THE 2004-05 BUDGET: PERSPECTIVES AND ISSUES

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

California Legislature

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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 *2004-05 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 2004-05 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2004-05 Budget Bill*, which contains our review of the *2004-05 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 2004-05 Budget: Perspectives and Issues is divided into five parts:

- Part I, "State Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part II, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part III, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2005-06.

- Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2004-05 and evaluates the major expenditure proposals in the budget.
- Part Five, "Major Issues Facing the Legislature," (1) reviews the Governor's property tax shift proposal; (2) offers an alternate budget approach to dealing with unexpected expenses; (3) recommends an approach to remodeling the Drug Medi-Cal program; (4) suggests an approach to provide better health care at reduced costs for aged and disabled persons; (5) reviews the state's mandate process and identifies areas of reform; (6) describes the problem of abusive tax shelters; and (7) identifies additional options to address the state's budget shortfall.

I

State Fiscal Picture

State Fiscal Picture

The basic budget problem currently facing the state involves an unfunded gap of slightly over $17 billion. Most of this—$15 billion—represents an ongoing projected structural imbalance between current-law revenues and expenditures in 2004-05 and beyond. The remaining $2 billion reflects a shortfall in the current-year budget. This latter amount—which was not included in our January budget overview—takes into account the administration's January 2004 announcement regarding the maximum size of the previously authorized deficit reduction bond. The significance of this technical issue is discussed further below.

The Governor's proposed 2004-05 budget seeks to address the projected budget shortfall in 2004-05 through a combination of major and wide-ranging spending reductions, additional borrowing, and a diversion of local property taxes for the benefit of the state. The Governor's plan does not include new taxes as part of the solution. In addition, it recognizes that it only partially addresses the underlying structural budget problem projected beyond 2004-05.

A key element of the Governor's plan is the assumed approval of a $15 billion economic recovery bond on the March 2004 statewide ballot to pay off the accumulated 2002-03 budget deficit and help address the remaining budget shortfall. This bond would replace the smaller statutorily authorized deficit-financing bond assumed in the 2003-04 budget plan but currently facing a legal challenge.

LAO Bottom Line

We believe that the Governor's proposal is a solid starting point for budgetary negotiations. However, a considerable amount of work remains to be done to bring 2004-05 into balance and to fully resolve the state's

chronic budget-related problems. In particular, our own evaluation of the proposal indicates that *even if* all of its elements were adopted, 2004-05 would end with a General Fund deficit of $0.8 billion. We further project that an ongoing General Fund structural deficit of close to $7 billion would exist beyond the budget year, absent corrective action.

In the remainder of this part, we summarize the *2004-05 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 plans and priorities for dealing with the state's fiscal situation.

THE BUDGET'S ECONOMIC AND REVENUE OUTLOOK

The budget's economic forecast, which we discuss in detail in "Part II," assumes that the recent strengthening of economic activity will continue for both the nation and state in 2004 and 2005. For example, it forecasts that California personal income, a key determinant of state tax revenue performance, will grow 5.6 percent in 2004 and 5.9 percent in 2005. The budget further assumes that the expanding economy will boost collections from the state's major taxes by roughly 6 percent in both 2003-04 and 2004-05. As detailed in "Part III," the administration's updated tax revenue forecast is up about $2 billion from the 2003-04 budget estimate. Its projections for both the current year and budget year are similar to the forecasts in our *California Fiscal Outlook* report that was published in November 2003.

THE BUDGET PROPOSAL

Total State Spending

The budget proposes total state budgetary spending in 2004-05 of $97.2 billion (excluding expenditures of federal funds and bond funds). This represents a decrease of 0.2 percent from the current-year total of $97.4 billion. General Fund spending is projected to fall from $78 billion to $76.1 billion while special funds spending rises from $19.4 billion to $21.1 billion. As discussed below, however, the way in which the proceeds from the assumed economic recovery bond are treated for budgetary purposes somewhat distorts the underlying expenditure trend. Absent this factor, total spending would be up from $94.4 billion in the current year to $100.2 billion in the budget year, a difference of 6.1 percent. Much of this increase is related to the expiration of one-time savings in

2003-04 associated with federal funds, debt-service restructuring, accounting changes, and other factors.

General Fund Condition

Figure 1 shows the General Fund's condition from 2002-03 through 2004-05 under the budget's assumptions and proposals.

Figure 1

Governor's Budget General Fund Condition

(Dollars in Millions)

			Proposed for 2004-05	
	2002-03	2003-04	Amount	Change
Prior-year fund balance	-$1,474	$1,607	$1,219	
Revenues and transfers	71,322	74,627	76,407	2.4%
Bond proceeds	9,242	3,012	—	
Total resources available	($79,090)	($79,247)	($77,626)	
Expenditures	$77,482	$75,016	$79,074	5.4%
Deficit Recovery Fund transfer	—	3,012	-3,012	
Total expenditures	($77,482)	($78,028)	($76,062)	-2.5%
Ending fund balance	$1,607	$1,219	$1,563	
Encumbrances	929	929	929	
Reserve	$679	$290	$635	

Detail may not total due to rounding.

Prior Year

$2.1 Billion Improvement. In a very significant positive budgetary development, the 2002-03 budget's condition has improved by about $2.1 billion since the 2003-04 budget was enacted last summer. As a result, the prior-year's estimated deficit has been lowered—from the earlier $10.7 billion assumed in the 2003-04 budget to $8.6 billion. This improvement means that the state needs about $2.1 billion less than previously thought in savings and/or other budgetary solutions to keep its budget in balance in 2004-05. About one-half of the improvement relates to recent increases in prior-year revenue accruals made by the Controller, based on information from the state's tax agencies for 2002-03 and earlier

years. The other half relates to lower expenditures and reduced encumbrances in 2002-03.

This reduction in the year-end deficit has enabled the administration to both propose using fewer bond proceeds and fund a reserve. Specifically, it has reduced the amount of the proposed economic recovery bond proceeds applied to 2002-03 from $10.7 billion down to $9.2 billion, a reduction of $1.5 billion. (This reduction is significant because any unused bond proceeds will be available to offset budgetary shortfalls in the current and budget years or thereafter.) Second, along with the smaller bond size, the administration has chosen to increase the size of the 2002-03 reserve from zero at the time the 2003-04 budget was enacted to a modest $679 million. As a result, the state is able to start the current fiscal year in a stronger position than previously anticipated, and have more bond proceeds "left over" to address future budget shortfalls.

Current and Budget Years

Under the administration's budget plan, the large projected General Fund shortfall for the budget year would be eliminated and 2004-05 would conclude with a small reserve. Specifically:

- *Revenues* are projected to grow from $74.6 billion in the current year (exclusive of any economic recovery bond proceeds) to $76.4 billion in 2004-05—an increase of 2.4 percent. As discussed below, the revenue totals in both the current year and budget year are affected by numerous policy actions associated with prior budgets, as well as with the new budget proposal.

- *Expenditures* are projected to decline from $78 billion in 2003-04 to $76.1 billion in 2004-05. As shown in the figure, the current-year spending totals have been increased by the proposed transfer of $3 billion in bond proceeds to a new "deficit recovery" special fund. These bond monies are then proposed to offset General Fund spending in 2004-05. Absent these bond-related shifts, proposed General Fund expenditure growth in 2004-05 is 5.4 percent.

- The reserve at the end of 2004-05 is projected to be $635 million.

How the Plan Addresses the Budget Shortfall

The Governor's plan addresses the shortfall by proposing roughly $18 billion in budgetary solutions. The proposed budget incorporates most of the mid-year savings reductions proposed in late November by the Governor, and includes major new savings proposals in 2004-05. As shown in Figure 2, about 40 percent of the total solutions relates to program reductions/sav-

ings. The remaining 60 percent relates to the use of the proposed economic recovery bonds; other loans and borrowing; a cost shift to local governments; and a variety of other revenues, transfers, and funding shifts.

Figure 2

Allocations of Governor's Proposed Budget Solutions

(In Billions)

	2003-04 And Prior	2004-05	Two-Year Total
Program reductions/savings	$0.8	$6.5	$7.3
Economic Recovery Bond:[a]			
Proceed amounts	0.7	3.0	3.7
Reduced debt service	—	1.3	1.3
Other loans/borrowing	1.6	1.0	2.6
Local government-related	—	1.8	1.8
Transfers/other revenues and fund shifts	0.9	0.8	1.6
Totals	**$4.0**	**$14.4**	**$18.3**

Detail may not total due to rounding.

[a] Incorporates administration's recent reduction in estimated allowable size of statutory authorized deficit bond from $10.7 billion to $8.6 billion.

One-Time Versus Ongoing Savings. Of the $14.4 billion in total savings shown in 2004-05, we estimate that about $5.3 billion, or 37 percent, are one-time and the remaining $9 billion, or 63 percent, are ongoing in nature—meaning that they will provide budget benefits in future years.

Program Reductions/Savings

The budget includes $7.3 billion in program reductions and related cost savings in the current and budget years combined. These include:

- A $2 billion reduction in Proposition 98 spending.
- A $950 million reduction in transportation spending related to suspension of the Proposition 42 transfer (the remaining portion of the $1.1 billion suspension is reflected in the local government category).

In addition, the budget includes:

- A $1.4 billion reduction in social services related to grant reductions, cost-of-living adjustment deletions, and elimination of state-only services in In-Home Supportive Services.

- A $1.1 billion reduction in Medi-Cal, primarily related to 10 percent provider rate reductions, and a $400 million unallocated reduction to corrections.

- Significant reductions in higher education, backfilled partly by student fee increases.

Economic Recovery Bond

This category accounts for about $5 billion of total solutions, including about $3.7 billion in net new borrowing and $1.3 billion from debt-service savings.

Background. The 2003-04 budget assumed that the state would sell a $10.7 billion deficit reduction bond as authorized by the Legislature in 2003, and that the proceeds would be used to eliminate the then-estimated $10.7 billion accumulated 2002-03 budget deficit. (As noted in the nearby shaded box, on January 29 the administration announced that the allowable size of the statutory bond has declined to $8.6 billion.) Repayment of this bond would require annual General Fund expenditures equal to one-half cent of the state sales tax, or somewhat over $2.4 billion annually, beginning in 2004-05. The 2004-05 budget proposes instead to use $12.3 billion in proceeds from the larger, up to $15 billion, economic recovery bond that will be considered by the voters in March 2004.

Fiscal Implications. The use of the larger bond would result in near-term budget-related savings in two ways:

- ***More Bond Proceeds.*** The proposal would use a total of $12.3 billion in proceeds from the Governor's proposed economic recovery bond to offset a portion of the budget problem, with any unused balance of the net proceeds in excess of this $12.3 billion available for use in the future. This $12.3 billion in bond proceeds is $3.7 billion more than the $8.6 billion in proceeds now allowed under the statutory bond.

- ***Less Debt-Service Costs.*** Repayment of the proposed economic recovery bond would involve annual General Fund payments to investors equivalent to one-quarter cent of the sales tax, or roughly $1.3 billion annually, beginning in 2004-05. This would produce ongoing near-term annual General Fund savings of a like amount, given that the other bond's debt service would have been twice as much—equivalent to one-half cent of the sales tax.

Administration's Announcement About Previously Authorized Deficit Bond—What Does It Mean?

On January 29, 2004, the administration announced that, after consulting with the Attorney General's Office and its bond counsel, it is reducing its estimate of the maximum size of the previously authorized deficit recovery bond from $10.7 billion down to $8.6 billion. This revision is related to three factors: (1) the statutory bond is limited to the size of the budget deficit as of June 30, 2003; (2) the estimate of that deficit has declined from $10.7 billion to $8.6 billion; and (3) the current court validation process for the statutory bond requires that the certification of the deficit's size (made last fall based on the $10.7 billion estimate) be updated to reflect the current lower estimate.

Implications

This finding has no direct impact on the state's projected reserve condition under the Governor's 2004-05 budget proposal. This is because the budget proposal relies on $12.3 billion in proceeds from the $15 billion economic recovery bond that is being considered by the voters in March 2004 (Proposition 57). The proposed bond is not limited to the size of 2002-03 year-end deficit, since it can also take into account "other obligations" of the General Fund, such as loan repayments to special funds.

While not having a direct impact on the Governor's proposed 2004-05 budget, the administration's finding does have other potential implications for the General Fund. In particular:

- If the economic recovery bond were rejected by the voters, the "fall back" statutory bond would be $2.1 billion smaller than what was assumed by the administration in its 2004-05 budget presentation. This means that, if the state were to rely on the statutory bond, it would need to find $2.1 billion more in alternative budget solutions than indicated by the Governor's January budget proposal.

- Likewise, the incremental size of budget savings attributable to voter approval and sale of the $12.3 billion in economic recovery bonds is now $2.1 billion more than assumed in the Governor's budget. Specifically, the total savings associated with the proposed bond is now $5 billion, compared to the $2.9 billion displayed in the Governor's January budget. (We have reflected this larger amount in Figure 2.)

Other Loans and Borrowing

This category accounts for $2.6 billion of the budget's overall solutions. It includes about $930 million related to a proposed pension obligation bond sale, $947 million related to Proposition 98 "settle-up" obligations for 2002-03 and 2003-04 which are being deferred until after 2005-06, an increase in the loan amount to local governments associated with 2003-04 backfill payments, and loans from transportation funds.

Local Government-Related Actions

This category accounts for $1.8 billion of the total solutions. It includes a $1.3 billion property tax shift from local governments to schools, reduced funding for juvenile probation, the elimination of booking fee reimbursements, and a reduction in transportation funding related to the suspension of the Proposition 42 transfer.

Transfers/Other Revenues and Fund Shifts

This category accounts for $1.6 billion of the total solutions. It includes a one-time shift of about $685 million of transportation funds to the General Fund in 2003-04, $350 million in new federal funds, a net of $75 million from a Medi-Cal proposal involving a quality improvement assessment fee on managed care plans, and $55 million in proceeds from a land sale at the University of California at Riverside.

Key Programmatic Features

Figure 3 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.*

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 *2004-05 Analysis of the Budget Bill.* The causes of our differences from the budget's projections are limited to (1) assumptions about the economic and revenue outlook, and (2) estimation differences in the level of expenditures that would be needed to fund the Governor's budget plan. We have also reduced total savings modestly to reflect "erosion" of potential savings from certain

Figure 3

Main Programmatic Features of the 2004-05 Budget

- ✓ ***Proposition 98 Education.*** Suspends Proposition 98 to achieve ongoing savings of $2 billion. Remaining funding covers enrollment growth, cost-of-living, and some program expansions.
- ✓ ***Higher Education.*** Contains significant General Fund reductions in University of California and California State University, mostly offset by fee increases.
- ✓ ***Health.*** Reduces reimbursement rates to Medi-Cal providers. Caps enrollment and establishes co-pays for various other programs.
- ✓ ***Social Services.*** Eliminates cost-of-living adjustments for California Work Opportunity and Responsibility to Kids (CalWORKs) and Supplemental Security Income/State Supplementary Programs. Reduces CalWORKs grants by an additional 5 percent, and imposes stricter work requirements. Eliminates the state-only In-Home Supportive Services “residual” program.
- ✓ ***Transportation.*** Shifts substantial resources from transportation programs to help the General Fund.
- ✓ ***Local Governments.*** Provides General Fund payments to cover the VLF rate reduction. Shifts $1.3 billion of local property taxes to the state (via schools), and reduces funding in other selected areas.
- ✓ ***General Government.*** Proposes a pension obligation bond to cover state payments to Public Employees Retirement System in 2004-05. Increases employee contributions to retirement funds, and reduces retirement benefits for new employees. Assumes $500 million from new/renegotiated tribal gaming compacts.

current-year proposals—mainly in the health and social services areas—that have not been adopted by the Legislature by the date of our analysis. In these cases, our estimates continue to assume the Governor’s policies, but with implementation dates of April 1 or later (depending on the program).

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 high-

lighted in Figure 4, while our estimates of revenues, expenditures, and the General Fund's condition are shown in Figure 5.

More Solutions Will Be Needed for 2004-05 to Balance

As shown in Figure 4 and Figure 5, we estimate that if *all* of the budget's provisions and proposals were adopted, the state would end 2004-05 with a deficit of $783 million. This compares to the budget estimate of a $635 million surplus. The difference—about $1.4 billion—relates to our forecast of lower revenues and higher costs in both 2003-04 and 2004-05.

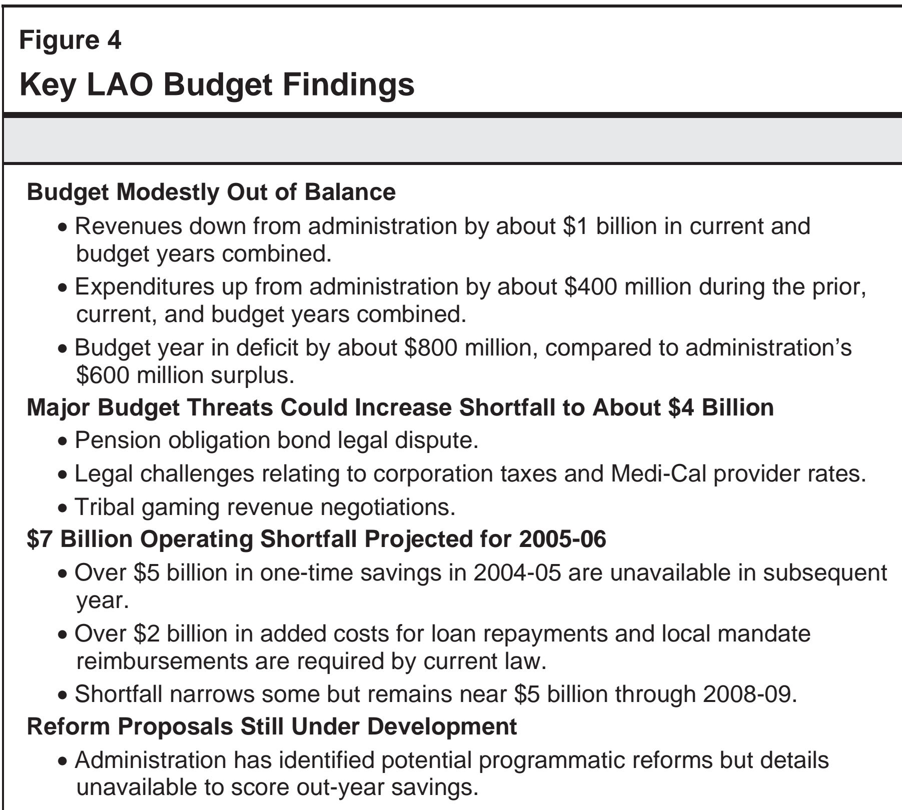


Figure 4

Key LAO Budget Findings

Budget Modestly Out of Balance

- Revenues down from administration by about $1 billion in current and budget years combined.
- Expenditures up from administration by about $400 million during the prior, current, and budget years combined.
- Budget year in deficit by about $800 million, compared to administration's $600 million surplus.

Major Budget Threats Could Increase Shortfall to About $4 Billion

- Pension obligation bond legal dispute.
- Legal challenges relating to corporation taxes and Medi-Cal provider rates.
- Tribal gaming revenue negotiations.

$7 Billion Operating Shortfall Projected for 2005-06

- Over $5 billion in one-time savings in 2004-05 are unavailable in subsequent year.
- Over $2 billion in added costs for loan repayments and local mandate reimbursements are required by current law.
- Shortfall narrows some but remains near $5 billion through 2008-09.

Reform Proposals Still Under Development

- Administration has identified potential programmatic reforms but details unavailable to score out-year savings.

Lower Revenues. Based on somewhat weaker-than-expected wage trends in 2003, we have forecast lower receipts from the personal income tax in both the current year and budget year. As a result, we project that General Fund revenues will be lower than the budget forecast by about $1 billion over the current and budget years combined.

Figure 5

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

(In Millions)

	2002-03	2003-04	2004-05	2005-06
Prior-year fund balance	-$1,474	$1,713	$450	$146
Revenues and transfers	71,322	74,136	75,881	78,421
Bond Proceeds	9,242	3,012	—	—
Total resources available	($79,090)	($78,861)	($76,331)	($78,567)
Expenditures	$77,377	$75,398	$79,197	$85,387
Deficit Recovery Fund transfer	—	3,012	-3,012	—
Total Expenditures	($77,377)	($78,410)	($76,185)	($85,387)
Ending fund balance	$1,713	$450	$146	-$6,820
Encumbrances	929	929	929	929
Reserve	**$784**	**-$479**	**-$783**	**-$7,749**

Detail may not total due to rounding.

Higher Expenditures. We estimate that General Fund expenditures would exceed the amount in the budget proposal by about $400 million over the prior, current, and budget years combined. Part of the net increase is related to the erosion of current-year savings related to certain proposed mid-year reductions in health and social services that the Legislature has not adopted. For purposes of these estimates, we are assuming implementation dates of April 1 or later, which are about three months later than assumed in the budget. We also project higher spending for the vehicle license fee backfill and for various state operations. Partly offsetting these increases is a reduction in K-14 education funding related to (1) the interaction of the Proposition 98 minimum funding guarantee with our lower revenue estimates, and (2) our higher estimate of local property taxes (which offset General Fund spending dollar for dollar).

The 2004-05 budget shortfall we project assuming the budget's proposals is relatively small compared to both the overall size of the budget and the uncertainties inherent in the revenue and expenditure assumptions and projections. However, it is important to stress that the estimate assumes that *all* of the budget's proposals are implemented and the anticipated budgetary benefits associated with them are *fully* realized. Thus, our deficit estimate gives the "benefit of the doubt" to the administration, and if anything could prove conservative.

Major Threats Could Increase Shortfall to About $4 Billion

The budget plan faces real and imminent threats from court challenges and certain other factors which could push the shortfall much higher. Among these threats are the following:

- ***Pension Obligation Bond Proposal ($930 Million).*** A Superior Court has invalidated a similar bond proposed for the current year, and the state is currently appealing the decision.
- ***Corporation Taxes ($0.5 Billion to $1.5 Billion).*** The state is facing large potential near-term corporation tax revenue losses related to a legal challenge involving the state's treatment of dividend income received by corporate taxpayers (see discussion regarding *Farmer Bros. Co.* case in "Part III").
- ***Medi-Cal Provider Rates (Several Hundred Millions of Dollars).*** A federal district court has blocked, for now, the 5 percent reduction in provider rate reimbursements that was scheduled to take effect in January 2004. Unless overturned by a higher court, the decision could eliminate the related savings assumed in the 2003-04 budget, as well as the additional savings proposed in the 2004-05 budget. We have scored the risk at this level because we believe savings attributable to portions of the administration's proposal are achievable.
- ***Other Assumptions (Over $1 Billion).*** The state also faces risks associated with its assumption of $350 million in new federal funds, and $500 million in new tribal gaming revenues. Finally, the budget includes savings in several areas where the proposals are undeveloped. Of particular concern is a $400 million unallocated reduction in corrections. In addition, savings have been scored for reforms in the areas of foster care, judiciary, and developmental services, for which detail are limited.

Collectively, these factors could push the cumulative shortfall in 2004-05 to over $4 billion. While unused portions of the proposed economic recovery bond, if approved, could be used to address some of any added shortfall, other actions and solutions of a substantial magnitude would still be needed if most or all of the above threats were to materialize.

Nearly $7 Billion Operating Shortfall to Remain in 2005-06

We estimate that the growth rate in ongoing revenues would outpace ongoing expenditure growth rates for most major state programs in 2005-06 and beyond. Despite this, we project that the state would face an operating shortfall in 2005-06 and beyond under the Governor's plan. As

indicated in Figure 5, annual spending would exceed annual revenues by roughly $7 billion in 2005-06, absent corrective action. This shortfall would occur *even if* all of the savings and other solution assumptions in the Governor's plan were fully realized. When combined with the nearly $800 million deficit carried over from 2004-05, we estimate that the year-end 2005-06 deficit would be over $7.7 billion. This large projected 2005-06 shortfall is the result of two main factors:

- First, about $5.3 billion of the budget's proposed 2004-05 savings are *one-time* in nature, and thus do not provide benefits to the General Fund in 2005-06 and subsequent years. These include the above-noted use of the $3 billion in economic recovery bond proceeds to support expenditure programs in the budget year, about $1.1 billion from the suspension of Proposition 42, and about $930 million related to the proposed sale of the pension obligation bond.
- Second, under current law, the state will be faced with roughly $2 billion in additional expenditures in 2005-06 related to (1) a scheduled large loan repayment to the Transportation Congestion Relief Fund ($1.4 billion), and (2) a resumption of mandate payments to local governments (about $600 million for both current costs and a portion of past-year liabilities).

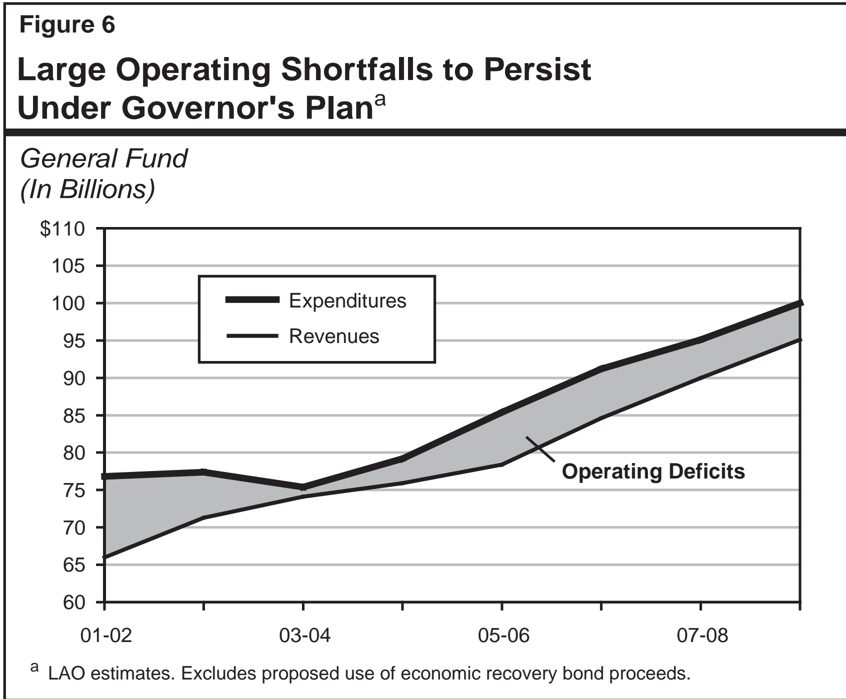
Although our longer-term forecast indicates that the General Fund's operating shortfall would narrow some over time, the annual gap still will remain in the range of $5 billion through 2008-09 (see Figure 6 next page). Thus, further significant ongoing budget solutions will have to be found beyond those currently proposed by the Governor to bring the budget into balance over time. We would note that the administration has alluded to out-year savings from several reform proposals. However, since the details for these proposals will not be available until later this spring, it is not possible for us to currently review their potential savings in 2005-06 and subsequent years.

Considerations for the Legislature

We believe that the Governor's budget proposal contains many positive features. It includes, for example, significant ongoing savings from a wide variety of program areas. As such, it offers a solid starting point for budget deliberations. At the same time, however, the budget poses serious questions and concerns for the Legislature in several areas.

Figure 6

Large Operating Shortfalls to Persist Under Governor's Plan[a]



[a] LAO estimates. Excludes proposed use of economic recovery bond proceeds.

More Solutions Will Likely Be Needed in 2004-05. Given our projections, it is likely that the Legislature will need to find additional solutions of at least $783 million to bring the budget into balance in 2004-05. Furthermore, this amount could rise sharply if either (1) some or all of the budget threats noted above materialize or (2) the Legislature rejects key savings proposals or other solutions incorporated in the budget plan without adopting alternatives of a similar magnitude.

Does the Budget Push Too Much Off Into the Future? One of the main features of recent budgets is that they have not meaningfully addressed the ongoing structural budget shortfalls that have confronted the state since 2001-02. While this budget proposal does contain large amounts of real and ongoing savings, it still leaves a significant amount of the underlying structural problem for future years. As noted above, we estimate that the Governor's plan would leave the state with a budget shortfall of roughly $7 billion in 2005-06, *even if* all of the savings and other solution assumptions in the plan were fully realized. Furthermore, the unaddressed budget shortfall would be even larger if some or all of the risks noted above materialize. The fundamental issue for the Legislature is thus how the projected multibillion-dollar out-year problem should be dealt with and whether it should be more completely addressed at this time.

Should Additional Revenues Be Considered? There are several reasons to ask this question. One involves the large magnitude and potentially far-reaching effects of the proposed budget reductions on state programs. A second is the multibillion-dollar ongoing budget shortfall that would still remain unresolved, even under the Governor's plan, and would have to be dealt with through more borrowing or further spending cuts if additional revenues are "left off the table." We believe the Legislature should consider whether solutions involving taxes—such as the elimination of selected tax expenditures or increased tax rates—should be part of the 2004-05 budget plan. Even if limited tax increases have certain negative effects on the economy, these consequences should be weighed against the negative consequences of the alternatives, including deeper cuts in public spending in infrastructure, education, and other areas, or more borrowing.

What About Budgetary Reforms? The Governor has stressed his intent to undertake a broad-based comprehensive review and restructuring of state operations that will improve efficiency and produce fiscal benefits. While the budget plan does include some examples in these areas, such as an outline of future reforms in the Medi-Cal area, many of the ideas are not very well developed at this point. In fairness, the administration has only been in office for four months. However, if significant fiscal benefits in these areas are to be achieved, it will be important for the administration to translate its ideas into specific proposals which can be considered in a timely fashion by the Legislature.

Timely and Decisive Action Is Needed. Finally, as was the case last year, we believe that it is important that the Legislature act in a timely and decisive manner to address the budget shortfall, and that it seek to maximize the amount of ongoing solutions to the budget problem. Otherwise, the state will both forego the full potential benefits that different solutions have to offer, and will face renewed budget shortfalls in subsequent years.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics

The U.S. and California economies are entering 2004 with significant momentum which we believe will continue through the budget year. The one major exception to the generally upbeat economic picture is employment growth, which continues to lag despite major gains in consumer and business spending and output in the economy. The lack of job growth has not held back the recovery so far, but continued softness in this key area could undermine consumer and business confidence, spending, and ultimately at some point in the future, the overall economic expansion.

RECENT ECONOMIC DEVELOPMENTS

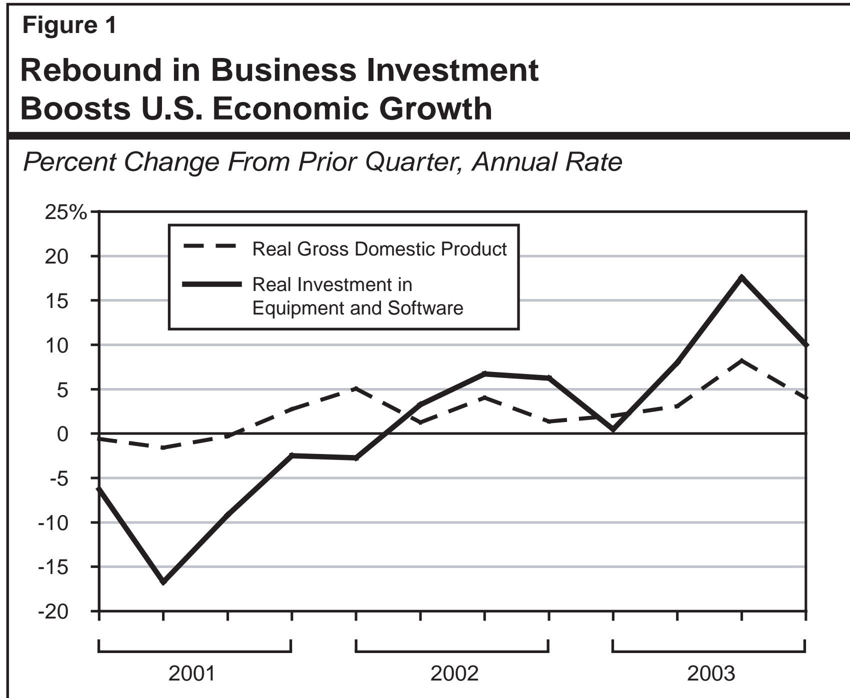
National Trends

Recovery Finally Gaining Balance and Momentum

For nearly two years following the 2001 downturn, the U.S. economy expanded at a slow and uneven pace. The recovery was concentrated in consumer-durable purchases and home construction, boosted by historically low interest rates and federal tax cuts. Business spending and hiring remained stubbornly weak during this period, reflecting sluggish profit growth, falling stock prices, and cautious attitudes of businesses executives.

As shown in Figure 1 (next page), business investment finally joined the expansion in the second half of 2003, and is slated to exhibit added strength throughout the forecast period. Led by major increases in computer and software spending, total investment in equipment jumped by 18 percent in the third quarter and 10 percent in the final quarter of 2003.

These increases—coupled with solid gains in consumer spending, housing activity, and exports—contributed to a 6 percent annual rate of increase in gross domestic product (GDP) during the second half of the year.



Strength Is Carrying Over Into 2004

Monthly reports for December 2003 and early January 2004 suggest that the economy entered this year with substantial forward momentum. For example:

- Retail spending grew by 6.7 percent between December 2002 and December 2003, as retailers reported mostly solid holiday sales.
- New home construction jumped above a 2 million unit annual pace in November and December of 2003, the highest level since 1984.
- The Federal Reserve's "beige book" survey in early January found business conditions and confidence levels improving in most regions of the country.
- Similarly, the University of Michigan survey of consumer confidence jumped to a four-year high early in the month.

Inflation and Interest Rates Remain Subdued

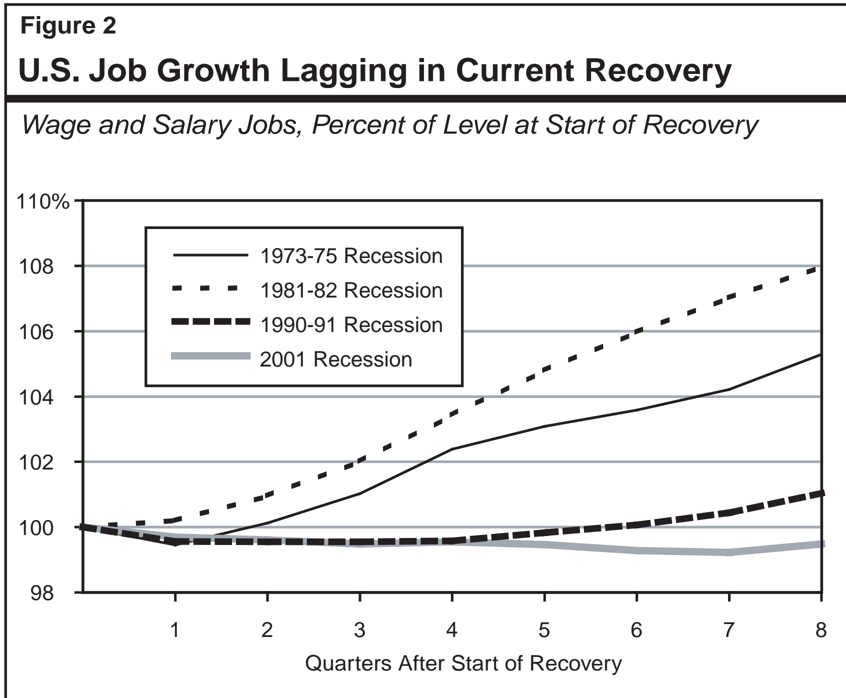
The Consumer Price Index was up just 1.9 percent between December 2002 and December 2003, with the "core" rate (that is, the rate excluding the volatile food and energy sectors) up just 1.1 percent. Furthermore, there are no signs of accelerating inflation right now. Most commodity prices remain stable, wage increases are staying mild, and there still is considerable unused production and resource capacity both in the U.S. and in many other regions throughout the world. This lack of inflationary pressures should result in limited increases in interest rates in the near future. While long-term interest rates have risen in recent months, these rates remain low by historical standards, providing continued support for those key sectors of the economy such as housing and investment that are sensitive to them. The future course of interest rates will depend in part on the response of federal monetary authorities to economic developments—particularly any signs of emerging inflation.

Jobs Lag

The one "weak link" in this expansion has been jobs. Employment growth normally lags in economic upturns, as businesses initially add hours and utilize their existing workforce more intensively before hiring new workers. However, the lag in this expansion between when production improved and job growth occurred has been much longer than in the past. This is depicted in Figure 2 (next page), which compares job performance in the respective economic recoveries following the 1973-75, 1981-82, and 1990-91 recessions. It indicates that:

- Fully two years after the current recovery began in 2001, U.S. employment still remains 0.5 percent *below* its level at the bottom of the recession.
- In contrast, after two years following the start of the recovery from the 1981-82 recession, the nationwide job totals had *increased* 8 percent.
- The current job performance is even weaker than it was in the initial recovery period following the 1990-91 recession, a particularly severe downturn whose recovery was itself characterized by extremely slow GDP growth in its early stages.

What Explains This Poor Employment Performance? Although economists do not yet seem to fully understand why recent job performance has been so weak, several different factors appear to be at work. For example, there is evidence that significant outsourcing of jobs to low-wage countries has been occurring in certain industries. In addition, many businesses have continued to pursue aggressive cost-cutting measures even as the expansion has taken hold. However, many economists believe the



major single factor involves productivity. Specifically, output gains in this expansion have been primarily accomplished through significant increases in the rate of productivity growth, which in turn has allowed the output gains to occur despite weak job growth. From a long-term perspective, rapid productivity growth is generally a very positive development. This is because increased output per worker typically translates into rising incomes, wealth, and living standards over time. In the current environment, however, the lack of jobs that has accompanied the recent productivity surge is a concern. In particular, there is a potential risk that continued stagnation on the job front will translate into reduced consumer and business confidence levels, less spending, less profits, and still-lower employment levels in the future.

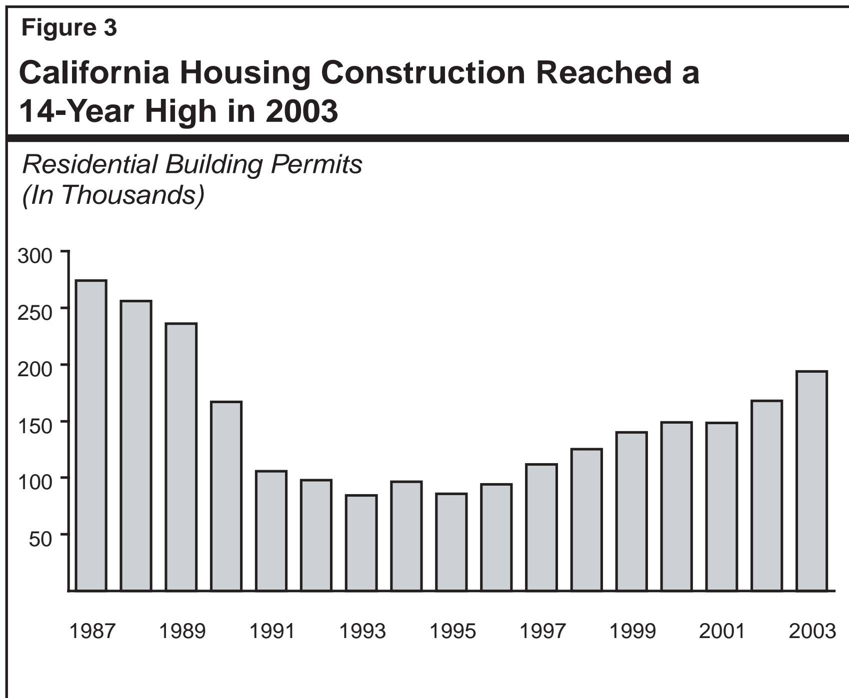
So far, there is little evidence that this is occurring. Indeed, despite the lack of payroll job growth, the other major source of employment data (the household survey) has been showing some modest gains, the unemployment rate continues to fall slowly, and surveys are indicating that consumer confidence levels are rebounding. Furthermore, as discussed in more detail below, it is possible that true job growth is itself being understated by the payroll survey of businesses, and that the modest gains reported in the household survey are more reflective of the economy. Regardless, a resumption of more job growth remains a critical assumption in the outlook.

California Trends

State Also Participating in the Recovery

By most accounts, California's economy also is on the upswing. Recent positive indicators include:

- ***Housing Markets.*** Despite recent increases in mortgage interest rates, California's home markets remain strong, with sales and price levels at all-time highs in the fourth quarter of last year. The median home price is now nearly $400,000 statewide. Sales of existing homes averaged 595,000 units (annual rate) during the first ten months of 2003, well ahead of the record pace of 570,000 for 2002. Finally, permits for new construction totaled 193,000 units last year, the highest level since 1989 (see Figure 3).
- ***Consumer Confidence***. According to the California Consumer Confidence Survey released in mid-January by the Survey and Policy Research Institute at San Jose State University, consumers in California are sharing in the national upturn in confidence levels. This survey, which is patterned after the University of Michigan survey of confidence for the nation as a whole, indicates that



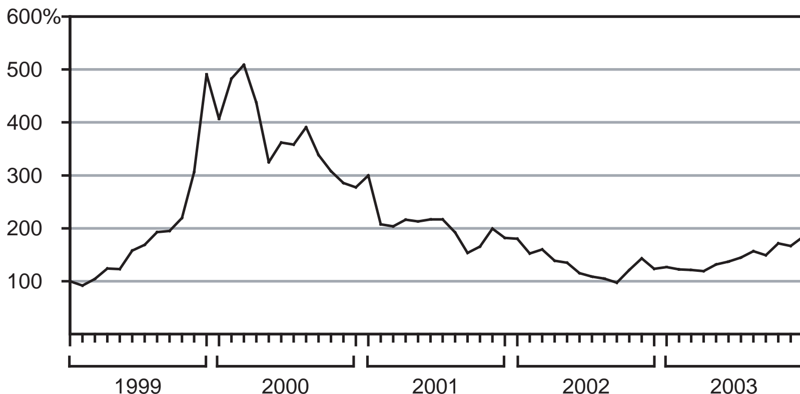
household perceptions of current conditions still lag in Silicon Valley. However, most other California regions reported rising positive sentiment about current economic conditions, and virtually all regions—including Silicon Valley—were becoming more optimistic about the future.

- ***Company Earnings and Stock Values.*** The current rebound in computer and software spending is benefiting California-based high-tech companies, many of which have been reporting major increases in sales and profits in late 2003 and early 2004. These improvements are boosting the firms' stock prices, with per-share prices for many companies up sharply from their late 2002 lows. Figure 4 shows an index of average-per-share stock prices for eight of California's largest high-tech firms. These companies had accounted for the bulk of the booming stock-option activity that occurred in California in the late 1990s. The figure shows that, as of late January 2004, the index had doubled from the bottom hit in late 2002. If sustained, these stock-price increases will result in renewed California income from stock options granted in 2001 and 2002 (once the options have been fully "vested").

Figure 4

Stock-Price Index for Major California High-Tech Firms[a]

Percent of January 1999 Level



[a] Based on stock prices for: Cisco Systems; Intel Corporation; Sun Micro Systems; Oracle Corporation; Hewlett Packard Company; Qualcomm, Inc.; Apple Computers; and Applied Materials, Inc.

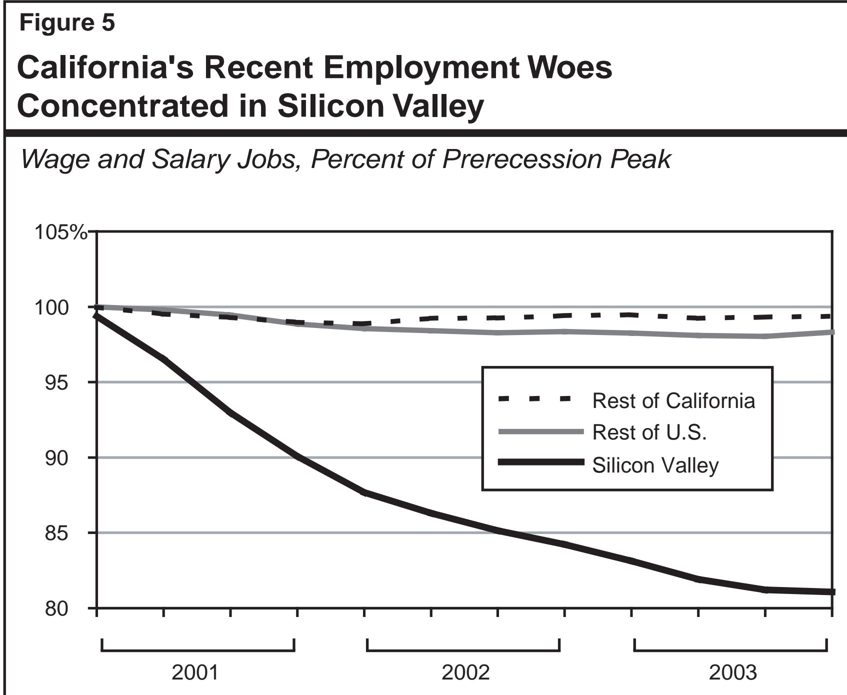
- ***Exports.*** Exports are of particular importance to California manufacturers, since a significant share of their products is sold in foreign markets. After falling sharply in 2001 and 2002, exports turned upward in the second half of 2003. We estimate that this positive trend will continue in 2004, reflecting improving worldwide economic growth and the recent decline of the dollar in foreign currency markets. The latter has the effect of lowering the effective price of U.S. products sold to individuals and businesses in other nations and to foreign governments, thereby making them more competitive and marketable.
- ***Revenues.*** Cash-revenue trends often provide helpful information regarding how strong the economy is. Recent monthly tax receipts from withholding and taxable sales are up significantly from the prior year, suggesting that California sales and incomes are experiencing significant gains. The strength in withholding may be partly related to noneconomic factors, such as higher withholding rates for stock options and bonuses (see related discussion in "Part III"). However, even after allowing for this and other factors, the recent revenue gains suggest that the expansion is boosting incomes and sales in the state.

However, Jobs Are Also Lagging in the State

As with the rest of the nation, the job market remains weak in California. In fact, employment performance in California was even softer than for the remainder of the country in late 2003. After jumping 32,000 in October, state jobs fell by 20,000 in November and another 8,000 jobs in December.

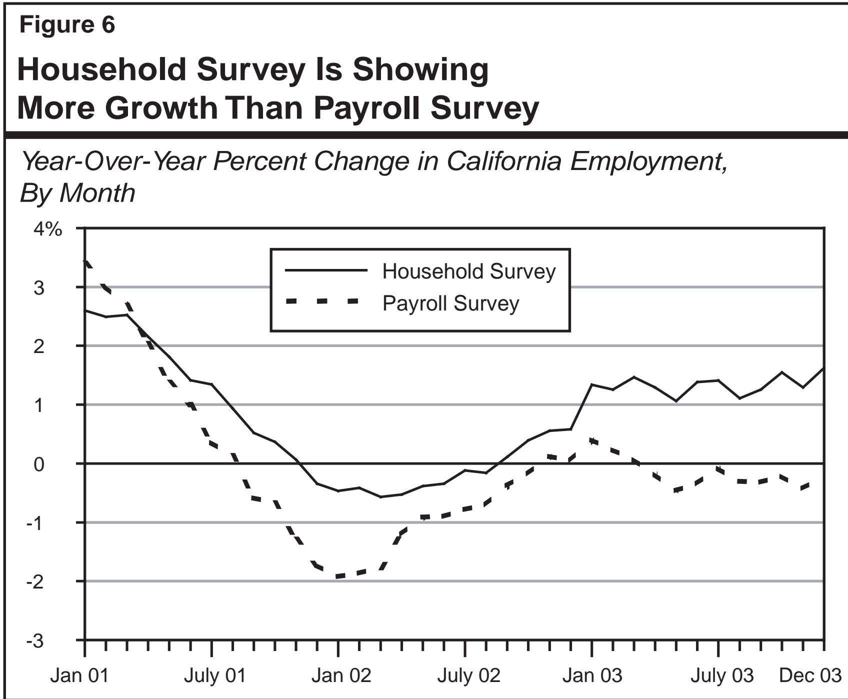
Declines Steeper Than Nationally. Overall job losses in this state have been slightly steeper than for the nation as a whole since the recession began in early 2001. Specifically, California has lost 1.9 percent of its payroll jobs since the beginning of the 2001 downturn. This compares to a 1.7 percent job loss for the nation as a whole. During the same period, manufacturing employment fell by 18 percent for California compared to 15 percent for the nation.

Virtually All of the Weakness Concentrated in Silicon Valley. A closer look at the state's geographic employment patterns reveals that virtually all of its slightly weaker-than-average performance is related to the major economic downturn that has occurred in the Bay Area's Silicon Valley. Figure 5 (next page) shows that total employment fell by 19 percent in the San Jose metropolitan area between the first quarter of 2001 and the fourth quarter of 2003. By contrast, the rest of the state has lost just 1 percent of its employment base, or proportionally less than the rest of the nation.



Household Employment Survey Showing More Growth. As discussed in detail in our November fiscal outlook and noted above, employment data come from two sources—a monthly payroll survey of employers and a household survey. There is some evidence that the payroll survey is currently understating employment performance. As shown in Figure 6, the separate survey of households—which also is used to calculate the unemployment rate and provides data on labor force characteristics—shows a state employment gain of 1.6 percent (256,000 jobs) between December 2002 and December 2003. This compares to the payroll survey estimate of a 0.2 percent loss (32,000 jobs) during the same period.

Which Employment Data Are the More Accurate? Normally, the payroll survey is considered to be a more reliable measure of industry employment trends than the household survey. This is due to its larger sample size and greater industry detail. However, the household survey's results are presently more consistent with the other currently upbeat indicators of the economy's performance. There is some evidence that the discrepancy in the employment data is related, in part, to the rapid growth in self-employed individuals and contract employees, which are not included in the payroll survey. If this is indeed occurring, the implications for the economy will depend on the quality of the nonpayroll jobs—such



as their compensation levels, their permanence, and whether they are full or part time. At a minimum, however, the growth in the household survey provides some evidence that the job market is "turning the corner," even if the strength of the underlying employment trend is not completely clear.

THE BUDGET'S ECONOMIC OUTLOOK

The budget's economic forecast, which was prepared in early December, assumes that the recent improvement in economic activity will carry over into and throughout 2004, with both the U.S. and California economies accelerating during the year.

National Outlook

As shown in Figure 7 (next page), the budget forecasts that real GDP growth will accelerate from 2.9 percent in 2003 to 4.2 percent in 2004, before moderating a bit to 3.6 percent in 2005. The administration assumes that consumer spending will pick up modestly in 2004 compared to the previous year, reflecting accelerating employment and income growth,

as well as larger-than-normal federal tax refunds associated with the 2003 tax cuts. The budget also assumes that business investment will accelerate, citing the positive effects of both federal tax incentives and strengthening economic conditions. Finally, the forecast assumes that inflation will remain low and that interest rates will increase modestly in 2004 and 2005 from their current historically low levels.

