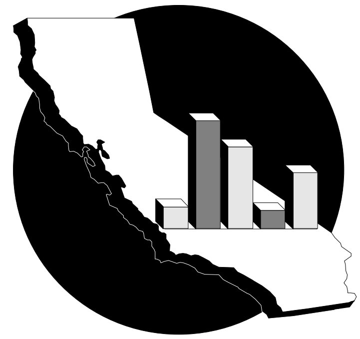


INTRODUCTION

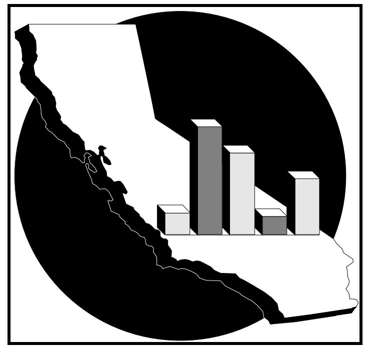
The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the 1995 Budget Bill and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 1995-96 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 1995-96 Budget Bill*, which contains our review of the Governor's Budget.

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

The 1995-96 Budget: Perspectives and Issues is divided into six parts:

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

- Part Four, “Perspectives on State Expenditures,” provides an overview of the state spending plan for 1995-96 and evaluates the major expenditure proposals in the budget.
- Part Five, "Major Issues Facing the Legislature," (1) examines the Governor's proposed 15 percent income tax cut, (2) analyzes the Governor's proposed plan to realign various services between counties and the state, and (3) describes problems with the state's civil service system and offers principles for guiding reform efforts.
- Part Six, "Options for Balancing the 1995-96 Budget," provides a list of spending and tax expenditure reductions that the Legislature can consider in fashioning a balanced budget for the coming year.



STATE FISCAL PICTURE

The plan adopted last July to pay off the 1993-94 budget deficit over a two-year period and achieve a balanced budget by the end of 1995-96 is now out of balance, by about $2 billion. The Governor proposes to eliminate the budget gap and end 1995-96 with a small surplus by taking several steps. These include $1.4 billion of program reductions (primarily welfare grant reductions) and other savings, and shifting $0.9 billion of costs to the federal government and localities (through a state/county restructuring proposal). The Governor's budget plan also proposes a phased-in 15 percent reduction in income tax rates, in combination with leaving high-income tax brackets in place that are scheduled to expire in 1996. The budget's estimated net revenue loss from this tax proposal is $225 million in 1995-96 and a cumulative $7.6 billion over four years.

Because the budget proposal does not include a meaningful reserve, it could easily be thrown out of balance by any significant increase in costs or shortfall in revenue. We have identified a number of major budget risks, totaling several billion dollars, that could jeopardize achieving a balanced budget in 1995-96. These risks include pending budget-related litigation and reliance on future federal actions.

Although California's economy is growing once more, and the budget situation has improved, the long-term outlook indicates that if the Legislature chooses to fund the Governor's spending priorities for education and corrections and adopt his tax cut proposal, substantial ongoing reductions will be necessary elsewhere in the budget. The Governor has proposed major reductions in welfare and health programs that (in combination with his other proposals) could yield sufficient savings to finance his budget plan through the end of the decade. However, our projections indicate that the budget situation is likely to remain precarious throughout this period, even with the magnitude of savings proposed by the Governor. Consequently, it appears unlikely that the state would have sufficient funds to create a meaningful reserve or to expand, restore or create new programs without making corresponding reductions elsewhere in the budget. Furthermore, the budget would remain highly vulnerable to risks and contingencies.

In this part we assess the state's current fiscal condition and outlook, and analyze the Governor's proposals to address the budget gap for 1995-96. We also examine the implications of the Governor's proposals over the next few years.

THE 1995-96 BUDGET PROBLEM

The 1994-95 budget plan adopted last July was intended to pay off prior-year deficits over a two-year period and achieve a balanced budget in 1995-96. That two-year plan has fallen out of balance, requiring significant budgetary adjustments to be made in order to achieve a balanced budget by the end of 1995-96.

The state's economic performance during 1994 is not to blame for the deterioration of the July budget plan. In fact, the state is experiencing a modest revenue increase due to improved economic growth, and caseload growth is moderating as well. Rather, the current budget problem reflects the large gap between the July plan's assumption that the state would receive $3.6 billion of federal funds for immigrant costs through 1995-96, and actual federal appropriations and authorizations to date, which will provide only about $300 million.

The Economic Outlook

The nation's economy experienced the best of both worlds in 1994—reasonably good growth with relatively modest inflation. Real Gross Domestic Product (GDP) rose by about 4 percent, and inflation was 3 percent. Labor markets reflected the strength in the economy, as the unemployment rate dropped to around 6 percent.

The Department of Finance (DOF) expects economic growth to slow to 2.5 percent in 1995 and 2.2 percent in 1996, with inflation in the mid-3-percent range in both years. Other elements of the forecast are for a slowing housing market, continuing gains in business investment, and ongoing strength in foreign trade. The DOF forecast is in general agreement with the consensus of other forecasters, although it is somewhat weaker for 1995 and stronger for 1996.

California's Economy Is Clearly Recovering. California's economy is strongly influenced by national economic performance. However, its unique characteristics also mean that its performance can differ significantly from the nation's. The state's recession was worse and its recovery has been slower than the nation's. For example, California experienced relatively sluggish economic performance through the early part of 1994, and has not yet regained its prerecession employment level, as has the nation. A variety of indicators suggest, however, that the state's economy is now on a sustained recovery path.

The DOF projects that state personal income will increase by 6.6 percent in 1995 and 6 percent in 1996. Employment growth is expected to be in the range of 2 percent to 3 percent annually, and moderate growth is predicted for corporate profits and taxable sales. The department's forecast of ongoing expansion is shared by us and by other forecasters as well.

Even though continued expansion is expected, the strength of the state's economy will be limited by continued cutbacks in defense spending, military base closures, and industry restructuring. It also will depend on the strength of the export market and whether further interest rate increases occur, which could depress the recovering housing market.

Employment Still Below Prior Peak. California employment is projected to finally get back to its prerecession level in the last half of 1996. Employment began declining in early 1990 and hit a low point in the first quarter of 1993. Job losses totaled nearly 700,000 during this period. Since then, employment has increased steadily, having risen by about 240,000.

Budget Based on Moderate Underlying Revenue Growth. Based on the budget's revenue estimates (in the absence of new policy proposals), underlying budget-year General Fund revenue growth is $1.4 billion, or 3.4 percent. Revenue growth is even somewhat higher if adjustments are made for a variety of special factors, such as the phasing-in of various previously enacted legislation. Overall, the budget estimates that the pace of underlying revenue growth will be moderate.

Two-Year Budget Plan Is Out of Balance

Despite the improvement in the state's economic and revenue outlook, the two-year budget plan adopted in July has fallen out of balance. This is because the budget's assumption of $3.6 billion of additional federal funding for immigrant costs far exceeds federal action to date. Figure 1 shows the changes to the July 1994 budget estimates for 1994-95 and

1995-96, based on the January 1995 estimates in the *1995-96 Governor's Budget*, adjusted to exclude new revenue and spending proposals in the budget. Thus, the changes shown in the figure reflect our estimate of baseline revenues and spending using the administration's latest revenue forecast and caseload projections. The federal funds shortfalls shown in the figure reflect the difference between the July budget estimates and our current estimate of California's share of federal appropriations and authorizations that have actually been approved by Congress to date.

Figure 1

July Two-Year Budget Plan Out of Balance

(Dollars in Billions)

	General Fund Impact[a]
Reduced 1993-94 carryover deficit	$0.5
1994-95	
Improved revenues	$0.8
Spending increases	-0.4
1995-96	
Improved revenues	$0.6
Spending increases	-0.3
Reduced encumbrance obligations	$0.1
Underlying Improvement	**$1.3**
Federal immigrant funds[b]	
1994-95	-$0.7
1995-96	-2.6
Federal funds shortfall	**-$3.3**
Budget Gap	**-$2.0**

[a] Measures change between July 1994 and January 1995 budget estimates. Excludes Governor's proposed budget solutions and proposals, including realignment and tax reduction.

[b] Based on current federal appropriations and authorizations.

State Faces $2 Billion 1995-96 Budget Gap

The budget plan adopted in July sought to eliminate an estimated $2 billion 1993-94 year-end budget deficit by the end of 1995-96, when the General Fund would achieve budgetary balance (with a minimal reserve of $29 million). As Figure 1 shows, however, absent corrective action, the state's General Fund now faces a $2 billion budget gap in 1995-96. The budget gap represents the minimum amount of savings and/or revenue from changes to existing laws and policies that is needed in order to achieve a balanced budget in 1995-96. As such, it is a useful "measuring stick" for budget-balancing actions and provides a basis for comparing different approaches to resolving the budget problem.

Based on the budget changes identified in Figure 1, the General Fund will end 1994-95 with a deficit of $740 million (which is less than the $1.0 billion year-end deficit projected in July). However, the shortfall in federal immigrant funds results in an operating shortfall of $1.2 billion between baseline spending and estimated revenues in 1995-96. The combined effect of the carryover deficit from 1994-95 and the 1995-96 baseline operating shortfall results in a 1995-96 year-end budget deficit of $2 billion if no corrective action is taken, as shown in Figure 2. While the state's underlying revenue and expenditure trends have improved by $1.3 billion, commitments of federal immigrant funds fall $3.3 billion short of the July assumptions.

Figure 2

1995-96 Budget Gap[a]

(In Billions)

Pay off deficit from 1994-95		$0.7
1995-96 baseline spending	$45.0	
1995-96 baseline revenue[b]	-43.8	
Operating shortfall		$1.2
Budget Gap		**$2.0**

[a] Excludes Governor's Budget proposals. Detail does not add to total due to rounding.

[b] Based on administration's revenue forecast.

Underlying Trends Improve

In contrast with recent years, changes in the state's underlying revenue and spending trends (excluding federal immigrant funding) have been positive since enactment of the budget. Budget estimates indicate that underlying revenues and expenditures both have grown, but that the revenue increase is twice as much as the spending increase.

Revenues Are Up. Estimated General Fund revenues show improvement over the two-year period, reflecting the strengthened economic outlook. Compared with the July budget estimates, revenues (before the proposed tax reduction) increase by a total of $1.4 billion—$817 million in 1994-95 and $583 million in 1995-96. Improved revenue collections in the final months of 1993-94 also account for most of the $500 million reduction in the deficit carried over from 1993-94.

Revenue Gains Increase Proposition 98 Spending. Projected spending increases in 1994-95 and 1995-96 offset half of the revenue gain in each year. These spending increases primarily reflect the effect of the additional revenues in increasing the state's funding obligation to schools and community colleges under Proposition 98. Other spending changes are roughly offsetting.

Federal Funds Shortfall

Of the total of $3.6 billion of new federal funds for the costs of illegal immigrants and refugees assumed in the July budget plan, we estimate that Congressional actions to date will provide about $300 million—all for incarceration costs of felons who are illegal immigrants. California will receive about $78 million over the two years from a current federal budget appropriation. The federal crime bill also authorizes an additional $300 million appropriation nationwide for the federal 1996 budget, of which California's share could be about $200 million.

To date, however, Congress has not provided any of the new funding assumed in the July budget plan for education and health care costs of illegal immigrants or for refugee costs. Thus, there is a $3.3 billion federal funds shortfall in the two-year budget plan.

THE GOVERNOR'S BUDGET PROPOSAL

Figure 3 shows the Governor's proposed amounts of revenues and spending for 1994-95 and 1995-96 and the resulting General Fund condition (consistent with traditional state accounting practices). Proposed revenues and spending in 1995-96 are almost unchanged from the estimated 1994-95 amounts. This lack of growth, however, reflects the effect of the Governor's realignment proposal, which shifts $1 billion of state revenues and expenditures to counties and off of the General Fund budget. (The proposal also includes a $600 million spending shift within the budget.) Figure 3 also shows the percentage growth in spending and revenues adjusted to include these shifted amounts in order to place figures for 1994-95 and 1995-96 on a comparable basis.

Adjusted for realignment, proposed General Fund revenues and spending both increase modestly in 1995-96, with revenues growing slightly faster than spending—2.8 percent revenue growth versus 2.5 percent spending growth. For comparison, our estimate of baseline spending grows by 8 percent from 1994-95 to 1995-96. The budget projects a small reserve of $92 million at the end of 1995-96. Thus, the administration still proposes to achieve the goal of the July two-year plan—eliminating the 1993-94 carryover deficit by the end of 1995-96.

Figure 3

Governor's Budget General Fund Condition 1994-95 and 1995-96

(Dollars in Millions)

			Percent Change	
	1994-95	**1995-96**	**As Presented**	**Adjusted for Realignment[b]**
Prior-year balance	-$1,119	-$459		
Revenues and transfers	42,353	42,538	0.4%	2.8%
Total resources available	**$41,234**	**$42,078**		
Expenditures	$41,693	$41,726	0.1%	2.5%
Ending balance June 30, 1993	**-$459**	**$352**		
Reserve	**-$740[a]**	**$92**		
Other obligations	$281	$260		

[a] The budget document shows a positive reserve of $285 million due to the inclusion of $1,025 million of deficit borrowing as a budget resource.

[b] Adjusted to include $1,021 million of revenues and costs that would be shifted out of the General Fund in 1995-96 under the Governor's realignment proposal.

How the Budget Addresses the Gap

Figure 4 (next page) shows how the budget proposes to address the $2 billion budget gap noted above and allow for the $92 million reserve.

Spending. As shown in the figure, program reductions and savings fill most of the budget gap ($1.4 billion). The bulk of the proposed reductions are in health and welfare programs, and they generally reflect a continuation of proposals that the Governor made last year. The largest amounts of savings come from proposed welfare grant reductions and restrictions in the AFDC and SSI/SSP programs.

Federal Funds and Realignment. The budget continues to rely on additional federal funding to offset the state costs of providing services to illegal immigrants and to refugees. However, the amount of new federal funds is much less than the $2.8 billion assumed in the July budget estimate for 1995-96 (see below). The budget also includes a net state savings of $241 million from the state/county realignment plan. Resources provided to counties would fall short of costs shifted to them by this amount, which the budget proposes to offset with county savings from proposed mandate relief legislation.

Figure 4

Governor's Proposed Resolution Of the 1995-96 Budget Gap[a]

(In Billions)

Program reductions/savings	
Welfare	
AFDC grant reductions and reforms	$0.4
SSI/SSP grant reductions	0.4
Restrict eligibility	0.1
Medi-Cal	
Eliminate optional benefits and prenatal services for undocumented persons	0.2
Various cost containment measures	0.1
Proposition 98—tax cut reduces school funding guarantee	0.1
Other reductions/savings	0.2
Augment funding for disasters and emergencies	-0.1
Other augmentations, including REACH and AIM	-0.1
Subtotal	**$1.4**
Shifts to other levels of government	
Federal Government	
Additional reimbursements for illegal immigrant costs	$0.5
Increased refugee funding	0.1
Eliminate SSI/SSP administrative charge	0.1
Counties—unfunded realignment costs	$0.2
Subtotal	**$0.9**
Taxes	
Tax reduction proposal	-$0.2
Total solutions	**$2.1**
Establish 1995-96 General Fund reserve	**$0.1**

[a] Detail does not add to totals due to rounding.

Revenues. Budgeted revenues reflect a proposed reduction of $225 million in 1995-96 due to the first year of a phased three-year reduction in personal and corporate income taxes. (This tax proposal is discussed in detail in Part Five of this volume.) Approximately half of this revenue loss is offset by a reduction in education funding due to the resulting reduction in the Proposition 98 minimum funding guarantee.

MAJOR BUDGET PROPOSALS

Governor's Realignment Proposal

The budget proposes a significant shift of responsibility and funding from the state to the counties for certain welfare and social services programs. As detailed in Figure 5, the proposal shifts about $1.9 billion of state costs to the counties, along with $1.6 billion of state resources (a combination of state sales tax revenue, fine revenue, and increased state funding for local trial courts). The state would realize a net savings (and the counties a cost) of $241 million in 1995-96 under the proposal. The current realignment proposal contains some of the same elements included in the more extensive restructuring proposal

Figure 5

Governor's State/County Realignment Plan[a] 1995-96

(Dollars in Millions)	
State Costs Shifted to Counties	
Increase county share of AFDC costs	$1,157
Shift programs to counties	
Foster care	329
Child welfare and abuse prevention	298
Adoption	83
Total	**$1,868**
State Resources Shifted to Counties	
Shift state sales tax revenues	$710
Increase state trial court block grants	605
Return trial court fines and forfeiture revenues	311
Total	**$1,626**
Net State Savings	**$241**

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

presented in the 1994-95 Governor's Budget. (We discuss the realignment proposal in more detail in Part Five of this volume.)

Budget Depends on Federal Actions

In order to achieve $1.5 billion of the new savings proposals in the budget, the state needs various federal actions to provide new funds or to change laws or waive existing program requirements. Figure 6 lists these budget proposals and categorizes them.

Figure 6

1995-96 Governor's Budget
Solutions Requiring Federal Action

(In Millions)	
Costs for Immigrants	
Pay full cost of Medi-Cal services to undocumented persons	$310
Reimburse state for incarceration of undocumented felons	177[a]
Fund 36 months of health and welfare benefits for refugees	101
Subtotal	**$588**
Other Proposals	
Federal legislation needed	
Eliminate federal administrative charge for SSI/SSP program	$50
SSI/SSP grant reductions	434
Bar sponsored immigrants from receiving Medi-Cal and AFDC benefits	64
Eliminate drug/alcohol abuse disability category for SSI/SSP program	52
Reduce Medi-Cal rates for "distinct part" nursing facilities	26
Waiver needed	
AFDC grant reductions	254
Subtotal	**$880**
Total	**$1,468**

[a] Amount budgeted in excess of estimated $245 million from existing authorizations and appropriations.

As shown in the figure, the budget assumes savings of almost $590 million in 1995-96 from additional federal funds to offset the state costs of health and welfare services to illegal immigrants and to refugees. This amount is in addition to $245 million for incarceration costs that we estimate is the state's share from existing federal appropriations or authorizations. The January budget proposal, however, does not include

$1.7 billion of federal reimbursements in 1995-96 assumed in the July budget plan for the education costs of illegal immigrant children. Figure 6 also shows that a total of $880 million of new savings proposals in 1995-96 depend on the enactment of federal legislation or the approval of administrative waivers.

Other Proposals

Welfare Proposals. The budget proposes legislation to enact various AFDC grant reductions and welfare reforms similar to proposals that the administration has put forward in previous budgets. These actions include a 7.7 percent grant reduction effective September 1, 1995, an additional 15 percent grant reduction after six months on aid, and a two-year time limit for aid to able-bodied adults. The budget estimates $254 million in General Fund savings from these actions in 1995-96. The budget also proposes SSI/SSP grant reductions of 8 percent for individuals and 10 percent for couples, for a General Fund savings of $434 million in 1995-96.

Medi-Cal Optional Benefits. The budget again proposes to eliminate certain optional benefits that California provides under the Medi-Cal program. The benefits that would be eliminated include adult dental care, psychology, and podiatry—for a net General Fund savings of $143 million in 1995-96.

Prenatal Services. The budget proposes to eliminate funding for a state-only program of prenatal services to undocumented immigrant women. This would reduce General Fund spending by $79 million in 1995-96. Undocumented women would remain eligible for federally required emergency and obstetric services under Medi-Cal.

Full Funding for Corrections. The budget proposes $3.5 billion ($3.3 billion from the General Fund) for support of the Department of Corrections (CDC). The budget proposal represents an increase of $374 million, or 13 percent, above estimated General Fund expenditures in the current year. The proposed increase will essentially provide full funding for workload growth in the department and provide augmentations for several policy changes.

Proposition 98. The budget proposes an additional $1.2 billion in Proposition 98 funding for K-12 and community colleges in 1995-96 due to General Fund revenue growth and a large anticipated increase in the K-12 student population. Consistent with existing law, the budget proposes to deduct a total of $514 million (1994-95 and 1995-96 combined) from the amount of funds distributed to school districts. These amounts would be set aside for making partial repayments of past Proposition 98 loans.

The additional funding has the result of increasing average per-student support for K-12 to $4,292, an increase of $61, or 1.4 percent over the current-year level. The budget proposes a 2.2 percent cost-of-living adjustment, at a cost of $444 million, in K-12 general-purpose and special education spending, and $55.2 million for community colleges. No cost-of-living adjustment is proposed for K-12 categorical programs.

Higher Education. The budget treats both the University of California (UC) and the California State University (CSU) similarly after adjusting for one-time expenditures at CSU. For each segment, the budget provides 2 percent increases for unspecified general purposes, and funds increases in debt-service costs for lease-payment bonds. The budget proposes a "four-year compact" with UC and CSU which includes a commitment to provide General Fund increases averaging 4 percent for the three fiscal years beginning in 1996-97. Among other things, the plan also calls for enrollment growth averaging about 1 percent annually, increases in faculty salaries, "productivity improvements," and reductions in students' time to obtain an undergraduate degree.

Department of Transportation Staff Reduction. The budget proposes to reduce the staffing level of Caltrans by over 1,200 personnel-years. This reduction is primarily due to a funding shortfall resulting from failure of various transportation bond measures. About one-third of these reductions are proposed in departmental administration and in highway project design and engineering.

The Governor's Tax Proposal

The Governor has adopted the recommendation of his Task Force on Tax Reform and Reduction that the state's income tax rates be reduced. The Task Force's view is that California's tax rates are too high, and that reducing them will stimulate economic activity, including attracting more businesses to California.

The tax proposal has two parts:

- ***Continue the Temporary High-Income Tax Rates.*** The 10 percent and 11 percent personal income tax rates for high-income taxpayers would be continued. These rates have been in place since 1991 and are scheduled to return to 9.3 percent in 1996.

- ***Across-the-Board Tax Rate Reductions.*** All tax rates for both individuals and businesses would be reduced by a total of 15 percent from their current (1995) level. The reduction would be phased-in evenly over three years—5 percent in 1996, 1997, and 1998.

ADJUSTMENTS SHOW OPERATING DEFICITS IN 1992-93 AND 1993-94

In 1990-91 and 1991-92, the state incurred large budget deficits as the recession proved unexpectedly deep and prolonged. Since then, according to the budget, the state has been "living within its means," in that General Fund revenues have equaled or exceeded General Fund spending each year. The state's ongoing budget problems, according to this view, result from the pre-1992-93 deficits and not from further imbalances since then.

Figure 7 shows General Fund operating balances for the current year and for the past two years. The operating balance compares current revenues with current spending in any year. As illustrated in the figure, the budget indicates that the General Fund has operating surpluses of $660 million in the current year and $1.1 billion in 1993-94, and that the operating budget was essentially balanced in 1992-93. However, during this three-year period, more than $2 billion of spending was placed off

Figure 7

General Fund Operating Surplus/Deficit Budgeted v. Adjusted 1992-93 Through 1994-95

(In Millions)

	Actual 1992-93	Actual 1993-94	Estimated 1994-95
Amounts shown in budget			
Revenues	$40,946	$40,095	$42,353
Expenditures	40,948	38,958	41,693
Budget operating surplus/deficit	**-$2**	**$1,137**	**$660**
Adjustments			
Net off-budget spending for Proposition 98 loans	-$80	-$596	$135[a]
Deferral of PERS retirement contributions	-489	-467	-302
One-time accounting switch for bond interest	—	-248	—
Totals, adjustments	**-$569**	**-$1,311**	**-$167**
Adjusted operating surplus/deficit	**-$571**	**-$174**	**$493**

[a] Adjustment *improves* 1994-95 surplus since budgeted loan repayment represents past, rather than current, spending.

budget or deferred to future years or was offset by a one-time accounting gain. Specifically, the budget spending figures benefitted from the following adjustments:

- ***Off-Budget Proposition 98 Loans.*** Funds provided to schools will not be recognized in budget expenditures until subsequent years.
- ***Deferral of PERS Contributions.*** State costs for employee retirement contributions were delayed for several years to be made up in the future.
- ***Bond Interest Accounting Change.*** Switching from accrual to cash accounting for bond interest payments provided a one-time budget savings, but did not affect actual interest payments or costs.

Figure 7 shows that if these "paper" savings are excluded, then the General Fund incurred operating deficits in 1992-93 and 1993-94 and that the estimated current-year operating surplus is reduced to $493 million.

Loans and Deferrals Push Obligations Into Future

In addition to the adjustments shown in Figure 7, the General Fund currently has obligations totaling almost $800 million in outstanding loans from special funds and deferred costs to meet various commitments set out in existing law. These loans and spending deferrals also have helped to improve the budget's operating balance on a temporary basis. These obligations fall into the following categories (amounts shown are approximate):

- ***Northridge Earthquake Costs—$300 Million.*** The state is borrowing $300 million from the federal government and the City of Los Angeles to cover its share of local earthquake repair costs under existing law. The budget proposes to make an initial loan repayment of $60 million in 1995-96.
- ***Sales Tax Refunds—$205 Million.*** The budget anticipates paying off the state's remaining liability for refunds to defense contractors pursuant to the *Aerospace* court decision at $60 million per year.
- ***State Share of Local Flood Control Costs—$135 Million.*** For several years, the state has not met its obligation under existing law to pay a share of the costs of local flood control projects.
- ***Loans from Special Funds—$130 Million.*** Under existing law, the General Fund owes the Transportation Planning and Development Account $98 million, plus interest, for loans provided in 1992-93 and 1993-94; another $29 million, plus interest, is owed to the Em-

ployment Training Fund for a loan in 1992-93.

MAJOR RISKS POSE THREAT TO BUDGET

Because the projected budget reserve at the end of 1995-96 is only $92 million, any significant added spending or loss of revenue would throw the budget out of balance. Consequently, it is important to assess the major budget risks that could affect the state by the end of 1995-96.

Figure 8 summarizes some of the major budget risks that could jeopardize achieving a balanced budget in 1995-96. The amounts shown represent the budget's *maximum* likely exposure. As the figure shows, the state faces budget risks totaling billions of dollars in 1995-96. While it is unlikely that all of these risks will be realized, and any actual budget impacts may be less than shown in the figure, clearly the magnitude of these risks poses a significant threat to the budget.

Figure 8

1995-96 Governor's Budget
Major Budget Risks

(In Billions)

	Potential Deterioration By End of 1995-96
Federal Actions	
Welfare grant reductions and other savings	$0.9
Additional immigrant/refugee funding	0.6
Medicaid administrative/ case-management funds	0.4
Local Actions	
AFDC savings to state from realignment	0.1
Pending Litigation	
CTA v. Gould—invalidates Proposition 98 loans	3.0
PERS v. Wilson—requires payment of deferred retirement contributions	1.0
Parr v. California—penalizes state for paying employees with IOUs	0.5
Welch v. Anderson—challenges 1994-95 AFDC welfare grant reductions	0.1

Approximately $1.9 billion of budget savings depend on federal actions assumed in the budget agreement, either to provide additional funds or to allow program revisions. This amount includes $400 million of Medi-Cal administrative/case-management funds assumed in the 1994-95 budget, but not yet approved by the federal government. The budget also depends on counties improving their AFDC administration to reduce state costs.

Pending litigation poses budget threats totaling billions of dollars. There have been initial trial court decisions adverse to the state in all of the cases cited in the figure, although they are subject to appeal and the actual fiscal impacts are still uncertain. Perhaps the most significant case is *CTA v. Gould,* which poses a $3 billion budget risk by invalidating certain Proposition 98 loans provided to schools and community colleges by the state. The decision would increase the carryover deficit by $1.8 billion to recognize spending for past off-budget loans, and it also could increase spending through 1995-96 by $1.2 billion by raising the base funding level for Proposition 98. Two other cases pose large risks. In *PERS v. Wilson,* the court determined that the state's deferral of its employee retirement contributions was unconstitutional and ordered the state to pay about $1 billion in deferred contributions and earnings. In *Parr v. California*, a federal court has found that the state violated the federal Fair Labor Standard Act by paying employees with registered warrants while the budget was delayed in 1992-93, and has ordered a proceeding to determine the damages and penalties against the state. These could range up to $500 million.

In addition to the litigation listed in Figure 8, cases that still are at the trial court level could impose substantial costs on the state. For example, *Orthopedic Hospital v. Kizer* is a pending suit that challenges Medi-Cal outpatient rates and seeks to increase them. Another case—*American Lung Association of California v. Wilson*—challenges the state's use of Proposition 99 cigarette tax funds to support certain programs. An adverse decision could result in pressure on the General Fund to replace Proposition 99 support for these programs. A decision appears imminent. Furthermore, several suits have been filed challenging past use of special fund money to help balance the budget. The Governor's Budget proposes to use an additional $49 million of special fund money (from the Employment Training Fund and the Beverage Container Recycling Fund) to support General Fund programs in 1995-96.

THE STATE'S 1995-96 CASH POSITION

The "trigger" legislation enacted as part of the 1994-95 budget plan prohibits the 1995-96 budget from ending the year with a cash shortfall, as defined. Based on the two-year budget plan adopted in July 1994, a cash "cushion" of $1.3 billion was estimated. The 1995-96 budget now estimates a cash cushion of about $1 billion. Given the magnitude of the risks discussed above, this cushion does not provide a large margin for error.

The actual determination of whether the trigger is pulled will be made by the State Controller in October 1995 with input and review by the Legislative Analyst's Office. That determination will depend primarily on the budget that is adopted and fiscal developments during the early part of the budget year.

LOOKING BEYOND THE BUDGET YEAR

Given the Governor's tax proposal and the tight budgets of recent years, it is important to know the implications of the Governor's budget proposals for the future. One natural question is what levels of funding for state programs would be possible, based on the revenues that would be available if the tax proposal is enacted.

The budget estimates that, assuming current tax laws, the state can expect to receive $28 billion in cumulative revenues from 1995-96 through 1998-99 beyond what would be received if revenues experienced *no growth* from their *1993-94* level. The budget projects, assuming adoption of the budget proposals, that the distribution of this added revenue would be $7.6 billion to pay for the tax cut, $11.9 billion for Proposition 98 education funding, $2 billion for debt and the remaining $6.5 billion for "discretionary" spending. (A more recent analysis of the tax cut proposal by the Franchise Tax Board estimates a slightly lower four-year cost of $7.3 billion.) The budget includes within this "discretionary" spending category such items as the homeowners' exemption (which is provided for constitutionally), debt service on lease-payment bonds, and interest costs on short-term cash borrowing. It also includes all remaining programs in the budget, including corrections, health and social services, and higher education.

Things Will Be Even Tighter

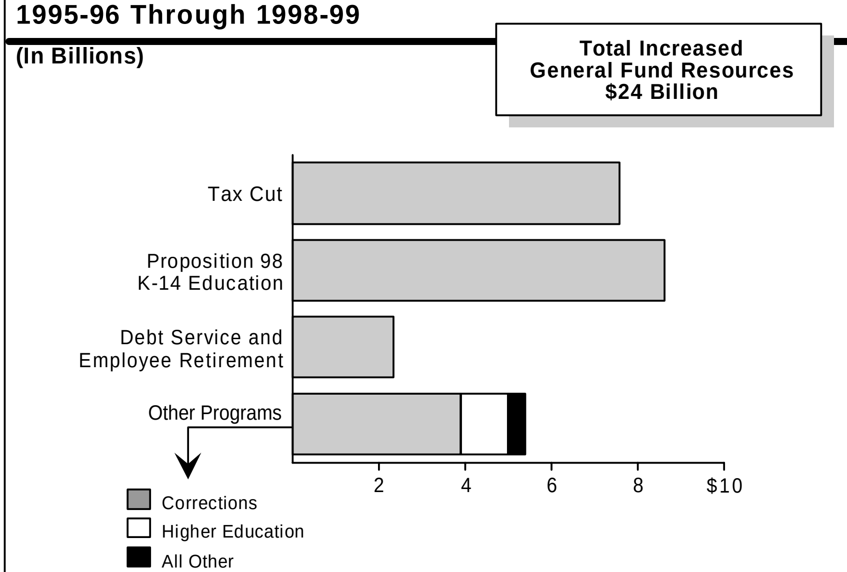
Our estimates indicate that, assuming a moderate economic and revenue growth scenario with no recessions or significant economic slowdowns, the state can expect to receive about $24 billion in cumulative additional resources between 1995-96 and 1998-99 compared to the administration's $28 billion figure. Our figure differs from the administration's primarily because we are looking at the additional resources that would be available compared with a situation in which revenues experienced no growth from their current *1994-95* level. We also have different assumptions pertaining to the pace of revenue growth and certain other factors.

Figure 9 shows that the distribution of these revenues would be $7.6 billion for the tax cut, $8.6 billion for Proposition 98, $2.4 billion for debt service and employee retirement, and $5.4 billion for all other programs. This means that spending growth for all of these other programs could increase at an average annual rate of 3 percent.

Figure 9

Use of Increased Resources 1995-96 Through 1998-99

(In Billions)



Given other commitments, however, the spending situation is actually much tighter. For example, the Governor has been committed to full funding of corrections—which, if continued, would absorb $3.9 billion in increased revenues over the four-year period. In addition, the Governor has called for specific levels of funding for UC and CSU—which would absorb about $1.1 billion over the four years. Thus, these two commitments alone would absorb virtually all the remaining resources available over the period. This would leave almost no room for growth in the total amount of funding in the remaining approximately 40 percent of the General Fund budget: primarily health, social services and general government spending.

Creating Reserve Would Further Reduce Spending Room. The above analysis probably overstates the actual level of resources available for other programs. For instance, there is no provision for a budget reserve. Normally, after several years of economic growth, the state would expect to have established at least a modest reserve. A 3 percent reserve would absorb about $1.5 billion.

Additional Spending Pressures. The analysis above implicitly assumes that the state will win on appeal several costly outstanding lawsuits. As noted earlier, the state's fiscal exposure in these cases is in the billions of dollars. Finally, the analysis does not directly take into account the impact of certain provisions of law that are set to go back into effect in the near future. For instance, the renters' credit is scheduled to go back into effect in 1996, resulting in cumulative costs over the remainder of the period of about $1.5 billion. Unless the credit were postponed again or repealed, these costs would have to be absorbed within available resources.

Would the Proposed 1995-96 Reductions Keep the Budget in Balance?

Clearly, the tax cut and spending scenario described above would require some major spending reductions compared with current trends, especially for health and social services programs, which comprise more than 75 percent of the "other programs" portion of the budget. Spending on health and social services programs has increased by an annual average rate of about 8 percent over the last ten years. Even a 5 percent annual growth rate would require a cumulative total of about $7 billion of additional General Fund spending on health and social services programs through 1998-99. The Governor's 1995-96 budget proposal, however, includes significant welfare grant reductions and other savings proposals that would reduce spending on an ongoing basis. We have projected these savings into future years in order to determine how they would affect funding available for the remaining "discretionary" programs in the scenario through 1998-99.

Using the budget's assumptions and implementation schedule, our projections indicate that the Governor's savings proposals could generate several billion dollars of savings through 1998-99—potentially enough savings to provide for increases to offset inflation and population growth in the remainder of the "discretionary" portion of the budget.

OPTIONS FOR BALANCING THE 1995-96 BUDGET

State Faces Significant Budget Gap

Over the last four years, the state has faced substantial budget gaps as a result of the recession's impact on revenues and the effect of rapidly growing caseloads in some program areas. The proposed 1995-96 budget is no different in this regard. It marks the fifth year in a row of a budget gap, where the amount of spending needed to fund existing programs is projected to exceed anticipated revenues. We estimate this gap to be about $2 billion in the budget year, as discussed in Part One of this volume. This gap remains even after taking into account the fact that the state's economy is improving and the state's expenditures are moderating.

The Governor's Budget proposes to eliminate the gap by (1) program reductions (primarily welfare grant reductions) and other savings totaling $1.4 billion and (2) shifting costs of $0.9 billion to the federal and local governments.

Recognizing that the Legislature will want to establish its own priorities in balancing the budget, we provide here a list of potential budget actions that could be used to close this gap and result in a balanced budget for 1995-96. This list is in addition to specific recommendations for reductions we make in our companion volume, the *Analysis of the 1995-96 Budget Bill.*

Budget-Balancing Approach

Achieving a balanced budget in 1995-96 will require difficult and painful decisions. In part, this is because the budget gap is equivalent to about five percent of General Fund spending in the current year. Closing such a gap is not a matter of simply tightening the belt by snipping away inefficiency or reducing administrative overhead, as helpful as such reductions may be. After four consecutive years of major budget shortfalls, the “easy” solutions already have been taken, and new savings have to be found to replace budget solutions that were one-time in nature.

Our approach was to identify the major program areas of the budget from which any budget-balancing reductions would have to be made. Within these major areas, we provide a broad range of options from which the Legislature can choose. In compiling this range of options, we have used the following criteria:

- ***Target the Reductions.*** We have identified specific reductions instead of across-the-board cuts because unallocated reductions would further erode service levels and program effectiveness regardless of their priority. By making specific choices, the Legislature can provide adequate funding to its highest-priority programs.

- ***Examine All State Spending.*** All major program areas—including education and corrections—are identified for potential reductions. We also have included several actions on the list that would increase state revenues by reducing or eliminating certain “tax expenditures.”

- ***Identify Actions That Benefit The General Fund.*** The actions we have identified result in General Fund savings in order to address the budget gap. We also have identified various ways to achieve savings in special fund programs when they benefit the General Fund.

- ***Focus on Permanent, Not One-Time Solutions.*** Because the state will likely face tight budgets in the next few years, our emphasis is on budget solutions that will be ongoing.

- ***Achieve Real, Not “Paper” Savings.*** Effective budget solutions must generate real savings. “Paper” savings using accounting changes, loans, or other “gimmicks” would contribute to a continuation of the state's budget problems.

