The 2005-06 Budget: Perspectives and Issues

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

California Legislature

Hon. Don Perata
President pro Tempore

Hon. Fabian Nuñez
Speaker of the Assembly

Members of the Committee

Wesley Chesbro, *Chair*
Jim Battin
Denise Moreno Ducheny
Joseph Dunn
Dennis Hollingsworth
Tom McClintock
Carole Migden
Jack Scott

John Laird, *Vice Chair*
Judy Chu
Hector De La Torre
Jackie Goldberg
Rick Keene
Kevin McCarthy
Pedro Nava
Sharon Runner

Elizabeth G. Hill, *Legislative Analyst*

Staff

Elizabeth G. Hill — Legislative Analyst
Hadley Johnson, Jr. — Deputy
Mac Taylor — Deputy

Directors

Todd R. Bland
Steve D. Boilard
Daniel C. Carson
Michael Cohen
Chi-Ming Dana Curry
Gregory P. Jolivette
Robert Manwaring
Mark C. Newton
Jon David Vasché
Brad Williams

Managers

Larry Castro, Administration and Human Resources
Wil Davies, Information Services

Principal Fiscal and Policy Analysts

Farra C. Bracht
Anna Brannen
J. Paul Guyer
Mark A. Ibele
Jennifer Kuhn
Marianne O'Malley
Joel Riphagen
Anthony Simbol
Paul Warren

Senior Fiscal and Policy Analysts

Todd Clark
Jennifer Giambattista
Robert Ingenito
Christopher M. Guyer
Lisa Mangat
Shawn Martin
Lauren Nackman
Julie Salley-Gray

Fiscal and Policy Analysts

Michelle Baass
Brian C. Brown
Rachel S. Ehlers
Kirk Feely
Mariama K. Grimes
Brendan McCarthy
Celia Pedroza
Paul D. Steenhausen
Melissa M. Tanner
Melissa Eiler White

Support Staff

Judith Cashner
Karry Dennis-Fowler
Sandi Harvey
Irina Lobacheva
Anthony E. Lucero
Pamela A. Mash
Tina McGee
David Rendahl
Jim Stahley
Supatra Tuttle
James S. Will

TABLE OF CONTENTS

FIGURES

Part I:
State Fiscal Picture

Part II:
Perspectives on the Economy and Demographics

Part III:
Perspectives on State Revenues

Part IV:
Perspectives on State Expenditures

Part V: Major Issues Facing the Legislature

Governor's Budget-Related Reforms

Addressing Public Pension Benefits and Cost Concerns

Assessing the Governor's Reorganization Proposals

Transportation Funding Instability Continues

Toll Bridge Seismic Retrofit: Hard Decisions Before the Legislature

Water Policy Issues Facing the State

Evaluating the Administration's California Rx Proposal

Lowering the State's Costs For Prescription Drugs

INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2005-06 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 2005-06 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2005-06 Budget Bill*, which contains our review of the *2005-06 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 2005-06 Budget: Perspectives and Issues is divided into five parts:

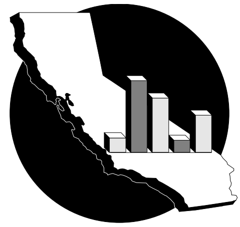
- Part I, "State Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part II, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part III, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2006-07.

- Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2005-06 and evaluates the major expenditure proposals in the budget.
- Part V, "Major Issues Facing the Legislature," (1) reviews the Governor's proposed budget-related reforms; (2) analyzes issues with public pension systems and various options to address these concerns (including the Governor's proposed defined contribution proposal); (3) reviews the Governor's reorganization plans involving state boards and commissions, and state correctional agencies; (4) describes the current instability in transportation funding and offers ways to address it; (5) assesses the issues facing the Legislature regarding the redesign and funding of the Bay Bridge; (6) analyzes the funding challenges facing the state for two major water issues—flood control and the CALFED Bay-Delta Program; (7) reviews the Governor's plan for drug discounts for the uninsured; and (8) offers ways for the state to save money on prescription drugs purchased as part of its responsibility to deliver health care services in state facilities.

I

State Fiscal Picture

State Fiscal Picture



The state continues to face a substantial structural shortfall in its General Fund budget. The Governor's budget released in January proposes to eliminate the shortfall in 2005-06 through significant program reductions (mainly in K-12 education, social services, and employee compensation), a suspension of Proposition 42 payments, and the use of $1.7 billion in remaining deficit-financing bonds. The Governor has also called the Legislature into special session to consider several Constitutional changes involving the budget process, Proposition 98, pensions, and transportation funding.

LAO Bottom Line

2005-06 Budget. We believe that revenues will be significantly higher and expenditures will be slightly lower than forecast by the administration. As a result, we estimate that adoption of the Governor's budget would result in a 2005-06 budget reserve of $2.9 billion, or $2.4 billion more than assumed in the budget. Adoption of the plan would also significantly reduce the longer-term structural shortfall facing the state, although a significant shortfall would persist.

While this improvement is a welcome development, it is important to keep in mind that it depends on adoption of *ongoing savings* that are *similar in magnitude* to those proposed by the Governor. As it establishes its priorities for 2005-06, the Legislature should aim at achieving the magnitude of ongoing solutions proposed in the budget.

Reforms. As we discuss in "Part V," we believe that the proposed budget reforms work against the administration's goal of reducing autopilot spending and addressing future shortfalls. Before adopting reforms, it will be important for the Legislature to determine what is wrong with the structure of the present budgeting system, and what actions will most effectively remedy the problem.

THE BUDGET PROPOSAL

The Budget's Economic and Revenue Projections

The U.S. and California economies expanded at a healthy pace in 2004, leading to major gains in business-related earnings, and moderate growth in employment and wages. The major growth in business profits resulted in sharp increases in state tax receipts in the first half of 2004-05.

The budget forecast assumes that economic growth will continue at a moderate pace in 2005 and 2006, with jobs and personal income benefiting from an accelerated pace of hiring by businesses. Reflecting the recent gains in tax receipts and continued growth in the economy, the budget assumes that revenues from the state's major taxes will increase by 8.7 percent in the current year and by 7 percent in 2005-06.

Total State Spending

The budget proposes total state spending in 2005-06 of $109 billion (excluding expenditures of federal funds and bond funds). This represents an increase of 4.4 percent from the current year. General Fund spending is projected to increase from $82.3 billion to $85.7 billion, while special funds spending rises from $22.1 billion to $23.3 billion.

General Fund Condition

Figure 1 shows the General Fund's condition from 2003-04 through 2005-06 under the budget's assumptions and proposals.

- ***2003-04***. The prior year concluded with a positive reserve of $2.9 billion. The reserve amount is up significantly from the $2.1 billion assumed in the *2004-05 Budget Act*, due to both higher-than-expected revenues and lower-than-expected expenditures for 2003-04 and prior years.
- ***2004-05***. In the current year, the budget assumes that revenues will be $78.2 billion and expenditures will total $82.3 billion. The resulting $4.1 billion operating deficit is covered through (1) the use of $2 billion in deficit-bond proceeds and (2) $2.1 billion of the carry-over reserve from 2003-04. This leaves the current year with an estimated reserve of $783 million.
- ***2005-06.*** In the budget year, General Fund revenues and transfers are projected to increase to $83.8 billion, or $1.9 billion less than

the proposed expenditure total of $85.7 billion. The budget bridges the gap between revenues and expenditures with $1.7 billion of the remaining deficit-bond proceeds, and a $0.3 billion drawdown of the reserve balance. This leaves 2005-06 with a year-end reserve of $500 million.

Figure 1

Governor's Budget General Fund Condition

(Dollars in Millions)

			Proposed for 2005-06	
	2003-04	2004-05	Amount	Percent Change
Prior-year fund balance	$5,060	$3,489	$1,425	
Revenues and transfers	74,762	78,219	83,772	7.1%
Bond proceeds	—	2,012	1,683	
Total resources available	$79,822	$83,720	$86,879	
Expenditures	$76,333	$82,295	$85,738	4.2%
Ending fund balance	$3,489	$1,425	$1,141	
Encumbrances	641	641	641	
Reserve	**$2,847**	**$783**	**$500**	

Detail may not total due to rounding.

How the Plan Addresses the Budget Shortfall

The Governor's budget includes about $9.1 billion in solutions to (1) eliminate a projected budget deficit of $8.6 billion and (2) build a small reserve of $500 million. About $1.1 billion of the savings are proposed for the current year, and $8 billion are proposed for 2005-06. Figure 2 (see next page) allocates the budget's proposed solutions into four main categories—program savings, funding shifts, loans, and revenues.

Program Savings. About one-half of the solutions fall into this category. The main proposals are:

- ***Proposition 98 Education.*** The administration is proposing to hold Proposition 98 spending roughly at the *2004-05 Budget Act* level (instead of providing schools with additional funds to meet the target suggested by language adopted with the 2004-05 budget). This results in state Proposition 98 savings of slightly over $1.1 billion in each of the current and budget years.

Figure 2

Proposed Solutions in 2005-06 Governor's Budget

(In Millions)

Program Savings	
Proposition 98	$2,284
Social services grants	714
Employee compensation	408
Noneducation mandate suspensions	219
IHSS wage participation	195
Senior citizens' tax assistance	141
Other	599
Subtotal, Program Savings	($4,560)
Funding Shifts	
Increased school contribution to STRS	$469
Retain PTA spillover in General Fund	216
Federal funds for certain prenatal care	191
Other	93
Subtotal, Funding Shifts	($969)
Loans[a]	
Deficit financing bonds	$1,682
Proposition 42 suspension[b]	1,310
Judgment bond for *Paterno* lawsuit settlement	464
Mandate deferral	31
Subtotal, Loans	($3,487)
Revenues	
Increased tax compliance	$77
Total	**$9,093**

a In addition to these totals, assumes $765 million in proceeds from pension-obligation bonds authorized in 2004-05 budget.

b The administration indicates this is treated as a loan in its debt consolidation proposal.

- ***Social Services Grants.*** The budget proposes a 6.5 percent reduction in California Work Opportunity and Responsibility to Kids (CalWORKs) grants beginning in the budget year, plus the elimination of the statutory cost-of-living adjustment (COLA) for

CalWORKs grants. It would suspend COLAs for Supplemental Security Income/State Supplementary Program grants in the budget year.

- ***Employee Compensation.*** The budget proposes $408 million in employee compensation savings from (1) an increase in state employees' share of annual retirement contributions, (2) a reduction in state holidays, and (3) employee furloughs. These changes would need to be negotiated through the collective bargaining process.

- ***Noneducation Mandate Suspensions.*** The budget would suspend most noneducation mandates in 2005-06, for a savings of $219 million.

- ***In-Home Supportive Services (IHSS) Wage Participation.*** The budget proposes to limit state participation in IHSS provider wages to the minimum wage, rather than the $10.10 per hour level currently authorized.

- ***Senior Citizens' Property Tax and Renters' Assistance Programs.*** The budget proposes elimination of the senior citizens' property tax assistance program and a reduction in the senior citizens renters' tax assistance program.

- ***Other Savings.*** The remaining $599 million in savings is related to a variety of proposals throughout the budget. These include: a package of Medi-Cal reforms such as a modification of dental benefits for adults; tiered reimbursements for child care providers for CalWORKs recipients and the working poor; procurement savings; and an across-the-board reduction to state operations.

In other areas, the budget provides funding for workload and, in some cases, price adjustments. It proposes funding increases for higher education consistent with the Governor's compact with the University of California and California State University.

Funding Shifts. In this area, there are three main proposals. First, the administration is proposing that the state no longer fund annual base program contribution costs for the State Teachers' Retirement System. Under the proposal, these costs would be borne by the school districts or their employees. Second, the budget proposes to retain Public Transportation Account "spillover" funds in the General Fund in 2005-06, instead of transferring them to transportation-related special funds, as is required by current law. Third, the budget proposes to replace General Fund support for certain prenatal care services with new federal funds.

Loans. In this area, the administration is proposing the following:

- It would use $1.7 billion of the remaining deficit-financing bonds in 2005-06, leaving slightly less than $2 billion of the original $15 billion in Proposition 57 related bonding authority for 2006-07 and beyond.
- It would suspend the Proposition 42 transfer of sales taxes on gasoline from the General Fund to transportation funds. The budget proposes to repay the suspended amount under certain conditions. Specifically, the Governor's reform proposal includes a provision requiring that all Proposition 42 payments suspended prior to 2007-08 be paid off over a 15-year period beginning in 2007-08.
- It would issue a "judgment bond" to finance a pending $464 million settlement of flood-related litigation (*Paterno* case) against the state.
- It would defer about $31 million in noneducation local mandate payments.

In addition to these proposals for new borrowing, the budget assumes $765 million in proceeds from pension obligation bonds that will be sold in the budget year. This amount is not shown in Figure 2 (which highlights *new* proposals), because the pension bonds were previously authorized in the 2004-05 budget package.

Revenues. The budget does not include proposals for state tax increases. It does, however, include some funding for increased tax compliance (see discussion in "Part III" of this document).

Ongoing Savings in Budget Plan

Of the $8 billion in solutions proposed for 2005-06, slightly over $4 billion are ongoing in nature. We estimate that these savings would expand to roughly $5 billion in 2006-07, as the full-year impacts of some of the grant reductions and other proposals take hold.

BUDGET'S REFORM PROPOSALS

In addition to the 2005-06 budget, the Governor is proposing several changes to the state Constitution. These changes, which are discussed in "Part V" of this document, involve Proposition 98, the budget process (including a provision for automatic across-the-board reductions), and pensions for future state employees. They also would prohibit future suspensions of Proposition 42 transfers to transportation and borrowing from special funds. Finally, the proposal would require that certain outstanding obligations be paid off within 15 years.

LAO OUTLOOK

In this section, we examine the implications of the Governor's 2005-06 budget on the near-term and longer-term General Fund condition, using our own revenue forecast and our estimates of the impacts of the Governor's proposals. Our estimates do not reflect any of the programmatic recommendations that we make in our *2005-06 Analysis of the Budget Bill*. The causes of our differences from the budget projections are limited to (1) assumptions about the economic and revenue outlook and (2) estimation differences in the level of expenditures that would be needed to fund the Governor's budget plan.

The intent of these estimates is to provide the Legislature with our assessment of the extent to which the 2005-06 budget solutions proposed by the Governor address the full magnitude of the short-term and longer-term fiscal imbalance facing the state. Our key budget-related findings are highlighted in Figure 3, while our estimates of revenues, expenditures, and the General Fund's condition are shown in Figure 4 (see next page).

Figure 3

Key LAO Budget Findings

✓ **2005-06 Would End With $2.9 Billion Reserve—$2.4 Billion More Than the Administration's Forecast**

- Revenues up from budget forecast by $2.2 billion.
- Expenditures down from budget by about $250 million.

✓ **Reserve Needed in Subsequent Year**

- Budget shortfall reemerges as temporary solutions expire and deferrals come due.

✓ **Budget Reduces, But Does Not Eliminate, State's Structural Shortfall**

- Out-year annual shortfalls in the $4 billion range remain in subsequent three years.
- Using 2005-06 reserve to fund ongoing commitments would worsen the out-year picture.
- For this reason, policymakers should still aim to achieve the magnitude of ongoing solutions proposed in the budget.

Figure 4

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

(In Millions)

	2003-04	2004-05	2005-06	2006-07
Prior-year fund balance	$5,060	$3,489	$2,992	$3,578
Revenues and transfers	74,762	79,634	84,537	88,423
Bond proceeds	—	2,012	1,683	—
Total resources available	$79,822	$85,135	$89,212	$92,001
Expenditures	$76,333	$82,143	$85,634	$92,417
Ending fund balance	$3,489	$2,992	$3,578	-$416
Encumbrances	641	641	641	641
Reserve	$2,847	$2,350	$2,937	-$1,058

Detail may not total due to rounding.

2005-06 Budget Would Have $2.9 Billion Reserve

As indicated in both Figures 3 and 4, we estimate that if *all* of the budget's proposals were adopted and nearly all of its savings realized, the state would end 2005-06 with a reserve of $2.9 billion, or $2.4 billion more than assumed in the Governor's budget. Of the total, $2.2 billion is related to higher revenues and about $250 million is related to lower costs.

Higher Revenues. Total revenues in December and January were up from the administration's new budget forecast by over $800 million, reflecting stronger-than-expected year-end estimated payments by individuals and corporations toward their 2004 income tax liabilities. As discussed in "Part III," these year-end payments often provide an early indication of the strength of payments associated with final returns remitted in March (for corporations) and April (for individuals). Coupled with other evidence that California concluded 2004 on a strong note, we are forecasting that the revenue trend is higher than assumed by the administration. Accordingly, we are projecting that revenues will exceed the budget forecast by $1.4 billion in the current year and $0.8 billion in 2005-06.

Lower Costs. Our expenditure total is down from the administration by $152 million in the current year and $104 million in the budget year. We estimate that local property taxes available to Proposition 98 education will be higher than estimated by the administration. This would reduce, dollar for dollar, the amount of General Fund spending that is needed to meet the guarantee. Partly offsetting these savings are higher costs that we anticipate in trial courts, noneducation mandates, corrections, and other state operations.

Reserve Estimate Provides Overly Optimistic Picture Of State's Fiscal Condition

The higher reserve we are projecting would clearly be a positive development for the state. We warn, however, that it is subject to the following important qualifications:

- First, the 2005-06 budget includes $1.7 billion in proceeds from deficit-financing bonds. Absent these borrowed funds, the reserve would be about $1.3 billion.
- Second, the year-end reserve balance will be needed in 2006-07, when temporary solutions (such as the two-year diversions of local property taxes and onetime proceeds from pension obligation bonds) expire and past obligations come due. As indicated in Figure 4, even if the full reserve were carried over and used to support expenditures in 2006-07, that fiscal year would still conclude with a deficit of about $1.1 billion.
- Third, the budget faces many risks. In particular, it continues to assume the sale of a $765 million pension-obligation bond originally authorized in 2004-05, which is currently subject to court challenge. The $408 million in employee compensation savings are dependent on collective bargaining negotiations. The budget also includes savings from unallocated reductions to state operations in most program areas, and procurement reforms are anticipated to generate more savings in the budget year. Savings related to collective bargaining negotiations, unallocated reductions, and procurement reforms, however, have often fallen short of expected levels in the past.

Budget Reduces, But Does Not Eliminate, State's Structural Shortfall

Assuming our revenue forecast, this budget makes significant progress toward resolving the state's out-year structural budget shortfall, but still leaves a significant portion of the gap to be dealt with in future years.

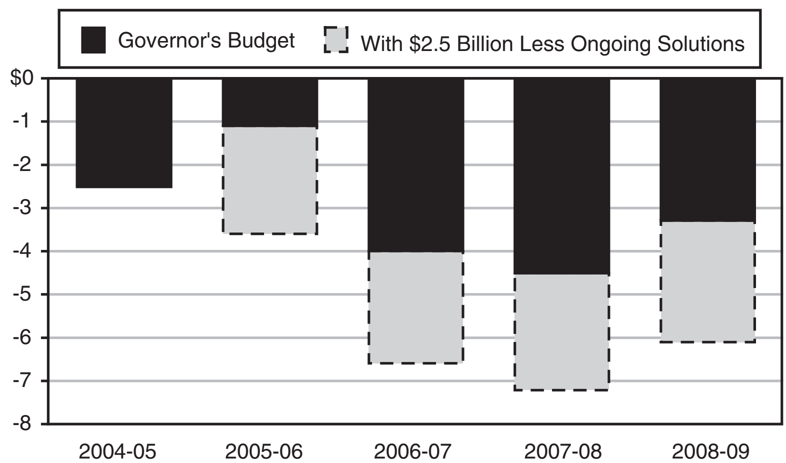
Current Law Shortfalls. As background, in November we indicated that under current law, the state faced annual operating deficits (that is, shortfalls between current revenues and expenditures) reaching a peak of $10 billion in 2006-07 and averaging roughly $9 billion in the subsequent two years.

Out Years Under Governor's Budget. The Governor's budget plan would eliminate over one-half of the current-law operating shortfalls. The estimate takes into account the ongoing solutions in the Governor's plan, the administration's stated intention of suspending the Proposition 42 transfer in 2006-07, and the elimination of COLAs for CalWORKs grants. As shown in Figure 5, the annual shortfalls under these assumptions would be about $4 billion in 2006-07, $4.5 billion in 2007-08, and $3.3 billion in 2008-09.

Figure 5

Despite Near-Term Improvement, General Fund Operating Shortfalls Remain

Annual Difference Between Revenues and Expenditures Under Alternative Scenarios (In Billions)



The $4 billion operating shortfall in 2006-07 could be covered with the $2.9 billion in carry-over reserves and remaining deficit-financing bond proceeds. Because these one-time resources would then be nearly exhausted, the state would need to find additional savings to cover the operating shortfalls in 2007-08 and 2008-09.

"Consolidation Proposal" Would Reduce Shortfalls in 2007-08 and 2008-09. As discussed in "Part V," one of the Governor's budget reform proposals involves the consolidation and payment within 15 years of outstanding obligations related to transportation, education, local governments, and special funds. If this proposal were implemented, the state could save about $1 billion relative to current law in both 2007-08 and

2008-09 (when large transportation loan repayments would otherwise be due). However, the net impact of the consolidation on the state's overall fiscal condition in subsequent years is uncertain, and would depend on a variety of factors.

Operating Shortfalls Do Not Include Reserve Contributions. Under the terms of Proposition 58, the state is required to make annual transfers into a newly created budget stabilization account beginning in 2006-07. The annual transfers are 1 percent of revenues in 2006-07 ($880 million), 2 percent in 2007-08 ($1.9 billion), and 3 percent in 2008-09 ($3 billion) and thereafter until the balance in the reserve reaches $8 billion. The annual transfers can be suspended by the Governor during periods in which the state is facing fiscal shortfalls. Given the state's ongoing structural shortfall, we have not added the costs of these transfers to our calculation of future operating shortfalls. Inclusion of these transfers, however, would increase the size of the out-year funding gaps that would need to be covered.

Impacts of Adopting Fewer Ongoing Solutions. The improvement in the state's projected longer-term fiscal picture is predicated on the Legislature adopting ongoing solutions that are similar in magnitude to those in the Governor's budget. Absent these savings, the out-year budget shortfalls will remain formidable. As one illustration, if the Legislature were to reduce the magnitude of ongoing solutions in the 2005-06 budget by $2.5 billion relative to the Governor's budget, the out-year operating shortfalls (the difference between current revenues and expenditures) would expand to roughly $7 billion (see Figure 5).

CONSIDERATIONS FOR THE LEGISLATURE

The Legislature faces significant policy decisions related to both the Governor's specific proposal for balancing the 2005-06 budget, and his longer-term reform proposals.

Aim at Ongoing Solutions Similar in Magnitude to Governor's Proposal. Regarding the budget, we strongly urge the Legislature aim at achieving ongoing solutions in 2005-06 that are of similar magnitude to those proposed in the budget. This is because in 2006-07 the state will face a $4 billion operating shortfall *even if all of the budget's solutions are adopted*. As illustrated in Figure 5, if the magnitude of ongoing savings is diminished significantly, the out-year problem becomes much more formidable.

Be Cautious About Reforms. Regarding the Governor's reform proposals, we strongly support the objectives of eliminating the state's long-term structural problem, paying off its debts, and maintaining balanced budgets in the future. However, we believe that specific proposals relating to Proposition 98, Proposition 42, and the across-the-board reduction work against these goals. As we discuss in "Part V," before undertaking major Constitutional reforms, it will be important for the state to have a clear understanding of "what is broken" in the existing process, and what steps would most directly address the problems without compromising other objectives of good fiscal policy.

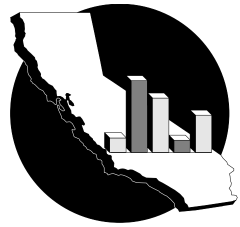
For instance, the administration suggests that a key problem is that state spending is on autopilot. If the Legislature believes that this is the case, the solution would not be placing *more* spending on cruise control—as the administration is proposing for Proposition 98 and other areas of the budget. The solution would be to eliminate these types of provisions that limit the Legislature's and Governor's authority to make annual budgetary decisions.

Similarly, the perceived deficiency may be that the recently enacted balanced-budget and mid-year correction provisions in Proposition 58 are not adequate to maintain fiscal balance. If so, there may be alternative proposals which strengthen the existing process while not diminishing the Legislature's central authority in budgetary appropriations.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics



Summary

Both the U.S. and California economies grew at a solid pace in 2004. As shown in Figure 1 (see next page), U.S. real gross domestic product (GDP) expanded by 4.4 percent, the largest gain since 1999. Employment grew modestly despite continued cost-cutting and merger activity by businesses. Prices for oil and raw materials jumped during the year, but overall inflation accelerated only modestly. Looking ahead, we expect economic growth at both the nation and in California to slow some, but continue at moderate pace through the forecast period.

RECENT U.S. DEVELOPMENTS

Economic growth in 2004 was driven by a sharp acceleration in business spending and continued above-average gains in consumption. As indicated in Figure 2 (see next page):

- The fastest-growing category was nonresidential fixed investment, which jumped 9.9 percent (in inflation-adjusted terms). The increase was driven by healthy growth in spending on computers, software, and communications equipment. The rapid growth in investment spending benefited the many California businesses that are engaged in the production and sales of information technology (IT)- related products
- Consumer spending increased at a solid 3.9 percent inflation-adjusted rate, reflecting gains in purchases of home furnishings, clothing, and services.

Figure 1

2004 Was Best Year of U.S. Expansion

U.S. Real Gross Domestic Product, Annual Percent Change

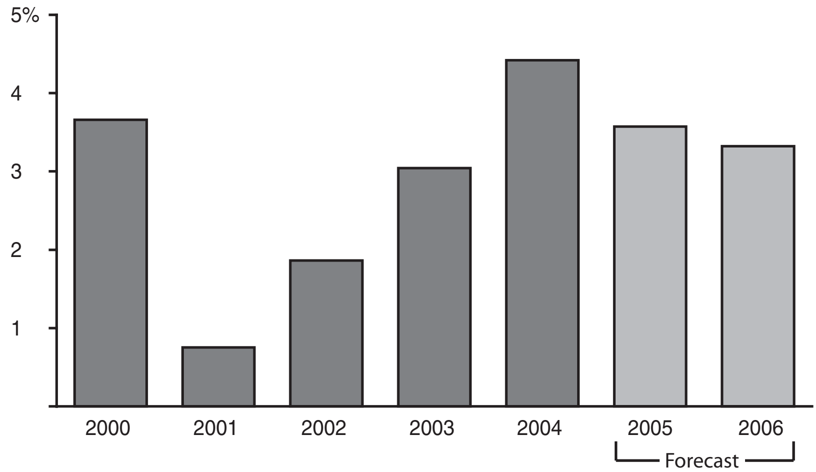
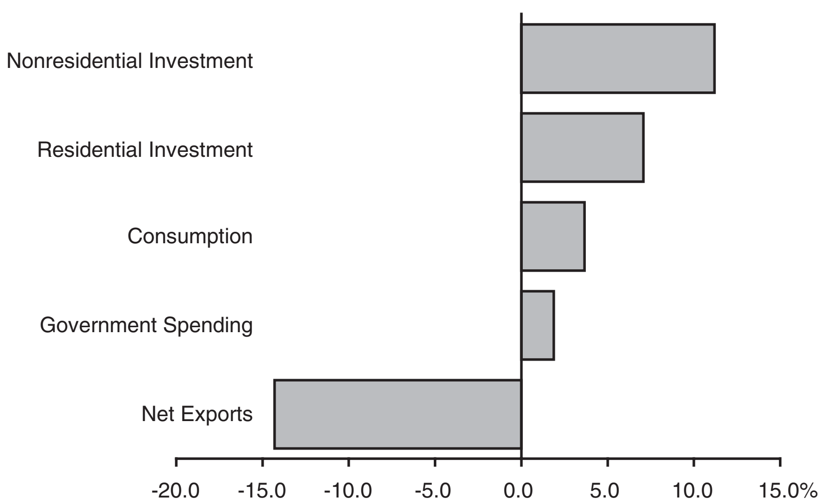


Figure 2

Business Spending Led U.S. Growth in 2004

Percent Change in Components of Real GDP
Fourth Quarter 2003 Through Fourth Quarter 2004



- Government spending rose 1.6 percent during the year, reflecting 5.5 percent growth in federal purchases of military equipment, but a much smaller gain in state and local spending (0.2 percent).
- The trade deficit expanded by 20 percent during the year, as a healthy increase in exports was offset by an even larger rise in imports during the year.

Personal Income and Jobs Finally Improved

The current expansion has been characterized by intense competition and a major focus by businesses on reducing costs and finding efficiencies. Over the recent expansion period, these actions have boosted productivity gains, restrained inflation, and contributed to large increases in business profits.

At the same time, however, the intense focus on costs and efficiencies also translated into extremely slow improvement in labor market conditions through 2003, as businesses remained extremely reluctant to add to their payrolls. Economists had become concerned that the lack of hiring would eventually undermine consumer confidence, leading to a downward spiral in spending and output in the economy. However, these concerns eased once employment started to grow in 2004. The lack of stronger job growth remains a concern—for example, it was a factor cited for the decline in one key consumer confidence survey index in January. However, the continued strength in retail spending and home sales suggests that these concerns have not yet had a chilling effect on actual spending by households. (We more fully discuss recent productivity increases and their implications for the economy in the box on page 22.)

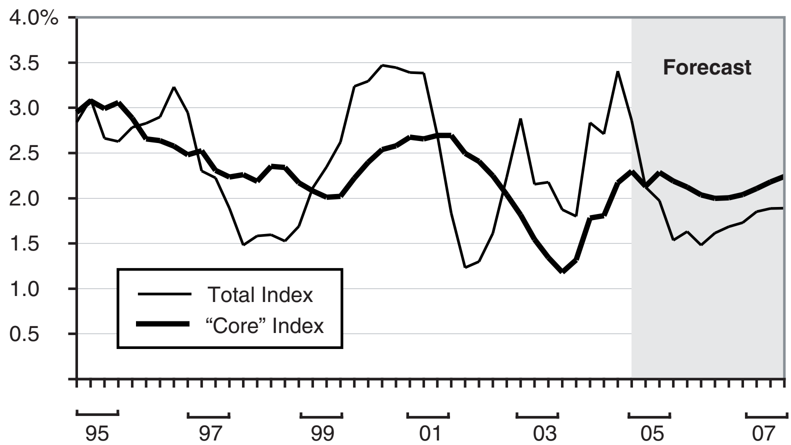
Oil Prices Soared, But Did Not Fuel Inflation

Inflation accelerated significantly in 2004, but the increase was relatively mild in view of the dramatic jump that occurred in energy and raw material prices. As indicated in Figure 3 (see next page), growth in the U.S. consumer price index (CPI) rose from 1.8 percent in the first quarter of 2004 to 3.4 percent by the final quarter of the year. Much of the increase, though, was concentrated in the energy-related components. The CPI *excluding* the volatile food and energy categories (which is often referred to as the "core rate" of inflation) rose much more modestly during the year—from 1.3 percent to only 2.2 percent. The rapid growth in energy-related prices was largely absorbed by businesses and not "passed along" to customers in the form of higher prices. The lack of more widespread price increases was a welcome development. Higher inflation would have quickly translated into higher short- and long-term interest rates, which would have had damaging effects on housing and other sectors of the economy.

Figure 3

Inflation Remains Moderate

U. S. Consumer Price Index, Year-to-Year Percent Change, by Quarter



Recent Monthly Reports Suggest Continued Growth

Although high energy prices and the lack of strong job growth remain a concern to consumers, most recent indicators suggest that the economy is entering 2005 with significant momentum. For example:

- Retail spending jumped 1.2 percent between November and December, reflecting strength in sales of "big ticket" items such as automobiles and home furnishings. Department stores reported solid, if unspectacular, sales during the holiday shopping season. Over the full year, retail spending was up 8 percent, the largest gain since 1999.
- Housing starts jumped to over 2 million at an annual rate in December, bringing the full-year total to 1.95 million, the strongest since 1978.
- The Federal Reserve's "beige book" survey, which reflected business conditions from mid-November 2004 through early January 2005, found that business conditions remain solid throughout the country, with the pace of sales and orders in many regions accelerating late in the year. The survey also found that businesses planned to further increase hiring and capital spending in 2005.

CALIFORNIA TRENDS

Because of data limitations, gross domestic product data are not reported on a current quarterly basis at the state level. (Currently, such estimates are available on an annual basis only through 2003.) Given the lack of current state-level output data, economists focus on the information that *is* available for jobs and personal income. In the current environment, however, the slightly weaker job growth in California is providing an incomplete picture of California's economic performance compared to the rest of the nation.

This is because while job growth is lagging slightly behind other states, a variety of other reports suggest that sales and output growth is probably exceeding the nation (see Figure 4). Specifically:

- ***Exports*** of products made in California jumped 23 percent in 2004, with quarterly levels approaching the all-time peak reached in 2000. The improvement reflects economic growth in several key foreign markets and the recent decline in the U.S. dollar on international currency markets, which make our products less expensive in foreign countries.
- ***Company sales and profits reports*** to shareholders indicate that California-based firms in a variety of industries enjoyed major growth in sales and profits during 2004.

Figure 4

California's Economic Picture

✓ **Sales, output, and profits are strong, as evidenced by:**
- Strong real estate construction.
- Booming exports.
- Strong company reports of sales and profits.
- Healthy gains in business-related tax receipts.

✓ **Job growth lagging, due to:**
- Intense focus on cost cutting and efficiencies, particularly in high-tech.
- Declining government employment.

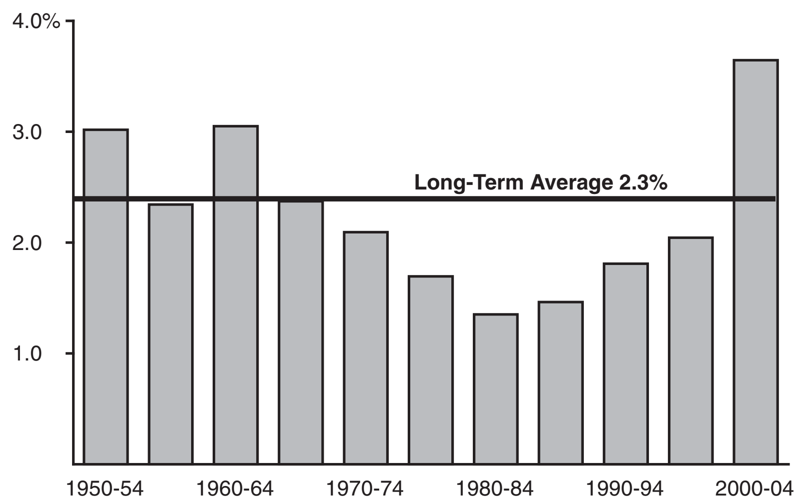
What Is Behind Recent Strong Productivity Increases?

One of the more significant developments over the past decade has been the acceleration in productivity (defined as output per hour worked in the economy). Over the long term, productivity growth is a key determinate of output and income in the economy—with strong productivity translating into rising wealth and living standards. In recent years, high productivity growth contributed to low prices and strong profit growth. On the other hand, it has also been cited as a factor behind the lack of job growth, since businesses have been able to expand production without adding workers. Given these developments, future productivity growth has implications for inflation, job growth, and output growth in the years ahead.

Historical Perspective. As shown in the accompanying figure, nonfarm business productivity in the U.S. economy has increased at an average annual pace of 2.3 percent during the past 55 years. The growth rate exceeded that average during much of the 1950s and 1960s, then fell below the average in the 1970s and early 1980s—an era when the economy was absorbing many younger and less experienced workers—before partially recovering in the 1980s and

Recent Productivity Growth at All-Time High

Annual Average Increase in U.S. Nonfarm Business Productivity



early 1990s. In the second half of the 1990s, the average rate accelerated again—to 2 percent per year in 1995-1999 period and to 3.6 percent during the past five years.

Factors Behind Recent Gains. Economists generally agree that two related factors are principally responsible for the recent surge in productivity gains—expanded use of information technology (IT) and an increase in "competitive intensity" in many sectors of the economy.

- ***Growth in IT.*** This factor has affected economywide productivity in two ways. First, the IT industry is characterized by innovation, rapidly expanding capabilities, and high-valued products. The rising share of total output attributable to this highly productive industry has, by itself, contributed to economywide productivity growth during the past 10 to 15 years. Second, there is evidence that—after many false starts in the 1990s—investments made by companies in IT products are finally paying off in the form of streamlined inventory management, and improvements in marketing, purchasing, and production activities.

- ***Intense Competition.*** A second and closely related factor cited by economists has been increased competitive intensity that emerged in the mid-1990s in a wide variety of industries ranging from retailing, manufacturing, airlines, banking, and telecommunications. Factors cited for the increased intensity include deregulation and globalization. In this highly competitive environment, productive companies—those that are most successful in organizing work flows, holding down costs, and targeting markets—are expanding at the expense of their less productive counterparts.

Outlook. Most forecasters assume that the nearly 4 percent annual increases will subside as the pace of mergers and cost-cutting activities slows and businesses focus more on expanding operations to meet future growth. We forecast that productivity growth will settle into the range of 2.5 percent per year over the forecast period. Such gains would still be quite high compared to gains recorded during similar stages of past expansions. We believe that the continued gains will benefit both businesses, in the form of higher profit margins, and their employees, who will benefit from lower prices and potentially larger wage gains. At the same time, the productivity increases we are projecting also imply that job growth will remain well below the rates in previous economic expansions.

- ***Tax receipts*** have been strong in recent months, particularly those related to business earnings. For example, quarterly estimated payments by corporations in the final six months of 2004 were up by 20 percent from the prior year. Withholding payments, which reflect wages, bonuses, and stock options, were up by 8.7 percent during the same time period.
- ***Permits*** for new home construction jumped to an annual pace of 237,000 units in November, the strongest monthly pace since 1988. Other real estate indicators point to continued demand, especially in the more affordable areas of the state. Sales of existing homes reached a 650,000 annual rate in November, the highest on record, and the median home price stood at $473,000, up 23 percent from November 2003.

One key to the divergent trends between jobs and other growth indicators is that the competitive pressures discussed earlier are extremely intense in California's high-tech industries. These trends are particularly evident in Silicon Valley, which continues to experience mergers, acquisitions, restructurings, and job cuts, even as sales and profits of its major companies rebound.

How Strong Is Job Growth?

A basic question related to California's economic picture is: Exactly how strong is employment growth? As shown in Figure 5, two surveys of employment are providing decidedly different pictures of employment strength in this state. Specifically:

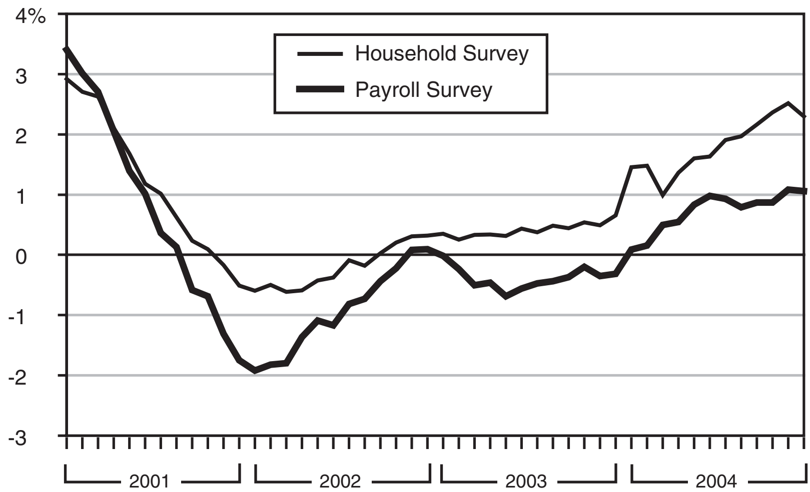
- According to the payroll survey of employers, nonfarm employment increased about 1.1 percent (152,000 jobs) between December 2003 and December 2004.
- According to the survey of households, the job gain for the same period was about 2.3 percent (376,000 jobs).

While there is often some discrepancy between the two series, the current difference is much larger than normal. It may reflect the growth in use of independent contractors (which are picked up in the household survey but not in the payroll survey), and rapid job growth in newly created small businesses (which are often missed in initial payroll surveys and only appear after annual benchmark revisions). While the payroll series with its larger sample size is normally a better indicator of employment trends, the household series is presently more consistent with other measures of growth evident in California at this time.

Figure 5

California Jobs Are Up—But by How Much?

Year-to-Year Percent Change, by Month



Even the modest gain in the payroll series during 2004, however, is an improvement from the prior two years, when this series was showing job losses. The overall growth in payroll employment reflects a 4.8 percent year-over-year gain in construction, a 3.1 percent increase in businesses and professional services, and more modest increases in most other private sector categories. Government employment fell 0.7 percent, reflecting tight budgets at the state and local government levels.

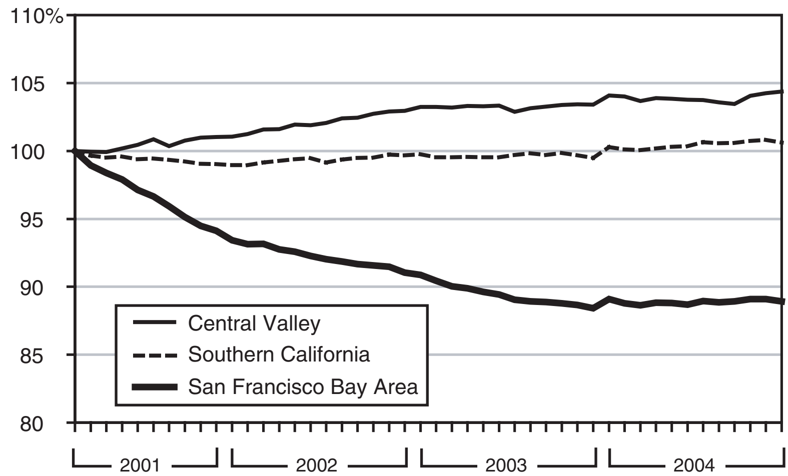
Regional Picture—Bay Area Finally Stabilizing

California's job downturn during 2001 through mid-2003 was concentrated in the Bay Area. As shown in Figure 6 (see next page), that region lost nearly 12 percent of its job base between 2001 and mid-2003, reflecting major declines in the high-tech industry. In contrast, job losses in Southern California were mild and the Central Valley continued to grow during the period. As Figure 6 indicates, the overall improvement in California's job picture is largely the result of (1) continued steady, albeit slow, growth in Southern California and the Central Valley and (2) the stabilization in the Bay Area's job market.

Figure 6

Employment Stable or Rising In All California Regions

Payroll Jobs–Percent of Prerecession Peak



THE BUDGET'S ECONOMIC OUTLOOK

The budget's economic forecast, which was prepared in early December, assumes that economic growth will ease some from the 2004 pace, but that growth will continue at a moderate pace in both 2005 and 2006. It assumes that jobs and personal income will accelerate as a result of a stepped-up pace of business hiring.

National Outlook

As shown in Figure 7, the budget forecasts that real GDP growth will slow from 4.4 percent in 2004 to 3.3 percent in 2005, and further to 3 percent in 2006. The administration assumes that both consumer spending and business investment will ease from the 2004 pace, as rising interest rates diminish home mortgage refinancing and the fiscal stimulus from the previous federal tax cuts fades. Finally, the forecast assumes that inflation will retreat from 2004 levels, as the result of less upward pressure from oil prices.

Figure 7

Summary of the Budget's Economic Outlook

			Forecast	
	2003	**2004**	**2005**	**2006**
U.S. Forecast				
Percent change in:				
Real gross domestic product	3.0%	4.4%	3.3%	3.0%
Personal income	3.2	5.2	4.9	5.4
Wage and salary employment	-0.3	1.0	1.7	1.2
Consumer Price Index	2.3	2.6	2.3	2.0
Unemployment rate (%)	6.0	5.5	5.3	5.5
Housing starts (000)	1,850	1,940	1,830	1,690
California Forecast				
Percent change in:				
Personal income	3.1%	5.6%	5.8%	6.0%
Employment:				
Payroll survey	-0.4	1.0	1.8	1.8
Household survey	0.4	1.8	1.8	1.6
Taxable sales	4.3	5.7	5.7	5.6
Consumer Price Index	2.3	2.7	2.9	2.5
Unemployment rate	6.7	6.2	6.2	6.3
New housing permits	197	210	199	195

California Outlook

The administration's forecast also assumes that California's economy will expand at a moderate pace in both 2005 and 2006. It assumes that businesses will step up the pace of hiring, which will result in an acceleration in wages and jobs. It specifically projects that the state's personal income growth will accelerate from 5.6 percent in 2004 to 5.8 percent in 2005 and 6 percent in 2006, and that job growth (as measured by the payroll survey) will accelerate from 1 percent in 2004 to 1.8 percent in both of the subsequent two years.

LAO'S ECONOMIC OUTLOOK

Our economic outlook has changed only modestly since our November 2004 fiscal forecast. We continue to believe that economic output will slow some in 2005 from last year, but that the national and state economies will continue to expand at a moderate pace.

National Outlook

As shown in Figure 8, we project that real GDP growth will shift down from 4.4 percent in 2004 to 3.6 percent in 2005 and 3.3 percent in 2006. This reflects a slightly slower pace in consumer spending and business investment, partly offset by improvement in the foreign trade deficit. Specifically:

Figure 8

Summary of the LAO's Economic Outlook

		Forecast		
	2004	**2005**	**2006**	**2007**
U.S. Forecast				
Percent change in:				
Real gross domestic product	4.4%	3.6%	3.3%	3.3%
Personal income	5.4	5.2	5.7	5.6
Wage and salary employment	1.0	1.8	1.5	1.1
Consumer Price Index	2.7	2.1	1.6	1.8
Unemployment rate (%)	5.5	5.3	5.3	5.3
Housing starts (000)	1,933	1,815	1,702	1,669
California Forecast				
Percent change in:				
Personal income	5.6%	5.5%	5.7%	6.0%
Employment:				
Payroll survey	0.8	1.5	1.5	1.6
Household survey	1.8	2.0	1.7	1.5
Taxable sales	6.4	5.7	5.4	6.0
Consumer Price Index	3.0	2.8	1.9	2.1
Unemployment rate	6.1	5.4	4.9	4.8
New housing permits	209	204	184	192

- ***Real consumer spending*** is expected to slow from 3.7 percent in 2004 to around 3 percent in 2005 and 2006. These increases are roughly in line with projected gains in real disposable income. The main factors behind the slowdown are high debt loads, less mortgage debt refinancing (as interest rates rise), and fading impacts from previous federal tax cuts.
- ***Real business fixed investment*** is forecast to ease from 10 percent in 2004 to 9 percent in 2005 and about 7 percent in 2006. The slight slowdown partly reflects the expiration of "bonus depreciation" provisions in federal law. These provisions allowed accelerated-depreciation deductions for equipment put in place through the end of 2004, and likely resulted in some acceleration in equipment spending late last year. The still-healthy gains projected for 2005 and 2006 reflect continued strong investment in IT-related equipment. They also reflect an improvement in spending on facility expansion and modernization, as businesses focus on meeting future increases in demand.
- ***The trade deficit*** is expected to peak in 2005 before starting to decline in 2006. The main factor behind the assumed turnaround is the weaker U.S. dollar against the Euro and other foreign currencies. The decline in the dollar should further boost exports by making U.S. goods less expensive on foreign markets, and depress imports by making foreign goods relatively more expensive in the U.S.

In other developments, inflation is forecast to ease some in 2005 and 2006, reflecting more stable prices for energy products, and modest increases in other categories. Solid (although slower) productivity growth and continued intense competition are also expected to restrain price increases in the forecast period. In this environment, we expect continued slow but steady increases in interest rates.

Other Elements of the U.S. Outlook

Oil Prices. After jumping from $35 per barrel at the beginning of 2004 to $55 per barrel in late October, oil prices fell back to below $45 in late 2004, before partly rebounding to near $50 as of late January. The price will continue to fluctuate in the months ahead, as updated reports of inventories, production, and demand are issued. However, we forecast the overall trend will be downward, with prices averaging around $40 per barrel by the end of 2005. Factors suggesting somewhat lower prices include (1) slowing worldwide economic growth, especially among major oil importers such as China and (2) increases in drilling and oil production. We would note, however, that the oil market remains quite vulnerable to supply disruptions and other factors.

Federal Policies. Federal policies had a stimulative impact on the economy in 2002 through 2004, as tax reductions were spent by consumers and increased federal defense purchases boosted growth in the aerospace sector. However, federal policies will become much less stimulative in 2005 and beyond, as the effects of tax cuts fade and financing of the deficit adds upward pressure on interest rates. Given that there is still plenty of liquidity in worldwide credit markets, we expect the upward pressure on interest rates to be modest in the near term. Although social security reforms that are being discussed could have significant effects on the economy, the timing and nature of these effects could vary widely, depending on policies that are eventually adopted.

California Outlook

We believe that overall sales and output growth of California firms will continue at a solid but moderating pace over the next two years, reflecting slowdowns in consumer and business spending. We expect that, while business earnings growth will ease, an accelerated pace of hiring will result in a modest increase in employment growth during the year. As shown in Figure 8:

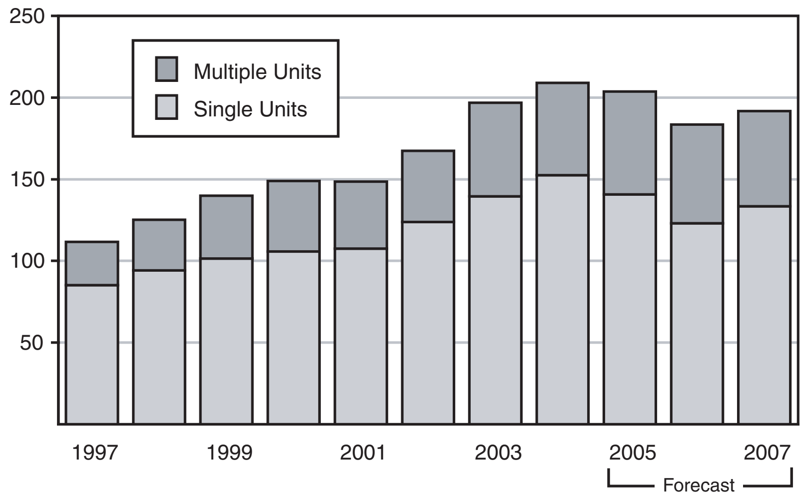
- ***Personal income*** growth is projected to expand by 5.5 percent in 2005, or about the same pace as 2004. Compared to 2004, we expect income related to wages to accelerate modestly but earnings attributable to businesses to moderate.
- ***Payroll employment*** growth is projected to increase from 0.8 percent in 2004 to 1.5 percent in both 2005 and 2006. Compared to 2004, we project growth to accelerate in most industry sectors.
- ***Housing permits*** are expected to remain above the 200,000 unit pace in 2005 reflecting continued strong demand in moderate-priced regions of the state, before easing back in 2006 (see Figure 9).
- ***Nonresidential building permits*** are projected to grow modestly in 2005 and 2006, as businesses step up expansion plans.

Outlook for Individual Geographic Regions and Industries. We expect that employment growth will encompass all major economic regions in 2005 and 2006. In terms of industry sectors, we also expect growth to be broad-based, encompassing services, trade, finance, manufacturing, and construction. The one industry sector that will continue to lag is the combined state and local government sector, which will continue to be affected by difficult budget circumstances facing governments in California.

Figure 9

California Home Construction to Remain Strong

Permits for New Home Construction (In Thousands)



Gasoline Prices. We forecast that, while seasonal factors will likely push gasoline prices upward from their present levels in 2005, they will remain slightly below the peaks reached last summer. This forecast assumes that that (1) crude oil prices will remain below last year's levels and (2) serious shortages in California refinery capacity will not develop—whether from unexpectedly strong demand or refinery problems. These assumptions are obviously subject to major risks, and while the economy was resilient to energy price increases last year, substantially higher gasoline prices could have a more significant negative effect in 2005 and 2006.

Comparison to Other Forecasts

Figure 10 (see next page) compares our forecasts for the nation and California to our November 2004 forecasts, as well as to a variety of other economic projections made in recent months by other forecasters. These include the projections made by the University of California, Los Angeles (UCLA) Business Forecast Project in December 2004, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2005), the consensus outlook forecast in the *Western Blue Chip Economic Forecasters* (February 2005), and the *2005-06 Governor's Budget* forecast.

Figure 10

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

	Forecast		
	2004	2005	2006
United States Real GDP:			
LAO November	4.3%	3.4%	3.5%
UCLA December	4.4	3.0	2.6
DOF January	4.4	3.3	3.0
Blue Chip "Consensus"[b] January	4.4	3.6	3.4
LAO February	4.4	3.6	3.3
California Payroll Jobs:			
LAO November	0.9%	1.4%	1.5%
UCLA December	0.8	1.6	1.7
DOF January	1.0	1.8	1.8
Blue Chip Consensus[c] February	0.9	1.7	1.5
LAO February	0.8	1.5	1.5
California Personal Income:			
LAO November	5.9%	5.5%	5.8%
UCLA December	5.6	5.2	5.0
DOF January	5.6	5.8	6.0
Blue Chip Consensus [c] February	5.3	5.5	5.3
LAO February	5.6	5.5	5.7
California Taxable Sales:			
LAO November	6.5%	5.6%	5.6%
UCLA December	6.0	4.8	5.1
DOF January	5.7	5.7	5.6
Blue Chip Consensus [c] February	5.2	5.3	5.0
LAO February	6.4	5.7	5.4

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

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

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

Overall, there is not a great deal of variation among recent forecasts, with most outlooks calling for continued moderate economic growth. The figure shows that our updated forecast for the nation is similar to the consensus of forecasters polled in January by *Blue Chip Economic Indica-*

tors. However, it is slightly higher than either the UCLA or administration's January projections. With respect to California, our forecast for personal income growth is modestly higher than the UCLA December projection, but slightly lower than the budget forecast.

Risks to the Outlook

The economic outlook is subject to numerous risks from both abroad and at home. One of the main near-term risks relates to further price increases for oil and other raw materials. In 2004, the economy was hit with sharply rising costs for these commodities. These increases did not, however, translate into a more generalized rise in inflation, as businesses were able to absorb the costs through offsetting efficiencies.

Our forecast assumes that the economy will not be beset by a second round of sharp price increases that would push prices for oil and raw materials to well above last year's levels. If such a shock were to occur—either from faster-than-expected growth in worldwide demand or from supply disruptions—it would be increasingly difficult for U.S. businesses to hold the line on their product prices. The result would be more inflation, higher interest rates, and weaker growth, particularly in the interest-sensitive sectors of the economy. The impacts could be particularly significant in California, where many individuals have financed recent expensive home acquisitions with large variable-rate mortgages. For these households, a rise in market interest rates would translate into substantial increases in monthly mortgage payments, leaving less funds for other purchases.

THE DEMOGRAPHIC OUTLOOK

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

State Population to Approach 38 Million in 2006

Figure 11 (see next page) summarizes our updated state demographic forecast. We project that California's total population will rise from an estimated 37.1 million in 2005 to 37.7 million in 2006, and 38.3 million in 2007. These population projections use as their starting point published 2000 Census data for California, and have *not* been adjusted to correct for issues related to potential undercounting (for a detailed discussion of the issue of undercount in the Census, see page 32 of *The 2003-04 Budget: Perspectives and Issues*).

Figure 11

Summary of the LAO's California Demographic Forecast

(Population in Thousands)

	2005	2006	2007
Total population (July 1 basis)	37,172	37,747	38,320
Changes in population:			
Natural change (births minus deaths)	314	316	318
Net in-migration (in-flows minus out-flows)	266	259	255
Total changes	**581**	**575**	**573**
Percent changes	1.6%	1.6%	1.5%

Slight Slowing Projected. The state's population is projected to grow at an average rate of about 1.6 percent annually over the next three years. This is down slightly from the 1.7 percent average for the 2002 through 2004 period. Birth rates are forecast to stabilize at historically low levels, and net in-migration is projected to continue its modest downward trend.

In numeric terms, the number of new Californians being added each year—about 576,000 people—is well above the size of such cities as Long Beach, Fresno, and Sacramento, and very similar to such states as Wyoming.

Population Growth Components

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

Natural Increase. We project that the natural-increase component will contribute an average of 316,000 new Californians annually over the forecast period. This reflects stable birth rates, but growth in the female population of child-bearing age groups.

Net In-Migration. The population growth associated with net in-migration is projected to continue its downward trend. This component dropped from 388,000 in 2001 to 284,000 in 2004, due to declines in net in-migration from both other states and other countries. The drop was partly related to California's economic downturn in the early part of this decade. We expect a modest partial rebound in domestic migration during 2006 and 2007, as the state's economy strengthens.

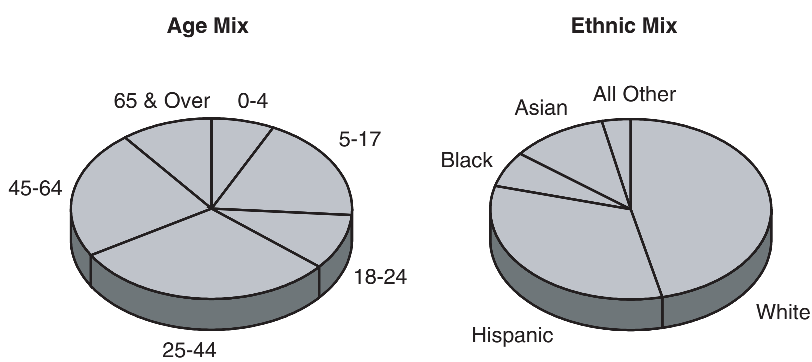
Growth to Vary by Age Group

The implications of demographic trends for the budget depend not only on the total number of Californians, but also on their characteristics. California is well known for having one of the world's most dynamic and diverse populations, including an increasingly rich ethnic mix and a large number of in-migrants. The state's age and ethnic mix is shown in Figure 12.

Figure 12

The Age and Ethnic Mix of Californians

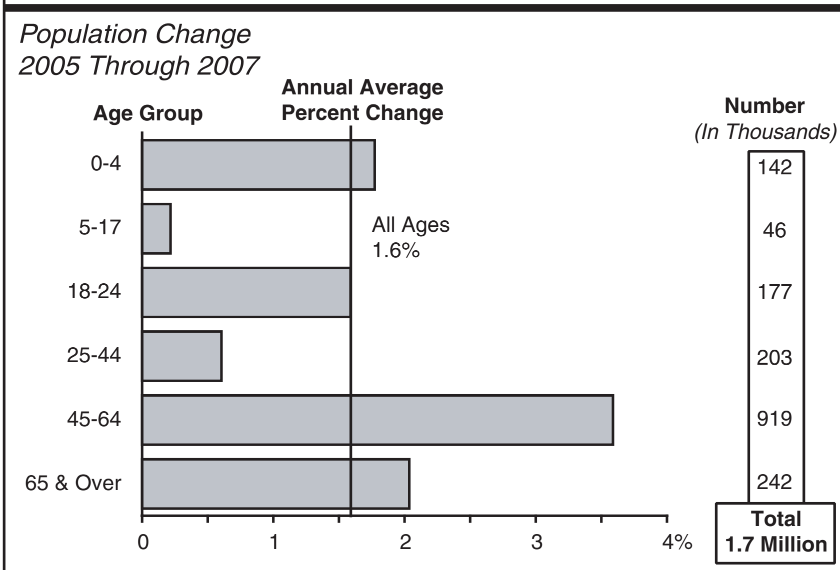
July 1, 2005



The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 13 shows our forecasts for both the percentage and numeric changes in different population groups. The 45-to-64 age group (baby boomers) continues to be the fastest growing segment of the population. About 919,000 new people are expected to move into this age category over the next three years, as the tail end of the baby-boom generation moves into its mid-40s.

Figure 13

California's Population Outlook by Age Group



Overall Budgetary Implications

California's continued strong population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in 2005-06 and beyond. For example, strong growth of the 45-to-64 age group generally benefits tax revenues since this is the age category that normally earns the highest wages and salaries. Alternatively, the below-average growth in the 5-to-17 age groups imply slower growth in K-12 school enrollments. More general examples of demographic influences include the following:

- Economic growth will benefit from an expanded labor force, due to a stronger consumer sector and the increased incomes that accompany job growth.
- However, overall demographic growth will also produce additional strains on the state's physical and environmental infrastructure, including demands on the energy sector, transportation systems, parks, and water-delivery systems.
- Similarly, the "graying" of the baby boomers will place strains on the state's health programs and related services, including the portion of Medi-Cal related to the elderly and disabled.
- The increasing ethnic diversity of the state's population will also mean that many public institutions, especially schools, will serve a population that speaks a multitude of languages and has a wide range of cultural backgrounds. Currently, for example, more than one-third of students in kindergarten and first grade are English language learners.

