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LAO
60 YEARS OF SERVICE

2004-05: Overview of the Governor's Budget

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On January 9, the Governor released his proposed plan for addressing the state's large budget problem. The Governor proposes an approach that relies on substantial spending cuts; a large shift of property taxes from local governments; as well as additional borrowing, deferrals, and fund shifts. Also, while raising certain fees, the proposal avoids new taxes. The Legislature faces a formidable challenge in evaluating the many important policy issues the plan raises. These include the appropriate mix between borrowing, spending reductions, and revenue augmentations; the viability of certain proposed solutions; and its multiyear approach to eliminating the projected out-year structural budget problem.

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OUR "BOTTOM LINE"

The basic budget problem currently facing the state involves an ongoing projected structural imbalance between current-law expenditures and revenues of roughly $15 billion annually. The Governor's 2004-05 budget proposal seeks to address this problem in 2004-05 largely through a combination of major and wide-ranging spending reductions, additional borrowing, and a diversion of local property taxes for the benefit of the state. It casts a wide net in terms of its proposed cuts, includes significant fee increases in higher education and other areas, and does not impose tax increases. Finally, the budget proposal is self-described as a "workout plan" and acknowledges that it does not fully address the structural budget problem.

LAO Assessment. The proposal has several positive attributes, including realistic revenue and caseload assumptions, as well as real and ongoing solutions from most areas of the budget. As such, we believe that it provides a solid starting point for budget deliberations. At the same time, however, it presents the Legislature with numerous policy issues and concerns. For example, its reductions would have far-reaching consequences for the scope of state services in a variety of program areas. Some of its proposals lack detail or have savings estimates that may not be achievable. And, even with the serious spending reductions it proposes in 2004-05, the plan does not fully address the state's ongoing budget problem—leaving a roughly $6 billion shortfall between expenditures and revenues in 2005-06. This means that further cuts, more borrowing, revenue increases, or other solutions beyond those included in 2004-05 would be needed to achieve budgetary balance in the out years.

In view of these factors, it will be necessary for the Legislature to "look beyond" this proposal and consider other options—including additional savings proposals and revenue increases—if it wishes to fully resolve the state's chronic budget crisis.

TOTAL STATE SPENDING

The budget proposes total state spending in 2004-05 of $97.2 billion (excluding expenditures of federal funds and bond funds). This represents a decrease of 0.2 percent from the current year. General Fund spending is projected to fall from $78 billion to $76.1 billion while special funds spending rises from $19.4 billion to $21.1 billion.

GENERAL FUND CONDITION

Figure 1 (see next page) shows the General Fund's condition from 2002-03 through 2004-05 under the budget's assumptions and proposals.

Prior Year

In a very significant positive development, the 2002-03 budget's condition has improved by about $2.2 billion since the 2003-04 budget was enacted last summer. This improvement means that the state needs about $2 billion less in savings and/or other budgetary solutions to keep in balance in 2004-05.

About one-half of the improvement relates to recent increases in prior-year revenue accruals made by the Controller, based on information from the state's tax agencies for 2002-03 and earlier years. Another one-fourth of the improvement is related to lower estimates of the amount of expenditures that were encumbered at the close of 2002-03, while the remainder is from reduced estimates of actual expenditures during the prior year.

As a result of this improvement, the new budget proposes that the amount of deficit bond proceeds used to offset the accumulated budget deficit through 2002-03 be reduced. Specifically, the amount of bond proceeds has been lowered from the earlier $10.7 billion figure to $9.2 billion—a $1.5 billion reduction. (This reduction is significant because the unused bond proceeds will be available to offset budgetary shortfalls in the current fiscal year.) The Governor is proposing that the remainder of the $2.2 billion budgetary improvement be used to increase the year-end 2002-03 budget reserve—from zero at the time the 2003-04 budget was enacted to $679 million. Thus, the state was able to start the current fiscal year in a stronger position than previously anticipated.

Figure 1

Governor's Budget
General Fund Condition

(Dollars in Millions)

			Proposed for 2004-05	
	2002-03	2003-04	Amount	Change
Prior-year fund balance	-$1,474	$1,607	$1,219	
Revenues and transfers	71,322	74,627	76,407	2.4%
Bond proceeds	9,242	3,012	—	
Total resources available	($79,090)	($79,247)	($77,626)	
Expenditures	$77,482	$75,016	$79,074	5.4%
Deficit Recovery Fund transfer	—	3,012	-3,012	
Total expenditures	($77,482)	($78,028)	($76,062)	-2.5%
Ending fund balance	$1,607	$1,219	$1,563	
Encumbrances	$929	$929	$929	
Reserve	**$679**	**$290**	**$635**	

Current and Budget Years

Under the budget plan, the large projected budget shortfall for the budget year would be eliminated and 2004-05 would conclude with a small reserve. Specifically:

- *Revenues* are projected to grow from $74.6 billion in the current year to $76.4 billion in 2004-05, an increase of 2.4 percent. As discussed below, the revenue totals in both the current year and budget year are affected by numerous policy actions associated with prior budgets as well as with the new proposal.

