THE 1993-94 BUDGET: PERSPECTIVES AND ISSUES

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

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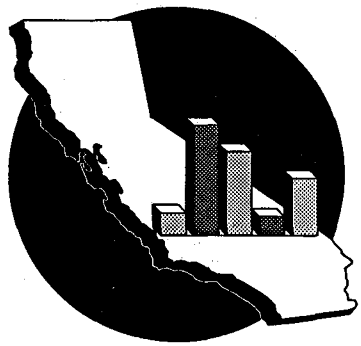


INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1993 Budget Bill and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 1993-94 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 1993-94 Budget Bill,* which contains our review of the Governor's Budget.

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

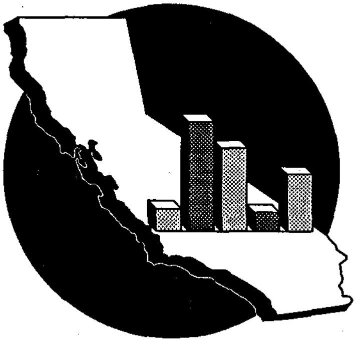
The 1993-94 Budget: Perspectives and Issues is divided into five parts:

- Part One, "State Fiscal Picture," provides an overall perspective on the serious fiscal problem currently confronting the Legislature.
- Part Two, "Perspectives on the Economy," describes the current economic situation and the Administration's forecast for the budget year.
- Part Three, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and an assessment of their reliability.

- Part Four, "Perspectives on State Expenditures," provides an overview of the state spending plan for 1993-94 and evaluates the major expenditure proposals in the budget.
- Part Five, "Restructuring California Government," discusses the issue of public sector restructuring and offers a model for fundamental change in state-local governmental responsibilities and financing.

I

State Fiscal Picture



STATE FISCAL PICTURE

As has been the case in each of the past four years, the *1993-94 Governor's Budget* recognizes a substantial decline in the state's fiscal fortunes. The continuing state recession has once again undermined the state's current-year spending plan, and will force the Legislature and the Administration into more painful choices as they struggle to balance the budget for the 1993-94 fiscal year. Even without attempting to provide for a prudent reserve, this task will require spending cuts or revenue increases conservatively estimated at $8.6 billion over the next 18 months. Given the magnitude of actions already taken in recent years, resolving this year's fiscal crisis requires a fundamental rethinking of governmental responsibilities in California.

The budget fully recognizes the magnitude of the crisis and proposes that the state respond with major changes in fiscal policy. However, the budget as presented does not realistically address the problem and could not be adopted as proposed. It provides little explanation of the policies inherent in its proposed changes or of the mechanics of implementing those changes. The budget also relies on overly optimistic assumptions about federal funding and the timing of statutory changes.

The budget essentially retains the same priorities for state spending as were followed in the adoption of the current year's budget. K-12 school funding and corrections spending receive the highest priorities, while major spending reductions are proposed in the health and welfare area. Local governments would take the largest cut, by means of a $2.6 billion shift of their local property taxes to school districts. The budget also calls on the federal government to assume $1.4 billion worth of responsibility for the impact of its immigration policy on the state's treasury. As was the case last year, the budget proposes to eliminate the renter's tax credit, but otherwise places no reliance on state-level tax increases to resolve the problem. However, tax increases at the local and federal levels are at least implicit in the budget.

In this part, we asses the state's current fiscal outlook and evaluate the Governor's response to the situation. We also examine the implications of the 1994-95 outlook on possible budget strategies for 1993-94.

THE 1993-94 BUDGET PROBLEM

Current Year Will End With Large Deficit

The 1992-93 budget plan adopted in September anticipated that the state would pay off its 1991-92 carry-over deficit and end the year with a small reserve of $31 million. This expectation was based on the Administration's May 1992 revenue estimate, which assumed that California's economy would resume moderate growth by the end of 1992. That assumption has proved overly optimistic, and the Governor's Budget now projects that the state's economy will remain mired in recession until late 1993. As a result, rather than ending 1992-93 in balance, the state now faces another multibillion dollar deficit at the end of the current year.

The Economy: A Weak Recovery in 1993-94

The Administration's forecast for the California economy assumes that the state's current recession will cause problems for the state in the budget year. Specifically, the recession is forecast to continue through the third quarter of 1993, followed by a relatively weak recovery continuing through 1994. Personal income is forecast to increase 3.5 percent in 1993 and 5.8 percent in 1994. Employment is expected to decline by 1 percent (120,000 jobs) in 1993 and increase by just 1.2 percent in 1994.

California's projected ongoing recession is the result of an expected weak national recovery and a number of other factors that will hit California especially hard, particularly the continuing declines in defense spending. California also has suffered more than most states from declines in residential and nonresidential construction and increasing competition in nondefense high-tech manufacturing, such as computers and commercial aircraft.

The Revenue Forecast

Due to the weaker-than-anticipated performance of the California economy, the Administration forecasts that current-year General Fund revenues will be $2.5 billion below the level anticipated by the 1992 Budget Act (that is, revenues will be approximately $40.9 billion). General Fund revenues are forecast to fall again in 1993-94 by almost $1.1 billion (-2.6 percent). This 1993-94 decline is entirely attributable to two major tax changes required by existing laws:

- The decrease in the state General Fund portion of the sales and use tax from 5.5 to 5 percent, effective July 1, 1993.
- Reintroduction of the net loss carry forward for businesses.

In the absence of these scheduled tax changes, General Fund revenues for 1993-94 would actually show a small increase of approximately $800 million (2 percent).

The Current-Year Deficit

Figure 1 compares the September 1992 budget estimates for 1992-93 with the January 1993 estimates in the *1993-94 Governor's Budget,* adjusted to exclude the spending and revenue changes proposed by the budget to mitigate the projected current-year deficit. As the figure

Figure 1

1992-93 General Fund Condition Deteriorates Rapidly Since Budget Enactment[a]

(In Millions)

	Estimate Date		
	September 1992	January 1993	Change
Prior-year balance	-$2,191	-$2,220	
Revenues and transfers	43,421	40,939[b]	
Total resources available	$41,230	$38,719	-$2,511
Expenditures	$40,792	$41,665[c]	873
Fund balance	$438	-$2,946	
Reserve	**$31**	**-$3,357**	**-$3,388**
Other obligations	$407	$410	$3

[a] Detail may not add to totals due to rounding.
[b] Excludes $3 million of new transfers proposed in the budget.
[c] Governor's Budget estimate adjusted to restore $843 million of proposed savings.

shows, the budget anticipates that, absent any corrective action, the state will end 1992-93 with a *deficit* of about $3.4 billion instead of the $31 million reserve originally planned. The $2.5 billion drop in estimated revenues discussed above accounts for most of this deterioration in the state's fiscal condition.Although weak revenues are the main problem, unbudgeted spending also contributes to the current-year deficit. General Fund expenditures in 1992-93 will exceed the previous estimate by $873 million (absent proposed spending reductions), according to the budget estimates. There are three major reasons for the increased spending. First, the federal government failed to provide all of the State Legalization Impact Assistance Grant (SLIAG) funds that were anticipated in the budget. Second, caseloads and costs increased over the amounts budgeted for Medi-Cal and prisons. Third, some of the savings that had been budgeted will not occur because of implementation delays or the need to enact enabling legislation.

1993-94 Budget Gap: $8.6 Billion

As shown in Figure 2, we estimate that the 1993-94 budget gap totals $8.6 billion. This amount consists of the carry-over deficit from 1992-93 ($3.4 billion) and the $5.2 billion operating shortfall between baseline spending and estimated revenue in 1993-94. For this calculation, we have used the Governor's Budget estimates of revenue (excluding proposed changes) as our base. On the expenditure side, our estimates recognize both increasing caseloads and the increasing costs of providing state services. Funding increases to offset one-time savings in 1992-93 are also included. This results in a baseline expenditure estimate of $44.7 billion for 1993-94, which is $3.0 billion, or 7.2 percent, more than current-year spending (excluding proposed changes). Our estimated budget gap does not include any funds to establish a prudent reserve. Including the creation of a prudent reserve would increase the size of the gap to almost $10 billion.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 3 shows the Governor's proposed amounts of spending and revenue for 1992-93 and 1993-94 and the resulting General Fund condition. Estimated General Fund revenues decline by 2.6 percent from the current year, while spending falls to $37.3 billion. This represents a reduction of $3.5 billion relative to estimated current-year spending (after taking into account the savings proposed in the budget). Although the budget is presented as balanced, the proposed $31 million reserve is much too small to cover the risk inherent in the budget plan.

Figure 2

1993-94 Budget Gap[a]

(In Billions)		
Pay off deficit from 1992-93		$3.4
1993-94 baseline spending	$44.7	
1993-94 estimated revenue[b]	-39.4	
Operating shortfall		$5.2
Budget Gap		**$8.6**

[a] Excludes Governor's Budget proposals. Details do not add to total due to rounding.
[b] Based on Administration's revenue forecast.

Figure 3

Governor's Budget General Fund Condition[a]

(Dollars in Millions)

	1992-93	1993-94	Percent Change
Prior-year balance	-$2,220	-$2,100	—
Revenues and transfers	40,942	39,875	-2.6%
Total resources available	$38,722	$37,774	-2.4%
Expenditures	$40,822	$37,333	-8.5%
Fund balance	-$2,100	$441	—
Reserve	**-$2,511**	**$31**	**—**
Other obligations	$410	$410	—

[a] Detail may not add to totals due to rounding

How the Budget Addresses the Spending Gap

Figure 4 shows how the budget proposes to address the $8.6 billion funding gap that we identified above. Half of the gap is addressed by shifting $4.3 billion of costs to other levels of government. Local governments would bear $2.7 billion of this burden, primarily through a shift of property tax revenue to schools and community colleges, where those revenues would replace state support. The budget also assumes that the federal government will provide $1.6 billion of additional federal funds, primarily to offset state costs of providing services to immigrants and their children.

Figure 4

Budget's Proposed Resolution Of the 1993-94 Spending Gap[a]

(In Billions)	
Cost shifts to other levels of government	
Reduced local government resources:	
Property tax shift to education	$2.6
Trial Court Funding and other	0.1
Increased federal funding:	
Reimbursements for health, welfare, and prison cost of immigrants	1.1
Additional SLIAG legalization aid	0.3
IHSS: shift to federal personal care program	0.2
Subtotal	$4.3
Program reductions	
Welfare proposals:	
Welfare reform/AFDC reductions	$0.5
No pass-through of federal SSI COLA	0.1
Shift special fund monies to General Fund programs	0.4
Unallocated cuts and other shortfalls at UC/CSU	0.4
Proposition 98:	
Reversion of K-12 funds in 1992-93	0.3
Unallocated CCC cut/fee increase	0.3
Eliminate Medi-Cal optional benefits	0.2
Downsizing state agencies, the Legislature and courts	0.2
Subtotal	$2.4
Cost deferrals	
Proposition 98:	
New K-12 loan for 1993-94	$0.5
Defer scheduled CCC loan repayment	0.1
Cash accounting for debt service	0.2
Defer repayment of 1992-93 loans from special funds	0.1
Subtotal	$0.9
Increased resources	
Tax expenditures:	
Repeal renters' credit	$0.8
Repeal small business health care tax credit	0.1
Subtotal	$0.9
Total	**$8.6**

[a] Figures reflect both 1992-93 and 1993-94 effects. Detail does not add to total due to rounding.

Program funding reductions account for $2.4 billion of savings. The largest savings come from the proposed AFDC grant reductions and related welfare reform proposals. Cost deferrals, including a loan to schools against their future Proposition 98 guarantees, provide about $900 million of savings. Other than the elimination of the renters' credit, the only tax-related proposal actually reflected in the budget is the repeal of the small business health care credit (which has never been implemented), for a savings of $110 million.

Major Budget Proposals

Property Tax Shift

The largest single feature in the budget proposal is the shift of $2.6 billion of property taxes and redevelopment funds from local governments to schools. This shift would reduce required state funding under Proposition 98 by a like amount, and would be in addition to the $1.1 billion permanently shifted to schools from cities, counties, and special districts in the current year.

The largest portion of the additional shift in 1993-94 consists of $2.1 billion that would be allocated among cities, counties, and special districts by an unspecified methodology that the budget proposes should be developed jointly by the state and local governments. The budget proposes to continue this year's one-time $200 million shift of redevelopment funds to schools, and to permanently restrict the allocation of property taxes to redevelopment agencies to generate another $100 million. In addition to the redevelopment funds, the shift also includes $150 million from enterprise special districts (other than hospital and transit districts) and a one-time diversion of $70 million to recapture savings from anticipated federal allocations to Los Angeles and certain other counties.

Increased Federal Funds

California has seen a massive influx of foreign immigrants over the last decade. The Administration indicates that it will seek $1.1 billion of increased federal funding for 1993-94 to reimburse the state for its ongoing costs of health and welfare benefits and services provided to refugees, immigrants, and their citizen children ($878 million), and for the costs of prison inmates who are undocumented immigrants ($250 million). The budget assumes that the federal government will provide these funds in 1993-94, and the Administration has requested that federal statutes and appropriations be enacted by May 15, 1993. The budget also includes savings of $314 million by assuming that the federal government will provide California with the full amount of remaining SLIAG funding owed for services already provided to newly legalized immigrants.

If this $1.4 billion of additional federal funds is not forthcoming, the budget presents a list of additional program reductions that the Administration would consider, including $809 million of additional Medi-Cal cuts. The Medi-Cal reductions would include eliminating additional optional benefits for adults (such as drugs and optometry) and optional eligibility categories for the medically needy and indigent. The list also includes $243 million from reducing the state's SSI/SSP benefits for elderly and disabled persons to the federal minimum amount.

Proposition 98

The budget reflects a downward revision in the level of K-12 enrollment for 1992-93. Combined with the reduction in estimated state revenues for the current year, this enrollment decline has lowered the Proposition 98 funding guarantee by $525 million. On this basis, the budget proposes to lower the amount appropriated for the 1992-93 guarantee by $437 million. More specifically, the budget proposes to lower K-12 school funding in the current year by $315 million, and to use $122 million of the $525 million "over-appropriation" to pay for outstanding Proposition 98 obligations from prior years. On a cash basis—what schools actually receive—total K-12 funding per pupil in the current year (from state and local sources) remains at essentially the same level contemplated in the 1992 budget agreement.

For 1993-94, the budget proposes to maintain this same K-12 per-pupil funding policy, while at the same time achieving a savings of $3.6 billion. As discussed above, the property tax shift provides $2.6 billion of this savings. The remaining savings are achieved primarily in two ways. First, the Administration proposes to designate $540 million of 1993-94 K-12 funding as a loan against future state Proposition 98 requirements. (The Administration has revised the original loan figure of $375 million that appears in the budget document.) None of these "loaned" funds are counted as state expenditures in 1993-94. Second, the budget proposes an unallocated reduction to the community colleges of $266 million. The Administration supports legislation allowing the Board of Governors to make up for this reduction with increased fees.

Other Significant Proposals

Higher Education. The budget proposes unallocated General Fund reductions totaling $430 million for the University of California and the California State University. This represents a reduction of 7.2 percent and 4.5 percent, respectively. The budget document does not contain proposed 1993-94 student enrollment or student fee levels for the UC and CSU.

Welfare Proposals. The budget proposes immediate enactment of many of the AFDC grant reductions and welfare reform proposals that the Governor put forward last year in his 1992-93 budget and in Proposition 165, with certain modifications. These proposals account for a net savings of $499 million, including $32 million in the current year.

Medi-Cal Optional Benefits. The budget again proposes, with some modifications, to eliminate certain optional benefits that California provides under the Medi-Cal program. The benefits that would be eliminated include adult dental care, psychology, and podiatry. The proposal assumes enactment of legislation to eliminate these benefits in the current year. Net savings would total $202 million, including $43 million in 1992-93.

Renters' Credit. The budget proposes the immediate enactment of legislation to eliminate the renters' credit, effective with the 1992 tax year. The total savings from this action would be about $840 million for both the current and budget years.

State Operations Reductions. The budget includes savings of $197 million in 1993-94 from a proposed downsizing of state operations. Of this total, $150 million would be allocated among state agencies and programs by the Director of Finance. The budget documents contain a list of departments and programs that the Administration intends to review to identify opportunities to consolidate functions, reduce costs, and improve accountability. The budget also includes savings of $47 million from "voluntary" 15 percent reductions that the Administration is requesting from the Legislature and the judiciary.

New and Expanded Programs. Given the magnitude of the state's fiscal problems, the budget contains very few new spending proposals. The welfare reform proposal includes a $26 million expansion in state funding for the GAIN program (which provides education and training to welfare recipients). The budget also requests $8.2 million for a new Strategic Technologies program in the Trade and Commerce Agency and $5 million to implement a volunteer mentor program for school children. Within spending required to meet the Proposition 98 guarantee, the budget proposes to allocate $58 million to expand preschool services, the Healthy Start program, and the Early Mental Health program. These programs reflect the Governor's emphasis on prevention programs and children.

THE EFFECT OF OFF-BUDGET TRANSACTIONS

Another important consideration needs to be included in assessing the state's financial position. This concerns commitments that are being made against future-year resources, but which are not accounted for in the budget displays. The largest of these is the off-budget "loan" of $973 million that the state provided to schools and community colleges in the current year against future Proposition 98 requirements. The budget proposes a second off-budget loan of $540 million in 1993-94, which would bring the total amount of these loans to $1.5 billion.

In effect, the state has borrowed money from the future to maintain its current level of spending for schools and community colleges. This spending will have to be reflected in future budgets when the loans are "repaid" to the state, either by offsetting the repayments against the Proposition 98 guarantee at that time (a reduction in actual funding to education) or by forgiving the loans and reflecting the amounts as spending in the budget.

The state also has used an off-budget transaction to postpone its liability for a $600 million sales tax refund to federal contractors, pursuant to the *Aerospace* court decision. The state plans to pay off this liability (with interest) over ten years. The 1993-94 budget reflects only the $60 million first installment on this debt, leaving $540 million still owed. Including this amount, the General Fund would end 1993-94 with a total liability of more than $2 billion for off-budget financing of 1992-93 and 1993-94 spending.

The Growing Cash Gap

The use of off-budget transactions is one of several ways in which the state has used accounting techniques to balance its budget during the last few years of fiscal crisis. These accounting techniques have widened the gap between the budgetary and the cash position of the General Fund.

The Difference Between the Cash Balance And the Budget Balance

The reserve or deficit figures shown in the budget displays have little relationship to the amount of cash in the General Fund at year-end. Figure 5 illustrates the conceptual difference between the cash balance and budget balance of the General Fund at the end of each fiscal year.

Figure 5

Relationship Between General Fund Budget Balance and Cash Balance (End of Fiscal Year)

Budget balance[a]

– Net revenue accruals

\+ Net expenditure accruals

–/+ Adjustments for off-budget spending

= Cash balance

[a] Shown in budget as "Fund Balance."

The budget fund balance and the cash balance may be quite different, both in their amount and direction. Generally, the budget uses an accrual method of accounting. This means that the revenues shown in the budget include some money not yet in the state's possession on June 30, but owed to the state. Likewise, budget spending figures include amounts needed to pay outstanding bills for goods and services already provided to the state at year-end. As discussed above, the budget balance does not reflect off-budget spending, such as the Proposition 98 loans. In order to reconcile the actual cash balance to the General Fund "fund balance" that is shown in the budget displays, it is necessary to adjust for accruals and off-budget spending.

The Importance of the Cash Balance

Regardless of the budget's stated reserve, a cash deficit requires the General Fund to borrow money to cover current expenses, which results in interest costs. "Internal" borrowing (from other state funds) can provide some of these loans, but large cash deficits require the state to borrow externally from investors, such as by issuing revenue anticipation notes (RANs). Traditionally, California and most other state and local governments have issued RANs for cash-flow loans. These loans help pay expenses during the earlier part of the fiscal year when revenues are low, and are repaid later in the year when the revenue flow picks up. A year-end cash deficit that requires external borrowing creates difficulties, however. Investors are uncertain whether the state will have enough cash to repay them before the end of the fiscal year and, in the absence of an enacted budget, they may be willing to lend across fiscal years only at relatively high interest rates—or not at all.

Monitoring *changes* in the relationship between the cash balance and the budget balance over time also provides important information. If the cash balance worsens relative to the budget balance, this can indicate a growing imbalance between current revenues and spending that has been offset in the budget by accounting changes or other "paper" transactions. This type of situation signals increasing borrowing needs to finance current operations, and it also could signal an unsustainable level of spending.

General Fund Cash Deficit Much Greater Than Budget Deficit

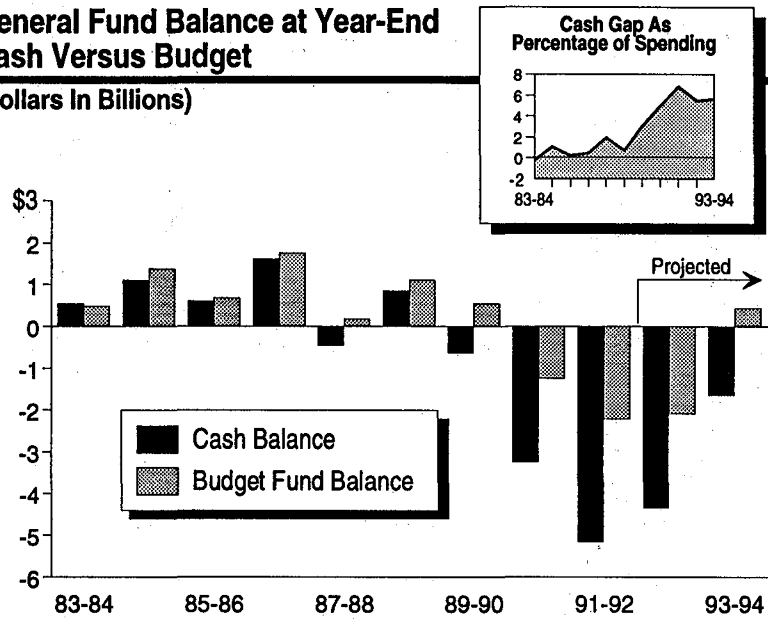
The cash-flow statement in the budget document indicates that the state ended 1991-92 with almost $5.2 billion in outstanding General Fund borrowing (excluding long-term debt, such as bonds). However, the deficit in the General Fund year-end fund balance displayed for budget purposes was much smaller—$2.2 billion. (The overall budget deficit, which was $3 billion in 1991-92, also includes reserves for obligated, but unspent, amounts.) Thus, the General Fund's cash borrowing exceeded the deficit shown in the budget fund balance by $3 billion, or 6.8 percent of General Fund spending that year.

Figure 6 compares the General Fund's year-end cash and budgetary position since 1983-84. The "gap" illustrated in the figure shows the difference between the budget fund balance and the year-end cash balance as a percentage of spending. Through 1988-89, there was relatively little difference between the General Fund's ending fund balance on a cash basis and its fund balance on a budget accrual basis—the differences amount to less than 2 percent of spending. Beginning in 1989-90, however, the General Fund's cash and budget positions began to diverge rapidly, as the figure illustrates. Although the budget's cash flow projections indicate that the gap will stabilize in the current year and 1993-94, those projections still indicate a need to borrow almost $1.7 billion at the end of 1993-94 in order to pay the state's current bills, despite a positive budget fund balance of $441 million.

Figure 6

General Fund Balance at Year-End Cash Versus Budget

(Dollars In Billions)



In addition to off-budget transactions, the widening gap between the General Fund's budget and cash positions reflects a variety of accounting changes used to improve the General Fund's budget position. For example, as part of the 1991-92 budget solution, budget revenues were increased by accruing revenue from taxes on sales that took place before the end of the fiscal year, but which retailers actually remit to the state during the first quarter of the next fiscal year. Similar types of accrual adjustments were made for several other taxes. Although the state took a partially offsetting action to accrue Medi-Cal expenses incurred before year-end, these accrual changes provided the General Fund with a net *one-time* gain of roughly $700 million to its budget balance. However, they also *permanently* widened the gap between the General Fund's budget balance and its cash balance.

The widening cash deficit means that the state must borrow substantial sums to carry it from one fiscal year to the next, even *without* a budget deficit—unless the budget generates a large reserve. This increased year-end borrowing has contributed to increased interest costs for cash-flow borrowing. These costs will have grown from $85 million in 1986-87 to $295 million in 1992-93 and 1993-94, according to budget estimates.

AVOIDING ANOTHER FISCAL CRISIS IN 1994-95

The current year will be the third consecutive year in which the state budget has had an ending deficit of more than a billion dollars, despite the fact that each of these budgets appeared to be balanced when they were adopted. In each of these years, the Legislature struggled to reconcile large operating shortfalls between spending requirements and ongoing revenues, as well as to find ways to pay off large carry-over deficits. Thus, the outlook for 1993-94 is essentially no different from recent years, except that prior state actions have shortened the list of available options. In this context, it is useful to examine whether the projected change in the state's economic fortunes next year could help to reverse this trend.

In order to examine the 1994-95 outlook, we have extended our baseline spending projection to that year. We also have projected ongoing revenues in 1994-95 based on the Department of Finance's economic forecast. Under these conditions, the fiscal picture does improve, in that revenues grow faster than spending (6.5 percent versus 5 percent). However, unless the existing 1993-94 operating shortfall of $5.2 billion is eliminated, this growth differential is not sufficient, by itself, to bring revenues and expenditures back into balance for 1994-95. In fact, it only reduces the operating shortfall to roughly $5 billion in 1994-95.

Our 1994-95 baseline projections have two implications for 1993-94 budget actions:

- At least $5 billion of the budget solutions adopted in 1993-94 must be ongoing in order to avoid another operating shortfall in 1994-95.
- No cushion is available in 1994-95 to absorb a carry-over deficit or cost deferrals from 1993-94. Risky 1993-94 solutions, especially

in the absence of a reserve, are almost certain to require more cuts in 1994-95.

There is another consideration for 1994-95 and beyond that our baseline projections do not address. This concerns the $2 billion of off-budget commitments against future-year resources that were discussed above. The expanded use of these practices will lead to further fiscal problems in the years ahead.

Does the Budget Work?

The Governor's January budget proposal does propose major policy changes and, in some cases, specific legislative proposals to accomplish them. Taken as a whole, however, it fails to provide a workable plan to resolve the state's fiscal problems. There are two reasons why the budget falls short. First, some major portions of the budget are presented only in outline form, with the substance to be filled in later. The most significant example of this is the proposed $2.1 billion property tax shift from local governments, where a methodology for allocating this massive shift is left to future negotiations, and the impacts on local governments have not been addressed.

The budget's second shortfall is that it entails a variety of large risks:

- There are a number of pending court cases that could have massive fiscal implications for the state. For example, up to $5 billion is at stake in one suite (*CTA v. Hayes*) that challenges the constitutionality of the Proposition 98 recapture and loans used to balance the current-year budget.
- Another large risk is the assumption that the state will receive $1.4 billion in federal immigration funding, most of it outside of any existing federal program.
- Savings from several major budget proposals—such as AFDC welfare reform, elimination of some Medi-Cal optional benefits, and repeal of the renters' credit—are likely to fall short of their targets because the budget unrealistically assumes that they will be enacted and implemented essentially immediately.
- We also have identified a number of costs not recognized in the budget, and costs that will likely exceed budget estimates. For example, the budget does not include funds for a rate increase for long-term care providers under Medi-Cal (potentially $73 million), which is required by federal law.

Together, these risks total roughly $8.5 billion.

Significant 1993-94 Deficit Likely. Of course, some of the risks discussed above probably will not materialize, and the spending for others may turn out to be different from the anticipated amounts. However, changing circumstances inevitably will add new risks as the year progresses. As a result, General Fund spending requirements are virtually certain to exceed the budget estimate, and probably by hundreds of millions to several billion dollars, by the end of 1993-94. Given that the budget as presented has no meaningful reserve, this additional spending would result in an equivalent deficit, absent correction action.

Nevertheless, this budget does serve useful purposes. It does not attempt to hide the seriousness of the state's fiscal crisis. The magnitudes of the proposed local funding shifts and the amount of federal funds sought clearly point out the size of the state's fiscal problem and the difficulty of solving it. The inclusion of local governments and the federal government in the budget solutions also highlights the state's interdependence with them. They will have to play major roles in any realistic budget solution.

The Legislature's Dilemma

The state's fiscal problems present the Legislature with a threefold budget dilemma.

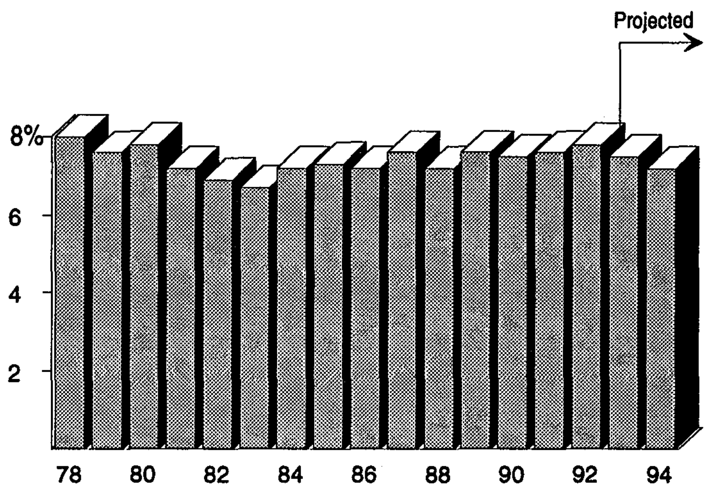
How Much Can Spending Be Cut? After several consecutive years of budget cuts, achieving significant additional savings will require deep and painful reductions in major programs. How deeply can *state and local* spending be cut without fundamentally damaging the state's social fabric, its ability to guarantee public safety, or its ability to retain and attract businesses and jobs?