III

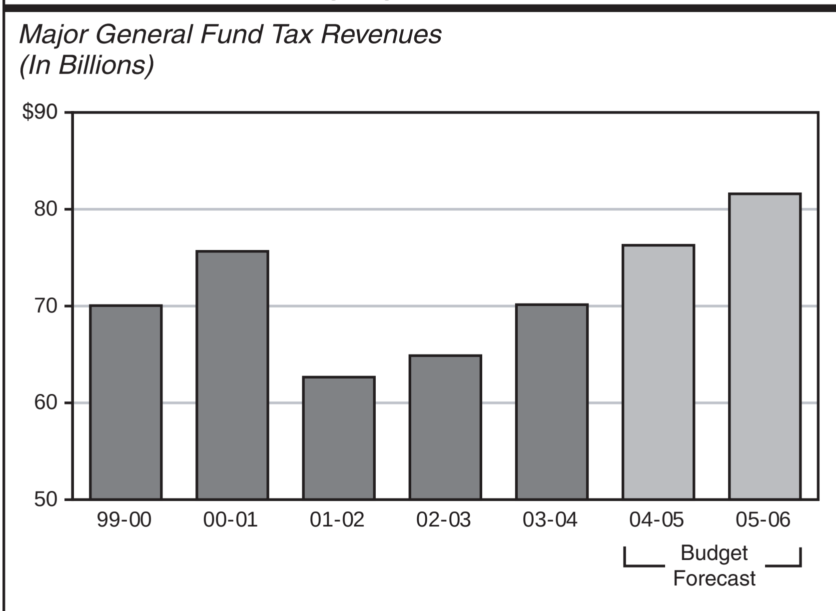
Perspectives on State Revenues

Perspectives on State Revenues

After falling sharply early in the decade, revenues are on the rise once again (see Figure 1). The administration assumes that General Fund tax receipts will increase by 8.7 percent in the current year and by 7 percent in 2005-06. These gains are indicative of a healthy expansion in profits, sales, and personal income in California. In this Part, we provide

Figure 1

Tax Revenues Rising Again



background information relating to the revenue outlook, discuss recent revenue developments, summarize the budget's revenue projections, and present our own revenue forecast.

THE BUDGET'S FORECAST FOR TOTAL STATE REVENUES

The *2005-06 Governor's Budget* projects that California's state government will receive nearly $107.6 billion in revenues during the budget year, a 7.3 percent increase from the current year. These revenues are deposited into either the General Fund or a variety of special funds. Figure 2 shows that:

Figure 2

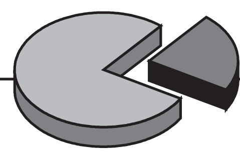
State Revenues in 2005-06

(In Billions)

General Fund Revenues

Personal Income Tax	$42.9
Sales and Use Tax	26.9
Corporation Tax	9.0
All Other	4.9
Total	**$83.8**

Total State Revenues $107.6 Billion



Special Funds Revenues

Motor Vehicle-Related Revenues	$8.4
Sales and Use Tax[a]	4.3
Tobacco-Related Taxes	0.9
All Other	10.2
Total	**$23.8**

Detail may not total due to rounding.

[a] Includes $2.7 billion to Local Revenue Fund and $0.3 billion for transportation-related purposes. Also includes $1.4 billion in sales taxes redirected to pay off deficit-financing bonds. Excludes $2.7 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

- ***General Fund Revenues.*** About 78 percent of total state revenues are deposited into the General Fund. These revenues are then allocated through the annual budget process for such programs as education, health, social services, and criminal justice.
- ***Special Funds Revenues.*** The remaining 22 percent of revenues are received by special funds and are primarily earmarked for specific purposes, such as transportation, local governments, and targeted health and social services programs.

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

Sources of General Fund Revenues. Figure 2 indicates that about 94 percent of total General Fund receipts are attributable to the state's "big three" taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporation tax (CT). The remainder are related to a variety of smaller taxes (including insurance, tobacco, and alcoholic beverage taxes), fees, investment earnings, and various transfers from special funds.

Recent and Proposed Revenue-Related Changes

Targeted revenue increases and related policy-related changes adopted with the 2004-05 budget will increase revenues by about $593 million in 2004-05 and $284 million in 2005-06. Figure 3 (see next page) shows that the main provisions were a two-year suspension of the teachers' tax credit; a change in the application of the use tax on purchases of vessels, aircraft, and certain vehicles; and a tax amnesty program.

In 2005-06, the Governor's budget does not include any new state tax proposals. It would, however, eliminate the Senior Citizens' Property Tax Assistance Program and reduce the Senior Citizens' Rental Assistance Program. (These proposals show up as expenditure reductions for tax relief and are discussed in the "General Government" chapter of our *Analysis of the 2005-06 Budget Bill*.) The budget also proposes additional resources for tax compliance initiatives (see discussion in the shaded box, page 46), which are expected to generate about $104 million in additional receipts in 2005-06. Finally, it proposes to retain sales taxes on gasoline in the General Fund, instead of transferring them to transportation special funds, as required by current law.

The Budget's General Fund Revenue Outlook

Figure 4 (see next page) shows the budget's revised estimate of General Fund revenues for the prior year and current year, as well as its forecast for 2005-06. (The revenue totals shown in this Part *do not* include the deficit financing bond proceeds used in 2003-04 or proposed in 2005-06. In "Part I," we display these proceeds separately in our estimates of the General Fund budget condition.)

Prior-Year Estimate. The budget estimates that 2003-04 General Fund revenues and transfers totaled $74.8 billion, a 4.8 percent increase from 2002-03. The administration's estimate is up $192 million from the level assumed when the 2004-05 budget was enacted.

Figure 3

2004-05 and 2005-06 Revenue Measures Summary of Fiscal Impact

(In Millions)

	Fiscal Impact		
2004-05 Revenue Measures	**2004-05**	**2005-06**	**2006-07**
Personal Income Tax			
Teacher tax credit: two-year suspension	$210	$180	—
Natural Heritage Preservation Tax Credit: two-year suspension	10	9	$4
Tax amnesty program	150	-30	-5
Sales and Use Tax			
Vehicle, vessel, and aircraft use tax (sunsets July 1, 2006)	$26	$35	—
Retain sales tax revenues on gasoline in General Fund	128	—	—
Tax amnesty program	11	62	-$37
Corporation Tax			
Tax amnesty program	$50	$20	$15
Other	8	9	7
Total, 2004-05 Revenue Measures	**$593**	**$284**	**-$16**
2005-06 Revenue Measures			
Personal Income Tax			
Tax Gap	—	$22	$29
Abusive Tax Shelters	—	28	39
Corporation Tax			
Tax Gap	—	$12	$15
Abusive Tax Shelters	—	15	21
Sales and Use Tax			
Retain sales tax revenues on gasoline in General Fund	—	—	$216
Total, 2005-06 Revenue Measures	**—**	**$77**	**$320**

Figure 4

Summary of the Budget's General Fund Revenue Forecast

(Dollars in Millions)

		2004-05		2005-06	
Revenue Source	**Actual 2003-04**	**Estimated Amount**	**Percent Change**	**Projected Amount**	**Percent Change**
Taxes					
Personal income	$36,399	$39,527	8.6%	$42,895	8.5%
Sales and use	23,847	25,168	5.5	26,947	7.1
Corporation	6,926	8,678	25.3	9,015	3.9
Insurance	2,115	2,230	5.4	2,300	3.1
Other	849	662	-22.0	454	-31.5%
Other Revenues, Transfers, and Loans					
Tribal gaming revenues	—	$16	—	$34	112.5%
Other revenues	$3,913	1,623	-58.5%	1,584	-2.4
Transfers related to pension obligation bond	—	—	—	600	—
Other transfers and loans	713	315	-55.8	-56	—
Totals	**$74,762**	**$78,219**	**4.6%**	**$83,772**	**7.1%**

Current-Year Estimate. The January mid-year forecast for 2004-05 assumes that General Fund revenues and transfers will be $78.2 billion, a 4.6 percent increase from the prior year. This is up by $968 million from the estimate in the *2004-05 Budget Act.* The revision is the net result of two offsetting factors:

- The administration's forecast of revenues from the major taxes is *up* $2.2 billion, primarily reflecting much stronger-than-expected receipts from the CT, and more moderate gains from the SUT and PIT during the first five months of the fiscal year.
- In contrast, the new forecast assumes that nontax revenues associated with actions adopted in the 2004-05 budget will be *down* by roughly $1.2 billion. The reduction is due largely to (1) smaller-than-expected receipts from tribal gaming compacts and asset sales, and (2) a delay in the pension bond sale from 2004-05 to 2005-06.

Tax Agency Enforcement and Compliance Measures

The 2005-06 budget contains funding for two programs related to the enforcement and compliance of personal income and corporation taxes. The budget anticipates these efforts will result in additional state revenue as discussed below.

Abusive Tax Shelters

Certain methods of sheltering income from taxation have been identified by the Internal Revenue Service or the Franchise Tax Board (FTB) as violating the spirit or intent of the tax laws. These so-called abusive tax shelters typically have no underlying economic or business purpose other than tax reduction. In 2003, the Legislature approved a voluntary compliance initiative for taxpayers who had participated in abusive tax shelters. Under the initiative, such taxpayers could avoid various penalties by paying their full tax liability. The program resulted in $1.4 billion in tax payments. In the 2004-05 budget, FTB received funding for an abusive tax shelter task force, which is dedicated to enforcement and compliance activities in this area.

Proposal. The budget proposes $1.8 million in additional funding for FTB's abusive tax shelter task force, which is expected to result in additional revenues of $43 million in the budget year and $60 million in 2006-07.

Tax Gap

The "tax gap" is the difference between tax liabilities owed to the state and the revenues that are actually collected. The tax gap is due to noncompliance on the part of taxpayers, and typically results from understating income, underpaying taxes, or simply not filing a tax return. The FTB has estimated California's current income tax gap at about $6.5 billion.

Proposal. The 2005-06 budget includes an additional $8.6 million to FTB for tax enforcement and compliance measures. The components of this proposal are designed to target specific areas of noncompliance that contribute to the state tax gap. These tax gap-related reporting and auditing activities are expected to generate additional revenue of $34 million in the budget year and $44 million in 2006-07.

2005-06 Forecast. The budget forecasts that General Fund revenues and transfers will be $83.8 billion in the budget year, a 7.1 percent increase from 2004-05. The major taxes are projected to increase by 7 percent, or about one percentage-point faster than statewide personal income.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

Figure 5 shows our projections of General Fund revenues for 2004-05 through 2006-07. Our projections are based on our economic and demographic forecasts presented in "Part II" and reflect the impacts of the Governor's revenue-related policy proposals. Our revised estimates are significantly higher than the administration's forecast, mainly because of stronger-than-expected 2004 year-end tax collections.

Figure 5

Summary of the LAO's General Fund Revenue Forecast

(Dollars in Millions)

	2004-05		2005-06		2006-07	
Revenue Source	**Amount**	**Percent Change**	**Amount**	**Percent Change**	**Amount**	**Percent Change**
Taxes						
Personal income	$40,627	11.6%	$43,200	6.3%	$45,720	5.8%
Sales and use	25,288	6.0	26,850	6.2	28,210	5.1
Corporation	8,928	28.9	9,370	5.0	9,820	4.8
Insurance	2,220	5.0	2,287	3.0	2,355	3.0
Other	660	10.8	443	-32.9	443	—
Other Revenues, Transfers and Loans						
Tribal gaming revenues	$16	—	$34	112.5%	$50	47.1%
Other revenues	1,676	—	1,810	8.0	1,861	2.8
Transfers related to pension obligation bond	—	—	600	—	—	—
Other transfers and loans	219	-69.3%	-56	—	-37	-34.8
Totals	**$79,634**	**6.5%**	**$84,537**	**6.2%**	**$88,423**	**4.6%**

Year-End Cash Trends Positive

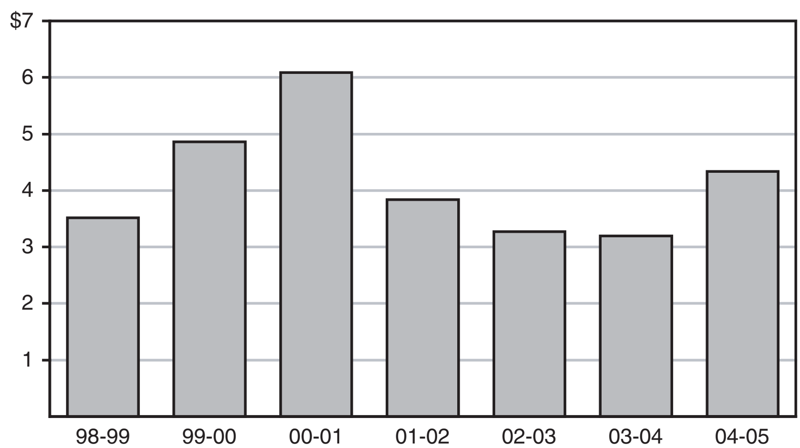
Each year, the administration completes its economic and revenue projections sometime in early December—prior to when large year-end tax payments are due to the state. This is significant because the quarterly estimated payments due in December (from corporations) and January (from individuals) can fluctuate a great deal, and can provide an early indication of the strength or weakness in final payments that will be remitted in March and April.

As shown in Figure 6, prepayments from individual taxpayers were particularly strong near the end of 2004, increasing by over 35 percent from the previous year. The growth was about $500 million greater than assumed by the administration. Combined with smaller gains from other tax sources, the gains boosted cumulative cash receipts through late January to about $800 million above the administration's budget estimate.

Figure 6

PIT Estimated Payments Increasing Again

December and January Receipts of PIT Quarterly Estimated Payments (In Billions)



Why the Strength? We believe that stronger-than-expected revenue gains are related to stock market-related capital gains and business earnings. To the extent that investment income and business earnings accrue to higher income taxpayers, the strength in these areas are subject to high tax PIT rates, and thus have a magnified effect on revenues. While the increases are welcome, they are also cyclical in nature, and thus may not fully continue into 2005 and beyond.

LAO Forecast

We project that revenues will exceed the administration's January budget estimates by about $1.4 billion in the current year and $766 million in 2005-06—for a two-year increase of $2.2 billion. Slightly less than $2 billion of the two-year gain is related to our estimate of higher tax receipts. The remainder is related to our inclusion of $294 million in Medi-Cal quality improvement fees. As discussed in more detail below and in the accompanying *Analysis of the 2005-06 Budget Bill*, the administration omitted these fee-related revenues from its estimates.

We specifically forecast that:

- ***In 2004-05,*** General Fund revenues and transfers will total $79.6 billion, a 6.5 percent increase from 2003-04. This is up $1.4 billion from the budget forecast, reflecting a $1.1 billion increase in the PIT and more modest gains from the other two major revenue sources. A partially offsetting factor is a $96 million reduction related to a transfer from the State Highway Account to the General Fund. The budget assumes this transfer in the current year. However, the federal government has informed the state that the transfer is in violation of federal law.
- ***In 2005-06,*** revenues and transfers will total $84.5 billion, a 6.2 percent increase from the current year. This is up $765 million from the budget forecast. About $530 million of the increase is related to our higher projection of tax receipts. The remaining $236 million is related to the quality improvement fees.
- ***In 2006-07,*** revenues and transfers will total $88.4 billion, an increase of 4.6 percent. Excluding the impact of recently enacted revenue measures (such as the two-year suspension of the teachers' credit), the underlying growth rate of major tax revenues is about 5.6 percent, or about the same as projected statewide personal income growth for the period.

The LAO's Forecast for Major Revenue Sources

As indicated above, the great majority of General Fund revenues are attributable to the state's three major taxes—the PIT, SUT, and CT. The performance of these taxes will have a major influence on the overall revenue outlook. In the following sections, we discuss in more detail recent developments and the outlook for each of these revenue sources.

Personal Income Tax

Background

We project that the PIT will account for 51 percent of total General Fund revenues in 2005-06. Although this share is significantly below the peak reached in 2000-01 (57 percent), the PIT remains by far the largest source of state General Fund revenues. In general, the PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Under the PIT, taxable income is subject to marginal rates ranging from 1 percent to 9.3 percent, with the top rate applying to taxable income in excess of $80,692 for joint returns in 2004 (and one-half of that for taxpayers filing single returns).

California PIT Liabilities Concentrated at High End of Income Spectrum

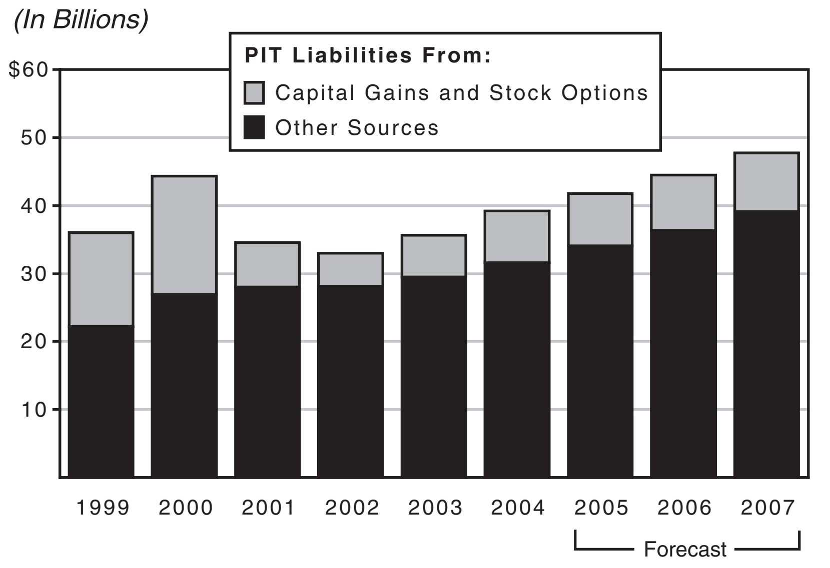
Over the past two decades, personal income in California has become increasingly concentrated. At the peak of the stock market boom in 2000, the top 5 percent of returns accounted for over 40 percent of adjusted gross income (AGI) reported on California personal income taxes. Under California's progressive PIT rate structure, these taxpayers accounted for over 70 percent of total PIT payments in the state. While these shares dropped following the stock market bust, the top 5 percent of taxpayers still account for over one-third of AGI and nearly two-thirds of PIT payments. The concentration of tax liabilities is significant because taxpayers at the top end of the income spectrum receive much of their income from such volatile sources as capital gains, stock options, and business earnings.

PIT Liabilities—History and Forecast

Recent History. Figure 7 shows the historical and forecasted levels of PIT liabilities. It shows that, after growing 8 percent in 2003, PIT liabilities jumped by a further 10 percent in 2004, the largest gain since 2000. The jump is nearly double the 5.6 percent increase in statewide personal income, as currently measured by the U.S. Bureau of Economic Analysis. The much larger gains in liabilities is likely related to strong growth in capital gains and business income. Business income is becoming an increasingly important component of AGI, as an ever-increasing number of companies file as S-corporations and limited liability corporations (whose income is largely taxable under the PIT—as opposed to under the CT).

Figure 7

PIT Liabilities on Rebound



Forecast. We forecast that PIT revenues will continue to expand during the next two years, but at rates that are more consistent with underlying growth in statewide personal income. The main reason for the slowdown is that the two cyclical sources that boosted PIT liability growth in 2004—capital gains and business earnings—are projected to grow more modestly in 2005 and 2006 than in 2004. Specifically, we forecast that:

- ***Business earnings*** growth will moderate from 12 percent in 2004 to about 5 percent in both 2005 and 2006, as business profit margins are restrained by slower productivity growth and higher wages.
- ***Capital gains and stock options-related income*** growth will slow from 25 percent in 2004 to just 4 percent in 2005 before partly rebounding to 5.5 percent in 2006. Our forecast assumes that slowing profit growth and slightly higher interest rates will restrain stock market prices during the next two years, which in turn will hold down capital gains and stock option income during the period.

The slowdown in the growth rates in the above sources will be partly offset by a modest acceleration in ordinary wages (that is, wages excluding stock option income) growth next year. We specifically forecast that wage growth will accelerate from 5 percent in 2004 to about 5.5 percent in 2005 and 2006 reflecting improvement in wage and salary employment growth in the state.

PIT Revenue Forecast

Based on our estimated changes in PIT liabilities, we forecast that fiscal-year PIT receipts will total $40.6 billion in 2004-05, $43.2 billion in 2005-06 and $45.7 billion in 2006-07. Compared to the budget forecast, our current projection of PIT revenues is up by $1.1 billion in the current year and by a more modest $305 million in 2005-06. Our large current-year gain reflects the positive year-end cash trends discussed above. Our relatively smaller gain in the budget year reflects our view that a portion of the current-year increase is due to cyclical factors (that is, above average growth in business profits and capital gains) and is thus "one time" in nature relative to the administration's forecast.

Sales and Use Tax

Background

The SUT is the General Fund's second largest revenue source, accounting for just under one-third of total revenues in 2004-05. The main SUT component is the *sales* tax, which is imposed on retail sales of tangible goods sold in California. Some examples of sales tax transactions include spending on clothing, furniture, computers, electronics, appliances, automobiles, and motor vehicle fuel. Purchases of building materials that go into the construction of homes and buildings are also subject to the sales tax, as are purchases of computers and other equipment used by businesses. Roughly 70 percent of the SUT is remitted by retailers, while the remaining 30 percent is directly paid by businesses who themselves consume or use the products being taxed. The largest exemption from the sales tax is for most food items consumed at home. The great majority of services are not subject to the sales tax.

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

SUT Rates

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

- ***State Rate.*** The basic state SUT rate is 6 percent. The largest single component is the 5 percent state General Fund rate. Also included in the overall state rate are two half-cent rates, whose proceeds are respectively deposited into (1) the Local Revenue Fund, which supports health and social services program costs associated with the 1991 state-local realignment legislation; and (2) the Local Public Safety Fund, which was approved by the voters in 1993 for the support of local criminal justice activities.
- ***Uniform Local Rate.*** This is a uniform local tax rate of 1.25 percent levied by all counties (the so-called Bradley-Burns rate). Of this total, 0.25 percent is deposited into county transportation funds, while the remaining 1 percent is allocated to city and county governments for their general purposes. Under the terms of Proposition 57, which was approved by the voters in March 2004, 0.25 percent of the Bradley-Burns rate is diverted to a special fund for purposes of repayment of the deficit-financing bond. (These diverted local sales taxes are replaced by a shift of property taxes from schools, which are in turn reimbursed by the state's General Fund. As a result of these various steps, state government is ultimately responsible for the bond's repayment.) The diversion of sales tax revenues will remain in effect until the bonds are paid off.

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

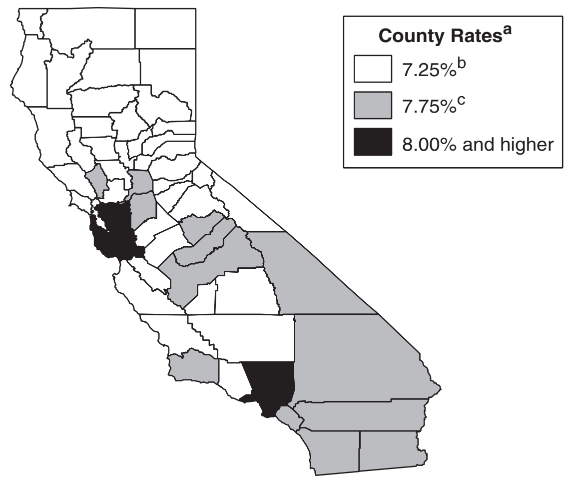
Combined SUT Rates. The combined state and local SUT rate varies significantly across California due to differences in the local optional rates that are levied (see Figure 8, next page). The combined SUT rate currently ranges from 7.25 percent (for those counties with no optional rates) up to 8.75 percent (for Alameda County and the City of Avalon in Los Angeles County).

Taxable Sales Growth Accelerated in 2004

After falling in 2002, taxable sales started to rebound in 2003, and accelerated to an over 6 percent gain in 2004. As indicated in Figure 9 (see next page), retail spending held up reasonably well during the recession and bounced back early in the ensuing recovery. In contrast, business-related sales were hit hard during the recession—as businesses sharply curtailed investment spending—and they took longer to recover.

Figure 8

Sales Tax Rates Vary by County

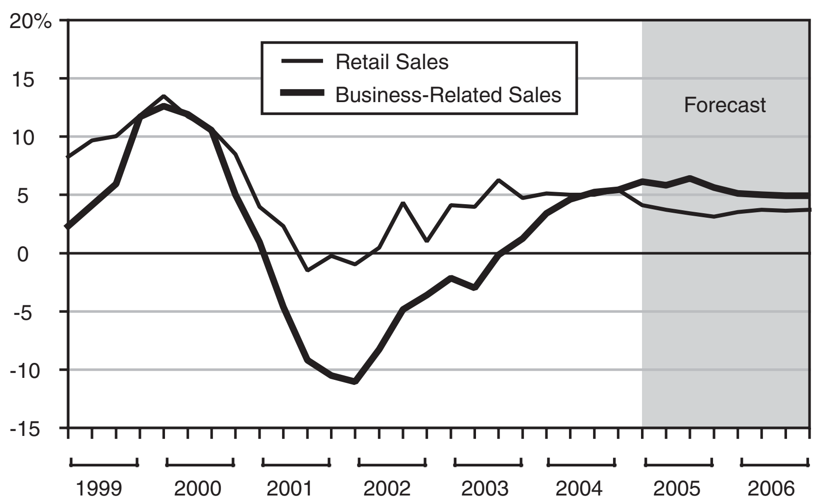


[a] As of April 1, 2005.
[b] Includes Stanislaus, Nevada, and Solano (7.375%), and Sonoma (7.50%).
[c] Includes Fresno (7.875%).

Figure 9

Business Related Taxable Sales Rebounding

Year-to-Year Percent Change, by Quarter



By 2004, we estimate that both categories were on the upswing, and this balanced growth contributed to the largest gain in the overall total since 1999.

Outlook—More Moderate Growth in 2005 and 2006. Looking ahead, we believe that total taxable sales growth will moderate to 5.7 percent in 2005 and further to 5.4 percent in 2006. The main reason for the slowdown is our expectation that—like the rest of the nation—household spending in California will ease some due to high consumer debt levels and rising interest rates. In contrast, we expect business spending to continue at a solid pace during the next couple of years.

SUT Revenue Forecast

Based on our forecast of taxable sales, we project that SUT receipts will total $25.3 billion in 2004-05, $26.9 billion in 2005-06, and $28.2 billion in 2006-07. Compared to the budget forecast, our SUT revenue estimate is up $120 million in the current year, but down $97 million in the budget year. Our estimates take into account changes passed with the 2004-05 budget affecting the application of the use tax, as well as the proposed retention of "spillover" revenues in the General Fund.

Corporation Tax

Background

The CT is the third largest revenue source, accounting for 11 percent of total revenues in 2004-05. The tax is levied at a general rate of 8.84 percent on California taxable profits. Banks and other financial institutions subject to the CT pay an additional 2 percent tax, which is in lieu of most other state and local levies. Corporations that qualify for California Subchapter "S" status are subject to a reduced 1.5 percent corporate rate. In exchange, the income and losses from these corporations are "passed through" to their shareholders where they are subject to the PIT. Similarly, businesses that are classified as Limited Liability Companies pay a fee at the corporate level and their income and losses are passed through to their shareholders, where they are subject to the PIT.

Approximately two-thirds of all CT revenues come from multistate and multinational corporations. These companies have their consolidated U.S. income apportioned to California based on a formula involving the share of their combined property, payroll, and sales that is attributable to this state. California's CT allows for a variety of exclusions, exemptions, deductions, and credits, many of which are similar or identical to those provided under the federal corporate profits tax. Major examples include the research and development tax credit and net operating loss carryforward provisions, whereby companies can use operating losses incurred in one year as a deduction against earnings in subsequent years. Under legislation enacted in 2002, corporations were not able to use these losses to offset their income during 2002 and 2003. However, such deductions were allowed again beginning in 2004, and the percentage of losses which may be carried forward and deducted against future taxes jumps from 65 percent to 100 percent beginning for losses incurred in January 2005.

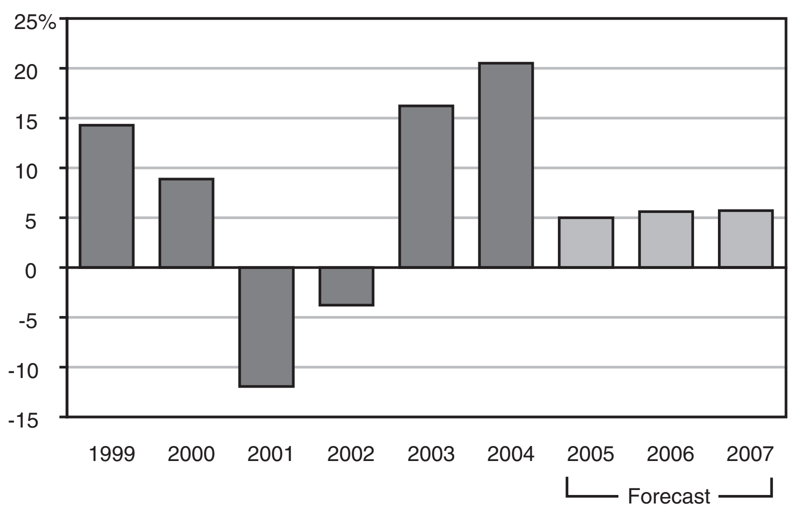
Profits Soared in 2004

The key determinant of CT receipts is the strength of corporate profits reported on California tax returns by businesses. After falling in 2001 and most of 2002, California earnings rebounded in 2003 and then soared by over 20 percent in 2004 (see Figure 10). The recent boom reflects both intensive cost-cutting efforts by businesses throughout the economy, as well as a sharp rebound in sales and output last year. Profit growth was widespread, encompassing manufacturing, trade, services, real estate, and financial industries. The surge in oil prices also boosted earnings of refiners in the state.

Figure 10

After Two Strong Years, Profit Growth to Slow

Annual Percent Change in California Taxable Corporate Profits



Looking ahead, we forecast that taxable California corporate profit growth will slow significantly, to around 5 percent annually in each of the following three years. The more moderate increases projected for the next two years reflect (1) rising wage costs (as companies step up hiring), (2) a slowdown in productivity growth (as normally occurs as an expansion ages), and (3) a more moderate pace of economic expansion, which will result in more moderate gains in company sales and output growth.

CT Revenue Forecast

We forecast that CT receipts will be $8.9 billion in 2004-05, a 29 percent increase from the prior year, and $9.4 billion in 2005-06, a 5 percent increase. Our estimate for the current year is up by $250 million from the budget forecast, and our estimate for 2005-06 is above the budget estimate by $355 million.

Other Revenues and Transfers

The remaining 6 percent of total 2005-06 General Fund revenues and transfers consists primarily of taxes on insurance premiums, alcoholic beverages, and tobacco products. It also includes interest income and a large number of fees, loans, and transfers. We forecast that combined revenues from all of these other sources will fall from $7.5 billion in 2003-04 to $4.8 billion in 2004-05, and then rebound slightly to $5.1 billion in 2005-06. Of the annual totals, roughly $4.5 billion is related to ongoing taxes, fees, and interest earnings, and the remainder is related to various one-time factors. Key one-time factors include (1) $2.3 billion in 2003-04 associated with one-time proceeds of a tobacco securitization bond sale, (2) slightly over $600 million in 2005-06 from the assumed sale of a pension obligation bond authorized in the 2004-05 budget, (3) various other one time loans and transfers from special funds in each of the three years.

Quality Improvement Fees Omitted From Governor's Budget. The Legislature has approved three quality improvement fees on various health care service providers, thereby enabling the state to draw increased federal reimbursements. (This fee is discussed in more detail in the "Health and Social Services" chapter of the *Analysis of the 2005-06 Budget Bill.*) One of the fees has already been implemented and the budget assumes that the other two will receive federal approval in time for implementation in the budget year. The budget recognizes revenues from one of the proposed fees, but fails to recognize revenues from the other two—including one that has already been implemented. As a result, it has understated quality improvement fee-related revenues by $58 million in the current year and $236 million in the budget year. We believe that all three of the fees will be implemented, and thus have included the additional revenues in our estimates.

Estate Tax Phased Out. Our forecast includes the impact on the state of a provision included in the federal tax reduction package enacted in the spring of 2001 which is resulting in the phase out of revenues from California's "pick-up" estate tax. We specifically estimate that revenues from this tax will fall from $398 million in 2003-04 to $209 million this year, to zero in 2005-06 and thereafter.

THE BUDGET'S FORECAST FOR SPECIAL FUNDS REVENUES

Special funds revenues are related to a variety of sources:

- About $8.4 billion (or one-third of the budget-year total) is related to motor vehicle revenues. These include the vehicle license fee, which is in lieu of the property tax and whose proceeds are distributed to local governments, mostly for their general purposes. They also include fuel taxes and registration fees, which support transportation-related spending.
- Another $4.3 billion is related to SUTs. Of this total, about $2.7 billion is used to fund health and social services programs that were realigned from the state to local governments beginning in the early 1990s, $1.4 billion is related to the diversion of local sales taxes for deficit-financing bond debt service, and about $275 million is used for transportation programs.
- About $920 million is from tobacco taxes that have been approved by voters in various elections.
- About $683 million is related to the PIT surcharge for mental health programs, which was approved by voters in November 2004.
- The remaining revenues are related to a wide variety of sources, including energy resource surcharge, beverage container redemption fees, and California State University fees.

Budget Forecast. As shown in Figure 11, the Governor's budget assumes that special funds revenues will total $22 billion in the current year (a 12 percent increase) and $23.8 billion in 2005-06 (an 8.2 percent increase). The large current-year increase is partly due to two key policy factors: (1) the diversion of about $1.3 billion of sales taxes to a special fund for repayment of the deficit-financing bonds approved by the voters in March 2004; and (2) a PIT surcharge for mental health programs. Ongoing revenues are expected to grow by roughly 4 percent, reflecting moderate increases in sales and vehicle registration taxes, and modest changes in most other taxes and fees.

Figure 11

Summary of the Budget's Forecast for Special Funds Revenues and Transfers

(Dollars in Millions)

Revenue Source	Actual 2003-04	2004-05 Estimated Amount	2004-05 Percent Change	2005-06 Projected Amount	2005-06 Percent Change
Motor Vehicle Revenues					
License fees (in lieu)[a]	$2,052	$2,144	4.5%	$2,215	3.3%
Fuel taxes	3,325	3,357	1.0	3,441	2.5
Registration, weight, and miscellaneous fees	2,342	2,672	14.1	2,775	3.9
Subtotals	($7,719)	($8,173)	(5.9%)	($8,431)	(3.2%)
Sales and Use Tax					
Realignment	$2,443	$2,525	3.4%	$2,699	6.9%
Deficit financing[b]	—	1,167	—	1,358	16.4
PTA	217	406	87.0	275	-32.3
Subtotals	($2,660)	($4,098)	(54.1%)	($4,332)	(5.7%)
Other Sources					
Personal income tax	—	$254	—	$683	168.9%
Cigarette and tobacco taxes	$964	946	-1.9%	920	-2.7
Interest earnings	126	101	-19.8	102	0.3
Other revenues	8,715	8,794	0.9	9,761	11.0
Transfers and Loans	-593	-334	-43.6	-389	16.4
Totals	**$19,591**	**$22,031**	**12.5%**	**$23,839**	**8.2%**

Detail may not total due to rounding.

a Includes loans from transportation funds to the General Fund.

b Sales tax revenues used to pay debt service on deficit-financing bonds.

IV

Perspectives on State Expenditures

AN OVERVIEW OF STATE EXPENDITURES

Proposed Total Spending in 2004-05 and 2005-06

The Governor's budget proposes total spending in 2005-06 of $109 billion, including $85.7 billion from the state's General Fund and $23.3 billion from its special funds (see Figure 1). This total budget-year spending is $4.6 billion higher than current-year spending—an increase of 4.4 percent. Of total budget-year spending, General Fund spending accounts for about 79 percent. Proposed spending translates into $2,910 for every man, woman, and child in California.

Figure 1

Governor's Budget Spending Totals

(Dollars in Millions)

			Change	
	2004-05	**2005-06**	**Amount**	**Percent**
Budget Spending				
General Fund	$82,295	$85,738	$3,443	4.2%
Special funds[a]	22,091	23,270	1,179	5.3
Totals	**$104,386**	**$109,008**	**$4,622**	**4.4%**

Detail may not add due to rounding.

[a] Does not include Local Public Safety Fund expenditures of $2.5 billion in 2004-05 and $2.7 billion in 2005-06. These amounts are not shown in the Governor's budget.

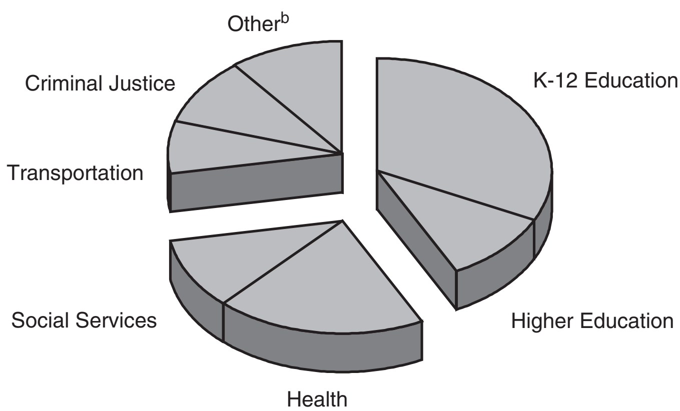
Allocation of Total State Spending

Figure 2 shows the allocation of the proposed $109 billion of total state spending in 2005-06 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of support in some areas (such as transportation).

Figure 2

Proposed Total State Spending By Major Program Area[a]

2005-06



[a] Excludes bond funds, federal funds, and Local Public Safety Fund.
[b] Includes expenditures on resources, environment, and shared revenues.

The figure shows that K-12 education receives the largest share of total spending—about 32 percent of the total. (It also should be noted that K-12 education spending receives additional funding from local sources.) When higher education is included, education's share rises to almost 43 percent. Health and social services programs account for about 30 percent of proposed total spending, while transportation and criminal justice together account for roughly 17 percent. The "other" category (10 percent) includes general-purpose fiscal assistance provided to local governments in the form of shared revenues.

General Fund Spending

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

Proposed Spending. As shown in Figure 3 (see next page), the Governor proposes General Fund spending of $85.7 billion for 2005-06. General Fund spending would rise by $3.4 billion from 2004-05, or 4.2 percent, reflecting decreases in some areas and increases in others. Specifically:

- General Fund spending for K-12 education and community colleges is proposed to increase by 6.9 percent and 9.4 percent, respectively. A portion of the growth is the result of General Fund spending replacing property taxes that are being shifted between local school districts and noneducation local governments. These shifts are related to the local government agreement that was included in the 2004-05 budget. In 2005-06, total state and local spending for K-12 education is increasing 6 percent, and spending for community colleges is increasing by 7.5 percent.
- The University of California and California State University funding is proposed to increase 3.9 percent. The increase is consistent with the compact between the Governor and the two segments, which calls for increases to cover enrollment and cost-of-living growth in 2005-06.
- Other education program spending is proposed to decline by 10.6 percent, reflecting a proposed a shift of certain teachers' retirement contribution payments to school districts.
- Medi-Cal funding is proposed to increase 8.2 percent, reflecting growth in caseloads, costs, and utilization of the program. The increase also reflects the expiration of one-time savings in the current year as well as a variety of other, partly offsetting, funding shifts and policy-related changes in the program.
- The slow growth—or declines—in the other health and social services categories reflect proposed savings related to (1) suspension of cost-of-living adjustments (COLAs) for Supplemental Security Income/State Supplementary Program grants, (2) California Work Opportunity and Responsibility to Kids (CalWORKs) grant reductions and COLA eliminations, and (3) a reduction in the state's participation in In-Home Supportive Services (IHSS) provider wages.
- The small increase in the all other category reflects savings related to employee compensation and across-the-board reductions.

Figure 3

General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 2003-04	Estimated 2004-05	Proposed for 2005-06 Amount	Percent Change
Education Programs				
K-12 Proposition 98	$28,154	$30,992	$33,117	6.9%
Community Colleges Proposition 98	2,272	3,036	3,321	9.4
UC/CSU	5,527	5,212	5,413	3.9
Other	2,159	4,559	4,076	-10.6
Health and Social Service Programs				
Medi-Cal	$9,879	$11,965	$12,948	8.2%
CalWORKs	2,064	2,146	1,940	-9.6
SSI/SSP	3,123	3,444	3,523	2.3
In-Home Supportive Services	1,091	1,184	1,024	-13.5
Other	6,605	6,805	7,273	6.9
Youth and Adult Corrections	$5,389	$6,933	$7,014	1.2%
All Other	$10,069	$6,021	$6,089	1.1%
Totals	**$76,333**	**$82,295**	**$85,738**	**4.2%**

Special Funds Spending

Background. Special funds are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources (including many licenses and fees) for *specific* functions or activities of government designated by law. In this way, they differ from General Fund revenues, which can be spent by the Legislature for *any* purpose. Over one-third of the special funds revenues come from motor vehicle-related levies, another one-sixth comes from sales taxes, and the remainder come from numerous sources, including a new 1 percent surcharge on personal income taxes, tobacco taxes, charges, and fees.

Proposed Spending. In 2005-06, the Governor proposes special funds spending of $23.3 billion (see Figure 4). This is a 5.3 percent increase from the current-year total of $22.1 billion. As indicated in the figure, this increase reflects 13 percent growth in state transportation-related programs (accounting for two-thirds of the total year-to-year increase) and an 8.3 percent increase in subventions to local governments for various purposes, such as transportation and the 1991 realignment of health and social services programs. The above-average increases in transportation and local subventions are related to an assumed repayment of a loan from the Traffic Congestion Relief Fund. This repayment is contingent on the sale of a tribal gaming bond in 2005-06. Resources-related spending and funding for the Public Utilities Commission would decline, and spending in all other areas is proposed to remain flat.

Figure 4

Special Funds Spending by Major Program Area

(Dollars in Millions)

			Proposed for 2005-06	
	Actual 2003-04	Estimated 2004-05	Amount	Percent Change
Transportation	$5,456	$5,818	$6,601	13.4%
Local government subventions	5,288	5,504	5,963	8.3
Resources related	2,062	2,620	2,572	-1.9
Public Utilities Commission	1,085	1,230	1,203	-2.2
All other	5,001	6,918	6,931	0.2
Totals	**$18,892**	**$22,091**	**$23,270**	**5.3%**

It should be noted that the budget's special funds spending totals for 2005-06 exclude expenditures of roughly $2.7 billion from the Local Public Safety Fund (LPSF). Such spending is also excluded from the current-year and prior-year totals. Our view is that LPSF revenues are state tax revenues expended for public purposes. This treatment is consistent with how the budget treats other dedicated state funds, such as the Motor Vehicle License Fee Account (which, like the LPSF, is constitutionally dedicated to local governments) and the Cigarette and Tobacco Products Surtax Fund (Proposition 99), both of which the budget *does* include in its spending totals. However, although we believe that such spending does constitute state spending, we do not include it in our figures in order to facilitate comparisons with the budget's figures.

Spending From Federal Funds and Bond Proceeds

In addition to the $109 billion of proposed 2005-06 spending from the General Fund and special funds, the budget also proposes $55 billion in spending from federal funds and another $2.7 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, proposed 2005-06 spending exceeds $166 billion.

Federal Funds

As noted above, about $55 billion in federal funds are proposed to be spent through the state budget in 2005-06. (This is about one-fourth of the roughly $200 billion in total federal funds allocated to California. The remaining three-fourths are allocated directly to local governments, businesses, or individuals within the state.) About $29 billion (53 percent) of the total federal funds in the budget are for various health and social services programs, such as Medi-Cal, CalWORKs, and IHSS. Education receives another $14 billion (26 percent) of the total (split fairly evenly between K-12 and higher education), and transportation is expected to receive $2.5 billion (5 percent).

Bond Proceeds

Budgetary Treatment. Bonds are primarily sold by the state to finance large capital outlay projects, such as school facilities, water projects, and state buildings. From a budgetary perspective, the cost of bond programs is reflected when the actual debt-service payments (comprised of bond-related principal and interest payments) are made. For 2005-06, the budget proposes General Fund debt-service expenditures of $4 billion, of which $3.3 billion is for general obligation bonds and $655 million is for lease-revenue bonds.

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

Spending of General Obligation Bond Proceeds. The January budget proposal estimates that the state will spend $2.7 billion in general obligation bond proceeds for capital projects in 2005-06. This is down sharply from the $15.1 billion in spending shown for the current year, and $7 billion in the prior year. The comparatively larger amounts in the current- and prior year are related to the allocation of recently approved K-12 education bonds to specific school district projects.

Spending of Lease-Revenue Bond Proceeds. In addition to general obligation bonds, the state also uses lease-revenue bonds to finance the construction and renovation of capital facilities. Lease-revenue bonds do not require voter approval, and their debt service is paid from annual lease payments made by state agencies using the facilities financed by the bonds (funded primarily through General Fund appropriations). For

2005-06, the budget proposes $145 million in spending from lease-revenue bond proceeds for such purposes as construction of state buildings.

Budgetary Borrowing

In addition to borrowing for capital outlay purposes, the state has undertaken significant borrowing in recent years to help address budgetary shortfalls. We refer to this as budgetary borrowing. In November, we indicated that the state had accumulated $26 billion of outstanding budget-related debt, consisting of (1) $18 billion in bonds (including deficit financing, tobacco, and planned pension obligation bonds), $4 billion in loans from local governments and schools, and (3) $4 billion in loans from transportation-related and other special funds. As we discuss in Figure 2 of "Part I," the proposed 2005-06 budget would result in an additional $3.5 billion in budgetary borrowing. Taking into account scheduled repayments of previously sold bonds, the amount of budget-borrowing outstanding would be around $29 billion at the conclusion of 2005-06.

Scheduled repayments of this budgetary borrowing will result in annual General Fund costs of roughly $4 billion in the 2006-07 through 2008-09 fiscal years (as major loans from transportation and local governments are repaid), and about $2 billion thereafter. The administration has proposed a Constitutional amendment that would stretch out payment of some of these obligations for 15 years. This proposal would reduce General Fund costs in 2007-08 and 2008-09 (by lengthening the time frame during which transportation and local government loans are repaid), but raise them thereafter as the deferred payments come due. As discussed in "Part V," the proposal to defer transportation loan repayments would further delay transportation projects.

State Appropriations Limit

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

Expenditures Projected to Be Below Limit. Due to the downturn in the state's economy and its adverse affects on the state's revenues in the early years of this decade, the budget's proposed expenditures are well below the SAL in both the current and budget years. In 2004-05, appropriations subject to the limit are $9.4 billion below the limit. In 2005-06, the administration's estimate of this gap expands to $9.7 billion.

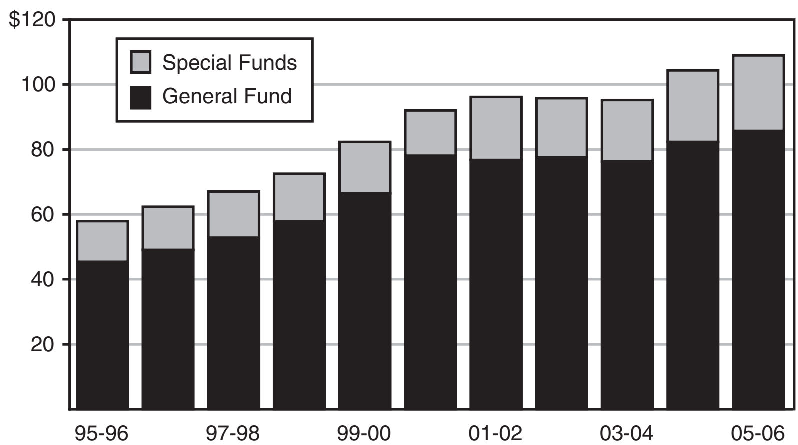
A Historical Perspective

Total Spending. Figure 5 shows that total state spending increased by 25 percent between 1995-96 and 1998-99, and then jumped by another 33 percent between 1998-99 and 2001-02. In contrast, spending has been relatively flat since 2001-02. Over the full ten-year period, total spending is up $51 billion (88 percent), for an average annual growth rate of 6.5 percent.

Figure 5

Total State Spending Over Time[a]

1995-96 Through 2005-06
(In Billions)



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

Real Per-Capita Spending. Figure 6 shows total state spending adjusted for inflation and population. It indicates that:

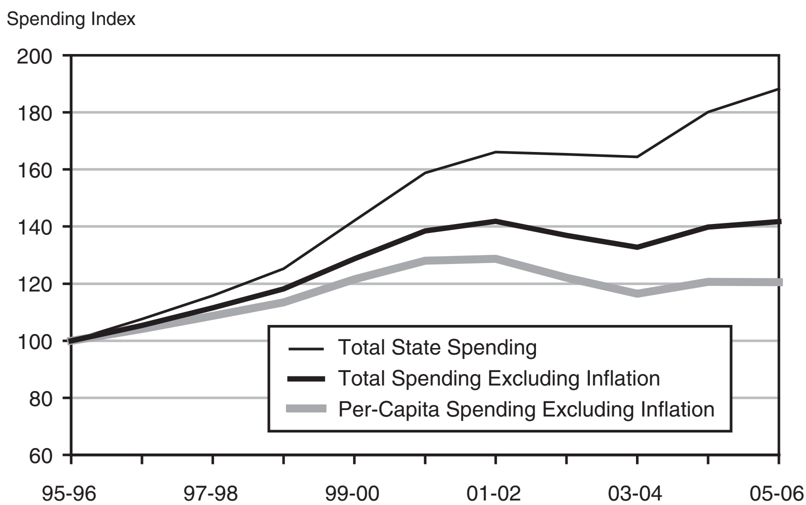
- After adjusting for inflation, spending has grown 42 percent over the entire ten-year period. This indicates that about one-half of the $51 billion increase was due to inflation.
- Real per-capita spending—which adjusts for *both* inflation and population growth—has increased by about 21 percent over the

period. This reflects projected spending of $2,910 per capita in 2005-06, up from $2,415 per capita in 1995-96. Real per-capita spending has grown an average of 1.9 percent over the entire period. Within this time frame, real per-capita spending grew at an average annual rate of 4.2 percent from 1995-96 to 2001-02, but has fallen 1.6 percent annually since then.

Figure 6

Spending Adjusted for Inflation and Population

Index Value = 100 in 1995-96



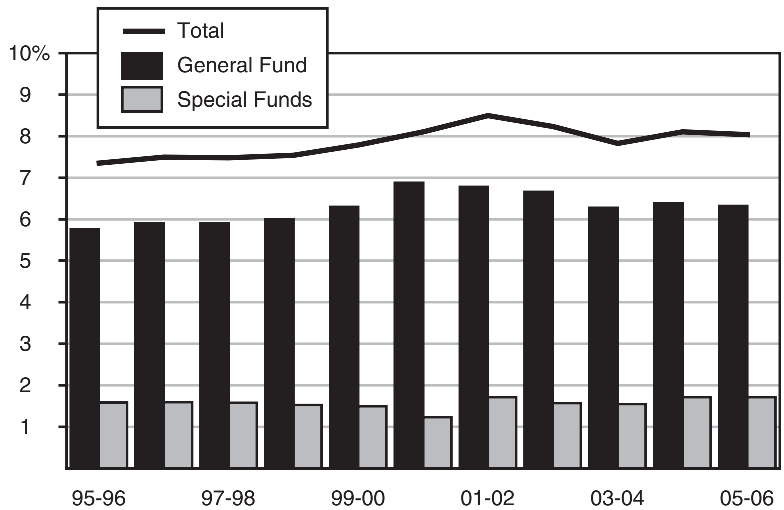
Spending in Relation to State's Economy. Figure 7 (see next page) shows how state spending has varied over recent years as a percentage of total California personal income (which is a broad indicator of the size of the state's economy). From 1995-96 through 2001-02, total state spending increased steadily as a share of personal income—from 7.3 percent to 8.5 percent. Growth in General Fund spending accounted for nearly all of the increase.

After 2001-02, however, total state spending as a percentage of personal income reversed direction, and dropped to 7.8 percent in 2003-04. There are numerous one-time factors leading to the decline in 2003-04, including an accounting change to Medi-Cal, increased federal funds (which temporarily offset state spending), and savings related to a restructuring of debt-service payments. The ratio is projected to be in the 8 percent range for both 2004-05 and 2005-06.

Figure 7

State Spending as a Percent of Personal Income

1995-96 Through 2005-06



MAJOR EXPENDITURE PROPOSALS IN THE 2005-06 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 2005-06 Budget Bill.*

PROPOSITION 98

Background

Proposition 98 is a set of formulas for determining a minimum annual funding level for K-12 schools and community colleges (K-14 education). While the formulas get rather complicated at times, the goal of Proposition 98 is a relatively straightforward one. Generally, Proposition 98 provides K-14 schools with a guaranteed funding source that grows each year with the economy and the number of students. The guaranteed funding is provided through a combination of state General Fund and local property tax revenues. The actual amount the state is required to spend on Proposition 98 depends on specific calculations or "tests" (see Figure 8, next page).

Over the last decade, Proposition 98 spending has on average grown with the economy and number of K-12 students. However, this longer-term average masks the fact that K-14 education spending has experienced two distinct trends over the decade—significant program expansion from the mid-1990s through 2000-01, and program reductions since 2000-01. Figure 9 (see page 75) shows that Proposition 98 grew faster than the economy in the late 1990s. The state provided more funding for K-14 education than the Proposition 98 minimum guarantee required (so-called

Figure 8

Proposition 98 Basics

- ✓ ***Over time, K-14 funding increases to account for growth in K-12 attendance and growth in the economy.***
- ✓ ***There Are Three Formulas ("Tests") That Determine K-14 Funding.*** The test used to determine overall funding in a given budget year depends on how the economy and General Fund revenues grow from year to year.
  - ***Test 1—Share of General Fund.*** Provides 39 percent of General Fund revenues. This test has not been used since 1988-89.
  - ***Test 2—Growth in Per Capita Personal Income.*** Increases prior-year funding by growth in attendance and *per capita personal income*. Generally, this test is operative in years with normal to strong General Fund revenue growth.
  - ***Test 3—Growth in General Fund Revenues.*** Increases prior-year funding by growth in attendance and *per capita General Fund revenues*. Generally, this test is operative when General Fund revenues fall or grow slowly.
- ✓ ***Legislature Can Suspend Proposition 98.*** With a two-thirds vote, the Legislature can suspend the guarantee for one year and provide any level of K-14 funding.

"overappropriations") for five years in a row. Since Proposition 98 builds upon the prior-years' actual spending, the overappropriations become part of the long-term base. Proposition 98 funding has grown at a slower pace than the economy since 2000-01.

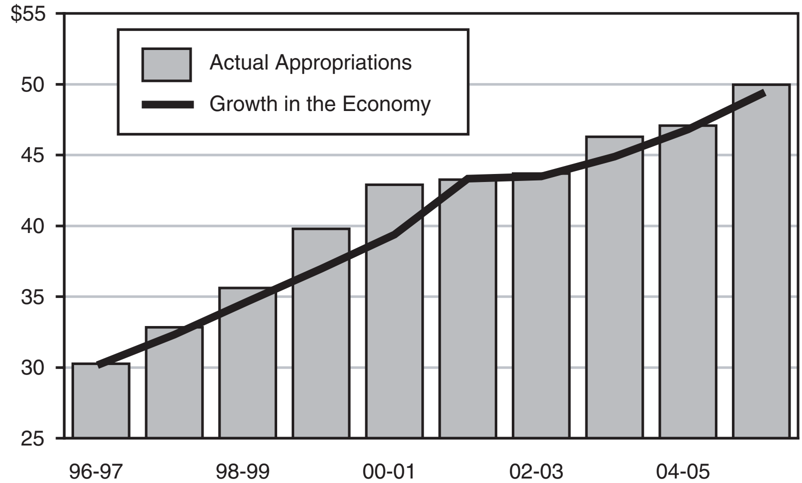
Governor's Proposal

The Governor's budget proposes to leave 2004-05 Proposition 98 appropriations at roughly the level provided in the *2004-05 Budget Act*. The proposal would create $2.3 billion in General Fund savings over two years (as discussed below). For 2005-06, the Governor provides $2.9 billion in growth that supports full growth and cost-of-living adjustments (COLAs), and $380 million of program expansion. The program expansions include a $329 million increase to school district revenue limits that partially restores reductions made during 2003-04, and $51 million for additional community college enrollment growth above the level needed to accommodate natural population increases.

Figure 9

Growth in Proposition 98 Compared to Growth in the Economy

(In Billions)



The Governor's budget continues to defer roughly $315 million in annual costs for state-reimbursable mandates. This deferral effectively borrows $315 million from K-14 education to fund current operating expenses. In addition, the Governor proposes to shift two significant program responsibilities to K-14 education. First, the budget proposes to shift from the state to school districts and community colleges $469 million in annual State Teachers' Retirement System (STRS) costs. No additional funds are proposed in the budget to help school districts pay for these retirement costs. Second, the Governor proposes to shift from county mental health departments to school districts fiscal responsibility for mental health services needed by special education students. Based on the most recent county claims, the cost of this program totaled $143 million (non-Proposition 98 funds), $43 million more than the budget would provide to school districts.

Proposed Constitutional Amendments Affect K-14. The Governor also called a special session of the Legislature to address four major changes to the State Constitution that would affect school districts or community colleges. Specifically, the proposals:

- ***Proposition 98.*** Revamp the constitutional spending requirements of Proposition 98 as part of a larger reform of the state budget process (see "Governor's Budget-Related Reforms" in "Part V").

- ***Retirement.*** Prohibit all public agencies in California, including K-12 and community college districts, from enrolling new employees in a retirement plan that guarantees a specific benefit level upon retirement (see "Addressing Public Pension Benefit and Cost Concerns" in "Part V").
- ***Merit Pay and Tenure.*** Alter existing regulation of local school district employee practices.
- ***School Budget Reports.*** Require school districts to annually report to the public each school's revenues and expenditures.

Issues for Legislative Consideration

Current-Year Guarantee Level Is Pivotal

A central issue facing the Legislature in developing the 2005-06 budget is the amount of Proposition 98 spending that ultimately is approved for 2004-05. As part of the *2004-05 Budget Act*, the state suspended the minimum Proposition 98 guarantee and set a target appropriation level that was $2 billion lower than the amount called for by the guarantee. The legislation authorizing the suspension—Chapter 213, Statutes of 2004 (SB 1101, Committee on Budget and Fiscal Review)—establishes a target funding level for K-14 education. The target suggests that higher General Fund revenues in 2004-05 would result in an increased funding level and lower revenues would reduce it.

The Governor's budget assumes that General Fund revenues in 2004-05 will be $2.2 billion higher than previously assumed, which would generate an increase to the Proposition 98 guarantee of $1.1 billion. The budget, however, does not propose to appropriate these funds to schools and community colleges, instead making only technical adjustments to the current-year funding level. By leaving the level of Proposition 98 spending at roughly the level included in the *2004-05 Budget Act*, the Governor's budget frees about $2.3 billion over 2004-05 and 2005-06 to help address the state's budget problems.

LAO Forecast—Higher Revenues, Lower Guarantee. Our updated economic and revenue forecast projects General Fund revenues will be significantly higher in 2004-05 and modestly higher in 2005-06 compared to the administration's revenue forecast. Over the two years, our estimate suggests that General Fund revenues will be $2.2 billion higher than assumed in the Governor's budget for the two-year period. The impact of our higher revenues on the Proposition 98 guarantee would depend on the level of K-14 spending approved by the Legislature in the current year. Specifically:

- ***Governor's Proposed 2004-05 Spending Level.*** Assuming the level of spending proposed in the Governor's budget, our higher revenues would have no impact on the Proposition 98 obligations in 2004-05 (as the guarantee is suspended). In 2005-06, our revenues result in a $420 million *decline* in the minimum guarantee compared to the Governor's proposed level.
- ***Meeting the Chapter 213 Target.*** Under this assumption, our revenue estimate would result in an additional $1.9 billion for K-14 in the current year. This higher current-year spending level would lead to a $2.1 billion increase in 2005-06, for a two-year impact of $4 billion in additional costs.

Building a Base Budget for 2005-06

Our recommendation on the level of Proposition 98 spending in both the current and budget year reflects the need to resolve the state's structural budget problem by bringing revenues and expenditures into alignment. Moderating increases in the minimum guarantee would greatly assist the Legislature in addressing the state's structural budget problem. We are reluctant, however, to recommend that the Legislature reduce Proposition 98 spending consistent with our current forecast for 2005-06 that is $420 million below the Governor's proposed level. Our lower estimate is an artifact of the Proposition 98 formulas and not caused by a reduction in General Fund revenues. Instead, we recommend the Legislature develop a budget for schools and community colleges that provides for adjustments in workload and other anticipated costs for 2005-06. A workload budget would provide a base the Legislature could build on if it decides to appropriate a higher level of funds for Proposition 98.

Our workload budget shows that the amount proposed in the Governor's budget provides approximately the amount needed to pay for the current level of K-14 services. It also highlights the fact that the Governor's budget does not fund the ongoing costs of K-14 mandates. In our view, providing a funding source for ongoing K-14 mandates in the base budget constitutes a higher priority than the budget's proposed increases for revenue limits or extraordinary community college growth.

STRS Proposal Lacks Benefits

The Governor's budget also proposes to shift financial responsibility from the state to K-14 education for $469 million in annual contributions to STRS. The proposal, however, creates few tangible benefits. In the short-run, the shift could require a "rebenching" of Proposition 98, which would eliminate any savings from the proposed shift. In the long-run, the Governor's proposal does not offer the state, districts, or local employees any significant advantages. For the state, the proposal misses an opportunity to clarify the state's responsibility for long-term retirement fund liabilities. For districts and local employees, the proposal fails to offer additional flexibility over retirement benefits. For these reasons, we conclude that there is no strong rationale to support the STRS proposal.

