THE 2002-03 BUDGET: PERSPECTIVES AND ISSUES

Report from the Legislative Analyst's Office to the Joint Legislative Budget Committee

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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2002-03 Budget Bill* and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 2002-03 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2002-03 Budget Bill,* which contains our review of the *2002-03 Governor's Budget*.

The *Analysis* continues to report the results of our detailed examination of state programs and activities. In contrast, this document presents a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the Legislature.

The 2002-03 Budget: Perspectives and Issues is divided into five parts:

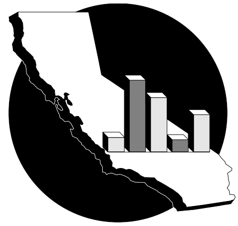
- Part I, "State Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part II, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part III, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues.

- Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2002-03 and evaluates the major expenditure proposals in the budget.
- Part V, "Major Issues Facing the Legislature," provides analyses of: (1) how the administration uses borrowing to address the state's budget shortfall, (2) how the state's various energy-related agencies might be reorganized, (3) the extent to which CalWORKs recipients are meeting the requirement to participate in employment and training programs, and (4) the vehicle license fee (VLF) and issues related to the state's "backfill" of VLF reductions to local governments.

I

State Fiscal Picture

State Fiscal Picture



For the first time since the early 1990s, the state is experiencing a substantial budget shortfall. Its primary cause is two-fold—a moderate economic downturn and an accompanying sharp drop-off in taxable income from stock options and capital gains. In this challenging environment, the Legislature faces the difficult task of developing a budget plan that both preserves funding for its highest priorities but also addresses the large projected deficit.

In this part, we summarize the Governor's 2002-03 budget proposal and present our own perspective on the budget outlook. We then discuss key decisions and additional options that the Legislature may wish to consider in addressing the state's projected budget shortfall, both as alternatives to the Governor's proposals and as additional actions that will be needed if the more negative budget outlook we are forecasting emerges.

OVERVIEW OF THE GOVERNOR'S BUDGET

Total State Spending

The 2002-03 Governor's budget proposes total state spending of $97.9 billion (excluding expenditures of federal funds and selected bond funds). This represents a slight decrease of about $400 million, or 0.4 percent, from the current year. About 80 percent of proposed total spending is from the General Fund, while the remainder is from special funds.

General Fund Condition

Under the Governor's budget proposal, the General Fund would end both the current and budget years in balance. Specifically, Figure 1 shows that:

- In the current year, revenues are estimated to be $77.1 billion, expenditures are estimated to be $78.4 billion, and the year is expected to end with a small reserve of $12 million.
- In 2002-03, the budget projects that General Fund revenues will total $79.3 billion, an increase of about $2.2 billion (2.9 percent) from the current year. Expenditures are estimated to be $78.8 billion, a $426 million (0.5 percent) increase from the current year. Under the budget proposal, 2002-03 would end with a modest budgetary reserve of $511 million.

Figure 1

Governor's Budget General Fund Condition

(Dollars in Millions)

			2002-03	
	2000-01	2001-02	Amount	Percent Change
Prior-year fund balance	$9,408	$2,783	$1,486	
Revenues and transfers[a]	71,428	77,083	79,305	2.9%
Total resources available	$80,836	$79,865	$80,790	
Expenditures	78,053	78,380	78,806	0.5%
Ending fund balance	$2,783	$1,486	$1,984	
Encumbrances	1,473	1,473	1,473	
Reserve	$1,310	$12	$511	

[a] Reflects $6.2 billion General Fund loan to Electric Power Fund in 2000-01 with repayment in 2001-02.

Detail may not total due to rounding.

How the Budget Addresses the Shortfall

The budget identifies a cumulative shortfall of $12.5 billion as of year-end 2002-03, consisting of a current-year year-end deficit of $3 billion, a budget-year imbalance between expenditures and revenues of about $9 billion, and a rebuilding of the reserve to $511 million. (The administration's shortfall amount is similar in overall magnitude to the $12.4 billion estimate included in our November 2001 fiscal outlook report, although the components of the shortfall are somewhat different.) The budget proposes to close the $12.5 billion funding gap through a variety of actions, which are summarized in Figure 2 (see next page). These include:

- ***Spending Reductions ($5.2 Billion).*** The January budget assumes implementation of the mostly current-year reductions that the Governor proposed in November 2001. These reductions were largely enacted by the Legislature in late January. The budget plan also contains an additional $2.7 billion in budget-year reductions, including suspensions of cost-of-living adjustments (COLAs) in various social services programs, reduced inflationary adjustments for higher education, and various other program reductions.

- ***Funding Shifts ($586 Million).*** These include shifts of capital outlay support from the General Fund to lease-payment bonds and various spending shifts from the General Fund to special funds.

- ***Federal Funding Increases ($1.1 Billion)***. The budget assumes additional federal funds to offset state costs for Medi-Cal, undocumented felon incarceration, and security activities. It also assumes elimination of federal child support penalties.

- ***Revenue Accelerations, Spending Deferrals, Loans, and Transfers ($5.6 Billion).*** About $2.4 billion of this total would come from the Governor's tobacco securitization proposal, whereby the state would sell investors a revenue bond whose debt service payments are backed by future tobacco settlement receipts. These settlement receipts are currently earmarked for a variety of recently adopted health expansions. Also included in this category are payment deferrals to the Public Employees' Retirement System and State Teachers' Retirement System, a loan from the Traffic Congestion Relief Fund, and various other special fund loans and transfers.

Economic and Revenue Assumptions

The budget forecast assumes the consensus view that the U.S. and California economies will emerge from the current recession in spring 2002. The administration assumes that income from capital gains and stock options declined in 2001 by about 47 percent from their peak level of just under $200 billion in 2000, and will remain basically flat in 2002.

Based on these assumptions, the budget forecasts that total revenues will grow from $71.4 billion in 2000-01, to $77.1 billion in 2001-02, and to $79.3 billion in 2002-03. These figures are affected by a variety of policy related factors, including the budget's treatment of the electricity loans and the tobacco securitization proposal. Excluding these factors, underlying revenues are projected to decline by 10.5 percent in 2001-02, before partially rebounding by 8.5 percent in 2002-03.

Figure 2

How the Governor "Bridges the Gap"

(In Millions)

	Amount
Major Spending Reductions	**$5,226**
November Revision reductions	2,449
Budget-year reductions	2,677
Reserve for litigation	100
Fund Shifts	**$586**
Shifts proposed in November Revision	152
Other shifts	434
Federal Funding Increases	**$1,066**
Federal share for Medi-Cal	400
Security/bioterrorism funding	350
Child support system penalty relief	181
Undocumented felon incarceration	50
All others	85
Loans/Accelerations/Transfers	**$5,624**
Securitization of tobacco settlement funds	2,400
Loan from Traffic Congestion Relief Fund	672
Loans from various other special funds	579
STRS payment deferral/benefit improvement	508
PERS payment deferral/benefit improvement	371
All others	1,094
Total	**$12,502**

KEY FEATURES OF THE GOVERNOR'S EXPENDITURE PLAN

Total Spending by Program Area

Figure 3 shows the proposed distribution of General Fund spending in 2002-03 by major program area. It indicates that:

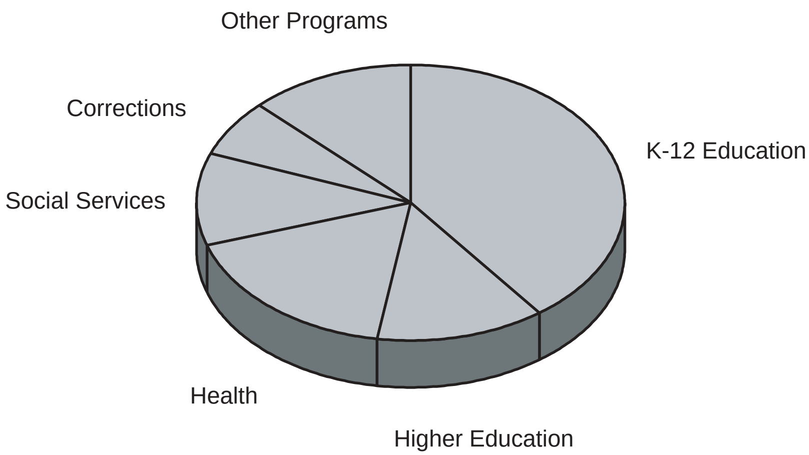
- About 53 percent of the total is allocated to education, including 40 percent for K-12 and 13 percent for higher education (mainly the University of California, California State Universities, and California Community Colleges).

- About 29 percent is for programs related to health and social services, including Medi-Cal, the Supplemental Security Income/State Supplementary Program, and the California Work Opportunity and Responsibility to Kids program.
- Another 7 percent is for youth and adult corrections.
- The remaining 12 percent includes funding for general government and local tax relief (including the backfill to local governments for recently enacted reductions to the vehicle license fee).

Figure 3

How General Fund Spending Is Distributed

2002-03



Programmatic Features

The budget's main programmatic features are summarized in Figure 4 (see next page). In general, while the budget contains a variety of current-year and budget-year reductions, it maintains most of the core programs. The budget funds K-12 education at the minimum guarantee level, providing for a modest 2 percent increase in per-pupil funding relative to the current year. In other areas, the budget funds enrollments and caseloads. It does not change major subventions for local governments. Finally, it reduces or eliminates COLAs in most non-Proposition 98 areas of the budget.

Figure 4

Key Programmatic Features of the Governor's Budget

✓ **K-12 Education**
- Funds Proposition 98 at minimum guarantee level.
- Provides funding to cover enrollment and general cost-of-living adjustment (COLA) for general apportionments and most categorical programs.
- Includes reforms related to state-assisted child care.

✓ **Higher Education**
- All three segments receive funding to cover enrollment increases.
- Community colleges receive additional funding for 2.15 percent COLA, while UC and CSU receive funding for 1.5 percent general increase.

✓ **Health and Social Services**
- Funds caseload for most core programs.
- Medi-Cal includes savings from cuts in certain provider rates and reforms involving drug purchases.
- Statutory and discretionary COLAs suspended for social services programs.

✓ **Local Governments**
- Does not change major local government subventions.
- Existing criminal justice grant programs are continued.

The LAO's Budget Outlook

In this section, we examine the implications of the Governor's proposal on the near-term and longer-term General Fund condition, using our own estimates of revenues and expenditures that would occur under the Governor's proposal. Our estimates *do not* reflect any of the policy recommendations that we make in our *Analysis of the Budget Bill*. The causes for our differences from the administration's projected General Fund condition are limited to (1) contrasting assumptions about the economic and revenue outlook and (2) estimation differences relating to the level of expenditures that would occur under the Governor's budget plan. The latter includes assumptions about the Proposition 98 minimum funding guarantee, the level of caseloads and school enrollments, and other factors affecting state program costs. We provide these estimates to give the

Legislature an indication of the magnitude of additional spending and revenue adjustments that will likely be needed to address the budget shortfall.

Treatment of Federal Funds and Electricity Loans. To help facilitate a direct comparison between the administration's and our own estimates, we have assumed in making our projections that the state receives the entire $1.1 billion in new federal funds assumed in the budget. Our projections also reflect the budget's treatment of the electricity loan in 2000-01 and its assumed repayment in 2001-02.

With these assumptions in mind, our key budget-related findings are highlighted in Figure 5, while the implications of our revenue and expenditure estimates for the General Fund's condition are shown in Figure 6 (see next page).

Figure 5

Key LAO Budget Findings

✓ **Additional Budget Solutions Totaling $5 Billion Needed**

- Revenues down by $3.9 billion in current and budget years combined.
- Expenditures up by about $1.1 billion during current and budget years combined.
- Loss of anticipated federal funds would add to problem.

✓ **Ongoing Budgetary Imbalance Would Persist**

- Annual operating shortfall in range of $7 billion in 2003-04 and 2004-05.

✓ **Need to Evaluate Tradeoffs Involved in Budget Solutions**

- Impact on programs.
- Impact on state's future fiscal condition.

Additional Solutions of $5 Billion Likely Needed

Based on our projections of revenues and expenditures, adoption of the Governor's spending policies would result in a year-end deficit of about $4.5 billion in 2002-03. This represents a $5 billion deterioration in the budget condition relative to the administration's estimate, which assumes a $511 million reserve. About three-fourths of this deterioration relates to our lower revenue projections, and about one-fourth relates to our higher expenditure estimates.

Figure 6

The LAO's General Fund Condition Assuming Governor's Policy Proposals

(In Millions)

	2000-01	2001-02	2002-03
Prior-year fund balance	$9,408	$2,783	-$1,401
Revenues and transfers[a]	71,428	74,322	78,213
Total resources available	$80,836	$77,105	$76,812
Expenditures	78,053	78,506	79,804
Ending fund balance	$2,783	-$1,401	-$2,991
Encumbrances	1,473	1,473	1,473
Reserve	$1,310	-$2,874	-$4,465

[a] Reflects $6.2 billion General Fund loan to Electric Power Fund in 2000-01 with repayment in 2001-02.

Detail may not total due to rounding.

Lower Revenues. While we generally agree with the administration's forecast of an economic recovery beginning this spring, we believe that revenues will fall substantially below the administration's revenue forecast. Specifically, based on our estimate of much steeper declines in capital gains and stock options in 2001, as well as recent evidence of much-lower-than-expected cash receipts, we project that revenues will fall below the budget forecast by $2.8 billion in the current year and another $1.1 billion in the budget year—for a two-year shortfall of about $3.9 billion. The detail behind our forecast, and how it differs from the administration's projections, are provided in "Part III" of this document.

Higher Expenditures. We estimate higher expenditures in the current year and budget year combined of $1.1 billion. Most of this is due to our higher estimate of the General Fund portion of the Proposition 98 minimum guarantee, which exceeds the budget forecast by $825 million in 2002-03.

Additional Risks Exist Related to Federal Funds Shortfalls

As indicated above, we have incorporated the Governor's budget assumptions regarding the amount of new federal funds that the state will receive in 2002-03. However, while we believe that the state will receive some additional funds, the actual amount is likely to be considerably less than the full $1.1 billion. For example, while the Governor's budget assumes a $50 million increase in federal funding to reimburse

California for its costs of incarcerating undocumented felons, the President's new federal budget contains no funds for this program.

Impact On General Fund Could Vary. The implications of federal funding shortfalls for the state's General Fund condition will depend on where the shortfalls occur. Specifically:

- ***Areas With Direct Impacts.*** About $700 million of the $1.1 billion in new federal funds assumed in the budget is in the areas of health, social services, and corrections (see Figure 2 earlier). If shortfalls occur in this broad category, these would directly result in added General Fund costs and thereby hurt the bottom line. This is because the budget explicitly assumes that federal funding in these areas will be available to offset General Fund expenditures that would otherwise occur.

- ***Areas Without Direct Impacts.*** The remaining $350 million of the $1.1 billion in new federal funds relates to antiterrorism activities. If shortfalls were to occur in this category, there would not be a direct cost impact on the General Fund. This is because about $164 million of antiterrorism federal funds is appropriated through special funds (mostly the Motor Vehicle Account) to support increased California Highway Patrol costs). The remaining $186 million is not appropriated in the budget proposal.

Budget Shortfall Would Persist in Future

The $5 billion shortfall for 2002-03 that we have identified in the Governor's budget plan is of particular concern in light of the fact that we also estimate that expenditures would continue to exceed revenues in the future. As we indicated in our November fiscal forecast, the state currently faces a large, ongoing underlying operating deficit (that is, expenditures in excess of revenues). Since the budget relies primarily on one-time solutions, a large underlying operating shortfall—which we estimate would be in the range of $7 billion in both 2003-04 and 2004-05—would persist. This means that the state would face the risk of another large cumulative budget shortfall in 2003-04.

CONSIDERATIONS FOR THE LEGISLATURE

The Governor and Legislature have acted early and taken important first steps toward addressing the current large budget shortfall. Our estimates suggest, however, that the state still has a long way to go to reach a balanced budget in 2002-03. Thus, in addition to evaluating Governor's proposals in terms of how they compare to its own priorities, the Legislature will face the challenging task of working with the administration to find *additional* solutions in order to bring the budget into balance.

To assist the Legislature in finding such additional solutions, our office has released, along with this document and our annual *Analysis of the Budget Bill*, a compendium of budget options. These options, in total, would save several billion dollars in 2002-03. The specific options provide savings from caseload reductions, funding shifts, improved efficiencies, service reductions, federal tax conformity, and elimination or reduction of tax expenditures.

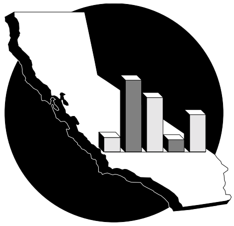
Out-Year Implications Are Important

Given the out-year imbalances that we project under the Governor's plan, it will be important that the Legislature keep in mind the longer-term implications of the various budget solutions it considers. For example, a mix of one-time and multi-year solutions should be considered which, at a minimum, does not exacerbate the budget's underlying imbalance between revenues and expenditures. Otherwise, the state will likely face a formidable budget shortfall again in 2003-04.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics



Economic and demographic trends will have important effects on California's 2002-03 budget outlook. For example, the strength of California's economy is an important factor determining the level of revenues collected from the state's major taxes. Similarly, both economic and demographic variables affect state government expenditure programs, including those relating to education, health and social services, and youth and adult corrections.

In this part, we review recent economic developments for the nation and state, discuss the Governor's economic forecast, and present our own perspective on California's economic outlook. We also discuss current demographic developments and highlight our population projections through 2004.

THE ECONOMIC OUTLOOK

Our Bottom Line. The U.S. and California economies are nearly one year into a recession that was initially caused by such factors as sharp declines in spending by businesses on capital goods, and then aggravated by the September 11 terrorist attacks. The downturn has been mild so far in terms of employment, although more severe in terms of income losses. Our forecast is that the recession will conclude in the next couple of months and that a sustained expansion will begin before mid-year. While employment will recoup its losses by the end of 2002, the decline in income related to stock options will be longer lasting. Our outlook is predicated on (1) a rebound in high-tech spending in the second half of the year and (2) the absence of significant terrorism-related disruptions to the national or state economies.

2001 IN RETROSPECT

U.S. Economy

After a record-long expansion, the U.S. economy fell into recession in early 2001. The main factors initially behind the downturn were: (1) a drop in business investment, caused partly by a plunge in spending on computers and software following the Y-2K boom; (2) economic slowdowns among our key trading partners, which resulted in a steep decline in exports; and (3) an abrupt cutback in production and employment by manufacturers, made in an effort to keep inventories under control.

The September 11 terrorist attacks aggravated the slowdown, as personal and business travel fell sharply and airlines quickly announced major cutbacks. Other industries affected by the aftermath of September 11 were airline manufacturers (which experienced major reductions and cancellations of aircraft orders) and travel-related businesses (such as convention centers, eating and drinking establishments, and entertainment facilities, all of which suffered from declines in tourism and business travel). While consumer confidence and spending partially recovered in November and December, businesses remained extremely cautious, holding the overall economy in check through the end of the year.

Figure 1 shows the extent to which the recent downturn in the U.S. economy has been business- and globally-driven. Total gross domestic product (GDP) increased a marginal 0.1 percent between the fourth quarter of 2000 and the fourth quarter of 2001, reflecting gains in the first half and moderate declines in the second half of the year. Underneath this overall modest change, however, were sharply diverging trends in different economic components. Specifically:

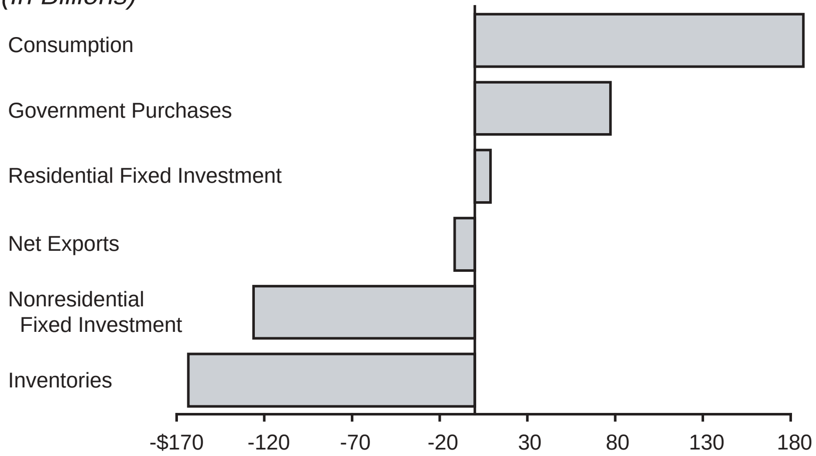
- *Increases* occurred in consumption (which took place despite sharp declines in tourism-related expenditures), residential fixed investment, and government spending. The increases in the first two categories were due to the impact of low interest rates on household expenditures, automobiles, and housing. The growth in government spending was partly due to federal appropriations following the terrorist attacks.

- *Declines* occurred in nonresidential fixed investment, net exports, and inventories. The drop in investment was primarily due to major declines in business spending on computers, networks, software, and telecommunications. The drop in net exports was related to steep declines in sales to Japan, Europe, and Latin America. Finally, the decline in inventories resulted from sharp cutbacks in manufacturing production in response to evidence of softening demand.

Figure 1

Recent Areas of Strength and Weakness In the U.S. Economy

Change in Components of Real GDP Fourth Quarter 2000 Through Fourth Quarter 2001 (In Billions)



While the liquidation of inventories depressed real GDP in 2001, the reduced supplies of finished goods is a positive factor in the near-term outlook. The depletion of inventories implies that manufacturers will need to step up production quickly in order to fill new orders once that spending starts to increase.

California's Economy

The California economy faced enormous challenges in 2001. These included the high-tech slowdown, declines in stock market-related wealth and income, soaring energy prices, fading exports, and uncertainties early in the year associated with threats of rolling blackouts. As with the nation, California's slowdown was aggravated by the September 11 terrorist attacks, which led to major layoffs in the air transportation and other travel-related industries within the state.

In view of all of the challenges facing the state last year, job losses in California can be considered reasonably modest. Even after taking into account recent downward revisions to historical data, job losses in this state have been proportionally smaller than for the nation as a whole.

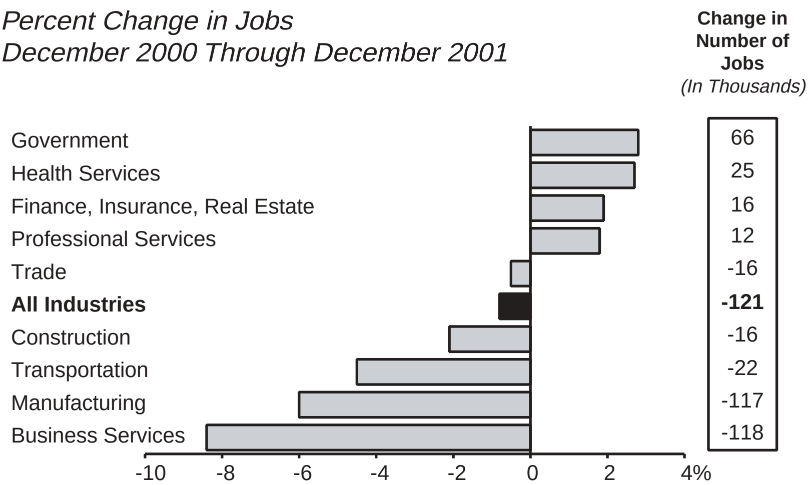
Slowdown Concentrated in Manufacturing And Business Services

Figure 2 shows how key California employment sectors were affected by the economic downturn in 2001. Clearly, the losses were concentrated in business services and manufacturing. The losses in these two sectors were predominately related to the slump in high-tech activities, although other forces, such as inventory cutbacks and weak exports, also had an impact. Losses also occurred in the transportation industry—reflecting the post-September 11 layoffs of airline employees—as well as in the trade and construction industries. The figure also shows that several industries experienced growth last year, including government, health services, professional services, and finance.

Figure 2

California's Job-Gaining and Job-Losing Industries in 2001

Percent Change in Jobs December 2000 Through December 2001

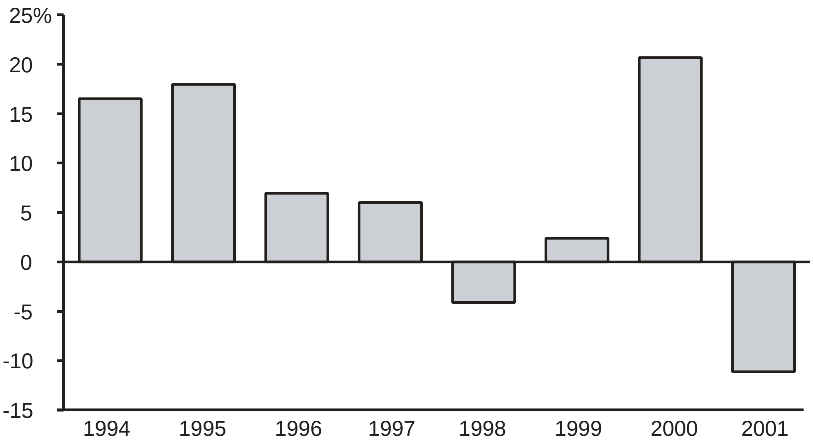


Exports Fell Sharply. As noted above, a significant factor in the downturn in manufacturing has been a sharp decline in exports. This decline stems from global weakness in economic activity, particularly in Asia and Latin America. Figure 3 shows that, after jumping 20 percent in 2000, total exports of California-produced goods fell by an estimated 11 percent for all of 2001, and by more than 20 percent in the second half of the year. The decline was concentrated in the computer and electronics sectors, which account for over one half of total California exports.

Figure 3

California Exports From Boom to Bust in 2001

Percent Change in California-Produced Exports



It is likely that exports will remain flat in 2002 before growing in 2003. The outlook could be even weaker, however, if the expected rebounds in foreign countries fail to materialize. A special concern involves Japan. It is California's second leading export market, remains mired in recession, and its currency (the yen) continues to lose value in international currency markets. This reduction in its currency value makes U.S. goods more expensive in Japan's markets. Japan's problems are also having indirect impacts on the economic strength of other California trading partners in Asia, to the extent that many developing countries in the region rely on exports to Japan as a key source of economic growth.

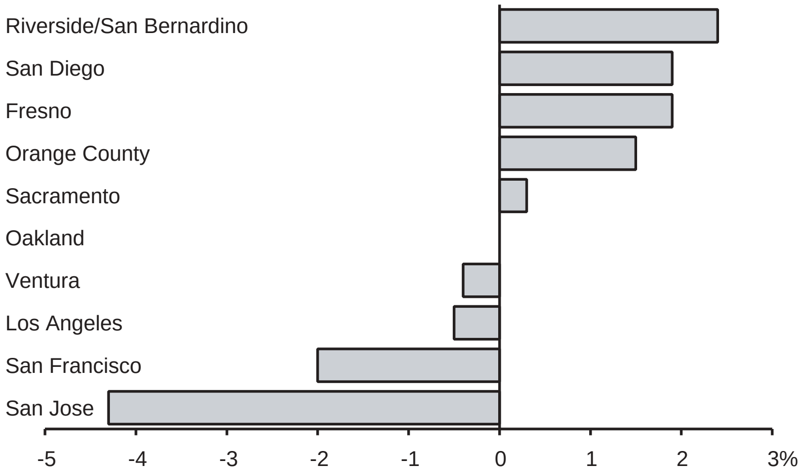
Regional Impact of Downturn

In marked contrast to the early 1990s' recession—which was centered in Southern California—the current downturn is being felt most intensely in the Bay Area. Figure 4 (see next page) shows that most major metropolitan regions within Southern California experienced modest job growth in 2001. The major exception was Los Angeles, where employment fell by 0.5 percent last year, due to declines in manufacturing, wholesale trade, and motion picture production. Modest job gains also occurred in the Fresno and Sacramento metropolitan regions in the Central Valley. In contrast, significant job losses occurred in the San Jose and San Francisco metro-

Figure 4

Current Recession Centered in Bay Area

Percent Change in Jobs
December 2000 Through December 2001



politan areas, reflecting major declines in manufacturing and business services, and moderate declines in a wide variety of other industry sectors.

Recent Positive Signs

In the opening months of 2002, there have been some positive signs that the U.S. and California economies are stabilizing. These include reported increases in consumer and business confidence, increased air-passenger loads, declines in new unemployment insurance claims, and increases in hotel occupancy rates. One key positive factor, particularly for California, has been the recent decline in inflation. After accelerating in 2000 and early 2001, price indices for key commodities (such as gasoline, natural gas, food, clothing, and rents) stabilized and in some cases declined in the latter half of the year. Falling prices have the positive effect of making household discretionary incomes and business margins less depressed than they otherwise would be in the current recessionary environment.

Budget's Outlook in Brief

The Governor's budget forecast assumes that both the U.S. and California economies will stabilize in the first quarter of 2002 and then begin a sustained moderate expansion in the spring. As shown in Figure 5, real GDP is projected to increase 0.5 percent in 2002 and 4.4 percent in 2003. The administration also projects that the recent slowdown in inflation will continue in 2002 and 2003. For example, the U.S. Consumer Price Index is forecast to increase by only 1.8 percent in 2002 and 2.2 percent in 2003.

Figure 5

Summary of the Budget's Economic Outlook

		Forecast	
	2001	**2002**	**2003**
U.S. Forecast			
Percent change in:			
Real GDP	1.1%	0.5%	4.4%
Personal income	5.0	2.6	5.6
Wage and salary employment	0.3	-0.5	1.1
Consumer Price Index	2.9	1.8	2.2
Unemployment rate (%)	4.8	6.2	5.7
Housing starts (000)	1,590	1,570	1,510
California Forecast			
Percent change in:			
Personal income	1.4%	2.6%	7.5%
Wage and salary employment	1.8	0.3	2.4
Taxable sales	-2.0	0.8	7.5
Consumer Price Index	4.1	1.7	1.8
Unemployment rate (%)	5.2	6.2	5.9
New housing permits (000)	142	145	149

Regarding California, the administration forecasts that wage and salary employment will increase a marginal 0.3 percent in 2002, before accelerating to 2.4 percent in 2003. It also projects that personal income will accelerate from 1.4 percent in 2001, to 2.6 percent in 2002, and 7.5 percent in 2003.

LAO'S ECONOMIC OUTLOOK

In general terms, our updated forecast is similar to both our November projection and the administration's January budget forecast. We continue to believe that California's mild recession will give way to a moderate recovery beginning in spring 2002. The key uncertainty remains

Figure 6

Summary of the LAO's Economic Outlook

		Forecast		
	2001	**2002**	**2003**	**2004**
U.S. Forecast				
Percent change in:				
Real GDP	1.1%	0.5%	3.8%	3.8%
Personal income	4.8	2.1	5.4	5.7
Wage and salary employment	0.4	-0.4	1.3	1.8
Consumer Price Index	3.1	2.0	2.4	2.6
Unemployment rate (%)	4.8	6.2	5.9	5.3
Housing starts (000)	1,600	1,550	1,530	1,580
California Forecast				
Percent change in:				
Personal income	1.2%	2.8%	7.6%	7.8%
Wage and salary employment	1.3	-0.4	2.5	2.6
Taxable sales	-1.9	2.6	7.7	7.3
Consumer Price Index	4.1	2.4	2.2	2.6
Unemployment rate (%)	5.5	6.5	5.7	5.3
New housing permits (000)	147	143	158	161

the strength and timing of the expected revival in business investment spending on information technology goods and services. Our national and state economic forecasts through 2004 are displayed in Figure 6.

National Outlook

Following its 1 percent increase in 2001, we forecast that U.S. real GDP will increase by 0.5 percent in 2002 (reflecting small declines in the first half and accelerating increases in the second half), before rebounding to a 3.8 percent growth rate in both 2003 and 2004. Key forces behind the acceleration include: (1) the stimulative effects of past interest rate cuts by the Federal Reserve; (2) spending increases and tax reductions by the federal government; (3) the recent observed rebound in consumer confidence; and (4) the recent declines in business inventories, which means that new spending will need to be matched by increased manufacturing output.

Economic growth during the early stages of the expansion is likely to be somewhat muted by historical standards. This is partly a reflection of the mild nature of the current recession. Some categories of GDP that are traditionally hard hit during recessions—such as housing and durable goods spending—have held up during this downturn, leaving less "pent up" demand for new products once the expansion begins. A related factor is that, because consumers kept spending through the downturn, they have not "worked off" their debt loads that were built up during the past expansion.

We expect growth to gain some momentum in late 2002 and into 2003 as a result of stepped-up business spending. Increased government outlays for defense and security-related purposes are also likely to provide a boost to GDP in 2003 and beyond.

