

# THE 2006-07 BUDGET: PERSPECTIVES AND ISSUES

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

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## INTRODUCTION

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The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2006-07 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 2006-07 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2006-07 Budget Bill*, which contains our review of the *2006-07 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 2006-07 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 2007-08.
  - Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2006-07 and evaluates the major expenditure proposals in the budget.
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- Part V, “Major Issues Facing the Legislature,” (1) analyzes issues relating to state and local governments’ provision of retiree health benefits and offers recommendations on how to address these funding obligations, (2) reviews the state’s emergency preparedness and response system and related Governor’s budget proposals in 2006-07, (3) identifies issues the Legislature will need to consider when implementing the new federal transportation funding act, (4) analyzes issues related to reorganizing the state’s energy activities, and (5) assesses two state-mandated programs which provide mental health services for special education children.
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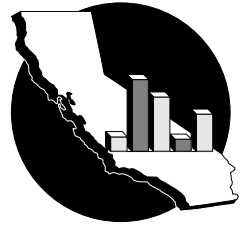
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I

STATE  
FISCAL PICTURE



## State Fiscal Picture



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The Governor's budget released in January uses unexpected revenues to raise ongoing budgetary commitments, prepay some budgetary debt, and provide baseline funding increases for most other programs. Along with the budget plan for 2006-07, the Governor is also proposing a ten-year Strategic Growth Plan to improve state infrastructure in the areas of education, flood control, water supply, public safety, and courts.

**LAO Bottom Line.** California has benefited greatly from an over \$11 billion three-year revenue increase since the 2005-06 budget was enacted; yet, the Governor's budget plan would still leave the state with major structural budget shortfalls and a large amount of other financial obligations outstanding. In this regard, we believe the proposal misses a real opportunity to finally get the state's fiscal house in order by meaningfully addressing what is still a formidable fiscal problem. Capitalizing on the opportunity presented by these added revenues is particularly important at this time, given the inherent uncertainties about how long the strong revenue performance the state has been experiencing will last. Accordingly, we recommend that the Legislature reduce the amount of ongoing spending increases proposed in this budget, and either hold more of the unexpected revenues that this frees up in reserves or use them to pay down more of the still-formidable budgetary debt the state owes.

## THE BUDGET PROPOSAL

### Budget's Economic Forecast—Moderate Growth

The U.S. and California economies generally outperformed expectations in 2005, although their growth did slow late in the year. The adminis-

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tration assumes that moderate economic growth will continue in 2006 and 2007, although at a more subdued pace than in 2005. It specifically projects that U.S. real gross domestic product growth will ease from 3.6 percent in 2005, to 3.2 percent in 2006, and 3 percent in 2007. Similarly, it projects that California personal income growth will slow from 6 percent in 2005, to 5.8 percent and 5.5 percent during 2006 and 2007, respectively.

### **Budget's Revenue Forecast—Up Substantially**

The Governor's budget assumes that revenues will be up strongly from the estimates included in the *2005-06 Budget Act*. It specifically estimates that revenues were \$82.2 billion in 2004-05—a full \$2.3 billion more than the estimate in the *2005-06 Budget Act*. It further projects that revenues will rise to \$87.7 billion in 2005-06 (up \$3.2 billion from the *2005-06 Budget Act*) and \$92 billion in 2006-07 (up \$3.7 billion from the preliminary out-year estimates made at the time the *2005-06 Budget Act* was adopted). These increases, which total \$9.2 billion over the three years combined, are largely related to much-stronger-than-expected revenues from volatile sources, such as corporate profits and investment earnings. (As discussed below, we also believe that there will be an additional \$2.3 billion in revenues beyond what the administration is projecting, bringing the total three-year improvement to \$11.5 billion.)

**Policy Changes.** The budget contains no general tax increases. However, it does include \$252 million in new 2006-07 revenues from targeted changes to existing law. The majority of this increase is related to the proposed one-year extension of two measures that were set to expire this year—specifically, the suspension of the teachers' personal income tax credit (\$210 million) and the recent change in the application of the use tax to vessels and aircraft (\$35 million).

## **BUDGET OVERVIEW**

The budget proposes total state spending in 2006-07 of \$123 billion (excluding expenditures of federal funds and bond funds). General Fund spending is projected to increase from \$90.3 billion to \$97.9 billion (an increase of 8.4 percent), while special funds spending falls slightly from \$25.4 billion to \$25 billion. The decline in special funds spending is due to one-time factors affecting current- and budget-year totals.

### **General Fund Condition**

Figure 1 shows the General Fund's condition from 2004-05 through 2006-07 under the budget's assumptions and proposals. It shows that:

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**Figure 1**  
**Governor's Budget**  
**General Fund Condition**

(In Millions)

	Actual 2004-05	Estimated 2005-06	Proposed 2006-07	
			Amount	Percent Change
Prior-year fund balance	\$7,228	\$9,634	\$7,031	
Revenues and transfers	82,209	87,691	92,005	4.9%
Total resources available	\$89,438	\$97,325	\$99,036	
Expenditures	\$79,804	\$90,294	\$97,902	8.4%
Ending fund balance	\$9,634	\$7,031	\$1,134	
Encumbrances	\$521	\$521	\$521	
<b>Reserve</b>	<b>\$9,112</b>	<b>\$6,510</b>	<b>\$613</b>	
Budget Stabilization Account	—	—	\$460	
Reserve for Economic Uncertainties	\$9,112	\$6,510	153	

- **2004-05.** The 2004-05 fiscal year concluded with a reserve of \$9.1 billion. This reserve amount is up sharply from the \$6.9 billion estimate included in the *2005-06 Budget Act*. The improvement is due mainly to large upward revisions to year-end revenue accruals to the three major taxes. More generally, the large 2004-05 reserve is a reflection of strong amnesty-related payments received last year, and includes the proceeds of the deficit-financing bonds issued in 2003-04.
- **2005-06.** In the current year, expenditures are expected to exceed revenues by \$2.6 billion, leaving \$6.5 billion in the reserve.
- **2006-07.** In the budget year, projected expenditures increase to nearly \$98 billion, while revenues are projected to reach \$92 billion. The resulting large (nearly \$5.9 billion) operating shortfall results in a further decline in the reserve, to \$613 million by the close of the budget year.

### Key Features of the Budget Proposal

The key programmatic features of the budget are shown in Figure 2 (next page). They include the following.

**Figure 2**  
**Key Programmatic Features of the**  
**2006-07 Budget Proposal**

<b>Proposition 98</b>	<ul style="list-style-type: none"> <li>• Spends \$1.7 billion more than required by the minimum guarantee in 2006-07. This fully funds growth and cost-of-living adjustments (COLAs), and provides an additional \$1 billion in program spending, including equalization funding for school districts and community colleges, restorations of COLAs foregone in prior years, and teacher retention initiatives.</li> <li>• In addition, provides \$426 million in new spending for K-12 after-school programs as required by Proposition 49.</li> </ul>
<b>CSU/UC</b>	<ul style="list-style-type: none"> <li>• Provides funds for Governor's higher education compact.</li> <li>• Provides General Fund monies to "buy out" student fee increases in 2006-07.</li> </ul>
<b>Transportation</b>	<ul style="list-style-type: none"> <li>• Makes full \$1.4 billion Proposition 42 transfer for 2006-07, plus pays \$920 million toward loan repayment due to transportation in 2007-08.</li> </ul>
<b>Health and Social Services</b>	<ul style="list-style-type: none"> <li>• Further delays "pass through" of federal COLA for Supplemental Security Income/State Supplementary Program recipients from April 2007 to July 2008.</li> <li>• Assumes state will prevail on appeal of <i>Guillen</i> court case, avoiding \$460 million in additional costs.</li> <li>• Reduces funding for county administration, child care, and welfare-to-work services.</li> <li>• Includes series of actions to enroll more children in health coverage and augmentations for disaster preparedness efforts.</li> </ul>
<b>Criminal Justice</b>	<ul style="list-style-type: none"> <li>• Expands inmate and parolee programs and the correctional officer academy.</li> <li>• Proposes phase-in of 150 new judgeships over three years.</li> </ul>
<b>Statewide</b>	<ul style="list-style-type: none"> <li>• Assumes \$920 million transfer to Budget Stabilization Account, with one-half of the total going for prepayment of outstanding deficit-financing bonds.</li> <li>• Assumes \$258 million in unspecified savings.</li> </ul>



**Program Augmentations Totaling Over \$2 Billion.** The majority of the increase is in K-14 Proposition 98 education funding, where the Governor is proposing to spend \$1.7 billion more than required by the Proposition 98 minimum funding guarantee in 2006-07. In addition, the budget proposes \$426 million in new spending for K-12 after-school programs (as required by Proposition 49). In higher education, the Governor is proposing to “buy out” student fee increases at the University of California and the California State University in 2006-07. In the criminal justice area, the Governor is proposing additional funds for inmate and parolee programs, as well funding for the phase-in of 150 new judgeships over three years.

**Savings of Roughly \$500 Million.** Most of these reductions are in the social services area, where the Governor is proposing to (1) further delay the pass-through of the federal cost-of-living adjustment (COLA) for Supplemental Security Income/State Supplementary Program recipients from April 2007 to July 2008, and (2) reduce funding for child care and welfare-to-work services. Other savings are proposed in the areas of state operations and county administration of health and social services programs.

**Prepayment of Budgetary Debt Totaling About \$1.4 Billion.** This includes \$920 million toward the \$1.3 billion loan repayment due to transportation in 2007-08, and \$460 million toward prepayment of outstanding deficit-financing bonds (per Proposition 58).

## LAO OUTLOOK

In this section, we examine the implications of the 2006-07 Governor’s Budget proposal on the near-term and longer-term General Fund condition, using our own revenue forecast and our own estimates of the impacts of both current law and the Governor’s proposals on expenditures. Our estimates do not reflect any of the programmatic recommendations that we make in our *Analysis of the 2006-07 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. In cases where there are budgetary risks related to court cases, we have given the administration “the benefit of the doubt,” and thus have not included their potential added costs.

### 2006-07 Budget Would Have a \$2.6 Billion Reserve

As indicated in both Figures 3 and 4 (next page), we estimate that if the Governor’s budget were fully adopted, the state would end 2006-07 with a reserve of \$2.6 billion, or \$2 billion more than assumed in the Governor’s budget. This increase is largely related to our higher revenue projections, partly offset by higher costs.

### Figure 3 Key LAO Budget Findings

- ✓ **2006-07 Budget Would Conclude With a \$2.6 Billion Reserve**
  - Revenues up by \$2.3 billion during current and budget years combined, mainly from higher personal income taxes.
  - Expenditures up by \$340 million in current and budget years combined, due to higher spending in Proposition 98, state operations, and local mandates.
  - Year-end reserve masks large operating shortfall of \$5 billion.
- ✓ **Structural Shortfall Would Continue in the Following Years**
  - Operating shortfall would be nearly \$4 billion in 2007-08 and nearly \$5 billion in 2008-09.
  - Shortfalls would be larger if economic or budgetary risks materialize.
- ✓ **General Fund Faces Other Major Financial Pressures**
  - Obligations from past borrowing.
  - Unfunded liabilities related to employee health and teachers' retirement.

### Figure 4 The LAO's General Fund Condition Assuming Governor's Policy Proposals

(In Millions)

	Actual 2004-05	Estimated 2005-06	Projected 2006-07
Prior-year fund balance	\$7,228	\$9,634	\$8,073
Revenues and transfers	82,209	88,972	93,033
Total resources available	\$89,438	\$98,605	\$101,105
Expenditures	\$79,804	\$90,532	\$98,003
Ending fund balance	\$9,634	\$8,073	\$3,102
Encumbrances	\$521	\$521	\$521
<b>Reserve</b>	<b>\$9,112</b>	<b>\$7,551</b>	<b>\$2,581</b>
Budget Stabilization Account	—	—	\$465
Reserve for Economic Uncertainties	\$9,112	\$7,551	2,116

**Higher LAO Revenues.** We believe that the recent strength in personal income tax and corporation tax receipts is indicative of the fact that 2005 tax liabilities, once tabulated, will prove to be even higher in 2005 than assumed in the Governor's budget. As discussed in "Part III," these higher payments and the liability trend generating them will likely translate into additional receipts this spring, when final returns are due for the 2005 tax year. We also expect the higher payments trend to continue into 2006-07. Accordingly, we are projecting that revenues will exceed the budget forecast by \$1.3 billion in the current year and \$1 billion in 2006-07, or \$2.3 billion for the two years combined.

**Higher LAO Costs.** On the expenditure side, we estimate that General Fund expenditures under the Governor's budget proposal would exceed the administration's estimate by a two-year amount of about \$340 million. This is the net effect of higher costs associated with Proposition 98, local mandates, and state operations, partly offset by lower spending for Medi-Cal.

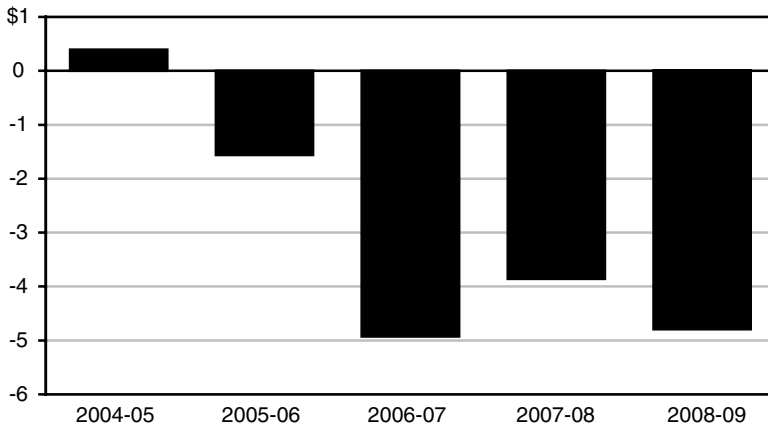
### State Would Continue to Face Structural Shortfalls Thereafter

The 2006-07 fiscal year would end with a meaningful reserve, but only because the operating deficit of about \$5 billion is more than covered by the \$7.6 billion in carry-in reserve funds. As Figure 5 shows, the operating shortfalls would continue under the budget proposal, reaching nearly \$4 billion in 2007-08 and nearly \$5 billion in 2008-09.

**Figure 5**

### Operating Shortfalls<sup>a</sup> Persist, Despite Booming Revenues

General Fund (In Billions)



<sup>a</sup>Annual revenues minus expenditures. Legislative Analyst's Office estimates of Governor's revenue and expenditure policies.

## PROJECTIONS SUBJECT TO SIGNIFICANT RISKS

Although our fiscal projections reflect our assessment of the most likely fiscal outcomes for the state, it is important to understand that there are several very significant budgetary risks and pressures that lurk beneath our forecasts. These are highlighted in Figure 6. These risks and pressures could add several billions of dollars to the operating shortfalls during the next several years, were they to materialize. They include:

**Figure 6**

### Beyond Structural Deficits— Near-Term Risks and Pressures

- ✓ **Economy.** Higher energy costs or steeper real estate decline.
  - Potential General Fund impact of steeper slowdown—\$4 billion in 2006-07.
- ✓ **Lawsuits.** State currently appealing lower court rulings.
  - California Work Opportunity and Responsibility to Kids grants (*Guillen* case)—\$460 million.
  - Pension obligation bonds—\$525 million.
  - State Teachers' Retirement System contributions—\$500 million.
- ✓ **Federal Deficit Reduction Act.** Federal reductions and added state costs of several hundreds of millions of dollars annually over the next five years.

- **Steeper Economic Slowdown.** Our projections assume that California's economy and General Fund revenues, while slowing some from current levels, expand at a moderate pace through the forecast period. However, as we discuss in "Part II" and "Part III," the state faces significant economic risks during the next year associated with such factors as higher energy costs and a steeper-than-expected slowdown in real estate sales, prices, and construction activity. A more pronounced slowdown in California's economy during the next two years than we are projecting could easily reduce General Fund revenues by as much as \$4 billion from our projected level in 2006-07.

- **Lawsuits.** The state is currently appealing three lower court rulings that would result in about \$1.5 billion added General Fund costs. These rulings (whose fiscal effects are not included in our projections) include: the *Guillen* lawsuit, where a lower court ruled that an October 2003 COLA for California Work Opportunity and Responsibility to Kids grant levels is required by state law; a State Teachers' Retirement System (STRS) case, where a lower court ruled that the state's suspension of about \$500 million of contributions in 2003-04 was illegal; and a pension bond validation suit, where a lower court ruled that the \$525 million pension obligation bond authorized in conjunction with the 2005-06 budget was illegal. The administration assumes the pension bond-related savings will occur in 2007-08.
- **Federal Actions.** The federal Deficit Reduction Act of 2005 will likely have an adverse fiscal impact on California. Over federal fiscal years 2006 through 2010, the act would result in several hundreds of millions of dollars annually in increased state costs, mostly in health, social services, and higher education.

## FINANCIAL OBLIGATIONS ARE LOOMING

In addition to the near-term risks and pressures shown in Figure 6, the state also faces in the tens of billions of dollars in financial burdens from unfunded liabilities related to employee retirement. Although not necessarily imposing immediate costs on the state budget, these unfunded liabilities are very important from the standpoint of the state's overall fiscal health. They are similar to other forms of budgetary borrowing (discussed below), in that they will require *future* taxpayer dollars to be diverted to fund state employee and teachers' services already rendered. Figure 7 (see next page) highlights these factors.

**Retiree Health Care.** State costs to pay for retired employees' health care premiums have been rising sharply, and will increase even more dramatically in the future as more of the workforce reaches retirement age. Like most state and local governments, California currently funds retiree health benefits on a "pay as you go" basis. However, the Governmental Accounting Standards Board (GASB) has issued a new financial reporting standard (GASB 45) that requires states to recognize such retirement health benefits being accrued by their employees (thereby accounting for accrued health care benefits in the same manner as accrued retirement benefits). Under the revised standard, we estimate that California state government faces an unfunded liability associated with health benefits already accrued of between \$40 billion to \$70 billion.

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## Figure 7

### Beyond Structural Deficits— Longer-Term Financial Pressures

- ✓ **Employee Retiree Health Care Costs**
  - Unfunded liability of \$40 billion to \$70 billion for already-accrued benefits.
  - An additional \$1 billion annually would be required to prefund benefits accruing annually.
- ✓ **State Teachers' Retirement System Unfunded Liability**
  - Over \$24 billion.
  - "Catch up" contributions, if paid by the state, would cost an additional \$1 billion per year.

As discussed in "Part V," we recommend that California begin to partially prefund the accrued health care benefits of its current employees. For example, if the state were to pay the costs of retiree health benefit costs accruing in 2006-07, it would need to raise annual General Fund contributions by over \$1 billion annually. (The cost to pay off past unfunded liabilities would be considerably more.)

**The State Teachers' Retirement System.** Both of the state's main retirement funds face unfunded liabilities in the range of \$24 billion. While employer contribution rates for the Public Employees' Retirement System's (PERS) members have been automatically adjusted upward to address its unfunded liability over a 30-year period, the STRS fund has no such "catch up" mechanism. If the STRS contribution rates were adjusted upward in the same manner as PERS, and the state were to pay these additional contributions, the added annual costs would be more than \$1 billion.

### State Still Coping With Past Budgetary Borrowing

The risks and financial pressures discussed above come on top of the substantial costs the state is already incurring related to its past budgetary borrowing. At its peak, this borrowing reached \$25 billion. Although the 2005-06 and 2006-07 budgets make progress toward reducing these outstanding liabilities, we estimate that over \$20 billion in budget-related obligations will remain at the close of the budget year. As discussed in "Part IV" of this volume, the outstanding borrowing includes about \$15 billion from private markets (which includes the deficit reduction bonds and tobacco bonds) and another \$5 billion from local governments, schools, transportation, and other special funds. Annual costs of repaying this budgetary debt

rise from about \$3.7 billion in 2006-07 to a peak of over \$5 billion in 2008-09 (when a \$1 billion Proposition 42 loan repayment is due).

## LEGISLATIVE CONSIDERATIONS

When one takes a narrow view of the state's 2006-07 budget with its projected \$2.6 billion year-end reserve, it is easy to mistakenly conclude that the state's finances are not all that bad and that there is no need to feel any urgency about taking difficult budget-balancing actions. However, the reality is that the 2006-07 surplus masks large General Fund fiscal pressures both now and in the future when one considers both the risks associated with the economy, litigation, and the federal budget, as well as outstanding budgetary borrowing and unfunded retiree obligations. Given this, we believe that the first priority for the use of new revenues should be to strengthen the state's financial position and flexibility, rather than expanding state programs. Accordingly, for example, in our accompanying *Analysis of the 2006-07 Budget Bill*, we recommend that spending growth in Proposition 98 be limited to 6.6 percent versus the Governor's proposed 8.7 percent, and that the state take other actions to reduce future pressures on the General Fund. For instance, we recommend that the Legislature place measures before the voters that would repeal both Proposition 42 (which requires annual transfers of sales taxes on gasoline to transportation special funds) and Proposition 49 (which requires increased funding for after-school programs). We also propose replacing the reduction in Proposition 42 transfers with an increase in the excise tax on gasoline, thus holding transportation harmless.

While addressing the state's fiscal problems can mean less funding for some state programs in the near term, we believe that holding new revenues in reserves or applying them to budgetary debt reduction will yield important fiscal benefits to the state that will be of value in the longer-term context. For example, it will be in a stronger position to address high-priority matters and withstand future economic slowdowns when they occur.

The state's experience of recent years has shown how difficult it can be to eliminate structural budgetary imbalances once they take root, even in the midst of highly favorable revenue circumstances. It also has demonstrated that getting the state's fiscal house in order can only occur if it is made a top priority, along with the willingness to make the difficult choices that balancing the budget will require.

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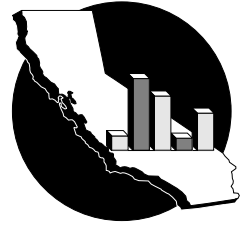
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# II

## PERSPECTIVES ON THE ECONOMY AND DEMOGRAPHICS



# *Perspectives on the Economy and Demographics*



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## **Summary**

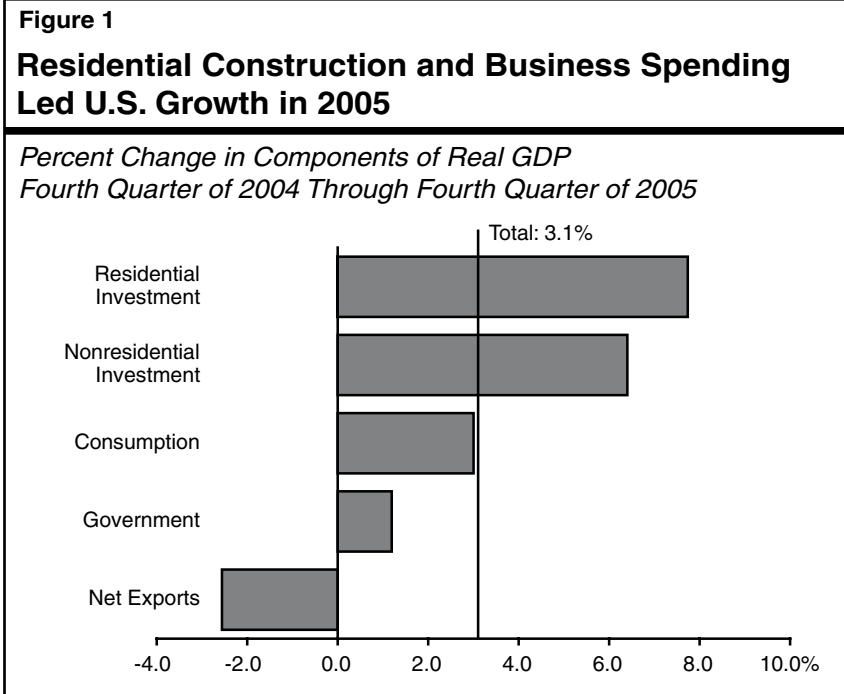
Despite a slowdown in the final quarter of the year, the U.S. and California economies generally outperformed expectations in 2005, shrugging off soaring energy costs, rising interest rates, and the impacts of three major hurricanes on Gulf Coast states. Recent monthly data on spending, employment, and production suggest that the softness that occurred in late 2005 will be short-lived, and the economy will expand at a moderate pace in 2006 and 2007. This outlook is subject to significant downside risks, however, associated with the potential for further increases in energy prices and steeper-than-expected declines in the real estate market. The latter risk is of particular importance to California, where real estate markets showed some signs of weakening late last year.

## **RECENT U.S. DEVELOPMENTS**

### **Solid Growth In 2005**

Despite a marked slowdown in the final quarter of the year (when growth slowed to an annual rate of only 1.1 percent), real gross domestic product (GDP) still expanded by a solid 3.1 percent pace between the fourth quarter of 2004 and the fourth quarter of 2005. As indicated in Figure 1 (see next page).

- The fastest growing output categories were home building (referred to as residential investment) and business spending on computers, software, networks, other equipment, and new facilities (referred to as nonresidential investment).
-



- Consumer spending increased by a respectable 3 percent during the year, reflecting over 3.5 percent increases during the first three quarters (seasonally adjusted annual rates) followed by a subdued 1.1 percent increase in the final quarter of the year. The marked slowdown in the year's fourth quarter was concentrated in automobile sales, and was partly related to the expiration of vehicle incentive programs at the end of summer. Holiday sales grew moderately during December over the prior year.
- Government spending rose 1.2 percent, reflecting modest increases at the federal, state, and local levels.
- One factor that consistently depressed U.S. growth during 2005 was the expanding trade deficit, as imports from abroad continued to outpace our nation's exports to foreign markets.

### Slowdown in Fourth Quarter Likely to Be Short-Lived

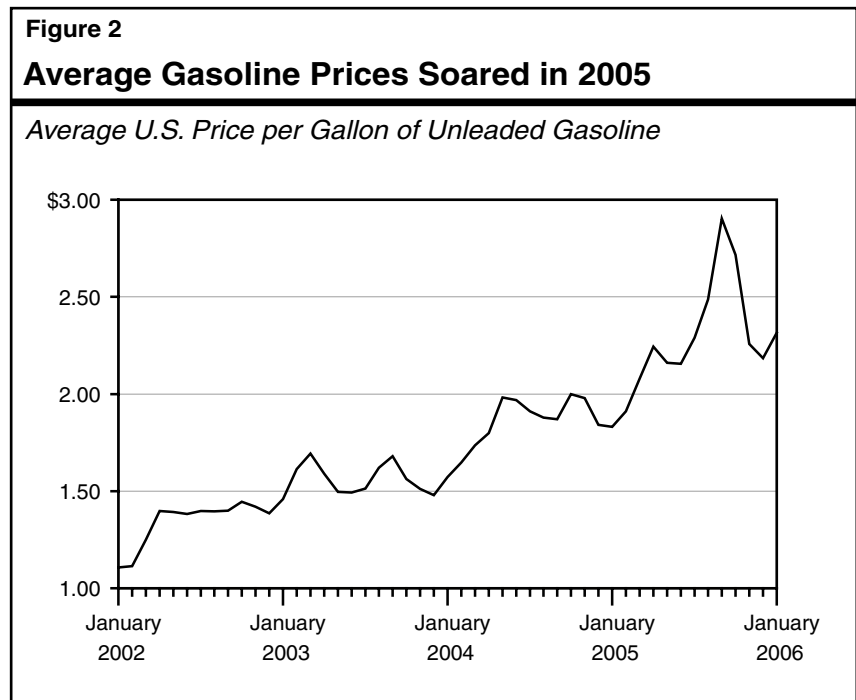
Although 2005's fourth quarter slowdown caught many economists by surprise, monthly indicators released in January and early February of 2006 suggest that the U.S. economy will regain momentum. Positive indicators include rebounding car sales, major drops in initial claims for unemployment, and rising new orders for manufactured goods. In addi-

tion, surveys of both consumers and businesses in January found high confidence levels, improving business conditions, and increased hiring. While these conditions could quickly change in response to, for example, renewed increases in energy prices, they suggest that the economy is on an upward growth track as of early 2006.

**Energy Prices Soared ...**

World crude oil prices climbed sharply between late 2004 and summer 2005, pushed upward by supply disruptions and strong demand, particularly from China and other industrializing countries. Prices temporarily retreated in October and November of 2005, but then rebounded again in December of 2005 and January of 2006 when it was becoming apparent that consumption of oil was continuing to outpace new supplies.

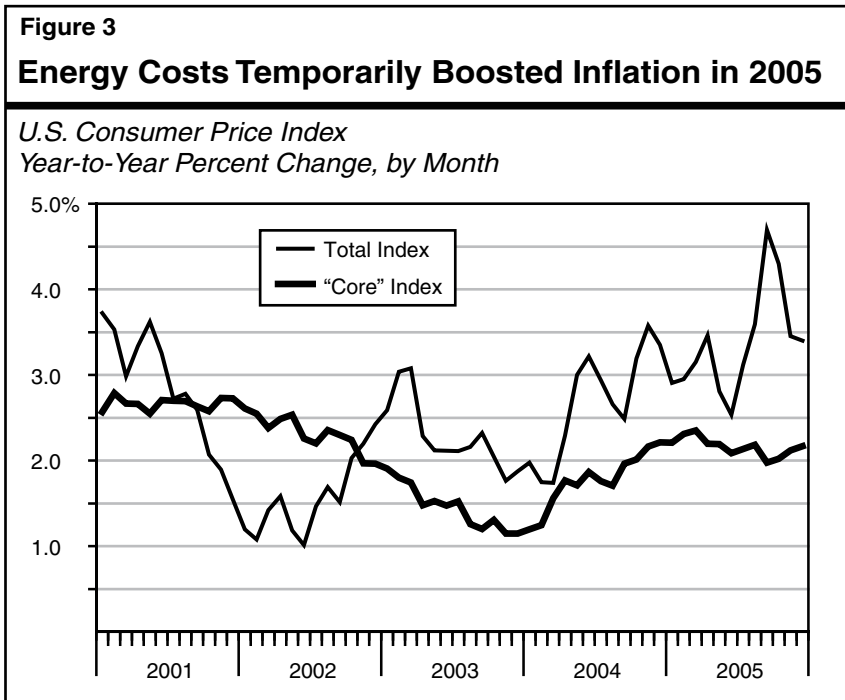
High crude oil prices, coupled with the damage to U.S. refineries caused by hurricanes Katrina and Rita, resulted in record gasoline prices in the nation. As indicated in Figure 2, the national average per-gallon price for unleaded gasoline increased from \$1.83 in January 2005 to a peak of \$2.90 in September 2005 (with many regions seeing prices well above \$3 per gallon during the latter month), before retreating late in the year. Prices of aviation fuel and diesel also increased sharply, raising operational



costs for fuel-dependent industries such as airlines and trucking. Prices of home heating fuel and natural gas also rose sharply during the year, further stretching the budgets of households across the nation.

### ... But They Did Not Derail the Economy

Perhaps the most pleasant surprise in 2005 was that the higher energy costs did not have the more widespread adverse impacts that some analysts had feared. While there were some negative effects on automobile sales and inflation during the second half of 2005, the impacts on the broader economy were relatively mild compared to those that rising energy prices had on economic growth and inflation 25 years ago. Increases in energy-related price components temporarily pushed the year-over-year increase in the U.S. consumer price index (CPI) to 4.7 percent in September 2005, but the growth in the index subsequently slowed late in the year (see Figure 3). The so-called “core” inflation rate (that is, the CPI excluding food and energy costs) never exceeded 2.3 percent during the year, indicating that the jump in energy costs did not “spill over” broadly into other sectors of the economy.



Similarly, while higher energy prices stretched household budgets and curtailed spending on light trucks and SUVs, consumer expenditures outside of the automotive sector remained on an upward track for most of 2005.

The relatively mild impact of higher energy prices appears to be related to two main factors:

- First, energy usage represents a much smaller share of the overall economy today than it did 25 years ago. For example, energy consumption per unit of GDP declined by over one-third between 1975 and 2000, reflecting both greater fuel efficiencies and a change in the composition of the economy away from manufacturing to services.
- Second, strong productivity growth and intense competition have resulted in only a relatively small share of energy price increases being “passed along” in the form of higher product prices to consumers. This has translated into much smaller increases in general inflation and long-term interest rates than occurred in the 1970s and early 1980s.

While these factors have enabled the economy to avoid widespread problems so far, further energy-related price increases still pose a risk to future economic growth and inflation.

### **Job and Income Growth Moderate**

Job growth continued at a moderate pace in 2005. Total nonfarm payroll employment rose by 1.6 percent nationally, reflecting a 1.8 percent increase in private jobs and 1.1 percent growth in the government sector. Personal income increased by a solid 5.4 percent during the year, reflecting moderate increases in wages, and above-average increase in business-related earnings.

### **Profits Jumped**

U.S. after-tax corporate profits increased by an estimated 34 percent in 2005, reflecting major gains in a wide variety of industries. Profits were boosted by changes in federal laws that provided for a temporary tax reduction on foreign earnings that were “repatriated” back into the U.S. by multinational companies. Even when these repatriated earnings are subtracted out, however, remaining profits were still up by more than 20 percent during the year. These gains reflect major increases in oil-related profits, as well as the ongoing benefits of high productivity and robust sales growth on businesses’ bottom-line earnings. As noted in the Part III revenue section of this volume that follows, strong profit growth is

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clearly benefiting the state's fiscal picture by boosting tax receipts from both corporate and personal income taxes.

## CALIFORNIA TRENDS

### State Economic Performance Better Than Expected For Most of 2005 ...

As with the rest of the nation, California's economy grew at a solid pace in 2005. Its growth was led by high levels of real estate sales, construction, and financing activity, but many other industries experienced healthy growth as well during the year. Some key indicators of recent state economic performance include the following:

- *Personal income* was up by over 6.6 percent during the first three quarters of 2005 compared to the first three quarters of 2004, reflecting solid gains in both wage and nonwage income (such as business earnings and dividends). While we expect the year-over-year increase to be smaller in the final quarter once data become available (mainly because there were large one-time dividends paid in the fourth quarter of 2004), it appears that personal income growth for all of 2005 was only slightly less than 2004.
- *Estimated tax receipts* from individuals and corporations were up nearly 25 percent in 2005, suggesting that profits and investment income were up sharply during the year.
- *Nonresidential building permit values* totaled \$18.2 billion in 2005, a 17 percent increase from the prior year. This increase was consistent with other signs of renewed strength in the nonresidential market, such as rising rents and falling vacancy rates for both commercial and industrial property across the state.
- *Consumer confidence*, as measured by the January 2006 survey conducted by the Survey and Policy Research Institute at San Jose State University, was up sharply in January compared to the prior survey taken in October 2005. The increase was partly in response to the softening in gasoline prices late last year, but also reflected improving perceptions by respondents about business conditions and the employment outlook generally, as well as their own financial situations.