- *Expenditures* are projected to decline from $78 billion in 2003-04 to $76.1 billion in 2004-05. As shown in the figure, the current-year spending totals have been increased by the proposed transfer of $3 billion in bond proceeds to a new "deficit recovery" special fund. These bond monies are then proposed to offset General Fund spending in 2004-05.

- The reserve at the end of 2004-05 is projected to be about $635 million.

HOW THE PLAN ADDRESSES THE BUDGET SHORTFALL

The budget proposal addresses the shortfall through about $16 billion in budgetary solutions. It incorporates most of the mid-year savings reductions proposed in late November by the Governor, and includes major new savings proposals in 2004-05. As shown in Figure 2, 45 percent of the total solutions is related to program reductions/savings. The remaining 55 percent is related to the use of the proposed economic recovery bonds; other loans and borrowing; a cost shift to local governments; and a variety of other revenues, transfers, and funding shifts.

One-Time Versus Ongoing Savings. Of the $14.4 billion in total savings in 2004-05, we estimate that about $5.3 billion, or 37 percent, is one-time and the remaining $9 billion, or 63 percent, is ongoing in nature, meaning that they will provide budget benefits in future years.

Program Reductions/Savings

The budget includes $7.3 billion in program reductions and related cost savings in the current and budget years combined. These include a $2 billion reduction in Proposition 98 spending and a $950 million reduction in transportation related to suspension of the Proposition 42 transfer (the remaining portion of the $1.1 billion suspension is reflected in the local government category). In addition, the budget includes over $700 million in reductions in higher education, backfilled in large part by student fee increases; a $1.4 billion reduction in social services related to grant reductions, cost-of-living adjustment (COLA) deletions, and elimination of state-only services in In-Home Supportive Services (IHSS); a $1.1 billion reduction in Medi-Cal, primarily related to 10 percent provider rate reductions; and a $400 million unallocated reduction to corrections.

Figure 2

Allocations of Governor's Proposed Budget Solutions

(Dollars in Billions)

	2003-04 And Prior	2004-05	Two-Year Total
Program reductions/savings	$0.8	$6.5	$7.3
Economic Recovery Bond:			
Proceed amounts	-1.4	3.0	1.6
Reduced debt service	—	1.3	1.3
Other—loans/borrowing	1.6	1.0	2.6
Local government-related	—	1.8	1.8
Transfers/other revenues and fund shifts	0.9	0.8	1.6
Totals	**$1.9**	**$14.4**	**$16.2**

Detail may not total due to rounding.

Economic Recovery Bond

This category accounts for about $2.9 billion of total solutions and involves about $1.6 billion in net new borrowing and $1.3 billion in reduced debt-service costs.

As background, the 2003-04 budget assumed that the state would sell the $10.7 billion deficit reduction bond authorized by the Legislature in 2003, and that the proceeds would be used to eliminate the accumulated 2002-03 year-end budget deficit. Repayment of this bond would require annual General Fund expenditures equal to one-half cent of the state sales tax, or about $2.5 billion annually, beginning in 2004-05.

This budget proposes instead to use $12.3 billion in proceeds from the larger, up to $15 billion, economic recovery bond that will be considered by the voters in March 2004. The use of this bond would result in near-term budget-related savings in two ways.

- ***More Bond Proceeds.*** The proposal would use a total of $12.3 billion in proceeds from the Economic Recovery Bond to offset a portion of the budget problem. This $12.3 billion in bond proceeds is $1.6 billion more than the $10.7 billion in proceeds assumed from the smaller bond in the 2003-04 budget. (Any unused balance of the net proceeds in excess of $12.3 billion from the economic recovery bond would be available for use in the future.)

- ***Less Debt-Service Costs.*** Repayment of the proposed bond would involve annual General Fund payments to investors equivalent to one-quarter cent of the sales tax, or about $1.25 billion annually, beginning in 2004-05. Thus, the lower debt service-related expenses compared to those of the other bond produces ongoing near-term savings of about $1.25 billion annually.

Other Loans and Borrowing

This category accounts for $2.6 billion of the budget's overall solutions. It includes about $930 million related to a proposed pension obligation bond sale, $947 million in Proposition 98 "settle up" obligations for 2002-03 and 2003-04 which are being deferred to after 2005-06, an increase in the loan amount to local governments associated with 2003-04 backfill payments, and loans from transportation funds.

Local Government-Related

This category accounts for $1.8 billion of the total solutions. It includes a $1.3 billion property tax shift from local governments to schools, reduced funding for juvenile probation, the elimination of booking fee reimbursements, and a reduction in transportation funding related to the suspension of the Proposition 42 transfer.

Transfers/Other Revenues and Fund Shifts

This category accounts for $1.6 billion of the total solutions. It includes a one-time shift of about $685 million of transportation funds to the General Fund in 2003-04, $350 million in new federal funds, a net of $75 million from a Medi-Cal proposal involving a quality improvement assessment fee on managed care plans, and $55 million in proceeds from a land sale at the University of California (UC) Riverside.