In the following pages, we describe each potential action and identify its fiscal effect relative to the 1995-96 Governor's Budget, as introduced. It is important to note that program reductions in one budget area can create cost pressures in other state programs or for local governments.

Looking for Longer-Term Reform

Our list of potential budget balancing actions primarily includes options that generate savings starting in 1995-96. As such, it does not include many other actions that we believe the Legislature and Governor should consider in order to save money in the future or to make governmental operations more efficient and effective. For instance, we believe one of the most important matters to address is reforming the relationship between the state and local governments. During the last two years, we have outlined a number of options for rationalizing state-local governmental operations, all revolving around our *Making Government Make Sense* model (please see *The 1993-94 Budget: Perspectives and Issues*, page 111). The Governor's Budget for 1995-96 contains a state-county realignment proposal which we review and comment on in Part Five of this volume.

In addition, there are many ways that the Legislature could restructure existing state programs. For instance, in recent years we have offered recommendations on:

- A retirement program for new teachers, thereby eliminating future state costs.
- The state's K-12 school categorical programs in order to increase local control and improve service delivery.
- Alternative methods of providing housing assistance in order to reduce administrative costs and ensure the provision of more affordable housing.

We have also made recommendations in prior years to consolidate state programs. For example, we have recommended the consolidation of the Franchise Tax Board and the Board of Equalization, and state financial regulatory agencies. Typically, such consolidations do not save money right away, but they do generate savings in the future and can improve the delivery of services to taxpayers.

These are just some examples of other actions that the Legislature and Governor could take to save money and make government run better. In developing an overall response to the state's fiscal problem, actions should be taken that have a positive impact on the state's fiscal balance sheet in both the near and longer term.

Figure 1

Options for Balancing the 1995-96 Budget

(Dollars in Millions)

Proposal	Savings	Comments
K-12		
Department of Education		
Proposition 98—suspend the minimum funding guarantee in 1994-95 but hold harmless the 1995-96 guarantee. • K-12 • Community Colleges	$200 (153) (47)	For K-12, this option would not eliminate any funding already appropriated in 1994-95 or drop them below the per-pupil funding level envisioned in the 1994 Budget Act. For community colleges, it represents a loss in funding from the 1994-95 level. However, the Chancellor's Office has allocated funds on the assumption that these monies are *not* available in 1994-95.
Proposition 98—suspend the guarantee in 1994-95 and allow the lower 1994-95 spending level to affect the 1995-96 funding guarantee. • K-12 • Community Colleges	409 (341) (68)	This option would eliminate the $200 million as in the first option and reduce 1995-96 funding by a similar amount. No suspension of Proposition 98 in 1995-96 is needed. Savings in 1995-96 would probably be achieved by reducing K-12 and community college cost-of-living adjustments (COLAs).
Proposition 98—suspend the minimum funding guarantee in 1994-95 and 1995-96. • K-12 • Community Colleges	696 (597) (99)	This option would eliminate the $200 million in 1994-95 funding and the proposed COLA in 1995-96.

Continued

Program Proposal	Savings	Comments
Higher Education		
University of California		
Graduate student fee increase (additional $300 above *Analysis* recommendation).	$5	The cost of graduate programs and earning potential of graduate students is higher than for undergraduate programs and students. Revenues are net after a 33 percent set-aside for financial aid.
Fee increase for current professional students (additional $1,000) and new professional students in medicine, dentistry, and veterinary medicine (additional $1,000). Amounts are above *Analysis* recommendations.	4	The cost of professional programs and earning potential of professional students is higher than for other graduate degree programs. Revenues are net after a 33 percent set-aside for financial aid.
Eliminate increase for general purpose expenditures.	37	Governor's Budget provides sufficient funds for a 2 percent increase. System would have to live with current-year funding level.
Redirect funds from teaching hospitals.	10	Redirects a portion of clinical teaching support funds to meet critical needs on the campuses.
Reduce state-funded research budget by an additional 5 percent above *Analysis* recommendation. (Reduction applies to state General Fund support for unrestricted research.)	9	Research activity can be reduced by (1) setting priorities among research efforts and (2) relying to a greater degree on systemwide competition for research grants. This change can be made without affecting the instructional mission of the university.
California State University		
Graduate student fee increase (additional $90 above *Analysis* recommendation).	3	The cost of graduate programs and earnings potential of graduate students is higher than for undergraduate programs and students. Revenues are net after a 33 percent set-aside for financial aid.
Eliminate increase for general purpose expenditures.	31	Governor's Budget provides sufficient funds for a 2 percent increase. System would have to live with current-year funding level.

Continued

Proposal	Savings	Comments
Judiciary and Criminal Justice		
Department of Corrections		
Offenders with limited time to serve would not go to prison, but would:		
Remain in county custody or be released: • One year or less to serve. • Nine months to serve. • Six months to serve.	 $135 70 16	The state incurs significant costs to house short-term inmates. These offenders barely make it through a state prison reception center before being released. Under this option, counties could choose to keep the offenders in custody or release them.
or		
Go directly to state parole: • One year or less to serve. • Nine months to serve. • Six months to serve.	 111 55 12	Under this option, the offenders would begin immediate supervision in the community on parole.
Eliminate state prison sentences and parole for 10 specified nonviolent offenses. Impact for selected crimes:	103	Prioritizes state prisons and parole supervision for offenders who pose the most risk to public safety—those with convictions for violent offenses. Felons would remain in county custody.
• Petty theft (value of property under $400) with prior felony conviction.	11	
• Driving under the influence.	12	
• Perjury, bookmaking, bribery, other property crimes.	1	
• Drug possession.	29	
• Drug possession for sale.	24	
• Marijuana offenses.	4	
• Forgery, fraud.	2	
• Receiving stolen property.	5	
• Vehicle theft.	8	
• Grand theft (value of property over $400)	5	

Proposal	Savings	Comments
Upon release from prison, parole supervision provided only for felons convicted of:		Prioritizes services to adult parolees who pose the greatest risk to public safety.
• Violent offenses.	117	
• Violent *or* drug sale offenses.	93	
• Violent or drug sale offenses, or prior violent or serious offense.	65	

Continued

Proposal	Savings	Comments
Provide more extensive work credits for some inmates:		
• Two days credit for each day an inmate works in a fire camp.	$13	Inmates who work in fire camps would be rewarded for the service they provide to the state.
• One day off for each day eligible inmates in reception centers work in prison jobs.	15	Reception center inmates would receive the same full work credits now given other eligible inmates.
Reduce inmate sentences by one month.	35	Releasing inmates one month earlier would not substantially change the overall level of punishment received by felons.
Department of the Youth Authority		
Do not accept less serious offenders from counties.	15	Prioritizes Youth Authority for most severe offenders.
Increase the charge to counties for accepting less serious offenders, using a sliding scale.	44	Currently, counties pay just $25 per month for each commitment, which has not changed since 1961. Requiring counties to pay 40 percent to 100 percent of costs based on the seriousness of the offense, would provide an incentive to counties to develop local alternatives to state placement, for less serious offenders.
Limit access to institutional programming for CDC inmates who are housed in the Youth Authority (known as “M cases”) age 18 and over.	4	Reinforces primary mission of the Youth Authority—providing rehabilitative services to *juvenile* offenders.
Transfer all wards and inmates age 21 and older to the CDC regardless of court of commitment.	12	Same as above.
Transfer to the CDC responsibility for parolees age 18 and over.	12	Provides same level of parole services as adult parolees in the CDC.
Youthful Offender Parole Board		
Eliminate the YOPB, and rely on Youth Authority for ward parole determinations.	3	Currently, the YOPB relies on Youth Authority staff recommendations over 85 percent of the time for parole determinations.
Eliminate YOPB intake and annual hearings.	2	Prioritize board's activities to most important hearings (Parole and parole revocation)

Continued

Proposal	Savings	Comments
Trial Court Funding Program		
Eliminate state funding for court-appointed counsel for juveniles for certain civil actions.	$38	Funds provided by state under Court Appointed Counsel function provide attorney services to juveniles for certain civil actions, such as child custody and visitation disputes. Because these actions are civil and not criminal, the state does not have legal obligation to provide the service.
Eliminate funding for Assigned Judges Program.	12	This option would result in the Trial Court Funding (TCF) Program absorbing the costs of the Assigned Judges Program. The services provided by the program are part of trial court operations and, therefore, could be financed by the TCF Program.
Department of Justice		
Eliminate the Bureau of Narcotic Enforcement.	24	Bureau duplicates local law enforcement function.
Eliminate the Violent Weapon Suppression Program.	4	Same as above.
Require local agencies to reimburse the Department of Justice for forensic laboratory services.	11	Criminalistic laboratory work provided to local law enforcement primarily benefits local governments.
Commission on Peace Officer Standards and Training		
Eliminate local assistance training programs for law enforcement.	26	Costs for training and equipment for local law enforcement primarily benefits local agencies and should be funded by local governments.
Board of Corrections		
Eliminate local assistance training programs for law enforcement.	11	See Commission on Peace Officer Standards and Training above.

Continued

Proposal	Savings	Comments
Health and Social Services		
Medi-Cal		
Contract out Medi-Cal drug program to pharmacy benefit management company.	$46	Outside company could negotiate lower rates with pharmacists and drug companies in exchange for higher volume.
Require a supplemental rebate of up to 10 percent from drug manufacturers.	40	Proposal assumes that state can take further advantage of its buying power, given the size of Medi-Cal program. A reduction of this magnitude could cause some companies to withdraw their drugs from the Medi-Cal formulary.
Eliminate statutory COLA for prescription drug ingredient costs.	11	Consistent with practice of not providing COLAs to other providers. Would force pharmacists to absorb drug price increases and may reduce number of participating pharmacists.
Require $50 copayment for nonemergency hospitalizations.	Up to 10	Requires beneficiaries to share in cost of care; would not reduce services because some of the copayments would be absorbed by hospitals since not all beneficiaries will agree to make the copayment.
Reimburse hospital inpatient services on “per-discharge” rather than per diem basis	10 - 20	Reduces incentive for hospitals to keep Medi-Cal patients longer than necessary. Savings would result from fewer inpatient days, since disproportionate-share hospitals would face a lessened incentive to keep Medi-Cal patients longer. Proposal would *not* reduce disproportionate-share payments in aggregate.
Eliminate budgeted rate increase for contract hospitals.	22	Excess hospital bed capacity in California suggests that the state could negotiate a rate freeze with contract hospitals through 1995-96.
Establish a budget for hospital inpatient services at 7 percent below current spending level.	111	Given excess hospital bed capacity, the state could take advantage of a “buyer's market” for hospital services. A reduction of this magnitude could cause some hospitals to refuse to contract with the state and seek cost-based reimbursement instead.

Continued

Proposal	Savings	Comments
Include newly enrolled SSI/SSP-linked beneficiaries in managed care expansion, and reduce payments for all managed care contractors to 97 percent of the fee-for-service equivalent.	$20 - 30	Consistent with current policy for existing pre-paid health plan contractors. Managed care is designed to give local providers, including counties, an incentive to provide care more efficiently. Beginning in 1996-97, savings would increase to between $50 million and $100 million.
Require integration of IHSS and Medi-Cal long-term care, with county share of cost.	15	Giving counties a share of costs provides an incentive for them to divert patients from institutionalized care to IHSS when appropriate.
Eliminate "asset waiver" for services for pregnant women.	8	Eliminating the asset waiver would target available state funding to individuals with least resources. Low-income persons with excess assets will still be served by counties.
Suspend Medi-Cal county administration COLA.	5	Consistent with budget's policy of requiring state departments to absorb salary COLAs.
Public Health Programs		
Reduce eligibility for California Children's Services Program to 200 percent of the federal poverty level.	3	Targets services to the most needy. Reduction would affect about 5 percent of caseload. (It would target services for a family of four to those families with incomes of $30,000 or less, instead of $40,000 or less.)
Eliminate General Fund support for the County Medical Services Program (CMSP) on a one-time basis.	20	1995-96 year-end fund balances are estimated to be $54 million. Consequently, those reserves can be used to fund program expenditures without reducing service levels.
Delete proposed augmentations:		These are new initiatives or program enhancements which lack sufficient budget detail.
REACH	56	
Teen Pregnancy	12	
Managed Risk Medical Insurance Board		
Reject proposed expansion of AIM eligibility from 250 to 300 percent of poverty level.	14	Better targets services to those who are less able to pay them.

Continued

Proposal	Savings	Comments
Department of Aging		
Eliminate General Fund nutrition overmatch for congregate and home-delivered meals to the elderly.	$7	Additional donations could offset a portion of the reduction.
Department of Developmental Services		
Charge fees for all services purchased by regional centers.	49	Fees provide an incentive for more efficient utilization of services. Fees would average $20 per month for Medi-Cal eligible clients and $46 per month for non-Medi-Cal clients. Average monthly fee would be $27. Total fee revenues would amount to 6.8 percent of expenditures.
Department of Mental Health		
Delete proposed augmentation to Childrens' System of Care program.	2	This program provides funds to counties for support of interagency projects designed to reduce costs for other publicly supported programs, including AFDC-FC. Because counties have to pay a share of the costs of AFDC-FC, sufficient incentives exist for counties to use their own funds for such projects.
AFDC		
Limit AFDC-U grants—delete adult portion of grant after 6 months.	102	AFDC-U recipients, by definition, are two-parent families who have had an attachment to the labor force and would therefore be likely to focus on finding employment during their spell on aid. Depending on income level, affected families would be eligible to receive food stamps and Medi-Cal.
County Administration of Welfare		
Delete proposed COLA	9	Consistent with budget's policy requiring state deprtments to absorb salary.

Continued

Proposal	Savings	Comments
IHSS		
Include IHSS "income eligibles" in Personal Care Services Program caseload.	$19	Maximizes federal funds by obtaining 50 percent federal funding under the Personal Care Services Program for "income eligible" IHSS cases. These cases are primarily persons who pay a share of cost for IHSS services.
Substitute IHSS individual provider mode for the contract mode in providing services.	14	IHSS contract caseload could be served by individual providers at a lower cost.
Community Care Licensing		
Increase licensing fees for family day care homes and child day care centers.	3	Fees are relatively low compared to operating revenues. Increase annual fees for small day care homes from $25 to $50 and large homes from $50 to $100. Increase center fees from $100-$1,000 to $200-$2,000, depending on size of program. Increased fee revenues would be used to offset General Fund spending for program.

Continued

Proposal	Savings	Comments
General Government		
Board of Control		
Rescind state payment of county costs of special elections.	$2	Elections are county responsibilities.
Eliminate General Fund support to Victims of Crime Program—allow board to pay claims proportionately based on total available federal and special fund revenues.	31	Program was designed to be supported by special funds and federal funds. This option prioritizes funding to ensure that some funds are paid on all claims.
Institute restitution fines for those who complete certain diversion programs and use revenues in lieu of General Fund.	20	Currently, those who complete diversion programs are not required to pay restitution. This option requires offenders who are sent to diversion programs to pay restitution.
California Arts Council		
Limit state support to programs that leverage most private contributions.	9	Reduces state involvement to what is essentially a private function.
California Coastal Commission		
Increase permit application fees.	1	Fees have not kept pace with inflation. In 1977-78, fee revenues covered about 22 percent of coastal development regulatory programs. By 1991-92, fee revenues only accounted for 5 percent. Estimated savings assume raising fees to replace General Fund support.
Department of Food and Agriculture		
Share program funding for Medfly control and eradication with industry on a 50-50 basis.	9	Agricultural industry benefits from control and eradication efforts. (Federal government would continue to match the state-industry total.)
Share support of the various detection, control, and eradication programs (other than Medfly) with industry on a 50-50 basis.	14	Agricultural industry benefits from control and eradication efforts. (Federal government would continue to match the state-industry total.)

Continued

Proposal	Savings	Comments
Reduce General Fund support of animal pest and disease prevention and inspection efforts by 50 percent.	$8	Proposal would require industry to share in prevention and inspection costs to a greater degree.
Eliminate all General Fund support of the market news and marketing export programs.	2	Programs to enhance the marketability of private-sector goods should be the responsibility of the private sector rather than the general taxpayer.
Department of Forestry and Fire Protection		
Impose fees on property owners who benefit from fire protection services.	29	Property owners in State Responsibility Areas directly benefit from fire prevention and suppression activities provided by the state and should share in the costs of providing the services. A fee covering 10 percent of costs would generate about $29 million.
Provide service on a reimbursement basis for the department's nonfire emergency response activities.	Several million dollars	The department responds to about 180,000 nonfire emergency incidents per year. Obtaining full reimbursement from local governments or individuals would generate an unknown amount, but potentially millions of dollars annually.
Department of Parks and Recreation		
Sell/transfer beaches in Los Angeles County to private entities or local governments.	—	Los Angeles County is currently evaluating a proposal by the department to transfer ownership of eight state beaches to the county. The estimated net annual cost of operating the beaches is about $5 million. Savings would accrue to the state in future years from not being responsible for management of these beaches.
PERS		
Conform retirement and health benefits for CSU employees and retirees to those given other state employees, on prospective basis. Requires legislation.	1	Eventual annual savings of $30 million or more (GF), as newly hired CSU employees replace existing employees.

Continued

Proposal	Savings	Comments
Department of Pesticide Regulation		
Establish mill tax assessments at level which will eliminate General Fund support of the DPR's regulatory activities.	$12	Individuals who use or degrade a public resource should pay for the costs imposed by their use of the resources.
STRS		
End state subsidies of retirement benefits for teachers hired after 6/30/95. Requires legislation.	3	Retirement costs should be fully supported by school districts. Eventual annual savings exceeding *$450 million*, as newly hired teachers replace existing teachers.
Tax Relief		
Senior Citizens' Property Tax Assistance.	2	Property tax relief not needed after Proposition 13.
Senior Citizens' Renters' Tax Assistance.	14	Property tax relief not needed after Proposition 13.
Repeal Renters' Tax Credit.	—	Property tax-related relief not needed after Proposition 13. Produces major expenditure savings in future years (about $500 million annually).
Trade and Commerce		
Eliminate the following:	2	
• Office of California Mexico Affairs.		This program's functions could be absorbed by the Mexico trade office and export development program.
• Business Marketing Fund.		There are not measurable benefits to the state from the use of this fund.
• General Fund financing of Welcome Centers.		The authorizing legislation for this program specifies that the program would be self-supported by fees charged to the Welcome Centers.
• Office of Foreign Investment.		This program's functions could be absorbed by the agency's foreign trade offices and export development program.
Eliminate General Fund financing of Tourism Program.	7	This program, if needed, can be supported through fees assessed by the tourism industry.

Continued

Proposal	Savings	Comments
San Francisco Bay Conservation and Development Commission		
Increase permit application fees.	$2	Fees recover only a small percentage of the BCDC's permitting costs. Estimate of savings assumes raising fees to a sufficient level to replace proposed 1995-96 level of General Fund support.
State Water Resources Control Board		
Set fees to fully fund waste discharge permit program.	19	Require private individuals who use or degrade a public resource to pay for the costs imposed by their use of the resources. Fully funding the discharge permit program without General Fund support would require eliminating current $10,000 fee cap.
Establish annual permit fees for the diversion and storage of water sufficient to eliminate General Fund support.	7	Require private individuals who use or degrade a public resource to pay for the costs imposed by their use of the resources. Fully funding the discharge permit program without General Fund support would require eliminating current $10,000 fee cap.

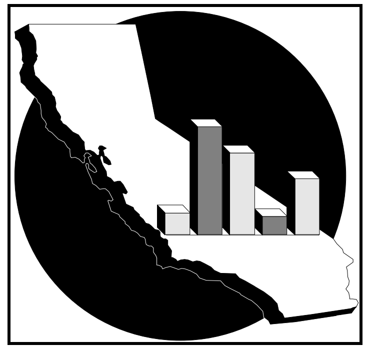
Continued

Proposal	Savings	Comments
Tax Expenditures		
Repeal use tax exemption for printed advertising materials.	$61	Enacted due to perceived competitive disadvantage for in-state printers; court decisions now allow application to printing by out-of-state printers.
Eliminate exclusion of capital gains at death.	530	The basis of an asset transferred to a relative at death is "stepped-up" to its market value. This option would require the use of the decedent's basis in the property.
Limit exclusion of unemployment insurance benefits.	98	Conformity to federal rules on taxation of unemployment insurance benefits.
Cap on mortgage interest deduction ($50,000 in annual interest)	65	Restricts deduction when home value is far in excess of the average.

However, if such increases were provided, this scenario does not leave any significant room to establish a reserve, create or expand programs, or restore programs (such as the renters' credit) without making offsetting savings elsewhere. Furthermore, as discussed above, this scenario presumes that all of the actions assumed in the Governor's budget proposal occur on a timely basis, including federal funding and law changes. These assumptions appear optimistic given the magnitude of the proposed changes.

Conclusion

Although the California economy is again experiencing moderate growth, and the budget is on firmer ground than previously, the long-term outlook indicates that funding the Governor's spending priorities and his tax cut proposal will require substantial and ongoing reductions elsewhere in the budget. The Governor has proposed major reductions in welfare and health programs that (in combination with his other budget solutions), could yield sufficient savings to finance his budget plan through the end of the decade. However, our projections indicate that the budget situation is likely to remain precarious throughout this period, even with the magnitude of savings proposed by the Governor. Consequently, our long-term projections suggest that the state would continue to face tight budgets under the Governor's proposals and that the budget would be highly vulnerable to the risks that we have identified and to contingencies that could generate costs or revenue losses.



PERSPECTIVES ON THE ECONOMY

The state's budgetary shortfalls in recent years have largely been due to the poor performance of the California economy. Employment declines, sluggish personal income growth, flat corporate profits, and a housing market collapse all resulted in very weak revenue performance during the early 1990s. This, combined with continued population growth and strong demand for state services, led to severe budgetary imbalances.

California's economy finally has "turned the corner" and is again expanding. It still has much ground to make up, however, before it regains its prerecession peak.

The key questions at this point are:

- To what extent will the national economy be slowing down in 1995 and 1996?
- How strong will California's continued expansion be in light of softer economic conditions nationally?

This part discusses the economic outlook for the nation and California in 1995 and 1996, including the reasonableness of the budget's economic assumptions.

1994 IN RETROSPECT

Figure 1 (see next page) summarizes national and state economic performance in 1994. The nation's overall economic performance was among the best in years:

- Output grew by 4 percent, the fastest rate in ten years.
- Inflation was well under 3 percent, the lowest in 30 years.
- Unemployment averaged 6.1 percent, nearly one percent below the average for the last 15 years.

Figure 1

Department of Finance Economic Outlook For California and the Nation 1994 Through 1996

	1994 Estimated	1995 Projected	1996 Projected
California Economic Indicators			
Percent change in:			
Personal income	4.2%	6.6%	6.0%
Wage and salary employment	1.3	1.8	2.5
Consumer Price Index	1.5	2.9	3.2
Unemployment rate (percent)	8.7	7.8	7.4
Residential building permits (thousands)	97	109	153
New car registrations (thousands)	1,347	1,359	1,414
National Economic Indicators			
Percent change in:			
Real Gross Domestic Product	3.9%	2.5%	2.2%
Personal income	5.9	5.8	4.7
Wage and salary employment	2.6	2.7	2.0
Consumer Price Index	2.7	3.5	3.6
Pre-tax corporate profits	12.9	5.5	4.5
Unemployment rate (percent)	6.1	6.0	6.3
Prime interest rate (percent)	7.1	9.3	8.6
Housing starts (thousands)	1,430	1,237	1,270
New car sales (thousands)	9,300	9,300	9,100

As the year ended, relatively rapid growth and low inflation were continuing. For example, in the year's final quarter the U.S. economy was growing at a 4.5 percent pace, inflation was barely over 2 percent, and unemployment was only 5.4 percent. Economic strength was broad-based, with good growth in both the consumption and investment sectors. Some signs were starting to appear (such as a decline in December retail sales) that the national economy might be slowing, however.

California's Economy Rebounds

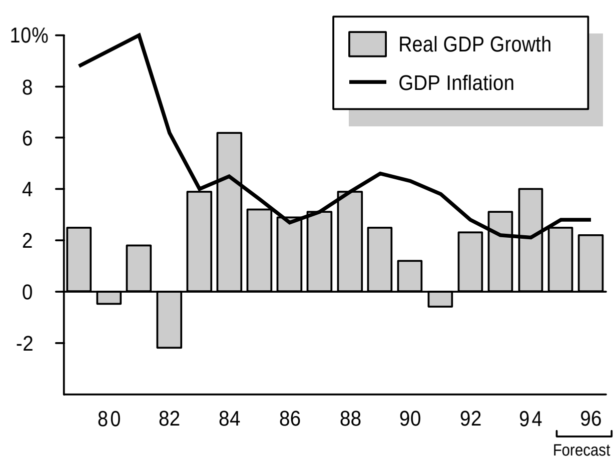
California's performance in 1994 continued to lag the nation's. However, its economy got stronger as the year progressed, and clearly was expanding at year end. Unemployment had dropped to 7.4 percent as 1995 began, the lowest level in four years. Personal income, employment, taxable sales and corporate profits all were rising.

THE NATIONAL OUTLOOK FOR 1995 AND 1996

Most economists are predicting that economic growth will continue in 1995 and 1996, although at a slower pace than 1994 and with a modest rise in inflation. Figure 1 (above) and Figure 2 indicate that the department shares this view. Continued gains in employment and corporate profits also are expected, along with rising interest rates, relatively stable unemployment and some softening in the housing market.

Figure 2

**Trends in Gross Domestic Product and Inflation
1979 Through 1996**



Can a "Soft Landing" Be Achieved?

The main concern that economists currently have is that the nation's economy is nearing the point of full capacity, at which time inflationary pressures might take hold. As a result, economists generally expect interest rates to rise further in 1995 and early 1996, because of both increased inflation and overt attempts by the Federal Reserve (FED) to slow down the economy through restrictive monetary policies. For example, during the past year the FED has increased the short-term interest rates it directly controls on seven occasions, including earlier this month. Interest rates, however, are generally anticipated to remain well below their 1980s levels. Figure 3 shows that the department again shares this expectation.

Figure 3

Trends in Interest Rates 1980 Through 1996

The main challenge and uncertainty in the national outlook is whether a "soft landing" can be achieved that balances continued moderate economic growth with modest inflation. Accomplishing soft landings has always been difficult. However, the task may be especially difficult to engineer today because of new uncertainties about the levels of unemployment and capacity utilization that can trigger significant inflationary pressures.

THE CALIFORNIA OUTLOOK FOR 1995 AND 1996

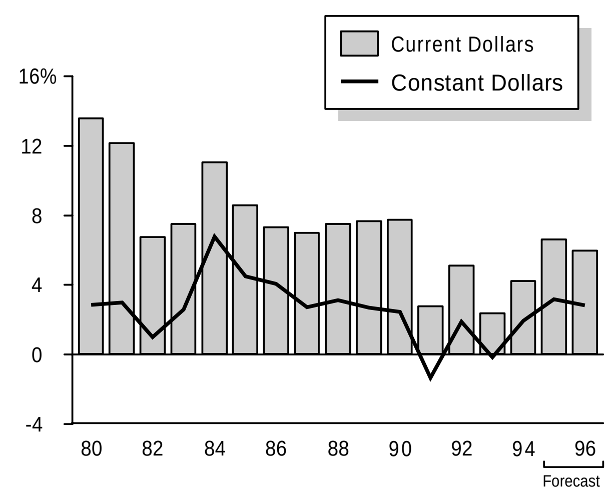
Economic performance during 1995 and 1996 will be the single most important determinant of state revenues during the remainder of 1994-95 and 1995-96. About 40 percent of 1994-95 revenues will depend on economic conditions during 1995, whereas about 60 percent of 1995-96 revenues will depend on conditions during 1995 and 40 percent on 1996 conditions.

Personal Income to Increase Moderately

No economic variable is more important in terms of overall economic performance and state revenues than personal income. Figure 4 shows how personal income has performed in recent years. During the 1980s, personal income growth averaged 8.3 percent in current dollars and 3.3 percent in real terms. During the recession (from 1991 through 1993), however, income growth was anemic, averaging only 3.4 percent in current dollars and 0.1 percent in real terms, including declines in both 1991 and 1993. Moderate increases then occurred in 1994, as the economy began to firm up.

Figure 4

Annual Percent Change in California Personal Income 1980 Through 1996



Growth To Be Below-Normal for a Recovery

It is common that strong snapbacks in income growth occur during post-recession economic recoveries. This occurred following the previous recession, when real income growth averaged 5 percent. This is unlikely to happen in California in 1995 or 1996, however, due to such factors as a slowing national economy, continued defense spending reductions, prospects of additional military base closures, ongoing industry restructurings, and a soft housing market. It is more realistic to expect less-than-average, modest real income growth for California and, because of low inflation, only moderate nominal income growth.

The department's personal income forecast is consistent with this view—nominal growth of 6.6 percent in 1995 (5.7 percent if the effects of the 1994 earthquake are excluded) and 6 percent in 1996, an average real growth of about 3 percent.

Real Per Capita Income to Increase Slightly

Real per capita income is a key indicator of economic well-being. It also is the principal determinant of consumer expenditures, which are responsible for about two-thirds of all spending, output demand and jobs in the economy. Thus, trends in real per capita income say much about the overall strength of the economy. Real per capita income growth depends on the relative rates of growth in total income and population.

Figure 5 shows that real per capita income growth was strong in the mid-1980s, grew little during the late 1980s, and declined for four years during the 1990s. This was due both to the recession and continued strong population growth. As Figure 6 indicates, population growth was especially strong during the late 1980s and very early 1990s, despite the weakening economy.

Income Growth Should Outweigh Population Growth. Real per capita income will increase in 1995 and 1996 as aggregate real income growth outstrips population growth. As Figure 6 indicates, population growth slowed sharply during the recession, partly because California's weak job market triggered increased outflows of job seekers to other states and reduced inflows from other states. As California's economy improves in 1995 and 1996, these trends should reverse and population growth will again pick up, although the increase should not be so great as to preclude some modest rise in real per capita income. Even after this improvement, however, 1996 real per capita income will still remain below its 1989 peak.

Figure 5

Annual Percent Change in California Real Per Capita Personal Income 1978 Through 1996

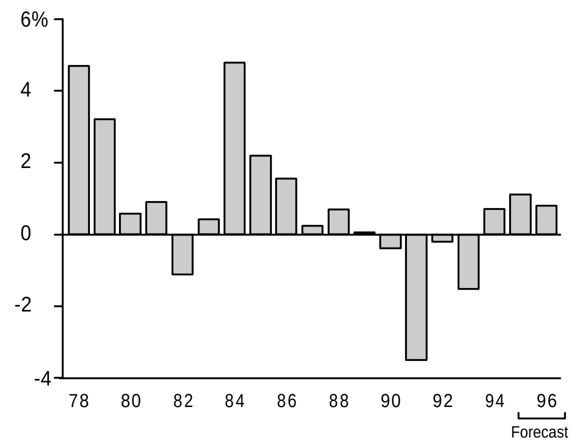
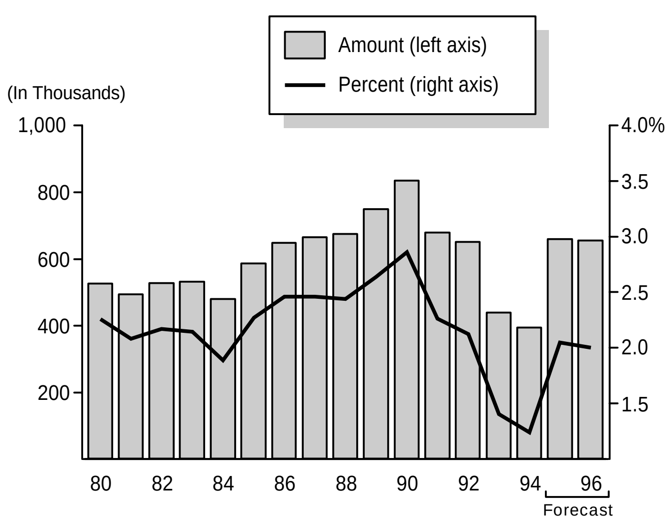


Figure 6

California Population Growth 1980 Through 1996



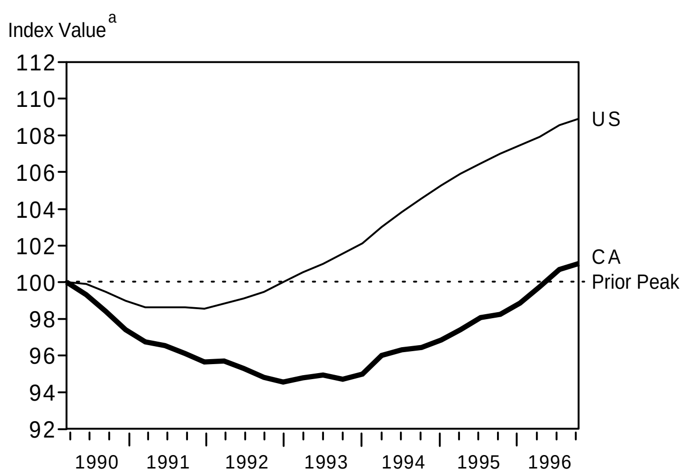
Employment—
A Lagged but Continued Recovery

Figure 7 shows that job losses during the recession were worse, and job recovery has been slower, for California than the nation:

- Employment in the U.S. hit a low in the first quarter of 1992, having experienced a 1.5 percent drop in jobs, and regained its pre-recession peak one year later.
- In contrast, California did not hit its low point until the first quarter of 1993, with job losses of nearly 700,000, or 5.4 percent. California is not expected to reach its pre-recession job peak until the latter-half of 1996.

Figure 7

California Employment Rising But Still Trailing Nation



[a] Nonfarm payroll employment indexed to 100 in second quarter of 1990.

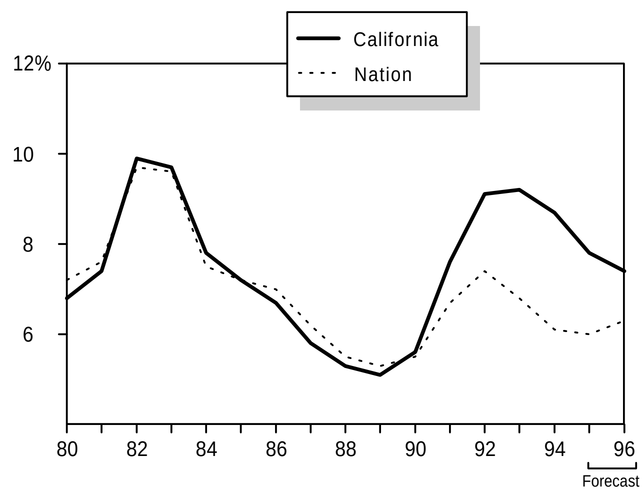
California's relatively weaker job performance in the 1990s contrasts with the 1970s and 1980s, when California consistently outperformed the nation.

Unemployment Gap To Remain

Unemployment rates further dramatize how badly California was hit in the recession. Figure 8 shows that the nation's and California's unemployment rates moved closely together throughout the 1980s. However, due to California's relatively larger job losses during the recession, California's rate rose much more and then declined later and by much less than the nation's. The state's rate currently is running about two percentage points above the nation's, and a gap of nearly one percentage point is expected to still remain at the end of 1996. Although the state's rate shot up to 8.2 percent in January from December's 7.7 percent, most economists attribute this to the heavy rains in January, and expect declines to resume over the coming months.

Figure 8

Trends in Unemployment Rates
1980 Through 1996



Over 500,000 New Jobs To Be Created

There are two different ways that economists measure employment performance. The first is the number of people employed, which is forecast to rise moderately by 2.8 percent in 1995 and 2.3 percent in 1996. These data come from a small survey.

The second measure is the number of jobs, which recognizes, among other things, that people can hold more than one job. Many economists prefer to use the jobs data, in part because they come from a large survey, and include information about the types of industries where people are employed, the hours they work and how much they are paid. Job growth is forecast to be 1.8 percent in 1995 and 2.5 percent in 1996. Figure 9 shows that this translates into 500,000 new jobs in 1995 and 1996 combined.

Figure 9

Changes in California Employment 1990 Through 1996

(In Thousands)

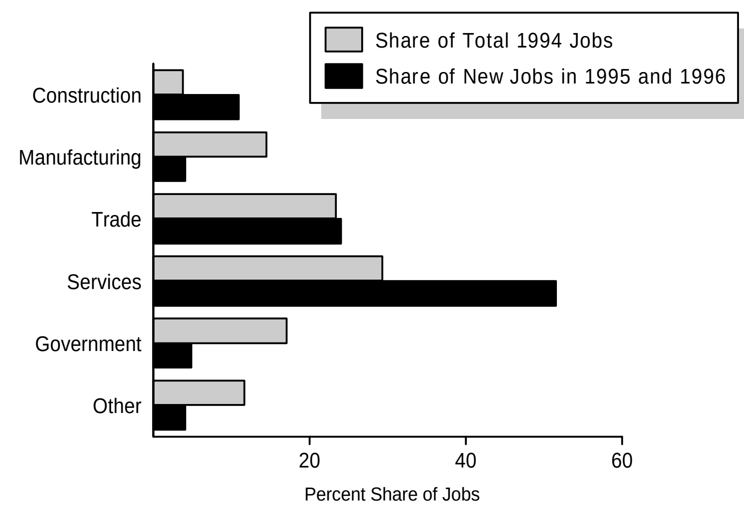
Where Will the New Jobs Be?

