



California Spending Plan 2003-04

The Budget Act and Related Legislation

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The 2003-04 Budget— The Problem and The Solution

SCOPE OF THE PROBLEM

The Legislature was faced with addressing an enormous two-year General Fund budget shortfall in developing the state's spending plan for 2003-04. Using the administration's "baseline" revenue and expenditure totals, this two-year cumulative shortfall was estimated at about \$38 billion. Although the shortfall was closer to \$30 billion by our own accounting (see shaded box, next page), the gap was huge by either standard, accounting for well over one-third of annual General Fund spending. The administration's projected shortfall was the basis for estimating the amount of budgetary actions that would be needed to bring the 2003-04 budget into balance.

HOW THE PROBLEM DEVELOPED

During the extremely strong boom period of the late 1990s, when both the economy outperformed expectations and stock market-related activity soared, unexpectedly large gains in state revenues occurred. The Governor and Legislature fully allocated these revenues to numerous purposes, including increases in education funding, expansions in health care coverage, and tax relief. Shortly thereafter, however, the economy significantly slowed and the stock market bubble burst, causing revenues to fall dramatically in 2001-02. Because the state failed to scale back spending or augment revenues commensurately, it proved unable to fully come to grips in either 2001-02 or 2002-03 with the large operating shortfalls that emerged. It is the compounding effect of these annual operating shortfalls that was responsible for the huge cumulative budget shortfall confronting the state in 2003-04.

Annual Operating Shortfalls. As shown in the top of Figure 1, annual General Fund revenues and expenditures were roughly in balance in 2000-01. However, following the economic downturn and stock market decline, revenues plunged by over \$12 billion the following year, and remained depressed in 2002-03. Despite the significant budget-balancing

How Big Was the Shortfall?

As we noted beginning in January 2003, we believe that the administration overstated by about \$8 billion both the size of the underlying 2003-04 cumulative budget problem and the corresponding magnitude of real solutions needed to deal with it. This overstatement was due to three main factors:

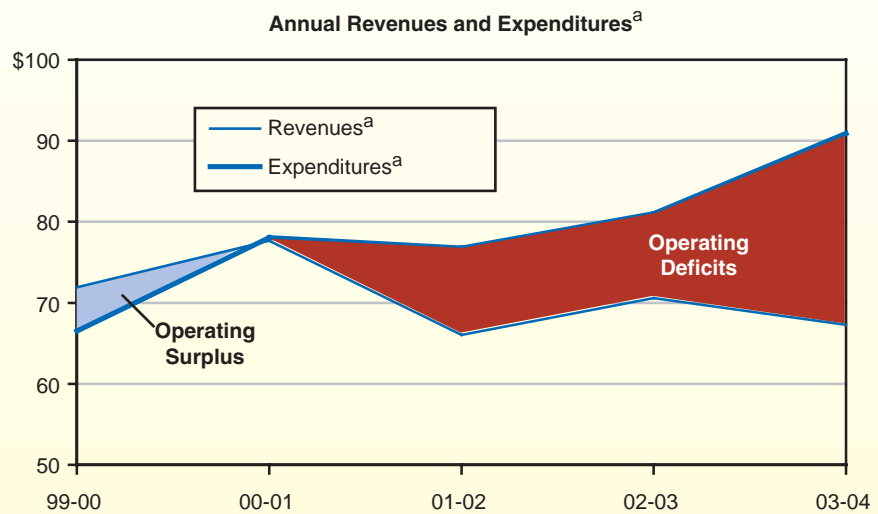
- First, the administration's baseline expenditure totals included funding for various priorities of the Governor (such as the partnership for higher education as one example) that exceeded current-law and/or current-service spending requirements which are the basis of LAO estimates.
- Second, the administration's baseline expenditure and revenue estimates did not include solutions adopted in the 2002-03 budget. The budgetary benefits from these solutions were then "scored" against the 2003-04 problem definition. Examples of this factor include state operations reductions and the second tobacco bond sale.
- Third, the administration counted improvements in the baseline revenue and expenditure picture (for example, from lower interest costs, caseload savings, and 2002-03 revenue improvements) as "solutions" to the budget problem, instead of as adjustments to the baseline revenue and expenditure levels themselves.

Because the administration's "scoring" of the budget was adopted by the Legislature for purposes of its budget deliberations, we have also used the administration's estimates in our presentations in this report so as to avoid the confusion that might arise from using multiple sets of numbers. However, we believe that the use of the administration's methodology and figures overstate the true magnitude of the 2003-04 budget problem that faced the Legislature and, thus, the real solutions needed to address it.

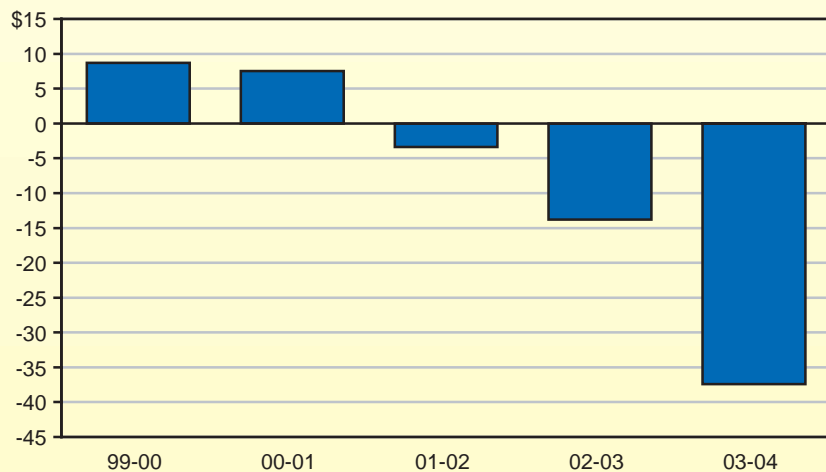
actions that were undertaken in both 2001-02 and 2002-03, the General Fund experienced huge operating shortfalls of over \$11 billion in both of these years. The persistence of these shortfalls reflected continued weakness in the economy and associated state revenues, as well as smaller-than-anticipated savings from the budget actions that had previously been taken, particularly in 2002-03.

Figure 1
Persistent Annual Operating Shortfalls. . .

Amounts in Billions



. . . Led to Huge Projected Cumulative Deficits



^aEstimates of what projected revenues, expenditures, and year-end surpluses/deficits would have been absent any budget-balancing actions following the adoption of the 2002-03 budget. Figures for 2000-01 and 2001-02 also exclude the impact of the \$6.2 billion electricity loan and its repayment.

The figure also shows that the operating shortfall would have more than doubled to \$23 billion in 2003-04, had no further budget-balancing actions been taken following the adoption of the 2002-03 budget. This projected deterioration was primarily related to the fact that many of the budget solutions adopted in 2001-02 and 2002-03 were one-time or limited-term in nature. Examples include the deferral of debt-service payments, borrowings from special transportation funds, and securitization of tobacco settlement receipts. The expiration of savings from these actions alone would have created a large shortfall in 2003-04 under even favorable economic circumstances. As it turned out, however, persistent weakness in the economy only served to aggravate the budgetary imbalance facing policymakers in 2003-04.

Cumulative Budget Shortfalls Resulted. The successive years of annual operating shortfalls resulted in a major projected cumulative budget gap by the close of 2003-04. Absent any corrective actions after the 2002-03 budget was enacted in September 2002, the cumulative shortfall would have grown from \$3.5 billion in 2001-02 to \$14 billion in 2002-03, and to \$38 billion in 2003-04.

THE BUDGET SOLUTION—KEY COMPONENTS

The adopted 2003-04 budget package addresses the projected cumulative shortfall through a variety of actions, which are summarized in Figure 2. These include:

- **Loans/Borrowing.** Over \$16 billion of the shortfall is dealt with through borrowing, either from the private credit markets or internal sources (largely intergovernmental loans). The main borrowing involves a planned \$10.7 billion deficit financing bond, whose proceeds will be used to eliminate the accumulated 2002-03 year-end deficit. Other budgetary borrowing includes the planned issuance of \$1.9 billion in pension obligation bonds, the deferral of mandate payments to local governments, and loans from special funds. Finally, we have included \$834 million of foregone vehicle license fee (VLF) backfill payments to local governments for the July 1 through October 1, 2003, period in this category. Current law provides for the General Fund to eventually repay localities for their loss of the backfill (see discussion in Chapter 4).
- **Program Savings.** The budget includes about \$9.2 billion in program savings from throughout the budget, including K-12 and higher education, criminal justice, Medi-Cal, Supplemental Security Income/State Supplementary Program (SSI/SSP), employee

Figure 2
Major Actions Taken to Close 2003-04
Projected Budget Shortfall

(In Billions)

	2002-03	2003-04	Two-Year Total
Loans/Borrowing:			
Deficit financing bond	\$10.7	—	\$10.7
Pension obligation bond ^a	—	\$1.9	1.9
Other	0.1	3.6	3.7
Subtotals	(\$10.8)	(\$5.5)	(\$16.3)
Program Savings	\$0.9	\$8.3	\$9.2
New/Accelerated Revenues:			
Tobacco bond ^b	—	\$2.0	\$2.0
Other	\$0.3	2.2	2.5
Subtotals	(\$0.3)	(\$4.2)	(\$4.5)
Shifts to Other Funds			
New federal funds	\$0.3	\$1.8	\$2.2
Other	0.7	1.2	1.9
Subtotals	(\$1.0)	(\$3.1)	(\$4.1)
VLF Tax Increase	—	\$3.4	\$3.4
Deferrals	\$1.1	\$1.0	\$2.0
Totals	\$14.1	\$25.3	\$39.4

^a In September 2003, the state's attempt to obtain court validation for this bond was unsuccessful in Superior Court.

^b In September 2003, the sale of this bond generated net proceeds of \$2.26 billion, or \$260 million more than assumed in the budget.

Detail may not total due to rounding.

compensation, and resources. This category includes the \$930 million in one-time savings in Medi-Cal associated with an accounting shift from an accrual basis to a cash basis. Some of the expenditure reductions, particularly in higher education, are offset with fee increases.

- **New/Accelerated Revenues.** The main components of this category are the assumed (1) one-time proceeds totaling \$2 billion from a second tobacco securitization bond sale originally authorized in 2002-03 and (2) ongoing increase of \$680 million from new and renegotiated tribal gaming compacts. This category also includes (1) the use of the LAO's revenue forecast for 2003-04, which was \$587 million higher than the administration's May Revision estimate; (2) the transfer of unused balances from a variety of special funds; and (3) additional revenue from abandoned property.

- **Shifts to Other Funds.** The budget relies on \$2.2 billion in new one-time, federal funds in 2002-03 and 2003-04 combined. About one-half of this total is used to offset Medi-Cal costs and the remainder covers other state spending in a variety of other program areas. Other components in this category include shifts of capital outlay spending to bond funds and of certain resources-related spending to fees.
- **VLF Tax Increase.** The budget anticipates \$3.4 billion in additional revenues to local government due to the triggered increase in the VLF rate. This assumes that the higher VLF rate will be in effect for automobiles registered on or after October 1, 2003. This increase will result in a commensurate reduction in General Fund spending.
- **Deferrals.** This category primarily consists of the deferral of (1) Proposition 42 payments to transportation programs and (2) year-end education apportionments to K-12 school districts.

As shown in Figure 2, the sum of these solutions is \$39.4 billion, or \$1.2 billion *more* than the administration's \$38.2 billion projected budget shortfall. Since the administration's definition of the budget shortfall had already included \$1 billion to fund a reserve, the additional \$1.2 billion in solutions results in a projected cumulative reserve of \$2.2 billion at the close of 2003-04.

BUDGET GAP TO RE-EMERGE IN 2004-05

Although the 2003-04 budget does include significant amounts of ongoing actions, the majority of savings adopted are one-time or limited-term in nature. Significant one-time or limited-term actions include the \$16 billion in borrowing, the \$2 billion tobacco securitization bond sale, the \$930 million in savings from the Medi-Cal accounting change, and the deferral of \$856 million in transportation spending.

Although these actions did help to eliminate the 2003-04 budget shortfall, their one-time or limited-term nature means that they did not address the ongoing mismatch between revenues and expenditures that has existed since 2001-02. In fact, many of the actions will have the effect of increasing out-year obligations. For example, the annual debt-service payments on the deficit financing bond will be about \$2.5 billion beginning in 2004-05, assuming that repayment occurs over a roughly five-year period as proposed.

The expiration of one-time savings and the added out-year costs for debt service will combine to produce a sizable operating shortfall in 2004-05 of slightly more than \$10 billion. Taking into account the projected current-year reserve (\$2.2 billion), this means that the cumulative deficit at the close of 2004-05 would be roughly \$8 billion, absent further corrective actions.



Chapter 2

Key Features of the Budget Act and Related Legislation

THE BUDGET TOTALS

Total State Spending

The state spending plan for 2003-04 authorizes total state expenditures from all funds of \$100.9 billion. As indicated in Figure 1, this total includes budgetary spending of \$93.5 billion, reflecting \$71.1 billion from the General Fund and \$22.3 billion from special funds. In addition, spending from selected bond funds totals \$7.5 billion. These bond-fund expenditures reflect the use of bond proceeds on capital outlay projects in a given year. The General Fund costs of these outlays, however, involve the associated ongoing principal and interest payments that must be made until the bonds are retired; thus, for budgetary scoring purposes, these costs show up as General Fund debt-service expenditures.

Figure 1
The 2003-04 Budget Package
Total State Expenditures

(Dollars in Millions)

Fund Type	Actual 2001-02	Estimated 2002-03	Enacted 2003-04	Change From 2002-03	
				Amount	Percent
General Fund	\$76,752	\$78,142	\$71,137	-\$7,005	-9.0%
Special funds	19,448	19,163	22,314	3,151	16.4
Budget Totals	\$96,200	\$97,305	\$93,451	-\$3,854	-4.0%
Selected bond funds	3,020	14,491	7,469	-7,022	-48.5
Totals	\$99,220	\$111,795	\$100,919	-\$10,876	-9.7%

The amount of 2003-04 budgetary spending compared to 2002-03 represents a net reduction of \$3.9 billion (4 percent)—a \$7 billion (9 percent) decline for the General Fund, partly offset by a \$3.2 billion (16 percent) increase for special funds.

The General Fund Condition

Figure 2 summarizes the estimated General Fund condition for 2002-03 and 2003-04 that results from the adopted spending plan and related legislation.

Figure 2
The 2003-04 Budget Package
Estimated General Fund Condition

(Dollars in Millions)

Fund Type	2002-03	2003-04	Percent Change
Prior-year fund balance	-\$1,983	\$1,402	
Revenues and transfers	70,852	73,353	3.5%
Deficit Financing Bond	10,675	—	
Total resources available	\$79,544	\$74,755	
Expenditures	78,142	71,137	-9.0%
Ending fund balance	\$1,402	\$3,618	
Encumbrances	1,402	1,402	
Reserve	—	\$2,216	

2002-03. Figure 2 shows that expenditures (\$78.1 billion) exceeded revenues and transfers (\$70.9 billion) by slightly over \$7.2 billion in 2002-03. When combined with a negative carry-in balance of \$2 billion and year-end encumbrances of \$1.4 billion, this operating shortfall would have produced a cumulative year-end deficit of \$10.7 billion at the close of the fiscal year. This deficit, however, was taken “off book” and thus eliminated for budgetary scoring purposes by the issuance of a \$10.7 billion deficit financing bond, leaving the year-end reserve at zero.

2003-04. Figure 2 also shows that revenues in the current year are projected to be \$73.4 billion, or \$2.2 billion more than the expenditure total of \$71.1 billion. This results in a planned reserve of \$2.2 billion, which is equivalent to slightly over 3 percent of General Fund spending during the year.