Can the State Afford to Raise Taxes? The magnitude of the budget crisis and the pain of large spending cuts require consideration of tax increases and the modification of tax expenditures as part of a solution. One straightforward option is to extend the half-cent temporary sales tax rate that expires this year. As illustrated in Figure 7, the burden of state taxes (as a share of personal income) appears to be on the decline. However, the primary reason for the 1992-93 decline is the recession. As incomes fall, the state's progressive tax structure takes a smaller share of income in taxes. When economic recovery occurs and raises incomes, on the other hand, the tax burden will tend to rebound to former levels because of this progressive tax structure. The 1993-94 decline, however, is primarily attributable to the expiration of the one-half cent temporary sales tax rate and return of net operating loss deductions. This does represent an ongoing reduction in the state's existing tax burden.

Should state taxes be reduced in the face of the ongoing fiscal crisis? How much can state or local revenues be raised without overburdening taxpayers and discouraging economic growth and job creation? Can tax increases be structured to minimize the impact on those already hurt by the recession and to avoid negative economic consequences?

Figure 7

Forecast for California's State-Level Tax Burden Is Declining Due to Recession, Tax Changes[a]



[a] Data are for fiscal years ending in year shown; includes both General Fund and special fund taxes.

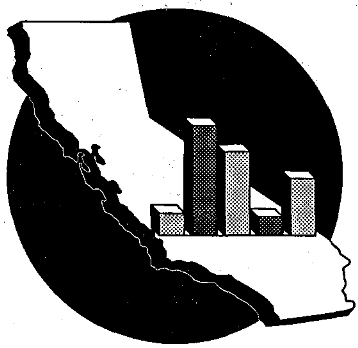
Can the State Afford to Roll the Deficit Over? The state will have what amounts to a rollover of more than $4 billion in the current year. This includes an ending deficit of at least $2.5 billion (assuming all of the budget's savings proposals are adopted), the off-budget Proposition 98 loan of $973 million provided to schools and community colleges in 1992-93, and the unpaid *Aerospace* refunds of $600 million. This rollover (most of which was not planned) has exacerbated the 1993-94 fiscal problem. Moreover, 1994-95 promises to be another difficult year, even if economic recovery does begin in 1993-94, as projected by the budget. Is it reasonable for the budget to borrow any more from the future to finance current spending?

Conclusion

The Legislature has an extremely complex task before it in developing a budget plan for next year. Difficult choices and legal constraints will make the task appear impossible, but a way out of the dilemma must be found. Rethinking the appropriate roles of government is critical to the ultimate resolution of this fiscal crisis. More fundamentally, all available options must be considered if a workable solution is to be put in place.

II

Perspectives on the Economy



PERSPECTIVES ON THE ECONOMY

The single most important factor that determines state government revenues from year to year is the performance of the state's economy. Major revenue shortfalls in each of the last three fiscal years have been caused by the unprecedented weakness of the California economy. Expenditures are also driven, in part, by the short- and long-term performance of the economy. For example, the recession has increased the need for government support of programs in such categories as welfare and medical care. In the long run, economic performance affects the overall level of services that can be provided for the state's citizens.

THE CURRENT ECONOMIC CLIMATE

According to the official statistics, the national economy hit the bottom of the most recent recession in the spring of 1991. Since then, the official measure of the nation's output of final goods and services, Gross Domestic Product (GDP), has increased in every quarter. This rate of expansion, however, has been extremely slow. The nation's unemployment rate continued to increase until its apparent peak in the third quarter of 1992. In contrast, the California economy has continued to sag, with declines in payroll employment and real (inflation-adjusted) personal income continuing through the fourth quarter of 1992.

The National Economy—Slow Recovery in Progress

During the first six quarters of the current expansion—through the third quarter of 1992—growth has been slow by historical standards. For example, real GDP increased at an annual rate of just 2 percent, well below the 4 to 6 percent experienced during the first two years of most post-recession periods in the past 50 years. Growth in output in the range of 3 percent is usually required to pull the nation's unemployment rate down in the early stages of a recovery. Because of slow growth in demand and output, the national unemployment rate continued to drift upwards from 6.8 percent in the second quarter of 1991 to 7.6 percent in the third quarter of 1992. In comparison, the national unemployment rate dropped by around one-third during the first six quarters following the end of the deep 1981-82 recession, when output expanded rapidly.

Why the Slow Recovery? A variety of factors have been suggested as causes of the slow national recovery to date. These include slow growth in basic money supply indicators; new regulatory constraints on the banking system; an accumulation of household, business, and government debt burdens; increased global competition; and major restructurings of several basic industries, including especially the defense sector. Neither the Bush Administration nor the Clinton Administration to date have undertaken a major fiscal stimulus effort, that is, tax cuts and/or expenditure increases. They have been constrained by the recent history of high annual federal budget deficits and the resultant accumulated debt.

Another underlying factor affecting the nation's growth potential is the fact that the economy has not done well for the past 20 years in terms of the most basic measure of economic progress: growth in labor productivity (output per worker). From 1952 to 1972, output per worker in the private sector rose nearly 3 percent per year, while increasing under 1 percent per year from 1972 to 1992. Although recently released statistics indicate that labor productivity rose by 2.7 percent in 1992, this is typical for the early stages of recovery and does not necessarily represent a fundamental change in labor productivity growth.

The California Economy—Decline Continues

In contrast with the national economy, California's real income and employment has been in a continuous decline since May 1990. By the end of 1992, the state had lost over 800,000 nonfarm jobs (6 percent), according to the Department of Finance (DOF). Real personal income declined 3 percent between the third quarter of 1990 and the third quarter of 1992. The state's unemployment rate continued to rise through most of 1992, reaching an average of 9.9 percent in the fourth quarter of 1992, far above the national rate for the period, 7.3 percent.

Housing Hardest Hit. In percentage terms, California's construction industry has been hardest hit thus far, losing 29 percent of its jobs since the peak in mid-1990. Housing construction in the state—as measured by building permits—has always been extremely cyclical. Despite continuing population growth, however, building permits have averaged only around 100,000 units per year for the past two years, far below the 223,000 units that was the average in the 1980s.

National Recession and Defense Declines to Blame? The easiest factors to pinpoint in explaining California's economic woes are the national recession and slow recovery, plus the steep decline in defense spending. During the past 25 years, around 80 percent of the year-to-year variation in the state's employment growth could be explained by variations in national employment growth. Defense contract and military base spending is the largest single "industry" in the state. A wide variety of other factors, however, have converged to make the state's performance much weaker than these latter two factors can explain. These range from overbuilding of commercial structures to government regulatory and fee issues, such as air quality improvement programs and workers' compensation.

New Forecast—Moderate California Recovery Begins in Late 1993

Figure 1 shows the data from the DOF's economic forecast for the nation and California for 1993 and 1994 on a calendar-year basis. For both the nation and the state, the department projects extremely slow progress.

A Below-Consensus U.S. Economic Outlook

GDP is forecast by the DOF to increase only 1.8 percent from 1992 to 1993 (calendar-year basis) and 2.6 percent in 1994. These growth rates are well below those predicted in other national forecasts. For example, the consensus of 50 private forecasters surveyed for the December 1992 Blue Chip Economic Indicators is for 2.8 percent GDP growth in 1993. The December 1992 UCLA Business Forecast Project expects growth rates of 2.8 percent in 1993 and 3.0 percent in 1994.

The DOF forecasts the U.S. unemployment rate to fall only slightly, from an average 7.4 percent in 1992 to an average 6.9 percent in 1994.

Inflation (measured by the percentage change in the Consumer Price Index) and short-term interest rates (measured by the prime rate charged by banks) are forecast to stay close to their current levels.

Figure 1

Department of Finance Economic Outlook For California and the Nation 1992 Through 1994

	1992 Estimated	1993 Projected	1994 Projected
California Economic Indicators			
Percent change in:			
Personal income	2.6%	3.5%	5.8%
Wage and salary employment	-2.3	-1.0	1.2
Consumer Price Index	3.5	3.6	3.8
Unemployment rate (percent)	9.1	10.1	9.5
Residential building permits (thousands)	95	115	144
New car registrations (thousands)	1,227	1,269	1,445
National Economic Indicators			
Percent change in:			
Real Gross Domestic Product	1.7%	1.8%	2.6%
Personal income	4.4	4.0	6.0
Wage and salary employment	0.1	0.5	1.7
Consumer Price Index	3.0	3.2	3.3
Pre-tax corporate profits	9.1	11.3	8.3
Unemployment rate (percent)	7.4	7.2	6.9
Prime interest rate (percent)	6.2	5.6	6.5
Housing starts (thousands)	1,200	1,215	1,325
New car sales (thousands)	8,300	8,700	10,100

A Cautious California Economic Outlook

As shown in Figure 1, the basic economic indicators for California are also projected to be quite weak for the next two years. Personal income is forecast to rise just 3.5 percent in 1993, essentially the same rate as the California Consumer Price Index. This implies no growth in real income and a further decline in real income per capita because of continuing growth in the state's population. The budget forecasts 5.8 percent growth in personal income in 1994. While this translates into real growth, it is still significantly below the levels usually experienced in a "rebound" year.

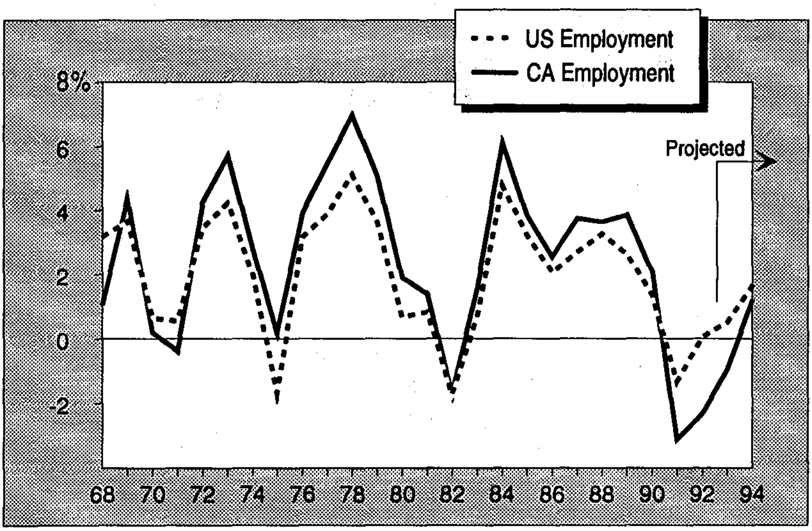
On a yearly average basis, employment is forecast to decline a further 1 percent in 1993. On a quarterly basis, the level of employment is expected to hit bottom in the third quarter of 1993. The state's unemployment rate is forecast to top out at 10.3 percent, over 3 percentage points above the national rate, in that quarter.

Unusual Recovery Pattern for Job Growth

Figure 2 graphically illustrates how California's rate of employment growth has paralleled the nation's during the past 25 years. In general, California's rate of expansion has exceeded the nation's, particularly during periods immediately following national recessions. The pattern that has occurred recently and is projected by the budget through 1994 is radically different. Even during a previous four-year period of rapid decline in defense spending (1967-71), California's employment grew by essentially the same percentage as the nation's. If the department's forecast for 1993 and 1994 is correct, the nation's employment will increase by 1 percent during the four years from 1990 to 1994, while California's employment will decline by 5 percent.

Figure 2

U.S. and California Nonfarm Employment Growth Rates 1968 Through 1994



Some California Weaknesses Have a Long History. Figure 3 illustrates that California has previously experienced large differences between its unemployment rate and the national unemployment rate. During the winding down from the Vietnam conflict in the early 1970s, California's unemployment rate averaged 2.2 percent above the nation's. For the five-year periods before and after 1970-74, the differential averaged 1.1 percent. The low and negative differentials that occurred during the 1980s (a California boom period) actually were unusual. The 1990-94 average differential is projected to be 1.6 percent by the department.

Figure 3

Average Difference of California Unemployment Rate Over National Rate During Five-Year Periods 1965-69 Through 1990-94

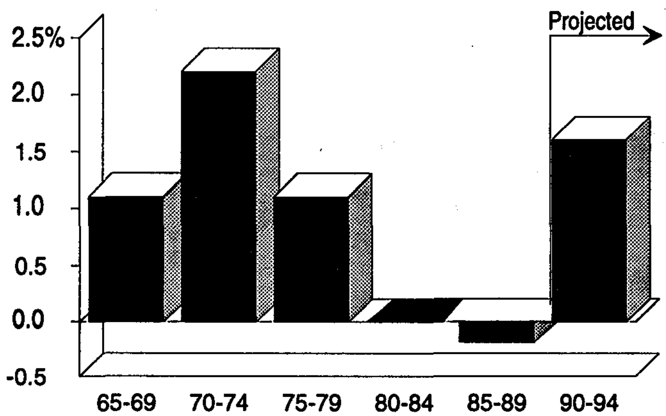
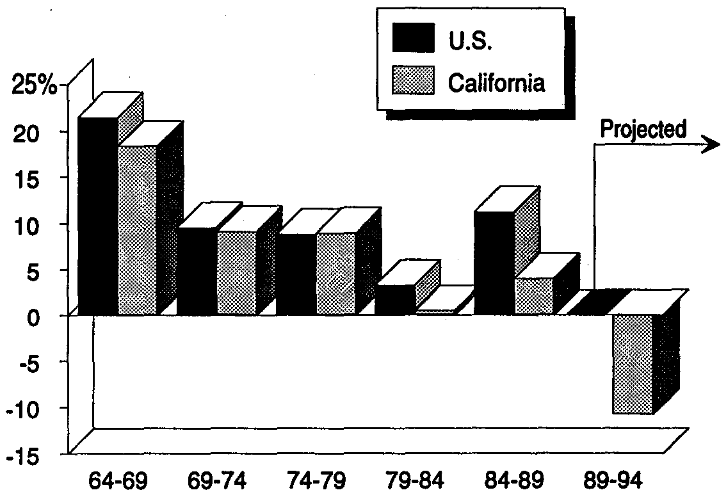


Figure 4 depicts a little-recognized fact about the California economy: the state's real per capita income growth did not keep pace with that of the nation during the 1980s, despite the boom in employment. Although the nation's real per capita income is projected by the department to show no growth from 1989 to 1994, the state is projected to experience an incredible 11 percent decline. This is the basic reason for the expected continuing squeeze on state revenues, particularly income and sales tax collections.

Figure 4

Average Annual Growth Rates in California and U.S. Real Per Capita Income During Five-Year Periods 1964-69 Through 1989-94



This startling change in the state's real income per person (in absolute terms and relative to the nation) is based on several factors, including:

- California inflation running around 0.4 percentage points above the national rate during the past 20 years.
- A changing labor force mix, with relatively fewer high-skill workers and more low-skill workers.
- A recent trend of losing high-paying jobs in such sectors as high-tech manufacturing and construction.
- The relatively severe continuing California recession compared with the nation.

Job Losses Vary Across Sectors

Figure 5 indicates the breakdown of job losses and gains by major sector projected for California by the DOF for 1993 and 1994. The largest absolute losses are forecast for manufacturing of durable goods, which includes defense and commercial aerospace products. Durable products manufacturing is one of the most important "basic" sectors in the California economy, in that most of its products are "exported" from the state to the rest of the nation and the world. As such, basic sector jobs tend to create higher levels of regional demand for nonbasic sector jobs, such as in trade and real estate. As Figure 5 shows, job losses in the basic sectors have been accompanied by job losses in the nonbasic sectors. This explains much of the state's current economic problems.

Figure 5

California Employment Gains and Losses By Industry 1992 Through 1993

(In Thousands)

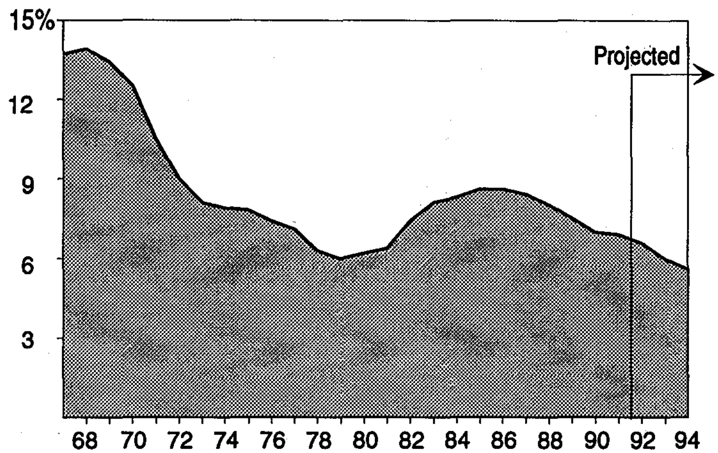
Industry	1992 Estimated	1993 Projected	1994 Projected
Mining	-5	—	1
Construction	-63	-36	20
Manufacturing—durables	-116	-64	-7
Manufacturing—nondurables	-11	-5	16
Transportation and utilities	-7	-6	2
Wholesale trade	-12	-7	10
Retail trade	-65	-20	36
Finance, insurance, and real estate	-28	-7	5
Services	19	58	93
Government	-1	-33	-27
Totals	**-289**	**-120**	**149**

Role of Defense Spending

Figure 6 indicates how the importance of defense spending in the California economy has changed during the past 25 years. At the peak of the Vietnam conflict in 1968, spending on military contracts and bases in the state accounted for 14 percent of the state's gross product, compared with a 9 percent share for defense spending in the nation's GDP. By 1991, the respective state and national shares had fallen to 7 percent and 6 percent. This supports the view that California is losing its share of the market for defense contracts. Although the California economy performed relatively well in the early 1970s despite the steep decline in defense spending, the state has performed poorly during the early 1990s defense retrenchment, which has been less severe in terms of percentage decline in spending than the early 1970s.

Figure 6

Defense Expenditures in California As Percent of Gross State Product 1967 Through 1994



Housing Has Been Particularly Volatile

Figure 7 illustrates the pattern of California single-family home prices relative to the nation, based on National Association of Realtors and California Association of Realtors median sales price data. In 1970, California's median home price was close to the national level. Since the state's household income and personal income per capita were around 15 percent above the national averages in the early 1970s, homes were just as affordable in California for the average family as they were in the rest of the country.

The home price differential rose rapidly between 1974 and 1982, reaching a new plateau of around 60 percent above the nation. California's family income differential from the nation fell during this same period, so that California homes became much less affordable for the average family. The second wave of absolute and relative home price appreciation took place in the late 1980s, as the California median home price reached 110 percent above the nation in 1989. This was a positive phenomenon for existing home owners, but a major problem for young families and those moving to California from other parts of the nation and the rest of the world. More recently, the home price differential has fallen to 90 percent in 1992. Absolute and relative declines in home prices are part of the economic adjustment process occurring in California. Given that the state is still far above the median, this process may not yet be complete.

Figure 7

California Median Home Price Percent Difference From National Median 1970 Through 1992

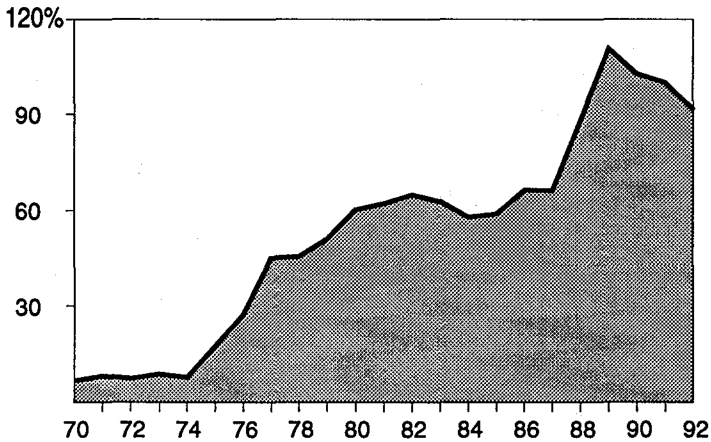


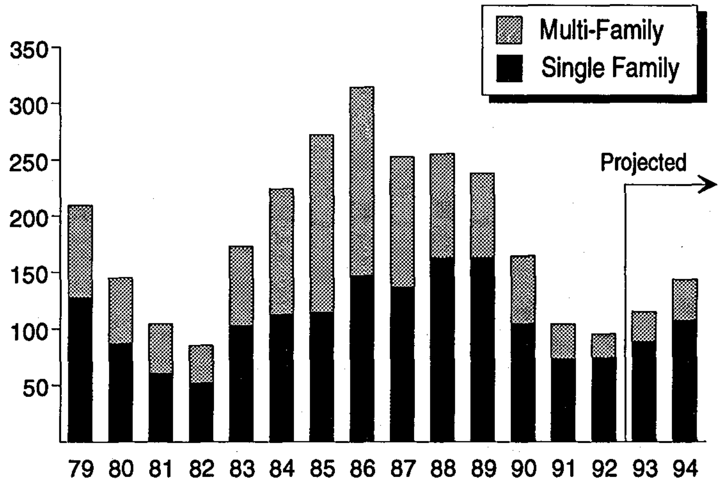
Figure 8 illustrates the high volatility of housing construction in California, with data from the late 1970s through the early 1990s. The lower part of the bars are single-family permits, which have held up much more than multi-family permits during the past several years. By 1992, single-family permits had dropped to just under half of their peak level in the most recent cycle, attained in 1988. In contrast, multi-family permits declined by nearly 90 percent from their peak in 1986 to the expected low in 1992. A precipitous decline in multi-family construction—around 80 percent—also took place at the national level after 1986, when federal tax reform sharply reduced the net financial returns to income property development, particularly for individual investors.

California's population has continued to increase at approximately a 2 percent annual rate, twice the national percentage increase, despite the state's recession and high housing prices. Low multi-family housing construction, which is primarily rental apartments, will eventually put pressure on the housing stock, particularly for the large number of lower-income residents. Recent construction rates of housing units amount to one housing unit per approximately six new residents, which is well below the one unit per three new residents built during the 1980s.

Figure 8

California Housing Permits 1979 Through 1994

(In Thousands)



The department's forecast for housing permits is for a relatively gradual increase in 1993 and 1994, well below the rapid rebound that took place in 1983 and 1984. Multi-family construction improvement is expected to be quite weak, whereas in past recoveries, this sector experienced much greater percentage improvement than single-family construction. Construction activity is an important factor in sales and use tax collections since building materials are subject to the tax.

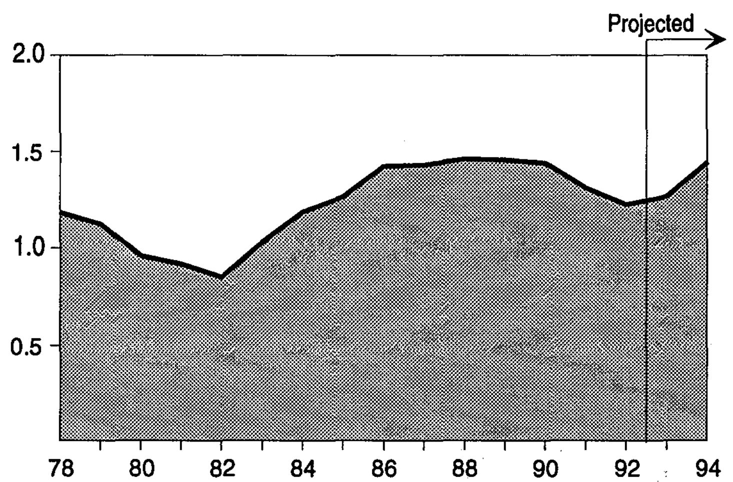
Auto Sales Have Been More Stable

Figure 9 illustrates the previous pattern and the DOF forecast for new motor vehicle registrations in California. Since the state is now down to one major automobile assembly plant (in Fremont), production jobs in this sector are not significant for the state. However, as with construction, new car sales are an important element in wholesale and retail jobs and sales tax collections, particularly during a time of economic recovery. Unlike housing and nonresidential construction, new car sales have held up relatively well in the state and give a significant boost to sales tax collections under the department's forecast.

Figure 9

California New Vehicle Registrations 1978 Through 1994

(In Millions)



How Reliable Is the Economic Forecast?

As with most other forecasters of the state's economy since late 1990, the Department of Finance has continually overestimated the outlook for the state's economy. The most bearish, widely publicized forecasts for the state for 1991 and 1992—therefore the most accurate, as it turned out—were by the UCLA Business Forecast Project. Yet, in both December 1990 and December 1991, even the Project's outlook was too optimistic. For example, in December 1991, the Project indicated that California nonfarm employment would decline 1.3 percent in 1992, while the actual decline is now estimated at 2.3 percent by the DOF. Although the Project's outlook for the national economy is more optimistic than the DOF's, the Project's outlook for California employment in 1993 and 1994 is essentially the same as the DOF's.

National Forecast Too Pessimistic. The DOF's forecast for the nation is likely too low. Their assumption for real GDP growth in 1993 is 1.8 percent. In contrast, most major national forecasters recently have been tending to boost their GDP projections for 1993 to 3 percent and above. In past years, at least, higher national growth in output and employment has meant higher growth for California.

California Forecast More Appropriate. Even if higher national growth than assumed by the DOF is factored in, however, a projection of continuing weakness of the California economy is likely justified. The accumulated problems of California—which were partially masked by the boom of the 1980s—are so severe that a cautious outlook is justified at this time. Because of factors such as those listed in Figure 10, it does not appear prudent to count on a major turnaround in 1993-94 in jobs, the unemployment rate, and personal income in California at this time.

Figure 10

Negative Factors Affecting California's Economic Outlook

Factors Cited by the Department of Finance:

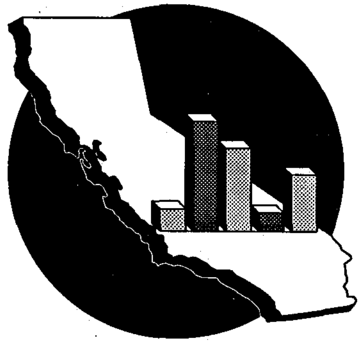
- Further defense spending cuts, including base closures, are coming—and these may be accelerated by the Clinton Administration.
- The construction sector, particularly commercial real estate, is highly troubled.
- The state's commercial high-tech firms face increasing global competition.
- The state has an above-national-average dependence on international exports, and several major U.S. trading partners are in recession.
- Many California industries, such as financial services, utilities, and transportation, continue to pare employment.

Other Factors:

- Last spring's riots in Los Angeles have heightened investor uncertainty, which may retard rebuilding efforts.
- Conflicts are growing over the effects of continued heavy immigration, both legal and illegal, on the state's public service costs.
- State and local governments have been unable to resolve conflicting views and interests over such issues as workers' compensation and environmental regulation.
- Viewpoints over growth management policies, recently addressed in a report by the Governor, continue to be polarized.
- The housing market is in the midst of recovering from a speculative binge in the 1980s and may be moving toward a lower level relative to the national marketplace.

III

Perspectives on State Revenues



PERSPECTIVE ON STATE REVENUES

State government revenues in California are divided into two broad categories: General Fund revenues and special fund revenues. As the name suggests, General Fund revenues are relatively flexible in terms of the purposes for which they can be used. Special fund revenues, on the other hand, tend to be earmarked for specific purposes. For example, motor vehicle fuel taxes are used primarily to fund highway construction and maintenance.

Figure 1 summarizes the major components of these two revenue categories and their relative sizes as proposed in the Governor's Budget. General Fund revenues are projected to be $39.9 billion for 1993-94, while special fund revenues are projected to be $12.1 billion. Thus, General Fund revenues are expected to account for 77 percent of the $52 billion state revenue totals.

THE FORECAST FOR GENERAL FUND REVENUES

As shown in Figure 2, three main taxes comprise 90 percent of General Fund revenues, as projected in the Governor's Budget for 1993-94. The personal income tax (PIT) accounts for 42 percent of the total, followed by the sales and use tax at 36 percent, and the bank and corporation tax (B&C) at 12 percent. The next most important revenue source is the insurance tax, at 3 percent. Other sources of General Fund revenue are much smaller in terms of the share they contribute, but still provide important sources of state income. The larger of these include

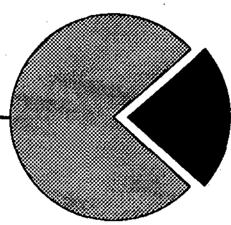
Figure 1

State Revenues in 1993-94

(In Billions)

General Fund Revenues	
Personal Income Taxes	$16.9
Sales and Use Taxes	14.3
Bank and Corporation Taxes	4.9
All Other	3.8
Total	**$39.9**

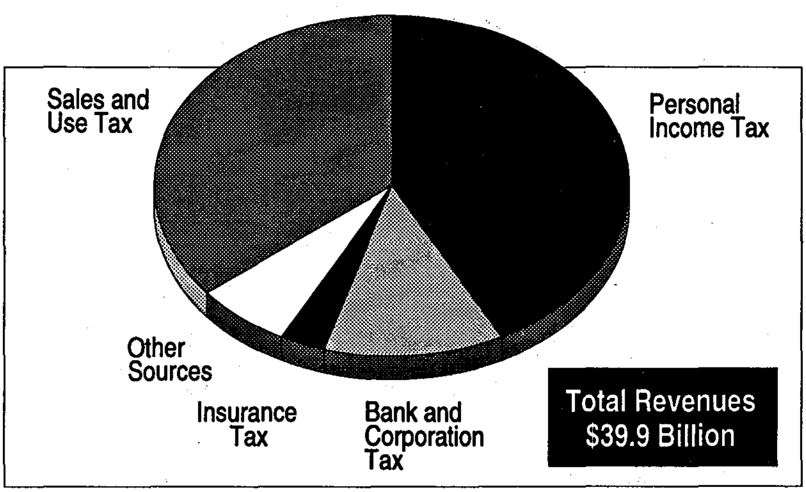
Total State Revenues $52 Billion



Special Fund Revenues	
Motor Vehicle-Related Taxes	$7.2
Sales and Use Taxes	1.6
Tobacco-Related Taxes	0.5
All Other	2.8
Total	**$12.1**

Figure 2

1993-94 General Fund Revenues by Source



the estate and inheritance taxes, alcoholic beverage and cigarette taxes, and interest income.

