THE 2003-04 BUDGET: PERSPECTIVES AND ISSUES

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

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INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2003-04 Budget Bill* and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 2003-04 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2003-04 Budget Bill,* which contains our review of the *2003-04 Governor's Budget*.

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

The 2003-04 Budget: Perspectives and Issues is divided into five parts:

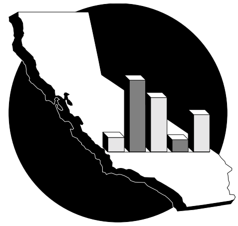
- Part One, "State Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part Two, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part Three, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2004-05.

- Part Four, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2003-04 and evaluates the major expenditure proposals in the budget.
- Part Five, "Addressing the State's Fiscal Problem," provides: (1) an analysis of the Governor's tax proposal including an identification of possible revenue alternatives for the Legislature's consideration, (2) an assessment of the role realignment could play in improving service delivery and addressing the state's budget difficulties, and (3) an identification of additional spending reduction options for addressing the state's budget shortfall.

I

State Fiscal Picture

State Fiscal Picture



California faces an unprecedented budget shortfall in 2003-04. This shortfall—which is roughly one-third of the General Fund budget—is due to an unexpected dramatic decline in state tax receipts combined with ongoing increases in state government costs. The Governor's budget proposal lays out a comprehensive plan for dealing with this enormous problem. The plan incorporates a variety of specific proposals, including tax increases, program realignment, deep spending cuts, and major reductions in local government subventions.

The actions proposed by the Governor reflect *his* priorities for dealing with the shortfall. In evaluating and acting on these proposals, the Legislature will be confronted with applying its *own* priorities to make fundamental decisions about the scope of government services; how these services are distributed among the citizenry; and what the nature, amount, and mix of taxes in California should be. Given the unprecedented scope of the problem, any budget that seriously addresses the budget imbalance will necessarily involve difficult choices that will likely affect all Californian's to one degree or another.

In this part, we summarize the *2003-04 Governor's Budget* proposal and present our own perspective on the budget outlook. We then discuss key considerations that the Legislature may wish to take into account as it develops its own priorities for dealing with the state's fiscal problem.

THE BUDGET'S ECONOMIC AND REVENUE OUTLOOK

The budget's economic and revenue outlook is down sharply from the *2002-03 Budget Act* estimates. The new projections reflect the persistent softness in U.S. and California economic activity and the associated weakness in General Fund revenues through the end of 2002. The budget forecast assumes that economic softness will continue throughout much of 2003, with California personal income—a key determinant of state revenues—growing by just 3.3 percent this year, before accelerating to a more moderate pace of 5.3 percent in 2004. Based on this subdued economic forecast, the budget assumes that General Fund revenues will grow from $72.2 billion in 2001-02 to $73.1 billion in 2002-03, before falling to $69.2 billion in 2003-04. After excluding the numerous one-time revenue changes involved in both the prior and current years, underlying revenue growth is forecast to be sub par—just 1.4 percent in 2002-03 and only 2 percent in 2003-04.

THE BUDGET PROPOSAL

Total State Spending

The budget proposes total state spending in 2003-04 of $89.2 billion (excluding expenditures of federal funds and bond funds). This represents a decrease of 5.7 percent from 2002-03. General Fund spending is projected to fall from $75.5 billion in the current year to $62.8 billion in the budget year, while special funds spending will rise from $19.2 billion in 2002-03 to $26.5 billion in 2003-04. These totals reflect the proposed $8.2 billion realignment program and elimination of the current base vehicle license fee (VLF) backfill to localities, as discussed below.

General Fund Condition

Figure 1 shows the General Fund's condition under the budget's assumptions and proposals. It indicates that:

- *Revenues* are projected to fall from $73.1 billion in 2002-03 to $69.2 billion in 2003-04, a decline of 5.5 percent. This decline is due to weak underlying growth in revenues from major taxes, and the large amount of one-time receipts in 2002-03 from tobacco securitization and loans from special funds.

- *Expenditures* are projected to decline from $75.5 billion in 2002-03 to $62.8 billion in 2003-04, a drop of 16.8 percent. The decline reflects both major program reductions and the above-cited proposed program realignment to local governments.

- The large decline in expenditures results in an *operating surplus* (that is, revenues in excess of expenditures) of $6.5 billion in

2003-04. This causes the cumulative year-end reserve to increase from a minus $5.9 billion in 2002-03 to a positive $531 million in 2003-04.

Figure 1

Governor's Budget General Fund Condition

(Dollars in Millions)

	2001-02	2002-03	2003-04 Amount	2003-04 Percent Change
Prior-year fund balance	$2,380	-$2,133	-$4,451	
Revenues and transfers[a]	72,239	73,144	69,153	-5.5%
Total resources available	$74,618	$71,010	$64,702	
Expenditures	76,752	75,461	62,769	-16.8%
Ending fund balance	-$2,133	-$4,451	$1,933	
Encumbrances	1,402	1,402	1,402	
Reserve	-$3,535	-$5,853	$531	

[a] Reflects $6.2 billion loan repayment to the General Fund in 2001-02 from the Electric Power Fund.
Detail may not total due to rounding.

How the Budget Addresses the Shortfall

The administration has identified a budget problem of $34.6 billion in 2003-04. As we indicated in January, we believe that the administration has somewhat overstated the problem facing the state, primarily because its baseline expenditure estimate includes spending for education and other areas that is above what would be required under current law or current practices. (As we also have noted, these added baseline costs do not diminish the need for real solutions necessary to bring the budget into balance. Instead, they result in differences in the scoring of the size of the problem and the corresponding size of the budget solutions that are embedded in the budget's proposals.)

However, using for the moment the administration's definition of the budget problem and its corresponding size of the solutions needed, Figure 2 (see next page) shows how the Governor's solutions are distributed among major categories and by fiscal year.

It indicates that, of the total solutions, roughly 40 percent are related to program savings; slightly less than one-fourth are related to realignment; about one-sixth are related to a shift of local government resources to the state; and the remaining one-fifth is split between fund shifts, transfers / other revenues, and loans / borrowing. Regarding each of these major categories:

Figure 2

Allocation of Governor's Proposed Budget Solutions[a]

(Dollars in Billions)

			Two-Year Total	
	2002-03	**2003-04**	**Amount**	**Percent of Total**
Program savings	$2.7	$11.0	$13.7	40%
Realignment	—	8.2	8.2	24
Shifts to local governments	1.8	3.3	5.1	15
Other fund shifts	0.8	1.4	2.2	6
Transfers/other revenues	0.2	1.9	2.1	6
Loans/borrowing[b]	—	3.3	3.3	9
Totals	**$5.5**	**$29.1**	**$34.6**	**100%**

a LAO categorization of solutions using administration's problem definition.

b The loans/borrowing category includes $25 million in 2002-03.

Detail may not total due to rounding.

- ***Program Savings.*** The budget contains approximately $13.7 billion in program savings. This includes $2.7 billion in current-year reductions (mostly in K-14 Proposition 98 spending) and $11 billion in savings in 2003-04. Most programmatic areas of the budget are affected.
- ***Realignment.*** The budget would raise a net of $8.2 billion in new taxes to fund the shift of a like amount of primarily health and social services responsibilities to local governments. The tax increases consist of (1) a 1 percent increase in the sales and use tax (SUT), (2) the imposition of 10 percent and 11 percent personal income tax (PIT) marginal rates on the earnings of high-income taxpayers, and (3) a $1.10 per-pack increase in the state cigarette tax rate.
- ***Local Government Reductions.*** Aside from the realignment proposal (which is intended to balance estimated expenditure responsibilities with new resources in 2003-04), the budget shifts $5.1 billion in resources away from local governments in order to produce

General Fund savings. Key components of this shift include (1) the elimination of about three-fourths of the subventions to backfill the VLF revenue losses sustained by localities when the VLF rate was lowered in past years, (2) a shift of redevelopment-related funds from local governments to schools, and (3) the elimination of open-space subventions and booking fee reimbursements. These amounts do not include the non-Proposition 98 mandate deferrals which, as noted below, we are classifying as loans / borrowing.

- ***Funding Shifts***. These total $2.2 billion and include (1) student fee increases in all three of the higher education segments, (2) other fee increases for trial courts and various resources programs, and (3) use of federal funds to support some child-care costs.
- ***Transfers and Other Revenues.*** These account for $2.1 billion in revenues. The major component is $1.5 billion in new revenues associated with tribal gaming pacts, which are up for renegotiation in March 2003. This category also includes about $95 million in General Fund revenues from tax proposals involving the eligibility for the investment tax credit and taxation of regulated investment companies.
- ***Loans and Borrowing.*** This category accounts for $3.3 billion of total budget solutions. The largest components are the deferral of local government and education mandates, and the deferral of contribution costs to the state's pension funds (either through direct loans from the funds or the issuance of some sort of pension obligation bonds).

Program Savings Overstated. As noted above, we believe that the budget overstates both baseline costs and budget program savings in various areas of the budget. Adopting our definition of baseline costs would reduce both the size of the budget problem and the corresponding value of the solutions shown in Figure 2 by roughly $5.5 billion. The main area affected in Figure 2 by this adjustment is the program savings category, which would fall by approximately $4 billion. The effect of this change would be to reduce the proportion of the total budget solution due to program savings from about 40 percent to roughly one-third, with the other components' shares increasing commensurately.

Programmatic Features

Figure 3 (see next page) summarizes the budget proposal's main programmatic features. Its specific proposals are discussed in more detail in "Part IV" and in our *2003-04 Analysis of the Budget Bill*.

Figure 3

Main Programmatic Features of 2003-04 Budget

- ✓ ***Taxes/Realignment.*** Proposes a net $8.2 billion of new taxes to fund program realignment to local governments.
- ✓ ***K-12 Education.*** Includes about $2.6 billion in mostly across-the-board reductions to current-year programs, which are largely carried forward into budget year.
- ✓ ***Higher Education.*** Assumes student fee increases for all three segments. Total funding up modestly for CSU and UC, but down for community colleges.
- ✓ ***Health.*** Proposes savings from provider rate reductions, elimination of optional benefits, and tightening of eligibility.
- ✓ ***Social Services.*** Reduces CalWORKs and SSI/SSP grants by an average of 6.2 percent.
- ✓ ***Transportation.*** Suspends Proposition 42 transfers and forgives General Fund loan repayments to the Traffic Congestion Relief Fund.
- ✓ ***Local Government.*** Eliminates base VLF backfill to local governments, defers mandate reimbursements, and shifts property taxes from redevelopment funds to schools.
- ✓ ***General Government.*** Borrows funding for $1.6 billion annual contribution to retirement funds. Proposes $470 million savings from employee compensation. Assumes $1.5 billion in new tribal gaming revenues from new/renegotiated compacts.

THE LAO'S BUDGET OUTLOOK

In this section, we examine the implications of the Governor's proposal on the near-term and longer-term General Fund condition, using our own estimates of revenues and expenditures that would occur under the Governor's proposal. Our estimates do not reflect any of the programmatic recommendations that we make in our *2003-04 Analysis of the Budget Bill*. Nor do they take into account legislative actions that have been taken to date on the budget. The causes of our differences from the budget's projections are limited to (1) contrasting assumptions about the economic and revenue outlook; and (2) estimation differences, such as from caseload projections, in the level of expenditures that would be needed to fund the Governor's budget plan.

The intent of these estimates is to provide the Legislature with our assessment of the extent to which the budget solutions proposed by the Governor address the full magnitude of the short-term and longer-term fiscal imbalance facing the state. Our key budget-related findings are highlighted in Figure 4, while our estimates of revenues, expenditures, and the General Fund's condition are shown in Figure 5 (see next page).

Figure 4

Key LAO Findings

✓ **If Fully Adopted, Governor's Budget Is Balanced**

- Our estimates suggest a $1.6 billion 2003-04 reserve would result, largely because of higher LAO budget-year revenues.
- Shortfalls in tribal gaming revenues, federal reimbursements, or other factors could eliminate most or all of reserve.

✓ **Proposal Would Also Address Long-Term Structural Imbalance**

- Revenues and expenditures would roughly balance in 2004-05.

✓ **But Balance Only Achieved if Dramatic Actions Are Taken**

- Requires benefits from all elements of plan to regain fiscal balance, or need alternative solutions of similar magnitude.
- Fiscal situation quickly deteriorates without agreement on key budget elements.

Budget Plan Would Balance

As shown in Figure 4 and Figure 5, we estimate that adoption of *all* of the budget's provisions and proposals would result in a positive reserve of about $1.6 billion at the conclusion of 2003-04. This reserve amount is about $1 billion higher than the $531 million included in the Governor's budget. The increase is due to our higher revenues, partly offset by the additional spending requirements that we believe would be needed to fund the Governor's plan.

- ***Higher Revenues***. Despite current-year softness in PIT receipts, we project that General Fund revenues will exceed the budget forecast by $1.3 billion over the current and budget years combined. Our forecast assumes that an earlier and stronger economic accelera-

Figure 5

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

(Dollars in Millions)

	2001-02	2002-03	2003-04	2004-05
Prior-year fund balance	$2,380	-$2,135	-$4,490	$2,967
Revenues and transfers[a]	72,239	72,964	70,643	73,293
Total resources available	$74,618	$70,829	$66,154	$76,260
Expenditures	$76,754	$75,318	$63,186	$72,562
Ending fund balance	-$2,135	-$4,490	$2,967	$3,698
Encumbrances	$1,402	$1,402	$1,402	$1,402
Reserve	**-$3,537**	**-$5,891**	**$1,565**	**$2,296**

[a] Reflects $6.2 billion loan repayment to General Fund in 2001-02 from the Electric Power Fund.

Detail may not total due to rounding.

tion in California will produce more revenue growth in 2003-04 than the administration is anticipating.

- ***Additional Expenditures.*** Partly offsetting our higher revenues are about $273 million in net added costs that we believe are needed to fund the Governor's proposal. This increase primarily reflects added General Fund costs needed to fund proposed spending in the Healthy Families program, likely cost deficiencies in the California Department of Corrections, and added cash-flow borrowing expenses.

Many Threats Exist

There are a number of key risk factors that could easily consume the total $1.6 billion year-end cushion that we are projecting for 2003-04. For example, our estimates include the budget's assumption of $1.5 billion in new tribal gaming revenues. The amount of these revenues, however, is dependent on the outcome of negotiations with the Indian tribes involved, and early indications are that it is unlikely that the state would achieve the targeted amount of revenues.

Similarly, while the budget does not rely on significant amounts of *new* federal funds, it nevertheless faces risks associated with its assumptions about the continuation of *existing* federal reimbursements. Specifically, the budget includes $155 million in both the current year and budget year in federal reimbursements for costs associated with the incarceration of undocumented felons. While this is consistent with prior-year funding levels, *neither* the President's budget for the current or subsequent federal fiscal year *nor* the Congressional versions of the 2003 federal spending bill include funding for this purpose.

Just these two factors could easily consume our estimated $1.6 billion budget-year reserve—even if all the budget's provisions were adopted.

Governor's Plan Would Also Address State's Structural Imbalance . . .

We believe that the Governor's budget plan—to the extent its assumptions and proposals are realized—would meaningfully address the longer-term structural shortfall facing the state. Based on current law, we believe this structural imbalance—defined as the annual excess of expenditures over revenues—would likely be in the general range of $18 billion yearly. In contrast, as indicated in Figure 6, we estimate that under the budget proposal, revenues would slightly exceed expenditures in 2004-05, boosting the cumulative reserve at the end of that year to $2.3 billion. Our longer-term projections further suggest that revenues would continue to exceed expenditures in subsequent years. Thus, the structural imbalance would be gone.

The favorable impact of the plan on the state's structural shortfall results from the fact that most of the budget's major proposals involving education, health, social services, realignment, and local governments, would produce *ongoing* savings.

. . . But Only if Major Actions Are Taken

Our fiscal estimates do not imply that it will be easy for the state to regain fiscal balance in 2003-04 and beyond. On the contrary, a restoration of California's fiscal health will occur only if the Legislature either (1) adopts the major savings and revenue proposals included in the budget plan or (2) finds alternative solutions of similar magnitude that are real and largely ongoing in nature. Absent this, the modest positive fiscal balance we are projecting would be quickly transformed into a large deficit.

Illustration. Figure 6 (see next page) demonstrates the cumulative adverse impact that the rejection of two key administration proposals would have on the state's fiscal picture—if they were not replaced with alternative solutions of similar magnitude. For example:

- Rejection of the proposal to eliminate the base VLF local backfill would result in lost annual savings of $1.3 billion in 2002-03, $2.9 billion in 2003-04, and $3 billion in 2004-05. The figure shows that the cumulative impact of these lost savings would be a $4.2 billion deterioration in the cumulative reserve by the end of the budget year, and a $7.2 billion deterioration by the close of 2004-05.

Figure 6

Illustrative General Fund Impacts of Rejecting VLF Backfill and Realignment Proposals[a]

(In Billions)

	2002-03	2003-04	2004-05
LAO Estimated General Fund Reserve Assuming All Budget Proposals	-$5.9	$1.6	$2.3
Change to LAO Estimated General Fund Reserve From Rejecting:			
VLF backfill proposal	-$1.3	-$4.2[a]	-$7.2[a]
Realignment proposal	—	-8.2[a]	-15.9[a]
Revised LAO Estimated General Fund Reserve Without VLF Backfill And Realignment Proposals	-$7.2	-$10.8	-$20.8

a These reflect the cumulative effects of rejecting the Governor's proposals.

- Rejection of the realignment-related tax increases and the accompanying shift of program responsibilities to localities would reduce annual state budgetary savings by about $8 billion beginning in 2003-04. The figure shows that this would lead to a two-year deterioration in the reserve of nearly $15.9 billion by the end of 2004-05.

The figure shows that the rejection of both of these proposals would transform the projected $2.3 billion 2004-05 reserve into a $20.8 billion deficit.

Rejection of other key savings proposals in the areas of Medi-Cal, social services, or transportation, would also have major adverse impacts on the reserve.

CONSIDERATIONS FOR THE LEGISLATURE

Given the enormity of the budget problem and the large number of major proposed solutions included in the Governor's plan, the Legislature will be faced with many important policy issues and questions as it considers the 2003-04 budget. Among the more important of these are the following:

- ***How Do the Proposal's Spending Priorities Square With the Legislature's?*** In general, the budget's deepest cuts are in local government, K-12 education, community colleges, Medi-Cal, SSI/SSP, and CalWORKs. At the other extreme, only modest reductions are included for criminal justice programs, UC, and CSU. In considering current-year actions on the budget, the Legislature has already indicated its intent to include reductions in corrections. In our accompanying *2003-04 Analysis of the Budget Bill*, and in "Part V" of this volume, we offer recommendations and options that the Legislature may wish to consider in addressing the budget problem.

- ***Is the General Nature, Overall Amount, and Distribution of the Proposed Tax Increases Appropriate?*** Roughly one-fourth to one-third of the Governor's proposed budget solutions are related to increased taxes (depending on how the budget problem is defined). The basic questions in this area include whether the aggregate amount and mix of taxes proposed are appropriate. We discuss the Governor's tax proposals in detail in "Part V."

- ***Can Local Governments Realistically Absorb a $5 Billion Funding Reduction?*** The Governor's proposals to eliminate the base VLF backfill and transfer redevelopment funds to schools would have a significant adverse impact on many city and county services. This raises such issues as whether the Legislature should increase the VLF rate itself and/or provide localities with other options for raising revenues.

- ***What About Mandates?*** For the second year in a row, the budget would defer state payments for local government mandate claims. The accumulated liability for such claims now exceeds $1 billion. As discussed in "Part V" and in various sections of the *Analysis*, the Legislature may wish to consider alternatives to mandate deferrals, including the outright elimination or suspension of certain mandates, and the inclusion of education mandate funding in a block grant.

- ***Does the Governor's Realignment Proposal Make Sense?*** In evaluating the administration's realignment proposal, the Legislature may wish to consider such issues as: (1) will counties have sufficient program authority and flexibility to effectively and efficiently manage their new responsibilities; (2) would other programs benefit from realignment, either in lieu of or in addition to those being proposed; and (3) will the realignment revenue stream match future growth in program costs? In "Part V" we review the Governor's realignment proposal in more detail, and suggest other programs that the Legislature may wish to include in a realignment plan.

- ***What Are the Long-Term Budgetary Implications of Alternatives?*** As indicated above, we believe that the Governor's budget proposal would address the state's current multibillion dollar long-term structural fiscal imbalance, assuming that it was fully implemented and its assumptions held up. As the Legislature considers modifications and alternatives to the Governor's proposal, it will be important that it try to avoid diminishing the long-term fiscal benefits that are inherent in the current proposal.

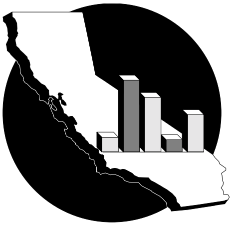
Conclusion

The state clearly faces an enormous challenge in getting its fiscal house in order. We therefore continue to recommend that the Legislature put everything "on the table" including both program reductions and taxes, and adopt solutions that are both real and ongoing.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics



THE ECONOMIC OUTLOOK—SUMMARY

Most areas of the U.S. and California economies are struggling in early 2003. Although there have been some positive developments—namely, strength in interest-sensitive home and automobile sales—overall economic growth has subsided in recent months, and is currently at risk of stalling out altogether. At present, consumer and business spending are being held in check by lagging confidence and uncertainties surrounding a potential war with Iraq. Looking ahead, we anticipate sluggish economic performance to continue through the first half of 2003, before giving way to more moderate growth in the second half of the year. A key to improved economic performance is business capital spending and hiring, which have been extremely soft during the past two years.

2002 IN RETROSPECT

U.S. Economy

The performance of the U.S. economy was generally disappointing in 2002. Although the year began on an upbeat note and real gross domestic product (GDP) did expand by 2.8 percent over the 12-month period, growth was unbalanced between major economic sectors, and the gains that did occur were insufficient to produce an improvement in employment and wages during the year.

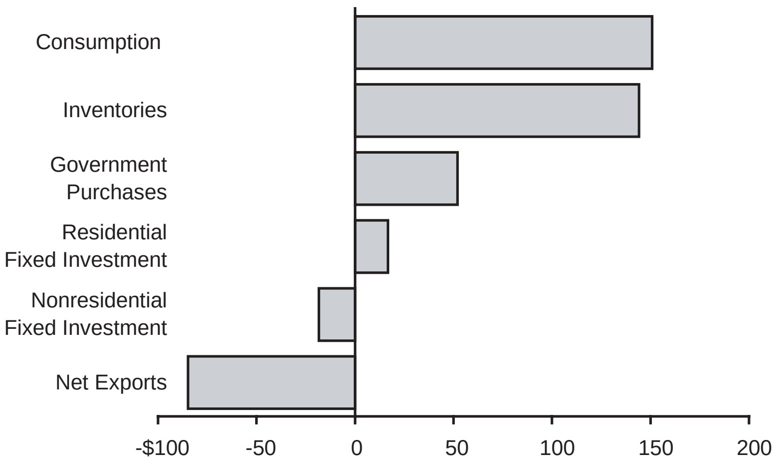
Unbalanced Growth

Figure 1 shows that virtually all of the economic growth that did materialize came from consumer spending, inventory restocking, and government purchases. Nonresidential fixed investment—which includes business spending on equipment, software, and facilities—and net exports *fell* during the year. The declines in these two latter sectors were of particular importance to California, whose manufacturing and business services industries are dependent on business investment and foreign demand.

Figure 1

Factors Underlying Modest GDP Growth in 2002

Change in Components of Real GDP
Fourth Quarter 2001 Through Fourth Quarter 2002
(In Billions)



Jobless Recovery Thus Far

The growth in output that occurred in 2002 was largely accomplished through increased worker productivity and extended hours, as opposed to increases in the number of jobs. In fact, the nation lost about 180,000 jobs between December 2001 and December 2002, as businesses cut back payrolls in an effort to eliminate excess capacity, curtail costs, and boost profits. These economizing measures have had a positive effect on businesses' "bottom lines." For example, earnings reports for the fourth quarter show significant profit gains from the prior year. However, especially in a state with California's continuously expanding population, the key to healthy economic growth involves increases in productive capacity, output, and jobs. Absent an improvement in the job market, it is unclear how much longer consumer spending on homes, cars, and other durable goods will be buoyed by low interest rates. The lack of consumer demand could, in turn, further delay any meaningful pick up in business investment. Given this, our expectation that there will be an improvement in business hiring and capital spending during 2003 and 2004 is an important element of our forecast.

California's Economy

Like the nation's, California's economy struggled in 2002. Wage and salary employment grew a marginal 0.3 percent between December 2001 and December 2002, with widely divergent performances among both industries and geographical regions within the state. The main bright spot has been housing construction, which strengthened during the year.

Divergence Among Industries

As indicated in Figure 2 (see next page), job gains occurred in industrial sectors that particularly benefited from population growth and low interest rates. These included nonbusiness services, retail trade, government, and finance-related industries. Losses occurred in construction—mostly related to declines in the nonresidential markets—as well as in business services, transportation (reflecting continued layoffs in airline-related industries), and manufacturing. The latter was battered by weak U.S. investment spending and declines in foreign demand for California-produced goods.

Manufacturing Job Losses Were Severe. As shown in Figure 3 (see next page), California's manufacturing sector lost over 250,000 jobs between early 2000 and the end of 2002. About one-half of these jobs were in high-paying computer-related industries, which were adversely affected by the downturn in U.S. capital spending and ongoing softness in exports. Computer-related services also experienced a major downturn, losing more than 60,000 jobs over the past two years. The job declines in these industries are of special significance, given that their wage levels tend to be well above those of other sectors of the economy (see Figure 4, see next page). On a slightly more positive note, however, both manufacturing and computer-related services job losses have subsided in recent months, and industry reports show an uptick in orders for computer chips. These reports provide tentative evidence that the worst of the manufacturing slump is over.

Figure 2

California's Job-Gaining and Job-Losing Industries in 2002

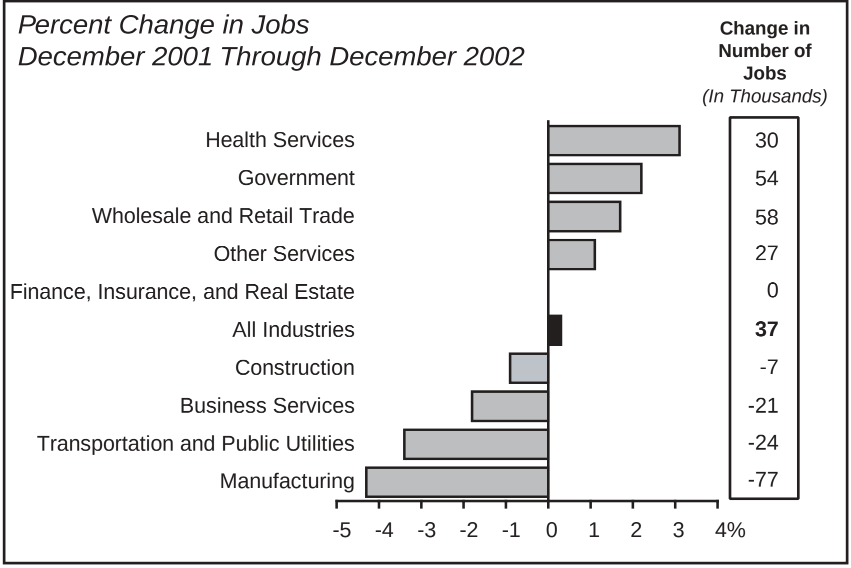


Figure 3

California Manufacturing Jobs Hit Hard By Economic Slowdown

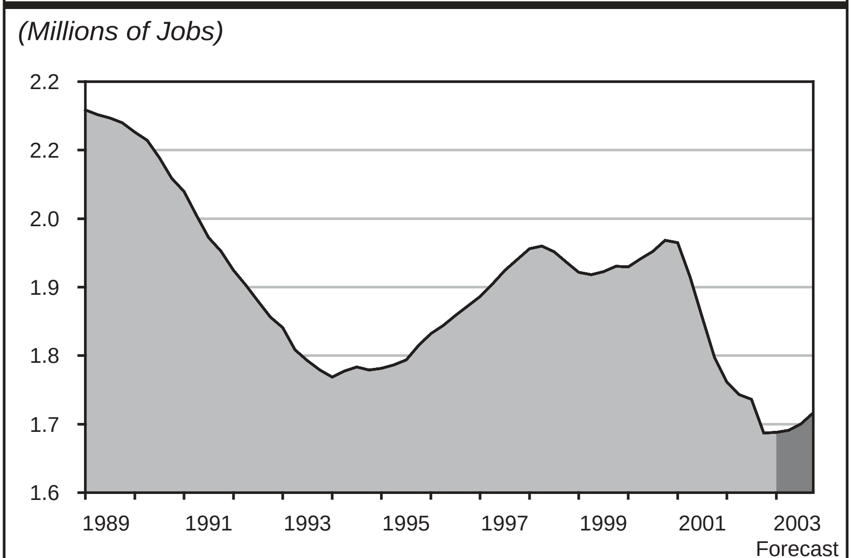
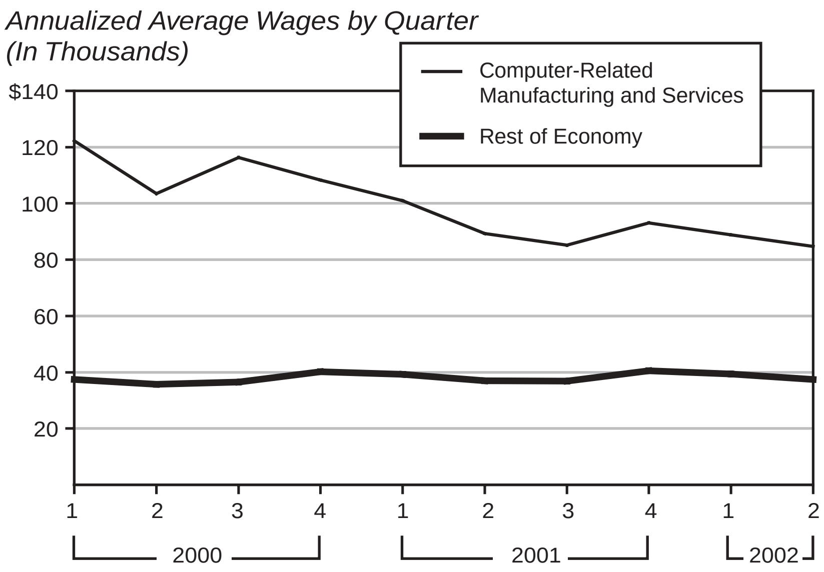


Figure 4

California High-Tech Wages Falling Dramatically



Pay In High-Tech Jobs Also Down. Along with job losses, Figure 4 shows that average wages within the high-tech manufacturing and services industries have also experienced major declines over the past two years. These losses are partly related to a nearly 80 percent slide in stock option-related income and bonuses (which are included in the wage totals). Figure 4 shows that average wages within the computer-related manufacturing and services industries fell from a peak of $120,000 (annual rate) in the first quarter of 2000 to about $80,000 as of mid-2000. While the average wages in these industries remain over double the statewide average, the nearly one-third average wage decline in these sectors has sharply depressed overall California income growth during the year. Given the continued poor performance of the stock market, it is unlikely that average wages in these industries will recover any time soon.

Divergence Among Regions

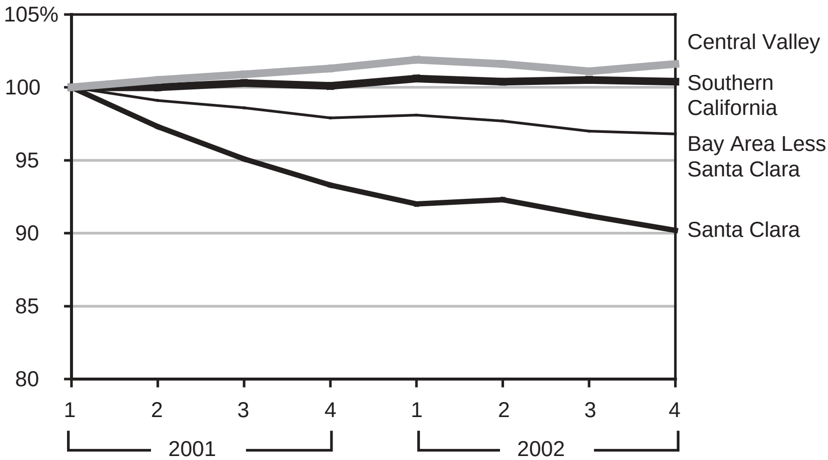
In sharp contrast to the early 1990s, when the recession was centered in southern California, the current economic slowdown is focused in the San Francisco Bay area. This is illustrated in Figure 5 (see next page), which expresses jobs in each geographic region as a percentage of their first quarter 2001 totals (which is when the national recession began). It shows that:

- The overall impact of the statewide slowdown on jobs in southern California and the Central Valley region has been comparatively moderate. As shown in the figure, both of these regions have experienced modest job growth since early 2001, although not enough to avoid increases in unemployment.
- In contrast, the San Francisco Bay area has experienced major job losses, with Santa Clara County having lost over 10 percent of its job base. These job losses reflect the massive adverse impact that the high-tech downturn has had on employment and income in the region.

Figure 5

Recession Has Been Concentrated In the San Francisco Bay Area

Wage and Salary Jobs, Percent of Prerecession Peak



Softness Persists Into Early 2003

As of early 2003, most evidence suggests that California, like the nation, is in a period of very sluggish growth that is likely to persist for several months. While residential real estate markets remain strong, employment, income, and spending remain soft, as do most other areas of the economy.

THE GOVERNOR'S ECONOMIC FORECAST IN BRIEF

The Governor's budget assumes that both the U.S. and California economies will expand at a sluggish pace throughout most of 2003, before accelerating in 2004. At the national level, real GDP is projected to increase by 2.5 percent in 2003—about the same pace as last year—and by 3.5 percent in 2004 (see Figure 6). Key assumptions in the forecast are that (1) U.S. consumer spending growth will subside to 2 percent in 2003, before partially rebounding to about 3 percent in 2004, and (2) business capital spending will remain dormant throughout most of this year, before reviving to a moderate pace in 2004. The forecast assumes that interest rates and inflation will rise some from current levels, but will remain low by historical standards.

Figure 6

Summary of the Budget's Economic Outlook

		Forecast	
	2002	**2003**	**2004**
U.S. Forecast			
Percent change in:			
Real GDP	2.3%	2.5%	3.5%
Personal income	3.0	4.1	5.4
Wage and salary employment	-0.8	0.9	2.1
Consumer Price Index	1.6	2.5	2.4
Unemployment rate (%)	5.8	6.0	5.5
Housing starts (000)	1,691	1,570	1,660
California Forecast			
Percent change in:			
Personal income	0.9%	3.3%	5.3%
Wage and salary employment	-0.7	0.7	2.1
Taxable sales	-2.2	3.4	5.6
Consumer Price Index	2.5	2.8	3.2
Unemployment rate (%)	6.4	6.5	6.2
New housing permits (000)	159	157	162

The administration's forecast assumes that California's economic performance will parallel that of the nation as a whole—with sluggish employment and income growth this year, and moderate growth next year. State personal income is projected to increase by an estimated 3.3 percent in 2003 before mildly accelerating to a 5.3 percent pace in 2004.

