resulting in additional revenue of $112 million. These actions would reduce the unfunded costs to $597 million ($211 million for CCC, $180 million for CSU, and $206 million for UC). The major cost-cutting proposals to bridge this $597 million gap are:

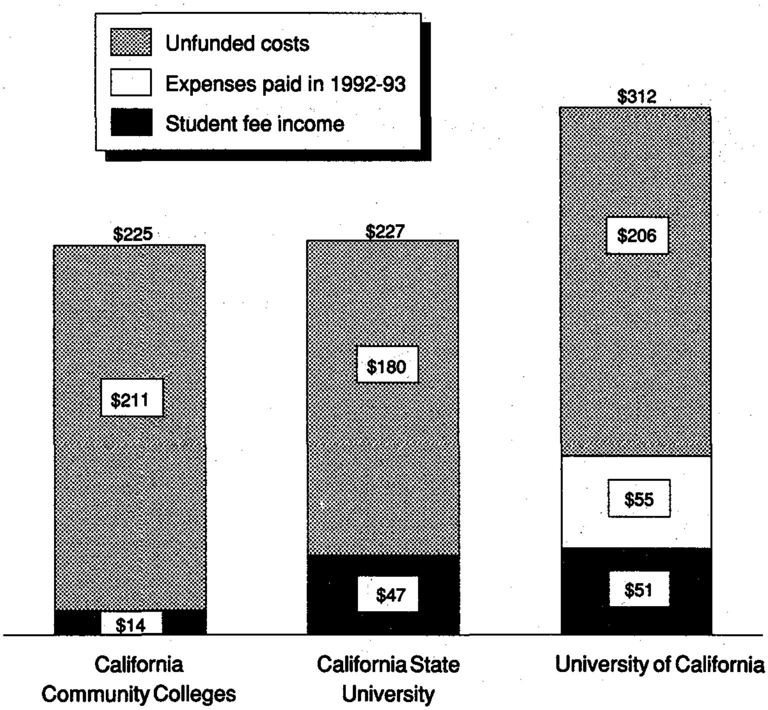
- ***Suspension of Proposition 98 ($225 million).*** The Governor proposes to suspend Proposition 98 in the budget year. We estimate that the CCC would receive an additional $225 million at the Proposition 98 "full funding" level.
- ***Other expenditure reductions ($194 million).*** The budget proposes spending reductions of $99 million for UC and $95 million for CSU. These consist of unallocated reductions and reductions in research, administration, and equipment. As a result of these deductions, some of the activities the budget purports to fund may not be supported. For example, the budget shows that projected budget-year enrollment is fully funded. However, one of the actions the UC and CSU probably will have to take to generate the necessary savings is to hold new faculty positions open, thereby not fully providing for workload increases related to new enrollment.

- ***No salary adjustments ($128 million).*** The budget proposes no salary increases for UC and CSU faculty and staff in 1991-92 ($70 million), and the budget does not fund faculty and staff merit salary adjustments in 1991-92 ($58 million).
- ***No price increases ($28 million).*** The UC and CSU anticipate increased costs of $28 million for a variety of price increases that are not addressed in the budget.
- ***No instructional equipment replacement ($24 million).*** The budget underfunds the normal level of funding for instructional equipment by $24 million, according to the formula traditionally used for this purpose.

Figure 8

Higher Education
Current Service Level Funding Shortfalls

1991-92 (in millions)



SOCIAL SERVICES

Funding for social services programs is proposed to total $6.6 billion, which is approximately 15 percent of General Fund expenditures proposed in the Governor's Budget for 1991-92. This level of expenditures represents an increase of $7 million, or 0.1 percent, over the level of expenditures estimated for 1990-91.

BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

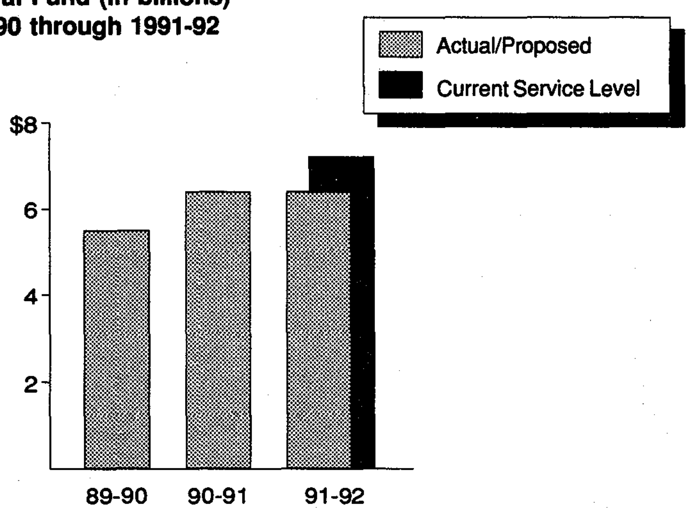
Figure 9 shows the spending levels for major social services programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. As the figure indicates, the budget proposes funding that is $831 million, or about 12 percent, less than we estimate would be needed to cover the General Fund share of the costs of providing the current level of services for these programs. This shortfall reflects two major factors:

- ***The budget underestimates AFDC caseloads by about 7 percent.*** The budget includes an estimate of caseloads

Figure 9

Growth in Social Services Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



[a] Covers 98 percent of total General Fund expenditures for social services.

that does not reflect the downturn in the state's economy or the most recent trends in actual caseloads. As a result, we estimate that the budget understates the costs of the AFDC program by about $175 million. Since there is a statutory appropriation for AFDC that ensures that all eligible recipients will receive their statutorily determined grants, the actual expenditures in this program are not limited to the amounts provided in the Budget Act.

- ***The budget proposes a variety of statutory changes.*** Most of the $831 million shortfall represents proposed service reductions. We describe the four major proposals to reduce services, totaling $594 million, below.

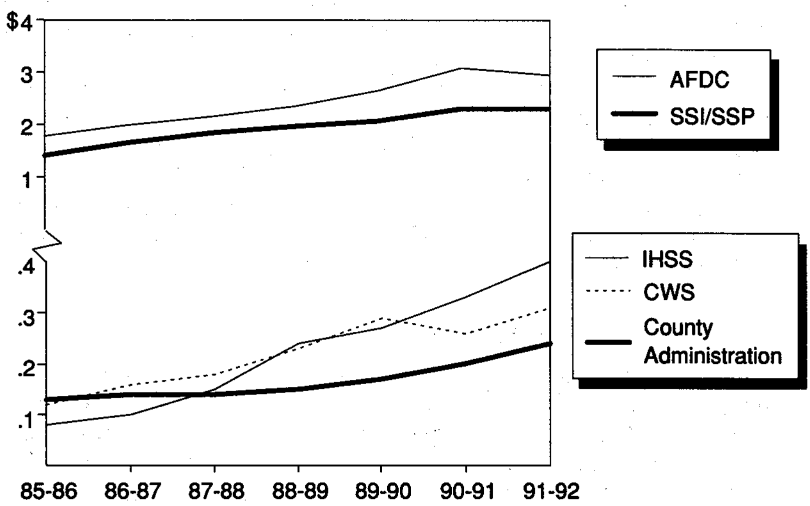
SPENDING BY MAJOR PROGRAM

Figure 10 shows General Fund expenditures for the five major social services programs. The figure shows that expenditures for AFDC, the largest welfare program, have grown steadily since 1985-86, with especially rapid growth in 1989-90 and 1990-91.

Figure 10

Social Services Expenditures By Major Program

General Fund (in billions)
1985-86 through 1991-92



The state's other major welfare program, SSI/SSP, also grew throughout the period displayed, although the rate of growth dropped off substantially in 1990-91. This occurred because the state suspended the statutory SSI/SSP COLA. At the same time, SSI/SSP caseload growth accelerated to 7.4 percent, higher than its historical average rate of 4.5 percent per year. The net effect of the reduction in state COLA costs and the increase in costs due to increased caseloads was an overall General Fund increase of about 4 percent in 1990-91.

In addition, the figure shows that the costs of the Child Welfare Services (CWS) program and the In-Home Supportive Services (IHSS) program grew at extremely high rates since 1985-86. The downturn in CSW costs in 1990-91 is due to the Governor's veto of $55 million from the program. While the veto reduced costs in 1990-91, the figure illustrates that this had little, if any, impact on the ongoing rate of growth in program costs. With respect to the IHSS program, it is important to note that the General Fund costs of this program are growing substantially faster than the program's total costs. For example, in 1991-92, total IHSS costs are projected to increase by 10 percent, while the General Fund cost is anticipated to increase by 20 percent. This occurs because the federal contribution to the program increases only slightly from year to year and county funds are capped at the 1987-88 level. Thus, the General Fund bears a disproportionate share of any cost increases in this program.