Programmatic Spending in 2003-04

Most areas of General Fund spending are declining markedly in 2003-04. As shown in Figure 3, spending for K-12 education is down 0.5 percent, spending for health is down 1.5 percent, and the higher education segments will experience declines ranging from 8 percent to 17 percent.

Regarding these decreases, however, it is important to note that while General Fund spending is down sharply, *total* support for most programs is at or above prior-year levels. For example, the decline in health spending is more than accounted for by the Medi-Cal accounting shift from an accrual basis to a cash basis and the increased federal funds for Medi-Cal. Likewise, the drop in General Fund support for higher education and criminal justice spending is largely offset by higher fees, while the major decline in “all other” spending is related to the issuance of pension bonds in lieu of General Fund contributions to the Public Employees’ Retirement System. Absent these special factors, overall program spending in the 2003-04 budget is roughly *similar* to the prior year’s level. Nevertheless, after accounting for caseload, inflation, and other factors affecting costs, 2003-04 spending is *well below* the level that would support baseline spending requirements (that is, spending levels that would have been required based on laws in effect in 2002-03). Thus, in real terms, the budget has somewhat declined.

Figure 3
The 2003-04 Budget Package
General Fund Spending by Major Program Area

(Dollars in Millions)

Fund Type	Actual 2001-02	Estimated 2002-03	Enacted 2003-04	Change From 2002-03	
				Amount	Percent
K-12 Education	\$29,923	\$29,469	\$29,317	-\$152	-0.5%
Higher Education					
CCC	2,851	2,891	2,403	-488	-16.9
UC	3,371	3,191	2,928	-263	-8.2
CSU	2,687	2,707	2,492	-215	-7.9
Other	736	755	856	101	13.3
Health	13,530	14,266	14,049	-217	-1.5
Social Services	8,290	8,860	9,033	172	1.9
Criminal Justice	7,867	7,868	6,668	-1,201	-15.3
VLF offset	3,558	4,014	—	-4,014	—
All other	3,938	4,120	3,391	-729	-17.7
Totals	\$76,752	\$78,142	\$71,137	-\$7,005	-9.0%

EVOLUTION OF THE BUDGET

In this section, we highlight the major developments in the evolution of the 2003-04 budget, beginning with the Governor's proposed mid-year adjustments in December 2002 and ending in August 2003, when the budget was signed into law.

December Mid-Year Reductions

In our November 2002 report, *California's Fiscal Outlook*, we estimated that the state faced a cumulative year-end General Fund shortfall of \$21 billion in 2003-04. On December 6, the Governor released a list of proposed mid-year adjustments totaling \$3.4 billion in 2002-03 and \$6.8 billion in 2003-04, and called on the Legislature to enact these savings as an initial step toward addressing the state's enormous budget problem. The majority of these proposed mid-year savings were related to across-the-board cuts to K-14 education programs, the elimination of social services cost-of-living adjustments (COLAs), and various reductions in Medi-Cal.

Governor's January Proposal for 2003-04

In January, the Governor proposed a 2003-04 General Fund budget which incorporated his proposed 2002-03 mid-year savings discussed above, as well as numerous other actions to cover a shortfall that the administration estimated to be \$34.6 billion. This plan attempted, over an 18-month period, to both (1) deal with the full magnitude of the budget shortfall and (2) eliminate the ongoing structural imbalance between annual revenues and expenditures (so that a deficit would not automatically re-emerge in 2004-05). The January plan included \$5.5 billion in 2002-03 savings as well as \$29 billion in 2003-04 savings.

Some of the plan's major features included the following:

- About \$8 billion in new revenues from (1) new 10 percent and 11 percent marginal personal income tax rates on high-income taxpayers, (2) a one-cent sales tax rate increase, and (3) a \$1.10 per pack increase in cigarette taxes. The proceeds of these taxes were to be used to fund a realignment of various health and social services program responsibilities from the state to local governments.
- Deep spending cuts in most program areas. These included: (1) a 15 percent cut to provider rates and the elimination of several optional benefits under the Medi-Cal program; (2) cuts in California Work Opportunity and Responsibility to Kids (CalWORKs) and SSI/SSP grants of about 6.2 percent; (3) major reductions in Gen-

eral Fund spending on higher education funding (mostly offset by higher fees); (4) across-the-board reductions to K-12 education spending; and (5) savings in employee compensation, achieved through either reductions in workforce or renegotiation of collective bargaining agreements.

- The elimination of the VLF backfill payments to local governments beginning in April 2003.
- A variety of loans, funding shifts, new revenues from renegotiated tribal gaming compacts, and funding redirections.

Actions Following January Budget

In the months following the release of the January budget, the Legislature enacted various savings provisions totaling about \$3.3 billion for 2002-03 and \$3 billion for 2003-04. These mid-year savings actions—which were about \$2.2 billion less in 2002-03 than the \$5.5 billion requested by the administration—included many of the reversions, cuts, and funding redirections proposed by the Governor in December. In K-12 education, however, the Legislature replaced the program reductions proposed by the Governor with a deferral of cash payments to school districts from late 2002-03 into early 2003-04, creating one-time savings. The Legislature also rejected administration proposals involving the elimination of VLF backfill payments to localities and the reduction in health care expenditures.

May Revision

In the May Revision, the administration asserted that the budget problem had increased from \$34 billion to \$38 billion, or about \$4 billion. This reflected a number of relatively modest technical adjustments to projected revenues and expenditures, which together added a net of about \$1 billion to the projected shortfall. In addition, the administration withdrew the plan for a second tobacco bond sale (which had been assumed as part of the 2002-03 budget) in favor of a much larger deficit financing bond, and reflected this policy change as an increase in the size of the budget problem. The remaining \$1 billion of the budget's deterioration reflected an increase in Proposition 98 spending.

In the May Revision, the administration's basic approach to solving the budget shortfall shifted dramatically. Instead of attempting to fully solve the budget problem in an 18-month period, the May Revision adopted a multiyear approach that relied much more on borrowing and relatively

less on near-term spending reductions than did the January proposal. Specifically, the May Revision made the following major modifications to the January spending plan:

- It proposed to move the 2002-03 year-end deficit off book by issuing a \$10.7 billion deficit financing bond, which would be repaid over roughly five years using revenues dedicated from a *new* half-cent sales tax.
- It eliminated all state VLF backfill payments to local governments effective July 1, 2003, and assumed that a VLF rate increase would be triggered by the “insufficient monies” provision of the VLF law. Thus, local governments took less of a reduction than had originally been proposed.
- It restored many of the reductions proposed in the areas of social services, health, and community colleges. It also retained the January proposals to eliminate COLAs to CalWORKs and SSI/SSP and the 15 percent reduction in Medi-Cal provider rates.
- It reduced the realignment proposal (including the new taxes associated with it) from \$8 billion down to \$1.7 billion.

Final Budget

Following about two months of negotiations and unsuccessful votes on several alternative budget proposals, the Senate reached an agreement on a budget plan in late July. The budget bill was passed by the Senate on July 28, and by the Assembly on July 31. It was signed by the Governor on August 2, following a modest number of line-item vetoes.

Key Features of the Budget. The budget that was adopted contains many of the features of the May Revision proposal, but differs from the Governor’s proposal in several significant ways. For example:

- It includes the May Revision’s proposed issuance of a \$10.7 billion deficit financing bond. However, the repayment of the bond is to come from *existing* resources—instead of a new tax—beginning in 2004-05.
- It does not include the May Revision’s realignment proposal (including the \$1.7 billion in new taxes to fund the transfer of various program responsibilities from the state to localities).

- It includes the second \$2 billion tobacco bond sale that had been suspended in the May Revision, and the use of about \$2.2 billion in newly available one-time federal funds (that resulted from passage of the federal tax and fiscal relief measure in May).
- It includes an increased amount of assumed employee compensation-related savings, and includes language providing the administration with executive authority to reduce and reallocate expenditures among state operations.

2004-05 Savings. The budget package includes language stating the Legislature's intent that the administration *not* include certain funding adjustments in developing the 2004-05 budget. These include funding for: (1) University of California (UC) and California State University (CSU) salary increases not already approved and enrollment growth; (2) discretionary price adjustments to state, UC, and CSU operations; (3) local mandate reimbursements; (4) direct appropriations for capital outlay in excess of \$50 million; and (5) Proposition 98 spending in excess of the minimum guarantee. In excluding these items, the Legislature has already "built in" savings from a traditional baseline budget in 2004-05. This is significant because the estimated \$8 billion shortfall in 2004-05 *already assumes* the above spending reductions relative to current-service levels.

More detailed descriptions of the budget's key programmatic features are included in "Chapter 4."

STATE APPROPRIATIONS LIMIT

Background. Article XIII B of the State Constitution places limits on the appropriation of taxes for the state and each of its local entities. Certain appropriations, however, such as for capital outlay and subventions to local governments, are specifically exempted from the state's limit. As modified by Proposition 111 in 1990, Article XIII B requires that any revenues in excess of the limit that are received over a two-year period be split evenly between taxpayer rebates and increased school spending.

State's Position Relative to Its Limit. As a result of the sharp decline in revenues over the past two years, the level of state spending is now well below the spending limit. Specifically, based on the revenue and expenditure estimates incorporated in the 2003-04 budget, state appropriations were \$16.9 billion below the limit in 2002-03 and are expected to be \$13.2 billion below the limit in 2003-04.

BUDGET-RELATED LEGISLATION

In addition to the *2003-04 Budget Act*, the budget package includes a number of related measures enacted to implement and carry out the budget's provisions. Figure 4 lists these bills.

Figure 4
2003-04 Budget-Related Legislation

Bill Number	Chapter	Author	Subject
AB 7x	13x	Oropeza	Deficit bond
AB 296	757	Oropeza	State and local government
AB 1266	573	Budget Committee	Education—various policy provisions
AB 1485	773	Firebaugh	Education—Federal Reading First program
AB 1747	240	Budget Committee	Omnibus resources bill
AB 1748 ^a	—	Budget Committee	Resources: Proposition 40 and Proposition 50
AB 1750	223	Budget Committee	Transportation: Proposition 42
AB 1751	224	Budget Committee	Transportation: Proposition 42
AB 1752	225	Budget Committee	Omnibus social services bill
AB 1753	226	Budget Committee	Habilitation services
AB 1754	227	Budget Committee	Omnibus education bill
AB 1756	228	Budget Committee	Omnibus general government bill
AB 1757	229	Budget Committee	Technology, Trade, and Commerce Agency; OCJP ^b
AB 1758	158	Budget Committee	Corrections
AB 1759	159	Budget Committee	Courts
AB 1762	230	Budget Committee	Omnibus health bill
AB 1763	161	Budget Committee	Proposition 99
AB 1766	162	Budget Committee	Property tax swap
AB 1768	231	Budget Committee	Vehicle license fees
SB 857	601	Speier	Medi-Cal: providers
SB 1045	260	Budget Committee	Redevelopment funds
SB 1049	741	Budget Committee	Omnibus resources fee bill
SB 1055	719	Budget Committee	Motor Vehicle Account fees

^a Enacted by the Legislature but vetoed by the Governor.

^b Office of Criminal Justice Planning.

Chapter 3

Revenue-Related Provisions

The Governor and Legislature considered, but did not adopt, proposals for various tax increases to help address the budget problem. Aside from the triggered increase in the vehicle license fee, the 2003-04 budget contains no new taxes. However, it does assume new revenues from tribal gaming compacts, the securitization of tobacco settlement revenues, and various loans and transfers from special funds. Also of note is that the state's manufacturers' investment credit (MIC) will sunset as of January 1, 2004.

Tribal Gaming Compacts

The state has signed compacts with more than 60 Indian tribes related to gaming on tribal lands. Currently, pursuant to these compacts, tribes contribute over \$100 million annually to state (non-General Fund) accounts for specified uses. The budget assumes that, as a result of the renegotiation of existing compacts and the signing of new compacts, Indian gaming tribes will contribute an additional \$680 million in annual revenues—all accruing to the General Fund.

The Legislature approved three new compacts in 2003—Chapter 790, (SB 411, Ducheny) and Chapter 802, (SB 930, Ducheny)—which have provisions requiring some future payments to the General Fund. To date, the Legislature has not been presented with any renegotiated compacts from existing gaming tribes.

Tobacco Securitization

The 2002-03 budget package authorized the sale of bonds backed by the state's future rights to its flow of tobacco settlement revenues (TSRs) over roughly the next 25 years. Under the provision of the 1998 Master Settlement Agreement between certain large tobacco companies and most states, California will receive TSRs annually in perpetuity, including an estimated \$10-plus billion over the next 25 years.

The 2002-03 budget package authorized the state to essentially convert this future TSR stream into a one-time, up-front payment of \$4.5 billion. In return, those investors who pay the \$4.5 billion to the state will be repaid over time, with interest, from the TSRs when they are actually received.

The state sold the first of its two tobacco-backed bonds in February 2003, raising \$2.5 billion in net proceeds to the General Fund. In the May Revision to the 2003-04 budget, the Governor canceled a planned second sale, relying instead on a deficit financing bond to cover the 2002-03 budget deficit. However, the second bond sale was reaffirmed in the final 2003-04 budget package, along with a provision that authorized General Fund backing for the debt repayment in addition to the pledged TSRs. This General Fund backing was added to enhance the marketability of the bonds. In September, the Treasurer sold the second tobacco bond, raising net proceeds of \$2.262 billion for the General Fund—\$262 million more than anticipated in the 2003-04 budget package.

Transfers and Loans From Special Funds

The 2003-04 budget package includes \$1.8 billion in transfers and loans from special funds. About \$1 billion of this total represents pension fund contributions from special fund-supported agencies that is scheduled to be replaced in 2003-04 by pension obligation bond proceeds. The remaining \$800 million is made up of loans and transfers from numerous special funds, including the California Teleconnect Fund, the Beverage Recycling Fund, and the Employment Development Contingent Fund.

Manufacturers' Investment Credit

Since 1994, qualified manufacturing firms have benefited from the MIC, based on their expenditures for qualified capital equipment. The MIC is available to firms with either corporation tax or personal income tax liabilities. The MIC was originally adopted by the Legislature out of concerns about the health of the state's economy (and, in particular, its severe declines in manufacturing employment).

Under current statute, the MIC is scheduled to sunset in any year in which the number of California manufacturing jobs (excluding aerospace) at the start of the previous year does not exceed by 100,000 the number of such jobs that existed on January 1, 1994. There is no provision in current statute that would reactivate the MIC in the event that, in subsequent years, the job threshold is met. In March 2003, the Employment Development Department released figures indicating that the state's manufacturing

employment as of January 1, 2003, was less than the January 1, 1994 jobs figure. Accordingly, the MIC is scheduled to sunset effective January 1, 2004.

Although there are currently bills pending in the Legislature to extend the MIC's sunset date, eliminate its jobs requirement, or ensure the MIC's continuation through other means, none of this legislation has been approved. Attempts to incorporate the continuation of the MIC in the 2003-04 budget agreement similarly failed.

The General Fund revenue gain from the MIC's sunset is projected to be \$40 million in 2003-04 (a partial-year effect), \$195 million in 2004-05, and eventually about \$400 million annually.