Figure 3 presents the budget's forecast for the primary sources of General Fund revenue. As the figure shows, General Fund revenues are expected to decrease by $1.1 billion in both 1992-93 and 1993-94. Most of this weakness in the performance of state revenues can be attributed to the weak performance of the state's economy. Several recent or pending tax changes also are contributing to these revenue reductions:

Figure 3

General Fund Revenues 1991-92 Through 1993-94

(Dollars in Millions)

Source of Revenue	Actual 1991-92	Estimated 1992-93	Projected 1993-94	Change From 1992-93 Amount	Change From 1992-93 Percent
Taxes					
Personal income	$17,240	$16,760	$16,900	$140	0.8%
Sales and use	16,146	15,110	14,256	-854	-5.7
Bank and corporation	4,494	4,850	4,900	50	1.0
Insurance	1,167	1,212	1,223	11	0.9
Estate, inheritance, and gift	447	540	608	68	12.6
Alcoholic beverage	321	307	291	-16	-5.2
Cigarette	169	178	192	14	7.9
Horse racing	88	80	75	-5	-6.3
Subtotals	$40,072	$39,037	$38,445	-$592	-1.5%
Other Sources					
Interest on investments	$322	$253	$268	$15	5.9%
Transfers and loans	689	795	371	-424	-53.3
Abandoned property	195	155	100	-55	-35.5
Other revenues	748	702	691	-11	-1.6
Subtotals	$1,954	$1,905	$1,430	-$475	-24.9%
Totals	**$42,026**	**$40,942**	**$39,875**	**-$1,067**	**-2.6%**

- The passage of Proposition 163 in November 1992, rescinding the 1991 application of the state's sales tax to "snack" foods and bottled water.
- The reinstatement of the net operating loss (NOL) deduction as of January 1, 1993.

- The termination of the state's temporary 1/2 cent sales tax on July 1, 1993.

In contrast to the Proposition 163-related revenue losses, which occur in both 1992-93 and 1993-94, the reinstatement of NOL deductions and the termination of the temporary sales tax rate primarily affect 1993-94 revenues. That is, the General Fund revenue estimates for 1993-94 have been reduced by approximately $1.8 billion to account for these tax changes, which more than explains the overall decline of $1.1 billion. In the absence of these scheduled tax changes, revenue collections would actually increase by about $700 million over 1992-93.

Tax Proposals in the Budget

The budget contains two proposals for legislation affecting state tax programs. First, the budget proposes that the existing renters' personal income tax credit be repealed, effective for the 1992 tax year. This change would raise approximately $840 million between the current and budget years, but it has no effect on reported levels of General Fund revenues because it is accounted for as an expenditure program. Second, the budget again proposes that the Small Business Health Care Tax Credit program be repealed. This program, which has never become operational, was suspended for the 1992 tax year by the 1992 budget agreement.

INDIVIDUAL GENERAL FUND REVENUE SOURCES

The Forecast for Personal Income Taxes

Background. California's personal income tax provides the largest single source of General Fund revenue. The structure of the tax is quite progressive, meaning that the proportion of income paid in taxes rises as income increases. This is illustrated by the fact that, in 1990, the top 4 percent of taxpayers in the state—those with over $100,000 in adjusted gross income (AGI)—paid 49 percent of the personal income tax collected, while accounting for 26 percent of AGI. The marginal tax rates range from 1 percent to 11 percent. The PIT tax base generally has conformed to the federal income tax laws since 1987 and includes a variety of deductions, credits, and income exclusions. The brackets and other basic elements are indexed for inflation.

The PIT is also the most sensitive of the state's taxes to changes in the rate of economic growth. The progressive structure of the personal income tax makes it highly "elastic" relative to personal income. In general, this means that income tax collections tend to rise by significantly more than 1 percent for every 1 percent increase in personal income, after accounting for inflation. The converse is also true, in that declines in "real" personal income in the state, as have occurred during the past two years, result in a more than proportionate decline in real income tax revenues.

The PIT Forecast. PIT collections are projected to reach $16.9 billion in the budget year, an increase of only 0.8 percent. Taking into account projected inflation as measured by the California Consumer Price Index (CPI), this translates into a decline in *real* income tax collections of 2.8 percent. The $16.9 billion is slightly *less* than the level of revenue the state received in 1990-91, which was prior to the addition of the 10 and 11 percent tax brackets. This illustrates the recession's severe impact on income tax revenues.

Proposed tax changes do not significantly influence the budget projections. The reinstatement of NOL deductions, required under existing law, reduces PIT collections by $86 million (the balance of the NOL effect is reflected in the B&C estimate). The net effect of other adjustments made to reflect 1992 legislation and other factors is essentially zero.

The "Clinton Factor." The forecast does include a small special adjustment, however, which is unrelated to state-level tax changes. Uncertainty over the potential for increases in federal tax rates on upper-income taxpayers has led the Department of Finance (DOF) to include an additional $220 million in the forecast for 1992-93 PIT revenues, partially offset by a reduction of $160 million in 1993-94 PIT revenues. In effect, the DOF anticipated that taxpayers would choose to accelerate the realization of some capital gains (including stock options) and other income into 1992, earlier than originally planned, in order to avoid the potentially higher 1993 federal tax rates. Based on information from December and January PIT collections, it appears that the acceleration adjustment was appropriate.

Salary and Wage Income Dominates PIT Base. Figure 4 indicates the relative importance of wages and various types of nonwage income in the PIT base. In 1990, the latest year for which final data are available, 63 percent of income was salaries and wages. Business and dividend income together accounted for 15 percent, while capital gains totaled 8 percent. As shown in Figure 5, however, the recession has taken a relatively greater toll on these latter sources of nonwage income than it has on income from salaries and wages. For example, the share of total taxable income attributable to salaries and wages is projected to

Figure 4

Personal Income Tax Liabilities By Source of Income, 1990

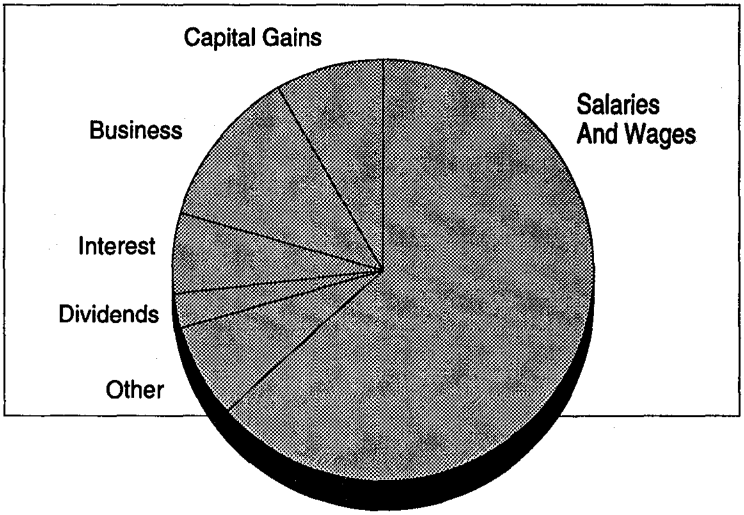
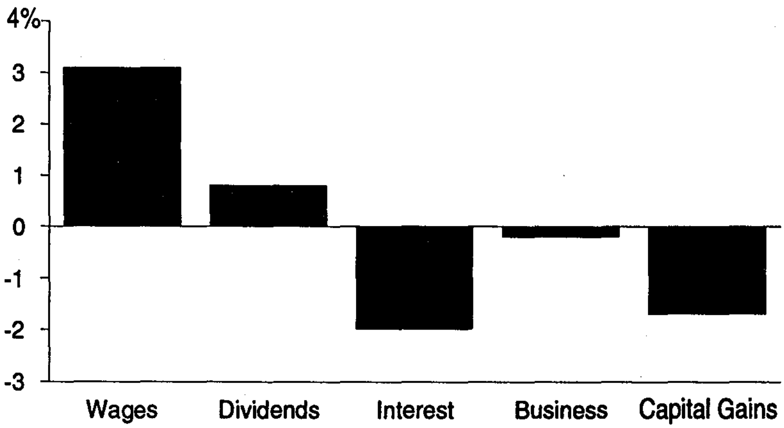


Figure 5

Changes in Shares of Taxable Income 1988 Through 1994

(In Billions)



increase by 3 percent between 1988 and 1994, while the shares attributable to interest and capital gains are projected to fall by about 2 percent each.

Capital Gains to Remain Weak. Capital gains have been one of the most volatile components of the income tax base in recent years. This results from changes in investor behavior in response to such factors as changes in tax rates, stock market fluctuations, and conditions in the real estate industry. The forecast assumes that capital gains realizations will fall by 10 percent in 1992 (to the lowest level in ten years), and then increase by 10 percent both in 1993 and 1994. In part, this projected weak performance reflects the fact that, although the share of total capital gains accounted for by sales of appreciated real estate has been increasing in recent years, the current declines taking place in commercial and residential asset values will dampen this increase.

The Forecast for Sales and Use Taxes

Background. Sales and use taxes are the second largest source of General Fund revenues. The tax is imposed primarily on retail sales of goods to consumers within the state. However, it also applies to many items purchased by businesses, such as capital goods or items consumed in the course of doing business. Examples include business machinery and equipment, stationery, and fixtures.

The "use" tax is imposed on products purchased by Californians from out of state for use and consumption within the state. Needless to say, many of the "use" items are difficult to track; a major exception is when automobiles purchased in another state are registered in California by either long-time residents or new immigrants.

Both the state and local governments levy sales and use taxes. The *state* tax rate is now 6.0 percent, including the temporary 0.5 percent rate scheduled to expire on June 30, 1993, and the 0.5 percent special fund rate levied to finance health and welfare program costs transferred to county governments under the 1991 program realignment legislation. A portion of the state's sales tax revenues—those generally derived from imposition of the sales tax on motor vehicles fuels—are deposited into special fund accounts for transportation purposes.

Local Sales and Use Taxes. Local governments also levy sales and use taxes, which are collected by the state on their behalf and are not included in the state revenue totals. These include the basic 1.25 percent Bradley-Burns tax rate levied by cities and counties, and a variety of other optional 0.5 and 0.25 percent tax rates levied for transportation, education, and general local government purposes. The maximum local tax rate may not exceed 2.75 percent in the aggregate, except in San Mateo County, which may levy an additional 0.5 percent if the proceeds are devoted to educational purposes. The actual local rates now imposed range from 1.25 percent to 2.5 percent, with the highest rate levied by the City and County of San Francisco.

The Sales Tax Forecast. General Fund sales tax collections are forecast to drop by approximately $850 million in 1993-94, following a fall of over $1 billion in 1992-93. The current-year decline reflects the recession's impact on taxable sales, as well as the voters' rejection in November 1992 of the so-called "snack tax" imposed in 1991. The budget-year decline, however, is entirely explained by the scheduled expiration of the state's temporary 0.5 percent tax rate, which reduces the 1993-94 forecast by slightly more than $1.4 billion.

Figure 6 illustrates the impact of the recession on sales tax collections by comparing changes in state personal income and taxable sales during the period 1990 through 1994. (For purposes of this figure, we have excluded those taxable sales associated with the "snack tax.") As these data indicate, total taxable sales generally move in step with personal income. Sales declined in response to the recession through the 1992 calendar year, but are expected to exhibit moderately strong growth (7.4 percent) in 1994, once the state's economy enters its projected recovery from the recession. This expected increase is less than the state has experienced during previous recovery periods, which reflects the relatively weak expansion projected by the DOF for the state and nation.

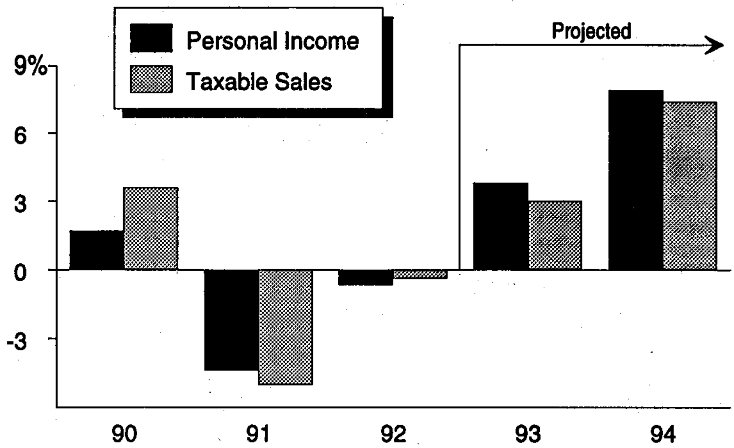
Figure 7 shows how two of the largest components of the sales tax base have been most affected by the recession. As these data indicate, the automobile and building materials categories have declined more drastically than total taxable sales, but are expected to rebound more strongly once the expansion begins.

The Forecast for Bank and Corporation Taxes

Background. Bank and corporation taxes are derived primarily from a 9.3 percent tax on taxable profits of corporations doing business in the state. This tax is projected to raise $4.9 billion in revenues in the budget year, which is a 1 percent increase over the projected 1992-93 level. In part, this low rate of increase reflects the effects of 1991 legislation suspending NOL deductions for 1991 and 1992 and reinstating them for 1993 and subsequent years. Adjusting for the effects of this legislation, 1993-94 B&C revenues would show a relatively strong rate of underlying growth—approximately 13 percent.

Figure 6

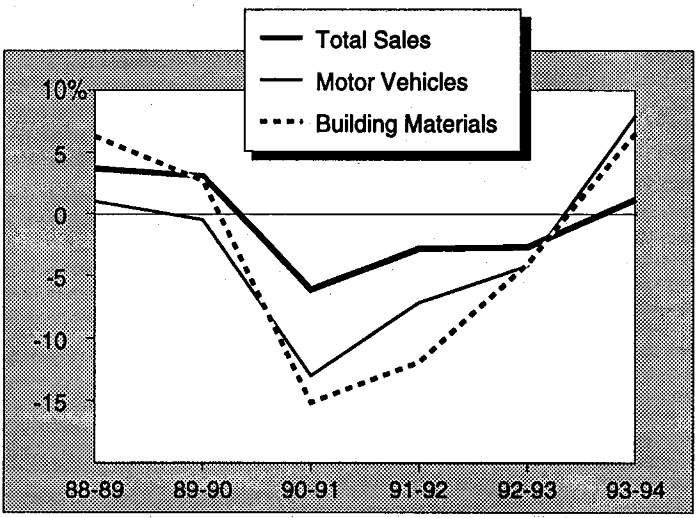
Comparison of Growth in Personal Income and Taxable Sales [a] 1990 Through 1994



[a] Excludes effect of "Snack Tax" in 1991 and 1992.

Figure 7

Growth in Real Taxable Sales 1988-89 Through 1993-94



Bank and Corporation Tax Collections Subject to Wide Fluctuations. Of the major state tax sources, the B&C tax is the most volatile and difficult to project. This is because of the economic and financial position of profits in business activity: they are the residual return to business owners after all business costs are paid. As such, they are influenced by a wide variety of factors, including contractual arrangements, market growth, competition from other firms, and investment decisions. During the past decade, B&C tax revenue growth fluctuated over a range between a minus 8 percent and a positive 27 percent.

Profits Expanding. The budget forecast anticipates that corporate profits will rebound strongly in 1992 and 1993, after declining in 1990 and 1991. This appears to reflect the expected recovery, as well as the combined effects of increasing productivity and a relatively low rate of growth in wages. Corporate staff downsizing programs, increased use of overtime, and other cost-cutting efforts do seem to be producing sizable productivity increases, according to recently released federal statistics. Nonfarm business sector labor productivity increased 2.7 percent in 1992, according to the U. S. Department of Labor, the highest rate of increase in 20 years.

Impact of NOL Deductions. The reinstatement of NOL deductions is projected to result in a $231 million reduction in B&C tax collections in 1993-94, which is about 5 percent of projected 1993-94 revenue. In years after 1993-94, revenue losses associated with the deduction are projected to increase substantially. This increase reflects a combination of factors, including:

- The ability of corporations to take the deduction was suspended during the past two years (1991 and 1992), so the deductions that otherwise would have been taken in these years will be taken in future years instead.
- Many businesses in the state have incurred large losses due to the long and serious state recession.
- The deduction is only available as an offset to future profits, so that the level of deductions claimed will rise as current profits recover from the recession.

The DOF estimates that B&C revenue losses due to the NOL deduction will climb from $231 million in the budget year to over $600 million by 1997.

Other General Fund Revenues

Other General Fund revenues are projected to decrease by $403 million (9.5 percent) in the budget year. This primarily reflects a drop in the amount of special fund monies to be transferred to the General Fund, following a large shift of these funds in 1992-93 for General Fund budget-balancing purposes. The budget anticipates that these transfers in 1993-94 will be about $371 million—less than half the amount transferred in 1992-93.

Reliability of the General Fund Revenue Forecast

As has been the case for several years now, the accuracy of the budget's revenue forecast hinges on one key question—when will California's current recession end? Job losses, personal income declines, and revenue shortfalls in the state are the worst since the Great Depression of the 1930s. It cannot be overemphasized that the most critical factor in making accurate forecasts of state revenues is making accurate economic forecasts. This is always the most difficult at turning points in the economy—when the state moves from expansion to recession or, as in the present case, from recession back to expansion. The past two years have been the most difficult for making such forecasts for California in the past half century.

The Past Two Forecasts Were Far Too Optimistic

Over the past several years, the economic forecasts contained in the Governor's Budget, and those developed for the May Revision, have been consistently wrong as to the timing of the state's recovery from recession. In each case, recovery was projected to have already begun or be "just around the corner," and the budget's revenue forecasts were based on this assumption.

As shown in Figure 8, there have been substantial downward revisions to the state's initial estimates of total General Fund revenue in each of the last three years. The shortfalls for 1990-91 and 1991-92, however, are actually *greater* than indicated in the table. Specifically:

- For 1990-91, the initial revenue estimate proved to be over $5 billion too high, after accounting for revenue legislation enacted along with the budget.
- For 1991-92, the budget forecast that General Fund revenues would total $45.8 billion, including approximately $2.8 billion of

revenue enhancements. Actual revenues for 1991-92 amounted to $42.0 billion, including about *$6 billion* of major revenue enhancements. Thus, this initial estimate was about $7 billion too high.

For 1992-93, General Fund revenues were initially projected at $45.7 billion, and now are forecast to come in at $40.9 billion, or $4.8 billion lower. (No major revenue enhancements were included in either figure.)

Figure 8

History of Governor's Budget Revenue Forecasts 1990-91 Through 1993-94

(In Billions)

Estimate Date	1990-91	1991-92	1992-93	1993-94
January 1990	$43.1	—	—	—
January 1991	40.4	$45.8	—	—
January 1992	38.2	43.6	$45.7	—
January 1993	—	42.0	40.9	$39.9

1993-94 Budget Takes a Conservative Approach

This year's economic and revenue forecasts in the Governor's Budget are more conservative than the initial forecasts made in the prior two years. The current forecast recognizes that the state's economy has been battered by the recession to an unprecedented and unforeseen extent and, despite signs of a national economic recovery, anticipates that the state's recovery will be slow in coming. In the longer run, however, the budget anticipates that the inherent strengths of the California economy will generate economic performance on a par with that of the nation.

Given the conservative nature of the budget's economic forecast, we believe that the major risks to the revenue forecast lie in three key areas.

Could the Recovery Be Delayed Beyond Late 1993? The budget anticipates that the state's employment losses will continue until the third quarter of 1993 and show modest gains thereafter through 1994. Because the state's 1993-94 fiscal year revenues are primarily derived from 1993 economic activity, any delay in the onset of recovery would cause significant reductions in state revenues.

Has the Recession Reduced the Predictive Power of Revenue Forecasting Models? The state's revenue forecasting models, which are based primarily on historical relationships between economic variables and tax receipts, are currently subject to greater-than-normal error margins. In part, this reflects the fact that the state has no relevant historical experience to guide it in forecasting revenues under severe recessionary conditions. In addition, there are concerns about the accuracy of federal data and economic statistics upon which the state's models must rely. Of special concern is the B&C forecasting model, where the reconciliation of actual tax receipts with reported profits data now requires extensive ad hoc adjustments.

What Impact Will Federal Policy Changes Have? Finally, there is substantial uncertainty as to the specifics of federal policy changes to be announced by the Clinton Administration. These policy changes could have both positive and negative effects in the short run. Among the more significant changes are the potential for further reductions in defense spending, the imposition of broad-based energy and other tax increases, and the possibility of increased federal assistance to state and local governments.

General Conclusion—Forecast is Reasonable

Based upon the most recent economic and revenue collection information available, we conclude that the budget's revenue estimates provide a reasonable basis for the Legislature to use in developing the 1993-94 budget. Although we have identified certain differences and potential risks associated with specific components of the forecast, these differences tend to be offsetting. Our findings include:

- ***Recent Improvements in PIT Collections.*** The performance of PIT collections in January was stronger than expected. Specifically, declarations of estimated taxes on 1992 income were about 8 percent higher than projected, and withholding was also up slightly. This performance may indicate that 1992 income tax liabilities were higher than forecast, which would tend to support a higher forecast of 1993 tax liabilities as well. Between the current and budget years, this stronger tax base could generate extra revenues, potentially in the $500 million range.

- ***B&C Estimates Too Strong.*** Our review of the B&C tax revenue estimate indicates that there is ample reason to be more cautious in this area. Specifically, we believe that the DOF's treatment of legislation enacted in recent years has led to an overstatement of actual profit levels. In addition, it is likely that the NOL deduction will reduce 1993-94 revenue collections by more than the budget estimates. These factors lead us to suspect that the forecast is at least $300 million too high.

- ***Effect of* Quill *Case Not Reflected.*** A recent U.S. Supreme Court decision (*Quill v. State of North Dakota*) has set back state efforts to require collection of sales taxes by out-of-state firms, particularly the rapidly growing mail-order industry. This court decision found that states have no authority to require firms without in-state premises to collect state sales taxes. Prior to the court's decision, the state had successfully persuaded a number of out-of-state firms to collect taxes on sales to California residents. The state had argued that these firms were in violation of its law, and the threat of legal action was sufficient to bring about compliance by many firms. At this point, in the absence of congressional action to prompt continued compliance (and the extension of collection responsibilities to other out-of-state firms), the existing collections of up to $100 million from out-of-state firms are at risk. Several small firms have already informed the state that they will no longer collect the tax, and others may do so as their current catalogs expire.

On the basis of the above factors, we conclude that the prospect of higher-than-expected PIT revenues generally offsets the risks associated with potential shortfalls in other areas of the forecast. Thus, for the Legislature's initial planning purposes, we conclude that the budget's forecast of current- and budget-year revenues provides a reasonable basis to proceed with the development of the budget plan. Revenue collections and economic data will need to be watched closely in the coming months, however, to allow for the early identification of significant deviations from these projections.

THE FORECAST FOR SPECIAL FUND REVENUES

Figure 9 presents the budget's forecast for special fund revenues in the prior, current, and budget years. These data indicate that special fund revenues are projected to total $11.5 billion in 1992-93 and $12.1 billion in 1993-94, which represents an increase of $0.6 billion, or 5.3 percent. Special fund revenues account for 24 percent of total state revenues in the budget year. The budget does not propose any major changes in special fund tax or fee structures for 1993-94. Under the terms of Proposition 111 (passed in 1990), however, a 1 cent increase in the motor vehicle fuel tax took effect on January 1, 1993, and a final 1 cent increase will take effect on January 1, 1994.

Figure 9

Special Fund Revenues 1991-92 Through 1993-94

(Dollars in Millions)

Source of Revenue	Actual 1991-92	Estimated 1992-93	Projected 1993-94	Change From 1992-93 Amount	Change From 1992-93 Percent
Motor Vehicle Revenues					
License fees (in lieu)	$2,943	$2,974	$3,041	$67	2.3%
Fuel taxes	2,458	2,428	2,625	197	8.1
Registration, weight, and miscellaneous fees	1,427	1,514	1,548	34	2.2
Subtotals	$6,828	$6,916	$7,214	$298	4.3%
Other Sources					
Sales and use taxes	$1,437	$1,546	$1,630	$84	5.4%
Cigarette and tobacco products tax	551	528	497	-31	-5.9
Interest on investments	109	85	79	-6	-7.1
Other	2,166	2,418	2,681	263	10.9
Subtotals	$4,263	$4,577	$4,887	$310	6.8%
Totals	**$11,091**	**$11,493**	**$12,101**	**$608**	**5.3%**

How Are Special Fund Revenues Used?

Figure 10 illustrates that motor vehicle license fees, fuel taxes, and other motor-vehicle-related fees are, by far, the largest category of revenues (60 percent). These funds primarily pay for transportation-related programs. Other sources of special fund revenues are earmarked for a variety of specific programs. Examples of special fund programs include the following:

- Around half of motor vehicle-related revenues are transferred to local governments, in part for their general purposes and in part for such programs as road maintenance and mass transit. The remaining funds are used for state programs such as the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), the Department of Transportation (Caltrans), and the Air Resources Board (ARB).

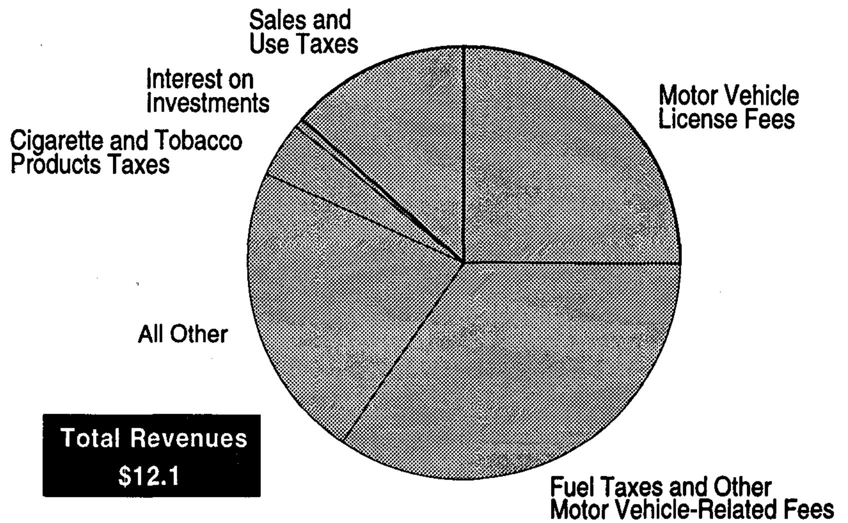
- Tobacco-related taxes imposed by Proposition 99 (separate from those imposed for the General Fund) are distributed to various state accounts, usually for health and natural resources programs.

- Oil and gas revenues have generally been used to fund capital outlay projects.

Given the severe budget problems faced by the state the past three years, where legally possible, special fund revenues have been transferred and loaned to the General Fund, in effect to finance the general functions of state and local government.

Figure 10

1993-94 Special Fund Revenues By Source



Motor Vehicle Fee Revenues

Motor vehicle fee revenue grew a rapid 38 percent over the two years from 1989-90 and 1991-92 because of major increases in registration fees and changes in vehicle license fee depreciation schedules. In contrast to this rapid past-year growth, the budget forecasts a 1.1 percent increase in the current year and a 2.3 percent increase in the budget year. In part, this reflects the recession's impact on new auto sales. Sales of new autos are not expected to increase significantly in the state until 1994.

Motor Vehicle Fuel Taxes

Reduced travel during the recession, both by residents and visitors, has resulted in an estimated decline of $30 million (1.2 percent) in motor vehicle fuel tax revenues in the current year, despite the 1 cent rise in the fuel tax rate. This is in contrast with the 82 percent increase in these revenues from 1989-90 through 1991-92 that resulted primarily from Proposition 111's tax rate increases. The budget-year forecast is for a $0.3 billion (8.1 percent) increase in these revenues for 1993-94. This reflects both the recovery and the final scheduled 1 cent tax increase next January.

Realignment Revenues Sluggish

As shown in Figure 11, about $1.4 billion of sales and use taxes and $741 million of vehicle license fee revenues will be deposited into the Local Revenue Fund in 1993-94. This represents an increase of $72 million, or 3.4 percent, in 1993-94. This brings the amount of total revenues deposited in this fund to a level slightly below that originally forecast for 1991-92, when the program realignment legislation was first enacted.

Figure 11

Local Revenue Fund Tax Receipts
1991-92 Through 1993-94

(In Millions)

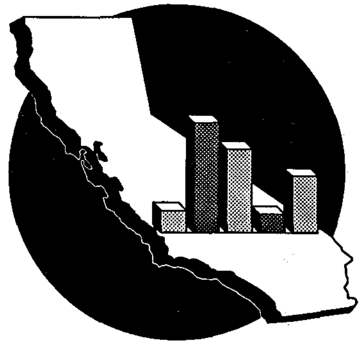
	1991-92	1992-93	1993-94
Sales and Use Taxes	$1,308	$1,366	$1,422
Vehicle License Fees	677	725	741
Totals	**$1,985**	**$2,091**	**$2,163**

Cigarette Tax Revenues Falling

The Cigarette and Tobacco Products Surtax is projected to decline 5.9 percent, to $497 million, in the budget year. In part, this reflects the large increase in the rate of the tax on tobacco products approved by the voters in 1988 (Proposition 99). The increased price, including federal as well as state tax increases, and continuing concern by the public over health effects have resulted in a pattern of declining consumption. On a per capita basis, consumption is expected to decline by approximately 4 percent in the current and budget years.