Figure 10 shows that job growth will be highly concentrated in services and trade, and to a lesser extent construction. In contrast, manufacturing, government, and the economy's other sectors (like finance, transportation and utilities) will experience relatively slow job growth. For instance, Figure 10 shows that:

- Four of five new jobs will be in services and trade. By comparison, these sectors accounted for only slightly over half of existing jobs in 1994.
- In contrast, manufacturing currently has 15 percent of jobs but will account for only 4 percent of new jobs, and the government sector's share of new jobs (5 percent) also will be significantly less than its current share (17 percent).

Figure 10

Compositon of Job Growth by Industry
1995 and 1996



The service sector's large share of new jobs is a continuation of recent trends. Over the past eight years, service jobs increased by over 3 percent yearly and accounted for nearly three-fourths of the economy's total 1.1 million job growth. This partly reflects California's importance as a center for financial services and high-tech activities that require highly trained service personnel.

Continued Declines in Aerospace

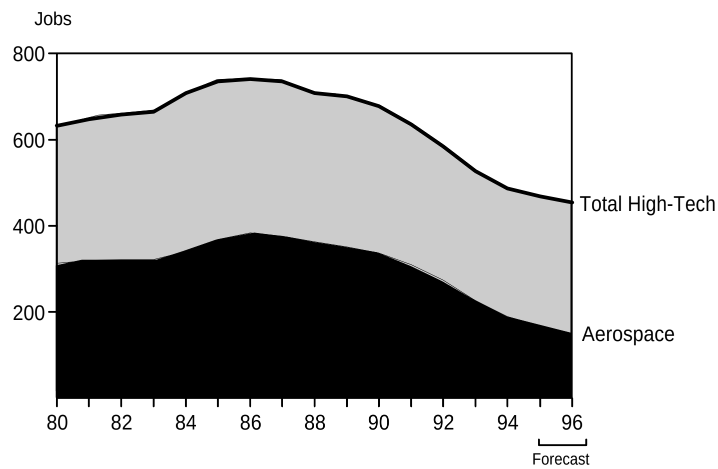
There are several reasons for the weak job growth expected in manufacturing, but one of the main factors involves the declines expected in high-tech jobs. High-tech jobs, which primarily involve electronics and aerospace, account for about one-fourth of all manufacturing jobs.

Figure 11 (see next page) shows that high-tech jobs fell by over one-third between 1986 and 1994, as more than half of the state's aerospace jobs were lost. Further aerospace declines are expected in 1995 and 1996, due to additional federal defense-related spending cuts.

Figure 11

California Employment in High-Tech Industries 1980 Through 1996

(In Thousands)



As Figure 12 shows, federal defense spending has fallen sharply since the mid-1980s, and now accounts for less than 6 percent of the state's gross product. Further declines can be expected.

Housing Market Remains Fragile

Although direct employment in the construction industry accounts for only about 4 percent of all California jobs, its impact on the economy is considerably greater. This is because it gives rise to economic activity in many other sectors of the economy, including equipment and building materials, manufacturing, services and trade.

Figure 13 shows that California's housing market was especially hard hit by the recession and has only recently begun to recover. By 1993, new building permits had plummeted by over 70 percent from their 1986 peak and per capita permits were the lowest in 25 years. Performance for multi-family housing has been especially anemic. In 1994, the housing market began firming up and experiencing a modest upturn,

Figure 12

Defense Spending As a Percent of Gross State Product 1967 Through 1996

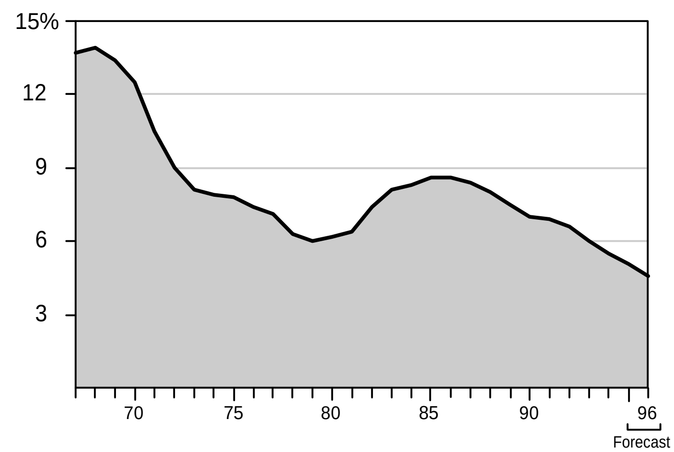
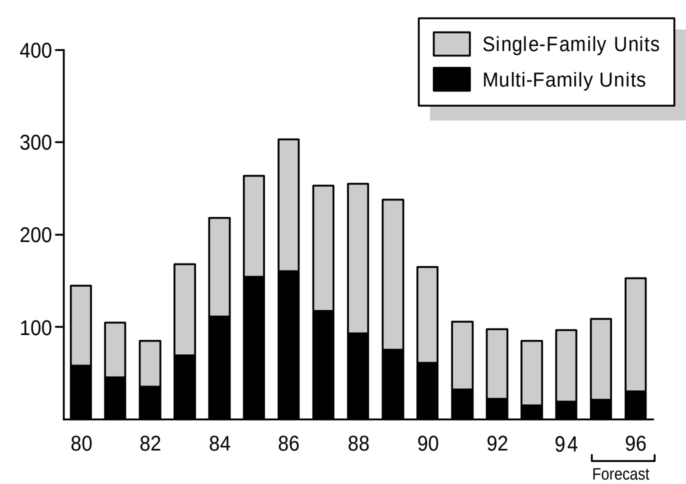


Figure 13

Housing Was Hard Hit by the Recession California Residential Building Permits

(In Thousands)



and additional gains are likely in 1995 and 1996. The market's strength will be constrained, however, by rising interest rates, the moderate overall pace of the economy, and above-average housing inventories.

Peso Brings Added Uncertainty

After the Governor's Budget was issued, the Mexican peso experienced a dramatic fall in value. President Clinton recently announced a $50 billion aid package for Mexico in an attempt to "shore up" the peso and stabilize its value, aimed at keeping Mexico from slipping into a serious recession. The aid package includes $20 billion in U.S. loans or loan guarantees to Mexico, and $18 billion of International Monetary Fund credit. Mexico also would get $12 billion in short-term credit from other nations.

Effects Will Be Negative

The peso's decline clearly will have negative implications for the U.S. economy, although economists currently are "across the board" in predicting their likely magnitude, ranging from minor to major.

The effects on California will be mixed, but on balance negative. On the positive side, Californians will enjoy lower prices for Mexican goods and services, and certain California firms with Mexican operations will experience improved profitability. On the other hand, demand by Mexico for California goods and services will decline, affecting California employment. The peso crisis offsets some of the gains to California from the tariff cuts under the North America Free Trade Agreement (NAFTA), at least temporarily. It will also exert some drag on Southern California's economy, especially cross-border retailing and tourism activities. Its ultimate impact, however, will depend on where the peso's value eventually stabilizes, what happens to foreign investment flows into Mexico, and whether California exports to other nations can backfill for reduced exports to Mexico.

IS THE BUDGET'S ECONOMIC FORECAST REASONABLE?

The department's basic expectation of continued though slowing national economic expansion with some increase in inflation and interest rates is shared by the vast majority of forecasters. In this sense, the department's national forecast is reasonable. The same can be said of its California forecast.

Stronger National Growth Possible

Although the budget's national forecast is reasonable, we share the current view of many economists that 1995 economic growth could be a bit stronger than assumed in the budget. The main reason involves the unexpectedly strong economic performance at the end of 1994 and the momentum that this brought going into 1995, as well as continued commitment by the FED to achieve sustained growth without triggering significantly higher inflation. It should be noted that the department's economic forecast on which the budget's revenue forecasts are based had to be prepared well before relatively complete data on 1994's economic performance was available.

Figure 14 (see next page) compares the department's outlook with the slightly stronger outlooks that we and the Blue Chip consensus have for such variables as real GDP growth, corporate profits and housing starts.

California Forecast—Reasonable Given Risks

The department's California economic forecast also is reasonable, especially in light of the many uncertainties surrounding the outlook noted above. As shown in Figure 14, both the LAO and consensus forecasts expect slightly slower 1995 and 1996 personal income growth than the department, partly due to favorable inflation trends. Our outlook for employment growth and housing permits is a bit more optimistic for 1995, however, given recent strength in the economy, but less optimistic for 1996, given interest rate trends and defense-related factors. As discussed in Part Three, our forecasts for taxable sales and California's taxable corporate profits also are a bit more optimistic than the department's. The forecasts shown are fundamentally similar, however, in that they expect continued moderate economic growth with modest inflation.

Other Very Different Scenarios Also Are Possible

Of course, should the “soft landing” predicted by most economists not be achieved at the national level, California's outlook could take a turn for the worse. As of January, economists seemed to feel that the soft-landing, although the most likely outcome, has about a 50-50 chance of occurring. There are three major alternative national economic scenarios that realistically could occur:

- ***A “Boom-Bust” Scenario.*** Here, the economy overheats in 1995 and this causes a recession, due to accelerating inflation and high interest rates. The odds of this are currently pegged at about 30 percent.

Figure 14

Comparative National and California Economic Forecasts[a]

	1995	1996
National		
Real GDP Growth		
DOF	2.5%	2.2%
LAO	3.0	2.3
Blue Chip	3.1	2.2
Consumer Price Inflation		
DOF	3.5	3.6
LAO	3.3	3.4
Blue Chip	3.2	3.6
Pre-Tax Profits		
DOF	5.5	4.5
LAO	7.0	4.2
Blue Chip	7.3	3.9
Unemployment Rate		
DOF	6.0	6.3
LAO	5.7	5.9
Blue Chip	5.5	5.7
Housing starts (in millions)		
DOF	1.24	1.27
LAO	1.34	1.40
Blue Chip	1.37	1.32
California		
Personal Income Growth		
DOF	6.6%	6.0%
LAO	6.5	5.7
Blue Chip	6.2	5.8
Employment Growth		
DOF	1.8	2.5
LAO	1.9	2.3
Blue Chip	1.8	2.0
Housing permits (in thousands)		
DOF	109	153
LAO	125	140
Blue Chip	121	146

[a] Blue Chip forecasts as of February 1995.

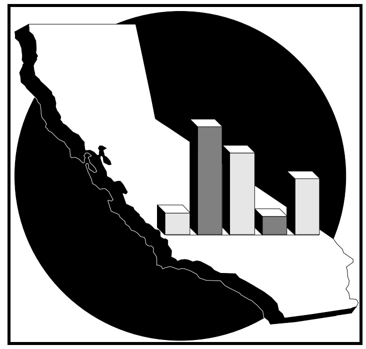
- ***A Cyclical Slowdown.*** This is where the economy slows and growth then simply fizzles out. Economists currently think the probability of this slow-growth outcome is about 10 percent.
- ***Continued Strong Growth Without Serious Inflation.*** This optimistic outcome is given the lowest odds—about 5 percent to 10 percent.

WHAT ABOUT THE LONG-TERM?

The long-term outlook for an economy as complex and diverse as California's depends on a great number of different types of individual factors. Some of the most important are demographic trends, labor force characteristics, rates of change in labor productivity, technological change, capital investments by businesses, the quantity and quality of different types of public infrastructure, the inflationary environment, perceptions about the state's "business climate," economic and political developments in foreign nations that are our main trading partners, and societal factors. Also important are federal fiscal policies, including tax policies and budget-related developments involving such areas as state and local grants and defense-related spending.

Generally speaking, the outlook for California over the longer run is positive. Growth will not be spectacular, but most economists believe that reasonably good performance is likely.

Looking beyond 1996 and the immediate economic cycle, it is most likely that California employment growth will average in the range of 2 percent to 3 percent, given underlying demographic trends. Assuming inflation in the 3 percent range, personal income growth would average in the range of 5 percent to 6 percent, with real income growth between 2 percent and 3 percent. Of course, actual performance in many individual years would lie outside these ranges, especially if a significant national slowdown or recession emerges within the next few years.



PERSPECTIVES ON STATE REVENUES

California state government revenues are generally divided into two broad categories: General Fund revenues and special fund revenues. General Fund revenues are used to support a wide variety of different types of expenditures, which compete with each other for funding amounts. In contrast, special fund revenues are usually earmarked for relatively specific purposes. Examples of special fund revenues include the portion of funds from cigarette and tobacco products taxes that are used to support certain health-related programs. Other examples are hunting and fishing permit fees, which are allocated to support outdoor recreation programs. However, by far the largest single category of special fund revenues involves motor vehicles and transportation.

Revenues Projected in the Budget. Figure 1 (see next page) provides a broad overview of the major revenue sources that support General Fund and special fund expenditures, as outlined in the *1995-96 Governor's Budget*. It shows that total state revenues in 1995-96 are projected in the budget to total $57.6 billion. This includes General Fund revenues of $42.5 billion and special fund revenues of $15.1 billion. These figures reflect several major initiatives by the Governor, including a realignment proposal and a tax proposal.

General Fund Share To Decline. General Fund revenues are expected to support nearly three-fourths of the proposed $56.6 billion total 1995-96 state spending plan. This is a slight decline from the share that General Fund revenues represented in both 1993-94 and 1994-95.

This shift toward special funds is a continuation of past trends, which reflect both differences in the rates at which General Fund and special fund revenues have been growing, and more importantly, past and proposed shifts of revenues from the General Fund to special fund accounts. Figure 2 shows that while total state revenues (excluding transfers) have been relatively flat in recent years, they have averaged about 6.6 percent growth over the last 12 years. However, the growth rate for special fund revenues has averaged over 11 percent, compared to 5.5 percent for General Fund revenues.

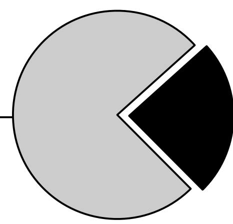
Figure 1

State Revenues in 1995-96[a]

(In Billions)

General Fund Revenues	
Personal Income Taxes	$19.5
Sales and Use Taxes	14.9
Bank and Corporation Taxes	4.8
All Other	3.3
Total	**$42.5**

Total State Revenues $57.6 Billion



Special Fund Revenues	
Motor Vehicle-Related Taxes	$7.5
Sales and Use Taxes[b]	4.1
Tobacco-Related Taxes	0.5
All Other	3.0
Total	**$15.1**

[a] Includes transfers. Detail may not add to totals due to rounding.

[b] Includes $1.6 billion to Local Revenue Fund, $0.7 billion to Children's Social Services Account (proposed), and $0.2 billion for transportation-related purposes. Also includes $1.6 billion allocated to Local Public Safety Fund which is not included in Governor's Budget totals.

OVERVIEW OF THE GENERAL FUND REVENUE FORECAST

Figure 3 shows that the bulk of General Fund revenues are raised from three sources. The largest of these is the personal income tax (PIT), which is proposed to generate 46 percent of General Fund revenues in 1995-96. The sales and use tax is the next largest source, accounting for 35 percent, while the bank and corporation tax (B&C) share is about 11 percent. Thus, these three largest taxes are projected to account for 92 percent of 1995-96 General Fund revenues.

Figure 4 (see page 46) summarizes the budget's forecasts for 1995-96 General Fund revenues by major source, along with actual 1993-94 and estimated 1994-95 revenues.

Figure 2

State Revenues Excluding Transfers 1983-84 Through 1994-95

(In Billions)

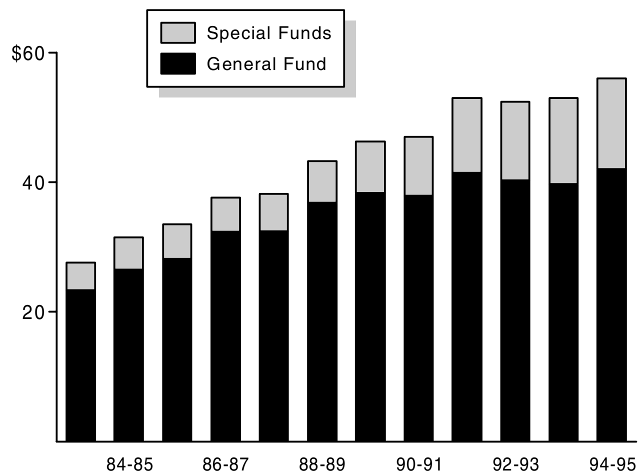


Figure 3

1995-96 General Fund Revenues by Source

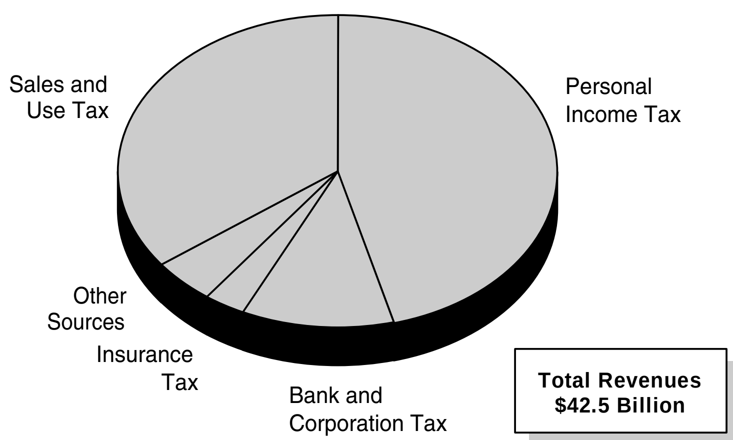


Figure 4

General Fund Revenues and Transfers[a] 1993-94 Through 1995-96

(Dollars in Millions)

Source of Revenue	Actual 1993-94	Estimated 1994-95	Proposed 1995-96	Change From 1994-95 to 1995-96 Amount	Percent
Taxes					
Personal income	$17,590	$18,485	$19,490	$1,005	5.4%
Sales and use	13,912	14,804	14,947	143	1.0
Bank and corporation	4,734	5,525	4,800	-725	-13.1
Insurance	1,197	967	1,252	285	29.5
Death-related	552	529	552	23	4.3
Alcoholic beverage	276	274	270	-4	-1.5
Cigarette	179	172	166	-5	-3.0
Horse racing	79	75	71	-4	-5.3
Subtotals, taxes	($38,520)	($40,831)	($41,548)	($718)	(1.8%)
Other Sources					
Interest on investments	$237	$270	$238	-$32	-11.7
Abandoned property	194	160	165	5	3.1
Trial court revenues	303	311	—	-311	—
Other revenues	350	410	367	-43	-10.5
Transfers and loans	492	371	219	-152	-41.0
Totals	**$40,095**	**$42,353**	**$42,538**	**$185**	**0.4%**

[a] Amounts for 1995-96 reflect Governor's tax and realignment proposals.

Little Revenue Growth Projected

The budget forecast for General Fund revenues shows basically no growth — an increase of only $185 million, or 0.4 percent, from 1994-95. The increase in tax revenues is 1.8 percent. Revenue growth is predicted to vary considerably by source, however. For example, PIT grows moderately (5.4 percent), sales and use taxes are basically flat (up 1 percent), B&C taxes fall (by 13 percent), and insurance taxes surge (by 30 percent).

As discussed below, the low growth in total revenues and disparate growth in individual revenue sources in large part reflects various special factors that distort their underlying rates of revenue growth. These include the Governor's budget proposals involving taxation and realignment, discussed below.

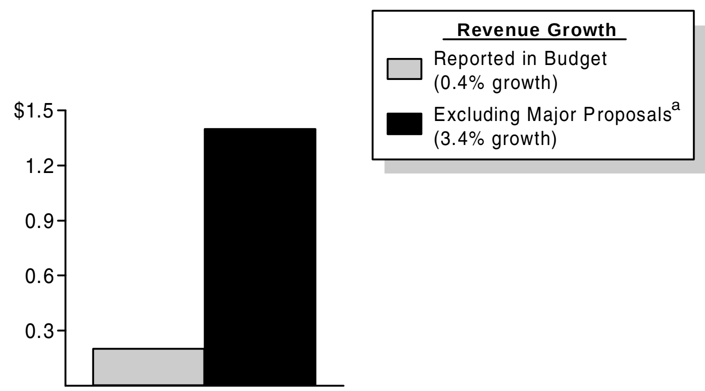
Modest Growth Adjusted for Major Budget Proposals

Figure 5 shows that, after the revenue effects of the Governor's taxation and realignment proposals are removed, General Fund revenue growth in 1995-96 is greater, but still modest—$1.4 billion, or about 3.4 percent.

Figure 5

Effect of Major General Fund Revenue Proposals On 1995-96 Revenue Growth

(In Billions)



[a] Major proposals include realignment and tax reduction.

After also adjusting for variety of other special factors, such as the phasing-in of past law changes, 1995-96 revenue growth turns out to be a bit higher—closer to the range of $2 billion, or nearly 5 percent.

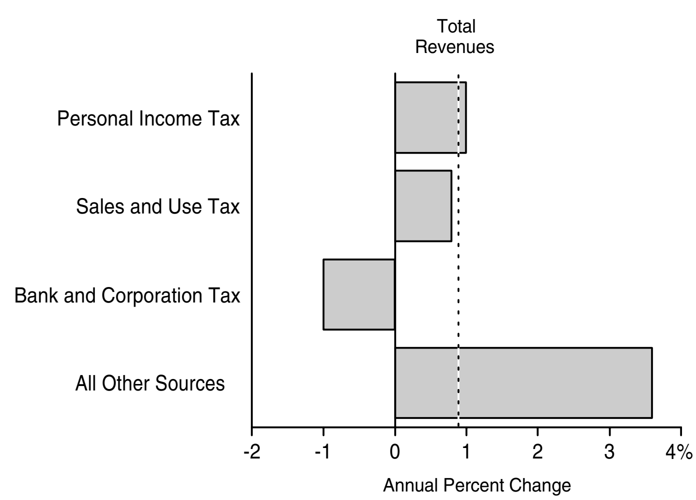
Growth for Individual Revenue Sources

The revenue growth rates of individual revenue sources generally vary considerably from one another, depending on the economic climate and year involved. One reason is that the pace of economic activity can vary from one year to the next, and individual revenue sources respond differently to these changes. Another is that the basic characteristics of different tax bases and tax rates differ from each other. For example, income taxes and sales taxes are *ad valorem* taxes, which apply percentage tax rates to dollar tax bases. These tend to fluctuate with the economy, because they capture the effects of both real economic growth and inflation. Certain others, in contrast, rely on *per unit* taxes, which levy certain dollar taxes per physical unit of the item being taxed. Alcohol, cigarette and fuel taxes are examples. These taxes tend to grow more slowly over time than ad valorem taxes, partly because they do not reflect inflation in their bases.

Figure 6 shows how revenue growth varied during the recession for major sources. Over the past five years, by far the greatest weakness was in bank and corporation taxes, reflecting the sluggish performance of corporate profits during the economic downturn.

Figure 6

Growth in General Fund Revenue Sources 1989-90 Through 1993-94



Growth Adjusted for Special Factors. The wide variations in 1995-96 revenue growth for individual sources noted above are considerably less significant when adjustments are made for special factors pertaining to them. For example:

- PIT growth rises from 5.4 percent to 6 percent after adjusting for the Governor's tax proposal.
- Sales and use tax growth increases from 1 percent to 5.8 percent after adjusting for the Governor's realignment proposal.
- The large drop in bank and corporation taxes disappears altogether after accounting for the tax proposal, the phasing-in of past law changes, and revenue effects of court cases.

- Insurance tax growth drops from 30 percent to about 9 percent after adjusting for one-time refund effects.

The Governor's Tax and Realignment Proposals

The Tax Proposal. The Governor is proposing a 15 percent reduction in both PIT and B&C tax rates. These reductions are to be phased-in over a three-year period beginning with the 1996 income year — 5 percent each in 1996, 1997 and 1998. In conjunction with these rate reductions, the Governor is proposing to continue the 10 percent and 11 percent high-income PIT rates that were put in place in 1991 and are scheduled to expire after 1995.

The budget projects that the tax proposal will reduce 1995-96 revenues by $225 million, including $105 million for PIT and $120 million for B&C. From 1995-96 through 1998-99, the budget projects the proposal will reduce revenues by a cumulative total of $7.6 billion, including $3.6 billion in 1998-99 when it would be fully phased in. A recent analysis by the Franchise Tax Board (FTB) estimates the cumulative four-year revenue reduction at $7.1 billion.

The Realignment Proposal. As it relates to revenues, the realignment proposal has two parts. First, it would shift .2215 cents of the state sales tax to localities. In 1995-96, this would amount to $710 million. Second, the proposal would return trial court fines and forfeiture revenues to localities. In 1995-96, this would amount to $311 million. Thus, the realignment proposal would reduce General Fund revenues by about $1 billion in 1995-96, and increasing amounts thereafter.

Taken together, the Governor's tax and realignment proposals would reduce 1995-96 General Fund revenues by $1.2 billion. These proposals are both discussed in greater detail in Part Five of this volume.

INDIVIDUAL GENERAL FUND REVENUE FORECASTS

Below we discuss the budget forecasts for the state's individual taxes, including some general background information on each tax and the assumptions on which the budget projections are based. The overall reasonableness of the forecast and how it compares with our forecast is discussed at the end of the section.

The Forecast for Personal Income Taxes

Background

As shown earlier in Figure 3, the personal income tax accounts for the largest share of state General Fund revenues. The PIT's structure has a series of marginal tax brackets for each of several categories of taxpayers, including single taxpayers and married couples who file jointly. As one moves to higher income levels, the rates which apply to the income of each successive bracket rise. These marginal rates currently range from 1 percent to 11 percent. Thus, the PIT has what is known as a *progressive* graduated marginal rate structure.

The PIT tax base generally conforms to federal law and includes various income exclusions, exemptions, deductions, and credits. An Alternative Minimum Tax (AMT) is levied, which assesses a special tax when taxpayers have unusually large amounts of tax deductions, exclusions and exemptions. The PIT AMT tax rate currently is 8.5 percent, and is scheduled to return to 7 percent after 1995. In addition, income brackets and other key elements are indexed for inflation so that taxpayers' real income generally must rise before their real tax liabilities rise.

The effect of the progressive PIT structure is that higher-income taxpayers generally pay a higher proportion of their income in taxes than do lower-income taxpayers. This is illustrated by the fact that, in 1992 (the most recent data available), the top 10 percent of taxpayers paid nearly 60 percent of all liabilities, and the top 1 percent paid nearly 30 percent of all liabilities, considerably more than their share of taxable income. In contrast, the 50 percent of taxpayers with the lowest incomes paid only 1.3 percent of all liabilities.

Sources of PIT Liabilities by Income Type Figure 7 shows that about two-thirds of PIT liabilities are attributable to wages and salaries paid to individuals. The next largest share is from business-related income, including partnerships and sole proprietors—12 percent. The remaining 20 percent is from interest, dividends, capital gains and other sources.

Moderate Growth Expected

PIT revenues began experiencing abnormally weak growth in 1989-90 and actually declined in 1990-91, due to the recession. Relatively weak PIT growth persisted throughout the remainder of the recession, especially after removing the effects of legislation adopted to enhance revenues. Due to the strengthening economy, however, moderate PIT revenue growth now has returned and is expected in both the current and budget years.

Figure 7

Personal Income Tax Liabilities By Source of Income, 1992

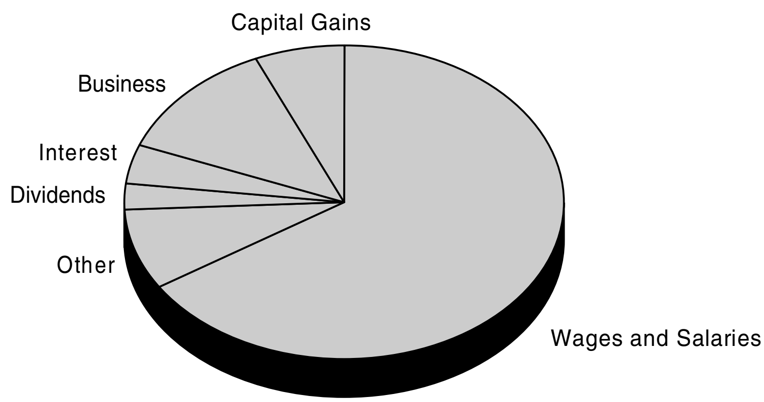


Figure 4 shows that PIT revenues are projected to reach $19.5 billion in the budget year, an increase of $1 billion, or 5.4 percent. Current-year revenues are projected to be $18.5 billion, an increase over the prior year of $895 million, or 5.1 percent. After adjusting for the Governor's tax proposal, the budget year increase is about 6 percent. These moderate growth rates are roughly in line with underlying trends in projected personal income growth, the main determinant of both taxable income and PIT tax liabilities.

Because wages and salaries account for the largest share of PIT liabilities, overall PIT liability growth depends in large part on growth in wages and salaries. Figure 8 (see next page) shows that taxable income is expected to rise by 6.1 percent in both 1995 and 1996. This primarily reflects growth in wages and salaries, which are predicted to rise moderately—by 5.3 percent in 1995 and 6.3 percent in 1996.

Timing Shift in Capital Gains

Figure 8 also shows expected growth for the other main sources of taxable income. The principal reason why taxable income growth is predicted to exceed wage and salary growth in 1995 involves a sharp upturn from 1994 in capital gains realizations (that is, profits from the sale of capital assets). Although Figure 7 indicates that capital gains accounted for only about 7 percent of PIT liabilities in 1992, capital gains realizations tend to experience considerable volatility that can significantly influence year-to-year changes in PIT liabilities. For example, capital gains realizations rose by 24 percent in 1988 and 5 percent in 1989, then fell by over 20 percent in both 1990 and 1991. Given this volatility, capital gains are one of the hardest components of taxable income to predict.

Figure 8

Percent Changes in Components of Taxable Personal Income 1993 Through 1996

Income Component	1993	1994	1995	1996
Wages	0.5%	4.2%	5.3%	6.3%
Dividends	11.1	7.0	11.7	11.6
Interest	-10.8	3.1	6.2	0.1
Business Income	5.4	5.3	6.2	6.9
Capital Gains	6.0	-5.0	14.2	4.9
Totals	**0.8%**	**4.0%**	**6.1%**	**6.1%**

Capital gains realizations since the late 1980s are shown in Figure 9. It indicates that the budget predicts capital gains to be $18.6 billion in 1994 (down 5 percent), $22.3 billion in 1995 (up 14.2 percent), and $24.5 billion in 1996 (up 4.9 percent). Figure 9 also indicates, however, that an estimated $980 million of the 1995 amount is assumed to have been shifted out of 1994, as taxpayers delayed realizing some of their gains in expectation of a federal tax cut in 1995. Exactly what the shift will turn out to be is unknown at this time, but the department's allowance for some shift makes sense.

Without this shift, capital gains would be flat in 1994, up a modest 3.5 percent in 1995, and up 10 percent in 1996. The shift has the effect of reducing current-year revenues by around $100 million, and increasing 1995-96 revenues by an equivalent amount.

The Forecast for Sales and Use Taxes

Background

The sales and use tax is imposed primarily on retail sales of tangible goods, but generally not services, to consumers in the state. It also generally applies to goods purchased by businesses to the extent that they are not intended for resale (such as machinery used in the production process). Somewhat over one-third of all taxable sales fall into this latter category. The "use" tax is imposed on products bought from out-of-state firms by California individuals and businesses for use in the state. Such purchases generally are difficult to monitor, and an increasingly large portion of purchases by individuals appear to be escaping taxation due to the state's inability to require out-of-state "mail order" businesses to collect this tax.

Figure 9

California Profits From Sales of Capital Assets 1988 Through 1996

(In Billions)

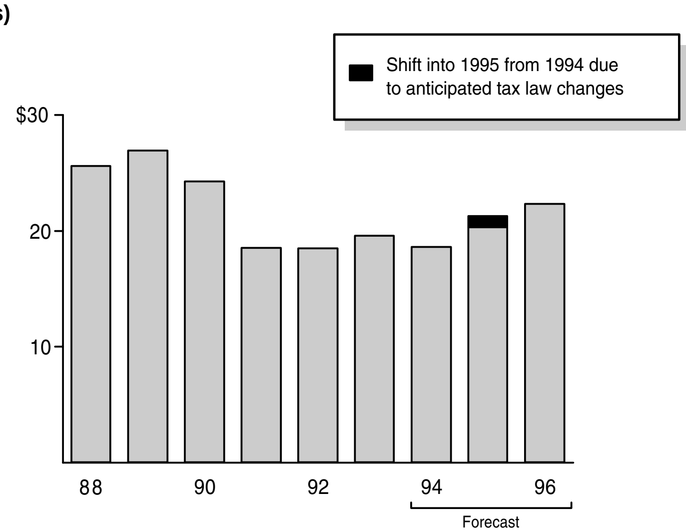


Figure 10 (see next page) shows that the overall sales and use tax rate actually consists of a number of different individual rates of tax, reflecting the different purposes for which the sales and use tax is levied. As the figure shows, both the state and local governments levy multiple rates of tax. Figure 10 also indicates how the Governor's realignment proposal will affect these rates.

Statewide State Rates. Under current law, the basic state sales tax rate is 6 percent, of which the state General Fund portion is 5 percent. In addition, the state levies two 0.5 percent sales taxes: one to fund health and welfare program costs associated with the 1991 program realignment legislation, and one dedicated to local public safety programs. The local public safety monies do not appear in the budget totals, and are directly given to localities. The Governor's 1995 realignment proposal includes shifting .2215 cents of the state sales tax from the General Fund to localities to pay for children's social services.

Figure 10

Sales and Use Tax Rates in California

	Current Law	Proposed
State		
General Fund	5.00%	4.78%
1991 program realignment (Local Revenue Fund)	0.50	0.50
Local Public Safety Fund[a]	0.50	0.50
1995 realignment proposal (Children's Social Services Account)	—	0.22
Totals, state	**(6.00%)**	**(6.00%)**
Local		
Uniform local taxes[b]	1.25%	1.25%
Optional local taxes[c]	1.50	1.50
Totals, local	**(2.75%)**	**(2.75%)**
Statewide maximum rate	**8.75%**	**8.75%**

[a] These revenues are not shown in the Governor's Budget totals for the budget year, current year or last half of 1993-94.

[b] Levied in all counties.

[c] Maximum allowable combined rate, except maximum combined rate is 1.75 percent in San Francisco and 2 percent in San Mateo.

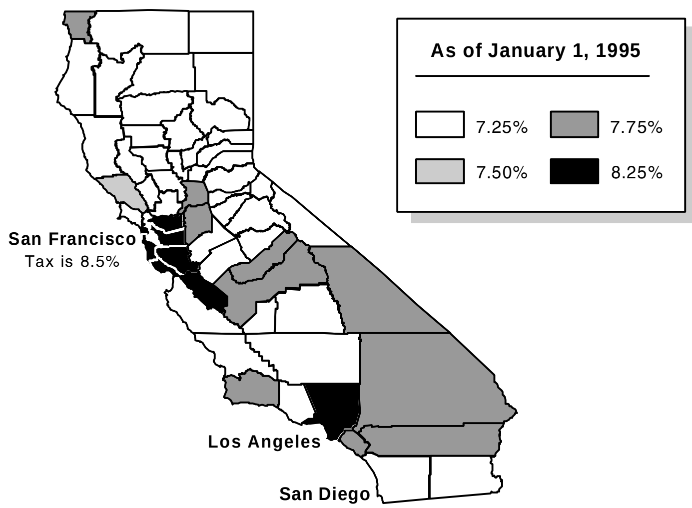
Statewide Local Rates. At the local level, a 1.25 percent rate is levied in all counties. Of this amount, revenue from the 0.25 percent portion of the rate is deposited in county transportation funds, while the 1.0 percent portion of the rate is allocated to city and county governments for general purposes. City governments receive the proceeds generated within their boundaries and counties receive the remainder.

Optional Local Rates. In addition to statewide sales taxes, many local governments—mostly on a county-wide basis—levy sales taxes for a variety of other purposes (primarily transportation). These taxes can be imposed at rates of either 0.25 percent or 0.5 percent, and generally cannot exceed an aggregate of 1.5 percent. In total, existing sales tax rates range from 7.25 percent in counties with no optional taxes, to 8.5 percent in the City and County of San Francisco. At this time, no county levies the maximum rate generally possible of 8.75 percent.

Figure 11 shows how the total sales and use tax rate varies in different counties in California.

Figure 11

Sales Tax Rate Variations By County



Moderate Underlying Budget-Year Growth

The budget projects that General Fund sales and use taxes will total $14.9 billion in the budget year (1 percent growth) and $14.8 billion in the current year (6.4 percent growth). After adjusting for the realignment proposal, however, budget-year growth is 5.8 percent.

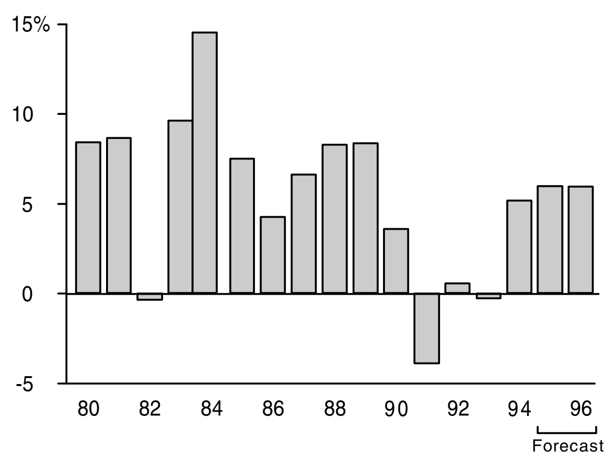
Aerospace-Related Refunds. The estimates for both the current and budget years assume that $60 million will be paid out in each year as refunds associated with direct overhead items purchased under U.S. government cost-reimbursement contracts. Based on a 1990 Supreme Court ruling, an estimated $325 million in state revenue, plus interest, will need to be refunded. The budget reflects the assumption that these refunds will be paid out over a 5-year period starting in 1993-94.