The LAO's Economic Outlook

Our forecast assumes that the current period of sluggish economic growth will persist until mid-year, before improving in the second half of 2003 and in 2004. While our updated outlook is more conservative than our November 2002 projection, it nevertheless remains a bit more positive than the administration's January budget forecast—reflecting an earlier and stronger acceleration in economic activity.

U.S. Outlook

As shown in Figure 7, we project that real GDP will expand by 2.6 percent in the current year and by 3.8 percent in 2004. This forecast is predicated on the assumptions that (1) consumer spending will remain on an upward track, and (2) business investment and hiring will gain momentum in the second half of 2003 and accelerate further in 2004.

Consumer Spending

Despite a disappointing holiday shopping season, consumer spending held up reasonably well in 2002. This is especially the case given the loss of jobs and the weak income growth that persisted through the year. The primary force behind spending growth was low interest rates, which boosted sales of automobiles, houses, and related big-ticket items such as large appliances. While these factors will help keep spending on an upward track during 2003, it is unlikely that consumption will regain significant momentum until late in the year when more fundamental improvements in employment and income take hold.

Business Investment

A key to achieving improved economy-wide income and job growth—and thus the hoped-for improvement in consumer spending—is stepped-up hiring and capital spending by businesses. Normally, investment spending turns up sharply in an economic recovery, as businesses seek to expand capacity to meet new demand. However, businesses remained reluctant to step up spending in 2002. Factors cited by business executives for such limited investment spending include significant over-capacity in many industries and, more recently, uncertainties concerning the timing and consequences of a Middle Eastern conflict.

Figure 7

Summary of the LAO's Economic Outlook

		Forecast		
	2002	**2003**	**2004**	**2005**
U.S. Forecast				
Percent change in:				
Real GDP	2.4%	2.6%	3.8%	3.3%
Personal income	3.0	4.8	6.3	5.6
Wage and salary employment	-1.0	0.5	2.3	1.9
Consumer Price Index	1.6	2.3	2.4	2.6
Unemployment rate (%)	5.8	6.2	5.3	5.0
Housing starts (000)	1,691	1,564	1,641	1,668
California Forecast				
Percent change in:				
Personal income	1.0%	3.6%	6.5%	6.3%
Wage and salary employment	-0.6	0.8	2.5	2.6
Taxable sales	-1.5	3.6	6.5	6.0
Consumer Price Index	2.4	2.5	2.7	2.9
Unemployment rate (%)	6.5	6.6	5.7	5.5
New housing permits (000)	164	174	176	190

Several key factors favor an eventual upturn in capital spending. For example, investment spending relative to GDP is currently at historically low levels, and many businesses have not upgraded their major information technology (IT) systems since late 1999 (in preparation for Y-2K). However, these positive forces will not take hold until some of the near-term uncertainty clears up, and business executives regain a greater degree of confidence in the economy.

Our forecast assumes that business spending on equipment will start to improve in the second half of this year, as uncertainties about war and the durability of the expansion subside. Regarding investment in facilities, we are projecting that this will turn upward in 2004, as the rate of capacity utilization recovers. As discussed below, the timing and strength of the capital spending recovery is the single largest "wild card" in the current economic outlook.

California Outlook

We forecast that California's economy will continue to struggle in the first half of 2003, as ongoing softness in national investment spending and exports depress the state's manufacturing industries. Then, we expect that economic growth will turn upward in the second half of the year and further accelerate in 2004. Our forecast assumes that the manufacturing slump will bottom out in the first half of this year, and that the interest-sensitive housing and finance-related sectors will continue to push the economy upward.

California's Income Growth to Eventually Overtake Nation

Historically, California's employment and income growth has outpaced the nation, reflecting the state's relatively faster population growth and its large share of fast-growing, high-tech industries. However, during the past two years, its personal income growth fell well below the nation's, due to the sharp cyclical downturn in computer and software employment, and the major drop in stock-option income. As shown in Figure 8, our forecast assumes that California personal income growth will once again lag the nation in 2003, but will overtake it in the subsequent two years, as improvement in business capital spending results in added jobs and income in California's high-tech industries.

Residential Construction to Remain Relatively Strong . . .

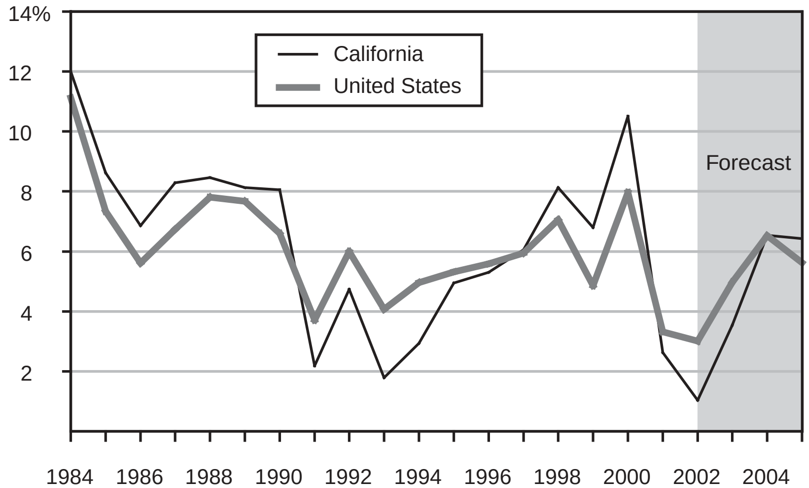
California's residential construction activity was up considerably in 2002. New building permits were issued at an annual rate of about 180,000 units in the final quarter of the year—the highest level since the first quarter of 1990. Single-family housing permits were up in almost all geographic regions of the state, with particularly large gains experienced in the Sacramento and Riverside / San Bernardino regions. Multi-family permits were also up in most regions other than the San Francisco Bay area, with Los Angeles experiencing particularly large gains.

We are forecasting residential permit activity to drop back some from its fourth quarter levels (in part because we understand that some of the fourth quarter activity may have been an acceleration to avoid scheduled permit-related fee increases in some geographic areas of the state). However, we still expect this sector to remain relatively strong though 2003 and 2004, reflecting low interest rates and continued population growth in California.

Figure 8

California Personal Income Growth To Slowly Recover

Annual Percent Change in Personal Income



. . . But Nonresidential Construction to Lag

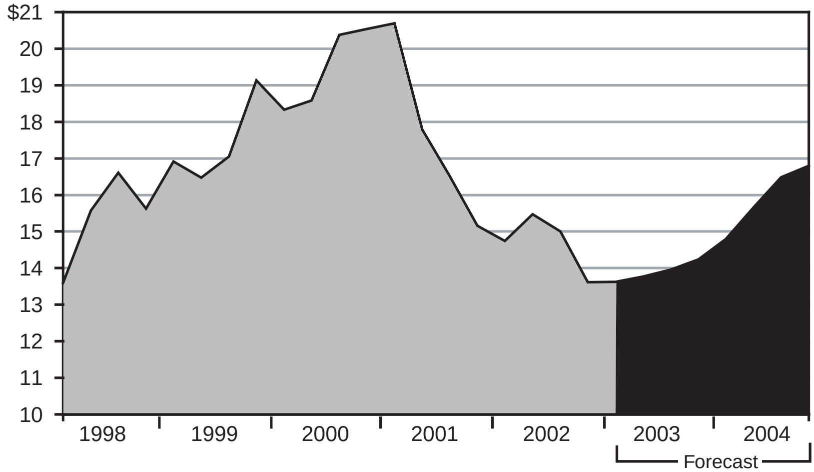
In contrast to residential construction, nonresidential construction fell in both 2001 and 2002. As shown in Figure 9 (see next page), the total value of nonresidential permits has fallen by about 30 percent, or roughly $7 billion, from its 2000 peak of nearly $21 billion. This substantial overall decline reflects a major drop in office construction throughout the state, which in turn is due to rising office vacancy rates. It also reflects a major drop in industrial building in Silicon Valley, where new construction is only a small fraction of prior-year levels due to the battering the high-tech sector and its supplier industries have taken there.

We forecast that nonresidential construction will continue to lag in 2003, reflecting soft business conditions, before partially rebounding in 2004. Regarding the components of nonresidential construction, we expect commercial building to rebound beginning in late 2003, and industrial and office construction to start improving in 2004, as vacancy rates start falling and business once again starts adding to its available capacity.

Figure 9

California Nonresidential Construction To Pick Up in 2004

Value of Building Permits in 1996 Dollars (In Billions)



Comparison to Other Recent Economic Forecasts

Figure 10 compares our forecasts for the nation and California to our November 2002 forecast, as well as to a variety of other economic forecasts made in recent months. These include the projections made by the University of California, Los Angeles (UCLA) Business Forecasting Project in December 2002, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2003), the consensus outlook in the *Western Blue Chip Economic Forecasts* (February 2003), and the Governor's budget forecast.

It shows:

- Compared to the consensus of U.S. and California forecasters, we are forecasting less economic growth in 2003, but more growth in 2004. For example, we forecast that California personal income—a key determinant of state General Fund revenues—will expand by 3.6 percent this year and 6.5 percent in 2004. This compares to the consensus estimate of 4.3 percent for 2003 and 5.5 percent in 2004.
- Compared to the budget forecast and the UCLA December projections, our forecasts of both U.S. and California economic growth are slightly more positive in 2003 and significantly more positive in 2004.

Figure 10

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

	2002	2003	2004
United States Real GDP:			
LAO November	2.5%	2.6%	3.8%
UCLA December	2.4	2.5	3.5
DOF January	2.3	2.5	3.5
Blue Chip "Consensus"[b] January	2.4	2.8	3.6
LAO February	2.4	2.6	3.8
California Wage and Salary Jobs:			
LAO November	-0.8%	0.5%	2.4%
UCLA December	-0.2	0.7	2.2
DOF January	-0.7	0.7	2.1
Blue Chip "Consensus"[c] February	0.0	1.1	2.2
LAO February	-0.6	0.8	2.5
California Personal Income:			
LAO November	1.2%	4.0%	6.1%
UCLA December	1.1	3.4	5.3
DOF January	0.9	3.3	5.3
Blue Chip "Consensus" [c] February	1.9	4.3	5.5
LAO February	1.0	3.6	6.5
California Taxable Sales:			
LAO November	-1.4%	3.9%	6.2%
UCLA December	-3.3	4.1	6.1
DOF January	-2.2	3.4	5.6
Blue Chip "Consensus" [c] February	1.5	3.9	5.6
LAO February	-1.5	3.6	6.5

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

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

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

RISKS AND UNCERTAINTIES

The current economic outlook faces serious risks from a number of quarters. These include a protracted war and an associated spike in oil prices, further weakness in the European and Asian economies (which would have additional negative effects on U.S. net exports), and a further slump in the U.S. stock market (which would adversely impact U.S. consumer and business spending).

Even if the nation's economy avoids the above-mentioned pitfalls, however, there is still an inherent risk associated with our predicted improvement in business investment spending and related hiring. Continued weakness in this area would have direct adverse impacts on GDP growth and could also undercut consumer spending—the strength of which will depend increasingly on job growth and income gains over the next year.

THE DEMOGRAPHIC OUTLOOK

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

State Population to Approach 37 Million by 2005

Figure 11 summarizes our updated state demographic forecast. We project that California's total population will rise from an estimated 35.8 million in 2003 to 36.3 million in 2004 and 36.8 million in 2005. These population projections use as their starting point published 2000 Census data for California, and have *not* been adjusted to correct for issues related to potential undercounting (see discussion in shaded box, page 32).

Some Slowing Projected. The state's population is projected to grow at an average rate of about 1.4 percent annually over the next three years. This growth is slightly slower than that experienced in the latter part of the 1990s, reflecting both the dampening effects of a slower economy on net in-migration, as well as a continued decline in birth rates. Nevertheless, the state's projected growth rate still is well above the nation's current rate of about 1 percent annually.

In numeric terms, the number of new Californians being added each year—roughly 500,000—is well above the size of such cities as Long Beach, Oakland, and Fresno, and very similar to such states as Wyoming.

Figure 11

Summary of the LAO's California Demographic Forecast

(Population in Thousands)

	2003	2004	2005
Total Population (July 1 basis)	35,803	36,284	36,794
Changes in Population			
Natural change (births minus deaths)	261	266	270
Net in-migration (in-flows minus out-flows)	240	215	240
Total Changes	501	481	510
Percent Changes	1.42%	1.34%	1.40%

Population Growth Components

California's population growth can be broken down into two major components—*natural increase* (the excess of births over deaths) and *net in-migration* (persons moving into California from other states and countries, minus people leaving the state for other destinations). The population growth associated with natural increase accounts for just over one-half of California's projected annual growth over the forecast period, and is assumed to be fairly stable. Net in-migration accounts for the other half of the growth over the period, but varies with California's economic cycle.

Natural Increase. We project that the natural-increase component will contribute around 266,000 new Californians annually over the forecast period. This amount is slightly less than in the late 1990s due to the ongoing decline of birth rates being experienced by all ethnic groups. Despite declining birth rates, however, the natural-increase component is projected to grow slightly. This is due to significant growth in the female population of child-bearing age groups in faster-growing segments of the population, including Hispanic and Asian women.

Net In-Migration. We project that net in-migration will average roughly 232,000 annually over the next three years, or 34,000 less than the natural-increase component. The population growth associated with net in-migration is projected to decline in the near term, due to the economic slowdown. However, a modest rebound is forecast in 2005, reflecting the state's projected economic strengthening.

Roughly 95 percent of the state's net in-migration is associated with *foreign* in-migration. Foreign in-migration has remained relatively steady over the past decade and we expect similar levels in the near future, although some decline should result from the economy's sluggishness.

What Is the Latest on the Undercount Issue?

Background. For many years now, a major issue concerning the decennial census has been the size and distribution among states of the population "undercount" that occurs when the census is undertaken every ten years—that is, the number of individuals that are not counted through the traditional methods that the census uses. Because California's population includes many subgroups that are known to be particularly subject to being undercounted, the incorporation of accurate undercount figures into the census results would have significant beneficial implications for California, including the amount of federal funds that would be distributed to the state.

Adjusted Data Were Developed but Not Initially Released. Shortly after conducting the 2000 Census, the Census Bureau employed statistical methods to estimate the number of persons that census takers were unable to count via questionnaires or in-person visits. However, although the bureau did release an aggregate, national undercount figure, it elected not to use the adjusted data. In doing so, the bureau expressed concerns about imperfections in the sampling process. As a result, the bureau declined to publish adjusted numbers for states, counties, or cities.

Adjusted Data Were Then Released But Repudiated. Following numerous requests filed under the Freedom of Information Act, a federal court ordered the release of the adjusted data by the bureau, and the data were in fact made available in late 2002. In releasing the adjusted figures pursuant to the court order, the bureau noted that it has determined that its methodology dramatically *overstates* the number of individuals not picked up in the actual census count, and thus the adjusted total is no more accurate than the unadjusted data. The Department of Commerce (which oversees the Census Bureau) has taken the position these adjusted estimates should not be used for any purpose that legally requires use of data from the decennial census, and that it will not assist public or private entities in using or interpreting the adjusted

Regarding net *domestic* in-migration, this has historically fluctuated with California's economy. For example, California's early 1990s' recession resulted in negative net domestic in-migration, as more people were leaving the state than were moving in from other states. Similarly, we project that the current slowdown of the state's economy again will result in a decline in net domestic in-migration, especially in the very near

What Is the Latest on the Undercount Issue? *(continued)*

population numbers. At this point, the federal government is *not* using adjusted census data for distributing federal funds to states and localities.

What Do the Adjusted Data Show? The adjusted data that were released indicate that the 2000 census' national undercount was 3.2 million persons (1.2 percent of the total U.S. population), an improvement over the 1990 census' 4 million undercount (1.6 percent of the total). Likewise, according to the adjusted data, California's 2000 census undercount reportedly improved considerably from 1990. While California's undercount rate was 2.7 percent in 1990, it was just 1.5 percent in 2000. However, California's rate was still reportedly higher than the national rate as expected, given its population characteristics.

Not Having Accurate Demographic Data Hurts California. Because California is particularly vulnerable to undercounting, the use of unadjusted census data causes California to lose formula grant funding (the allocation of nearly $200 billion in federal formula grant funds to state and local governments depends on decennial census figures). Counties with high undercount rates are particularly disadvantaged. California counties thought to have undercount rates exceeding the national average include Alameda, Fresno, Kern, Los Angeles, Orange, San Bernardino, San Diego, San Francisco, and San Joaquin.

The use of inaccurate population figures also creates problems for the state in using demographic data to forecast such economic and fiscal variables as school populations, health and social services caseloads, infrastructure needs, available labor force, and housing needs.

So, Where Does This Leave Us? Despite the legitimate concerns about undercounting and California's predilection to being adversely affected by it, the allocation of federal funds continues to be based on the unadjusted data. Both public and private sector economists in the state, however, generally continue to rely on official census figures in their work, largely because better alternative comprehensive demographic data series are simply not available at this time.

term. However, net domestic in-migration should rebound somewhat in response to the economy's recovery, before tapering off to its projected long-term level.

Growth to Vary by Age Group

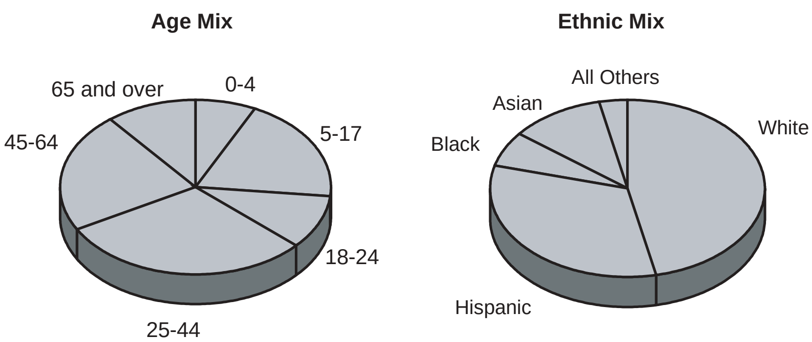
The implications of demographic trends for the budget depend not only on the total number of Californians, but also on their characteristics.

California is well known for having one of the world's most dynamic and diverse populations, including an increasingly rich ethnic mix; a large number of in-migrants; and a wide geographic dispersion encompassing highly urban, suburban, and rural lifestyles. The state's current age and ethnic mix is shown in Figure 12.

Figure 12

The Age and Ethnic Mix of Californians

July 1, 2003



Regarding ethnicity, we project a continuing trend toward increased diversity, as the whites' share drifts down and that for Hispanics and a wide variety of other ethnic groups rises. The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 13 shows our forecasts for both the percentage and numeric changes in different population groups. The 45-to-64 age group (baby boomers) continues to be the fastest growing segment of the population. About 890,000 new people are expected to move into this age category over the next three years, as the tail end of the baby-boom generation moves into its mid-40s.

Overall Budgetary Implications

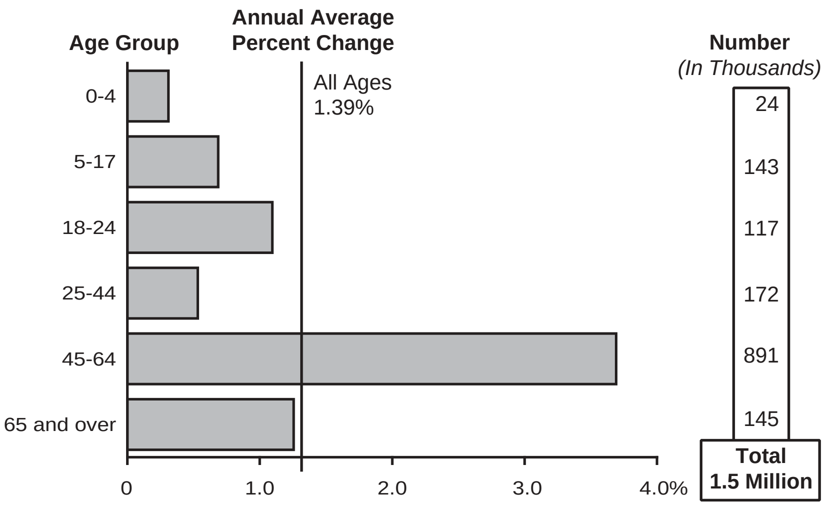
California's continued strong population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in 2003-04 and beyond. For example, strong growth of the 45-to-64 age group generally benefits tax revenues since this is the age category that normally earns the highest wages and salaries. The slowing growth in the 5-to-17 age group implies slower growth in K-12 school enrollments. More general examples of demographic influences include the following:

- Economic growth will benefit from an expanded labor force, due to a stronger consumer sector and the increased incomes that accompany job growth.
- However, overall demographic growth will also produce additional strains on the state's physical and environmental infrastructure, including demands on the energy sector, transportation systems, parks, and water-delivery systems.
- Growth in the young-adult population will place greater demand on higher education, job-training programs, and possibly the criminal justice and correctional systems.

Figure 13

Calfornia's Population Outlook by Age Group

Population Change 2002 Through 2005

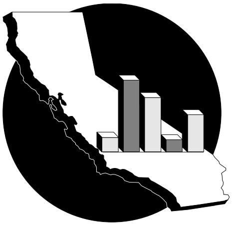


- Similarly, the "graying" of the baby boomers will place strains on the state's health programs and services, including Medi-Cal and long-term nursing care facilities.
- The increasing ethnic diversity of the state's population will also mean that many public institutions, especially schools, will serve a population that speaks a multitude of languages, and has a wide range of cultural backgrounds.

III

Perspectives on State Revenues

Perspectives on State Revenues



Recent Revenue Deterioration Has Been Unprecedented

As discussed in "Part I" of this volume, the precipitating factor behind the enormous fiscal imbalance currently facing California is the record postwar deterioration in state revenues that recently occurred. Revenue volatility is certainly nothing new to California, as it has accompanied essentially all of the state's past business cycles. What is unique abut California's most recent experience, however, has been the extreme nature of this volatility, with the state having experienced a truly unprecedented revenue cycle. This is illustrated in Figure 1 (see next page), which shows receipts from the state's three major taxes—the personal income tax (PIT), sales and use tax (SUT), and corporation tax (CT). These combined receipts rose at a modest pace in the early stages of the 1990s' expansion, accelerated late in the decade, then dropped by a staggering $13 billion between 2000-01 and 2001-02—primarily because of a 26 percent decline in PIT revenues. This deterioration reflects the effects of both the recession and the stock market's collapse.

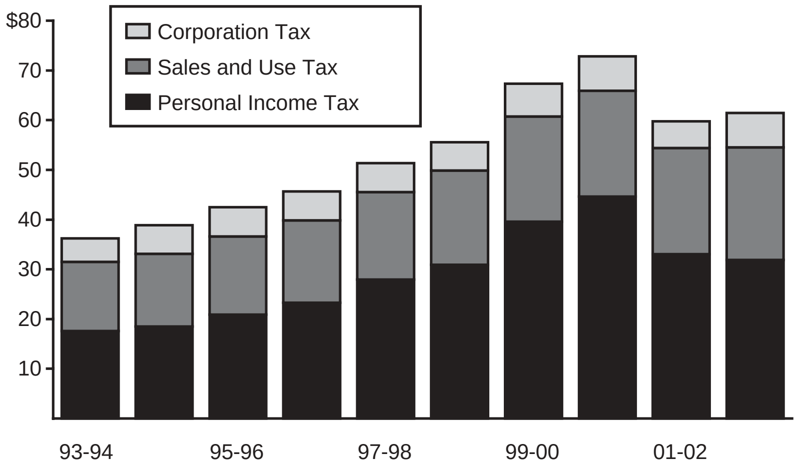
Revenue Outlook Is Key Factor in Addressing the Budget Shortfall

Just as recent revenue performance is the key factor explaining the budget shortfall's emergence, so too will future revenue performance be the key determinant of the amount of expenditure reductions, revenue augmentations, and other solutions necessary to balance the budget. Thus, in making its budget-related decisions, it is critical that the Legislature have available an accurate estimate of the amount of revenues the state can reasonably expect to receive over the next 18 months. Developing such an estimate is especially challenging at this time because the economy is still emerging from the recession, the stock market is still unsettled, and the possibility of war in the Middle East and other uncertainties cloud the outlook.

Figure 1

California's Dramatic Revenue Fall-Off

General Fund Revenues From Major Taxes (In Billions)



The remainder of this part provides background information relating to the revenue outlook, discusses recent revenue developments, summarizes the budget's revenue projections, and presents our own revenue forecast. Among the key questions considered are: (1) how much further might PIT receipts fall in the current year; (2) when will a meaningful, broad-based revenue rebound from all major tax sources begin; and (3) how strong will this bounce-back be?

THE BUDGET'S FORECAST FOR TOTAL STATE REVENUES

The *2003-04 Governor's Budget* projects that California state government will receive $96.1 billion in revenues during 2003-04, a 9.1 percent increase from the current year. These revenues are deposited into either the General Fund or a variety of special funds. Figure 2 shows that:

- ***General Fund Revenues.*** About 72 percent of total state revenue is deposited into the General Fund. These revenues are then allocated (largely through the annual budget process) for such programs as K-12 and higher education, health and social services, and criminal justice.

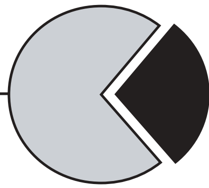
Figure 2

State Revenues in 2003-04

(In Billions)

Total State Revenues $96.1 Billion

General Fund Revenues	
Personal Income Tax	$33.6
Sales and Use Tax	23.2
Corporation Tax	6.4
All Other	6.0
Total	**$69.2**



Special Funds Revenues	
Proposed Realignment Revenues	$8.2[a]
Motor Vehicle-Related Taxes	7.6
Sales and Use Tax[b]	2.5
Tobacco-Related Taxes	2.0
All Other	6.7
Total	**$26.9**

Detail may not total due to rounding.

[a] Excludes $0.1 billion allocated to existing tobacco tax special funds.

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

- ***Special Funds Revenues.*** The remaining 28 percent of revenues are received by special funds and are primarily earmarked for specific purposes, such as transportation, local governments, and targeted health and social services programs. The 2003-04 special funds revenue total includes $8.3 billion in new taxes (discussed below) proposed by the Governor to support a shift of certain health and social services programs from the state to local governments as part of a major realignment program.

As the figure shows, some revenues, such as the SUT, support both the General Fund and special funds.

Sources of General Fund Revenues. Figure 2 indicates that over 90 percent of total General Fund receipts are attributable to the PIT, SUT, and CT. The remainder comes from a variety of smaller taxes (including the insurance, estate, tobacco, and alcoholic beverage taxes), as well as investment earnings and various transfers from special funds. The 2003-04 General Fund total also includes $1.5 billion in new revenues associated with the budget's proposal to renegotiate gaming compacts with various Indian tribes.

The Budget's General Fund Revenue Outlook

Figure 3 summarizes the budget's General Fund revenue outlook for 2002-03 and 2003-04.

Current-Year Forecast. The budget forecasts that General Fund revenues and transfers will total $73.1 billion in 2002-03, a modest 1.3 percent increase from the prior year. The prior-year and current-year revenue totals and growth rates reflect numerous one-time actions, including tobacco securitization in 2002-03, loans from special funds in both years, and the 2001-02 repayment of the General Fund's loan of $6.2 billion to the Electricity Power Fund for energy purchases. The 2002-03 revenue total also includes the effects of the tax increases and accelerations passed in conjunction with the current-year's budget.

If the distorting effects of these one-time factors on revenue growth are eliminated, underlying revenues are up by 1.4 percent in the current year. This reflects the administration's assumption that revenues from each of the major taxes will be soft in 2002-03, due to sluggish economic conditions.

Budget-Year Forecast. The administration forecasts that General Fund revenues and transfers will total $69.2 billion in 2003-04, a 5.5 percent decline from the current year. The drop is mainly related to the $8.5 billion in one-time revenues and transfers included in the current year totals (including $4.5 billion from tobacco securitization, about $3 billion in one-time loans and transfers, and $1 billion in one-time revenues). Excluding these and related factors, underlying revenues are projected to increase by 2 percent. This modest growth rate is related to the administration's assumption that the sluggish economic expansion in 2003 will boost revenues from the state's major taxes only modestly in the 2003-04 fiscal year.

Revenue-Related Changes and Proposals

The current-year and budget-year General Fund revenue totals include the impact of a variety of revenue-related changes enacted with the 2002-03 budget as well as the Governor's revenue-related proposals for 2003-04. Figure 4 (see page 44) displays the fiscal impacts of these measures (please note that the Governor's major realignment-related tax increase proposals that were identified in "Part I" of this volume are discussed separately in "Part V"). It shows the following:

- ***2002-03 Changes.*** Tax-related changes enacted with the 2002-03 budget will raise revenues by $2.1 billion in the current year, and $769 million in 2003-04. The main provisions include: (1) increased withholding on income associated with stock options, bonuses,

Figure 3

Summary of the Budget's General Fund Revenue Forecast

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

Revenue Source	Actual 2001-02	2002-03 Estimated Amount	2002-03 Percent Change	2003-04 Projected Amount	2003-04 Percent Change
Taxes:					
Personal Income Tax	$33,047	$32,880	-0.5%	$33,610	2.2%
Sales and Use Tax	21,355	22,349	4.7	23,210	3.9
Corporation Tax	5,333	6,452	21.0	6,361	-1.4
Insurance Tax	1,596	1,742	9.2	1,830	5.1
Other taxes	1,324	1,075	-18.8	819	-23.9
Other Revenues, Transfers, and Loans:					
Tobacco securitization bond proceeds	—	$4,500	—	—	—
Tribal gaming revenues	—	—	—	$1,500	—
Other revenues[a]	$1,929	1,148	-40.5%	1,471	28.1%
Transfers and loans	7,655	2,998	-60.8	353	-88.2
Totals	**$72,239**	**$73,144**	**1.3%**	**$69,153**	**-5.5%**

[a] Amount for 2001-02 includes $6.2 billion loan repayment to General Fund from the Electric Power Fund.

and real estate sales; (2) a two-year suspension of net operating loss carryforward deductions (followed by an increase in the percentage of such losses that can be carried forward and deducted in future years); and (3) a change in the treatment of bad debt reserves maintained by banks.

- ***2003-04 Changes.*** The Governor's budget proposes General Fund revenue-change increases totaling about $1.6 billion. The majority of this amount is related to an assumed $1.5 billion increase in tribal gaming revenues resulting from renegotiation of tribal compacts. The remaining $95 million is related to proposals that would (1) prohibit banks from utilizing Regulated Investment Companies for mutual fund investments to avoid California income taxes, and (2) clarify the industries that are eligible for the manufacturers' investment tax credit (MIC). The budget also proposes other legislation that would have revenue impacts in

2004-05 and beyond. These include the extension of the MIC beyond 2003. Under existing law, the MIC would likely expire in 2004, since manufacturing job growth between January 1994 and January 2003 will likely be less than the 100,000 required in statute to keep the program in effect.

Figure 4

Effects of Recently Enacted and Proposed Revenue Changes

(In Millions)

	2002-03	2003-04
Changes Enacted With 2002-03 Budget		
Personal Income Tax		
Withholding of stock options and bonuses	$200	$10
Withholding on real estate sales proceeds	195	10
Net operating loss suspension	175	75
Teachers' tax credit suspension	170	—
Other	142	23
Totals, Personal Income Tax	($882)	($118)
Sales and Use		
Waiver of penalties and interest	$20	—
Corporation Tax		
Net operating loss suspension	$750	$525
Bank bad debt reserves	285	15
Tax credit auditing	60	60
Other	58	51
Totals, Corporation Tax	($1,153)	($651)
Totals, 2002-03 Changes	**$2,055**	**$769**
2003-04 Proposals		
Renegotiation of tribal compacts	—	$1,500
Bank mutual fund investments	—	45
Investment tax credit definitions	—	50
Total, 2003-04 Proposals	**—**	**$1,595**

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Figure 5 presents our General Fund revenue outlook for 2002-03, 2003-04, and 2004-05. Our projections are based on our economic and demographic forecasts presented in "Part II," reflect all of the Governor's proposals—including the receipt of $1.5 billion in tribal gaming revenues—and take into account the recent negative cash developments noted below.

Figure 5

Summary of the LAO's General Fund Revenue Forecast

2002-03 Through 2004-05
(Dollars in Millions)

	2002-03		2003-04		2004-05	
Revenue Source	**Amount**	**Percent Change**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Taxes:						
Personal income tax	$31,900	-3.5%	$33,570	5.2%	$36,210	7.9%
Sales and use tax	22,600	5.8	23,750	5.1	25,270	6.4
Corporation tax	6,920	29.8	7,240	4.6	7,120	-1.7
Insurance tax	1,780	11.5	1,880	5.6	1,985	5.6
Other taxes	1,099	-17.0	842	-23.4	625	-25.8
Other Revenues, Transfers, and Loans:						
Tobacco Securitization Bond proceeds	$4,500	—	—	—	—	—
Tribal gaming revenues	—	—	$1,500	—	$1,538	—
Other revenues	1,167	-39.5%	1,508	29.2%	1,380	-8.5%
Transfers and loans	2,998	-60.8	353	-88.2	-835	—
Totals	**$72,964**	**1.0%**	**$70,643**	**-3.2%**	**$73,293**	**3.8%**

LAO's Forecast Up $1.3 Billion From Budget. As noted in "Part I," our General Fund revenue forecast is up from the administration's forecast by a net of $1.3 billion over the current- and budget-years combined. This net two-year increase is the combined result of two opposing factors. Specifically, we believe that cash trends point to *lower* revenues in the current year, but that the renewed economic expansion in late 2003 will produce *higher* revenues in 2003-04.

2002-03 Revenues

Down $180 Million From Budget. We forecast that General Fund revenues and transfers will total $73 billion in the current year, a 1 percent increase from 2001-02. As shown in Figure 5, we are forecasting increases in SUT and CT revenues, but a significant decline in PIT receipts. Compared to the administration, our forecast is down a total of $180 million, reflecting nearly $1 billion less in PIT receipts, partly offset by higher collections from the other major tax sources.