FACTORS DRIVING PROGRAM COSTS

Cost increases in social services programs in recent years can be categorized into those costs that are due to caseload increases and those that are due to increases in the average cost per case. For more detailed discussions of the reasons for increases in these programs, please see (1) our piece on the AFDC program in Part Four of this document, (2) our analysis of the SSI/SSP program in the *Analysis of the 1991-92 Budget Bill*, (3) our recent report on the CWS program (*Child Abuse and Neglect in California, A Review of the Child Welfare Services Program,* January 1991), and (4) our analysis of the IHSS program in the *Analysis of the 1990-91 Budget Bill.*

Factors Driving Caseload Increases

All of the major welfare and social services programs are designed to help individuals and families in specific target groups. As the numbers of people in each of these target groups increase, the caseloads of the programs increase as well. More than half of the increased costs of the major social services programs in recent years is attributable to increased caseloads, whose growth, in turn, has been driven by a variety of factors. Figure 11 highlights some of the major demographic, social, and programmatic factors which influence caseloads in the major social services programs.

Factors Driving Average Costs Per Case

The statutory COLAs for AFDC and SSI/SSP grants are probably the largest single influence on the costs of social services programs. For example, the General Fund costs of the COLAs granted since 1985-86 is about $700 million. This amount would

Figure 11

**Major Social Services Programs
Factors Affecting Caseload Growth**

AFDC

- An increase in women of child-bearing age.
- An increase in the number of births to unwed mothers.
- The increase in two population subgroups—Hispanics and refugees—accounts for some of the AFDC caseload growth, since these groups have in the past had welfare dependency rates that are considerably higher than the rest of the population.
- The different purchasing power of the AFDC grant in different regions of the state (due to variations in regional costs of living).
- The lack of a significant work incentive for recipients and potential recipients.

SSI/SSP

- The growth in the aged portion of the SSI/SSP caseload tracks the increase in the aged population, which has been substantially greater in recent years than the increase in the state's general population.
- Outreach efforts by the federal government.
- The AIDS epidemic has contributed to an increase in the disabled caseload.

IHSS

- Increase in the state's elderly population.
- Improved medical technology, which allows more severely disabled people to remain at home.

CHILD WELFARE SERVICES

- Increase in the known cases of child abuse and neglect.
- A lack of treatment services.

have increased by almost $300 million had the state not suspended the COLAs in 1990-91.

The COLAs that county welfare departments provide their employees are a major reason for increases in the costs per case in the CWS and county administration programs, since both of these programs rely heavily on county staff to serve clients. The 1991-92 budget, for example, includes $24 million to cover the state's share of the costs of COLAs that counties provided their employees in 1990-91.

In the IHSS program, the major determinant of the costs of serving the average case is the state's minimum wage. This is because most IHSS providers are paid at this rate. When the state increased the minimum wage from $3.45 per hour to $4.25 per hour in 1988, the General Fund cost of the IHSS program increased by $60 million, or 42 percent. Another significant factor in the IHSS program is the number of hours of service that counties award to clients. The average rate of growth in hours of service since 1985-86 has been 2.3 percent.

SPECIFIC PROPOSALS IN THE BUDGET

There are no significant proposals to add new services or increase the level of service in the social services budget for 1991-92. As noted above, the budget includes four major proposals to reduce services in this area for total savings of $594 million. In addition, the budget proposes a variety of smaller program reductions, which we describe in detail in the *Analysis of the 1991-92 Budget Bill.* The four major proposals are:

- ***Suspension of statutory welfare COLAs ($321 million General Fund savings).*** Under current law, AFDC recipients would receive a 5.49 percent increase in their grants on July 1, 1991 (for example, the grant to a family of three with no other income would increase from $694 to $732 per month) and SSI/SSP recipients would receive a 5.49 percent increase on January 1, 1992 (for example, the grant to an aged couple would increase from $1,167 to $1,231 per month). This would be the second straight year of suspending the statutory welfare COLAs, with the result that grant levels in 1991-92 would be the same as in 1989-90.
- ***Maximum Aid Payment (MAP) reduction ($193 million General Fund savings).*** The budget proposes to reduce the MAP for AFDC recipients to the 1988 level, a reduction of about 8.8 percent (for example, the MAP for a family of three would be reduced from $694 to $633 per

month). This proposal would affect the 18 percent of recipients who have outside (non-AFDC) income differently than it would affect the 82 percent of recipients with no outside income. Recipients with no outside income would have their grants reduced by the full 8.8 percent reduction in the MAP (because they currently receive the maximum grant). Most recipients who have outside income, however, already receive substantially less than the maximum grant and would not, therefore, experience any reduction in their grant. We discuss this proposal, and other options for reducing AFDC costs in Part Four of this document.

- ***Elimination of the Homeless Assistance Program ($35 million General Fund savings).*** This component of the AFDC program provides special grants for temporary shelter and for permanent housing to families who are homeless or who are about to become homeless.
- ***Foster care rate freeze ($45 million General Fund savings).*** The budget proposes to freeze for one year the monthly rates of reimbursements to foster care group homes and family homes at their 1990-91 levels. Chapter 1294, Statutes of 1989 (SB 370, Presley), created a new rate-setting system for group homes, to be phased in over a three-year period, and provided for a schedule of increases in foster family home rates, with a specialized care rate increase for family homes scheduled for 1991-92. The budget proposal would delay the phasing in of the group home rate schedule and put off the specialized care rate increase for family homes for one year.

HEALTH

Funding for health programs is proposed to total \$7.0 billion (all state funds) and \$6.4 billion (General Fund) in 1991-92. The General Fund amount is equal to approximately 17 percent of General Fund expenditures proposed in the Governor's Budget for 1991-92. The level of funding from all state funds represents an increase of \$346 million, or 4.6 percent, over the level of state-funded expenditures estimated for 1990-91. The level of funding from the General Fund represents a decrease of \$376 million, or 5.5 percent, from the level of General Fund expenditures estimated for 1990-91.

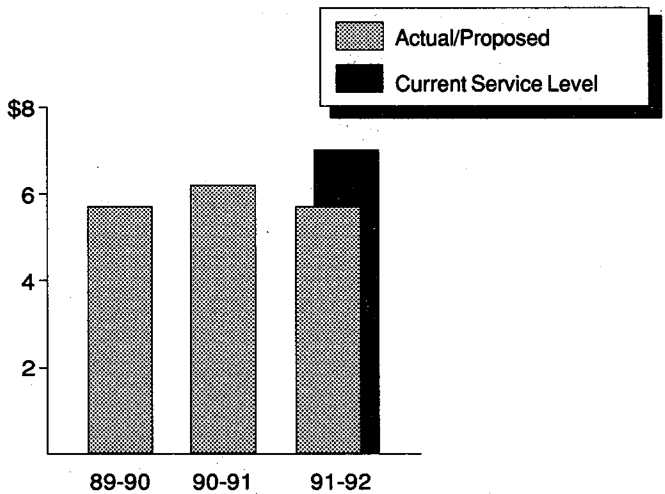
BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 12 shows General Fund local assistance spending levels for major health services programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the General Fund spending required to maintain the

Figure 12

Growth in Health Services Expenditures[a]

General Fund (in billions)
1989-90 through 1991-92



[a] Includes 78 percent of all state (General Fund and state special funds) expenditures in the health program area in 1991-92. Includes Medi-Cal figures on a cash, not accrual, basis. In addition, 1991-92 proposed funding reflects the administration's proposal to shift various health program responsibilities to counties.

1990-91 current service level in the budget year. These figures exclude approximately $900 million in funding associated with a proposed accrual accounting adjustment, because this proposal has no effect on program service levels. As the figure indicates, the proposed budget would result in significant General Fund reductions in the overall level of local assistance funding for health services programs relative to the current services funding level. This is due in large part to the proposed shift in responsibility to counties for providing mental health and public health services.