TOTAL GENERAL FUND SPENDING BY PROGRAM AREA

Figure 3 shows General Fund spending by major program area. Total spending under the proposal would fall by 2.5 percent in 2004-05, reflecting decreases in some areas and increases in others. There are numerous one-time factors affecting almost every major program area in the budget. For example, as discussed later:

- ➢ The substantial increase in Medi-Cal spending in 2004-05 reflects the expiration of one-time savings from new federal funds and an accounting change.
- ➢ Similarly, the jump in "other" education spending reflects expiration of one-time savings related to debt service and retirement costs.
- ➢ The increase in vehicle license fee (VLF) subventions reflects a partial one-time deferral in the current year.
- ➢ Finally, the drop in "all other" spending reflects the assumed use of pension obligation bond proceeds in place of state-funded retirement contributions in 2004-05.

After adjusting for these and other such changes, spending on most programs is at or below what would be required to maintain current-service levels in 2004-05.

The Governor's specific spending proposals in individual program areas are discussed in detail later in this brief.

Figure 3

General Fund Spending By Major Program Area

(Dollars in Millions)

	Actual 2002-03	Estimated 2003-04	Proposed for 2004-05	
			Amount	Percent Change
Education Programs				
K-12 Proposition 98	$26,106	$27,846	$27,233	-2.2%
Community Colleges Proposition 98	2,642	2,244	2,414	7.6
UC/CSU	5,874	5,530	5,080	-8.1
Other	3,653	2,660	4,284	61.1
Health and Social Services Programs				
Medi-Cal	$10,554	$9,765	$11,569	18.5%
CalWORKs	2,078	2,060	1,995	-3.1
SSI/SSP	3,004	3,144	3,346	6.4
Other	7,423	7,821	7,689	-1.7
Youth and Adult Corrections	$5,837	$5,326	$5,732	7.6%
Vehicle License Fee Subventions	$3,797	$2,703	$4,062	50.3%
Deficit Recovery Fund Transfer	—	$3,012	-$3,012	—
All Other	$6,512	$5,918	$5,669	-4.2%
Totals	**$77,482**	**$78,028**	**$76,062**	**-2.5%**

THE BUDGET'S ECONOMIC AND REVENUE PROJECTIONS

The Economic Forecast

The budget assumes that the recent strengthening of economic activity will continue for both the nation and state in 2004 and 2005. The U.S. real gross domestic product is projected to grow 4.2 percent in 2004 and 3.6 percent in 2005, reflecting continued growth in consumer spending and accelerating gains in business investment in equipment and software. As shown in Figure 4, both employment and personal income are forecast to accelerate in California over the next year, although the gains will remain moderate by historical standards.

The Revenue Forecast

The administration projects that General Fund revenues will grow from $74.6 billion in 2003-04 to $76.4 billion in 2004-05, a 2.4 percent increase. Both the current-year and budget-year revenue totals are affected by numerous policy-related actions. For example, the current-year total includes the proceeds from the tobacco bond authorized in the 2003-04 budget, as well as numerous loans and transfers from special funds. Likewise, the budget-year estimate includes new receipts from tribal compacts, fees, and pension obligation bonds. Revenues from the state's major taxes are projected to increase by about 6 percent between 2003-04 and 2004-05, consistent with the moderate economic expansion projected through the budget year.

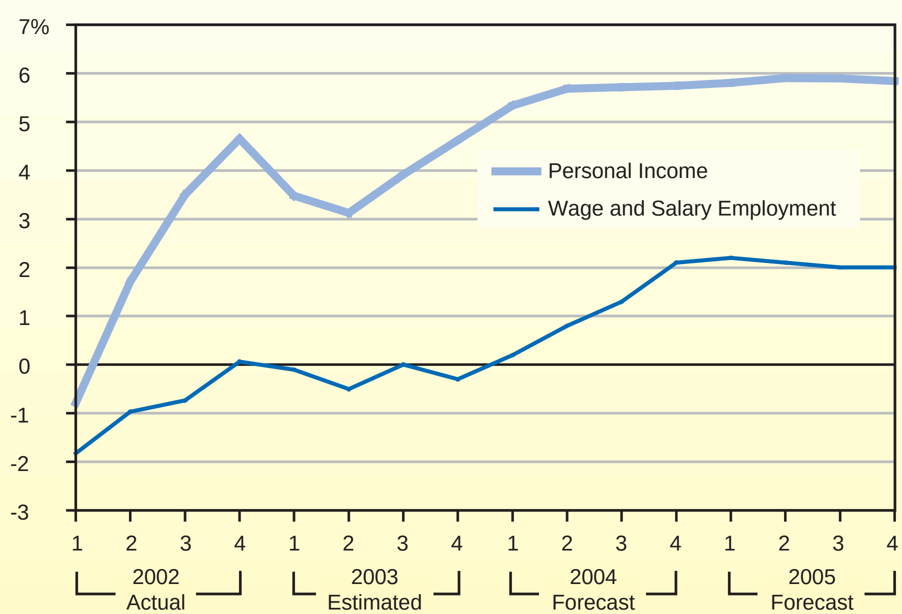
LAO Assessment

The administration's underlying economic and revenue assumptions are similar to those of our November fiscal forecast, and appear reasonable in light of recent economic and revenue developments. While the administration's forecast of total revenues and

Figure 4

Budget Forecasts Accelerating but Still Moderate California Economic Growth

Year-Over-Year Percent Change, by Quarter



transfers exceeds those in our November report, virtually all of the difference is due to policy-related factors—that is, the numerous loans, transfers, and fee proposals included in the budget proposal. The administration's forecast of collections from major taxes—which are devoid of major policy changes—is down from our November projection by just $184 million for 2003-04 and 2004-05 combined, a negligible difference given the large size of the tax bases involved. We will be updating our projections in February to account for updated information on revenue trends and on economic performance at the end of 2003 and start of 2004.