IV

Perspectives on State Expenditures



An Overview Of State Expenditures

State Spending Since 1982-83

Figure 1 illustrates the trends in state General Fund and special fund expenditures from 1982-83 through 1993-94. The figure shows expenditures in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars adjusted for the effects of inflation). This adjustment allows comparisons of the "purchasing power" of state spending over time.

As Figure 1 illustrates, state spending peaked in 1991-92 and is projected to decline in the current and budget years. This decline is without precedent in recent history—state spending has not registered a year-to-year reduction since the 1961-62 fiscal year. From 1982-83 through 1991-92, total spending increased at an annual rate of 8.1 percent (in current dollars) and, after adjusting for inflation, still grew by 5 percent annually.

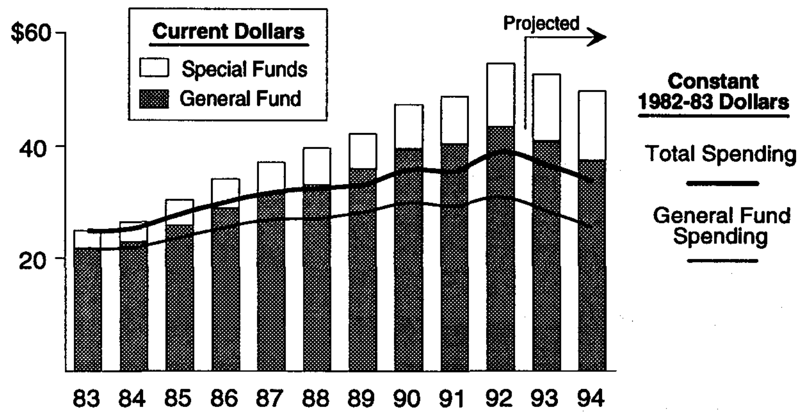
Proposed Current- and Budget-Year Spending

Figure 2 shows changes in the proposed level of spending for 1993-94. Total state spending is $49.7 billion, which is $3.0 billion, or 5.7 percent, *less* than estimated spending in 1992-93. This overall decline is the net result of a $3.5 billion reduction in General Fund spending, partially offset by an increase of $504 million in spending from state special funds.

Figure 1

State Spending[a]
Current and Constant Dollars
1982-83 Through 1993-94[b]

(In Billions)



[a] Excludes bond funds and federal funds.

[b] Data are for fiscal years ending in year shown.

Figure 2

Governor's Budget
Proposed and Adjusted Spending Changes
1992-93 and 1993-94

(Dollars in Millions)

	1992-93	1993-94	Change from 1992-93 Amount	Change from 1992-93 Percent
Budgeted Spending				
General Fund	$40,822	$37,333	-$3,489	-8.5%
Special funds	11,854	12,358	504	4.2
Totals shown in budget	**$52,676**	**$49,691**	**-$2,985**	**-5.7%**
Proposition 98 loan adjustments	-$110[a]	$540[b]	—	—
Adjusted total spending	**$52,566**	**$50,231**	**-$2,335**	**-4.4%**

[a] Net General Fund adjustment from repayment of 1991-92 loan (-$1,083 million) and new 1992-93 loan ($973 million).

[b] Revised by the Administration from $375 million cited in the budget documents.

Adjustments for Proposition 98 "Loans"

The budget's proposed spending reduction in 1993-94 is somewhat exaggerated, due to the treatment of loans to K-14 school districts. Figure 2 shows the budget's proposed spending changes after adjustments for these "loans." These loans are an accounting mechanism that treat state funding in excess of Proposition 98's minimum funding guarantee as a loan against future state Proposition 98 requirements. The loaned funds are not counted as state expenditures in the year in which schools and community colleges actually receive the funds. Instead, the loan amount is counted as state spending when it is applied against the Proposition 98 minimum funding guarantee in a subsequent fiscal year. (Please see the Proposition 98 portion of "Major Expenditure Proposals in the 1993-94 Budget," later in this part, for a more detailed discussion of these loans.)

Adjusting for the effects of the Proposition 98 loans in the current and budget years lessens the proposed 1993-94 spending reduction by $650 million. Thus, on the adjusted basis, the spending decline amounts to $2.3 billion (4.4 percent) rather than the stated decline of $3 billion (5.7 percent). The budget proposes a significant drop in General Fund spending, even after these adjustments.

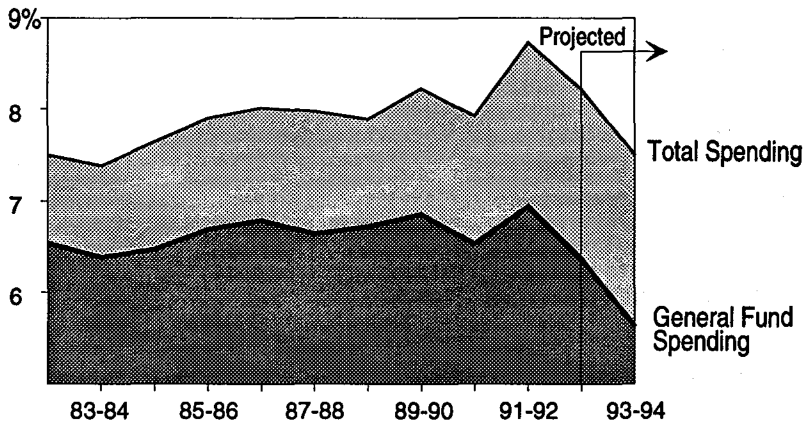
Spending in Relation to the State's Economy

Figure 3 shows how state spending has varied since 1982-83 as a percentage of personal income (which is an indicator of the size of the state's economy). From 1982-83 through 1989-90, total state spending generally increased as a percentage of personal income—from 7.5 percent to 8.2 percent. More than half of this growth was due to increased spending from special funds, which grew at an annual rate of almost 14 percent during the period.

Slow General Fund spending growth caused total spending to decline as a percentage of personal income in 1990-91. That decline was followed by a sharp rise in 1991-92 (to 8.7 percent). Two factors contributed to this rapid growth. First, tax increases and other actions taken to close the 1991-92 budget funding gap provided additional resources to finance rapidly growing program costs. Second, the recession had greatly reduced growth in personal income compared with past years. In addition, changes in accounting practices exaggerate somewhat the differences between 1990-91 and 1991-92. Spending in 1990-91 is understated because it excludes $1.2 billion provided to schools that year as an off-budget Proposition 98 loan, and 1991-92 spending is inflated by $1 billion due to a one-time accrual accounting adjustment for the Medi-Cal program. Taking all of these factors into account, the ongoing trend of state spending growing in proportion to personal income basically continued through 1991-92.

Figure 3

State Spending as a Percentage of Personal Income 1982-83 Through 1993-94



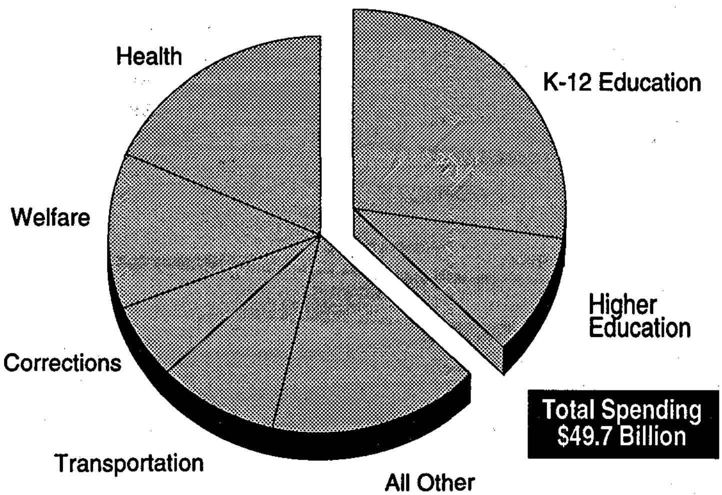
In the current year, as well as the proposal for 1993-94, state spending drops sharply as a percentage of personal income. Based on the budget's proposed spending and its projection of modest growth in personal income, total state spending in 1993-94 would fall to 7.5 percent of personal income—the same percentage as in 1982-83. This result, however, is attributable primarily to the budget's proposals to shift costs to the local and federal governments, as opposed to proposed reductions in programs.

State Spending By Program Area

Figure 4 shows the distribution of the proposed $49.7 billion of state spending in 1993-94 among the state's major program areas. The figure includes both General Fund and special fund expenditures in order to provide a meaningful comparison among program areas, since special funds provide the bulk of support in some areas (such as transportation). Also, including all state funds eliminates the distorting effects of past program funding shifts that have occurred between the General Fund and special funds.

Figure 4

Total State Spending By Major Program 1993-94



As Figure 4 shows, K-12 education receives the largest share of proposed state spending from all funds—28 percent. When higher education is included, education's share of total spending rises to 38 percent. The next largest shares of spending are for health programs (18 percent) and welfare programs (13 percent). The largest component of the "all other" category is $2.5 billion of general-purpose assistance provided to local governments in the form of vehicle license fee and homeowners' exemption subventions.

Spending from Federal Funds and Bond Proceeds

Debt service on general obligation bonds and lease-payment bonds is included in spending for the appropriate programmatic areas, as are direct expenditures on capital outlay projects from the General Fund and special funds. This gives a more complete picture of the current allocation of spending among programs. Spending from bond proceeds has *not* been included in these figures, however, because the spending of bond proceeds does not represent a *current* state cost. Instead, the cost of bond programs is reflected when the debt-service payments are made. The budget estimates that the state will spend $1.5 billion of general obligation bond proceeds in 1993-94. The majority of these bond fund expenditures are for transportation projects ($503 million), higher education facilities ($440 million), and prisons and jails ($276 million).

The budget also proposes to spend $29 billion of federal funds in 1993-94, including $1.4 billion that the Administration will seek from the federal government to offset state costs of services to refugees, immigrants, and their citizen children. The largest portions of these budgeted federal funds are for federal contributions to health and welfare programs ($19.1 billion), education ($6.2 billion), and transportation ($2.1 billion).

Including bond funds and federal funds, spending proposed in the budget for 1993-94 totals $80.2 billion—a decline of over $6 billion from the current year.

Spending Growth by Program Over Time

Figure 5 compares the annual growth rates of state spending for each major program area during the past ten years (1983-84 through 1992-93) and the proposed funding changes by program area for 1993-94. The figure reflects total spending from the General Fund and from state special funds. The difference between the trends of the last ten years and the current budget proposal is striking. Total state spending has grown at an annual rate of 8 percent during the last ten years, but the budget proposal would reduce overall spending by 5.7 percent in 1993-94. Further, the proposed reductions for several program areas contrasts sharply with their above-average historical growth rates.

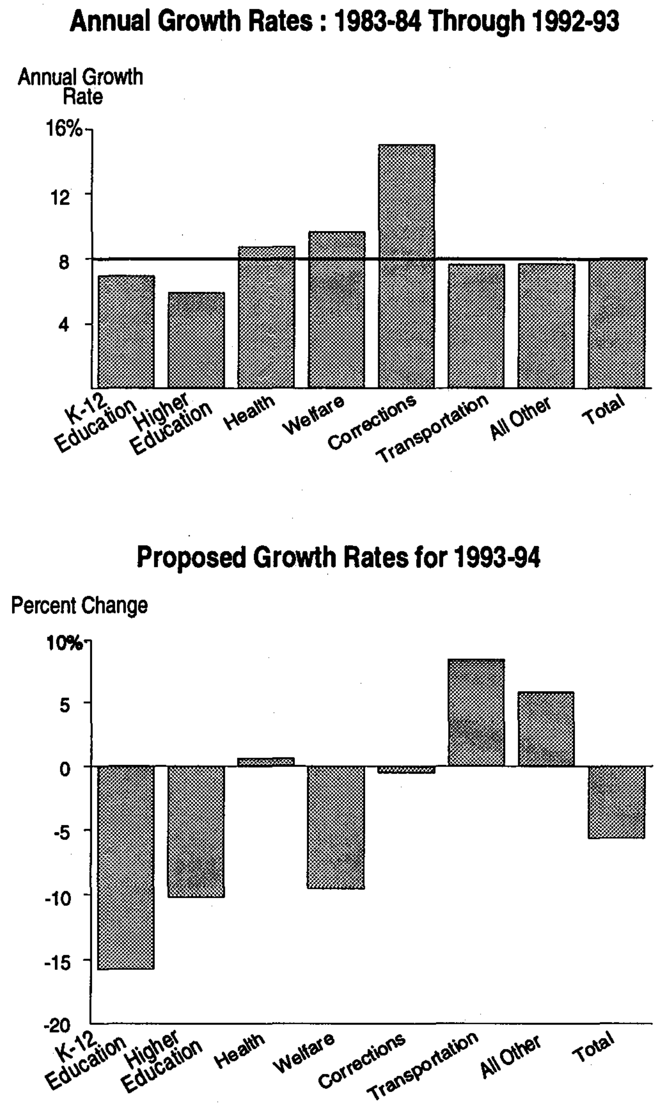
Corrections

The most rapid growth among the major program areas has occurred in Youth and Adult Corrections, for which spending has grown at an annual rate of 15 percent since 1983-84. The growth in corrections spending reflects the costs of supporting an increasing inmate population, which has risen at an annual rate of almost 12 percent since 1983-84, and the cost of paying off bonds used to finance prison and jail construction. For 1993-94, the budget proposes a slight funding reduction of $18 million (0.6 percent). However, the principal reason for the reduction is the Administration's assumption that the state will receive $250 million in funding from the federal government to pay for the cost of inmates who are undocumented immigrants. Including these requested federal reimbursements, proposed funding for Youth and Adult Corrections would increase by 7.6 percent in 1993-94.

Figure 5

Spending Growth For Major Program Areas

All State Funds



Health and Welfare

Spending on health and welfare programs (including state/local realignment funding and Proposition 99 funds) also has grown more rapidly than overall state spending. From 1983-84 through 1992-93, state spending for health and welfare has grown at annual rates of 8.8 percent and 9.7 percent, respectively, compared with the 8 percent overall rate of spending growth. A major reason for the spending growth has been an acceleration in caseloads. In 1984-85, for example, the number of persons receiving Aid to Families with Dependent Children (AFDC) benefits increased by 1.4 percent. In 1992-93, however, the budget estimates that the number of persons on AFDC will grow by almost 10 percent. Likewise, the growth in the number of Medi-Cal eligibles has risen from 3.6 percent in 1984-85 to an estimated 11.1 percent in 1992-93. Spending growth in health and welfare programs has a significant effect on budget totals, since these programs account for 30 percent of total state spending.

Figure 5 shows that, for 1993-94, the budget proposes essentially flat state funding for health programs (an increase of 0.6 percent) and a reduction of 9.6 percent for welfare spending. The budget also includes additional federal funding of $1.1 billion that the Administration is seeking from the federal government to cover state costs associated with providing health and welfare benefits to refugees, immigrants, and their citizen children. Including these additional federal funds in the year-to-year comparison results in health program spending increasing by 9 percent in 1993-94 and welfare spending declining by 4.4 percent (versus 9.6 percent for state funds only). If the additional federal funds are not forthcoming, the Administration proposes to make offsetting reductions, primarily in the health and welfare areas.

Education

During the past ten years, state funding for both K-12 education and higher education has grown somewhat more slowly than overall spending. The annual growth rates have been 7 percent for K-12 and 5.9 percent for higher education, compared with total state spending growth of 8 percent annually since 1983-84. This slower spending growth reflects the fact that, even though the number of students has increased faster than the state's total population, the number of students has grown relatively more slowly than has caseload in other programs. Over the ten-year period, K-12 average daily attendance (ADA) grew at an annual rate of 3.2 percent, and the number of students (full-time equivalents) at UC and CSU grew by only 1.2 percent annually. As discussed above, the numbers of prison inmates, Medi-Cal eligibles, and

AFDC recipients grew at much higher annual rates—11.6 percent, 6.7 percent, and 5.2 percent, respectively.

A funding shift also explains some of the slower apparent growth of education funding. As part of the 1992-93 budget solution, schools and community colleges received $1.4 billion of additional property tax revenue, which was diverted from local governments to offset state funding requirements.

For 1993-94, the budget proposes a reduction of $2.6 billion (15.8 percent) in state funding for K-12 education. The reduction in K-12 state funding, however, is more than offset by a $2.2 billion increase in the amount of property taxes shifted to K-12 schools from local governments, and by an off-budget Proposition 98 loan of $540 million in 1993-94. If these additional funds are included, then K-12 funding would *increase* by 2 percent in 1993-94 over comparably adjusted K-12 funding in 1992-93.

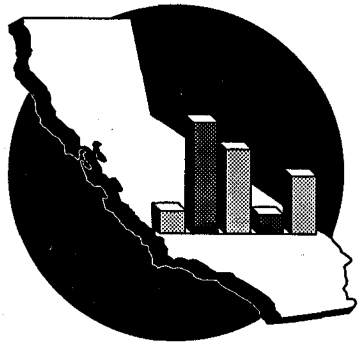
For higher education, the budget proposes a reduction of 10.3 percent in state funding in 1993-94. For the most part, this does represent a real funding reduction. Under the budget proposal, the community colleges also would receive an additional shift of property taxes from local governments ($400 million), but this gain is partially offset by the loss of $241 million from a one-time off-budget loan in the current year. The inclusion of these adjustments would still yield a reduction of 8.2 percent in higher education funding. The budget anticipates that a portion of this reduction may be offset by fee increases.

Transportation

Funding for transportation programs, including subventions to cities and counties for streets and highways, has grown at essentially the same rate as the overall budget since 1983-84. Unlike spending for most other programs, however, proposed state spending on transportation in 1993-94 continues to grow—increasing by 8.4 percent over estimated 1992-93 spending. The primary reason for this continued growth is that transportation spending is financed by its own revenue sources, including the gasoline tax. Proposition 111 authorized annual increases in the gasoline tax rate through 1994, so that transportation revenues have grown despite recession-caused declines in gasoline consumption.

Other Programs

Proposed spending for all other programs in 1993-94 appears to increase by 5.8 percent over 1992-93. This increase is misleading, however, because it reflects the budgeting practice of including in this category various statewide savings and costs that are not allocated among the individual program areas. For example, this spending category includes one-time savings in 1992-93 for retirement contributions for state employees in all program areas. In addition, proposed 1993-94 spending in this category includes funding for employee compensation increases required by bargaining agreements. These costs and savings will eventually be allocated to the other program areas when the final accounting for these years is completed. Excluding these statewide amounts, proposed funding for "other programs" falls by 3.9 percent in 1993-94.



Major Expenditure Proposals In the 1993-94 Budget

As discussed in Part One, the state continues to face severe fiscal constraints due to the ongoing recession. Balancing the 1993-94 budget will require large spending cuts and/or revenue increases, and these decisions will be especially difficult because many of the available options already have been used in recent years. The budget's General Fund expenditure proposals primarily rely on shifts of program costs to local governments and the federal government. Figure 6 lists the major budget-balancing expenditure proposals in the budget and indicates whether legislation or federal action is needed to implement them, as well as the timing assumed by the budget. The amounts of savings shown in the figure are budget estimates.

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 1993-94 Budget Bill.*

Proposition 98

Proposition 98 established minimum funding levels that the state must provide for K-14 education in each year. Generally, this is determined based on one of three so-called "tests." Specifically, the minimum funding level is equal to the greater of:

Figure 6

Summary of Major Budget-Balancing Proposals in the 1993-94 Governor's Budget

(In Millions)

Proposal	Legislation Required	Federal Action Required?	Effective Date	Savings 1992-93	Savings 1993-94
Property Tax Shift (Proposition 98)					
Cities, counties, special districts	Yes	No	7/1/93	—	$2,075
Redevelopment agencies	Yes	No	7/1/93	—	300
Enterprise special districts	Yes	No	7/1/93	—	150
Recapture of county SLIAG funds, one-time	Yes	No	7/1/93	—	70
Other Proposition 98					
K-12 loan for 1993-94	Yes	No	7/1/93	—	540
Current-year reversion	Yes	No	6/30/93	$315	—
Unallocated CCC cut/fees	Yes	No	7/1/93	—	266
Defer CCC loan repayment	Yes	No	7/1/93	—	121
Increased Federal Funding					
Reimbursements for state immigration-related costs	No	Yes	5/15/93	—	1,128
Provide remaining SLIAG funds	No	Yes	5/15/93	—	314
DDS regional centers: waiver for community-based service	No	Yes	1/1/93	18	28
Welfare Reductions					
AFDC grant reductions and other welfare reforms	Yes	Yes	3/1/93	32	467
SSI/SSP: no pass-through of federal COLA	Yes	No	1/1/94	—	69
Medi-Cal					
Eliminate some optional benefits	Yes	No	3/1/93	43	159
Higher Education					
Unallocated cuts and other shortfalls at UC/CSU	No	No	7/1/93	—	440
Trial Courts					
Shift additional funding to fees	Yes	No	7/1/93	—	71
Reduce funding	No	No	7/1/93	—	46
State Administration					
Downsize state agencies, Legislature, and courts	Possibly	No	7/1/93	—	197
Debt Service					
Cash accounting for bond interest payments	Yes	No	7/1/93	—	184
Special Fund Programs					
Special fund transfers to General Fund	Budget	No	7/1/93	—	226
Tax Expenditures					
Repeal renters' credit, starting 1992	Yes	No	Indefinite	395	445
Repeal small business health care credit	Yes	No	1/1/94	—	110

- ***Test 1—Percentage of General Fund Revenues.*** This is defined as the 1986-87 percentage of General Fund tax revenues provided K-14 education.

- ***Test 2—Maintenance of Prior-Year Funding Levels.*** This is defined as the prior-year level of total funding for K-14 education from state and local tax sources, adjusted for enrollment growth and for growth in per capita personal income.

In low revenue growth years, defined as years in which General Fund revenue growth, measured on a per capita basis, is more than one-half percentage point below the growth in per capita personal income, the minimum funding guarantee is based on:

- ***Test 3—Adjustment Based on Available Revenues.*** This is defined as the prior-year total level of funding for K-14 education from state and local sources, adjusted for enrollment growth and for growth in General Fund revenues per capita, *plus* one-half percent of the prior-year level. However, the increase in per-pupil funding must be at least equal to the increase in per capita expenditures for all other General Fund supported programs. This per-pupil funding floor (the so-called "equal pain, equal gain" or "Test 3b" provision) was intended to ensure that K-14 education is treated no worse, in years of low revenue growth, than are other segments of the state budget.

Other provisions of Proposition 98 allow the minimum funding level to be suspended by the Legislature and establish a "maintenance factor," which provides for restoration of funding levels in years following suspension or low revenue growth. These provisions ensure that any reductions in K-14 funding levels below those called for by the Test 1 or Test 2 formulas are only temporary in nature.

"Cash" Spending. In evaluating the effect of budget proposals, it is important to determine the amount actually available for K-14 programs ("cash" spending), as well as the Proposition 98 funding provided in a given fiscal year. Cash spending differs from Proposition 98 funding due to a variety of adjustments involving funding sources that are not recorded on the state's books at all or are not recorded in the fiscal year that the schools receive the funds. For example, community college fees are not shown in the state budget at all. In the case of loans, funds are received by districts in a different year than the expenditures are recorded on the state's books.

For a more complete discussion of Proposition 98 provisions and additional background on Proposition 98 funding levels, please see the "Overview of K-12 Education" in the *Analysis of the 1993-94 Budget Bill.*

Proposal

The thrust of the Proposition 98 budget proposal is to maintain per-pupil K-12 funding at the 1991-92 level in both the current year and 1993-94.

Current Year

The Proposition 98 funding requirement (from the General Fund and local property tax sources) is at a Test 3 level of $23.8 billion. This is $725 million ($526 million General Fund) less than the level provided in the 1992 Budget Act because of a decline in state tax revenues and a reduced estimate of K-12 enrollment. The General Fund reduction is less than the total reduction because the state has to make up a $199 million decline in estimated local property tax revenues.

The Governor's Budget proposes to reduce current-year Proposition 98 spending below the 1992 Budget Act level by $637 million ($438 million General Fund). This is $88 million above the funding requirement.

The budget reflects a total of $24.1 billion in *cash* spending in the current year, a decrease of $460 million from the amount assumed in the 1992 Budget Act. This consists of the reduction of $637 million in Proposition 98 funding, offset by $177 million in changes involving non-Proposition 98 funding. Because of slower-than-expected growth in K-12 enrollment, this reduced level of cash spending would maintain K-12 funding at $4,187 per pupil, the same level as provided in 1991-92.

Budget Year

The DOF estimates that the Proposition 98 funding requirement for 1993-94 is at a Test 3 level of $23.5 billion, $390 million less than proposed current-year funding. This reduction is primarily the result of a projected decline in per capita General Fund tax revenues. The budget proposes to fund Proposition 98 at this level. Within the funding requirement, however, the budget proposes to shift $2.6 billion in property tax revenues from local governments to schools and community colleges. This shift would reduce the state funding requirement under Proposition 98 by an equal amount, assuming that proposed revisions are made to Test 3b to adjust for the property tax shift. The budget also proposes not to implement a provision stating legislative intent that 1993-94 funding exceed the Proposition 98 minimum funding level by $100 million.

The budget reflects Proposition 98 cash spending of $24.2 billion, an increase of $40 million from the proposed 1992-93 level of cash spending. The proposed level of spending would support K-12 schools at the same level of per-pupil funding as provided in 1992-93. Major budget proposals include (1) a new loan of $540 million for K-12 schools, (2) an unallocated reduction of $266 million in community college spending, and (3) deferral of a scheduled $121 million loan repayment from the community colleges.

We discuss issues affecting the community colleges under "Higher Education" and issues affecting property tax revenues under "Local Government."

Issues for Legislative Consideration

Our analysis indicates that there are several issues which the Legislature may wish to consider in evaluating the Administration's proposal for funding Proposition 98 programs. These include:

Reduced General-Purpose Spending

Although the budget maintains overall per-pupil funding levels for K-12 Proposition 98 programs, the budget proposal is about $260 million short of funding the per-pupil level of school district general-purpose spending supported by the 1992 Budget Act and related legislation. This is because the budget, in effect, proposes to fund categorical program growth, augmentations, and initiatives at the expense of per-pupil spending for general purposes. General-purpose spending represents around three-quarters of K-12 Proposition 98 spending.

New Loan

In order to maintain overall per-pupil funding levels for K-12 programs in 1993-94, the budget proposes a new loan of $540 million for K-12 schools. If added to the current-year $732 million K-12 loan, the new loan would result in total K-12 loans of $1.3 billion.

Our analysis indicates that borrowing an additional $540 million from future Proposition 98 funding to maintain spending during 1993-94 would place the state at risk of borrowing more funds in 1994-95 simply to maintain 1993-94 levels of per-pupil funding in Proposition 98 programs.

Categorical Mega-Item: Governor's Proposal Falls Short

The Governor's Budget proposes to continue funding most categorical programs through a single mega-item, and appropriates $3.7 billion for this purpose. The budget proposal differs from the current-year categorical mega-item, in that local education agencies (LEAs) would be permitted complete flexibility to redirect mega-item funding to any program that is funded in the item. LEAs would receive the same amount of funds for mega-item programs as they received in 1992-93, plus 1.55 percent growth.

As an alternative to the budget proposal, which does not simplify programs at the local level, the Legislature may wish to consider a more thorough reform of the current system of categorical programs. In our *Analysis of the 1993-94 Budget Bill,* we identify principles that we believe would be useful in guiding such a reform effort.

HIGHER EDUCATION

California's system of public higher education is the largest in the nation, and serves approximately 2 million students. This system is separated into three distinct segments—the University of California (UC) with 9 campuses, the California State University (CSU) with 20 campuses, and the California Community Colleges (CCC) with 107 campuses. The UC awards bachelor's degrees and a full range of graduate and professional degrees. It accepts students in the top eighth of high school graduates. The CSU primarily awards bachelor's degrees and accepts students from the upper third of high school graduates. The CCC offers a variety of academic and occupational programs, and basic skills and citizenship instruction.

Proposal

The UC and the CSU

General Fund support for the UC and the CSU will total $3.2 billion in 1993-94, a reduction of 6 percent compared with the current year. We estimate that this amount is $429 million less than the amount needed to fully fund salary and price increases, and to replace instructional equipment.

The budget document does not include any details regarding how the reductions would be implemented. It also does not include any information on projected enrollment or proposed student fees. It indicates that the segments will propose specific plans for consideration during spring budget hearings, and indicates the Governor's support for fee increases to offset at least part of the funding reduction.

Although the budget does not propose any specific fee increases related to the 1993-94 budget, the budget *does* reflect a fee increase of $605 at the UC in 1993-94 related to the current-year budget. The regents currently plan to borrow up to $70 million to balance the UC's 1992-93 budget. This loan would be paid off over a five-year period with student fee revenue. The $605 student fee increase scheduled for 1993-94 provides approximately $50 million in ongoing support in 1993-94 and sufficient funds over a five-year period to pay off the $70 million loan.

Community Colleges

The budget proposes $882 million in General Fund local assistance for the community colleges in 1993-94, of which $841 million counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 1993-94 General Fund request represents a reduction of $388 million, or 31 percent, from the amount of General Fund spending shown in the budget for the current year. Considering all funding sources available to the community colleges, including property taxes, fees, and loans, the net reduction is $297 million, or 11 percent.

The General Fund reduction is the net effect of a number of major changes, including (1) an increase of $224 million in budget spending to partially support services funded by an off-budget Proposition 98 loan in the current year (the proposed 1993-94 Proposition 98 loan would only be for K-12 schools), (2) a reduction of $367 million that is offset by a proposed shift of additional property taxes from local governments to the community colleges, and (3) an unallocated reduction of $266 million.