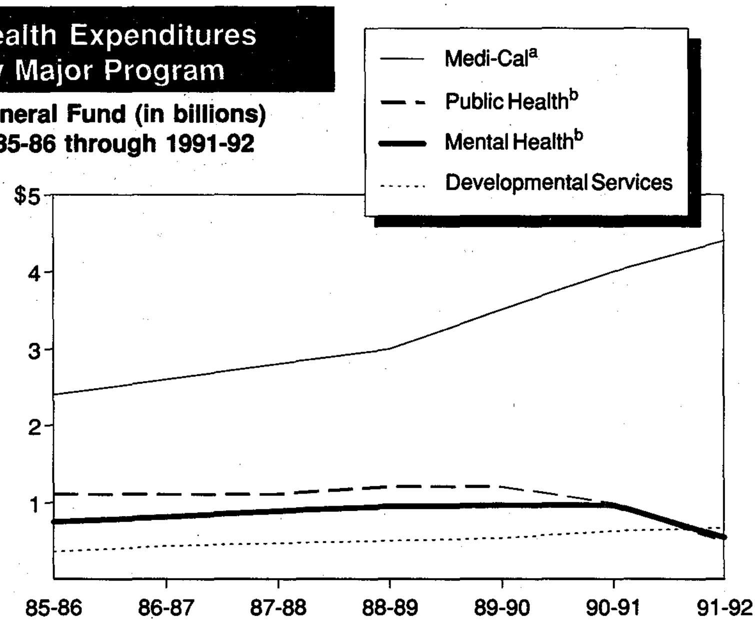
SPENDING BY MAJOR PROGRAM

Figure 13 shows General Fund expenditures for the four major health programs—Medi-Cal local assistance, public health local assistance, and programs administered by the Department of Developmental Services (DDS) and the Department of Mental Health (DMH)—from 1985-86 through 1991-92. As the figure shows, changes in funding for each of the programs has varied substantially over this time period. For example, funding for Medi-Cal and DDS programs has grown by roughly 50 percent

Figure 13

Health Expenditures By Major Program

General Fund (in billions) 1985-86 through 1991-92



[a] Medi-Cal figures are on a cash, not accrual, basis.
[b] 1991-92 expenditures reflect Governor's program realignment proposal.

over this time period. On the other hand, funding for public health and for DMH programs has declined substantially during the same period. These declines relate primarily to (1) reductions enacted in the current year and (2) budget proposals to shift responsibility for the AB 8 County Health Services and most local mental health programs to the counties in 1991-92 (discussed below).

FACTORS DRIVING PROGRAM COSTS

During the period 1985-86 through 1990-91, General Fund support of Medi-Cal, public health, and programs administered by DDS and DMH grew by about $2 billion, or more than 40 percent. This section examines the specific factors responsible for increases in health services costs during this period. These factors are also likely to drive health care expenditures for the next several years.

Demographic Changes. During the period from 1985-86 through 1990-91, funding for Medi-Cal grew by about $1.5 billion (General Fund). Roughly $400 million, or one-quarter, of this increase was due to caseload growth. In particular, two of the major population groups served by Medi-Cal—the elderly and children—have grown faster than the general population as a whole over this period.

Similarly, General Fund support for DDS increased by about $200 million, or over 50 percent, between 1985-86 and 1990-91. Approximately $75 million of this increase appears to be due to caseload growth that is tied to demographic factors.

State Policy Changes. During the period 1985-86 through 1990-91, funding for DMH-administered programs increased by about $200 million, or roughly 25 percent. (As Figure 13 shows, the budget's proposal to shift virtually all local mental health programs to the counties would reverse this growth trend.) Approximately $50 million of the increase has been due to the effect of major state policy changes, such as (1) the establishment of the Conditional Release program for parolees in 1986-87 and (2) the provision of staff for accreditation and other purposes resulting from the department's state hospital initiative in 1984-85.

In addition, about $40 million, or 20 percent, of the growth in DDS funding over the five-year period was due to specific state program changes, such as adding community placement and prevention activities, implementing rate increases through the Alternative Residential Model (ARM), and achieving and maintaining accreditation at the state developmental centers.

For Medi-Cal, the expansion of Medi-Cal coverage beginning in 1988 for pregnancy services to include women in families with incomes of up to 185 percent of the federal poverty level has increased costs by more than $50 million since that time.

New Federal Requirements. Roughly $300 million, or almost 20 percent, of the growth in Medi-Cal funding from 1985-86 through 1990-91 has been related to meeting major new federal requirements.

- The federal Immigration Reform and Control Act (IRCA) and the federal Omnibus Budget Reconciliation Act of 1986 (OBRA 86) require states to provide coverage for certain medical services to newly legalized and undocumented persons.
- The Medicare Catastrophic Coverage Act of 1988 requires Medi-Cal to pay Medicare premiums, coinsurances, and deductibles for people with low incomes and few assets, as specified.
- The federal Family Support Act of 1988 requires Medi-Cal to extend coverage to beneficiaries for up to 12 months after they become ineligible for Aid to Families with Dependent Children (AFDC) due to factors such as increased earnings or increased hours of employment.

Societal Changes. Funding for AIDS programs increased from roughly $2 million to approximately $50 million (General Fund) during the period due to a major social change—the AIDS epidemic. In addition, our field visit observations and discussions with health experts indicate that two other social changes—increases in the number of unmarried teenage women having children and children born to substance-abusing mothers—may have increased pressure for state funding for Medi-Cal and DDS. The funding impact of these changes, however, is not possible to quantify given existing data.

Inflation. Overall, the reimbursement levels and mix of services provided by various health programs are influenced by underlying trends in the costs of medical care. Costs of the major health programs (particularly Medi-Cal) have increased despite cost-containment measures, in part because medical care costs have increased more rapidly than the costs of other goods and services.

SPECIFIC PROPOSALS IN THE BUDGET

While the proposed budget for health services is based upon funding levels required to meet statutorily required caseload and utilization growth, it actually provides less than the necessary amounts due to the inclusion of unallocated reductions. It also proposes to reduce General Fund costs by (1) shifting major programs to the counties and (2) budgeting copayments or fees for various health services.

The major cost-cutting proposals in the budget are:

- ***Shift funding responsibility for health services and local mental health programs to the counties ($942 million General Fund savings).*** The budget proposes to shift funding responsibility for the AB 8 County Health program and virtually all local mental health programs to the counties. These proposals also transfer a similar amount of revenues to the counties through increased vehicle license fees and alcohol taxes.
- ***Establish fees for regional center services for persons with developmental disabilities ($30 million General Fund revenues).*** The budget proposes enactment of legislation to establish certain regional center fees in order to obtain federal reimbursement for targeted case management at the regional centers administered by the DDS. The budget assumes that the appropriate legislation will be enacted in February 1991. At the time this analysis was prepared, legislation (SB 92, Presley) had in fact been enrolled.
- ***Establish or increase various fees and copayments ($25.7 million General Fund savings).*** The budget proposes to institute beneficiary copayments for Medi-Cal, for a General Fund savings of $21.2 million. Exemptions from copayments would be made for all services to children and long-term care patients, pregnancy-related and emergency services, and services provided in "capitated" systems (such as, for example, health maintenance organizations). As a result of these exemptions, it appears that copayments would be applied primarily to services for the blind and disabled and for primary care services.

The budget proposes to establish an enrollment fee for the California Children's Services and the Genetically Handicapped Persons Program via legislation, for a $2.6 million General Fund savings. The budget also proposes to replace $1.9 million in General Fund support for various genetic disease testing and related programs with (1) Genetic Disease Testing Fund reserves in the budget year and (2) fees in future years.

New Initiatives

The budget contains three major new health proposals for 1991-92:

- ***Shift to accrual accounting for Medi-Cal.*** The budget proposes to shift from cash to accrual accounting in Medi-Cal, for a General Fund cost of $876 million.
- ***Perinatal access.*** The budget proposes to use $90 million from Cigarette and Tobacco Products Surtax funds to establish a perinatal insurance program, to be administered by the Major Risk Medical Insurance Board (MRMIB). The program would provide prenatal care, delivery, and one year of well-baby services to women with incomes between 185 percent and 250 percent of the federal poverty level, with participants sharing premium costs.
- ***Family planning increase.*** The budget proposes to increase funding for family planning services by $10 million, and to target the funds to teenage parents and substance-abusing women. The budget also anticipates $5.1 million in related General Fund savings—$4 million from Medi-Cal and $1.1 million from AFDC.

CRIMINAL JUSTICE

Funding for criminal justice programs is proposed to total $3.5 billion, which is approximately 6.5 percent of all state expenditures proposed in the Governor's Budget for 1991-92. This level of funding represents an increase of $312 million, or 9.9 percent, over the level of expenditures estimated for 1990-91.

