

The 1992-93 Budget:
**Perspectives
and Issues**



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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 1992 Budget Act 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 1992-93 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 1992-93 Budget Bill*, which contains our traditional item-by-item review of the Governor's Budget.

The *Analysis* continues to report the results of our detailed examination of programs and activities funded in the Governor's Budget. 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 1992-93 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 1992-93 and evaluates the major expenditure proposals in the budget.
- Part Five, "State-County Partnership Issues," consists of three pieces dealing with the state-county relationship: (1) the major program realignment which occurred in 1991, (2) trial court funding "realignment" (which also occurred last year), and (3) child support enforcement.

State Fiscal Picture

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State Fiscal Picture

The outlook for the 1992-93 budget is dominated by the continued poor performance of the state and national economies. Even if recovery from the recession is now underway, as anticipated by the *1992-93 Governor's Budget*, state revenues will not be sufficient to both pay off the accumulated budget deficits and fund state services at current levels. Further delays in the timing of the state's recovery will compound the problem faced by the Legislature in crafting a budget for 1992-93.

The Governor's Budget realistically addresses only a portion of the state's budget problem. Although it would make some significant reductions in major state programs, it relies upon optimistic assumptions as to the availability of federal and other funds to bring the budget into balance, and does not offer an adequate reserve fund to protect the budget against unanticipated changes.

As it develops a more realistic strategy for resolving the state's budget problems, the Legislature needs to focus on the state's long-run needs. California's state and local governments face rapidly changing conditions that necessitate improvements in the effectiveness and coordination of their services. These improvements will help to ensure that the state's diverse citizenry will continue to enjoy a high quality of life and a healthy economy in the future.

State Fiscal Picture

Just six months after acting to close a \$14.3 billion gap in the 1991-92 budget, the Legislature is faced with a current-year deficit and another budget-year funding gap. The extended recession has undermined the 1991-92 budget estimates, which assumed that the recovery would begin in mid-1991. If no action is taken, the state will end the current year with a General Fund deficit of \$2.8 billion, and will be at least \$6 billion short of the amount needed to pay off that deficit, maintain state services at their current levels, and establish a prudent reserve.

The *1992-93 Governor's Budget* proposes a number of significant spending reductions and other budget actions to close the budget gap. It also continues the administration's emphasis on "prevention" programs, which are intended to reduce state expenditures in the long run. However, because of its reliance on optimistic budget assumptions, it represents a risky strategy that virtually assures a 1992-93 deficit.

As a result of the deficiencies in the Governor's Budget, the Legislature must begin its deliberations by identifying the types of changes needed to place the budget on a more sound footing. Among these changes, the Legislature must determine how it will provide a more sufficient level of protection for the budget plan, and ensure that it adequately addresses the needs of the state in the years to come.

In this part, we review the nature of the state's budget funding gap, both in the absence of corrective action and assuming that the Governor's plan is adopted as proposed. We summarize the budget's major proposals and examine their impact on the different program areas. Next, we provide our overall assessment of the Governor's Budget, in terms of the extent to which it adequately addresses the fiscal problem facing the state in 1992-93 and beyond. Finally, we discuss the additional steps that need to be taken to arrive at a fiscally sound 1992-93 budget.

THE 1992-93 BUDGET PROBLEM

Current-Year Situation Has Deteriorated

The 1991-92 budget adopted last July was designed to resolve a massive two-year budget gap that had grown from \$7 billion as identified in the Governor's January 1991 budget proposal to \$14.3

billion by May. Part of that gap was due to an underlying structural budget problem — the growth of spending for some of the state's major state programs was outpacing normal ongoing revenue growth. However, the gap was primarily due to the national recession that started in mid-1990.

The 1991-92 budget plan was based on the assumption that the recession had ended, and that a resumption of economic growth would enable the state to end 1991-92 with a reserve of \$1.2 billion. Instead, the recession has continued, and the state once again faces a large gap between estimated revenues and expenditures.

Figure 1 compares the July 1991 budget estimates with those released in the *1992-93 Governor's Budget*, adjusted to exclude the roughly \$1 billion of spending reductions and revenue enhancements proposed by the budget to mitigate the current-year deficit. As these data show, the budget anticipates that, absent any corrective action, the Special Fund for Economic Uncertainties (the General Fund reserve) will end 1991-92 with an accumulated deficit of about \$2.8 billion, rather than the \$1.2 billion allocated in July. This represents a deterioration of \$4 billion in the state's fiscal condition since the enactment of the 1991-92 budget plan in July.

Figure 1

**1991-92 General Fund Condition
Deteriorates Since July 1991**

(in billions)

	<i>Estimate Date</i>		Change
	July 1991	January 1992	
Carryover of 1990-91 deficit	-\$1.7	-\$1.7	
Revenues and transfers	46.3	43.3 ^a	-\$3.0
Total resources	\$44.6	\$41.6	-\$3.0
Expenditures	43.4	44.4 ^b	\$1.0
Reserve^c	\$1.2	-\$2.8	-\$4.0

^a Governor's Budget estimate adjusted to remove \$307 million of proposed 1991-92 revenue enhancements and transfers.

^b Governor's Budget estimate adjusted to restore \$732 million of proposed savings and funding shifts.

^c Special Fund for Economic Uncertainties.

Recession Dominates Budget-Year Outlook

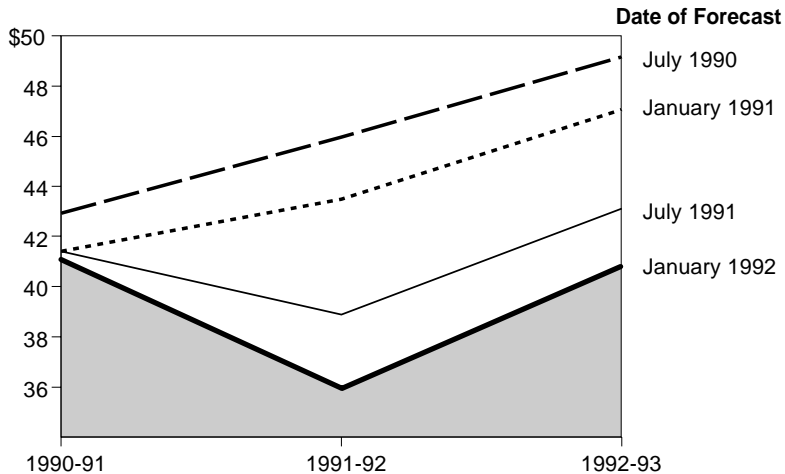
Although the administration anticipates that an economic recovery will be underway by early 1992, the outlook for the budget year continues to be heavily influenced by the recession's impact. As shown in Figure 2, the Department of Finance's revenue estimates have declined dramatically since the onset of the recession in July 1990, and the declines have affected both current- and budget-year revenues by similar amounts. Over the three-year period between 1990-91 and 1992-93, the figure shows that, cumulatively, General Fund revenue estimates have declined by roughly \$20 billion. Thus, the recession clearly has had an enormous impact on the state's fiscal condition and is the primary cause of the fiscal difficulties anticipated for 1992-93.

The administration anticipates that General Fund revenues will grow from \$43.6 billion in the current year to \$45.7 billion in 1992-93, an increase of 4.7 percent. However, when 1991-92 and 1992-93 revenues are adjusted to exclude the effects of the Governor's proposed revenue enhancements and a one-time

Figure 2

Estimates of General Fund Revenues Have Declined Significantly

(in billions)



Source: July 1990 forecast is LAO extrapolation of Department of Finance 1990-91 estimates. All other figures reflect LAO adjustments to the department's estimates in order to remove the effects of revenue changes enacted in 1991 and 1992.

accrual accounting gain in the current year, the underlying increase in revenue is about 8 percent. These estimates reflect the Department of Finance’s assumption that revenues will “rebound” from their low recession levels during the expected recovery, consistent with the state’s experience in prior recessions.

While the recession has significantly reduced revenues, it has had the opposite impact on certain state spending programs. Caseloads in the state’s health and welfare programs, for example, have been growing *more* rapidly as people lose their jobs or cannot find employment and must seek assistance. Other spending pressures are independent of the economy. For example, education spending increases to keep pace with the school-age population, which is growing almost twice as fast as the overall population.

Our latest projections indicate that baseline spending in 1992-93 would require \$47.1 billion, an increase of \$2.7 billion over current-year spending (excluding changes proposed in the budget), and \$3.3 billion more than the amount of spending actually proposed in the budget for 1992-93.

1992-93 Budget Gap: \$6 Billion

As shown in Figure 3, we estimate that the 1992-93 budget gap totals \$6 billion. This amount consists of the \$2.8 billion carryover deficit from 1991-92, the \$2 billion shortfall between baseline

Figure 3

1992-93 Budget Gap^a

(in billions)

Pay off deficit from 1991-92		\$2.8
1992-93 baseline spending	\$47.1	
1992-93 estimated revenue ^b	<u>-45.2</u>	
Operating shortfall		\$2.0
Restore reserve		\$1.2
Total budget gap		\$6.0

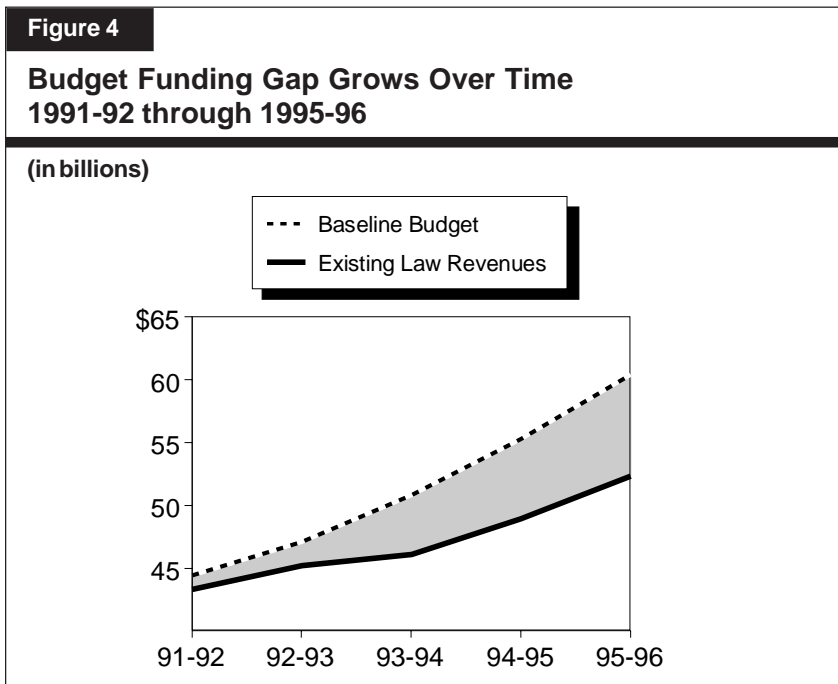
^a Excludes Governor’s Budget proposals. Detail does not add to total due to rounding.
^b Based on administration’s revenue forecast.

spending and estimated revenue, and the \$1.2 billion needed to restore the General Fund reserve to a level comparable to that approved in the 1991-92 budget plan. This estimate relies upon the administration's estimates of current- and budget-year General Fund revenues, adjusted to eliminate the revenue enhancements proposed in the budget. Because, as we discuss later, it is likely that these estimates will be revised downwards as the year progresses, this estimate of the budget gap should be regarded as a *conservative* one.

A Growing Long-Term Problem

Figure 4 presents our estimates of the annual operating shortfall between baseline spending and baseline revenues over the period 1991-92 through 1995-96. In preparing these estimates, we have again assumed that the administration's economic forecast for 1992 and 1993 is correct, and have extended it through 1995-96, assuming a continued moderate economic expansion. As the figure shows, the state's operating shortfall widens considerably during this period and, by 1995-96, has increased to approximately \$8 billion.

The operating shortfall widens considerably in 1993-94 for



several reasons. First, revenue growth is restrained by the expiration of the state's current temporary 1/2-cent sales tax rate, and because deductions for business' net operating losses will once again become available (they were suspended for the 1991 and 1992 tax years). Spending growth, however, accelerates. Education spending rises rapidly as increased per capita personal income begins to push up the K-14 funding requirement under Proposition 98. Increased state General Fund costs for retirement contributions also add significantly to the gap in that year, because the state's special retirement funding offsets will have been fully consumed by that time.

After 1993-94, the gap continues to widen because of the ongoing disparity between baseline spending growth and the rate of revenue growth. Our estimates indicate that this widening of the gap can be attributed primarily to expected cost increases for the trial court funding program, corrections programs, debt service on general obligation bonds, and the Medi-Cal program. Expected state cost increases for welfare programs actually mitigate these cost increases to some extent, because provisions of state law have suspended cost-of-living adjustments for these programs through 1995-96.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 5 shows the Governor's proposed levels of spending

Figure 5

**Governor's Budget
General Fund Condition**

(dollars in millions)

	1991-92	1992-93	Percent Change
Prior-year balance	-\$1,258.9	-\$1,343.8	--
Revenues and transfers	<u>43,633.3</u>	<u>45,673.1</u>	<u>4.7%</u>
Total resources	\$42,374.4	\$44,329.3	4.6%
Expenditures	<u>\$43,718.2</u>	<u>\$43,817.0</u>	<u>0.2%</u>
Fund balance	-\$1,343.8	\$512.3	--
Reserve^a	-1,781.3	105.4	--
Other obligations	437.5	406.9	--

^a Special Fund for Economic Uncertainties.

and revenue for 1991-92 and 1992-93 and the resulting condition of the General Fund. Estimated General Fund revenues increase by 4.7 percent over the current year, but the additional revenue is needed to pay off the 1991-92 carryover deficit. Total spending is essentially unchanged at \$43.8 billion, which is only \$99 million more than estimated current-year spending. On its own terms, the budget is balanced, but only by the slimmest of margins. At the end of 1992-93, the budget estimates that the balance in the General Fund reserve would be only \$105 million — or about 0.2 percent of 1992-93 estimated revenues.

HOW THE BUDGET RESOLVES THE SPENDING GAP

Figure 6 shows how the budget proposes to resolve the \$6 billion budget funding gap that we identified above. The largest contribution to resolving the gap comes from program reductions, which provide a total savings of \$2.8 billion (net of about \$100 million in new spending proposals). The largest component of these savings is from the Governor's proposals to reduce welfare costs for Aid to Families with Dependent Children (AFDC). Shifting program costs to others — primarily to local governments and the federal government — provides \$1.2 billion, and increased revenues and transfers to the General Fund provide \$0.8 billion. These proposals sum to \$4.8 billion. The remaining \$1.2 billion of the spending gap is absorbed by not restoring the reserve.

About \$1 billion of the budget's gap-closing solutions would be realized in 1991-92. This reduces the deficit carried over from 1991-92 into 1992-93, from \$2.8 billion to \$1.8 billion.

Major Policy Proposals

The budget proposes a number of major policy changes, particularly in the welfare and health areas.

Welfare Proposal. The budget proposes enactment of the AFDC provisions of the Governor's welfare initiative in time for those provisions to be implemented by March 1, 1992. The budget includes net savings of \$72 million in 1991-92 and \$638 million in 1992-93 due to these AFDC changes. Figure 7 shows the major AFDC program changes proposed by the Governor.

Medi-Cal Reductions. The budget proposes the elimination of several federally optional services, including adult dental care, psychology, chiropractic and podiatric services, and occupational therapy, for a General Fund savings of \$109 million. Payment for hospital stays would be limited to 60 days per year for a savings of \$61 million, and other limits on provider rates and payments

Figure 6**Budget's Proposed Resolution
of the 1992-93 Spending Gap^a****(in billions)****Program Reductions**

AFDC: Welfare proposals	\$0.7
State employees: No COLA, reduce pay and health benefits	0.5
Eliminate renters' credit	0.4
UC/CSU: Eliminate COLAs and other adjustments	0.3
Proposition 98: Reduce 1991-92 funding	0.2
Medi-Cal: Limit optional benefits, inpatient days and rates	0.2
Defer lease revenue bond payments	0.1
Other	0.5
New program proposals	-0.1
Subtotal	\$2.8

Funding Shifts

To local governments	\$0.5
To federal government	0.5
To Proposition 99 (Medi-Cal)	0.1
To fees	0.1
Subtotal	\$1.2

Increased Revenues

Transfers from special funds and bond funds	\$0.5
Eliminate health care tax credit	0.1
Increased audit and collection efforts	0.2
Other	0.1
Subtotal	\$0.8

Reserves

Reduce reserve level	\$1.2
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Total **\$6.0**

^a Estimates include impacts in both 1991-92 and 1992-93. Detail may not add to totals due to rounding.

would save an additional \$65 million.

Proposition 98. The budget meets the minimum funding requirement for K-12 education and the Community Colleges under Proposition 98. However, the budget does propose two adjustments that affect the state's costs.

Figure 7

Governor's Welfare Proposal Budget Estimates of Impact on General Fund^a

(in millions)

Savings	1991-92	1992-93
Reduce maximum grant by 10 percent ^b	\$81	\$287
Transitional grant: Reduce grant by additional 15 percent after 6 months on aid ^b	--	252
No grant increase for additional children while on aid ^b	--	16
Residency: Limit grant to home-state amount for 1 year ^b	2	15
Eliminate pregnancy benefits	6	38
Estimated savings from reduction in dependency	--	70
Subtotals, Savings	\$89	\$679
Costs		
County and state administration	\$12	\$11
Job Club employment workshops	--	15
Child care for children of teens attending school	6	15
Subtotals, Costs	\$18	\$41
Net savings in budget	\$72	\$638

^a Detail may not add to totals due to rounding.

^b Federal waiver needed.

First, the budget proposes a \$183 million reduction in current-year expenditures to take advantage of a decline in the minimum funding requirements of Proposition 98. The shortfall in current-year revenues has reduced the 1991-92 minimum payment relative to the amount appropriated in the budget. The state would not actually reduce allocations to school districts in the current year. Instead, this would be implemented by "loaning" the \$183 million to school districts in the current year but counting it toward the 1992-93 minimum guarantee.

Second, the budget proposes enactment of legislation to reallocate an estimated \$347 million of property tax revenue away from enterprise special districts (such as water and sanitation districts) to school districts. These funds would reduce the state's funding obligation under Proposition 98. In effect, this proposal shifts \$347 million of education costs from the state General Fund to the residents of these special districts, who will be asked to offset the property tax losses with increased user charges and special assessments.

Renters' Credit. The renters' tax credit would be eliminated starting in 1992, for a savings of \$376 million. In 1991, legislation limited eligibility for the credit to renters with incomes of less than \$41,000 (joint) or \$20,500 (single).

New Programs. The budget proposes a limited amount of additional spending for new programs — about \$100 million. It also proposes new programs that are funded by redirection of existing funds and by reallocations within the Proposition 98 minimum funding guarantee. These proposals generally continue the Governor's emphasis on prevention programs and include the following:

- **Check-Up (\$20 million).** Establishment of a subsidized insurance program to provide access to basic health services for low-income infants and preschoolers.
- **Healthy Start and Early Mental Health (\$30 million).** Expansion of these programs, which seek to prevent and treat health and mental health problems among schoolchildren.
- **Parole Failure Prevention (\$13.5 million).** Augmentation to provide shelter, employment preparation, drug treatment and other services to parolees in order to prevent parole violations and reincarcerations.

DOES THE BUDGET WORK?

In evaluating how well this budget works as a fiscal plan for the state, we have asked four questions:

- What are the risks? How likely is the budget to perform as planned?
- Is the size of the reserve commensurate with the amount of risk?
- Does the budget take steps to resolve long-standing fiscal problems?
- Does the budget resolve the state's structural budget problem?

MAJOR DOWNSIDE RISKS

The budget contains major downside risks, which generally fall into the following categories:

- **Optimistic Revenue Estimate.** We conclude that the state's economic recovery will be delayed until mid-1992 and reduce state revenues by at least \$2 billion. An extension of the recession through 1992 could reduce
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current- and budget-year revenue by at least \$3 billion.

- ***Uncertainty of Federal Waivers and Their Timing.*** Several of the Governor's major AFDC proposals require waivers of federal requirements before they can be implemented. In addition to the risk that some waivers may be denied, the time needed to obtain waivers is likely to delay implementation beyond the dates assumed in the budget.
- ***Speculative Sources of Funding.*** The receipt of some funds included in the budget is highly speculative. For example, it is unlikely that the state will receive \$404 million of federal SLIAG grants that the budget relies upon to offset General Fund costs.
- ***Questionable Fund Diversions.*** Some proposed uses of funds may be prohibited by the provisions of initiatives (for instance, the proposed use of Proposition 99 funds), and others involve policy changes that the Legislature may not find acceptable (for example, the use of State Highway Account and Transportation Planning and Development Account monies to repay the General Fund for debt service).
- ***Uncertain Timing of Legislation and Other Actions.*** Many of the budget proposals require legislation (for example, elimination of the renters' credit) and/or regulatory and administrative actions (for example, savings associated with refinancing lease-revenue bonds) in order

Figure 8

**Identified General Fund Risks
1992-93 Budget**

(in millions)

	Amount ^a
Economic recovery — delayed until 1993	\$3,000
PERS: Availability of special retirement funds	760
AFDC: Inability to implement proposals	530
SLIAG: Availability of federal funds in doubt	404
Medi-Cal: Proposition 99 perinatal program funding	123
Medi-Cal: Court decision on dental costs	76
Lease-revenue bonds: Treasurer may decline to refinance	60
Elk Hills Oil Revenues: No transfer is likely	45
Total	\$4,998

^a Reflects 1991-92 and 1992-93 amounts combined.

to be implemented and achieve savings. The budget's accelerated schedule for these savings is optimistic.

Figure 8 summarizes the major budget risks that we have identified to date and their potential General Fund impact, which totals up to \$5 billion. The risks in Figure 8 do not include any possible losses due to potential delays in the enactment or implementation of budget proposals by state agencies (such as the 5 percent pay cut that the budget assumes was effective on January 1, 1992).

Budget Reserve is Inadequate

The variety and magnitude of the spending and revenue risks in this budget would necessitate a reserve substantially more than the budget's \$105 million level to cover what are almost certain to be significant revenue shortfalls or spending increases. In fact, given these risks, a reserve of more than \$2 billion could be technically justified even though it is practically unattainable. If, on the other hand, the Legislature adopts a budget plan with far fewer downside risks, a reserve somewhat below the customary 3 percent of expenditure level is reasonable on a temporary basis.

Budget Does Not Address Some Long-Standing Problems

The budget does not attempt to resolve a number of large outstanding fiscal problems and, in some cases, exacerbates them. For example:

- ***Deteriorating Fiscal Condition of Local Governments.*** The fiscal condition of local governments also has been deteriorating during recent years. Local revenues have been reduced by the recession, and state allocations of realignment revenues to counties will fall short of last year's estimates by at least \$150 million. The budget increases the local fiscal burden by shifting about \$500 million of state costs to local entities — primarily counties and enterprise special districts.
 - ***Unaddressed Infrastructure Needs.*** The backlog of unfunded infrastructure needs continues to grow. The budget provides no funding for state/local partnership transportation projects, which will cause further delays in meeting these infrastructure needs. In addition, the budget ignores the state's policy to own, rather than lease, most of its office space. The cost of leasing office space now exceeds \$200 million per year, and is expected to exceed \$500 million by 1995-96.
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- **Growing Pension Liabilities.** The state continues to accumulate large unfunded liabilities in its pension programs (particularly in the State Teachers' Retirement System and the Judges' Retirement System), and no action is proposed to curb the state's exposure to these future costs.

Long-Term Gap Remains

To what extent do the Governor's budget proposals help address the growing long-term gap between baseline spending and revenues, and by how much do they reduce that long-term budget gap? In order to examine this issue, we projected the effect of the budget proposals on baseline spending and revenues through 1995-96. Many of the Governor's budget proposals, such as the AFDC and Medi-Cal reductions, do have an ongoing effect that grows with time. They reduce the size of the ongoing gap, but they do not eliminate it. By 1995-96, the budget proposals still result in a gap of \$4 billion, a reduction by one-half of the baseline funding gap of \$8 billion.

Budget Needs More Work

On the basis of the concerns outlined above, we conclude that the Governor's Budget is, for all practical purposes, unbalanced and incomplete. Additional steps to reduce spending, increase revenues, and to bring the rates of growth of revenues and spending into balance are needed.

HOW DOES THE BUDGET "STACK UP" AGAINST BUDGET BALANCING PRINCIPLES?

In our December Policy Brief, entitled *The State's Fiscal Problem*, we presented six fiscal principles that should guide budget decisions under current conditions. Below, we evaluate how the Governor's Budget measures up to these principles.

Make Significant Reductions in Major Programs

The budget does propose significant and specific reductions to the AFDC program and in Medi-Cal to a lesser extent. Savings also are achieved in higher education (UC and CSU), but primarily by limiting enrollment at CSU, not providing salary increases, and by shifting more costs to fees, rather than by making specific program decisions. This leaves the Master Plan goals in place, but the institutions' ability to meet them in doubt. The budget, however, does not make any significant reductions in K-14 education or in corrections, consistent with the Governor's

priorities. Together, these two areas account for almost one-half of the General Fund budget, so that leaving them intact significantly increases the amount of reductions that must be made in other programs.

Restructure Programs

The budget proposes to restructure the AFDC program by instituting various changes in grant levels and authorizing new sanctions and incentives for various categories of recipients. The budget contains few other significant restructuring proposals.

Make Choices Rather Than “Across-the-Board” Cuts

The budget clearly reflects policy choices that target reductions at specific programs. Furthermore, the budget proposes to suspend the “trigger” mechanism that would require automatic across-the-board cuts in many programs. However, in building the budget, most departments were required to absorb some costs, such as merit salary increases and equipment price increases, by making offsetting reductions. These reductions reflect priorities within departments, but do not reflect any overall budget priority.

Use One-Time Solutions Appropriately

One-time savings or revenue increases can be used appropriately to finance one-time costs, such as paying off the 1991-92 deficit and restoring the reserve. The budget includes roughly \$1 billion in one-time savings or revenues. Additional one-time solutions of up to roughly \$2 billion could be used appropriately to pay off the deficit and to establish a prudent reserve. However, one-time solutions should not be used to address ongoing shortfalls in the budget because this would worsen the state’s long-term fiscal imbalance.

Avoid Short-Term Savings that Increase Long-Term Costs

The budget generally avoids this pitfall, but there are a few exceptions. The budget proposes to refinance lease-revenue bonds to achieve a savings of \$60 million in bond payments through 1992-93. This immediate savings, however, would result in an ongoing annual cost of \$20 million for increased debt service on the replacement bonds, which would more than offset the short-term savings. The budget also defers various equipment purchases and maintenance expenses, which could result in higher future costs.

Examine Tax Base and Coverage

The budget eliminates the small business health care credit (which has never been implemented) and the renters' credit (although this is treated as an expenditure savings). Otherwise, the budget does not contain any proposals for expanding the tax base or the coverage of the state's tax system.

CHALLENGES FOR THE LEGISLATURE

Figure 9
Challenges for the Legislature
Fill in the gaps left by the administration's budget plan:
<ul style="list-style-type: none"> • Make additional significant reductions in major programs. • Increase reserve to prudent level commensurate with risks. • Restructure major programs to enhance long-run effectiveness.
Act early to mitigate the current-year deficit and resolve the budget-year shortfall
<ul style="list-style-type: none"> • Open up the entire budget for review, reduce or eliminate activities that are low-priority or are not cost-effective. • Review tax expenditure programs on the same basis as regular spending programs, and examine the coverage of the state's tax base.
Ensure that a longer-run perspective and a vision of California for the year 2000 and beyond remains present in budget deliberations by asking:
<ul style="list-style-type: none"> • How does the state ensure quality governmental services in the most effective manner? • How can the ability of the state and local governments to deal with the problems of the future be improved? • What steps need to be taken to ensure healthy economic growth in the future?

The budget presented by the Governor leaves a great deal of difficult work to be done by the Legislature. Spending cuts and/or revenue increases will be needed in order to fill the gaps in the Governor's plan. Furthermore, additional actions will be needed to provide a higher reserve level which takes into account the risks assumed in a final budget plan. Also, more should be done to target the state's limited funds at the highest priority programs in all of the major program areas. Finally, the Legislature should reevaluate tax expenditures and the coverage of the state's tax system for options to increase revenues, and weigh these against spending reductions. Figure 9 summarizes these challenges.

While dealing with the immediate task of crafting a budget for 1992-93, the Legislature also will need to keep its eyes on the state's long-run needs. California and its economy are changing rapidly. The state and local governments must improve their effectiveness and cooperation in order to provide the services and facilities needed to meet these changing conditions, provide for healthy economic growth, and maintain a high quality of life for the state's diverse population.

Perspectives on the Economy





Perspectives on the Economy

This part provides a discussion of the outlook for the state's economy in 1992 and 1993. Our discussion of the state's economic outlook begins with a description of the current economic climate. We review the performance of the economy over the last year in comparison to what had been expected at the time the budget was adopted last July. We then describe the forecast upon which the 1992-93 Governor's Budget was predicated. Finally, we present our views as to the reliability of this forecast, including a discussion of how economic data released, subsequent to the preparation of the forecast, affect its overall viability.

The major findings of this part include:

- The 1991 economic recession in California was more severe than had been anticipated by the administration. What had been forecast to be a modest downturn actually appears to be the longest recession since the 1930s, and the most severe recession in terms of job losses since World War II.
- The administration expects the California economy to begin its recovery from the recession in early 1992, although economic growth will be more modest than has been the state's experience in its recovery from prior recessions.
- There are significant downside risks to the administration's economic forecast. Generally, most of the risks point to a delay in the recovery, as opposed to further declines in the state's economy. The Legislature should anticipate a later recovery in making its plans to balance the budget.

Perspectives on the Economy

The expected performance of the state's economy is the major factor determining the level of state revenues. Economic factors such as the level and rate of growth in jobs and income are translated into estimates of tax revenue to be received by the state, so that changes in the forecast for economic activity in the state will often have dramatic effects on the level of expected tax revenues.

THE CURRENT ECONOMIC CLIMATE

The current economic climate is very negative, with both the national and state economies still deeply mired in continuing recession. Job losses and low levels of consumer confidence are the dominant story in today's economic headlines, although record-low interest rates and inflation offer hope that recovery is imminent. The key questions at this time are how long it will take for the state's economy to begin expanding once again, and how strong the expansion is likely to be.

1991 Recession More Severe Than Expected

Last July, the Department of Finance (DOF) anticipated that the state's economy would pull out of its mild recession and begin a modest economic upturn in the second half of 1991. This upturn was expected to grow stronger during 1992. The budget for the current fiscal year (1991-92) was adopted based on this forecast.

However, by late summer the DOF announced disturbing new data which showed that job losses among wage and salary workers had been much larger than previously reported. (See the box on the next page for a more detailed discussion of this issue.) This information changed the perception of the current recession — it has been much deeper and more severe than originally estimated.

Last May, the DOF estimated that California would gain 63,000 jobs during 1991. By late summer, it was evident that job losses had been more severe than expected and that the recession wasn't ending. As a result, the DOF changed its employment estimates from a modest increase to a loss of over 400,000 jobs during 1991. That, in turn, led to a \$20 billion downward revision

in the estimate of personal income — from \$650 billion to \$630 billion. As the incomes of Californians declined, so did the level of taxable sales, which was reduced by \$12 billion. These changes not only lowered the 1991 economic base, but they also reduced the expected level of economic activity during 1992. Thus, the revenue trend line for both the current and budget years had to be lowered because of these economic changes.

NEW FORECAST — WEAK UPTURN FOLLOWED BY MODERATE GROWTH IN 1993

Figure 1 summarizes the DOF's current economic forecast. As these data show, the forecast predicts a weak upturn in the California economy during 1992, with somewhat stronger, but still moderate, growth in 1993. It also indicates that the 1991 recession was probably more severe in California than in the

Problems in Measuring

Obtaining timely and accurate information on employment is critical for an understanding of the economy and trends in state revenues. There are two sources of information which are used to measure the number of wage and salary jobs in California.

First, the Employment Development Department (EDD) conducts a monthly job survey which covers about 37,000, or 5 percent, of all employers. Most large- and medium-sized employers are covered by this survey. Fewer of the small and newer firms, however, are covered. This monthly survey is the official state series on employment statistics. Once a year, these survey results are updated by tying them to quarterly payroll reports. Second, the EDD collects quarterly payroll and employment reports from all employers. Once a year, these quarterly data are rigorously reviewed and a count of total employment by sector are published by the department. That publication takes place after the close of the year. To obtain information on employment trends between annual updates, the DOF prepares its own monthly estimates on employment. This "interim series" is based on the EDD's quarterly reports.

These two sources — the EDD survey estimates and the DOF interim series — do not always provide comparable information on the number of jobs and, therefore, trends in the economy. During periods of economic expansion, the EDD survey method can underestimate the growth in employment. During recessions, the opposite can occur (that is, employment totals are overestimated).

nation, although the national job loss of 0.8 percent is likely to be revised downward significantly this summer. Based on the DOF forecast, job growth in the nation will be somewhat higher than in California during 1992, but by 1993 California should outpace the nation.