California Outlook

We forecast that California's economy will stabilize in early 2002 and begin a sustained recovery prior to mid-year. In its early stages, California's rebound will be powered by the same forces as those boosting the national economy—namely, expansionary monetary and fiscal policies, improving consumer confidence, increased travel and tourism, and a restocking of business inventories. The recovery should gain momentum in the second half of the year, as the anticipated rebound in capital spending "kicks in." Regionally, we expect that the recovery will come earlier and be stronger in Southern California than in the Bay Area, but all regions should be growing by 2003.

As indicated in Figure 6, we forecast that California wage and salary employment will fall 0.4 percent in 2002, reflecting weakness in the first half and improving conditions late in the year. Personal income growth is expected to improve from 1.2 percent in 2001, to 2.8 percent in 2002, and 7.6 percent in 2003.

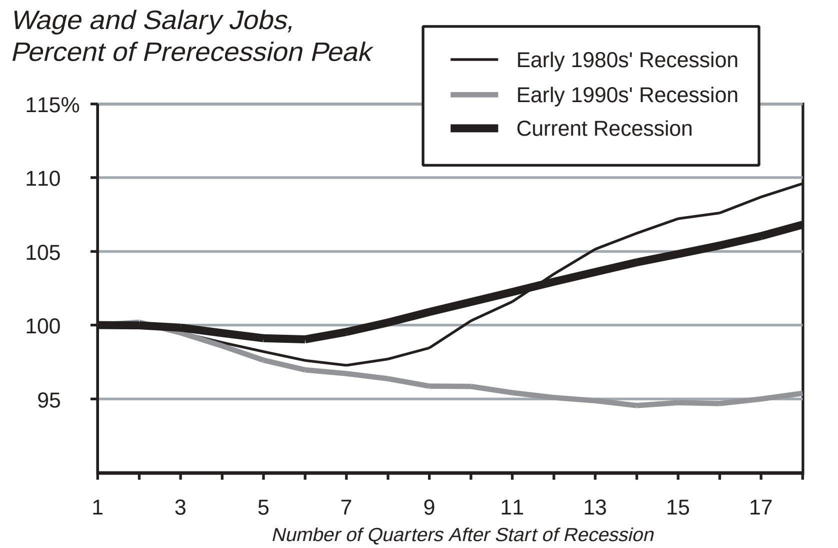
Current Downturn Mild Compared to Previous Recessions

In terms of job losses, the current recession is expected to be much milder and shorter-lived than the other two recessions that California has experienced during the past 20 years. Figure 7 (see next page) contrasts the current downturn to the recessions that occurred in 1981 to 1982 and 1990 to 1993, by showing for each the cumulative four-year percent change in employment that occurred following its pre-recessioeak. It shows that:

- The current recession is expected to have a peak-to-trough decline in jobs of roughly 1 percent (about 145,000 jobs), with the subsequent recovery starting about five quarters following the onset of the recession.
- The early 1980s' recession was slightly longer and the job losses were much more severe than the current recession. As indicated in Figure 7, the peak-to-trough decline was nearly

Figure 7

Current Recession Expected to Be Mild By Historical Standards



3 percent (or 280,000 jobs). However, the recovery from this recession was much stronger than the current projected upturn, as falling interest rates and a major defense buildup led to a surge in jobs and income in the mid-1980s.

- The early 1990s' recession, which was the deepest and most prolonged since the Great Depression, resulted in cumulative job losses totaling 5.5 percent (about 700,000 jobs). Moreover, the recovery did not occur until late 1993. This was nearly three and one-half years after the recession's onset, and even then, job growth was initially very sluggish due to ongoing job losses in the defense, construction, and banking industries.

Thus, in terms of lost jobs and output, the current recession is nowhere near as severe as the previous two downturns.

Employment and Income in the Current Economic Cycle

While this recession has been fairly mild in terms of its impact on California employment, the effects on income have been much more pronounced. As indicated in Figure 8:

Figure 8

Recession's Impacts–Mild Job Losses But Severe Income Declines

Year-Over-Year Percent Change, by Quarter

- Employment is expected to decline about 1 percent between the second quarter of 2001 and the second quarter of 2002, before recovering to an annual growth rate of over 2.5 percent by late 2003.
- Real personal income growth is expected to decline from over 8 percent in early 2000 to a minus 6 percent in early 2002, before returning to positive growth over the balance of the year.

The sharp decline in personal income is primarily due to the dramatic drop in stock options related income, as well as a slump in business profits in 2001 and early 2002. At its peak, we estimate that income from stock options totaled over $80 billion in 2000, representing about 8 percent of total personal income during the year. As a result of the major decline that occurred in stock prices—especially among high-tech companies that had been the major sources of stock options earnings in the past—we estimate that options-related income fell to $21 billion in 2001, a decline of about 75 percent.

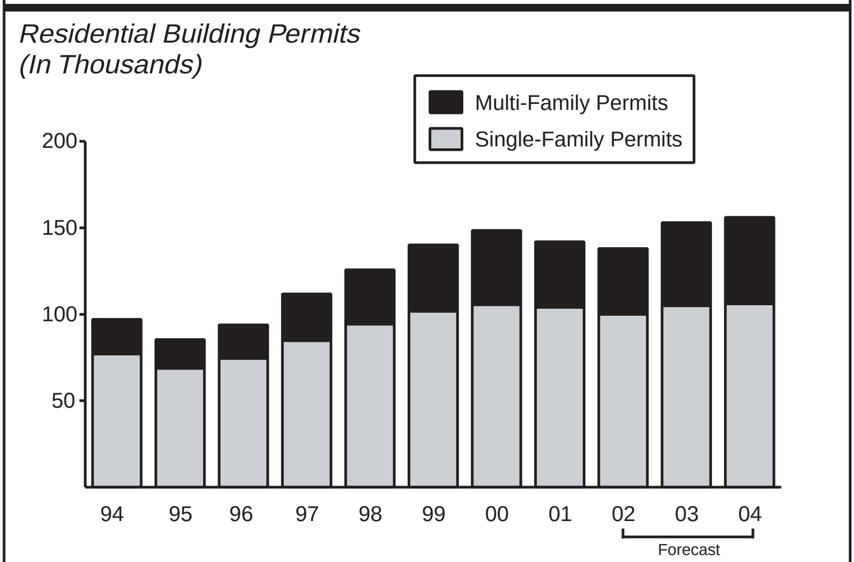
Our forecast assumes that income from stock options will partly rebound in 2002 and 2003, increasing by 15 percent in each of the two years. Even with these increases, however, option-related income would only be $28 billion in 2003, or about one third the 2000 peak. As discussed in "Part III," the decline in options is having major adverse effects on California's revenues in 2001-02 and beyond. (We note in "Part III" that capital gains also fell in 2001. Our discussion in this section is focused on stock options because, under current income accounting methods, options are counted as part of personal income whereas capital gains are not.)

Mild Cycle for Residential Construction

In contrast to the 1980s' and 1990s' recessions, building activity in the 2001 downturn has held up remarkably well. As shown in Figure 9, construction permits are expected to fall slightly from 149,000 in 2000 to 143,000 by 2002, before recovering in 2003. Part of the reason for the mild cycle is simply that housing starts never really "took off" in the 1990s' expansion, as they had in the 1970s' and 1980s' post-recession growth periods. By some estimates, home construction for the past decade has been below the 160,000 to 180,000 units needed to replace existing homes and keep up with California's growing population. The limited amount of new housing has led to low inventories of new homes and excess demand in many regions of the state. This, in turn, has kept home sales and new construction from falling by as much as in past downturns.

Figure 9

Mild Downturn and Recovery Forecast For California Housing



But Steeper Declines in Nonresidential Building

In contrast to residential construction activity, nonresidential building increased sharply in the 1990s' expansion, reaching an all-time high of $19 billion in total real (that is, inflation-adjusted) valuations in 2000. With the onset of the recession, however, businesses put expansion plans on hold and this led to substantial declines in permit activity. As of November, permit valuations had fallen back to an annual rate of $13 billion. Although some of the late 2001 decline may have been related to business uncertainties following September 11, we expect that permits will remain soft until late in 2002, when businesses gain confidence that economic conditions are improving. On an annual basis, we estimate that permit valuations averaged $16.5 billion for all of 2001, a decline of 14 percent from their 2000 peak. We forecast that nonresidential real permit valuations will total $14 billion for all of 2002, before partly rebounding to $16 billion in 2003.

COMPARISONS OF RECENT ECONOMIC FORECASTS

Figure 10 (see next page) compares our forecasts for the nation and California to our November 2001 forecasts as well as a variety of other forecasts made in recent months. These include the projections made by the University of California, Los Angeles (UCLA) Business Forecasting Project in December 2001, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2002), the consensus outlook in the *Western Blue Chip Economic Forecast* (February 2002), and the Governor's budget forecast.

Our overall forecast for both the nation and California is more conservative than the consensus projections cited above. It is similar, however, to both the UCLA and Governor's budget forecasts, which call for a recovery beginning near the middle of 2002. With regard to estimates of specific California economic measures:

- Our forecast of 2002 California *wage and salary employment* is more conservative than all other forecasts listed in Figure 10—including the administration and UCLA. This is partly due to our use of recently revised preliminary employment data for 2001, which indicates that the economic downturn has taken a larger toll on employment in the business services industry than previously thought. Incorporating this information has lowered our estimate of 2001 employment and, thus, the base from which our 2002 projection is made.

- Our forecast assumes that both personal income and taxable sales slowed in late 2001 by more than what other forecasters

Figure 10

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

	2001	2002	2003
United States Real GDP:			
LAO November	1.0%	0.8%	4.0%
UCLA December	1.1	0.4	3.5
DOF January	1.1	0.5	4.4
Blue Chip "Consensus"[b] January	1.0	1.0	3.4
LAO February	1.1	0.5	3.8
California Wage and Salary Jobs:			
LAO November	1.8%	0.4%	2.4%
UCLA December	1.9	0.7	2.2
DOF January	1.8	0.3	2.4
Blue Chip "Consensus"[c] February	1.8	0.6	2.4
LAO February	1.3	-0.4	2.5
California Personal Income:			
LAO November	1.7%	4.2%	7.8%
UCLA December	2.1	1.3	5.6
DOF January	1.4	2.6	7.5
Blue Chip "Consensus" February	3.2	3.0	6.5
LAO February	1.2	2.8	7.6
California Taxable Sales:			
LAO November	-2.0%	3.9%	7.9%
UCLA December	0.3	3.5	5.7
DOF January	-2.0	0.8	7.5
Blue Chip "Consensus" February	1.7	2.9	5.6
LAO February	-1.9	2.6	7.7

a Acronmyms used apply to Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).

b Average forecast of about 50 national firms surveyed in January by *Blue Chip Economic Indicators*.

c Average forecast of organizations surveyed in February by *Western Blue Chip Economic Forecast*.

were assuming. Our growth rates in the current year are generally similar to other projections, but a bit higher than UCLA and the administration. Finally, compared to other recent forecasts, we assume a stronger "snap-back" in both income and sales in 2003.

Risks and Uncertainties

Although economic forecasts are always subject to error, this can be especially true when economies are transitioning into and out of recessions. Even if California's economic recovery emerges in the spring as we expect, for example, its strength could differ from what we are projecting. Among the key risks and uncertainties potentially affecting the recovery's exact timing and strength are:

- ***Timing and Strength of Business Investment Spending***. As indicated above, we forecast that business investment—particularly in high-tech goods and services—will stabilize in the first half and turn upward in the second half of 2002. This is an important assumption for California, given the large amount of California employment, income, and wealth that is tied to this high-paying and dynamic sector. Further declines in information technology spending could delay or weaken the overall recovery projected for this state.

- ***Consumer Confidence and Spending.*** It was noted earlier that consumer spending has held up remarkably well in view of the negative forces affecting the U.S. and California economies. Our forecast assumes that consumer spending will expand in 2002 and 2003, as confidence and perceptions about personal safety continue to rebound from post-September 11 lows. A risk to the forecast is that recent layoffs and corporate restructurings will undercut the expected increase in spending.

- ***Exports.*** As discussed previously, exports fell sharply in 2001, but we expect them to stabilize in 2002 and then expand in 2003. This outlook is contingent on improving global economic conditions, particularly in Japan and other countries in Asia. Further softening abroad could undercut any improvement in California's manufacturing industries, especially if it were coupled with prolonged weakness in U.S. spending on capital goods.

California's Demographic Outlook

California's demographic trends both directly and indirectly affect the state's economy, revenue collections, and expenditure levels. For example, they influence the size of the labor force, the demand for autos and homes, the volume of taxable sales, and the amount of income taxes paid. Similarly, the population and its age distribution affect school enrollments and public programs in many other areas, such as health care and social services. Given this, the state's demographic outlook is a key element in assessing and projecting the state's budgetary situation.

State Population Exceeds 35 Million

Our updated demographic forecast is summarized in Figure 11. We forecast that California's total population will rise from an estimated 35.2 million in 2002, to 35.8 million in 2003, and 36.4 million in 2004. These population levels reflect published 2000 Census data and recent decisions by the federal government involving the issue of adjusting its Census data for demographic undercounts (see discussion that follows). California's current annual growth rate of roughly 1.6 percent is well above the nation's current rate of about 1.2 percent annually.

Census Results and the Undercount

Background. Last year at this time, considerable ongoing controversy was occurring about whether the Census 2000 results should be adjusted for an anticipated undercount and, if so, how this should be accomplished. In the *2001-02 Perspectives and Issues*, we discussed the issue of using statistical sampling to adjust for the undercount, and indicated that by March 2001 we anticipated having adjusted Census 2000 California data available from the U.S. Census Bureau.

Recent Developments. As anticipated, the bureau released California's 2000 Census total population count and basic demographic profile in March of 2001. In addition, it released a preliminary undercount adjustment for the nation as a whole although state-level data adjusted for any undercount were not released at that time. Later in 2001, however, the bureau concluded that there was very little undercount for the nation overall, rescinded its preliminary national undercount adjustment, and decided not to release a revised Census data set. The bureau did acknowledge that differential undercounts were likely to exist in different subgroups of the population, but did nothing to address this issue.

Current Situation. At this time, there are no data available on which to adjust California's published Census data. The Department of Finance, however, has made a Freedom of Information Act request of the bureau to provide the information necessary for the state to develop its own adjustment to California's published 2000 Census data to account for any undercount.

California's Population Has Traditionally Been Undercounted. Although the amount of any undercount of Californians is not currently

Figure 11

Summary of the LAO's California Demographic Forecast

(Population in Thousands)

	2002	2003	2004
Total population (July 1 basis)	35,230	35,785	36,363
Changes in population			
Natural change (births minus deaths)	271	275	278
Net in-migration (in-flows minus out-flows)	310	280	300
Total changes	**581**	**555**	**578**
Percent changes	1.68%	1.58%	1.61%

Census Results and the Undercount *(continued)*

known, it is known that California's demographic characteristics reflect many population subgroups that are traditionally undercounted in census enumerations. For example, California has a diverse population, including the largest Hispanic population in the nation and the fifth largest black population, according to the 2000 Census. Both of these subgroups are traditionally undercounted and had much higher estimated undercount rates in 1990 than other ethnic groups. Likewise, Census undercounts also tend to be higher in states with younger populations, which makes California even more at risk for undercount since California's median age is nearly two years less than the nation's. Similarly, California also has the largest foreign-born population in the nation—over 30 percent—that experts believe also raise the likelihood of an undercount. The state's highly mobile population is yet another reason. Given these factors, it is very likely that the 2000 Census data would much better reflect California's actual population if it was adjusted for an undercount, utilizing whatever unpublished statistically reliable data the bureau has previously developed using sampling and other techniques.

Implications for California. The decision of the bureau to not release 2000 Census data that has been adjusted for an undercount could have significant implications for California. For instance, many grants from the federal government are based on the bureau's estimates; thus, if unadjusted data are used to allocate such monies, California could be placed at a relative disadvantage. In addition, unadjusted data could lead to more inaccurate estimates of the funding levels needed to provide minimum levels of service to California's population. Another problem is that the use of unadjusted data biases the basic information relied on in evaluating infrastructure needs and projecting the state's economy.

Growth Exceeds Half-a-Million People Annually. California is adding over 550,000 people each year—roughly equivalent in size to a city like Long Beach or the entire state of Vermont. About half of this yearly growth is attributable to net in-migration (inflows from minus outflows to other nations and states), while the remainder is due to "natural" increase (that is, births in excess of deaths). Foreign in-migration dominates the net in-migration component, as more than a net quarter-million people enter California from foreign countries annually.

Legislative Analyst's Office Projections Based on Published 2000 Census. In making our projections, we have updated our demographic forecasting model to incorporate the available 2000 Census data for California that was released in March 2001. At this time, the only 2000 Census data available is the "raw" data count, which has not been adjusted for any possible undercount that may have occurred during the Census process. As discussed in the shaded box, the U.S. Census Bureau is not making estimates of the undercount available at this time, and in fact has taken the position that previous estimates of the undercount are not reliable.

Disagreement Exists Regarding Domestic Migration Estimates. The bureau and the Department of Finance (DOF) currently disagree regarding what California's current population is and how much net domestic migration the state is experiencing. For instance, the bureau estimates that there were 34.5 million residents in California as of July 1, 2001, while DOF estimates nearly 34.8 million—a 300 thousand difference. Our current forecast lies between these two extremes.

The main difference between these different total population forecasts involves net domestic migration. The bureau believes that a large domestic *outflow* from California to other states occurred between 2000 and 2001, based on change-of-address data from the Internal Revenue Service (IRS). In contrast, both DOF and we believe that a net domestic population *inflow* into California occurred between 2000 and 2001—with our estimate being 120,000 and DOF's over 140,000. While DOF and we also use change-of-address information in making our estimates, we both rely on data from the driver's license records maintained by the California Department of Motor Vehicles. We believe these data are superior to IRS data for making domestic net-migration calculations. We do, however, believe that DOF's estimate is too high, given that California's domestic migration inflows lessen somewhat when its economy weakens, as was occurring throughout 2001.

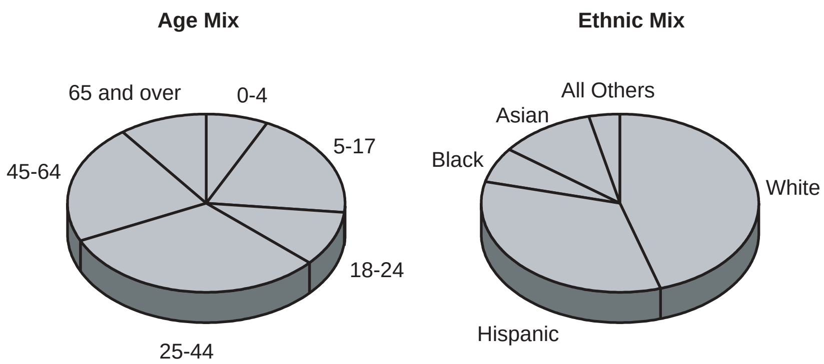
California's Population Characteristics

The implications of population trends for the budget depend not only on the total number of Californians but also on their characteristics. California's population continues to be not only the largest, but also the most diverse, in the nation. For example, the state's population reflects a rich mix of different ethnicities; a large number of people from other nations and states; a broad age distribution; and considerable geographic dispersion amongst urban, suburban, and rural areas. The state's current age and ethnic mix is shown in Figure 12.

Figure 12

The Age and Ethnic Mix of Californians

July 1, 2002

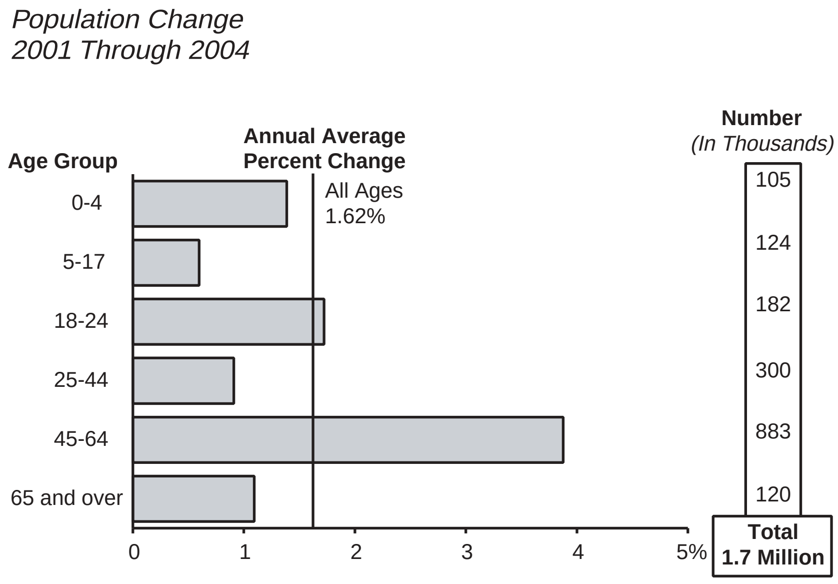


Growth by Age Group. The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 13 (see next page) shows our forecasts for both the percentage and numeric changes in different population age groups. It indicates that the only age group which is growing at a rate well above that of the population as a whole is the 45 to 64 age group, which includes the "baby boomers." The 18 to 24 age group is expected to grow at a rate roughly equal that of the total population, while the remaining age groups are projected to grow slower than the population as a whole.

Growth by Ethnicity. As shown in Figure 12, no single ethnic group currently holds a majority in California. The Hispanic and Asian cohorts of the state's population are projected to continue to expand and are estimated to grow 3 percent annually over the next three years. This is compared to the near-stagnant growth of both the white and black populations.

Figure 13

California's Population Outlook by Age Group



Overall Budgetary Implications

California's relatively steady population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in the budget year and beyond. Some examples of demographic influences are as follows:

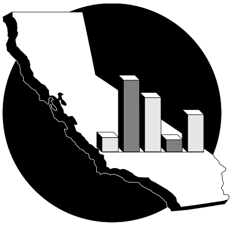
- Economic growth will benefit from an expanding labor force, due to the stronger consumer sector and increased incomes that typically accompany job growth.
- However, overall demographic growth will also produce additional strains on the state's physical and environmental infrastructure, including demands on the energy sector, transportation system, educational facilities, parks, and water-delivery systems.
- The "graying" of the baby-boomers will place strains on the state's health programs and services, including Medi-Cal and long-term nursing care facilities.

The increasing ethnic diversity of the state's population will also mean that many public institutions, especially schools, will serve a population that speaks a multitude of languages and has a wide range of cultural backgrounds.

III

Perspectives on State Revenues

Perspectives on State Revenues



As discussed in “Part I,” the state is facing a major budget shortfall caused largely by an unprecedented decline in tax receipts. Specifically, General Fund revenues (excluding transfers and loans) are projected to fall by over 14 percent in 2001-02, just two years after the state experienced a more than 23 percent increase.

Given these tremendous revenue swings and the dramatic impacts they have on the state budget, the first portion of our revenue discussion is devoted to looking at the factors underlying the volatility in the state’s General Fund revenue base. We focus especially on the increased importance in recent years of personal income taxes and the related heightened dependence on stock options and capital gains. Following this discussion, we then turn to the near-term revenue outlook for the state, first reviewing the administration’s forecast, then presenting our own projections of General Fund revenues for 2001-02 through 2003-04.

REVENUE VOLATILITY

Revenue volatility has been a “fact of life” in California for the past three decades, with tax receipts booming during good economic times and plunging during bad times. Such volatility is not surprising, given the dynamic nature of California’s economy, and the fact that the state’s major taxes are closely linked to such cyclical economic variables as consumer spending on automobiles and houses, business investment in capital equipment, corporate profits, and investment income.

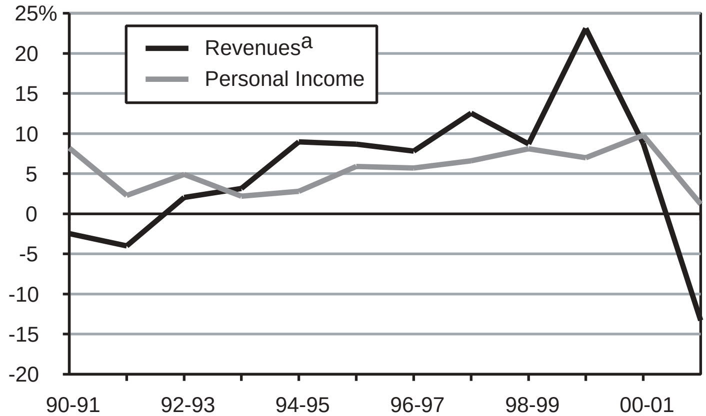
In addition, changes in the state's economy are magnified by California's progressive personal income tax (PIT) structure, where higher income levels are subject to higher marginal tax rates. Under this progressive tax rate structure, revenues grow faster than income during expansions (as rising real incomes are subjected to higher rates) and fall by more than income during recessions (as incomes slide back down into lower tax brackets).

While always present, revenue volatility increased in the 1990s, especially in comparison to the fluctuations in economic activity that were experienced. As noted in Figure 1, the year-to-year changes in revenues over the past decade have been dramatic—ranging from a minus 4 percent in the early 1990s, to a plus 23 percent in 1999-00, before plunging by an estimated 14 percent in 2001-02. These fluctuations in revenue growth have been much larger than fluctuations in statewide personal income (the single most important determinant of revenues) during this period.

Figure 1

Revenues Have Been Much More Volatile Than State's Economy

Annual Percent Change in General Fund Revenues and California Personal Income



[a] Excluding effects of law changes.

What's Behind the Increased Volatility?

The key factor behind the increased revenue volatility is the growing dominance of the PIT, which itself has experienced increased volatility in recent years.

PIT's Increased Share of California Revenues. As shown in Figure 2 (see next page), the PIT's share of total General Fund revenues increased from 35 percent in 1980-81 to nearly 58 percent in 2000-01. This occurred largely because PIT revenues grew faster than California's economy (as measured by such variables as statewide personal income or gross state product), while the other two major revenue sources (the sales and corporation taxes) grew more slowly than the overall economy during this period. Other factors, such as the elimination of the inheritance tax, also played a role in the PIT's increased dominance.

Factors Making the PIT More Volatile. At the same time that the PIT was gaining dominance, the tax itself was becoming more volatile. In general, this greater volatility can be linked to the increased concentration of income in the hands of high-income taxpayers in California who themselves have large amounts of volatile forms of income—such as stock options, capital gains, and business earnings. As shown in Figure 3 (see page 41), the share of total income attributable to the top 5 percent of state taxpayers increased from 22 percent in 1980 to nearly 30 percent in 1990, and further to 42 percent in 2000. (In 2000, taxpayers in this group had adjusted gross incomes of at least $150,000.) The share of total PIT liabilities attributable to this top 5 percent of taxpayers was even higher, reaching nearly 68 percent in 2000. As indicated earlier, this higher tax share is due to California's progressive PIT rate structure, where the effective tax rate on high-income filers can be several times that of low- and middle-income filers.

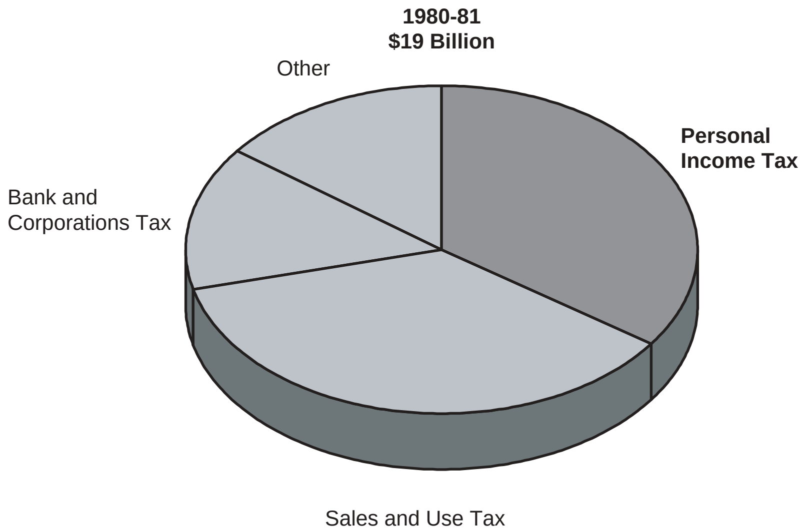
Income and Tax Burden Concentration Accelerated in the 1990s. The trend toward increased concentration of income and PIT liabilities predates the stock market run-up, and has been attributed to a variety of fundamental factors occurring nationally and particularly in California. These include (1) changes in the makeup of the workforce; (2) business restructurings within California's economy which have resulted in fewer middle-income jobs; and (3) an increase in the economic returns to education and skill levels in the economy, which have resulted in increased demand and higher wages for those with education and highly developed work skills. This long-established trend toward increasing concentration of income and PIT liabilities accelerated dramatically in the late 1990s.

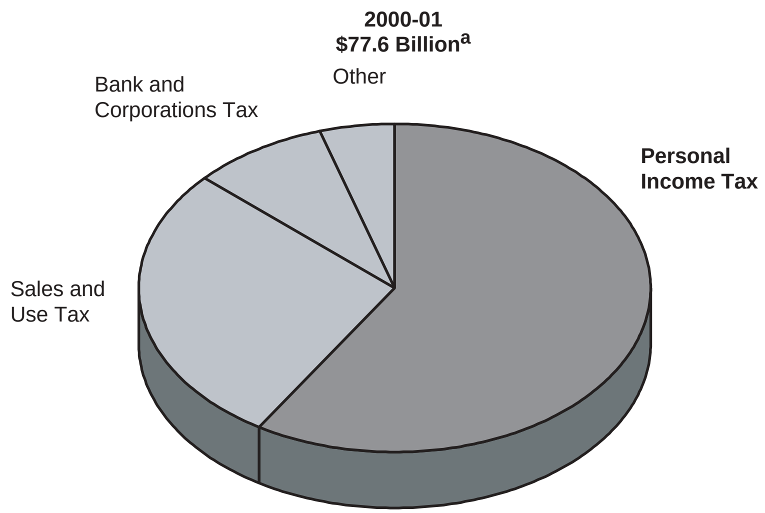
What Does the Increasing Income Concentration Imply for Volatility? Increasing income concentration is extremely significant from a revenue standpoint because it results in greater revenue volatility. Figure 4 (see page 41) compares the annual percent change in income reported by the top 5 percent versus the bottom 95 percent of California taxpayers over the past decade. It shows that fluctuations in income at the top end have been consistently larger over the past decade—even prior to the major run up and subsequent decline in the stock market.

Figure 2

The PIT Has Become California's Dominant Revenue Source

Total General Fund Revenues





[a] Excludes electricity loans.