Current-Year PIT Receipts Are Soft. Our lower estimate of PIT revenues is largely related to soft year-end cash receipts from this source. The PIT payments—other than withholding that the state receives in late December and January—are very important in assessing the current PIT revenue outlook, since they are related to quarterly estimated payments remitted by taxpayers with substantial amounts of capital gains and other forms of nonwage compensation. These receipts often provide an early indication of the strength or weakness of the payments received by the state the following spring, when final PIT payments are due. This January, these December-January nonwithholding payments were about $250 million below the administration's updated forecast. Although this deviation is only one-fourth the size of last year's, such lower-than-expected receipts still suggest that final payments on 2002 returns will also be down from the administration's expectations—perhaps by $500 million or more. Combining this $750 million total with the likelihood of further softness in current-year prepayments suggests that 2002-03 PIT revenues will end up falling short by roughly $1 billion.

Trends in other revenue indicators have been more positive. In particular, PIT withholding and CT prepayments have been a little stronger than we would have expected, given the economy's current sluggishness. Nevertheless, given the fact that year-end PIT prepayments have been such an important indicator in the past and that the PIT is our largest revenue source, recent cash developments constitute on balance a significant negative factor in the near-term revenue outlook.

2003-04 Revenues

Up $1.5 Billion From the Budget. We forecast that revenues and transfers will total $70.6 billion in 2003-04, a 3.2 percent decline from the current year. After adjusting for the special factors affecting both current-year and budget-year receipts, the underlying growth rate from ongoing revenue sources is somewhat stronger—about 4.5 percent. Our 2003-04 forecast is up about $1.5 billion from the budget projection, consistent with our expectation of a somewhat earlier and stronger rebound in the economy. Most of this net revenue gain is from higher SUT and CT receipts. In contrast, we expect the PIT to be down slightly from the budget's forecast.

2004-05 Revenues

Moderate Growth Projected. We forecast that total revenues and transfers will increase by about 3.8 percent in 2004-05, to $73.3 billion. Excluding the impact of the Governor's policy proposals on the revenue totals, the underlying increase would be about 6.5 percent. This increase is consistent with our assumption that the economic rebound will gain momentum in 2004, thereby boosting revenues from all three of the state's largest taxes during the year.

The LAO's Forecast for Major Revenue Sources

As indicated above, the state's three major taxes—the PIT, SUT, and CT—are expected to account for over 90 percent of total General Fund revenues in 2003-04. Thus, the performance of these taxes will dominate the overall revenue outlook. In the following sections, we discuss in more detail recent developments and the outlook for each of these three key taxes.

Personal Income Tax

Background

Personal income taxes account for about 48 percent of forecasted total General Fund revenues in 2003-04. Although its share has fallen significantly since 2000-01, the PIT remains by far the largest source of state General Fund revenues. In general, the PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Under the PIT, taxable income is subject to marginal rates ranging from 1 percent to 9.3 percent, with the top rate applying to taxable income in excess of $76,582 for joint returns in 2002.

PIT Liabilities

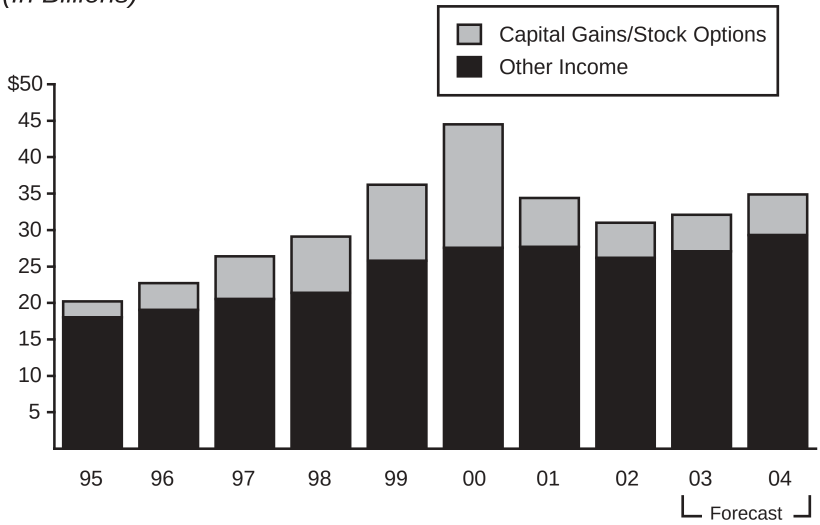
Recovery to Begin in 2003. Our forecast of PIT liabilities is shown in Figure 6 (see next page). After soaring in the late 1990s, PIT liabilities have plunged during the past two years, falling by over 30 percent from the peak reached in 2000. We forecast that liabilities will recover slowly in 2003, before accelerating in 2004.

Factors Behind the Liability Forecast. As indicated in Figure 6, the majority of the PIT liability decline between 2000 and 2002 was related to a huge drop in stock options and capital gains, both of which are subject to PIT taxation. Combined PIT liabilities attributable to these two sources fell from $17 billion in 2000 to $6.5 billion in 2001, and further to $4.7 billion in 2002. Liabilities from other income sources, such as ordinary wages,

Figure 6

After Plunging, PIT Liabilities to Grow Moderately

California Annual PIT Liabilities, by Source (In Billions)



business earnings, interest, rents, and pensions, fell modestly, reflecting the impacts of the general economic slowdown on employment, wages, and profits in the economy. Looking ahead, we forecast that PIT liabilities will grow moderately faster than personal income in 2003 and 2004, reflecting both a strengthening economy and the PIT's progressive rate structure.

PIT Stock Market-Related Bubble Gone

As noted above, our forecast for 2003 and beyond does assume that PIT revenues will benefit from an overall improvement in economic activity. However, we are not counting on a significant rebound in stock market-related revenues at any time during the forecast period.

In general, this reflects our assumption that the 1990s' dramatic run-up in the stock market will in part be viewed retrospectively as an historical anomaly, especially since it was unaccompanied by many of the factors traditionally viewed as economically justifying such a run-up, like strong profit performance. Thus, we do not foresee such a run-up as recurring, at least in the near term. Furthermore, even if this view proves wrong and the stock market does rebound and expand sharply in the next year, it will likely take capital gains and stock option-related income themselves a while to materially recover. This partly reflects two factors:

- First, many stocks and options are currently "under water" (that is, their current market price is well below their purchase price).
- Second, recently granted options (reflecting current low stock market prices) normally have vesting periods of up to four years, with such vesting periods being the minimum time period that a stock option must be held prior to being exercised.

Given the above, the odds are small that PIT liabilities will be significantly boosted from this source.

PIT Revenue Forecast

Based on our estimated changes in PIT liabilities, we forecast that fiscal-year PIT receipts will decline from $33 billion in 2001-02 to $31.9 billion in 2002-03, and then expand to $33.6 billion in 2003-04 and $36.2 in 2004-05. Even with these latter two years' gains, however, PIT receipts as of mid-decade would remain nearly $9 billion below their 2000-01 peak level.

Comparison to the Budget Forecast. Compared to the budget forecast, our current projection of PIT revenues is down by $980 million in the current year, and by a much smaller $40 million in 2003-04. Our current-year estimate reflects the impact of the softer near-term cash trends, discussed above. Our budget-year forecast reflects our projection of a stronger rebound in overall economic growth in late 2003 and early 2004, which should boost PIT liability growth by more than assumed by the administration.

Sales and Use Tax

Background

The SUT is the General Fund's second largest revenue source, accounting for about 34 percent of total revenues in 2003-04. The main component is the *sales* tax, which is imposed on retail sales of tangible goods sold in California. Some examples of tax transactions include spending on clothing, furniture, computers, electronics, appliances, automobiles, and motor vehicle fuel. Purchases of building materials that go into the construction of homes and buildings are also subject to the sales tax, as are purchases of computers and other equipment used by businesses. The largest exemption from the sales tax is for most food items consumed at home. The great majority of services are not subject to the sales tax.

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

SUT Rates

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

- ***State Rates.*** The current state SUT rate is 6 percent. The largest single component is the 5 percent state General Fund rate. Also included in the overall state rate are two half-cent rates, whose proceeds are respectively deposited into (1) the Local Revenue Fund, which supports health and social services program costs associated with the 1991 realignment legislation; and (2) the Local Public Safety Fund, which was approved by the voters in 1993 for the support of local criminal justice activities.

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

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

Combined SUT Rates. The combined state and local SUT rate varies significantly across California due to differences in the local optional rates that are levied. As depicted in Figure 7, the combined SUT rate currently ranges from 7.25 percent (for those counties with no optional rates) up to 8.5 percent (for the City and County of San Francisco). No county currently imposes the maximum allowable SUT rate of 8.75 percent. Imposition of the Governor's proposed 1 percent rate increase for realignment would boost the current SUT rates up to a range of 8.25 to 9.5 percent.

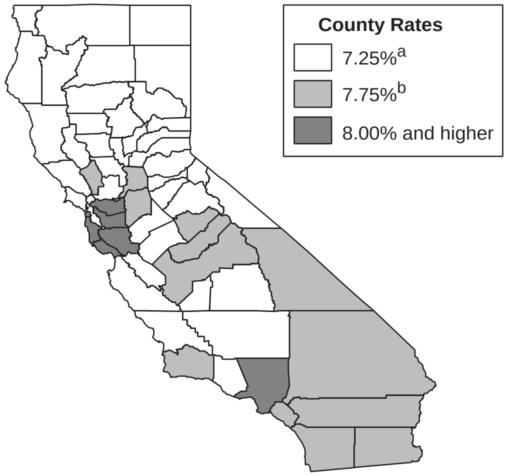
Recent Taxable Sales Held in Check by Weak Business Spending

The key determinant of annual sales tax receipts is the performance of consumer and business spending on taxable items. Figure 8 shows recent and projected changes in taxable sales. After increasing by 12 percent in 2000, taxable sales declined by 1.5 percent in 2001, and another 0.7 percent in 2002. Looking at detailed industry data for 2001 (the most

Figure 7

Sales Tax Rates Vary by County

January 1, 2003

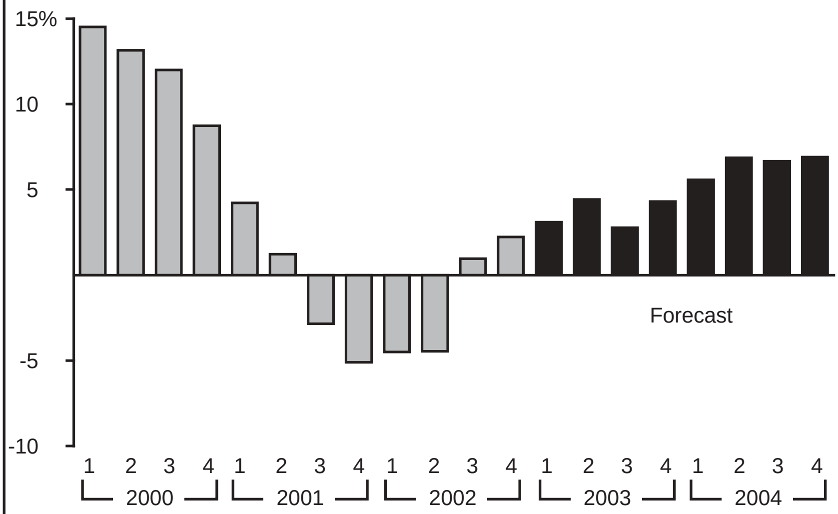


[a]Includes Stanislaus, Nevada, and Solano (7.375%), and Sonoma (7.50%).
[b]Includes Fresno (7.875%).

Figure 8

Taxable Sales Slowly Improving

Year-to-Year Percent Change, by Quarter



recent year for which such data are available), the main culprit behind the downturn was exceedingly weak business spending, which was down by nearly 10 percent in the fourth quarter of that year. Retail spending by consumers has fared better, reflecting strong car sales, and mixed results elsewhere.

It appears that total taxable sales bottomed out in early 2002 and expanded modestly in the second half of the year, reflecting slow gains in consumer spending and a second-half increase in home construction.

Taxable Sales Outlook—Accelerating Growth in Late 2003. We forecast that taxable sales will continue to grow at a sluggish and uneven pace in early 2003, reflecting continued softness in business-related spending, and some retrenchment in auto sales. We expect sales to gain momentum in the second half of the year, as business spending begins to accelerate. Overall, we forecast that taxable sales will increase by 3.6 percent for 2003 as a whole and 6.5 percent in 2004, or roughly in line with personal income growth for the two years.

SUT Revenue Forecast

Based on our forecast of taxable sales, we project that SUT receipts will increase from $21.4 billion in 2001-02 to $22.6 billion in the current year. About one-half of the year-to-year projected increase is related to slow underlying improvement in taxable sales. The other half is related to the fact that the SUT rate had been reduced by one-quarter percent during the first half of 2001-02 due to a previously adopted "trigger" provision, lowering revenues by about $600 million in that fiscal year.

In 2003-04, we forecast that sales tax receipts will increase to $23.8 billion, a 5.1 percent increase from the current year. This anticipated growth is due to our projected acceleration of taxable sales beginning in the second half of 2003.

Comparison to the Budget Forecast. Our SUT estimate is up from the budget forecast by $251 million in the current year and by $540 million in 2003-04. Our higher forecast for SUT receipts is related to our assumption of an earlier and stronger recovery in taxable sales beginning in the second half of this calendar year.

Corporation Tax

Background

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

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

Profits Have Bottomed Out …

The key determinant of CT receipts is the strength of corporate profits reported on California tax returns by businesses. While these profits have been hit hard by the economic downturn, it appears that the worst is over, and that profits will expand significantly once economic growth picks up. As shown in Figure 9, profits fell by over 14 percent in 2001, as earnings were squeezed by falling sales and large amounts of unused capacity. Businesses then undertook major cost-cutting efforts in 2002, writing off underutilized assets, and scaling back their workforce. Fourth quarter earnings reports for that year suggest that these cost-cutting measures were paying off, as companies reported small increases in sales but larger increases in earnings for the quarter. Consistent with this, December 2002 corporate prepayments were up sharply from the prior December, suggesting that the aggregate annualized earnings of California firms have at least stabilized, and may even have begun to turn upward.

... and Should Accelerate in 2003 and 2004

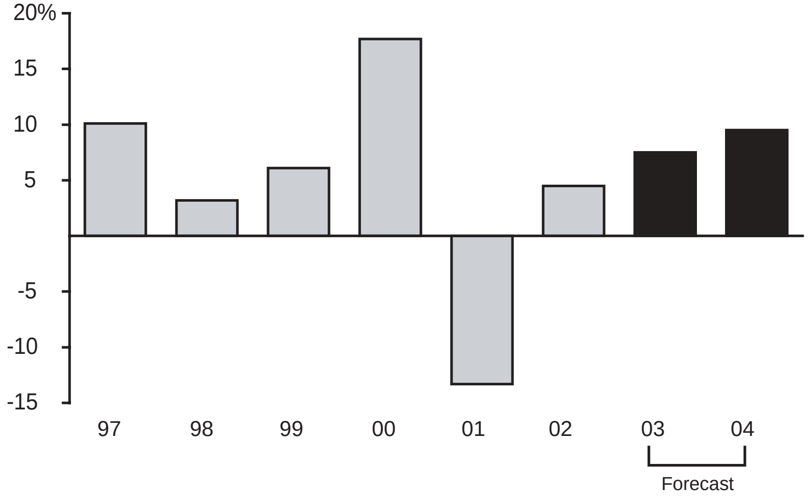
Looking ahead, we forecast that taxable California profits will increase by 7.5 percent in 2003 and by 9.5 percent in 2004 (see Figure 9, next page). While sales and production will likely be restrained in the first half of 2003, we believe that companies will continue to benefit from cost-savings actions taken over the past 12 months. We then expect that profits will improve significantly in the second half of the year when sales and output pick up.

Less Stock Option Activity Should Boost Profits. An additional factor that should boost profits relative to past years relates to stock options.

Figure 9

Profits on Upswing

Percent Change in California Taxable Corporate Profits



Specifically, the difference between the grant price and the market price of options which are exercised is deductible as an expense on corporate tax returns. The huge amount of options being exercised in the late 1990s clearly boosted PIT receipts, as discussed previously. However, the options also had the opposite effect on profits reported by companies, who were deducting the options as a business expense. Currently, just the reverse is happening. Namely, the sharp decline in the amount of stock options is depressing PIT receipts, while the reduced amount of corporate deductions for options should have a correspondingly positive effect on the amount of reportable earnings. This is an especially important factor in California's high-tech manufacturing and business services industries, which have been responsible for large amounts of stock options in recent years.

Corporation Tax Revenue Forecast

We forecast that CT receipts will be $6.9 billion in 2002-03, a nearly 30 percent increase from the prior year. About one-third of this gain is related to underlying profit improvement, while the remaining two-thirds is due to the net operating loss deduction suspension and other tax-related provisions adopted in conjunction with the 2002-03 budget. These provisions combined will boost CT receipts by $1.1 billion this year. We also forecast that CT receipts will increase further to $7.2 billion in 2003-04. This moderate increase reflects healthy underlying profit growth, but a reduced second-year amount of revenues associated with above-cited 2002-03 tax-related provisions.

Comparison to the Budget Forecast. Our CT forecast is above the budget forecast by $468 million in 2002-03 and by $879 million in 2003-04. The increase is largely related to the recent favorable CT cash trends and our more positive assumption about profit growth in 2002 through 2004.

Other Revenues and Transfers

The remaining 10 percent of total 2003-04 General Fund revenues and transfers consists of taxes on insurance premiums, estates, alcoholic beverages, and tobacco products. It also includes interest income and a large number of other more minor revenues and fees, loans, and transfers. We forecast that combined revenues from all of these "other" sources will fall from $12.5 billion in 2001-02 to $11.5 billion in 2002-03, and then decline further to $6.1 billion in 2003-04. About $4.5 billion of the annual totals is related to ongoing taxes and fees, which we expect will grow modestly over time. The remainder is related to numerous special factors. For example:

- ***2001-02.*** The prior-year total includes (1) over $6.2 billion in loan repayments for energy purchases made by the General Fund on behalf of the customers of the state's major private utilities in 2000 and (2) about $1.4 billion in one-time General Fund loan receipts from various special funds.
- ***2002-03.*** The current-year total includes (1) $4.5 billion from the tobacco securitization bond sale and (2) roughly $3 billion from additional one-time loans and transfers from special funds.
- ***2003-04.*** The budget-year forecast includes (1) about $353 million more in mostly one-time loans and transfers from special funds, plus (2) $1.5 billion in new gaming revenues resulting from the planned renegotiation of tribal gambling compacts.

Estate Tax Phase-Out Continuing. Our forecast includes the impact on the state of a provision included in the federal tax reduction package passed in the spring of 2001 which is resulting in the phase-out of California's estate tax. This phase-out involves California's voter approval in 1982 of Proposition 6—a statutory initiative that eliminated California's inheritance and gift tax and replaced it with a "pick-up" tax. This pick-up tax equals the maximum state credit that is allowed, under federal law, to be applied against a California estate's *federal* estate tax liability.

For example, if the federal estate tax law allows a $10,000 state credit against a $100,000 federal liability, the state tax would be set at $10,000 and the federal $100,000 tax would be reduced to $90,000 after application of the credit. Thus, while the tax provides revenues for California, it does not impose any net cost on the taxpayer. The 2001 federal change provides for the phase-out of the state credit (and thus the state's pick-up estate tax) over a four-year period, beginning in 2002. This is causing California's estate tax revenues to decline from $891 million in 2001-02 down to an estimated $670 million in the current year, $430 million in 2003-04, and just $220 million in 2004-05.

THE BUDGET'S FORECAST FOR SPECIAL FUNDS REVENUES

As shown in Figure 10, the Governor's budget assumes that special funds revenues will total $26.9 billion in 2003-04. This includes about $8.3 billion in new taxes associated with the administration's realignment proposal.

New Realignment Revenues. The Governor's budget includes three major tax increases, the proceeds of which would go into a special realignment fund to support the shift of a roughly equivalent amount of program responsibilities from the state to local governments. The tax increases consist of (1) the establishment of a 10 percent and an 11 percent PIT rate to be imposed on high-income tax payers, (2) a 1 percent increase in the SUT, and (3) a $1.10 per pack increase in the cigarette tax. These major tax proposals are discussed in more detail in "Part V" of this volume.

Other Special Funds Revenues. About one-half of the remaining special funds revenues are associated with motor vehicle-related taxes and fees. These include the vehicle license fee, which is in-lieu of the property tax and whose proceeds are distributed to local governments for their general purposes. They also include fuel taxes and registration fees, which support transportation-related spending. Virtually all of the budget-year increase in such fee revenues is related to proposed increases in various registration fees to address the funding shortfall in the state's Motor Vehicle Account.

Finally, special funds revenues include a variety of other types of taxes and fees. These include a portion of the SUT's revenues (which are related to the 1991 realignment of health and social services programs to local governments), and cigarette taxes (which are earmarked for various anti-smoking and health programs). The budget-year special funds revenue totals also include a variety of increases in fees to support programs in the areas of the courts, higher education, and resources.

Figure 10

Summary of the Budget's Special Funds Revenue Forecast

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

Revenue Source	Actual 2001-02	2002-03 Estimated Amount	2002-03 Percent Change	2003-04 Projected Amount	2003-04 Percent Change
2003-04 Realignment-Related Revenues:					
Personal income tax	—	—	—	$2,580	—
Sales and use tax	—	—	—	4,584	—
Cigarette tax[a]	—	—	—	1,170	—
Subtotals	—	—	—	($8,334)	—
Motor Vehicle Revenues:					
License fees (in lieu)	$1,927	$1,868	-3.1%	$1,900	1.7%
Fuel taxes	3,296	3,307	0.3	3,332	0.7
Registration, weight, and miscellaneous fees	1,892	1,955	3.3	2,325	18.9
Subtotals	($7,115)	($7,130)	(-0.2%)	($7,556)	(6.0%)
Other Sources:					
Sales and use tax	$2,461	$2,383	-3.2%	$2,503	5.0%
Cigarette and tobacco taxes	981	951	-3.1	821	-13.6
Interest earnings	214	182	-14.6	147	-19.5
Other revenues	7,595	6,932	-8.7	7,880	13.7
Transfers and loans	-824	-2,648	—	-338	—
Totals	**$17,541**	**$14,930**	**-14.9%**	**$26,903**	**80.2%**

[a] Includes $96 million from gross realignment revenues to compensate existing cigarette-related special funds for revenue losses.

KEY REVENUE RISKS AND UNCERTAINTIES

In any year, there are a variety of risks and uncertainties in the revenue outlook. One always relates to the future performance of the economy. Another involves stock market activity, including taxpayer decisions regarding, for example, capital gains realizations and the granting and exercise of stock options. Other risks and uncertainties typically can include such factors as domestic and foreign political and military developments, future federal fiscal and monetary policies and, especially in California, developments in such critical areas as energy and water.

This year, we are seeing a variety of conflicting evidence concerning the revenue outlook. Our forecast attempts to balance these positive and negative factors. However, we believe that the main risks to the forecast are on the downside, and are related to three key factors:

- ***The Near-Term Economic Outlook.*** As indicated in "Part II," the U.S. and California economies ended 2002 on a soft note, and there is considerable restraint among businesses and consumers as 2003 unfolds. Our economic forecast assumes that confidence and spending will improve once uncertainties over a potential conflict with Iraq are cleared up, and that growth will accelerate in the second half of the year. If the current slowdown turns out to be deeper or more prolonged than anticipated in our forecast, however, revenues from each of the state's major taxes would fall substantially below our current projections.

- ***PIT Final Payments.*** Given the weak January prepayments, a second risk is that PIT receipts will fall below expectations this spring when final payments are due. In preparing our current PIT estimate, we attempted to take into account the effect of current soft cash trends on our PIT forecast by using historical information on the relationship between tax prepayments and final payments. However, there is considerable variability in this historical relationship and it is possible that in the current soft economic environment, actual receipts this spring will fall even below our forecasted levels. Thus, even if the overall economy performs as expected, the state faces a near-term risk that cash receipts will fall below our estimates.

- ***Tribal Gaming Revenues.*** The $1.5 billion in new tribal gaming revenues is related to the administration's assumption that it will be able to renegotiate existing gaming compacts and enter into new compacts with tribes that will involve revenue sharing agreements capable of generating $1.5 billion in new receipts for the General Fund. At this point, it is unclear how many tribes will enter into negotiations, or what the terms of any new compacts will be.

IV

Perspectives on State Expenditures

Perspectives on State Expenditures

AN OVERVIEW OF STATE EXPENDITURES

PROPOSED TOTAL SPENDING IN 2002-03 AND 2003-04

The Governor's budget proposes total spending in 2003-04 of $89.2 billion, including $62.8 billion from the state's General Fund and $26.5 billion from its special funds (see Figure 1). This total budget-year spending is significantly less than current-year spending—by $5.4 billion (5.7 percent). Proposed spending translates into $2,469 for every man, woman, and child in California, or $244 million per calendar day.

Figure 1

Governor's Budget Spending Totals

2002-03 and 2003-04
(Dollars in Millions)

			Change	
	2002-03	2003-04	Amount	Percent
Budget Spending				
General Fund	$75,461	$62,769	-$12,692	-$16.8%
Special funds[a]	19,203	26,464	7,261	37.8
Totals	**$94,665**	**$89,233**	**-$5,431**	**-5.7%**

a Does not include Local Public Safety Fund expenditures of $2.2 billion in 2002-03 and $2.3 billion in 2003-04. These amounts are not shown in the Governor's budget. Includes $8.2 billion in proposed new realignment spending in 2003-04.

Detail may not total due to rounding.

As discussed in "Part I" of this volume, the budget proposes a major realignment of state, county, and court program funding responsibilities. Under this plan, the state would shift responsibility to counties for roughly $8 billion of health, child care, and social services programs—and reduce by $300 million state General Fund support for trial courts. To offset these changes, the budget raises a net $8.2 billion from increased revenues from the personal income tax, sales and use tax, and cigarette tax, and provides this funding to counties and the courts via a new special fund. Because of this realignment proposal, the composition of spending between the General Fund and special funds will change significantly. For example, of total budget-year spending, General Fund spending accounts for slightly more than 70 percent. This compares to the average General Fund share of about 80 percent for the ten years ending in 2002-03.

General Fund Spending

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

Proposed Spending. As shown in Figure 2, the Governor proposes General Fund spending of $62.8 billion for 2003-04. This is down $12.7 billion, or 16.8 percent, from the current-year's level. Under the proposal, most program areas would experience major General Fund reductions. It should be noted that the large declines in state spending shown for health and social services reflect both the realignment proposal and deep program-specific cuts (the Governor's specific proposals in individual program areas are discussed in the next section of this volume). Without the realignment proposal, the decline in total General Fund expenditures in 2003-04 would be 6 percent.

Special Funds Spending

Background. Special funds are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources (including many licenses and fees) for *specific* functions or activities of government designated by law. In this way, they differ from General Fund revenues, which can be spent by the Legislature for *any* purpose. Historically, over one-half of the special funds revenues come from motor vehicle-related levies. Other major funding sources include the SUT and tobacco-related receipts.

Figure 2

General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 2001-02	Estimated 2002-03	Proposed 2003-04 Amount	Proposed 2003-04 Percent Change
Education Programs				
K-12—Proposition 98	$26,755	$26,373	$26,320	-0.2%
Community Colleges—Proposition 98	2,577	2,525	1,906	-24.5
UC/CSU	6,058	5,894	5,622	-4.6
Other	4,178	3,721	2,052	-44.9
Health and Social Services Programs				
Medi-Cal	$10,005	$10,844	$7,147	-34.1%
CalWORKs	2,016	2,082	1,604	-23.0
SSI/SSP	2,793	3,013	2,317	-23.1
Other	7,006	7,090	4,079	-42.5
Youth and Adult Corrections	$5,641	$5,674	$5,639	-0.6%
All Others	$9,722	$8,246	$6,085	-26.2%
Totals	**$76,752**	**$75,461**	**$62,769**	**-16.8%**

Proposed Spending. In 2003-04, the Governor proposes special funds spending of $26.5 billion. This is a 37.8 percent increase from the current-year's proposed total of $19.2 billion. As indicated in Figure 3 (see next page), this sharp increase is due almost entirely to the additional special funds spending associated with the realignment proposal. This explains the dramatic 166 percent increase in local government subventions. Excluding the realignment proposal, special funds spending is proposed to decline by 4.7 percent.

It should be noted that the budget's special funds spending total for 2003-04 excludes expenditures of roughly $2.3 billion from the Local Public Safety Fund (LPSF). Such spending is also excluded from the current- and prior-year totals. Our view is that LPSF revenues are state tax revenues expended for public purposes. This treatment is consistent with how the budget treats other dedicated state funds, such as the Motor Vehicle License Fee Account (which, like the LPSF, is constitutionally dedicated to local governments) and the Cigarette and Tobacco Products Surtax Fund (Proposition 99), both of which the budget *does* include in its spending totals. However, although we believe that such spending does constitute state spending, we do not include it in our figures in order to facilitate comparisons with the budget's figures.

Figure 3

Special Funds Spending by Major Program Area

(Dollars in Millions)

	Actual 2001-02	Estimated 2002-03	Proposed 2003-04 Amount	Proposed 2003-04 Percent Change
Transportation	$5,332	$5,533	$5,060	-8.5%
Local government subventions[a]	6,434	4,921	13,101	166.2
Resources-related programs	1,665	1,862	1,948	4.6
Public Utilities Commission	1,132	1,438	1,224	-14.9
All others	4,885	5,448	5,131	-5.8
Totals	**$19,448**	**$19,203**	**$26,464**	**37.8%**

a Budget-year increase reflects the Governor's realignment proposal, while current-year reduction reflects proposed base vehicle license fee backfill elimination.

Spending in Relation to the State's Economy

Figure 4 shows how state spending has varied as a percentage of total California personal income (which is a broad indicator of the size of the state's economy). From 1993-94 through 2001-02, total state spending increased steadily as a share of personal income—from 7.1 percent to 8.5 percent. Growth in General Fund spending accounted for all of the increase, since special funds spending as a percentage of personal income actually declined—by 0.6 percentage points.

Since 2001-02, however, total state spending as a percentage of personal income has reversed direction, and is projected to drop to 7.3 percent in 2003-04. The decline in the ratio results from previously noted 2003-04 declines in combined General Fund and special funds spending, and our projection that personal income will resume moderate growth.

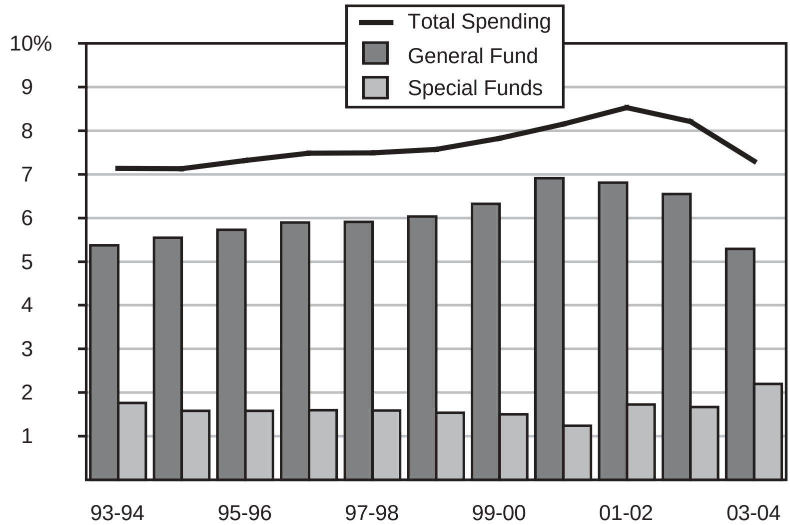
Spending From Federal Funds and Bond Proceeds

In addition to the $89.2 billion of proposed 2003-04 spending from the General Fund and special funds, the budget also proposes $50.6 billion in spending from federal funds and another $7.2 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, proposed 2003-04 spending exceeds $147 billion.

Figure 4

State Spending As a Percent of Personal Income

1993-94 Through 2003-04



Federal Funds

As noted above, about $50.6 billion in federal funds are proposed to be spent through the state budget in 2003-04. (This is about one-fourth of the roughly $200 billion in total federal funds allocated to California. The remaining three-fourths are allocated directly to local governments, businesses, or individuals within the state.) Federal funds in the budget consist almost exclusively of federal contributions to health and social services programs ($32.1 billion, or 64 percent of the total), education ($13 billion, or 26 percent), and transportation ($2.8 billion, or 6 percent).

Spending of Bond Proceeds

Budgetary Treatment. Debt service on general obligation and lease revenue 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 different program areas. Spending from bond proceeds has *not* been included in the General Fund and special funds budget totals, however, because the spending of bond proceeds does not represent a current state cost. Instead, the cost of bond programs is reflected when the actual debt service payments (comprised of bond-related principle and interest payments) are made. For 2003-04, the budget proposes General Fund debt service expenditures of $2.4 billion, including $1.9 billion for general obligation bonds and $572 million for lease revenue bonds.

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

Spending of General Obligation Bond Proceeds. The budget estimates that the state will spend $7.2 billion in general obligation bond proceeds for capital projects in 2003-04. This compares to $14.7 billion in the current year and $3 billion in the prior year. About two-thirds of budget-year bond fund expenditures is for various local assistance projects such as K-12 school construction and local water quality improvements. The remaining one-third is dedicated for state-level capital outlay projects, primarily in the area of higher education.

Spending of Lease Revenue Bond Proceeds. In addition to general obligation bonds, the state also uses lease revenue bonds to finance the construction and renovation of capital facilities. Lease revenue bonds do not require voter approval, and their debt service is paid from annual lease payments made by state agencies (funded primarily through General Fund appropriations). For 2003-04, the budget proposes $1.8 billion in spending from lease revenue bond proceeds for such purposes as construction of state buildings, resources projects, and prison construction.

State Appropriations Limit

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

Expenditures Projected to Be Below Limit. Due to the downturn in the state's economy and its adverse affects on the state's revenues, the budget's proposed expenditures are well below the SAL in both the current and budget years. This is in contrast to recent years when rapid spending growth eroded the "room" under the limit until the SAL was finally exceeded by $702 million in 1999-00.

In 2002-03, appropriations subject to the limit are $15 billion below the limit. In 2003-04, the administration's estimate of the gap shrinks to just under $6 billion. The smaller budget-year gap is partly due to the proposed $8.2 billion net increase in realignment-related taxes, and the fact that many of the budget reductions being proposed are in areas that are currently exempt from the limit. These include vehicle license fee subventions, and K-14 education apportionments.

