PART III

MAJOR FISCAL ISSUES FACING THE LEGISLATURE

INTRODUCTION

This part discusses some of the broader issues facing the Legislature in 1983. Some of these issues are closely linked to the Governor's Budget for 1983–84. Others are more long range in nature and will, in all probability, persist for many years beyond 1983. Even so, however, legislative action to address these issues in 1983 generally will allow the Legislature to consider a wider range of options than it will have available to it in subsequent years. We have grouped these issues into six major sections.

State Revenue Issues. The first section identifies issues related to state revenues. Specifically, we discuss options for reducing tax expenditures and increasing legislative oversight of this significant portion of the state budget. We also discuss the allocation of tidelands oil revenues and how these funds can be used so as to give the Legislature the most fiscal flexibility in funding its priorities. Finally, we review the practicality of using one-time revenue sources to balance the state's budget.

State Expenditure Issues. The second section identifies issues related to state expenditures. Here, we discuss the allocation of funds for cost-of-living adjustments, and changes in the amount and form of federal aid to the state. We also identify the status of the legislatively approved capital outlay program for the current and budget years and suggest a way in which the Legislature can more effectively apply its priorities to the capital outlay program for 1983–84. Finally, we examine several of the Governor's cross-cutting budget proposals to reduce state legal staff and consolidate state funding for selected public health, substance abuse, and education programs into three state block grants to local governments.

State Borrowing Issues. In this section, we identify policy issues and make recommendation designed to improve the state's ability to borrow—both on a short-term basis, for cash management purposes, and on a long-term basis to finance capital projects.

Local Government Finance Issues. The fourth section identifies issues that involve the state's relationship with local governments. We discuss state fiscal relief for local governments and local fiscal flexibility. We also identify difficulties experienced by local governments in financing capital outlay projects, and the cost to the state of reimbursing local governments for implementing state-mandated programs.

Legislative Control of the Budget. The fifth category identifies issues that involve the Legislature's ability to monitor and control state spending. One of these issues has to do with the Legislature's role under those state laws that extend the right to collective bargaining to state employees. Other issues involve the availability, comprehensiveness and reliability of data on revenues, expenditures, and state employment.

In addition, we discuss options available to the Legislature for improving the oversight provided on behalf of the Legislature by the State Public Works Board, and options for reducing the extent to which the courts are able to thwart legislative priorities and policies.

Emerging Issues. The sixth and final section deals with issues which may have a significant effect on state programs and spending in the future. These include the increasing demand for state services on the part of California's growing refugee population, the performance record of four work-for-benefit programs and their potential applicability to California's welfare population.

I. REVENUE ISSUES

A. TAX EXPENDITURES—OPTIONS FOR THE LEGISLATURE

Should the Legislature Consider Reductions in Tax Expenditures as a Means for Minimizing Cuts in Direct Expenditure Programs?

In the Governor's Budget for 1983–84, the administration has provided its plan for two categories of General Fund "spending": (1) *direct* expenditures, which are made pursuant to appropriations contained in the Budget Act, and (2) *tax* expenditures, which are made pursuant to provisions of the tax code.

With regard to *direct* expenditures, the budget proposes to spend $21.7 billion from the General Fund in 1983–84, or $379 million (1.7 percent) less than estimated expenditures in the current year. Virtually all of the 1,350 pages in the budget document are devoted to detailed fiscal information supporting these expenditures as well as the direct expenditures from special and other funds. In the coming months, the members of the Legislature will spend hundreds of hours reviewing, debating, and approving the proposed items that will fix the level of direct expenditures for virtually every state program.

With regard to *tax* expenditures, the budget proposes to spend $8.9 billion in 1983–84. While the budget calls for direct expenditures to decline in 1983–84, it—in effect—proposes to increase tax expenditures by nearly 8 percent from the estimated current-year level.

In stark contrast to the attention that both the administration and the Legislature routinely give to direct expenditures, however, virtually *no* review is given to tax expenditures as part of the budget process. The budget devotes only nine pages to the subject, providing some historical background and some summary fiscal information. Moreover, little if any discussion of tax expenditures will occur during legislative budget hearings. As a consequence, the level of tax expenditures during 1983–84 will be set without benefit of legislative review or approval.

Tax Expenditures Defined

The term tax expenditures refers to various tax exclusions, exemptions, preferential tax rates, credits, and deferrals, which reduce the amount of revenue collected from the basic tax structure.

Although there are several reasons why tax expenditures have been enacted, the principal ones are as follows: (1) to provide incentives for taxpayers to alter their behavior in certain ways (for example, the tax deduction for mortgage interest is intended to encourage homeownership), and (2) to provide aid or relief to a particular group or class of people (for example, the sales tax exemption for prescription medicines is intended to lessen the financial burden on those who must purchase such medication).

The "tax expenditure" concept provides a systematic means for identifying those revenues foregone by the state for policy reasons. Information on tax expenditures allows the state to compare the "costs" of these policy decisions with the results achieved by them.

Table 53 provides summary information on tax expenditures, by tax, from 1981–82 to 1983–84.

Table 53
Estimated Cost of General Fund Tax Expenditures 1981–82 Through 1983–84 (in millions)

	1981–82	*1982–83*	*1983–84*
Personal income tax	$4,600	$5,443	$5,890
Sales and use tax	2,300	2,566	2,733
Bank and corporation tax	200	222	236
Insurance tax	[a]	46	57
Cigarette tax	[a]	14	14
Horse racing	[a]	2	2
Totals	$7,100	$8,293	$8,932

[a] Less than $50 million.

Need for Legislative Control Over Tax Expenditures

Although tax expenditures are an appropriate means of accomplishing legislative objectives, there are three basic reasons why their use needs to be monitored closely. First, *tax expenditures may not be effective tools in influencing taxpayer behavior.* For example, because California's income tax rates are low relative to federal tax rates, certain deductions allowed by California law (such as the deduction for charitable contributions) do not result in large tax savings to individual taxpayers. It is doubtful that those state tax expenditures which provide a relatively moderate amount of tax relief per return have much, if any, impact on taxpayer behavior. These types of tax expenditures, however, can result in significant amounts of foregone revenue.

Second, *tax expenditures weaken the Legislature's control of the budget.* Once a tax expenditure has been established in law, the revenue loss occurs automatically thereafter. Unlike regular expenditure programs, for which funds must be appropriated annually in the Budget Act, tax expenditures do not come under annual legislative review. Furthermore, tax expenditures are like entitlements, in that there is no limit on the number of persons who can claim the benefits. In short, once a tax expenditure is enacted, the Legislature—for all practical purposes—loses control over the annual amount of state resources allocated to the accomplishment of the particular objective. This makes it extremely difficult for the Legislature to alter the allocation of existing resources to reflect changing priorities, as may be necessary in times of fiscal constraint.

Finally, *widespread use of the tax system to achieve public policy objectives may have an adverse impact on the tax system itself.* The proliferation of tax expenditures is one of the main reasons why the present tax system is so complicated. While the impact of adding one more line or one more form to a tax return packet may—by itself—be minor, the *cumulative* burden placed on the tax system by *all* tax expenditures is a heavy one. In fact, the plethora of special provisions (that is, tax expenditures) added to the tax system over the years has drastically increased the opportunities for tax evasion and cheating, and at the same time given many taxpayers the impression that the tax system is inequitable.

Tax Expenditures in 1983–84

The case for legislative review of tax expenditures, which is convincing in a "normal" year, is particularly convincing in 1983–84. It is by no means clear that the *Legislature's* priorities are best served by increasing the amount of tax expenditures by 7.7 percent, and reducing the amount spent directly through the state's General Fund by 1.7 percent.

Put another way, were the resources allocated to various policy objectives through the tax system subject to legislative review and approval through the budget process, the Legislature might choose to use some or all of the $639 million in increased tax expenditures to prevent or minimize cuts in direct spending programs. For example, the Governor's Budget proposes to spend $70 million to provide a tax exemption for interest earned on government bonds. This is an increase of $10 million, or 16.7 percent, over the amount provided in 1982–83. About two-thirds of this amount represents the cost of subsidizing bonds issued by local governments. This subsidy is available to all local governments, and the amount of the subsidy for any local government is not limited in any way. At the same time as the state is providing these subsidies, practically for the asking, it is at the same time undertaking extensive discussions over the amount of fiscal relief and other local aid to be taken *away* from cities and counties. Much of the aid to local governments that has already been reduced, or is under consideration for further reductions, is earmarked for programs in the health and welfare area, which have traditionally had a high priority for funding. Looked at in this light, the failure to review this tax expenditure in the same manner as a direct expenditure, in effect, gives local economic development a higher priority for funding than state health and welfare programs, as well as other basic local services.

Hence, a review of tax expenditures is particularly timely in 1983–84.

Options for Reducing Tax Expenditures in 1983–84

We suggest that the Legislature, in acting on the 1983–84 Budget, consider specific options for modifying state tax expenditure programs.

In our June 1982 report to the Legislature entitled *Options for Modifying State Tax Expenditure Programs: 1982–83* (#82-11), we provided a series of options for eliminating or modifying 17 existing tax expenditures. We selected existing tax expenditures for review based on the extent to which they satisfied one of the following criteria:

- Provides windfall benefits to taxpayers whose behavior is unaffected by the tax incentive.
- Appears to be contrary to the objectives of other state programs.
- Works at cross purposes with other tax expenditures.
- Has less priority to the Legislature than it had when enacted.

Of the options discussed in the report, some present legal, constitutional and/or administrative problems which might be difficult to resolve within a short period of time. Accordingly, we have selected from the 17 tax expenditures discussed in the report those 9 options which would involve a less dramatic departure from present tax policy. The Legislature could address these options in the 1983–84 budget process without lengthy hearings and debate. These options are summarized in Table 54, which also shows the 1983–84 General Fund revenue gain from implementing each option.

Table 54
Options for Eliminating or Modifying State Tax Expenditure Programs (in millions)

Sales Tax[a]	*1983–84 Revenue Gain*[b]
Exemption for candy and confectionary products:	
• Repeal exemption	$70
Exemption for items sold in vending machines:	
• Repeal exemption	17
Income Taxes	
Energy conservation credit:[c]	
• Repeal credit	20
• Reduce credit (from 40% to 20%)	15
• Make credit complementary to federal credit	15
Solar energy credit:[c]	
• Repeal credit	30
• Make credit complementary to federal credit	20
• Disallow credit for pool water heating	10
Itemized deduction for casualty losses:	
• Limit deduction to losses in excess of 10% of adjusted gross income (federal conformity)[d]	25
Itemized deduction for gas taxes:	
• Accelerate phaseout of deduction[e]	7
Itemized deduction for political contributions:	
• Repeal deduction	2
Military pay exclusion:	
• Repeal exclusion	4
Percentage depletion of minerals:	
• Repeal percentage depletion	8

[a] Modifications to the sales tax expenditures would also result in additional *local* sales tax revenue, equal to about one-third of the gains shown for the state.
[b] Effective date for options: (1) sales tax options: July 1, 1983; and (2) income tax options: tax and income years beginning on or after January 1, 1983 (except for the energy credits, see footnote "c").
[c] Effective date: July 1, 1983. Thus, the credit would be allowed for measures installed between January 1, 1983, and June 30, 1983, resulting in one-half year fiscal impacts for 1983–84.
[d] This option is slightly different from options presented in our report on tax expenditure. We have used the 10 percent threshold (instead of 3 percent and 5 percent), in conformity with recent changes in federal law.
[e] Chapter 1595, Statutes of 1982, provides for the phaseout of this deduction by 1984. Under this act, however, taxpayers may claim, in 1983, 25 percent of the deduction which would have been allowed under prior law. This option provides for the complete repeal of the deduction in 1983.

The only proposal regarding tax expenditures made by the administration in the 1983–84 budget is that the solar energy and energy conservation credits be eliminated. The justifications submitted by the administration on behalf of the proposal are virtually identical to those provided in our June 1982 report. We find that these arguments continue to have merit.

Treatment of Tax Expenditures in Future Years

As noted earlier, the Legislature currently has no way of reviewing the level of resources committed to tax expenditure programs on an ongoing basis. Because tax expenditures, just like direct expenditures, are undertaken to achieve state objectives, we see no basis for giving tax expenditures less legislative oversight.

If the Legislature considers it desirable to incorporate the review of tax expenditures into the budget process, there are several methods available to it for doing so. For example:

- The Legislature could establish a budget subcommittee in each house whose sole function is to review tax expenditures. In any year for which the existing tax system is not expected to provide adequate funding to meet the needs of the state, these subcommittees could be given revenue quotas by their respective houses, as a means of requiring the review and modification of tax expenditures.
- Alternatively, the existing budget subcommittees of each house could be given a list of tax expenditures falling within their jurisdiction. For example, subcommittees handling budget appropriations related to resources could review the energy tax credits. This would enable the subcommittees to assess the effectiveness of *all* state spending—both directly through appropriations and indirectly through tax expenditures. This would also assist the subcommittees in setting priorities for available funds, because they would be able to compare funding requests for *all* of the related programs in their jurisdictional area.
- The Legislature could also address the tax expenditure control issue in the context of overall reform of the budget process. The Legislature could, for instance, use a process similar to Canada's "envelope system," whereby direct and tax expenditures relating to a particular program function are analyzed in the same light and subjected to the same spending controls. Under this system, the budget subcommittees would be constrained by a ceiling on the combined amount of tax and direct expenditures that could be funded each year.