The Taxable Sales Outlook

The key to the outlook for sales and use tax revenues is the outlook for taxable sales. Figure 12 shows that taxable sales are anticipated to grow moderately by 6 percent in both 1995 and 1996, following a 5.2 percent gain in 1994. Taxable sales performed poorly during the recession, declining in both 1991 and 1993 and remaining essentially flat in 1992. In contrast, taxable sales grew at an average rate of over 7 percent during the 1980s. The taxable sales increases predicted for 1995 and 1996 are pretty much in line with personal income growth.

Figure 12

Percent Change in California Taxable Sales 1980 Through 1996



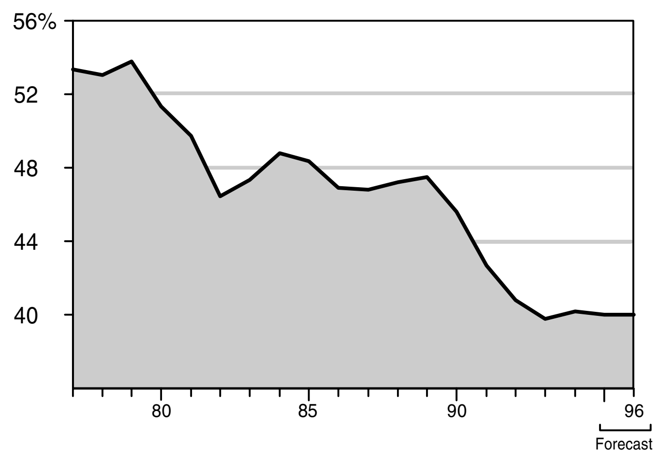
The strongest areas of growth in taxable sales are expected to be in construction-related categories like building materials and in motor vehicles. This is consistent with the increased spending on consumer durable goods and housing activity that typically accompany economic recoveries.

New Low for Taxable Sales Ratio. Figure 13 shows that, even with the moderate growth expected for taxable sales, their ratio to personal income will be at a near-record low of 40 percent in 1996. This ratio has generally followed a downward trend over the past 15-plus years. The ratio's decline is due largely to increased spending on services, which means that an increasingly large portion of sales transactions are not subject to taxation. This is especially so given the dominant role of the services sector in California's economy, and the fact that, according to a recent study by the

Federation of Tax Administrators, California taxes fewer services than most states.

Figure 13

Taxable Sales As a Percent of Personal Income 1977 Through 1996



The Forecast for Bank and Corporation Taxes

Background

Banks and corporations doing business in California are subject to a general tax rate of 9.3 percent measured against the portion of their net taxable income (profits) that are earned in California. Corporations that qualify for California Sub-Chapter S status are taxed at a 1.5 percent rate. Banks and other financial corporations pay an additional tax, currently set at 2 percent, which is in lieu of all other state and local taxes except those on real property, motor vehicles and business licenses. An $800 minimum tax applies to all taxpayers, and an Alternative Minimum Tax (AMT) similar to the federal AMT is imposed on taxpayers based primarily on the amount of their tax exemptions and deductions. The B&C AMT tax rate is 7 percent.

Taxpayers with multistate or multinational activities are subject to having their business income apportioned to California based on a formula which takes account of California's share of their sales, property and payroll. Multinational taxpayers, however, can elect to have only their U.S. (versus worldwide) income included in calculating their California taxable income.

Poor Revenue Performance in Recent Years

Bank and corporation (B&C) revenues have been weak for a number of years. For example, B&C revenues have declined in four of the past seven years. As a result, 1993-94 revenues were nearly 10 percent below their previous peak in 1988-89, five years earlier. In contrast, B&C revenue growth averaged eight percent annually during the 1980s.

Several factors explain this poor recent performance. The most important was the national recession, which both directly and indirectly hurt the profitability of many corporations doing business in California. The rapid growth in net operating loss (NOL) deductions and corporate conversions to Sub-Chapter S status also were key factors. For example, NOL deductions and Sub-Chapter S provisions reduced 1993-94 revenues by an estimated $300 million and over $490 million, respectively.

Revenues Finally Turning Up

The budget forecasts that B&C revenues finally will be experiencing good growth in the current year. It predicts revenues of $5.5 billion in the current year, an increase of 17 percent. Budget-year revenues are forecast to drop to $4.8 billion, a decline of 13 percent. However, the large current-year growth and budget-year reduction are both overstated, due to special factors. After adjusting for these special factors, current-year revenue growth is in the range of 14 percent and budget-year revenues are up slightly.

Special Factors Distort Revenue Trend

The most important factors responsible for distorting the B&C revenue trend are the following:

- California is receiving additional revenues in both the current and budget years due to the favorable resolution of litigation involving "unitary" tax disputes. The budget-year gain, however, is much less than the current-year gain — $100 million versus $410 million.
- The phasing-in of the investment tax credit legislation enacted in 1993 reduces budget-year revenues by an estimated $366 million, compared to a current-year reduction of $116 million.
- The Governor's tax proposal reduces budget-year revenues by an estimated $120 million.
- The combined revenue loss from NOLs and Sub-Chapter S corporation status increases dramatically in the current year, from about

$790 million in 1993-94 to $1.1 billion in 1994-95. In the budget year, the loss is about the same—$1.2 billion.

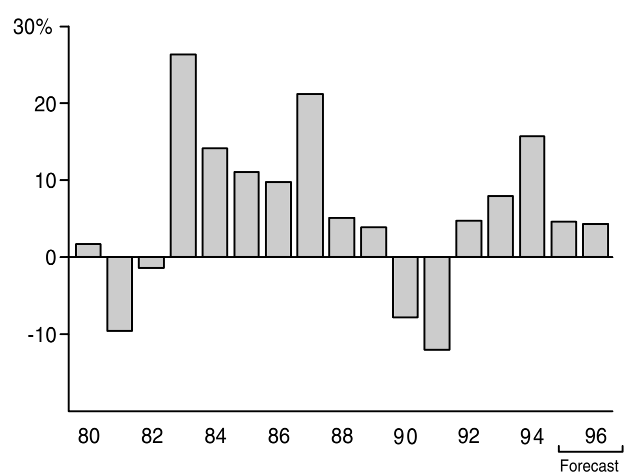
- The budget assumes that cash receipts from B&C liabilities in 1996 will be somewhat skewed toward the latter half of the year, reflecting prepayment pattern assumptions.

Taxable Corporate Profits—Strong 1994 Growth

The key to the B&C revenue forecast is the projection of taxable California corporate profits. Figure 14 shows that profits are estimated to have risen by 16 percent in 1994. Although 1994 has already ended, this figure is necessarily a rough estimate because it will be nine months before many of the corporate tax returns for 1994 are even filed, given the common corporate practice of filing for extensions. Figure 14 also indicates that modest profit growth of 5 percent in 1995 and 4 percent in 1996 is forecast. Despite this growth, the post-recession recovery of profits is considerably weaker than what occurred after the 1980s recession.

Figure 14

Percent Change in California Taxable Corporate Profits 1980 Through 1996

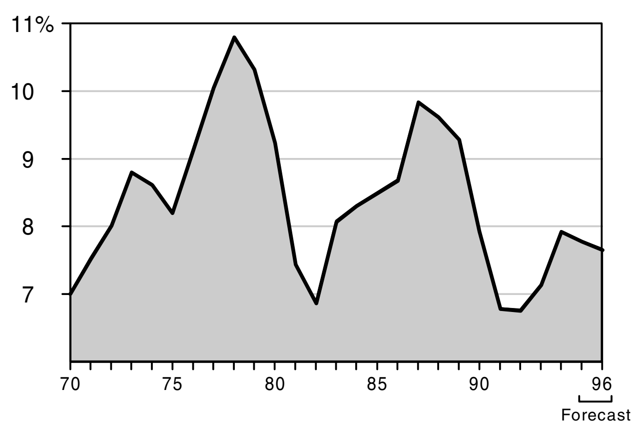


Continued Below-Normal Corporate Profits Ratio

The ratio of corporate profits to personal income is one indicator of how strong the corporate tax base is relative to the overall economy. This ratio is cyclical, given the inherent volatility of corporate profits, declining when the economy weakens and rising when the economy strengthens. Figure 15 shows that the ratio hit an all-time low in 1992. The ratio is estimated to increase moderately for 1994. However, it is predicted to decline again slightly in 1995 and 1996, leaving it well below the post-recession recovery years of the 1980s. Thus, although corporate profits are again growing, from an historical perspective only a relatively limited snapback is projected.

Figure 15

Taxable California Corporate Profits As a Percent of Personal Income 1970 Through 1996



Limited Liability Companies Now Allowed

The budget includes revenue increases of $17 million in the current year and $5 million in the budget year associated with the enactment of 1994 legislation allowing for limited liability companies (LLCs) in California. In addition, a budget-year reduction of $5 million is included for the impact of various Trade and Commerce Agency initiatives with respect to enterprise zones and program areas. The forecast also includes a variety of other adjustments relating to 1994 enacted legislation.

The Forecast for Other Revenues

As shown in Figure 4, most of the remaining 8 percent of General Fund revenues after accounting for the "Big 3" taxes are raised from insurance taxes, death-related taxes, and taxes on cigarettes, horseracing and alcohol. These smaller taxes account for around 5 percent of all General Fund revenues. The remaining 3 percent comes from interest income, abandoned property, and a wide variety of relatively small sources, including fees.

Modest Growth for Insurance Taxes

Insurance taxes are the fourth largest General Fund revenue source. They are predicted to experience a drop of 19 percent in the current year and a gain of 30 percent in the budget year. However, the underlying revenue growth trend is modest, after adjusting for some large tax refunds anticipated to be paid out later this fiscal year.

Decline in Worker's Compensation Premiums. Insurance tax revenues depend on taxable insurance premiums. Figure 16 shows premium amounts for 1993 through 1996 for major categories of insurance. It indicates that, over this entire four-year period, total premium growth is only 5.3 percent. However, the performance for individual lines of insurance varies greatly. For example, estimated growth in life insurance premiums is over 26 percent. In contrast, workers' compensation premiums show a large decline—over 18 percent. This reflects the effects of workers' compensation reform, which became effective in July 1993.

Figure 16

California Insurance Premiums 1993 Through 1996

(Dollars in Billions)

Category	Premium Amounts 1993	1994	1995	1996	Total Change 1993-1996
Life, including annuities	$11.9	$12.8	$13.9	$15.1	26.1%
General disability	6.7	6.2	6.2	6.3	-6.1
Workers' compensation	9.0	8.2	7.8	7.4	-18.4
Auto, including liability	11.5	11.7	12.2	12.8	11.1
Other liability	2.2	2.0	2.1	2.1	-1.3
Other, including casualty	11.1	11.0	11.2	11.6	4.6

Category	Premium Amounts 1993	1994	1995	1996	Total Change 1993-1996
Total premiums	$52.4	$51.8	$53.3	$55.2	5.3%

Modest Growth in Total Premiums. The budget forecast of premiums is based on a large survey of insurance companies doing business in California. Premiums are predicted to rise by 3 percent in 1995 and 4 percent in 1996. The strongest growth is expected for life insurance premiums—9 percent in each year.

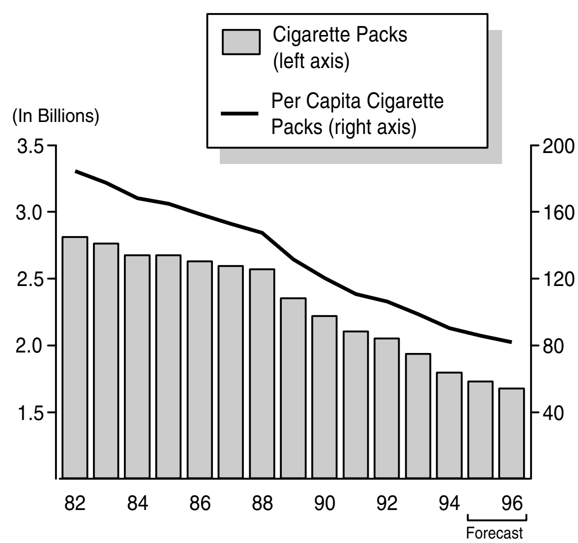
Continued Declines in Excise Taxes

Revenues are predicted to decline in both the current and budget years for excise taxes on alcoholic beverages, cigarettes and horseracing wagering. This is a continuation of past trends, reflecting declining per capita consumption of these items and activities.

Figure 17 shows, for example, that per capita consumption of cigarettes is projected to reach an all-time low of 82 packs in 1996, down from 185 packs as recently as 1982. This dramatic decline reflects both societal attitudes about smoking and the effects of increased cigarette prices due to the increased taxes imposed on tobacco under Proposition 99. Because per capita declines have exceeded population growth, total cigarette consumption has fallen continuously. The same general trend also holds true for alcohol consumption and horseracing wagering.

Figure 17

Trends in Cigarette Consumption 1982 Through 1996



IS THE BUDGET'S REVENUE FORECAST REASONABLE?

Like its economic forecast, the budget's General Fund revenue forecast is reasonable. The moderate revenue growth that it assumes is generally consistent with its forecast for a "soft landing," with continued moderate economic recovery and modest inflation. Our own estimate also is for moderate revenue growth. However, based on our own economic assumptions and revenue-estimating models, we project a bit more revenues than the budget does.

Figure 18 shows that our estimate is $170 million more in the current year and $425 million more in the budget year than the department's forecast, or $595 million for the two years combined. Compared to the budget, our forecast reflects somewhat higher ratios of taxable sales and corporate profits to income, and somewhat greater sensitivity of the PIT tax structure to personal income growth.

Figure 18

Difference Between LAO and DOF Revenue Forecasts

(In Millions)

	LAO Minus DOF Forecasts		
Source	**1994-95**	**1995-96**	**Two-Year Total**
Personal Income Tax	$40	$75	$115
Bank and Corporation Tax	55	180	235
Sales and Use Tax	75	170	245
Total, "Big 3" Taxes	**$170**	**$425**	**$595**

It should be noted, however, that the difference between our revenue forecast and the budget forecast is not as great as the revenue change that would occur if either a boom-bust economic scenario, significant economic slowdown, or extremely strong sustained economic expansion were to take place. As discussed in Part Two, many economists think the odds are only about 50-50 that a "soft landing," such as that assumed both by us and the department, will occur.

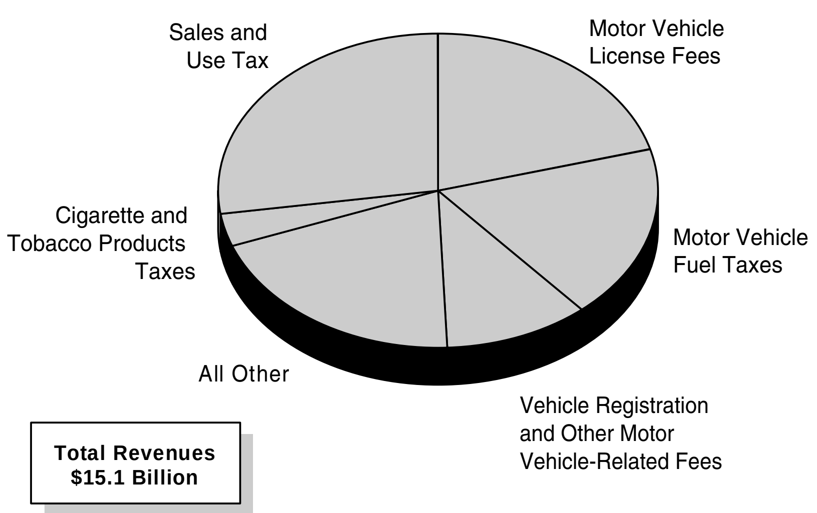
THE BUDGET FORECAST FOR SPECIAL FUND REVENUES

Special fund revenues support a variety of specific state and local government programs. These range from transportation-related activities to health services.

Figure 19 indicates that motor vehicle-related revenues account for nearly 50 percent of projected 1995-96 special fund revenues. These include motor vehicle license fees (21 percent), fuel taxes (18 percent), and vehicle registration and related fees (11 percent). Other major sources of special fund revenues include sales and use taxes (27 percent) and tobacco-related revenues (3 percent). Figure 20 shows the dollar amounts and growth rates for special fund revenues by type, projected for the current and budget years and compared to actual revenues for 1993-94. The amounts we show include Local Public Safety Fund revenues, which do not appear in the Governor's Budget totals.

Figure 19

1995-96 Special Fund Revenues by Source



Modest Underlying Revenue Growth Expected

Total 1995-96 special fund revenues are predicted to reach $15.1 billion, an increase of 10 percent over 1994-95. In contrast, budget-year revenues are projected to increase by 5.9 percent compared to the prior year. These year-to-year growth patterns are distorted by various special factors. For example:

- The Governor's realignment proposal increases budget-year sales and use tax revenues by $710 million.
- Transfers and loans show declines in both 1994-95 and 1995-96.

After removing the effects of these factors, underlying special fund revenue growth is about 5 percent in 1994-95 and 4 percent in 1995-96.

Figure 20

Special Fund Revenues and Transfers[a] 1993-94 Through 1995-96

(In Millions)

Source of Revenue	Actual 1993-94	Estimated 1994-95	Proposed 1995-96	Change From 1994-95 to 1995-96 Amount	Percent
Motor Vehicle Revenues					
License fees (in lieu)	$2,977	$3,050	$3,104	$54	1.8%
Fuel taxes	2,526	2,700	2,734	35	1.3
Registration, weight, and miscellaneous fees	1,496	1,564	1,623	59	3.7
Subtotals	($6,999)	($7,314)	($7,461)	($147)	(2.0%)
Other Sources					
Sales and use taxes[b]	$2,978	$3,191	$4,091	$900	28.2%
Cigarette and tobacco taxes	486	482	468	-15	-3.0
Interest on investments	68	66	65	-1	-1.4
Other revenues[c]	2,850	2,957	3,183	226	7.6
Transfers and loans	-408	-266	-157	110	-41.2
Totals	**$12,973**	**$13,744**	**$15,111**	**$1,367**	**9.9%**

[a] Amounts for 1995-96 reflect Governor's realignment proposal.

[b] Includes Local Public Safety Fund revenues of $1.4 billion for 1993-94, $1.5 billion for 1994-95, and $1.6 billion for 1995-96. The Governor's Budget totals include only $0.7 billion for 1993-94.

[c] 1995-96 increase includes $147 million from proceeds of tax and revenue anticipation notes.

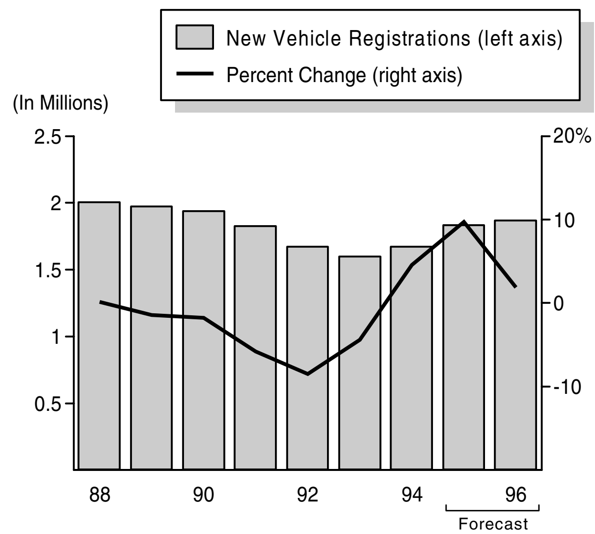
Motor Vehicle Fee Revenues Up Modestly

Motor vehicle license fee revenues are projected to rise by about 2 percent in both 1994-95 and 1995-96. Registration fee revenues are expected to rise somewhat faster—about 4 percent. The registration fee increase results from changes in new and existing vehicle registrations.

Figure 21 shows that beginning in 1989, new vehicle registrations declined for five straight years before rising by 5 percent in 1994. Further increases of 10 percent in 1995 and 2 percent in 1996 are projected. Even with these increases, new registrations will lie about 7 percent below their pre-recession peak in 1988.

Figure 21

Trends in New Vehicle Registrations 1988 Through 1996



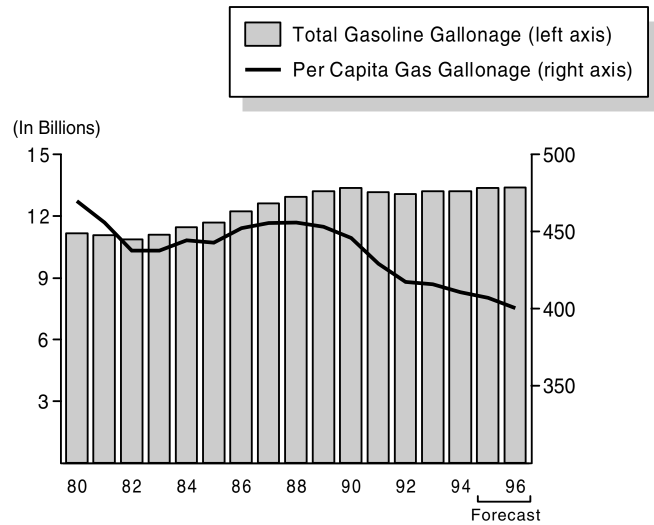
Fuel Taxes Reflect Declining Per Capita Gallonage

Fuel taxes are projected to increase by 1.3 percent in the budget year, to over $2.7 billion. This is considerably less than the 7 percent increase projected for the current year. However, the high current-year growth is due to it being the first full-year effect of the final year of tax increase provided for under Proposition 111 (November 1990).

The low growth in fuel tax revenues is largely because total gasoline consumption is basically stable, having been flat over the past five years (as shown in Figure 22). This reflects declining per capita fuel use due to increased fuel economy and conservation efforts. This has been sufficient to offset growth in aggregate fuel demand from such factors as population growth.

Figure 22

Trends in California Gasoline Distributions 1980 Through 1996



Tobacco-Related Revenues to Decline

Figure 23 (see next page) shows the share of tobacco-related tax revenues going to special funds. In 1995-96, special funds will receive an estimated 74 percent of these revenues, with 69 percent being distributed in accordance with Proposition 99 and 5 percent going to the Breast Cancer Fund. The remaining 26 percent of total revenue goes to the General Fund.

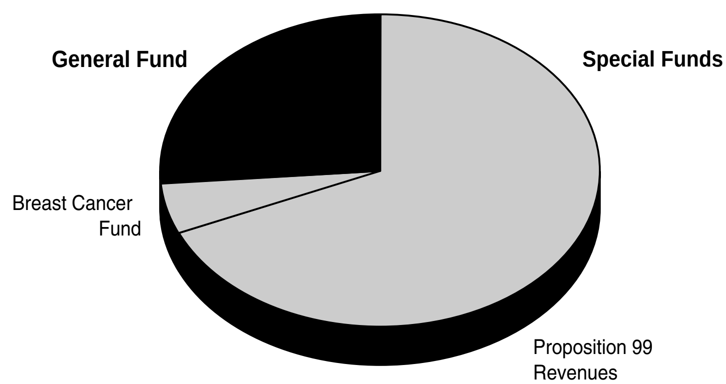
As is true for General Fund cigarette tax revenues, special fund tobacco-related tax revenues are projected to decline modestly in both the current and budget years. In 1995-96, they are projected to be $468 million, down from $482 million in 1994-95. As discussed previously, this drop reflects declining per capita consumption of tobacco products, due to both societal attitudes and price hikes attributable to past tobacco tax increases.

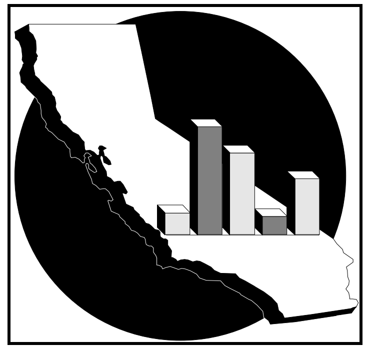
Proceeds of Securities Sales Counted as Revenue

The 8 percent growth shown in Figure 20 for "other" special fund revenues includes $147 million in proceeds from the sale of tax and revenue anticipation notes that are to be deposited in the State Highway Account. These notes are to be retired using future fuel tax revenues. Although these note proceeds do represent resources that can be spent for transportation-related purposes, proceeds from note sales are not normally treated as revenues. Rather, the taxes themselves are counted as revenues when they are received. Absent counting these note proceeds as revenues, growth in the "other" revenue category would be less than 3 percent in the budget year.

Figure 23

Distribution of Tobacco-Related Tax Revenues 1995-96





AN OVERVIEW OF STATE EXPENDITURES

PROPOSED CURRENT- AND BUDGET-YEAR SPENDING

The Governor's Budget proposes spending $55.5 billion from the General Fund and state special funds in 1995-96, as shown in Figure 1 (see next page). This expenditure level is about $1.5 billion, or 2.7 percent, more than estimated current-year spending of $54 billion. Spending from special funds accounts for almost all of this increase. General Fund expenditures remain essentially flat at $41.7 billion from 1994-95 to 1995-96.

Realignment Distorts Spending Comparisons. The lack of General Fund spending growth in the budget primarily reflects a proposed change in program financing arrangements. The Governor's Budget contains a state-county realignment proposal which shifts a variety of social services programs and funding responsibilities from the state to the counties along with existing General Fund revenues to help finance those costs. As a result, budgeted General Fund spending in 1995-96 excludes some existing costs that will continue to be financed with General Fund revenues which will be provided to counties directly or through a special fund. Adjusting the budget amounts for the realignment proposal makes 1995-96 spending totals more comparable with those in the current year. On this basis, General Fund spending grows by 2.5 percent and spending from special funds grows by 6 percent in 1995-96. A detailed discussion of this proposal is contained in Part Five.

Figure 1

Governor's Budget
Proposed and Adjusted Spending Changes
1994-95 and 1995-96

(Dollars in Millions)

	1994-95	1995-96	Change From 1994-95 Amount	Change From 1994-95 Percent
Budgeted Spending				
General Fund	$41,693	$41,726	$33	0.1%
Special funds	12,340	13,792	1,452	11.8
Totals shown in budget	**$54,033**	**$55,519**	**$1,485**	**2.7%**
Adjustments				
Proposition 98 loan repayment	-$135	-$379		
Add Local Public Safety Fund	1,508	1,590		
Adjusted totals	**$55,406**	**$56,730**	**$1,323**	**2.4%**

Spending Adjustments to Budget Figures. Figure 1 also includes two adjustments that we have made to the spending totals shown in the budget in order to better reflect actual state spending levels and to make year-to-year spending comparisons more meaningful. The first adjustment deducts Proposition 98 loan "repayments" from the spending totals. These repayment amounts are deducted from the funds actually provided to schools. They represent a portion of past off-budget spending that the state provided to schools as a loan against their future Proposition 98 entitlements. Thus, the loan repayments represent past spending rather than current spending.

The second adjustment adds spending from the Local Public Safety Fund (LPSF) established by Proposition 172, approved in November 1993. Proposition 172 made permanent a temporary half-cent increase in the state sales tax and dedicated the revenue to the LPSF for allocation to cities and counties. These LPSF allocations, in effect, offset some of the local revenue loss from property taxes that were shifted to schools in order to reduce state obligations for school funding. The budget treats the LPSF as a trust fund and excludes it from spending totals. However, we include LPSF expenditures in spending from special funds because the LPSF consists of state tax revenues expended for public purposes. As such, it is not fundamentally different from other dedicated state funds, such as the Motor Vehicle License Fee Account (also constitutionally dedicated to local government) that the budget *does* include in spending totals.

These adjustments add approximately $1.4 billion to the budget spending totals in 1994-95 and $1.2 billion in 1995-96 on a net basis, raising them to $55.4 billion and $56.7 billion, respectively. We use these adjusted figures in our discussions below.

Spending from Federal Funds and Bond Proceeds

In addition to the $56.7 billion of proposed spending from the General Fund and state special funds discussed above, the budget also proposes almost $34 billion of spending from federal funds and from the proceeds of general obligation bonds.

Federal Funds. The budget proposes to spend a total of $33 billion of federal funds in 1995-96. Most of this spending is for federal contributions to health and welfare programs ($21.3 billion), education ($6.6 billion), and transportation ($2.3 billion). Compared with the current year, total proposed spending from federal funds in 1995-96 increases by $1.1 billion, or 3.3 percent. Federal funding assumed in the budget for the costs of illegal immigrants and refugees ($835 million) accounts for most of this net increase. Excluding this immigrant and refugee funding, spending from federal funds would remain virtually flat (an increase of 0.7 percent).

Bond Proceeds. Figure 1 includes expenditures for capital outlay, debt service on general obligation bonds, and debt service on lease-payment bonds. However, spending from bond proceeds (funds derived from the sale of bonds) has not been included in these figures.

The budget estimates that the state will spend $810 million of general obligation bond proceeds in 1995-96. Almost half of these bond expenditures ($367 million) are for rail projects funded by the California Transportation Commission. Other major bond expenditures will be for seismic safety improvements to state facilities ($166 million) and for the construction of local jails and state prisons ($105 million). Expenditures of general obligation bond proceeds have declined sharply since 1992-93, when they totaled $3.9 billion, primarily because voters have approved few new bond measures in recent elections.

In addition to general obligation bonds, the state also uses lease-payment bonds (supported almost entirely from the General Fund) to finance the construction and renovation of facilities—particularly for higher education institutions and the prison system. The budget proposes $525 million in new authorizations of lease-payment bonds in the Budget Bill. In addition to these proposals, the Governor is also proposing another $3.1 billion in lease-payment bond authorizations for the following purposes:

- $2 billion to develop six state prisons.
- $181 million to develop 1,950 new beds for the California Youth Authority.
- $560 million for five state office consolidation projects.

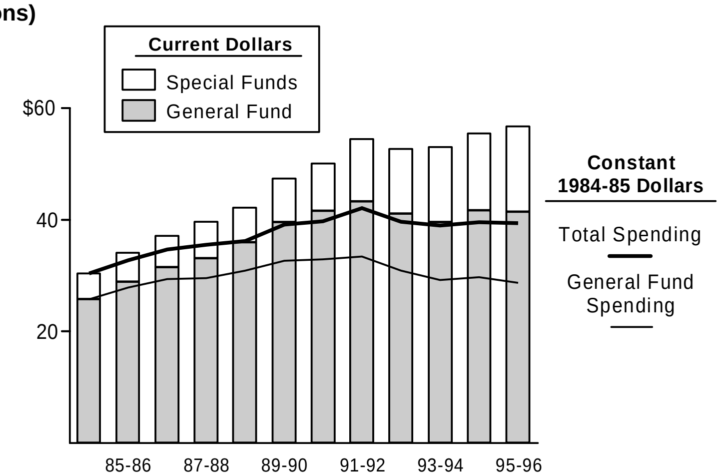
State Spending Trends

Figure 2 illustrates the trend in state General Fund and special fund expenditures from 1984-85 through 1995-96 (as proposed). The figure shows expenditures in both "current dollars" (amounts as they appear in the budget) and "constant dollars" (current dollars removing the effect of inflation). Using constant dollars allows comparisons of the purchasing power of state spending over time.

Figure 2

State Spending[a]
Current and Constant Dollars
1984-85 Through 1995-96

(In Billions)



[a]Excludes bond funds and federal funds.

Recession Still Constraining Spending Growth

Spending grew at an average annual rate of almost 9 percent between

1984-85 and 1991-92, when it peaked at $54.4 billion (a one-time accounting change in Medi-Cal exaggerates this spending peak by $1 billion). After adjusting for inflation, spending still grew at an annual rate of 4.8 percent, which was more than twice the rate of population growth. However, spending fell in 1992-93 and remained essentially flat in 1993-94, as the state's prolonged and deep recession constrained revenues. In the current year, total spending will increase by 4.6 percent, according to budget estimates, and proposed spending for 1995-96 would increase by 2.4 percent over the current-year amount.

As Figure 2 shows, spending increases in the current and budget years will only be sufficient to offset the effects of inflation. In constant dollars, the purchasing power of proposed spending in 1995-96 is essentially the same as in 1992-93. On a per-capita basis, constant-dollar spending will decline by 5.2 percent compared with 1992-93 and by 13 percent compared with the peak year of 1991-92.

Funding Shifts Increase the Role of Special Funds

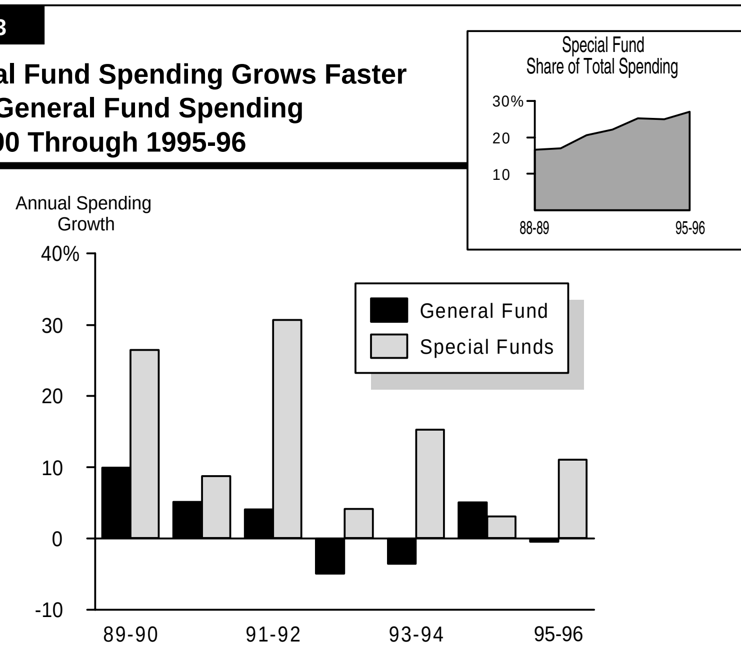
Special funds account for a growing share of total state spending, as shown in Figure 2. Figure 3 (see next page) compares annual growth in spending from special funds with the growth in General Fund spending since 1989-90. Between 1990-91 and 1994-95, the portion of state spending financed by special funds has increased from 17 percent to 25 percent. The Governor's budget proposal would increase the special fund share of spending to 27 percent. Over the period shown in Figure 3, the percentage increase in spending from special funds has exceeded that of General Fund spending in every year except one (the current year)—usually by a substantial margin.

Recent Growth of Earmarked Funds Reflects Restructuring of State and Local Programs. Prior to 1991-92, rapid growth in special fund spending primarily reflected increases in revenues earmarked for programs that had not been traditional General Fund responsibilities. Major examples of this trend were the approval of Proposition 99 in 1988 (which imposed additional cigarette and tobacco taxes) and Proposition 111 in 1990 (which authorized phased increases in the gasoline tax and other transportation revenues).

Since 1991-92, special fund spending growth largely reflects restructuring within the budget, involving shifts of General Fund costs to counties along with shifts of state special fund revenues to counties to offset those costs. The realignment of state and county health and welfare responsibilities enacted in 1991-92 placed revenue from a half-cent increase in the state sales tax, traditionally a General Fund revenue source, into a special fund to help counties offset a portion of the General Fund costs that were shifted to them. This realignment also provided counties with additional special fund revenues from increased vehicle license fees to offset the remainder of the costs that were shifted to them. Furthermore, Proposition 172, approved in November 1993, dedicated an additional half-cent of the state sales tax to the Local Public Safety Fund for allocation to local governments to partially offset the loss of property tax revenues shifted to schools and community colleges in order to reduce state General Fund spending.

Figure 3

Special Fund Spending Grows Faster Than General Fund Spending 1989-90 Through 1995-96



1995-96 Realignment Proposal Continues Trend. The Governor's proposed 1995-96 realignment of social services programs would continue the trend of shifting General Fund spending to special funds. This proposal shifts $710 million of existing General Fund sales tax revenue to the Local Revenue Fund, which provides realignment funds to counties, in order to offset some of the costs that counties would take over from the state. Additional financing for the proposal is provided by allowing counties to retain current General Fund revenues from trial court fines and forfeitures ($311 million). The combined effect of these two funding rearrangements is to increase special fund spending and to reduce General Fund spending by an even larger amount. As a result, special funds' share of total spending increases to 27 percent in the proposed 1995-96 budget, versus 25 percent in the current year.

Major Special Fund Expenditure Programs. Two categories of spending account for three-fourths of the total $15.4 billion in projected spending from special funds in 1995-96. Local government allocations from sales tax and vehicle license fees total $6.8 billion, and transportation-related spending (including local transportation subventions) totals $4.9 billion. A wide variety of special funds financed by special fees and taxes make up the remainder of special fund spending sources. Among the largest of these are California State University student fees and income ($575 million), Proposition 99 cigarette and tobacco surtax funds ($331 million), and the Beverage Container Recycling Fund ($321 million).

PROPOSED SPENDING BY PROGRAM AREA

Figure 4 (see next page) shows the distribution of the proposed $56.7 billion of state spending in 1995-96 among the major state program areas. The figure includes both General Fund and special fund expenditures in order to provide a meaningful comparison of program areas that have different mixes of General Fund and special fund support.

As Figure 4 shows, education receives the largest share of state spending—a total of 38 percent (28 percent for K-12 education and 10 percent for higher education). Education's share of General Fund spending is much greater—51 percent. Health and social services programs account for 27 percent of proposed total spending (including state-county realignment funds).

1995-96 PROGRAM FUNDING CHANGES

Although the Governor's Budget increases total spending by 2.4 percent in 1995-96, spending changes for individual program areas vary widely. Figure 5 (see next page) shows the percentage increase or decrease in *budgeted* spending proposed for major program areas. It shows, for instance, that proposed transportation spending would increase almost 15 percent, while health and social services expenditures would decline by almost 24 percent.