### ... Although Residential Real Estate Softened Late In the Year

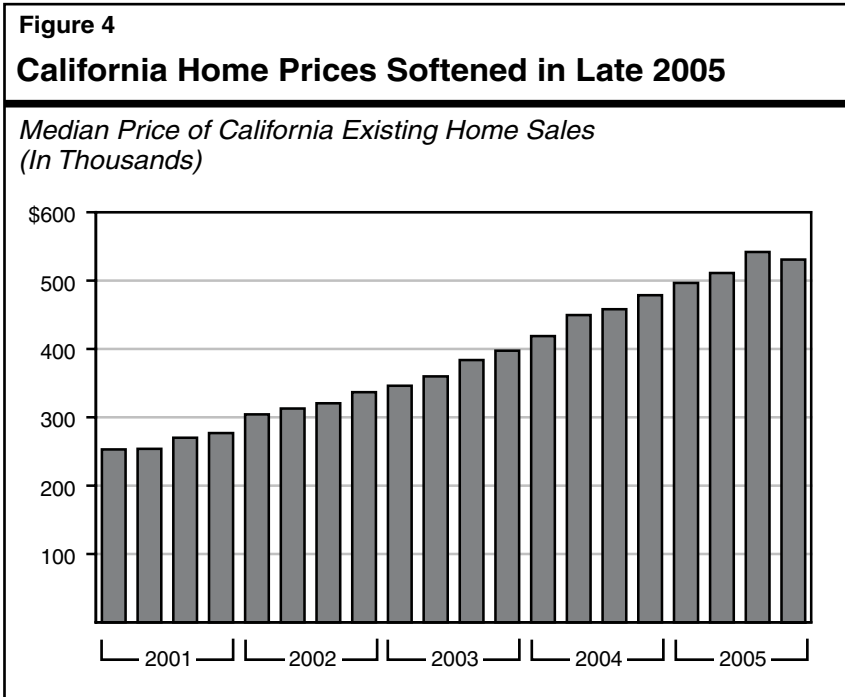
While all sectors of the state's economy experienced economic growth during 2004 and most of 2005, the leading sector for this period was real

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estate. However, this sector showed definite signs of softening in the final quarter of the last year. As shown in Figure 4, the median price for existing home sales more than doubled between 2001 and mid-2005, but then dropped back late in the year. Similarly, permits for new residential construction activity dropped from nearly 220,000 (annual rate) during the first three quarters of 2005 down to 180,000 in the final three months of the year, with December falling to just 160,000 units. Other indicators pointing to a slowdown include fewer loan applications, rising inventories of homes on the market, and a slower pace of new building permit activity.

The late-2005 decline may have been exaggerated by unusually harsh weather and building code changes (which accelerated some permits from the fourth into the third quarter of last year). Our forecast assumes that the underlying housing trend, though falling, is less negative than the late 2005 performance would suggest. However, if the fourth quarter experience is indicative of a more disturbing underlying downward trend, the negative effects in terms of losses in wealth, income, and employment could be much more pronounced than we are assuming.



## Extent of Employment Growth Remains Uncertain

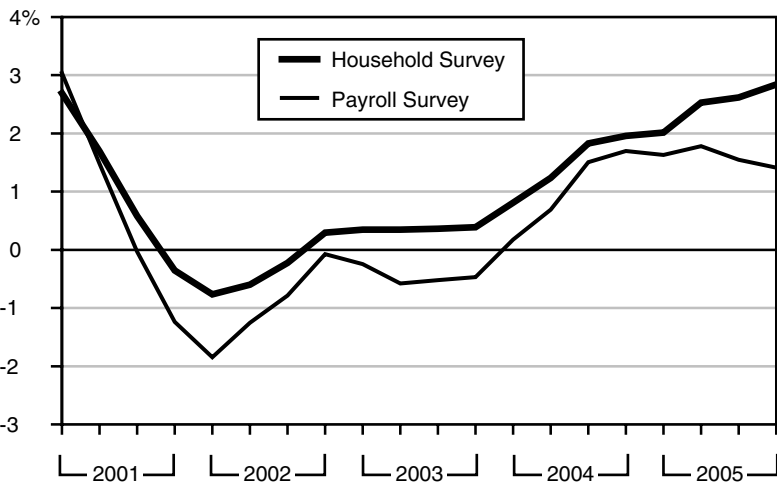
The discrepancy between two key surveys of employment that has been present through much of this decade widened markedly in 2005. As indicated in Figure 5:

- Based on the payroll survey of *employers*, total jobs increased at a moderate rate of about 1.4 percent between the fourth quarter of 2004 and the fourth quarter of 2005, roughly equaling the growth rate in the prior year. The payroll survey is based on responses of about 50,000 businesses that file withholding and unemployment insurance reports with state and federal agencies. This series, which does not include self-employed and contract workers, is used by economists and analysts to evaluate industry trends in employment.
- According to the survey of *households*, jobs grew at a more robust rate of 2.7 percent during the same period. The household survey is based on monthly interviews by the U.S. Bureau of Labor Statistics to measure labor market characteristics, including the unemployment rate. It includes everyone who is working, including those who are self-employed.

**Figure 5**

### Two California Job Surveys Telling Different Stories

*Year-Over-Year Percent Change in California Employment, By Quarter*



**Which Survey Is Correct?** We believe that the “true” amount of job growth is probably closer to that portrayed by the household survey, for two reasons:

- First, the payroll survey is based on larger, well-established firms, and often initially misses new jobs created by small and newly created businesses. To the extent that recent job growth has been in areas with significant numbers of small businesses (such as construction, financial services, and trade), it is probable that the payroll job totals will be revised up once these new jobs are captured in annual benchmark revisions (which are based on a complete count of employers) that are released for 2005.
- Second, an increasing share of job growth in this expansion involves workers that are classified as self-employed, and thus are not covered in the payroll survey (but are being picked up in the household survey). This would include contract workers, consultants, real estate agents, and other independent contractors.

We would note that some of the self employed jobs included in the household survey may be of lesser quality in terms of wages earned, hours worked, and benefits received than similar-type jobs captured in the payroll survey. Despite this, however, we believe that the household survey is more consistent with other economic and revenue indicators suggesting that 2005 was generally a good year for California.

### **All Major Industries and Regions Expanded In 2005**

**Jobs Performance by Industry.** Figure 6 (see next page) shows the increase in jobs reported by the payroll survey by major industry sector between December 2004 and December 2005. It shows:

- Construction was clearly the fastest growing sector, reflecting high levels of residential and nonresidential building, as well as a strong market for construction-related alterations and additions.
- Most other industries expanded by 1 percent to 2 percent last year, as business hiring continued at a measured pace. Even manufacturing, which had been declining through the first four years of this decade, managed a small increase in 2005.

**Jobs Performance by Region.** Regionally, payroll employment growth was under 1.5 percent in both Southern California and the San Francisco Bay Area. It was a little stronger—over 2 percent—in the Central Valley and Central Coast regions. Regarding unemployment rates, these have declined across the state over the past two years, and now generally range from 4 percent to 5 percent in Southern California, the San Francisco Bay Area, and Sacramento. The rates are somewhat higher in the San Joaquin

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Valley counties, the Central Coast, and the rural areas of Northern California (due partly to the greater presence of seasonal jobs in agriculture in these areas). However, unemployment in these regions is also down significantly from prior-year levels.

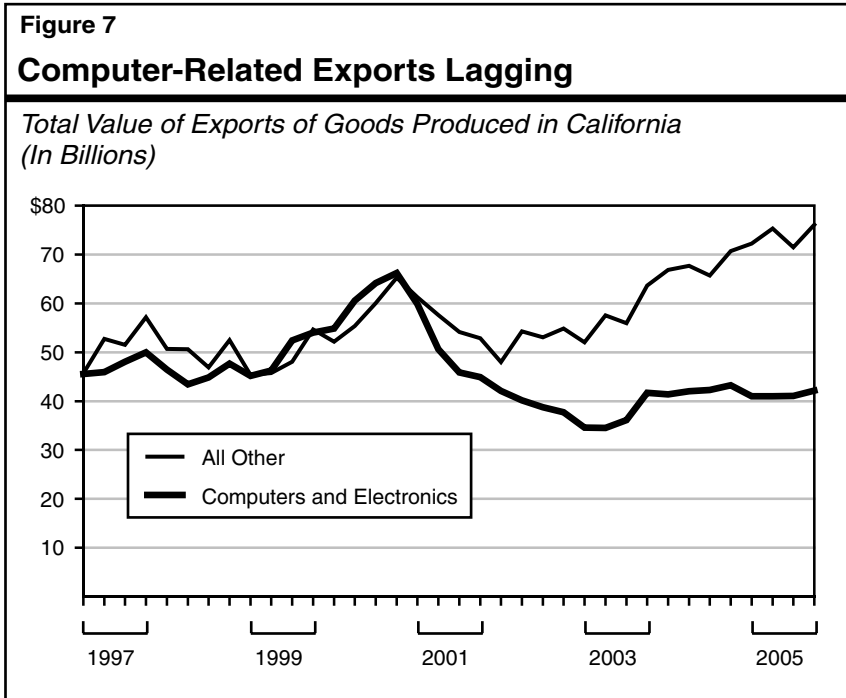


### Export Growth Slowed in 2005

Following a strong 21 percent gain in 2004, exports of goods produced by companies in California increased at a much more subdued rate of 6 percent in 2005. The slowing growth rate was largely due to a flattening in computers and electronics exports, which jumped 15 percent in 2004, but fell by 2 percent in 2005 (see Figure 7).

Although exports have jumped substantially over the past three years combined, they are still below the all-time peak of \$120 billion reached in 2000. As shown in the figure, this is because the exports of computers and electronics products—which accounted for one-half of the total in 2000—fell sharply in 2001 and 2002, and have since only recovered a fraction of their losses. The drop in foreign shipments of computers and electronics is consistent with the decline in high-tech manufacturing activity that has taken place during the past several years. While the state

remains a center for research, design, and development of information technology (IT) products, the production of such products has migrated to lower-cost locations both within the U.S. and abroad.



## THE BUDGET’S ECONOMIC OUTLOOK

The budget’s economic forecast assumes that U.S. and California economic growth will subside but remain on track in 2006 and 2007, reflecting slowing consumer spending and less construction activity. Key elements of the administration’s forecast are displayed in Figure 8 (see next page). The budget forecasts that real GDP growth will slow from 3.6 percent in 2005 to 3.2 percent in 2006, and further to 3 percent in 2007. The forecast assumes that inflation will retreat slightly from 3.5 percent in 2005, to 3.2 percent in 2006, and further to 2.4 percent in 2007. The inflation forecast assumes that energy-related prices will flatten in 2006 and drop slightly in 2007.

The administration’s forecast assumes that California’s economy will generally grow in line with the rest of the nation. It projects that personal income—the broadest measure of state-level economic activity—will slow

from a growth rate of 6 percent in 2005 to 5.8 percent in 2006, and further to 5.5 percent in 2007. The forecast assumes solid growth in a variety of services and trade industries, but a decline in construction activity.

**Figure 8****Summary of the Budget's Economic Outlook**

	Estimate		Forecast	
	2004	2005	2006	2007
<b>U.S. Forecast</b>				
Percent change in:				
Real gross domestic product	4.2%	3.6%	3.2%	3.0%
Personal income	5.9	5.7	6.4	5.8
Wage and salary employment	1.1	1.6	1.5	1.3
Consumer Price Index	2.7	3.5	3.2	2.4
Unemployment rate (%)	5.5	5.1	4.9	5.0
Housing starts (000)	1,950	2,060	1,830	1,780
<b>California Forecast</b>				
Percent change in:				
Personal income	6.6%	6.0%	5.8%	5.5%
Employment:				
Payroll survey	0.9	1.4	1.3	1.3
Household survey	1.5	2.4	1.5	1.4
Taxable sales	8.5	5.3	4.9	5.0
Consumer Price Index	2.6	3.9	3.6	3.0
Unemployment rate (%)	6.2	5.3	5.1	5.2
New housing permits (000)	213	219	197	183

**LAO'S ECONOMIC OUTLOOK**

Our updated economic outlook is similar to both the administration's January budget forecast and our November 2005 fiscal forecast. We continue to expect the national and state economies will expand through the forecast period.

**National Outlook**

As shown in Figure 9, we forecast that real GDP growth will ease from 3.5 percent in 2005 to 3.3 percent in 2006, and further to 2.9 percent in 2007.

The slowdown reflects a slightly slower pace in consumer spending and housing activity, partly offset by a slightly accelerated pace of business investment. Specifically:

**Figure 9**  
**Summary of the LAO's Economic Outlook**

	Estimate		Forecast	
	2005	2006	2007	2008
<b>U.S. Forecast</b>				
Percent change in:				
Real gross domestic product	3.5%	3.3%	2.9%	3.0%
Personal income	6.3	5.7	5.5	5.9
Wage and salary employment	1.6	1.5	1.4	1.2
Consumer Price Index	3.4	2.6	2.2	2.4
Unemployment rate (%)	5.1	4.8	4.9	5.0
Housing starts (000)	2,077	1,984	1,808	1,760
<b>California Forecast</b>				
Percent change in:				
Personal income	6.3%	5.7%	5.5%	5.9%
Employment:				
Payroll survey	1.6	1.5	1.5	1.6
Household survey	2.5	2.1	2.0	1.8
Taxable sales	6.5	5.3	5.4	5.6
Consumer Price Index	4.0	2.8	2.1	2.6
Unemployment rate	5.4	5.2	5.4	5.5
New housing permits	208	190	181	178

- *Real consumer spending* is expected to slow from 3.5 percent in 2005 to 3 percent in 2006 and 2.9 percent in 2007. These increases are slightly less than the projected growth in real disposable income for the same period, as consumers focus over the next two years on reducing their outstanding debt burdens so as to lower their interest costs.
- *Real residential fixed investment* is projected to fall by 3 percent in 2006, and by 7 percent in 2007. The decline is consistent with recent and projected slowdowns in home sales and new housing starts over the next two years.

- **Real nonresidential fixed investment** is forecast to accelerate slightly from 8.8 percent growth in 2005 to 10.1 percent growth in 2006, before easing to a 6 percent growth in 2007. The pattern of growth over the next two years is distorted by the effects of regulatory changes on the timing of large truck sales. Absent these timing changes, the underlying increase is close to 8 percent in both years. This growth reflects strong spending for IT equipment by businesses seeking further productivity gains, and an acceleration in spending on structures by companies seeking to expand facilities. A key positive factor in the investment outlook is booming profits in recent years, which have provided businesses with large amounts of cash to support new spending on equipment and structures. The spending on IT equipment is a positive force in California's outlook, because many high-tech products are designed in California.
- **The trade deficit** is expected to expand in 2006, and then decline beginning in 2007. Although a weaker dollar is expected to boost exports by nearly 10 percent during each of the next two years, imports are likely to grow even faster in 2006, due to the high cost and increased volume of oil imports.

### **Energy Costs to Stabilize**

A key assumption in our economic forecast relates to energy prices. This is because, although recent increases have not substantially depressed economic activity so far, further increases could have that effect. We project that crude oil prices will average close to \$60 per barrel in 2006, and then trend down slightly to \$55 per barrel in the 2007-through-2009 period. Our outlook assumes that, while some of the recent price increases are driven by speculation, underlying market conditions will remain tight, as worldwide oil demand continues to grow and new supplies are slow to come on the market. We expect prices of gasoline to move in tandem with crude oil costs, with unleaded gasoline averaging \$2.35 per gallon nationwide in 2006, and about \$2.30 per gallon the following year.

### **Inflation to Ease**

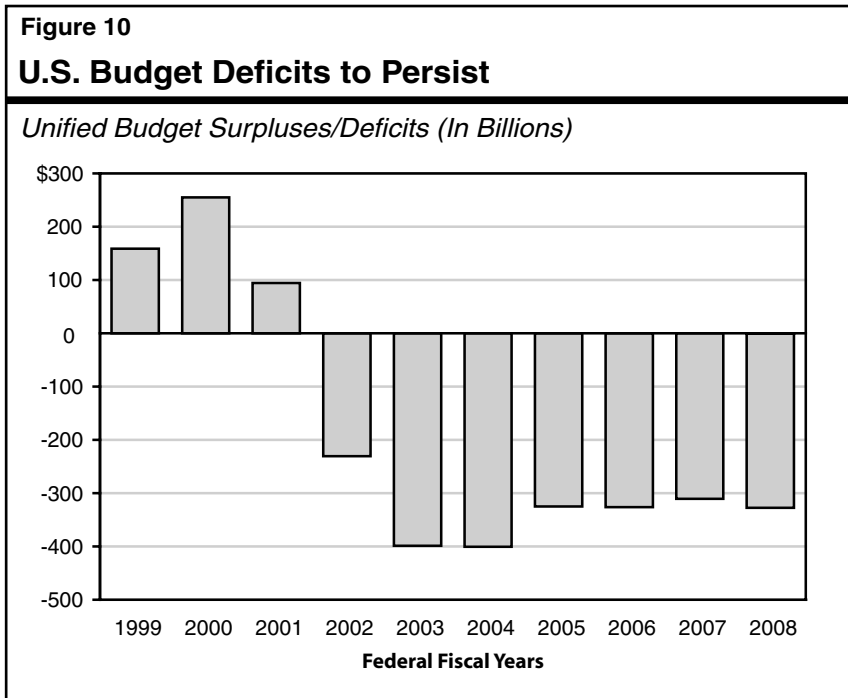
Based on our assumption that energy costs will stabilize and then fall modestly over the next several years, we are forecasting that overall inflation will subside from recent levels. For example, growth in the U.S. CPI is projected to slow from 3.4 percent in 2005 to 2.6 percent in 2006, and further to 2.2 percent in 2007, as energy costs start to decline and nonenergy-related inflation holds steady in the 2 percent to 3 percent range. Factors holding down inflation include continued business productivity growth, moderate wage increases, and intense international competition.

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## U.S. Budget Deficits to Remain Large

Our forecast for the nation assumes that large federal budget deficits will persist through the next decade despite sustained economic growth during the period. As shown in Figure 10, the federal budget moved from a surplus to deficit situation in 2002 following the stock market crash, economic downturn, tax reductions (which were aimed at boosting the economy out of the 2001 recession), spending related to Iraq, recent U.S. hurricanes, and expansions in the Medicare program. These deficits are projected to remain large throughout the next decade, despite ongoing economic expansion during the period. In the early years of this decade, the large deficits had a stimulative effect on the economy, as consumers and businesses spent their proceeds from the federal tax reductions. In the future, however, added financing costs associated with the federal debt will have some depressing effects on long-term economic growth.



## California Outlook

We forecast that California’s economic growth will ease some in 2006 and 2007, but that the state’s economy will continue to expand during the next two years. A key assumption underlying our forecast is that the

slowdown in real estate will not be dramatic, and that output and hiring in other industries will offset most of the softness in this sector. As shown earlier in Figure 9:

- *Personal income* is projected to expand by 5.7 percent in 2006 and 5.5 percent in 2007, compared to 6.3 percent for 2005. Virtually all of the slowdown is related to more subdued growth in nonwage earnings, particularly business profits related to real estate. Wages, in contrast, are expected to grow at a steady pace during the next two years.
- *Payroll employment* growth is projected to increase by 1.5 percent in 2006 and 2007, down slightly from the 1.6 percent gain in 2005. These moderate increases are slightly greater than the state's adult population and labor force growth rates, which will result in a decline in the unemployment rate from 5.4 percent in 2005 to 5.2 percent in 2006.
- *Residential construction permits* are projected to fall from 208,000 units in 2005, to 190,000 units in 2006, and 181,000 units in 2007, as higher interest rates, tighter lending standards, and slower sales take their toll on building activity during this year and the next.
- *Nonresidential permit valuations* will continue to grow, from \$17.7 billion in 2005 to over \$20 billion in 2006, reflecting increases in both commercial and industrial building activity.
- *Taxable sales* growth is expected to slow from 6.5 percent in 2005, to 5.3 percent in 2006 and 5.4 percent in 2007. The slowdown is related to less spending on residential building materials and a slight softening of consumer spending on home furnishings, automobiles, and other durable goods. Business investment-related spending is expected to remain strong during 2006 and 2007.

## Key Forecast Risks

Key assumptions underlying our economic forecast are that (1) energy prices will hold near current levels, rather than rising significantly further in 2006 and 2007, and (2) California's housing markets will experience only modest declines in sales, construction, and prices in 2006. Both of these assumptions are subject to risks.

### Energy Costs

As indicated earlier, the energy markets remain extremely tight, with little excess capacity worldwide. While our forecast assumes that a delicate balance between supply and demand will result in prices staying

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near current levels, one forecast risk is that unanticipated supply disruptions or faster-than-expected growth in demand could quickly translate into another round of energy price increases. Such a development would depress consumer discretionary incomes, put upward pressure on general inflation and interest rates, and ultimately result in a more pronounced slowdown in economic activity during the next year.

### **Real Estate Activity**

Our forecast assumes that the decline already underway in real estate will be orderly and limited in 2006, with sales rates, prices, and new construction activity falling by between 5 percent to 10 percent from 2005 levels. There is always the risk at such times, however, that rising mortgage rates and a tightening of lending standards will send the California housing markets into a steeper decline. Such a development would directly depress earnings and income in real estate-related industries, and indirectly affect many other areas of the economy, through the effects of lost wealth and income on sales, hiring, and confidence in the economy. Another type of risk involves the housing market sharply contracting to the extent that some of its past strength has reflected speculative behavior.

*Illustration of Potential Downside Effects.* As an indication of the potential reductions to our economic forecast that the above risks could produce, we have estimated the adverse impacts of a steeper-than-expected decline in the real estate sector using the following assumptions:

- Permits for new home construction fall to around 140,000 units in both 2006 and 2007, instead of our baseline projections of 190,000 and 181,000 for the two years. (These lower levels would be comparable to the 148,000 average for 1996 through 2003, but still much higher than the 94,000 average for the 1991 through 1995 period.)
- California median home prices and sales rates each fall by roughly 20 percent from their peak during the next two years, instead of the less than 10 percent declines assumed in our baseline forecast.

Under this alternative projection, we estimate that California personal income growth would fall from our baseline forecast by about 1.4 percentage points in 2006 (from 5.7 percent to 4.3 percent) and by about 2 percentage points in 2007 (from 5.5 percent to 3.5 percent). As discussed in Part III of this volume, reductions of this magnitude in our economic forecast would have substantial downward impacts on state General Fund revenues.

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## Comparison to Other Forecasts

Figure 11 compares our economic forecasts for the nation and California to our November 2005 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 2005, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2006), the consensus outlook forecast in the *Western Blue Chip Economic Forecast* (February 2006), and the *2006-07 Governor's Budget* forecast.

Our projections have not changed a great deal since November, and we are generally similar to those of the administration and most other forecasts shown in Figure 11. To varying degrees, all of the projections call for slowing growth over the next two years, with UCLA anticipating a bit more of a slowdown than other California forecasters.

## 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 2007

Figure 12 (see page 36) summarizes our updated state demographic forecast. We project that California's total population will rise from an estimated 37.5 million in 2006 to 38 million in 2007, and 38.5 million in 2008. These population projections use as their starting point published 2000 Census data for California and incorporate developments since then regarding births, deaths, and migration flows.

*Slight Slowing Projected.* The state's population is projected to grow at an average rate of somewhat above 1.3 percent annually over the next three years. This is down slightly from the 1.5 percent average for the 2002 through 2005 period. Birth rates are forecast to stabilize at historically low levels, and net in-migration is projected to turn upward after having fallen for the past several years.

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**Figure 11**  
**Comparisons of Recent Economic Forecasts<sup>a</sup>**

*(Percent Changes)*

	Forecast		
	2005	2006	2007
<b>United States Real GDP:</b>			
LAO November	3.7%	3.3%	3.0%
UCLA December	3.6	2.8	2.5
DOF January	3.6	3.2	3.0
Blue Chip "Consensus" <sup>b</sup> January	3.6	3.4	3.1
LAO February	3.5	3.3	2.9
<b>California Payroll Jobs:</b>			
LAO November	1.4%	1.3%	1.4%
UCLA December	1.6	1.1	0.8
DOF January	1.4	1.3	1.3
Blue Chip Consensus <sup>c</sup> February	1.6	1.5	1.2
LAO February	1.6	1.5	1.5
<b>California Personal Income:</b>			
LAO November	6.3%	5.7%	5.5%
UCLA December	6.2	5.2	4.5
DOF January	6.0	5.8	5.5
Blue Chip Consensus <sup>c</sup> February	5.9	5.9	5.6
LAO February	6.3	5.7	5.5
<b>California Taxable Sales:</b>			
LAO November	6.1%	5.2%	5.6%
UCLA December	6.9	5.1	4.0
DOF January	5.3	4.9	5.0
Blue Chip Consensus <sup>c</sup> February	5.2	5.6	5.7
LAO February	6.5	5.3	5.4

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

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

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

In numeric terms, the number of new Californians being added each year—about 505,000 people over the forecast interval—is above the size of such cities as Long Beach, Fresno, and Sacramento, and very similar to such states as Wyoming.

**Figure 12****Summary of the LAO's California Demographic Forecast***(Population in Thousands)*

	2006	2007	2008
<b>Total population (July 1 basis)</b>	37,480	37,987	38,508
<b>Changes in population:</b>			
Natural change (births minus deaths)	306	306	307
Net in-migration (in-flows minus out-flows)	182	202	214
<b>Total changes</b>	<b>488</b>	<b>508</b>	<b>521</b>
<b>Percent changes</b>	1.3%	1.4%	1.4%

**Population Growth Components**

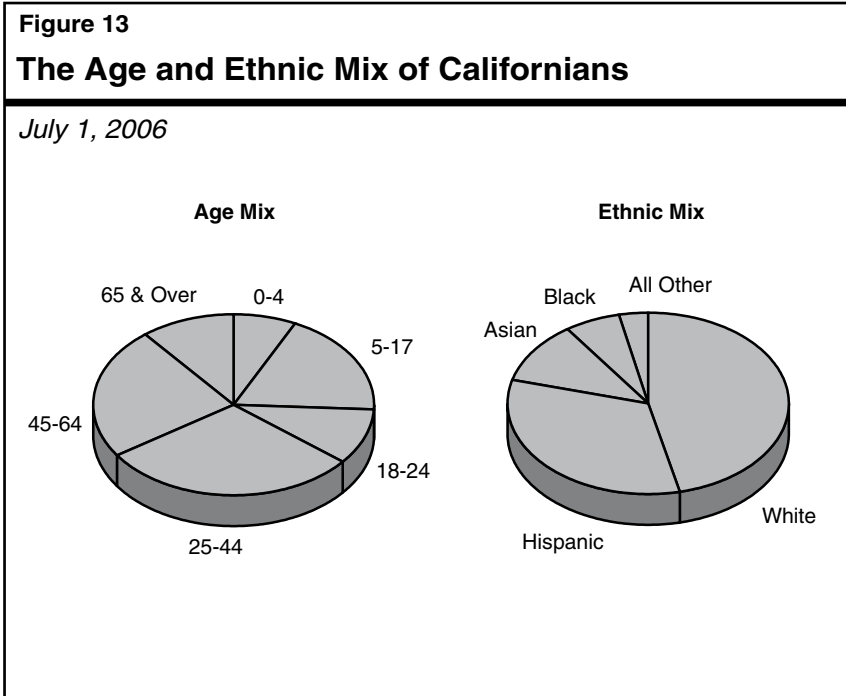
California's population growth can be broken down into two major components—*natural increase* (the excess of births over deaths) and *net in-migration* (persons moving into California from other states and countries, minus people leaving the state for other destinations). The population growth associated with natural increase accounts for about 60 percent 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 40 percent of the growth over the period, but has historically varied in response to changing economic conditions in the state.

**Natural Increase.** We project that the natural increase component will contribute an average of 307,000 new Californians annually over the forecast period. This reflects stable birth rates, but growth in the female population of child-bearing age groups.

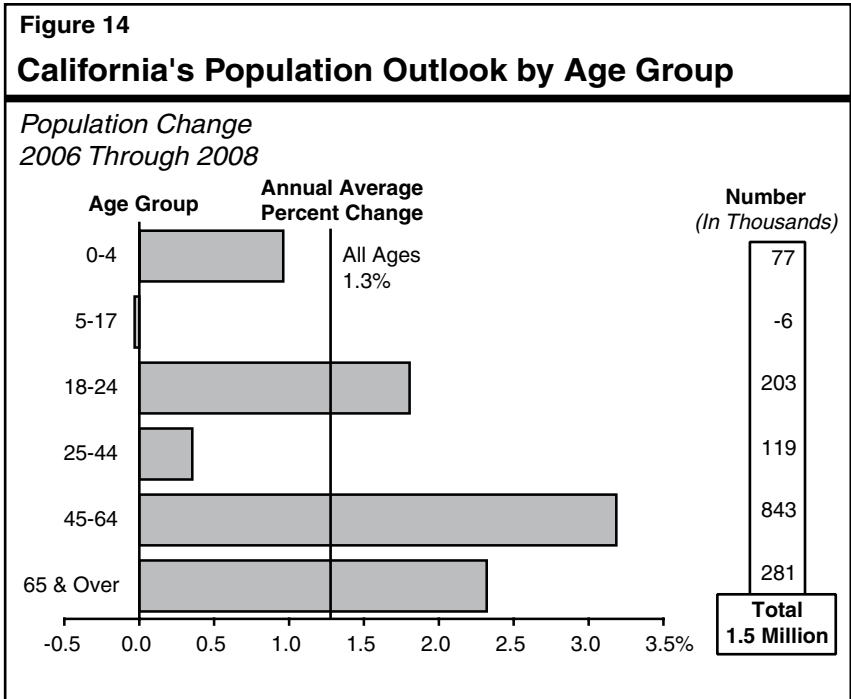
**Net In-Migration.** This component dropped from 388,000 in 2001 to 179,000 in 2005, due mainly to a decline in net in-migration from other states. Specifically, net domestic in-migration from other states fell from a positive 97,000 in 2001 to a *negative* 29,000 in 2005, meaning that in 2005 more people left California for other states than moved into California from them. The decline in net domestic in-migration in recent years appears to reflect, to some degree, the impact of high home prices and a slower rate of hiring in California compared to past expansions. We expect net domestic in-migration to slowly turn positive during the next several years, but remain well below the levels realized in past economic expansions. Combined with our projections for steady rates of immigration from other countries, the slow increase in inflows from other states will result a modest rise in total in-migration over the next several years.

### 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 are shown in Figure 13.



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 14 (see next page) shows our forecasts for both the percentage and numeric changes in different population age groups. The 45-to-64 age group (largely representing baby boomers) continues to be the fastest growing segment of the population. About 843,000 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. In contrast, the leading edge of the baby boomers will be only 62 years of age by the end of the forecast period, and thus still occupants of this age category.



**Overall Budgetary Implications**

California’s continued 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 2006-07 and beyond. For example, strong growth of the 45-to-64 age group generally benefits tax revenues since this is the age category in which people normally earn their highest wages and salaries. Alternatively, the lack of growth statewide in the 5-to-17 age group translates into significant declines in enrollment for many school districts.

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.
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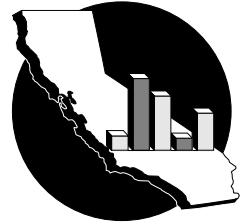
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# III

## PERSPECTIVES ON STATE REVENUES



## *Perspectives on State Revenues*



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The state budget continues to benefit from healthy revenue growth. After climbing by over 8 percent in 2004-05, the *2006-07 Governor's Budget* assumes that revenues from the state's major taxes will increase further by 6.2 percent in 2005-06 and 5.7 percent in 2006-07. As indicated in Figure 1 (see next page), the administration's current forecast is up substantially from the estimates included in the *2005-06 Budget Act*. It is also up significantly from our office's prior forecast presented in November 2005.

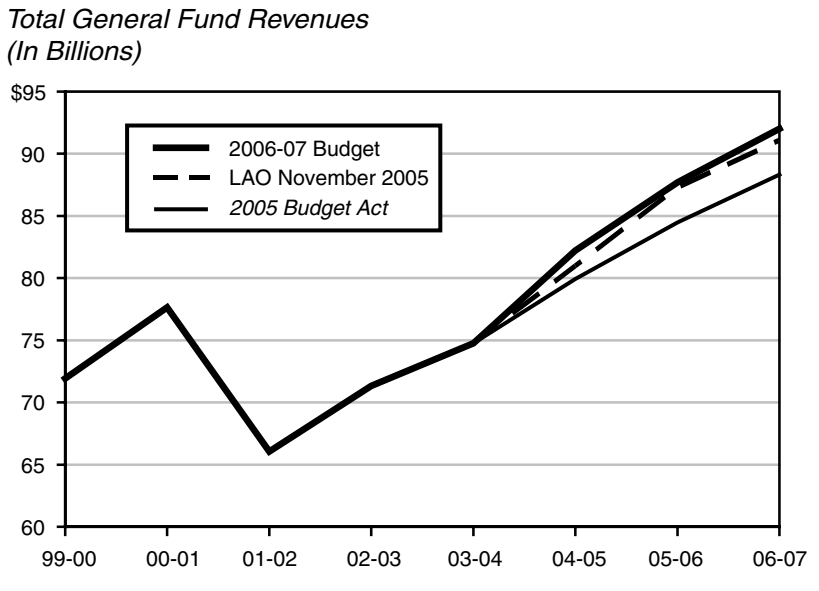
While the continued revenue strength is clearly positive news, we note that most of the growth is coming from volatile sources such as business earnings and investment income, which would subside quickly should the state experience a more severe slowing than is currently anticipated. In this Part, we provide background information relating to the revenue outlook, discuss recent revenue developments, summarize the budget's revenue projections, and present our own revenue forecast.