K-14 Priorities Under a Higher Guarantee

If the Legislature chooses to provide a higher level of funding than suggested by our workload budget, additional funds would help the Legislature address a number of borrowing issues that have resulted from the lingering budget crisis. We have referred to this as the education "credit card" to reflect amounts the state has borrowed from schools and community colleges. Figure 10 displays the "charges" on the education credit card.

Figure 10

Status of the Education Credit Card Debt

(In Millions)

One-Time (Through 2004-05)		Ongoing (2005-06)	
Unpaid K-12 mandate payments	$1,400[a]	Ongoing K-14 mandate payments to budget	$315[a]
CCC and K-12 deferrals	1,271	Revenue limit reductions made in 2003-04	646
Total	**$2,667**	**Total**	**$961**
Grand Total		**$3,628**	

[a] Includes funding for the Standardized Testing and Reporting mandate, which is under review by the Commission on State Mandates.

The figure shows that our estimate of the credit card debt totals $3.6 billion. The largest charge results from unpaid school district claims for the cost of state-mandated local programs. Funding for mandates in the annual budget act ceased in 2002-03. We estimate that the ongoing cost of mandated programs totals $315 million in 2005-06. The backlog in payments through 2004-05 totals $1.4 billion. If the Legislature wanted to provide additional funding to K-14 education in either the current or budget year, we would suggest that it dedicate funds to reduce the outstanding obligations on the education credit card.

K-12 Proposition 98

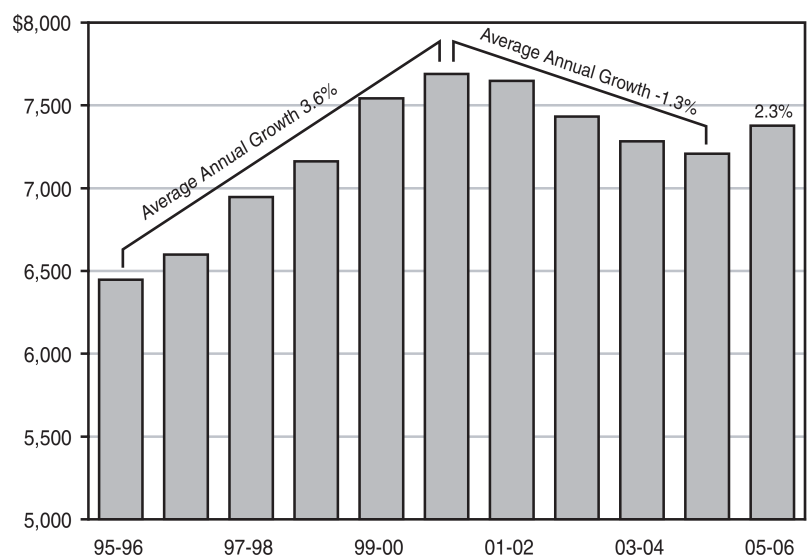
Background

Similar to total Proposition 98 spending over the last decade, K-12 spending has experienced two distinct periods. Figure 11 shows how K-12 Proposition 98 funding per pupil, in inflation adjusted dollars, has changed over that time. The figure shows growth in per-pupil spending between 1995-96 and 2000-01 of $1,200 per pupil (3.6 percent annual growth), and a decline of roughly $480 per pupil between 2000-01 and 2004-05 (1.3 percent decline annually). Much of the reductions in K-12 funding in recent years are reflected in the obligations on the education credit card. These include accumulated deferred mandate costs, deferrals, and revenue limit reductions.

Over the whole period, per-pupil spending has grown by $930 (14 percent). This means that schools have been able to expand programs by around 14 percent over the last decade. Some of these expansions included K-3 class size reduction, large child care expansions, and new school intervention programs.

Figure 11

K-12 Per Pupil Spending Adusted for Inflation



Governor's Proposal

The Proposition 98 allocation to K-12 schools (including property tax revenues) is proposed at $44.7 billion, or $7,374 per pupil for 2005-06. This represents an increase of $362 per pupil, or 5.2 percent, from the current-year estimate.

The major 2005-06 budget proposals include:

- Over $1.6 billion for COLAs for revenue limits and most categorical programs.
- Roughly $400 million to reflect growth in student attendance for revenue limits and most categorical programs.
- $329 million for revenue limit "deficit reduction." This proposal would partially restore reductions in revenue limits that occurred in 2003-04.
- A shift of financial responsibility to school districts from the state for payments under STRS. This would transfer $433 million in program costs to districts.
- A shift of financial responsibility to school districts from counties for financial responsibility for mental health services to special education students. This would shift about $43 million in net program costs to districts.

Issues for Legislative Consideration

The issues facing K-12 education depend largely on the decisions the Legislature makes on the overall Proposition 98 issues discussed above. In addition to the overall Proposition 98 issues, there are several K-12 specific issues.

Retiree Benefit Costs. Most districts pay for all or a portion of the annual cost of retiree health benefits. Actuarial studies of future liabilities for these benefits, however, indicate that the liabilities some districts face are very large—so large they potentially threaten the districts' ability to operate in the future. For Los Angeles Unified School District, for instance, the study suggests the district needs to set aside $500 million each year for the next 30 years to pay for these benefits. We suggest several steps the Legislature could take to begin addressing this issue.

Declining Enrollment Districts. Available data suggest that about 40 percent of districts experienced declining enrollment in 2003-04—most for the second consecutive year. Because state funding is based on the number of students in school each day, declining enrollment reduces the amount of funding districts receive. Under current law, declining enrollment districts are eligible for a one-year funding "hold harmless" that provides time for budget reductions consistent with the drop in the number of students. The Legislature will face difficult tradeoffs between providing some fiscal relief for these districts, and other K-14 cost pressures.

Fixing Technical Problems. We raise several technical issues with proposals in the budget. First, the Legislature enacted Chapter 871, Statutes of 2004 (AB 825, Firebaugh), to begin to consolidate K-12 categorical programs. The statute created some unintended consequences that the Legislature will face in considering the 2005-06 budget. Second, the federal government recently reauthorized the federal special education law, and made significant changes to state maintenance of effort (MOE) requirements. We have concerns with the method that the budget proposes to address the new MOE requirements. Finally, the Governor has proposed a new charter school funding model that would create ambiguity in charter school finance, and would not meet the original legislative intent of the block grant.

HIGHER EDUCATION

Background

The state's higher education system includes the University of California (UC), the California State University (CSU), and the California Community Colleges (CCC), as well as agencies charged with coordinating higher education policy and administering state financial aid programs. The state's higher education policies and funding obligations are generally established by the Master Plan for Higher Education.

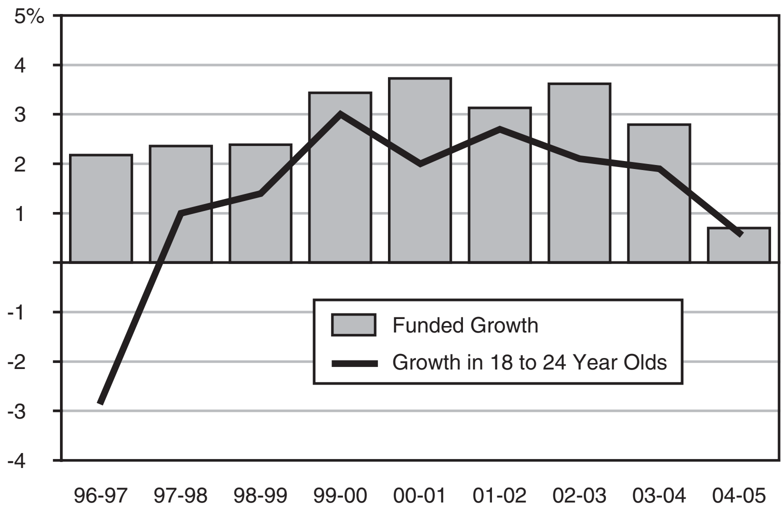
Annual adjustments in the state's cost of providing higher education funding largely arise from three major factors: (1) enrollment, (2) inflation, and (3) student fee levels.

Enrollment Growth. The state uses a "marginal cost" formula that estimates the added cost imposed by enrolling each additional full-time equivalent (FTE) student at the public universities. An increase in the state's college-age population generates an increase in those who are eligible to attend each segment. Therefore, most enrollment growth projections begin with estimates of the growth of this population group. As shown in Figure 12 (see next page), over the past several years, the state has provided enrollment growth funding that exceeds the growth in the college-age population.

Inflation. Higher education costs rise with general price increases. For example, inflation increases the costs of supplies, utilities, and services that are purchased by campuses. In addition, price inflation creates pressure to provide COLAs to maintain the buying power of faculty and

Figure 12

Funding for Enrollment Exceeds College-Age Population Growth



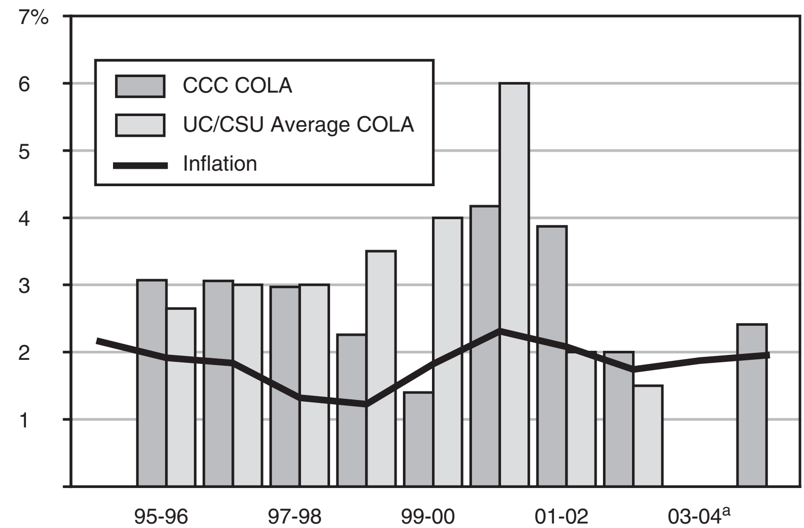
staff salaries. Figure 13 compares funded COLAs with actual inflation rates over the past decade.

Student Fees. Student fees comprise a portion of total revenue available to the segments. When fees are increased, this creates new revenue that can substitute for General Fund revenue or add to the total resources available to the segments. Since 2002-03, undergraduate fees at UC and CSU increased by 48 percent. During that same time, CCC's per-unit fee increased from $11 to $26.

Overall Funding Trends. Largely as a result of student fee increases, total fee revenue collected by the three segments is about $1.2 billion higher in 2004-05 than it was three years earlier. A little less than half this amount was offset by General Fund reductions over the same period, which were made to address the state's fiscal problems. When fee revenue and General Fund support are combined, funding for the three segments has increased about $635 million, or at an average annual rate of 1.7 percent, over the past three years. By comparison, over the past decade funding from these sources has increased at an average annual rate of about 6 percent.

Figure 13

COLAs for Public Colleges and Universities



[a] None provided for any segment in 2003-04 or for UC and CSU in 2004-05.

Governor's Proposal

UC and CSU. The Governor's budget proposes General Fund support of $5.4 billion in 2005-06 for the state's public universities. This represents an increase of $208 million over the current year. The budget includes various provisions to fulfill an agreement the Governor made with UC and CSU in 2004. This includes a base increase of 3 percent and funding for enrollment growth of 2.5 percent, which would serve an additional 5,000 FTE students at UC and 8,100 FTE students at CSU. In addition, the budget includes an 8 percent increase in undergraduate fees and a 10 percent increase in graduate student fees at both universities, as well as a 3 percent increase in professional school fees at UC. In contrast to prior years, the Governor's 2005-06 budget treats the additional revenue generated from fees as an extra source of revenue for use at the public universities' discretion.

CCC. The budget proposes $3.3 billion in General Fund support for CCC, almost all of which is Proposition 98 funding. Under the Governor's proposal, General Fund spending would increase by $299 million, or 9.8 percent, from the current year. When student fee revenues and property taxes are also considered, the budget proposal would increase funding for CCC by $387 million, or 7.5 percent.

The Governor's budget proposal includes $142 million for enrollment growth of 3 percent, $196 million for a 3.93 percent COLA, and $20 million for an initiative to increase coordination of vocational education with high schools. The budget proposes no fee increases.

Issues for Legislative Consideration

The Governor's higher education budget proposal follows predetermined funding targets he agreed upon last year with UC and CSU. We believe the Legislature should disregard these targets and instead determine funding needs for all of higher education based upon the Master Plan and legislative priorities. In our *Analysis of the 2005-06 Budget Bill*, we discuss how such an approach would work and make a number of specific recommendations about programmatic funding and related policy impacts. We highlight the major issues raised in that analysis below:

Treatment of New Fee Revenue Limits Legislative Oversight. Under the Governor's proposal, the public universities would be allowed full discretion to decide how to spend the additional revenue generated from fee increases. We are concerned that this proposal makes funding augmentations that are not linked to specific needs. Further, it removes a significant amount of revenue—approximately $100 million—from legislative budgetary oversight.

CCC Fees Can Leverage Federal Funding. Student fees contribute to CCC's total funding, and various financial aid policies insulate needy students from fee increases. In the *Analysis* we discuss how higher student fees could leverage up to $50 million in additional funding from the federal government, while imposing no net new costs on needy and middle-income students.

New Enrollment Costs Are Driven by Population Growth and Instructional Costs. One of the fundamental budgeting decisions for higher education is how many additional students to fund, and how much to pay for each additional student. In our *Analysis*, we offer recommendations for both of these choices, and identify savings relative to the Governor's budget.

HEALTH SERVICES

Background

Overall Growth Trend. If the spending levels proposed in the 2005-06 budget are adopted, General Fund spending on health services programs will have grown by $3.4 billion or almost 24 percent since 2002-03. That represents an average annual growth rate of about 7.4 percent.

Much of the increase in General Fund expenditures has been driven by increases in caseload, cost, and utilization of services in the Medi-Cal Program, including the continuing effects of recent expansions in program eligibility. Growth in caseloads and costs for community services for persons with developmental disabilities and the mentally ill have also contributed significantly to the increase in General Fund spending for health services.

Programs Also Driven by Federal Spending and Federal Rules. Notably, federal support for health services programs has also grown over the period—by about $2.2 billion and 11 percent—although not as much as General Fund spending. Nonetheless, federal funding and federal rules, to a significant degree, shape the caseload, costs, and operations of the state's major health services programs. Each of the state's largest health services programs—including Medi-Cal, Healthy Families, as well as community services for the developmentally disabled, mentally ill, and those in need of drug treatment—has a significant federal component.

The Governor's budget plan assumes that $22 billion, about 51 percent of the $43 billion in total expenditures proposed for health services programs in 2005-06, will come from the federal government. All of this federal money comes with federal statutes and regulations, as well as administrative decisions and federal court rulings interpreting these rules, that can have major implications for the operation of these programs and, inevitably, state, local, and federal finances.

For example, our analysis indicates that a new federal law establishing drug benefits for Medicare beneficiaries, and the federal regulations to implement that new law, have been drafted in a way that will have a major, negative fiscal impact on the state's Medi-Cal Program for at least the next several years.

Governor's Proposal

The Governor's budget plan includes several major budget proposals that are intended to maximize the receipt of available federal funds:

- ***Prenatal Services Shift***. The Governor's budget proposes a shift of support for prenatal services for women enrolled in the Access to Infants and Mothers program and Medi-Cal to federal funding available under the State Children's Health Insurance Program. This move is estimated to result in net state savings of about $289 million.

- ***Restructuring of Hospital Finances.*** As one component of its Medi-Cal reform package, the administration is proposing to implement a comprehensive design of hospital financing which, if approved by federal authorities, could result in an overall net gain for the state's hospital systems of as much as $700 million annually when fully implemented.

- ***Quality Improvement Fees.*** The budget plan implements prior decisions of the Legislature to impose so-called "quality improvement fees" on Medi-Cal managed care health plans and nursing homes. Under this financial mechanism permitted under federal law, states may impose fees on certain health care service providers and in turn repay the providers through increased reimbursements. Because the costs of Medicaid reimbursements are split between states and the federal government, this arrangement provides a mechanism by which states can draw down additional federal funds for the support of their Medicaid programs. The budget plan assumes that these fees will generate almost $450 million in additional federal funds for Medi-Cal in 2005-06.

Issues for Legislative Consideration

In addition to considering the Governor's budget proposals, the Legislature may wish to examine further actions it could take to preserve the funding the state now receives from the federal government and to build upon those resources.

Consider Further Changes in State Programs. While the state has been making some progress in changing the structure of its health programs to maximize federal funding, our analysis indicates there may be additional opportunities to do so. For example, our analysis indicates that additional quality improvement fee mechanisms, besides those already in place, could be considered for certain hospitals, mental health managed care plans, and state-supported methadone clinics. (Both the Departments of Mental Health and Alcohol and Drug Programs [DADP] have been directed to report to the Legislature this year on strategies to maximize federal funding in their respective programs.) The state could also change the way it claims federal Medicaid reimbursements for Intermediate Care Facilities for the Developmentally Disabled to substitute as much as $50 million in federal funds for state resources.

More Beneficiaries Could Be Shifted to Federal Programs. In addition to obtaining more federal funding for *state-supported health programs*, the Legislature may wish to explore ways to shift beneficiaries *to federal programs*. For example, it might be possible to screen and assist Medi-Cal beneficiaries who are military veterans, and are thus entitled to the comprehensive health coverage offered by the U.S. Department of Veterans Affairs, to apply for and receive those benefits. The DADP has already instructed counties to do so for veterans needing assistance from community substance abuse treatment programs.

Another such opportunity may be to find ways to encourage county mental health systems to more frequently undertake the sometimes time-consuming process of securing Medicare coverage for mentally ill persons who, as disabled persons, qualify for this federal health coverage. The advent of the new Medicare Part D drug benefit program means that such a shift of individuals to Medicare coverage might eventually reduce the significant, long-term costs to the state of providing medications for mentally ill children and adults.

Seek Cost-Saving Changes in Federal Laws and Regulations. Congress is expected in its upcoming session to consider making major changes in the Medicaid Program—Medi-Cal in California—to reduce the growth in federal costs. In this context, some proposals which have been mentioned would have the effect of shifting even more health care costs to the states, including California. A better alternative, from the state's perspective, would be to change Medicaid in ways that reduced its costs for both the federal government and the states.

For example, Congress could modify the statute governing the Early and Periodic Screening, Diagnosis and Treatment Program—one of the state's fastest-growing programs in recent years—to give states more discretion to determine exactly which medical services for children would be covered. Federal law could be changed to shield state Medicaid agencies from federal court litigation that has often overruled state actions to control program costs, or allow Medicaid programs to follow the practice of private health plans and impose meaningful copayment requirements that would deter the inappropriate overutilization of medical services.

In addition, the Legislature may wish to work with California's congressional delegation to attempt to modify some federal rules and statutes that distinctly work to the state's disadvantage. For example, federal cost-sharing rules depress the share of federal Medicaid funds allocated to California because of the state's relatively high personal income level, but disregard the state's relatively high costs. Also, as noted earlier, the regulations drafted to implement the new Medicare Part D prescription drug benefit are likely to prove costly to the state's Medi-Cal Program. Reversal of these policies would provide substantial fiscal relief to the state.

SOCIAL SERVICES

Background

California's major social services programs provide a variety of benefits to its citizens. These include income maintenance for the aged, blind, and disabled; cash assistance and welfare-to-work services to low-income families with children; protecting children from abuse and neglect; providing home-care workers who assist the aged and disabled in remaining in their own homes; and subsidized child care for families with incomes under 75 percent of the state median. Under the Governor's budget proposal, General Fund expenditures for the state's social services programs would be $9 billion in 2005-06, about 11 percent of proposed General Fund expenditures for all purposes.

Overall Growth Trend. Since 2002-03, total General Fund spending for social services programs has been relatively flat, rising from $8.8 billion to just over $9 billion proposed for 2005-06. The $240 million increase over this period represents an annual growth rate of less than 1 percent, significantly less than the typical caseload growth in a number of social services programs. This relatively flat growth in General Fund support for social services is attributable to many factors including additional federal funds for In-Home Supportive Services (IHSS), COLA suspensions and grant reductions in income maintenance programs, and shifting habilitation services to the Department of Developmental Services in 2004-05.

Governor's Proposal

The Governor's budget proposes a total of $1.1 billion in reductions for social services programs in 2005-06. When annualized in 2006-07, the savings increase to nearly $1.5 billion. With respect to the overall budget, social services reductions represent a significant share of the Governor's proposed solution. As described earlier, the Governor identified a budget "problem" of $9.1 billion and his budget closes this shortfall with a combination of borrowing, fund shifts, revenues, and program reductions. The $1.1 billion in reductions in social services represent 12 percent of the budget solutions proposed by the Governor. (It represents 20 percent of the budget solution when additional borrowing is excluded.)

The proposed reductions span several programs. The majority of the reductions are in the areas of income maintenance for low-income Californians and wages for home-care workers. Figure 14 summarizes the fiscal effect of the proposed reductions for both 2005-06 and 2006-07. The largest proposed reduction is $653 million for the California Work Opportunity and Responsibility to Kids (CalWORKs) program which provides income maintenance and welfare-to-work services for low-income families with children. The second largest reduction is $259 million for aged, blind, and disabled recipients of Supplementary Security Income/State Supplementary Program (SSI/SSP). Finally, the budget achieves savings of $195 million by reducing to the minimum wage the state support for the wages for home-care workers in the IHSS program. These

Figure 14

Social Services
Two-Year Fiscal Effects of Savings Proposals

(In Millions)

	2005-06	2006-07[a]
CalWORKs		
Delete state cost-of-living adjustment (COLA)	$163.8	$163.8
Reduce grants by 6.5 percent	212.3	212.3
Reduce earned income disregard	82.0	109.3
County block grant reductions	92.9	92.9
Child care reimbursement rate reductions	62.6	62.6
Other CalWORKs reductions	39.2	39.2
Subtotals	($652.8)	($680.1)
SSI/SSP		
No January 2006 state COLA	$174.2	$348.4
No "pass through" of federal 2006 COLA	84.7	169.4
Subtotals	($258.9)	($517.8)
IHSS		
Limit state participation to minimum wage	$194.8	$259.7
Other Savings		
Department of Social Services	$10.2	$10.2
Other departments	2.0	2.0
Totals	**$1,118.7**	**$1,469.8**

[a] LAO estimate based on 2005-06 proposals.

workers provide various personal care services to the aged, blind, and disabled persons who are unable to remain in their homes without such assistance.

Issues for Legislative Consideration

Social Services Reductions Represent Ongoing Solutions. All of the proposed reductions in social services are of an ongoing nature, rather than one-time. In fact, the proposed savings in SSI/SSP double in 2006-07 and some of the savings in CalWORKs and IHSS increase when the proposals are implemented on a full-year basis. Moreover, the Governor proposes to eliminate the statutory COLA for CalWORKs, further reducing cost pressures in the out years.

CalWORKs Reductions Result in Proposed Savings in Other Programs. The Governor proposes to reduce CalWORKs spending by $653 million (mostly from grant reductions). The CalWORKs program is funded by a combination of federal Temporary Assistance for Needy Families (TANF) block grant funds, the General Fund, and county funds. By reducing the program mostly through grant cuts, the budget frees up federal TANF funds which are used to offset costs in other programs including juvenile probation, foster care, and developmental services.

CalWORKs Program Costs and Resources in Balance Through 2007-08. In order to receive the federal TANF funds ($3.7 billion annually), the state must meet a MOE requirement of $2.7 billion in combined state and county spending. Based on our five-year forecast, the reductions proposed by the Governor would permit the state to hold spending at the MOE level while continuing to use TANF funds to offset other program costs described above through 2007-08. Beginning in 2008-09, meeting estimated program costs will require spending more General Fund than the MOE level or, alternatively, making additional program reductions.

Despite MOE Requirement, Legislature Has Flexibility. When considering the CalWORKs budget, the Legislature will need to first look at its overall budget priorities. The Governor has set a goal of achieving sufficient savings so as to enable substantial TANF transfers (over $300 million per year) to offset General Fund costs in juvenile probation, developmental services, and Foster Care. Depending on its fiscal priorities, the Legislature could spend more or less than the Governor proposes on CalWORKs while maintaining compliance with the MOE requirement. This is because the Legislature controls through the budget act which spending, in which departments, counts towards the MOE requirement.

Impact of Grant Reductions on Welfare Recipients. Under the Governor's proposal, SSI/SSP recipients would not receive a state or federal COLA in 2005-06. For individuals receiving SSI/SSP the maximum grant would be about 105 percent of the 2004 federal poverty guideline, compared to 109 percent under current law. The grant for couples would be 138 percent of the poverty guideline, compared to 144 percent under current law. With respect to CalWORKs, the Governor proposes to reduce grants by 6.5 percent effective July 2005. If this reduction is adopted, a family of three in a high-cost county would see its grant and Food Stamps drop to about 77 percent of the federal poverty guideline, compared to 81 percent under current law.

Reducing IHSS Wages. Currently, federal, state, and county governments share in the cost of wages for IHSS home-care workers. The Governor proposes to reduce state participation in wage costs to the minimum wage ($6.75 per hour), rather than the $10.10 per hour currently authorized. If counties elect to reduce wages in response to this loss of state participation, home-care workers could see their wages drop by as much as 33 percent. Reduction in provider wages will impact recipients in different ways. For recipients with relative providers (about 43 percent of all cases), we would assume, given the familial relationship, that most of these providers would continue to serve their family members despite the reduction in wages. However, this could result in a significant loss of income for the recipient's household. For cases in which the provider is not a relative, a reduction in wages is likely to reduce the size of the labor pool of available providers. It is possible that some recipients may be unable to find providers and/or that their providers will be less skilled.

Conclusion. The Legislature faces very difficult choices in the area of social services. On the one hand, the proposed reductions are all of an ongoing nature, some of them increase in 2006-07, and together they represent key components in the Governor's approach to closing the structural deficit. On the other hand, the reductions will impact many of California's low-income individuals and families.

JUDICIARY AND CRIMINAL JUSTICE

Background

Overall Growth Trend. Spending for judiciary and criminal justice programs represents about 11 percent of total General Fund spending. Between 2002-03 and 2005-06, the budget for these programs is projected to grow at an average annual rate of about 6 percent. Below we discuss some of the factors that have led to increased spending, as well as briefly summarize recent budget initiatives.

Corrections. In recent years, corrections spending has primarily been driven by (1) growth in the number of inmates, (2) correctional officer salary increases, and (3) court-mandates related to inmate health care. Recent budget initiatives to reduce spending have sought to reduce the number of parolees returned to prison for nonviolent offenses, as well as spending on overtime.

Judiciary. Growth in state spending for court operations has resulted primarily from increases in court employee salaries, and other expenses. Budget strategies to reduce General Fund spending included one-time and ongoing unallocated reductions, as well as the support of judicial programs from increased fee revenues.

Governor's Proposal

Corrections. The Governor's budget proposes to increase spending for corrections by about $102 million, or 1.5 percent. This includes funding for the California Department of Corrections (CDC), the Youth Authority, and other boards and commissions within the Youth and Adult Correctional Agency. This overall increase consists of General Fund increases in some areas and decreases in others. However, it is largely driven by increases for CDC, mostly to fund salary increases, and positions associated with the opening of a new prison in Delano. Other augmentations are included for inmate health care services, inflation on operating expenses and equipment, and implementation of the voter approved DNA initiative (Proposition 69). The budget reductions in this area include cuts to inmate and parolee programs, juvenile crime prevention programs, and grants for local law enforcement.

Judiciary. Overall, the budget proposes to increase spending for the judicial branch by $178 million, or 6 percent. This includes funding for the Trial Court Funding Program, as well as the Supreme Court and Courts of Appeal. The increase is the result of salary and benefit increases, as well as an augmentation for trial courts based on growth in the state appropriations limit. The budget also restores funding for one-time reductions and loans made in prior years. No reductions are proposed for the judicial branch.

Issues for Legislative Consideration

CDC Reforms. In the last two years, the Legislature and Governor have taken steps to try to reduce the inmate population. Specific policy changes include, for example, expansions of work credits for certain reception center inmates, and the use of intermediate sanctions for some parole violators who would otherwise be returned to prison. However, much of the General Fund savings from these changes has not materialized because the policy changes in some cases were not implemented, or in other cases have only been partially implemented. As a result, the proposed budget adds millions of dollars in the current year to backfill for savings that did not materialize. The reasons given for delays include slow development of new policies and procedures, difficulty contracting for treatment beds, and protracted negotiations with state employee unions. It will be important for the Legislature to follow-up with CDC on the implementation of policy reforms, with a focus on the department's progress to date and its timeline for reaching full implementation.

Potential Reduction in Spending for Inmate and Parolee Programs. As mentioned above, the Governor's budget proposes to reduce funding for inmate and parolee programs, such as education and substance abuse treatment. Research has shown that academic and vocational education programs, as well as substance abuse treatment help to prepare inmates for re-entry into the community, and assist parolees in making the transition from prison to the community. Thus, to the extent that less of these types of services are provided in the budget year, it could increase the number of parolees returned to custody; thereby increasing state prison costs. In lieu of budget cuts to inmate and parolee programs, the Legislature may wish to consider achieving savings in other areas such as changing the way CDC manages its inmate population.

Juvenile Justice Reform. The budget indicates that the administration is developing a juvenile justice reform proposal that will be provided to the Legislature in the May Revision. The budget further indicates that the specific reform will likely involve shifting some portion of the services currently provided by the Department of the Youth Authority to the counties. Although the budget lacks detail on the Governor's proposal, we believe there are potential benefits from shifting the responsibility for the Youth Authority population to the counties since the counties already serve over 95 percent of juveniles in the criminal justice system. For example, we believe that shifting responsibility and funding for state Youth Authority wards to the local level would reduce the level of duplication within the state and local system, as well as provide counties an incentive to build upon the services that are already provided at the local level. (For more information, please see *The 2004-05 Budget: Perspectives and Issues*, page 93.)

In reviewing any proposal to shift services to the counties, it will be important for the Legislature to ensure that funds are provided to cover the full cost of those services proposed to be shifted to the local level. Under the California Constitution, as recently amended by Proposition 1A, the transfer of additional program responsibility to local government would have to be accompanied by commensurate offsetting revenues or program savings.

As a cautionary note, we point out that a May release date for the Governor's proposal leaves the Legislature with a very limited time to review and respond to a policy change of the magnitude indicated.

Court Fees. In recent years, the Legislature and the Governor have increased court fees, as well as established new fees to offset General Fund costs for the courts during the state's fiscal crisis. It is our understanding that the courts are seeking legislative action to establish a uniform civil filing fee structure. Generally, this proposal involves collapsing a number of existing fees into a single fee, as well as raising certain specific fees. In the past, we have raised concerns regarding the potential impact of fee increases on citizen access to the courts. As the Legislature considers the proposed fee structure, it should evaluate whether such increases limit access.

Chapter 275, Statutes of 2003 (SB 940, Escutia) established a working group on court collection of fees and fines to evaluate court collection efforts and identify strategies to enhance future collections. Based on discussions with court staff, it is our understanding that the workgroup identified hundreds of millions of dollars in uncollected criminal penalty revenue statewide. To the extent some portion of this revenue can be recovered, it would potentially reduce state General Fund costs, and reduce pressure to raise fees in the future. We note that a portion of any recovered revenues would go to the counties since the state and counties share penalty revenues. At the state level, criminal penalties support various programs consisting of victim restitution, peace officer training, corrections training, and the court facility program. At the local level, the revenues support a variety of general fund programs, including the MOE payment to the State Trial Court Trust Fund.

TRANSPORTATION

Background

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

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

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

Overall Growth Trend. Figure 15 shows the amount of expenditures on state transportation programs, funded by state funds and federal funds, from 2002-03 through 2005-06. The figure shows total expenditures on state transportation programs stayed about the same in 2002-03 and

Figure 15

Expenditures on State Transportation Programs

2002-03 Through 2005-06
(In Billions)

	2002-03	2003-04	Estimated 2004-05	Projected 2005-06
State funds	$3.5	$3.8	$3.9	$4.1
Federal funds	2.7	2.3	2.9	2.4
Totals	**$6.2**	**$6.1**	**$6.8**	**$6.5**

2003-04. These expenditures are estimated to increase in the current year, mainly due to higher expected expenditures of federal funds for local assistance. For 2005-06, total expenditures are projected to be lower than the current-year level, with more expenditures to be funded from state sources.

The primary reason for little growth in state-funded transportation expenditures over the four-year period is the use of transportation funding to aid the General Fund, as discussed below.

Substantial Transportation Funds Used to Help the General Fund. In the past four years, funds designated for transportation have been redirected annually to help the General Fund. The 2005-06 budget continues this practice. The repeated diversion of transportation funds, while helping the General Fund condition, raises a number of issues regarding the predictability of future transportation funding.

Governor's Proposal

The 2005-06 budget includes a number of proposals that will affect transportation funding not only in 2005-06, but also in future years.

- ***Transportation Funds to Provide $1.5 Billion to the General Fund.*** The budget proposes to suspend Proposition 42 in the budget year to provide $1.3 billion for the General Fund. The budget also proposes to retain in the General Fund about $200 million that would otherwise be used for mass transit projects.

- ***Tribal Gaming Bonds Deferred to Budget Year.*** The 2004-05 budget assumed that $1.2 billion in transportation loans to the General Fund would be repaid in the current year with bonds backed by tribal gaming revenues. Due to an ongoing lawsuit challenging those bonds, the Governor's budget assumes this money will instead be repaid in the budget year.

- ***Proposition 42 Protected in Future, But Repayments Delayed.*** The administration proposes to increase the stability of transportation funding in the long run by prohibiting the suspension of Proposition 42 beginning in 2007-08. However, it also proposes to delay repaying certain loans to transportation that are due in 2007-08 and 2008-09. Instead, the administration proposes to repay these loans over a 15-year period.

Issues for Legislative Consideration

State Transportation Funding Is Already Limited and Uncertain. State transportation funding has been limited in recent years due to several factors. These factors include repeated suspension of Proposition 42 and a decline in the value of the excise tax on gasoline and diesel fuel. These and other factors have reduced the state's allocations of funding for new projects. As a result, some transportation needs are now being met through borrowing, which reduces funding available for other transportation projects both now and in the future.

Proposals Further Constrain Near-Term Transportation Funding. The administration's 2005-06 proposals to use transportation funding to aid the General Fund will further constrain near-term funding of transportation programs. For example, as Figure 16 shows, when combined with previous actions to reduce General Fund money for transportation, the Governor's proposals would reduce the total amount of General Fund money provided to transportation over a six-year period to about $2 billion, which is $5.5 billion less than was originally anticipated in the TCRP.

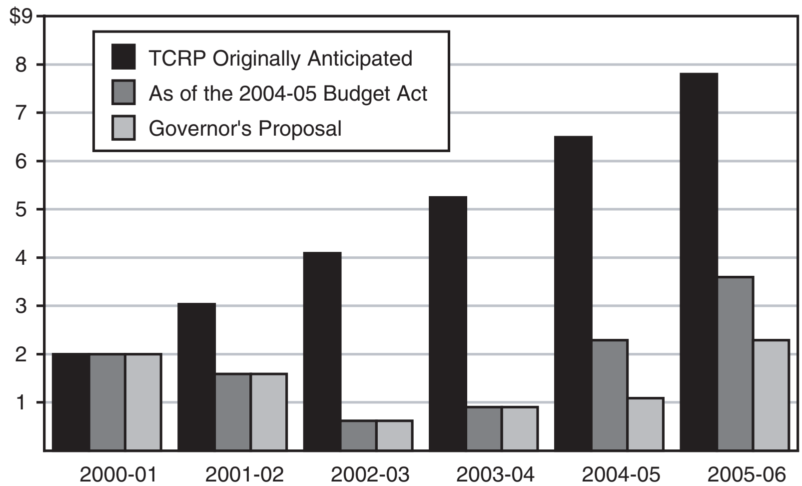
Reducing transportation funding in turn slows down the completion of transportation projects. However, the administration has not estimated how much its proposals will reduce the commitment of funds to new transportation projects. We believe that the administration should provide information to the Legislature that would allow it to determine the effect of the Governor's proposals on the size of the transportation program.

Budget-Year Funding for TCRP Is Uncertain. The TCRP would be particularly affected by the Governor's proposals. If the tribal gaming bond revenue does not materialize in the budget year, there is a possibility that ongoing work on TCRP projects would have to stop. Unfortunately, the budget for TCRP projects contains errors and is built on out-of-date information. Therefore, it is uncertain whether there will be sufficient funding in the budget year to continue work on TCRP projects. We think that the administration needs to provide corrected and updated information to the Legislature that would allow it to determine TCRP project funding requirements in 2005-06.

Figure 16

Traffic Congestion Relief Program Cumulative General Fund Support

(In Billions)



Long-Term Funding Stability Is Still Paramount. Over the long run, the Governor's proposal to prohibit the suspension of Proposition 42 transfers to transportation would provide added stability to transportation funding. However, in the event of future General Fund shortfalls, another component of the Governor's proposals would require expenditures to be cut across the board. Such cuts would affect Proposition 42 funding as well, which would lessen transportation funding stability. We have previously recommended an alternate means of stabilizing transportation funding by repealing Proposition 42, raising the gas tax to provide an equivalent amount of funding, and indexing the gas tax to inflation in future years.

RESOURCES

Background

Overall Growth Trend. State expenditures for resources and environmental protection programs have increased from about $2.7 billion in 1998-99 to $4.7 billion in 2005-06. This reflects a 76 percent increase, or an average annual increase of about 8 percent. The increase mostly reflects growth in expenditures from fee-based special funds and bond funds, while General Fund expenditures proposed for 2005-06 are roughly at the 1998-99 level.

Given the weakened condition of the General Fund, a number of program activities that have traditionally been funded from the General Fund—such as flood project maintenance and environmental risk assessments—have experienced expenditure reductions over this period. When adjusted for inflation, General Fund expenditures proposed for resources and environmental protection programs in 2005-06 are actually lower than the 1998-99 level.

Bond fund expenditures increased during the period, reflecting the availability of bond funds from five resources bond measures (totaling $11.1 billion) approved by the voters between 1996 and 2002. These bond measures provide funding for a mix of water, park, and land acquisition and restoration purposes. In general, funds from these five bonds have not been used to replace General Fund expenditures. Rather, they have largely supported new or expanded local assistance loan and grant programs (such as for local parks, water conservation projects, and wastewater treatment plant upgrades) or been used to increase capital outlay expenditures, such as for land acquisitions for state parks or conservation purposes. These bond funds are running out, however. At the end of 2005-06, about $1.2 billion of the $11.1 billion allocated in the five bonds will remain available for new projects.

The bulk of the increase in special fund spending during this period is due to new or increased fee revenues. A significant proportion of the increases in special fund expenditures since 1998-99 reflect expenditures that fully or partially offset General Fund reductions. This has occurred mainly in regulatory programs where fees are levied on the regulated parties that benefit directly from the state program. In this regard, fees have replaced General Fund revenues to a significant degree in the Air Resources Board, Department of Pesticide Regulation, and State Water Resources Control Board.

Cost Drivers. Some resources departments own and operate public facilities, such as state parks and boating facilities, which drive their costs. In addition, the state's resources and environmental protection programs include a number of regulatory programs whose costs are driven by their regulatory activities. Finally, some resources activities have a public safety purpose, and the cost drivers include emergency response costs that can vary substantially from year to year.

Governor's Proposal

Financing Flood-Related Lawsuit Settlement With a Judgment Bond. The budget proposes to finance a pending $464 million settlement of a flood-related lawsuit against the state (the *Paterno* case) by issuing a "judgment bond." Although not defined in statute, a judgment bond is basically a debt payment mechanism issued to finance a court judgment or lawsuit settlement. To our knowledge, the state has never issued a judgment bond.

While the Governor's January budget proposes to pay the *Paterno* settlement with a judgment bond, the Director of Finance has recently indicated that the administration would use this financing option only if it represents the least costly method to resolve this case.

Addressing Flood Management. The budget proposes an increase of $31 million for the Department of Water Resources' (DWR) flood management program in 2005-06. With these increases, DWR's total flood management budget for 2005-06 will be about $73 million, an increase of over 70 percent above current-year appropriations. The requested increase is for maintenance work on levees and flood channels, an initial start at evaluating levees and channels to identify deficiencies, floodplain management (including floodplain mapping), and emergency response.

The requested increase reflects the first year of a three-year budget plan to begin addressing what the department has characterized as a "crisis" in flood management. According to DWR, several factors have created this crisis, including an aging flood control infrastructure with potential design flaws, substantial deferred maintenance, out-of-date floodplain mapping, and a history of declining funding.

CALFED Bay-Delta Program. The budget proposes $240.6 million of state funds—spread throughout seven state departments—for CALFED-related programs in 2005-06. Of this amount, $12 million is proposed from the General Fund, with the balance mainly from various bond funds ($201 million) and State Water Project funds ($25.4 million). This level of expenditure is a 40 percent reduction from the current year, mainly reflecting a reduction in available bond funds.

The Governor's January budget document indicates that an $8.1 billion ten-year finance plan for CALFED—recently approved by CALFED's oversight agency, the California Bay-Delta Authority—will be incorporated in the Governor's May Revision. The plan is guided by the application of the "beneficiary pays" funding principle and relies significantly on new sources of revenue, including water user fees.

Issues for Legislative Consideration

Financing Flood-Related Lawsuit Settlement With a Judgment Bond. We think that there may be alternative ways of paying the state's obligation in the *Paterno* case in addition to the judgment bond proposal in the Governor's January budget. These include (1) paying the settlement fully out of available resources in the budget year and (2) structuring the settlement payments over a few years.

If the administration decides to proceed with a judgment bond, there are several legal, policy, and fiscal issues that the Legislature should consider when evaluating such a proposal. These include (1) whether a judgment bond would require a vote of the people and/or legislative authorization, (2) whether debt financing of a lawsuit settlement is good policy, and (3) how much the judgment bond would cost over time. Because the court has not finalized the *Paterno* settlement, we recommend that the Department of Finance report at budget hearings on several issues.

Addressing Flood Management. The budget's requested increases for flood management are well justified in light of the flood management challenges facing the state that were identified in a recent DWR White Paper—*Flood Warnings: Responding to California's Flood Crisis.* However, the increases reflect a small fraction of the funding requirements identified by the department.

We address the flood management challenges facing the state more fully in a separate write-up, *Water Policy Issues Facing the State*, found in "Part V" of this document. In that write-up, we enumerate what we consider to be the most important initial actions that the Legislature should take to begin addressing the problems. These include:

- Directing DWR to develop a multiyear plan to assess the structural integrity and carrying capacity of the Central Valley flood control system.
- Enacting a Central Valley flood control benefit assessment, to provide a stable, dedicated funding source to meet flood management funding requirements.
- Re-evaluating the state's role with respect to levees in the Delta that are not federally authorized projects, perhaps by expanding the state's oversight role.
- Taking steps to reduced the likelihood of ill-advised local development approvals in flood-prone areas, by making local land use agencies bear more of the flood-related fiscal burden and liability resulting from their decisions.

CALFED Bay-Delta Program. The Legislature will be asked to evaluate CALFED's ten-year finance plan with its anticipated inclusion in the Governor's May Revision. The current finance plan relies heavily on greatly increased levels of federal funds and substantial new, but unidentified, sources of state public funds. We think that the finance plan's funding targets—adding up to $8.1 billion over the term of the plan—may be unrealistic given the uncertainty surrounding many of the plan's revenue assumptions.

We identify two sets of actions that the Legislature should take in conjunction with its evaluation of the finance plan proposal:

- ***Establish Statutory Parameters to Guide Beneficiary Pays Principle Application.*** While the finance plan generally includes an analysis of the basis for its allocations of program costs among beneficiaries, these allocations are based on an assumed level of program activity. We think that the Legislature should enact legislation to guide the application of the beneficiary pays principle in the event the program level or the nature of activities in a program change.
- ***Set Expenditure Priorities for CALFED.*** Second, given the significant uncertainty underlying the funding targets in the finance plan, we think that the Legislature should play a role in setting expenditure priorities for CALFED by holding joint hearings of its policy and budget committees. At the hearings, the Legislature should be informed of the programmatic implications, and CALFED's expenditure priorities, if the assumed level of funding in the finance plan does not materialize. To the extent that those priorities do not coincide with the Legislature's priorities, the Legislature should provide clear direction to guide CALFED expenditures at reduced funding levels.

EMPLOYEE COMPENSATION

Background

Pay for State Employees. The state's costs for paying state employees are determined through collective bargaining with employee unions. The pay, benefits, and working conditions for these employees are typically spelled out in memoranda of understanding (MOUs) negotiated between unions and the state. Since 2002-03, most state employees have received a 5 percent raise and increased state coverage of health care costs. Two groups—correctional officers and highway patrol officers—negotiated a series of four annual pay raises, which began July 1, 2003. In total, salary costs in 2004-05 are an estimated $894 million above their 2002-03 level. Costs for state employment (including higher education) are projected to total more than $24 billion in 2005-06, about half of which is supported from the General Fund.

Retirement Costs. As part of the employee compensation package, the state makes annual contributions to various retirement programs to fund benefits for state employees and teachers that will be paid out in the future. In recent years, the state's retirement costs have increased significantly. For instance, state General Fund retirement costs have increased from $2.7 billion in 2002-03 to a projected $3.9 billion in 2004-05. The largest factor in this increase is the poor investment performance of retirement funds. The state's General Fund retirement costs for 2004-05 and 2005-06 are summarized in Figure 17.

Governor's Proposal

Increased Pay for Employees. The Governor's budget includes funds ($261 million, of which $198 million is from the General Fund) to pay for MOUs with previously agreed-upon provisions. The largest portion of this amount is for a 7.2 percent raise for highway patrol officers and a 5.1 percent raise for correctional officers. To offset these increased costs, the Governor proposes to save even more ($741 million, of which $408 million is from the General Fund) by negotiating with unions with expired MOUs for reductions in benefits. The most significant proposals relate to retirement (discussed below). The other sought concessions include allowing the Governor to furlough employees for up to five days a year and reducing the amount the state would contribute to health benefits.

Retirement Changes. The Governor's budget has four retirement-related proposals. As shown in Figure 17, these proposals would reduce the state's 2005-06 General Fund retirement costs by $1.5 billion.

- ***Reduced Costs for Existing Employees.*** As part of the negotiations with unions, the administration seeks to have existing state employees either opt out of the state's retirement system (in exchange for a pay raise) or pay a greater share of the ongoing costs of the system.
- ***Defined Contributions for New Employees.*** The administration proposes that all newly hired employees be covered by a defined contribution retirement plan instead of the traditional defined benefit plan. Instead of guaranteeing a certain benefit upon retirement, defined contribution plans provide fixed annual employer contributions to employee accounts. The proposed 2005-06 budget does not include any estimated savings from this change since it would not start until 2007-08. (We discuss this proposal in "Part V" of this publication.)

Figure 17

General Fund Costs for Retirement Programs[a]

(In Millions)

	Estimated 2004-05	Proposed 2005-06
State Retirement Plans		
Public Employees' Retirement (PERS)	$1,401	$1,466
State Teachers' Retirement	1,149	1,050
Judges' Retirement	148	144
Defined Contribution Plans[b]	47	21
Subtotals	($2,745)	($2,681)
Other Retirement Benefits		
Health and Dental Benefits for Annuitants	$796	$861
Social Security and Medicare[c]	385	401
Subtotals	($1,181)	($1,262)
Totals	**$3,926**	**$3,943**
Proposed Budget Savings		
Proposed pension bond savings	—	-765
Proposed shift of state teachers retirement contribution to school districts	—	-469
Proposed PERS opt-out/cost-sharing for existing state employees	—	-296
Net General Fund Cost	**$3,926**	**$2,413**

[a] Excludes costs for University of California employees.

[b] State's contribution to supplemental retirement plan for correctional officers and their supervisors and managers.

[c] Legislative Analyst's Office estimates.

- ***Shift of Teacher Retirement Costs.*** The Governor proposes to shift the state's roughly 2 percent of payroll contribution for teachers' base retirement program to school districts and/or teachers.
- ***Pension Bond.*** The 2004-05 budget package authorizes the issuance of a pension obligation bond to cover a portion of the state's retirement contributions. Using existing statutory authority, the administration now plans to issue the bond in 2005-06 at a somewhat reduced amount.

Issues for Legislative Consideration

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

Governor's Defined Contribution Plan Proposal. Due to the guaranteed benefits provided its retired employees, the existing state retirement system places significant financial risks on the state. Annual payments can rise dramatically from year to year. A defined contribution would address this concern (as well as other concerns that we discuss in "Part V") by limiting the state's obligation to a fixed amount each year. On the other hand, the proposal shifts investment risk to employees and increases uncertainty as to the level of benefits that can be expected upon retirement. Moreover, reductions in retirement compensation for employees could lead to increases in other types of employee compensation. For instance, in order to attract and retain employees, the state might need to increase salaries to compensate for lower retirement benefits. In addition to considering the administration's retirement proposal for new employees, the Legislature could also consider alternatives in order to address concerns with the existing system. For instance, the Legislature could modify the existing defined benefit system or develop a hybrid of the two types of plans.

Shift of Teacher Retirement Costs Should Be Evaluated on a Short-Term and Long-Term Basis. The Governor's proposal to shift some state costs to schools and/teachers should be evaluated both as a short-term budget solution and as a long-term solution to the system's shortcomings. The existing teachers' retirement system is a local program over which local school districts have little control or responsibility. In evaluating the proposal on a short-term basis, the Legislature will need to determine whether the proposal would generate the intended General Fund savings. On a long-term basis, the Legislature will need to determine whether the proposal would move the system towards greater local control and responsibility.

LOCAL AGENCY AND EDUCATION MANDATES

Background

The California Constitution requires the state to reimburse local governments, including schools, when it mandates a new program or higher level of service. During times of fiscal difficulty, the state frequently has delayed making these mandate payments. As a result, through the end of the 2004-05, we estimate the state will owe about $2.8 billion, including:

- About $2.2 billion for unpaid claims from 2003-04 and earlier years.
- Over $500 million for unpaid claims in 2004-05.
- $100 million for new mandates recently identified by the Commission on State Mandates. (Figure 18 displays these new mandates and indicates where they are reviewed in the *2005-06 Analysis*.)

Figure 18

Analysis of Newly Identified Mandates

(In Millions)

	Cost Through 2004-05	2005-06 Analysis	
		Item	Department
Grand Jury Proceedings	$12.6	0250	Judicial Branch
Presidential Primaries	1.2	0890	Secretary of State
Absentee Ballots: Tabulation by Precinct	0.2	0890	Secretary of State
Administrative License Suspension	10.0	2740	Motor Vehicles
Standards Based Accountability	0.6	6160	Education
School District Reorganization	—[a]	6160	Education
Immunization Records: Hepatitis B	29.6	6160	Education
Attendance Accounting	—[a]	6160	Education
Charter Schools II	0.2	6160	Education
Sexual Assault Response Procedures	—[a]	6160	Education
Criminal Background Checks II	0.3	6160	Education
Comprehensive School Safety Plans	37.1	6160	Education
Pupil Promotion and Retention	9.0	6160	Education
AIDS Prevention Instruction II	—[a]	6160	Education
Teacher Incentive Program	0.1	6160	Education
Redevelopment Agencies: Tax Disbursement Reporting	0.1	9100	Tax Relief
Total	**$100.7**		

Total may not add due to rounding.

[a] Costs of less than $50,000.

New Requirements Regarding Local Agency Mandates. In November 2004, the state's voters approved Proposition 1A, generally requiring the state to either (1) fund city, county, and special district ("local agency") mandates in the annual budget bill or (2) suspend them for the fiscal year. (Suspending a mandate places a one-year pause on a local agency's obligation to carry out the mandate and eliminates any state fiscal liability for the mandate during that time.) Proposition 1A also authorizes the state to pay over time all local agency mandate liabilities incurred before 2004-05. Chapter 211, Statutes of 2004 (SB 1096, Committee on Budget and Fiscal Review), specifies that the payment term shall be five years, beginning in 2006-07.

Governor's Proposal

The budget proposes $44 million for 30 local agency mandates, including $13.9 million for the animal adoption mandate and $2 million for a greatly revised open meetings act mandate. The administration proposes deferring funding for the mandate relating to the Peace Officer Procedural Bill of Rights (POBOR). (Under Proposition 1A, mandates relating to employee rights are exempt from the provision requiring annual funding in the budget.) The budget suspends many major local agency mandates, including the mandate on counties to provide mental health services to special education pupils (the "AB 3632" program) and various mandates relating to the provision of absentee ballots. The administration also proposes a constitutional amendment (ACA 4x, Keene) that, among other items, lengthens to 15 years the term of payment for overdue local agency mandates.

In terms of K-14 mandates, the budget contains no new proposals. (Education mandates were not addressed by Proposition 1A.) Two education mandates suspended in 2004-05 are proposed for suspension again in 2005-06. In addition, with the proposed suspension of the AB 3632 mandate, the budget shifts to school districts the obligation for funding a major mental health program.

For both K-14 school districts and local agencies, the budget reflects the elimination of a series of mandates resulting from the passage of legislation in 2004 sponsored by the Assembly Special Committee on Mandates: Chapter 206 (AB 2854, Laird); Chapter 316 (AB 2851, Laird); Chapter 889 (AB 2853, Laird); Chapter 890 (AB 2856, Laird); and Chapter 895 (AB 2855, Laird).

Issues for Legislative Consideration

Significant Attempt to Reduce 2005-06 Mandate Costs

Based on information from prior-year claims, we estimate that the administration's proposals would relieve the state of about $250 million in costs for local agency mandates in 2005-06. This amount includes:

- $210 million of one-time savings due to mandate suspensions.
- $31 million of cost deferral due to the postponement of POBOR mandate reimbursements to an unspecified date.
- $14 million of ongoing savings due to changes (yet to be announced) in the open meeting act mandate.

The administration's proposals, therefore, represent a significant attempt to reduce costs in 2005-06, but not necessarily a plan for ongoing budget savings. This is because only $14 million of the $250 million savings would be ongoing.

In addition, by relying on one-time mandate suspensions in the budget bill, rather than permanent changes to underlying statutes, the administration's plan makes it difficult for local agencies or the public to understand the requirements of state law. In reviewing the administration's proposals, the Legislature should consider whether any mandates could be permanently eliminated or restructured to reduce the state's costs and local government responsibilities.

Additional Mandate Costs Pushed Into the Future

No Funding for K-14 Mandates. The budget includes no funding for K-14 mandates. All payments for education mandates would be deferred to an unknown future date. As shown in Figure 19 (see next page), this would bring total unpaid K-14 mandates by the end of 2005-06, including the new mandates recently identified by the Commission on State Mandates, to $1.7 billion.

Insufficient Funding for Local Agency 2005-06 Mandates. The budget includes $44 million for the 30 mandates the administration proposes to be active (not suspended) in the budget year. Based on prior-year claims, we estimate the local agency claims for these mandates in 2005-06 will be $111 million—or $67 million more than proposed. As shown in Figure 19, by the end of 2005-06 we estimate that state local agency mandate liabilities will total $1.5 billion.

Changing a Commitment to Local Agencies

Proposition 1A authorizes the state to pay over time all local agency mandate liabilities incurred before 2004-05. Chapter 211 specifies that the payment term will be five years, beginning in 2006-07. The administration, through ACA 4x (Keene), proposes lengthening the mandate payment term to 15 years. Such a change increases state fiscal flexibility at the expense of local fiscal flexibility. We note that, in some cases, local agencies are awaiting payment for mandated activities carried out over a decade ago.

Figure 19

Estimated State Mandate Liabilities As of End of 2005-06

(In Millions)

Unfunded Costs	Local Agencies	K-14 Districts	Total
Claims through 2003-04	$1,162	$1,018	$2,181
Claims for 2004-05	240	300	540
Claims for 2005-06 (in excess of budget proposal)	67	315	382
New mandates determined in 2004-05	24	77	101
Estimated Mandate Costs at The End of 2005-06	**$1,493**	**$1,710**	**$3,204**

Source: The State Controller's Office for costs through 2002-03, the Commission on State Mandates for cost of new mandates, and the Legislative Analyst's Office for other costs.

Major Proposals Lack Explanation

The administration proposes to suspend, revise, or defer funding for mandates relating to significant programs, including mental health services for special education pupils, statewide policies regarding absentee ballots, and the Open Meeting Act. (Figure 20 summarizes these proposals and indicates the section of the *Analysis* where they are discussed.) Despite the sensitivity of these proposals, the administration has provided no information regarding its intent or expected outcomes from these changes. The administration's failure to provide information regarding its proposals makes legislative oversight difficult. It also stands in sharp contrast to the administration's usual practice of providing the Legislature written budget change proposals for policy changes. We note, by way of contrast, that the administration provided a 38-page explanation of its proposal to add four people to the Commission on State Mandates' staff.

Apparent Inconsistency With Proposition 1A

Proposition 1A authorizes the state to pay local agency mandate liabilities incurred before 2004-05 over a period of years. Proposition 1A does not specifically mention mandate liabilities incurred *during* 2004-05, but it appears to require the Legislature to fund these costs in the 2005-06 budget unless (1) the Legislature suspends the mandate in 2005-06 or (2) the mandate pertains to employee rights.

Figure 20

Major Mandate Budget Proposals

	Reviewed in the *Analysis* Under:	
Proposal	**Item**	**Department**
Suspend all mandates relating to absentee ballots	0890	Secretary of State
Defer about $30 million for POBOR mandate	1880	State Personnel Board
Defer all reimbursements for education mandates	6160	Department of Education, Proposition 98 Priorities
Suspend the "AB 3632" mandate	6160	Department of Education, Special Education
Provide $14 million for animal adoption mandate	8570	Department of Food and Agriculture
Restructure open meetings act mandate	9210	Local Government Financing
Suspend the mandate reimbursement mandate	9210	Local Government Financing

Other than one Department of Motor Vehicles mandate, the administration does not include funding for 2004-05 mandate liabilities in its 2005-06 budget. Rather, the administration indicates that its proposed $44 million is for budget-year mandate liabilities only. The administration indicates it will pay the 2004-05 mandate claims over time, along with the rest of the mandate backlog.

While it may be reasonable from a policy standpoint to pay the state's 2004-05 costs over time, this proposal does not appear consistent with the requirements of Proposition 1A. We estimate that it would require an additional $62 million to pay the 2004-05 liabilities for those mandates that (1) the administration proposes to fund in the 2005-06 budget and (2) do not pertain to employee rights. In summary, to fully fund the administration's mandate proposal and comply with the provisions of Proposition 1A, we estimate that, in addition to the $44 million proposed in the budget:

- $67 million is needed to fully fund the mandates' 2005-06 costs.
- $62 million is needed to reimburse local agencies for their 2004-05 costs.

V

Major Issues Facing the Legislature

Governor's Budget-Related Reforms

What Is the Rationale Behind the Governor's Budget Reforms? Will the Proposals Accomplish the Administration's Stated Objectives? What Other Options Should the Legislature Consider?

Summary

The Governor has proposed constitutional reforms involving several areas of the budget—including Proposition 98 K-14 education funding, the budget process, and transportation. The Governor has indicated that the main purpose of the reforms is to deal with "autopilot spending" and instill discipline in future budgets.

We believe, however, that the administration's specific proposals work in exactly the opposite direction. That is, they would put more spending on autopilot and make it more difficult to balance future budgets in a rational way. The changes would also result in a diminution of legislative authority. To the extent that the Legislature considers reforms, it should focus on those which: (1) build on existing provisions in law related to balanced budgets, restrictions on borrowing, and building large budgetary reserves; and (2) modify existing provisions of law that allocate General Fund dollars on a formula-driven basis.

Along with the release of the 2005-06 budget proposal, the Governor proposed several budget reforms that involve changes to Proposition 98, the budget process, transportation funding, and employee pensions. The administration asserts that the budget reforms are necessary to contain future spending growth and prevent future deficits. In this piece, we describe the Governor's budget-related reforms and then discuss several key issues that the Legislature should consider when evaluating them. The Governor's pension reform proposal is discussed in the following write-up in this part.

DESCRIPTION OF PROVISIONS

At present, the main vehicle for the budget-related provisions is ACA 4x (Keene). Our description of the proposals generally relies on the language in this measure as introduced. We note, however, that the measure differs in key respects from the descriptions of the proposals contained in the Governor's budget summary. We highlight the differences in our descriptions of the specific provisions below.

The Governor's major budget-related proposals are highlighted in Figure 1 and discussed in more detail below.

Proposition 98

Proposition 98 establishes in the State Constitution an annual funding mechanism for K-14 education, where school spending is based on the interaction of three different "tests." Under the test that is normally operative, total spending for K-14 education is based on the actual amount of Proposition 98 spending in the prior year as adjusted for changes in average daily attendance and per capita personal income. This adjustment is often referred to as the "Test 2" growth factor.