EXPENDITURES BY MAJOR INDIVIDUAL PROGRAM AREA

PROPOSITION 98

Figure 5 summarizes the budget's proposed Proposition 98 allocations for K-12 schools and community colleges. It shows a total of $46.6 billion in 2004-05, an increase of $752 million, or 1.6 percent, over the Governor's current-year estimate. This low growth rate is due to the Governor's proposal to suspend the Proposition 98 minimum guarantee for 2004-05. The Governor's proposed funding level is approximately $2 billion less than would be required under the minimum guarantee, creating a $2 billion maintenance factor that would have to be restored in future years. (See shaded box next page.) Suspension would likely result in annual savings of roughly $2 billion for several years in the future.

Figure 5

Governor's Proposed Proposition 98 Funding

(Dollars in Millions)

	2003-04			Change From 2003-04	
	Budget Act	Mid-Year Revision[a]	2004-05 Proposed	Amount	Percent
K-12 Proposition 98					
State General Fund	$27,645	$27,846	$27,233	-$613	-2.2%
Local property tax revenue	13,609	13,664	14,709	1,046	7.7
Subtotals[b]	$41,254	$41,510	$41,942	$432	1.0%
CCC Proposition 98					
State General Fund	$2,244	$2,244	$2,414	$170	7.6%
Local property tax revenue	2,121	2,115	2,264	150	7.1
Subtotals[b]	$4,365	$4,359	$4,679	$320	7.3%
Total Proposition 98					
State General Fund	$29,889	$30,071	$29,647	-$443	-1.5%
Local property tax revenue	15,730	15,779	16,974	1,195	7.6
Totals[b]	**$45,619**	**$45,868**	**$46,621**	**$752**	**1.6%**

[a] These dollar amounts reflect appropriations made to date, or proposed by the Governor in the current year. In order to meet the minimum guarantee in 2002-03 and 2003-04, the Legislature would need to appropriate an additional $518 million and $429 million, respectively.

[b] Totals may not add due to rounding. Total Proposition 98 amounts also include about $93 million in funding that goes to other state agencies for educational purposes.

The Governor also proposes to fund Proposition 98 below the minimum guarantee in 2002-03 and 2003-04, but does not propose suspension in these years. Thus, for these years, the state would need to appropriate additional resources to settle up to the minimum guarantee. However, the California Constitution does not specify a timeline by which the state must settle up. Under the Governor's proposal, the state would not begin paying the settle-up obligation of $947 million until 2006-07. This effectively creates a $947 million loan from Proposition 98 to the General Fund until that time.

While the Governor's budget proposes to increase total Proposition 98 spending, General Fund spending on Proposition 98 actually falls by $443 million between 2003-04 and 2004-05. This occurs because local property tax (LPT) revenues increase by almost $1.2 billion. The growth in LPT results from a combination of natural growth in school LPT, a proposal to transfer additional property tax revenues from local governments to school districts through the Education Revenue Augmentation Fund (ERAF), and transfers of ERAF revenues from school districts to local governments as part of the

How a Proposition 98 Suspension Would Work

Over the long-run, the Proposition 98 minimum guarantee is determined by the growth in K-12 attendance and growth in per capita personal income (referred to as the long-term Test 2 level). The Constitution allows the Legislature to appropriate less for K-14 education than this long-term Test 2 level under two circumstances: (1) the Legislature suspends the requirements of Proposition 98 or (2) percapita General Fund revenues grow slower than per capita personal income (known as a Test 3 level).

In either of these circumstances, the Constitution requires the state to restore in future years the difference between the actual level of spending and the long-term Test 2 level of spending. This difference is known as the maintenance factor. Generally, maintenance factor is restored during Test 2 years (when the growth of General Fund revenues exceeds growth in personal income). We estimate that under the Governor's proposal, the state would start the budget year with a $2.5 billion maintenance factor obligation. Absent a suspension, $500 million of this amount would have been paid off in 2004-05, leaving a $2 billion factor at the end of the budget year. The Governor proposes to suspend the minimum guarantee in 2004-05, providing $2 billion less than Proposition 98 would require. Consequently, the proposed suspension would increase the year-end maintenance factor obligation to $4 billion.

The Governor's proposal, beginning in 2005-06, would restore the maintenance factor consistent with existing law. Thus, this maintenance factor would take multiple years to restore, and under the most recent LAO forecast would only be partially restored by 2008-09. As a result, the Governor's proposal would likely result in annual savings of $2 billion for a number of years.

"triple flip" payment mechanism for the Economic Recovery Bond on the March 2, 2004 ballot.