### **THE BUDGET'S FORECAST FOR TOTAL STATE REVENUES**

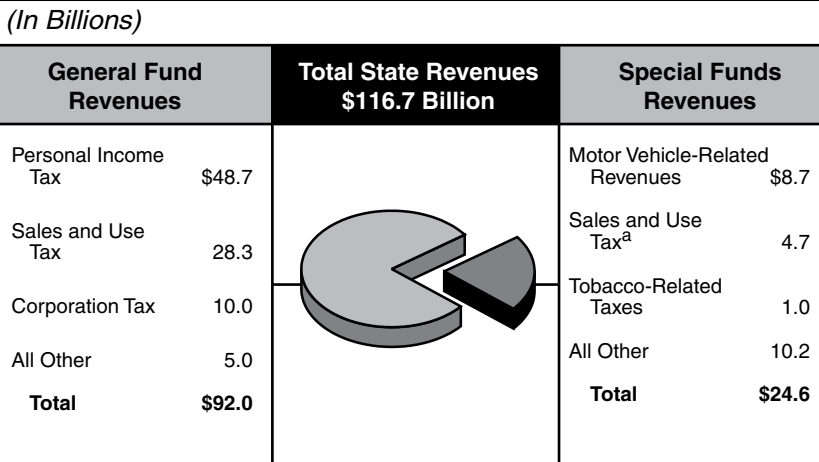
The *2006-07 Governor's Budget* projects that California state government will receive \$117 billion in revenues in 2006-07. These revenues are deposited into either the General Fund or a variety of special funds. Figure 2 (see next page) shows that:

- **General Fund Revenues.** About 79 percent of total state revenues are deposited into the General Fund. These revenues are then allocated through the annual budget process for such programs as education, health, social services, and criminal justice.
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**Figure 1**  
**Budget Forecasts Continued Revenue Strengthening**



**Figure 2**  
**State Revenues in 2006-07**



Detail may not total due to rounding.  
<sup>a</sup> Includes \$2.9 billion to Local Revenue Fund and \$0.4 billion for transportation-related purposes. Also includes \$1.4 billion in sales taxes redirected to pay off deficit-financing bonds. Excludes \$2.9 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

- **Special Funds Revenues.** The remaining 21 percent of revenues are received by special funds and are primarily earmarked for specific purposes, such as transportation, local governments, and targeted health and social services programs.

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

**Sources of General Fund Revenues.** Figure 2 indicates that about 95 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 is related to a variety of smaller taxes (including insurance, tobacco, and alcoholic beverage taxes), fees, investment earnings, and various transfers from special funds.

### Proposed Revenue-Related Changes

The proposed budget does not include any major tax proposals, although there are a number of limited measures that have an effect on revenues. The adoption of these various measures—which would affect PIT, SUT, and cigarette tax—would result in a net increase in revenues for 2006-07 of slightly over \$250 million.

As shown in Figure 3 (see next page), the largest of the proposals continues the suspension of the Teacher Tax Credit for the 2006 tax year. This PIT credit is available to credentialed teachers and ranges from \$150 to \$1,500 per claimant depending upon years of experience. The continued suspension of the credit would result in a net increase in PIT revenues of \$210 million in the budget year. This program was adopted in 2000, but was suspended for tax years 2002, 2004, and 2005. Also, the administration proposes conforming the state PIT to federal law regarding Health Savings Accounts for individuals, and making these accounts more flexible. This would result in a revenue reduction of \$3 million in the current year and \$8 million in the budget year.

An additional policy change involving the application of SUT to the out-of-state purchase of vehicles, vessels, and aircraft would result in revenues of \$35 million in the budget year. Legislation passed along with the *2004-05 Budget Act* increased the period of time that such purchases have to be kept out of state in order to avoid the payment of SUT from 90 days to one year. This provision is scheduled to sunset July 1, 2006 (at which point the period returns to 90 days); the Governor's proposal would extend the sunset date to July 1, 2007.

**Figure 3**  
**2006-07 General Fund Revenue Changes**  
**Proposed in Governor's Budget**

(In Millions)

	Fiscal Impact		
	2005-06	2006-07	2007-08
<b>Personal Income Tax</b>			
Teacher tax credit: suspend for an additional year	—	\$210	—
Health Savings Accounts: conform to federal law	-\$3	-8	-\$15
<b>Sales and Use Tax</b>			
Vehicle, vessel, and aircraft use tax: extend recent changes for an additional year	—	\$35	—
Compliance measures <sup>a</sup>	—	14	\$13
<b>Cigarette Tax</b>			
Compliance measures <sup>a</sup>	—	\$1	\$1
<b>Totals, 2006-07 Revenue Measures</b>	<b>-\$3</b>	<b>\$252</b>	<b>-\$1</b>
<sup>a</sup> There also are additional special funds revenue gains of \$30 million in 2006-07 and \$15 million in 2007-08.			

Finally, the administration proposes a number of collection efforts involving SUT that are intended to help address the state's tax gap. These proposals, which are reviewed in the General Government section of our *Analysis of the 2006-07 Budget Bill*, consist of (1) additional collections based on agricultural inspection station information, (2) expanded licensing of retailers, and (3) enhanced enforcement of Internet and mail order sales of cigarettes. This last measure would also have an impact on increasing cigarette excise taxes.

## THE BUDGET'S GENERAL FUND REVENUE OUTLOOK

The Governor's budget reflects a major improvement in the revenue outlook. It assumes that revenues during 2004-05 and 2005-06 will be up by a combined total of over \$5.4 billion relative to the estimates contained in the *2005-06 Budget Act*. The budget's revenue projections are summarized in Figure 4.



**Figure 4**  
**Summary of the Budget's**  
**General Fund Revenue Forecast**

*(Dollars in Millions)*

	Actual 2004-05	2005-06		2006-07	
		Estimated Amount	Percent Change	Projected Amount	Percent Change
<b>Taxes</b>					
Personal income	\$42,738	\$45,493	6.4%	\$48,716	7.1%
Sales and use	25,759	27,184	5.5	28,295	4.1
Corporation	8,670	9,621	11.0	10,024	4.2
Insurance	2,233	2,246	0.6	2,340	4.2
Other	671	456	-32.0	459	0.5
<b>Other Revenues, Transfers, and Loans</b>					
Other revenues	\$1,904	\$2,705	42.1%	\$2,144	-20.7%
Transfers	235	-14	—	27	—
<b>Totals</b>	<b>\$82,209</b>	<b>\$87,691</b>	<b>6.7%</b>	<b>\$92,005</b>	<b>4.9%</b>

**2004-05 Actual.** The budget shows that 2004-05 General Fund revenues and transfers totaled \$82.2 billion, a 6.9 percent increase from 2003-04. The administration's estimate is up \$2.3 billion from the level assumed when the 2005-06 budget was enacted. This is an unusually large prior-year revision. It includes a \$1 billion increase in CT revenues, a \$700 million increase in PIT revenues, and over \$500 million from SUT.

The prior-year increase is related to stronger cash collections and lower refunds occurring during the current year that are attributable to prior-year tax liabilities. Under California's accrual method of accounting, these payments and refunds are accrued back to 2004-05. The transactions are mainly related to audit assessments and taxes owed on PIT and CT extension returns that were filed in the second half of calendar 2005.

**2005-06 Estimate.** The administration's forecast assumes that General Fund revenues and transfers will be \$87.7 billion, a 6.7 percent increase from the prior year. This revised estimate is up \$3.2 billion from the revenue forecast contained in the *2005-06 Budget Act*. Of this total, about \$2.2 billion is related to PIT, \$800 million is related to CT, and \$200 million is from SUT. In all three cases, the main factor behind the upward revisions is stronger-than-expected payments associated with tax liabilities in 2005.

**2006-07 Forecast.** The budget forecasts that General Fund revenues and transfers will be \$92 billion in the budget year, a 4.9 percent increase from 2005-06. The relatively low growth rate reflects a decline in nontax revenues in 2006-07. Adjusting for one-time factors (such as proceeds from the refinancing of a tobacco bond in the current year), the underlying growth rate is higher—about 5.6 percent—or about the same pace as the projected growth in the state’s economy.

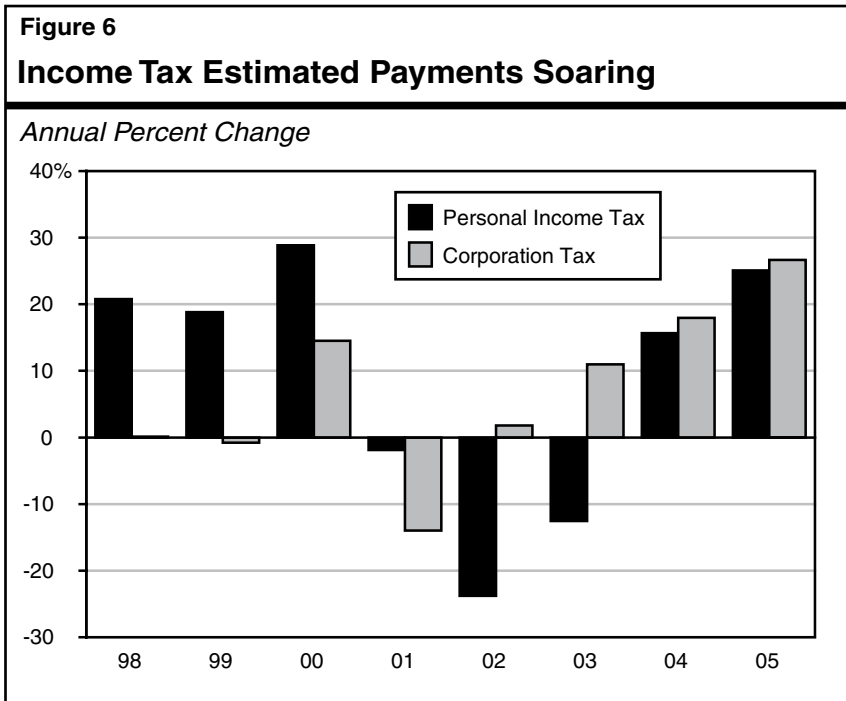
## THE LEGISLATIVE ANALYST’S OFFICE’S (LAO) GENERAL FUND REVENUE OUTLOOK

Figure 5 shows our projections of General Fund revenues for 2005-06 through 2007-08. These projections are based on our economic and demographic forecasts presented in Part II of this volume and reflect the impacts of the Governor’s revenue-related policy proposals. For the current year and budget year combined, our revised estimates are higher than the administration’s by roughly \$2.3 billion.

<b>Figure 5</b>						
<b>Summary of the LAO’s General Fund Revenue Forecast</b>						
<i>(Dollars in Millions)</i>						
	<b>Estimated 2005-06</b>		<b>Projected 2006-07</b>		<b>Projected 2007-08</b>	
	<b>Amount</b>	<b>Percent Change</b>	<b>Amount</b>	<b>Percent Change</b>	<b>Amount</b>	<b>Percent Change</b>
<b>Taxes</b>						
Personal income	\$46,490	8.8%	\$49,480	6.4%	\$52,360	5.8%
Sales and use	27,210	5.6	28,410	4.4	29,890	5.2
Corporation	9,800	13.0	10,170	3.8	10,610	4.3
Insurance	2,250	0.8	2,363	5.0	2,433	3.0
Other	456	-31.9	454	-0.5	459	1.1
<b>Other Revenues, Transfers, and Loans</b>						
Other revenues	\$2,779	45.9%	\$2,129	-23.4%	\$2,230	4.7%
Transfers	-14	—	27	—	28	1.9
<b>Totals</b>	<b>\$88,971</b>	<b>8.2%</b>	<b>\$93,033</b>	<b>4.6%</b>	<b>\$98,010</b>	<b>5.4%</b>

### Cash Trends Have Been Positive

The main reason for our higher revenue estimates is our assessment of recent very strong cash payment trends. As indicated in Figure 6, quarterly estimated payments from individuals and corporations rose by about 25 percent during 2005, reflecting strong growth in business earnings and (in the case of PIT payments) healthy gains in investment income. Personal income tax withholding, though less robust, nevertheless was up by a solid 8 percent during the year. These positive cash trends suggest that final payments on 2005 tax liabilities will be stronger than assumed in the Governor’s budget forecast. Absent an abrupt downturn in the economy, the higher levels of CT and PIT liabilities in 2005 will have positive implications for the 2006-07 outlook as well.



### LAO Forecast

Based on these recent strong growth trends, we project that General Fund revenues will exceed the administration’s forecast in both the current and budget years. We specifically forecast that:

- *In 2005-06*, General Fund revenues and transfers will total \$89 billion, an 8.2 percent increase from 2004-05. This is up \$1.3 billion

from the budget forecast, reflecting a \$1 billion increase in PIT, and more modest gains from the other major revenue sources.

- *In 2006-07*, revenues and transfers will total \$93 billion, a 4.6 percent increase. This projected growth rate is affected by one-time factors, such as the current-year refinancing of tobacco bonds. After adjusting for these effects, the underlying growth in revenues is about 5.2 percent, or slightly less than personal income. Our forecast is up \$1 billion from the budget projection, reflecting gains from each of the three major taxes.
- *In 2007-08*, revenues and transfers will total \$98 billion, an increase of 5.4 percent. Excluding the impact of temporary revenue measures set to expire in that year (such as a suspension of the teachers' credit), the underlying growth rate of major tax revenues is about 5.6 percent, or about the same as the projected growth in statewide personal income during the period.

### **Outlook Subject to Significant Downside Risks**

While the current revenue strength is welcome, it is important to remember that it is coming mainly from soaring profits and investment earnings, which are highly sensitive to changes in the economy. This is an important consideration, given the underlying risks in the economic outlook discussed in Part II associated with energy costs and the state's housing markets. As we indicated in that discussion, a steeper-than-expected housing slowdown could easily reduce overall economic growth relative to our baseline forecast by 1.4 percent in 2006 and 2 percent in 2007. Given the historical relationship between cyclical changes in the economy and state revenues, we estimate that a steeper slowdown of this nature in economic activity would reduce General Fund revenues from our baseline forecast by more than \$4 billion in 2006-07.

## **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—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 key revenue sources.

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## **Personal Income Tax**

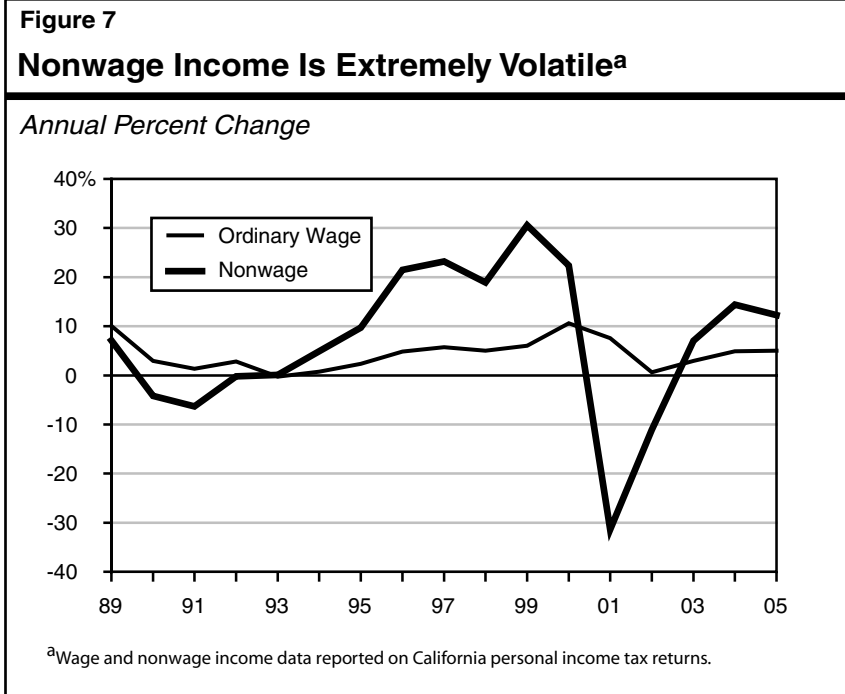
### **Background**

The PIT is, by far, the state's largest revenue source, accounting for 53 percent of total General Fund revenues in 2006-07. In general, PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Under 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 about \$83,000 for joint returns in 2006 (and one-half of that for taxpayers filing single returns). Beginning in 2005, a 1 percentage surcharge was imposed on incomes in excess of \$1 million (for a total marginal rate of 10.3 percent for affected taxpayers). The proceeds of this surcharge, which was implemented following approval of Proposition 63, are allocated to a special fund to support various mental health programs.

### **Year-to-Year Changes In PIT Liabilities Dominated by Nonwage Income**

Overall, nearly 75 percent of adjusted gross income (AGI) declared on tax returns is attributable to ordinary wages and salaries of workers. However, the other 25 percent of AGI—consisting primarily of business earnings, capital gains, stock options, and other forms of investment income—has a disproportionate effect on year-to-year changes in PIT liabilities. This is so for two main reasons:

- First, nonwage income accrues mainly to taxpayers at the top end of the income spectrum, and thus is taxed at higher marginal rates than most other income. For example, over 90 percent of stock options, capital gains, and business income—which combined account for the majority of nonwage income—accrue to the top 5 percent of taxpayers (those with incomes in excess of \$160,000 in 2003, the most recent year for which such data are available).
  - Second, nonwage income is volatile. It rises much faster than ordinary wages in good times and falls much further in bad times. This is illustrated in Figure 7 (see next page), which compares year-to-year changes in ordinary wages (that is, wages excluding stock options) and nonwage income during the past 16 years. While the extreme income changes in the late 1990s and early 2000s were the result of unprecedented swings in capital gains and stock options, the greater volatility in nonwage income sources has been present throughout the period.
-



In recent years, PIT revenues have benefited from the boom in nonwage income. Between 2003 and 2005, for example, growth in these sources was responsible for much of the 35 percent growth in overall PIT liabilities. Looking ahead, we expect nonwage income sources to continue to expand, but at a much slower pace. Specifically, our forecast assumes that:

- **Business earnings** growth will slow from 15 percent in 2005 to slightly less than 5 percent per year in 2006 and 2007. The anticipated slowdown reflects more modest increases in profits generally, and significant declines in earnings related to real estate construction, sales, and financing over the next two years.
- **Capital gains and stock-option-related income** growth will slow from 10 percent in 2005 to just 5 percent in both 2006 and 2007. Our forecast assumes that slowing corporate profit growth coupled with rising interest rates will hold down stock price appreciation, and that a slowdown in the housing market will result in modest declines in capital gains related to real estate sales.

The assumption that these PIT-related income sources will continue to expand, albeit at a modest pace, is crucial to the overall revenue outlook. Declines in these volatile sources next year would significantly depress PIT liabilities relative to our forecast in 2006 and 2007.

We expect ordinary wages (that is, wages excluding stock-option income) to grow at a steady pace of around 5 percent annually for the next two years, reflecting modest gains in employment and compensation rates during the period.

### **PIT Revenue Forecast**

Based on our estimated changes in PIT liabilities, we forecast that fiscal-year PIT receipts will total \$46.5 billion in 2005-06, \$49.5 billion in 2006-07, and \$52.4 billion in 2007-08. Our revenue estimates also take into account amnesty-related revenue effects on audit collections (discussed in accompanying box) as well as the Governor's proposal to extend the suspension of the teachers' credit for an additional year. Compared to the budget forecast, our current projection of PIT revenues is up by \$1 billion in the current year, and by about \$760 million in 2006-07.

## **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 2005-06. 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 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 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, vessels, and aircraft (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:

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- **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 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 bonds that were issued in 2004 to help deal with the state's budget problem. (These diverted local sales taxes are currently replaced by a shift of property taxes from schools, which are in turn reimbursed by Proposition 98 payments to schools by the state General Fund. As a result of these various steps, state government is ultimately responsible for the bonds' 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).

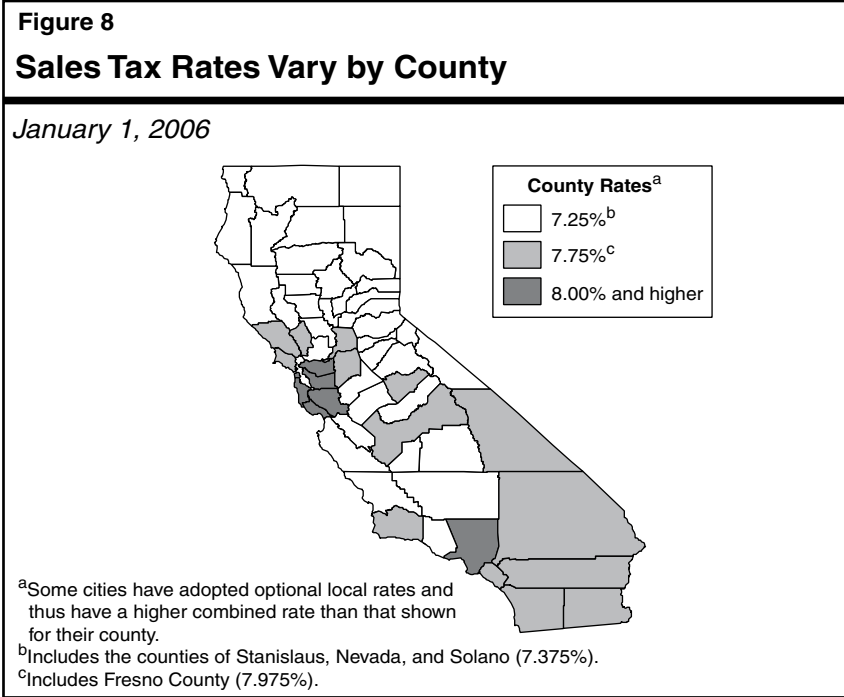
**Combined SUT Rates Throughout California.** The combined state and local SUT rate varies significantly across California geographically due to differences in the local optional rates that are levied (see Figure 8). The combined SUT rate currently ranges from 7.25 percent (for those counties with no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

### **Taxable Sales Grew at Moderate Pace in 2005**

Taxable sales jumped by 8.7 percent in 2004, the second largest gain in the past two decades. The overall increase reflected balanced growth in transactions related to consumer retail spending, business investment, and home construction. Detailed taxable sales data for 2005 are not yet available. However based on preliminary information, it appears that

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taxable sales expanded at a more moderate pace of around 6.5 percent in 2005. This increase appears to be related to less-robust, but still healthy, growth in consumer and construction-related spending last year. The jump in gasoline prices likely resulted in dramatic increases in taxable sales. However, these increases were likely offset, to some extent, by reduced spending on other areas, such as in automotive sales.

**Outlook—Continued Slowing in 2006 and 2007**

As indicated in Figure 9 (see page 58), we forecast that taxable sales growth will ease to 5.3 percent in 2006 and 5.4 percent in 2007. Most areas of taxable spending are expected to slow. Specifically, the forecast assumes:

- A reduced level of home sales and construction activity, which implies less taxable spending on building materials and home furnishings.
- Some tapering in consumer spending on other commodities, due to high debt levels and rising interest rates.
- Continued solid gains in business-related sales, as companies maintain a high level of investment activity.

## Revenue Impact of Tax Amnesty

In addition to the basic economic factors (such as profits and personal income) that affect revenues from the personal income tax (PIT) and the corporation tax (CT), another factor that is currently having significant revenue impacts on both taxes involves the cash-flow effects of the state's recent tax amnesty program.

***Large Cash In-Flow Initially Occurred.*** The tax amnesty program ran for part of 2004-05 from February 1, 2005 to March 31, 2005. Although the net revenue gain from amnesty is ultimately expected to be relatively modest once all cash-flow shifts over time are accounted for—about \$380 million—the amnesty program resulted in an increase in General Fund cash receipts totaling \$3.8 billion in 2004-05. Under California's system of accrual accounting, these receipts were reflected as a \$3.8 billion upward adjustment to the state's carry-in balance for the 2004-05 fiscal year.

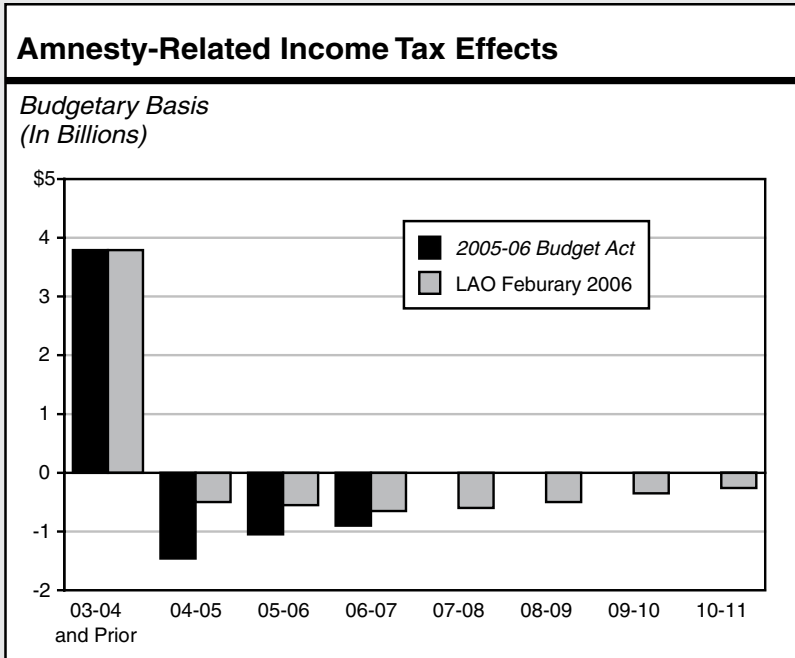
***Nature of the Amnesty Payments.*** About one-fifth of the amnesty-related payments received was attributable to the program's voluntary participants, while the remaining four-fifths was attributable to companies that chose not to participate in the amnesty program but still chose to file so-called "protective claim" payments. These are payments made by these taxpayers to avoid the possibility of being charged high post-amnesty penalties if their outstanding tax challenges are not ultimately upheld, or if they receive future audit assessments related to past tax years.

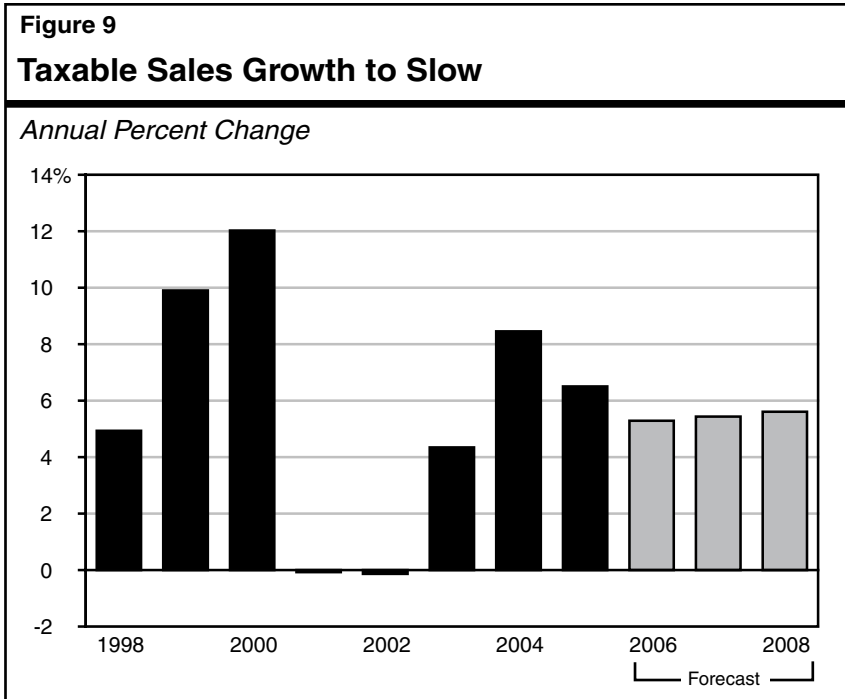
***Most Payments Represent Accelerations.*** The majority of the payments received are expected to be offset by lower net collections in the future. The *2005-06 Budget Act* revenue forecast assumed that all but \$380 million of the \$3.8 billion cash gain represented either tax payments that will eventually be refunded (which will occur in those cases where the taxpayers prevail in their audit disputes), or accelerations of collections that would have otherwise been received in future years through the normal audit process. It was specifically assumed in the *2005-06 Budget Act* that these refunds and accelerations would reduce net PIT and CT cash collections by \$1.5 billion in 2005-06, \$1 billion in 2006-07, and \$900 million in 2007-08. However, under the state's accrual accounting system, these annual reductions would be accrued back to the respective preceding years. As a result, all of the amnesty-related offsets were expected to occur in the 2004-05 through 2006-07 fiscal years (see accompanying figure).

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Based on audit trends evident this fall, both our office and the administration modified the timing of the future revenue reductions, spreading out the offsets over a larger number of years. However, both our November forecast and the 2006-07 Governor's Budget continued to assume that the ultimate net gain from the amnesty program would be \$380 million.

**Faster-Than-Expected Amnesty Processing Also to Generate Benefits.** Our updated estimated net revenue gain from those filing amnesty and protective claims payments is still \$380 million. However, based on updated audit workload information from the Franchise Tax Board (FTB), we are now assuming that there will be an additional \$400 million in revenues from 2006-07 through 2011-12 indirectly associated with amnesty. This is because FTB indicates that the filing of protective claims is resulting in faster and less costly resolution of the audit cases than it had estimated previously. This, in turn, is expected to "free up" audit staff once the protective claims related audits are completed by 2006-07, to undertake other revenue-producing activities in 2006-07 through 2008-09. It remains the case, however, that all of these amnesty-related estimates are subject to future revision as FTB closes out more cases involving protective claims payments.





### SUT Revenue Forecast

Based on our forecast of taxable sales, we project that SUT receipts will total \$27.2 billion in 2005-06, \$28.4 billion in 2006-07, and \$29.9 billion in 2007-08. Compared to the budget forecast, our SUT revenue estimate is up just \$26 million in 2005-06 and by \$115 million in 2006-07.

## Corporation Tax

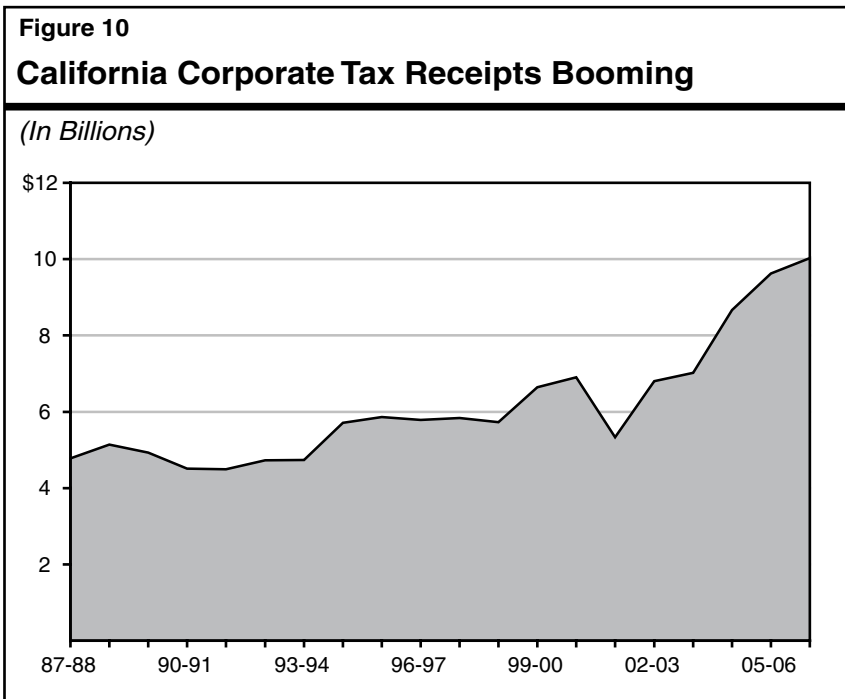
### Background

The CT is the third largest state 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 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 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 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. Key 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 in tax years 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 tax liabilities jumped from 65 percent under prior law to 100 percent beginning for losses incurred starting in 2004.

After many years of near-stagnant growth, revenue collections from CT have soared in recent years (see Figure 10). These increases, which have coincided with strong increases in collections experienced in other states and also at the federal level, reflect major increases in reported taxable profits and a recent increase in audit collections.



## **Profits Soared in 2005**

The key determinant of CT receipts is the strength of corporate profits reported on California tax returns by businesses. These profits have grown at a dramatic pace during the past two years, up by 20 percent in 2004 and a further 22 percent in 2005. Based on CT payments information from the Franchise Tax Board (FTB), it appears that most major industries experienced significant growth during 2005, with businesses in the construction, finance, energy, and utility industries experiencing particularly large gains. Factors underlying strong profit growth include solid growth in sales, modest increases in compensation, and continued strong rates of productivity growth.

## **Slower Profit Growth Expected**

Looking ahead, we forecast that taxable California corporate profit growth will slow significantly to around 6 percent in 2006 and just 4 percent in 2007. This anticipated slowdown is partly related to projected declines in real estate activities and their related financial earnings. It also reflects more-moderate profit growth in other industries, reflecting a reduced pace of expansion in sales and output in the overall economy.

## **Baseline Audit Collections Rising**

In addition to strong profit growth, a second factor that has contributed to CT revenue increase is a large increase in audit collections. The year-to-year pattern of these collections is being distorted by the cash-flow effects of the amnesty program (see earlier box). However, after adjusting for these effects, the “baseline” level of audit collections appears to have doubled in the past five years, rising from \$600 million in 2000-01 to \$1.2 billion in 2005-06. (We note PIT-related audit collections have also increased, although at a less dramatic pace.) The recent increase has been greater than expected, adding \$250 million per year to our estimated revenue totals from 2004-05 through 2006-07.

*Reasons for Recent Increases.* The FTB indicates that these recent increases are related to audit assessments associated with business activity in the late 1990s and early 2000s. During this period, there was significant growth in income sheltering and use of abusive tax shelters.

## **CT Revenue Forecast**

We forecast that CT receipts will be \$9.8 billion in 2005-06, a 13 percent increase from the prior year. Thereafter, we forecast that collections will expand more modestly, by 3.8 percent (to \$10.2 billion) in 2007-08 and 4.3 percent (to \$10.6 billion) in 2007-08. Our estimates take into account the projected increases in business profits, as well as the factors affecting audit collections. Our CT revenue forecast is above the budget estimate by \$179 million for the current year and \$146 million for the budget year.

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## Other Revenues and Transfers

The remaining 5 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 \$5.5 billion in 2005-06 to \$5 billion in 2006-07, and then rise to \$5.2 billion in 2007-08. The current-year total includes \$525 million in one-time funds related to the refinancing of a previously issued tobacco securitization bond. The projection for 2006-07 reflects lower receipts from state tidelands oil revenues and abandoned property, moderate increases in insurance and alcohol-related taxes, and slight declines in cigarette tax receipts.