Personal Income Growth Slows

Figure 2 shows historical growth trends in California personal income, both in current and real (inflation-adjusted) dollars. From 1985 to 1990, personal income grew at an annual rate of 8 percent in current dollars and 4 percent in real dollars. In 1991, however, current-dollar growth dropped to a meager 1.8 percent. After adjusting for inflation, personal income actually declined 2.1 percent last year. By contrast, during the 1982 recession, there was a small, but still positive, growth in real personal income. The

The Number of Jobs

For example, during the 1970 and 1982 recessions, the EDD surveys overstated the number of jobs compared to the quarterly payroll reports. Based on the quarterly reports, it appears that the survey data are again resulting in an overstatement of job levels. The EDD's official estimate of employment for 1991 is 365,000 jobs higher than the DOF's budget estimate. The disparities are primarily in estimates of construction, trade, and service employment. These disparities give vastly different pictures of what happened to the economy last year. According to the EDD's numbers, California lost only 43,000 jobs in 1991, which translates into a very mild downturn. By contrast, the DOF budget estimates show a 408,000 job loss. In percentage terms, the DOF figure is almost double the loss experienced during the severe 1982 recession, and it is the largest drop in employment since 1945.

These divergent employment numbers partially explain why there is so much confusion over the depth of the current recession and the direction of the economy. Other states also are finding wide disparities between their survey and payroll reports. As a result, current forecasts of the gross domestic product (GDP) and personal income, which are partially based on employment survey estimates, understate the magnitude of the current recession.

By March 1992, the EDD will publish its reconciled estimate of 1991 employment, presumably eliminating this wide gap in California employment estimates. Reconciliation of national employment estimates will not occur until this summer.

Figure 1
**Department of Finance Economic
Outlook for California and Nation
1991 through 1993**

California Economic Indicators	1991 Estimated	1992 Projected	1993 Projected
Percent change in:			
Personal income	1.8%	4.9%	6.9%
Wage and salary employment	-3.2	0.6	2.7
Consumer Price Index	4.2	4.2	3.7
Unemployment rate (%)	7.7	7.6	6.7
Residential building permits (thousands)	109	133	197
New car registrations (thousands)	1,315	1,380	1,496
National Economic Indicators			
Percent change in:			
Real GNP	-0.6%	1.5%	2.7%
Personal income	3.4	4.8	5.8
Wage and salary employment	-0.8	1.0	1.6
Consumer Price Index	4.2	3.6	3.5
Unemployment rate (%)	6.7	6.7	6.2
Housing starts (millions)	0.98	1.11	1.38
New car sales (millions)	8.4	8.8	10.2

DOF's estimates of income growth rates for 1992 and 1993 are positive, but below the growth trends of the late 1980s.

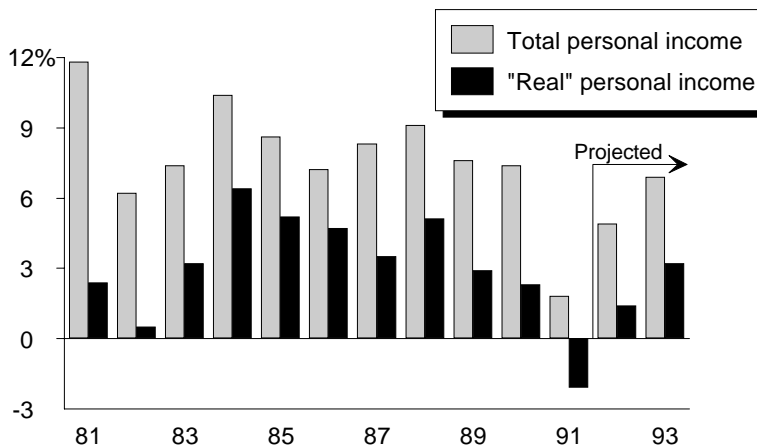
Job Losses to Be Recouped By 1993

During the late 1980s, about 400,000 new jobs were created each year in California. By 1990, this growth rate had slowed to 300,000 new jobs. Figure 3 shows that the DOF estimates that California lost over 400,000 jobs in 1991, and that it will take two years to make up that loss. In 1992, job growth is expected to be only 73,000, or less than 1 percent. In 1993, 342,000 additional jobs are expected, but that will only bring employment back to its 1990 level.

Figure 4 shows the quarterly pattern of the anticipated increases in employment. The DOF expects the upturn to start in the first quarter of 1992 and then gain strength during the

Figure 2

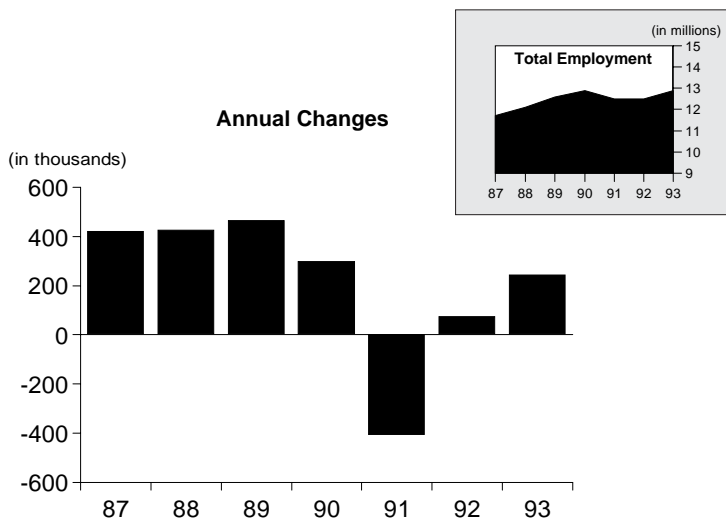
**Annual Growth in California Personal Income
1981 through 1993**



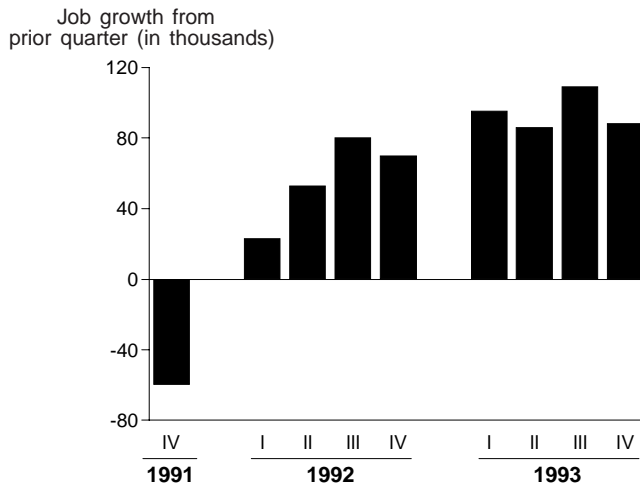
^a"Real" personal income is defined as total personal income deflated by the GNP personal consumption expenditures deflator.

Figure 3

**Changes in California Employment^a
1987 through 1993**



^aWage and salary workers.

Figure 4**Projected Upturn in California Employment
1991 through 1993**

Source: Department of Finance.

second half of the year. This assumption is critical to the department's revenue forecast, as it results in a substantial growth in personal income for 1992 — and therefore higher tax revenues for 1992-93.

Figure 5 shows the California job gains and losses by type of industry. It indicates that 1991 losses were heaviest in construction, manufacturing, and trade. The DOF estimates that by 1993 only 30 percent of the construction jobs lost the prior two years will be replaced, and that an even smaller percentage (18 percent) of the manufacturing jobs will be recaptured. Because of projected large gains in service employment, however, *total* employment is expected to return to its 1990 level by 1993.

Housing Starts to Rebound

Figure 6 shows the number of new housing units constructed in California and in the nation. The growth in housing units was especially strong after the 1982 recession. Nationally, they grew from about a million units in 1982 to an average of 1.7 million from 1983 through 1986, when the rate dropped to about 1.4 million.

Similarly, California had six years in the 1980s when the number of new housing units was over 200,000. In fact, the

Figure 5

**California Employment Gains and Losses
By Industry
1991 through 1993**

(in thousands)

Industry	1991 (estimated)	1992 (projected)	1993 (projected)
Construction	-106	-16	+36
Manufacturing	-103	-16	+22
Transportation, utilities	-11	-3	+6
Trade	-126	+22	+82
Finance, insurance, and real estate	-20	-2	+9
Services	-68	+86	+165
Mining	-2	+1	+2
Government:			
Federal	-13	—	-3
State and local	+40	+3	+20
Totals	-408	+73	+342

^a Detail does not add to totals due to rounding.

Source: Department of Finance

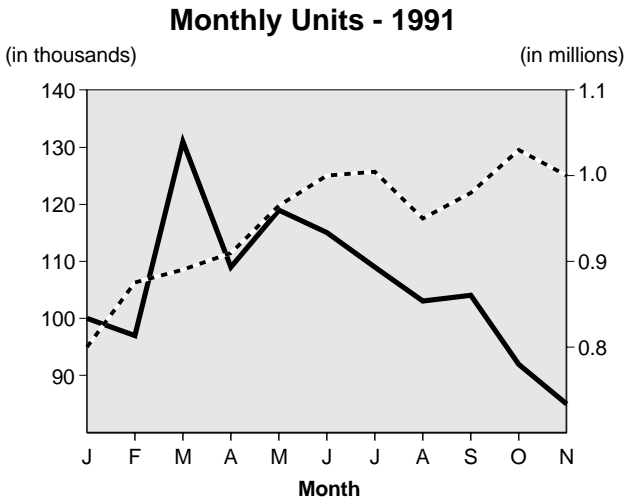
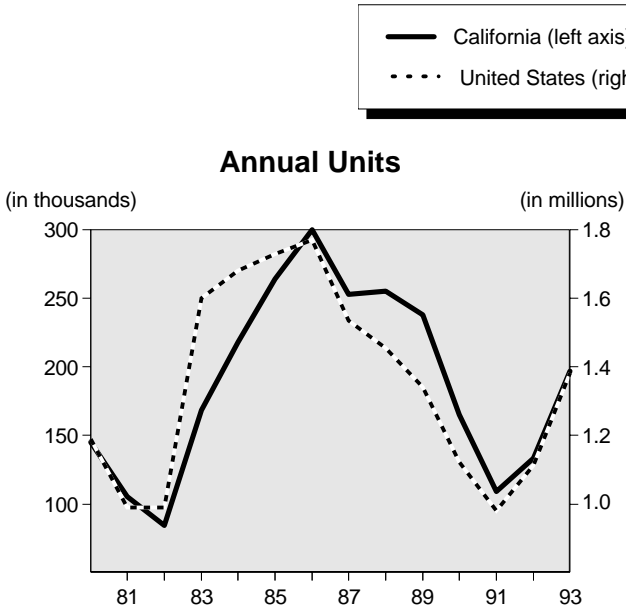
average from 1984 to 1989 was 255,000 units per year. The housing “boom” of the 1980s held up longer in California than it did nationally. During 1991, new housing increased modestly on a national basis, but continued to decline in California (see bottom part of Figure 6). The DOF forecasts that California’s rebound in housing will outpace the nation’s. From 1991 to 1993, it estimates an 80 percent increase in California versus a 40 percent increase nationally.

Car Sales to Accelerate

As shown in Figure 7, car sales both in California and nationally grew at double-digit rates during the first two years following the 1982 recession. From 1986 through 1990, California sales were fairly steady, averaging a healthy 1.4 million units each year, while national sales peaked at the beginning and then steadily declined. During 1991, car sales dropped by 9 percent in California, and by close to 12 percent nationally. The DOF expects the rebound in California car sales to be very strong, reaching a peak in 1993 that is above the level of the late 1980s. Because national sales dropped further, the DOF expects a bigger percentage increase, but its level in 1993 would still be below previous

Figure 6

**New Housing Units in California and the United States
1980 through 1993**

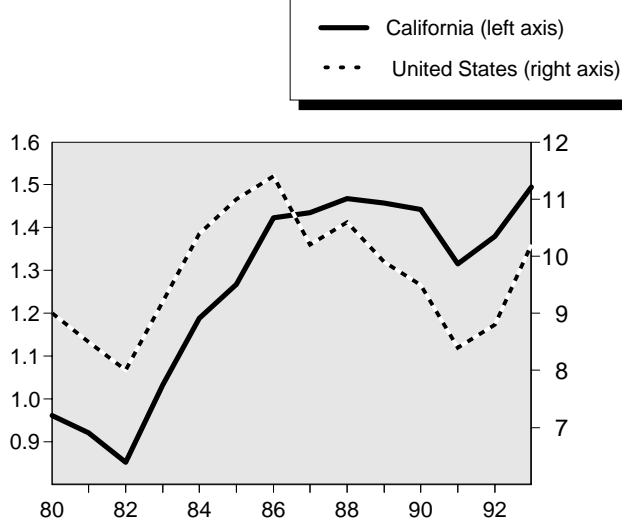


Source: Department of Finance.

Figure 7

New Car Sales^a 1980 through 1993

(in millions)

^a California data includes light trucks.

Source: Department of Finance

peaks.

HOW RELIABLE IS THE ECONOMIC FORECAST?

Any economic forecast is subject to considerable error, but particularly so at turning points in the business cycle. Both California and the nation are now at such a juncture, but at this time it is unclear how long the transition from recession to recovery will take. Thus, the basic concern about the administration's economic forecast centers on its assumed timing of the recovery, as opposed to the direction in which the economy is headed.

The most common method used to evaluate an economic forecast is to compare it with other forecasts. When the budget's economic forecast was prepared in November 1991, the administration's national forecast was somewhat more pessimistic than the consensus of other forecasters. Since that time,

most other forecasters have lowered their estimates and are now more in line with the department. Certain forecasters, however, such as First Interstate Bank and Bank of America, have higher state personal income growth figures for 1992. Both of them relied upon the EDD's employment figures for last year which were substantially higher and, therefore, not comparable to, the DOF's "interim" series. Most other forecasts, with the University of California at Los Angeles (UCLA) being a strong exception, called for the upturn to start at least by the middle of 1992, and then to gain strength in the following year. The DOF's forecast calls for an upturn to start in the first part of the year and then gain momentum in the second half. The UCLA forecast, by contrast, was more pessimistic and stated the upturn would be delayed until the start of 1993.

Since these forecasts were made, the economy has turned softer. For example, California employment was weaker in the fourth quarter of 1991 than anticipated, and it now looks like the total job loss last year was 460,000, rather than 408,000.

Downside Risks to the Economic Outlook

The budget clearly states that there are downside risks to its economic forecast. Some of the major ones are:

- California employment remains stagnant.
- Consumer confidence remains depressed.
- Tight credit holds back business expansions.
- Delays in action on the federal budget and tax changes defer economic activity.
- Cutbacks in defense orders increase.

Most of the risks point to a possible delay in the recovery, rather than a further decline in the economy. Therefore, the main issue is one of timing, rather than what direction the economy will take. From a revenue estimating viewpoint, the timing issue is crucial. The DOF anticipated an early upturn, which would help boost 1991-92 and 1992-93 revenues. To date, this upturn has not occurred. As a result, the Legislature should anticipate a later recovery — with lower revenues — when making its initial plans to balance the budget. By May, we should have a clearer picture of how deep the 1991 recession actually was and whether the anticipated recovery has begun.

Perspectives on State Revenues





Perspectives on State Revenues

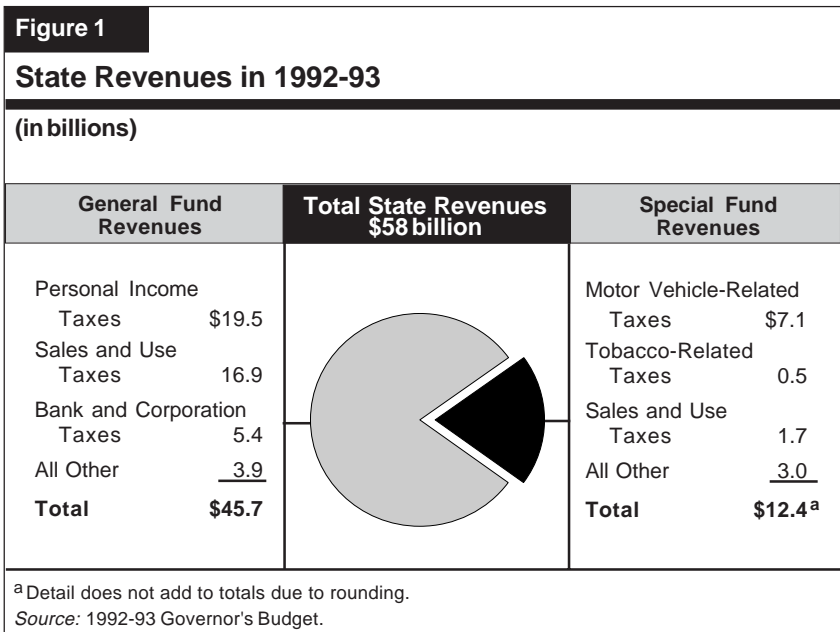
This section reviews the budget's estimates of state revenues, including our evaluation of the reliability of the revenue forecast. We first discuss the General Fund revenue forecast, and then turn to a discussion of the special fund revenue forecast.

The major findings of this part include:

- The administration's economic assumptions lead to a relatively strong forecast for state revenues. Our assessment of the budget's revenue forecast is that the Legislature should anticipate downward revisions of \$1 billion in each of the current and budget years. This is because the recession appears to have had a greater effect on revenues attributable to 1991 economic activity than anticipated in the forecast, and because the economy does not appear to be recovering as quickly as forecast, thereby reducing the levels of economic activity and state revenues that can be expected for 1992.
- In the longer run, low levels of interest rates and inflation, and the declines in consumer and business debt, should provide a solid basis for an economic upturn.

Perspectives on State Revenues

State revenues are divided into two general categories: General Fund revenues and special fund revenues. Figure 1 summarizes the relative size of these revenue categories and their major components. As the figure shows, total state revenues are expected to total \$58 billion in 1992-93, which is an increase of \$3.1 billion, or 5.7 percent, over total state revenue collections in 1991-92.



THE FORECAST FOR GENERAL FUND REVENUES

General Fund revenues account for approximately 80 percent of all state revenue collections. As Figure 1 indicates, the budget estimates that these collections will total approximately \$45.7 billion in 1992-93, and will be derived primarily from three tax sources: the personal income tax, the sales and use tax, and the bank and corporation tax. Figure 2 presents the department's forecast for General Fund revenues, by source, for the prior, current, and budget years.

Figure 2**General Fund Revenues
1990-91 through 1992-93****(dollars in millions)**

Source of Revenue	Actual 1990-91	Estimated 1991-92	Projected 1992-93	Change	
				1991-92 to 1992-93 Amount	Percent
Taxes					
Personal income	\$16,849	\$18,133	\$19,522	\$1,389	7.7%
Sales and use	13,303	16,188	16,859	671	4.1
Bank and corporation	4,508	5,017	5,420	403	8.0
Insurance	1,286	1,195	1,217	22	1.8
Estate, inheritance and gift	499	489	540	51	10.4
Cigarette and tobacco	146	168	188	20	11.9
Alcoholic beverage	130	332	313	-19	-5.7
Horseracing	106	94	87	-7	-7.5
Subtotals	\$36,827	\$41,616	\$44,146	\$2,530	6.1%
Other sources					
Interest on investments	\$383	\$224	\$242	\$18	8.0%
Transfers	413	843	368	-475	-56.4
Abandoned property	254	150	95	-55	-36.7
Trial court funding	—	436	508	72	16.5
Other revenues	337	364	314	-50	-13.7
Subtotals	\$1,387	\$2,017	\$1,527	-\$490	-24.3%
Totals, General Fund	\$38,214	\$43,633	\$45,673	\$2,040	4.7%

Figure 2 shows that General Fund revenues in the current year (1991-92) are expected to total \$43.6 billion, which is an increase of \$5.4 billion over the prior year. This increase is entirely attributable to 1991 legislation which added \$6.5 billion to current-year revenue collections. Without this legislation, state General Fund revenues would have fallen by \$1.1 billion in 1991-92. Only once in the last 50 years (in 1987-88) have revenues actually declined from their prior-year level.

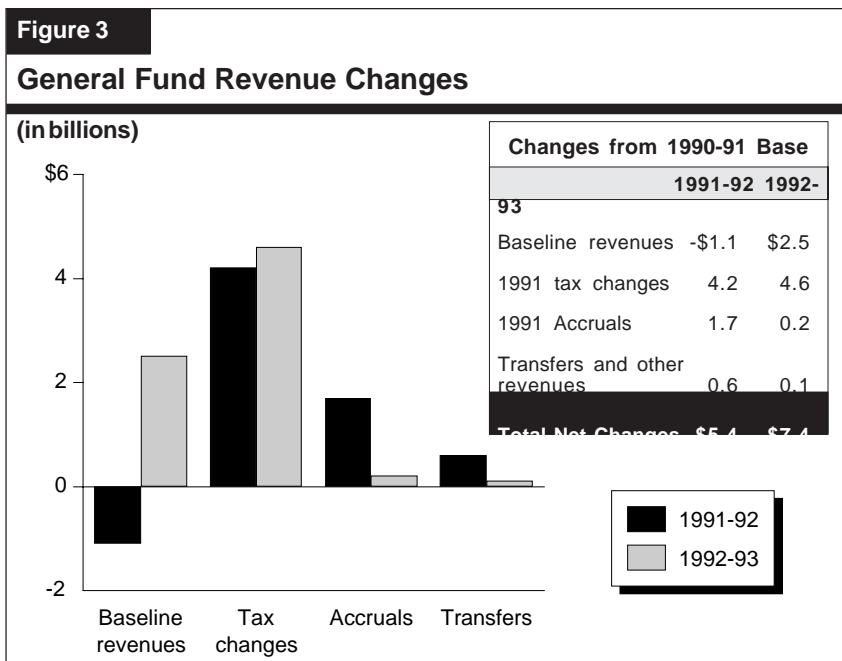
General Fund revenues are expected to grow by approximately 4.7 percent (\$2 billion) in 1992-93 (see Figure 2). This is a relatively modest rate of growth by historical standards, as General Fund revenue growth has averaged approximately 8

percent per year over the last decade. The 4.7 percent rate of growth, however, is artificially low because of the second-year impact of the switch to accrual accounting. Excluding this factor and the effect of the budget's proposed revenue enhancements, the increase in underlying revenue is about 8 percent.

Impact of 1991 Legislation

Figure 3 summarizes the effect of the 1991 tax legislation on anticipated revenue collections for 1991-92 and 1992-93. These changes are measured from the 1990-91 base level of revenues. As the figure indicates, these tax changes fall into three categories:

- **Tax increases**, including increased sales, personal income and alcoholic beverage tax rates, the phase-out of personal income tax exemptions for higher-income taxpayers, the elimination of sales and use tax exemptions, and changes in corporate accounting rules. These changes add \$4.2 billion to estimated current-year revenues and \$4.6 billion to estimated budget-year revenues.
- **Accrual accounting**, which allows the state to treat taxes as revenue at the time they are *earned*, as opposed to at the time they are actually *received*. This change, the effect of which is largely one-time, will add approximately



\$1.7 billion to current-year revenues and \$0.2 billion in the budget year.

- **Transfers and Other Miscellaneous Changes.** Transfers essentially represent idle special fund resources which are redirected for General Fund purposes by legislative action in the budget. Other miscellaneous changes primarily include the various fee, fine, and penalty assessment revenues which must now be remitted to the state by county governments as part of the trial court realignment legislation enacted in 1991. (See Part V of this document for a discussion of this legislation.) These changes account for approximately \$600 million of the current-year revenue increase and \$100 million of the budget-year revenue increase.

As noted earlier, these revenue changes more than offset the \$1.1 billion decline in “baseline” revenues that would have otherwise occurred in the current year.

Revenue Enhancements Proposed in the Budget

The Governor’s Budget proposes an additional series of transfers and revenue changes which are anticipated to increase General Fund revenues by \$307 million in the current year, and by \$514 million in the budget year. These include:

- **Repeal of Small Business Health Tax Credit.** State law will allow, beginning January 1, 1993, small employers to take a tax credit for part of their costs for providing health insurance coverage to their employees. The maximum credit is equal to the greater of \$25 per employee per month, or 25 percent of the amount paid per month per employee. The budget proposes that this credit, which has never gone into effect, be repealed in its entirety, thereby avoiding a revenue loss of \$110 million in the budget year.
 - **Assumption of City Cigarette Tax Revenues.** The state’s cigarette tax revenues (exclusive of those associated with Proposition 99) have traditionally been shared between the state (70 percent) and the cities and counties (30 percent). Last year’s trial court funding legislation redirected all of the counties’ share of these revenues, and about one-half of the cities’ share, to the state General Fund. The budget proposes to redirect the remaining portion of the cities’ revenues (\$26 million) to the General Fund in 1992-93.
-

- **Additional Tax Audit and Collections Activities.** The budget proposes to augment the budgets of the state's two tax agencies to enable them to conduct additional audits and collections efforts. These efforts are expected to generate an additional \$32 million in 1991-92 and \$125 million in 1992-93.
- **Transfer of Lease-Payment Bond Debt Service Reserves.** The budget anticipates that about \$1.2 billion in existing lease-payment bonds will be refinanced in the current year, thereby "freeing up" approximately \$130 million in debt service reserve funds for transfer to the General Fund.
- **Transfer of Tidelands Oil Settlement Revenues.** The recent settlement of an anti-trust lawsuit resulted in additional revenues to the Special Account for Capital Outlay. The budget proposes that \$120 million of these funds be transferred to the General Fund in 1991-92.
- **Transfer of Funds to Reimburse Rail Bond Debt Service Costs.** The budget proposes to transfer funds from the State Highway Account (\$85 million) and the Transportation Planning and Development Account (\$11 million) in 1992-93 to repay the General Fund for debt service costs associated with rail bonds authorized by Propositions 108 and 116.

INDIVIDUAL GENERAL FUND REVENUE SOURCES

The Forecast for Personal Income Taxes

Background. The personal income tax (PIT) is the single largest General Fund revenue source, accounting for over 40 percent of the total. The tax is imposed on income using a progressive tax rate schedule ranging from 1 percent to 11 percent, and includes a variety of income exclusions, deductions, and credits.

The PIT Forecast. As shown in Figure 4, PIT revenues are projected to total \$18.1 billion in 1991-92 and \$19.5 billion in 1992-93, which represents an increase of \$1.4 billion, or 7.7 percent, over the projected current-year level. If the effects of the 1991 tax legislation and the one-time accrual accounting change are excluded, however, the department's projection for 1992-93 represents an increase of almost 11 percent.

Figure 5 shows the major components of the PIT base. It indicates that almost two-thirds of income tax liabilities are derived from wage and salary income. Business income, such as income earned by partnerships and proprietorships, comprises

Figure 4

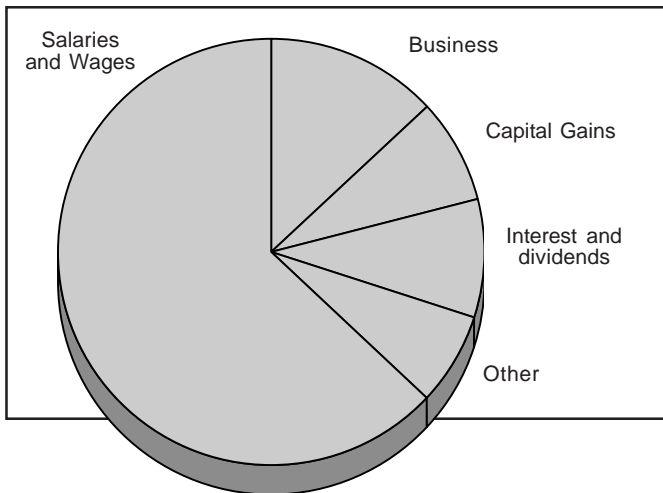
Personal Income Tax Changes

(dollars in millions)

	1991-92	1992-93	Change	
			Amount	Percent
Baseline revenues	\$16,427	\$18,216	\$1,789	10.9%
1991 tax changes				
Added tax brackets	1,060	849	-211	-20.0
Federal conformity	277	259	-18	-6.5
Accelerated collections	115	9	-106	-92.2
Net operating losses (NOL)	79	39	-40	-50.6
Accrual accounting	175	150	-25	-15.3%
Subtotals, 1991 tax changes	\$1,706	\$1,306	-\$400	-24.4%
Totals	\$18,133	\$19,522	\$1,389	7.7%

Figure 5

**Personal Income Tax Liabilities
By Source of Income**



about 13 percent. Capital gains income, which is one of the more volatile elements of the tax base, accounts for about 8 percent of total collections.

Figure 6 presents the department's estimates of changes in these major components of personal income over the three-year period 1991 through 1993. These data show that declines in all the major components of income contributed to the depressed overall levels of personal income in 1991, and thus the drop in 1991-92 baseline tax revenues mentioned earlier. The figure also indicates that a significant rebound in business income and capital gains is expected to lead the recovery in 1992. These increases are

Figure 6

**Changes in Income Tax Liabilities
1991 through 1993**

	Income Year		
	1991	1992	1993
Source of Income			
Salaries and wages	-2.6%	6.3%	9.3%
Interest and dividends	-1.2	5.2	7.5
Business	-2.5	15.7	12.0
Capital gains	0.0	17.2	10.0
Totals	-2.1%	8.1%	9.5%

Source: Department of Finance

largely responsible for the projected 10.9 percent increase in baseline revenues for 1992-93. Finally, wage and salary income is not expected to show substantial gains until 1993.

The Forecast for Sales and Use Taxes

Background. Sales and use taxes are the second largest source of General Fund revenues, comprising about 37 percent of the total. Sales and use tax revenues are derived from a 5.5 percent levy on taxable sales. This tax rate was increased by 0.75 percent, from 4.75 percent to 5.5 percent, by 1991 legislation, including a 0.5 percent temporary levy which will expire on June 30, 1993. That legislation also expanded the tax base to include such items as candy, snack foods, newspapers, certain aircraft fuel, and bottled water. In addition to the 5.5 percent state General Fund tax rate, the state in 1991 began to impose a new 0.5 percent special fund levy to finance health and welfare

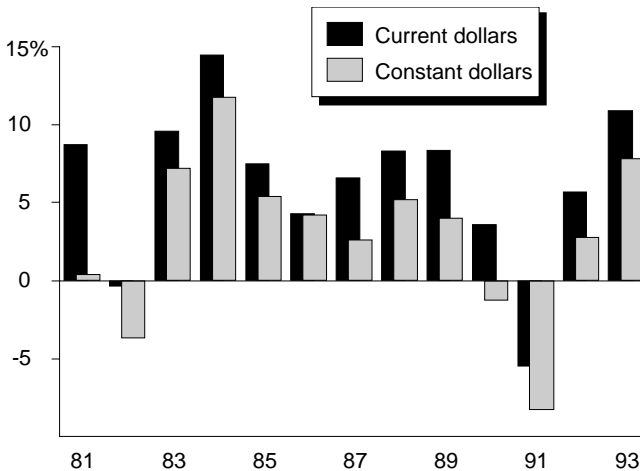
program costs shifted to county governments under the 1991 program realignment legislation.

Local governments also levy sales and use taxes, which are collected by the state but not treated as state revenues. These include the basic 1.25 percent Bradley-Burns tax rate levied by cities and counties, and a variety of other optional 0.5 percent or 0.25 percent tax rates for transportation, education, and general local government purposes. These local government tax rates may not exceed 2.75 percent in the aggregate, so the maximum permissible combined state and local tax rate in the state is now 8.75 percent.

1991 Taxable Sales Were Dismal. Figure 7 traces the

Figure 7

**Annual Growth in Taxable Sales
1981 through 1993^a**

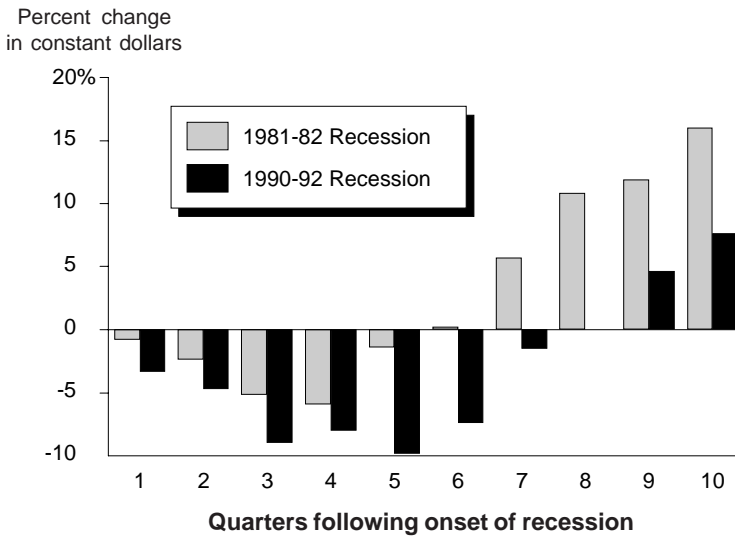


^a Excludes impact of 1991 legislation.

annual growth in taxable sales over the last decade. It shows that current-dollar sales (excluding the tax base broadeners mentioned above) were down by 5.5 percent in 1991. When the effects of inflation are taken into account, however, the decline is significantly larger — 8.3 percent. That decline is more than twice as large as the decline experienced in the 1981-82 recession.

Figure 8

Change in Taxable Sales During the Last Two Recessions



Source: Department of Finance.