Department of Finance: Reporting Requirements

We recommend adoption of supplemental report language requiring the Department of Finance to expand its presentation of tax expenditures in subsequent Governor's Budgets.

Since 1975–76, the Department of Finance has provided a brief presentation on tax expenditures in the introductory (or "A") pages to the annual Governor's Budget. This presentation includes background information and a fiscal summary of the major identifiable tax expenditures. Chapter 575, Statutes of 1976, requires the department to include in the Governor's Budget, on a biennial basis, a more detailed analysis and recommendations.

The Governor's Budget for 1983–84 proposes that the Ch 575/76 reporting requirement be repealed (although the budget trailer bill, as introduced, does not reflect this proposal). The rationale for the department's recommendation is that the information provided in the report has not been used by the Legislature, nor have many of the recommendations made by the report since its inception in 1977–78 been implemented. While it is true that few tax expenditures have been modified or repealed as a result of the reports, we believe the department should continue to prepare the report required by Ch 575/76. We believe the main reason why there has not been more legislative action on tax expenditures is the absence of a mechanism for considering tax expenditures as part of the budget process (see prior discussion).

Because the annual tax expenditure report provides the Legislature with important summary information that otherwise would not be available, it is important that the department continue to include the report in the Governor's Budget document. Consequently, we recommend that the Legislature *not* repeal the reporting requirement of Ch 575/76.

In fact, we believe that the annual tax expenditure report in the Governor's Budget could be made much more useful to the Legislature if it were expanded and modified. Specifically, we believe that the following items be included in the annual tax expenditure report:

- ***Comprehensive List of Tax Expenditures.*** Currently, the report includes only "major identifiable" tax expenditures instead of a complete list of state tax expenditures. As a result, the listing fails to identify those tax provisions for which the revenue loss is difficult or impossible to estimate, even though it may be significant.
- ***More Detailed Information on Individual Categories of Tax Expenditures.*** Currently, the tax expenditure report provides only a one-year fiscal estimate for aggregated categories of tax expenditures (for example, the revenue loss from interest deductions is not broken out by mortgage and nonmortgage deductions). In order to facilitate legislative review, the department should include, for each tax expenditure, at least the following: (1) the authorizing section of the Revenue and Taxation Code, (2) a brief description, (3) the sunset date, if any, and (4) the estimated annual revenue loss.
- ***Historical Information.*** The 1983–84 Governor's Budget, for the first time, includes as part of the tax expenditure report, a chronology of tax expenditures enacted and repealed since 1977 (see Tables 2 and 3, pp. A-114 and A-115). The department should continue to provide this type of information, in order to facilitate an ongoing evaluation of changes to the tax expenditure budget.
- ***Proposals.*** For the budget year, the department has proposed changes to two tax expenditures: the solar energy and energy conservation credits. The department should, in future years, evaluate tax expenditure programs in the light of current priorities, fiscal realities and the accomplishments of these programs, and recommend the repeal or modification of those programs that the administration believes have a low priority for funding. These recommendations should be included in companion legislation to the Budget Bill.

Accordingly, we recommend that the Legislature adopt the following supplemental report language:

"The Department of Finance shall, in its annual report to the Legislature on tax expenditures, provide the following: (1) a comprehensive list of tax expenditures, (2) additional detail on individual categories of tax expenditures, (3) historical information on the enactment and repeal of tax expenditures, and (4) any proposals to repeal or modify existing tax expenditure programs that the department determines are warranted."

B. ALLOCATION OF TIDELANDS OIL AND GAS REVENUES

Should Tidelands Oil and Gas Revenues Be Earmarked for Specific Categories of Projects or Deposited in the General Fund?

History of Tidelands Revenues and Their Allocations

The state has received revenues from its tidelands oil and gas properties since 1929. Most of these revenues are secured from offshore areas along Santa Barbara and Ventura Counties, and adjacent to the Cities of Long Beach and Huntington Beach.

Prior to 1960, these revenues were allocated to the Investment Fund, the General Fund and to the Beach and Park funds. As the magnitude of these revenues increased, funds were allocated for other purposes such as financing a portion of the State Water Project. The bulk of these revenues, however, went for higher education capital outlay projects, primarily at the University of California and the California State University.

In the late 1960's, state tidelands revenues averaged about $47 million annually. During most of the 1970's, these revenues were over $100 million per year. Since 1979–80, they have averaged over $400 million per year.

Description of the Current Allocation Formulas

Chapter 981, Statutes of 1968, initiated the present system of allocating these revenues. This system was substantially revised, however, by Chapter 899, Statutes of 1980. These laws established a *priority sequence* for the distribution of the revenues. Under this arrangement, target amounts are established for four program areas, and six special funds. Those at the top of the priority list receive their full allocation before any revenues are allocated to the next lower priority. Put another way, a shortfall in revenues is not apportioned among all programs, but instead is borne by the funds at the bottom of the list.

Table 55 shows (1) the statutory target amounts to be allocated among the various tidelands oil claimants for 1983–84, (2) the allocations that would occur under existing law, based on the anticipated funding level, and (3) the changes in allocations proposed by the Governor's Budget. This comparison shows:

1. The state would have to receive $543 million in tidelands oil revenues in order to fund the "target amounts" for all claimants.

2. Because estimated revenues are more than $200 million *below* the "target" figure, the State School Building Lease Purchase Fund would, under existing law, receive only part of its target allocation, and no allocations would be made to the lower priority funds such as the Energy and Resources Fund (ERF), the State Parks and Recreation Fund (SPRF), the Transportation Planning and Development (TP&D) Account, and the Special Account for Capital Outlay (SAFCO).

3. The Governor's Budget proposes to change the allocation of these funds by (a) reallocating funds among the ten claimants, eliminating the allocation for some, reducing it for others, and increasing it for some of those who otherwise would receive nothing in 1983–84, and (b) diverting $192 million (57 percent of total tidelands revenues) to the General Fund to help balance the 1983–84 budget.

During deliberations on the last two Budget Acts, the Legislature reallocated tidelands oil revenues in a manner similar to what the Governor's Budget proposes. For example, the 1982 Budget Act reallocated $175 million to the General Fund to help balance the 1982–83 Budget, and reduced the targeted allocations for the Capital Outlay Fund for Public Higher Education (COFPHE) and the State School Building Lease-Purchase Fund, redirecting part of the money to the ERF and SAFCO.

Table 55
Allocation of Tidelands Revenues in 1983–84
(in thousands)

Priority Sequence	Existing Law: Target Amount	Existing Law: Reduced Funding Allocations	Governor's Budget
1. State Lands Commission	$7,500	$7,500	$7,498
2. California Water Fund	25,000	25,000	—
3. Central Valley Water Project Construction Fund	5,000	5,000	—
4. Sea Grant Program	500	500	400
5. Capital Outlay Fund for Public Higher Education (COFPHE)	125,000	125,000	56,715
6. State School Building Lease-Purchase Fund	200,000	172,000	—
7. Energy and Resources Fund (ERF)	120,000	—	30,098
8. State Parks and Recreation Fund (SPRF)	35,000	—	10,081
9. Transportation Planning and Development (TP&D) Account	25,000	—	—
10. Special Account for Capital Outlay (SAFCO)	Remainder	—	38,208
11. (General Fund)	None	None	192,000
Totals	$543,000	$335,000	$335,000

Analysis of Existing Allocation Formulas

When Chapter 899 was adopted, tidelands oil revenues were expected to total more than $500 million annually. As Table 55 illustrates, the "target allocations" depended on revenues being at or above this level. Actual revenues, however, have consistently fallen below expectations, due to a drop in oil prices. In fact, the gap between anticipated and actual revenues is widening. Thus, in 1980–81, tidelands revenues were $475 million, in the next two years they dropped to about $460 million, and the estimate for 1983–84 is only $335 million, or 60 percent of the target allocation.

These revenue shortfalls, plus changes in legislative priorities, have made the existing statutory allocations obsolete. Each year since Chapter 899 was adopted, the Legislature has made substantial changes in these allocations, often under circumstances where it must "take back" funds that have already been "given" for one specific purpose or another. As a result, the original purpose of Chapter 899—namely, that a fixed amount of revenue would be dedicated in advance for specific purposes—has never been achieved, and rather than make the Legislature's job in allocating these funds easier, Chapter 899 has actually made it more difficult.

Considering the volatility of this revenue source, it is doubtful whether the original goal can be achieved in the next several years. (For a discussion of future tidelands leasing operations see Item 3560 of the *Analysis,* the State Lands Commission.)

Tidelands Oil Revenues Should be Deposited Directly in the General Fund.

So as to maximize Legislative flexibility, we recommend that legislation be enacted requiring all tidelands oil revenues to be deposited in the General Fund for allocation based on legislative priorities as determined through the budget process, starting on July 1, 1983.

From an analytical standpoint, tidelands oil revenues are indistinguishable from General Fund revenues. They are not raised for a particular function of state government, and may be used by the state for any public purpose. Depositing tidelands oil revenues into special purpose funds tends to limit the Legislature's options in allocating available state resources among state-supported programs and activities, and greatly increases the complexity of managing the money, thereby weakening legislative control of the budget. Earmarking these revenues for capital outlay projects gives such projects a higher priority because, having a dedicated revenue source, they do not have to compete for funding with other state programs.

Under existing law, the Chapter 899 allocation formulas sunset on July 1. Based on the Legislature's recent experience with this distribution mechanism, and the impact it has had on legislative decision-making, we believe it would be appropriate at this time to change these formulas. Accordingly, we recommend that legislation be enacted requiring all tidelands oil revenues to be deposited in the General Fund, starting on July 1, 1983.

C. VIABILITY OF USING ONE-TIME REVENUES

To What Extent Should "One-Time" Revenues Be Used to Balance the State's Budget?

As discussed in Part II of this document, a significant amount of General Fund expenditures in the prior, current, and budget years have been (or are proposed to be) financed with "one-time" revenues or "one-time" expenditure savings. These "one-time" funds primarily come from three sources: (1) tax collection accelerations, (2) tidelands oil and gas revenues which have been deposited into the General Fund instead of various special funds that, under existing law, are supposed to receive them and (3) transfers of monies from the Motor Vehicle License Fee Account to the General Fund which would otherwise go to local governments. To what extent is it viable to continue to rely on these types of "one-time" monies to pay for General Fund expenditures?

Tax Accelerations

There is a limit on the extent to which tax payment dates can be moved forward and prepayment requirements raised. Thus, a clear limit exists as to the amount of "one-time" revenue gains which are possible from this source. During the last two years, the Legislature has adopted many of the more feasible accelerations. As a result, there is limited potential for additional accelerations in the future.

Special Fund Revenues

In the case of special fund revenues, however, there clearly is an opportunity to use "one-time" monies on a *repeat* basis. Such monies are available each year, and the Legislature has the option of deciding whether or not these monies should go into the General Fund. This is true, for example, with respect to both Motor Vehicle License Fee Account funds and tidelands oil and gas revenues. In a sense, then, these monies are not strictly "one-time" in the same way that, for example, tax accelerations are "one-time".

The extent to which special funds should be used on a repeat basis to support the General Fund is a legislative policy issue. Deciding what to do with these monies involves weighing the benefits from using them for General Fund activities against the costs of not using them to support activities ordinarily financed by these special funds. This decision, however, should also take into account whether there are other, perhaps more feasible, ways of supporting the programs which in the past have relied on special fund monies. For example, higher education capital outlay projects could be financed through from the proceeds of bond sales, in recognition of their long life, rather than from tidelands oil and gas revenues.

In the preceding issue discussion, we recommended that one source of "one-time" monies—tidelands oil and gas revenues—be made "on-going" by the enactment of legislation requiring these funds to be deposited automatically into the General Fund, where they can be used for whatever programs the Legislature believes have the highest priority claim on the state's general purpose resources.

In the case of the Vehicle License Fee Account monies, however, each dollar transferred to the state reduces the income to localities by the same amount. Thus, in deciding whether to tap these monies repeatedly, the Legislature must also consider the impact of funding reductions on local government programs, especially given the property tax limitations imposed by Proposition 13.