## THE BUDGET'S FORECAST FOR SPECIAL FUNDS REVENUES

Special funds revenues are related to a variety of sources:

- About \$8.7 billion (or one-third of the budget-year total) is related to motor vehicle revenues. These include the vehicle license fee, which is assessed 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 \$4.7 billion is related to SUT. Of this total, about \$2.9 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 \$442 million is used for transportation programs.
- About \$978 million is from tobacco taxes that have been approved by voters in various elections.
- Roughly \$690 million is related to the high-income PIT surcharge for mental health programs, which was approved by voters as Proposition 63 in November 2004.
- The remaining special funds revenues are related to a wide variety of sources, including an energy resource surcharge, beverage container redemption fees, and California State University fees.

### Modest Underlying Growth Expected

As shown in Figure 11 (see next page), the Governor's budget assumes that special funds revenues will total \$24.5 billion in the current year

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(a 10 percent increase) and \$24.6 billion in 2006-07 (a 0.6 percent increase). The current-year total reflects one-time proceeds from the assumed sale of a \$1 billion tribal gaming bond, the proceeds of which would be used for transportation purposes. Because of court challenges, the administration has indicated that the sale will be delayed until at least 2006-07. Excluding these bond proceeds and other one-time factors, special funds revenues from ongoing sources are projected to increase by roughly 4 percent in both 2005-06 and 2006-07, reflecting modest increases in sales taxes, vehicle license fees, and tobacco-related taxes.

**Figure 11**  
**Summary of the Budget's**  
**Special Funds Revenue Forecast**

*(Dollars in Millions)*

	2005-06			2006-07	
	Actual 2004-05	Estimated Amount	Percent Change	Projected Amount	Percent Change
<b>Motor Vehicle Revenues</b>					
License fees (in lieu)	\$2,136	\$2,221	4.0%	\$2,308	3.9%
Fuel taxes	3,366	3,398	0.9	3,483	2.5
Registration, weight, and miscellaneous fees	2,716	2,847	4.8	2,935	3.1
Subtotals	(\$8,218)	(\$8,467)	(3.0%)	(\$8,725)	(3.1%)
<b>Sales and Use Tax</b>					
Realignment	\$2,625	\$2,758	5.1%	\$2,862	3.8%
Deficit-financing bonds	1,163	1,378	18.5	1,415	2.7
PTA <sup>a</sup>	420	329	-21.8	442	34.5
Subtotals	(\$4,209)	(\$4,464)	(6.1%)	(\$4,719)	(5.7%)
<b>Other Sources</b>					
Personal income tax surcharge	\$254	\$683	168.9%	\$690	1.0%
Cigarette and tobacco taxes	977	948	-3.0	978	3.2
Interest earnings	126	109	-13.9	109	0.5
Other revenues	8,712	9,875	13.4	9,038	-8.5
Transfers and loans	-244	-67	-72.5	358	—
<b>Totals</b>	<b>\$22,252</b>	<b>\$24,479</b>	<b>10.0%</b>	<b>\$24,618</b>	<b>0.6%</b>

<sup>a</sup> Public Transportation Account.

Detail may not total due to rounding.



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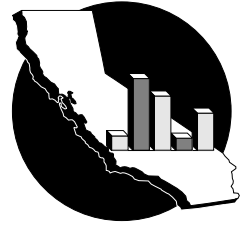
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# IV

## PERSPECTIVES ON STATE EXPENDITURES



*Perspectives on  
State Expenditures*



# AN OVERVIEW OF STATE EXPENDITURES

## PROPOSED TOTAL SPENDING IN 2005-06 AND 2006-07

The Governor's budget proposes total spending in 2006-07 of \$122.9 billion, including \$97.9 billion from the state's General Fund and \$25 billion from its special funds (see Figure 1). This total budget-year spending is \$7.2 billion higher than current-year spending—an increase of 6.3 percent. Of total budget-year spending, General Fund spending accounts for about 80 percent. This proposed spending level translates into \$3,268 for every man, woman, and child in California.

**Figure 1**

### **Governor's Budget Spending Totals**

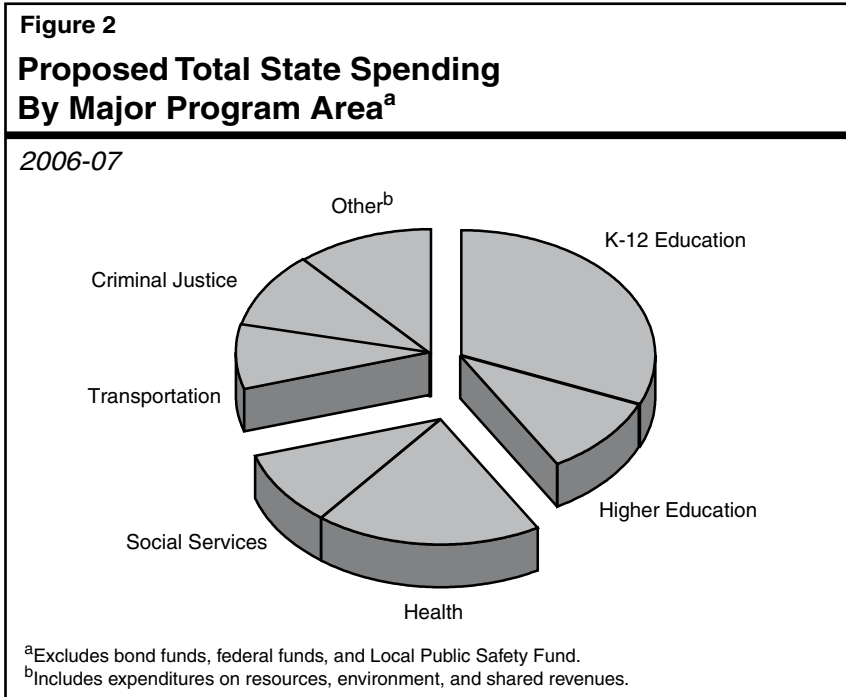
*(Dollars in Millions)*

	2005-06	2006-07	Change	
			Amount	Percent
<b>Budget Spending</b>				
General Fund	\$90,294	\$97,902	\$7,608	8.4%
Special Funds <sup>a</sup>	25,400	25,024	-376	-1.5
<b>Totals</b>	<b>\$115,693</b>	<b>\$122,925</b>	<b>\$7,232</b>	<b>6.3%</b>

<sup>a</sup> Does not include Local Public Safety Fund expenditures of \$2.8 billion in 2005-06 and \$2.9 billion in 2006-07. These amounts are not shown in the Governor's budget.  
Detail may not add due to rounding.

## Allocation of Total State Spending

Figure 2 shows the allocation of the proposed \$122.9 billion of total state spending in 2006-07 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of support in some areas (such as transportation).



The figure shows that K-12 education receives the largest share of spending—31 percent of the total. (It also should be noted that K-12 education spending receives additional funding from local sources.) When higher education is included, education's share rises to 42 percent. Health and social services programs account for 29 percent of proposed total spending, while transportation and criminal justice together account for roughly 18 percent. The "other" category (11 percent) primarily 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, as well as tax relief provided through the budget.

**Proposed Spending.** As shown in Figure 3, the Governor proposes General Fund spending of \$97.9 billion for 2006-07, an increase of 8.4 percent, reflecting substantial growth in education, and more modest increases in most other areas. Specifically:

<b>Figure 3</b>				
<b>General Fund Spending by Major Program Area</b>				
<i>(Dollars in Millions)</i>				
	<b>Actual</b>	<b>Estimated</b>	<b>Proposed 2006-07</b>	
	<b>2004-05</b>	<b>2005-06</b>	<b>Amount</b>	<b>Percent Change</b>
<b>Education Programs</b>				
K-12 Proposition 98	\$30,863	\$32,792	\$36,403	11.0%
Community Colleges Proposition 98	3,036	3,412	3,949	15.7
UC/CSU	5,175	5,446	5,834	7.1
Other	4,380	4,567	4,918	7.7
<b>Health and Social Services Programs</b>				
Medi-Cal	\$11,593	\$13,197	\$13,739	4.1%
CalWORKs	2,054	1,958	1,951	-0.4
SSI/SSP	3,411	3,506	3,564	1.7
In-Home Supportive Services	1,198	1,259	1,310	4.1
Other	6,596	7,341	7,909	7.7
<b>Corrections</b>	\$6,968	\$7,658	\$8,081	5.5%
<b>Transportation</b>	\$347	\$1,686	\$2,683	59.1%
<b>All Other</b>	\$4,183	\$7,473	\$7,561	1.2%
<b>Totals</b>	<b>\$79,804</b>	<b>\$90,294</b>	<b>\$97,902</b>	<b>8.4%</b>

- General Fund spending for K-12 education and community colleges is proposed to increase by 11 percent and 16 percent, respectively. Total Proposition 98 spending from both state and local sources grows by somewhat less—8.4 percent for K-12 education

and 12 percent for community colleges. The higher General Fund increase occurs because of the conclusion of a two-year \$1.3 billion annual property tax shift from local governments to schools. This shift resulted in corresponding reductions in General Fund spending in 2004-05 and 2005-06. The Governor proposes to spend \$1.7 billion more than required by the administration's estimate of the Proposition 98 minimum guarantee in 2006-07 for a variety of purposes. In addition, new spending for Proposition 49 after school programs (totaling \$426 million) is included in the budget for the first time.

- University of California (UC) and California State University (CSU) funding increases by 7.1 percent. The Governor proposes that additional General Fund support be used to replace planned student fee increases in both segments.
  - Medi-Cal funding increases 4.1 percent. The unusually small growth rate is related to a technical budgeting shift of \$340 million from Medi-Cal to the Department of Mental Health budget. Absent this shift, underlying growth in the Medi-Cal program is 7.5 percent.
  - In-Home Supportive Services (IHSS) spending would increase modestly, Supplemental Security Income/State Supplementary Program (SSI/SSP) spending would grow by less than 2 percent, and California Work Opportunity and Responsibility to Kids (CalWORKs) spending would decline. The budget reflects the two-year suspension of state cost-of-living adjustments (COLAs) adopted in the 2005-06 budget for CalWORKs and SSI/SSP grants. It further proposes that the "pass through" of the federal COLA to SSI/SSP recipients be delayed from April 2007 to July 2008.
  - Corrections spending rises 5.5 percent, reflecting (1) increases in inmate population, (2) added costs for various court settlement agreements, and (3) proposed new and expanded inmate and parolee programs.
  - Transportation receives a sharp increase in General Fund spending, mostly related to an early payment of \$920 million toward a \$1.4 billion Proposition 42 loan due in 2007-08.
  - The all other category increases modestly, partly due to assumed savings related to across-the-board reductions in state operations and a 1 percent reduction in each department's personnel budget.
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## 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 allocated by the Legislature among a variety of programs. About 35 percent of special funds revenues come from motor vehicle-related levies, another 18 percent comes from sales taxes, and the remainder comes from numerous sources; including a 1 percent surcharge on personal income taxes, and from tobacco taxes, charges, and fees.

**Proposed Spending.** In 2006-07, the Governor proposes special funds spending of \$25 billion (see Figure 4). This is a 1.5 percent decrease from the current-year total. This decrease is related to a 6.5 percent drop in transportation spending and a 6.8 percent decline in resources-related spending. In both cases, the declines are related to one-time factors rather than underlying changes in policies. In the case of transportation, the budget assumes one-time expenditure in the current year of Indian gaming revenues. In the case of resources, the decline between the current year and budget year is related to the timing and magnitude of energy incentive payments administered by the Energy Resources Conservation and Development Commission, and capital outlay expenditures by the Department of Parks and Recreation.

<b>Figure 4</b>				
<b>Special Funds Spending by Major Program Area</b>				
<i>(Dollars in Millions)</i>				
	<b>Actual 2004-05</b>	<b>Estimated 2005-06</b>	<b>Proposed 2006-07</b>	
			<b>Amount</b>	<b>Percent Change</b>
Transportation	\$6,772	\$6,851	\$6,406	-6.5%
Local government subventions	5,630	6,191	6,258	1.1
Resources related	2,263	2,764	2,577	-6.8
Public Utilities Commission	1,124	1,211	1,230	1.5
All Other	6,404	8,383	8,553	2.0
<b>Totals</b>	<b>\$22,192</b>	<b>\$25,400</b>	<b>\$25,024</b>	<b>-1.5%</b>

## **Local Public Safety Funds Not Included in Special Funds Total**

It should be noted, that the budget's special funds spending total for 2006-07 excludes expenditures of roughly \$2.9 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, and *should* be counted. 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.

## **Spending From Federal Funds and Bond Proceeds**

In addition to the \$123 billion of proposed 2006-07 spending from the General Fund and special funds, the budget also proposes \$57 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 2006-07 spending exceeds \$182 billion.

### **Federal Funds**

As noted above, about \$57 billion in federal funds are proposed to be spent through the state budget in 2006-07. (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 \$30 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 \$15 billion (26 percent) of the total (split fairly evenly between K-12 and higher education), and transportation is expected to receive \$3.6 billion (6 percent). The remaining roughly \$8.4 billion (15 percent) is spread across all other program areas.

### **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 2006-07, the budget proposes General Fund debt-service expenditures of \$4.2 billion, of which

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\$3.6 billion is for general obligation bonds and about \$620 million is for lease-revenue bonds. About \$65 million of the lease-revenue bond debt service is paid through Proposition 98.

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.

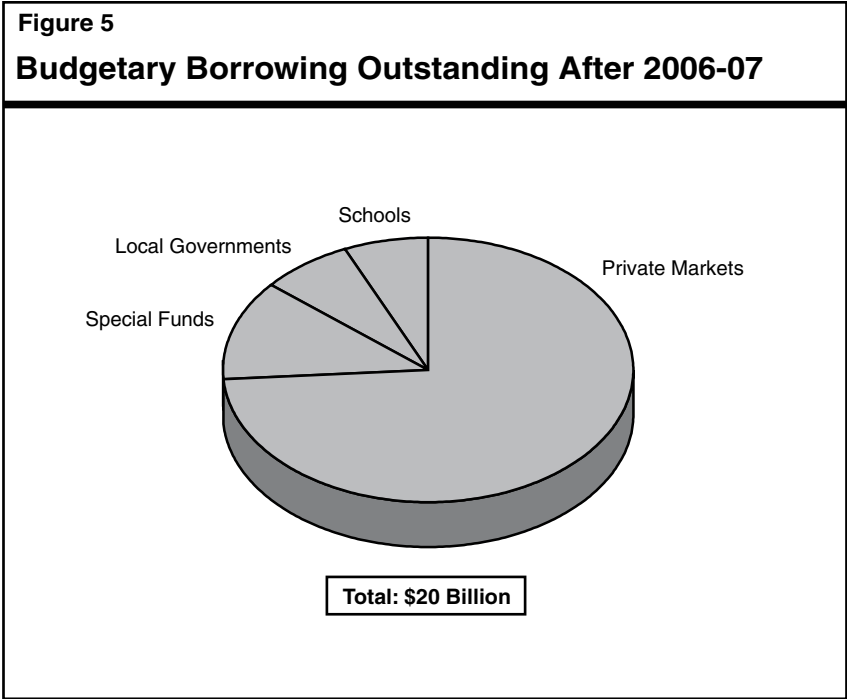
*Spending of General Obligation (GO) Bond Proceeds.* The January budget proposal estimates that the state will spend \$2.7 billion in GO bond proceeds for capital projects in 2006-07. This is down sharply from the \$11.8 billion in spending shown for the current year, and \$5.6 billion in the prior year. The comparatively larger amounts in the current and prior years 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 GO 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 2006-07, the budget proposes \$855 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. At the peak, the state had more than \$25 billion in budget-related debt outstanding from private investors, schools, local governments, transportation, and other special funds. The amount of outstanding borrowing has subsequently fallen, and will continue to decline through the budget year under the Governor’s budget proposal (which includes prepayment of a transportation loan and some deficit-financing bonds). However, as Figure 5 (see next page) shows, we estimate that even after these repayments, the state will be left with \$20 billion in budget-related debt at the close of 2006-07. This consists of:

- About \$15 billion from private markets, including \$8 billion in deficit-financing bonds, over \$5 billion in tobacco-related bonds, and over \$1 billion from other sources.
  - Around \$2.4 billion from special funds, one-half of which is related to deferred Proposition 42 payments.
  - About \$1.4 billion from noneducation local governments related to deferred mandate payments.
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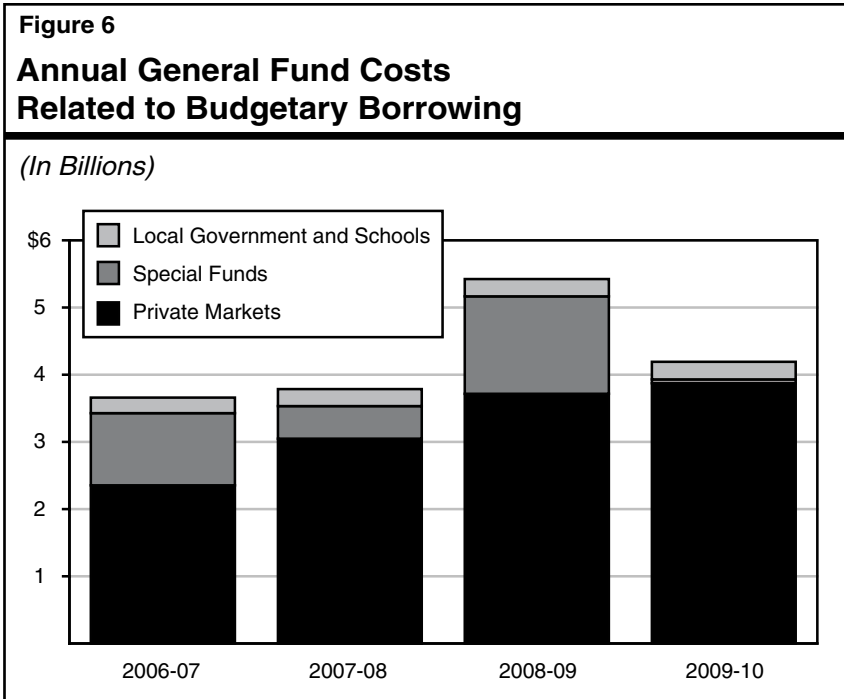


- About \$1.3 billion in settle-up payments owed to Proposition 98 education.

As shown in Figure 6, scheduled repayments of this budgetary borrowing will result in annual General Fund costs of \$3.7 billion in 2006-07, rising to a peak of \$5.4 billion in 2008-09. These amounts are included in our projections.

## 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 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 SAL over a two-year period, the excess must be divided among taxpayer rebates and Proposition 98 education funding.



*Expenditures Projected to Be Well Below the Limit.* Due to the downturn in the state's economy and its adverse effects on the state's revenues, expenditures supported by taxes fell during the early years of this decade. (While the state used borrowed funds to support spending in excess of revenues during this period, spending supported by borrowed funds does not count against SAL.) Although tax-supported spending has rebounded in recent years, a large gap still remains between the limit and spending subject to it. In 2005-06, appropriations subject to the limit are \$15.2 billion below the limit, and in 2006-07, the gap grows to \$15.9 billion. Part of the reason that spending remains so far below the limit is that a large portion of the expenditure increases in the current and budget years are in areas such as K-12 school district apportionments, which are exempt from the state's limit.

## COST-OF-LIVING ADJUSTMENTS IN THE BUDGET

Each year, the budget includes funds for cost-of-living adjustments, commonly referred to as COLAs. The purpose of these adjustments is to compensate for the adverse effects of inflation on the purchasing power of the previous year's funding level. Existing law authorizes automatic

COLAs for over two-dozen programs, mostly in the areas of K-12 education, social services, health, and trial courts. These are generally referred to as statutory COLAs. Other programs receive COLAs on a discretionary basis, through decisions arrived at in the annual budget process. The major General Fund COLAs in the 2006-07 proposed budget are shown in Figure 7.

**Figure 7****General Fund COLAs—2006-07 Governor's Budget***(Dollars in Millions)*

Program/Department	COLA Percent	Statutory or Discretionary	Funded	2006-07 Cost
<b>Education</b>				
<b>Proposition 98</b>				
Apportionments	5.18%	Statutory	Yes	\$1,689
Categorical programs <sup>a</sup>	5.18	Statutory	Yes	875
<b>Non-Proposition 98 K-12 Education</b>				
Child nutrition programs	5.18	Statutory	Yes	1
<b>Higher Education</b>				
University of California <sup>b</sup>	3.0	Discretionary	Yes	81
California State University <sup>b</sup>	3.0	Discretionary	Yes	76
<b>Judicial Branch</b>				
Judiciary and Trial Courts <sup>c</sup>	4.70%	Statutory <sup>d</sup>	Yes	\$123
<b>Health</b>				
<b>Medi-Cal</b>				
County eligibility administration <sup>e</sup>	3.75%	Discretionary	No	—
Long-term care rate adjustments	Various	Statutory	Yes	\$94
Part B deductible increases	Various	Discretionary	Yes	20
Certain clinics	2.9	Statutory	Yes	20
Managed Care plans	Various	Discretionary	No	—
<b>Department of Alcohol and Drug Programs</b>				
Drug Medi-Cal	3.0	Statutory	No	—
<b>Department of Mental Health</b>				
Mental Health Managed Care Program	—	Discretionary	No	—
<b>Department of Developmental Services</b>				
Various regional center vendors	3.0	Statutory	Yes	46

Continued

### Important Features of State COLAs

State COLAs have several key features that are particularly important to understand from a budgetary perspective. In particular:

- *Not All Programs Get COLAs.* As shown in Figure 7 and discussed below, some state programs do not receive either statutory or discretionary COLAs.
- *Different COLA's Often Reflect Different Data Sources.* For example, the COLA for the major social services programs is based on selected components of the California Consumer Price Index (food, rent, fuel, transportation, and clothing). In contrast, the COLA for K-12 education is based on a national price index—the U.S. gross domestic product (GDP) deflator for state and local government purchases—which measures costs associated with the compensation of government employees, their operations (including energy costs), and construction. Alternatively, the adjustment for the Trial Court Funding Program is the SAL adjustment factor, which is based on per-capita personal income and a weighted population factor. The SAL adjustment is not strictly a COLA,

Program/Department	COLA Percent	Statutory or Discretionary	Funded	2006-07 Cost
<b>Social Services</b>				
<b>CalWORKs July 2006</b>	3.75	Statutory	No	—
<b>SSI/SSP</b>				
State	3.75	Statutory	No	—
Federal	2.6	Statutory	Delayed	—
<b>Foster Care</b>	3.75	Discretionary	No	—
<b>State Departments</b>				
Operations cost	3.1	Discretionary	Yes	\$88
<b>Total</b>				<b>\$3,113</b>
<p>a Most of the large categorical programs have statutory cost-of-living adjustments (COLAs). All of the statutory COLAs, and many of the discretionary COLAs, are proposed to receive funding.</p> <p>b The Governor has a nonbinding compact with higher education that contains specified increases for cost-of-living and enrollment.</p> <p>c The Judicial Branch is proposed to receive an adjustment based on the state appropriations limit growth factor. This factor encompasses both cost-of-living and population.</p> <p>d Existing law limits the adjustment to the trial court program. The budget proposes to apply the adjustment to the entire branch, including the judiciary.</p> <p>e The Governor proposes trailer bill language to freeze state participation in county costs for health and human services administration at the 2005-06 Budget Act level with future adjustments limited to caseload.</p>				

in that it encompasses both population and economic growth, in addition to price increases. The fact that different programs often have different COLAs means that the adjustment for inflation that they receive can vary.

- ***COLAs Are Based on Inflation in the Preceding Year.*** While the precise measurement time frames used vary from one COLA factor to another, COLAs for a particular budget year are generally based on changes in the applicable price indexes that took place during the preceding fiscal year. For example, the COLA adjustments in the 2006-07 budget proposal are based on inflation that took place in 2005 and, in some cases, in early 2006. These time lags were built in so that enacted budgets could be based on actual, versus projected, price adjustments. As such, however, they do not compensate budgets for inflation currently being experienced.
- ***Soaring Energy Prices From 2005 Are Affecting Next Year's COLAs.*** The above-noted one-year time lag is currently of particular significance. This is because inflation in late 2005 was boosted by soaring energy and construction costs (the latter being a significant factor in the state and local deflator used for the education COLA). The increases in inflation that occurred in the first half of this fiscal year are translating into large increases in COLAs for 2006-07. In particular, the K-12 education COLA is estimated in the budget to be 5.18 percent, but we now estimate it will be an even higher 5.8 percent. Likewise, we expect inflation to slow in 2006. This slowdown, however, will not be reflected in smaller state COLAs until 2007-08.

### **Which Programs Receive COLAs in the 2006-07 Budget?**

As indicated in Figure 7 and noted above, the budget proposes COLAs for some areas, but not others. Programs receiving COLAs include:

- K-12 and community college education, where general apportionments and most categorical programs receive a 5.18 percent statutory COLA.
  - UC and CSU, which receive 3 percent COLAs. These increases are consistent with the Governor's compact with these two higher education segments.
  - The judicial branch, which receives a 4.7 percent increase, based on the growth in the SAL adjustment factor. The administration is proposing that the statutory COLA currently being provided to trial courts be expanded to cover the state judiciary.
  - Selected health programs, particularly long-term care providers and regional center vendors.
-

- Selected state operations, which receive various price increases to cover nonwage costs.

**COLAs Not Provided for Social Services and County Administration.** The budget provides no COLAs for CalWORKs, SSI/SSP, foster care, or child welfare services. Regarding CalWORKs and SSI/SSP, the budget reflects actions taken in the 2005-06 budget which suspended the statutory COLAs in these two programs, and delayed the pass through of the federal SSI/SSP COLA for three months. The new budget proposal would further delay the pass-through of the federal SSI/SSP COLA until the end of 2007-08. Finally, the budget does not provide COLAs for county administration of health or social services programs.

## A HISTORICAL PERSPECTIVE ON SPENDING

**Total Spending.** Figure 8 shows total state spending over the ten-year period 1996-97 through 2006-07 (as proposed), and breaks down this spending according to General Fund and special funds spending. It indicates, for example, that total spending grows over this period from \$62.4 billion to \$122.9 billion.

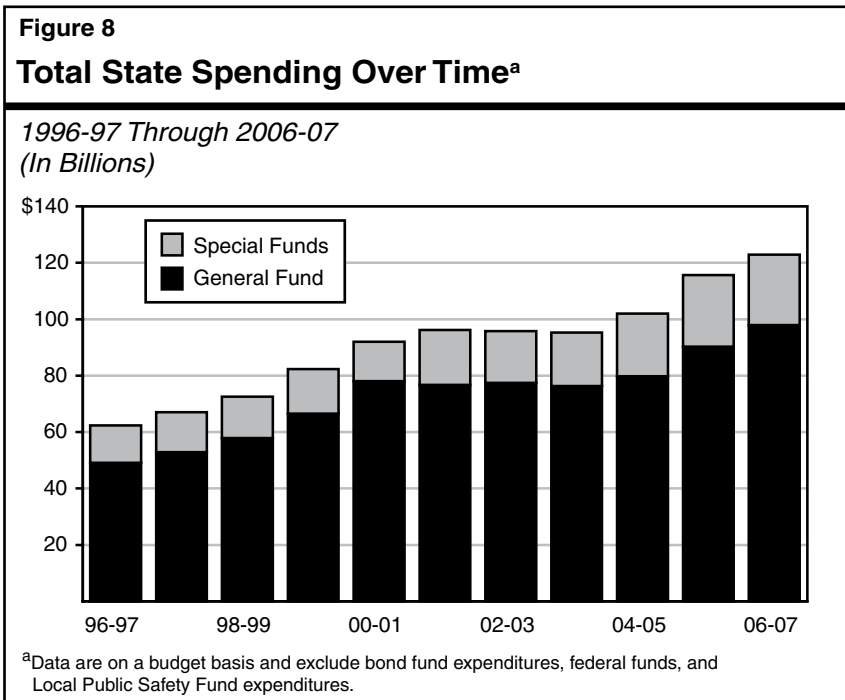
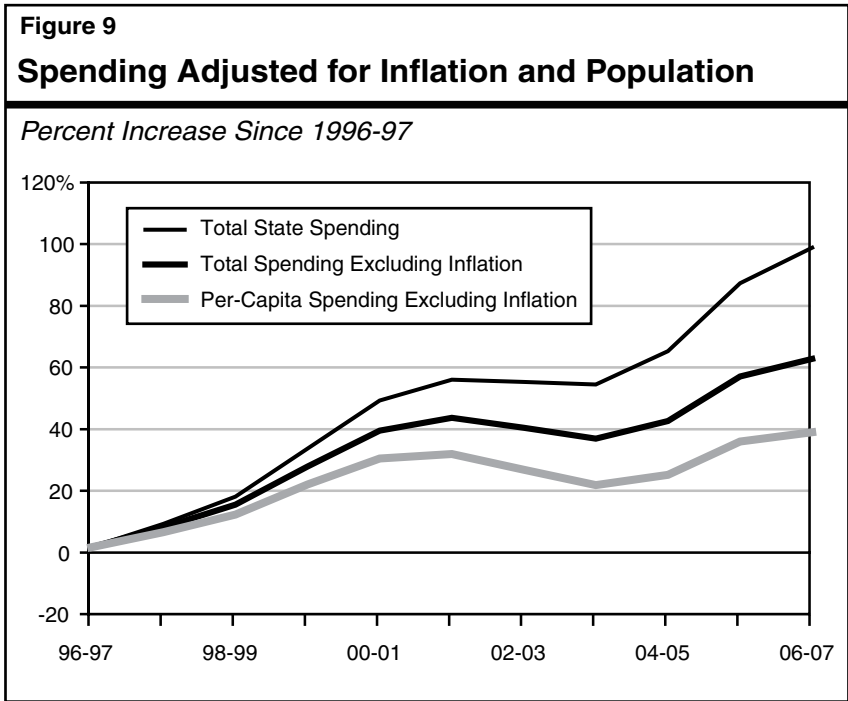


Figure 9 shows cumulative percent changes in various measures of state spending over the past ten years. It indicates that total state spending increased by over 50 percent between 1996-97 and 2001-02, reflecting funding increases in education, health, and a variety of other areas in the budget. Spending then flattened for the next two years, as the state reduced program spending and deferred costs to help cope with the major fiscal imbalances that occurred following the 2001-02 revenue downturn. Spending then started growing once again in 2004-05, and would increase further in 2005-06 and 2006-07 under the Governor’s proposal. Under the budget plan, total spending over the entire ten-year period would about double, reflecting an average annual growth rate of roughly 7 percent.



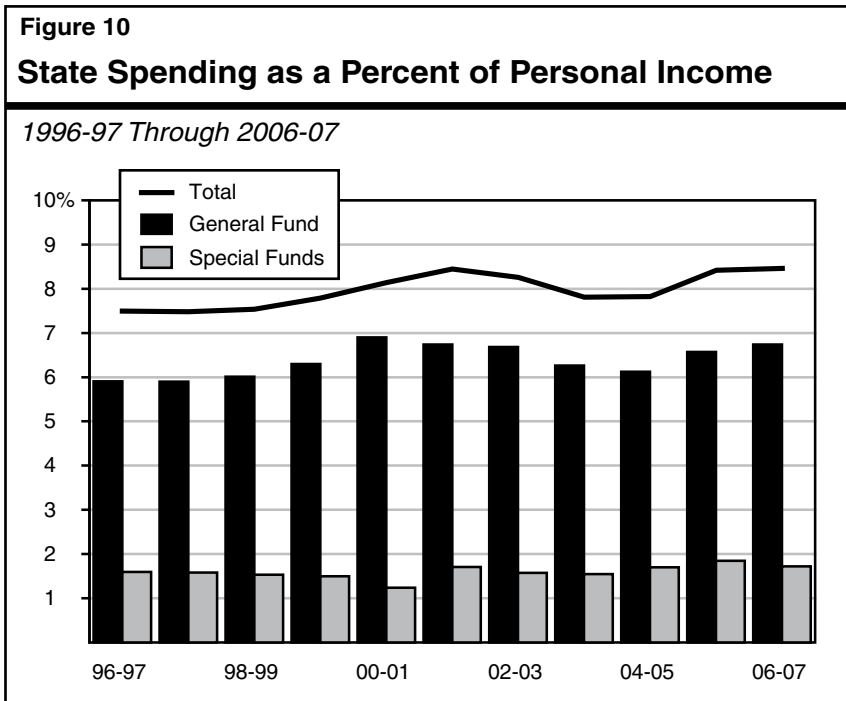
**Real and Real Per-Capita Spending.** Part of the spending growth discussed above is related to the effects of a growing population and rising prices over time. Figure 9 shows total state spending after adjusting for these factors. It indicates that:

- After adjusting for inflation, real spending has grown by a bit over 60 percent over the entire ten-year period, or an annual average growth rate of roughly 4.9 percent.



- Real per-capita spending—which adjusts for *both* inflation and population growth—would increase by about 37 percent over the period under the Governor’s plan, for an average annual rate of 3.2 percent. Since 2003-04, however, the rate of growth has averaged 4.6 percent.

**Spending Relative to the State’s Economy.** Figure 10 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 1996-97 through 2001-02, total state spending increased steadily as a share of personal income—from 7.5 percent to 8.4 percent. As shown in the figure, growth in General Fund spending accounted for nearly all of this increase.



After 2001-02, however, total state spending as a percentage of personal income reversed direction, and dropped to below 8 percent in both 2003-04 and 2004-05. This reduction reflects both budget savings and numerous one-time funding shifts, deferrals, and other forms of budgetary borrowing. The one-time factors included an accounting change to Medi-Cal, increased federal funds (which temporarily offset state spending), savings related to a restructuring of debt-service payments, and a two-year shift

of property taxes from local governments to schools (resulting in savings to the General Fund). The spending totals for 2004-05 also reflect a \$2 billion offset related to the deficit-financing bonds authorized by the voters in March 2004.

The ratio of total state spending to California personal income under the Governor's budget plan would jump back up to over 8 percent in both 2005-06 and 2006-07, as various temporary budget savings expire, some debt obligations are prepaid, and spending on education and other state programs is increased. The 2006-07 ratio would be 8.5 percent—the highest in the past ten years.



# MAJOR EXPENDITURE PROPOSALS IN THE 2006-07 BUDGET

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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 2006-07 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 11, next page).