Chapter 4

Expenditure Highlights

PROPOSITION 98 SPENDING

The budget package includes \$45.7 billion in Proposition 98 spending in 2003-04 for K-14 education. This represents an increase of \$1.8 billion, or 4 percent, from the revised 2002-03 spending level. By comparison, the package reflects a reduction of around \$800 million, or 1.7 percent, from the appropriation level of the *2002-03 Budget Act*. Figure 1 summarizes for the two fiscal years the effect of the budget package on K-12 schools, community colleges, and other affected agencies. Between 2002-03 and 2003-04, \$1.1 billion of the \$1.8 billion growth in Proposition 98 funding

Figure 1
Proposition 98 Budget Summary

2002-03 and 2003-04
(Dollars in Billions)

	2002-03 Budget Package		2003-04
	As Enacted	Revised	
K-12 Proposition 98			
General Fund	\$28.6	\$26.5	\$27.6
Local property taxes	12.9	12.6	13.6
Subtotals, K-12	(\$41.6)	(\$39.2)	(\$41.3)
<i>Average Daily Attendance (ADA)</i>	5,880,576	5,911,519	5,990,495
<i>Amount per ADA (in dollars)</i>	\$7,067	\$6,624	\$6,887
California Community Colleges			
General Fund	\$2.8	\$2.6	\$2.2
Local property taxes	2.0	2.0	2.1
Subtotals, Community Colleges	(\$4.8)	(\$4.6)	(\$4.4)
Other Agencies			
	\$0.1	\$0.1	\$0.1
Totals, Proposition 98			
General Fund	\$31.6	\$29.3	\$30.0
Local property taxes	14.9	14.6	15.7

is funded by increased local property tax revenues (resulting from a combination of strong local property tax growth and a one-time transfer of property tax revenues from redevelopment agencies to schools).

Spending in 2002-03. Proposition 98 spending for 2002-03 was reduced by a total of \$2.6 billion as a result of actions taken in the First Extraordinary Session of 2003—Chapter 4x (SB 18x, Chesbro) and Chapter 10x (SB 28x, Committee on Budget and Fiscal Review)—and Chapter 26, Statutes of 2003 (SB 1040, Committee on Budget and Fiscal Review). Because the Proposition 98 reductions lowered the Proposition 98 base for future years, the Legislature’s mid-year actions allowed the state to save a commensurate amount annually for 2003-04 and beyond.

Figure 2 shows how the Legislature reduced Proposition 98 spending through a combination of funding deferrals (\$1.3 billion), K-12 funding reductions (\$460 million), funding source shifts (\$734 million), and community college funding reductions (\$168 million). Most of the actions taken were one-time savings, leaving the decisions about ongoing reductions for the 2003-04 budget discussion. This was especially true for K-12, for which only a couple hundred million of the \$2.5 billion in reductions were ongoing. In contrast, most of the \$168 million community college reduction was ongoing.

Figure 2
2002-03 Mid-Year Reductions Generate
Ongoing Proposition 98 Savings

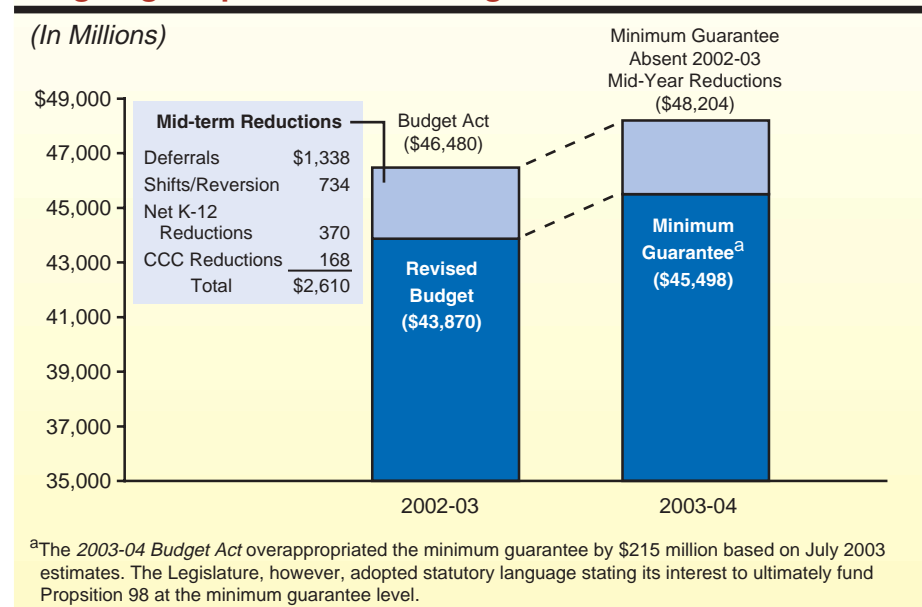


Figure 2 also shows what Proposition 98 spending would have been for 2003-04 if the Legislature had not enacted mid-year 2002-03 reductions. If the *2002-03 Budget Act* Proposition 98 funding level had not been reduced, the 2003-04 minimum guarantee would have been \$48.2 billion instead of \$45.5 billion. Thus, the ongoing impact of the combined reductions taken in 2002-03 resulted in lowering Proposition 98 funding by around \$2.7 billion for 2003-04 and beyond. Additionally, Chapter 10x also eliminated a recent requirement in statute that the state fully restore the Proposition 98 “maintenance factor” in 2003-04, which would have cost the state \$3.4 billion for K-14 programs above the *2003-04 Budget Act* level.

Reductions in 2002-03 left the 2002-03 Proposition 98 spending level slightly below the Proposition 98 minimum guarantee. As a result, the state may owe a slight settle-up obligation depending on the final level of 2002-03 General Fund revenues.

K-12 PROPOSITION 98

As shown in Figure 1, spending on 2003-04 K-12 Proposition 98 declined by \$300 million compared to the *2002-03 Budget Act*. This net change consists of increased funding for deferrals, enrollment growth, and increased retirement costs totaling \$1.65 billion, offset by numerous funding reductions totaling \$1.95 billion.

Per-Pupil Funding

The revised 2002-03 budget yields a K-12 per-pupil funding level of \$6,624. The 2003-04 budget results in per-pupil funding of \$6,887, an increase of \$263, or 4 percent, above the 2002-03 level. The level of growth in Proposition 98 spending per pupil, however, is distorted because expenses were deferred from one fiscal year to another (discussed in detail below). Figure 3 (see next page) displays the impact that the deferrals have on the growth of per-pupil spending. Adjusting for the deferrals, per-pupil spending decreased by \$36 per pupil, or -0.5 percent, over the 2002-03 level.

Figure 4 (see next page) displays K-12 per-pupil funding amounts from 1993-94 through 2003-04. After adjusting for deferrals, the effects of inflation, and changes in attendance accounting, per-pupil funding increased \$1,161, or 21 percent, over the period. Most of the growth in adjusted dollars per pupil occurred in the late 1990s, and adjusted per-pupil spending has actually fallen \$175 per pupil, or 2.5 percent, since 1999-00.

Figure 3
K-12 Proposition 98 Spending Per Pupil
Adjusted for Funding Deferrals Between Years

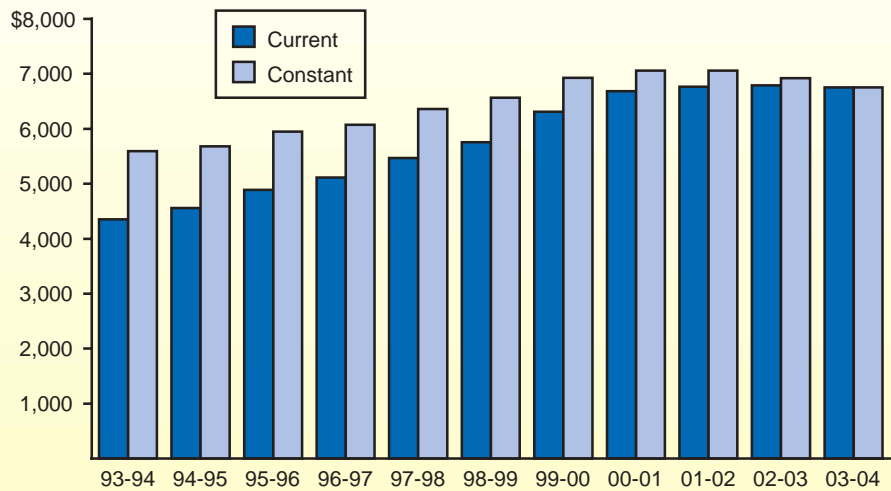
2001-02 Through 2003-04

	2001-02 Actual	2002-03 Revised	2003-04
Budgeted Funding			
Dollar per ADA ^a	\$6,608	\$6,624	\$6,887
Percent growth	—	0.2%	4.0%
Programmatic Funding			
Dollar per ADA	\$6,768	\$6,788	\$6,752
Percent growth	—	0.3%	-0.5%

^a Average Daily Attendance.

Figure 4
Proposition 98 Funding Per Student^a

Current and Constant Dollars



^a Average daily attendance adjusted to exclude excused absences. The 2001-02 through 2003-04 funding levels are adjusted to reflect deferrals.

2002-03 Major Adjustments

When the Legislature adopted the *2002-03 Budget Act*, it appropriated at the Proposition 98 minimum guarantee level based on a projection of moderate General Fund revenue growth. When that revenue growth did not materialize, there was a significant decline in the minimum guaran-

tee. As mentioned above, the Legislature took action in three separate bills to lower the Proposition 98 spending level to the minimum guarantee. Figure 5 summarizes the major mid-year 2002-03 K-12 funding reductions. The figure shows that deferrals and other one-time actions account for most of the reductions. The only major ongoing K-12 reduction was the elimination of a Proposition 98 reserve created when the Governor vetoed spending when signing the *2002-03 Budget Act*.

Figure 5
Major Mid-Year 2002-03 K-12 Funding Reductions

(In Millions)

Purpose	Amount
Defer principal apportionment	\$1,087
Proposition 98 Reversion Account swap	605
Eliminate Proposition 98 reserve	132
Defer state mandated programs	122
Reduce one-time instructional materials	103
Defer targeted instructional improvement grants	80
Child care federal fund swap	78
Public School Accountability Act timing adjustment	76
Defer staff development buyout	49

2003-04 K-12 Funding Changes

The net reduction in K-12 funding in 2003-04 from the *2002-03 Budget Act* is approximately \$300 million. This net change consists of increased funding for deferrals, enrollment growth, and increased retirement costs totaling \$1.65 billion, offset by numerous funding reductions totaling \$1.95 billion (see Figure 6, next page).

Major funding changes include:

- **Net Deferral Costs (\$965 Million).** The budget package provides \$1.9 billion in 2003-04 Proposition 98 funds to cover program costs deferred from 2002-03 to 2003-04. This represents an increase of \$965 million above the \$931 million provided in the 2002-03 spending package to pay for program costs deferred from 2001-02.
- **Growth and Cost-of-Living Adjustment (COLA) (\$504 Million).** The budget includes \$504 million to accommodate a projected 1.34 percent growth in student attendance. The budget suspends the 1.8 percent COLA for 2003-04 (approximately \$550 million), but creates a

“deficit factor,” requiring the state to build the foregone COLA back into the funding base starting in 2005-06. The budget provides neither growth nor COLA for categorical programs with the exception of providing growth for special education.

No deficit factor is created for foregone categorical growth or COLAs.

Figure 6
Major K-12 Funding Changes
From 2002-03 Budget Act

2003-04
(In Millions)

Purpose	Amount
Net deferrals	\$965
Revenue limit growth	504
PERS ^a offset reduction	459
Revenue limit deficit	-350
Instructional materials	-220
Public School Accountability Act	-164
Child care	-130
Deferred maintenance	-129
Mandates	-125

^a Public Employees' Retirement System.

- **Public Employees' Retirement System (PERS) Offset Reduction (\$459 Million).** The state budget increases revenue limit funding by \$459 million to school districts to pay increased PERS costs for school district classified employees (nonteaching) staff.
- **Revenue Limit Deficit (-\$350 Million).** In addition to the foregone COLA, the package reduces revenue base limits by \$350 million or 1.2 percent. The package creates a deficit factor for this \$350 million that must be restored in 2005-06.
- **Instructional Materials (-\$220 Million).** The budget eliminated \$145 million in one-time funding and \$75 million in ongoing funding for instructional materials aligned to the new state academic content standards. The package also delayed the timeline for school districts to purchase the new materials and allowed school districts to continue to use textbooks from previous adoptions.
- **Public School Accountability Act (-\$164 Million).** The budget package includes savings in the Immediate Intervention for Underperforming Schools Program of \$85 million because of schools exiting this intervention program and \$77 million in savings because the state is not providing rewards to schools improving their academic achievement in 2003-04.

- **Child Care (-\$130 Million).** The budget package (1) reforms the state's subsidized child care system by modifying current eligibility rules and reimbursement rate limits and (2) spends additional federal funds on child care. By these actions, the state will achieve \$349 million in General Fund savings compared to current practice, resulting in current-year General Fund spending which is \$130 million less than the level provided in the *2002-03 Budget Act*.
- **Deferred Maintenance (-\$129 Million).** The budget reduces funding for deferred maintenance by \$129 million. Since this program has a dollar-for-dollar local match, school districts can reduce local contributions to deferred maintenance by a similar amount.
- **Mandates (-\$125 Million).** The package provides virtually no funding for state-reimbursable education mandates, instead deferring the costs for 36 mandates to future years. We estimate that the cost to fully reimburse school districts for these 2003-04 mandates would be \$300 million.
- **Revenue Limit Equalization.** Chapter 227, Statutes of 2003 (AB 1754, Committee on Budget), repeals a \$204 million appropriation for equalization originally provided as part of the 2002-03 budget package. The Assembly also took action in SB 1046 (Committee on Budget and Fiscal Review) to redirect \$50 million from specific categorical programs to fund school district equalization. However, the Senate did not act on the matter.

Budget Provides Local Flexibility

Chapter 227 provides school districts with three budget flexibility tools to help them mitigate the impact of the proposed funding reductions. Two of the flexibility tools can be used for whatever purpose local school districts determine—including offsetting reductions to their revenue limit funding resulting from the district's share of the \$350 million revenue limit reduction. Specifically:

- **Reduced Requirements on Local Reserves for Economic Uncertainty.** School districts were previously required to maintain local reserves for economic uncertainty of 1 percent to 5 percent of their general purpose funding, depending on the size of the district. Chapter 227 reduces the reserve requirements by half to between 0.5 percent and 2.5 percent for the 2003-04 and 2004-05 fiscal years. Freed-up reserve funds could be used for any purpose.

- **Reduced Maintenance Funding Requirements.** Previously, school districts which had received state school bond funds from Proposition 1A or Proposition 47 were required to use 3 percent of their local general funds on facility maintenance. Chapter 227 reduces the requirement to 2 percent for 2003-04.

Districts Can Access Categorical Ending Balances. Chapter 227 allows school districts to access up to 100 percent of categorical fund reserves for 2003-04 (except capital outlay, sinking funds, federal funds, Targeted Instructional Improvement Grants, Economic Impact Aid, special education, instructional materials, and accountability programs). The measure, however, restricts the use of any redirected categorical reserve funding to backfill a district's share of the \$350 million reduction to revenue limits. There is some legal uncertainty about whether a district's use of either of the aforementioned flexibility options (reserves for economic uncertainty and lowered maintenance match requirements) limit a district's ability to redirect categorical reserves.

Out-Year Impacts and the Education "Credit Card"

The budget package expresses legislative intent to guide future Proposition 98 appropriations. First, Chapter 228, Statutes of 2003 (AB 1756, Committee on Budget), states legislative intent not to provide Proposition 98 funding in excess of the minimum guarantee in 2003-04 or 2004-05. Based on current economic forecasts, the Legislature would need to reduce 2003-04 spending by \$215 million to meet this goal for 2003-04. Second, Chapter 227 states that the first priority for increases in Proposition 98 funding is to restore approximately \$900 million in deficit factor related to COLA and revenue limit reductions. Further, Chapter 227 states the intent of the Legislature to pay off some of the deferrals (discussed below) when the state provides additional Proposition 98 funds to meet maintenance factor requirements.