Policy Considerations

As a general policy, the Legislature should fund *ongoing* expenditures from the *ongoing* revenue base. Reliance on one-time income from such sources as tax accelerations is *not* a viable means of funding *ongoing* expenditures. Only when it is *evident*—not merely hoped—that the state's fiscal condition will be better in the following year should the Legislature consider using one time resources to support on-going programs. Under these circumstances, use of one-time resources can minimize program disruptions that result from stop-and-go funding.

Otherwise, the Legislature should limit the use of one-time funding to one-time, or non-recurring purposes, such as building-up the size of the Reserve for Economic Uncertainties.

II. EXPENDITURE ISSUES

A. COST-OF-LIVING ADJUSTMENTS (COLAs)

What Policy Should the Legislature Adopt with Respect to the Provision of Cost-of-Living or Inflation Adjustments?

Each year, the Governor's Budget typically includes funds for various cost-of-living adjustments, commonly referred to as COLAs. These adjustments generally have a common objective: to compensate for the effects of inflation on the purchasing power of the previous year's funding level.

Discretionary and Statutory COLAs

Existing law authorizes *automatic* COLAs for 18 different programs, most of them in the health, education and welfare areas. These adjustments generally are referred to as statutory COLAs. Many other local assistance programs generally have received COLAs on a *discretionary* (or non-statutory) basis, through the budget process.

In 1983–84, statutory COLAs will range from 3.6 percent (county health services) to 10.9 percent (Department of Rehabilitation programs). Those statutory COLAs with the largest costs are for K–12 apportionments ($560 million), SSI/SSP grants ($230 million), and AFDC grants ($99 million). If fully funded, statutory COLAs would increase General Fund expenditures by $1.1 billion in 1983–84.

Governor's Budget Proposal

The budget proposes a total of $925.7 million from the General Fund for COLAs in 1983–84, including $580.8 million for statutory COLAs and $344.9 million for discretionary COLAs. The components of this proposal are highlighted in the table on page A-38 of the Governor's Budget. The amount requested for statutory COLAs is $553.7 million, or 49 percent, less than what would be needed to provide full increases for all programs with statutory COLAs.

The budget proposes that *none* of the programs with statutory COLAs receive the full COLA required by existing law. Instead, the Governor has sponsored provisions of SB 124 and AB 223 which would suspend the operation of statutory COLAs in 1983–84. In lieu of the statutory COLAs, the budget proposes a 3 percent increase for most (but not all) programs which normally receive a statutory or discretionary adjustment to offset the effects of inflation on what the prior year's funding level can buy.

Two programs would receive COLAs which are higher than 3 percent: K–12 apportionments (6 percent plus an additional variable increase for low wealth districts), and state employee compensation (5 percent). The SSI/SSP program would receive a 2.1 percent increase. The budget proposes no cost-of-living increase for a number of programs with statutory COLAs: Medi-Cal hospital inpatients, AFDC, teachers' retirement benefits, personal property tax relief, the Gifted and Talented Education program, and the Educational Instructional Materials program. (The administration proposes to include the latter two programs in the state education block grant.) In addition, the administration proposes no COLAs for several programs which had received discretionary COLAs prior to 1982–83. These include a number of health, substance abuse, and education programs which the budget proposes to incorporate in three new state block grants to local agencies.

As a result of technical budgeting errors, the budget proposes more than a 3 percent increase for the community care licensing program, the social services "other" program and the Student Aid Commission, and less than 3 percent for regional centers for the developmentally disabled. We discuss these budgeting errors under the appropriate budget items, in the *Analysis.*

Baseline Budget Reductions May Offset COLA Increases

A COLA does not necessarily result in a net increase in the amount of funds appropriated to a particular program. In many cases, the administration proposes to first reduce a program's budget base and then add a COLA to the lower base. Obviously, any baseline budget reduction will offset, in whole or in part, the increase intended as a COLA. For example, the budget proposes to reduce the budget base for county health services by $25 million and provide funds for a 3 percent COLA ($11 million). This results in a net reduction in program expenditures of $14 million below the estimated current-year level. We discuss each of these situations under the appropriate budget items in the *Analysis.*

Purpose of COLAs

Most discussions of COLAs typically focus only on those programs which are summarized in the COLA table on page A-38 of the Governor's Budget. Generally, these COLAs are used in one of four primary ways: (1) to increase salaries and operating expenses for employees of counties, schools and community college districts; (2) to increase the maximum grants paid to welfare recipients; (3) to provide rate increases for providers who contract with the state or counties to provide specified services (mostly in the health and welfare areas); and (4) to provide salary increases for state employees. In addition, COLAs are used to maintain the real value of (1) the state's contribution to the State Teachers' Retirement System that is intended to offset a portion of the system's unfunded liability, (2) reimbursements to offset local property tax relief revenue losses, and (3) student grant levels provided under the California State University Educational Opportunity Program.

COLAs for State Operations

Any COLA discussion also should take account of COLA-type adjustments that are provided for the state operations portion of the budget. Budget items which are classified as state operations can receive an adjustment to compensate for inflation using one of two methods. The first involves applying an across-the-board percentage increase to funding for operating expenses. This year a 5 percent adjustment was allowed by the Department of Finance. The second is to provide specific percentage increases identified in the Department of General Services' Price Book for particular items of expense, and a fixed percentage increase for all other items that are not specifically identified (4 percent in 1983–84).

Need for a Consistent Policy in Awarding COLAs

The practice of awarding COLAs to different programs has developed in a piecemeal, haphazard manner. The result is that there is no consistent policy—either in the executive branch or the legislative branch—for deciding which programs get how much or for what purposes. Below we summarize some of the major inconsistencies in the ways in which COLAs currently are determined:

1. ***There is No Rationale for the Wide Variations in Statutory Colas.*** Statutory COLAs in 1983–84 range from a low of 3.6 percent to a high of 10.9 percent. This is due to differences in the base years and indices used in calculating the adjustment. For example, some statutory COLAs are tied to a particular inflation index, such as the U.S. or California Consumer Price Index. Most welfare programs use a specially constructed California Necessities Index (CNI). Other programs are provided statutorily specified increases, based on such measures as the manufacturers' direct list prices for Medi-Cal drug ingredients, administratively determined "reasonable cost" guidelines for work activity services administered by the Department of Rehabilitation, or legislatively established revenue limits for K–12 apportionments.

In past issues of the *Analysis,* we have noted that we could find no analytic justification for the wide variations in statutory adjustments. As a result, we have recommended that the Legislature use the Gross National Product personal consumption deflator and state and local government deflator as the bases for judging how inflation affects private citizens and state and local governments, respectively. In addition, we concluded that the CNI may prove to be a good measure of inflation's effect on welfare recipients if refinements in certain spending subcategories can be made.

2. ***Variations in COLAs Often Reflect Budget Accounting Concepts, Rather than Policy Considerations Categories.*** The Governor's Budget for 1983–84 proposes that many of the programs categorized in the budget as local assistance get a 3 percent COLA, while programs categorized as state operations are recommended for a 5 percent (or higher) increase. Yet there seems to be no analytic justification for awarding different increases to these two groups of state-funded programs. In most cases, the funding adjustment is awarded for the same purpose—that is, maintaining purchasing power at current levels. In addition, many spending items classified as local assistance are similar to state administrative activities, and some spending items classified as state operations actually are used to fund local programs. The result is that budgeting procedures, rather than policy considerations, determine which programs get larger COLAs. Some examples of the haphazard treatment given by the budget to similar programs follow:

a. The proposed budget for the *Department of Rehabilitation* provides a 5.7 percent discretionary COLA for grants to certain community rehabilitation facilities which are budgeted as state operations. Yet, the budget provides a 3 percent COLA to those community rehabilitation programs budgeted as local assistance.

b. The budget proposes no COLA for *emergency medical services* grants to local agencies which are budgeted as state operations. Elsewhere, the budget proposes a discretionary 3 percent COLA for selected other public health programs which are categorized as local assistance. Those public health programs incorporated in the new state block grant, however, would receive no COLA.

c. The budget proposes a 3 percent COLA for *regional centers* for the developmentally disabled, which is categorized as a local assistance item. Regional center staff are used, in part, to review regional center client utilization of services. Staff in the Department of Health Services perform a similar utilization review function for *Medi-Cal* clients, yet the budget proposes that department staff receive a 5 percent COLA for employee compensation, and a price letter adjustment (minimum of 5 percent) for operating expenses, because these costs are classified as state operations.

d. The Department of Health Services' budget proposes that *county health services* funded under the provisions of AB 8 and categorized as local assistance receive a 3 percent COLA. Yet, the funding proposed for health services which the state provides directly, under contract with small counties, includes a 5 percent increase for employee compensation and a price letter adjustment (minimum of 5 percent) for operating expenses, because it is categorized as state operations.

e. The proposed budgets for the *University of California* and the *California State University system,* which are categorized as state operations, contain 5 percent pay increases for their employees and price letter adjustments (minimum of 5 percent) for operating expenses. The proposed budget for the *California Community Colleges,* on the other hand, is categorized as local assistance, and includes no funds for a COLA on the apportionments portion of its budget and a 3 percent COLA for handicapped student and equal opportunity program activities.

f. The budget for the *State Department of Education* proposes a 5 percent increase for employee compensation and price letter adjustments (minimum of 5 percent) for operating expenses. Funding for K–12 educational programs, which are budgeted as local assistance, will provide for a 6 percent COLA on district apportionments, an additional variable increase for low wealth districts, a 3 percent COLA for selected program components, and no COLA for other components. Districts, in turn, will pool these funds before deciding how much cost-of-living adjustment to provide for their own staff and operating expenses.

g. Both the *Work Incentive (WIN) program* and the *Employment Preparation Program (EPP)* fund county social workers to provide supportive social services to applicants and recipients of AFDC. The social worker component of the WIN program is included in the Department of Social Services' local assistance budget item. The EPP is included in the Employment Development Department's state operations budget item. If EPP were categorized as local assistance, rather than as state operations, it would receive a 3 percent COLA rather than the 5 percent COLA proposed in the budget.

3. ***The Budget Proposes COLAs for Other Government Entities, but Doesn't Always Expect Them in Return.*** In one case, the budget proposes a COLA to protect the purchasing power of other governmental agencies from whom the state purchases services. The budget, however, does not provide comparable protection for the state when it acts as a seller, rather than as a buyer, of services. For example, the California Department of Forestry's budget proposes a 1 percent COLA for payments to the U.S. Forest Service and six counties which provide fire protection for state responsibility areas. Yet the budget does not propose that the state receive a similar COLA for the cost of fire protection services *it* provides the U.S. Bureau of Land Management (BLM) on BLM land in California.

Conclusion

In order to ensure that the amounts of COLAs provided to individual programs are determined in a rational, consistent manner, we recommend that the Legislature establish a formal policy governing cost-of-living or inflation adjustments. This policy should require that the size of any COLAs awarded be based on the extent to which a COLA is needed to protect and maintain the purchasing power of a program or activity, after giving due recognition to the options available to the recipient for improving productivity or reducing costs. The Legislature will want to adjust this basic policy from time to time to reflect changing legislative priorities and program needs. *Any variations in the level of COLAs awarded to different programs, however, should reflect specific legislative objectives, rather than historical spending differences or how the program is categorized in the budget.*

B. STATEWIDE LEGAL STAFF REDUCTIONS

Should the Legislature Reduce Legal Staffing in the Line Departments so that the Provision of Legal Services Can Be Centralized?

The Governor's Budget proposes to reduce the attorney staffing for 39 state departments, boards and commissions by approximately one-third. The reductions are designed to minimize the proliferation of individual departmental legal staffs which may duplicate centralized state legal services provided by the Attorney General's Department of Justice.

Generally, the budget suggests that the departments affected by the reduction should adjust workload to the reduced staffing level by performing only high priority legal work. Further, the budget indicates that, prior to reestablishing any of the deleted legal positions, the departments must justify the positions on a cost-benefit basis and provide reasons why centralized legal services should not be used instead of in-house staff.

In our review of the budget, we identified proposals to delete over 170 attorney positions and 82 related clerical staff. The budgets of the affected departments were reduced by approximately $11.7 million, including $4.4 million from the General Fund, $5.4 million from special funds, $1.2 million in federal funds and $0.7 million from other sources. Table 56 summarizes the proposed reductions in legal staff.

Table 56
Statewide Legal Staff Reductions

Agency	*Number of Departments Affected*	*1982–83 Authorized Attorney Positions*[a]	*1983–84 Proposed Reductions: Attorneys*	*1983–84 Proposed Reductions: Clerical Staff*	*Dollar Amount (in thousands)*	*Percent of Attorney Staff Deleted*
Business, Transportation and Housing	10	239.1	77	38	$5,808	32%
Health and Welfare	8	104.5	40	19	2,385	38
Resources	8	80.5	27	13.5	1,795	34
State and Consumer Services	5	39.6	13.6	6	848	34
Youth and Adult Corrections	3	7.0	3	—	167	43
Other affected departments	5	77.5	10.1	5.5	647	13
Totals	39	548.2	170.7	82	$11,650	31%

[a] Reflects authorized level only for affected departments.