The minimum funding guarantee is based on the previous year’s appropriation level plus an amount required under one of the three tests. If the state approves more K-14 funding than is required under Proposition 98, the additional spending becomes part of the long-term funding base. Thus, actions to “overappropriate” Proposition 98 have consequences for future budgets and the state’s long-term financial condition.

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## Figure 11

### 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 around 41 percent of General Fund revenues. While not applicable since 1988-89, this test may begin to determine the minimum guarantee near the end of the decade.
  - **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.
- ✓ **Mechanism Exists to Ensure Growth With Economy and Attendance.** When Test 3 or suspension occurs, the state creates a funding gap called maintenance factor. Proposition 98 contains a mechanism to accelerate spending to restore maintenance factor and close the gap in future years.

## Governor’s Proposal

The Governor’s budget proposes to increase Proposition 98 expenditures by \$4.3 billion in 2006-07 compared to the revised 2005-06 spending level. This increase is composed of three components. First, the Proposition 98 minimum guarantee increases by \$2.2 billion. Second, Proposition 49 requires the state to spend \$426 million above the minimum guarantee to expand the state’s after school program. Third, the Governor’s budget would provide \$1.7 billion to restore K-14 funding roughly to the

funding target in Chapter 213, Statutes of 2004 (SB 1101, Committee on Budget and Fiscal Review). This act suspended the Proposition 98 minimum funding guarantee for 2004-05 by about \$2 billion and established a target funding level for K-14 education if revenues increased. Although General Fund revenues in 2004-05 were significantly higher than originally estimated, Proposition 98 expenditures in both 2004-05 and 2005-06 fell short of this target.

Figure 12 shows how the new 2006-07 funding is spent. The budget provides \$2.9 billion for baseline cost increases, including \$2.6 billion for cost-of-living adjustments (COLAs) for K-12 and community colleges. Since the minimum guarantee only increases by \$2.2 billion, funding the base program would cost almost \$700 million more than required by the minimum guarantee.

<b>Figure 12</b>	
<b>Proposition 98 Expenditure Plan</b>	
<b>2006-07 Governor's Budget</b>	
<i>(In Millions)</i>	
<b>Baseline Adjustments</b>	
Cost-of-living adjustment	\$2,566.8
Attendance	304.9
Mandates	133.6
Other	-96.9
Subtotal	(\$2,910.7)
<b>New or Expanded Programs</b>	
Proposition 49 after school	\$426.2
K-12 revenue limit increases	406.2
CCC <sup>a</sup> equalization	130.0
Recruitment and retention	100.0
Arts and music	100.0
Other CCC proposals	60.1
Other K-12 proposals	198.2
Subtotal	(\$1,420.3)
<b>Total</b>	<b>\$4,311.0</b>
Details may not add due to rounding.	
<sup>a</sup> California Community Colleges.	

The budget proposes to spend an additional \$1.4 billion to create new programs and expand existing ones. Major expansions include \$426 million for after school programs, and \$406 million in K-12 revenue limit increases for equalization (\$200 million) and restoration of a prior-year COLA (\$206 million). For community colleges, the budget provides \$130 million for equalization and \$60 million for other increases.

### Why Is the COLA So High?

The annual budget typically provides most Proposition 98 programs with a COLA to reflect the higher costs schools experience due to inflation. The K-12 COLA (also used for community college programs) is based on the gross domestic product deflator for purchases of good and services by state and local governments (GDPSL). Based on GDPSL data available at the time the budget was developed, the administration estimated a 5.2 percent COLA rate for K-14 programs, resulting in a cost of \$2.6 billion in Proposition 98 funds in 2006-07.

Based on more recent data on actual inflation in the state and local government sector, we estimate a K-14 COLA of 5.8 percent. Fully funding our higher estimate would cost just over \$300 million more than the level currently funded in the Governor's budget, or a total of \$2.9 billion. Final data needed to calculate the K-14 COLA factor will be available at the end of April.

*Costs Affected by Energy and Construction Costs.* As shown in Figure 13, the projected budget-year COLA of 5.8 percent is considerably higher than K-12 COLAs have been in recent years, and substantially

**Figure 13**  
**Rates for K-12**  
**Cost-of-Living Adjustment (COLA) and COLA Factors**

*2002-03 Through 2006-07*

	2002-03	2003-04	2004-05	2005-06	2006-07 Estimate <sup>a</sup>
<b>K-12 COLA</b>	2.0%	1.9%	2.4%	4.2%	5.8%
<b>K-12 COLA Factors</b>					
Nondurable goods—including oil and gas	-3.5%	3.6%	4.5%	12.1%	14.0%
Gross investment—including construction	1.9	1.9	1.3	3.7	5.8
General government employee compensation	4.1	4.6	4.4	3.6	3.8

<sup>a</sup> Projected based on three quarters of 2005 data and estimates for first quarter of 2006.

higher than other COLAs provided in the state budget. (For a detailed discussion of COLAs, see “An Overview of State Expenditures” earlier in this document). The figure also displays the historical and projected growth rates for the primary inputs to the overall GDP<sub>SL</sub>—general government employee compensation, gross investments (which include construction and building costs), and nondurable goods (which include costs for oil and gas). As shown in the figure, however, 2006-07 estimates for these latter two factors appear significantly higher than they have been in prior years. This is primarily due to substantial increases in the costs of energy and construction, in part resulting from the hurricanes in the fall of 2005.

## **Issues for Legislative Consideration**

### **High General Fund Revenues, But Little Additional Proposition 98 Costs**

Our forecast projects General Fund tax revenues will be \$1.2 billion higher than the administration’s estimate in 2005-06 and \$1 billion more in 2006-07. We estimate that the additional revenues in 2005-06 will increase the minimum guarantee by \$465 million. Since the Governor’s 2005-06 spending level is \$265 million above the minimum guarantee, the extra revenues would only require an additional \$200 million in Proposition 98 spending in 2005-06. For the budget year, the additional revenues would increase the minimum guarantee by only \$115 million. (This small increase—relative to the additional \$1 billion in 2006-07 revenues—is because our year-to-year growth in estimated General Fund revenues is actually somewhat less than the administration’s.) Because the Governor’s budget provides \$2.1 billion above the minimum guarantee, the state would have no additional obligation for 2006-07. However, the cost of meeting the Chapter 213 target funding level would increase by roughly \$115 million.

### **K-14 Funding Is Linked to State’s Fortunes**

It is important for the Legislature to consider the significant increase in Proposition 98 spending proposed by the Governor in the context of the administration’s overall General Fund spending plan. As discussed in “Part I” of this document, the Governor’s budget raises the issue of whether the proposed level of expenditures—including funding for education—can be sustained in future years. We estimate that if his budget were adopted, the state would face operating deficits of almost \$4 billion in 2007-08 and \$5 billion in 2008-09. In addition, these are several factors that could add significantly to these shortfalls. These include: (1) the loss of various court decisions, (2) unfunded costs related to retirement-related obligations, and (3) major reductions in revenue in the event of an economic slowdown.

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The fiscal health of the state is important to K-14 education. When times are good, state spending on schools and community colleges re-sults in new and expanded programs and extra base increases. When the economy—and state revenue—slows, the state typically cuts categorical programs and inflation adjustments.

The Governor's budget proposes to spend \$1.4 billion for new and expanded Proposition 98 programs in 2006-07. Thus, the issue facing the Legislature is whether the state can afford this higher level of spending in 2007-08 and beyond. Given the state's continuing fiscal pressures, we suggest the Legislature balance the need to get the state's "fiscal house" in order with its desire to approve new discretionary funding for K-14 education.

### **Proposition 98 Issues Affect Long-Term Cost of K-14 Education**

As discussed above, Proposition 98 determines the minimum amount the state must spend on K-14 education each year based on several factors. While the constitutional provisions of Proposition 98 have not changed in recent years, state actions and initiatives have affected the calculation of the minimum guarantee for 2006-07 and beyond. The Legislature faces several issues relating to Proposition 98 that could affect the General Fund cost of meeting the minimum guarantee in future budgets. We discuss two of the most significant issues below.

*Rebenching the Test 1 Factor.* The Test 1 factor requires that Proposition 98 receive a minimum fixed percentage of General Fund revenues. When Proposition 98 was passed by voters in 1988, the Test 1 factor was set at 40.7 percent—that is, spending on K-14 education had to make up at least 40.7 percent of overall General Fund spending. To date, Test 1 has been operative only in 1988-89, the first year after Proposition 98 was passed by voters.

In 2004-05, the state transferred property tax revenues to local governments as part of a (1) vehicle license fee revenue "swap," and (2) a financing mechanism to pay off the deficit-financing bonds passed by the voters in March 2004. By shifting property taxes to local government, the state met the Proposition 98 minimum guarantee by increasing General Fund spending to backfill the reallocated property tax revenues. These transfers total \$6.8 billion in 2006-07.

To hold schools harmless from the shift of property taxes, the Test 1 percentage must be adjusted. This adjustment represents an important issue for the Legislature because we project that Test 1 may become operative again as early as 2008-09. While there is general agreement for the need to adjust Test 1, there are several ways to calculate this adjustment. The difference in the Test 1 percentage generated by different methodologies can be large—as much as 0.5 percent of General Fund revenues, or \$500 million.

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Since 2006-07 is the final year of significant adjustments resulting from the recent local government agreements, we believe it makes sense to adjust the Test 1 factor now. In addition, because Test 1 is a major factor influencing long-term General Fund spending projections, making this adjustment during the coming year will give the Legislature a clearer picture of the impact of its budget-year decisions on the state's fiscal situation over the next few years.

**Budgeting for Proposition 49.** The budget provides \$426 million in Proposition 98 spending above the minimum guarantee to expand the state's after school program as required by Proposition 49. We continue to recommend the repeal of Proposition 49 because (1) it triggers an autopilot augmentation even though the state is facing a structural budget gap of billions of dollars, (2) the additional spending on after school programs is a lower budget priority than protecting districts' base education program, and (3) existing state and federal after school funds are going unused. If the Legislature chooses to implement Proposition 49, the Legislature will need to clarify how Proposition 49 interacts with the Proposition 98 guarantee.

## K-12 PROPOSITION 98

### Governor's Proposal

The Proposition 98 allocation to K-12 schools (including property tax revenues) is proposed at \$48.4 billion, or \$8,030 per pupil for 2006-07. This represents an increase of \$604 per pupil, or 8.1 percent, from the current-year estimate. Figure 14 (see next page) displays the Governor's proposed use of \$1.2 billion in discretionary funds in the budget year. Implementing the requirements of Proposition 49 accounts for \$426 million. The initiative requires the state to expand existing after school programs for K-8 students by a specific amount starting in 2006-07. An additional \$406 million is proposed to equalize K-12 district revenue limits (\$200 million) and restore past-year reductions in revenue limits (\$206 million). Finally, the budget proposes to spend almost \$400 million for a number of new K-12 categorical programs, including programs to help attract and retain teachers in low-performing schools (\$100 million) and an arts and music block grant (\$100 million).

### Issues for Legislative Consideration

In addition to its decision on the overall Proposition 98 level of spending the Legislature will face other key issues:

**School Districts Face Difficult Fiscal Condition.** Various financial pressures have created a difficult fiscal environment for school districts.

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Weak district financial conditions left over from the recent economic slowdown, loss of funding due to declining enrollment, and the need to begin budgeting for retiree health care costs present a fiscal challenge that many districts will be unable to meet satisfactorily. While retiree health costs represent a long-term financial threat to districts, the rapid escalation in these costs projected over the next decade could seriously degrade the quality of education provided in some districts. We suggest several steps the Legislature could take to encourage districts to address these issues.

<b>Figure 14</b>	
<b>Governor's K-12 Discretionary Spending Proposals</b>	
<i>2006-07 (In Millions)</i>	
	<b>Amount</b>
<b>Governor's Proposals</b>	
Proposition 49 after school	\$426.2
K-12 revenue limit increases	406.2
Teacher recruitment and retention	100.0
Arts and music	100.0
Physical education	85.0
Beginning teacher support	65.0
Digital classroom grants	25.0
Fresh Start	18.2
<b>Total</b>	<b>\$1,225.6</b>

*Mandate Finance in Need of Reform.* The budget includes \$134 million to pay for the ongoing costs of state-mandated education programs in 2006-07. This is the first time in four years the Governor's budget has included funding for these costs. Our review of the current K-12 mandates process, however, indicates that the process could be streamlined, reducing state and local administrative costs and making mandate funding more predictable for both districts and the state.

*Is It the Right Time for New Categorical Programs?* The budget provides almost \$400 million for several new categorical programs. For many of these new programs, the administration has not been able to articulate the problems that it is trying to solve or how the new programs would address the identified problem. These programs focus on narrow issues while leaving broader issues like state and district fiscal solvency

unaddressed. Given that both the state and school districts face difficult budget pressures, we believe it is unwise to direct funding to these lower priority issues.

## 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. 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.

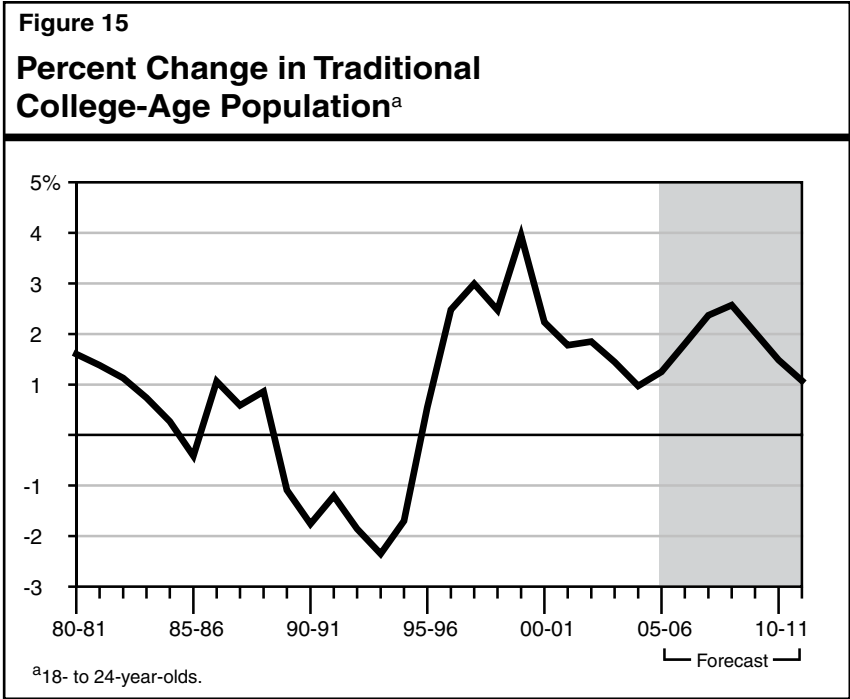
**Enrollment Growth.** The state uses a "marginal cost" formula that estimates the added cost imposed by enrolling each additional full-time equivalent (FTE) student at the public universities. An increase in the state's college-age population is a key determinant of increases in those who are eligible to attend each segment. Therefore, most enrollment growth projections begin with estimates of the growth of this population group. As shown in Figure 15 (see next page), the rate of growth in the college-age population will peak in a couple of years, after which population growth for this age group will slow.

**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 staff salaries.

**Student Fees.** Student fees constitute an important source of general revenue for all three segments. Through these fees, nonneedy students pay a portion of their own education costs. (In general, financially needy students receive financial aid to cover their fees.) The state currently has no formal policy for setting fees. Thus, fees can be adjusted annually to increase, decrease, or maintain the share of cost borne by students. Cost increases not covered by a student fee increase are generally covered by increased General Fund spending.

**Overall Funding Trends.** Despite the state's difficult budget situation in recent years, general-purpose funding (including student fee revenue) received by the higher education segments has generally kept pace with cost increases due to inflation and enrollment growth. This funding increased by about \$1.9 billion between 2002-03 and 2005-06, which reflects a 15.5 percent increase over the period.

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**Governor’s Proposal**

**UC and CSU.** The Governor’s budget proposes General Fund support of \$5.8 billion in 2006-07 for the state’s public universities. This represents an increase of \$385 million (7.1 percent) over the current year. This amount would fund enrollment growth of 2.5 percent, which would serve 5,149 additional FTE students at UC and 8,490 additional FTE students at CSU. The Governor’s budget also reflects a proposed new formula for calculating the marginal cost of serving additional students. Under this formula, the state cost of serving an additional UC student would increase by 34 percent from the current-year amount, while the state cost for an additional CSU student would increase by about 8 percent.

The budget also includes two General Fund base increases for the segments: a 3 percent increase to cover cost increases, and an additional increase provided in lieu of planned fee increases at the universities. When the two base increases are combined for each segment, UC and CSU would receive base increases of 5.8 percent and 5.2 percent, respectively.

**CCC.** The budget proposes about \$4 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 \$501 million,

or 14.5 percent, from the current year. When student fee revenues and property taxes are also considered, the budget proposal would increase funding for CCC by \$581 million, or 10.3 percent.

The Governor's budget proposal includes augmentations of \$149 million for enrollment growth of 3 percent, \$265 million for a 5.18 percent COLA, \$130 million to advance the state's efforts to equalize apportionment funding among community college districts, and \$50 million to expand the Governor's career technical education initiative. The budget proposes no fee increases.

## Issues for Legislative Consideration

The Governor's budget proposal for UC and CSU follows predetermined funding targets he negotiated with the segments in 2004. We believe the Legislature should instead set its own priorities. Specifically, for all three higher education segments (including CCC) we advise the Legislature to (1) determine higher education funding needs based on the anticipated costs of enrollment growth and other factors, and (2) determine how these additional costs should be shared between the state and students. In our *Analysis of the 2006-07 Budget Bill*, we discuss how such an approach would work and make a number of specific recommendations about programmatic funding, student fees, and related policy impacts. We highlight the major issues raised in that analysis below.

***New Enrollment Costs Are Driven by Population Growth.*** One of the fundamental budgeting decisions for higher education is how many additional students to fund. In our *Analysis*, we recommend increasing enrollment funding to accommodate growth in the college-eligible population, as well as modest increases in participation rates. This approach would result in savings relative to the Governor's budget.

***Fee Decisions Should Be Driven by Share-of-Cost Considerations.*** The Governor's budget in effect treats student fee increases as a "cost" that can be "bought out" by state General Fund resources. In contrast to that approach, we think fees should reflect a policy choice about what share of their educational costs students should pay. In our *Analysis*, we recommend that students maintain their current share-of-cost in the budget year.

***Marginal Cost Formula Should Be Revised.*** As part of the 2005-06 budget package, the Legislature directed our office and the Department of Finance to convene a working group to develop a new formula for determining the marginal cost of serving each additional FTE student at UC and CSU. The working group was unable to reach a consensus on a new marginal cost formula. The Governor's budget reflects the administration's own marginal cost formula. In our *Analysis*, we recommend the Legislature adopt an alternative marginal cost formula that would better reflect

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actual costs. Our recommendation would achieve savings relative to the Governor's budget, but would fund enrollment growth at a higher rate than would be provided under the existing marginal cost methodology.

***Funding Allocation Mechanism Could Undermine CCC Equalization Efforts.*** The Governor's budget provides \$130 million to advance the state's current effort to equalize apportionment funding among community college districts. However, these equalization efforts will be gradually eroded if the existing method for allocating general apportionment revenue is not changed. In our *Analysis* we discuss how the Legislature can achieve and sustain its equalization objectives.

***Administration of Financial Aid Programs Could Be Improved.*** The state has struggled with how to structure the administration of its financial aid programs. As directed by the Legislature, we recently released a report evaluating structural options available to the state for administering state financial aid grant programs and federal student loan programs. In our *Analysis*, we recommend the Legislature authorize a single agency, with one board and executive director, to administer these programs.

## HEALTH SERVICES

### Background

California's major health programs provide health coverage and additional support services for various groups of eligible persons, but primarily poor families and children as well as seniors and persons with disabilities. Medi-Cal is by far the largest state health program with an average monthly caseload estimated to reach about 6.7 million persons in the budget year. The Healthy Families Program (HFP), which provides coverage only to children, is assumed in the Governors budget plan to reach an enrollment of 933,000 by June 2007. In addition, the state supports various public health programs, community services and state facilities for the mentally ill and persons with developmental disabilities, and community substance abuse treatment programs.

***Overall Growth Trend.*** If the spending levels proposed in the 2006-07 budget are adopted, General Fund spending on health services programs will have grown by \$10.9 billion, or almost 63 percent, from 1999-00 through 2006-07. That represents an average annual growth rate of about 7.1 percent.

***Main "Cost-Drivers."*** Much of the increase in General Fund expenditures has been driven by increases in caseload, cost, and utilization of services in Medi-Cal. Increased expenditures for prescription drugs, hospitalization, and long-term care for the aged and disabled have been

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a significant component of this increase in program costs. Growth in case-loads 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.

### **Governor's Proposal Increases General Fund Commitments**

The Governor's budget plan includes a number of major budget proposals that would result in significant and ongoing commitments of General Fund resources for the support of health programs. We discuss several examples below.

***Enrollment in Children's Health Coverage.*** The administration is proposing various changes in the Medi-Cal and HFP to enroll more eligible children in health coverage and to increase the number of children in such programs whose families renew enrollment each year. The successful implementation of these proposals would result in additional General Fund costs in future years for the additional caseload of children who were added to the rolls of Medi-Cal and HFP.

***Staffing Expansions.*** The administration proposes to add 534 positions for the support of health programs and administration of Medi-Cal and public health programs. The budget would also add 453 positions to the state hospital system to respond to deficiencies found in federal civil-rights investigations. If approved by the Legislature, many of these positions would require General Fund support on an ongoing basis.

***Provider Rate Increases.*** The Governor's budget proposal would allow a temporary 5 percent rate reduction for certain Medi-Cal providers to expire in January 2007, in effect providing a rate increase for part of 2006-07 and beyond. The proposed budget would also increase rates in the Medi-Cal Program for long-term care facilities, federally qualified health clinics, and some managed care plans. A 3 percent rate increase would be provided to regional center system vendors. These rate increases would all require ongoing state General Fund support in the future.

***Disaster Preparedness Efforts.*** The proposed budget would increase General Fund support for various activities intended to prevent a flu pandemic or other public health outbreaks in the state and to respond more effectively in the event such a disaster occurs. A number of these activities are proposed to continue into 2007-08 and beyond.

### **Issues for Legislative Consideration**

We indicate in "Part I" of this volume, the state is still facing significant fiscal challenges despite projected hefty revenue increases during our forecast period. Federal policies affecting California's health programs are likely to aggravate the state's future General Fund gap. We project that

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the state is likely to exhaust its carryover of surplus federal funds for the support of HFP as soon as 2007-08, making it likely that General Fund support for HFP would have to increase markedly if the present eligibility and benefit levels were to be maintained. Also, in about three years, the recently enacted Federal Deficit Reduction Act will result in the loss of about \$250 million annually in General Fund revenues from so-called quality improvement fees now collected from Medicaid managed care plans.

Under these circumstances, the Legislature should carefully consider its opportunities for achieving savings in the near term. For example, our analysis indicates that recent changes in the way the federal government is implementing the new Medicare Part D prescription drug benefit will allow the state to make corresponding reductions in the Medi-Cal Program. We also recommend that some of the proposed new disaster preparedness activities be supported with newly available federal funds and other funding sources instead of the General Fund, and that the Legislature reject some of the Department of Health Services (DHS) staffing requests that we found lacked sufficient workload justification.

***Invest in Reforms Offering Future General Fund Savings.*** We believe that the Legislature could initiate cost-cutting reforms in health programs that, perhaps with some initial state investment, are likely to pay off over time in significant reductions in state health program costs. These reform options include the following:

- ***Shift From Emergency Rooms to Primary Care.*** The state could improve access to community-based primary care programs and create appropriate incentives and referral systems to encourage patients to use less expensive clinics and doctor's offices instead of hospital emergency rooms for nonemergency services.
  - ***Managed Care for Seniors and Persons With Disabilities.*** More seniors and persons with disabilities (SPDs) could be placed into managed care where their medical services could be better coordinated and their high costs for hospitalizations reduced through greater access to preventive care. A new federal hospital finance waiver would reward the state's hospitals with as much as \$315 million in extra federal funds for moving in this direction.
  - ***Long-Term Care Integration.*** A logical next step after expansion of managed care for SPDs would be the integration of fragmented health and social services programs for long-term care. Counties could have a "single point of entry" that would perform comprehensive assessments of the needs of the elderly and shift individuals who do not need to be in expensive institutional settings, such as hospitals and nursing homes, to less costly community care.
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- **Family Health Coverage.** If future allocations of federal funds by Congress for HFP remain limited, the state faces the choice as soon as 2007-08 of either backfilling a major shortfall of funding for HFP completely with General Fund support or reducing program eligibility and benefits. One alternative, however, would be to shift some children now eligible for HFP into Medi-Cal, which is generally funded 50-50 with state and federal funds. Other options for resolving the HFP shortfall are also worth considering.
- **Pharmacy Reimbursements for Generic Drugs.** The state could tighten up its reimbursements to pharmacies for prescription drugs provided to Medi-Cal beneficiaries, particularly for generic drugs. This involves getting more accurate information about the prices paid to drug makers and giving DHS greater authority to reimburse pharmacies at more appropriate levels.
- **Audits to Improve Fiscal Controls.** Weaknesses evident in the fiscal controls for two major program areas, public health services operated by DHS and purchase of services by regional centers, could be addressed by conducting audits of these programs. We believe such audits would likely lead to tighter scrutiny and savings in expenditures for these programs.
- **Provider Rate Setting.** Provider rates for state programs are often set on an *ad hoc* basis with increases or decreases depending on the state's near-term financial condition. Instead, the state could link provider rates, such as those for regional center vendors, to objective measures which would determine the minimum rates needed to ensure appropriate access to services as well as quality of services for program beneficiaries. Over time, we believe this approach would hold down state costs.
- **State Mandates for Mental Health.** The state has accumulated more than \$350 million in unpaid claims for two state-mandated programs requiring mental health services for children in special education programs. These costs are likely to continue to grow. The state could better control these expenditures and improve the quality of services for children by ending the state mandates and creating a new state categorical program in their place.

The above proposals are outlined in more detail in "Part V" of this volume "Major Issues Facing the Legislature," and in the "Health and Social Services" chapter of the *Analysis of the 2006-07 Budget Bill*.

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## 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 \$9.4 billion in 2006-07, about 9.6 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 \$9.4 billion proposed for 2006-07. The \$600 million increase over these four years represents an annual growth rate of 1.7 percent, less than the typical caseload growth in a number of social services programs. In contrast, General Fund spending on all other programs has increased at an average annual rate of 6.4 percent during this time period. As a result social services share of the total General Fund budget has declined from 11.4 percent to 9.6 percent.

This relatively flat growth in social services is attributable to many factors including additional federal funds (and corresponding General Fund savings) for In-Home Supportive Services, state COLA suspensions, delays in passing through federal Supplemental Security Income COLAs, shifting habilitation services (previously provided in the Department of Rehabilitation) to the Department of Developmental Services, and not funding inflationary cost increases for county administration.

### Governor's Proposal

The Governor's budget continues the recent pattern of minimal increases in General Fund support for social services programs, in amounts that are generally less than would be required to maintain current service levels based on inflation. With respect to grant payments, the budget follows current law, which suspends both the July 2006 California Work Opportunity and Responsibility to Kids (CalWORKs) COLA and the January 2007 Supplemental Security Income/State Supplementary Program (SSI/SSP) COLA. The budget further delays the "pass-through" of the federal SSI COLA from April 2007 to July 2008. Compared to current law, this results in General Fund savings of \$48 million in 2006-07, rising to \$185 million in 2007-08.

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**Freezing State Participation in County Administration.** The Governor proposes trailer bill legislation which limits state participation in county administration costs for salaries, benefits, and overhead to the amount appropriated in the *2005-06 Budget Act*, adjusted for caseload. The proposal applies to all county administered health and human services programs. It results in General Fund savings of \$21.2 million in Medi-Cal administration. No savings are achieved in social services programs because county allocations have been frozen with respect to price increases since 2001-02.

**New Initiatives.** The Governor proposes \$5.6 million from the General Fund for 81 new positions for the Community Care Licensing Division within the Department of Social Services. The additional inspectors will increase the rate of random visits from the current 10 percent of facilities to about 20 percent. The Governor also proposes \$19.1 million from the General Fund to support a child welfare services initiative. This proposal would increase adoptions, expand funding for kinship support services, provide additional funding for transitional housing for foster youth, and fund recently enacted legislation.

## Issues for Legislative Consideration

**Community Care Licensing Proposal Ignores Enforcement Gaps.** The Governor's proposal to increase the number of routine inspections of care facilities and foster homes should be sufficient to meet an existing statutory requirement that all facilities be visited at least once every five years. However, increased inspection alone, as the Governor proposes, will not guarantee safer facilities. The Legislature could consider enacting legislation (1) requiring that family child care homes be subject to civil penalties when unsafe conditions are not remedied on a timely basis and (2) replacing the current "permanent" license with a license that must be renewed.

**Increasing County Flexibility.** The Governor's proposal to increase adoptions and kinship support represents a one size fits all approach to improving child welfare because it assumes that these approaches are the key to improving performance in each county. Pursuant to current law, counties have developed individualized self-improvement plans to meet federal performance outcome measures in child welfare services. The Legislature could consider redirecting the proposed increase for adoptions and kinship support into flexible grants for use by the counties in their self-improvement plans which are specifically designed to meet local improvement goals.

**Proposal for Freezing County Administration Raises Many Issues.** The Governor proposes trailer bill legislation to limit increases in state support for county administration (salaries, benefits, and overhead) to changes in caseload, with no adjustment for inflation. Most budgets for county admin-

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istration (with the exception of Medi-Cal) have been frozen since 2001-02. Depending on their priorities, counties may elect to backfill with their own funds to cover the cost of inflation. The Governor's proposal would restrict future legislative flexibility to adjust funding and service levels.

***Budget Presents Substantial Risks.*** The Governor's budget assumes that the state will successfully appeal a lower court ruling in the *Guillen* lawsuit. If the state's appeal is denied, there would be one-time costs for retroactive grant payments of \$336 million in 2006-07 in the CalWORKs program. In addition, the state would face ongoing grant costs of \$122 million each year, unless it enacted legislation to reduce grants prospectively. Furthermore, the state faces a potential disallowance of \$100 million in federal funds for foster care because the state was out of compliance with federal rules concerning identical treatment of relative and nonrelative foster parents back in 2001.

***Budget Does Not Address Impacts of Deficit Reduction Act.*** The President signed the Deficit Reduction Act of 2005 on February 8, 2006. With respect to social services programs, we estimate potential net costs of \$1.1 billion for federal fiscal years (FFYs) 2006 through 2010, with the majority of the costs occurring after FFY 2008. Most of these costs are for potential federal penalties and required General Fund backfills if the state cannot meet increased federal work participation rates in the CalWORKs program. The Governor's budget, prepared before this legislation was enacted, does not reflect any of these costs. There are a variety of strategies which the Legislature could consider in order to increase work participation thereby potentially avoiding or reducing these penalties.

## JUDICIAL AND CRIMINAL JUSTICE

### Background

The judicial and criminal justice portion of the budget consists primarily of funding for the California Department of Corrections and Rehabilitation (CDCR), the Judicial Branch, and the Department of Justice (DOJ). The CDCR is responsible for the incarceration and supervision of nearly 300,000 felons, including about 168,000 adult inmates, and over 115,000 parolees. The Judicial Branch includes the Supreme Court, Courts of Appeal, 58 trial court systems, the Judicial Council, and the Habeas Corpus Resource Center. The DOJ enforces state laws, provides legal services to state and local agencies, and provides support services to local law enforcement primarily through the operation of the state's 11 crime laboratories.

Spending for judicial and criminal justice programs represents about 11 percent of total General Fund spending. In the past ten years, the budget

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for these programs has grown at an average annual rate of about 8 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 staff overtime.

**Judicial Branch.** Growth in state spending for court operations has resulted primarily from increases in court employee salaries, and county charges for services provided to the courts (for example, court security). Budget strategies to reduce General Fund spending included one-time and ongoing unallocated reductions, as well as the establishment of new and increased court fees.

## **Governor's Proposal**

**Corrections.** The Governor's budget proposes to increase spending from all sources for corrections by \$364 million, or 4.7 percent. This includes funding for all correctional departments that reported to the Youth and Adult Correctional Agency prior to the enactment of Chapter 10, Statutes of 2005 (SB 737, Romero), which consolidated all of the correctional departments into a single entity—the CDCR. The overall increase is largely driven by costs associated with a growing inmate population, salary increases, and the implementation of court settlement agreements. Other augmentations are included for inmate health care services, and inflation on operating expenses and equipment.

**Judicial Branch.** Overall, the budget proposes to increase spending for the judicial branch by \$140 million, or 4.3 percent. This includes funding for the Trial Court Funding program (primarily superior courts), as well as the judiciary (Supreme Court, Courts of Appeal, Judicial Council and the Habeas Corpus Resource Center). The increase is the result of salary and benefit increases, as well as an augmentation for trial courts and the judiciary for inflation and growth based on the year-to-year change 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**

**Reorganization of Correctional Departments.** The reorganization of the state correctional agencies into one department was intended to improve the efficiency and effectiveness of the state criminal justice system, as well

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as to improve accountability. During last year's legislative budget and policy discussions on the reorganization, the administration committed to providing the Legislature updates on its progress in accomplishing the numerous and varied goals and objectives of the reorganization.

To date, the department has provided no information demonstrating whether, or to what extent, the reorganization has improved departmental operations and resulted in efficiencies and a higher degree of effectiveness. As we discuss in the "Judicial and Criminal Justice" chapter of our *Analysis of the 2006-07 Budget Bill*, the department has failed to provide numerous reports intended to facilitate legislative oversight. It will be important for the Legislature to follow-up with CDCR on the implementation of policy reforms, with a focus on the department's progress to date and its timeline for reaching full implementation.

***Proposed Expansion of Inmate and Parolee Programs.*** Consistent with the goals of the newly created CDCR, the administration proposes funding for new and expanded programs for inmates and parolees designed to reduce recidivism. While many aspects of the Governor's proposal are consistent with recent legislative efforts to reduce the number of inmates who return to prison, we believe the administration's proposal attempts to address too much too fast. For example, the "recidivism reduction" initiative requests more than \$50 million in 2006-07 to implement over 20 program enhancements to address a variety of programmatic concerns. We think it will be important for the Legislature as part of budget discussions to consider whether the department can realistically accomplish all that CDCR has proposed to reduce recidivism in the budget year in light of the numerous other demands currently being placed on CDCR by court settlement agreements and prison overcrowding. For a detailed description and assessment of the administration's recidivism reduction proposal, please see our *Analysis of the 2006-07 Budget Bill*.