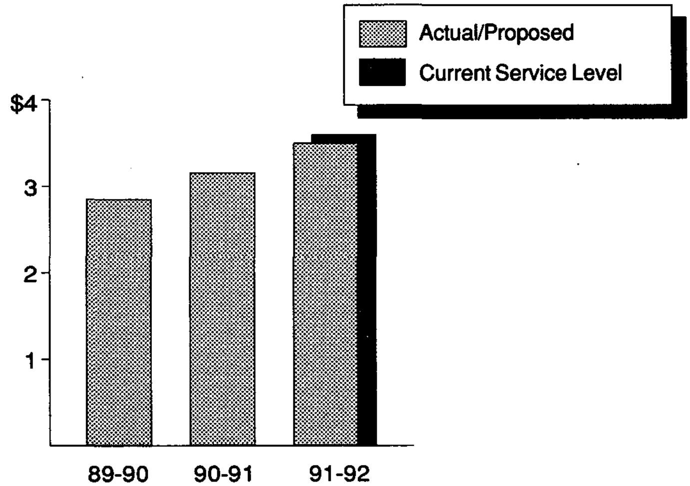
BUDGET PROPOSAL VERSUS CURRENT SERVICE LEVEL

Figure 14 shows spending levels for major criminal justice programs for 1989-90 and 1990-91, and compares the budget proposal for 1991-92 with our estimate of the spending required to maintain the 1990-91 current service level in the budget year. As the figure indicates, the proposed budget would result in minor reductions in the overall level of funding for criminal justice programs relative to the current services funding level.

Figure 14

Growth in Criminal Justice Expenditures

General Fund (in billions)
1989-90 through 1991-92



SPENDING BY MAJOR PROGRAM

Figure 15 shows General Fund expenditures for the three major criminal justice programs—adult corrections, youth corrections, and judicial—from 1985-86 through 1991-92. The figure indicates that: (1) adult corrections has grown steadily and rapidly over the period, (2) youth corrections has remained fairly flat, and (3) the judicial program grew significantly in 1988-89 and 1989-90 due to the implementation of the Trial Court Funding Program.

FACTORS DRIVING PROGRAM COSTS

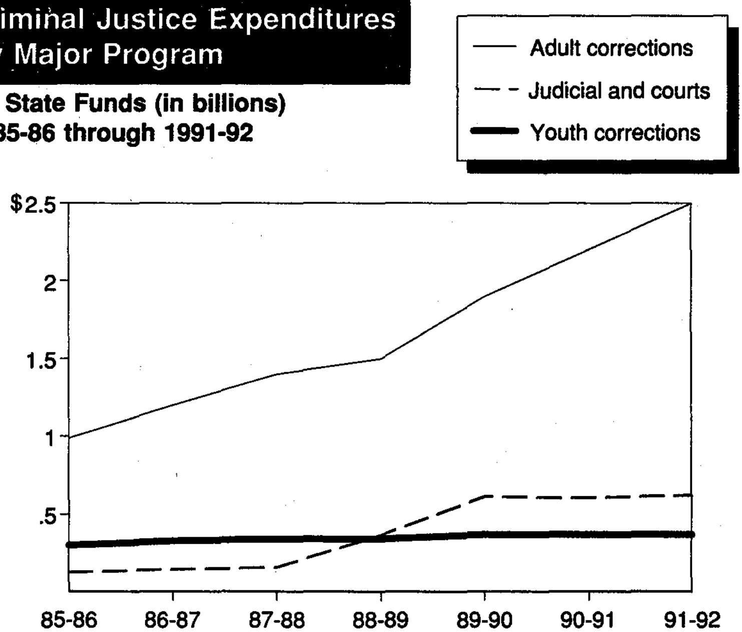
This section examines the specific factors responsible for increases in criminal justice program costs in recent years, which also are likely to drive expenditures for the next several years.

The rising costs of criminal justice programs are directly related to the continuing increase in the state's prison population. The inmate population climbed from 26,768 inmates in 1980-81 to 93,810 in 1989-90, an increase of 250 percent. The

Figure 15

Criminal Justice Expenditures By Major Program

All State Funds (in billions)
1985-86 through 1991-92



Department of Corrections projects that the population will increase further to 173,000 by 1995-96, a rise of 85 percent. These population increases have been due to a variety of factors:

State Policy Changes. The most significant factor has been state policy changes. The Legislature has enacted numerous laws to increase the length of prison sentences since it changed in 1977 the state's sentencing structure from indeterminant sentencing (where the offender's release from prison was largely discretionary) to determinant sentencing (where the offender's length of sentence is set in statute). In addition, there have been numerous measures requiring mandatory prison sentences (as opposed to less costly probation or jail) for specified crimes.

Parole Violation Rates. Another factor driving costs has been the dramatic increase in the number of parolees returned to prison for violation of the terms of their parole (more than half of all parolees are returned to prison). The increase in parole violation rates is due, in part, to discretionary administrative policies of the Department of Corrections.

Local Jail Overcrowding. Overcrowding of county jails has had an indirect effect on the state's criminal justice budgets. This is because many county jails now have court-ordered population caps, and persons who would have otherwise served their terms of incarceration in county jails are now serving terms in state prison.

Higher Cost of New Facilities. Expenditures have also been driven by increasing costs for operation of new prison facilities. The state has been engaged in a massive prison construction program in recent years in an attempt to accommodate the increased inmate population. These new facilities are generally more costly to operate than the state's older prison facilities, as they require higher staffing levels.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for criminal justice programs is to *fully fund most program expenditures*. The budget for 1991-92 proposes increases of $313 million (10 percent), financed almost completely from the General Fund.

The Governor's Budget contains no major policy proposals for criminal justice programs.

GENERAL GOVERNMENT

Funding for general government programs is proposed to total $7.2 billion, which is equal to approximately 13 percent of General Fund and special fund expenditures proposed in the Governor's Budget for 1991-92. This level of expenditures represents an increase of $1.1 billion, or 19 percent, over the level of expenditures estimated for 1990-91. The large increase for 1991-92 is attributable to legislation proposed in the budget which would increase aid to local governments by increasing the level of vehicle license fees distributed to cities and counties. Figure 16 shows the level of spending for general government programs in 1989-90, 1990-91, and 1991-92.

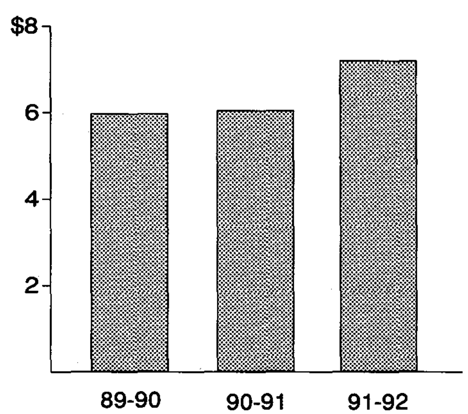
SPENDING BY MAJOR PROGRAM

Figure 17 shows General Fund and special fund expenditures for the four major general government programs from 1985-86 through 1991-92. As these data indicate, the largest general government program is aid to local governments, which is funded primarily by motor vehicle license fees. These revenues are

Figure 16

Growth in General Government Expenditures

All State Funds (in billions)
1989-90 through 1991-92



collected by the state and returned to cities and counties for general purposes according to statutory formulas. As noted above, the sharp budget-year increase is due to the Governor's proposal for increased vehicle license fees. All of the other major programs in this area exhibit relatively stable funding trends over the period indicated.

FACTORS DRIVING PROGRAM COSTS

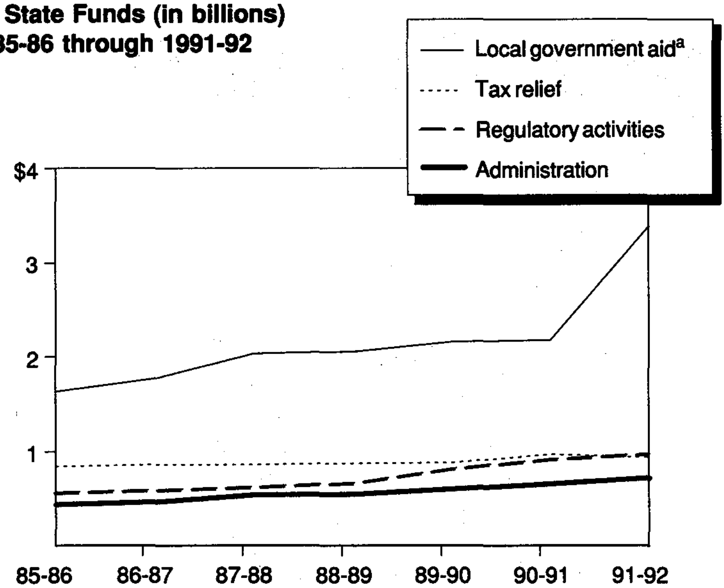
This section examines the specific factors responsible for increases in general government program costs in recent years, which also are likely to drive expenditures for the next several years. These include:

Demographic Changes. The state's increasing population is the primary driver of general government program costs. Cost increases in the state's tax relief programs, for example, are driven by increases in the number of homeowners and renters

Figure 17

General Government Expenditures By Major Program Area

All State Funds (in billions)
1985-86 through 1991-92



[a] Increase in 1991-92 reflects Governor's proposal to raise vehicle license fees and alcohol taxes as part of his realignment plan.

who are eligible to receive these benefits. Local government aid, whose primary funding source is the vehicle license fees paid on each car in the state, is also driven primarily by population increases.