Figure 4

Total State Spending By Major Program 1995-96

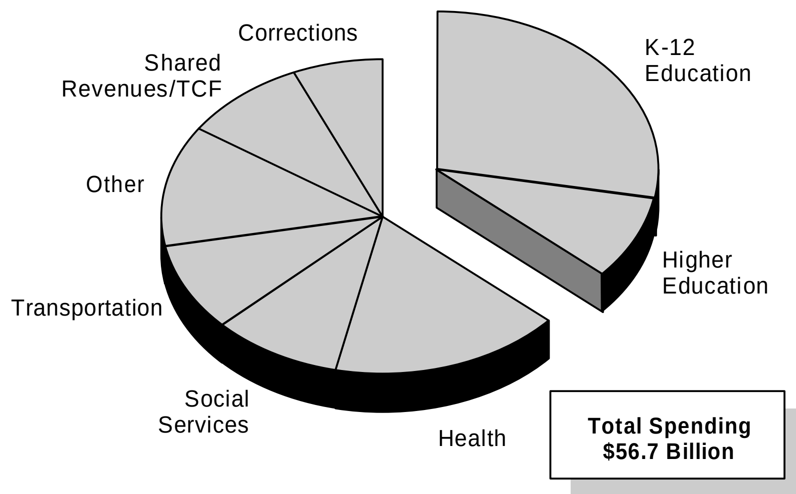


Figure 5

Proposed Spending Growth in 1995-96 Program Support Levels vs. Budgeted Amounts

	Program Support Level	Budgeted	Reason Program Support Level Different
K-12 education	4.1%	4.5%	Slow growth of revenue from property tax shift to schools.
Higher education	2.8	2.9	—
Health	1.8	-1.8	Includes new federal immigrant funds assumed in 1995-96.
Social Services	-10.2	-23.9	Includes trial court funds for state/county realignment and new federal immigrant funds.
Corrections	11.5	1.0	Includes federal immigrant funds.
Transportation	14.8	14.8	—
All other	16.4	17.4	Excludes trial court funding used to finance social services via state/county realignment.
Totals	**4.4%**	**2.4%**	

Program Support Levels. The figure also shows what the 1995-96 spending changes would be if calculated on the basis of what we call "program support levels." These levels are a measure of the *total* funding provided to a program through state actions, not just the amount of state funding shown in the budget. Program support levels include support provided through funding shifts to local governments, the federal government, or to the future (using loans), and treat the total as a package.

Cost shifts and program restructuring changes proposed in the budget mean that spending changes from one year to the next do not necessarily translate into similar changes in program support levels. For example, Figure 5 shows that budgeted state spending for corrections programs increases by only 1 percent in 1995-96. However, the budget also assumes receipt of $422 million of federal funds that will offset the state's costs of incarcerating illegal immigrants. Taking these additional federal funds into account results in an increase of 12 percent in the program support level for corrections in 1995-96. (For a more detailed discussion of the program support level concept please see *The 1994-95 Budget: Perspectives and Issues*, pp. 77-83.)

Program Support Levels Increase More than Budgeted Spending

Figure 5 shows that the budget results in an increase of 4.4 percent in total program support levels in 1995-96, almost twice the 2.4 percent increase in total budgeted spending. The explanation for this difference is that program support levels include $1.1 billion of resources in excess of budgeted spending in 1995-96. This amount consists of $835 million of federal immigrant funding that offsets General Fund costs, and $311 million of state trial court revenues that the counties would retain instead to help finance the realignment proposal.

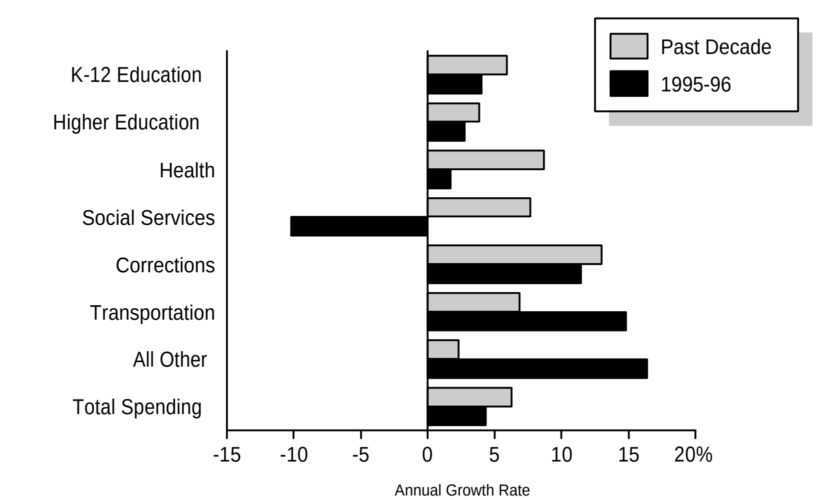
The largest difference between the change in program support levels and the change in budgeted spending occurs for social services programs. Spending for social services declines sharply in 1995-96, reflecting the Governor's proposed welfare grant reductions. However, the budgeted spending drop of 24 percent ($1.7 billion) overstates the impact on program support levels for social services. This is because state spending for social services does not include $916 million of additional funds that counties will receive to offset costs shifted to them under the Governor's realignment proposal. These funds consist of increased Trial Court Funding grants and revenues from fines and forfeitures. After including these additional resources and federal refugee funding assumed in the budget to offset state costs, the resulting reduction in social services program support levels would be 10 percent—a substantial cut, but less than half of the reduction in budgeted social services funds..

Program Support Trends Over Time

Figure 6 compares proposed changes in support for major program areas in 1995-96 with the average annual growth rates of program support over the past decade. Total program support has grown at an annual rate of 6.3 percent over the past 10 years, compared with the 4.4 percent increase in overall support proposed for 1995-96. Consequently, the proposed rate of growth is below the average over the past decade. Furthermore, the growth rate in 1995-96 is lower than the average over the past decade for every major program area except transportation and the "all other category," although the magnitude of the difference varies considerably.

Figure 6

Growth in Program Support Levels
1984-85 Through 1994-95/Proposed for 1995-96



Most of the slowdown in program support growth cannot be attributed to lower rates of inflation and population growth compared with the last decade. From 1984-85 to 1994-95, program support grew faster than the combined annual rate of inflation and population growth—6.3 percent versus 5.7 percent. For 1995-96, the budget projects combined inflation and population growth of 5.1 percent. Since program support levels will grow by only 4.4 percent in 1995-96, they will not keep pace with inflation and population growth based on the budget proposal.

Transportation and Corrections Programs Grow Rapidly

The budget increases funding for transportation programs and corrections programs in 1995-96 by 15 percent and 12 percent, respectively, in terms of program support levels. Budgeted federal funds for incarceration of illegal immigrants provide most of the increased support for corrections—state funding increases by only 1 percent.

The high rate of growth of corrections support is driven by the continuing growth in the inmate population—estimated at 13 percent in the budget year. As Figure 6 shows, the proposed rate of growth in support for corrections programs is similar to the average growth rate of corrections support over the last decade (13 percent).

Proposed spending for transportation programs in 1995-96 grows at twice its average rate of growth during the past ten years. The budget proposes increasing transportation spending by more than $700 million in 1995-96. Much of this increase is to pay for projects started prior to 1995-96, projects started in the budget year, and seismic retrofit. In order to fund this increase, Caltrans plans to "borrow" from its future state and federal funds.

Significant Reduction in Social Services Support

As discussed above, support for social services programs (including realignment funds and new federal refugee funding) declines by 10 percent, or about $700 million, in 1995-96. The funding decline reflects significant reductions in welfare grants proposed by the Governor. Caseload growth in the major welfare programs has moderated, but the budget estimates that caseload in Aid to Families with Dependent Children (AFDC) still will grow by 3.5 percent in 1995-96, even after accounting for the impact of the proposed grant reductions and restrictions. The budget estimates that proposed grant reductions and eligibility restrictions will keep caseload flat in the state's other major welfare program—Supplemental Security Income/State Supplementary Payment (SSI/SSP)—which provides benefits for the aged, blind and disabled. The proposed funding decline contrasts sharply with support trends over the last decade, during which funding for social services grew at an average annual rate of 7.7 percent.

Health Funding Growth Slows Considerably

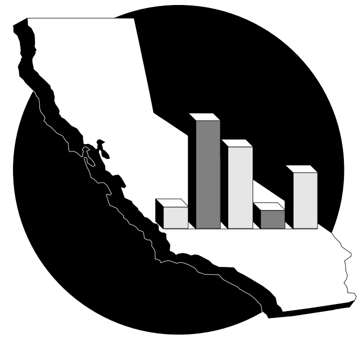
Support for health programs (including new federal immigrant funds) would grow by 1.7 percent in 1995-96, based on the budget proposal, compared with an annual growth rate of 8.7 percent over the past decade that reflected high rates of caseload growth and increases in the cost of medical care. Although the budget estimates that caseload in the state's largest health program—Medi-Cal—will grow by 4.5 percent in 1995-96, program support grows by less than half that amount due to the proposed elimination of a number of "optional benefits" currently provided by Medi-Cal, and a variety of new cost-containment measures.

Education Funding Grows Modestly

Support for K-12 education (including funding provided through property tax shifts enacted in 1992-93 and 1993-94) grows by 4.1 percent, based on the budget, compared with average annual growth of 5.9 percent over the past ten years. The budget projects K-12 enrollment growth of 2.6 percent in 1995-96. General Fund Proposition 98 spending grows by 4.9 percent after adjusting to exclude loan repayments, as discussed earlier. However, school revenues from the property tax shifts grow by only 1.9 percent in 1995-96. This relatively small increase in 1995-96 reflects the fact that school property tax revenues are abnormally high in the current year because they include one-time allocations to make up for past shortfalls.

Special Factors Increase Spending for Other Programs

Support for all other programs increases by 16 percent in 1995-96, compared with an annual growth rate of only 2.3 percent during the past decade. However, most of this large increase does not represent any actual growth in programs. Instead, it primarily reflects two spending increases needed to replace one-time savings or to pay for costs deferred in the current year. First, General Fund borrowing costs increase by $417 million in 1995-96, mainly because interest payments on the $4 billion of revenue anticipation warrants sold in the current year do not come due until the budget year. Second, the cost of state employee retirement contributions increases by $302 million in 1995-96 in order to replace one-time savings in the current year that were achieved by using balances in special retirement fund accounts to offset state contributions. Excluding these two special factors (which affect all programs), support for the "all other" programs category increases by 3.9 percent in 1995-96.



MAJOR EXPENDITURE PROPOSALS IN THE 1995-96 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 1995-96 Budget Bill*.

Major Spending Changes Focus On Welfare and Health Programs

As discussed in Part One, the Governor's Budget proposal relies on major reductions in welfare grants and savings in health programs for $1.1 billion of savings in 1995-96. Other major budget savings are due to the assumption of additional federal funds and a shift of state costs to counties. Outside the health and welfare area, the budget itself does not present the Legislature with many major proposals to change spending priorities or existing levels of program support. The budget's plan for restructuring state and county responsibilities for social services and welfare (which we discuss in detail in Part Five) would make revisions in the division of responsibilities between the state and the counties. Although it results in $241 million of net state savings, it does not change existing program spending priorities.

Proposals that Require Legislation or Federal Action

Figure 7 lists the major budget-balancing proposals in the budget and indicates whether legislation or federal action is needed to implement them, as well as the timing of these actions assumed by the budget.

Figure 7

Summary of Major Budget Balancing Proposals In the 1995-96 Governor's Budget

(In Millions)

Proposal	State Legislation Required?	Federal Action Required?	Assumed Effective Date	Savings
Increased Federal Funding				
Reimbursements for undocumented felons	No	Yes	10/1/95	$177[a]
Pay full Medi-Cal costs for undocumented immigrants	No	Yes	10/1/95	310
Pay three years health and welfare costs of refugees	No	Yes	10/1/95	103
Eliminate SSI/SSP administrative charge	No	Yes	10/1/95	50
Welfare Reductions				
AFDC grant reductions and reforms	Yes	Yes	9/1/95	254
SSI/SSP grant reductions	Yes	Yes	10/1/95	434
Eliminate drug/alcohol abuse disability category for SSI/SSP program	Yes	Yes	10/1/95	52
Medi-Cal				
Eliminate some optional benefits	Yes	No	10/1/95	143
Eliminate prenatal services for undocumented immigrant women	Yes	No	7/1/95	79
Bar sponsored immigrants from receiving Medi-Cal and AFDC benefits	Yes	Yes	10/1/95	64
Reduce Medi-Cal rates for "distinct part" nursing facilities	Yes	Potentially	8/1/95	26
State/Local Restructuring				
Restructure social services programs	Yes	No	7/1/95	341
Other Proposition 98				
Higher Education				
Increase CSU fees	Yes	No	7/1/95	30
Increase UC fees	No	No	7/1/95	38
Increase community college fees	Yes	No	7/1/95	20
Special Funds				
Shift ETP and beverage container funds to General Fund programs	Yes	No	7/1/97	39

[a] Amount in excess of funds currently appropriated or authorized.

Federal Immigrant Funding

Immigration policy and enforcement is the responsibility of the federal government. The federal government also determines the eligibility of immigrants for health and welfare benefits under programs such as Medicaid (Medi-Cal in California), AFDC, and SSI/SSP, which are supported jointly by state and federal funds. In addition, the U.S. Supreme Court has determined that the U.S. Constitution entitles immigrant children to public education, regardless of their legal status. Although Proposition 187, approved by the voters in November 1994, prohibits the state and local entities from providing undocumented persons with most education, health and social services, the courts have enjoined these restrictions while they consider legal challenges to the measure.

The budget includes a total of $835 million of federal funds for services related to illegal immigrants ($732 million) and refugees ($103 million). Of this amount, approximately $245 million currently has been appropriated or authorized by the federal government.

Incarceration Costs. The budget assumes that the state will receive $422 million in federal funds for the cost of incarcerating and supervising the parole of illegal immigrants who have been convicted of a felony in California. The 1994 federal Crime Bill provides a portion of these funds. California will receive $45 million from an existing appropriation, and the state's share of additional funds authorized by the Crime Bill is about $200 million. The President's 1996 budget requests an appropriation to fully fund this authorization. However, there is no federal authorization for the remaining $177 million of incarceration funds assumed in the Governor's Budget.

Medi-Cal Costs of Emergency Care. The budget includes $310 million of federal funds for the state costs of providing emergency medical care (including labor and delivery services for pregnant women) to illegal immigrants in 1995-96. The federal Omnibus Budget Reconciliation Act (OBRA) of 1986 requires states to provide emergency medical services to illegal immigrants who, aside from their legal status, would otherwise qualify for the Medicaid (Medi-Cal) program. The additional federal funds assumed by the Governor's Budget would replace the state's share of these costs, so that the federal government would cover 100 percent of these Medi-Cal expenses. President Clinton's 1996 budget proposes $150 million nationwide for this purpose, which also will require a change in federal law.

Services to Refugees. The federal Refugee Act of 1980 entitles refugees to a full range of health and welfare services. The budget assumes that the federal government will provide $103 million to fund 100 percent of these

AFDC, SSI/SSP and Medi-Cal services during the first 36 months of residence by refugees, as required by the Act. Federal funding for this purpose has been declining since 1986 and the state received no funds for this purpose in 1994-95.

WELFARE GRANT REDUCTIONS AND REFORMS

The state's two primary welfare programs are known as Aid to Families with Dependent Children (AFDC) and the Supplemental Security Income/State Supplementary Program (SSI/SSP). Both the state and federal governments contribute to funding these programs. In the current year, the budget estimates that the General Fund cost of these programs will be $3.1 billion for AFDC and $2.1 billion for SSI/SSP.

The AFDC program provides cash grants to qualifying families with children whose incomes are not sufficient to provide for their basic needs. The largest component of the AFDC caseload is the AFDC-Family Group (AFDC-FG), in which a family's financial need is related to the death, incapacity, or continued absence of one or both parents. Other program components provide for unemployed families with children (AFDC-U) and for children in foster care (AFDC-FC). The federal government funds half of the cost of AFDC grants, and the state provides 45 percent of the cost. Counties, which administer these grants, fund the remaining 5 percent of the cost. The Governor's state-county realignment proposal would divide the nonfederal share of the AFDC-FG and AFDC-U programs equally between the state and the counties; the budget proposes that the counties assume 100 percent of the nonfederal share of costs for the AFDC-FC program.

The SSI/SSP program provides cash assistance to low-income persons who are elderly, blind or disabled, with the disabled being the largest group of recipients. The federal Social Security Administration administers the program and pays the cost of the SSI grant. California has chosen to supplement the federal payment by providing a state-funded SSP grant. Although the provision of an SSP grant originally was optional, the state now is subject to federal maintenance-of-effort requirements that restrict the state's ability to reduce or eliminate its SSP grant.

AFDC Proposals

The Governor's package of AFDC grant reductions and reforms is similar to previous proposals made by the administration. The budget estimates that the package would result in General Fund savings of $254 million (net of administrative costs) in 1995-96. The major proposals are summarized below:

- ***Across-the-Board Grant Reductions.*** The budget proposes a 7.7 percent reduction in the AFDC maximum grant levels effective September 1, 1995, and an additional 15 percent reduction for families that have an able-bodied adult and have been on aid more than six months, beginning March 1, 1996. The impact of the reductions would be felt most by nonworking recipients—who comprise the largest share of the caseload. The grant reductions would be partially offset by increases in federally funded food stamps. The estimated state savings from these grant reductions in 1995-96 is $254 million.

- ***Teen Parent Provisions.*** The budget proposes to require parents under age 18, with some exceptions, to reside with their parents, legal guardian, or an adult relative in order to receive AFDC.

- ***Time-Limited Aid.*** The budget proposes legislation to reduce AFDC grants for families with an able-bodied adult by the amount of the grant associated with the adult, once the family has been on aid for more than two years cumulative time. The two-year "clock" would not start running until July 1, 1995, so that these reductions would not affect any grants until July 1, 1997.

The budget also includes savings of $27 million that would be achieved by excluding legal immigrants from aid during their first five years in the country if they have financial sponsors who are able to provide support. Although state law (Ch 148/94—AB 836, Pringle and Goldsmith) enacted such an exclusion last year, it cannot be implemented until Congress changes federal law.

Issues for Legislative Consideration

The Governor's AFDC proposals would result in significant savings to the state in 1995-96, with the amount increasing substantially in future years when the full-year impact of the grant reductions and two-year time limit on aid occurs. The grant reductions could be fully offset (without penalty) by increases in earnings from employment. Thus, one effect of the proposals would be to increase the financial incentive for recipients to work. The proposals raise a number of significant issues.

Impact on Families. To the extent that recipients do not or cannot offset the grant reductions with additional income from other sources, the total income available to families would be reduced substantially. Under current law, the combined maximum grant and food stamps benefit is equal to about 81 percent of the federal poverty guideline. Those subject to both the 7.7 percent and additional 15 percent reductions in grants would have their resources reduced to about 70 percent of the guideline to the extent that these reductions are not offset by income from other sources such as employment.

Availability of Training. Many AFDC recipients have relatively low levels of education and work experience. To address this problem, California's GAIN Program provides training and basic education specifically for AFDC recipients. The program, however, currently is not funded at a level sufficient to accommodate all recipients who are required to, or wish to, participate. Under the Governor's proposal, persons facing the expiration of their two-year time limit would have a priority for receiving GAIN services.

Availability of Jobs. Some recipients may not be able to find employment. Job growth in California remains weaker than in past economic recoveries and the number of jobs will not reach its pre-recession peak until the latter half of 1996, according to the budget's economic projections.

Reductions for Persons in County Work Assignments. Chapter 148 also requires AFDC recipients in the GAIN program to work in county-provided assignments if they have not found regular employment within two years, as specified. Recipients who refuse county work assignments would have their grants reduced. However, it is not clear how many of these work assignments, if any, counties will make available. The Governor's proposed two-year time limit on aid would reduce the grants of families with able-bodied adults (eliminate the portion of the grant associated with the adult) after two years on aid. The proposal differs from existing law by not allowing for continuation of the full grant if the recipient participates in a county work preparation assignment.

Potential for Cost-Shifting. The reduction in families' incomes may, to some extent, increase the use of other public services such as health and foster care. Thus, to the extent that such shifting occurs, some of the savings in the AFDC Program will be offset by unknown costs, to the federal, state, and county governments in other programs.

SSI/SSP Proposals

The Governor's SSI/SSP proposals assume that Congress will enact federal legislation allowing the proposed changes by October 1, 1995. The budget estimates that the package would result in General Fund savings of $530 million in 1995-96. The major proposals are summarized below.

- ***Across-the-Board Grant Reductions:*** The budget proposes a reduction in the combined SSI/SSP grant of 8 percent for individuals and 10 percent for couples, exempting those in Non-Medical Out of Home Care living arrangements. The proposal would result in a General Fund savings of $433.6 million in 1995-96. This amount would be partially offset by a cost of $4.8 million in order to continue no-cost Medi-Cal coverage for those persons whose SSP grant is eliminated by the proposed reductions, and who would therefore be ineligible for Medi-Cal. The budget proposal would reduce monthly grants for aged and disabled individuals (the largest category of recipients) by $49, and by $110 for aged or disabled couples. The proposed reductions would reduce the monthly SSP payment levels below current federal maintenance-of-effort requirements. Accordingly, this proposal requires a change in federal law.
- ***Elimination of Substance Abuse as Qualifying Disability.*** Individuals who are disabled by drug addiction or alcoholism (DA/A) currently are eligible for SSI/SSP grants. In January 1995, there were roughly 30,000 DA/A recipients of SSI/SSP. The budget assumes that legislation will be enacted by Congress to eliminate substance abuse as a qualifying disability in the SSI/SSP Program. The budget estimates that 40 percent of the substance abuse cases would continue to qualify for the program under other disability criteria, while the remainder would be ineligible. This eligibility restriction would result in General Fund savings of $24.8 million in SSI/SSP grants and $26.5 million in the Medi-Cal Program in 1995-96.
- ***Termination of Federal Fees.*** Under the federal Omnibus Budget Reconciliation Act (OBRA) of 1993, the federal Social Security Administration charges states a fee for administering SSP benefits. The budget assumes that Congress will enact legislation to eliminate the fee for a General Fund savings of $50 million in 1995-96. Last year's Governor's Budget included the same assumption, but it was not enacted by Congress.

Issues for Legislative Consideration

The Governor's proposals raise several significant issues.

Impact on Individuals' and Couples' Grant Levels. The SSI/SSP grant reductions would, if authorized by Congress and adopted by the Legislature, result in a loss of income to recipients. Many SSI/SSP recipients do not have the option of offsetting this loss through earnings.

Other than the federal poverty level, which serves only as a general guideline, there is little empirical data to determine what constitutes an "adequate" amount of support. The SSI/SSP grant for an aged or disabled *individual* was above the federal poverty level until 1994, when the monthly SSI/SSP grant for an individual fell to 98 percent of the poverty level. The budget proposal would reduce the grant level for those individuals to 92 percent of the poverty level. The grant for aged or disabled *couples* has exceeded the poverty level by a greater amount and would continue to exceed the poverty level after the Governor's proposed reduction.

The Governor's Budget indicates that the grant for couples would be reduced by a larger percentage than the grant for individuals in order to achieve a more reasonable relationship between the two groups. California is the only state where the SSI/SSP grant for couples exceeds 1.5 times the grant for individuals. The Governor's proposal would reduce the ratio from 1.79 to 1.75.

Cost Shifting. The proposal to eliminate eligibility based on substance abuse could result in shifting costs to treat or care for these individuals to other state and locally funded programs.

Availability of Treatment. The budget treats services offered to AFDC and SSI/SSP recipients differently. The Governor's two-year time limit proposed in the AFDC Program gives priority for the GAIN Program to AFDC recipients who are facing a grant reduction. However, the SSI/SSP proposal does not give a similar priority for treatment to substance abusers who would no longer be eligible for benefits but may seek publicly funded treatment to overcome their addictions.

MEDI-CAL

The California Medical Assistance Program is a joint federal-state program that provides necessary health services to public assistance recipients and to other individuals who cannot afford to pay for these services themselves. Federal laws establish a set of minimum eligibility criteria and the basic scope of the benefits to be provided. The states may provide for additional optional categories of eligibility and benefits. Funding for most services provided under California's program is split equally between the state and the federal governments. The budget estimates that the General Fund cost of the Medi-Cal program will be $5.7 billion in the current year.

Proposals

The budget makes several major proposals for program reductions in Medi-Cal.

Elimination of Medi-Cal Optional Benefits. The budget assumes enactment of legislation to eliminate 9 of the 28 optional service categories in the Medi-Cal Program, for a net General Fund savings of $143 million in 1995-96.

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

Eliminate Prenatal Care for Undocumented Women. The budget proposes to eliminate the existing "state-only" program that provides prenatal care for undocumented immigrant women. Federal law does not require or fund this program, which is financed entirely from the General Fund. Undocumented immigrants would remain eligible for delivery services and emergency treatment, which are required by federal law and partially funded by the federal government. The budget estimates savings of $79 million in 1995-96 from eliminating this program. Proposition 187, approved by the voters in November 1994, also would eliminate this program. However, the courts have enjoined enforcement of Proposition 187 while they consider legal challenges to the measure.

Changes in Nursing Facility Reimbursement Rates. The budget estimates savings of $76 million from three major changes in the reimbursement levels for nursing facility services. Specifically, the budget proposes to: (1) lower the minimum requirement for nursing hours per patient, if the nursing facility industry agrees to the change ($20 million); (2) impose a 20 percent rate reduction for nursing facilities that are a "distinct part" of a hospital ($26 million); and (3) establish a *higher* reimbursement rate category for nursing facilities in certain cases, in order to shift patients to these facilities who would otherwise remain in hospitals at a higher cost ($30 million).

Issues for Legislative Consideration

Potential for Cost-Shifting. In some cases, eliminating one type of optional medical service could result in increased costs for other services provided by the Medi-Cal program or other health programs. The budget has attempted to account for this with respect to the proposed elimination of optional benefits; however, its savings assumptions may still be optimistic. For example, elimination of van transportation as an optional benefit does not relieve the state of its responsibility under federal law to provide "necessary transportation" for Medi-Cal beneficiaries who cannot otherwise access medical care. Thus, it is likely that most, if not all, of the savings from eliminating this service will be offset by other transportation costs, such as the increased use of ambulances. Similarly, eliminating prenatal care for undocumented immigrant women could result in poorer birth outcomes, which would increase long-term Medi-Cal costs. The Legislature will need to evaluate the net savings potential of these proposals, in particular, if it wishes to achieve General Fund savings in the Medi-Cal Program.

Nursing Facility Rate Proposals. The budget proposal raises issues regarding: (1) the likelihood of the freestanding nursing facility industry's willingness to agree to the department's proposal to reduce minimum nursing hours in those facilities; (2) the potentially adverse effects on quality of care associated with that proposal; and (3) for the distinct part proposal, potential conflicts with federal law, which requires these facilities to be reimbursed at actual cost.

In our analysis of the Medi-Cal budget, we recommend that the Legislature avoid these potential problems and uncertainties by implementing a contracting program for nursing facilities in order to achieve savings. This contracting program would be similar to the existing program for hospital inpatient services (wherein the California Medical Assistance Commission negotiates reimbursement rates with these facilities).

REACHING EARLY ACCESS FOR CHILDREN'S HEALTH (REACH) PROGRAM

Under current law, the state and counties provide health care services for low-income children through a variety of programs. For example, the Medi-Cal Program and the Child Health and Disability Prevention (CHDP) Program provide health screening services (assessments). Medi-Cal also provides comprehensive health care. Families on welfare receive Medi-Cal services at no cost. Other low-income families receive Medi-Cal services on a “share-of-cost” basis, in which families must pay for medical expenses by “spending down” their incomes to 133 percent of the June 1991 AFDC payment level ($694 per month for a family of three). County health departments provide outpatient treatment based on CHDP screens. The counties also provide other, or “episodic,” outpatient treatment and inpatient care for emergencies to persons who are not eligible for Medi-Cal and cannot afford to pay for these services. The scope of treatment varies among the counties.

Proposal

The budget proposes a General Fund augmentation of $56.1 million to establish the REACH Program in 1995-96. The new program would provide free health care coverage for children, from birth through age five, who are in families with incomes between 133 percent and 200 percent of the federal poverty level. Currently, these families have to pay a share-of-cost or rely on the counties or private providers for services to these children. (Program participants would have to be citizens or legal residents of the U.S.) Thus, the program would, in effect, shift some costs from the counties to the state.

Beginning in 1996-97, the program would expand to include children who are in families with incomes up to 300 percent of the poverty level, provided the family was enrolled in the Access for Infants and Mothers (AIM) Program when the child was born. The AIM Program provides subsidized health insurance for pregnant women, and their infants up to age two, with incomes between 200 and 250 percent of the poverty level. (The budget proposes to extend AIM eligibility to 300 percent of the poverty level, and reduce the age limit of the child's participation to one year.)

In addition to the $56.1 million in new General Fund monies, funding for REACH would include $43.8 million in redirected state funds from the CHDP Program ($22.2 million General Fund and $21.6 million Cigarette and Tobacco Surtax Fund) to match $100 million in federal funds, which will require federal legislation. In addition, $6.3 million of federal funds would be redirected from the CHDP Program. Funding would be capped by the appropriation. In other words, the program would not be an entitlement.

Issues for Legislative Consideration

The REACH proposal raises a number of issues concerning its programmatic and budgetary impacts.

Impact on Children's Health Care is Uncertain. The administration has not provided information to assess the extent to which REACH would *increase* the level of health care provided to children, as opposed to merely shifting funding sources and responsibilities for furnishing the services.

Cost Shift from Counties to State. As indicated above, the proposal would make services available to eligible children who, under current law, would receive these services from county health departments. The amount of this potential shift of costs is unknown but could account for a significant part of the total program costs.

Funding in Question. The $100 million in federal matching funds would require enactment of legislation by the Congress in response to the state's request to demonstrate an alternative to expanding Medi-Cal. Thus, there is no assurance that the funds will be provided. In addition, $21.6 million of proposed funding is in jeopardy due to a recent Superior Court ruling that restricts the use of Cigarette and Tobacco Surtax Fund monies for such purposes.

PROPOSITION 98

Proposition 98 establishes a minimum funding level that the state must provide for public schools and community colleges (K-14 education) in each year. Generally, this is determined based on one of three so-called "tests." Specifically, the minimum funding level is equal to the greater of:

- ***Test 1—Percentage of General Fund Revenues.*** This is defined as the 1986-87 percentage of General Fund tax revenues provided to K-14 education (as adjusted by property tax shifts that have occurred in the 1990s).
- ***Test 2—Maintenance of Prior-Year Funding Levels.*** This is defined as the prior-year level of total funding for K-14 education from state and local tax sources, adjusted for enrollment growth and for changes in per capita personal income.
- ***Test 3—Adjustment Based on Available Revenues.*** This formula takes effect during times of relatively low growth of General Fund revenues. It provides the prior-year level of funding for K-14 education from state and local resources, adjusted for enrollment growth and for growth in General Fund revenues. Other adjustments are made in the formula to ensure that K-14 programs receive a proportionate increase in General Fund support compared to the rest of the state budget.

During the current year, Test 2 applies. Test 3 would apply in 1995-96 under the budget proposal.

The Legislature, by a two-thirds vote, may suspend the minimum funding level requirement and appropriate a lesser amount. Proposition 98, however, requires the state to calculate a "long-term" restoration level each year based on Test 1 or Test 2, as appropriate. If the Legislature suspends the funding minimum or if Test 3 is used to calculate the minimum level, Proposition 98 establishes a "maintenance factor," which requires funding increases in future years to eventually restore spending to the long-term level. Thus, the guarantee mechanism works in such a way that any reductions in K-14 funding levels below the Test 1 or Test 2 levels are designed to be temporary.

*"**Cash" Spending.*** In evaluating the effect of budget proposals, it is important to determine the amount actually available for K-14 programs ("cash" spending from state, local, and student fee sources) as well as the Proposition 98 funding provided in a given fiscal year. Cash spending differs from Proposition 98 funding due to a variety of adjustments involving funding sources that are not reflected on the state's books or appear as state spending in a different fiscal year than the year when the schools receive the funds. For example, revenues from community college fees are not included in state spending. Another example of this difference is the case of Proposition 98 loans. The state provided these loan funds to districts during 1992-93 and 1993-94 (that is, they were *cash* to schools in those years), but the funding is not reflected as a state *expenditure* until the year the loans are "repaid."

For a more complete discussion of Proposition 98 provisions and additional background on Proposition 98 funding levels, please see the "Overview of K-12 Education" in the *Analysis of the 1995-96 Budget Bill.*

Proposal

The Governor's budget funds the Proposition 98 minimum guarantee in the current and budget years. These funding levels increase K-12 funding on a per-pupil basis in both years, and also include set-asides totaling $514 million over the two years to partially repay Proposition 98 loans.

Current Year. The budget proposes a total of $24.9 billion in 1994-95 Proposition 98 cash spending, or $9 million less than estimated in the 1994 Budget Act. This small change is the net result of faster-than-expected growth in state tax revenues, partially offset by slower-than-anticipated growth in K-12 enrollments. While schools would have slightly less total cash than assumed in the Budget Act, per-pupil spending actually increases from $4,198 to $4,231 per pupil. These changes reduce general-purpose funding, which varies with enrollment, and increase funding for categorical programs. The additional categorical funds are proposed to be spent on a variety of one-time activities including deferred maintenance, education technology and instructional materials.

The budget also proposes to set aside $135 million within the 1994-95 minimum funding requirement as partial repayment of off-budget loans provided to K-14 programs in previous years. These funds, while recognized as state spending in 1994-95 for budgetary purposes, were already provided to K-14 programs in previous years. Under existing statute, these deductions for loan repayments occur if the Proposition 98 minimum spending requirement increases the per-student funding level above that in the previous year. Under the statute, half of any "excess" funding above the previous year's level is set aside to repay the Proposition 98 loans. The other half of the "excess" funding is provided as cash to K-14 programs.

While the total amount of cash available to schools under Proposition 98 in 1994-95 is projected to stay about the same as estimated when the 1994 Budget Act was enacted, the budget now estimates that the General Fund share has increased by $520 million. This increase is caused by two factors. First, $376 million is needed to backfill a shortfall in local property tax revenue for schools and community colleges. An additional $144 million is due to an increase in the Proposition 98 minimum funding guarantee. Of this total amount, however, $135 million is set aside as a loan repayment.

Budget Year. The budget proposes to provide $25.9 billion in total Proposition 98 funding on a cash basis in 1995-96. This is an increase of $1 billion above cash funding proposed in the current year, allocated as follows:

- K-12 schools would receive $904 million, which would increase per-pupil funding to $4,292, or $61 above the revised 1994-95 level. In addition to enrollment growth, the funding increase provides a 2.2 percent cost-of-living adjustment (COLA) for general purpose spending and a variety of categorical funding increases.

- Community colleges would receive a $96 million increase, primarily to fund enrollment growth, a 2.2 percent COLA and to backfill a current-year property tax revenue shortfall. In addition, the budget proposes a $2 per unit fee increase, which would generate $20 million in additional revenues to community colleges.

The 1995-96 budget also includes a Proposition 98 loan repayment of $379 million, consistent with the existing repayment formula. As with the current-year repayment, this amount would count as a current Proposition 98 expenditure but would not be available for K-14 spending.

The budget estimates that meeting the 1995-96 Proposition 98 requirement for state funding will require a General Fund increase of $968 million. This estimate includes the impact of the proposed tax cut in reducing the Proposition 98 funding requirement.

Issues for Legislative Consideration

We have identified several issues raised by the budget proposal.

Governor's Tax Cut Affects Proposition 98. The Governor's Budget proposal to reduce income taxes over three years would significantly reduce the minimum funding guarantee under Proposition 98 below the level it otherwise would reach. In 1995-96, based on budget estimates, the tax cut would lower Proposition 98 funding by $136 million. By 1998-99, when the proposal would be fully phased in, we estimate that the annual reduction could grow to $1.8 billion, assuming moderate economic growth. Based on this projection, the tax cut would reduce the annual growth of per-pupil funding under Proposition 98 during this period from about 4 percent to about 2.4 percent. Consequently, if inflation averages 3 percent annually, as anticipated, then the proposed tax cut would result in a continued decline in K-14 purchasing power per student through the late 1990s.

Proposition 98 Loan Repayment. The budget proposes to deduct $514 million ($135 million in 1994-95 and $379 million in 1995-96) from funds provided to K-14 programs in order to begin repaying Proposition 98 loans made in 1992-93 and 1993-94. While a lawsuit *(CTA v Gould)* clouds the issue of whether the state can require these repayments under Proposition 98, an initial negative judgment against the state has been stayed pending appeal. As a result, the loan repayments continue to be required under current law. Accordingly, we recommend approval of the budget proposal. Making the loan repayments improves the state's cash position, which is crucial to the state's ability to finance the budget. Also, by improving the state's cash position, the loan repayments reduce the likelihood of potential "trigger" cuts that would be required to remedy any cash shortfall.

Governor Proposes Partial COLA. The budget proposes to appropriate $444 million in 1995-96 for a 2.2 percent COLA for K-12 general purpose and special education funding. To provide the full statutory COLA of 3.35 percent, an additional $254 million would be needed. The Legislature has expressed its desire to provide a full COLA in 1995-96. Intent language adopted as part of trailer legislation to the 1994 Budget Act commits the Legislature to providing a full COLA if (1) sufficient funding is available under Proposition 98 and (2) providing a full COLA does not result in a reduction in funding to other K-12 programs. Our review indicates that, if the Legislature approves the Proposition 98 loan repayment discussed above, providing a full COLA is not a realistic option. Instead, we recommend that the Legislature increase the COLA funds by redirecting funds from other K-12 program augmentations. Our alternative plan would provide an additional $93 million for cost-of-living increases in education.