Figure 3

Income Has Become Concentrated At High End of Distribution

Share of California AGI Reported on Top 5 Percent of Returns

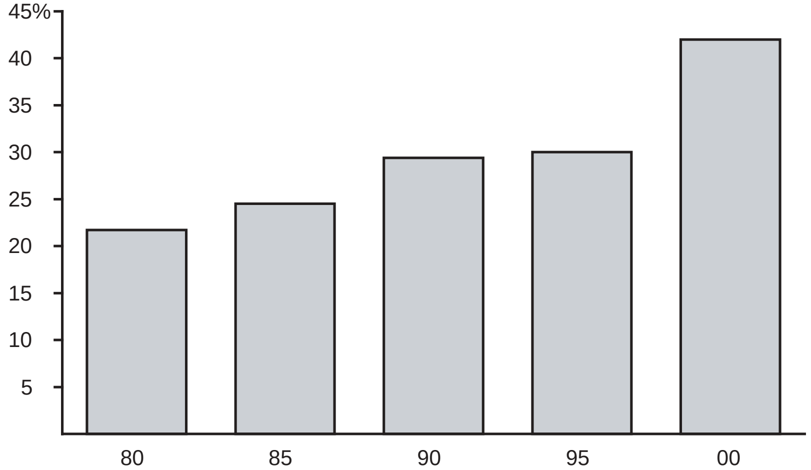
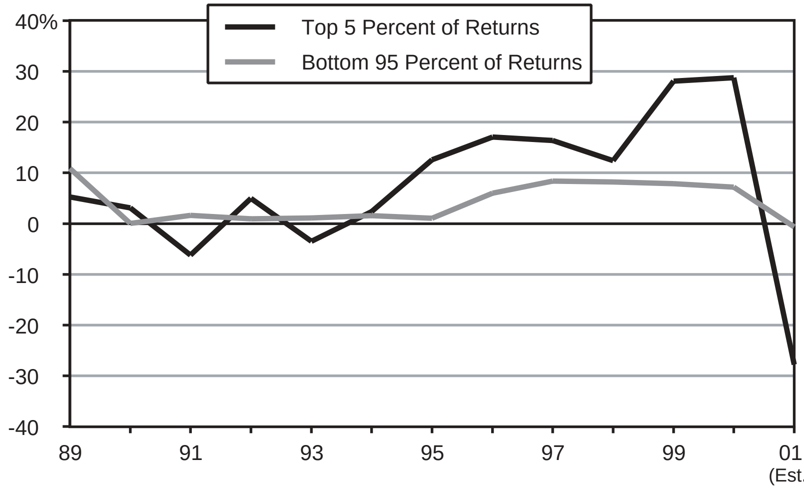


Figure 4

High-End Income Subject to Large Swings

Annual Percent Change in Income Reported On California Tax Returns

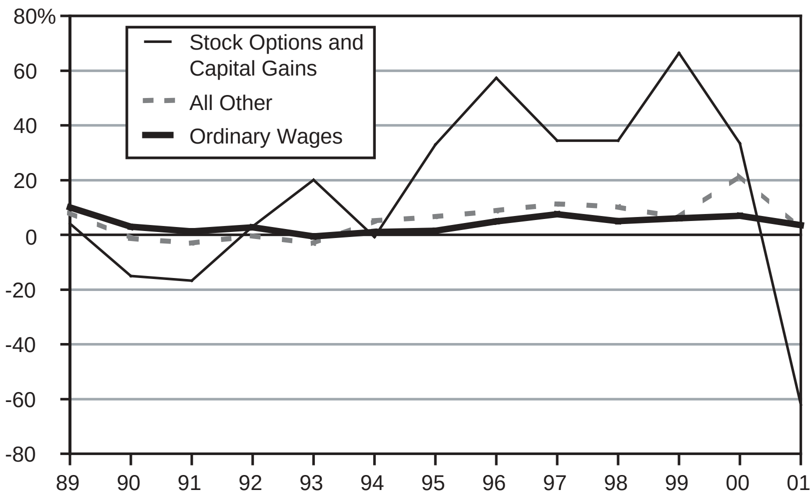


Why Do High Incomes Exhibit High Volatility? In general, the greater income volatility associated with high-income returns is related to this group's greater reliance on nonwage sources of income. Many components of nonwage income are inherently highly volatile, such as business profits and capital gains. In addition, taxpayers often have more discretion over the timing and amount of such income that they report in a given year. For example, individuals can choose when to exercise stock options and when to realize their capital gains from asset sales. As shown in Figure 5, nonwage income has been much more volatile over the past decade than ordinary wages.

Figure 5

Nonwage Income–Key Source of Revenue Fluctuations

Annual Percent Change in Income Reported on California Returns



The Enormous Volatility of Stock Options and Capital Gains. As indicated above, significant increases in the concentration of income, and thus in PIT volatility, would likely have occurred even without the explosion of stock options and capital gains in the later half of the 1990s. However, the dramatic growth that took place in these sources during this period has clearly been the single most important factor behind recent increases in revenue volatility. Total income related to stock options and capital gains increased from $25 billion in 1994 to a peak of about $200 billion in 2000 an eight-fold rise—before falling an estimated 62 percent to $77 billion in 2001. At their peak, combined PIT revenues from these sources totaled about $17 billion in 2000-01, or roughly 22 percent of total General Fund revenues during the year.

As an indication of the increased volatility stemming from stock options and capital gains, we currently estimate that the 62 percent reduction in these sources will cause total General Fund revenues to fall by $10.5 billion in 2001-02, to $6.5 billion. This decline is equivalent to about 13 percent of total General Fund revenues. Had the same decrease occurred a decade earlier—when capital gains and stock options accounted for just 5 percent of the total revenues, the impact on the General Fund would have been just $1.3 billion, or only about 3 percent of total revenues during 1990-91.

What About Future Volatility?

With the burst of the high-tech bubble last year, a natural question to ask is: *Will future revenue growth become less volatile and more predictable, as the revenues related to stock market activity "settle down?"* A more stable market would certainly reduce revenue fluctuations relative to California's most recent experience.

Future Volatility Can Be Expected. At the same time, however, volatility will likely remain a key feature of California's future revenue experience. Even with the recent market declines, stock ownership continues to expand, especially among high-income households. A related factor is the evolution of compensation practices involving increased usage of stock options and employee stock ownership programs, especially for highly compensated workers and managerial employees. Even in a normal stock market environment, individual company share price fluctuations, coupled with decisions by employees and investors regarding when to exercise options and sell stocks, will have unpredictable impacts on the state's annual revenue stream.

More generally, the forces behind the shift toward greater concentration of income in California—including increased economic returns to education and skill levels in the economy—are likely to remain powerful forces in the future. Given the inherently high degree of income volatility associated with high-end returns, it is likely that significant revenue fluctuations will remain a characteristic of California's current revenue structure well into the future.

The Budget's Forecast for State Revenues

The Governor's budget projects that California state government will receive $94.8 billion in total revenues in 2002-03, a 1.4 percent increase from the current year. These revenue are deposited into either the General Fund or a variety of special funds. Figure 6 shows that:

- About 84 percent of total state revenue is deposited into the General Fund. Revenues from this fund are then allocated through the annual budget process for such programs as K-12 and higher education, health and social services, and criminal justice.

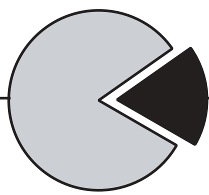
- In contrast, the remaining 16 percent of revenues received by special funds is primarily earmarked for specific purposes, such as transportation, local governments, and targeted health programs. Some revenues, such as sales and tobacco taxes, are allocated among the General Fund and special funds.

Figure 6

State Revenues in 2002-03

(In Billions)

Total State Revenues $94.8 Billion



General Fund Revenues		Special Funds Revenues	
Personal Income Tax	$42.6	Motor Vehicle-Related Taxes	$7.0
Sales and Use Tax	22.9	Sales and Use Tax[a]	2.5
Bank and Corporation Tax	5.9	Tobacco-Related Taxes	1.0
All Other[b]	7.9	All Other[b]	5.0
Total	**$79.3**	**Total**	**$15.5**

[a] Includes $2.3 billion to Local Revenue Fund and $0.2 billion for transportation-related purposes. Excludes $2.3 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

[b] Includes transfers and loans. General Fund amount includes $2.4 billion in tobacco securitization bond proceeds. Special funds amount includes $0.4 billion in settlements from tobacco-related litigation.

Numerous Transfers and Accelerations Are Assumed in the Budget Year. As shown in Figure 6, about 90 percent of total General Fund receipts are attributable to the PIT, sales and use tax (SUT), and bank and corporation tax (BCT). The remainder is normally attributable to a variety of smaller taxes (including the insurance, estate, tobacco, and alcoholic beverage taxes) as well as investment earnings and various transfers from special funds. However, the administration's 2002-03 revenue forecast includes a variety of proposals. These include $2.4 billion in revenues related to the Governor's tobacco securitization proposal, whereby the state would sell investors a revenue bond for "up-front" cash. The bond would be backed by future tobacco settlement receipts. Also included is a $672 million loan from the Traffic Congestion Relief Fund, as well as a variety of other loans and transfers from special funds totaling about $900 million.

The Budget's General Fund Revenue Outlook

Figure 7 summarizes the budget's General Fund revenue outlook for 2001-02 and 2002-03.

Figure 7

Summary of the Budget's General Fund Revenue Forecast

2000-01 Through 2002-03
(Dollars in Millions)

		2001-02		2002-03	
Revenue Source	**Actual 2000-01**	**Estimated Amount**	**Percent Change**	**Projected Amount**	**Percent Change**
Taxes:					
Personal Income Tax	$44,614	$38,455	-13.8%	$42,605	10.8%
Sales and Use Tax	21,277	21,165	-0.5	22,850	8.0
Bank and Corporation Tax	6,899	5,261	-23.7	5,869	11.6
Insurance Tax	1,497	1,560	4.2	1,656	6.2
Other taxes	1,381	1,280	-7.3	1,039	-18.8
Other Revenues, Transfers, and Loans:					
Tobacco securitization bond proceeds	—	—	—[a]	$2,400	—[a]
Other revenues	$1,940	$1,702	-12.3%	1,314	-22.8%
Electricity loans	-6,210	6,210	—[a]	—	—[a]
Other transfers and loans	30	1,450	—[a]	1,572	8.4
Totals	**$71,428**	**$77,083**	**7.9%**	**$79,305**	**2.9%**
Adjusted Totals[b]	$77,608	$69,423	-10.5%	$75,333	8.5%

[a] Not a meaningful number.

[b] Excludes certain factors that distort the basic underlying revenue trend, including tobacco securitization bond proceeds, electricity loans, and other transfers and loans.

Current-Year Forecast. The budget forecasts that revenues will total $77.1 billion in 2001-02, a 7.9 percent increase from the prior year. The prior-year and current-year revenue totals and growth rates are affected by the administration's decision about how to display the General Fund's loan of $6.2 billion to the Electricity Power Fund for energy purchases. The loan is displayed as a $6.2 billion transfer out of the General Fund in 2000-01 and the assumed loan repayment (plus $413 million in interest) is included in the General Fund totals in 2001-02. Adjusting for this and a variety of other one-time loans and transfers, the administration is estimating that underlying revenues will fall by 10.5 percent between 2000-01 and 2001-02. The 2001-02 forecast reflects particularly large declines in PIT and BCT revenues, due to a slowing economy and a large drop in PIT revenues related to stock options and capital gains.

The Budget-Year Forecast. The administration forecasts that revenues and transfers will total $79.3 billion in 2002-03, a 2.9 percent increase from the current year. The estimate is affected by the administration's proposed $2.4 billion tobacco securitization bond sale, as well as a variety of loans and transfers from special funds. Excluding these and related factors from both the current year and budget year, the underlying revenue increase is about 8.5 percent. This growth is related to the administration's assumption that the mid-2002 economic recovery will boost revenues from each of the major taxes during the 2002-03 fiscal year.

Proposed Tax Relief and Recent Tax Changes

The budget's revenue forecast reflects tax-related legislation passed in conjunction with last year's budget and proposed in this year's budget. In addition, the quarter-cent SUT rate that was adopted in 1991 for budget-balancing purposes but subsequently "triggered off," was "triggered on" effective January 1, 2002 due to the state's poor budget condition. Thus, the administration's forecast reflects the additional funds that are received pursuant to this SUT rate component—approximately $1.2 billion during the current and budget years combined. The fiscal effects of the Governor's tax proposals are summarized in Figure 8.

2002 Proposed Tax Measures. The Governors' tax proposals are primarily in the area of federal conformity, and result in both revenue decreases and revenue increases for the General Fund. The net effect of all the tax proposals would be an increase in revenue of $177 million in 2002-03 and a decrease of $59 million in 2003-04.

Tax Reduction Provisions. These include significant tax proposals that would substantially conform California to the federal Economic Growth and Tax Relief Reconciliation Act of 2001, and thereby result in revenue

Figure 8

Governor's Proposed 2002 Tax Measures

(In Millions)

Provision	2002-03	2003-04	2004-05
Federal Conformity—Revenue Reductions			
Pension and retirement measures	-$44	-$48	-$59
Qualified tuition plans	-1	-1	-1
Dependent care tax credit	-6	-40	-45
Charitable contributions	-12	-10	-10
Total Reductions	**-$63**	**-$99**	**-$115**
Federal Conformity—Revenue Increases			
Estimated payments	$210	$10	$10
Filing election for corporations	30	30	30
Total Increases	**$240**	**$40**	**$40**
Net Effect	$177	-$59	-$75

reductions to the state. These proposals would increase the amounts that could be contributed to an Individual Retirement Account, as well as to 401 (k) and / or 457 retirement accounts, among other things. Other federal-conformity changes that would result in revenue decreases include more generous treatment of qualified tuition plans, an expanded household and dependent care expense credit, and the more favorable alternative minimum tax treatment of certain charitable contributions.

Tax Increase Provisions. The budget also proposes two federal conformity changes in the tax treatment of individuals and corporations that together would result in a substantial one-time increase in state revenues. First, the state would conform to federal law requiring that PIT filers pay at least 90 percent (instead of 80 percent) of their final tax liability through withholding or estimated tax payments. The second proposal is to require that corporations maintain the same tax filing status for federal and state purposes. This would have the most significant effect on Subchapter S and Subchapter C corporations.

One issue that remains outstanding is with respect to the SUT exemption for diesel fuel used in agricultural activities, which was adopted in conjunction with the 2001-02 budget. The proceeds of this tax are deposited into the Public Transportation Account. The regulations governing this exemption that subsequently were adopted by the Board of Equalization resulted in a more generous interpretation of agriculture activities than was originally anticipated. Unless legislative action is taken that would make the exemption more restrictive, ongoing revenues will be approximately $50 million lower annually. (See the "Transportation" section of the *Analysis*.)

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Recent Revenue Developments

Our estimate for combined current-year and budget-year revenues that we made three months ago in our November 2001 *Fiscal Forecast* is, after adjusting for tax proposals, $2 billion lower than the Governor's new forecast. However, recent cash developments since our November forecast indicate that revenues are even weaker than we previously thought, especially those relating to the all-important areas of stock options and capital gains.

Cash Down Over $1 Billion

The PIT payments that the state receives in late December and the first half of January are extremely important to the revenue outlook, since they are significantly related to quarterly estimated payments remitted by taxpayers with substantial amounts of capital gains and other forms of nonwage compensation. In past years, these payments have been reliable indicators of the strength of tax payments made in April, when final PIT returns are due. For this reason, the level of the year-end 2001 payments and early-year 2002 receipts serves as a "spring board" from which the revenue estimates for the remainder of 2001-02 and 2002-03 are made.

As shown in Figure 9, after doubling between 1997-98 and 2000-01, these year-end payments plunged by over one-third in the December through January period. The current-year decline in these payments was about $1 billion greater than expected by the administration when it put its revenue forecast together, indicating that tax liabilities associated with high income returns are falling by more than anticipated. This weakness also suggests that final payments will be soft this coming April.

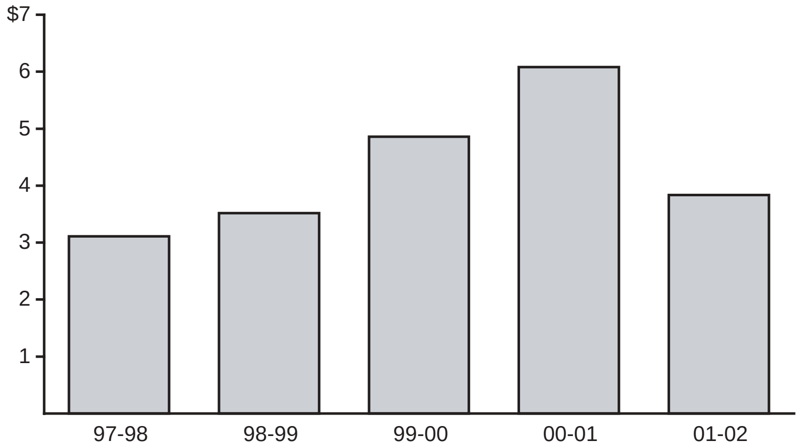
LAO Revenues Down $3.9 Billion From Budget Forecast

Figure 10 (see page 50) presents our General Fund revenue outlook for 2001-02 and 2002-03. In addition, to help the Legislature in its fiscal planning, we also provide our fiscal projections for an additional year—2003-04. Our projections are based on our economic forecast presented in "Part II," reflect all of the Governor's proposals, and take into account the recent negative cash developments noted above.

Figure 9

Estimated Payments Down Sharply

December and January Receipts of PIT Quarterly Estimated Payments (In Billions)



2001-02 Revenues. We forecast that General Fund revenues and transfers will total $74.3 billion in the current year, an increase of 4.1 percent from 2000-01. After adjusting for the electricity loan and the Governor's various proposals, underlying receipts are down by 14 percent. As shown in Figure 10, we are projecting major declines in PIT and BCT revenues, and a minor decline in SUT receipts. Compared to the administration, our forecast is down $2.8 billion, mainly reflecting lower PIT and BCT collections. This reflects recent cash trends and our assumption that capital gains and stock options fell by more in 2001 than assumed by the administration.

2002-03 Revenues. We forecast that revenues and transfers will total $78.2 billion in 2002-03, a 5.2 percent increase from the current year. After adjusting for the assumed electricity loan repayment in the current-year and the budget's various revenue-related proposals for 2002-03, underlying revenues are up 11.4 percent. As with the administration, our budget-year revenue forecast is predicated on an economic recovery occurring beginning in spring 2002.

As shown in Figure 10 (see next page), each of the major taxes is expected to increase significantly in the budget year. Our 2002-03 forecast is down about $1.1 billion from the budget projection—a significantly smaller gap than

Figure 10

Summary of the LAO's General Fund Revenue Forecast

2001-02 Through 2003-04
(Dollars in Millions)

Revenue Source	2001-02 Amount	2001-02 Percent Change	2002-03 Amount	2002-03 Percent Change	2003-04 Amount	2003-04 Percent Change
Taxes:						
Personal Income Tax	$35,978	-19.4%	$41,123	14.3%	$45,850	11.5%
Sales and Use Tax	21,225	-0.2	23,305	9.8	24,940	7.0
Bank and Corporation Tax	4,870	-29.4	5,567	14.3	6,285	12.9
Insurance Tax	1,616	7.9	1,793	11.0	1,901	6.0
Other taxes	1,306	-5.4	1,139	-12.8	901	-20.9
Other Revenues, Transfers, and Loans:						
Tobacco securitization bond proceeds	—	—[a]	$2,400	—[a]	—	—[a]
Other revenues	$1,667	-14.1%	1,314	-21.2%	$1,340	2.0%
Electricity loans	6,210	—[a]	—	—[a]	—	—[a]
Other transfers and loans	1,450	—[a]	1,572	8.4	-300	—[a]
Totals	**$74,322**	**4.1%**	**$78,213**	**5.2%**	**$80,917**	**3.5%**
Adjusted Totals[b]	$66,662	-14.1%	$74,241	11.4%	$81,217	9.4%

[a] Not a meaningful number.

[b] Excludes certain factors that distort the basic underlying revenue trend, including tobacco securitization bond proceeds, electricity loans, and other transfers and loans.

our current year difference of $2.8 billion. In general, this reflects our more cyclical forecast for stock options and capital gains. While we expect these income sources to fall by more than the administration during the current year, we also expect them to rebound by more next year (thereby bringing them "back up" closer to the administration's projection in 2002-03).

2003-04 Revenues. We forecast that total revenues and transfers will increase by about 3.5 percent in 2003-04, to $80.9 billion. Excluding the impact of the Governor's policy proposals on the revenue totals, however, the underlying increase would be about 9.4 percent. This increase is consistent with our assumed continuation of the state's economic rebound. We project that all three major taxes will increase at above-average rates during the year.

THE LAO'S FORECAST FOR MAJOR REVENUE SOURCES

The state's three major taxes—the PIT, SUT, and BCT—are expected to account for nearly 90 percent of total General Fund revenues in 2002-03. Thus, the performance of these taxes will have a major impact on the overall revenue outlook. In the following sections, we discuss in more detail recent developments and the outlook for each tax.

Personal Income Tax

Background

Even with its current-year decline, the PIT remains, by far, the General Fund's single largest revenue source—accounting for an estimated 53 percent of total revenues and transfers in 2002-03. In general, the PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Taxable income is subject to marginal rates ranging from 1 percent to 9.3 percent, with the top rate applying to taxable income in excess of about $75,000 for joint returns and $37,000 for single filers in 2001.

PIT Liabilities

As shown in Figure 11 (see next page), after soaring from $29 billion in 1998 to slightly over $44 billion in 2000, we estimate that PIT liabilities plunged to $36 billion in 2001. Thereafter, we forecast that they will recover to $39 billion in 2002 and $44 billion in 2003. Under our forecast, however, PIT liabilities do not surpass their previous 2000 peak until 2004.

Factors Behind the Liability Forecast. Although the economic slowdown has had some adverse impact on overall wages and business profits, the main factor behind the drop in PIT liabilities has been the plunge in stock market-related options and capital gains. As indicated earlier, we estimate that income from these sources fell from $200 billion in 2000 to $77 billion in 2001, before partly rebounding to $91 billion in 2002, and $105 billion in 2003. Even with the partial rebound, however, 2003 liabilities forecast from these sources are still down by almost one half from their 2000 peak.

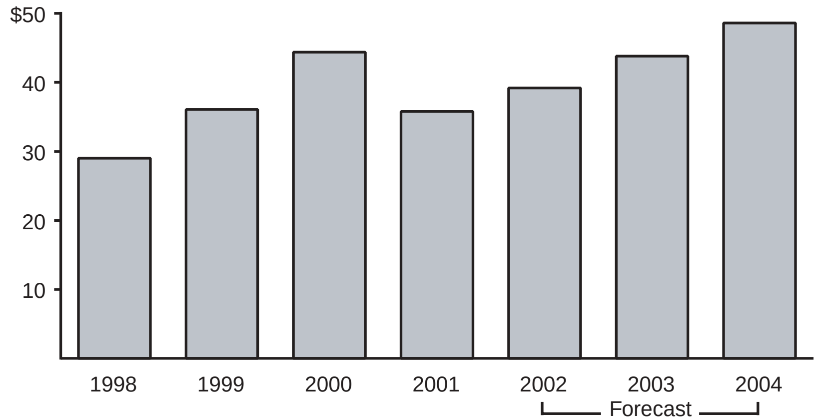
PIT Revenue Forecast

Based on these estimated changes in liabilities, we forecast that fiscal-year PIT receipts will decline from $44.6 billion in 2000-01 to $36 billion in 2001-02, before partially rebounding to $41.1 billion in 2002-03, and $45.9 billion in 2003-04.

Figure 11

Three Years Needed for PIT to Recoup 2001 Losses

Annual California PIT Liabilities (In Billions)

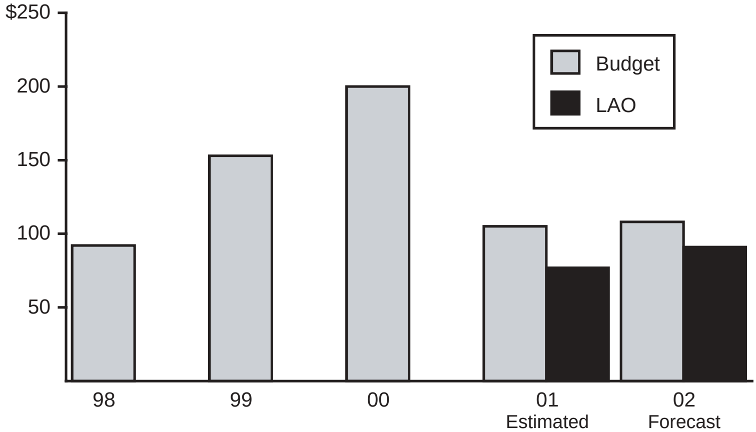


Comparison to the Budget Forecast. Compared to the budget forecast, our current projection of PIT revenues is down $2.5 billion in the current year and down $1.5 billion in the budget year. The resulting $4 billion two-year decline is largely related to our differing assumptions about the level of capital gains and stock options. As shown in Figure 12, our estimated 2001 decline in income from these sources is much steeper than the administration's estimate. While we assume a stronger "snap back" in 2002 than the administration, our estimate remains below the budget forecast by a significant margin in that year as well.

Figure 12

LAO Forecasts Steeper Decline in Options and Gains Than DOF

Combined Stock-Option and Capital-Gain Income Reported on California Tax Returns (In Billions)



Sales and Use Tax

Background

The SUT is the General Fund's second largest revenue source, accounting for about 30 percent of total revenues in 2002-03. The SUT actually is comprised of two separate levies:

- ***Sales Tax.*** This is the main component of the SUT. It is imposed on retail sales of tangible goods purchased in California. These include spending on clothing, furniture, computers, electronics, appliances, automobiles, and motor vehicle fuel. Purchases of building materials that go into the construction of homes and buildings are also subject to the sales tax, as are purchases of computers and other equipment used by businesses. The largest exemption from the sales tax is for most food items consumed at home.

- ***Use Tax.*** The use tax is imposed on products bought from out-of-state firms by California residents and businesses for use in this state. With the exception of automobile purchases (which must be registered), out-of-state purchases are difficult to monitor, and the state is prohibited under current federal law from requiring most out-of-state sellers to collect the use tax for California. As a result, use tax receipts account for only a small portion of total SUT revenues.

SUT Rates

The total SUT rate levied is a combination of several different individual rates imposed by the state and various local governments.

- ***State Rates.*** The current state SUT rate is 6 percent. The largest single component is the 5 percent state General Fund rate. This rate was temporarily lowered to 4.75 percent in calendar year 2001 under the terms of above-noted 1991 "trigger" legislation, but returned to 5 percent on January 1, 2002. Also included in the overall state rate are two half-cent rates, whose proceeds are deposited into (1) the Local Revenue Fund, which supports health program costs associated with the 1991 realignment legislation, and (2) the Local Public Safety Fund, which was approved by the voters in 1993 for the support of local criminal justice activities.

- ***Uniform Local Rate***. This is a uniform local tax rate of 1.25 percent levied by all counties (the so-called Bradley-Burns rate). Of this total, 0.25 percent is deposited into county transportation funds, while the remaining 1 percent is allocated to city and county governments for their general purposes.

- ***Optional Local Rates.*** The final overall SUT rate component involves optional local tax rates, which local governments are authorized to levy for any purpose. These taxes, which require local voter approval, are normally levied on a countywide basis—primarily for transportation-related purposes. They can be levied in 0.25 percent or 0.5 percent increments and cannot exceed 1.5 percent (except in San Francisco and San Mateo Counties).

Combined SUT Rates. The combined state and local SUT rate varies significantly across California due to differences in the local optional rates that are levied. As depicted in Figure 13, the combined SUT rate currently ranges from 7.25 percent (for those counties with no optional rates) up to 8.5 percent (for the City and County of San Francisco). No county currently imposes the maximum allowable rate of 8.75 percent.

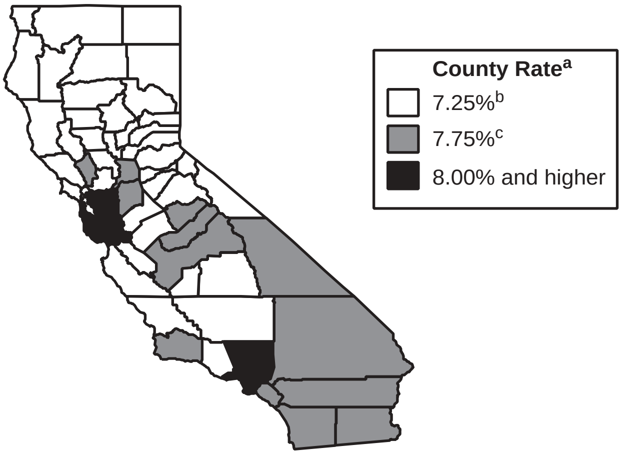
Taxable Sales Fell in 2001 . . .

Figure 14 shows that, after booming in 1999 and 2000, taxable sales fell nearly 2 percent in 2001. Some of this year-to-year decline is the result of the fact that 2000 spending levels—propelled by unprecedented increases in stock-market-related wealth and income—were so unusually

Figure 13

Sales Tax Rates Vary by County

January 1, 2002

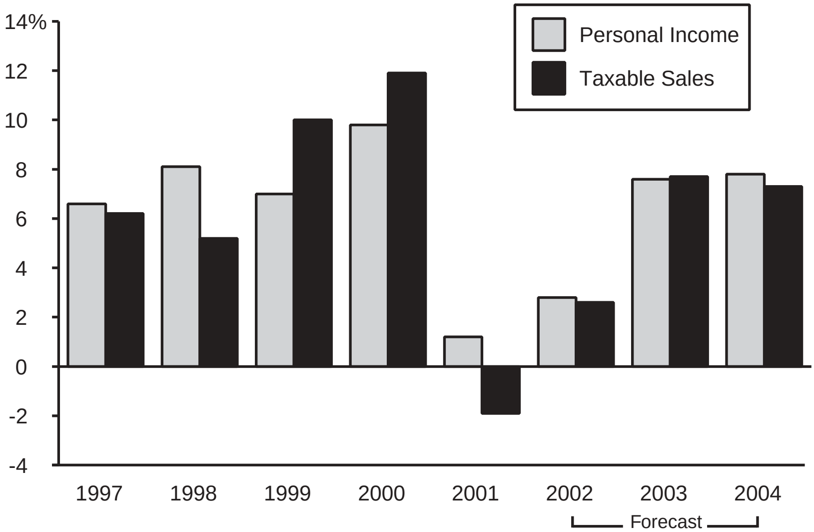


[a] Reflects 0.25 percent increase in state portion of rate for the 2002 calendar year.
[b] Includes Stanislaus, Nevada, and Solano (7.375%), and Sonoma (7.50%).
[c] Includes Fresno (7.875%).

Figure 14

Taxable Sales to Rebound With Economy

Annual Percent Change



strong that 2001 growth rates would have likely looked anemic even without the negative impacts of the recession. The taxable sales slowdown was compounded by the sharp drop in business capital spending and the adverse impacts of higher energy prices on household budgets. Following the September 11 attacks, the declines in tourism-related spending also depressed taxable spending late in the year, although these declines were offset to some degree by strong year-end auto sales, boosted by zero-interest-rate auto financing promotions.

. . . But Recovery Is Expected Beginning in Mid-2002

Looking ahead, we project that taxable sales will remain soft in early 2002, but turn upward in the spring as tourism increases and the economic recovery gets underway. Our forecast also assumes that business spending on computers and other capital goods picks up in the second half of the year. As indicated in Figure 14 (see next page), taxable sales are projected to increase in line with California personal income, growing by 2.6 percent in 2002 and 7.7 percent in 2003.

SUT Revenue Forecast

Based on our forecast of taxable sales, we project that SUT receipts will fall slightly from $21.3 billion in 2000-01 to $21.2 billion in 2001-02. The revenue totals in both the prior year and current year reflect the previously noted quarter-cent sales tax reduction that was in effect during calendar year 2001. In the budget year, we forecast that sales tax receipts will jump to $23.3 billion in 2002-03, a 9.8 percent increase from the current year. The growth is due to the projected increases in taxable sales and the full-year impact of the restoration of the quarter-cent sales tax in 2002.

Comparison to the Budget Forecast. Our SUT estimate is up from the budget forecast by $60 million in the current year and by $455 million in 2002-03. Our higher forecast for SUT receipts is related to our assumption that the recovery in taxable sales will come a bit earlier and be somewhat stronger in 2002 than the budget forecast.

Bank and Corporation Tax

Background

The BCT is levied at a general tax rate of 8.84 percent on California taxable profits. Banks and other financial corporations pay an additional 2 percent tax, which is in lieu of most other state and local levies. Corporations that qualify for California Subchapter "S" status are subject to a reduced 1.5 percent corporate rate. In exchange, the income and losses from these corporations are "passed through" to their shareholders where they are subject to the PIT.

Approximately two thirds of all BCT revenues come from multistate and multinational corporations. These companies have their consolidated U.S. income apportioned to California based on a formula involving the share of their combined property, payroll, and sales that is attributable to this state. California's BCT allows for a variety of exclusions, exemptions, deductions, and credits, many of which are similar or identical to the federal corporate profits tax. Major examples include the research and development tax credit and net operating loss "carry forward" provisions, whereby companies can use a portion of their operating losses incurred in one year as a deduction against earnings in subsequent years. California also offers a Manufacturers' Investment Credit.

Profits Plunged in 2001

Based on cash receipts through December, we estimate that California corporate profits fell by about 17 percent in 2001 (see Figure 15, next page). Company earnings have been squeezed by soft revenues and rising costs in a number of areas, including health care premiums, transportation, and energy. The manufacturing sector, which has traditionally accounted for roughly one third of total taxable profits in California, has been especially hard-hit by the U.S. high-tech slump and the weakness in export markets. Other industries that were hard-hit include transportation and business services. The transportation sector was adversely affected by both the slump in the airlines industry and the declines in international trade activity (which reduced the need for both warehousing and transportation). Business services were negatively impacted by the drop in software sales and advertising revenues.

Earnings Turnaround Expected in 2002

We forecast that profits will partially rebound in 2002, reflecting generally improving economic conditions. Given that inventories are lean, we believe that recent increases in new orders, if sustained, will quickly translate into stepped-up production and profits. An important factor affecting California's earnings will be the timing and strength of the recovery in information technology spending. As shown in Figure 15, we forecast that California taxable profits will increase by 6.1 percent in 2002 and 12 percent in 2003, as the economic expansion gains momentum.