The budget document also states that the Governor supports legislation to authorize the Board of Governors to raise fees from $10 per credit unit to $30 per credit unit. A fee increase of this magnitude would raise sufficient funds to almost entirely offset the unallocated reduction.

Issues for Legislative Consideration

As we noted above, the Administration has not offered its view on major issues affecting the higher education segments. The Legislature will have to "start from scratch" in addressing those key issues. For instance:

Enrollment Levels. Perhaps the most important higher education issue for the Legislature to address is enrollment. While the budget contains no enrollment figures for 1993-94, it is clear that the segments are struggling to meet current Master Plan goals. For instance, CSU is serving at least 20,000 students fewer than called for by the plan, and many community colleges have been rationing their enrollments for years. The current situation raises the issue of the terms of the "contract" the state has with Californians who wish to pursue higher education goals. Put another way, what access should Californians have to public higher education?

Management of Resources. One way for the systems to accommodate more students for a given amount of money is to improve the way existing resources are managed. For instance, by increasing the percentage of time UC faculty spend on teaching (versus research and other activities), the UC can serve more students with the same number of faculty, with no impact on class size. Similarly, increased application of educational technology and improved course management can translate into higher productivity.

Fees and Financial Aid. While the budget does not propose any specific fee levels, it offers the prospect of potentially large fee increases. Coming on the heels of large increases in preceding years, these potential increases raise certain fundamental questions: (1) How much of the total education costs should be borne by students and their families? (2) How can the state provide more certainty as to fee levels and the rate of change in fees? On a related issue, the Legislature will face the issue of how to allocate a shrinking amount of financial aid monies to a growing number of eligible students.

FEDERAL REIMBURSEMENT FOR IMMIGRANT-RELATED COSTS

California has experienced large amounts of foreign immigration over the last decade. The Administration estimates that about 2.3 million foreign immigrants (both legal and undocumented) came and stayed in California during the 1980s.

Immigration policy and enforcement is the responsibility of the federal government. The federal government also determines the eligibility of noncitizen immigrants for health and welfare benefits under programs such as Medicaid (Medi-Cal in California), AFDC, and SSI/SSP, which are supported jointly by federal and state funds. Thus, federal policies and laws that have allowed increased immigration and expanded health and welfare benefits to which immigrants are entitled have increased California's costs to provide the state's share of funding for these benefits. Furthermore, children born in the U.S. to immigrants (regardless of status) are automatically U.S. citizens, and are entitled to the full range of benefits available to any other citizen.

Proposal

The Administration is seeking a total of $1.6 billion of additional federal funds for services related to immigrants, refugees, and the citizen children of immigrants in 1993-94. Of this amount, $1.4 billion will offset state General Fund costs. These funds are included in the budget, which assumes that Congress will appropriate the funds by May 15, 1993, and that the state will receive the funds in 1993-94. Figure 7 lists the programs for which these federal funds are budgeted and the amount of General Fund savings that are assumed. The budgeted federal funds are related to a variety of federal requirements and past funding commitments that the Administration has identified.

State Legalization Impact Assistance Grants (SLIAG). Funding from SLIAG pays for services already provided to persons pursuant to the federal Immigration Reform and Control Act (IRCA) of 1986. That act established an amnesty program which allowed qualified undocumented immigrants to become legal residents. The act also established the SLIAG funding program to reimburse state and local governments for health, education, and public assistance grants and services provided to these legalized immigrants during the amnesty period. Through the current year, California has received a total of $1.63 billion of the $2.1 billion that the Administration estimates the state should receive as a minimum under the program. The budget assumes that California will receive the remaining $467 million of these funds in 1993-94, and that this will result in General Fund savings of $314 million (the remainder of the SLIAG funds will offset local costs or be used to provide discretionary services).

Refugee Act of 1980. The funding request includes $104 million to pay for the state's costs of providing Medi-Cal, AFDC, and SSI/SSP benefits for the first 36 months of residence by refugees, as required by the act. Federal funding for this purpose was provided at times in the past.

Figure 7

Federal Funding for State Immigration Costs 1993-94 Proposed General Fund Savings

(In Millions)

Program	Immigrant Categories	Amount
State Legalization Impact Assistance Grant (SLIAG)		
Medi-Cal	Legalized immigrants under the 1986 Immigration Reform and Control Act (IRCA)	$254
SSI/SSP		53
Food stamps		3
County Medical Services		2
AFDC		1
California Children's Services		1
Total SLIAG[a]		**$314**
Other Costs		
Medi-Cal	Citizen children, undocumented immigrants, legalized IRCA) immigrants, refugees	$574
AFDC	Citizen children, refugees	289
SSI/SSP	Refugees	15
Incarceration of undocumented felons	Undocumented immigrants	250
Total other costs		**$1,128**
Total budgeted federal funds		**$1,442**

[a] Excludes $153 million of unallocated SLIAG funds that do not offset required General Fund costs.

Citizen Children. The budget includes $240 million for the state's costs of providing AFDC benefits and Medi-Cal services to the citizen children of undocumented immigrants. No federal funding has been provided for this purpose in the past.

IRCA and Omnibus Budget Reconciliation Act of 1986 (OBRA) Medi-Cal Benefits. The budget includes $534 million for the state's costs of providing Medi-Cal benefits to newly legalized immigrants and to undocumented immigrants. The IRCA entitles newly legalized immigrants who are children, aged, blind, or disabled to full health benefits, and it entitles other newly legalized immigrants to emergency services, including labor and delivery, and prenatal and postnatal care. The OBRA requires states to provide emergency and labor/delivery services to undocumented immigrants.

Incarceration Costs. The budget assumes that the state will receive $250 million in federal funds for the cost of incarcerating undocumented immigrants who have been convicted of a felony in California. The IRCA authorizes federal reimbursement—subject to annual appropriations—for these state costs. However, Congress has never appropriated any funds for this purpose.

Alternative Program Reductions

In the event that the requested federal funds are not forthcoming, the Administration indicates that it would propose the following list of alternative reductions:

- ***Medi-Cal Optional Eligibility.*** Eliminate certain Medi-Cal optional eligibility categories, including medically needy adults and children (with some exceptions), and medically indigent children ($453 million).
- ***Medi-Cal Optional Benefits.*** Eliminate additional Medi-Cal optional benefits (beyond those already proposed for elimination in the budget), such as outpatient drugs and optometry ($356 million).
- ***Foster Care Rates.*** Delay foster care rate increases for group homes ($30 million).
- ***AFDC Homeless Assistance.*** Eliminate the AFDC Homeless Assistance Program ($31 million).

The Administration also states that it will seek to control Medi-Cal inpatient costs, for an $87 million savings. Furthermore, the Administration may seek additional reductions in other state services that are not federally mandated, such as services for developmentally disabled persons, rehabilitation services, nursing homes, and higher education.

Issues for Legislative Consideration

Unrealistic Deadline for Federal Action

The Governor's May 15 deadline for federal appropriations is not realistic. The next federal fiscal year does not begin until October, and Congress and the new Clinton Administration also face difficult budget decisions that will take time to resolve. Consequently, the Legislature almost certainly will have to make its budget decisions while the availability and amount of these federal funds remains uncertain.

This prospect necessitates a two-part strategy. First, the Legislature, along with the Administration, should continue to seek as early and as strong a commitment to funding as possible from Congress through the state's delegation. Second, the Legislature will need a contingency plan reflecting its priorities that it can put in place with the budget to make up for any shortfall in federal funding. Because the amount of federal funding is not likely to be certain until after the beginning of 1993-94, the contingency plan may require more solutions than the level identified by the Governor, in order to generate the same dollar savings during the remaining portion of 1993-94.

DEPARTMENT OF CORRECTIONS

The California Department of Corrections (CDC) is responsible for the incarceration, training, education, and care of adult felons and nonfelon narcotic addicts. It also supervises and treats parolees released to the community, as part of their prescribed terms.

Currently, the department operates 23 institutions, including a medical facility and a treatment center for narcotic addicts under civil commitment. The department also operates 38 fire and conservation camps. The department will activate two additional prisons before the end of the current year and a third new prison during the budget year. The Community Correctional Program includes parole supervision, operation of community correctional centers and facilities, outpatient psychiatric services for parolees and their families, and narcotic testing.

Proposal

The Governor's Budget requests $2.6 billion from the General Fund for support of the Department of Corrections (CDC) in 1993-94, an increase of 9.2 percent over the current year. This amount fully funds projected growth in the numbers of prison inmates and parolees, and provides an increase of 4.6 percent in funding per inmate. Moreover, the budget does not propose any significant policy or program changes to reduce inmate and parolee populations or to achieve savings in other ways in the budget year.

The budget's *total* spending figures assume that the CDC's General Fund costs will be reduced by $250 million in federal funds that the state is seeking to offset the cost of incarcerating undocumented immigrants who have been convicted of a felony in California (see our earlier discussion of the Governor's proposal for federal funds for immigration-related costs). However, the Budget Bill provides the full amount of General Fund support to CDC, so that the department's budget would be held harmless should the federal funds not materialize. In contrast, Budget Bill items for health and welfare programs already reflect the General Fund savings from the anticipated federal funds, and the Administration has proposed health and welfare program reductions to make up for any shortfall in federal immigration funding.

Issues for Legislative Consideration

The size of the 1993-94 budget shortfall will require the Legislature to consider budget-cutting options in *all* areas of the budget, including the CDC. Significant reductions in the CDC's budget would require reducing inmate and parole populations. In considering reductions to these populations, the Legislature should:

- Target reductions to nonviolent offenders.
- Target reductions to offenders incarcerated for very short periods.
- Consider greater use of enhanced community supervision (such as intensive parole or electronic monitoring) for offenders who would be redirected from the prison system.
- Consider greater use of other community-based sanctions in lieu of incarceration.
- Consider the impacts of any changes on local governments, particularly local law enforcement.
- Consider whether or how the reductions will affect crime in California.

In our *Analysis of the 1993-94 Budget Bill,* we offer a number of specific options for reducing the inmate and parole populations that we believe merit consideration.

Trial Court Funding

The Supreme Court, the courts of appeal, and the superior, municipal, and justice courts make up the components of the California judicial system. The Supreme Court and the courts of appeal are entirely state-supported. The state and the counties share the costs of supporting the trial (superior, municipal, and justice) courts. State expenditures for trial court operations are partially offset by a portion of the fines, fees, and forfeitures collected by the courts. The fines, fees, and forfeitures transferred to the state pursuant to Ch 90/91 (AB 1297, Isenberg) are deposited into the General Fund, while the fees collected pursuant to Ch 696/92 (AB 1344, Isenberg) are deposited into the Trial Court Trust Fund. These fines, fees, and forfeitures, once collected by the trial courts and remitted to the state, are then redistributed back to participating counties.

Proposal

The Governor's Budget proposes total expenditures of $706 million for support of the Trial Court Funding Program. This amount is $45.7 million, or 6.1 percent, below estimated expenditures in the current year. The budget proposes significant shifts in funds to support the program, including a General Fund decrease of $125 million to trial court block grants and an increase of $71 million from fees deposited in the new Trial Court Trust Fund.

Issues for Legislative Consideration

There are a number of policy issues for the Legislature to consider regarding the Trial Court Funding Program.

Expenditure Level. For the second year in a row, the budget proposes to provide significantly less funding for the program than the amount needed to comply with previous statements of legislative intent. Specifically, existing law indicates that the state should support 60 percent of trial court costs, but the amount proposed in the budget would support only about 46 percent of these costs. In order to reach the 60 percent level, the budget would have to be augmented by $218 million.

Revenue Sources. The program has become increasingly dependent on revenues from fees and penalties generated at the local level, which are transferred to the state and used to finance trial court funding. As a result, the program has increasingly become a *redistribution* program.

Failure to Meet Expectations. The purposes of the Trial Court Funding Program are to (1) increase state funding for the trial courts, (2) transfer local court revenues to the state for a net benefit (at least in the short term) to the General Fund, and (3) improve the public's access to justice through the implementation of a number of court operating efficiencies and cost savings measures. In our view, the program has failed on the first two counts, and had mixed results on the third.

Please refer to the "Judiciary and Criminal Justice" section of our *Analysis of the 1993-94 Budget Bill* for a more complete discussion of these issues.

WELFARE REFORM

The bulk of the state's expenditures on welfare programs are for benefits in two programs known as AFDC and SSI/SSP. Both the state and federal governments fund these programs. In the current year, the budget estimates that the General Fund cost of these programs will be $2.9 billion for AFDC and $2.3 billion for SSI/SSP.

Aid to Families with Dependent Children (AFDC) provides cash grants to qualifying families with children whose incomes are not sufficient to provide for their basic needs. The largest component of the AFDC caseload is for the program component termed AFDC-Family Group (AFDC-FG), in which a family's financial need is related to the death, incapacity, or continued absence of one or both parents. Other program components provide for unemployed families with children and for children in foster care. The federal government shares the cost of AFDC grants with the state and (to a much smaller extent) the counties.

The Supplemental Security Income/State Supplementary Program (SSI/SSP) provides cash assistance to low-income persons who are elderly (age 65 or older), blind, or disabled, with the disabled being the largest group of recipients. The federal Social Security Administration, which administers the program, pays the cost of the SSI grant. California has chosen to supplement the federal payment by providing a state-funded SSP grant.

Proposal

The Governor's proposed welfare reform package generally consists of those components of last year's proposal (contained in the *1992-93 Governor's Budget* and Proposition 165) that were not enacted, with some modifications and additions. The net General Fund savings of the welfare reform proposals, as estimated by the budget, is $32 million in 1992-93 and $467 million in 1993-94, including related costs for administration and employment services programs. The major proposals are summarized below:

- ***Across-the-Board Grant Reductions.*** These account for the bulk of the savings. The budget proposes a 4.2 percent reduction in the AFDC maximum aid payment (MAP) and an additional 15 percent reduction for families that have an able-bodied adult and are on aid more than six months. The impact of the reductions would be primarily on nonworking recipients—those who currently get the maximum grants. The grant reductions would be partially offset by increases in federally funded food stamps. These grant reductions are proposed to take effect March 1, 1993, for a net savings (after administrative costs) of $40 million in 1992-93 and $367 million in 1993-94.

- *Maximum Family Grant.* Under this proposal, the MAP, which increases with family size, would not increase for a child born after the parent has been on aid for nine months. (In effect, the MAP would not increase for children conceived while the family is on aid.)

- *Expansion of Earned Income Disregard.* The budget proposes to remove the current four-month limit on the ability of working recipients to disregard about one-third of their earnings in calculating the amount of income that acts as an offset against their grant. This change would have the effect of increasing the grants for recipients who work for more than four months. The federal administration has approved a necessary waiver, contingent on funding the initial costs ($26 million), which are proposed in the 1993-94 budget.

- *Reduction in Pregnancy Benefits.* AFDC pregnancy-related payments would be eliminated, except for the federally assisted program, which provides payments during the last trimester of pregnancy.

- *Teen Parent Provisions.* The budget proposes to establish the Cal Learn Program, which would provide grant penalties based on secondary school attendance, and bonuses based on progress in school. The budget also proposes to require parents under age 18, with some exceptions, to reside with their parents, legal guardian, or adult relative in order to receive AFDC.

- *Expansion of the Greater Avenues for Independence (GAIN) Program.* The budget proposes to increase state funding for the GAIN Program, which provides employment training and education to AFDC recipients, by $15 million in the current year and $41 million in the budget year.

In our *Analysis of the 1993-94 Budget Bill,* we review these proposals in detail in our "Health and Social Services" section and offer several alternatives for legislative consideration, including proposals that have recently been implemented, on a demonstration basis, by other states.

Issues for Legislative Consideration

The goals of the budget proposal are to achieve current and future General Fund savings and to enhance the self-reliance of AFDC recipients so they can find jobs, improve their living standard, and contribute to the state's economic growth. The budget proposes to accomplish these goals by (1) reducing the size of grants, (2) increasing incentives and opportunities for AFDC recipients to work or continue their education, and (3) removing perceived incentives in the current system for women on aid to have more children. However, the proposal raises several significant issues.

Impact on Families. Will the reduced grant amounts be adequate to cover the basic living costs of families, especially in high-cost urban areas?

Effectiveness of Work Incentives. Will the grant reductions and the GAIN augmentation provide adequate incentives and opportunities for employment to AFDC recipients in order to achieve the dependency savings that are assumed in the budget? Also, employment may not be feasible or cost-effective for many recipients (for example, women with several young children requiring child care).

Timing and Feasibility. Many of the proposed AFDC changes require waivers of existing federal requirements. They also require enactment of state legislation to authorize the changes, and administrative and regulatory actions to implement them. The budget assumes implementation of the basic grant reductions by March 1, 1993, and implementation of the other proposals by July 1, 1993. This schedule appears to be too optimistic, given the number of steps involved, the complexity of some of the issues, and administrative requirements. Furthermore, court challenges could impose unanticipated delays. Consequently, the Legislature should take these factors into account in estimating the realistic level of savings that adoption of any of the AFDC proposals could achieve during the current and budget years.

MEDI-CAL

The California Medical Assistance Program is a joint federal-state program that is intended to assure the provision of necessary health services to public assistance recipients and to other individuals who cannot afford to pay for these services themselves. Federal laws establish a set of minimum eligibility criteria and the basic scope of benefits to be provided, and the states may provide for additional categories of eligibility and benefits at their discretion. Funding for most services provided under California's program is split equally between the state and federal governments. The budget estimates that the General Fund cost of the Medi-Cal Program will be $5.5 billion in the current year.

Proposal

The budget proposes the enactment of legislation, effective March 1, 1993, to eliminate 9 of the 28 optional service categories in the Medi-Cal program, for a General Fund savings of $47 million in 1992-93 and $172 million in 1993-94. These savings would be partially offset by additional costs of $3.7 million in the current year and $12.7 million in the budget year in the Department of Developmental Services, in order to maintain these services for Regional Center clients.

The services that would be eliminated are: adult dental; nonemergency transportation; medical supplies, excluding incontinence; speech and audiology; psychology; acupuncture; podiatry; chiropractic; and independent rehabilitation centers. Most of the savings would result from elimination of adult dental services. The budget proposes to continue these services for children under age 21, persons in long-term care facilities, and developmentally disabled clients.

Issues for Legislative Consideration

Potential for Cost-Shifting. In some cases, savings to the Medi-Cal program could result in shifting costs to other health programs. For example, elimination of adult dental care could result in untreated dental problems that later require more expensive emergency medical treatment. The Legislature should examine the cost-shifting potential for the optional services proposed for elimination, in order to determine the likely net savings and whether alternatives are needed to prevent shifts to higher-cost services.

Renters' Tax Credit

The renters' credit is a personal income tax credit that is available to low- and moderate-income Californians who are not homeowners.

Unlike other tax credits, however, the renters' credit is fully refundable—meaning that renters receive the full amount of the credit, even if their tax liability is less than the amount of the credit. Persons who have no tax liability may file a separate claim for the credit. For budgeting purposes, the entire cost of the credit, including the revenue loss, is counted as spending. Approximately two-thirds of the total cost of the credit is for the "refundable" portion (payments in excess of tax liability). The maximum credit is $120 (for a joint return).

Proposal

The budget proposes to eliminate the renters' credit program beginning in 1992-93. Elimination of the program would reduce General Fund expenditures for tax relief by $395 million in the current year and $445 million in 1993-94. The budget projects that, if the renters' credit is eliminated for tax year 1992, costs in 1992-93 to pay outstanding claims for preceding tax years will be $30 million. The proposal is contingent on the enactment of legislation, which is needed to eliminate the program.

Issues for Legislative Consideration

Retroactive Action. By proposing elimination starting with the 1992 tax year, the budget, in effect, is proposing a *retroactive* tax increase for those who qualified for the credit in 1992. This raises the general tax policy issue of the fairness of retroactive tax changes.

Proposal Unlinks Renters' Credit and Homeowners' Exemption. The Homeowners' Exemption and the predecessor to the renters' credit program were established simultaneously to mitigate rapidly rising property taxes in the late 1960s and early 1970s. The relative significance of the amount of relief provided to homeowners and renters has diminished over time, however. In addition, the passage of Proposition 13 in 1978 (1) has provided massive tax relief for both homeowners and renters and (2) prevents the rapid rise in property taxes that provided the original rationale for establishing these programs. Eliminating the renters' credit program would eliminate tax relief benefits for renters, while maintaining them for homeowners. The budget offers no policy justification for this choice. We believe that a better approach would be to seek the prospective elimination of *both* programs. This action would free up over $800 million annually to programs that are effective and are a higher priority to the Legislature. (Please see Item 9100 in the *Analysis of the 1993-94 Budget Bill* for a more detailed discussion.)

LOCAL GOVERNMENT PROPERTY TAX TRANSFER

Property taxes are the largest source of general purpose revenue available to local governments. Cities, counties, special districts, and redevelopment agencies depend upon these revenues to provide a wide variety of programs and services to California residents.

Recognizing the important role property tax revenues play in local government finance, the Legislature acted in 1979 to offset substantially the property tax losses local governments experienced as a result of Proposition 13. Specifically, the Legislature adopted a permanent fiscal relief mechanism which (1) shifted about $800 million of school and community college (K-14) district property tax revenues to cities, counties, and special districts (the so-called "AB 8" shift), and (2) assumed financial responsibility for approximately $1.3 billion of county health and welfare program expenses, thereby reducing financial strain on county general tax revenues. The property taxes shifted from schools to local governments were offset by higher allocations of state aid to K-14 education. Thus, the cost of the Proposition 13 "bailout" program for local governments (excluding schools) was about $2.1 billion in 1979-80.

Proposal

Due to the state's severe fiscal condition, the Administration indicates in the budget document that it is eliminating the Proposition 13 "bailout" of local governments. Specifically, the budget proposes to shift $2.6 billion in local government property tax dollars to K-14 districts in 1993-94. This shift would be *in addition* to the permanent redirection of $1.1 billion in property tax revenues to K-14 districts in the current year.

Figure 8 shows the allocation of property tax revenues between local governments and schools in 1991-92, 1992-93, and proposed in the budget for 1993-94. It is important to note that, although Figure 8 shows that K-14 districts would receive *more* property tax dollars under the budget proposal, total revenues for K-14 education *would not* increase. This is because the Administration proposes to *decrease* state funding for K-14 education on a dollar-for-dollar basis.

Figure 9 sets forth the details of the Administration's property tax shift proposal. As the figure indicates, the budget document does not state how almost $2.1 billion of the proposed $2.6 billion property tax shift is to be distributed or accomplished. Instead, the Administration intends that such a plan be developed collaboratively between the state and local governments.

Figure 8

Allocation of Property Taxes Between Local Government and Schools 1991-92 Through 1993-94

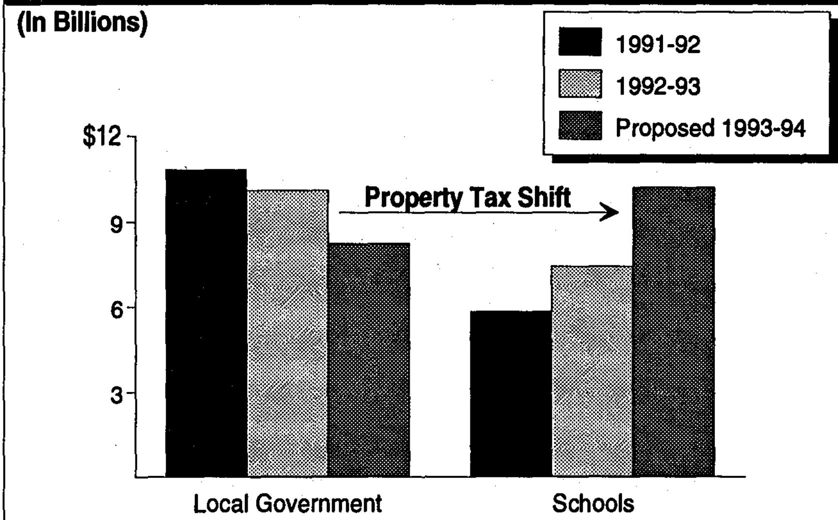


Figure 9

Components of the Proposed Property Tax Transfer

(In Millions)

Local Government Agency Affected	Amount Shifted to Schools	Methodology
Cities, counties, and special districts	$2,075	Unspecified.
Redevelopment agencies	200	Require transfer of funds in an amount equal to 16 percent of property tax increment.
Redevelopment agencies	100[a]	Limit allocation of property increment to amount needed to pay debt service.
Enterprise Special Districts	150	Eliminate entire property tax allocations for enterprise activities, except transit and hospitals.
Counties	70	One-time reduction in county property taxes to reflect projected increase in federal SLIAG monies.
Total	**$2,595**	

[a] This budget proposal would also shift $80 million from redevelopment agencies to counties, cities, and special districts.

Issues for Legislative Consideration

The magnitude of the proposed revenue transfer, the lack of a plan by the Administration, and the complexity of local government finance make this budget proposal one of the most difficult the Legislature will consider this year. We outline some of the important issues for legislative consideration below.

Impact of Budget Reduction On Total Local Government Revenues

The cumulative effect of the current-year and proposed budget-year property tax transfers would be to shift 31 percent of local government property tax revenues to K-14 districts. As Figure 10 indicates, this property tax shift represents a loss of about 4.1 percent of *total* local government revenues in the budget year—or a total of 5.8 percent over the two-year period.

While the percentage reductions shown in the figure may appear lower than reductions sustained recently by many state agencies, our analysis indicates that, in some cases, these funding reductions are *not* comparable. This is because the state has greater ability than some local governments to reduce expenditures. About 88 percent of all county expenditures, for example, are *required* by state or federal governments, and the counties have little control over this spending. Our analysis indicates that counties have discretion over the expenditure of only about $3.1 billion statewide. The current-year property tax shift, therefore, represents a 16 percent reduction in county discretionary spending. The proposed property tax shift (depending on the share allocated to counties) would bring the cumulative reduction in county discretionary spending to *50 percent or more.*

Role of Local Government in Resolving State's Fiscal Crisis. Despite the magnitude of this proposed local government revenue transfer, our review indicates that this does *not* constitute elimination of the Proposition 13 "bailout" to local government, as suggested by the Administration.

Specifically, the budget proposes to shift a total of $2.3 billion from agencies that benefitted from the Proposition 13 fiscal relief program (cities, counties, and special districts). As we show in Figure 11 (see page 84), however, the current value of the Proposition 13 bailout is approximately $6.1 billion. This estimate incorporates the current-year property tax shift and 14 years of growth in assessed value and health and welfare program costs. It does not, however, reflect other fiscal transactions between state and local government that have occurred since 1979-80—such as trial court funding changes and the transfer of financial responsibility to counties for medically indigent adults.

Figure 10

Local Government Impact of 1992-93 And Proposed 1993-94 Budget Cuts

(Dollars in Millions)

Type of Local Agency	Property Tax Shift	Total Revenues[a]	Percent Reduction
1992-93			
Counties[b]	$525	$25,036	2.5%
Cities	200	22,468	0.9
Special districts	375	14,504	2.6
Redevelopment agencies[c]	200	1,946	10.3
Totals	**$1,300**	**$63,954**	**2.0%**
1993-94 Proposed			
Counties, cities, and nonenterprise special districts (unallocated)	$2,075	$50,879	4.1%
Redevelopment agencies[d]	380	1,946	19.5
Enterprise special districts	150	11,129	1.3
Counties	70	—	—
Counties, cities, and nonenterprise special districts–unallocated tax gain[e]	-80	—	—
Totals	**$2,595**	**$63,954**	**4.1%**
Two-Year Totals	**$3,695**	**$63,954**	**5.8%**

[a] All revenue figures are 1990-91 data, except special districts (1989-90 fiscal year). Revenues include local taxes, state and federal aid, and user charges.
[b] City and County of San Francisco included in county totals.
[c] Redevelopment agencies funding reduction in 1992-93 was one-year only.
[d] Governor proposes to maintain the 1992-93 agency reduction ($200 million) and modify agency Statement of Indebtedness (SOI) calculations ($180 million). We estimate that modifications to the SOI will reduce agency funding by $300 million—or $120 million more than estimated by the Administration.
[e] Administration estimates that increases to city, county, and special district property tax revenues will be $80 million as a result of modifying agency SOI. We estimate that it will be $135 million.

The Administration's proposal, therefore, would take *more* than the estimated remaining value of the "AB 8" property tax shift, but *less than half* of the current value of the total Proposition 13 "bailout".

Our review also indicates that the budget proposal is inconsistent with its stated purpose of eliminating the bailout in two other ways:

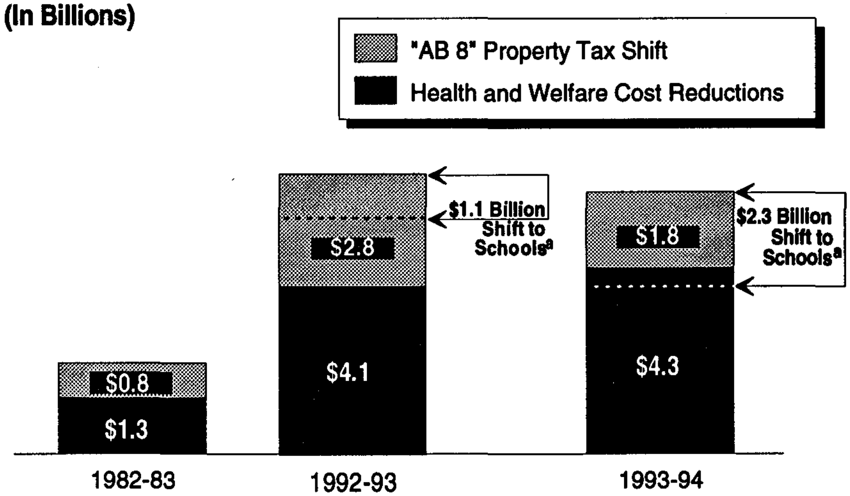
- It would take property taxes away from local agencies that did not benefit from the Proposition 13 fiscal relief package (such as redevelopment agencies).