Inflation. General Fund costs for annuitant health benefit premiums are expected to increase by $134 million between 1989-90 and 1991-92, which amounts to an average annual increase of 23 percent. Most of the increase (78 percent) is attributable to the rise in premium costs, reflecting the high current rates of inflation in the health care industry. The remainder is due to increasing numbers of state retirees.

State Policy Changes. State policy changes also have had, and will continue to have, a significant impact on expenditures in this program area. For example, state-mandated local program reimbursements reflect costs that have been incurred as a result of state legislation imposing costs on local government agencies. Another example is the State Board of Equalization's 1990 decision in the *Diaz* case, which expanded the benefits provided to public assistance program beneficiaries under the renters' tax credit program.

SPECIFIC PROPOSALS IN THE BUDGET

The proposed budget for general government programs generally proposes to continue past funding practices in this area. That is, most programs receive funding increases to offset workload increases, and several of the economic development programs receive funding for continued expansion. In many cases, however, these increases are offset by unallocated reductions.

Cost Reduction Proposals

The major cost-cutting proposals contained in the budget are:

- ***Reduction of renters' tax credit ($210 million General Fund savings).*** The budget proposes that legislation be enacted to reduce the level of the state's renters' tax credit. Specifically, the budget proposes that this tax credit be reduced from its present level of $120 for joint returns and $60 for single returns to $70 and $35, respectively.
- ***Forego general salary increases ($108 million General Fund savings).*** The Governor's Budget proposes that no general salary increase be provided to state employees in 1991-92. Based on an anticipated 3.9 percent

increase in the U. S. Consumer Price Index (the index is used in determining current-year salary increases), and assuming that any COLA would have been effective January 1, 1992, we estimate that the proposal would save $108 million (General Fund) in 1991-92 and approximately twice that amount annually thereafter. The ongoing savings assume that the foregone 1991-92 increase is not subsequently restored through collective bargaining agreements.

- ***PERS—Change in amortization period for actuarial gains and losses ($70 million General Fund savings).*** The Governor's Budget proposes to reduce the state's contributions for employee retirement benefits by $127 million ($70 million General Fund) by amortizing the gains anticipated for the 1989-90 fiscal year over a five-year period beginning in 1991-92. The PERS Board of Administration approved a similar amortization period for 1988-89 gains last year, thereby providing annual General Fund retirement contribution savings of $73 million annually until 1994-95.

  Subsequent to the introduction of the Governor's Budget, however, the PERS has determined that there was no gain for 1989-90, and that there will, in fact, be a *loss of $79 million.* As a result, this proposal will not result in the retirement contribution savings that had been anticipated in the budget.

- ***PERS—Increase actuarial interest assumption ($86 million General Fund savings).*** The Governor's Budget proposes to increase from 8.5 percent to 9.5 percent the rate of return on investments (interest assumption) used to calculate the annual funding need for the PERS. This action would effectively lower the state's employer contribution, resulting in projected state savings of $156 million ($86 million General Fund) in 1991-92.

- ***Continue optional status for 18 mandates ($30 million General Fund savings).*** Consistent with action taken in the 1990 Budget Act, 18 existing state-mandated local programs would be made optional for 1991-92. This means that local agencies would not have to comply with their provisions, and the state, therefore, would not be liable for any reimbursements to local agencies.

New Initiatives

The budget proposes to significantly expand local government aid in 1991-92 as part of its "program realignment" package. Under this proposal, state vehicle license fees and alcoholic beverage taxes would be increased, with most of the proceeds earmarked for distribution to county governments. This proposal also calls, however, for the termination of existing state assistance provided to counties for local mental health and public health programs. On balance, the new funding sources would provide about the same level of aid in 1991-92 as the existing subventions.

In the economic development area, the budget proposes to expand several programs. These include increased funding of $6.6 million for additional grants provided through the Competitive Technology Program, $1 million for a joint state-federal expansion of the Small Business Development Center Program, and an additional $1 million allocation for export loan guarantees offered by the World Trade Commission.

RESOURCES

Funding for resources programs is proposed to total $1.5 billion from all state funds in 1991-92. This is equal to 2.2 percent of expenditures from all state funds proposed in the Governor's Budget for 1991-92. The General Fund supports about one-third of these programs, or about 1.2 percent of total 1991-92 proposed General Fund expenditures. The remaining two-thirds of state support for resources programs will come from special funds, including the Environmental License Plate Fund, the Motor Vehicle Account, the Public Resources Account (Proposition 99), and funds generated by beverage container recycling fees and fees for support of specific regulatory activities.

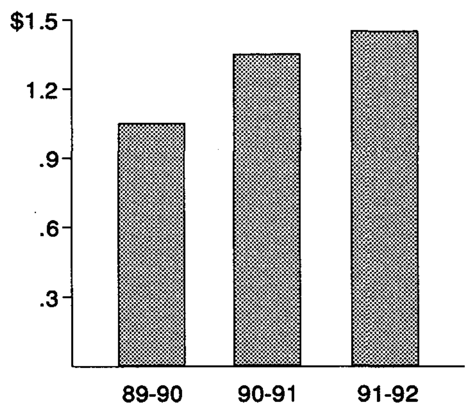
BUDGET PROPOSAL

Figure 18 shows spending levels for resources programs for 1989-90 and 1990-91 and proposed spending for 1991-92. As the figure indicates, total spending from all state funds is proposed to increase by 7.5 percent in the budget year. This consists of special fund growth of nearly 20 percent and a General Fund decline of nearly 10 percent.

Figure 18

Growth in Resources Expenditures

All State Funds (in billions)
1989-90 through 1991-92



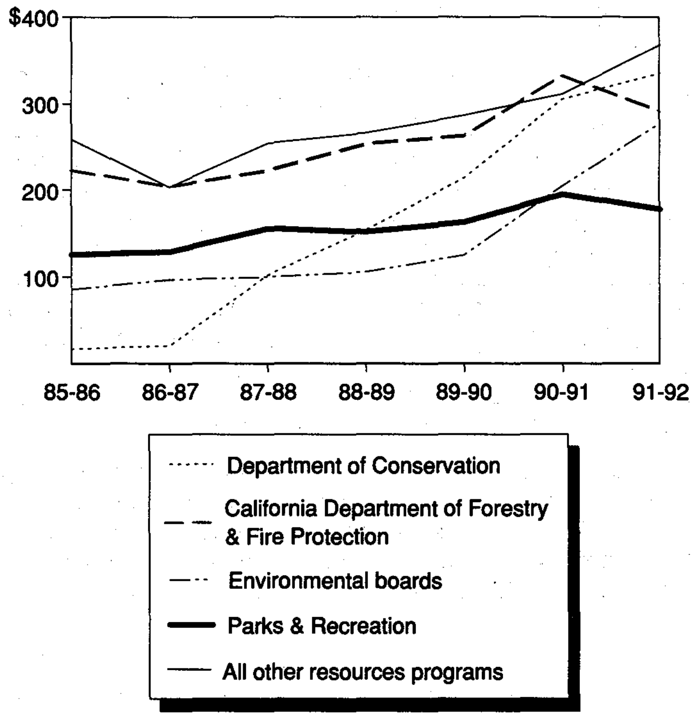
SPENDING BY MAJOR PROGRAM

Figure 19 shows total state spending trends for the four largest state-funded programs within the resources area: the Departments of Conservation (DOC), Forestry and Fire Protection (CDF), and Parks and Recreation (DPR), and the Environmental Affairs Agency boards with responsibility for water quality, air quality, and waste management. As the figure shows, expenditures for CDF, DPR, and all other resources programs have increased modestly over the period. In contrast, spending on the DOC and the environmental boards has increased dramatically, due to higher spending on various environmental regulatory and beverage container recycling programs.