Figure 7

Summary of the Budget's Economic Outlook

		Forecast	
	2003	**2004**	**2005**
U. S. Forecast			
Percent change in:			
Real GDP	2.9%	4.2%	3.6%
Personal income	3.2	5.1	5.8
Wage and salary employment	-0.2	1.3	2.1
Consumer Price Index	2.3	2.0	2.3
Unemployment rate (%)	6.0	6.0	5.8
Housing starts (000)	1,790	1,720	1,630
California Forecast			
Percent change in:			
Personal income	3.8%	5.6%	5.9%
Employment:			
Payroll survey	-0.2	1.1	2.1
Household survey	1.2	1.2	2.0
Taxable sales	2.3	5.8	5.6
Consumer Price Index	2.4	1.9	2.7
Unemployment rate (%)	6.7	6.7	6.5
New housing permits (000)	194	192	198

California Outlook

The administration's forecast also assumes that California's economy will expand at a moderate pace in both 2004 and 2005, reflecting strengthening national conditions and federal tax reductions. It specifically projects that the state's personal income growth will accelerate from 3.8 percent in 2003 to 5.6 percent in 2004, and to 5.9 percent in 2005. It also projects that payroll employment will turn the corner in 2004, growing by 1.1 percent during the year, and by an additional 2.1 percent in 2005.

LAO'S ECONOMIC OUTLOOK

Our expectations for the economy have not changed a great deal since publication of our November 2003 fiscal forecast. Increases in output and spending during late 2003 and early 2004 have generally been consistent with our November projections, although employment in the final months of 2003 was below our forecast. We have also reduced our estimate of California personal income modestly to account for recently released historical evidence that wage levels were lower-than-expected in the first half of 2003. This has reduced our income forecast because it has lowered the base from which our forecast builds. On the whole, we continue to forecast that the U.S. and California economies will grow at a moderate pace in both 2004 and 2005. Our current economic forecast is generally similar to the budget's economic forecast.

National Outlook

As shown in Figure 8 (next page), we project that real GDP growth will accelerate from 3.1 percent in 2004 to 4.5 percent in 2005, before moderating to 3.5 percent in 2005. This forecast assumes that consumer spending continues to grow at a moderate pace, while business investment and net exports continue to strengthen during the year. Specifically:

- ***Consumer spending*** is expected to increase by about 3.5 percent in 2004 and 3.1 percent in 2005—or roughly in line with projected gains in real disposable income. Spending should be restrained compared to past expansionary periods by heavy current debt loads and high debt-service costs facing consumers.

- ***Business fixed investment*** is forecast to increase by 10 percent in 2004 and 9 percent in 2005. These healthy projected gains are fueled by a resurgence in spending on computers, software, telecommunications equipment, and other high-tech goods and services. After falling for three consecutive years, nonresidential construction spending is forecast to stabilize in 2004 and start growing again in 2005, as businesses begin to expand capacity next year.

- ***Net exports*** are expected to improve in both 2004 and 2005, reflecting strengthening growth in the economies of major U.S. trading partners in Europe and Asia. The decline in the U.S. dollar against the Euro and other foreign currencies will also boost net exports, by making foreign goods relatively more expensive and making U.S. goods comparatively less expensive in foreign markets.

Figure 8

Summary of the LAO's Economic Outlook

		Forecast		
	2003	**2004**	**2005**	**2006**
U.S. Forecast				
Percent change in:				
Real GDP	3.1%	4.5%	3.5%	3.3%
Personal income	3.2	5.0	5.7	5.7
Wage and salary employment	-0.2	1.4	2.0	1.6
Consumer Price Index	2.3	1.4	1.8	2.0
Unemployment rate (%)	6.0	5.7	5.4	5.5
Housing starts (000)	1,810	1,809	1,693	1,619
California Forecast				
Percent change in:				
Personal income	3.5%	5.7%	6.0%	6.0%
Employment:				
Payroll survey	-0.2	1.1	2.2	2.2
Household survey	1.3	1.6	2.0	1.8
Taxable sales	3.9	5.9	5.8	5.7
Consumer Price Index	2.6	1.9	2.2	2.4
Unemployment rate (%)	6.6	6.1	5.8	5.7
New housing permits (000)	194	187	189	181

With respect to inflation, we expect it to remain low through the next two years, partly reflecting the available productive capacity that exists in both the U.S. and foreign economies. Major productivity growth and moderate wage increases are also limiting cost pressures that can cause inflation.

What About the Federal Budget Deficit? Federal fiscal policies have become extremely expansionary in the past two years. Policy initiatives involving tax reductions and increases in defense and Medicare spending, combined with the recent recession, have transformed federal budgetary surpluses into large projected federal deficits.

In the near term, these fiscal policies are highly stimulative. The federal tax cuts are resulting in more disposable income, which should lead to more business and household spending, while the added federal spending will produce more outlays in defense and health-related industries.

However, over the longer-term, the resulting large deficits could become a drag on economic growth. This will occur to the extent that the added borrowing needed to finance the annual budget deficits puts upward pressure on interest rates, or as policy makers are forced to curtail spending or raise taxes to cover the added debt-service costs in the budget. It is not possible to predict how these factors will ultimately "play out" over the longer-term. However, our forecast assumes that the deficits' impacts on interest rates during the next several years will be relatively modest. This is related to the present lack of inflationary pressures in the economy and the large amount of idle funds both inside the U.S. and in foreign countries that are available to finance the budget deficits.

California Outlook

We anticipate that California's economy will continue to strengthen in 2004, with growth in employment, personal income, and taxable sales accelerating from 2003. We anticipate that layoffs will stabilize and that job growth will commence by the second quarter of this year. As shown in Figure 8:

- ***Personal income*** growth is projected to accelerate from 3.5 percent in 2003 to 5.7 percent in 2004, and 6 percent in 2005. The main factors behind this acceleration are renewed job growth, moderate wage increases, and a pickup in stock-option income.
- ***Employment*** is expected to slowly improve, with payroll jobs increasing by 1.1 percent in 2004 and 2.2 percent in 2005. These gains are in contrast to the 0.2 percent decline that occurred in 2003. Manufacturing jobs are expected to stabilize in early 2004 and turn upward in the second half the year.
- ***Housing permits*** are expected to remain near 2003 levels, which are the highest since 1989.
- ***Nonresidential building permits*** are projected to grow modestly in 2004 and accelerate in 2005, as businesses step-up expansion plans.

Outlook for Individual Geographic Regions and Industries. We expect all geographic regions of the state to expand during the next year, although the gains in the San Francisco Bay Area will lag the rest of the state in the first half of 2004. In terms of industry sectors, we expect growth to be broad-based, encompassing services, trade, finance, and construction. As noted above, manufacturing employment should stabilize in the first half of this year, grow slowly in the second half of 2004, and then expand at a more moderate pace in 2005. Finally, we forecast that employment in the combined state and local government sector will be soft, reflecting the difficult budget circumstances facing governments in California.

Comparison to Other Forecasts

Figure 9 compares our forecasts for the nation and California to our November 2003 forecasts, as well as to a variety of other economic projections made in recent months by other forecasters. These include the projections made by the University of California at Los Angeles (UCLA) Business Forecast Project in December 2003, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2004), the consensus outlook forecast in the *Western Blue Chip Economic Forecasters* (February 2004), and the *2004-05 Governor's Budget* forecast.

The figure shows that our forecast for U.S. real GDP growth has not changed a great deal since our November fiscal forecast. It is also similar to both the Governor's January budget projection and the consensus forecast. It is significantly higher, however, than UCLA's projection.

The figure also indicates that our forecasts for California employment and personal income are down slightly from our November forecast. These reductions are partly related to recent negative job trends, and the above-noted revision to wage trends based on revised historical data going back to the first half of 2003. Our overall updated forecast is similar to the budget forecast, but higher than the UCLA and consensus forecasts.

Risks to the Outlook

In addition to the obvious ongoing risks associated with terrorism at home and abroad, our economic outlook is subject to three other key risk factors—namely, persistent job stagnation, rising interest rates, and an abrupt decline in California home prices.

Jobs. As noted above, a key to continued economic growth in both the nation and state is an improvement in the job picture. A continuation of the lack of job growth during the current recovery—whether because of cautious business attitudes, more outsourcing and expansions abroad, or other factors—could eventually undermine consumer confidence and spending in the state. This, in turn, would produce a significant drag on the economy and possibly undercut the recovery.

Interest Rates. Our forecast assumes that interest rates will remain low throughout much of 2004, and then rise moderately in 2005 and thereafter. A risk to this outlook, particularly in 2005, is that the large amount of federal borrowing needed to support federal spending will put more upward pressure on interest rates in the future than assumed in our forecast. This would have potentially significant adverse impacts on such interest-sensitive areas as business investment, durable goods spending, and housing. The latter is especially significant given California's

Figure 9

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

	2003	2004	2005
United States Real GDP:			
LAO November	3.0%	4.2%	3.7%
UCLA December	2.9	3.6	3.5
DOF January	2.9	4.2	3.6
Blue Chip "Consensus"[b] January	3.1	4.6	3.7
LAO February	3.1	4.5	3.5
California Wage and Salary Jobs:			
LAO November	-0.4%	1.3%	2.6%
UCLA December	-0.1	0.9	2.1
DOF January	-0.2	1.1	2.1
Blue Chip "Consensus"[c] February	-0.2	1.3	2.1
LAO February	-0.2	1.1	2.2
California Personal Income:			
LAO November	4.2%	5.9%	6.3%
UCLA December	3.6	4.9	5.4
DOF January	3.8	5.6	5.9
Blue Chip "Consensus" [c] February	3.4	4.7	5.2
LAO February	3.5	5.7	6.0
California Taxable Sales:			
LAO November	2.4%	5.9%	6.3%
UCLA December	2.6	5.0	4.9
DOF January	2.3	5.8	5.6
Blue Chip "Consensus" [c] February	3.4	5.1	5.5
LAO February	3.9	5.9	5.8

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*.

currently strong housing market, ongoing rapid rise in home prices, and above-average ratios of median home prices and mortgage levels to household income.

California Home Prices. The median home price in California has nearly doubled in the past four years, and as of late 2003 was nearly $400,000. Most economists still do not characterize the current situation

as a "speculative bubble" that is about to burst. Rather, they attribute the recent price increases primarily to such basic economic factors as rising demographic-based demand, limited availability of developable land in many key population areas, and low interest rates. These rates have enabled households to take on much larger mortgages relative to their income levels than in the past. However, regardless of whether or not present conditions can be characterized as a speculative bubble, there is no question that housing prices in many areas of the state are vulnerable to setbacks—should weaker-than-expected economic growth materialize or a significant rise in interest rates from current levels occur.

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 estimating economic performance and in assessing and projecting the state's budgetary situation.

State Population to Hit 37 Million in 2005

Figure 10 summarizes our updated state demographic forecast. We project that California's total population will rise from an estimated 36.5 million in 2004 to 37 million in 2005, and 37.6 million in 2006. 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 last year's detailed discussion on page 32 of the *2003-04 Perspectives and Issues*).

Some Slowing Projected. The state's population is projected to grow at an average rate of just under 1.5 percent annually over the next three years. This growth is considerably slower than that experienced in the late 1990s and very early 2000s, 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—over half-a-million people—is well above the size of such cities as Long Beach, Oakland, and Fresno, and very similar to such states as Wyoming.

Figure 10

Summary of the LAO's California Demographic Forecast

(Population in Thousands)

	2004	2005	2006
Total Population (July 1 basis)	36,455	36,997	37,560
Changes in Population:			
Natural change (births minus deaths)	285	281	283
Net in-migration (in-flows minus out-flows)	236	260	280
Total Changes	**521**	**541**	**563**
Percent Changes	1.45%	1.49%	1.52%

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 roughly 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 an average of 283,000 new Californians annually over the forecast period. This amount is slightly less than in the 1990s, due to the ongoing decline of birth rates being experienced by all ethnic groups. Despite declining birth rates, however, the natural-increase total is projected to increase slightly over time, primarily 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. The population growth associated with net in-migration is projected to be well below that of the early 2000s—dropping from its 2001 peak of 388,000 to only 236,000 in 2004, a decline of over 150,000. This reflects the last two years' marked deterioration in the state's economic and fiscal climate, which led to increased population outflows to other states and countries and lessened in-flows from them. A modest partial rebound is forecast in 2005 and 2006, as the state's economy strengthens.

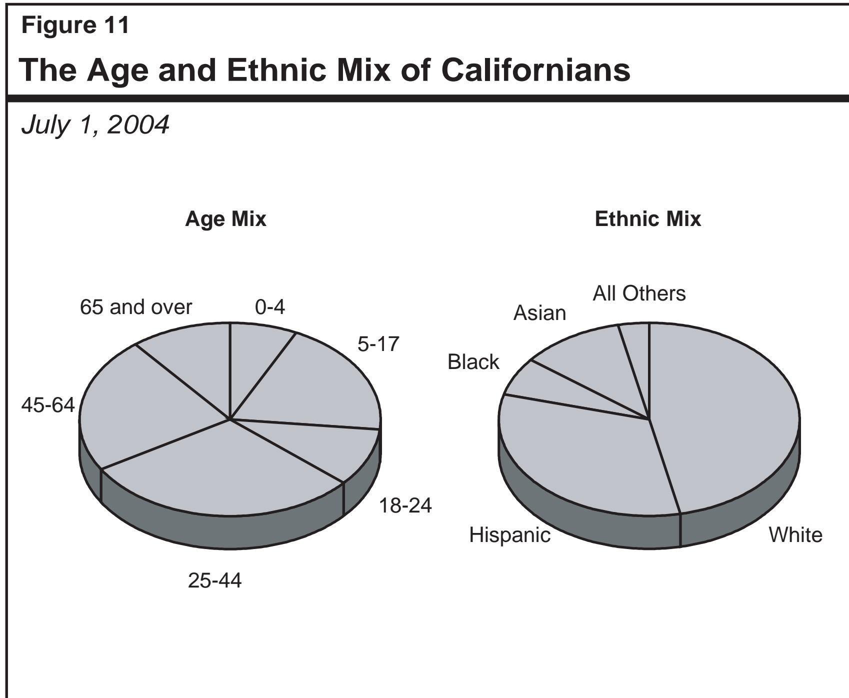
Growth to Vary by Age Group

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 11.

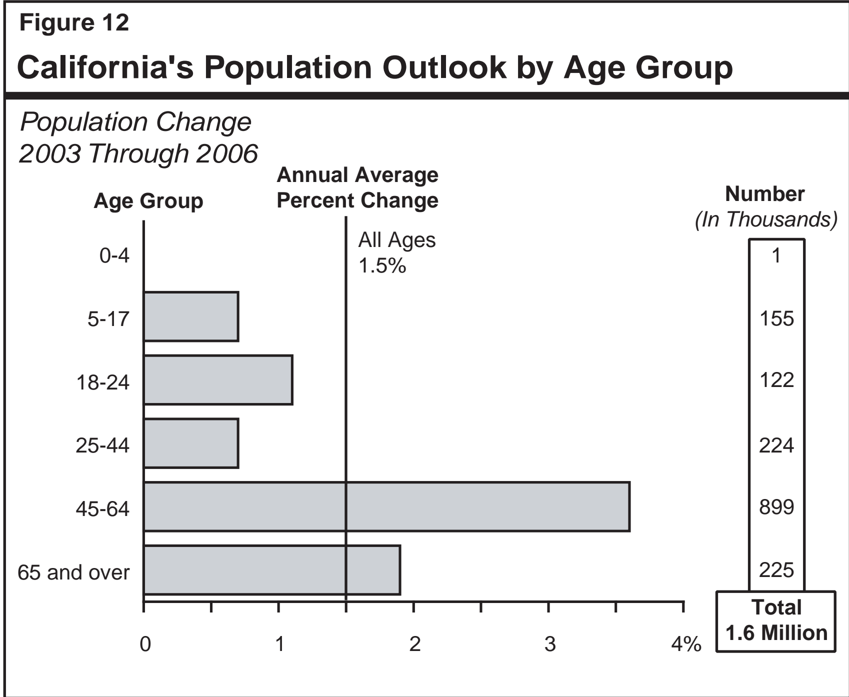
Figure 11

The Age and Ethnic Mix of Californians

July 1, 2004



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 12 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 900,000 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 2004-05 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. Alternatively, the weak growth in the 0-to-4 and 5-to-17 age groups imply 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.

- Slowing growth in the young-adult population will place lesser demand on higher education, job-training programs, and possibly the criminal justice and correctional systems.
- Similarly, the "graying" of the baby boomers will place strains on the state's health programs and related services, including the portion of Medi-Cal related to the elderly and disabled.
- 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. Currently, for example, more than one-third of students in kindergarten and first grade are English language learners.

III

Perspectives on State Revenues

Perspectives on State Revenues

As always, a key determinant of California's current budget outlook is the strength of state revenues. These revenues will be affected by the performance of the state's economy, decisions by investors regarding their stock options and capital gains, numerous policy actions taken in past years, and proposals included in the Governor's current budget. In this Part, we provide background information relating to the revenue outlook, discuss recent revenue developments, summarize the budget's revenue projections, and present our own revenue forecast.

The Budget's Forecast for Total State Revenues

The *2004-05 Governor's Budget* projects that California's state government will receive over $97 billion in revenues during 2004-05, a $4.3 billion (1.3 percent) increase from the current year. These revenues are deposited into either the General Fund or a variety of special funds. Figure 1 (next page) shows that:

- ***General Fund Revenues.*** About 79 percent of total state revenues are deposited into the General Fund. These revenues are then allocated through the annual budget process for such programs as education, health, social services, and criminal justice.
- ***Special Funds Revenues.*** The remaining 21 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.

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

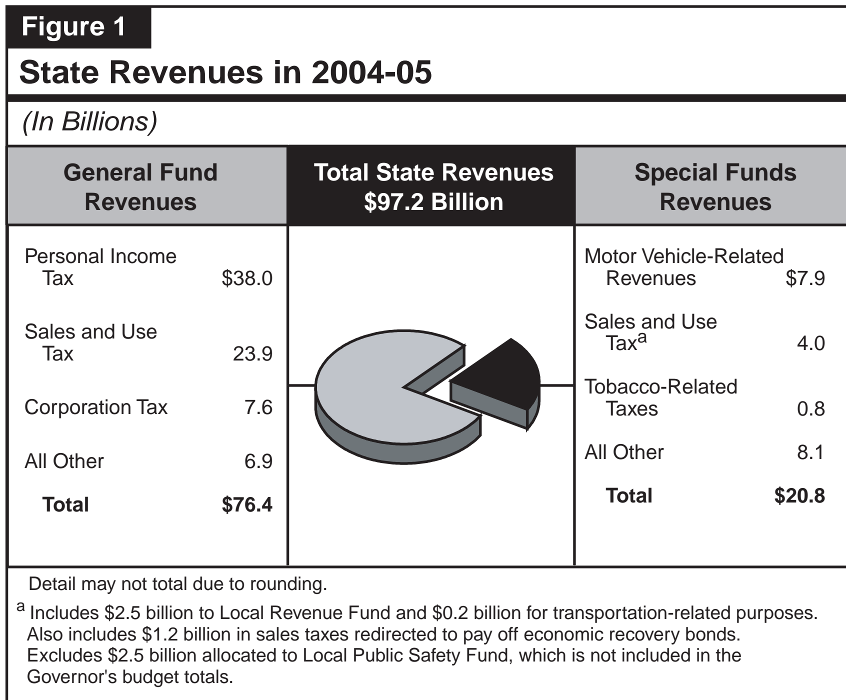


Figure 1

State Revenues in 2004-05

(In Billions)

Total State Revenues $97.2 Billion

General Fund Revenues	
Personal Income Tax	$38.0
Sales and Use Tax	23.9
Corporation Tax	7.6
All Other	6.9
Total	**$76.4**

Special Funds Revenues	
Motor Vehicle-Related Revenues	$7.9
Sales and Use Tax[a]	4.0
Tobacco-Related Taxes	0.8
All Other	8.1
Total	**$20.8**

Detail may not total due to rounding.

[a] Includes $2.5 billion to Local Revenue Fund and $0.2 billion for transportation-related purposes. Also includes $1.2 billion in sales taxes redirected to pay off economic recovery bonds. Excludes $2.5 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

Sources of General Fund Revenues. Figure 1 indicates that about 91 percent of total General Fund receipts are attributable to the state's "big three" taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporation tax (CT). The remainder comes from a variety of smaller taxes (including insurance, estate, tobacco, and alcoholic beverage taxes), as well as investment earnings and various loans and transfers from special funds.

Recent and Proposed Tax-Related Changes

Figure 2 shows the effects of policy changes and other special factors on tax revenues for 2002-03 through 2004-05. This table does not include numerous other special factors involving nontax revenues, such as loans, transfers, asset sales, or tribal gaming revenues. (These latter factors are discussed below in the "Other Revenues and Transfers" section of this Part.) The figure shows:

- In 2002-03, major tax revenues were increased by $2.1 billion, primarily as a result of withholding increases on stock options and real estate sales, a two-year suspension of net operating loss (NOL) "carryforward" provisions, and a variety of other tax compliance and acceleration measures.

Figure 2

Revenue Effects of Recent and Proposed Tax Law Changes

(In Millions)

	2002-03	2003-04	2004-05
2002-03 Changes			
Personal Income Tax (PIT)			
Stock option and bonus withholding	$200	$10	$10
Real estate sales withholding	195	10	10
Net operating loss suspension	175	75	-50
Teacher tax credit suspension	170	—	—
Other	142	23	—
Sales and Use Tax			
Waiver of penalties and interest	$20	—	—
Corporation Tax			
Net operating loss suspension	$750	$525	-$275
Bank bad debt reserves	285	15	—
Tax credit auditing	60	60	60
Other	58	51	26
Subtotals, 2002-03 Changes	($2,055)	($769)	($-219)
2003-04 Changes			
Personal Income Tax			
Voluntary compliance initiative	—	$60	$60
Nonfiler compliance	—	4	4
Sales and Use Tax			
Excess sales tax from General Fund	—	$105	—
Use tax collection	—	10	$10
Corporation Tax			
Regulated investment trust shelters	—	$10	—
Voluntary compliance initiative	—	30	$30
Subtotals, 2003-04 Changes	—	($40)	($30)
2004-05 Proposals			
PIT nonfiler compliance—additional funds	—	—	$12
National heritage preservation tax credit	—	$9	10
Bunker fuel exemption reinstatement	—	-9	-18
Subtotals, 2004-05 Proposals	—	—	($4)
Other Tax-Related Factors			
Manufacturers' investment credit	—	$40	$195
Totals of All Changes	**$2,055**	**$849**	**$10**

- In 2003-04, the net revenue impact of special factors is a $849 million increase. Most of this gain relates to the second year of the NOL suspension adopted in 2002-03 and modest gains related to tax compliance.
- In 2004-05, in contrast, the net revenue impact of special factors is only a marginal $10 million increase. This effect is the net result of revenue *gains* related to the expiration of the manufacturers' investment tax credit and tax compliance proposals, offset by revenue *losses* from the resumption and expansion of NOL carryforward deductions per the 2002-03 legislation.

Changes in Underlying Revenues

Figure 3 provides an indication of the trend in "underlying" General Fund revenues—that is, revenues excluding all of the previously adopted and currently proposed policy-related changes and other special factors. These include the tax-related changes shown in Figure 2, as well as numerous other loans, transfers, asset sales, and fee increases adopted in past years or proposed in the current budget. This underlying trend isolates how the state's basic tax structure has been affected primarily by changes in the economy and stock market in the recent past, and how we anticipate it to respond to economic changes in the future. It shows that:

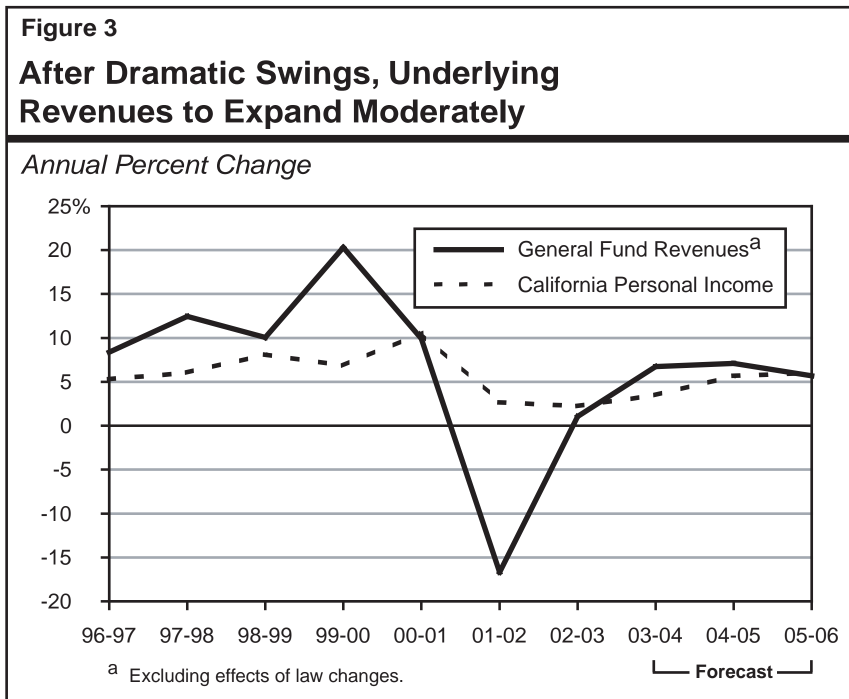


Figure 3

After Dramatic Swings, Underlying Revenues to Expand Moderately

- Revenues boomed in the late 1990s, reflecting healthy economic growth and an unprecedented run-up in stock market-related revenues from stock options and capital gains.
- However, receipts dropped by over 15 percent in 2001-02, due to the stock market plunge and the economic recession.
- Revenues then stabilized in 2002-03 and are projected to grow moderately, roughly in line with statewide personal income, in 2003-04 through 2005-06.

The Budget's General Fund Revenue Outlook

Figure 4 (see next page) shows the budget's revised estimate of General Fund revenues for the prior year and current year, as well as its forecast for 2004-05. (The revenue totals shown in this Part *do not* include the $12.3 billion in proceeds from the economic recovery bonds. In "Part I," we display these proceeds separately in our estimates of the General Fund budget condition).

Prior-Year Estimate. The budget estimates that 2002-03 General Fund revenues and transfers totaled $71.3 billion, a $470 million increase from the level assumed in the 2003-04 budget (and included in our November report). This increase is largely related to year-end accrual adjustments recently made by the State Controller totaling roughly $270 million for the PIT and about $100 million each for the SUT and CT.

Current-Year Estimate. The January mid-year forecast for 2003-04 assumes that General Fund revenues and transfers will be $74.6 billion, a $3.3 billion (4.6 percent) increase from the prior year. This is up by $1.3 billion from the estimate in the *2003-04 Budget Act.* The revision is the net result of three main factors:

- First, the new forecast of revenues from the major taxes is up $2 billion, primarily reflecting stronger-than-anticipated economic growth and higher tax receipts during the first half of the fiscal year.
- Second, the forecast includes about $800 million in newly proposed revenues, loans, and transfers, primarily from transportation-related special funds.
- Third, and partially offsetting the first two factors, the revised forecast excludes $1.6 billion in revenues that had been assumed in the 2003-04 budget. These are related to (1) a pension bond sale which has been invalidated by a Superior Court and is currently being appealed by the state, and (2) new or renegotiated

Figure 4

Summary of the Budget's General Fund Revenue Forecast

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

Revenue Source	Actual 2002-03	2003-04 Estimated Amount	2003-04 Percent Change	2004-05 Projected Amount	2004-05 Percent Change
Taxes:					
Personal income tax	$32,710	$35,117	7.4%	$38,043	8.3%
Sales and use tax	22,415	23,714	5.8	25,022	5.5
Corporation tax	6,804	7,466	9.7	7,609	1.9
Insurance tax	1,880	1,985	5.6	2,078	4.7
Other taxes	1,070	822	-23.2	563	-31.5
Other Revenues, Transfers, And Loans:					
Tobacco securitization bond proceeds	$2,485	$2,262	-9.0%	—	—
Tribal gaming revenues	—	—	—	$500	—
Other revenues	1,173	1,742	48.5	1,795	3.0%
Transfers related to pension obligation bond	—	—	—	577	—
Other transfers and loans[a]	2,785	1,520	-45.4	220	-85.5
Totals	**$71,322**	**$74,627**	**4.6%**	**$76,407**	**2.4%**

Detail may not total due to rounding.

[a] 2002-03 and 2003-04 include large amounts of loans from transportation funds.

tribal gaming compacts, which have so far yielded no significant new revenues. (The administration is assuming smaller amounts from both of these sources in 2004-05).

2004-05 Forecast. The budget forecasts that General Fund revenues and transfers will be $76.4 billion in the budget year, a $1.8 billion (2.4 percent) increase from the current year. Major taxes are forecast to increase about 6 percent, roughly in line with growth in statewide personal income. In contrast, nontax revenues and transfers are projected to fall by roughly 44 percent, due to smaller amounts of one-time loans and transfers from special funds.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Figure 5 presents our General Fund revenue outlook for 2003-04, 2004-05, and 2005-06. Our projections are based on our economic and demographic forecasts presented in "Part II" previously, and reflect the impacts of the Governor's major revenue-related policy proposals.

Figure 5

Summary of the LAO's General Fund Revenue Forecast

2003-04 Through 2005-06
(Dollars in Millions)

	2003-04		2004-05		2005-06	
Revenue Source	**Amount**	**Percent Change**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Taxes:						
Personal income tax	$34,640	5.9%	$37,430	8.1%	$40,080	7.1%
Sales and use tax	23,690	5.7	25,090	5.9	26,500	5.6
Corporation tax	7,450	9.5	7,560	1.5	8,250	9.1
Insurance tax	2,000	6.4	2,100	5.0	2,205	5.0
Other taxes	824	-23.1	601	-27.1	527	-12.3
Other Revenues, Transfers, And Loans:						
Tobacco securitization bond proceeds	$2,262	-9.0	—	—	—	—
Tribal gaming revenues	—	—	$500	—	$513	—
Other revenues	1,750	—	1,803	3.0%	1,689	-6.3%
Transfer related to pension obligation bond	—	—	577	—	19	—
Other transfers and loans[a]	1,520	-45.4	220	-85.5	-1,361	—
Totals	**$74,136**	**3.9%**	**$75,881**	**2.4%**	**$78,421**	**3.3%**

Detail may not total due to rounding.

a 2003-04 includes a large amount of loans from transportation funds and 2005-06 includes a related loan repayment.

LAO Forecast Down Modestly From Budget

Our current forecast is generally similar to the budget forecast. For example, we agree with the administration's assumption that economic growth will result in a strengthening of the state's revenue picture this year and in 2004-05. Our one significant departure from the administration (and from our own November revenue projection as well) is that we have reduced our estimate of PIT liabilities in the 2003 "base year" to reflect recently revised historical information on wages and withholdings (please see discussion in box on page 55). This reduction results in a lower revenue trend, which in turn affects both our current-year and budget-year revenue forecasts. Specifically:

- ***2003-04 Forecast.*** We forecast that General Fund revenues and transfers will total $74.1 billion in the current year, a $2.8 billion (3.9 percent) increase from 2002-03. This is down $491 million from the budget forecast, of which $477 million is related to our lower estimate of PIT revenues.
- ***2004-05 Forecast.*** We forecast that revenues and transfers will total $75.9 billion in 2004-05, a $1.7 billion (2.4 percent) increase from the current year. This is down about $525 million from the new budget's projection, primarily reflecting the ongoing effects of the current-year reduction in PIT receipts.

2005-06 Outlook. We forecast that total revenues and transfers will increase from the current year by about $2.5 billion (3.3 percent) in 2005-06, to $78.4 billion. Excluding the impact of the Governor's policy proposals on the 2004-05 and 2005-06 revenue totals, the underlying increase would be a more robust 5.7 percent. This increase is consistent with our assumption that the economic rebound will continue in 2005, boosting revenues from the state's main taxes during the year.

The LAO's Forecast for Major Revenue Sources

As indicated above, the great majority of General Fund revenues are attributable to the state's three major taxes—the PIT, SUT, and CT. 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 revenue sources.

Personal Income Tax

Background

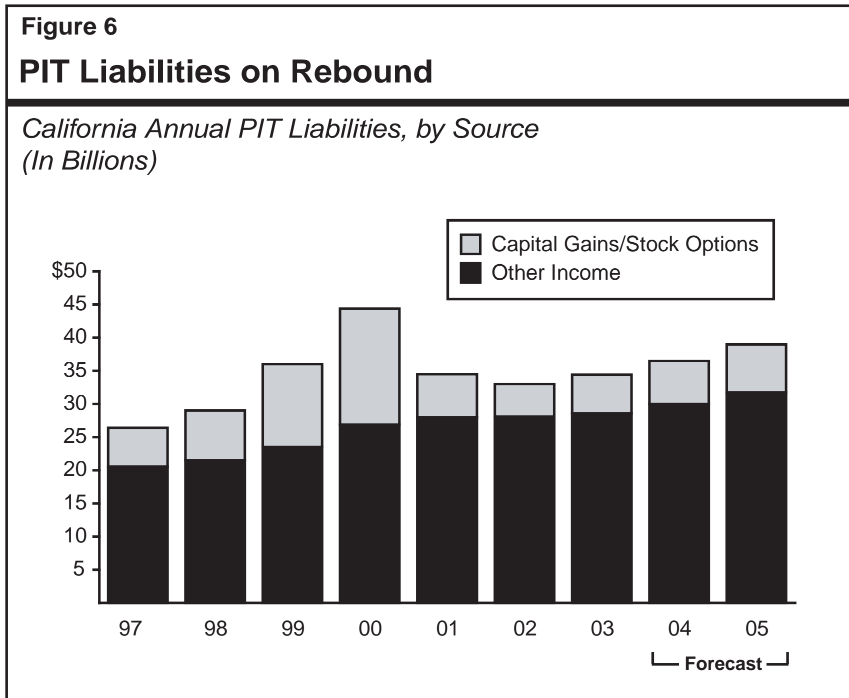
We project that the PIT will account for just under 50 percent of total General Fund revenues in 2004-05. Although this share has fallen significantly from its peak in 2000-01, the PIT remains by far the largest source of state General Fund revenues. In general, the PIT is patterned after federal law 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 $78,266 for joint returns in 2003 (and one-half of that in the case of single taxpayers).

PIT Liabilities

Our forecast of PIT liabilities is shown in Figure 6. After soaring in the late 1990s, PIT liabilities plunged in 2001 by nearly $10 billion (over 20 percent) from their unsustainable peak reached in 2000, and by another $1.5 billion in 2002. Liabilities then experienced a modest partial recovery in 2003. We expect them to grow at a stronger pace in both 2004 and 2005, reflecting healthy gains from most major income sources. Specifically:

Figure 6

PIT Liabilities on Rebound



- ***Ordinary wages*** (that is, wages excluding bonuses and stock options) are forecast to increase by roughly 4.5 percent in 2004 and 5.5 percent in 2005, reflecting an upturn in jobs and moderate growth in wage rates.
- ***Capital gains and stock options*** are forecast to increase by roughly 10 percent in both 2004 and 2005. These increases reflect the healthy gains in stock market values that have already occurred, and our expectation that growth in output, sales, and profits will push stock prices moderately higher in 2004 and 2005. Such stock market gains, if sustained, eventually will result in significant growth in taxable capital gains. However, the up-side revenue potential in the near term from this is somewhat limited by the large amount of related prior-year losses which are available to offset gains accruing in 2004 and 2005.
- ***Business-related income*** is also forecast to grow by nearly 10 percent in both 2004 and 2005, reflecting healthy increases in sales, output, and productivity in the economy. The outlook for business earnings is becoming an increasingly important factor in the PIT outlook. This is due to the ever-increasing number of companies filing as S-corporations and limited liability corporations (whose income is largely taxable under the PIT—as opposed to under the CT, as is the case for taxpayers filing as regular corporations).

PIT Revenue Forecast

Based on our estimated changes in PIT liabilities, we forecast that fiscal-year PIT receipts will total $34.6 billion in 2003-04, and then expand to $37.4 billion in 2004-05 and $40.1 billion in 2005-06. Compared to the budget forecast, our current projection of PIT revenues is down by $477 million in the current year and by $613 million in 2004-05—or $1.1 billion for the two years combined. As noted earlier and discussed further in the nearby shaded box, our lower PIT estimates primarily reflect our reassessment of historical withholding and wage data for 2003, which suggests that PIT liabilities are less than assumed in the budget forecast.

Sales and Use Tax

Background

The SUT is the General Fund's second largest revenue source, accounting for about one-third of total revenues in 2004-05. The main SUT component is the *sales* tax, which is imposed on retail sales of tangible goods sold in California. Some examples of sales 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. Roughly 70 percent of the SUT is remitted by retailers, while the remaining 30 percent is directly paid by businesses who themselves consume or use the products being taxed. 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 overall 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 state-local 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).

Withholding Mysteriously Outpaces Wage Growth

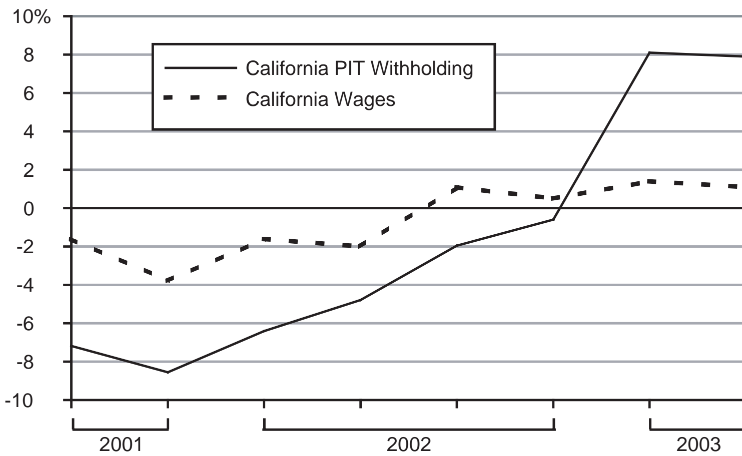
One of the key determinants of our personal income tax (PIT) forecast is the strength of PIT liabilities in 2003. This base year is important because it serves as the "springboard" for our projections of future PIT revenues. Since actual liabilities for 2003 will not be known until after final 2003 returns are remitted in April 2004, our 2003 liability estimate made prior to that time is based on alternative indicators. These include information on PIT withholding collections, PIT quarterly prepayments, and more detailed wage data once they become available (usually about five months after the end of each calendar quarter).

Initial Withholding Indicators Showed Strength. As indicated in Figure 7, after falling in most of 2001 and 2002, these payments turned sharply upward in the first half of 2003, increasing by roughly 8 percent from the prior year. Given the other positive economic indicators available late last year, we interpreted these strong payments as indirect evidence that wages were increasing—particularly in high-paying industry sectors such as information technology and electronics manufacturing. Wage growth in high-paying sectors is significant because, under California's progressive income tax structure, these wages are subject to high marginal tax rates.

Figure 7

PIT Withholding Growth Far Outpaced Wages in 2003

Year-to-Year Percent Change, by Quarter



Withholding Mysteriously Outpaces Wage Growth *(continued)*

Subsequent Wage Data Reveal Softness. Our review of historical wage data that were compiled subsequent to the release of our November 2003 fiscal forecast indicates that wage growth in the first half of 2003 was much weaker than we had previously assumed based on the strong withholding gains (see figure). For example:

- Wages in the second quarter of 2003 (the most recent quarter for which detailed information currently is available) were up only 1.5 percent from the same quarter of the prior year.
- Wages in the highest-paying industries (that is, the top 10 percent in terms of average annual wages in 2002) were up by a slightly stronger 3 percent, but still by well less than the growth in withholding.

Potential Cause of the Discrepancy. We know that some of the discrepancy between withholding and wages is due to law changes enacted along with the 2002-03 budget which increased the withholding rate on bonuses and stock options to 9.3 percent beginning in 2003. When enacted, these changes were expected to increase the overall growth in withholding by about 1.5 percent in 2003—a relatively small amount compared to the actual 8 percent growth that occurred. The true impact of the changes is uncertain, however, since there is no historical data on the amount of wages attributable to bonuses and stock options, nor is there information on what the average withholding rate on such income had been prior to the law change.

In view of the lack of wage growth that is now evident, it appears that much of the withholding growth in early 2003 was merely due to an underestimate of the impact of the 2002 legislation on withholding rates, rather than an underlying increase in wages. To the extent this is the case, the withholding increases seen in 2003 do not represent a permanent revenue gain, and will be offset by less final payments and more refunds than projected when final PIT returns are filed in April 2004.

It is possible that other factors—such as an underreporting of wages—may be playing a role in the discrepancy. However, given the current lack of hard evidence that this is occurring, we have lowered our estimate of 2003 PIT liabilities to take into account the lack of wage growth during the first half of that year. This downward adjustment to our base-year estimate lowers our underlying PIT revenue trend by about $500 million annually through the forecast period.

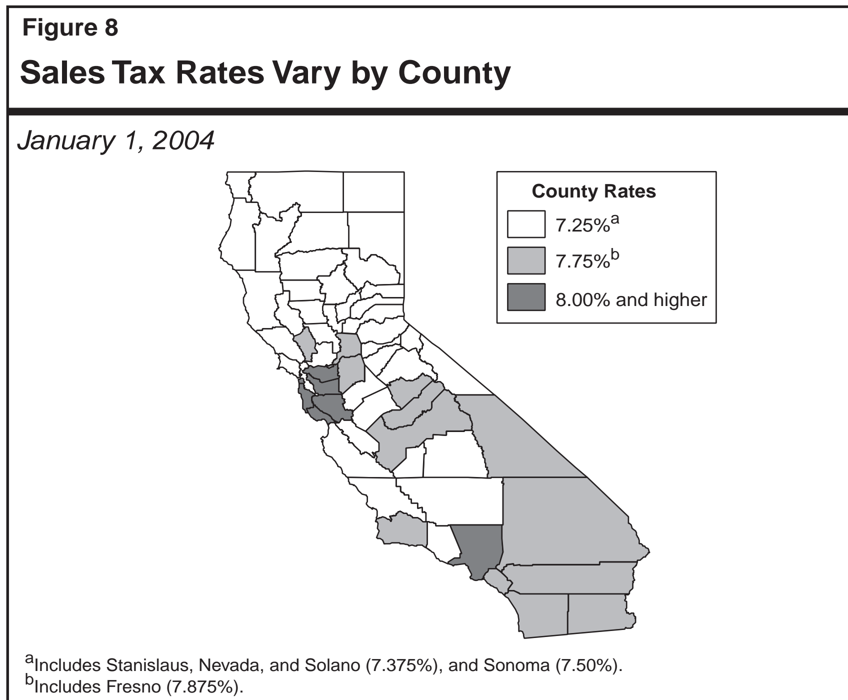
Impact of Proposition 57 on the Sales Tax Allocation. The budget assumes the approval of Proposition 57 on the March 2004 ballot. This measure authorizes up to $15 billion in bond sales to eliminate the state's 2002-03 General Fund budget deficit and address other obligations. This bond would be repaid through a multiple step process involving the diversion of a one-quarter cent portion of the Bradley-Burns local sales tax to a state special fund created for the purpose of making annual debt-service payments on the bonds. (Local governments would then be reimbursed for their SUT losses through a shift in property taxes to them from schools, which in turn would be reimbursed through added General Fund payments to them.) The diversion of SUT revenues would remain in effect until the bonds are paid off.

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 8, 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.

Figure 8

Sales Tax Rates Vary by County

January 1, 2004



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

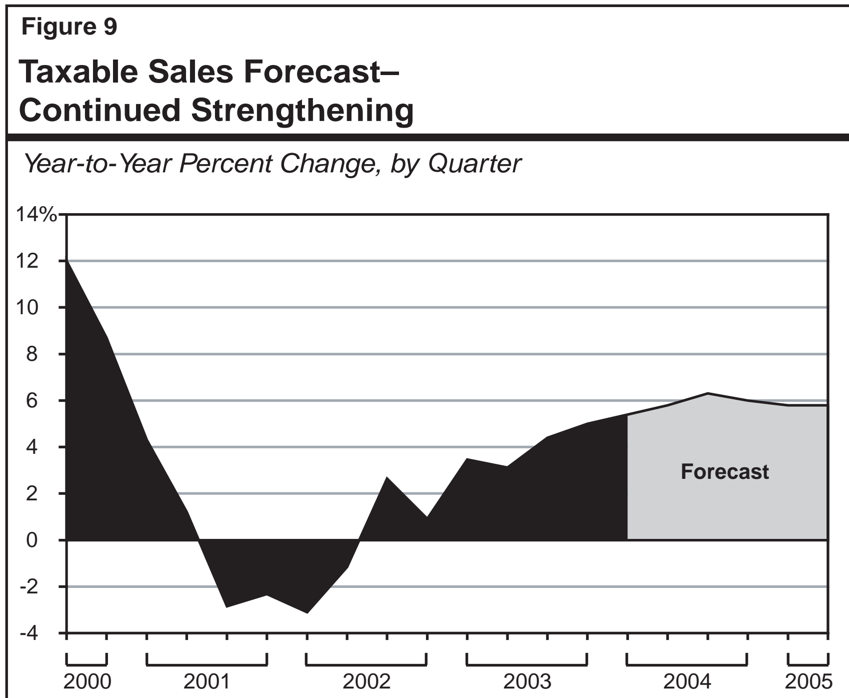
Taxable Sales Improved in 2003

The key determinant of sales tax receipts is the performance of consumer and business spending on taxable items. After falling in both 2001 and 2002, taxable sales increased about 3 percent in the first half of 2003 and by slightly over 4.5 percent during the second half of the year. While we have yet to receive industry detail on the sources of the improvement, we believe that the 2003 increases were primarily related to a revival in business investment spending in the second half of the year (which as noted above accounts for about 30 percent of total taxable sales). Other positive factors included a strong housing market—which boosted sales of building materials, appliances, and home furnishings—and a reasonably healthy holiday shopping season.

Outlook—Continued Growth in 2004 and 2005. We forecast that taxable sales will continue to strengthen, increasing by 5.9 percent in 2004 and 5.8 percent 2005 (see Figure 9). The main positive forces will continue to be healthy business investment and home construction. Consumer spending is forecast to grow moderately, roughly in line with personal income. As with the rest of the country, we believe that household spending in California will be somewhat restrained by high levels of consumer debt.

Figure 9

Taxable Sales Forecast–
Continued Strengthening



SUT Revenue Forecast

Based on our forecast of taxable sales, we project that SUT receipts will total $23.7 billion in 2003-04, $25.1 billion in 2004-05, and $26.5 billion in 2005-06. The great majority of the year-to-year changes in these amounts are related to underlying growth in the economy and taxable sales. In contrast, SUT-related law changes play a relatively minor role in the overall revenue totals. Our SUT revenue estimate is similar to the budget forecast—the current-year estimate is down by just $24 million and our budget-year forecast is up by $68 million.

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 carryforward provisions, whereby companies can use a portion of their operating losses incurred in one year as a deduction against earnings in subsequent years Under legislation enacted in 2002, due to the state's tight budgetary situation, corporations were not able to use these losses to offset their income during 2002 and 2003. However, such deductions will be allowed once again in 2004, and the percentage of losses which may be carried forward has been increased in accordance with the above-noted 2002 legislation.

Profits Rebounding

The key determinant of CT receipts is the strength of corporate profits reported on California tax returns by businesses. After falling in 2001 and most of 2002, California earnings rebounded in 2003 (see Figure 10). This turn-around is partly related to the intensive cost-cutting efforts

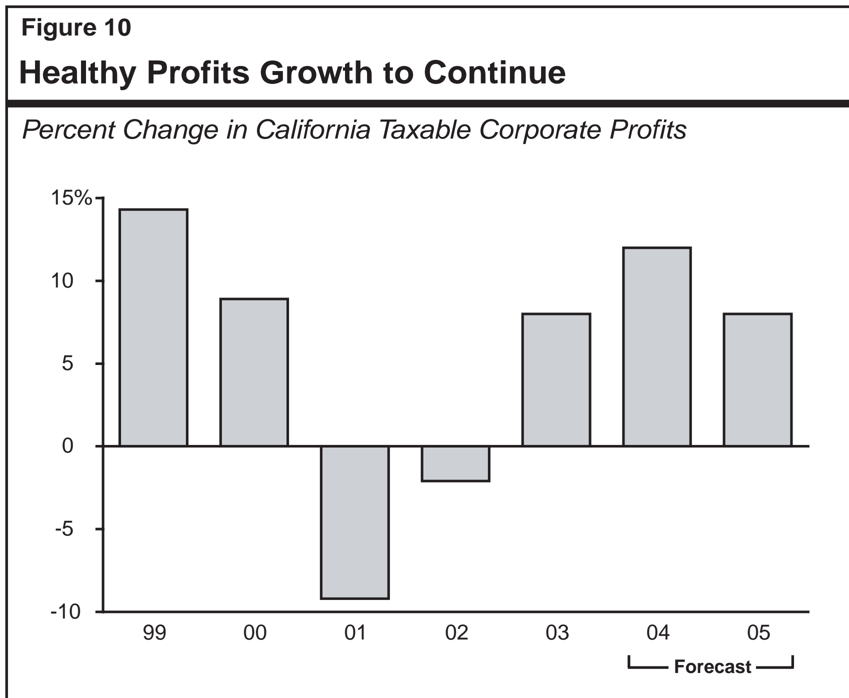
undertaken during the prior two years and the related productivity gains that materialized in 2003. Looking ahead, we forecast that taxable California corporate profits will increase by another 12 percent in 2004 and by 9.5 percent in 2005. While productivity growth will continue to play a key role, the majority of the anticipated profit growth during the next two years is related to expanded sales both at home and abroad.

Corporation Tax Revenue Forecast

We forecast that CT receipts will be $7.5 billion 2003-04, a 9.5 percent increase from the prior year, and $7.6 billion in 2004-05, an increase of 1.5 percent. The relatively small budget-year increase primarily reflects the conclusion of the two-year suspension of the net operating loss deduction after 2003. Absent this and other special factors shown earlier in Figure 2, the underlying increase in CT collections would be over 10 percent, or more in line with the underlying growth in California taxable profits. It also should be noted that our estimates do not include the significant potential negative effects on corporate tax revenues of the Farmer Bros. Co. legal challenge (see nearby shaded box). Our CT forecast is similar to budget forecast in both 2003-04 and 2004-05.

Figure 10

Healthy Profits Growth to Continue



Farmer Bros. Co. Legal Challenge

The California Franchise Tax Board has been involved in a legal dispute with the Farmer Bros. Co., a California coffee manufacturer. The state has lost in this dispute at both the Superior Court and Appellate Court levels and, unless reversed by the Supreme Court, these adverse court rulings will have a major negative revenue impact on the General Fund budget.

The case involves California's treatment of dividend income under its corporation tax law. Specifically, in determining a company's tax liability, California law allows companies to *exclude* most of the dividends they receive from another company, if the dividend-paying company also is doing business in California and has had its income subject to California taxation. The basis for this exclusion is that such dividends represent the distribution of earnings that were already subject to income taxation in California, and by allowing the company receiving the dividends an exclusion, the state is avoiding the "double taxation" of such earnings. This exclusion is not allowed, however, for dividends from companies doing business exclusively outside of California—regardless of whether the company paying the dividend is subject to income taxes in another state.

In the court case at hand, the plaintiff challenged the above law on the grounds that it violates the U.S. commerce clause, by favoring businesses that do business and pay taxes in California over those who do not do business in California. As noted above, Farmer Bros. Co. prevailed against the state at both the Superior Court and Appellate Court levels. The state has, however, appealed the Appellate Court's ruling to the Supreme Court, which has set February 20, 2004 as the date by which it will decide whether or not to hear the case. If the court does not accept the case, or if the state ultimately loses the case at the Supreme Court level, California would be faced with paying net tax refunds of between roughly $0.5 billion and $1.5 billion to the plaintiff and other affected taxpayers, according to the Franchise Tax Board. The exact magnitude and timing of such refunds is not clear at this time. In addition, the state could face ongoing annual revenue reductions of $180 million under a worst-case scenario.