- Local agencies that already lost all their Proposition 13 fiscal relief in the current year would face further property tax reductions.

Figure 11

Property Tax Shifts Reduce Value Of Proposition 13 Local Government "Bailout"

(In Billions)



[a] Excludes portions of property tax shifts relating to redevelopment agencies (which received no Proposition 13 bailout) and 1992-93 one-time related shifts.

Given the severity of the state's fiscal crisis, it is inevitable that some portion of the budget solution will be borne by local governments. Rather than considering this budget proposal in the context of a 14-year old fiscal relief program, however, we recommend that the Legislature consider this proposal in light of the relative need for state and local programs—and the appropriateness of the property tax to finance these needs.

Local Governments' Dependence Upon the Property Tax

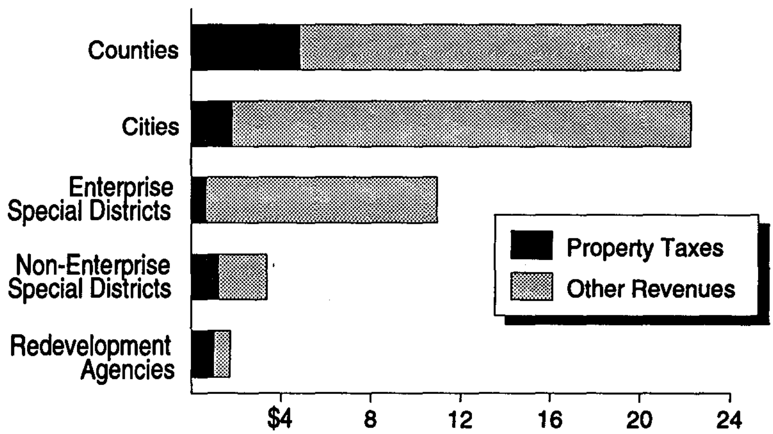
Local governments vary considerably in their dependence upon the property tax. This great variation will make the Legislature's task in allocating any property tax reduction much more complex.

Figure 12 shows the dependence on the property tax across local governments. Reliance upon the tax ranges from a high of about 61 percent for redevelopment agencies to less than 4 percent for enterprise special districts. There are also, however, very significant differences *within* groups of local government. Older cities, for example, tend to be much more dependent upon property tax revenues than newly incorporated cities (which receive relatively low allocations of property tax revenues). Similarly, counties without large retail establishments tend to depend more heavily upon property tax revenues than counties with auto malls and regional shopping centers in their unincorporated areas. Finally, fire protection, cemetery, flood, water conservation, and recreation and park districts depend on property taxes more than many other special districts.

Figure 12

Local Agency Dependence on Property Taxes
Property Taxes Relative to Other Revenues[a]

(In Billions)



[a] Excludes City and County of San Francisco. Data are for 1990-91 (1989-90 for special districts). Figures have been reduced to reflect the 1992-93 property tax shift.

Impact on Programs and Services

Almost all expenditures by special districts and cities are for traditional municipal programs, such as police and fire protection, and parks and recreation programs. Reducing one of the largest sources of general purpose revenues to these local agencies, therefore, inevitably will reduce the level of services provided under these programs.

The proposed property tax reduction for counties also would result in a decrease in funding for traditional municipal programs—although for somewhat different reasons. Unlike special districts and cities, counties provide a great variety of programs and services to California residents (from indigent health care to jails and elections). As we discussed above, however, about 88 percent of county expenditures are required by state or federal law, leaving counties direct control over the expenditure of only about $3.1 billion. These county discretionary funds are spent for public protection and other traditional municipal service programs. Unless the Legislature acts to give counties greater discretion over their budgets or access to other sources of funding, property tax losses will necessarily reduce county municipal service programs.

Finally, California's redevelopment agencies (RDAs) also would experience severe program reductions under the budget proposal. This is because the budget proposal (1) maintains the current-year requirement that RDAs transfer to schools an amount equal to 16 percent of agency property tax revenues and (2) further limits agency property tax revenues to the dollar amount needed to pay that year's debt service. Aside from the difficulties this may pose for existing RDA programs, it also raises the concern that RDAs will (1) cease all new urban revitalization and low-income housing construction activities and (2) shift costs to administer existing programs and repay debt service to cities and counties, requiring further cutbacks by these agencies.

Impact on New Development

Virtually all new developments—residential, commercial, and industrial— impose increased costs to local governments. New housing subdivisions, for example, enlarge the population needing public services. New manufacturing centers increase traffic and demand for water and solid waste disposal services.

Currently, many of these increased public costs are fully offset through the payment of property taxes by owners of new developments. By transferring a substantial amount of local government property tax revenues to K-14 districts as proposed, however, property tax revenues from new developments will offset *much less* of their public cost to local governments. As a result, local governments will have less incentive to rezone land or make other changes required in the process of approving new development projects.

Ability to Raise Revenues to Replace Loss of Property Taxes

While local governments have authority to levy assessments, charge fees, and impose a variety of taxes, our review indicates that these revenue sources will not be sufficient to offset the proposed property tax losses.

Most local governments, for example, have authority to levy benefit assessments and institute user charges. These revenue sources only can be used, however, to recapture the cost of providing a specific benefit to a group of property owners or service users. Thus, special districts may collect assessments or fees to cover the cost of providing flood protection, lighting services, or recreational programs, but counties may not use assessments or fees to pay for general governmental programs, such as elections, or for their required share of AFDC costs.

Cities and counties also have authority to institute a variety of taxes, including utility users', business license, property transfer, and transient occupancy taxes. These taxes raised a total of $2.4 billion in general purpose revenue for California's cities and counties in 1990-91. While cities and counties could increase the total revenues from these sources somewhat by raising the tax rates, many of the tax rates are at (or near) their practical or legal limit.

Finally, California counties have authority to impose a half-cent increase on the sales tax. While imposing such a tax could raise up to $1.5 billion for county programs in the budget year, our review indicates that counties cannot depend on this revenue source to replace their property tax losses for a variety of reasons. First, California voters have been reluctant to approve such measures by the requisite margins. (Tax increases for general governmental purposes require a majority vote; tax increases to fund specific programs require a two-thirds vote.) Second, imposition of the tax would require at least 120 days (to organize an election and to wait the statutorily required 90 days after the election before collecting the tax). Thus, even if a sales tax measure were to pass, it is unlikely that a county would receive substantial revenues from this source in the budget year. Third, some rural counties have few retail establishments. Increasing the sales taxes in these counties would not fully replace property tax revenue losses.

Fiscal Condition of Local Government

Like state government, the fiscal condition of many local governments in California has become strained and has resulted in significant program reductions. Given the continuing recession and increased demand for public services, many local governments would continue to experience significant fiscal difficulties—even without the proposed loss in property tax dollars.

Dubious Assumptions Included in Proposal

The Legislature's task in evaluating the proposed property tax transfer is further complicated by two unlikely assumptions included in the proposal. Specifically, the budget assumes that:

- Special districts will transfer $375 million in property taxes to schools again in the budget year, even though only a portion of these monies will be transferred in the current year, and court cases questioning the constitutionality of this transfer are pending.
- School districts in counties throughout the state can use the full amount of additional property tax revenues to replace state aid. Our analysis indicates that, in some counties, the amount of revenue proposed to be shifted could *exceed* the amount of state General Fund monies that could be freed up by the shift.

Finally, the budget includes very rough estimates of the amount of property tax revenues to be transferred by (1) modifying the Statement of Indebtedness (SOI) calculations by redevelopment agencies and (2) eliminating most property taxes to enterprise special districts. In the case of the SOI modifications, we estimate that the budget *understates* the amount of property tax to be transferred by $120 million. In the case of the enterprise special districts, we estimate that the budgeted amount could be in error in either direction by a range of tens of millions of dollars.

V

Restructuring California Government

Restructuring Government In California

What Steps Should the Legislature Take Toward Implementing Restructuring in California?

Summary

There is currently much talk about the need for the public sector to "restructure" or "reinvent" itself. Generally, restructuring involves a fundamental rethinking of the way public services and functions are organized and delivered. It involves challenging the traditional ways of doing things and searching for new and better ways to do the tasks now being done, including not doing some of them any longer.

Restructuring efforts are characterized by certain traits: (1) they have service and market orientations, (2) they are more concerned with outcomes than process, (3) they encourage risk-taking, and (4) they typically decentralize authority for program development and implementation.

Restructuring can help the state address its short- and long-term budget problems. We recommend that the Legislature take action now on various fronts. First, it should start work on a fundamental restructuring of state and local government. (See the following piece for our recommendations on how this should be approached.) Second, the Legislature should select a couple of issues (for example, state procurement) that would be subject to intensive review by policy committees in both houses. Finally, we identify a number of specific program restructurings that the Legislature could take action on during this year's budget deliberations.

INTRODUCTION

There is currently much talk about the need for the public sector to "restructure" or "reinvent" itself. The subject has taken on more prominence of late, as governments at all levels struggle with fiscal problems.

Governmental restructuring can, in fact, result in significant savings to taxpayers, as well as provide improved services to the public. In this piece, we describe what restructuring is and what's involved in doing it, and suggest strategies for the Legislature to pursue in considering restructuring proposals.

WHAT IS RESTRUCTURING?

Most generally, restructuring involves a fundamental rethinking of the way public services and functions are organized and delivered. Essentially, restructuring involves challenging the traditional ways of doing things and searching for new and better ways to do the tasks now being done, including not doing some of them at all.

For example, restructuring a particular state agency would involve not just marginal changes in the way it operates, but answering such questions as:

- What is the mission of this agency? Is that mission still appropriate today?
- Are the efforts of the agency geared toward achieving specific results?
- Can the agency show that it is actually achieving results?
- Can the tasks of the agency be accomplished in a completely different fashion that is more effective or efficient (for example, by providing incentives to individuals or by shifting it to a more appropriate level of government or the private sector)?

In the process of asking questions like these, restructuring assumes that "anything's game." In addition, it tries to define a certain "culture" in which policymakers can make such decisions. This culture consists of several key characteristics.

Characteristics of Restructuring Efforts

Restructuring efforts are generally characterized by the following:

- *Service Orientation.* Typically, governments approach their "jobs" as simply performing specific tasks required by laws and/or regulations in order to carry out the public's business. Restructuring tends to turn that view on its head. Public entities, instead, become service providers focused on meeting the needs of customers (that is, the public).

- *Outcome—Not Process—Oriented.* Restructuring focuses on end results, not on process. It stresses specific, measurable goals, not the specific steps that have to be taken to reach those goals.

- *Decentralized Authority.* Traditional bureaucracies (public and private) are "top-down" organizations. Restructuring attempts to move decision-making down as far as possible. This is to discourage micro-managing at higher levels, and encourage greater involvement and innovation by "line" employees.

- *Market-Oriented.* Most public entities are the sole providers of the service they deliver. As with any "monopoly" situation, this can result in higher costs and poorer service compared to competitive situations. Restructuring stresses the importance of competition and market incentives as a means for achieving improved—and cheaper—public services.

- *Risk-Taking.* As noted earlier, restructuring means trying different ways of addressing problems. This requires decision-makers and public officials to take risks by trying new and creative ways of addressing existing problems, and to accept failures when results fall short of the mark.

Levels of Restructuring

All restructuring efforts tend to incorporate the traits discussed above. There are, however, several different levels at which restructuring can occur.

Intergovernmental Restructuring. One of the most important types of restructuring involves changes in the relationship between and among levels of government. The Legislature tackled such restructuring in a major way in 1991-92 with the realignment of various health and social services programs between the state and the counties.

"Process" Restructuring. There can also be restructuring in the way that governments operate—the processes that they use to implement

programs. Process changes typically apply across program lines. This type of restructuring could involve changes in: (1) civil service (for example, opening up more job examinations to people outside the system, and providing rewards for successful program performance); (2) contracting (increasing competition for state contracts); (3) state budgeting practices (more performance-based budgeting); and (4) regulation (more incentives-based, rather than "command and control" regulatory practices).

Program Restructuring. Most of the ideas for restructuring pertain to a specific program. Changes can result from asking basic questions about the *mission* of a program or agency and by questioning the traditional ways of achieving program goals. (See the questions posed above.) Such restructurings can result in programs which are consolidated, downsized, streamlined, and/or revamped.

It's important to note that *eliminating* a program is *not* necessarily restructuring. For instance, if a program or agency is proposed to be eliminated because it is the state's lowest-priority, that decision does not involve restructuring. It is simply part of the annual budgetary process. If, on the other hand, a program is proposed to be eliminated because its tasks no longer achieve the desired goals or its tasks can be performed as well by another agency or the private sector, then that involves restructuring.

WHY IS RESTRUCTURING NECESSARY?

As discussed above, restructuring involves taking "fresh looks" at governmental operations. This kind of approach is beneficial any time decision-makers are reviewing budgets or overseeing programs. There are, however, good reasons why restructuring deserves particular emphasis at this time:

End of a Rapid Growth Period. Prior to this current recession, California experienced steady growth in state spending. For example, between 1965-66 and 1989-90, state General Fund spending increased at an average annual rate of 12 percent. As a result of this growth, the state now has almost 100 departments administering hundreds of programs. Given the virtually uninterrupted growth in state revenues over that time period, the state did not have a pressing need to reevaluate many of these programs. As a result, there are most certainly numerous cases of program duplication, irrelevant missions, and outdated practices.

More Complex Governing Environment. Not only has the public sector grown significantly, but it has become much more complex. The passage of Propositions 13 and 98, alone, has drastically altered and complicated the relationship between the state and local governments. In addition, the federal government is far more involved in state affairs, as are the courts. As a result of these factors, government has become more centralized, more process-oriented, and infinitely more complicated.

Dated Processes. Many of the processes used in state government were devised decades ago. For instance, the state's personnel, contracting, and budgeting practices have changed little over the years, despite drastic changes in the fiscal environment (as just noted). New approaches in each of these areas have the potential for significant improvements in program operations.

Beginning of a Slower-Growth Era? It is very likely that the state could face budget gaps in future years. For instance, we estimate that projected expenditures (based on current services) will exceed revenues for several years. Restructuring efforts can help bridge those gaps.

Lack of Public Confidence in Government. Finally, the public sector currently suffers from a lack of public confidence. Restructuring efforts can address this problem to the extent that it improves services to the public and at equal or less cost.

WHAT ARE THE RISKS?

Given the obvious benefits of successful governmental restructuring, why not plunge headlong into a major effort in this regard? Unfortunately, there are some very real risks involved for policymakers in attempting far-ranging restructuring.

Politically Difficult Process. Real restructuring is a time-consuming, tedious process that ends up alienating long-established interests. This will take a lot of effort and commitment, with no guarantee of success.

Loss of Control. A large part of the restructuring agenda (as noted earlier) involves decentralizing decisionmaking, and relying more on market forces to achieve public ends. While the Legislature obviously would retain policy control over general program goals and objectives, these types of restructuring involve a lot of "letting go" over much program decisionmaking.

Consequences of Failure. Restructuring encourages public entities to try new things in the search for more efficient ways of serving the citizenry. By definition, that means there will be failures (for example, monies will be "wasted" or service delivery will suffer). Such failures are unavoidable and may be a small price to pay in order to achieve numerous other successes. The Legislature, however, will still have to deal with the downside consequences, including the public's lack of tolerance for mistakes.

Will Restructuring Solve California's Budget Problem?

Some restructuring advocates have suggested that reexamining government is the answer to the state's short-term budget problem. While restructuring efforts can make important contributions to a budget solution, there are reasons for caution:

Many Benefits Are Not Budget-Related. Restructuring often involves changes which have nothing to do with the state's *current* fiscal situation. For instance, workers' compensation is an oft-mentioned candidate for restructuring. Yet, successful reform of the system would have virtually no impact on the state budget in 1993-94. (It could, however, have significant positive effects on state revenues and costs in future years.) Similarly, many potential restructurings have as their primary objective the improvement of service delivery, not budgetary savings.

Restructuring Can Cost Money in the Short Run. The budgetary benefits of some restructurings will not be realized until later years. For example, we have recommended several times in the past that the state's revenue-collecting agencies be consolidated into one department. This restructuring would probably result in major state savings and improved taxpayer services *in future years*. The proposal would *cost* money in the near term, however, to plan for and consolidate the agencies. The same is the case with most investments in computer technology.

Restructuring Can Take Time to Achieve. Finally, major changes in many programs—especially large and/or complex ones—can simply take time to plan and implement.

These are not reasons to shy away from restructuring. Rather, they serve as reminders that not all the benefits of restructuring are budgetary in nature, and that much of the fiscal savings will occur in later years.

What Strategies Should The Legislature Pursue?

The Legislature has recently explored many restructuring ideas. The 1991-92 realignment legislation for health and social services programs is easily the most dramatic example of its restructuring efforts. The Legislature has also spent considerable effort in examining ways to restructure state boards and commissions (from large entities—like the Public Utilities and Energy Commissions—to small advisory boards).

As a result, there are already a lot of ideas "on the table" about how to restructure state operations. As part of our office's statutory mandate, we have made many suggestions on how state programs can be restructured in past *Analysis* and *Perspectives and Issues* documents, and in special reports and publications. (See, in particular, *Options for Balancing the State's General Fund Budget: 1991-92*, June 1990, and *Options for Addressing the State's Fiscal Problem*, January 1992).

We have also provided numerous examples of restructuring in this year's documents. Most significantly, we recommend in the following piece ("Making Government Make Sense") that the Legislature undertake a fundamental restructuring of state and local governments in the state. The last write-up in this document ("Collaborative Efforts to Coordinate Service Delivery") describes how state and local programs can be devised so as to foster more collaborative efforts among service providers.

In addition, this year's *Analysis* includes many discussions of restructuring opportunities. Figure 1 summarizes these issues and shows where they can be found in the *Analysis*.

The Governor's Budget document also provides some discussion on "reinventing" government. For instance, the budget summary proposes to: (1) downsize state operations (cuts of almost $200 million), (2) privatize various state functions (such as law schools and the Maritime Academy), and (3) initiate "performance budgeting" on a pilot basis. There are, however, no details on these proposals.

The only significant restructuring proposal actually reflected in the budget involves the Aid to Families with Dependent Children Program. The proposed changes, which are similar to those offered last year, are intended to increase work incentives, thereby reducing long-term welfare dependency. For the typical recipient, however, the most immediate effect would be a reduction of the monthly grant.

Figure 1

Restructuring Opportunities Identified by Legislative Analyst's Office 1993-94

Subject Area	Issue	Analysis Section
Transit Capital Improvements	Consolidate funds with another program	Transportation
Department of Conservation	Transfer recycling program	Resources
County Medical Services Program	Options for restructuring funding	Health and Social Services
Primary Care and Family Planning Programs	Consolidate administrative functions	Health and Social Services
Department of Corrections	Options for controlling prison population	Judiciary and Criminal Justice
Special Education	Improve incentives regarding nonpublic school placements	K-12 Education
Categorical Programs	Consolidate various programs into block grants	K-12 Education
Community Colleges	Alternative ways to ration enrollments	Higher Education
Financial Services	Consolidate various departments into one	Business and Labor
Savings and Loan	Eliminate state charters	Business and Labor
Housing Elements	Rethink the current process	Business and Labor
CALDAP	Limit eligibility to earthquake claims	Business and Labor
Agricultural Export Program	Consolidate within Trade and Commerce Agency	Business and Labor
Consumer Affairs	Eliminate 13 boards and bureaus	Business and Labor
Consumer Affairs	Consolidate remaining boards and bureaus	Business and Labor
Judges' Retirement	Create new system for new judges	State Administration
Teachers' Retirement	Create new system for new teachers	State Administration
Tax Agencies	Create a new Department of Revenue	State Administration

A Strategy for 1993-94 Action

In thinking about how best to deal with restructuring issues in the coming months, we recommend that the Legislature take action on various fronts. Below, we provide examples of where the Legislature could direct its efforts in each of the three levels of restructuring we discussed earlier.

Intergovernmental Restructuring. There is perhaps no more important issue facing the Legislature than the structure of state and local governments. As we describe in the next piece, our current structure is simply not working. We strongly recommend that the Legislature begin work on a permanent, comprehensive solution. This type of fundamental restructuring will take time, and will not solve the budget-year fiscal problem; but—in our opinion—it should have the Legislature's highest priority in order for state and local governments to again make sense in California.

Process Restructuring. In this area, the Legislature could identify a couple of issues (for example, state procurement and contracting) that would be subject to intensive review by policy committees in both houses. Again, there would not be a payoff—in terms of budgetary savings—in 1993-94, but restructuring efforts in such areas could make future state operations more effective and efficient.

The Administration's concept of performance budgeting also holds some promise. The fiscal committees should seriously consider a pilot project which gives certain agencies more operational discretion in return for greater accountability of results.

Program Restructuring. Finally, there are many specific program restructurings, such as those identified in Figure 1, that can be considered during this year's budget deliberations. As described above, there are many ideas and suggestions that are already in circulation. The Legislature's task is devising a specific approach for addressing such restructuring proposals which will result in better services and provide budgetary savings.

MAKING GOVERNMENT MAKE SENSE:
A MORE RATIONAL STRUCTURE FOR STATE AND LOCAL GOVERNMENT

How Should the Legislature Reorganize State and Local Government Program Responsibilities?

Summary

California citizens receive government services from a variety of federal, state, and local agencies. Although many of these services may appear to be provided by a single agency, in most cases, more than one agency is involved in paying for the service, determining how much of that service is provided, and in controlling the specifics of how the service is actually provided. Because the roles of the different types of governments are so interrelated, it is appropriate to view them as a "system" of government. This "system" should be organized in such a fashion that each of its component parts works together to achieve the public's goals.

California's existing "system" of government clearly does not work together to achieve the public's goals. Rather, in our system, the component parts have no common conception of mission, and often work at cross-purposes with each other. Local governments complain that state requirements interfere with their ability to satisfy local community needs. The state, in turn, issues more requirements to ensure that its service objectives are uniformly achieved. Governments compete amongst themselves to obtain larger shares of dwindling resources. Citizens observe declining levels and quality of services and find that they cannot hold any particular agency responsible. In short, we find that California's existing "system" of government is dysfunctional.

While the difficulties inherent in attempting to reorganize our system of government may appear to be insurmountable, we believe that a fundamental reorganization of state and local government responsibilities is required. Only in this way can the Legislature assure the achievement of the public's goals, the future health of the California economy, and the fiscal integrity of its government entities. We offer a model of a more rational system of government for the state, and recommend that the Legislature proceed to develop a specific plan for the implementation of these changes.

INTRODUCTION

The relationship between the state and other entities of government in California is currently characterized by substantial fiscal and programmatic tension. Scarce resources and increasing service demands at all levels of government dominate the picture. These conditions have exacerbated long-existing conflicts over the state's role in the undermining of local government spending priorities and the state's control over local program and fiscal decisions. The increased fiscal pressure has also exposed other weaknesses inherent in our existing system of government, including its encouragement of cost-shifting between levels and entities of government, and the lack of accountability for program results.

Figure 2 summarizes the major problems we have identified in the existing state-local relationship. Most of these problems have been previously documented in "The County-State Partnership" (please see the *1991-92 Budget: Perspectives and Issues*, pp. 159-188). The remainder reflect problems characterizing relationships between other entities of government, such as exist between cities and counties.

Legislation enacted in 1991 (the so-called "program realignment" legislation) attempted to address some of these issues in the context of county-operated health and welfare programs. This legislation effectively reduced some of the counties' incentives for cost-shifting by making the counties' share of costs more equal across programs, and provided greater flexibility for counties to determine spending priorities by allowing some limited shifting of state-provided funds between health and welfare program areas. It also contained features which encourage a more coordinated approach to service delivery, recognizing that, often, more than one type of service is provided to an individual service recipient. In our view, this legislation demonstrates the potential for achieving better program outcomes through restructuring government fiscal and program relationships.

Ultimately, however, more fundamental change will be required to address the problems of our existing system of government. These problems are inherent to our system, and stem from its failure to assign responsibilities clearly among government agencies and provide them with the authority and tools to get their jobs done. The *1993-94 Governor's Budget* would make these problems worse by further reducing local government property tax allocations. Despite its recognition of the need for "a fundamental re-examination of what services local government can realistically provide and how those services can best be provided," the Administration's approach to these problems merely transitions local agencies to lower levels of revenues. As such, it does not attempt to address the fundamental problems of our system of state and local government.

Figure 2

Problems in California's State-Local Relationship

Counterproductive Fiscal Incentives

Fiscal incentives are present which encourage decision-makers to choose the least costly option from their perspective, even when this option is the least effective or most costly option from a statewide or overall program perspective.

Inappropriate Assignment of Responsibilities

Existing assignments do not recognize constraints on the ability of the state or local government to carry out program responsibilities.

Failure to Avoid Duplication and Realize Scale Economies

The existing system requires extensive duplication of efforts by local agencies and the state in the administration of programs, and precludes the realization of scale economies that might be achieved through consolidation of these efforts.

Inappropriate Exercise of Administrative Oversight

Existing program reporting and monitoring requirements are serving little useful purpose, and are diverting scarce resources from more productive uses.

Unproductive Competition for Resources

The existing system pits local agencies against each other in a competition for taxpayer resources. This competition sacrifices good land use practices, job development, and interagency cooperation in the process.

Lack of Accountability for Program Outcomes

The system fails to adequately link program spending control and funding responsibility, so that decision-makers are not accountable for program outcomes.

Erosion of Local Control

The system has eroded local fiscal capacity by redirecting local resources to pay for increasing costs of state-required programs.

In this piece, we offer a model of a rational organization for our system of government. While this model does not represent a detailed plan of action, we believe that it offers a realistic framework for the Legislature to consider in its efforts to resolve the problems of government in California. We also briefly discuss some of the implementation issues associated with the model.

THE PROPOSED REORGANIZATION

In developing this reorganization model, we have relied on the four basic principles summarized in Figure 3. These principles essentially reflect a consolidation of the basic reform principles we first outlined in our 1991-92 *Perspectives and Issues* document. In addition, however, they reflect a recognition that there is a significant practical interrelationship between all of the services provided by government. That is, better efforts to provide services in one program area can reduce the demand for services in other areas. Further, greater use of collaborative efforts across program areas can be more successful than program efforts pursued separately. As a result, greater cooperation and coordination between all entities of government must be achieved if the "system" as a whole is to function most effectively.

Figure 3

Basic Principles of Reform

- Maximize separation of state and local government duties through appropriate alignments of control and funding responsibilities.
- Match redistributive programs with redistributive revenue sources at the highest level of government.
- Recognize program linkages by restructuring to promote coordination of service delivery mechanisms, removing barriers to innovation.
- Rely on financial incentives to promote prevention and coordination.

The Importance of Local Communities Working Together

We believe that one of the keys to achieving this greater effectiveness lies in promoting the interest of local communities in working together towards common goals. Local entities—schools, cities, and counties—share a common interest in achieving the higher levels of health, productivity, and safety their local citizens desire, but they currently pursue their individual goals in a mostly disparate fashion. While some communities have begun their own efforts to work more cooperatively, there remain substantial barriers to these efforts.

The state also has an interest in the success of local communities, as this translates into both lower demands for state services and a stronger economy. The state's existing fiscal relationship with local governments, however, is threatening their very survival. In addition, the state's support for local communities is not distributed in a way that provides equal opportunities for local community success. The resolution of these problems is a central objective of the reorganization model.

Greater Attention To Outcomes Needed

Another key objective is to promote a greater level of attention to the outcomes of government social service programs. Essentially, the basic objective of these programs is to restore some degree of individual independence and lessen the need for additional social services or treatment. In most cases, recipients of these services need more than one type of assistance to achieve this independence. For example, an adult criminal offender may require a mix of substance abuse, mental health, education, probation, low-cost housing, and job training services in order to resolve his situation successfully. Other types of typical service recipients require different mixes of services, but in each case, the focus should be on delivering the appropriate mix necessary to minimize the need for further government intervention. Accordingly, we believe that local agencies must be given greater flexibility as to delivery choices, but they also should be held more accountable for both program failures and successes.

The Advantages of Full Program Control

One of the most often cited complaints about the existing system is that, while local agencies must operate and fund state-required programs, they have little control over service levels or approaches to service delivery. The lack of control over service levels precludes local government entities from effectively responding to their citizens' service level and service mix preferences. Further, because local funds are expended for these programs, this lack of control has eroded local resources available for other local programs.

The lack of flexibility in approaches to service delivery has precluded or restrained the potential for innovation at the local level, as legislation or regulatory changes are required before such changes can be made.

Thus, the final key to greater effectiveness lies in allowing local agencies to exercise full control over service levels and delivery approaches in locally operated programs. In addition, this control must be provided if local governments are to be held accountable for program outcomes.

A Three-Step Process

There are three major types of changes contemplated by the model:

- Changes in the assignment of primary *program control and delivery* responsibilities.
- Changes in *state and local revenue sources* to support the program assignment changes.
- The establishment of *new incentives and sanctions* to promote the achievement of broad public goals.

Each of these components is critical to the potential for achieving the benefits of the proposed reorganization. Indeed, the model should be adopted in its entirety, as a package, rather than taken incrementally, although implementation could occur in stages.

Changes in the Assignment of Program Responsibilities

Figure 4 displays the proposed assignment of responsibilities under our model. As indicated earlier, the model contemplates a clear separation of the assignments between entities of government. In this section, we describe the basis for the model's suggested assignments of responsibility.