STATE SPENDING—AN HISTORICAL OVERVIEW

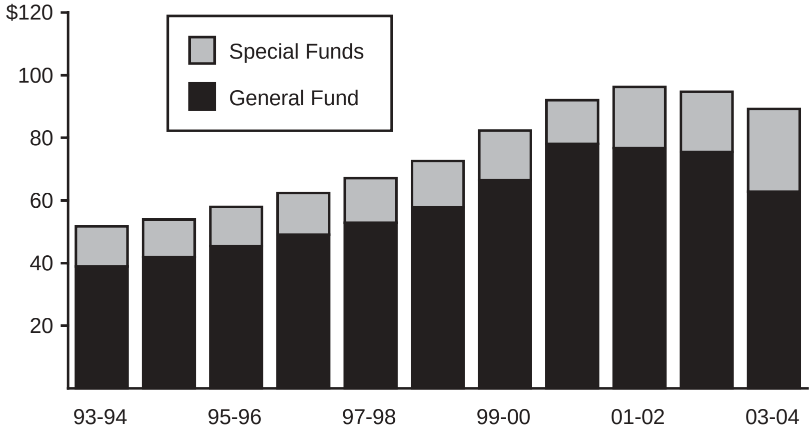
Prior to looking at the programmatic details of the Governor's spending plan for 2003-04, it is first helpful to provide some perspective on state spending by looking at how the new plan's spending amounts compare to historical trends.

Figure 5 shows that total state spending increased moderately between 1993-94 and 1998-99, then jumped by nearly 33 percent between 1998-99 and 2001-02. In contrast, it is projected to fall 1.6 percent in the current year, and by a steeper 5.7 percent in 2003-04. Over the full ten-year period, total spending is up an estimated $37.6 billion (73 percent), an average annual rate of growth of 5.6 percent.

Figure 5

Total State Spending Over Time[a]

1993-94 Through 2003-04
(In Billions)



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

Figure 6 shows total state spending adjusted for inflation and population. It indicates that:

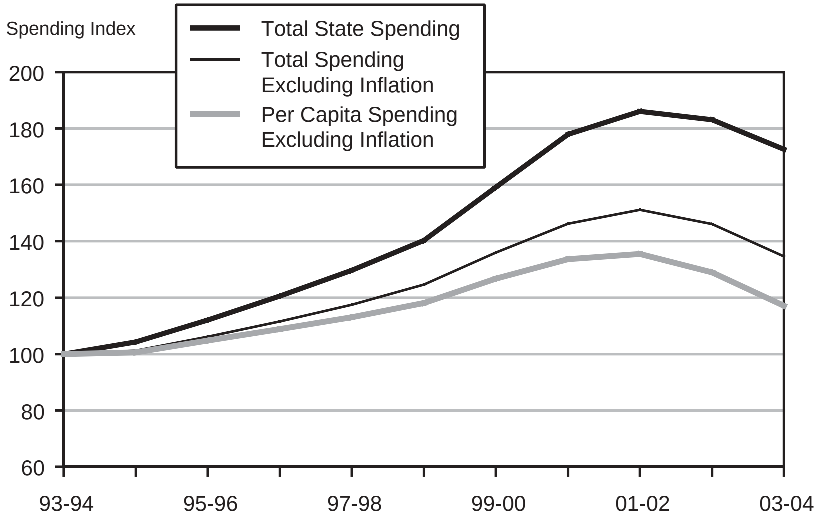
- After adjusting for inflation, spending has grown 35 percent over the entire ten-year period. This indicates that about one-half of the $37.6 billion increase was due to inflation.

- Real per-capita spending—which adjusts for *both* inflation and population growth—has increased by about 17 percent over the period. This reflects projected spending of $2,469 per capita in 2003-04, up from $2,109 per capita in 1993-94. Despite a projected decline in per capita expenditures in the budget year of 9.2 percent, real per-capita spending has grown an average of 1.6 percent over the entire period.

Figure 6

Spending Adjusted for Inflation and Population

Index Value = 100 in 1993-94



SPENDING BY PROGRAM AREA

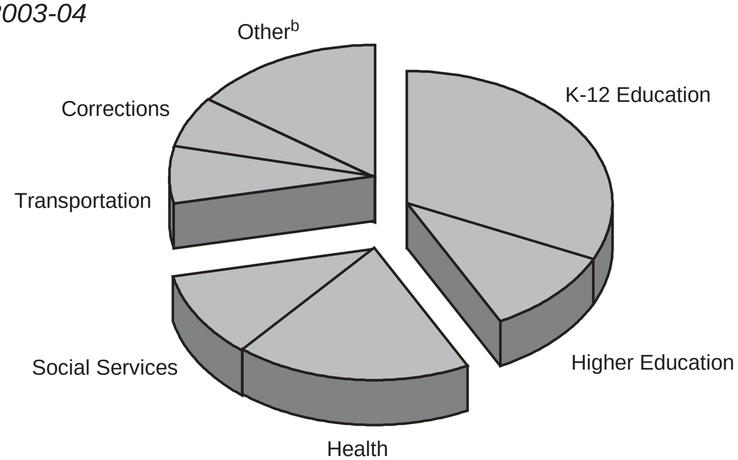
Total State Spending

Figure 7 shows the allocation of the proposed $89.2 billion of total state spending in 2003-04 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of the support in some areas (such as transportation).

Figure 7

Proposed Total State Spending By Major Program Area[a]

2003-04



[a] Excludes bond funds, federal funds, and Local Public Safety Fund. Spending for the Governor's realignment proposal is distributed by program area.
[b] Includes expenditures on resources, environment, and shared revenues.

The figure shows that K-12 education receives the largest share of total spending—slightly less than one-third of the total. (It should also be noted that K-12 education receives additional funding from local sources.) When higher education is included, education's share rises to over 42 percent. Health and social services programs account for about 29 percent of proposed total spending, while transportation and corrections together account for roughly 13 percent. The "other" category (16 percent) includes general-purpose fiscal assistance provided to local governments in the form of shared revenues.

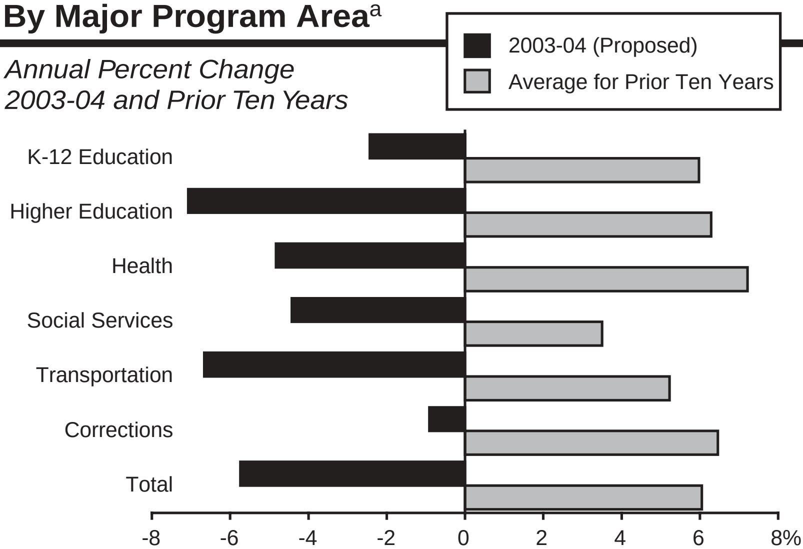
Relative Program Area Growth in the Budget Year

In order to gain perspective on how total state spending has changed for each broad programmatic area, Figure 8 (see next page) shows their proposed growth in the budget year compared to the average annual growth in these programs over the past ten years. For the second consecutive year, the Governor is proposing a budget with fewer expenditures than the current year. Total state spending is projected to decline significantly in the budget year (by 5.7 percent), which is in striking contrast to the average total growth over the past ten years (6.1 percent).

Figure 8

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

Annual Percent Change 2003-04 and Prior Ten Years



[a]Excludes "all other" spending. Proposed realignment spending for 2003-04 is allocated by program area.

As Figure 8 illustrates, spending for every broad programmatic area is projected to decline during 2003-04, in contrast with average annual increases ranging from over 3.5 percent to nearly 7 percent for the prior decade. Higher education shows the largest decrease in state support during the budget year (7.1 percent), reflecting allocated and unallocated reductions at both the University of California and California State University. These reductions were largely offset in the budget proposal by assumed student fee increases. Transportation would decline by about 6.6 percent, health by 4.9 percent, and social services by 4.4 percent. K-12 education fares better (declining 2.4 percent), while corrections spending would drop by less than 1 percent.

MAJOR EXPENDITURE PROPOSALS IN THE 2003-04 BUDGET

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 2003-04 Budget Bill*.

PROPOSITION 98

The Governor's budget appropriates $44.1 billion in Proposition 98 funding for 2003-04. This is $182 million, or 0.4 percent, higher than the Governor's revised current-year amount. The proposed 2003-04 appropriation exceeds the constitutionally required minimum level by $104 million. In contrast, the Governor's 2002-03 mid-year revisions would reduce current-year Proposition 98 appropriations from the enacted level of $46.5 billion to the revised minimum guarantee of $43.9 billion. Below, we discuss the K-12 Proposition 98 proposal.

Proposal—K-12 Proposition 98

Proposition 98 allocations to K-12 schools (which include local property tax revenues) are proposed at $40 billion in 2003-04. This represents an increase of $624 million, or 1.6 percent, over the Governor's current-year estimate. The current-year estimate includes significant spending reductions proposed by the Governor in December and January. As of this writing, the Legislature had passed AB 8x (Oropeza), which would reduce the K-12 Proposition 98 spending by $2 billion. Relative to the level of funding approved in the *2002-03 Budget Act*, the proposed spending level for 2003-04 represents a decrease of $1.6 billion, or 3.9 percent.

The budget proposes Proposition 98 resources of $6,723 per pupil for 2003-04. This represents an increase of 0.6 percent relative to the revised current-year estimate, but a 5.1 percent decrease relative to the *2002-03 Budget Act* amount.

The major 2003-04 budget proposals include:

- $1.5 billion in savings from the continuation of the across-the-board cuts proposed by the Governor in the 2002-03 mid-year revisions.
- $322 million for a 1 percent enrollment growth in revenue limits, and $37 million for special education. The budget does not fund growth for any other programs.
- Provides no funds for the statutory cost-of-living adjustment (COLA). Estimated cost of the COLA (1.55 percent) is $635 million.
- Realignment of $968 million of most child care responsibilities to counties.
- $382 million increase for the Public Employees' Retirement System offset reduction due to anticipated contribution rate increases.
- $250 million for revenue limit equalization.
- $364 million in net deferral costs:
  - — $931 million freed-up from one-time costs of deferrals from 2001-02 to 2002-03.
  - — $648 million in 2002-03 program costs deferred to 2003-04.
  - — Building $648 million in programs back into the 2003-04 base.

K -12 Education Issues for Legislative Consideration

Permanent Reductions Needed Because Education Credit Card is Maxed Out. Assuming adoption of AB 8x (Oropeza) as amended on February 4, 2003, which would reduce 2002-03 K-12 funding by $2 billion, the state would enter the 2003-04 fiscal year with almost $2.8 billion in K-12 education deferrals. For the last two years, the state has deferred state reimbursable mandates, categorical programs, and revenue limit funding in order to avoid real program reductions. We believe that the state has reached a critical point which requires permanent program funding reductions. The Governor has proposed $1.6 billion in program reductions, most of which are accomplished through a $1.5 billion across-the-board reduction. We support the level of program reductions proposed by the Governor, although we suggest some alternative reductions. We believe that a $1.5 billion across-the-board reduction is reasonable if combined with categorical program consolidation discussed below. However, if the Legislature rejects the categorical program consolidation, we would suggest targeted reductions, and provide a list of budget options in "Part V" of this document.

Need for Greater Local Flexibility—Categorical Reform. We believe that now more than ever, the Legislature needs to provide school districts with greater fiscal and programmatic flexibility to absorb funding reductions while minimizing the impact on students. The Governor's proposal to combine 58 categorical programs into a K-12 Categorical Block Grant would have many advantages for school districts over current law. It also would create significant problems. Most importantly, the proposed block grant does not adequately address the negative local incentives that led to the initial creation of many categorical programs. As we discuss in detail in the *2003-04 Analysis*, we recommend the Legislature consolidate 62 programs into five block grants. Districts would report to the state key fiscal and outcome data on each grant. We believe our proposal would increase district fiscal and program flexibility while increasing district accountability for providing needed services to students

Restoring Funding for High Priority Programs. We have identified approximately $427 million of additional Proposition 98 costs for 2003-04 because either (1) the Governor's budget under-funded specific programs, or (2) the Legislature increased 2003-04 obligations because of actions taken in the first extraordinary session. As we discuss in detail in the *2003-04 Analysis*, we recommend that the Legislature fund these priority needs, and have identified savings from other proposals to stay within the Governor's Proposition 98 funding level. Specifically, we recommend: (1) setting aside funding for the special education deferral ($214 million), (2) paying off ongoing mandate costs ($100 million), and (3) fully funding state intervention and sanction programs ($50 million).

Higher Proposition 98 Minimum Guarantee Would Allow State to Reduce Debts. We forecast a $372 million higher Proposition 98 minimum guarantee for 2003-04 than the Governor. Our fiscal forecast projects an economic recovery starting in the latter part of 2003, resulting in higher General Fund revenues than assumed in the Governor's budget. In order to begin to reduce the amount of education deferrals discussed above, we recommend the use of additional Proposition 98 funding to reduce the outstanding deferrals.

Child Care Realignment Merits Consideration. The Governor's budget proposes a major "realignment" of state and county program funding responsibilities. Under this proposal, the state would shift responsibility for most child care programs administered by the State Department of Education to counties. As we discuss in detail in the "Education" chapter of the *Analysis*, the state's existing child care system creates significant problems for families and local providers. For example, the system (1) requires local providers to comply with cumbersome rules regarding allowable expenditures, attendance accounting, eligibility, and reimbursement rates; and (2) treats families with similar incomes differently, depending on whether they have received assistance through the California Work Opportunity and Responsibility to Kids (CalWORKs) program. In view of these problems, we believe the Governor's child care realignment proposal merits legislative consideration. Realignment would give counties the flexibility to use child care funds as part of an integrated county strategy to serve low-income families and to tailor their child care programs to meet the needs of their communities' working poor. It would also reduce administrative complexity in the system by allowing counties to provide child care under their own set of program rules.

California Community Colleges (CCC)

Proposal

The Governor proposes Proposition 98 funding of $4.1 billion for 2003-04. This represents a decrease of $527 million, or 11.5 percent, from the Governor's current-year estimate. The current-year estimate includes about $327 million in targeted and across-the-board reductions proposed by the Governor in December and January. Among these reductions is $80 million in base apportionment funding that the administration believes was inappropriately added in recent years for concurrently enrolled high school students.

For 2003-04 the budget proposes the first fee increase in a decade for community college students, from $11 to $24 per unit. The budget assumes that the fee increase will cause enrollment attrition of 5.7 percent. In anticipation of this enrollment decline, as well as the receipt of additional student fee revenue, the budget reduces apportionment funding by $365 million. It also makes $215 million in targeted reductions to categorical programs. When all resources—including General Fund support, student fees, property taxes, and other funds—are considered, CCC's budget would decline by $383 million, or 6 percent, from the revised current-year level. This compares with overall *increases* of 1 percent to 4 percent at the other higher education segments.

Issues for Legislative Consideration

In the *Analysis* we assess the proposed changes in student fees and student enrollment. While we believe that it is reasonable to increase student fees and to reduce enrollment funding, we find the following:

Governor's Fee Proposal Misses Opportunity to Help Needy Students. We find that the proposed fee increase to $24 per unit is reasonable. However, we note that if the fee were raised $1 higher, needy students would each become eligible for up to $108 dollars in additional federal financial aid. We therefore recommend that the Legislature approve a $25 fee, which would still be the lowest fee in the nation.

Additional Enrollment Funding May Be Warranted. We find that some decline in student enrollment at CCC is appropriate. However, we believe that the projected decline of about 62,000 full-time equivalent students (or 5.7 percent of total enrollment) may be unnecessarily high. To the extent that additional Proposition 98 resources are available, we recommend that the Legislature consider increasing enrollment funding by up to $100 million. This additional funding would support an additional 25,000 students.

OTHER HIGHER EDUCATION PROGRAMS

Proposal

Besides CCC, the state's higher education agencies include the University of California (UC), the California State University (CSU), Hastings College of the Law, the California Student Aid Commission, and the California Postsecondary Education Commission. None of these agencies is subject to Proposition 98. The 2003-04 budget proposal would provide $6.3 billion in General Fund support for these programs. This is $183 million, or 2.8 percent, less than the revised current-year level.

The budget includes a number of General Fund reductions in higher education. These include targeted and across-the-board reductions to various programs. Further reductions are made possible by offsetting General Fund support with revenue generated by increased student fees. The budget includes no funding for COLAs, nor does it include any major new initiatives. However, it does fund enrollment growth of about 7 percent at UC and CSU. It also significantly expands various financial aid programs operated by the Student Aid Commission, UC, and CSU.

The budget assumes that student fees at UC and CSU would increase about 25 percent (for resident undergraduates) in the budget year. When the new revenue generated from these fees, as well as all other fund sources, are considered, the UC and CSU budgets would increase by 4.1 percent and 1.2 percent, respectively, in the budget year.

Issues for Legislative Consideration

In the *Analysis* we recommend an alternative to the Governor's budget proposal concerning fees, enrollment growth, and financial aid. Our alternative would achieve the same level of General Fund savings as proposed by the Governor, while at the same time improving student access and avoiding additional reductions to instructional programs. Specifically, we recommend:

- ***Budget-Year Fee Increases Should Be Lower.*** We recommend that the undergraduate fee increases for UC and CSU assumed by the budget should be reduced from 25 percent to 15 percent. We also recommend that the Legislature adopt in statute an explicit fee policy that would result in gradual, moderate, and predictable fee adjustments in subsequent years.
- ***Enrollment Growth Should Be Lower***. We recommend that the increase in budgeted enrollment at UC and CSU be reduced to 4 percent at each segment. This is more in line with projected demand.
- ***Financial Aid Should Be Expanded at State Level.*** We recommend actions that would reduce the significant increase proposed for university-based financial aid, and instead fund meaningful augmentations in statewide financial aid programs.

Health and Social Services

Under the Governor's budget proposal, state General Fund expenditures for health and social services programs would total $15.1 billion in 2003-04, about 24 percent of proposed General Fund spending for all purposes. Besides the Governor's realignment proposal, which is discussed in "Part V" of this volume, the budget's most significant impact on health and social services programs involves various program reductions affecting program beneficiaries.

Proposal

The budget proposes $2.9 billion in major reductions affecting current beneficiaries of cash assistance, social services, and health programs. Figure 9 summarizes these reductions compared to current law service levels. About $1.5 billion of the proposed savings is in the form of COLA suspensions and grant reductions for social services, and about $1.3 billion relates to reductions in health services.

Issues for Legislative Consideration

In addressing California's budget shortfall, the Legislature faces many difficult choices, perhaps none more difficult than determining the level of income support and health services to be provided by the state to low-income individuals (often aged or disabled persons or children). Below

Figure 9

Health and Social Services Major Budget Reductions Affecting Program Beneficiaries

(In Millions)

	Savings	
Program	**State**	**Federal**
Social Services		
SSI/SSP		
Delete June 2003 state COLA	$280.8	—
Reduce SSI/SSP grants by an average of 6.2 percent	662.4	—
Delete January 2004 state COLA	91.5	—
CalWORKs[a]		
Delete June 2003 COLA	146.0	—
Reduce CalWORKs grants by 6.2 percent	238.0	—
Delete October 2003 COLA	106.0	—
Subtotals	($1,524.7)	—
Health Services		
Medi-Cal		
Reduce provider rates by 15 percent	$630.1	$630.1
Eliminate optional benefits (dental, medical supplies)	298.6	298.6
Roll back Section 1931(b) expansion	111.8	111.8
Reinstate quarterly status reporting	80.0	80.0
Require share of cost for certain aged and disabled recipients	63.8	63.8
Developmental Services		
Require share of cost for services for certain children	29.5	—
Establish statewide standards for purchases of services	100.0	—
Early Mental Health Initiative		
Eliminate program	15.0	—
Subtotals	($1,328.8)	($1,184.3)
Totals	**$2,853.5**	**$1,184.3**

[a] Combined General Fund and TANF block grant funds, which are fungible with the General Fund.

we present several factors that the Legislature may consider in evaluating these and other proposed reductions for health and social services programs.

What Is the Impact on Federal Funds? Many health and social services programs have federal matching funds. A reduction in such matching funds, in our view, should not constitute justification for rejecting a budget reduction proposal. Given the magnitude of state's fiscal problems, and the many cases in which state General Fund savings can be achieved only with a further loss of federal funds, such an approach would make it much more difficult for the state to achieve a budget solution.

Moreover, such a criterion may not fully take into account the Legislature's own judgments about which services and programs meet the most critical needs of Californians, and thus merit preservation, versus those which, while perhaps worthwhile services, are of secondary importance.

Nevertheless, in choosing reductions among programs deemed by the Legislature to be of equal value to beneficiaries, budget reduction proposals that do not result in reduced federal funding, or that take advantage of the availability of federal funding to "leverage" state dollars, may be preferable to proposals that result in the loss of federal funds. For example, the Department of Developmental Services budget includes a proposal to expand the number of Regional Center clients eligible for partial federal support under the Medicaid waiver program (Medi-Cal in California) that we believe could be modified to result in an even greater savings to the state for the cost for these services.

Availability of Other Support. In considering the Governor's proposals, the Legislature should evaluate whether other services or supports will be available to affected beneficiaries. For example, about 40 percent of the 6.2 percent reduction in CalWORKs grants would automatically be offset by an increase in federal Food Stamps coupons. With respect to health programs, some beneficiaries who might become ineligible for Medi-Cal benefits might become eligible for coverage under the Healthy Families Program or might be able to receive some of the same medical services through county indigent care programs or through the charity of private medical institutions.

Suspension Versus Elimination of Services or Programs. For most of the proposed reductions, the Legislature has the option of making the changes temporary (for example, for one or two fiscal years) to achieve state savings rather than permanent reductions. For example, the administration's proposal to reduce Medi-Cal provider rates by 15 percent is limited to a three-year period (through 2005-06).

In cases in which the Legislature may be unwilling to consider a permanent program reduction, it might nonetheless wish to consider a temporary reduction in that same program. For example, suspension of dental services for a year for adult beneficiaries would be less harmful to most beneficiaries than the permanent elimination of such services.

We caution that this approach would not be wise in all situations. For example, it may be difficult or unduly expensive to reestablish the delivery system for a health or social services program that has been suspended. Moreover, adopting temporary suspensions of programs on a large scale would only postpone the hard choices needed to balance the state's budget, and would potentially result in the return of fiscal problems once the budget reductions expire.

Selectively adopting some temporary reductions in programs might make sense, however, to the extent the Legislature also adopted significant long-term programmatic reforms of programs that took some time to achieve their full savings potential for the state.

JUDICIARY AND CRIMINAL JUSTICE

Proposal

The budget proposes about $7.3 billion from the General Fund for judiciary and criminal justice programs in the budget year, a decrease of 4.7 percent below estimated current-year spending. The California Department of Corrections (CDC) accounts for the largest share of this funding, $5.1 billion. The CDC's budget is proposed to increase about 1 percent above the current-year amount. The budget does not include proposals that would reduce the inmate or parole populations. Instead, it proposes to reduce funding for inmate academic and vocational programs. In addition, as we recommended in our *2002-03 Analysis*, the budget proposes to close the Northern California Women's Facility in Stockton.

The Trial Court Funding program represents the next largest share of expenditures in this area of the budget at $2.2 billion. The budget proposes General Fund spending of $791 million, about 28 percent below the revised current-year amount. This reduction is achieved by shifting partial General Fund support for the courts to new sales tax (as part of the realignment proposal) and fee revenue. In addition, the budget proposes significant unallocated reductions to the court budget.

Issues for Legislative Consideration

Cost Reduction Measures Needed in Corrections. The CDC is the largest state corrections agency in the nation. With over 45,000 employees and a total budget of about $5.3 billion, the CDC manages over 160,000 prison inmates, and more than 119,000 parolees. During the past ten years, the average annual growth rate of CDC expenditures has been about 8 percent. Given the magnitude of the state's fiscal problem, the Legislature may wish to consider ways to reduce the inmate and parole populations. Because the CDC is a caseload-driven budget, it will not be possible to significantly reduce expenditures for the department without taking action to reduce the inmate and parole population.

In considering reductions to the inmate and parole populations, the Legislature should focus on two target groups: nonviolent offenders and short-term offenders. The state prison system has a significant number of inmates who are serving time for nonviolent offenses such as property and drug offenses. Similarly, there is a sizeable number of offenders with short prison terms, some with terms as short as six months or less. The state incurs significant costs to process and house these inmates. Targeting reductions on these two groups makes the most sense both from a fiscal and public safety standpoint.

It should also be noted that maintaining an offender in the community under supervision is significantly less costly than incarceration in prison. For example, inmates who are released early from prison to parole could be placed in the community with intensive supervision. For example, electronic monitoring devices could be used to ensure that individuals remain within a confined area. This could work particularly well for nonviolent, chronically ill, and elderly inmates.

- ***Elderly Inmates***. Research shows that elderly inmates are two to three times as costly to incarcerate in state prison than younger inmates, and that elderly offenders are less likely to re-offend and have greater success on parole. For these reasons, we recommend the Legislature adopt trailer bill language requiring that nonviolent elderly inmates be released early to parole. We estimate this would generate savings of $9 million in the budget year.
- ***Inmate Work Credits***. Inmates who are being processed in the reception centers and who are unassigned to a full-time work or education program due to a shortage of slots earn less than the maximum level of work credits. The state could save $70 million by allowing these inmates to earn day-for-day work credit instead of the one-day-for two days participation they currently earn. According to CDC, on average, this would reduce the sentence of approximately 29,000 inmates by only 27 days.

Other Criminal Justice Issues. In addition, there is potential for reductions in other areas of the criminal justice budget. For example, the state could close several of its Youth Authority facilities, and shift Office of Criminal Justice Planning (OCJP) programs to other departments with similar missions and programs. These are discussed below.

- ***Shift OCJP Programs to Other Departments.*** The OCJP is mostly a vehicle for disbursing state and federal funds. Given the office's poor performance in the administration of its programs, and the significant level of overlap of its mission and programs with those of other departments, we recommend that OCJP programs be shifted to other departments. This would improve the efficiency and service delivery of state government, save $1.5 million from the General Fund, and free up $3.7 million in federal funds for other programs.
- ***Closure of Youth Authority Facilities.*** Last year, in response to the significant decline in the ward population, the Legislature adopted legislation requiring the Youth Authority to close one institution by the end of the budget year, and to develop a plan to close three facilities by 2006-07. The plan submitted by the Youth Authority would close the male portion of the Ventura Youth Correctional Facility and the DeWitt Nelson Youth Correctional Facility (in Stockton) by the end of the budget year, and close the Fred C. Nelles Youth Correctional Facility (in Whittier) by the end of 2005-06.

Trial Courts Funding Shift to Special Funds. For the first time in a number of years, fee revenues are proposed to exceed the General Fund share of the Trial Court Funding budget. These special funds have grown from 19.5 percent of court funding in 2001-02 to an estimated 42.6 percent in 2003-04. This growth is the result of fee and penalty increases included in the *2002-03 Budget Act*, as well as proposed budget year increases in fees. For the budget year, the Governor proposes to increase the existing trial motion fee from $23 to $33, establish a new court security fee, and transfer certain "undesignated fees" from the counties to the courts to offset General Fund reductions. In addition, the Governor proposes to shift $300 million in court security costs from the General Fund to newly proposed realignment sales tax revenues. Our review of the new court security fee and undesignated fee proposals indicates that the level of projected revenue from these fees is uncertain, and potentially puts the state at risk to make further unallocated reductions to the court budget, or backfill the shortfall with General Fund monies.

TRANSPORTATION

In 2000, the Legislature enacted the Traffic Congestion Relief Program (TCRP), which established a six-year funding plan for state and local transportation needs, covering the period from 2000-01 through 2005-06. The plan was later extended to eight years, through 2007-08. The program is funded from two sources:

- ***Traffic Congestion Relief Fund (TCRF).*** The TCRF received $2 billion from the General Fund in 2000-01. This amount included $1.6 billion which, combined with future transfers from the TIF (discussed below), is to pay for a portion of the costs of 141 TCRP projects defined in statute. The remaining $400 million went for local street and road improvements.
- ***Transportation Investment Fund (TIF).*** Beginning in 2003-04, the General Fund is to transfer revenues from the sales tax on gasoline—more than $1 billion per year—into the TIF. Of these funds, a total of $3.3 billion is to be made available for the 141 TCRP projects from 2003-04 through 2007-08. The remaining TIF money is to be divided among other state transportation improvement projects, local street and road improvements, and public transportation.

TCRF Monies Loaned to General Fund. As the state's financial situation worsened in recent years, about $1.3 billion from TCRF has been loaned to the General Fund. Current law requires that this money be repaid to TCRF in time to prevent any delay to TCRP projects, or in any case no later than June 30, 2006.

Proposal

Budget Proposes Further Redirection of TCRF and TIF Money. The Governor proposes to shift about $1.7 billion from TCRF and TIF to the General Fund. Specifically, the budget proposes the following actions:

- Transfer $100 million from TCRF to the General Fund in the current year.
- Forgive a $500 million loan repayment from the General Fund to TCRF scheduled for the budget year.
- Suspend the transfer of about $1.1 billion in sales tax revenue from the General Fund to TIF in the budget year.

These actions would permanently redirect about $1.3 billion designated for TCRP projects and $400 million from the other transportation purposes funded by TIF to the General Fund. The proposal would leave no money for TCRP projects in 2003-04 and about $300 million in TCRF monies for the current year to pay for expenditures that have already occurred and to close out existing contracts.

Proposal Would Delay TCRP Projects and Raises Substantial Uncertainties Regarding TCRP Status. At a minimum, the Governor's proposal would delay many TCRP projects until 2004-05, when TIF money would again be available. In the interim, only projects that have access to other funding sources may be able to continue. In response to the Governor's proposal and other transportation funding pressures, the California Transportation Commission (CTC) stopped all new allocations for TCRP projects in December 2002 in order to avoid increasing the amount it has committed to pay for these projects. It is uncertain at this point whether any project would be permanently cancelled. The status of the program's future is also uncertain, as the administration's intent regarding TCRP funding beyond 2003-04 is unknown. This creates doubt about whether project sponsors need only find temporary funding to keep projects going in the budget year, or whether they will need to find permanent replacements for lost TCRP funding.

Issues for Legislative Consideration

In considering the Governor's proposal, the Legislature should address two issues related to the funding of TCRP. Addressing these issues in a timely manner would significantly reduce the uncertainties regarding the program's status.

Should Near-Term "Bridge" Funding Be Provided? While the budget leaves no funding in 2003-04 and only $300 million to cover TCRP expenditures in the rest of the current year, some TCRP projects will continue to incur expenditures in the budget year unless outstanding contracts are terminated. The administration has developed rough estimates of the amounts of funds that would be needed in 2003-04 to move projects through different stages. For example, the administration estimates that about $200 million would be needed in the budget year to continue work on projects that are currently under construction, and about $310 million would be needed to continue work on all projects that are currently under contract. However, CTC has begun collecting more up-to-date information on project status and near-term funding needs.

We believe that the information being collected by CTC is essential in order for the Legislature to determine whether to provide any funding for TCRP projects in 2003-04. Accordingly, we recommend that CTC provide to the Legislature by mid-March detailed information on the status of each TCRP project, including projected expenditures to close out all contracts, to continue construction contracts through the budget year, and to continue *all* contracts through the budget year.

What Is the Ultimate Fate of TCRP? The Legislature has a number of options in considering the ultimate status of TCRP. The Legislature could adopt the Governor's proposal as a *one-time* action, making clear that total funding for the program is reduced by $1.3 billion. In adopting this option, the Legislature should also determine how to allocate the reduction among the TCRP projects.

Other options range from terminating any future funding for the program to making a full funding commitment to the program. We discuss these options below.

- ***Option: End the State's Commitment to TCRP.*** This option would remove the statutory commitment of state funds to TCRP projects, thereby allowing the Governor's proposal to aid the General Fund to be adopted without having to repay any money to TCRF. The TCRP projects would still be able to compete with other transportation improvement projects for state funding. However, absent the funding provided under TCRP, some large projects might never get built. This is because local entities do not have sufficient funds from other sources to make up the TCRP projects' funding gap. The Legislature may have to provide separate funding for these projects if they are still a priority.
- ***Option: Commit to Repayment of TCRP Dollars From the General Fund.*** This option would entail a clear commitment to partially or fully repay in future years the redirected amount ($1.3 billion) plus the loans already made to the General Fund ($0.8 billion). Full repayment would allow the state to fulfill its commitment to TCRP projects, but it would significantly delay funding for the projects. It would also increase General Fund expenditures by $2.1 billion in future years.
- ***Option: Provide Full TCRP Funding From a Predictable Funding Source.*** The Legislature could consider a gas tax to raise revenues to fully fund the TCRP. A 3-cent-per-gallon increase would provide about $2.1 billion over four years, relieving the General Fund of any obligation to repay TCRP projects. It would also provide a steady revenue stream, allowing projects to proceed without further delay. If the tax were to be continued on a permanent basis, the additional revenues could begin to address a 10-year transportation funding shortfall of over $100 billion that was identified by CTC in 1999.

Legislature Should Act Soon to Minimize Uncertainty. The Governor's proposal to remove $1.3 billion from TCRP projects creates uncertainty about the ultimate fate of these projects. This uncertainty affects the decisions that project sponsors must make regarding the priorities of these projects relative to other transportation projects. In order to assist these parties in making informed decisions regarding the priorities of their transportation projects and to avoid having to revisit TCRP funding on an annual basis, the Legislature should act as quickly as possible to determine its level of commitment to the TCRP and to ensure that funds are available to match this level of commitment.

RESOURCES

Proposal

Funding for Resources and Environmental Protection Programs. While the Governor's budget proposes several fee increases in order to reduce General Fund expenditures in this area, General Fund support still remains substantial for 2003-04.

- ***Fire Protection.*** The budget proposes $341 million from the General Fund for the California Department of Forestry and Fire Protection (CDFFP) to provide fire protection services to property owners in "state responsibility areas" (SRAs).
- ***Timber Harvest Plan (THP) Review.*** The budget proposes about $23.5 million (almost all General Fund) for state agencies to review and enforce THPs which lay out proposed harvest volume, cutting method, and wildlife habitat protection.
- ***Water Rights Regulation.*** The budget proposes $8.7 million ($7.2 million General Fund) for the State Water Resources Control Board's (SWRCB's) water rights program which issues new water rights, approves changes to existing rights, and conducts enforcement and compliance monitoring.
- ***Dam Safety Regulation.*** The budget proposes $8.8 million ($7.8 million General Fund) for the Department of Water Resources' (DWR's) dam safety program for supervising the maintenance and operation of about 1,250 dams in the state that are not under federal jurisdiction.
- ***Air Quality Regulation.*** The budget proposes $39.6 million ($10.4 million General Fund) for the Air Resources Board's (ARB's) stationary source program. The budget proposes to shift $10 million from the General Fund to fees and to add manufacturers of consumer products (such as aerosol sprays) and architectural coatings (paints, stains, and varnishes) to the fee-paying base.
- ***Pesticide Regulation.*** The budget proposes $53.3 million for the Department of Pesticide Regulation's (DPR's) pesticide regulatory program. Most of funding is proposed to come from the DPR Fund, supported mainly by an assessment on pesticide sales. The

budget proposes to shift $10.5 million in funding from the General Fund to the DPR Fund, leaving essentially no General Fund support in the department.