School Safety. The budget proposes to spend $12.3 million to increase support for three school safety programs in 1995-96. Specifically, the additional funding would (1) increase by $1.1 million support for the Gang Risk Intervention Program, (2) expand by $1.2 million the School/Law Enforcement Partnership Program, and (3) provide $10 million in support for county office of education alternative programs to reflect enactment of proposed legislation that would result in an increased number of mandatory expulsions. These proposals raise two issues. First, should expulsion policies be set by the state or by local school districts? Second, under what circumstances should county offices of education—rather than school districts—be responsible for students who cannot be served in a regular classroom? We recommend an alternative approach that stresses (1) local discretion over disciplinary outcomes and (2) additional funding for school district alternatives.

HIGHER EDUCATION

California's system of public higher education is the largest in the nation, serving approximately 2 million students. This system consists of three distinct segments—the University of California (UC) with 9 campuses, the California State University (CSU) with 21 campuses, and the California Community Colleges (CCC) with 107 campuses. The UC awards bachelor's degrees and a full range of graduate and professional degrees. The CSU awards bachelor's and master's degrees and accepts students from the upper third of high school graduates. The CCC offers a variety of academic and occupational programs, as well as basic skills and citizenship instruction. It is basically open to all persons 18 years or older.

Proposal

The UC and the CSU. The budget proposes General Fund support for the UC and the CSU of $3.5 billion in 1995-96, an increase of 3.1 percent compared with estimated current-year expenditures. The budget anticipates that fees will increase by at least 10 percent for each segment, and provides an additional $11.5 million in the Student Aid Commission budget for the related Cal Grants costs. For the third year in a row, the administration does not propose budget-year enrollment levels for the UC and the CSU.

The proposed budget increase will fund a 2 percent increase in general-purpose expenditures at each segment as well as debt costs on previously authorized lease-payment bonds. The budget also authorizes the UC to obtain a $25 million loan for deferred maintenance in 1995-96. Debt payments on the loan would be made from future annual General Fund appropriations to the UC.

Community Colleges. The budget proposes $1.2 billion in General Fund local assistance for the community colleges in 1995-96. This entire amount counts towards the state's K-14 minimum funding guarantee under Proposition 98. The 1995-96 General Fund request represents an increase of $61 million, or 5.3 percent, from the amount of estimated General Fund expenditures in the current year.

The budget also proposes to raise fees from $13 per credit unit to $15 per credit unit. The combined increase proposed from the General Fund, local property tax revenues, and net student fee revenues (after accounting for financial aid) is $92 million, which represents a 3.4 percent increase in combined funding.

The budget provides $55 million to fund a 2.2 percent COLA for general-purpose spending, $25 million to fund statutory enrollment growth, and $22 million to backfill fee revenue shortfalls (primarily from the current year). The budget also recognizes savings of $15 million related to enrollment declines among bachelor's degree holders in prior years. For the first time in recent years, the budget proposes to backfill current-year property tax shortfalls ($47 million) in the current year, instead of waiting until the budget year.

Longer-Term Higher Education Budget Plan. The budget proposes a "four-year compact" with the UC and CSU which includes a commitment to provide General Fund operating budget increases averaging 4 percent for the three fiscal years beginning in 1996-97. Among other things, the plan also calls for enrollment growth averaging about one percent annually, increases in faculty salaries and capital outlay funding, "productivity improvements," and reductions in students' time to obtain an undergraduate degree.

Issues for Legislative Consideration

Again this year, the administration has not offered its views on a variety of major issues affecting the higher education segments. The budget does not specify enrollments at the UC and CSU. The administration's proposal also would leave to the UC and CSU the decisions concerning the allocation of funds among competing needs, such as salary increases, other costs of continuing existing programs, and addressing critical long-term needs, such as deferred maintenance.

Budget-Year Issues. As in past years, the Legislature faces the difficult task of determining—within significant budget constraints—how to achieve the twin goals of providing open access to higher education and maintaining high-quality programs.

In its deliberations on the higher education budget, we believe the Legislature should:

- Specify each segment's enrollment levels and hold the segments accountable for achieving them.
- Specify fee levels, including moderate fee increases, and provide for adequate financial aid.
- Address, to the extent possible, long-term critical needs such as deferred maintenance, instructional equipment replacement, and library materials purchases.
- Require productivity increases and use of non-General Fund resources (such as federal overhead funds for the UC) where reasonable.

In our *Analysis of the 1995-96 Budget Bill*, we offer alternative budget proposals for the UC and the CSU and make various recommendations for the CCC that address these issues. As a starting point, our proposals would provide about the same level of funding as allotted to higher education by the Governor's Budget. We will revise our recommended budget actions, as necessary, to reflect additional enrollment and other information that will become available in the spring.

Longer-Term Issues. The administration's proposed UC and CSU budget "compact" would absorb $1.1 billion on a cumulative basis over the four-year period beginning in 1995-96. To the extent that the Legislature provides a cumulative increase of this magnitude for higher education, its ability to address priorities in other areas of the budget will be limited accordingly. Thus, we believe the Legislature should review the proposed higher education compact in the context of its overall priorities for funding various programs, including higher education.

With regard to the programmatic aspects of the proposed compact, we note that in adopting the 1994-95 budget, the Legislature has already established some program goals and priorities over the longer term. In particular, the Legislature has acted to (1) allocate funding for specific enrollment increases, (2) require specific increases in productivity, and (3) ensure that four-year-degree pledge programs and other programs designed to shorten students' time to attain a degree are established at all UC and CSU campuses. The Legislature needs to consider whether it wishes to guarantee a portion of the budget at a specified rate of growth over a time period when the state's fiscal condition will be tight.

DEPARTMENT OF CORRECTIONS

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

Currently, the department operates 29 institutions, including a treatment center for narcotic addicts under civil law commitment. The department also operates 38 fire and conservation camps. The department will open two new prisons before the end of the current year and another two new prisons during the budget year. The Community Correctional Program includes parole supervision, operation of community correctional centers and facilities, outpatient psychiatric services for parolees, and narcotic testing.

Proposal

The Governor's Budget requests $3.3 billion from the General Fund for support of the CDC in 1995-96, an increase of $374 million, or 13 percent, over the current year. This amount provides full funding for projected growth in the number of prison inmates and parolees under current law, as well as several program changes. It also includes funds to offset the effects of inflation—the CDC is the only state department to receive a specific inflation adjustment to its non-salary costs. The budget does not propose any policy or program changes to reduce the inmate or parolee populations.

The budget's total spending figures assume that the state will receive $422 in federal funds to offset the state's costs of incarcerating, and supervising on parole, illegal immigrant adults and juveniles who have been convicted of a felony in California.

Issues for Legislative Consideration

Over the past 10 years, the CDC has been one of the state's fastest growing budgets, increasing at an average annual rate of 13 percent. Given projected increases in the state's prison population, in part due to enactment of the recent "Three Strikes and You're Out" law, the budget will likely continue to increase substantially. We estimate that the state will need to construct 21 new prisons in the next five years just to maintain the existing levels of prison overcrowding, and that annual support costs of the CDC will likely exceed $5 billion by the end of the decade.

Given the long-term implications of the CDC's projected growth on the state's budget, the Legislature may wish to consider various options for addressing these increases. These considerations could take two forms: (1) reductions in the costs of constructing new prisons and managing the existing and projected prison population and (2) reductions in caseloads themselves.

First, the Legislature will have a unique opportunity this year to consider ways to reduce the costs of managing the prison population as it considers requests by the administration for funding to construct new prisons. We recommend that the Legislature consider all options to accommodate the prison population in alternative ways that may be less costly. For example, the Legislature could direct the CDC to construct facilities that are less costly due to design features that require less staff.

Second, because the CDC is a *caseload-driven* budget, significant expenditure reductions require controlling inmate and parole population growth. Because most options would require changes in sentencing law, savings would not be immediate, but would primarily accrue in future years. For example, the Legislature could target parole supervision to violent offenders or those with a history of violence. Additionally, the Legislature could make greater use of enhanced community supervision for offenders who would be redirected from the prison system.

TRIAL COURT FUNDING

The Supreme Court, the courts of appeal, and the superior and municipal courts make up the components of the California judicial system. The Supreme Court and the courts of appeal are entirely state-supported. The state and the counties share the costs of supporting the trial (superior and municipal) courts. Currently, state expenditures for trial court operations are partially offset by a portion of the fines, fees, and forfeitures collected by the courts. Pursuant to existing law, most fines, fees, and forfeitures transferred to the state are deposited into the General Fund, while other fees (mostly civil case filing fees) are allocated by the state back to the counties.

Proposal

The Governor's Budget proposes total expenditures of $1.3 billion for support of trial courts in 1995-96. This amount is $631 million above estimated current-year expenditures, or roughly a twofold increase. This major increase is part of the financing mechanism for the Governor's state-county restructuring plan, which proposes to shift program and funding responsibilities for some social services from the state to counties. Another element of the restructuring plan proposes that counties retain fine, fee, and forfeiture revenues that they currently transmit to the General Fund (estimated to be $311 million in the budget year). The administration estimates that the entire restructuring proposal will result in net costs to counties (and savings to the state) of $241 million in 1995-96.

Issues for Legislative Consideration

There are a number of policy issues for the Legislature to consider regarding the budget proposal for trial court funding.

State Has Strong Interest in Trial Courts. We find much programmatic merit to the Governor's plan to move toward state financial assumption of the majority of trial court functions because of the compelling statewide interest in promoting the uniform application of justice, and because trial court operations are governed almost exclusively by state statutes and regulations. It will be important, however, for the Legislature to consider this change in the context of the entire restructuring plan and to determine whether the plan in its entirety is in the best interest of the state (for a full discussion of the restructuring proposal, please see Part Five of this volume).

Need for Cost Controls. The Governor's Budget indicates that the proposed expenditure level will support 70 percent of trial court costs. This level of support is consistent with legislative intent as expressed in Ch 90/91 (AB 1297, Isenberg). The Governor's restructuring plan does not make clear, however, the state's ultimate objective for the funding and operation of the trial courts. This question has important implications for the Legislature to consider. Specifically, increased state funding for the trial courts, *without greater state involvement and control over trial court expenditures,* will create a potential new source of uncontrolled costs in the state budget. Although many courts have implemented efficiencies and cost savings measures, wide cost disparities still exist among courts. Thus, we believe that if the Legislature decides to finance an increased share of trial court costs, it will be important to exercise greater control over the costs of trial court operations.

Coordination Efforts Should Be Encouraged. Recently some courts have retreated from efforts to coordinate activities of superior and municipal courts in the same jurisdictions. To the extent that courts abandon coordination efforts, costs for support of trial courts are likely to increase, thus increasing state costs. The Judicial Council is currently moving to enhance coordination efforts at the local level. We believe that the Legislature will need to do so as well by distributing state funds for trial courts based on the coordination efforts and success of individual courts.

Incentives to Collect Court Revenues. Permitting counties to retain fines, fees, and forfeitures that they currently transmit to the state is likely to increase collections because of changes in counties' incentives to collect these revenues. This could mitigate, to some extent, the net cost of the restructuring proposal to counties. Should the Legislature decide to allow counties to retain these revenues, however, it should reduce expenditures in the trial court funding budget that are proposed to support local revenue collection enhancement programs (about $35 million in 1995-96), since retaining these revenues should provide sufficient incentive for the counties to collect them.

CALTRANS STAFF REDUCTION

The Department of Transportation (Caltrans) is responsible for planning, coordinating, and implementing the development and operation of the state's transportation system. Most of Caltrans' expenditures are for the design, construction, and maintenance of the state highway system. In addition, Caltrans operates programs for mass transportation, aeronautics and transportation planning.

In the current-year, the budget estimates that Caltrans will spend a total of almost $6.2 billion (including state, federal, local, and bond funds) and that the department's staffing will total 18,866 personnel-years (PYs)—16,635 for the highway transportation program, with the remainder for the department's other programs.

Proposal

The budget proposes a staffing level of 17,640 PYs for Caltrans in 1995-96. This is a reduction of 1,226 PYs (6.5 percent) from the current-year level. The reduction has three primary components:

- ***Current-Year Reductions—252 PYs.*** In order to accommodate, on an ongoing basis, reductions imposed by the Legislature in 1994-95, Caltrans' budget proposes to eliminate 252 PYs—200 PYs in administration and 52 PYs in the highway program. Caltrans estimates savings of about $14 million from this reduction.

- ***Capital Outlay Support Workload Reduction—220 PYs.*** Because of an ongoing shortfall in transportation funding, Caltrans is proposing to reduce the number of transportation projects that it will design and construct. As a result, the department has determined that it will require 220 fewer PYs of staff for capital outlay support. The budget assumes savings of $12 million from the elimination of these PYs, plus additional savings of $3 million in related operating expenses.

- ***Unallocated Reduction—716 PYs.*** The budget also contains an unallocated reduction of 716 PYs and $76.4 million. The department has not specified how much of the total reduction is for staff costs versus savings in other types of expenses, nor has the department described how the reduction will be distributed among its various programs.

These three reductions total 1,188 PYs. The remaining 38 PYs included in the total reduction of 1,226 PYs are from miscellaneous adjustments and proposals.

Issues for Legislative Consideration

Long-Term Staffing Decline. The reduction in Caltrans' staffing makes more funds available for capital outlay projects. However, the reduction also signals a long-term trend towards a smaller Caltrans. For several years, Caltrans has been staffed at a level sufficient to design all projects that are scheduled in the State Transportation Improvement Program (STIP), even though transportation revenues were not sufficient to construct those projects as scheduled. The proposed staff reductions in the 1995-96 budget take a step towards shrinking Caltrans staff to a size that more closely corresponds to available transportation revenues.

This reduction assumes that in future years the size of the state's transportation improvement program will be determined by the level of revenue that is produced by existing transportation taxes, rather than by the number of projects in the STIP or by a determination of overall transportation needs. Should the Legislature later increase the size of the state's transportation program, it will likely take several years for Caltrans to hire and train new employees. The Legislature would, however, have other options at its disposal to implement a future increase in the transportation program. For example, contracting out could be used to accommodate workload increases (although this approach may require a Constitutional amendment), or the Legislature could transfer funds and project development responsibility to local and regional transportation agencies.

THE GOVERNOR'S TAX PROPOSAL

How Will the Governor's Tax Proposal Affect Individual Taxpayers, the State's Fiscal Condition, and the Performance of the California Economy?

Summary

The 1995-96 Governor's Budget proposes a 15 percent across-the-board income tax cut for both corporations and individuals, along with maintaining the high-income tax rates scheduled to sunset in 1996 . The plan's stated purpose is to reduce the tax burden on individuals and businesses in California so as to stimulate business location and expansion in the state, thereby improving the economy.

The plan's net cost to the state is estimated in the budget to be $225 million in 1995-96 and $7.6 billion over the four-year period ending in 1998-99. A more recent analysis by the Franchise Tax Board (FTB) estimates the four-year cost at $7.3 billion. Two-thirds of the cost comes from reduced personal income taxes and the remainder from reduced bank and corporation taxes. Benefits to individual taxpayers will vary widely, with lower income individuals receiving no savings and high-income taxpayers initially paying more in taxes. After it is fully implemented, though, the plan will benefit most taxpayers, and will produce a more progressive personal income tax structure.

The proposal will reduce California's tax burden modestly. A number of measures suggest that California's current tax burden is about average when compared to other states. The proposal will not change this result dramatically. How much of a stimulative effect this decreased tax burden will have on California's economy is open to debate. Economists disagree on what its net impact will be, and no model currently exists that has a proven track record in accurately predicting the effect of a change of the type and size that the Governor is proposing.

Ultimately, whether the Governor's tax proposal is adopted is a legislative policy choice. Important policy decisions will need to be made regarding the tradeoff between reducing taxes and funding state services. The distributional consequences of any tax change and the resulting change in the mix of public versus private spending also would need to be considered.

INTRODUCTION

One of the key features of the Governor's 1995-96 budget is a proposed tax reduction for businesses and individuals. The proposal, which retains the two highest individual income tax brackets while phasing in an across-the-board rate reduction over three years, was developed with the view that California's tax rates are too high and that reducing them will stimulate the economy and attract more businesses to California.

In this analysis, we examine the arguments for adopting a tax cut and what its fiscal impact would be on the state and on individual taxpayers. We discuss how the tax burden would change under the proposal and what its effects would be on the progressivity of California's tax structure. We also consider California's tax levels, whether a tax cut will stimulate the economy, and the overall fiscal implications of the proposal. Lastly, we discuss some options available to the Legislature if this particular tax reduction plan is not adopted but a tax change of some other type is desired.

WHAT IS THE GOVERNOR'S PROPOSAL?

The Governor's tax proposal contains two key parts:

- ***Continued High Income Tax Rates.*** The 10 percent and 11 percent personal income tax rates for high-income taxpayers that were implemented in 1991 are scheduled to return to 9.3 percent in 1996. Under the Governor's proposal, these higher rates would remain in effect. In addition, the current 8.5 percent Alternative Minimum Tax (AMT) rate would stay in place, instead of returning to 7 percent in 1996. The phased-in rate reductions would be taken off of these higher rates.
- ***Across-the-Board 15 Percent Rate Cuts for the Personal Income Tax (PIT) and the Bank and Corporation (B&C) Tax.*** All tax rates will be reduced by 5 percent increments each year over a three-year period. Thus, by 1998, all PIT and B&C tax rates will be 15 percent lower than their 1995 levels. At that time, the highest rate under the proposal would be 9.3 percent—the same as it would be under current law.

Why Has a Tax Cut Been Proposed?

In January 1994, during his State of the State Address, the Governor requested that his Council of Economic Advisors organize a task force to study and advise him on how to reduce taxes so as to stimulate job growth in the state. The resulting Task Force on California Reform and Reduction reviewed the state's fiscal structure in light of historical trends and present forecasts. It also focused on the reasons behind the decline of the state's tax revenues in the early 1990s. In late December, the Task Force presented its findings and recommendations on how to reduce taxes so as to spur employment and economic growth.

Findings of the Task Force

California's Tax Burden Is High. According to the Task Force, one of the key reasons for the decline in California tax revenues in the early 1990s was that California's tax rates had reached levels where they were inhibiting revenue growth. In particular, it concluded that the state's high marginal PIT and B&C tax rates gave individuals and businesses an incentive to locate elsewhere and shift economic activities out of state.

The Task Force emphasized that high corporate tax rates play a part in eroding California's competitive position relative to neighboring states, and that to improve the state's business climate, these rates should be reduced. Moreover, by lowering PIT rates for all Californians, businesses would not have to compensate workers for high taxes with higher wages, thus lowering their labor costs and increasing their profits. In addition, individuals would keep a higher percentage of their income, which would stimulate work incentives and increase productivity.

Reducing Taxes Will Stimulate Employment. According to the Task Force, firms and investors would see the rate reductions as a signal that the state is concerned about its business climate, and it would play a favorable role in business location decisions, both attracting new firms to California and encouraging already-established firms to remain and invest additional monies in the state. As more firms locate and expand in California, more jobs would be created, which in turn would benefit both individuals and the state's economy in general.

Government Funding Will Still Be "Adequate." The Task Force concluded that total funds available for spending on state programs would grow a little faster than needed to compensate for population and inflation, even with a tax cut in place. The Task Force acknowledged that spending restraint would be required, but noted that the state could provide public services more effectively and efficiently than it does currently.

A "top-down" budgeting approach was suggested by the Task Force. This approach takes the tax revenues that are available (in this case, reduced for the proposed tax cut) and then sets aside funds for certain spending requirements (Proposition 98 and debt service). It then marks all remaining funds for "discretionary" use. As noted above, the Task Force acknowledged that because discretionary revenues would be limited, hard choices would have to be made regarding the funding of the remaining program areas in the budget.

What Is the Cost of the Governor's Tax Proposal?

Costs to Reach Over $7 Billion by 1998-99. Figure 1 shows the budget's estimate of how the state would be affected by the Governor's proposal. The cumulative cost by 1998-99 to the state of the rate reduction alone is $10.6 billion. However, this amount is offset by $3 billion due to retention of the high-income PIT rates. Thus, the budget estimates that the net state four-year revenue reduction would be $7.6 billion.

Since the budget was released, the Franchise Tax Board (FTB)—which administers both income taxes—has made its estimate of the proposal's fiscal impact. The FTB's estimate for the first four fiscal years is $7.3 billion, or $300 million less than the budget's estimate.

Figure 1

State Revenue Effects of the Tax Reduction Proposal 1995-96 Through 1998-99

(Dollars in Billions)

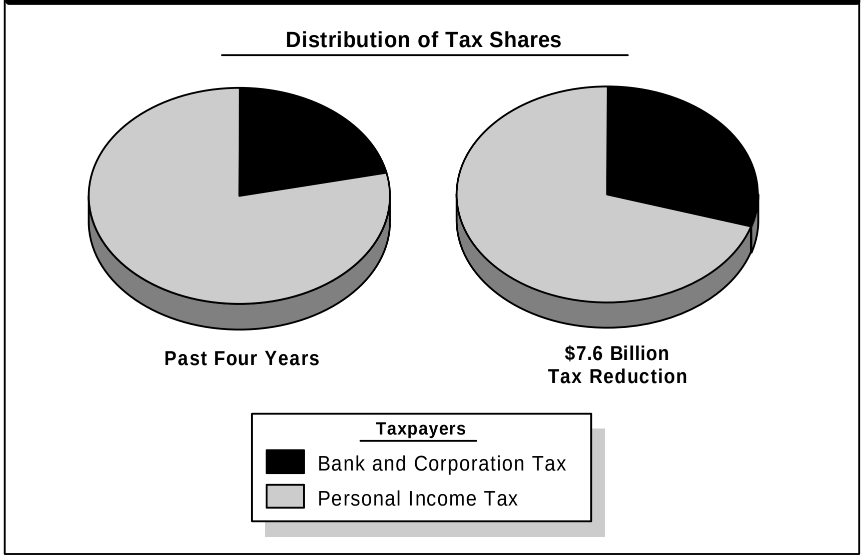
State Revenue Effects	1995-96	1996-97	1997-98	1998-99	Four-Year Total
Personal Income Tax					
Continuation of high-income tax brackets after 1995	$0.3	$0.8	$0.9	$1.0	$3.0
Phase-in of 15 percent tax cut	-0.4	-1.5	-2.7	-3.6	-8.3
Net effect	**(-$0.1)**	**(-$0.7)**	**(-$1.9)**	**(-$2.7)**	**(-$5.3)**
Bank and Corporation Tax					
Phase-in of 15 percent tax cut	-$0.1	-$0.4	-$0.7	-$1.0	-$2.3
Total State Revenue Effect	**-$0.2**	**-$1.1**	**-$2.6**	**-$3.6**	**-$7.6**

[a] Source: Department of Finance. Detail may not add to totals due to rounding.

Individuals Receive Over Two-Thirds of Benefits. Figure 2 shows the share of the net tax savings going to PIT filers versus B&C tax filers. Based upon the budget, over two-thirds of the net revenue benefits go to individuals and the remainder to corporations. The share that corporations receive is a bit larger than their share of tax liabilities in recent years. This is because certain individuals do not receive the full amount of the rate reduction because of the retention of the 10 percent and 11 percent rates. In the following section, we show that these individuals initially pay more under the proposal than under current law. Absent these high brackets, the distribution of the tax reduction between the PIT and the B&C tax would be similar to their tax shares in recent years.

Figure 2

Distribution of Net Tax Reduction 1995-96 Through 1998-99



HOW WILL INDIVIDUAL TAXPAYERS BE AFFECTED?

Because the dollar amount of the tax reduction is based upon income levels and tax rates, the dollar amount of tax savings that individuals and businesses would receive varies widely. In general, by 1998, the higher an individual or corporation's tax liability, the greater the dollar amount of tax reduction they will receive under the tax proposal. How much specific taxpayers would benefit is addressed in the following sections.

About Half of All Corporations Will Benefit

According to the FTB's most recent annual report, nearly one-half of all corporations in California reported either a net loss or no income for the 1992 tax year. Such corporations would receive no tax savings because they do not have any tax liabilities. Of the 50 percent of corporations that did file with a positive net income, one-tenth of one percent had incomes over $10 million and paid nearly 60 percent of the total tax liability. Thus, most of the tax savings would be going to these corporations because of their high tax liabilities.

Benefits to Individuals Will Differ

Figure 3 shows how individual taxpayers with different income levels would be affected in 1996 through 1998, as the tax proposal is phased in. For illustrative purposes, the examples used in this section are for a married couple filing jointly, with two children and tax deductions equal to the average of California taxpayers having the same income level. The figure displays both the state tax savings from the rate reduction, and the net tax savings after adjusting for higher federal income taxes. Federal income taxes are increased because, in most cases, lower state tax liabilities reduce the amount of itemized deductions a taxpayer can claim for federal income tax purposes. This is because state income taxes are an allowable itemized deduction on federal tax returns. Thus, except for high-income individuals in 1996 and 1997, the taxpayers' federal income tax increases. This federal tax increase from current-law levels is deducted from total state tax savings to arrive at the net amount. In the case of B&C taxpayers, their state taxes also are deductible, but as a business expense; thus, they also would generally see their federal taxes rise.

Figure 4 displays the aggregate impact of the federal offset. About one-fourth of the state tax savings for individuals and businesses is offset by an increase in federal income taxes because of lower deductions. In the case of the PIT, however, this proportion differs by income level. By 1998, taxpayers with income over $1 million have over one-third of their state tax savings offset by higher federal income taxes, compared to less than one-tenth for those individuals with income levels under $25,000. This reflects the progressive nature of the federal PIT bracket structure. Figure 5 (see page 118) shows how the tax proposal distributes savings over the phase-in period taxpayers.

Low-Income Taxpayers Receive No Benefits. Individuals that have no tax liabilities, as with corporations having no liabilities, do not receive any tax savings under the proposal. Thus, a married couple with income of $20,000 or below would not receive any tax reduction from

Figure 3

Tax Reduction Proposal
Effects on Individuals, by Income Level[a]
1996 Through 1998

Adjusted Gross Income	1996		1997		1998	
	State Tax Savings	Net Tax Savings	State Tax Savings	Net Tax Savings	State Tax Savings	Net Tax Savings
$20,000	$0	$0	$0	$0	$0	$0
40,000	34	29	66	56	96	82
60,000	74	63	142	121	206	175
80,000	130	94	252	181	365	263
100,000	210	151	407	293	593	427
150,000	410	283	807	557	1,193	823
200,000	628	402	1,244	858	1,849	1,276
250,000	826	529	1,639	1,049	2,441	1,563
500,000	384	232	2,562	1,547	4,666	2,818
1,000,000	-5,078	-3,067	-175	-106	4,896	2,957

[a] Data are for a married couple filing jointly, with two children and average itemized deductions for their income level. Negative amounts reflect tax increases. Net savings equals state savings adjusted for related increases in federal income taxes (resulting from lower itemized deductions).

Figure 4

Total Versus Net State Tax Savings
Individuals and Businesses
1996 Through 1998

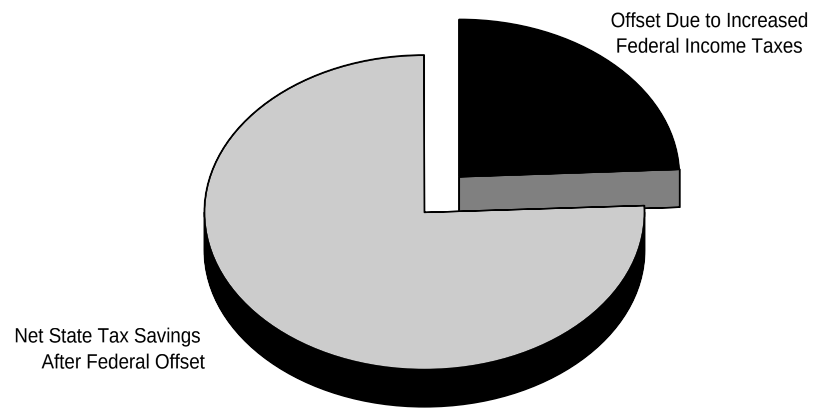
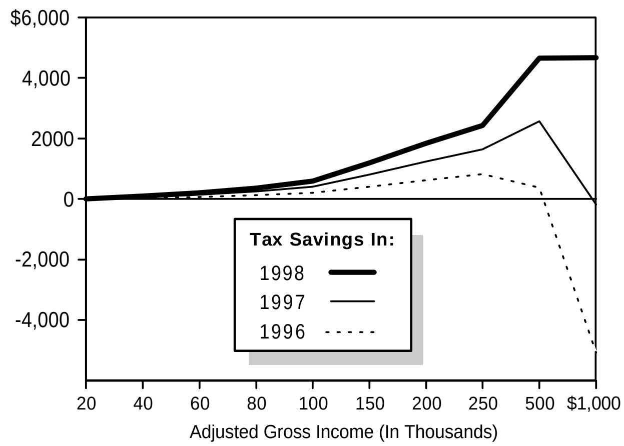


Figure 5

Tax Proposal — State Tax Effects On Individual Taxpayers By Year and Income Class 1996 Through 1998



the tax proposal. Such taxpayers have no current-law liability, either because they have little taxable income or what taxes they do have are eliminated because of their personal and dependent credits.

High-Income Taxpayers Will Initially Pay More. A married couple with income over $1 million would initially pay more under the tax proposal because of the retention of the high-income tax rates. Specifically, a married couple with income of $1 million would have net tax increases of $3,067 in 1996 and $106 in 1997. Under certain conditions, high-income individuals may end up paying more under the proposal even after it is fully phased in. This is because their Alternative Minimum Tax (AMT) could increase.

All Other Taxpayers Will Eventually Benefit. In 1996, all taxpayers with income levels under $500,000 (except those low-income taxpayers mentioned above) would receive some tax savings. By the time the proposal is fully-phased in, high-income individuals would also realize a reduction in their taxes.

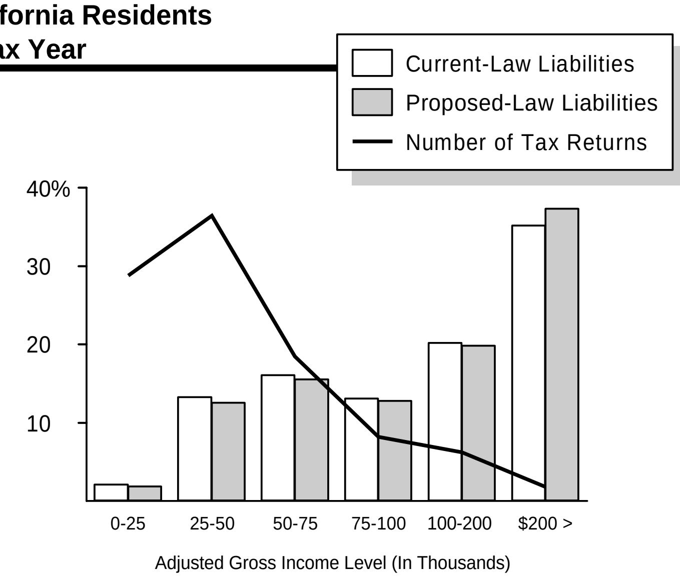
Tax Structure Slightly More Progressive

The tax proposal would produce a slightly more progressive PIT structure for California, largely due to retaining the high-income rate brackets. Under both current law and the tax proposal, taxpayers with higher levels of income bear a proportionately greater share of total tax liabilities than do lower-income taxpayers. Under the proposal, this effect increases.

Figure 6 shows the distribution by adjusted gross income (AGI) of tax liabilities under both current and proposed law, compared to the distribution of taxpayers. It shows that taxpayers with income over $200,000 as a group would pay a larger share of total tax liabilities—about 2 percent higher under the proposal, whereas all income levels below this would experience slight drops in their shares of total tax liabilities. The figure also shows that under current law, high-income taxpayers, who represent less than one-tenth of all taxpayers, would pay almost 60 percent of the total tax burden. This proportion would increase slightly under the proposed system. Thus, the PIT structure becomes more progressive under the tax proposal because a greater share of the tax liabilities is borne by higher income individuals.

Figure 6

Taxpayers and Tax Liabilities By Income Class
All California Residents
1998 Tax Year



The average tax rate is another indicator of how the distribution of the tax burden changes under the proposed tax plan. Figure 7 shows that, for 1998, there is over a half a percentage point drop in the total average tax rate under the tax proposal. The average rate drops the least in percentage terms for individuals with income levels over $1 million (1.8 percent) and the most for individuals with income less than $20,000 (22 percent). Thus, the average tax rate structure becomes more progressive under the proposal.

Figure 7

Average Tax Rate by Income Class, 1998[a]

Adjusted Gross Income	Current Tax Law	Proposed Tax Law	Percentage Decline
$0-25,000	0.77%	0.60%	22.1
25,000-50,000	2.44	2.02	17.2
50,000-75,000	3.67	3.10	15.5
75,000-100,000	4.78	4.09	14.4
100,000-200,000	6.33	5.43	14.2
200,000-500,000	8.13	7.15	12.1
500,000-1,000,000	8.80	8.16	7.3
1,000,000 and over	9.08	8.92	1.8
Totals	**4.43%**	**3.87%**	**12.6%**

[a] Rates are for all filing statuses (California residents only).

WHAT ABOUT CALIFORNIA'S TAX LEVELS?

High tax rates were cited by the Governor's Task Force as a key problem for California's business climate and the state's economy. The following section compares California's tax levels to other states to see how we rank in terms of tax levels.

Marginal Rates Are High

California's tax rate for corporations is generally a flat 9.3 percent under current law. Compared to other western states, it is among the highest, being surpassed only by Alaska. Arizona has the next highest rate at 9 percent. Among major industrial states, California's tax rate is more comparable. Pennsylvania and Massachusetts have higher rates than California, and New York, New Jersey, and Ohio are currently at or near 9 percent.

Figure 8 shows the 1994 marginal PIT rate schedule for individuals. While the example is for a married couple filing jointly, the structure is the same for single tax filers but all dollar values are halved. The marginal tax rates for high-income individuals are above those for other western states. Lower-income Californians, however, face lower tax rates than in many other western states. For example:

- Oregon's highest tax rate (9 percent) applies to a married couple with joint taxable income slightly over $10,000. In California, a similar couple would be taxed at a 2 percent marginal rate and would not face a 9 percent tax rate until taxable income was over $60,000.
- A married couple in Utah with income of about $15,000 would be taxed at a 7.2 percent marginal rate (this includes the effect of a large exemption). In California, a similar couple would be taxed at a 2 percent marginal rate and would not face a 7.2 percent rate until taxable income exceeded almost $50,000.
- Californians with taxable income significantly over $60,000, however, would face lower marginal rates in both Oregon and Utah.

Figure 8

1994 Personal Income Tax Rate Schedule For Married Individuals Filing Jointly[a]

If taxable income is:		Computed tax is:			
Over	But not over				of the amount over:
$ 0	$9,444	$ 0.00	+	1.0%	$ 0
9,444	22,384	94.44	+	2.0	9,444
22,384	35,324	353.24	+	4.0	22,384
35,324	49,038	870.84	+	6.0	35,324
49,038	61,974	1,693.68	+	8.0	49,038
61,974	214,928	2,728.56	+	9.3	61,974
214,928	429,858	16,953.28	+	10.0	214,928
429,858	and over	38,446.28	+	11.0	429,858

[a] Tax rate schedule for single taxpayers is the same except all dollar amounts are halved.

Marginal rates, however, are only one part of the tax structure. Other factors that should be considered when making interstate tax comparisons include deductions, exclusions, exemptions, and credits. Two studies that have attempted to include such elements (completed by the Minnesota Department of Revenue and the consulting firm of KPMG Peat Marwick for the Governor of North Carolina) arrive at conclusions similar to those illustrated above. That is, low-income taxpayers face lower tax liabilities and high-income taxpayers pay more in taxes in California than many other western states. While these studies make several generalized assumptions that may not reflect specific tax conditions for all taxpayers in each state, they give a sense of California's ranking relative to other states.

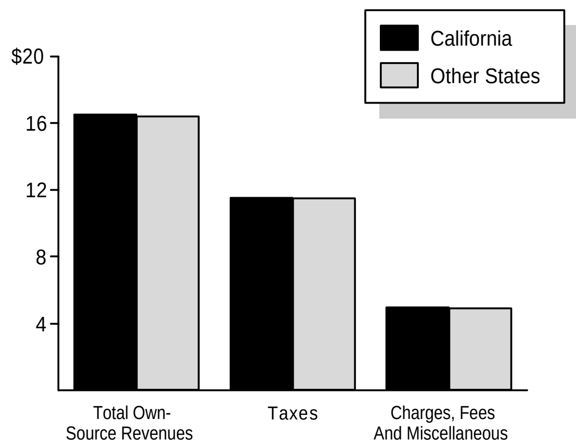
California About Average in Terms of Average Revenue Burden

Average revenue burden is another measure that can be used to make interstate tax comparisons. Most comparisons below are made in terms of revenues or taxes relative to personal income rather than in per capita terms. Many economists believe that expressing taxes relative to personal income is the better measure because per capita comparisons do not standardize for income level differences across states.

Figure 9 shows that, according to U.S. Department of Commerce figures for 1991-92 (the most recent data available), California is about average in terms of revenue burden per $100 of personal income. California is about 1 percent above the national average in total own-source revenues, while its total state and local tax revenues are less than one-half of a percent above the average.

Figure 9

State and Local Revenues Per $100 Personal Income 1991-92



If we focus strictly on tax revenues per $100 personal income, Figure 10 shows state taxes are about 11 percent higher than the average of other states, while local taxes were about 14 percent below the average.