State Government

The duties assigned to the state are determined primarily on the basis that they represent truly *statewide functions,* in that state control is needed to ensure adequate service levels. There are three primary criteria we have used to make this determination:

- The costs or benefits of a program are not restricted geographically.
- Service level variation will create adverse incentives for migration.
- Uniformity is needed to achieve statewide objectives.

Figure 4

LAO Reorganization Model
Proposed Assignment of Basic Responsibilities

State	
Uniformity Needed	**Statewide Benefits**
Cash grant programs:	Higher Education
Aid to Families With Dependent Children (Family Group and Unemployed Parent)	Long-term custody:
	State prisons
	State hospitals
General Assistance	Trial courts
Basic health care:	Appeals courts
Medi-Cal	State parks
Indigent health	K-14 school funding
In-Home Supportive Services	
Developmental Services	
Public health	
Welfare administration	
Child support enforcement	
Unemployment Insurance and Disability Insurance administration	

Local (Cities and Counties)	
Linkage-Driven (Community-based services)	
Mental health	Greater Avenues for Independence
Child welfare services	District Attorney
Foster care	Public Defender
Adult protective services	Probation/parole
Substance abuse services	Jails/corrections
Job training and employment	Police
Local Benefits (Municipal services)	
Fire	Culture/leisure
Paramedics	Housing
Sanitary inspections	

However, in some cases the need to preserve linkages between services is a more important consideration. For example, while *mental health* services meet the three criteria mentioned above to some extent, these services often should be provided in conjunction with other community-based services, such as child welfare services and job training, to most effectively resolve the problems of an individual. The specific changes in state responsibilities are discussed below.

Cash Grants and Health Care. The model recognizes that state intervention is needed to ensure that certain minimum service levels are provided for cash grants and basic health care services provided to needy individuals. Under the existing system, counties provide widely differing service levels in their General Assistance and indigent health care programs, causing incentives for migration between counties. Further, it is impossible to effectively achieve the basic objective of these programs—redistributing income—without state-level control and funding. (Ideally, the federal government should play a greater role in these programs.) For these reasons, the model assigns responsibility for Aid to Families With Dependent Children (Family Group and Unemployed Parent), General Assistance, Medi-Cal, Developmental Services, and Indigent Health Care to the state government. Also, because the In-Home Supportive Services is becoming predominantly a Medi-Cal program under recent legislation implementing the Personal Care Option, it also is assigned to the state level. Figure 5 lists some of the benefits from state assumption of these functions.

Figure 5

Benefits of State-Operated Cash Grant And Health Care Programs

- ☑ Uniform access for the needy.
- ☑ Increased market power in negotiating for health care coverage.
- ☑ Greater uniformity of service levels will eliminate migration incentives.

Welfare Administration. The model contemplates state takeover of welfare administration functions from the counties, in order to reflect its complete assumption of responsibility for cash grant programs and basic health care functions. The state could carry out this function directly, or do it by contract with counties or other providers. Figure 6 summarizes the benefits from the state's assuming these responsibilities.

Figure 6

Benefits of Consolidating Welfare Administration

- ☑ Ensures accountability for program outcomes.
- ☑ Statewide computer system allows better uniformity, data capture.
- ☑ Allows consolidation with Unemployment Insurance and Disability Insurance systems.
- ☑ Eliminates duplication, allows realization of scale economies.

Public Health. Communicable disease is a threat to all the state's residents. For this reason, the model assigns to the state the primary responsibility for those public health programs that focus on *individuals,* such as immunization programs. This arrangement also provides the state with a greater incentive to provide for the public health needs of individuals covered under its basic health care programs, because effective provision of public health services can prevent the higher cost of treating these persons for communicable diseases.

Custody. It appears necessary for the state to continue to play a role in the area of long-term custody, albeit one that is much more limited than now exists. Our model places a great emphasis on community-based institutionalization and alternatives to incarceration and institutionalization, as will be discussed in greater detail later. However, even with this greater emphasis, it appears that the state should continue to be the custodian in very long-term situations, such as for persons sentenced to life imprisonment and for the severely mentally and developmentally disabled. The state also could provide prison beds to local communities on a "cost-recovery" basis, as is now done under the 1991 realignment legislation for state hospital services. However, the state would be financially responsible for the custody of fewer prisoners than it is currently.

Trial Courts. Responsibility for funding and operation of the trial courts would be shifted to the state government. A partial shift of funding responsibility has already been started under existing law. This arrangement recognizes the state's existing role in controlling trial court operations, and facilitates the state's ability to redirect resources as workload conditions change.

Other. The model continues other existing state responsibilities, such as those in the areas of transportation and economic development. State funding of these activities, whether through tax incentives or expenditure programs, recognizes the need for a cooperative partnership between the state and local communities in these areas. Lastly, the model proposes no changes in the existing division of responsibilities for regulatory functions (such as the Department of Corporations) and other special fund program areas supported by program-related revenues. Such changes are beyond the scope of the model.

Local Governments

As noted above, changing the "system" so that its component parts do a better job of working together to achieve common goals is a central objective of the proposed reorganization. To this end, the model assigns responsibility for all community-based service programs and housing to local government, with city governments financially responsible in the case of city residents, and counties financially responsible for unincorporated area residents. This arrangement recognizes that cities and counties face the same set of problems, and provides an incentive for them to work together to find solutions to these common problems.

These agencies would be accorded complete flexibility to provide these services as they see fit, including through multi-agency contracting arrangements. Counties would retain responsibility for certain existing county-wide functions, such as sanitary inspections, property tax assessment and collection, recording, and elections. Cities would need to establish, or contract with the county for, other existing county services like jails, district attorneys, and public defenders.

Incentives and sanctions would be built into the system to encourage responsibility in service provision while maintaining local control of decision-making (see discussion of these provisions below). In addition, a new constitutional provision would be needed to ensure the independence of local decision-making from state intervention in areas of local responsibility.

Critical Program Linkages. The assignment of responsibility for *all* community-based service programs to local governments recognizes the linkages that exist between the services. As noted above, a mix of different services often must be provided individual social service recipients—or even entire families—if their needs are to be resolved successfully. In addition, there has always been a relationship between traditional types of municipal services, such as police and fire services, and other social service programs. That is, success in resolving individual social service needs can reduce the need for these other municipal-type services. The model seeks to eliminate the artificial barriers that now exist between the different providers of these critical services, and to facilitate a more collaborative approach to the resolution of community-wide problems. (For a more complete discussion of this opportunity, please see "Collaborative Efforts to Coordinate Service Delivery," following this section.) To this end, local decision-makers would have the flexibility to determine the mix of services and methods of delivery appropriate for their community.

Social Services. Communities would be responsible for providing the broad range of existing social service programs shown in Figure 4. Because, at least initially, cities probably would contract with counties for these services, this would not differ dramatically from how the *operating responsibility* for these programs is now assigned. What would differ is that communities would bear the full financial responsibility for the programs, and the state would not exercise program control. The state, in many cases, would have to distribute federal funds to the communities and disseminate state program and client data. In addition, some state oversight or monitoring role would probably be needed to comply with federal requirements in some areas.

Job Training. The development of job skills and work aptitude among the unemployed is critical to the success of all communities, both in terms of limiting the costs of social services and correctional programs, and in terms of making these communities more desirable places for people to live and for businesses to locate. For this reason, communities would become the primary providers of job training and job development programs. Existing state funds and programs committed to these purposes would be channeled through the communities in order to most effectively integrate them with community efforts.

Corrections. The model contemplates a greater reliance on community-based institutionalization and alternatives to state prison sentences for convicted criminal offenders. Although communities would have the option of placing offenders in state prisons on a cost-reimbursement basis, the high costs of this alternative would provide an incentive for them to explore local options. Because each community would remain responsible for any costs associated with individual offenders, it would have a great incentive to develop alternative methods of incarceration and to provide whatever services would be necessary to minimize that individual's risk of repeated offenses. Ultimately, the treatment of mental illness or substance abuse problems, and job placement assistance are needed to achieve this result. Figure 7 notes some potential benefits of this community corrections approach.

Figure 7

Benefits of Community Correctional Approach

- ☑ Potential for greater integration with other community-based service programs.
- ☑ Potential for reduced recidivism.
- ☑ Cost reduction for treatment of nonviolent offenders.

Housing Development. The availability of housing for Californians of all incomes and ages is critical to community success. Specifically, a diverse housing stock enables businesses to recruit and maintain a full work force (without the need for lengthy commutes)—and enables family members of differing incomes and housing needs to live near one another. Local governments play a very major role in determining the cost and availability of housing in their communities—through the adoption of local zoning, growth management, building fee, and other regulatory policies. Finally, there are numerous linkages between the provision of housing for certain groups and the provision of social and public health services, such as in the case of the homeless mentally disabled. For these reasons, the model assigns communities full responsibility for housing development, including the development of low-income housing.

School Districts

K-12 schools and community colleges would continue to play their traditional role of providing education and vocational education.

However, the model seeks to encourage greater involvement of K-12 school districts in the provision of services for children. Again, this is a linkage issue, in that community-based services are often needed to ensure the success of children in school, and in that successfully educated children may be less prone to needing other community-based services. This greater involvement would be achieved through the use of incentives for schools to identify and work with children in need of community-based services. Similarly, the model seeks to encourage greater coordination of community college districts' vocational education efforts with other community job training programs. In general, this would involve providing additional state funding in the form of matching grants or pilot project funding to districts that have entered into agreements with their local communities.

Changes in Revenue Sources

The changes in program responsibility would have the net effect of shifting program costs from the state to the local government level. One objective of the model's revenue system is to counterbalance these cost changes. The other primary objectives are to (1) eliminate barriers to priority-setting at both the state and local levels and (2) eliminate the existing counterproductive fiscal incentives and fiscal disparities of the existing local revenue system. Figure 8 summarizes the changes in revenue allocation that would be needed to accomplish these objectives. The remainder of this section discusses these changes in greater detail.

Local-Level Changes

As noted above, the model would offset the cost shifts by allocating a higher share of the local property tax to cities and counties, and a lower share to school districts. Recognizing that local communities differ in the needs of their residents for community-based services, the allocation of base property tax revenues would be initially equalized across communities, in a fashion that promotes equal opportunities for local community success. In addition, in order to eliminate unproductive competition between local agencies over the siting of retail operations, the existing Bradley-Burns local 1 percent sales tax would be replaced by a corresponding increase in the state sales tax rate.

Allocation of Property Tax Revenues. Local property tax allocations for cities and counties would be increased by the aggregate amount of shifted costs and local sales tax revenues. The increased property tax revenues, together with existing local property tax revenues, would

Figure 8

Changes in Revenue Allocations

Offset Cost Impacts of Program Responsibility Changes.

Shift property tax allocations from schools to cities and counties to offset net state-local cost shifts.

Eliminate Counter-Productive Fiscal Incentives

Transfer 1 percent local sales and use tax to state level, offset with increased property tax allocations.

Higher State Funding for Schools to Offset Property Tax Shift

Reduced school property tax allocations offset by higher state assistance.

Equalize Opportunities for Community Success

Redetermine each community's allocation of property taxes, taking into consideration the need for both municipal and community-based services.

Facilitate Priority-Setting

Repeal earmarking of realignment and cigarette tax revenues, eliminate schools' minimum funding guarantee.

be entirely reallocated among local agencies. This would take place in two steps:

- An allocation for *traditional municipal services,* such as fire, parks, and libraries would be determined, taking into consideration other existing sources of local revenue.
- An allocation for *community-based services* would be determined, based on each community's relative needs for these services, including police and community corrections.

Thus, the initial allocation of property taxes is intended to equalize revenue allocations on the basis of communities' relative needs for services, in order to promote equal opportunities for local community success.

Following the initial allocation, the annual growth in property tax revenues would be allocated to the jurisdictions in which the growth occurs (situs), as is now the case. The use of the situs basis for allocating growth provides a feedback mechanism which reflects the level of community success. To the extent communities are successful, they become more attractive places for citizens and businesses, leading to increased property values and higher tax revenues.

The model also recognizes the need of local communities for control over the level of the local revenue stream. The ability of local agencies to determine the appropriate mix and level of expenditures to reflect their community's preferences is dependent upon the community's ability to raise—or lower—the level of local taxes they pay. To this end, the model would allow a majority of local voters to alter the existing 1 percent limit on local property tax rates, either for services or to fund improvements in public infrastructure. The existing provisions of Proposition 13 limiting increases in assessed values would be retained.

Property tax revenues now allocated to special districts would, instead, be entirely allocated to counties, or to cities in the case of city-dependent districts. These counties or cities would be responsible for funding them or taking over their operations.

Local Sales Taxes. The existing local sales tax encourages cities and counties to make land use decisions that are not optimal from a regional perspective. That is, in order to gain the increased revenues generated by a retail operation, local governments will make siting decisions that increase traffic congestion and other problems for nearby local jurisdictions. In addition, this fiscal incentive causes retail operations to be favored over other types of nonresidential development, which may be preferable from employment and community development perspectives. To remedy this problem, the model eliminates the existing Bradley-Burns 1 percent local sales tax, and replaces it with a corresponding increase in the state sales tax. As noted above, local property tax allocations would replace the revenues lost, on a statewide basis. The existing county-wide 1/4 cent levied for transit purposes and the existing authority for county-wide local option sales taxes would be continued.

State-Level Changes

Changes also are necessary at the state level. Specifically, the model makes changes in the allocation of existing revenues dedicated for "program realignment," and in the Cigarette and Tobacco Product Surtax (CTPS) funds, which help to facilitate the changes in program responsibilities. Changes in the allocation of trial court and vehicle-related revenues are needed for similar reasons. Finally, in order to facilitate priority-setting, changes are needed in existing constitutional provisions related to school funding. In the remainder of this section, we discuss these aspects of the model in greater detail.

Realignment Revenues and Tobacco Taxes. Under existing law, certain portions of the state's sales and use tax revenues and of the Vehicle License Fee (VLF) revenues are deposited in the Local Revenue Fund and transferred to counties to pay health and welfare program costs associated with the 1991 realignment legislation. In addition, revenues attributable to the CTPS are earmarked for health services, health education, and resources programs. This model eliminates the earmarking of the existing realignment and CTPS-related revenues to provide greater flexibility at the state level for the prioritization of state expenditures. The loss of realignment revenues at the local level would be taken into consideration in determining the level of property tax revenues needed to support costs shifted from the state level. Sales tax revenues associated with the realignment program and the CTPS revenues would instead be deposited in the state General Fund. The realignment-related VLF revenues, in combination with the basic VLF revenues, would be allocated to cities and counties on a per capita basis for general purposes.

Trial Court-Related Revenues. Revenues derived from the wide variety of existing fines, forfeitures, penalty assessments, and filing fees would be retained by the state and deposited in the General Fund. Local agencies would retain parking and other vehicle-related fines, and jurisdiction over these infractions would be transferred from the trial courts to local agencies.

Schools' Minimum Funding Guarantee. The changes in revenue allocation discussed above cannot be accomplished without, at a minimum, modifications in the existing Proposition 98 minimum funding guarantee. This is because the guarantee is based, in part, on levels of General Fund revenues, and these levels would be increased by the model's changes. While the model does not address the appropriate aggregate level of school funding, the earmarking of specific portions of state-level resources is fundamentally inconsistent with the overall changes the model seeks to implement. For this reason, the model eliminates the existing funding guarantee, rather than attempt to modify it to accommodate the model's revenue changes.

Establishment of Incentives and Sanctions

Even with the separation of state and local functions we propose, a great deal of interdependence would remain. For example, the success of local communities in providing job training to needy individuals could reduce the demands on the state for cash grant payments. Similarly, greater effectiveness of local land use planning and development practices can contribute to the reduction of regional environmental problems for which the state has assumed responsibility. In order to promote a greater consistency of local actions with statewide objectives, the model relies upon incentives and sanctions to achieve this goal. This section discusses the general types of incentives and sanctions that appear to be necessary.

"Failure Cost" Incentives

As noted above, the effectiveness of local efforts in the provision of community services can reduce the demands placed on the state's cash grant and health care programs. In order to provide a greater incentive for communities to be successful in certain critical areas, the model would impose a local share of cost for specific state services provided to community residents. Specific examples of where these "failure cost" incentives would impose a local share of cost include:

- *Prenatal and pregnancy* services provided by the state, to encourage more effective provision of family planning and education services locally.
- *AFDC-U* payments to individuals, where those individuals remain on welfare past some period of time, to encourage greater efforts to employ these persons.

Success Awards

Similar to the "failure cost" incentives, the success awards attempt to increase the incentive for effective community service provision by rewarding local actions that have a positive effect on reducing the demand for state cash grant programs. For instance, this would take the form of state payments to local agencies which successfully convert long-term AFDC Family Group payment recipients to financial independence.

Another area where such an incentive is appropriate is to encourage the establishment of alternative dispute resolution mechanisms. Civil cases account for a large share of court workload, and often wind up being settled after trial procedures have already begun. To the extent that these mechanisms are successful, they reduce trial court workload, as well as reduce the legal expenses of community participants.

Planning and Performance Sanctions

This portion of the model addresses the need for a mechanism both to motivate better coordination between levels of government and to promote achievement of statewide objectives. It accomplishes this through revisions and expansions of the existing local planning process, reinforced by the use of sanctions. There are two major types of changes contemplated:

- Changes that better integrate statewide objectives into the local *land use planning and development process.*

- Changes that incorporate objectives and goals for *local community-based services* into the planning process.

The nature of these changes essentially converts the existing local general plan process into a community strategic planning process akin to that now pursued by major corporations.

Land-Use Planning and Development. Essentially, the model seeks greater consistency between local plans and statewide objectives in the areas of housing, environmental protection, air and water quality, and transportation. It also contemplates that plans include standards by which their progress towards meeting these objectives may be measured. While communities are not required to comply with these changes, the model makes compliance a condition of state assistance. Specifically, local agency plans would have to pass a consistency review in order for the agency to qualify to receive state fuel tax and vehicle license fee subventions, transit subsidies, and priority for project inclusion in the State Transportation Improvement Program. As is now the case with general plan housing elements, the model would require state or regional agency review of new and existing plan elements to determine consistency. In order to ensure that progress is made towards the achievement of these planning goals, the model would grant broad standing to bring legal actions asserting lack of compliance. The primary remedy in such actions would be the loss of state assistance funding.

In addition, the model would make alterations in existing environmental review procedures to facilitate "master environmental impact" statements for these plans. This would allow local agencies to issue final development permits for projects that do not require special or unusual review procedures, instead of requiring that multiple permits be obtained from several different agencies, as is now the case.

Community-Based Service Plans. Local plans would contain a new community services element to lay out the community's general approach to the provision of community-based services. It would specify how services would be coordinated and delivered for different categories of recipients, the roles of different public and private organizations in the communities, and how it would meet its job training and development needs. In this case, state review would be limited to those aspects needed to address federal requirements, but the same broad standing to bring legal action would be provided to address performance concerns.

IMPLEMENTATION ISSUES

The reorganization model discussed above obviously involves some dramatic changes in the current structure of state and local governments. There are a wide variety of legal and other obstacles to its actual implementation, and its scope probably dictates that the package of changes be phased in over time. In this section, we discuss some of the larger constitutional and federal issues that would need to be dealt with in proceeding to develop this model, and in providing for a transition to the new system.

Changes in the State Constitution

Several of the changes described above would require the elimination or addition of provisions in the State Constitution. In addition to these specific changes, however, there are other changes needed to eliminate provisions which are now or would become obsolete, or changes which would be appropriate for other reasons. Because of the scope of changes envisioned by this model, the Legislature should propose them in the form of a package of changes to be submitted to the voters. Some of the more important changes include:

State and Local Appropriations Limits. The existing Article XIII B provides for limitations on the growth in tax-funded spending of the state, schools, and local agencies; requires adjustments in these limits to reflect transfers of financial responsibility; and requires state reimbursement of costs mandated on local agencies. Because of the scope of changes envisioned, the improvement in accountability, and the restoration of local control over spending decisions provided by the model, we believe that Article XIII B in its entirety could be eliminated.

Local Government Powers. Article XI now describes the powers of cities and counties, including provisions governing the adoption of charters, ordinances, and boundary changes. These provisions should be revised to reflect the changes in the roles of cities and counties under the model. At a minimum, these changes should include the granting of equivalent municipal powers to all cities and counties.

Homeowners' Property Tax Exemption. The Constitution now provides for a small exemption from property taxes for homeowners and requires that the state provide reimbursement for the associated revenue losses. This provision was originally rationalized on the basis that it encourages home ownership. We believe that this goal is fully addressed by the existing Proposition 13 assessment limitations and by income tax deductions for mortgage interest, and that the provision of state reimbursement for the revenue losses associated with the exemption is inconsistent with the changes contemplated by this model. Accordingly, these provisions of the Constitution should be eliminated.

Trial Courts. Article VI prescribes the powers and composition of the judiciary. These provisions would need to be revised to transfer the responsibility for operating the trial courts to the state from the counties.

Changes in Federal Laws and Regulations

Some of the changes contemplated by the model may not be permitted under existing federal laws or regulations, or would require the creation of new oversight mechanisms at the state level. The state would need to seek law changes or waivers to obtain the necessary authority, or find other ways to satisfy the existing federal requirements. Because the state has had some success in addressing these requirements in the past, these difficulties do not appear to be unsurmountable. For example, federal requirements to maintain a certain funding level for mental health programs did not prevent the transfer of responsibility for these programs to counties under the 1991 realignment legislation.

Issues Involved With the Transition

The scope of changes contained in this model, and the amount of time that would be needed to work out its details, clearly preclude its immediate implementation. Further, difficulties associated with aligning service capabilities with the changes in responsibility argue that a transition period is needed, during which the features of the model would be gradually implemented. While we have not attempted to identify all of the issues that would need to be addressed, they would certainly include the following:

- *Facility Constraints.* The shift in emphasis to community corrections suggests an eventual expansion in the capacity of local jail and youth custody facilities. In part, this could be accommodated by the state's turning over title to some state prisons and Youth Authority facilities to local agencies, perhaps in recognition of trial court-related facilities the state would need to assume from local agencies. However, the location of these existing state facilities may not match local jail capacity needs, and time would be needed to accommodate their development.
- *Sentences of Current Prisoners.* The model assumes that the sentencing of existing inmates to state prison could be altered to

enable their transfer to local arrangements. A specific method for accomplishing this would have to be developed.

- *Existing Local Financial Commitments.* The changes in the allocation of revenues could undermine the basis of certain existing contractual arrangements between local agencies and lenders. For example, local agencies may have pledged local sales tax receipts as security for notes of one type or another. Thus, it may be necessary to find ways to facilitate the restructuring of such arrangements.

- *Public Employees.* The model would effectively change the status of many state and local employees. Actions to facilitate the transfer of state employees to local employment, and local employees to state employment, would be necessary.

Conclusion

The model we have outlined above requires a major reworking of our system of government, and the changes are potentially disruptive to both the citizens and institutions of this state. Notwithstanding this fact, we believe that continued reliance upon our existing system of state and local government entails a far larger risk to the public—the failure to move forward in resolving the social and economic problems of the state. The restructuring we are calling for, in contrast, would provide expanded opportunities for improving the effectiveness and quality of public services needed to ensure the state's future social and economic health.

The realization of these opportunities cannot be accomplished without fundamental changes in how the state assigns responsibility for program operations. This includes allowing those designated to carry out the responsibility to determine how best to carry it out. The public could then hold them completely accountable for the achievement of program outcomes.

As discussed earlier, the development and implementation of the proposed changes would take a period of time to achieve, and we do not underestimate the difficulties inherent in overcoming the implementation problems. Despite these impediments, we believe this model offers a useful framework for making government make sense in California. In the context of resolving the current fiscal crisis, it argues against transferring the local property tax away from local governments to schools, as proposed by the Governor, because this would leave local agencies insufficient incentive to increase the property wealth of their communities. Fundamentally, it suggests that the review of the roles and duties of government at all levels must be considered *prior to making revenue allocation decisions.* The model we have described shows how state and local government program roles can be changed in ways that allow increased flexibility and program control to help mitigate reductions in fiscal capacity. We see no alternative to such a reorganization in the long run and, accordingly, we recommend that the Legislature set in motion a process for implementing a major restructuring of state and local government responsibilities.

COLLABORATIVE EFFORTS TO COORDINATE SERVICE DELIVERY

Can They Increase Self-Sufficiency Among Public Assistance Recipients?

Summary

State and local governments in California provide a wide variety of services. In order to better deliver those services, we argue in the preceding write-up that California needs to restructure the responsibilities of the state and local governments. A key objective of the proposed restructuring is to avoid the fragmentation and lack of coordination that characterizes the current service delivery system. Adoption of our restructuring model will, we believe, facilitate the coordination of services in California.

In this write-up, we review innovative efforts undertaken recently to improve coordination in the delivery of social, health, and educational services. Traditionally, these services have been delivered by specialized agencies working in relative isolation, with little coordination among the service providers. This has resulted in numerous problems, particularly if the recipients require more than one service.

In order to remedy the deficiencies of the traditional approach, a variety of efforts to coordinate the delivery of public services have been implemented over the last few decades. Generally, these have focused on a specific problem in a particular group, such as at-risk children. Recently, however, more broadly focused collaborative efforts have been undertaken, stimulated by the recognition that working with at-risk children requires the coordinated delivery of a range of services to the whole family.

In our analysis, we discuss some of the issues that should be addressed in order to successfully implement a collaborative approach to service delivery. Also, in order to facilitate further development of broadly focused collaborative efforts, we recommend legislation to (1) provide planning and operational grants for community-based collaborative efforts, (2) allocate a portion of existing categorical funds as block grants to local governments, and (3) conduct long-term evaluations of these demonstrations.

INTRODUCTION

State and local governments in California have long provided social, health, employment, and various educational services to low-income families and individuals with special needs. Traditionally, these services have been delivered by specialized agencies that have operated in relative isolation from each other. Often this has occurred because programs and funding had been developed in response to particular identified needs without adequate consideration given to other existing programs. This focus on narrow program objectives, categorical funding, and lack of formal coordination among programs or agencies has resulted in a complex system of relatively fragmented services which, in many cases, have not met the needs of those for whom they were intended.

Over the last three decades, efforts have been made to better coordinate service delivery through the collaborative efforts of service providers. The underlying theory of this approach is that, in order to help families become self-sufficient, service providers must work with the entire family. This approach has been justified on the grounds that it (1) leads to better long-term outcomes and (2) allows public and private agencies to better target scarce resources on those families or individuals that most need the services.

In this analysis, we compare the traditional approach to service delivery to that embodied in the "new wave" of broadly focused collaborative efforts. We then discuss collaborative efforts currently under way in California. Finally, we offer suggestions as to how the Legislature can aid the development of future collaborative efforts.

TRADITIONAL APPROACH TO SERVICE DELIVERY

In this section we identify the characteristics of the traditional service delivery model, and review some of the reasons why this approach to service delivery is deficient. As we discuss below, the limitations of this approach fall into three categories: (1) it provides narrowly defined interventions, (2) it focuses on remedy rather than prevention, and (3) it results in a fragmented service delivery system.

Narrowly Defined Interventions

Most social services are provided by public and private organizations with narrowly defined missions. Typically, a program is developed in response to some identified need. That need may be a specific illness, educational deficiency, or other social problem, such as chemical dependency, child neglect or abuse, or mental illness. In response to the problem, a program is created to treat the affected group and funds are appropriated to support some level of service to that group. These funds often have restrictions that prevent their use for any other purpose. Generally, when an under-served group is found, another program with its own restricted funding is established to provide for that new group.

Over the years, the cumulative result of this approach to social and health service delivery has been to create a complex set of programs with relatively narrow mandates, separate administrative structures and reporting requirements, and restricted funding streams. For example, a mother with two children may be receiving Aid to Families with Dependent Children (AFDC) and may be participating in the Greater Avenues for Independence (GAIN) Program (with its limited case management services). At the same time, she may be receiving some services from the Child Welfare Services Family Prevention Program (with its limited case management services). In addition, one of her children may be in a special education program (with its limited case management services) and the other child may be receiving counseling through a dropout prevention program. Each of these programs provides services to the family for specific problems, but, typically, none of them is coordinated in a way that focuses on the entire family and its ability to function independently over the long run.

Focus on Remedy Rather Than Prevention

Another characteristic of these narrow—and possibly overlapping—programs is that they generally focus on remediating problems that have already been identified, rather than on the prevention of problems, whether through early intervention, screening, or preventive education. Generally, this service strategy results because of severe short-term budget constraints, significant up-front costs of preventive programs, difficulty identifying "pre-crisis" situations, and the severity of the problems among the targeted groups.

Fragmentation

The accumulation of large numbers of specific programs operated by different public and private agencies ultimately leads to a system of fragmented services. This fragmentation prevents effective delivery of services in a number of ways.

- *Multiple Applications.* Clients in need of several services generally must fill out multiple applications and conform to multiple eligibility requirements. This can be confusing to the client, and may create barriers that prevent clients from using services that would be of benefit.

- *Services Offered at Different Locations.* Typically, each agency chooses its location in order to best meet the needs of that organization. When an organization does base its location decisions on client needs, consideration typically is limited to that organization's specific set of service offerings. Because services are offered by many different public and private agencies at many locations, clients may find it difficult to use available services.

- *Little Information Sharing Between Service Providers.* Because services are offered as separate packages, there is little information exchange between service providers. This lack of communication between providers can lead to either gaps in service or duplicative service delivery. Thus, service providers are less likely to be offering a mix of services in an efficient manner.

- *Insufficient or Overlapping Case Management.* Many programs either do not provide for a case management function or provide only limited case management services. In these instances, the client may not receive the information or counseling needed to obtain the appropriate mix of services. In other instances, clients may have multiple case managers, in which case the client can become confused about who is the appropriate case manager or what is the correct treatment. Further, no one may follow up on services made available to the client to determine whether the treatment was effective or specific to the client's needs.