***More Autopilot Spending and Less Legislative Control of the Court Budget.*** The Governor's budget proposes to expand use of formula-based budgeting for the courts by annually adjusting the entire court budget based on the year-to-year change in the state appropriations limit (SAL). In 2005-06, pursuant to Chapter 227, Statutes of 2004 (SB 1102, Committee on Budget and Fiscal Review), the budget for the Trial Court Funding program was adjusted based on the projected change in SAL to reflect inflation and growth in that program. The Governor's budget would expand this formula-based budgeting methodology to all of the programs in the state judiciary, including the Supreme Court, Courts of Appeal, and the Judicial Council as well as to judicial salaries. The administration also proposes to make most of the \$3 billion in spending for the courts available without regard to the fiscal year. We could identify no policy rationale for the proposed expansion of autopilot budgeting. Based on our review,

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we think the Governor's proposal would result in overbudgeting of the courts, as well as reduced legislative oversight of a significant amount of state spending.

## 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 funding for transportation, with revenues generated mainly by an excise 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 between 2000-01 and 2005-06, primarily by redirecting the sales tax on gasoline from the General Fund to transportation purposes. The original TCRP was to provide funding for several transportation programs, including \$4.9 billion for 141 specified projects and about \$2.7 billion for new projects in the State Transportation Improvement Program (STIP), local streets and roads, 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 16 shows expenditures on state transportation programs from state and federal fund sources between 2003-04 and 2006-07. The figure shows that total expenditures on state transportation programs are estimated to be significantly higher in 2005-06 and 2006-07 than they have been in past years. This increase in expenditures is attributable to fully funding Proposition 42 in the current and budget years, as well as reauthorization of the federal transportation program in August 2005. While gas tax and weight fee revenues remain the primary source of funding for transportation in California, these revenues have not contributed to the increase.

### Governor's Proposals

*The Governor's Budget.* The 2006-07 budget includes a number of proposals related to transportation funding. In the aggregate, these proposals would result in significantly higher levels of transportation funding in 2006-07 than in recent years. Specifically, the budget proposals include:

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**Figure 16**  
**Expenditures on State Transportation Programs**

(In Billions)

	2003-04	2004-05	Estimated	Projected
			2005-06	2006-07
State funds	\$3.8	\$5.2	\$6.2	\$6.2
Federal funds	2.3	2.5	3.4	3.5
<b>Totals</b>	<b>\$6.1</b>	<b>\$7.7</b>	<b>\$9.6</b>	<b>\$9.7</b>

- **Full Funding of Proposition 42.** The budget proposes to transfer \$1.4 billion of gasoline sales tax revenues to transportation. Of these funds, \$678 million will be available for TCRP projects, \$582 million will be used for STIP projects, and \$146 million will be allocated for mass transportation. Consistent with current law for the budget year, none of the revenues will be allocated for local streets and roads.
- **Early Repayment of a Previous Suspension.** In 2004-05, due to the state's fiscal condition, the entire Proposition 42 transfer was suspended. The suspended amount of about \$1.3 billion must be repaid with interest by 2007-08. The Governor's budget proposes to repay early a portion of the loan—\$920 million (principal and interest)—in the budget year. The balance (\$430 million) would be repaid in 2007-08.

**Strategic Growth Plan.** In addition to the transportation funding proposals specific to the 2006-07 budget, the Governor is proposing a Strategic Growth Plan (SGP). The SGP lays out a ten-year funding plan to improve state infrastructure and includes \$107 billion for transportation in particular. The key features for the transportation component of the plan include:

- \$47 billion in existing transportation funding sources such as state gas tax and weight fee revenues, the Proposition 42 transfer and federal funds.
- \$48 billion in new funding including private investments, future local sales tax revenues for transportation, and bonds backed by future state transportation funds. Specifically, the Governor proposes \$14 billion in bonds to be backed by future state gas tax and weight fee revenues.



- \$12 billion in general obligation (GO) bonds, including \$6 billion each to be authorized by voters in 2006 and 2008 elections.
- A permanent “firewall” of Proposition 42 funding for transportation by deleting the authority to suspend the transfer after 2006-07.

### **Issues for Legislative Consideration**

*2006-07 Budget Proposal Boosts Funding, but No Money for New Projects.* The budget proposes to fully fund Proposition 42 and provide \$920 million in early repayment of a previous suspension. In addition, the budget assumes that \$1 billion in tribal gaming bond revenues will be received in 2005-06. However, even if fully realized, the funding increase would not provide for additional projects beyond what has already been scheduled for delivery. This is because many projects have to “catch up” on prior-year delays that resulted from the redirection of transportation funds to nontransportation uses due to the state’s overall fiscal condition.

*Bonds Would Provide One-Time Funding Increase.* The GO bonds proposed in the SGP would provide a one-time infusion of funding to transportation. How effectively this additional funding would address the state’s transportation priorities, however, would depend on the types of projects funded. For instance, the state has already committed to many projects in STIP and TCRP, which do not yet have full funding. Thus, additional resources will be needed to complete these projects. Furthermore, the new federal act earmarked \$3.7 billion in federal dollars to provide partial funding to many projects statewide. To the extent that the Governor’s bond provides full funding for projects that are high in state priority, the impact on mobility and congestion could be significant. Otherwise, the effect on congestion and mobility would be less noticeable.

Similarly, the timing of when projects funded by the bond proposals could be delivered affects their ability to address statewide congestion and mobility issues. To the extent the proposed projects have been defined and scoped, project delivery could be sooner than if these projects are still in the early stages of the planning process.

*Administration Has Failed to Demonstrate Projects’ Congestion Benefits.* Instead of adhering to the existing STIP fund allocation process, the Governor’s plan would inject most of the \$12 billion in GO bond funds into a list of projects selected exclusively by the administration. The existing state process requires projects to be defined, scoped, and fully funded by Caltrans or a regional transportation agency before receiving STIP funds. Although requested, the administration has not provided the Legislature with the proposed projects’ costs, congestion benefits, or estimated completion date. In the absence of this information, the Legislature is unable to assess the merits of the Governor’s proposed projects.

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**Revenue Bond Would Crowd Out Highway Maintenance and Rehabilitation.** Beginning in 2015 and continuing for 30 years, the Governor’s proposal would take “off the top” up to \$1.025 billion annually from state gas tax and weight fee revenues for debt service on a \$14 billion revenue bond. This would reduce the amount of funding available for highway maintenance and rehabilitation, which are funded almost exclusively by gas tax and weight fee revenues. Providing adequate funding for these activities while paying debt service on the bond would necessitate either an increase in the gas tax or weight fees, or a redirection of Proposition 42 funds.

**Long-Range State Funding Requirement Should Be Assessed.** The state does not currently have an up-to-date assessment of its transportation needs. Such an assessment is necessary for the Legislature and the administration in order to determine how much funding the state should provide for transportation.

**How Should State Funding Be Provided?** Transportation spending has traditionally been funded from user fees such as the state’s 18 cent per gallon excise tax on gasoline and diesel fuel. The tax approximates a fee charged for the provision of roads used by the driver. Thus, it provides a clear signal to road users of the cost of the service they receive. Accordingly, we think that the state should continue to rely on user fees to provide ongoing funding for transportation.

The Governor’s proposal to firewall Proposition 42 would eliminate the state’s authority to suspend the transfer of gasoline sales tax revenue to transportation when the state faces tight fiscal conditions. While this proposal would enhance long-term funding stability for transportation, it would also remove a budget balancing tool that has been used when the state faced tight fiscal conditions.

## RESOURCES

### Background

**Resources and Environmental Protection Programs.** The state’s resources and environmental protection programs are administered under the Resources and California Environmental Protection (Cal-EPA) Agencies, respectively. The Resources Agency, through its 26 departments, boards, commissions, and conservancies, is responsible for the conservation, restoration, and management of California’s natural and cultural resources, including state parks and wildlife habitat. The Cal-EPA, through its six departments, boards, and offices, is responsible for the protection and improvement of the state’s environmental quality and public health,

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mainly through regulatory programs that control, mitigate, and clean up the impacts of pollution on the environment.

**Overall Growth Trend.** State expenditures for resources and environmental protection programs have increased from about \$2.9 billion in 1999-00 to \$4.6 billion in 2006-07. This reflects a 69 percent increase, or an average annual increase of about 7 percent. The increase mostly reflects growth in expenditures from fee-based special funds and bond funds, while General Fund expenditures proposed for 2006-07 (\$1.6 billion) are roughly the same as 1999-00 spending—an increase of \$250 million.

Given the weakened condition of the General Fund, a number of program activities that have traditionally been funded from the General Fund—such as resources land management, wildlife resource assessments, and state park maintenance—have experienced expenditure reductions over this period. In fact, when adjusted for inflation, General Fund expenditures proposed for resources and environmental protection programs in 2006-07 are actually lower than the 1999-00 level.

Bond fund expenditures increased during this period, reflecting the availability of these 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, these funds 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 2006-07, only about \$950 million 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 1999-00 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 the 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

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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**

*Flood Protection and Water Management.* The budget proposes significant expenditures for various flood protection and water management activities.

For flood protection, the budget proposes increases of \$38.2 million for state operations and local assistance and \$41.3 million for capital outlay in the Department of Water Resources' (DWR) flood management program in 2006-07. With these increases, DWR's total flood management budget for 2006-07 will be about \$109 million. The requested increases for state support are for maintenance work on levees and flood channels, evaluation of levees and channels to identify deficiencies, floodplain management (including floodplain mapping), and emergency response. The requested increases for local assistance are for maintenance of and improvements to local levees in the Delta region. The requested increases reflect the second year of a three-year budget plan to begin addressing what the department has characterized as a "crisis" in flood management.

For water management, the budget includes \$249.9 million of state funds—spread throughout eight state departments—for the CALFED Bay-Delta Program (CALFED) in 2006-07. Of this amount, \$26.4 million is proposed from the General Fund, with the balance mainly from various bond funds (\$181.2 million) and State Water Project funds (\$39 million). This level of expenditure is a 23 percent reduction from the current year, mainly reflecting a decline in available bond funds. The Governor is currently evaluating proposals to reform CALFED's organizational structure as well as a draft long-term finance plan for the program. Given the status of the Governor's review, the budget proposed in January does not reflect any significant changes to how CALFED is financed or governed.

Finally, although not reflected in his budget proposal, the Governor, as part of his SGP, proposes new bonds to be placed before the voters in 2006 and 2010 that would provide a total of \$9 billion for flood protection (\$2.5 billion) and water management (\$6.5 billion). The Governor's SGP also proposes a new assessment on retail water suppliers that would raise around \$5 billion in revenues over ten years. These revenues would be used to support a variety of water management projects, with two-thirds of the funds collected being returned to local public agencies, private entities, and nonprofit organizations for regional water management projects.

*Reorganizing the State's Energy-Related Activities.* The budget proposes expenditures in six energy-related state entities. Although the budget

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does not contain a proposal to reorganize California's energy-related activities, the Governor's budget document acknowledges that the administration is sponsoring legislation (AB 1165, Bogh), to do this. The Governor's proposal contained in this legislation would create a single Department of Energy that would be charged with making the state's energy policy. The current California Energy Commission, Electricity Oversight Board, California Power Authority, and California Energy Resources Scheduling Division in DWR would all be abolished, and their functions transferred to the new department. Under the Governor's proposal, a modified Energy Commission would be created in the new department, with responsibilities limited to permitting new power plants, approving energy efficiency standards, and permitting electricity transmission infrastructure. The latter responsibility would be transferred from the California Public Utilities Commission where it currently resides.

*Addressing Fiscal Issues in the Department of Fish and Game.* The budget proposes \$311 million from various sources for the Department of Fish and Game in 2006-07. The fee-supported Fish and Game Preservation Fund (FGPF) is the department's largest single source of funding, providing \$94 million and supporting about one-third of the department's expenditures. The budget proposes a number of actions to bring FGPF into balance in the budget year due to revenue shortfalls. These include reducing FGPF expenditures by over \$7 million, shifting funds among various accounts within the fund, and increasing the General Fund support of the department by \$10 million.

## Issues for Legislative Consideration

*Flood Protection and Water Management.* In general, the budget's requested increases for flood management are 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 in the White Paper. To some extent, the larger funding requirements are addressed in the bond proposals that are part of the Governor's SGP. The Legislature should consider how the budget and bond proposals fit with one another and the appropriate mix of General Fund and bond funds in addressing the state's flood management funding requirements.

*Flood Protection.* There are other issues that the Legislature should consider when evaluating solutions to the state's flood management problems that are not addressed in the budget. First, the Legislature should consider the role for beneficiaries of the Central Valley flood control system—such as property owners living behind the levees—to help pay a portion of the infrastructure-related costs of the system. While the Governor's SGP references support for a funding contribution from the

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beneficiaries, the Governor does not propose a specific mechanism to accomplish this.

Second, the Legislature should consider strategies to reduce the likelihood of ill-advised development approvals in flood-prone areas. One such strategy would be to require local agencies to make a determination that a new development has an adequate level of flood control, as they must currently do for water supply. This strategy has been included in AB 1899 (Wolk), introduced this session.

Finally, while the budget proposes increased funding to local agencies for the maintenance of Delta levees that are outside the state's Central Valley flood system, it does not address the issue of the lack of state oversight over the operations and maintenance of these levees. The Legislature should consider increasing the state's oversight of these levees as a cost-effective measure to reduce the state's risk of incurring significant emergency response and repair costs when these levees fail.

***Water Management and CALFED.*** Regarding CALFED, there are a number of actions that the Legislature can take to improve the program. First, the Legislature should revise the program's organizational structure to better focus authority and responsibility for CALFED policy making and program management within the administration. Second, the Legislature should set expenditure priorities for CALFED and establish much needed performance measures for the program. Third, the Legislature should provide guidance statutorily on how to implement the "beneficiary pays" funding principle in financing CALFED. While the Legislature has on a number of occasions stated its intent that the program be funded according to this funding principle, there remains much disagreement as to how to implement it, as demonstrated by the administration's failure to deliver a CALFED water user fee proposal pursuant to legislative direction.

***Resource Bonds.*** There are a number of issues for the Legislature to consider when evaluating the Governor's, as well as other, proposals for new resources bonds. First, the Legislature should retain an appropriate level of oversight of bond expenditures. The Legislature's oversight is substantially weakened if bond funds are "continuously appropriated" and thus outside of the budget process as they are in the Governor's proposal.

Second, in evaluating bond proposals, the Legislature will need to consider the funding eligibility of private entities, which in our view is mainly a policy choice. (Under the Governor's bond proposals, private entities are eligible for grant funds.) We believe that the Legislature should explicitly declare its policy position on this matter in the bond measure.

Third, the Legislature should take action to ensure that bond-funded administrative costs are reasonable. In order to do this, the Legislature

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should provide a reasonable limit on, and definition of, administrative costs funded from bond proceeds.

Finally, in cases where a bond measure allocates funds for a programmatic purpose that is already being carried out by another existing program, the bond measure should explicitly address how the programs will be consolidated or at least coordinated. In analyzing the Governor's bond proposals, we found a number of cases where it was unclear how programs funded by the bonds fit within existing programs with similar purposes.

*Reorganizing the State's Energy-Related Activities.* While the long-term market structure for electricity in the state has been settled, we think that the timing is right for the Legislature to create a more efficient and accountable structure for the state's energy-related activities. We recommend a revised organizational structure that should improve the state's ability to address the energy challenges that remain whether or not a reorganization is adopted. (See "Part V" of this volume for a more detailed discussion of our recommendation.)

## 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. Costs for state employees (including higher education) are projected to total more than \$25 billion in 2006-07, about one-half of which is supported from the General Fund. As shown in Figure 17 (see next page), 18 of the state's 21 units will have expired MOUs by July 2, 2006. (One of the remaining three units—the state's attorneys—currently has its MOU pending before the Legislature.) When a union has an expired MOU, the terms of that agreement generally remain in effect until a new MOU is signed and approved by the Legislature.

*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 \$2.8 billion in 2002-03 to a projected \$4.2 billion in 2006-07. The largest factors in this increase are the poor investment performance of retirement funds in the early part of the decade and rising health care costs. The state's General Fund retirement costs for 2005-06 and 2006-07 are summarized in Figure 18 (see page 111).

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**Figure 17**  
**Status of Memoranda of Understanding (MOUs)**

Unit Number	Bargaining Unit
<b>MOUs Continuing Through 2006-07</b>	
7	Protective Services and Public Safety
9	Professional Engineers
<b>MOUs Awaiting Legislative Action</b>	
2	Attorneys, Administrative Law Judges, and Hearing Officers
<b>MOUs Expiring on or Before July 2, 2006</b>	
5	Highway Patrol
6	Corrections
8	Firefighters
10	Professional Scientific
16	Physicians, Dentists, and Podiatrists
18	Psychiatric Technicians
19	Health and Social Services/Professional
<b>MOUs Currently Expired</b>	
1	Administrative, Financial, and Staff Services
3	Educators and Librarians (Institutional Settings)
4	Office and Allied
11	Engineering and Scientific Technicians
12	Craft and Maintenance
13	Stationary Engineer
14	Printing Trades
15	Allied Services (Custodial, Food, Laundry)
17	Registered Nurses
20	Medical and Social Services
21	Education, Consultants, and Librarians (Noninstitutional Settings)

**Governor's Proposal**

*Increased Pay for Some Employees.* The Governor's budget includes funds (\$303 million, of which \$135 million is from the General Fund) to pay for the costs of previously negotiated MOUs with 5 of 21 employee bargaining units (and associated managers). Among the largest components of these costs are the final raises under the state's 2001 MOUs with highway patrol and correctional officers. In addition, the Governor's budget includes \$68 million (of which \$57 million is from the General Fund) for compensation increases connected to the *Plata v. Schwarzenegger* court order concerning prison medical staff.



**Figure 18****General Fund Costs for Retirement Programs***(In Millions)*

	<b>Estimated 2005-06</b>	<b>Proposed 2006-07</b>
<b>State Retirement Plans</b>		
Public Employees' Retirement Fund	\$1,336	\$1,366
Teachers' Retirement Fund	1,081	1,080
Judges' Retirement Funds	144	155
Defined Contribution Plans <sup>a</sup>	—	48
Subtotals	(\$2,561)	(\$2,649)
<b>Other Retirement Benefits</b>		
Health and Dental Benefits for Annuitants	\$895	\$1,019
Social Security and Medicare <sup>b</sup>	401	420
Subtotals	(\$1,296)	(\$1,439)
<b>University of California (UC) Retirement Programs</b>		
UC Retirement Plan	—	—
Health and Dental Benefits for UC Annuitants <sup>b</sup>	\$71	\$71
Subtotals	(\$71)	(\$71)
<b>Totals</b>	<b>\$3,928</b>	<b>\$4,159</b>
<sup>a</sup> State's contribution to supplemental retirement plan for correctional officers and their supervisors and managers. <sup>b</sup> Legislative Analyst's Office estimates.		

**Retirement Costs.** The Governor's budget includes no significant proposals to change the way the state funds retirement benefits. As shown in Figure 18, the state's 2006-07 General Fund retirement costs are projected to rise by over \$200 million. Required contributions to the state's two largest pension systems have leveled off due to modest growth in employee payrolls and the California Public Employees' Retirement System's new policies to stabilize employer contribution rates. The costs of health and dental benefits for retired state employees, however, continue to rise rapidly. About two-thirds of the total increase in General Fund costs for retirement benefits results from projected higher costs to provide health and dental benefits to 200,000 retired state employees and their dependents.

## Issues for Legislative Consideration

***Costs Will Probably Be Higher Than Budgeted.*** The budget—typical of recent practice—includes no funding for possible new MOUs. As shown in Figure 17, only three bargaining units have current MOUs extending past July 2, 2006 (including the proposed contract for the state’s attorneys). Combined, these three bargaining units represent about 12 percent of the state’s civil service employees. New MOUs for the other 88 percent of employees, if any, probably will increase costs above those included in the budget proposal. It would cost about \$120 million (\$65 million of which would come from the General Fund) for each 1 percent salary increase for state personnel in the other 18 state employee unions. In addition, most expiring MOUs require the state to pay a specific percentage of average health plan premium costs for employees. Even without new MOU agreements, rising state health plan premiums in 2007 would increase the amount the state must pay for health premiums. If no new MOUs are negotiated, costs for health, dental, and vision benefits could increase annually by up to \$120 million (about one-third from the General Fund) for rank-and-file employees, assuming a 10 percent increase in 2007 state health plan premiums. The Governor’s budget includes no funding for these potential costs.

***Unfunded Liability for Retiree Health.*** Under state law, the state pays for most of the costs of health plan premiums for retired state employees and their dependents. Annual payments are rising significantly to pay for existing retirees’ benefits. Like most governments across the United States, the state has set aside no assets that could be used to fund part of the future costs of benefits for the state’s current and past employees. Under a new governmental accounting rule to take effect soon, the state and other governmental entities will be required to calculate the unfunded liability for retiree health benefits (similar to the one already calculated for pension benefits). As we discuss in “Part V” of this publication, this liability will be very large—for the state, some school districts, many local governments, and UC. The Governor’s budget proposes a \$252,000 appropriation for the state’s first actuarial valuation of retiree health liabilities, which is required under the new accounting rule. The Legislature should consider steps to encourage disclosure of liabilities and to plan for future costs. Finally, in anticipation of the results of the state’s proposed actuarial valuation, the Legislature could begin taking actions to address the future costs of retiree health benefits. Specifically, we recommend that the Legislature consider setting aside funds to moderate long-term budgetary pressures in this area.

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## LOCAL GOVERNMENT MANDATES

### Background

The California Constitution generally requires the state to reimburse local governments, including schools and community colleges, when it mandates a new program or higher level of service. During times of fiscal difficulty, however, the state frequently has delayed making these mandate payments, resulting in the accrual of a large backlog of unpaid mandate claims.

Partly to address these matters, the state's voters approved Proposition 1A in 2004. This measure requires the Legislature annually to take one of the following actions regarding each state-mandated local program: appropriate funds in the budget to pay its outstanding bills, "suspend" the mandate (render it inoperative for one year), or repeal it (permanently eliminate it or make it optional). Two categories of mandates—those relating to K-14 education and employee rights—however, are exempt from the payment requirement. Proposition 1A also authorizes the state to pay over a term of years unpaid non-education mandate claims incurred prior to 2004-05.

### Governor's Proposal

The Governor's budget includes \$240 million (General Fund) and \$1.7 million (special funds) under the Commission on State Mandates' budget item to pay noneducation, nonemployee rights mandate claims in 2006-07. (Funding for K-14 mandates is included under the K-12 and community colleges budget items. The \$240 million for noneducation mandates includes:

- \$98.1 million for the first year of the state's 15-year plan to repay mandate obligations incurred before 2004-05.
  - \$46.2 million to fund the 2006-07 operations of ongoing mandates. (Funding for one employee relations mandate—the Peace Officer Procedural Bill of Rights—is deferred to an unspecified future date.)
  - \$45.7 million to pay the prior-year costs of new mandates recently identified by the Commission on State Mandates.
  - \$50 million set aside to transform two mental health mandates (jointly called the "AB 3632" mandate) into a categorical program.
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## Issues for Legislative Consideration

### Budget Begins Paying Mandate Backlog

Proposition 1A authorizes the state to pay over a term of years unpaid non-education mandate claims incurred prior to 2004-05. The Legislature specified the term of this repayment plan to be 15 years. At the time this *Perspectives and Issues* was prepared, the State Controller's Office (SCO) reported that the backlog of these claims totaled \$1.1 billion. (This amount may change in the coming months after SCO finishes tallying late mandate claims and completing mandate audits.) The administration proposes \$98.1 million as the first year of payment of this backlog.

### Likely Current-Year Mandate Deficiency

Based on claims submitted to date, we estimate that the 2005-06 budget will not have sufficient resources to pay all claims for mandate reimbursement. We estimate that the size of this current-year deficiency will be about \$140 million. Most of this mandate deficiency is associated with two mandates to provide mental health services for special education pupils, mandates commonly referred to as the AB 3632 mandates. Under the California Constitution, this deficiency must be paid in full if the mandates are to remain operative in the budget year.

### Higher Cost for Mandates in 2006-07

The administration includes a total of \$91.9 million for (1) ongoing, nonemployee relations mandates in the budget year (\$46.2 million) and (2) newly identified mandates (\$45.9 million). Our review indicates that \$91.9 million may be insufficient. Specifically, we estimate that the cost to reimburse local agencies for ongoing, nonemployee relations mandates in 2006-07 will total about \$100 million. This higher estimate for ongoing mandates, however, may be offset by lower costs for newly identified mandates. Specifically, at the time this *Perspective and Issues* was prepared, the state's liability for new noneducation mandates was only \$142,000. We note, however, that *additional* noneducation mandates were working their way through the process and the Commission on State Mandates might approve their cost estimates later this spring.

### No Proposal for AB 3632 Mandates

At the time he signed the *2005-06 Budget Act*, the Governor directed the Department of Mental Health, in collaboration with the California Department of Education, to develop a plan to transform the AB 3632 mandates into a categorical program in 2006-07. The administration's January budget proposal does not include a proposal for such a redesigned program. Instead, it includes \$50 million as a set aside and indicates that

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the administration intends to submit a proposal to the Legislature in time for the May Revision. To give the Legislature sufficient time to consider options for changing these mandates, we recommend the Legislature convene early policy committee hearings. (We discuss the AB 3632 mandate and the Legislature's options in greater detail in "Part V.")

### **Provide More Information About Mandates in Budget**

Every year, the Legislature makes decisions whether to suspend, repeal, fund, or defer mandates. Each action has different but important implications for the state's budget and local agency program obligations. The mandate information provided in the *2006-07 Governor's budget* and the *2006-07 Budget Bill*, is disorganized and incomplete. The problems associated with these documents are so significant that they make it impossible for the Legislature or local agencies to understand what the administration proposes for the budget year. If not corrected, these budgeting practices will undermine the Legislature and public's ability to understand the administration's proposals and track the Legislature's decisions regarding mandates over time. We recommend the Legislature request that the administration provide key mandate information in all future Governor's budgets and budget bills, including each mandate's name, number, budgeted amount, and the funds appropriated in the current and prior years.

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# V

## MAJOR ISSUES FACING THE LEGISLATURE





# RETIREE HEALTH CARE: A GROWING COST FOR GOVERNMENT

***What Will New Government Accounting Standards Reveal About State and Local Government Liabilities for Retiree Health Care Benefits? What Steps Can the Legislature Take to Begin Addressing These Issues?***

## **Summary**

*Retired state employees and their dependents receive health care benefits financed in part by the state. The costs of providing health care to retired state employees and their dependents—now approaching \$1 billion per year—are increasing significantly. Many other public employers (including school districts, universities, cities, and counties) face similar pressures.*

*In this piece, we describe the health benefits provided to retired public employees, focusing on state retirees. We find that the current method of funding these benefits defers payment of these costs to future generations. Retiree health liabilities soon will be quantified under new accounting standards, but state liabilities are likely in the range of \$40 billion to \$70 billion—and perhaps more. We describe actions that the Legislature could take to address the costs of these benefits and to encourage state and local governments to begin planning and paying for these future costs.*

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## INTRODUCTION

*Background.* Like many employers, governments in California often pay for health and dental insurance for their employees and eligible family members after retirement. Costs for retiree health benefits have been rising rapidly—increasing faster than both inflation and the overall growth rate of government spending.

*Retiree Health Benefits Are Not Prefunded...Unlike Pensions.* Almost all public entities in the United States pay for retiree health benefits in the year the benefits are used by retirees. This is sometimes called the “pay-as-you-go” approach, and it differs from the prefunding model used for most pension benefits—where most costs are funded in advance during employees’ working years and invested until paid to retirees. The pay-as-you-go approach has led to the accumulation of massive financial liabilities to pay for future retiree health benefits. These liabilities will be quantified under new government accounting rules that come into effect in 2007-08.

*Structure of This Report.* This report focuses on the state’s costs for providing benefits to its own retired employees, while also discussing similar issues for the University of California (UC), local governments, and school districts. The report first describes existing benefits for retirees and then outlines the new accounting rules. We then discuss the magnitude of financial liabilities for retiree health benefits and offer policy recommendations and options for governments to address these liabilities.

## STATE RETIREE HEALTH BENEFITS

### History

In 1961, the Legislature for the first time appropriated funds to the State Employees’ Retirement System—the predecessor to the California Public Employees’ Retirement System (CalPERS)—to provide health benefits to state employees and retirees. The state paid most of the costs of a basic employee and retiree health plan—with state contributions per employee set at \$5 per month in 1961-62. Total costs at that time were \$4.8 million (then under 0.3 percent of General Fund spending). The \$5 state contribution mirrored the provisions of the new federal employee health program, which began operations in 1960. Figure 1 lists key events in the evolution of the state’s retiree health program over the past half century. Since 1974, the state has paid a percentage of health costs, rather than a fixed amount.

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**Figure 1****State Retiree Health Benefits—Key Historical Events**

Year	Event
1961	State contributions of \$5 per month begin.
1967	Local agencies begin contracting with CalPERS for health benefits.
1974	State pays 80 percent of employee/retiree and 60 percent of dependent costs.
1978	State pays 100 percent of employee/retiree and 90 percent of dependent costs.
1984	State costs exceed \$100 million. Legislature increases years required for employees to vest in retiree health benefits.
1991	State begins to pay less than 100/90 formula for current employees. The 100/90 formula continues for retirees.
2006	The <i>2006-07 Governor's Budget</i> projects that costs will exceed \$1 billion.

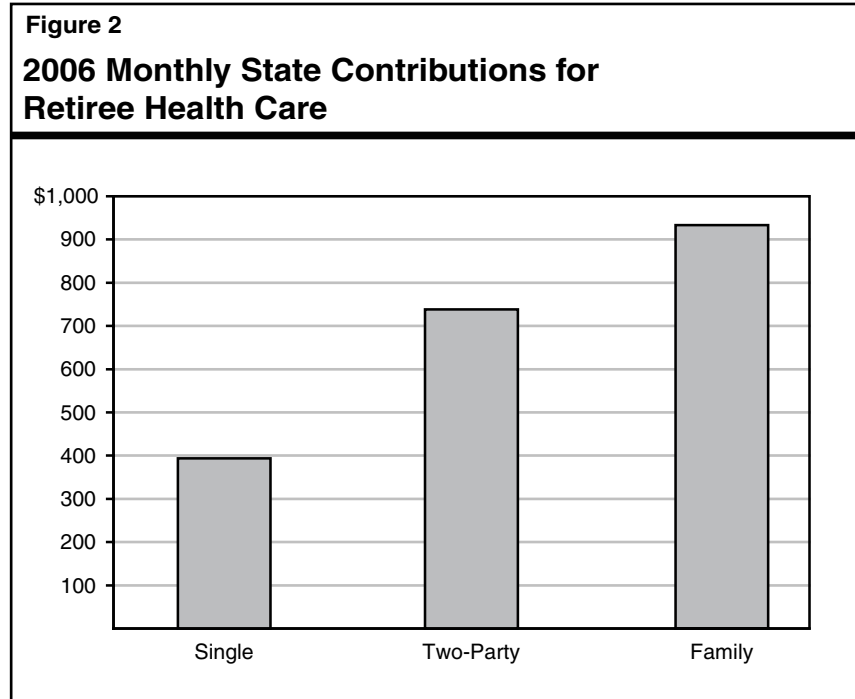
**The 100/90 Formula**

Current law provides state contributions for retiree health benefits on the basis of a “100/90 formula.” Under the formula, the state’s contributions are equal to 100 percent of a weighted average of retiree health premiums and 90 percent of a similar weighted average for additional premiums necessary to cover eligible family members of retirees. The formula bases payments on the weighted average of premium costs for single enrollees in the four basic health plans with the largest state employee enrollment during the prior year. The formula applies to all eligible retirees, including those from the California State University system.

***Vesting Requirements for State Contributions.*** Most state employees hired since 1985 receive full state contributions only after a period of vesting. Retirees and their eligible family members generally receive no state health contributions with less than ten years of service. They receive 50 percent of the contribution with ten years of service, increasing 5 percent annually until the 100 percent level is earned after 20 or more years of employment. State employees hired prior to 1985 are fully vested for health benefits upon retirement.

***2006 State Contribution Levels.*** Legislative approval of funding for retiree health and dental benefits occurs in the budget act, following CalPERS’ negotiation of health plan rates for the upcoming calendar year. For 2006, the 100/90 formula contributions are based on the premium costs for the four largest CalPERS health plans: Blue Shield’s health maintenance organization (HMO), Kaiser Permanente’s HMO, the PERSCare preferred

provider organization (PPO), and the PERS Choice PPO. This results in a 2006 required state contribution of \$394 per month for a single retiree, \$738 per month for a retiree and a family member, and \$933 per month for a retiree family, as shown in Figure 2.



### State Benefits and the Individual Retiree

*Retirees Under Age 65.* A retiree's vested state contribution amount may or may not cover the entire premium cost for a desired health care plan. For instance, for a fully vested 60-year-old retiree with a spouse or domestic partner of the same age, the 100/90 formula results in state contributions of \$738 per month. In 2006, the state contribution for this couple covers all premiums for the Kaiser Permanente HMO plan. To join a Blue Shield HMO plan in 2006, the couple must pay \$33 extra per month above the state contribution. To join PERSCare—with its flexible PPO options, including the ability to switch physicians or see specialists without referral—the family must pay \$609 extra per month. (The 2006 monthly premiums for selected health plans administered by CalPERS are listed in Figure 3. Retirees under age 65 enroll in the basic plans listed in the top part of the figure.)

For many retirees from state service who are between the ages of 50 and 65, retirement brings no immediate change in health plans or coverage.

**Figure 3****2006 Monthly Premiums for Selected State Employee Health Plans**

	Single	Two-Party	Family
<b>Basic Plan Premiums</b>			
Kaiser Permanente Basic HMO	\$365	\$730	\$949
Blue Shield Basic HMO	386	771	1,003
PERS Choice Basic PPO	401	801	1,042
PERSCare Basic PPO	674	1,347	1,752
<b>Medicare Plan Premiums</b>			
Kaiser Permanente HMO Medicare Advantage	\$219	\$437	\$656
Blue Shield HMO Medicare Supplement	286	573	859
PERS Choice PPO Medicare Supplement	322	644	966
PERSCare PPO Medicare Supplement	347	694	1,042

HMO = Health Maintenance Organization. PPO = Preferred Provider Organization.