Figure 19

Resources Expenditures By Major Program

All State Funds (in millions)
1985-86 through 1991-92



FACTORS DRIVING PROGRAM COSTS

This section examines the specific factors responsible for increases in resources program costs in recent years, which also are likely to drive expenditures for the next several years.

State Policy Changes and New Environmental Requirements. The most significant increases in expenditures for resources programs have resulted from increases in various environmental regulatory programs. For example, in 1986-87 the DOC implemented a statewide beverage container recycling program; and in 1989-90, the state began to implement a new California Clean Air Act program (Ch 1568/88—AB 2595, Sher). These, and expanded responsibilities for waste management and water quality as a result of new legislative initiatives, explain much of the growth in resources programs over the six-year period. The trend towards greater environmental regulation is likely to continue for some time as California's population growth continues to place increasing pressures on the state's land, air, and water resources.

Drought Conditions and Other Natural Phenomena. Expenditures in the resources area vary depending on the weather and other natural phenomena. For instance, at the time this analysis was prepared (early February), it appeared that the state would be facing a fifth straight year of drought. The primary effect of the continuing drought on the resources budget is to require additional expenditures for emergency wildland fire suppression. Estimated General Fund expenditures in the current year for emergency wildland fire suppression are $83.8 million, which significantly exceeds historical costs (average annual costs for the previous four years were only $30 million). The CDF advises that, even if the state experiences above-average rainfall in the current year and/or 1991-92, the extensive damage to timber caused by the drought thus far makes it unlikely that actual costs would fall below the historical average during this period. A secondary effect of the drought on the resources budget is to require greater spending on restoring fisheries and habitat damaged by the drought.

A second natural phenomenon affecting resources expenditures is the future danger of floods in many areas of the state. The 1991-92 budget includes $53.2 million for flood control, including $42.5 million for subventions to local agencies and $10.7 million in the capital outlay budget for work in the Sacramento area.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for resources programs is "business as usual," despite the state's overall fiscal problems. Where General Fund support has been reduced, it generally has been replaced from other funding sources, including new fees.

Cost Reduction Proposals

The budget includes several proposals to fund programs through fees. First, it proposes to fund some currently General Fund-supported programs in the Air Resources Board from the Motor Vehicle Account, for a General Fund savings of $2.9 million. Second, the budget proposes $4.3 million in increased fees charged by the State Water Resources Control Board. The budget proposes to use additional revenues for new regulatory program staff.

New Initiatives

The budget does not propose any major program initiatives in the resources area. The Budget Summary indicates that the administration intends to submit a proposal to establish a new California Environmental Protection Agency within a year; however, the budget does not contain any details of this proposal.

TRANSPORTATION

Funding for transportation programs is proposed to total $4.3 billion, which is approximately 7.9 percent of expenditures from all state funds proposed in the Governor's Budget for 1991-92. This level of funding represents an increase of $615 million, or 17 percent, over the level of expenditures estimated for 1990-91.

Up until the current year, state funds for transportation programs have been provided almost entirely from state excise taxes on gasoline and diesel fuel, truck weight fees, and vehicle registration and driver's license fees. Only minimal amounts of General Fund money were used for the state's transportation programs. Beginning in 1990-91, as a result of the June 1990 passage of Proposition 108 (the Passenger Rail and Clean Air Act of 1990) and Proposition 116 (the Clean Air and Transportation Improvement Act of 1990), general obligation bond money will be used to fund rail capital outlay projects throughout the state. The interest and principal payments to retire these bonds will come from the General Fund. (The Governor's Budget proposes, however, to pay the current- and budget-year debt service from the Transportation Planning and Development Account.)

OVERVIEW OF TRANSPORTATION BUDGET

Figure 20 shows spending levels for major transportation programs from 1989-90 through 1991-92. As the figure shows, state-funded expenditures for transportation programs have increased steadily since 1989-90. Specifically, expenditures increased by 28 percent from 1989-90 to 1990-91, and are proposed to increase by 16 percent from the current to the budget year.

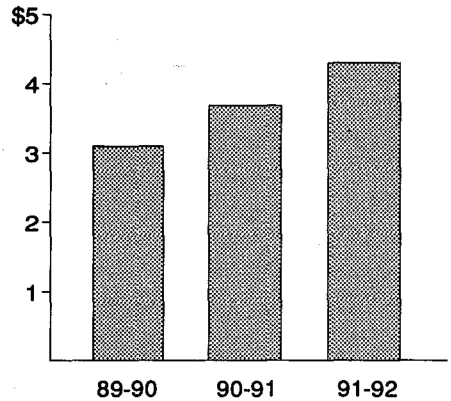
In particular, the budget proposes to:

- Increase Department of Transportation staff operational expenditures by $78 million (5.7 percent) to develop state highway capital outlay projects; earthquake retrofit and restoration projects and projects funded by local sales tax measures; and for various highway maintenance, mass transit, and rail activities.
- Provide about $460 million in state (including general obligation bond) funds for rail capital outlay improvements.
- Increase traffic licensing and enforcement programs by $93 million for 441 additional staff to accommodate workload increases, continued office automation and

Figure 20

Growth in Transportation Expenditures

All State Funds (in billions)
1989-90 through 1991-92



data processing, and to implement new programs mandated by legislation.

- Transfer funds from the Transportation Planning and Development Account to the General Fund to pay debt service costs in the current and budget years for bonds issued pursuant to Propositions 108 and 116.

SPENDING BY MAJOR PROGRAM

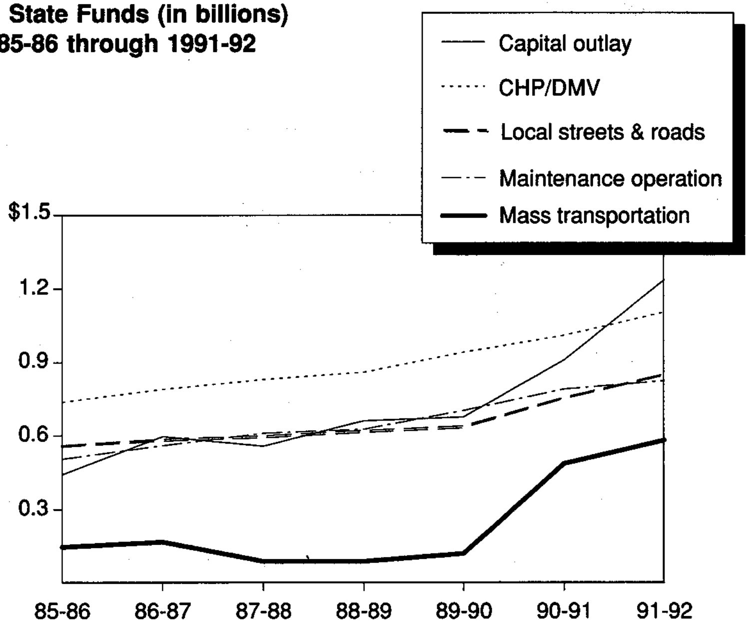
Figure 21 shows state-funded expenditures for the five major transportation programs since 1985-86. It indicates that two programs in particular—capital outlay for highways and mass transportation—have increased sharply in the current year. The increase is due to the additional funds made available as a result of the passage of Proposition 108 and Proposition 111 (the Traffic Congestion Relief and Spending Limitation Act of 1990) in June 1990. (Proposition 116, adopted at the same election, also provides bond funds for rail capital improvements. Because these funds are continuously appropriated, they are not reflected in the annual Budget Act.)

The passage of Proposition 111 triggered an increase in the gas tax and truck weight fees beginning in August 1990, provid-

Figure 21

Transportation And Enforcement Expenditures By Major Program

All State Funds (in billions)
1985-86 through 1991-92



ing increased revenues mainly for highway capital outlay improvement. Because part of the additional gas tax revenues are apportioned to local governments for transportation use, Figure 21 also shows an increase in state-funded expenditures on local streets and roads in the current year. The passage of Propositions 108 and 116 authorizes the state to issue a total of nearly $3 billion in general obligation bonds for rail capital outlay improvement purposes. As a result of expenditures of Proposition 108 bond funds, mass transportation expenditures are expected to experience a threefold increase in the current year. As reflected in the figure, the growth in expenditures for this program is projected to continue into the budget year (an increase of 20 percent).