Suspension, Test 3, and Maintenance Factor

Current Law. K-14 school funding can be reduced below the level required by Test 2 when either (1) the guarantee is suspended through a two-thirds vote of the Legislature or (2) an alternative funding formula becomes operative during low-revenue years ("Test 3"). When reductions from the Test 2 funding level occur, a "maintenance factor" is created, which is equal to the difference between actual appropriations and the higher level required by Test 2. In subsequent years, the maintenance factor is restored (thereby causing spending to rise up toward the Test 2 level) through a formula that allocates extra funding to education in above-average revenue growth years. The maintenance factor can also be eliminated through

Figure 1

Main Budget Reform Proposals

Proposition 98
• Eliminates ability to suspend minimum guarantee. • Eliminates "Test 3" and maintenance factor. • Overappropriations not counted in Proposition 98 base.
Budget Process
• Late budget. — Prior year's appropriations continued. • Across-the-board cuts following Governor's proclamation of shortfall. — Late budget—if no legislative solution within 30 days. — Midyear—if no legislative solution within 45 days.
Proposition 42 Transportation Funding
• Eliminates ability to suspend transfer after 2006-07.
Special Funds
• No borrowing from special funds after 2006-07.
Consolidation and Repayment of Obligations Within 15 Years
• Existing Proposition 98 settle up and maintenance factor. • Proposition 42 suspended amounts (no less than one-fifteenth per year). • Mandate claim balances. • Loan balances from special funds.

additional appropriations by the Legislature. The operation of Test 3 and maintenance factor allows K-14 education funding to automatically slow down during "bad times" and rise again during "good times."

Proposal. The Governor's proposal would eliminate the ability of the state to suspend Proposition 98. The proposal would also eliminate operation of Test 3 and maintenance factor. Thus, spending could not be reduced below the Test 2 level, regardless of the budgetary circumstances. The maintenance factor outstanding as of June 30, 2006 (along with other items discussed below) would be paid within 15 years. However, in contrast to existing law, the maintenance factor payments (currently estimated to total $3.9 billion at the end of 2005-06) would not raise future Proposition 98 minimum guarantees.

Impact on K-14 School Funding. The net impact of the proposal on K-14 schools would depend on a variety of circumstances. For example:

- If the state experiences above-average revenue growth over the next several years, the changes in the treatment of the existing maintenance factor would result in smaller increases in the minimum funding guarantee than would be the case under current law.
- If the state experiences below-average revenue growth, however, the Proposition 98 minimum guarantee would be higher than under current law, since the measure eliminates both suspension and Test 3.

Treatment of Overappropriations

Current Law. If the Governor and Legislature fund Proposition 98 above the minimum guarantee in a given year, the higher spending level becomes the "base" from which future minimum guarantee calculations are made. In this regard, an overappropriation in one year raises minimum requirements in subsequent years.

Proposal. Under this proposal, overappropriations would be considered "one-time" payments to K-14 schools. They would not raise future minimum guarantees.

Late Budgets and Midyear Adjustments

Current Law

Legislative and Executive Powers. The Constitution vests the power to appropriate funds with the Legislature. The annual state budget is the Legislature's primary method of authorizing expenses for a particular year. The Constitution requires that the Legislature pass a budget by June 15 with a two-thirds vote of both houses. When the Governor receives a budget bill, he or she may either sign or veto it. The Governor may also reduce certain individual appropriations in the budget before signing the measure. However, this line-item veto authority cannot be applied to some programs where expenditures are governed by separate laws. Also, once the budget is signed, the Governor may not unilaterally reduce any appropriations.

Balanced Budget Requirements. As amended by Proposition 58 (approved by the voters in March 2004), the budgets passed by the Legislature and ultimately signed into law must be balanced, meaning that expenditures cannot exceed revenues.

Late Budgets. When a fiscal year begins without a state budget, most state programs do not have authorization to make payments. Over time, however, a number of court decisions and legal interpretations of the Constitution have expanded the types of payments that may continue to be made when a state budget has not been enacted. Consequently, when there is not a state budget, payments now continue for some portion of state employees' pay, debt service, and various programs authorized in statute or by federal law.

Midyear Adjustments. Under the terms of Proposition 58, if an enacted budget falls out of balance, the Governor may declare a fiscal emergency and call the Legislature into special session to consider proposals to deal with the fiscal imbalance. If the Legislature fails to pass and send to the Governor legislation to address the budget problem within 45 days after being called into special session, it is prohibited from acting on other bills or adjourning in joint recess.

Proposal

The Governor's proposal makes changes relating to late budgets and midyear adjustments.

Late Budgets. If a budget is not enacted prior to the beginning of a new fiscal year, the appropriation levels in the prior year's budget would remain in effect until a new budget is enacted. If the Department of Finance finds that the continuing budget is out of balance by more than $250 million, then the Legislature would be required to send legislation to the Governor within 30 days that addresses the shortfall. After the 30-day period, the administration would be required to calculate a percentage reduction in General Fund spending that would be necessary to eliminate the projected shortfall. The State Controller would then be required to reduce each payment by that percentage until a budget is enacted.

Midyear Adjustments. Following the enactment of a budget, if the Governor finds that the budget is falling out of balance by more than $250 million, he or she is required to issue a proclamation of fiscal emergency and call the Legislature into special session to deal with the emergency. If legislation that eliminates the shortfall is not passed within 45 days, all General Fund appropriations would be reduced proportionally by an amount sufficient to eliminate the shortfall, in the same manner as described above

Application of Proportional Reductions. The proportional reductions would apply to *all* General Fund spending except for (1) amounts required by federal law and (2) state bonded indebtedness. These reductions would pertain to all contracts, collective bargaining agreements, or laws signed *after* the effective date of ACA 4x.

Different Versions of Budget Provisions. As described above, ACA 4x exempts payments required by federal law from across-the-board cuts. However, as described in the *Governor's Budget Summary*, exemptions would only be allowed for payments required by federal *constitutional* law. Also, under ACA 4x, the across-the-board reductions would be initiated only if the Legislature failed to *pass* a budget or bill addressing a midyear shortfall. The proposal does not require that these legislative measures be enacted into law. *The Governor's Budget Summary*, however, suggests that the across-the-board reductions would go into effect if the Governor and Legislature *failed to agree* on a plan to address the budget imbalance—presumably meaning that such a plan would need to be passed by the Legislature *and* signed into law by the Governor.

Proposition 42 Transfers

Current Law. Under Proposition 42 (approved by the voters in November 2002), sales taxes on motor vehicle fuel are transferred to the Transportation Investment Fund (TIF) for public transit, capital improvement, and maintenance projects. Proposition 42 included a provision allowing for its suspension when the Governor finds (and the Legislature concurs) that the transfer will have a significant negative effect on General Fund programs. To help address the state's major budget shortfalls, the Governor and Legislature fully or partially suspended Proposition 42 transfers in 2003-04 and 2004-05. Legislation passed with the 2003-04 and 2004-05 budgets designated the suspensions as "loans" from the TIF, which will be repaid in 2007-08 and 2008-09.

Proposal. The state would be prohibited from suspending annual Proposition 42 transfers after 2006-07. The total amount of transfers that were suspended in 2003-04 ($856 million) and 2004-05 ($1.1 billion), as well as any additional amounts suspended through June 30, 2007, would be paid within 15 years, at an annual rate of no less than one-fifteenth of the cumulative amount owed.

Loans From Special Funds

In 2004-05 and prior years, the Governor and Legislature have borrowed balances in special funds to cover General Fund shortfalls. The state currently owes $2.4 billion to these special funds. Under this measure, such loans would be prohibited beginning in 2006-07 (except for short-term cash-flow borrowing purposes). Outstanding loans from special funds as of July 1, 2006 would be repaid within 15 years.

Payment of Obligations Within 15 Years

The measure requires that several items be paid within 15 years. As noted previously, these include suspended Proposition 42 payments, K-14 education maintenance factor payments, and outstanding special fund loan balances. The proposal also requires the following other items to be paid off within 15 years:

- Noneducation local mandates. (We estimate that these claims would total $1.5 billion at the end of 2005-06. Current law requires payment over five years.)
- Education mandates. (We estimate this obligation will total $1.8 billion at the end of 2005-06, payable from within Proposition 98.)
- Proposition 98 "settle up" obligations. (These obligations are estimated to total approximately $1.3 billion.)

KEY ISSUES RELATING TO GOVERNOR'S PROPOSALS

Before undertaking major constitutional reforms, we believe that it is important for the Legislature to consider three major issues related to these proposals.

- First, what problems do the proposals address and what criteria should be used for evaluating the proposals?
- Second, how do the proposals stack up and what are the key issues and concerns that they raise?
- Third, are there alternative changes which would more directly address the perceived deficiencies in the current process?

What Problems Do the Proposals Address?

The administration has offered several reasons for its individual proposals. These include the need to (1) eliminate chronically late budgets (2) strengthen the midyear budget-adjustment provisions in Proposition 58, (3) create a more certain funding stream for transportation, and (4) pay off certain obligations.

Administration's Main Concern—Autopilot Spending

The main reason for the constitutional budget reform offered by the administration, however, is the need to control spending. For example, in his budget transmittal letter to the Legislature, the Governor asserts that the problem facing California is "laws that have put much of our spending on automatic pilot," and that "we have a budget system that forces us to spend more than we take in."

What Is Autopilot Spending? There are many factors that affect General Fund spending. These include caseloads and utilization of entitlement programs, federal or state laws, and court decisions. For purposes of this discussion, however, we define autopilot spending as expenditures which arise from predetermined commitments made through state and federal statutes, voter-approved initiatives, collective bargaining agreements, or administration compacts. Some specific examples are shown in Figure 2.

Figure 2

Examples of Formula-Driven Spending

- ✓ Statutory cost-of-living adjustments
  - Trial court funding.
  - CalWORKs and SSI/SSP.
  - K-12 revenue limits.
- ✓ Voter approved propositions
  - Proposition 98 (K-14 school funding).
  - Proposition 49 (after school funding).
  - Proposition 42 (transportation funding).
- ✓ Multiyear collective bargaining agreements
- ✓ Higher education compacts

Policy Choices—Not Autopilot Spending—Drive Shortfalls. While the various provisions shown in Figure 2 can create budgeting challenges, we do not believe that they have been the principal factor behind the state's fiscal problems. For example, the large increases in spending that occurred in the late 1990s were largely related to policy decisions to expand funding above the levels required by then-existing formulas. During this period, the state expanded programs in a variety of health and social services areas, and overappropriated the Proposition 98 minimum funding guarantee five years in a row. It also raised state spending for tax relief (mainly in the form of increased funding to local governments to replace—or "backfill"—reductions in the vehicle license fee). The effect of these policy changes was to increase ongoing spending commitments to a level that ultimately became unsustainable when revenues fell in 2001-02.

Why Do We Continue to Face Fiscal Problems? The budget shortfalls have persisted since revenues plummeted in 2001-02 because the Governor and Legislature have not been able to agree on a sufficient amount of *ongoing* solutions—involving either revenues or expenditures—to bring revenues and expenditures back into line. Much of the annual shortfalls have been covered with borrowing, deferrals, and other one-time factors. Because the state has not sufficiently changed underlying spending commitments or revenue generation, renewed shortfalls occur both as the one-time savings in annual budgets expire and as repayments of past borrowing come due. For example, about $4 billion in projected annual expenditures during the 2006-07 through 2008-09 period is related to repayments of past budgetary borrowing.

Out-Year Prospects. The administration suggests that major reforms are needed because future spending will grow faster than revenues. However, we disagree with that assessment. As noted above, the state faces a structural budget shortfall because policymakers have not been able to agree on sufficient ongoing solutions to cover the gap between revenues and ongoing expenditures. However, once the state resolves its structural imbalance, we project that growth rates in revenues can cover growth in current-law expenditures over the forecast period.

What Are the Main Budgetary Challenges? We believe the main challenges confronting policymakers are related to managing budgets through times of volatile revenues and rapidly changing fiscal circumstances. (We discuss the volatility of the state's revenue structure in a January 2005 report entitled *Revenue Volatility in California*.) In this regard, provisions in law that direct funding to specific purposes can complicate budgeting. Although most of the provisions can be suspended or modified, these requirements can create a sense of entitlement for certain programs at the expense of others, and can shift the focus toward formulas and away from debates about programs' effectiveness, needs, and relative merits.

What Does This Imply for Reform Proposals? Given the causes of our current structural shortfall and the challenges that lawmakers will continue to face related to volatile revenues, we believe that any reforms should enhance—rather than limit—the amount of flexibility and tools that lawmakers have to manage future budgets.

How Do the Governor's Proposals Stack Up?

We believe that the Governor's specific proposals would not reduce autopilot spending. Rather, they would *increase* autopilot spending and reduce the flexibility that policymakers need to balance budgets in a rational way. Figure 3 highlights some of the key concerns raised by the proposals.

Figure 3

Major Concerns Raised by Governor's Proposal

✓ **Proposition 98 Changes Would Seriously Limit Legislative Flexibility**

- Suspension and Test 3 have been effective tools.
- Their elimination would leave 45 percent of the budget off limits.
- The limited flexibility could drive the state to across-the-board reductions.

✓ **Across-the-Board Reductions—A Blunt Tool**

- Result in unpredictable and uneven impacts on programs.
- Represent major delegation of legislative powers.
- Fail to distinguish between high- and low-priority programs.

Proposition 98 Proposal Seriously Constrains Legislative Flexibility

Our main concern with the Proposition 98 proposals is that they would undo the very provisions that voters put in place 15 years ago to deal with the flaws that were perceived to exist with the original versions of the measure. Proposition 111 added Test 3 and maintenance factor to Proposition 98 to allow for slower growth in the guarantee in low revenue years. (A detailed description of how the various provisions of Proposition 98 have worked over time is contained in a report released by our office in February 2005 entitled *Proposition 98 Primer*.) Since that time, Test 3 has been operative four times. Also, the suspension provision in Proposition 98 (which has been in law since the measure was first enacted in 1988) was used in 2004-05 to help deal with a major shortfall in that budget. Without the maintenance factor and suspension provisions, the state would have needed to find even more major reductions in non-Proposition 98 programs—or more revenues—to balance its budgets in the early 1990s and in recent years. For example, if the state had not been able to suspend the minimum guarantee when the budget was enacted for 2004-05, Proposition 98 would have required the state to provide $3.1 billion more than was actually budgeted—an amount which already funded growth and cost-of-living adjustments and provided limited program expansion. The added funding for K-14 would have necessitated a correspondingly greater amount of solutions from either other program reductions, more borrowing, or more taxes.

The elimination of Test 3, maintenance factor, and the ability to suspend would place the roughly 45 percent of the budget devoted to K-14 education "off limits" for purposes of eliminating fiscal shortfalls. The provisions eliminating future suspension and operation of Test 3 would appear at first blush to be advantageous to schools. However, the much greater amount of solutions that would be required from other budget areas or taxpayers could push the state toward the default of across-the-board reductions (which *would* apply to Proposition 98 spending), as discussed in more detail below.

Across-the-Board Reductions—A Blunt Tool

The provisions requiring across-the- board reductions to state programs under certain circumstances raise a myriad of serious policy and technical concerns. For example:

- ***Scope of Federal Law Exclusions Uncertain.*** It is not clear how broadly or narrowly the courts would interpret the federal law provisions involving benefit entitlements, maintenance of effort requirements, provider rates, and other factors. If a significant amount of spending for health, social services, and criminal justice programs were exempted because of federal law requirements, the impact on remaining spending in education, transportation, and other programs would be relatively greater.
- ***No Distinction Between High- and Low-Priority Programs.*** After the federal-law exclusions were made, spending in remaining areas—ranging from the state's highest priorities down to its lowest priorities—would be treated exactly the same.
- ***Starting Point for Reductions Could Create Inequities.*** Since the across-the-board reductions arising from a late-budget scenario would be based on prior-year appropriations levels, programs that had taken major one-time reductions in the prior year could be disadvantaged, while programs that received one-time augmentations would be advantaged under the mechanism. Similarly, programs with increasing caseloads could be affected more severely than programs with flat or declining caseloads.

- ***Late-Year Proclamations Could Require Dramatic Cuts.*** For example, if the across-the-board reductions were not implemented until May, all of the burden of covering the shortfall would fall on payments made in the final two months of the fiscal year.
- ***Contracting Could Be More Cumbersome and Expensive.*** The uncertainties created by the proportional reductions could affect the terms of future contracts entered into with service providers.

Diminution of Legislative Authority. Finally, the across-the-board reductions that would go into effect when the Legislature could not agree on how to cover a budget shortfall would represent a major shift of authority from the legislative branch to the executive branch of government. The administration's revenue and expenditure estimates would serve as the sole basis for the determination of the existence and size of budget shortfalls. Thus, the administration would have full control regarding the timing and magnitude of emergency proclamations. More fundamentally, the default to across-the-board reductions in the event that the Governor and Legislature could not agree on budget solutions represents a diminution of the Legislature's constitutionally vested power to determine appropriations and make reductions in them.

Issues Raised by Other Provisions

While not of the same magnitude as the Proposition 98 and budget process proposals, the Governor's other proposals raise significant policy issues. For example, the Governor's proposal to pay off existing loans over 15 years would mean less money for transportation programs that, under current law, are scheduled to receive loan repayments in 2007-08 and 2008-09. The Governor's proposal to eliminate the ability to suspend Proposition 42 transfers after 2006-07 means that transportation programs would have somewhat more stable revenue sources in the future. We note, however, that the Proposition 42 transfer would be subject to the across-the-board reductions discussed earlier, causing continued funding uncertainty for transportation programs. The state budget tradeoff is that the proposal to eliminate the suspension would leave the General Fund with still less flexibility to deal with budgetary shortfalls.

Regarding restrictions on future borrowing from special funds, such restrictions would take away another budget balancing tool used by this and previous administrations.

Finally, the inclusion of noneducation local mandates among the items that must be repaid within 15 years would override a commitment made to local agencies last year that would require that these mandates be repaid within five years.

What Alternatives Could the Legislature Consider?

As noted above, we believe that the main longer-term challenge for the Legislature and Governor will be managing budgets in the face of revenue fluctuations and rapidly changing fiscal circumstances. The state has already adopted provisions in Proposition 58—some of which have not yet taken effect—that should help protect the state against revenue fluctuations and instill more discipline in the budget process. These include an enhanced reserve requirement, a balanced budget requirement, a midyear adjustment process, and restrictions on future borrowing.

To this end, we believe that new reforms considered by the Legislature should (1) build on the reforms that have already been enacted by voters in Proposition 58 and (2) provide lawmakers with more flexibility to deal with changing budgetary circumstances. Specifically, the Legislature may wish to consider options that:

- ***Strengthen Reserve Provisions of Proposition 58.*** A large budget reserve is potentially a powerful tool for dealing with budget fluctuations. Proposition 58 has a mechanism that would build up substantial reserves to cushion the state against budget shortfalls. If the provisions of Proposition 58 are not considered adequate to ensure a large reserve, the Legislature may consider strengthening the provisions by, for example, making the annual transfers to the reserve more difficult to suspend and payments out of the reserve more difficult to make.
- ***Unlock Budget.*** If the goal is to maximize budgeting flexibility, then the solution would be to modify or eliminate the existing provisions in law that earmark General Fund dollars for specific purposes.

Finally, we would generally argue against any delegation of legislative authority to determine appropriations, especially with respect to the enactment of a budget. However, if the Legislature wished to grant *limited* authority to the administration to deal with, for example, budget shortfalls that emerged when the Legislature was out of session, it could do so by modifying existing provisions of Proposition 58 to include provisions for such a delegation. It would be important, however, that the administration's authority (1) only apply when the state was headed toward a *significant* shortfall, (2) be limited to once per year (in November or December), (3) apply only to areas of the budget previously specified by the Legislature, and (4) be subject to a predetermined cap.

In summary, we share the administration's basic goals of regaining fiscal stability in California. However, we believe that the specific proposals work in the opposite direction. They would leave the state with more autopilot spending and fewer options to deal with budget challenges that will continue to occur in the future. To the extent that the Legislature wishes to consider budgetary reforms, we believe the emphasis should be on increasing budgeting flexibility and building on existing provisions in the Constitution relating to balanced budgets, midyear reductions, and budgetary reserves.

Addressing Public Pension Benefits and Cost Concerns

What Are the Issues Regarding "Defined Benefit" Retirement Plans? How Does the Governor's "Defined Contribution" Proposal Address These Issues? What Other Alternatives Are Available?

Summary

California "defined benefit" pensions in the public sector raise certain benefits and cost issues. The Governor proposes shifting all new public sector employees to "defined contribution" plans to address the high cost of the current system. Defined contribution plans address concerns with defined benefit pensions, but also introduce issues of their own.

The Legislature could also address the benefits and cost concerns of current retirement plans within the existing defined benefit structure or with other pension plan alternatives.

INTRODUCTION

Over the last decade, state and local retirement systems have experienced dramatic changes:

- A booming stock market in the late 1990s resulted in well-funded systems, which in turn led to low employer contribution rates and significant benefit increases.
- The subsequent market collapse resulted in system funding problems and skyrocketing employer rates.

In response to these dramatic cost changes, the Governor has proposed a constitutional amendment to switch new public sector employees from defined benefit pensions to defined contribution plans.

In this piece, we:

- Describe how defined benefit programs currently operate.
- Identify key issues with this type of pension plan.
- Describe the Governor's proposal regarding defined contribution plans.
- Assess alternative ways for the Legislature to address concerns with public sector retirement plans.

BACKGROUND

Defined Benefit Plans Are Core of Public Retirement

In public sector employment, defined benefit plans are the norm. Below, we outline the features of this type of retirement plan.

Benefit Formula Guaranteed. Under a defined benefit program, an employee receives a set pension amount based on a formula that includes age and salary at retirement and the number of years of service. These benefits are guaranteed lifetime annuities in that the retiree receives benefits until death.

Public Safety Employees Get Higher Benefits. Public safety employees—primarily police and firefighters—have richer defined benefit formulas than nonsafety employees. That is, they generally receive a higher percent of salary for each year of service, and they can retire at a younger age with similar benefits. This reflects an expectation that public safety employees have shorter careers due to the hazards of the job. In addition, public safety employees do not participate in the federal Social Security program, unlike most nonsafety employees. Thus, public pensions have been structured to provide more income in retirement for safety than nonsafety employees.

Public Sector Retirement Benefits Considered an Unbreakable Contract. Court decisions have prohibited reducing retirement benefits for current employees without an offsetting benefit. Courts have considered pension benefits to be part of the employment contract, and the State Constitution prevents the government from unilaterally breaking contracts.

The expected employment contract is determined by the benefits in place when one begins work. Public agencies, therefore, can adopt different retirement benefits prospectively for *new* employees. Such changes would not violate the court decisions noted above regarding employment changes for *existing* employees.

How Are Defined Benefit Plans Funded?

Defined Benefit Plans Have Three Sources of Funding. Defined benefit plans have three sources of funding—employee contributions, employer contributions, and returns on invested assets. (Investment returns, in fact, are the biggest component of defined benefit funding.) These contributions—and the earnings on them—are intended to pay for future retirement benefits as they are earned.

Employee contributions are usually fixed, while employer contributions vary from one year to the next. Investment returns depend heavily on the financial markets. When returns are greater than expected, fewer contributions are needed. When investment returns are less than assumed, larger contributions are needed. With a fixed employee contribution, employers tend to reap any benefit of extra investment income through lower contributions. Conversely, employers pay for lagging investment income through higher contributions.

Employer Contribution Consists of Two Parts. The annual employer contribution for retirement is comprised of two parts—the “normal cost” and the “unfunded liability”/”actuarial surplus.”

The normal cost is the average annual cost of the retirement benefits earned by the employee in a given year of service. In other words, it is the amount (usually expressed as a percentage of salary) the plan needs to invest, earning the assumed returns over time, to accumulate enough assets to pay the retirement benefits for that year of work when the employee retires. (The normal cost is often expressed for the employer contribution only. The employee contribution, however, can be considered to pay for a portion of the annual cost of service as well.)

For several reasons, the normal cost collected over time and invested can be insufficient to pay future retirement benefits. This shortfall is known as an unfunded liability. Unfunded liabilities can arise when:

- Investment returns fall short of expectations.
- Benefit enhancements are implemented retroactively to apply to past, as well as current, service time. (For the years of past service covered by the enhancement, no one contributed payments to cover the costs.)
- Demographic changes do not conform to assumptions. For example, earlier-than-expected retirements reduce the assumed amount of time the plan has to collect contributions and generate sufficient assets to pay for these retirement benefits.

These liabilities are paid off by increasing employer contributions.

By contrast, in some cases, greater-than-assumed investment returns generate more assets than needed to pay future benefits. In this instance, this actuarial surplus offsets annual normal cost contributions, thereby reducing total employer contributions. In fact, it is possible for contributions to be reduced to zero.

"Smoothing" Spreads Out Investment Returns, Liabilities. To keep plan funding on track to acquire sufficient assets to pay future retirement benefits, any unfunded liability must be reflected in contributions. If these shortfalls were paid off or credited in full each year, employer contribution rates would swing dramatically and could easily be a very large percentage of payroll. To limit such a yo-yo effect of wildly varying contribution rates from one year to another, retirement systems spread out—or smooth—the recognition of investment gains and losses over multiple years. Similarly, retirement systems credit contributions for actuarial surpluses over time to limit rate fluctuations.

Four Sets of Laws Govern State and Local Government Retirement Plans

Public Employees' Retirement System. The Public Employees' Retirement System (PERS) administers the defined benefit plans for state employees. In addition, many local government entities contract with PERS to administer their retirement plans. This includes almost all cities and a majority of counties. Current law specifies the benefit formulas for state retirement plans. Local agencies that contract with PERS can select from a variety of benefit formulas enumerated in state law.

State Teachers' Retirement System. The state prescribes in statute a standard retirement plan for all K-14 public school teachers. This plan is administered by the State Teachers' Retirement System (STRS). Teacher and school district contributions are set in statute, and the state annually contributes an additional amount of General Fund resources. (Please see page F-67 of our *2005-06 Analysis* for a discussion of the STRS retirement program.)

1937 Act Counties. Twenty counties have chosen to establish their own retirement systems under a separate body of law. These public agencies are known as "'37 Act counties" (named for the 1937 legislation that created these statutes). As with PERS contracting agencies, state law specifies the benefit formulas from which these counties can select for their employees. In some cases, these counties also offer their plans and services to cities and special districts within their boundaries.

General Pension Law. A fourth category of law authorizes local governments to establish their own retirement systems as pension trusts. These statutes are much more limited than PERS or '37 Act county law and do not specify what level of retirement benefits these entities can offer. Pension trusts have been established by large cities such as Fresno, Los Angeles, San Diego, and San Francisco, as well as San Luis Obispo County.

State Law Ultimately Sets Parameters for All. Proposition 162 (approved by voters in November 1992) gives authority for administering and determining actuarial funding requirements for retirement plans to the governing retirement boards. This limits state and local government control of funding and oversight of retirement plans. Regardless of the type of plan established under different statutes, however, the Legislature has the authority to establish provisions of law governing retirement benefit programs.

KEY ISSUES WITH CURRENT DEFINED BENEFIT PLANS

In our research and discussions with state, county, and city representatives, a number of issues came up regarding the current retirement programs offered to state and local employees. These concerns fall into two broad categories—benefits and funding. (Ultimately, these categories overlap to some degree since benefits affect costs.)

Concerns Regarding Benefits

Below, we discuss several issues with particular aspects of benefit formulas.

Benefits Are "Locked In"

As noted previously, employers cannot readily change retirement benefits for current employees without an offsetting benefit. In other words, public agencies face a lot of inflexibility under a defined benefit structure to "undo" past decisions. Consequently, in cases where the cost of a benefit enhancement was underestimated, a market downturn increases contribution rates far above what was expected, or a future governing body wants to change a retirement decision of a past body, very little can be done affecting existing employees. Benefit formulas and employee contributions tend to be locked in place.

Some Benefit Formulas Are Overly Generous For Maintaining Living Standard

Income Needs Are Usually Less in Retirement. Retirement income generally comes from three sources—Social Security, employer-based pensions, and private savings. A person's income needs are generally less in retirement than when working. This is because clothing and daily travel expenses decline, home mortgages are often paid off at this point in life, and retirees may be in a lower tax bracket than when working. As a result, retirees typically need less income to maintain the same standard of living as when they worked.

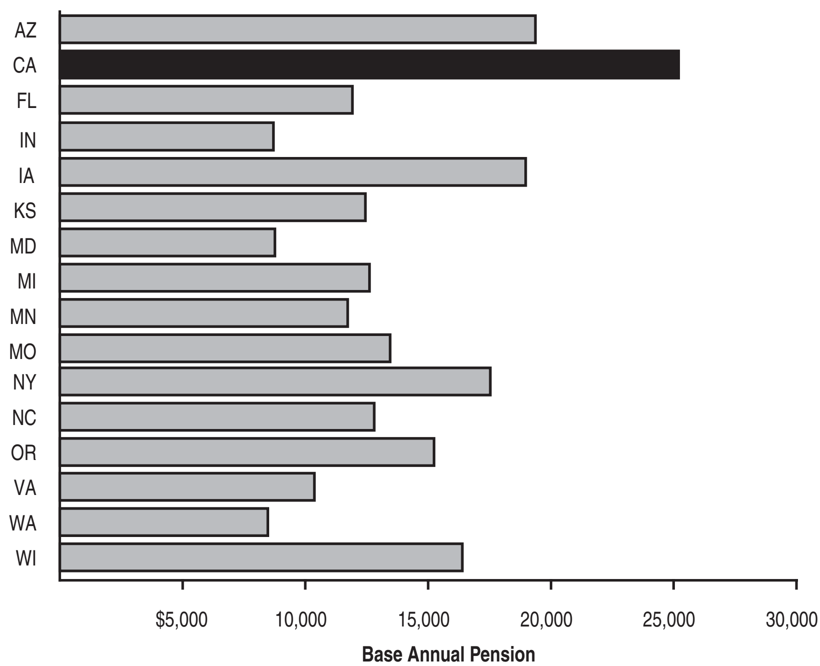
California Comparatively Generous in State Benefits. In our *2004-05 Analysis* (please see page F-19), we compared state retirement benefits for a typical California employee with a few other states. California pensions surpassed the other states—often significantly—at all retirement ages. Figure 1 shows that this comparison holds for an expanded number of states for an average employee retiring at age 55. (We have included larger states—that also participate in Social Security—from each region of the U.S. In many states, employees are not even eligible to retire at this early age with the given years of service.) Of the 16 states shown, California offers the highest retirement benefits.

Formulas Can Be Particularly Generous. For longer-term employees or those covered by particularly generous formulas at the local level, some can receive more annual income in retirement than when they worked.

Miscellaneous. In 2001, the state approved two Miscellaneous retirement formula options for local governments—2.7 percent at 55 and 3 percent at 60. Since that time, more than 50 local governments contracting with PERS have elected to provide the 2.7 percent at 55 benefit, and more than 20 have elected to provide 3 percent at 60. (This amounts to 15 percent to 20 percent of PERS contracting entities.) Most of these agencies also have at least some of these employees in Social Security. As noted above, the typical employee needs significantly less income in retirement to maintain the same standard of living. With these benefit formulas, it takes just 20 to 30 years of work (that is, less than a full career) to have retirement income (adding in Social Security and/or private savings) equal to working pay. Even for Miscellaneous employees not in Social Security, these formulas provide a large amount of retirement income.

Figure 1

State Employee Retiring in 2004 at Age 55[a]



[a] Assumes Miscellaneous employee started working for the state at age 34 and has earned $60,000 in salary in the last year before retirement.

Public Safety. Similarly, in 1999, the Legislature approved 3 percent at 50 formulas for California Highway Patrol and local public safety officers (effective beginning in 2000). Pursuant to their current collective bargaining agreements, state firefighters and correctional officers also will be eligible for 3 percent at 50 formulas beginning January 1, 2006. For 25 years of service, this benefit provides three-quarters of income in retirement. As noted previously, public safety officers in California do not participate in Social Security. Private savings, however, and the likelihood of post-retirement employment (given the age at retirement), would significantly add to the guaranteed public pension.

Final Salary Used to Calculate Retirement Benefit

Salary Period Used to Calculate Pension Affects Benefits. One of the key components of a defined benefit pension is the salary used to calculate the benefit. Almost all states use the average of the three- or five-year period of highest salary (typically the final years an employee works). This averages the impact of any pay raises or promotions during the designated period.

California, on the other hand, uses the highest one-year salary. Using a single year increases retirement payments for most employees by fully capturing their highest level of pay. Local agencies that contract with PERS and '37 Act counties use three years, unless they specifically elect to use a one-year period. Most PERS entities have switched to the one-year calculation. In our review of other retirement systems, we did not find any other state that uses one year.

One-Year Salary Calculation Encourages "Salary Spiking." The one-year period can encourage salary spiking, in which an individual gets a sharp increase in compensation during the last year of work to deliberately "bump up" their retirement benefits. This can occur, for example, when a housing or car allowance (which is not compensable for retirement purposes) is eliminated in favor of a corresponding pay raise. Based on our discussions with state and local agencies, it is not clear whether this is a frequent practice. Basing pensions on the highest single year of salary, however, certainly provides a fiscal incentive for such spiking.

Retroactive Benefit Enhancements

Typically, when public agencies increase retirement benefits, the enhancements apply not just for service following the changes, but to all years of service previously rendered by current employees. For instance, state employees who retired in 2000 and thereafter have received enhanced benefits for their entire careers even though they had worked most of that career under the expectation of the lower benefits.

Granting benefit increases retroactively has serious consequences for plan funding. Neither employees nor employers were paying the increased normal cost of the higher benefits for the previous years of service. Thus, the cost of this benefit for past service is essentially paid for with plan assets on hand. This immediately creates an unfunded liability or reduces surplus funds (if the plan had sufficient assets). Providing retroactive benefits violates the principle of paying for retirement benefits as they are earned—that is, through annual normal cost payments.

In addition, the inevitable cycles of the stock market can quickly reduce or erase any surplus (or enlarge an existing unfunded liability). If these excess assets are used up or diminished to pay for retroactive benefit increases, then they no longer can serve as a financial cushion to weather an investment downturn. Consequently, we consider retroactive benefit increases to be fiscally unsound.

Concerns Regarding Funding

Concerns regarding the funding of retirement systems often come down to the employing agency being "on the hook" for all rate fluctuations. We describe various aspects of this concept below.

Volatile and Uncertain Contribution Rates

The state and local governments have seen their contributions decline—even to zero or near-zero levels—and then climb significantly again in recent years. This volatility and uncertainty can make overall budgeting difficult, particularly in times of fiscal crisis.

Down, Then Up…When Agency Budgets Could Ill Afford It. After a series of double-digit investment returns in the late 1990s greatly improved plan funding, employer contributions dropped substantially. In addition, the state and local governments increased benefits, which used up surplus assets and increased the annual normal cost. When the stock market declined, plans experienced consecutive years of less-than-expected investment returns. This double whammy—higher benefit costs and major asset losses—led to hefty increases in employer contribution rates. For example, Figure 2 (see next page) shows how state contributions went from almost nothing at the start of the decade to over $2.5 billion just four years later. These cost increases came at a time of operating budget shortfalls for the state and many local jurisdictions—forcing additional programmatic reductions or revenue increases elsewhere in their budgets.

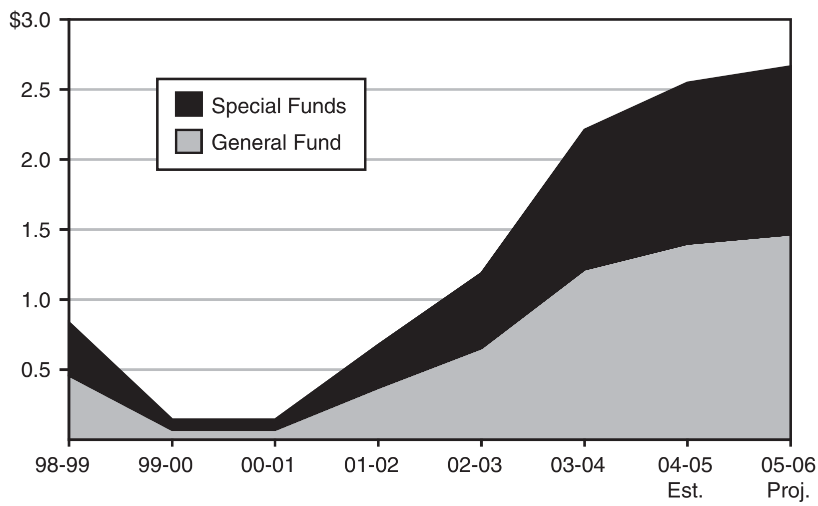
Unknown Annual Costs. The dramatic stock market changes were such that even the moderating effects of the smoothing techniques described earlier could not prevent sizeable changes in contribution rates. Consequently, many governments did not know from one year to the next what annual contributions would be—making budgeting even more difficult.

More Difficult Compensation Decisions. Retirement is one component of a total compensation package for employees. With defined benefit pensions that require contributions that can vary each year (sometimes significantly), it can be difficult for the state and local governments to accurately gauge compensation levels and make total compensation decisions. Retirement compensation is subject to contribution changes that are driven by actuarial calculations—outside of a government's direct control. As a result, compensation choices to enhance pay or retirement benefits based on costs at the time of the decision can turn out much costlier than expected.

Figure 2

State Employer Retirement Contributions to PERS

(In Billions)



Employees Shielded From Costs of Retirement Decisions

Employee Contributions Fixed, If They Pay Them at All. For the state and local governments that contract with PERS, employee retirement contributions are set in statute for each retirement plan. While the Legislature has reserved the right in law to change these employee contribution rates, in practice, the state has included the amount of employee contribution rates in collective bargaining agreements.

For '37 Act counties, employee contributions are set by the county. In many cases, however, these counties have agreed in collective bargaining to pay all or part of the employee retirement contribution, in addition to paying the employer contribution.

Employees Shielded From Cost of Decisions. Because their contributions are fixed or paid by their employing agency, employees are generally shielded from the cost of decisions about benefit enhancements and from investment performance. Consequently, employees do not have an incentive to weigh the costs of enhanced pension plan provisions.

How Can the Legislature Address These Issues?

To address the growing cost of defined benefit pensions, the Governor has proposed defined contribution plans for all new public sector employees. We review this proposal, which is embodied in a proposed ballot initiative, below. The Governor's proposal would address many of the benefit and funding issues highlighted above, but would introduce other concerns as well. In addition, we also discuss ways the Legislature can address the concerns identified above through (1) changes within the current defined benefit structure and (2) other types of retirement plans.

Including Local Governments or Not? We noted above that the state has authority over the structure of local government retirement plans. To the extent the state adopts changes for its own employees, the Legislature could give local governments the option to make similar changes. This would allow local governments to retain the retirement programs they have, at their discretion and responsibility, instead of being required to implement changes. In some cases, however, the Legislature may wish to apply certain changes to local governments as well as the state.

Governor's Defined Contribution Plan

Under the Governor's proposal, all new public sector employees—state and local government employees as well as teachers—would be prohibited from enrolling in defined benefit plans after June 30, 2007. Instead, they could enroll in defined contribution retirement plans. While the defined benefit plans guarantee *at career's end* a certain formula-based pension, defined contribution plans guarantee *upfront* a certain employer contribution (as a regular percent of pay) to individual accounts. Employee and employer contributions are invested, and the employee has whatever these assets have generated for retirement income. There is no guaranteed benefit.

Contribution Maximums Specified. As shown in Figure 3 (see next page), employer contributions could be up to 6 percent for nonsafety employees and up to 9 percent for police officers and firefighters (if employees contribute specified matching amounts). For employees not covered by Social Security, employers could contribute an additional 3 percent above these maximums. Local agencies could increase employer contributions with two-thirds approval of voters. The state could amend any part of the established defined contribution plans with three-fourths approval of the Legislature in two consecutive sessions.

Figure 3

Maximum Employer Contribution Rates Under the Governor's Defined Contribution Proposal

	Employer	Employee	Total	Maximum Employer Rate If No Employee Match[a]
In Social Security				
Nonsafety	6.0%	3.0%	9.0%	3.0%
Safety[b]	9.0	4.5	13.5	4.5
Not in Social Security				
Nonsafety	9.0%	4.5%	13.5%	3.0%
Safety	12.0	6.0	18.0	4.5

a For employers to contribute above this level, employees must match at least one-half of the employer's total contribution.

b This category would apply to few employees. Virtually all safety employees are not in Social Security.

Fiscal Impact of the Plan. Whether this plan results in reduced retirement contributions compared to current pension plans for an individual government entity would depend on whether defined benefit contributions are higher or lower than the specified maximums. On a statewide basis, the proposed maximum rates are generally lower than the employer normal cost contributions governments are currently paying for their defined benefit plans. Consequently, the proposal would result in a net reduction statewide in retirement contributions for new employees. The amount of savings would depend on the extent to which public agencies chose employer contributions that are less than the maximums allowed. Once fully phased in for all public sector employees after several decades, these savings in annual retirement costs could potentially be in the hundreds of millions of dollars to over $1 billion annually.

Proposal Would Resolve Identified Issues With Current System

We assess the Governor's plan against the benefit and funding issues described above. Figure 4 summarizes our findings. Based on these criteria, the plan does well in addressing issues with the current system. It resolves the benefit issues discussed above by not guaranteeing a benefit level. As a result, there are no fiscal problems arising with end-of-career benefits that are locked in place. Providing compensation retroactively and based on a final salary are no longer considerations. In addition, the set contribution maximums eliminate the volatility of annual costs and the uncertainty about compensation decisions. The plan also gives employees a stake in retirement decisions by requiring employee contributions to get the maximum rates from employers.

Figure 4

How Does the Governor's Defined Contribution Proposal Address Concerns With the Current System?

Concerns	Does the Plan Address Concerns?
Benefit Issues	
Locked in	Yes—No benefit is guaranteed to tie a government's hands in the future.
Overly generous	To a large extent—Maximum employer contributions are less than typical defined benefit normal cost contributions. Employers periodically can adjust the generosity of their plans by altering the contribution rates.
Final salary used to calculate pension	Yes—No benefit to calculate so the issue is addressed.
Retroactivity	Yes—No guaranteed benefit to enhance so the issue is addressed.
Funding Issues	
Volatile rates	Yes—Eliminated with fixed annual contributions, which makes compensation decisions transparent. Any changes from year to year would be under a government's control.
Employees shielded from costs	Yes—Higher level of employer contributions must be matched by employees.

Other Advantages

Flexibility, Portability. Defined contribution plans are flexible for employees. Those who leave public service can take these funds with them and either keep them for retirement or cash them out to use for other purposes. In other words, defined contribution plan assets are "portable."

Defined benefit assets, however, are not as flexible or portable. Employees who leave service can only take with them the accumulated value of their own contributions plus interest. They lose all employer contributions and excess investment earnings above the interest rate applied to member accounts. Individuals who work in public service for less than five years are not eligible (or "vested") to receive a defined benefit pension upon retirement. For employees who leave public service before five years, the loss of the employer contributions can be significant.

Individual Control Over Assets. With their own retirement accounts, individuals can determine how much risk they are willing to accept in their investments in exchange for potentially higher returns. Those who are risk-averse can choose investment funds with lower and less variable returns. Those who are willing to accept higher levels of risk (such as younger employees who are far from retirement) can choose investment funds with historically higher yields but greater volatility.

But Also New Concerns

No Guaranteed Benefit, Retirement Income Uncertain. As highlighted above, defined contribution plans do not guarantee a certain benefit level for retirees. This means that employees would have significant uncertainty about their expected level of retirement benefits. In addition, defined contribution plans shift investment-related risk from the employer to employees.

Retirement systems, on average, tend to have better returns investing assets for defined benefit plans than individuals in charge of investing their own defined contribution plan assets. This does not necessarily mean that defined contribution accounts will provide inadequate retirement income (especially when combined with additional resources from Social Security benefits and private savings). The risk of inadequate retirement income does exist, however, due to inadequate contributions and/or insufficient investment returns over time. We note that the Governor's proposal does not preclude PERS or other existing systems from offering investment options and managing the accounts for employees. Such an approach would allow employees to avoid many of the risks of individual investment choices.

Investment Fees. Because retirement systems invest plan assets for all members together, their annual administrative and investment consultant costs tend to be small as a portion of assets—a fraction of 1 percent in the case of PERS. Defined contribution plan assets, however, are invested on an individual-account basis, with each employee making individualized investment selections. As a result, the per-account charge as a portion of assets is higher than for retirement systems investing defined benefit plan assets altogether. These annual charges can be 1 percent to 2 percent of assets.

No Specific Provisions for Disability Retirement. Defined benefit plans usually include provisions that pay a modified retirement benefit to individuals who become disabled and cannot work. The cost of these benefits is included in plan funding. Defined contribution plans, however, do not provide for such contingencies. Absent a separate insurance policy or program, a disabled worker would have the balance in the retirement account to draw from as needed. If the disabling injury occurred relatively early in the career, an employee's retirement account assets could be relatively modest. Thus, the account could provide significantly less income than disability retirement under a defined benefit program.

Pressure to Raise Other Forms of Compensation. With a defined contribution plan that has a smaller portion of salary going toward retirement than defined benefit plans, employees face the potential for lower pension benefits in retirement. Since pensions are one piece of overall compensation, switching to defined contribution plans could result in pressure for public agencies to increase other forms of compensation. For example, employee unions could press for (1) additional salary now to make up for potentially reduced compensation in retirement or (2) a separate disability benefit program. Collective bargaining negotiations that add such items to make up for reduced retirement benefits would offset some portion of savings in total compensation from moving to defined contribution plans.

What Have Other Entities Done?

Some States Have Added or Switched to Defined Contributions. Five states have defined contribution plans. Michigan's program is mandatory for its employees. The plan is optional in the other states. Figure 5 shows the provisions of these plans in other states.

Figure 5

Defined Contribution Retirement Plans

State	Effective Date	Optional/ Mandatory	Employer Contribution	Employee Contribution
Florida	2002	Optional	7.4%	5.4%
Michigan	1997	Mandatory	4.0[a]	Voluntary
Montana	2002	Optional	6.9	6.9
Ohio	2002	Optional	13.3	8.5
South Carolina	1987	Optional	7.6	6.0

[a] Plus up to an additional 3 percent if matched by employee.

Recent Switches From Defined Contributions. In contrast to the Governor's plan, some public entities have recently replaced defined contribution programs with defined benefit-type plans. In 2003, the City of Irvine adopted a defined benefit plan in place of defined contribution plans for nonsafety employees. This occurred because of perceived difficulty recruiting employees to work for the city without a guaranteed PERS pension.

After several decades of experience with a defined contribution plan, Nebraska recently implemented a "cash balance" retirement program for nonsafety employees. Cash balance plans are a hybrid between defined benefit and defined contribution. These plans guarantee an annual rate of return on contributed funds (thus eliminating the employee's risk of variable investment returns with a defined contribution plan), but do not set a benefit level upon retirement. At retirement, an employee has the balance of the plan to (1) draw from directly or (2) purchase an annuity that does guarantee annual payments. Prior to the switch, a contracted consultant's analysis of Nebraska's defined contribution program found that the plan, combined with Social Security and additional personal savings, met nearly all of estimated retirement income needs. Nonetheless, Nebraska officials decided to end the defined contribution plan and replace it with the cash balance plan.

Identified Issues Can Also Be Addressed Within Defined Benefit Structure

While the Governor's proposal would address the current system's problems, the Legislature could instead choose to amend or restructure its defined benefit plans. As discussed below, many of the problems could be lessened or eliminated through various changes. These changes could apply prospectively to new employees or through collective bargaining to existing employees. Securing changes through collective bargaining usually involves some tradeoff—that is, agreeing to some other benefit in return. Consequently, the Legislature would want to consider whether a desired change in pension plans for current employees is worth the cost of the potential offsetting concessions.

Possible Benefit Changes

Benefits Still Locked In. Fixed benefit guarantees are inherent to defined benefit plans. Revising defined benefit plans, therefore, would not address the issue of locked-in benefits.

Close Some Formulas to New Entrants. There are a number of ways to modify benefit levels. For instance, if some benefit options are deemed too generous, the Legislature could close benefit formulas that far surpass those in other states and/or readily result in retirees having more income in retirement than when working. Most notably, this would include the 2.7 percent at 55 and 3 percent at 60 Miscellaneous formulas, as well as 3 percent at 50 for public safety.

Return to Three-Year Final Salary for Pension Calculations. As discussed above, the state and many local governments calculate pensions based on the highest one-year salary. The Legislature could adopt the three-year standard again for new employees. This would limit the incentive for salary spiking and conform with a typical defined benefit structure in other states.

Restrict Retroactive Benefit Enhancements. Because the stock market goes in cycles, excess pension assets at any particular point in time will likely be needed in the future to weather a market downturn. With retroactive benefit increases, these assets are used to pay the unfunded liability created by the enhancement. As a matter of fiscal prudence, the Legislature could prohibit retroactive benefit enhancements, or at least require them to be paid for upfront with governmental operating funds—not pension plan assets.

Possible Funding Changes

Set Aside Funds When Rates Dip. As mentioned previously, there is an ongoing, annual cost for defined benefit pensions—the normal cost. Contribution rates will vary around the normal cost over time—above to pay off unfunded liabilities and below to credit actuarial surpluses. The normal cost percent of salary, however, is the expected annual cost of retirement benefits over the long term. Consequently, one idea to explore is budgeting at least the normal cost in times when contribution rates dip below that amount because of higher-than-assumed returns. The budgeted funds above required contributions could be set aside to help offset future rate increases when investment returns inevitably decline. This would help blunt the impact of rate volatility and uncertainty, keeping budgeted contributions more stable during up and down times for the stock market.

Variable Employee Contributions to Share Cost Fluctuation. The Legislature could require employees to share in the growing or declining cost of the system, depending on investment performance and benefit enhancements. This would be accomplished through employee contributions that vary in the same manner as employer rates. Currently, state employees do not share any risk or benefit from changing contribution rates.

The Governor's proposed package of employee compensation savings includes this concept of shared costs. Current state employees would pay half the total (employee and employer shares) contributions to PERS. For most state employees, this would mean contributing approximately 11 percent of pay in 2005-06 instead of the current 5 percent. The Legislature could adopt this approach for new employees without collective bargaining.

Reassert Right to Change Employee Contribution. In addition to variable employee contributions, the Legislature could also reassert the right it has reserved in statute to change, at its discretion, employee retirement contributions for PERS. At the state level, this would need to be done for current employees through collective bargaining since current contribution rates have been established in employee contracts. For new employees, the Legislature could enact legislation specifying such adjustments.

Compensation Decisions Still Obscured. Revising defined benefit plans would not address the concern that they fundamentally make total compensation decisions more difficult because of the variable costs involved. Having a less generous benefits structure, however, would tend to reduce the annual cost of those benefits to the public agency. A smaller share of total compensation, therefore, would be variable.

Figure 6 summarizes how adjustments to the defined benefit structure could address many of the concerns with the existing system.

Figure 6

How Could Modified Defined Benefit Plans Address Concerns With the Current System?

Concerns	Could Modified Plans Address Concerns?
Benefit Issues	
Locked in	No—Benefits are still locked in.
Overly generous	Yes—Could close some generous formulas to new entrants.
Final salary used to calculate pension	Yes—Could return to standard three-year salary period for calculating retirement benefit for new employees to average out the impact of final pay raises.
Retroactivity	Yes—Could prohibit retroactive benefit enhancements, or restrict by requiring upfront payment apart from pension plan assets.
Funding Issues	
Volatile rates	To a large extent—A less generous benefit structure would limit annual rate fluctuations. Could set aside funds when contribution rates drop below a certain level.
Employees shielded from costs	To a large extent—Could adopt variable employee contributions (like Governor's employee compensation savings proposal) to share cost fluctuations. Could also reassert right to change new employee contributions.

Other Pension Possibilities

In addition to modifying defined benefit plans within their current structures, there are other types of plans besides defined contribution pensions that can address the identified concerns. Below, we highlight these other possibilities.

Blended, or Hybrid, Plans

Smaller Defined Benefit Plus Defined Contribution. The federal government and several states have retirement programs that include both defined benefit and defined contribution components. The guaranteed benefit with these blended plans is reduced (generally paying approximately one-half the benefit per year of service as their original defined benefit plans). The contribution to the employee's defined contribution account adds additional retirement income from investment returns. With blended plans, employer contributions typically pay for the defined benefit component, and employee contributions go into the defined contribution account. Figure 7 shows the details of the plans sponsored by other states and the federal government. Two plans are optional and two are mandatory.

Figure 7

Blended Retirement Plans

	Effective Date	Optional/ Mandatory	Defined Benefit Formula (Per Year of Service)	Employer Contribution	Employee Contribution
Federal	1983	Mandatory	1.0%[a]	1% to 5%[b]	0.8%[c]
Ohio	2002	Optional	1.0[a]	13.3	8.5
Oregon	2003	Mandatory	1.5	8.0	6.0
Washington	2002	Optional	1.0	1.4	5.0

[a] Offer increased percentages based on years of service.
[b] Depending on employee contribution.
[c] Plus employer match up to 5 percent.

Reduces Magnitude of Rate Fluctuation. By maintaining a defined benefit component, blended pension plans would not necessarily resolve the cost concerns we identified. The costs of the system would depend on plan design. The smaller guaranteed benefit, however, would reduce the magnitude of employer contribution rate fluctuation. The defined benefit component of a blended pension plan could be structured to account for the benefit changes and cost controls outlined above in our discussion of modifying the existing system.

Cash Balance Plans

As discussed previously, cash balance plans share features of both defined benefit and defined contribution designs. These plans guarantee a certain annual return on mandated contributions, but do not guarantee a specific benefit level in retirement. Funds are invested and administered collectively by the retirement system (like defined benefit plans), rather than on an individual basis. These plans build up reserve funds with excess assets earned from returns that exceed the guarantee to offset later periods of lagging returns. Figure 8 shows the details of cash balance plans for nonsafety state employees in Nebraska and part-time teachers in California.

Figure 8

Cash Balance Retirement Plans

State	Date	Optional/ Mandatory	Employer Contribution	Employee Contribution	Guaranteed Interest Rate
Nebraska	2003	Mandatory	6.8%[a]	4.3%[b]	5.0% minimum
California—part-time teachers	1996	Optional	4.0	4.0	Currently 5.0%

[a] On first $19,954 of salary, 7.5 percent after that.

[b] On first $19,954 of salary, 4.8 percent after that.

Cash Balance Plans Can Address Most Concerns. Cash balance plans address the contribution rate concerns with defined benefit programs because employer *contributions* generally are fixed. They do not have to vary to guarantee a particular benefit level in retirement. They do not completely eliminate the locked-in feature of defined benefit plans, however, since a *return rate* is guaranteed. But they can be designed to allow interest guarantees to change from year to year at the agency's discretion. In addition, the reserve funds from excess assets are intended to meet the guarantee when investments fall short. Depending on plan design, cash balance plans may or may not address the concerns regarding overly generous pensions under defined benefit programs. Like defined contribution plans, cash balance programs offer employees portable benefits. By investing funds at a system level, they also avoid high individual account fees.

Conclusion

Defined benefit pensions are the norm for public sector retirement. These types of plans, as currently structured in California, raise several benefits and cost issues. Focused on the high cost of the current system, the Governor proposes to shift all new public sector employees—state and local employees as well as teachers—to defined contribution plans. This type of retirement system addresses the concerns with defined benefit pensions and offers additional benefits, but also introduces some other considerations.

The Legislature has a variety of options from which to choose. In addition to defined contribution plans, these options include restructured defined benefit, hybrid, and cash balance plans. Each option generally has the ability to address the identified concerns with the current system.

ASSESSING THE GOVERNOR'S REORGANIZATION PROPOSALS

What Should the Legislature Consider When Reviewing the Administration's Proposals to Eliminate Boards and Commissions and Reorganize the Youth and Adult Correctional Agency? Would the Plans Reduce State Costs?

Summary

On January 6, 2005, the administration released its plans to eliminate 88 boards and commissions and to reorganize the Youth and Adult Correctional Agency.

This piece provides an overview of the reorganization process. Then for each of the plans, we provide an assessment of its fiscal effect and raise key issues and considerations. For instance:

- *Are short-term implementation costs outweighed by any long-term benefits?*
- *Do the submitted plans have sufficient details to fully evaluate them?*
- *Would the reorganized entities still allow for sufficient legislative and public oversight?*

INTRODUCTION

On August 3, 2004, the California Performance Review (CPR) released its report on reforming California's state government, with the aim of making it more efficient and more responsive to its citizens. One of the major components of the CPR report was a reorganization plan for all of state government. On January 6, 2005, the Governor submitted two reorganization plans that are based upon the work of CPR:

- The first reorganization plan would eliminate 88 boards and commissions.
- The second reorganization plan would create a corrections mega-department by merging a number of Youth and Adult Correctional Agency (YACA) entities.

In this piece, we:

- Provide an overview of the reorganization plan process.
- Describe the Governor's two reorganization plans.
- Discuss the fiscal effect of each plan.
- Offer key considerations for the Legislature as it approaches its decisions whether to approve or reject the plans.

REORGANIZATION PROCESS

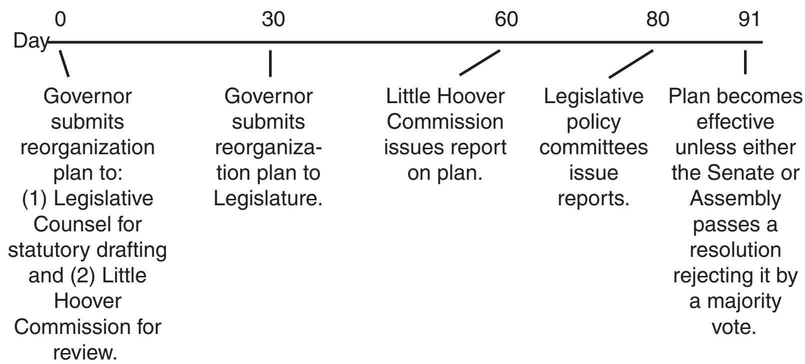
State law provides a specific process for the Governor to propose reorganizations to the Legislature. From 1968 to 2004, various Governors submitted 29 reorganization plans through this process. The Legislature rejected 11 of these plans, and 18 plans went into effect. Below, we describe the details of the process as it will apply to the Governor's two reorganization plans submitted earlier this year.

Timeline. Figure 1 provides the timeline for the reorganization process, beginning with the Governor's submittal of the plans to the Little Hoover Commission on January 6, 2005. In total, a reorganization plan can take about 90 days to become effective. As of February 14, 2005, the Governor had not formally submitted the plans to the Legislature—likely extending the time period beyond 90 days.

Goals. State law encourages the Governor to seek reorganizations which reduce expenditures, increase efficiency, and eliminate duplications of effort.

Figure 1

Timeline for Governor's Reorganization Plans[a]



[a] Pursuant to Government Code Sections 8523 and 12080 through 12081.2.

Little Hoover Commission. As part of the process, the Governor submits any plans to the Little Hoover Commission for review and public hearings. The commission has 60 days to report any findings to the Governor and the Legislature.

Civil Service Transition. Plans must provide for the transfer of existing state employees from their original department to a new entity carrying out the same function.

Legislative Review. From the time the Governor formally presents a reorganization plan to the Legislature, the statute provides for a 60-day legislative review period and calls for policy committees in each house to issue a report on a plan. (By statute, the Legislature's scheduled spring recess does not count as part of the 60 days.) A plan goes into effect after the 60-day period unless the Legislature takes action to reject it. Either house can reject a plan by passing a resolution by a majority vote. The vote is "yes" or "no"—the plan cannot be amended by the Legislature.

Implementing Legislation. Under the process, Legislative Counsel is responsible for drafting statutory language to implement the reorganization plan. The reorganization authority provides that the plan can go into effect even if this statutory language is not adopted by the Legislature.

How Should the Legislature Approach the Reorganization Plans?

In reviewing the two reorganization plans, there are many considerations for the Legislature. In the past, when reorganization plans have not met its needs, the Legislature has requested amended plans from the administration or used the regular statutory process to reorganize state government. Figure 2 lists some of the broad criteria that we would suggest the Legislature use in evaluating any proposed reorganization. Below, we describe the two plans in detail and address how the plans meet these criteria.

Figure 2

Criteria for Considering the Merits of a Reorganization Proposal

As the Legislature considers the reorganization proposals, it may want to consider the following questions to help determine a proposal's merits.

- ✓ ***Effectiveness.*** Would the reorganization make the programs more effective? Would the public receive better services as a result of the reorganization?
- ✓ ***Accountability.*** In the current and the new structures, who is responsible for the program's outcomes? Is the new structure likely to improve program accountability to the public?
- ✓ ***Oversight.*** Will the new structure provide for effective, independent oversight by the executive and legislative branches?
- ✓ ***Efficiency.*** Would the reorganization improve the use of limited resources? Are there reasons to believe that the programs can be administered more efficiently? Do existing programs exhibit duplication of effort or lack of coordination?
- ✓ ***Other Options.*** What is the problem that is being addressed? Is a reorganization the best approach to solve that problem? Could improved leadership, changes in policy, better coordination between departments, or other solutions provide a better result?
- ✓ ***Implementation.*** Do the expected long-term benefits outweigh the short-term costs and disruptions from the implementation of the reorganization? Will the public experience a disruption in services? Does the implementation need to occur now, or can it be phased in over time?