Generally, we are unable to determine the impact of these reductions on state programs because the budget does not identify specific workload or activities that will be discontinued in 1983–84. In fact, most departments have not yet determined how they will absorb the staff reductions, or decided which legal services they will eliminate.

It is quite possible that some of the proposed reductions would have little or no adverse impact on state programs, because departments could eliminate non-essential services which currently are performed by in-house legal staff or requested from the Attorney General. Further, such reductions could result in cost efficiencies, to the extent that a larger percentage of the state's legal work is performed by the centralized legal staff at the Attorney General's office.

We are concerned, however, that some of the staff reductions could affect various departments in a way that might result in increased state costs. In the *Analysis,* we have identified a number of departments that could be affected adversely if they were unable to adjust to the cutbacks by eliminating low-priority legal work. Among these are the following:

- The Department of Veterans Affairs has a backlog in home loan foreclosure cases. Delays in resolving the cases could result in major revenue losses to the Cal-Vet Farm and Home Building Fund.
- The Department of Health Services legal staff (a) conducts administrative hearings on Medi-Cal provider audit appeals, disputes and suspensions, (b) represents the department in audit appeal hearings involving millions of dollars annually, and (c) provides general advice and consultation on recent Medi-Cal reform legislation, state and federal laws and regulations, and various preventive health programs. A reduction in some of these activities could result in additional Medi-Cal program costs.
- The State Lands Commission legal staff is involved in (a) the negotiation of tidelands oil leases and contracts which produce revenue for the state, and (b) litigation protecting the state's economic interests in disputes arising from the commission's revenue producing activities. A reduction in these activities may have an adverse impact on future state revenues.
- The State Teachers' Retirement System and the Public Employees' Retirement System are authorized by the Attorney General to provide their own legal representation in administrative and court proceedings involving retirement benefits. The loss of legal staff could cause the systems to forego or lose legal challenges, and result in additional retirement program costs in future years.
- The Department of Corporations Enforcement Division legal staff (a) conducts proceedings to suspend, revoke or deny licenses of securities brokers, dealers and investment advisers, (b) initiates civil litigation in cases of suspected investment fraud, (c) prosecutes complex cases of investment and financial crimes, in conjunction with district attorneys and (d) directs the investigative activities of the division's investigators and examiners. The loss of legal staff could reduce the department's ability to take action against licensees engaged in improper financial transactions, and initiate civil or criminal proceedings against suspected violators of state statutes under the department's jurisdiction.

Our analysis indicates that the amount of legal services available to the 39 affected state departments in 1983–84 will be significantly less than current-year levels, because the proposed staff reductions have not been offset by corresponding increases in staffing for the Department of Justice.

In order to assess the adequacy of the departments' budgets, it is important that the Legislature have an adequate description of the workload that will no longer be performed by in-house legal staff as a result of the cutbacks proposed in the budget. Only then will it be possible to identify the adverse fiscal effects or decreases in program activities that would result from the reductions in legal staff. Accordingly, we recommend in the *Analysis* that many of the affected departments report to the Legislature, prior to budget hearings, on the impact of the reductions on their operations.

C. FEDERAL AID TO STATE AND LOCAL GOVERNMENT

What Effect Are Recent Federal Funding and Program Changes Having on the Allocation of Funds Within the Budget?

Grants-in-aid to state and local governments consist of funds provided by the federal government in support of a state or local program of service to the public. This assistance is composed primarily of two components: (1) payments to individuals and (2) discretionary grants.

This section discusses the actual and potential impact of changes in the amount of federal funds available to California as well as the way in which these funds are provided. Specifically, it examines trends in national funding levels as well as amounts received in California, the effect of the 1981 Omnibus Budget Reconciliation Act on the state, the nine federal block grants established in 1981 and the state's response.

1. Federal Funding Changes

Importance of Federal Grants in Financing State Expenditures. Federal fund expenditures in California account for almost one-third of the governmental expenditures in the 1983–84 state budget. For each $10 proposed to be spent by the state in the budget year from governmental sources, $3.00 would be provided by the federal government. Thus, program and funding changes made by the federal government have a significant effect on the funding levels and program activities reflected in the state's budget. Moreover, as has been the case during the last two years, reduced federal funding for programs supported in whole or in part by the federal government puts presssure on the state to maintain programs at current operating levels.

Recent Trends in Federal Grants-in-Aid. Beginning in 1972, with the enactment of federal revenue sharing, the grant-in-aid portion of the federal budget grew steadily, reaching a high of $105.8 billion in 1981. Since then, this portion of the federal budget has been declining.

Chart 25 compares national grants-in-aid funding totals with the amounts received in California from 1977–78 to 1983–84. The chart shows that through 1980 grants to the state grew pretty much in line with total federal grants-in-aid. As a result, California's share of total grants-in-aid remained relatively constant at about 8 percent.

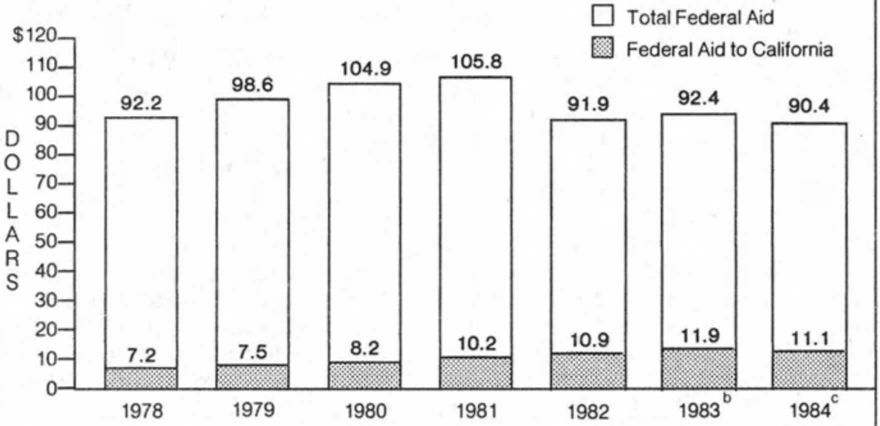
In 1981, the amount of federal funds received by the state increased by $2 billion, causing the state's share to increase sharply, reaching approximately 10 percent of the national total. In the following year—1982—federal grants-in-aid declined by 13 percent, but the amount received by the state continued to grow. As a result, the state's share of the total reached 12 percent in 1982, and increased to 13 in 1983. The President's Budget for 1984 shows a modest decline in federal grants, while the Governor's Budget anticipates an even sharper decline in state receipts from Washington. In part, this decline reflects the lag between when "budget authority" is provided and when grants are actually disbursed. California's receipts, like the national totals, remained relatively constant.

Changes in the Composition of Federal Expenditures

A closer look at the composition of the federal budget places the recent reductions in aid to state and local governments in better perspective.

Chart 25

Federal Aid to State and Local Governments
National/California Comparison
1977–78 to 1983–84[a] (in billions)



Source: Office of Management and Budget's Special Analysis H/Governor's Budgets

[a] Federal data based on budget authority in federal fiscal years. State data shown in state fiscal years.
[b] Estimated
[c] Proposed

Categorizing Federal Expenditures. The federal budget can be divided into the following four categories:

- ***National Defense***—includes military and civilian salaries, operation and maintenance of military installations and the costs of procuring military hardware.
- ***Non-Means Tested Social Programs***—includes programs that provide benefits to individuals regardless of their income, such as social security, medicare and unemployment compensation.
- ***Interest on the Public Debt***—includes interest on the debt and tax refunds, adjusted for interest received by federal trust funds.
- ***Means-Tested Programs, Grants to State and Local Governments, All Other***—includes such income-based programs as Medicaid, Food Stamps, Aid to Families with Dependent Children, Supplemental Security Income, discretionary grants to state and local governments, and foreign aid.

Despite sizable cuts in the federal budget beginning in federal fiscal year 1982, total federal expenditures are expected to increase in the future. According to a 1982 report of the Congressional Budget Office analyzing the President's 1983 budget, if existing policies continued through 1985, federal outlays in 1985 will be $910 billion, or $232 billion above the 1981 level.

Expenditure Momentum in the Federal Budget. What explains the continued growth in federal spending, despite sizable cuts in the federal budget? The answer is the powerful momentum that has been built into the way in which the federal government spends the taxpayer's money. The source of this momentum is three-fold:

- First, the Congress has enacted a series of laws that create *entitlements* to benefits under certain federal programs, year-in and year-out. Under these laws, anyone who meets the qualifications for benefits gets those benfits, regardless of what is happening elsewhere in the federal budget. Medicare is a good example of an entitlement program.
- Second, the Congress has provided for *automatic cost-of-living adjustments* to benefit levels under a number of programs that automatically push expenditures up each year. In many cases, the way in which these adjustments are calculated causes benefits to rise faster than living costs. Social security is the prime example of a program with this type of adjustment mechanism.
- Third, the federal government utilizes a *budgetary accounting system* that gives an upward bias to spending. Because the federal budget is geared to cash disbursements, rather than spending commitments, it is possible under many programs, in effect, to buy now and pay later. The Department of Housing and Urban Development's subsidized housing programs provide a good example of how the federal system of accounting promotes expenditure momentum. Despite the fact that the President's 1983 budget called for a 78 percent *cut* in the volume of new commitments under these programs between 1981 and 1983, the budget projected a 28 percent *increase* in outlays during this two-year period. The increase in outlays reflects the cost of commitments made during the Carter (and perhaps even the Ford) administration.

Changes in the Mix of Federal Expenditures. As a result of these factors and certain policy proposals made by the President, major changes in the *composition* of the federal budget are taking place. In essence, the federal government is spending more on guns, more on certain types of butter, and a lot less on everything else. Specifically, the Congressional Budget Office's analysis of President Reagan's proposed 1983 budget showed that, between 1981 and 1985:

- The share of the federal budget going for *national defense* will increase from one-fourth to one-third.
- The share going for *non-means-tested social programs*—will increase from 38 percent to 39 percent.
- The share going for *interest on the public debt*—will increase from 10 percent to 12 percent; and
- The share going for *everything else*—largely the means-tested social programs, grants to state and local governments, and federal "overhead"—will drop from 28 percent to 16 percent.

These changes are displayed in Chart 26.

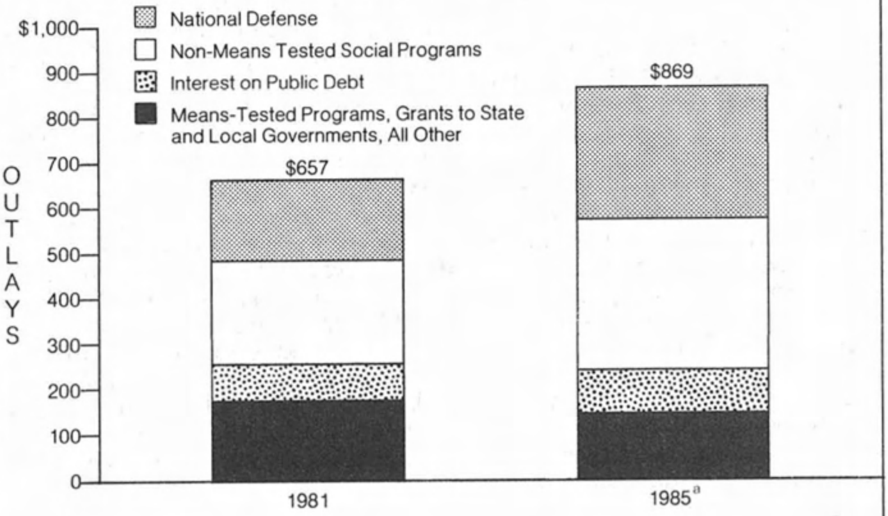
Status of Federal 1983 Appropriations

During recent years, the task of preparing a state budget that contains reliable estimates of the federal funds which California will receive in the budget year has become increasingly difficult for several reasons. First, the state budget must be enacted by July 1, when the state fiscal year begins. The federal fiscal year, however, does not begin until October 1, and the Congress usually is in the early stages of its budget deliberations at the time when the Legislature must conclude action on the state's budget.

Chart 26

Composition of Federal Outlays

1981 and 1985 (in billions)



Source: Congressional Budget Office (1982)

[a] As proposed by President Reagan in his 1983 budget

Second, the Congress must complete action on 13 separate appropriations bills before the federal budget is in place, rather than a single appropriation bill as in California.

In recent years, Congress has not come close to completing its work prior to October 1, and instead has come to rely on a series of continuing resolutions to authorize the expenditure of federal funds. These continuing resolutions are operative for whatever period of time within the fiscal year that the Congress designates. When there is a series of continuing resolutions for any one year, spending levels authorized for individual programs may change from resolution to resolution.