Because of the state's recent budget problems, the Legislature has opted to defer significant K-14 program costs to subsequent fiscal years rather than make additional spending cuts. The result has been a growing balance on the state's education credit card. The 2003-04 budget package begins to reduce the balances on the education credit card. Figure 7 shows that the state ended 2002-03 with approximately \$3 billion of outstanding Proposition 98 liabilities. The 2003-04 budget package reduces these liabilities by \$310 million—to \$2.7 billion—by the end of 2003-04. The reduction represents the net impact of (1) paying off \$810 million in K-12

categorical program deferrals, (2) incurring new liabilities by deferring community colleges payments (\$200 million), and (3) not providing funding for reimbursement of additional education mandate costs (\$300 million) in 2003-04. Chapter 228 states the intent of the Legislature to defer funding for K-12 mandate reimbursements again in 2004-05.

Figure 7
Legislature Reduces Balance on the Education Credit Card

(In Millions)

	2002-03	2003-04
Deferrals		
Principal apportionment—K-12	\$1,089	\$1,089
K-12 categoricals	810	—
Mandate reimbursements	860	1,160
California Community Colleges	—	200
Prior Year Settle-Up Obligations	\$250	\$250
Totals	\$3,009	\$2,699

HIGHER EDUCATION

The budget provides a total of \$10.7 billion in General Fund and local property tax support for higher education in 2003-04. (This amount includes a \$200 million “loan” for community colleges, discussed in more detail below.) As shown in Figure 8 (see next page), this is \$402 million, or 3.6 percent, less than the amount provided in 2002-03.

All three segments of higher education imposed student fee increases for 2003-04. Figure 9 (see next page) shows the change in resident undergraduate fees from 2002-03 to 2003-04. As the figure shows, the University of California (UC) and the California State University (CSU) increased their student fees by 30 percent, whereas the California Community Colleges (CCC) increased their student fees by 64 percent. The higher fees will provide additional revenue to partially backfill General Fund reductions. When this new fee revenue is counted, total higher education funding actually *increases* by \$58 million, or 0.5 percent, from the revised 2002-03 level. We note that this reflects the net year-over-year change in higher education funding, which involves funding increases in some areas (such as enrollment) and decreases in others (such as outreach). Below, we discuss major augmentations and reductions in the budget for higher education.

Figure 8
Higher Education Budget Summary
General Fund and Local Property Tax Revenue

(Dollars in Millions)

	2003-04 Budget	Change From Revised 2002-03		Percent Including Fee Revenue ^a
		Amount	Percent	
University of California	\$2,902.1	-\$247.9	-7.9%	-1.6%
California State University	\$2,492.0	-\$214.9	-7.9%	-1.7%
California Community Colleges	\$4,576.0	-\$18.0	-0.4%	1.6%
General Fund ^b	(2,470.5)	(-150.8)	(-5.8)	—
Property taxes	(2,105.5)	(132.8)	(6.7)	—
Student Aid Commission	\$682.9	\$81.7	13.6%	—
California Postsecondary Education Commission	\$2.2	\$0.1	4.6%	—
Hastings College of the Law	\$11.4	-\$3.0	-21.1%	4.4%
Totals, Higher Education	\$10,666.7	-\$402.1	-3.6%	0.5%

^a Reflects percent change after reductions are partially backfilled with new fee revenue. Does not include fee revenue which UC and CSU divert to campus-based financial aid.

^b Adjusted to reflect costs that are "deferred" to later fiscal years.

Figure 9
Resident Undergraduate Fees

(Mandatory Systemwide Fees for Full-Time Students)

	2002-03 ^a	2003-04	Change From 2002-03 ^a	
			Amount	Percent
UC	\$3,834	\$4,984	\$1,150	30%
CSU	1,572	2,046	474	30
CCC	330	540	210	64

^a Reflects full-year impact of mid-year fee increase.

The 2003-04 budget includes no funding for cost-of-living increases at any of the higher education segments. The budget does include funding to increase enrollment for the entire public higher education system by 2.8 percent. However, related legislation expresses the Legislature's intent to fund neither enrollment growth nor cost-of-living increases in 2004-05.

University of California

The budget provides \$2.9 billion in General Fund support for UC in 2003-04. This is \$248 million, or 7.9 percent, less than was provided in the prior year. However, most of this amount (\$196 million) will be backfilled by increased student fee revenue, for a net reduction of \$52 million, or 1.6 percent.

This net reduction results from both augmentations and reductions. Major General Fund augmentations include:

- \$117 million to serve approximately 13,000 additional full-time equivalent (FTE) students (a 6.9 percent increase).
- \$24.4 million for increased lease-revenue bond payments.
- \$16.1 million for increased annuitant health and dental benefits.
- \$7.3 million for startup costs at UC's new campus in Merced. (This is \$4 million less than the amount proposed in the Governor's budget and reflects the Legislature's intent that the opening of the campus be delayed from fall 2004 to fall 2005.)

Major General Fund reductions include:

- \$293 million in "unallocated" reductions. (As noted earlier, most of this amount would be backfilled with revenue from student fee increases of about 30 percent.)
- \$37.8 million in funding for several outreach programs.
- \$19 million in funding for student services.
- \$16.5 million in academic and institutional support.
- \$15 million in funding for UC's Subject Matter Projects.
- \$12.5 million in funding for public service.
- \$10.2 million in research funding.

In addition to these formal budget actions, the budget also assumes that UC's institutional financial aid programs will receive a total of \$352 million. This is \$125 million, or 55 percent, more than provided under the *2002-03 Budget Act*. The augmentation is a result of UC's decision to set aside for institutional aid one-third of all additional student fee revenue

it expects to collect in 2003-04. The UC has full discretion in allocating these aid monies. It indicates that these monies will be used to assist students with family incomes of up to \$90,000.

California State University

The budget provides \$2.5 billion in General Fund support for CSU in 2003-04. This is \$215 million, or 7.9 percent, less than was provided in the prior year. However, most of this reduction (\$169 million) is offset by increased student fee revenue, for a net reduction of \$46 million, or 1.7 percent, from the prior year.

This net reduction results from both augmentations and reductions. The budget provides CSU with a \$151 million augmentation to serve 22,881 additional FTE students (a 7.1 percent increase). This augmentation was proposed by the Governor in January, and supported by the Legislature in the enacted budget. However, CSU has indicated that it intends to increase funded enrollment by only 4.3 percent. This is because CSU plans to use some enrollment growth funding to help “backfill” unallocated reductions in its budget.

Major General Fund reductions include:

- \$204 million in unallocated reductions. (As noted earlier, most of this reduction would be backfilled by revenue from a student fee increase of about 30 percent. In addition, CSU intends to shift enrollment growth funding to backfill the remainder of the reduction.)
- \$58.1 million in academic and institutional support.
- \$53.5 million from increasing the student-faculty ratio from 18.9:1 to 19.9:1.
- \$53.2 million in funding for student services.
- \$12.6 million in funding for several outreach programs.

In addition to these formal budget actions, the budget also assumes CSU's institutional financial aid programs will receive a total of \$208 million in 2003-04. This is \$86 million, or 70 percent, more than provided under the *2002-03 Budget Act*. The augmentation is a result of CSU's decision to set aside for institutional aid one-third of all additional student fee revenue it expects to collect in 2003-04. The CSU has full discretion in allocating these institutional aid monies.

California Community Colleges

The budget appropriates \$2.3 billion in General Fund support for CCC in 2003-04. In addition, the budget also provides \$200 million in General Fund support in 2003-04 loaned from the next fiscal year. When other fund sources, including student fees and property taxes are considered, CCC's total funding increases about 1.6 percent from 2002-03 to 2003-04. As noted in the section on Proposition 98, CCC's 2002-03 Proposition 98 funding was reduced by \$168 million as part of the mid-year budget actions.

Major features of CCC's budget include:

- \$57.9 million for enrollment growth of 1.5 percent, or 16,427 FTE students.
- \$90.7 million in new fee revenue, resulting from an increase in student fees from \$11 per unit to \$18 per unit.
- A shift of \$38 million from the Partnership for Excellence to financial aid programs. This funding is intended to encourage and assist students in applying for and receiving financial aid as a way to mitigate the impact of the fee increase on needy students.
- A reduction of \$25 million and about 6,500 FTE students from "concurrent enrollment" programs which enroll high school students in CCC courses. Related legislation (Chapter 786, Statutes of 2003 [SB 338, Scott]), further restricts the types of concurrent enrollment courses eligible for funding.
- Allows CCC to "defer" \$200 million in costs incurred in 2003-04 until 2004-05. In this way, CCC is able to increase its programmatic costs by \$200 million without a corresponding increase in its Proposition 98 appropriations in 2003-04. In effect, CCC will receive a \$200 million loan from 2004-05 funds.

In addition, the 2003-04 budget package makes the following changes affecting CCC's budget:

- Requires the Chancellor of the CCC to "consider" ways to promote the equalization of per-student funding among districts as he allocates enrollment growth funding to the districts.
- Prevents the Chancellor from providing a de facto COLA in the form of reduced district workload obligations.

- Expresses the Legislature's intent that the 2003-04 and 2004-05 budgets shall not appropriate Proposition 98 funding in excess of the minimum guarantee.

Student Aid Commission (SAC)

The budget provides \$683 million in General Fund support for SAC. This is \$82 million, or 14 percent, more than 2002-03 expenditures. Of the total appropriation, \$652 million is for Cal Grant programs; \$30 million is for the Assumption Program of Loans for Education; and the remainder is for three very small, specialized financial aid programs. The budget raises Cal Grant awards for UC and CSU students to cover anticipated fee increases and maintains all other award amounts at their 2002-03 levels.

California Postsecondary Education Commission (CPEC)

The budget includes General Fund support of \$1.9 million for CPEC. This is \$237,000, or 11 percent, less than the 2002-03 revised budget. It is \$1.7 million, or 48 percent, less than actual 2001-02 expenditures. Although the Governor's May Revision proposed to consolidate CPEC with SAC, the Legislature rejected this proposal, leaving CPEC as a separate state agency. However, pending legislation (AB 655, Liu) would merge CPEC, SAC, and possibly other state agencies.

HEALTH

The 2003-04 budget plan provides \$14.8 billion from the General Fund (including capital outlay spending) for health services, an increase of about \$414 million or 2.8 percent above the revised level of spending for the prior fiscal year. When the General Fund amounts are reduced primarily to reflect receipt of federal fiscal relief funds, health program expenditures for 2003-04 drop below those for 2002-03 by about \$200 million. Several significant aspects of the budget package are discussed below.

Figure 10 summarizes the changes in expenditures between 2002-03 and 2003-04 for major health programs. (The 2002-03 budget totals shown for Medi-Cal, the Department of Developmental Services (DDS), and the Department of Alcohol and Drug Programs (DADP) have been modified for purposes of comparison with 2003-04 figures to exclude one-time federal fiscal relief funds received by the state.) Figure 11 (see page 36) provides a summary of some of the most significant actions adopted in the budget plan to address the state's fiscal difficulties.

Figure 10
Health Services Programs
General Fund Spending

(Dollars in Millions)

	2002-03	2003-04	Change	
			Amount	Percent
Medi-Cal (local assistance only) ^a	\$10,885	\$10,522	-\$363	-3.3%
Department of Developmental Services ^a	1,900	2,113	213	11.3
Department of Mental Health	846	872	26	3.1
Healthy Families Program (local assistance only)	26	294	268	1,030.8
Department of Alcohol and Drug Programs ^a	238	235	-3	-1.3
Emergency Medical Services Authority	28	11	-17	-60.7
All other health services	683	706	23	3.4
Subtotals	(\$14,606)	(\$14,354)	(\$414)	(2.8%)
Less miscellaneous adjustments ^b	-\$340	-\$704	-\$364	107.1%
Totals	\$14,266	\$14,049	-\$217	-1.5%

^a Program amounts for 2002-03 do not reflect impact of federal fiscal relief.

^b Total for 2002-03 is federal fiscal relief only. Total for 2003-04 includes federal fiscal relief and several other adjustments. Federal fiscal relief over 2002-03 and 2003-04 for the DHS portion of the Medi-Cal budget totals \$891 million.

Medi-Cal Program

The 2003-04 enacted budget provides about \$10.5 billion from the General Fund (\$28.7 billion all funds) for Medi-Cal local assistance expenditures (medical services and county administrative costs). Under the plan, General Fund spending for Medi-Cal local assistance decreases by about \$363 million or 3.3 percent.

The budget reflects both increases in Medi-Cal expenditures for various purposes and expenditure reductions. The overall net decrease in Medi-Cal spending is due primarily to the inclusion in the spending plan of a program accounting change (discussed further below) that reduces program costs on a one-time basis by \$930 million. Were it not for this budget change, the Medi-Cal budget would have grown by more than \$570 million or about 5.2 percent compared to the revised level of spending in the prior year.

Governor's Major Budget Reductions Rejected or Modified. The budget plan adopted by the Legislature rejected or significantly modified a number of the Governor's proposals for major reductions in Medi-Cal eligi-

Figure 11
Major General Fund Reductions in State Health Programs

(In Millions)

	Change From Prior Law
Medi-Cal	
Shift accounting method from accrual to cash basis	\$930
Federal fiscal relief from change in cost-sharing (two-year total)	891
Assume savings from ensuring timely annual redeterminations	194
Reduce selected provider rates by 5 percent	115
Enact various reductions in dental benefits	50
Impose quality assurance fee on managed care plans	38
Increase effort to collect outstanding pharmaceutical rebates	35
Require semiannual status reporting for adults	21
Increase antifraud efforts	20
Impose quality improvement fee for intermediate care nursing beds	15
Public Health Programs	
Discontinue allocations for trauma care centers	\$20
Reduce prostate cancer treatment program	15
Reduce DHS cancer research grant program	9
Assume savings from an anticipated increase in drug rebates	9
Department of Developmental Services	
Freeze rates paid to certain community service providers	\$26
Adjust caseload ratios for service coordinators	14
Reduce purchase of services funds	10
Department of Mental Health	
Reduce mental health managed care by 5 percent	\$12
Reduce Early Mental Health Initiative grants	5
Department of Alcohol and Drug Programs	
Reduce discretionary allocations to counties	\$12

bility, provider rates, and optional services for beneficiaries. For example, proposals to scale back the past expansion of coverage for adults in working poor families and for the aged and disabled were not included in the final spending plan. A proposal to drop selected optional services for beneficiaries, such as durable medical equipment, was rejected, although dental benefits were reduced, but not eliminated through cost-containment actions.

The budget imposes a 5 percent rate reduction primarily for physicians, pharmacies, and managed care plans effective January 1, 2004 that would achieve General Fund savings of about \$115 million in 2003-04 and \$245 million in 2004-05. In effect, the action modifies and narrows an administra-

tion proposal that originally called for a 15 percent reduction in rates that would also have affected nursing homes. Under the final budget plan, nursing homes will receive some modest rate increases in 2003-04 rather than rate reductions. Hospitals, certain community clinics, and some other specific services also are excluded from the 5 percent provider rate reduction. Except for these exclusions, managed care plans are also subject to the provider rate reductions.

Accounting Shift. The budget plan achieves one-time savings of \$930 million in 2003-04 by shifting the budgeting for Medi-Cal benefits from an accrual to a cash basis of accounting. This means that funding would no longer be appropriated to pay for services based upon the date when a medical service was rendered, but according to when the bill for a medical service was paid. The state in effect shifted expenditures for some services that would otherwise have been paid for out of the 2003-04 budget appropriation into the budget for the following fiscal year.