BOARDS AND COMMISSIONS

Most state functions are carried out by departments. These departments have directors appointed by and responsible to the Governor. Outside of these departments, the state also has hundreds of boards, commissions, and task forces which serve a variety of roles. Boards and commissions are generally more autonomous than departments. Board members and commissioners are appointed by a variety of individuals—including the Governor, legislative leaders, and constitutional officers. Members may be appointed for a fixed length of time (whereas department directors serve at the pleasure of the Governor).

In its first reorganization plan, Governor's Reorganization Plan 1 (GRP-1), the administration proposes to eliminate 88 boards and commissions. Below, we describe the components of the reorganization plan, comment on its likely fiscal effect, and provide some key considerations for the Legislature. A more detailed discussion of the reorganization plan's effects on energy and recycling policy can be found in the *Analysis of the 2005-06 Budget Bill* (please see the "Resources" chapter).

Governor's Proposal

The reorganization plan would affect a broad array of boards and commissions. These entities perform a wide range of functions—including advising the Legislature and Governor, allocating funds, hearing appeals of departmental decisions, and licensing and regulating professions. We classify the proposal into six categories below, based on what would happen to them under the Governor's proposal (summarized in Figure 3, next page).

Many Dormant Entities. For 19 of the entities, GRP-1 would have no significant effect because the boards are currently performing no or minimal activities. For instance, in the cases of the Child Development Policy and Advisory Committee and the Industrial Welfare Commission, the current-year budget provides no funding for these entities and they are not currently functioning. In other cases, such as the Small Business Reform Task Force, the entities have already completed their statutory tasks, such as writing a report. For these 19 entities, the administration basically proposes a "clean-up" function—such as deleting references in state law.

Office of Higher Education and Financial Aid. The administration proposes a new Office of Higher Education and Financial Aid to handle higher education policy and financial aid matters—by merging the Loan Advisory Council, the Student Aid Commission, and the California Postsecondary Education Commission. The Governor would appoint the office's executive director, subject to Senate confirmation.

Figure 3

GRP-1 Boards and Commissions Proposed for Elimination

Currently Dormant
Advisory Committee on Managed Health Care
Bipartisan California Commission on Internet Political Practices
Brown vs. Board of Education of Topeka Advisory Commission
Campus Sexual Assault Task Force
Child Development Policy and Advisory Committee
Commission of the Californias
Consumer Power and Conservation Financing Authority
Electronic Commerce Advisory Council
Commission on Veterans' Cemeteries
Heart Disease and Stroke Prevention and Treatment Task Force
Heritage Preservation Commission
Industrial Welfare Commission
Interagency Aquatic Invasive Species Council
Mexican American Veterans' Memorial Beautification and Enhancement Commission
Public Library Construction and Renovation Board
Racial Profiling Panel
Small Business Reform Task Force
Vietnam Veterans Memorial Commission
Water Commission
New Office of Higher Education and Financial Aid
Loan Advisory Council
Postsecondary Education Commission
Student Aid Commission
New Employment and Benefits Appeals Board
Occupational Safety and Health Appeals Board
Unemployment Insurance Appeals Board
Workers' Compensation Appeals Board
Absorbed Into Department of Consumer Affairs
Acupuncture Board
Alarm Company Operator Disciplinary Review Commission
Architects Board
Board for Geologist and Geophysicists
Board of Accountancy
Board of Barbering and Cosmetology
Board of Behavioral Sciences
Board of Guide Dogs for the Blind
Board of Occupational Therapy
Board of Optometry
Board of Pharmacy
Board of Pilot Commissioners
Board of Podiatric Medicine
Board of Professional Engineers and Land Surveyors
Board of Psychology

Board of Registered Nursing
Board of Vocational Nursing and Psychiatric Technicians
Committee on Dental Auxiliaries
Contractors' State License Board
Court Reporters Board
Dental Board
Hearing Aid Dispensers Advisory Committee
Landscape Architects Technical Committee
Medical Board
Physical Therapy Board
Physician Assistant Committee
Private Security Disciplinary Review Commission (North and South)
Registered Veterinary Technicians Committee
Respiratory Care Board
Service Agency Advisory Committee
Speech-Language Pathology and Audiology Board
Structural Pest Control Board
Veterinary Medical Board

Absorbed Into Other Departments

9-1-1 Advisory Board
Boating and Waterways Commission
Building Standards Commission
Clinical Advisory Panel
Colorado River Board
Electricity Oversight Board
Commission on Emergency Medical Services
Board of Fire Services
Board of Forestry and Fire Protection
Commission on Health and Safety and Workers' Compensation
Health Policy and Data Advisory Committee
High-Speed Rail Authority
Integrated Waste Management Board
Mining and Geology Board
Off-Highway Motor Vehicle Recreational Commission
Reclamation Board
Recreational Trails Committee
Rural Health Policy Committee
Seismic Safety Commission
Transportation Advisory Committee

Advisory Functions Eliminated

Agriculture Bargaining Association Advisory Commission
Commission on Asian and Pacific Islander American Affairs
Credit Union Advisory Committee
Commission for Economic Development
Inspection and Maintenance Review Committee
Mortgage Bankers Advisory Committee
Quality Education Commission
Real Estate Advisory Commission
Commission on Uniform State Laws

Employment and Benefits Appeals Board. The new Employment and Benefits Appeals Board would provide a consolidated board to hear appeals currently heard by three entities—the Occupational Safety and Health Appeals Board, the Unemployment Insurance Appeals Board, and the Workers' Compensation Appeals Board. The new board would consist of nine full-time members appointed by the Governor and subject to Senate confirmation.

Eliminate Consumer Affairs Boards. The Department of Consumer Affairs (DCA) is responsible for promoting consumer protection while supporting a fair and competitive marketplace. The department includes 27 semiautonomous regulatory boards, commissions, and committees that regulate various professions. These boards are comprised of appointed consumer and industry representatives. In addition, the department regulates additional professions through 11 bureaus and programs, which are statutorily under its direct control. (The Governor's proposal would not affect these 11 programs.) The Governor's reorganization plan would eliminate 34 consumer boards and commissions and transfer their functions into DCA:

- Twenty-five of the semiautonomous boards and commissions. (The Athletic Commission and the Osteopathic Medical Board would be the only remaining independent boards.)
- Seven advisory and appeals boards which provide support to other DCA activities.
- The Board of Pilot Commissioners (licenses and regulates bay pilots) and the Service Agency Advisory Committee (advises the California Department of Food and Agriculture [CDFA] on weights and measures), which currently have no relationship to DCA.

Other Functions Absorbed. The Governor's plan would transfer the functions currently performed by 20 independent boards and commissions into various state departments. A majority of these boards are in the resources area. Most of the boards are advisory in nature. A number of the boards, however, perform administrative functions such as developing high speed rail for the state, or setting state policy such as the Board of Forestry and Fire Protection (BOF).

Elimination of Advisory Boards. The Governor's plan would eliminate nine entities and their current advisory functions. For instance, the Inspection and Maintenance Review Committee evaluates the state's Smog Check program and recommends improvements to the Governor and Legislature.

Fiscal Effect

The administration has not provided a comprehensive fiscal evaluation of its proposal. In some cases, savings estimates have been provided by the administration for individual components of the proposal. The Governor's budget, however, does not assume any savings from the implementation of the reorganization plan. In fact, the budget documents do not reflect the proposed elimination of the boards and commissions.

Savings From Members' Expenses. The reorganization plan would eliminate hundreds of appointed board members and commissioners. For nearly all of these boards and commissions, their members do not receive salaries. Instead, members receive various minimal payments to cover their expenses. The most common such arrangement is for a member to be paid $100 for each board meeting attended and to be reimbursed for actual expenses (primarily travel). Consequently, the administration has estimated roughly $10,000 in annual savings per entity for a number of these boards.

Only four of the boards and commissions proposed for elimination have full-time salaried members—the Integrated Waste Management Board (IWMB) and the three entities proposed to be consolidated into the Employment and Benefits Appeals Board. The elimination of the $114,000 in annual salaries and associated benefits of each of the six IWMB board members would save the state a total of about $1 million annually. Regarding the employment board, the existing boards have a combined 17 members. The Governor's proposed new board would have only nine members. The salary savings for these eight eliminated positions would save over $1 million annually.

A few boards currently have staff dedicated to meeting their members' needs. These types of positions could be eliminated along with board and commissioner members. It is unknown how many such positions could be eliminated. (In the case of IWMB, however, such savings could total about $1 million annually.)

Implementation and Transition Costs. The proposed reorganization could result in significant implementation costs, particularly in the short term. The Governor's budget does not include funding for these expenses, such as the costs for integrating data and budget systems and relocating offices. As an example, the recent closing of the Technology, Trade, and Commerce Agency cost millions of dollars in shutdown expenses—nullifying most of the savings for the first year. The Legislature should be aware of these types of implementation costs in making its decisions.

Potential for Efficiencies. In some instances, the reorganization plan identifies possible efficiencies the administration hopes to achieve. For instance, for the DCA boards, the administration aims to make administration and consumer outreach more streamlined. In addition, DCA might be better able to reallocate resources among multiple programs as dictated by workload. In contrast, since they administer individual programs, boards typically do not have the same degree of flexibility. It appears reasonable that these types of efficiencies could be achieved over time. To what extent this occurred, however, would depend primarily on executive leadership within state departments.

Savings Would Benefit Special Funds' Conditions. Most of the entities proposed for elimination are funded by a variety of special funds. Any long-term savings achieved, therefore, would principally benefit these funds. Any savings achieved would allow (1) the programs funded by these accounts to be expanded and/or (2) reductions in the fees paid (such as annual occupational license fees) to these accounts. Overall, we would not expect the plan to result in a significant amount of General Fund savings—likely less than $1 million annually.

State Costs for River Activities Could Increase. In at least one instance, the proposal may increase state-funded costs. Under current law, the Colorado River Board's membership includes various Southern California water agencies. The member agencies reimburse the board for the full cost of the board's operations, based on an annual contract. If the Colorado River Board were reorganized under the Department of Water Resources as proposed, the state might lose this source of reimbursement funding—$1.2 million in the 2005-06 proposed budget—thereby adding to state-funded expenditures. Although the board is proposed to be eliminated, most of these costs would continue—as staff would continue to perform functions related to the Colorado River.

Key Legislative Considerations

Below, we outline some additional considerations specific to the boards and commissions reorganization plan that the Legislature may wish to consider when evaluating the plan.

Details Lacking. In our initial assessment of CPR's reorganization proposal (please see our August 27, 2004 publication), we noted that the proposal often lacked sufficient detail to evaluate whether a proposed consolidation would improve state government. To date, the administration's boards and commissions reorganization plan has not added a significant level of detail to the proposals. Consequently, it is difficult to know how new functions would be integrated into departments. Until the full details are put forth, drawing conclusions about whether a consolidation is advisable is difficult.

For instance, in the case of DCA, it is not clear whether the administration intends to group the transferred functions by program area or instead maintain them as separate offices within the larger department. Since many of the functions proposed for transfer are medical-related, the department could create a medical bureau which, over time, would have staff trained across multiple disciplines for licensing and investigative work. By having a broader perspective than individual boards, such an approach could offer improved state oversight of the entire medical field. In addition, the public would have a single point of contact for medical professions. In contrast, if the administration intends to maintain each board's function as a separate office, there would be far fewer opportunities for efficiencies. In addition, any existing problems with lack of coordination between boards would likely continue.

Simpler Solutions? In some cases, it appears that the administration has favored the elimination of boards even if simpler solutions exist to perceived problems. For example, the administration cites the benefits of developing a toll-free number for the consolidated consumer affairs boards. Yet, the department already has a toll-free number that provides—for all of DCA's boards and bureaus—documents via fax upon request and allows consumers to speak to an operator about complaints or questions. If the administration's goal is to improve telephone access, the existing phone system could be upgraded absent a reorganization.

Policy Rationales Lacking. In other cases, the administration has not put forward a policy rationale for its proposal. For instance, with regards to the employment appeals board, it is not clear what problem the administration is trying to address. If the administration believes board members are overpaid for the amount of work they perform, a simpler solution would be to reduce salaries. Another example is the Service Agency Advisory Committee, which advises the state on the regulation of weights and measures. It is not clear why the administration merges this entity into DCA. The CDFA, not DCA, is the state entity responsible for the regulation of these standards. A clear problem statement would help the Legislature evaluate whether the proposed solution makes the most sense.

Policy Expertise Lost? By having multiple members, boards can include experts in a policy field who offer a variety of policy perspectives. Departments, by comparison, generally reflect the single view of the administration. Consequently, it is possible that the elimination of boards will reduce or eliminate the range of policy perspectives. The administration responds to this concern by noting that departments can utilize *ad hoc* advisory committees when necessary. Such an informal process could be effective. Future administrations, however, might not choose to use them.

Effects on Legislative Oversight Uncertain. The Legislature often has the ability to oversee a board's management through the nomination approval process. In other cases (such as the High Speed Rail Authority), the Legislature has the authority to appoint board members directly. Under the reorganization plan, the Legislature would lose the ability to review the nomination of program-specific board members. Instead the Legislature would only review the nomination of a department director.

Potential Conflicts of Interest. Some of the proposed reorganizations may create conflicts of interest within the resulting organization. For instance, in our discussion of energy-related consolidations in the *2005-06 Analysis*, we note that the reorganization plan could threaten the ability of the state to effectively oversee the electricity market if the functions of the Electricity Oversight Board were transferred into the California Energy Commission.

A similar problem could develop if the State Mining and Geology Board's (SMGB) functions were transferred to the Department of Conservation (DOC). The SMGB assumes Surface Mining and Reclamation Act (SMARA) lead agency responsibilities when local lead agencies fail to administer and enforce the SMARA. (It is currently the lead agency for two counties and 16 cities.) In its current capacity, DOC exercises oversight and enforcement responsibilities over lead agencies. If SMGB's functions were transferred to DOC, the same department—DOC—would have both oversight and enforcement responsibilities. To correct these potential conflicts, it may be possible to develop "firewalls" to prevent inappropriate influence within the organization. The administration's proposal, however, lacks sufficient detail to determine whether these issues would be addressed sufficiently, if at all.

Uncertain Impact on Public Access. Many of the boards and commissions that have been proposed for elimination provide extensive public oversight of and input into the decision making process. For instance, BOF is responsible for developing the general forest and fire protection policy of the state and adopting the forest practice rules which govern timber harvesting in the state. The BOF—which would be consolidated into the Department of Forestry and Fire under the reorganization plan—actively involves the public in crafting these policies and rules. On the other hand, departmental decision making typically does not involve this level of public input.

In response to the concern that the reorganization would limit public input, the administration asserts that state law provides for public comment on any changes in rules and regulations (through the Administrative Procedures Act). In addition, the administration states its intention to utilize public workshops and the Internet to inform the public and gather public input. The board system guarantees the public access since meetings are subject to the Open Meetings Act. On the other hand, transferring programs to within departments would make input more dependent on each department's chosen policies.

YOUTH AND ADULT CORRECTIONS REORGANIZATION

Background

In February 2004, the Corrections Independent Review Panel (CIRP) was established to conduct a broad examination of California's correctional system and make recommendations to improve its operations. While CIRP made hundreds of recommendations regarding various aspects of the correctional system, it recommended that reorganization of the youth and adult correctional agencies be given the highest priority. The Governor's proposed reorganization incorporates many of CIRP's recommendations.

The administration's proposed "overhaul" of the correctional system is contained in two separate but related documents. These are the *Governor's Reorganization Plan 2, Reforming California's Youth and Adult Correctional System* (GRP-2), and the *Youth and Adult Correctional Agency Strategic Plan* (the YACA Strategic Plan). The GRP-2 primarily focuses on proposed *organizational* changes, while the YACA Strategic Plan primarily focuses on *policy* and *operational* changes within the organization that are intended to support the goals of increased accountability, efficiency, and effectiveness in the delivery of correctional services.

In this analysis, we (1) provide an overview of the proposed major policy and organizational changes; (2) evaluate the plan (both GRP-2 and the YACA Strategic Plan) against its stated objectives of increased efficiency, accountability, and effectiveness; and (3) raise issues for legislative consideration. It is not our intent to evaluate every aspect of the plan; rather, our intent is to focus on key aspects of the plan that are important to its overall goals.

Governor's Proposal—Major Changes

The GRP-2 focuses on consolidating administrative functions to eliminate duplication of effort and improve the delivery of services. Specifically, the plan proposes to:

- ***Change the Mission and Focus of YACA.*** The administration proposes to shift the mission of the correctional agencies toward providing more inmate rehabilitation programs, including education, job training, and substance abuse treatment, as well as "custody and security" as a means of increasing public safety.
- ***Consolidate Existing Corrections Departments Effective July 1, 2005.*** This includes placing the youth and adult institution and parole programs within a single department—the California Department of Corrections and Rehabilitation (CDC-R)—along with the Board of Corrections, Board of Prison Terms, Prison Industry Authority, and the Commission of Peace Officer Standards and Training.
- ***Merge the Youth and Adult Parole Boards.*** A new Board of Parole Hearings would be created by merging the Youth Authority Board, the Board of Prison Terms, and the Narcotic Addict Evaluation Authority. The new board would consist of 17 members appointed by the Governor and confirmed by the Senate. It reduces (1) the overall number of appointments from 22 to 17 and (2) the length of appointments from the current four-year terms to three-year terms.
- ***Centralize Policy and Administrative Functions.*** The new department's policy and administrative functions would be centralized in the Office of the Secretary. The Secretary would have two Chief Deputy Directors: one in charge of programs—education, substance abuse, and health care—and one in charge of institution operations. Each of these chief deputies has a second tier of managers to cover the different divisions, such as the Division of Youth Operations.
- ***Discontinue Senate Confirmation of Prison Wardens.*** Under the administration's proposal, the Senate would no longer confirm prison wardens. The Governor would appoint wardens who would serve at the pleasure of the Secretary.

Fiscal Effect

Similar to our discussion of the boards and commissions, the Governor's budget does not reflect the proposed reorganization of YACA nor identify any of its fiscal effects. Our analysis first assesses whether, and to what extent, the GRP-2 and the YACA Strategic Plan would improve the efficiency of California's youth and adult corrections system and result in savings.

Would the Reorganization Improve Efficiency And Result in Savings?

The administration asserts that GRP-2 will increase government efficiency by enabling the state to provide higher level of services at a lower cost. Our analysis indicates that (1) short-term savings from consolidating departments are likely to be more than offset by the upfront costs of implementing the plan and (2) the budgetary benefits of the proposed reorganization are not likely to be realized until later years.

Plan Could Cost in the Short Run. The administration states that one of the fiscal benefits of the plan is that merging the youth and adult correctional departments and boards would result in "economies of scale" and create an opportunity to "leverage" its expanded population to obtain lower prices on the purchase of goods and services. We agree there would be some savings from economies of scale. For example, combining the budget and accounting offices of the various departments and boards probably creates an opportunity to eliminate some positions without disrupting the fiscal operation of the new department. However, as regards leveraging, we do not believe this will result in significant savings for two reasons.

First, CDC is already a large operation—with 47,000 employees and over 165,000 inmates and 110,000 parolees. As such, state costs for many goods and services provided by the department already reflect savings from economies of scale. Therefore, increasing its already large population by a relatively small amount (7,000 juveniles—3,100 wards and 3,800 juvenile parolees) would probably yield minimal savings. Second, the Youth Authority population is declining, and would decline further under the administration's proposal to shift the responsibility for providing some juvenile justice services from the state to the local governments. Such a shift would make it even less likely that there would be any significant short-term savings from the consolidation.

Whatever minimal level of administrative savings is achieved from the GRP-2 would likely be more than offset by the upfront costs of the reorganization. Based on our discussions with YACA staff, it is our understanding that in the short term, the reorganization would require moving staff and related office furniture and computer equipment. Additionally, YACA staff advised us that the new department would probably require a new telephone system and space modifications. The plan does not specify how many staff will be required to move offices or change locations. However, for a large reorganization, such as proposed in the GRP-2, these upfront costs could easily run into a few million dollars. For this reason, we think the GRP-2 could potentially result in net costs in the short run.

Plan Could Result in Major Savings in Future Years. In the long term, however, we think the administration's proposal has the potential to result in major state savings. For example, the plan envisions a correctional system that relies more on rehabilitation and treatment programs as a means of increasing public safety. Academic research shows that well-designed education and training programs can reduce inmate recidivism. California currently spends hundreds of millions of dollars housing parolees returned to custody for relatively minor violations because there are only a limited number of education, training, and treatment programs and available slots for inmates. Therefore, to the extent that the administration's goal of providing more and better rehabilitation is achieved, and there is a lower rate of recidivism, for example, the plan would potentially result in major state savings from a reduced prison population. We note that there would be costs to implement effective programs and the GRP-2 does not provide an estimate of such costs. Nonetheless, based on independent evaluations of the cost-effectiveness of various inmate programs, we believe that in the long run these costs would likely be more than offset by population savings.

Efficiency Without Reorganization. We note, however, that some of these efficiency savings would result from changes already adopted by the Legislature. This is because, in recent years, the Legislature and the administration have already adopted several policy changes aimed at making the correctional system more efficient. In particular, legislation was enacted requiring the Department of General Services and CDC to take steps to reduce pharmacy costs. In addition, parole policy changes were adopted to reduce the number of nonviolent inmates who return to prison for low-level offenses. Also, more than 1,000 positions were established to reduce the department's reliance on overtime. To the extent these changes are implemented, it should reduce CDC operating costs.

In addition to these actions, there are further opportunities to achieve efficiencies that do not require agency reorganization. For example, CDC could use lower cost noncustody staff to perform certain tasks that are now performed by custody staff, such as administrative work at headquarters. Additionally, for certain inmates the department could implement "disciplinary confinement" strategies that are less costly than administrative segregation. (For more information on these options, please see the "Judiciary and Criminal Justice" chapter in our companion document, *Analysis of the 2005-06 Budget Bill*.)

Key Legislative Considerations

In the sections that follow, we outline key issues to assist the Legislature with its consideration of GRP-2. We first examine whether the plan would improve the accountability and effectiveness of the system. We then discuss the proposed mission of the new CDC-R.

Would the Reorganization Plan Improve Accountability?

The reorganization plan includes a number of proposals aimed at improving accountability of the state's criminal justice system. For example, the GRP-2 would place the entire system under the direction of a single individual. In addition, the YACA Strategic Plan proposes to enhance training and establish a new employee evaluation system. It also proposes to evaluate programs for effectiveness. Our analysis indicates that the plan would increase accountability at the executive management level. However, due to lack of information, it is unclear how the plan would improve accountability *throughout* the correctional system.

Greater Accountability at the Top of the Organization. The GRP-2 would increase accountability at the highest levels by placing responsibility for the various components of the state corrections system with *one* appointed official rather than with several appointed officials as under the current structure. In doing so, it establishes clearer lines of authority and responsibility; thus, eliminating potential uncertainty about whom at the executive level is responsible for successes or failures within the state corrections system. It is unclear, however, how the reorganization plan would affect accountability in the prisons (or in the community for parole), mainly because the plan focuses almost exclusively on structural changes at the executive level. Except for eliminating Senate confirmation of wardens, the GRP-2 does not appear to change the organizational structure "on the front line" where most staff work and where most services (custodial and rehabilitative) are delivered. We discuss this issue in more detail later in this analysis as it relates to implementation of the new department mission.

Systemwide Accountability Will Depend on Details. Among other things, the YACA Strategic Plan proposes to establish an employee evaluation system that "includes clear standards for employee accountability and performance metrics." We think that employee evaluations can be an effective tool for improving accountability at all levels of an organization. We note, however, that employee evaluation systems are most effective when the performance measures are aligned with the organization's mission and when compensation is tied to performance. A correctional "model" that places equal emphasis on custody and rehabilitation, such as that proposed by the administration, should have an evaluation tool that measures employee performance on both of those duties. For example, parole agents could be evaluated based, in part, on the percentage of parolees on their caseload who are employed. Medical escort officers could be evaluated on their effectiveness in getting inmates to medical appointments as scheduled. The YACA Strategic Plan does not provide this level of detail. Without details on the administration's proposed employee evaluation system, the Legislature cannot assess the merits of this particular aspect of the YACA Strategic Plan, which directly relates to the level of accountability on the front line.

Would the Plan Improve Legislative Oversight? The plan includes a number of features that could improve legislative oversight. For example, the YACA Strategic Plan proposes to develop and implement "comprehensive" information systems. Due to the existing outdated information technology and the lack of emphasis on program outcomes, the youth and adult correctional departments often cannot provide information that is useful to the Legislature in its oversight role. If designed properly, the information systems proposed in the plan could, for example, enable the department to provide detailed information to the Legislature regarding its (1) use of resources, (2) progress in implementing legislative priorities, and (3) program outcomes. Based on this, we concluded that the plan has the potential to improve legislative oversight. It is important to note, however, that under the plan it would be five years (2010) before these comprehensive systems are in place.

Effectiveness: Not Enough Information to Evaluate

The GRP-2 and the YACA Strategic Plan lack the three key ingredients that would enable the Legislature to evaluate the plan's potential effectiveness. These are (1) measurable program goals, (2) a baseline assessment of where we are today in relation to those goals, and (3) detail about how to get from here to there. In fairness, because the plan attempts to address such a broad array of issues, providing this level of detail probably was not possible within the given timelines. Nonetheless, the Legislature has the opportunity to work with the administration to more clearly define program goals and performance measures.

Strategic Plan Has Very Optimistic Timeline for Implementation

Although certain key information is missing from the YACA Strategic Plan, such as estimates of costs and specific program goals, it represents a comprehensive strategy for changing the state's corrections system within five years. This includes implementing (1) the new organizational structure, (2) a "workforce excellence" plan, (3) a comprehensive information technology system, (4) expanded inmate and parolee programs, and (5) a managed care inmate health delivery system.

Some of these changes are already underway because of recent legislative actions and court mandates. However, we think the plan is likely to experience delays due to staffing limitations. Specifically, there are a number of significant existing projects that are likely to compete for time and resources that would otherwise be used to implement the plan. Examples of existing projects include the roll out of the *Plata* settlement agreement (related to inmate health care) and compliance with the *Farrell v. Allen* settlement agreement (related to conditions of confinement in Youth Authority institutions). We discuss additional issues that are likely to delay implementation of the plan later in this analysis.

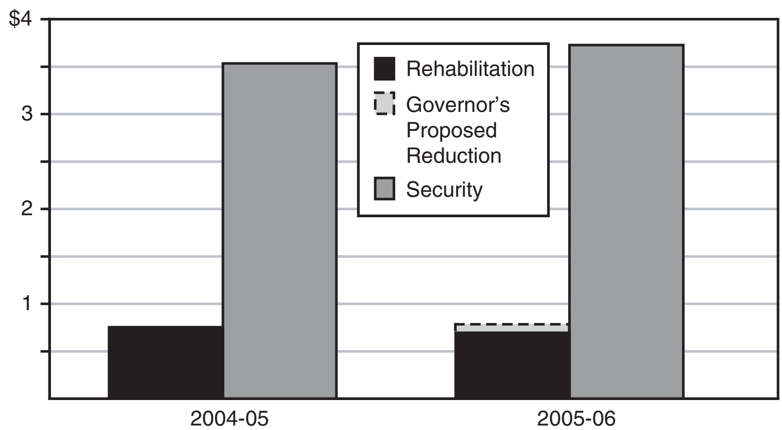
Focus on Rehabilitation Will Require a Major Shift

Current and Proposed Expenditures Weighted Toward Security. Some corrections experts have characterized California's prison system as a security-oriented model as opposed to a rehabilitative model. One way to assess whether this is the case is to compare the department's expenditures for security functions to its spending for rehabilitation functions. Figure 4 shows total spending for CDC and Youth Authority rehabilitation and treatment programs, as compared to spending on security (or custody functions). (It also shows the effect of the Governor's proposed $95 million reduction in inmate and parole services in 2005-06.)

Figure 4

Spending on Security Versus Rehabilitation[a]–CDC and Youth Authority

(In Billions)



[a] Rehabilitation program includes academic and vocational education, job training, and substance abuse and mental health programs. It does not include health care. Administrative costs are not included for either category.

As Figure 4 shows, spending for security—custody staff in the institutions—is much greater than spending for inmate, ward, and parolee rehabilitation and treatment programs. This largely reflects a comparison of staff costs for custody functions in the institutions and on parole to staff and contract costs for academic and vocational education, substance abuse treatment, and mental health services.

The YACA Strategic Plan represents a significant departure from the current way of doing business. Among other things, the plan proposes to establish offender risk and needs assessments, "evidence-based" programs, and a classification system that rewards inmate and ward programming. We note that YACA has already administratively adopted a new vision and mission statement that places emphasis on "crime prevention" and "reintegration."

Balancing Custody and Rehabilitation Will Take Time. Given CDC's historical focus on custody and security, we think the administration will face many challenges in its effort to make California's prison system more rehabilitation oriented. Changing the name of CDC and its mission is a first step, but it is of relatively minor importance compared to the tasks that lie ahead if the department is to realize its goal of providing better treatment services. It will require a change in the organizational culture, changes in policies and procedures aimed at maximizing prison security, and involve some risk. The five-year YACA Strategic Plan does not appear to account for these issues. Sorting through all of this and making tradeoffs that support the department's new mission will take time.

Proposed Organization Raises Profile of Inmate Programs. The proposed organizational structure appears to place a higher priority—at the executive level—on inmate programs. Under the current CDC organizational structure, the Institutions Division manages and oversees both inmate programs and prison operations. In contrast, under the proposed reorganization, management and oversight of inmate and ward programs would be the sole responsibility of a Chief Deputy Secretary who reports directly to the Secretary. This should reduce the likelihood that programs "take a back seat" to prison operations. It should also improve the Secretary's oversight and control of resources for inmate and ward programs. On the other hand, the plan does not appear to provide the management infrastructure required to actually implement its vision as discussed below.

Infrastructure Needed to Support Rehabilitation Mission. Due to the history of budget reductions in education and treatment programs, as well as the tendency to place a higher priority on prison security, the department does not currently have the infrastructure—staff and program expertise, space within the prisons, and information systems—to effectively implement more or better programs. Given the size of California's prisons and geographical dispersion of those prisons (and parole offices), the Secretary and his chief deputies will likely require a program management infrastructure at the regional level and within the prisons to effectively implement and monitor uniform policies and procedures for inmate and ward programs. The administration's plan does not provide details on the level of resources that would be required to put such an infrastructure in place.

It should also be noted that the GRP-2 leaves open several important questions regarding the delivery and oversight of programs within the institutions. It states that wardens will no longer have responsibility for programs, such as health care, education, and vocational training, but does not indicate who would be in charge of these functions at the prison level.

Policy Changes Needed to Shift Department Focus Toward Rehabilitation. In some instances, the department's proposed dual missions—rehabilitation and security—can both be met operationally through the same programs. For example, vocational education programs further the objectives of both prisoner reintegration and prison safety. This is because vocational programs (as well as other programs) reduce inmate idleness, which often leads to incidents that require a custody or security response. In other cases, however, some activities that promote the objective of security can conflict with efforts to promote the objective of rehabilitation. For example, when inmates are placed in administrative segregation or on lockdown for security reasons, often they are not allowed to participate in academic and vocational education programs. While administrative segregation may further the objective of security, it works against the goal of rehabilitation.

The department will need to evaluate its existing inmate housing policies and make explicit tradeoffs between custody and rehabilitation activities that reflect its goal of providing an increased level of inmate programming. In so doing, the department will need clear criteria to guide its decisions regarding the allocation of resources to security activities versus inmate and parolee programs. We note that this process may require ongoing negotiations with employee unions.

Neither GRP-2 nor the YACA Strategic Plan provides clear criteria to assist the department in balancing the two objectives. In reviewing the plan, we would recommend the Legislature direct the administration to specify the criteria it proposes to use in allocating resources between the two missions. This will provide a point of reference for measuring future progress, as well as a tool to assist the department and the Legislature in making budgetary decisions. Should the Legislature approve the plan, it should—as part of its process for reviewing labor contracts—focus on the extent to which labor contracts are consistent with legislative priorities for the new department, especially as it relates to inmate and ward programs.

Administration Inconsistent on Inmate and Parole Programs. At the same time that the administration is presenting a reorganization plan that proposes to provide a higher level of rehabilitation services, the Governor's budget reduces CDC inmate and parolee programs by $95 million, as shown in Figure 4. This represents a 27 percent decrease compared to current-year spending. The proposed reduction raises concerns about the administration's commitment to this aspect of the plan.

Risk of Combining Youth Programs and Adult Programs Can Be Mitigated

Some experts in the field of corrections have expressed concerns regarding the GRP-2 proposal to merge the Youth Authority and CDC. The concern is that the Youth Authority, being a relatively small operation in comparison to CDC, will "get lost" and that institutions for wards will begin to operate more like adult prisons—with a greater emphasis on custody and control rather than rehabilitation.

We agree that these are important issues for the Legislature to carefully consider in its deliberations on the plan. Academic research shows that juveniles have different program needs than adults. There are a number of actions the Legislature can take to improve its own oversight of youth programs. For example, the Legislature could require funding for ward programs to be separately budgeted from adult programs. The Legislature could require employees within the Youth Division of the new department to meet specific training and educational requirements to ensure that these employees are prepared to work with juveniles. Additionally, the new department could be required to provide detailed information to the Legislature on its academic and vocational education programs, such as institution-specific pupil scores on certain standardized tests. Finally, the Legislature could provide that the Youth Authority merger only occur after certain conditions are met, such as certain program requirements of the *Farrell v. Allen* settlement agreement.

Intergovernmental and Interagency Partnerships Matter

GRP-2 Recognizes Importance of Partnerships, Juvenile Justice Reform Will Be First Test. To its credit, the administration's proposed organizational structure includes a Division of Community Partnerships whose responsibility it would be to "establish, maintain, and expand cooperative agreements…. that can aid in the rehabilitation and reintegration of inmates, wards, and parolees." In addition to improved collaboration with local law enforcement, the YACA Strategic Plan proposes to improve interagency relations with other state departments such as the Mental Health and Employment Development departments, as well as with academic and research communities. We think this makes sense. We note that the Governor's 2005-06 budget includes—as part of its inmate medical services request—an example of such collaboration in its proposal to establish interagency agreements with the University of California for assessment and training of CDC medical staff, as well as physician consultations related to direct patient services.

Reorganization Alone Will Not Address Chronic Problems

Over the years, various audits, investigations, and lawsuits have uncovered numerous problems within the state's youth and adult correctional agencies. The problems range from a lack of fiscal control and employee misconduct, to prison overcrowding, to inadequate care and treatment of inmates and wards. In recent years, much attention has been focused on the escalating cost of operating the state prison system. The underlying premise of the proposed reorganization is that many of the problems facing corrections officials stem from its current organizational structure.

While we agree that some problems probably stem from the organizational structure of the state correctional system, we also note that some of the significant problems facing corrections officials, such as prison overcrowding and budget deficiencies, have little to do with the current organizational structure. For example, corrections spending is determined in large part by the number of individuals sentenced to prison and the labor costs to operate the prisons pursuant to state laws and court-ordered requirements. The GRP-2 does not propose to change sentencing laws nor labor costs. The Legislature should carefully consider its vital role in establishing sentencing laws, as well as its role in reviewing and approving labor contracts to determine if changes are required to further the goals of the reorganization.

Conclusion

Many aspects of state government's organization could be improved. Both reorganization plans aim to make improvements in this area. Given the lack of detail accompanying both of the Governor's proposed reorganization plans, however, it will be difficult for the Legislature to assess if they meet their stated goals.

Since the legislative vote is "yes" or "no," making decisions under the reorganization plan process can be awkward. The normal legislative process of amendments and compromises is not immediately available. This is particularly a problem when a plan includes 88 boards and commissions across a broad range of policy areas. What if the Legislature objects to just a handful of the proposed changes? What if the Legislature wants to add a few more boards? The process is inflexible to these types of changes. Similarly, GRP-2 focuses exclusively on organizational changes at the executive level but does not include any information on potential structural changes throughout the organization. If the Legislature is comfortable shifting the mission of the state correctional system toward rehabilitation, how can it ensure that the changes envisioned in GRP-2 meet this goal?

Ultimately, the Legislature should satisfy itself that (1) there is a clearly defined problem to be addressed by the reorganization plan and (2) the proposed organization will address the problem and enable the state to provide services more efficiently and economically.

TRANSPORTATION FUNDING INSTABILITY CONTINUES

What Are the Implications of the Governor's Budget Proposal for Transportation Programs? Can the Legislature Ensure Continuous Funding for Traffic Congestion Relief Program Projects? What Can the Legislature Do to Stabilize Long-Term Transportation Funding?

Summary

Transportation funding has been limited and uncertain in recent years. The Governor's budget proposals for 2005-06 would further restrict transportation funding and increase uncertainty in the near term. The budget proposes to use $1.5 billion in transportation funding to aid the General Fund. It also changes the repayment conditions for several outstanding transportation loans, thereby reducing the General Fund's commitment to repay transportation in the near term. These proposals would particularly affect the Traffic Congestion Relief Program (TCRP). We recommend that the administration provide information to the Legislature that would allow it to determine (1) the effect of the Governor's proposals on the size of the transportation program and (2) TCRP project funding requirements in 2005-06.

The administration also proposes changing the State Constitution to protect transportation funding in the long run by preventing future suspensions of Proposition 42. This would increase transportation funding stability at the expense of the General Fund, although transportation funding uncertainties would remain. We have previously recommended a means for stabilizing transportation funding without affecting the General Fund.

INTRODUCTION

California's state transportation programs are funded by a variety of sources, including special funds, federal funds, and general obligation bonds. Two special funds—the State Highway Account (SHA) and the Public Transportation Account (PTA)—have traditionally provided the majority of ongoing state revenues for transportation. Additionally, in 2000, the Legislature enacted the Traffic Congestion Relief Program (TCRP), which created a six-year funding plan for state and local transportation needs. Later statutes have delayed much of the funding for this program, so that funding for TCRP projects now extends through 2008-09.

The TCRP is funded by two sources—the Traffic Congestion Relief Fund (TCRF) and the Transportation Investment Fund (TIF)—from a combination of General Fund revenues (one-time) and ongoing revenues from the sales tax on gasoline. In March 2002, voters passed Proposition 42, which permanently extended the transfer of gasoline sales tax revenues into the TIF and dedicated the funds to various transportation programs. These programs include local street and road improvement, the State Transportation Improvement Program (STIP), State Transit Assistance, and other mass transportation activities funded by the Department of Transportation (Caltrans).

The STIP. The state's primary program for the construction of new transportation projects is the STIP. Funding comes primarily from the SHA and federal funds. In addition, under Proposition 42, a portion of TIF money will annually be made available for the STIP. Each even-numbered year, the California Transportation Commission (CTC) programs new projects to receive STIP funding based on an estimate of the funds available over the next five years. Statute allows Caltrans to spend 25 percent of the available STIP funds on interregional transportation improvements, with the remaining 75 percent going to designated regional transportation planning agencies for regional transportation improvements. The regional funding is further allocated to counties based on statutory formula.

The TCRP. The TCRP is the second major project construction program. It mainly consists of 141 statutorily-defined projects located throughout the state, with each project receiving a specified amount of money. Collectively, TCRP projects are to receive about $4.9 billion through 2008-09 from the General Fund and the sales tax on gasoline. Through 2004-05, they will have received about $680 million from these sources, in addition to loans from other transportation accounts. Because TCRP does not provide full funding for all of the projects, many of them are funded from multiple sources, including STIP money.

In addition to funding specified projects, TCRP also provides funding for STIP projects, local street and road improvements, and mass transportation programs. Including all of these purposes, TCRP was to provide a total of $7.8 billion to transportation through 2005-06.

Funds Redirected. In the past four years, funds designated for transportation have been redirected annually to help the General Fund. The 2005-06 budget continues this practice. The repeated diversion of transportation funds, while helping the General Fund condition, raises a number of issues regarding the predictability and adequacy of future transportation funding. In the following three sections, we describe the administration's proposals regarding transportation funding, explain the state of transportation funding over the past few years, and discuss the implications of the administration's proposals for transportation funding in both the near and the long term.

BUDGET PROPOSES CONTINUED TRANSPORTATION AID TO GENERAL FUND

The 2005-06 budget includes a number of proposals that will affect transportation funding not only in 2005-06, but also in future years.

First, the budget proposes to use transportation funds to provide $1.5 billion in aid to the General Fund in the budget year.

Second, the budget anticipates tribal gaming bonds repaying in the budget year some transportation loans that were scheduled to be repaid in the current year.

Third, the administration proposes to increase the stability of transportation funding in the long run by prohibiting the suspension of Proposition 42 transfers to transportation beginning in 2007-08. However, it also proposes to delay certain loan repayments to transportation in future years.

As Figure 1 (see next page) shows, the administration's proposals, when added to previous actions taken to aid the General Fund, would result in transportation loans and transfers to the General Fund totaling $4 billion by the end of the budget year. We discuss the details of the Governor's proposals in the following sections.

Figure 1

Major Transportation Loans and Transfers to General Fund, Including Governor's Proposals

(In Millions)

	Proposition 42/ TIF	Spillover	TCRF	Totals
2001-02	—	—	$238	$238
2002-03	—	—	1,145	$1,145
2003-04	$868	$87	—	$955
2004-05	1,243	268	-183	$1,328
2005-06	1,310	216	-1,200[a]	$326
Totals	**$3,421**	**$571**	**—**	**$3,992**

[a] Loan payment amount does not include interest.

Budget Proposes $1.5 Billion to Aid General Fund

Proposition 42 Suspension to Provide $1.3 Billion for General Fund. Proposition 42 provides that all sales tax revenues on gasoline that would otherwise be deposited in the General Fund shall be used for specified transportation purposes beginning in 2003-04. However, the transfer of this money to transportation can be suspended under certain circumstances. Proposition 42 was partially suspended in 2003-04 and fully suspended in the current year.

The budget proposes to again suspend the Proposition 42 transfer in 2005-06. This would be the third suspension, in whole or in part, in the first three years of the proposition's existence. The budget estimates that the suspension would save the General Fund $1.3 billion. As Figure 1 shows, when added to the previous suspensions, this action would result in the General Fund retaining a total of $3.4 billion over three years that would otherwise have been available to transportation.

Under current law, the current-year and prior-year suspensions must be repaid to transportation in 2007-08 and 2008-09, respectively. The administration proposes that the amount to be suspended for 2005-06 also be repaid under certain conditions. However, the administration proposes to delay the repayment for all the outstanding Proposition 42 suspensions, as described later.

"Spillover" Transfer to Provide $216 Million. Current law provides that, in years in which revenue from the sales tax on gasoline and diesel fuel is relatively high and revenue from the sales tax on all other goods is relatively low, some of the sales tax that would otherwise go to the General Fund is to be transferred to the PTA. This is known as spillover. Under current law, spillover transfers to PTA would have occurred in 2003-04 and 2004-05, and would again occur in the budget year. However, statute has been changed in each of the past two years to prevent the spillover transfer to PTA. The administration again proposes to retain the spillover in the General Fund in the budget year. The Governor's budget estimates this amount to be $216 million. As Figure 1 indicates, from 2003-04 through 2005-06, spillover revenue retained in the General Fund will total about $570 million if the administration's proposal is implemented.

Tribal Gaming Bonds Deferred to Budget Year

Gaming Compacts Were to Provide $1.2 Billion for Transportation in Current Year. As Figure 1 shows, $1.4 billion was loaned from the TCRF to the General Fund in 2001-02 and 2002-03 combined. Current statute requires repayment of these loans by the end of the budget year. The 2004-05 budget repaid $183 million of the loan from the General Fund and provided repayment of the remaining $1.2 billion from bonds backed by revenue from newly negotiated tribal gaming compacts. Chapter 91, Statutes of 2004 (AB 687, Nuñez), specified how the bond revenue would be distributed among various transportation programs.

Bonds Delayed by Litigation, Budget Assumes 2005-06 Repayment. Due to an ongoing lawsuit that challenges the bonds' legality, the state has not been able to issue the tribal gaming bonds to date. The budget now assumes that the sale of the bonds will occur in the budget year, rather than in the current year. In order to eliminate any General Fund liability to repay the TCRF loans by the June 30, 2006 deadline, the administration is proposing a trailer bill to make the loan repayment explicitly contingent on receipt of the tribal gaming bond proceeds. This means that repayment will only occur after the bonds are issued, and the General Fund would no longer be liable for repaying any portion of the $1.2 billion.

Proposition 42 Protected in Future, But Repayments Delayed

Constitutional Amendment Would Prevent Future Suspension. While the budget proposes suspending Proposition 42 in the budget year, the administration also proposes to prevent suspension of Proposition 42 permanently, after 2006-07. Specifically, the administration proposes to amend the State Constitution to delete the language that provides for suspension, effective 2007-08. This would allow Proposition 42 to be suspended again in 2006-07 if the General Fund condition warrants.

Repayments of Previous Suspensions to Be Spread Over 15 Years. As stated earlier, under current law, the suspended Proposition 42 amounts for 2003-04 and 2004-05 ($868 million and $1.2 billion, respectively) are to be repaid by 2007-08 and 2008-09. These repayments would total $2.1 billion plus interest. In order to reduce the near-term pressure on the General Fund, the administration proposes to spread the repayment of these loans over 15 years. The administration proposes to repay the 2005-06 Proposition 42 suspension in the same manner and, if it occurs, the 2006-07 suspension as well. This means that instead of transportation programs receiving large lump-sum repayments in specified years, they would receive around $320 million per year for 15 years. Also, the Governor's proposal contains no provision for the payment of interest on these repayments, which would reduce the total amount provided to transportation by hundreds of millions of dollars.

State Transportation Funding Is Already Limited and Uncertain

State transportation funding has been limited in recent years due to several factors. These factors have reduced the state's allocations of funding for new projects. As a result, some transportation needs are now being met through borrowing. In addition, some actions taken in the 2004-05 budget, discussed in more detail below, have increased uncertainty for transportation funding in the near term.

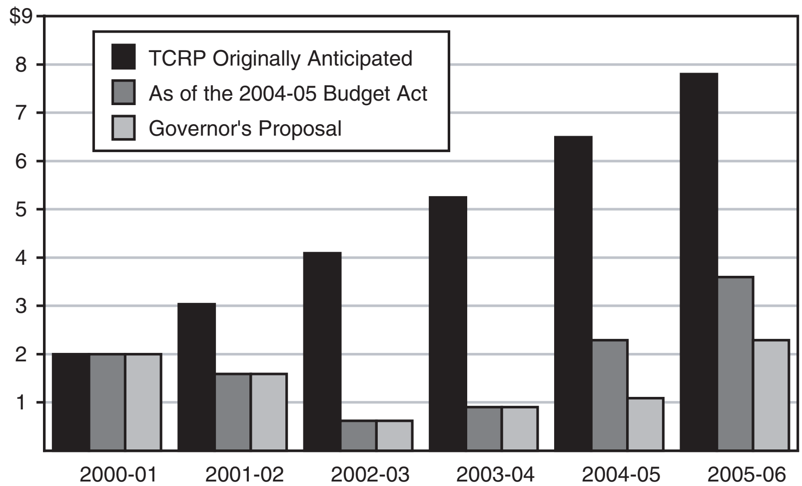
Several Factors Have Limited Transportation Funding

General Fund Money for Transportation Has Not Materialized. The TCRP was enacted in 2000 to invest more General Fund money in transportation. As Figure 2 shows, as originally envisioned, it would have provided about $7.8 billion to transportation by the time the program was to expire in 2005-06. (This includes $4.9 billion for TCRP projects, with the remaining $2.9 billion divided among STIP projects, local street and road improvements, and mass transportation programs.) However, with the actions taken in past budgets and proposed in the Governor's budget, the cumulative amount of General Fund money made available to transportation through the budget year will only be $2.3 billion, assuming that the tribal gaming bond revenue is received in the budget year. About $1.7 billion of this amount would be for specific projects and about $600 million for other transportation purposes. This is $5.5 billion less than envisioned in the original statute.

Figure 2

Traffic Congestion Relief Program Cumulative General Fund Support

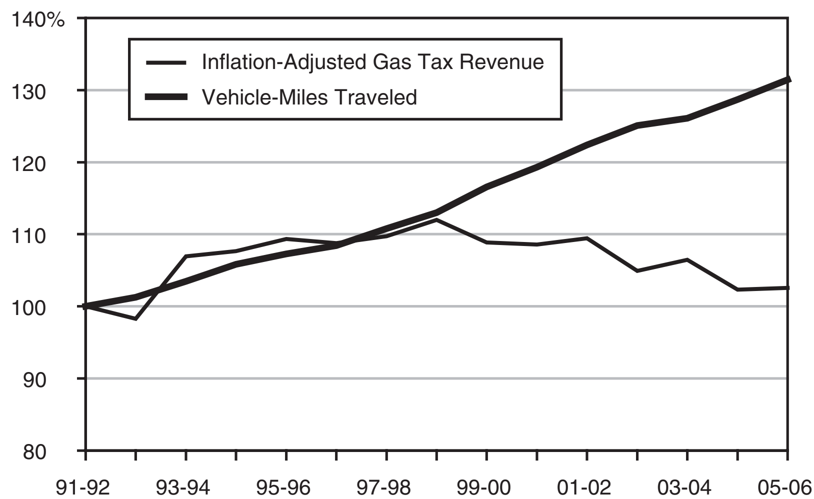
(In Billions)



Gas Tax Has Lost Value as Travel Has Increased. The number of miles driven on California roads has steadily increased over the past decade. As Figure 3 (see next page) indicates, vehicle-miles traveled on all California roads increased 20 percent between 1991-92 and 2001-02. This trend is projected to accelerate through the budget year, with vehicle-miles traveled expected to be over 30 percent higher in 2005-06 than in 1991-92. However, revenue from the state's primary transportation fund source—namely, the excise tax on gasoline and diesel fuel—has not kept pace with this trend. Figure 3 shows that revenues from this tax roughly kept pace with miles traveled throughout the 1990s, as the tax rate was gradually increased in that period from 9 cents to 18 cents per gallon. From 1998-99 through 2005-06, however, inflation-adjusted state gas tax revenues are projected to decline 8 percent while vehicle-miles traveled increase by more than 16 percent. The decline in the real value of the gas tax means that the costs of the things the gas tax is used to buy are increasing faster than the gas tax revenue. Thus, even though the state is nominally receiving more dollars from the gas tax each year, current revenue can buy fewer transportation projects than the revenue received in 1998-99.

Figure 3

Real Gas Tax Revenues Have Not Kept Pace With Road Use



Other Funding Sources Have Experienced Temporary Decline. Other transportation funding sources have experienced a one-time decline. These are truck weight fees and federal fuel taxes.

Truck weight fees are a major source of revenue to the SHA. As we discussed in the *Analysis of the 2003-04 Budget Bill*, weight fee revenues declined sharply in 2002-03 following the passage of Chapter 861, Statutes of 2000 (SB 2084, Polanco), which changed how truck weight fees are collected. Although the change was intended to be "revenue neutral," weight fee revenues in 2002-03 were $124 million lower than anticipated prior to the change. Chapter 719, Statutes of 2003 (SB 1055, Committee on Budget), subsequently increased weight fees as of January 1, 2004 to correct the decline. Nonetheless, a total of $223 million in revenue that had been programmed for projects was lost.

Federal gas tax receipts have also experienced a one-time decline. The decline is due to the state's conversion from fuel blended with MTBE to an ethanol blend. At the time the state converted to ethanol-based fuel, that fuel was taxed at a lower rate than nonethanol fuel under federal law. The 2004 STIP projected that the lower tax rate would result in California receiving about $560 million less in federal transportation revenues in 2005-06 and over $700 million less in each year after that. Fortunately, the federal law was amended to make the tax on ethanol-blended fuel equal to the tax on fuel without ethanol. With this change, the impact of ethanol conversion on the amount of federal funding to the state was limited to a one-time decline of about $560 million in the budget year.

Reduced Funding Has Reduced Allocations, Precipitated More Borrowing. Because expected transportation funding did not materialize, CTC temporarily stopped all allocations for new capital projects in December 2002. This included both STIP and TCRP projects, as well as projects in the State Highway Operation and Protection Program (SHOPP), which funds capital projects that improve the state highway system without expanding capacity. Since that time, CTC has resumed making new allocations, but at a reduced level. The CTC will likely have allocated about $600 million for new STIP projects and $1.5 billion for new SHOPP projects, with no new TCRP allocations, between December 2002 and the end of the current year—a two and one-half year period. By way of comparison, CTC typically allocates more than $2 billion annually for STIP and SHOPP projects alone.

Without a state funding allocation, a project that is ready to begin a new phase of work is unable to continue unless the regional or local agency can come up with alternative funding. As a result, a backlog of "ready-to-go" projects has developed. The CTC reports that, as of June 2004, the backlog of STIP and SHOPP projects totaled $800 million, and could grow to $1.3 billion by June 2005 if new allocations remain largely suspended. Similarly, $314 million worth of TCRP projects were ready to go by December 2004 but were held back due to a lack of funding. The CTC's staff have advised us that these figures are actually understated, as project sponsors have little incentive to request funding for additional projects that have no prospect of being funded in the near term. Thus, CTC does not have a complete list of the specific projects that have been delayed.

To minimize project delays, some projects have proceeded with money borrowed from other sources. For example, several local transportation agencies have proceeded with projects using their own funding under laws that allow them to be reimbursed from the state, should funds become available. In this way, local agencies have begun work on $455 million worth of STIP projects and $269 million worth of TCRP projects that would otherwise have to wait for state funding to be available. However, to proceed with these projects, local agencies are using money that could have otherwise been used for other transportation projects. Thus, while advancing projects using local funding reduces the effect of funding shortfalls on the STIP and TCRP, this practice simply spreads the effect of the shortfalls to other areas of transportation.

The state has also borrowed money to advance certain projects. Federal legislation allows states to issue Grant Anticipation Revenue Vehicle

(GARVEE) bonds, which are repaid with future federal transportation revenue. In January 2004, CTC approved the issuance of GARVEE bonds for eight STIP projects worth $658 million. These bonds are accelerating some transportation projects, but they will reduce the funding available for other projects for the 12-year duration of the debt service.

Unresolved Current-Year Issues Create Additional Uncertainty

In addition to the issues mentioned above that limit and destabilize transportation funding, additional actions taken in the 2004-05 budget to aid the General Fund have added uncertainty to the state's transportation funding.

Diversion of Non-Article XIX Funding in Question. The *2004-05 Budget Act* transferred to the General Fund $108 million in miscellaneous revenue that would otherwise go to the PTA. The money was to be used to pay part of the debt service on general obligation bonds that the state has issued for transportation purposes. This revenue, which includes $96 million in income from the rental and sale of state property, is not restricted by Article XIX of the State Constitution to be used exclusively for transportation.

However, some of the properties that generated the sale and rental revenue were purchased with federal transportation funds. The Federal Highway Administration (FHWA) has informed the state that revenue from those properties may not be transferred to the state's General Fund under federal law, even if it is used for debt service payments on transportation bonds. According to FHWA, if this money were transferred to the General Fund, the state would have to repay the federal government the entire amount of federal funds that were used to purchase the properties, which could be many times the amount of revenue to be transferred.

Because Caltrans has not been able to determine the type of funds that were used to purchase each property, it cannot determine what portion of the $96 million is at issue. Therefore, it has not transferred this revenue to the General Fund because of the FHWA decision. The administration is attempting to resolve its difference of opinion on this matter with FHWA. However, until the issue is resolved, none of the $96 million can be transferred to help the General Fund. At the same time, the money cannot be used for transportation purposes.

Tribal Gaming Bonds Will Likely Provide Less Money. As mentioned earlier, the administration expects that the tribal gaming bonds will not be issued until 2005-06 to repay a $1.2 billion transportation loan. However, even if the bonds can be issued, the total amount would most likely be lower than $1.2 billion. This is because, according to the Department of Finance (DOF), gaming revenue generated from the five compacts that are the source of this funding would provide no more than $1 billion in bonding capacity. Furthermore, the State Treasurer has indicated that these bonds will be more expensive to sell than the administration first assumed, reducing the amount of bonding capacity to around $850 million.

Thus, unless similar compacts are negotiated with additional tribes in the current or budget years and the lawsuit is resolved favorably, the transportation community should not expect to receive the amount of money assumed in the Governor's budget.

GOVERNOR'S PROPOSALS RAISE FURTHER TRANSPORTATION ISSUES

The administration's 2005-06 proposals to use transportation funding to aid the General Fund will further constrain near-term funding of transportation programs and increase program uncertainties in the short term. Over the long run, the proposal to prohibit the suspension of Proposition 42 transfers to transportation would provide added stability at the expense of the General Fund. However, another component of the administration's proposal to reform the state budget, namely the across-the-board reduction provisions, could lessen that stability and increase the volatility of Proposition 42 funding.

Proposals Further Constrain Near-Term Transportation Funding

Proposals Would Remove Funds From Several Programs. Figure 4 (see next page) summarizes the programmatic impact of the Governor's budget-year proposals. As the figure shows, the largest effect would be a reduction of $678 million for TCRP projects, due to the suspension of Proposition 42. The suspension would also reduce funding for local street and road improvements, STIP projects, and mass transit programs. Additionally, mass transit programs and certain STIP projects (namely, transit and rail capital improvements) would also lose money due to the proposed retention of spillover money in the General Fund, instead of being transferred to the PTA.

Allocations for New Projects Would Have to Be Reduced. Caltrans estimated that if transportation were to receive $1.2 billion from the tribal gaming bonds and Proposition 42 were not suspended in the budget year or the following years, over $3 billion could be allocated in 2005-06 for new STIP and SHOPP projects. The CTC would also be able to restart allocations for new TCRP projects, which have been suspended since December 2002. However, with the Governor's proposal for 2005-06 and suspension of Proposition 42 uncertain (but highly likely) in 2006-07, the level of project funding in 2005-06 would be greatly curtailed.

Figure 4

Budget-Year Impact of Governor's Transportation Proposals

(In Millions)

Program	Impact
Traffic Congestion Relief Program	-$678
Local street and road improvements	-253
State Transportation Improvement Program	-253
State Transit Assistance	-171
Other mass transit programs	-171
Total	**-$1,526**

Slower Loan Repayment Would Further Delay Projects. The impact on project funding would be compounded if the repayment of the loans due in 2007-08 and 2008-09 ($2.1 billion plus interest) were instead spread over 15 years as proposed. This is because projects typically take several years to expend their allocations, so that allocations made in one year depend not only on funding available in that year, but subsequent years as well. Thus, the less money that is available in the next few years, the less funds CTC will be able to allocate.

Analyst's Recommendation. At the time this analysis was prepared, Caltrans had not estimated how much further near-term allocations for STIP, SHOPP, and TCRP would have to be reduced by spreading repayment of Proposition 42 suspensions over 15 years. The expected level of allocations will in turn drive the size of Caltrans' capital outlay support budget in the budget year. As we discuss in our Caltrans budget analysis, Caltrans will revise its capital outlay support budget request in May 2005.

The Legislature would benefit from having a better understanding of the effect of the Governor's proposals on STIP, SHOPP, and TCRP allocations relative to other possible funding scenarios, as well as having a basis from which to evaluate Caltrans' capital outlay support request in the spring. Therefore, we recommend that Caltrans, in coordination with CTC, provide the Legislature by April 1 with an updated projection of near-term allocations under several different scenarios, including:

- ***Best Case.*** Assume no Proposition 42 suspension after the current year, repayment of the full TCRF loan (by tribal gaming bonds) in the budget year, and repayment of previous Proposition 42 suspensions per current law.

- ***Governor's Proposal Assuming Gaming Bond Revenue.*** Assume Proposition 42 suspension in 2005-06 and 2006-07 only, repayment of the full TCRF loan in the budget year, and repayment of all Proposition 42 suspensions over 15 years.
- ***Governor's Proposal Assuming No Gaming Bond Revenue.*** Assume Proposition 42 suspension in 2005-06 and 2006-07 only, no repayment of the TCRF loan, and repayment of all Proposition 42 suspensions over 15 years.
- ***Worst Case.*** Assume continued Proposition 42 suspension in every year through 2008-09, no repayment of the TCRF loan, and no repayment of any Proposition 42 suspensions.

Budget-Year Funding for TCRP Is Uncertain

Temporary TCRP Shutdown Should Be Avoided. The TCRP relies on Proposition 42 transfers and repayment of past loans to the General Fund for continued program funding. Absent these funds, work on TCRP projects would have to stop unless local agencies were able to use more of their money to continue work on these projects. Stopping work on projects would result in the state incurring extra costs in order to close out contracts for ongoing work. While this extra expense would be unavoidable if the state intended to shut down the program permanently, it would not make sense to incur closeout costs if TCRP funding were going to be provided in the future.

Even though Proposition 42 transfers were suspended in 2003-04 (partially) and the current year (wholly), the Legislature continued the program by requiring that suspended amounts be repaid in future years. To avoid incurring closeout costs, the Legislature provided sufficient funding in each of the past two years to allow TCRP projects that had already received allocations from CTC to continue. If the Legislature intends to fund TCRP in the future, it should ensure that it provides enough funding in the budget year to continue work on projects with existing allocations.

Receipt of Tribal Gaming Bond Revenue Is Uncertain. Of the amount anticipated from tribal gaming bonds, $290 million would be for TCRP projects. If the tribal gaming bonds are sold as anticipated by the Governor's budget, there will be enough funding available to continue work on TCRP projects that already have allocations. However, if the bonds cannot be sold for reasons discussed earlier, the Legislature may have to provide additional funding so that projects with existing allocations can continue in 2005-06 without work stoppage.