- ***Resource Assessment.*** Various state agencies, including the Department of Fish and Game (DFG), engage in resource assessment efforts preparatory to issuing permits for activities that may impact natural resources. In addition, local agencies use these resource assessments prior to approving developments. Resource assessment activities relate to determining the condition of natural resources in the state. The DFG also gathers data on individual fisheries and uses this information to manage and regulate commercial and recreational fisheries.

Bond Expenditure Proposals. The budget proposes about $2.2 billion of bond funds for various resources and environmental protection programs. A number of these proposals are to implement a new program, or to substantially expand an existing one. These bond expenditure proposals include:

- $33.3 million (Propositions 40 and 50) for the river parkway program and $7 million (Proposition 50) for the Sierra Nevada Cascade program in the Secretary for Resources.
- $84.8 million (Proposition 50) for the integrated regional water management program (SWRCB and DWR) and $15.1 million (Proposition 50) for the water security program (DWR and the Department of Health Services [DHS]).
- $442 million (various bond funds) for a number of state agencies to implement the CALFED Bay-Delta Program.
- $363.5 million (Proposition 50) in the Wildlife Conservation Board (WCB) for various programs, including $32.5 million for Colorado River management.
- $98 million (Proposition 40) for an historical and cultural resources preservation grant program in the Department of Parks and Recreation.

Issues for Legislative Consideration

Funding for Resources and Environmental Protection Programs. We identify a number of opportunities to shift General Fund costs to fees, beyond those proposed in the Governor's budget. Adopting our recommendations would result in General Fund savings totaling $214 million. Fees are an appropriate funding source in these cases, either because the state is (1) providing a service that directly benefits an identifiable person or business (such as fire protection services) or (2) administering a pollution control program that could reasonably be funded on a "polluter pays" basis. Under the polluter pays principle, private parties that benefit from using public resources are responsible for paying the costs imposed on society to regulate such activities.

The specific opportunities for General Fund savings are:

- ***Fire Protection.*** Property owners in SRAs directly benefit from CDFFP's fire protection services and therefore should share in funding the department's costs. Although fees could be structured in a number of ways, we recommend establishing a $6 per-acre fee for 2003-04 and 2004-05, resulting in annual General Fund savings of $170 million. We recommend that the Board of Forestry develop a permanent fee structure that would apply in later years, based on statutory direction.

- ***THP Review.*** We think that timber operators who benefit from the state's review and enforcement of THPs should pay for those activities. Of the available options for structuring fees, we recommend a timber yield fee, calculated as a percentage of the value of harvested timber. Such a fee would save the General Fund $22.1 million annually.

- ***Water Rights Regulation.*** Because water rights holders directly benefit from all aspects of the water rights program—including permit issuance and compliance monitoring—the existing fee structure should be revised so that fee revenues replace all General Fund support for this program. Adoption of such a recommendation would reduce General Fund costs by $7.2 million annually.

- ***Dam Safety Regulation.*** Because dam owners benefit from the dam safety program, we believe that they should pay for such services. Such a shift would reduce General Fund costs by $5.4 million annually.

- ***Air Quality Regulation.*** About $4.4 million of ARB's stationary source budget is for General Fund expenditures related to planning and monitoring activities that provide a scientific and technological basis for air quality-related permits. These activities prevent permit requirements from being arbitrary or unduly burdensome on the holder of the permit. As such, they provide a benefit to the permit holder and therefore should be funded from fees. By shifting funding for these activities to fees as we recommend, the General Fund would save $4.4 million.

- ***Pesticide Regulation.*** In addition to DPR, a number of other state agencies conduct work associated with the regulation of pesticides. These include ARB, SWRCB, DFG, and DHS. These agencies primarily conduct environmental reviews that are necessary to permit the sale of pesticides in the state. The budget proposes at least $3.3 million ($2.9 million General Fund) for the pesticide-related work of these other agencies. (The level of funding proposed for DHS is not currently known.) We think that the pesticide-related activities of ARB, SWRCB, DFG, and DHS should be funded by fees charged to registrants and users of pesticides since they benefit from the activities of these agencies. By shifting funding to fees as we recommend, the General Fund would save at least $2.9 million.

- ***Resource Assessment.*** Many permit applicants and developers benefit from resource assessment activities because the assessments are used by the department in the environmental review of permits and conservation plans, which must be approved before the development process can go forward. We conclude that the assessment activities related to permit and development approvals should at least be partially funded by the permit applicants / developers. Similarly, we conclude that DFG's costs to conduct marine assessments should be at least partially borne by the commercial and recreational fishing activities that benefit from the management of those resources. Shifting one-half of the General Fund support of these activities to fees would save the General Fund $2 million annually.

Bond Expenditure Proposals. There are a number of issues for legislative consideration when evaluating the Governor's budget proposals to expend resources bond funds:

- ***Legislative Oversight.*** We recommend that the budget and policy committees of each house hold joint hearings on the Governor's budget proposal related to Propositions 40 and 50, thereby allowing the Legislature to be apprised of the Governor's overall expenditure priorities from each of these bond measures. Additionally, we recommend that the Legislature appropriate the Proposition 40 and Proposition 50 bond funds for the Wildlife Conservation Board in the budget bill. These expenditures would not otherwise be reviewed by the Legislature, given the board's existing "continuous appropriations" authority for most of its bond expenditures.

- ***Improving Bond Fund Accountability.*** Legislative oversight of bond fund expenditures is made more difficult because the fund condition statements of most of the recently enacted resources bonds are not displayed in the Governor's budget document. Absent this information it is difficult for the Legislature to ascertain spending requirements and available balances. We therefore recommend the enactment of legislation that requires the Governor's budget document to display these fund conditions. This will promote accountability and will facilitate the monitoring of fund balances for use in current and future budget appropriations.

- ***Providing Legislative Guidance for Bond Fund Expenditures.*** The budget provides few details on the bond fund expenditure proposals for the river parkway, Sierra Nevada Cascade, integrated regional water management, and water security programs. For these programs, we recommend that funding be deleted from the budget bill, and instead be put in legislation that defines the programs and guides their implementation.
- ***Ensuring That Legislative Direction Is Followed.*** A number of the Governor's proposals are inconsistent with previous legislative direction, and we recommend legislative actions to ensure consistency. Specifically, the Governor's proposals for the CALFED Bay-Delta Program provide the new California Bay-Delta Authority with greater expenditure authority than permitted in statute. Also, the proposal for the Colorado River program in WCB is inconsistent with statutory direction (Chapter 617, Statutes of 2002 [SB 482, Kuehl]), regarding the use of the Proposition 50 allocation that is relied on to fund the proposal. Finally, the proposal for a historical and cultural resources grant program in DPR should be made consistent with Chapter 1126, Statutes of 2002 (AB 716, Firebaugh), that specifies a structure and criteria for the award of historical and cultural resources preservation grants using Proposition 40 bond funds.

EMPLOYEE COMPENSATION AND RETIREMENT

Employee Compensation. The Governor's budget proposes $22 billion in salary, wage, and benefit compensation for 325,000 authorized personnel-years in state government. Under current contracts, most state employees are scheduled to receive a 5 percent salary increase on July 1, 2003. Both highway patrol and corrections employees have long-term contracts—with the first of four annual pay raises also scheduled to begin on July 1, 2003 (6 percent and 3.5 percent, respectively). In total, the budget-year costs of these pay raises are estimated to be $532 million. More than half of these costs are attributable to the General Fund.

Retirement Contributions. The state makes annual contributions to the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS) to fund retirement benefits for state employees and teachers that will be paid out in the future. In 2003-04, the estimated state contribution to PERS is $2.1 billion. Of that amount, the General Fund would contribute $1.1 billion. The General Fund provides the entire contribution to STRS, which is estimated at $448 million in the budget year.

Proposal

Employee Compensation Reduction. The budget does not include the $532 million for the scheduled employee salary increases. Instead, the Governor proposes an $855 million ($470 million General Fund) reduction in employee compensation expenditures. The $855 million in savings is roughly equivalent to an across-the-board 8 percent salary reduction. The savings, however, could be achieved through any combination of pay cuts, reduced benefits, or other actions like furloughs or layoffs. The administration proposes to achieve these savings through the collective bargaining process with the employee unions.

Financing Retirement Contributions. The Governor's budget proposes not to make the standard retirement contributions to PERS and STRS. Instead, the budget proposes two alternatives: (1) issue pension obligation bonds or (2) borrow the necessary funds from the systems. The alternatives would save the state up to $2.5 billion ($1.5 billion General Fund) in 2003-04. These alternatives instead would have the state finance these retirement operating costs over a number of years.

Issues for Legislative Consideration

Options for Exercising Control Over Compensation Reductions. The Governor's proposal has the administration leading the determination of employee compensation reductions. Given the state's fiscal condition, we believe it is appropriate to consider reductions in employment costs. But the Legislature need not defer to the administration in determining or allocating the negotiated reductions. Specifically, the Legislature could choose to exercise some control over the proposed reductions—such as determining the desired level of cuts, establishing parameters for negotiations, and ensuring adequate time for review of any reductions.

Retirement Proposal. We have two major concerns with the Governor's retirement proposal:

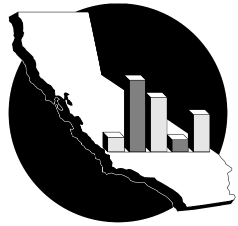
- ***Departure From Standard Use.*** Since 1993, more than two dozen cities and counties in California have issued taxable pension obligation bonds to pay off the difference between retirement benefit liabilities and existing resources. These local governments have relied on court interpretations that pension bonds *exchange* the existing retirement debt obligation for the new bond obligation. The Governor's proposal, however, is fundamentally different than these efforts in that the state would primarily be issuing debt to pay for current operating costs. As a result, it is unclear to us if local government precedents would apply.

- ***Incurring Debt for Operating Costs Is Ill Advised.*** Incurring decades worth of debt to avoid an annual operating expense as a budget-balancing tool is poor fiscal policy. Consequently, we recommend that the Legislature reject these debt proposals.

V

Addressing the State's Fiscal Problem

Addressing the State's Fiscal Problem



As discussed in "Part I" of this volume, California faces an enormous budget problem in 2003-04. To address this problem, the Governor's budget proposal includes deep spending cuts in most program areas; major reductions in local government subventions; and a variety of other loans, funding shifts, and borrowing. Our companion volume, the *2003-04 Analysis*, evaluates the spending proposal in detail.

Approaching the Budget Problem

In evaluating and deciding how to respond to the Governor's overall budget-balancing plan and individual proposals, the Legislature faces a formidable challenge. It must first identify its own spending and revenue priorities. It must then assess whether the Governor's proposals in various areas are consistent with its own priorities, and if they are not, what other budget-balancing options it should consider.

In December 2001, we identified for the Legislature certain key budget-balancing principles, strategies, and tools that it might wish to consider in evaluating the Governor's proposals and formulating its own budget-balancing options. We continue to stress the need to:

- Undertake current-year actions to accompany the budget-year solutions that will be adopted later, so as not to concentrate the entire solution to the shortfall all in one year.

- Put everything "on the table" when considering alternative budget solutions, so as to neither overly rely on any one group of solutions nor overlook others.

- Recognize that a significant amount of ongoing solutions will be needed to supplement the one-time ones if the state's underlying structural budget deficit is to be fully and comprehensively addressed.

We also have suggested the Legislature pursue such key strategies in order to (1) decide on the relative roles of expenditure and revenue options in dealing with the shortfall, (2) identify the appropriate contributions to come from different program areas, and (3) decide the appropriate mix of one-time versus ongoing solutions.

Overview of "Part V" Analysis

This part includes three pieces that are intended to assist the Legislature in addressing the state's fiscal problem and developing its own response and options to it. These three pieces deal with the following key topics:

- The Governor's $8.3 billion tax increase proposal and alternative revenue-raising proposals to help address the problem.
- The budget's realignment plan to shift roughly $8.2 billion of state program responsibilities (primarily in health and social services) to localities, and provide new tax revenues to support them.
- Alternative options for reducing state expenditures that the Legislature may wish to consider in addition to, or as substitutes for, the budget's proposals.

The Governor's Tax Proposal: Evaluation and Alternatives

What Are the Major Considerations for the Legislature in Assessing the Governor's Proposal to Increase Tax Rates, And What Alternatives Should it Consider?

Summary

The 2003-04 Governor's Budget proposes a major tax increase to help address the budget shortfall by using these new revenues to fund the realignment of various programs to local governments. The budget proposes establishing new personal income tax (PIT) rates on high-income taxpayers, increasing the sales and use tax (SUT) rate by 1 percent, and raising the cigarette excise tax by $1.10 per pack. The proposal is expected to result in additional revenues of $8.3 billion in 2003-04.

The administration's revenue proposal raises numerous issues relating to the characteristics of the revenue sources that are slated for a rate increase, as well as regarding the impacts of these tax proposals on the state's business and individual taxpayers. In order to assist the Legislature in its evaluation of this proposal, we suggest a number of criteria upon which the assessment of the Governor's plan should be based.

Based on these criteria, we discuss the various characteristics associated with the three taxes, especially with respect to their growth and volatility. In addition, we examine the impact of the tax increase proposal on different categories of taxpayers in the state and on individual taxpayers within them. Finally, given the importance of revenues to the Governor's realignment plan—and the budget as a whole—we also identify and discuss a number of other revenue options the Legislature may want to consider in its deliberations.

INTRODUCTION

As one of his solutions to the budget shortfall, the Governor proposes a substantial tax increase. The tax proposal involves increasing the rates on three major taxes—the SUT, the PIT, and the cigarette excise tax—and earmarking the revenues resulting from these tax increases for the Enhanced State and Local Realignment Fund (ESLRF). As noted in the realignment discussion in this part, the ESLRF is to be used to provide funds for various programs shifted to the local level as part of the budget's realignment proposal.

In the following discussion, we describe the Governor's tax proposals and their likely revenue impacts on the state. We consider the characteristics of the affected taxes, and how these characteristics might affect their suitability both as a partial solution to the overall budget problem, and as sources of revenue for the Governor's realignment proposal. We also investigate the impact of the tax proposals on individual taxpayers. Finally, we identify various revenue alternatives to the above tax changes and compare them to the Governor's proposals.

WHAT IS THE TAX PROPOSAL?

The Governor's tax proposal consists of three principal components:

- ***One Cent Increase in the SUT Rate.*** The *2003-04 Governor's Budget* proposes to increase the statewide SUT rate by 1 cent, beginning on July 1, 2003. The increase would result in raising the SUT rate to a minimum of 8.25 percent and to a maximum of 9.50 percent, depending upon the county and the existence of any special tax districts within it.
- ***New High-Income PIT Brackets.*** The Governor's budget proposes to establish new 10 percent and 11 percent PIT brackets for tax years beginning in 2003. Currently, the top PIT rate is 9.3 percent. The 10 percent rate would affect married taxpayers filing jointly with annual taxable incomes between $272,230 and $544,460. The 11 percent bracket would affect joint filers with taxable annual incomes in excess of $544,460. The applicable income thresholds for single taxpayers would be one-half these amounts. The proposal also increases the Alternative Minimum Tax rate from 7 percent to 8.5 percent.
- ***Increase in the Cigarette Excise Tax.*** Under the 2003-04 plan, the excise tax on cigarettes is proposed to increase by $1.10 per pack

from the existing tax rate of 87 cents per pack. The cigarette tax increase is scheduled to go into effect July 1, 2003.

The increase in the SUT rate and the cigarette excise tax rate are relatively straightforward, since—in each case—they involve no change in the nature of the tax base and utilize existing administrative procedures. Our understanding is that the additional state administrative and taxpayer compliance costs from (1) requiring registered sellers to collect an additional 1 cent of the SUT and (2) charging $1.10 more for cigarette tax indicia are relatively minor. However, the PIT rate increase proposal is somewhat more complex and involved, from both the state's and the taxpayers' perspectives.

Specifically, the PIT proposal would result in a new tax rate schedule and require additional withholding schedules for certain taxpayers. The PIT increase proposal would also require the Franchise Tax Board (FTB) to separate PIT receipts resulting from the higher 10 percent and 11 percent brackets from the PIT revenues resulting from the existing tax rates and bracket structure. We discuss this issue further below, when we examine the PIT proposal and consider various associated administrative issues.

Overall Impacts on Taxpayers. The Governor's tax proposal would have very different effects on California taxpayers, depending upon their incomes and consumption patterns. For example, the PIT increase proposal would have a direct impact only on a very limited number of high-income taxpayers. The cigarette tax increase proposal would obviously have a direct effect only on cigarette smokers. Only the proposed increase in the SUT would have a broad-based direct impact on California taxpayers. We discuss the impacts of the individual taxes later in this analysis.

Proposition 98 Considerations. In general, state tax increases implemented in 2003-04 have the potential of raising the Proposition 98 minimum funding guarantee for education. Because of this potential interaction, an important issue related to the budget's proposal is the extent to which its new taxes would be available to address the state's budget shortfall (through realignment or some other means) versus how much would instead be required to go to added school funding (see shaded box, next page).

The administration's view is that because counties and courts—not the state—would receive the new tax revenues, they need not be included in its calculations of the state's Proposition 98 minimum funding guarantee. Thus, the administration reflects these tax increases as special fund revenues and excludes them from the Proposition 98 calculation.

Although the interaction with Proposition 98 is certainly a vital consideration for the Legislature, we would also note that the realignment and revenue proposals warrant consideration on the basis of their own merits as well.

New Taxes and Proposition 98

Proposition 98 guarantees a certain level of funding for K-14 education. Given current law, we estimate that this minimum funding guarantee for 2003-04 is $44.1 billion. Should the Legislature wish to increase General Fund taxes to help address the budget shortfall, we estimate that education's funding guarantee would grow by an amount equal to about half of the new tax revenues. Put another way, only half of the new taxes would go towards eliminating the budget gap.

The California Constitution allows the Legislature to suspend Proposition 98 in an urgency bill other than the budget bill. Suspension allows the Legislature to fund K-14 education in an amount lower than indicated by the Proposition 98 formulas. The Legislature, for example, could fund education in 2003-04 at the same amount it would have received in the absence of new taxes, or $44.1 billion.

Such a one-time suspension of Proposition 98 would not materially alter future state education funding obligations under Proposition 98 relative to what the state's funding obligation would have been without new taxes. Thus, it would allow the full amount of any new General Fund taxes to be applied to addressing the budget problem.

Revenue Impacts of the Tax Proposal

The proposed tax increases for 2003-04 are estimated to result in total revenues of $8.3 billion, with $8.2 billion to be used to fund the Governor's realignment program. (The remainder of the increase involves cigarette taxes that would be used to compensate special funds for expected revenue losses from consumption declines caused by cigarette tax increases.) Figure 1 indicates the additional revenues estimated for the three taxes through 2005-06. As indicated in the figure, revenue stemming from the high-income tax brackets is expected to decline in 2004-05. This is because in 2003-04—the first year affected by the PIT rate change—there is a one-time "doubling up" of revenues, due to both higher payments for 2003 tax year liabilities *and* increased withholding for 2004 tax year liabilities. Cigarette taxes are also expected to decline in future years due to ongoing decreased per capita consumption—a trend that has been occurring for some time.

LAO's Evaluation of the Tax Proposal

The Governor's proposal to raise tax rates for three of the state's existing revenue sources raises important issues regarding such factors as: the

Figure 1

Revenue Effects of the Governor's Tax Increase Proposal

2003-04 Through 2005-06[a]
(In Billions)

	2003-04	2004-05[b]	2005-06[b]
Sales and Use Tax			
1 percent increase	$4.6	$4.9	$5.2
Personal Income Tax			
High-income brackets	2.6	1.8	2.0
Cigarette Excise Tax			
$1.10 per pack increase[c]	1.2	1.1	1.0
Totals	**$8.3**	**$7.8**	**$8.2**

a Detail may not total due to rounding.

b LAO estimates based on Governor's revenue forecast.

c Includes backfill amounts for the provisions of Proposition 99, Proposition 10, and Breast Cancer Fund legislation.

characteristics of the associated revenue streams, their effect on the state's economy, and their impact on the state's taxpayers—both individually and collectively. Some of the taxes' characteristics are of heightened importance due to the fact that their increased revenues are proposed as realignment revenues earmarked to fund particular programs.

In evaluating changes to the state's tax system, there are a number of commonly cited elements that the Legislature should consider. In very broad terms, these elements relate to the efficiency, equity, revenue sufficiency, and administrative qualities associated with the tax system. Given that the Governor's proposal involves increasing the rates for three particular taxes and devoting the revenues raised to particular programs, there are certain other specific characteristics that the Legislature should also consider in evaluating the appropriateness of the revenue proposals. These characteristics—which are incorporated in Figure 2 (see next page)—are of particular importance given the current budget challenge facing the state.

With these criteria in mind, we next discuss the specific individual changes in taxes that the Governor has proposed.

Figure 2

Essential Criteria for Evaluating The Governor's Tax Proposals

- ✓ ***Growth Performance***—Will the new tax revenues grow along with the economy and/or the program responsibilities they are expected to fund?
- ✓ ***Reliability and Volatility***—Are new revenues raised by the taxes relatively stable over time or are they excessively volatile and difficult to predict?
- ✓ ***Distributional Effects***—Is the additional burden or "incidence" from the increased taxes distributed among taxpayers in a manner that the Legislature believes is appropriate?
- ✓ ***Tax Administration***—Are the new taxes simple to collect and administer or do they add additional complexity to the existing administrative structure?
- ✓ ***Federal Interaction***—Would the increased taxes be deductible for federal purposes, allowing the state to "shift" some of the additional tax burden to the federal government?
- ✓ ***Economic Climate***—What effects are the proposed tax increases likely to have on the business climate and overall economic activity?

SUT Proposal

Overall Performance of the SUT and Its Base—Relatively Steady

The performance of the SUT and taxable sales (the SUT's primary determinant) has been relatively steady, although on average, their growth has generally lagged that of the overall economy and been a bit more volatile.

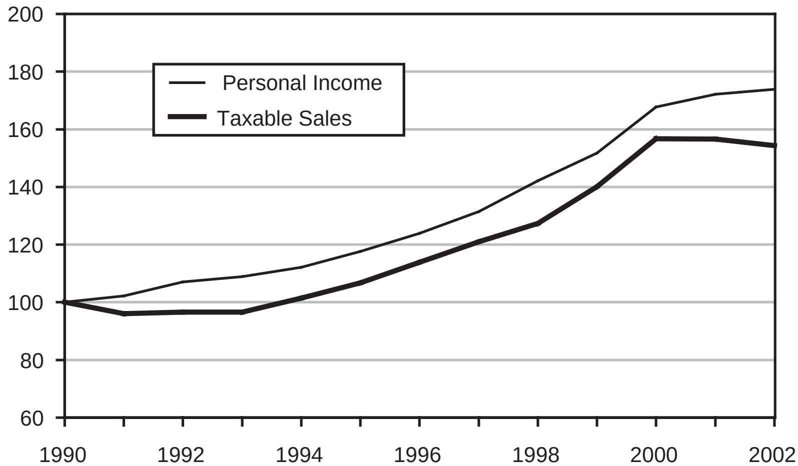
Growth. Figure 3 shows the overall growth of taxable sales compared to the state's personal income for the period 1990 through 2003. The annual average growth in taxable sales over this period was approximately 3.7 percent, compared with the overall growth rate in personal income during the same period of roughly 4.6 percent annually.

The reasons for this discrepancy in the two growth rates are partially related to the large increase in personal income that occurred in the late 1990s among high-income taxpayers. Increases in income—particularly for these groups—do not necessarily translate fully into additional taxable

Figure 3

Taxable Sales Growth– Generally Steady But Less Than Personal Income

Index Value Equals 100 in 1990



consumption. For example, much of the additional earnings may be saved or invested rather than used for current consumption. Furthermore, the lower growth rate in taxable sales (and indirectly, the SUT) is also likely related to some of the structural weaknesses in the tax base, as we discuss below.

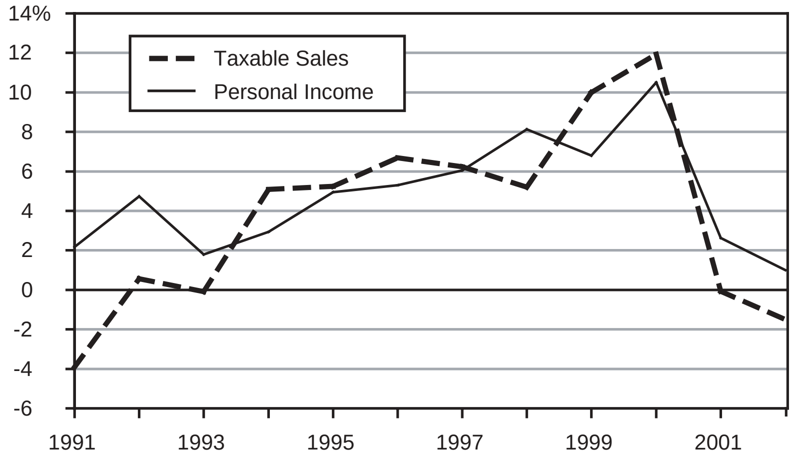
Volatility. Taxable sales exhibit moderate volatility, having fluctuated a bit more than personal income over the last decade. They have been less volatile than some other tax bases upon which the state relies—for example, taxable personal income and corporate profits. Figure 4 (see next page) indicates annual percent changes in taxable sales over the last decade or so and the corresponding changes that have occurred with respect to personal income in California. As shown in the figure, taxable sales oftentimes outperform the economy in an expansion period and underperform during periods of contraction.

Despite this particular quality, the structure of the SUT makes it somewhat more protected from economic variability in some circumstances than it would otherwise be. This is because the SUT is composed of roughly two-thirds retail sales and one-third business-to-business sales, a profile that makes the tax somewhat protected in the event a decline in either consumer spending or business investment alone occurs.

Figure 4

Taxable Sales Can Be A Bit More Volatile Than the Economy

Annual Percent Change in Taxable Sales and California Personal Income



The SUT Possesses Some Fundamental Weaknesses

Despite its overall steady growth and moderate volatility, taxable sales do suffer from some basic weaknesses that could adversely affect the SUT's revenue performance in the medium to long term. These features are particularly important to the extent that revenues from the tax are used for particular program financing rather than having such support come from the General Fund at large, with its more diversified tax base. Specifically, these structural issues are:

- ***Taxable Sales as a Percent of Personal Income***. Taxable sales represented close to 50 percent of personal income in the mid-1980s, but in more recent years the figure has declined to less than 40 percent. Ongoing shifts in the economy towards services and the development of new telecommunications technology suggest that additional changes in the tax base are possible. For example, alternative means of acquiring goods for consumption—such as through the Internet—make it possible that the SUT base may continue to erode. These new avenues of consumption make it easier for residents to (1) order from out-of-state businesses (who are not obligated to collect the California SUT from the purchaser) and (2) purchase nontaxed intangible goods as substitutes for the taxed tangible versions. We examine these issues further in our writeup on the Board of Equalization (BOE) in the *Analysis.*

- ***Narrow Base and High Tax Rate.*** As consumption patterns have shifted over the years towards services and intangible goods, the base of the SUT has narrowed relative to the economy in general and consumption in particular. The trend among many states (including California) to increase SUT rates may be at least partially due to an effort to compensate for the reduced base. Higher rates make the state more susceptible to cross-border sales and outright tax evasion. Higher tax rates also cause disproportionate economic distortions, due to consumption and investment decisions being made on a tax basis rather than based on more fundamental economic considerations.

How Would the Increase Affect Taxpayers?

Incidence of the SUT. How a tax—and the proposed increase in the SUT in particular—affects taxpayers in the aggregate and individually is one of the key questions that policymakers should consider with respect to the Governor's budget proposal. How the burden of a tax affects different groups of taxpayers is referred to as the tax's "incidence," and is typically measured in relation to the proportion of taxpayers' income that goes to paying the tax.

Most studies have shown that the SUT is a *regressive* tax—meaning that the proportion of income used to pay the tax decreases as income increases. (In contrast, *progressive* taxes show an increase in the tax as a proportion of income as income increases.) Thus, economists have found that lower income households pay a larger share of their income in sales taxes than do higher income households.

California's SUT does not levy the tax on food (which accounts for a large share of consumption for low-income households). Even with this substantial tax exemption, however, California's SUT is considered to be generally regressive. Some recent studies have found that the proportion of income spent on taxable purchases ranges from something in excess of 40 percent for households with incomes of $30,000 or less to about 22 percent for households with incomes greater than $100,000. Correspondingly, the percent of income spent on the sales tax for these two groups is about 3 percent and 1.5 percent, respectively. Figure 5 (see next page) shows (using as a guideline the findings of past research) what typical taxpayers in various income classifications would experience due to the change in the SUT rate, given an average level of taxable purchases by each taxpayer.

Figure 5

Effect of Proposed SUT Increase on Taxpayers Varies by Income Level

Household Income	Taxable Consumption[a]	Sales Tax Amount		Sales Tax Increase	
		Current[b]	Proposed[c]	Amount	Percent of Income
$25,000	$11,250	$889	$1,001	$113	0.45%
50,000	15,500	1,225	1,380	155	0.31
75,000	18,750	1,481	1,669	188	0.25
100,000	23,000	1,817	2,047	230	0.23
150,000	33,000	2,607	2,937	330	0.22
250,000	52,500	4,148	4,673	525	0.21

a Assumptions on taxable consumption adapted from "Estimating the Tax Burden in California," Steven Sheffrin and Marla Dresch, California Policy Seminar, 1995.

b Computed at the current statewide average rate of 7.9 percent.

c Computed at the proposed statewide average rate of 8.9 percent.

PIT Proposal

Growth In PIT Has Been Strong . . .

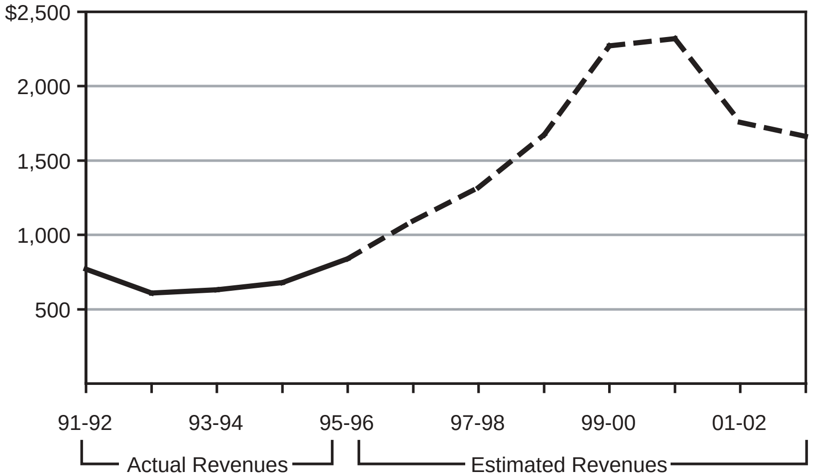
Overall PIT Growth. Since 1990, personal income in the state has grown rapidly, especially at the higher end of the income spectrum. The annual average growth in personal income in the state from 1990 to 2003 was approximately 4.6 percent. By comparison, the state's income from the PIT has generally grown even more rapidly than overall growth in personal income, largely due to the increased income at the high-end of the income spectrum and the higher average marginal tax rate to which these taxpayers' income is subject. Accordingly, the annual growth in the PIT from 1990-91 through 2002-03 was 5.8 percent. Through 2000-01, the growth in the PIT was significantly higher at over 10 percent, but revenues dropped by over 25 percent in 2001-02.

High-Income PIT Growth. Between 1991 and 1995, California had 10 percent and 11 percent brackets in place similar to those proposed by the Governor. Figure 6 indicates the actual revenue that was raised from these higher income brackets during the fiscal years for which they were in effect (1991-92 through 1995-96) and an estimate of the revenue that would have been raised from these brackets had they continued to exist through 2002-03. The revenue that would have been associated with these high-income brackets grew considerably over the period—at an approximate annual rate of 13 percent through 2000-01. However, revenues from the high-income brackets would have declined significantly in the last two years, making the annual growth rate over the entire period equal to 7.2 percent.

Figure 6

Actual and Estimated Revenue From PIT High-Income Brackets

(In Millions)



. . . But Revenues Can Be Quite Volatile

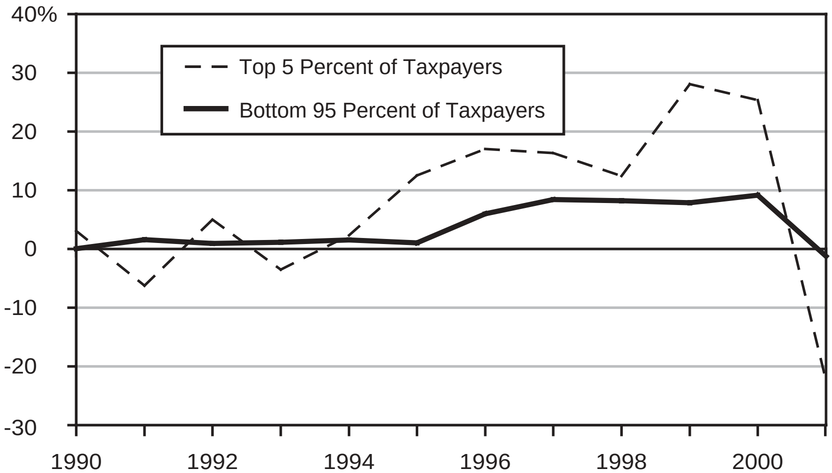
Indicators of Volatility. The above growth rates obscure the significant degree of annual fluctuation in revenues generated from these top PIT brackets. As shown in Figure 7 (see next page), over the entire period of the 1990s high-income taxpayers experienced significant changes in personal income relative to other taxpayers. For example, income increased by 28 percent for high-income taxpayers in 1999, but by about 8 percent for all other taxpayers. Similarly, in 2001, income associated with high-income taxpayers dropped by over 22 percent compared to a decline of only slightly more than 1 percent for all other taxpayers.

What Is Causing the Volatility? The reason for the volatility in the PIT in general, and that for the PIT revenues from high-income taxpayers in particular, are interrelated. First, there has been an increase in the concentration of income at the upper end of the income spectrum over the last decade, resulting in an increasingly larger proportion of the PIT being paid

Figure 7

High-End Income Is Subject To Considerable Volatility

Annual Percent Change in Income Reported On California Tax Returns



by taxpayers paying at the highest marginal tax rate. This, coupled with the fact that these very taxpayers receive a large proportion of their income from sources which are themselves quite variable, has led to the increased volatility overall in this revenue source.