- *Lack of Accountability for Outcomes.* Service providers generally are accountable for the units of services they provide or the funds they spend. They generally are not held accountable, either as individuals or as a group, for the outcomes of their interventions.

EFFORTS TO CHANGE THE DELIVERY SYSTEM

The deficiencies of the service delivery system identified in the previous section served as the basis for many recent reform proposals. There are two basic ways in which the traditional service delivery model can be changed to a more collaborative system. One approach is the "service-oriented" change, which focuses on building links between existing service providers. The other approach is the "systems" change, which attempts to merge funding streams and administrative structures to create integrated service delivery systems. In this analysis, we concentrate on service-oriented change, since this best characterizes existing collaborative efforts; however, we describe one system change model that has been the subject of legislation.

What is the Service-Oriented Delivery System?

The service-oriented delivery system is based on the need for service providers to work together to solve problems and achieve better long-term outcomes for families. These efforts typically are community-based (located within the community or neighborhood where the needs are identified). They attempt to identify underlying causes of problems so that appropriate services can be provided, and they attempt to intervene before problems become so severe that they become crises.

Figure 9 summarizes the major elements that experts have identified as important to the success of collaborative efforts. In general, the prospects for a successful collaboration are enhanced if:

- There is a planning process that involves the communities being served.
- Participants are able to break down barriers that might come between the collaboration and its individual members.
- Participants focus on long-term behavior change and establish accountability based on outcomes.
- Participants focus on preventing problems within the family, rather than by focusing on problems after they become crises.

In order to achieve these elements, the following specific program components are necessary:

- *Links to Services Provided by Public and Private Agencies.* In some instances, collaborative participants have funding available so they can directly purchase services, but this is not common. Most collaborative efforts, however, establish links to existing public and private service providers to obtain needed services.
- *Case Management and Follow-Up.* Collaborative efforts ideally include both case management and follow-up components in order to provide a single point of reference for clients. The case manager and the client determine the mix of services needed and arrange for the client to receive them. Follow-up, in which the

Figure 9

Factors That Improve the Prospects For Successful Collaboration

- **Shared Vision:** The participants agree on the purpose and goals of the collaboration, and identify clearly defined target populations.
- **Community Input:** The participants actively seek and use input from all relevant communities of interest; often this is done by creating an advisory group that includes clients and other members of the community.
- **Work Together:** The participants are able to surmount organizational and cultural barriers that often prevent agencies and other groups from working together.
- **Outcome Measures to Establish Accountability:** The participants establish accountability, and measure success based on well-defined, measurable programmatic and fiscal outcomes, rather than on services provided.
- **Prevention Oriented:** The participants place great weight on preventive strategies, and do not focus solely on responding to crises.
- **Solve the Confidentiality Problem.** The participants find a way to share information that is important for the successful treatment of their clients.
- **Focus on the Whole Family.** The participants focus on the whole family, rather than only on the individual with the diagnosed problem.
- **No Agency "Owns" the Process:** The participants learn to share responsibility, accountability, and decision-making.

case manager checks back with the client and the service provider, is important in order to determine whether the clients availed themselves of the services and to identify whether the services delivered were helpful.

- ***Accountability Based on Outcomes.*** Collaborative efforts should identify clearly stated goals and define measurable outcomes based on those goals. These outcomes allow the participants to determine its success or failure, and to identify where operating changes are needed.

- ***Identify Target Groups.*** No single collaborative effort is able to serve everyone. Therefore, target groups for service must be identified.

- ***Sharing of Client Information.*** Confidentiality requirements in existing law restrict the ability of providers, such as mental health workers, child welfare service workers, and probation officers to share information. Collaborative efforts should make arrangements with the client to allow service providers to share relevant information in order to make decisions about appropriate services.

- ***Co-Location of Services.*** Collaborative efforts should attempt to co-locate at least some services in order to make critical services more easily available to the client. This helps relatively immobile clients, and makes coordination of services easier.

- ***Cross-Training of Workers.*** Cross-training of workers is often identified as an important element of collaborative efforts, because it increases the ability of workers to take the "larger view" of the client's needs. In addition, cross-training tends to break down differences in the way agencies do business (sometimes referred to as the agency "culture") and allows the collaboration to work more effectively.

There is no consensus on which of these components is the most important. Some people familiar with collaborative efforts suggest that the most important component is the development of target groups and establishment of outcome-based accountability. Others suggest that the key elements center around the way service providers view their role in helping clients and the way the partners work together. Some experts argue that service delivery models will not provide dramatic improvements in outcomes. In their view, only a system change model (a truly integrated service delivery system) will accomplish the goals of the current set of broadly based initiatives directed toward multi-problem low-income families.

What Is the Systems-Oriented Delivery System?

One example of a systems-oriented change model is the Neighborhood Family Services Organization (NFSO), which is designed to provide services to "underclass" neighborhoods (AB 3380, 1991-92 Regular Session, Bates, embodied the NFSO concept). While the NFSO is yet to be fully implemented in practice, in theory it is a community-based entity whose purpose is to improve the economic condition of underclass neighborhoods. Its major strategy is to combine existing funding for all health, welfare, social service, educational, and law enforcement activities within the NFSO area. The NFSO would then provide these services from selected sites in the target neighborhood. Alternatively, the NFSO could directly supervise city, county, school district, and private nonprofit staffs assigned to work for the NFSO. In addition to the delivery of health, social, law enforcement, and educational services, the NFSO would undertake economic and infrastructure development activities, such as providing small business loans, developing low-income housing, and identifying the infrastructure needs of the area.

Perhaps the most unique features of the NFSO concept are its local administration and its control over various funding sources. The NSFO could be either a nonprofit organization, special district, or joint powers agreement. The organization would be governed by a board, composed of members elected by area residents and appointed by local officials. The NFSO would control a consolidated account that could receive funds from a number of sources, including (1) state, federal, and local funds redirected from existing health, welfare, and education programs; (2) "tax increment" revenues, which would consist of the portions of sales, property, and other unspecified taxes that are a "direct result" of the economic development activity of the NFSO; (3) supplemental state funding of NFSO activities; and (4) foundations and other private funds.

While there have been efforts to implement systems change models, those collaborative efforts that have been implemented can generally be described as service delivery change models.

COLLABORATIVE SERVICE DELIVERY IN CALIFORNIA

In this section, we describe a number of collaborative demonstrations and coordinated service delivery efforts in California. Figure 10 summarizes the major state and federal legislation supporting collaborative service delivery efforts operated by various state or local agencies.

Current collaborative service delivery systems span a range of efforts, from those that are narrowly focused to those that are broadly focused. We first describe some of the more narrowly focused coordinated service delivery efforts (those efforts that include a small number of collaborative participants and address a specific problem), which are directed at pregnant or parenting women, infants, or at-risk children. We then describe some of the newer, more broadly focused collaborative efforts (those efforts that include a large number of participants and attempt to address the entire family).

Narrowly Focused Collaborative Efforts

Early Childhood Development. Early childhood development is provided, primarily, through the federal Head Start Program for preschool children of low-income families. California also has provided funds for a similar State Preschool Program. These programs primarily provide preschool classes to low-income children, generally aged three to five. In addition, there is a collaborative component to these programs, in that they typically include nutritional and other adult class components, case management services, links to the Child Health and Disability Prevention Program (discussed below), and sometimes include child care for children after the child development classes.

The Head Start Program has been subject to a number of evaluations. These evaluations generally conclude that children participating in these programs perform better in school, at least in the short run (through grade 6). Some studies, which employed long-term follow-up of Head Start students, have found that those students continue to have fewer problems in school, and have lower dropout rates than similar cohorts that did not attend Head Start. A number of reviewers have concluded that the benefits significantly exceeded the costs of the program.

Infant and Child Health. A number of federal programs provide nutrition and health services for pregnant and parenting women and their children. Among the programs that have been implemented over the last three decades are:

- *Women, Infants, and Children (WIC) Nutrition Program.* The WIC Program is administered by the federal Food and Nutrition Service, and provides nutritional training, limited case management, and food vouchers for pregnant and parenting low-income women and their children. This program recently was evaluated by the U.S. General Accounting Office (GAO), which found that the program reduced spending in other public social and health programs by more than $3 for each dollar spent in the WIC Program.

Figure 10

Major Collaborative Service Delivery Programs

Narrowly Focused Collaborations

Economic Opportunity Act of 1964 (43 USC 9801 et seq) and Chapter 2 of the Education Code	**Federal Head Start and State Preschool Programs.** Comprehensive developmental services, including health, nutritional, educational, and other services to low-income preschool children and their families.
Social Security Act Amendments of 1967 (PL 90-248) and Ch 1069/73 (AB 2068, W. Brown)	**Early and Periodic Screening, Diagnosis and Treatment (EPSDT) and Child Health and Disability Prevention (CHDP) Programs.** Health screening, diagnosis, case management, and treatment for children.
Federal Child Nutrition Act of 1966, as amended in 1972	**Special Supplemental Food Program for Women, Infants, and Children (WIC).** Food assistance, nutritional training, and referrals to other services for eligible women.
Omnibus Budget Reconciliation Act of 1981	**Maternal and Child Health Block Grants.** Prevention and treatment projects for pregnant women, infants, and mothers. In California, these funds have provided support for some collaborative efforts.
Individuals with Disabilities Education Act of 1986 (PL 99-457, part H)	**Early Intervention Program.** Interagency planning and service delivery process for children (under three years old) with developmental disabilities.
Ch 1361/87 (AB 377, Wright)	**Child Mental Disease.** Four-county demonstration of the Ventura Planning Model, which provides for interagency collaboration for children with mental disease.
Ch 982/88 (AB 3777, Wright)	**Adult Mental Disease.** Three-county demonstration to extend the Ventura Planning Model, which provides for interagency collaboration for adults with mental disease.
Ch 105/88 (AB 558, Hannigan) and Ch 91/91 (AB 948, Bronzan)	**Family Preservation Program.** Counties authorized to use state Foster Care funds to provide intensive short-term family maintenance and family reunification services.
Ch 1025/85 (AB 2580, Agnos) and Family Support Act of 1988 (PL 100-485)	**Greater Avenues for Independence (GAIN) Program.** Multiagency welfare-to-work collaborative effort, coordinated by counties, which provides education, job training, job search skills, and support services to AFDC recipients.
Ch 931/89 (AB 501, Eastin)	**New Chance Demonstration.** Demonstration program in which the Departments of Social Services and Education and the Manpower Demonstration Research Corporation collaborate on a comprehensive program for disadvantaged young mothers who have not completed high school, and their children.

Continued

Broadly Focused Collaborations	
Ch 1303/89 (SB 997, Presley	**Interagency Children's Services Coordination Councils.** Counties authorized to create councils to better coordinate child welfare services activities and foster interagency collaborations.
Ch 759/91 (SB 620, Presley)	**Healthy Start Support Services for Children Grant Program.** Family-oriented school-linked program to encourage comprehensive collaborations among local social service, education, and health care providers.
National Affordable Housing Act of 1990 (PL 101-625)	**Family Self-Sufficiency Program.** Local public housing authorities required to establish links to training programs and to provide case management to housing voucher clients if the authority seeks additional federal Section 8 funds.

- *Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) Program.* The federal EPSDT Program, created in the 1960s, provides annual medical, dental, vision, and hearing screenings to low-income children up to age 21 who are eligible for Medi-Cal. The state CHDP Program (which receives the EPSDT funds) was created in 1976 to provide similar services to low-income children up to age 19. In addition, these programs provide for case management and appropriate medical and other services to children with identified problems.

- *Maternal and Child Health (MCH) Block Grant.* The MCH block grant was created when ten federal grant programs were consolidated in 1981. California uses its allocation from these funds for various programs, including the Adolescent Family Life Program, the High-Risk Infant Follow-Up Program, and the Children's Medical Services Program. These programs all have collaborative elements, although they primarily use their funds to provide services directly.

Child Abuse or Neglect. A number of programs have evolved that attempt to prevent or remediate child abuse or neglect cases. While focused on children, these efforts often involve the whole family and include agencies, such as child welfare services, mental health, special education, and juvenile justice.

- *Family Preservation Program.* The Family Preservation Program was created in 1988 as a pilot program to provide intensive short-term family maintenance and family reunification services, such as counseling, substance abuse treatment, respite care, parent and homemaking training, and crisis intervention. Under the program, counties are authorized to "draw down" up to 25 percent of the state share of their expected foster care funds to provide these services, with the intent of preventing out-of-home placement. The social worker overseeing the family has considerable discretion to purchase services that could improve the family's ability to remain together. The program was authorized statewide in 1991. A three-year evaluation of the program is expected to be completed in 1995.

- ***AB 377 Demonstrations.*** These demonstrations are designed to (1) reduce the number of out-of-home (primarily foster care group home) placements for severely mentally ill children and (2) improve a number of specified outcomes, such as academic performance, incarcerations, and attendance in school. One demonstration program, the Ventura County Children's Demonstration Project, identifies a target group of children with severe mental illness through referrals from juvenile justice authorities, schools, or mental health facilities. The project then intervenes to provide comprehensive, coordinated services to these children. Evaluations have shown that out-of-home placement costs have been reduced significantly, and specified outcomes have improved.

Developmentally Disabled and Mentally Ill Infants and Children. Developmentally disabled children often require services from a wide range of agencies. These children can be supported more effectively, and their families can function better, if the child is properly diagnosed and provided with appropriate treatment as soon as possible after birth.

In 1986, the federal Early Intervention Program (PL 99-457, part H), was enacted to encourage states to develop comprehensive systems for providing early intervention services for infants who manifest "developmental delays." The law requires these programs to include specific components such as (1) multi-disciplinary infant and family assessments and (2) a system to track and coordinate services provided to infants and their families by various agencies or programs, such as mental health, regional centers, and special education. The state is in its fifth and final year of planning and developing the early intervention system encouraged by PL 99-457, part H. An application must be submitted to the federal government by June 30, 1993 in order to implement the program. The Department of Developmental Services has not indicated if an application will be submitted. A similar program was authorized in PL 99-457, part B, for developmentally delayed children aged three to five.

New Wave of Broadly Focused Collaborative Efforts

As schools and social service agencies began to work together to better serve children, they came to realize that serving the child also meant dealing with the problems of the whole family. This realization led, in the last few years, to a new wave of larger scale collaborations that are focused on the entire family.

What Do These Collaborations Look Like? Past attempts to improve the circumstances of multi-problem—often relatively dysfunctional—families too often were fragmented and ill-focused. Typically, the children were handled by Child Protective Services, Special Education, or in some ad hoc, generally uncoordinated, manner. The families (adults and siblings), if helped at all, were provided separate and uncoordinated services. Slowly, schools began to see themselves as a more central player in the delivery of services to their students, both because children are in school for significant amounts of time and because schools are under pressure to improve student performance. Some of the early efforts to use school-linked services were in the public health arena. More recently, because of their early involvement with health-related collaborations, schools have been seen as a central point for the coordination and delivery of a broad range of services in order to attempt to deal more effectively with multi-problem children *and* their families.

These new collaborations are much more ambitious in scope (though not necessarily in funding), and typically involve a broad range of county social service and municipal service agencies (such as police or health inspectors), private nonprofit agencies, and local school districts. Generally, the goal of these efforts is to improve the ability of families to function independently by more effectively delivering services to families in need. The early focus of these efforts is on communities that have large concentrations of disadvantaged families. These families often have multiple interactions with public assistance and other social service agencies, and they may have multiple health, social, and financial problems.

Below, we present a description of collaboratives that exemplify the characteristics of these new efforts. These examples are drawn, in part, from our site visits and discussions with local officials during the past year. We note that there are other demonstrations, either under development or in operation, in communities throughout the state.

Sacramento County Collaborative Efforts. Sacramento County is engaged in several collaborative efforts. These include the reorganization of county agencies, and initiatives to decentralize and coordinate services in community-based settings.

- ***County Government Reorganization.*** Sacramento County has recently completed a reorganization of its health and human resources departments. The new structure consolidated a number of agencies into three departments. This is designed to foster a broader perspective on the delivery of services. A Department of Human Assistance was created to administer all public assistance such as AFDC, food stamps, general assistance, IHSS, and Medi-Cal. In addition, a Department of Human Resources was created to oversee all social services programs, and a Department of Health was formed to administer all health programs. The goal is to provide more opportunities for county staff to work across programs under one department and to develop broad knowledge about these programs. Also, combining public assistance programs under one department allows the county to more effectively use their staff as "generic" eligibility workers and case managers.

- ***Community-Based Collaborative Demonstrations.*** In parallel with the county-level reorganization, Sacramento County began to encourage demonstrations that involved decentralizing service delivery in different community settings. Among the proposals moving toward implementation are two community-based collaborations. One is a public housing development-based large-scale collaboration (New Helvetia/River Oaks), primarily for the residents of these developments. The other will be a community-wide project (Del Paso Heights), which is proposed to become an NFSO-type organization. Each collaboration includes out-stationed county public assistance eligibility staff, Child Protective Service (CPS) staff, alcohol and drug program staff, parks and recreation resources, Head Start programs, adjacent schools, job training program staff, and other service providers. These collaboratives are staffed by agency personnel who have volunteered for the assignment, cross-trained in the various programs participating in the collaborative, and received training in team-building skills. Each demonstration has a community-based advisory group that provides guidance and input on needs. Sacramento County also is testing a community-based health collaborative in the Oak Park neighborhood.

- ***School-Based Collaborative Demonstration.*** Howe Avenue School, which is part of a six-school group, is of particular interest due to the large number of collaborations centered at the school and available to the cluster. The schools are located in a relatively disadvantaged part of the San Juan Unified School District. It has developed several collaborations, including (1) Cities in Schools, a locally supported public/private partnership, which provides a CPS worker and a tutoring program for students; (2) Alliance for Excellence, supported by a federal grant to develop collaborations focused on dropout prevention; and (3) California State University, Sacramento (CSUS), Departments of Social Work and Counseling projects, to provide services and interns for a counseling center and to aid the Cities in Schools social worker. Also, Sacramento County has out-stationed public assistance eligibility workers at the school. Finally, the cluster has been awarded a Healthy Start grant (this program is discussed below) that is providing resources to coordinate these collaborations and to start an on-site health clinic (with participation by a major local health care provider and the CSUS Department of Nursing).

In order to assist the development of these collaborations, the county developed a policy and process for handling confidentiality issues. Further, the Sacramento City Police Department has been providing a problem-oriented policing team to the New Helvetia/River Oaks project. Finally, the projects have been supported by the Office of the County Executive.

Fresno County Collaborative Efforts. Fresno County has been engaged in a school-based effort since 1986 and, more recently, has been engaged in a housing project demonstration.

- ***Fresno County/Local School District "K-6" Program.*** The K-6 Program currently operates in ten urban and rural schools in Fresno County. Students who are identified as "at risk" are referred to a team of school site personnel, including a county case manager, who may be from any one of several agencies that have contributed personnel to the collaborative (the case managers are employed by their "home" agency, but are supervised by the county K-6 coordinator). An assessment of the student is completed, and a plan is developed by the case worker in collaboration with the family. That plan can include referrals to mental health, counseling, chemical dependency, or health services programs provided by the county or private organizations. Each case manager has available a package of resources to help assure that the family will receive needed services. The case manager also follows up on the case to assure that services are received. Data collected on the program suggest that it has resulted in improvements (at least in the short term) in the behavior of referred children. In addition, there is some evidence to suggest that children from the program do better (do not drop out and do not become pregnant) in high school than other children with similar characteristics.

- ***Palm Village Apartments.*** Palm Village was an abandoned motel that was renovated into apartments by the Fresno County Economic Opportunity Commission (EOC). The apartment complex has been open for about a year and provides temporary shelter (for up to ten months) for homeless families and single women. The commission has established employment training, chemical dependency classes, referrals to counseling, and other programs and classes in offices on the grounds of the complex. The EOC receives funding from McKinney Act homeless funds to provide case managers and other services. It also receives funds from the Federal Emergency Management Agency to provide meals to residents (the apartments have only minimal cooking facilities). In addition, all families receive "money management" services. The main thrust of the program is to provide short-term services in order to improve family stability.

County-wide Interagency Coordinating Councils (CICCs)

CICCs are authorized by Ch 1303/89 (SB 997, Presley), to encourage the development of a comprehensive and collaborative system for the delivery of health and social services to children and youths at the local level. The legislation authorizing the CICCs also creates a waiver process to provide fiscal incentives for agencies to collaborate and effect systems change. Any county that establishes a CICC and creates a three-year plan that specifies outcome objectives may request waivers of existing state regulations pertaining to single agency operations and auditing and accounting requirements that may hinder integration of children's service delivery.

California Tomorrow and the Children and Youth Policy Project recently surveyed counties to determine how they responded to SB 997 and other legislation encouraging collaborations. They found that there is considerable variation in the county responses to SB 997 and other related legislation. Two counties, San Bernardino and Solano, were identified as having particularly comprehensive and effective CICCs. These counties were able to develop support for their collaborative efforts through fund-raising efforts in the private sector, and had developed significant links to obtain guidance and in-kind services from the private sector. In each case, however, the county had begun efforts to coordinate its programs for at-risk children and youth prior to SB 997. While the waiver authority in SB 997 is potentially an important mechanism for fostering systems change, no waivers had been granted at the time this analysis was prepared.

Healthy Start Program

The Healthy Start Program is a state-level initiative that has several elements. It provides planning and implementation grants to local school-linked children's service delivery collaborative efforts. In the current year, the State Department of Education funded 40 three-year implementation grants and 110 two-year planning grants. Additionally, the state has entered into a multi-year partnership with several private foundations that includes funding of a comprehensive evaluation of the Healthy Start grant projects.

In addition to Howe Avenue School (discussed previously), we visited two other Healthy Start grant sites. These sites are indicative of the kinds of collaborative efforts funded by this program:

- *Project SMART.* Project SMART is located in the administrative wing of Longfellow Elementary School in Riverside. This collaborative effort provides county public assistance eligibility services to neighborhood residents, a county social worker, a part-time mental health worker, CHDP screenings, various parenting classes, and classes such as English-as-a-Second-Language and household finances. In addition, the collaborative has developed links to the police department to create a bike patrol, and engages in significant community outreach in order to develop participation in school and Project SMART activities.
- *New Beginnings.* New Beginnings is located in a building on the campus of Hamilton Elementary School in San Diego. This collaborative has used employee cross-training to improve services provided by its "family service advocates." In addition, the school does all registrations of new pupils through New Beginnings in order to do preliminary assessments and to link residents to services, many of which are provided on a referral basis. The project has a health clinic staffed by nurse practitioners, and provides other counseling. One unique feature is a kiosk, which provides services information electronically in several languages to clients.

These examples provide a flavor for the variety of broadly focused collaborative efforts that are developing in California in order to find better, more effective ways to improve outcomes for multi-problem families. Nonetheless, there is much that still needs to be learned.

WHERE DO WE GO FROM HERE?

What Do We Still Need to Learn?

Evaluations of some narrowly focused collaborative efforts, such as Head Start and WIC, suggest that short- or intermediate-term benefits can exceed the costs. Evaluations of other collaborative efforts, such as those focused on teen parents or family preservation demonstrations, provide mixed results. Finally, there are no evaluations of broadly focused collaborations focused on multi-problem families and their children. Among the issues yet to be resolved are:

- *Is There a "Best" Model for Broadly Focused Collaborations?* Many of the current group of collaborative efforts are school-based. Some observers argue that more attention should be given to community-based efforts, such as Sacramento's Del Paso Heights and New Helvetia/River Oaks projects or Fresno's Palm Village project. Community-based efforts tend to focus on community development, as well as multi-problem families.

- *How to Pay for the Up-Front Costs?* The resources needed for successful collaborations in low-income neighborhoods are in short supply due to ongoing budget pressure at all levels of government. Among the constrained services are mental health, chemical dependency and other counseling services, job training slots, and general case management services. In order to justify these up-front costs, it is important to know whether the intervention has a reasonable prospect for long-term payoff.

- *Are There Long-Term Benefits?* The existence of long-term benefits is important because many collaborations stress intensive interventions that are expected to improve the life prospects for children still in school and effect permanent behavioral change in their families. Because the recent large-scale collaborations are so new, there are no evaluations that can provide the kind of evidence needed to justify large increases in funding.

- *Who Benefits and Who Pays?* Many services are provided through shared funding by different levels of government. Unless the sharing ratios reflect the benefits to each level of government, services may not be provided in the most cost-effective manner. Therefore, it is important to understand the costs and benefits to all funding partners when determining how collaborations will be administered and funded.

- *Are Other States and Localities Achieving Successes?* An important part of building successful collaborations is the exchange of information about what works and—perhaps more important—what is not working, and why. The institutional framework for these exchanges is just now evolving. Foundations and groups, such as the National Center for Children in Poverty (Columbia University), California Tomorrow, and the Center for Integrated Services (UC Berkeley), are developing clearinghouses to serve as information exchanges.

- ***Do We Know How to Target Services?*** There are at least two issues related to targeting services. First, scarce resources prevent collaborations from serving everyone; therefore, priorities must be established and target groups must be identified. This was a critical element for the AB 377 mental health project in Ventura County. Second, different target groups require different services specific to their individual needs. It is frequently difficult to determine which mix of services is most effective. For example, studies have shown that one of the biggest problems for teen parents and school dropouts is finding a set of interventions to achieve self-sufficiency by these individuals.

- ***Is it Possible to Target the Multi-Problem Low-Income Family?*** The multi-problem low-income family does not have a single, well-defined problem at which services can be targeted. Instead, these families experience a number of interrelated problems, all of which need, in some way, to be addressed. For this reason, some experts argue that collaborations that target these groups are too unfocused to succeed. At the same time, others argue that, in order to solve specific problems, it is necessary to focus on the entire family and its ability to function.

- ***Do We Know How to Get Service Delivery Agencies to Work Collaboratively?*** Any organization (whether it is public, private nonprofit, community-based, or private for-profit) that has a specific mandate and funding stream develops a way of doing business that generally differs from other organizations. This "culture" allows the institution to work by itself, but often makes it difficult to work with other agencies. In addition, the mix of services that an organization provides is determined by requirements placed on the funds available to it. These institutional features that evolve within an organization can, too often, prevent organizations from working together. Further, organizations may be averse to collaborations, because collaborating could "dilute" their authority.

Are Broadly Focused Collaborations Worth Pursuing?

Some evaluations have indicated that collaborations can lead to better outcomes than are possible from the traditional approaches to service delivery. These results, however, are primarily from evaluations of collaborations that narrowly focus on specific problems facing infants and young children, and their families. Based on these preliminary results, it appears that collaborations should be considered as part of a comprehensive program to improve conditions in low-income neighborhoods. As we discussed above, however, there is much we still need to understand about the use of broadly focused collaborations.

Recommendations for Legislative Action

Many of the new wave of broadly focused collaborations have evolved out of needs identified at the local level. Each community has unique needs, and each locality has a unique set of agencies and organizations that can provide support. This suggests that collaborations should "percolate up" from those communities. The difficulty is that low-income neighborhoods tend to have a limited number of institutions to sustain these community-based collaborations. What can the state do to facilitate these efforts?

Restructuring State and Local Responsibilities. In the preceding write-up, we argue that California needs to restructure the responsibilities of the state and local governments. One of the key objectives of our proposed restructuring model is to avoid the fragmentation and lack of coordination that characterizes current service delivery. Under the model, local entities would be given control over, and responsibility for, community-based services. By giving local decision-makers control over the delivery of these services, the model seeks to eliminate the artificial barriers (such as those imposed by the state) that exist between the different providers of services. To the extent that these changes are made, we believe that they will facilitate the development of the types of collaborative efforts that we have discussed in this write-up.

There are, however, more limited steps that the Legislature can take in order to facilitate collaborative activities at the local level. We discuss these below.

Provide Seed Money to Encourage Collaborations. The Healthy Start Program provides "seed money" for both planning and operational grants to local schools in order to develop collaborative efforts. Thus, the current operational grant recipients are school-site based collaborations. We recommend enactment of legislation to provide planning and operational grants to sites other than schools in order to test community-based collaborative efforts (perhaps including communities' economic development components).

Provide Funding Discretion to Local Agencies. One of the barriers to better coordination of service delivery is the restriction on the use of funds imposed by categorical program funding. Integration of services can be better achieved by providing funds in a way that allows local governments discretion in setting priorities for the use of available funds. (We discuss this concept further in the state/local restructuring analysis in this volume.) Consequently, we recommend enactment of legislation to (1) allocate a portion of existing categorical funds as block grants to local agencies and (2) establish outcome-based performance measures. This would allow the state to retain program accountability, while allowing local agencies flexibility in structuring their collaborative efforts.

Provide for Long-Term Evaluations. Perhaps the most discouraging aspect of our review is the lack of long-term evaluation findings, particularly of the broadly focused collaborations. In part, this is because these efforts are relatively new. In addition, it is because competent outcome-based evaluations are difficult and require adequate funding. Nonetheless, they are important in order to determine whether the long-term benefits are sufficient to justify the up-front costs of the more intensive interventions these collaborations require. Further, good evaluations would be helpful in determining what works and what does not. Thus, we recommend that, when enacting legislation to encourage collaborative efforts, the Legislature require comprehensive evaluations of these programs. These evaluations could be funded in partnership with private foundations and the federal government.

Risk of Imposing a Single Model

Our review of existing and proposed large-scale collaborations suggests that each community needs significant flexibility in the design of its service mix and organizational structure. Each community has unique needs and unique local service delivery organizations. We do not know enough at this time to suggest a "best" model for broadly focused collaborations. Our recommendations would encourage local agencies to pursue the use of collaborative efforts to delivery public services.