These persons can remain in the same CalPERS basic health plan they had when they worked for the state. Rather, the changes they experience after retirement are largely financial. During their working years, these individuals and their family members probably received health benefits under 80/80 or 85/80 state contribution formulas included in collective bargaining agreements between the state and employee bargaining units. After retirement, the new retirees and their families typically receive benefits under the more generous 100/90 formula. Upon retirement, therefore, an individual may experience a reduction in the premium expenses he or she pays—with the state contributing an increased share.

*Retirees, Age 65 and Over.* Upon reaching age 65, most state retirees receive coverage under the federal government's Medicare Part A program (for hospital and similar benefits). Eligible state retirees must join Medicare Part A and Part B (for outpatient benefits), and at that time, they become eligible for coverage under one of CalPERS' Medicare health plans. These CalPERS plans supplement the federal government's health coverage and reduce the out-of-pocket costs required under Medicare—including premiums, deductibles, and copayments. Because the federal government covers a significant portion of health costs for retirees on Medicare, the premiums for CalPERS' Medicare plans are lower than those of CalPERS' basic health plans for current state employees and retirees under age 65. Monthly premiums in 2006 for some of CalPERS' Medicare plans are listed in the bottom part of Figure 3.

Retirees over age 65 and eligible family members receive the same monthly state contribution for health premiums as younger retirees. For a fully vested 67-year-old state retiree with a spouse or domestic partner of the same age, for example, this means that the state contribution for 2006 covers all monthly premium costs for the four CalPERS Medicare plans listed in Figure 3. After providing for these premium costs, \$301 of the state contribution is unused if the couple enrolls in the Kaiser Permanente Medicare Advantage plan, and \$44 is unused if the couple enrolls in the PERSCare Medicare Supplement plan. State law provides that this unused portion of the state contribution may be used to pay all or part of Medicare Part B premiums for retirees and eligible family members. (In 2006, monthly Medicare Part B premiums are just under \$89.) If any portion of the state contribution remains unused after paying these costs, it will remain unused since the retiree does not receive a refund for any remaining amount.

Some state retirees—including some who were first hired before 1986, when Medicare taxes became mandatory for most state and local government employees—are not automatically eligible for Medicare Part A coverage when they reach the age of 65. These retirees and some others can remain in CalPERS' basic health plans.

## Soaring Costs

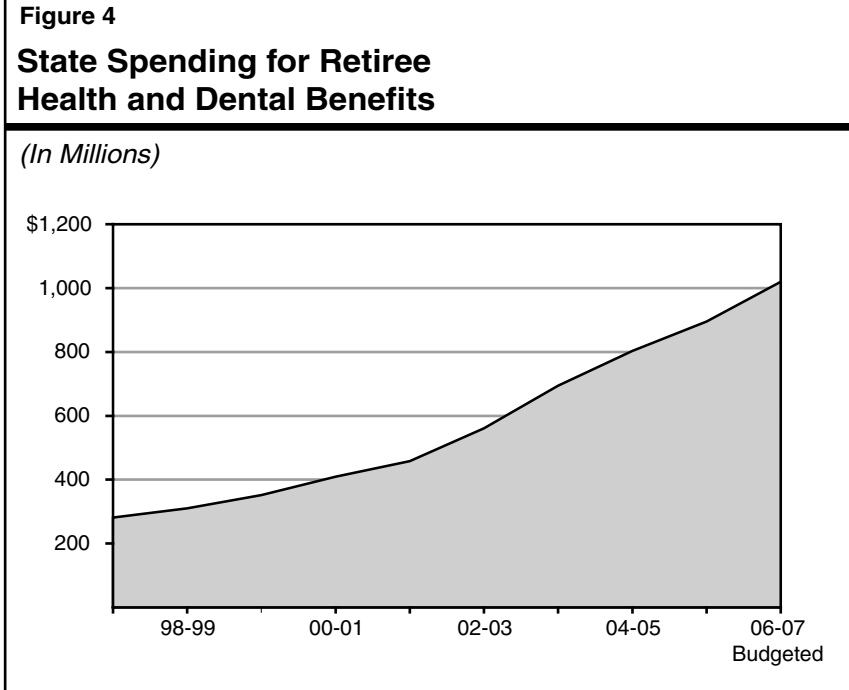
Figure 4 shows that state costs for retiree health and dental benefits have increased rapidly in recent years. They have more than tripled in the last nine years, reaching \$895 million in 2005-06. The 2006-07 *Governor's Budget* projects that retiree health and dental costs will exceed \$1 billion in 2006-07. Since 2000-01, retiree health expenditures have increased an average of 17 percent annually, or more than five times the rate of growth of state spending.

## Why Are Costs Increasing?

***Health Care Costs Have Risen Rapidly.*** For the last four decades, national health expenditures consistently have grown at a faster rate than the overall economy. Since 1999, health spending has increased by more than three times the rate of inflation. Federal data show that the cost drivers in California's health care system mirror those of the nation as a whole: principally, prescription drugs, physicians and other professional services, and hospital care. The bargaining power of hospitals has increased in recent years, and a limited supply of nurses has also contributed to cost increases.

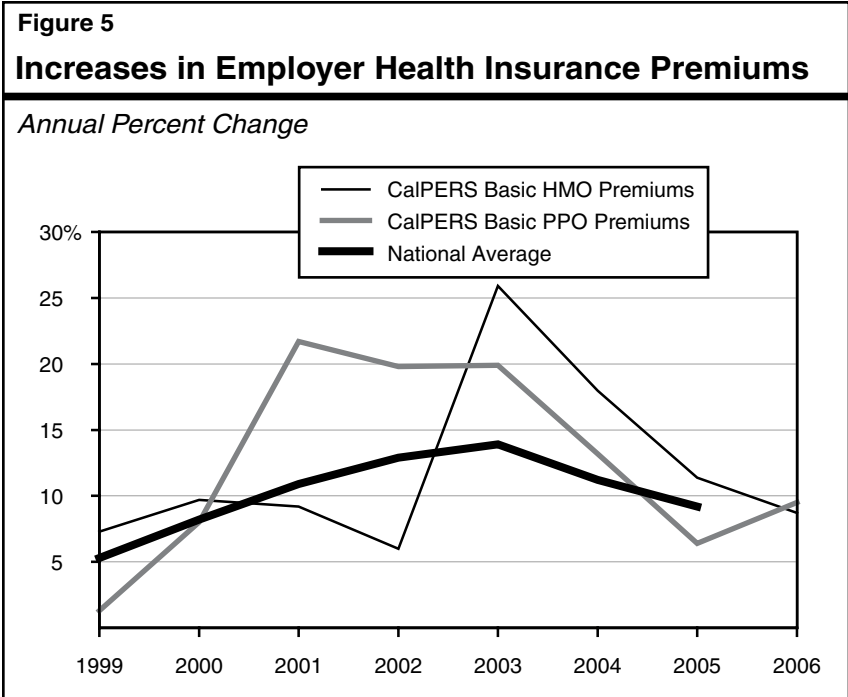
***Employer Health Premiums Rising Even Faster.*** In recent years, employer health premiums—such as those negotiated for the state by CalPERS—have risen even faster than the rate of overall medical expenditures. Employers' expenditures to purchase health coverage reflect the

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general costs of medical care, other costs associated with a private insurance market (insurer reserves, the pricing of pooled risk, and a return on capital), and the health care industry's shifting of costs not paid by the large, but typically unprofitable, Medicare and Medicaid programs. As shown in Figure 5 (next page), the state's premiums in most recent years have risen faster than the national average for public and private employers. The growth each year, which is determined by annual negotiations with health plans, can be quite volatile. Some recent years have seen double-digit increases.

Research shows that trends in the rate of growth of employer premiums follow a cyclical pattern, characterized by some experts as an insurer underwriting cycle. Many, if not most, researchers believe that U.S. health insurers are entering a lull in this underwriting cycle, when annual premium growth will be slower than in recent years. Recent cost containment actions of CalPERS (summarized in Figure 6, see page 127) and other purchasers of health coverage seem to have contributed to a slowdown in premium growth since 2004. In our fiscal outlook for the state, we project that CalPERS premiums will continue to grow through 2010-11, but moderate and move closer to the overall rate of medical inflation over time.



**More Retirees: The Other Cost Driver.** The number of retirees that the state covers in its health programs continues to rise. Californians are living longer, and the large “baby boom” generation has begun to retire. Consequently, state employees are entering retirement faster than prior retirees and family members are dying. Figure 7 (see page 128) shows that the number of retirees covered by state health plans has increased an average of 3.6 percent annually since 1998.

We estimate that 35 percent to 45 percent of the state’s active workforce will retire within the next ten years. Assuming this level of retirements and retirees’ increasing longevity, we forecast that the number of retirees and dependents covered by the state’s health program will increase by almost 4 percent annually through 2010-11. This trend, combined with continued premium growth, results in our projection of continued double-digit growth in the cost of state retiree health and dental benefits. We project that these costs will increase from \$1.0 billion in 2006-07 to \$1.6 billion in 2010-11.

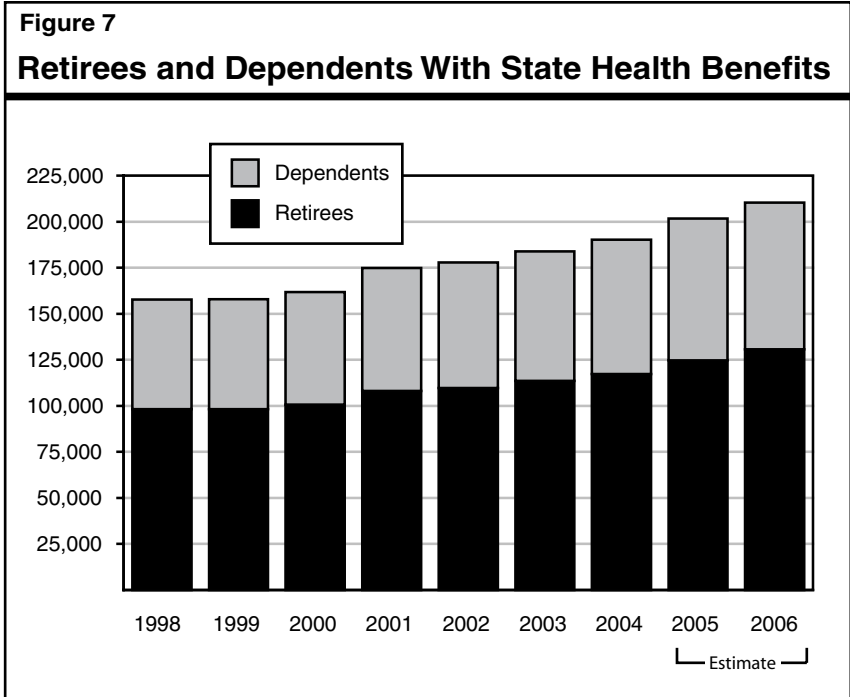


**Figure 6****Selected CalPERS Cost Saving Measures Since 2002**

<b>Action</b>	<b>Comment</b>
Ended relationship with Health Net and PacifiCare Health Maintenance Organizations (HMOs) in 2003.	Avoided \$77 million cost increase for state and local health programs.
Raised office visit copayments to \$10 in 2002, as well as other copayment increases.	First changes in copayments for HMO members since 1993.
Eliminated high-cost hospitals from Blue Shield provider network beginning in 2005.	Saved an estimated \$45 million.
Adopted regional pricing.	Prevented large-scale exodus of local participants in Southern California, which would have diminished health plan's bargaining power.
Provided incentives to purchase over-the-counter drugs and refill prescriptions by mail.	Saved an estimated \$27 million.
Moved certain age 65 and older members from basic to Medicare plans.	Saved an estimated \$19 million.
Building large purchaser coalition, Partnership for Change, to enhance bargaining power.	May produce uniform standards for hospital quality and pricing.
Encouraging health plan partners' disease management programs.	May produce savings and improved care for conditions like diabetes and asthma.

## OTHER PUBLIC RETIREE HEALTH BENEFITS

In addition to state health benefit programs provided through CalPERS, other public agencies in California offer a wide variety of health benefit programs for current employees, retirees, and eligible family members. Some offer coverage until retirees (and, in some cases, family members) reach the age of eligibility for Medicare—usually age 65. Some provide benefits to supplement Medicare after age 65. Below, we summarize selected characteristics of some of these plans.

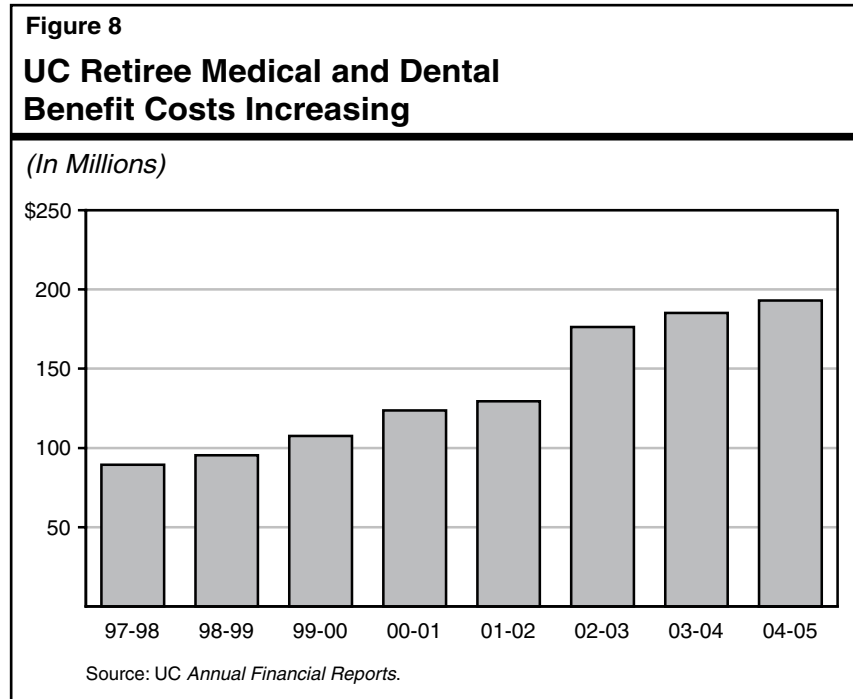


### University of California

The UC administers its employee and retiree health program separately from CalPERS. As a result, there are some differences in plan options and premiums. One difference is that, unlike CalPERS, UC benefit plan documents explicitly state that retiree health benefits are not vested or accrued entitlements and that the Regents may change or stop benefits altogether.

**2006 UC Contributions.** The UC’s maximum retiree health contribution—provided based on years of service—covers most premium costs. For single UC retirees in California under age 65, UC’s maximum 2006 health plan contributions cover all but \$18 to \$27 of monthly HMO premiums and all but \$70 to \$75 of monthly PPO and point of service (POS) plan premiums. The UC also offers a high-deductible fee-for-service plan—for which the maximum UC contribution covers all premium costs—designed to provide some protection in the event of a catastrophic illness. For UC retirees over age 65 and on Medicare, UC’s supplement plans generally have premiums that are entirely covered by the maximum UC contribution (which also typically pays all Medicare Part B premiums).

**Costs Growing Rapidly.** In 2004-05, UC retiree health and dental benefit costs totaled \$193 million, or 1 percent of total university revenues. Between 1997-98 and 2004-05, as illustrated in Figure 8, these costs grew an average of 12 percent annually. The UC retiree population grew at a rate of 2.2 percent annually during this period.



### K-14 Education

**A Wide Variety of Benefit Packages.** Hundreds of California school districts and community college districts offer varying levels of health benefits to employees and retirees. Premiums, employer contributions, copayment levels, deductibles, covered services, and retiree benefits differ based primarily on collective bargaining agreements with certificated employees (that is, teachers and other licensed staff) and classified employees. In contrast to the standardized management of *pension* benefits offered to school employees—through the California State Teachers’ Retirement System (CalSTRS) and CalPERS—administration of school district health plans varies widely.

As of 2004, 114 school and community college districts (out of a total of almost 1,100) contracted with CalPERS for employee and retiree health coverage. About 265 districts purchased coverage through 11 benefit trusts,

which allow multiple districts to join together to achieve economies of scale. In addition, the Kern County Office of Education administers the Self-Insured Schools of California joint powers agency, which provided benefits to more than 250 school employers in 31 counties, as of 2004. The remaining districts either secure health benefits on their own or do not provide these benefits.

***CalSTRS Survey of Benefits.*** A survey conducted by CalSTRS in 2003 revealed more information about the variety of health benefits offered to retired teachers. The CalSTRS estimated that districts covering 57 percent of retired teachers statewide pay all or a portion of retirees' health insurance premiums. The survey, however, showed that only about 7 percent of districts offer lifetime benefits, such as those offered by the state, UC, and by some of the largest school districts, including the Los Angeles Unified School District. In more than half of responding districts retired teachers were required to pay all of their own health insurance premiums beginning at age 65.

***Legislative Actions to Enhance Retired Teachers' Benefits.*** Since 1985, the Legislature has taken several actions to enhance health benefits of retired teachers. Districts that provide health or dental benefits for current teachers must permit retired teachers and their spouses to enroll in the same plan, pursuant to a series of laws that began with enactment of Chapter 991, Statutes of 1985 (AB 528, Elder). Chapter 991 does not include a requirement for districts to contribute to retirees' coverage, and the law also allows plans to set higher premiums for retired members (compared to current employees) based on retirees' typically higher utilization of medical services. Many districts offer only the minimum required benefits to retirees under Chapter 991 and subsequent legislation. A CalSTRS program authorized by Chapter 1032, Statutes of 2000 (SB 1435, Johnston), also pays Medicare Part A premiums for 6,000 retired teachers not automatically eligible for this federal program.

## **Counties, Cities, and Special Districts**

Counties, cities, and special districts offer a wide variety of retiree health benefits. Most appear to offer some type of health benefit to retired employees through a publicly administered health program also offered to current employees. Many offer benefits through CalPERS.

In September 2005, the California State Association of Counties surveyed county officials on retiree health benefits. Of 49 counties responding (including eight of the ten largest counties), 48 reported that retired employees are eligible for some type of health benefits. (Modoc County was the only one reporting that retirees received no health benefits.) An estimated 117,000 retired employees of responding counties currently receive health benefits at a combined cost of around \$600 million per year. In more than

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two-thirds of counties, retirees pay the same premium rates as active county employees. Of the 49 counties, 43 continue to offer health benefits to retirees after the age of 65, and 44 extend coverage to retirees' dependents. Of the total cost for county retiree health benefits, about half is paid directly from county operating budgets, and another one-fourth is paid from funds of retirement systems or county trusts. Almost all counties use a pay-as-you-go approach for part or all of their retiree health benefits. We did not locate similar surveys of cities or special districts during our research.

## **GASB 45: NEW ACCOUNTING RULES**

The rules that govern how governments account for retiree health benefits are in the process of changing. The Governmental Accounting Standards Board (GASB) establishes accounting rules for state and local governments (and related entities, such as public universities and retirement plans). Audited financial statements of governments prepared according to GASB rules are most closely scrutinized by investors in state and local bonds and the rating agencies that make judgments on the likelihood those bonds will be paid off as required. The board was created in 1984 as a parallel to a similar board that governs corporate accounting. In that same year, the Legislature enacted a law requiring the state's financial statements to comply with GASB's rules.

To bring governmental accounting standards more into line with those of private companies, GASB has implemented a series of accounting rules, known as statements, concerning governmental liabilities related to retirement benefits. In 2004, GASB released Statement 45 (GASB 45) concerning health and other non-pension benefits for retired public employees. These benefits, collectively, are known as "other postemployment benefits," or OPEB. Retiree health programs are, by far, the most costly of these benefits.

The GASB has no power to change how governments fund retiree health, pension, and other benefits. Instead, the GASB governs the rules that auditors must follow in providing opinions on the reliability of government financial statements.

### **What Is Required to Comply With GASB 45?**

The new accounting rule dramatically increases the amount and quality of information included in government financial reports with respect to retiree health and other retiree benefits. State and local governments—working with their accountants and actuaries—must take a series of steps that include quantifying the unfunded liabilities associated with retiree health benefits. Results of the actuarial valuations must be reported

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in government audits and updated regularly. The accounting standard sets deadlines requiring large governments (including the state, most counties, many cities, and some school districts) to comply beginning with release of their 2007-08 financial reports. (The state's financial reports usually are released in February or March following the end of the fiscal year.) Smaller governments will implement GASB 45 in the following two years.

Under GASB 45, government financial statements will list an actuarially determined amount known as an annual required contribution. This contribution, with regard to health and related benefits, is comprised of the following two costs:

- The “normal cost”—the amount that needs to be set aside in order to fund future retiree health benefits earned in the current year.
- Unfunded liability costs—the amount needed to pay off existing unfunded retiree health liabilities over a period of no longer than 30 years.

### **New Rules Similar to Existing Pension Requirements**

Retiree health benefits, like pension benefits, are a form of deferred compensation—that is, compensation earned by employees during their working years, but paid to (or used by) individuals after they retire. Pension systems typically are funded by governments paying normal costs each year—as employees earn this type of deferred compensation—and the funds are invested so that they generate returns and grow until required to be paid to the employees after retirement. This is known as “prefunding,” and pension accounting standards focus on how well retirement systems are prefunded. To the extent that funds set aside each year (with assumed, future investment earnings) are insufficient to cover projected benefit costs, the system has an “unfunded liability.” Retiree health programs now will have accounting standards that are very similar. GASB 45 will result in calculation of an unfunded liability for retiree health programs similar to the comparable figure for pension systems.

For governments that fund retiree health benefits on a pay-as-you-go basis (such as the state), 100 percent of retiree health liabilities will be unfunded. (In contrast, the average state pension system currently has about a 20 percent unfunded liability. Although this unfunded liability totals tens of billions of dollars in the cases of CalPERS and CalSTRS, more than 80 percent of their liabilities have been funded in advance from investment returns and contributions by employees and employers.)

The liabilities for retiree health benefits—like those for pension systems—will be determined by actuaries and accountants based on certain assumptions of future health care cost inflation, retiree mortality, and investment returns. This unfunded liability can be characterized as an

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amount which, if invested today, would be sufficient (with future investment returns) to cover the future costs of all retiree health benefits *already earned* by current and past employees.

### **GASB 45 and Other States**

All 50 states offer health benefits to their retirees in some or all age groups. As of 2003, 17 states, including California, covered up to 100 percent of health benefit costs for some retirees. Only 11 states reported any prefunding of retiree health benefits at all (most of these with only a tiny amount of funds set aside). The GASB 45 accounting requirements likely will lead to an increase in the number of states prefunding these benefits. Only a few states have completed the actuarial valuations needed to determine unfunded retiree health and other liabilities, as well as the annual contributions, required by GASB 45. We discuss the status of two states below and corporate responses to similar rules in the nearby box.

*Maryland: Considering How to Finance a Large Liability.* The State of Maryland—which has a AAA bond rating (the highest possible)—assessed its situation relative to the GASB 45 requirements through a valuation completed in October 2005. The state’s unfunded liability under GASB 45, principally for retiree health benefits, was valued at \$20 billion, or about twice the size of the state’s general fund budget. Maryland currently pays \$311 million per year for retiree health benefits on a pay-as-you-go basis. Maryland’s state workforce and retirees number about one-fourth of California’s, and the state annually pays about one-third of the amount California pays for retiree health benefits. Maryland’s annual retiree health contribution under GASB 45, according to the October 2005 valuation, is just under \$2 billion. (This consists of \$634 million in annual normal costs for retiree health benefits earned each year and more than \$1.3 billion in annual costs to amortize Maryland’s existing unfunded liabilities.)

*Ohio: Already Prefunding Some Retiree Health Liabilities.* The State of Ohio generally has been recognized as a leader in addressing retiree health liabilities. A portion of public employers’ retirement system contributions is set aside for funding of retiree health care. The system’s actuarial accrued liability for retiree health and similar benefits was pegged at \$19 billion, as of December 31, 2002. The Ohio system already has set aside \$10 billion to fund these benefits, significantly reducing the unfunded portion of the liability that eventually will be reported under GASB 45.

## **CALIFORNIA’S LIABILITIES: LARGE AND GROWING**

As discussed above, the state and many other public entities (in California and elsewhere) have made retiree health benefits an important

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part of the overall compensation package offered to government workers. These benefits, however, have become significantly more costly than they used to be.

### **Corporate America's Retiree Health Liabilities**

*Sharp Decline in Retiree Health Coverage.* Since corporations began to account for retiree health liabilities in 1990 (due to a change in business accounting standards), investors have pressured them either to fund the liabilities or drop the benefits altogether. The percentage of large private U.S. firms offering health benefits to retirees has dropped from about 66 percent in 1988 to about 33 percent in 2005. The trend among California companies has been similar, with 32 percent of large firms here continuing to offer retiree benefits.

Even companies continuing to offer benefits have cut costs in some cases by: imposing caps on the amount they will pay toward retiree health care; increasing copayments, deductibles, and drug costs paid by retirees; aggressively bargaining with health insurers and providers; and making many other changes. Companies also may seek bankruptcy protection to restructure retirement benefits. (Local governments and school districts also can do this under state law.)

*General Motors Corporation (GM).* The second largest purchaser of employer health benefits in the United States, GM ranks behind the U.S. government and ahead of CalPERS (the third largest purchaser). As of September 2004, GM reported in financial statements that its unfunded retiree health and related liabilities exceeded \$61 billion. Retiree health expenses add significantly to the costs of GM cars and trucks and are believed to have contributed to a decline in the company's finances. Ratings of GM bonds have dropped to junk status, and some have speculated that a bankruptcy filing may be inevitable.

In October 2005, GM and the United Auto Workers (UAW) reached agreement to cut retiree health liabilities by \$15 billion. The company agreed to start a new defined contribution health plan to offset other reductions in the health benefits provided to retired workers. While UAW's rank-and-file employees approved the agreement, implementation awaits a U.S. District Court review of objections from a retiree claiming that UAW lacks the authority to negotiate concessions of retiree health benefits. The retiree claims the benefits are vested contractual rights.

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## **Policy Makers Need Much More Information**

Up until recently, policy makers have had little information with which to evaluate key characteristics of retiree health benefit programs. These characteristics include the programs' long-term costs, how benefits compare with the vast array of retiree health plans offered by other governments, and how other public agencies are addressing these costs. The GASB's new accounting rules will result in important new tools for policy makers to use in evaluating retiree health programs.

## **State Government Liabilities: Likely \$40 Billion to \$70 Billion...Or More**

Over the next year or two, actuaries and accountants will be the experts making complex calculations concerning the size of GASB 45 liabilities for the state and local governments. Our educated guess is that unfunded retiree health liabilities for state government will total in the range of \$40 billion to \$70 billion and perhaps more. (This is based on the results of other liability valuations.) The unfunded retiree health liability may exceed the combined unfunded liabilities of CalPERS' and CalSTRS' pension systems—which were \$49 billion, as of June 30, 2004.

Using Maryland's valuation as a potentially comparable example, we can make a rough guess about the state's annual contribution for retiree health benefits, as defined by GASB 45. This amount might be in the range of \$6 billion. This would consist of about \$2 billion in normal costs (the value of retiree health benefits estimated to be earned by current employees each year) and around \$4 billion more in yearly payments to retire the unfunded retiree health liability over 30 years. Compared to the state's current funding of \$1 billion, the normal costs under this scenario would be about twice the amount the state now spends each year for benefits under a pay-as-you-go system.

## **Other Public Liabilities: Very Large**

We expect that UC, most local governments, and school districts also will obtain actuarial valuations of their retiree health liabilities. Combined, their liabilities could exceed those of the state itself, but there will be significant variation among governments. Some local governments and school districts will have relatively small liabilities and others will have very large ones. (The significant liabilities of the school districts in Los Angeles and Fresno, as an example, are discussed in the nearby box.)

## **State and Other Public Entities Defer Costs to Future Years**

Retiree health benefits, like salaries, are earned during an employee's working years. The benefits, however, are paid out after retirement. Unless

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enough funds (with assumed, future investment earnings) are set aside to cover normal costs of benefits while an employee is working, future taxpayers pay all or a part of the costs of the employee's health care after retirement.

***An Example of Shifting Liabilities to Future Generations.*** For example, take a state employee earning a \$25,000 salary in 1985. In addition to this salary compensation, the employee was promised in 1985 that the state would pay 100 percent of his or her health benefits during retirement (if the employee worked at least 20 years). The state, however, did not set aside any funds for those future health costs in 1985 or in any year thereafter. If that employee retires this year, taxpayers of today and the future must pay about \$5,000 per year for the employee's retirement health costs. While these benefits were earned doing work for the prior generation of taxpayers, the current generation of taxpayers will bear the financial burden of paying for them. In the same way, today's state workforce is earning future retirement health benefits. While paying for current retirees' health costs, the state is not setting aside any money for future costs. The next generation of taxpayers will be left paying this bill. Because health care costs are rising and retirees are living longer than ever before, the future costs will be much higher than the current \$5,000 per year. In this way, each generation shifts a growing liability to the next generation.

***Current Taxpayers Should Pay for Current Expenses.*** The state (and nearly every other public entity nationwide) does not pay its current (or normal) costs for retiree health benefits each year. Consequently, the state fails to reflect in its budget the true costs of its current workforce. Since 1961, the state has been shifting costs to future taxpayers. The tens of billions of dollars in unfunded liabilities now owed by the state is the result of this approach. For this reason, the pay-as-you-go approach to retiree health care conflicts with a basic principle of public finance—*expenses should be paid for in the year they are incurred*. This principle requires decision makers to be accountable—through current budgetary spending—for the costs of whatever future benefits may be promised.

## **ADDRESSING RETIREE HEALTH COSTS: RECOMMENDATIONS AND OPTIONS**

In this section of the report, we:

- First discuss the need for the Legislature to take action to ensure that the vast amount of information about retiree health liabilities soon to be released under the new accounting rules is disclosed publicly. By doing so, the Legislature will improve the information
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available to it (and to local and school district leaders) as these issues are considered over the next few years.

- Next, we recommend prefunding retiree health benefits in order to begin addressing the state's massive unfunded liabilities.
- Finally, we discuss a range of options that the Legislature may consider if it wishes to reduce future cost increases in retiree health benefits.

### **Retiree Health in Two School Districts**

*Los Angeles Unified School District (LAUSD).* The LAUSD is one of the few districts offering comprehensive lifetime health benefits to its retirees. The LAUSD health program covers 32,000 retirees and 18,000 of their family members. The cost to the district is about \$200 million annually.

Like the state, LAUSD pays retiree health benefits on a pay-as-you-go basis. Retiree health benefits have grown from 2.6 percent to 3.9 percent of general fund spending since 2001-02. A July 1, 2004 actuarial valuation pegged the unfunded retiree health liability of the district at \$4.9 billion. Normal costs—the amount needed to keep the liability from growing—were estimated to be \$326 million per year. The actuarial valuation estimated that annual spending of \$529 million would be needed to pay off the unfunded liability within 30 years. Currently, this would raise retiree health expenditures by 8 percent of general fund spending.

*Fresno Unified School District (FUSD).* The FUSD had an unfunded retiree health and other benefits liability of approximately \$1.1 billion before the district ratified a new agreement with the Fresno Teachers Association in August 2005. Previously, retirees with at least 16.5 years of service received premium-free benefits, which continued as supplemental coverage to Medicare after age 65. The new agreement includes various employee concessions, such as a new requirement for retirees under age 65 to pay the same portion of their benefit costs as active employees—reportedly \$40 to \$80 per month—and a cap on the amount FUSD will pay in the future for benefits.

A group of FUSD retirees has indicated that it may file suit regarding the health benefit changes. The group says it was not invited to participate in negotiations on the new agreement.

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## More Disclosure and Planning Needed

Currently, the Legislature—and other elected officials throughout the state—lack much of the information needed to develop a concrete, long-term strategy for addressing retiree health care liabilities. We recommend the Legislature take several actions to make information on these liabilities easily accessible to policy makers, researchers, and the public. Legislative actions also should promote efforts by governments to plan for payment of future retiree health costs.

**Actuarial Valuation.** The State Controller has requested \$252,000 in the 2006-07 Budget Bill to obtain a retiree health actuarial valuation for the state, consistent with GASB 45's requirements. The valuation would provide important information for the Legislature on the magnitude of the state's unfunded liabilities and possible funding options. We recommend approving the State Controller's funding request.

**Inventory of Retiree Health Liabilities Statewide.** As state officials begin the process of evaluating state government's retiree health liabilities, local officials also are beginning the process of complying with GASB 45's requirements. As discussed earlier, GASB 45 will result in government financial statements having information on retiree health liabilities similar to the information already provided for pension systems.

The State Controller already compiles audited reports of state and local pension systems. We believe it would be valuable to have GASB 45 liabilities publicly disclosed in a similar fashion. For this reason, we recommend enactment of legislation requiring governmental entities in California to submit their actuarial valuations to the State Controller. We also recommend that the State Controller be required to post the valuations on the Internet (if governments choose to submit them electronically) and produce a report annually on retiree health liabilities similar to the one produced on the finances of public pension systems. (Any reimbursable state mandated costs under this proposal should be minimal because local governments voluntarily obtain valuations.)

**School District Recommendations.** For some school districts, the size of retiree health benefit liabilities will be so large that unless steps are taken soon to address the issue, it seems likely that districts will eventually seek financial assistance from the state. For this reason, we reiterate our recommendations in the *Analysis of the 2005-06 Budget Bill* (please see page E-50) that the Legislature require county offices of education (COEs) and school districts to take steps to address school districts' long-term retiree health liabilities. Specifically, we recommend that the Legislature enact legislation to require districts to provide COEs with a plan to address retiree health liabilities. We also recommend that the state's school district fiscal oversight process (the AB 1200 process) be modified to require COEs to review

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whether districts' funding of retiree health liabilities adequately covers likely costs. We will discuss this issue further in the Education chapter of the upcoming *Analysis of the 2006-07 Budget Bill*.

**UC Recommendations.** The UC, independently of the state, negotiates with its employees concerning compensation and retirement benefits. Historically, the Legislature has opted to appropriate funds to UC to cover increased health benefits costs. Like the state, UC is expected to release its own retiree health valuation (under the terms of GASB 45) by 2008. We recommend that the Legislature request UC—upon completion of the valuation—to propose a long-term plan for addressing unfunded retiree health liabilities. Such a plan would provide the Legislature with information regarding the long-term costs of the existing benefits and any measures UC plans to take to lower these costs. Upon receipt of such a plan, the Legislature would be in a much better position to consider whether additional General Fund resources should be provided to address any portion of UC's future retiree health costs.