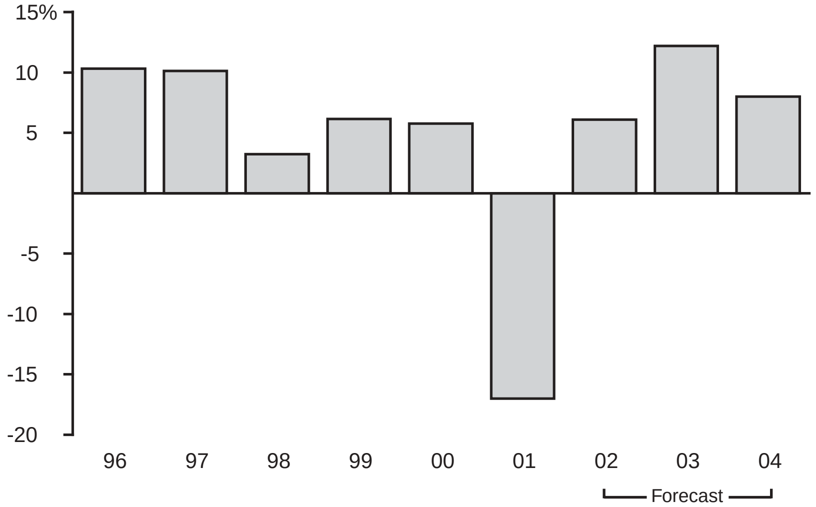
BCT Revenue Forecast

We forecast that BCT receipts will be $4.9 billion in 2001-02, a 29 percent decline from the prior year. The current-year reduction is partly due

Figure 15

2002 Profits to Rebound After Tough Year

Percent Change in California Taxable Corporate Profits



to the major drop in profits we estimate for 2001. It also reflects large refunds made in late 2001, which were related to over-payments made by corporations on their 2000 earnings. We forecast that BCT revenues will rebound to $5.6 billion in 2003, an increase of 14 percent. About one-half of this increase is related to improvement in corporate earnings. The balance of the gain is related to our assumption that the majority of current-year BCT refunds were one-time adjustments related to prior-year tax liabilities. We forecast that BCT receipts will increase further to $6.3 billion in 2003-04, consistent with the growth in profits we are projecting for 2003.

Comparison to the Budget Forecast. Our BCT estimate is $391 million below the budget forecast in the current year and $302 million below the budget forecast in 2002-03. Our lower estimate is related to two main factors: (1) our estimate of a larger profit reduction in 2001 and (2) the inclusion in our estimate of about $270 million in unexpected refunds that occurred after the budget forecast was prepared

Other Revenues and Transfers

The remaining 11 percent of total revenues and transfers consists of taxes on insurance premiums, estates, alcoholic beverages, and tobacco, along with interest income and a large number other revenues and fees. The budget proposal also includes a variety of loans and transfers from special funds, plus proceeds from the Governor's planned tobacco securitization bond sale proposed to help balance the budget.

Excluding the administration's budget proposals, as well as various other policy and accounting related changes made in recent years, revenues from the nonmajor sources are expected to total roughly $4 billion in both the current and budget years. This reflects moderate increases in insurance taxes, and small declines in tobacco and alcoholic beverage receipts.

Estate Tax Being Phased Out. Our forecast also includes the impact of a provision included in the federal tax reduction package passed last spring, which will phase out California's estate tax over the next four years. The reason for this phase-out involves California's voter approval in 1982 of Proposition 6—a statutory initiative that eliminated California's inheritance and gift tax and replaced it with a "pick-up" tax. This pick-up tax is the amount of state taxes that can be applied as a credit against the federal estate tax liability. (Thus, while the tax provides revenues for California, it does not impose any net cost on the taxpayer.) The new federal law phases out the state credit over a four-year period, beginning in 2002. This will reduce California's estate tax revenues by $100 million in the current year, $370 million in the budget year, and $650 million in 2003-04.

The Budget Forecast for Special Funds Revenues

Special funds revenues support a wide variety of state and local government programs. As shown in Figure 16 (see next page), nearly one half of special funds revenues are related to motor vehicle-related taxes and fees. These include motor vehicle license fees, which are in-lieu of the property tax and whose proceeds are distributed to local governments for general purposes. They also include fuel taxes and registration fees, which support transportation-related spending.

The remaining special funds include a portion of the SUT's revenues (which support local health programs), tobacco taxes (which are earmarked for various anti-smoking and health programs), and tobacco settlement receipts (which are dedicated to various recent health program expansions).

Figure 16

Summary of the Budget's Forecast for Special Funds Revenues and Transfers

2000-01 Through 2002-03
(Dollars in Millions)

Revenue Source	Actual 2000-01	2001-02 Estimated Amount	2001-02 Percent Change	2002-03 Projected Amount	2002-03 Percent Change
Motor Vehicle Revenues					
License fees (in lieu)[a]	$3,289	$1,734	-47.3%	$1,808	4.3%
Fuel taxes	3,142	3,184	1.3	3,244	1.9
Registration, weight, and miscellaneous fees	1,943	1,987	2.3	2,107	6.0
Subtotals	$8,374	$6,905	-17.5%	$7,159	3.7%
Other Sources					
Sales and use tax[b]	$3,021	$2,435	-19.4%	$2,531	3.9%
Cigarette and tobacco taxes	1,024	1,012	-1.2	997	-1.5
Interest earnings	347	215	-38.1	208	-3.2
Other revenues[c]	4,347	6,636	52.7	6,098	-8.1
Transfers and loans	-123	-729	—	-1,465	—
Totals	**$16,991**	**$16,474**	**-3.0%**	**$15,528**	**-5.7%**

a Incorporates impacts of vehicle license fee rate reduction.

b Excludes Local Public Safety Fund revenues.

c Includes tobacco settlement receipts of $402 million in 2001-02 and $412 million in 2002-03.

The budget forecasts that special funds revenues and transfers will decline from $17 billion in 2000-01 to $16.5 billion in 2001-02, and further to $15.5 billion in 2002-03. The declines in both the current year and budget year reflect the net impact of a large number of policy and accounting changes previously enacted and proposed for 2002-03. One example is the drop in the vehicle license fees, which is related to the 67 percent fee reduction first enacted in 1998 and then accelerated in 2000. The reduction in these revenues is replaced with increased General Fund subventions to "backfill" the local revenue losses. Other examples include (1) a one-time redirection of sales taxes in 2000-01, (2) major loans to the General Fund, and (3) the ongoing redirection of tobacco settlement receipts into a special fund beginning in the current year.

Adjusting for these various policy-related changes, ongoing receipts from both vehicle related levies and the SUT are expected to increase by slightly less than 4 percent next year. Tobacco tax receipts are projected to decline slightly, by about 1.5 percent, due to lower cigarette consumption.

IV

Perspectives on State Expenditures

AN OVERVIEW OF STATE EXPENDITURES

PROPOSED TOTAL SPENDING IN 2001-02 AND 2002-03

The Governor's budget proposes total state spending in 2002-03 of $97.9 billion, including spending from both the state's General Fund and its special funds (see Figure 1). Total budget-year spending is slightly less than estimated current-year spending—by $402 million (0.4 percent). Of total budget-year spending, General Fund spending accounts for slightly more than 80 percent.

Figure 1

Governor's Budget Spending Totals

2001-02 and 2002-03
(Dollars in Millions)

			Change	
	2001-02	**2002-03**	**Amount**	**Percent**
Budget Spending				
General Fund	$78,380	$78,806	$426	0.5%
Special funds[a]	19,941	19,113	-828	-4.2
Totals	**$98,321**	**$97,919**	**-$402**	**-0.4%**

[a] Does not include Local Public Safety Fund expenditures of $2.2 billion in 2001-02 and $2.3 billion in 2002-03. These amounts are not shown in the Governor's budget.

Detail may not total due to rounding.

General Fund Spending

Background. The General Fund is the predominate source of support for state programs, and thus finances a wide variety of activities. For example, it is the major funding source for K-12 and higher education programs, health and social services programs, youth and adult correctional programs, and tax relief.

The General Fund is primarily funded from tax revenues. As discussed in "Part III" of this volume, three large taxes are projected to account for nearly 90 percent of total 2002-03 General Fund revenues. These taxes are the state's personal income tax, sales and use tax (SUT), and bank and corporation tax.

Proposed Spending. Figure 2 summarizes General Fund spending in the prior, current, and budget years. In 2002-03, the Governor proposes General Fund spending of $78.8 billion. This is up a modest $426 million, or 0.5 percent, from the current-year's level. This growth rate is about the same as that for the current year and considerably slower than the exceptionally rapid growth experienced during the last half of the 1990s. The slow budget-year growth rate reflects a 0.2 percent decline in the General Fund portion of the Proposition 98 guarantee (about 40 percent of General Fund spending) and 1 percent growth in other programs (60 percent of spending).

Special Funds Spending

Background. The special funds category involves a variety of components. Special funds generally are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources (including many licenses and fees) for particular functions or activities of government designated by law. Over one-half of special funds revenues come from motor vehicle-related levies. Other major funding sources include the SUT and tobacco-related receipts.

Proposed Spending. In 2002-03, the Governor proposes special funds spending of $19.1 billion (see Figure 3). This is $828 million, or 4.2 percent, less than the current-year estimated total of $19.9 billion. As indicated in the figure, this net reduction reflects an increase in transportation-related spending combined with more-than-offsetting reductions elsewhere. Specifically:

- Transportation spending, the programmatic area most reliant on special funds, is proposed to increase in 2002-03 by $626 million, or 10.4 percent. This primarily reflects an increased number of proposed capital outlay projects.

Figure 2

General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 2000-01	Estimated 2001-02	Proposed 2002-03 Amount	Proposed 2002-03 Percent Change
Education Programs				
K-12—Proposition 98	$27,229	$28,270	$28,582	1.1%
Community colleges—Proposition 98	2,680	2,693	2,682	-0.4
UC/CSU	5,644	6,166	6,104	-1.0
Other	3,343	4,202	3,933	-6.4
Health and Social Services Programs				
Medi-Cal	$9,168	$9,705	$10,072	3.8%
CalWORKs	1,966	2,015	2,151	6.7
SSI/SSP	2,555	2,821	3,049	8.1
Other	6,121	7,181	7,169	-0.2
Youth and Adult Corrections	$5,298	$5,372	$5,274	-1.8%
All Others	$14,050	$9,956	$9,790	-1.7%
Totals	**$78,053**	**$78,380**	**$78,806**	**0.5%**

Figure 3

Special Funds Spending by Major Program Area

(Dollars in Millions)

	Actual 2000-01	Estimated 2001-02	Proposed 2002-03 Amount	Proposed 2002-03 Percent Change
Transportation	$3,595	$5,993	$6,619	10.4%
Local government subventions[a]	5,512	6,165	5,105	-17.2
Resources related	1,535	1,905	1,742	-8.6
Public Utilities Commission[b]	84	1,477	1,300	-12.0
All others	3,246	4,401	4,347	-1.2
Totals	**$13,972**	**$19,941**	**$19,113**	**-4.2%**

a Budget-year reduction reflects accounting changes involving vehicle license fee subventions to local governments.

b Amounts reflect several new Universal Service Telephone programs that came "on budget" in the current year.

- Local government subventions are proposed to drop by nearly $1.1 billion in the budget year. This, however, is only a “paper” decline, in that it primarily reflects a change in the budgetary treatment of vehicle license fee subventions.

It should be noted that the budget’s special funds spending data exclude expenditures from the Local Public Safety Fund—estimated at $2.3 billion in the budget year. Although we believe that such spending does constitute state spending, we do not include it in our figures so as to facilitate comparisons with the budget’s figures.

Spending From Federal Funds and Bond Proceeds

In addition to the $97.9 billion of proposed 2002-03 spending from the General Fund and special funds, the budget also proposes $47.6 billion in spending from federal funds and another $2.1 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, the 2002-03 spending level exceeds $147 billion.

Federal Funds

Of the total funds that California receives annually from the federal government, about three-fourths goes directly to local governments and other recipients, while roughly one-quarter flows through the state budget. Of the $47.6 billion in federal funds flowing through the state budget in 2002-03, about $30 billion is for various health and social services programs, such as Medi-Cal, California Work and Responsibility to Kids (CalWORKs), and In-Home Supportive Services (IHSS). Education receives another $11 billion of the total (split fairly evenly between K-12 and higher education), and transportation is expected to receive slightly less than $4 billion during the year.

New Federal Funds Assumed. The Governor’s budget assumes that $1.1 billion in new federal funding will be received over the current and budget years. This includes $400 million in 2001-02 to offset the costs of Medi-Cal services, $350 million for security and bioterrorism funding, and around $180 million due to a waiver of federal penalties imposed due to delayed implementation of a statewide automated child support system. The risks associated with both of these funding assumptions and the remainder of the federal funding increases assumed in the budget are discussed in “Part I” of this volume.

Spending of Bond Proceeds

Budgetary Treatment. When the state relies on bond proceeds instead of direct appropriations to fund its capital outlay projects, the use of these proceeds is not itself reported as budgetary spending as it occurs. Rather, the debt service cost for principal and interest on the bonds is what is recorded as budgetary spending. For 2002-03, the budget's proposed General Fund debt service costs total $3.1 billion, including slightly under $2.6 billion for general obligation bonds and $556 million for lease-payment bonds.

Although this way of treating bonds makes sense from a budgetary standpoint, tracking bond fund expenditures themselves still is useful as an indication of the actual volume of "brick and mortar" activities going on in a given year with respect to capital projects.

Spending of General Obligation Bond Proceeds. The budget estimates that the state will spend $2.1 billion in general obligation bond proceeds for capital projects in 2002-03. This compares to $4.6 billion in the current year and $4.4 billion in the prior year. Of the proposed 2002-03 general obligation bond fund expenditures:

- Around 45 percent is for various local assistance projects such as K-12 school construction, as well as local water quality and supply projects.
- Nearly 40 percent is dedicated to state-level capital outlay projects, with over 80 percent of the funds dedicated to higher education projects ($648 million).
- The remaining 15 percent is proposed for expenditures related to CalFed and other purposes.

Spending of Lease-Payment Bond Proceeds. In addition to general obligation bonds, the state also uses lease-payment bonds to finance the construction and renovation of capital facilities. Lease-payment bonds do not require voter approval and their debt service is paid from annual lease payments made by state agencies (funded primarily through General Fund appropriations). The budget proposes slightly over $670 million in new lease-payment bonds in 2001-02 and 2002-03, which are part of the Governor's Economic Stimulus Package to accelerate new public works projects.

State Appropriations Limit

Background. In 1979, California's voters established a state appropriations limit (SAL) when they approved Proposition 4. The SAL places an "upper bound" on the amount of tax proceeds that the state can spend in any given year and grows annually by a population and cost-of-living factor. Most state appropriations are subject to the SAL; however, certain appropriations are exempt—including subventions for schools and local governments, capital outlay spending, and tax relief. If actual tax proceeds exceed the SAL over a two-year period, the excess must be divided among taxpayer rebates and Proposition 98 education funding.

SAL Not Currently Binding. Due to the economic downturn in the state's economy and its adverse effects on the state's revenues, the budget's proposed expenditures are well below the SAL in both the current and budget years. This is in contrast to recent years when rapid spending growth eroded the "room" under the limit until the SAL was finally exceeded, by $702 million, in 1999-00. (State appropriations fell well below the limit in 2000-01. Thus, the SAL's "excess revenue" provisions noted above did not take effect.)

The budget projects that appropriations subject to the limit will be $14.5 billion below the limit in the current year and $6.3 billion below the limit in 2002-03. The amount of room under the limit shrinks next year because tax proceeds are expected to grow by nearly 7.7 percent at the same time as the limit itself is expected to fall by 1.4 percent. (The latter decline is due to the effects of the recession on the per-capita income factor used to adjust the limit in 2002-03.)

STATE SPENDING—A HISTORICAL OVERVIEW

Prior to looking at the programmatic details of the Governor's spending plan for 2002-03, we first provide a perspective on state spending by looking at how the new plan's spending amounts compare to historical trends.

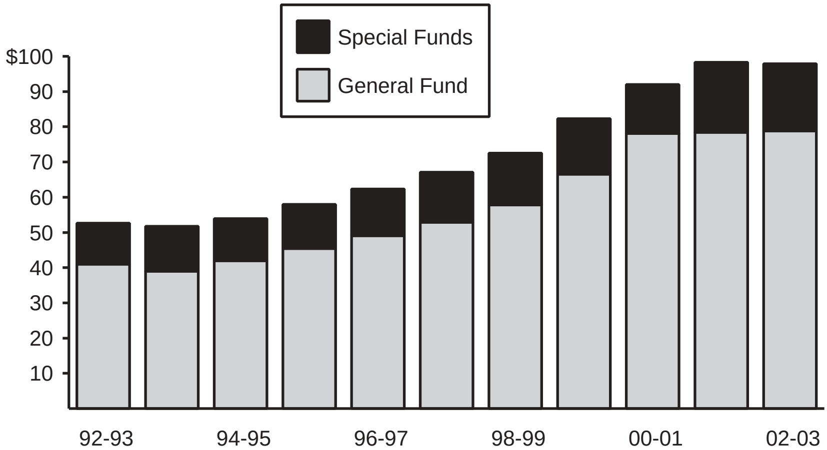
Spending Trends and Their Determinants. Figure 4 shows the amounts of state General Fund and special funds expenditures since 1992-93. Their underlying trends and year-to-year variations are affected by a variety of factors. Generally, the most important factor tends to be the strength of the economy and the state revenues it generates to fund expenditure programs. However, decisions that policy makers and voters make also can have major effects on spending levels. One example is voter approval of Proposition 10 in 1998, which raised cigarette and tobacco taxes. Another example involves the numerous decisions made by the Governor and Legislature in recent years about how to allocate the state's large revenue increases between (1) tax relief and new spending, and (2) one-time and ongoing purposes.

Upward Trend to End. Figure 4 indicates that the modest decline in total state expenditures that is proposed in the Governor's budget is the first such fall-off since 1993-94. It also shows that expenditures have nearly doubled over the past ten years and that over two-thirds of this total growth has occurred since 1997-98. This growth was facilitated by the state's especially strong revenue performance during the latter part of the 1990s, driven by its robust economy and the stock market's gains.

Figure 4

Total State Spending Over Time[a]

1992-93 Through 2002-03
(In Billions)



[a] Data are on a budget basis and exclude bond fund expenditures, federal funds, and Local Public Safety Fund expenditures.

Symmetrically, the budget-year's slight proposed decline reflects the current softness in California's revenue performance, caused by the recession and sharp drop in capital gains and stock-option income.

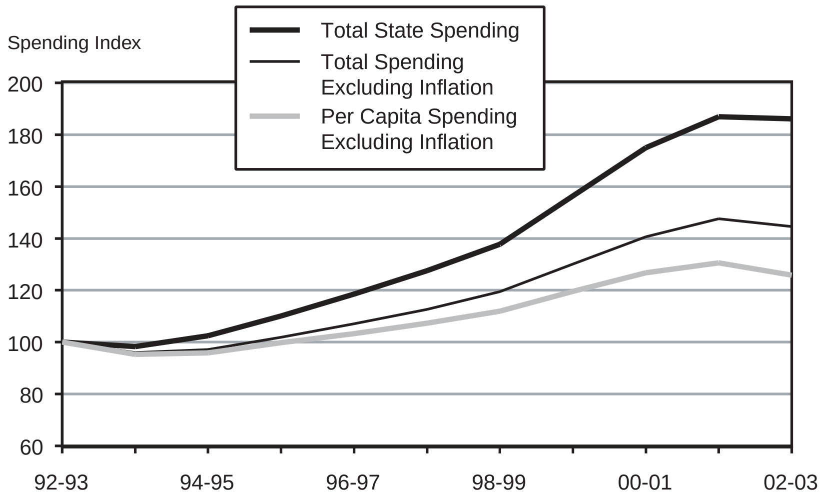
Components of Past Growth. Figure 5 (see next page) breaks out the causes for the state's expenditure growth over the past ten years according to its three principal components—inflation in the costs of providing public services, population growth, and "real" growth in state programs. It indicates that:

- ***Inflation-adjusted spending*** has grown by about 45 percent over the period, indicating that less than one-half of the doubling in spending has been due to higher prices.
- ***Real per-capita spending***—which adjusts for both inflation and population growth (which grew by 15 percent)—has increased by about 26 percent over the period. For 2002-03, real per capita spending is proposed to be $2,114, up from $1,680 in 1992-93. Even taking account of its budget-year decline, real per capita expenditures have grown at an average annual rate of 2.3 percent over the entire period.

Figure 5

Spending Adjusted for Inflation and Population

Index Value = 100 in 1992-93



SPENDING BY PROGRAM AREA

Distribution of Total State Spending

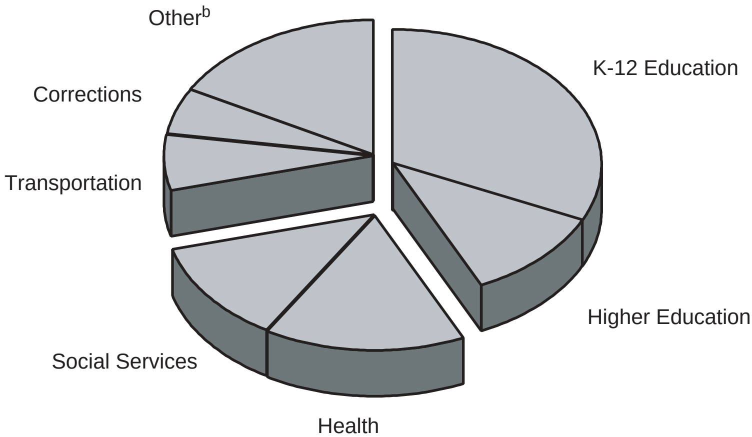
Figure 6 shows the allocation of the proposed $97.9 billion of total state spending in 2002-03 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of the support in some areas (such as transportation).

The figure shows that K-12 education receives the largest share of total spending—about one-third. (It should also be noted that K-12 education receives additional funding from local sources.) When higher education is included, the education share rises to over 43 percent. Health and social services programs account for about 28 percent of proposed total spending, while transportation and corrections together account for roughly 12 percent. In the "all other" category (17 percent), the largest share is for general-purpose fiscal assistance provided to local governments in the form of shared revenues and General Fund payments that backfill local losses from the recent VLF reductions.

Figure 6

Proposed Total State Spending By Major Program Area[a]

2002-03



[a] Excludes bond funds, federal funds, and Local Public Safety Fund.
[b] Includes expenditures on resources, environment, and general government.

Relative Growth Over Time and in the Budget Year

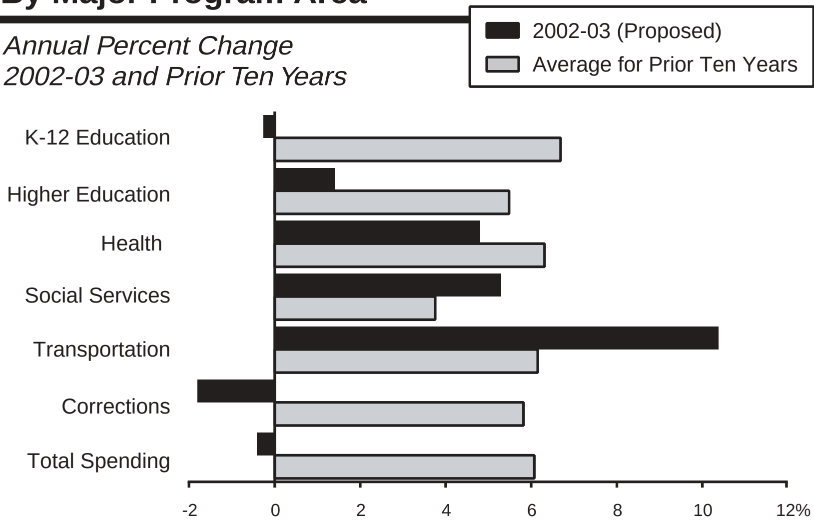
In order to gain a perspective on changes in total state spending by program area, Figure 7 (see next page) shows proposed 2002-03 program-by-program growth compared to such growth over the past ten years. It indicates that:

- ***Total state spending growth*** over the past ten years averaged 6.1 percent, compared to the 0.4 percent decline proposed for the budget year.
- ***Transportation*** shows the largest spending increase in the budget year (10.4 percent), mainly reflecting the earlier-noted large increases in special funds spending for capital outlay projects. By comparison, growth averaged in the mid-6 percent range over the past ten years.
- ***Health-related programs*** are proposed to increase by 4.8 percent in 2002-03, or somewhat less than the 7 percent average annual increase over the past decade. This slower-than-average growth rate reflects some programmatic reductions the Governor is proposing for Medi-Cal.

Figure 7

Growth in Total State Spending By Major Program Area[a]

Annual Percent Change 2002-03 and Prior Ten Years



[a] Excludes "all other" spending.

- ***Higher education*** is proposed to increase a modest 1.4 percent in the budget year, compared to its 5.5 percent increase over the past decade. The small budget-year increase is due to a significant amount of one-time expenditures in the current year for the University of California (UC) and California State University (CSU) segments.

- ***Social services spending*** is proposed to increase about 5 percent in 2002-03, or by slightly more than the annual average increase for the past ten years. Much of this increase is attributable to expenditure growth in the Supplemental Security Income/State Supplementary Program (SSI/SSP) and IHSS.

- ***Corrections spending*** is proposed to decline by 1.8 percent in 2002-03, partly due to a projected decline in the inmate population. This decline is in contrast to the experience of the past ten years, when spending grew at an average annual rate of about 6 percent.

- ***K-12 spending*** is projected to decline slightly in 2002-03. (This decline is due to the Governor's proposed budget-year reduction in state retirement contributions for schools.) As discussed below, total combined state and local funding for schools increases modestly in the budget year. The budget is assuming, however, that growth in local property taxes will cover the increase.

Key General Fund Spending Developments

Given the multibillion-dollar budget shortfall that the Governor's proposed spending plan attempts to address, program expansions and new initiatives are limited in the new budget. However, the Governor does propose at least some of these, and funding levels for many key programs are maintained.

Most of the Governor's new proposals and augmentations are discussed in detail in our accompanying *Analysis of the 2002-03 Budget Bill.* Below, however, we provide a general overview discussion of the Governor's key General Fund spending proposals as previously summarized in Figure 4 of "Part I" of this document. A more detailed discussion follows in the next section entitled "Major Expenditure Proposals in the 2002-03 Budget."

K-12 Education

Proposition 98 allocations to K-12 schools (which include local property tax revenues) total $41.2 billion in 2002-03. This represents an increase of $1.2 billion, or 3.1 percent, over the Governor's current-year estimate. This current-year estimate includes significant reductions proposed by the Governor in November. (Most of these reductions have been adopted by the Legislature in the Third Extraordinary Session.) Relative to the level of funding approved in the *2001-02 Budget Act*, the proposed spending level for 2002-03 represents an increase of $734 million, or 1.8 percent. The budget proposes Proposition 98 resources of $7,058 per pupil for 2002-03. This represents an increase of 2 percent relative to the revised current-year estimate and 0.8 percent relative to the *2001-02 Budget Act* amount.

Spending to Equal Minimum Required Amount. Unlike in recent years when the Proposition 98 minimum funding guarantee has been overappropriated, the budget proposes Proposition 98 spending equal to the minimum funding requirement. Within this amount, the budget provides $843 million for a 2.15 percent cost-of-living adjustment (COLA) for revenue limits and most categorical programs. The budget also provides $438 million for statutory growth, based on projected statewide attendance growth of 1.07 percent. In addition, the budget proposes several program augmentations, and also provides ongoing funds for various programs funded in the current year with one-time monies. To offset these augmentations, the budget for K-12 education relies on current-year and budget-year reductions to various existing programs.

Higher Education

Community Colleges. The budget proposes $4.7 billion in Proposition 98 funding for California Community Colleges. This represents an increase of 3 percent over the current year. This increase includes support for 3 percent growth in enrollments and a 2.15 percent COLA. The General Fund component of Proposition 98 funding is reduced by 0.4 percent due to an anticipated increase in local property taxes.

UC and CSU. Here, the budget proposal includes a combined 2002-03 General Fund reduction of 1 percent, comprised of a 2.5 percent reduction for UC and an increase of about 1 percent for CSU. (The overall decline is due to one-time expenditures in the current-year budgets for both segments.) These budgets support a 1.5 percent general increase and 4 percent enrollment growth for both UC and CSU.

State Retirement Contributions

The Governor's budget proposes to postpone payment of the state's retirement contributions to the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS) in exchange for the administration's support of particular retirement benefit enhancements. Specifically, in exchange for lowering the state's PERS contributions earlier than scheduled, the administration has agreed to support legislation that increases future payments to retirees that provide purchasing power protection at 80 percent instead of 75 percent of the initial pension amount, effective January 1, 2005. The provisions of the STRS agreement have not been finalized.

Other Programs

Health Programs. In the Medi-Cal program, the budget includes proposals for certain spending reductions, including reforms in the way drugs are purchased and provided to patients ($100 million), cuts in provider rates ($78 million), and establishment of copayments for certain patients ($31 million). The budget also assumes that expansion of the Healthy Families Program to parents—initially slated to start in the current fiscal year—will be postponed until 2003-04. (Following recent approval of a federal waiver, however, the Governor has indicated support for the expansion to occur in the budget year.)

Social Services. The budget proposes to suspend statutory COLAs for CalWORKs and SSI/SSP, and does not provide the discretionary COLA for Foster Care and related programs. The budget also provides no inflation adjustment for county administration of CalWORKs, Foster Care, or Food Stamps. The Governor also proposes to reform California's subsidized child care system by modifying current eligibility rules, reimbursement rate limits, and family fees.

Youth and Adult Corrections. The budget proposes reduced General Fund spending for the California Department of Corrections and the Department of the Youth Authority due to reduced inmate and ward populations, respectively. In addition, the budget proposes savings from deactivating some community correctional facilities and shifting General Fund support for some programs to Workforce Investment Act funds.

Transportation. The budget proposes to loan $672 million from the Transportation Congestion Relief Fund (TCRF) to the General Fund. This amount is in addition to the $238 million transferred in the current year from the TCRF to the General Fund. The budget anticipates that the General Fund will repay the TCRF loans over a three-year period beginning in 2003-04.

Local Government. The budget does not change major local government subventions provided by the state, including those associated with the property tax and vehicle license fee. Existing criminal justice grant programs, such as the Citizens' Option for Public Safety and technology grant programs, are continued. Certain proposals of the Governor regarding state-county health and social services programs may increase county costs.

Capital Outlay. The budget includes $1.7 billion for capital outlay projects, of which the vast majority are financed from bonds. Included in this total are new lease-payment bonds for the Governor's Economic Stimulus Package to accelerate new public works projects. Direct General Fund appropriations for capital outlay total $66 million.

Perspectives on
State Expenditures

MAJOR EXPENDITURE PROPOSALS IN THE 2002-03 BUDGET

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 2002-03 Budget Bill*.

EDUCATION

Education programs account for 53 percent of General Fund spending in the *2002-03 Governor's Budget*. Below, we provide an overview of the budget for K-12 and higher education, beginning with a focus on Proposition 98.

Proposal—K-12

Background. Proposition 98 establishes a minimum funding level that the state must provide for public schools and community colleges each year. K-12 education receives about 90 percent of total Proposition 98 funds.

Governor's Budget-Year Plan. The budget proposes $41.2 billion in total K-12 Proposition 98 funding in 2002-03 (consisting of state General Fund and local property tax allocations). This is an increase of about $1.2 billion, or 3.1 percent, compared to the 2001-02 revised amount. Pupil attendance is projected to increase by 1.07 percent, resulting in funding of $7,058 per pupil, an increase of $136 (2 percent) from the revised 2001-02 amount.

The major 2002-03 budget proposals include:

- $843 million for a 2.15 percent cost-of-living-adjustment (COLA).
- $438 million for projected 1.07 percent growth in average daily attendance (ADA).
- A major child care reform proposal that would modify current eligibility rules, reimbursement rates for child care providers, and family fees.
- A major restructuring of instructional materials and library materials programs, including $250 million for an instructional/library materials block grant and $375 million of one-time funds for three separate grants for instructional materials, library materials, and science lab equipment.

Proposal—Higher Education

The University of California (UC) and the California State University (CSU). The budget proposes General Fund support for UC and CSU of $6.1 billion in 2002-03. This represents an increase of $68.5 million, or 1.1 percent, above estimated current-year expenditures. Budgeted enrollment would increase by 7,100 full-time equivalent (FTE) students at UC and 12,030 FTE at CSU—a 4 percent increase in enrollment for each system. The Governor's budget provides UC and CSU with a 1.5 percent base increase totaling $85.3 million. The budget proposal also includes various programmatic reductions totaling $65 million.