Other Revenues and Transfers

The remaining 9 percent of total 2004-05 General Fund revenues and transfers consists primarily of taxes on insurance premiums, estates, alcoholic beverages, and tobacco products. It also includes interest income

and a large number of fees, loans, and transfers. We forecast that combined revenues from all of these other sources will fall from $9.4 billion in 2002-03 to $8.4 billion in 2003-04, and then further to $5.8 billion in 2004-05. About $4 billion of the annual totals are related to ongoing taxes and fees, which we expect will grow modestly over time. The remainder is related to new proposals and numerous one-time factors. For example:

- ***2002-03.*** The prior-year total in this category includes $2.5 billion from a bond sale related to the securitization of tobacco settlement receipts, and about $2.8 billion in one-time loans and transfers from special funds. Nearly one-half of the special fund loans and transfers are related to transportation funds.
- ***2003-04.*** The current-year total includes an additional $2.3 billion related to tobacco securitization bond sale proceeds, and an additional $1.5 billion in one-time loans and transfers, mostly from transportation special funds.
- ***2004-05.*** The budget-year forecast includes $577 million associated with proceeds from the pension obligation bond (with the balance of the savings from the bond—$353 million—counted as an expenditure reduction), $300 million from a proposed Medi-Cal quality assessment fee, $500 million from tribal gaming revenues, and $220 million in one-time loans and transfers from special funds.

Estate Tax Phase-Out Continuing. Our forecast includes the impact on the state of a provision included in the federal tax reduction package enacted in the spring of 2001 which is resulting in the phase-out of revenues from California's "pick-up" estate tax. We specifically estimate that revenues from this tax will fall from $647 million in 2002-03 to $400 million this year, to $175 million in 2004-05, and to $100 million in 2005-06.

The Budget's Forecast for Special Funds Revenues

As shown in Figure 11 (next page), the Governor's budget assumes that special funds revenues will total $18.3 billion in 2003-04 and $20.8 billion in 2004-05. About one-third of the budget-year total is related to 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, mostly for their general purposes. They also include fuel taxes and registration fees, which support transportation-related spending. The increases in registration fee revenues in 2003-04 and 2004-05 are related to rate increases enacted with the 2003-04 budget.

Figure 11

Summary of the Budget's Special Funds Revenue Forecast

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

Revenue Source	Actual 2002-03	2003-04		2004-05	
		Estimated Amount	Percent Change	Projected Amount	Percent Change
Motor Vehicle Revenues:					
License fees (in lieu)	$1,885	$1,917	1.7%	$1,970	2.8%
Fuel taxes	3,203	3,300	3.1	3,322	0.7
Registration, weight, and miscellaneous fees	1,987	2,269	14.2	2,591	14.2
Subtotals	($7,074)	($7,486)	(5.8%)	($7,882)	(5.3%)
Other Sources:					
Sales and use tax	$2,484	$2,570	3.5%	$3,952	53.8%
Cigarette and tobacco taxes	941	940	-0.1	917	-2.5
Interest earnings	134	124	-7.3	115	-7.5
Other revenues	7,044	8,651	22.8	8,510	-1.6
Transfers and loans[a]	-2,446	-1,453	40.6	-573	60.6
Totals	**$15,230**	**$18,318**	**20.0%**	**$20,803**	**13.6%**

Detail may not total due to rounding.

[a] Includes loans from transportation funds to the General Fund.

Another $4 billion of the total is related to sales and use taxes. This includes a one-half cent portion of the sales tax which is devoted to the 1991 realignment of health and social services programs to local governments, and a one-quarter cent diversion of the local Bradley-Burns sales tax to a special fund used to repay the economic recovery bonds proposed in Proposition 57. The remaining revenues are related to cigarette taxes (which are earmarked for various antismoking and health programs), certain higher education fees, and numerous other fines, fees, and assessments.

Key Revenue Risks and Uncertainties

In any given year, there are a variety of risks and uncertainties in the revenue outlook involving such factors as the direction and pace of the

economy, and taxpayer decisions regarding capital gains realizations. This year, in addition, the state also faces specific legal and estimation risks in several areas:

Legal Risks. As noted above, the CT estimate faces a significant risk related to the Farmer Bros. Co. legal challenge to California's application of the dividend income exclusion under corporation tax law. Also, the administration's assumption of $577 million in revenues (as well as $353 million in expenditure savings) associated with the sale of a pension bond is subject to legal risk. A similar bond authorized in the 2003-04 budget was invalidated by a Superior Court and is currently on appeal.

Estimation Risks. In addition to uncertainties posed by the mismatch between recent withholding payments and underlying wages discussed earlier, we believe that there is a risk to the budget's estimate of tribal gaming revenues. The administration estimates that the state will receive $500 million in 2004-05 related to new and renegotiated tribal compacts. This is less than the $680 million assumption contained in the 2003-04 budget for the current year. However, we note that the state has yet to receive any significant revenues from new or renegotiated tribal gaming compacts, and the timing and amount of revenues from such sources remains uncertain.

IV

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 2004-05 of $97.2 billion, including $76.1 billion from the state's General Fund and $21.1 billion from its special funds (see Figure 1). This total budget-year spending is slightly less than current-year spending—by $229 million (0.2 per-

Figure 1

Governor's Budget Spending Totals

2003-04 and 2004-05
(Dollars in Millions)

			Change	
	2003-04	**2004-05**	**Amount**	**Percent**
Budget Spending				
General Fund[a]	$78,028	$76,062	-$1,966	-2.5%
Special funds[b]	19,406	21,144	1,737	9.0
Totals	**$97,434**	**$97,206**	**-$229**	**-0.2%**

a Includes transfer of $3 billion from the General Fund to the Deficit Recovery Fund in 2003-04, and reduced General Fund expenditures of this amount in 2004-05 as spending from the Deficit Recovery Fund supplants General Fund programmatic spending. Absent this factor, General Fund spending would be up $4.1 billion in the budget year (5.4 percent), and total spending would be up $5.8 billion (6.1 percent).

b Does not include Local Public Safety Fund expenditures of $2.3 billion in 2003-04 and $2.4 billion in 2004-05. These amounts are not shown in the Governor's budget.

cent). Of total budget-year spending, General Fund spending accounts for about 78 percent. Proposed spending translates into $2,645 for every man, woman, and child in California, or $266 million per calendar day.

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 $76.1 billion for 2004-05. General Fund spending would fall by $2 billion from 2003-04, or 2.5 percent, reflecting de-

Figure 2

General Fund Spending by Major Program Area

(Dollars in Millions)

			Proposed for 2004-05	
	Actual 2002-03	Estimated 2003-04	Amount	Percent Change
Education Programs				
K-12—Proposition 98	$26,106	$27,846	$27,233	-2.2%
Community colleges—Proposition 98	2,642	2,244	2,414	7.6
UC/CSU	5,874	5,530	5,080	-8.1
Other	3,653	2,660	4,284	61.1
Health and Social Services Programs				
Medi-Cal	$10,554	$9,765	$11,569	18.5%
CalWORKs	2,078	2,060	1,995	-3.1
SSI/SSP	3,004	3,144	3,346	6.4
Other	7,423	7,821	7,689	-1.7
Youth and Adult Corrections	$5,837	$5,326	$5,732	7.6%
Vehicle License Fee Subventions	$3,797	$2,703	$4,062	50.3%
Transfer To/From Deficit Recovery Fund	—	$3,012	-$3,012	—
All Others	$6,512	$5,918	$5,669	-4.2%
Totals	**$77,482**	**$78,028**	**$76,062**	**-2.5%**

creases in some areas and increases in others. One of the major factors responsible for the overall decline is the 2003-04 transfer of $3 billion from the General Fund in proceeds from the economic recovery bond to the Deficit Recovery Fund (which adds $3 billion to the 2003-04 General Fund spending total) and the support of General Fund programs from this fund in 2004-05 (which reduces General Fund spending by $3 billion in that year). In addition, there are numerous other one-time factors affecting almost every major program area in the budget. For example:

- The substantial increase in Medi-Cal spending in 2004-05 reflects the expiration of one-time savings from new federal funds and an accounting change.
- Similarly, the jump in "other" education spending reflects expiration of one-time savings related to debt service and retirement costs.
- The increase in vehicle license fee subventions reflects a partial one-time deferral in 2003-04.
- Finally, the drop in "all other" spending reflects the assumed use of pension obligation bond proceeds in place of state-funded retirement contributions in 2004-05.

These factors will also have an impact on the spending comparison statistics that follow.

Special Funds Spending

Background. Special funds are used to allocate specified 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 sales and use tax and tobacco-related receipts.

Proposed Spending. In 2004-05, the Governor proposes special funds spending of $21.1 billion (see Figure 3 next page). This is a 9 percent increase from the current-year total of $19.4 billion. The increase is primarily related to additional special funds spending for debt service on the proposed economic recovery bond.

It should be noted that the budget's special funds spending total for 2004-05 excludes expenditures of roughly $2.4 billion from the Local Public Safety Fund (LPSF). Such spending is also excluded from the current-

year 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)

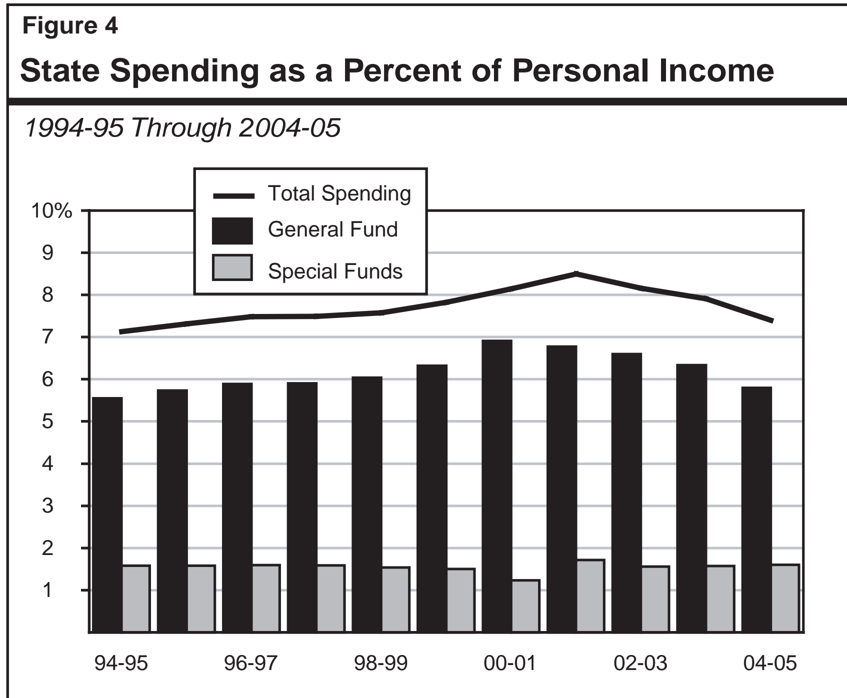
			Proposed for 2004-05	
	Actual 2002-03	Estimated 2003-04	Amount	Percent Change
Transportation	$5,485	$5,486	$5,303	-3.3%
Local government subventions	5,133	5,092	5,297	4.0
Resources-related programs	1,691	2,205	2,449	11.1
Economic recovery bond debt service	—	—	1,256	—
Public Utilities Commission	1,068	1,265	1,191	-5.8
All others	4,905	5,358	5,647	5.4
Totals	**$18,282**	**$19,406**	**$21,144**	**9.0%**

Spending in Relation to the State's Economy

Figure 4 shows how state spending has varied over recent years as a percentage of total California personal income (which is a broad indicator of the size of the state's economy). From 1994-95 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 nearly all of the increase.

Since 2001-02, however, total state spending as a percentage of personal income has reversed direction, and is projected to drop to 7.4 percent in 2004-05. The decline in the ratio results from the previously noted 2004-05 decline in combined General Fund and special funds spending, and our projection that personal income will grow moderately during

the year. After adjusting for the use of the $3 billion in economic recovery bond proceeds and other special factors discussed previously, the 2004-05 ratio would be somewhat higher—about 7.6 percent. However, even with these adjustments, the ratio of proposed spending to California personal income would be well below the 2000-01 peak.



Spending From Federal Funds and Bond Proceeds

In addition to the $97.2 billion of proposed 2004-05 spending from the General Fund and special funds, the budget also proposes $55 billion in spending from federal funds and another $1.9 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, proposed 2004-05 spending exceeds $154 billion.

Federal Funds

As noted above, about $55 billion in federal funds are proposed to be spent through the state budget in 2004-05. (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, busi-

nesses, or individuals within the state.) About $27 billion (roughly 50 percent) of the total federal funds in the budget are for various health and social services programs, such as Medi-Cal, California Work Opportunity and Responsibility to Kids, and In-Home Supportive Services. Education receives another $14 billion, or 26 percent, of the total (split fairly evenly between K-12 and higher education), and transportation is expected to receive $2.6 billion, or 5 percent. In addition, the Governor's budget assumes that $350 million in new federal funding will be received in the budget year to offset General Fund costs.

Spending of Bond Proceeds

Budgetary Treatment. Debt service on general obligation and lease-revenue bonds is included in spending for the appropriate programmatic areas the bond funds are used in, 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 2004-05, the budget proposes General Fund debt-service expenditures of $3.6 billion, of which $3.1 billion is for general obligation bonds and $520 million is 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 January budget proposal estimates that the state will spend $1.9 billion in general obligation bond proceeds for capital projects in 2004-05. This compares to $10.4 billion in the current year and $11 billion in the prior year. Almost all of the decline is related to resources-related spending from bond proceeds. The administration has indicated that the January budget proposal for resources is incomplete and that it will submit the balance of the spending proposal in the spring.

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 using the facilities financed by the bonds (funded primarily through General Fund appropriations). For

2004-05, the budget authorizes $143 million in spending from lease-revenue bond proceeds for such purposes as construction of state buildings and resources projects.

State Appropriations Limit

Background. In 1979, California's voters established a state appropriations limit (SAL) when they approved Proposition 4. The SAL places an "upper bound" on the amount of tax proceeds that the state can spend in any given year and grows annually by a population and cost-of-living factor. Most state appropriations are subject to the SAL; however, certain appropriations are exempt—including 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 recent downturn in the state's economy and its adverse effects on the state's revenues, the budget's proposed expenditures are well below the SAL in both the current and budget years. This is in contrast to the late 1990s when rapid spending growth eroded the "room" under the limit until the SAL was finally exceeded by $702 million in 1999-00.

In 2003-04, appropriations subject to the limit are $13.4 billion below the limit. In 2004-05, the administration's estimate of this gap shrinks to just under $12.8 billion. The amount of room under the limit shrinks next year because tax proceeds are expected to grow by nearly 6 percent, while the limit itself is only expected to grow by 3.7 percent.

State Spending—A Historical Overview

Prior to looking at the programmatic details of the Governor's spending plan for 2004-05, 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 (see next page) shows that total state spending increased moderately between 1994-95 and 1998-99, then jumped by nearly 33 percent between 1998-99 and 2001-02. In contrast, spending has been relatively flat since 2001-02. Over the full ten-year period, total spending is up $43 billion (80 percent), for an average annual rate of growth of 6.1 percent.

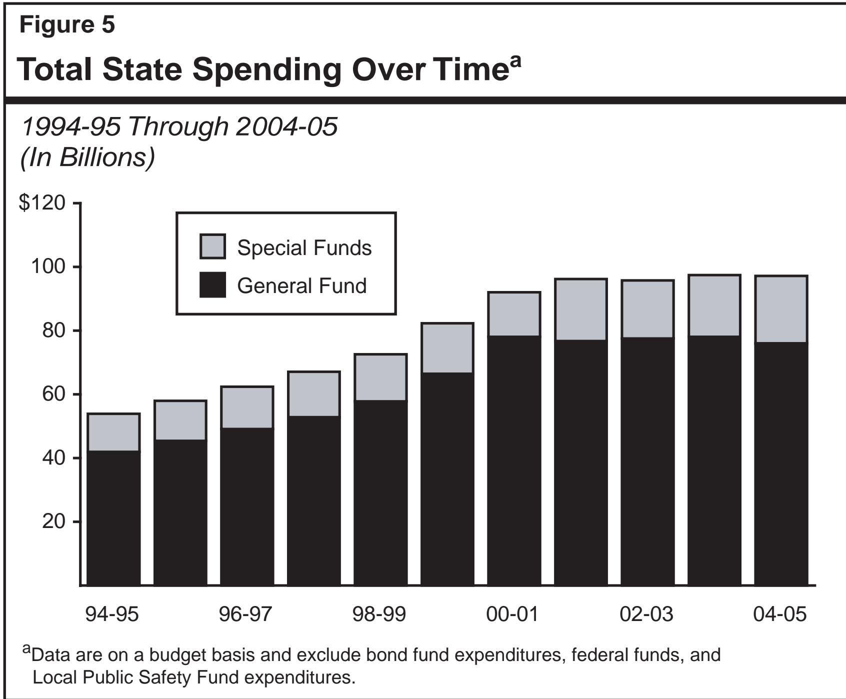


Figure 5

Total State Spending Over Time[a]

1994-95 Through 2004-05
(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 42 percent over the entire ten-year period. This indicates that about one-half of the $43 billion increase was due to inflation.

- Real per-capita spending—which adjusts for *both* inflation and population growth—has increased by about 22 percent over the period. This reflects projected spending of $2,645 per capita in 2004-05, up from $2,173 per capita in 1994-95. Despite a projected decline in per-capita expenditures in the budget year of 3.9 percent (the third consecutive year of decline), real per-capita spending has grown an average of 2 percent over the entire period.

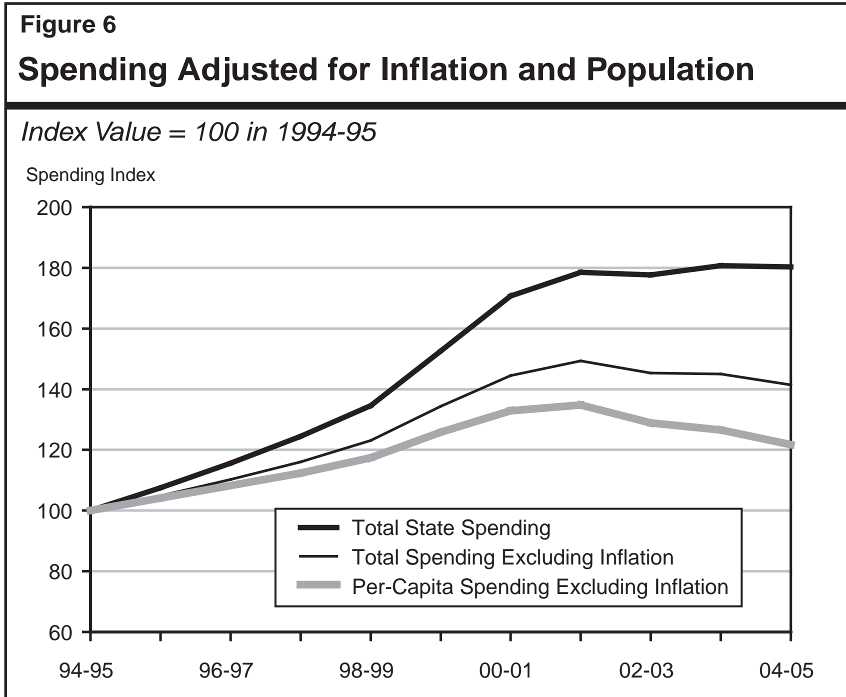


Figure 6

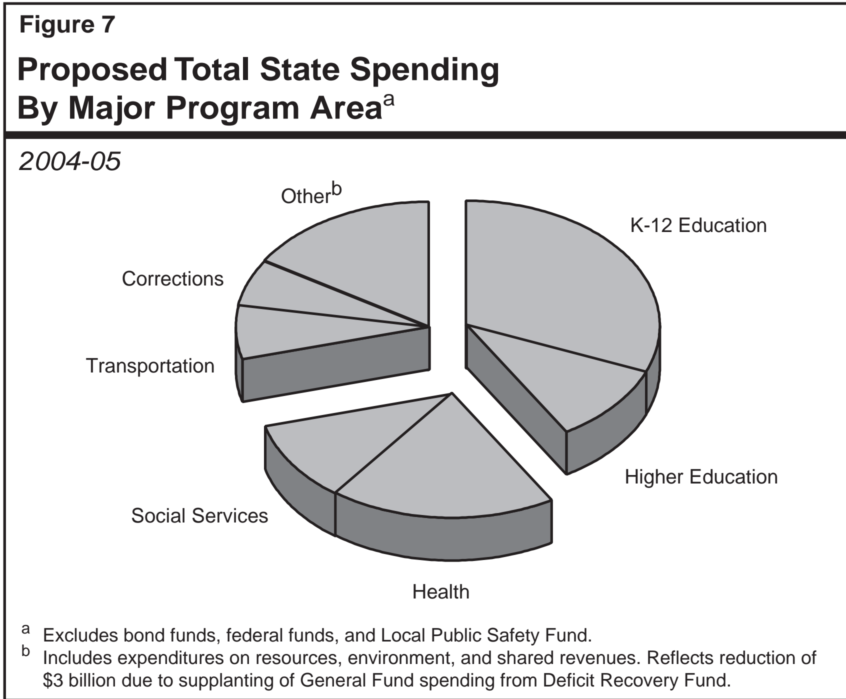
Spending Adjusted for Inflation and Population

Spending by Program Area

Total State Spending

Figure 7 (see next page) shows the allocation of the proposed $97.2 billion of total state spending in 2004-05 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 support in some areas (such as transportation).

The figure shows that K-12 education receives the largest share of total spending—about 31 percent of the total. (It also should be noted that K-12 education spending receives additional funding from local sources.) When higher education is included, education's share rises to somewhat over 41 percent. Health and social services programs account for about 30 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.

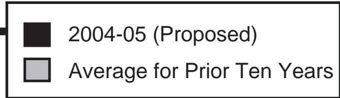


Relative Program Growth in the Budget Year

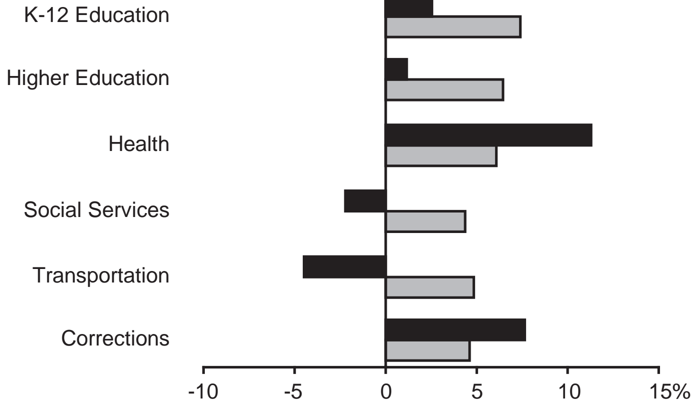
In order to gain perspective on how state spending has changed for each broad programmatic area, Figure 8 shows their proposed growth in the budget year compared to the average annual growth in these program areas over the past ten years. As the figure shows, most program areas would under the Governor's proposal either grow by less than their historical average or actually decline during the year. These slowdowns reflect real program reductions from current-law spending levels in a variety of program areas. The year-to-year changes in several categories are also affected, however, by the numerous one-time actions and other anomalies described earlier. For example, the above-average increases in corrections and health are related to the expiration of one-time savings in 2003-04 associated with one-time federal funds and a Medi-Cal accounting change.

Figure 8

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



Annual Percent Change 2004-05 and Prior Ten Years



[a]Excludes "all other" spending.

MAJOR EXPENDITURE PROPOSALS IN THE 2004-05 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 2004-05 Budget Bill.*

PROPOSITION 98

Proposal

The Governor's budget proposal suspends the Proposition 98 minimum guarantee by $2 billion in 2004-05. Thus, the overriding issue for the Legislature in crafting the 2004-05 budget for K-12 education and the community colleges (both funded primarily through Proposition 98 funds) is whether to approve the proposed suspension. If suspended, the Legislature then could set the funding level for K-12 education and the community colleges at whatever level it felt appropriate. How the Legislature addresses the issue of suspension will shape K-14 budgets for the next several years.

The Governor's budget proposes $46.7 billion in Proposition 98 funding for 2004-05. This is $751 million, or 1.6 percent, higher than the revised current-year amount. This provides sufficient resources to fully fund enrollment growth, statutory cost-of-living adjustments (COLAs), and some program expansions and restorations. The Governor's budget, however, does not provide a COLA for the community colleges and some K-12 categorical programs.

Governor's Suspension Proposal Reasonable. Given the size of the structural deficit and Proposition 98's share of General Fund expenditures (roughly 40 percent), it would be very difficult to close the budget gap without suspending Proposition 98. Absent a suspension, the Legislature would either have to :

- ***Make Additional Non-Proposition 98 Reductions.*** The Legislature would need to make an additional $2 billion in reductions in non-Proposition 98 programs (health, social services, higher education, and corrections), which would be difficult on top of the Governor's proposed reductions in those program areas.
- ***Increase General Fund Tax Revenues.*** In this case, however, a large share of any new revenues would go to Proposition 98. If, for example, the Legislature increased General Fund tax revenues by $5 billion, $4 billion of the increase would need to be appropriated for Proposition 98. This is because higher General Fund revenues would significantly increase the minimum Proposition 98 guarantee level.

As noted above, even with suspension, the Governor's proposed Proposition 98 funding level provides sufficient resources to fully fund growth, COLAs, and some additional expansions and program restorations. Accordingly, we recommend the Legislature suspend the minimum guarantee for 2004-05. If the Legislature chooses to suspend, we recommend the Legislature determine the appropriate level of K-14 funding by balancing K-14 priorities with its other General Fund priorities—without regard to the dollar amount of the suspension.

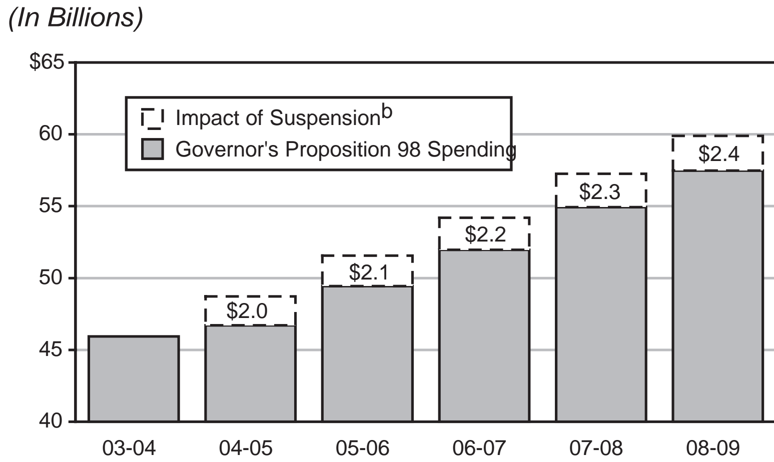
Suspension Would Result in Multiyear Savings. Figure 9 shows our estimate of the annual savings to the state from the Governor's proposed suspension. The figure shows that the $2 billion of General Fund savings in 2004-05 grows by about $100 million each year, reaching $2.4 billion by 2008-09. In other words, the savings grow with the annual growth in K-12 attendance and personal income. We explain below why the savings from the Governor's proposed suspension increase over the forecast period.

Current Maintenance Factor Paid Off First. Figure 10 shows the impact a $2 billion suspension would have on widening the gap between the required minimum guarantee and the long-term Test 2 level (this gap is known as the "maintenance factor"). Absent suspension, the state would slowly close the gap between the Proposition 98 funding level and the long-term Test 2 level over the forecast period. (We estimate this maintenance factor payoff at over $200 million annually on average.) Lowering the 2004-05 spending level by $2 billion through suspension, however, widens the gap from the long-term Test 2 level.

Figure 9

Suspension Would Result in Multiyear General Fund Savings[a]

(In Billions)



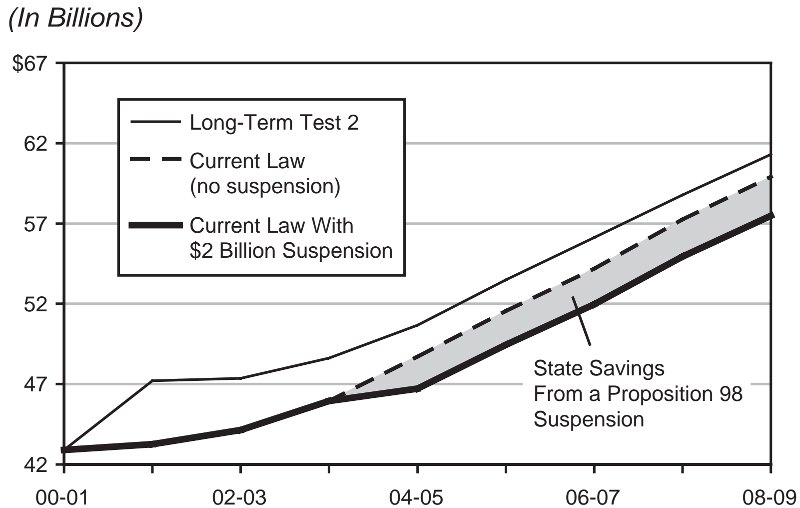
[a] Based on LAO revenues and assuming the state appropriates funds at the minimum guarantee in out years.

[b] Savings to the state General Fund resulting from suspension.

Figure 10

Impact of Suspension On Proposition 98 Funding Over Time[a]

(In Billions)



[a]LAO Estimates.

The shaded area shown in Figure 10 represents the savings to the state from the Governor's proposal. Since the state does not pay off its preexisting maintenance factor over the period shown, the maintenance factor created by suspension ($2 billion) generates savings of that magnitude each year. (As noted above, it actually grows slightly because of growth in K-12 attendance and per capita income.) When the state fully restores all maintenance factor and returns to the long-term Test 2 level (which based on our forecast would be after the period shown in Figure 10), the savings to the state from the $2 billion suspension would end. However, in the interim, the state would generate annual savings from the Governor's proposed suspension.

Issues for Legislative Consideration

Legislature Can Eliminate Prior- and Current-Year Proposition 98 Obligations Through Suspension. For 2002-03 and 2003-04, the Governor proposes to fund Proposition 98 a total of $966 million below the existing minimum guarantee levels. The budget, however, does *not* propose suspension in these years. Thus, for these years the state would need at some future time to appropriate additional resources to "settle up" to the minimum guarantee. Under the Governor's proposal, the state would not begin paying the settle-up obligation of $966 million until 2006-07. This effectively creates a $966 million loan from Proposition 98 to the General Fund until that time. While this would help the state's balance sheet in the short run, the "tab" would have to be paid in 2006-07. Given that the budget does not fully address the state's structural problem (see "Part I" of the *2004-05 Budget: Perspectives and Issues*), the loan would add to the state's problem when the settle-up payments were made in 2006-07.

Due to the severity of the state's fiscal situation, we recommend the Legislature suspend the minimum guarantee for 2002-03 and 2003-04, thereby eliminating the $966 million future obligation. If the state does not suspend the minimum guarantee for 2002-03 and 2003-04, the state will be obligated to pay off the $966 million in the near term regardless of the state's fiscal situation at the time.

"Credit Card" Balance High and Growing. The Governor's proposal continues the recent trend of increasing future state obligations to fund current expenses. The result has been a steadily growing balance on the state's education credit card. Combined, the credit card balance would grow from $3.5 billion in 2003-04 to $3.8 billion in 2004-05 under the Governor's budget, an increase of $321 million. Most of this increase results from a lack of funding for state mandates, which we estimate will exceed $300 million in 2004-05. Given the large and growing backlog of mandate claims, the mandate deferral presents special problems for the state. By the end of 2004-05, the state is likely to have a total of almost

$1.6 billion in outstanding Proposition 98 mandate liabilities. We provide several recommendations to reduce the costs of K-12 mandates in the "Education" chapter of the *Analysis of the 2004-05 Budget Bill*.

To address the overall balance, we recommend the Legislature begin gradually paying off deferrals and develop a repayment plan to eventually restore all deferred funds. We note that since school districts and community colleges have already spent the funding to meet the program obligations of the deferred programs, any funding provided to reduce deferrals is effectively general purpose in nature at the local level. In the budget and future years, we recommend the Legislature make it a priority to repay deferrals before making expenditure increases or funding new programs.

K-12 Proposition 98

Proposal

The Proposition 98 allocation to K-12 schools (which includes local property tax revenues) is proposed at $41.9 billion or $6,941 per pupil for 2004-05 (adjusted for funding deferrals). This represents an increase of $175 per pupil, or 2.6 percent, from the revised current-year estimate.

The major 2004-05 budget proposals include:

- $740 million for COLAs of 1.84 percent for revenue limits and some categorical programs.
- $369 million to reflect growth in student attendance for revenue limits and certain categorical programs.
- $136 million for higher unemployment insurance costs, and $106 million for higher Public Employees' Retirement System (PERS) costs.
- $110 million for revenue limit equalization.
- $188 million for standards-aligned instructional materials.
- $173 million to restore deferred maintenance spending.

Issues for Legislative Consideration

Proposed Categorical Program Consolidation. The Governor proposes to consolidate $2 billion in funding for 22 existing categorical programs into revenue limits. With this change, districts would have complete discretion over the use of these funds. The proposal would balance

this new flexibility by requiring a district plan that is intended to increase local accountability for district spending decisions. In addition, the budget proposes to provide additional flexibility for five small school safety competitive grant programs.

We believe these proposals take a significant step toward the goal of establishing a streamlined system of categorical programs by increasing fiscal and program flexibility and reducing state and local administrative costs. We recommend several modifications to the list of programs included in the revenue limit. Most significantly, we recommend the Legislature exclude from the consolidation staff development programs and programs that support services for special needs students because we are concerned that local incentives are likely to lead districts to underinvest in these two areas. Instead, we recommend (1) creating a teacher quality block grant from ten existing categorical programs and (2) restructuring Economic Impact Aid by adding other programs serving special needs students.

Of the 17 programs we recommend shifting into revenue limits, three are not ones the administration proposes shifting. Specifically, we recommend shifting K-3 and high school class size reduction, as well as deferred maintenance. We also suggest modifying the budget's school safety program proposal. Specifically, we recommend creating a block grant that would contain funding from all existing categorical and state-mandated local programs in this area. This would give districts greater flexibility over the use of funds and reduce the state and local administrative burden of existing categorical programs and mandates.

HIGHER EDUCATION

The state's higher education agencies include the University of California (UC), the California State University (CSU), the California Community Colleges (CCC), Hastings College of the Law, the California Student Aid Commission, and the California Postsecondary Education Commission. Of these agencies, only funding for CCC is part of Proposition 98. The 2004-05 budget proposal would reduce total General Fund support for higher education by $197 million, or 2.3 percent, from the revised 2003-04 level. When all fund sources are included (such as student fees, which the Governor proposes to increase at all three segments, and federal funds), total support for higher education *increases* by $803 million, or 2.6 percent.

We are concerned that a number of the Governor's proposals would unreasonably impede student access to higher education. In the *Analysis*,

we offer recommendations to better promote access while still achieving the level of General Fund savings envisioned by the Governor.

California Community Colleges

Proposal

The Governor proposes Proposition 98 funding (General Fund and local property taxes) of $4.7 billion for CCC in 2004-05. This represents an increase of $320 million, or 7.3 percent, from the Governor's current-year estimate. Adjusting for deferrals, the CCC's increase in Proposition 98 funding would be $120 million, or 2.6 percent.

The Governor's proposal would provide $121 million to fund enrollment growth of 3 percent, or about 32,000 additional full-time equivalent (FTE) students. This is higher than the statutory rate of 1.8 percent, in part to accommodate the Governor's proposal to redirect 10 percent of new freshman enrollment from UC and CSU to CCC. The budget proposal also includes $80 million to raise per-student funding in low-revenue districts, thus promoting the "equalization" of per-student funding among districts.

The Governor's CCC budget includes two new fee proposals. First, regular student fees would increase from $18 per unit to $26 per unit. The average full-time student taking 24 units per academic year would pay an additional $192. The new fee amount would permit needy students (who do not pay fees at community colleges) to collect up to $112 in additional federal Pell Grant aid. The Governor's second fee proposal applies to students who already hold a baccalaureate degree. Instead of paying the $26 per unit fee, these students would pay $50 per unit. The combined effect of the two fee proposals would increase student fee revenue by $91 million, thus permitting General Fund savings of the same amount.

Finally, the Governor's proposal would consolidate funding from some categorical programs into general apportionments, thus providing districts with greater flexibility in using these funds. It would also rearrange several other categorical programs into larger groups.

Issues for Legislative Consideration

In the *Analysis*, we assess the major features of the Governor's CCC proposal. While we generally support the proposed fee increases and the enrollment growth augmentation, we raise the following concerns:

Categorical Reform Proposal Needs Work. We support the objective of categorical reform. However, we believe that the Governor's proposal

to move some categorical funding into base apportionments lacks adequate accountability measures. In addition, we believe that the regrouping of several other categorical programs is largely symbolic because proposed restrictive language would prevent any new flexibility for local districts. We recommend ways to address these concerns.

State Should Address Existing Obligations Before Expanding Programs. While we support the goal of equalization, we believe that the $80 million proposed for this purpose would be better spent addressing existing obligations. For example, the Governor's budget would defer $200 million in 2004-05 apportionment costs to 2005-06, and would defer tens of millions of dollars in state reimbursements to districts for mandated programs. We recommend that the $80 million for equalization instead be applied to these or other existing obligations.

Other Higher Education Programs

Proposal

The Governor's budget proposes a variety of student fee increases at UC and CSU. These include a 10 percent increase in undergraduate fees, a 40 percent increase in graduate fees, and a 20 percent increase in nonresident tuition. The budget also reduces General Fund support for professional schools, assuming UC will backfill these reductions with fee increases. These fee increases would generate about $300 million in new fee revenue, which in turn would backfill unallocated General Fund reductions of the same amount. The Governor's budget also proposes a new student fee policy for UC and CSU. (The policy would *not* apply to CCC.) In general, the policy limits future fee increases to 10 percent per year.

While increasing student fees, the budget cuts back on eligibility for Cal Grant financial aid programs and reduces the value of some Cal Grant awards. At the same time, the budget increases funding for campus-based financial aid programs run by UC and CSU.

The budget reduces funding for various UC and CSU programs, including all General Fund support for outreach programs at the two segments. Consistent with legislative intent expressed in the 2003-04 budget package, the Governor's 2004-05 proposal does not include new funding for enrollment growth at UC and CSU. In fact, it reduces enrollment funding by about 7,000 FTE students and redirects these students to CCC.

Issues for Legislative Consideration

The combination of fee increases of up to 40 percent, restricted and reduced financial aid, and defunding of K-12 outreach programs could

seriously hinder student access to higher education. While we understand that the state's fiscal situation justifies some reductions in General Fund support for higher education, we believe that a similar level of savings can be achieved in a way that would better preserve student access. In the *Analysis* we make a number of recommendations to accomplish these ends.

Preserve Selected Outreach Programs. We recommend establishing a College Preparation Block Grant to allow targeted K-12 schools to contract for outreach services. We also recommend that state funding for a small number of existing outreach programs at UC and CSU be preserved.

Align Student Fee Increases to Student Costs. We recommend adoption of a fee policy that bases student fees at all segments on a fixed percentage of educational costs. While we support the Governor's proposed budget-year increases in undergraduate fees, we recommend adoption of smaller fee increases for resident graduate students and nonresident undergraduate students.

Maintain Integrity of Cal Grant Program. We make a number of recommendations that would ensure state Cal Grant aid is sufficient to address the identified costs, including planned fee increases, experienced by needy students.

Segments Still Have Unused Enrollment Funding. Although the Governor's budget includes no new funding for enrollment growth at UC and CSU, we find that both segments have unused enrollment funding in their base budgets that would permit them to enroll more students in 2004-05 than are enrolled in the current year.

HEALTH AND SOCIAL SERVICES

Under the Governor's budget proposal, state General Fund expenditures for health and social services programs would total $24.6 billion in 2004-05, about 31 percent of proposed General Fund spending for all purposes.

Proposal

The Governor's budget plan includes a number of specific proposals intended to reduce 2004-05 expenditures for health and social services programs to help address the state's fiscal problems. The types of proposals presented to the Legislature include: (1) caps on the enrollment of certain programs, or certain populations in those programs; (2) the imposition of other restrictions on program eligibility; (3) the restructuring of some state programs into a county block grant; (4) reductions or freezes

in rates and wages paid to various health care providers; (5) suspension of cost-of-living adjustments; (6) reductions to specified cash assistance grants; and (7) increases in the fees paid by program beneficiaries.

In addition to these specific types of budgetary changes, the administration has also outlined in concept several broader proposals to reform health and social services programs for the stated purpose of reducing their cost and improving program results in the long term. Among these proposals are the following:

- ***Medi-Cal.*** A series of cost-cutting changes to the Medi-Cal Program are proposed to save about $400 million annually beginning in 2005-06. The package includes the proposed creation of a multitiered benefit and eligibility structure. Some core groups of beneficiaries would see little change in their coverage, but others for which state coverage is optional would receive a less costly benefits package and be subject to more effective copayment requirements. Also, managed care coverage would take the place of fee-for-service medicine for certain Medi-Cal beneficiaries in additional counties.

- ***Healthy Families Program.*** The Healthy Families Program insurance coverage would be split into two tiers, with the current level of benefits provided for children in families with higher incomes who were willing to pay a higher premium. A lesser package of benefits would be provided for children in higher-income families who wanted to continue to pay the current premium amounts. Children in families with lower incomes would not be affected by these changes, and the premiums paid by their families would not change.

- ***Early and Periodic Screening, Diagnosis and Treatment (EPSDT).*** The EPSDT program mandates the provision of a broad range of services to Medi-Cal-eligible children and youth under age 21, including specialty mental health services, to "ameliorate" any medical conditions they may have. The administration is proposing to draft and submit a request for a federal waiver of this mandate to enable the state to more narrowly define which EPSDT mental health services must be provided to eligible Medi-Cal beneficiaries.

- ***Regional Centers.*** The administration proposes to achieve a total of $100 million in state savings in 2004-05 through a series of actions affecting services for persons with developmental disabilities. These include imposing copayments on additional families of clients who receive community services and the establishment

of statewide standards for the purchase of services. Additional reforms that would achieve an unspecified amount of savings are proposed to take effect in 2005-06, such as a further expansion of copayments, revisions to the way rates are established for community services, and efforts to give clients more decision-making authority over the services provided to them.

- ***California Work Opportunity and Responsibility to Kids (CalWORKs).*** The Governor's budget proposes significant reforms to the CalWORKs program. Major changes include an additional 25 percent grant reduction for families who remain in sanction status for more than one month, a 25 percent sanction on families who have reached their five-year time limit and are not working, and limiting the range of activities that count as work participation. Specifically, all recipients must engage in employment or on-the-job training (OJT) within 60 days of receiving aid. In order to receive other services, such as substance abuse treatment or vocational education, recipients must first work or participate in OJT for 20 hours per week.

- ***In-Home Supportive Services (IHSS).*** The Governor's budget notes that state level reviews of county determinations of IHSS service hours indicate that up to 25 percent of authorized service hours "may be unnecessary or not actually provided" to the recipient. The administration has indicated its intent to submit a quality assurance proposal in the spring designed to improve the IHSS needs assessment process and reduce the over-authorization of service hours.

- ***Foster Care.*** The Governor's budget assumes savings of $72 million ($20 million General Fund) from unspecified reforms to the Foster Care program. The goal of these reforms is to increase permanence of placement for children and generally improve outcomes for children and families without imposing rate reductions. Potential areas for reform identified by the Governor include: (1) performance-based contracts for Foster Family Agencies and Group Homes, (2) restructuring foster care rates to encourage counties to increase the use of less restrictive and less costly placements, and (3) pursuing a federal funding waiver to allow California to use federal Title IV-E funding on prevention and services designed to keep children out of the foster care system (currently IV-E funds may only be used for children in foster care).

Issues for Legislative Consideration

We discuss and comment upon many of the Governor's specific budget reduction proposals, as well as the longer-term reforms that he has outlined in concept, in the "Health and Social Services" chapter of the *Analysis*. There are several key factors that the Legislature may wish to consider as it evaluates the merit of his broader reform proposals. We discuss these in more detail below.

Right Programs Focus of Reform. In general, the administration has chosen to focus on containing the costs of the state's fastest-growing health and social services programs. Our initial review indicates that the Governor's budget plan has chosen good candidates for these broader reform efforts. With the exception of Foster Care and CalWORKs, the programs outlined above involve significant General Fund costs and are projected to experience average expenditure growth of about 7 percent over the next five years. If major cost-reduction efforts were successful in these programs, the state would have taken some significant steps toward addressing the ongoing gap between current-law state revenues and spending that we have forecast through 2008-09.

Reforming CalWORKs makes sense for two reasons. First, the program is experiencing cost pressures because the state has virtually exhausted all of its available federal TANF carryover funds. Second, program participation is below the levels envisioned in the CalWORKs statute and is also below the standards contemplated under the pending congressional versions of federal welfare reform reauthorization.

More Specifics Needed. In some cases, the administration has identified an aggregate amount of future state savings from the proposed changes, but has not indicated the specific amount of savings identified with each separate component of the reform package. In other cases, the estimated overall fiscal impact of the proposed changes has not been identified. Also, some proposals are so general in their nature that it is not clear exactly how program benefits or services would change if they were adopted

Thus, in many cases the Legislature does not have sufficient information at this time to fully assess the impact of the Governor's reform proposals. The administration has indicated its intention to work with "stakeholders"—the various parties affected by the programs—to further develop the broad reform concepts into more specific proposals. The work product from these activities is proposed to be submitted to the Legislature at a later date—in some cases, at the time of the May Revision.

In general, we recommend that the Legislature request that the administration present more detailed information about its proposals dur-

ing budget hearings, prior to the May Revision. We are concerned that a mid-May submittal will not provide the Legislature with sufficient time to assess the merits of the Governor's proposals or to consider appropriate modifications, where necessary, to improve them.

Be Open to Additional Reforms and Alternatives. Based upon our knowledge of the affected programs, a number of the Governor's proposals appear to represent a good starting point for discussions of program reform. However, we recommend that the Legislature broaden the discussion in some cases to consider complementary reforms that go beyond those the Governor has offered, and in other cases, to consider alternatives to the administration approach.

For example, while the administration has put forward a potentially worthwhile proposal to expand Medi-Cal managed care to additional counties within California, we would urge the Legislature to also examine the idea of shifting an additional 330,000 aged or disabled beneficiaries from fee-for-service medicine to managed care to both improve the quality of their health care and to reduce state costs. In this case, our approach would complement, and not conflict, with the administration proposal. (We discuss this proposal in more detail in "Part V" of this volume.)

Given the current low rate of engagement with program activities, we concur that the CalWORKs program is in need of reforms which will increase work participation so that recipients can move toward self-sufficiency. We are concerned, however, as discussed in the *Analysis,* that the Governor's proposals to restrict eligible work activities may unnecessarily limit county flexibility to find the optimal mix of work, training, and employment activities so as to help recipients leave cash assistance. Further, the administration's assumptions concerning the effectiveness of its proposed reforms may be overly optimistic. Given that counties have a fiscal incentive to help recipients become self-sufficient, the Legislature should consider retaining as much county flexibility over program control as is possible. Finally, in evaluating the Governor's welfare reform proposal, the Legislature should weigh the benefits of increased program participation against the potential adverse impact on children in families who are unable or unwilling to comply with stricter work requirements

The Governor has suggested a good starting point for discussion of foster care reforms. To improve the foster care system, we suggest that the Legislature examine three additional potential areas of reform beyond those proposed by the Governor. First, in previous analyses, we have presented Foster Family Agency (FFA) reform proposals that would reduce the length of time a child stays in FFA homes by increasing the incentive to move toward permanency placement. This could substan-

tially reduce state costs. Second, under current law, specialized care increments paid to Foster Care providers vary by county and have little rational connection to the actual needs of the child. We suggest reforming these increments so as to reflect state policy concerning the special needs of foster youth rather than historical rate structures which vary by county. Finally, we would suggest developing and implementing a detailed plan to increase the supply of foster family homes, which are the lowest cost type of placement.

Another program that could benefit from reform is the fast-growing Adoptions Assistance Program (AAP). Currently, AAP provides the maximum foster care grant to virtually every child who is adopted from the foster care program regardless of whether that child would be "hard to place" with an adoptive family. We recommend that the Legislature consider (1) setting AAP grants at levels that recognize the adoptive parents' financial responsibility for their adoptive children and (2) tying benefit levels more closely to the needs of the adoptive children. (We discuss our proposal in more detail in the *Analysis*.)

Timing an Important but Secondary Concern. As the Legislature considers the Governor's proposals, it should carefully assess whether the savings that are proposed can be achieved in the time frame identified in the budget plan. This is a particularly important issue for the Legislature to consider in cases in which the budget plan assumes the achievement of savings in the budget year. For example, our analysis indicates that it may be difficult to obtain the savings projected for 2004-05 from reform of the foster care system. To the extent that the budget plan overestimates the fiscal benefit of such reform proposals, it could prolong the state's fiscal difficulties by contributing to future budgetary shortfalls.

However, we also recommend that the Legislature consider the timing of the "payoff" from program reform as a secondary matter, and to first judge reform proposals primarily on their overall policy merit and potential long-term fiscal benefit to the state. In other words, we urge the Legislature not to disregard reform proposals simply because their savings will be minimal or nonexistent in the budget year, or perhaps even require an "up-front" investment of state resources in the short term to accomplish. This is because, while a particular reform proposal may not "ramp up" to provide substantial state savings in some instances for another year or more, the state's structural budget gap means that those savings may nonetheless be needed to help prevent future budget shortfalls.

JUVENILE JUSTICE SYSTEM REFORM

Proposal

The Governor's budget proposes a number of reforms for the California Department of Corrections (CDC) and the Youth Authority. (For our comments on the administration's proposals in CDC please see page D-68 of the *Analysis*.) In this piece, we discuss the Governor's proposals regarding the Youth Authority.

The *Governor's Budget Summary* indicates that the administration seeks to preserve the mission of the Youth Authority by focusing its efforts on treatment and training, and the provision of services for specialized populations. The budget proposes to accomplish this by moving certain wards out of the Youth Authority and into CDC. Specifically, it proposes to lower the age jurisdiction of the Youth Authority from wards who are 25 years of age to those 22 years of age. It also proposes sentencing reform, referred to as "blended sentence," in which the juvenile is given a dual sentence to both the juvenile and adult system, so that he or she can be transferred to prison under certain circumstances.

Details Lacking on Fiscal and Programmatic Impact. At the time this analysis was prepared, the details of the Youth Authority proposals had not been provided to the Legislature. Based upon the description in the budget summary document, and discussions with Youth Authority staff, it seems likely that the proposals will shift some costs from the Youth Authority to CDC. In addition, to the extent that the proposed sentencing changes affect juvenile and/or criminal trial procedures, there potentially could be unknown budgetary impacts on state trial court funding and local law enforcement.

The Problem

The Governor's budget suggests that the problem facing the Youth Authority is that it has had to shift its focus away from its rehabilitation mission in order to control the behavior of wards that have limited interest in rehabilitation. We believe the Legislature should take a broader view of juvenile justice reform.

From our perspective, the juvenile justice system in California is bifurcated with the state and local systems providing many of the same services. Because both the state and local governments provide services, there is a reduced level of accountability for program outcomes, and reduced local incentives to develop programs targeted to all juvenile offenders. The state has a unique opportunity because of the declining popu-

lation of wards at both the state and local levels, as well as the trend of below average growth in the juvenile population, to reform this system.