FACTORS DRIVING PROGRAM COSTS

Expenditures in the transportation programs are affected by the following key factors.

Demographic Changes. Transportation demand increases with growth in population and economic activity. With the increase in the number of drivers and vehicles, there is a correspondingly higher usage of the state's highways and road system. This in turn increases traffic licensing and enforcement activities by the California Highway Patrol and the Department of Motor Vehicles. Similarly, the greater use of the highway and road systems necessitates expansion of the systems and increases maintenance and operations expenditures. Furthermore, a growing population increases demand for new and expanded mass transit services.

State Policy Changes. Up until the current year, transportation activities have been funded on a pay-as-you-go basis. The passage of Proposition 108 and 116 authorizes the state to use general obligation bonds for rail capital outlay expenditures. This policy change has significantly changed the state's role in funding mass transportation rail activities and will allow a sustained higher level of transportation expenditures in future years.

SPECIFIC PROPOSALS IN THE BUDGET

The major thrust of the proposed budget for transportation programs is to continue to improve and expand the state's highway system, increase funding for rail projects, and accommodate workload increases in traffic licensing and enforcement activities.

New Initiatives

The budget contains two proposals for funding of the transportation program.

- First, it proposes to transfer Transportation Planning and Development Account money to the General Fund to pay for the current- and budget-years' debt service costs of bonds issued under Propositions 108 and 116.
- Second, the budget proposes that legislation be enacted to increase vehicle registration fees by $5 (from $23 to $28) and drivers' license fees by $2 (from $10 to $12), in order to raise about $73 million in revenues to the Motor Vehicle Account in the budget year for various traffic licensing and enforcement activities.

CAPITAL OUTLAY

Funding for capital outlay expenditures represents 2.6 percent of expenditures from all state funds (both General Fund and special funds) proposed for 1991-92. These expenditures reflect the state's current costs for capital outlay programs, either through debt service payments or direct appropriation of state funds to purchase assets (that is, "pay-as-you-go" financing). (The funding figure does *not* include the appropriation of bond proceeds, themselves, because they do not represent a direct cost to the state until the bonds are paid off in future years.)

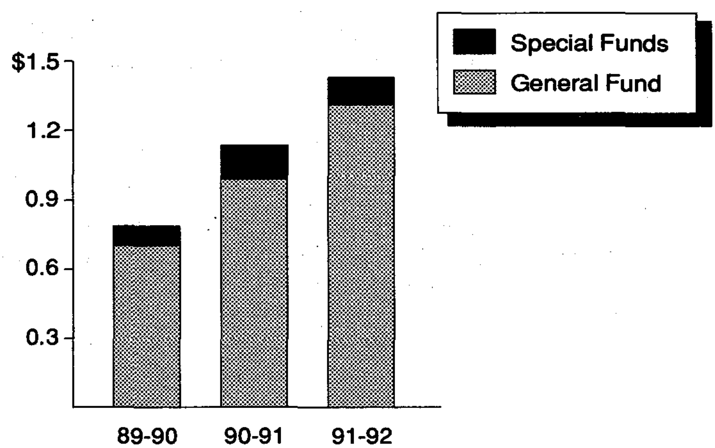
As shown in Figure 22, expenditures for capital outlay programs over the past three years have increased significantly—from $786 million in 1989-90 to over $1.4 billion in 1991-92. This increase is directly attributable to the increase in General Fund debt service payments on bond programs. These expenditures have increased from $691 million in 1989-90 to $1.3 billion in 1991-92.

Expenditures for debt service payments include amounts for both general obligation bonds and lease-payment bonds. With

Figure 22

Growth in Capital Outlay Expenditures

All State Funds (in billions)
1989-90 through 1991-92



lease-payment bonds, the General Fund makes the debt service payments through direct appropriations to the department using the capital asset. These funds are then used to make lease payments to the Public Works Board, which in turn uses them to pay off the bonds. As a percent of debt service payments, expenditures for lease-payment bonds have increased from 7.2 percent in 1989-90 to 16 percent in 1991-92. As we have mentioned on several occasions, lease-payment bonds are more costly than general obligation bonds, and the Legislature should use caution when considering the use of this financing method. (Please see our piece on state infrastructure in Part Four of this document for a more detailed discussion of this issue.)

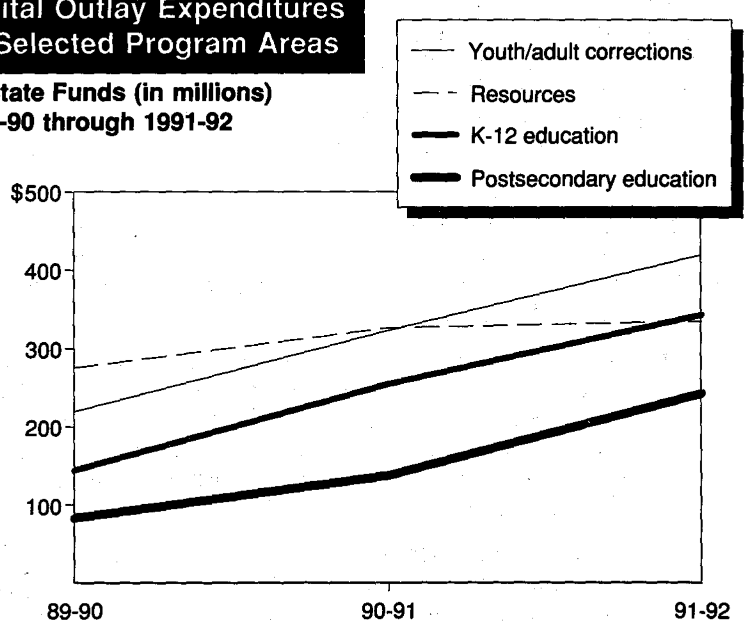
SPENDING BY MAJOR PROGRAM

The vast majority of annual expenditures for capital outlay (over 90 percent) is in four areas: (1) Youth and Adult Corrections (YAC), (2) K-12 education, (3) higher education, and (4) resources. Figure 23 shows the expenditures in these areas over the past three years. It indicates that, with the exception of the resources area, expenditures have grown steadily and rapidly. Total expenditures are highest in YAC, where in 1991-92 they are

Figure 23

Capital Outlay Expenditures By Selected Program Areas

All State Funds (in millions) 1989-90 through 1991-92



expected to reach $419 million, compared to $219 million in 1989-90.

We note that 28 percent of 1991-92 debt service payment expenditures for YAC and higher education is for lease-payment bonds. This is up from a level of 16 percent in 1989-90. This upward trend will continue in the future as projects financed under this method are completed.

PROPOSED DIRECT APPROPRIATION OF FUNDS FOR CAPITAL OUTLAY

The Governor's Budget proposes appropriations of nearly $564 million for the *acquisition* of capital assets. This includes:

- ***$440 million (or 78 percent of the total) from bond financing.*** This total consists of $107 million in appropriations from general obligation bonds in the areas of YAC, higher education and resources, and $333 million in appropriations from lease-payment bonds for higher education.
- ***$124 million in direct appropriations*** from various special funds ($118 million), such as the Special Account for Capital Outlay (SAFCO), the Motor Vehicle Account, the Cigarette/Tobacco Products Surtax Fund, and from federal funds (over $5 million).

The major emphasis of the Governor's Budget for capital outlay is in the area of higher education. This area receives $385 million, or 68 percent, of the proposed funding. Again this year, the Governor's Budget *does not include any proposals for new prisons.* Apparently, the administration will continue the practice of proposing individual new prisons in a piece-meal fashion through separate legislation.

Failure of General Obligation Bond Measures. The failure of several bond measures on the November 1990 ballot has had a significant effect on the state's ability to address its capital outlay needs. For instance:

- About 55 percent of the capital outlay plan for higher education is proposed for funding in 1991-92. Although upon examination the entire higher education program may not merit funding, much of the program is needed if enrollment growth throughout higher education is to be accommodated.
- Two prisons authorized by the Legislature—at Susanville and Madera—were funded for construction from the prison bond measure that failed in November. Thus,

these prisons, along with other new prisons that would have been financed through this measure, are unable to proceed.

For additional discussion of the implications of the 1990 election on state capital outlays, see our earlier cited piece in Part Four on infrastructure.

OTHER STATEWIDE EXPENDITURE ISSUES

This section discusses certain other expenditure-related features of the budget which are significant from a statewide perspective. These include the unallocated "trigger-related" reductions reflected in budgets of departments funded from the General Fund and the state's appropriations limit.