TCRP Budget Display Is Incorrect; Administration Intends to Revise. In order to ensure that sufficient funding is available for TCRP projects in the budget year, the Legislature needs to know how much program expenditures are expected to be in the current and budget years, as well as the balance in the TCRF. Unfortunately, the administration has confirmed that information presented in the Governor's budget for TCRF is incorrect. For instance, the budget shows no capital outlay or local assistance expenditures from TCRF in the current year, but $343 million for such expenditures in the budget year. The DOF now indicates that $269 million of the expenditures shown in the budget year are actually expected to occur in the current year. The DOF indicates that it plans to make the appropriate revisions to the Governor's budget in April.

Even Corrected Expenditures Are Out of Date; CTC and Caltrans Should Update. Our review shows that adjusting for the errors in the budget display alone would not provide an accurate picture of the condition of TCRF and thus, how much is available to fund projects in 2005-06. This is because, according to Caltrans, the current-year and budget-year expenditure levels shown in the budget are based on information that has not been updated since April 2004, and actual TCRP project expenditures could be very different from those assumed last year. Recognizing this, Caltrans and CTC have started to survey all TCRP project sponsors to update project expenditures. Without this information, the Legislature cannot determine the amount of funding that will be required to continue work on ongoing TCRP projects. We recommend that the Legislature direct CTC and Caltrans to provide the survey results to the Legislature by April 1, 2005. Based on this information, and pending DOF's revision to the TCRF condition in the budget, the Legislature can determine how much additional funding is needed in the budget year to continue work on TCRP projects with existing allocations or to provide funding to new projects.

Long-Term Funding Stability Is Still Paramount

As we stated in our *Analysis of the 2004-05 Governor's Budget*, funding stability is of paramount importance to transportation. Uncertainty in funding for transportation projects makes long-term planning difficult and results in money being wasted due to stopping and restarting projects. Unfortunately, transportation funding remains unstable due to several factors, which we have discussed in this analysis. The Governor's budget adds to this uncertainty in the near term while proposing to address the primary source of instability—Proposition 42—in the long term.

Uncertain Funding Delays Projects, Causes Waste. Large transportation projects typically take years to complete. If a transportation project is begun without sufficient funding available to complete it, it may need to be stopped and restarted, wasting time and money. If the project is only in its early stages and work is being performed by Caltrans staff, then project work can stop with potentially minimal cost impact. If work under contract has to cease before the contract is complete, however, there could be financial penalties to the state to stop work. This problem is exacerbated if the project is under construction, as there would likely be additional costs to bring the partially completed project to a state in which it can safely be left unattended for an indefinite period of time. In order to avoid situations such as these, the state funds transportation projects based on a long-term projection of available funding.

Funding Uncertainties Remain. Unfortunately, transportation funding has fluctuated greatly in recent years, as described earlier. Several uncertainties remain for transportation funding in the near future. For example:

- ***Proposition 42 Revenue Is Not Guaranteed.*** The largest uncertainty for long-term transportation funding in California is how much money to expect from Proposition 42. The ability to suspend the transfer of Proposition 42 funds to transportation on an annual basis, combined with the General Fund's ongoing funding problems, calls into question future scheduled transfers and makes long-term planning based on this funding source impossible.
- ***Toll Bridge Seismic Cost Increases May Affect STIP.*** Yet another uncertainty for future STIP funding is the cost of toll bridge seismic retrofit projects. As we mention in our write-up on this topic, the state must find several billion dollars in additional funding for the seismic retrofit of toll bridges. One option to provide the money is to use existing state transportation funding sources. Doing so, however, would reduce available funding for STIP projects. (Please see *"Toll Bridge Seismic Retrofit: Hard Decisions Before the Legislature"* in this section.)
- ***Federal Funding Level After Reauthorization Is Uncertain.*** The federal government reauthorizes transportation funding on a six-year cycle. Congress, however, did not reauthorize the federal act when it expired in October 2003, and it has yet to do so to date. Instead, it has extended transportation funding at the existing level several times, with the latest extension set to expire in May 2005. While the reauthorization seems certain to increase federal transportation funding, the amount and timing of the increase are uncertain.

Governor Proposes to Add Stability to Transportation Funding at Expense of General Fund, But Uncertainties Remain. The administration's proposal to remove the ability to suspend Proposition 42 beginning in 2007-08 would remove the primary source of uncertainty for transportation funding and allow more projects to be completed more quickly than if Proposition 42 could continue to be suspended.

Our review, however, shows that the proposal may not eliminate all uncertainties. This is because the Governor is also proposing various measures to reform the state budget, including a measure that calls for automatic across-the-board reductions in General Fund expenditures during a fiscal year under specified conditions. If this proposal is adopted, Proposition 42 funding could be subject to unplanned fluctuations. This is because Proposition 42 transfers to transportation are counted as General Fund expenditures and would be subject to any across-the-board reductions in a fiscal year. This could, depending on the magnitude of the required reduction, create unanticipated volatility in the funding of transportation projects and make long-term planning more difficult.

At the same time, the Governor's proposal reduces policymakers' discretion to set expenditure priorities for General Fund money. By requiring the Proposition 42 transfer to transportation under any circumstance, the Governor's proposal permanently increases General Fund expenditures and removes an option to address General Fund shortfalls.

LAO's Recommendation Would Stabilize Funding Without Affecting General Fund. In our discussion of transportation funding in the *2004-05 Analysis*, we recommended an alternative means of stabilizing transportation funding that would not require transferring money from the General Fund. Our recommendation was to repeal Proposition 42, raise the gas tax by six cents per gallon, and adjust the gas tax for inflation in future years. These actions would provide about the same amount of money to transportation as Proposition 42 while freeing General Fund revenues to be used for nontransportation purposes. Additionally, because gasoline tax revenue is restricted by the State Constitution to be used for transportation only, it would not be subject to uncertainties created by fluctuations in the state's fiscal condition. (Please see the *2004-05 Analysis* for more details.)

CONCLUSION

Transportation funding has been limited and uncertain in recent years due to several factors, including actions taken in the *2004-05 Budget Act* that have not produced the expected results.

The Governor's budget proposals would further restrict transportation funding and increase uncertainty in the near term. The TCRP would be particularly affected, and it is uncertain whether there will be sufficient funding in the budget year to continue work on TCRP projects. We recommend that the administration provide information to the Legislature that would allow it to determine (1) the effect of the Governor's proposals on the size of the transportation program and (2) TCRP project funding needs in 2005-06.

The proposed protection of Proposition 42 in the future would increase transportation funding stability at the expense of the General Fund, though funding uncertainties will remain. We have previously recommended a means of stabilizing transportation funding without affecting the General Fund.

TOLL BRIDGE SEISMIC RETROFIT: HARD DECISIONS BEFORE THE LEGISLATURE

Should the Legislature Approve the Administration's Proposed Redesign for the East Span of the San Francisco-Oakland Bay Bridge? How Should the Toll Bridge Seismic Retrofit Program Be Funded?

Summary

The administration recently estimated that Caltrans' toll bridge seismic retrofit program will require an additional $3.2 billion to complete and has recommended changing the design of the east span of the Bay Bridge to save money. The Legislature faces two key decisions: (1) whether to approve a redesign of the Bay Bridge east span and (2) how to fund the program's completion.

Redesigning the Bay Bridge could save money, but also raises the risk of cost and schedule increases that could more than offset the savings. While no amount of information will allow the Legislature to be certain that any one design is the "correct" choice, additional information would help to ensure that policymakers are not misled by seemingly precise bridge cost estimates.

We believe that funding for the program should be shared between state and local sources, consistent with current practice. The Legislature has several options for the sources used and the amount to provide from each. The Legislature could also create a cost control incentive by requiring that any future cost overruns be taken from Caltrans' transportation construction programs.

Finally, the Legislature should hold the administration accountable for delivering the program by adopting the Bureau of State Audits' reporting recommendations and holding periodic hearings.

In August 2004, the administration estimated that the total cost to seismically retrofit seven state-owned toll bridges would be $8.3 billion, including $900 million in funding for contingencies. This amount is $3.2 billion more than the total funding provided for the program to date. Most of the cost increase is associated with the rebuilding of the east span of the San Francisco-Oakland Bay Bridge (Bay Bridge). In order to reduce total costs, the administration reexamined various design options and recommended to the Legislature in December 2004 that the bridge design be changed from the current self-anchored suspension (SAS) bridge to a viaduct (or "skyway") with no tower.

This report first provides a brief history of the Department of Transportation's (Caltrans') toll bridge seismic retrofit program. It then (1) explains the current status of the program and the administration's proposal to complete it, (2) discusses several factors the Legislature should consider when deciding whether to redesign the Bay Bridge, and (3) identifies the key options available to the Legislature for funding the program.

A History of Delays and Cost Increases

Cost overruns and delays in the toll bridge seismic retrofit program are not a new phenomenon. Estimated total costs for the program increased more than seven-fold between 1996, when dedicated funding was first set aside for the program, and 2001. Estimated completion dates for the most complicated work are also now significantly later than originally projected. As the total cost of the program has grown, state law has been changed repeatedly to authorize more funding for the program. Figure 1 lists the main features of the toll bridge seismic retrofit funding legislation over time. These statutes are further detailed in the brief history that follows.

Earthquakes Highlight Bridge Deficiencies

After the Loma Prieta earthquake in October 1989, Caltrans expanded its previously limited efforts to retrofit highway bridges into a statewide bridge seismic retrofit program. The new program called for retrofitting 1,039 of the most seismically vulnerable of the state's 12,000 highway bridges. Caltrans later termed these the "Phase I" bridges. In addition, Caltrans determined that seven of the nine state-owned toll bridges needed retrofitting. These seven bridges are listed in Figure 2. Two other state-owned toll bridges, the Antioch and Dumbarton bridges, were determined not to need retrofitting. (Because the Golden Gate Bridge is not owned by the state, the state is not responsible for the seismic retrofit of that bridge.)

Figure 1

Major Features of Toll Bridge Funding Legislation

Year	Statute	Features
1996	Proposition 192	• Authorized $2 billion in general obligation bonds to fund bridge seismic retrofit, including $650 million for toll bridges. • Stated that all toll bridge seismic retrofit costs were to be funded with bonds, with no contribution from state funds or tolls.
1997	SB 60 and SB 226 (Kopp)	• Provided total authorization of $2.6 billion for toll bridge seismic retrofit from three sources (Proposition 192, state transportation funds, and increase in tolls). • Implemented a "seismic surcharge," increasing Bay Area bridge tolls from $1 to $2 for up to ten years. • Created the Bay Area Toll Authority to administer toll funds.
2001	AB 1171 (Dutra)	• Provided total authorization of $5.1 billion (primarily from extension of $1 toll increase) for toll bridge seismic retrofit, including $448 million in overrun authority. • Extended seismic surcharge to January 1, 2038.

Figure 2

Bridges in Toll Bridge Seismic Retrofit Program

San Francisco Bay Area

- San Francisco-Oakland Bay Bridge
- Richmond-San Rafael Bridge
- San Mateo-Hayward Bridge
- Benicia-Martinez Bridge
- Carquinez Bridge

Southern California

- San Diego-Coronado Bridge[a]
- Vincent Thomas Bridge[a]

[a] Toll collection has been discontinued on these two bridges.

While work on the Phase I bridges and study of the retrofit options for the toll bridges were underway, the Northridge earthquake struck Southern California in January 1994. This prompted Caltrans to expand its retrofit program to an additional 1,155 bridges throughout the state, which became known as the "Phase II" bridges. However, there was no dedicated funding source identified for bridge seismic retrofit programs. Rather, work on the Phase I, Phase II, and toll bridges was funded primarily with federal transportation funds that Caltrans could otherwise have used for non-seismic retrofit projects.

Proposition 192 Provided $2 Billion in Bond Funds for Seismic Retrofit. In order to relieve the pressure on transportation funding, the Legislature and administration placed on the March 1996 ballot Proposition 192, which the voters passed. Proposition 192 authorized the issuance of $2 billion in general obligation bonds for the seismic retrofit program, including $650 million for toll bridge seismic retrofit and $1.35 billion for the Phase II bridges. Phase I bridges were still to be funded from existing funding sources, but the Proposition 192 bonds were expected to cover the full costs of both Phase II and the toll bridges. However, later that same year, Caltrans reported that the estimated cost of retrofitting the Bay Bridge alone had jumped above $1 billion, thus exceeding the total toll bridge funding level provided by Proposition 192.

Replacement, Not Retrofit

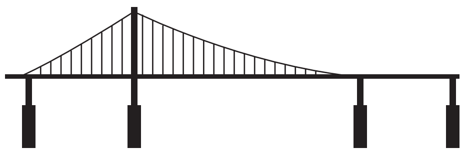
In February 1997, following recommendations from Caltrans and two review committees, the administration decided to replace, rather than retrofit, the east span of the Bay Bridge (from Oakland to Yerba Buena Island). This decision was based on estimates that a retrofit of the existing span would cost about $1 billion and that a new span, while it could be somewhat more expensive than a retrofit, would be safer as well as cheaper and easier to maintain.

Bay Area Chose SAS Design for Replacement Bridge. The administration recommended that the replacement bridge be a viaduct with no tower, commonly known as a skyway design. However, the Metropolitan Transportation Commission (MTC)—the Bay Area's transportation planning agency—was given the option to choose a more expensive, "signature" design, as long as the Bay Area paid for the additional cost. After evaluating a cable-stayed design and a SAS design, the MTC decided on the SAS design in June 1998. The features of the three primary types of design under consideration are detailed in Figure 3. It should be noted that even the SAS as currently designed has a viaduct—or skyway—portion.

Figure 3

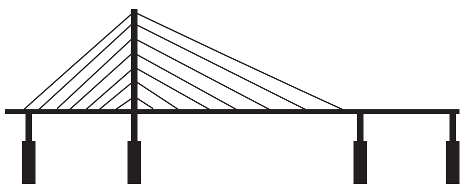
East Span of Bay Bridge Designs Under Consideration

Self-Anchored Suspension (SAS)



- Currently-approved design.
- Few existing examples.
- Most complicated to construct.

Cable-Stayed



- More familiar to builders.
- Simpler to construct than SAS.
- Design and environmental approval not complete.

Skyway

- Easiest to build.
- Does not have a "signature" tower.
- Design and environmental approval not complete.

Funding for Toll Bridge Seismic Retrofit Program Increased to $2.6 Billion. In order to fund the higher costs of the toll bridge seismic retrofit program, Chapters 327 and 328, Statutes of 1997 (SB 60 and SB 226 respectively, Kopp), authorized the expenditure of up to $2.6 billion on the retrofit of all toll bridges, of which $1.3 billion was for the east span of the Bay Bridge. Funding would come from three sources:

- A "seismic surcharge" of $1 extra toll collected on all seven state-owned Bay Area toll bridges for up to ten years would provide up to $907 million, or about one-third of the total cost of the program.
- Another third of the total funding would come from state sources, mainly the State Highway Account (SHA).

- The remainder would be funded by Proposition 192.

Caltrans estimated at the time that all work to retrofit the toll bridges would be complete by 2004.

More Complications, More Delays, More Money

Caltrans Revises Toll Bridge Retrofit Cost to $4.6 Billion. Unfortunately, the schedules estimated in 1997 proved to be optimistic, particularly for the Bay Bridge east span replacement. Other toll bridges also experienced delays as construction work progressed, and all toll bridges were pushed back at least a year from their 1997 estimated schedules.

Project delays in turn pushed costs upward. Caltrans, however, did not reestimate the program's costs until April 2001, when it revised toll bridge retrofit costs upward to $4.6 billion—77 percent higher than the 1997 estimate.

Total Funding of $5.1 Billion Provided in 2001. In order to fund these new, higher estimated costs, Chapter 907, Statutes of 2001 (AB 1171, Dutra), was enacted. This statute authorized $5.1 billion in total expenditure authority, including up to $4.6 billion to cover the cost of toll bridge seismic retrofit as estimated by Caltrans, plus an additional $448 million in "overrun" authority if costs should rise even higher. The majority of the increased funding would come from extending the seismic surcharge ($1 extra toll) to January 1, 2038 and allowing the state to bond against this revenue stream to finance the cost of retrofit projects. This would bring tolls' contribution to the seismic retrofit program to $2.3 billion, or about 50 percent of the total costs, not including the overrun authority. At that time, the final work on the Bay Bridge was expected to be complete by 2008.

Bay Bridge Bids Bust Budget

Bids and Costs Repeatedly Higher Than Estimated. The funding level provided by AB 1171 assumed a cost of $2.6 billion for the Bay Bridge east span replacement. However, in December 2001, the low bid for the skyway portion of the east span came in about $300 million higher than Caltrans had estimated, and in May 2004, the lone bid for the SAS portion of the east span replacement exceeded Caltrans' estimate by $700 million. Costs for the Richmond-San Rafael Bridge also turned out to be significantly higher than assumed in AB 1171.

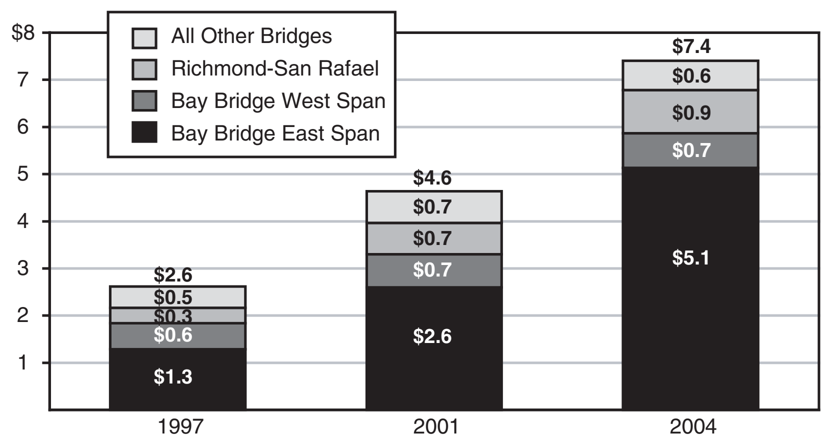
Latest Cost Estimate Ballooned to $8.3 Billion; Completion Due in 2011. With these and other cost increases, Caltrans reported in August 2004 that it would cost $7.4 billion to complete the toll bridge seismic retrofit program. Caltrans also identified an additional $900 million to cover potential future cost overruns. This brought the total cost estimate for the program to $8.3 billion—$3.2 billion more than the level authorized in 2001 by AB 1171. The estimated completion date for the program was again pushed back, to 2011.

Figure 4 compares the latest projected total costs of the toll bridge seismic retrofit program to earlier projections, divided by bridge. As the figure indicates, the majority of the increase in the program's estimated costs over time has been associated with the east span of the Bay Bridge. However, the Richmond-San Rafael Bridge's costs have also significantly increased, growing by $249 million—or 37 percent—since the 2001 estimate in AB 1171.

Figure 4

Caltrans' Toll Bridge Seismic Retrofit Cost Projections[a]

(In Billions)



Detail may not total due to rounding.

[a]Includes cost overrun authority.

Bid for SAS Allowed to Expire. In August 2004, the administration proposed using additional and redirected toll revenues to fund the entire $3.2 billion cost increase for the program. The Legislature rejected the administration's proposal, but did not have sufficient time to resolve the funding issues before it adjourned at the end of August.

In the absence of additional funding for the program, Caltrans allowed the bid for the SAS portion of the east span to expire at the end of September. At the same time, the administration began to re-assess its options for the bridge's design in the hope that another design would be less expensive.

CURRENT STATUS

Expensive Work Remains on Two Bridges

Caltrans has completed seismic retrofit work on five of the seven toll bridges in the seismic retrofit program. At this time, only the Bay Bridge and the Richmond-San Rafael Bridge remain to be completed. Caltrans' latest estimates are that the Richmond-San Rafael Bridge is 80 percent complete and will be finished in 2005. The west span of the Bay Bridge is complete except for the rebuilding of the San Francisco approach to the bridge, which will last through 2008. The Bay Bridge east span has the most work left before completion, and is not likely to be open to traffic before 2012. The viaduct portion of the east span is currently under construction and is projected to be complete in 2007.

Not coincidentally, the bridges that are taking the longest to complete are also the cause of the program's most recent cost overruns. Figure 5 shows the administration's August 2004 estimate of the additional funding required to complete these two bridges, broken down by bridge and, for the Bay Bridge east span, by the major bridge components. The figure shows that the Bay Bridge east span accounts for 77 percent of the additional program costs, with the SAS accounting for 41 percent of the total. Figure 5 also shows that 14 percent of the additional $3.2 billion in estimated costs is for added contingency funding, which cannot be attributed to any specific bridge. Not shown in the figure is the administration's estimate that costs on the other bridges in the program have actually decreased by $48 million from their 2001 estimates.

Administration Now Proposes Skyway Redesign

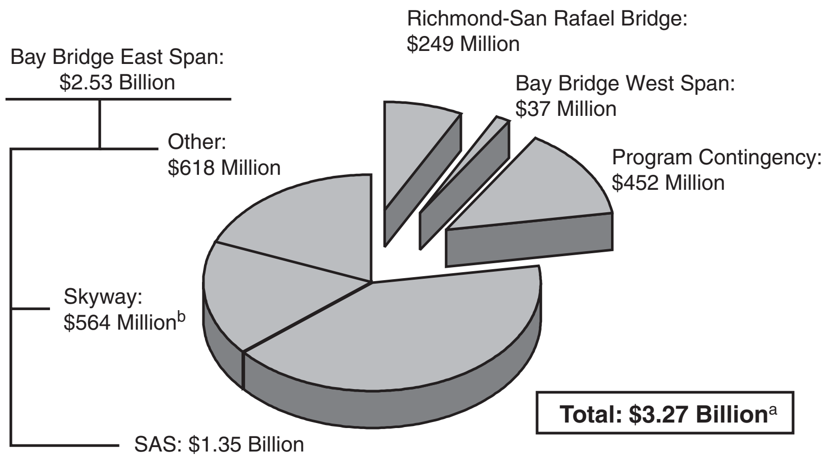
After allowing the bid for the SAS contract to expire, the administration focused its review efforts on three main alternatives (with some variations) for the Bay Bridge east span. These included: rebidding the existing SAS design, redesigning the bridge as a cable-stayed span, and redesigning the bridge as an extended skyway with no tower.

Administration Solicited Input From Multiple Sources. The administration solicited input from multiple sources to assist its efforts to review its bridge design options. These sources included:

- ***Independent Review Team (IRT).*** The IRT, consisting of nine construction industry professionals, examined the technical feasibility of the different design options, including cost and schedule impacts.

Figure 5

Toll Bridge Seismic Retrofit Program Additional Funds Requested



[a] Because of $48 million in cost savings on the other bridges in the program, the administration instead has requested $3.22 billion in additional funding.
[b] Skyway portion of existing SAS design.

- ***Peer Review Team (PRT).*** The PRT was led by the Federal Highway Administration (FHWA) and included FHWA staff, representatives from other states with large transportation projects, academicians, and management consultants. The PRT's goal was to assess the risks associated with each of the alternatives based on input from the IRT, Caltrans, the bridge designer, and a previously-completed report by an outside consultant.

- ***Caltrans.*** Caltrans conducted its own review in addition to those performed by the IRT and PRT. As part of its review, Caltrans consulted with construction, insurance, and design firms, as well as state and federal regulatory agencies and public interest groups.

No Consensus on Redesign Alternative; Administration Recommends Skyway Option. Based on its technical review, the IRT concluded that changing to a cable-stayed design was the most attractive alternative. This is because the IRT found that a cable-stayed bridge could require minimal changes to the already designed SAS foundation, and would require only minor modifications to existing permits. The IRT estimated that the cable-stayed bridge could save the state more than $600 million without delaying completion of the bridge.

Caltrans, however, concluded that the state would not be able to achieve the cost savings identified by the IRT. This is mainly because both the cable-stayed and skyway options were only at the "conceptual" stage, meaning that very little design work had been performed. Because of the uncertainty associated with estimating costs for projects at this early stage of development, Caltrans concluded that it would be appropriate to add a significant amount of contingency funding to the respective cost estimates, thereby reducing the potential cost savings. Additionally, Caltrans noted that altering or canceling other ongoing east span contracts due to a redesign would further increase the cost of a redesign. As a result, Caltrans' first recommendation was to rebid the existing SAS design. However, Caltrans also noted that, while much uncertainty existed for any redesign of the bridge, the skyway design would be simpler to construct than the other options and provided the most potential to save money from the existing SAS design. Therefore, Caltrans also recommended that the state consider pursuing a skyway design.

The PRT did not recommend any one option over the others, but rather estimated the relative risk of cost and schedule growth associated with each option. The PRT concluded that the existing SAS design had the lowest risk of all the options. This remained true even when risk due to lack of public acceptance was excluded from the redesign options, though under this second scenario the skyway design ranked a close second to the SAS.

Based on the input received from these sources, the administration recommended in early December 2004 that the state redesign the Bay Bridge east span as a skyway. However, the administration indicated that it would also continue to prepare the existing SAS design for a rebid. This is a reasonable course of action, as it preserves the Legislature's option to choose to keep the existing bridge design. The administration indicated that it could rebid the SAS in early 2005 if funding were available. However, the administration did not revise its cost estimate for the toll bridge seismic retrofit program.

MAJOR DECISIONS BEFORE THE LEGISLATURE

Legislature Must Make Two Critical Decisions Soon

For the toll bridge seismic retrofit program to move forward, the Legislature must address both the design of the Bay Bridge east span and the funding for the entire toll bridge seismic retrofit program. Since the current SAS design of the east span is specified in statute, the administration cannot pursue a redesign without legislative action. Furthermore, since statute also specifies a funding cap for the program that would not provide sufficient funds to award the contract for either a rebid of the SAS design or a redesigned bridge, additional funding must be identified for the program before bidding that contract.

The Legislature's decision on the bridge design has a direct bearing on when additional funds are required. If the Legislature chooses to retain the SAS design for the east span, funding is needed more quickly than if it decides to redesign the bridge. This is because Caltrans could be ready to rebid the SAS contract in early 2005. The earlier funding is provided, the sooner the SAS contract could be rebid and awarded. If the Legislature chooses to redesign the bridge, that new design would take some time before it would be ready to go to bid. This would allow the Legislature more time to consider the program's funding. In either case, the Legislature must decide on the bridge design as soon as possible.

The following sections detail the options before the Legislature in dealing with these two issues. We first discuss the issue of the design of the Bay Bridge east span. In particular, we note the tradeoffs that the Legislature faces in weighing the potential savings of a redesign against the risk of cost and schedule increases associated with a redesign. We recommend that the Legislature request additional information from Caltrans to assist it in making its design decision.

We then discuss the funding options before the Legislature, noting that there is no analytical basis for determining the proportion of funding that should come from state sources versus local sources. We recommend that funding come from both state and local sources. We further recommend that the toll bridge seismic retrofit program be made more like the state's other transportation funding programs by removing the statutory funding cap and giving Caltrans an incentive to control any additional cost increases. Finally, we note the need for continued oversight of the toll bridge seismic retrofit program and recommend that the Legislature implement the State Auditor's program oversight recommendations and hold periodic hearings to oversee Caltrans' progress on the program.

Should the Bay Bridge East Span Be Redesigned?

Various engineers and designers have reviewed the design options for the Bay Bridge east span and estimated the costs and schedules for the different options. A comparison of the various studies and their conclusions highlights the risk-versus-reward tradeoff that the Legislature faces in choosing the bridge's design.

Redesigning Bridge May Lower Cost

Figure 6 (see next page) shows the different construction cost estimates of the various teams that have reviewed the design options. The figure includes not only the IRT's and Caltrans' estimates, but also estimates from the bridge designer as well as the outside consultant originally hired to review Caltrans' August 2004 program cost estimates.

Figure 6

Construction Cost Estimates For East Span Designs Vary[a]

(In Billions)

	Rebid SAS	Cable-Stayed[b]	Skyway
Bridge designer[c]	$1.2 to $1.4	$1.0 to $1.3	$0.8 to $1.0
Outside consultant[d]	$1.9 to $2.1	$1.7 to $1.8	$1.3 to $1.7
IRT	$1.6 to $1.7	$0.9	—[e]
Caltrans	$1.8 to $2.1	$1.5 to $1.6	$1.3 to $1.6
Average	**$1.7**	**$1.4**	**$1.3**
Range	**$1.2 to $2.1**	**$0.9 to $1.8**	**$0.8 to $1.7**

a All cost estimates include the cost of bridge foundations, but do not include Caltrans' support costs.
b Cable-stayed estimates are for primary cable-stayed design, one of three such designs studied.
c TY Lin/Moffatt & Nichol.
d Bechtel.
e No estimate prepared.

As the figure shows, construction cost estimates vary widely for each bridge design, with about a $900 million difference between the high and low estimates for each design, including the SAS. Much of the difference in the cost estimates appears to be due to the different assumptions and methodologies of the different reviews. Nonetheless, the different reviews generally agreed on the relative cost of the different design options. Specifically, Figure 6 shows that the construction cost estimates for the SAS are the highest of the design options, while the estimates for a cable-stayed or a skyway design are lower, with a skyway design having the lowest cost estimate.

While the estimates quoted in Figure 6 are informative, they are missing some key information. Most importantly, these estimates do not include the Caltrans support costs for each design, which primarily include Caltrans' costs to oversee bridge construction. These construction oversight costs would likely be different for each bridge design. Because the SAS is more complicated and would take more time to construct, it would require more construction oversight than the other options and would therefore likely have higher Caltrans support costs. To provide a true comparison of the costs of the different options, these costs would have to be included as well. While we do not expect the addition of the missing capital outlay support costs to change the relative order of the cost estimates for the different bridge designs, these potentially significant costs should be included to give the Legislature better information about the choice it faces. The cost estimates also do not factor in the potential cost and schedule risks that correspond to the results of the PRT's risk review, which we discuss in more detail in the following section.

The review teams also estimated the completion dates when construction would be finished for the different east span designs, as shown in Figure 7. While the review teams differ in their estimated completion dates, the average of those estimates for each bridge design is the same—2012.

Figure 7

Completion Date Estimates For East Span Designs Vary

	Rebid SAS	Cable-Stayed[a]	Skyway
Bridge designer[b]	2011	2013	2012
Outside consultant[c]	2012	2013	—
IRT	2011	2010	—
Caltrans	2012-2013	2012-2014	2011-2013
Average	**2012**	**2012**	**2012**
Range	**2011-2013**	**2010-2014**	**2011-2013**

[a] Cable-stayed estimates are for primary cable-stayed design.
[b] TY Lin/Moffatt & Nichol.
[c] Bechtel.

Redesign Options Have More Risk

Given the above information, redesigning the Bay Bridge east span as a skyway appears to have the greatest potential to reduce costs while potentially being completed as quickly as a SAS design. However, there are additional risks associated with any redesign that should be considered. These risks include:

- ***Alternative Bridge Is Not Yet Designed.*** Both the cable-stayed and skyway designs that the review teams considered are at the conceptual level only, being no more than 5 percent designed. Much additional work would be required to fully design these bridges, which Caltrans estimates could take 18 months to 2 years. As design progressed, Caltrans would learn more about the seismic issues associated with the new bridge design. Addressing these issues would affect the ultimate cost and schedule of the bridge. By way of comparison, when the current plan for the east span was 30 percent designed, it was estimated to cost between $1.5 billion and $1.6 billion in total. The latest cost estimate of $5.1 billion for the current east span design is more than three times the cost estimate at the 30 percent design stage.

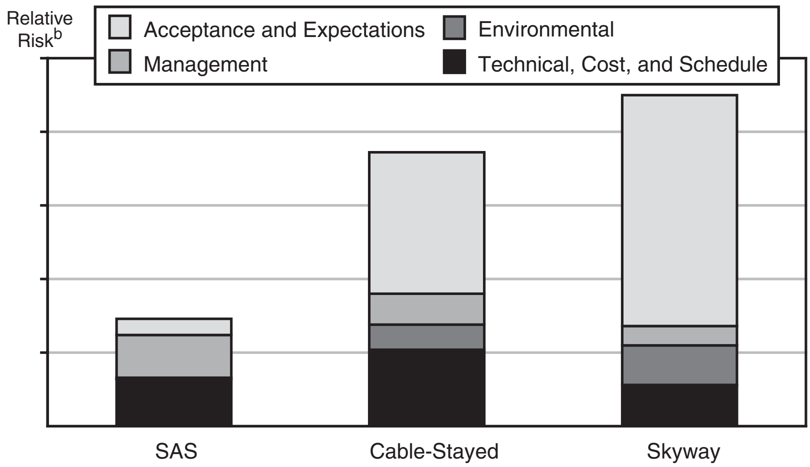
- ***Environmental Approval Has Not Yet Been Granted.*** There is significant risk of delay in environmental approval for a bridge redesign, with the most risk associated with a skyway design. Caltrans' report cited approval from several agencies as being high risk for a skyway design. For example, the United States Coast Guard has indicated that there is a risk that it may not approve any bridge design that significantly narrows the navigation channel east of Yerba Buena Island.
- ***Aesthetics of a Redesign Have Not Yet Been Agreed To.*** Bay Area representatives rejected a skyway design when Caltrans first proposed one, and it is not clear that there is agreement on the skyway design at the current time. Any lengthy debate on this topic could erode the possible cost and schedule benefits of a skyway redesign.

In its review, the PRT evaluated the risk for each bridge design in four areas: (1) technical, cost, and schedule; (2) environmental; (3) management; and (4) acceptance and expectation. Figure 8 shows the relative risk levels for the three main bridge design options. Specifically, the PRT concluded that the SAS has the lowest environmental and acceptance risk because the design is already approved and the environmental process complete, but the highest management risk due to the complexity of the project and the possibility of again getting only one bid. The skyway, on the other hand, ranked lowest in technical and management risk due to the relative simplicity of the design, but it ranked among the highest in environmental and acceptance risk. As the figure indicates, the issue of design acceptance had a large effect on the PRT's final results. Recognizing this fact, the PRT recalculated the risks for each bridge excluding the acceptance issue area. These secondary results still rated the SAS as the lowest risk option, but with the skyway a close second.

All of these considerations mean that the redesign options (cable-stayed and skyway) for the east span have a higher risk of cost and schedule growth than the existing SAS design. Thus, the Legislature faces a choice between an existing Bay Bridge design (SAS) that is known to be expensive and complicated to construct, but that has already completed the difficult

Figure 8

Peer Review Team Risk Assessment Results[a]



[a]Results are shown for three primary designs only.
[b]Higher bars can be interpreted as higher risk of cost and schedule growth.

design and environmental processes; and a redesign (skyway or cable-stayed) that initially has the potential to save money, but that could end up taking longer and costing more due to risks in the environmental and design phases. In choosing the design of the east span of the Bay Bridge, the Legislature must weigh its desire for lower costs against its tolerance of risk that could more than offset the potential savings.

Caltrans Should Provide More Information to the Legislature

Because of the risk of cost and schedule growth for each of the east span design options, no amount of additional information would allow the Legislature to be certain that any one design is the "correct" choice. In our view, the design of the Bay Bridge east span is truly a judgment call for the Legislature. However, we believe some additional information is needed to ensure that policymakers are not misled by the seemingly precise cost estimates quoted previously.

As noted earlier, the different design reviews conducted for the administration reached different conclusions in part due to differing assumptions. These different assumptions may include, but are not limited to:

- The amount of competition and thus the likely bid prices for rebidding the existing SAS design or for bidding a redesigned bridge.
- The amount of contingency funding that should be added to the cost estimate for bridges that are at a conceptual stage of design.
- The cost of canceling or changing the other Bay Bridge east span contracts to make them compatible with a different bridge design.
- The length and expense of the additional environmental review required for a redesign.

We have also noted that the cost estimates of the various review teams do not include the capital outlay support costs that Caltrans would incur for each of the bridge designs.

If all of the assumptions that fed into each cost estimate were made explicit, and capital outlay support cost estimates were added, the Legislature would be better able to compare the costs and benefits of the various bridge design options. This would facilitate the bridge design choice the Legislature must make. Accordingly, we recommend that the Legislature direct Caltrans to make explicit the assumptions that affect the projected cost and schedule estimates in its report and the IRT report, as well as for other estimates that may be available from the bridge designer or independent outside consultants. The specific cost and schedule implications of each of the assumptions should be made explicit to facilitate comparison among the various design reviews. We further recommend that Caltrans estimate the capital outlay support costs associated with each of the design options and include those estimates in the total projected cost for each of the design options.

How Shall the Program Be Funded?

The administration's cost estimate calling for an additional $3.2 billion in funding for the toll bridge seismic retrofit program was based in part on the assumption that the contract for the SAS span of the Bay Bridge would be awarded by September 2004. As this did not occur, neither rebidding the SAS nor opting for a bridge redesign will cost the same as the administration estimated in August 2004. Nonetheless, because the program will ultimately require multiple billions of additional dollars and there is no better estimate of the program's cost, we think that the Legislature should work from the assumption that it will need to provide at least $3.2 billion in additional funding.

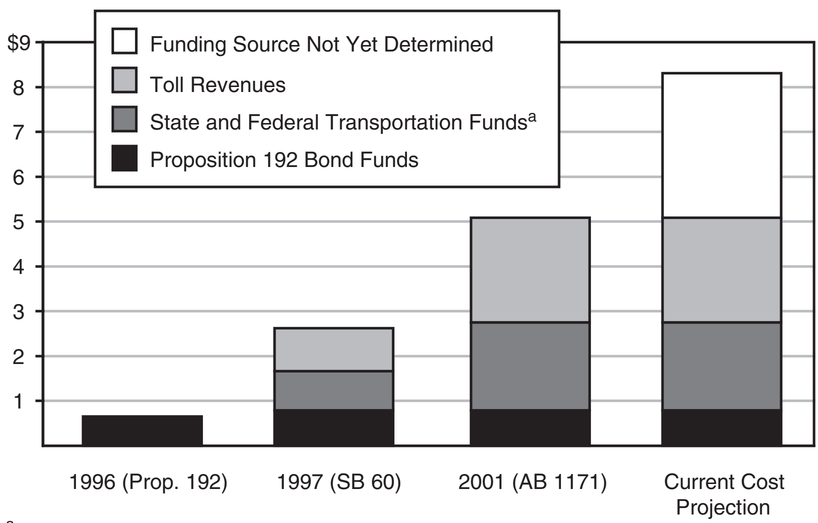
Funding Responsibility Has Been and Should Be Shared

Previous Funding Has Come From Local and Statewide Sources. To date, the Legislature has twice increased funding for the toll bridge seismic retrofit program. In each instance, the Legislature decided to fund part of the increase with tolls collected from drivers on the Bay Area bridges and part with state and/or federal funds derived primarily from the excise taxes on gasoline and diesel fuel. As shown in Figure 9, total funding for the program was divided approximately in thirds with the enactment of SB 60 in 1997—one-third from tolls, one-third from state transportation sources, and one-third from Proposition 192 bonds. In 2001, AB 1171 added over $600 million in federal funds that would have otherwise funded bridge rehabilitation projects around the state, as well as about $450 million in overrun authority that could be funded by state or federal sources. However, the largest source of additional funding in AB 1171 was an additional $1.4 billion that was to be generated from Bay Area tolls. This increase brought tolls' share to about 50 percent of the program's funding.

Figure 9

Toll Bridge Seismic Retrofit Funding Sources

(In Billions)



[a]Includes overrun authority.

New Funding Should Also Be Shared. Who should fund the additional costs of the toll bridge seismic retrofit program? One could argue that improving the bridges' seismic safety benefits primarily users of the bridges and, therefore, charging those drivers (in the form of a toll) is an appropriate means to pay for the retrofit work. On the other hand, the toll bridges are part of the state highway system, owned by the State of California. Therefore, it could be argued that the state should pay for them from statewide transportation funding sources. We believe that both the arguments for Bay Area funding and state funding have merit. Therefore, we believe that the additional funding provided by the Legislature should include both Bay Area and statewide sources. There is, however, no analytical basis to determine exactly what percent of the program should be funded by tolls and what percent from statewide transportation sources. Ultimately, the exact funding split for the program is a policy decision for the Legislature.

Primary Funding Source Likely to Involve Revenue Increases or Borrowing

Depending on the funding split between state and local sources the Legislature chooses, the Legislature has a number of options to generate the funding the toll bridge seismic retrofit program requires. These options, listed in Figure 10, range from a large transportation revenue increase to a drastic cut in funding for other transportation programs, along with several borrowing options. In the following section, we discuss some of the pros and cons of using funding from each of these sources.

Increase Gas Tax Revenue. One state funding possibility would be to raise the excise tax on gasoline and diesel fuel. A 6-cent increase in this tax, for example, would raise more than $3 billion over three years. If the funding is not needed that quickly, smaller tax increases could be considered. Once the necessary amount of bridge funding was provided, the tax increase could be discontinued or used for other transportation needs. This option would spread payment for the retrofit program among all the state's drivers, while not reducing funding for other transportation projects.

Bond Against Increased Toll Revenue. The largest funding source currently being used for the toll bridge seismic retrofit program is a $1 seismic surcharge on Bay Area bridge tolls. In effect until January 1, 2038, this surcharge will be used to pay the debt service on bonds issued in 2003 and to be issued in 2009 for toll bridge seismic retrofit, as well as to fund several other Bay Area transportation projects.

Increasing the bridge tolls statutorily by another dollar (to an effective $4 per passenger vehicle) for 30 years would generate enough revenue to pay the debt service on an additional $1.9 billion in bonds. Relying exclusively on tolls for the additional $3.2 billion (for example, by increasing tolls to $5 per passenger vehicle) would put the entire funding burden for the bridges on Bay Area drivers, while not reducing funding for other transportation projects.

Figure 10

Potential Primary Sources for Additional Toll Bridge Funding

- ***Increase Gas Tax Revenue.*** Puts burden on all drivers in state, does not impact other transportation projects.
- ***Bond Against Increased Toll Revenue.*** Puts burden on users of Bay Area bridges, does not impact other transportation projects.
- ***Bond Against Existing Gas Tax Revenue.*** Reduces funding for transportation projects statewide. Need for voter approval would delay funding availability.
- ***Bond Against Future Federal Revenue.*** Reduces funding for transportation projects statewide.
- ***Issue General Obligation Bond.*** Increases General Fund debt service costs, putting additional cost pressure on non-transportation programs. Need for voter approval would delay funding availability.
- ***Use Near-Term State Transportation Funding.*** Severely reduces funding for transportation projects statewide.

Bond Against Existing Gas Tax Revenue. The State Constitution authorizes bonding against future gasoline and diesel excise tax revenues, subject to voter approval. The annual debt service on these bonds, however, must be less than 25 percent of the state's annual excise tax revenue that is used for street and highway purposes. Given that these revenues total over $3 billion annually, the state would certainly have the capacity to issue a bond to cover the entire amount of additional seismic retrofit funding needed. However, this would reduce gas tax funding for transportation projects statewide for the duration of the debt-service payments (typically 30 years).

Another important consideration with this option is that, since it must be approved by voters, this funding source would not be available until after the next statewide election in June 2006 unless a special election is called before then. A June 2006 timeframe would be less of an issue if the Bay Bridge east span is to be redesigned, as that construction contract would not be awarded for at least two years. Caltrans has sufficient funding to cover its other seismic retrofit costs through the end of 2005, and the amount of additional funding needed to pay for ongoing contracts through June 2006 would be a small fraction of the total additional funding the program needs. However, if the Legislature decides to keep the

SAS design, that contract could be ready to go to bid in early 2005. The earlier funding is provided, the earlier the SAS contract could be awarded.

Bond Against Future Federal Revenue. Federal law allows states to bond against future federal transportation revenues. This debt instrument is known as a Grant Anticipation Revenue Vehicle (GARVEE) bond. Current state law limits the amount of GARVEE bonding. Specifically, debt service on the bonds cannot exceed 15 percent of the state's annual federal transportation funding. To date, the California Transportation Commission (CTC) has issued $658 million in GARVEE bonds to allow transportation projects to continue through the current funding downturn. In addition, the CTC's current policy is to issue GARVEE bonds with terms no longer than 12 years. However, even within these restrictions, the State Treasurer estimated in May 2004 that the state had the capacity to issue about $5 billion-worth of GARVEE bonds. Issuing these bonds would reduce funding for transportation projects statewide for the duration of the bonds by the amount of the annual debt service.

Issue General Obligation Bond. Finally, the state's other major borrowing option is to issue general obligation bonds. Pledging the state's full faith and credit could provide all the funding needed by the toll bridge seismic retrofit program. However, because the General Fund already faces a sizeable budget shortfall, any additional borrowing would put additional pressure on non-transportation programs for the duration of the debt-service payments.

Also, issuance of general obligation bonds requires voter approval. As with the bonds backed by excise taxes described above, if the SAS design is chosen, funding would not be available until the next statewide election in June 2006 unless a special election is called before then.

Use Near-Term State Transportation Funding. The only major option that does not require borrowing or revenue increases would be to use state funding that is dedicated to other transportation projects in the near term. Cutting the state's expected allocations for new transportation projects in half over the next three years could provide over $3 billion for toll bridge seismic retrofit in the near term. However, this would have a severely detrimental effect on the rest of the state's transportation program.

Other Options Are Available to Provide Additional Funding

In addition to the options listed above, there are other funding options that could provide smaller amounts of money. These secondary options are listed in Figure 11. Even if all of the actions in this list were taken, they could not provide the amount of additional funding the toll bridge seismic retrofit program needs for project completion. However, they could be used to supplement one or more of the options in the previous list if the Legislature chose not to utilize those options to their fullest extent.

Figure 11

Potential Secondary Sources for Additional Toll Bridge Funding

- ***Refinance Existing Toll Bonds.*** Consolidates all toll bridge financing under Bay Area Toll Authority. May free up $400 million to $500 million with little downside effect.
- ***Redirect Toll Money Used for Other Purposes.*** Reduces funding for specific Bay Area transportation projects to generate $550 million.
- ***Extend Existing Seismic Surcharge.*** Extends surcharge for an additional ten years to generate $150 million bonding capacity.
- ***Delay Funding for Old East Span Demolition.*** Recognizes funding for demolition not needed for more than five years, delaying about $300 million in future costs.

Refinance Existing Toll Bonds. Currently, the seismic surcharge dollar in the Bay Area tolls is administered by Caltrans, while the other two dollars of toll are administered by the Bay Area Toll Authority (BATA). One option originally proposed by the Governor in August 2004 was to consolidate the administration of all tolls under BATA. This would allow BATA to combine the toll bridge seismic bonds with its own outstanding debt and refinance them as a single package. The BATA estimates that this could reduce debt-service costs and free up $400 million to $500 million for use on the seismic retrofit program. This money would come at no expense to other projects and would not require a revenue increase.

Redirect Toll Money Used for Other Purposes. A portion of the revenue from the current seismic surcharge is to be used for certain specified Bay Area transportation projects unrelated to toll bridge seismic retrofit. The administration has proposed redirecting this money to the seismic retrofit program. This action could generate an additional $550 million, though this would be at the expense of those Bay Area transportation projects.

Extend Existing Seismic Surcharge. The current seismic surcharge is set to expire on January 1, 2038. Extending this surcharge for ten years and bonding against that revenue stream would allow the state to generate approximately $150 million. This would be paid primarily by Bay Area drivers.

Delay Funding for Old East Span Demolition. While it is not technically a source of funding, the state does have the option of delaying the provision of funding for the demolition of the existing east span of the Bay Bridge. This would reduce the amount of funding the state must raise in the near term by approximately $300 million. The existing span cannot be demolished until after the new span is complete, so funding will not be needed for this contract for more than five years.

Additional Overruns Are Possible; Cost Control Incentives Needed

Additional Cost Overruns Should Be Anticipated. As noted earlier, the administration's estimate of a $3.2 billion shortfall in the toll bridge seismic retrofit program was based on an assumption that the contract for the SAS design of the Bay Bridge east span would be awarded in September 2004. This did not happen, so the ultimate cost of the bridge will likely be different. Further, no matter which bridge design is ultimately chosen, there is potential for cost overruns and schedule delays on all of the ongoing and future contracts. Because of these factors, the amount of additional funding that the toll bridge seismic retrofit program will ultimately need is unknown.

As work continues and the amount of work left to complete is reduced, the risk of further cost increases will begin to decline. However, risk remains that Caltrans' current cost estimates are still too low.

Most Transportation Projects Do Not Have Statutory Funding Caps. Most transportation projects funded by the state do not need statutory overrun authority because they do not have specific funding caps set by the Legislature. Instead, the CTC allocates to each project the amount of funding the project sponsor expects to need. When Caltrans or a local transportation agency needs to expend more money on a project than was originally allocated, the CTC then generally provides a supplementary allocation. However, Caltrans and each regional transportation agency only get a fixed share of the available transportation project funding over a four-year period. If one of a project sponsor's projects requires a supplemental allocation, the amount of that allocation is deducted from the sponsor's share of the funding, so that it has less money available for other projects. In this way, project sponsors have an incentive to keep their projects within budget.

Legislature Could Remove Funding Cap While Providing Incentive to Reduce Costs. Similarly, the Legislature could allow Caltrans unlimited expenditure authority for the toll bridge seismic retrofit program, but specify that any funding required beyond that currently estimated be counted against Caltrans' share of transportation funding. In this way, any further cost overruns on the toll bridges would impact Caltrans' other programs. The Legislature could structure this funding to ensure that individual counties' projects are not affected, by specifying that the additional funding is to come from Caltrans' interregional highway expansion program or Caltrans' support budget. Similar action was taken with the provision of state funds for the toll bridge program in SB 60 and AB 1171. Of the $875 million in state funds provided by SB 60, $300 million was to be achieved through "better efficiency and lower costs" at Caltrans. Also, to the extent the overrun authority provided by AB 1171 was to come from state funds, it was to affect only Caltrans' highway rehabilitation and interregional expansion. Providing additional funding in this way would reduce the likelihood that the Legislature will again have to adjust funding for the program in the future, while providing an incentive for Caltrans to try to control any further cost increases.

Future Oversight Should Be Improved

Even after the Legislature makes design and funding decisions, it must continue to oversee the toll bridge seismic retrofit program. As noted earlier, the program still faces substantial risk of cost and schedule increases over the remaining years of the program. The Legislature should hold the executive branch accountable for delivering the program and exercise its oversight to reduce the likelihood that it will again be surprised by a large budget overrun.

At the Legislature's request, the Bureau of State Audits (BSA) conducted an audit of the toll bridge seismic retrofit program to determine the causes of the most recent cost increases in the program and to examine Caltrans' project management practices. In its report released in December 2004, BSA found among other things that Caltrans has failed to report on the program to the Legislature to the extent required by statute. Caltrans did not submit a required annual report to the Legislature in 2003, nor did it submit the first required quarterly report in 2004. The BSA recommended that the Legislature change statute to require that Caltrans submit each report by a certain date—for example, within 45 days of the end of each quarter. The BSA also recommended several improvements to the reports that Caltrans submits. These recommended improvements include reporting additional information, such as a comparison of the program's budget with actual and projected expenditures, as well as more review of the information submitted, including certification of the reports by an independent engineering consultant. We think that adopting BSA's recommendations, and holding periodic hearings on the program's status, would improve the Legislature's future oversight of the toll bridge seismic retrofit program.

CONCLUSION

The Legislature faces two major decisions for the toll bridge seismic retrofit program: (1) which design to use for the Bay Bridge east span and (2) how to fund the program's completion. There are a number of options for each major decision. Ultimately the design choice is a judgment call requiring the Legislature to weigh its desire for lower costs against its tolerance of risk that could more than offset the potential savings. Regarding funding for the program, we think it should include both state and local sources. The Legislature has several options regarding the specific sources used and the amount of funding provided from each.

WATER POLICY ISSUES FACING THE STATE

How Should the State Address the Impending Crisis in Flood Management? How Should the $8.1 Billion CALFED Bay-Delta Program Be Financed?

Summary

A Department of Water Resources White Paper submitted to the Legislature in January 2005 identifies several factors leading to a "crisis" in flood management, including an aging flood control infrastructure that has substantial deferred maintenance, is modestly inspected, and may be subject to inherent design flaws. Moreover, residential and commercial development in flood-prone areas continues to escalate, with local land use decision makers often immune from the fiscal burden and liability of their development decisions. We evaluate the strategies offered by the White Paper to begin addressing the crisis and make recommendations for legislative action.

The CALFED Bay-Delta Program—a consortium of state and federal agencies addressing water problems in the Bay-Delta region—is at a funding crossroads. The program's traditional funding sources are running out, and it projects $8.1 billion of funding requirements over the next ten years. The Governor's budget indicates that elements of a recently adopted ten-year finance plan will be incorporated into the Governor's May Revision. The plan assumes substantial new federal revenues, new water user fees, and a large amount of unidentified new state funds. However, the finance plan's revenue assumptions may be unrealistic. As a result, the Legislature will need to establish its expenditure priorities so that the program can be "right sized" consistent with those priorities.

INTRODUCTION

Two of the most important water policy issues facing the state today are how to address what has been characterized by the administration as a "crisis" in flood management and how to finance the $8.1 billion CALFED Bay-Delta Program (CALFED).

The issue of flood management gained the attention of the Legislature last session due to a court decision that found the state liable for potentially several hundreds of millions of dollars as a result of a 1986 failure of a levee in the state's flood control system. The Legislature accordingly directed the Department of Water Resources (DWR) to report by January 2005 on its flood management expenditure priorities and options for funding. The department responded with a "White Paper"—*Flood Warnings: Responding to California's Flood Crisis*—that identified various factors leading to a flood management crisis. These factors include an aging flood control infrastructure with substantial deferred maintenance, escalating development in floodplains, declining resources available for flood management, and a number of recent court decisions that highlight the state's potential liability exposure from flood events.

In this write-up, we examine the problems identified by the White Paper, as well as some additional ones, assess the solutions proposed by the White Paper, and make recommendations for legislative action.

The CALFED is a consortium of 25 state and federal agencies created to address a number of interrelated water problems in the state's Bay-Delta region. The program is at a funding crossroads. This is because the program's traditional funding sources—General Fund monies and state bond funds—either are no longer available or have been substantially depleted. In addition, the program has delayed establishing fees to pay for the components of the program that directly benefit specific water users.

The state agency overseeing CALFED—the California Bay-Delta Authority (CBDA)—has recently approved a ten-year, $8.1 billion finance plan for CALFED. The plan provides that this cost be allocated among state public funds, federal funds, local matching funds, and new water user fees. Much of the plan requires legislative action to implement, and the Governor's January budget proposal indicates that a legislative package will be presented as part of the Governor's May Revision.

In this write-up, we discuss the Governor's 2005-06 budget proposal for CALFED and evaluate the proposed finance plan. We make recommendations on how the Legislature should respond to the plan.

ADDRESSING THE FLOOD MANAGEMENT CRISIS

The Problem

As shown in Figure 1, DWR's White Paper identifies a number of factors leading to a crisis in flood management. We discuss each of these in turn, and raise additional issues for legislative consideration. To provide context for these issues, we first provide background on the state's responsibilities for flood management, as well as the roles of federal and local agencies.

Figure 1

Flood Management: The Problem As Identified by DWR's White Paper

- ✓ Aging infrastructure and deferred maintenance.
- ✓ Escalating development in floodplains.
- ✓ Declining fiscal resources.
- ✓ State's potential liability

Background: Responsibilities for Flood Management

Multiple Agencies Responsible for Flood Management. Multiple agencies at every level of government have some responsibility for flood management.

As far as *federal* agencies are concerned, the U.S. Army Corps of Engineers (Corps) is generally the lead agency on the construction of federally authorized flood control projects. (The construction costs are shared among federal, state, and local governments.) The Federal Emergency Management Agency (FEMA) administers the National Flood Insurance Program, which limits new development in the 100-year floodplain. A 100-year floodplain is defined as an area with a 1 percent chance of flooding per year, which translates to a one in four chance of flooding over the life of a 30-year mortgage.

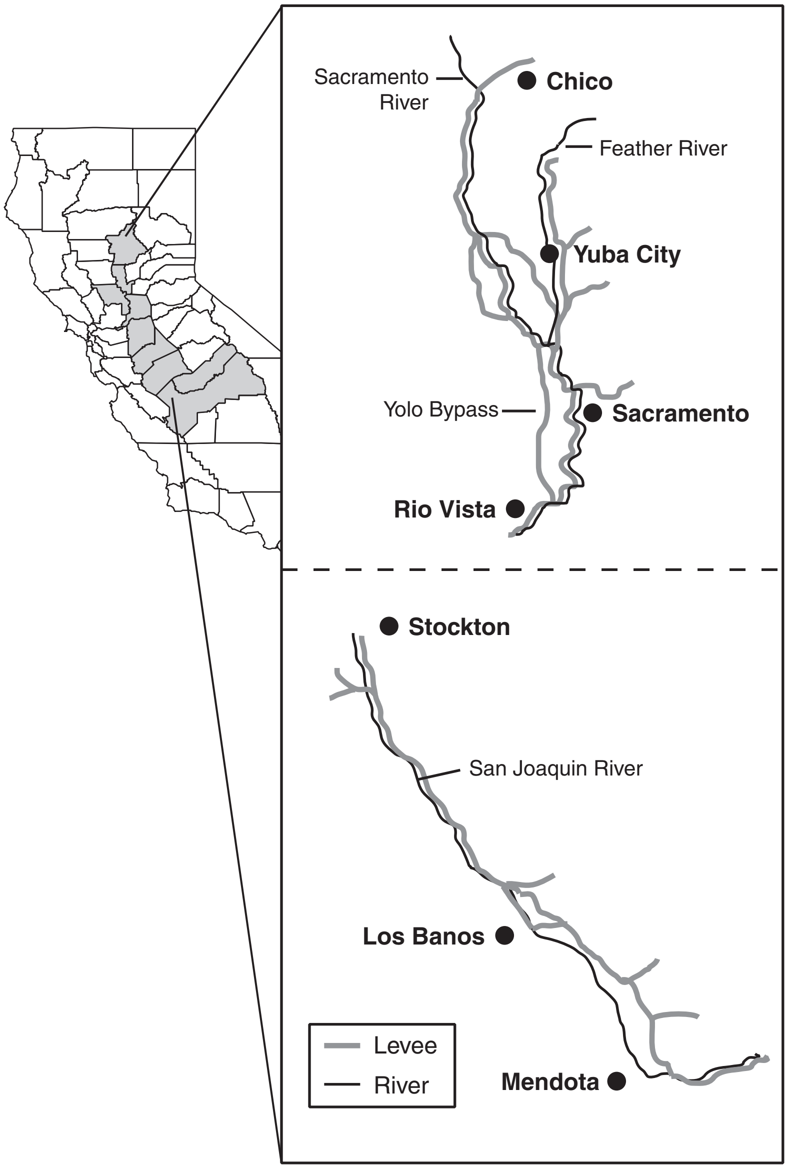
Local agencies provide day-to-day maintenance and operation of the majority of flood control facilities in the state and have significant control over land use decisions in and around flood prone areas of the state, as discussed later.

As for the *state*, its roles in flood management fall into the following categories:

- ***Fund Flood Control Infrastructure.*** Along with the federal and local governments, the state shares in the funding of federally authorized flood control projects that are located throughout the state. These federal projects are sponsored by either (1) the state and are located within the Central Valley (commonly referred to as the Sacramento and San Joaquin flood control projects or the "Central Valley flood control system") or (2) local agencies that receive "subvention" funding from the state. In addition, the state provides financial assistance to local reclamation districts that operate levees in the Delta region that are outside of the federal-state-local cost sharing arrangement.
- ***Operate and Maintain Flood Control Infrastructure.*** The state has the responsibility to operate and maintain the Central Valley flood control system. This includes about 1,600 miles of levees, as well as other flood control works such as overflow weirs and channels. The location of these 1,600 miles of levees within the state-run Central Valley flood control system is shown in Figure 2. However, for about 1,300 (80 percent) of the levee miles, the state has turned over the operations and maintenance responsibilities (including the fiscal responsibility for such) to local reclamation districts. The remaining 300 or so levee miles are *directly* operated and maintained by DWR, with half of these miles paid by the state and the other half paid by local districts through reimbursements to DWR.
- ***Provide Oversight of Local Agencies.*** As mentioned above, the state oversees the locally performed operations and maintenance of about 1,300 miles of levees in the Central Valley flood control system.
- ***Provide Floodplain Management.*** The state provides floodplain management in the Central Valley by designating floodways and issuing permits for development within the designated floodways. These activities are carried out by the state Reclamation Board, which is part of DWR. Outside of the Central Valley, the state's role in floodplain management is relatively modest, consisting largely of providing technical assistance to local communities on complying with federal flood insurance requirements and mapping areas that are prone to flooding.

Figure 2

Sacramento/San Joaquin Rivers Flood Control System Federally Authorized Levees



Not to Scale

We now turn to the various flood management problems identified by the White Paper.

Aging Infrastructure and Deferred Maintenance

Inherent Design Deficiencies. As discussed in the White Paper, the state's Central Valley flood control system of levees, weirs, and channels is old. Some of the levees are well over 100 years old. There is much evidence that the system is deteriorating, in part due to deficiencies in the original design of the system. Specifically, many levees consist simply of dredged materials (such as mud) that were piled up on top of foundations that are subject to seepage and movement. Seepage is dangerous because it can undermine the levee's foundation, potentially causing it to collapse. In addition to seepage, erosion of levees and riverbanks is a major problem. For example, a recent study by the Corps found over 180 spots along the Sacramento River alone where levees have noticeably eroded.