K-12 Education

Budget Fully Funds Growth, COLA, and Some Program Expansions. The Governor's budget proposes about $1.9 billion in new K-12 expenditures in 2004-05. Funds for these proposals come from three sources. First, total K-12 Proposition 98 funding is proposed to grow by $432 million in the budget year. Second, the budget proposes over $300 million in specific program reductions. Third, the budget uses $1.1 billion appropriated in the *2003-04 Budget Act* for one-time expenditures as ongoing revenues in 2004-05. The one-time expenditures in the current year reduced the amount of deferred program costs from the level assumed in the *2002-03 Budget Act*. Rather than further reduce the level of deferrals in 2004-05, the Governor's budget proposes to direct these funds to ongoing program expenditures.

The budget proposes to spend the $1.9 billion in available funds as follows:

- $750 million for a COLA (1.84 percent) for revenue limits and most categorical programs.
- $600 million to compensate for a 1 percent growth in the number of K-12 students.
- $500 million for other funding adjustments including (1) categorical program increases such as instructional materials ($188 million) and deferred maintenance ($173 million), and (2) funds to equalize school district revenue limits ($110 million).

$2 Billion in Categorical Funding Transferred to Revenue Limits. The Governor proposes to eliminate $2 billion in funding for 22 categorical programs, and fold those funds into school district (and county office of education) revenue limits. Districts would receive the funds based on the distribution of the categorical funds for those 22 programs in 2003-04—that is, school districts would receive similar amounts of monies as if the programs were still in place. However, the districts would have full discretion over the use of the funds. Accompanying the categorical reform proposal will be trailer bill language requiring greater "sunshine" on the local budget process, and requirements for increased opportunities for community and school site participation in academic and budget decisions. In addition, school districts would be required to present local budgets that fully restore their reserves for economic uncertainty by 2005-06.

Greater District Fiscal Accountability Proposed. The Governor proposes several reforms to ensure greater fiscal stability for school districts. Most significant of these is the requirement that all districts' collective bargaining agreements be subject to a 15-day review and comment period on their budgetary impact prior to school board adoption. The proposal will also include (1) greater specificity for defining fiscal insolvency, (2) guidelines for making multiyear projections, and (3) clearer authority for the Superintendent of Public Instruction to assign the Fiscal Crisis Management Assistant Team to districts in fiscal distress.

Comments, Issues, and Concerns

Suspension Reasonable Given Overall Budget Situation. We believe that the proposed suspension of the Proposition 98 minimum guarantee merits serious legislative consideration. Given the size of the structural deficit and Proposition 98's share of General Fund expenditures (roughly 40 percent), it would be very difficult to close the budget gap without involving Proposition 98. In addition, the Governor's proposed funding level provides sufficient resources to fully fund growth, COLA, and some additional expansion and program restorations. The Legislature may want to consider addressing the $947 million settle-up obligation through either a suspension for those years or other options that do not require additional General Fund expenditures.

Higher Education

UC and CSU

The Governor's budget proposal would reduce General Fund support for UC by $198 million, or 6.9 percent, from the revised 2003-04 level. The California State University's (CSU's) General Fund support would decline by $221 million, or 8.4 percent. Most of these reductions would be backfilled with new revenue from proposed student fee increases of 10 percent to 40 percent. When General Fund support and fee revenue are combined, UC and CSU's funding would decline by 0.3 percent and 2 percent, respectively.

In keeping with legislative intent expressed in the 2003-04 budget package, the Governor's 2004-05 budget proposal includes no funding for enrollment growth at UC and CSU. In fact, the Governor proposes to reduce the enrollment of new freshmen at the two segments by 10 percent, with the foregone enrollment being redirected to community colleges. The budget also would eliminate General Fund support for outreach programs, increase the student-faculty ratio at both segments, restore various one-time reductions from 2003-04, and fund increases in various health benefits and retirement costs.

California Student Aid Commission (CSAC)

General Fund support for CSAC would increase by a total of $53.8 million. The budget proposes to lower by 10 percent the income ceiling for students qualifying for Cal Grants, and would reduce the maximum Cal Grant award for students attending private institutions by about 44 percent. In a departure from recent practice, it would *not* increase the dollar amount of a Cal Grant award for UC and CSU students to accommodate proposed fee increases. At the same time, the budget assumes substantial growth in the *number* of Cal Grant awards.

Health

Key Proposals by Program

Medi-Cal. The Medi-Cal budget proposal for 2004-05 reflects a significant increase in the overall level of General Fund support for the program. The increased cost is primarily due to one-time budgetary solutions (federal funds and accounting changes) in 2003-04 which do not continue into 2004-05.

These additional costs would be partly offset with spending reductions. The Governor's budget proposal reflects the continuation into the budget year of various reductions that were proposed in November (but that have not been enacted to date) for implementation beginning in the current fiscal year. These proposals would reduce the reimbursement rates paid to specified providers, which were already set to decrease by 5 percent, by a total of 15 percent; impose enrollment caps on nonemergency services for recent immigrants and undocumented persons; and eliminate funding earmarked to increase pay for nursing home workers. In addition, reductions proposed in the spending plan to commence in the budget year would reduce Medi-Cal expenditures by delaying payments to providers by one week; establishing a "quality improvement fee" for managed care health plans; and reducing the reimbursements paid to certain clinics and hospitals.