For federal fiscal year (FFY) 1983, the year which began October 1, 1982, the Congress enacted two continuing resolutions. The first, Public Law 97-276, was effective from October 1 through December 17, 1982 and was in lieu of 10 of the 13 appropriations bills. The second resolution, Public Law 97-377, provides funding through the end of the federal year. As of January 15, 1983, the following seven appropriation bills had been enacted: Agriculture; District of Columbia; Housing and Urban Development/Independent Agencies; Interior; Legislative Branch; Military Construction; and Transportation. Those that had not been enacted were: Labor, Health and Human Services, Education; Commerce, Justice, State and Judiciary; Defense; Energy and Water Development; Foreign Operations; and Treasury, Postal Service and General Government.

Nevertheless, the second resolution puts the state in a position where, unlike past years when a series of four or more resolutions were required, it should now be able to estimate the amount of federal funds it will receive through the first quarter of 1983–84. It may be as long as a year from now, however, before the state has any firm indication of how much it can expect to receive from the federal government during the last three quarters of 1983–84. By that time, of course, the Legislature will be considering the state's 1984–85 budget.

In 1982, congressional work on the federal budget focused on two major pieces of legislation in addition to the appropriations bills: The Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) and the Omnibus Budget Reconciliation Act of 1982 (Public Law 97-253).

P.L. 97-248 is expected to raise federal revenues by $98.3 billion over the next three years, and reduce spending—primarily under Medicare—by $17.5 billion over the same period. It is estimated that P.L. 97-253 will result in additional spending reductions of $13.2 billion over the 1983–85 period. These reductions, totaling $30.7 billion, are $111.8 billion, or 78 perent, *less* than the three-year expenditure reductions enacted by Congress in 1981. The Department of Finance estimates that the 1982 changes will result in a federal funds loss to California of $350 million. Approximately 78 percent of this amount represents a loss of support to individuals receiving Medicare, rather than a reduction of funds for programs financed in the state budget.

2. Federal Program Changes

Impact on California. During the 1970s, the fastest growing form of grants-in-aid to state and local governments was direct aid from the federal government to cities, counties and other *local* government entities. The Congress, in 1981, initiated a new era for federal/state relationships by establishing nine block grant programs that provide federal funding directly to states. These block grants encompassed a number of categorical programs which had not previously fallen within the state's purview. The Community Development Block Grant is a case in point. States are now authorized to design their own programs for assisting local development and redevelopment efforts, thus superseding a direct federal-local relationship that dates back to 1949 and the establishment of the urban renewal program.

Table 57 details the current federal block grant programs, the dates on which California assumed responsibility for them, and the funding levels for each in the current and budget years. Of the nine grants established by Congress in 1981, the Legislature assumed responsibility for two in 1981–82, and six in 1982–83. The Legislature declined to accept the ninth block grant—primary care—primarily because of state General Fund matching requirements.

Congress established one new block grant in 1982—the mass transit block grant, which will become effective in 1983–84. Congress eliminated the prior four-tiered capital and operating assistance transit program and replaced it with a formula-based block grant funded from general revenues. The formula provides for the following apportionments of funds: (1) approximately 88 percent to urban areas with populations exceeding 200,000, (2) approximately 9 percent to urban areas with populations up to 200,000, and (3) approximately 3 percent to nonurbanized areas.

Table 57
Federal Block Grants in California
1981–82 to 1983–84

Block Grant Program	*State Administering Agency*	*Starting Date in California*	*Funding Levels (in millions)*	
			1982–83	*1983–84*
1. Social Services	Department of Social Services	7-1-81	$253.4	$260.7
2. Low-Income Home Energy Assistance	Office of Economic Opportunity [a]	7-1-81	80.2 [b]	80.2
3. Alcohol, Drug Abuse and Mental Health	Departments of Mental Health and Alcohol and Drug Programs	7-1-82	40.3	46.7
4. Community Services	Office of Economic Opportunity	10-1-82	29.1 [c]	29.1
5. Maternal and Child Health	Department of Health Services	7-1-82	19.6	20.6
6. Preventive Health Services	Department of Health Services and Emergency Medical Services Authority	7-1-82	8.3 [d]	6.4
7. Primary Care	Department of Health Services	Not Accepted	—	—
8. Community Development	Department of Housing and Community Development	10-1-82	24.7	25.6
9. Education	Department of Education	7-1-82	41.3	41.5
10. Mass Transit	Department of Transportation	10-1-83	—	370.5 [e]

[a] Proposed by the Governor to be transferred to the Department of Social Services on October 1, 1983.
[b] Represents state's grant award for federal fiscal year 1983. Estimated expenditures will total $95.7 million in the current year due to prior year carryover.
[c] Of this amount, the federal government spent $15.1 million prior to January 1983 and OEO administered $14 million for the period January through June 1983.
[d] Includes two years of emergency medical services funding.
[e] Represents California's share of authorized funding in federal fiscal year 1984. Of this amount, the Governor's Budget only includes funds for state administration ($224,000).

Most of the transit block grant funds will flow directly from the federal government to regional transportation planning agencies. Funds for nonurbanized areas as well as urban areas with populations up to 200,000 will be administered by the state. The state anticipates receiving $224,000 in the budget year to cover the cost of administering this block grant, as shown in Table 57. A more detailed discussion of the transit block grant appears in our review of the Department of Transportation's budget, Item 2660 of the *Analysis.*

Proposed Block Grant Changes in 1983–84. The Governor's Budget proposes one significant change in the administration of federal block grant funds in the budget year. It proposes to transfer responsibility for state administration of the Low-Income Home Energy Assistance Program from the State Office of Economic Opportunity (OEO) to the Department of Social Services (DSS), effective October 1, 1983. OEO has administered the block grant since it was assumed by the state in 1981–82. DSS, however, administered the block grant's predecessor (the Low-Income Energy Assistance Program) in 1980–81.

Consistent with legislative policy direction in previous years, the administration proposes to transfer $8,022,000 from the energy block grant to the social services block grant administered by DSS. A more detailed discussion of the proposed transfer is included under Items 5180-136-866 and 0660-101-890 in the *Analysis.*

Impact of Federal Changes Enacted in 1981 on California

In President Reagan's first budget proposal, he sought spending reductions totaling approximately $270 billion over the four-year period 1981–84. Congress, in enacting the 1981 Omnibus Budget Reconciliation Act (Public Law 97-35), approved spending reductions totaling $143 billion over this same period, or slightly over one-half of the total reductions proposed by the President. What has been the effect of these reductions on California?

Several factors make this question very difficult to answer, and must be kept in mind when reviewing the level of program activity in California which is supported by federal funds.

Federal Funds Received in Prior Years Cushioned Reductions. A number of departments have been able to carry-over unspent federal funds received in prior years (so-called "carry-over funds") to cushion the initial effect of reduced federal funding. In 1981–82, for example, the first year in which the impact of significant federal funding cutbacks could be expected to appear, the Department of Rehabilitation spent $3.4 million in carry-over funds that originally became available in prior years. These carry-over funds helped to lessen the impact of program funding reductions totaling $14 million. Moreover, the department carried over $6.6 million from 1981–82 to 1982–83, which will lessen the effect of federal reductions in the current year. While the use of carry-over funds may cushion the effect of funding reductions on a short-term basis, support of ongoing activities in this manner merely postpones program adjustments. It does not prevent these effects unless federal funding levels for subsequent years are increased. In cushioning the effect, however, use of carry-over funds makes it difficult for the Legislature to assess the ongoing impact of federal funding reductions on particular state programs.

Forward Funding Delays Program Impacts. A number of federal programs, including those in the areas of housing, emergency medical services, and substance abuse, provide support for activities that will be undertaken *beyond* the year in which the funds are provided. In other words, 1983 activities are supported by funds appropriated in 1982. This is referred to as "forward funding". The forward funding method differs substantially from normal state budgeting practices, which support current-year activities with funds appropriated for the current year. Thus, in the case of programs supported by forward funding, changes made by the federal government which became effective in 1982 may not be felt by the state until 1983. The delayed effect of forward funding also makes it difficult to advise the Legislature regarding actual program changes resulting from reduced federal funding levels.

Funds That Previously Were Received Directly by Local Governments Now Flow Through the State Budget. As discussed earlier, the establishment of the federal block grants in 1981 reversed a long-standing federal policy of awarding federal funds directly to local governments. As a result, more federal funds now flow through the state budget.

While updated estimates are not available for each program, our analysis indicates that Public Law 97-35 redirected to the state more than $140 million that previously went directly to local governments. This change makes it difficult for the Legislature to determine, on a program basis, the extent to which the "new" funds offset federal reductions made elsewhere. Moreover, in terms of the total impact of federal changes on the state as a whole, this additional flow of funds through the state budget to local governments makes it difficult to account for total funding changes experienced by state and local government in California.

Fiscal Effect of Federal 1981 Reconciliation Act. Conventional wisdom holds that enactment of the federal budget reductions in 1981 resulted in program funding reductions averaging 25 percent. In order to evaluate the conventional wisdom with respect to California, we compared federal funding levels received by the state prior to the act, with funding levels received afterwards for the programs primarily affected by the federal changes. (All programs could not be compared over an identical time period because of implementation delays and/or data limitations.)

Our analysis of actual funding received before and after the act indicates that, on balance, California programs experienced less than a 25 percent reduction. In some cases, such as AFDC, a percentage change was impossible to calculate because other factors, such as additional caseload due in part to economic downturns, resulted in total program increases rather than decreases. Our specific findings with regard to federal reductions in 12 state programs totaling approximately $280 million are as follows:

- ***Community Development.*** Funding for the state-administered Small Cities Community Development Block Grant Program has remained essentially level from 1980–81 through 1982–83, at roughly $25 million.
- ***Education.*** California's share of funds for programs consolidated in the education block grant decreased from $57.2 million in 1981–82 to $41.3 million in 1982–83 (the first year of the block grant)—a drop of $15.9 million, or 28 percent.
- ***Social Services.*** Funds for the social services block grant, supported by appropriations under Title XX of the Social Security Act were reduced from $303.8 million in 1980–81 to $265.4 million in 1981–82—a drop of $38.4 million, or 13 percent. The Legislature offset a portion of these reductions by transferring various funds to the social services program. The largest component of the transfer was federal support received under the low-income home energy assistance block grant.
- ***Community Services.*** California programs consolidated in the community services block grant were reduced from $35.4 million in FFY 81 to $29.1 million in FFY 82—a drop of $6.3 million, or 18 percent.
- ***Energy Assistance.*** California's award of low-income home energy assistance block grant funds decreased slightly as a result of the 1981 Reconciliation Act, declining from $80.9 million in FFY 81 to $80.2 million in FFY 82—a difference of $700,000, or 0.9 percent. This reduction was significantly offset, however, by a supplemental congressional appropriation for energy crisis intervention assistance, from which California received $5.7 million.
- ***Preventive Health.*** California's share of the preventive health services block grant declined from $7.2 million in FFY 81 to $5.6 million in FFY 82—a drop of $1.6 million, or 22 percent. The program effect

of this reduction in the current state fiscal year, however, was minimized to a certain extent by carry-over funds and monies available for programs forward funded by the federal government, such as emergency medical services.

- ***Maternal and Child Health.*** Federal awards for programs consolidated in the maternal and child health block grant declined from $21.0 million in FFY 81 to $18.1 million in FFY 82—a reduction of $2.9 million, or 14 percent. This decrease also was offset in the current year by federal carry-over funds.
- ***Alcohol and Drug.*** Alcohol and drug program funds decreased from a total funding level of $35 million in FFY 81 to $27.5 million in FFY 82—a reduction of $7.5 million, or 21 percent over the period.
- ***AFDC.*** The first full-year effects of the 1981 Reconciliation Act on California's Aid to Families With Dependent Children (AFDC) program represent a 1982–83 savings of approximately $204 million to all funding sources. Of this amount, savings of $108 million, $82 million and $14 million will accrue to the federal, state and county governments, respectively.

  These savings are the result of increased grants in approximately 34,991 cases, and reduced grants in approximately 78,530 cases. Most of the savings, however, is due to the limitation placed on eligibility for grants. The Department of Social Services estimates that there are approximately 32,000 fewer cases per month in 1982–83 than there otherwise would have been without the 1981 federal changes.
- ***Employment Services.*** Federally funded employment services programs in California, a component of grants-in-aid to state and local governments, were reduced approximately $53 million, or 23 percent between 1980–81 and 1981–82.
- ***Medi-Cal.*** Changes in federal sharing ratios in the Medi-Cal program are estimated to have resulted in state General Fund costs of $44.8 million in 1981–82. As discussed in Item 4260 of the *Analysis,* we estimate that the state will be able to recoup these funds due to a provision in federal law which allows state recoupment under specified circumstances.
- ***Health Planning.*** The 1981 Reconciliation Act significantly reduced state health planning funds. Due to the structure of this program, these changes are being felt in the state for the first time during 1982–83, and represented a reduction of about $890,000 or 34 percent compared to 1981–82. Increases in fee assessments due to increased health facilities operating costs, however, have maintained these programs at 1981–82 dollar levels.