Figure 10

State and Local Taxes Per $100 Personal Income 1991-92

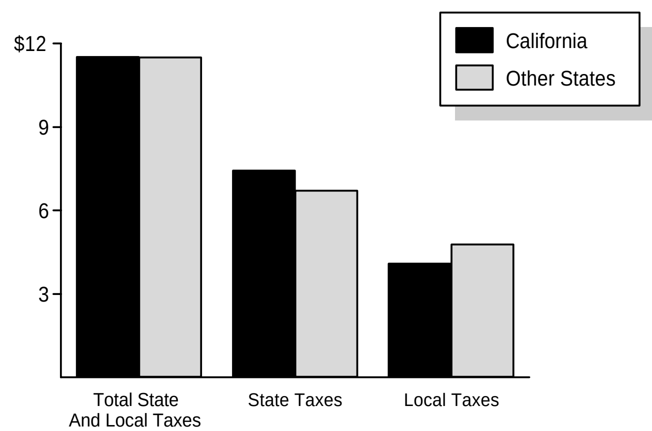


Figure 11 (see next page) compares California state and local tax burdens to the average of other western states (excluding Alaska) and the average of other major industrial states. California's total state and local tax burden per $100 of personal income is about 2.5 percent lower than the average of western states and about one-fourth of a percent lower than industrial states. California ranks between western and industrial states in terms of both state taxes and local taxes.

Figure 12 (see next page) shows that, in per capita terms, California is slightly higher than western and industrial states for state-local taxes combined and state taxes alone. By most measurements, California is about average in terms of average revenue or tax burden. This is a common view amongst economists who follow such data.

Figure 11

California Tax Revenues Per $100 Personal Income Compared to Other Western and Industrial States 1991-92

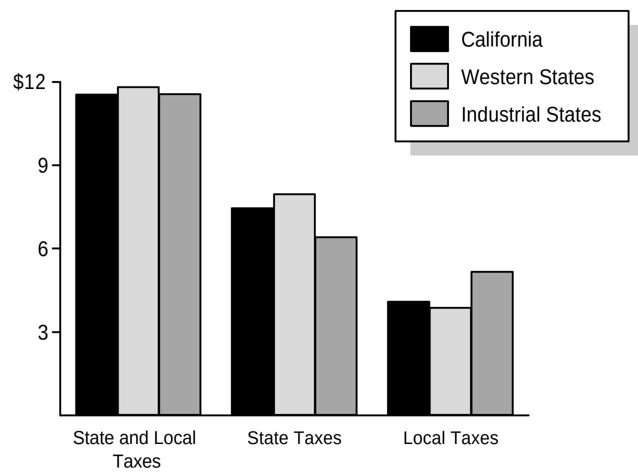
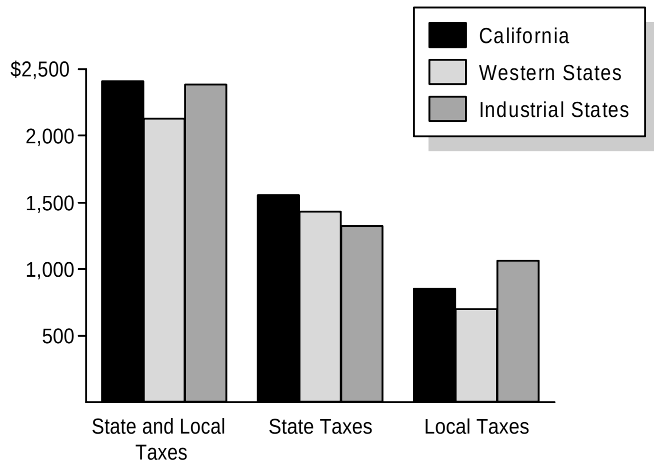


Figure 12

California Tax Revenues Per Capita Compared to Other Western and Industrial States 1991-92

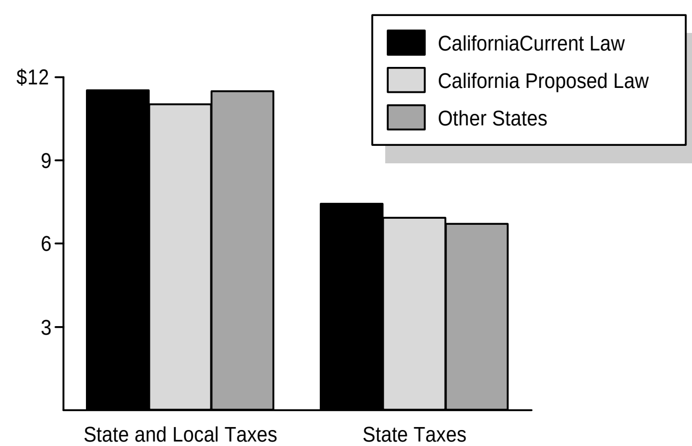


The Impact of the Proposal on Average Tax Burden

How does the tax proposal affect the comparisons made above? Figures 13 and 14 (see next page) show the level of California tax revenues under current and proposed law compared to average tax revenue levels in other states (again, as of 1991-92). (We calculated the impact of the proposed tax cut by applying the fully phased-in percentage tax reduction to 1991-92 California tax levels.) California state and local taxes per $100 of personal income with the proposal in place would have been 4.1 percent below the average of other states, and state taxes would have been 3.3 percent (instead of 11 percent) higher than other states. In per capita terms, California would still have higher tax levels, though the gap between it and other states would narrow. Even adjusting for the tax proposal, however, the drop in relative tax burden is fairly modest, and California still appears to be an average state.

Figure 13

Illustrative Effect of Tax Proposal on Taxes Per $100 Personal Income 1991-92

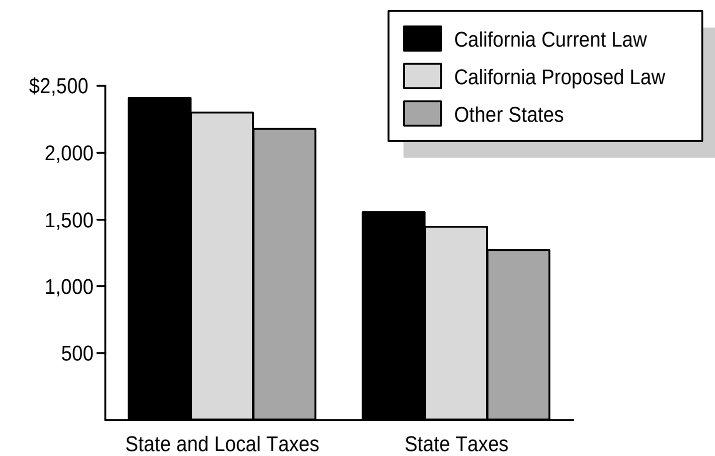


Other Factors Influencing the Business Climate

California's state and local tax burden clearly does play a role in affecting the state's business climate. There are other elements, though, that should be considered when evaluating the state's competitiveness

Figure 14

Illustrative Effect of Tax Proposal on Taxes Per Capita 1991-92



and comparing it to other states. Figure 15 lists some key factors that economists agree influence the business climate.

The effect of each factor on business location decisions varies, depending on the particular industry and taxpayer involved. However, taxes are sometimes focused more heavily upon in discussions and debates about the business climate than are some of the other elements in Figure 15, because taxes are one factor that is changeable in the short-run. Changes in other factors, such as infrastructure, usually require time to evolve, and some factors, such as climate, can not be altered by policy decisions at all.

HOW WILL THE ECONOMY BE AFFECTED BY THE TAX PROPOSAL?

There is little debate that the proposed tax reduction would benefit most taxpayers, and the state's economy would profit from individuals and businesses investing or spending their tax savings in California. The question that remains, though, is how much net economic stimulus can we expect from the tax proposal, especially when offsets are considered.

Figure 15

Key Factors Influencing Business Climate

- ✔ Access to Markets
- ✔ Infrastructure, Including Transportation Facilities
- ✔ Labor Force Availability, Skill-Level and Costs
- ✔ Living Costs and Overall Quality of Life
- ✔ Regulatory Environment
- ✔ Resource Availability
- ✔ Tax Structure and Incentives
- ✔ Weather and Climate

Some Stimulus Will Occur

Behavioral and Dynamic Feedback Effects. The topic of behavioral and dynamic feedback effects relates to the revenue impacts that tax law changes produce in addition to their direct static revenue impacts. Static revenue analyses assume that economic activity is unaffected by tax law changes. In contrast, dynamic analyses recognize that tax law changes can result in both (1) direct behavioral responses by individuals, businesses and governments, and (2) feedback effects. Feedback effects occur because direct effects trigger further behavioral responses. For example, in the case of a gasoline tax increase, a static analysis would assume a revenue gain based on current levels of gasoline consumption. Alternatively, a dynamic analysis might predict less of a revenue increase, because of behavioral changes that could reduce gasoline consumption, such as driving less, and feedbacks, such as reduced spending on other goods after paying more for gasoline.

Increased After-Tax Income Will Encourage Growth. All else constant, increasing the amount of after-tax income individuals and businesses receive will tend to stimulate economic growth. A significant portion of the increase in individual after-tax income can be expected to go toward consumption. In addition, part of the tax savings will go towards investments by businesses and individuals, another form of spending, and some will go into savings. All of these responses can stimulate economic growth, directly or indirectly. However, the size of impact will vary according to the specific use of the funds.

How Much Growth Will Occur? There is considerable debate among economists regarding the fiscal and economic impacts of tax law changes, especially at the state-local level. One important reason involves the types of government spending that tax reductions displace, including how the public values the resulting cutbacks, and subsequently how much of the tax savings will go towards activities in the state that actually stimulate economic growth. Some research has concluded that these effects can be significant, while other studies conclude that the net impact is minimal. Other studies have concluded that state-local tax policies can definitely affect the behavior of certain *individual* taxpayers, but in the *aggregate* have much less identifiable or significant effects.

To date, state governments have rarely attempted to quantify feedback effects of state tax law changes on their economies or on their revenue collections. Revenue analyses done in California by the FTB, the Board of Equalization (BOE), and the DOF, have to varying degrees attempted to consider certain direct behavioral responses in evaluating tax law changes, but have not in the past comprehensively evaluated the dynamic feedback effects of such changes. The FTB in particular does estimate the effects of direct behavioral responses using various modelling approaches and assumptions; therefore in this respect, its estimates are not static. Existing law adopted in 1994 now requires the DOF to incorporate dynamic effects into its revenue analyses under certain conditions and when reasonable. Our office has a similar requirement, but only for tax law changes proposed in the budget. Initial steps have been taken toward developing methodologies to meet these requirements. For example, the DOF has requested funds in the 1995-96 budget to pay for contract work and staff in this area. At present, however, a proven tool for accurately estimating dynamic feedback does not exist, either in California or elsewhere.

In an effort to see whether we could draw any conclusions about what the dynamic feedbacks of the Governor's tax proposal might be, we conducted a review of what 25 other states had seen happen when they made major changes to state taxes in the past. Figure 16 (see next page) summarizes what other states told us were their experiences with major tax law changes in the past 15 years. The bottom line is that little is known regarding dynamic feedback effects. Of those states that have attempted to conduct dynamic analyses, only Massachusetts has completed more than a few. And, even in this case, validating the results of this work and other static analyses is often difficult because states do not conduct retrospective analyses. (A retrospective analysis looks back at tax law changes and measures what their effects actually were.) While states are interested in discerning the dynamic feedback effects of tax law changes, many factors (including those in Figure 16) have precluded them from doing so.

Offsets Also Will Occur

Any feedback effects that occur from the Governor's tax proposal will be mitigated by several offsetting factors. The most significant are off sets resulting from various "leakages." For example, many corporations doing business in California have multi-state or multi-national operations; thus, a tax reduction might be used by certain companies for investments and activities outside of California, reducing the feedback effects on revenues here. Likewise, if the funds are saved, they might end up financing economic activities elsewhere, given the national and international nature of our capital markets today. And, as earlier noted, additional offsets would occur if the state cuts spending in certain areas to pay for the tax reduction. For example, some individuals and businesses might have to use tax savings to supplement activities that the state has chosen to cut-back, partially offsetting the positive impact of the tax cut on the economy.

DIFFICULT DECISIONS WOULD NEED TO BE MADE

As the Task Force noted, under a "top-down" budgeting approach, many hard choices would have to be made with a tax cut in place because of restricted revenue growth. Decisions would have to be made to cut certain program areas, and the state could be faced with ongoing tight budgets.

One-Third of New Revenues Would Be Lost. In Part One, we discussed what the budget pressures might be with the tax proposal in effect. We estimated, and Figure 17 shows, that of the $24 billion of cumulative new resources between 1995-96 and 1998-99 under a moderate-growth scenario, nearly one-third would be redistributed back to taxpayers through the tax proposal. After distributing revenues for Proposition 98, debt service, and employee retirement, about one-fourth of increased revenues would be left for other program areas. The Proposition 98 amount is about $3.9 billion less than what it would be absent the tax cut because, under existing law, educational spending declines with reductions in General Fund revenues.

Figure 16

Experiences in Other States Analyzing Tax Law Changes

✔ Few Dynamic Analyses Have Been Attempted

- Static analyses are generally done
- Limited dynamic analyses have been done in two states—Massachusetts and Minnesota

✔ Analyses are Prospective Rather than Retrospective

- Results often cannot be validated

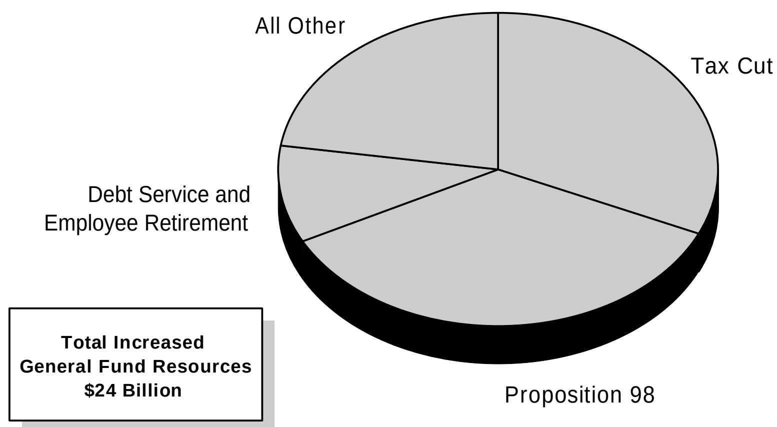
✔ Many Factors Create Problems in Identifying and Measuring Effects of Tax Changes, Including:

- Recessions, federal tax law changes, and structural adjustments in state economies that also are affecting revenues
- Data limitations
- Distinguishing between cause and effect when both tax laws and economic activity change
- Timing lags between when policy changes occur and behavioral effects result
- Lack of empirical evidence and limitations of economic theory
- Sorting out the effects of multiple law changes occurring simultaneously
- Resources constraints

This estimate did not include the establishment of a budget reserve fund, nor the impact of certain factors, such as the renters' credit, which is scheduled to go back into effect in the future. It also implicitly assumes the state will win several costly lawsuits currently being appealed. Thus, this analysis probably overstates the actual amount of resources available for other programs. It is likely that with the tax proposal in effect, the state would face tight budgets in the years to come.

Figure 17

Distribution of Increased Resources Under the Governor's Budget Plan 1995-96 Through 1998-99



SHOULD OTHER ALTERNATIVES BE CONSIDERED?

The Governor's tax reduction proposal is but one method for reducing the state's tax burden. Figure 18 (see next page) shows several of the many different other tax-related policy choices that could be considered, depending on the objective or desired outcome.

One would be lowering other tax rates, such as the state sales tax rate. This would affect essentially all Californians and have its own effect in terms of changing the distribution of the tax burden. Fundamental changes in the PIT bracket structure also could be considered, such as by eliminating certain brackets or establishing a flat tax. These options would also redistribute the tax burden. In both cases, revenues would decline and the progressivity of California's overall tax structure would change.

Figure 18

Alternatives to the Governor's Tax Proposal

- ✔ **Changing Other Tax Rates**
- ✔ **Altering the Personal Income Tax Bracket Structure**
- ✔ **Broadening Tax Bases**
- ✔ **Modifying or Eliminating Existing TEPs**

Broadening the tax base in order to lower tax rates also could be considered, such as a value-added tax (VAT) or a similar consumption-based tax. These again would change the distribution of the tax burden. The existing sales tax also could be applied to certain services. Another less sweeping possibility involves modifying or eliminating certain existing tax expenditure programs (TEPs), so as to broaden the tax base and thereby allow for rate reductions. By reducing the amount of TEPs, the tax burden could be eased for those taxpayers who do not currently qualify for them.

Thus, the Governor's tax proposal is but one of many options for changing the existing tax structure and providing for a tax reduction that changes the tax burden. In evaluating the Governor's tax proposal, or any alternative proposals, the Legislature will need to first decide what its fundamental tax policy objectives are, and then what types of tax changes, if any, are needed to best achieve these objectives. The fiscal and distributional consequences should be examined to ensure that they are consistent with legislative objectives, such as the desired mix of public versus private spending in the state.

THE GOVERNOR'S 1995-96 STATE-COUNTY REALIGNMENT PROPOSAL

What Elements of the Governor's 1995-96 Realignment Proposal Should the Legislature Adopt as It Seeks to Restructure the State-County Relationship?

Summary

The 1995-96 Governor's Budget includes a realignment proposal which would increase county funding responsibility for the Aid to Families with Dependent Children (AFDC) Program and for several children's services programs. Most of the additional county costs would be offset by increasing the state share of the trial court program and by a transfer of sales tax and trial court revenues to the counties.

The Governor's proposal is similar in some respects to a restructuring proposal offered by this office in 1993. The Governor's proposal, however, is narrow in its focus and asserts that shared interests justify extensive sharing of program responsibilities. In contrast, our Making Government Make Sense *proposal focused on the broad structure of the state-county relationship and sought to maximize separation of responsibilities to enhance accountability.*

As an initial step in achieving a better state/county partnership, the Governor's proposal is, in our judgment, seriously flawed because it exacerbates budgetary pressures on county governments while giving the counties few tools with which to control costs and guide local destinies. One portion of the proposal, however, relating to the realignment of children's services programs, does have considerable merit and we believe that it should be seriously considered by the Legislature.

To assist the Legislature in crafting a plan of action for 1995-96 which will move the state towards the critical objective of restructuring California's dysfunctional system of government, we outline the elements of the Governor's proposal and evaluate its fiscal implications for both the state and the counties. In addition, we suggest ways in which the proposal for realignment of children's services programs could be improved.

INTRODUCTION

The relationship between the state and local governments has been characterized by considerable tension in recent years. Although these tensions were present even before the passage of Proposition 13, they have been exacerbated by a more restrictive fiscal environment and an increasing tendency towards state control of programs and services. The property tax shifts of the last three years have further reduced the fiscal capacity of local governments, especially counties, and there is a growing recognition that the existing relationship between the state and local governments must be changed.

Background

In *The 1993-94 Budget: Perspectives and Issues* we reviewed the problems that characterize California's dysfunctional system of state and local government. We offered a set of principles to guide the state's efforts to address this problem, and presented a proposal for restructuring the state and local government relationship. Our *Making Government Make Sense* model generally urged a greater separation of state and local government program responsibilities and funding sources, in order to promote both greater innovation and accountability for program results. It advocated a three-step process for restructuring the state and local relationship, beginning with an examination of the assignment of governmental responsibilities for program control and delivery of services. This would be followed by changes in the allocation of resources to support the changes in assignment of program responsibilities, and the establishment of incentives and sanctions to promote the achievement of public goals. This proposal contributed to a broader discussion of the role of governmental structure in achieving higher levels of governmental effectiveness, but did not result in any legislative action.

In the following year, the *1994-95 Governor's Budget* contained a new proposal for governmental restructuring. Aimed primarily at the state-county relationship, the proposal sought to increase county shares of cost in existing health and welfare programs, and balance these increased costs with increased revenues transferred to counties from the state. The proposal would have resulted in a greater decentralization of programs and funding relative to what exists today, and in this sense moved in the same direction as our *Making Government Make Sense* proposal. The proposal's assertion that shared interests justified extensive sharing of program responsibilities marked the major area of difference with our earlier proposal.

In addition, the discussion of changes in the state-local relationship has been receiving considerable attention on other fronts within the state. The Constitutional Revision Commission created by Ch 1243/93 (SB 16, Killea) is in the process of preparing a proposal for constitutional reform, and changes to the state-local relationship are expected to occupy a major portion of its effort. The Commission plans to issue its first report in August 1995. Any of its proposals accepted by the Legislature would appear on the statewide ballot during 1996. Other organizations, such as the California State Association of Counties and the League of Cities, have prepared major working papers on the topic. In addition, a coalition of non-public sector organizations has engaged in a "consensus project" on this topic with the assistance of academic sponsors.

Recent discussions at the federal level could lead to a reshaping of the federal-state partnership and in turn continue the momentum for state-local restructuring. Recent federal proposals could dramatically increase the ability of states to design their own approaches to the administration of social services programs. If enacted, these proposals, at a minimum, could eliminate some of the perceived obstacles to the state-local restructuring proposals that have been discussed in the past. More positively, they also could encourage the consideration of new approaches to collaboration in service delivery.

These developments appear to indicate that there is a significant opportunity to make changes to the state-local relationship in the coming year. The administration has presented its second proposal for restructuring in *The 1995-96 Governor's Budget*, and this report presents our analysis and evaluation of its viability. In general, we conclude that the Governor's proposal fails to address many of the serious problems facing California in the years ahead, and does not take advantage of the opportunities that are present today. In our view, the Legislature should recognize the changing context and fiscal resources of governments at all levels as it fashions its own course of action for 1995.

1995-96 Proposal

The 1995-96 Governor's Budget contains a proposal for restructuring the relationship between county governments and the state. Borrowing significantly from the approach used in the 1991 state-county program realignment, this proposal increases county shares of cost in existing social services programs, and balances most of these increased costs with (1) increased revenues transferred to counties from the state and (2) increased state share-of-cost in other programs.

In this report, we review the Governor's proposal and its fiscal implications. In addition, we discuss our concerns with the proposal. We make recommendations about which portions of the proposal should be seriously considered by the Legislature, and which portions of the proposal should be rejected because they serve to exacerbate underlying problems in the state/county relationship.

WHAT IS THE GOVERNOR'S PROPOSAL?

Overview

Figure 1 illustrates the shifts in financial responsibility and funding associated with the Governor's proposal. As the figure shows, the administration's estimates indicate that counties would face increased costs of approximately $1.9 billion in a variety of social services programs. These costs would be offset by increased county resources amounting to $1.6 billion, resulting in a net cost to the counties (and savings to the state) of $241 million. To compensate the counties, the Governor proposes legislation to abolish the state mandate for General Assistance, as well as relief from state mandates in the indigent health, public health and mental health programs.

These elements of the proposal are described in more detail below.

Increased County Responsibilities

Higher County Share of Cost for Aid to Families with Dependent Children (AFDC). As shown in Figure 1, the county share of the non-federal program costs of AFDC grants would be increased from 5 percent to 50 percent. The administration believes that giving counties a higher share of costs will give them a strong fiscal incentive to make program investments in job training, employment services, and other services that will contribute to a reduction in welfare dependency.

Counties to Take Over Social Services Programs. Under the administration's proposal, complete financial and program responsibility for the Foster Care, Child Welfare Services (CWS), adoptions, and child abuse prevention programs would be transferred to the counties. Counties would have discretion to determine service levels and approaches to service delivery (within the constraints of federal regulations), and the involvement of state agencies in these program areas would be limited. These program transfers reflect a recognition of the linkages that exist among these and other community-based services. By allowing counties greater flexibility in the operation of these programs, the administration expects the results to be a service delivery system which is more callaboratively innovative and outcome-based.

Figure 1

State and County Realignment Proposal 1995-96

(Dollars in Millions)

Program	County Share of Nonfederal Costs 1994-95	1995-96	Amount
Cost shifts to counties			
AFDC-FG&U	5%	50%	$1,157.3
AFDC-FC	60	100	308.3
Foster Care Administration	30	100	20.4
Child Welfare Services[a]	30	100	289.5
Adoptions Assistance Program (AAP)	25	100	61.3
AAP Administration	—	100	1.1
Other Adoptions Programs[b]	—	100	20.8
Child Abuse Prevention[a]	—	100	8.8
Subtotal			$1,867.6
Revenues/savings to counties			
Trial Courts Funding	64%	30%	$605.0
Trial Courts Fines and Forfeitures	NA	NA	311.0
Sales Tax Revenues[c]	NA	NA	710.2
Subtotal			$1,626.2
Net county costs/state savings			$241.3

[a] Excluding certain program components.

[b] Includes the Independent Adoptions Program and the Agency ("Relinquishment") Adoptions Program.

[c] Deposited into social services realignment subaccount for children's programs (foster care, child welfare services, adoptions, child abuse prevention).

Increased County Resources

Increased State Funding for Trial Courts. Under the proposal, the state would significantly increase its funding for trial courts within the existing Trial Court Funding (TCF) Program. The administration proposes that the state funding level be increased to 70 percent of total statewide trial court operations expenses, corresponding to the level intended by current statutes. This portion of the proposal reflects the view that a greater state share of costs is consistent with the statewide interest in promoting the "uniform application of justice throughout the 58 counties" and recognizes that trial court operations are controlled primarily by state laws and regulations.

Court-Related Fine and Penalty Revenues Returned to Counties. The proposal would return the state's share of local trial court-related fine and penalty assessment revenues (about $311 million) to counties. The return of these trial-court related revenues is intended to improve local incentives to collect these funds, which has been a problem over the entire period that local governments have been required to remit these funds to the state.

Increased Sales Tax Allocations. The proposal would increase allocations of state sales taxes to the counties. This would be accomplished by earmarking a portion (.2215 cent) of the state's sales tax to pay for the increased county costs of the foster care, CWS, adoptions, and child abuse prevention programs.

Increased County Program Flexibility

Under the proposal, the increased sales tax revenue would be combined with existing realignment revenues allocated to the foster care and CWS programs and deposited into a new Children's Services Subaccount within the Realignment Account for the counties. This would give counties greater flexibility in the use of these funds for the programs covered. For example, counties would have the ability to use part of their foster care allocation for preventive CWS activities such as family preservation.

The Governor's 1995-96 restructuring proposal also includes proposed legislation to provide mandate relief to counties. Under the Governor's plan, mandate relief would be provided by (1) allowing counties broad control over the General Assistance program and (2) reducing maintenance of effort (MOE) requirements for indigent, public, and mental health programs. The purpose of this mandate relief is to provide counties with a means of offsetting the net cost of $241 million resulting from the realignment of AFDC program expenditures and the TCF Program.

General Assistance. The Governor proposes major changes in the General Assistance (GA) Program, including proposals to:

- Permit counties to eliminate the GA Program entirely. Currently, counties spend about $400 million statewide for this program, which provides grants and in-kind assistance to indigents who are not eligible for Medi-Cal, AFDC, or Supplemental Security Income/State Supplementary Program (SSI/SSP). As a result, the maximum savings potential of this proposal would be about $400 million, if all counties abolished their GA programs.
- Permit those counties who choose to maintain a GA Program to (1) establish time limits for aid under the program and (2) reduce GA costs by (a) reenacting a provision of prior law allowing GA reduc-

tions if recipients share housing with another adult and (b) counting the value of county indigent health care in computing GA grant allowances.

Relief from Maintenance-of-Effort Requirements. The Governor also proposes to give counties greater flexibility in funding decisions with respect to indigent, public, and mental health expenditures. Specifically, the Governor proposes to:

- Reduce by 10 percent one component of the counties' maintenance-of-effort requirement for indigent and public health expenditures under Proposition 99 (the Tobacco Tax and Health Protection Act of 1988), for a potential estimated savings of $96 million annually. Currently, counties must spend a specified amount of funds on these programs in order to receive funding made available under Proposition 99. According to the administration, counties can reduce spending by $96 million and still meet the programmatic requirements of Proposition 99.
- Reduce by $25 million the counties' maintenance-of-effort requirement for mental health programs. In order to meet a federal maintenance-of-effort requirement, the state must spend not less than the average of the two preceding years. The statutory requirement to meet this spending level can be reduced by $25 million and still result in total spending above the federal maintenance level, according to the Department of Mental Health. (Current law reduces the requirement by $15 million, but this provision expires at the end of 1994-95.)

WHAT ARE THE FISCAL IMPLICATIONS OF THE GOVERNOR'S PROPOSAL?

Our review of the proposal's fiscal implications is primarily intended to address the question of the proposal's fiscal impact on the counties, both in the immediate 1995-96 time frame and through the remainder of this decade. We discuss the likely cost and revenue trends under two scenarios. We also discuss certain other issues that may affect the fiscal impact of the proposal.

The Current Outlook

County Impact Depends on Unrelated State and Federal Actions, and Assumed Savings from County Administration. As shown in Figure 1, the level of costs transferred to the counties in 1995-96 is $241 million short of the level of increased county resources, given the assumptions that underlie the 1995-96 Governor's Budget.

From the *county* perspective, this conclusion is, however, dependent upon the budget's assumptions that there will be significant savings from several major policy proposals and assumptions, including increased federal funds in the AFDC Program and the adoption of grant reductions (please see Part IV of this volume for a detailed description of these proposals). This is because the estimates of increased county shares of cost under the proposal are based upon the budget's estimates of total program costs, which reflect these savings. To the extent that these assumptions are not realized—for example, the increased federal funds are not forthcoming and the grant reductions are not adopted—we estimate that the level of costs transferred to the counties would be up to $161 million *higher* than shown above.

Similarly, the budget assumes significant savings in AFDC grants resulting from more efficient county administration of the program, due to (1) the increased incentive for counties to reduce program costs as a result of giving counties a higher share of these costs and (2) a proposed General Fund augmentation of $20 million for counties to implement unspecified projects in administering the program. To the extent that the assumed savings do not materialize, actual program costs transferred to the counties would be up to $58 million *higher* than anticipated in the budget. (We discuss this proposal in more detail in our analysis of the AFDC Program in the *Analysis of the 1995-96 Budget Bill*.)

Figure 2 summarizes the fiscal impact of the budget's assumptions on county costs in 1995-96. Because it is unlikely that all of the savings from policy changes and federal actions will be realized, the proposal's assertion of a $241 million “gap” is a tenuous one, and the actual gap represented by the restructuring proposal could be much larger.

The Legislature could make adjustments in the level of resources it provides to the counties to account for action it takes on the state's budget. However, in the case of the anticipated federal funds, it is unlikely to have any firm basis on which to proceed because federal budget actions will not be finalized until September or October of this year. Similarly, it will not be known to what extent the counties can achieve the assumed savings from more efficient administration of the AFDC Program until well into the budget year.

Impact on Counties in the Short Run

Currently, the Trial Court Budgeting Commission (TCBC) is responsible for allocating state funding among the trial courts. Although the Budget Bill, as proposed, reflects continuation of this arrangement, the administration indicates that it will hold discussions with the TCBC and the Judicial Council regarding the ultimate scope of the state's responsibilities for supporting trial courts and the method for allocating state funds based on those responsibilities. Thus, at this time it is unclear how the increased Trial Court Funding support would be allocated among counties. Without this information, we are not currently able to fully evaluate the proposal on a county-by-county basis. We note, however, that there are likely to be uneven impacts on counties, particularly in the relationship between the increased costs for the AFDC Program and the increased resources due to shifts in the Trial Court Funding Program.

Figure 2

County Fiscal Risks in 1995-96 Under Governor's Budget Assumptions[a]

Policy Changes—$201 million

- $126 million to reflect AFDC grant reductions
- $58 million in AFDC grant savings from more efficient county administration
- $12 million to reflect assumed federal legislation to bar sponsored aliens from AFDC eligibility for five years
- $5 million to reflect limit on AFDC homeless assistance

Federal Funds Assumptions—$18 million

- $18 million to reflect expected additional federal support for refugees on AFDC

[a] Dollar amounts reflect assumed reductions in county expenditures associated with restructuring proposal. The list does not include the budgeted shortfall of $241 million.

More "Losers" than "Winners" Can Be Anticipated. Because counties vary widely in the costs of court operations relative to the costs of AFDC within the county, the effects of the Governor's proposal on counties will vary widely as well. Moreover, some counties would benefit more from proposed AFDC program changes than would other counties, depending on the underlying demographics of the welfare population within the county. Thus, in counties where the AFDC Program expenditures are high relative to the size of the TCF Program, there will be a realignment gap under the Governor's proposal. Conversely, and notwithstanding the statewide gap of $241 million, in counties with court costs that are disproportionately high relative to the county's AFDC caseload, it is possible that the proposal would result in a fiscal gain. While sufficient information is not currently available to fully assess the county-by-county impacts of the Governor's proposal, certain data that are available suggest that the proposal to swap trial court funding for a greater county share of AFDC program costs *cannot* be made fiscally neutral, at least for some counties, even if the state were to fund more than 70 percent of the TCF Program.

For example, we estimate that if both the Governor's current realignment proposal and the 7.7 percent AFDC grant reductions had been implemented for 1994-95, Merced County's AFDC costs would have increased by $14.1 million, while its trial court costs would have decreased by $4.6 million—a gap of $9.5 million. Even if the Governor's proposal ultimately allowed for Merced County to pay *none* of its trial court costs, a gap totalling $7.2 million between the county's AFDC costs and TCF program savings would still exist.

In fact, our preliminary review of county costs in both the AFDC and the TCF programs suggests that in the short run significantly more counties are likely to experience net increased costs from the swap than are likely to benefit from net savings. This is particularly true if major program reductions are not adopted in tandem with the proposed swap.

What Can Counties Expect in the Long Run from the Governor's Proposal?

Our analysis indicates that the statewide county gap of $241 million in 1995-96 could become a small surplus (roughly $100 million) to counties by the end of the decade. This surplus would occur, however, only if (1) all of the Governor's proposed welfare reforms were adopted, (2) increased federal funds become and remain available as proposed in the Governor's Budget, (3) the economy grows at a steady pace, and (4) the state takes no action to curtail the current underlying growth rate in court costs, despite its assumption of an increased share-of-cost. Moreover, the mismatch between AFDC grant costs and court costs is so striking in some counties that we believe that despite this small statewide surplus, there would continue to be deficits in some counties. Thus, even under the most optimistic scenario, some counties would likely continue to lose under the Governor's realignment proposal. Preliminary data suggest that these losses would be concentrated in the Central Valley counties because they tend to have AFDC costs that are higher relative to their trial court costs.

In contrast, if the Governor's welfare reform package is not adopted, the statewide gap in county resources under the Governor's proposal could be about $300 million by the end of the decade. This projection assumes that the shift of the state resources to counties is increased to balance the higher county AFDC costs resulting from not adopting the Governor's proposals.

Counties Are on Unstable Fiscal Footing

As indicated above, the preliminary data show that (1) more counties would be losers than winners in the short-run under the current restructuring proposal and (2) the long-term impact on counties depends largely on implementation of welfare reform and the underlying growth rates in trial court costs. Moreover, it is possible that even when counties on a statewide basis are "in the black", a significant number of counties would continue to run deficits as a result of the wide variation in AFDC and court costs at the county level.

Counties' Fiscal Condition Is Deteriorating. Our review of current county fiscal condition, however, suggests that *all* counties are under unprecedented budgetary pressures as a result of (1) the long-term effects of the recent recession, (2) permanent state transfers of property tax revenues to schools, and (3) underlying slow-growth in county revenue sources relative to growth in demand for county services.

General Fiscal Condition Affects Program Management Decisions and Long-Term Policy Choices. Because of (1) the negative impact the AFDC-TCF transfer is likely to have on most counties in the short-run, and (2) counties' generally poor fiscal condition, counties would be under extreme budgetary pressure to maximize short-run savings and minimize short-run costs under this proposal. As a result of this "fiscalization" of policy decisions, counties may not make wise programmatic decisions concerning such things as front-end investment in long-term preventive measures designed to get recipients off welfare and keep them off. This in turn could have long-term impacts on program costs at both the state and local level.

As we discuss below, these fiscal constraints would place considerable pressure on counties to reduce or eliminate their General Assistance Program, as would be permitted under the Governor's proposal.

Potential Mandate Liabilities

The estimated county shortfall of $241 million in the Governor's proposal establishes a potential state liability for unfunded mandates on local governments. It is not clear, at this time, that the proposed mandate relief provisions would absolve the state of this obligation. Also, to the extent that the budget's assumptions regarding federal funds and program reductions are not borne out, or if revenue growth in future years is not sufficient to offset program cost growth, the state could be liable for reimbursement of the excess costs faced by the counties.

SHOULD THE LEGISLATURE ADOPT THE GOVERNOR'S PROPOSAL?

At the outset, the Legislature should recognize that the Governor's proposal is but one of many different courses of action it could choose to begin the process of restructuring the state-local relationship. The Legislature's own realignment task force last year considered many of these options, and although it took no action, its work identified a wide range of programs and approaches under which an initial step towards its restructuring goals could be taken. Figure 3 identifies the programs that have been considered in the realignment context over the last two years, along with the 1995-96 fiscal impact of these changes on the state and the counties.

As we discussed in our *Making Government Make Sense* report, we believe that it is appropriate for the Legislature to evaluate the full range of existing state and local government responsibilities to determine whether changes in the existing assignment of responsibilities could improve the delivery of program services. However, we also recognize that the Legislature may find it necessary to implement changes in an incremental fashion over time. The key to such an approach is having a clear sense of the ultimate objective. Otherwise, policies initiated one year may be reversed the next. The listing of options presented in Figure 3 is intended to facilitate the Legislature's consideration of changes that could be implemented in the budget year recognizing the importance of beginning the restructuring process as soon as possible.