The administration also proposes to pursue a federal waiver to achieve Medi-Cal savings by 2005-06 by simplifying eligibility standards, imposing copayments for services, modifying benefit packages for certain optional populations, expanding managed care plans, and implementing other changes.

Department of Developmental Services. As announced previously, the 2004-05 spending plan drops administration proposals presented in November to cap caseloads for Regional Center community services and to end certain services, such as respite care. About $100 million in savings would be achieved in 2004-05 by establishing copayments for families of persons receiving services, standardizing statewide the program reimbursement rates and services that are provided, and taking other steps.

Other Health Programs. The budget plan continues into 2004-05 a November proposal to cap caseloads and reduce provider rates for various programs starting in 2003-04. In addition to the enrollment limit, Healthy Families Program spending would be changed by making benefits for recent immigrants part of a block grant to counties, and further changed in 2005-06 by modifying the premiums and benefits provided for children of families with higher incomes.

Comments, Issues, and Concerns

The exact magnitude of savings that can be achieved from proposed reductions in Medi-Cal rates is uncertain at this time given recent litigation over similar reductions enacted as part of the 2003-04 budget plan. A preliminary injunction issued by a federal district court in December has blocked, at least for now, the implementation of the first 5 percent reduction in rates that was scheduled to take effect on January 1, 2004. If the litigation prevented any rate reduction from occurring, the state would lose hundreds of millions of dollars in savings. The state is appealing the decision.

Social Services

Key Proposals by Program

IHSS. The budget retains the mid-year proposal to eliminate the "residual" program, which is funded exclusively with state and county dollars. The proposal assumes that 24 percent of residual recipients will switch to providers who are not "responsible relatives," thereby retaining eligibility for the federally funded Personal Care Services Program. Net savings from the elimination of the residual program are estimated to be $366 million.

In addition, the budget limits state participation in provider wages to the minimum wage, rather than the $10.10 per hour level currently authorized. This results in savings of $100 million (including associated administrative savings). Finally, the budget proposes savings of $26 million by reducing services for recipients living with able-bodied relatives.

California Work Opportunity and Responsibility to Kids (CalWORKs). The budget contains savings proposals related to CalWORKs grants and COLAs, as well as several CalWORKs policy changes. As regards grants and COLAs, the budget retains the mid-year proposal to (1) reduce CalWORKs grants by 5 percent effective April 1, 2004, and (2) avoid both the October 2003 and July 2004 COLAs. These proposals result in savings of $135 million in 2003-04 and $407 million in 2004-05.

As regards program policy changes, the Governor proposes (1) a 25 percent grant reduction for cases in sanction status and (2) stricter work requirements. These proposals result in grant savings of $163 million, partially offset by increased childcare costs of $134 million, for a net savings of $29 million. With respect to state childcare programs, the budget proposes several changes including increases in family fees, reductions in payments to providers, modifications to eligibility rules, and an elimination of dedicated funding for childcare for families who have been off of cash assistance for at least three years. For 2004-05, these childcare reforms would result in savings of $42 million in CalWORKs and $123 million in Proposition 98.

Supplemental Security Income/State Supplementary Program. The budget proposes to suspend the January 2005 state COLA resulting in cost avoidance of $85 million. In addition, the budget does not "pass through" the federal January 2005 COLA, resulting in savings of $62 million.

Comments, Issues, and Concerns

Major Reductions to IHSS. The Governor proposes to reduce spending on IHSS by $492 million (35 percent) compared to the requirements of current law. In evaluating the proposed reductions, the Legislature should weigh the budgetary savings against the impact on aged and disabled individuals who will lose services.

Governor's Welfare Reform Proposal. The Governor proposes to achieve higher rates of work participation from stricter work requirements and greater sanctions. In evaluating this proposal, the Legislature should weigh the benefits of increased work participation versus the potential adverse impact on children in families whose parents are unwilling or unable to comply with the new rules.

Judiciary and Criminal Justice

General Fund spending for judiciary and criminal justice programs is proposed to increase $425 million, or 6 percent. This increase reflects the replacement of one-time federal funding ($852 million) with General Fund monies. The budget actually proposes approximately $600 million in reductions to judiciary and corrections programs. However, it does not provide specific details on how most of the savings will be accomplished in 2004-05. Instead, it proposes large unallocated reductions ($400 million in corrections and about $70 million in the courts) as a placeholder for proposals that will be submitted to the Legislature as part of the May Revision. This will result in a significantly compressed timeframe for legislative review, particularly for an unspecified solution of this magnitude.

The budget contains administrative and programmatic proposals focused on improving accountability and service delivery in the California Department of Corrections (CDC) and the Department of the Youth Authority. In the case of CDC, this includes establishing over 1,200 additional positions in the prisons at a cost of nearly $100 million. The budget also proposes to implement information technology projects and internal cost controls in the department. The Youth Authority proposals involve significant policy issues such as changing the age jurisdiction of the department, authorizing the transfer of wards to the adult prison system, and reforming juvenile sentencing. The budget also proposes to change the staffing of ward living units to allow additional time for treatment services. The budget indicates that additional details regarding these proposals will be provided to the Legislature during the spring, thus leaving limited time for legislative review and consideration.