Lack of Knowledge About State of Central Valley Flood Control System. While there is ample visible evidence of deterioration in the Central Valley flood control system, there is no program at the local, state, or federal level that assesses the structural integrity and the channel carrying capacity of the flood control projects on an ongoing basis. With sediment deposits and vegetation clogging channels, the department believes that some sections of the Central Valley flood control system have lost substantial capacity to carry the flow of water for which they were designed. However, there currently is no program (at any level of government) to verify that the components of the Central Valley flood control system are today meeting their "design flows" safely.

How much would it cost to complete a comprehensive assessment of the structural integrity and the channel carrying capacity of the Central Valley flood control system? According to estimates of the Corps, it would cost about $60,000 per levee mile for exploration, lab testing, and analysis. With 1,600 levee miles in the system, this translates to close to $100 million.

Inspection Program Is Modest. The state is responsible for overseeing the operations and maintenance work performed by local entities on the Central Valley flood control system. Our review finds that the department's current inspection program of the work performed by local reclamation districts is modest in scope. While the frequency of inspections is similar to federal inspection standards (four times per year), the inspections themselves generally only involve checking the status of maintenance practices and looking for any easily visible deterioration of the infrastructure. For example, levee inspections are done by driving on the levee crown roadway only, even though inspections from the water side by boat or by foot (which would be needed to identify damage caused by rodent burrows, for example) would provide much more information about the condition of the levee. The state does not conduct field studies to assess the structural integrity of the levees or their foundations.

Delta Levees Present Special Set of Problems. In the Delta, there are about 1,100 miles of levees, of which a majority (over 700 levee miles) are outside of the state flood control system and operated mostly by local reclamation districts. The department's role with respect to these 700-plus miles of levees is essentially to provide subvention funding for levee improvements and maintenance. The department's "inspections" of these levees are largely to ensure that subvention funds are being spent properly. The department indicates that if these 700-plus miles of levees were inspected to the same degree as levees of the Central Valley flood control system, it would cost an additional $1.4 million (and seven personnel-years) annually.

The 700-plus miles of Delta levees outside the state flood control system present their own set of challenges. Many of these levees were built on peat soil, a type of soil that is prone to sinking and erosion. Over the last 100 years, there have been over 140 levee failures in the Delta, including one as recently as June 2004 at Jones Tract. This recent levee break resulted in costs of close to $100 million—largely paid for by federal emergency and state public funds—for emergency response, levee repairs, and to cover property losses. The marginal condition of Delta levees is of substantial concern because these levees serve to protect a region of abundant resources, including major sources of the state's drinking water supply, fisheries, and agriculture.

The White Paper does not explicitly address the issue of the lack of state oversight over the operations and maintenance of flood control projects in the Delta that are outside the state Central Valley system. However, as the state recently found with the Jones Tract levee failure (a Delta levee outside the state system), the state can find itself paying significant emergency response and repair costs when these projects fail. Given the condition of other Delta levees outside of the state system, future Delta levee failures are possible. Over the long run, it may be more cost-effective for the state to assume an oversight role in the operations and maintenance of Delta levees. This is because it may be less costly to run an oversight program that serves to reduce the risk of levee failures than to pay for emergency response and other costs when the levees fail.

Substantial Backlog of Deferred Maintenance. The White Paper identifies a substantial backlog in deferred maintenance in the Central Valley flood control system, attributable to a significant reduction in resources for this activity since the mid-1980s. (Declining funding will be discussed in detail below.) For example, the White Paper notes that the number of maintenance staff members in DWR decreased by about one-third between 1986 and the present—from 81 to 53. Over this same period, the cost of performing the maintenance has increased substantially, in part reflecting environmental requirements (such as Endangered Species Act requirements). For example, in the 1980s, the cost to repair an erosion site was around $300 per linear foot; today, that repair cost has skyrocketed to $5,000 per linear foot. The department estimates that the cost to address the current backlog of 200 erosion sites alone would be around $600 million. When asked what it would cost to bring the flood control system for which the state is responsible to a safe level, the department provided a very rough estimate of $2 billion for capital improvements, remediation of deficiencies, and deferred maintenance.

Escalating Development in Floodplains

Land Use Decisions Made With Limited Flood Risk Information. The White Paper recognizes the challenge that is presented to the state's flood management system by new development that frequently occurs in areas that are susceptible to flooding. In this regard, DWR estimates that lands adjacent to at least 50,000 of the state's 200,000 miles of streams will likely see development over the next 20 years. In addition, some of the new development is occurring in areas where flood maps are out-of-date or in areas that have never been mapped.

The main floodplain mapping effort is conducted under FEMA's flood insurance program. While the department has supplemented the FEMA mapping efforts, in part by mapping areas outside the 100-year floodplain that may be at considerable risk of flooding, resources available for this activity have been reduced considerably in recent years. Accordingly, local governments often lack reliable information about the potential flood risks when making land use decisions.

Disconnect Between Who Makes Land Use Decisions and Who Pays the Related Fiscal Bills. The White Paper notes that while new development is being approved by local governments in flood-prone areas, it is often the state that bears the fiscal burden and the liability of these land use decisions after the floods have struck. The state, for example, often bears the burden of providing emergency response during floods to protect the development and has been found liable by a court for flood-related damages. We discuss the state's potential liability exposure from flood events in further detail later in this write-up.

Declining Fiscal Resources

Declining Funding for Flood Management. The White Paper identifies as an important issue the decline in funds for flood management at all levels of government. State funding for flood management supports capital outlay, operations, and maintenance expenditures for the Central

Valley flood control system; subventions to local agencies for construction and upgrades of flood control projects; and floodplain management activities, such as floodplain mapping. As shown in Figure 3, state funding for flood management and DWR's flood management staffing peaked in 2000-01, largely reflecting the availability of General Fund and Proposition 13 bond monies to make one-time appropriations to pay for the state's share of federally authorized flood control projects. Appropriations for 2004-05 reflect a decrease of almost $200 million, or over 80 percent, from the 2000-01 peak. In addition, staffing for flood management has been reduced by about 30 percent from 1999-00 levels. General Fund resources for flood management have declined due to the weakened condition of the General Fund. In addition, state bond funds for these purposes have largely been depleted. These bond funds were used mainly for local assistance (flood control subventions, delta levee rehabilitation, and flood corridor projects).

Figure 3

DWR's Flood Management Appropriations and Staffing

(Dollars in Millions)

Fund Source	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
General Fund	$90.8	$84.3	$77.2	$22.6	$28.7	$14.1
Proposition 13 bond funds	1.8	142.7	15.6	28.2	14.7	1.7
Proposition 50 bond funds	—	—	—	2.3	21.4	21.4
Other funds[a]	12.1	13.8	12.1	6.7	6.5	5.3
Totals	**$103.7**	**$240.8**	**$104.9**	**$59.8**	**$71.3**	**$42.5**
Staffing						
Number of personnel-years	182.5	150.5	176.9	143.5	127.0	126.7

[a] Includes federal funds and reimbursements.

State's Potential Liability Exposure

Court Decisions Highlight State's Liability Exposure. The White Paper highlights a couple of recent court decisions that expose both the state and local flood management agencies to major liability. First, in *Paterno v. State of California*, the court held the state liable for damages resulting from a 1986 levee break in Yuba County. The levee in question was constructed in the early 1900s by Yuba County and was turned over to the state in 1953 to become part of the state Central Valley flood control system, with the agreement that the local reclamation district would be responsible for maintenance and operations. Even though the state had not constructed the levee, the court held the state liable for the damages from the levee break. This was on the basis that the levee's original *design* deficiencies (the levee was built on a weak foundation, allowing water to seep through the levee) could have been discovered and should have been remedied by the state. (We discuss the budget's proposal to finance a pending $464 million settlement in the *Paterno* case with a judgment bond, in our write-up on DWR's budget in our companion document, *Analysis of the 2005-06 Budget Bill*.)

In another recent case, *Arreola v. Monterey County*, the court held a local flood management agency liable for flood damages resulting from its failure to properly *maintain* a flood channel. The court made this finding even though environmental requirements had impeded the agency's ability to remove vegetation that was clogging the channel. Specifically, the local agency was unable to secure the required permits from the state Department of Fish and Game.

Our review finds that in addition to the pending *Paterno* settlement, there have been at least two other major settlements of flood-related lawsuits against the state in recent years. These include a $20 million settlement in the *Strawberry Manor* case (relating to flood damage in the Sacramento area from the 1986 floods) and a recent $45 million settlement in the *McMahan* case (relating to flood damage in Yuba County from the 1997 floods). Based on these cases, there is a strong potential for the state being found liable for future flood events.

White Paper's Solution Strategies to Address Crisis

The White Paper recommends several solution strategies to address the many flood management challenges identified in the report. Basically, the strategies can be characterized as addressing one of two sets of issues—(1) those that address public safety issues and (2) those that seek to limit the state's liability exposure from flood events. Sometimes a strategy to address one of these sets of issues also addresses the other. For example, making upgrades to the flood control infrastructure serves to improve public safety and would likely also reduce the state's liability exposure. However, in other cases, a strategy to address one set of these issues does nothing to address the other. For example, a strategy to limit the state's liability exposure by requiring mandatory insurance for property owners in flood-prone areas may protect the General Fund, but it does nothing in and of itself to improve public safety.

The White Paper's main solution strategies are summarized in Figure 4.

Figure 4

White Paper's Solution Strategies to Address Flood Management Problems

- ✓ Evaluate flood control system integrity, rehabilitate as needed, and improve maintenance.
- ✓ Create reliable funding sources.
- ✓ Improve floodplain mapping and outreach on flood risks.
- ✓ Reduce state's liability exposure.

LAO's Comments on White Paper's Recommended Strategies. In general, the White Paper recommends a set of rather aggressive strategies to address the challenges identified. We think that the White Paper appropriately recognizes the importance of evaluating the integrity and capability of existing flood control facilities as a fundamental first step. As discussed previously, there is an enormous information gap on this issue that needs to be filled. Second, the White Paper has a number of recommendations for creating reliable funding sources for flood management programs, including a recommendation for a fee (benefit assessment) on property owners who directly benefit from the Central Valley flood control system. There is a statutory precedent for such an assessment, and the concept merits the Legislature's consideration, as discussed later.

The White Paper is more limited in addressing the disconnect between agencies making land use decisions and the fiscal consequences of those decisions. We offer some additional recommendations to address this issue later in the write-up.

We summarize and comment on the White Paper's main strategies below.

Evaluate System Integrity, Rehabilitate as Needed, and Improve Maintenance. At the heart of this strategy is the objective of gathering the information needed to set priorities for the state's flood management expenditures. The strategy includes:

- Evaluating the state's system of levees using current Corps design standards and rehabilitating deficiencies in projects that are identified.
- Developing a state program to continuously evaluate flood system performance and capacity.
- Improving maintenance.
- Expanding the scope of routine inspections.

These strategies will be costly to implement fully. For example, the department's preliminary estimates of the capital improvements needed for the Central Valley flood control system are on the order of $2 billion, which would be spent over 10 to 15 years.

Create Reliable Funding Sources. The White Paper identifies two categories of funding requirements—funding to finance flood management activities and funding to provide reimbursement for flood damages. In addition to funding from the General Fund, bond funds, and federal funds, the White Paper proposes two new funding sources—(1) benefit assessments from a yet-to-be-established Central Valley Flood Control Assessment District and (2) insurance as a replacement for public funds to compensate property owners for damages from floods.

The strategy to enact a flood control benefit assessment in the Central Valley is intended to distribute the state's costs of flood control measures among those that directly benefit from such protection. This is an application of the "beneficiary pays" principle that is a statutory policy guiding the funding of many of the state's environmental protection and resources programs. Specifically, the White Paper envisions a state-levied benefit assessment that would be levied on property parcels in the Central Valley that are within floodplains or in upland areas draining into floodplains. The entire valley could be one assessment district, or it could be split into multiple districts, with the Delta being a single district, for example. Funds from the assessments would be used largely for the operations, maintenance, and rehabilitation of the Central Valley flood control system, but could also be used for floodplain mapping and potentially to compensate property owners for flood damages. A systemwide assessment makes sense because of the interconnectedness of the Central Valley system and the need to evaluate the design and capacity of the system from a systemwide perspective.

Our review finds that there is a statutory precedent for such a benefit assessment to fund flood management in the Central Valley. Specifically, current statute (dating from the early 1900s) establishes the Sacramento-San Joaquin Drainage District, with the authority to fund levee construction. Although such a district is currently inactive, these statutory provisions could serve as a starting point for establishing the assessment district envisioned by the White Paper. Importantly, the current statutory provisions would need to be revised to authorize the district's assessment to cover flood control costs beyond construction, such as maintenance.

As far as the insurance-related funding strategy is concerned, the White Paper recommends that the state require all homes and businesses in flood-prone areas have some form of flood insurance. In discussions with the department, it appears that this strategy is also viewed as a means to reduce the likelihood of ill-advised development approvals in flood-prone areas. The White Paper envisions that such an insurance requirement would encompass property owners beyond those which are required to have insurance under the federal program (which is limited to property owners with less than 100-year floodplain protection). The state requirement, which presumably would be integrated with the federal program, could be implemented by establishing a statewide insurance fund (as is done for earthquake insurance) or by requiring those at risk to purchase private insurance. From the state's fiscal perspective, the latter option would probably involve less risk.

The insurance strategy raises issues about how a state insurance program would be integrated with the current federal program as well as with any system of local flood assessments. In addition, the White Paper assumes that by implementing the insurance strategy, the state would be reducing its liability exposure from flood events. However, for this to be the case, the insurance would have to be structured in a way that includes the state as an additional insured party on any privately issued insurance policy or waives the right to sue the state if a state insurance fund were to be established.

Improve Floodplain Mapping and Outreach on Flood Risks. The White Paper recommends increasing floodplain mapping efforts as a tool to provide more comprehensive and up-to-date flood risk information to local agencies that authorize development as well as the public. Local agencies have expressed the need for better information about flood risks; in general, local land use agencies do not have the expertise to evaluate flood risks, so they defer to the state to provide them with this information.

This is a good step in an effort to ensure that local land use decision makers are aware of flood risks. However, we do not think that it goes far enough, as it leaves largely unaddressed the disconnect between agencies making land use decisions and the fiscal burden and liability resulting from such decisions. We offer our recommendations in this regard later.

Reduce State's Liability Exposure. Finally, in addition to the insurance strategy discussed above, the White Paper recommends a few statutory and constitutional changes to reduce the state's exposure for funding flood disaster claims. First, the White Paper recommends that the state

Tort Claims Act be amended to preclude recovery of tort-based damages from the state due to flooding and to add a specific immunity for flood protection activities, similar to that which is provided currently for police, correctional, and fire protection activities. Second, the White Paper recommends that the State Constitution be amended to exempt flood control projects from the type of liability—"inverse condemnation"—that was the basis for the court's decision in *Paterno*. Inverse condemnation claims have their basis in both the State Constitution (Article 1, Section 19) and the United States Constitution (Fifth Amendment). Simply stated, these constitutional provisions require the just compensation of property owners whose property is "taken" or severely damaged by governmental action.

The Legislature may wish to evaluate the pros and cons of enacting the statutory change related to tort claims recommended by the White Paper, given the statutory precedent to grant tort-related liability immunity to other public safety activities. As far as the White Paper's recommended change to the State Constitution is concerned, the Legislature may wish to ask Legislative Counsel to evaluate the legal issues raised by this proposal.

Governor's Budget: First Steps in Addressing Crisis

Budget Proposes Increases for Flood Management. The Governor's budget proposes an increase of $9.7 million (General Fund) for state support and $21.1 million ($16.7 million General Fund and $4.4 million reimbursements) for capital outlay in DWR's flood management program in 2005-06. The budget request includes an increase of 27 personnel-years. With these increases, DWR's total flood management budget for 2005-06 will be about $73 million, an increase of about $31 million, or 72 percent, above the current-year appropriations. The increase in expenditures requested by the Governor's budget request is summarized in Figure 5.

First Steps to Addressing Crisis. According to DWR, the requested increase reflects the first steps under a three-year budget plan to begin addressing the flood management crisis by improving public safety and reducing the liability threat to the General Fund. (The $9.7 million increase from the General Fund for state support is part of a series of General Fund increases for state support planned over the next three years, totaling cumulatively $43 million.) Of the requested increase for the budget year, about $5.1 million (19 personnel-years) is for maintenance work on levees and flood channels. This is about a doubling of current expenditures for this purpose. In addition, $835,000 is proposed to begin a systematic evaluation of levees and channels to identify deficiencies. This is a minimal start for an effort that is projected to cost about $100 million for a full systemwide evaluation. The department indicates that it will seek funding from the Corps to share in the total costs of a systemwide evaluation, perhaps up to 75 percent. The requested increase also includes $2 million for floodplain management (leveraging federal funds for floodplain mapping) and $1.7 million for emergency response (including flood forecasting).

The requested increases for flood management are well justified in light of the challenges identified in the White Paper. However, the increases reflect a small fraction of the funding requirements identified. Finally, it is important to note that the budget does not reflect the establishment of new funding sources recommended by the White Paper. Rather, the department has indicated that a legislative package to implement such funding strategies is currently under consideration by the administration.

Figure 5

Governor's 2005-06 Budget Request: Increase for Flood Management

(In Thousands)

State Support	
Flood project maintenance	$5,123
Floodplain management	2,000
Emergency response	1,730
System re-evaluation and rehabilitation	835
Total	**($9,688[a])**
Capital Outlay	
Various capital outlay projects	$21,112[b]
Total	**$30,800**

a All General Fund.

b $16,700 from the General Fund, $4,412 from reimbursements.

Recommended Next Steps

We think that the White Paper does a good job of identifying the major flood management challenges facing the state today. The Governor's budget proposal takes some initial steps in addressing these challenges. Below, we enumerate what we consider to be the most important initial actions that the Legislature should take to begin addressing the problems. We highlight the recommended next steps in Figure 6 (see next page).

Figure 6

LAO's Recommended Legislative Steps To Begin Addressing Flood Management Problems

- ✓ Direct development of multiyear plan to assess systemwide structural integrity and carrying capacity.
- ✓ Enact Central Valley flood control benefit assessment.
- ✓ Re-evaluate state's role with respect to Delta levees.
- ✓ Improve connection between land use decision making and resulting flood-related fiscal consequences.

Develop Multiyear Plan to Assess Systemwide Structural Integrity and Carrying Capacity. While the budget proposes a modest effort to begin evaluating the structural integrity and channel carrying capacity of the Central Valley flood control system ($835,000 in the budget year), it is clear that a comprehensive systemwide evaluation is required. This will require a multiyear effort and a substantial funding commitment. We therefore recommend the Legislature direct the department to develop and submit to the Legislature for its review a plan that: (1) schedules over time an evaluation of the complete system, based on a clear set of priorities to guide the timing of the work; (2) estimates the costs of such an evaluation; and (3) identifies funding sources to support the effort, including federal funds and flood control benefit assessments.

Enact Central Valley Flood Control Benefit Assessment. Based on the application of the beneficiary pays funding principle, we recommend the enactment of legislation to establish a systemwide benefit assessment as recommended by the White Paper. Potentially, this could be done by revising existing statutory provisions governing the Sacramento-San Joaquin Drainage District.

Re-Evaluate State's Role With Respect to Delta Levees. As discussed, a majority of the levees in the Delta are not subject to Corps construction standards or state oversight of their operations and maintenance. (These are referred to as "nonproject" levees.) Yet, there is a statewide interest in ensuring the performance of these levees, particularly given much of the state's dependence on the Delta for water supplies. Given the substantial public costs that can result when a nonproject levee fails (such as the recent levee failure at Jones Tract), it may be more cost-effective for the state in the long run to expand its oversight role over these levees. However, such an expanded oversight role would have to be carefully structured so as avoid exposing the state to additional liability due to its new role.

Improve Connection Between Land Use Decision Making and Resulting Flood-Related Fiscal Consequences. Finally, as noted, the White Paper recommends improved floodplain mapping as well as mandatory flood insurance requirements as strategies to reduce the likelihood of ill-advised development approvals in flood-prone areas.

We think that additional strategies are warranted. First, the Legislature could provide that local agencies are ineligible for flood subvention funding from the state in cases where local land use decisions result in substantial flood risks. Such eligibility criteria could be used to encourage land use decision makers to give greater consideration to the potential costs and benefits of their decisions.

Second, the Legislature might also consider enacting a floodplain development fee that would fund the state's additional flood-related costs resulting from new development in floodplains. The rationale for this fee would be "growth funding growth." As with the Central Valley systemwide benefit assessment discussed earlier, such a fee would be justified based on the beneficiary pays principle. However, while the systemwide benefit assessment would be used to pay for the rehabilitation, operations, and maintenance of the existing system, the floodplain development fee would pay for the additional costs that are imposed on the flood control system because of new development.

FINANCING THE CALFED BAY-DELTA PROGRAM

The Governor's January budget document indicates that elements of a ten-year CALFED finance plan recently approved by CBDA will be incorporated in the Governor's May Revision, along with a package of legislation necessary to implement the plan. The finance plan, as currently developed, is a framework to guide the financing of CALFED from 2004-05 through 2013-14, with a total funding target of $8.1 billion. As noted in the budget document, the plan calls for new revenue sources, including water user fees.

In the sections that follow, we first provide background information on CALFED, including legislative and other direction on how CALFED should be financed; CALFED's funding history; and why CALFED is at a funding crossroads. We then summarize the Governor's January budget proposal for CALFED for 2005-06. Finally, we address the ten-year finance plan, where we discuss the uncertainty underlying some of the plan's assumptions and make recommendations on how the Legislature should respond to the plan.

In order to give the Legislature sufficient time to evaluate the finance plan (which will be further refined and detailed from the version approved by CBDA in December 2004) and the legislation proposed to implement it, we recommend the administration provide the Legislature with the implementing legislation proposal by April 1.

Background

What Is CALFED? Pursuant to a federal-state accord signed in 1994, CALFED was administratively created as a consortium of state and federal agencies that have regulatory authority over water and resource management responsibilities in the Bay-Delta region. The CALFED program now encompasses 12 state and 13 federal agencies, overseen by a new state agency—CBDA—created by statute in 2002. The objectives of the program are to:

- Provide good water quality for all uses.
- Improve fish and wildlife habitat.
- Reduce the gap between water supplies and projected demand.
- Reduce the risks from deteriorating levees.

After five years of planning, CALFED began to implement programs and construct projects in 2000. The program's implementation—which is anticipated to last 30 years—is guided by the "Record of Decision" (ROD). The ROD represents the approval of the lead CALFED agencies of the final environmental review documents for the CALFED "plan." Among other things, the ROD lays out the roles and responsibilities of each participating agency, sets goals for the program and types of projects to be pursued, and includes an estimate of the program's costs—$8.5 billion—for its first seven years (2000-01 through 2006-07). As discussed below, the program's actual funding for its first five years has been significantly lower than envisioned by the ROD. In addition, the relative contribution of the various funding sources has differed significantly from that which was envisioned by the ROD.

The ROD Adopts the "Beneficiary Pays" Funding Principle. The ROD states that "a fundamental philosophy of the CALFED Program is that costs should, to the extent possible, be paid by the beneficiaries of the program actions." The ROD, however, provides few details as to how this principle would be implemented. One exception where specific guidance was provided is the ROD's direction that a user fee be developed—to raise $35 million annually—to support ecosystem restoration activities that benefit Bay-Delta water users.

Legislative Direction Regarding CALFED Financing. While neither the CALFED governance legislation (Chapter 812, Statutes of 2002 [SB

1653, Costa]) nor any other legislation lays out a comprehensive framework for how CALFED should be financed over the long term, the Legislature on a number of occasions has stated its intent regarding CALFED financing. These include budget control language in the *1999-00* and *2000-01 Budget Acts* stating that beneficiaries of surface water storage projects that proceed to construction should reimburse all prior planning expenditures made from the General Fund. Similarly, in the *Supplemental Report of the 2002-03 Budget Act*, the Legislature directed CALFED to draft a financing plan for potential surface storage facilities consistent with the beneficiary pays principle. Finally, the *2003-04 Budget Act* includes a statement of legislative intent that CBDA submit a broad-based user fee proposal for inclusion in the *2004-05 Governor's Budget*, consistent with the beneficiary pays principle specified in the ROD. However, such a fee proposal was not submitted to the Legislature.

State Funds Have Contributed Most to CALFED. Although the ROD envisioned CALFED being financed over time by roughly equal contributions of federal, state, and local/user funding, the state has been by far the major funding source for the program's first five years, providing about $1.9 billion, or close to 60 percent, of funding. Figure 7 shows the imbalance of the contributions from these three funding sources.

Figure 7

CALFED Funding, by Source

2000-01 Through 2004-05
(In Millions)

Year	State Funds	Federal Funds	Local/User Funds[a]	Total Funding
2000-01	$320.3	$53.1	$125.2	$498.6
2001-02	416.0	67.8	138.0	621.8
2002-03	276.1	45.1	154.5	475.7
2003-04	471.2	40.3	228.7	740.2
2004-05	368.4	35.3	509.1	912.8
Totals	**$1,852.0**	**$241.6**	**$1,155.5**	**$3,249.1**

[a] Includes revenues from Central Valley Project Improvement Act Restoration Fund (funded by water users), State Water Project contractor revenues, and local matching funds mainly for water recycling grants. There is additional local funding of an unknown amount that supports CALFED objectives, but is not currently tracked by the California Bay-Delta Authority unless it is in the form of matching funds.

Almost all of the state funds supporting CALFED have been taxpayer-supported "general-purpose" funds, namely monies from the General Fund and bond funds. Apart from a relatively small contribution from the State Water Project and Central Valley Project contractor revenues, no user fees have supported the program. The local funding support for the program, while significant, largely reflects a local match for state bond funds, mainly for water use efficiency projects.

CALFED Is at a Funding Crossroads. The CALFED program is clearly at a funding crossroads. This is for a number of reasons. First, funding sources that the program has traditionally relied on—such as the General Fund and state bond funds—are either essentially unavailable or have been substantially depleted. There will be a significant drop in available funding beginning in 2006-07, particularly due to the depletion of available bond funds. Second, the program's funding requirements are likely to increase as major projects that have been in the study stage for a number of years move toward funding. Third, as will be discussed below, the ten-year CALFED finance plan projects a substantial funding gap between its ten-year funding targets and currently available funding. The funding shortfall absent new revenue sources—$6.3 billion—is close to 80 percent of the funding targets.

Governor's Budget Proposal

Figure 8 shows the breakdown of CALFED expenditures from state funds in the current year and as proposed for 2005-06, among the program's 12 elements.

Current-Year Expenditures. As shown in the figure, the budget estimates CALFED-related expenditures from state funds of $397.9 million in 2004-05. Of this amount, $11.9 million is from the General Fund, with the balance mainly from Proposition 50 bond funds ($194.4 million), Proposition 13 bond funds ($147.9 million), and State Water Project funds ($40 million).

For the current year, the largest state expenditures are in the ecosystem restoration ($101 million) and water storage ($92.4 million) programs.

Budget Proposes $240.6 Million of State Funds for 2005-06. As shown in Figure 8, the budget proposes $240.6 million of state funds for various departments to carry out CALFED in 2005-06, a decrease of $157.3 million, or 40 percent, from the current year. Of this amount, $12 million is proposed from the General Fund, with the balance mainly from Proposition 50 bond funds ($137.3 million), Proposition 13 bond funds ($57.1 million), and State Water Project funds ($25.4 million).

Figure 8

CALFED Expenditures—State Funds Only

(In Millions)

Expenditures by Program Element	2004-05	Proposed 2005-06
Ecosystem restoration	$101.0	$30.5
Environmental Water Account	32.5	18.1
Water use efficiency	35.6	75.8
Water transfers	0.6	0.6
Watershed management	28.7	5.8
Drinking water quality	17.5	2.6
Levees	21.8	19.1
Water storage	92.4	17.3
Water conveyance	36.7	44.7
Science	21.9	9.7
Water supply reliability[a]	1.8	8.9
CALFED program management	7.4	7.5
Totals	**$397.9**	**$240.6**
Expenditures by Department		
Water Resources	$263.8	$203.1
California Bay-Delta Authority	31.1	19.7
State Water Resources Control Board	24.1	8.5
Fish and Game	75.2	5.7
Conservation	3.3	3.3
Forestry and Fire Protection	0.3	0.2
San Francisco Bay Conservation And Development Commission	0.1	0.1
Totals	**$397.9**	**$240.6**
Expenditures by Fund Source		
Proposition 50	$194.4	$137.3
Proposition 13	147.9	57.1
Proposition 204	1.6	6.6
General Fund	11.9	12.0
State Water Project funds	40.0	25.4
Other state funds	2.1	2.2
Totals	**$397.9**	**$240.6**

[a] Could include conveyance, water storage, water use efficiency, water transfers, and Environmental Water Account expenditures.

As Figure 8 indicates, CALFED expenditures are spread among seven departments. The largest expenditures are found in DWR ($203.1 million) and CBDA ($19.7 million). The largest state expenditures are proposed for water use efficiency ($75.8 million), water conveyance ($44.7 million), and ecosystem restoration ($30.5 million).

Fee Proposals Will Come at May Revision. As previously noted, the budget proposal does not reflect any new revenue source, such as new water user fees. Rather, these will be incorporated in the Governor's May Revision. As discussed above, we recommend that the proposed legislation to implement the finance plan be submitted to the Legislature for its review by April 1.

The Ten-Year Finance Plan: A Summary

Finance Plan Revises Funding Targets in ROD Downward. The finance plan adopted by CBDA in December 2004 provides a funding framework for CALFED from 2004-05 through 2013-14. The plan is based on a ten-year funding target of about $8.1 billion. The financing plan reflects a significant reduction ($4.5 billion, or 36 percent) from the funding targets envisioned in the ROD for this time period. According to the finance plan, the ROD funding targets were updated based on a review of several factors, including program actions needed to meet program objectives, program priorities, and the "fiscal realities" of the next ten years.

Finance Plan Allocates Funding Among Beneficiaries. Using the $8.1 billion ten-year funding target, the finance plan allocates this cost among state taxpayers, federal taxpayers, water users, and local grant matching sources. It does this based on the plan's evaluation of who benefits from the programs and projects encompassed by the $8.1 billion. Figure 9 shows the finance plan's allocation of the $8.1 billion total cost, by beneficiary category.

Finance Plan Shifts Costs Away From State. Figure 9 highlights a significant reallocation of funding contributions for the program, compared to the allocations in the program's first five years (as shown in Figure 7). Specifically, in the program's first five years, state taxpayer funds supported close to 60 percent of the program's costs. However, the ten-year finance plan allocates about 30 percent of costs to the state, with increased shares to be assumed by the federal government (from 7 percent to 21 percent), water users (from 6 percent to 9 percent), and local matching fund sources (from 27 percent to 40 percent).

Figure 9

CALFED Ten-Year Finance Plan

2004-05 Through 2013-14
(Dollars in Millions)

Program Element	Funding Allocation by Beneficiary: State	Federal	Water Users	Local Match	Total Funding Target
Ecosystem restoration	$542	$408	$400	$150	$1,500
Environmental Water Account	180	135	123	—	438
Water use efficiency	575	530	—	2,048	3,153
Water transfers	6	—	—	—	6
Watershed	196	161	—	66	423
Water quality	81	72	17	105	276
Levees	186	175	32	53	446
Storage	292	36	9	750	1,087
Conveyance	109	6	71	—	185
Science	167	151	108	11	437
Oversight and coordination	75	46	—	—	121
Totals	**$2,408**	**$1,722**	**$760**	**$3,183**	**$8,073**
Total Percentage	30%	21%	9%	40%	100%

Finance Plan Anticipates Substantial But Undefined New Revenues. As noted previously, revenue sources that CALFED has traditionally relied on are running out. In order to meet the $8.1 billion funding target, substantial new sources of revenue—totaling over $6.3 billion, or 78 percent of the funding target—will need to be identified. Figure 10 (see next page) shows the finance plan's funding target versus currently available funding for each of the broad fund source categories that support CALFED.

Specifically, the finance plan target anticipates a federal funding contribution that is many times greater than federal funding received to date. We discuss in the next section whether this is realistic.

In addition, the finance plan includes new fee revenues from water users to account for benefits to these users in four program elements: ecosystem restoration, Environmental Water Account, levees, and science. Water users benefit from these four programs since each of these programs serves in part to make the supply of water to these users more reliable. The finance plan does not include specific proposals for these new fees. Rather, CBDA staff is currently developing fee options. It is anticipated that the structure for a water user fee that would raise $25 million annually (in

Figure 10

CALFED
Funding Requirements Versus Available Funding

2004-05 Through 2013-14
(Dollars in Millions)

	CALFED Funding		Shortfall	
Fund Source	**Target[a]**	**Available[b]**	**Amount**	**Percent**
State funds	$2,407	$885	-$1,522	-63%
Federal funds	1,722	34	-1,688	-98
Water users	760	225	-535	-70
Local match	3,184	604	-2,580	-81
Totals	**$8,073**	**$1,748**	**-$6,325**	**-78%**

a Pursuant to ten-year finance plan approved by California Bay-Delta Authority, December 2004.

b Includes remaining state bond funds and assumed continuation of base-level state funding from sources other than bonds, such as the General Fund; local matching funds to match remaining state bond funds; and continuation of existing level of revenues from State Water Project and Central Valley Project water users.

addition to the $20 million paid currently by Central Valley Project water users) for the ecosystem restoration program will be ready for legislative evaluation at the May Revision. The authority's staff is considering a number of fee structures, including fees based on the amount of Bay-Delta water diverted by the water user from the system, the storage capacity in Bay-Delta system reservoirs, or some combination of these two options.

Finally, the finance plan anticipates a substantial amount of new state funds (about $1.5 billion). These could include funds from a yet-to-be-proposed state water bond, the General Fund, or a new statewide water surcharge. Apart from stating a need for new sources of state funding, the finance plan includes no recommendations or proposals for new state funding sources.

Uncertainty Underlying Finance Plan

Two major sources of uncertainty underlying the finance plan are the plan's assumption of greatly increased levels of federal funding and new sources of state public funds.

Federal Funding Uncertainty. As shown in Figure 7, the federal government has lagged significantly in its funding contribution to CALFED. Since 2000-01, only about $240 million, or 7 percent, of the program's funding has come from federal funds, in spite of the ROD envisioning that

that the federal government would cover roughly one-third of the program's costs. The finance plan assumes that the federal share would increase to 21 percent over the next ten years, with about $1.7 billion of new federal funding. While this is certainly more realistic than a one-third share, it is still many times greater than the federal contribution to date.

While a recent federal authorization bill signed by the President includes $389 million for CALFED, it is risky to assume that all of those funds actually will be appropriated over the six years of the authorization. Under prior legislation authorizing $430 million for CALFED, only about one-half was actually appropriated.

State Funding Uncertainty. As mentioned previously, the plan assumes that $1.5 billion of the program's costs will be funded by unidentified new sources of state public funds. This amount reflects the funding shortfall between the funding target for state funds ($2.4 billion) and "available" state funding ($885 million). It is risky to assume such a high level of funding from unknown sources.

How Should the Legislature Respond to Finance Plan?

We think that there are a number of issues for the Legislature to consider when it evaluates the finance plan.

Are Funding Targets Unrealistic? We think CBDA has made a good effort to incorporate the beneficiary pays principle into the finance plan, consistent with legislative direction and the ROD. However, we are concerned that the funding targets may be unrealistic, given that they assume high levels of highly uncertain federal funding and unspecified sources of new state funds.

Unrealistic funding targets can lead to implementation problems if fee structures are set too rigidly. Here is a simple example to illustrate this. Suppose that a funding target of $100 million is set for a program, and the application of the beneficiary pays principle would allocate this cost based on who benefits to water user fees (50 percent) and federal funds (50 percent). Suppose further that the water user fee is structured rigidly to raise $50 million (50 percent of $100 million), but only $10 million of federal funds materialize. Then the actual funding for this program would deviate substantially from the beneficiary pays principle and water users would be paying for a share of the program's costs that does not benefit them directly.

In order to avoid this problem while holding true to the beneficiary pays principle, it would be important for any CALFED funding mechanism approved by the Legislature, such as new water user fees, to be flexible so that it will adjust accordingly when changes are made to the funding target that drives the amount of revenues to be contributed by a particular funding source. If funding targets are realistically set, frequent adjustments to the fee structure should not be required.

Need Statutory Parameters to Guide Beneficiary Pays Principle Application. As we discussed in our *Analysis of the 2004-05 Budget Bill* (see page B-28), we recommend the enactment of legislation that adopts the beneficiary pays principle for funding CALFED and provides guidance regarding its application. We think that providing this guidance will be important for two reasons. First, if this funding principle is not defined, there is a substantial risk that stakeholder gridlock would result when CALFED attempts to apply it on its own, due to inevitable disagreements among program beneficiaries about the extent to which costs should be allocated to them. Second, as noted by the California Business Roundtable in a report on financing water infrastructure, there is a tendency to overallocate the costs of water projects to the broad public benefit, perhaps because it is easier to do and it avoids difficult decisions about allocating costs to specific beneficiaries.

Since adjustments to CALFED's funding targets are likely to be made over time, as the targets are brought in line with realistic revenue assumptions, legislative direction is needed to guide the resulting reallocation of costs among beneficiaries. Specifically, we think that there should be a statutory definition of "public benefit" and "user benefit," so as to provide objective guidance when public funding and fee-based water user funding, respectively, are appropriate.

Setting Expenditure Priorities for CALFED. Finally, given the significant uncertainty underlying the funding targets in the finance plan, we think that the Legislature should play a role in setting expenditure priorities for CALFED. To this end, we recommend the Legislature hold joint hearings of the water and natural resources policy committees and budget subcommittees in each house on the finance plan. At the hearings, we recommend that CBDA inform the Legislature of the programmatic implications and CALFED's expenditure priorities if the assumed level of funding in the finance plan does not materialize. To the extent that those priorities do not coincide with the Legislature's priorities, the Legislature should provide clear direction to guide CALFED expenditures at reduced funding levels.

CONCLUSION

Addressing the state's flood management problems and the financing requirements of CALFED present major fiscal challenges for the state. In both cases, there are opportunities to apply the beneficiary pays funding principle to shift costs away from the state to those who directly benefit from the state's programs.

The crisis in flood management, reflected by an aging, deteriorating state flood control infrastructure, grows every day that the problems go unaddressed. As a first step, the state needs to perform a comprehensive evaluation of the structural integrity and the capacity of the state's flood control system, to serve as the basis for developing a multiyear plan to rehabilitate the system.

The Legislature has a major role to play in guiding the financing of CALFED. The program's funding targets should be based on realistic revenue assumptions, and the Legislature will need to establish expenditure priorities so that the program can be "right sized" consistent with those priorities. Statutory guidance regarding the application of the beneficiary pays principle in financing CALFED would significantly facilitate the implementation of this funding principle.

EVALUATING THE ADMINISTRATION'S CALIFORNIA RX PROPOSAL

How Would the Governor's Pharmacy Assistance Proposal Work and How Could it Be Improved?

Summary

The Governor's 2005-06 budget plan includes a funding request and related legislation for a new state program to help low- and moderate-income Californians purchase prescription drugs at discounted prices. Our analysis indicates that the Governor's California Rx plan provides a reasonable starting point for the development of such a program, but we recommend modifications to the proposal that we believe will result in a more effective program that will protect the interests of California taxpayers and consumers. We propose, among other changes, that in the event that drug makers fail to make good on their promises for significant price concessions, an automatic trigger would phase-out the proposed voluntary approach to obtaining rebates from drug manufacturers, and be replaced by an alternative strategy likely to result in greater discounts on more drugs for consumers.

Introduction—Discounts for Drugs

Steadily increasing consumer prices for prescription drugs and estimates that more than 6 million Californians lack health insurance have prompted the Legislature to explore a number of options for providing assistance to those with high prescription drug bills.

In response, the Legislature enacted Chapter 946, Statutes of 1999 (SB 393, Speier), to require retail pharmacies to sell prescription drugs to persons enrolled in the Medicare Program at a discount—just above Medi-Cal Program prices. Further legislation (Chapter 696, Statutes of 2001 [SB 696, Speier]) was enacted to provide deeper discounts to these individuals through rebates from drug companies. The latter measure (known as the Golden Bear Pharmacy Assistance Program) has never been implemented, partly because of administrative problems related to passing those rebates along to consumers. In addition to these state programs, some private parties, including a number of drug manufacturers, have offered their own privately subsidized programs to provide discounted drugs, or in some cases even free medications, for some consumers.

The Governor's Proposal for Pharmacy Assistance

Governor's Proposal. The Governor's 2005-06 budget plan for the Department of Health Services (DHS) proposes to establish a California Rx program aimed at reducing the costs certain California consumers would have to pay for drugs purchased at pharmacies. The California Rx plan was initially offered in a modified form as amendments to several legislative measures last year, but was not adopted. Since that time, the Governor has revised his legislative proposal in some significant respects (now contained in SB 19 [Ortiz]), and incorporated a request for 18.5 staff positions and about $3.9 million from the General Fund into the 2005-06 spending plan for DHS. Key features of the proposal are summarized in Figures 1, 2, and 3 (see following pages), and discussed below.

Eligibility. The Governor proposes to allow low- and moderate-income California residents to enroll in the program by paying a $15 annual fee in order to obtain a prescription drug purchase discount card. In general, those eligible would be individuals and families with incomes up to 300 percent of the federal poverty level (FPL)—up to roughly $28,000 a year in income for an individual or $56,500 for a family of four. The new discount program would be available on a voluntary basis mainly for persons who do not have other forms of health insurance coverage through either private health insurance or enrollment in the state's Medicaid Program (known as Medi-Cal in California) or in the Healthy Families insurance

Figure 1

Major Components of California Rx

- ✓ ***Who Is Covered?*** Uninsured California residents in families with income up to 300 percent of the federal poverty level would be eligible to enroll.
- ✓ ***Voluntary Pharmacist Participation.*** Pharmacists who voluntarily chose to participate would assist individuals in applying for discount cards and must sell prescription drugs at agreed-upon discounts.
- ✓ ***Voluntary Drug Company Participation.*** Drug manufacturers could participate in the program if they voluntarily agreed to enable further discounts on prices through payment of rebates to the state.
- ✓ ***Federal Designation.*** The state would obtain federal designation as a State Pharmacy Assistance Program, which opens the door to deeper price-cutting by drug makers.
- ✓ ***Program Integration.*** The state's California Rx card would be integrated with private consumer discount programs operated by the drug companies themselves. One discount card would access all participating programs.
- ✓ ***Related Efforts.*** In a related effort, drug makers have pledged to spend $10 million over two years to publicize and fund toll-free telephone lines and Internet web sites to create a "single point of entry" for discounted drugs for Californians or, in some cases, free medications through existing privately funded assistance programs.

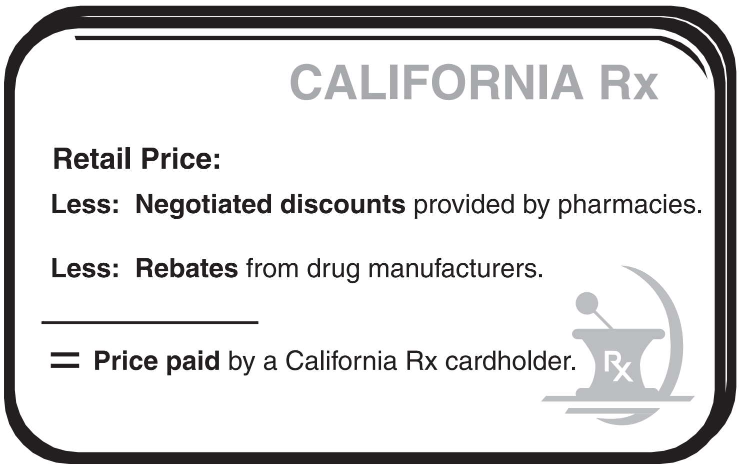
programs for children. Medicare enrollees could participate in the program in some circumstances.

An applicant would not be required to provide any form of written proof of family income level. The administration estimates that up to 5 million Californians would be eligible to enroll in California Rx.

Pharmacy Discounts. The drug discount card would be generally similar in nature to the discount cards now available from various public and private programs including, most recently, the Medicare Program. Pharmacists who voluntarily chose to participate in the program would assist qualifying individuals in applying to the state for the discount cards, and must also agree to sell prescription drugs to persons possessing such cards at an agreed-upon discount negotiated in advance on a statewide basis with the state.

Figure 2

How California Rx Would Cut Retail Drug Prices for Consumers



Voluntary Rebate Mechanism. The prescription drug prices paid by California Rx cardholders are to be further discounted through rebates the state would negotiate and obtain on a voluntary basis with drug manufacturers. In effect, the state would collect an agreed-upon amount of rebate money from a drug manufacturer each time a California Rx participant purchased one of the manufacturer's covered drug products using the discount card. The measure sets as a goal that the state obtain discounts for consumers equal to the lowest available commercial price—on average, about 40 percent below the price available in retail pharmacies.

The pharmacies would act as a sort of middleman in such transactions. In addition to the discount that a pharmacy would be required to provide a consumer on the price of a drug purchase, the pharmacy would further discount the price of a drug sold to a California Rx participant by a dollar amount equal to the applicable drug manufacturer's rebate. The pharmacy would subsequently be reimbursed by the state in an amount equal to that rebate. The state, in turn, would be reimbursed for these payouts to pharmacies through regular payments of the rebates from the drug manufacturers.

Figure 3

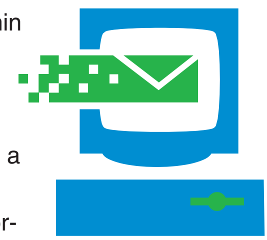
How an Individual Would Participate In California Rx Discounts

Step 1:

A consumer goes to a pharmacy (among other locations) and, after being screened for eligibility, would receive assistance in filling out a one-page enrollment application form. No proof of income level would be required. A $15 enrollment fee would be charged to the consumer.

Step 2:

The application form would be sent electronically to the state for a determination of eligibility that would have to be made within four hours of receipt of an application. A California Rx card would be mailed to a successful applicant within four days. But an applicant could immediately be issued a California Rx identification number that would enable the person to receive California Rx discounts on a drug purchase.



Step 3:

The consumer presents the prescription form and California Rx card to the pharmacy. The card is "swiped" through an electronic register to determine almost instantaneously, using key data about the cardholder, which specific drug discount offers them the best price on that particular drug. If private drug assistance provided a better drug price than the negotiated California Rx price (or even free medications), the purchase would be made through that private program at that lower cost.

State Pharmacy Assistance Program Designation. Due to its voluntary nature, the California Rx program would not necessarily provide discounts for all available prescription drugs. Also, a drug maker could agree to allow some drugs, but not others, to be included in the California Rx program. The administration proposes to encourage drug manufacturers to cooperate in providing deeper discounts, and on a greater product line of drugs, by obtaining federal designation for California Rx as a State Pharmacy Assistance Program (SPAP).

Federal law generally requires drug manufacturers to offer their lowest prices to certain federally supported health programs. If a state were to negotiate a significant discount on a drug with its manufacturer, federal law effectively requires that the company cut its price even further for all of its sales of the same product to federal health programs. These federal constraints thus ordinarily make drug manufacturers resistant to negotiating deep discounts on drugs with other private or public entities, such as for the California Rx program. Designation as an SPAP addresses this concern, because drug sales to an SPAP are exempted from these so-called federal "best price" rules. If a drug company discounted the price at which it sold its product for the California Rx program, it would be under no obligation to further discount its prices for federally supported health programs. A state program such as California Rx can qualify for this federal designation so long as no federal funds are used for its support and the program has set income limits on eligibility. The exact income limits that must be set are not specified in federal rules.

Integration With Other Drug Discounts. Another aspect of the Governor's proposal involves integration of the California Rx discounts with other consumer discount programs, including a number offered by the drug companies themselves. The administration proposes to create a "seamless" system by which one discount card would automatically provide consumers access to the best discount available to them for a particular drug purchase. The administration believes that available computer technology would allow a pharmacy to determine, almost instantaneously, which private or public discount program would offer the best price for a drug to a consumer presenting a California Rx card at the time of purchase.

Related Efforts. As part of the California Rx program, the administration has indicated that the Pharmaceutical Researchers and Manufacturers Association (PhRMA), a private group representing major drug makers, has pledged to contribute $10 million over two years for related efforts to reduce the drug prices paid by Californians. The funds would be used to publicize and fund toll-free telephone lines and Internet web sites for a "single point of entry" by which eligible citizens would obtain discounted drugs or, in some cases, free medications through already-established privately funded assistance programs. These efforts are scheduled to begin this spring.

WEIGHING THE PROS AND CONS AND THE ALTERNATIVES

As it considers its response to the Governor's California Rx budget request and the associated proposed legislation, we recommend that the Legislature carefully weigh the pros and cons of the Governor's proposal and also compare his approach to alternative strategies for reducing drug costs being considered in other states. These issues are discussed below.

Benefits of the Governor's Proposal

Our analysis indicates that the Governor's plan offers some potential advantages and benefits to the state if it were implemented effectively.

Low Risk of Litigation. For reasons discussed in more detail later in this analysis, a number of pharmacy assistance proposals developed in other states have encountered legal challenges that have, thus far, prevented their full implementation. The Governor's approach relies upon voluntary participation by drug manufacturers, an approach that health policy and legal analysts have suggested minimizes the risk of major legal challenges that could slow or even thwart start-up of the discount program. The PhRMA, a leading plaintiff in such legal challenges in other states, has endorsed the Governor's proposal and indicated that it would not mount a legal challenge to it in court.

Academic researchers interpret a recent U.S. Supreme Court ruling involving a program in the State of Maine ("Maine Rx Plus") to mean that alternative approaches for providing pharmacy assistance are available to the states. One commonly discussed approach is to require drug companies to provide participants in such programs the same or similar rebates that are mandated for Medicaid beneficiaries. Nonetheless, it is likely that some of these alternative approaches would provoke legal challenges that, even if ultimately rejected by the courts, would probably delay the implementation of a pharmacy assistance program. The Governor's approach would probably not encounter such legal delays, at least on that basis. The state would also avoid the potential unknown costs of engaging in such litigation.

Broader Access to Drug Discounts. Most existing drug discount programs target the elderly and disabled for assistance. That is now largely true for the private discount programs being sponsored by drug manufacturers, and it is also the case for the state's existing pharmacy assistance program. That program, enacted in 1999 as Chapter 946, requires pharmacies to sell prescription drugs to persons enrolled in Medicare—the elderly and disabled—at just above Medi-Cal prices. California Rx would result in greater access to drug discounts to persons who are largely excluded from these existing discount programs—including children and families in low- and moderate-income households. While this group, as a whole, is in better health overall and thus does not ordinarily bear heavy prescription drug costs, some individual families and children may have chronic medical conditions, such as asthma, that could require ongoing and regular prescriptions for sometimes-expensive medications.

Potential Fiscal Benefits for the State. The implementation of a pharmacy assistance program, such as California Rx, could provide some fiscal benefits to the state by keeping some uninsured individuals from becoming eligible or enrolled in full-scope state-supported medical benefit programs, such as Medi-Cal. Absent the discounts that might be available under such a pharmacy assistance program, for example, some poorer uninsured individuals might forego the purchase of their prescribed drugs, eventually become disabled as a result of their untreated medical condition, and thus become eligible for a full package of Medi-Cal benefits. Other individuals might "spend down" their financial assets on expensive drug purchases absent such discounts and in that way become eligible for Medi-Cal. The exact fiscal benefit to the state from a pharmacy assistance program is unknown, but could be significant if California Rx enrolled a large number of consumers.

Key Trade-Off: Ease of Implementation Versus the Best Price

In discussions with the Legislature, the administration has emphasized its belief that its proposal would clear the way for implementation of its pharmacy assistance program in a timely manner. This ease and speed of implementation involves a significant tradeoff, in that some of the alternative approaches discussed below would give the state a stronger bargaining position in negotiations with drug manufacturers that would probably result in greater discounts for the public for a more extensive list of prescription drugs. In particular, the administration's proposal to negotiate rebates on a voluntary basis with drug manufacturers would probably result in lower rebates, and agreements for rebates on fewer types of drugs, than if the state took the same approach as the State of Maine.

The Maine Rx Plus Approach. Maine, along with some other states, intends to leverage its Medicaid Program to strongly encourage drug manufacturers to provide substantial rebates on drug prices for participants in its Maine Rx Plus pharmacy assistance program. In particular, any drug maker which does not agree to provide deep rebates on prescription drug prices for Maine Rx Plus cardholders (who are not enrolled in Medicaid) will lose its preferred status for providing drugs for Maine's Medicaid Program.

This means that a doctor would be required to have prior authorization to prescribe that manufacturer's drug for a Maine Medicaid enrollee, making it less likely in some cases to be prescribed if other similar drugs are available which do not require such prior authorization. Drug makers which agree to provide significant rebates will not face prior authorization requirements for their products. This phase of Maine's program is expected to commence this spring. The state reports that it has already secured rebates with 20 drug companies for 200 drugs with prices up to 60 percent below the retail pharmacy price.

Iowa Had Little Success at Voluntary Rebate Approach. It does not appear likely that California Rx will be able to obtain rebates comparable to Maine through a voluntary approach. Iowa state officials took a comparable voluntary approach in the state's "Iowa Priority" program but, according to academic researchers, deemed their effort a failure after only 3 of 20 companies that were approached agreed to participate.

The administration has indicated that it has received preliminary commitments from major drug industry leaders to cooperate with the new California program, and projects that the pharmacy and manufacturer rebates together will reduce the cost of drugs on average by 40 percent compared to retail pharmacy prices. However, that would still be significantly below the 60 percent to 65 percent savings off pharmacy retail prices that the state generally receives under the Medi-Cal Program. The full extent of rebate savings that could be achieved under a voluntary California Rx approach and the full list of drugs for which rebates would be received, would not be known, in any event, until after rebate contracts were negotiated and signed over the next year with drug companies.

A Strategy for Savings

A Fundamental Strategic Choice. The administration's California Rx proposal presents the Legislature with a fundamental choice between what we view as two valid strategic approaches.

The first choice is to proceed relatively quickly and easily with the Governor's approach of attempting to gain rebates on a voluntary basis from drug manufacturers. This approach would probably generate some significant discounts on some prescription drugs for low- and middle-income consumers, although the exact level of savings will be hard to know until rebate agreements are finalized. The experience of Iowa's program that we noted earlier is evidence that major price concessions on a wide range of drugs is by no means assured for Californians.

In the alternative, the Legislature could follow the lead of Maine and other states and implement a pharmacy assistance program that does not rely upon voluntary rebates but instead requires rebates from companies as a condition of allowing their drug products to keep their preferred status in the Medi-Cal Program (meaning that they would not be subject to prior authorization requirements).

This alternative approach would probably result in a greater level of savings for consumers than the Governor's proposal, with greater rebates being received on a more extensive list of prescription drugs. Last year's U.S. Supreme Court ruling in the Maine case has opened the door to such an approach, and Maine itself appears to be on the brink of implementing such a strategy.

However, we also believe the Medi-Cal leveraging strategy is not one that would be implemented quickly. Creating a direct linkage between California Rx and Medi-Cal would probably require a lengthy and complicated process for obtaining the necessary federal approvals. Moreover, the experience of other states is that such a statutory approach would almost certainly face a protracted legal challenge from the pharmaceutical industry that would probably delay the implementation of a discount program in California.

Our recommended approach for addressing this key strategic choice is discussed below and summarized in Figure 4.

Figure 4

The LAO Alternative: A "Trigger" for California Rx

- ***Voluntary Rebates.*** The Department of Health Services (DHS) would negotiate voluntary rebates with drug manufacturers sufficient to meet the specific goals established in the California Rx legislation for providing significant discounts on a full complement of drug products.
- ***Annual Certification.*** The Director of DHS would certify in writing each year whether drug manufacturers were complying with these statutory goals, including specifically whether the average discounts being received resulted in the anticipated level of discounts. A written report on drug makers' compliance with California Rx goals would be provided to the Legislature and the public each year.
- ***Program Continuation.*** If the DHS Director certified that the statutory goals of California Rx were being met (including provisions requiring continuation of private outreach efforts and the single point of entry for discount programs) the voluntary rebate approach would continue for at least another year.
- ***Trigger New Programs.*** If the DHS Director did not certify compliance with the goals of the program by drug makers, he or she would automatically be required by statute to phase out the voluntary rebate program and to seek federal approval for and implement a strategy to leverage the Medicaid Program to obtain deep discounts for persons enrolled in California Rx. A drug might no longer have preferred status in Medi-Cal if its manufacturer did not have a written agreement with the state to provide a rebate for California Rx.

Try Governor's Approach First, But With a Trigger. In our view, both of the strategic approaches we have discussed have some merit. Accordingly, we recommend that the Legislature try the administration's approach for voluntary rebates first—but direct DHS in advance to move forward with the second approach if the Governor's program should fail to achieve its goals.

Specifically, we recommend that the California Rx legislation be amended to automatically require the director of DHS to phase out the voluntary approach, and to commence the implementation of a Medi-Cal leveraging strategy for California Rx, in the event that drug makers fail to make good on their promises to the administration to offer significant price concessions on an extensive list of prescription drug products.

In such a circumstance, the eligibility standard for the program would also automatically be expanded to 400 percent of FPL in place of the present 300 percent of FPL standard. We believe this additional trigger would provide a further incentive for drug makers to agree to substantial rebates because of the additional number of Californians who would be eligible to participate in the program.

Under our approach, the legislation would require the Director of DHS to certify each year the level of drug manufacturer compliance with the California Rx program. In a publicly released report that would be made available to the Legislature for its review, the Director of DHS would have to certify whether: (1) the drug discount goals identified in the legislation were being met for a full complement of medically necessary drugs, (2) that private entities were still cooperating with state efforts to create a single seamless California Rx program with access to private pharmacy assistance programs, and (3) that private support was continuing for outreach activities to make consumers aware of California Rx as well as the single point of entry to provide improved access to private discount programs.

The legislation would specify that, if the Director of DHS did not certify in writing each year that all three of these conditions were being met, the director would automatically be required to seek federal approval for, and to implement, a Medicaid leveraging strategy for the California Rx program. Specifically, the measure would generally require that signed, written agreements exist between the state and drug companies for agreed-upon rebates as a condition of letting their drug products have preferred status in the Medi-Cal Program (meaning they could be prescribed for Medi-Cal beneficiaries without prior authorization).

We believe that such a trigger provision would increase the odds that the administration's approach to pharmacy assistance would succeed. As drug makers considered whether to provide drug discounts on a voluntary basis for a full range of drugs, the consequences of any failure to follow through on their promises to the administration would be clear: If a voluntary approach does not work, the state will automatically move forward with a strategy to ensure such rebates are provided by use of the state's considerable Medi-Cal drug purchasing power. Our proposed trigger language would also hold the drug industry accountable for ensuring that it fulfilled its promises to make its own pharmacy assistance programs more accessible to eligible Californians.

Other Weaknesses and Policy Concerns

Beyond not resulting in the lowest prices, the Governor's approach to establishing a pharmacy assistance program has other weaknesses and raises some policy issues that may be of concern to the Legislature. These concerns are summarized in Figure 5 and discussed below.

Figure 5

Additional LAO Issues and Concerns With California Rx

- ***Some basic accountability*** measures are lacking.
- ***Proposed timing*** for start-up of the program is problematic.
- ***Continuation of outreach*** is not assured after two years.
- ***Integration*** of multiple private and public drug discount programs into one "seamless" system will be difficult to accomplish.
- ***Proposed legislation*** exempts California Rx from competitive bidding requirements that apply to most other state agencies and programs.
- ***Proposed consumer fee*** level is high compared to other states.
- ***Budget request lacks key details*** and does not account for the "float"—the funding gap between when rebate money is paid to the state and when the state must pay pharmacies for rebates paid to consumers.

Accountability Measures Lacking. The administration proposal does not put in place any specific mechanism for estimating and evaluating the effectiveness of the California Rx program in regard to reducing drug prices, or for informing the Legislature on a regular basis of the progress being made by the program in that effort.

Other provisions for ensuring accountability in the new program also seem to be missing from the California Rx legislation. Although the measure specifies that drug manufacturers who agree to voluntarily participate in the program are obliged to pay rebates at least quarterly to the state, for example, no sanctions are provided in the measure for drug companies which fail to remit their rebates to the state completely and in a timely fashion. Although the administration has indicated the California Rx program would include audits to ensure rebates are being appropriately paid to the state by drug companies, the budget request does not include any auditors to check their books.

Basic measures to protect against fraudulent applications for enrollment in California Rx also seem to be absent from the proposal. While the legislation specifies that the California Rx enrollment form must include a statement indicating that making a false statement is punishable under penalty of perjury, for example, the measure does not actually contain language making it a crime to make a false claim of eligibility for the program. Moreover, the California Rx legislation would mandate a turnaround time for the state of no more than four hours to make an eligibility determination once it received an application. While prompt processing of applications is a worthy program goal, we are concerned that no exemption from this rule is provided, even if fraud is suspected and the application warrants further investigation before an eligibility determination can be made. This requirement could also add to state administrative costs for operating the program in the future.