UNALLOCATED REDUCTIONS

The "Trigger"

Under the provisions of Chapter 458, Statutes of 1990 (AB 2348, Willie Brown), state General Fund appropriations are to be reduced by up to 4 percent when state General Fund revenues are projected to be insufficient to fund the state's "workload budget" expenditure level. This automatic reduction provision is referred to as the "trigger." The determination as to whether the trigger is activated is to be made by the Director of Finance on or before May 21 of each year, subject to certification by the Commission on State Finance of the general accuracy of the calculations involved.

If the Director's estimate of General Fund revenues is more than 0.5 percent *less* than the Director's estimate of workload budget expenditures, then *all* General Fund appropriations for the new fiscal year are to be reduced by the same percentage difference as that between the estimated General Fund workload budget expenditures and estimated General Fund revenues.

Defining a "Workload Budget." Chapter 1209, Statutes of 1990 (AB 756, Isenberg), defines "workload budget" for purposes of making the above determinations. Specifically, Chapter 1209 defines "workload budget" as the budget-year cost of currently authorized services, adjusted for changes in enrollment, caseload, or population. In addition, adjustments are to be made for statutory cost-of-living adjustments, legislation, costs incurred pursuant to constitutional requirements and court/federal mandates, general price increases, merit salary adjustments, and certain other technical factors. On this basis, the Department of Finance calculates the cost of the 1991-92 workload budget to be $46.8 billion, while General Fund revenues (excluding the effect of legislation proposed in the budget) are estimated to be $43.1 billion. Because the difference between these estimated expenditures and revenues is 9.2 percent, the trigger's reduction percentage would be set at the 4 percent maximum.

The statute exempts from these trigger reductions those General Fund appropriations which are required by operation of the State Constitution (for example, Proposition 98-required expenditures, general obligation bond debt service payments, and state subventions for the Homeowners' Property Tax Exemption Program). The total amount of state spending exempted from trigger reductions is approximately $19 billion.

The trigger's reductions apply to all General Fund appropriations as they appear in the Budget Act or as provided for in statute. In the case of four specific programs (such as AFDC), however, the amount of the reduction is limited by Chapter 458 to the *lesser of* the amount of any statutory cost-of-living adjustment required or the amount of the percentage reduction. Finally, to the extent that a funding reduction would require the reduction of a statutory entitlement, Chapter 458 provides general authority (and specific authority for certain programs) to make the reduction.

What the Budget Proposes. The Governor's Budget proposes that the reductions envisioned by the trigger mechanism be made instead through the Budget Bill, by including a specific unallocated reduction in the budgets of most General Fund state agencies and programs. Section 1.2 of the 1991 Budget Bill, as introduced, states that the Budget Bill "incorporates the reductions required by Chapter 458," and provides that no further reductions shall be made to General Fund appropriations on July 1, 1991.

In the context of the overall budget proposed by the administration, the unallocated reductions undermine the budget's claim of funding "population enrollment and caseload growth for all programs." While the budget details appear to reflect this goal, the unallocated reductions mean that the *actual proposed appropriations will be insufficient to achieve it.*

The administration's proposal raises several issues regarding how the Legislature should approach unallocated reductions:

- ***Reductions in statutory entitlements.*** As mentioned earlier, Chapter 458 provides that, if an appropriation for any program is reduced pursuant to its provision, then the level of any payment amount specified in statute may be correspondingly reduced. This authority, however, may not apply if, as the administration proposes, appropriations are instead reduced pursuant to the Budget Bill. In this event, additional legislation would be needed to actually achieve General Fund savings.

- ***Distribution and level of reductions.*** The Governor's approach on unallocated reductions would result in a different distribution (for example, between state operations and local assistance) and level of cuts than under the trigger. These differences generally result from two factors. First, the administration's general approach to determining the unallocated reductions is different than the approach specified in Chapter 458. Second, the administration has made a number of policy choices to *exempt* certain departments or programs from these reductions, or to *reduce* the amount of reduction that would have otherwise applied. However, the exact amount of these differences cannot be known without making assumptions about the level of Budget Act appropriations that would have existed if the statutory trigger mechanism had been used.
- ***The use of unallocated reductions.*** In relying on the use of unallocated reductions to achieve budgetary savings, the Legislature, in effect, delegates sole authority for determining how these reductions will be implemented to the administration. Our review indicates that, in many cases, there is no plan for how these savings are to be achieved. The Legislature will probably have little additional information on the implementation of these reductions as it works its way through the budget process.

STATE APPROPRIATIONS LIMIT

The state's appropriations limit, imposed by Article XIII B of the State Constitution, was significantly changed by Proposition 111 in June 1990. This measure both increased the level of the state's appropriations limit and exempted certain additional types of expenditures from the limit's control. As Figure 24 shows, the Governor's Budget indicates that the state will be $3.6 billion below its limit in 1990-91 and $2 billion below its limit in 1991-92.

Current Year

Last year at this time, the state was projected to be within $143 million of its 1990-91 appropriations limit. The dramatic increase in "room" under the limit—to $3.6 billion—reflects both the decline in anticipated state revenue collections that has occurred since that time and passage of Proposition 111. State tax revenue collections for 1990-91 are now estimated to be approximately $2.4 billion *less* than anticipated in the 1990-91

Figure 24

State Appropriations Limit Estimates Governor's Budget Estimates

1990-91 and 1991-92 (in millions)

	Appropriations Limit	Appropriations Subject to the Limit	Amount Under the Limit
1990-91	$32,161	$28,531	$3,630
1991-92	34,990	32,946	2,044

Governor's Budget. The remaining difference is due to various Proposition 111 changes, which are discussed below.

Proposition 111 Adjustments. Proposition 111 changed the index that the state and local governments use to annually adjust their appropriations limits. Specifically, the measure requires them to use the change in California per capita personal income instead of the lesser of per capita personal income or the change in the U. S. Consumer Price Index. Furthermore, Proposition 111 redefines the population factors for all governmental entities subject to the limit. With regard to the state's limit, the population adjustment is now computed as an average of the changes in statewide population and average daily attendance (ADA) for K-14 schools, weighted to reflect the non-K-14 and K-14 shares of the state's budget. Proposition 111 also allows the state to exclude from the limit calculation appropriations for "qualified capital outlay projects" and for certain emergency expenditures, such as disaster relief. Finally, Proposition 111 allows the state to include all of the increased transportation revenue resulting from its passage as "user fees."

Budget Year

The budget anticipates that the state's appropriations limit for 1991-92 will be set at almost $35 billion, an increase of 8.8 percent over the level estimated for 1990-91. This figure reflects an anticipated increase in per capita personal income of 5.31 percent, and an increase in the weighted average population/ADA measure of 3.31 percent. Appropriations subject to the limit are estimated to total $32.9 billion, leaving slightly more than $2 billion in "room" under the limit for 1991-92.

The administration's calculation of the appropriations limit, however, is incomplete in several respects.

Capital Outlay Projects. The administration's estimates do not fully account for the additional exempt appropriations allowed by the provisions of Proposition 111. Specifically, that measure allows the state to exclude from the limit all appropriations for "qualified capital outlay" projects. The budget states that this is "still under review," but our analysis suggests that a number of state expenditures should be excluded under this provision. The largest of these is the state's debt service on its lease-payment bonds for higher education and correctional facilities, estimated at $356 million for 1991-92.

Federal Mandates. A 1990 California Supreme Court decision appears to allow the state to treat over $600 million of existing expenditures for various program activities as "federal mandates" which can be *excluded* from the limit calculations.

Shifts of Financial Responsibility. The Constitution requires that, when the responsibility for providing a service is transferred from one level of government to another, or its funding source is transferred from tax revenues to fee revenues, the appropriations limit be adjusted to reflect the transfer. The budget contains several proposals which involve transfers of financial responsibility—almost all of which are *from* state taxes *to* other funding sources—but the appropriations limit calculations do not reflect any downward adjustment on their account. The largest of these proposals involves the transfer of state funding responsibilities for local mental health and public health programs to counties. Additional proposals relevant to this point include the proposed higher education student fee increases, which will offset General Fund support, and fee increases for the adoptions and community care licensing programs. Depending upon how these proposals are ultimately structured, a downward adjustment to the state's appropriations limit of approximately $1 billion may be required.

On balance, the potential adjustments discussed above, as well as a variety of other adjustments, would leave the state with approximately $200 million *less* limit "room" than estimated by the administration.