Figure 8 compares the quarterly pattern of sales tax receipts during the current recession and the 1981-82 recession. As this figure shows, the drop in taxable sales has been deeper and has lasted longer during the current recession than during the 1981-82 recession. In addition, the figure shows that the growth in taxable sales following the end of the current recession is expected to be more modest than was the case following the earlier recession.

The current recession has depressed virtually all sectors of taxable sales. Those suffering the largest declines were motor vehicle dealers and building supply sellers. These two sectors account for about one-fourth of all taxable sales. They are expected to show strong growth as the economy recovers from the recession.

The steep decline in taxable sales in the current recession produced a correspondingly steep decline in state sales tax revenues. Baseline revenues in 1991-92 declined by about \$600 million from the 1990-91 levels. To place this in perspective, a significant year-to-year decline in sales tax revenues has oc-

Figure 9

Sales Tax Changes 1991-92 and 1992-93

(dollars in millions)

	1991-92	1992-93	Change	
			Amount	Percent
Baseline revenues	\$12,722	\$13,888	\$1,166	9.2%
1991 tax changes				
New tax rates	\$1,800	2,275	475	26.4
Base expansions	421	548	127	30.2
Accrual accounting	1,245	148	-1,097	-88.1
Subtotals, 1991 tax changes	\$3,466	\$2,971	-\$495	-14.3%
Totals	\$16,188	\$16,859	\$671	4.1%

curred only once before in the 59-year history of the sales tax — in 1938-39.

1991 Tax Changes Boost Collections. Figure 9 shows that the 1991 sales tax changes will increase current-year revenues by \$3.5 billion. About one-half of this increase is attributable to the higher tax rate, while the shift to accrual accounting is responsible for about one-third of the gain. The tax base broadeners account for the remainder of the total increase. The size of the revenue gain attributable to these tax changes declines in 1992-93 to about \$3 billion, primarily because the accrual accounting change is largely a one-time gain. These data also show that the department is forecasting a 9.2 percent increase in baseline revenues for 1992-93, which would restore the level of real taxable sales to about the same level they were prior to the onset of the current recession.

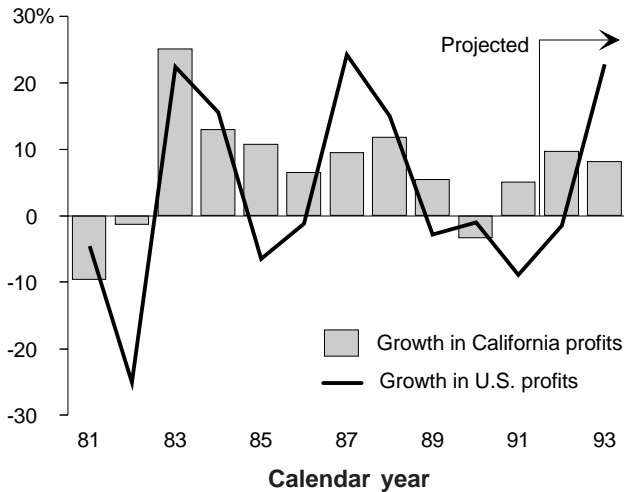
The Forecast for Bank and Corporation Taxes

Bank and corporation taxes, the third largest source of General Fund revenues, are derived primarily from a 9.3 percent levy on the taxable profits of corporations doing business in California. These revenues are projected to total \$5 billion in 1991-92 and \$5.4 billion in 1992-93, which is an increase of 8 percent over the projected current-year level.

Forecast Calls for Moderate Growth in Profits. Figure 10 compares the growth rates of U.S. corporate profits to those in

Figure 10

Annual Growth in Taxable Corporate Profits 1981 through 1993



California over the last decade. As this figure indicates, the department expects California profits to increase by 9.7 percent in 1992 and 8.1 percent in 1993. The U.S. profits, on the other hand, are expected to decline by 1.5 percent in 1992 before rebounding at a rate of 23 percent in 1993. Although there is historically a high degree of correlation between California and U.S. profits, the figure shows that California profits have tended to be less volatile than U.S. profits. As a result, California's profits did not decline as far during the recession and are projected to grow less rapidly than the nation's as the economy emerges from the recession.

1991 Tax Changes Boost Corporate Taxes. Figure 11 shows that the 1991 tax legislation is expected to add approximately \$476 million to corporate tax collections in 1991-92, and another \$290 million in 1992-93. The bulk of this revenue was provided by 1991 legislation suspending corporate net operating loss (NOL) deductions, which otherwise would have been used to offset current income. Instead, these corporations will accumulate these losses and use them to offset income in years after 1992. This suspension of NOL deductions is expected to add \$178 million

Figure 11

**Bank and Corporation Tax Changes
1991-92 and 1992-93**

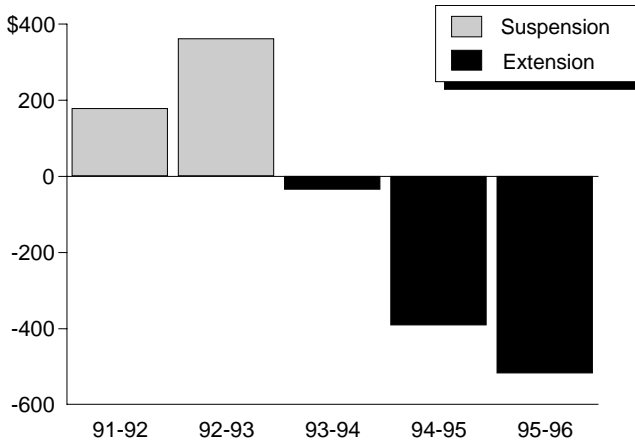
(dollars in millions)

	1991-92	1992-93	Change	
			Amount	Percent
Baseline revenues	\$4,541	\$5,130	\$589	13.0%
1991 tax changes				
Net operating losses	\$178	\$362	\$184	103.4
Federal conformity	22	20	-2	-9.1
Accrual accounting	276	-92	-368	-133.3
Subtotals, 1991 tax changes	\$476	\$290	-\$186	-39.1%
Totals	\$5,017	\$5,420	\$403	8.0%

Figure 12

**Revenue Impact of Suspending and Extending
Net Operating Loss Provisions
1991-92 through 1995-96**

(in millions)



Source: Department of Finance.

in the current year and \$362 million in 1992-93, which is substantially less than originally anticipated due to lower profit expectations since the time the changes were adopted.

The 1991 legislation also extended the 1992 sunset date for NOL deductions until 1997, so that corporations may take tax deductions beginning in 1993 for both losses generated prior to 1993, and losses generated after that date. Figure 12 shows that once the suspension is lifted, state revenue losses from NOL deductions will grow very rapidly, reaching over \$500 million in 1995-96.

The switch to accrual accounting, discussed earlier, also has a significant impact on bank and corporation tax revenues. This change is expected to add \$276 million in the current fiscal year, but reduce the level of reported income by \$92 million in 1992-93. Minor revenue gains are expected from federal conformity provisions adopted in 1991, which are primarily changes in accounting rules. As shown in Figure 11, after accounting for the revenue effects of the 1991 legislation, baseline revenues are expected to increase by 13 percent in 1992-93.

Other General Fund Revenues

Other General Fund revenues are projected to decline by \$403 million in 1992-93, from \$4.3 billion to approximately \$3.9 billion. This decline is primarily attributable to an extraordinarily high level of special fund transfers in the current year, which were undertaken to help balance the 1991-92 budget. The budget proposes approximately \$368 million in special fund transfers for 1992-93, which is less than one-half the level of transfers made in 1991-92.

RELIABILITY OF THE REVENUE FORECAST

California's economy has now been in the grips of recession for 19 months, the longest economic downturn since the 1930s. In terms of job losses and the impact on state revenues, this has been the most severe recession since World War II. From June 1990 through December 1991, over 600,000 jobs were lost in California. Since January of 1991, when the Governor's Budget for 1991-92 was first introduced, General Fund revenue estimates for the current fiscal year have been reduced by approximately \$7.5 billion, or 17 percent, and all indications are that further declines must be expected. Obviously, the economy's steep decline was not anticipated by the department's forecasts last year.

In 1992, accurately forecasting state revenues will be made more difficult because the state's economy appears to be at a

turning point. Forecasting is most difficult at the peak or trough of an economic cycle, when economic trends are changing direction. Prospects are that, in the near-term, economic conditions will be flat, rather than continuing to deteriorate. In the longer term, however, the reduction in interest rates, the low level of inflation, and the declines in business and consumer debt should provide a solid basis for the beginnings of an economic upturn.

During this period between recession and recovery, the Legislature should be cognizant of the three major areas of risk associated with the department's forecast of revenues. They are:

- ***Was the Recession Deeper Than Estimated by the Department?*** Some early indications provided by employment and tax collection data, which became available subsequent to the release of the department's forecast, imply that the recession may have been deeper than estimated. The depth of the recession has a direct bearing on the amount of personal income and corporate taxes that will be paid when final tax returns are filed in March and April. It also would tend to influence the levels of personal income and corporate profits forecast for 1992 and 1993.
- ***Will the Recovery Be Delayed?*** The department's forecast assumes that the trough of the recession has already been reached. It forecasts that minor increases in employment will take place in the first two quarters of 1992, with more significant increases beginning thereafter. To the extent that job losses continue in early 1992, revenues in both the current and budget years would be adversely affected.
- ***Will the Recovery Be As Strong As Forecast?*** To the extent that the recovery is more modest than forecast by the department, return to pre-recession levels of economic activity will take longer than anticipated. This would primarily affect revenues for the budget year.

General Conclusion — \$2 Billion Shortfall is Likely

Based upon the most recent economic information available, we conclude that the department's revenue estimates are overly optimistic. Specifically:

- ***Weak Recent Tax Collections.*** The performance of state revenue collections for the month of January brought disturbing news in the form of significantly lower-than-expected PIT declarations. These payments, which were
-

\$293 million below forecast, indicate that taxpayers' incomes from capital gains and business income in the fall of 1991 were below anticipated levels. The department expected that these January payments would be higher than the prior year's level, due to the new higher-income tax brackets adopted in 1991. Instead, these payments were 13 percent *below* the prior-year level. To some extent, these losses may have been offset by higher-than-expected, year-end withholding payments that were received in December. Because corporate estimated tax payments were also weak, these data provide a strong indication that the department's estimates of 1991 economic activity are overstated.

- ***Employment Losses Continue.*** The latest estimates of state employment levels are approximately 60,000 jobs lower than the levels assumed in the budget forecast for the current time period. As a result, there is no evidence at this time that the early upturn anticipated by the department has begun.
- ***Trial Court Revenues Not Materializing.*** The budget anticipates receipt of \$436 million in 1991-92 and \$508 million in 1992-93 from the trial court funding realignment legislation enacted in 1991. This legislation requires counties to transfer significant portions of the fee, fine, and penalty assessment revenue they receive from trial court operations to the state. In addition, the legislation imposed higher fees and penalties which also must be remitted by the counties to the state. Actual collections through the end of January show a disturbing trend — only \$77 million has been remitted to date. Some of this shortfall may be due to cash-flow factors, but we expect that current- and budget-year receipts will fall significantly short of the amount expected.

On the basis of these findings, we conclude that the department's revenue estimates are likely to overstate actual collections by approximately *\$1 billion* in each of the current and budget years. These losses assume a delay in the recovery until mid-1992, and could increase to the extent that the recovery is delayed until later in the year. Thus, for the Legislature's initial planning purposes, we conclude that revenue collections for the two-year period will be approximately \$2 billion below the amount forecast in the Governor's Budget.

Figure 13

Special Fund Revenues 1990-91 through 1992-93

(dollars in millions)

Source of Revenue	Actual 1990-91	Estimated 1991-92	Projected 1992-93	Change 1991-92 to 1992-93	
				Amount	Percent
Motor Vehicle Revenues					
License fees (in lieu)	\$2,215	\$2,975	\$3,124	\$149	5.0%
Registration, weight and other fees	1,296	1,426	1,527	101	7.1
Fuel taxes	1,988	2,481	2,489	8	0.3
Subtotals	\$5,499	\$6,882	\$7,140	\$258	3.7%
Other sources					
Sales and use taxes	\$536	\$1,477	\$1,726	\$249	16.9%
Cigarette taxes	600	540	496	-44	-8.2
Interest on investments	269	251	260	9	3.6
Oil and gas revenues	101	171	56	-115	-67.3
Beverage container fees	267	291	378	87	30.0
All other	1,538	1,671	2,315	644	38.5
Subtotals	\$3,311	\$4,401	\$5,231	\$830	18.9%
Total, Special Funds	\$8,810	\$11,283	\$12,371	\$1,088	9.6%

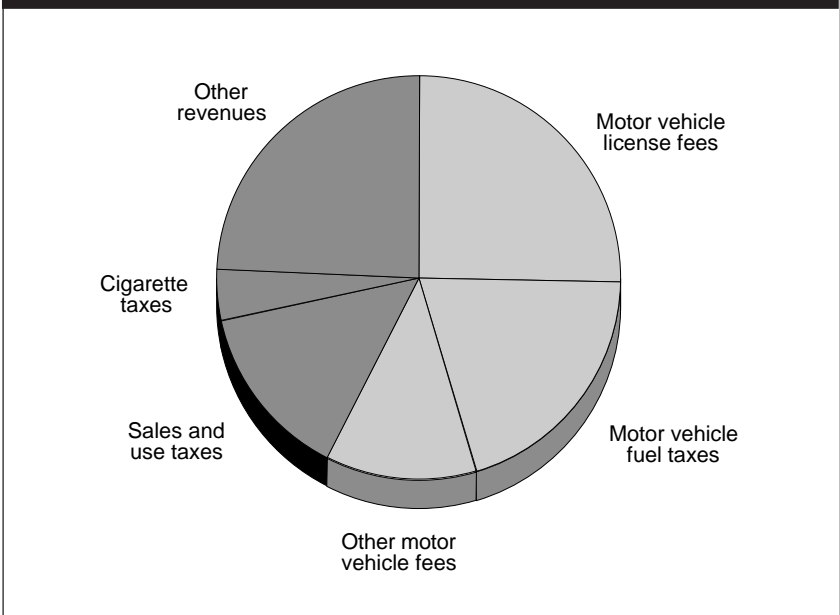
THE FORECAST FOR SPECIAL FUND REVENUES

Figure 13 presents the department's forecast for special fund revenues in the prior, current, and budget years. These data indicate that special fund revenues are projected to total \$11.3 billion in 1991-92 and \$12.4 billion in 1992-93, which is an increase of \$1.1 billion or 9.6 percent. These revenue levels reflect additional legislative changes enacted in 1991 related to program realignment, including the new 0.5 percent state sales tax rate and a revision to the depreciation schedule which is used to determine Vehicle License Fee (VLF) payments. Motor vehicle registration and driver's license fees also were increased, with the revenues dedicated for existing motor vehicle-related law enforcement activities. Finally, the figure also shows the fuel tax rate and other fee revenue increases attributable to Proposition 111 (1990).

Figure 14 indicates that about 58 percent (\$7.1 billion) of all special fund revenues are motor-vehicle related. These sources

Figure 14

1992-93 Special Fund Revenues



include the VLF (\$3.1 billion), fuel taxes (\$2.5 billion), and vehicle registration, weight, and other vehicle fees (\$1.5 billion). Sales and use taxes and Proposition 99 cigarette taxes account for about 18 percent of total revenues. A wide variety of other minor revenue sources account for the remaining \$3 billion of special fund revenues.

How Are Special Fund Revenues Used?

Special Fund revenues are used for a variety of purposes, and most of them are dedicated to specific uses. For example:

- Motor-vehicle related revenues are used for various programs, many of which are related to transportation. Over one-half of these revenues are transferred to local governments for use in a variety of programs, including street and road maintenance and mass transit purposes. The remainder is used for state programs relating to transportation and vehicle use, including support of the Department of Motor Vehicles (DMV), the California Highway Patrol (CHP), the Department of Transportation (Caltrans),

Figure 15**Motor Vehicle Fee Revenues
1991-92 and 1992-93**

(dollars in millions)

	1991-92	1992-93	Change	
			Amount	Percent
Vehicle license fees				
Local discretionary revenues	\$2,263	\$2,368	\$105	4.6%
Local realignment revenues	712	756	44	6.2
Subtotals	\$2,975	\$3,124	\$149	5.0%
Other fees				
Motor vehicle registration	\$760	\$833	\$73	9.6%
Driver's licenses	100	112	12	12.0
Weight fees	527	541	14	2.7
Other fees	39	41	2	5.1
Subtotals	\$1,426	\$1,527	\$101	7.1%
Totals	\$4,401	\$4,651	\$250	5.7%

and the Air Resources Board (ARB).

- Revenues raised by the tobacco-related taxes imposed by Proposition 99 are distributed to various state accounts, to be used for health and natural resources-related purposes.
- Oil and gas revenues are used primarily to fund capital outlay projects, although they have been increasingly used for General Fund purposes in recent years.

Motor Vehicle Fee Revenues Show Modest Gains

Motor vehicle fees will total approximately \$4.7 billion in 1992-93, an increase of \$250 million, or 5.7 percent, over estimated current-year revenues. Figure 15 shows that the largest component of these fees is the VLF, most of which is subvended to cities and counties for their General Fund purposes. The new depreciation schedule adopted in 1991 is expected to raise \$712 million in 1991-92 and \$756 million in 1992-93, and these revenues will be subvended to counties for program realignment purposes.

Motor vehicle registration fees were increased by \$5 per registration, effective January 1, 1992. This change will provide about \$60 million of additional revenue in 1992-93. The Governor also is proposing to extend the existing \$1 per vehicle temporary

Figure 16**Motor Vehicle Fuel Revenues
1991-92 and 1992-93****(dollars in millions)**

	1991-92	1992-93	Change	
			Amount	Percent
Pre-Proposition 111				
Gasoline	\$1,182	\$1,193	\$11	0.9%
Diesel fuel	153	166	13	8.5
Subtotals	\$1,335	\$1,359	\$24	1.8%
Proposition 111 revenues				
Gasoline	\$842	\$982	\$140	16.6%
Diesel fuel	107	133	26	24.3
Subtotals	\$949	\$1,115	\$166	17.5%
Accrual Accounting				
Gasoline	\$175	\$12	-\$163	-93.1%
Diesel fuel	22	3	-19	-86.4
Subtotals	\$197	\$15	-\$182	-92.4%
Totals	\$2,481	\$2,489	\$8	0.3%

surcharge, raising another \$13 million in 1992-93. These revenues are deposited in the Motor Vehicle Account (MVA).

Driver's license fees were increased by \$2, effective January 1, 1992. This change will produce an additional \$12 million for the MVA during 1992-93.

Motor Vehicle Fuel Taxes Show No Growth

Figure 16 indicates that the budget forecasts virtually no change in fuel tax receipts. The flat forecast is, however, the combined result of significant increases in Proposition 111 fuel tax revenues offset by the second-year effect of the switch to accrual accounting.

As shown in Figure 16, baseline gasoline tax revenues are expected to increase by less than 1 percent, while diesel fuel tax revenues are expected to grow by 8.5 percent. Diesel fuel revenues fell by over 7 percent in 1990-91, largely reflecting the recession's impact on the trucking industry.

Proposition 111 increased fuel tax rates by 5 cents per gallon, effective August 1, 1990, with an additional 1 cent-per-gallon increase occurring in each of the next four years on January 1. Figure 16 shows that these rate increases will add \$166 million to revenue collections for 1992-93.

Realignment Revenues to Rebound

The realignment legislation adopted in 1991 imposed a new 0.5 percent sales tax and increased the VLF depreciation schedule, as discussed above. These revenues are deposited in the Local Revenue Fund and subvended to counties to fund the health and welfare costs transferred to them from the state. As shown in Figure 17, the department estimates that realignment revenues will total \$2,062 million in the current year, which is about \$150 million less than the amount anticipated when the realignment legislation was enacted. Revenues for 1992-93, however, are expected to be \$2,336 million, an increase of \$274 million or 13 percent. This amount is sufficient to fund all of the allocations of incremental or "growth" revenues anticipated by the 1991 legislation. (For a further discussion of the realignment program, please see Part V of this document.)

Figure 17

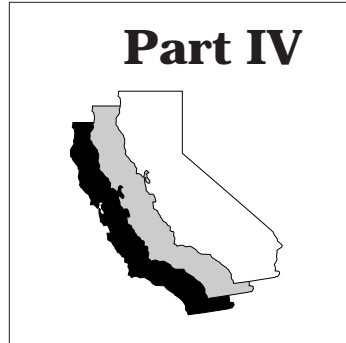
Local Revenue Fund Revenues 1991-92 and 1992-93

(dollars in millions)

	1991-92	1992-93	Change	
			Amount	Percent
Vehicle license fees	\$712	\$756	\$44	6.2%
Sales and use taxes	1,350	1,580	230	17.0
Totals	\$2,062	\$2,336	274	13.3%

**Perspectives on
State
Expenditures**

IV



Perspectives on State Expenditures

This section reviews the budget's overall spending plan. We begin with a discussion of the budget proposal in the context of recent trends in state spending. Our major findings include the following:

- The budget proposes an increase of \$1.9 billion, or 3.5 percent, in state spending in 1992-93 compared with 1991-92 spending (adjusted for a one-time accounting change).
- State spending as a percentage of personal income has increased, especially in the current year. The budget would reverse this trend in 1992-93, based on its economic assumptions.
- Among the programs with significant portions of total state spending, those with above average spending growth since 1986-87 are Corrections; Business, Transportation and Housing; Health; and Welfare. The rate of spending growth for both K-12 and Higher Education has been less than the overall average.
- Spending from special funds has been growing more than twice as fast as General Fund spending.

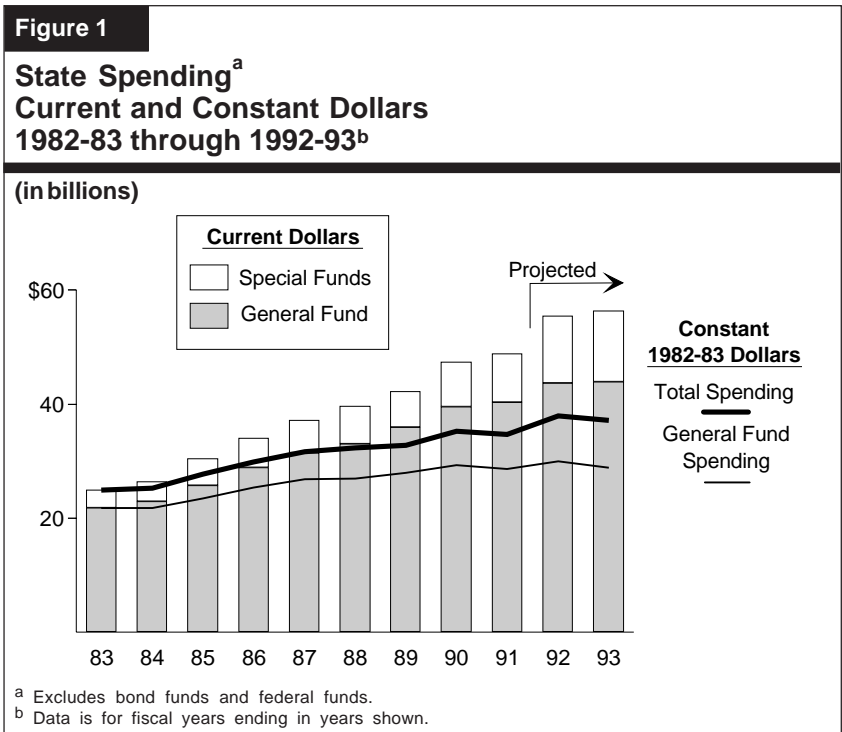
We then discuss the following major expenditure proposals in the 1992-93 budget and present a number of issues that each of them raises for legislative consideration:

- Welfare reform.
- Medi-Cal reductions.
- Renters' tax credit repeal.

- State employee compensation savings.
- Higher education savings.
- Proposition 98 education funding.
- Enterprise special district tax shift to schools.
- Lease-payment bond refinancing.
- The “trigger” — including an overview of the implementation of the trigger reductions and other unallocated reductions in the current year.

An Overview of State Expenditure Trends

Figure 1 shows state expenditures from 1982-83 through 1992-93 from the General Fund and special funds in both “current dollars” (amounts as they appear in the budget) and “constant dollars” (current dollars adjusted for the effects of inflation). This adjustment relies upon the Gross National Product (GNP) implicit price deflator for state and local government purchases of goods and services. The GNP deflator is a good general measure of price increases for the types of goods and services that state and local governments buy, and it allows comparisons of the “purchasing power” of state spending over time.



Proposed 1992-93 total state spending (in current dollars) is \$56.3 billion, an increase of \$0.9 billion, or 1.6 percent, compared with estimated spending in 1991-92. Almost 90 percent of the additional spending would be from special funds; General Fund spending would remain essentially flat.

The comparison of spending between 1991-92 and 1992-93 is distorted, however, by an accounting change implemented in the current year for the Medi-Cal program. This change accrues charges for Medi-Cal services that have been provided before the end of the fiscal year, but which have not yet been paid. Previously, Medi-Cal spending was counted on a cash basis. The effect of this accounting change is to inflate General Fund spending by \$1 billion on a one-time basis in 1991-92. After eliminating the distortion caused by this accrual accounting adjustment, total spending increases by \$1.9 billion, or 3.5 percent, in 1992-93, and General Fund spending increases by \$1.1 billion, or 2.6 percent. Spending growth, however, would not be sufficient to fully offset the anticipated rate of inflation, which the budget estimates will be 4.1 percent in 1992-93. Consequently, total 1992-93 spending in constant dollars would *decline* slightly (by about 0.5 percent). Taking population growth into account, per capita spending would decline by 2.8 percent in constant dollars.

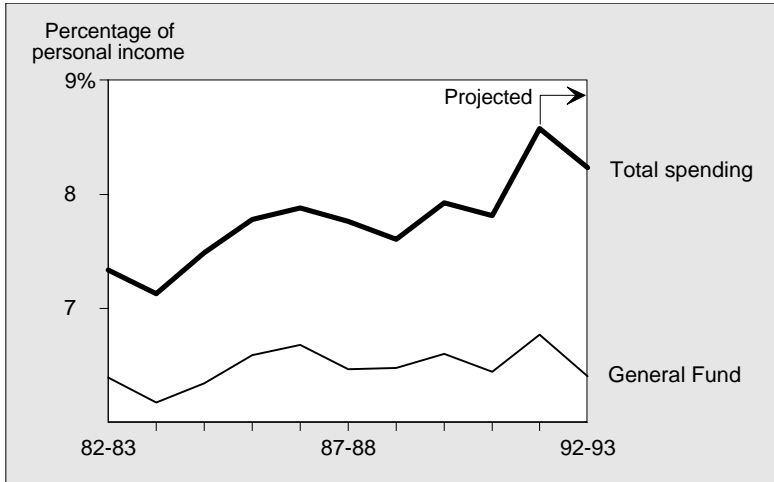
The budget proposal represents a significant slowdown in spending growth compared with trends over the period illustrated in Figure 1. During this period, spending has more than doubled, growing at an annual rate of 8.5 percent. After adjusting for inflation, spending still grew at an annual rate of 4.1 percent.

Spending in Relation to the State's Economy. Figure 2 shows for the same period how state spending varies as a percentage of total California personal income (which is an indicator of the size of the state's economy). From 1982-83 through 1990-91, Figure 2 shows that total state spending increased slowly as a percentage of personal income — from 7.3 percent to 7.8 percent. Growth in special fund spending accounted for all of this increase, since General Fund spending as a percentage of personal income remained the same in 1990-91 as in 1982-83 (6.4 percent).

The current year, however, has seen a sharp rise in total spending as a percentage of personal income, which has grown from 7.8 percent in 1990-91 to 8.6 percent in 1991-92 (8.4 percent excluding the Medi-Cal accrual adjustment). This rapid growth results from the combination of two factors. First, tax increases, fund transfers, and accounting changes enacted to help solve the 1991-92 budget funding gap provided a total of \$9.1 billion of additional resources (as then estimated) to sustain spending

Figure 2

State Spending As a Percentage of Personal Income 1982-83 through 1992-93



growth in 1991-92. Second, the recession has greatly reduced growth in personal income compared with past years. In 1992-93, however, budget projections indicate that state spending will decrease as a percentage of personal income because proposed spending grows very little while personal income resumes moderate growth, based on the budget's assumption of an economic recovery in early 1992.

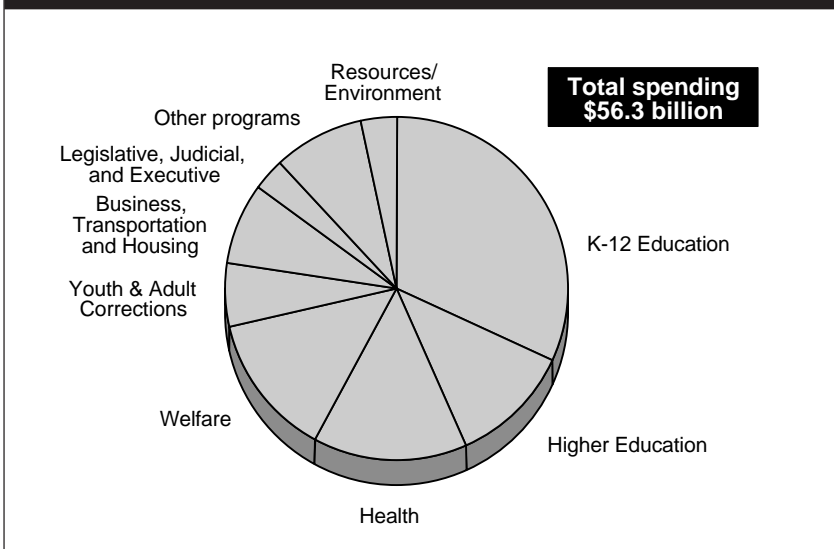
State Spending by Program Area

Figure 3 shows the distribution of the proposed \$56.3 billion of 1992-93 state spending among the state's major program areas. Both General Fund and special fund expenditures are included in order to provide a meaningful comparison among program areas, since special funds provide the bulk of the support in some areas (such as transportation). Also, funding shifts between the General Fund and special funds would distort comparisons that did not include all state funds (for example, the current-year shift of a portion of health and welfare spending to a special fund for state-local program realignment).

The program area groupings used in Figure 3 reflect the traditional groupings used in the Governor's Budget, with two

Figure 3

Total State Spending By Major Program 1992-93



modifications. Specifically, spending on health and welfare programs has been divided to show spending in each of these two major program areas. Also, the category “other programs” combines spending in the General Government and the State and Consumer Services categories, since both include a wide range of general governmental activities.

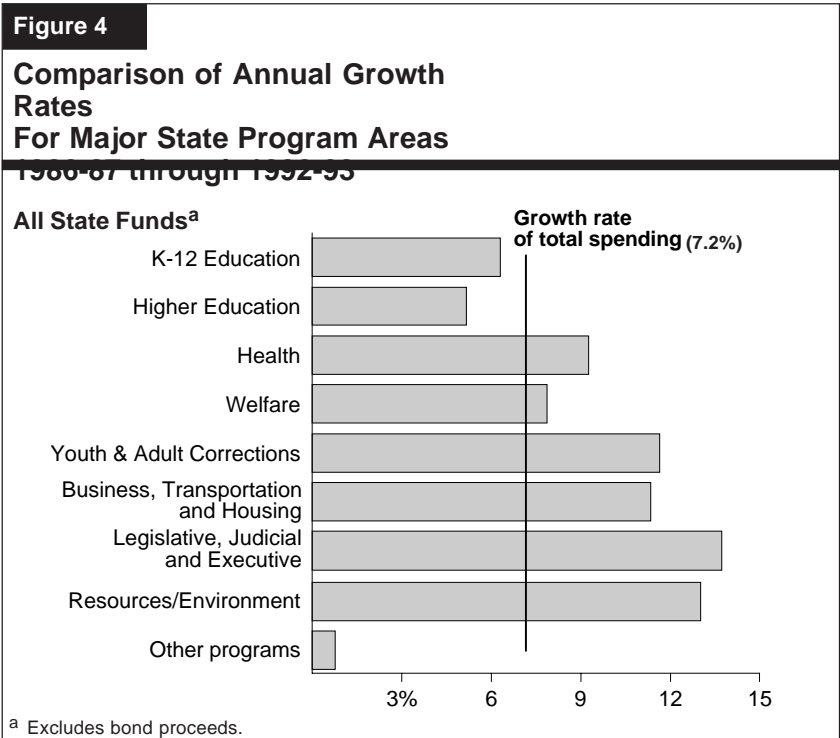
Figure 3 shows that K-12 education receives the largest share of proposed state spending from all funds — 32 percent. When higher education is included, the share rises to 43 percent. The next largest shares of spending are for health programs (15 percent) and welfare programs (14 percent).

Spending From Bond Proceeds and Federal Funds. Debt service on general obligation bonds and on lease-payment bonds is included in spending for the appropriate programmatic areas, as are direct expenditures on capital outlay projects from the General Fund or 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 bond proceeds do 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 \$4.1 billion of bond proceeds in 1992-93, about one-half of which will be for educational facilities. The state also proposes to spend \$25.2 billion of federal funds in 1992-93. The largest portions of these funds are for federal contributions to health and welfare programs (\$15.9 billion), education (\$5.9 billion), and transportation (\$1.8 billion).