The Governor's 1995-96 realignment proposal has some commonality with the principles that we offered in our *Making Government Make Sense* model. The thrust of the proposal seeks to refocus important parts of the state-county relationship towards achievement of better outcomes. It attempts to improve those outcomes through reliance on fiscal incentives to motivate greater program performance. It also recognizes the need for more flexible approaches to service delivery, and promotes collaborative efforts among programs in delivering services to clients.

Figure 3

Realignment Options

(Dollars in millions)

Option	Existing Sharing Ratio State / County	Annual Fiscal Impact State	Annual Fiscal Impact County
Cost Shifts to Counties			
Juvenile Justice			
• Increase charges to counties to recover 100 percent of the state's costs to operate the California Youth Authority (CYA)	Counties pay $25 per month per ward	-$262	$262
• Increase charge to counties to recover 10 percent of the state's costs to operate the CYA and impose a surcharge for low-level admissions	Counties pay $25 per month per ward	-86	86
• Transfer responsibility for supervision of parolees discharged from CYA to counties, and make counties responsible for costs of re-incarcerating parole violators	100 / 0	-68	68
Adult Parole			
• Transfer responsibility for supervision of parolees discharged from state prison to counties, and make counties responsible for costs of re-incarcerating parole violators	100 / 0	-400	400
Drug and Alcohol Programs			
• Transfer program and financial responsibility to counties	100 / 0	-62	62
County Services Block Grant			
• Eliminate state funding	Not applicable	-16	16
In-Home Supportive Services (IHSS)			
• Transfer program and financial responsibility to counties	65 / 35	-420	420
Non-medical residential facilities			
• Require counties to pay 50 percent of costs for board and care homes	100 / 0	-1,313	1,313
Medi-Cal			
• Equalize county share of cost for long-term care to current IHSS level	100 / 0	-330	330
• Require counties to pay 50 percent of both long-term care and IHSS costs	100 / 0	-570	570
• Require counties to pay 100 percent of both long-term care and IHSS costs	100 / 0	-1,365	1,365

Continued

Option	Existing Sharing Ratio State / County	Annual Fiscal Impact State	Annual Fiscal Impact County
Medi-Cal Substance Abuse			
• Require counties to pay all nonfederal costs associated with substance abuse; allow counties to control utilization	100 / 0	-150	150
AFDC			
• Require counties to pay 50 percent of all nonfederal costs for grants and administration		-1,260	1,260
—Grants	95 / 5		
—Administration	70 / 30		
• Require counties to pay 11 percent of all nonfederal costs for grants (their share prior to 1991 realignment)	95 / 5	-150	150
• Impose higher county sharing ratios for AFDC grants based on length of time on aid	95 / 5	up to -450	up to 450
Increased County Resources[a]			
Trial Courts			
• Increase state funding to 100 percent of total costs and eliminate county funding responsibility	—	-1,144	1,144
• Increase state funding to 70 percent of total costs	—	-606	606
• Return fines, fees and penalties to counties	—	-311	311
General Assistance			
• State assumption of GA program costs	—	-425	425
Indigent Health			
• State assumption of indigent health care and public health costs	—	-600	600
Sales Taxes			
• Shift 1/2 cent of existing state tax to counties	—	-1,481	1,481
• Impose new 1/2 cent sales tax to fund programs shifted to counties	—	—	1,450
Property Taxes			
• Increase state funding for schools to replace local property tax support; reallocate property taxes to counties	—	-1,495	1,495
• Allow counties to recover property tax administration expenses from schools	—	-63	63

[a] State fiscal impacts are either increased expenditures or revenue loses; county fiscal impacts are either reduced expenditures or revenue increases.

In our view, however, as a short-term or initial step towards making the longer term changes that are needed in the relationship between the state and all units of local government, the proposal is seriously flawed.

This is because, taken as a whole, it exacerbates budgetary pressures on county governments while giving the counties few tools with which to control costs and guide local destinies. One portion of the proposal, however, relating to the realignment of children's services programs, does have considerable merit and we believe that it should be seriously considered. In addition, we believe that the Legislature should consider alternative approaches to the proposed AFDC-Trial Court Funding program swap, and that the issue of "mandate relief" should be considered on its merits *outside* of the general debate on the issue of program realignment. Our recommendations are summarized in Figure 4 and are discussed in more detail in the remainder of this analysis.

Figure 4

Summary of Legislative Analyst's Recommendations

✔ **Children's Services**
Adopt Governor's proposal to increase positive local incentives.

- Include state-operated adoptions programs.
- Increase Youth Authority placement fees.

✔ **Sales Tax to Counties**
Adopt Governor's proposal to offset Children's Services costs.

✔ **County Share of AFDC to 50%**
Reject Governor's proposal because share-of-cost is not commensurate with county control.

✔ **State Share of TCF to 70%**
Legislature should consider in context of alternative realignment options.

✔ **General Assistance and Other Mandate Relief**
Legislature should consider on policy merits outside of realignment debate.

Children's Services Realignment Is a Sensible Step

Under the Governor's proposal for realigning children's services, the counties would assume full financial responsibility for foster care, child welfare services, and most components of the adoptions programs. The proposed shift of foster care funding responsibility has merit because it would give the counties a strong fiscal incentive to focus on activities designed to reduce the need to place children in foster care arrangements.

We believe the Governor's proposal is reasonable. Assigning full financial responsibility to the counties recognizes the linkage between CWS and foster care, encourages accountability by clarifying governmental responsibility for the program, and still gives counties an incentive to invest in the preventive kinds of CWS activities because of the relatively high cost of foster care. Similarly, assigning counties full responsibility for the adoptions programs recognizes the linkage between these programs and foster care, and is consistent with the way the programs are currently administered in many counties.

In summary, we believe that the realignment of these children's services programs would result in greater accountability for program outcomes and provide more incentive to operate them on a cost-effective basis. We believe, however, that several modifications should be made to the proposal to improve it.

State Administered Adoptions Should Be Included in Proposal. The Governor's proposal did not address those adoptions programs where counties have decided to turn the program over to the state for administration (an option available to the counties under current law). According to the administration, this omission was inadvertent. We believe that, from a policy standpoint, there appears to be no reason to have a bifurcated program under the Governor's proposed realignment of responsibilities. Accordingly, we recommend transferring the state-operated programs to the counties ($4.6 million) as part of the realignment, and adjusting the amount of sales tax transferred to counties to reflect these increased costs.

Youth Authority Placement Incentives Need Correction. The Governor's proposal ignores fiscal incentive problems associated with two of the major treatment choices for juvenile offenders—foster care and the Youth Authority. In fact, the Governor's proposal may significantly worsen an existing counter-productive fiscal incentive. This is because it would increase the counties' cost for foster care placements while maintaining an extremely low county share of cost for Youth Authority placements. There are currently 5,000 juveniles on probation who have been placed in foster care, most of whom are placed in group homes costing an average of $3,100 per month. Under the proposal, counties could place these probationers instead into the Youth Authority, for which the counties are charged *$25 per month* per ward. The Governor's proposal contains no provisions requiring the maintenance of juvenile probationers in their existing placements, nor does it otherwise constrain a county's ability to transfer these persons to the CYA. By making such transfers, counties could avoid foster care placement costs, while shifting costs to the state.

In order to correct for this problem, we recommend that the cost faced by the counties for CYA placements be increased. From our perspective, charging the counties a fee similar to the cost of a group home placement for additional CYA placements would ensure that these decisions continue to be based primarily on treatment requirements.

AFDC/TCF Program Funding Realignment: Unworkable for Counties

AFDC. In order to give counties a greater incentive to pursue strategies that keep people off of AFDC, the budget proposes to increase the counties' share of the nonfederal costs of the program from 5 percent to 50 percent. We are concerned that the proposal would give counties a share of cost that is not commensurate with their ability to control program costs and which could threaten counties' financial stability during periods of economic downturn. This is because the bulk of expenditures for AFDC is driven by economic and demographic factors which counties have limited ability to influence. (This is not to say that counties have no ability to influence program costs, but their influence is of a far more marginal nature than that assumed by the Governor's proposal.)

Trial Court Funding. As discussed earlier, the Governor's proposal would significantly increase the state's share of funding for the trial courts, consistent with Ch 90/91, the Trial Court Realignment and Efficiency Act of 1991 (AB 1297, Isenberg). That act expressed legislative intent to increase state support of the trial courts each year to a maximum of 70 percent by the 1995-96 fiscal year.

We agree with the administration that the courts represent a truly statewide function, and the state has a strong interest in promoting uniform access to justice. In addition, greater state funding is justified on the basis that the state exercises primary control over trial court procedures and appoints the judges.

However, the Governor's proposal leaves open the question of what the state's ultimate objective is for funding and operation of the trial courts. This question has important implications for the Legislature.

Specifically, if the Legislature wishes to significantly increase state funding for the trial courts, it will be important for the state to have greater involvement and control over trial court expenditures. Thus, we believe that the Legislature should first determine its ultimate funding objective for support of trial courts and the time period in which it wishes to achieve that objective.

After making these determinations, the Legislature should exert its influence to control trial court expenses and bring about operational efficiencies. This can be accomplished in a variety of ways. For example, the Legislature could provide for the allocation of trial court funds based on performance criteria, such as courts' ability to meet administrative cost-reduction goals and implement certain efficiency measures. The Legislature could also require superior and municipal courts in the same county to coordinate or unify their support services in order to take advantage of economies of scale.

In our view, if the Legislature does not wish to become involved in exercising more control over trial court operating costs, it makes little sense to purchase an increased share of trial court costs. This is especially true if the Legislature wishes to create new trial court judgeships in the coming years, which could increase trial court operating costs substantially.

Governor's AFDC/TCF Proposal Would Make County Fiscal Problems Worse. We find that the Governor's proposal to increase the state's share of trial court costs would not fully offset the transferred AFDC costs, particularly in the near term and would exacerbate pre-existing county fiscal capacity problems.

Consequently, we recommend that the Legislature reject the AFDC/TCF realignment at this time. Such a realignment of responsibilities should only be undertaken after the Legislature develops strategies concerning (1) overall county fiscal capacity, (2) appropriate partnership shares for AFDC and (3) long-term objectives for the financing of trial courts.

Alternatives to the AFDC Swap. If the Legislature makes the long-term decisions regarding the financing of trial courts and wishes to increase state support of trial courts, we suggest that it consider shifting fiscal responsibility for programs other than AFDC to the counties. As discussed earlier, Figure 3 summarizes the other program realignment options that have been identified in the last two years and could be matched with a trial court finding proposal. In evaluating the appropriateness of these other options, the Legislature should consider their long-term impacts on the state and counties.

Mandate Relief Proposals Should Be Considered Outside of the Realignment Debate

As indicated above, the proposal's lack of fiscal neutrality represents a potential state liability as an unfunded mandate. We are also concerned that tying the shortfall to *specific* mandate relief provisions acts as a fiscal incentive for counties to make certain programmatic decisions without due consideration for the underlying reasons that caused the state originally to establish the GA Program requirements. Furthermore, the proposed changes in the GA Program could result in widely differing grant levels among the counties, leading to problems of inter-county migration, thereby encouraging counties to further reduce or eliminate the program. The resulting loss of income to recipients could have significant adverse impacts—on recipients' health, for example—which could lead to additional costs to the state and the counties. These potential consequences of abolishing the state mandate for GA are too important to be cast as a "budget-balancer" in the current realignment debate. Rather, the pros and cons of maintaining or eliminating the GA—and at what level of government—should be discussed on their own merits.

CONCLUSION

The need to begin serious efforts to restructure California's dysfunctional system of government is a critical one, and it is important that steps be taken during 1995 towards achieving this objective. At a minimum, the Legislature should take action this year to lay the long-term foundation for progress. In our view, real progress can be made only when both the state and county governments can enter a program partnership on a solid fiscal base. Toward this end, the Legislature needs to consider changes that improve, not worsen the fiscal capacity of county governments. Because of their weak fiscal condition, counties will face pressure to make program investment decisions based more on short-term fiscal considerations as opposed to the potential for improved long-term outcomes.

With the exception of the Children's Program realignment, the Governor's proposal would serve to put increased fiscal pressure on counties, thereby further "fiscalizing" many policy decisions at the local level. The Governor's proposal would have unequal impacts across counties, and would hurt more counties than it would help. Moreover, the Governor's proposed increased county share-of-cost for AFDC grants does not reflect the level of control that counties can reasonably be expected to exert over AFDC program costs.

REINVENTING THE STATE CIVIL SERVICE

What Principles Should Guide the Legislature in Rethinking and Reinventing the Structure and Nature of the State Civil Service?

Summary

There is currently much talk about the need for the public sector to "restructure" or "reinvent" itself. Generally, reinvention involves a fundamental rethinking of the way public services and functions are organized and delivered. It involves challenging the traditional ways of doing things; searching for new and better ways to do the tasks that need to be done; not doing tasks that are no longer needed.

No reinvention of the way public services are organized and delivered can ignore the central facet of a government's operations—its work force. The state depends on nearly 200,000 state civil service employees to carry out the tasks of state government, as do the people of California.

In this piece we discuss the origins and background of the civil service, and highlight evidence of problems caused by current civil service laws and rules. These include (1) departure from the system's original merit principles, (2) preoccupation with process over results, (3) impediments to effective conduct of programs, and (4) barriers to personal and career development of employees.

Our findings point in a compelling direction—that the Legislature should begin a fundamental rethinking, or "reinvention," of the state civil service system in order to make it again serve the state, its employees and the public. We conclude by offering a set of basic principles to assist the Legislature in this important effort and recommend that the Legislature begin hearings to start the process to revamp the state's civil service system.

OVERVIEW

Historical and Legal Foundations

California's current system of state civil service employment dates back to the November 1934 election, when the voters approved Proposition 7, adding what is now Article VII to the State Constitution.

The principal concern that led to establishment of the current civil service system was two-fold in nature: (1) to prohibit a political "spoils" approach to state government jobs and (2) to assure instead a competent, efficient work force. This theme is well displayed in the official argument in favor of Proposition 7 in 1934:

> The purpose of this Constitutional Amendment is to promote efficiency and economy in State Government. The sole aim of the Act is to prohibit appointments and promotions in State service except on the basis of merit, efficiency and fitness ascertained by competitive examination. Appointments of inefficient employees for political reasons are thereby prohibited, thus eliminating the 'Spoils System' from State employment.

Under civil service, all appointments and promotions must be made under a general system based on merit determined by competitive examination. All state employees are in civil service unless specifically exempted by the Constitution. These constitutional exemptions include all employees of the legislative and judicial branches, the University of California, the California State University, the Governor's office and the Lieutenant Governor's office. The Governor's various appointments are also exempt. Within the state's executive branch, practically all employees outside the very top ranks of management (such as department directors and deputy directors) are in the civil service. Currently there are almost 200,000 civil service employees in California state government.

In the sixty years since enactment of Proposition 7, an edifice of statute, rules, and practices has been built upon the constitutional framework. This includes:

- The State Civil Service Act, enacted in 1937 and modified from time to time since.
- The Ralph C. Dills Act, enacted in 1977, providing for collective bargaining between the state and rank-and-file civil service employees of terms and conditions of employment.

- Rules, guidelines and decisions issued by the State Personnel Board (SPB) on the *merit* aspects of personnel matters (such as entry-level and promotional examinations and disciplinary appeals).
- Rules, guidelines and decisions issued by the Department of Personnel Administration (DPA) on the *non-merit* aspects of personnel matters (such as collective bargaining, compensation, and employee training).
- Rules and practices of other state departments, to the extent personnel responsibilities are delegated to them by the SPB, the DPA, or by law.
- Extensive case law, rendered by the courts to interpret all of the above.

In this report we speak of the civil service *system* in a broad sense, to include not only the merit aspects governed by the Constitution and the Civil Service Act, but the full complex of laws, rules and practices listed above as they relate to civil service employees. Below we briefly describe the basic features of the current system. (It should be noted that the descriptions below, by their brief nature, do not convey the full flavor of complexity of these processes. In fact, complexity is a distinguishing hallmark of the civil service system.)

Classification and Hiring

The SPB has established 4,486 job classifications in the California civil service. Each classification delineates a distinct job title and duty description. Positions in each classification generally must be filled on the basis of a competitive examination that is specific for the classification.

The hiring process has two distinct phases. The first is the examination phase, in which one attains eligibility to be considered for hiring. The second is the hiring phase, in which candidates interview for an advertised position opening. The two events can be widely separated in time, in many cases by several years.

Examinations may consist of one or more of the following:

- A written test (usually multiple choice).
- An oral test (similar to an interview).
- A performance test (such as heavy equipment operation or typing).
- Agility/physical ability tests (usually for law enforcement classifications).

Alternatively, some examinations consist solely of filling out an application that asks for information on one's education and experience.

For many exams, existing law requires the award of additional test points for veterans, widows and widowers of veterans, and incumbent state employees. After the award of additional points, the scores of test-takers are re-ranked. These rankings create an “eligibility list.”

Departments may interview and hire candidates from a job classification eligibility list. They are constrained by law, in most instances, to select candidates according to two alternative rules:

- Under the “rule of three names” departments may consider only the top three names on the list (which may contain many names). If more than three names received equal scores the order of these names on the list is determined at random.
- Under the “rule of three ranks” (usually applied for professional, scientific and administrative classes) departments may consider candidates in the top three “ranks” of a list. (A rank is a grouping of identical test scores.) A candidate in the fourth rank, for example, is not “reachable” unless at least one of the upper ranks has been “cleared” by all persons in the rank either accepting or declining a job offer.

An eligibility list may be used for one to six years.

The SPB has delegated to departments the design and conduct of examinations for most classifications. If requested, the SPB will conduct examinations and charge requesting departments a fee to cover the SPB's cost.

Probation and Tenure

The SPB establishes for each classification a probation period of either six months or one year. Generally, persons entering a classification from outside the civil service—or newly promoted into a classification—hold their appointment subject to satisfactory completion of the probation period. During this period the employee may be rejected from the position for, among other things, “failure to demonstrate merit, efficiency, fitness and moral responsibility.” An employee may appeal a probationary rejection to the SPB, but the burden of proof is on the employee to demonstrate that there is no substantial evidence to support the rejection or that it was made in fraud or bad faith.

After the probation period, successful employees are considered permanent (tenured) civil service employees. The State Civil Service Act states that: "Tenure of civil service employment is subject to good behavior, efficiency, the necessity of the performance of the work, and the appropriation of sufficient funds."

Promotion

The system places strong emphasis on promotion from within the civil service. Accordingly, many promotional examinations are open only to current civil service employees or, in some cases, only to current employees of the department giving the exam. Moreover, in some examinations in which both state employees and outside candidates compete, state employees are awarded additional points to their examination scores.

Compensation

For each classification the DPA establishes salary ranges specifying a minimum and maximum pay rate, with one or more "steps" in between. For rank-and-file employees the salary ranges are determined through collective bargaining agreements negotiated between the DPA and employee representatives. These agreements also determine benefits and various other terms and conditions of employment. For non-represented employees, the DPA directly determines salaries, benefits and other terms and conditions.

Apart from promotions from one classification to another, pay rates generally increase over time in two ways. Periodically, employees receive cost-of-living-adjustments (COLAs). In addition, employees who receive a good performance evaluation annually receive "merit salary adjustments" (MSAs) until they reach the top of the classification salary range. (For additional detail on compensation please see our overview of employee compensation issues in the *Analysis of the 1995-96 Budget Bill*.)

Discipline

The state employs a three-phased system of discipline consisting of (1) preventive, (2) corrective and (3) disciplinary or "adverse" actions. Preventive actions cover a wide range of steps that may be taken to minimize the occurrence of serious discipline problems. These steps include the setting of reasonable work objectives, employee training and staff development, and provision of regular feedback regarding job performance. Corrective actions range from reminders of expected performance to informal or formal counseling sessions to written letters of warning. For the vast majority of employees discipline problems either do not arise or are resolved through corrective actions. As in any large organization, however, serious problems of discipline do arise and require formal disciplinary action.

In state employment this ultimate disciplinary phase is referred to as "adverse action." Adverse actions range in severity from formal letters of reprimand to dismissal from employment. Government Code Section 19572 identifies 24 specific grounds for adverse action. These include problems such as incompetency, inefficiency, insubordination, drunkenness on duty, and discourteous treatment of the public or other employees.

State law and rules (some necessitated by court rulings that have treated civil service employment as a form of property right) provide for an appeals process for employees wishing to contest adverse actions. First, an employee is entitled to a "Skelly" hearing (named after a State Supreme Court decision). The "Skelly" hearing affords an informal forum for the employee to present his or her case to a high-level departmental officer that the proposed adverse action be modified or withdrawn. If, after the Skelly hearing, the department proceeds with an adverse action, the employee may appeal the action to the SPB. At the SPB the case receives a full evidentiary hearing before an administrative law judge, whose recommended decision is considered for final judgment by the five-member board. The board takes one of four actions: (1) sustains the adverse action, (2) revokes the action, (3) modifies the action to provide for a *less* severe sanction, or (4) approves a settlement agreed to by the parties.

If an employee is dissatisfied with the outcome of the SPB appeal, he or she may petition a court for adjudication. An employee also may file separate appeals to the SPB alleging that adverse action resulted from discrimination on the basis of age, gender, sexual orientation, race, religion, disability, national origin, ancestry or marital status. Discrimination appeals also may be brought before the Fair Employment and Housing Commission and/or the federal Equal Employment Opportunity Commission.

CONCERNS WITH THE SYSTEM

In our review of the state's civil service system, we found numerous indications that the system is no longer operating in an optimal manner for either the state, its employees or the public. Our review included the following:

- Discussions with a wide range of parties and observers, including current and former staff of the DPA and the SPB, civil service employees in managerial, supervisorial and rank-and-file positions in state government, employee union representatives, academicians, and various interested parties outside California state government.

- Review of testimony from groups and individuals who appeared before the "Little Hoover" Commission, the National Commission on the State and Local Public Service, and the California Constitution Revision Commission.
- Review of literature on civil service systems and other public- and private-sector systems, and efforts at civil service reform in the federal government and in other states.
- Or own collective experience in reviewing the state's programs and operations.

In this review we found a wide range of problems, some broad, some specific, yet all ultimately connected as part of a larger whole. In some cases the evidence is subjective or anecdotal. On their own, these bits of evidence might not be cause for great concern. Viewed collectively, however, we find the evidence points in a compelling direction—that the Legislature should begin a fundamental rethinking, or "reinvention," of the state civil service system in order to make it again serve the state, its employees and the public.

We outline below significant findings from our review of the state civil service system.

Departure From the Original Merit Principles

The core foundation of the civil service is the merit principle—that people should attain appointment and promotions in state service on the basis of qualifications and merit in performance. In several significant respects we find that laws, rules and practices which have been added since the system's inception have departed from this core principle. We cite some examples below.

Merit Salary Adjustments Lack Merit

As described in the background section of this piece, employees who have not reached the maximum of a salary range are eligible to receive annual "merit salary adjustments" (MSAs). Originally, these were conceived to accomplish what the name implies—a pay raise earned by meritorious performance.

Over time MSAs seem to have degenerated into a virtually automatic entitlement. For example, in the 1993 calendar year, more than 99 percent of eligible state employees received an MSA. Most state employees work well and conscientiously. One therefore would expect a high percentage to receive MSAs. The current MSA practice, however, appears to merely reward employees for time spent on the job.

Seniority-Driven Layoffs

At times it becomes necessary, due to fiscal constraints, or desirable, due to policy decisions, to reduce the size of state departments or programs. Under existing law and rules regarding layoffs, seniority is the dominant factor in the layoff process. This involves an elaborate "bumping" process, under which a chain reaction of demotions and transfers is set off, more senior employees bumping less senior employees from positions in successive rounds until the least senior employees are bumped out of state service. The state's layoff process is complex. The DPA estimates that it takes up to eight months or longer to implement the layoff process.

In addition to the complex nature of the layoff process, it also does not (1) take into account specific job performance or (2) recognize talented, but less senior, employees who have superior performance and exhibit a high potential for advancement in state service. Furthermore, the layoff "bumping" process causes significant disruption to state programs, not necessarily limited to programs within the department that initiated the layoff. This is the result of not only the loss of time and talent, but also because of the arbitrary nature of placing "bumped" employees in positions for which they may have limited program knowledge or aptitude.

Extra Exam Points Can Shut Out Excellent Candidates

As mentioned earlier, for many hiring examinations extra points are awarded to veterans, widows and widowers of veterans, and incumbent state employees. For example, one examination conducted recently resulted in a hiring list consisting *exclusively* of veterans and incumbent state employees. Well over a hundred outside candidates who attained the *highest* score in this exam (before the awarding of extra points) *cannot even be considered for hiring*. Thus, in this case, the rules undermined the purpose of holding open examinations, which is to maximize the pool of highly qualified candidates for potential hire. The award of extra points to an individual because he or she happens to be a veteran or a state employee has no direct connection with the individual's ability to fulfill job requirements.

System Often Impedes Efficient and Effective Conduct of State Programs

One of the stated purposes of the State Civil Service Act is "...to promote economy and efficiency in the state service." This principle also was emphasized in the 1934 campaign for the constitutional amendment creating the current system. Our review indicates that the principle is not being well served. The examples below illustrate this.

Costly Exam Process Does Not Serve Hiring Needs

For a host of reasons, the state's examination process is exceptionally costly. One reason is because each job classification (4,486 at the latest count) requires its own examination. Examinations tend to be logistically demanding and, in many cases, the number of applicants is overwhelming. The process of oral tests—three-person panels examining one applicant at a time—is inefficient and expensive.

Yet despite all the time and resources expended, the process does not consistently provide a department with the best possible candidates for specific positions. The arbitrary shrinkage in eligible candidate pools caused by the award of extra exam points for veterans and state employees has been noted above in another context. Another example is provided by the "rule of three names." This rule, required for many job classifications by law, places three individuals at the top of an eligibility list. Departments may consider only these three for hiring, even if dozens or even hundreds passed the exam. No testing method devised can identify from a large or moderately sized group the *three* people best suited for a particular job. Department personnel officers, in fact, have complained to us that they often feel forced by this rule to hire candidates who are not the best-suited for the open positions. In addition, in cases where there are multiple openings, it may be the only way to reach better candidates who are farther down an eligibility list. Such job-person mismatches, at best, are an inefficient use of state resources. At worst, these mismatches can produce long-lasting personnel problems.

Finally, the logistical demands and costs of examinations cause departments to schedule examinations for some classifications at intervals of several years. This results in eligibility lists that become obsolete over time. High quality candidates on the list accept jobs elsewhere during the long intervals between exams and hirings. Other promising candidates may not be on the current eligibility list because at the time the last examination was held they might not have been eligible to take it or may not have been interested. These individuals, however, cannot be considered until the department goes through the laborious exercise of another examination and the creation of a new list.

Explicit and Hidden Costs of Adverse Action Appeals

The process for appeals of adverse actions provides another example of disproportionate costs and counterproductive effects on state operations. As discussed in the background part of this piece, employees may appeal adverse actions (which range from letters of reprimand to dismissal) to the SPB. Here they are afforded a quasi-judicial forum, with legal representation at full evidentiary hearings presided over by administrative law judges (ALJs), and final reviews of ALJ recommendations by the five-member board. This process costs the SPB at least $2.5 million each year (charged to the departments whose actions are appealed) for the ALJs and their support. (In the 1994 Budget Act the Legislature appropriated an additional $2.2 million on a one-time basis to address the backlog of appeals.) For the 1995-96 fiscal year the DPA projects their attorney and related costs at $1.3 million (again, charged to the departments whose adverse actions are before the board). We have not identified the amounts spent directly by departments in preparation for, and participation in, adverse action hearings.

Over the last ten years the number of adverse action appeals brought to the board each year has grown from approximately 1,400 to 2,000, paralleling the growth rate in the civil service work force. Over the same time period the *average* time to decide an appeal doubled from six to 12 months. (Statute dictates a *maximum* of six months.) Clearly, the process is time-consuming and expensive. Moreover, much of this time and expense is consumed on matters such as letters of reprimand, five-day suspensions without pay, and even failures to pass the probationary phase of hiring (which isn't even a disciplinary matter). Existing law gives the SPB discretion to review these and other these types of cases without full evidentiary hearings, but the board has adopted a rule automatically assigning all appeals to full hearings.

The above indicates that the explicit costs of the adverse action process are high. The hidden costs may be higher still. Many managers and supervisors find the prospect of having to navigate the appeals process so prohibitive, in terms of time, expense and disruption to operations, that they avoid taking disciplinary actions that are warranted. This approach produces a series of negative consequences, including productivity losses and reduced morale among co-workers. It usually comes back to haunt the manager (or his or her successor) and the department, as unaddressed discipline problems worsen.

Process Dominates Substance and Results

Our review found numerous indications of concern for process dominating concern for substance and results. The SPB disciplinary review process provides dramatic evidence of this. We describe that example and another below.

Adverse Action Appeals

As noted above, many supervisors refrain from taking warranted adverse actions against employees because of the high procedural costs. According to many observers, far too many adverse actions are overturned by the SPB simply on technicalities (such as incomplete documentation records). Under the current process, no distinction is made between major and minor adverse actions, as we have noted above.

In a recent, and major, instance the SPB itself was overruled on a procedural issue by a state appellate court. The court ruled last year in *California Correctional Peace Officers Association v. SPB* that the SPB loses jurisdiction when the board fails to decide appeals within the statutory six-month period for SPB review. Accordingly, the court nullified the board's decisions in approximately 50 adverse actions. Initially, the court ruled that all the adverse actions were overturned and ordered the reinstatement of dismissed employees with back-pay. The court later amended the ruling to provide instead that the employees were now free to challenge the adverse actions in courts of law. This ruling has created something of a crisis for the handling of adverse actions generally since the precedent potentially affects hundreds of other appeals.

Administrative Procedure Act Ties State's Internal Operations in Knots

The Administrative Procedure Act, administered by the Office of Administrative Law (OAL), was enacted by the Legislature in 1979 to reduce the complexity, and improve the clarity and legal consistency, of state regulations. The legislation was intended to minimize unnecessary regulatory burden on private firms and citizens. Over the years, however, the OAL has repeatedly interpreted the act as applying to the state's internal personnel policies. In one 1990 determination the OAL concluded that a DPA policy requiring state employees to fill out sick leave forms specifying the nature of the illness is a state regulation, and is therefore not legally enforceable unless and until the DPA promulgates the policy as a formal regulation. Among other things, this process would require the DPA to (1) prepare detailed documentation in support of its proposed regulation, (2) provide public notice and receive comments, (3) respond to each comment received, (4) hold a public hearing (if requested by anyone), and (5) submit the regulation and final documentation to the OAL for its review and approval.

Recently, the SPB had to inform state departments that it could not issue any guidelines or clarifying instructions concerning departments' preparations of affirmative action goals and timetables (as required by the state's law on affirmative action in civil service) because the OAL had determined that the guidelines are regulations subject to the Act. The SPB memo stated that up to two years might be required to promulgate the guidelines as regulations. Meanwhile, of course, departments are not relieved of their obligations to prepare and submit goals and timetables.

System Hinders Full Personal and Career Development

The examples below indicate that the current system also hinders opportunities for growth for employees.

Employees Forced Into Confining Job Classifications and Career Tracks

As mentioned above, the state has created 4,486 separate job classifications. As of February 1995, a total of 726 of these classifications had *only one incumbent*. The minute distinctions between classifications often border on the ridiculous. The stultifying effects of this classification maze, however, are serious for employers and employees alike.

One of the problems for employers—an increased number of costly examinations—has been noted above. Another problem facing employers is the inability to readily adapt to changing needs in both the workplace and the delivery of services. The rigidity of the classification definitions also poses barriers, both procedural and psychological, to the formation of project-or task-specific teams, within and among departments. They often create organizational tunnel vision. For employees, the confining classifications inhibit broadening career and personal development.

To its credit, the DPA has recognized that the current proliferation of job classifications is a serious problem and has proposed an alternative, on a pilot basis. According to a January 30, 1995, notification letter to the Legislature, the DPA will experiment with “broad banding” within the department. This will involve consolidating 15 classifications into four job "bands" to allow employees greater breadth in their duties and experience and allow the department greater flexibility in matching staff resources with changing tasks.

Lack of Lateral Entry

The system creates numerous barriers to lateral entry into the civil service, including extra exam points for current state employees, and the frequent use of exams closed to outside candidates. This, we believe, works to the detriment of employees as well as the state. In advocating the elimination of such barriers in state governments across the country, the National Commission on the State and Local Public Service points to the desirability of encouraging "...free movement between the public and private sectors. Many of the skills they require are interchangeable, and it is in the nation's long-term best interest to have its workers understand both worlds."

System Does Not Actively Recruit Top Candidates to State Service

The quality of any organization depends ultimately on the quality of the people who work for it, and the test of any personnel system is its effectiveness in this regard. We find that too often the state pursues a passive strategy toward attracting the best candidates for civil service or that the ponderous nature of the system creates its own barriers to recruitment, as shown by the examples below.

Lack of Centralized Employment Information

The state lacks a centralized source of employment information that can be easily accessed by people interested in state service. There is only one physical location in the entire state where a complete posting of exam and position announcements can be viewed (the SPB headquarters in Sacramento) and that location is not staffed. Centralized information about state employment opportunities also is not available on any computer networks.

Lack of Recruitment at Colleges and Universities

Some civil service veterans we spoke with remember a time when state departments actively recruited on college and university campuses to fill entry level professional positions. This effort has largely disappeared. Instead, the state now takes a *passive* approach to the filling of these positions and waits for candidates to present themselves for consideration.

Departments rely heavily, in some cases almost exclusively, on the promotion of employees in nonanalytical positions (various support functions) into analytical positions, under rules allowing time spent in state employment to be equivalent to higher education degrees. While many competent employees are available under this approach, the civil service managers we spoke with feel the quality of analytical/professional staff has declined due to the lack of recruitment of top university graduates. A number of factors have contributed to the decline of such recruiting, including hiring freezes ordered by the Governor.

We believe this problem has serious implications for the future quality of the civil service from bottom to top, and should be a matter of special concern to the Legislature.

Special Problems in Information Technology

The state in the last several years has experienced a series of costly and highly publicized problems in the area of information technology, which led the Governor to appoint a Task Force on Government Technology Policy and Procurement. Among the task force's findings and recommendations were several in the area of personnel policy. The task force observed that: "Few state IT [information technology] employees possess the technical skill sets needed to implement current IT solutions." The task force also stated that: "The civil service system does not facilitate a regular or timely infusion of new people, new thinking, or creativity from the outside—elements that are critical to meet the needs of a rapidly changing discipline like IT."

The Department of Motor Vehicles (DMV), site of a recent particularly egregious problem with implementation of a computer system now finds itself stymied by civil service barriers in its attempt to reorganize its information technology operations. Specifically, the DMV is interested in heading the reorganized office under a new "chief information officer" position. The department believes that an open search is necessary to secure the best possible candidates for this position. The DMV, however, finds that its options to seek outside candidates are constrained by a variety of civil service rules, and the department's reorganization plans are on hold.

PRINCIPLES FOR CHANGE

We believe that the breadth and the seriousness of the problems noted above point in a compelling direction—that the Legislature should begin a fundamental rethinking, or “reinvention”, of the state civil service system in order to make it again serve the state, its employees and the public.

Such a fundamental review would parallel similar efforts under way in other states and the federal government (under the Vice President's ongoing National Performance Review), and would be consistent with recent findings and recommendations directed at state and local governments by the National Commission on the State and Local Public Service. The timeliness of this “reinvention” effort is further underscored by the present work of the California Constitution Revision Commission, which will be presenting its initial report to the Legislature In August 1995.

In Figure 1 (see next page), we suggest a set of guiding principles to assist the Legislature in reviewing and crafting specific proposals directed at a reinvention of the state civil service.

Begin Process to Revamp the State's Civil Service System

We believe the Legislature should begin a fundamental rethinking, or “reinvention,” of the state civil service system. Specifically, we recommend that the Legislature begin holding hearings to fully solicit the views of state officials, employees and their representatives, and the public on this vital and far-reaching subject. Through these hearings, the Legislature can develop necessary legislation and foster necessary administrative changes.

Based on our findings, we believe the Legislature should approach the subject with its collective mind open to a wide range of alternative system models, rather than limit itself to consideration only of incremental changes at the “edges” of the current system. We hope the above principles will serve as a helpful guide for this process. In addition, we will continue to look at ways to improve specific aspects of the state's civil service system and, where indicated, to recommend specific statutory or administrative changes.

Figure 1

Principles for Reinventing California's Civil Service System

✔ **The Public Comes First**
Every other principle underlying the design of a good civil service system should tie back to this one.

✔ **Base Fully on The Merit Principle**
This was the core foundation of the civil service established by the State Constitution in 1934. The principle is as appropriate now as it was then.

✔ **Guard Against Politicization and Patronage**
Although societal and legal changes have diminished the threat of a return to a "spoils" system in state service, it is not an obsolete concern. Any system of state service must contain safeguards against politicization and patronage.

✔ **Make Adaptable to Change**
The system must have the ability to adapt to change, including change in the state's demographics, the organization of work, and the conceptions of work and career on the part of employees.

✔ **Promote Excellence in State Service and, Thereby, Efficient and Effective Delivery of Services to The Public.**
A good system should foster a culture of excellence. The state should not be content with mediocrity in the public service.

✔ **Promote Full Use and Development of Employees' Talents and Ideas**
The civil service system must provide an attractive place for people to work and to grow in talent and fulfillment. Employees must feel that their contributions make a difference—that they are engaged in valuable (and valued) public service.

✔ **Promote a Workforce Representative of The State's People.**
We believe this is an important principle for any organization, but particularly so for government in a representative democracy. We also believe this principle can and should be implemented in harmony with the other principles enunciated above.