Issues for Legislative Consideration

We agree with the Governor's policy goal of improving treatment and training opportunities for juvenile offenders because this is consistent with the statutory mission of the Youth Authority. We also agree that there may be opportunities to target resources to the provision of specialized services, and that this would be an improvement over providing across-the-board treatment services which are duplicative of services provided at the local level.

As an alternative to the Governor's proposal, the Legislature may wish to consider a reform proposal that we have recommended in the past (*Making Government Make Sense: Applying the Concept in 1993-94*, May 1993). It would (1) shift responsibility for the relatively small population of youthful offenders in the Youth Authority back to the counties and (2) change the role of the state to that of a "service provider" from whom the counties would buy services.

Local Control and Delivery. Under the current system, the state assumes full responsibility for the treatment and incarceration of certain wards. From the time the wards are committed to the Youth Authority to the time they complete parole, the programming and much of its attendant costs fall squarely on the state. As we discuss below, counties pay a share of incarceration costs. Even when these juveniles—or young adults as the case may be—return to their communities on parole supervision, the state remains responsible for funding their services.

As an alternative, our proposal would shift responsibility for these youth offenders—including both incarceration and community supervision—to the local governments. Under this model, the state would be a service provider to the counties. Counties would make the programmatic and fiscal decision to serve juvenile offenders locally or send them to state institutions.

Funding Mechanism. Although our proposal envisions shifting responsibility for both incarceration and community supervision to the local level as part of the local juvenile justice system, from a funding perspective it may be desirable to handle them separately.

- ***Incarceration Services.*** Under current law, counties pay through the sliding scale fee a share of the cost of *incarcerating* wards committed by them to the Youth Authority. The share that counties pay is based upon the commitment offense of the juvenile. The purpose of the sliding scale fees is to encourage counties to re-

tain lower level offenders in the local program rather than send them to the Youth Authority. Accordingly, counties pay more for Youth Authority wards with lower level offenses and less for wards with more serious commitment offenses. Under our proposal, the sliding scale fees would be replaced by a flat rate covering the full cost to the state for all commitments to the Youth Authority should counties choose to buy the services offered by the state.

In view of the fiscal challenges facing local governments, as well as other budget proposals affecting them, the Legislature may wish to apply the full cost prospectively. To further mitigate the potential fiscal impact on local governments, the Legislature may also wish to consider phasing-in the proposed change.

- ***Community Supervision.*** In addition to incarceration of youthful offenders, the Youth Authority provides community supervision of wards released from its institutions. Counties currently do not pay for these services. Under our approach, this function would be completely absorbed within the existing local probation system. In other words, the state would no longer provide community supervision, or parole services for youthful offenders not even as a service provider. Individuals leaving the state Youth Authority would transition directly into the local probation system. State funding that would otherwise be used for juvenile parole services could be redirected to county probation departments in the form of a subvention grant based on the number of wards being released to those communities from the institutions.

State and Local Benefits of Reform. We believe this reform proposal will likely result in a number of benefits. First, it would reduce the level of duplication within the state and local system. Second, it would place both programmatic and fiscal control of juvenile justice services at the local level, which would make one entity accountable for program outcomes, and at the same time provide greater discretion to communities. Third, we believe it would provide counties a stronger incentive to intervene early with criminal offenders and develop alternative methods of incarceration and services to minimize the risk of reoffending. Fourth, it would provide counties an incentive to build upon the services that are already provided at the local level.

Consider a More Specialized Role for Youth Authority. The downsizing of the Youth Authority that would likely occur under this proposal would also present an opportunity for the development of more specialized programs. Rather than offering across-the-board services to

juvenile offenders, the state may offer specialized services to a targeted group of juvenile offenders. For example, the Youth Authority has experienced an increase in the number of wards with mental health needs. Our discussions with state officials indicate that local juvenile justice systems in many counties are not equipped to serve juvenile offenders with a combination of violent offenses, and mental illness. One option for legislative consideration is targeting the Youth Authority mission to serving this population, and perhaps other special populations of youthful offenders. The objective would be to focus the state's resources on providing services that are lacking at the local level, and that would be costly to develop in individual counties.

TRANSPORTATION

California's state transportation programs are funded by a variety of sources including special funds, federal funds, and general obligation bonds. The State Highway Account (SHA) has traditionally provided the primary source of state funds for transportation, with revenues generated mainly from an 18-cent per gallon tax on gasoline and diesel fuel (referred to as the gas tax) and truck weight fees.

In 2000, the Legislature enacted the Traffic Congestion Relief Program (TCRP) to supplement state transportation funding from 2000-01 through 2005-06, primarily by redirecting the sales tax on gasoline to transportation purposes. (Otherwise, these funds would have gone to other state General Fund purposes.) The original TCRP was to provide funding for several transportation programs, including $4.9 billion for 141 specified projects and about $2.7 billion for other capital outlay projects, local street and road improvements, and mass transportation programs.

The TCRP was later extended by statute through 2007-08. In addition, in March 2002, the voters passed Proposition 42, which committed the sales tax on gasoline to transportation in perpetuity. However, Proposition 42 also contained a provision that allows this funding to remain in the General Fund under specified circumstances.

Substantial Transportation Funds Used to Help the General Fund. Since the enactment of TCRP, most of the additional money that was supposed to be used for transportation purposes has instead remained in the General Fund. Transfers to transportation funds have been delayed or suspended, and much of the General Fund money that was transferred has been loaned back. Specifically, since 2001-02, about $2.2 billion in TCRP and Proposition 42 funds have been loaned to the General Fund. This amount includes a total of about $1.4 billion prior to the enactment

of Proposition 42, and $856 million in 2003-04 as a result of the partial suspension of Proposition 42. Under current law, these loans are to be repaid by 2005-06 and 2008-09, respectively.

Proposal

The Governor proposes a number of actions in transportation in order to provide an additional $2 billion in help to the General Fund for 2003-04 and 2004-05 combined.

2003-04 Mid-Year Changes. In November 2003, the administration proposed the following actions to provide $920 million in help for the General Fund:

- "Cash in" $800 million in federal money sooner by changing—from an accrual basis to a cash basis—the way the state accounts for these funds used on local transportation projects. Of the amount generated, (1) $406 million would be paid to the General Fund for debt service on three existing general obligation bonds for transportation; (2) $200 million would be loaned to the General Fund, to be repaid by June 30, 2007; and (3) the remaining $194 million would remain in the SHA for statewide transportation purposes.
- Eliminate funding of TCRP projects and revert $189 million to the General Fund.
- Transfer to the General Fund, over the two years, $108 million in various nongas tax income in the SHA that is not subject to restrictions of Article XIX of the State Constitution, and retain in the General Fund about $18 million in gasoline and diesel sales tax revenue that otherwise would have been available for various mass transportation programs.

Budget-Year Adjustments. For 2004-05, the Governor proposes to:

- Suspend the Proposition 42 transfer of about $1.1 billion in gasoline sales tax revenue. Instead, the revenue would remain in the General Fund.
- Repeal the TCRP and eliminate the existing statutory commitment to fund TCRP projects.
- Transfer to the General Fund $745,000 from the Aeronautics Account, which gets its revenues mainly from an excise tax on gasoline used in aviation. Funds are used to provide operating and capital improvement grants to general aviation airports statewide.

Proposed Transportation Aid to General Fund Is Substantial. The Governor's mid-year proposals together with the Proposition 42 suspension in 2004-05 would provide about $2 billion in transportation funds to the General Fund in the current and budget years. Combined with previous loans of $2.2 billion, the Governor's proposals would bring the total aid to the General Fund from various transportation funds to about $4.3 billion since 2001-02.

Proposals Would Reduce Already Limited Transportation Funding in the Near Term, Causing Project Delays That Harm the Economy. The state had expected a large influx of funding in transportation for the past few years, but this influx has not materialized. Specifically, state funding promised in the TCRP has been delayed and loaned back to the General Fund, and truck weight fee revenues have been lower than anticipated. In addition, a delay in the reauthorization of the federal transportation act has resulted in less federal money available for transportation in 2003-04 than originally anticipated. This decline in expected funding has severely restricted the state's capacity to fund new transportation projects, causing project delays.

Delays in transportation projects harm the state's economy. When the transportation system fails to keep pace with the state's population and travel demand, traffic congestion worsens. Congestion now costs California drivers more than $4.7 billion in wasted time and fuel—thereby diverting these resources from more productive uses, causing higher costs and reduced profits for businesses, and potentially reducing economic output and jobs.

By reducing near-term transportation funding in the current and budget years, the administration's proposals would further slow transportation projects. Eliminating funding for TCRP projects would result in complete stoppage of work on many of these projects, resulting in unknown closeout costs.

Proposals Would Increase Instability for Transportation Funding in the Long Term. While vehicle travel and transportation funding requirements continue to increase, inflation-adjusted state transportation revenues have declined, primarily revenues from the state gas tax. In addition, the level of future transportation revenues is highly uncertain. The primary source of uncertainty is the possibility that Proposition 42 will be suspended in the future, particularly in light of projected ongoing General Fund problems. These problems also make it highly unlikely that the General Fund will repay on schedule the substantial loans it has received from transportation. Uncertainties in funding, particularly for large projects with multiple funding sources, could result in projects being cancelled or delayed, incurring potentially large costs in the process.

Issues for Legislative Consideration

In considering the Governor's proposals related to Proposition 42, the Legislature should address (1) how much funding to provide to TCRP projects in the near term, if any, and (2) how to provide long-term funding stability for the state's transportation program.

Should TCRP Projects Be Continued in the Near Term? A significant near-term transportation funding decision facing the Legislature is whether to suspend all TCRP funding and repeal the program, as proposed by the administration, or to continue funding the program at some level. Repealing the program would eliminate all project expenditures in the budget year, but would also result in unknown project closeout costs. Additionally, eliminating dedicated funding for TCRP projects means that some of the projects would compete with other non-TCRP projects for funding in the State Transportation Improvement Program (STIP). This could cause a reprioritization of projects in many regions of the state, with some existing STIP projects being pushed back. As a result, both TCRP and STIP projects would be delayed.

To decide on whether to repeal the program, the Legislature first needs to know what is the expected cost to close out TCRP projects. Absent this information, the Legislature cannot compare the potential fiscal impact of all the options before it.

If the Legislature decides not to terminate the program, it has various options to allow the program to proceed. These range from funding only projects with existing allocations, to providing enough funding to allow allocations for new projects in the budget year. Clearly, the more projects the Legislature decides to fund, the more money will have to be provided. Increasing funding for TCRP projects would compete with other legislative priorities.

How Can Long-Term Funding Stability Be Provided? Funding stability is of paramount importance for transportation projects. Uncertainty in funding makes long-term planning difficult. Large fluctuations in funding, like those experienced in recent years due to TCRP and Proposition 42, result in money being wasted due to stopping and restarting work on projects. Thus, stabilizing transportation funding would increase the efficiency of transportation expenditures. The Legislature has primarily two options to reduce funding uncertainty, both requiring a change in the Constitution.

- ***Firewall Proposition 42.*** This change would entail removing the provision within Article XIX B of the Constitution that allows for the suspension of Proposition 42. This would ensure that transportation projects receive all the funds that are expected from

this source. However, this would eliminate a means for the state to address any significant future General Fund problems.

- ***Repeal Proposition 42.*** This change would remove Article XIX B from the Constitution and remove all statutory references to TCRP. This would allow the sales tax on gasoline to remain in the General Fund, as was the practice prior to Proposition 42. Under this option, more than $1 billion annually would be available for General Fund-supported programs on an ongoing basis. However, transportation funding, while more predictable, would be at a lower level unless alternative sources are provided.

While both options would increase long-term transportation funding predictability, they differ in terms of the amount of transportation funding they provide. Since identified transportation funding requirements far outweigh available funding, if the Legislature chooses to repeal Proposition 42, we believe the lost transportation funding should be replaced from a different source.

Gas Tax Is a Logical Transportation Funding Source. Transportation spending has traditionally been funded by an excise tax on gasoline and diesel fuel. This tax has several qualities that make it a logical source for transportation funding:

- ***Roughly a User Fee.*** The gas tax is charged to drivers only, in rough proportion to the amount of driving they do. The relationship is not exact because gas mileage varies according to vehicle type and driving conditions, but the amount of tax paid does track closely with the amount of mileage driven. Thus, the gas tax approximates a fee charged for the provision of a service—that is, the road used by the driver. Most other potential transportation funding sources, such as local sales taxes, bear no relationship to miles driven. Only direct tolls for road use are closer to a user fee for driving than the gas tax.

- ***Simple to Collect.*** Collection of the gas tax is relatively efficient. Drivers are not inconvenienced, as they pay the tax whenever they stop for fuel. Collection at the state level is simple as well, as the state collects the tax directly from fuel distributors, which are few in number.

Because of the qualities noted above, we believe that the state should rely on the excise tax on gasoline and diesel fuel as the main source of transportation funding. We estimate that an increase of 6-cents per gallon in this tax would generate about the same amount of revenue that otherwise would be provided by Proposition 42. In addition, since Propo-

sition 42 revenue increases with inflation over time, a per-gallon excise tax meant to replace this revenue would also need to grow over time to remain at that value level.

Recommend That Legislature Raise and Index Gas Tax to Provide Stable Transportation Funding. To provide ongoing predictability for transportation funding at a level equivalent to that envisioned under current law, we recommend that the Legislature take actions to (1) ask the voters to repeal Proposition 42 and (2) increase the state gas tax to provide an equivalent amount of revenue as would be generated under Proposition 42. Furthermore, to prevent the future erosion of transportation funding relative to road use, we recommend that the gas tax be indexed to the California consumer price index.

RESOURCES

Proposal

Funding for Resources and Environmental Protection Programs. The Governor's budget proposes a few fee increases in order to reduce General Fund expenditures in the resources area, the largest being an increase of $15 million in state park fees. General Fund support remains substantial for 2004-05 in the following areas.

- ***Fire Protection.*** The budget proposes $589.5 million for the California Department of Forestry and Fire Protection (CDFFP) to provide fire protection services to property owners in "state responsibility areas" (SRAs). Of this amount, $353.1 million is from the General Fund, with the balance from fees ($52.5 million), reimbursements ($165.5 million), and federal and other funds ($182.3 million).
- ***Timber Harvest Plan (THP) Review.*** The budget proposes $20.3 million for various state agencies to review and enforce THPs which lay out proposed harvest volume, cutting method, and wildlife habitat protection. Of this amount, $9 million is from the General Fund, with the balance coming from fees ($10 million) and other special funds ($1.3 million).
- ***Coastal Development Permitting and Enforcement.*** The budget proposes total expenditures of about $10.1 million for the California Coastal Commission and the San Francisco Bay Conservation and Development Commission (BCDC) to issue and enforce coastal development permits. Of this amount, about $7.8 million

is from the General Fund, with the balance coming from reimbursements, penalties, and federal funds.

- ***Risk Assessment.*** The budget proposes $12.5 million for the Office of Environmental Health Hazard Assessment's (OEHHA's) risk assessment programs. Of this amount, about $8.1 million is from the General Fund, with the balance coming from various special funds and reimbursements.

Bond Expenditure Proposals. The budget proposes $136 million of bond funds for various resources and environmental protection programs—a reduction of about 97 percent from estimated bond expenditures in the current year. This substantial reduction largely reflects the administration's decision to defer the submittal of most of the Governor's resources bond proposals to later in the spring. The significant bond expenditure proposals in the January budget include:

- ***CALFED Bay-Delta Program (CALFED).*** The budget proposes $20.3 million from various bond funds for CALFED. These funds are to support staff in several CALFED program elements, with the surface storage program receiving the largest amount of funding.

- ***Habitat Conservation Fund (HCF).*** As in the current year, the budget proposes to transfer $21 million of Proposition 50 bond funds to HCF. The HCF funds wildlife habitat acquisitions and improvements in the Wildlife Conservation Board.

- ***State Parks.*** The budget proposes about $24 million from Proposition 12 and Proposition 40 bond funds for state park operations and capital outlay.

- ***Safe Drinking Water.*** The budget proposes $24 million from Proposition 13 bond funds for grants and loans to upgrade safe drinking water infrastructure. (These funds are administered by the Department of Health Services [DHS].)

CALFED Bay-Delta Program. The budget proposes $68.6 million of state funds—spread throughout six state departments—for CALFED-related programs in 2004-05. Of this amount, $12 million is proposed from the General Fund, with the balance mainly from State Water project funds ($33.4 million) and various bond funds ($20.3 million). This level of expenditure is an 87 percent reduction from the current year. This substantial expenditure reduction largely reflects the administration's decision to defer to later in the spring the submittal of most of the Governor's resources bond proposals.

The largest state expenditures for CALFED are proposed for water conveyance ($21.5 million) and ecosystem restoration ($11.9 million).

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 $170 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 an environmental regulatory program (such as coastal development permitting or timber harvest plan review) that could reasonably be funded from entities seeking regulatory approval to conduct a business activity.

The specific opportunities for General Fund savings are:

- ***Fire Protection.*** Although there is an existing fee levied on property owners in SRAs, the fee covers less than 10 percent of CDFFP's costs to provide its fire protection services. We think that the level of benefit directly received by these property owners from CDFFP's services justifies an increase in the funding contribution from the property owners. We therefore recommend that the existing fee be increased so that CDFFP's fire protection costs are shared equally between the General Fund and the property owners. Adoption of this recommendation would save the General Fund an additional $150 million annually.

- ***THP Review.*** We think that timber owners who benefit from the state's review and enforcement of THPs should pay fully for those activities, rather than partially as proposed by the budget. Adoption of this recommendation would save the General Fund an additional $9 million annually.

- ***Coastal Development Permitting and Enforcement.*** Because developers benefit from the permitting and enforcement activities of the Coastal Commission and BCDC, we believe they should pay for such services. Such a shift would reduce General Fund costs by $7.8 million annually.

- ***Risk Assessment.*** A number of OEHHA's risk assessment activities—currently funded by the General Fund—directly support environmental regulatory programs and benefit the parties regulated under these programs. We recommend that fee payers in those regulatory programs pay for these activities. Adoption of

this fund shift would save the General Fund about $3.6 million annually.

Bond Expenditure Proposals. We offer a framework to assist the Legislature in evaluating the Governor's forthcoming bond proposals:

- ***Ensure Proposal Reflects Legislative Funding Priorities.*** The Legislature should ensure that the Governor's bond proposals include funding for legislative priorities. For example, in recent years, the Legislature has expressed its commitment to funding CALFED by approving substantial bond fund expenditures for this program.

- ***Consider Status of Prior Bond Fund Appropriations.*** We recommend that the administration report at budget hearings on (1) the expenditure of resources bond funds appropriated in the current and prior years and (2) its plan for improving the timeliness of implementing bond-funded programs that have been delayed for various reasons, including staffing reductions. This information will assist the Legislature in determining the amount of bond funds to appropriate in 2004-05 (as balances from prior-year appropriations could affect the total level of budget-year expenditures) and in identifying and addressing impediments to the timeliness of implementing bond-funded programs.

- ***Ensure Coordination of Land Acquisition Activities.*** With multiple agencies acquiring land for resources purposes with bond funds, it is important that the state's efforts be coordinated. We recommend that the Secretary of Resources report to the Legislature on its plans to coordinate the state's land acquisition activities. As part of this report, we also recommend that the Secretary discuss the administration's plan to ensure that development and operational costs that arise from land acquisitions are adequately funded.

- ***Ensure Administrative Costs Are Reasonable.*** The administrative costs associated with implementing the Governor's bond proposals should be evaluated for their reasonableness. While what is reasonable may vary by program, we think that a 5 percent cap on administrative costs for bond-funded grant programs and property acquisitions is a good rule of thumb, in light of historical experiences with bond program administration and prior legislative direction on this issue in past bond measures.

- ***Ensure Legislative Direction Is Followed.*** In evaluating the Governor's proposals, the Legislature should consider whether

the proposals are consistent with previous direction provided by the Legislature, such as that found in implementing legislation. For example, Chapter 240, Statutes of 2003 (AB 1747, Committee on Budget), requires the development of grant and loan project solicitation and evaluation guidelines and specifies that priority be given to certain types of projects.

CALFED Bay-Delta Program. The CALFED program is estimated to cost about $9.2 billion over the program's first seven years from 2000-01 through 2006-07. However, a funding gap of roughly $6 billion exists, based on actual funding to date and projections of expected funding. Our review finds that, to date, there has been little direct application of the "beneficiary pays" principle in allocating the costs of this program. We recommend applying this principle in funding CALFED, both as a means to address the funding gap and provide a more appropriate allocation of the program's costs to the program's beneficiaries.

We recommend a funding framework for CALFED, consisting of the following four steps to be taken by the Legislature:

- ***Adopt Beneficiary Pays Principle in Statute.*** We recommend the enactment of legislation that adopts the beneficiary pays principle for funding CALFED and provides guidance for its application. Fairness and administrative simplicity should guide the application of this principle. The CALFED activities should be broadly categorized based on the directness of the connection between costs and the benefits received by a well-defined, discrete group of beneficiaries. The legislation should recognize that for a large number of CALFED activities, benefits are shared between the public-at-large and a large, but definable, group of water users.
- ***Enact a Fee on Water Users Taking Water From the Bay-Delta System.*** We recommend the enactment of legislation imposing a fee on the broad group of water users taking water from the Bay-Delta system under the state's system of water rights. This would include water agencies receiving water under contract from the State Water Project, as well as individual water right holders. Revenues from this fee would partially cover the costs of CALFED activities that jointly benefit the public-at-large and these water users.
- ***Reevaluate Existing Statutory Cost-Sharing Provisions for Water Projects.*** We recommend that the Legislature reevaluate cost-sharing provisions for water projects under current law for their consistency with the beneficiary pays principle. These provisions include cost-sharing arrangements for flood control and Delta

levee projects. As regards to federally authorized flood control projects, we specifically recommend increasing the local portion of the cost share to better reflect the local benefit from these projects.

- ***Establish Financial Planning Requirements for California Bay-Delta Authority.*** Finally, we recommend that the California Bay-Delta Authority be directed to develop, and update annually, a long-term financial plan for funding CALFED for submittal with the Governor's annual budget proposal.

EMPLOYEE COMPENSATION

Pay for State Employees. State employees were scheduled for a salary increase on July 1, 2003 (5 percent for most employees). In order to generate 2003-04 savings, the prior administration entered into negotiations with employee unions. Bargaining units that agreed to defer these salary increases received additional benefits. In particular, in exchange for delaying pay increases for one year, the administration agreed to (1) pay 80 percent of health insurance costs effective January 1, 2004; (2) allow employees to accrue one additional vacation day per month (approximately equivalent to the deferred 5 percent salary increase for most employees); and (3) in some cases, continue the suspension of employees' retirement contributions to maintain take-home pay at June 2003 levels.

Retirement Costs. The state makes annual contributions to the 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 2004-05, the estimated state contribution to PERS is $2.6 billion. Of that amount, the General Fund would contribute $1.4 billion. The General Fund provides the entire state contribution to STRS, which is estimated at $1.1 billion in the budget year.

Proposal

Increased Pay for Employees. The Governor's budget includes $875 million ($464 million General Fund) for increased expenses in employee salaries and benefits. Specifically, the increased funds would primarily pay for:

- Last year's renegotiated collective bargaining agreements ($569 million).
- Pay raises for highway patrol and correctional officers ($295 million). In 2004-05, pursuant to long-term agreements, correctional

officers will receive increases of 11 percent and highway patrol officers will receive increases of 12 percent (5 percent of this amount is deferred from 2003-04).

Retirement Changes. The Governor's budget has three retirement-related proposals:

- A pension obligation bond to finance more than $900 million of the state's 2004-05 retirement contributions.
- A 1 percent increase in employee contributions from current state workers.
- Enrolling new employees in the retirement plans in effect prior to the benefits increase authorized by Chapter 555, Statutes of 1999 (SB 400, Ortiz). This would enroll new Miscellaneous employees in the "Tier 2" plan.

Issues for Legislative Consideration

Incurring Debt for Operating Costs Is Ill Advised. Courts have thus far prevented the state from issuing pension obligation bonds. Regardless of its legality, 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 the administration's pension bond proposal.

Additional Contributions From Current Employees Would Require Agreement of Unions. Increasing current employee retirement contributions would require the agreement of state employee unions. It is unclear at this time what concessions the administration would have to make in order for unions to agree to such a change. Thus, when reviewing negotiated contracts for approval, the Legislature will have to consider the merits and costs of the total package.

State Could Adopt Proposal for New Employees on Its Own. The administration has assumed that rolling back retirement benefits for new employees would be negotiated as current collective bargaining agreements expire. This would delay full implementation for several years. This delay, however, is not necessary. The state previously has changed retirement benefits for new employees through legislation outside of the collective bargaining process. Adopting this proposal immediately would increase state savings in the short term.

Other Options Worth Considering. In addition to considering the administration's proposal for new employees, the Legislature should also consider alternatives such as Tier 2 and defined contribution plans for *all* new employees. These alternatives would result in more state savings

and provide other state benefits. For instance, defined contribution plans would give the state predictable retirement expenses each year.

MID-YEAR SPENDING REDUCTIONS

In order to achieve budget savings in the current year, Control Section 4.10 of the *2003-04 Budget Bill* authorizes the administration to reduce state operations appropriations, abolish positions, and reallocate funds among items of appropriation. Specifically, Control Section 4.10 instructs the administration to abolish as many as 16,000 positions throughout state government and reduce individual state operations appropriations by up to 15 percent. The reductions to appropriations must total at least $307 million, including at least $181 million in General Fund reductions. The administration is required to notify the Legislature 30 days prior to adjusting an appropriation pursuant to Control Section 4.10.

Appropriations Reduced by $425 Million. Thus far, the administration has notified the Legislature of Control Section 4.10 actions reducing appropriations by $425 million ($181 million General Fund). The administration has also eliminated 9,313 positions. Figure 11 summarizes the reductions by program area.

Proposal

As part of the Governor's budget, all of the Control Section 4.10 reductions already implemented have been built into departments' baselines for 2004-05. In addition, as part of its mid-year reductions proposed in November 2003, the administration stated its intention to use Control Section 4.10 to make further reductions this year in General Fund appropriations totaling $150 million (beyond those already shown in departmental budgets). As with the reductions already implemented, the administration expects to build these additional reductions into departments' 2004-05 budgets to provide ongoing savings. The administration, however, does *not* propose to include any language similar to Control Section 4.10 in the *2004-05 Budget Bill.*

Figure 11

Control Section 4.10 Reductions, by Program Area

(Dollars in Millions)

	Personnel		Reduction to Appropriations			
Area	Reduced Personnel Years	Share of Total	General Fund	Share of Total	All Funds	Share of Total
Criminal Justice	1,540	17%	$27.5	15%	$29.3	7%
General Government	3,236	35	65.1	36	116.6	27
Health	1,077	12	39.1	22	43.2	10
Higher Education	103	1	3.2	2	5.3	1
K-12 Education	75	1	5.9	3	6.8	2
Resources	1,086	12	32.7	18	69.2	16
Social Services	469	5	7.6	4	13.9	3
Transportation	1,727	19	0.1	—	140.3	33
Totals	**9,313**	**100%**	**$181.2**	**100%**	**$424.6**	**100%**

Totals may not add due to rounding.

Issues for Legislative Consideration

Program Impact Unknown. The Control Section 4.10 reductions were implemented with almost no detail provided to the Legislature regarding their programmatic impact. For example, in fall 2003, we sought to determine how the reductions would affect the delivery of services and the collection of revenues. The administration, however, has not shared the departmental reduction plans (which would allow this type of detailed analysis) with the Legislature. On December 22, 2003, after the 30-day legislative review period elapsed, the administration did provide details on the positions eliminated. Yet, this information still does not provide sufficient detail to determine programmatic impacts. For instance, the information lists which positions were eliminated but not the specific work that the positions were performing. The information also does not tell the Legislature if the eliminated positions' workload will be absorbed by other positions or no longer completed.

Reductions Reflect Administration's—Not Legislature's—Priorities. Any unallocated reduction authority given to the administration will expose legislative priorities to reductions. On the natural, an administration will protect its own priorities and sacrifice programs that it deems

less important. In order to protect its own priorities, the Legislature would need to identify *specific* lower priority reductions during the budget process—rather than relying on unallocated reductions. While the full programmatic impact of the Control Section 4.10 reductions may not be known for some time, it is likely that many of the reductions will have been made to programs of particular interest to the Legislature. For example:

- ***Department of Health Services (DHS).*** The department's prostate cancer treatment program was reduced from $8.2 million to $3.9 million (a reduction of 52 percent) under this authority. (Such a large reduction can occur under Control Section 4.10 if a program is funded as a part of a larger item of appropriation.) Additionally, the Legislature provided DHS with 161 new positions in the 2003-04 budget to increase Medi-Cal antifraud activities. The Control Section 4.10 reductions, however, eliminated 31 of these new positions, thus slowing implementation of this cost-saving effort.

- ***Department of Motor Vehicles (DMV).*** The department lost about 600 positions, including about 300 positions in the field operations division. The reductions have contributed to significantly longer lines at DMV offices and average wait times of nearly an hour (twice the goal set by the Legislature).

Will the Reductions Affect Revenues? In the absence of programmatic impact information, it is impossible to assess how the reductions will affect the collection of revenues for some departments. For example, the Board of Equalization's (BOE) appropriations were reduced by $16.5 million and the Franchise Tax Board's (FTB) appropriations were reduced by $21.9 million. The administration has reported that BOE's reductions will reduce General Fund revenues by $27 million in 2004-05, but has not indicated a revenue loss associated with FTB's reductions.

Are the Reductions Achievable? In addition, it is not known if the reductions are actually achievable. For instance, the CDC General Fund appropriation was reduced by $23 million through Control Section 4.10. The administration, however, then requested a General Fund *increase* in the hundreds of millions of dollars through the deficiency process. In essence, rather than reducing costs for CDC, the administration simply shifted $23 million of costs to the deficiency process.

Questionable Benefit of Including Special Funds. While the state's financial problems are largely limited to the General Fund, Control Section 4.10 authorizes position reductions and savings in all funds. As noted in Figure 12, non-General Fund appropriations have been reduced by $243 million. In some cases, the special fund position and appropriation

reductions may have streamlined operations, eliminated unnecessary positions, or created efficiencies. Through the course of our analysis of the Governor's budget proposals for 2004-05, however, we have found that the implementation of some of these special funds reductions has been detrimental to the state's efforts to serve the public—while providing no benefit to the General Fund. Moreover, as a result of reductions to staff and appropriations, fees or other revenues paid into special funds may now sit unused because there is no staff to implement the scheduled programs. For instance:

- ***Department of Transportation.*** The department lost a significant number of positions which had been funded by the Toll Bridge Seismic Retrofit Account. The revenues to the account are from a recent increase in toll bridge fees, intended to be used for the seismic retrofit of bridges in the Bay Area. Despite the increased revenues, the retrofit projects have been slowed by the loss of positions.
- ***Department of Alcoholic Beverage Control.*** The department lost 26 positions which were funded out of the Alcoholic Beverage Control Fund. Chapter 488, Statutes of 2001 (AB 1298, Wesson), increased industry licensing fees with the expectation of increased licensing and regulatory activities. The department indicates that the lack of positions has impeded its efforts in this area, even though the fund has sufficient revenues.

Conclusion. While Control Section 4.10 has generated significant savings, it has resulted in a number of unintended consequences. We concur that this administrative authority should be discontinued.

MAXIMIZING FEDERAL FUNDS

Under the Governor's budget proposal, federal funds for the support of state operations and local assistance programs would total $55 billion in 2004-05, a decrease of about $3 billion, or 5.2 percent, below the revised current-year level of spending.

Proposal

Efforts to Secure Additional Federal Funds. The administration proposes various actions to increase the state's share of federal funding or to reduce the impact on the state of various federal sanctions and mandates in order to help hold down the growth in state costs. The administration indicates it is pursuing issues related to health and social services programs, transportation, homeland security, criminal justice, and educa-

tion funding, and assumes that these efforts to secure federal assistance will collectively result in $350 million in offsets to state costs.

The administration has specifically indicated that it will seek action by Congress to ensure that the state receives its "fair share" of federal funds by (1) extending a temporary increase allowed last year in the federal share of costs for the Medicaid Program (known as Medi-Cal in California), thereby reducing the state share of support for Medi-Cal; (2) making available to the state federal matching funds to offset its estimated $182 million annual cost for providing nonemergency services, such as family planning and long-term care, for undocumented immigrants; (3) updating state allocations for federal Child Care and Development Fund grants that disadvantage California; (4) changing federal allocation formulas for homeland security funds to base them on a state's threat and vulnerability to terrorism; (5) seeking congressional help to increase the state's share of federal transportation funding; and (6) increasing community college fees to the point where California students would become eligible to access the full grant levels allowed for federal Pell Grants, and making students aware of their eligibility for federal education tax credits.

Relief Sought From Federal Mandates and Sanctions. The administration has also indicated that it will seek relief from various federal requirements that could have a fiscal impact on the state. Among the requirements cited are (1) mandates that information materials be sent to all mental health managed care clients, (2) financial penalties assessed against the state for delays in establishing a statewide child support system, (3) sanctions for error rates in the Food Stamps Program, (4) disallowance of federal funding for the Child Welfare Services/Case Management System, and (5) potential financial sanctions against the state for noncompliance with Child Welfare Program standards. The state is already subject to penalties for the child support system delays (estimated at $220 million for 2004-05). The state budget plan at this point generally does not account for costs relating to the other potential sanctions identified by the administration.

Issues for Legislative Consideration

Federal Funding a Longstanding Concern. Federal funds are a critical source of support for a wide range of state programs. Seemingly minor changes in governmental programs can put the state at a major financial disadvantage in its receipt of federal funds. For example, in our discussion of the transportation budget in the *Analysis* (please see page A-32), we note that the state's conversion from fuel blended with MTBE to an ethanol blend could reduce federal revenues to California by as much as $563 million in 2005-06 and by more than $700 million annually

thereafter. Because the federal tax on ethanol-blended fuel is about 29 percent less than on fuel with no ethanol content and a portion of the revenue is directed to the federal General Fund, federal funding for California's projects would be less than before the conversion.

Some Actions Within State Control. Our analysis indicates that there are some steps the state can take largely on its own to take greater advantage of available federal funding. For example, in the *Analysis*, we propose that some participants in the largely state-funded Access for Infants and Mothers program be shifted to the Healthy Families Program, in which two dollars in federal support can be drawn down for each one dollar of state funding. Similarly, in the "Crosscutting Issues" section of the "Health and Social Services" chapter of the *Analysis*, we highlight a strategy by which "quality improvement fees" could be assessed on certain groups of medical providers to draw down additional federal funding and reduce state program costs.

Likewise, in our analysis of the Food Stamps Program, we raise concerns about a proposal in the Governor's budget plan to repeal a recently enacted state law to expand eligibility for food stamps by 81,000 individuals. While the proposed repeal would achieve General Fund savings of about $3.5 million in the budget year, and somewhat lesser savings thereafter, it would also result in foregoing federal food coupons in the amount of about $203 million annually. In addition, forgoing that amount of food coupons would have the effect of reducing overall consumer spending by families. (Since they would have to pay more for food, they would have less to spend on other taxable items.) We estimate that this would cause an offsetting revenue loss of $4.5 million annually to the General Fund—more than the estimated administration savings of $3.5 million associated with the proposed repeal.

Similarly, we note in the "Department of Fish and Game" write-up in the "Resources" chapter of the *Analysis*, that the state could maximize federal funds for the Fisheries Restoration Grant Program by augmenting Proposition 40 bond funds to fully meet the federal requirement for state matching funds. Finally, we recommend approval of the Governor's proposal to increase fees at the Community Colleges. This fee level would enable federal Pell grant recipients (roughly 10 percent of all Community College students) to receive a $112 increase in their awards.

Some Actions Would Require Federal Help. While there are steps the state could take on its own to maximize the availability of federal funds, other changes would require federal congressional or regulatory action to accomplish. For example, changes are possible in the federal Medicaid Program that could save the state as much as hundreds of millions of

dollars annually on the cost of operating Medi-Cal. We cite some examples below:

- ***Authorize Collectable Copayments.*** Federal law strictly limits which Medicaid beneficiaries may be charged copayments for medical services and makes it difficult, if not impossible, in many cases, to collect copayments by specifying that no one who refuses to pay them can be denied medical services. Providing states real authority to charge and collect copayments that were more comparable to what private insurers now require could help hold down program costs. For example, the states could more effectively deter the nonemergency use of emergency rooms by imposing meaningful copayments in such situations.

- ***Limit Children's and Youth Services Mandate.*** The administration is proposing to obtain a waiver of a federal statutory mandate, known as EPSDT, which requires states to screen, diagnose, and treat all eligible children and youth under age 21. This broad mandate has resulted in hundreds of millions of dollars of costs to the state and regularly involved California in costly litigation regarding the expansion of medical services. While the waiver proposal warrants consideration, the state could go further and seek congressional action to modify the EPSDT statute. For example, Congress could provide an enhanced federal match to assist states in carrying out these programs, or narrow EPSDT requirements to basic medical services.

- ***Reduce State Exposure to Litigation.*** California, like many other states, has found itself in the difficult position of attempting to comply with federal requirements while at the same time being subject to litigation over the way these programs are operated. (The most recent example is the ongoing legal challenge to reductions in Medi-Cal provider rates.) The Legislature may wish to consider pursuing a change in federal statute to specify that any legal challenges to the way Medicaid programs are administered must be filed against the Center for Medicare and Medicaid Services (CMS), the federal agency ultimately responsible for ensuring that the state programs are run in conformity with federal law. One potential standard in such cases would be whether CMS abused its discretion in allowing states to operate their programs in a particular way, with deference provided under the law to CMS to interpret and administer federal Medicaid law. Establishing such a standard could reduce the state's exposure to litigation over the operation of the Medi-Cal Program.

- ***Improve Coordination Between Medicaid and Medicare.*** States could do a better job of managing the health care costs of persons eligible for both Medicaid and Medicare (also known as "dual eligibles") if they had the appropriate financial incentives to do so and if administrative barriers to more effective management were minimized. For example, federal authorities could improve the federal Medicaid data systems so that it would be cost-effective and administratively prudent to enroll dual eligibles in systems of managed care. The federal government could also allow states to share in any cost savings that the Medicare program might experience because of services provided under the Medicaid program, such as disease management services.

- ***Transform Successful Waivers Into Standard Practices.*** The process of obtaining and maintaining numerous federal waivers for Medicaid programs is administratively burdensome to both states and the federal government. Once granted, some waivers are also subject to extensive procedures to obtain their periodic renewal. If waivers have been cost-effective, states should be permitted to incorporate them permanently into their state Medicaid plans without having to obtain waiver after waiver. As an alternative, the federal government could streamline the process for waiver renewals.

- ***Ensure Renewal of Hospital Contracting Waiver.*** The Medi-Cal program competitively negotiates hospital services under a federal waiver, subject to renewal every two years, known as the Selective Provider Contracting Program. When last renewed in 2002-03, federal authorities initially proposed to "score" the savings from the waiver in a way that did not give full credit to the state, potentially leading to its denial. Ultimately, the federal government modified its position, allowing the waiver to be renewed, but the scoring issue could be revisited in 2004-05. Nonrenewal of the waiver, and the resulting inability of the state to negotiate rates for hospital services, would put the state at risk of incurring significant increases in expenditures for hospital services.

The Legislature may wish to consider which if any such changes are in keeping with its own policies, and how the state could be most effective in advocating those changes it believes are warranted in Medicaid and other state programs to increase federal funding and reduce state program costs.

V

Major Issues Facing the Legislature

ANOTHER PROPERTY TAX SHIFT?

Should the State Shift Property Taxes to Help Solve Its Budget Difficulties? If So, How Could the Proposed Shift Be Modified to Reduce Its Negative Effects on Local Governments?

Summary

Similar to the 1990s, the budget proposes to shift $1.3 billion of property taxes from local governments to K-14 districts—and reduce state education spending by an equal amount. This proposal raises questions concerning the Legislature's role regarding the property tax. In our view, the Legislature should use its authority over this tax for the overall betterment of local government, not as a state rainy day fund. Accordingly, we recommend the Legislature reject this proposal.

Given the state's fiscal difficulties, we recognize that the Legislature may decide to explore elements of this proposal, despite evident shortcomings. If the Legislature reviews proposals to reduce local taxes, we recommend it consider these guidelines:

- *Minimize Reductions to General Purpose Revenues.*
- *Leave Past Formulas in the Past.*
- *Give Local Control.*
- *Be Mindful of Effect on Land Use Incentives.*
- *Consider Impact of Revenue Reductions.*

Consistent with these guidelines, we outline an alternative budget reduction. While this alternative also represents an undesirable intrusion into local finance, it would have fewer negative effects. Our alternative includes a: $216 million reduction in local subventions, $400 million locally determined special district property tax shift, $320 million redevelopment property tax shift, and $400 million reduction in city and county sales taxes.

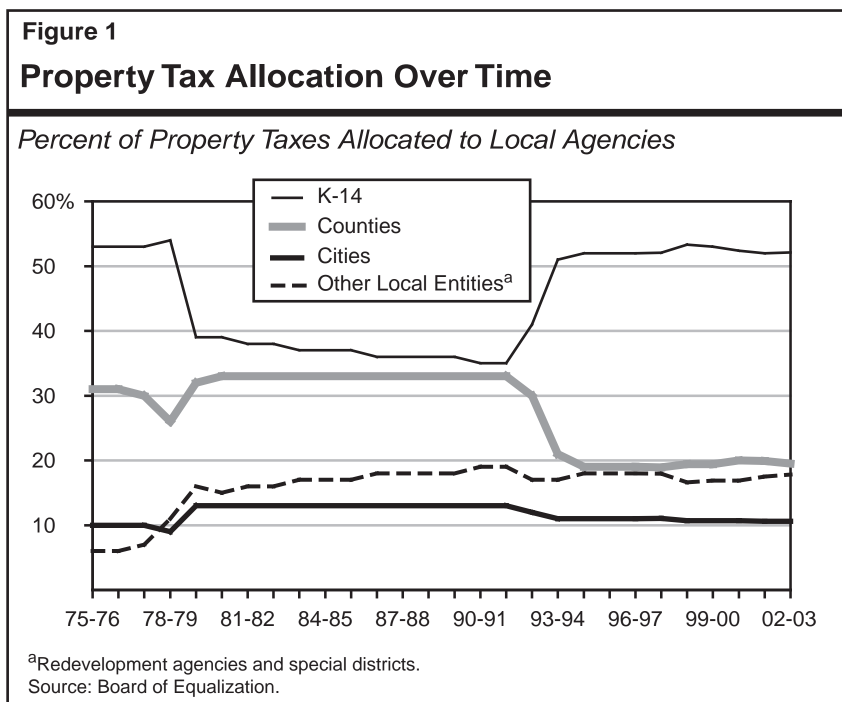
Background

California—like most other states in this country—relies extensively on local governments to protect the public, help the needy, educate students, and respond to local concerns. For nearly a century, California's property tax has been reserved for the exclusive use of local governments and has served as the mainstay of local finance.

Before passage of Proposition 13, local governments and their residents controlled property tax rates and the distribution of property tax revenues to local agencies. Proposition 13, however, placed into the California Constitution a maximum rate for nondebt-related property taxes and specified that its revenues are to be allocated to local agencies "according to law."

As Figure 1 shows, immediately after Proposition 13's passage, the Legislature established a property tax allocation system that reduced the share of property tax revenues allocated to educational local agencies from a statewide average of 54 percent to 39 percent—and increased the share of property taxes allocated to cities, counties, and special districts. (The state replaced the shifted K-14 district property taxes with increased state funding.) Specific property tax allocation formulas then were assigned to every area of the state, designating the portion of the property tax to be allocated to each local agency serving the area. These property tax allocation shares were based on each agency's proportionate share of property taxes in the mid-1970s and are commonly referred to as "AB 8" shares, after the bill that created this property tax allocation system—Chapter 282, Statutes of 1979 (AB 8, L. Greene). With the exception of several relatively minor changes, the state did not alter these AB 8 shares until the early 1990s.

Faced with significant budgetary challenges in 1992 and 1993, the state twice enacted major changes to the state's AB 8 property tax allocation system to direct larger shares of property tax revenues to K-14 districts—and reduce state General Fund spending for education accordingly. These changes reduced noneducational local agencies' share of the property tax from a statewide average of 65 percent to 48 percent. The property taxes shifted to K-14 districts because of the 1990s property tax shift now total about $5 billion. (For context, total property tax revenues in the current year are estimated at $29 billion.) These property tax allocation changes commonly are referred to as "ERAF," after the name of the fund into which the shifted property taxes initially are deposited, the Educational Revenue Augmentation Fund.



Administration's Proposal

In 2004-05, the administration proposes to redirect to K-14 districts $1.3 billion of property taxes that otherwise would be allocated to cities, counties, special districts, and redevelopment agencies. This shift, if enacted, would bring K-14's share of the property tax to an overall statewide average of 56 percent and would decrease state General Fund education spending by $1.3 billion. Similar to the ERAF shifts in the 1990s, this redirection of property taxes is expected to provide ongoing, growing state fiscal relief.

Figure 2 (see next page) below summarizes the distribution of property tax losses to each group of local agencies under the administration's plan. The largest component of this property tax shift would be from counties.

LAO Assessment

The administration's proposal raises significant questions regarding the appropriate role of the state regarding local taxes. The State Constitu-

Figure 2

Proposed 2004-05 Local Government Property Tax Shift

(Dollars in Millions)

	Amount
Counties	$909
Cities	188
Redevelopment agencies	135
Special districts	105
Total	**$1,336**

Detail does not add due to rounding.

tion establishes the property tax as a *local* tax. While the state's voters gave the Legislature responsibility to allocate property tax revenues, nothing in the Constitution or the history of Proposition 13 suggests that the intent of this delegation of authority was for the state to benefit fiscally from its control of the property tax—or that the tax should serve as a de facto rainy day fund for state government.

The administration's proposal raises further questions regarding the future of the property tax. That is, if the state enacts a *third* major reduction in city, county, special district, and redevelopment agency property taxes within a dozen years, what would prevent the state from imposing additional reductions in the future—or eliminating noneducational agency property taxes over time?

In reviewing proposals to reallocate the property tax, we recommend the Legislature avoid viewing the local property tax as a "state" resource. Rather, we suggest the Legislature approach its authority over property tax allocation with the restraint of a fiduciary: enacting changes to the property tax allocation system only for the overall benefit of local governments and striving to avoid conflicts of interests in carrying out these responsibilities.

In addition to these policy concerns relating to the proposed property tax shift, the proposal presents significant practical and immediate problems for local agencies. Simply put, based on their projections of future property tax revenues, local governments made myriad program and financial commitments to their residents, employees, businesses, bondholders, and others. A sudden and major loss in general purpose revenues will

disrupt local agency ability to meet these commitments. The administration's proposal is not, therefore, a budget "solution" in any real sense: it is simply a transfer of fiscal problems from one level of government to another.

Because of these significant policy and practical concerns, we recommend the Legislature reject the administration's proposal to use local taxes to remedy the state's fiscal problems.

GUIDELINES TO CONSIDER

Given the severity of the state's budget constraints and the difficult choices it faces, we recognize that the Legislature may decide to explore elements of the administration's proposal, despite its evident shortcomings. We also note that the administration has indicated a willingness to consider alternative local government proposals, provided they offer ongoing state fiscal relief.

Accordingly, Figure 3 outlines several guidelines for the Legislature to consider as it reviews budget proposals involving local governments revenues. We discuss these guidelines in more detail below. In the following section of this analysis, we outline an alternative local government budget proposal that is more reflective of these guidelines.

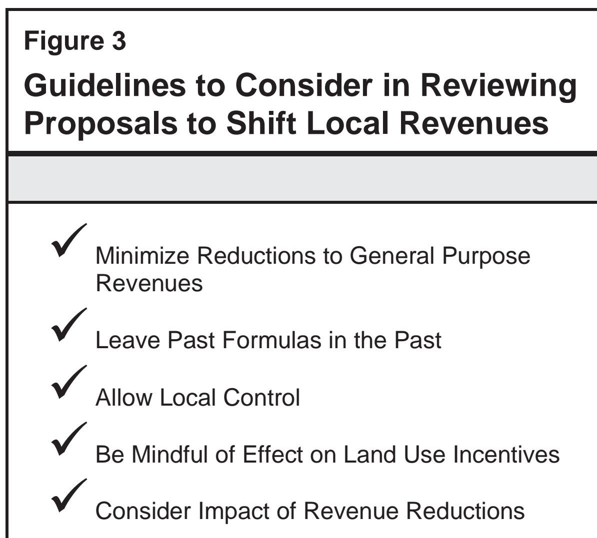


Figure 3

Guidelines to Consider in Reviewing Proposals to Shift Local Revenues

- ✓ Minimize Reductions to General Purpose Revenues
- ✓ Leave Past Formulas in the Past
- ✓ Allow Local Control
- ✓ Be Mindful of Effect on Land Use Incentives
- ✓ Consider Impact of Revenue Reductions

Minimize Reductions to General Purpose Revenues

General-purpose revenues, such as the property tax, allow local governments to respond to their community's perceptions of their greatest local needs, a function integral to local governance. State actions to reduce local general-purpose revenues limit local governments' ability to fulfill their commitments and responsibilities to local residents. Accordingly, we suggest that any reduction to local property taxes or other general-purpose revenues be imposed at an amount that is as modest as possible.

Leave Past Formulas in the Past

Instead of offering a policy rationale regarding how these major local revenue reductions should be imposed across local governments, the administration simply proposes to extend the property tax shift formulas used in the 1990s. (These 1990s methodologies, in turn, were based on property tax formulas dating from the 1970s.)

Given the magnitude of this proposal, we believe it would be inadvisable for the Legislature to rubber stamp dated formulas. This is particularly true because, as we explained in our 1999 publication *Shifting Gears: Rethinking Property Tax Shift Relief,* the 1990s shift had disparate fiscal effects on local governments, often without any obvious policy rationale.

Finally, we note for clarification purposes that the formulas provided by the administration to estimate proposed local agency 2004-05 property tax losses *differ* notably from the state's intent and decision making in the 1990s. Figure 4 outlines major differences between the administration's formulas and state actions in the 1990s.

Allow Local Control

In a state as large and diverse as California, it is impossible to reflect each community's needs and interests when making centralized fiscal decisions regarding thousands of local governments. Instead of seeking to design another statewide formula to redirect local taxes, we suggest the Legislature permit at least some degree of local decision making. Allowing local decision making would increase the likelihood that property taxes are allocated to local governments in a manner that best promotes community needs and objectives.

Be Mindful of Effects on Land Use Incentives

Under our governance system, cities and counties have considerable authority over new land developments. These local governments establish general plans for their communities, determine the intensity and purpose by which areas may be developed, and approve permits for individual projects. While cities and counties review many factors when making these

Figure 4

Major Differences Between Administration's Proposal And 1990s Property Tax Shifts

✓ ***County Reduction Is Much Greater***

- Under the 1992 tax shift, county losses comprised less than half of the total shift from nonredevelopment agencies. (Because the 1990s redevelopment shifts were temporary, analyses of ongoing ERAF liabilities usually exclude them.)
- In 1993, after accounting for the $1.5 billion in offsetting Proposition 172 revenues, county tax losses also made up less than half the tax losses from nonredevelopment agencies.
- Under the administration's proposal, however, counties contribute more than three-quarters of the property taxes shifted from agencies other than redevelopment agencies. The administration's formula differs from past state actions because it does not acknowledge the state's actions to mitigate county property tax losses through Proposition 172 revenues.