Spending Growth by Program

Figure 4 compares the annual growth rate of state spending for each program area during the period 1986-87 through 1992-93 with the overall rate of growth in expenditures from state funds. The figure shows that the two areas with the most rapid growth were Legislative, Judicial, and Executive programs and Natural Resources and Environmental Protection programs. However, these two areas represent only 6.4 percent of state spending in 1992-93. Increased spending for Natural Resources and Environmental Protection programs reflects the rapid growth in fee-supported programs, such as beverage container recycling and



waste management. It also reflects the recent reorganization that created the California Environmental Protection Agency, which shifted into the Environmental Protection category spending on certain programs that previously had been included in the Health and General Government categories. The reason for the high growth in spending on Legislative, Judicial, and Executive activities is that the state took over a major role in funding trial courts during this period.

Among the larger program areas, the most rapid growth (more than 11 percent annually) occurred for Youth and Adult Corrections and for Business, Transportation and Housing. The growth of corrections spending reflects increases in the inmate population and the cost of paying off bonds used to finance prison construction. Growth in spending for Business, Transportation and Housing programs primarily is due to increased transportation spending financed by the gasoline tax increases authorized by Proposition 111, and to the implementation of a new residential earthquake insurance program financed by a surcharge on insurance premiums.

As shown in Figure 4, spending on Health and Welfare programs (including state-local realignment funds) between 1986-87 and 1992-93 has been growing at annual rates of 9.3 percent and 7.9 percent, respectively, compared with overall annual state spending growth of 7.2 percent. Moreover, spending growth in Health and Welfare programs has a significant effect on budget totals, since these programs account for 28 percent of total 1992-93 state spending. In contrast, spending on both K-12 Education and Higher Education has grown more slowly than overall spending. The very low rate of growth of spending on other government programs is somewhat misleading because it reflects, in part, the budgeting practice of counting in this category all of the statewide savings that have not yet been allocated to specific programs, such as savings from proposed salary reductions and reduced retirement contributions. The low growth rate also reflects the proposed elimination of the renters' tax credit, which is a tax relief program included in General Government spending.

Comparison of General Fund and Special Fund Spending

Of the \$56.3 billion of total proposed state spending in 1992-93, the budget indicates that the General Fund will provide \$43.8 billion, or 78 percent, while special funds will provide the remaining \$12.5 billion.

General Fund Spending. The budget proposes to increase

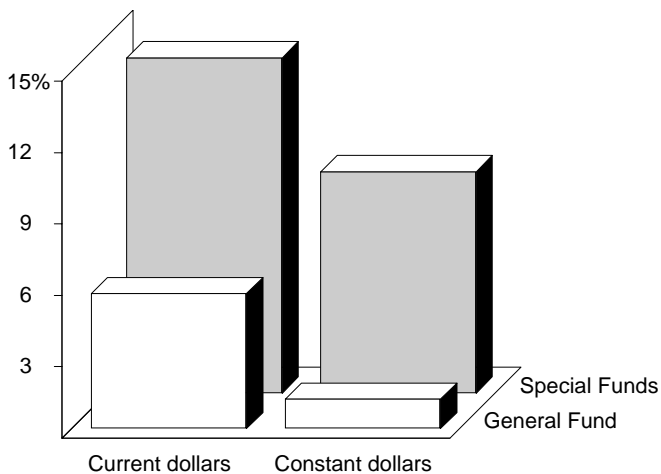
General Fund spending in 1992-93 by 2.6 percent (after adjusting for the Medi-Cal accrual change). In contrast, General Fund spending grew at an annual rate of 6.8 percent between 1986-87 and 1991-92. We estimate that General Fund spending would have to grow by an additional \$3.3 billion in 1992-93 in order to maintain current levels of state-supported services. Consequently, the budget reflects a significant reduction in the level of services to be provided from the General Fund.

Special Fund Spending. The budget's proposed \$12.5 billion of special fund expenditures represents an increase of \$808 million, or 6.9 percent, compared with estimated spending from special funds in the current year. This increase is roughly the amount needed to offset inflation and population growth in 1992-93.

The Growing Importance of Special Funds. The budget projects that special funds will provide 22 percent of total state spending in 1992-93. In contrast, special funds provided only 15 percent of total state spending in 1986-87. Figure 5 compares the annual growth rates of spending from the General Fund and from special funds during the period 1986-87 through 1992-93, both in

Figure 5

Annual Growth Rates of General Fund
And Special Fund Spending
1986-87 through 1992-93



current dollars and in constant (inflation-adjusted) dollars. As shown in the figure, General Fund spending has grown at an annual rate of 5.7 percent. Adjusted for inflation, however, General Fund spending has grown by only 1.2 percent annually, which is less than the annual rate of population growth during this period (2.4 percent). Spending from special funds, however, has grown at an annual rate of 14 percent in current dollars, or 9.3 percent in constant dollars. Consequently, rapid growth in special fund spending has enabled total annual spending to grow at 7.2 percent, while General Fund spending growth has been very modest.

Figure 6 shows the major increases in special fund spending programs that have taken place since 1986-87, and the amount of spending attributable to them in 1992-93. All of these spending increases are financed by increased taxes or new fees that are dedicated to specific uses. The \$4.8 billion of new spending shown in Figure 6 represents more than two-thirds of the total increase in special fund expenditures from 1986-87 to 1992-93.

Figure 6

Major Increases in Spending From Special Funds Since 1986-87

(in millions)

	Amount in 1992-93
New tax revenues dedicated to state/local realignment of health and welfare programs	\$2,336
Increased gasoline tax money for transportation authorized by Proposition 111	1,116
Cigarette and tobacco surtax dedicated primarily to health programs by Proposition 99	524
Beverage container recycling fees	350
Residential earthquake insurance surcharges	311
Underground storage tank cleanup fees	77
Waste management fees	74
Total	\$4,788

Major Expenditure Proposals in the 1992-93 Budget

As discussed in Part One, the prolonged recession and resulting revenue shortfall have placed the state in a deficit situation in the current year and severely reduced anticipated revenues in 1992-93. In light of these fiscal restraints, the budget's General Fund expenditure proposals are predominantly spending reductions or shifts of program costs to other funding sources. Figure 7 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 Figure 7 are budget estimates.

In this section, we discuss several of the most significant spending proposals in the budget. For more information on many of these major spending proposals and our findings and recommendations concerning them, please see the corresponding portion of the *Analysis of the 1992-93 Budget Bill*.

WELFARE REFORM

Caseloads in Aid to Families with Dependent Children (AFDC) have been rising rapidly in recent years. The budget estimates that the number of people assisted will increase by 11 percent in the current year. Spending on AFDC will total \$5.9 billion (\$2.9 billion General Fund), an estimated increase of only 1 percent. One major reason for the slower growth of spending is that a 4.4 percent reduction in the maximum aid payment (MAP) was adopted as part of the 1991-92 budget package. Another reason is that some funding for AFDC was shifted to counties under the realignment of state-local health and welfare programs.

Our analysis of the AFDC budget proposal in Item 5180 of the *Analysis of the 1992-93 Budget Bill* discusses some of the factors that have contributed to the recent caseload growth and that make estimating future caseload and spending growth difficult. These factors include:

- ***The Economy.*** Unemployment caused by the recession has increased AFDC caseloads, but the specific portion of

Figure 7

Summary of Major Budget-Balancing Proposals in the 1992-93 Governor's Budget

(dollars in millions)

Proposal	Legislation Required?	Federal Action Required?	Effective Date	Savings	
				1991-92	1992-93
Welfare Reform					
10 percent grant reduction	yes	yes	3/1/92	\$71	\$282
Transitional grant reduction	yes	yes	3/1/92	—	245
Additional children on aid	yes	yes	3/1/92	—	16
Out-of-state resident limits	yes	yes	3/1/92	1	13
Eliminate pregnancy benefits	yes	no	3/1/92	6	40
Other Social Services					
SSI/SSP Food Stamp cash-out	yes	no	7/1/92	—	73
IHSS service level reduction	yes	no	7/1/92	—	47
County administration COLA	no	no	7/1/92	—	20
Foster Care COLA	yes	no	7/1/92	—	4
Medi-Cal					
60-day inpatient limit	yes	no	7/1/92	—	61
Long-term care reimbursements	yes	no	8/1/92	—	28
Eliminate optional benefits	yes	no	6/1/92	8	101
Use Prop 99 for perinatal services	yes	no	7/1/91	60	63
Crossover claims	no	no	10/1/92	—	31
Other Health					
Shift costs to SLIAG funds	no	yes	7/1/91	185	218
Education					
Reduce 1991-92 funding level	yes	no	6/30/92	183	—
Shift local property taxes to schools	yes	no	6/30/92	—	347
Increase UC student fees	no	no	7/1/92	—	60
UC/CSU COLAs	no	no	7/1/92	—	343
Judicial					
Freeze trial court funding	no	no	7/1/92	—	143
Transportation					
Reimburse debt-service costs	budget	no	7/1/92	—	96
Tax Relief					
Eliminate Renters' Credit	yes	no	12/31/92	—	376
Shared Revenues					
Eliminate City Cigarette Tax Funds	yes	no	6/30/92	—	27
Employee Compensation					
5 percent salary rollback	yes	no	1/1/92	74	148
Health benefit contribution rollback	yes	no	6/30/92	—	54
Debt Service					
Refinance lease-payment bonds	no	no	1/1/92	145	45
Tax Expenditures					
Repeal health insurance tax credit	yes	no	12/31/92	—	110
Transfers					
Elk Hills settlement	yes	yes	6/30/93	—	45
SAFCO settlement funds	budget	no	6/30/92	120	—

the caseload growth that is due to this factor is uncertain. To some extent, the current caseload growth will moderate when the economy improves. However, structural changes also have occurred in the job market, which make the extent of a recovery's effect on caseload uncertain.

- **Undocumented and Newly Legalized Persons.** Children born in the U.S. are eligible for AFDC assistance, although their parents may be undocumented or recently legalized immigrants who are not eligible. This "citizen children" portion of the caseload has been growing rapidly. Legalized immigrants, themselves, will become eligible for AFDC benefits in 1992-93, when their five-year exclusion period ends.
- **Growth in Disabled SSI/SSP Caseload.** The state's other major welfare program, SSI/SSP, provides grants to poor elderly or disabled persons. The SSI/SSP disability caseload has been growing at 7 percent annually, and many of these adults have children who qualify for AFDC grants.

Proposal

The Governor has proposed an initiative measure for the November ballot entitled the "Government Accountability and Taxpayer Protection Act of 1992," which would make significant changes in the AFDC program. The budget proposes statutory enactment of these same AFDC provisions in time for implementation on March 1, 1992, so that savings would begin in the current year.

Figure 7 lists the major AFDC grant changes proposed by the Governor, and the budget's estimate of the net General Fund savings of each. The budget estimates savings of \$78 million in 1991-92 and \$596 million in 1992-93 due to these AFDC changes. Most of the Governor's proposed changes could not be implemented without waivers of existing requirements from the federal government, as noted in Figure 7. The major proposals are summarized below.

Grant Reductions. The budget proposes a 10-percent reduction in the MAP for the first six months that a family is on aid, and an additional reduction of 15 percent in the MAP after six months for families with an able-bodied adult. (These cuts would be in addition to the 4.4 percent MAP reduction in the current year.) However, the "need standard," which is the basis for determining grant amounts up to the MAP would not be changed. Consequently, the MAP reduction would have the most impact on those

recipients who currently receive the full MAP — primarily nonworking recipients. Benefit amounts for recipients who receive less than the MAP (for example, those with earnings that reduce their aid amount) would be less affected or not affected at all. The 10 percent reduction would reduce the monthly MAP for a family of three (currently \$663) by \$66, partially offset by an increase in food stamps of \$20 (provided by the federal government) due to the reduced grant size. The 15 percent reduction would reduce the MAP by an additional \$90, partially offset by a \$27 increase in food stamps.

Maximum Family Grant. The Governor's proposal would eliminate increases in the MAP (which varies with family size) for children conceived while a family is on aid.

Residency Requirement. The proposal would limit grants to persons who move to California from other states. During their first 12 months of residence, they would receive the lesser of their California grant or the MAP amount in their former state.

Elimination of Pregnancy Benefits. The budget proposes to eliminate all AFDC pregnancy-related payments. This would eliminate grants currently provided to pregnant women who have no other children but who would qualify for regular AFDC grants if they did, as well as an additional \$70 monthly grant provided to these women and to other pregnant women who are regular AFDC recipients.

Requirements for Teen Parents. The budget calls for the establishment of a new Cal Learn program for teen parents on AFDC. Monthly grants would be increased or decreased by \$50 for parents under age 19, based on their school attendance. Teen parents under age 18 would be required to live with their parents, guardian or an adult relative in most cases in order to receive AFDC.

Job Club. The budget proposes to spend \$15 million (plus matching federal funds) for a new program (not included in the initiative measure) to fund workshops on basic job skills that AFDC recipients could attend on a voluntary basis during their initial six months on aid. The budget also earmarks \$4 million in employment training funds and federal funds to help welfare recipients find jobs.

In addition to the direct savings due to grant reductions and elimination of benefits, the budget also includes a net savings of \$75 million in 1992-93 from a reduction in welfare dependency. The administration assumes that the job clubs and increased work incentives due to the proposed changes in the grant program will enable more welfare recipients to obtain employment and reduce or eliminate their dependence on aid.

Issues for Legislative Consideration

The goals of the budget proposal are to achieve current and future 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 and for AFDC recipients to move to California. 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 job clubs program provide adequate incentives and opportunities for employment to AFDC recipients in order to achieve the dependency savings that is 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). Our AFDC budget analysis evaluates the work incentives in the budget proposal and presents several alternative approaches to increasing work incentives that better reflect the job readiness of AFDC parents.

Consistency Among Welfare Programs. The budget does not propose any reduction in state benefits to the poor elderly, blind or disabled under the SSI/SSP program (other than a shift from cash to food stamps for a portion of the benefit). Presumably, one reason for this different treatment is a presumption that SSI/SSP recipients are not able to work and so cannot supplement their benefits with earnings. However, some SSI/SSP recipients are able to work, at least on a limited basis, and program revisions to increase work incentives for those SSI/SSP recipients also could be explored.

Timing and Feasibility. As shown in Figure 7, 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, 1992, and implementation of all of the proposals by July 1, 1992. 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 the AFDC proposals could achieve during the current and budget years.

MEDI-CAL

The California Medical Assistance Program is a joint federal-state program which 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.

Proposal

The budget proposes to eliminate some existing optional benefits, limit hospital stays, reduce certain provider payments, and shift some costs from the General Fund to Proposition 99 funds. Each of these changes is discussed below.

Eliminate Some Optional Benefits (\$109 million). California's Medi-Cal program currently provides recipients with many services that are not required by federal law, although the federal government does provide matching funds to states that choose to offer them. The budget proposes to eliminate the following optional services starting June 1, 1992, for a savings of \$7.6 million in 1991-92 and \$101 million in 1992-93:

- Adult dental care.
- Chiropractic, acupuncture, podiatric, outpatient psychological, and occupational therapy services.
- Services provided at independent rehabilitation centers and blood banks.
- Certain medical supplies.

Limit Hospital Stays (\$61 million). The budget proposes to limit Medi-Cal payments for in-patient hospital stays to a maximum of 60 days each year for most recipients. This limit would save \$61 million, according to budget estimates.

Reduce Some Provider Payments (\$65 million). Some rates paid for long-term care would be reduced, for an estimated savings of \$28 million. Currently, all long-term care facilities in each "peer group" of facilities are reimbursed at the group's median cost. The budget proposes to pay a lower rate to facilities whose costs are less than the median. In addition, provider

payments will be reduced for some hospitals that serve beneficiaries who are eligible for benefits under both Medi-Cal and Medicare (the federal health program serving the elderly and disabled). Rates for hospital inpatient services vary between the two programs. The budget proposes to save \$31 million by implementing administrative procedures to compare rates for these "crossover" beneficiaries to ensure that the combined Medi-Cal and Medicare payments do not exceed the Medi-Cal rate. Finally, the budget proposes to save \$6.2 million by reducing the mark-up allowed on certain medical supplies, and by obtaining lower prices on high-volume drugs that are available from competing manufacturers.

Shift Cost to Proposition 99 Funds (\$123 million). Since 1989-90, pregnant women with incomes of up to 185 percent of the federal poverty level have qualified for perinatal benefits under Medi-Cal. Originally a state option, eligibility for these women and infants is now federally required. Programs supported by the Cigarette and Tobacco Products Surtax established by Proposition 99 provide perinatal services to women with higher incomes (up to 250 percent of the poverty level). The budget proposes to shift \$123 million of the cost of the "185 percent" perinatal program from the General Fund to Proposition 99 funds (\$60 million in 1991-92 and \$63 million in 1992-93).

Issues for Legislative Consideration

The Medi-Cal proposals raise the following issues for consideration:

Potential for Cost Shifting. In some cases, savings to the Medi-Cal program could result in shifting costs to other Medi-Cal services or to other health programs. For example, the limit on Medi-Cal payment for inpatient hospital days would force hospitals, including county hospitals, to absorb the cost of more extended stays for patients who require longer inpatient care. 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 to be eliminated, in order to determine the actual savings that can be expected and alternatives for preventing shifts to services with greater costs.

Loss of Federal Matching Funds. Medi-Cal savings also reduce federal matching funds. This could be a particular problem in any instances in which Medi-Cal limitations shift costs to programs that are supported only by state or local funds, such as indigent health care.

Access to Care. Reducing payments to providers could limit the ability or willingness of some to accept Medi-Cal patients. This could reduce access to care for beneficiaries and also could shift additional costs to counties, which are the providers of last resort.

Questionable Use of Proposition 99 Funds. The provisions of Proposition 99 (1) restrict the use of monies in the Cigarette and Tobacco Products Surtax accounts and (2) prohibit the use of some of these funds to match federal funds. The Legislative Counsel advises that the budget proposal violates both of these requirements, and consequently, voter approval of a ballot measure to amend Proposition 99 will be necessary before this proposal can be implemented.

RENTERS' TAX CREDIT

The renters' credit is a personal income tax credit that is available to qualifying Californians who are not homeowners. Unlike other tax credits, however, the renters' credit is fully refundable — meaning that renters are entitled to 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.

From 1979 through 1989, the amount of the credit was \$137 (joint) or \$60 (single). In 1990, the maximum credit was reduced to \$120. As part of the 1991-92 budget package, Ch 117/91 (SB 169, Alquist) limited eligibility (until 1996) for the credit to renters with incomes less than \$41,000 (joint) or \$20,500 (single). Previously, there had been no income test for the credit. The budget estimates that almost two-thirds of the cost of the credit currently is for the "refundable" portion (payments in excess of tax liability).

The credit's rationale is that it complements the homeowners' property tax exemption by offsetting a portion of the property tax burden that landlords pass through in rents to tenants. Article XIII, section 3(k), of the California Constitution entitles homeowners to a property tax exemption worth about \$75 annually (state subventions offset this local revenue loss), and it requires the Legislature to *increase* the amount of the renters' income tax credit if it increases the homeowners' exemption above this amount. However, the State Constitution does not specifically require the continuation of the renters' credit.

Proposal

The Governor's Budget proposes that the renters' tax credit be completely eliminated, effective for the 1992 income year, for

an estimated savings of \$376 million in 1992-93. (An appropriation of \$30 million is proposed in 1992-93, however, to pay any remaining claims for 1991.)

Issues for Legislative Consideration

This proposal raises the following policy issues.

Relationship With Homeowners' Tax Relief. Historically, the renters' program has been tied to the Homeowners' Property Tax Relief program. The budget proposal "unlinks" the two because the homeowners' property tax exemption would remain in place (a constitutional amendment would be needed to eliminate it).

Distribution of Tax Burden. Since the renters' credit benefits only persons with low or modest incomes, its elimination would make California's personal income tax less progressive; that is, lower-income persons would pay a higher percentage of their incomes in taxes.

STATE EMPLOYEE COMPENSATION SAVINGS

Traditionally, the budget includes funds for cost-of-living adjustments (COLAs) for state employees. In addition, under existing law, the state generally covers cost increases for employee health benefits. Specific pay and benefit changes for most state employees, however, are negotiated between the Department of Personnel Administration and the employee organizations in collective bargaining. Agreements that result from this bargaining are embodied in memoranda of understanding (MOUs) that, when ratified by the Legislature, become contracts between the state and the employee groups.

In addition to COLAs, state civil service employees are entitled to a one-step (generally about 5 percent) merit increase each year until they reach the top step in the salary range of their job class (most classes have four or five steps). Compensation for faculty and other employees of state higher education institutions (such as the University of California and California State University) is addressed separately in the budgets of those institutions.

In order to help resolve the 1991-92 funding gap, the 1991 Budget Act did not provide any salary COLA or any funds for health benefit cost increases (the latter currently estimated at \$58 million from the General Fund). Moreover, the Budget Act included an unallocated General Fund reduction of \$351 million in Control Section 3.90 to reflect anticipated savings from staff reductions and salary cuts, and from increasing the employee share of benefit costs. However, the courts have held that the

administration may not reduce pay or benefits for represented employees in the absence of legislation specifically authorizing the cuts or of MOUs agreeing to the cuts.

As of February 1992, none of the employee collective bargaining units had agreed to the salary reductions or benefit rollbacks. As a result, the salary and benefit cuts have been implemented only for managers and supervisors to date, and most of the savings that have been realized have been achieved through departmental spending reduction plans that have eliminated positions and shifted some costs to other funding sources. Even with these actions, \$118 million of the budgeted savings remains unrealized.

Proposal

In addition to providing no COLA for 1992-93, the budget assumes General Fund savings of \$221 million (including \$74 million in the current year), based on extending the 5 percent salary cut to all employees as of *January 1, 1992*. Special funds also would realize savings totaling \$97 million. In addition, the budget proposes to roll back state health benefit contributions in 1992-93 to their 1990-91 level and to freeze dental contributions at 1991-92 levels, for a General Fund savings of \$54 million. Although the budget's savings estimates were calculated using these specific proposals, the budget document indicates that the administration is willing to explore alternative ways to improve the cost-effectiveness of employee salary and benefit programs.

Issues for Legislative Consideration

Realistically, some employee compensation and benefit savings will almost certainly be a part of the adopted 1992-93 budget. However, the specific proposals in the budget raise several issues, and there are many alternative ways to achieve savings in these areas that the Legislature may wish to consider.

Implementation Questions. The proposed salary and benefit cuts raise a number of issues. If the pay cut were applied uniformly to the existing pay classifications, employees at less than the maximum step in their class would not have their current salary reduced, since their merit increase would offset the pay cut. However, employees who currently are at the top step *would* have their pay cut. In addition, pay cuts would make the state a less competitive employer in high-cost urban areas, but would not have as much impact in many rural areas where jobs are scarcer and usually pay less.

Alternative Ways to Achieve Savings. There are at least three primary alternatives to the proposed salary and benefit rollback, as follows:

- **Furloughs.** Rather than reduce salary rates, employees could be furloughed. Employees might be furloughed one or two days per month or, alternatively, for two or three weeks during the year. This approach also would reduce the total salaries of state employees, but they would receive time off in return. However, the additional time off would reduce levels of service to some extent and may not be feasible in some cases, such as for 24-hour care facilities that require specific levels of staffing.
- **Flexibility.** Allowing employees more flexibility in the selection of benefits, such as by offering a “cafeteria plan,” might provide employees with more value at lower cost to the state.
- **Reduce the Number of Employees.** Rather than reducing the salaries and benefits of all state employees, the Legislature could achieve savings by eliminating lower-priority programs and the positions currently in those programs. This would help maintain employee productivity in high-priority programs, but it could require layoffs in terminated programs.

HIGHER EDUCATION

California’s system of public higher education is the largest in the nation and serves approximately two 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 bachelors degrees and a full range of graduate and professional degrees. It generally accepts students in the top eighth of their high school class. The CSU primarily awards bachelors degrees and generally accepts students in the upper third of their high school class. The CCC offer basic skills and citizenship instruction, and a variety of academic and occupational programs.

Proposal

General Fund support for the UC and the CSU will total \$3.8 billion in 1992-93, an increase of 1.4 percent compared with the current year. We estimate that this amount is \$343 million less than the amount needed to fully fund salary and price increases, and to replace instructional equipment.

About \$93 million of the \$219 million funding shortfall for the CSU would be covered by a student fee increase that has been tentatively adopted by the CSU trustees. This fee increase was not assumed in the budget, but was put forth as an option for the

trustees to consider. The UC's shortfall of \$124 million would be \$60 million larger if not for a student fee increase assumed in the budget and recently adopted by the UC Regents.

We estimate that the number of students that can be served at the CSU in 1992-93 will fall 12,000 short of projected full enrollment under the state's Master Plan for Higher Education. Despite the UC's budget shortfall, however, the system will be able to serve all Master Plan-eligible undergraduates and increase graduate enrollments in 1992-93.

The budget provides full funding for community colleges consistent with Proposition 98 requirements.

Issues for Legislative Consideration

The budget proposal and actions by the UC Regents and the CSU trustees have relied in large part on student fee increases to mitigate the need for additional General Fund support. There are many other approaches, however, for the Legislature to consider. For instance, the Legislature could reevaluate the enrollment goals set forth in the Master Plan. Reduced enrollment goals would allow the CSU and the UC to provide a high-quality education to a smaller number of students than contemplated in the Master Plan without augmenting their budgets. Below, we identify other restructuring ideas for the Legislature to consider that would not require changing Master Plan goals.

Redirect UC Faculty Workload to Teaching. Research and other activities outside of regular teaching occupy a significant amount of faculty time at the UC. Requesting UC faculty to reduce the time spent on these activities in order to increase the number of courses taught from the current five courses to six could result in annual savings of approximately \$47 million. (The CSU administration and California Faculty Association are currently planning to *reduce* faculty teaching workload by one unit per year in 1992-93. This workload reduction would exacerbate the course selection problem currently facing students.)

Make More Effective Use of Community Colleges. It currently costs the state considerably more to educate a student at the UC and the CSU than at a community college. A policy whereby the UC and the CSU would admit qualified freshmen but redirect a portion of them, on a voluntary basis, to enroll in a specific community college would allow the state to provide a given level of enrollment at less cost.

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:

- **Test 1 — Percentage of General Fund Revenues.** This is defined as the 1986-87 percentage of General Fund tax revenues provided K-14 education — about 40 percent.
- **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 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 level of total funding for K-14 education from state and local tax sources, adjusted for enrollment growth and for growth in per capita General Fund tax revenues, plus one-half of 1 percent of the prior-year level. However, the per-pupil funding increase that results from this formula 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” 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 General Fund budget.

Other provisions of Proposition 98 allow the minimum funding level to be suspended by the Legislature and establish “maintenance factors,” which provide 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. For a more complete discussion of these provisions and additional background on Proposition 98 funding levels, please see the Overview of K-12 Education in the *Analysis of the 1992-93 Budget Bill*.

Proposal

The Governor’s Budget proposes full funding for Proposition 98, albeit at a slightly reduced level for the current year relative to the amount approved in the 1991 Budget Act. As a result of a decline in state revenues, funding for the current year would be reduced from \$18.4 billion to \$18.2 billion, to generate savings of

\$183 million in 1991-92. Budget-year funding would amount to \$18.5 billion from the General Fund, based on the Test 2 formula described above, and assuming that the Governor's proposal to transfer property tax revenues to the schools from enterprise special districts is approved by the Legislature. (For a review of this proposal, please see the discussion of enterprise special districts, which is the next budget proposal that we discuss in this part.)

Current Year. The reduction in current-year funding proposed by the budget is made possible by a \$2.8 billion reduction in current-year tax revenues. This revenue reduction has the effect of lowering the amount of funding required under Proposition 98. Because of the current-year revenue shortfall, the 1991-92 budget appropriation now exceeds the minimum funding requirement by \$183 million. This amount is proposed to be "loaned" to school districts in the current year (when it would be spent by the districts), but *counted* towards the state's 1992-93 funding guarantee.

In 1990-91, revenue reductions occurring after the adoption of the budget reduced the minimum required funding level below the amount appropriated in the budget, and the Legislature "shifted" these excess appropriations forward across fiscal years to help fund the 1991-92 funding guarantee. That shift is similar to the one proposed in the budget.

Budget Year. The budget indicates that the 1992-93 minimum funding level is determined on the basis of Test 2. In combination with restoration payments carried over from 1991-92, this results in a total state funding requirement of \$18.5 billion, an increase of \$283 million, or 1.5 percent, over the proposed current-year level of state support. However, when local funding is included, the total amount of the Proposition 98 guarantee amounts to \$25.4 billion in 1992-93, which is an increase of \$842 million, or 3.4 percent. The relatively low rate of growth in the total guarantee reflects a negative adjustment for per capita personal income: -0.95 percent.

Issues for Legislative Consideration

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

Revenue Estimates May Decline Further. Earlier in this document, we present our evaluation of the administration's estimates of current- and budget-year revenues. As that discussion concludes, there is a significant risk of further declines in

revenue for both years, and such declines could lower the minimum required funding level in both 1991-92 and 1992-93.

- **1991-92.** Reductions in the revenue estimates for 1991-92 would directly affect the amount of funding required by Proposition 98 for 1991-92. We estimate that each \$100 million of revenue reduction reduces the funding requirement by \$57 million.
- **1992-93.** Reductions in the revenue estimates for 1992-93 will lower Proposition 98 requirements only to the extent that they exceed \$1.5 billion. Assuming that the current year funding level is reduced by \$183 million as proposed in the budget, a revenue reduction in excess of approximately \$1.7 billion could eliminate the 1992-93 restoration payment requirement, for a savings of \$240 million. Revenue reductions of \$2.2 billion or more would result in a switch to the Test 3 formula, and further reduce the guarantee amount.

Revenue reductions do not, by themselves, require K-14 spending reductions. The Legislature could, however, consider reductions in K-14 appropriations in line with reductions in the Proposition 98 minimum funding requirements in order to help accommodate the impact of revenue reductions in other, non-K-14 education portions of the budget.

Accrual Accounting Adjustment Could Increase Flexibility. Even if further revenue reductions do not materialize, the Legislature may wish to spread the required expenditure reductions beyond the program areas chosen by the administration in its proposals to balance the budget. One option for accomplishing this is to change the way that revenues generated in 1991-92 by a switch to accrual accounting are treated for purposes of Proposition 98.

State General Fund revenues were augmented in the 1991-92 year by changing the way that the state accounts for revenues. Specifically, this change allows the state to count revenues as “received” when they are *earned* instead of at the time they are physically received by tax collection agencies. The effect of this change is a one-time increase in 1991-92 General Fund revenues of \$1.7 billion.

When the 1991-92 budget was enacted in July of 1991, the Legislature never explicitly addressed the issue of whether these one-time revenues should count as General Fund tax revenues in determining the level of the guarantee. There was no need to decide the issue because, at the level of revenues anticipated at the time, excluding or including them had no impact on the

amount of the 1991-92 guarantee. The revenue reductions identified in the budget, however, have altered this situation, so that the treatment of the accrual revenues could make a significant difference in the computation of the current-year funding guarantee.

We estimate that excluding the one-time accrual revenues — which would require the enactment of legislation — would reduce the 1991-92 guarantee by \$945 million. This amount would be in addition to any savings occasioned by further reductions in the estimates of 1991-92 General Fund revenues. Capturing the full amount of these savings in 1991-92 could be extremely difficult, because it would likely cause severe financial problems for school districts that have few options to reduce their expenditures in the current year. The Legislature could, however, increase the amount of funds that may otherwise be shifted from 1991-92 to 1992-93 by up to \$945 million. This would increase the amount of one-time savings in the education area available to address spending pressures in other areas of the budget, but it also would reduce the amount of K-14 spending proposed for 1992-93.

ENTERPRISE SPECIAL DISTRICTS

According to the State Controller's Office, there are 5,195 special districts in California. The Controller divides these districts into two categories: nonenterprise districts (3,654) and enterprise districts (1,541). *Nonenterprise* districts provide many types of governmental services (for instance, fire protection and street lighting) and pay for their activities with local property tax revenues, user charges, and property assessments. *Enterprise* districts, on the other hand, are operated like businesses. They provide services — such as waste disposal and water delivery — that can be charged to specific households or businesses. Enterprise districts receive 95 percent of their total revenues from user charges and about 4 percent from property taxes; however, the mix of these revenue sources varies markedly between districts.

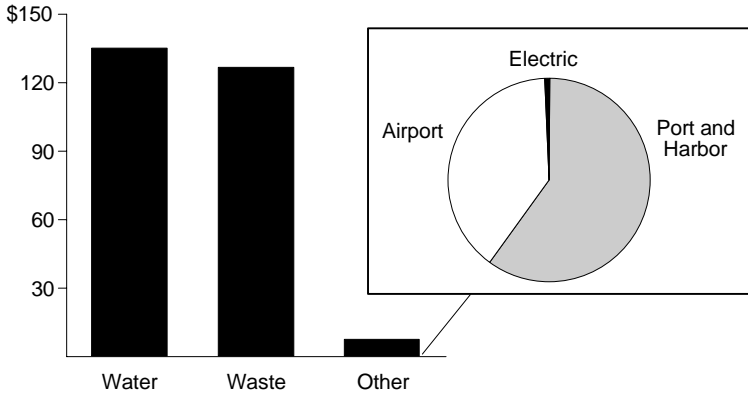
Proposal

The budget proposes to redirect \$347 million of property tax revenue in 1992-93 from special districts with enterprise activities to K-14 school and community college districts. The net effect of this redirection would be to reduce state General Fund expenditures for education, thereby freeing money for other General Fund programs.