TRANSPORTATION

The budget proposes a number of actions in the area of transportation in order to provide savings to the General Fund.

2003-04 Mid-Year Changes

For the current year, the administration proposes the following actions:

- Shift the funding of local transportation projects from an accrual basis to cash basis in order to realize, for one-time purposes only, approximately $800 million in federal cash reimbursements. Of this amount: (1) $406 million would be transferred to the General Fund for debt-service payments related to three transportation bond issues, (2) $200 million would be loaned to the General Fund, and (3) the remaining $194 million would remain in the State Highway Account (SHA) for transportation expenditures.
- Transfer $189 million from the Traffic Congestion Relief Fund to the General Fund.
- Transfer about $60 million in non-Article XIX (gas tax) SHA funds to the General Fund instead of the Public Transportation Account (PTA).
- Retain in the General Fund $30 million in additional "spillover" gasoline sales tax revenue that otherwise would accrue to the PTA.

Budget-Year Adjustments

For 2004-05, the budget proposes to:

- Suspend the Proposition 42 transfer to the Transportation Investment Fund of about $1.1 billion in gasoline sales tax revenue. Instead, the revenue would remain in the General Fund. Specific statutory authority for Traffic Congestion Relief projects would also be removed.
- Transfer about $47 million in non-Article XIX (gas tax) SHA funds to the General Fund instead of the PTA.
- Transfer $745,000 from the Aeronautics Account to the General Fund.

In total, the budget's transportation proposals would provide about $2.1 billion to the General Fund over the two years.

Comments, Issues, and Concerns

The budget proposals to use transportation funds to help the General Fund would significantly reduce funding available for transportation-related improvements. The proposals raise a number of issues both in the short and the long term, related to the funding of the state's transportation programs, including the following:

- ***Uncertain Transportation Funding Hinders State and Local Project Delivery.*** If adopted, the administration's proposal to suspend Proposition 42 would be the second suspension (in full or in part) in the first two years of this program, thereby creating uncertainty regarding future Proposition 42 transfers when the state faces a budgetary crisis. Such uncertainty makes long-term planning difficult, and money will be wasted in stopping and restarting projects, many of which are local priorities. Furthermore, shifting local transportation funding to a cash basis reduces local governments' ability to deliver projects. Any future fluctuations in the availability or timing of funding could cause temporary shortfalls in available funds and result in project delays.

- ***One-Time Benefit Creates Ongoing Bureaucracy.*** Shifting local transportation funding to a cash basis will require Caltrans to project the future cash needs of thousands of local projects annually to ensure that their cash needs in any one year do not outstrip available funding. Caltrans does not currently possess this capacity, and it is still unknown what additional resources Caltrans will need to make these projections on an ongoing basis.

Resources

The budget proposes substantially lower state expenditures for resources and environmental protection programs in 2004-05, mainly in bond-funded programs. Although the budget proposes some relatively small reductions in General Fund expenditures—reflecting a combination of program reductions and funding shifts to fees—the major feature of the Governor's resources budget proposal relates to the use of bond funds.

Bond Plan Incomplete. The budget proposes expenditures of $136 million from bond funds in 2004-05. This represents a reduction of $3.9 billion, or 97 percent, from estimated expenditures in the current year. In recent years, bond funds have provided the majority of funding for resources programs. The administration has indicated that the January budget proposal for resources bonds is substantially incomplete and that it will submit the balance of the Governor's proposal in the spring. The Governor's budget summary document, however, indicates that the Governor's resources bond expenditure priorities include implementation of the CALFED Bay-Delta program, Lake Tahoe environmental protection, and state park facility improvements. In the interim, the administration plans to evaluate opportunities to reorganize and streamline the implementation of resources conservation efforts receiving bond funds.

General Government

Retirement-Related Proposals

The administration is proposing major changes in the retirement area for state employees, with an estimated General Fund benefit of $950 million in 2004-05.

Modified Pension Obligation Bond. The administration proposes replacing the current-year $1.9 billion pension obligation bond assumed in the 2003-04 budget with a bond of one-half that amount. The new bond would cover a portion of the state's 2004-05 retirement contribution obligations, for a General Fund benefit of $929 million. A recent Superior Court decision ruled that the state cannot sell these types of bonds without voter approval, but the state has appealed the decision.

Increased Employee Contributions. The Governor proposes increasing the percentage of salary that state employees contribute to retirement. The budget assumes $14 million in General Fund savings from increasing employee contributions by 1 percent. This would require renegotiating contracts with the state's collective bargaining units.

Reduced Retirement Benefits for New Employees. The administration proposes rolling back retirement benefits for new employees to those in place prior to the enactment of Chapter 555, Statutes of 1999 (SB 400, Ortiz). This would generate long-term savings as more employees are hired, but only an estimated $6 million in General Fund savings in 2004-05.

Indian Gaming Revenue

The state has signed compacts with 64 Indian tribes related to gaming on tribal lands. Currently, pursuant to these compacts, tribes contribute over $100 million annually to state accounts. These funds are then allocated to nongaming tribes and various other purposes. The administration proposes to have compact tribes additionally contribute $500 million in revenues to the General Fund in 2004-05. This revenue proposal depends on the state successfully negotiating such a payment with the tribes.