✓ ***Special District Reduction Is Lower***

- In 1992 and 1993, the state's budget plan expected special districts to shoulder 27 percent of the nonredevelopment agency net tax losses. Because of data inadequacies and technical problems, however, implementation of the special district shifts failed to achieve expected results.
- Under the administration's plan, special districts make up just 9 percent of nonredevelopment property tax losses. The administration's lower amount reflects actual special district ERAF contributions, rather than the state's intended reduction.

✓ ***Redevelopment Shift Is Ongoing***

- Since the 1990s, the state has imposed several limited-term ERAF obligations on redevelopment agencies, but never for a term greater than two years.
- Under the administration's proposal, redevelopment agencies contribute to ERAF annually.

decisions, the impact of land development on the fiscal health of the local government is among the higher considerations.

Under the state's local finance system, cities and counties typically report that they receive the highest net revenues from retail developments—and that housing and manufacturing developments frequently yield more costs to the local government than tax revenues. These fiscal evaluations of

developments have resulted in many cities and counties orienting their land use policies to promote retail over other land uses.

While an individual city or county may be "better off" by promoting retail development in their community, this undue focus on retail is undesirable from a state standpoint. We note, for example, that the cost of new manufacturing or housing developments may be increased if a community zones disproportionate amounts of ready-to-develop land for future retail development—and leaves less desirable land for other development purposes. Similarly, developers of manufacturing plants or housing may face higher costs if local agencies require them to pay impact fees, build infrastructure improvements, or modify their plans to alter their development's fiscal effect on local government.

From the perspective of overall state economic development, the administration's proposal reduces the local tax that probably has the best local government land use incentives. Specifically, the property tax gives local governments incentives to encourage a broad range of high value development in their community: retail, industrial, office, hotel, or residential.

Consider Impact of Revenue Reductions

In addition to K-14 districts, California has five other groups of local agencies: counties, cities, "nonenterprise" special districts (districts organized and financed like governmental agencies), "enterprise" special districts (districts organized like a business, usually with the ability to charge fees for services), and redevelopment agencies. Because these local agencies have different responsibilities, authority, and revenue bases, reducing their property taxes would yield very different effects. We urge the Legislature to consider these effects in reviewing any proposal for shifting local government property taxes.

City and County Program Reductions Likely. Most city and county programs currently financed with property taxes are not amenable to user fee financing. In addition, the Constitution requires voter or property owner approval before a local agency may impose or increase a local tax or assessment. Thus, reductions in city and county property taxes likely will trigger program reductions. Because some local agency programs (particularly county programs) are subject to statutory and other spending requirements, the programs likely to be reduced most due to a property tax shift include: parks and recreation, libraries, public safety and, in some counties, local health programs. The level of program reduction would vary considerably across the state. Because counties and some older cities are heavily reliant upon the property tax, these agencies are likely to impose the deepest reductions. More recently incorporated cities, in contrast, tend

to be more reliant upon the sales tax. Similar to the 1990s shift, these cities are less likely to sustain major losses from the proposed property tax shift.

Effect on Nonenterprise Special Districts Not Clear. While almost half of these districts rely entirely on other revenue sources (fees, assessments, and payments from other governments) to finance their operations, some districts depend on property taxes for most of their budgets. Under the 1990s shifts, various categories of nonenterprise special districts were partially or fully exempt from the shift (including fire districts, multicounty districts, and cemetery districts), placing the burden of the shift on a narrow group of districts—mostly flood control, library, and park and recreation districts. In addition to these fiscal differences, local perceptions of the efficiency and importance of these districts appears to differ greatly. Because of these factors, it is difficult to project how a property tax shift would affect these agencies. If the shift were structured similarly to 1990s, we assume that there would be significant cuts to flood control, library, and park and recreation programs, possibly offset to some extent through new fees and assessments. On the other hand, if the property tax shift were imposed selectively—on districts with the greatest capacity to raise revenues from alternative sources or districts that had potential for efficiency improvements—a tax shift might have less pronounced effect on governmental services.

Enterprise Special Districts Likely to Raise User Charges. Most of the state's approximately 1,700 enterprise special districts provide water or waste disposal services. Enterprise special districts have considerable authority to levy user fees to pay for services. As Figure 5 (see next page) indicates, based on the most recent data available, more than half of these districts do not receive property tax revenues and those that do rely on property taxes for only 7 percent of their revenues. Given the significant fee authority of enterprise special districts and the nature of the services they provide, we assume that increased user fees would offset a significant portion of a property tax shift. The Constitution does not require local voter approval for increases in water, sewer, and refuse collection service user fees.

Redevelopment Agencies May Offset Tax Losses Through Project Expansions. Unlike other local agencies, redevelopment agencies do not receive a share of the property tax under the AB 8 system. Rather, after a redevelopment agency identifies a "project area" in the community needing redevelopment to eradicate "urban blight," the agency receives most of the annual growth in property taxes from that area. (That is, the existing AB 8 formulas for sharing the property tax are modified for the life of the project. K-14 districts and other local agencies do not receive their usual shares of property tax revenue growth. The state backfills K-14 districts, however, for their property tax losses.) Redevelopment agencies use prop-

Figure 5

Enterprise Special District 2001-02 Financial Data

(Dollars in Millions)

District	Property Taxes	
	Do Not Receive	Receive
Water Disposal		
Number of districts	292	280
Property taxes	—	$173
Total revenues	$872	$1,566
Property taxes as percent of total revenues	—	11%
Water		
Number of districts	499	398
Property taxes	—	$193
Total revenues	$2,941	$2,908
Property taxes as percent of total revenues	—	7%
Other[a]		
Number of districts	160	61
Property taxes	—	$119
Total revenues	$7,759	$2,203
Property taxes as percent of total revenues	—	7%
Totals		
Number of districts	951	739
Property taxes	—	$484
Total revenues	$11,573	$6,676
Property taxes as percent of total revenues	—	7%

a Airport, electric, harbor and ports, hospital, transit.

Source: Preliminary 2001-02 Data, State Controller's Office.

erty taxes—often in conjunction with private developer funds or other governmental resources—to finance capital improvements, land and real estate acquisitions, affordable housing, and planning and marketing programs. In the short term, decreasing redevelopment property taxes likely would result in decreases to all redevelopment activities, with the possible exception of affordable housing (because statutes specify a level of spending on housing). Over the longer term, however, it is likely that redevelopment agencies would *increase* their efforts to establish or expand redevelopment areas. This is because under current law, cities and counties gain

control over a greater amount of property tax revenues when their subordinate redevelopment agencies create redevelopment projects—and this fiscal advantage would increase significantly if city and county property tax shares were reduced as part of a 2004 property tax shift. Over the long term, therefore, a redevelopment property tax shift might be offset by an expansion of redevelopment activity.

An Alternative Approach

In this section, we outline an alternative budget option involving local finances that reflects the guidelines discussed above. While we acknowledge that this alternative represents an undesirable intrusion into local finance, we think it would have fewer negative effects on local governments and their residents than the administration's proposal.

In order to "compare apples with apples," we scaled our alternative so that it would provide $1.3 billion in ongoing state fiscal relief. We note, however, that each element in our alternative, summarized in Figure 6, could be reduced or eliminated, to reduce its particular negative effects on local governments.

Figure 6

LAO Alternative: Local Government

(In Millions)

Component	Amount
Reduced subventions	$216
Special districts	400
Redevelopment agencies	320
Cities	200
Counties	200
State Fiscal Relief	**$1,336**

Reduce Restricted Purpose Subventions First

To mitigate the impact of the early 1990s property tax shifts and increase funding for local programs, the state established or augmented several restricted-purpose subventions to local governments. While some of these subvention programs were eliminated last year or are scheduled for

elimination in the proposed budget, the administration proposes $216 million in 2004-05 for:

- Citizens' Option for Public Safety (COPS)—$100 million subventions to all cities and counties for local law enforcement.
- Juvenile Justice Challenge Grants—$100 million in grants to counties to improve juvenile justice programs.
- Public Library Foundation—$16 million to support local libraries.

While these subventions support valuable local activities, we note that local agencies cannot use restricted purpose subventions to meet community needs as flexibly and efficiently as general-purpose revenues. We also note that local communities are acutely aware of their public safety and library needs and historically have used general-purpose revenues to support these programs. Thus, if local government general-purpose revenues are preserved, public safety and library programs likely would receive high consideration for local support.

LAO Alternative. Our first guideline recommends the Legislature minimize any reduction to local general-purpose revenues. Accordingly, before acting to shift local property taxes, we recommend the Legislature consider eliminating these restricted purpose subventions. In our alternative, we use all funding from these subvention programs to reduce by $216 million the amount of the property tax shift. (We note that in the "Judiciary and Criminal Justice" chapter of the *Analysis of the 2004-05 Budget Bill*, we suggest alternate uses for two of these subventions in lieu of the Governor's proposal on juvenile justice probation programs.)

Give Local Flexibility Over Special District Shift

In the 1990s property tax shift, the Legislature enacted statewide formulas that directed county auditors to reduce special district property taxes. Because the state did not allow communities to revise these shift formulas (or change underlying special district AB 8 shares) to reflect local interests, the formulas resulted in greater reductions to valued local government services than otherwise would have been the case.

We note, for example, that the 1990s shifts did not allow communities to reconsider the shares of property taxes allocated to enterprise special districts. Because enterprise districts can finance most of their activities through user fees, local communities might have preferred to reduce or eliminate enterprise special district property taxes in order to preserve property tax resources for other local agencies. (Government Code Section 16270, dating from 1978, declares the Legislature's intent that these districts transition to user fee financing.)

The 1990s shift formulas also did not give communities an opportunity to reallocate property tax shift amounts, or AB 8 shares, of nonenterprise special districts. This authority would have allowed local communities to preserve funding for their highest priority programs and caused other districts to improve efficiency, consolidate, reduce programs, and/or shift to other forms of financing.

LAO Alternative. Our alternative includes a $400 million special district shift. This amount is equivalent to almost an 80 percent reduction to enterprise special district 2004-05 property taxes, or about a 15 percent reduction to all special district property taxes. Consistent with our guidelines, the allocation of this property tax shift would not reflect dated formulas, but would be locally determined. Communities would have full flexibility in the implementation of this reduction. Specifically, the Legislature would establish a special district property tax shift amount for each county. Every county Board of Supervisors, after public hearing and debate, would revise the share of property taxes received by special districts in their county to implement the shift and reallocate property tax resources in a manner that best meets the needs of their county residents.

Transition Period. Because local communities have had no authority over property tax allocation in more than a quarter century, we are mindful that such an approach would engender both concerns by special districts and significant public debate. In general, we believe that this result would be a sign of a healthy local democratic process, appropriately debating the allocation of local revenues. Should the Legislature wish to moderate the rate of change resulting from this alternative, it could impose certain limitations on this authority for a defined period. For example, the Legislature could specify that county boards of supervisors may not (1) reduce a nonenterprise special district's property taxes by more than 20 percent in any single year or (2) reallocate property taxes so that county-dependent special districts receive increased property tax revenues.

Focus the Redevelopment Shift

Over the years, the Legislature and administration frequently have voiced concerns regarding local agency overextension or misuse of redevelopment powers and the resulting increased state education costs. In an effort to address these long-standing concerns, the Legislature enacted in 1993 Chapter 942 (AB 1290, Isenberg), clarifying that local agencies may establish redevelopment projects only in areas that meet specific "urban blight" definitions and that redevelopment expenditures must be limited to projects needed to eradicate blight and create affordable housing. Chapter 942 also sought to reduce redevelopment agency subsidies to auto dealerships, large volume retailers, and other sales tax generators.

Since enactment of Chapter 942, many concerns regarding local agency use of redevelopment powers have persisted. Cities and counties have expanded redevelopment project areas so much that 15 percent of all assessed valuation in the state is contained within a redevelopment project. In three counties, more than one in five property tax dollars is allocated to redevelopment agencies, instead of K-14 and other local agencies. Redevelopment agencies continue to find ways to subsidize retail developers and auto dealerships. Finally, the Department of Housing and Community Development (HCD) reports that redevelopment agencies frequently spend more than 50 percent of their housing funds on planning and administration, not housing development—and that some agencies undercount funding that should be deposited to housing funds or use the monies for nonhousing purposes. For example, HCD auditors found that Santa Ana redevelopment officials spent three-quarters of their housing funds over a seven-year period on planning and administration and off-site street and sidewalk improvements.

Administration Proposal. Although redevelopment agencies receive about 20 percent of the property taxes allocated to local agencies other than K-14 districts, redevelopment property tax shift losses account for only 10 percent of the administration's plan, or $135 million. Because redevelopment's share of the property tax shift is relatively low, other local agencies' shares are commensurately greater. In addition, because the administration proposes that all redevelopment agencies contribute the same percentage of their property taxes to ERAF, cities and counties are likely to perceive increased fiscal incentives to create or enlarge redevelopment projects.

LAO Alternative. Our alternative sets the amount of the redevelopment shift at $320 million, approximately 11 percent of redevelopment 2004-05 property taxes. Setting the shift at a higher amount allows a larger share of the property tax shift to be borne by an agency that has greater ability to offset property tax losses with other revenues than do many cities, counties, and some special districts. In addition, we would replace the administration's single-percentage redevelopment property tax shift with a sliding scale approach that decreases—on an ongoing basis—city and county incentives to inappropriately expand redevelopment activities.

How Would the Sliding Scale Work? Under our alternative, agencies that show restraint in their use of redevelopment authority and place little land under redevelopment would sustain little property tax shift. An agency's ERAF obligation would be higher, however, in any year that it (1) had large amounts of developed land under redevelopment, (2) did not meet its affordable housing obligations, and/or (3) failed to comply with redevelopment requirements specified under the Health and Safety Code.

Shift Sales Taxes and Reallocate Vehicle License Fee (VLF) Instead

As discussed earlier in this document, the administration's proposal to shift property taxes from cities and counties would (1) worsen the fiscal incentives these agencies face when considering new land uses and (2) place significant burdens on the same property-tax dependent agencies that sustained the greatest losses from the 1990s shifts. In addition, the administration's proposal for counties to shoulder a large share of the property tax shift would result in deep reductions to county programs because counties have limited ability to offset property tax reductions with other revenues.

LAO Alternative. To mitigate the adverse land use incentives and program reductions that would result from the administration's proposal, our alternative (1) focuses on taxes other than the property tax and (2) minimizes county revenue losses. Specifically, our alternative imposes city and county reductions, totaling $200 million *each*, through the following reduction in the local sales tax and reallocation of VLF revenues:

- ***Sales Tax Reduction.*** The local agency sales tax rate (referred to as the "Bradley Burns" tax) is reduced from 1 percent to .92 percent, or $400 million annually. The state sales tax rate is increased by an equivalent percentage.
- ***VLF Reallocation.*** Because most taxable sales occur within incorporated areas, cities would bear a disproportionate share of the $400 million sales tax reduction. City sales tax losses exceeding $200 million would be offset through a statutory revision to the existing VLF allocation formula—shifting some county VLF revenues to cities.

CONCLUSION

By shifting to K-14 districts $1.3 billion of property taxes currently allocated to city, county, special districts, and redevelopment agencies, the administration's proposal places significant burdens on local agencies as a means of resolving the state's budget difficulties. We think it is inappropriate for the state to reallocate local taxes for the sole purpose of reducing state spending obligations. We also find that the shift would impose considerable fiscal disruptions to local governments and does not, in any real sense, represent a budget "solution." Accordingly, we recommend that the Legislature reject the administration's proposal.

If the state determines that, given its fiscal difficulties, local agency funding must play a role in resolving the state's budget crisis, we recom-

mend the Legislature avoid relying upon the dated property tax shift formulas from the 1990s. Rather, we recommend the Legislature develop a new approach, consistent with the guidelines outlined in this analysis.

In our view, the alternative local government budget reduction outlined above—while still imposing undesirable fiscal effects on local governments—offers significant advantages over the administration's approach. Specifically, our alternative focuses a larger percentage of the property tax losses on those agencies that can offset revenue reductions through user fees or other revenues, if the community so desires. Our alternative also minimizes the loss of general-purpose revenues to cities and counties—and modestly improves the fiscal incentives local agencies face regarding land development and redevelopment.

DEFICIENCIES: RETHINKING HOW TO ADDRESS UNEXPECTED EXPENSES

What Is the Deficiency Process? What Problems Has the Misuse of the Process Caused? Is There a Better Way to Efficiently Address Unexpected Expenses?

Summary

The Constitution gives the Legislature the power to appropriate funds. In order to address unexpected expenses (or "deficiencies") that arise during a fiscal year, the Legislature provides the administration with limited authority to spend at higher rates than foreseen in the budget act.

The use of this deficiency process, however, has a history of problems—from being used to establish new programs with no statutory authority to serving as an alternative to the normal state budget process. Given this history, we outline a framework for legislative consideration which identifies a new approach to meet unexpected expenses. In our view, this framework would continue to allow necessary adjustments, while better protecting the appropriation authority of the Legislature.

INTRODUCTION

Due to the severity of the state's budget problem, the Legislature granted the administration new executive powers for the 2003-04 budget. Among these was Control Section 4.10 (discussed in Part IV of this document), which gave the administration the authority to make various reductions in state operations. In addition, the administration was given new powers to address deficiencies. This piece reviews the way the state addresses these unanticipated expenses. First, we provide background on the Legislature's appropriation authority and limited delegations of authority to the executive branch. Then, we review longstanding concerns with the delegated authority, as well as changes that were made to the process this year. Finally, we outline an alternative framework to improve the process—by maintaining necessary administrative flexibility, while increasing legislative oversight.

APPROPRIATION AUTHORITY AND DELEGATED POWERS

The State Constitution separates the powers of state government into three branches—legislative, executive, and judicial. The Constitution specifies that each branch is charged with the exercise of certain powers that may not be exercised by either of the other branches. In this way, the Constitution defines the relationship among each branch of government.

Legislature Has Sole Power of Appropriation. One of the powers given exclusively to the Legislature is the power of appropriating funds. Article XVI, Section 7, of the California Constitution provides for this power:

> Money may be drawn from the Treasury only through an appropriation made by law and upon a Controller's duly drawn warrant.

In other words, the Controller is bound by the Constitution to only pay those state expenses that have been expressly authorized by the Legislature through an appropriation made by law (or, in limited circumstances, by the Constitution, federal law, or initiatives). The annual state budget is the Legislature's primary method of authorizing expenses for a particular year. Any changes to these budget appropriations, therefore, must also be authorized by the Legislature in statute.

Changes to Spending After the Start of a Fiscal Year

Given the size and diversity of state government, changes to enacted budget plans after the start of a fiscal year are often needed to respond to unanticipated events. These changes may be minor and technical in nature or more significant—such as responding to an earthquake or the receipt of a large federal grant.

How Is Spending Changed? In order to respond to unanticipated needs, the Legislature can always pass a bill subsequent to the enactment of the budget that increases or decreases an existing appropriation or creates a new appropriation. In other cases, the administration can use various "control sections" of the budget act which establish procedures to adjust spending levels.

Why Does the Legislature Delegate Authority? Through the control sections, the Legislature provides the administration *limited* authority to adjust spending. The Legislature provides this authority in recognition that there can be the need for administrative adjustments to the budget, particularly during the periods when the Legislature is out of session. The challenge for the Legislature is to provide the administration the needed authority and guidance to respond efficiently and adequately to unexpected events without compromising its own appropriation authority.

Legislative Review Periods. In most cases, the Legislature has specified a review period (generally 30 days) before the administration can finalize an action pursuant to the control sections. This provides a brief opportunity for the Legislature to review and comment on the proposed changes. It also provides early notification to the Legislature of any changes occurring to the originally enacted budget plan.

Controller's Responsibilities. The Controller is the state official who oversees the state's spending during the year. As required by Article XVI of the Constitution, it is the Controller's responsibility to monitor a department's spending to ensure that all spending is authorized by a specific appropriation.

Examples of Delegation

There are a number of examples of authority delegated to the executive branch to modify spending, which we describe below.

State of Emergency. The California Emergency Services Act (Government Code Section 8550 et seq.) allows the Governor to declare a "state of emergency" under specified circumstances—including natural disasters. Upon such a declaration, the administration is authorized to redirect existing appropriations to address the emergency.

Control Section 27.00. Section 27.00 is a limited delegation of authority to allow the administration to address unexpected spending needs after the passage of the budget. Through the section (in conjunction with Government Code Section 11006), the administration can be given the authority to spend funds at a rate that will require a subsequent deficiency appropriation by the Legislature. A more detailed description of the deficiency process appears in the nearby shaded box.

Control Section 28.00. This control section provides the administration flexibility to expend unanticipated federal or other nonstate funds. Departments must show a need to spend the unexpected monies in the current year. In addition, Section 28.00 can only be used if the funds are designated for a specific purpose (as opposed, for instance, to a block grant with many possible uses).

CONCERNS WITH DELEGATED AUTHORITY

While the Legislature delegates authority to the executive branch to make government more manageable, the following discussion illustrates that the use of this authority has created legislative oversight problems.

Overview of Deficiency Spending

What Is a Deficiency? Each year, the budget act specifies appropriations for state departments to operate and deliver programs, as approved by the Legislature. In some cases after the enactment of the budget, departments may determine that additional funding—above its appropriation level—is needed to deliver the approved programs. These additional needs can be due to a variety of unexpected events—such as changes in caseload or new federal laws. The gap in funding between what was originally appropriated and the revised spending need is known as a "deficiency." In almost all cases, the department would not deplete its original resources until late in the fiscal year. The department, however, is required to notify the Legislature at the point that it anticipates the need to spend funds at a rate that will require an increased appropriation by the end of the fiscal year. In no case can the department spend more than its appropriation. Instead, it must have a supplemental appropriation—typically provided in the annual deficiency bill during the spring.

How Do Section 27.00 and Item 9840 Work? If departments need funding *before* the passage of a deficiency bill, the administration can access funding appropriated to Item 9840. The amounts appropriated in this item are minimal—including $2 million in General Fund dollars—since most departments have sufficient resources to operate until a deficiency bill is enacted. Figure 1 below illustrates the Section 27.00 process for a typical department. The department learns in December that it will need to spend at a rate for the remainder of the year which

30-Day Review Is Not Full Oversight. For Section 27.00 and 28.00 authorizations, a 30-day review period for the Legislature is standard. (In cases of emergencies, Section 27.00 also has a provision to notify the Legislature *after* an action is taken.) In some instances, however, this review period does not provide enough time for the Legislature to gain a complete understanding of the nature of the proposed adjustments. In contrast, during the regular budget process, the Legislature has several months to explore alternative approaches to an administration proposal.

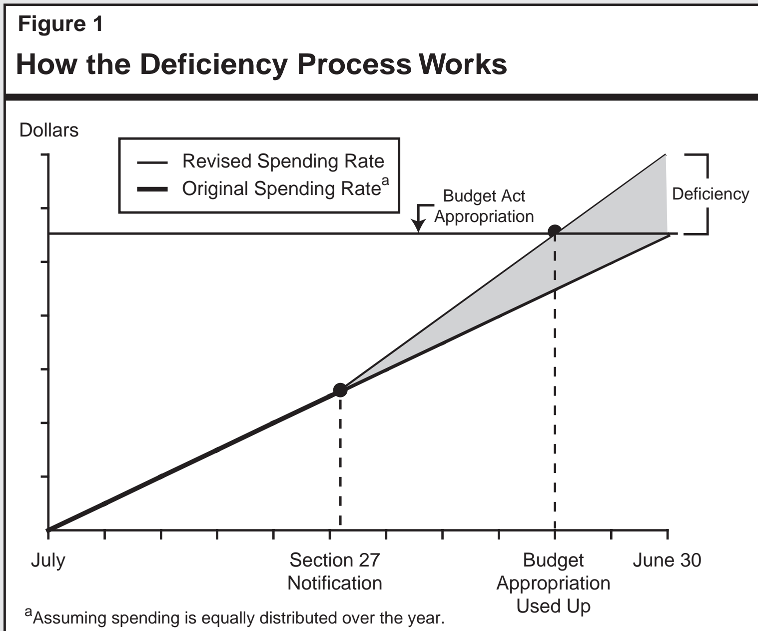
Concerns Can Be Ignored. In those cases when the Legislature develops concerns during the review period, the Legislature advises the administration of these concerns. While the administration has typically abided by the Legislature's wishes, the administration has also ignored legisla-

Overview of Deficiency Spending *(continued)*

is higher than assumed in the budget act. It submits a Section 27.00 deficiency request and, if approved, changes its rate of spending. Note, however, that the department would not actually need increased appropriation authority until April, when its budget act appropriation is "used up."

Figure 1

How the Deficiency Process Works



[a]Assuming spending is equally distributed over the year.

tive concerns on occasion and proceeded with the implementation of a proposal. In such cases, the Legislature has virtually no practical recourse.

Uses Not Consistent With Intent. Section 27.00 is intended to address *unanticipated* expenses. Yet, past administrations have on occasion attempted to use the process for a variety of expenses that were or should have been anticipated. For instance, a long-standing problem area is the use of Section 27.00 to adjust for a change in program requirements, resulting, for example, from a federal regulatory change that was known by the administration before the budget was enacted. Another problem area is the use of Section 27.00 for expenses that should have been included in the administration's budget estimates (such as salary increases or the full costs to implement a newly approved program). The consequence of using Section 27.00 in this manner means that departments can "low ball" their budget estimates and then supplement them for their true costs through the deficiency process. As a result, the Legislature does not have an accurate picture of the state's expenses when considering its budget priorities. Finally, the process also has been used to initiate new programs that have not been reviewed by the Legislature or for which there is no statutory authority, or to fund bills that were passed without appropriations (thus enabling Governors to fund bills consistent with their priorities, rather than the Legislature's).

Attempt to Circumvent Budget Process

Section 27.00 is intended to allow adjustments when program costs exceed budget estimates (such as an increase in the program's caseload) or the state experiences a natural disaster (such as the Southern California fires late last year). In other words, it is intended to allow adjustments to spending amounts, ***consistent with the Legislature's policy objectives*** as reflected in the annual budget. ***It is not intended to provide an alternative to the regular budget process for changing policy decisions.*** Likewise, Section 28.00 is intended to provide authorization to spend funds when there is no discretion over their use (such as federal funds which supplement an existing program). Section 28.00 is not intended to provide an avenue for the administration to take discretionary federal funds and craft new programs outside of the regular budget process.

To a large extent, the Legislature depends on the administration to police itself to ensure the delegated authority is used appropriately. At various times, however, the executive branch has abused both control sections in efforts to develop programs outside of the budget process and in the absence of statutory authority. For instance, our office raised concerns in 2002 about the prior administration's use of Section 28.00 to preclude the Legislature from developing priorities for federal K-12 education funding. Similarly, in December 1999, our office raised concerns about the ex-

ecutive branch using Section 27.00 for the California Department of Corrections (CDC) to implement new programs not approved by the Legislature.

CHANGES TO THE DEFICIENCY PROCESS IN 2003-04

The magnitude of the state's budget problem this year and ongoing frustration with the Section 27.00 process resulted in the Legislature adding new provisions to the deficiency process. These changes were intended to address some of the past problems described above and to help control costs. Below, we summarize the major changes made in the deficiency process.

Addressing Past Concerns

New Timing for Deficiency Appropriations. In past years, there was no specific schedule for the passage of the deficiency appropriations bill. This year, Section 27.00 specifically requires the Legislature to approve a deficiency bill by March 1, 2004 for those deficiencies authorized prior to the release of the Governor's budget in January. For those deficiency requests authorized after the release of the budget, the Joint Legislative Budget Committee is to hold a hearing to discuss their merit. These changes are efforts to improve legislative oversight of deficiency requests.

New Limits on Use. This year's revised Section 27.00 language also includes some new specific limitations on its use—clarifying what the Legislature means by "unanticipated expenses." The language specifies that Section 27.00 cannot be used for:

- Expenses attributed to a prior year.
- Legislation enacted without an appropriation.
- Startup costs of programs that have not been authorized by the Legislature.
- Costs that the Governor had knowledge of in time to include in the May Revision.
- Costs incurred at the discretion of the Governor.
- Authorizations after May 15.

Limiting Deficiency Requests

Ability to Transfer Funds. Section 27.00 now also includes the authority for the administration to transfer funds from one appropriation to another in order to avoid the need for a deficiency. Specifically, Section 27.00 (b) allows the administration to transfer up to 5 percent of

one item's funds to other items of appropriation. The Legislature intended that this authority be used judiciously so, for example, that such a transfer would not create a new deficiency in the item from which the funds were transferred. As with other actions related to deficiencies, the administration must provide the Legislature 30 days to review the transfers.

Use of Section 27.00 in 2003-04

Deficiency Authorizations

The administration reports that it has approved a total of $384.8 million ($378.1 million General Fund) in deficiencies for various departments so far in 2003-04 (excluding the vehicle license fee [VLF] backfill, which we discuss below). Over four-fifths of this amount is due to deficiencies in the CDC.

Transfers of Funds

So far in 2003-04, the administration has approved about $48 million in transfers pursuant to Section 27.00 (b) to avoid deficiencies. The administration has approved an additional $149 million in transfers as part of its VLF actions (discussed below). The administration's use of this transfer provision to date has been a source of legislative concern.

Abiding by Section 27.00's Restrictions. The administration may transfer funds from one item to another pursuant to Section 27.00 (b), only as needed to avoid seeking a deficiency appropriation. As such, Section 27.00 (b) is tied to the meaning of the entire deficiency process. The prohibitions contained in Section 27.00 on starting new programs and funding legislation, therefore, apply to the ability to transfer funds as well. The administration, however, has asserted that Section 27.00 (b) stands alone and provides the administration with broad authority to transfer funds between items. Under the administration's interpretation, then, it could transfer up to 5 percent of any appropriation for *any* purpose, such as starting a new program or funding a request that was specifically rejected by the Legislature during the budget process. Some of the funding transferred this year has not met the tests for using Section 27.00, and the transfers were made over the objections of the Legislature.

Overstep of Authority. The administration also has proposed transfers of funds pursuant to Section 27.00 (b) that did not comply with the 5 percent limit on such transfers. The administration proposed several transfers of funds from a Department of Health Services budget item. The transfers totaled roughly 9 percent of that appropriation. The administration suggested it was "waiving" the 5 percent limit, even though no such waiver process exists. (In this case, the administration has since amended its proposal to abide by the 5 percent limit.)

Misuse of Section 27.00 for the VLF Backfill

In December 2003, the administration notified the Legislature of its intent to increase General Fund payments to local governments (VLF backfill) by $2.652 billion. The administration noted its intention to provide $148.8 million of this amount through reductions from other budgetary appropriations pursuant to Section 27.00 (b). The administration contended that the action required an emergency authorization and, therefore, only notified the Legislature after its decision. As we advised the Legislature in December, this action represented both a flagrant misuse of Section 27.00 and a serious infringement of legislative powers. As an action which far exceeds the authority provided to the executive branch, it is illustrative of how delegated authority can be abused. Our critique of the proposal is discussed below.

Proposal Was Not a Deficiency. Under the basic VLF backfill statute, funds to local governments are provided through a continuous appropriation (eliminating the need for an annual budget appropriation). To prevent this continuous appropriation authority from being exercised in the current year, the Legislature appropriated $1,000 in Item 9100 (Tax Relief) of the budget and specified that the $1,000 was in place of the statutory VLF backfill appropriation. In our view, this action represents the Legislature's policy determination to spend a minimal amount on the backfill in 2003-04 absent further appropriations for this purpose. As such, the administration has not made any case for meeting the requirements of a deficiency authorization. Furthermore, the administration's action to increase funding for this purpose by $2.6 billion represents a major revision to legislative policy, is completely disproportionate to the amount of spending authorized by the budget, and is not necessary to accomplish the purposes of the $1,000 appropriation.

Administration Inappropriately Assumes Legislature's Appropriation Authority. As noted above, appropriating funds is solely the authority of the Legislature. Yet, the administration reported that it had "approved a deficiency *appropriation*" of $2.5 billion. Given the appropriation of $1,000 in Item 9100, however, we believe the Legislature has not provided to the administration in the budget act or other state law, any appropriation authority which the administration can access to cover this proposed backfill expense.

Controller Has No Authority to Implement. In the absence of a specific appropriation from the Legislature, the Controller has no authority to implement the administration's proposal. The continuous appropriation for the backfill was suspended this year by the $1,000 appropriation. The Controller has not identified another appropriation from which to draw. Yet,

the Controller has been authorizing payments for the backfill to local governments since December.

Emergency Criteria Not Met. The emergency provision of Section 27.00 has historically been used to respond to specific and urgent incidents—such as natural disasters. In this case, the administration has not put forth any evidence of specific disaster or peril. Rather, the administration relies on a broad assertion that the reduction of local spending will impair public safety. The administration has provided no analysis of individual local government finances that would suggest an imminent threat to health or safety. If the administration were to provide such an analysis, the Legislature has in the past addressed individual local governments' financial situations through legislation specific to their needs.

Transfers Require 30-Day Notification. As described above, the administration's action fails to meet the tests for a deficiency authorization. However, even if the request were for a legitimate deficiency, the administration appears to believe that it can implement the $149 million in transfers without a 30-day notification period (as part of Section 27.00's emergency provisions). Yet, Section 27.00 (b) provides no such authority to circumvent the 30-day period for transfers. Consequently, the administration is always obligated to wait the 30 days before implementing budget transfers to avoid deficiencies under Section 27.00 (b). As a result, the Controller did not process the transfers immediately as requested by the administration. (It is our understanding as of early February 2004 that the transfers have yet to be made.)

Lawsuits Pending. The state has been sued in two separate cases to stop the administration's actions related to the VLF backfill. As this analysis was prepared, the cases were pending before a superior court and the Supreme Court.

Administration's Proposals for 2004-05

No Changes in Sections 27.00 and 28.00. For 2004-05, the administration proposes the continuation of the current wording of Sections 27.00 and 28.00.

New Control Section 7.50 Proposed. The administration proposes a new Section 7.50 for 2004-05 which relates to federal funding. The new Section 7.50, which contains a 30-day review period for the Legislature, would allow the executive branch broad new authority with regard to the use of federal funds beyond what is currently authorized by Section 28.00. Section 28.00 already provides the administration with the authority to allocate and spend federal funds when the funds are distributed for a spe-

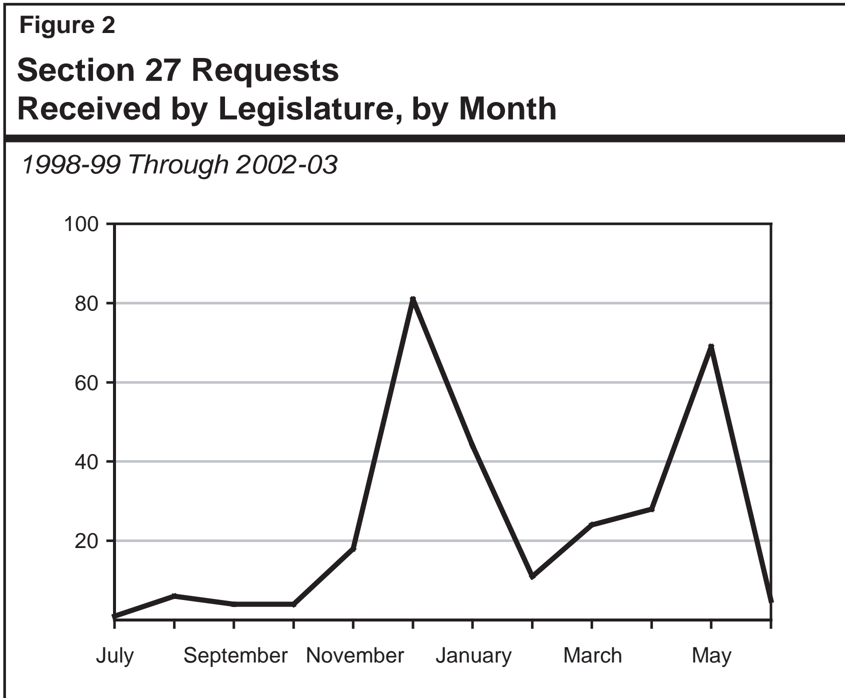
cific purpose. In contrast, Section 7.50 would let the administration decide how to spend *discretionary and anticipated* federal funds. For instance, Section 7.50 would allow the administration to choose how to spend $250 million in expected federal election reform funds using only a notification process. The administration states that it needs the authority of Section 7.50 to use federal funds to offset General Fund costs. The budget assumes $350 million in new federal funds for such a purpose.

How Much Authority Should the Legislature Provide?

Given the concerns expressed above, we believe the Legislature should approach the delegation of spending authority with caution. Such delegations should only be made to the extent essential for the efficient operation of government. When considering delegation, we believe the Legislature should keep the following factors in mind:

- ***Emergency Powers Are Available.*** As noted above, the Governor already has expansive powers in case of a disaster or emergency. Consequently, regardless of any changes that the Legislature makes to the budget's control sections, the administration will have sufficient authority to respond to any emergency situation.
- ***Legislature in Session Much of Year.*** For most of the year, the Legislature is in session. While using the budget's control sections is convenient during these months, their use is not essential. Legislation can be enacted to address unanticipated events or expenses. Such a process already is used to pay court settlements. Passing a bill, rather than using a control section, allows for legislative oversight and a more thorough review of proposals than is possible during a 30-day review process.
- ***Focus Delegation to When Legislature Out of Session.*** There is a greater need for administrative flexibility when the Legislature is not regularly in session. This generally only affects the months of September through November. (The Legislature is back in session in January shortly after any December requests are submitted.) Our records indicate that, from 1998-99 to 2002-03, the Department of Finance (DOF) sent the Legislature 295 requests pursuant to Section 27.00. As shown in Figure 2, less than 10 percent of these requests were sent during this three-month period. These requests in the fall totaled $108 million, of which $93 million was for General Fund spending. (These totals exclude emergency fire response costs

which are now funded through a separate process.) Thus, the average level of General Fund deficiencies during this period was less than $20 million a year.



Rethinking How to Address Unanticipated Expenses

While recognizing the need for some administrative authority to make adjustments to the budget, we believe the current powers provided to the administration are overly broad. The result has been recurring problems with the executive branch (the current and past administrations) exceeding the Legislature's intended use of these powers. In order to assist the Legislature in addressing these issues, we outline below a framework for a new approach to meeting unexpected needs. We recognize there are many possible alternatives to address the problems outlined above. In our view, the alternative described below would maintain the needed authority for administrative adjustments, while protecting the appropriation authority of the Legislature. The main components of this new approach are:

- Moving from deficiency authorizations to "pay as you go" budgeting.

- Providing administrative flexibility when the Legislature is out of session.

This approach would prevent departments from using the deficiency process as a "fall back" plan for departments' budget requests. Over the longer term, we believe the framework instead would encourage departments and the administration to more accurately estimate their needs in the formal budget process *prior to* the passage of the budget bill.

When in Session—Affirmative Approval

Under the current system, the deficiency process presumes that the administration is making changes consistent with the Legislature's intent. It forces the Legislature into the position of shouldering the burden of proof to encourage the administration to change course when there is a disagreement. Yet, when the Legislature is in session, there is little reason to delegate such control and authority to the executive branch. Instead, the administration should be able to affirmatively prove its case to the Legislature that additional funding is needed for an unanticipated need. As noted in Figure 2, most of the Section 27.00 requests from the past few years have been concentrated during two periods—the release of the Governor's budget in January and its revision in May. (This is not surprising given DOF is updating budget projections at these times.)

Pay As You Go Budgeting. The new framework would rely on "pay as you go" budgeting. Under current law, upon the expiration of a 30-day review, departments can begin to spend at rates which will lead to a deficiency. Under pay as you go budgeting, departments would *not* be able to engage in such spending. Instead, departments would have to wait for a supplemental appropriation to begin spending at a rate that would go beyond their budgeted authority. This approach would better protect the Legislature's appropriation authority by always keeping departments within their approved spending levels. This change, over time, should restrict the instances when the Legislature is backed into a corner to approve appropriations for departments (because there is no other feasible alternative at the time the deficiency bill is considered). It also should make the administration budget more honestly in the annual budget act.

Timing of Supplemental Appropriations. The Legislature could approach the timing of supplemental appropriation bills in a variety of ways. For example, the Legislature could handle the majority of unexpected expense requests through two supplemental appropriation bills each year—upon its return in January and later in the spring. New language in Section 27.00 this year is already moving in this direction by requiring a deficiency bill to be passed by March 1 and by requiring hearings to be held for deficiency requests submitted after the January budget.

More Options for the Legislature. The intent of Section 27.00 (b) this year was to avoid unexpected expenses causing net increases in overall state spending. Multiple supplemental appropriation bills would give a similar ability to make mid-year corrections. If for instance the administration requests sizable supplemental appropriations, it could at the same time request downward adjustments to other appropriations. As with the increased spending, the administration would have to make the case that the budget's original spending level for a department or program was no longer justified. In such cases, the Legislature could approve supplemental appropriation bills that did not increase overall state costs.

When Out of Session—Use Only Appropriated Funds

Increase Appropriation in Item 9840. Item 9840 currently gives the administration a small amount of funding annually to address unexpected needs. For minor adjustments, the administration can access this item without the need for a future deficiency appropriation. In this way, Item 9840 works as a type of reserve for unanticipated expenses. For the fall when the Legislature is out of session, this concept could be expanded. With a higher appropriation level in the item, the administration could address unanticipated needs with funds *already* appropriated by the Legislature. As with its current use, the appropriated dollars would be transferred from Item 9840 to the department's budget once a request was approved. In expanding this appropriation, the Legislature has a constitutional obligation to establish the parameters for its use, as we discuss below.

Delineating Use of Item 9840 Funds. As discussed earlier, the Legislature this year tightened the language governing the circumstances under which a deficiency is authorized. For instance, Section 27.00 now specifies that it should not be used for expenses that were known at the time of the May Revision, to pay for prior-year costs, or to fund new programs. To ensure that the funds in Item 9840 are used for expenses consistent with the Legislature's policy objectives, this language could be brought into the item to restrict its use. In other words, the funds in Item 9840 could not be accessed to pay for prior-year costs or to fund new programs. Moreover, the Legislature should identify the specific circumstances for which it intends funds appropriated in Item 9840 to be used. The use of Item 9840 could also retain the same notification and review procedures of Section 27.00.

Budgeting for Contingencies. In this manner, the Legislature would be budgeting dollars and setting the parameters for the typical contingencies that occur when it is out of session. Upon its return in January, the Legislature would face a budget that would not have exceeded its original authorized level of total spending.

No Loss in Legislative Oversight. In our view, the use of a revised Item 9840 would result in no loss of legislative oversight. In fact, taken together with the "in session" process we have outlined, we believe oversight would be enhanced.

What's a Reasonable Amount of Funding? The administration has sought an average of about $20 million in General Fund dollars through Section 27.00 for the past five years during September through November. Increasing this amount slightly and appropriating $25 million from the General Fund to Item 9840 should be sufficient to cover unanticipated expenses during the fall. (The special fund appropriations under Item 9840 could also be increased.) If this amount was insufficient to fund all unanticipated needs during the fall, the administration would have to prioritize its use of the funds. Any remaining needs could be addressed upon the Legislature's return.

Section 27.00 Would Be Unneeded. Given the revised process as described above, the authority provided by Section 27.00 would be unnecessary. If the Legislature adopted such an approach, related changes would need to be made in the Government Code.

Other Recommendations

Controller Should Verify Appropriation Authority. As part of its constitutional duties, the Controller must ensure that every state payment is tied to a specific authorized appropriation. The state's fiscal accountability systems depend on this occurring. Based on the continued payment of the VLF backfill and subsequent conversations with the Controller's office, however, we are concerned that this has not been the case. It is not clear that a systematic process is in place. We therefore recommend that the Controller report to the Legislature on the specific process used to verify that state warrants are backed by an appropriation. We also recommend that the Controller report on the status of the VLF backfill payments beyond the $1,000 appropriation made by the Legislature for this purpose.

Delete Section 7.50. The proposed Section 7.50 would provide the administration with excessively broad authority to spend federal funds. If California is to receive discretionary federal funds in 2004-05, it is the responsibility of the Legislature, not the administration, to identify the highest priorities for that funding. The administration's stated goal of offsetting General Fund costs with federal funds could be achieved through much more narrow means. (Section 8.25 served a similar purpose in this year's budget.) As such, we recommend that the Legislature delete Section 7.50 from the budget bill.

Conclusion

The Legislature has grappled for many years with delegating sufficient authority to the administration to deal with unanticipated events which impact the budget. This authority must be balanced with the Legislature's own authority to set state policy and appropriate funds. In our view, the current system is out of balance. We have identified one approach the Legislature might take to achieve a better balance.

"REMODELING" THE DRUG MEDI-CAL PROGRAM

How Could the Drug Medi-Cal Program Be Restructured To Hold Down Administrative Costs, Draw Down More Federal Support, and Improve Participation?

Summary

California's program for substance abuse treatment services for Medi-Cal beneficiaries, known as Drug Medi-Cal, provides a patchwork of services with an inconsistent level of support for different modes of treatment and for different treatment populations. In this analysis, we recommend an approach for addressing these concerns which would provide greater authority and resources for community-based services, contain the fast-growing costs of methadone treatment, and integrate a new and potentially more cost-effective mode of treatment into Drug Medi-Cal that does not require a net increase in state General Fund resources.

INTRODUCTION

Legislature Commissioned Study. The *Supplemental Report of the 2002-03 Budget Act* directed the Legislative Analyst's Office to examine the operations of the Drug Medi-Cal Program. Our analysis was to include, but was not limited to, an examination of what barriers exist to broaden provider participation and beneficiary access to Drug Medi- Cal, as well as a review of the options and recommendations available to the Legislature to maximize federal financial participation for its support.

BACKGROUND

What Is Drug Medi-Cal?

Five Modes of Treatment. The Drug Medi-Cal Program provides five different statutorily defined modes of treatment services for an estimated 45,000 persons annually with an alcohol or drug abuse problem. The modes of treatment are (1) narcotic treatment, (2) Naltrexone, (3) outpatient drug free, (4) day care habilitative, and (5) perinatal residential services. These services, which are discussed in the shaded box on the next page, are provided in an outpatient rather than a hospital setting.

Drug Medi-Cal services are reimbursed on the basis of each increment of service furnished by a provider (on a so-called "fee-for-service" basis) at maximum rates set by the state, and are not provided in a "capitated" or managed care setting. These community treatment services are "carved out" from the regular Medi-Cal Program, which means that they are delivered by a specialized system of providers certified by the state rather than through participating physicians or health plans. Federal law generally requires that, if a state includes a particular service, such as Drug Medi-Cal, in its Medicaid plan, that service must be (1) in effect statewide; (2) provided equally in amount, duration, and scope to different categories of Medicaid beneficiaries; and (3) furnished "with reasonable promptness" to participants.

One of Several Treatment Programs. Drug Medi-Cal is one of several major sources of support for substance abuse treatment services provided in the community. Additional support for community outpatient treatment of individuals with substance abuse problems is provided under the Substance Abuse and Crime Prevention Act (Proposition 36 of 2000), the CalWORKs program for welfare recipients, discretionary state grants, federal Substance Abuse Prevention and Treatment (SAPT) federal block grants, with contributions of county funds, and from other funding sources. Also, the U.S. Department of Veterans Affairs (VA) operates a separate health care system that includes an array of substance abuse treatment services for qualified veterans.

Drug Medi-Cal's Five Primary Modes of Treatment

Narcotic Treatment Program—An outpatient service that utilizes methadone or levo-alpha-acetylemethadol (LAAM) to help clients detoxify from and subsequently to maintain their freedom from narcotic dependence. Narcotic treatment clinics are also required to conduct medical evaluations, treatment planning, drug testing, and counseling. These services are limited to individuals age 18 and older. The LAAM treatment will be discontinued early this year because the drug will no longer be available.

Naltrexone—An outpatient service in which the medication Naltrexone, which blocks the euphoric effects of heroin and other opiates, is used to prevent relapse by clients who have been detoxified. Medical evaluations, treatment planning, drug testing, and counseling are also provided. These services are limited to individuals age 18 and older who are currently drug free. These services cannot be provided to pregnant women.

Outpatient Drug-Free—An outpatient service in which counseling, medical evaluations, crisis intervention, and other rehabilitative services are provided to clients. At least two group counseling sessions per month are required. This service is available to all eligible Medi-Cal beneficiaries with a substance abuse problem.

Day Care Habilitative—Also referred to as day care *rehabilitative*, these are more intensive outpatient services in which both group and individual counseling and other rehabilitative services are provided to clients at least three hours per day three times per week in a more structured program. These services are currently limited to pregnant and postpartum women and certain children under age 21.

Perinatal Residential—This mode of service, which is limited by state law to pregnant and postpartum women, currently includes various substance abuse counseling and rehabilitative services, education, training in child development, transportation, and coordination of additional services in treatment facilities of 16 beds or less, not including beds occupied by children. Room and board are paid for with other funding sources.

Program Administration and Funding

County Delivery System. Drug Medi-Cal is administered by the Department of Alcohol and Drug Programs (DADP) under the terms of a memorandum of understanding with the Department of Health Services (DHS), the state agency ultimately responsible for all Medicaid funds. With the

exception of so-called "direct contracts" with providers, Drug Medi-Cal services are delivered through county substance abuse treatment systems, which often contract with community-based providers for the delivery of treatment services directly to clients. A provider must be state-certified to be eligible to participate in the Drug Medi-Cal Program. Most such services are provided in outpatient clinics or in residential facilities in the community.

The 2004-05 budget proposal for DADP would provide about $116 million from all fund sources ($61 million General Fund) for Drug Medi-Cal. This includes funds for administrative support and local assistance for the main portion of the program, as well as a separate component for perinatal programs. Federal funds are shown as reimbursements in the DADP budget, and are reflected as federal funds within the DHS budget. Figure 1 summarizes the proposed Drug Medi-Cal budget for 2004-05.

Figure 1

The DADP 2004-05 Drug Medi-Cal Proposed Budget

(In Thousands)

	General Fund	Reimbursements (Federal Funds)	Funding Total
Regular Drug Medi-Cal			
Administrative support	$3,162	$3,162	$6,324
Local assistance	55,579	49,588	105,167
Subtotal	($58,741)	($52,750)	($111,491)
Perinatal Drug Medi-Cal			
Administrative support	$205	$205	$410
Local assistance	2,219	2,219	4,438
Subtotal	($2,424)	($2,424)	($4,848)
Total Funding	**$61,165**	**$55,174**	**$116,339**

The state provides the vast majority of the matching funds that are used to draw down a dollar-for-dollar match of federal support for Drug Medi-Cal services. However, some additional funding for the support of Drug Medi-Cal services is contributed by counties. In 2000-01, the last year for which information is available, this amounted to about $7.5 million.

A PATCHWORK OF SERVICES

Our analysis of Drug Medi-Cal indicates that there are problems inherent in the structure of the program that have had the unintended effect of limiting the availability and effectiveness of the community substance abuse treatment services it is intended to provide to Medi-Cal enrollees. The central problem is that, while counties play the leading role in the delivery of Drug Medi-Cal services, the state has retained financial responsibility for and control over the nonfederal costs of the program. As discussed in more detail later in this analysis, this split in operational and financial authority is a key reason why the Drug Medi-Cal Program, as currently designed, provides a patchwork of services with an inconsistent level of support for modes of treatment from county to county and for different treatment populations.