California Community Colleges (CCC). The budget proposes $2.7 billion in General Fund support for CCC in 2002-03. All but $11.6 million of this amount counts as Proposition 98 spending. The 2002-03 General Fund request represents a decrease of $80.1 million, or 2.8 percent, from the current-year estimate. When all funding sources are considered, including student fee revenues and local property taxes, the 2002-03 budget proposal would increase funding for CCC by $101.6 million, or 1.7 percent.

The Governor's budget proposal includes $88.8 million for a 2.15 percent COLA, $120.2 million for enrollment growth of 3 percent, and $91.2 million to replace one-time funds in the current year for ongoing program costs. The budget also would reduce various categorical programs by $121.7 million.

Student Aid Commission. The Governor's budget proposes a General Fund increase of $162 million, or 28.4 percent, for the Student Aid Commission. The majority of this increase ($155 million) is due to an estimated increase in the number of Cal Grant awards in 2002-03.

Issues for Legislative Consideration

Budget Could Understate Proposition 98 Minimum Requirement. The Governor's budget proposes Proposition 98 spending of $46 billion for 2002-03—the administration's estimate of the minimum guarantee. Of this total, an estimated $14.6 billion is provided by local property tax revenues and the remaining $31.4 billion is provided by the General Fund. The administration's estimate of the General Fund amount needed to meet the guarantee is driven by three key factors: its estimate of property tax revenues ($14.6 billion), its estimate of K-12 ADA growth (1.07 percent), and its estimate of growth in California per capita personal income (negative 3 percent). Our estimates depart from the administration's estimates on two factors:

- ***Property Tax Revenues***. Our estimate of the property tax revenues that will be allocated to school districts, county offices of education, and community college districts is $110 million less than the administration's estimate. This difference would not affect the overall amount guaranteed for K-14 education programs, but would affect the amount of General Fund money needed to supplement property tax revenues in order to meet a given guarantee level. Thus, our estimate implies that the state will need to "find" $110 million from the General Fund to make up for a shortfall in property tax revenues.
- ***Per Capita Personal Income***. The Governor's budget assumes that California per capita personal income will decline 3 percent. Based upon more recent information, our best estimate is that the decline will be 1.5 percent. If our estimate is correct, the guarantee will be $715 million higher than the budget, with the entire amount due from the General Fund.

Combining our property tax revenue estimate and the impact of per capita personal income, we think the budget could understate General Fund needs for meeting the Proposition 98 guarantee by a total of $825 million.

In the "K-14 Education Priorities" section of the education chapter in the *Analysis*, we discuss ways for the Legislature to act strategically in response to the challenge posed by an increased General Fund demand from Proposition 98. These ways include exercising still-viable options to save current-year Proposition 98 monies (an estimated $161 million), substituting monies available from the Proposition 98 reversion account for other current-year Proposition 98 funding (saving $535 million), and "moving" certain education expenditures budgeted from non-Proposition 98 sources to Proposition 98 (potentially hundreds of millions of dollars).

Need for Greater Local Flexibility—K-12 Education. The *2001-02 Budget Act* allocated approximately 31 percent of K-12 Proposition 98 funds, or about $12 billion, for over 70 categorical programs. (The remaining 69 percent of funding is available for local education agencies to spend for general educational purposes.) Programs range from the very large ($2.7 billion in special education funding during 2001-02) to the small ($250,000 for civic education). The main rationale for categorical programs is to address program areas where local school boards may have incentives to under-invest. An example is special education, where high per-pupil costs could lead districts to provide less service than needed.

As we have discussed in previous publications, including *A Special Session Guide to K-12 Reform* (January 1999) and *A K-12 Master Plan: Starting the Process* (May 1999), the existing system of categorical programs causes many problems for the state and local school districts including:

- No conclusive evidence on the success of categorical programs.
- State rules restrict needed local flexibility.
- A fragmentation of local programs.
- Funding formulas create negative incentives.
- Blurred accountability for meeting student needs.

Consolidating categorical programs maximizes local control for districts in order to best meet their particular needs and, if structured well, shifts the focus from process to educational results. Specifically, the benefits of categorical reform include: (1) increased local control, (2) more efficient allocation of program funds, (3) clearer program directives, and (4) clearer lines of accountability.

To increase local flexibility, eliminate negative incentives, and provide a more cohesive system for categorical programs, we recommend that the Legislature consolidate 51 programs into five categorical block grants—Academic Improvement, Compensatory Education, Alternative Education, School Safety, and Teacher Support and Development.

Adopting a Higher Education Fee Policy. For the eighth straight year, the Governor's budget for higher education proposes no increase in student fees, and the share of educational costs covered by fees continues to decline. However, in a departure from recent practice, the budget does not include an increase in General Fund support to compensate for the lack of a fee increase. In the *Analysis* we recommend that the Legislature enact in statute a consistent fee policy which provides for an appropriate sharing of educational costs between students and the state and which preserves student access to higher education.

Expand Competitive Cal Grant Programs. In the *Analysis* we recommend expansion of the competitive Cal Grant program by redirecting state funds from certain financial aid programs at UC and CSU. This would help create a statewide financial aid system that is more efficient and objective. A total of $294 million in General Fund monies would be shifted to the competitive Cal Grant programs from UC's and CSU's institutional aid programs.

Combine Community Colleges' Categorical Programs. The Governor's budget would reduce funding for several of CCC's categorical programs by a total of $121.7 million. We recommend, however, that these reductions be accompanied by a consolidation of funding for 12 categorical programs into two block grants in order to allow greater flexibility in directing available resources where they are the most needed.

CALWORKS PROGRAM

The federal welfare reform legislation of 1996 replaced the Aid to Families with Dependent Children (AFDC) program with the Temporary Assistance for Needy Families (TANF) program. The Legislature subsequently enacted Chapter 270, Statutes of 1997 (AB 1542, Ducheny, Ashburn, Thompson, and Maddy), which created the California Work Opportunity and Responsibility to Kids (CalWORKs) program to replace the state's AFDC program. The CalWORKs program provides cash grants and employment and training services to eligible families.

Proposal

The CalWORKs Budget System. Funding for CalWORKs employment services, child care, and program administration are provided to the counties in a block grant known as the "single allocation." Within the block grant, counties have the discretion to move funds among programs in order to address local priorities.

The budgeting system for the employment services and administrative cost components of the single allocation is based on county projections of costs. Under this system, known as the proposed county administrative budget (PCAB) process, the Department of Social Services (DSS) reviews the counties' PCAB requests for consistency with state law and workload needs and adjusts the county funding requests accordingly. The budget proposes three significant changes to the CalWORKs budgeting system:

- ***PCAB Suspension.*** Due to funding pressures in the CalWORKs program, the budget proposes to suspend the PCAB process for 2002-03, thereby funding county administrative and employment services costs at their current-year funding levels, adjusted for caseload changes. Current funding levels will not be adjusted for inflation.

- ***New County Block Grant.*** The Governor proposes to replace the county single allocation with a new county block grant, to be known as the "county program grant." In addition to funding for employment services, administration, and child care, the county block grant will include $109 million in funding currently earmarked for mental health and substance abuse treatment and $201 million in funding currently earmarked for probation camps and juvenile treatment facilities. Rolling these allocations into a county block grant will increase county flexibility to move funds across program purposes as needed.
- ***Holdback of County Allocations.*** The Governor proposes to retain up to 5 percent (approximately $95 million) of the county block grant allocations to cover potential cost increases for assistance payments in CalWORKs or the Kinship Guardianship Assistance Payment Program (Kin-GAP)—a program that enables children to exit the foster care system and live with a relative guardian. Because assistance payments from these programs are "entitlements," unanticipated cost increases in these programs due to caseload growth or changes in federal law would be funded automatically with either TANF or General Fund resources. Under the Governor's proposal, such program cost increases would instead be funded first from the 5 percent holdback funds, which would otherwise support employment services and program administration. In other words, the Governor proposes to use up to approximately $95 million of county program grant funds to mitigate the potential General Fund impact of unanticipated caseload growth.

Issues for Legislative Consideration

Expanding the County Block Grant. We believe that counties are in the best position to weigh the educational and employment service needs of their CalWORKs caseloads against various competing county priorities, both within and outside of the CalWORKs program. Thus, we recommend that the Legislature build on the Governor's county block grant proposal by including additional TANF categorical allocations. Currently, $44 million in TANF funds are allocated to the California Community Colleges, the State Department of Education, the Department of Health Services, and local Boys and Girls Clubs. We recommend that these categorical allocations, which provide (1) employment and educational services to CalWORKs recipients and (2) teen pregnancy prevention services, should instead be incorporated into the county block grant. Counties would have the flexibility to contract with local colleges, universities, and community-based organizations as needed.

Holdback Is Disruptive. While we recognize the need to limit the risk to the General Fund in the budget year given the state's fiscal condition, we believe that the Governor's 5 percent holdback proposal is disruptive to the counties' planning process and their ability to budget for employment services and administrative costs. This is because the actual amount of county funds that will ultimately be redirected for grant payments is unspecified.

A less disruptive approach for the counties, while also protecting the General Fund in the event of unanticipated caseload growth, would be to establish a larger TANF reserve. This could be accomplished either through an outright program reduction (for example, reducing the level of employment services), or by retaining a portion of the proposed $431 million reappropriation for performance incentives. In our view, these incentive funds are not as necessary for core program services as the basic allocation for employment services. We therefore recommend that the Legislature reject the Governor's 5 percent holdback of the county block grant. To the extent the Legislature wishes to augment the TANF reserve for the purpose of protecting the General Fund, we recommend that the Legislature retain a portion of the proposed reappropriation for performance incentives.

CalWORKs Needs Long-Term Budget Plan. Since its enactment in 1997, CalWORKs funding has remained essentially stable, due primarily to a fixed amount of TANF block grant funds and the state's decision to limit its share of funding to the minimum maintenance-of-effort (MOE) requirement. This funding level was sufficient to support the CalWORKs program in its early years. However, our most recent review finds that in 2001-02, the welfare-to-work allocations for 11 counties (representing approximately 50 percent of the statewide caseload) were underfunded. The cost of bringing all counties up to a minimum funding level (without redistributing funding from the higher-funded counties) would be approximately $125 million.

The Legislature has recognized the likelihood that funding pressures would continue to intensify in future years. Accordingly, it directed DSS to develop a new budgeting methodology for both CalWORKs and non-CalWORKs programs funded with TANF funds. The department has not yet submitted a new budgeting methodology to the Legislature.

To address the growing fiscal pressures in the CalWORKs program, we have identified three issues for legislative consideration in developing a long-term budget plan:

- ***Should the Legislature Fund CalWORKs Above the MOE Floor?*** Since CalWORKs was enacted, the Legislature has taken steps to maintain General Fund spending at the MOE floor. Prior to the current year, this budgeting approach was possible without funding reductions in core program elements. However, as caseloads increase and available resources decrease, maintaining General Fund spending at the MOE floor will require reductions in either the level of employment services or assistance payments. The decision about whether to exceed the minimum state spending requirement therefore involves balancing the benefits of budgetary savings against the impact on time-limited CalWORKs families.
- ***How Should the Legislature Weigh Funding of Grants Versus Services?*** The decision about the appropriate funding level for CalWORKs also involves weighing the relative importance of two primary goals of a welfare-to-work program: (1) providing an adequate level of cash assistance to enable needy families to maintain a minimum standard of living and (2) providing an adequate level of employment services to enable recipients to gain the skills needed to work and eventually become self-sufficient. Investing in employment services is especially important given the lifetime limit on cash assistance for adult recipients. However, the costs of this investment must be balanced against the costs of ensuring that needy families are provided with sufficient income maintenance. We note that if the Legislature elected to reduce grants, about 45 percent of any such reduction would be offset by an increase in federal food stamp benefits.
- ***How Should Funds Be Allocated to Counties?*** Finally, developing a long-term budget plan requires consideration of how funding for employment services and administration is allocated among counties. Current funding allocations per aided adult vary widely across the counties. Such variation in allocations raises concerns about equitable access to employment services. In order to ensure more equitable access to services, the Legislature should consider allocating all funding for employment services and administration on a per-aided-adult basis (because adults receive the employment services). Final allocations could be adjusted for high- and low-cost regions and for small counties with high fixed costs. In order to avoid unnecessary disruption, this change could be phased in over two to three years.

CRIMINAL JUSTICE AND JUDICIARY

State and local governments spend more than $18 billion annually to fight crime. Local governments are largely responsible for crime fighting and, thus, spend the bulk of total criminal justice monies for law enforcement activities. State expenditures have grown significantly in recent years, however, particularly for support of the state's largest criminal justice department, the California Department of Corrections (CDC). The CDC is responsible for the incarceration, training, education, and supervision in the community of adult criminals. Other state entities spend large sums of money on criminal justice activities as well, including the Departments of the Youth Authority and Justice; the trial courts; and the Office of Criminal Justice Planning.

Proposal

The budget proposes about $8.2 billion from the General Fund and other state funds for support of criminal justice programs in the budget year, a decrease of 1.4 percent below estimated current-year spending.

The CDC accounts for the largest share of this funding, $4.8 billion, or about 1 percent below the current-year amount. The budget provides full funding for the number of prison inmates and parolees under current law. The budget proposes to deactivate approximately 1,850 low-level offender community facility beds for modest budget savings. The budget does not propose new spending initiatives, but rather maintains recent criminal justice program augmentations, such as for the War on Methamphetamine, and grants to local law enforcement agencies.

Issues for Legislative Consideration

Crime Rates Increase Slightly. The crime rate dropped dramatically through the 1990s, reaching an all-time low in 1999. However, the most recent data reported by the California Department of Justice indicates that the *overall* California crime rate rose by 1 percent in 2000 after nine years of decline. The increase occurred in four out of six major crime offense categories. These include homicide, forcible rape, property crimes, and aggravated assault. The most significant change occurred in the forcible rape category, which increased by 2.5 percent over 1999. The robbery rate decreased slightly (1 percent), bringing it to its lowest level since 1967. Overall, *violent* crime remained at about the same level after declining for seven consecutive years.

There are probably many reasons for this slight increase, including growth in the crime-prone age bracket (ages 16 to 49), higher reporting of crimes, and improvements in policing and other law enforcement techniques. Another factor which is usually considered, but which does not seem to be at play here, is the economy. All the economic indicators were strong throughout most of 2000 suggesting that the economy was not a factor in the rising crime rate during the reporting period. However, the more recent downturn in the California economy could have the effect of further pushing the crime rate upward.

Cost Reduction Measures Needed in Corrections. The CDC is the largest state corrections agency in the nation. With over 45,000 employees and a total budget of about $4.8 billion, the CDC manages over 156,000 prison inmates, and more than 121,000 parolees. During the past ten years, CDC's average annual growth rate has been about 8 percent, although during the last couple of years the rate of growth has slowed somewhat. Nevertheless, overall CDC's growth during this period was significantly faster than most other departments. Given the magnitude of the state's fiscal problem, the Legislature may wish to consider ways to reduce the inmate and parole populations. Because CDC is a caseload-driven budget, it will not be possible to significantly reduce expenditures for the department without taking action to control inmate and parole population growth.

In considering measures to control the inmate and parole populations, the Legislature should focus on two target groups: nonviolent offenders and short-term offenders. The state prison system has a significant number of inmates who are serving time for nonviolent offenses such as property and drug offenses. Similarly, there is a sizeable number of offenders with short prison terms, some with terms as short as six months or less. The state incurs significant costs to process these inmates. Targeting reductions on these two groups could result in budgetary savings while not jeopardizing public safety.

It should also be noted that maintaining an offender in the community under supervision is significantly less costly than incarceration in prison. For example, inmates who are released from prison early or who are redirected from prison could be placed in the community with more intensive supervision. Electronic monitoring devices could be used to ensure that individuals remain within a confined area. This could work particularly well with certain inmates, including those who are nonviolent, chronically ill, and elderly. In our report, *Options for Addressing the State's Fiscal Problem*, we provide estimates of the impact of such options on the prison population and CDC's budget.

Question of State Support for Trial Courts Needs Resolution. The state General Fund now contributes over $1.2 billion toward the cost of trial court operations. This is a result of recent legislation that transferred responsibility for court operations and personnel systems from the counties to the state. One issue which remains unresolved is whether, and under what circumstances, responsibility for court facilities should be transferred to the state. In our view, state responsibility for those facilities would be consistent with prior legislative actions in the area of court operations and personnel.

This issue of facility responsibility is one which deserves legislative attention for several reasons. First, until this issue is resolved, some counties are likely to continue to backlog deferred maintenance, thereby resulting in continued facility deterioration. Second, facility transfer poses a potentially huge funding liability to the state's General Fund. The current annual cost of supporting court facilities is estimated at $140 million (which would be offset by $80 million to $90 million in county maintenance-of-effort agreements). The larger cost, however, is the estimated *future* capital funding needs which are estimated in the multibillion dollar range over the next 20 years.

Because of the fiscal implications and complexity of the task, we recommend that Judicial Council report at budget hearings on the status of its plan to transfer trial court facilities to the state. We believe that such a plan should (1) address the timing for state assumption of responsibility for these facilities, (2) streamline the facility transfer process, (3) include court facilities in the state's existing capital outlay planning process, and (4) count court facility funding from the state as fiscal relief in the context of the state-county fiscal relationship.

TRANSPORTATION

California's state transportation programs are funded by a variety of sources, including special funds, federal funds, and general obligation bonds. These funds include the following:

- The State Highway Account (SHA) provides the largest share of ongoing state revenues for transportation.
- The Traffic Congestion Relief Fund (TCRF) funds projects in the Traffic Congestion Relief Program (TCRP) enacted in 2000.
- The Toll Bridge Seismic Retrofit Account (TBSRA) funds the ongoing seismic retrofit of state-owned toll bridges.

Proposal

The Governor's budget proposes shifting transportation funds to provide money to the General Fund in the budget year. This proposal has several components:

- A $672 million loan from TCRF to the General Fund in the budget year, to be fully repaid over the following three years.

- A $474 million loan from SHA to TCRF in the budget year to prevent TCRF cash-flow problems, also repaid over three years.
- Deferral of a current-year transfer of $342 million from SHA to TBSRA. This transfer must eventually occur to fulfill SHA's commitment to the seismic retrofit of state-owned toll bridges.
- "Interim financing" of $210 million into TBSRA in the budget year, to be repaid by a later bond issuance. The bonds in turn will be repaid by toll revenues.

Issues for Legislative Consideration

Actual TCRF Balance Likely to Be Higher Than Projected. Based on our review of the department's cash-flow needs for TCRP projects, the proposed TCRF loan to the General Fund will most likely not have an adverse impact on project delivery. In fact, over the past seven years, the Department of Transportation has consistently overestimated its capital outlay expenditures. This past experience suggests that budget-year TCRF expenditures in all likelihood will be lower than projected. We believe TCRF expenditures by the end of the budget year could be about $300 million lower than the budget projects, leaving a higher balance by a like amount in the fund.

TCRF May Not Need Large Loan from SHA; More Money May Be Available for General Fund. To the extent TCRF expenditures are lower than the budget projects, the Legislature would have flexibility in determining how to use the money not needed for projects in 2002-03. For instance, part of the proposed loan from SHA to TCRF may not be needed. Reducing the SHA loan would allow Caltrans to use the money for other purposes, such as transferring the funds for toll-bridge seismic retrofit. Additionally, due to a higher fund balance in the TCRF, the Legislature could transfer more of these monies to the General Fund, if needed.

Analyst's Recommendation. To provide Caltrans with maximum flexibility and not commit it to needless transfers, we recommend the adoption of budget bill language limiting the transfer from SHA to TCRF to only what is needed for cash-flow purposes. Similarly, to provide the Legislature with the flexibility to transfer more from TCRF to the General Fund, if necessary, we recommend the adoption of budget bill language to allow the Department of Finance, after notification to the Legislature, to transfer more than $672 million if TCRF expenditures are lower than projected.

RESOURCES

Proposal

Funding for Resources and Environmental Protection Programs. For 2002-03, the budget proposes that the General Fund contribute substantially, if not entirely, to funding a number of resources programs:

- ***Fire Protection.*** The budget proposes $282 million from the General Fund for the California Department of Forestry and Fire Prevention (CDFFP) to provide fire protection services to property owners in "state responsibility areas" (SRAs). Property owners do not currently pay a fee to the state for these services.
- ***Water Quality Regulation.*** The budget proposes $68.3 million ($22.5 million General Fund) for the State Water Resources Control Board's (SWRCB's) core regulatory program overseeing dischargers of waste into the state's waters.
- ***Air Quality Regulation.*** The budget proposes $43.1 million ($24.9 million General Fund) for the Air Resources Board's (ARB's) stationary source program in 2002-03. Fees support less than 10 percent of the program, and are levied mainly on high-emitting polluters. Statute currently caps total fee revenues collected from these polluters at $3 million.
- ***Timber Harvest Plan (THP) Review.*** The budget proposes about $22 million (almost all General Fund) for state agencies to review and enforce THPs in 2002-03. A THP covers such matters as harvest volume, cutting method, and wildlife habitat protection. The CDFFP and other agencies reviewing and enforcing THPs currently do not have the authority to charge fees to cover their costs for these activities.

The Department of Parks and Recreation's (DPR's) Land Acquisitions. The budget proposes a limited amount of funding to develop existing acquisitions and acquire new lands, reflecting the near depletion of available Proposition 12 bond funds for this purpose. Proposition 40, if approved by the voters at the March 2002 election, will provide $225 million for state park improvements and acquisitions, of which no more than 50 percent can be used by DPR for land acquisitions. If Proposition 40 is approved, the Governor could propose expenditures of these bond funds at the time of the May Revision.

Tahoe Environmental Improvement Plan (EIP). The 2002-03 budget proposes $26.6 million of state funds for various state departments to implement the Tahoe EIP. Funds are appropriated for capital outlay projects and local assistance to achieve environmental standards in the

Lake Tahoe basin. The majority of the expenditures are to be funded from bonds, with less than 25 percent from the General Fund and special funds.

Issues for Legislative Consideration

Funding for Resources and Environmental Protection Programs. We think that several opportunities exist to create additional General Fund savings by shifting funding for resources and environmental protection programs from the General Fund to fees. Fees are an appropriate funding source in these cases, either because the state is providing a service that directly benefits an identifiable person or business (such as fire protection services) or administering a pollution control program that should be funded on a "polluter pays" basis. Under the polluter pays principle, private parties that benefit from using public resources are responsible for paying the costs imposed on society to regulate such activities.

Specifically, these opportunities for General Fund savings are:

- ***Fire Protection.*** We think that property owners in SRAs directly benefit from CDFFP's fire protection services and that they should share in funding the department's costs. Several other western states assess fees on property owners benefiting from state-provided firefighting services. There are a number of options available to structure the fees.
- ***Water Quality Regulation.*** All of the activities conducted under SWRCB's core regulatory program involve controlling water pollution created by dischargers of waste that operate under board-issued permits. It is appropriate that fee-based support fully replace the General Fund on the basis of the polluter pays principle. This would result in a General Fund savings of $22.5 million.
- ***Air Quality Regulation.*** A majority of the General Fund expenditures proposed for ARB's stationary source program is for planning and monitoring activities that provide a basis in science and technology for air quality-related permits. These activities prevent permit requirements from being arbitrary or unduly burdensome on the holder of the permit. As such, they provide a benefit to the permit holder and therefore should be funded from fees. By shifting funding for these activities to fees, the General Fund would save $18.7 million.
- ***THP Review.*** We think that fees levied on timber operators should cover the total state agency costs to review and enforce THPs. This is because there is a direct link between the THP review and enforcement and those who directly benefit from it through harvesting of timber. Enacting timber harvest fees as we recommend would save the General Fund $21.5 million.

The DPR's Land Acquisitions. The DPR's land acquisitions can create future development and operating obligations for the department. However, in many cases, these obligations have not been provided for or identified as part of the acquisition process. To the extent that these obligations are unaccounted for in the funding decision, neither the full benefits to the public associated with the acquisition are likely to be achieved nor are the stewardship needs of the acquisition likely to be met.

In order that the Legislature can assess the extent of obligations created by recent park acquisitions, we recommend that the Legislature direct the department to identify the costs associated with developing and providing access to these acquisitions as well as potential funding sources. Once the Legislature has reviewed the department's funding plan, it may wish to give funding priority to future capital outlay appropriations that would be used to develop timely public access to *existing* acquisitions.

We also recommend a number of statutory actions the Legislature can take to ensure that the development and ongoing operating costs associated with future state park acquisitions are better identified and addressed. Specifically, we recommend the enactment of legislation requiring DPR to submit funding plans for future land acquisitions and set aside bond funds for future development of bond-funded acquisitions. In addition, the Department of Finance should be required to approve the general plan proposal for new park acquisitions or significant revisions to existing parks. We also recommend the Legislature set specific limits in future bond measures on the proportion of funding allocations to DPR to be spent to acquire lands.

Tahoe EIP. Because of the state's potentially large financial commitment to the EIP effort in coming years, and because of a recent status report conducted by the Tahoe Regional Planning Agency showing that the program was failing to meet most of its short-term goals, we think that legislative oversight of the Tahoe EIP is needed. Such legislative oversight would be enhanced by holding joint hearings, in each house, of the environmental quality, natural resources, and budget committees. These hearings would give the Legislature the opportunity to be informed of the policy choices and funding priorities inherent in the budget proposal, as well as to be apprised of the progress being made in the program.

We also find that the Legislature's oversight of the Tahoe EIP has been complicated by the lack of a clear identification of Tahoe EIP expenditures in the Governor's budget document. We recommend that future budgets separately identify these expenditures.

ENERGY-RELATED ACTIVITIES

Due to the state's markedly different energy situation this year versus last, the Governor's budget proposes significantly less total expenditures for energy-related activities in 2002-03 than in 2001-02. The various agencies directly involved in these activities include the: (1) California Energy Commission (CEC); (2) California Public Utilities Commission's Energy Division; (3) Electricity Oversight Board; (4) California Consumer Power and Conservation Financing Authority (California Power Authority, or CPA); (5) California Energy Resources Scheduling (CERS) division within the Department of Water Resources (DWR); and (6) Division of Oil, Gas, and Geothermal Resources within the Department of Conservation.

Budget Proposal

Spending Down Significantly. The Governor's budget proposes roughly $314 million to support the state's energy-related activities carried out by the different boards, commissions, and departments identified above. This is about $157 million less than estimated current-year expenditures of roughly $471 million. Prior-year expenditures totaled around $680 million.

Reasons for the Decline. The reduction in budget-year expenditures from the current-year amount reflects two factors. About three-quarters of the reduction involves lower CEC expenditures, primarily in the energy conservation area for various loans, grants, rebates, efficiency standards, and technical assistance to deal with the 2001 electricity crisis. The remaining quarter largely reflects reduced CERS administrative expenditures associated with managing the state's power purchasing program (see below regarding projected electricity purchases). In contrast, there are relatively few new budgetary proposals for 2002-03 in the energy area, and General Fund spending levels in many of the energy-related boards, commissions, and departments have returned to their pre-crisis levels.

New Entities Now Operational. During 2001, two new state energy-related entities were created—the CPA and CERS:

- ***CPA.*** The CPA was created by Chapter 10x, Statutes of 2001 (SB 6x, Burton), to finance the building or acquisition of new generation capacity so as to assure a reliable supply of power to Californians at just and reasonable rates. Currently, the CPA's start-up activities are being funded by a General Fund loan authorized in the current year and allocated in the current and budget years. However, both this loan and the CPA's ongoing operating expenses are to be covered in the future by revenue bond proceeds.

- ***CERS.*** The CERS division, created by Chapter 4x, Statutes of 2001 (AB 1x, Keeley), purchases electricity for the state on behalf of the investor owned utilities (IOUs). To date, CERS has entered into over $40 billion in long-term contracts to purchase electricity over the next 10-plus years. While its actual electricity purchasing activities are technically "off budget," CERS' administrative costs are subject to budget act appropriation. The DWR's Electric Power Fund, which is the depository of payments from ratepayers for the use of electricity purchased by DWR, supports the costs associated with administering CERS' power purchasing activities.

State Electricity Purchasing Activities. The administration projects "off-budget" 2002-03 expenditures of $5.1 billion for the purchase of electricity and related needs associated with DWR's activities, down from $7.6 billion in the current year.

The significant drop in amounts to be spent for electricity reflects three factors. First, when DWR began purchasing electricity on behalf of the IOUs in 2001, it had to buy largely on the spot market and prices there were extremely high. In the future, however, a large share of DWR's electricity purchases—estimated at as much as 75 percent by 2004—will be made under existing contracts at prices well below the spot market prices previously incurred. For example, prices under these long-term contracts average $84/megawatt hour (MWh) over the next five years and $74/MWh over the next ten years. This compares to previous spot market prices that at one time were well over $400/MWh.

The second reason for the lower projected budget-year electricity expenditures is the fact that, when the state does need to buy on the spot market, prices there are now much lower than earlier—currently around $40/MWh. The third factor is that the budget-year expenditure figure reflects only a half-year cost for purchasing the state's "net short" amount of electricity, since DWR's existing authority to do this expires at the end of 2002.

Reorganizing the State's Energy-Related Activities

Given deregulation and the state's 2001 energy crisis, the question has been asked: Should the state reorganize its energy-related entities and activities? In "Part V" of this volume, we describe the state's various energy-related entities and activities and discuss certain observed problem areas associated with them. We then suggest steps and organizational principles that may be helpful to the Legislature as it considers how to most effectively and efficiently organize and coordinate the state's energy-related activities.

STATE RETIREMENT CONTRIBUTIONS

The state contributes annually to the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS). Contributions to PERS cover state employees and nonteacher school employees. About 55 percent of the contributions towards state employees' retirement are paid from the General Fund, with the other 45 percent coming from various special funds. Contributions towards nonteacher school employees' and public school teachers' retirement come entirely from the General Fund.

Proposal

The Governor's budget proposes to postpone payment of the state's retirement contributions to both PERS and STRS in exchange for the administration's support of increased retirement benefits. The objective of these proposals is to achieve one-time savings, largely in the current year and budget year, to help address the state's General Fund shortfall. (Some savings would also occur in 2003-04.) In the aggregate, the two proposals would result in $2 billion of savings, including $1.6 billion to the General Fund, over three years.

Deferral of PERS Contribution. The proposed PERS deferral would reduce the state's contribution amount for the budget year by $1.029 billion, resulting in General Fund savings of $621 million. In exchange for lowering the state's retirement contributions earlier than scheduled, the administration has agreed to support legislation that would maintain the purchasing power protection of retirees' pensions at 80 percent of the initial amount, instead of the current 75 percent. Both the deferral and the benefit increase would require the state to pay higher contributions in the future.

Deferral of STRS Contribution. The provisions of the STRS agreement had not been finalized at the time this analysis was prepared. Under the current tentative agreement, however, the state would defer payment of nine quarters of its contributions for public school teachers' retirement benefits. This results in current-year and budget-year General Fund savings of $508 million. Additional savings in 2003-04 are estimated at $441 million. In exchange for deferring these contributions, the administration has agreed to support an as-yet-undetermined increase in benefits. Both the deferral and the benefit increase would require the state to pay higher contributions in the future.

Issues for Legislative Consideration

As part of its review of the deferral proposals, the Legislature should consider the following.

Deferral Proposals Are Extremely Costly. Our review shows that the state would have to pay a high price for the amount of General Fund flexibility it gets with the PERS and STRS agreements. These costs as currently structured would total over $13 billion and would last for the next 30 or so years, thereby reducing the state's fiscal flexibility for a long time to come. In present value terms (that is, adjusted for cheaper dollars in the future and foregone investment returns), this is equivalent to getting about $2 billion worth of fiscal flexibility at a cost of over $4 billion.

State Will Pay Interest Rates Higher Than the Market Rate. The interest rates charged to pay off the deferrals—8.25 percent for PERS and 8 percent for STRS—equal the rates of return the retirement systems assume they can achieve from investments. These rates are significantly higher than what the state would have to pay to borrow the funds in the private market (currently about 5 percent), and are higher than the Pooled Money Investment Account rate (currently about 3 percent). Thus, even if the state did not have to provide any additional benefits under either the PERS or the STRS proposal, the state would still be paying a premium to achieve the budget-year savings in state retirement contributions.

Special Funds Would Incur Cost for Deferral. The state's revenue problem principally affects the General Fund. However, the retirement proposals would result in budget-year savings to special funds as well, even though these funds do not face a budgetary shortfall. While the deferred special fund contributions would not benefit the state's fiscal condition in the budget year, the additional cost that results could necessitate increases in the future in the various fees and taxes that support these funds.

Proposals Will Tie Up Future Funds. The PERS and STRS proposals would commit General Fund revenues for decades to come in order to solve a relatively short-term fiscal problem. We estimate that beginning in 2006-07, the state would have to pay at least $312 million for the proposals, including $228 million from the General Fund. (This amount would likely increase when the STRS benefit change is determined.) These ongoing costs would reduce the state's fiscal flexibility by hundreds of millions of dollars for many years to come.

