

Research Department
Federal Reserve
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San Francisco

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The Morning After

In presenting his fiscal year 1984 "common sense" budget to the State Legislature early in January, California's new governor, George Deukmejian, proposed a \$25.2 billion level of spending. The new budget represented about a \$450 million (or 2 percent) reduction from the prospective 1983 fiscal year outlays. Noting that spending had increased about \$6 billion more than revenues since 1978, wiping out the State's \$4 billion surplus in the process and pointing to a potential fiscal 1983 deficit of \$1.5 billion, the Governor commented that "now we are paying the terrible price for this overindulgence."

E pluribus unum?

The Golden State is not alone in its fiscal dilemma. According to the National Governor's Association, the financial condition of most states in the nation deteriorated sharply over the last year as a result of the recession. Of course, finances at the national level have yielded some unpleasant news too. The present administration in 1981 forecasted a \$23 billion deficit for fiscal 1983 and a balanced budget for fiscal 1984, but these estimates have been superceded by deficits now forecasted at \$208 billion and \$189 billion respectively. The economic and tax revenue growth that was expected to result from large tax cuts in particular, simply did not materialize as planned.

A similar combination of circumstances, including tax cuts in conjunction with continued rises in spending, relatively high real interest rates, and the impact of a protracted recession on revenues, have made coping with soaring deficits the name of the game at the state and local as well as national levels.

The past was prologue

In the ninety odd years following the Gold Rush until the advent of World War II, California's population swelled to 7 million and the State boasted a per capita income over

30 percent above the national average. Its residents prided themselves on having enacted progressive legislation that not only made the Golden State the True Land of Hope and Glory, but the home of the ballot initiative and referendum as well.

In response to these legislative enactments and the dynamics of a highly diversified growth environment, State revenues blossomed and reached a record \$298 million by 1941, or \$40 per capita. The amount sufficed (as was the case during most years of the Great Depression) not only to cover expenditures, but also to provide a moderate surplus of \$23 million.

At that time, one-third of state outlays supported education, and a quarter, the highway system; both were elements of a social infrastructure of superior quality that induced in-migration and furthered economic growth.

On the revenue side, 47 percent of receipts (General and Special Fund) came from the retail sales tax and taxes on alcoholic beverages, 30 percent from motor vehicle fuel taxes and license fees, 11 percent from bank, corporation and insurance taxes, and only a very modest 7 percent (\$20 million, or \$3 per capita) from the personal income tax. In addition, property taxes at the local level generated \$300 million (\$40 per capita) Statewide and supported public schools, parks, fire, police and other local government functions.

Growth a go-go

In the first flush of rapid growth following World War II, the State budget reached \$1 billion in 1951, while at the local government level, expenditures reached almost \$2 billion. Local spending was financed in part by property taxes aggregating \$800 million. Receipt of a \$112 property tax bill in this writer's Bay Area home in 1946 triggered a

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typical reaction: "Where will it end?" The question was still being asked in fiscal year 1978 when the State budget reached almost \$14 billion and outlays at the local government level reached \$31 billion, financed in part by property taxes that reached a record \$10.3 billion.

The fifteen-fold increase in total State and local government spending in the interim since 1951 far outpaced a nine-fold increase in aggregate personal income. As a result, *per capita* State and local taxes increased from \$162 to \$1,096. The increase not only contributed to a State surplus of almost \$4 billion by 1978, but also set the stage for irate taxpayers' overwhelming approval of Proposition 13 (which slashed property taxes by about one-half) and action of the Legislature (subsequently "permanitized" by voter approval of Proposition 7 last year) indexing income tax rates to inflation.

Sending a message

Nevertheless, and in spite of the belief of voters that they were "sending Sacramento a message," spending (General Fund plus Special Fund) has almost doubled since 1978 to a projected level just under \$26 billion for fiscal year 1983. The jump far outpaces increases in the price level (up 50 percent), surpasses the net increase in spending over the previous *eighteen* years, and far exceeds a roughly \$8 billion rise in revenues. The principle elements in the sharp rise in spending since 1978 have been a more than doubling of outlays for education and a 67 percent net increase in outlays for health and welfare which, together, represent 70 percent of the total budget.

On the revenue side, proceeds from the sales, bank and corporation, and personal income taxes have increased by about 50 percent since 1978 and account for three quarters of total revenues (the personal income tax alone, for 31 percent). Still, as a result of the recession and overly optimistic forecasts of the performance of the national and California economies, revenues this

year will probably fall at least \$2 billion short of earlier estimates. Still other factors contributing to a revenue loss are the indexing of personal income tax rates to inflation (resulting in a \$9 billion cumulative loss of revenues since 1978), and last year's voter-approved abolition of the State gift and inheritance taxes (resulting in a \$500 million revenue loss during the current fiscal year).

Meanwhile, property tax revenues, which dropped from \$10 to \$5 billion following Proposition 13, have recovered to an estimated \$7.5 billion this year in response to a 50 percent net increase (since 1978) in assessed valuations. Local government spending, however, has increased from \$32 billion to an estimated \$40 billion or more, financed in part by federal and state transfer payments that included a \$1.4 billion annual state property tax "bailout" (representing approximately 30 percent of the initial \$5 billion loss in property tax revenues).