The findings from our analysis of the program are summarized in Figure 2 and discussed in more detail below.

Figure 2

Drug Medi-Cal
A Patchwork of Services

LAO Findings

- Significant inconsistencies exist in the resources being provided to support different modes of treatment.
- A disproportionately small share of the Drug Medi-Cal budget is spent on services for children and female Medi-Cal beneficiaries.
- Significant variations exist in the availability and extent of Drug Medi-Cal services from one county to another in California.
- The state is failing to take full advantage of available federal support for community substance abuse treatment services.
- Drug Medi-Cal is a rigidly controlled program that is relatively complex and costly to administer.
- The state is incurring substantial costs for the hospitalization of Medi-Cal beneficiaries whose substance abuse problems have gone untreated.

Significant Inconsistencies in Resources

Our review of Drug Medi-Cal confirmed that there are inconsistencies in the resources being provided for different modes of treatment now authorized in state law. The heavy focus of the program on methadone treatment, the most expensive mode of treatment under Drug Medi-Cal, means that a disproportionate share of state resources are being devoted to persons addicted to narcotics.

Allocations Inconsistent. As can be seen in Figure 3, some specific modes of treatment within the Drug Medi-Cal Program have grown much more quickly or slowly than the program as a whole.

Figure 3

How State Spending for Drug Medi-Cal Has Changed Over Time[a]

(Dollars in Thousands)

	1994-95	2004-05	Percentage Change
	General Fund	General Fund	General Fund
Day Care Habilitative	$5,977	$2,457	-58.9%
Outpatient Drug Free	8,408	12,544	49.2
Naltrexone	3	—	-100.0
Narcotic Treatment Program	13,531	41,746	208.5
Residential Perinatal	389	1,051	170.2
Total	**$28,308**	**$57,798**	**104.2%**

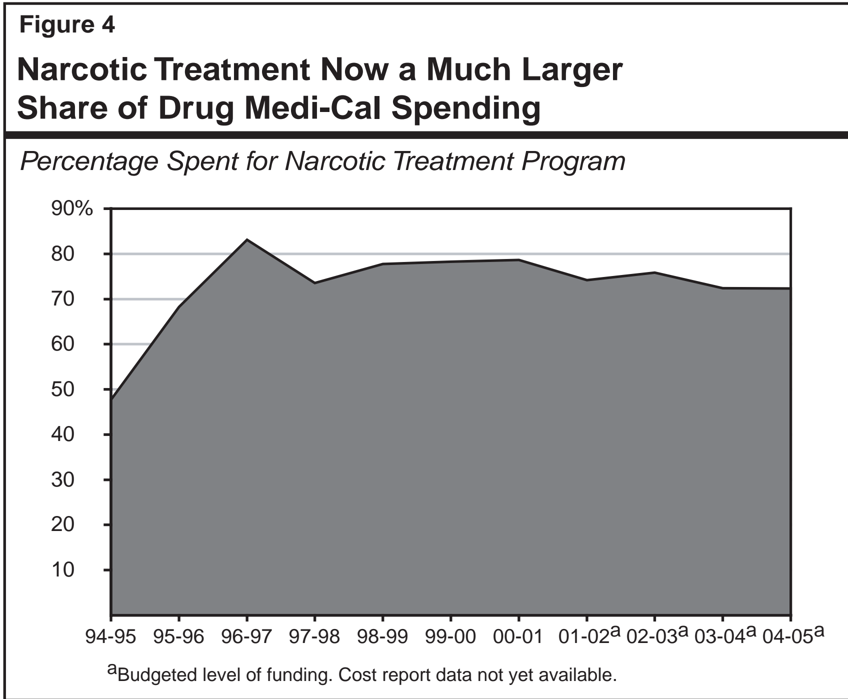
[a] Figure includes only state expenditures for local assistance.

General Fund spending on narcotic treatment program services has tripled. Expenditures for residential perinatal services have grown much faster than the overall Drug Medi-Cal budget, but have remained a relatively small share of total spending. Overall spending has stayed fairly flat for outpatient drug free services, although the General Fund share of those costs has increased. Meanwhile, spending for more intensive day care habilitative services has dropped significantly over time, and the small amounts of funding initially provided for Naltrexone treatment services have ceased altogether.

As a result, as shown in Figure 4, a much larger share of Drug Medi-Cal spending is now devoted to narcotic treatment. In 1994-95, just under half of every state General Fund dollar in the program was devoted to this purpose, but the 2004-05 budget earmarks almost three of every four General Fund dollars for the narcotic treatment program, primarily for methadone maintenance.

Figure 4

Narcotic Treatment Now a Much Larger Share of Drug Medi-Cal Spending



Changes in Mid-1990s Help Explain Trend. A number of factors have contributed to the inconsistent way in which services have grown. However, a redesign of the Drug Medi-Cal Program in the mid-1990s is a major reason for this outcome.

During that fiscally difficult period for the state, the Legislature and the administration initiated a series of statutory and regulatory changes in treatment services with the primary intention of slowing future growth in the Drug Medi-Cal Program budget. The program was placed for several years under a General Fund spending cap, eligibility for some services was restricted to certain populations, payment rates for services were reduced, and some services restructured to make them less costly.

During this same period, however, pursuant to a federal court order in a case known as *Sobky v. Smoley*, other changes were implemented in the Drug Medi-Cal Program that facilitated an expansion of narcotic treatment services. For example, counties were prohibited from using waiting lists and caps to limit the number of persons that could be provided such services, and the state took on the responsibility of directly contracting for the provision of such services with any willing certified provider of the service in a county if that county was unwilling to do so. The Legislature also agreed to

simplify the process by which claims for methadone services were reimbursed and the rates paid for the service under Drug Medi-Cal were restructured.

Consequently, General Fund support for narcotic treatment services grew at an average annual rate of almost 12 percent from 1994-95 through 2004-05. Caseload, cost per case, and the utilization of services by each client have all increased under the current design of the program.

Heroin Addicts Prioritized for Treatment. As a result of the programmatic changes discussed above, the Drug Medi-Cal Program spends almost three-fourths of its General Fund resources on the 43 percent of its caseload that is in narcotic treatment programs. Given the current structure of the Drug Medi-Cal Program, this trend is not likely to be reversed in the near term. The methadone caseload is building slowly but steadily each year, with each client on average spending an increasingly longer period of time in treatment, DADP data show.

Arguably, the Drug Medi-Cal program's strong emphasis on methadone has helped to provide more balance overall to a community treatment system that, in many counties, provides little or no resources at all for this mode of treatment. It should also be noted that methadone maintenance has particularly strong scientific validation as being an effective means of treatment. However, the current approach involves making a significant tradeoff in terms of the number of persons overall who receive Drug Medi-Cal assistance. Methadone is the most expensive of the five modes of treatment provided under Drug Medi-Cal with an average annual cost per client (all funds) of almost $4,000. Fewer persons with addiction problems are receiving treatment than might otherwise be possible if Drug Medi-Cal program resources had been allocated instead to less expensive modes of outpatient treatment.

We would also note that heroin addiction, while certainly a serious problem, is not nearly as prevalent as other types of drug problems, such as alcohol abuse or addiction to cocaine and methamphetamine. The most recently published DADP survey data collected in 1996 regarding drug use by Californians age 18 or older indicated that 0.3 percent reported using heroin and other opiates within the previous year. In comparison, marijuana use was reportedly 11.1 percent; cocaine, 1.9 percent; amphetamines (including methamphetamines), 1.6 percent; and hallucinogens, 1.4 percent.

Disproportionately Small Share of Program for Children and Women

The structure of the Drug Medi-Cal Program—and particularly its heavy emphasis on narcotic treatment—has important implications in re-

gard to who is now receiving treatment services, creating some clear "winners" and "losers" among those eligible for services.

Children Only a Small Share of Spending. The current program structure has generally meant the allocation of fewer resources to Drug Medi-Cal services for children and youth than might otherwise be the case.

Although the number of children and youth receiving treatment services under the Drug Medi-Cal Program increased in recent years, spending on these groups has remained a disproportionately small share of the overall program budget. The annual number of persons under age 21 who received treatment services under Drug Medi-Cal increased from about 4,500 to 10,500 between 1996-97 and 2002-03. While children and youth constitute about 23 percent of the caseload, they received only about 6 percent to 8 percent of the Drug Medi-Cal budget. Part of the reason is that individuals under 18 are generally prohibited under state and federal rules from participating in methadone maintenance. The DADP data also indicate that the recent expansion of treatment services for children and youth has occurred in outpatient drug free and day care habilitative services, which are much less costly modes of treatment.

Females Underrepresented in Drug Medi-Cal. Fewer Drug Medi-Cal resources are also spent on females. While they constitute almost three-fifths of Medi-Cal enrollment and expenditures, DHS data suggest that females account for only about half of the caseload and local assistance expenditures within Drug Medi-Cal.

Notably, many poor women who are eligible for Drug Medi-Cal are also eligible for substance abuse treatment services provided with CalWORKs program funding. This factor could account for part of the underrepresentation of women in the Drug Medi-Cal caseload. On the other hand, we would also note that the gender gap within Drug Medi-Cal is part of a larger pattern of gender imbalance within the community treatment programs tracked by DADP.

Variations in Services From County to County

Our analysis indicates that there are significant variations in the availability and extent of Drug Medi-Cal services from one county to another within California.

County Access to Drug Medi-Cal Varies. According to DADP data, 39 counties provide one or more Drug Medi-Cal services. However, 19 counties, all of them small in population and in rural areas, will receive no allocations of funding in 2003-04 for the provision of Drug Medi-Cal services because they have declined to participate in the program.

In theory, the residents of counties which do not offer Drug Medi-Cal services are permitted to obtain them from a neighboring county. But DADP and DHS data indicate that the distance between the county of residence of Medi-Cal beneficiaries and the places where services are available poses a significant barrier to their taking advantage of their Drug Medi-Cal benefits.

The available statistical evidence suggests that clients residing in counties which do not have Drug Medi-Cal services are often not taking advantage of services that are available to them in adjacent counties.

Nearly all counties which do participate in Drug Medi-Cal have nonetheless chosen not to provide all of the five modes of treatment authorized under state law. Outpatient drug-free treatment is available in many counties. However, methadone maintenance services remain unavailable in about half of the counties. Most of the counties lacking methadone services are rural and small in population. However, a large number of counties, including some in more populated areas, are not providing day care habilitative, perinatal residential, or Naltrexone services as part of their Drug Medi-Cal programs. The available statistical evidence suggests that some counties offering fewer services have lower rates of participation in the program.

State Not Taking Full Advantage of Federal Assistance

Our analysis indicates that California's treatment system is failing to take full advantage of federal support for substance abuse treatment services.

Medicaid Not Always Used When Possible. The state appears to be missing an opportunity to draw down additional federal funding through the Drug Medi-Cal Program that could otherwise have been used to improve or expand services. Specifically, DADP data for 2001-02 indicate that about 54,600 persons across the state in various treatment programs were considered *eligible* for Drug Medi-Cal on the basis of their families' incomes, but only about 43,100 of those individuals *actually received their services* through Drug Medi-Cal that same fiscal year.

The data collected by DADP do not allow a determination of how much of the 11,500-client gap discussed above consists of individuals who are eligible for, but not paid for, under Drug Medi-Cal. (Although income eligible, some of these individuals may ultimately be determined to be ineligible for other reasons.) To the extent these individuals are eligible, however, the state is missing an opportunity to draw down about one dollar of federal matching funds under Drug Medi-Cal equal to each dollar spent on the treatment of these clients. We estimate that the loss of these matching funds probably amount to millions to low tens of millions of dollars annually on a statewide basis.

Veterans Program Eligibility Not Being Tracked. Health services for veterans were expanded significantly with the enactment by Congress of the Veterans Health Care Eligibility Reform Act of 1996. Qualified veterans are entitled to comprehensive medical services, including substance abuse treatment services, through the federal VA system.

Our analysis indicates that it is likely that a significant number of veterans are receiving services through Drug Medi-Cal and other programs operated by the counties rather than through the VA system, even though they would be eligible to do so. While some counties are referring some persons needing treatment to VA, there is no systemwide requirement that they screen individuals for VA eligibility or to make such referrals. While counties are required to screen whether the individual is eligible for Medi-Cal or CalWORKs, they are not similarly required to document whether an individual is eligible for VA benefits.

This means that state and county treatment systems may be missing an opportunity to preserve their limited resources for treatment services. While the state would pay half of the cost of treatment for a veteran receiving services through the Drug Medi-Cal Program, for example, the state would pay nothing if that same veteran received his/her services from the VA.

A Difficult and Costly Program to Administer

Our analysis of the design of the Drug Medi-Cal Program indicates that it is rigidly controlled and relatively expensive and difficult to administer. This arrangement is, in large part, a consequence of the way the program is designed, with counties being primarily responsible for the delivery of Drug Medi-Cal services but the state retaining the main responsibility for the nonfederal share of program costs. As we discuss below, the state has imposed extensive rules intended generally to constrain state expenditures for Drug Medi-Cal benefits that also have the unintended effect of making it more difficult for counties to meet the needs of clients and increasing program administrative costs.

Program Tightly Controlled. The statutes and regulations governing Drug Medi-Cal are highly specific. They delineate the specific modes of services that are to be made available; which specific clients can receive each mode of treatment; the providers from whom the service can be obtained; the minimum number of hours each week or each month that the services must be provided; and, in the case of outpatient drug-free services, even the minimum and maximum number of individuals who must participate in a group counseling session.

Some program restrictions, such as those implementing federal Medicaid rules, are unavoidable. But many program restrictions adopted by the state are the result of the split in operational and financial responsibility

for the program between the state and counties. As a result of changes to limit state expenditures for the program, county and provider discretion as to how to deliver the services has been reduced considerably.

We are advised by treatment experts and county officials that these restrictions sometimes make it more difficult or impossible to deliver the specific services that an individual client may need. For example, DADP issued updated youth treatment guidelines last year calling for these clients to receive, whenever clinically appropriate, individual counseling sessions and residential treatment services. However, under Drug Medi-Cal, children receive only limited access to individual counseling and residential treatment.

This specificity in state rules also means that providers who wish to be reimbursed under Drug Medi-Cal have less flexibility to modify their treatment methods in keeping with changes in professional treatment practices, academic research, or changes in federal law.

Overhead Rate High. Our review of the Drug Medi-Cal Program indicates that its administrative costs are relatively high in comparison with the Medi-Cal Program when both state and county overhead are taken into account. In 2000-01, the overhead rate of more than 14 percent was more than double that for the Medi-Cal Program as a whole.

Some of the administrative costs are due to standard federal requirements for the fiscal management and auditing of Medicaid funds and the sometimes lengthy process of submitting, processing, and settling provider claims for payment. But some factors driving up costs are specific to Drug Medi-Cal, such as the program's elaborate rate-setting mechanisms, and the split in administrative duties among DADP, DHS, and the counties.

Lack of Treatment May Be Adding to State Costs

Our study found evidence suggesting that, by inconsistently providing treatment services to persons in the Medi-Cal Program who need them, the state may be incurring substantial costs—far beyond those incurred for the Drug Medi-Cal Program itself—for the hospitalization of persons with substance abuse problems.

Hospital Data Demonstrate Treatment Demand. The amount of funding provided in the DADP budget for community treatment services has increased significantly over the years. However, except for methadone treatment, the resources allocated for Drug Medi-Cal services have not expanded significantly overall since 1994-95.

This situation has significant consequences for state expenditure levels because the state often bears the cost of health problems experienced by Medi-Cal beneficiaries who have substance abuse problems. Data collected

in 2000 by the Office of Statewide Health Planning and Development indicate that substance abuse problems suffered by Medi-Cal beneficiaries are a major factor driving up Medi-Cal Program costs.

As shown in Figure 5, Medi-Cal beneficiaries with a primary diagnosis related to substance abuse were responsible for almost $41 million in charges at California hospitals in 2000. Those with a secondary diagnosis related to substance abuse were responsible for an additional $1.3 billion in hospital charges. (The amounts actually paid under Medi-Cal after disallowance of some charges would be somewhat less.) Almost 47,000 persons enrolled in Medi-Cal who had a diagnosis of a substance abuse problem (primary or secondary) ended up in the hospital that year.

Figure 5

Medi-Cal Hospitalization Costs for Individuals With a Substance Abuse Diagnosis

Facility type	Number of Discharges	Average Charge Per Stay	Sum of Reported Charges (In Millions)
Primary diagnosis was a substance abuse-related problem			
Acute care	1,860	$18,099	$33.3
Skilled nursing	28	55,864	1.6
Psychiatric care	821	6,692	5.5
Chemical dependency	39	11,800	0.3
Rehabilitation care	3	28,340	0.1
Totals[a]	**2,751**	**$14,808**	**$40.7**
Secondary diagnosis was a substance abuse-related problem			
Acute care	31,642	$35,870	$1,123.0
Skilled nursing	888	58,961	52.4
Psychiatric care	11,024	11,328	124.8
Chemical dependency	3	3,243	0.0
Rehabilitation care	499	98,473	49.1
Totals[a]	**44,056**	**$30,628**	**$1,349.4**
Total for all patients with substance abuse problem	**46,807**	**$29,698**	**$1,390.1**

[a] Year 2000 data. Total may differ from sum of items due to rounding.

In some cases, the secondary diagnosis of substance abuse might have been incidental to the main reason an individual was admitted to a hospital. But treatment experts indicate that such hospital admissions are frequently the result of individuals who (1) have overdosed on drugs and subsequently required emergency hospitalization, (2) were involved in motor vehicle accidents while under the influence of alcohol or drugs, or (3) have suffered a variety of health problems (such as cirrhosis of the liver) from the sustained abuse of alcohol or use of illegal drugs over time. In many cases, treatment experts indicate, the individuals being hospitalized had been going without effective treatment for their drug or alcohol problem.

DRUG MEDI-CAL COULD BE "REMODELED"

State Could Change System. Most of the problems with Drug Medi-Cal that we have identified in this analysis are primarily the result of inherent flaws in the way the program and the statewide delivery system for treatment services are designed.

Some of the problems result from federal rules that are beyond the state's control. However, there are a number of other changes in the design of the program that the state does have the authority to make. The treatment services provided for persons enrolled in Medi-Cal could be remodeled to address these concerns.

Our recommended alternative for redesigning the Drug Medi-Cal Program and the state's delivery system for alcohol or drug treatment services has two main components. First, the existing community-based system of care would be redesigned to provide counties with broad new authority under a new financial structure to decide the modes of treatment to be provided within their jurisdiction and to determine exactly how such services should be provided. Second, the state would take over direct responsibility statewide for the provision of narcotic treatment services as part of a strategy to help contain the fast-rising cost of methadone maintenance treatment. Buprenorphine, a medication approved this year for prescription in the United States that offers an alternative to methadone, would be integrated into the Drug Medi-Cal Program. Our approach would not require a net increase in state General Fund support for the program. The specific components of our proposal are summarized in Figure 6 and outlined in more detail below.

Figure 6

Building a Better Community-Based Treatment System

Shift Funding and Programs to Local Control

- Shift various state funding allocations for drug or alcohol treatment services to counties.
- Make counties responsible for nonfederal share for Drug Medi-Cal services (except narcotic treatment).
- Abolish state laws and regulatory constraints and thereby provide more county flexibility in service delivery.
- Ensure continued state role of administering federal rules, setting and enforcing health and safety standards, and providing statewide leadership for the treatment system.

Implement Cost Containment for Methadone

- Shift funding and responsibility for narcotic treatment programs to the state.
- Review state licensing and certification rules to see which duplicate or exceed federal requirements.
- Reexamine the "cost-plus" structure for setting rates.
- Conduct an external review of cases where clients receive methadone maintenance for extended periods of time.
- Screen clients for eligibility for treatment by the federal VA health system.
- Eliminate LAAM services due to withdrawal of the product by its manufacturer.
- Make statutory and regulatory changes to formally integrate buprenorphine as a treatment method.

Shifting Funding and Programs to Local Control

Shift State Funding to Counties. Under our approach, much of the state funding now used for the support of local alcohol or drug treatment programs (with the exception of narcotic treatment programs) would be shifted to the control of counties, which would in turn be allowed to allocate these resources among such treatment programs in keeping with local priorities. These state funds—which could amount to as much as $225 million based on current program spending levels—would be placed in a local trust fund for alcohol or drug treatment services, subject to state audit, and could not be diverted by counties to other local purposes, such as transportation.

In addition to some of the state funds now used for the support of Drug Medi-Cal, our proposed fund shift to counties would include other discretionary state grant funds now allocated through the DADP budget and,

after 2005-06, the funding now allocated to counties under Proposition 36 of 2000. The state could also add to local treatment trust funds the $46 million now provided for substance abuse treatment services under the CalWORKs program, although these funds could not be used under federal rules as a match to draw down additional federal Medicaid funding.

This pool of funding could be provided under a realignment approach, in which the state could earmark a portion of existing or new state revenues and authorize by statute the automatic and ongoing transfer of these monies to the counties. An alternative would be the enactment of a state block grant program that provided a statutory mechanism to annually adjust the allocations to counties to take into account changes in caseload and inflation.

Our analysis indicates that, so long as the use of state funds was restricted as we propose to substance abuse treatment, these appropriations could be counted toward meeting the maintenance-of-effort requirement that exists for the federal SAPT block grant program.

Counties Would Gain Responsibility and Authority. In trade for this commitment of these ongoing state resources to counties, the state would statutorily transfer the responsibility to counties for paying the nonfederal share of costs for Drug Medi-Cal services (except narcotic treatment programs) for the Medi-Cal beneficiaries within their jurisdiction. Under our proposal, all of the counties would be provided with sufficient state resources that they could spend to meet this new obligation. The resources they would be allocated would be equivalent to the amounts now spent by the state for substance abuse treatment for the Medi-Cal beneficiaries residing in their jurisdiction. Also, counties unable or unwilling to operate their own Drug Medi-Cal program would be permitted to enter into partnerships with other counties or contract with other counties for these services.

Our proposal contains several features intended to ensure that counties would be able to meet their obligation for providing the nonfederal match for those Drug Medi-Cal services (again, not including narcotic treatment) for which they would gain financial responsibility. One key component of our plan is that the state would repeal or modify significantly various state laws and regulations limiting the modes of treatment offered and other constraints, and each county could be allowed to make its own decisions about these matters. By gaining more authority to control the intensity as well as the duration of services and, within the constraints of federal Medicaid law, the ability to decide which clients should receive which services, we believe the counties would have the programmatic tools to manage their fiscal obligation to provide the nonfederal match for Drug Medi-Cal services. Counties would also have the flexibility to use local resources to expand and improve services. For example, counties could

add a so-called "rehabilitation option" including outreach activities, after-care, and case management for clients as well as to provide more expensive modes of treatment for children and youth, such as residential care, if they so chose.

As noted earlier, our plan does not propose to transfer the financial responsibility for Drug Medi-Cal narcotic treatment services to the counties. The state would continue to retain financial responsibility for providing the nonfederal matching funds for narcotic treatment, shielding the counties from any risks associated with managing the component of the Drug Medi-Cal Program for which costs have grown rapidly over time. The counties would generally be responsible for other treatment services for which, as a group, costs have grown little if at all since 1994-95. Were counties to choose to keep in place the cost containment measures that were imposed and proved to be effective for these other treatment services, we believe the resources they would be allocated would prove sufficient to meet their Drug Medi-Cal obligations.

We would also note that, in the unlikely event that a county experienced a surge in Drug Medi-Cal costs beyond its control, it would receive additional revenues under our plan to address any such deficiency. That is because, under our proposal, each county would receive additional resources, such as the monies now allocated under Proposition 36, which could be used in the future for the substance abuse treatment programs it deems to be a priority.

The state would still continue to play an important role overall in the state treatment system. In addition to the direct administration of narcotic treatment services provided through Drug Medi-Cal, the state would continue to ensure compliance with federal Medicaid rules, set and enforce health and safety standards for the quality of care, help prevent fraud or overspending, and provide leadership for the treatment system on a statewide basis.

Implementing Cost Containment For Methadone

State Would Keep Methadone Program. In theory, the state could also transfer control of funding and responsibility for narcotic treatment programs to the counties. We recommend against such an approach for two reasons. First, federal and state regulations and statutes intended to prevent the illegal trafficking in methadone make it more difficult to delegate program authority to counties. Such a program shift could also run afoul of the federal court injunction in the *Sobky v. Smoley* case which requires a number of steps to ensure that these services are available in any county in which a provider is available.

We propose instead that the state assume operational and financial responsibility for narcotic treatment program services and directly contract for these services with providers across the state. The state already directly contracts for methadone treatment in some California counties as part of the resolution of *Sobky v. Smoley*. Counties could still choose to pay for these services for non-Medi-Cal clients. We believe our proposal is consistent with the court's goal of making methadone services available to Medi-Cal beneficiaries more uniformly statewide.

Along with this takeover in responsibility of narcotic treatment programs, we further propose that the state implement a cost-containment strategy to reduce state spending for these services. If the effort were successful, the Legislature would have the choice of reducing overall state expenditures or reallocating savings to treatment programs in the community.

Among the cost-containment strategies that could be considered are the following:

Review Program Requirements. In the course of our review, we have identified a number of program requirements which may unnecessarily add to the costs of this program. A more detailed review of these requirements is appropriate and could lead to program savings. The DADP could be directed to review the extent to which state licensing and certification requirements for the operation of methadone maintenance programs duplicate or exceed federal requirements for the operation of such clinics and unnecessarily add to the cost incurred by providers of such services.

For example, current restrictions on the program that warrant review are limitations on clients' ability to take their medications at home, limitations on the capacity of clinics, requirements for the repeated testing of clients for various diseases, and restrictions on dispensing methadone in physicians' offices. These reviews would ensure that these limits are justified either by medical necessity or concern for public safety.

Revise Rate-Setting System. The Legislature could revise the process set in statute for setting rates for narcotic treatment programs. The present "cost-plus" rate structure for methadone clinics, which is based on costs reported by providers statewide, provides little incentive for them to become more efficient or cost-effective and allows for no review as to whether rates are already sufficient to provide good access to care and quality of care. This could involve modest modifications of the existing rate system, but could also include a basic restructuring of the way payments are made to providers.

Examine Treatment Extensions. Given the growing methadone caseload and the lengthening period of time that each client is remaining in such treatment, the DADP could be directed to oversee a review by an outside panel of experts of these trends. Using a sample of cases, the review would attempt to determine whether clients now being maintained for a prolonged

period on methadone are clinically appropriate candidates for a reduction or a gradual phase-out of their dosage. Such a one-time state review would confirm whether only medically necessary extensions of treatment are being provided. In addition, it would shed light on the criteria used as the basis for extending treatment, and offer the potential of modifying that criteria. The review would also shed light on whether state law should be changed to establish whether methadone maintenance should be offered only as an interim step toward the eventual elimination of client dependence on all drugs, including methadone.

Screen for Veterans and VA Eligibility. The DADP could direct that Medi-Cal beneficiaries now receiving methadone treatment, and those admitted for such treatment in the future, be screened and, when appropriate, referred to VA health benefits. Counties could similarly be required to conduct such screens for other community treatment services and to collect admissions data on the number of veterans admitted to care.

Eliminate LAAM Benefits. Levo-alpha-acetylemethadol (LAAM), a medication now provided under Drug Medi-Cal for treatment of some narcotic addicts, will soon no longer be available due to withdrawal of the product by its manufacturer. State law and regulations should be changed to eliminate the LAAM mode of treatment and to allow clients now on LAAM to transfer, as deemed clinically appropriate, to a new mode of treatment, buprenorphine, that we discuss in more detail below.

Integrate Buprenorphine Treatment. The Legislature could consider integrating burprenorphine, a newly available mode of treatment for narcotic addiction, into the Drug Medi-Cal Program. We discuss this approach in more detail in the shaded box on the next page.

CONCLUSION

Weighing the Advantages and Disadvantages. Our proposal for remodeling Drug Medi-Cal is not the only possible approach to improving the program. Our study examined alternative approaches that the Legislature may also wish to take into consideration as it examines how and if the program should be modified. Under one alternative, the responsibility for providing treatment services for children and youth would be shifted from DADP and the Drug Medi-Cal Program to a separate new outreach and treatment program administered by the Managed Risk Medical Insurance Board as part of the Healthy Families Program. Under another alternative we reviewed, Drug Medi-Cal services would be consolidated administratively either with regular Medi-Cal health coverage or with mental health programs.

Integrating Buprenorphine Into Drug Medi-Cal

New Mode of Treatment Available. As part of our proposal to contain the fast-growing state cost for methadone services, the Legislature could consider integrating buprenorphine into the Drug Medi-Cal Program. This medication was approved by federal authorities last year for prescription in the United States as a treatment for heroin and other opiate addictions.

We are advised that for many clients (although by no means all), buprenorphine treatment offers some advantages over methadone. It can be distributed in tablet form through the offices of qualified physicians instead of just through narcotic treatment clinics, potentially making these services more widely accessible to clients without the stigma perceived from visitation to a drug-treatment clinic. Formulation of the drug in a combination with another medication called naloxone lowers the risk that the drug itself can be abused, as has sometimes been the case for methadone. Published medical evaluations show that it is less toxic and poses fewer medical risks to clients, and that treatment can often be phased out in a shorter period of time than methadone.

While the *cost per dose* for buprenorphine is higher than for methadone, the overall *cost per treatment episode* can be lower for buprenorphine due primarily to the shorter duration of treatment.

Some hurdles to a shift to the new drug are federal rules requiring that physicians have special qualifications or receive special certification to prescribe it and limitations on the number of patients for whom each physician can prescribe the medication.

Formal Recognition of Treatment Method. Federal law requires that the physicians within each state be permitted to prescribe buprenorphine unless that state has by October 17, 2003 enacted a law explicitly prohibiting its availability. That date has passed without any such action by the California Legislature. However, absent a change in state law, buprenorphine treatment is not permissible as part of the Drug Medi-Cal Program. The Legislature has the option of formally integrating the medication through statutory and regulatory changes into both the regular Medi-Cal Program and the Drug Medi-Cal Program and modifying state licensing and certification procedures for treatment programs.

As part of this change in approach, the Legislature may wish to consider including counseling as a part of buprenorphine treatment, due to evidence suggesting that counseling reduces relapse rates of

Integrating Buprenorphine Into Drug Medi-Cal *(continued)*

persons treated with the medication. It may also wish to consider a "step therapy" approach by which buprenorphine would ordinarily become the first method of treatment attempted for narcotic addicts before other methods, such as methadone, were attempted.

Expand the Physician Pool. The Legislature could phase in a licensing requirement specifying that narcotic treatment clinics establish a network of qualified physicians sufficient to meet the needs of their caseload of clients receiving burprenorphine treatment. A delay of several years before full implementation of such a rule would almost certainly be necessary to ensure that a sufficient number of physicians with the necessary qualifications were available to clinics to manage the buprenorphine caseload.

Reducing Buprenorphine Costs. The cost of a daily dose of buprenorphine is relatively high compared to methadone. The Medi-Cal Program is already able to obtain rebates under federal and state law to lower the cost of the medication to the state. The cost of the drug could drop significantly in about six years when it could become available in so-called "generic" form.

We are also advised that, were the market for the medication to grow to the point where it became a profitable product for its manufacturer, its price could be reduced at an earlier date. For this reason, the Legislature may wish to consider directing DADP and DHS to examine the strategy of establishing a consortium of state and local potential purchasers of the medication in a sufficient quantity to induce the manufacturer to consider a price reduction in the short term.

We believe our recommended approach has some distinct advantages. Consolidating operational and financial responsibility for the Drug Medi-Cal Program at the county level, in our view, could allow more individuals overall to receive necessary services, ensure the more flexible and effective delivery of services, potentially even out at least some of the inconsistencies among the various modes of treatment, potentially bolster the participation of children and women, simplify the program, and hold down its administrative costs. Counties would have the opportunity and the authority to leverage the resources available to them, such as their share of Proposition 36 funding, to draw down additional federal Medicaid funds. The net gain in resources overall could be used at a county's discretion to expand Drug Medi-Cal services for children and youth, as well as for women. Rigid state laws and rules would no longer constrain them from

doing so. Our review of the 1991 realignment of mental health programs indicated that counties used a comparable increase in their program and fiscal authority to improve the overall delivery of mental health services. For example, we found that realignment generally worked to allow counties to run better coordinated, more flexible, and less costly community programs.

Placing methadone services under stronger state control would more effectively contain the growing cost of this mode of treatment while potentially making such services available on a more consistent basis across the state. The gradual integration of buprenorphine into Drug Medi-Cal narcotic treatment programs could also hold down methadone costs while involving more "mainstream" physicians in addiction medicine.

Better Care Reduces Health Care Costs for Aged and Disabled Persons

How Can the State Better Coordinate Care for the Aged and Disabled in Medi-Cal and Save Money?

Summary

Today, the Medi-Cal Program offers a paradox: aged and disabled beneficiaries who would benefit the most from the improved health care that can come from receiving coordinated care are the very population that has largely been excluded from Medi-Cal managed care plans. Moreover, because this group has the most costly health care needs, it offers the state the greatest opportunity to contain Medi-Cal expenditures.

The Governor's 2004-05 budget proposes to reform the Medi-Cal Program, including an expansion of the managed care system. While the administration's reforms are intended to encourage the enrollment of additional aged and disabled persons in managed care, his proposal would primarily reduce costs by enrolling families and children.

In this analysis, we describe the current Medi-Cal health care delivery system and evaluate its strengths and weaknesses in regard to addressing the health care needs of the aged and disabled. We identify additional aged and disabled persons that would benefit from receiving care from managed care plans. We recommend the enactment of legislation directing the Department of Health Services (DHS) to gradually shift an estimated 330,000 aged or disabled persons from the fee-for-service system to the Medi-Cal managed care system. We further recommend strengthening the existing Medi-Cal managed care system to address problems that limit the ability of DHS to ensure access to services and quality of care.

INTRODUCTION

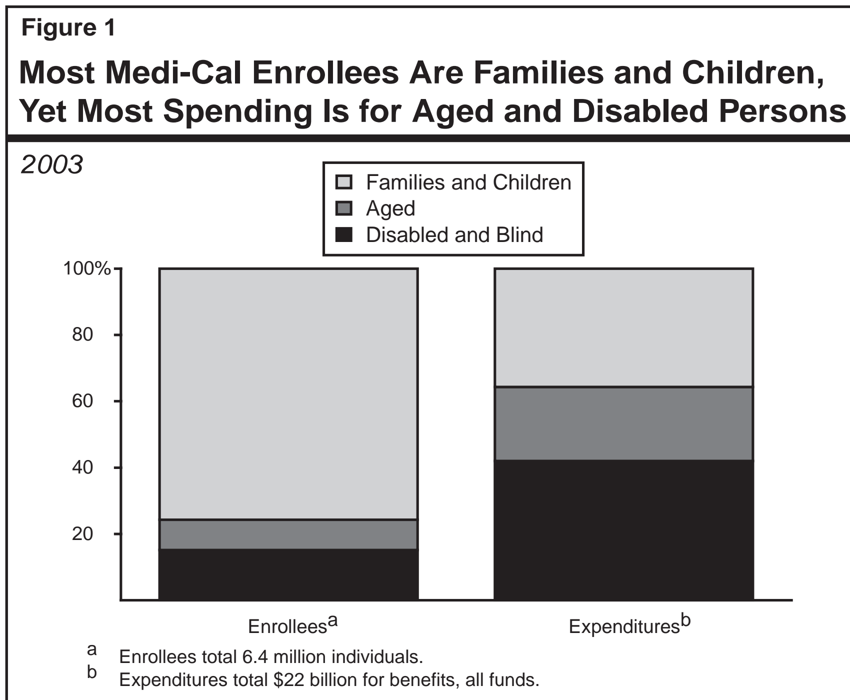
In California, the federal Medicaid program is administered by the state Department of Health Services (DHS) as the California Medical Assistance Program (Medi-Cal). The funding of the program is shared about equally by the state General Fund and by federal funds.

While the largest group of beneficiaries is families and children, a disproportionate share of Medi-Cal spending (64 percent) is for the aged and disabled (includes the blind), as shown in Figure 1. That is because the aged and disabled typically have more intensive needs for expensive medical services such as prescription drugs, inpatient hospital care, and long-term care.

Figure 1

Most Medi-Cal Enrollees Are Families and Children, Yet Most Spending Is for Aged and Disabled Persons

2003



a Enrollees total 6.4 million individuals.
b Expenditures total $22 billion for benefits, all funds.

More than a decade ago, the Medi-Cal Program and Medicaid programs in many other states began placing children and nondisabled adults in managed care systems as a way to reduce benefit costs. Relatively few aged and disabled beneficiaries however, were initially included in managed care. Since that time, other states have stepped up their efforts to enroll aged and disabled persons in managed care as a way to better man-

age their care and to help contain program costs. However, with some notable exceptions discussed later in this analysis, California has not yet followed that path.

The Governor's 2004-05 budget plan outlines a concept for a wide-ranging reform of the Medi-Cal Program, including an expansion of the existing system of managed care, beginning in 2005-06. While the administration's reform proposal endorses the idea of an expansion of managed care to aged or disabled beneficiaries, it focuses on a proposed geographic expansion of coverage primarily for families and children.

In this analysis, we describe the current Medi-Cal health care delivery system and evaluate its strengths and weaknesses in regard to addressing the health care needs of the aged and disabled. We discuss which additional groups of aged and disabled Medi-Cal enrollees could receive care from managed care plans. We recommend: (1) the enactment of legislation directing DHS to gradually shift an estimated 330,000 aged or disabled individuals we have identified as appropriate candidates from fee-for-service Medi-Cal to a managed care system, and (2) strengthening the existing Medi-Cal managed care system to address problems that limit the ability of DHS to ensure access to services and quality of care.

THE MEDI-CAL HEALTH CARE DELIVERY SYSTEM

Medi-Cal provides health care coverage through two basic types of arrangements—fee-for-service and managed care. Participation in managed care is generally voluntary for the aged and disabled.

Medi-Cal Fee-for-Service System

Medi-Cal began as a fee-for-service health care delivery system. In a fee-for-service system, a health care provider receives an individual payment from DHS for each medical service delivered to a Medi-Cal beneficiary. Beneficiaries generally may obtain services from any provider who has agreed to accept Medi-Cal payments. This model exists in all counties in California and does not typically provide for the coordination of care for beneficiaries who have several medical providers.

Medi-Cal Managed Care

Legislation enacted as part of the *1992-93 Budget Act* gave DHS broad authority to implement a different system of medical care for Medi-Cal beneficiaries—managed care. Under this system, DHS contracts with health care plans, also known as a health maintenance organizations (HMOs), to provide health care coverage for Medi-Cal beneficiaries residing in certain

counties. The health plans are reimbursed on a "capitated" basis with a predetermined amount per person, per month regardless of the number of services an individual receives. The health plans in return assume financial risk, in that it may cost them more or less money than the capitated amount paid to them to deliver the necessary care. In contrast, fee-for-service providers assume no financial risk, in that they are reimbursed for each service after it is delivered.

Figure 2 identifies the three types of Medi-Cal managed care systems that operate in California. Figure 3 shows that 22 of the state's 58 counties—generally those counties with greater populations—operate Medi-Cal managed care systems. County Organized Health System (COHS) plans operate in eight counties, the Two-Plan Model operates in 12 counties, and Geographic Managed Care (GMC) systems operate in two counties. These managed care plans are similar to those offered by many public and private employers. Managed care is not available in 36 mostly rural counties where Medi-Cal beneficiaries exclusively receive their medical care from fee-for-service providers.

Over time, the proportion of Medi-Cal beneficiaries enrolled in managed care has grown significantly. About 3.3 million, or 52 percent, of all Medi-Cal beneficiaries received health care services from a managed care plan as of June 2003. The remainder received care from fee-for-service health care providers.

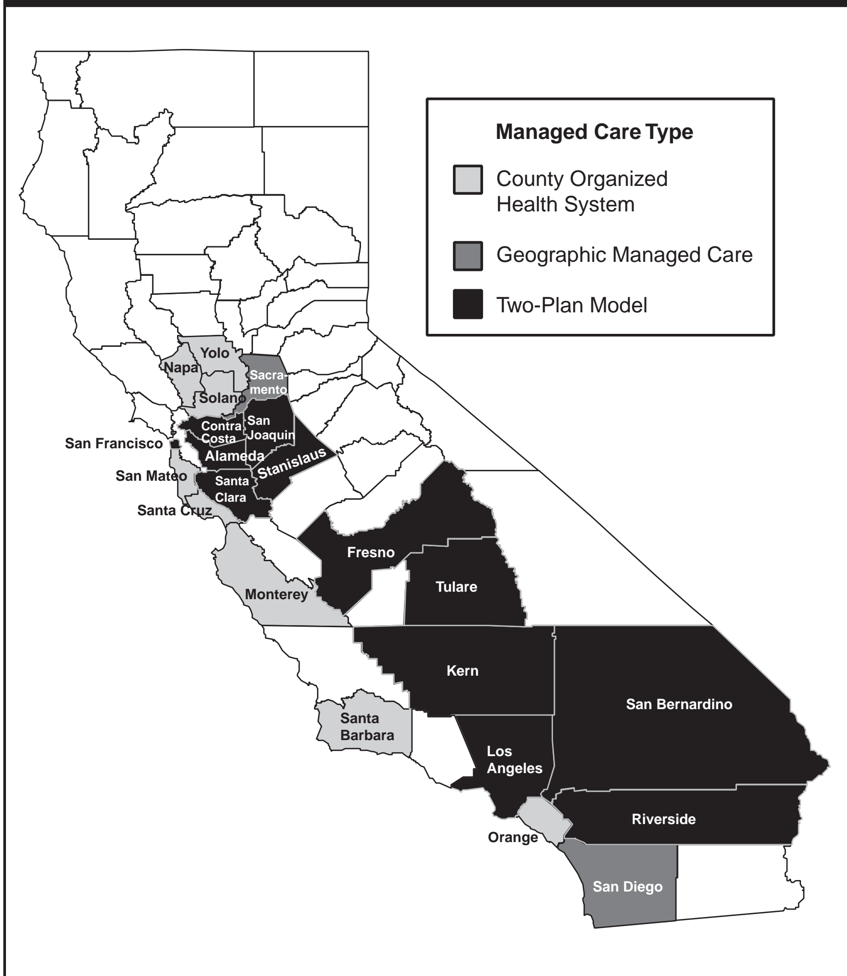
Figure 2

Three Major Types of Managed Care Plans

- ✓ ***County Organized Health System (COHS).*** Under this model, there is one health plan run by a public agency and governed by an independent board that includes local representatives. The COHS are different from the other managed care systems because nearly all Medi-Cal enrollees residing in the county are required to receive care from this system.
- ✓ ***Geographic Managed Care (GMC).*** The GMC system allows Medi-Cal beneficiaries to choose to enroll in one of many commercial HMOs operating in a county.
- ✓ ***Two-Plan Model.*** The Two-Plan Model consists of counties where the department contracts with only two managed care plans. One plan generally must be locally developed and operated. The second plan is a commercial HMO, selected through a competitive bidding process.

Figure 3

Map of California's Medi-Cal Managed Care Counties



Mandatory and Voluntary Participation in Managed Care

Most families and children residing in counties operating Medi-Cal managed care systems are required to receive care from health plans. The aged or disabled in those same counties generally have the option of participating in either the fee-for-service or managed care system. Typically, few have chosen managed care. As a result, most managed care enrollees continue to be families and children. The exception is the eight COHS coun-

ties, where nearly all Medi-Cal beneficiaries are required to receive their care from a COHS plan.

These program rules, which are summarized in Figure 4, explain the variance in participation rates for different groups of Medi-Cal beneficiaries in managed care and fee-for-service medicine. Families and children are about 58 percent of the population receiving care from fee-for-service providers and the remaining 42 percent are aged or disabled, as shown in Figure 5. An overwhelming majority of the population enrolled in managed care, 91 percent, consists of families and children, while only 9 percent of the population in managed care is made up of aged or disabled beneficiaries.

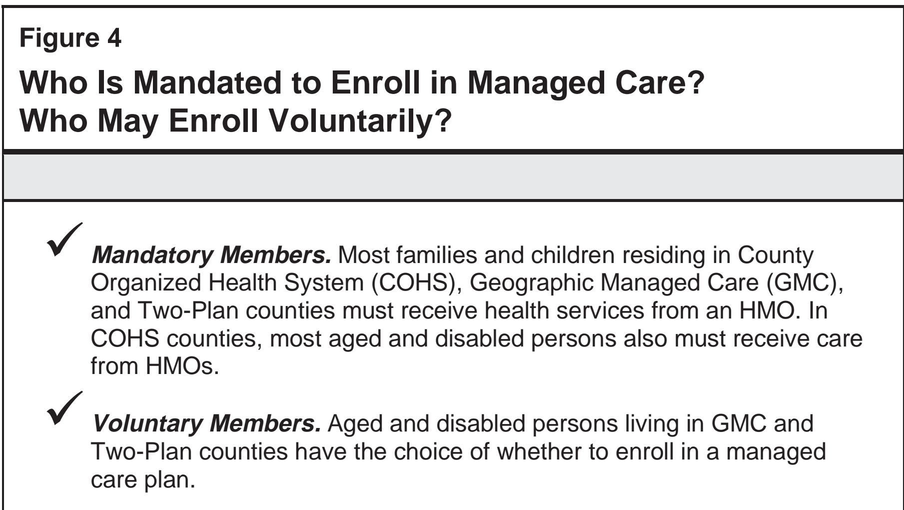


Figure 4

Who Is Mandated to Enroll in Managed Care? Who May Enroll Voluntarily?

- ✓ ***Mandatory Members.*** Most families and children residing in County Organized Health System (COHS), Geographic Managed Care (GMC), and Two-Plan counties must receive health services from an HMO. In COHS counties, most aged and disabled persons also must receive care from HMOs.
- ✓ ***Voluntary Members.*** Aged and disabled persons living in GMC and Two-Plan counties have the choice of whether to enroll in a managed care plan.

Managed Care has Proven Advantages Over the Fee-for-Service System

During its period of steady expansion over the past decade, Medi-Cal managed care has proven to offer some significant advantages over fee-for-service coverage in regard to coordination of patient care, quality and access to care, and containment of program costs. These advantages are summarized in Figure 6 and discussed in more detail below.

Coordination of Services to Improve Health Outcomes

Fee-for-Service System Provides Fragmented Care. Under the fee-for-service system, patients receive care from a fragmented collection of providers and do not have a primary care provider to coordinate their health

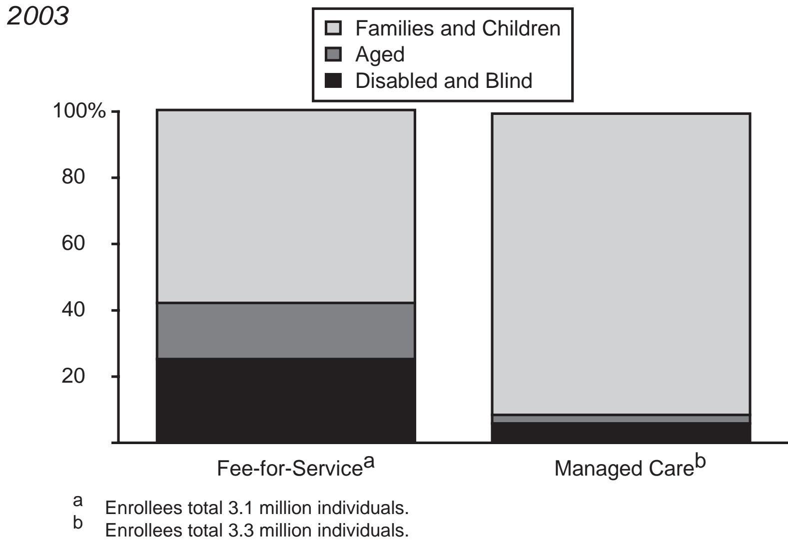


Figure 5

Most Managed Care Enrollees Are Families and Children

Figure 6

Advantages of Managed Care Over The Fee-for-Service System

- ✓ Provides coordinated instead of fragmented care.
- ✓ Quality of care is measured and monitored.
- ✓ Access to providers is improved.
- ✓ Incentives are provided to contain costs.

care. Essentially, patients must act as their own care coordinator, or attempt to find someone who can assist them in making medical appointments and determining when they need to see a specialist. In addition, enrollees in fee-for-service sometimes lack basic information about what

services they are eligible for, which makes them less likely to use preventative care and specialized services.

Managed Care Has Provided Coordinated Care. Managed care enrollees may choose their own primary care physician, or otherwise will have one assigned to them, who has access to their medical history, will coordinate their health care, and is authorized to provide their patients with access to other more specialized services as necessary. Under this arrangement, aged and disabled beneficiaries have been more likely to receive prevention-oriented care meant to slow the progression of specific diseases and help them to maintain their good health according to studies we have reviewed. This care often includes behavioral health services, prescription drugs, durable medical equipment, physical therapy, in-home supportive services, and long-term care.

Quality of Care

Quality of Fee-for-Service Care Is Unknown. The DHS does not regularly attempt to monitor and measure the quality of care that is delivered by fee-for-service health care providers. The state, in effect, assumes that if Medi-Cal beneficiaries do not like the quality of care they receive from one fee-for-service provider, that they can seek out another. However, this assumption does not take into account the possibility that the number of fee-for-service providers participating in the Medi-Cal Program could be insufficient (due to relatively low reimbursement rates for some services) to give Medi-Cal beneficiaries a real opportunity to change providers in response to problems in the quality of their services.

Managed Care Plans Undergo Quality Reviews. The DHS, as part of its oversight of Medi-Cal managed care plans, conducts quality reviews annually to measure health plan performance in regard to the quality of services provided to Medi-Cal beneficiaries. These studies include the collection and annual public reporting of data measuring their performance according to Health Plan Employer Data and Information Set quality indicators. The DHS contracts with private companies to conduct a Consumer Assessment of Health Plans Survey (CAHPS) of patients to obtain standardized information about Medi-Cal members' experiences with their health plans. In addition, Medi-Cal managed care plans are rated by the Department of Managed Health Care (DMHC), the state agency which regulates HMOs. The DMHC publishes information regarding their quality in an annual *Quality of Care Report Card* that is available to the public on the Internet.

Access to Providers

Patient Access to Fee-for-Service Providers Is Unknown. Access to medical care is often a significant concern for aged or disabled patients because they typically have more intensive medical needs. However, DHS

does not regularly monitor or collect information measuring patient access, such as how long it takes Medi-Cal patients to obtain an appointment with a fee-for-service provider. In fact, the patient information that DHS obtains from fee-for-service claims for payment from providers lacks data that could be used to measure their access to health services. One reason for concern is that several reviews of Medicaid programs in other states have found that aged and disabled patients receiving care from fee-for-service providers wait longer for appointments and travel further for care than those enrolled in managed care.

Managed Care Improved Access. Under program rules, Medi-Cal patients enrolled in managed care must be ensured access to a network of primary care and specialist health care providers. Health plans licensed by the state are required to comply with various state standards to ensure timely patient access to care. Federal law further requires that Medicaid managed care plans take specific steps to help potential enrollees in Medicaid to understand their health care benefits. For example, health plans must make available free interpretation services for enrollees who are not fluent in English and to publish health plan information in the prevalent non-English language in the area. Providers participating in the Medi-Cal Program on a fee-for-service basis are not subject to these requirements. A recently published national study found that shifting Medicaid persons to a managed care setting improved their access to primary care physicians and specialists.