Analyst's Recommendation. Given these concerns, we recommend that the Legislature reject the proposed deferral of state retirement contributions to PERS and STRS and the additional retirement benefits as proposed. Instead, the Legislature should investigate other means of freeing up General Fund resources or reducing expenditures in 2002-03 that are less costly or have less impact on future revenues. Our office has presented recommendations in our *Analysis of the 2002-03 Budget Bill* for the Legislature's consideration and also identified additional expenditure and revenue options in a companion publication.

CAPITAL OUTLAY

The state owns a vast amount of infrastructure—including nearly 2.5 million acres of land, 180 million square feet of building space, and 15,000 miles of highways. Much of this infrastructure is aging. For example, 55 million square feet in the three public higher education segments was built or renovated over 30 years ago and most of the 9.5 million square feet of buildings in the state hospitals and developmental centers was built over 40 years ago.

Proposal

Budget Bill Proposal. The budget includes nearly $1.7 billion for the state's infrastructure (excluding highways and rail programs). As shown in Figure 8, over 56 percent of the proposal is for higher education, with the next largest amount in resources. Virtually all of the budget-year capital outlay program is financed from bond proceeds. This spending totals $1.5 billion, consisting of general obligation bonds ($637 million) and lease payment bonds ($875 million). The proposed general obligation bonds primarily finance projects for higher education ($511.5 million) and resources ($103.7 million). Only 9 percent of the amount proposed in the budget is for pay-as-you-go funding. (This compares to nearly 50 percent in the 2001-02 budget.) Of this amount about $65 million is from the General Fund, with the balance from special funds and federal funds.

Bond Debt. The state's debt payments on bonds will be about $3.1 billion in the budget year. This is an increase of slightly less than 1 percent over current-year payments. The payments include $2.6 billion for general obligation bonds and $555 million for lease-payment bonds. We estimate that the amount of debt payments on General Fund-backed bonds as a percent of General Fund revenue (that is, the state's debt ratio) will rise modestly from its current level of 4 percent to just over 5 percent in 2007-08 if (1) the Governor's proposed $30 billion in school bonds were approved over the next three election cycles, (2) the $2.8 billion in resources and voter equipment bonds on the March 2002 ballot were approved and, (3) the new bonds were sold off rapidly.

Issues for Legislative Consideration

California Infrastructure Plan. Existing law requires the Governor to submit, beginning in 2002, a five-year infrastructure plan in conjunction with the budget. The plan, however, was not submitted with the *2002-03 Governor's Budget*. Without this plan, the Legislature does not have information it needs to make informed decisions about capital outlay proposals in the budget. Accordingly, we recommend the Legislature defer approval of new capital outlay projects until the infrastructure plan has been submitted and the Legislature has had an opportunity to review it.

Figure 8

State Capital Outlay Program

2001-02 and 2002-03
(In Millions)

	2001-02[a]	2002-03[b]	Difference
Legislative, Judicial, and Executive	$3.7	$44.1	$40.4
State and Consumer Services	26.8	193.4	166.6
Business, Transportation, and Housing	194.4	106.9	-87.5
Resources	354.0	230.4	-123.7
Environmental Protection	2.2	—	-2.2
Health and Human Services	359.9	73.0	-286.9
Youth and Adult Corrections	63.0	41.5	-21.5
K-12 Education	2.6	0.5	-2.1
Higher Education	897.3	933.7	36.4
General Government	27.3	34.9	7.6
Totals	**$1,931.1**	**$1,658.3**	**-$272.8**

a Consists of spending from the *2001-02 Budget Act* and Governor's legislative package of $1.03 billion of lease-payment bonds, of which $403 million would provide funding for 24 projects as part of an economic stimulus package and $117 million to shift funding for ten projects from the General Fund.

b Includes funding proposed in the budget bill plus $269 million from lease-payment bonds as part of the Governor's pending legislative package for nine continuing and four new projects.

We also recommend the Legislature establish a select committee to address procedural changes that could be adopted to allow the Legislature to proactively address California's infrastructure needs and respond to the Governor's future infrastructure plans.

Project Management Fees. The Department of General Services (DGS) is currently managing in excess of 350 major capital outlay projects with a total value of approximately $4 billion. In its role as the state's capital outlay project manager, DGS assesses client agencies' various project management fees. Our review of the capital outlay program proposals for 2002-03 has identified many instances where the fees assessed to a project appear to be either excessive, unnecessary, or inconsistently applied. We also found there is a lack of justification and accountability for the methods used to calculate the fee included in the capital outlay project cost estimates. As such, there is currently no way to accurately determine or evaluate the cost of a given project using the DGS method of assessing project fees.

To address these concerns, we recommend that the Bureau of State Audits be commissioned to conduct a performance audit of the DGS relative to capital outlay project cost estimates in order to evaluate (1) the appropriateness of fees charged, (2) the method of determining fee levels, and (3) the quality control process in place for budget development.

Funding Higher Education Capital Outlay. As in previous years, we recommend the Legislature provide funding for higher education capital outlay based on statewide priorities and criteria, using reasonable construction cost guidelines, and based on year-round operation. This year we examined how intensively the segments are utilizing their existing facilities and found that improvements were needed. We found that the University of California (UC) does not use its facilities as intensively as required by current standards and that the California State University (CSU) and community colleges do not report their utilization to the Legislature. We therefore recommend the Legislature direct the segments to utilize their facilities *at least* as intensively as required by current standards, and that CSU and the community colleges report their actual utilization at least biennially. (The UC already reports this information.) Also, because of limited state resources for capital outlay, we recommend the Legislature authorize UC to use Garamendi bonds (revenue bonds backed by UC research revenue) to fund the construction of research space. This would allow state resources to be used for improvements to instructional facilities.

V

Major Issues Facing the Legislature

Using Borrowing to Help Address the Budget Problem

To What Extent Does the Governor Rely on Borrowing-Related Solutions to Address the Budget Shortfall? What Should the Legislature Focus On in Evaluating Such Options?

Summary

The 2002-03 Governor's Budget *proposes to use several different types of borrowing to help balance the budget. These borrowing-related proposals amount to about $4.8 billion in 2002-03, and together account for over one-third of the Governor's $12-plus billion set of solutions to eliminate the estimated budget shortfall.*

This analysis summarizes the various types of borrowing-related actions that are either proposed in the budget or could be considered by the Legislature for budget-balancing purposes. It also describes their main features, and identifies their estimated fiscal effects.

We then discuss the key factors that the Legislature should focus on in evaluating both the Governor's borrowing-related proposals and others that could be considered.

The first of these factors is the interest rate that must be paid—either directly or indirectly—on different types of borrowing. A second factor is the amount and timing of future borrowing repayments, and the implications of these repayments for the General Fund's condition beyond the budget year. A third factor is how different borrowing options "stack up" against the alternatives for addressing the budget shortfall, such as reducing expenditures and/or augmenting revenues.

The Legislature's ultimate decision regarding what borrowing options to use should depend on which of the above criteria it values most highly and where its relative priorities lie.

INTRODUCTION

As discussed in "Part One" of this volume, the January budget proposal offers the Governor's plan for addressing his estimated $12.5 billion projected budget problem for 2002-03. Our own estimate of the 2002-03 shortfall is even larger, and suggests that an additional $5 billion in solutions *beyond* those proposed by the Governor would be needed to bring the budget into balance.

Among the many different budget-balancing proposals offered by the Governor, there are several that involve borrowing as a means of helping to address the shortfall.

Traditional Versus Budget-Balancing Borrowing

These budget-balancing borrowing options are fundamentally different from the two traditional types of borrowing routinely undertaken by the state. These traditional types include (1) the annual use of short-term cash-flow borrowing in order to "bridge" temporary intrayear mismatches between revenue inflows and expenditure outflows, and (2) the issuance of long-term bonds to finance capital outlay projects.

Neither of the two traditional types of borrowing has budget balancing as its primary goal. In contrast, the borrowing options we are speaking of in this piece are being considered for the specific purpose of helping to address the budget shortfall—by enabling the state to either get revenues sooner or delay expenditures until later.

In the remainder of this piece, we discuss the specific budget-balancing options proposed by the Governor, their individual features and characteristics, and considerations that the Legislature should focus on in evaluating them. We also discuss other borrowing-related options not specifically proposed by the Governor.

TYPES AND AMOUNT OF BUDGET-BALANCING BORROWING

Governor's Borrowing Proposals

The Governor's plan includes four proposed major types of budget-balancing borrowing. As summarized below and discussed in greater detail later, these include:

- ***Partial TSR Securitization ($2.4 Billion).*** This involves securitizing the state's expected tobacco settlement revenues

(TSRs), so as to get cash "up-front" in exchange for a portion of its future stream of TSRs.

- ***Retirement Contribution Deferrals ($1 Billion).*** This proposal involves the state avoiding state contributions to its employer pension funds in 2001-02 through early 2003-04, in exchange for funding benefit enhancements later.
- ***General Fund Borrowing From Other Funds ($1.3 Billion).*** The main proposal here involves the General Fund taking out a loan from one of the state's transportation funds, with repayment beginning after the budget year.
- ***Using Bonds Instead of Direct Appropriations ($115 Million).*** This proposal involves funding certain infrastructure projects with lease-payment bonds instead of using direct appropriations.

Overall Fiscal Effect—About $4.8 Billion

Taken together, it is estimated that these options would produce a combined $4.8 billion in budget-year expenditure savings and / or added resources, or well over one-third of the Governor's $12.5 billion estimate of the 2002-03 budget shortfall.

Other Borrowing-Related Options

In addition to the Governor's proposals involving borrowing, the following budget-balancing borrowing options have also been proposed by various parties:

- ***Additional TSR Securitization.*** This would involve securitizating more of the state's expected future TSR stream, versus only the amount of securitization proposed by the Governor.
- ***Refinance Outstanding Bond Debt.*** Here, the state would refinance a portion of its currently outstanding general obligation bond debt. The technique used would be to essentially elongate the maturity length of various individual bonds so as to delay when their principal has to be repaid.

Overall Fiscal Effect. These additional two options could provide a combined $2.7 billion in added budget-year resources. They could be used either in lieu of or in combination with the Governor's proposed borrowing-related options. For example, they could contribute to the $5 billion in additional solutions beyond those proposed by the Governor that we identify in "Part One" as necessary to balance the budget.

Discussion of the Governor's Borrowing Proposals

Partial Tobacco Securitization—$2.4 Billion

General Background. Under the terms of a 1998 agreement which California and most other states signed with the four leading tobacco companies, California will receive annual payments in perpetuity. It is currently estimated that these payments will total about $21 billion for the 25-year period 1998 through 2023. One half of that total—about $10.6 billion—will go to the state, while the other half will be divided among California's local governments. It should be noted that these TSR estimates are just that—*estimates*. As such, they are subject to a variety of uncertainties, such as future tobacco sales, litigation, and the financial health of tobacco companies.

Pursuant to legislation passed in conjunction with the 2001-02 budget (Chapter 171, Statutes of 2001 [AB 430, Aroner]), the receipts from the tobacco settlement are deposited in the Tobacco Settlement Fund, from which they are used to fund recently enacted expansions to health care programs.

Specific Proposal. The state would sell about 45 percent of its rights to future expected TSRs in exchange for up-front cash to help the state balance the budget.

To accomplish this, the state would issue a $2.4 billion revenue bond whose debt service payments (principal and interest) would be backed by TSRs. The remainder of the TRSs left over each year after the debt service was paid, would continue to be deposited into the Tobacco Settlement Fund. As discussed later in this piece, the amount of these remaining funds would depend on a variety of factors, including the interest rates on the bonds, other provisions needed to market the bonds, and whether the entire estimated TSR stream is realized. (For a more detailed discussion of this proposal and its implications for health-related programs, see the "Crosscutting Issues" writeup in the "Health and Social Services" section of our accompanying *Analysis*.)

Fiscal Effect. According to the budget, the tobacco bond issue would be sold in August 2002, thereby raising 2002-03 General Fund revenues by this amount. Offsetting this would be the ongoing expenditures over the bond issue's lifetime for the debt service needed to compensate investors for loaning the state the $2.4 billion. According to the administration, these debt service costs would be $62 million in 2002-03 and $190 million thereafter over the bond issue's 23-year lifetime.

Deferral of Retirement Fund Contributions—$1 Billion

General Background. The state's General Fund makes annual contributes to both the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS). Contributions to PERS cover state employees and nonteacher school employees, whereas those to STRS cover public school teachers.

Specific Proposal. The Governor's budget proposes to postpone payment of a combined total of about $1 billion in state retirement contributions to PERS and STRS during 2001-02 and 2002-03. In exchange, the administration has pledged to support increased retirement benefits for PERS annuitants in the form of better "purchasing power protection" for their retirement benefits. (For a detailed discussion of this proposal, see the "General Government" section of our A*nalysis*). The added costs of this increase would be funded with annual contributions to the PERS fund beginning in 2006-07 and continuing for 20 years. The administration has also agreed to support as-yet-unspecified benefit increases for STRS.

Fiscal Effect. As indicated above, this proposal would result in state General Fund savings of about $1 billion in the current and budget years combined. The payback would have two components:

- ***Basic Loan Repayment.*** This basic contribution deferral (or "loan") would be repaid over a 30-year period in the form of increased annual General Fund contributions to PERS and STRS. The basic payments to replace the amounts borrowed would reflect an interest rate of 8.25 percent for the PERS contributions and about 8 percent for the STRS contributions (these are the projected rates of return that the respective funds are projected to earn on their future investments).
- ***Financing the Increased Benefits.*** The second component of the General Fund payments would take the form of increased contributions for the enhanced benefits, beginning in 2006-07. These payments would take place over a 20-year period.

In 2003-04, the General Fund cost of the basic loan repayment would be $52 million for PERS. (The STRS repayment would not start until 2004-05.) When the added payments associated with financing the increased benefits begin in 2006-07, the annual General Fund payments would amount to $167 million for PERS. The annual cost to STRS for the payback of the deferral is $61 million in 2006-07. These costs will be higher once the as-yet-unspecified benefit increases are finalized.

Transportation Loan—$672 Million

General Background. In 2000, the Legislature enacted the Traffic Congestion Relief Program, which created a six-year funding plan for state and local transportation needs (later extended to eight years by legislation passed in 2001).

Specific Proposal. The budget proposes loaning $672 million from the Traffic Congestion Relief Fund (TCRF) to the General Fund in 2002-03. It also proposes a variety of other funding shifts among various transportation funds in order to prevent a shortfall in the TCRF (see details of this proposal in the "Transportation" section of our *Analysis*). This loan would be repaid over the subsequent three years—2003-04 through 2005-06.

Fiscal Effect. This no-interest loan would augment General Fund resources by $672 million in 2002-03. The General Fund would then make loan repayments to the TCRF over the next three years.

Using Bonds Instead of Direct Appropriations—$115 Million

General Background. Each year, the budget includes funding to support capital expenditures for state facilities and equipment in a variety of different program areas, mostly involving higher education, corrections, and resources. The funding for these projects can come from either direct appropriations or bond proceeds, with the latter including general obligation bonds, revenue bonds, and lease-payment bonds. The debt service on lease-payment bonds, which do not require voter approval, is paid for from lease payments appropriated by the Legislature to the state departments and agencies who occupy the facilities the bonds are used to finance.

Specific Proposal. The Governor proposes to shift support for about $115 million in current-year capital expenditures from the General Fund to lease-payment bonds.

Fiscal Effect. This proposal will result in a reduction in direct General Fund appropriations for capital outlay of $115 million in the budget year. In the future, the General Fund will pay slightly over $8 million annually to fund lease payments necessary to pay the debt service on the bonds.

Discussion of Other Borrowing Options

Additional Tobacco Securitization—$1.6 Billion

General Background. This option would involve expansion of the partial tobacco securitization proposal offered by the Governor and discussed above.

Specific Proposal. This alternative would involve the securitization of an additional portion of the state's expected future TSR stream, versus only the partial securitization noted above. Under the Governor's proposal, the state would securitize, and thus collect in the form of an "up-front" payment, $2.4 billion of its future TSR revenue stream. The "present value" of the full TSR stream over the next 25 years is currently valued at roughly $5.3 billion. This option would involve selling an additional portion of this full stream, not just the rights for the TSRs necessary to pay the debt service on $2.4 billion in bonds.

Fiscal Effect. The additional General Fund money that could be raised under this option in 2002-03 would depend on the amount of money investors would be willing to pay for the remaining part of the TSR stream. (The present value of this remaining part of the stream is $2.9 billion—the $5.3 billion full amount minus the Governor's proposed $2.4 billion.) This, in turn, will depend on such factors as the perceived risks to the stream in the future. However, if the state were able to sell 75 percent of its entire stream, this would amount to $4 billion in total sales. Thus, under this option, an additional $1.6 billion of TSRs could be sold beyond the $2.4 billion the Governor proposes.

The additional General Fund debt service costs under this option would be about $40 million in the budget year and $130 million annually thereafter over the bonds' lifetime. These debt service payments would reduce the amount of TSRs currently earmarked to fund certain health programs.

Refinance Existing Bond Debt ($1.1 Billion)

General Background. California currently has about $20 billion in outstanding general obligation bonds on which the General Fund pays debt service (principal and interest). One option that has been suggested to help deal with the budget shortfall is to essentially "stretch out" the maturity structure of some of its individual bonds, thereby reducing debt service costs in the near term.

Specific Proposal. The way this could be accomplished mechanically would be to issue a "refunding" bond, the proceeds of which would be used to make principal payments that come due on existing debt. The refunding bond would be structured to avoid principal repayments until after the budget year. Existing tax and bond law allows this refinancing to be done as long as the maturity dates within the refunding bond do not exceed the maximum maturity dates of the original bond issues.

Fiscal Effect. The State Treasurer has identified about $2 billion in general obligation principal repayments owed to investors between January 2002 and June 2004 that could be refinanced. The Treasurer has also estimated that the near-term General Fund savings from refinancing these principal repayments would amount to $223 million in 2001-02, $866 million in 2002-03, and $832 million in 2003-04. Thus, this option could provide $1.1 billion toward addressing the 2002-03 budget problem. These savings would more than be offset, however, when the new loans have to be repaid in the future.

CONSIDERATIONS FOR THE LEGISLATURE

In evaluating the different types of borrowing that potentially can be used to help address the budget shortfall, the Legislature may find it helpful to focus on three key questions:

- ***What interest rate has to be paid—either directly or indirectly—on a given type of borrowing?***

  This information is important for understanding both the true underlying cost of a borrowing option, as well as assessing the relative costs of different options.

- ***What are the timing and magnitude of future borrowing repayments, and what do they imply for managing future budgets?***

  The pattern of required repayments can differ markedly for different borrowing options, even if their underlying interest rates are not dissimilar. Depending on how these repayments compare to underlying revenue and expenditure trends, one option may be preferable to another if it makes managing future budgets easier. As an example, an option that imposes heavy repayment liabilities at the same time than an operating deficit (expenditures in excess of revenues) is already likely may not be desirable.

- ***How does a given option "stack up" when compared to other options for achieving needed budget savings?***

  The answer to this question involves legislative policy priorities. For example, even if two options are similar in terms of their interest costs and repayment characteristics, one may be preferable to another in terms of the programs it adversely impacts and/or individuals it affects.

Trade-Offs Must Be Weighed

In applying the above information to arrive at a decision regarding different borrowing options to help address the budget shortfall, some alternatives may score well on one or more of the above criteria but poorly on another, and vice versa. Thus, the Legislature will need to decide which criteria it values most highly and where its relative priorities lie. For example:

- ***Retirement Contribution Deferrals.*** The Governor's proposal to borrow from the retirement systems would produce a large amount of General Fund savings in the budget year and its repayment would be stretched out over many years. Some might thus view this option as favorable, especially given the large budget shortfall facing the state. However, our calculations indicate that the proposal would also be very expensive in terms of its implicit interest cost—roughly 20 percent annually for the PERS loan. Given this, we have recommended in the *Analysis* that the Legislature reject the proposal.
- ***Tobacco Securitization.*** As another example, the administration's securitization proposal would contribute even more dollars to solving the 2002-03 budget imbalance than the pension option. However, it may or may not prove to be a good financial deal for the state, depending on the interest rate investors require to buy the tobacco revenue bonds, other provisions needed to market the securities, and the adverse out-year effects on health programs currently supported by tobacco settlement revenues.
- ***Transportation Loan.*** The main trade-off here involves the interest-free nature of the loan, versus the quick repayment requirements that the administration believes would be necessary to avoid transportation program disruptions. We note in the *Analysis*, however, that additional transfers are possible.

Thus, weighing the relative costs and benefits of different borrowing options will be important for the Legislature to focus on in considering the role that borrowing should play in addressing the state's current fiscal problem.

Reorganizing California's Energy-Related Activities

Does California Need to Reorganize Its Energy-Related Activities, Given Its Recent Deregulation of Electricity, 2001 Electricity Crisis, and Multiplicity of Different State Energy-Related Entities?

Summary

California has a number of different state departments, boards, and commissions involved in implementing, overseeing, and managing the state's various energy-related policies and responsibilities. Some of these entities are long-standing, while others have come into being only recently as a result of electricity deregulation and the 2001 electricity crisis.

This multiplicity of agencies, and evidence of certain duplicative activities and other problems, suggests that it is time for the state to "stand back" and assess how its various energy-related entities are organized and interacting with one another.

This review describes the state's various energy-related activities and entities and discusses certain observed problem areas associated with them. It then suggests steps and organizational principles that may be helpful to the Legislature as it considers how to most effectively and efficiently organize and coordinate the state's energy-related activities.

INTRODUCTION

Over the years, a number of different state agencies have been involved at any one time in implementing, overseeing, and managing the state's various energy-related policies and responsibilities. Given this, ensuring that California's overall energy-related activities are consistent with one another, well coordinated, and handled in an effective and efficient manner is not a new challenge. What *is* new is that the energy market has changed significantly since deregulation in 1996, and the state has undertaken new responsibilities in the energy area. Some of these include large-scale electricity buying and statewide energy resource planning. In addition, new state entities to carry out these tasks have come into being.

This analysis deals with the issue of effectively reorganizing and coordinating the state's various energy-related activities, especially in light of deregulation. Specifically, in considering the state's energy-related agencies, we:

- Identify and describe the state's different energy-related entities, including their history and purpose, governance, duties and responsibilities, and funding structure.
- Discuss some of the current coordination and organizational problems with the state's existing energy agencies.
- Outline the basic elements of one energy-related organization plan currently proposed, and key challenges facing the Legislature in developing its own plan.
- Highlight specific steps that may help the Legislature in designing a system for better organizing and coordinating the state's energy-related activities and entities.
- Suggest basic principles that should guide the reorganization of the state's energy-related activities.

CHARACTERISTICS AND ORGANIZATION OF CALIFORNIA'S CURRENT ENERGY-RELATED ENTITIES

Several agencies play a role in developing, implementing, and managing the state's energy-related policies. These include the:

- ***California Energy Commission (CEC).*** This is the state's primary policy and planning agency in the energy area.

- ***California Public Utilities Commission (CPUC).*** The commission is involved with various energy-related regulatory activities.
- ***Electricity Oversight Board (EOB).*** Its responsibilities include monitoring the state's electricity market.
- ***California Power Authority (CPA).*** This is a new entity, created during the state's 2001 electricity crisis, to finance new electricity generation and assure an adequate electricity supply for the state.
- ***California Energy Resources Scheduling (CERS) division within the Department of Water Resources (DWR).*** This is the entity that currently purchases electricity for the state on behalf of the state's three largest investor owned utilities (IOUs).
- ***Division of Oil, Gas, and Geothermal Resources (DOGGR) Within the Department of Conservation (DOC).*** This division is involved in various energy-related regulatory activities—including oil-drilling activities.
- ***California Independent System Operator (ISO).*** The ISO is a not-for-profit corporation that was created by the state when it deregulated its wholesale electricity industry in 1996. The ISO is not considered a state agency, but was created by the Legislature and is governed by a board of gubernatorial appointees. However, its activities are regulated by the federal government. The ISO is charged with managing the majority of the state's electricity transmission system, in order to ensure competitive access to the grid by all electricity sellers. It also seeks to ensure that the power grid is safe and reliable.

Figure 1 (see next page) shows the total state funding for the above energy-related entities as reported in the *2002-03 Governor's Budget*. It indicates total funding of $680 million for the prior year, an estimated $471 million in 2001-02, and a proposed $314 million in 2002-03.

As discussed below, these state energy-related entities vary from one another in a variety of respects. Some, for example, were established nearly a century ago, while others are relatively new. Likewise, some have very broad responsibilities, while the mission of others is narrower in scope. However, because all have energy-related duties and responsibilities, each merits review from the perspective of coordinating and effectively organizing the state's energy-related activities. Figure 2 (see next page) summarizes selected activities and responsibilities of the state's energy-related agencies. Information is also included on the ISO.

Figure 1

Summary of Total State Spending on Energy-Related Activities, by Entity

All Funds (In Millions)

California Energy Entity	Actual 2000-01	Estimated 2001-02	Proposed 2002-03
California Energy Commission	$607	$345	$223
California Public Utilities Commission (Energy Division)	45	43	40
Electricity Oversight Board	3	4	4
California Power Authority[a]	—	5	5
California Energy Resources Scheduling (division within Department of Water Resources)	13	61	28
Division of Oil, Gas, and Geothermal Resources (division within Department of Conservation)	12	13	14
Totals	**$680**	**$471**	**$314**

[a] The support for the California Power Authority is a General Fund loan.

Figure 2

Selected Activities and Responsibilities of the State's Energy-Related Agencies

Activities/Responsibilities	CEC	CPUC	EOB	CPA	CERS	DOGGR	ISO[a]
Representing state at FERC[b]		✔	✔		✔		
Promoting energy conservation/efficiency	✔	✔		✔			
Forecasting electricity demand	✔	✔			✔		✔
Licensing generators	✔					✔	
Promoting renewable resources	✔			✔	✔		
Planning natural gas infrastructure	✔	✔		✔			
Planning transmission infrastructure	✔	✔	✔	✔			✔
Conducting integrated resource planning	✔	✔		✔			
Monitoring the electricity market		✔	✔				
Monitoring/planning system reliability		✔	✔				✔

[a] The ISO is not considered a state agency.

[b] Federal Energy Regulatory Commission.

California Energy Commission

History and Purpose. The CEC (formally the Energy Resources Conservation and Development Commission) was created in 1974 following the Mid-East oil embargo and rapidly rising fuel prices of the previous year. The CEC was initially established to address the many energy challenges facing the state at the time, and act as the state's primary energy policy and planning organization.

Governing Structure. A board of five commissioners, appointed by the Governor and confirmed by the Senate, governs the CEC. The Governor appoints a chair and vice chair every two years and these appointments require Senate confirmation. The commissioners represent expertise in the fields of engineering, economics, and environmental protection, except for one commissioner that is required, by law, to be selected from the public at large. The Governor also appoints a Public Advisor who is responsible for ensuring that the public is adequately represented in all of CEC's decision making activities.

Basic Duties and Responsibilities. The CEC is the primary department that implements the state's energy policy. Its primary responsibilities include:

- Forecasting future electricity needs and keeping historical energy data.
- Siting and ongoing compliance associated with thermal power plants of 50 megawatts or larger (including natural gas-fired, coal-fired, oil-fired, and nuclear facilities).
- Promoting energy efficiency and conservation.
- Developing alternative energy technologies and supporting renewable energy resources.
- Planning for and directing state response to energy emergencies.

Funding Structure. The CEC receives funding for the majority of its activities from an electricity consumption surcharge collected by the electric utilities through customer billings. This surcharge amounts to around 40 cents per month for an average residential customer. The CEC also receives some funding from other energy resources surcharges collected to administer specific public-purpose programs. In addition, it also receives a limited amount of federal funding to finance specific programs.

California Public Utilities Commission (Energy Division)

History and Purpose. The CPUC was established by constitutional amendment as the Railroad Commission in 1911. A year later, the Public

Utilities Act was passed, expanding the CPUC's regulatory authority to include electricity, natural gas, telephone, and water companies. The CPUC was created as the primary agency responsible for regulating privately owned companies that provide basic services to California residents. It is also responsible for assuring that utility customers receive safe, reliable service at reasonable rates.

Governing Structure. Five commissioners appointed by the Governor govern the CPUC. The commissioners serve six-year staggered terms and are confirmed by the Senate. The Governor also appoints one individual to serve as the CPUC's President. In addition, the Governor is responsible for appointing the director of the CPUC's Office of Ratepayer Advocates, which represents the interests of consumers in decisions made by the CPUC.

Basic Duties and Responsibilities. With regard to electricity and natural gas utilities, the CPUC is responsible for the following:

- Establishing service standards and safety rules.
- Approving retail rate changes.
- Monitoring the safety of the operations under its jurisdiction.
- Overseeing the electricity and natural gas markets to inhibit anticompetitive behavior.
- Prosecuting unlawful utility activities and governing business relationships between utilities and their affiliates.

The CPUC is also responsible for overseeing energy efficiency programs and programs that provide reduced utility rates for low-income customers. It oversees the merger or reorganization of utility corporations and also enforces the California Environmental Quality Act for construction of energy facilities. The CPUC is additionally responsible for representing California's interests in utility proceedings at the federal government on issues that affect California utility rates or services.

Funding Structure. Fees collected from the utility industries that the CPUC regulates support its programs. In 2000-01, $25 million was collected from electric corporations and $13 million from gas corporations to partially support the Energy Division.

Electricity Oversight Board

History and Purpose. Chapter 854, Statutes of 1996 (AB 1890, Brulte), the statute that restructured California's electricity industry, created the EOB. The EOB was established to oversee both the newly created ISO and Power Exchange (PX) in carrying out their role in ensuring the reliability of the electricity supply to the state. The EOB also was to serve as an appeal board for decisions made by the ISO's governing board.

Governing Structure. The EOB is comprised of five members. Three of these members are appointed by the Governor and confirmed by the Senate for three-year staggered terms. The other two members include one representative each from the Assembly and Senate. The legislative members are nonvoting members.

Basic Duties and Responsibilities. As noted above, the original role of the EOB was to oversee the activities of the ISO and the PX, as well as determine the composition of the governing boards of these organizations. However, among the many developments and changes associated with the energy crisis this past year, these duties no longer exist. This is because (1) the PX declared bankruptcy and was dissolved in January 2001 when the utilities could no longer pay their bills, and (2) the ISO's stakeholder board appointed by the EOB was dissolved this past January by Chapter 1x, Statutes of 2001 (AB 5x, Keeley). This latter measure replaced the ISO's 26-member stakeholder board with a 5-member panel appointed by the Governor.

While the EOB's statutorily defined duties have been sharply curtailed, it also monitors the electricity market. This includes reviewing market and reliability rules, transmission and grid plans, and emergency and contingency plans. It also plays a role in representing the state's interests before the Federal Energy Regulatory Commission (FERC)—the federal commission that oversees wholesale electricity markets. In addition, there is currently pending legislation that would give EOB oversight over scheduling planned power outages, as well as monitoring, investigation, and enforcement activities relating to unplanned power outages.

Funding Structure. The majority of the funding for the EOB is from the fees collected from electricity utilities by the CPUC for regulation of the industry. Additional support is from the electricity consumption surcharge on utility bills collected for support of the CEC.

California Power Authority

History and Purpose. The CPA was created by Chapter 10x, Statutes of 2001 (SB 6x, Burton). It was established last spring in the wake of rolling blackouts and historically high electricity prices, in an effort to provide stability and rationality to California's electricity market. The CPA was given the authority to build new generation capacity so as to assure a reliable supply of power to Californians at just and reasonable rates.

Governing Structure. The CPA is governed by a five-member board of directors, four of whom are appointed by the Governor and confirmed by the Senate. The fifth board member is the State Treasurer. The board members are appointed to serve staggered four-year terms and the Governor appoints the chairperson of the board.

Basic Duties and Responsibilities. Because of the short history of the CPA, it is difficult to assess what exactly its role will be in California's electricity market in the future. The CPA was created with the broad charge of assuring a reliable supply of power to Californians at just and reasonable rates, including planning for a prudent energy reserve. In addition, the CPA is charged with encouraging energy efficiency, conservation, and the use of renewable energy resources. In order to meet these goals, the CPA has $5 billion in revenue bonding authority, with any bonds issued being secured by the revenues generated from the specific projects being financed by the CPA. In addition, the CPA has also been given the authority to finance natural gas transportation and storage projects, as well as to provide financing to retrofit old and inefficient power plants. Finally, the CPA is required to develop an Energy Resource Investment Plan (ERIP) due to the Legislature on February 15. At the time this review was prepared, a draft of the plan had been completed and it appeared that the plan would be submitted on time.