Change in Federal Share of Costs. The Department of Health Services' (DHS) portion of the Medi-Cal budget reflects the receipt by the state of about \$890 million in additional federal funds over the 2002-03 and 2003-04 state fiscal years from a temporary increase in the federal share of support for the program. This increase in federal funds allowed an offsetting reduction in the General Fund budget for Medi-Cal.

Quality Improvement Fees. The budget plan proposes to increase payments to Medi-Cal managed care plans under a new financial mechanism by which the plans would be charged a "quality improvement fee" that would enable the state to draw down additional federal Medicaid matching funds. Most of the additional funds generated in this way were to have been passed through to the health plans with some of the additional federal funds gained through this mechanism retained by the state General Fund to help achieve an estimated net savings of \$38 million in the Medi-Cal Program. In September, we were advised by DHS that the proposal was being withdrawn because it was unlikely to receive federal approval.

A similar fee mechanism, termed a "quality assurance fee," was adopted in the budget plan to provide some additional funds to certain nursing homes that receive reimbursement under the Medi-Cal Program and specialize in providing an intermediate level of care for persons with developmental disabilities. The budget plan assumes this change will generate net savings to the state General Fund of about \$15 million. This proposal was expected to receive federal approval.

Tighter Eligibility Procedures. The spending plan also assumes \$194 million in General Fund savings from reduced caseloads by ensuring that county workers complete redeterminations of Medi-Cal eligibility in a more timely manner. In addition, the budget plan assumes about \$21 million in savings due to the enactment of a semiannual reporting process to verify Medi-Cal eligibility of adult beneficiaries. This action was in lieu of an administration proposal to reestablish quarterly status reporting for these beneficiaries.

Increased Antifraud Efforts. The budget plan scaled back an administration proposal to add 315 positions to increase departmental staffing for various expanded antifraud efforts. The revised approach approved 161.5 positions and focused generally on those activities that are anticipated to produce the highest initial savings to the General Fund.

These activities include expanding and strengthening the enrollment process for Medi-Cal providers, new procedures to more carefully screen provider claims before checks are issued to them, and more timely replacement of identification cards provided to Medi-Cal beneficiaries. In addition, a strategic plan based on statistically valid data is to be developed to determine the most effective and efficient areas to target with additional antifraud resources.

Drug and Medical Supply Cost Containment. The Legislature agreed to a number of other specific proposals proposed by the administration to slow the growth in the cost of Medi-Cal benefits through changes in the way it purchases drugs and other medical items. In accordance with the budget plan, changes are to be made in the way the state purchases antihemophilic blood factors, durable medical equipment, hearing aids and accessories, pharmaceuticals, and laboratory services.

To help curb fast-rising drug costs, the budget plan provides for increased efforts to collect outstanding rebates on drug purchases owed to the state and to accelerate efforts to conduct special reviews of certain categories of drugs to see which ones are most clinically effective as well as cost-effective. Also, DHS was authorized to impose limits on the number of laboratory tests that could be claimed by a provider without obtaining prior authorization from the state.

Disease Management. The budget plan includes \$374,000 (all funds) to begin a disease management program to improve patient outcomes and quality of life, and reduce costs for some Medi-Cal enrollees. While the

budget plan does not assume savings from start-up of this activity in the budget year, it is expected to result in significant state savings in future years.

Further Savings in 2004-05. The budget plan includes several measures intended to slow the growth of Medi-Cal next year. Cost-of-living increases for nursing homes would be suspended in order to save an estimated \$64 million and rates paid for inpatient hospital care would be limited to save an additional \$70 million during 2004-05.

Public Health Programs

AIDS Drug Assistance Program (ADAP). The budget plan does not include a proposal offered by the administration to increase copayments for some participants in ADAP, which assists individuals with HIV to obtain prescription drugs. The budget plan assumes about \$9 million in program savings will be realized through an increase in state rebates on the purchase of pharmaceuticals.

Emergency Services. The spending plan does not include an administration proposal to consolidate the Emergency Medical Services Authority within DHS. It does accept an administration proposal not to continue support allocations to trauma care centers, for a General Fund savings of \$20 million.

Cancer Programs. The budget plan modifies an administration proposal to eliminate the remaining \$12.5 million for a cancer research program by instead reducing the annual funding level by about \$9 million. The budget plan also reduces a \$20 million per-year treatment program for individuals with prostate cancer by \$15 million.

Healthy Families

The budget plan provides about \$294 million from the General Fund (\$954 million all funds) for local assistance under the Healthy Families Program during 2003-04. This reflects an overall increase of about \$258 million (all funds) or 37 percent in annual spending for the program. General Fund spending for Healthy Families local assistance would increase by about \$268 million. This reflects an assumption in the budget plan that all remaining tobacco settlement revenues received by the state would be securitized during 2003-04 and thus would no longer be available specifically for support of the program.

In addition to caseload growth, the budget plan anticipates an additional \$154 million in county and federal funds to implement a new program to

support local health insurance initiatives for children. The budget plan also reflects a decision of the Legislature to continue funding for the Rural Health Demonstration Project program through a redirection of funding available under Proposition 99, a 1988 measure increasing cigarette taxes to fund various health and resources programs.

Finally, the budget plan assumes that the rates paid to health plans would be limited to achieve about \$9.6 million in savings in 2004-05.

Department of Developmental Services

The budget provides \$2.1 billion from the General Fund (\$3.4 billion all funds) for services to individuals with developmental disabilities in developmental centers and Regional Centers (including capital outlay spending). Under the spending plan, General Fund support for DDS would increase by about \$213 million, or 11 percent, over the revised prior-year level of spending.

Community Programs. The 2003-04 budget includes a total of \$1.7 billion from the General Fund (\$2.6 billion all funds) for community services for persons with developmental disabilities, an increase in General Fund resources of about \$200 million over the prior fiscal year.

In enacting this budget plan, the Legislature rejected an administration proposal to save about \$100 million in 2003-04 by establishing statewide standards for the purchase of services, but did adopt various substitute cost-containment actions. These actions included limiting the rates paid to certain providers (for estimated General Fund savings of about \$26 million), adjusting caseload ratios for service coordinators (about \$14 million General Fund savings), and an unallocated reduction to purchases of services by Regional Centers (for assumed General Fund savings of \$10 million).

The budget plan includes the development of a financing system requiring copayments by some families of children with developmental disabilities. The copayments would be implemented beginning in 2004-05. An administration proposal to shift habilitation services from the Department of Rehabilitation to DDS' Regional Centers was adopted but modified to delay the change until 2004-05.

Developmental Centers. The budget provides a total of about \$377 million from the General Fund for operation of the developmental centers (almost \$700 million all funds excluding capital outlay), an increase in General Fund resources of about \$14 million over the prior fiscal year.

Most of the spending increase relates to the imposition of the quality assurance fee for intermediate care nursing beds (one of the Medi-Cal Program changes discussed above). The Legislature also accepted an administration proposal to initiate the closure of the Agnews Developmental Center.

Department of Mental Health

The budget provides about \$872 million from the General Fund (\$2.3 billion all funds) for mental health services provided in state hospitals and in various community programs. This amounts to about a \$26 million, or 3.1 percent, increase in General Fund support over the revised prior-year level of spending for mental health programs.

Community Programs. The 2003-04 budget includes about \$320 million from the General Fund (\$1.5 billion all funds) for local assistance for the mentally ill, about a 1.7 percent decrease in General Fund support compared to the revised prior-year level of spending.

The budget provides a \$60 million increase in expenditures for mental health services for children under the Early and Periodic Screening, Diagnosis and Treatment program. The Legislature approved about a \$12 million reduction in funding for mental health managed care plans and reduced the Early Mental Health Initiative by \$5 million—in both cases approving lesser cuts than those initially proposed by the administration. The Legislature also shifted \$69 million in costs for a state-mandated program for local mental health services for special education students to federal special education funding.

State Hospitals. The budget provides a total of about \$500 million from the General Fund for state hospital operations (about \$640 million all funds). The \$28 million, or 6 percent, increase in General Fund resources was due primarily to adjustments for growth in caseload and operating expenses.

Department of Alcohol and Drug Programs

The budget provides about \$235 million from the General Fund (\$586 million all funds) for drug and alcohol treatment programs, about the same amount as the revised level of expenditures estimated for the prior fiscal year. This budget total includes \$120 million appropriated under Proposition 36, a voter-approved initiative that expanded treatment programs for offenders convicted of a nonviolent drug possession offense. The budget plan includes an administration proposal for an approximate \$12 million

reduction in General Fund support for discretionary county allocations for treatment programs. The spending plan also reflects the enactment of a legislative proposal to restructure and expand drug courts, partly with an augmentation to DADP of \$2.3 million, in order to achieve an estimated \$9.6 million in savings on state prison operations.

SOCIAL SERVICES

The 2003-04 budget increases General Fund support for social services programs by \$461 million (5.2 percent) to a total of \$9.4 billion (excluding one-time federal fiscal relief funds). After adjusting for the receipt of the federal fiscal relief funds, expenditures for social services increased by \$172 million (1.9 percent) in 2003-04, as shown in Figure 12.

Figure 12 summarizes the changes in General Fund spending by major program. In brief, substantial increases in Supplemental Security Income/State Supplementary Program (SSI/SSP) (\$349 million) and In-Home Supportive Services (IHSS) (\$147 million) were partially offset by reductions in California Work Opportunity and Responsibility to Kids (CalWORKs) (-\$37 million) and other social services expenditures (-\$39 million). Although underlying expenditure growth in social services was \$461 million, spending would have increased by an additional \$275 million had

Figure 12
Social Services Programs
General Fund Spending

(Dollars in Millions)

	2002-03	2003-04	Amount	Percent
SSI/SSP	\$3,031	\$3,380	\$349	11.5%
CalWORKs	2,107	2,070	-37	-1.7
IHSS	1,122	1,269	147	13.1
Children's Services/Foster Care/Adoptions Assistance	1,352	1,377	25	1.9
Department of Child Support Services	462	469	7	1.5
County administration/automation	415	423	8	2.0
Other social services programs	410	371	-39	-9.5
Subtotals	(\$8,898)	(\$9,359)	(\$461)	(5.2%)
Federal fiscal relief funds ^a	-\$38	-\$326	-\$289	762.1%
Totals	\$8,860	\$9,033	\$172	1.9%

^a Includes FMAP relief of \$14.7 million in 2002-03 and \$50.2 million in 2003-04 in IHSS. Also includes additional general federal fiscal relief of \$23.2 million in 2002-03 for the June 2003 SSI/SSP COLA, \$61.4 million in 2003-04 for IHSS, and \$214.9 million for SSI/SSP.

the Legislature not made significant reductions, reforms, and cost shifts in comparison to previous statutory requirements. Figure 13 lists the \$275 million in net program reductions.

SSI/SSP

The adopted budget includes \$3.4 billion from the General Fund for the program, which is an increase of almost 12 percent.

Grant Payments. The overall increase in SSI/SSP expenditures is mostly attributable to the June 2003 COLA, resulting in General Fund costs of

Figure 13
Major Changes—Social Services Programs
2003-04 General Fund

(In Millions)

Department/Program	Change From Prior Law
Department of Social Services (DSS)—SSI/SSP	
Suspends January 2004 COLA	-\$104.0
DSS—CalWORKs	
Replaces General Fund with Employment Training Funds	-\$26.4
No COLA due to elimination of vehicle license fee relief	—
Redirects TANF funds to Child Welfare Services	-11.0
DSS—Licensing	
Increases licensing fees (revenues)	-\$10.2
Reduces licensing inspection visits	-5.3
DSS—Food Stamps	
Provides transitional Food Stamps benefits	\$1.6
Department of Child Support Services	
Allocates 25 percent of automation penalty to counties	-\$52.1
Adopts various reforms to increase collections and incentives	-42.3
Increases funding to establish medical support orders (net savings)	-5.2
Department of Rehabilitation	
Deletes statutory provider rate adjustment	-\$9.7
Reduces provider rates in Work Activity and Supported Employment Programs	-4.2
Department of Community Services and Development	
Eliminates Naturalization Services Program	-\$2.9
Eliminates Mentoring Program	-1.0
Department of Aging	
Reduces funding for Senior Companion Program	-\$1.5
Eliminates funding for Foster Grandparent Program	-1.1

\$281 million in 2003-04. The budget suspends the January 2004 state COLA for a savings of \$104 million in 2003-04 and full-year savings of \$213 million in 2004-05. The budget does pass along the federal COLA which is applied only to the federal SSI portion of the grant. Figure 14 shows that the June 2003 COLA increased the maximum grant for an individual by \$21 (2.8 percent); the federal COLA in January 2004 will increase grants by another \$12 (1.5 percent). Figure 14 also shows similar percentage increases in the maximum monthly grant for couples receiving SSI/SSP.

Figure 14
SSI/SSP Grant Levels
June State COLA and January Federal COLA

(Maximum Monthly Grants)

	2003		2004
	January	June ^a	January
Individuals			
SSI	\$552	\$552	\$564
SSP	205	226	226
Totals	\$757	\$778	\$790
Couples			
SSI	\$829	\$829	\$846
SSP	515	553	553
Totals	\$1,344	\$1,382	\$1,399

^a June COLA will be implemented in October 2003, but payments will be retroactive to June 2003.

CalWORKs

The budget includes \$2.1 billion from the General Fund in the Department of Social Services (DSS) budget for the CalWORKs program in 2003-04, which is a decrease of about 1.7 percent compared to the prior year.

June and October 2003 COLAs. The budget provides funding for the June 2003 COLA, resulting in combined General Fund/Temporary Assistance for Needy Families (TANF) costs of \$126 million in 2003-04. Pursuant to current law, the October 2003 COLA is contingent upon continuation of vehicle license fee relief. Because this fee relief has been eliminated, there is no October COLA (which would have cost \$91 million in TANF funds in 2003-04 and resulted in General Fund costs of \$121 million in 2004-05).

The June 2003 COLA raised the maximum grant for a family of three in high-cost counties by \$25 to a total of \$704. In low-cost counties, the maximum grant increased by \$24 to a total of \$671.

Other Changes Result in Savings. Budget legislation increases the appropriation from the Employment Training Fund for support of the CalWORKs program from \$30 million in 2002-03 to \$56.4 million in 2003-04. This transfer results in General Fund savings of \$26.4 million in CalWORKs compared to the prior year, with a corresponding reduction in funds available for Employment Training Panel programs. Finally, the budget shifts \$11 million in TANF funds to offset General Fund costs in Child Welfare Services.

IHSS

The budget increases General Fund support for the IHSS program by \$147 million (13 percent) to a total of almost \$1.3 billion. The spending growth is attributable to increases in caseload and workload (\$81 million) and the full-year costs associated with provider wage increases which were granted by counties during the 2002-03 fiscal year (\$47 million). Because revenue growth in 2003-04 was less than 5 percent, there is no “triggering” of increased state participation in hourly wages paid to certain providers.

DSS Children’s Programs

The budget provides a combined total of \$1.4 billion from the General Fund for Foster Care, Child Welfare Services, and Adoptions. This is an increase of \$25 million (1.9 percent) compared to 2002-03. This increase is the net result of a reduction in Foster Care due to continuing caseload declines and increases in Adoptions Assistance and Child Welfare Services.

Inflation Adjustments. Due to the continuing weakness in the General Fund condition, the budget for 2003-04 follows the practice of 2002-03 of not providing a discretionary COLA for Foster Care or the Adoptions Assistance program. The budget also follows the 2002-03 practice of not providing inflationary adjustments to cover county administrative cost increases for Foster Care or Child Welfare Services.