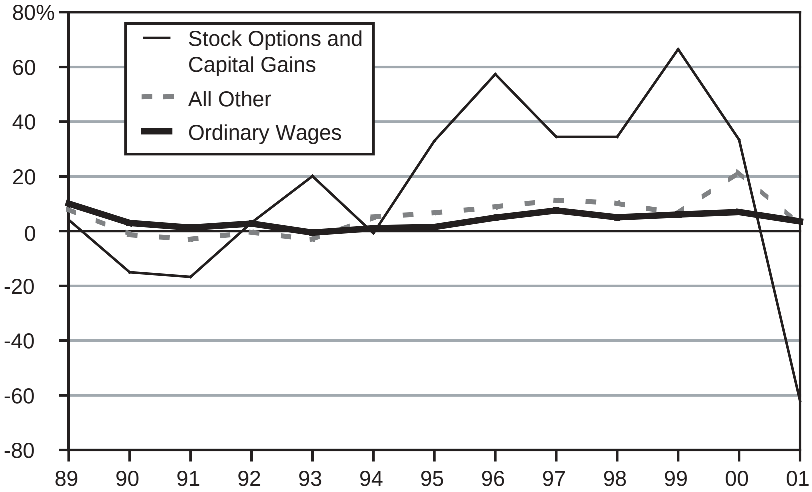
The greater volatility at the high end of the income spectrum is largely the result of stock options and certain nonwage income received by this group. Many components of nonwage income fluctuate enormously depending upon economic conditions and taxpayer decisions. For instance, those business profits that are taxed under the PIT tend to swing more than most other forms of income. Similarly, capital gains—which comprised a significant component of high-income taxpayers' nonwage income in the late 1990s—are subject to enormous and frequent swings. The volatility of ordinary wage income compared to these more volatile other income sources is shown in Figure 8.

Volatility Will Continue, But Could Lessen. Volatility is likely to be a continuing characteristic of the PIT given the current structure of the tax. Even with the market declines that have occurred, high levels of stock ownership—especially among high-income households—will continue, along with compensation practices involving stock options. Thus, even in a normal market environment, individual company stock performance—along

Figure 8

Stock Options and Nonwage Income– Key Source of Revenue Fluctuations

Annual Percent Change in Income Reported on California Returns



with employee behavior regarding stock options—will have unpredictable impacts on the PIT. These factors, in conjunction with forces underlying the continuing concentration of income in California, make it likely that revenue fluctuations associated with the PIT—especially in the high-income brackets—will continue.

Despite this characteristic, however, it seems likely that future PIT volatility will not reach the extremes of the recent past. Given that the capital gains and stock options gyrations of the last few years have been unparalleled in their magnitude, these fluctuations could prove to be historical anomalies.

How Will Taxpayers Be Affected by the Proposal?

Creation of New Tax Schedule. The Governor's tax proposal will result in two additional brackets for high-income taxpayers. As noted earlier, California previously imposed new brackets for high-income individuals for the 1991 through 1995 income years, in response to the previous recession and accompanying budget crisis. The income earned by these taxpayers is currently taxed at the marginal rate of 9.3 percent; however, the proposal will result in a new tax schedule as shown in Figure 9 (see next page).

Figure 9

Preliminary Tax Brackets—Current and Proposed[a]

Married Couples Filing Jointly
2003

If Taxable Income Is:		Current Law Tax Liability Is:			
Over	But Not Over	This Amount		And	Of The Amount Over
$0	$11,925	$0	+	1.0%	$0
11,925	28,266	119	+	2.0	11,925
28,266	44,612	446	+	4.0	28,266
44,612	61,929	1,100	+	6.0	44,612
61,929	78,267	2,139	+	8.0	61,929
78,267	and over	3,446	+	9.3	78,267

If Taxable Income Is:		Proposed Law Tax Liability Is:			
Over	But Not Over	This Amount		And	Of The Amount Over
$0	$11,925	$0	+	1.0%	$0
11,925	28,266	119	+	2.0	11,925
28,266	44,612	446	+	4.0	28,266
44,612	61,929	1,100	+	6.0	44,612
61,929	78,267	2,139	+	8.0	61,929
78,267	272,230	3,446	+	9.3	78,267
272,230	544,460	21,485	+	10.0	272,230
544,460	and over	48,708	+	11.0	544,460

[a] Based on 2002 tax rate schedule indexed by 2.2 percent.

Incidence of the Tax Increase. It has been estimated that the PIT rate changes proposed will affect approximately 4 percent of all income tax filers (and about 6.5 percent of those filers with a tax liability). The income categories affected by the tax proposal have been responsible for roughly two-thirds of all PIT liabilities in recent years. The change would result in an increase in the share of the total state liability paid by taxpayers with adjusted gross incomes (AGI) of more than $600,000 and declines in the share of the total PIT paid by all other taxpayers. The percentage of the total paid by taxpayers with AGIs of $1 million or more would increase from 19 percent to 23 percent.

How Will Individual Taxpayers Be Affected? Figure 10 shows average tax liabilities and the percentage change in them due to the proposal for each of five AGI classes. Taxpayers in the upper end of the income spectrum would face an average tax increase of 24 percent, or about $27,000, while those in the lowest income class shown in the figure would experience an average increase of only $2. We should also note that the tax increases are also likely to affect a large number of businesses that file under the PIT, such as partnerships, sole proprietorships, and Subchapter S corporations.

Figure 10

Some Taxpayers Would Experience Large Increases in Liabilities

Average California PIT Liabilities by Adjusted Gross Income

Adjusted Gross Income	Average Liabilities[a]		Increase in Average Liabilities	
	Current Law	Proposed Law	Actual	Percent
Up to $200,000	$1,592	$1,594	$2	0.13%
$200,000 - $400,000	13,271	13,390	119	0.90
$400,000 - $600,000	27,366	28,317	951	3.48
$600,000 - $1,000,000	44,654	47,923	3,269	7.32
$1,000,000 and over	114,160	141,520	27,360	23.97

[a] State liabilities only. Does not incorporate effects of federal deductibility.

Under most circumstances, some of the increase in taxpayers' state tax liabilities is likely to be offset by reduced federal income taxes due to the deductibility of state and local taxes for federal income tax purposes. For example, as noted above, an average taxpayer with AGI of $1 million or more would have an increased state liability of $27,360 under the Governor's proposal. That taxpayer's federal taxes, however, would decline by $10,561 (due to higher itemized deductions for state taxes). This deductibility feature would result in reducing the additional *net* taxes to $16,799. We discuss additional issues associated with deductibility below.

Cigarette Excise Tax Proposal

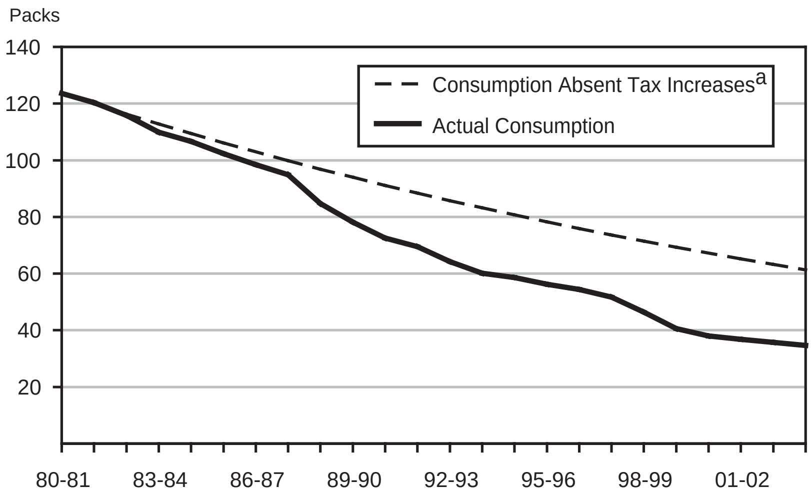
Cigarette Smoking Has Been Trending Down

Due to a variety of factors, the per capita consumption of cigarettes in California has trended downward over the last 20 or so years. As shown in Figure 11 (see next page), per capita cigarette consumption in the state has declined from 124 packs annually in 1980-81, to an estimated 35 packs annually in 2003-04. The number of packs consumed in California dropped from a peak of 2.9 billion in 1980-81 to an estimated 1.2 billion in 2002-03. This drop occurred despite the fact that California's population grew by roughly 50 percent over the same period.

Figure 11

Cigarette Consumption Has Declined Steadily

Per Capita Consumption of Packs of Cigarettes



[a] LAO estimate based on standard price elasticity assumptions, California consumption.

Why Has Per Capita Smoking Fallen?

The main reasons for the over 70 percent decline in per capita consumption are the following:

- Overall health concerns associated with tobacco use.
- Restrictions on smoking in workplaces and public areas.
- Tobacco price increases associated with increased taxes or manufacturers' cost increases.

Figure 11 indicates that if the adverse consumption effects of tax-induced price increases were removed from the calculations, per capita cigarette consumption would still have declined. These declines, primarily due to smoking *restrictions and health concerns*, have averaged on the order of 3 percent per year.

Tax Evasion Has Also Played a Role in the Decline

It should be noted that the data involving consumption are based on actual sales of cigarette stamps sold for tax purposes. To the extent that there has been increased evasion, however, there will be a discrepancy between the *apparent* consumption, shown in the official tax data, and *actual* consumption of tobacco products. That is, actual consumption will be greater than that suggested by the data.

The effect of tax evasion (primarily smuggling and stamp counterfeiting) has been of concern to states and federal regulatory agencies for some time, but has increased in importance in recent years as many states and the federal government have raised their cigarette excise taxes. Tax increases—including those proposed by the administration—increase existing incentives to engage in tax evasion and cigarette smuggling activities, leading to additional governmental revenue losses.

While the data on cigarette smuggling and tax evasion activity are sketchy, the BOE puts the total annual state revenue loss due to tax evasion at between $130 million and $260 million, a range that generally coincides with state-by-state estimates reported by the General Accounting Office. We examine revenue impacts and other issues associated with cigarette tax evasion in our write-up regarding the BOE in the *Analysis***.**

Downside Risks to the Revenue Estimate Exist

Given the above, the administration's estimate of the revenue gain from the cigarette tax increase proposal is subject to a number of risks and uncertainties. One, of course, is that evasion could rise. Another involves price effects. In terms of declines due to *price increases* (including those arising from higher taxes), most studies have shown that consumption declines by approximately 5 percent for every 10 percent increase in price. These estimates of the consumption response to a price increase (known as price elasticity of demand) have been based on situations where the percentage price increase has been relatively modest.

With larger price increases (such as those that would likely result from the adoption of the Governor's proposal), however, the established price-consumption relationship may not hold. Thus, if there were a larger-than-normal consumption decline due to a significant increase in price from the proposal (assuming the tax is largely passed through to consumers), revenues would be lower than estimated.

How Much Should Cigarettes Be Taxed?

In considering the Governor's proposal, a related question that should be addressed is: How much should the state tax cigarettes? This involves considering both the tax's incidence and the social costs (or "externalities") associated with smoking.

Incidence of the Tax. In general, economists have concluded that the cigarette excise tax is a regressive tax, in that it is largely borne by the consumer, and imposes a greater burden on low-income individuals than on high-income individuals. Research has indicated that cigarette expenditures amount on average to over 3 percent of incomes in the bottom income quartile but only 0.4 percent in the highest income quartile.

Social Costs. There is some divergence of opinion among economists and tax analysts regarding the "appropriate" level of cigarette taxation. If the appropriate level of taxation on cigarettes is an amount that basically recovers the adverse external costs imposed on society by smokers (such as increased health care costs), much of the existing research indicates that the tax should be less than $1 per pack. However, these estimates have not traditionally included such factors as (1) impacts of secondhand smoke on nonsmokers and (2) adverse effects on infant birth weight of smoking by pregnant women. Including these factors could justify cigarette taxes in excess of $1 per pack according to some researchers. In addition, some analysts have argued that—due to tobacco's addictive qualities—there are reasons beyond simply recovering social costs that justify additional taxation.

Will a Cigarette Tax Increase Hurt Tobacco Securitization?

The significant cigarette tax increases that have been recently proposed in California and other states have undoubtedly had an adverse impact on the interest rates and other terms of tobacco securitization bond sales across the nation. Investor expectations about future tax increases are important because (1) tobacco settlement receipts are the sole security for the tobacco bonds; (2) under the terms of the 1998 agreement between the states and cigarette companies, settlement payments are tied to national cigarette consumption levels; and (3) consumption levels can be reduced by tax increases imposed by states.

The expectation of future cigarette tax increases in California and other states were incorporated within the terms of California's first securitization bond sale, which was completed in January 2003, and these expectations will also affect the terms of the state's second sale, currently planned for later this spring. Once the bonds are sold, enactment of a tax increase would have no further impact on the state's ability to raise the planned $4.5 billion in cash. However, higher taxes and reduced consumption levels may affect (1) the amount of time it takes the state to retire the debt and (2) the amount of interest the state will have to pay in the future to retire the bonds.

Outside Influences on Cigarette Tax Revenues

The cigarette tax is susceptible to other influences that may affect its performance as a governmental revenue source, over which state and local governments have no control. First, as a regulated substance, cigarette sales and consumption could be further restricted in a fashion that would lead to additional reductions in smoking and reduced taxes. Second, additional taxation at the federal level (or cost increases to manufacturers) would lead to price increases for California smokers and a reduction in revenue, either due to actual consumption declines or increased smuggling.

The Realignment Tax "Portfolio"

The Governor's proposal is to devote the revenues from the above three increased tax rates toward the funding of specific realigned programs. The above examination of these increases indicates that the taxes exhibit very different characteristics:

- The SUT has been a relatively stable but slow-growing tax, and possesses certain structural weaknesses that may become increasingly important.
- The PIT on high-income taxpayers can be very fast growing and responsive, but is susceptible to volatility due to the fluctuating incomes associated with many of these taxpayers.
- Cigarette excise taxes do not fluctuate much, but are levied on a declining base that is susceptible to additional regulation and price increases that could further erode the base.

Given these features associated with the individual taxes, two important questions arise:

- First, what are the characteristics of the overall portfolio of these three taxes combined?
- Second, are the characteristics of the overall realignment revenues compatible with the new program responsibilities being shifted to these localities?

Characteristics of the Revenue Portfolio

Based on a simulation using our economic and revenue projections, we estimate that the realignment revenue portfolio would grow in the range of 5.5 percent to 6 percent annually during the next five years. With respect to volatility, the combined portfolio is obviously more stable than the PIT alone, but still displays substantial swings. The data and our simulation basically indicate that the other components of the tax package do not fully compensate for the significant swings in PIT revenue from the high-income tax brackets.

Characteristics of the Realigned Programs

A major concern with the Governor's realignment proposal is whether the revenue stream that is proposed is one that can be reasonably assumed to provide adequate revenue for funding the various program responsibilities to be taken on by local governments. We estimate that the growth in realignment revenues is potentially somewhat lower than overall growth in the programs being shifted to local governments. This may constrain the ability of local governments to fund programs in the future at the level they would prefer. In addition, the tax portfolio has displayed significant volatility in the past, and is likely to continue to manifest this characteristic in the future. This may pose problems for local governments, which have fewer tools to manage volatility than does the state. We discuss these issues further in the companion piece in this part on realignment.

How Can a Potential "Mismatch" Be Addressed? In the case of the state government, there is a large variety of revenue sources available and considerable latitude in being able to adjust these sources to reflect expenditure choices. In the case of the Governor's realignment proposal, however, local governments are likely to be somewhat limited in their expenditures by the characteristics of the new revenue sources. Given this, it becomes important to develop a means to address possible funding shortfalls.

Other Tax Issues for Consideration

Tax Administration

The SUT. Since the increase in the SUT builds from the state's existing tax administrative system, there would not be any significant tax administration issues associated with this portion of the tax proposal. In addition, this tax revenue would be allocated to local governments based on statewide taxable sales, such that local government land use decisions would not have an effect on the tax.

The Cigarette Tax. Although the proposed increase in the cigarette tax also builds on an established system, there are already identified compliance problems associated with the tax base. As discussed earlier, additional cigarette taxes are likely to worsen the existing compliance problem, possibly requiring significant additional enforcement resources devoted to preventing tax evasion.

The PIT. The PIT increase also raises administrative issues, particularly with respect to allocating revenues from the high-income brackets to the realignment programs. The proposal would require the FTB to separate

PIT revenues generated by the 10 percent and 11 percent brackets from all other PIT revenues. While the FTB has carried out such procedures for the purposes of research and analysis, its existing methodology has not been used prior to this date for the actual allocation of revenue, since all PIT revenues have been devoted to the General Fund.

An additional concern is that actual data regarding PIT revenues are not available when the budgets for the local governments receiving the funds are adopted. In fact, actual tax data may not be available until 12 to 18 months after final PIT payments are due for the previous tax year. Thus, for example, information regarding the 2002 tax year may not be available until the middle of 2004. This time lag would require the use of estimates for purposes of revenues flowing into the ESLRF. Reconciliation of the accounts would then need to take place subsequently when data on actual taxpayer returns are available.

Federal Interaction

Business Taxpayers. Under federal law, businesses can deduct all state and local taxes from their federal returns as business expenses. This will result in lowering their federal tax liabilities, and partially offset the state tax increases.

Individual Taxpayers. The federal government allows the deduction of certain state and local taxes from income for federal PIT purposes for those taxpayers who itemize deductions. This reduces a taxpayer's federal taxable income and associated federal tax liability. Among the California taxes that taxpayers are generally allowed to deduct are state income taxes, real property taxes, and the vehicle license fee (VLF).

Unlike many other types of state and local taxes, the *SUT* is not deductible for purposes of the federal PIT. Therefore, taxpayers would not be in the position of being able to reduce their federal PIT due to the increase in SUT taxes paid. This nondeductibility also applies to any excise tax, including the cigarette tax.

For itemizing taxpayers, California's *PIT* is deductible from income for federal income tax purposes. As shown earlier, this can result in a reduction in federal taxes (when state taxes are raised) equal to the amount of the state PIT change times the taxpayer's federal marginal tax bracket—or 38.6 percent for high-income taxpayers. However, the full deduction may not be available in many cases. In particular, the effects of the deduction are lessened for some higher income taxpayers and completely eliminated for others. This is due to two factors:

- ***The Phase Out of Deductions for High-Income Taxpayers.*** Current federal tax law requires taxpayers with incomes above a certain dollar threshold to reduce certain of their itemized deductions—including state taxes—by a scheduled percentage. For the 2003 tax year, the preliminary phase out threshold is $139,500 for joint return and single taxpayers.

- ***The Alternative Minimum Tax (AMT) calculation.*** Under certain conditions, the AMT is a tax that must be paid by taxpayers who claim a large dollar amount of deductions (including state taxes), exemptions, and other tax preference items in the determination of their regular PIT liability.

As noted earlier, the addition of the high-income brackets is estimated to raise $2.6 billion in 2003-04. Absent the above factors, federal deductibility would result in reduced federal tax liabilities of about $1 billion. However, due to the above factors, we estimate that the reduction in federal taxes will actually be about $550 million, resulting in a net tax increase to high-income Californians of approximately $2 billion.

Economic Climate

In weighing various budget options—and the appropriate role of any revenue increases—the Legislature should consider the effect that such decisions can have on economic activity in the state and the state's business climate. While taxes can be a deciding factor for some firms, the level of state taxation has not been identified in most studies as a major factor that is considered by investors seeking to expand or relocate activities. Typically, in fact, taxes are well down the list of considerations after such major factors as access to markets, transportation availability, general infrastructure, and labor availability and productivity. Nevertheless, taxes clearly enter into business and individual decisions with regard to their location and investments. In addition, given the current subdued economic conditions in the state, taxes may take on a heightened importance as businesses and individuals attempt to minimize their costs.

With respect to its economic environment, California is generally considered a high cost state in which to conduct business, as are most industrial states. However, its overall tax burden relative to income is only slightly above the average for all states and below that of many of the large industrial states. On the other hand, California's tax burden is generally higher than in other western states. In addition, the state has other regulatory and associated business costs that may be higher than in some states.

While the possible effects of any tax increases on California's economic climate should be considered carefully by the Legislature, this should occur with an awareness of the mix of public and private spending. Decisions on the part of the Legislature to invest in infrastructure, education, and other public goods have impacts on the well-being of the state and, in fact, are crucial to its economic performance. Given this, the Legislature needs to carefully balance the role of state expenditure programs with the effects of revenue increases that are needed to fund them. The goal should be a balanced approach to public and private spending.

OTHER REVENUE OPTIONS

There are a number of other general approaches the Legislature could consider in terms of revenue options, whether to fund realignment or more directly address the budget shortfall. While the Governor's proposals are strictly limited to raising rates on existing taxes, there are a number of alternatives the Legislature could consider, including broadening tax bases and restricting certain tax programs. Figure 12 shows some of the general alternatives that the Legislature could consider.

Figure 12

Additional Revenue Options for Legislative Consideration

✓ **Personal Income Tax**
- Tax surcharge of 5 percent for all taxpayers.
- Income limits on the dependent care credit.
- Reduction in the dependent exemption credit.
- Restriction of the mortgage interest deduction.

✓ **Business Taxes**
- Suspension of selected business activity credits.
- Elimination of selected business investment credits.
- Restrictions on Subchapter S corporation treatment.

✓ **Sales and Use Tax**
- Base broadening through taxation of selected services.

Various PIT Options

Tax Surcharge. One alternative to a PIT rate increase to the high-income brackets would be to levy a tax surcharge on the before-credit tax liability of all taxpayers. Such a tax surcharge, levied at a rate of 5 percent, would result in additional revenues of approximately $1.5 billion annually. This approach would keep the state's basic existing rate structure in place—and thus its distributional effects—by requiring all taxpayers to pay an additional but proportionately similar amount. The approach also avoids incorporating at least some of the revenue volatility that would result from the proposed high-income brackets.

Tax Expenditure Programs. Other PIT options would involve reforming or eliminating some of the tax expenditure programs (TEPs) currently available to taxpayers. For example, the dependent care credit allows a refundable credit equal to a specified percent (varying with income level) of household and dependent care expenses incurred as necessary costs to sustain employment. The credit is available to taxpayers with annual incomes of up to $100,000. Limiting the availability of the credit to those earning $50,000 or less would result in additional revenues of $60 million annually; eliminating the credit entirely would result in additional revenues of $220 million in the budget year.

Other TEP changes that the Legislature might consider include:

- ***Dependent Exemption Credit.*** Through 1997, the dependent credit exemption was equal to the personal exemption credit. As a component of tax relief granted by the Legislature beginning in 1998, the amount of the credit was expanded. For the 2002 tax year, the dependent exemption credit is $251 (compared to $80 for the personal exemption credit). Returning the dependent exemption credit to the level of the personal exemption credit would result in additional revenues of $895 million in the budget year.
- ***Restriction of Mortgage Interest Deduction.*** The mortgage interest deduction is allowed for interest on mortgages up to a total of $1 million on first and second homes. Restricting the deduction to interest on mortgages up to $500,000 and first homes only would result in additional revenues in the budget year of $220 million.

Selected Business Tax Alternatives

Businesses located in California are generally subject to a tax rate of 8.84 percent on income earned in the state. California also grants various credits, deductions, and other tax provisions, usually in order to encourage additional business activity. These TEPs are available to businesses through the corporation tax, the PIT, or the SUT, depending upon the structure and activity of the business. Suspending, eliminating, or limiting these TEPs could result in additional revenues for the state. For example:

- ***Suspend Certain Business Activity Credits.*** The research and development credit (RDC) is available to businesses which engage in certain applied research activities and is equal to 15 percent of the qualified expenses associated with this activity. Temporarily suspending the RDC for 2003 and 2004, would result in additional revenue in the budget year of $770 million.

- ***Eliminate Certain Business Investment Credits.*** The manufacturers' investment credit (MIC) is an income tax credit equal to 6 percent of the purchase costs of certain capital equipment. Investment credits of this type have not been shown to be either particularly effective or efficient at generating economic activity, as we indicated in our October 2002 report, *An Overview of the Manufacturers' Investment Credit.* Eliminating the MIC would result in approximately $400 million of additional revenues annually.

- ***Restrict Subchapter S Corporation Treatment.*** Subchapter S corporations are business entities that are allowed to "pass through" their income for tax purposes to shareholders and are subject to a minor corporation tax of 1.5 percent, rather than the 8.84 percent rate paid by most other California corporations. While most S corporations are small, there are a number of quite large ones as well. Restricting the S corporation option to businesses with receipts of less than $20 million would result in additional revenues of $785 million in 2003-04. Restricting the option further to those with receipts of less than $10 million would result in total additional revenues in excess of $1 billion in 2003-04.

Expanding the SUT Base

As we discussed earlier, while the SUT has shown steady overall growth, in the recent past it has generally lagged somewhat the overall growth in the economy. One manner in which to address the revenue implications of this is to broaden the tax base to include certain business or personal services and intangible personal property. For example, levying the SUT on certain entertainment activities—such as admissions fees, private club memberships, and cable television—could result in additional revenues in the mid-to-high hundreds of millions of dollars.

The Governor's tax proposal is administratively more straightforward than SUT base-broadening would be. The taxation of certain services could add additional complexities to the tax system, which would likely extend beyond a short transition period. For example, the taxation of some business service purchases by firms with locations out-of-state would be difficult to enforce without the existence of an effective multistate compact or similar institutional framework.

CONCLUSION

The Governor's tax proposal is just one of many options for changing the state's tax system and providing additional revenues to assist in addressing the budget problem in a manner that reflects the Legislature's priorities. If raising additional revenues is one of the broad approaches the Legislature wishes to consider in dealing with the state's budgetary shortfall, the Legislature needs to address what its fundamental tax policy objectives are, and what types of tax changes are needed to most appropriately achieve these objectives. The fiscal, economic, and distributional consequences of these tax changes should be carefully examined and weighed to determine whether they are consistent with the Legislature's objectives with respect to their effects on both the state's finances and its individual and business taxpayers.

REALIGNMENT AND THE 2003-04 BUDGET

What Role Could Realignment Play in Improving Service Delivery and Addressing the State's Budget Difficulties?

Summary

The centerpiece of the administration's spending plan is a "realignment" of 12 percent of state General Fund program obligations. Under this plan, the state would increase taxes by a net of $8.2 billion and shift this funding to counties and courts, along with a commensurate amount of program obligations. Similar to state actions to implement its 1991 realignment plan, the administration does not include the new taxes in its calculation of the minimum spending requirement for K-14 education under Proposition 98.

Given the size and diversity of California, we think that realignment of some state programs could improve program outcomes. For this reason, we think realignment merits consideration by the Legislature—regardless of its decisions regarding taxes or education funding.

To assist the Legislature in its review, we identify factors for the Legislature to weigh in considering which programs would benefit from realignment. Using these factors, we identify $9.1 billion in programs meriting consideration: $5.1 billion of programs proposed by the administration and $4 billion of programs suggested by our office. Because of complexities associated with realignment, however, we do not think that a full $9.1 billion realignment plan could be "ready to go" by the start of the fiscal year. Instead, some realignment changes would need to be phased in over several years.

Given the requirements of the California Constitution and voter-approved measures, enacting realignment will require achieving a broad consensus among many parties. Because realignment plans are difficult to modify over time, we recommend the Legislature take a long-term view in enacting program and funding changes.

INTRODUCTION

When different levels of government share responsibility for a program, deciding *which* government should control, pay for, and administer the program is a complex, but critical, task. If these program responsibilities are aligned sensibly, intergovernmental tension is minimized and program managers can focus their efforts on improving program outcomes and finding efficiencies.

The relationship between the State of California and its 58 counties long has been complicated by tension arising from a poor "sorting out" of many program duties. Typically, the state controls a program's rules, but counties administer the program, paying for it with a mixture of state and county funds. Frequently, state and county governments disagree over the efficacy and efficiency of state program requirements, the extent of county administrative discretion, and the allocation of program costs.

The centerpiece of the Governor's budget proposal is a major "realignment" of program duties, similar to the plan enacted by the state in 1991. In short, the Governor's plan raises $8.3 billion in taxes, and shifts $7.9 billion to counties to implement increased program obligations, $300 million to courts for security costs, and $100 million to other funds to compensate for cigarette tax revenue losses. To enable counties to manage their increased fiscal responsibilities, the administration proposes giving them some increased authority over most realigned programs.

Because counties and courts—not the state—would receive the new revenues, the administration indicates that the new revenues are not included in its calculations of the state's Proposition 98 minimum funding guarantee. Thus, the administration counts the $8.2 billion realignment package as part of its "budget solution."

In our opinion, this proposed realignment, like California's 1991 realignment plan, has potential to improve the delivery of services. For this reason, we believe realignment merits consideration *regardless* of the Legislature's decisions regarding new taxes or Proposition 98 spending.

Enacting any program realignment, however, would be very complex and involve difficult trade-offs regarding state and county control. In addition, given the difficulties associated with modifying a realignment plan *after* its enactment, the Legislature would need to develop a plan that could withstand the test of time.

To assist the Legislature in its deliberations, this piece:

- Summarizes the administration's proposal.

- Discusses several overarching fiscal and policy considerations related to realignment.
- Identifies factors to weigh in considering which programs may be appropriate to realign.
- Reviews the programs the administration proposed to realign—and provides an initial list, totaling $9.1 billion, of programs we believe merit legislative consideration.

OVERVIEW OF ADMINISTRATION PROPOSAL

What Program Changes Are Proposed?

The administration proposes to shift about 12 percent of state General Fund spending obligations to counties and trial courts—and to fund these programs from new realignment revenues.

County Changes. The realignment plan transfers to counties full—or increased—funding responsibility for a variety of health, social services, and child care programs, effective July 1, 2003. Along with this $7.9 billion increase in county fiscal responsibilities, the administration indicates it would support changes to increase county authority over most realigned programs.

Court Changes. The administration's plan provides $300 million of realignment revenues to replace state General Fund support for trial court security. The administration indicates courts would be given increased authority over court security decisions.

Figure 1 (see next page) displays the programs in the realignment plan, along with the administration's characterization of the extent of program discretion it proposes be given to counties and the courts. In the chart, the word "Full" identifies programs for which the administration envisions transferring full program authority to counties or courts, including the authority not to operate the program at all. "Partial" identifies programs over which the administration proposes to give counties or courts some additional discretion, such as the authority to change eligibility rules or administrative practices. "Minimal" indicates that the administration envisions very limited changes to county or court program control.

What Taxes Would Support Realignment?

The administration proposes three tax increases to raise $8.3 billion in new revenues: a one cent increase in the sales tax, new 10 percent and 11 percent tax brackets for the personal income tax, and a $1.10 per pack increase in the excise tax on cigarettes. After compensating special funds for expected revenue declines due to the cigarette price increase, $8.2 billion would be available for realignment.

Figure 1

The Administration's Realignment Plan

(Dollars in Millions)

Programs	Cost Shift[a]	Level of County Discretion
Health Programs		
Medi-Cal benefits	$1,620[b]	Minimal
Medi-Cal long-term care	1,400	Minimal
Substance abuse treatment programs and drug courts	230	Partial
Integrated Services for Homeless and Children's System of Care	75	Full
Public health	68[c]	Partial
Subtotal	($3,393)	
Social Services Programs		
In-Home Supportive Services and administration	$1,171	Partial
Child Welfare Services	610	Partial
CalWORKS (administration and services)	547[d]	Partial
Foster Care grants	460	Minimal
Foster Care administration	34	Partial
Food stamp administration	268	Partial
Adoptions Assistance	217	Minimal
Programs for immigrants	110	Full
Adult protective services	61	Full
Kin-GAP	19	Minimal
Subtotal	($3,497)	
Child Care		
Required child care matching payments	$498	Partial
Discretionary child care	470[e]	Full
Court Security	$300	Partial
Total[f]	**$8,154**	

a Represents 100 percent cost shift unless other wise noted (excluding federal funds).

b 15 percent cost shift to counties.

c In addition, counties would receive $78 million in Proposition 99 and federal funds.

d 50 percent cost shift to counties.

e In addition, counties would receive $63 million in additional realignment revenue and $863 million in federal funds.

f Detail may not total due to rounding.

As discussed in the preceding piece, we estimate that over the next several years the realignment revenue portfolio would likely grow in the range of 5.5 percent to 6 percent annually. This rate of projected growth is slightly lower than the 6.4 percent we estimate for the state's General Fund over the same period.

How Would the New Revenues Be Distributed?

Under the administration's proposal, about $3 billion of the new revenues would be set aside in a new statewide funding pool for county Medi-Cal costs and $300 million of the funds raised from the sales tax increase would be deposited in the state's Trial Court Trust Fund. The remainder of the realignment money, about $5 billion, would be allocated to counties as a single large block grant. In the first year of realignment, the administration proposes to allocate the $5 billion block grant to individual counties based on existing program formulas. Because many existing program formulas reflect dated distribution methodologies rather than current conditions, the administration proposes that a working group comprised of the Legislature, administration, and counties develop a new county block grant formula for 2004-05 and thereafter.

It is our understanding that counties would have the authority to allocate the block grant funds to any realigned program, as local priorities indicate. In the case of drug and alcohol programs, however, counties would need to send a certain portion of its realignment funding *back* to the state to have it counted as a state expenditure pursuant to a federal maintenance of effort agreement. (We discuss this issue in more detail below.)

Finally, the administration indicates that the new realignment revenues would not affect any element of the 1991 realignment. For programs realigned in 1991 and 2003, therefore, counties would comply with separate sets of funding and program provisions.

Does the Plan Affect Proposition 98?

The administration indicates that it did not include the realignment revenues in its calculation of Proposition 98's minimum funding guarantee because the new realignment revenues are allocated to counties and the courts, not the state. Were these revenues included in the calculation, we estimate it would raise the state's minimum funding level for schools by about $3.5 billion.

The administration also indicates that it "rebenched," or lowered its estimate of 2003-04 Proposition 98 support, by $880 million to reflect the transfer of child care responsibilities from the State Department of Education (SDE) to counties.

The administration indicates that it is evaluating whether legislation is needed to suspend Proposition 98 if a court were to rule that the realignment revenues must be included in the minimum funding calculation. (The 1991 realignment legislation included such a conditional suspension of Proposition 98.) The administration is also evaluating options to reduce the likelihood of a challenge to the rebenching of Proposition 98.

OVERARCHING CONSIDERATIONS

Before reviewing the individual components of the administration's realignment plan, we recommend that the Legislature consider several matters relating to the realignment package as a whole. Figure 2 summarizes these considerations, which we discuss separately below.