Comments, Issues, and Concerns

Viability of Proposals. The administration's major proposals in the general government area of the budget (retirement and Indian gaming revenues) are similar to those included in the 2003-04 budget. The courts thus far have prevented the state from issuing pension bonds, and the prior administration was unable to generate any significant revenues from negotiating for increased tribal gaming revenues. As such, the viability of obtaining the $1.4 billion in budget solutions proposed in these areas should be seriously questioned by the Legislature.

Local Government

VLF Backfill. The budget provides funding for General Fund backfill payments to cover the full reduction in the VLF. The cost of the backfill is $2.7 billion in 2003-04 (with an additional $1.3 billion payable to local governments in 2006), and $4.1 billion in 2004-05.

Property Tax Shift. The budget includes a $1.3 billion shift of local government property taxes to the ERAF. This $1.3 billion shift equates to a roughly 25 percent increase in ERAF obligations, or a decrease in local government property taxes of about 10 percent. These increased ERAF property taxes reduce state K-14 spending obligations by a commensurate amount.

Mandate Reimbursement Deferred. Finally, consistent with legislative intent expressed in the *2003-04 Budget Act*, the budget defers reimbursement to counties, cities, and special districts for state mandates. Under current law, local agencies must carry out state-mandated requirements, regardless of delays in state reimbursement. By the end of the budget year, we estimate the state will owe local agencies (mostly counties and cities) over $1 billion for deferred mandate reimbursements.

Other Local Government Proposals. In addition to the ERAF shift, the budget proposes more than $400 million of other changes that reduce local government funds or increase local costs. These proposals include: reducing funding for juvenile probation ($134 million), suspending the Proposition 42 General Fund transfer for local transportation programs ($179 million), and eliminating booking fee subventions ($38 million).

CONSIDERATIONS FOR THE LEGISLATURE

We believe that the budget has many positive features. Its underlying revenue and caseload assumptions are reasonable, it provides an accurate depiction of the size of the problem facing California, and many of its solutions would provide real and lasting savings. Given the magnitude of the problem, we also believe that it is appropriate that the administration looked to all expenditure areas of the budget for solutions. As such, the proposal offers a solid starting point for budget deliberations.

At the same time, however, the budget poses serious questions and concerns for the Legislature in several areas. For example, as touched on earlier in this brief:

Some Budget Savings May Not Be Realized. The amount of savings scored for various budget proposals may not be fully achievable due to legal and other factors. Examples include the $400 million in corrections savings, the $500 million in tribal gaming revenues, the over $900 million in savings from pension obligation bonds, and potentially hundreds of millions of dollars in Medi-Cal savings from provider rate reductions.

Does the Budget Push Too Much Off Into the Future? One of the main features of recent budgets is that they have not meaningfully addressed the ongoing structural budget shortfall that has confronted the state since 2001-02. While this budget does contain large amounts of real and ongoing savings, it still leaves a significant amount of the structural problem for future years. Our initial projections—based on our November economic and revenue assumptions—suggest the Governor's plan would leave the state with a budget shortfall of roughly $6 billion in 2005-06, *even if* all of the savings and other solution assumptions in the plan were fully realized. Furthermore, the unaddressed budget shortfall would be even larger if some or all of the risky assumptions noted above fail to materialize. We will be revising our estimate next month of the out-year structural problem under the proposal to reflect updated economic, revenue, and expenditure assumptions. However, regardless of the precise estimate, the issue for the Legislature is how the projected multibillion-dollar out-year problem should be dealt with and whether it should be more completely addressed at this time.

Should Additional Revenues Be Considered? There are several reasons to ask this question. One involves the large magnitude and potentially far-reaching effects of the proposed budget reductions on state programs. A second is the multibillion-dollar ongoing budget shortfall that would still remain unresolved even under the Governor's plan, and that would have to be dealt with through more borrowing or further spending cuts if additional revenues are "left off the table." We believe the Legislature should consider whether solutions involving taxes—such as the elimination of selected tax expenditures or increased tax rates—should be part of the 2004-05 budget plan. Even if limited tax increases have certain negative effects on the economy, these consequences should be weighed against the negative consequences of the alternatives, including deeper cuts in public spending in infrastructure, education, and other areas, or more borrowing.

What About Budgetary Reforms? The Governor has stressed his intent to undertake a broad-based comprehensive review and restructuring of state operations that will improve efficiency and produce fiscal benefits. While the budget plan does include some examples in these areas, such as an outline of future reforms in the Medi-Cal area, many of the ideas are not very well developed at this point. In fairness, the administration has only been in office for three months. However, if significant fiscal benefits in these areas are to be achieved, it will be important for the administration to translate its ideas into specific proposals which can be considered in a timely fashion by the Legislature.

Timely and Decisive Action Is Needed. Finally, as was the case last year, we believe that it is important that the Legislature act early and decisively to address the budget shortfall, and that it seek to maximize the amount of ongoing solutions to the budget problem. Otherwise, the state will both forego the full potential benefits that different solutions have to offer, and will face renewed budget shortfalls in subsequent years.