In summary, our analysis of California's experience in selected program areas following enactment of the 1981 federal Omnibus Budget Reconciliation Act shows considerable variation in the size of program funding reductions. With few exceptions, however, the reductions have been less than 25 percent of pre-1981 Reconciliation Act *awards.* From the standpoint of purchasing power, however, the reductions have been more than 25 percent. Due to the existence of carry-over funds and allowable transfers under the federal block grants, however, the full effect of the federal changes has yet to be felt in many program areas.

Education Task Force

The education task force, established by the Legislature pursuant to federal requirements of the 1981 Omnibus Budget Reconciliation Act, is charged with advising the Superintendent of Public Instruction, the State Board of Education, the Legislature, and the Governor on the allocation of federal education block grant funds under Chapter 2 of the federal Education Consolidation and Improvement Act of 1981. The 32-member task force issued its recommendations in the spring of 1982. The Legislature followed the thrust of the task force's recommendations concerning the 1982–83 allocation of federal education block grant funds by appropriating 16 percent of total funds for state operations and the remaining 84 percent for local assistance. This action is consistent with federal requirements that (1) no more than 20 percent of the funds be retained for state operations, (2) at least 80 percent of the funds be allocated to local school districts, and (3) the state not direct how local districts may spend the local assistance funds.

State Block Grant Advisory Task Force

In response to the federal block grants created by the 1981 Omnibus Budget Reconciliation Act, the Legislature also established the 18-member state block grant advisory task force (hereafter referred to as the task force) to advise the Governor and the Legislature on the allocation, administration and use of block grant funds. The task force is authorized until July 1, 1984, and has jurisdiction over the following eight block grants: (1) social services, (2) low-income home energy assistance, (3) alcohol, drug abuse and mental health, (4) community services, (5) maternal and child health, (6) preventive health services, (7) primary care and (8) community development.

The task force issued its first report to the Legislature and the Governor on April 12, 1982. Its recommendations included the following:

- The primary care block grant should not be assumed by the state in federal fiscal year 1983.
- State and local administrative costs should be capped in the state-administered federal block grants.
- No funds should be transferred between or within block grants, except as authorized by existing state law.
- For the first year only (1982–83), existing projects should be funded on a pro rata basis, with specified exceptions such as rape crisis funds in the preventive health services block grant and the small cities portion of the community development block grant.

1982 Legislation. Chapter 1343, Statutes of 1982 (AB 3295), made various changes related to the federal block grants. The act (1) revised the state block grant advisory task force's duties, (2) appropriated $135,000 in federal funds during 1982–83 for task force activities and staff, and (3) established reporting and audit requirements applicable to each of the eight block grants operating in the state in 1982–83. Specifically, the act directed the state to assume five new block grants in 1982–83. The state had assumed the social services and low-income home energy assistance block grants in 1981–82. The following three new grants became operational on July 1, 1982: preventive health and health services; maternal and child health; and alcohol, drug abuse and mental health services. The community services and community development block grants became effective on October 1, 1982.

The task force is required by Chapter 1343 to issue two additional reports on February 1, 1983 and February 1, 1984, respectively. These reports shall discuss various issues including the following:

(1) Integration of block grant programs with existing state and local programs.
(2) Funding allocation methods.
(3) An analysis of which level of government can perform administrative functions most effectively in relation to the needs of the population served.
(4) Effective methods of monitoring state and local compliance with legislative intent.
(5) Options for transferring funds between and within block grants.

Administrative Support. Chapter 1343 appropriated $135,000 from a newly-created Federal Block Grant Fund. Pursuant to the act, the following state agencies each made available $27,000 in federal block grant administrative dollars to the fund during 1982–83: the Departments of Social Services, Health Services, Mental Health, Alcohol and Drug Programs and the Office of Economic Opportunity. No funds have been included in the 1983–84 Budget Bill for this purpose.

In order to prepare the required reports, the task force signed a $110,000 contract with a private consulting firm for 1983, following a competitive bid process. Pursuant to the contract, the consulting firm will prepare the following three reports:

1. A comprehensive review of the administration of federal block grant funds by the state for 1983–84. This is the 1983 report required by Ch 1343 and will include recommendations for legislative policy deliberations. (Due: April 1, 1983)
2. An analysis of the impact of block grants on California, including the task force's recommendations related to how implementation of the grants should be monitored. (Due: June 1, 1983)
3. A review of the impact of federal block grants in 1984 and future years, including recommendations on the state's response to these programs (Due: December 1, 1983)

Based on conversations with the Controller's office and the contractor, it is our understanding that staff support will be available to the task force through the first half of 1983–84. This will allow for completion of the task force's final report, as required by Ch 1343.

The balance of the $135,000 appropriation ($25,000) will be used for travel, per diem, and related expenses of the task force. Our analysis indicates that sufficient funds were appropriated by Ch 1343 to meet the task force's anticipated expenses in the current and budget years, because actual expenditures for this purpose totaled $2,000 in 1981–82.

Legislature's Information Needs on Federal Block Grants Unmet

We recommend that the Department of Finance ensure that state agencies administering federal block grants comply with the Legislature's information needs, as specified in Ch 1343/82 and the 1982 Budget Act, by April 15.

We further recommend that the State Controller report to the Legislature regarding the status of financial and compliance audits required by

the federal block grants by April 15.

Information Requirements. Ch 1343/82 recognized that the Legislature did not have adequate data on many of the programs consolidated in the federal block grants. As a result, the act requires:

- Establishment of fiscal reporting requirements by the Department of Finance.
- Development of standard definitions of units of service, costs per unit of service, citizen participation processes and due process notification procedures for each block grant.
- Annual reports by each administering department on current year funding and allocations, problems, and program options for block grant administration.
- Annual reports by the Health and Welfare Agency on options and recommendations for integrating the block grants.

In addition, the 1982 Budget Act requires that the Departments of Alcohol and Drug Programs, Health Services, and Mental Health make specific additional reports to the Legislature by specified dates in the current year. The departments are each required to (1) project state and local administrative costs for 1982–83, (2) propose definitions and limitations on all 1983–84 administrative expenses, and (3) report specified data related to clients, programs, and funding.

Timely Response Needed. Our analysis indicates that as of February 1, 1983, state agencies which administer the block grants, as well as the Department of Finance, were still in the process of addressing the Legislature's information needs.

In some cases, such as the community development block grant, current-year allocation decisions have yet to be made, and thus a report to the Legislature at this time would be meaningless. The Department of Housing and Community Development advises that final 1982–83 allocations are not expected for this block grant until April/May 1983. Thus, it is difficult for some of the administering agencies to provide the requested information at this time.

Furthermore, the Health and Welfare Agency's response to the requirements of existing law does not appear to be in conformance with legislative intent. Specifically, the agency's first report, submitted to the Legislature on January 25, 1983, is largely descriptive in nature and does not identify specific options and recommendations for integrating the block grants under its jurisdiction, as specified in Ch 1343/82.

In order to ensure that the Legislature's information needs are met, and to assist the Legislature in establishing its priorities for 1983–84, we recommend that the Department of Finance make certain that the seven state agencies administering the federal block grants provide the information prescribed in Chapter 1343 and the 1982 Budget Act to the Legislature by April 15, 1983.

Audit Requirements. Ch 1343/82 also established the state's policy with regard to audits of the federal block grants. State agencies are required by the act to rely on federally mandated audits arranged by local agencies. With regard to the state's role, the act requires the Controller to:

1) Review audit plans prepared by state agencies.
2) Provide local agencies federal financial and compliance audit guidelines.

3) Monitor and review audit findings to determine that both state and local entities have taken appropriate corrective action.
4) Report annually to the Legislature and the Governor on the status of federally mandated audits.

In addition, the act requires:

1) State agencies to develop audit plans based on audit plan guidelines.
2) The Governor's Budget to identify all planned disbursements for audit purposes to local agencies, as well as state audit costs for each block grant. The act authorizes up to 1 percent of the funds for each federal block grant for audit purposes.

Our analysis indicates that due to the effective date of the act (January 1, 1983), the Controller is still in the process of developing audit guidelines for local agencies. Moreover, the Governor's Budget does not separately identify any 1983–84 state or local costs related to audits.

Some progress, however, has been made. On December 23, 1982, the Department of Finance, the State Controller, and the Auditor General jointly issued "Guidelines for the Preparation of Audit Plans" to the seven state agencies administering the block grants (see Table 57 for an agency listing). State agencies in turn were required to submit their plans to the State Controller by February 1, 1983 for the current fiscal year. As of February 8, however, no plans had been received. In future years, such plans are required annually by August 1.

In order to ensure that audit plans and procedures for the eight block grants assumed by the state are proceeding in the manner intended by the Legislature, we recommend that by April 15, 1983 the Controller report to the Legislature regarding the status of financial and compliance audits required by the federal block grants. (For a related discussion on proposed positions in the State Controller's Office to administer this program, see Item 0840 of the *Analysis.*)

D. PROPOSED STATE BLOCK GRANTS

Should the Legislature Consolidate 21 Existing Categorical Programs Into Three Block Grants?

The Governor's Block Grant Proposals

In his budget, the Governor proposes to consolidate 21 existing programs into three state block grants. These proposed consolidations are shown in Table 58. Funds consolidated in two of the proposed block grants (alcohol/drug and public health) would flow from the state to counties, while education block grant support would be provided directly to local school districts.

The budget maintains that establishment of the three block grants would permit a reduction of $12.5 million in state operations from the current-year funding level (as shown in Table 59), and a $15.1 million decrease compared to what normally would have been budgeted for 1983–84 (as shown in Table 60). The anticipated savings result primarily from the proposed reduction of nearly 500 personnel-years, consisting of 101 personnel-years in the Department of Alcohol and Drug Programs, 321 personnel-years in the Department of Health Services and 71 personnel-years in the Department of Education.

While the state operations component of the budget for these programs would be cut sharply in 1983–84, the amount of local assistance funds would remain at about the 1982–83 level. This is shown in Table 59. However, the budget does not include state funds for a cost-of-living adjustment to the local assistance amounts included in the block grants.

Table 58
Proposed State Block Grants
1983–84

Proposal	*Administering Department*	*Consolidated Programs*
Alcohol and Drug Block Grant	Department of Alcohol and Drug Programs	• Alcohol Programs • Drug Programs
Public Health Block Grant	Department of Health Services	• Adult Health • Dental Health • Vector Biology and Control • Family Planning • California Children's Services • Child Health and Disability Prevention • Genetically Handicapped • Rural Health • Maternal and Child Health
State Education Block Grant	Department of Education	• Economic Impact Aid • School Improvement Program • Instructional Materials • Gifted and Talented Education • Miller/Unruh Reading Program • Staff Development • Demonstration Programs in Reading and Mathematics • Educational Technology • Native American Indian Education Program • Vocational Education (state administration)

Table 59
Proposed State Block Grant Funding Levels
All Funds
1982–83 and 1983–84
(in thousands)

	Estimated 1982–83	*Proposed 1983–84*	*Change*	
Local Assistance			*Amount*	*Percent*
Alcohol and Drug [a]	$91,147	$93,021	$1,874	2.1%
Public Health	123,688	123,128	−560 [b]	−0.5
Education	425,669	425,612	−57 [c]	[d]
Subtotals	$640,504	$641,761	$1,257	0.2%
State Operations				
Alcohol and Drug [a]	$9,290	$7,079	−$2,211	−23.8%
Public Health	16,641	9,813	−6,828	−41.0
Education	11,558	8,097	−3,461	−29.9
Subtotals	$37,489	$24,989	−$12,500	−33.3%
Totals	$677,963	$665,972	−$11,991	−1.8%

[a] Figures exclude reimbursements.
[b] Reflects deletion of $2.1 million in one-time funds partially offset by increases for California Children's Services.
[c] Reduction due to staff development funds carried over from 1981–82 to 1982–83.
[d] Less than 0.1 percent.

As noted earlier, the Governor's Budget indicates that 1983–84 state operations funding associated with these programs will be $15.1 million less than it otherwise would be *under existing law.* This is shown in Table 60. This amount assumes that in the absence of this program change state support for these programs would have received additional funding in the budget year for merit salary increases, higher retirement contributions and inflation adjustments. As a result, if the Legislature does not concur with the state block grant proposal *and* wishes to continue current staffing patterns in the budget year, it will have to augment the budget by $14.4 million from the General Fund.