Under existing law, airport, electric, harbor and port, waste, and water enterprise districts will receive about \$347 million in local property tax revenues in 1992-93. The distribution of these

Figure 8**Enterprise Special Districts
Property Tax Revenues by Type of District^a**

(in millions)



^a Figure shows property tax revenues in 1989-90, the last year for which data are available.

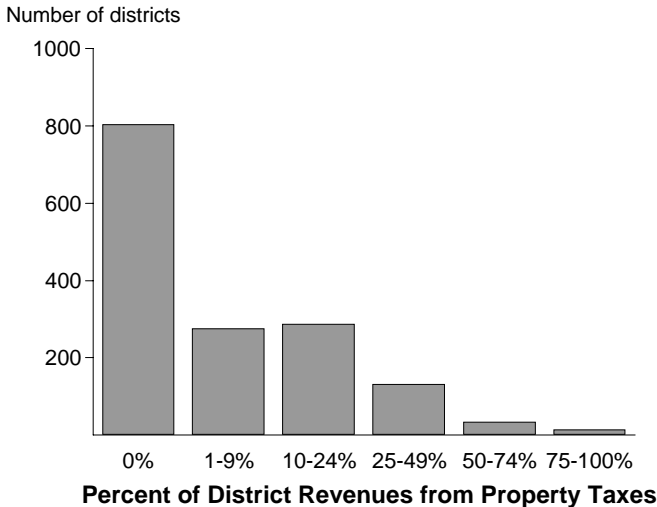
revenues among districts is shown in Figure 8. The Governor proposes to modify the existing statutory property tax allocation formula (AB 8) to permanently redirect these special districts' property tax revenues to K-14 school districts. (Property taxes levied in excess of the 1 percent rate for general obligation bonds would be exempt from the transfer.) Although K-14 school districts would receive a greater share of local property taxes under this proposal, total revenues for K-14 education would not increase. Under the terms of Proposition 98 (Tests 2 and 3), increases in K-14 districts' property tax revenues *decrease* the state's funding obligation for K-14 education on a dollar-for-dollar basis. This proposed shift of property tax revenue, therefore, would result in \$347 million in revenue *losses* to enterprise special districts and \$347 million in *savings* to the state's General Fund. Enterprise districts could potentially offset property tax losses by increasing user fees and/or property assessments — or by lowering costs.

Issues for Legislative Consideration

Our review indicates that the *concept* of redirecting property tax revenues away from enterprise districts has merit. From an economic standpoint, it is generally more efficient and equitable

Figure 9

Enterprise Special Districts Dependence Upon Property Tax Revenues^a



^a Figure shows property tax dependence in 1989-90, the last year for which data are available.

to finance enterprise services from user fees rather than general taxes, such as the property tax. The Governor's proposal, however, poses several significant policy questions for the Legislature to consider.

Impact on Service Delivery. As Figure 9 indicates, the majority (70 percent) of enterprise special districts do not receive any property taxes, or depend on these taxes for less than 10 percent of their total revenues. These districts, therefore, are unlikely to be significantly affected by the proposed redirection of property taxes.

A minority of districts, however, depend on property tax revenues extensively to provide services. For example, property taxes represent more than a quarter of all revenues to 177 districts — and more than one-half of all revenues to 46 districts. At the time this analysis was prepared, it was not clear (1) whether these property tax-dependent districts have the legal and/or practical ability to raise fees (or lower costs) in time to offset the proposed revenue loss or (2) the extent to which they rely upon

property taxes to repay long-term debt (other than general obligation bonds). If these districts cannot act quickly to replace their lost property tax revenues, the districts and their creditors may face significant financial uncertainty — and businesses and residents could risk disruptions in important services.

If the Legislature is inclined to approve the proposed shift, it may wish to consider options for mitigating the negative effects of the revenue loss to districts. For example, the Legislature may wish to provide a minimum amount of property tax revenues to districts which otherwise would be unable to repay long-term debt or meet service-related contractual obligations, such as the delivery of water. Alternatively, the Legislature could specify that the transfer of property taxes be phased in over several years — with no district losing property taxes representing more than 25 percent of its total revenues in the first year. We estimate that this approach would redirect about \$277 million, instead of \$347 million, of property tax revenue to K-14 districts in 1992-93.

Who Should Benefit From the Redirection of Property Tax? Property taxes traditionally have been considered to be a local tax. Revenues from property taxes are allocated to local agencies — counties, cities, K-14 districts, redevelopment agencies, and special districts. While the concept of redirecting property tax revenues from enterprise special districts has merit, it is not clear why the *state* should be the beneficiary of this transfer of local funds — rather than local agencies. Although the state is facing considerable fiscal troubles, many local agencies, particularly counties, are experiencing fiscal crises analogous to the state's.

How Accurate is the Budget's Estimate of Savings? Our analysis indicates that the total amount of revenues to be transferred from enterprise districts to K-14 school and community college districts may be significantly more — or less — than the budgeted amount. The reasons for this uncertainty are twofold.

- ***Reliance on Two-Year Old Data.*** The administration relied upon self-reported, unaudited, two-year old data in making its estimate. The administration assumes that the number and territorial boundaries of these enterprise districts have remained the same since 1989-90 (district dissolutions or city annexations of district territory generally reduce district property tax allocations). Finally, the administration further assumes that, on average, property tax revenues in the enterprise districts have grown at the same rate as property tax revenues gener-
-

ally. While these assumptions represent the best data available, the resulting estimate of \$347 million may have a significant margin of error.

- ***Homeowners' Property Tax Relief (HOPTR) Not Counted.*** Our analysis indicates that the budget does not account for the transfer of about \$9 million in HOPTR funds from enterprise districts to K-14 school districts. The HOPTR funds are state reimbursements for taxes lost to local agencies due to the homeowners' exemption. If enterprise districts do not receive property taxes, the districts will no longer be eligible for HOPTR funds. These tax relief funds would be credited, instead, to K-14 districts. The budget, however, *does not* reflect this transfer of HOPTR funds to K-14 school and community college districts.

Given the above, the \$347 million estimate may well understate or overstate the transfer of revenues between enterprise districts and K-14 school and community college districts, but it appears to be reasonable given the data limitations noted above.

LEASE-PAYMENT BOND REFINANCING

The state has generally used two types of debt instruments to finance its long-term capital outlay requirements. *General obligation* bonds are voter-approved bonds backed by the full faith and credit of the state, and the annual debt service on these bonds is paid from a continuous statutory appropriation. *Lease-payment* bonds are authorized by the Legislature in statute, and are backed only by the projects they are used to finance. The debt service on these bonds is essentially paid from annual budget act appropriations to the departments or agencies that use the facilities financed from these bonds.

The budget indicates that the state's debt service payments in 1992-93 for general obligation bonds will amount to approximately \$1.5 billion. Debt service for lease-payment bonds will be considerably less, but still a substantial amount at approximately \$213 million.

Proposal

The *1992-93 Governor's Budget* indicates that the administration will attempt to carry out a refinancing of nine outstanding lease-payment bond issues, including eight issued by the State Public Works Board and one issued by the Los Angeles State Building Authority. The nine issues have bonds outstanding in the approximate principal amount of \$1.25 billion. The proposed refinancing would result in two forms of "cash-flow" savings to the state:

- **Released Debt-Service Reserve Funds (\$130 million)**, which represent cash presently held in reserve as security under the terms of the outstanding bonds. These funds are proposed to be transferred to the General Fund in 1991-92.
- **Deferral of Debt-Service Payment Obligations (\$60 million)**, which represents the amount of state funds that would be required to service the debt in 1991-92 and 1992-93 on these outstanding bonds in the absence of the refunding proposal. These savings would be generated by structuring the replacement bond issue so that no debt-service payments are required until mid-1993.

According to the State Treasurer's Office, the state would need to issue a total of \$1.5 billion in new bonds to replace the \$1.25 billion in outstanding lease-payment bonds. Debt-service requirements would increase over the life of the bond issue by a total of \$312 million. No legislative action is required to implement the refinancing proposal; however, the State Treasurer must agree to carry it out.

Issues for Legislative Consideration

The administration's refinancing proposal raises serious fiscal and policy questions for the Legislature to consider. Although legislative action is not required for its implementation, the proposal has consequences that the Legislature should address.

Increased Long-Term Costs. As noted above, the State Treasurer's fiscal analysis of the refinancing proposal indicates that the state's debt-service costs over the next 20 years would be increased by \$312 million. This exceeds the total short-term savings of \$190 million anticipated by the budget, and results in a loss in present value terms of approximately \$18 million. This type of transaction would thus exacerbate the state's long-term fiscal imbalance.

Potential Market Impacts. According to the State Treasurer's Office, this proposal also could have negative consequences for future state bond issues. These include the potential impact on borrowing costs that could result from an additional sale of \$1.5 billion of state bonds in the marketplace. Furthermore, the proposal could have negative effects upon investor perception of the state's fiscal management practices because it amounts to a reliance on long-term debt financing to support current state operational expenditures.

THE “TRIGGER”

Background. Chapter 458, Statutes of 1990 (AB 2348, Willie Brown), established a “trigger” mechanism that automatically reduces appropriations when anticipated General Fund revenues fall more than one-half percent short of the amount required to fund a “workload” budget. Chapter 458 requires the Director of Finance to estimate revenues and workload budget requirements by May 21 each year in order to determine whether the trigger will be “pulled.” Unless the Commission on State Finance refuses to certify the general accuracy of the Director’s calculations, General Fund appropriations for the new fiscal year are reduced on July 1.

Generally, the trigger reduces appropriations by the percentage by which revenues fall short of a workload budget, up to a maximum of 4 percent. However, constitutionally required spending — Proposition 98 spending, debt service, mandates, and homeowners’ tax relief — is exempt from trigger reductions. Exempt spending makes up a substantial portion of the budget (almost one-half). For the state’s major entitlement programs (including AFDC and Medi-Cal), the trigger reduction cannot exceed the amount of any statutory cost-of-living adjustment (COLA).

Existing law (Ch 1209/90 — AB 756, Isenberg) defines the workload budget as the budget-year cost of currently authorized services adjusted for changes in enrollment, caseload, or population. In addition, adjustments are made for statutory COLAs, new laws, constitutional requirements, court or federal mandates, general price increases, merit salary adjustments, and some additional technical factors.

The Trigger and Other Unallocated Reductions in 1991-92. The trigger was pulled in 1991-92, but, rather than have the trigger operate automatically, the 1991 Budget Act contained specific trigger reductions in most General Fund appropriations. These trigger reductions totaled \$802 million, consisting of \$243 million from the suspension or reduction of COLAs, \$210 million from eliminating funds for price increases and merit salary adjustments, and \$349 million from other unallocated reductions in appropriations specified in the budget.

In addition to the trigger cuts, departments were required to take additional unallocated reductions totaling more than \$300 million:

- About \$233 million of the employee compensation savings required by Section 3.90 has been distributed among departments for them to allocate by reducing positions or other means.
-

- Section 1.20 of the 1991 Budget Act increased the amount of the original unallocated reductions reflected in the budget, for a General Fund savings of \$37 million.
- Departments must redirect approximately \$46 million of General Fund support within their budgets to cover additional health benefit costs for rank and file employees that the Governor vetoed in the budget.

Together with the unallocated portion of the trigger reductions (all but the COLA-related reductions), state departments and programs are absorbing a total of about \$875 million of unallocated reductions in the current year.

Trigger Reductions Varied Widely. The amount of the trigger reduction applied to each department or program was calculated by the Department of Finance, based on its estimate of a workload budget for that department or program and a variety of technical considerations. The actual reductions varied considerably in percentage terms. For example, the trigger reduction amount was 1.4 percent of the General Fund support appropriation for the Department of Parks and Recreation, but 3 percent of General Fund support for the Department of Forestry and Fire Protection. Some departments or programs, such as the Horse Racing Board, which are not directly supported by the General Fund, were not subject to trigger reductions, although reductions in their costs would have benefitted the General Fund.

Implementation of the 1991-92 Unallocated Reductions

Most departments that are subject to the trigger reductions and other unallocated cuts have prepared reduction plans to implement those cuts. However, the specificity and completeness of those plans varies greatly. For example, the State Water Resources Control Board prepared a specific plan that eliminates several programs. On the other hand, at the time that this review was prepared, the Department of Food and Agriculture had no specific proposal for achieving \$4.3 million of its unallocated reductions. Our review of the plans presented by the departments indicates that a variety of approaches have been used to implement the cuts. We discuss these approaches below.

Eliminate Unnecessary Staff or Functions. In some cases, departments have identified unneeded resources that they can eliminate without adversely affecting programs. For example, the Department of Mental Health plans to save \$2.8 million by eliminating 53.9 personnel-years of staff budgeted for patient care of mentally disordered offenders in state hospitals. The department has determined that these positions are excess to its actual staffing needs and that the reduction will have “no

impact” on patient services. The Department of Mental Health also will eliminate 51 administrative positions that are no longer needed because of workload reductions due to the realignment of state-local health and welfare programs. An unanticipated slowing in the growth of the inmate population has enabled the Department of Corrections to achieve almost \$28 million of its unallocated reductions without taking any action.

Use New Money. New funding sources, such as federal grants, that were not included in the budget have enabled some departments to absorb a portion of their cuts without reducing programs. For example, the Department of Education replaced \$677,000 of its \$7.2 million unallocated reduction with new federal Child Care Block Grant funds.

Shift Costs to Others. Some General Fund savings were achieved by shifting costs previously borne by the General Fund to special funds, other agencies, or to local government. The Department of Housing and Community Development, for example, has shifted \$322,000 from the General Fund to other funding sources by allocating the costs of its policy development and legislative units to all of its funding sources instead of supporting them solely from the General Fund. The Department of Education is reducing some special education assessment services at the state diagnostic schools, which could require school districts to obtain outside diagnostic services at district expense. The Resources Agency has shifted most of its unallocated reduction to the departments within the agency by requiring them to support agency staff with reimbursements.

Eliminate Programs. Although program *reductions* are common, eliminating programs is a much less frequent response to unallocated cuts. As discussed above, this approach was used, in part, by the State Water Resources Control Board, which is eliminating its review of leak tests conducted by owners of landfills as well as its activities related to Proposition 65.

Reduce Program Services or Level of Effort. This is one of the more frequent methods of implementing the unallocated cuts, and often shows up in departmental plans as “miscellaneous savings,” or simply “funding reductions.” In some cases, however, the reductions are specific. For example, the Department of Justice is scaling back its “Crack Down on Cocaine” program and the Youth Authority is reducing financial assistance available to parolees. The Department of Health Services is eliminating certain fraud-related investigations of drug utilization. The Department of Alcoholic Beverage Control is reducing compliance and enforcement efforts by closing five of its 23 district offices. In some instances, these reductions may simply eliminate low-priority program components or force programs to operate more

efficiently. In other cases, however, program services may be reduced significantly or programs may be reduced to a "caretaker" status.

Defer Costs. Some departments have identified deferrals of spending within their unallocated reduction plans. The Military Department, for example, plans to defer maintenance of armories, and it and many other departments are deferring equipment purchases. In some cases, deferrals can increase costs in the long run, such as when lack of maintenance requires major repairs later on. Deferrals can make sense if permanent reductions require additional time to implement. However, they may just postpone real decision making. Given the tight budget situation for 1992-93, many of the cost deferrals identified in the current year will be further extended.

Avoid Layoffs. Another frequent approach is to avoid the need for layoffs by using hiring freezes, or by reducing equipment and contract budgets. The Department of Social Services has identified savings of \$5.3 million in the current year, for example, from a hiring freeze. This approach generates savings with the least impact on existing staff, but with the disadvantage that there is little or no control over programmatic impacts. Savings will be generated wherever vacancies occur, rather than in those areas with the lowest priority. Likewise, across-the-board equipment and contracting reductions may create significant problems for some programs or activities while hardly affecting others. Thus far, departments have succeeded in avoiding major layoffs to meet their reductions. As of January 1992, layoffs totaled only 125 employees statewide, one-half of whom were in the Military Department.

Proposal

The budget proposes to suspend operation of the trigger in 1992-93 (this is done in Section 1.25 of the 1992 Budget Bill). The Governor's Budget Summary presents the following justification for suspension:

After many successive years of "unallocated" or "across-the-board" cuts, most state programs and departments have made substantial reductions in the level of services. Further reductions of this sort will simply reduce the effectiveness of remaining programs.

How Much Would the Trigger Save in 1992-93? We estimate that the trigger reductions would total \$823 million, or just slightly more than the amount of trigger reductions in the current year.

Issues for Legislative Consideration

Our review of the executive branch's implementation of the 1991-92 unallocated reductions supports the following findings, which the Legislature should consider in evaluating the administration's proposal to suspend the trigger for 1992-93.

- ***Many Program Reductions and Some Eliminations Occurred.*** Clearly, most departments could not absorb the reductions by merely trimming "fat"; instead, most reduced services or scaled back programs and, in some cases, eliminated programs.
- ***Priorities Were Primarily Determined at the Departmental Level.*** Most of the decisions concerning how to implement the unallocated reductions were made at the department level, with some input from agency secretaries. As a result, there was little coordination and no overall strategy.
- ***Effects Are Spread Throughout State Government.*** The trigger reductions and other unallocated cuts were applied to most departments supported by the General Fund. Departments tended to spread the reductions around internally, rather than eliminate major programs, in part because there was no change in their statutory program requirements.
- ***Some Reductions May Have Hidden Costs.*** Reductions at the Department of Health Services will result in the loss of \$4.5 million of federal matching funds, for example, and deferring necessary maintenance and equipment purchases could increase future costs.
- ***The Full Impact of the Cuts Cannot Be Determined.*** Some of the cuts have not been identified yet, but those that have include general hiring freezes and other types of broad reductions. Often, it will not be possible to specifically identify the impact of these cuts.

In our December Policy Brief entitled *The State's Fiscal Problem*, we recommended that one of the principles that the Legislature should use in resolving the 1992-93 budget problem is to make choices, rather than across-the-board cuts, for essentially the same reasons cited by the administration. We believe that the findings above continue to support that recommendation. The trigger mechanism is incompatible with the need for the Legislature to make broad priority choices this year in order to balance the budget while maintaining the state's most important programs and services.

The 1991-92 State and Local Program Realignment

Overview and Current Issues

What Steps Should the Legislature Take to Ensure the Effective Implementation of Realignment?

Summary

The 1991 realignment legislation represents a fundamental change in the state and county fiscal relationship. This legislation included three major components: (1) program transfers from the state to the counties, (2) changes in state/county cost-sharing ratios for nine social services and health programs, including AFDC, and (3) an increase in the state sales tax and the vehicle license fee earmarked for support of the programs. Thus, the legislation did not give counties discretion to use these revenues for any local purpose, nor did it make the realigned programs discretionary.

The legislation includes a number of programmatic and fiscal reforms. It also addressed the state's budget gap to some extent. In the near term, this was due primarily to the revenue increase to support the county's share of realigned program costs. In the longer term, the legislation's reforms could result in a more significant contribution to closing the state's structural budget gap than would have been achieved through a tax increase alone.

The Legislature will face several significant issues related to realignment in the current legislative session and in later years. These include (1) a net \$130 million revenue shortfall for the counties in the current year, (2) pending court cases that could trigger the legislation's "poison pill" provisions, (3) the implementation of performance-based contracts for county mental health programs, (4) the state's role with regard to IHSS service reductions, (5) the need to establish a fund reserve to ensure the long-term viability of realignment, and (6) the state's future oversight role for the realigned programs.

Finally, we believe the Legislature should consider extending some of the concepts that underlie this legislation to other program areas as one strategy to address the state's current budget gap.

INTRODUCTION

The state and local program realignment legislation enacted in 1991 represents a fundamental change in the state and county fiscal relationship. In this piece, we (1) provide background on the evolution of the legislation, (2) review its primary components, (3) assess its likely programmatic and fiscal effects, and (4) identify realignment-related implementation and policy issues we believe the Legislature will face in the current legislative session and in later years. Finally, we identify program areas where we believe the Legislature might effectively extend some of the legislation's features to enact further reforms.

BACKGROUND

In January 1991, the Governor proposed a transfer of responsibility for community-based mental health programs and the AB 8 county health services program from the state to counties as part of a "realignment" of state and local programs. The administration proposed to eliminate a total of about \$900 million in General Fund support for these services, and to provide counties with roughly equivalent additional revenues from an increase in the alcohol tax and the vehicle license fee (VLF). This proposal was a major component of the administration's initial plan to address the significant funding gap that faced the state for 1991-92.

The administration's rationale for its proposal to transfer program responsibility included the following:

- Authorizing legislation did not require extensive state oversight of the two programs as compared to most others in the health and welfare area.
- Funding for mental health local assistance had historically been considered "discretionary" expenditures, and had been reduced significantly in years where the state faced a major budget shortfall.
- Allowing local governments greater flexibility in determining program structure and ultimate funding levels would improve program services and their responsiveness to local concerns.
- The specified funding sources would provide a stable and growing revenue base to support the programs over the long term.

In responding to the administration's initial proposal, the Legislature endorsed a number of these principles, but raised several concerns:

- Providing counties complete discretion over mental health expenditures could have jeopardized over \$300 million in federal funding for substance abuse and mental health treatment services annually, due to certain federal requirements.
- The administration's proposal for mental health would have potentially shifted significant costs to other, primarily state-funded programs (such as AFDC-Foster Care and the state hospitals) that were generally more costly and less consistent with the programmatic goal of mental health legislation (that is, that persons should receive services in the least restrictive settings).
- There were other health and welfare programs administered as a "partnership" between the state and the counties that could be incorporated into a realignment package to give counties more flexibility and a greater fiscal stake in the programs. Incorporating such programs would recognize programmatic linkages among various health and welfare programs, thereby adopting a "system-building" approach to programmatic reform.
- Realignment legislation needed to be structured in such a way as to limit intercounty migration — the movement of individuals to counties that provide relatively higher levels of services. Such migration could become more severe to the extent that service level variations became more extreme.

LEGISLATIVE ACTION: THE 1991-92 REALIGNMENT

Based on the concerns raised in the realignment hearings (including those noted above), the Legislature saw advantages in a modified and significantly expanded version of the administration's original proposal. Through a task force, the Legislature and the administration jointly developed three pieces of legislation — Ch 87/91 (AB 758, Bates), Ch 89/91 (AB 1288, Bronzan), and Ch 91/91 (AB 948, Bronzan),^a which affected a total of 18 programs (16 in the health and welfare area).

This legislation included three major components: (1) program transfers from the state to the counties, (2) changes in state/county cost-sharing ratios for certain social services and health programs, and (3) an increase in the state sales tax and the VLF earmarked for supporting the increased financial obligations of counties. Figure 1 summarizes the major components of the 1991-92 realignment, as well as the amount of 1991-92 General Fund

^a Subsequent to the passage of the 1991-92 budget plan, Chapter 89 was amended by "technical cleanup" legislation, Ch 611/91 (AB 1491, Bronzan).

expenditures transferred to counties and funded by the revenue increases.^b

The realignment measures eliminated a total of \$1.7 billion in projected General Fund expenditures for the transferred programs, and increased net county sharing ratio costs by approximately \$469 million. As Figure 1 indicates, these actions increased county expenditure requirements by a total of \$2.2 billion for the current year. The Legislature also enacted an increase in the VLF (through a modified depreciation schedule) and state sales tax (1/2 cent) that was projected to raise \$2.2 billion in revenues for 1991-92, and additional amounts in future years to cover caseload and other costs in the realigned programs.

Program Transfers

The realignment legislation transferred some degree of additional responsibility to counties for:

- **Community-Based Mental Health Services.** These services, which are administered by county departments of mental health, include short- and long-term treatment, case management, and other services to seriously mentally ill children and adults. Previously, these services were funded 90 percent state, 10 percent counties and, in most cases, by additional county funds.
- **State Hospital Services for County Patients.** The state hospitals, administered by the state Department of Mental Health, provide inpatient care to seriously mentally ill persons placed by counties, the courts, and other state departments. They were previously funded 85 percent state, 15 percent counties.
- **Institutions for Mental Diseases (IMDs).** IMDs, administered by independent contractors, generally provide short-term nursing level care to the seriously mentally ill. They were previously funded by the state and, in some cases, by additional payments from counties.
- **AB 8 County Health Programs.** Under this program, counties carry out public and indigent health services. Indigent health services include direct patient care services, such as clinic visits or inpatient care. Public health activities include services that are generally preventive in nature or that limit the spread of disease, although they may also encompass certain services provided directly to patients, such as immunizations.

^b A portion of expenditures displayed in Figure 1 for the Medically Indigent Services Program reflects the earmarking of \$116 million in revenues to replace funding that was anticipated to be lost in 1992-93 due to the expiration of funding under the federal Immigration Reform and Control Act.

Figure 1

**Components of State and Local Program Realignment
1991-92**

(in millions)

Transferred Programs		1991-92 COSTS SHIFTED TO COUNTIES
<i>Mental Health</i>		\$750
• Community-based Mental Health Programs		452
• State Hospital Services for County Patients		210
• Institutions for Mental Diseases (IMDs)		88
<i>Public Health</i>		\$506
• AB 8 County Health Services		503
• Local Health Services (LHS)		3
<i>Indigent Health</i>		\$435
• Medically Indigent Services Program (MISP)		348
• County Medical Services Program (CMSP)		87
<i>Local Block Grants</i>		\$52
• County Stabilization Subventions		15
• County Juvenile Justice Subventions		37
County Cost-Sharing Ratio Changes		1991-92 COSTS SHIFTED TO COUNTIES
	STATE/COUNTY SHARES OF NONFEDERAL PROGRAM COSTS	
	PRIOR LAW	REALIGNMENT
<i>Health</i>		
• California Childrens' Services	75 / 25	50 / 50
		\$30
<i>Social Services</i>		\$441
• AFDC - Foster Care (AFDC-FC)	95 / 5	40 / 60
• Child Welfare Services (CWS)	76 / 24	70 / 30
• In-Home Supportive Services (IHSS)	97 / 3	65 / 35
• County Services Block Grant (CSBG)	84 / 16	70 / 30
• Adoption Assistance Program	100 / 0	75 / 25
• Greater Avenues for Independence (GAIN) Program	100 / 0	70 / 30
• AFDC - Family Group and Unemployed Parent (AFDC FG & U)	89 / 11	95 / 5
• County Administration (AFDC-FC, FG, U, foodstamps)	50 / 50	70 / 30
		-155
		-95
Additional County Expenditures (Net)		\$2,212
Additional County Revenues		JAN '92 ESTIMATE
	ORIGINAL ESTIMATE	
• State Sales Tax	\$1,422	\$1,350
• Vehicle License Fee (VLF)	769	712
	\$2,191	\$2,062

- ***The Medically Indigent Services Program (MISP).*** Under the MISP, larger counties provide indigent patient care to persons not eligible for the state Medi-Cal Program.
- ***County Medical Services Program (CMSP).*** Under the CMSP, the state generally provides indigent patient care to persons in smaller counties who are not eligible for the state Medi-Cal Program.
- ***Local Health Services (LHS) Program.*** This program provides public health staff to small rural counties.

In addition, the realignment package included revenues to offset the Budget Act elimination of two block grants. These were the County Justice Subvention Program (CJSP), which provided assistance to counties for local juvenile justice programs, and the County Revenue Stabilization Program (CRSP), which provided assistance to stabilize the fiscal condition of smaller counties. The legislation provided funding equal to the block grant amounts proposed in the Governor's Budget and gave counties discretion to use these funds for juvenile justice, health, mental health, or social services programs.

County Cost-Sharing Ratio Changes

Realignment increased the county share of nonfederal costs for certain health and social services programs, and reduced the county share for others, as detailed in Figure 1. Specifically, the legislation increased the counties' share of the following programs:

- ***California Children's Services (CCS) Program.*** The CCS Program provides medical diagnosis, treatment, and therapy to financially eligible children with specific disabilities.
 - ***AFDC-Foster Care.*** This program pays for the care provided to (1) dependent children who are removed from their homes due to child abuse and neglect and (2) wards of the court who have committed offenses.
 - ***Child Welfare Services (CWS) Program.*** The CWS Program investigates allegations of child abuse and neglect, and provides services to abused and neglected children in foster care and their families.
 - ***In-Home Supportive Services (IHSS).*** This program provides assistance to eligible aged, blind, and disabled persons who are unable to remain safely in their own homes without assistance.
-

- **County Services Block Grant (CSBG).** CSBG funds can be used for various social services, including adult protective services and programs to provide information and referrals.
- **Adoption Assistance Program.** This program provides monthly grants to parents who adopt “difficult-to-place” children.
- **Greater Avenues for Independence (GAIN) Program.** Under the GAIN Program, AFDC (Family Group and Unemployed Parent) recipients receive education and job training services in order to help them find jobs and become financially independent.

The legislation also *reduced* the county share of grant costs in the AFDC Family Group and Unemployed Parent Programs, and for county administration of social services programs.

Revenue and Transfer Provisions

The legislation established a Local Revenue Fund, into which the additional revenues attributable to the increase in the sales tax are deposited, and established several provisions to govern their expenditure. The State Constitution requires that VLF proceeds be subvended directly to counties and does not allow them to be earmarked for specific purposes. In order to expend the realignment sales tax revenues, however, the legislation requires counties to deposit into the health accounts of the Local Revenue Fund an amount equal to the increase in VLF funds they receive. Accordingly, counties will use the VLF funding to support health programs.

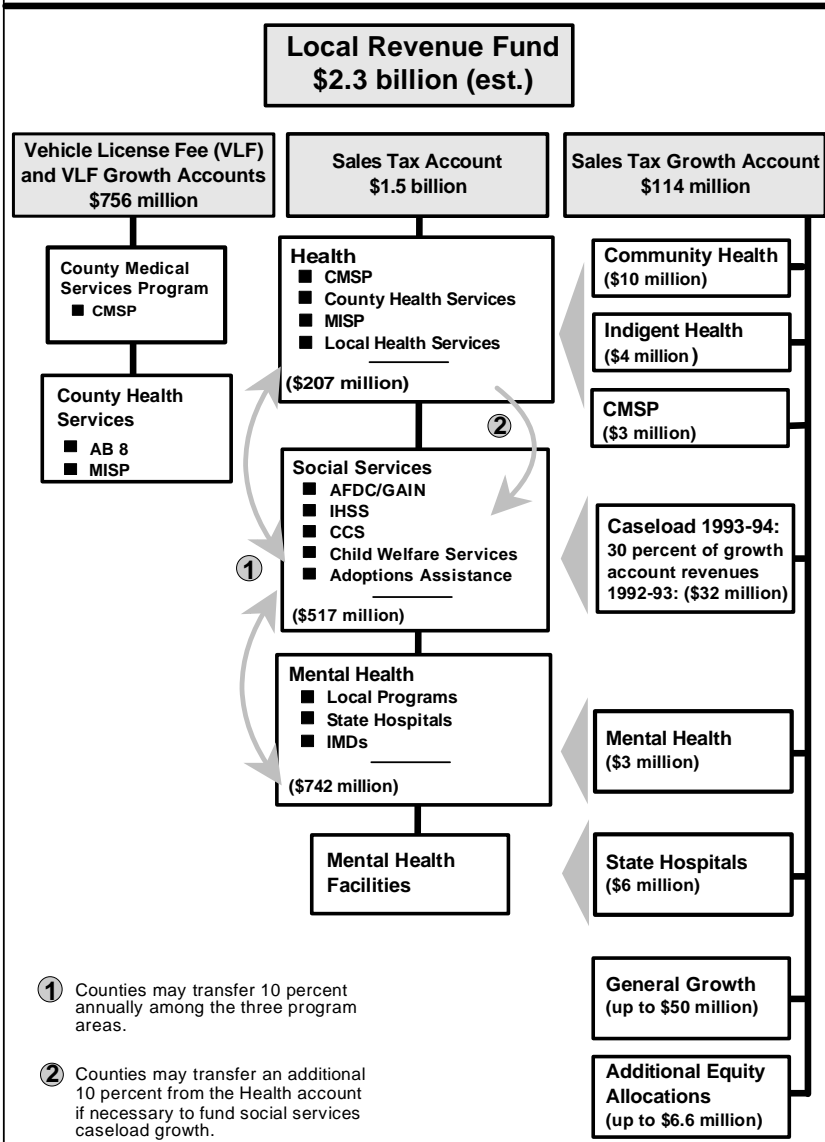
The legislation allocates both VLF and state sales tax funds among the counties, generally according to the amount of funding counties would have received in 1991-92 had prior law for the various programs continued. The flow of revenues to the programs encompassed in the legislation is shown in Figure 2.

As the figure shows, the legislation authorizes counties to transfer up to (1) 10 percent of funding from one major program area to another (for example, from mental health programs to social services programs) and (2) an additional 10 percent from health programs to the entitlement-driven programs if increased caseload costs exceed the amount of revenues available in the social services account.