How to cope

As initially introduced, Governor Deukmejian's proposed budget for fiscal year 1984 contemplated a slight reduction in State spending to slightly more than \$25 billion. It also anticipated a \$2.2 billion rise in total revenues in spite of an expected slow to moderate recovery in the national and State economies. The budget called for no increase in tax rates or any imposition of new taxes. The reason was that the rise in revenues during the next fiscal year (starting June 30), including an almost 20 percent increase in revenues from the personal income tax, was estimated to cover and pay off the current fiscal year's (1983) deficit.

Compromise

Applauded by Republicans, the Governor's budget proposals were sharply criticized by Senate Democrats in particular, who characterized as "fiscally irresponsible" and incompatible with at least the spirit of the State's Constitution, his proposal to carry a large deficit over to fiscal 1984.

MONETARY POLICY OBJECTIVES

Federal Reserve Chairman Paul Volcker presented a report to the Congress on "Monetary Policy Objectives for 1983" on February 16. The report includes a summary of the Federal Reserve's monetary-policy plans for 1983, along with a review of economic and financial developments in 1982. Single or multiple copies of the report can be obtained upon request from the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120. Phone (415) 974-2246.

However, after much inter- and intra-party acrimony, the Legislature on February 16 finally approved a compromise budget. It calls for a combination of about \$638 million in additional spending cuts, tax speedups, hiring and purchasing freezes, and internal borrowings from Special Funds to help cover General Fund expenditures by June 30. The compromise budget thus leaves a deficit of between \$900 million and \$1 billion to be "rolled over" into fiscal year 1984.

As noted previously, the deficit is expected to be covered by a substantial rise in revenues generated by a recovering state economy. However, the compromise stipulates that in the event that revenues fall more than \$150 million below their forecast level by November 1 (the first three months of the new fiscal year), or if remaining State reserves fall below \$100 million by February 1, 1984, a "temporary" 1 cent increase in the State's six cent sales tax will be imposed. When the "rolled over" deficit is paid off, the sales tax will then be reduced below its present level so that over a two-year period there will be no net tax increase.

The compromise also broadens the Controller's authority to obtain loans from private lenders to cope with the current cash flow problem. (The Controller estimates that \$850 million in borrowings will be necessary in the remainder of the current fiscal year.)

Spending increases and cuts

As the budget now stands, spending on education next year will show a slight increase, financed in part by increased fees at the University of California and the nine State universities as well as the imposition of a fee by the State's numerous community colleges. At the same time, health and welfare payments are slated for a reduction (to under \$7 billion from a peak of \$7.5 billion in fiscal year 1982), largely in response to the completion of a phase-out of medical payments for the indigent.

As part of the "compromise," the Governor has agreed not to make "significant cuts" in programs favored by the Democrats, but barring further changes, families with dependent children will get no increase in aid, while aid to the aged, blind and disabled will increase by about 2 percent. Outlays for mass transit also are earmarked for a decrease as are most of the State's regulatory agencies. While an overall reduction of 1,000 in the State's 232,000 workforce is planned, a 5-percent salary increase also has been programmed, and increased personnel and budgets are contemplated for the State prison and highway patrol system.

It is the accuracy of the revenue forecasts, however, which will largely determine the final shape and dimensions of the fiscal year 1984 State budget.

Overly optimistic revenue forecasts?

While some Senate Republicans predict that the sales tax "trigger"—the key element in the "compromise"—never will be pulled, others are far from certain. The Governor himself has urged the State's citizens to start their Christmas spending 250 days early to help bolster State revenues. In the meantime, the negotiation of \$420 million in short-term loans from private lenders has forestalled a massive issuance of registered warrants, or I.O.U.'s (which have not been used since the Depression), to State contractors and taxpayers filing for refunds, although some were printed for distribution prior to receipt of the short-term loans.

Some observers also are convinced that California's economy may lag the national recovery this time due to the loss of traditional heavy industries and the fact that California has become increasingly dependent upon "high tech" industries that primarily are business rather than consumer oriented. In short, some observers detect in the revenue forecasts at least a potential replay of the overly optimistic forecasts of the last five years. They note that wishful thinking never has balanced a budget.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from	
	2/9/83	2/2/83	Dollar	Percent
Loans (gross, adjusted) and investments*	163,047	-1,136	5,316	3.4
Loans (gross, adjusted) — total#	141,843	-1,203	5,627	4.1
Commercial and industrial	44,981	- 435	2,835	6.7
Real estate	57,247	- 32	708	1.3
Loans to individuals	23,689	- 126	294	1.3
Securities loans	2,555	- 276	562	28.2
U.S. Treasury securities*	7,540	- 95	1,287	20.6
Other securities*	13,664	162	- 1,598	- 10.5
Demand deposits — total#	38,145	-2,040	- 546	- 1.4
Demand deposits — adjusted	27,652	457	120	0.4
Savings deposits — total	61,288	1,436	30,697	100.3
Time deposits — total#	74,083	-1,364	- 17,143	- 18.8
Individuals, part. & corp.	65,424	-1,269	- 16,609	- 20.2
(Large negotiable CD's)	25,189	- 626	- 10,562	- 29.7
Weekly Averages of Daily Figures	Week ended 2/9/83	Week ended 2/2/83	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	40	83		79
Borrowings	0	7		30
Net free reserves (+)/Net borrowed(-)	40	75		49

* Excludes trading account securities.

Includes items not shown separately.

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