Proposed Personnel Changes. Table 60 also shows the personnel-year reductions proposed in the budget, by department. The Governor proposes to eliminate 101 personnel years associated with the alcohol and drug programs, a reduction of 50 percent from currently authorized staffing levels. The public health block grant would result in the biggest staffing reduction—321 personnel years, or 87 percent of the Department of Health Service's authorized staffing level of 371 personnel-years for the categorical programs included in the block grant. The Department of Education would experience the smallest reduction, 71 personnel years out of a current-year total of 542 General Fund-supported personnel-years, a reduction of 13 percent.

Table 60
Governor's Proposed Savings
1983–84
(in thousands)

Block	*Personnel years*	*State Operations: General Fund*	*Federal Funds*	*Total*
Alcohol and Drug	101[a]	−$1,552	−$665	−$2,217
Public Health	321	−9,000	—	−9,000
Education	71	−3,859	—	−3,859
Totals	493	−$14,411	−$665	−$15,076

[a] The Governor's Budget inadvertently reflects a reduction of 108 positions. Funding savings, however, are based on a reduction of 106 positions, or 101 personnel years.

County Justice System Subvention Program Proposal

In addition to the three new block grants, the Governor has proposed a significant modification to the County Justice System Subvention Program (CJSSP) that currently operates in a manner similar to a block grant. CJSSP, established by Ch 461/78 (AB 90), makes funds available to counties on a per capita basis for expenditure on the local criminal justice system.

Historically, the state has allocated funds to counties (approximately $63 million in 1982–83) for expenditure in one or more of seven broad program categories, such as improving offender-centered services or operating crime and delinquency programs. In order to receive state funds, counties have had to maintain commitment rates to state correctional institutions below specified levels.

The Legislature modified the CJSSP program in the 1982 Budget Act by suspending the commitment rate targets, and instead requiring that counties spend their 1982–83 allocations in the same manner as in 1981–82.

In 1983–84, the Governor proposes that CJSSP become an unrestricted block grant for maintaining and improving local criminal justice systems. Specifically, the Governor proposes to repeal the program's enabling legislation and require that counties make applications for funding to the Secretary of the Youth and Adult Correctional Agency. Counties, in turn, could spend the money for activities that maintain and improve local criminal justice systems. Unlike the budget for the three newly proposed block grants, the administration proposes a 3 percent cost-of-living adjustment for the CJSSP.

Program Detail Not Yet Available

The administration's County Justice System Subvention Program proposal is contained in the budget companion bill (SB 124).

Detail on the statutory program and administrative changes for the three new block grants, however, is not yet available. According to the budget, program requirements and administrative responsibilities for each of the block grants will be specified in legislation to be introduced in the spring of 1983.

In two cases, the budget indicates that information on personnel reductions will be provided by the administering agencies to the Legislature, prior to legislative hearings on the budget. The 1983–84 Budget Bill indicates, however, that the plan for allocating state educational block grant funds will not be submitted to the Legislature until August 1, 1983, *one month after the new fiscal year begins.*

In the absence of this information on program requirements and administrative reponsibilities, we have no basis at this time on which to analyze the Governor's assertion that the proposed state grants would increase direct services at the local level without increasing cost to the taxpayers. In order to assist the Legislature in its deliberations, we have specified in the *Analysis* questions related to each of the block grants that should be addressed by the Departments of Alcohol and Drug Programs, Health Services, and Education prior to budget hearings.

Proposal Inconsistencies

Our review of the limited information available on the three block grant proposals, however, has turned up a number of inconsistencies. In order to assist the Legislature in its deliberations, we identify several of these inconsistencies below. Further discussion of these and other program issues is included in the *Analysis*, as part of our review of the budgets proposed for the three block grant administering departments.

Education Block Grant. The Governor proposes to consolidate nine local assistance programs and one state operations activity in the new block grant. The state operations component, state administration of vocational education, has a local assistance counterpart that is *not* included in the block grant, and that will continue to be allocated on the basis of federally-approved formulas. Furthermore, the proposed block grant does not include several categorical programs, such as Special

Education, that are similar to those programs which *have* been proposed for consolidation.

Alcohol and Drug Block Grant. Programs consolidated in the proposed state alcohol and drug block grant are part of the federal Alcohol, Drug Abuse and Mental Health block grant. The state block grant, however, would not include mental health programs. This would seem to ignore the fact that at the county level, alcohol and drug programs and mental health services frequently are administered by the same department.

Public Health Block Grant. Like the alcohol and drug block grant, the proposed state public health block grant would consolidate some programs that are already included in the federal Maternal and Child Health (MCH) block grant. Our analysis indicates, however, the following inconsistencies:

- The state block grant includes 98 percent of federal MCH block grant funds for local assistance, but excludes the remaining 2 percent, or $318,000.
- Five programs have not been included in the state block grant, even though closely related programs *have* been included. These programs include comprehensive public health services grants, health education, risk reduction and hypertension, urban rat control, and fluoridation.
- One of the components of the Adult Health program, which has been proposed for consolidation, is local assistance grants for medical research on the disease lupus erythematosus, a chronic disease which may affect the nervous system. Counties have never had a role in this activity, nor do they generally conduct or contract for medical research.
- The Governor proposes to delete 87 percent of the positions related to the consolidated categorical programs, but has reduced support funding from all sources, by 48 percent. Moreover, despite the fact that federal funds are used to support many of the consolidated programs, only General Fund monies have been deleted. Our analysis indicates that such a significant staffing reduction could not be accomplished without some federally funded positions being reduced.

Conclusion

At the time this review was prepared, there was not sufficient information on the three proposed block grants to permit legislative consideration of the proposals. Considerably more information—and perhaps a rationalization of the inconsistencies noted above—is needed before the Legislature can assess the merits of these proposals.

E. CAPITAL OUTLAY ISSUES

How Can the Legislature Assure that Limited Capital Outlay Funds Are Used to Meet the State's Most Urgent Capital Outlay Needs?

1. Status of Capital Outlay Funding for 1982–83

The 1982 Budget Act included $560.4 million from several funds for the state's capital outlay program in 1982–83. Table 61 shows the fund distribution for this program.

Table 61
1982 Budget Act—Capital Outlay Program
(in thousands)

Fund	*1982 Budget Act Amount*[a]
Capital Outlay Fund for Public Higher Education	$38,407
Energy and Resources Fund	20,268
State Park and Recreation Fund	14,273
Special Account for Capital Outlay	46,880
Subtotal (Tidelands Oil Revenue)	($119,828)
Transportation—Special Funds	$197,435
Other Special Funds	11,496
Park Bonds	81,365
Prison Bonds	149,276
Higher Education Bonds	1,000
Total	$560,400

[a] Does not include funds for support and operating expenses of administering departments.

Several problems have occurred during the current year which have affected the 1982 capital outlay program. The most important of these problems involve (1) the availability of resources (2) the allocation of funds by the State Public Works Board, (3) the deficit in the General Fund and (4) the State Treasurer's freeze on bond sales.

1. ***Resources Available At The Start of The Year Were Over-Estimated.*** Beginning in January 1982, the Department of Finance indicated to the State Public Works Board that the condition of those capital outlay funds supported by tidelands oil revenues was uncertain. During hearings on the 1982–83 Budget Bill, the Department of Finance testified that on June 30, 1982, the balance in each fund would be zero. On this basis, the Legislature deposited into each fund an amount equal to the total 1982 Budget Act appropriation from the respective fund.

These amounts, which for capital outlay totaled $119.8 million, are shown in Table 62.

Table 62
Tidelands Oil—Capital Outlay Funds
1982 Budget Act Appropriations Compared to
State Public Works Board Allocations
(in thousands)

	1982 Budget Act Amount	*Amount Allocated by Public Works Board*[a]	*Unallocated Appropriation*	
			Amount	*Percent*
Capital Outlay Fund for Public Higher Education	$38,407	$35,305	$3,102	8%
Energy and Resources Fund	20,268	7,516	12,752	63
State Park and Recreation Fund	14,273	12,478	1,795	13
Special Account for Capital Outlay	46,880	22,331	24,549	52
Totals	$119,828	$77,630	$42,198	35%

[a] As of December 1982

The State Controller, however, has indicated that the information which the Department of Finance provided to the Legislature during hearings on the 1982–83 Budget Bill was not correct. Instead, three of the four funds were *overcommitted* on June 30, 1982. Table 63 provides a comparison of the estimated balance as of June 30, 1982, as reported by the State Controller, and as reported by the administration in the 1981–82 column of the Governor's Budget for 1983–84.

Table 63

Selected Funds Receiving Tidelands Oil Revenue Comparison of State Controller's Balances and Governor's Estimated Balance as of June 30, 1982 [a] (in thousands)

Fund	*Controller's Balances*	*Governor's Estimate*	*Difference*
Capital Outlay Fund for Public Higher Education:			
1. Reserve for economic uncertainties	−$6,274	$523	$6,797
2. Reserve for unencumbered balances of continuing appropriations	4,405	1,452	−2,953
Energy and Resources Fund:			
1. Reserve for economic uncertainties	−8,998	−8,825	173
2. Reserve for unencumbered balances of continuing appropriations	5,483	2,315	−3,168
State Park and Recreation Fund:			
1. Reserve for economic uncertainties	12,602	−184	−12,786
2. Reserve for unencumbered balances of continuing appropriations	35,731	36,839	1,108
Special Account for Capital Outlay:			
1. Reserve for economic uncertainties	−40,260	12,612	52,872
2. Reserve for unencumbered balances of continuing appropriations	65,082	23,303	−41,779

[a] Sources: Controller's data as of 1/14/83. Governor's 1983–84 Budget.

Based on the Controller's data, it is evident that from the very beginning there has not been sufficient funds available to finance the 1982 capital outlay program approved by the Legislature.

The Governor's 1983–84 budget—prepared by the Department of Finance during November and December 1982—now reveals that in 1982–83, "unspecified savings" of $6.6 million from the Energy and Resources Fund and $10.5 million from the Special Account for Capital Outlay must be made in order to avoid a deficit in these funds on June 30, 1983. In addition, on January 18, 1983, the Governor issued an Executive Order freezing all capital outlay expenditures except under certain restricted conditions. The cumulative effect of all these factors on the state's 1982 capital program are unknown.

2. ***Allocation of Funds by the Public Works Board Has Not Reflected the Urgency of Individual Projects.*** In early 1982 and again in November 1982, we recommended that the State Public Works Board obtain a written fund status report from the Department of Finance, so that the board could (1) avoid over-committing any fund, and (2) ensure that available funds were used for those projects having the highest priority to the state. The department, however, chose not to provide written information on

the status of these funds.

As shown in Table 62, the 1982 Budget Act included $119.8 million for capital outlay from funds which received tidelands oil revenue. At the time this was written, $77.6 million (65 percent) had been allocated by the State Public Works Board.

In late 1982, the Department of Finance recognized that the balance available in each of these funds was uncertain. As a consequence, the department has deferred allocation of funds for most projects which had not been presented to the Public Works Board prior to November 1982. This deferral has affected security improvement projects for the Department of Corrections, and fire and life safety and environmental improvements for the state hospitals.

We discuss this issue further in our review of the State Public Works Board in Section V of this part where we recommend that the board receive funding status reports on a routine basis.

3. ***Projected Deficit in the General Fund May Affect Balances Available for Capital Outlay.*** Further compounding the uncertainty regarding the availability of funds for capital outlay in the current year is the condition of the state's General Fund. At the time this was written, the administration was projecting a deficit in the General Fund exceeding $1.5 billion. One of the proposals that was being considered to remedy the problem was the transfer to the General Fund of $37 million in unencumbered and uncommitted balances remaining from capital outlay appropriations made by the 1982 Budget Act and other acts. The proposal also included a requirement that the Director of Finance submit to the Joint Legislative Budget Committee a list of the projects from which funds would be transferred plus a list of projects which would proceed. If this proposal is approved by the Legislature, the information from the Department of Finance must be available prior to budget hearings, or the Legislature will have no basis for acting on the capital outlay portion of the Governor's Budget. This is because the impact of the freeze on capital expenditures coupled with the reversion of $37 million in unencumbered funds will undoubtedly have an impact on the Legislature's priorities for 1983–84.

4. ***State Treasurer's Freeze on Bond Sales Contributes to Delays in New Prison Construction.*** The 1982 Budget Act appropriates $149.3 million from the New Prison Construction Fund (bonds) for planning and construction of additional prison facilities. The Legislature appropriated this amount on the basis that (1) additional facilities were *urgently* needed and (2) the Department of Corrections' project schedule indicated that this amount of money could be encumbered in 1982–83.

The prior administration, however, chose to offer for sale in September 1982, only $100 million of the $495 million in bonds authorized by the electorate. Subsequently, the State Treasurer imposed a moratorium on issuing additional bonds for this program or any other bond program. As a result, implementation of the new prison program approved by the Legislature in 1982 will be delayed.