Finally, the legislation establishes a schedule for allocating future increases in revenue collections attributable to the VLF and sales tax increases among the programs and across counties. For this purpose, the legislation anticipates approximately \$114

Figure 2

**Proposed Allocation of Realignment Funds
1992-93**



million in additional sales tax revenue in 1992-93, and allocates it for specified purposes, as shown in Figure 2. In general, however, the legislation does not establish priorities for these allocations if actual revenue growth is below the amount anticipated. (This issue is discussed further below.)

“Poison Pill” Provisions

In addition to the various fiscal and programmatic provisions described above, the individual realignment statutes each contain “poison pill” provisions that would render them inoperative under specified circumstances. These provisions fall into three categories:

Reimbursable Mandate Claims. If, as a result of the provisions of the realignment legislation itself, (1) the Commission on State Mandates adopts a statewide cost estimate or (2) an appellate court makes a final determination that upholds a reimbursable mandate, the general provisions governing realignment would become inoperative.

Constitutional Issues. If a final appellate court decision finds that the provisions of realignment requiring counties to deposit funds equal to their share of the VLF increase into the realignment funding accounts violate the constitutional requirement that VLF proceeds be subvended directly to counties, the VLF increase would be repealed.

Similarly, if a final appellate court decision finds that revenues raised pursuant to the realignment portion of the 1991-92 sales tax increase (1/2 cent out of the 1-1/4 cent increase) count against the Proposition 98 funding guarantee, the realignment portion of the sales tax increase would be repealed.

Court Cases Related to Medically Indigent Adults. If a final appellate court decision finds that the 1982 legislation that transferred responsibility from the state to the counties for providing services to medically indigent adults constitutes a reimbursable mandate, the VLF increase, which supports the realigned health programs, would become inoperative.

If any of these provisions take effect, the affected statute would become inoperative within 30 to 90 days, depending on the provision.

IMPACT OF THE REALIGNMENT

The realignment legislation encompasses a number of policy changes that were intended to achieve various programmatic and fiscal reforms. The legislation’s major fiscal and policy features are summarized in Figure 3.

In this section, we review the specific policy changes in health, mental health, and social services programs and the potential programmatic effects of the legislation's revenue and transfer provisions. In addition, we discuss the short- and long-term implications of the legislation's fiscal provisions on state and county governments. Our review is based in part on our field visits to 10 counties and discussions with staff in several other counties.

Policy Changes to Expand County Flexibility and Service Coordination

Indigent and Public Health. For the indigent and public health programs, the legislation makes limited programmatic changes. The AB 8 program originally was established by Ch 282/79 (Leroy Greene) to provide block grants to counties for funding inpatient and outpatient services and public health programs. This legislation was one part of the state's response to the passage of Proposition 13. Previously, these services had been funded at the county level. Thus, the state's oversight and policy direction has historically been limited.

Under the realignment legislation, both the AB 8 and MISP statutes were eliminated, allowing counties to use funding previously allocated for these programs for indigent and public health generally. The near-term effect of this change is not as dramatic as it may appear, for the following reasons:

- Counties that wish to receive Proposition 99 funds must continue to maintain specified expenditure and service levels, or "maintenance of effort." (We discuss this issue in more detail below.)
- Counties had previously been able to use AB 8 funds for either public or indigent health purposes. Furthermore, based on our field visits, it does not appear that counties will use MISP funds (which were previously restricted to indigent health services) for public health to any significant degree in the near term. However, this could change in future years.

For the CMSP, specific statutes defining the program were retained and/or modified; and the state continues to have fiscal responsibility for the program's costs, to the extent these costs exceed limits specified in the legislation. (These dollar limits are based on the projected revenue growth for the CMSP counties.) Accordingly, the state continues to have funding responsibility to meet increases in the need for indigent health services in smaller counties. (We discuss CMSP costs further in our *Analysis of the 1992-93 Budget Bill*, Department of Health Services, Item 4260.)

Figure 3

Major Fiscal and Policy Changes in the 1991-92 Realignment

Reflects a “System-Building” Approach

- Establishes incentives for programmatic coordination among 16 health and welfare programs by (1) authorizing funding transfers across programs and (2) changes in cost-sharing ratios for some programs.
- Establishes incentives for innovation by (1) authorizing funding transfers across programs and (2) providing a fixed amount for realigned entitlement programs.

Establishes Mechanisms for Cost Control in Major Entitlement Programs

- Increases county share of costs for California Children’s Services (CCS), AFDC-Foster Care, Child Welfare Services, In-Home Supportive Services (IHSS), and other social services entitlement programs.
- Establishes new county administration funding structure for CCS that provides incentives for case management and cost control.

Provides Greater Flexibility to Counties

- Gives counties authority to make resource-allocation decisions in mental health by determining state hospital and IMD usage.
- Authorizes funding transfers across programs.
- Authorizes counties to reduce IHSS expenditures through 1993-94.

Emphasizes Performance-Based Oversight

- Directs the DMH to develop “outcome measures” and requires “performance-based contracts” for local mental health programs.
- Establishes data task force to recommend future reporting requirements for both health and mental health programs.

Contributes to Addressing State’s Budget Gap

- Provides \$2 billion in revenues for existing health and welfare programs.
- Establishes two fiscal incentives to reduce long-term growth in entitlement program expenditures:
 - (1) Increases county share of costs for entitlement services.
 - (2) Provides incentives for case management in CCS.

Mental Health. For mental health programs, the legislation made a number of major policy changes. First, the legislation provided counties additional flexibility regarding the use of funds that support services for county patients. These include services provided through the state hospitals, IMDs, and community-based programs. The legislation authorizes counties, beginning in 1992-93, to increase or decrease their use of state hospital beds by up to 10 percent annually. In addition, the legislation authorizes counties to use funds previously budgeted for the purchase of IMD services for any mental health purpose, again beginning in 1992-93.

These changes provide counties with the authority to make resource allocation decisions regarding mental health services based on counties' assessments of programmatic effectiveness. Previously, counties were required to use state hospital and IMD services whether or not they considered these services to be more valuable than community-based alternatives.

Finally, the legislation expressed intent that the most seriously mentally ill be given priority for receiving mental health services provided by counties. Under prior law, the legislative mandate was quite broad and could be interpreted to cover less seriously ill persons.

Changes in State Administration

The legislation also made changes in the responsibilities of the state Department of Mental Health (DMH) and, to a much lesser extent, the Department of Health Services (DHS). We discuss these changes below.

Department of Mental Health. Under the legislation, the department is charged with the development (in collaboration with counties and others) of performance outcome measures and with integrating those measures into its current data system. The legislation directs the department to negotiate performance-based contracts with counties in future years on the basis of these outcome measures.

The DMH also continues to have responsibility to:

- Review county expenditure plans (though in less detail).
 - Provide technical assistance to counties.
 - Ensure compliance with federal ADAMH and Medicaid requirements.
 - Manage the state hospital system, which serves county and judicially committed clients and clients of the Departments of Corrections and the Youth Authority.
-

- Administer additional programs, including the Conditional Release Program, local assistance for services to special education pupils, the Primary Intervention Program, and pilot projects for coordinated service delivery for children and adults (more commonly known as the AB 377 and AB 3777 programs, respectively).

In other areas, the department's responsibility for oversight of county programs generally is limited to aspects that involve compliance with federal law.

It is difficult to assess the ultimate effect of these changes on the DMH's role in the state's mental health system. However, the legislation clearly continues a state/county partnership regarding mental health programs and, as a result of the provisions regarding outcome measures and performance-based contracts, may potentially result in oversight of local mental health programs similar to that for the existing AB 377 and AB 3777 pilot programs. In these pilot programs, the department's responsibility is to monitor counties' successes in achieving specified outcomes for clients receiving mental health services (such as the extent to which state hospital and AFDC-Foster Care group home placements for children are avoided). The realignment legislation does not, however, authorize the department to implement specific sanctions if county performance falls short of the specified performance objectives.

Department of Health Services. With certain minor exceptions, the realignment legislation did not explicitly change the department's responsibilities regarding oversight of public and indigent health programs. The department, however, has consolidated its public and indigent health units and eliminated several monitoring and technical assistance positions as part of its allocation of various budget reductions, stating that these changes are "due to realignment." The DHS realignment-related workload will depend in large part on its eventual data monitoring duties, which are one subject of the Health and Welfare Agency data task force meetings we discuss later. (Also, please see the *Analysis of the 1992-93 Budget Bill*, Item 4260.)

The realignment legislation increased DHS responsibilities related to the administration of the CCS Program. This is because the legislation requires the department to (1) implement and maintain oversight over a new county administration system (which we discuss below) and (2) develop program changes that would expand eligibility or benefits through consultation with the counties.

Policy Changes to Facilitate Cost Control

AFDC-Foster Care. The Legislature increased county cost-sharing ratios for AFDC-Foster Care to provide an incentive to contain rapid expenditure growth in the program, and in recognition of the link between the program and children's mental health services. The Legislature sought to avoid placements of seriously emotionally disturbed children in AFDC-Foster Care group homes who could be more appropriately served through community mental health programs. Without a change in the AFDC-Foster Care county sharing ratio, counties' own costs for foster care group home placements would in many cases have been significantly less than the costs counties would incur to provide services through their mental health programs, even though the total costs (state and local) for group home placements frequently would have been higher.

AFDC-Family Group and Unemployed Persons (FG&U) Program. The legislation reduced county costs for the AFDC-FG&U Program in recognition of the fact that the ability of counties to control expenditures in this program is limited because the program's costs generally are driven by changes in the state's economy and population.

Accordingly, through increased sharing ratios for AFDC-Foster Care, the legislation gives counties a relatively higher fiscal stake in the cost of services that they may be able to control and, with regard to AFDC-FG&U, attempts to reduce their costs for services that are largely driven by forces beyond their control.

California Children's Services. The legislation establishes a new system for funding CCS county administrative costs beginning in 1992-93 that is designed to provide incentives for reducing program costs through (1) improved case management and (2) improved collections of federal and third-party payor funds. The previous system effectively *discouraged* such activities. This new system, in combination with increased county cost-sharing ratios, provides incentives for containing expenditure growth in the program.

In-Home Supportive Services. The legislation changed the entitlement nature of the IHSS Program by limiting costs to the Budget Act appropriation and authorizing counties to reduce IHSS services through 1993-94. The legislation also significantly increased the county share of costs for IHSS services. While the primary effect of these changes will be service reductions, they may also provide a strong incentive for counties to provide IHSS services more efficiently.

Revenue and Transfer Provisions

The legislation establishes a number of requirements on counties regarding the use of funds deposited into the Local Revenue Fund, including that they may only be used for the activities provided under the various indigent and public health, mental health, juvenile justice, and caseload-driven social services programs that were the subject of realignment. Accordingly, the realignment ultimately enacted did not give counties discretion to use these additional revenues for any local purpose, nor did it make the programs encompassed in the legislation discretionary.

The legislation established three separate accounts for program funding and established limits on transfers, to ensure that (1) entitlement program cost increases would not result in cuts to health and mental health programs beyond the specified transfer percentages in any given year, (2) state and federal maintenance-of-effort provisions for health and mental health programs could be tracked to ensure compliance, and (3) some level of service for each of the program areas would be provided in every county.

Finally, the Legislature sought to provide counties with a fiscal incentive to manage costs in entitlement programs. The legislation does so by establishing a defined revenue source to fund the counties' share of entitlement costs, and by effectively requiring either (1) transfers of funding from health and mental health programs or (2) additional county expenditures, if costs in the entitlement programs exceed the amount of revenues allocated to fund them.

Implications for the State's Budget Gap

The realignment legislation was a major component of the solution to the \$14 billion budget funding gap the state faced in 1991-92. Of the approximately \$7 billion in additional tax revenue increases enacted as part of the state's spending plan for the year, approximately \$2 billion was for additional revenues to support the programs encompassed in the realignment legislation. In the shorter term, this increase, dedicated to offset the county's additional share of realigned program costs, was the primary contribution of the legislation in addressing the 1991-92 funding gap.

In the longer term, however, the legislation's cost-sharing ratio changes could have an additional effect on addressing the state's underlying structural funding gap. First, to the extent that service costs in the realigned programs continue to grow at a rate in excess of the state's revenue growth, a significantly higher

portion of these costs will be absorbed by the counties. Second, the ratio changes may result in improved efficiencies and greater effectiveness in delivering and managing entitlement program services. As discussed above, the provisions that may have this “behavioral” effect include:

- Strong fiscal incentives to better coordinate service delivery for individuals whose need for more expensive entitlement services (such as AFDC-Foster Care) may be reduced through other services included in the legislation (such as community mental health). For many counties, such “targeting” will be critical.
- Strong fiscal incentives for counties to engage in case management and be innovative in structuring their programs, potentially reducing long-term costs for both the state and the counties.

Thus, as a result of county sharing ratio changes, the realignment legislation could result in a more significant contribution to closing the state’s budget gap than would have been achieved through a tax increase alone.

Fiscal Impact on Counties: Fund Condition

As we discussed earlier, the VLF and sales tax increases were projected to raise approximately \$2.2 billion in additional revenues, which would fully offset anticipated county costs under realignment for 1991-92. Due to the lingering recession, however, counties face a major shortfall in the current year:

- **Revenues.** Actual revenue collections to date have been significantly less than the administration’s original projections. The administration currently anticipates revenue collections of \$2,062 million in the current year, or about \$150 million (7 percent) less than the amount originally estimated.
 - **Expenditures.** The administration’s latest estimates of county expenditure requirements for entitlement programs during the current year, however, have decreased only slightly, by \$18 million (or 1 percent).
 - **Shortfall.** We estimate that the resulting shortfall for counties in 1991-92 is slightly over \$130 million. (Note, however, that the administration’s expenditure estimate assumes a March 1 enactment of the Governor’s welfare reform initiative. If the initiative’s proposed AFDC cost reductions are not implemented or are implemented later in the year, the county shortfall would increase slightly.)
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For 1992-93, the budget projects that total realignment revenues will increase by \$274 million (or 13 percent) to a total of \$2.3 billion, which would fully restore the originally anticipated current-year funding level and provide \$114 million to fund the legislation's growth allocation provisions. However, given current estimates of economic recovery, these estimates appear to be somewhat optimistic.

Whatever the ultimate growth in realignment revenues, we estimate the counties will need to spend an additional \$200 million in 1992-93 simply to offset current-year reductions due to the revenue shortfall and fund their share of projected caseload and state hospital rate increases for 1992-93. Thus, counties will have, to the extent the administration's revenue forecast proves accurate, up to \$74 million in additional funds during 1992-93 to make "discretionary" cost adjustments, such as for indigent and mental health services.

Current-Year Implications for Counties. For the counties, a shortfall of the magnitude estimated for the current year (\$130 million) has serious implications: the need for most counties to make up the shortfall through use of their general purpose revenues and service reductions.

The realignment legislation provided counties with various options for dealing with shortfalls. Under the legislation, counties may:

- Transfer up to 10 percent of funding from the health or mental health accounts that could be used to offset entitlement caseload costs.
- If necessary, transfer sales tax revenue growth allocated to other programs to fund caseload costs.
- If necessary, transfer up to an additional 10 percent of funding from health programs to fund caseload costs.
- Reduce IHSS expenditures.
- Reduce indigent health, public health, and mental health expenditures.

However, a Proposition 99 maintenance-of-effort requirement significantly constrains county options. Proposition 99, passed by voters in 1988, established a surtax on cigarettes and tobacco products and specified that the surtax funds "shall be used to supplement existing levels of service" for indigent and mental health programs, "and not to fund existing levels of service" based on 1988-89 expenditure amounts.

Chapter 1170, Statutes of 1991 (SB 99, Watson), defined “existing levels of service” for these programs to be the amount each county was *projected to receive* from the realignment revenue sources. Although Chapter 1170 adjusts these amounts for future revenue *increases*, it did not adjust required health expenditures in the event of a revenue *shortfall*. Thus, the maintenance-of-effort level required by Chapter 1170 effectively requires counties to make up the full amount of the current-year shortfall in the health account (projected at \$70 million) from their general purpose revenues if they wish to continue receiving Proposition 99 funds. The major Proposition 99 funds at stake are \$215 million in 1991-92 for the larger counties for the California Healthcare for Indigents Program.

For the remaining \$60 million current-year shortfall in the Local Revenue Fund, counties must either (1) “backfill” from their general purpose revenues to maintain services or (2) implement service reductions in health, community mental health, and IHSS programs. During our county visits, almost all the counties mentioned that they plan to transfer funds from the health account to the social services account for caseload costs, if necessary. It was unclear, however, how many of the counties would actually choose to make such transfers given the Proposition 99 implications discussed above. Thus, it is too soon to tell what changes in indigent and public health services might occur as a result.

In the long run, however, a number of the smaller counties we visited indicated that they might choose to forego Proposition 99 funds in order to gain additional flexibility to transfer their health account funds to social services programs.

IMPLEMENTATION: LEGISLATIVE OVERSIGHT ISSUES FOR 1991-92 AND 1992-93

The realignment legislation established a number of implementation steps, reporting requirements, and evaluations of programmatic impacts that will occur in 1991-92 and in subsequent years. The more significant implementation steps and reporting requirements are summarized in Figure 4, and the evaluation requirements are shown in Figure 5.

In this section, we review issues related to these implementation steps that are of particular importance from a legislative oversight perspective. Specifically, we discuss (1) future data reporting requirements, (2) alternatives to the proposed IHSS “A through E” cuts, (3) county authority over state hospitals and IMDs, and (4) the status of the legislation’s “poison pill” provisions.

Figure 4

**What Happens Next?
Implementation Steps and Reporting
Requirements Through 1992-93**

Date	Responsible Organization	Implementation Step or Reporting Requirement
(January 10, 1992)	Department of Mental Health	Report on realignment legislation's impact on departmental responsibilities and duties
(January 15, 1992)	Department of the Youth Authority Task Force	Present recommendations for improving coordination of, and achieving savings in, services for youthful offenders
(January 31, 1992)	Health and Welfare Agency IHSS Task Force	Recommend alternatives to targeted IHSS Program reductions ("A through E cuts") in case of funding deficiency
April 1, 1992	Health and Welfare Agency Data Task Force	Recommend county data reporting requirements for all programs subject to realignment
July 1, 1992	Department of Health Services	Implement revised state/county funding match system for California Children's Services Program county administration
July 1, 1992	Department of Mental Health	Develop plan for statewide data system to include performance outcome measures for mental health services
July 1, 1992 and annually thereafter	County Departments of Mental Health	Assume responsibility for management and reimbursement of Institutions for Mental Diseases, and implement negotiated contracts for state hospital services
April 1, 1993	Department of Health Services and Local Health Officers	Present review of all public health statutes and recommend appropriate changes

Figure 5

**What Happens Next?
Realignment Evaluation Requirements**

Date	Responsible Organization	Requirement
Health		
February 1992	Legislative Analyst	Report on realignment legislation's impact on California Children's Services Program
May 15, 1992; April 1, 1993; and April 1994	Legislative Analyst	Present report summarizing county health service plans and site visits
April 15, 1992 and annually thereafter	Department of Health Services	Report on county health services, including fiscal and programmatic impact of realignment
Mental Health		
March 15, 1992	Organization of Mental Health Advisory Boards	Report on realignment's impact on local mental health programs and recommend future role and structure of advisory boards
January 15, 1993	California Council on Mental Health	Report on impact of realignment on local mental health services, and review budgets of various departments providing mental health and related services
All Programs		
April 1, 1992	Health and Welfare Agency Data Task Force	Recommend plan for evaluation of realignment legislation and identify necessary county data reporting requirements
June 30, 1992	Legislative Analyst Auditor General	Present plan for evaluation of various issues, including the programmatic impact of realignment

County Data Reporting Requirements

Prior to the 1991-92 realignment, counties were subject to a number of data reporting requirements to assist the state in its oversight of county mental health, indigent health, and public health programs. The realignment legislation generally continued these requirements for 1991-92, and directed the Health and Welfare Agency to convene a task force of administration, county, advocacy group, and legislative staff representatives to identify reporting requirements that should be retained or modified, and those which should be repealed.

In addition, the Legislature expressed its intent that (1) the state implement a data system for mental health programs that will measure performance outcomes and (2) any new requirements, such as those which would focus on performance outcomes, should not result in increased county costs as compared to current law. Thus, modifications to, or repeal of, existing requirements will be necessary if both goals are to be realized. The task force is due to report its findings to the Legislature in April, and the Department of Mental Health (DMH) is to present a plan for incorporating performance outcome measures into its data system in July. (Because the legislation generally made only cost-sharing ratio changes for social services programs, related data reporting requirements were not addressed in the legislation.)

State/County Responsibilities. In our view, decisions regarding the types of data counties will be required to collect and provide to the state reflect the inherent tensions of programs administered through a state/county partnership, such as the desire for both state oversight and local flexibility. We believe the Legislature's actions regarding data requirements are important because they (1) affect both the focus and the scope of the state's oversight capacity and (2) will structure policy debates for years to come. The Legislature may elect to make changes in any of the programs encompassed in the legislation. Below, we discuss the two program areas — health and mental health — that are the specific charge of the Health and Welfare Agency task force.

Mental Health. Many of the existing data requirements for mental health programs are linked to federal conditions for participation in the Short-Doyle/Medi-Cal Program. Accordingly, if the Legislature continues to believe that both a performance-driven data collection system and the principle of no additional reporting costs are important, it will have few options and may find that the two goals are mutually exclusive.

However, it is also important to note that federal requirements for data reporting are fairly broad. Thus, from our

perspective, one option for the state to implement a performance-driven data system without imposing additional costs on counties is to identify opportunities to revise existing data collection and reporting procedures that are linked to federal requirements so that federal objectives can be met more simply and less expensively. To do so will, in many cases, require federal approval through the state plan review process. (Note, however, that it is difficult to determine the degree of flexibility the state actually has in revising federally related reporting requirements without actually seeking approval to implement changes.)

To assist the Legislature in determining whether the task force recommendations take full advantage of whatever flexibility the state may have to modify procedures for federally linked data requirements, we have suggested in task force meetings that the task force include in its findings a review of reporting requirements in other states. We believe this review should focus on areas where (1) other states have developed satisfactory data procedures from a federal perspective and (2) modifications to California's procedures along similar lines would result in reduced state and county costs for data collection and reporting. Even significant changes in existing requirements, however, may not be sufficient to offset the cost of establishing a performance-driven system. Accordingly, it is possible that the Legislature will face a choice between its two objectives.

Indigent and Public Health. Generally, the Legislature has greater freedom to restructure indigent and public health data requirements, with the exception of certain federally mandated disease monitoring. Our review indicates that some data — particularly in the indigent health area — could be collected and monitored in a more efficient manner. We also believe, however, that it will be important for the Legislature to maintain the state's ability to monitor trends in county expenditure and service delivery decisions for public and indigent health. In particular, we believe the state needs to continue its ability to ensure an adequate degree of public health activities and services which may have significant long-term fiscal and health consequences if they are not maintained. As an example, if counties fail to ensure adequate immunizations, measles or other epidemics could occur.

The IHSS “A through E” Program Reductions

The realignment legislation authorized a departure from the IHSS Program's entitlement status and specified the manner in which potential service level reductions can be made.

Background. The IHSS Program provides assistance to eligible aged, blind, and disabled persons who are unable to

remain safely in their homes without assistance. While this implies that the program prevents institutionalization (such as in nursing facilities), eligibility for the program is not based on the individual's risk of institutionalization. Instead, an individual is eligible for IHSS if he or she lives in his or her own home — or is capable of safely doing so — if IHSS is provided, and meets specific criteria related to eligibility for the Supplemental Security Income/State Supplementary Program (SSI/SSP) for the aged, blind, and disabled.

The types of services available through the IHSS Program are domestic and related services, such as meal preparation and cleanup; nonmedical personal services, such as bathing and dressing; essential transportation; protective supervision, such as observing the recipient's behavior to safeguard against injury; and paramedical services, which are performed under the direction of a licensed health care professional and are necessary to maintain the recipient's health.

The Governor's Budget proposes \$744 million (\$150 million General Fund, \$338 million federal funds, and \$256 million county funds) for the IHSS Program in 1992-93. According to the Department of Social Services (DSS), the proposed expenditures for the IHSS Program are \$82 million (\$47 million General Fund and \$36 million county funds) *less than* the amount needed to fully fund the projected increases in caseload and the average number of service hours per case.

The realignment legislation limits the state's share of IHSS costs to the annual Budget Act appropriations in 1992-93 and 1993-94. The measure also permits counties to reduce services (on the basis of an assessment of each recipient) to stay within their annual IHSS budget allocations in these years. The act further provides that any such reductions must be made according to the following priorities (known as the "A through E" program reductions):

- A. Reduce the frequency of nonessential (that is, domestic and related) services.
 - B. Eliminate these services.
 - C. Terminate or deny eligibility to individuals requiring only domestic services.
 - D. Terminate or deny eligibility to persons who would not require institutionalization in the absence of services.
 - E. Reduce, on a per capita basis, the cost of services authorized.
-

If the Legislature approves the budget-year funding reflected in the Governor's Budget, counties will be required to either (1) make significant service reductions in the program according to the "A through E" criteria or (2) transfer funds from their realignment revenues (health or mental health subaccounts) or from their general purpose funds to maintain the IHSS Program.

The realignment legislation also established a task force to recommend IHSS program efficiencies and improvements. The task force explored alternatives to the "A through E" criteria for implementing service reductions, and recently submitted a required report to the Legislature.

In the report, the task force concludes that the "A through E" program reductions are not a practical option because (1) to implement service level reductions would require a case-by-case review of current IHSS recipients and (2) such a review would be administratively difficult and expensive. As an alternative, the task force recommends replacing the "A through E" program reductions with unallocated (across-the-board) reductions.

Comments. We believe that the Legislature should reevaluate the task force's conclusion to determine whether specific groups or services should in fact be targeted in order to reduce program costs. For instance, targeted reductions would be preferable to unallocated across-the-board reductions to the extent that they resulted in fewer institutionalizations of program recipients.

This is because long-term care services (typically Medi-Cal nursing facility services) can be significantly more expensive than those provided through the IHSS Program. Counties, however, do not currently have a fiscal stake in the funding of long-term care services, as these costs are covered entirely by state and federal funds. A strategy that targets IHSS reductions to avoid, wherever possible, the placement of recipients in nursing facilities could improve the quality of life for those patients and prevent cost shifts from the IHSS Program to the Medi-Cal long-term care program. We note, in this respect, that the "A through E" priorities, although they may be administratively burdensome, are structured to avoid institutionalization.

In order to assist the Legislature in considering the proposed service level reductions, we identify several options to control program costs in our companion document to this publication, the *Analysis of the 1992-93 Budget Bill* (Item 5180).

State Hospitals and IMDs

As noted above, realignment provides county departments of mental health with significant additional flexibility regarding

their use of state hospitals and IMDs beginning in 1992-93. Under the legislation, counties are specifically authorized to determine both the number of state hospital bed-days they wish to purchase, and the types of units (acute, subacute, etc.) in which their patients are to be placed.^c Counties are required to reimburse the state for these services according to rates set by the department. Under the legislation, the department and the counties may negotiate other issues related to state hospital services, including procedures for admissions and discharges, pooled beds for a group of counties, potentially collaborative agreements for a unique type of treatment program (such as one featuring an expanded emphasis on vocational rehabilitation), or the number of treatment hours to be provided to patients.

Comment. We believe these features of the realignment legislation have the potential to improve services for patients and provide counties with the opportunity to determine an effective and efficient allocation of treatment resources for their patients. To ensure that the Legislature's intent in enacting these provisions is realized, we also believe it will be important for the Legislature to review the department's performance in negotiating the contracts to ensure responsiveness to the needs of counties, particularly regarding the types of treatment services the counties believe their patients require.

Related Issues

In addition to the implementation steps and reporting requirements discussed above, there are additional issues that, in general, are the subject of proposals in the Governor's Budget and that have implications for realignment. Please see the *Analysis of the 1992-93 Budget Bill* for a discussion of the following issues:

- Public and indigent health budget for the Department of Health Services (DHS) and the CCS Program (Item 4260).
- Support budget for the DMH (Item 4440).
- Implementation of Child Welfare Services case management data system (Item 5180).
- Department of the Youth Authority report on integrating services to youthful offenders (Item 5460).

Status of "Poison Pills"

As we discussed earlier, the realignment legislation contains several "poison pills," including a provision that would render the

^c The legislation specifies that if county bed-day requests would, on net, reduce the total of number of beds (a) in any given state hospital or (b) statewide by more than 10 percent, the requests are subject to the approval of the department. Counties with a population of less than 125,000 are exempt from this provision.

VLF increase inoperative if an appellate court decision determines that the state must reimburse counties for the cost of providing services to medically indigent adults (MIAs). Currently, there are three lawsuits before the courts that are related to this provision.

First, there are two cases, *County of Los Angeles and County of San Bernardino v. State of California et al.* and *County of San Diego v. State of California et al.*, which seek a mandate claim against the state for the cost of providing care to MIAs pursuant to the 1982 statutes, which transferred the responsibility of providing MIA care from the state to the counties. As of February 1992, the San Diego case was being heard in superior court, which has made an interim ruling indicating that it may ultimately find in favor of the county. The Los Angeles/San Bernardino case is under appeal by the state after a superior court found in favor of the counties. A final appellate court ruling in favor of the counties in either case would trigger the poison pill provision of the realignment legislation.

In addition to these two cases, San Bernardino County recently filed a separate action in an appellate court against the state (*County of San Bernardino v. State of California et al.*) claiming that the realignment legislation's mandate-related poison pill provisions are themselves unconstitutional. San Bernardino notes that under the State Constitution, the counties are entitled to claim reimbursement for the cost of implementing a state mandate. In its brief, the county argues that these poison pill provisions serve as "punitive financial disincentives" that would force the abandonment of the Los Angeles/San Bernardino mandate claim. A decision in favor of the county in this case would not trigger the poison pill provisions of the realignment legislation. Rather, it would invalidate them. (At the time of this analysis, an appellate court had rejected the claim not on its merits but because it must first go to a superior court. Apparently, the claim will be filed shortly in a superior court.)

Of the three cases, the Los Angeles/San Bernardino case alleging a mandate for indigent health services appears closest to resolution, and could conceivably be scheduled for oral arguments before the California Court of Appeals this spring, though requests by either party for postponement could easily delay a resolution of the case beyond the current legislative session. If the case is decided in favor of the counties, the Legislature would be faced with decisions regarding (1) the expiration of the realignment statutes and (2) how to fund a likely General Fund obligation for MIA-related mandate costs in the range of \$3 billion.

ADDITIONAL POLICY ISSUES FOR THE LEGISLATURE

The 1991-92 realignment represents a fundamental change in the state/county partnership. The impact of this legislation presents a number of issues that warrant further consideration by the Legislature. In this section, we discuss issues related to (1) the Local Revenue Fund condition, (2) the issue of varied funding allocations among counties, and (3) the future role of the state in overseeing programs encompassed in the legislation.

Issues Related to the Local Revenue Fund Condition

As a result of the precarious condition of the Local Revenue Fund for 1991-92 and potentially in 1992-93, the Legislature should address three issues: (1) the need for a Local Revenue Fund reserve, (2) the definition of each county's "base" allocation, and (3) county match requirements. We discuss these issues below.

Need for a Reserve. The funding shortfall in the current and budget years is causing numerous problems for counties, raising the issue of whether counties need a reserve for "economic uncertainties" similar to the state's reserve. While counties already have general purpose revenue reserves, realignment transferred a substantial amount of increased expenditure requirements to counties. In addition, the need for services provided through the "realigned" programs generally increases during periods when economic conditions are poor and, therefore, when available revenues are most constrained.

Accordingly, we believe that action by the Legislature to provide counties a reserve for economic uncertainties within the Local Revenue Fund would mitigate the need for both (1) significant reductions in service levels in the realigned programs and (2) demands on county general purpose revenues in future years when realignment revenues may again fall short. Accordingly, we believe a reserve would improve the prospects for the long-term viability of realignment.

One approach to establishing a reserve would be to earmark a share of realignment revenue growth over a period of several years, to build a reserve of some level, potentially in the range of \$100 million (or 5 percent of revenues). Were a reserve of this level available during 1991-92, the need for counties to make significant service reductions in the realigned programs and to backfill from their general purpose revenues would be greatly reduced. Under any approach, the Legislature could specify that access to the reserve would be dependent on a specific level of weakness in the performance of realignment revenues.

Definition of County “Base” Allocations. The legislation establishes each county’s share of the amount of revenues collected in the current year as the county’s “base” allocation. All revenue in excess of this amount will be allocated in 1992-93 according to the legislation’s growth allocation provisions. Given the current-year shortfall, however, some counties have expressed concern that the existing base definition is defined according to actual collections during the current year, rather than the amounts that were *anticipated* (which more closely relate to each county’s anticipated additional costs under the legislation). They note that as a result of this definition and the legislation’s growth allocation provisions, a significant share of the 1992-93 revenue increase will be allocated only to certain counties (those whose share of resources is less than their relative need) before all counties have received at least the amounts necessary to cover their current-year costs.

As with the “equity” issue we discuss shortly, this issue presents the Legislature with a choice between (1) providing funding stability for all counties or (2) equalizing individual county shares of total resources relative to each county’s need.