Funding Structure. The *2001-02 Budget Act* provided the CPA with a $10 million General Fund loan to start up its activities. However, on an ongoing basis the CPA's administrative expenses are to be funded from the proceeds of the revenue bonds the CPA is authorized to issue to build new power plants and implement energy conservation.

Department of Water Resources, California Energy Resources Scheduling Division

History and Purpose. The CERS division was created by Chapter 4x, Statutes of 2001 (AB 1x, Keeley), a year ago. This statute provides for DWR to purchase and sell electricity on California's markets on behalf of the state's major IOUs. The state "stepped in" to take this role after the credit-worthiness of the state's three largest IOUs deteriorated because they were purchasing electricity on the wholesale market at much higher prices than they were allowed to charge retail customers under California's regulated electricity rate structure. This, and the increasingly dysfunctional electricity market, raised fears regarding chronic blackouts if the state did not undertake the electricity-buying responsibility.

Governing Structure. Since CERS is a division contained within DWR, it is governed by DWR's gubernatorially appointed director.

Basic Duties and Responsibilities. The primary responsibility of CERS is to purchase enough electricity to meet the "net short" demand of the customers of the state's three largest IOUs. (The net short refers to the amount of electricity needed to serve the demand in the IOUs' service area that exceeds the sum of the IOUs' retained generation resources, qualifying facility contracts, and other bilateral contracts.) The CERS division was directed to enter into long-term contracts in order to stabilize the price the state was paying for electricity, and thus far has contracted for $40-plus billion in electricity for the future. The primary activity of CERS over the next ten-plus years will be to manage these contracts and minimize the costs involved for ratepayers.

The CERS division is also responsible for the purchase of electricity on the short-term spot market, if needed, to meet the total demand of the IOUs' customers. However, at the end of calendar year 2002 CERS will be prohibited under current law from buying additional electricity on the spot market. This is because it was assumed when CERS was set up that the utilities would have returned to financial health and, thus, be able to resume purchasing electricity themselves by the end of 2002. At this time, this is uncertain.

Funding Structure. Assembly Bill 1x provides a complex funding structure that contemplated financial support for CERS' electricity purchases and administration of this activity from several sources.

- Initially, the General Fund supported DWR's electricity purchase activities by loaning $6.2 billion to the DWR Electric Power Fund.
- In addition, beginning when DWR started purchasing electricity on behalf of the IOUs, the generation component of the retail electricity rate "belongs" to DWR for the electricity it purchases. This amount is key in financing the state's electricity purchases over the long run. However, because wholesale prices exceeded regulated retail rates in the first half of 2001, this funding source was not adequate to pay off the above General Fund loan in a timely manner.
- Assembly Bill 1x also authorized DWR to issue revenue bonds to pay for electricity purchases and to pay back the General Fund loans. However, because of complications regarding the security of the revenue stream to pay off the bond debt, no revenue bonds have been issued to date. Nevertheless, the state was able to acquire $4.3 billion in "bridge financing" for the purpose of funding electricity purchases until the larger revenue bond issue can be sold. The revenue bond issuance has been delayed due to lack of a rate agreement between DWR and the CPUC. However, at the time this analysis was prepared, the CPUC had released a draft rate agreement and was scheduled to make a final decision on it on February 21, 2002.
- Additionally, AB 1x provides for the collection of the California Procurement Adjustment from the IOUs. (This adjustment is the

difference between the generation component of the retail electricity rate and the cost of the IOUs' retained generation, qualifying facility contracts, existing bilateral contracts, and ancillary services contracts.) However, the IOUs have not been remitting this payment to CERS to help defray the costs associated with the state's purchasing of electricity on their behalf.

Department of Conservation, Division of Oil, Gas, and Geothermal Resources

History and Purpose. The DOGGR, located within DOC, was created in 1915 to regulate statewide oil and gas activities. The division is responsible for supervising the drilling; operation; maintenance; and plugging and abandonment of onshore and offshore oil, gas, and geothermal wells. The division is charged with protecting the environment and preventing damage to the state's natural resources.

Governing Structure. Since DOGGR is a division contained within DOC, it is governed by DOC's gubernatorially appointed director.

Basic Duties and Responsibilities. The DOGGR regulates around 88,000 active oil, gas, and geothermal wells currently drilled in California. It also oversees oil production of roughly 860,000 barrels a day, which ranks California fourth among oil producing states. In addition, the division oversees the state's relatively large geothermal electricity generation sector. The division is specifically responsible for the permitting and testing of wells, as well as safety inspections. It also inspects oil field tanks and pipelines, as well as handles hazardous well plugging and abandonment contracts. Lastly, DOGGR is responsible for collecting data regarding the state's oil, gas, and geothermal resources.

Funding Structure. The DOGGR is supported primarily by the General Fund. It also receives some minimal amounts of funding from federal sources and penalty income.

Problems With the Current System

Below, we examine various problems and shortcomings with the current structure of energy-related organizations.

Difficulties in Coordinating Efforts

While there was coordination amongst the state's energy agencies in responding to the state's energy crisis in 2001, shortcomings involving interagency coordination also have existed.

- ***Electricity Revenue Bonds.*** One example involves DWR's effort to issue its electricity revenue bonds to repay the General Fund its $6-plus billion loan, the $4-plus billion bridge loan, and make future purchases of electricity on behalf of the state's IOUs. This process had been at a standstill for months, since the CPUC's approval of a rate order and rate agreement are required to market the bonds. As previously mentioned, the CPUC has released a draft rate agreement and plans to make a final decision on the agreement in late February.

- ***Siting and Approval of New Energy-Related Infrastructure.*** There are several "hurdles" that have to be jumped over to build new energy-related infrastructure, including power generation, transmission facilities, and natural gas infrastructure. These hurdles include basic site approvals, "needs"assessments, environmental standards, licensing, and rate approvals. Because different entities are involved, the overall process is often extremely time consuming and fraught with uncertainties about what the eventual outcome will be.

Excessive Duplication and Overlaps

As noted above, new energy-related agencies have recently been formed and the responsibilities of others have expanded. (Please see Figure 2—earlier in this write-up—for a summary of the responsibilities of these state entities.) Given the number of these organizational changes and the speed with which they have occurred, it is not surprising that a number of potentially unnecessary duplications and overlaps have come to light. Four, for example, involve:

- ***Representation Before FERC.*** Both the EOB and the CPUC currently represent the state before FERC, the federal agency that has jurisdiction over some key aspects of California's restructured wholesale electricity market. The CERS division has also been involved in representing the state's interests before FERC.

- ***Administration of Energy Conservation and Peak-Load Reduction Programs***. Presently, both the CEC and the CPUC are involved in implementing energy conservation and peak-load reduction programs. The CPA has also made plans to implement conservation programs with a portion of its bonding authority.

- ***Energy Demand Forecasts.*** It has not always been entirely clear which agency's forecasts of electricity and other energy demand elements should be relied on by state agencies. For example, the CPA is statutorily directed to use forecasts by *both* the CEC and

ISO. The CERS is also involved in electricity forecasting as illustrated in Figure 2.

- ***Integrated Resource Planning.*** Various state agencies are involved in planning for the state's energy needs from an integrated resource perspective. This activity includes long-term planning for the state's energy use taking into account different energy sources, and economic, reliability, and environmental factors. Currently, both the CEC and the CPUC informally provide integrated resource planning. The CPA is also working on its ERIP which is a plan that synthesizes its view of integrated state resource planning into its strategy for energy-related investments.

Potential Conflicts of Interest

With the role being played by CERS and the creation of the CPA, the state is now a direct participant in the wholesale energy market. This is a different role for the state to play than previously, since in the past it has primarily been responsible for energy-related regulation and monitoring activities. This raises some potential conflicts, for example, involving:

- The integrity of the independent function of siting and monitoring power plants according to market need, safety, and environmental standards versus the state's interests in acquiring power at low prices.

- The state using its tax-exempt borrowing authority to compete with the private sector parties it regulates when financing energy-related projects. This could be the case with the CPA, which gets its funding from the proceeds of its bond sales.

Difficulty in Speaking With "One Voice"

Some industry observers have noted that the current decentralized organization of the state's energy-related agencies means that the state will not always be able to present a "unified front" when working with the federal government and other bodies regarding energy-related issues. It is argued that this, in turn, inherently can hinder the state's ability to be effective in achieving its energy-related objectives.

Unnecessary Costs

The concern here is that, the greater the number of different entities involved in energy-related activities, the greater the total overhead expenses for the collective managerial and support staff, office facilities, equipment, and supplies. Another concern relates to the large amount of contracting being done in some areas as opposed to handling workload internally.

Staffing Issues

Another issue involves the ability of some of the state's energy-related entities to hire and retain appropriate staff, given the current uncertainties about their long-term mission and activities. For example, the CPA is slated for termination as of January 1, 2007, and CERS is prohibited from purchasing any new electricity contracts after the end of calendar year 2002. (However, CERS will be involved in managing its existing electricity contracts until they expire—after 2010.)

Another important staffing issue is the continued heavy reliance on contract services, as opposed to state employees. This includes the use of contractors to both manage the activities in some new state agencies and perform certain ongoing activities not done by the state previously. Such contracts were helpful this past year because it was important to work expeditiously to hire the expertise needed to manage activities related to the state's energy crisis. Now that the crisis has subsided, however, these contracts may need to be reconsidered. In addition, many of these contracts are relatively expensive when compared to similar state employee positions or even positions within the energy industry.

Interagency Differences in Accountability

Some observers argue that the current structure of the state's energy agencies tends to result in different levels of accountability. That is, whether the administering agency is a board (or commission) versus a department can influence the decision making process used and how programs are implemented and managed. Four of the six energy agencies described above are administered by boards—the CEC, CPUC, EOB, and CPA. Each of these boards is an independent body whose membership is appointed by the Governor and in most cases confirmed by the Legislature. The members themselves serve set terms and each of the boards appoints its entity's executive director. In contrast, the remaining two energy programs—CERS and DOGGR—are located within departments whose directors serve at the pleasure of the Governor and whose appointments are confirmed by the State Senate. These different structures can result in different accountability characteristics. For example:

- ***State Board Structure***. The independent structure of a board can be both an advantage and a disadvantage in terms of implementing a program effectively. Each board has a particular energy-related mandate. The independence of a board can help ensure that this mandate is achieved, even when there are legislative or administration pressures to do otherwise. On the other hand, the lack of direct accountability of a board to an executive appointed by the Governor and approved by the Legislature can make it more difficult for the Legislature or the administration to set policy directions for its energy policies.

- ***Department Structure***. Although the department structure generally is more accountable to the administration and the Legislature than is a board structure, there often is less public accountability. This is because many department actions are not subject to public hearings processes. Consequently, there generally is less public input into departmental decisions than board decisions, where all substantive decisions are made at public hearings.

CURRENT AND PAST REFORM PROPOSALS

In response to the various problems and issues raised regarding the state's management of energy-related matters in the past and currently, a number of reform proposals have been offered for better coordinating and organizing the state's activities.

Previous Proposals. Several reform proposals have been offered in past years. For example, in the *1995-96 Governor's Budget*, Governor Wilson proposed consolidating various state energy-related activities and entities into a new Department of Energy and Conservation. This proposal was never implemented.

Current Proposals. The administration has not thus far offered a plan of its own for better coordinating and organizing the state's energy-related activities. However, SB 6x, which created the CPA, appears to have anticipated the possible need for, and appropriateness of, an administration proposal in this area, stating that:

"Nothing in this division shall be construed to obviate the need to review the roles, functions, and duties of other state energy oversight agencies and, where appropriate, change or consolidate those roles, functions, and duties. To achieve that efficiency, the Governor may propose to the Legislature a Governmental Reorganization Plan . . . "

There is one proposal currently circulating to reorganize the state's energy agencies (a second plan had previously been circulating in the Legislature, but recently was put aside). The main features of this proposal by the California Chamber of Commerce and California Business Roundtable are:

- The state's various existing energy boards and agencies would be consolidated into a new, cabinet-level California Department of Energy.

- This department would have a broad spectrum of responsibilities, including energy-related regulation, oversight, and financing functions.

- Within this department would be a separately constituted board responsible for siting energy-related infrastructure, including generation and transmission facilities.

- Also within the department would be a board, appointed by the Governor, responsible for electricity and natural gas ratemaking decisions.

In addition to these and other provisions, the ISO, although not a state agency, would be reconstituted as a Regional Transmission Organization or have its grid operations functions returned to the various investor and municipal utility corporations. Also, the CEC's and CPUC Energy Division's functions would be subsumed within the new department, and the CPA and EOB would be eliminated.

So—What Should the Legislature Do?

In approaching the issue of how best to coordinate and organize the state's energy-related activities and agencies, we believe that the Legislature should begin with four steps.

Step One—Inventory the State's Needs and Objectives

This step involves developing a comprehensive, detailed inventory of the various types of energy-related activities that the state currently engages in or might wish to undertake in the future. This inventory should cover:

- ***Different Sources of Energy.*** These should include fossil fuels, hydroelectric, nuclear, and renewable resources (including wind, solar, geothermal, and biomass).

- ***Different Energy-Related Processes Involving These Energy Sources.*** These include power generation, transmission, distribution, and storage.

- ***Different Specific Energy-Related Functions.*** These include basic oversight and monitoring, licensing, litigation, operational regulation, financing, sale and acquisition, security, public safety, research, and ratemaking or rate review.

Step Two—Identify Specific Problem Areas That Need Fixing

This involves taking a close look at the way that the state's energy agencies currently operate and interact, and identifying such shortcomings as inefficiencies, duplication of effort, overlapping responsibilities, inconsistent policies, ineffective coordination, programs that work at cross purposes, and similar issues.

Step Three—Uncover the Underlying Reasons for Why These Performance Problems Exist

Simply reorganizing how the state's existing energy-related agencies are structured may or may not "make things better," depending on the underlying reasons for the problems that need to be fixed. For example, problems requiring the reorganization of state agencies need to be distinguished from problems involving: (1) poor management, (2) funding problems, (3) ill-defined and / or conflicting missions and objectives, and (4) inadequate mechanisms to effectively accomplish missions and objectives.

Step Four—See What Has and Has Not Worked Elsewhere

This involves taking a look at the lessons learned by other states and the federal government in managing its energy-related activities. Although differences exist between California and these other entities, it may be helpful to see what has and has not worked well elsewhere, and how these other entities have solved or avoided some of the problems encountered in California. The Legislature should also carefully review all current and previous reorganization proposals made in California and identify their strengths and weaknesses to aid in developing its own plan.

Basic Principles to Incorporate

In addition to being guided by the above information, we believe that whatever organizational form the Legislature ultimately adopts for the state's energy-related activities should reflect the key organizational principles shown in Figure 3.

We have grouped these principles into three main areas—basic organizational framework needed for the state's energy-related functions, interrelationships between state energy agencies, and effectiveness and efficiency of state energy-related activities. For example:

- One of the key principles in the first area is to select the proper form of governance—board versus commission versus department. Another involves prioritization of goals and objectives, such as the relative importance of augmenting power supplies versus keeping prices low versus environmental protection.

Figure 3

Key Organizational Principles for the State's Energy-Related Activities

✓ **Framework and Basic Structure**

- Adopt appropriate forms of governance.
- Establish clear lines of accountability and decision-making authority.
- Prioritize goals and objectives.

✓ **Interrelationships, Communication, and Coordination**

- Do not work at cross-purposes.
- Resolve issues and conflicts quickly.
- Guard against inconsistent outcomes.
- Avert conflicts of interest.

✓ **Effectiveness and Efficiency**

- Eliminate overlapping responsibilities.
- Avoid duplication of effort.
- Take advantage of scale economies.
- Minimize costs to private sector parties.
- Limit over-reliance on contracting.

- In the second area, a key principle involves having a system that enables issues and conflicts to be resolved quickly. An example of what to avoid is the long time delay in arranging for the sale of the $6-plus billion in electricity revenue bonds needed to repay the General Fund.

- Two of the principles in the third area include eliminating overlapping responsibilities and avoiding unnecessary duplication of effort. An example involves multiple entities doing energy-related forecasting and statewide resource planning.

We believe that legislative focus on these basic organizational principles is the key to ensuring that California's different energy-related priorities are successfully addressed, and its energy-related activities are carried out effectively and efficiently.

WELFARE-TO-WORK PARTICIPATION IN THE CALWORKS PROGRAM

How Could the Legislature Improve Participation in CalWORKs?

Summary

California has met federal work participation requirements each year since the California Work Opportunity and Responsibility to Kids program (CalWORKs) was implemented, thus avoiding federal penalties. However, the percentage of adults who are meeting their CalWORKs participation requirements is much lower than would be expected given the work-first approach envisioned in the CalWORKs statute. The relatively high percentage of able-bodied adults who are "disengaged" from the program—neither participating nor sanctioned for noncompliance—is of particular concern.

Because CalWORKs was designed as a time-limited, welfare-to-work program, we believe that increasing participation is an important long-term focus for the Legislature. Such a focus will help ensure that recipients receive the employment services they need to make the transition from welfare to work before they reach their limit on cash assistance. However, improving participation rates will likely require increased funding for the program's welfare-to-work component. Given the state's current fiscal situation, as well as the uncertain impact of federal welfare reform reauthorization on the CalWORKs program, we believe that in the short term a "wait and see" approach may be the most appropriate approach to addressing CalWORKs participation.

Background

In response to the 1996 federal welfare reform legislation, the Legislature created the California Work Opportunity and Responsibility to Kids (CalWORKs) program, enacted by Chapter 270, Statutes of 1997 (AB 1542; Ducheny, Ashburn, Thompson, and Maddy). CalWORKs replaced the Aid to Families with Dependent Children (AFDC) entitlement program with a welfare-to-work program requiring able-bodied adult recipients to work or engage in some type of work-related education or training activity in exchange for cash assistance.

Ensuring that CalWORKs recipients are actually participating in welfare-to-work activities is important for three primary reasons. First, participation data can give the Legislature a sense of how effectively counties have implemented the CalWORKs program and, more specifically, are enforcing the work-first approach envisioned in the CalWORKs statute. Second, because CalWORKs was designed as a temporary program, ensuring that recipients receive the employment services and work experience they need before they reach their five-year lifetime limit on aid may be critical to their reaching self-sufficiency. Finally, in order to avoid federal penalties and to maintain maximum General Fund spending flexibility, California must ensure that it meets the federal participation requirements.

Federal Participation Requirement

Federal law—the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA)—does not impose specific participation requirements on individuals. However, in order to hold states accountable for moving families from welfare to work, the federal law does require states to meet statewide participation rates. Figure 1 illustrates how the federal participation requirements have increased (as specified in PRWORA) since federal fiscal year (FFY) 1997 (October 1996 through September 1997). The figure also shows how the caseload reduction credit significantly reduces the statutorily required levels of participation.

Caseload Reduction Credit

Federal regulations allow states to reduce the required participation rate by applying a caseload reduction credit. This adjustment is based on the percentage decline in each state's welfare caseload since FFY 1995. It is designed to give "credit" to states that have moved families into work and off of cash assistance. Caseload reductions due to federal or state eligibility changes are not counted towards the credit. California, like most states, has experienced a significant caseload decline since FFY 1995 (over

Figure 1

Work Participation Rates
Federal Requirements Versus California's Performance

	Federal Fiscal Year					
	1997	1998	1999	2000	2001	2002
All Families[a]						
Statutory requirement	25.0%	30.0%	35.0%	40.0%	45.0%	50.0%
Less caseload reduction credit	-5.5	-12.2	-26.5	-32.1	-38.6	-42.6
Adjusted rate	19.5	17.8	8.5	7.9	6.4	7.4
Actual rate	29.7	36.6	42.2	27.5	—	—
Two-Parent Families[a]						
Statutory requirement	75.0%	75.0%	90.0%	—	—	—
Less caseload reduction credit	-34.2	-42.3	-53.1	—	—	—
Adjusted rate	40.8	32.7	36.9	—	—	—
Actual rate	42.3	36.2	54.3	—	—	—

[a] For federal fiscal year (FFY) 1997 through FFY 1999, "All Families" includes single- and two-parent families. Effective FFY 2000, "All Families" includes only single-parent families, since the two-parent caseload was moved to a separate state-funded program and is therefore no longer subject to the federal participation rate requirement.

40 percent through FFY 2001). Consequently, the caseload reduction credit has resulted in significantly lower adjusted participation requirements for California, as shown in Figure 1.

What Counts as Participation?

Federal regulations set forth the amount and types of work activities in which individuals must participate in order to be counted towards the *state's* participation rate. As shown in Figure 2 (see next page), in order to be counted, adults in two-parent families must participate for a combined total of at least 35 hours per week. Single parents with children over age 6 must participate an average of at least 30 hours per week, while single parents with a child under age 6 are required to participate 20 hours per week. (We note that in California, approximately 58 percent of single-parent cases have a child under age 6.) States also have the option to exempt single parents of a child under 12 months from participation, and disregard these cases in determining their participation rates.

State and federal law prescribe the various types of work activities that qualify as participation. Figure 3 (see next page) lists these activities.

Figure 2

Federal and State Participation Requirements

Hours Per Week

	Federal	State
Single-Parent Families		
Youngest child under age 6	20	32
Youngest child over age 6	30	32
Two-Parent Families	35	35

Figure 3

State and Federal Qualifying Welfare-to-Work Activities

Counts As Participation Under Both Federal and State Definitions

- Unsubsidized employment.
- Subsidized employment (public or private sector).
- Work experience.
- On-the-job training.
- Community service.
- Provision of child care to community service participants.

Counts As Participation Under Both Federal and State Definitions, With Some Limits

- Job search and job readiness assistance.
- Vocational education and training.
- Job skills training directly related to employment.
- Education directly related to employment.
- Secondary school or GED course of study.

Counts As Participation Only Under the State Definition

- Appraisal, assessment, or reappraisal.
- Grant-based on-the-job training.
- Work study.
- Supported work or transitional employment.
- Domestic violence services.
- Mental health services.
- Substance abuse services.
- Other work activities.

Federal Penalties for Noncompliance

States that fail to meet the federal participation rates are subject to a penalty of up to 5 percent of the state's block grant. The penalty increases by 2 percentage points each consecutive year of noncompliance, up to a maximum of 21 percent of the block grant. Depending on the degree of noncompliance—for example, how close the state came to meeting the participation requirement—the U.S. Department of Health and Human Services may reduce or waive the penalty.

As an additional incentive to meet the federal requirements, states that are in compliance are subject to a lower maintenance-of-effort (MOE) spending requirement (75 percent instead of 80 percent of their FFY 1994 welfare-related spending). In California, this means that if the state meets the participation rates, it has the option of reducing spending by $182 million each year.

California's Past Performance

Figure 1 shows California's actual participation rates since FFY 1997. For FFY 1997 through FFY 1999, California met the all-families participation requirement even without the caseload reduction credit. By contrast, California's two-parent participation rates in these years were well below the federal statutory requirements. The caseload reduction credit, however, enabled California to meet the *adjusted* rates for both the all-families and the two-parent families participation requirements for FFY 1997 through FFY 1999. By meeting both participation requirements, California was able to reduce state spending by approximately $182 million in each of those years.

Shift to a Separate State Program

For FFY 1997 through FFY 1999, the all-families rate included both single- and two-parent families. However, due to concern that California might not continue to meet the two-parent participation rate requirement, even with the caseload reduction factor, the state moved the two-parent caseload into a separate state-funded program in FFY 2000. Effective FFY 2000, therefore, the all-families rate includes only single-parent families. Separate state programs are not subject to many of the Temporary Aid to Needy Families (TANF) requirements, including the work participation requirement. Therefore, beginning in FFY 2000, the only applicable participation rate for California is the all-families rate, and only single-parent families are included in the calculation.

We note that shifting the two-parent caseload into a separate state-funded program did not result in additional General Fund costs above California's MOE spending requirement of $2.7 billion. This is because spending on the two-parent caseload falls within the $2.7 billion spending requirement. As a result, the reorganization was simply a budget-neutral shift of state and federal monies.

California's FFY 2000 Participation

Participation Rates. In FFY 2000 (the last year for which data are available), California's all-families participation rate was 27.5 percent, significantly lower than the required participation rate of 40 percent shown in Figure 1. However, California's caseload reduction credit was 32.1 percent, resulting in an adjusted participation rate requirement of only 7.9 percent (40 percent minus 32.1 percent).

Figure 1 also shows that the actual participation rates for all families dropped significantly from FFY 1999 (42.2 percent) to FFY 2000 (27.5 percent). This drop was largely a result of shifting the two-parent caseload, which has a relatively higher participation rate compared to one-parent families, into a separate state program. For example, in FFY 2000, the two-parent participation rate of 47.4 percent was approximately 20 percentage points higher than the single-parent rate. Had the two-parent caseload been excluded from the FFY 1999 calculation, the all-families rate that year would have been approximately 28 percent. Thus, it appears that from a federal perspective, participation among single-parent families remained relatively constant from FFY 1999 to FFY 2000.

How Participation Was Met. Of all those who met the federal participation requirement, a significant majority met it through unsubsidized employment (89 percent). Approximately 9 percent met the requirement through a combination of employment and other work-related activities, and the remainder met it solely through work-related activities. (For example, on-the-job training, vocational education and training, or community service.)

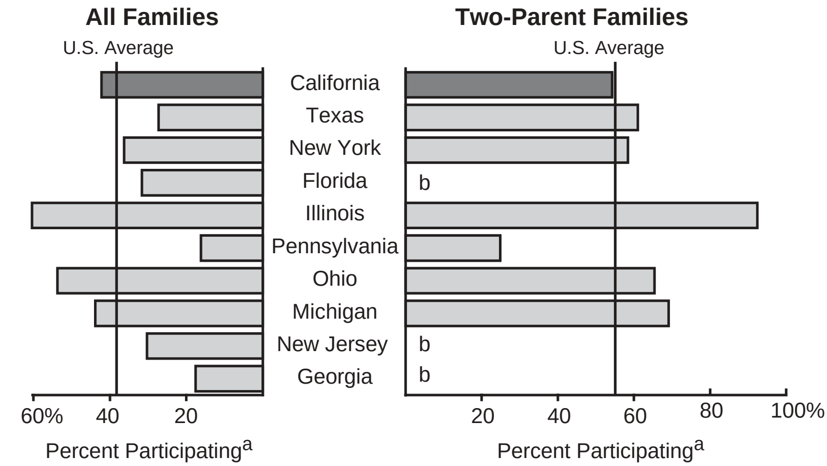
How Does California Compare to Other States?

Participation Rates. Federal fiscal year 1999 is the most recent year for which data are available to compare California's participation rates to those of other states. As Figure 4 shows, California's all-families participation rate of 42 percent was higher than the national average of 38 percent, while its two-parent family rate was just below the national average (54 percent compared to 55 percent). For the all-families rate, California ranked fourth among the ten largest states, behind Illinois, Ohio, and Michigan. For the two-parent family rate, California ranked sixth out of the seven largest states that included two-parent families in their TANF programs in FFY 1999.

Figure 4

Federal Participation Rates–Ten Largest States

FFY 1999



[a]Percent meeting federally required hourly participation in qualifying welfare-to-work activities.
[b]These states established state-only programs for two-parent cases and are not subject to federal participation requirements.

Unsubsidized Employment. In terms of the percentage of all adults who worked in unsubsidized employment, California's rate of 41 percent was well above the national average of 28 percent, as shown in Figure 5 (see next page). On this measure, California ranked second both among the ten largest states and overall.

California's high rate of participation in unsubsidized employment is in part due to the CalWORKs program's relatively high benefit levels, combined with a generous earned income disregard, whereby much of a recipient's income is disregarded for the purpose of determining the family's grant. Together, these policies allow recipients to work without immediately becoming income-ineligible for cash assistance. By contrast, in many other states full-time work results in too much income for the family to remain eligible for cash assistance.

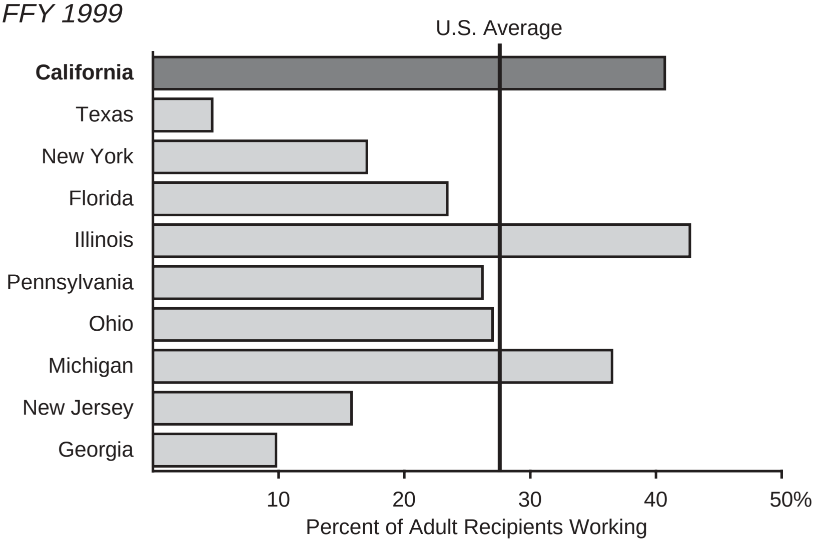
CalWORKs Participation Requirements

Just as California must meet statewide federal participation requirements, state law requires able-bodied adults on aid to meet individual participation requirements or face sanctions for noncompliance. These individual requirements differ somewhat from the federal

Figure 5

Percent of Adult Recipients in Unsubsidized Employment–Ten Largest States

FFY 1999



participation standards in terms of both the number of hours required as well as which welfare-to-work activities qualify as participation.

In general, all nonexempt, single-parent adults are required to participate in welfare-to-work activities for an average of at least 32 hours per week. Adults in two-parent families must participate a total of at least 35 hours per week (with one parent participating at least 20 hours per week). The two-parent weekly requirement increases to 55 hours for families receiving federally-funded child care. Figure 2 compares the state and federal hourly participation requirements.

Although the CalWORKs hourly participation requirement is greater than the federal standard for single-parent families, the number of activities that count towards the CalWORKs requirement is also greater, making it somewhat easier to meet the CalWORKs participation requirement. However, there are some limits on which activities count towards the CalWORKs requirement. For example, after 24 months on assistance, recipients must meet their participation requirement through unsubsidized employment, community service, or a combination of the two. Figure 3 compares the qualifying welfare-to-work activities under both the state and federal definitions.

Exemptions

The CalWORKs statute exempts some individuals from participation. In general, individuals are exempt if they are disabled, elderly, unable to work due to caretaking responsibilities, or pregnant. Single parents with a child under six months are also exempt (counties have some discretion to modify this time period). The law also permits counties to excuse nonexempt recipients from participation for "good cause." Conditions that may be considered good cause for not participating include, but are not limited to, domestic violence, mental disability, or a lack of necessary support services, including child care and transportation. Counties must establish procedures for making such determinations and must review individual determinations every three months.

Penalties for Noncompliance

Nonexempt individuals who fail to comply with participation requirements are subject to a financial sanction, meaning that the family's grant payment is reduced by the adult portion (about $131 for a family of three). Before the sanction may be imposed, however, the county welfare department must notify the individual, at which point the individual becomes formally noncompliant. The individual is then provided the opportunity to either demonstrate good cause for noncompliance or agree to a compliance plan to cure the pending sanction.

Are Able-Bodied Recipients Meeting Their Participation Requirement?

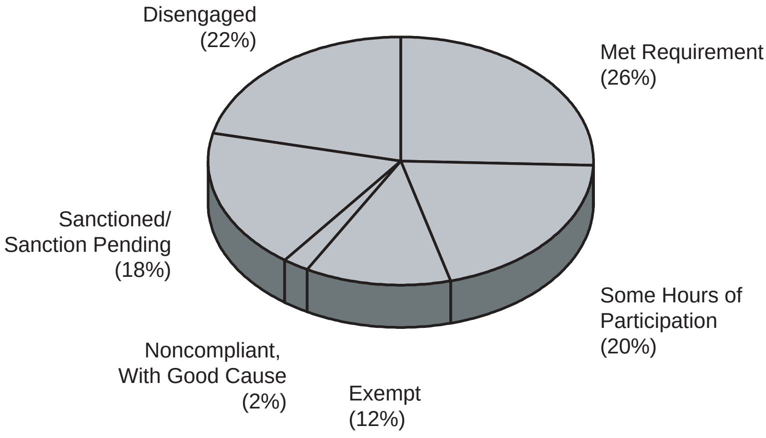
Data Limitations. We note that there are certain limitations to the two principal data sources used to analyze CalWORKs participation. Specifically, one data source is designed for federal reporting purposes, and therefore likely underreports participation in activities that count only under the CalWORKs definition. The second data source, which does capture CalWORKs-specific information, does not capture the actual number of hours of participation. This data source may also underreport participation in work activities other than unsubsidized employment. Finally, both data sources are designed to capture point-in-time participation information for a given month and cannot track an individual's participation over time. Taken together, we believe that the data limitations likely result in a modest bias for underreporting of participation. We discuss the data findings below.