This delay compounds an already *critical* capacity problem in the state's correctional system. Currently, the state prison system has the capacity to house 25,600 inmates. In January 1983, there were 33,500 inmates in the system—131 percent of the system capacity—and the inmate population was increasing by about 100 inmates per week. Further, the Department of Corrections projects that the inmate population will be 71,000 by the year 1992—227 percent of the current capacity. If this inmate population is to be housed in appropriate facilities, the administration must start addressing the problem and implementing legislatively approved programs.

2. Funding For Capital Outlay

The state's capital improvement program is funded from various special funds and bond funds. Since the late 1960's, higher education capital outlay has been funded from the Capital Outlay Fund for Public Higher Education (COFPHE). State parks capital outlay generally has been funded from park revenues and bond funds. Prior to 1980–81, the capital programs for General Fund-supported departments, other than higher education and state parks, usually were funded from the General Fund.

Tidelands Oil Revenue. In 1980, unprecedented increases in the price of oil resulted in major increases in the state's tidelands oil revenues. In view of this increase, the Legislature enacted Chapter 899, Statutes of 1980, which provided for the redistribution of tidelands oil and gas revenues that, under prior law, would have been deposited in the COFPHE. Pursuant to this measure, six special funds are recognized as eligible to receive tidelands oil revenues.

Chapter 899 arranges these funds in descending order of priority and establishes a target funding level for each one. Under this arrangement, no fund receives *any* allocation of tidelands oil revenues until all funds assigned a higher priority receive their *full* target amounts. Put another way, a shortfall in revenues is not apportioned among all the programs, but instead is borne by the funds at the bottom of the list. The priority sequence and the target distributions for each are as follows:

Table 64
Distribution of Tidelands Oil Revenues
Comparison of Current Law with Actual and Proposed Distributions in 1982–83 and 1983–84
(in thousands)

Funds	*Chapter 899, Statutes of 1980*	*1982–83*	*Proposed 1983–84*
State Lands Commission	$7,498 [a]	$7,719	$7,498
California Water Fund	25,000	14,710	—
Central Valley Water Project Construction Fund	5,000	—	—
Sea Grant Program	500	400	400
Capital Outlay Fund for Public Higher Education	125,000	71,133 [b]	56,715 [b]
State School Building Lease/Purchase Fund	200,000	100,000	—
Energy and Resources Fund	120,000	64,081 [b]	30,098 [b]
State Park and Recreation Fund	35,000	12,417	10,081
Transportation, Planning and Development Account	25,000	—	—
Special Account for Capital Outlay	Remaining balance	54,725 [c]	38,208
Off-Highway Vehicle Account	—	1,000	—
General Fund	None	175,805	192,000 [d]

[a] This amount varies and is to meet State Lands Commission budget needs plus miscellaneous required payments to certain cities and counties.
[b] Total revenue deposit—does not bring fund balance to $125 million in COFPHE or $120 million EFR.
[c] $42 million of this amount is to be transferred to the General Fund to offset revenue losses due to energy tax credits (Ch 904/80).
[d] Includes the $42 million transfer required by Ch 904/80.

- $125 million—COFPHE
- $200 million—State School Building Lease/Purchase Fund
- $120 million—Energy and Resources Fund (ERF)
- $35 million—State Parks and Recreation Fund (SPRF)
- $25 million—Transportation, Planning and Development Account
- Remaining balance—Special Account for Capital Outlay (SAFCO)

In the case of the COFPHE and the ERF, any unused balances remaining in the fund from prior years are deducted from the target amount. In the case of the other funds, however, no deductions are made. Thus, for example, the SPRF may have available more than $35 million in any year, if balances are carried over from the previous year.

Funds Not Distributed According to Chapter 899/80. In recent years, the distribution of tidelands oil revenues has not been made in accordance with the provisions of Ch 899/80. Instead, the statutory distribution has been modified in response to changing priorities among these programs and the need to increase General Fund revenues so as to keep the budget in balance. Table 64 compares the distribution of tidelands oil funds under the provisions of Ch 899 with the actual distribution in 1982–83 and the proposed distribution in the Governor's 1983–84 Budget.

Legislative Flexibility Restricted. From an analytical standpoint, tidelands oil revenues are indistinguishable from General Fund revenues. They are not raised for a particular function of state government, and may be used for any public purpose. As a result, depositing tidelands oil revenue into special purpose funds tends to limit the Legislature's options in allocating available state resources among state-supported programs and activities. While the Legislature has been able to overcome these limitations by overriding the provisions of Chapter 899 during the annual budget process, its task is made much more difficult by the fact that funds already "given" must be "taken back". The task becomes even more difficult once funds have been earmarked for specific projects.

To improve the Legislature's fiscal flexibility in responding to statewide programs and priorities (including capital outlay) supported by the General Fund, *we recommend that tidelands oil revenues be deposited directly into the General Fund.*

3. 1983–84 Demands on Capital Outlay Funding

As discussed earlier, the Governor's Budget includes a limited amount of funds for capital outlay. Moreover, there will continue to be limited amounts available from traditional capital outlay fund sources—tidelands oil revenues and bonds. There are however, several major capital improvement programs which, if funded in the budget year, will overburden these sources. In addition, there are continuing needs to repair and maintain the state's vast infrastructure. Examples of these major programs and repair/maintenance needs follow.

Higher Education—Capital Outlay. The 1983–84 budget includes $21.6 million for capital outlay expenditures in the three segments of higher education—the University of California, California State University, and the California Community Colleges. This amount provides for only a portion of the amount originally requested by the three segments. In fact, the segments submitted requests that, together, were more than seven times the amount budgeted for 1983–84 capital outlay—$160 million, compared with $21.6 million. The total three-year cost for the programs requested by the University of California and the California State University is $476 million. (The total three-year cost for the California Community College program was not available.)

Although our analysis indicates that some of the proposed projects are not essential and may not be warranted at all, the total amount requested provides an indication of the general magnitude of capital outlay needs, as seen by the respective system.

Some of the proposed prospects, if approved by the Legislature, will have implications for state expenditures in future years. For example, the University of California requests funding in 1983–84 to plan four projects that will cost nearly $140 million during the next three years. Moreover, the secondary effects of these projects (such as alterations of vacated space) could cost another $60 to $70 million after completion of the initial project.

Higher Education—Support Budget. The three segments of higher education have also identified ongoing problems in the areas of deferred maintenance and replacement of instructional equipment. The Legislature has recognized these problems, and since 1981, it has appropriated a total of $53 million from the COFPHE for deferred maintenance ($22.5 million) and instructional equipment ($30.5 million). The budget recognizes these support needs and requests $36 million from the COFPHE for these activities. This amount is divided evenly between maintenance and replacement of equipment.

This is the first year that the amount budgeted from the COFPHE for deferred maintenance/instructional equipment replacement ($36 million) exceeds the amount budgeted for capital outlay ($21.6 million). If this trend continues, funding for deferred maintenance and replacement of instructional equipment will continue to deplete the amount of funds available for statewide capital outlay programs.

Additional Prison Capacity. The Department of Corrections' *final draft* of its "1983 Facilities Master Plan" indicates that an additional $1,900 million (1983 costs) will be needed over the next eight years to provide additional prison capacity. This estimate is based on housing the anticipated 1992 male inmate population of approximately 71,000 in permanent beds (50,145), contract beds (1,910), and temporary compounds (7,200). This plan would leave a capacity deficit of 11,605 beds. To eliminate this deficit, an additional $900 million (1983 costs, based on average estimated cost per bed) would be required. Thus, the total costs to house the department's projected male inmate population in 1992, without double celling or overcrowding, would be $2,800 million beyond the amounts previously appropriated by the Legislature.

The 1982 Budget Act included $149.3 million from the New Prison Construction Fund (bonds) for additional prison capacity. A detailed discussion of the department's plan and the Governor's 1983–84 capital outlay program for additional prisons is included under Item 5240-301-723 in the *Analysis.*

Currently, there is a $345.7 million balance available for appropriation from the $495 million bond program approved by the electorate. This balance, however, will fund only 18 percent of the department's master plan and only 12 percent of the cost to house the department's projected population. Consequently, if the state's prison capacity is to be increased to meet the projected male inmate population, *an additional $1,500 million* *(with overcrowding) to $2,400 million (no overcrowding) will be needed over the next eight to ten years.*

Moreover, the department's master plan does not address either the ongoing capital improvement needs or the infrastructure renovation/repair needs of *existing* prisons. The state has not constructed a new prison since 1961, when the California Men's Colony at San Luis Obispo was completed. In addition, much of San Quentin State Prison is over 100 years old. The facilities in the state prison system are aging rapidly, and there will be a continuing requirement for capital improvements to meet both changing needs and renovations/repairs. The cost for these purposes has not been identified, but the department's "1980 Facilities Master Plan" included over $600 million (at 1980 costs) over a nine-year period for renovation of existing facilities. Although all of the work envisioned by the 1980 Plan probably is not necessary, the order of magnitude of anticipated costs is an indication of the problems that must be addressed over the next decade.

State Office Space. As of June 30, 1982, the state was leasing 8.1 million square feet of office space, at an annual cost of $61.3 million dollars. The largest share of this lease cost was in Sacramento County, where on June 30, 1982, the state was leasing 3.5 million square feet, at an annual cost of $25.3 million. In mid-1976, the lease space in Sacramento County totaled 2.1 million square feet, at a cost of $10.1 million per year. Thus, in six years, the state's leased cost has increased 150 percent, while the amount of space has increased 67 percent.

Our analysis indicates that the most cost-effective solution to the state's office space needs is to house ongoing functions of state government in state-owned buildings, rather than house these functions in privately owned space (assuming no difference in quality between a state-built facility and leased space). For the past several years, the Legislature has appropriated funds to construct state-owned space in Sacramento, as well as in other metropolitan areas. Nevertheless, the amount of and cost for space leased by the state continues to increase at a rapid rate. These costs reduce the amount of discretionary funds available to the Legislature for financing other statewide programs and needs. Consequently, the Legislature may wish to invest funds in constructing new state office buildings in order to—in the long term—increase the amount of state funds available for expenditure at the Legislature's discretion.

The capital outlay programs discussed above highlight some of the demands which will be placed on state funds. Other areas where major capital outlay programs have been identified include the Department of Forestry, the Veterans' Home in Yountville, the Department of Food and Agriculture, state hospitals, energy conservation, and others.

4. Priorities Need to be Established for the Statewide Capital Outlay Program

We recommend that each fiscal committee establish a subcommittee to consider all capital outlay programs so that (1) available funds can be used to support the Legislature's statewide capital outlay priorities, and (2) the Legislature can provide guidance to the administration for revising the capital outlay program in the event that cutbacks should be necessary during 1983–84.

The major capital improvement programs discussed above, coupled with the continuing needs to repair and maintain the state's vast infrastructure system that includes state office buildings, state hospitals, state prisons, and higher education facilities will overburden the current sources of capital outlay funding—tidelands oil revenues and bonds.

We believe the Legislature can ensure that such funds as are available are used in the most productive manner possible if it evaluates statewide capital outlay needs as a single program and establishes *statewide priorities,* instead of considering each proposed project on a department-by-department basis. Authorization of projects on a department-by-department basis may result in the funding of projects which the Legislature otherwise would consider to have a lower priority, in comparison with other statewide needs.

In contrast, if the Legislature were to consider *all* capital outlay requests as part of a single statewide program, it would result in (1) improved evaluation of individual projects, (2) more consistent application of legislatively established priorities to individual projects and (3) funds being committed to projects on the basis of statewide, rather than departmental needs.

Further, during the past two years it has been necessary to make mid-year adjustments to offset a General Fund deficit. Part of these adjustments has been the deferral or cancellation of capital outlay projects and the transfer of the associated funds to the General Fund. The Legislature has limited post-budget control and consequently, the decision, as to which projects are to proceed and which are to be deferred, has been left to the administration. The Legislature, however, can provide guidance to the administration by establishing the *Legislature's* statewide priorities for capital outlay. In this way, if mid-year adjustments are necessary, the administration will know the relative priority of projects in the Legislature's capital outlay program and will be able to identify those lower priority projects which, if necessary, could be deferred.

Given the limited resources available for all state programs, and capital outlay projects in particular, and the demands on these funds, a new approach to legislative consideration of capital outlay projects would appear to be warranted. Thus, in order to improve the Legislature's ability to review and control capital outlay programs, we recommend that each fiscal committee establish a subcommittee, to consider all capital outlay programs.

III. STATE BORROWING ISSUES

As discussed in some detail in Part II, the state borrows money for a variety of purposes. Some of this borrowing is short-term in nature, while other borrowing is long-term. Each type of borrowing raises policy issues of concern to the Legislature.

A. SHORT-TERM BORROWING

What Should Be the Legislature's Policy Regarding Short-term Borrowing?

With respect to short-term borrowing, we recommend that the Legislature:

(1) ***Designate the State Treasurer as the official statutorily responsible for managing all short-term General Fund external borrowing activities;***

(2) ***Limit the use of short-term external borrowing to borrowing within***