County Match Requirements for Health Programs. As a condition for receiving funding under realignment, counties must provide a match according to a schedule specified in the legislation. This requirement continues the approach of prior law, which required counties to provide some amount of locally generated revenues to support health and mental health programs. This amount was defined according to a percentage of state funding provided. For example, counties generally were required to spend on local mental health programs an amount equal to 10 percent of the state funding they received.

In the realignment legislation, the match amounts for health programs were specified in *dollar* terms, based on June 1991 Department of Finance estimates of anticipated sales tax and VLF revenue collections. More recent estimates indicate that total revenues for both the sales tax and VLF for 1991-92 are expected to fall substantially below those projections. Because the legislation specifies the matching requirements as a fixed dollar amount, rather than as a percentage of actual revenue collections, counties are required to spend in the current year an amount that is significantly higher than their share would have been under prior law.

Because the current-year shortfall was not anticipated, the dollar amounts that define health program matching requirements under the legislation may not reflect the Legislature’s intent. If the Legislature wishes to continue the approach of prior law (which determined county expenditure obligations for *both*

health and mental health programs based on the amount of funding provided by the state), it would need to amend the realignment legislation to specify matching requirements for health programs in percentage terms. The Legislature may also need to establish a “floor” for the matching requirements to ensure compliance with Proposition 99.

Issues Related to “Equity”

Prior to the enactment of realignment, “equity” in funding health and mental health allocations was generally defined as the point at which each county’s share of funds equaled the share they would have received according to their population and the degree of poverty in their county. Progress toward equity prior to realignment was limited by constraints on available funding for the programs. Accordingly, the realignment legislation continues this approach by (1) allocating a portion of growth in Local Revenue Fund revenues above the amount collected in 1991-92 to those counties whose 1991-92 share of funding is “under-equity” and (2) ensuring that no county’s allocation will be reduced below the amount of revenues collected in 1991-92.

Based on the administration’s revenue projections for 1992-93, it appears that approximately \$54 million, or about 35 percent, of the anticipated growth in revenues will be used for equity purposes for both mental health and the AB 8 programs. Due to the extremely wide variation in actual funding allocations as compared to the amount counties would receive according to the equity definition, this amount will not result in significant change. Over the longer term, the realignment legislation’s current formulas are unlikely to result in equity within the next several decades.

To illustrate this point, achieving equity for mental health programs alone would require roughly \$800 million (or at least 50 times the amount of funding that is earmarked for distribution according to the equity formula) to raise all counties to the funding level of the county with the highest allocation according to the equity definition. Equity could be achieved more quickly if the “benchmark” were less than the amount allocated to the highest county. This approach, however, would require a reallocation of base allocations among the counties, which is not provided for in the realignment legislation.

The equity issue presents the Legislature with a trade-off. The Legislature’s choice is to (1) make more rapid progress toward equity by reallocating base funding levels in mental health and health programs or (2) provide stability in funding for

individual counties, with equity adjustments occurring slowly over a period of many, many years.

Future Role of the State

Although the realignment legislation “transferred” authority for implementing indigent health, public health, and mental health programs to counties, it continued a significant oversight and administrative role for the DHS and DMH. (Because the legislation’s effect on social services programs generally was confined to changes in county cost-sharing ratios, the legislation did not significantly affect the role of the Department of Social Services.)

The Legislature will consider three reports this spring that will have major implications for the future role of the DMH and DHS. These reports are:

- The plan completed in October 1991 by the AB 904 Task Force regarding the governance and structure of California’s mental health system.
- The Health and Welfare Data Task Force report (due this April).
- A report by the DMH regarding the impact of realignment on its responsibilities and workload (currently in draft form).

As the Legislature considers various requests for changes, including those which will be proposed in these reports, we believe the principles we presented in response to the administration’s original realignment proposal in January 1991 continue to provide a useful framework for the Legislature’s deliberations regarding the future role of the counties and the state and, more specifically, of these two departments. Among these earlier principles are the following:

- ***Make it Clear.*** The Legislature should ensure that its emphasis on clear system goals and specific target populations is maintained.
 - ***Ensure Accountability.*** The realignment legislation places greater responsibility for resource allocation decisions with the counties in both the health and mental health areas, but continues certain state responsibilities. The state can play an important role in ensuring program effectiveness by holding counties accountable for results. For instance, strengthening the role of the DMH and DHS by giving them the authority to contract with regional service providers or other organizations when counties do not achieve performance outcomes would help ensure
-

accountability for results while preserving opportunities for local innovation and flexibility.

- ***Allow Flexibility.*** The realignment legislation removed many barriers to innovation and efficiency, particularly in the mental health and social services areas. For example, the legislation allows counties to “buy” more community mental health services and fewer state hospital services if they wish. We believe the Legislature should ensure that future proposals do not dilute this approach of focusing on outcomes rather than on prescriptions for specific methods of service delivery.
- ***Expect People to Work Together.*** The realignment legislation does not generally require formal interagency collaboration between state departments or within counties. However, due to the fiscal interactions between the three program accounts and the state’s continued role in expanding the AB 377 and AB 3777 pilot projects in mental health (which require formal interagency agreements), we believe the legislation made significant progress at the county level in this area. We believe that the Legislature should continue to identify opportunities where interagency collaborations at the state and county level might be strengthened, consistent with the state’s fiscal stake in improved programmatic outcomes.
- ***Get Results.*** Again, the focus on outcome measures, their eventual integration into the existing data system, and the implementation of performance-based contracts are, from our perspective, among the more significant reforms that were included in the 1991-92 realignment. We believe the Legislature should, in its oversight capacity, ensure that implementation of these management approaches continue.

The realignment legislation continues some measure of shared responsibility for the effectiveness of all programs encompassed within it. As the Legislature reviews the administration’s implementation of the legislation and makes decisions regarding those issues which will come before it this spring and in later years, it will continue to face the inherent tensions of implementing programs through a state/county partnership. From our perspective, the bottom line is that the state must strike a balance between maintaining enough state-level accountability and oversight to ensure that its key programmatic objectives are achieved, without stifling innovation at the local level.

EXPANDING THE CONCEPT

We believe that some of the policy changes reflected in the 1991-92 realignment collectively provide a blueprint for restructuring state health programs, social services programs, and potentially those in other areas. We believe the Legislature should consider extending some of the concepts that underlie this legislation to other program areas, with an eye toward opportunities to more effectively and efficiently deliver services. The key features of the legislation that could be applied in other programs are shown in Figure 6.

We believe the Legislature could productively apply these principles to achieve meaningful long-term policy reform and potentially significant expenditure reductions for services that are currently provided to many groups, including the following:

- Families who require a number of health, education, and welfare services in order to reduce their dependence on long-term state assistance (“multi-problem families”).
- Correctional institution parolees.
- Probationary youths.

Figure 6

Realignment Features That Provide a Blueprint for Health and Welfare Reform



The establishment of clearly defined target populations.

The use of mechanisms to facilitate coordinated service delivery.

The creation of fiscal incentives that (1) match program objectives and (2) assist the state in achieving cost containment for the most expensive services.

The development of management and oversight that is driven by performance outcomes, rather than through regulatory detail.



- Substance abusers.
- Pregnant teens and teenage parents.
- Persons at risk of placement in long-term care facilities.
- High school drop-outs.

Given the need for further responses to the state's structural budget gap, we recommend that the Legislature draw on the elements of the 1991-92 legislation identified in Figure 6 to reform services that are provided to these and other appropriate groups.

CONCLUSION

In this review, we have described the major features of the 1991-92 realignment, presented some of the more significant fiscal and policy implications of the legislation, highlighted major issues that the Legislature will face in this legislative session and in later years, and suggested those features of the 1991-92 realignment which could be productively applied to other program areas. We summarize our principal findings and recommendations in Figure 7.

In our view, the realignment legislation demonstrates the potential for achieving fiscal solutions that enhance the Legislature's policy objectives. It does so by combining program restructuring with budget balancing measures. While the major fiscal impact of the legislation in the near term was to provide new revenues dedicated for health, mental health, and social services programs, the legislation may, in the long run, succeed in bringing down the *rate* of expenditure growth in a major policy area of the state's budget. Thus, some elements of the legislation may provide a road map for the Legislature as it attempts to navigate the fiscal challenges of 1992-93.

Figure 7

**The 1991-92 Realignment:
Summary of Findings and Recommendations**

Legislation Reflects a “System-Building” Approach

- Recognizes programmatic links between 16 health and welfare programs.
- Provides programmatic and funding flexibility.
- Establishes incentives for innovation.

Calls for Performance-Based Oversight

- Places resource allocation decisions at local level for mental health and health programs.
- Scales back some regulatory functions of Departments of Health Services and Mental Health.
- Seeks development of performance outcome measures and performance-based contracts for mental health and indigent health programs.

Legislation is Still Evolving

- Legislative oversight of implementation steps is vital to legislation's ultimate success.
- State and federal maintenance-of-effort requirements will determine real funding flexibility.
- Some significant decisions have yet to occur, such as which data reporting requirements will be continued.

Key Actions for the Legislature

- Providing greater financial stability, such as through a reserve, would strengthen the long-term viability of realignment.
- Expanding requirements for formal interagency collaboration at the state and local levels could enhance effectiveness.

Some Elements of the Legislation Provide a Blueprint for 1992-93

- Uses program restructuring to achieve fiscal benefits, including a greater fiscal stake at the service delivery level.
- Includes major *policy changes* (especially in mental health area) that improve local flexibility and may result in more efficient service delivery.

California's Child Support Enforcement Program ^a

How Can the Program Be Made More Cost-Effective?

The child support enforcement program has as its primary purpose the collection of child support payments for custodial parents. In California, the program is administered by county district attorneys, under the general supervision of the state.

Collections made on behalf of persons receiving AFDC offset a portion of the public costs of the AFDC grants. As a result, the program provides a significant savings — an estimated \$106 million in 1991-92 — to the state through the reductions in AFDC grant expenditures.

Because of the manner in which the enforcement program is administered and funded, counties have a fiscal incentive to hold spending down to relatively low levels, even though increased spending is likely to be cost-beneficial from a statewide perspective. More specifically, we found evidence that marginal increases in spending — particularly in relatively efficient counties — are likely to result in net savings to the state as well as to the state and the counties when viewed as a combined unit.

We conclude, therefore, that the child support enforcement program could be improved by changing the existing set of incentives that affect decision making on program funding. To accomplish this, we present two options for the Legislature. Under the first option, the responsibility for administration and funding of the program would be transferred from the counties to the state. In the second option, the state would provide a state-funded incentive payment to augment program funding, based on each county's efficiency as measured by the ratio of the marginal increase in child support collections to the marginal increase in administrative costs.

^a This analysis was published in January 1992 as a separate paper.

INTRODUCTION

In recent years, child support enforcement has attracted considerable attention at the state and federal levels of government. This is due, in part, to the program's potential for shifting a significant amount of the costs of public assistance provided to custodial parents and their children from the government to the noncustodial parents.

In this report, we describe the child support enforcement program and its funding system, analyze the factors that determine program effectiveness and the fiscal impact of the program on the state and the counties, and conclude with the presentation of two options for improving the performance of the program.

BACKGROUND

All children are legally entitled to support from both parents. Single parents seeking child support may do so through the courts or through private agreements. Federal law requires the states to provide child support enforcement services to anyone requesting these services, regardless of his or her income. In California, the DSS oversees administration of the child support enforcement program, but the state has assigned to the county district attorneys the responsibility for local administration. Child support enforcement services are provided to families receiving public assistance through the AFDC Program and, on request, to non-AFDC families.

The type of services provided will vary with the needs of the family. In some cases, it is necessary to locate an absent parent, establish paternity, establish a court order for support, enforce the order, and collect and distribute payments. In other cases, an order has already been established — perhaps through divorce proceedings — but it may still be necessary to locate the parent and collect the required support. Currently, the county district attorneys in California provide child support enforcement services to about one million custodial parents, including both welfare and nonwelfare cases.

From a fiscal as well as policy perspective, it is important to note that almost all AFDC families have a living absent parent. Only a small percentage of these absent parents, however, are providing child support, and many of those who do so are not current in their payments. This is particularly relevant to the government because collections made by the state on behalf of recipients of AFDC offset the governmental costs of the AFDC grant, less \$50 per month which is distributed directly to the recipient.

Fiscal Components

The child support enforcement program in California has three fiscal components: (1) administrative costs, (2) welfare recoupments, and (3) incentive payments.

Administrative Costs. The vast majority of administrative funds for the program are spent by the counties. They will spend about \$236 million in the current year, with the federal government picking up two-thirds of the costs and the counties almost all of the remainder. (As discussed below, these county costs are, on the whole, offset completely by other savings.) The state also has administrative costs — about \$22 million in 1991-92 — of which the federal government paid about three-fourths and the state one-fourth. (The federal government pays for 66 percent of most costs and 90 percent of certain costs, including development of a statewide automation project.)

Welfare Recoupments. As a result of the counties' enforcement efforts, increased support payments to AFDC families reduce the grant expenditures. These savings are shared by the federal, state, and county governments, according to how the cost of AFDC grant payments are distributed among them — generally 50 percent federal, 47.5 percent state, and 2.5 percent county (in accordance with recent "realignment" changes).

Incentive Payments. Counties receive incentive payments from the state and the federal government designed to encourage them to maximize collections. Generally, these incentive payments are based on each county's child support collections. The federal government allocates to the states an incentive payment based on a percentage of AFDC and non-AFDC collections, with the percentage (usually 6 percent to 6.5 percent for California) varying according to the state's ratio of collections to program costs. In California, the state supplements these funds and distributes the combined federal and state incentive payments to counties based on a specified percentage of total AFDC and non-AFDC collections.

Pursuant to Ch 1647/90 (AB 1033, Wright), the counties will receive up to 11 percent of total collections in 1992-93, increasing annually by 1 percent through 1995-96 (to a 14 percent maximum). The actual amount that counties receive will consist of a minimum "base" rate and an additional percentage depending on their *compliance* with state and federal regulations and *performance* against certain benchmarks. Figure 1 summarizes this revised system for distributing incentive payments.

Figure 1

Combined State and Federal Child Support Program Incentive Payments to Counties^a
1992-93 through 1995-96

(in millions)

Year	Base Rate	Compliance Rate	Performance Rate	Total
1992-93	9%	2%	—	11%
1993-94	8	3	1%	12
1994-95	7	4	2	13
1995-96	6	5	3	14

^a Applied to total child support collections (AFDC and non-AFDC).

Fiscal Impact of Program

Figure 2 summarizes the net fiscal impact of these various components on each level of government in 1991-92. The figure indicates that the impact varies significantly:

State. The state is the big winner (net General Fund savings of \$106 million), as it receives almost half of all welfare recoupments, yet incurs relatively small costs (primarily for incentive payments).

Figure 2

Child Support Enforcement Program
Net Fiscal Impact
1991-92^a

(in thousands)

	General Fund	Federal Funds	County Funds	Total
Program costs				
County administration	\$1,014	\$158,981	\$76,193	\$236,188
State administration	5,257	16,815	—	22,072
Incentive payments	27,022	43,841	-70,913	—
Savings				
Welfare recoupments	-139,506	-143,186	-14,860	-297,552
Net fiscal impact	-\$106,163	\$76,451	-\$9,580	-\$39,292

^a Estimated.

Federal Government. By contrast, the federal government is the big fiscal loser, as it will spend \$76 million more in 1991-92 in program costs than it will receive in the form of grant savings.

Counties. In the aggregate, California counties realize a savings (\$9.6 million) from the program. They will spend about \$76 million of their own money this year on enforcement efforts, yet these costs will be more than offset by incentive payments and recoupments. It is important to note, however, that the net effect of the program can vary significantly by county (as we discuss below).

HOW DOES CALIFORNIA'S CHILD SUPPORT ENFORCEMENT PROGRAM COMPARE WITH OTHER STATES?

A Comparison of Recoupment Rates

One way of assessing California's performance in its child support enforcement program is to compare it with other states. The most comprehensive rating of this kind is published by the Human Resources Subcommittee of the House Ways and Means Committee. In its most recent "Child Support Enforcement Report Card," based on federal fiscal year (FFY) 1989 data, California ranked 48th among the 50 states.

The Ways and Means Committee report relies on a variety of measures to derive its ranking. Some of these measures, and the reliability of the data on which they are based, have been subject to criticism. While much of this criticism is justified, we believe that one of these measures — the AFDC recoupment rate — can, with one significant modification, provide a useful comparison of the states' performance in the AFDC component of their child support programs.

The AFDC recoupment rate is the percentage of a state's total AFDC grants recovered through child support enforcement services on behalf of AFDC recipients. We emphasize this measure because (1) it is a direct measure of the output — collections — of the program, whereas most of the other yardsticks are measures of program inputs, (2) it reflects the direct fiscal savings to government (especially for the state) that are derived from the program, and (3) the data are reliable. (This measure does not, however, measure the *cost-effectiveness* of enforcement efforts. We discuss measures that do later in the piece.)

What Accounts for Superior Performance By Other States?

In FFY 89, the states' recoupment rates ranged from a high of 33.2 percent in Idaho to 3.8 percent in Arizona, with California ranking 48th at 5.9 percent. One problem in comparing the states'

AFDC recoupment rates, as the House Ways and Means Committee report does, is that the basis of the measure — AFDC grant expenditures — is affected by the variation among the states in average grant levels, a factor that is generally independent of the other component of the recoupment measure, child support collections. This places California at a disadvantage in such comparisons because the state's average AFDC grant is second highest in the nation.

In order to compensate for this, we adjusted the states' recoupment rates in FFY 89 to account for the differences in average grants (using California as the reference point). As a result, California's ranking rises to 31st among the 50 states. As Figure 3 shows, California ranked 5th among the 10 largest states in FFY 89, after adjusting for the grant differentials. We note, however, that the adjusted rate of Michigan (the highest-performing state) is still significantly higher than California's — almost twice as much.

Figure 3

**AFDC Recoupment Rates of the 10 Largest States
Actual and Adjusted for AFDC Grant Differentials
Federal Fiscal Year 1989**

	Recoupment Rate	Average Grant/Case	Adjusted Recoupment Rate ^a
Michigan	13.6%	\$482	10.7%
New Jersey	13.9	358	8.1
Pennsylvania	13.2	352	7.6
North Carolina	18.9	238	7.4
California	5.9	611	5.9
New York	6.0	532	5.2
Ohio	9.6	310	4.9
Florida	11.2	249	4.6
Illinois	5.3	317	2.7
Texas	9.4	169	2.6

^a Adjusted for differences in average grant, using California as the reference point.

Trying to account for other states' superior performance is made difficult by (1) our lack of detailed knowledge on the operations of other states and (2) the lack of reliability, for purposes of comparison, of some of the data reported by the states. In an attempt to gain some insight in this area, we reviewed the child support enforcement programs in Wisconsin and Michigan,

two states that have recoupment rates that are almost twice that of California, after adjusting for grant differentials.

With respect to administrative procedures (such as specific enforcement techniques and the level of automation), we cannot point to anything that might have led to the higher recoupment rates reported by Wisconsin and Michigan. As to organizational structure, Wisconsin permits each county to select its administering agency at the local level, but state officials believe that the resulting lack of uniformity is disadvantageous rather than beneficial. Michigan has a more uniform local organizational structure, but divides functional and funding responsibility at the local level along three lines: the state-funded county departments of social services, county-funded prosecuting attorneys, and county-funded "Friends of the Court."

The Friend of the Court in Michigan is a court-appointed employee who works exclusively on child support cases and is empowered to conduct hearings and recommend awards based on the state guideline. Program administrators believe that this helps to expedite the process. In California, court commissioners and referees can perform a similar function, but the use of these personnel for child support cases is not widespread. Currently, three counties — Los Angeles, Orange, and Santa Clara — use at least one commissioner or referee exclusively for child support.

Expenditure data indicate that both Wisconsin and Michigan allocate relatively more resources (in relation to their AFDC cases and expenditures) to the AFDC component of their child support programs than does California. This may be an important factor in explaining the differences in performance. We can hypothesize that the additional resources translate into lower caseloads for local case workers, but caseload data are not sufficiently reliable to verify this. From an organizational standpoint, it is also important to recognize that in Michigan the state has more (although not total) control over funding decisions for administration of the program than does the state in California.

DIFFERENCES IN PERFORMANCE AMONG CALIFORNIA'S COUNTIES

Just as the states differ significantly in their performance, so do California's 58 counties. Figure 4 ranks the counties by their AFDC recoupment rates in 1990-91, after adjusting for differences in their average AFDC grant levels per case. (While maximum AFDC grants are the same statewide for a given family size, counties can have different *average* grant levels due to different average family sizes and income levels.) As the figure shows, the adjusted recoupment rates ranged from 17.7 percent in Napa County to 3.6 percent in Mono and Los Angeles Counties.

Figure 4

**Child Support Enforcement Program
AFDC Recoupment Rates^a
1990-91**

County		County	
Napa	17.7%	Santa Cruz	9.8%
Ventura	15.2	Tehama	9.7
El Dorado	15.1	San Francisco	9.5
Plumas	14.6	Stanislaus	9.4
Inyo	14.5	Marin	9.4
Sierra	14.4	Contra Costa	9.1
Santa Barbara	13.8	San Mateo	8.7
Sonoma	13.7	Orange	8.6
Sutter	13.2	Santa Clara	8.2
San Luis Obispo	13.2	Trinity	8.1
Colusa	13.0	Calaveras	7.9
Merced	12.5	Tulare	7.8
Shasta	12.4	Solano	7.6
Yolo	12.4	Alpine	7.5
Kings	12.4	Kern	7.4
Mariposa	12.3	Lake	7.3
Nevada	12.2	Imperial	7.3
Placer	12.0	Riverside	7.2
Monterey	11.9	Lassen	7.1
Del Norte	11.6	Alameda	6.9
Mendocino	11.4	San Bernardino	6.7
Tuolumne	11.2	San Joaquin	6.3
San Benito	11.1	Modoc	6.1
Glenn	10.8	Yuba	6.0
Siskiyou	10.7	San Diego	5.9
Humboldt	10.6	Amador	5.1
Butte	10.4	Sacramento	4.3
Madera	10.4	Mono	3.6
Fresno	9.9	Los Angeles	3.6

^a Adjusted for AFDC average grant differentials, using the unweighted statewide average as the reference point.

“Administrative Effort” Explains Much of the Intercounty Differences

In an effort to account for these differences, we updated, refined, and expanded a statistical analysis of data on child support enforcement that we presented in the *Analysis of the 1990 Budget Bill* (please see pp. 707-710). In that analysis, we devised a method of measuring a county's “administrative effort,” expressed as the ratio of total spending on the child support program to total expenditures for AFDC-Family Group (AFDC-FG) grants. We chose AFDC-FG grant expenditures as the base because it provided a way to differentiate between the counties in terms of the scope of their task in collecting child support for AFDC families. We found that administrative effort was an important factor in determining the counties' performance, explaining 40 percent of the variation among the counties in their AFDC recoupment rates in 1988-89.

In updating and modifying this analysis, we used 1990-91 data and revised our measure of administrative effort by substituting administrative spending on the AFDC component of the program for total administrative spending, so that both variables — administrative effort and recoupment rate — correspond to the AFDC part of the program. We also adjusted recoupment rates and administrative effort to compensate for the differences between the counties in their average AFDC grants per case. The results confirmed our earlier finding: administrative effort explained 44 percent of the variation in recoupment rates.^b

We also tested a variety of other variables in order to see if we could add to the explanation of variation in recoupment rates and to determine if administrative effort remained an important variable when controlling for the effects of other factors. These included several demographic variables that, according to some program administrators, might have an effect on the ability to collect child support: unemployment rate, percentage of out-of-wedlock births, degree of urbanization, percentage of Blacks and Hispanics in the AFDC caseload, percentage of AFDC recipients in the county's population, and the growth trend of AFDC cases in the county. The results showed that these variables either were statistically insignificant or added very little to the explanation of variation in recoupment rates. Administrative effort, however, retained its explanatory power when including these other variables in the analysis.

The importance of administrative effort is illustrated in Figure 5, which shows that counties in the top quartile in

^b In this and subsequent regression analyses, we excluded the 10 smallest counties because they are susceptible to volatile changes that can distort the results. For example, if a county has an unusually high level of administrative spending in a particular year, compared to all other counties, it will have a disproportionately strong influence on the results of the analysis.

Figure 5

**Child Support Enforcement Program
Administrative Effort of High- and Low-Performing Counties
1990-91**

High-Performing Counties (Top Quartile)			Low-Performing Counties (Bottom Quartile)		
County	AFDC Recoup- ment Rate ^a	Adminis- trative Effort ^a	County	AFDC Recoup- ment Rate ^a	Adminis- trative Effort ^a
Napa	17.7%	7.9%	Lake	7.3%	3.7%
Ventura	15.2	9.0	Imperial	7.3	2.8
El Dorado	15.1	10.5	Riverside	7.2	3.6
Plumas	14.6	8.0	Lassen	7.1	1.7
Inyo	14.5	9.0	Alameda	6.9	3.0
Sierra	14.4	16.6	San Bernardino	6.7	1.9
Santa Barbara	13.8	8.3	San Joaquin	6.3	1.6
Sonoma	13.7	6.2	Modoc	6.1	6.6
Sutter	13.2	8.8	Yuba	6.0	2.6
San Luis Obispo	13.2	5.9	San Diego	5.9	2.4
Colusa	13.0	5.6	Amador	5.1	7.7
Merced	12.5	2.5	Sacramento	4.3	2.3
Shasta	12.4	4.9	Mono	3.6	3.1
Yolo	12.4	4.3	Los Angeles	3.6	1.9
Unweighted average	13.9%	7.7%	Unweighted average	5.9%	3.2%

^a Adjusted for differentials in average grants.

recoupment rates expended, on average, 2.4 times as much administrative effort as did the counties in the bottom quartile.

Other Factors

If administrative effort — an indication of the level of resources allocated to the program — explains about half of the variation in recoupment rates, what accounts for the other half? Statistical analysis of the demographic variables yields very little. We suspect, however, that managerial ability plays an important role. We do not have a good way to measure this trait, although there is a commonly used measure of efficiency of operations — the ratio of child support collections to program costs — which

Figure 6

**Child Support Enforcement Program
AFDC Collections per Dollar of AFDC
Administrative Expenditures
1990-91**

County	Collections/ Costs	County	Collections/ Costs
Merced	\$4.92	Sonoma	\$2.21
Mendocino	4.63	Kern	2.15
Lassen	4.08	Mariposa	2.03
Humboldt	4.07	Riverside	2.01
San Joaquin	3.88	Trinity	1.96
San Bernardino	3.59	Lake	1.96
Madera	3.46	Santa Cruz	1.93
Fresno	3.21	Sacramento	1.89
Tuolumne	3.21	Placer	1.88
Monterey	3.07	Los Angeles	1.85
Tulare	2.96	Plumas	1.84
Yolo	2.85	Orange	1.78
Butte	2.82	Contra Costa	1.73
Kings	2.82	Del Norte	1.69
Siskiyou	2.60	Ventura	1.69
Imperial	2.58	Santa Barbara	1.67
Tehama	2.55	San Francisco	1.62
Shasta	2.54	Santa Clara	1.61
San Diego	2.51	Inyo	1.60
Solano	2.47	Nevada	1.51
San Benito	2.40	Sutter	1.50
Stanislaus	2.36	El Dorado	1.43
Yuba	2.34	San Mateo	1.34
Colusa	2.33	Mono	1.13
Glenn	2.29	Modoc	0.92
Alameda	2.28	Sierra	0.87
Calaveras	2.26	Marin	0.84
Napa	2.25	Amador	0.66
San Luis Obispo	2.24	Alpine	0.28

reflects one aspect of managerial ability. Figure 6 ranks the counties on the basis of their AFDC collections per dollar of administrative expenditures in the AFDC component of the program in 1990-91.

Two caveats about the figure are important. First, the ratios represent a return on a dollar of administrative spending from *all* levels of government. They do not tell you what a particular level

(say, the county) receives for a dollar of spending. (This is discussed in the next section.) Second, the ratios are *average*, not *marginal* figures. For instance, in Merced County the average return from every dollar in public spending on enforcement was \$4.92, which may suggest that each *additional* enforcement dollar would return as much. However, it is likely that the county's *first* dollars spent on enforcement were aimed at the most productive cases and that subsequent spending returned less and less. It may be, for instance, that the *last* dollar spent on enforcement returned less than a dollar, meaning that it was not a good investment from a fiscal perspective.

WOULD ADDITIONAL SPENDING ON CHILD SUPPORT ENFORCEMENT BE COST-EFFECTIVE?

Up to this point, we have emphasized recoupment rates as an indication of program performance. As a measure of child support collections, recoupment rates are particularly important to the federal and state governments, which primarily benefit from the offsets to their AFDC grant expenditures. We need to consider, however, the public costs of operating the program as well as the AFDC grant savings. As we have seen, there is a strong relationship between collections, as indicated by recoupment rates, and program costs, as reflected in our index of administrative effort. We turn now to an analysis of how these variables interact to produce the *net fiscal impact* of the program on the government, particularly the state and the counties.

Clearly, the state is the primary fiscal beneficiary from additional spending on child support enforcement. This occurs because administrative costs are borne almost entirely by the federal and county governments and yet the state and federal governments share most of the benefits from additional AFDC collections through offsets to AFDC grants (even after accounting for the incentive payments). The effect on the counties, however, is less clear. On the whole, the program has yielded net savings to the counties in past years, but this has not necessarily been true for all counties. Furthermore, even in those counties that made money overall, their spending "at the margin" may not have a return large enough to cover these costs.

We examined the statewide totals for changes in collections and expenditures between 1987-88 and 1990-91 and found that — at the margin — an additional dollar of expenditures (from all sources) was accompanied by an increase of \$3 in total collections (divided about equally between AFDC and non-AFDC collections). Based on these data, we developed three hypothetical scenarios that most counties are probably facing: marginal collections/marginal costs ratios of \$2/\$1, \$3/\$1, and \$4/\$1. Figure 7 shows

Figure 7**Net Costs (Savings) From \$1 Increase in Spending Under Three Marginal Collections/Costs^a Scenarios**

	Federal	County	State	County/State
Scenario 1: Collections/Costs Ratio = \$2/\$1				
Expenditures:				
Administration	\$.66	\$.34	—	\$.34
Incentive payments	.13	—	\$.07	.07
Revenues:				
Incentive payments	—	(.20)	—	(.20)
AFDC grant savings	(.50)	(.02)	(.48)	(.50)
Net fiscal impact	\$.29	\$.12	(\$.41)	(\$.29)
Scenario 2: Collections/Costs Ratio = \$3/\$1				
Expenditures:				
Administration	\$.66	\$.34	—	\$.34
Incentive payments	.20	—	\$.10	.10
Revenues:				
Incentive payments	—	(.30)	—	(.30)
AFDC grant savings	(.75)	(.04)	(.71)	(.75)
Net fiscal impact	\$.11	—	(\$.61)	(\$.61)
Scenario 3: Collections/Costs Ratio = \$4/\$1				
Expenditures:				
Administration	\$.66	\$.34	—	\$.34
Incentive payments	.26	—	\$.14	.14
Revenues:				
Incentive payments	—	(.40)	—	(.40)
AFDC grant savings	(1.00)	(.05)	(.95)	(1.00)
Net fiscal impact	(\$.08)	(\$.11)	(\$.81)	(\$.92)
^a Ratio of increase in AFDC and non-AFDC collections (net of \$50 disregard payments) to increase in total administrative costs.				

the net fiscal impact on the state, the county, and the state and county combined as total enforcement expenditures are increased by each \$1 under these three scenarios.

As the figure shows, the state and the combined state and county governments benefit from additional spending under all

three scenarios (that is, all the “net fiscal impact” numbers in the last two columns are in parentheses — meaning savings). For instance, the state makes money under all three scenarios (either 41 cents, 61 cents, or 81 cents on each additional dollar’s worth of enforcement effort). The *county*, however, shows a clear fiscal benefit only in the case where the marginal collections to marginal costs ratio is above the \$3 to \$1 ratio. If a county based its decisions solely on fiscal grounds and found itself in the situation where the ratio was at the \$2 to \$1 level, it would rationally decide *not* to make the additional expenditure. *It is important to note that, from a fiscal perspective, such a decision would be suboptimal from the combined state/county perspective.* This is because the state and counties combined make a net savings of 29 cents on each additional enforcement dollar expended.

Clearly, counties do not always base decisions on the level of child support enforcement solely according to their calculations of the fiscal impact. It would be surprising, however, if these key fiscal considerations were not important in the counties’ decision-making process. In this connection, we note that program administrators frequently told us that they were encouraged or instructed to operate a “no-cost” program.

Net Fiscal Impact on Counties

In order to gain additional insight into explaining a county’s willingness to commit resources to its child support enforcement program, we reviewed the program’s fiscal impact on the counties in 1990-91. Figure 8 ranks the counties on the basis of their “profitability” — net revenues or costs as a percent of the county’s share of expenditures. It shows, for instance, that Lassen County made money equal to 130 percent of the amount it spent on child support enforcement, whereas Alpine County had net costs equal to 81 percent of its enforcement expenditures.