Single-Parent Families. The average monthly caseload of single-parent families receiving cash assistance in FFY 2000 was about 310,000. Figure 6 (see next page) shows that 26 percent of the total caseload met the CalWORKs participation requirement. Of these, nearly 70 percent did

Figure 6

CalWORKs Participation Status Single-Parent Families

Federal Fiscal Year 2000



so through unsubsidized employment, while 27 percent met the requirement through other welfare-to-work activities, including community service. The remainder met the requirement through a combination of activities and unsubsidized employment.

An additional 20 percent of the total caseload participated for some hours, but not enough to meet the participation requirements. Approximately 12 percent of the caseload was exempt from participation requirements, while an additional 2 percent were formally noncompliant but had established good cause for not participating.

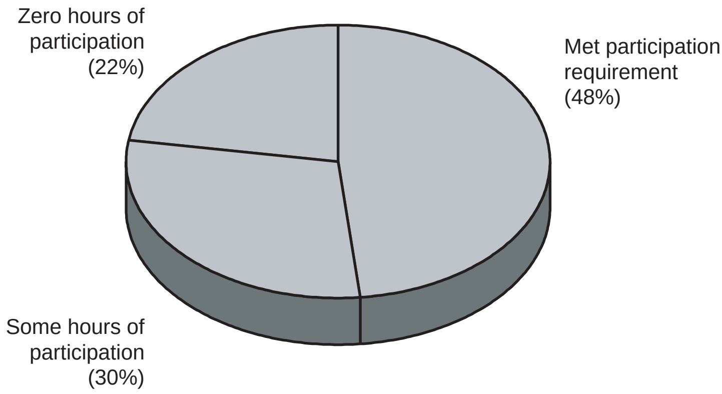
Finally, 40 percent of the caseload did not participate at all. This includes sanctioned cases or cases with a pending sanction (18 percent of the total caseload) and cases that were essentially unaccounted for—that is, they were neither participating, exempt, nor sanctioned (22 percent). We refer to these cases as "disengaged" from the program. Later we discuss the implications of and possible explanations for these participation figures.

Two-Parent Families. The average monthly caseload of two-parent families in FFY 2000 was about 65,000. By definition, both adults in two-parent families must be able-bodied and therefore are not exempt from the work participation requirement. As seen in Figure 7, 48 percent of the two-parent cases met the CalWORKs participation requirement. Of these

Figure 7

CalWORKs Participation Status Two-Parent Families

Federal Fiscal Year 2000



cases, the majority (85 percent) met the requirement solely through unsubsidized employment. An additional 29 percent of the caseload participated in some activity but for insufficient hours to meet the requirement. Finally, nearly one-quarter of the two-parent caseload—22 percent—had zero hours of participation.

Unlike single-parent families, it is not possible to determine how many of the two-parent cases with zero hours of participation were in sanction (or sanction pending) status, how many had good cause for not participating, and how many were disengaged from the program. This is due to data limitations that the Department of Social Services indicates will be corrected for the FFY 2001 participation data.

Regional Variation. The sample size and sampling methodology used by the department to calculate the participation rates do not permit county-by-county analysis or detailed regional comparisons. However, it is possible to compare Los Angeles County, which accounted for approximately 38 percent of the CalWORKs caseload in FFY 2000, to the rest of the state. The FFY 2000 comparisons show little difference between Los Angeles and the rest of the state. Los Angeles had a slightly higher two-parent participation rate (49 percent versus 48 percent for the rest of the state), and a slightly lower single-parent rate (24 percent versus 28 percent for the rest of the state).

Summary

The figures presented above suggest a mixed story. On the one hand, California has met the federal participation requirements each year since the enactment of PRWORA, thus avoiding federal penalties. Further, the rate of participation—particularly in unsubsidized employment—among CalWORKs recipients is greater than under any of California's previous welfare programs. For example, in FFY 1996, under the AFDC program, about 19 percent of all aided adults had some earnings. In FFY 2000, that figure increased to 44 percent. California's performance is also impressive compared to other states. As discussed above, in FFY 1999 California ranked second in terms of the percentage of adult recipients in unsubsidized employment. California also ranked above average in terms of overall participation among all families. Thus, compared to both past performance as well as the experience in other states, California's participation rates are encouraging.

On the other hand, given the CalWORKs goal of universal participation among able-bodied adults, California's participation rates are much lower than would be expected. The percentage of *able-bodied* adults who are not participating is of particular concern. Figures 6 and 7 show the participation status for single- and two-parent families, respectively. When we examine the participation status for both groups together, we find that, among all nonexempt adults:

- 33 percent are meeting their work participation requirements;
- 24 percent are participating but for insufficient hours to meet their requirements; and
- 43 percent are not participating at all.

While some of the nonparticipating adults are sanctioned or have a pending sanction for noncompliance, it is clear that a significant number of recipients are essentially disengaged from the CalWORKs program—that is, they are neither participating in welfare-to-work activities, nor facing penalties for noncompliance. Thus, although California's performance is comparable if not better than that of other states, the state clearly has room for improvement in terms of both engaging more recipients, as well as increasing the work effort of those who are participating but are doing so with too few hours to satisfy their participation requirements.

What Explains California's Participation Rates?

As discussed above, the number of CalWORKs recipients who are (1) participating with insufficient hours to meet their participation requirements or (2) not participating at all is higher than would be expected given that one of the primary goals of the CalWORKs program is universal participation among able-bodied recipients. We have identified a number of factors that explain California's relatively low participation rates. These include the dynamic nature of the CalWORKs caseload, the CalWORKs sanction policy, and county enforcement of the participation requirement.

A Dynamic Caseload. We note that a certain number of disengaged cases—cases that are neither participating, nor in a formal noncompliance or sanction status—is to be expected, given the dynamic nature of the CalWORKs caseload. Specifically, in a given month, new cases represent approximately 8 percent of the caseload. The lag times between when applications are approved and when the new recipients actually start participating means that some cases will appear to be disengaged in a given month, even if the recipients are complying with program requirements. Similarly for existing cases, the lag time between when referrals for certain activities are made and when the recipient actually participates in (and completes) those activities also means that some compliant cases will report no participation in a given month. These cases are not sanctioned because their case workers expect them to report participation in the following month.

We recognize that a certain number of recipients might not be accounted for in a given month. However, we believe that the 22 percent figure for the single-parent caseload—more than one-fifth of the caseload—is higher than expected given California's relatively strong work requirements. Specifically, such a high figure suggests that a significant number of CalWORKs recipients have little contact with their county welfare department, and consequently are neither participating in welfare-to-work activities nor receiving penalties for failure to do so. In other words, county welfare departments are probably not fully engaging all clients as intended by the Legislature.

The CalWORKs Sanction Policy. Before imposing a sanction for failure to comply with program requirements, the county welfare department must initiate a conciliation process to address a recipient's noncompliance. The statute's due process provisions, which allow recipients a certain length of time by which to come into compliance, mean that financial penalties may not be imposed until several months after the incidence of noncompliance. The second process evaluation of CalWORKs implementation, conducted by RAND, reported that some case workers believe that this lengthy sanction process significantly weakens the impact of the sanction policy on recipients' behavior. Our interviews with county staff confirmed this finding.

Additionally, many of the case workers and managers we talked to indicated that they believe the sanction *amount*—equal to the adult portion of the family's grant payment—does not represent a large enough penalty to induce participation. In other words, these staff believed that even if the sanction were imposed, the recipient's behavior would not change. Given their concerns that the current sanction policy has limited effect on recipients' behavior, case workers in some counties are reluctant to initiate what is a very time-consuming sanction process.

It therefore appears that, at least in some counties, the reluctance on the part of some case workers to initiate the sanction process may explain a certain number of disengaged cases.

County Enforcement of the Participation Requirement. Finally, based on our interviews with county staff, it appears that county expectations about a reasonable participation effort are sometimes lower than the CalWORKs hourly requirements. Specifically, staff in some of the counties we visited indicated that recipients who are participating, but for insufficient hours to meet their requirement, are not always required to fulfill the remaining hours of their requirement. For example, some case workers we talked to would not necessarily require a recipient who is working 25 hours to meet the remaining required hours by participating in community service activities. Instead, these staff indicated that they focus their time and the available employment service resources on those recipients who are not participating at all. Thus, to the extent that some counties do not strictly enforce the CalWORKs *hourly* participation requirement, the statewide percentage of recipients who are meeting their requirement will be lower than expected.

Budget and Policy Implications

California's participation rates raise several budget and policy implications. We identify three approaches the Legislature could consider in addressing welfare-to-work participation in the CalWORKs program. These include (1) increasing participation, (2) prioritizing welfare-to-work resources, and (3) doing nothing to change current policy and county practice. Each approach has advantages and disadvantages, which we discuss below.

We note that, in considering the following options, the Legislature should be aware of the fiscal pressures within the CalWORKs program. Specifically, as discussed in our *Analysis of the 2002-03 Budget Bill,* in certain counties (representing about 50 percent of the statewide caseload) the CalWORKs welfare-to-work component is underfunded in the current year. Because the Governor proposes to freeze budget-year funding for the welfare-to-work component—in order to maintain CalWORKs spending within available resources—this underfunding would persist in 2002-03. As we noted in our *Analysis*, funding pressures within

CalWORKs are likely to intensify in future years for several reasons, including the potential for continued caseload increases. These pressures would result in continued underfunding of the program's welfare-to-work component, which in turn may result in fewer services available for families trying to become self-sufficient prior to reaching their time limit on cash assistance.

Focus on Increasing Participation

Given the CalWORKs lifetime limit on aid, the Legislature may want to focus on increasing participation in order to ensure that recipients receive the employment services they need to make the transition from welfare to work as quickly as possible. Strategies to increase participation include increasing available employment services targeted specifically to recipients with multiple barriers to participation.

Strengthening the sanction policy for noncompliance may also increase participation. Examples of strengthening the sanction policy include implementing a graduated sanction policy, where multiple months of noncompliance eventually lead to a full-family sanction. Another approach would link grant payments to actual hours of participation. Under such a "pay-for-participation" policy, grants would be reduced for every hour of participation below the required number of hours. Thus, for example, a recipient who participates an average of only 16 hours per week instead of 32 hours per week in a given month would receive only half the grant amount the family would otherwise receive. Wisconsin's grant payments are based on a similar approach.

A third strategy to increase participation would involve implementing penalties for counties that have relatively high rates of disengaged cases. To ensure that counties continue their efforts to increase participation without simply increasing sanction rates, a county could also face penalties for high sanction-to-participation rate ratios.

Advantages. The primary advantage of focusing on higher participation rates is that it would help ensure that recipients who are facing the five-year lifetime limit on cash assistance receive the services they need to become self-sufficient as quickly as possible. We note that only *adult* recipients face a time limit on assistance. Thus, if the family were to remain income-eligible for CalWORKs, the family will still receive assistance on behalf of the children even after the adult has reached their time limit. Therefore, to the extent that increasing participation leads to more families eventually leaving cash assistance altogether, this approach could also achieve long-term program savings.

Disadvantages. The primary disadvantage of this approach is that increasing participation may require a higher level of investment in the program's welfare-to-work component. Some of the county staff we talked to indicated that achieving higher participation rates would require increased funding for both county administration and direct employment services costs. As noted above, in certain counties the welfare-to-work component is underfunded. In our *Analysis of the 2002-03 Budget*, we further noted that the additional current-year cost of bringing all counties up to a minimum funding standard would be approximately $125 million. (We calculated this minimum standard based on 1999-00 allocations to Riverside and San Bernardino Counties, both of which have relatively high participation rates.)

Prioritize Welfare-to-Work Resources

As noted earlier, while states must meet statewide participation rates, the federal regulations do not impose specific participation requirements on *individuals*. California therefore has flexibility in both determining the number of hours that individuals are required to participate, and granting exemptions from the participation requirement for certain individuals (for example, parents of very young children or elderly recipients). As shown in Figure 1, for FFY 2000, California exceeded the federal participation rate requirement for all families by nearly 20 percentage points. As a result of the caseload reduction credit, California is likely to continue to meet (and exceed) the federal rate even if its participation rates were to drop significantly. Consequently, the Legislature has several options for prioritizing available welfare-to-work resources in terms of which recipients are required to participate in welfare-to-work activities and for how many hours.

For example, the Legislature could align the number of hours of participation required under CalWORKs with the federal participation standards. As shown in Figure 2, the CalWORKs hourly participation requirement for single-parent families is higher than the required federal rate. The difference is particularly significant for families with a child under age 6 (32 hours versus 20 hours), and this group constitutes approximately 58 percent of all CalWORKs families. Adopting the federal participation standard would likely result in significant savings in child care, other employment services, and associated administration. This is because some families who are currently participating for more than 20 hours would choose to reduce their hours of participation.

Similarly, adopting the federal option to exempt single parents with a child under 12 months from participation could also result in savings. The current state standard is a 6-month exemption for the first child, and 12 weeks for subsequent children born while on assistance. Counties have the option to extend the exemption period for up to 12 months for the first child and for up to 6 months for subsequent children. While the majority of counties do provide for the maximum allowable exemption period under state law, some do not. Consequently, some savings could be achieved by amending state law to automatically exempt all single parents with a child under 12 months, regardless of the number of children born while on assistance. We note that because infant care is more expensive and more difficult to obtain than noninfant care, adopting this federal option could result in significant child care savings.

In addition to aligning the CalWORKs participation requirements with the federal standards, the Legislature could also consider exempting more individuals from the participation requirement. This could be achieved by either (1) statutorily exempting certain individuals or (2) giving counties discretion to exempt individuals as they deem appropriate. This approach would also result in administrative, child care, and other employment services savings. We note that this approach would impact California's federal participation rate. However, as described above, California currently easily exceeds the federal participation rate requirement (due to the caseload reduction credit). Thus, even if California's participation rates were somewhat lower than the current rates, California would not risk a federal penalty for failing to meet the federal requirement.

To ensure that California continues meeting the federal participation rate, counties could be held to a minimum participation standard. However, as long as they met that standard, they would have flexibility to decide how to target their available welfare-to-work resources. For example, some counties may decide to exempt all individuals with a child under age 2, or to not require individuals who are working at least 20 hours per week to participate in additional activities in order to meet the hourly requirement.

Advantages. The primary advantage of either (1) aligning the CalWORKs requirements with the federal standards or (2) exempting more individuals from the participation requirement is that the resulting savings would relieve funding pressures within the welfare-to-work component of the CalWORKs budget.

Disadvantages. The primary disadvantage of prioritizing welfare-to-work resources for certain families is that some families may not receive the welfare-to-work services they need in order to reach self-sufficiency before they reach their 60-month lifetime limit on cash assistance. Additionally, exempting more individuals from the participation requirement may weaken the work-first message of the CalWORKs program. Finally, giving counties additional discretion to exempt certain individuals raises the concern that similar families would be subject to different program requirements and penalties depending on their county of residence.

Wait and See

Finally, the Legislature could do nothing to change current policy and county practice. CalWORKs is a relatively young program and counties have just recently built up their capacity to operate the welfare-to-work component envisioned in the CalWORKs statute. The effects of the recent recession on both the CalWORKs caseload trends and the ability of recipients and former recipients to find and retain employment are still unknown. It is also unclear how federal welfare reform reauthorization, which is scheduled to happen by October 1, 2002, will impact the CalWORKs program. The issues under debate at the federal level include both the level of federal funding that will be available to the states, as well as whether to change federal participation requirements. Given these uncertainties, the Legislature could adopt a wait and see approach, allowing the program to run its course through the recession, while awaiting the outcomes of reauthorization.

Advantages. Waiting until federal reauthorization to reexamine CalWORKs policy would be the least disruptive approach. Moreover, given the state's fiscal condition, retaining current policy and county practice would require no additional funding for the CalWORKs program.

Disadvantage. The primary disadvantage of the wait and see approach is that a significant number of CalWORKs families may continue to use up their remaining months on assistance without receiving the necessary services they need to become self-sufficient.

Conclusion

The three approaches discussed above each have advantages and disadvantages. Because CalWORKs was designed as a time-limited, work-first program, we believe that increasing participation is an important long-term focus for the Legislature. However, as noted above, improving participation rates will likely require increased funding for the program's welfare-to-work component. Due to the state's fiscal situation, augmenting state spending in the CalWORKs program may not be feasible in 2002-03. Given these fiscal considerations, combined with the uncertain impact of federal welfare reform reauthorization on the CalWORKs program, we believe that the wait and see option may be the most appropriate short-term approach to addressing CalWORKs participation.

THE VEHICLE LICENSE FEE AND THE 2002-03 BUDGET

How Has the VLF Been Cut in Recent Years? What About the "Insufficient Moneys" Provision? Are Local Government Revenues Protected?

Summary

The vehicle license fee (VLF) is an annual fee on the ownership of a registered vehicle in California—with the revenues distributed to cities and counties. Since 1998, the Legislature has reduced the VLF by 67.5 percent. The average vehicle owner now saves about $124 annually in VLF paid.

As part of the tax reductions, the Legislature has provided cities and counties with the same amount of revenues as under prior law. As a result, the state is scheduled to reimburse local governments for $3.8 billion in 2002-03 for lost VLF revenues.

In this piece, we provide a history of the VLF tax reductions and an explanation of the distribution of the revenues. We also answer many common questions regarding the VLF—including information about the insufficient moneys provision in current law.

What Is the VLF?

The VLF is an annual fee on the ownership of a registered vehicle in California, in place of taxing vehicles as personal property. The VLF is paid to the Department of Motor Vehicles (DMV) at the time of annual vehicle registration. The fee is charged in addition to other fees, such as the vehicle registration fee, air quality fees, and commercial vehicle weight fees. In 1998, the Legislature began a series of reductions in the VLF. The fee was reduced from a level of 2 percent down to an effective rate of 0.65 percent—a 67.5 percent decline.

How Is the VLF Calculated?

The statutory fee rate is 2 percent of a vehicle's current estimated value and calculated on the basis of the current owner's purchase price (see Figure 1). For each year the vehicle is owned, the fee paid declines in accordance with a statutory depreciation schedule—to reflect the declining value of the vehicle. The depreciation schedule charges 100 percent of the purchase price for the first year of ownership, declining to 15 percent in the eleventh year of ownership and thereafter. When an individual purchases a used car, the new owner pays the VLF based on the price paid when acquiring the car and the depreciation schedule returns to year one. Once the VLF owed is calculated using the 2 percent tax rate,

Figure 1

Example of How the Vehicle License Fee Is Calculated

Step		Sample Calculation
1. Purchase price		$22,050
2. Round value to nearest odd hundred dollar		22,100
3. Multiply rounded value by depreciation percentage:		
Year 1:	100%	$22,100
Year 2:	90%	19,890
4. Multiply by 2 percent tax rate:		
Year 1		$442
Year 2		398
5. Apply 67.5 percent tax reduction to calculate amount owed:		
Year 1		$144
Year 2		129

the 67.5 percent tax reduction—or "offset"—is applied to the amount owed. The amount of the tax reduction is shown as a credit on the vehicle owner's registration bill.

How Has the VLF Been Cut in Recent Years?

As shown in Figure 2, the Legislature has reduced the VLF through a series of decisions associated with the annual budget agreements. The first VLF reduction began on January 1, 1999, as part of the 1998-99 budget agreement. The fee was permanently reduced by 25 percent with the possibility of reductions increasing to 67.5 percent based on state revenue growth. A series of statutory triggers were constructed to

Figure 2

VLF Reduction Legislation Since 1998

Legislation	Action
1998	
Chapter 322, (AB 2897, Cardoza)	As part of the 1998-99 budget agreement, the VLF was permanently reduced by 25 percent beginning in 1999, with the potential of greater reductions beginning in 2001 if General Fund revenues grew faster than projected. The maximum reduction was 67.5 percent, possibly beginning in 2003. Future reductions were to be offset by any alternative tax relief subsequently enacted.
1999	
Chapter 74, (AB 1121, Nakano)	As part of the 1999-00 budget agreement, the VLF was reduced by a cumulative 35 percent for calendar year 2000 on a one-time basis.
2000	
Chapter 106, (AB 858, Kuehl)	As part of the 2000-01 budget agreement, the VLF was reduced by a cumulative 67.5 percent beginning in 2001. Required that the additional reduction be sent to vehicle owners as a rebate check for 2001 and 2002. Eliminated the VLF interaction with alternative tax relief.
Chapter 107, (AB 511, Alquist)	Appropriated $2.052 billion to implement the rate reduction provided in the 2000-01 budget agreement.
2001	
Chapter 5, (SB 22, Chesbro)	Eliminated the rebate program as of July 1, 2001 and provided the full tax relief as a credit on a vehicle owner's registration bill.

determine future reductions by comparing General Fund revenue levels to the Department of Finance's *1998-99 May Revision* forecasted amounts. The maximum percentage reductions could increase to 35 percent in 2001, 46.5 percent in 2002, and 67.5 percent in 2003 and thereafter. The tax reduction level in place for 2004 would remain permanently.

The Legislature, however, eliminated the need for the revenue triggers as part of the 2000-01 budget—by implementing the maximum 67.5 percent reduction beginning in 2001 on an ongoing basis. The 67.5 percent reduction, therefore, was instituted two years earlier than would have been possible under the 1998 agreement. For the first half of 2001, vehicle owners received this additional tax relief in the form of a rebate check. Since then, owners have received the full amount of tax relief as an offset on their registration bill.

Figure 3 lists the VLF reduction percentages by year that resulted from the Legislature's actions.

Figure 3

Annual VLF Reduction Percentages

Calendar Year	Reduction
1999	25.0%
2000	35.0
2001 and thereafter	67.5[a]

[a] For January through June 2001, a portion of this reduction (32.5 percent) was provided in the form of a rebate check.

How Does the Backfill Work?

The revenues from the VLF are allocated to cities and counties. The tax reductions, therefore, would have resulted in significant local government revenue losses. Instead, for each of the tax reductions, the Legislature has replaced the reduced VLF revenues with General Fund allocations to local governments on a dollar-for-dollar basis. Thus, this VLF backfill has provided cities and counties the same amount of revenues as under prior law. Currently, for every $325 collected in VLF payments from vehicle owners (and allocated to local governments), an additional $675 is contributed by the state's General Fund for allocation to local governments. Figure 4 summarizes the annual backfill costs since the VLF reductions began. The backfill is continuously appropriated and, therefore, is not subject to annual appropriation in the budget bill.

Figure 4

LAO Estimated General Fund Backfill For VLF Tax Reductions

(In Millions)

Year	Fiscal Impact
1998-99	$482
1999-00	1,324
2000-01	2,684
2001-02	3,612[a]
2002-03	3,778
2003-04	4,040

a Approximately $1.2 billion of this amount was appropriated in 2000-01.

How Is the VLF Allocated?

In 2002-03, the VLF is expected to raise about $1.8 billion in revenues from vehicle owner payments. The General Fund backfill will contribute an additional $3.8 billion for allocation to local governments. Thus, a total of about $5.6 billion will be allocated in 2002-03. In general, the funds are distributed to cities and counties for two purposes:

- ***Base VLF.*** About three-fourths of the funds sent to local governments can be used for any spending purpose. These funds are mostly distributed on a per capita basis.
- ***Realignment VLF.*** The remaining quarter of local government VLF funds is restricted for funding "realignment" programs (various health, mental health, and social services programs). The state increased VLF revenues in 1991 (by changing the depreciation schedule) and dedicated these additional revenues to realignment programs.

Figure 5 (see next page) shows the proposed distribution of VLF revenues for 2002-03 under current law.

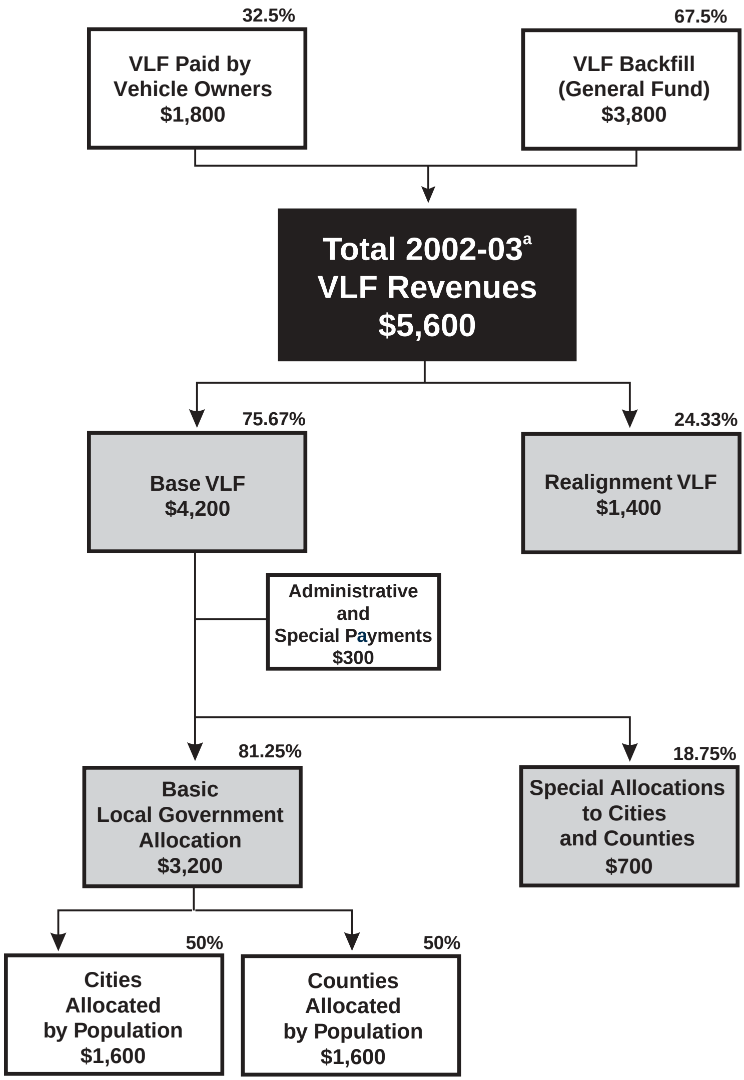
What Is the Average VLF Paid?

Generally, any vehicle required to be registered with the DMV is also required to pay the annual VLF. The DMV groups these vehicles into four categories—automobiles, motorcycles, commercial / trucks, and trailers.

Figure 5

How VLF Funds Are Distributed

2002-03 (Projected Under Current Law)
(In Millions)



[a] Excludes trailer coach and delinquent collections.

In 2000-01, about 27.1 million vehicles paid the VLF. Figure 6 shows the estimated average fee paid by each of these classifications, as well as the corresponding level of tax relief under the 67.5 percent reduction.

The DMV commercial/trucks classification includes larger pick-up trucks (based on their weight)—regardless of whether they are used as a commercial or personal vehicle. In addition, the automobiles classification contains all passenger vehicles, including those used for commercial purposes (such as a rental car or a corporate fleet vehicle).

Figure 6

Vehicles Registered and VLF Paid

Classification	Number of Vehicles (In Millions)	Percent of Total	Estimated Average VLF Paid	Estimated Average VLF Tax Relief
Automobiles	19.4	72%	$66	$138
Motorcycles	0.5	2	28	59
Commercial/trucks	5.2	19	58	120
Trailers	2.0	8	8	17
Totals/averages	**27.1**	**100%**	**$60**	**$124**

Estimates based on 2000-01 data. Totals may not add due to rounding.

What Determines Growth in VLF Revenues?

Absent any new or used car sales, VLF revenues would decline by roughly 10 percent annually due to the statutory depreciation schedule. The sale of a used car to a new owner will generate additional VLF revenues only to the extent that the value of the vehicle sold differs from the value determined by the depreciation schedule. For most vehicles, the depreciation schedule will roughly mirror a vehicle's declining value. As a result, used car sales generally do not generate increases in VLF revenues.

The two most important factors in the growth of the VLF, therefore, are (1) the number of new vehicle registrations (both from new sales and out-of-state registrations) and (2) the price of these new vehicles. Over the past five years, California has averaged more than 6 percent annual growth in the number of new vehicle registrations. Over that same time period, the prices of new cars on a national level have increased by about 4 percent annually. As a result, total VLF revenues have grown by more than 8 percent annually over that period. In our most recent revenue forecast, we project VLF revenues to grow slightly slower over the next five years—at about 6 percent annually.

What About the Insufficient Moneys Provision?

The original VLF rate reduction legislation in 1998 included a paragraph governing VLF tax relief during periods in which insufficient moneys are available to pay for the General Fund backfill to local governments (see shaded box). In those cases, the level of tax relief was to be reduced in the proportion necessary so that there would be sufficient General Fund dollars to pay for the backfill. This provision remains in effect today and has not been amended since its original enactment. If this provision were activated, General Fund expenditures for the backfill would be reduced, with a commensurate increase in VLF payments by vehicle owners. Local governments would not be affected.

Although the state is projected to face a large budget shortfall in 2002-03, it is unclear whether this provision would be activated in the budget year absent any additional legislative action. This is because the provision is ambiguous in a number of important regards.

- ***Lack of Specified Decision Maker.*** The provision fails to specify an actor (such as the Department of Finance or Controller) to make a determination over whether the state is experiencing a period of insufficient funds. Without a designated decision maker, it is unclear who would have the authority to instruct the DMV to adjust the rate reductions and by how much.
- ***Lack of Definition of Insufficient Moneys.*** The statute also fails to define the term insufficient moneys. Since the VLF backfill is continuously appropriated, the Legislature does not annually determine the level of funding provided. It is unclear what definition of insufficient would be used to determine whether moneys are available for a General Fund transfer.

Given the ambiguity regarding this insufficient moneys provision, the Legislature may wish to enact legislation clarifying the provision's meaning. The budget-year costs of the VLF backfill would be better known by specifically defining (1) who is responsible for making a determination of insufficient moneys and (2) under what circumstances. Additionally, the Legislature may wish to amend this provision to specify that any period of insufficient funds last an entire year—so that taxpayers are treated equally in the VLF rate that they pay within any 12-month period. While the vote requirement on legislation implementing these types of changes would depend on a bill's exact language, further defining the meaning of the insufficient moneys provision could be viewed as expand-

Text of the Insufficient Moneys Provision

Revenue and Taxation Code Section 10754 (a)(3)(C)

"During any period in which insufficient moneys are available to be transferred from the General Fund to fully fund the offsets required by subparagraph (A) [67.5 percent], within 90 days of a reduction of funding, the department [DMV] shall reduce the amount of each offset computed pursuant to that subparagraph by multiplying that amount by the ratio of the amount of moneys actually available to be transferred from the General Fund to pay for those offsets to the amount of moneys that is necessary to fully fund those offsets."

ing the conditions of the provision's use and, therefore, be subject to a two-thirds majority vote as a tax levy.

Are Local Government Revenues Protected?

Proposition 47, passed by the voters in 1986, provides that all VLF revenues—except those from trailer coaches—must be allocated to cities and counties (Article XI, Section 15 of the State Constitution). The Legislature, however, maintains control over both the tax rate and allocation formula. The Constitution specifies only that those funds which are collected must be transferred to local governments. Thus, the state is not constitutionally obligated to provide for the General Fund backfill of funds, and the Legislature could reduce the backfill appropriation through a majority-vote bill. If the appropriation were reduced, vehicle owners would continue to receive the same level of tax relief, while local governments would receive fewer dollars.

Both the base VLF and the realignment VLF dollars are an important part of local government finances. In providing for the statutory backfill, the Legislature recognized that the base VLF is an important revenue source for local governments. Along with the property tax and local portion of the sales tax, the base VLF provides a major source of discretionary revenues. For instance, the base VLF represents roughly 10 percent of city tax revenues and 25 percent of county tax revenues.

For counties, the realignment VLF dollars pay for a portion of a number of health, mental health, and social services programs. Realignment contains a number of "poison pill" provisions which render the program's components inoperative under specified circumstances. The elimination or reduction of the VLF backfill for realignment revenues could result in the activation of one of these poison pills.

Conclusion

The VLF reduction represents a major component of tax relief provided by the Legislature in recent years, totaling $3.8 billion in 2002-03. With the VLF reduction, local governments now rely on the state's General Fund for an important source of their general purpose revenues. As a result, in considering any changes to the VLF, the Legislature will have to balance the impacts on local governments, taxpayers, and the state's General Fund.