We are concerned that if fraud in program enrollment is not effectively prevented, the California Rx program may ultimately be at risk of losing its federal SPAP designation and the better discounts on drugs that this designation makes possible.

Start-Up Timing Problematic. The administration proposes that the new pharmacy assistance program commence January 1, 2006. That date coincides with the startup date for the new Medicare "Part D" drug coverage across the nation. We are concerned that a launch of both programs on the very same day could result in avoidable confusion for consumers and pharmacies. For example, consumers could end up being confused as to which new program had actually enrolled them. In some cases, the result of this confusion could be the loss of an opportunity to enroll in coverage that could save them thousands of dollars in costs annually.

Continuation of Outreach Not Assured. The California Rx proposal relies on private funding for outreach activities. However, that funding is only available for two years. After that point, no mechanism is in place to ensure that efforts continue to make eligible California consumers aware of the program. While the legislative proposal authorizes continued outreach activities, it does not directly provide any state funds for such ongoing efforts. The evidence from other states is that, even with outreach efforts to encourage enrollment, relatively few consumers (as low of 5 percent of those eligible) participate in such programs. We are concerned that, absent ongoing efforts to increase public awareness of the California

Rx program, participation rates will be low. We also would note that if the Legislature wished to ensure a greater number of participants, it has the option of expanding program eligibility beyond families with incomes up to 300 percent of FPL. Other states are including families with incomes up to 400 percent of FPL in their drug discount programs.

Integration of Multiple Programs May Not Be Seamless. The proposal for a seamless system that quickly and easily gives consumers access automatically to the best program with the swipe of a card may not prove to be so seamless if private pharmacy assistance plans refuse to modify their rules of participation to conform to the California Rx approach. A number of these private plans limit participation to a lower standard of income, require more documented proof of the family's income levels, and separate application forms, all of which potentially conflict with the California Rx approach.

Exemptions Provided From Competitive Bidding Rules. A provision of the administration's bill allows the California Rx contracts to be exempted from various state competitive bidding requirements. However, the budget request provides no explanation or justification for setting aside these rules.

Fee Level Appears High. The administration's proposed legislation mandates that California consumers pay a $15 application fee, with $15 renewal fees each year thereafter, to participate in California Rx. Pharmacies would keep all fee revenue they collected, which presumably would go to offset their administrative costs for assisting enrollees in enrollment in the discount card program.

A recent national study of drug discount programs suggests that the fee proposed for California Rx is higher than the fee charged by other states with comparable programs. A number of states charge no fee at all to participants. No rationale for the proposed fee level has been provided in the administration's plan. We have been advised that it was the result of negotiations between the administration and pharmacy representatives, and does not reflect any administration estimate of the costs to pharmacies of administering the California Rx enrollment system.

If the administration's initial estimates of enrollment of about 1 million proved to be correct (although we believe they may be high), a $15 fee would generate about $15 million annually in revenue for the pharmacies who agreed to join the California Rx program. We would note that these pharmacies would also benefit financially from the program to the extent that their participation in California Rx brought them new customers bearing the discount drug cards, or at least preventing them from losing customers to other pharmacies participating in the state's new program.

Proposal Raises Major Fiscal Issues

Our analysis of the $3.9 million spending request for California Rx identified several significant fiscal issues, which are described below.

"Float" is Unfunded. As we noted earlier, the California Rx legislation requires that drug manufacturers pay rebates to the state on at least a quarterly basis. However, another separate provision of the bill requires that the state reimburse pharmacies for rebates within two weeks of a consumer's purchase of a drug. In other words, the state will in many cases be obligated to pay out rebates to pharmacies before it actually collects the rebate funds from a drug manufacturer. Moreover, any disputes that will likely arise over the actual amounts owed for rebates could further slow payments of rebate funds from drug makers to the state.

These provisions could have a very significant fiscal impact on the state. It is highly likely that the state would have to put aside a large sum of money up front—ranging from $15 million to as much as $60 million, according to administration estimates—to cover the so-called float, the funding gap between the time the rebate money comes to the state and when the state has to pay pharmacies. The administration indicates that it believes the most likely scenario would require $30 million in float funding.

The Governor's budget request did not identify this fiscal impact or request any state funds for the float. When questioned about this issue, administration officials indicated that their intent was to seek sufficient advances of private funds from drug makers to address the cash-flow problem. Failing that, they indicated, their intention is to seek a one-time General Fund appropriation at the time of the May Revision for this purpose. If that turns out to be the case, the first-year cost of the Governor's proposals could be more than eight times the original request included in the Governor's January budget plan.

Some Key Fiscal Details Missing. The budget proposal presented to the Legislature fails to completely justify about $2 million included in the request for "special items of expense." For example, about $1 million is set aside in the budget proposal for computer processing of prescription drug claims and payments of rebates. The budget request assumes that there will be about 5.6 million such claims in 2005-06. Administration officials indicate that this initial estimate of claims was based on the assumption that perhaps about 1 million persons—roughly 20 percent of the eligible population—would purchase prescription drugs about five to six times per year. Further documentation provided by the administration indicates that enrollment would probably range between 180,000 and 823,000 persons by the end of the budget year. Moreover, the number of drug claims in 2005-06 would range between 400,000 and 1.7 million.

Based on these estimates, our analysis indicates that this component of the program is overbudgeted. We also note that the administration's budget request provides little information about how an additional $1 million requested for special items of expense would be used for the development of information systems for California Rx.

Finally, the budget plan proposes to appropriate funding and provide authority for 11 new staff positions who would be assigned to the collection of rebates. The budget plan assumes that all of these staff positions would be hired as of July 2005—six months before there would be any rebates for these staff members to collect. We see no reason why these staff would be needed until after the program starts and consumers begin to purchase drugs using their California Rx rebate cards.

Other Modifications Warrant Consideration

Our analysis of the Governor's budget request and related draft legislation indicates that the California Rx plan provides a reasonable starting point for the development of such a program. In addition to our proposal for a trigger mechanism to ensure the program obtains significant rebates from drug makers, we believe a number of other improvements to the measure should be considered by the Legislature. These recommendations are summarized in Figure 6 and discussed below.

Figure 6

How California Rx Could Be Improved

- ✓ ***Delay the start-up*** of California Rx by six months to avoid confusion with the startup of the new Medicare drug benefits program in January 2006.
- ✓ ***Amend the legislation*** to require immediate and enforceable penalties if drug makers fail to pay rebates in full and in a timely manner.
- ✓ ***Strengthen antifraud protections*** by, for example, eliminating the proposed statutory requirement that all applications be processed within four hours.
- ✓ ***Protect the state General Fund*** from the float by requiring private funding sources for these costs.
- ✓ ***Reduce the budget request*** to strike funding for which inadequate fiscal detail or justification has been provided and to conform to a recommended six-month delay in the program.

- ***Delay Start-Up Six Months.*** The issuance of California Rx discount cards should be delayed six months—to July 1, 2006—to avoid the confusion and other complications that could arise from launching the state's new discount card program on January 1, 2006—the very same day that the new federal Medicare drug benefit program is scheduled to go into effect. A slower start for California Rx could also provide DHS more time to resolve administrative problems and ensure a smooth implementation of this complicated new program.
- ***Add Penalties for Any Default on Rebate Payments.*** The legislation should be amended to require that any voluntary rebate agreements signed by the state include immediate and enforceable financial penalties upon any failure by a participating drug manufacturer to pay rebates it owes in full and in a timely manner.
- ***Improve Antifraud Protections.*** We recommend that the legislation be amended to eliminate the present statutory requirement that applications for enrollment be processed in no more than four hours. The measure should instead indicate the Legislature's intent that processing occur in a timely, same-day process whenever possible unless fraud is suspected in an application. Also, the legislation could clearly establish that filing a false enrollment application constitutes the crime of perjury.
- ***Protect General Fund From Float Costs.*** Given the state's current fiscal problems, the potentially costly float should be paid from private funding sources rather than the state General Fund. If it were determined that such private contributions are not available, the Legislature could consider authorizing a one-time General Fund loan to advance float funding contingent upon full repayment of the General Fund through assessments on drug manufacturers, pharmacies, or California Rx cardholders, or some combination of the three. For example, part of the rebate revenues received by the state from drug manufacturers could be redirected to repay such a loan. Part of the fees paid by individuals enrolling in California Rx to pharmacies could also be redirected to pay back the state's float costs. (Once one-time float costs were paid off, the annual enrollment fees charged to consumers could be reduced to a more reasonable level that was more in line with the fees charged in other states—perhaps $10 a year.)
- ***Reduce Budget Request.*** We recommend that the Legislature reduce the administration's 2005-06 budget request for California Rx by three positions and about $3.1 million. Our proposed

changes are summarized in Figure 7. Our recommendations: (1) strike about $1 million in funding for special items of expense for which no justification has been provided to date in the administration's budget request, and (2) modify the remaining proposed program funding, including the claim processing funding included as a special item of expense, and staffing levels to reflect our proposal to delay issuance of California Rx cards (and the collection of rebates) until July 2006—in the 2006-07 fiscal year. Our proposal provides some funding in 2005-06 for new DHS staff needed in advance of the issuance of the cards, such as personnel assigned to negotiation of rebates with drug firms. It does not include funding and staffing for any staff for rebate collections since these resources would not really be needed until 2006-07. We also recommend that auditor positions be added to the program in 2006-07 to check on rebate payments by drug companies.

- ***Require Competitive Bidding.*** Unless the administration can demonstrate to the Legislature why it cannot comply with the competitive-bidding rules that apply to almost all other state agencies and programs, the legislation should be amended to delete the proposed exemptions to bidding rules.

Figure 7

Pharmacy Assistance Funding Should Be Reduced

(Dollars in Thousands)

	Administration Proposal	LAO Proposal	Change in Funding Level
Salaries and benefits	$1,345	$550	-$795
(Number of staff positions)	(18.5)	(15.5)	(-3)
Operating expenses and equipment	992	409	-583
Special items of expense	2,000	—	-2,000
Distributed administration	-398	-163	235
Net totals	**$3,939**	**$796**	**-$3,143**

SUMMARY

As we have discussed, the administration proposal to establish a pharmacy assistance program has a number of advantages. It could broaden access to drug discounts to millions of low- and moderate-income Californians who are uninsured and thus have little choice but to pay the highest prices available for their medications. The program could be implemented relatively quickly and with a relatively low risk of litigation.

However, we believe some major changes in the proposal are warranted to improve the odds that the measure will actually result in significant discounts on an extensive list of drugs that are medically necessary. With these and other changes, we believe it is possible to implement an effective pharmacy assistance program in California that would protect the interests of both the taxpayers and consumers.

LOWERING THE STATE'S COSTS FOR PRESCRIPTION DRUGS

Is the State Paying High Prices for Prescription Drugs Used in State Programs? What Can Be Done to Lower Those Prices?

Summary

Of the state's annual procurements of prescription and nonprescription drugs, it has full control over about $400 million in purchases. Our review found several deficiencies in the state's procurement of drugs, which lead to it paying higher costs than necessary. For example, we found that the state is paying higher-than-necessary drug prices for Medi-Cal patients and is not leveraging Medi-Cal's purchasing power for other state programs. We offer several recommendations for lowering state drug costs—providing both short- and long-term fixes. For example, we recommend a short-term fix of increasing collaboration between state drug purchasers in order to share more drug pricing information and we recommend a long-term fix of leveraging the Medi-Cal drug formulary to lower drug prices in non-Medi-Cal programs. We believe our recommendations, if implemented, would generate savings totaling tens of millions of dollars annually.

INTRODUCTION

State agencies purchase about $4.2 billion annually in prescription and nonprescription drugs. These agencies purchase the drugs as part of their responsibilities to deliver health care services to their program recipients. For example, the Department of Mental Health (DMH) provides medications to patients residing in state hospitals. The Public Employees' Retirement System (PERS), as part of its health care coverage plans, pays for medications for public employees, their dependents, and retirees. Figure 1 identifies major state entities that purchase drugs, the primary recipients of those drugs, and the annual purchase amounts.

Figure 1

Annual State Drug Purchases 2003-04[a]

(All Funds)

Entity	Drug Purchase Amount (In Millions)	Recipients Served
Medi-Cal	$3,150.0[b]	Medi-Cal recipients
Public Employees' Retirement System	640.0	Public employees, dependents, and retirees
University of California	223.0	Students, clinics, and hospital patients
Corrections	128.5	Inmates
Mental Health	30.1	State hospital patients
Developmental Services	15.3	Developmental center residents
Alcohol and Drug Programs	4.5	Narcotics treatment clients
Veterans' Affairs	3.3	Veterans' home residents
California State University	2.0	Students
California Youth Authority	1.8	Wards
Total	**$4,194.0**	

a Legislative Analyst's Office estimates based on the best available data.

b Net of rebates. Amount does not include Medi-Cal managed care drug expenditures.

According to the Congressional Budget Office, the growth in prescription drug costs has outpaced every other category of health expenditure. California, like all other states, has experienced this growth in prescription drug costs. According to a 2002 Bureau of State Audits review, the five state agencies that most frequently purchase drugs experienced an annual average increase of 34 percent in their drug costs from 1996 to 2001.

In this report, we examine how the state purchases drugs for its program recipients. Specifically, our report identifies recent actions that have helped lower some drug costs, examines state agencies' purchasing practices, and makes recommendations for improving the state's costs for drug purchases. The report focuses on the $400 million in annual drug purchases which are most directly affected by the state's procurement and administrative operations. This report, however, does not examine how the state's medical practices influence drug utilization. While we believe changes to the state's medical practices are a fruitful area for future study, this subject was beyond the scope of this report. In addition, this report does not examine drug purchasing by individual Californians, the Governor's "California Rx" proposal to assist low- and moderate-income citizens in obtaining drug discounts, or the new Medicare drug benefit. These matters are discussed separately in the "Evaluating the Administration's California Rx Proposal" write-up also in "Part V," and our *Analysis of the 2005-06 Budget Bill.*

During our review, we discussed drug procurement practices with representatives of the University of California (UC) and the Departments of General Services (DGS), Developmental Services (DDS), Corrections (CDC), and Mental Health. In addition, we gathered information from PERS, California State University, the Departments of Health Services (DHS), Alcohol and Drug Programs (DADP), and Veterans Affairs (DVA), and state contractors involved in drug procurement transactions. We also met with experts on the federal and other states' drug programs.

BACKGROUND

There are many components to the nation's drug market which affect the prices that the state pays for drugs. Below, we describe how federal laws affect state government purchasing activities and how state entities conduct their drug purchases. (See the shaded box, next page, for a broader overview of the drug market.)

Federal Laws and Programs Regulate Drug Prices

U.S. Constitution Regulates Interstate Commerce. The U.S. Constitution prevents states from enacting laws that regulate commerce in other states. This "commerce clause" of the Constitution limits states from passing laws that regulate or affect the prices charged for drugs out of state. For example, the commerce clause has been interpreted as preventing a state from passing a law requiring drug manufacturers to charge the state the lowest drug prices in the nation. Such a provision would alter the prices that drug manufacturers can charge in other states by placing a "floor" on their selling prices.

Drug Prices Heavily Controlled by Federal Law. In contrast, the federal government *is* authorized to pass laws that regulate drug prices. Under this authority, the federal government has enacted legislation that requires drug manufacturers to offer their lowest prices to federal agencies. The federal government has adopted statutes guaranteeing deep drug discounts to the Veterans Administration (VA), Department of Defense, the Medicaid Program, and other specified public health programs. Under federal law, if drug manufacturers offer their federal prices to nonfederal

Basics of the Prescription Drug Market

According to the Congressional Budget Office, the nation's drug expenditures totaled $162 billion in 2002. The U. S. drug market is a complex and often confusing set of financial arrangements, resulting in a wide range of prices that consumers pay for these products. We describe below several distinctive elements of the drug marketplace.

Major Players in the Drug Market. The major "players" in the drug market supply chain are drug manufacturers, the federal government, wholesalers, pharmacies, pharmacy benefit managers (private third parties that manage drug benefits for large groups of individuals), and health plans. At the end of the supply chain are drug purchasers, which include government agencies, employers, and individual consumers.

Brand-Name Versus Generic Drugs. One key distinction of the drug marketplace is between brand-name and generic drugs. A drug manufacturer generally has exclusive patent rights for a brand-name drug for 20 years (although, as a practical matter, the period in which a product is actually available in the consumer market on an exclusive basis is typically half that time). In contrast, direct competition among drug manufacturers is possible for generic drugs. Cost-cutting and price competition is common for generic drugs, but less prevalent for brand-name products.

Prescription Versus Nonprescription Drugs. Another important factor affecting the pricing of medications is whether the U.S. Food and Drug Administration requires a prescription for a drug puragencies, then the prices they offer to the federal government generally would have to be lowered further. Under certain conditions, however, the federal regulations allow some state programs to seek further price reductions without affecting federal pricing agreements.

In addition, the federal government has implemented trade agreements and associated confidentiality rules which limit the information that is publicly available about drug prices. Consequently, the actual prices paid by public and private entities tend to be unknown. The most commonly available information is the drug's average wholesale price (AWP)—the price that manufacturers suggest wholesalers charge pharmacies. Private and public entities tend to compare their own drug pur-

Basics of the Prescription Drug Market *(continued)*

chase, or instead permits over-the-counter sales without a prescription. In recent years, the reclassification of some drug products such as allergy medications to over-the-counter status has sharply reduced consumer prices.

Drug Formularies. In order to induce drug manufacturers to lower prices, health plans and other large drug purchasers typically adopt lists of the preferred drugs that they will agree to pay for—known as drug formularies. A formulary may be "closed," meaning that a drug not on the list is not authorized for purchase at all, or "open," meaning that a drug not on the list can sometimes be authorized for purchase.

Drug Manufacturers' Discounts and Rebates. Large-scale purchasers of drugs tend to receive lower prices due to their ability to purchase in volume. Some large-scale purchasers of drugs are able to obtain discounts on the price paid at the "front end" of a transaction. Others rely on obtaining rebates—either in the form of a partial refund of the purchase price or a credit against future drug purchases from the same supplier.

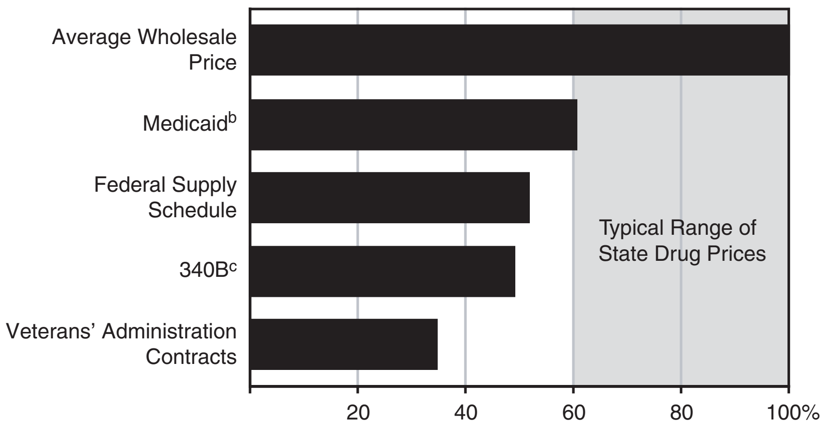
Other Factors Affecting Pricing. The particular medical qualities of a drug and the state of medical technology can also affect drug pricing. Even a brand-name drug may be subject to discounting pressures if other medications exist in the same class of drugs that can be substituted without medical harm for many patients with the same ailment. On the other hand, the latest drug in a therapeutic class may command a higher market price—either because it is perceived as improving health outcomes or reducing negative side-effects for patients.

chase prices to AWP. In addition to AWP information on drug prices, academic studies also provide some information on drug prices.

Figure 2 identifies specific federal drug programs and shows their prices relative to AWP. As the figure shows, the federal government pays between 35 percent and 60 percent of the AWP for its drug purchases. The various federal drug programs are:

Figure 2

Estimated Prices for Major Federal Agencies Based on Average Wholesale Price[a]



[a]Source: Stephen Schondelmeyer, PRIME Institute, University of Minnesota (2001). Data from various years.
[b]The state's Medi-Cal Program achieves additional savings, as discussed later in this report.
[c]Named after section of federal Public Health Act, see text for details.

- ***Medicaid.*** Drug manufacturers must offer the Medicaid Program discounted prices for brand-name drugs in keeping with the requirements of federal laws. This requirement typically allows the Medicaid Program to receive drug prices about 60 percent of AWP.

- ***Federal Supply Schedule (FSS).*** The FSS, which is a schedule of contracts any federal agency can use, receives prices that average 52 percent of AWP.

- ***340B.*** Under the 340B program (named for a particular section of the federal Public Health Act), certain hospitals, clinics, and public health programs that provide medical services to low-income and specific patient populations are able to acquire drugs at prices about 50 percent of AWP.

- ***VA.*** The VA, which provides health care services to veterans, receives the best drug prices in the nation, which are about 35 percent of AWP.

State Agencies Use Different Methods to Purchase Drugs

Because of different laws and procurement practices, state agencies in California purchase drugs in different ways as summarized in Figure 3 and discussed in more detail below. Some state entities are able to access federal drug pricing programs. For those state entities that do not qualify for federal drug discounts, the lowest achievable drug prices would tend to range between 60 percent and 100 percent of AWP (see Figure 2).

Figure 3

How State Entities in California Purchase Drugs

Purchasing Entity	Drug Purchase Method	Cost Control Mechanisms
Medi-Cal	• Directly reimburses pharmacies for cost of drugs dispensed. • Indirectly pays for drugs used by Medi-Cal patients enrolled in managed care plans.	• Medicaid drug prices under federal law. • State supplemental rebates. • Preferred drug list.
Public Employees' Retirement System	• Included in health care plan coverage.	• Health care benefit plans negotiations. • Pharmacy benefit manager.
University of California	• Orders placed through Novation contracts. • Orders distributed by Cardinal Health.	• 304B pricing for some hospitals and clinics. • Group Purchasing Organization (GPO) discounts.
Department of Veterans' Affairs	• Orders placed and distributed through federal contracts.	• Federal drug prices for veterans.
Department of General Services	• Orders placed through Massachusetts Alliance and state contracts. • Orders distributed by McKesson Corporation.	• Negotiated and competitive drug contracts. • GPO discounts. • Common drug formulary.

Medi-Cal. The DHS administers the Medi-Cal Program (California's version of the federal Medicaid Program), which provides health care services, including prescription drugs, to eligible low-income persons. Medi-Cal pays for the cost of outpatient prescription drugs in one of two ways:

- ***Direct Reimbursements.*** For some patients, Medi-Cal *directly* reimburses pharmacies for the cost of the drugs dispensed. The Medi-Cal Program reimburses pharmacies based on a formula that has two basic components—(1) the drug ingredient cost and (2) a dispensing fee. Most Medi-Cal drug purchases are direct reimbursements.

- ***Indirect Costs.*** Medi-Cal also *indirectly* pays for prescription drugs used by beneficiaries enrolled in managed care plans by paying the plans a fixed monthly amount per person. In turn, the health plan is responsible for the cost of most of the drugs used by these Medi-Cal beneficiaries in addition to other health care services.

Medi-Cal controls direct reimbursement costs in the following two ways:

- ***Preferred Drug List (PDL).*** The DHS has created a PDL which consists of a list of drugs that do not require prior DHS authorization for Medi-Cal prescriptions. For a drug to be placed on the PDL, DHS staff review the drug's efficacy, safety, misuse potential, essential need, and cost. As part of this review, staff might meet with the manufacturer to discuss the drug's therapeutic value or negotiate any state supplemental rebates. Drugs that are not on the PDL are still available to Medi-Cal beneficiaries through a prior authorization process.

- ***State Supplemental Rebates.*** To further reduce the amount it pays for a drug, DHS has the authority under state law to directly negotiate for supplemental rebates from drug manufactures. The DHS has established contracts with nearly 100 manufacturers for supplemental rebates. When DHS and the manufacturer agree to a state supplemental rebate, the drug is placed on the PDL (assuming the drug meets other PDL criteria), which tends to increase the frequency of Medi-Cal prescriptions. According to DHS, the supplemental rebates allow the state's Medi-Cal drug prices to be somewhat lower than typical Medicaid prices and closer to or below the 340B prices for some drugs.

PERS. State employees and many local government employees receive health insurance benefits through PERS. Currently, PERS offers three health maintenance organization (HMO) plans and two self-insured preferred provider organization (PPO) plans. Two HMOs—Kaiser Permanente and Blue Shield—manage their own prescription drug programs and offer this coverage as a part of their overall health insurance packages. The third HMO—Western Health Advantage—contracts with a pharmacy benefits manager (PBM) to administer its prescription drug program. (A PBM is a private third party that manages drug benefits for large groups of individuals.) Similarly, PERS contracts with a PBM (currently Caremark) to provide prescription drug services for the PPO plans. The PERS annually negotiates rates with HMOs and sets PPO premiums. The costs of drug coverage are included in these annual rate negotiations.

***UC*.** The UC purchases drugs for its medical centers and student health clinics. As part of a nationwide network of academic medical centers, each UC facility purchases drugs through a group purchasing organization (GPO) called Novation. (A GPO is a drug volume purchasing entity.) These drugs are delivered directly to the campus sites by a pharmaceutical distribution company (Cardinal Health). State law does not require UC to purchase drugs through DGS. All of the UC medical centers (Davis, Irvine, San Francisco, Los Angeles, and San Diego) are 340B hospitals and, therefore, are eligible for the federal drug program discounts. In addition, the UC medical centers provide services to some Medi-Cal patients.

***DVA*.** The DVA operates three homes in which veterans receive medical, rehabilitation, and residential services. Under an agreement with the federal government, DVA is able to purchase drugs through federal VA drug contracts. Participation in the VA drug program is restricted to veterans.

***DGS Purchases Drugs for Remaining Agencies*.** The DGS is responsible for procuring drugs for CDC, DMH, DDS, California Youth Authority, and the California State University's student health centers. The DGS contracts with a vendor, McKesson Corporation, to process departmental drug orders. McKesson is responsible for filling and then distributing those drug orders to the departments. McKesson acquires the drugs through (1) competitively procured state contracts for generic drugs, (2) negotiated state contracts for brand-name drugs, or (3) the Massachusetts Alliance, a GPO consisting of both public and private agencies. For drugs that are not available through these methods (that is, noncontract purchasing), McKesson acquires the drugs at discounted wholesale prices (below AWP). Figure 4 (see next page) shows the annual order volumes and drug costs for each of these methods. (What constitutes a "drug order" varies depending on the type of drug and its manufacturer.) McKesson receives a 0.5 percent service fee for each order.

State Agencies Purchase Many Different Kinds of Drugs

State agencies purchase a wide variety of drugs. The types of drugs purchased depend on the medical needs of their respective patient populations. For example, in Medi-Cal and other state agencies such as CDC and DMH, the most commonly purchased prescription drugs are those used to treat mental illness. In addition, some state agencies purchase drugs for the treatment of HIV/AIDS. In DVA, where most of the medical services relate to elder care, the most commonly purchased drugs are those used to treat high blood pressure, diabetes, high cholesterol, and dementia. For PERS, which provides medical services for employees and retirees, the most commonly purchased drugs are those used to treat high cholesterol and blood pressure, various stomach ailments, and depression.

Figure 4

Annual Drug Procurements Administered by Department of General Services

November 2003 Through October 2004

Purchase Method	Drug Orders	Costs (In Millions)
Noncontract	1,129,750	$83.7
Contracts:		
Negotiated contracts	127,956	$58.3
Massachusetts Alliance	1,285,427	28.5
Competitive contracts	478,782	6.7
Totals	**3,021,915**	**$177.2**

Recent Actions by Legislature and Administration May Lower Future Drug Costs

Recent state legislation and actions by the administration should lead to lower drug costs in the future. We discuss these developments below.

Significant Legislation. Since 2000, the Legislature has passed a number of bills aimed at (1) lowering state drug costs and (2) providing additional information on state drug purchases. As summarized in Figure 5, most of these bills have directed the state to conduct a number of new procurement-related activities. For example, Chapter 483, Statutes of 2002 (SB 1315, Sher), authorizes DGS, after receiving a vendor's final cost proposal, to enter into negotiations with the vendor in an effort to receive even lower prices. As described in Figure 5, the administration has made some overall progress in implementing portions of these bills. The savings achieved from implementing these new procurement authorities, however, are unknown. Several steps have also been taken to reduce drug costs in Medi-Cal. Some of these steps, such as reducing the pharmacy reimbursement rate, will reduce costs in the near term. Other actions—such as requir-

Figure 5

Recent Significant Legislation to Lower Drug Costs

Major Provisions	Accomplishments
Chapter 127, Statutes of 2000 (AB 2866, Migden)	
• Negotiation of drug rebates. • Use of a Pharmacy Benefit Manager (PBM). • Includes inmates in the AIDS Drug Assistance Program. • Membership in a group purchasing organization (GPO).	• Department of General Services (DGS) negotiated one drug rebate. • DGS purchases drugs through the Massachusetts Health Alliance GPO.
Chapter 483, Statutes of 2002 (SB 1315, Sher)	
• Negotiation of drug discounts and refunds. • Expands the use of a PBM. • Requires Departments of Corrections (CDC), Mental Health (DMH), Developmental Services (DDS), and Youth Authority participate in DGS' drug procurement strategies. • Authorizes DGS to explore new procurement strategies. • Authorizes local governments to use state's drug contracts. • Use of bulk purchasing agreements with nongovernment entities.	• DGS has signed four negotiated drug contracts. • Departments participate in DGS drug program. • DGS and departments have created a common drug formulary (CDF). CDC is currently using the CDF. In 2005, DDS and DMH will also use the CDF. • In 2005, DGS intends to release a bid for a PBM for parolees' drug purchases.
Chapter 208, Statutes of 2004 (SB 1113, Chesbro)	
• Reduces Medi-Cal reimbursements for drug ingredient costs. • Increases dispensing fees up to $8 for some prescriptions. • Requires that manufacturers provide Department of Health Services (DHS) with information on drugs' average sale price and the wholesale selling price.	• The *2004-05 Budget Act* estimates savings of $104 million ($52 million General Fund) from the reimbursement reduction. • DHS is working with drug manufacturers to receive pricing information.
Chapter 383, Statutes of 2004 (SB 1426, Ducheny)	
• Requires that CDC adopt drug utilization policies and report by April 1, 2006 on their impact.	• CDC is currently developing policies.
Chapter 938, Statutes of 2004 (AB 1959, Chu)	
• Requires that the Bureau of State Audits conduct an audit of state drug purchases by May 2005 and, if necessary, every two years afterwards.	• May 2005 audit underway.

ing drug companies to provide DHS with previously unavailable pricing information—should enable the state to achieve greater long-term savings.

Strategic Sourcing Has Potential to Reduce Future Drug Costs. In 2004, DGS began an effort to lower the state's overall goods and services costs. This effort—called "strategic sourcing"—involves using past years' purchasing information and standard procurement methods to create new contracts for those same goods and services. The new contracts should result in lower costs. The DGS has identified drug contracts as one of the state's goods that would benefit from strategic sourcing techniques. The estimated savings in drug costs from this effort is unknown but expected to be under $4 million annually.

Common Drug Formulary (CDF) Provides Some Purchasing Leverage. Chapter 483 authorizes DGS to explore procurement strategies that could result in lower drug costs. One of these strategies is the use of a CDF. Since 2001, DGS, CDC, DMH, and DDS have been developing the state's CDF for anti-psychotic drugs. Similar to the Medi-Cal PDL, the CDF involves two tiers—Tier One for drugs that can be prescribed without prior authorization and Tier Two for drugs that can be prescribed *after* receiving prior authorization. The state can use the CDF to lower drug costs. For example, if a drug is costly and the marketplace offers an equivalent, less costly drug, the state can put the more costly drug in Tier Two. This action could reduce the number of orders for the drug and/or act as an incentive for the drug manufacturer to negotiate with the state for a lower price. According to DGS, it has used this technique once. In this instance, the drug manufacturer was willing to renegotiate their drug price in order to move their product to Tier One status.

CDC Has Addressed Some Problems in Its Pharmacy Operations. Between 2000 and 2002, several external studies were conducted regarding CDC's pharmacy operations. These studies found that CDC's pharmacy program lacked the basic administrative infrastructure and management tools needed to effectively control drug costs and provide quality care. Specifically, these studies found that CDC did not have a CDF, lacked appropriate oversight of its pharmacy operations, and used an outdated pharmacy automation system that could not perform many quality and cost-control functions.

During our review, we met with CDC Health Care Services Division (HCSD) staff to follow up on the department's efforts to implement the studies' recommendations. Based on those discussions, we found that CDC has taken some steps to manage its pharmacy costs. For example, the department (1) uses the state's CDF, (2) has implemented guidelines for prescription doses, and (3) substitutes generic drugs for brand-name drugs in high-cost high-volume medication categories. In addition, HCSD is producing quarterly reports on each prison's usage of high-volume and high-cost medications. Prisons' medical and pharmacy staff are responsible for correcting deficiencies identified in these reports.

Deficiencies Found in State's Procurement and Administrative Operations

Our review found that there are three major groups of state drug purchasers. The largest group is the Medi-Cal Program, accounting for $3.2 billion of the state's drug purchases. We found that Medi-Cal drug prices are primarily affected by the federal Medicaid Program and the state's supplemental rebates. The PERS comprises the second group and it accounts for $640 million of the state's drug purchases. Our review found that the PERS' drug prices are primarily affected by the state's overall negotiations for the health benefit plans. In other words, the majority of these two groups' drug purchases are affected by factors other than the state's day-to-day procurement and administrative procedures that are the focus of this report.

The third group, accounting for only 10 percent—or about $400 million—of the state's drug purchasers consists of UC and DGS. This group's drug purchases are primarily affected by the state's procurement and administrative operations. Our review found several areas in which the state's activities were deficient. These deficiencies lead to the state paying higher drug costs than necessary. We discuss these deficiencies in detail below.

State Is Paying Non-Medi-Cal Drug Prices for Medi-Cal Patients

Our review of state drug procurement practices found that DDS, DMH, and DADP are purchasing drugs for Medi-Cal patients in their programs at relatively high prices and are not taking advantage of the better prices, including rebates, available under the federal Medicaid statute.

DDS and DMH. About 97 percent of the population served in the five developmental centers (DCs) operated by DDS is eligible for Medi-Cal. The DDS does obtain reimbursement under Medi-Cal for the drug costs of these DC clients. However, the current practice is for the costs of drug purchases for DC clients to be "bundled" together with other types of ancillary medical costs in billings for reimbursements through the Medi-Cal Program. Under this practice, the prices being paid by the state, and built into the bundled rates, are not the lowest available under the federal Medicaid statute. Instead, the bundled rates use the prices available through the McKesson contract. As described earlier, those prices are not nearly as low as those available under Medicaid. Lower prices would be available to the state if the drug costs for Medi-Cal eligibles in the DCs were accounted for separately and not bundled together with other medical costs. The same practice of rate bundling is currently in place for state hospital patients, although relatively few of these patients are eligible for Medi-Cal.

DADP. Similarly, the costs of methadone provided to beneficiaries under DADP's Drug Medi-Cal Program (which provides substance abuse treatment for Medi-Cal beneficiaries) are bundled together with reimbursements for counseling and other components of narcotics treatment services. The state does not collect the information needed to obtain rebates from methadone manufacturers. Thus, the state is not obtaining the discounts available for its methadone purchases.

State Does Not Leverage Medi-Cal's Purchasing Power For All State Programs

The commerce clause of the U.S. Constitution and other federal laws limit the ability of states to obtain discounts on their drug purchases. A number of states, however, have attempted to use the purchasing power of their Medicaid programs to reduce drug costs in other state programs. For example, some states have attempted to reduce drug prices for non-Medicaid populations by allowing drug manufacturers' products to remain on their Medicaid formularies only if they provide discounts or rebates to other state programs. In 2001, Michigan proposed to obtain drug manufacturer rebates for various non-Medicaid programs in that state, including mental health services and hospitals. Maine has also enacted a plan (known as Maine Rx) that, among other provisions, will require drug manufacturers to agree to negotiate rebates for drugs purchased for low- and moderate-income residents.

The Maine and Michigan efforts to extend Medicaid pricing to other programs have been slowed by litigation brought by the drug industry. A recent U.S. Supreme Count decision may better enable states to pursue such efforts. A June 2003 decision (*Pharmaceutical Research and Manufacturers of America v. Walsh)* has been interpreted by academic researchers as allowing states, under certain circumstances, to use their Medicaid Programs as a means to obtain lower drug prices for non-Medicaid populations. States may be able to do this as long as their actions would further the goals of Medicaid, such as providing assistance to individuals who might otherwise end up on the Medicaid rolls. Also, the state would have to receive prior federal approval for such actions.

To date, however, California's efforts to use Medi-Cal as a means to secure discounts on drugs have been limited to Medicare patients and workers' compensation. For example, under Chapter 946, Statutes of 1999 (SB 393, Speier), any pharmacy that participates in Medi-Cal is obligated to limit its charges for drugs sold to Medicare patients to the Medi-Cal pharmacy reimbursement rate plus a small transaction fee. As a result, Medicare patients are able to purchase drugs from certain California pharmacies for a lower price than they would otherwise. Chapter 693, Statutes of 2001 (SB 696, Speier), requires drug manufacturers to provide additional rebates to further reduce the cost of drugs for Medicare patients. Chapter 693, however, has never been implemented—due in part to administrative problems with the proposed mechanism to pass along rebate savings to patients.

DGS Not Providing Sufficient Leadership

No Statewide Work Plan for Purchasing Drugs. The DGS is responsible for procuring drugs for five state agencies through various state contracts. To accomplish this, DGS evaluates the state's drug purchases and, as necessary, conducts competitive bids or negotiates contracts. For example, in order to reduce state costs, DGS may monitor drug patent expiration dates and, when the expiration occurs, conduct a competitive procurement to acquire the drug at a lower price. These types of activities, however, appear to be conducted without a comprehensive approach. The DGS was unable to produce an annual work plan describing what procurements they will conduct over the year.

DGS Purchases Almost One-Half of Drugs Without Contracts. Large drug purchasers should be able to acquire their most frequently used drugs by establishing contracts with drug manufacturers. Based on competition or negotiations with the drug manufacturers, such contracts should result in lower drug prices. As shown in Figure 4, DGS uses four different methods to purchase drugs for departments. Three of these methods (accounting for 53 percent of DGS drug purchases) consist of using contracts to purchase drugs. Yet, the remaining one-half of DGS' drug purchases are being acquired without contracts including some of the state's most commonly purchased drugs. Given the magnitude of the state's purchases of these noncontract drugs, it is likely that DGS could secure lower prices for some of these drugs through a contract. (We recognize, however, that some companies such as those selling certain HIV/AIDS drugs have refused to contract with any entity.)

DGS Does Not Participate in Drug Reviews. Some drug purchasers participate in independent groups that develop information on the relative effectiveness of similar drugs in various categories. Drug purchasers then apply this information to their purchasing and management decisions. For example, the California Healthcare Foundation and PERS participate in the Drug Effectiveness Review Project (DERP) led by the Center for Evidence-Based Policy. The project's participants believe that purchasing in accordance with evidence-based information will generate long-term efficiencies, more appropriate drug utilization, and improved health outcomes. The state as a whole, however, does not participate in such a group and consequently lacks comparable information that it could use in price negotiations.

Insufficient Collaboration Among State Agencies

The DGS, CDC, DMH, and DDS have worked together to establish the CDF. The California Performance Review (CPR) (a Governor's task force that recently examined state government operations) and our own analysis both indicate, however, that—despite these ongoing efforts—state agencies are not doing all they could to share information and collaborate on a regular basis in their efforts to purchase drugs. The PERS does not share its DERP information with other state agencies. In addition, DGS officials indicated to us that they have had little regular interaction with the branch of DHS responsible for securing supplemental rebates and directly bargaining with drug manufacturers over the price of drugs for Medi-Cal patients. Representatives from UC indicated to us that they initially had encountered difficulty discussing joint procurement strategies with DGS. The DGS representatives indicated to us that they knew little about how the UC system purchases drugs for its large university hospital system.

Although there are some differences in the types of drugs needed by these various state agencies, our analysis indicates that there is a significant overlap in the types of drugs they purchase and in the drug manufacturers with whom they do business. For example, records indicate that UC, DHS, and DGS are all major purchasers of anti-psychotics and anti-depressants—usually from the same drug manufacturers. The lack of ongoing, regular communication and sharing of information among state agencies likely puts the state at a disadvantage in its dealings with these drug manufacturers. For example, DGS might be in a better position to bargain for a lower price for a drug if the department was able to take full advantage of DHS' expertise in negotiating for rebates for that class of medications, or if it were aware of the price that UC was paying. In our review, we could not find any state law that prohibits UC from collaborating with DGS in drug purchasing activities. (Federal law does limit some collaborations between DHS and the state.) Better collaboration between state entities could increase the state's drug purchasing power and further reduce the price it pays for drugs.

Multiple Formularies Redundant

State regulations issued by DHS require that any hospital facility (both public and private) with more than 100 beds have its own staff committee to develop its own drug formulary. The current regulations were adopted at a time when the cost of prescription drugs was not a major concern and before state agencies began managing their drug costs in a more comprehensive way. These regulations require extensive duplication of effort by state hospital and DC staffs. In addition, this approach reduces the state's bargaining power by allowing separate state facilities to favor their own selection of drugs. As noted previously, the state has developed a statewide CDF for anti-psychotic medications. Yet, DDS and DMH continue to use their own drug formularies for these same drugs—limiting the applicability and effectiveness of a statewide formulary.

CDC Pharmacy Operations Need Improvement

CDC Pays Retail Prices for Parolee Drugs. The CDC operates parole outpatient clinics that primarily provide medication management services to mentally ill parolees. To acquire drugs for these parolees, CDC allows its regional parole offices to negotiate drug contracts with local pharmacies. Under these contracts, local pharmacies fill parolee prescriptions and directly bill CDC for the prescribed drugs. According to CDC, its clinics have entered into contracts which pay for these drugs at retail prices—at a cost totaling about $18 million in 2003-04. Retail prices are somewhat higher than AWP and are probably some of the highest prices paid for drugs. (According to DGS, however, the clinics receive prices slightly below AWP. At the time this analysis was prepared, we were unable to reconcile this descrepancy.)

CDC Pharmacy Operations Improved but Still Lacking. Although CDC has made some progress in addressing deficiencies in its pharmacy operations, we found the CDC still lacks the administrative structure and management tools to effectively administer its pharmacy program. For example, pharmacy services are one of several responsibilities of CDC's HCSD—with few staff dedicated solely to oversight and management of pharmacy operations. Consequently, the prison pharmacies operate somewhat independently and without statewide standards and specific guidelines regarding ordering and dispensing of medications.

At the prison level, many pharmacies continue to use the outdated pharmacy information system, known as the Pharmacy Prescription Tracking System. This system lacks many of the capabilities of newer systems, making it more difficult for pharmacy staff to perform some functions that would help to reduce waste (such as estimating volume of drug purchases and tracking inventory). We also found that CDC, like other state departments, continues to experience relatively high vacancies among its pharmacy staff. These program deficiencies most likely result in the wasting of drugs and missed opportunities to save millions of dollars in the prison pharmacy program.

POTENTIAL APPROACHES TO LOWERING STATE'S DRUG COSTS

Our review found several deficiencies in how the state purchases prescription drugs. These findings generally are consistent with prior reviews of the state's drug purchasing practices. For example, in August 2004, a task force released its CPR report to the Governor, which identifies a number of ways to reduce state drug costs. This section of the report discusses potential approaches to lowering the state's drug costs.

One approach to reducing state drug costs, undertaken by some states and local governments, involves importing drugs from Canada and other countries. As described in the shaded box (see page 282), we believe that, absent several significant changes in federal policy and other factors, drug importation would probably not provide a long-term solution to reducing the state's drug purchasing costs. Below, we discuss CPR's approach and then offer our own recommended actions.

CPR's Approach to Lowering Drug Costs

The CPR estimates that its drug purchasing proposals would result in $75 million in annual state savings. (We found that CPR produced two differing versions of its proposal—a printed version and an Internet version. We were unable to determine which version contains the official CPR recommendation. For that reason, our review comments on both versions.) The main provisions of the CPR proposal are described below.

Hire a PBM to Administer State's Drug Procurements. The CPR recommends that DGS acquire a PBM to administer the state's drug purchases. The CPR asserts that a PBM could administer the state's drug program at a lower cost and receive lower drug prices than DGS is achieving.

Create Centralized Pharmaceutical Office (CPO). The CPR also recommends that the state create a CPO that would be responsible for all of the state's drug purchasing programs. This office would have the authority to establish relationships with local governments, all state entities, and drug manufacturers. The CPR states that this office would maximize the state's purchasing power.

Maximize State Use of 340B Program. The CPR recommends that the state maximize its use of the federal 340B drug discount program to significantly reduce the drug expenditures of various state departments. Specifically, the CPR proposes that UC or other 340B entities become responsible for providing medical and pharmaceutical services to institutionalized patients of the Health and Human Services (HHSA) and Youth and Adult Correctional Agencies—enabling the state to access 340B drug discounts for those individuals. In addition, CPR recommends that PERS and the State Teachers' Retirement System explore the use of 340B entities to provide health care benefits for employees and retirees.

Promote 340B Program. The CPR further recommends that HHSA promote the 340B program among certain hospitals, community health centers, and eligible entities that do not currently participate in the program.

Difficulties in Implementing Several CPR Recommendations

We have identified a number of difficulties with the approaches recommended by CPR, which we discuss below.

Use of PBM Has Limited Applicability in State Drug Purchases. Typically, a PBM offers a number of services to clients, such as establishing drug formularies, negotiating drug discounts with pharmacies, and negotiating rebates with drug manufacturers. It is unclear to us, however, what benefits a PBM would offer for the majority of the state's drug purchases. For example, for the purchases that DGS oversees, the state already has established a drug formulary, has authority to negotiate drug rebates, and usually does not purchase drugs from private pharmacies (except for parolee services).

Need for CPO Is Limited. The CPR does not specify which state entities would transfer their drug purchasing responsibilities to the proposed CPO. For that reason, it is difficult to assess the benefits of a CPO. As discussed elsewhere in this report, we do see potential fiscal benefits from consolidating some UC and DGS drug purchases. Due to restrictions in federal laws, it is probably not feasible to consolidate Medi-Cal and DGS drug purchases—since DGS is unable to receive Medi-Cal drug prices. Finally, the creation of a new state drug purchasing office could be costly, create organizational difficulties, and provide little strategic advantage to the state over the current arrangement in which procurement duties are already largely concentrated. As we discuss later in this report, we believe there is a better alternative approach for improving collaboration among state agencies.

Utilizing 340B Entities Requires Major Restructuring of State Programs. Under the 340B program, federal rules specify that discounts are only available for outpatient drugs provided to patients that (1) have an established relationship with the health care provider (such that health

Drug Importation Strategies

Due to rapidly escalating prices for prescription drugs from domestic suppliers and pharmacies, interest at all levels of government (and by individuals) in importing prescription drugs from other countries has grown in the past few years. Estimates of the annual prescription drug purchase revenues now flowing from the United States to Canada range from $600 million up to $1 billion. The Congressional Budget Office recently estimated that foreign prices for patented drugs are lower than U.S. prices by an average of 35 percent to 55 percent.

These and other reported price differences, however, typically reflect retail prices paid by individual consumers for brand-name drugs. Generic medications—which are a majority of drug sales in the domestic market—typically sell for less in the U.S. than in Canada. In addition, the reported price differences typically are not adjusted to reflect the discounts, rebates, and government actions that allow programs such as Medi-Cal to purchase brand-name drugs at prices well below retail levels.

Federal, State, and Local Government Drug Importation Programs. The federal Medicare Prescription Drug, Improvement, and Modernization Act of 2003 permits prescription drug importation programs if the federal Department of Health and Human Services (DHHS) certifies that imported drugs pose no additional risk and would generate significant savings for consumers.

At the state and local levels, a number of governments have begun programs aimed at assisting residents who wish to import drugs from other nations. For instance, Wisconsin, Kansas, and Missouri have joined an Illinois program called I-SaveRx (started in October 2004), which allows state residents to purchase prescription medications from Canada, the United Kingdom, and Ireland. Minnesota has established a program to allow eligible state employees to purchase drugs from Canadian pharmacies, as have several U.S. cities.

Canada May Restrict Drug Exports. Even if the state were able to reduce costs for its programs in the short run by importation of prescription drugs from Canada, it is not clear that those savings could be sustained in the long run. Since California's population exceeds Canada's, a surge in demand for imported drugs from Cali-

Drug Importation Strategies *(continued)*

fornia could prompt a response that would limit the effectiveness or duration of a state importation program. The Canadian Health Minister, for example, recently stated that his government might take action to end the sale of prescription drugs to U.S. residents if the practice overly strains Canada's drug supply. Also, pharmaceutical companies strongly oppose importation, and some have limited the number of drugs they supply to Canadian businesses whom they believe export drugs back to the U.S.

Drug Importation Raises Legal Issues. Part or all of the savings generated by state importation programs could be offset by the potential costs arising from federal or consumer legal issues and ensuring the safety of imported drugs. Federal law strictly limits the types of drugs that may be imported into the United States. An August 2003 letter from the U.S. Food and Drug Administration (FDA) to the California Department of Justice reiterated the FDA's position that almost all importation of drugs to the United States from Canada violates federal law because the medications are unapproved, labeled incorrectly, or dispensed without a valid prescription. Drug importation also raises legal issues related to federal oversight of state health care programs. In order to operate a program to directly import drugs for a state health program, the state likely would need to obtain a federal waiver to maintain federal funding for the participating departments. If DHHS were to approve such a waiver, it could require that California ensure the safety and efficacy of all imported drugs—in effect requiring the state to take on the role normally played by the FDA with respect to protecting the domestic drug supply. Obtaining federal approval of such a waiver seems improbable at this time, given the federal administration's consistent opposition to broad drug importation programs to date. Moreover, as an importing entity, the state might incur substantial costs to provide such assurance, potentially reducing or negating any savings gained through lower prices from foreign markets.

In summary, absent significant changes in federal policy and the other factors noted above, the possibility of procuring significant savings for the state's programs through drug importation seems problematic at this time.

records are maintained by that organization) and (2) receive a range of services from a medical practitioner employed or contracted by the covered entity. In other words, generally the covered entity must provide medical services to the patient beyond prescription services in order to obtain drug discounts through the 340B program.

While the CPR recommendation for the state to maximize use of the 340B program in the prisons or state mental hospitals is technically feasible, we would note that it would require major changes to the state's existing health delivery systems. In order to be compliant with federal law and obtain 340B discounts, state departments would have to reassign some or all of their core health delivery functions and responsibilities to another entity. Such a significant restructuring of the state's medical systems should be considered in the larger context of improving quality of care for institutionalized patients—rather than the more limited context of reducing drug costs.

In the more immediate future, we do believe that there are concrete opportunities for the state to develop new (or build on existing) cooperative agreements that involve 340B entities. For instance, telemedicine offers an opportunity to move further in the direction of shifting CDC inmate health care delivery to an outside provider, including providers which would qualify for the 340B program such as UC. The Legislature may wish to consider building upon the existing cooperative agreements between CDC and UC to expand or enhance the now limited telemedicine program. In addition to expanding the state's access to 340B discounts, an incremental approach would enable the state to evaluate the quality of care and fiscal benefits of shifting inmate health care delivery to UC before expanding the university's role elsewhere in the prison health care delivery system.

Promoting the 340B Program to Other Eligible Entities. Our analysis indicates the CPR's recommendation to promote the 340B program presents a reasonable way that more entities could access drug discounts for the patients they serve and make a more efficient use of their limited resources. It is uncertain, however, whether the state would directly achieve savings from this approach. While the state could direct Medi-Cal beneficiaries to these entities for health care, the Medi-Cal program currently pays net prices (after rebates), which according to DHS, are at least as low as those obtained through 340B.

LAO Recommended Actions to Lower State's Drug Costs

To address the deficiencies found in our review, we recommend a number of actions that the state could take to improve its procurement methods and reduce state costs for those purchases (see Figure 6). In the detailed discussion of each action below, we have grouped our recommendations as those involving changes in statutes, procurement approaches, and departmental practices. We recognize that some of these steps would take longer to implement than others. Accordingly, in Figure 6 we have categorized the steps as either short- or long-term. When possible, we have also provided our general estimate of the level of savings that they could generate. As a whole, we believe these steps could generate savings totaling tens of millions of dollars annually. The savings would be partially offset by implementation costs that we estimate likely would total under $1 million annually.

Figure 6

LAO Recommendations
State Drug Procurement and Administrative Operations

	Estimated Maximum Annual Savings[a] (In Dollars)		
LAO Recommendation	Unknown	Hundreds of Thousands	Millions
Short-Term (Less Than 18 Months)			
Require collaboration between state drug purchasers.	X		
Increase Department of General Services (DGS) staff in order to create more drug contracts.			X
Require DGS to develop annual work plan.	X		
Require DGS participation in drug reviews.	X		
Direct California Department of Corrections (CDC) and DGS to compare potential methods to lower parolee drug costs.			X
Direct Department of Health Services to modify regulations requiring multiple formularies.	X		
Direct Departments of Developmental Services, Mental Health, and Alcohol and Drug Programs to modify reimbursement systems.		X	
Long-Term (More Than 18 Months)			
Request use of Federal Supply Schedule.			X
Leverage Medi-Cal Preferred Drug List.			X
Direct University of California and DGS to identify joint drug purchases.			X
Require CDC to report on pharmacy improvements.	X		

[a] Does not include offsetting implementation costs.

Changes to Federal and Statewide Statutes

Request Use of Federal Program. Under current federal law, states are not allowed to use the FSS to purchase drugs. If the federal government were to allow the state to use the FSS for state drug purchases, the state could receive significant price reductions for those drugs. For this reason, we recommend that the Legislature adopt a joint resolution requesting Congress to change federal law to allow the state to access the FSS to acquire drugs for some of its state agencies. Although Congress has previously rejected full state access to the FSS for drug purchases, the state could propose a more limited approach. For example, the Legislature could request that federal law allow access to the FSS by residents in state hospitals and DCs. Such a change could result in annual savings of a few millions of dollars. We believe requesting FSS access for state hospital and DC residents is more likely to be accepted by the federal government because these residents are similar to recipients served by other federally funded health care programs.

Enact Statute to Leverage Medi-Cal. In the past, the Legislature has used the Medi-Cal Program as leverage to lower drug costs for Medicare beneficiaries and in other limited circumstances. We believe that a similar approach could also be used to lower state drug costs for other state health programs. Accordingly, we recommend that the Legislature enact legislation requiring drug manufacturers to provide certain state programs with the same types of supplemental rebates that are available under the Medi-Cal Program. For example, the legislation could help reduce drug costs for specialized health programs such as the "state-only" portions of the California Children's Services and Genetically Handicapped Person Programs, and parole outpatient clinics. Such legislation would encourage drug manufacturers to provide discounts by allowing, in exchange, their products to remain on the Medi-Cal PDL. This approach would need prior federal approval and could be subject to legal challenges but appears consistent with the U.S. Supreme Court ruling in *Pharmaceutical Research and Manufacturers of America v. Walsh*.

Changes to Statewide Procurement Approach

Require Collaboration Among State Drug Purchasers. Currently, state entities typically do not collaborate or share information regarding their drug purchases. For this reason, we recommend that the Legislature require state drug purchasing entities to share information on the purchase of prescription drugs. At a minimum, DGS, DHS, UC, and PERS should share information regularly. (In a subsequent recommendation, we identify how UC and DGS could achieve savings through actual consolidation of drug purchases.) In addition, other state agencies with large drug purchases, such as CDC, DMH, DDS, and DVA should communicate regarding their purchases. On an annual basis, these entities—coordinated through DGS—should provide a report to the Legislature on its collaboration activities and progress in reducing or holding down state drug costs. We believe the collaboration, over time, would help to strengthen communication among state agencies in the purchase of prescription drugs without the costs and difficulties of creating a new state entity to oversee drug procurements, as proposed by CPR.

Direct UC and DGS to Identify Consolidated Drug Purchasing Opportunities. The UC's annual drug purchases exceed all of DGS' annual purchases, yet the agencies do not communicate regularly. By combining the purchasing power of the two entities, we believe cost savings could be found for some state drug purchases. For this reason, we recommend that the Legislature adopt statutory language directing UC and DGS to identify opportunities for consolidating drug purchases. According to staff at the UC Office of the President, the university is willing to explore such collaborations. We believe this action would strengthen the bargaining power of both UC and DGS and potentially lead to lower drug prices for the purchases carried out by both agencies.

Increase DGS Staff to Create More Drug Contracts. As noted earlier, almost one-half of DGS drug purchases are being acquired without contracts—resulting in higher drug prices than necessary in some cases. Accordingly, we recommend that the Legislature increase the number of DGS staff devoted to state drug purchases. The additional staff should include at least one pharmacist who has experience working with drug manufacturers and government procurements. We estimate the ongoing costs of the additional staff would total a few hundred thousand dollars annually, but could result in annual savings of a few million dollars.

Require DGS to Develop Annual Work Plan for Purchasing Drugs. As we noted, DGS drug purchase strategies have been implemented on an individual basis rather than through a more comprehensive approach. In our view, given its responsibility for procuring almost $200 million annually in drugs, DGS should have a comprehensive annual work plan to guide its drug procurement activities. Consequently, we recommend that the Legislature require DGS to develop an annual work plan for state drug purchases. The work plan should describe what activities DGS will conduct over the year and the potential savings that may result from those activities. With the additional staff recommended above, DGS should be able to prepare such a plan. The DGS could use this work plan to guide its annual drug purchase activities and provide information to the Legislature on the savings it has been able to achieve.

Require DGS Participation in Drug Reviews. As noted above, some state entities participate in groups that provide information on the relative effectiveness of similar drugs in various categories. These data are useful in purchasing and management decisions. Yet, DGS does not currently participate in such a group. Since DGS is responsible for procuring almost $200 million annually in drugs, we recommend that the Legislature direct DGS to participate in an independent group of this type. Using a systematic approach to determine which drugs appear on the CDF could generate long-term savings and improve the quality of health care. Participation in such groups usually requires payment of a fee in the range of $100,000 annually.

Changes in Departmental Practices

Direct DGS and CDC to Compare Parolee Drug Costs. It appears that CDC parole outpatient clinics currently purchase parolee drugs at retail prices—generally the highest level of prices paid. Based on discussions with CDC and DGS, it is our understanding that these departments are currently working together to competitively contract for a PBM to manage parolee medications. We believe this approach would be less costly than purchasing the drugs under contract with retail pharmacies. However, depending on the fees charged by the PBM, it may not be less costly than if CDC were to purchase these medications under contracts negotiated and maintained by DGS. The latter could be accomplished by establishing a system in which parolee drugs would be purchased and dispensed for the parole clinics by the prison pharmacies. Under this approach, the health care professionals who work in the parole outpatient clinics would administer parolee medications. We recommend that the Legislature direct DGS and CDC to compare the overall cost of providing parolee medications through the PBM to the cost of purchasing these drugs under its own contracts, and to choose the least costly alternative.

Require CDC to Continue Pharmacy Improvements. The CDC has made some improvement is its pharmacy operations, but much work remains to be completed to resolve ongoing problems. For this reason, we recommend that the Legislature require CDC to provide an update on its pharmacy program. Specifically, CDC should report at budget hearings on its progress and timeline for implementing recommendations from external studies—including implementing a new pharmacy information system or contract for the service, and establishing statewide policies and procedures for prison pharmacy operations. The department should also report on whether, and the extent to which, additional staff resources are required to implement further improvements.

Direct DHS to Modify Formulary Regulations. Current DHS regulations require each DC and state hospital to establish its own drug formulary. This requirement duplicates the CDF and weakens the state's bargaining power for drug purchases. For this reason, we recommend that the Legislature direct DHS to amend its formulary regulations so that the hospitals operated by DMH and DDS would no longer be required to establish a separate staff committee and a separate drug formulary for each licensed facility. State regulations could be modified to allow the option of adopting a single department-wide formulary prepared by a single committee. Alternatively, departments could share the CDF.

Direct DDS, DMH, and DADP to Consider Modifying Reimbursement Systems. Due to limitations of their current billing systems, DDS, DMH, and DADP are not now taking advantage of the discounted drug prices that are available for their Medi-Cal patients. To remedy this situation, we recommend that the Legislature direct DDS and DMH to consider modifying their reimbursement systems to account separately for drug purchases for Medi-Cal patients in the DCs and state hospitals. (These modifications could occur when the departments implement other recent federally required changes to their systems.) The Legislature should also direct DADP to account separately for the medication costs of methadone services in its reimbursements for narcotics treatment clinics so that the state can obtain Medicaid prices and collect the rebates to which it is entitled from drug manufacturers. These changes would allow the state to take full advantage of the better prices available under Medi-Cal.

CONCLUSION

Our review found that the state has recently taken a number of steps to reduce overall prescription drug costs. In addition, we found that of the state's $4.2 billion in drug purchases, only about 10 percent, or $400 million, is affected primarily by the state's procurement and administrative operations. We found several deficiencies in those operations that the Legislature can correct. In general, the state can take better advantage of its bargaining power and improve its administrative operations. If these steps are taken, we estimate that the state could reduce prescription drug costs totaling tens of millions dollars annually.