In analyzing the counties’ “profitability,” there is a fairly strong *inverse* relationship between net profitability and administrative effort. This relationship suggests that, in spite of the existing set of incentive payments designed to encourage collections, counties apparently do not have a strong fiscal incentive to commit relatively high levels of resources to the program.^c

A review of the counties in terms of their combined state/county profitability indicates that all but one of the counties realized a net savings. Thus, even relatively inefficient counties contributed to the state’s net savings from the program.

^c The amount of profit a county can divert to its general fund is limited to its savings in AFDC grant expenditures. State law requires the counties to spend their incentive payments on the child support program. (An Auditor General report in 1989, however, indicated that counties were not properly restricting their excess revenue.)

Figure 8

**Child Support Enforcement Program
Net County Costs (Revenues) as Percent of County Expenditures
1990-91**

County		County	
Lassen	(130.2%)	Contra Costa	(10.5%)
Merced	(122.4)	Lake	(10.2)
Humboldt	(110.4)	Sonoma	(9.8)
Mendocino	(105.0)	Mariposa	(8.8)
San Bernardino	(88.4)	Solano	(5.4)
San Joaquin	(82.4)	Plumas	(3.6)
Madera	(73.4)	Del Norte	(1.3)
Napa	(73.3)	Santa Cruz	2.9
San Diego	(57.6)	Sacramento	4.0
Fresno	(56.6)	Orange	5.0
Tuolumne	(54.9)	Mono	6.3
Siskiyou	(38.7)	Placer	6.6
Imperial	(38.1)	Trinity	7.9
Butte	(37.6)	Los Angeles	9.0
Yolo	(37.4)	Ventura	12.1
Tulare	(36.3)	San Luis Obispo	12.8
San Benito	(36.2)	Nevada	18.6
Kings	(36.0)	Santa Barbara	19.0
Shasta	(34.2)	Sutter	20.2
Calaveras	(33.6)	Inyo	22.1
Tehama	(31.5)	Santa Clara	25.9
Yuba	(23.8)	El Dorado	26.1
Stanislaus	(21.7)	San Mateo	28.4
Glenn	(20.2)	San Francisco	30.0
Colusa	(18.6)	Amador	30.5
Kern	(17.9)	Sierra	31.2
Monterey	(16.5)	Modoc	35.0
Riverside	(16.1)	Marin	41.4
Alameda	(10.8)	Alpine	81.4

We can get a better idea of the program's potential for yielding additional savings by returning to our analysis of marginal increases in collections and costs. If we assume a \$3 to \$1 ratio of marginal collections to marginal costs, the combined state and county savings (in AFDC grant offsets and federal incentive payments) amount to about \$2.70 for every \$1 of state/county administrative costs. Thus, for every \$10 million in additional enforcement spending, the state and counties would make \$27 million, for a net savings of \$17 million.

HOW CAN THE STATE IMPROVE ITS CHILD SUPPORT ENFORCEMENT PROGRAM?

In the preceding analysis, we found that additional spending is likely to lead to more effectiveness in the child support program and additional savings to the state. There is also evidence, however, that — from the counties' fiscal perspective — these additional commitments often do not benefit the county, which has control over program funding decisions. *If anything, the existing funding system seems to provide an incentive for counties to hold spending down.* We conclude, therefore, that it would be in the interest of the state if the Legislature were to initiate changes in the program in order to effect an increase in its cost-effectiveness. In this section, we present two alternatives for revising the state's system of administering and funding the child support enforcement program.

Option 1: State Administration of the Child Support Program

Under this option, legislation would be enacted to provide that the state assume administrative control of the program, thereby making the state rather than the counties responsible for the decisions that affect program performance. Assumption of control of the program's funding would eliminate the problems discussed above that can result when the agency that has control over resource allocation decisions views these decisions from a fiscal perspective which differs substantially from the state's. Thus, the state would be able to allocate resources to the program according to a statewide perspective, based on the Legislature's policy decisions with respect to fiscal and other benefits associated with the delivery of child support enforcement services to AFDC and non-AFDC parents.

If the Legislature should decide to adopt this policy, we believe that it would be prudent to proceed by funding an implementation study to address the many implementation issues that would have to be resolved prior to state assumption of the program. We estimate that such a study would cost from \$75,000 to \$100,000.

Option 2: Collections/Costs Incentive Payment

Under this option, the state would add an additional state-funded incentive payment to augment program funding, based on each county's efficiency as measured by the ratio of the *marginal* increase in child support collections to the marginal increase in administrative costs. This would add funds where they would generate the greatest increase in collections. The incentive payment should be provided on the condition that it supplement, and not supplant, existing expenditures by the county. In addition, the payment should be "matched" by an increase in county expenditures.^d

There are many different formulas that could be devised to provide these additional incentive payments to counties. In order to implement this option, the Legislature would have to explore these alternatives carefully prior to selecting a specific approach.

CONCLUSION

Child support enforcement is, of course, more than simply a means of raising revenue for the state. The provision of an adequate level of support for children stands as the fundamental rationale for the program. Nevertheless, focusing on the program's net fiscal impacts can lead both to improved program effectiveness *and* additional savings to the state.

The existing system of administering and funding the child support enforcement program provides a set of fiscal incentives which result in decisions that are counter-productive from a statewide perspective. We believe that this problem can best be addressed by adopting one of the options that we present for revising the manner in which the program is funded. The first option — state administration — would permit the greatest degree of state control and facilitate an optimal allocation of resources to maximize net revenues. The second option — a new incentive payment — would facilitate the efficient use of limited resources that might be made available for program expansion.

Under either option, however, the state should commit to a higher level of investment in the child support program, a difficult course to take in the midst of a period of tight fiscal constraints. We believe, however, that such an investment would ultimately lead to a significant increase in savings to the state and thereby prove to be cost-effective in the long run.

^d This process would be dynamic rather than static. As noted above, we would expect the county's collections to costs ratio to decline as expenditures increase.

Trial Court Funding “Realignment”

What Steps Should the Legislature Take to Ensure the Effective Implementation of the Trial Court Funding “Realignment”?

Summary

Last summer, the Legislature enacted several major bills to provide additional state funding for support of trial courts and to require courts to make a number of reforms. The measures, which had multiple purposes, expressed the Legislature’s intent to fund an increasing share of court operating costs over the next five years. The additional costs to the state were projected to be more than offset by increases in General Fund revenues during this period. Based on collections to date, however, revenues may not approach the levels anticipated.

A number of short-term problems (such as delays in development of accounting guidelines) have hindered implementation of the realignment, mostly due to enactment of legislation after the fiscal year began. The realignment has, however, also raised a number of policy issues, such as the management and control of local court personnel and the need for clarification of judicial roles. The Legislature will need to address these issues as it considers providing additional funds for trial court operations in the budget year and beyond.

The California Constitution establishes a system of trial and appellate courts and delineates the jurisdiction of each court over judicial matters. The state has traditionally funded the operations of the Supreme Court and the courts of appeal from the General Fund and, until recently, counties have been primarily responsible for financing the operations of the trial courts — the superior, municipal, and justice courts. That tradition was fundamentally changed in 1985 when legislation was enacted to require the state to assume the primary responsibility for funding the costs of trial court operations through a system of block grants.

The enactment of Ch 90/91 (AB 1297, Isenberg) — the Trial Court Realignment and Efficiency Act of 1991 — made additional significant changes to the state's financial responsibility for trial court operations. Through Chapter 90 and related statutes, the Legislature expressed its intent to support an increasing share of trial courts costs.

In this analysis, we (1) review the short-term implementation issues surrounding Chapter 90 and the related measures, and (2) identify a number of policy issues that the Legislature will need to address as it considers providing additional support for the trial courts for the budget year and beyond. We discuss the *1992-93 Governor's Budget* proposals for trial court funding in detail in our companion document, *Analysis of the 1992-93 Budget Bill* (please see Item 0450).

BACKGROUND—STATE FUNDING FOR TRIAL COURTS

In 1985, the Legislature established the Trial Court Funding Program to promote a more uniform level of judicial services throughout California and to relieve some of the fiscal pressures on county governments. The program provided participating counties funding for both specific operating costs (such as salaries and benefits for selected judges) and general operating costs (such as ancillary court personnel and services).

The program was originally established by Ch 1607/85 (AB 19, Robinson), the Trial Court Funding Act of 1985, but was not made operative until the enactment of Ch 1211/87 (SB 709, Lockyer) two years later. The statutes required the state to assume the primary responsibility for funding the operations of the courts through block grants for certain judicial positions and increased state participation in funding of judges' salaries and benefits. As a means of offsetting the state's additional costs, participating counties were required to turn over to the state their share of certain court-related revenues (fines, fees, and forfeitures) and to forgo reimbursement for mandates related to trial court operations.

In 1988, the Legislature enacted the Brown-Presley Trial Court Funding Act (Ch 944/88 — AB 1197, Willie Brown, and Ch 945/88 — SB 612, Presley). These measures made several significant changes to the Trial Court Funding Program, including changing the amount of the block grants and eliminating the existing revenue recapture provisions.

OVERVIEW OF THE TRIAL COURT REALIGNMENT AND EFFICIENCY ACT OF 1991

The Trial Court Realignment and Efficiency Act of 1991 repealed several of the provisions of the Brown-Presley Trial Court Funding Act and made additional significant changes to the Trial Court Funding Program. Although Chapter 90 was the principal piece of legislation, several other related measures (especially Ch 189/91 — AB 544, Isenberg, and Ch 331/91 — SB 21, no author) made changes as well. Figure 1 lists the trial court funding-related legislation enacted in 1991.

Reform Had Many Purposes

Chapter 90 and the related legislation had several different purposes, some of which were expressed in legislative intent. These included: (1) helping the Governor and the Legislature close the 1991-92 state budget gap and providing net revenues to the General Fund through 1995-96, (2) relieving fiscal pressures on counties by having the state assume a larger role in court funding, and (3) improving access to justice and the uniformity of judicial services throughout the state by providing additional court funding and enacting a number of reforms.

These purposes were addressed by:

- Increasing state funding for trial court operations.
- Generating additional revenues for the state.
- Establishing mechanisms to improve collections of unpaid fines, forfeitures, and penalties.
- Enacting a variety of reforms in the trial courts that are designed to increase efficiency and reduce costs for support of the trial courts in the long run.

Increased State Funding for Trial Courts

Chapter 90 continues the state’s commitment to state funding for trial court operations that began in 1985. Specifically, the measure increases total state funding for trial courts by about \$225 million in 1991-92. Prior to enactment of Chapter 90, the state supported about 38 percent of trial court operating costs. Chapter 90 expresses the Legislature’s intent to fund 50 percent of the statewide costs for trial court operations in 1991-92 and increase the funding 5 percent per year until the state reaches 70 percent funding in 1995-96. The Governor’s Budget, however, proposes to freeze trial court expenditures at the current-year level (see our *Analysis* for more details). This would result in the state funding about 45 percent of these costs in the budget year.

Figure 1**1991 Legislation Relating to Trial Court Funding**

Measure	Author	Topic	Effective Date
AB 1297 (Ch 90/91)	Isenberg	Increased trial court funding, realignment of court-related revenues, court reforms.	June 30, 1991
AB 544 (Ch 189/91)	Isenberg	Court reforms and revenue transfers.	July 29, 1991
SB 21 (Ch 331/91)	no author	Appropriations for trial court funding, fines and fees transfers.	August 5, 1991
AB 2142 (Ch 1168/91)	Frazee	Distribution and uses of certain fines and fees, restricted application of certain fees.	October 14, 1991
AB 1485 (Ch 716/91)	Committee on Judiciary	Court staffing and the compensation of certain court personnel.	January 1, 1992
AB 195 (Ch 613/91)	Bentley	Requirements for Judicial Council reporting, compensation for municipal and justice court judges, extension of authority to hear guilty pleas in non-capital felony cases.	January 1, 1992
AB 1826 (Ch 598/91)	Bentley	Permit certain misdemeanors to be treated as infractions.	January 1, 1992
SB 526 (Ch 976/91)	Killea	Authorization for the State Controller to recover unpaid penalty assessments.	January 1, 1992

Transfers of Local Court Revenues

Prior to Chapter 90, court-related fine and forfeiture revenues were divided between counties and cities, based on the location of the violation of law that resulted in the fine. In order to offset the additional costs of state funding for the trial courts, the realignment measures transfer a large share of local revenues to the General Fund.

Specifically, the measures:

- Require cities to transfer 50 percent and counties 75 percent of their non-parking fines to the state.

- Increase existing penalty assessments on criminal and traffic offenses.
- Transfer traffic school fees to the state.

These provisions were estimated to result in revenues of \$462 million in 1991-92.

In addition, other court-related revenue enhancements were enacted in Chapter 331 in order to backfill for a \$205 million reduction taken in the program's base funding level in the 1991 Budget Act.

Enhanced Collection Efforts

Chapters 90 and 189 establish a number of new mechanisms to assist local governments in collecting unpaid fines, forfeitures, and penalties. These changes were partially designed to generate revenues to the state to cover the costs of additional state funding for trial court operations. The mechanisms include income tax and lottery intercepts, wage garnishment, use of private collection agencies, holds on vehicle registration and driver's license renewals, and use of credit cards and personal checks for payment of fines and penalties.

In order to provide an additional incentive for persons to pay their unpaid motor vehicle fines and penalties, Chapter 331 established an amnesty program in effect between February and April of 1992, and allows offenders to pay a reduced fine for each violation, except for offenses involving driving under the influence of alcohol or drugs.

These provisions were estimated to result in \$55 million in General Fund revenues in 1991-92.

Trial Court Reforms

Chapter 90 includes a number of reforms to increase the efficiency of the trial courts. These reforms are designed to reduce the long-term costs of trial court operations, improve the uniformity of judicial services throughout the state, and improve the public's access to the judicial system.

The most significant reform requires superior, municipal, and justice courts to coordinate their operations. Chapter 90 requires each court to develop a coordination plan to achieve efficiencies through the maximum utilization of court resources. Plans must consider a number of specific items, including the following:

- Assignment of any judge to hear any type of case, regardless of the jurisdictional or geographical boundaries.
-

- Using lower level judges to hear and try matters (such as a municipal court judge handling a case in superior court).
- Sharing and merging of court support staff within or across county boundaries.
- Using alternative dispute resolution programs, such as arbitration.
- Unifying the trial courts within a county to the maximum extent permitted by the California Constitution.

Although no savings were estimated from these reforms in the current year, Chapter 90 requires trial courts, on a statewide basis, to reduce their operating costs at least 3 percent in 1992-93, an additional 2 percent in 1993-94, and an additional 2 percent in 1994-95. Coordination plans must be submitted to the Judicial Council by March 1, 1992 and approved by the council by July 1, 1992. It is not clear how these reductions will be calculated or whether they will be achieved.

In addition, Chapter 90 requires trial courts to implement reforms to reduce court case backlogs. Specifically, the measure requires municipal and justice courts to establish delay reduction programs similar to programs already implemented in superior courts that were established by the Trial Court Delay Reduction Act of 1986 (Ch 1335/86 — AB 3300, Willie Brown). These programs set specific guidelines and standards for courts to resolve criminal and civil cases as expeditiously as possible.

The legislation also recognizes that inefficiencies exist because of the lack of automation in some courts. As a result, Chapter 90 allows counties to retain 2 percent of all fines from criminal convictions, including traffic cases, for the development of automated accounting and case management systems within the municipal and justice courts.

Net Fiscal Impact on State

Enactment of Chapter 90 and the related legislation was one of several actions taken by the Legislature and the Governor to close the \$14 billion budget gap for 1991-92. At the time of enactment, the Department of Finance (DOF) estimated that the measures would result in additional state revenues of \$517 million and additional costs of \$225 million, for a net savings to the General Fund of \$292 million, as shown in Figure 2. (The amounts shown in Figure 2 do not include any of the revenue enhancements enacted in Chapter 331 to fill the \$205 million “hole” in the base funding in the 1991 Budget Act.)

Figure 2

**Trial Court "Realignment"
1991-92 Fiscal Effect^a**

(in millions)

Revenues	
Transfers to the state:	
75 percent of county revenues	\$208.0
50 percent of city revenues	77.0
Enhanced collections	\$55.0
Penalty assessment increases	79.0
Traffic school fee transfers	98.0
Total, Revenues	\$517.0
Costs	
Trial courts	\$221.6
Judicial Council administration	2.6
Judicial Retirement System	0.9
Total, Costs	\$225.1
Net Savings	\$291.9

^aBased on Department of Finance June 1991 estimates.

The DOF's long-term projections showed that even with the increasing state funding for trial court operations, the measures would result in annual net savings to the state until 1995-96. After that time, the DOF estimated that the program would result in net costs.

TRIAL COURT FUNDING REVENUE

As indicated above, revenues provided through Chapter 90 and the related legislation were estimated to generate revenues to the state in excess of costs of almost \$300 million in the current year. It now appears, however, that the net savings will be far less than that amount.

DOF Has Revised Its Estimates

The DOF estimated in June 1991 that increases in court-related revenues would generate about \$592 million to the General Fund in 1991-92 and \$668 million in 1992-93. (The \$592 million

estimate differs from the revenue total shown in Figure 2 — \$517 million — as the former includes some additional court-related revenue increases that were added to fill the \$205 million “hole” in base funding.) In November 1991, the DOF adjusted the estimates downward to \$436 million in 1991-92 and \$509 million in 1992-93, a difference of \$315 million over the two-year period. (These are the figures assumed in the Governor’s Budget.) These adjustments resulted primarily from additional review of actual local fine, fee, and forfeiture data from previous years that indicated that the original estimates were overstated.

Figure 3 shows these estimates, by revenue source, for both 1991-92 and 1992-93. In addition, it shows actual collections from these sources as of January 31.

Figure 3

**Trial Court Funding
General Fund Revenue Collections
1991-92 and 1992-93**

(in millions)

Revenue Source 1991)	1991-92			1992-93	
	Original Projection (June 1991)	Revised Projection (Nov. 1991)	Actual Collections (as of Jan. 31)	Original Projection (June 1991)	Revised Projection (Nov. 1991)
Fines and Forfeitures					
Counties	\$208.0	\$156.0	\$18.8	\$224.1	\$165.4
Cities	77.0	74.0	9.6	82.9	78.4
Other ^a	55.0	20.0	0.1	81.0	40.0
Penalty assessments ^b	79.0	57.0	30.3	96.0	75.0
Traffic school fees ^c	128.0	102.0	15.3	139.0	111.0
Administrative fees ^d	45.0	27.0	2.2	45.0	20.0
Total^e	\$502.0	\$426.0	\$72.3	\$668.0	\$509.8

^a Includes increase in fines resulting from enhanced collection efforts, amnesty program (in effect February through April 1992), and state parking violations.

^b General Fund portion.

^c Includes both \$24 fee and state portion of fees based on amount of fine.

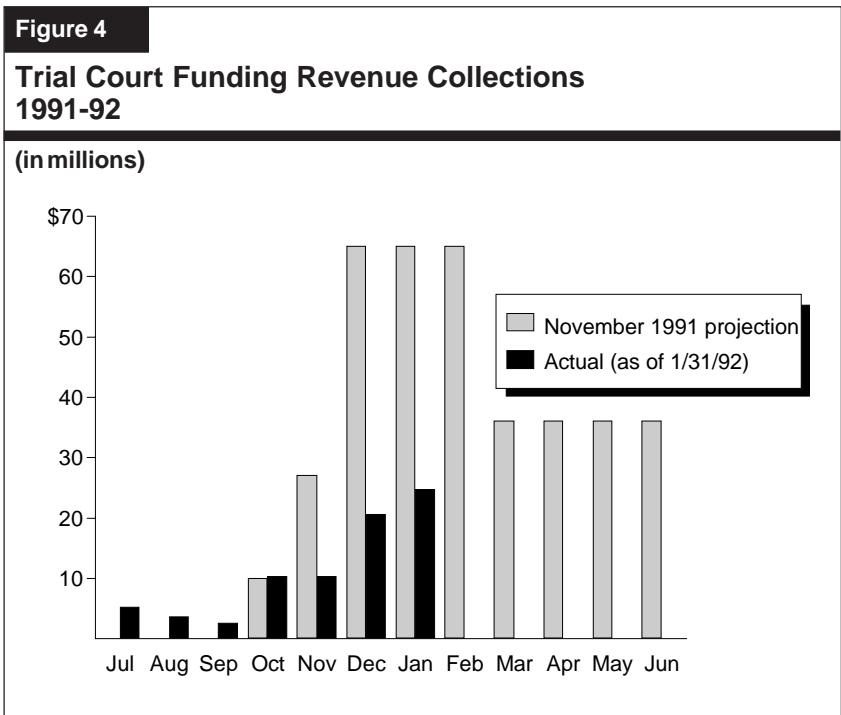
^d Includes administrative fees for persons convicted of crimes, \$1 surcharge on parking violations, and surcharge on document recordings.

^e Details do not add to totals due to rounding.

Current-Year Revenues Well-Below Projections

As Figure 3 shows, of the \$436 million in court-related revenues estimated in the revised 1991-92 projection, the state has actually received only about \$77.3 million (approximately 18 percent of the estimated total), with over half the fiscal year elapsed. Only the revenue transfers from increased penalty assessments have met expectations.

Figure 4 shows the revised DOF projection of court-related revenue transfers to the General Fund against *actual* revenues collected by the State Controller's Office (SCO) on a monthly basis. As the figure shows, the DOF estimated that after cities and counties had three to four months to implement the necessary changes, the state would receive a significant increase in revenues during December 1991, and in January and February 1992, before leveling off at a more moderate amount for the remainder of 1991-92.



Our analysis of revenue transfers to the General Fund indicates that court-related revenues for 1991-92 could be up to \$250 million less than DOF's revised projection.

Budget-Year Projections

In 1992-93, DOF projects that court-related revenues will total approximately \$509 million, which is 17 percent above current-year collections. Since 1982-83, court-related revenues have increased an average of 8.5 percent per year, half the rate of the projected budget-year increase. Given the lower current-year base and the optimistic budget-year growth assumptions, we believe that the budget-year projection is also overstated.

Net Fiscal Benefits to State Now in Question

Given that trial court-related revenue collections appear unlikely to meet expectations in the current year, it is likely that the trial court funding realignment will result in much lower General Fund savings in the current and budget years. In addition, the realignment may become a net cost to the state *before* 1995-96, rather than after that year, as was originally projected by the DOF.

IMPLEMENTATION ISSUES

Chapter 90 was enacted as an urgency measure on the last day of the 1990-91 fiscal year. Chapters 189 and 331, which were also urgency measures, were not enacted until July 27 and August 5, respectively. Because these measures became law after the new fiscal year started, state and local agencies were required to institute the changes quickly without full understanding of the statutes or the Legislature's expectations.

Not surprisingly, there have been some problems — primarily short-term ones — in implementing the trial court funding realignment changes. In this section, we describe some of these problems and identify actions the Legislature can take to help resolve them.

Accounting Guidelines Were Delayed

Current law requires the SCO to coordinate the transfer and distribution of revenues between the state and local governments. Chapters 90, 189, and 331 require the SCO and county auditors to establish new guidelines and accounts for the transfer of new court-related revenues from the counties to the state.

Due to the timing of the measures, the SCO's guidelines were not distributed to the counties until October. As a result some counties were still using the remittance guidelines established under the Brown-Presley Trial Court Funding Act as late as December, or stopped remitting revenues altogether.

Revenues that are improperly transferred to the SCO are placed in a temporary account until the remitting county can be contacted and the revenues sorted into the proper accounts. This can cause a one- to two-month delay in properly accounting for the revenues. In our view, this delay is part of the reason that General Fund collections are lagging to date.

Revenues Not Remitted from Local Governments

Chapters 90 and 189 establish a “cap” on the total amount of fines and forfeitures cities and counties can retain in 1991-92. The cap allows cities to retain an amount equal to 50 percent and counties 25 percent of the total fines and forfeitures each entity collected in 1990-91, plus 5 percent. Any amount above these “caps” must be transferred to the state General Fund. The statutes also require cities and counties to transfer the state’s share of the collections on a monthly basis.

Our review of local revenue transfer practices indicates that many cities and counties have not remitted the state’s share of their court-related revenues in a timely manner. The lack of familiarity has caused some delays that have or will be corrected. However, we also found that many cities and counties are filling their total annual caps before remitting any of the state’s share of collections to the SCO. This practice, which is contrary to the SCO’s county guidelines, not only delays state General Fund revenue collections, it also creates a disincentive for counties to vigorously continue their efforts to collect outstanding fines and forfeitures once they have filled their caps.

Delay in Revenue Transfers Will Need to Be Addressed by the Legislature. We believe that the Legislature should address the issue of cities and counties delaying the transfer of the state’s share of court-related revenues. Specifically, the Legislature should provide fiscal disincentives for cities and counties to delay the transfer. For example, the state could offset trial court funding payments to counties by the estimated amount of collections that the state should have received.

Judicial Reaction to Penalty Increases

Chapters 90, 189, and 331 require judges to implement increases to schedules for the assessment of fines and penalties. Most of the increases were implemented within the municipal and justice courts’ penalty schedules.

Trial court judges and staff are now becoming more familiar with the new fines and penalty assessment schedules. We believe that any administrative problems with the implementation of the basic fine and penalty schedules should soon be corrected.

There are, however, a number of reasons why judges have been slow to implement the increases in contested matters within their courts.

- Many judges have indicated that they believe that the fines and penalties are now excessive.
- For a variety of reasons, including the current condition of the state's economy and the high rate of unemployment, it appears that many judges are reducing some portion of the base fine and penalty amount for those persons who make an appearance in court. (Judges may do so based on the defendant's ability to pay.) As a result, many court personnel have indicated that the number of persons requesting an appearance in court has increased significantly since the new schedules have been implemented, with a corresponding impact on projected revenues.
- Many judges feel that they have been placed in the position of being a "revenue generator" for the state and have voiced opposition to this role, even though they have always performed this function for local governments.

Legislature May Need to Tie Additional Funding to Revenue Results. As the state is now more dependent on the revenues generated by the trial courts than prior to enactment of Chapter 90, it is critical to the success of the overall trial court realignment program that judges assess and the state receive its expected revenues from increased fines and penalties.

POLICY ISSUES RELATED TO STATE SUPPORT OF THE TRIAL COURTS

In this section, we identify four policy issues that the Legislature will need to address in order to meet the objectives of realignment. We believe that, as it considers these issues, the Legislature should keep certain state-local fiscal reform principles in mind, such as paying attention to incentives and linking program control to funding. (We reviewed these and other state-county partnership principles in detail in *The 1991-92 Budget: Perspectives and Issues*, please see page 173.) The Judicial Council will provide the Legislature with reports throughout the next year which should assist the Legislature in its consideration of these issues.

State Funding for "Court Operations"

Prior to the enactment of Chapter 90, the operating budgets for the trial courts were administered through the individual county's budgetary process. (The state simply provided counties

with funds to pay judicial salaries and block grants to assist them in paying for court operating costs.) As a result, there are disparities among counties in the manner of accounting for trial court operating budgets. Consequently, there is no definitive figure for the total *statewide* cost of trial court operations. This is a critical issue because the state will pay for a fixed percentage of court costs. Without adequate estimates of current and past statewide costs, it is difficult for the Legislature to make informed budget decisions on trial court funding.

In the past, estimates of trial court operating expenditures have been provided by the Judicial Council, based on information provided by a sample of counties using Rule 810 of the California Rules of Court as a guideline. Rule 810 specifies a number of trial court operational cost items, including judicial and nonjudicial salaries, services and supplies, costs for collective bargaining, and indirect costs. Cost accounting for salaries is relatively straight forward, but the costs for services and supplies and indirect costs have been difficult to estimate satisfactorily. Estimating county expenditures for "indirect costs" has created the largest problem in reaching a total statewide cost estimate.

Judicial Council is Studying the Issue. Chapter 90 requires the Judicial Council to report to the Legislature by November 1 of each year the expenditures for each superior, municipal, and justice court, and the statewide totals. In order to assist with this report, the Judicial Council has formed a committee comprised of trial court judges, court administrators, and staff from the Administrative Office of the Courts to address these questions.

The Legislature will need to conduct its own independent review of the council's report and enact legislation to statutorily define which items will be included in trial court operating costs.

Distribution of Funds to Counties

Chapter 189 repealed the provisions of law that specified the distribution of state monies to counties for support of trial courts. Thus, there is currently no statutory direction on how funds provided in the annual Budget Act (including \$565 million requested in the Governor's Budget) should be distributed.

Chapter 90 requires the Judicial Council to report to the Legislature by March 1, 1992, on the most efficient and cost-effective process for including trial court expenditures in the annual Budget Act and an equitable formula for allocating state funds. At the time this analysis was prepared, the council had developed a draft proposal and was seeking comments from judges,

court administrators, county officials, and other interested parties.

Under the draft proposal, each trial court would develop its own budget, which would be reviewed by a regional board selected by the courts. Individual court budgets would be compiled and approved by a state board of trial judges. Following approval by the Chief Justice of the California Supreme Court (the chair of the Judicial Council), a statewide trial court budget would be submitted to the Legislature and the DOF for inclusion in the annual Budget Act. This is a fundamental change from the existing budget process, in which the DOF develops the trial court funding budget.

The draft also provides that, following enactment of the Budget Act, state funding would be allocated to support 100 percent of specified court functions. Total state funding, however, would still have to be within the state's funding percentage. Future state funding would support additional functions each year as the state increased its share of trial court operating costs.

Legislature Should Consider Objectives in Developing a Distribution Formula. Ultimately, the Legislature will need to develop a specific methodology for distributing the trial court monies, either through the annual Budget Act or in separate legislation.

In considering how to distribute the funds, the Legislature should attempt to link the distribution to the objectives of the realignment. For example, in order to ensure access to and uniformity of justice, the Legislature may wish to provide funds to cover a minimal level of services to all counties.

In addition, the Legislature should pay particular attention to establishing incentives that will help meet the objectives of realignment. For example, the Legislature may wish to reward counties that are particularly successful at coordinating their operations and reducing case backlogs.

Management of Local Court Personnel

In addition to judges, trial courts employ thousands of nonjudicial personnel (such as attorneys, administrators, and clerical staff) to operate the court system. As the state takes on an increasingly larger percentage of total statewide operating costs for trial courts, it will have to address a number of issues regarding management and control of these personnel, including staffing levels, compensation, and workplace conditions.

It will be particularly important for the Legislature to link control of the court employees with funding. In the absence of such

a link, the state would be allowing a different level of government to set state funding priorities. For example, counties may have less incentive to manage salary and benefit levels for court employees as the state moves to support 70 percent of total court costs. The Legislature may need to consider a variety of options, such as specifying that salary and benefit increases be in line with similar increases provided to state employees.

Judicial Council to Report in July. The Legislature recognized the importance of these issues in Chapter 90 by requiring the Judicial Council to report to the Legislature by July 1, 1992, on the disposition of county employees currently employed in the trial courts.

Clarification of Judicial Roles

Our review indicates that some of the Legislature's purposes in enacting Chapter 90 (particularly improving access to and uniformity of justice) may be hindered by the existing roles of judicial officers in California.

Administrative Authority at the State Level is Limited. In order to fulfill the Legislature's objectives for realignment, some statewide oversight of trial courts is necessary. However, currently there is limited oversight and authority at the state level. Article VI of the California Constitution establishes the judicial authority for all trial courts judges and the method by which they are selected. Because trial court judges are elected by the voters within the jurisdictional boundaries of the court, judges have expressed a greater sense of responsibility and affinity to their constituents than to the state as a whole. This local tie also gives trial court judges a certain degree of freedom from legislative and judiciary intervention with respect to their respective court operations.

In addition, although the Chief Justice of the California Supreme Court is the state's chief judicial officer and chair of the Judicial Council, the Constitution provides only limited authority to the Chief Justice in the administration and operations of the trial courts. For example, the Chief Justice has no budgetary authority over trial courts.

In our view, in order for the Legislature to ensure the many purposes of the realignment are met, it may be necessary to provide additional authority for administration of trial courts at the state level. For instance, the Chief Justice or Judicial Council could be given additional authority to ensure that a single entity is ultimately responsible for implementing the coordination requirements.

Reforms May Blur Distinctions Between Trial Court Judges. Chapter 90 requires each court to submit to the Judicial Council a court coordination plan which considers a number of efficiencies, including the use of lower-level judges to hear and try matters, and the cross-assignment of judges to hear matters within the jurisdiction of another court. For example, this would allow municipal and justice court judges to hear and try felony cases that would normally be heard by a superior court judge.

If all trial court judges have the ability to do essentially the same work, distinctions of rank and status become blurred and the necessity for three levels of trial courts may cease to exist. As a result, the Legislature may need to consider whether the distinctions in status and rank of judicial officers are worth preserving.

CONCLUSION

Our analysis indicates that, although there have been implementation problems, the foundations have been laid for many of the reforms envisioned by the Legislature in the trial court funding realignment.

It seems clear that the realignment will fall short of one of its original objectives — helping close the 1991-92 budget gap. Due to revenue shortfalls, the net fiscal benefit from realignment will be much less than projected.

Although it is too early to determine whether the realignment will meet some of its other objectives, it is clear that the Legislature will need to consider and take action on a number of policy issues. The Judicial Council will provide the Legislature with several reports during the next year that should assist the Legislature in addressing these issues.