Community Care Licensing

The budget provides a total of \$35.3 million from the General Fund for Community Care Licensing. This is a decrease of 28 percent (\$9.8 million) compared to 2002-03.

Reduction in Licensing Inspection Visits. With the exception of certain facilities, the budget (1) eliminates the requirement that licensed facilities be visited annually or triennially and (2) generally limits “regular” inspections to a random sample of 10 percent of all licensed facilities. The reduction in annual visits results in a \$5.3 million General Fund savings.

Fee Increases for Licensing. The budget (1) increases licensing fees for adult and residential facilities by 25 percent, (2) doubles the fees for child care facilities, and (3) establishes a new “per home” fee to be paid by foster family agencies. Community Care Licensing fees have not been increased since 1992. These new fee increases result in additional revenues of \$7.4 million.

Suspension of Fee Exemption. The budget suspends for one year the fingerprint fee exemptions for providers working in facilities serving six or less individuals. These providers will now have to pay the one-time cost for fingerprinting (\$24 for fingerprint processing and an additional \$16 for live scan fingerprint imaging), as do providers working in larger facilities. This suspension results in a General Fund savings of \$2.8 million.

Department of Child Support Services (DCSS)

The budget includes \$469 million in General Fund support for the DCSS, an increase of \$7 million (1.5 percent) compared to 2002-03.

Collections Reform Package. The budget includes a series of reforms that result in increased revenues of \$42 million. These reforms include reducing the amount of default support orders; establishing a compromise payment program for parents owing back child support; and requiring local child support agencies to verify income and, when necessary, seek appropriate support order modifications. Implementation costs of \$2.5 million are more than offset by (1) an estimated \$39.2 million increase in revenues from higher collections and (2) an estimated \$5.6 million increase in federal performance incentives.

County Share of Federal Automation Penalty. The budget establishes a 25 percent county share of the child support federal automation penalty. Although prior law apportioned automation penalties to counties, the state had absorbed such penalty costs through discretionary annual budget act appropriations. For 2003-04, counties will pay \$52.1 million of projected penalty costs resulting in an identical increase in General Fund revenues.

Increased Medical Support Order Enforcements. The budget provides \$1 million from the General Fund for DCSS to increase its efforts to establish medical support orders. The projected increase in medical support orders results in estimated Medi-Cal savings of \$6.2 million (for a net savings of \$5.2 million).

Employment Development Department (EDD)

For 2003-04, General Fund support for EDD is \$21.6 million, a reduction of \$1.3 million (5.9 percent) compared to 2002-03.

Federal Funds Reserved for Automation Improvements. The Job Creation and Worker Assistance Act of 2002 (Public Law 107-147) authorized the distribution of \$8 billion in federal Reed Act funds to the states. In April 2002, California received \$936.9 million in these funds. Chapter 4xxx, Statutes of 2002 (SB2xxx, Alarcón), set aside \$600 million in Reed Act funds for payment of unemployment insurance benefits. Also, Reed Act funds have been used to offset General Fund costs in the job services program and unemployment insurance administration. Budget bill language in Item 7100-001-0871 sets aside \$85 million in Reed Act funds for the purpose of (1) redesigning the unemployment insurance continued claims system, (2) improving service levels at the unemployment insurance call centers, and (3) preventing and detecting fraud within the unemployment insurance system. These funds are available for expenditure until June 30, 2007.

Other Reductions

The budget eliminates the Naturalization Services Program and the Mentoring Program, both operated by the Department of Community Services and Development, for a combined General Fund savings of \$3.9 million. The budget also reduces programs in the Department of Aging by \$2.6 million.

JUDICIARY AND CRIMINAL JUSTICE

The budget package contains \$8.9 billion (all funds) for judicial and criminal justice programs, including \$7.5 billion from the General Fund. The total amount is a decrease of \$326 million, or 3.5 percent, from 2002-03 expenditures. The General Fund total represents a decrease of \$348 million, or 4.4 percent, relative to 2002-03 expenditures.

Subsequent to enactment of the budget, the administration notified the Legislature that federal fiscal relief funds were being allocated to reduce General Fund expenditures for the California Department of Corrections

(CDC). As a result, overall judicial and criminal justice expenditures decline by \$1.2 billion, or 15 percent, between 2002-03 and 2003-04.

Figure 15 shows the changes in expenditures in some of the major judicial and criminal justice budgets. Below, we highlight the major changes in these budgets.

Figure 15
Judicial and Criminal Justice Budget Summary
General Fund

(Dollars in Millions)

Program/Department	2002-03	2003-04	Change	
			Amount	Percent
Trial Court Funding	\$1,092	\$1,034	-\$58	-5.3%
Department of Corrections	5,200	5,143	-57	-1.1
Department of Youth Authority	366	344	-22	-6.0
Citizens' Option for Public Safety	116	100	-16	-13.8
Juvenile Justice Grants	116	100	-16	-13.8
Other corrections programs	978	799	-179	-18.3
Subtotals	(\$7,868)	(\$7,520)	(-\$348)	(-4.4%)
Federal fiscal relief funds	—	-\$852 ^a	-\$852	—
Totals	\$7,868	\$6,668	-\$1,200	-15.3%

^a This amount of federal funds will be allocated to the Department of Corrections, thereby reducing General Fund costs by a like amount.

Court Related Funding

The budget includes \$2.2 billion for support of trial courts. This amount includes \$1 billion from the General Fund; \$475 million transferred from counties to the state; and \$678 million in fine, penalty, and court fee revenues. The General Fund amount is \$58 million, or 5.3 percent, lower than 2002-03 expenditures. The overall decrease reflects reduced spending for court operations and increased fees to cover costs that would otherwise accrue to the General Fund. These are discussed below in more detail.

Court Operations Reductions. The budget as enacted includes a reduction of approximately \$95 million to the court operations budget. Based on discussions with court budget staff, these reductions will be achieved through a variety of approaches, including hiring freezes, voluntary furloughs, and reduced expenditures for some aspects of court security.

In lieu of the administration's proposal to allow the courts to competitively contract for court security, the Legislature adopted legislation es-

establishing a court security workgroup to develop and implement policies to reduce and contain growth in court security costs. This is projected to result in a savings of \$11 million in 2003-04.

New and Increased Court Fees. The budget offsets General Fund spending for the courts by approximately \$150 million by enacting a variety of new and increased court fees. (This amount also includes existing fees which will be transferred from the counties to the courts.) Figure 16 shows the prior and new/increased court fees and the projected increased revenues associated with them.

State Court Facilities Construction Fund Loan. The State Court Facilities Construction Fund was established to support the costs associated with transferring responsibility for court facilities from the counties to the state, including the cost of maintaining existing court facilities as well as

Figure 16
New and Increased Court Fees

	Fees		Increased Revenue (In Millions)
	Prior 2002-03	New/Increased 2003-04	
Trial Court			
New Court Security Fee ^a	—	\$20	\$40.2
Undesignated Fees ^b	—	—	31.0
New Continuance Fee	—	100	26.3
New Complex Case Fee	—	500	12.3
New Court Reporter Fee ^c	—	25	16.3
Limited Jurisdiction Filing Fee	\$90	185	11.7
Graduated Probate Fee ^d	185	185-3,500	7.3
Small Claims Fee	35	60	2.4
Trial Motion Fee	23	33	1.2
Summary Judgment Motion Fee	100	150	0.8
Judicial			
Appellate Filing Fee	\$265	\$420	\$1.5
Transcript Fee	100	270	0.4
Supreme Court Filing Fee	265	420	0.3
Totals	—	—	\$151.7

^a From January 1, 2004 to June 30, 2004, this fee will increase to either \$30 or \$40 depending on the case type.

^b These are existing fees that will be transferred from the counties to the courts.

^c This is a new \$25 fee for hearings that are less than one hour. Currently, courts have a half- and full-day rate.

^d Fee varies depending on the value of the estate.

constructing new court facilities. The budget transfers \$80 million from the State Court Facilities Construction Fund to the Trial Court Trust Fund, thereby reducing General Fund costs by a like amount. The budget requires repayment to the construction fund no later than January 1, 2006.

Corrections

The budget contains \$5.1 billion from the General Fund for support of CDC, a decrease of \$57 million, or 1 percent, below the revised 2002-03 level. This overall reduction reflects spending increases (for inmate population growth, for example) as well as spending decreases.

The Legislature made reductions totaling more than \$160 million. Most of this amount—approximately \$125 million—would be achieved through administrative policy changes aimed at reducing the inmate population and parolee recidivism. Examples of such policy changes include restructuring the delivery of education programs to maximize the credits that eligible inmates could earn, expanding prerelease planning services for parolees, and implementing community-based sanctions for nonserious and nonviolent parole violators.

Other reductions include \$13 million from more efficient delivery of inmate health care services, \$10 million from closure of the Northern California Women's Facility, \$9 million from delaying the opening of the Delano II prison, and \$5 million from delaying the implementation of 500 substance abuse treatment beds.

Federal Funds for Incarceration and Supervision of Undocumented Felons. The budget also assumes that the state will receive \$134 million in federal funds to offset the state's costs of supervising undocumented felons in CDC and the Department of the Youth Authority. This is about \$50 million more than received in 2002-03. The federal funds are counted as offsets to state expenditures.

Department of the Youth Authority

The budget provides \$344 million from the General Fund for support of the Youth Authority, a 6 percent reduction in comparison to 2002-03. The decrease primarily results from a projected decline in the ward population. As a result of the shrinking ward population, the Legislature closed the Karl Holton Youth Correctional Center in Stockton, as well as the male portion of the Ventura facility for 2003-04 savings of approximately \$3.6 million. The budget also adjusts for inflation the fees that counties pay to send juveniles to the Youth Authority, which is projected to result in General Fund savings of \$6 million.

Assistance to Local Law Enforcement

Citizens' Option for Public Safety (COPS) Program. The budget includes \$100 million to continue the COPS program, a decrease of \$16.3 million from the amount provided in 2002-03. The program provides discretionary funding on a per capita basis, for local police departments and sheriffs for front line law enforcement (with a minimum guarantee of \$100,000), sheriffs for jail services, and district attorneys for prosecution.

High Technology Crime Programs. The budget eliminated \$18.5 million for grants to local law enforcement agencies for technology equipment purchases. However, it continues to provide \$10.2 million for the High Technology Theft, Apprehension, and Prosecution program, and \$3.3 million for the High Technology Identity Theft program.

War on Methamphetamine. The budget includes \$9.5 million for local law enforcement in the Central Valley for antimethamphetamine activities. This is a reduction of \$5.5 million from the 2002-03 funding level.

Rural and Small County Law Enforcement Program. The budget eliminated \$18.5 million for the Rural and Small County Law Enforcement program, which provided discretionary funds to supplement local law enforcement resources.

Office of Criminal Justice Planning (OCJP). The budget phases-out OCJP by providing the office with funding for the first half of 2003-04 and assigning its programs to other state departments for the second half of 2003-04.

Assistance for Local Juvenile Justice Programs

Juvenile Justice Grants. The budget provides \$100 million, a reduction of \$16.3 million compared to the prior-year level. These funds go to county level juvenile justice coordinating councils to support locally identified needs related to juvenile crime.

TRANSPORTATION

Department of Transportation (Caltrans)

The 2003-04 budget provides total expenditures of \$6.5 billion from state special funds and federal funds for Caltrans. This is a 4.6 percent reduction in comparison to the 2002-03 expenditure level. The decrease is primarily due to lower anticipated expenditures for transportation capital outlay. The budget provides approximately \$5.6 billion for highway transportation expenditures, including \$1.6 billion for capital outlay,

\$1.2 billion for capital outlay support, \$1.9 billion for local assistance, and \$784 million for highway maintenance. The budget also provides \$267 million for Caltrans' mass transportation program and \$476 million for the transportation planning program and departmental administration.

The primary state funding source for Caltrans is the State Highway Account (SHA), which will fund \$2.4 billion of Caltrans' expenditures in 2003-04. The major sources of revenue into the SHA are state gas taxes and truck weight fees. Several factors, including loans to other funds, increased capital outlay expenditures, and an unexpected decrease in truck weight fee revenues, have combined to drastically reduce the SHA balance in the past few years.

Truck Weight Fee Increases to Achieve Revenue Neutrality. The manner in which truck weight fees are calculated was changed by legislation in 2000. This change was intended to leave SHA weight fee revenue at the same level it would have achieved if no change had been made. However, weight fee revenues after the change were significantly below projections. As part of the 2003-04 budget package, Chapter 719, Statutes of 2003 (SB 1055, Committee on Budget and Fiscal Review), raises weight fees on certain trucks by 20 percent over current levels beginning January 1, 2004. This increase is intended to counteract the previous decrease in weight fee revenue and achieve "revenue neutrality." It is projected to increase weight fee revenue into the SHA by \$38 million in 2003-04 and by \$78 million in 2004-05. Chapter 719 allows weight fees to increase further, up to 33 percent over current levels, in 2004-05 if total weight fee revenues in 2003-04 are below a specified amount. A 33 percent increase would raise SHA revenues by \$125 million in 2004-05.

Transportation Loans to General Fund and Repayments

In addition to funding the state's transportation programs, the 2003-04 budget provides for the use of transportation funds to aid the General Fund condition in a number of ways.

Proposition 42 Partially Suspended; Bulk of Revenue to Be Transferred Later. Under Proposition 42, approved by voters in March 2002, revenue from the sales tax on gasoline that previously went to the General Fund is to be transferred into the Transportation Investment Fund (TIF) for transportation purposes, beginning in 2003-04. Instead, the 2003-04 budget transfers to TIF only a portion of the Proposition 42 revenue—\$289 million, and retains the remaining \$856 million in the General Fund. This

amount will be transferred with interest for transportation purposes by June 30, 2009. Of the \$289 million transfer to TIF:

- \$189 million will be available for projects in the Traffic Congestion Relief Program.
- \$100 million will partially repay the outstanding loans from the SHA to the Traffic Congestion Relief Fund (TCRF).

Repayment of Transportation Loans. The 2003-04 budget also provides for the repayment from the General Fund to the SHA of a \$173 million loan made in 2001-02. However, the budget defers \$500 million in loan repayment from the General Fund to the TCRF that was scheduled for 2003-04. Under current law, this loan will be repaid by June 30, 2006.

Figure 17 summarizes the transportation loans, transfers, and repayments between the General Fund and various transportation funds, including the actions taken in the 2003-04 budget.

Public Transportation Account (PTA) “Spillover” Kept in General Fund. The budget retains in the General Fund up to \$87 million in spillover

Figure 17
Transportation Loans/Transfers and Repayments^a

(In Millions)

Year	To General Fund ^b			To TCRF ^c	
	From SHA	From TCRF	From TIF	From SHA	From PTA
2000-01	—	—	—	\$2	—
2001-02	\$173	\$238	—	41	\$180
2002-03	-173	1,145	—	534	95
2003-04	—	—	\$856	-100	—
2004-05	—	—	—	—	—
2005-06	—	-1,383	—	—	—
2006-07	—	—	—	-477	—
2007-08	—	—	—	—	-275
2008-09	—	—	-856 ^d	—	—

SHA = State Highway Account; TCRF = Traffic Congestion Relief Fund;
TIF = Transportation Investment Fund; PTA = Public Transportation Account

^a Amounts do not include interest.

^b Positive numbers are amounts payable to the General Fund, negative numbers are payable from the General Fund.

^c Positive numbers are amounts payable to TCRF, negative numbers are payable from TCRF.

^d Repayment will be made to the Transportation Deferred Investment Fund.

revenue that otherwise would accrue to the PTA. Any excess spillover revenue will accrue to the PTA.