The Medi-Cal managed care system, if not carefully monitored and structured, also has the potential to hinder access by patients to certain medical services in order to reduce costs. For example, a managed care plan could regularly deny treatment requests for legitimate treatments or assign a large number of Medi-Cal patients to providers making access to service difficult. However, the state has some safeguards in place, such as CAHPS, to detect the failure of managed care health plans to provide necessary services. In addition, DMHC regulations generally prohibit HMOs from denying patients necessary medical care that is a part of coverage, and Medi-Cal contracts with health plans in the managed care system are specific about the obligations of plans to provide these services.

Cost Containment

Fee-for-Service Lacks Incentives to Contain Costs. The Medi-Cal fee-for-service system generally allows patients to receive care from any number of providers as frequently as they wish. While providers of hospital and long-term care services are required to submit treatment authorization requests (TARs) to DHS for approval, physician services and those billed by many other types of providers generally do not require authorization through the TARS process. Thus, no process is in place to ensure that the health care services patients received were medically necessary. Also, there

is little incentive for providers to deliver preventative care that might reduce the future use of health care services by their patients, and incentives exist that tend to increase program costs—providers make more money the more services they deliver and bill to the state. This arrangement can lead to the unnecessary or preventable utilization of costly emergency room services, as well as the duplication or overspending on a wide variety of medical services.

Managed Care Has Reduced Costs and Limited Deficiencies. Enrolling Medi-Cal beneficiaries in managed care instead of fee-for-service for their health care has resulted in significant savings to the state. While the data to exactly calculate these savings is not publicly available, DHS has estimated that the three types of managed care plans cost the state between 81 percent and 87 percent of what would otherwise have been spent on patients if they were in fee-for-service medicine. We estimate that the state is probably saving in the hundreds of millions of dollars annually on patient care because of the shift of beneficiaries into managed care.

The Medi-Cal managed care system has saved money for the state because the capitation rates paid to plans result in an average cost of care per Medi-Cal beneficiary that is less than the equivalent cost of fee-for-service coverage. The plans provide health care services for a lower cost and stay within their capitation rates in part by better coordinating patient care, such as offering prenatal care that subsequently saves on emergency room costs, and by providing preventative care, such as tobacco cessation programs. The plans also help to control the duplicative or unnecessary use of medical services. The fee-for-service system, in contrast, generally allows patients to receive care from any number of providers as frequently as they wish, and does not necessarily ensure that the health care services they do receive are the ones that are medically necessary.

ADDITIONAL PERSONS COULD BE ENROLLED IN MANAGED CARE

Our analysis indicates that an estimated 310,000 aged and disabled persons, out of the total of about 1.5 million participating in Medi-Cal in 2003, are good candidates for a shift from fee-for-service to managed care. We believe this shift could both improve their care and result in a reduction in Medi-Cal expenditures for the state. We found that other aged and disabled persons are not currently good candidates for managed care, although their integration into managed care should be considered at some point in the future. We also found that some specific types of medical services needed by many aged and disabled patients should probably continue to be provided separately and not become a part of a managed-care delivery system.

Who Could Shift to Managed Care?

We estimate about 310,000 aged and disabled persons now participating in Medi-Cal could be shifted from fee-for-service to managed care in the near term (that is, within about the next two years). The majority of these persons are disabled adults; however the group also includes some disabled children and aged persons. (Figure 7 summarizes how these groups are defined in Medi-Cal Program rules.) Our analysis indicates that this group of Medi-Cal beneficiaries presents the best opportunity for the state to improve their care and to save on program costs. This group would present the fewest difficulties in terms of coordinating their care with other state, federal and local programs that serve their need for medical and social services.

Figure 7

How the Medi-Cal Program Defines Beneficiary Groups

✓ ***Aged.*** The aged consist of individuals aged 65 and older. There were more than 600,000 aged persons enrolled in Medi-Cal in 2003.

✓ ***Disabled Persons.*** These individuals are unable to engage in any substantially gainful activity because of a physical or mental impairment that is expected to last 12 months or more or result in death. The disabled population may include people with physical disabilities, developmental disabilities such as cerebral palsy or autism, mental disabilities such as schizophrenia, and long-term or episodic conditions such as HIV/AIDS and cancer. There were more than 900,000 such Medi-Cal enrollees in 2003.

✓ ***Blind.*** An individual is legally blind if his/her vision cannot be corrected to better than 20/200 in the better eye, or if his/her visual field is 20 degrees or less, even with a corrective lens. About 27,000 Medi-Cal eligibles are blind. This group is considered to be a part of the disabled category in our analysis.

We also found significant, unresolved coordination of care issues exist, at least for now, which mean that many other aged or disabled Medi-Cal beneficiaries currently are not the best candidates for transfer to coverage under managed care. In addition, we have concluded that, even for some persons shifted to managed care, some of their specific types of health services should continue to be provided outside the managed care network at this time. We discuss our findings in more detail below.

Focus Initially on Certain Aged or Disabled Persons

As noted above, we have identified an estimated 310,000 aged or disabled individuals who currently receive medical care through the Medi-Cal fee-for-service system as strong candidates in the near term for an expansion of managed care. Based on an analysis of current caseload trends, we estimate this number would grow to 330,000 by 2006-07. The majority of this group consists of disabled adults below the age of 65 with physical disabilities, developmental disabilities, psychological illnesses or chronic medical conditions. This group would also include some aged persons and disabled children. Not included in our estimate are about 140,000 aged or disabled individuals with a variety of health care needs who are already enrolled in managed care, particularly in the COHS counties, but also in the Two-Plan and GMC counties.

Shift to Managed Care Problematic for Some

Many aged and disabled Medi-Cal beneficiaries are simultaneously eligible for an array of other types of medical and social services both inside and outside of Medi-Cal. Our analysis indicates that the enrollment of about 1.2 million of these Medi-Cal beneficiaries into managed care could be problematic at this time. One reason is that such a shift in the provision of their physical health care would be more difficult to coordinate with the care they receive under various federal, state, and local programs. Also, Medi-Cal Program rules mean certain individuals are not the best candidates for inclusion in a managed care system at this time.

We have identified four specific groups of Medi-Cal beneficiaries that we believe are *not* the best candidates in the near term for enrollment in managed care.

- ***"Dual Eligibles."*** There are about 900,000 individuals who are simultaneously enrolled in Medi-Cal and the federal Medicare program. Medi-Cal generally pays the Medicare premiums, deductibles, and any co-payments for these dual eligibles, and Medi-Cal pays for services not covered by Medicare, such as long-term care. Dual eligibles are not now a good fit for Medi-Cal managed care because they would remain entitled to receive Medicare services outside of the Medi-Cal managed care network. As a result, coordination of program enrollment, payments to managed care plans, and oversight would be complicated for these beneficiaries.

- ***Share-of-Cost Eligibles.*** These are individuals with relatively higher incomes (typically from 100 percent to 133 percent of the federal poverty level) who are enrolled in Medi-Cal only in months in which they have paid a specified amount out of pocket toward

their own health care. Because share-of-cost eligibles tend to go on and off the Medi-Cal rolls on a month-to-month basis, it would probably be difficult for health plans to coordinate their care on an ongoing basis.

- ***Medi-Cal Enrollees Receiving Long-Term Care***. In general, placing aged or disabled individuals who require nursing home or other forms of long-term care into a managed care arrangement would be a complex task. Health plans would generally need to create new long-term care networks to serve such beneficiaries. Given the difficulty of such an expansion, we believe it could not be completed within two years. In addition, such a change would run contrary to the longstanding legislative goal of counties developing an integrated system of long-term care that includes both medical and social services for the aged and disabled.
- ***California Children Services (CCS) Beneficiaries.*** Some children enrolled in Medi-Cal also participate in CCS, a joint state-county program that provides specialty health care services for children with serious illnesses. Requiring CCS children to enroll in managed care at this time could be problematic. This is because existing program rules require that counties approve treatment for CCS-related health conditions, and provide for treatment by providers outside of the managed care network. Determining whether a health plan or CCS was responsible for payment for services for such children would also probably be a problem because of the overlap in responsibilities between the county and health plan for their care.

While we believe these groups are not good initial candidates for inclusion in managed care, it is possible that future changes in federal and state law and program rules could someday make it possible for some or all of these beneficiaries to be integrated into such a medical system. Also, we have identified some significant problems in the administration of Medi-Cal managed care that could affect efforts to expand coverage now to the aged or disabled. We discuss these problems in the shaded box on the next page, and later in this analysis suggest ways to address these problems in order to facilitate the transfer of certain aged and disabled persons to managed care.

Some Services Best Excluded From Managed Care

In addition to considering which groups of Medi-Cal beneficiaries are the best candidates for inclusion in a managed care system, we also examined what benefits appropriately belong in the state's managed care benefit package. We generally concluded that, in at least the near term, no changes are warranted in the list of benefits that are typically included in managed care benefit packages.

Medi-Cal Managed Care Administrative Problems

Some significant problems exist in the state's administration of the Medi-Cal system of managed care that limit the ability of the Department of Health Services (DHS) to safeguard the access to care and quality of care provided to Medi-Cal beneficiaries and hamper any future expansion efforts. The problems are discussed below. We discuss possible solutions later in this analysis.

Information Technology System Is Unreliable

There is significant evidence that the Management Information System/Decision Support System (MIS/DSS) project used by DHS to monitor the Medi-Cal managed care system is inadequate and underutilized because of key unresolved data issues. A recent study found that the data collected by the system is not accurate or complete enough to use to (1) make decisions as to the quantity, quality, or costs of health care services; (2) determine provider rates; or (3) make sound policy decisions about the program. Part of the problem is that Medi-Cal managed care health plans often submit incomplete data about the health care services that they provide to their members.

Since 1997, the state has spent more than $75 million ($15 million from the General Fund) for the development and support of MIS/DSS. In July 2003, the Department of Finance required DHS to hire a vendor to conduct an independent assessment of MIS/DSS to determine the extent to which it meets DHS' needs and to develop a corrective action plan to improve the system and estimate the costs and timeframe necessary to make needed modifications. At the time of this analysis, DHS has not begun such a review.

Rate-Setting Method Outdated

The methodology that DHS has used in the past to determine the capitation rates paid to managed care plans is outdated. This is because it is based on historical "fee-for-service claims paid" data dating back to 1997 rather than any current information about the actual cost of health care services being provided by health plans to individuals in a managed care environment.

The DHS is in the process of changing its rate-setting methodology in accordance with federal law. However, this may prove difficult, because Medi-Cal data systems (particularly MIS/DSS) do not collect accurate and complete information about the cost and utilization of

Medi-Cal Managed Care Administrative Problems (*continued*)

health care services by health plan patients. This data is critical to setting appropriate rates for Medi-Cal managed care plans.

A more sophisticated approach to rate-setting would better position the state for an expansion of Medi-Cal managed care to aged and disabled beneficiaries.

Managed Care Plans Lack Information on Health Needs of New Enrollees

One of the potential benefits of managed care lies in a health plan's ability to identify new enrollees' health care needs and to manage their care so that the need for costly or medically complex treatment is minimized. In order to help plans identify beneficiaries with the most significant health care needs and help to ensure that they receive appropriate care, some Medicaid programs in other states regularly provide their health plans with information in electronic form about the health status of persons as they are enrolled in managed care. However, that does not occur in California's Medi-Cal Program. Rather, DHS provides basic demographic information about new enrollees to health plans, but does not share any data about the medical services used by beneficiaries while they were enrolled in fee-for-service Medi-Cal. An alternative approach, followed in some states, is to mandate that managed care plans conduct health assessments for all new enrollees.

Plans Lack Quality Indicators for the Aged and Disabled

While useful, the Health Plan Employer Data and Information Set, and Consumer Assessment of Health Plans Survey performance measures discussed earlier in this analysis do not adequately address the medical conditions common to the aged and disabled. The existing quality measures tend to focus on the general population that is enrolled in managed care, and provide little information about the quality of care received by the aged and disabled. To date, DHS has not developed its own indicators to assess this population's quality of care or required its health plans to do so.

Other states have developed specific measures for the aged and disabled to address these information gaps. For example, in one state, Medicaid managed care plans monitor 16 different measures related to patients with complex health care needs, including the frequency of dental visits for the developmentally disabled and the availability of pharmaceutical treatments for patients newly diagnosed with depression.

This means that certain services would continue to be "carved out" or excluded from the list of benefits provided by health plans. The list of carved-out services, which would continue to be provided as they are today by other governmental entities or specialized providers, includes mental health, alcohol and drug treatment, adult day health services, and dentistry, in addition to many others.

In theory, shifting some of these currently excluded services into a managed care benefit package could have some advantages. For example, incorporating substance abuse treatment or mental health services into managed care could result in better linkages between primary care physicians and other providers who specialize in providing such treatment services. However, complicated and time-consuming changes in portions of the state's health care delivery system would be necessary to modify managed care benefits in this way. Moreover, some of these changes would run contrary to existing state policy. For example, shifting the care of Medi-Cal beneficiaries who receive mental health services from the counties to managed care plans would run counter to the state's prior decisions to consolidate such services at the county level. For these reasons, we recommend that the Legislature not include these services in managed care at this time.

SHIFT TO MANAGED CARE WOULD RESULT IN STATE SAVINGS

As discussed earlier in this analysis, managed care has already proven to be an effective strategy in helping to contain state costs for the Medi-Cal Program through better coordination of patient care and broader implementation of preventative care approaches. Our analysis indicates that additional savings to the state would be possible if the estimated 310,000 aged or disabled persons that we have identified as strong candidates for such a shift were gradually transferred from the fee-for-service system to managed care. We estimate that, while the state might incur some modest increases in administrative and benefit costs in the short run, the net additional savings to the state General Fund from such a change would probably exceed $100 million upon full implementation by 2006-07.

Key Assumptions

Our savings estimate is based on the assumption that the 310,000 persons that we have identified as candidates for a shift to managed care do so in the near term. We estimate that the total would grow to 330,000 by 2006-07, the year the change could first be fully implemented. This number excludes dual eligibles, share-of-cost beneficiaries, persons receiving long-term care, and children in the CCS program. Our estimate also takes into account the

fact that some beneficiaries in this group have already voluntarily enrolled in managed care. It also does not include beneficiaries in the largely rural counties where such plans do not now operate and are unlikely to do so in the near term.

Our estimate further assumes that DHS would be able to implement the proposal with a relatively small number of additional state staff and a limited additional amount of funding because the department already has existing staff dedicated to administering the managed care portion of the Medi-Cal Program. Moreover, we assumed a phased and gradual implementation of this change that would be more manageable for DHS staff and that would take up to 24 months. This includes 18 months of planning (although it may be feasible to begin shifting some persons to managed care earlier than that) and a six-month phased-in transition of new enrollees and beneficiaries from fee-for-service to managed care.

Our estimates assume that the costs for managed care health plan coverage would be in line with our estimate of the existing per beneficiary payments under COHS plans. We compared these estimated COHS plan costs with the amounts the state now pays for these beneficiaries under the fee-for-service system. For example, the average annual fee-for-service cost for an aged beneficiary was about $5,000 in 2002-03, with the annual cost for a disabled beneficiary at about $7,100. By way of comparison, we estimated that the average annual cost of an aged beneficiary enrolled in a COHS plan that same year was significantly less—about $4,200 for an aged beneficiary and $6,200 for a disabled beneficiary.

As noted above, we based our cost comparison on estimated COHS plan costs. We did so because COHS plans are the only ones that now largely cover the entire aged or disabled population within their coverage area, and thus would provide the best indicator of the actual cost of providing services to the aged or disabled. Had we based our estimate on the rates paid to GMC and Two-Plan Model health plans, which receive lower reimbursement rates than COHS plans, our projected savings would have been greater.

LAO Estimate of Net Savings

Based upon these assumptions, we estimate that the state would achieve net General Fund savings of more than $100 million annually ($200 million savings annually for all fund sources) by 2006-07. These savings would grow in subsequent years in line with growth in caseload and costs. Our estimate of caseload and state savings from expanded enrollment in managed care is summarized in Figure 8 (next page).

Figure 8

Significant Savings From Expanded Enrollment in Managed Care

(Dollars in Millions)

	2006-07[a]
Caseload shifted to managed care plans	330,000
Total cost if patients received fee-for-service care[b]	$2,574
Total cost if patients received managed care[b]	2,349
Net savings from shift to managed care (General Fund)	$112
Net savings from shift to managed care (all funds)	225

a First year of 12-month savings.

b Caseload grown by 2.6 percent and costs grown by 6 percent annually from 2004-05 through 2006-07.

The actual level of savings could be greater or lower than we have estimated, depending primarily on the capitation rates that the department eventually determined should be paid to managed care plans as part of the expansion. Financial instability encountered by COHS plans and litigation between various health plans and the state over rates have raised concerns recently about the adequacy of current capitation rates. To the extent that these factors resulted in increased rates, the savings from a shift to managed care could be less than we have estimated.

We would also note that an increase in utilization of some medical services by health plan members could occur as a result of their shift to managed care. For example, some aged and disabled enrollees who had been having difficulty gaining access to specialists through the fee-for-service system might receive referrals to such services after their enrollment in managed care, thereby increasing health plan costs for Medi-Cal patients. The extent of these costs are not known. However, we believe an initial increase in utilization of some medical services would probably be more than offset in the future by the savings achieved by improved coordination of patient care and the greater provision of preventative services.

A Blueprint for Expanding Aged or Disabled Enrollment in Managed Care

As it operates today, the Medi-Cal Program offers a paradox: the aged and disabled who potentially stand to benefit the most through the improved health care that can come from a shift from fee-for-service medicine to managed care are the very population that has largely been excluded from the arrangement. Moreover, the most costly groups in terms of their health care costs, for whom the state has the greatest opportunity for containing expenditures in Medi-Cal expenditures, has not been targeted for managed care programs. Meanwhile, the least costly group to the state in terms of health care coverage—families and children—is generally mandated to participate in managed care health coverage.

To better address the distinctive health care needs of the aged and disabled enrollees in Medi-Cal, and to achieve long-term savings to the state likely to exceed $100 million annually, we recommend the enactment of legislation directing DHS to gradually shift the populations we have identified as appropriate candidates from fee-for-service providers to a managed care system. While DHS has the authority today to accomplish this change, we believe it is appropriate for the Legislature to provide the department with policy direction. We further recommend that the Legislature direct DHS to take a series of specific steps to improve the administration of the Medi-Cal managed care system to ensure adequate oversight and quality of care.

As our findings in this analysis indicate, a carefully targeted expansion of enrollment in managed care could yield a number of benefits, including improved coordination of care; increased access to care; a greater emphasis on prevention, quality assurance, and improved outcomes; and potentially significant state savings. A "blueprint" for moving forward with these changes is discussed in more detail below.

Implement Gradual Shift of Some Aged or Disabled Into Managed Care

We recommend enactment of legislation directing DHS to prepare and implement a plan to gradually shift certain aged and disabled Medi-Cal beneficiaries in counties where Medi-Cal health plans already exist into managed care. In keeping with the findings of this analysis, Medi-Cal beneficiaries who are dual eligibles, have a share of cost, receive long-term care, or are enrolled in CCS would not be mandated to receive their health care from the managed care system. Accounting for expected caseload growth in the next several years, we estimate that approximately 330,000 individuals enrolled in fee-for-service medicine would eventually be affected by such a policy change.

Such an expansion of the Medi-Cal managed care system would require a change in the state's Medicaid plan, and thus would be subject to federal approval. We believe the state is likely to receive this federal approval, given that a comparable group of Medicaid beneficiaries are already part of the managed care system in California and in other states.

The state would also have to change its Medi-Cal enrollment process so that the beneficiaries meeting the criteria discussed above are required to enroll in a managed care plan. We recommend that the shift of individuals into managed care commence with new enrollees, then gradually expand to include those already enrolled in Medi-Cal in the fee-for-service component of the program.

Maximizing the Chances for a Successful Expansion

Our analysis suggests a transition of additional beneficiaries to the Medi-Cal managed care system is more likely to be successful if the state adopts several key implementation strategies. We summarize these strategies in Figure 9 and outline them below.

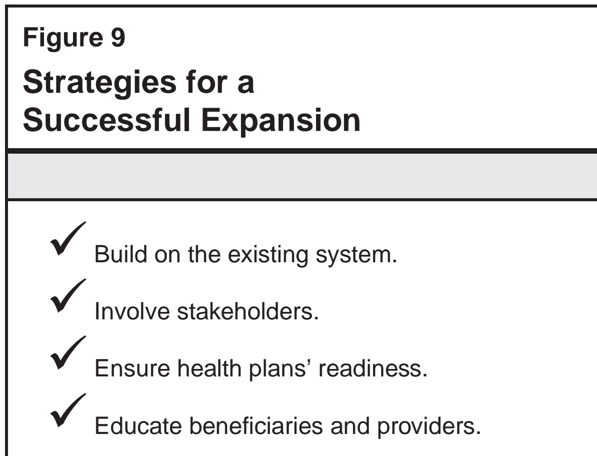


Figure 9
Strategies for a Successful Expansion

- Build on the existing system.
- Involve stakeholders.
- Ensure health plans' readiness.
- Educate beneficiaries and providers.

Build on the Existing System. An expansion is more likely to succeed if it builds upon the existing system in the 14 counties (excluding COHS plans) where Medi-Cal managed care is currently available and where health plans (GMC and Two-Plan models) are already available to support the expansion.

Involve Stakeholders. A transition to managed care is more likely to be accepted by those affected if DHS receives early and broad-based advice from health plans, direct medical providers, Medi-Cal beneficiaries, health advocacy groups, and other parties with an interest in health care for aged

and disabled persons. Such a collaborative effort should enable the department to identify problems and help to ensure that patients' needs are addressed. This could be accomplished through the stakeholder involvement process discussed in the Governor's 2004-05 budget proposal to reform the Medi-Cal Program.

Ensure Readiness for Expansion. The DHS should be directed by statute to include in its regular reviews of health plans an assessment of their systems to identify enrollees with significant medical needs. For example, the reviews could ensure that health plans develop care coordination plans for aged and disabled beneficiaries with significant health care needs. The DHS should also ensure that the provider networks established by the health plans are adequate to meet the specific medical needs of the aged and disabled.

Educate Beneficiaries and Providers. The DHS should be directed by statute to develop and distribute information to beneficiaries about how managed care plans work and to advise health care providers on best practices for managing the aged and disabled population.

Share Information on Best Practices. The DHS should be directed by statute to develop a formal process for the communication of best practices for caring for aged and disabled beneficiaries among Medi-Cal managed care plans. As a starting point, DHS could examine the practices of COHS plans who now serve many aged and disabled clients. (See the shaded box on the next page for a discussion of examples of COHS best practices in this regard.) The state should also consider requiring (by contract) that health plans consider and, where appropriate, incorporate these best practices into their health care systems.

Strengthen the Existing Managed Care System

Our review found weaknesses in the administration of the Medi-Cal managed care system that could affect efforts to expand coverage to the aged or disabled because these problems limit the ability of DHS to ensure access to services and quality of care. We recommend that the Legislature require DHS to make improvements in the areas discussed below to ensure adequate oversight of Medi-Cal managed care plans.

Ensure That the Data Collection System Is Effective. The department needs to improve its data collection system to safeguard state funds spent on those enrolled in managed care. The Legislature should require DHS to begin and complete the independent assessment and corrective action plan that the Department of Finance (DOF) required DHS to undertake in July 2003 and require DOF to share the results with the Legislature. Using this information, the Legislature can consider what further action to take.

County Organized Health System (COHS) Offers a Model

Aged and disabled persons have been enrolled in Medi-Cal managed care in the eight counties operating COHS plans since the 1980s. Roughly 60,000, or 9 percent, of the total nondual eligible aged and disabled persons enrolled in Medi-Cal are expected to receive care through the COHS plans in 2003-04. The COHS plans could serve as a model for other types of health plans to follow if the Legislature chose to expand the enrollment of these beneficiaries in Medi-Cal managed care. Their years of experience providing health care to the aged and disabled make them a good source of information regarding the best practices in managed care for these specific groups. The COHS plans have adopted a number of strategies tailored to meet the needs of the aged and disabled.

For example, one COHS plan conducted more than 90 community presentations and widely distributed information describing the enrollment process two months before it started enrolling aged and disabled persons. In addition, because so many Medi-Cal enrollees were referred by local Social Security Administration offices, the health care plan offered training on their enrollment process to Social Security staff and placed their own representative in the local Social Security office. This plan also administered its own customer service survey to aged and disabled beneficiaries and hosted several focus groups one year after they were enrolled to determine if and where improvements were needed. The plan will use the information to develop quality indicators specifically assessing the health needs of aged and disabled enrollees.

In order to address concerns that a shift to managed care would force disabled beneficiaries to sever relationships with their existing fee-for-service providers, one COHS plan worked with community and disabled advocates to identify the services they required and their preferred providers of those services in order to build a network that included many of their existing physicians.

Reform Capitation Rate-Setting Process. The Legislature should direct DHS to reform the process for setting rates for capitation payments paid to Medi-Cal managed care plans, particularly for their aged and disabled populations. This would begin with the steps outlined above to improve the Management Information System/Decision Support System. Additionally, DHS could provide incentives to encourage health plans to submit more complete and accurate data to the state. The improved data would be used by DHS to develop more appropriate capitation rates.

It is not clear at this time whether these changes would result in a net increase or decrease in Medi-Cal capitation rates. It may be necessary to consider such changes even if they would result in an increase in state expenditures in order to ensure continued financial stability in the Medi-Cal managed care system.

Require Health Plans to Conduct Health Assessments. The Legislature should require that all state contracts for Medi-Cal managed care direct health plans to conduct health assessments for all new enrollees. We believe this approach would help to ensure that plans have mechanisms in place to identify beneficiaries in need of intensive care management or specialized care.

Develop Quality Indicators for the Aged and Disabled. As noted earlier, the Medi-Cal managed care system currently lacks performance measures to address the medical conditions of the aged and disabled. The Legislature should require DHS, in consultation with the advisory committees we have proposed, to develop performance measures that are specific to this population of beneficiaries. Health plans should also be required to establish systems that monitor the availability and utilization of prescription drugs, durable medical equipment, home health care, and physical therapy and develop protocols to ensure treatment for certain conditions.

Consider Effects on the Health Care "Safety Net." Shifting aged or disabled persons in Medi-Cal to managed care could affect hospitals providing "safety net" assistance to the indigent as well as Medi-Cal patients. That is because such a shift would reduce the number of days aged or disabled patients would spend in these hospitals because of their greater access to primary care physicians, the greater provision of preventative services to these individuals, and the likelihood that managed care plans would use other hospitals to provide inpatient services for these Medi-Cal patients. The impact of these changes is significant, especially since a shift in Medi-Cal patient caseload away from "safety net" hospitals could also affect their receipt of certain federal funding.

CONCLUSION

While most Medi-Cal Program spending is for aged and disabled beneficiaries, more could be done to ensure the quality and cost-effectiveness of the care which this population now receives. Our analysis has found that managed care has the potential to both improve health care outcomes for the aged and disabled and to achieve significant long-term savings for the state. We recommend that as many as 330,000 aged and disabled persons move to managed care by 2006-07 and that specific improvements to the existing system of managed care be made.

MANDATES: MOUNTING LIABILITIES AND NEED FOR REFORM

How Much Does the State Owe Local Agencies for Mandates? What Problems Should Mandate Reform Correct?

Summary

While the California Constitution requires the state to reimburse local governments for state mandates, over $2 billion of unpaid mandate claims have piled up at the State Controller's Office. The budget proposes to defer these current- and prior-year mandate bills to an unspecified future date.

In terms of mandate costs for 2004-05, the budget proposes to defer payment to local agencies for 82 mandates, repeal 29 mandates, and suspend local obligations to carry out 19 mandates. If this budget proposal is enacted, the state's outstanding mandate liabilities may exceed $2.7 billion by the end of 2004-05.

The administration's budget summary outlines ideas for changing the mandate system. While these ideas have merit, they do not go far enough to correct the structural problems inherent in the existing system. We identify six areas of concern that merit legislative consideration in any reform proposal:

- *Lack of payments undermines credibility of mandate requirement.*
- *Little confidence in mandate determination process.*
- *Claiming system invites problems.*
- *Legislature needs better information.*
- *Delays decrease legislative oversight.*
- *Mandate determinations are stuck in the past.*

INTRODUCTION

The California Constitution generally requires the state to reimburse local governments—cities, counties, K-14 educational agencies, and special districts—when it "mandates" a new program or higher level of service. This constitutional provision was approved by the state's voters in 1979, in recognition of local governments' reduced ability to raise tax revenues after Proposition 13.

Figure 1 illustrates the process specified in the Government Code for determining whether a state law or regulation imposes a mandate on local governments. If the Commission on State Mandates (CSM) finds a mandate, the Legislature traditionally has appropriated funding for: (1) newly identified mandates in an annual claims bill and (2) ongoing mandates in the annual budget bill. Because of the state's budget difficulties, however, the state has provided virtually no state resources for mandate reimbursement since 2002-03. Despite this lack of funding, local governments continue to be responsible for carrying out state laws and regulations that impose mandates.

Over the last two years, the budget conference and subcommittees have expressed significant concerns regarding the state's mounting liabilities and the mandate process in general. To address these concerns, the Assembly established a Special Committee on Mandates last summer. Since its establishment, this committee has reviewed over 40 mandates and begun consideration of changes in the mandate process.

Below, we discuss the state's mounting mandate liabilities, the administration's proposal for specific mandates, and the need for reforming the mandate determination and payment process.

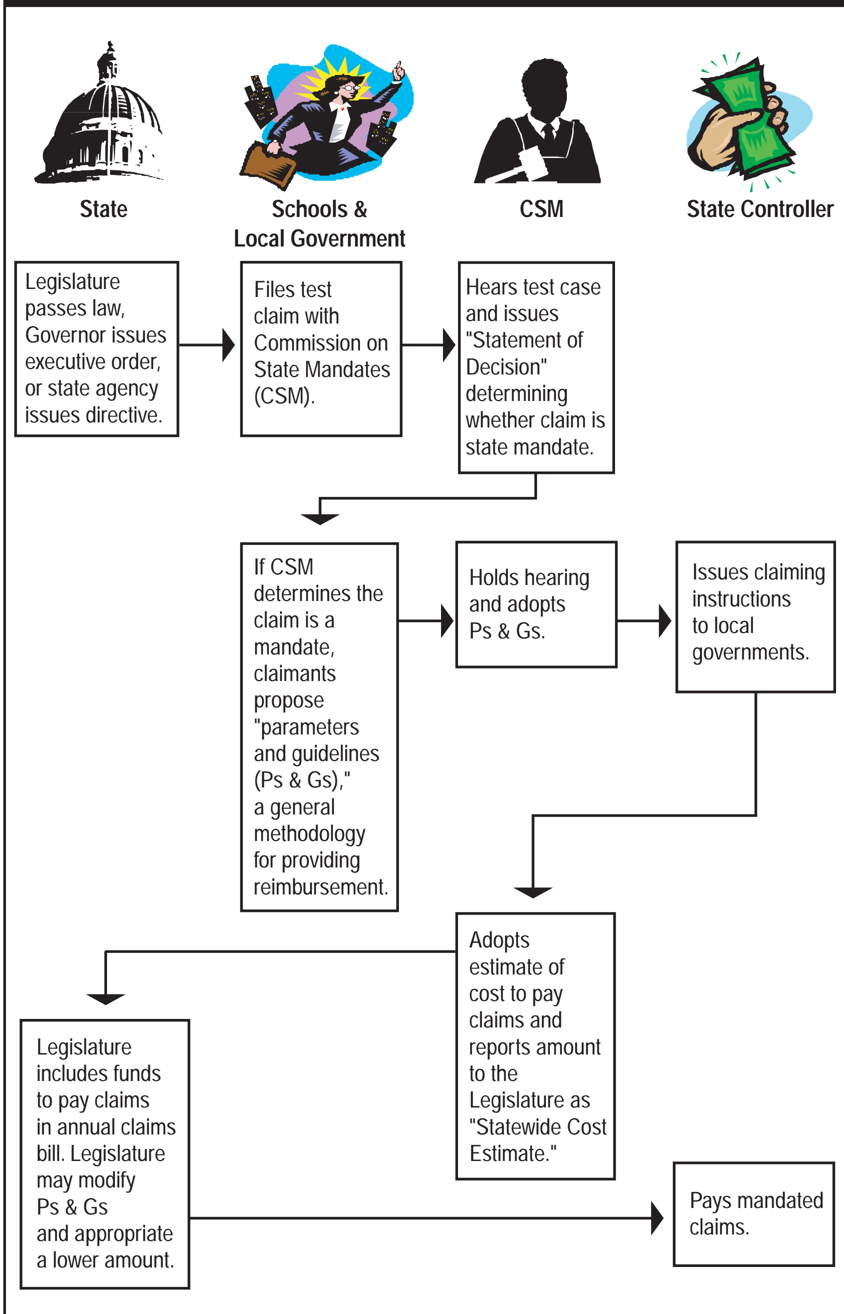
HOW MUCH DOES THE STATE OWE?

As of November 1, 2003, the State Controller's Office (SCO) reported it had $1.5 billion in outstanding claims from local governments for mandated activities dating from 1990-91 through 2002-03. Since that date, we estimate that local agencies have submitted over $600 million in additional claims, bringing the amount of delinquent claims awaiting payment to more than $2.1 billion. About half of these claims are for educational mandates and their payment would "count" towards the Proposition 98 minimum-funding guarantee. Payment of the remaining mandate costs, in contrast, would require non-Proposition 98 General Fund resources.

The administration's proposed budget reflects the Legislature's intent (as expressed in Chapter 228, Statutes of 2003 [AB 1756, Committee on Budget]), that the 2004-05 budget *not* include funding for mandates. By the

Figure 1

The Mandate Claim Decision Process



start of 2005-06, therefore, it is likely that the state's mandate backlog will exceed $2.7 billion. That is, the $2.1 billion owed in the current year, plus over $600 million for 2004-05. (Because new mandates are identified throughout the year and typically include several years of prior-year local government costs and local agencies may submit claims for an ongoing mandate's costs over a three-year period, estimating annual state mandate costs is subject to considerable uncertainties.)

Are the Claimed Amounts Valid? While the SCO typically performs a limited review of mandate claims as they are submitted and tallied, a sample of mandates also receives in-depth field audits after the Legislature appropriates funding for the mandates. Based on analyses done by this office, the Bureau of State Audits, and the SCO, it is likely that these future SCO field audits will determine that local agencies have overstated their mandate claims, possibly by as much as 25 percent overall. Even if SCO audits disallow a quarter of all mandate claims, however, the sum remaining by the end of the budget year (almost $2 billion) still would represent a significant fiscal challenge for the state—as well as a continued source of friction between state and local governments.

WHAT DOES THE ADMINISTRATION PROPOSE?

In its budget document and summary, the administration makes recommendations regarding individual mandates and the overall mandate determination and reimbursement system. Below, we discuss the administration's proposals for specific mandates, and the following section discusses the reform proposal.

Because it had difficulty with its new budget format, the administration informed us that the mandate display in the budget and the related provisions of the budget bill do *not* reflect the administration's intent. To correct these errors, the administration will propose changes to the budget bill in the spring.

To assist the Legislature in its review of the administration's intended mandate proposal, Figure 2 (see page 202) displays, by state department, the 29 mandates the administration proposes to repeal (that is, make optional) and the 19 mandates that the administration proposes to "suspend" during the budget year. (The shaded box provides information on mandate budget terminology.)

With regards to the 82 remaining ongoing mandates, the administration proposes that local governments carry out these responsibilities in the budget year, but that local government reimbursement be deferred to an unknown future date. In the budget bill, deferred mandates are shown with a $1,000 appropriation.

Mandate Budget Terminology

What Is Said	What It Means	How It Appears in the Budget Bill
"Repeal Mandate" or "Make Mandate Optional"	State requirements to perform mandate are eliminated. Local agencies may choose to perform an activity or carry out a program, but are not reimbursed for these costs.	Repealed mandates typically are not listed in the budget bill. In the first year of repeal, however, a repealed mandate may be shown with a $0 appropriation.
"Suspend Mandate"	For the budget year only, local agency requirements to perform an activity or carry out a program are eliminated. Local agencies many implement the state mandate, but are not reimbursed for these costs.	Suspended mandates are listed in the budget bill with a $0 appropriation and provisions specifically identifying the measures as suspended.
"Defer Mandate"	Local agencies must carry out the state mandate. Funding will be provided in the future.	Deferred mandates usually are shown in the budget bill with a $1,000 appropriation. Any mandate that is not repealed, suspended, or fully funded, however, is considered "deferred"—regardless of how it is displayed in the budget bill.

LAO Assessment of Mandate Proposals

Because the administration's proposal became available only shortly before the *2004-05 Budget: Perspective and Issues* was complete, we had little time to review it. In most cases, however, our office has previously reviewed the mandates the administration proposes to suspend or repeal. Figure 2, therefore, specifies the LAO's recommendation regarding these mandates, as well as the publication in which a discussion of our recommendation can be found. In the few cases in which we have not recently reviewed a mandate, we will prepare a recommendation by the time of budget hearings. Finally, to assist the Legislature in its review of mandates the administration proposes to defer, Figure 2 lists those mandates we recommend the Legislature consider for suspension or repeal.

Figure 2

Administration Proposals to Repeal or Suspend Mandates

2004-05

Department/Mandate	Governor's Budget	LAO
Board of Corrections		
Victims' Statements (Minors)	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
California Coastal Commission		
Local Coastal Plans	Suspend	Pending
Caltrans		
Two Way Traffic Signals	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Conservation		
Mineral Resource Policies	Suspend	Repeal—*2003-04 Analysis*, Page F-18[a]
Developmental Services		
Guardianship/Conservatorship Filings	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Food and Agriculture		
Animal Adoption	Repeal	Amend—*New Mandates*, December 2003
Forestry and Fire Protection		
Very High Fire Hazard Severity Zones	Suspend	Pending
Franchise Tax Board		
Substandard Housing	Suspend	Repeal—*2003-04 Analysis*, Page F-18[a]
Health Services		
Inmate AIDS Testing	Suspend	Pending
Sudden Infant Death Syndrome (SIDS) Autopsies	Suspend	Pending
SIDS Training for Firefighters	Suspend	Pending
SIDS Contacts by Local Health Officers	Repeal	Pending
SIDS Notices	Repeal	Pending

Continued

Department/Mandate	Governor's Budget	LAO
Industrial Relations		
Structural and Wildland Firefighter Safety Clothing and Equipment	Suspend	Repeal—*2003-04 Analysis*, Page F-18[a]
Personal Alarm Devices	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Justice		
Stolen Vehicle Notification	Suspend	Pending
Sex Offenders: Disclosure by Law Enforcement Officers-Megan's Law	Suspend	Request revision—*New Mandates*, December 2003
Misdemeanors: Booking and Fingerprinting	Repeal	Pending
Local Government Financing		
Domestic Violence Information	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Filipino Employee Surveys	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Involuntary Lien Notices	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Lis Pendens	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Proration of Fines and Court Audits	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Mental Health		
Residential Care Services	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Short-Doyle Audits	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Short-Doyle Case Management	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Office of Emergency Services		
Sex Crime Confidentiality	Suspend	Repeal—*New Mandates*, December 2003
CPR Pocket Masks	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Deaf Teletype Equipment	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]

Continued

Department/Mandate	Governor's Budget	LAO
POST		
Law Enforcement Sexual Harassment Training	Repeal	Repeal—*New Mandates*, December 2003
Elder Abuse, Law Enforcement Training	Repeal	Repeal—*New Mandates*, December 2003
Secretary of State		
Democratic Party Presidential Delegates	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Election Materials	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Handicapped Voter Access Information	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Local Elections Consolidation	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Voter Registration Roll Purge	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Social Services		
Child Abuse Treatment Services Authorization and Case Management	Suspend	Suspend—*New Mandates*, December 2003
State Treasurer's Office		
Investment Reports	Suspend	Repeal—*2000-01 Analysis*, Page F-110
County Treasury Oversight Committees	Suspend	Repeal—*New Mandates*, December 2003
Tax Relief		
Property Tax-Family Transfers	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Senior Citizens' Mobile Home Property Tax Deferral	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Victims Compensation and Government Claims Board		
Adult Felony Restitution	Repeal	Repeal—*2003-04 Analysis*, Page F-18[a]
Youth Authority		
Extended Commitment, Youth Authority	Suspend	Request revision—*New Mandates*, December 2003

Continued

Department/Mandate	Governor's Budget	LAO
Education		
Investment Reports	Suspend	Repeal—*2000-01 Analysis*, Page F-110
School Bus Safety I and II	Suspend	Pending
School Crimes Reporting II	Suspend	Pending
County Treasury Oversight Committees	Suspend	Repeal—*New Mandates*, December 2003
Law Enforcement Sexual Harassment Training	Repeal	Repeal—*New Mandates*, December 2003
Additional LAO Recommendations for Noneducation Mandates		
Housing and Community Development		
Regional Housing Needs Assessment	Defer	Repeal—*2004-05 Analysis*, Page
Local Government Financing		
Brown Act Reform	Defer	Repeal—*New Mandates*, December 2003
Health Benefits for Survivors of Peace Officers and Firefighters	Defer	Repeal—*New Mandates*, December 2003
Photographic Record of Evidence	Defer	Request revision—*New Mandates*, December 2003
Mental Health		
Services to Handicapped Students	Defer	Amend—*2002-03 Analysis*, Page C-159
State Personnel Board		
Peace Officer Procedural Bill of Rights	Defer	Suspend—*2002-03 Analysis*, Page F-56

[a] Included in discussion of long-suspended mandates.

NEED FOR REFORM

In the administration's budget summary, it outlines concepts for modifying shortcomings within the mandate system. For example, the administration proposes establishing a requirement that local agencies use the "least costly approach" when complying with state requirements. (For more information on the administration's proposal, see nearby shaded box.) In general, we think the administration's ideas have merit, but do not go deep

enough to correct the structural problems within the system. Below, we discuss our major concerns with the mandate system, summarized in Figure 3, and identify key elements of needed reform.

Figure 3

Mandate System Problems Meriting Legislative Attention

- ✓ Lack of Payments Undermines Credibility of Mandate Requirement
- ✓ Little Confidence in Mandate Determination Process
- ✓ Claiming System Invites Problems
- ✓ Legislature Needs Better Information
- ✓ Delays Decrease Legislative Oversight
- ✓ Mandate Determinations Are Stuck in the Past

Governor's Proposed Changes to Reimbursement Process

In the Governor's budget summary, the administration expresses its intent to reform the process for reimbursing local agency mandate costs. Specifically, the administration indicates that existing law "has created a confusing, expensive process that is not resulting in either the expected reimbursement for local agencies nor informed fiscal choices for the Legislature and the administration."

The budget proposes several changes to the reimbursement process, including:

- Legislation that would allow the Legislature to limit mandate costs through the annual budget act.
- Revising the Commission on State Mandates procedures so that the Legislature approves reimbursement guidelines and cost estimates earlier in the process.
- Limiting mandate reimbursement to the "least costly approach," rather than actual costs of complying.
- Increasing audits of mandate claims.

Lack of Payments Undermines Credibility of Mandate Requirement

The provisions in the California Constitution requiring mandate reimbursements serve two important public policy objectives, they:

- Safeguard local agencies from having to redirect resources from local programs and priorities to implement new state requirements.
- Place a "check" on state government's proclivity to impose obligations on subordinate governments.

Neither of these objectives is realized, however, if the state continually delays payment of its mandate bills as it has since 2002-03. Ultimately, any substantive reform of the mandate system must address this central question of state and local responsibility and authority. If the system is to be credible and fulfill its intended purposes, the mandate system should ensure that the state reimburses local governments on a timely basis—or that local agencies have authority to discontinue implementation of mandates.

Little Confidence in Mandate Determination Process

For the mandate system to function well, all parties—local agencies, the Legislature, the administration, and the public—should have reasonable confidence that the process for determining which state requirements constitute a mandate is fair and accurate. Under the current system, local agencies question the impartiality of the decision-making process, and state viewpoints often are not well represented. Comprehensive reform should address these concerns

Local Agencies Perceive Bias. While CSM members and staff strive to avoid giving preferential treatment in their proceedings, local agencies inherently worry about the impartiality of commission decisions. Specifically, four of the seven commissioners represent state-elected officials or their appointees. The remaining three commission positions (two representing local agencies and one representing the public) are appointed by the Governor, but these positions frequently are left unfilled. In addition, local agency and public commissioners, unlike their state counterparts, cannot send alternates to hearings when they have scheduling conflicts. Thus, mandate decisions frequently are made by a commission dominated by state representatives.

State's Interests Not Well Represented. Because the commission functions like a court, each party must submit detailed reviews and legal analyses supporting its arguments. Local agencies, aided by mandate consultants, typically document their positions well. For many reasons, including workload constraints and a failure to perceive a direct fiscal interest in the outcome of the process, state agencies seldom play a very active role during the mandate process. In its audit of the School Bus Safety II mandate, for

example, the Bureau of State Audits noted that neither the Department of Finance nor the California Department of Education provided input regarding the reimbursement guidelines for the school bus mandate, the statewide cost estimate for which later totaled $290 million. Similarly, in our December 2003 review of recently identified mandates, *New Mandates: Analysis of Measures Requiring Reimbursement,* we recommend the Legislature request the commission reconsider its decision making regarding six mandates. In many cases, the need for this review is at least partially attributable to state agencies' failure to provide important information during the mandate determination process.

Claiming System Invites Problems

As we have discussed in previous analyses, there is extraordinary variation among local agency mandate claims. For example:

- The City of Long Beach's Peace Officer Procedural Bill of Rights mandate claims were three times the costs claimed by the Cities of Sacramento, Fresno, and San Jose, *combined.*

- K-12 collective bargaining claims from similar size school districts over a five-year period varied by a factor of almost 15.

- While San Diego County has seven times more students than San Francisco, San Francisco's claims for the Handicapped and Disabled special education mandate (frequently referred to as the "AB 3632 mandate") was nearly 25 times the amount claimed by San Diego.

When individual mandates are reviewed by this office, the SCO, or Bureau of State Audits, each office finds significant costs that appear inconsistent with the underlying mandate. These claiming anomalies undermine the credibility of local claims and, in the Governor's budget summary, are cited as a reason for delaying payment of state mandates. As we discuss below, chief among the reforms we think necessary is a revised approach to the methodology used to reimburse local agencies.

Current Methodology Lacks Specificity. For most mandates, the CSM adopts open-ended mandate reimbursement methodologies, usually drafted in terms that parallel the legal findings in the mandate's Statement of Decision. Essentially, a local agency's mandate claim is its estimate of costs incurred in carrying out certain broadly defined activities. While the commission's intent in approving this type of reimbursement methodology is to ensure that all of the state's very different local agencies may claim their mandated costs, the open-ended nature of this approach lends itself to problems. This reimbursement methodology also is difficult for the SCO to review without an on-site audit.

Different Approach Needed. Nothing in the State Constitution specifies that California must use this open-ended methodology for mandate reimbursements. In our view, a better way to reimburse most mandates would be to study a sample of local agencies and develop unit costs for local agencies to use in their mandate claims.

Legislature Needs Better Information

Although state agencies impose some mandates through regulations, the Legislature enacts most mandates in legislation. The Legislature also is responsible for appropriating funds to reimburse mandate claims. Despite the centrality of the Legislature in the mandate process, the existing system gives the Legislature very limited assistance with which to carry out these responsibilities.

As legislation is developed, for example, Members of the Legislature frequently seek ways of encouraging certain local agency actions without imposing a mandate. In addition, to prepare bill analyses for fiscal committees, legislative staff seek information regarding the potential costs for California's thousands of local governments to implement certain activities. Because of their role as a quasi-judicial agency, CSM staff and commissioners indicate that it is inappropriate for them to comment on specific legislation. Thus, the Legislature frequently does not receive the information it needs.

When reviewing bills with potential local impacts, the Legislature should consider how better to obtain the timely information and assistance it needs regarding mandates and their costs.

Delays Decrease Legislative Oversight

The Government Code specifies timelines for the mandate review process, generally requiring the commission to complete its work reviewing and estimating the cost for a new mandate within one year. Given the highly legalistic manner in which mandate determinations are made, and staffing levels at the CSM and the Department of Finance (the state's representative in mandate proceedings), the statutory deadlines are virtually never met. Instead, under the current process the commission indicates that it takes *seven* years for it to complete its work on a typical mandate. In addition to compromising the credibility of the mandate system, these lengthy delays reduce the Legislature's ability to provide oversight on mandated programs.

Costs Escalate Before Legislature Gets to Act. During the time that a mandate is under review by the CSM, local governments must carry out the mandated responsibilities without reimbursement. When the CSM's work is complete, accumulated local government costs for the mandate—for the period the mandate was under review—are reported to the Legislature for

reimbursement in a claims bill. Should the Legislature determine it wishes to eliminate the mandate, its action would apply prospectively only. That is, the state still would be "on the hook" for local government mandated costs during the seven-year review period.

Information Comes Long After Measure Enacted. Because local agencies have a three year statute of limitations for filing new claims and CSM processing takes seven years, the Legislature may not learn about the costs of a new mandate *until seven to ten years after the legislation was enacted.* By this time, the Member of the Legislature who carried the legislation may no longer be in office and the reasons prompting the legislation may no longer be readily apparent. The lengthy mandate review process, therefore, complicates the Legislature's ability to review a mandate's costs and benefits.

In our view, developing a system that completes its work in a timely fashion so that the Legislature can provide oversight on mandate program costs should be a high priority in any mandate reform legislation.

Mandate Determinations Get Stuck in the Past

While Legislative Counsel has opined that the Legislature has authority to request the commission reconsider earlier decisions, there is currently no administrative process to carryout this review. As a result, when federal law, court rulings, or other matters change the framework under which a previously determined mandate was considered, state and local agencies have no process to request a reconsideration of a mandate decision. For instance, as we discuss in the "Education" chapter of the *Analysis of the 2004-05 Budget Bill*, there is no process for reconsidering the standardized testing and reporting mandate in light of the expanded federal testing requirements under the No Child Left Behind Act.

In our view, to promote state and local agency confidence in the mandate reimbursement system, mandate reform should include a process for updating mandate decisions to reflect modern legal opinions, federal law, and other factors.

Conclusion

In theory, the mandate provisions in the California Constitution serve an important role in our governance process, protecting local governments from state-imposed increased costs and ensuring that the state considers local government costs as it deliberates the imposition of new local requirements.

In practice, however, California's system for determining and reimbursing mandates has many shortcomings, most notably a failure to ensure that local governments receive reimbursements on a timely basis. In our view, the

mandate system needs substantial reform so that it can fulfill its purpose and generate mandate determinations and reimbursement claims in which state and local government has confidence. Figure 4 summarizes the key elements that we consider critical to any successful reform proposal.

While reforming the mandate system will not be easy, we note that it involves somewhat fewer complicating factors than many other program areas needing reform. Specifically, the existing constitutional provisions regarding mandates are broad: the California Constitution requires only that local governments be reimbursed for mandates. All other elements of the mandate system are in statute and amenable to change. In addition, the current mandate determination and reimbursement systems involve relatively few state and local employees. Finally, because concerns relating to state-local mandates are evident throughout the United States, other states have mandates reimbursement programs that the Legislature could review for suitability in California.