Figure 2

Overarching Considerations Relating to Realignment

- ✓ Realigning Some State-County Programs Makes Sense
- ✓ Programs, Not Taxes, Should Be the Focus of Realignment
- ✓ Realignment Plans Are Not Easily Changed
- ✓ Counties Will Need Control Over Realigned Programs
- ✓ Roughly Match Revenues and Expenditures
- ✓ Details Matter in Designing the Structure of Realignment
- ✓ Achieving General Consensus Will Be Critical

Realigning Some State-County Programs Makes Sense

In a state as large and diverse as California, it is difficult to establish statewide program rules, while at the same time promoting program innovation, efficiency, and responsiveness to local conditions. Typically, state laws and regulations strive for uniformity in county actions and compliance with minimum state standards. While this emphasis on "sameness" is appropriate for programs of great statewide concern, for other programs it is an impediment to county program collaboration and innovation.

Achieving good program outcomes in many health and human service programs, for example, requires county agencies to work across policy areas and to experiment with different approaches. Helping a homeless family, for example, often requires services in addition to housing assistance, such as mental health, drug or alcohol treatment, employment services, child care, and / or income assistance under California Work and Opportunity to Kids (CalWORKS). When each of these programs is operated in isolation, in compliance with extensive state rules, the total benefit may be less than if the county structured the programs to work collaboratively.

The administration's realignment plan provides the Legislature with an opportunity to "re-sort" state-county program responsibilities and consider which programs need statewide control and which could benefit from devolution to counties. The lesson California learned from the 1991 realignment is that counties, given the dependability of a dedicated funding stream and freed from centralized regulation, can achieve noteworthy program results.

Programs, Not Taxes, Should Be the Focus of Realignment

As discussed above, realignment, implemented correctly, can improve the management and delivery of important programs. For this reason, we believe the Legislature's decision to realign a program should focus on program policy objectives and interest in increasing local control—not simply on raising revenues.

To that end, we recommend that the Legislature begin its work by identifying programs that would benefit from realignment. Should the Legislature determine that it wishes to raise *more* revenues than it wishes to realign programs, we recommend the Legislature avoid adding programs to the realignment package that are inconsistent with the concept of realignment—or programs over which the Legislature is unwilling to grant counties greater control.

If the Legislature wishes to raise more revenues than is needed to finance its realignment plan, but is concerned about interactions with Proposition 98, we note that the Legislature has other options. As we discuss in the "Education" chapter of the *Analysis*, for example, the Legislature could enact additional revenues, allow the money to count towards Proposition 98, but suspend the minimum guarantee. Such a one-time suspension of Proposition 98 would have about the same long-term impact on school spending as enacting the realignment plan proposed by the administration.

Alternatively, should the Legislature wish to enact realignment without increasing taxes, the Legislature could earmark a portion of *existing* state revenues as the dedicated revenues for realignment.

Realignment Plans Are Not Easily Changed

Realignment plans are not easily amenable to future legislative or administrative change. Under the administration's realignment proposal (as well as the 1991 realignment), counties assume a series of program obligations and commit to pay for them with revenues from a dedicated tax base. Developing the realignment package requires extensive legislative work and negotiations with many parties. As discussed further below, the realignment plan likely will be "backed up" by legislative provisions referred to as "poison pills" which safeguard the state's fiscal interests if elements of the realignment are successfully challenged in court.

The net result of these elements is that future changes to the realignment program and tax "package" become exceedingly complicated to change. We note, for example, that very few provisions of the 1991 realignment plan have been modified over the last 12 years. In contrast with many other state-local program and funding relationships, the basic structure of the 1991 realignment plan has remained constant. Before enacting a realignment plan, therefore, the Legislature should have a high degree of comfort with the program changes and revenue base.

Counties Need Control Over Realigned Programs

The concept of realignment is to focus accountability by placing—to the greatest extent possible—program control, funding responsibility, and administration at the same level of government. Transferring funding responsibility to counties, therefore, is only the first step. Counties also need *authority* over the realigned programs.

Counties need program authority so that they may modify their programs to meet the highest needs in their community and facilitate innovative approaches and collaboration. Counties also need authority so that they can respond to the inevitable fluctuations in realignment revenues—as well as any long-term gap between realignment revenue growth and program demands. Just as the Legislature annually reviews program requirements and expenditures in light of the state's fiscal fortunes, counties would need authority to adjust program requirements and expenditures to reflect changes in realignment revenues. In fact, counties may have greater need for such authority because counties have less ability to increase taxes to pay for the programs.

Roughly Match Revenues and Expenditure Expectations

In determining a revenue base for the realignment programs, the Legislature should roughly match the revenue base's projected growth rate with projections for overall long-term program spending. This does not mean there must be a "perfect" match between revenues and expenditures, but that the revenue base should grow at about the same rate as program costs.

Our review indicates that, over time, the administration's proposal could result in a contraction of spending for some programs. Specifically, we project that, as currently administered, the cost of the programs proposed for realignment by the administration would grow at about 7 percent to 8 percent annually over the next several years, while realignment revenues likely will increase by 5.5 percent to 6 percent annually. Thus, unless counties used their increased program authority to reduce program costs, or supplementary state or local revenues were added to realignment, funding for some realignment programs may be constrained over time. Alternatively, the Legislature, in reviewing the Governor's proposal, may decide that it would prefer a different mix of revenue sources, a mix which more closely tracks to the projected expenditure growth of the realigned programs.

Details Matter in Designing Structure of Realignment

In addition to selecting programs suitable for realignment, the Legislature will need to develop an appropriate *structure* for the realignment package. Details of this structure are key to the success of the realignment program and, given the difficulties in enacting future realignment changes, should be considered carefully.

Several components of the realignment structure are particularly important:

- ***Implementation Timing.*** From a practical standpoint, it may not be possible to fully implement all realignment changes overnight. Thus, in developing the realignment plan, the Legislature should be cognizant of the possibility that the state may not realize a full year's fiscal benefit for each program change.
- ***Revenue Allocation.*** Currently, many program-funding formulas do not reflect present-day county conditions and needs. The Legislature should consider the extent to which it wishes to minimize program disruptions by *maintaining* these formulas—versus giving all counties a more comparable funding base.
- ***County Fiscal Authority***. Under the administration's proposal, counties would have significant fiscal authority over programs included in the block grant. To the extent that the Legislature wishes to *guarantee* funding for a program, or group of programs, the Legislature could limit county fiscal authority by placing some realignment resources into different program funding "pools." In considering such limitations to county fiscal authority, the Legislature should balance the state's need to control program funding with the county need for fiscal authority to: manage increased program obligations, foster program collaboration, and respond to community preferences. Finally, the Legislature may wish to con-

sider giving counties increased revenue raising authority so that they could supplement the realignment revenues, if desired.

- ***Realignment Reserve***. Given the volatility associated with the proposed realignment funding portfolio, a realignment reserve may be appropriate to minimize the adverse impact of revenue downturns on the realigned programs.
- ***Performance Measurement.*** Given the state's ongoing interest in many of the programs proposed for realignment, the Legislature should consider how it will monitor future county program performance and, if necessary, ensure that counties and the state comply with federal requirements.
- ***Integration With 1991 Realignment.*** To increase accountability to the public and decrease the administrative complexity of the proposed 2003 realignment plan, the Legislature should consider what changes are needed to integrate California's two state-county realignment plans.

Achieving General Consensus Will be Critical

California's Constitution and statutory measures approved by the state's voters contain provisions that constrain the Legislature's authority to modify state and local government responsibilities and revenues: Proposition 98, the mandate provision of Proposition 4, Proposition 36, and others.

In 1991, the Legislature's realignment plan sidestepped some of these provisions through the enactment of four legislative provisions referred to as "poison pills." For example, one of these poison pill provisions suspends Proposition 98 if a court rules that the 1991 realignment revenues must be counted towards the Proposition 98 minimum funding guarantee. Another provision renders the entire realignment plan inoperative if a court rules that its provisions are a state-reimbursable mandate under Proposition 4. These poison pill provisions continue to this day, placing the 1991 realignment plan and the delivery of important programs at some risk. To a large extent, therefore, the 1991 realignment plan survives because the various parties involved with realignment think its end results are superior to the alternatives.

Our review indicates that the administration's 2003 realignment plan probably would require at least as many poison pill provisions as in 1991. Before enacting realignment, therefore, the Legislature, administration, counties, education community, and other key parties should achieve general consensus that realignment is a reasonable approach. Absent this consensus, the various requirements in the State Constitution and voter-approved initiatives may prove to be too great of an obstacle to overcome.

WHAT FACTORS SHOULD THE LEGISLATURE WEIGH IN ASSIGNING PROGRAM RESPONSIBILITIES?

Much of the work involved in developing a realignment plan is “sorting out” which level of government should have program authority and funding responsibilities over different programs. As we have discussed in previous publications, government accountability is enhanced when residents know which level of government is responsible for different programs, and efficiency is enhanced when the level of government that pays the bill sets the program requirements. Thus, as the Legislature reconsiders state and county program responsibilities, we recommend that, whenever possible, a single level of government pay for a program and have authority over its design and implementation.

Given this, which programs should the state control and which should counties control? There is no “right” answer to this question. To assist the Legislature in its decision making, we highlight several factors, summarized in Figure 3 (see next page), for the Legislature to weigh as it reviews the assignment of program responsibilities.

Which Programs Should the State Control? As Figure 3 indicates, state control of programs makes sense under certain circumstances. If statewide uniformity is vital because service level variation would impede the achievement of overriding state objectives or create incentives for people to move across county borders, state control of a program makes sense. In addition, state control is appropriate for programs where the costs or benefits of a program are not restricted geographically, and thus individual counties might underinvest in a program because the county does not see the full impact of its actions. Finally, state control over income support programs makes sense, because it allows the redistribution of income to reflect the resources of the entire state, as opposed to the resources of a specific county.

Which Programs Should Counties Control? County control over programs offers different advantages. Counties have greater ability to adjust programs to meet the needs of their communities and experiment to determine which efforts improve program outcomes. Because county departments are smaller than state agencies, it is easier for counties to develop programs involving multiple program specialties. Finally, when budget constraints are significant, counties are in a better position to discern what works in their community and preserve the activities yielding the best outcomes. Thus, when program innovation, responsiveness to community interests, and efficiency is critical, we recommend the Legislature consider assigning the program to counties.

Figure 3

Factors to Weigh in Assigning Program Responsibilities

✓ **Programs where statewide uniformity is vital, where statewide benefits are the overriding concern, or where the primary purpose of the program is income redistribution—usually are more effectively controlled and funded by the state.**

- Reduces inappropriate service level variation.
- Focuses state attention on programs integral to state goals.
- Allows income support programs to reflect the resources of the state—not a single county.

✓ **Programs where innovation, responsiveness to community interests, and efficiency are paramount—usually are more effectively controlled by local governments.**

- Facilitates citizen access to the decision-making process and encourages experimentation.
- Allows community standards and priorities to influence allocation of scarce resources.

✓ **Coordination of closely linked programs is facilitated when all programs are controlled and funded by one level of government, usually local government.**

- Increases attention to programmatic outcomes.
- Reduces incentives for cost shifting among programs.

✓ **If state and local governments share a program's costs, the state's share should reflect its level of program control. If the costs of closely linked programs are shared, the cost sharing arrangements should be similar across programs.**

- Increases accountability to the public.
- Promotes efficiency in expenditures and discourages inappropriate cost shifting.

What About Programs That Are Closely Linked to Another? From a practical standpoint, many California programs are linked to others. Sometimes one person, or family, receives services under multiple programs simultaneously (such as mental health and drug or alcohol treatment services) or in succession (such as child welfare services, foster care, and adoptions), with some of the programs being "preventive" in nature and others oriented towards responding to acute problems. When assigning program responsibilities, it is important for the Legislature to acknowledge these program linkages because fostering collaboration among program administrators will facilitate successful program outcomes. Given the scale of California state government, usually counties are in a better position to manage these programs. By keeping closely linked programs "under the same roof," the government controlling the programs can make sure that different program efforts are coordinated—and have the appropriate incentives to invest in programs that focus on prevention.

What About Sharing Responsibilities for Programs? Sometimes, because of federal laws, overriding state concerns, or other factors, it is not practical for the Legislature to assign full program control and funding responsibility to a single level of government. In this case, the state may wish to develop a hybrid system of program control and funding responsibility. If the Legislature assigns funding and program responsibilities to multiple levels of government, we recommend that the Legislature ensure that the state's share of cost is reflective of its degree of program control. As a general rule, we believe that the greater the program control a level of government has, the greater its fiscal share should be. Making sure that the state pays a share reflective of its degree of program control serves as an important check on the state as it contemplates future program changes with fiscal implications.

PROGRAMS TO REALIGN: AN INITIAL LAO ASSESSMENT

Using the factors discussed above, we reviewed the programs the administration proposed for realignment, as well as programs not included in the administration's plan. In undertaking this review, we focused primarily on whether a program was a good "fit" with the concept of realignment. For example, we examined whether a transfer to counties of program and funding responsibilities might yield better outcomes—or whether it would impede achievement of overall state objectives. The purpose of our review, therefore, was not to develop a definitive recommendation as to whether the Legislature "should" realign a program, but to identify programs that show the greatest potential for improvement under realignment.

From this review, we identified programs, totaling $9.1 billion, which appear to be good candidates for realigning to county control. These programs are listed in Figure 4 (see next page), along with page numbers denoting where our discussion of each program begins. As shown in Figure 4, we recommend the Legislature consider for realignment $5.1 billion of programs from the administration's plan and $4 billion of additional programs. In considering the list of programs in Figure 4, however, it is important to note that we do not believe that all these proposed changes could be implemented by the start of the fiscal year. Figure 4 denotes the programs where we think the program changes are so significant that future-year implementation would be necessary.

Figure 4

Developing a 2003 Realignment Plan: Which Programs Should Be on the Legislature's List for Consideration?

(In Millions)

Program	LAO Recommendation		Page Discussed
	Consider	Remove	
Health Programs—Administration's Plan			
Medi-Cal benefits	—	$1,620	138
Medi-Cal long-term care	$1,400[a]	—	139
Public health	68	—	140
Integrated Services for Homeless and Children's System of Care	75	—	141
Substance abuse treatment programs and drug courts	230	—	142
Additional Programs—Suggested by LAO			
50 percent county share of Medi-Cal administration	$304	—	138
Other long-term care programs	210[a]	—	139
Battered Women's Shelter Program	24	—	140
EPSDT	381	—	141
Mental health managed care	213	—	141
Other mental health	39	—	141
Social Services Programs—Administration's Plan			
Child Welfare Services	$610	—	145
Foster Care grants and administration	494	—	145
Adoptions assistance	217	—	145
Adult protective services	61	—	148
Kin-GAP	19	—	145
CalWORKs (administration and services)	547	—	145
Food Stamp administration	134	$134	146
In-Home Supportive Services and administration	275	896	147
Programs for Immigrants	—	110	147
Additional Programs—Suggested by LAO			
Adoptions Program	$41	—	145
25 percent county share of CalWORKs grants	750	—	145
25 percent county share of automation projects	42	—	148

Continued

Program	LAO Recommendation		Page Discussed
	Consider	Remove	
Child Care—Administration's Plan	$968	—	149
Criminal Justice-Administration's Plan			
Court security	—	$300	150
Additional Programs—Suggested by LAO			
Juvenile Justice	$337	—	151
Adult Parole	435	—	151
Adult Parole-Return to Custody	807	—	151
COPS	116	—	151
Juvenile Justice Challenge Grants	116	—	151
13 Amended Mandates[b]—Suggested by LAO	140	—	152
Totals	**$9,053**	**$3,060**	
Administration	$5,098	$3,060	
LAO	3,955	—	

a This program shift could not be implemented in 2003-04.

b No funding is provided in Governor's 2003-04 budget, but spending obligation is a constitutional requirement.

In beginning the Legislature's review of realignment, we recommend the Legislature focus its efforts on the programs shown in the consider column of Figure 4. Over the coming weeks, we will continue to examine state-county programs and may be able to identify additional programs for legislative consideration. Given the short time since the release of the administration's realignment plan, and the conceptual nature of our review, we are not certain whether unknown factors—such as federal regulatory requirements—might limit the Legislature's ability to realign some of the programs in Figure 4. To the extent that we are aware of significant issues limiting the Legislature's ability to realign a program, however, we discuss them in the write-ups below.

Finally, in our program write-ups, we identify some of the areas where the Legislature would need to increase county program authority and flexibility. As we have discussed throughout this document, however, counties would need significant authority for *all* programs in the realignment package.

Health Programs

The Governor's budget summary indicates that the realignment plan shifts $3.4 billion of health program costs from the state to counties. If the

Legislature enacted the administration's provider rate and other budget cuts, however, the proposed health program shift to counties would total $2.9 billion. Regardless of the total amount shifted, as shown in Figure 1, the administration's plan gives counties "full" or "partial" program control over about $375 million of the realigned health programs. Thus, the administration's plan gives counties major fiscal responsibility without the program authority to manage the vast majority of these costs.

As we discuss below, we think that—with modifications—a substantial portion of the health programs in the administration's plan would be appropriate to realign. In our discussion below, we also identify additional programs (totaling about $1.2 billion) meriting consideration for realignment.

Medi-Cal Administration, Not Benefits, Suited for Realignment

The administration's realignment plan shifts to counties a 15 percent share of costs for Medi-Cal medical benefits, or $1.3 billion to $1.6 billion, depending on the Legislature's actions regarding the administration's budget reduction proposals. (The $1.6 billion amount shown in our figures reflects the amount shown in the Governor's Budget Summary.) The estimated Medi-Cal cost for all counties would be taken "off the top" of the new realignment revenues and placed into a single statewide health care cost pool. The state, in turn, would use this revenue pool to pay Medi-Cal benefit costs, without reference to the county in which the Medi-Cal cost was incurred. Individual counties, therefore, would not realize any direct advantage or cost from changes in their residents' utilization of Medi-Cal services.

As shown in Figure 4, we recommend the Legislature remove Medi-Cal benefits from the list of programs to be considered for realignment because federal law requires that this program be provided uniformly across the state and because counties have little ability to affect long-term Medi-Cal benefit costs. Federal and state governments establish eligibility requirements for this program, what services will be provided, and how much will be paid to health care service providers. For these reasons, we see little program or fiscal benefit to assigning counties a share of the cost for medical services provided under this program.

Consider Establishing a Medi-Cal Administrative Cost Share. Although counties have little control over the costs of Medi-Cal *benefits*, county decision-making and collective bargaining affect the costs of Medi-Cal *eligibility determinations*. Under current law, however, counties do not pay a share of costs associated with county employees screening applicants for Medi-Cal eligibility. Thus, counties do not face an incentive to minimize these administrative costs. To align county and state fiscal interests in minimizing the administrative cost of this program, we propose that the Legislature consider a county share of costs for Medi-Cal eligibility determinations. Such a cost arrangement would be consistent with current requirements for the CalWORKs and Food Stamps programs. In determining the level of costs to be shared, it is important to note that county Medi-Cal eligibility workers frequently screen individuals and families for other programs, such as CalWORKs and Food Stamps. Establishing a *similar* state-county administrative cost share for these programs would reduce any incentive for inappropriately cost shifting among programs. As we note under our CalWORKs discussion, we think an administrative cost-sharing ratio for these programs of up to 50 percent would be appropriate, given the extent of county control over these program costs.

Alternative Long-Term Care Proposal Merits Consideration

Under current law, the state and federal government share the cost of providing nursing home care for Medi-Cal recipients. The administration's realignment plan shifts to counties 100 percent of the state's cost for Medi-Cal long-term care: $1.1 billion to $1.4 billion annually. (The amount of the shift depends on the Legislature's actions regarding the administration's budget reduction proposals. The dollar amount shown in our figure reflects the amount shown in the administration's budget summary.) Similar to the administration's Medi-Cal services proposal, funding for nursing homes would be taken "off the top" of the new realignment revenues and placed into a single statewide cost pool.

Our review indicates that counties would have few tools to manage this major new funding responsibility. Specifically, counties would not have authority over the major factors driving Medi-Cal long-term care costs: provider reimbursement rates, program eligibility, or the decision to place Medi-Cal recipients into nursing homes. Moreover, the Governor's proposal would not address the serious fragmentation and lack of coordination that now exists for long-term care in which multiple agencies operate multiple programs with no real system in place.

Accordingly, we do not recommend the Legislature approve the program shift as proposed for the budget year. We find, however, that the state's long-term care delivery system would benefit greatly by county coordination and control. Thus, we recommend the Legislature transform the administration's proposal into a plan that phases-in over a longer period an integrated system of long-term care, managed by counties. Such a system, described below, would be similar to current county responsibilities for mental health services.

An Alternative Approach to Realignment of Long-Term Care. Under our modified realignment concept, commencing in two to three years counties would fund and manage a range of programs and services associated with long-term care. Thus, counties would manage the shift of Medi-Cal patients, when medically appropriate, from expensive acute care hospital beds to lower levels of care. Counties also would coordinate additional support services needed to care for Medi-Cal beneficiaries in the community and thus in some cases avoid inappropriate and costly institutionalization in nursing homes.

Developing such a major realignment of long-term care responsibility would be complex, and pilot projects to implement similar changes have encountered significant delays. Accordingly, we do not believe that the transfer of authority over long-term care programs could be implemented immediately. For this reason, we suggest the Legislature consider the following approach:

- Enact provisions directing that a realignment of both funding and responsibilities for long-term care programs to individual counties be phased-in on a timetable that is practical and feasible, perhaps two to three years. The state would work with counties during the intervening period to ensure a smooth transition to an integrated system of long-term care.
- Phase-in the realignment of additional long-term care programs (totaling $210 million) to the realignment package during the same timeframe: adult day health care (with a proposed 2003-04 budget of $152.6 million from the General Fund), Program of All-Inclusive Care for the Elderly ($35.3 million), and Multipurpose Senior Services Program ($22.3 million).

Realignment of Public Health Programs Generally Sound

The administration's realignment plan shifts to counties the fiscal and program responsibility for various maternal and child health, primary and rural health care, and county health grant programs. To offset these program costs, the county block grant includes $68 million in realignment revenues. In addition, counties would receive $78 million in additional Proposition 99 revenues and some related federal funding.

Public health programs, including indigent care for poor individuals not qualified for enrollment in Medi-Cal, were a major component of the 1991 realignment plan. The proposed shift of additional health "safety net" programs would increase county ability to develop innovative approaches for the provision of public health care services and meet specific health needs in their communities. Moving away from a structure where related public health programs receive separate categorical funding gives counties greater ability to coordinate services. For these reasons, we recommend the Legislature consider for realignment in 2003 all safety net programs proposed by the administration, as well as funding for a related program excluded from the administration's plan: the battered women's shelter program ($24 million General Fund proposed for 2003-04).

Finally, although we believe the administration's public health proposal makes sense, we note that currently there are restrictions on the use of Proposition 99 and federal funds. The administration's plan consolidates realignment funding into a single fund and gives counties flexibility to shift revenues in accordance with local priorities. The public health component of this plan, however, includes special funds collected under Proposition 99 (a voter-approved initiative that increased tobacco-related taxes) that must be used for specific purposes. Similarly, federal laws may limit the state's ability to shift Title V federal funds to county use.

Additional Mental Health Programs Merit Realignment

The administration's realignment plan shifts to counties two discretionary mental health grant programs totaling $75 million: (1) the Integrated Services for the Homeless, which helps transition homeless individuals into recovery and stability in the community, and (2) the Children's System of Care, which funds programs designed to provide a continuum of care for mental health programs for children.

Our review of the mental health programs realigned in 1991 indicates that counties used their increased program and fiscal authority to improve the overall delivery of mental health services. Given the similarity between the mental health programs proposed for realignment in 2003 with the programs realigned in 1991, we think the administration's proposal makes sense. Providing counties with revenues for services to the homeless and children would allow counties to develop ongoing programs that meet their community's needs.

Given the results of the 1991 realignment, we recommend the Legislature consider realigning mental health programs in addition to those identified in the Governor's plan. Specifically, we believe the following mental health programs, most of which are currently administered by counties, would benefit from increased local program and fiscal authority:

- Early and Periodic Screening, Diagnosis and Treatment ($381 million General Fund proposed for 2003-04). Such a transfer would provide counties with a strong incentive to implement appropriate utilization controls on these programs.
- Mental health managed care, including a separate San Mateo County effort ($213 million).
- Mental health local mandates, such as the AB 3632 program, which provides mental health services to special education students in compliance with the requirements of federal law (no funds for the mandates are proposed in Governor's budget).

- Ancillary services for individuals in Institutions for Mental Disease ($27 million).
- Community services for brain-damaged adults ($11.7 million).

In the case of the mental health managed care program, we note that because this program is funded under a federal Medicaid waiver, changes to the funding mechanism would require federal approval.

Overall, we believe these changes to the authority and control of mental health programs would improve county ability to meet critical local mental health system needs, reduce program administrative costs, and reduce the fragmentation of community mental health programs.

Drug Treatment Realignment Makes Sense, But Faces Major Obstacles

The Governor's plan shifts to counties $230 million of realignment funds to support a variety of substance abuse programs, including Drug Medi-Cal, various discretionary grants, drug court programs, services for parolees, and allocations for Proposition 36 (the November 2000 initiative requiring treatment services for nonviolent drug possession offenders). The $230 million represents a level of funding that is about 10 percent higher than current-year support for these programs.

The realignment plan obligates counties to transfer most of the proposed realignment funding to the state through an intergovernmental agreement. This transfer is intended to enable the state to comply with federal maintenance-of-effort (MOE) rules relating to state program spending. Violation of the federal MOE could jeopardize the ability of counties to obtain about $260 million annually in federal substance abuse treatment grants.

From a policy perspective, we believe the Governor's proposal make sense. Realignment would give counties flexibility in the design and operation of treatment programs. Under realignment, for example, counties may be better able to use their funds to serve people with a dual diagnosis of mental illness and addiction to drugs. Realignment also might open the door for expansion of Drug Medi-Cal services by allowing counties to draw down additional federal matching funds.

Despite these advantages, we find that the Governor's proposal has technical problems that may preclude or complicate its implementation. Specifically:

- ***Federal MOE and Court Order Must Be Resolved***. To preserve county eligibility to receive federal substance abuse treatment grants, federal authorities must be willing to count realignment funds as state expenditures satisfying the federal MOE. At this point, it is uncertain whether the federal government would provide such flexibility. In addition, elements of the administration's plan must be reconciled with a federal court order that appears to require certain treatment services be available statewide.

- ***Proposition 36 Changes Required.*** The Governor's plan proposes changes to Proposition 36 that some initiative proponents contend violate the terms of the measure, such as the elimination of state operations to supervise the measure's implementation.
- ***Funding Transfer Adds Complexity***. The mechanism by which realignment funding would be transferred to counties, transferred back to the state, and then transferred again to counties would increase administrative complexity. This transfer also may engender conflicts between the state and counties regarding which level of government has control over the realigned programs' funds.

If these significant issues cannot be resolved, the Legislature may wish to consider alternatives to the administration's proposal, such as (1) excluding Proposition 36 programs from realignment (at least until 2006-07 when state appropriations mandated by Proposition 36 expire), (2) funding realignment though existing state General Fund revenues or a new state revenue source, or (3) maintaining at the state level, outside of realignment, a share of the funding for the Drug Medi-Cal program to ensure compliance with the federal court order requiring certain treatment services be available statewide.

Social Services

The administration proposes to realign to counties $3.5 billion in state social services program responsibilities. This represents about 44 percent of 2002-03 General Fund spending within the Department of Social Services (DSS).

Given the large number of social services programs—and program components—proposed for realignment, Figure 5 (see next page) provides a more detailed look at the information summarized in Figure 4. As shown in Figure 5, the social services programs proposed for realignment fall into six categories: (1) children's programs, (2) CalWORKs, (3) Food Stamps administration, (4) In-Home Supportive Services (IHSS), (5) noncitizen benefit programs, and (6) Adult Protective Services (APS). With the exception of CalWORKs, the realignment plan shifts 100 percent of the nonfederal costs of these programs to counties. For CalWORKs, the plan shifts 50 percent of the cost for administration and welfare-to-work services. In general, the administration excludes the major social services automation projects from realignment.

Figure 5

Programs Meriting Consideration for Realignment Social Services

(In Millions)

Programs	Fund Shift	Recommendation Consider	Recommendation Remove
Administration Recommendations			
Children's Programs—100%			
Child Welfare Services	$596	X	
Foster Care grants	460	X	
Adoptions Assistance	217	X	
Foster Care administration	34	X	
Kin-GAP	19	X	
Child abuse prevention, intervention, and treatment	13	X	
CalWORKs			
50% county share of CalWORKs employment services	$423	X	
50% county share of CalWORKs administration	123	X	
Food Stamp Administration—100%	$268	50% see below[a]	
In-Home Supportive Services (IHSS)—100%	$1,171	50% see below[a]	
Noncitizen Benefit Programs—100%			
Cash Assistance Program for immigrants	$95		X
California Food Assistance Program	15		X
Adult Protective Services—100%	61	X	
Changes Suggested by LAO			
IHSS—50% county share of cost	$275		
Adoptions—100%	41	X	
Food stamp administration—50% county share of costs	134	X	
25 percent county share of CalWORKs grants	750	X	
25 percent county share of automation projects	42	X	
Total of Programs Recommended For Consideration	**$3,316**		

[a] The LAO recommends realigning 50 percent, rather than 100 percent, of these costs. See the "Changes Suggested by LAO" section of this table for the proposed shift.

Figure 5 shows the proposed funding shift for each social services program, our views as to whether the program should be considered for realignment, and three additional programs (totaling about $830 million) that we suggest the Legislature consider for realignment.

Realign Full System of Children's Programs

The administration proposes to realign all children's social services programs, with one exception. Specifically, the plan realigns child welfare services, foster care, and the adoptions assistance program (provides cash benefits), but excludes the adoptions program (provides services). Given the close linkages between the children's social services programs, we recommend that the Legislature incorporate the adoptions program into any decision it makes regarding the other programs.

In general, we think realigning the *full array* of children's programs to counties makes sense. Counties would have control and responsibility for the entire interactive system of child welfare and foster care. Specifically, counties would be responsible for deciding when to remove children from their homes (child welfare services), caring for children who are separated from their families (Foster Care), and determining the best long-range plan for foster children (adoption, reunification, emancipation, or permanent placement with a relative under the Kinship Guardian Assistance Program). Giving counties control and responsibility for this full system of care encourages counties to manage each element of the program effectively and efficiently.

Counties Would Need Increased Program Control As discussed throughout this analysis, in order for realignment to improve program outcomes, counties need sufficient program authority to allow them to administer programs in a way that responds to local needs and conditions. In the case of children's programs, giving counties this authority would require the state to eliminate as many nonfederal requirements as possible, such as the state's requirement for monthly social worker visits (the federal standards is semiannual visits).

Need to Address Federal Children and Family Services Reviews. California recently failed a federal performance review for children's services and must improve performance through a performance improvement plan, or face a reduction in federal funding. Accordingly, we recommend the realignment plan address how the state and counties would share the cost of the performance improvement plan, and how any loss in future federal funding would be allocated.

CalWORKs: Some Costs Appropriate to Realign

CalWORKs is a county administered entitlement program for which the state must meet strict federal participation requirements or face significant penalties. In addition, to prevent migration effects, the state has an interest in making sure grant levels are uniform and that recipients have access to necessary services before reaching their five-year time limits. For these reasons, we think that the state should be responsible for most CalWORKS program costs. However, we recognize that county actions do influence this program's long-term costs, and therefore we think there is merit to the administration's proposal to give counties a share of the program's costs for administration and employment services. In addition, we suggest that the Legislature consider giving the counties a share of the grant costs. We discuss these suggestions separately.

Employment Services and Administration Merit Inclusion in Realignment Plan. In general, we concur with the administration's proposal for a 50 percent county share of costs for administration and employment services. Although counties are responsible for developing welfare-to-work plans and providing the necessary training, child care, and case management services in support of those plans, counties pay no marginal cost for CalWORKs employment services or administrative costs. (Counties pay only a fixed cost based on their expenditures in 1996-97.) Without a marginal share of cost for employment services and administration, counties have limited incentive to control costs for these critical inputs, including the labor cost of county employees administering the CalWORKS program.

Add a Share of CalWORKs Grants to Realignment. While economic factors beyond a county's control drive the number of families eligible for CalWORKS in any community, local actions also influence the size of a county's CalWORKs caseload. Specifically, counties are responsible for providing welfare-to-work services that enable recipients to make the transition from cash aid to self-sufficiency. Thus, through the delivery of employment services, counties have some control over program exits. Increasing a county's share of grant costs—it is currently 2.5 percent—would give counties greater incentives to successfully move recipients toward self-sufficiency. Given the degree of control counties have over CalWORKs cash assistance costs, we recommend that the Legislature consider a partial share of cost for grants, perhaps in the range of 25 percent to 35 percent. A 25 percent share would be equivalent to about $750 million.

Food Stamps Administration—Sharing Costs Makes Sense

Currently, counties administer the Food Stamp program, in conformity with federal Food Stamps eligibility rules, but pay no marginal share of costs for this program. The administration proposes to shift to counties 100 percent of the cost of Food Stamps administration. In our view, a shift of 100 percent of the cost of administering this income assistance program would be inappropriate, given the limited county control over these costs. Instead, we recommend the Legislature consider realigning a *share* of the cost of Food Stamps administration as a reflection of the degree of control counties have over these costs, particularly employee wages.

To avoid any potential for cost shifting among social services programs, we suggest that the county share for Food Stamps administration *match* the share of cost for CalWORKs administration and services. (In some counties, the same workers perform the eligibility function for both programs.) The Governor has proposed a 50 percent share for CalWORKs administration. We believe any share of cost for Food Stamp administration—in the range of about 25 percent to 50 percent—would work, so long as this share of costs is consistent with the share of administrative costs for related programs.

Immigrant Programs Are Inappropriate to Realign

The Cash Assistance Program for Immigrants (CAPI) and California Food Assistance Program (CFAP) provide cash or food coupon benefits to federally ineligible legal immigrants. As shown in Figure 1, the Governor proposes to give counties full discretion in operating these programs, including the option of eliminating these benefits. As these programs are cash (or cash equivalent) programs, the state has an interest in maintaining uniformity in benefit levels. Variation in benefit levels could lead to migration, or potentially a "race to the bottom," whereby one county's reduction in benefits spurs others to reduce benefits in order to avoid becoming a benefit "magnet." Given the state's interest in uniform benefits, we believe that CAPI and CFAP should remain state responsibilities.

In-Home Supportive Services: Partial Realignment Makes Sense

The IHSS program provides various services to eligible aged blind, and disabled persons who are unable to remain safely in their own homes without such assistance. The IHSS program has two components: the Personal Care Services Program (PCSP), which is federally funded through Medicaid, and the Residual program, which is funded entirely with state and county funds. The nonfederal costs of the program are shared 35 percent county and 65 percent state.