California Highway Patrol (CHP) and Department of Motor Vehicles (DMV)

The 2003-04 budget provides about \$1.2 billion to fund the CHP, about the same level as in 2002-03. Of this amount, Motor Vehicle Account (MVA) support totals about \$1.1 billion.

With regard to the DMV, the budget provides \$683 million in departmental support, about the same level as in 2002-03. Of this amount, \$361 million will come from the MVA.

Budget Increases MVA Fees. In order to address a significant shortfall in the MVA and fund CHP and DMV in 2003-04, the budget increases a number of MVA fees beginning in 2004. Fees to be increased include fees for driver licenses, identification cards, and vehicle registration. The fee increases are projected to generate about \$194 million in additional revenue in 2003-04 and \$395 million annually thereafter, as shown in Figure 18. Specifically, the fee increases include the following:

Figure 18
Motor Vehicle Account Revenue Increases

(In Millions)

Program	2003-04	Annual Ongoing
Higher vehicle registration fees	\$136	\$271
Higher driver license fees	33	72
Increased identification card fees for nonseniors	9	19
Standardized transaction fees	15	31
Enactment of Business Partner Automation fee	1	2
Totals	\$194	\$395

- Higher vehicle registration fees, from the current \$30 to \$40. Of the increase, \$5 will be dedicated to the support of CHP officers.
- Higher fees for noncommercial driver licenses, including an increase from \$12 to \$24 for an original driver license, and from \$15 to \$24 for a renewed driver license. Original driver licenses will remain valid for five years, instead of the current four years.

- Higher identification card fees for nonseniors, from \$6 to \$20. Seniors, who currently pay \$3, will receive their cards free of charge.
- Increase in various DMV transaction fees to a standard \$15.
- Enactment of a new \$3 Business Partner Automation fee, which charges private firms for the convenience of registering vehicles and performing other transactions on-site.

RESOURCES AND ENVIRONMENTAL PROTECTION

The 2003-04 budget provides about \$5.5 billion from various fund sources for natural resources and environmental programs administered by the Resources and California Environmental Protection Agencies, respectively. This is a reduction of about \$1.5 billion, or 21 percent, when compared to 2002-03 expenditures. This reduction is mainly the result of a decrease of \$1.2 billion in bond fund expenditures for park and water projects. In addition, the budget reflects a General Fund reduction of about \$457 million. Some of this reduction reflects significant one-time General Fund expenditures in the 2002-03 budget for local flood control and fire suppression, as well as various program reductions in the budget year, which are discussed below. However, not all of the General Fund savings reflect program reductions, as over \$175 million of funding has been shifted from the General Fund to other fund sources, namely fee-based special funds and bond funds.

Figures 19 and 20 (see next page) compare expenditure totals for resources and environmental protection programs in 2002-03 and 2003-04. As the figures show, the largest reductions in these programs are generally in local assistance and capital outlay due to a reduction in available bond funds.

The following sections summarize the major features of the 2003-04 budget for natural resources and environmental protection programs. We also include a summary of energy and telecommunications-related spending highlights, including programs both within and outside the Resources Agency.

Overall Budget Solution: Fund Shifts, Borrowing, and Program Reductions

Resources and environmental protection programs assisted in the state's overall budget solution through: (1) shifting a number of General Fund

Figure 19
Resources Programs: Expenditures and Funding

*2002-03 and 2003-04
(Dollars in Millions)*

Expenditures	2002-03	2003-04	Change	
			Amount	Percent
State operations	\$2,756.4	\$2,660.7	-\$95.7	-3.5%
Local assistance	1,234.6	794.8	-439.8	-35.6
Capital outlay	1,403.8	734.2	-669.6	-47.7
Totals	\$5,394.8	\$4,189.7	-\$1,205.1	-22.3%
Funding				
General Fund	\$1,243.4	\$864.7	-\$378.7	-30.5%
Special funds	1,207.6	1,357.4	149.8	12.4
Bond funds	2,734.4	1,783.9	-950.5	-34.8
Federal funds	209.4	183.7	-25.7	-12.3
Totals	\$5,394.8	\$4,189.7	-\$1,205.1	-22.3%

Figure 20
**Environmental Protection Programs:
Expenditures and Funding**

*2002-03 and 2003-04
(Dollars in Millions)*

Expenditures	2002-03	2003-04	Change	
			Amount	Percent
State operations	\$885.3	\$856.6	-\$28.7	-3.2%
Local assistance	685.5	434.6	-250.9	-36.6
Capital outlay	2.4	0.9	-1.5	-62.5
Totals	\$1,573.2	\$1,292.1	-\$281.1	-17.9%
Funding				
General Fund	\$174.2	\$97.3	-\$76.9	-44.1%
Special funds	654.2	706.9	52.7	8.1
Bond funds	577.0	326.1	-250.9	-43.5
Federal funds	167.8	161.8	-6.0	-3.6
Totals	\$1,573.2	\$1,292.1	-\$281.1	-17.9%

costs to fee-based special funds or bond funds, (2) making loans and transfers from special funds to the General Fund, and (3) adopting General Fund program reductions. We discuss each of these components of the budget solution in the sections that follow.

Fee-Based Funding Shifts

The 2003-04 budget for several resources and environmental protection programs relies more heavily than in previous years on revenues from new fees and increases in existing fees. These new fees and fee increases result in General Fund savings of about \$115 million in 2003-04, relative to prior-year expenditures. In addition to these enacted fee changes, the *2003-04 Budget Act* assumed other fee changes requiring the enactment of subsequent legislation that did not occur. This includes new fees for timber harvest plan review and pesticide fee increases. As a consequence, the timber harvest review program faces a funding shortfall compared to the level of program expenditures anticipated in the budget act. Similarly, the pesticide regulatory program faces a funding shortfall, but this will likely not arise until 2004-05.

Figure 21 details the General Fund savings resulting from the enacted new fees and increases in existing fees.

Highlights of significant enacted fee changes include the following:

- Fire Protection Fees.** These new fees will be used to *partially* fund the fire protection services provided to private landowners by the California Department of Forestry and Fire Protection (CDFFP). Landowners will be charged \$35 per parcel for their lands in the roughly 30 million acres of “state responsibility areas.”
- Water Quality Fees.** The State Water Resources Control Board (SWRCB) regulates entities that discharge pollution into the state’s water bodies. The fees charged these entities were increased for 2003-04 in order to cover all of the board’s costs of regulating these entities, including funding various water quality monitoring efforts.

Figure 21
Resources and Environmental Protection Fees

2003-04
(In Millions)

Fees	General Fund Savings
Fire protection (new fee)	\$50.0
Water quality (increased fee)	20.4
Air quality (increased fee)	14.4
Dam safety (increased fee)	4.7
Water rights (new fee)	3.6
Fishing and hunting (increased fee)	2.0
Total	\$115.1

- **Air Quality Fees.** The Air Resources Board regulates and enforces air quality standards and collects fees on stationary sources that emit minimum levels of pollution. The budget increases the number of fee-payers by reducing the pollution threshold level for paying fees and by adding new sources of pollution (certain consumer products and architectural coatings) for which fees must be paid.
- **Dam Safety Fees.** These fees—increased in the budget—are assessed annually on dam owners to fund the Department of Water Resources' (DWR) dam safety program. This program is responsible for supervising the maintenance and operation of all nonfederal dams that are a specified minimum size.
- **Water Rights Fees.** These new fees will be assessed annually on parties that are applying for or hold water rights that are under the jurisdiction of the SWRCB. The fees will be used to support the board's water rights program that is responsible for issuing new water rights, approving changes to existing rights, and enforcing existing rights. Fees should cover approximately one-half of the program expenditures in 2003-04.

Bond-Based Funding Shifts

The budget includes a number of funding shifts from the General Fund to Proposition 50 bond funds, totaling about \$63 million. These include shifts from the General Fund to Proposition 50 bond funds of about \$35 million for the CALFED Bay-Delta Program, \$22 million to support the Habitat Conservation Fund, and \$6.4 million for the Drought Panel Recommendations Program under the DWR.

Loans and Transfers

The budget includes about \$431 million in loans and transfers to the General Fund from various resources-related special funds, as shown in Figure 22.

Significant General Fund Program Reductions

The budget includes various General Fund program reductions (that is, reductions in General Fund support for programs that have not been replaced with other funding sources, such as fees or bond funds). Significant General Fund program reductions are highlighted in Figure 23.

Other Spending Highlights

We now summarize other spending highlights, first making special note of expenditures from Proposition 40 and Proposition 50 bond funds.

Figure 22
Resources-Related Loans and Transfers

2003-04
(In Millions)

Loans to General Fund	
Various beverage container recycling funds	\$182.3
Teleconnect Fund	150.0
Various integrated waste management accounts	23.7
Public Interest Research, Development and Demonstration Fund	20.0
Underground Storage Tank Cleanup Fund	3.2
Total	\$379.2
Transfers to General Fund	
Colorado River Management Account	\$38.8
Energy Resources Programs Account	9.4
Other energy funds	3.5
Total	\$51.7
Total of Loans and Transfers	\$430.9

Resources and Environmental Protection Expenditures

- **Proposition 40.**

Proposition 40 is a \$2.6 billion resources bond measure approved by the voters in March 2002. The measure provides funds to conserve natural resources (land, air, and water); acquire and improve state and local parks; and preserve historical and cultural resources.

Figure 23
Significant General Fund Program Reductions

2003-04
(In Millions)

Fish and Game (various)	\$11.0
Parks and Recreation administration	9.0 ^a
California Conservation Corps (various)	8.5
Water planning and flood management	3.7
Water rights regulation	3.3
Air monitoring and compliance	2.0
Secretary for Resources	1.5
Secretary for Environmental Protection	1.2 ^b

^a Reflecting efficiencies from an administrative reorganization.

^b Includes closing of permit assistance centers.

The budget includes about \$831 million in expenditures from Proposition 40 in 2003-04, leaving about \$600 million available for projects

Figure 24
Proposition 40 Bond Expenditures

2003-04
(In Millions)

Program Area	Budgeted Expenditures
Local parks	\$486
Cultural and historical endowment	129
State Conservancies—acquisition, development, restoration	85
Wildlife Conservation Board—acquisition, development, restoration	79
State Parks—acquisition, development, deferred maintenance	24
Air pollution reduction	23
Grants to local conservation corps	4
Urban forestry grants	1
Total	\$831

and programs in future years. Figure 24 shows the breakdown of 2003-04 Proposition 40 expenditures by programmatic area.

The \$831 million expenditure amount for 2003-04 would have been slightly higher had the Governor not vetoed AB 1748 (Oropeza) that appropriated \$7.9 million from Proposition 40 for the river parkways program.

- **Proposition 50.** Proposition 50 is a \$3.4 billion resources bond measure approved by the voters in November 2002. The measure provides funds for various water-related programs, and allocates the majority of the funds to coastal protection and the CALFED Bay-Delta Program. The budget includes about \$1.1 billion in expenditures from Proposition 50 in 2003-04, leaving a little less than \$2 billion for projects and programs in future years. Figure 25 shows the breakdown of these expenditures by programmatic area.

The \$1.1 billion expenditure amount for 2003-04 would have been slightly higher had the Governor not vetoed AB 1748 that appropriated \$32.4 million from Proposition 50 to fund river parkways and acquisitions in the Sierra Nevada Cascade region.

- **CALFED Bay-Delta Program.** The CALFED Bay-Delta Program is a consortium of 24 state and federal agencies created to address a

Figure 25
Proposition 50 Bond Expenditures

2003-04
(In Millions)

Program Area	Budgeted Expenditures
Wildlife Conservation Board—acquisitions, development, restoration	\$388.2
CALFED Bay-Delta Program	349.3
Safe drinking water grants and loans	102.1
Integrated regional water management grants	91.2
State conservancies—acquisition, development, restoration	47.4
Water quality improvement	47.2
Desalination and other contaminant removal projects	36.9
Coastal water quality protection and restoration	25.4
Colorado river canal lining	19.0
Water security	10.3
Overall administration and coordination	2.0
Total	\$1,118.8

number of interrelated water problems in the state’s Bay-Delta region. The budget provides a total of about \$552 million from various state and federal funds for the CALFED Bay-Delta Program in 2003-04. This amount reflects an increase of about \$21 million in state funds for CALFED from estimated 2002-03 expenditures. Proposition 50 bond funds are by far the largest source of support for the program, providing about \$349 million of the program’s funding in 2003-04. The General Fund provides \$18 million of the program’s support.

- **Local Flood Control Subventions.** The budget does not include any funding for local flood control subventions in 2003-04. The budget, however, does include expenditures of \$116 million for local flood control subventions for 2002-03.
- **Emergency Fire Suppression.** The budget provides \$70 million from the General Fund to the CDFFP for emergency fire suppression.
- **Office of Environmental Health Hazard Assessment (OEHHA).** The budget provides about \$14.7 million from various funds (including reimbursements) for support of OEHHA, a slight decrease from estimated 2002-03 expenditures. However, the budget reflects a funding shift of about \$2.4 million for several activities, including

risk assessment and scientific review, from the General Fund to either reimbursements from other California Environmental Protection Agency agencies using OEHHA's services or direct appropriations from various special funds.

- ***Pesticide Regulation.*** The Department of Pesticide Regulation registers, regulates, and enforces pesticide laws in conjunction with the County Agriculture Commissioners (CACs). The department was instructed through Chapter 523, Statutes of 2001 (AB 780, Thomson), to prepare a budget for 2003-04 that provided long-term stable funding for both state and local activities. The enacted budget provides approximately \$44.2 million in state operations and \$14.6 million in local assistance to the CACs for 2003-04, mainly from a variety of fees. However, as discussed below, a funding gap will arise beginning in 2004-05 unless corrective action is taken.

The enacted budget approves the Governor's proposals to increase, through COLAs, license, exam, and registration fees, in order to fully cover the cost of administering these respective program activities.

The enacted budget also reflects a change in the mill assessment on the sale of pesticides—the funding source for a majority of the department's activities and assistance to the CACs—but at a level different than proposed by the Governor. The Governor's proposal, which intended to eliminate the department's General Fund support, gave flexibility to the department to set a mill rate beginning July 1, 2003 that would cover the cost of the department's programs, not to exceed 27 mills (\$0.027 per dollar of pesticide sales). However, legislation enacted subsequent to the budget act sets a fixed mill assessment of 17.5 mills until December 31, 2003, and up to 21 mills thereafter. In order to fill what would otherwise be a funding gap in 2003-04 due to the approved mill rate, the budget includes a \$5 million General Fund backfill and anticipates use of \$2.5 million of special fund reserves. These backfills are one-time in nature and therefore leave a projected budget gap of approximately \$7.5 million in 2004-05.

Energy and Telecommunications Expenditures

- ***California Energy Commission (CEC).*** The budget includes \$318 million from special funds for support of the CEC in 2003-04, a 10 percent increase from 2002-03. The increase is mainly due to the receipt of \$30 million from the proceeds of a California Consumer Power and Conservation Financing Authority bond sale to be used

to make loans to local public entities for energy efficiency projects. The increase also reflects augmentations of \$1.6 million for energy demand data collection and analysis and \$6 million from the Renewable Resources Trust Fund to provide incentives to biomass facilities that use agricultural waste.

The budget totals for CEC also include about \$17 million for the power plant siting program, most of the funding for which will come from utility ratepayers. The budget includes the enactment of a new fee on power plant developers that, when fully operational in 2004-05, is intended to provide roughly 50 percent of the funding for the siting program. However, only \$615,000 is expected to be collected from this new fee in 2003-04.