Figure 4

Key Elements of Mandate Reform

- ✓ The Legislature should have access to mandate cost and other information *during* the legislative process. State agencies also should have assistance during the development of regulations.
- ✓ The body charged with making mandate determinations should be reconstituted so that all parties view it as objective.
- ✓ State agencies should actively participate in the mandate determination process, ensuring that state views and interests are documented and presented.
- ✓ Local governments should have some recourse to reduce their fiscal liabilities if the state does not fund mandates.
- ✓ The mandate determination process should be timely, with the Legislature learning of new mandates and their costs *before* or *shortly after* the mandate is established.
- ✓ The mandate claiming process should be simple, credible, timely, and easy to audit. Whenever possible, claims should reflect unit cost methodologies rather than open ended claiming.
- ✓ Mandate determination and claiming procedures should be updated as needed to reflect modern conditions, laws, and court rulings.

The Problem of Abusive Tax Shelters

What Steps Should the Legislature Take to Curb the Increasing Use of Tax Avoidance Schemes and the Large and Growing State Revenue Losses They Produce?

Summary

The personal income tax (PIT) and the corporation tax (CT) are two of the state's most important sources of General Fund revenues. Under these tax programs, taxpayers are allowed to legitimately "shelter" certain income from taxation. Much of this tax sheltering activity is specifically identified in law—such as retirement accounts—or involves other permitted tax planning activity. However, in the last few years there has been a significant increase in tax sheltering activities that violate state and federal tax law, and therefore represent abusive tax shelters (ATSs).

Abusive tax shelters can occur under either the PIT and the CT and are usually marketed to and used by high-income or high-net-worth taxpayers. Such ATSs vary considerably, but they are usually quite complex, involving many layers of transactions, and multiple entities. This complexity makes it difficult for state and federal tax agencies to identify them and take corrective action in order to curtail their use. In general, California's Franchise Tax Board (FTB) and the federal Internal Revenue Service consider that the key feature of ATSs is that they have no true economic purpose but exist solely for reason of tax avoidance.

The current level of ATS activity—and its potential for future expansion—raises significant administrative challenges for FTB and for the continued viability of the state's revenue system. The use of ATSs not only results in significant immediate term revenue losses to California—in the hundreds of millions of dollars annually—but can also result in declining compliance by an increasing number of taxpayers over the longer term. While the Legislature has taken important steps to curtail the use of ATSs, it may want to consider additional measures in this regard. This discussion provides an overview of the ATS phenomenon, addresses the impacts of such shelters on the state, and suggests measures the Legislature may want to consider to address the ATS problem.

INTRODUCTION

The PIT and CT are two of the state's most important sources of income, with estimated revenues in 2004-05 of approximately $38 billion and $7.5 billion, respectively. Revenues from these tax programs are expected to constitute almost two-thirds of General Fund revenue in 2004-05. Both tax programs are administered by FTB.

Under both the PIT and the CT, taxpayers are able to shelter certain income from taxation. For example, under the PIT, establishing retirement accounts—such as under Section 401k of the Internal Revenue Code (IRC)—is a form of tax sheltering. Similarly, under the CT, businesses are allowed to engage in certain activities that either result in the avoidance of or delay in the payment of taxes—such as accelerated depreciation of particular types of equipment. Thus, some tax sheltering activity is explicitly allowable under the state's tax laws. Other types of tax sheltering activities, however, are not specifically identified in federal or state tax law. Some such activities are not considered allowable by the FTB or the Internal Revenue Service (IRS) and are deemed to represent ATSs.

FIELD OF SCHEMES

Historical Perspective and Recent ATS Trends

Inappropriate tax sheltering activity has always existed as a compliance problem under the PIT to some degree. However, in recent years such activities have proliferated, and have grown in size, scope, and sophistication. As a result, there have been substantial concerns raised at both state and federal levels regarding the magnitude and revenue impacts of ATS activity. This sheltering activity represents tax avoidance methods that are quite distinct from the typical (and legitimate) forms identified above.

The first generation of these schemes—which proliferated in the 1980s—represented transactions that were relatively straightforward in structure. The current generation, however, is often characterized by legally complex, opaque and financially technical transactions, coupled with an aggressive interpretation of state and federal tax law. The new ATS schemes are designed for either individuals or businesses and can vary substantially depending upon taxpayer circumstances.

Abusive tax shelters are usually marketed by accounting, banking, and consulting firms, and frequently involve several entities "teaming-up" in order to provide a tax shelter program, legal opinion regarding the transaction, and other financing assistance. In addition, such transactions can involve the provision of insurance policies that provide financial pro-

tection to the investor in the event of any tax losses related to the ATS, such as if the ATS is deemed nonallowable after an audit. Because of the complexities involved in many ATSs, their legal, accounting, and associated fees can be substantial. As a result, tax shelters tend to be marketed most aggressively to high-income and high-net-worth individuals, as well as large business entities such as major corporations or partnerships.

What Constitutes an ATS?

As noted above, there are many types of ATSs, with their exact characteristics varying considerably depending upon a taxpayer's situation. They can be quite difficult to identify and often even harder to understand, even for trained tax auditors. The Congressional Joint Committee on Taxation—which is responsible for drafting much of the federal legislation intended to restrict ATS activity—has itself indicated the difficulty in drawing distinctions between legitimate and unacceptable tax shelter activity. Despite the absence of a uniform and exact standard as to what constitutes a tax shelter, however, there exist statutory provisions, judicial doctrines, and administrative guidance that represent attempts to limit or define transactions in which the primary purpose is the avoidance of income tax.

Based on these rules and guidelines, the FTB and the IRS have arrived at an operational definition of an ATS. According to this definition, the key feature with respect to ATSs is that they have *no true economic purpose but exist solely for reason of tax avoidance,* and thus generate no true or economic loss with respect to taxpayer's income or assets that would justify a tax savings. In addition, ATS transactions typically:

- Are promoted with the promise of tax benefits.
- Have predictable tax losses or tax consequences.
- Involve a literal reading of a tax statute inconsistent with its underlying intent.

Administrative and court decisions have required that financial and related transactions must have *economic substance* or *business purpose* to avoid being considered an ATS. These requirements have been interpreted to mean that the transaction in question must have economic advantages other than those related merely to tax savings, and its business purpose must be separate and distinct from any tax consequences.

In addition to their working definition, the IRS and FTB have identified certain characteristics that typify such ATSs. Such transactions usually have some or all of the following characteristics:

- Involve separation of income and expenses.
- Use pass-through entities (such as partnerships).

- Use third-party facilitators.
- Employ offshore foreign accounts or facilitators.
- Allow double benefits from a single tax loss.
- Involve short-term transactions.

A couple of very simplified examples of tax shelters are provided in the shaded box below. These examples and the descriptions above provide only a general outline of an ATS transaction. In actuality, such shelters tend to be highly complex and extremely sophisticated, involving multiple layers of transactions and numerous participants.

Illustrative Examples of Abusive Tax Shelters

There exist a wide variety of tax sheltering schemes, making it impossible to easily capture the shared essence of all such types of transactions. Nevertheless, the two examples below are representative of the types of abusive tax shelter (ATS) transactions that have occurred in the recent past.

- ***Personal Income Tax ATS: The Roth IRA Expansion Kit.*** One of the more recent ATSs on the market allows individual taxpayers to essentially contribute to a Roth individual retirement account (IRA) more than the annual contribution level explicitly allowed by state and federal laws. The Roth ATS involves the establishment of a closely held corporation owned by the IRA. Valuable assets are then transferred to the Roth corporation and subsequently sold, with no taxes being paid by the Roth corporation. The result is that income from such sales escapes taxation, since no tax was paid on the initial contribution and Roth account funds are not taxed upon withdraw. (This ATS is now an IRS "listed transaction," and thus prohibited.)
- ***Corporation Tax ATS: Commercial Domicile.*** This ATS typically involves incorporating a business in a state without an income tax (for example, Nevada or New Hampshire). Stock or other intangible assets are then transferred by individual business owners to the corporation and subsequently sold. The proceeds would not be taxed (due to the business's incorporation in a non income-tax state) and the proceeds of the sale would eventually be realized by the individual business owners though various means. (Some versions of this ATS have been restricted by previous legislative action.)

Gimme Shelter: The Recent Growth of ATSs

There are a number of reasons why ATSs began proliferating in the 1990s. Tax analysts generally believe that the increase in ATSs was due in large part to the large stock market-related capital gains that were occurring during this period, as well as other large income gains on the corporate side. In response, there developed an increasingly sophisticated ATS industry that relies on complex tax and income optimization modeling and convoluted legal and financial structures to offer tax-avoidance schemes.

In addition, some factors leading to the increase in ATS activity resulted from institutional changes and other factors associated with the tax collection agencies—especially at the federal level. These institutional factors included: (1) a decline in the rate of tax agency compliance and auditing activities due to budgetary limitations and a shift of resources to taxpayer services, (2) the lack of meaningful disclosure requirements, and (3) an absence of sizeable penalties on ATS promoters and investors who are caught, relative to the magnitude of tax savings achievable.

Implications for California's Revenue System

Revenue Losses From ATSs

Estimates of the revenue impact of ATSs represent approximations primarily due to the difficulty of measuring revenues that are never paid to the federal or state governments. Nevertheless, there are a number of studies that have been conducted regarding the revenue impacts of the ATS phenomenon that provide a rough gauge as to its likely revenue magnitude.

- ***Impacts on Federal Revenues.*** According to an October 2003 analysis from the General Accounting Office (GAO), IRS-compiled data indicate that between January 2003 and September 2003, the number of ATS transactions increased by 42 percent. During the same period, the estimate of the revenue losses associated with these shelters increased from $74 billion to $85 billion.

- ***Impacts on All States' Revenues.*** The Multistate Tax Commission (MTC)—a multistate tax compact (of which California is a member) that addresses tax issues affecting states—recently estimated the impact of ATSs on state revenues. The MTC concluded that tax shelter activity by corporations reduced state revenues nationwide in the range of $8 billion to $12 billion in 2001-02. (The MTC estimate is limited to the CT, and does not include ATS activity that would be reflected in reduced PIT revenues.)

- ***Impacts on California's Revenues.*** The MTC study referenced above indicated that California's annual revenue losses in 2001-02 due to ATS activity were about $1.3 billion. The FTB has recently increased its own estimate of the revenue impact of ATS transactions from a total of $2 billion over the last four years—a figure that includes both PIT and CT revenues—to something in the range of $2.4 billion to $4 billion.

Because much ATS activity revolves around one-time income events, annual figures involving revenue losses may not always provide a particularly accurate portrayal of the ongoing revenue importance of these tax-avoidance methods; however, based on the FTB figures above, they would appear to average in the $600 million to $1 billion range annually. Thus, it is evident that ATS activity currently poses a significant challenge to California's revenue system. When the potential for significant future expansion of ATS activity is considered, the risk to California's revenue system is even greater.

A Fundamental Threat to the Tax System?

In addition to revenue losses, the concerns at the state and federal levels about ATS activity are related to some of the most fundamental principles that underlie tax and revenue systems. In particular, at this basic level there is a concern that individual and business taxpayers each remit what is appropriately owed by them. Tax avoidance by some taxpayers shifts the relative tax burden towards taxpayers in full compliance.

This principle of fairness is not only important for individual taxpayers and society as a whole, but it also has ramifications for the tax system itself. A perception that the tax system is not equitable could result in noncompliance and tax avoidance by an increasing proportion of taxpayers, potentially jeopardizing the viability of the tax system to raise funds for public purposes. This, in turn, could undercut the very ability of the tax system to function efficiently and effectively.

What Is Being Done About the ATS Problem?

At both the state and federal level, tax administration agencies have begun focusing on the ATS problem. As part of this effort, state and federal officials have developed cooperative programs to coordinate tax compliance activities and avoid any duplication of enforcement efforts. This coordination is vital, not only due to the fact that many ATS transactions involve multistate and international activity (which would generally be difficult for a single state to pursue alone), but also because the sheer com-

plexity of many ATS transactions makes the efficient use of limited available resources essential.

Federal ATS Efforts

For the most part, the IRS has chosen to focus on the promoters of (as opposed to the investors in) tax shelters—including accounting firms, law firms, financial advisory firms, and certain banking institutions—as a means of curtailing tax abuse. As part of its efforts, the IRS established an Office of Tax Shelter Analysis, which has specifically identified—and issued revenue rulings for—more than two dozen specific types of tax shelter transactions that it considers abusive. The IRS has also required promoter firms to disclose and register transactions deemed to be potentially ATSs. In addition, audits of promoter firms are now being conducted to determine whether such reporting requirements have been met—including the provision of investor lists if requested. Finally, as part of this initiative, taxpayers are required to notify the IRS if they have used such "listed" transactions.

The IRS recently completed a memorandum of understanding (MOU) with 33 states (including California) to share information and coordinate enforcement efforts regarding ATS activity. The MOU—executed in September 2003—allows state and federal governments to share information related to tax-avoidance transactions, including promoter information and investor activity. The IRS has also established contracts with various private firms in order to gain access to additional technical expertise in this area.

New Budget Proposals. As part of its efforts to curtail the use of ATS transactions, the U.S. Treasury announced new budget and regulatory proposals that are a component of the 2004-05 federal budget. These include additional penalties for disclosure violations; new disclosure rules; injunctions against ATS promoters; curbs on specific transactions (including sales of depreciation rights, as discussed in our January 2003 publication *"Lease-Leaseback Transactions By Public Transit Districts—Sales and Use Tax Exemption"*); as well as other enforcement measures. According to the Treasury Department, the President's 2004-05 budget includes $300 million in funding for the IRS's tax compliance efforts, including efforts to combat the use of ATSs. As part of this effort, the IRS is expected to shift emphasis from processing to enforcement, adding 2,200 new employees to its compliance effort, including ATS-related activities.

Room for Improvement. While the IRS is following a broad-based multifaceted strategy to combat ATS activity, the GAO noted in its previously cited report that the IRS has not incorporated long-term performance goals and associated measures that could help evaluate its progress. The GAO observes that given the shift in resources toward tax shelter enforcement, the IRS should make a concerted effort to refine its current assessment of

the scope and magnitude of the ATS problem as well as the amount of time required to resolve ATS cases. The GAO notes that an improvement in the analytic basis for resource deployment would facilitate the effective allocation of staff to ATS and other tax compliance activity.

California's ATS Efforts

The ATS-related enforcement efforts of the FTB have focused both on investors in and promoters of ATSs, and represent an attempt to complement the IRS effort to focus on shelter promoters. Although California is somewhat constrained in its ability to curtail the use of certain ATSs—particularly those involving interstate or international activities—it does possess the ability to pursue its own enforcement program in many areas.

The state maintains its own compilation of listed ATS transactions, which includes those on the IRS schedule but also contains certain other shelter schemes of particular importance to California. As noted above, FTB also cooperates with the IRS with respect to the federal ATS initiatives and participates in a number of multistate task forces and organizations (including the MTC and the Federation of Tax Administrators) focused on particular ATS activities.

Recent Legislative Action. Recently, California took legislative action with respect to ATSs, approving measures intended to make the state's tax enforcement against ATS activities more effective. Chapter 656, Statutes of 2003 (SB 614, Cedillo), and Chapter 654, Statutes of 2003 (AB 1601, Frommer), were modeled after S 476 (Grassley), which is currently being considered by Congress. The California law:

- Alters the system of penalties and reporting requirements for investors, promoters, tax advisors, and tax preparers involved in ATS activity.
- Provides a voluntary compliance initiative (VCI) permitting a taxpayer to file an amended tax return that eliminates the tax benefits resulting from an ATS and thus avoid certain new penalties. (The VCI extends from January 1, 2004 through April 15, 2004, and is estimated to result in payments of $90 million in 2003-04, $90 million in 2004-05, and $50 million in subsequent years.)
- Extends the statute of limitations for taxpayers involved in ATS transactions from 4 to 8 years.
- Expands FTB's ability to issue subpoenas to taxpayers involved in ATS activities.
- Increases the ability of FTB to enjoin ATS promoters from marketing shelters within California.

Administrative Steps. In addition to ATS policy initiatives resulting from actions taken by the Legislature, certain administrative steps have also been taken. For example, the FTB last year redirected certain tax compliance resources to the auditing of ATS transactions. This redirection—of which the Legislature was informed in June 2003—is expected to result in a net increase in revenues during a five-year period of approximately $350 million, with an additional $130 million received after the end of the five-year period. According to FTB, each ATS audit may take from 12 months to 24 months to complete, representing 150 hours to 500 hours of staff time.

CONSIDERATIONS FOR THE LEGISLATURE

The complex nature of ATS transactions and the extensive staff time required to pursue such cases place new and increased demands on FTB's existing enforcement efforts. Below we raise various questions regarding the board's ATS-related activities.

Are Current Resources Being Appropriately Shifted to ATS Auditing? As noted earlier, FTB has already shifted auditing resources from standard audits to ATS-related audits. The Legislature may want to consider directing additional shifts in resources to ATS activity. Such shifts would allow FTB to develop a comprehensive ATS plan more quickly than it otherwise could. However, redirecting staff from standard audits could result in revenue losses in the current and budget years, even though *future* audit revenues would likely increase as a result. This is because ATS audits require more initial investment in resources than other types of audits and it can take more years to close out these audits and realize the revenues.

Should Auditing Resources Be Increased? The federal government has proposed to increase spending on tax compliance during the next year—including spending on ATS enforcement—by increasing its auditing resources. Based on our analysis, FTB might benefit from additional resources in the ATS area as well, in order to allow for the hiring of auditors and attorneys skilled in the areas of ATS detection and enforcement. While additional resources may not result in near-term net revenues, such additional resources may be an appropriate long-term investment in tax compliance and enforcement from a revenue standpoint.

To What Extent Would Outside Assistance Be Suitable? The federal government has retained certain specialized tax consultants for its ATS enforcement efforts. The retention of outside consultants in the fields of economics, accounting, and tax analysis by FTB—on a limited-term and targeted basis—might provide valuable assistance by:

- Bringing specialized technical resources to bear on the detection and enforcement of specific tax shelter programs previously identified by the IRS or FTB.
- Assisting in developing ATS-related auditing expertise for FTB's existing staff, through training or other methods.
- Giving assistance and direction to FTB for the purpose of establishing and maintaining an ongoing integrated program for ATS detection and enforcement.

As with the addition of auditing resources, the limited use of outside consultants would be unlikely to result in near-term revenues, but rather would represent a long-term investment in tax compliance.

Should Additional Legal Tools Be Provided? There may be additional legal tools that the Legislature could consider regarding ATS enforcement, including:

- Restricting the issuance of tax insurance policies available to investors in ATSs.
- Expanding California's False Claims Act (which provides for penalties for making a false claim against the state) to include claims, records, or statements made under the Revenue and Taxation Code.

LAO Recommendations

Given the level of current ATS activity—and the potential for vastly increased activity in the future—we recommend that FTB report at budget hearings regarding ATS-related issues as well as various options for improving and expanding its tax compliance programs. Specifically, we recommend that the FTB (1) address the current status of its ATS enforcement efforts, (2) discuss the need for and potential effectiveness (including the net revenue impact) of the various approaches outlined above for curtailing ATSs, and (3) provide information regarding an integrated plan for ATS enforcement, including the development of performance goals.

We also recommend that the FTB expand its existing annual *Supplemental Report on FTB Audits and Collections Activities* to include a section that specifically addresses the status of ATS enforcement activities. Given the nature of ATS transactions and their adverse impact on the state's tax system, we recommend that these activities be analyzed not just with respect to net revenues, but also with reference to the impact of these activities on overall tax compliance.

Additional Options for Addressing the State's Fiscal Problem

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, as do his proposed revenue increases. In many cases, the Legislature will have very different takes on how spending should be reduced and revenue should be raised. As a result, it may need alternative proposals to adopt in place of or in addition to those proposals. We provide such alternatives in both the *Analysis of the 2004-05 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. We have also identified selected revenue options for the Legislature's consideration. These options generally involve tax expenditure programs which are either inefficient at achieving their objectives or are not the most efficient means of doing so.

These expenditure options are grouped in the following categories: (1) spending reductions, (2) fund shifts, (3) federal funds (in effect, using increased federal resources in place of state funds), and (4) fees (in place of General Fund support).

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. In Figure 3, we provide selected revenue options.

Figure 1

Selected LAO Budget Options

(In Millions)

Department/Program—Description	2004-05	2005-06
Health		
Spending Reductions		
Department of Health Services—Allow Medi-Cal applicants to self-certify the value of their assets at the time of application. Comments: The simplification of program rules would make it easier for applicants to complete the enrollment process. The number of persons enrolled in Medi-Cal would increase but a reduction in administrative costs would result in net savings.	**$1.3**	**$1.3**
Department of Health Services—Rescind continuous eligibility for Medi-Cal children and implement semi-annual status reports. Comments: This change would be consistent with the mid-year reporting requirement for parents established in the *2003-04 Budget Act*. This option would disenroll children who are no longer eligible to receive Medi-Cal benefits.	**$50.0**	**$51.5**
Department of Health Services—Streamline and reduce administrative and medical costs in treatment authorization and claims management in Medi-Cal. Comments: The current systems for processing claims result In provider and beneficiary dissatisfaction and unnecessary costs. Implementing this change would take the cooperation of several departments and providers.	**Unknown Savings**	
Department of Health Services—Reduce General Fund support for the Expanded Access to Primary Care Clinic Program (EAPC). Comments: Last May, the administration proposed a reduction in the EAPC program in lieu of the realignment proposal. The Legislature did not accept this proposal last year. Counties do receive realignment funding to provide services to this population.	**$2.4**	**$2.4**

Continued

Department/Program—Description	2004-05	2005-06
Department of Health Services—Reduce funding for HIV Education and Prevention Services. Comments: This option would reduce funds slightly to a base amount for local health agencies. This approach is consistent with the Legislature's intent to prioritize the provision of direct services over other activities.	**Up to $3**	**Up to $3**
Department of Health Services/Medi-Cal—Impose a one-year moratorium on new applications for adult day health centers. Comments: This option would temporarily slow the rapid growth that has been occurring in the number of adult day health centers. This is an alternative to a related proposal of the administration to immediately halt program expansion.	**—**	**$5.5**
Department of Developmental Service—Eliminate funding for Devereux program. Comments: This option would eliminate funding for Devereux, a nonprofit organization that provides programs for children and adults with developmental disabilities. Incorporating the funding for such programs into the department's budget is unusual, given that Regional Centers are responsible for the delivery of these services.	**$1.2**	**$1.2**
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.	**$114.2**	**$127.1**
Federal Funds		
Department of Developmental Services—Draw down federal funding for Regional Center services provided to 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 residents by modifying the rate structure of the ICF/DDs and through other options.	**$46.5**	**$51.1**

Continued

Department/Program—Description	2004-05	2005-06
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 United States Department of Veterans Affairs (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**	
Department of Health Services—Move the Indian Health Program from DHS to MRMIB. Comments: A consolidation of the program with the Rural Health Demonstration Projects (RHDP) under MRMIB would maximize federal matching funds and reduce General Fund expenditures. A significant, but not complete, overlap in client populations exists between these programs and the RHDP.	**Up to $4**	**Up to $4**
Department of Health Services—Move the Seasonal, Agricultural and Migratory Worker Program from DHS to MRMIB. Comments: A consolidation of the program with the Rural Health Demonstration Projects (RHDP) under MRMIB would maximize federal matching funds and reduce General Fund expenditures. A significant, but not complete, overlap in client populations exists between these programs and the RHDP.	**Up to $5**	**Up to $5**
Fund Shifts		
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**
Department of Health Services—Eliminate Proposition 99 funds to assist emergency room (ER) physicians given increased access to local Emergency Medical Services funds (EMS). Comments: The Legislature recently relaxed restrictions on EMS funds making tens of millions of additional local dollars available annually to assist ER physicians. In light of the local resources, the Legislature could eliminate Proposition 99 funding available for the same purpose, which it only began providing as of 2000. This option would allow these Proposition 99 funds to be used for other health programs currently supported by the General Fund.	**Up to $24.8**	**Up to $24.8**

Continued

Department/Program—Description	2004-05	2005-06
Fees		
Department of Health Services—Implement copayment for AIDS Drug Assistance Program (ADAP). Comments: Last May, the Administration proposed a per prescription copayment requirement for ADAP participants to partially offset General Fund support of this program. The Legislature did not accept this proposal. This option would require those who can afford to do so to contribute to the cost of their care.	**$1.5**	**$1.6**
Social Services		
Spending Reductions		
Social Services—Reduce maximum monthly SSI/SSP grants for couples by $174 . Comments: In January 2005, the SSI/SSP grant for couples will be $1,399 (39 percent above the 2003 federal poverty guideline) whereas the grant for an individual will be 5.5 percent above the guideline. Lowering grants for couples to the minimum required by federal law would reduce the disparity in grants between couples and individuals, while maintaining the grant for couples at about 21 percent above the poverty guideline.	**$89.0**	**$178.0**
Social Services—Reduce state-only SSI/SSP grants for immigrants by 10 percent. Comments: The Legislature set state-only SSI/SSP monthly grants for immigrants $10 below the level for regular SSI/SSP benefits. Under this proposal, maximum monthly grants would be reduced by 10 percent ($78 for individuals, $138 for couples).	**$7.0**	**$7.0**
Social Services—Eliminate CalWORKs grants for families above 120 percent of poverty Comments: CalWORKs families with incomes exceeding 120 percent of poverty generally have relatively modest grant payments (up to about $150 monthly). Removing these families from cash assistance would preserve their time on aid for future periods during which they may become unemployed. About 45 percent of the grant loss would be recouped in the form of greater food stamps benefits.	**$37.0**	**$37.0**
Social Services—Suspend Foster Care clothing allowance. Comments: Foster parents are given a monthly grant to cover the costs of food, clothing, and shelter for foster children. The clothing allowance provides an extra $100 per year to supplement the grant.	**$4.0**	**$4.0**

Continued

Department/Program—Description	2004-05	2005-06
Social Services—Suspend stipends for emancipated foster youth.	**$3.6**	**$3.6**
Comments: The emancipated foster youth stipend (created in 2000) is not a core component of the foster care program. Emancipating youth would still be provided with some assistance and services through the Independent Living Program.		
Social Services—Means test state-only Adoptions Assistance Program (AAP)	**$1.5**	**$4.9**
Comments: The state-only AAP program is not bound by federal prohibitions against means testing. This estimated savings assumes that only future AAP cases will be means tested; with an average savings of 50 percent per case.		
Social Services—Reduce frequency of group home visits from monthly to quarterly.	**$8.1**	**$8.1**
Comments: Federal law requires that group home facilities be visited semi-annually. State law currently requires a monthly visit. By reducing the visits to quarterly, the state would save General Fund dollars while still requiring twice as many annual visits as the Federal government requires.		
Social Services—Cap annual social worker costs at $135,000.	**$20.8**	**$20.8**
Comments: There is a considerable amount of variation among counties in the amount that is paid for social workers (including overhead). The variance in per social worker costs appears to be unrelated to actual cost differences. For example, Riverside County receives $162,558 per worker, while San Bernardino's cost is $112,675. Sacramento and Yolo Counties have a similar disparity. A statewide cap on the amount that the state will pay for social workers would help to temper some of this variation, without significant program impacts.		
Judiciary and Criminal Justice		
Spending Reductions		
Corrections—Place nonviolent elderly inmates on parole early.	**$11.0**	**$11.0**
Comments: Under this option nonviolent/nonserious inmates age 60 and older would be placed on parole early. Research shows elderly inmates are two to three times more expensive to incarcerate yet they have a high level of success on parole.		

Continued

Department/Program—Description	2004-05	2005-06
Corrections—Home detention for elderly inmates. Comments: This option would be limited to nonviolent/nonserious offenders age 60 and older who would be released early from prison to home detention with electronic monitoring. Research shows elderly inmates are two to three times more expensive to incarcerate yet they have a high level of success on parole.	**$9.0**	**$11.0**
Corrections—Discharge nonviolent parolees early. Comments: This option would allow parolees who have met the conditions of their parole for 6, 9, or 12 months to be discharged early. This option minimizes the risk to public safety by focusing on nonviolent and nonserious parolees. Savings would range up to amounts shown depending on the length of time required to meet conditions of parole. This option would exclude "lifers," "strikers," and inmates who have committed a serious or violent offense.	**$100.0**	**$125.0**
Corrections—Direct discharge of inmates from prison. Comments: This option would allow nonviolent/nonserious offenders to be discharged from prison without serving a parole term. This option would exclude "lifers," "strikers," and inmates who have committed a serious or violent offense.	**$200.0**	**$225.0**
Corrections—Place nonviolent inmates on parole early. Comments: This option would allow certain inmates to be discharged from prison and placed on parole up to 12 months early. This option would be limited to nonviolent inmates who would be released early from prison and placed on parole. The focus on nonviolent and nonserious inmates minimizes the risk to public safety. This option would exclude "lifers," "strikers," and inmates whose offense is serious or violent. Savings depend on how early inmates are placed on parole.	**$290.0**	**$290.0**
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. The public safety impact of this option would be minimal since these offenders would likely be sentenced to jail or probation.	**$28.0**	**$30.0**

Continued

Department/Program—Description	2004-05	2005-06
Corrections— Parole in lieu of prison for inmates with short sentences. Comments: This option would allow nonviolent/nonserious offenders with short-term sentences of 3, 6, 9, or 12 months to be placed directly on parole without incarceration. The focus on nonviolent and nonserious inmates minimizes the risk to public safety. Savings would range up to amounts shown depending on the maximum length of sentence permitted.	**$155.0**	**$170.0**
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 Department of Justice and Department of Education.	**$1.7**	**$1.7**
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 Citizens' Option 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 less than 1 percent of local law enforcement expenditures, its impact on public safety, if any, is likely to be relatively small.	**$100.0**	**$100.0**
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 option would suspend funding for one year pending evaluations currently underway. Suspension would not stop the programs because grant recipients receive funding one year in advance of projected expenditures.	**$100.0**	**$100.0**
Trial Courts—Authorize courts to implement electronic reporting. Comments: This option would give courts the authority to replace court reporters with electronic recording equipment in some courtrooms and for certain types of cases. Electronic reporting is used in other states and by the federal government. Research shows it can be as accurate as using court reporters, and is cost-effective.	**$33.0**	**$33.0**

Continued

Department/Program—Description	2004-05	2005-06
Higher Education		
Spending Reductions		
University of California (UC)—Reduce base funding for UC Merced. Comments: The university is able to provide neither information on expenditures in the current year nor an expenditure plan for the budget year. This option reduces half of the base budget for UC Merced. (We recommend rejection of a $10 million augmentation in the *Analysis*.) The 2003-04 budget expresses legislative intent that the opening of the campus be delayed from fall 2004 to fall 2005. This option could further delay the campus.	**$5.0**	**—**
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)—Defer costs associated with Common Management System (CMS). Comments: Governor proposes to defer $6 million (or roughly 10 percent) of the total $57 million costs that could be deferred for CSU's CMS. This option would cause a one-year delay in the implementation of new computer applications at selected campuses. These campuses would continue to use their existing computer applications another year.	**$51.0**	**—**
Resources		
Spending Reductions		
Department of Forestry and Fire Protection (CDFFP)—Sell King Air aircraft. Comments: The King Air is one of five "support" aircraft used by CDFFP to transport people and equipment in support of CDFFP's mission. It is not used directly for fire suppression efforts. The aircraft is used approximately 200 flight hours a year. Alternatives to the use of the King Air include the use of the other planes in CDFFP's fleet, commercial flights, and private charters. Selling the King Air would result in about $400,000 (General Fund) savings per year. (This savings level accounts for the additional costs CDFFP would incur if it elected to use charter flights instead of the King Air).	**$0.4**	**$0.4**

Continued

Department/Program—Description	2004-05	2005-06
Department of Water Resources (DWR)—Defer funding for Colorado River Management Account. Comments: Chapter 813, Statutes of 1998 (SB 1765, Peace) provides a continuous General Fund appropriation for Colorado River management, mainly to reimburse local beneficiary agencies for the lining of the All-American Canal. The Governor's budget proposes to transfer $16.1 million from the General Fund to the Colorado River Management Account for reimbursement, despite a 2003-04 budget trailer bill (Chapter 228, Statutes of 2003 [AB 1756, Budget Committee]) that explicitly directs the Governor to exclude funding for the All-American Canal in the 2004-05 budget proposal. Currently, $172 million remains from this appropriation. This option would defer funding in the budget year (as intended by the Legislature) and for an additional year. (The savings projected in 2005-06 is an estimate based on even allocation of the remaining funds owed the account by December 31, 2008, which is the statutory deadline for funding this account.)	**$16.1**	**$39.1**
DWR—Defer funding for local flood control subventions. Comments: Local flood control subventions pay for the state's statutorily obligated share of costs of federally authorized local flood control projects. The state is not obligated to make the payment by a specific date. No funding is proposed for these subventions in the budget year. This option would defer funding for subventions through 2008-09; estimated savings assume that amounts owing local governments will be allocated in even payments over a four-year repayment period.	**—**	**$91.2**
Fees		
Various Cal-EPA/Resources/Health and Human Services Departments—Establish fees to cover costs of all state agency pesticide-related workload. Comments: Based on the "polluter pays" principle, all departmental costs related to pesticide workload would be funded by fees. Departments include State Water Resources Control Board ($2.3 million), Office of Environmental Health Hazard Assessment ($0.6 million), Department of Fish and Game ($0.1 million), and Department of Health Services (unknown).	**$3.0**	**$3.0**

Continued

Department/Program—Description	2004-05	2005-06
General Government		
Spending Reductions		
Office of Planning and Research (OPR)—Eliminate office.	**$4.3**	**$4.3**
Comments: The OPR provides the Governor with staff support on land use, local government, and environmental issues. The office has been given a broad range of responsibilities—reducing its ability to effectively succeed in any one area. Any functions considered essential could be absorbed into the Governor's office or various other departments in state government.		
Department of Housing and Community Development— Reduce homeless shelter assistance.	**$2.0**	**$2.0**
Comments: The historical level of funding for the Emergency Housing Assistance Program was $2 million. Recently, the program—which provides funding to homeless shelters—has been funded at higher levels, including $5.3 million in 2003-04. The Governor proposes funding the program at $4 million in 2004-05. The Legislature could reduce the program's funding level to its historic level, for an additional savings of $2 million. This option would reduce the number of shelter bed nights funded by the state.		
Agency Secretaries—Eliminate General Fund support for agencies.	**$5.1**	**$5.1**
Comments: The need for the agency level of government is unclear. Most agency workload is legislative and budget document review, which are activities already conducted by departments and the Department of Finance. The *2003-04 Budget Act* reduced budgets for a number of agencies. This option is a continuation of that effort. Funding includes Youth and Adult Corrections ($1.5 million); Education ($1.5 million); Health and Human Services ($0.9 million); State and Consumer Ser-vices ($0.7 million); and Environmental Protection ($0.4 million).		
Business, Transportation & Housing Agency—Eliminate the Small Business Loan Guarantee program.	**$14.0**	**$14.0**
Comments: The $30 million reserve fund (from previous General Fund appropriations) backs bank loans to small businesses in the case of default. The Governor's budget proposes $4 million (General Fund) for 11 financial development corporations to administer the program. Based on a 1998 program review, the program results in little or no net tax revenue to the state. Eliminating the program would result in annual savings of $4 million for administrative costs and three years of approximately $10 million transfers to the General Fund from the reserve as guaranteed loans are paid off.		

Continued

Department/Program—Description	2004-05	2005-06
Department of Fair Employment & Housing—Handle employment discrimination complaints through mediation. Comments: In the *2000-01 Budget Act*, the department received $1 million for a pilot mediation program. Rather than having the department investigate complaints, parties using the program agreed to mediate the complaints. An independent evaluation found that participants were satisfied with the program. The department estimates a cost difference of about $500 per case between mediation and investigation. Thus, the department could handle the same number of cases at less cost by directing cases to mediation. Assuming 2,000 employment discrimination cases (approximately 20 percent) go to mediation, there would be ongoing savings of $1 million.	**$1.0**	**$1.0**
Department of Industrial Relations—Consolidate complaint investigations. Comments: The Division of Apprenticeship Standards approves and certifies apprenticeship programs for various occupations and trades and investigates complaints related to these programs. These complaint activities could be consolidated into the department's Division of Labor Standards Enforcement (DLSE). The DLSE currently handles all other workplace complaints related to labor standards. This could result in improved investigative efficiencies. The DLSE could work within its $36 million General Fund budget to investigate apprenticeship complaints on a priority basis.	**$1.7**	**$1.7**
Department of Public Employees' Retirement System (PERS)—Adopt alternative to the Governor's retirement plan for new employees. Comments: As we discuss in detail in the "General Government" chapter of the *Analysis*, the Legislature could adopt alternatives to the Governor's retirement plan for new employees. Such alternatives—Tier 2 or defined contribution plans for all new employees—would result in state savings and other benefits. The savings would likely total several millions of dollars annually in the short term but grow significantly in the longer term.	**Potentially Several Millions of Dollars**	
Office of Administrative Law (OAL)—Eliminate office. Comments: The OAL is responsible for reviewing proposed department regulations. The Legislature could eliminate OAL and transfer any essential activities to other departments. For example, department legal staff could perform regulation reviews, and the Attorney General or the Department of General Services' Office of Administrative Hearings could provide oversight and resolve regulation disputes. This proposal would require changes in the State Administrative Procedures Act.	**$1.8**	**$1.8**

Continued

Department/Program—Description	2004-05	2005-06
Stephen P. Teale Data Center/California Home Page— Outsource the home page and make it self-sufficient. Comments: The annual cost of the California Home Page is about $4 million (half is provided by the General Fund). Other states have outsourced their home pages and cover costs through the collection of fees for online services (primarily for businesses). In addition, these out-sourcing agreements have allowed states to implement more online services.	**$2.0**	**$2.0**
Science Center—Delay opening of Center for Science Learning. Comments: The Science Center School and Center for Science Learning are colocated and scheduled to open in July 2004. The elementary school will be operated and paid for by the Los Angeles Unified School District. The center, however, will be operated and paid for by the state at a cost of $1.4 million General Fund. The goal is for the center to provide programming to enhance the school's focus on science. The Legislature could delay the opening of the center. The school could still open as planned (with more limited services available).	**$1.4**	**$1.4**
Tax Relief—Senior Citizens' Tax Relief Comments: Lower senior citizens' renters and property-owners tax relief back to 1999-00 baseline level.	**$75.0**	**$75.0**
Treasurer's Office—Staffing Comments: Five positions in the Public Finance Division were approved in 2001 and 2002 to assist with the issuance of energy and tobacco bonds. Four of the five positions have had their responsibilities concluded.	**$0.3**	**$0.3**
Fees		
Department of Industrial Relations—Bill for safety inspections of elevators and pressure vessels. Comments: The department bills private building owners for elevator and pressure vessel safety inspections, but the General Fund pays for these inspections in buildings owned by the state or local governments. Local governments account for two-thirds of these inspections. Instead of providing General Fund support, the department could bill public agencies for these inspections which are a cost of doing business. This would treat all entities in the same manner for purposes of these safety inspections.	**$2.2**	**$2.2**

Continued

Department/Program—Description	2004-05	2005-06
Department of 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. Pierce's Disease, carried by the glassy-winged sharpshooter, threatens the wine, table and raisin grape industry. We discuss the program in more detail in the "General Government" chapter of the *Analysis*.	**$4.4**	**$4.4**
Fund Shifts		
Department of Fair Employment & Housing—Return joint jurisdiction cases to the federal government. Comments: By agreement with the federal government, the department investigates complaints on behalf of the Equal Employment Opportunities Commission (EEOC) and the Department of Housing & Urban Development (HUD) when there is joint jurisdiction between federal and state law (approximately 70 percent of department cases). The EEOC and HUD reimburse the department for part of the investigation expenses (about one-third for most cases). The General Fund covers the remaining costs. The state could return to EEOC and HUD these joint-jurisdiction cases instead of doing the federal government's work. As a result, the department would need fewer staff to handle remaining complaints that fall solely under state jurisdiction (medical condition, sexual orientation, and businesses with under 15 employees, for example).	**$8.0**	**$8.0**
Department of Housing and Community Development— Convert multifamily housing loan to bond funds. Comments: In past years, the state awarded several hundreds of millions of dollars from the General Fund for multifamily housing projects. These dollars are not disbursed until the construction of a project is completed. Consequently, the 2002-03 and 2003-04 budgets loaned $59 million in project funds back to the General Fund—with the loans to be repaid from the General Fund as needed. Instead of this approach, the Legislature could, with accompanying legislation, replace the General Fund dollars with Proposition 46 bond funds and eliminate the need to repay the loans. Of the original loans, $36.8 million would be available for this approach. This would be similar to actions taken in the 2003-04 budget package for other housing programs. Since the multifamily housing program still has more than $580 million in bond funds available, this action would not affect scheduled bond allocations until at least 2007-08.	**$36.8**	**—**

Proposition 98 Budget Options

The Governor proposes to suspend the Proposition 98 minimum guarantee. The Governor's proposed spending level would be $2 billion less than the minimum guarantee. In the *Analysis of the 2004-05 Budget Bill*, we recommend the Legislature (1) suspend the minimum guarantee for 2002-03 through 2004-05, and (2) balance funding for K-14 education with other General Fund priorities without regard to the exact suspension level proposed by the Governor.

The Legislature is likely to disagree with some of the spending reduction proposals in the Governor's budget-year plan. If it wants to stay at the Governor's proposed level of Proposition 98 spending, it would need to adopt alternative savings in place of those proposals. The Legislature would also need to consider alternative savings proposals if, in weighing education and noneducation spending priorities, it felt that a higher suspension was necessary. (It is important to note that while the Governor suspends the minimum guarantee by $2 billion, the budget still would provide sufficient funding to expand base programs beyond growth and COLA for K-14 education. In contrast, other General Fund supported program areas face base reductions and no COLAs under the Governor's proposal.)

In the *Analysis*, we identify about $400 million in recommended Proposition 98 funding reductions. In Figure 2 (next page), we provide additional options for K-14 spending reductions.

Figure 2

Selected LAO Budget Options Proposition 98 Spending Reductions

(In Millions)

Department/Program—Description	2004-05	2005-06
Revenue Limit Cost-of-Living Adjustment (COLA)—Suspend statutory adjustment. Comments: The 2004-05 COLA is 1.84 percent.	**$550.0**	**$567.8**
Revenue Limit Deficit Factor—Eliminate requirement to restore 3 percent revenue limit reduction taken in 2003-04. Comments: When the Legislature did not provide a COLA (1.8 percent)—and reduced revenue limits by 1.2 percent, it created an obligation to restore those reductions by 2005-06. This option would eliminate the restoration requirement.	**—**	**$942.0**
Statutory COLA (Categorical Programs)—Suspend statutory adjustments. Comments: Option covers categorical programs that receive a statutory COLA. The 2004-05 COLA rate is 1.84 percent. Excludes special education because the COLA is paid with federal funds.	**$114.6**	**$117.3**
Statutory Growth (Categorical Programs)—Suspend statutorily required growth allocations for categorical programs. Comments: Assumes 1 percent growth in student enrollment. Excludes special education for which the growth is paid for by increased federal funds.	**$88.7**	**$90.7**
County Offices of Education (COEs) COLA—Do not fund statutory growth in county apportionments. Comments: Adjustment is based on projected inflation for state and local goods and services. The 2004-05 COLA rate is 1.84 percent. We suggest treating county programs similar to categorical programs.	**$10.1**	**$10.3**
COEs Growth—Suspend statutorily required growth for county run programs. Comments: County programs are similar in nature to categorical programs. If the Legislature does not provide growth to categorical programs, we would suggest treating county programs similarly.	**$4.3**	**$4.4**

Continued

Department/Program—Description	2004-05	2005-06
K-3 Class-Size Reduction (CSR)—Allow a districtwide cap of 1:20 (teacher:student ratio), with the state capturing half of potential savings. Comments: Currently, K-3 CSR law requires each school site to maintain a teacher-student ratio of 1:20. This option would amend law to apply the cap at the district level rather than the school-site level. The existing school-site cap encourages sites to "undersize" K-3 classes (maintain classes serving fewer than 20 students). A district-level cap would make reaching the 1:20 ratio easier and would allow schools to keep children in the classroom that is best suited for them (rather than busing them to another school site just to remain under the school-site cap.	**$141.0**	**$143.0**
Ninth Grade CSR—Suspend program. Comments: Schools with greatest need less likely to use program because of the lack of qualified teachers.	**$110.0**	**$110.0**
Gifted and Talented Education Program—Suspend program. Comments: Targets extra resources at highest-achieving students to provide supplemental services that could be funded within base resources.	**$46.5**	**$46.5**
Year-Round Schools Facility Grant Program—Phase out over next two years. Comments: This program no longer meets its original intent, which was to provide schools with incentives to go year-round in lieu of building new facilities. Now, year-round schools can obtain bond funding to build additional facilities, and, contrary to the intent of the grant program, schools can simultaneously receive both bond funding and grant funding. Thus, the state's building program no longer provides any fiscal incentive to school sites to go year-round.	**$42.1**	**$84.2**
Development Program (MRPD)—Eliminate program. Comments: This option would eliminate the MRPD program but allow school districts to continue using staff development buyout monies to complete any MRPD training that the district already had begun. Several other large professional development programs would continue to be funded—including the staff development buyout program, the Peer Assistance and Review (PAR) program, the Beginning Teacher Support and Assessment (BTSA) program, and the National Board certification program.	**$31.7**	**$31.7**
Dropout Prevention Program—Eliminate program. Comments: Success of program difficult to determine due to the lack of accurate dropout data. Analysis of a selection of long-term grantees does not validate program effectiveness.	**$21.9**	**$21.9**

Continued

Department/Program—Description	2004-05	2005-06
Peer Assistance and Review—Eliminate funding. Comments: No available evidence showing program effectiveness.	**$25.9**	**$25.9**
Civic Education—Eliminate program. Comments: Program funds curriculum development by nonprofit entity that is duplicative of state efforts.	**$0.3**	**$0.3**
Paraprofessional Teacher Training Program—Eliminate program. Comments: Two other large programs also support paraprofessional teacher training. The state currently provides $230 million for the staff development buyout program, which reimburses school districts for one full day of paraprofessional training. The state also receives $343 million for the federal Title II program, which allows school districts to engage in a variety of activities designed to improve the quality of instruction of teachers and paraprofessionals.	**$6.6**	**$6.6**
School Library Materials—Suspend program. Comments: Expenses for school library materials are typically one time in nature and program's suspension will not affect core classroom services.	**$4.2**	**$4.2**
Gang Risk Intervention Program—Eliminate program. Comments: These services could be provided through existing school safety programs.	**$3.0**	**$3.0**
Statewide Education Technology Services Program—Eliminate program. Comments: Program provides services that do not affect core classroom services.	**$2.3**	**$2.3**
Bilingual Teacher Training Program—Eliminate program. Comments: The state funds several other professional development programs (including staff development buyout, PAR, and BTSA programs)—all of which may be used for bilingual teacher training. Additionally, the state spends a substantial amount on the University of California and the California State University's teacher education programs, many of which include bilingual and multicultural components.	**$1.8**	**$1.8**
Opportunity Programs—Account for lower-than-expected participation. Comments: These savings would reflect anticipated savings due to low participation.	**$1.1**	**$1.1**

Continued

Department/Program—Description	2004-05	2005-06
School Safety Competitive Grants—Eliminate program. Comments: These competitive grant programs have high state and local administrative burden, and may not focus on schools with the greatest need.	**$14.6**	**$14.6**
Advanced Placement Fee Waiver Program—Eliminate program. Comments: This state-funded program is duplicative of a federally funded program that serves the identical purpose.	**$1.5**	**$1.5**
College Readiness Program—Eliminate program. Comments: This is a very small scale program (it benefits only 25 to 30 schools each year), whose objectives (to improve classroom instruction in math) might be accomplished through other programs (such as PAR, the National Board certification program, Assumption Program of Loans for Education [APLE], and federal Title II program). For example, the PAR program also provides funding for full-time mentor teachers to work with new or struggling teachers, and the APLE program offers special benefits to teachers who agree to teach math in a low-performing school.	**$1.0**	**$1.0**
Angel Gate Academy—Eliminate program. Comments: The federal Department of Defense provides $4 million in funding that covers a majority of the program's expenses.	**$0.6**	**$0.6**
California Community Colleges—Terminate funding for Partnership for Excellence (PFE) when it sunsets. Comments: The 2004-05 budget includes $225 million for the PFE. Community college districts use this money to improve outcomes in specified areas. The PFE sunsets on January 1, 2005, but the Governor shifts funding to other community college purposes. This option would eliminate half of the proposed funding to reflect the program's sunsetting after half the fiscal year is over.	**$112.5**	**$225.0**

Selected Revenue-Related Options

Should the Legislature wish to consider additional revenue-related options as a means of addressing the budget problem, there are several approaches it could take. These include broadening tax bases, raising tax rates, and establishing new fees. It also could include eliminating or modifying tax expenditure programs, most of which have been established in the past to provide various incentives or income transfers to qualifying taxpayers.

We have long taken the position that many tax expenditures are either ineffective at achieving their objectives or are not the most efficient means of doing so. The revenue-related options listed in Figure 3 primarily involve tax expenditure programs that at least partially fall into one or both of the above two categories.

Figure 3

Selected LAO Revenue Options

(In Millions)

Department/Program—Description	2004-05	2005-06
***Mortgage Interest Deduction*—**Limit deduction beginning 2004 tax year. Comments: The mortgage interest deduction is currently available for interest paid on mortgages of up to $1 million on first and second homes. This option would limit the deduction to interest on mortgages of up to about $600,000 and on first homes only.	**$580**	**$525**
***Dependent Exemption Credit*—**Reduce credit to equal the personal exemption credit beginning 2004 tax year. Comments: Through the 1997 tax year, the dependent exemption credit was equal to most other exemption credits. In order to grant tax relief, this credit was increased beginning in 1998 to more than three times the personal exemption credit. The 2003 credits are $257 for the dependent exemption credit and $82 for the personal exemption credit.	**$1,180**	**$885**
***Teacher Retention Tax Credit*—**Eliminate credit beginning 2004 tax year. Comments: The adequacy of teacher compensation is best addressed through direct funding of education, not through the tax system. In addition, special treatment of particular professions weakens the neutrality of the tax system since it gives preferential treatment to certain taxpayers.	**$190**	**$190**

Continued

Department/Program—Description	2004-05	2005-06
Research and Development Tax Credit—Reduce credit amount to one-half current rate (7.5 percent) beginning 2004 tax year. Comments: While a federal-level research and development credit is an appropriate tax policy, evidence supporting state level credits is weaker. In addition, California's credit is the highest in the nation.	**$160**	**$170**
Subchapter S Corporation Tax Treatment—Limit filing status qualification beginning 2004 tax year. Comments: Subchapter S corporation filing status—which allows most income to be taxed at the individual level rather than the corporate level—was intended to assist small- and medium-sized businesses. Limiting the availability of this filing status to businesses with receipts of $20 million or less would be consistent with the original purpose.	**$275**	**$295**
Renter's Credit—Suspend credit availability for two years beginning with 2004 tax year. Comments: The renters' credit was suspended in the early 1990s, and is now income limited.	**105**	**$100**
Dependent Care Tax Credit—Limit availability of the credit beginning with 2004 tax year. Comments: The dependent care credit is based on a percentage of the similar federal credit and is currently not available to those earning $100,000 or more—an amount well in excess of the average California household income. This option would limit the availability of the credit to those earning $50,000 or less.	**$80**	**$80**
Sales and Use Tax—Expand base to include certain entertainment services beginning 2004-05. Comments: Expanding the sales and use tax to include certain entertainment services—such as admissions fees, cable television, and private club membership—would broaden the base of the tax.	**$500 - $700**	**$500 - $700**