The federal PCSP is an entitlement program, with eligibility governed by federal rules that generally provide that low-income aged or disabled individuals are eligible for services. However, such individuals are not eligible for PCSP if they choose a responsible relative provider or need supervisory care. Such persons are served in the state-only Residual program, which is also an entitlement pursuant to state law. Federal and state rules govern the types of services provided, but counties make specific determinations concerning the degree of impairment and hours of service provided. Counties also negotiate the rates paid to service providers. The IHSS program has been one of the fastest growing social services programs—since 1998-99 its General Fund costs have more than doubled to over $1 billion.

Because counties make decisions that significantly affect costs of the IHSS program—assigning hours of service based on their assessment of impairment and negotiating provider payment rates—realigning more program costs to counties has merit. However, we believe a 100 percent program shift to counties does not match counties' level of control over IHSS costs since they do not establish eligibility rules. Accordingly, we believe the Legislature should consider an increased county share, perhaps 50 percent (compared to 35 percent under current law). The Legislature should also consider giving counties more control over IHSS, especially in the Residual program, which is governed by state rather than federal law.

Interaction With Long-Term Care. The IHSS and long-term care programs are integrally linked. The IHSS program assists people in remaining in their homes; long-term care assists people unable to live independently. Earlier in this piece, we argued that the Governor's realignment plan for long-term care as proposed is unworkable. We offered suggestions for modifying the Governor's proposal to phase in a realignment plan for increased county responsibility for an integrated long-term care system. If long-term care is ultimately realigned to counties, then the Legislature should enact commensurate increases in county responsibilities under IHSS.

Adult Protective Services Makes Sense to Realign

Created by Chapter 946, Statutes of 1998 (SB 2199, Lockyer), the APS program provides assistance to elderly and dependent adults who are functionally impaired, unable to meet their own needs, and who are victims of abuse, neglect, or exploitation. Like CAPI and CFAP, the Governor proposes that counties have complete flexibility in determining the level of service in this program, including the option of eliminating these services. In recent years, as the Legislature reduced funding for this program, it amended the APS statute to free the counties from certain mandatory activities. The Governor's proposal moves further in this direction by making the program optional. Because we think it is reasonable to allow community standards and priorities to influence the management and funding of this program, we believe it merits legislative consideration for realignment to counties.

Automation Projects: Align State and County Interests

Currently the state is responsible for developing and maintaining several large welfare automation projects operated by the 58 counties. These systems include the Statewide Automated Welfare System, the Child Welfare Services / Case Management System, and the Case Management Information and Payrolling System.

Although counties share in the maintenance and operations of such systems, their share of development costs is very small (about 5 percent of nonfederal costs). Counties play a significant role in the development of these systems as the state project managers treat the counties as "clients." Further, counties benefit from these systems because increased automation capacity increases their ability to serve clients while reducing labor costs.

Under the current system, counties have financial incentives to "ask for more" during the development phase because their development cost share is low, and they will benefit from any increased automation functionality that is developed. Because the state has a large interest in overseeing statewide implementation and federal compliance, we believe that the state should continue to support the majority of automation costs. Nevertheless, increasing the county share of development costs would better align state and county goals in automation development. We suggest raising county costs to about 25 percent. For 2003-04, this would shift approximately $42 million in automation costs to the counties.

Child Care

Program Improvements Possible through Realignment

California's subsidized child care system is administered primarily through SDE and DSS. The *2002-03 Budget Act* allocates about $3.1 billion—$1.7 billion from the General Fund and $1.4 in billion federal funds—for over 15 different child care and development programs. About half of this funding is for programs restricted to current and former CalWORKs recipients. The remaining funding is for programs open to all California residents, based on income eligibility and space availability.

The administration's realignment plan shifts to counties responsibility for—and significant authority over—most child care programs administered by SDE. In addition to the $8.2 billion in new revenues that would be available to counties for child care and other programs, the proposed budget includes $863 million in federal funds for child care subject to enactment of the realignment proposal.

Currently, the state's centralized child care system creates significant difficulties for families and local child care providers:

- ***Difficult for Families to Access Services.*** The state's child care programs generally use separate eligibility criteria, require different points of entry, and maintain separate waiting lists. The uncoordinated manner in which these programs are administered impedes families' access to the system.

- ***Provider Rules Are Unduly Complex.*** Local child care providers that receive funding under more than one child care program often must negotiate separate contracts for each program and comply with separate rules regarding allowable expenditures, attendance accounting, eligibility, and reimbursement rates.
- ***Similar Families Treated Differently.*** The state's child care programs treat families with similar incomes differently, depending on whether they have received assistance through the CalWORKs program. In general, families that previously have been on CalWORKs continue to receive services, while other working poor families are placed on waiting lists.

In view of the above, we believe the administration's proposal to realign child care programs to counties merits legislative consideration. Realignment would give counties the flexibility to use child care funds as part of an integrated strategy to serve the needs of their communities' working poor. Counties could reduce the administrative complexity of the system by setting countywide rules relating to eligibility, family fees, and reimbursement rates. (Please see the "Child Care and Development" section in the "Education" chapter of the *Analysis* for further discussion regarding the child care realignment proposal.)

Criminal Justice

The administration's plan proposes changes to only one criminal justice program—trial court security. As shown in Figure 4, we recommend the Legislature reject the administration's trial court proposal, but consider for realignment several programs relating to juvenile and adult corrections.

Court Security Fund Swap Is Not Realignment

Under the administration's realignment plan, 6.54 percent of the revenues raised by the new sales tax is deposited into the Trial Court Trust Fund for court security purposes. State General Fund support for court security is then reduced by a commensurate amount. Our review indicates that the administration's plan does not realign any governmental duties or improve the delivery of services; it simply moves the costs of a state funded program from the General Fund to a new revenue source. For this reason, we recommend the Legislature exclude this program from the list of programs considered for realignment. While the administration's plan proposes to give courts needed increased flexibility in the management of security costs, the Legislature could provide this increased flexibility through a separate statute.

Realign Adult and Juvenile Offender Programs

Currently, the state is responsible for the incarceration and treatment of thousands of adult and juvenile offenders who, within a few years or months, will be released from state facilities. Upon their release, most juvenile and adult offenders return to their home communities. Thus, local governments have a significant interest in the future behavior of these individuals. Counties also administer many of the programs these individuals need to reduce their likelihood of recidivism—drug and alcohol treatment programs, mental health services, indigent health, and some employment services.

We believe that realignment of program and funding responsibility for certain components of the criminal justice system merits consideration by the Legislature because of the program linkages discussed above. In addition, such an approach would provide counties with a strong incentive to intervene early with criminal offenders and develop alternative methods of incarceration and services to minimize an individual's risk of reoffending. The programs we believe worth consideration for realignment are juvenile justice, adult parole, and return-to-custody.

Juvenile Offenders. Counties currently are responsible for more than 95 percent of all juvenile offender cases, primarily through their probation departments. The state's Department of the Youth Authority provides incarceration, rehabilitation services, and community supervision for juvenile offenders who have committed crimes that are more serious in nature or have repeatedly failed to respond to local juvenile justice programs. Current law requires counties to pay a share of the cost for Youth Authority commitments based on a sliding fee schedule that charges counties a higher fee for less serious offenders and a lower fee for more serious offenders. The county share of cost varies from about 4 percent to 63 percent depending on the classification of the ward being committed to the Youth Authority. Under our proposed realignment, counties would be responsible for treatment of *all* juvenile offenders at the local level, or for paying the full cost of placing offenders in state facilities. This realignment would clarify the responsibility for juvenile commitments and give counties greater incentives to invest in prevention and treatment programs.

Adult Parole. Currently, when a state prison inmate completes his or her sentence, he or she is supervised on parole by state staff in the community for up to three years. The community supervision services provided on parole are very similar to the services provided by county probation departments to probationers. Under our proposed realignment, state parole would be abolished and the community supervision function would be consolidated with county probation departments. Counties would determine the type and intensity of community supervision and how to make the best use of funds. For example, a county may decide to place an offender with a violent history in an intensive supervision program, or an offender with a history of substance abuse in a residential treatment program.

Adult Parole—Return-to-Custody. Currently, parolees who violate the conditions of their parole may have their parole administratively revoked and be returned to state prison for up to one year by the Board of Prison Terms. Such violations usually are for offenses that local law enforcement officials consider minor, such as unauthorized absence from parole supervision. Under our proposed realignment, counties would be responsible for offenders who violated the terms of their supervision. If an offender violated a condition of his or her supervision order (for which he or she is not prosecuted), counties would have the option to place the offender in custody, impose other community-based alternative punishments, or return the offender to state prison for up to one year at county expense.

Funding the LAO Proposed Realignment. We would propose that the realignment financing plan include $1.6 billion to realign these criminal justice programs to the counties. This reflects the current state costs to administer these programs. Counties would determine how best to make use of these realignment funds. In addition, we recommend dedicating additional discretionary funds of $232 million from the elimination of the COPS and Juvenile Justice grant programs for the development of new community-based programs, and / or the expansion of existing services to meet the needs of these juvenile and adult offenders.

Mandates

Realignment Plan Is Well Suited for Funding Mandates

The California Constitution requires the state to reimburse schools and other local agencies if it "mandates" a new program or higher level of service. As we have discussed in previous budget analyses, the claiming process associated with mandate reimbursement is slow, burdensome, and fails to give local governments incentives to contain costs.

Our review indicates that about 13 of the state's ongoing mandates (relating to voting procedures, property tax administration and, and mental health mandates, such as the AB 3632 program for children in special education, discussed above) represent county functions of significant statewide importance and could be consolidated and funded through the realignment plan. Such a realignment of mandate funding would provide counties with ongoing resources and eliminate the paperwork associated with mandate claiming. Before including these mandates in state-county realignment, however, we recommend that the Legislature modify the underlying mandate requirement to increase county flexibility and lower compliance costs. The amount of realignment funding provided to counties should reflect these mandate changes.

CONCLUSION

Given the size and diversity of California, we think realigning some programs from state to county control would provide the needed flexibility and fiscal incentives to improve program performance. For this reason, we think realignment merits consideration by the Legislature—regardless of its decisions regarding taxes or education funding.

Our review indicates that $5.1 billion of programs in the administration's plan and $4 billion of other programs may be good candidates for realignment and merit the Legislature's consideration.

Given the requirements of the California Constitution and voter-approved measures, enacting realignment will require achieving a broad consensus among many parties. Because realignment plans are difficult to modify over time, we recommend the Legislature take a long term view in enacting any program and funding changes.

ADDITIONAL OPTIONS FOR REDUCING STATE SPENDING

Introduction

As we have noted elsewhere in this document, the Governor's budget proposes significant reductions in most program areas. These proposed expenditure reductions reflect the Governor's choices and priorities. In many cases, the Legislature will have very different takes on how spending should be reduced. This was evident, for example, in its response to the administration's mid-year proposals, where the Legislature made significant changes.

Similarly, the Legislature is likely to disagree with many spending reduction proposals in the Governor's budget-year plan. As a result, it may need alternative savings proposals to adopt in place of those proposals. We provide such alternatives in both the *Analysis of the 2003-04 Budget Bill* and this piece:

- In the *Analysis*, we provide *recommendations* based on our detailed review of individual programs. We identify actions the Legislature can take to make programs more cost effective, use alternative funding sources to meet legislative priorities, and improve program efficiency.
- In this piece, we present *options* for the Legislature's consideration. We have identified expenditures that may be considered of lower priority in tough budget times. It is not that these activities are without merit or not desirable. In better fiscal times we would not necessarily put such options on the table. However, we offer them in the context of a need to solve a massive budget shortfall.

These expenditure options are grouped in the following categories:

- Spending reductions.
- Fund shifts.
- Federal funds (in effect, using increased federal resources in place of state funds).
- Fees (in place of General Fund support).
- Loans.
- Transfers.

We have also referenced in the "Comments" section of those options where there is a more extensive discussion of them in the *Analysis.* Figure 1 lists the options for all program areas except for Proposition 98. Further below, we describe the particular circumstances involving Proposition 98 funding and list options related to this area in Figure 2.

Figure 1

Selected LAO Budget Options

(In Millions)

Department/Program—Description	2003-04	2004-05
Spending Reductions		
Department of Developmental Services—Establish annual expenditure limits for regional centers for selected services. Comments: This option would establish limits for the maximum allowable units of specific types of services regional centers are allowed to purchase for clients thereby slowing the rapid rate of growth in this program. Regional centers would have to reduce the amount of services provided to clients in order to implement this option.	$97.1	$119.4
Department of Health Services/Medi-Cal—Impose a moratorium on new adult day health centers. Comments: This would temporarily slow the rapid growth that has been occurring in the number of adult day health centers.	30.1	31.1
Department of Health Services/Medi-Cal—Rescind continuous eligibility for children. Comments: This option would disenroll children who are no longer eligible to receive Medi-Cal benefits. Administrative set-up would take three months and implementation would phase-in after that.	76.2	175.2
Department of Health Services/Medi-Cal—Exclude over the counter drugs from coverage. Comments: Coverage is not required by federal government and such an exclusion is similar to many private health coverage plans. This option would exclude analgesics and cough and cold medications.	7.6	7.8
Department of Health Services/Medi-Cal—For newly enrolled disabled persons change default to managed care. Comments: This option could help improve the coordination of care for disabled persons.	0.8	0.9
Department of Veterans Affairs—Close acute care hospital at Yountville veterans' home. Comments: The state could close the underutilized acute care hospital at the Yountville veterans' home and provide care to veterans at a lower cost through facilities in the surrounding community.	2.0	2.1

Continued

Department/Program—Description	2003-04	2004-05
Department of Social Services/Child Welfare Services (CWS)—Cap total cost per caseworker (including administrative costs) at $135,000. Comments: Under this proposal, 11 high-cost counties would need to reduce their cost per caseworker.	**$20.8**	**$20.8**
Department of Social Services/CWS—Reduce frequency of group home visits from monthly to quarterly. Comments: This option would still leave the frequency of home visits above the federal requirement which is semi-annual.	**7.5**	**7.7**
Department of Social Services/CWS—Suspend emancipated foster youth stipend for two years. Comments: The emancipated foster youth stipend is not a core component of the foster care program.	**3.6**	**3.6**
Department of Social Services/Foster Care—Suspend supplemental clothing allowance for two years. Comments: The clothing allowance is not a core component of the foster care program.	**3.3**	**3.3**
Department of Child Support Services/Local Administration—Suspend half of child support program initiatives for two years. Comments: The initiatives that have been established over the last two years are not part of the core collections program.	**26.4**	**26.4**
University of California (UC)—Eliminate General Fund support for California State Summer School for Math and Science. Comments: Program serves high-achieving high school students.	**1.6**	**1.6**
UC—Eliminate General Fund support for Community Teaching Internships for Mathematics and Science Programs. Comments: Programs provide stipends to juniors and seniors majoring in math, science, and engineering, who work in local public schools as teaching interns. Other state and federal programs provide similar services.	**1.3**	**1.3**
UC—Reduce funding for Digital California Project by an additional 30 percent. Comments: Option leaves approximately $15 million for program.	**6.6**	**6.6**
UC—Reduce General Fund support for cooperative extension program by an additional 5 percent. Comments: Governor proposes a 10 percent reduction.	**3.0**	**3.0**

Continued

Department/Program—Description	2003-04	2004-05
UC—Eliminate enrollment growth funding in 2003-04. Comments: Budget funds growth of 6.9 percent. (See *Analysis* for detailed discussion of enrollment issues.)	**$117.2**	**—**
UC—Eliminate augmentation for UC Merced. Comments: UC Merced is not scheduled to open until fall 2004. Approximately $10 million will still be available for start up costs associated with the campus in 2003-04.	**11.3**	**—**
UC—Eliminate General Fund support for institutional aid programs. Comments: Substantial growth in state Cal Grant programs has weakened justification for separate institutional aid programs. (See *Analysis* for detailed discussion of financial aid issues.)	**68.9**	**$68.9**
UC—Increase state's share of federal overhead reimbursements by 10 percent. Comments: The federal government reimburses UC for the overhead costs of contracted research. The state funds much of this overhead, but currently shares with UC these federal reimbursements. This option would increase the state's share from 55 percent to 65 percent, generating an estimated General Fund savings of $35 million.	**35.0**	**35.0**
California State University (CSU)—Eliminate funding for enrollment growth in 2003-04. Comments: Budget funds growth of 7.1 percent. (See *Analysis* for detailed discussion of enrollment issues.)	**150.9**	**150.9**
CSU—Eliminate General Fund support for institutional aid programs. Comments: Substantial growth in state Cal Grant programs has weakened justification for separate institutional aid programs. (See *Analysis* for detailed discussion of financial aid issues.)	**51.1**	**51.1**
Student Aid Commission (SAC)—Raise GPA requirement by one-third point for Cal Grant entitlement programs. Comments: Option would raise the minimum GPA requirement for the Cal Grant A Entitlement program from 3.0 to 3.3 and for the Cal Grant B Entitlement program from 2.0 to 2.3. The Legislature would need to act now to achieve 2004-05 savings.	**—**	**50.9**
SAC—Reduce income ceiling by $5,000 for Cal Grant entitlement programs. Comments: Once reduced, the Cal Grant A and Cal Grant B income ceilings still would be approximately 3 times and 1.6 times the federal poverty level, respectively. Legislature would need to act now to achieve 2004-05 savings.	**—**	**19.4**

Continued

Department/Program—Description	2003-04	2004-05
SAC—Eliminate Cal Grant T program. Comments: State has another, better structured financial aid program that also encourages aspiring teachers to become fully credentialed and work in low-performing schools.	**$3.0**	**$3.0**
SAC—Eliminate Graduate Assumption Program of Loans for Education. Comments: This is a highly specialized program that benefits few students (only two warrants were redeemed in 2000-01, for a total cost of $4,000).	**0.5**	**0.5**
Corrections—Increase work credits for reception center inmates and involuntarily unassigned inmates. Comments: This would extend day-for-day work credits to inmates who receive less credit due to lengthy inmate processing and a lack of sufficient work and academic slots at CDC institutions. (See *Analysis*, for detailed discussion of the work credit issue.)	**70.0**	**68.0**
Corrections—Place nonviolent elderly inmates on parole early. Comments: Research shows elderly inmates are two to three times more expensive to incarcerate yet they have a high level of success on parole. (See *Analysis* for detailed discussion of elderly inmate issue.)	**9.0**	**10.0**
Corrections—Discharge nonviolent parolees early. Comments: This would allow parolees who have met the conditions of their parole for either 6, 9, or 12 months to be discharged early. Savings would range up to the amount shown depending on the length of time required to meet condition of parole.	**35.0**	**48.0**
Corrections—Place nonviolent inmates on parole early. Comments: This would allow certain inmates to be discharged from prison and placed on parole up to 12 months early. This option would exclude "lifers," "striker," and inmates whose offense is serious or violent. Savings depend on how early inmates are placed on parole.	**241.0**	**241.0**
Corrections—Remove prison as an option for persons convicted of petty theft with a prior. Comments: "Petty theft with a prior" is currently prosecuted as either a misdemeanor or a felony. This proposal would require the crime to be prosecuted as a misdemeanor, thereby reducing admissions to state prison in the budget year and beyond.	**15.0**	**34.0**
Youth Authority—Eliminate the Gang Violence Reduction Program. Comments: This program, which provides grants to local law enforcement agencies for gang prevention, is duplicative of crime prevention programs administered by the Office of Criminal Justice Planning, Department of Justice, and Department of Education.	**1.7**	**1.7**

Continued

Department/Program—Description	2003-04	2004-05
Youth Authority—Eliminate the Young Men as Fathers Program. Comments: This program provides grants to counties for parenting programs in county juvenile facilities and alternative schools. This program is duplicative of a program administered by the Department of Health Services.	**$0.9**	**$0.9**
Local Government—Eliminate the High-Tech Law Enforcement Grants Comments: This program provides grants to local law enforcement agencies for equipment. The statewide objective of this program is unclear. Law enforcement is largely a local function, and local funds can be used to purchase equipment if it is a local priority.	**18.5**	**18.5**
Local Government—Eliminate the Rural County Law Enforcement Grants Comments: This program provides grants to rural county sheriffs for equipment. The statewide objective of this program is unclear. Law enforcement is largely a local function and local funds can be used to purchase equipment if it is a local priority.	**18.5**	**18.5**
Local Government—Eliminate Citizen's Options for Public Safety (COPS) grant program. Comments: The COPS program provides grants to local law enforcement mostly for personnel and equipment. Given that COPS funding represents a small share of total local law enforcement expenditures, its impact on public safety, if any, is likely to be relatively small.	**116.3**	**116.3**
Local Government—Suspend the Juvenile Justice grants program for one year pending evaluation results. Comments: The Juvenile Justice grants provide funds to address service gaps in county juvenile justice systems. This proposal would suspend funding for one year pending completion of evaluations currently underway. Suspension should not adversely affect the programs because grant recipients receive funding one year in advance of projected expenditures.	**116.3**	**—**
Natural Heritage Preservation Tax Credit Program—Suspend award of new credits for two years. Comments: This program allows the donation of property to state or local agencies or nonprofit organizations, and gives the donor a partial state tax credit based on the assessed value of the property. The act authorizes $100 million of tax credits through 2005. As of January 2002, a balance of approximately $60 million of credits remains to be authorized by the Wildlife Conservation Board. The General Fund fiscal impact of this option reflects a reduction in tax credits that would otherwise be claimed if it were not for the suspension.	**8.7**	**10.3**

Continued

Department/Program—Description	2003-04	2004-05
Agency Secretaries—Eliminate General Fund support for agencies. Comments: The need for the agency level of state government is unclear.	**$7.0**	**$7.0**
Arts Council—Eliminate General Fund support for the department. Comments: None.	**12.0**	**12.0**
Fair Employment and Housing—Eliminate department and commission. Comments: In the absence of state law, federal law would provide for regulation and remedies for violations.	**12.6**	**12.6**
Health and Human Services and Teale Data Centers/Administrative Consolidation—Consolidate the administrative functions of the two data centers. Comments: This option is discussed in detail in the "General Government" chapter of the *Analysis*.	**4.0**	**4.0**
Health and Human Services and Teale Data Centers/Server Consolidation—Gain administrative efficiencies by transferring some servers from departments to the data centers. Comments: This option is discussed in detail in the "General Government" chapter of the *Analysis*.	**3.0**	**3.0**
Science Center—Eliminate General Fund support for the department. Comments: None.	**13.1**	**13.1**
Technology, Trade, and Commerce Agency—Eliminate General Fund support for various programs. Comments: Estimated savings assumes elimination of funding for the Film Commission, small business loan guarantee program, and Office of California-Mexico Affairs.	**16.5**	**16.5**
Various/Nonessential Commissions, Offices, and Departments—Eliminate nonessential state operations. Comments: Estimated savings assumes the elimination of the Office of Planning and Research, Office of Administrative Law, Little Hoover Commission, and Commission on the Status of Women.	**7.5**	**7.5**
Franchise Tax Board (FTB) and Board of Equalization (BOE)—Consolidate certain district office activities. Comments: Agencies would rely more on call centers to provide public assistance.	**1.8**	**1.8**

Continued

Department/Program—Description	2003-04	2004-05
Federal Funds		
Department of Developmental Services—Draw down federal funding for regional center services provided residents in intermediate care facilities for the developmentally disabled (ICF-DDs). Comments: The state could draw down additional federal funds to offset the state costs of services provided to these residents by modifying the rate structure of the ICF-DDs and through other changes.	**$48.8**	**$52.4**
Department of Developmental Services—Assume higher Medicaid waiver enrollment cap. Comments: The state can obtain greater federal fund support for regional center services than is budgeted to the extent that federal authorities will allow additional clients to be included in a Medicaid waiver program.	**49.5**	**56.7**
Department of Health Services/Public Health—Move the Indian Health Program from DHS to MRMIB. Comments: Consolidating this program with similar programs would maintain overall funding at the current level by shifting support from General Fund to federal funds.	**4.0**	**4.0**
Department of Health Services/Public Health—Move the Seasonal, Agricultural and Migratory Worker Program from DHS to MRMIB. Comments: Consolidating this program with similar programs would maintain overall funding at the current level by shifting support from General Fund to federal funds.	**5.0**	**5.0**
Department of Health Services/Medi-Cal—Screen for veterans who could receive VA health coverage. Comments: Federal survey data suggest that there could be more than 100,000 veterans on Medi-Cal (at a cost to the state of an estimated $250 million annually) who could be eligible instead for comprehensive health care from the Veterans Administration (VA). The state could verify this data to determine if actions are warranted to ensure they receive VA care, thereby reducing General Fund costs.	**Undetermined Savings**	

Continued

Department/Program—Description	2003-04	2004-05
Fees		
Department of Health Services/Medi-Cal—Establish a provider-specific fee to fund rate adjustments for long-term care facilities. Comments: This proposal would impose a fee on nursing homes to draw down additional federal funds that would offset General Fund costs.	**$39.6**	**$54.8**
Department of Social Services/Community Care Licensing—Remove FBI fingerprinting fee exemption for small licensed providers (caring for six children or less). Comments: This creates parity among large (nonfee exempt) and small (fee exempt) providers. The fee for FBI fingerprinting is $24 and there is an additional $16 live-scan fee.	**3.2**	**3.2**
Fund Shifts		
Department of Developmental Services—Shift General Fund spending for the Early Start program to Proposition 98 funds. Comments: This option would shift all of the state's General Fund cost of early intervention services to Proposition 98, thus permitting a net reduction in non-Proposition 98 General Fund expenditures.	**$59.1**	**$66.2**
Department of Health Services/Public Health—Shift financial responsibility for the California Children's Services Medical Therapy Program to Proposition 98. Comments: This option would shift all of the state's General Fund cost of these nonmedical therapy services to Proposition 98, thus permitting a net reduction in non-Proposition 98 General Fund expenditures.	**37.0**	**39.0**
Department of Alcohol and Drug Programs—Redirect state and federal asset forfeiture proceeds. Comments: This option would use part of the proceeds taken from illegal narcotics traffickers to help pay for substance abuse treatment programs.	**10.0**	**10.0**
Departments of Social Services and Education/Child Care—On a one-time basis, replace state child care spending with federal Temporary Assistance for Needy Families block grant funds transferred to the Child Care and Development Fund block grant. Comments: If child care is realigned, as proposed by the budget, General Fund savings can be achieved by either (1) reducing the amount of revenues transferred to the counties with the state "recapturing" these revenues or (2) shifting other state program costs to counties. If child care is not realigned, the cost of maintaining current child care programs could be reduced by the $400 million proposed fund shift.	**400.0**	**—**

Continued

Department/Program—Description	2003-04	2004-05
General Services/California Home Page—Outsource the home page and make it self-sufficient. Comments: Other states have outsourced their home pages and cover costs through the collection of fees for online services (primarily for businesses).	**$3.0**	**$3.0**
Food and Agriculture/Pierce's Disease—Eliminate General Fund support for control of Pierce's Disease. Comments: Fees already support a portion of the program's costs. The General Fund costs could be shifted to fees as well.	**6.4**	**6.4**
Housing and Community Development/Projects With Undisbursed Funds—Switch funding from the General Fund to the housing bond. Comments: This option is discussed in detail in the "General Government" chapter of the *Analysis*.	**200.0**	**—**
Loans/Transfers		
Department of Social Services/CalWORKs—Borrow county performance incentive funds that remain unspent at the end of June 2003. Comments: These funds may be borrowed at no interest costs. Any borrowed funds would be added to the state's current $394 million liability to the counties.	**$100.0**	**—**
Off Highway Vehicle (OHV) Trust Fund—Loan excess funds to the General Fund. Comments: The OHV fund balance at the end of 2003-04 is projected to be $49.1 million. This balance can be loaned with a specific repayment date, but cannot be transferred because it is a trust fund. Proposed loan would leave a balance of $9.1 million. The OHV Trust Fund consists of service fees for issuance of identification plates for OHV vehicles; user fees for the state OHV recreation areas; fines; and specified transfers from the Motor Vehicle Fuel Account.	**40.0**	**—**
California Debt and Investment Advisory Commission (CDIAC)—Borrow an additional $2.5 million from CDIAC's special fund balance. Comments: Budget includes $3 million loan from this fund. An additional $2.5 million would still leave a fund balance equal to roughly 40 percent of CDIAC's annual budget.	**—**	**2.5**

Proposition 98 Budget Options

In the *Analysis of the 2003-04 Budget Bill*, we provide an alternative Proposition 98 funding proposal. For K-12 education, we recommend consolidating 62 programs into five categorical block grants. The amount of funding provided for the categorical block grants builds on the appropriation levels proposed by the Governor, which reflect an over 11 percent across-the-board reduction. We believe that school districts can absorb the reductions if they are given the flexibility to react to the reductions. If, however, the Legislature chooses not to consolidate categorical programs, we would suggest that they make targeted cuts to programs providing noncore educational services. In Figure 2, we provide a list of K-12 alternatives totaling over $1 billion in targeted cuts.

For the community colleges, we believe that the overall level of categorical funding reductions proposed by the Governor (25 percent) is reasonable given the fiscal circumstances. In the event that the Legislature wishes to restore funding for some of the specific categorical programs, we have identified over $200 million in substitute categorical reductions that the Legislature could adopt in order to maintain the same overall level of Proposition 98 savings proposed in the Governor's budget (see Figure 2). This combined list of K-12 and community college reduction options also provides the Legislature with opportunities to adjust the K-12 and community college split depending on legislative priorities.

Figure 2

Selected LAO Budget Options
Proposition 98 Spending Reductions

(In Millions)

Department/Program—Description	2003-04	2004-05
Staff Development Buyout Days—Suspend funding for one year. Comments: One-time reduction would help preserve core services.	**$202.0**	**$202.0**
Mathematics and Reading Professional Development Program—Eliminate funding. Comments: Short-term program would serve only 3 percent of core subject matter teachers in 2003-04. The State Board of Education has approved few training providers.	**27.9**	**27.9**
Principal Training Program—Extend over next several years. Comments: The State Department of Education (SDE) can fund all existing commitments for 2003-04 using $15 million in 2001-02 carryforward funds. This option would increase costs in 2004-05.	**28.7**	**-15.1**
Administrator Training and Evaluation Program—Eliminate funding. Comments: Program is more than 20 years old and serves same purpose as new Principal Training program.	**4.7**	**4.7**
Peer Assistance and Review—Eliminate funding. Comments: No available evidence showing program effectiveness.	**76.6**	**76.6**
Advanced Placement Challenge Grant Program—Sunset one year early. Comments: Program would otherwise terminate at end of 2003-04.	**3.2**	**—**
National Board Certification Program—Eliminate additional commitments. Comments: Provide budget-year funding to honor existing commitments. Other recruitment strategies likely to be more cost-effective.	**—**	**5.0**
Teacher Recruitment Centers—Eliminate program. Comments: Various other entities recruit and assist aspiring teachers.	**8.3**	**8.3**
Year Round Operations Grant Program—Phase out over next two years. Comments: Program no longer meets original intent.	**14.2**	**16.5**
Charter School Facilities Grant Program—Eliminate funding. Comments: Program no longer needed because Proposition 39 requires school districts to provide charter schools with sufficient facilities.	**2.3**	**2.3**

Continued

Department/Program—Description	2003-04	2004-05
***K-3 Class Size Reduction*—**Change ratio to 22 to 1 for high-income schools. Comments: Change student teacher ratio to 22 to 1 for schools with less than 50 percent free and reduced priced lunch eligible students. Schools with at least 50 percent free and reduced lunch eligible students continue at 20 to 1.	**$219.0**	**$219.0**
***College Preparation Partnership Program*—**Eliminate funding. Comments: Duplicative and more restrictive than the Academic Improvement and Achievement program (also administered by SDE).	**4.8**	**4.8**
***Local Arts Education Program*—**Eliminate funding. Comments: Program provides supplemental services that could be funded using other resources.	**5.7**	**5.7**
***Miller-Unruh Reading Program*—**Eliminate funding. Comments: Current funding distribution promotes historic inequities.	**25.5**	**25.5**
***School Improvement Program*—**Reduce funds by 20 percent. Comments: Funds generally used for one-time purposes. These purposes could be delayed.	**85.8**	**85.8**
***Civic Education*—**Eliminate program. Comments: Program funds curriculum development by nonprofit entity that is duplicative of state efforts.	**0.3**	**0.3**
***County Offices of Education*—**Do not fund growth in county apportionments. Comments: County offices fund services similar to categorical programs, which would receive no growth funding in 2003-04.	**22.3**	**22.3**
***Elementary School Intensive Reading Program*—**Eliminate program. Comments: Services are duplicative of those provided through the existing supplemental instruction programs.	**26.9**	**26.9**
***At Risk Youth (Angel Gate Academy LAUSD)*—**Eliminate funding. Comments: The federal Department of Defense provides $4 million in funding that covers a majority of the program's expenses.	**0.6**	**0.6**
***Intensive Algebra Instruction Academies*—**Eliminate program. Comments: Duplicative of services provided through existing supplemental instruction programs.	**11.2**	**11.2**
***Gifted and Talented Education (GATE)*—**Suspend the program for one year. Comments: Targets extra resources at highest-achieving students. These students can be served within base resources.	**49.8**	**49.8**

Continued

Department/Program—Description	2003-04	2004-05
School Law Enforcement Partnership—Eliminate program. Comments: Program duplicative of services provided through the School Safety and Violence Prevention Grant Program.	**$13.1**	**$13.1**
Statewide Education Technology Services—Eliminate program. Comments: Program services do not directly affect core classroom services.	**2.3**	**2.3**
Gang Risk Intervention Program—Eliminate program. Comments: These services can be provided through existing safety programs.	**2.9**	**2.9**
School Library Materials—Suspend program for one year. Comments: Suspend this program because of one-time nature of expenses.	**20.4**	**20.4**
Institute for Computer Technology—Eliminate state funding. Comments: This program receives a significant amount of foundation and grant funding.	**0.5**	**0.5**
California Technology Assistance Project—10 percent reduction in funding. Comments: Program does not directly affect students.	**1.3**	**1.3**
Deferred Maintenance—Suspend funding for one year. Comments: Existing law would continue to require that 3 percent of districts' unrestricted funds go to maintenance.	**181.0**	**181.0**
9th Grade Class Size Reduction—Eliminate funding. Comments: Schools with greatest need less likely to use program because of lack of qualified teachers.	**97.0**	**97.0**
CCC—Eliminate Part-Time Faculty Compensation funding. Comments: This program increases part-time faculty salaries with no demonstrated linkage to improved student outcomes.	**50.8**	**50.8**
CCC—Eliminate Part Time Faculty Office Hours funding. Comments: Office hours can be negotiated as part of collective bargaining, without categorical funding.	**3.9**	**3.9**
CCC—Terminate Partnership for Excellence program. Comments: Program is due to sunset at end of 2004 calendar year. Has shown little evidence of progress in reaching performance targets.	**164.5**	**164.5**