- **California Public Utilities Commission.** The budget includes \$1.3 billion from special funds for support of the California Public Utilities Commission in 2003-04. This is an 11 percent reduction from estimated 2002-03 expenditures. This reduction is largely due to projected declines in the utilization of services provided by several telecommunications programs. The budget also includes \$8 million to continue retaining legal expertise related to Pacific Gas and Electric's bankruptcy, which reached a settlement agreement in June 2003.
- **California Energy Resources Scheduling Program.** The budget includes \$55 million from the DWR's Electric Power Fund for the administration of the California Energy Resources Scheduling (CERS) program within DWR. This program was established in early 2001 to purchase electricity on behalf of the state's three largest utilities. While the CERS program no longer purchases electricity, it continues to be financially responsible for managing a multi-billion portfolio of electricity contracts and overseeing the repayment of over \$11 billion of ratepayer-supported revenue bonds.

CAPITAL OUTLAY

The budget package includes \$2.2 billion for capital outlay (excluding highways and transit), as shown in Figure 26 (see next page). About 93 percent of total funding is from bonds (either general obligation or lease-revenue bonds).

State Capital Outlay. Some of the major state capital outlay projects and programs funded in the budget package include:

Figure 26
2003-04 Capital Outlay Programs
By Funding Source

(In Thousands)

Department	Bonds	General	Special	Federal	Total
Legislative, Judicial, and Executive					
Emergency Services	—	\$235	—	—	\$235
Board of Equalization	—	134	—	—	134
State and Consumer Affairs					
General Services	\$219,278	—	—	—	\$219,278
Business, Transportation and Housing					
Transportation	—	—	\$200	—	\$200
Highway Patrol	—	—	3,089	—	3,089
Motor Vehicles	—	—	19,563	—	19,563
Resources					
Conservation Corps	\$36,216	—	—	—	\$36,216
Tahoe Conservancy	8,517	—	\$483	—	9,000
Forestry and Fire Protection	33,221	\$491	—	—	33,712
Fish and Game	664	—	1,205	\$1,230	3,099
Wildlife Conservation Board	66,620	—	500	—	67,120
Boating and Waterways	—	—	8,659	—	8,659
Coastal Conservancy	69,387	—	5,700	2,000	77,087
Parks and Recreation	83,187	—	54,636	3,700	141,523
Santa Monica Mountains	21,500	—	77	—	21,577
San Gabriel/Lower Los Angeles Rivers and Mountains	16,900	—	—	—	16,900
Baldwin Hills	7,200	—	—	—	7,200
Coachella Valley Mountains	8,000	—	—	—	8,000
Water Resources	—	3,646	—	—	3,646
Health and Human Services					
Developmental Services	\$63,319	—	—	—	\$63,319
Mental Health	60,297	\$325	—	—	60,622
Youth and Adult Corrections					
Corrections	\$285,838	—	—	—	\$285,838
Youth Authority	—	\$2,750	—	—	2,750
Education					
Department of Education	\$5,600	—	—	—	\$5,600
University of California ^a	323,745	—	—	—	323,745
California State University	199,736	—	—	—	199,736
Community Colleges	531,914	—	—	—	531,914
General Government					
Food and Agriculture	\$10,961	—	—	—	\$10,961
Military	—	\$14,674	—	\$18,146	32,820
Veterans Home	—	399	—	—	399
Unallocated	—	1,000	—	—	1,000
Totals	\$2,052,070	\$23,654	\$94,112	\$25,076	\$2,194,912

^a Includes Hastings College of the Law.

Resources

- **California Conservation Corps**—\$36.2 million from bond funds for the relocation and replacement of two Conservation Corps centers.
- **Department of Forestry and Fire Protection**—\$33.2 million from bond funds for the design and construction of 19 major capital outlay projects.
- **Department of Parks and Recreation**—\$24.1 million from the Proposition 12 (March 2000) bond measure, \$58.6 million from the Proposition 40 (March 2002) bond measure, and \$54.6 million from special funds for 48 capital outlay projects.
- **Coastal Conservancy**—\$31.5 million from Proposition 50 (November 2002), \$32 million from Proposition 40, and \$5.9 million from Proposition 12 for various coastal conservation and restoration projects.
- **Wildlife Conservation Board**—\$67 million from bond funds including \$32.5 million for the Colorado River Acquisition, Protection and Restoration Program; \$21 million for the Habitat Conservation Fund; \$8.5 million for San Joaquin River Conservancy; and \$5 million for preservation of oak woodlands.

Higher Education

- **California Community Colleges**—\$532 million from bond funds for 100 projects at 67 campuses and 11 off-campus centers.
- **California State University**—\$200 million from bond funds for 11 projects at ten campuses.
- **University of California**—\$324 million from bond funds for 40 projects at ten campuses.

Other

- **Department of General Services**—\$216.3 million from bond funds to renovate a state office building and the central heating and cooling plant in downtown Sacramento.
- **Department of Developmental Services**—\$63.3 million from bond funds to construct a 96-bed residential facility and a recreation facility for forensic clients at the Porterville Developmental Center.

- **Department of Corrections**—\$220 million from lease-revenue bonds to construct a new condemned inmate housing complex on the grounds of the existing San Quentin State Prison.
- **Department of the Military**—\$14.6 million from the General Fund and \$18.1 million from federal funds for the construction of two new armories and one electrical infrastructure project.

STATE ADMINISTRATION

Employee Compensation and Retirement

The budget assumes \$1.1 billion (\$585 million General Fund) in reduced state employee compensation costs. This is equivalent to about a 10 percent decrease in employee salaries. These savings would come from a combination of renegotiated contracts with employee unions and/or the elimination of up to 16,000 positions. As described in Figure 27, the Legislature has approved 14 new agreements which are expected to result in \$185 million (\$67 million General Fund) in savings in 2003-04.

In addition, the budget does not provide funding for departments to pay annual retirement costs to the Public Employees' Retirement System. Instead, the budget package authorizes the issuance of \$1.9 billion in pension obligation bonds to pay the state's contributions (General Fund and special funds) in 2003-04. These bonds would be paid off over five years. (A recent Superior Court decision ruled that the state cannot sell these bonds without voter approval.)

Figure 27

Major Provisions of Recently Approved State Employee Contracts

- ✓ The Legislature has approved administration-negotiated agreements for 14 of the state's 21 bargaining units to defer scheduled July 1, 2003 salary increases, in exchange for additional benefits. (The largest group which has not come to a new agreement is bargaining unit 6 which represents corrections employees.)
- ✓ In particular, the administration agreed to (1) pay 80 percent of health insurance costs effective January 1, 2004, (2) allow employees to accrue one additional vacation day per month (approximately equivalent to the deferred 5 percent salary increase for most employees), and (3) in some cases, continue the suspension of employees' retirement contributions to maintain take-home pay at current levels.
- ✓ The Department of Personnel Administration estimates that these provisions will generate net savings of \$185 million (\$67 million General Fund) in 2003-04.

The budget also reduces a payment to the State Teachers' Retirement System supplemental benefit program by \$500 million on a one-time basis. This program protects retirees' benefits from the effects of inflation. Budget-related legislation provides that the funds will be repaid if they are necessary to maintain retirees' benefits.

The budget provides \$660 million from the General Fund for the state portion of retirees' health and dental insurance premiums. This is an \$84 million (15 percent) increase over 2002-03 spending, due largely to premium increases for health insurance. Although these costs are initially paid entirely from the General Fund, the state recovers a portion of these costs (about 33 percent) from special funds through pro rata charges.

Statewide Issues

Workers' Compensation. The budget shifts the costs for administering the workers' compensation system to an assessment on workers' compensation insurance policies (or claims paid by self-insured employers). Historically, the assessment has provided 20 percent of the funding for the system, with the General Fund providing the remaining funding. This change results in General Fund savings of \$60 million in 2003-04 and more than \$80 million in subsequent years. The budget also saves \$23 million by shifting General Fund costs for the uninsured employers and subsequent injury programs to assessments. In addition, the budget assumes \$50 million (\$30 million General Fund) in savings from reduced state employees' workers' compensation claims due to recently enacted workers' compensation reform legislation.

Enhanced Budget Powers for Administration. The budget and related legislation give new powers to the administration to reduce and alter appropriations during the 2003-04 year. A revised deficiency (Control Section 27.00) process allows the administration to transfer monies between funds to avoid budget deficiencies. In those cases where deficiencies remain, the process establishes new procedures for legislative review. In addition, budget legislation gives the administration broad authority to make changes to a department's budget in order "to ensure the integrity of the 2003-04 budget."

State Contracting. The budget assumes \$100 million (\$50 million General Fund) in savings from reduced state contract costs. The budget and related legislation give the Department of General Services new powers to achieve these savings.

Department Issues

Technology, Trade, and Commerce Agency. The budget eliminates the Technology, Trade, and Commerce Agency effective January 1, 2004. The elimination of the agency and many of its programs will save \$38 million in General Fund spending in comparison to 2002-03 funding. Among those programs for which funding is eliminated are Film California First, which subsidizes film production costs, and the state's 12 foreign trade offices. Several programs will be retained and transferred to other offices in state government:

- The Infrastructure Bank, Small Business Loan Guarantee Program; Manufacturing Technology Program, the state's tourism activities; and the Film Commission's permitting activities will be moved to the Business, Transportation and Housing Agency.
- The Military Base Reuse and Retention Program and the Enterprise Zone Program will be moved to the Department of Housing and Community Development.
- The Replacement of Underground Storage Tanks Program will be moved to the SWRCB.

Housing. The budget retains most funding for the state's housing programs. The plan provides \$40 million in savings by switching the funding source for housing projects from the General Fund to Proposition 46 housing bond funds. This action would not affect scheduled bond allocations until at least 2006-07.

Data Centers. Budget legislation requires the development of a plan to consolidate the Health and Human Services Agency Data Center with the Stephen P. Teale Data Center by July 1, 2004. This action is expected to begin generating savings in 2004-05.

Arts Council. The budget reduces General Fund spending for the Arts Council to \$1 million. The department received \$20 million in 2002-03.

LOCAL GOVERNMENT

Vehicle License Fee (VLF) Increase

The VLF Increases and the Backfill Ends. As a component of the budget solution, the budget agreement incorporates an increase in the VLF and the elimination of related General Fund backfill payments to local governments. The budget assumes an increase in the VLF from the prior rate

of 0.65 percent to 2 percent beginning October 1, 2003. As a component of the VLF reductions that were enacted in 1998, current law provides that the state backfill the difference between the lower VLF rate and the 2 percent rate, unless the state has “insufficient moneys” with which to make such payments. (This provision holds local governments harmless for any changes in the VLF rate.)

In June 2003, the Department of Finance made a determination that the state had insufficient moneys to provide any backfill to local governments, and as a result of this determination, the backfill ended in June 2003 (except for certain payments, see below) and the VLF returned to the 2 percent level in October 2003. This action will reduce General Fund expenditures during 2003-04 by an estimated \$4.2 billion.

Local Government VLF Losses. During the period between the cessation of the General Fund backfill and the subsequent increase in the VLF rate, local governments received only revenues generated by the 0.65 percent VLF rate (with no General Fund backfill). The loss in local government revenue due to the lag time between the elimination of the backfill and the increase in the VLF is estimated to be approximately \$834 million in 2003-04. In addition, local governments experienced a reduction in 2002-03 revenues during the month of June of approximately \$128 million. Thus, the total amount of local government revenue losses during the gap period is estimated to be \$962 million. The revenue loss is to be considered a “loan” to the state General Fund by local governments, with the budget agreement specifying that the loan will be repaid by August 2006. It is unclear, however, whether the loan provision applies only to the \$834 million or the entire \$962 million shortfall.

Local Government Hardship Cases. As part of the budget agreement, \$40 million has been set aside for local governments that would experience fiscal hardship because of the loss of VLF funds during the gap period. Hardship circumstances could include: (1) a pledge of VLF revenues for debt service on outstanding securities, (2) reliance on the VLF for more than 37 percent of general revenue, and (3) a newly incorporated city entitled to VLF allocations. The determination of hardship is to be made by the Department of Finance.

Due to the special circumstances relating to the issuance of Orange County’s financial recovery bonds and the state’s prior commitment regarding the county’s VLF payments, the Controller has made backfill payments of approximately \$25 million to Orange County through September 2003.

Any payments made to local governments under the hardship provisions—including payments to Orange County—would reduce the amount of the local government loan to the state.

Realignment Programs Will Be Made Whole. Currently, approximately one-quarter of VLF revenue is earmarked for the support of programs realigned to local governments in the early 1990s. The remaining revenue (referred to as “base VLF”) is sent to local governments as general purpose funds. Under the budget plan, the percentage of revenues restricted to realignment programs will increase during 2003-04 such that the realignment programs will be held harmless due to the revenue reduction during the gap period. As a result of this shift, city and county general purpose revenues will bear the entire revenue reduction generated by the gap period.

Sales and Property Tax Swap—the “Triple Flip”

A key feature of the 2003-04 budget package was the method devised to finance the deficit financing bonds. The state enacted a three-step approach—commonly referred to as the triple flip—that provides a dedicated funding source for the deficit bonds.

- Beginning in 2004-05, the budget package temporarily redirects a share of the local sales tax (one-half of 1 percent) to the state to use to repay the deficit reduction bonds.
- The budget package completely offsets those local sales tax losses (almost \$2.5 billion in 2004-05) by redirecting to cities and counties a commensurate amount of property taxes from the Educational Revenue Augmentation Fund (ERAF).
- Increased state education apportionments, in turn, will replace K-14 district revenue losses associated with the redirection of ERAF monies.

The retirement of the bonds is dependent on revenues received by the state, but is expected to occur over roughly five years. The swap of sales taxes for property taxes ends after the deficit financing bonds are repaid.

Mandates (Noneducation)

Similar to last year’s budget, the 2003-04 budget package does not include funding to reimburse local governments for state-mandated local programs. We estimate that these deferred reimbursements total over

\$1 billion, including \$700 million for deficient prior-year mandate claims, \$144 million for newly identified mandates, and about \$200 million for local governments to implement ongoing mandates in 2003-04. Chapter 228 declares the Legislature's intent to postpone payment of these mandate claims again in the 2004-05 budget.

The 2003-04 budget includes provisions that suspend local government obligations to implement 37 mandates during the fiscal year and eliminate the associated state fiscal liability for these mandates in the current year. While the Legislature has suspended many of these mandates annually for over a decade, 17 mandates were suspended for the first time in the 2003-04 budget plan. These 17 "newly suspended" mandates include provisions of state law requiring local agencies to report information relating to local investment policies and "Megan's Law," as well as requirements extending the time animal adoption agencies must hold stray animals prior to euthanasia.

Redevelopment

In his January budget plan, the Governor proposed shifting to K-14 school and community college districts about \$250 million of redevelopment agency property taxes in 2003-04—and increasing the amount of this property tax shift significantly over time. State education expenses for K-14 districts would decrease on a dollar-for-dollar basis.

Instead of enacting the administration's ongoing property tax shift, the budget package shifts, on a one-time basis, \$135 million of property taxes from redevelopment agencies to schools. This tax shift equates to roughly a 6 percent reduction in redevelopment agency property tax revenues in 2003-04.

Other

As discussed elsewhere in this report, the budget package reduces state support for a variety of local and state-local programs including: local streets and roads as a result of the partial suspension of Proposition 42 (\$187 million); local public libraries (\$15.8 million); and local law enforcement under COPS (\$16.3 million), Juvenile Justice Challenge (\$16.3 million), and High Technology (\$18.5 million) grant programs. The budget also establishes a 25 percent county share for the child support federal automation penalty (\$52.1 million).