**Recommend Creation of Working Group on State Retiree Health Funding.** Just as we recommend increased planning and disclosure by school districts and UC, we also recommend the state plan for how it might fund retiree health benefits in the future. Consequently, we recommend that the Legislature establish a working group—consisting of representatives from key state agencies—to advance the state's planning. Tasks for this working group might include consideration of and recommendations concerning: the types of prefunding vehicles available under state law and federal tax law, possible choices for a state agency or other entity to manage these funds, investment guidelines, the viability of issuing bonds to reduce retiree health liabilities, strategies to increase the funding for retiree health benefits paid from federal funds, and options to reduce state costs.

We would suggest that the working group provide an interim report to the Legislature on these subjects by January 1, 2008 and a final report by January 1, 2010—following its consideration of the state's first actuarial valuation. In considering the valuation, the working group should review the actuarial assumptions used (for health care inflation and retiree mortality, for example). Rosy assumptions about future health care inflation or investment return could result in a valuation that understates the true magnitude of state liabilities by tens of billions of dollars. For this reason, in its final report, the working group should be required to provide its opinions to the Legislature on the valuation's overall reliability, considering the actuarial assumptions that are used.

## **Funding Retiree Health Benefits**

As discussed above, the state (and almost all other governmental entities in California) pays for the health benefits of retired employees on

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a pay-as-you-go basis. This means that retiree health services are funded when retirees use them. The alternative is to prefund benefits.

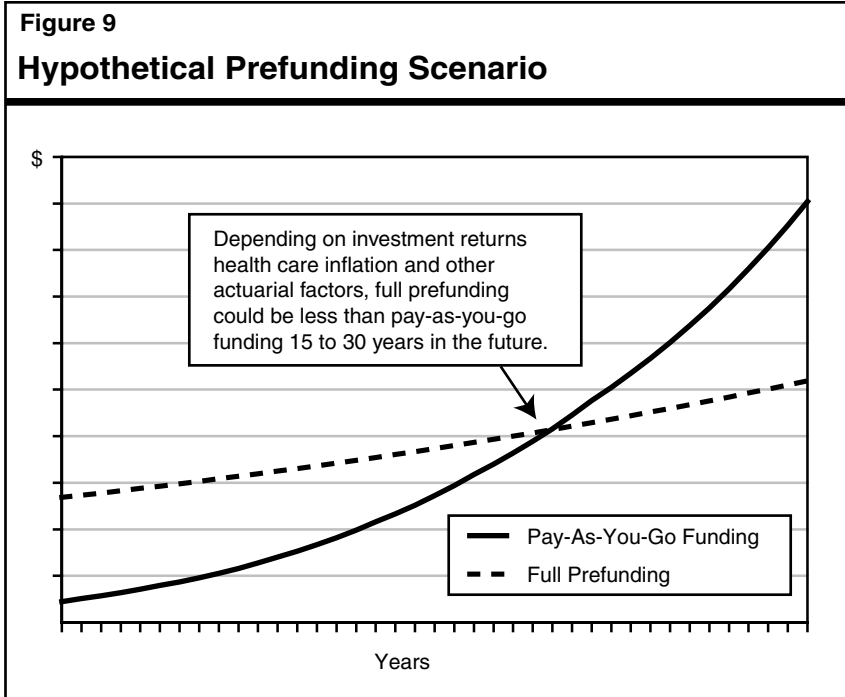
If the state and other governments were starting from scratch today and offering retiree health benefits for the first time, prefunding could be accomplished by paying the normal costs each year—the estimated amount that needs to be set aside and invested to pay for health services after employees enter retirement. However, since the state and other governments have offered these benefits for decades and have not set aside funds, they would have to pay considerably more to fully prefund all benefits. As noted previously, GASB 45 requires the calculation of a full prefunding annual contribution consisting of: (1) estimated normal costs and (2) an amount needed to retire the unfunded liability for unpaid past normal costs within 30 years.

***Prefunding Is the Approach Used for Pension Systems.*** Prefunding is the approach the state uses for its current pension systems. The board of CalPERS, for example, requires the state to pay an amount each year that is set aside and invested to prefund future retiree benefits. This annual amount paid to CalPERS is similar to the full prefunding annual contribution that will be calculated under GASB 45.

There is virtually no dispute that prefunding is the best way to fund a pension system. The Legislature—and California’s voters—have mandated a prefunding policy for state employee pensions for decades. In 1947, the Legislature adopted a prefunding policy for state employee pensions. At that time, the Legislature enacted laws that began to require actuarially determined contributions to the Public Employees’ Retirement Fund. In 1972, the Legislature passed a statute that began to prefund CalSTRS pension benefits under a long-range plan.

***Reasons to Prefund Retiree Health Benefits.*** As noted earlier, a pay-as-you-go approach to funding retiree health benefits is problematic in that it shifts current costs to future taxpayers. The alternative—prefunding benefits—not only avoids this problem, but also results in the following:

- ***More Economical Over Time.*** Over the long term, investment earnings would supplement state and any employee or retiree contributions for retiree health costs. This would allow the state to pay for a given level of benefits with fewer budgetary resources and retire unfunded liabilities for retiree health care. Figure 9 illustrates the long-term benefits of fully prefunding retiree health benefits by contributing the full annual contributions (normal costs and costs to retire unfunded liabilities) specified by GASB 45. Paying more now can dramatically reduce costs over the long term.
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- ***Helps Secure the Benefits Expected by Employees.*** Prefunding creates a pool of assets with which to support future benefits that public employees expect to receive. These assets would strengthen the state's ability to provide these benefits over the long term.
- ***Contributes to Higher Bond Ratings.*** Bond rating agencies, whose evaluations help determine the interest rates paid on state debt, monitor the funding status of the retiree health program. There is no indication that rating agencies will rush to downgrade ratings once GASB 45 reveals large retiree health liabilities. However, unfunded pension and retiree health obligations are viewed by bond analysts as similar to debt. For rating agencies and bond investors, more debt can be a negative consideration. As more states and local governments address retiree health liabilities, rating agencies may compare those governments that have acted with others that have not.

***Partially Prefunding Retiree Health Benefits Is an Option.*** As noted earlier, our rough guess of the state's cost for full prefunding under GASB 45 is in the range of \$6 billion annually. That amount would cover the future costs of today's employees, plus pay off the state's unfunded liability over 30 years. Clearly, given the state's budget situation, immediately moving to this level of funding is unrealistic. Another option is funding part of

the GASB 45 annual contribution. *Any* amount of prefunding reduces the exposure of the state to future increases in health costs. Investment earnings from funds set aside today would help reduce future budget pressures.

**LAO Recommendation.** For the reasons discussed above, we recommend that the Legislature—after receiving the state’s actuarial valuation—begin partially prefunding retiree health benefits. Recognizing the state’s current fiscal condition, we recommend that the state ramp up to an increased level of contributions over a period of several years. The near-term target should be the state’s normal cost level under GASB 45—the amount estimated to cover the cost of future retiree health benefits earned each year by current employees. This amount might be in the range of about \$1 billion above what the state spends under the current pay-as-you-go approach. Funding a minimum of the normal cost each year would help reduce the burden of future taxpayers to pay for benefits earned today. Over the much longer term, the state could then begin to address the unfunded liability that has been accumulated over the past half century.

## Options to Reduce Future Retiree Health Costs

The Legislature and other public policy makers—confronted with an accurate accounting of the long-term costs of retiree health benefits under GASB 45—may wish to consider options to reduce costs. In this section, we discuss such options. Some options would allow continuation of current benefit levels, but perhaps require that employees or retirees bear more of the costs of the benefits. Other options involve reduced benefits.

Whether the Legislature would want to pursue these options would depend on a variety of factors, such as: (1) the desired level of compensation provided to state employees, (2) the amount of the unfunded liability, and (3) other funding priorities. Consequently, at this point, we make no recommendations as to these options.

**For Current and Past Employees, Options May Be Limited.** The ability of companies and governments to cut retiree health benefits for current and past workers is an evolving area of law, according to sources we consulted during our research. To the extent that the state has promised employees—in statute, collective bargaining agreements, or elsewhere—that it will pay a portion of their health care during retirement as deferred compensation, these benefits may be a vested contractual right of the employee, just as pensions are. The Legislature may have little or no ability to unilaterally alter such vested benefits.

**For Future Employees, Extensive Options.** The Legislature has much more extensive options within the law to reduce or alter retiree health benefits for employees that begin state service in the future. There are many such options, including:

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- Changing the current 100/90 formula for retiree health benefits for future hires and their dependents.
- Increasing the share of retiree health benefit costs paid by employees (during their working years) and retirees (through premiums, copayments, deductibles, and similar mechanisms).
- Raising the number of years required to vest in retiree health benefits.
- Establishing a defined contribution program, to which the state would agree to contribute a set amount of money. This would eliminate the risk of unfunded state liabilities, but shift financial risk to retirees.

These types of actions would reduce the state's normal costs for retiree health benefits. Reducing benefits for future hires, however, would not change the unfunded liability already incurred for current and past state employees. Moreover, if the state continued paying for retiree health benefits on a pay-as-you-go basis, changing benefits for future hires would only result in savings decades into the future.

Reducing state costs by taking the types of actions discussed above may create a "two tier" system of retiree benefits (where one group of state retirees receives a richer benefit package than the other). Such systems can be difficult to administer and can cause conflicts between groups of employees and retirees. In addition, since providing retiree health benefits has been an important component of the state's compensation package for its employees, actions to significantly reduce these benefits could affect the state's ability to recruit and retain employees in the future without offsetting compensation increases.

## **CONCLUSION**

Unfunded retiree health care liabilities of the state and other public agencies in California are significant, and over the next several years, these liabilities will be quantified by actuaries and accountants pursuant to GASB 45. Because of the recent, rapid rise of health care costs, this category of state liabilities has been growing very rapidly in recent years. Figure 10 (next page) summarizes our recommendations for the Legislature to develop a strategy that will begin to address these unfunded liabilities and reduce costs imposed upon future taxpayers.

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**Figure 10**

**Summary of LAO Findings and Recommendations  
On Retiree Health Liabilities**



**Unfunded Liabilities**

State government retiree health liabilities are likely \$40 billion to \$70 billion and perhaps more.

Combined liabilities for the University of California (UC), local governments, and school districts could exceed those of state government.



**More Disclosure and Planning**

Recommend approving State Controller's request for \$252,000 in 2006-07 to obtain a retiree health actuarial valuation for the state, consistent with GASB 45.

Recommend requiring public entities choosing to obtain valuations to submit them to the State Controller.

Recommend requiring State Controller to report on retiree health benefits, costs, and liabilities statewide.

Recommend requiring school districts to develop plans to address retiree health liabilities.

Recommend requesting UC to propose a plan to address its retiree health liabilities.

Recommend establishing state working group to report to the Legislature on options for funding and reducing costs of retiree health benefits.



**Funding Retiree Health Benefits**

Recommend beginning to partially prefund retiree health benefits after receipt of state's retiree health actuarial valuation, ramping up to an increased level of contributions over several years.



**Options to Reduce Future Retiree Health Costs**

Extensive options exist to reduce costs for state employees hired in the future.

For costs related to current and past employees, options may be limited.

# A PERSPECTIVE ON EMERGENCIES AND DISASTERS IN CALIFORNIA

***What Is the State's Structure for Preparing for and Responding to Disasters and Emergencies? Should the Legislature Approve the Governor's Emergency Preparedness Proposals?***

## **Summary**

*In its history, California has experienced a wide variety of disasters. The state has developed a solid emergency management structure to respond to these emergencies. Yet, in order to remain effective, the structure relies on constant training and practice.*

*The Governor's budget contains proposals for increased spending of \$61 million (\$54 million General Fund) in the budget year related to the state's emergency preparedness and response—primarily for public health and agricultural emergencies. While some of the proposals are warranted, most of the proposals suffer from one or more deficiencies—such as the failure to maximize funds other than the General Fund, poorly designed solutions, and the failure to follow state information technology policy. Consequently, we recommend the Legislature reject many of the administration's proposals.*

*We also offer a number of key considerations for the Legislature as it evaluates the state's emergency preparedness. We comment on recent federal funding changes, reducing risks through land use decisions, and the creation of separate homeland security and public health departments.*

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## INTRODUCTION

The State of California has a long history of natural and man-made disasters, from earthquakes to fires to riots. As a result, the state also has significant experience in reacting to disasters. Over time, the state developed a formal emergency response structure to manage information and resources.

The terrorist attacks of September 11, 2001 and Hurricane Katrina in 2005 brought national attention to governments' planning and response to major disasters. Problems with response times, communication, and resources brought to light holes in the national disaster response structure. In addition, these disasters have reinforced the need for formal planning and prevention efforts.

These recent national disasters have driven California to reexamine the state's emergency and disaster preparedness and response structure. In this piece, we:

- Provide a broad overview of the state's existing structure for preparing for and responding to disasters and emergencies.
- Describe and analyze the 2006-07 *Governor's Budget* proposals in this area.
- Highlight key considerations for the Legislature as it considers the state's efforts.

## BACKGROUND

### California Disasters

In its history, California has experienced a wide variety of disasters and emergencies. Some of these have been natural disasters—such as earthquakes, floods, fires, and outbreaks of disease or pests. Others are “man-made” disasters—such as riots, hazardous waste spills, failures of levees, and shortages of energy.

Each type of disaster has its own specialized circumstances. For many types of disasters, a state department may be responsible for developing a special response plan. Depending on the type, different governmental entities are involved. Special equipment may be needed to respond. It is beyond the scope of this analysis to provide a detailed overview of each type of potential disaster that the state faces, what activities are being taken to prevent such a disaster, who is in charge, and what plans exist. Rather,

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we provide a broad overview of the state’s *structure* to address various types of disasters below.

### Phases of Emergency Management

Emergency management officials generally use four phases to describe their discipline:

- *In Advance of an Emergency*—(1) Prevention/mitigation and (2) preparedness.
- *At the Time of an Emergency*—(3) Response.
- *In the Aftermath*—(4) Recovery.

Figure 1 summarizes these phases and provides examples of what activities take place in each phase.

Figure 1 Stages of Emergency Management	
Stage and Description	Examples
<b>Prevention/Mitigation.</b> Actions taken to eliminate or reduce the effect of future disasters.	<ul style="list-style-type: none"> <li>• Fuel reduction to reduce the threat of wildland fires.</li> <li>• Immunizations.</li> <li>• Levee construction and maintenance.</li> <li>• State bridge seismic retrofit.</li> </ul>
<b>Preparedness.</b> Activities in advance of disasters regarding planning and the capability to respond.	<ul style="list-style-type: none"> <li>• Developing emergency plans.</li> <li>• Homeland security terrorism drills.</li> <li>• Creation of statewide mutual aid systems.</li> <li>• Vaccine stockpiling.</li> </ul>
<b>Response.</b> Immediate reactions to a disaster to save lives and minimize damage to people and property.	<ul style="list-style-type: none"> <li>• Search and rescue operations.</li> <li>• Electronic alerting system for public officials.</li> <li>• Emergency levee repairs.</li> </ul>
<b>Recovery.</b> Actions to return an area to a pre-disaster setting.	<ul style="list-style-type: none"> <li>• Rebuilding infrastructure and housing.</li> <li>• Planting seedlings in a wildland area damaged by fires.</li> </ul>

## STATE PREPAREDNESS AND RESPONSE

Of the four stages of emergency management, two stages—preparedness and response—tend to involve the most overlap of governmental enti-

ties and responsibilities. Below, we outline the state's statutory framework for preparing for and responding to emergencies, describe key features of the system, and assess the system's strengths and weaknesses.

## **Emergency Services Act**

*States of Emergency.* The Emergency Services Act (ESA) is the statutory framework for the state's responses to emergencies and disasters (Government Code 8550 et. seq.). The act gives the Governor broad authority to coordinate and access resources to respond to the emergency. The Governor can declare a state of emergency when requested by a local entity or if the Governor determines that a problem will require more than a single entity's capabilities. In the event of an emergency, the state's emergency plan is activated and the Director of the Office of Emergency Services (OES) is in charge of response activities (on behalf of the Governor).

*Fiscal Powers.* Upon declaring an emergency, the administration gains vast new fiscal powers. The administration is authorized to access any available funds from any existing appropriation (regardless of its original purpose). Also, the administration may transfer funds from the state's General Fund reserve for up to 120 days after an emergency is declared.

*Other Powers.* The ESA gives the administration many other powers during a state of emergency. For instance, the Governor can issue written orders and regulations that "have the force and effect of law" and take effect immediately. In addition, the Governor is authorized to suspend local zoning, public health, or other ordinances for up to 60 days after an emergency in order to provide temporary housing to victims. The Governor can also commandeer private property and personnel (with reimbursement by the state).

*Legislative Role.* Under the ESA, the Legislature delegates much of its authority to the administration during an emergency. The administration must notify the Legislature when using some of its emergency powers. In addition, the Legislature has reserved the right to end a state of emergency. It can do so by passing a resolution in both houses with a majority vote. (The Governor can also end a state of emergency through a proclamation.)

## **Key Features of Response System**

The Standardized Emergency Management System (SEMS) establishes the state's structure and processes that must be followed by state and local entities in response to an emergency. Below, we summarize the key features of SEMS.

*Bottom-Up Approach.* The current system relies on a decentralized model with response beginning at the local level. Local governments generally are expected to be the first responders to a disaster, using local

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resources. It is only when local resources are insufficient to respond that the emergency is elevated to additional levels of government. (There are some exceptions to this general rule. For instance, when state infrastructure or programs are involved—such as highways, wildland fire state responsibility areas, and state-sponsored levees—the state would be the primary responder.)

***Incident Command.*** One of the keys to responding to an emergency is designating an individual who is in charge. The SEMS uses a tactical decision-making structure that evolved from military use. An “incident command” is established at the site of an emergency to designate the individual who is in charge. The incident commander is determined by who has the jurisdictional responsibility and training to address the emergency. (In some cases, multiple individuals may be designated as part of a “unified command.”) The incident commander is then responsible for determining objectives and timelines related to emergency response at the site.

***Mutual Aid System.*** Some disasters and emergencies require more resources than a single local government can provide. California has a long history of neighboring jurisdictions providing help in these cases. Over time, these “neighbor helping neighbor” policies evolved into formal mutual aid agreements. The state is divided into 58 “operational areas” (with the same boundaries as counties) to coordinate local resources. The state has six formal mutual aid regions layered on top of these operational areas. Many specific types of responders have their own mutual aid agreements. For instance, police and fire departments use the mutual aid system to coordinate responses on a daily basis for events such as severe traffic accidents. Other mutual aid agreements—such as public health and emergency management—are used less frequently. When additional assistance is needed, an incident command alerts the county-wide operational area. The operational area can then manage the need for resources itself or seek assistance through the mutual aid system.

***State and Federal Roles.*** The OES operates the State Warning Center (SWC) to monitor responses to emergencies. When a mutual aid region is unable to provide the necessary resources in response to an emergency, OES staff coordinate assistance on a statewide level. At times, the OES will seek the assistance from other state departments with specific expertise and resources. For instance, in the case of a public health emergency, OES will coordinate with the Department of Health Services (DHS) and the Emergency Medical Services Authority (EMSA). Figure 2 (see next page) summarizes the state’s major entities that are involved in emergencies and disasters and their roles and responsibilities. When resource demands exceed the state’s ability, OES can seek assistance from the Federal Emergency Management Agency (FEMA) or through a mutual aid agreement with other states.

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<b>Figure 2 State Government Agencies Involved With Emergencies and Disasters</b>	
<b>Department</b>	<b>Primary Role and Responsibilities</b>
Office of Emergency Services	<ul style="list-style-type: none"> <li>• Provide training to state, local, and private responders.</li> <li>• Maintain State Emergency Plan.</li> <li>• Coordinate local, state, and federal response to emergencies.</li> </ul>
Military Department	<ul style="list-style-type: none"> <li>• Provide National Guard response in event of disaster.</li> <li>• Coordinate homeland security training and exercises.</li> </ul>
Office of Homeland Security	<ul style="list-style-type: none"> <li>• Provide grants to local governments.</li> <li>• Develop state homeland security strategic plan.</li> <li>• Analyze information related to terrorist threats and critical infrastructure.</li> </ul>
Department of Health Services	<ul style="list-style-type: none"> <li>• Provide grants to local health departments.</li> <li>• Develop public health sections of state emergency plan.</li> <li>• Administer alert network to notify public health offices and medical providers of urgent events.</li> </ul>
Emergency Medical Services Authority	<ul style="list-style-type: none"> <li>• Plan and manage the state’s medical response to disasters.</li> <li>• Coordinate statewide medical mutual aid system.</li> </ul>
Highway Patrol; Department of Justice	<ul style="list-style-type: none"> <li>• Conduct police work in support of emergency services.</li> <li>• Manage recovery logistics.</li> </ul>
Department of Forestry and Fire Protection	<ul style="list-style-type: none"> <li>• Respond to wildland fires on approximately 31 million acres of generally privately owned lands.</li> <li>• Identify areas at high risk for wildland fires.</li> <li>• Participate in fuel reduction programs and enforce state brush clearance requirements.</li> </ul>
Department of Water Resources	<ul style="list-style-type: none"> <li>• Maintain the Central Valley Flood Control System (“Project levees”).</li> <li>• Inspect nonproject levees.</li> <li>• Respond to levee breaks, support local flood responses.</li> </ul>
Department of Social Services	<ul style="list-style-type: none"> <li>• Provide mass care and shelter to evacuees.</li> <li>• Provide access to benefit programs for affected individuals and families.</li> </ul>
Department of Transportation	<ul style="list-style-type: none"> <li>• Inspect transportation system after event.</li> <li>• Communicate safe routes.</li> </ul>
Seismic Safety Commission	<ul style="list-style-type: none"> <li>• Research and make recommendations on earthquake preparation and risks.</li> </ul>
Department of Food and Agriculture	<ul style="list-style-type: none"> <li>• Prevent and respond to pest emergencies.</li> <li>• Inspect dairy and other agricultural production facilities.</li> </ul>



## Strengths and Vulnerabilities of California's System

Based upon our review of the state's structure for emergency response, we find that there are many strengths of the system. The system, however, is not without its vulnerabilities. We discuss both below.

**Strengths of System.** The SEMS provides a solid structure for approaching emergency response. Since local governments are closest to the scene of an emergency, it makes sense that they provide the first level of response. When the situation exceeds their capacity, the system moves outward to neighboring jurisdictions and upward to higher levels of government to supplement their resources. The system of sharing resources helps minimize the need for each jurisdiction to purchase specialized equipment and hire staff for "worst case" scenarios. In addition, since the state often experiences emergencies, it has a lot of practice in implementing incident commands and administering SEMS.

**Vulnerabilities of System.** Despite these strengths, our analysis indicates that the system also has some vulnerabilities. First, SEMS works best with individuals who are used to its processes, requirements, and lines of command. For instance, personnel must know how to determine who should take the incident command, which entities need to be involved, and when local resources are insufficient to address the problem. That means governments must constantly train their staff and practice responses. The system also works best when responders have established working relationships with each other. Staff turnover or a lack of funding can undermine the level of experience necessary to successfully use the system. Finally, SEMS functions on the premise that—when local resources are overwhelmed—another entity will have, and be willing to share, additional resources. The state has been fortunate not to have experienced the largest-scale of disasters, such as a statewide incident. It is, therefore, simply unknown how the system will respond to simultaneous drains on resources.

## Update on Recent Changes

Since September 11, 2001, the federal government has provided the state hundreds of millions of dollars in grant funds to address homeland security (Office of Homeland Security, OHS) and bioterrorism (DHS) priorities. While homeland security and bioterrorism emergencies are only a limited type of the possible emergencies, the influx of federal funding offers the state a rare opportunity to invest in its emergency preparedness. However, our review in the *Analysis of the 2005-06 Budget Bill* (please see page F-13) found that the state lacked a unified strategic approach with regard to these funds. Among our findings were:

- **Homeland Security Lacks a Comprehensive Plan.** Both OHS and DHS prepare a variety of reports and plans to meet federal grant
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requirements. These plans, however, were developed independently of one another, as opposed to taking a comprehensive view of the state's homeland security problems.

- ***Slow Expenditure of Funds.*** Neither department was regularly reporting the status of prior-year grants or what goals the administration was hoping to accomplish with new grants. Our review found that many of the grant programs were having difficulties in spending funds. For instance, as of January 2005, only 31 percent of the \$869 million in total federal grants received had been spent.
- ***Monitoring and Audits Not Performed.*** Our review found that neither department was conducting audits of local government grant recipients to ensure that the funds were being used consistent with requirements and approved proposals.
- ***Lack of Statutory Framework for OHS.*** Since its creation in 2003, OHS has been operating based on executive orders and broader authority under the ESA. Without specific duties, authorization, and powers, we found the office may experience difficulty in accomplishing its objectives.

***Legislative Changes.*** In response to these concerns, as part of the 2005-06 budget package, the Legislature enacted a number of changes to the way homeland security funds are managed. Among the changes adopted were:

- ***Strategic Plan.*** The OHS, in collaboration with DHS, is required to develop a strategic plan for the use of the state's grant funds. The plan is to assess the state's level of preparedness and develop goals and objectives for making improvements. The plan was due to the Legislature on February 1, 2006. The Legislature had not received the plan at the time this analysis was prepared.
  - ***Annual Expenditure Reports.*** Similarly, OHS, in collaboration with DHS, is required to provide an annual grant expenditure report. The report is to track prior grants and develop goals for future grants. As with the strategic plan, the first report was due February 1, 2006, but the Legislature has not yet received it.
  - ***Increased Staff for Monitoring.*** The 2005-06 budget provides both departments with significant increases in staff. For OHS, the budget provides 40 new positions for grant monitoring and other duties. For DHS, the budget provides the extension of 95 positions (that would otherwise have expired) to continue bioterrorism preparedness activities. In providing these staff, the Legislature intended for the departments to provide greater oversight of the grants.
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In addition, in June 2005, the Joint Legislative Audit Committee authorized a Bureau of State Audits review of the two departments' grant programs. That audit is scheduled to be released in the summer of 2006.

## **GOVERNOR'S PROPOSALS**

The state receives more than \$300 million annually in homeland security and bioterrorism funds from the federal government. These funds are intended to improve the state's emergency preparedness and response in case of a disaster. While these funds have some federally imposed restrictions on their allocation and use, the state has a great degree of discretion over how to use the funds each year. In addition, many departments' baseline budgets include funding for emergency planning, training, and response activities.

The 2006-07 *Governor's Budget* contains proposals for increased spending of \$61 million (\$54 million from the General Fund) in the budget year related to the state's preparedness and response to emergencies and disasters. (The Governor also proposes augmentations to current-year public health spending.) These proposals are summarized in Figure 3 (see next page) and described in more detail below.

### **Department of Health Services and the Emergency Medical Services Authority**

The Governor's budget plan proposes to augment state and local public health capacity to prevent and respond to disease outbreaks and disasters. This includes about \$48 million (about \$46 million from the General Fund) and 60 new positions for the budget year, as well as \$12 million (all from the General Fund) and seven positions in the current year. Figure 4 (see page 13) summarizes the Governor's proposals in this area.

*Strengthen Scientific Expertise and Capabilities.* The Governor's budget plan includes multiple proposals to bolster California's scientific expertise and capabilities in regards to communicable diseases. Specifically, the plan includes proposals to: (1) strengthen the infectious disease laboratory infrastructure and provide training for public health laboratories; (2) enhance laboratory capability to identify chemical and radiological agents contaminating food, water, and the environment; (3) develop a program for prevention and control of health care and community infections; (4) expand state and local capacity to conduct communicable disease surveillance; and (5) train existing public health field investigation staff to respond to infectious disease threats and outbreaks.

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<b>Figure 3</b>		
<b>Governor's Major 2006-07 Proposals Related to Emergencies</b>		
<i>(In Millions)</i>		
<b>Proposal</b>	<b>General Fund</b>	<b>Other Funds</b>
<b>Department of Health Services and Emergency Medical Services Authority</b>		
Strengthen scientific capabilities and expertise.	\$11.5	—
Strengthen state and local preparedness and response.	20.1	\$1.8
Public education and media campaign.	14.3	—
<b>Department of Food and Agriculture</b>		
Increase safety of the state's food supply.	\$7.2	—
<b>Office of Homeland Security</b>		
Establish office as separate entity.	—	—
Grants to mass transit operators.	—	\$5.0
Establish science and technology unit.	—	0.5
Increase administrative staff.	—	0.4
<b>Office of Emergency Services</b>		
Expand staffing at State Warning Center.	\$0.6	—
<b>Totals</b>	<b>\$53.7</b>	<b>\$7.7</b>

*Strengthen State and Local Preparedness and Response.* The Governor's budget plan also includes numerous proposals to strengthen state and local pandemic influenza preparedness and response. These include a proposal to: (1) provide funding to local health departments to support local pandemic influenza planning; (2) implement three medical disaster response teams; (3) purchase and stockpile antivirals, vaccines, and medical supplies; (4) bolster DHS's pandemic influenza planning effort; and (5) purchase personal protective equipment for ambulance units.

*Develop Public Education and Media Campaign.* Finally, the Governor's budget plan includes a proposal to develop and maintain a public education and media campaign for emergency preparedness and pandemic influenza. Specifically, the proposal includes funding for: (1) outreach to other state agencies and private organizations to assure that they are addressing the impact of public health emergencies; (2) print, radio, and television advertisements; (3) a telephone hotline; (4) a contract with a public relations firm; and (5) five new staff positions to coordinate the activities.

**Figure 4****The Administration's  
Public Health Emergency Preparedness Proposals***General Fund Unless Noted Otherwise  
(Dollars in Thousands)*

Description	2005-06		2006-07	
	Positions	Funding	Positions	Funding
<b>Scientific Capabilities and Expertise</b>				
Strengthen infectious disease laboratory infrastructure.	1.7	\$470	13	\$4,240
Prepare for chemical and radiological disasters and attacks on food, water, and environment.	—	—	15	4,179
Develop health care and community infection control program.	—	—	10	1,375
Expand local and statewide communicable disease surveillance infrastructure.	—	—	4	1,329
Train public health field staff for outbreak response.	—	200	—	350
<b>State and Local Preparedness and Response</b>				
Strengthen local health department preparedness for pandemic influenza.	1.7	\$4,840	5	\$17,879
Implement California Medical Assistance Teams.	—	—	2	1,750 <sup>a</sup>
Manage and stockpile antivirals and vaccines for pandemic influenza.	0.3	536	1	1,503
Enhance state pandemic influenza and disease outbreak preparedness and response.	1.7	272	5	673
Provide personal protective equipment to ambulance units.	—	2,311 <sup>b</sup>	—	—
<b>Public Education and Media Campaign</b>				
Develop outreach and media campaign for disaster preparedness and pandemic influenza.	1.7	\$3,021	5	\$14,294
<b>Totals</b>	<b>7.1</b>	<b>\$11,650</b>	<b>60</b>	<b>\$47,572</b>

<sup>a</sup> This amount is from reimbursements.<sup>b</sup> Total includes reimbursements of \$689,000.

## California Department of Food and Agriculture

The California Department of Food and Agriculture (CDFA) attempts to minimize and control livestock diseases and contamination of the food supply at the production level. The Governor's budget proposes a \$7.2 million increase to the department's General Fund budget and 39 positions to address threats to food production. The proposal includes funding to: (1) expand laboratory capacity at the University of California at Davis (UCD); (2) conduct community outreach; (3) develop a number of information technology (IT) projects; and (4) expand staff in related areas. The specific proposals are summarized in Figure 5. The proposals assume ongoing General Fund support of \$5.5 million in future years. The 2005-06 Governor's Budget proposed \$2.7 million in General Fund spending for many of the same activities. The Legislature rejected that proposal based on a lack of justification, the failure to coordinate the proposal with other state entities, and the availability of other fund sources.

**Figure 5**

### The Administration's Agriculture Emergency Preparedness Proposals

*General Fund (Dollars in Thousands)*

Description	2006-07	
	Positions	Funding
Expand lab capacity and develop lab information management system.	—	\$2,025
Conduct community outreach and surveillance.	10.0	1,173
Fund emergency response office.	8.0	1,017
Develop animal tracking system.	4.0	753
Assess safety of production facilities.	4.0	588
Review dairy safety measures.	4.0	499
Upgrade communications and databases.	4.0	418
Create research and policy development unit.	3.0	399
Create program to monitor use of personal protection equipment.	1.0	188
Enhance notification systems.	1.0	163
<b>Totals</b>	<b>39.0</b>	<b>\$7,223</b>

## Office of Homeland Security

*Creation of Independent Entity.* As noted above, OHS lacks a statutory framework. Currently, OHS is included within OES for budgetary purposes. In 2005, the administration proposed the creation of OHS as a separate state entity. In anticipation of administration-sponsored legislation to implement this proposal, the Governor's budget creates a new budget item (0685) for OHS. The budget assumes an effective date of January 1, 2007 for this legislation. Consequently, the office's funding for 2006-07 is split evenly between OES's budget and the new budget item.

*Mass Transit Security Grant Program.* The Governor's budget proposes \$5 million in 2006-07 to establish a state grant program for mass transit operators, with ongoing support of \$1 million in subsequent years. The design of the program would resemble a similar federal grant program. Only transit systems in designated urban areas would be eligible for funding. Resources would be allocated according to a formula based on ridership, track miles, number of stations, and threat risk. Unlike the federal program, however, construction and administration costs would be eligible activities. Funding for the program would come from the state Antiterrorism Fund, which receives its support from the sale of California memorial license plates. The proposal would use virtually all of the resources in the fund on an annual basis. (The fund currently has a comparatively large fund balance due to minimal spending in prior years.)

*Expansion of Administrative Staff.* The budget requests an expansion of OHS's administrative staff by \$444,000 (\$344,000 from federal funds and \$100,000 from the Antiterrorism Fund) and nine positions. These positions would provide fiscal services, information technology support, and legal staff.

*Science and Technology Unit.* The administration proposes \$465,000 in federal funds and five positions to establish a science and technology unit at OHS. The staff would be responsible for researching new technological and scientific developments.

## Office of Emergency Services

The administration proposes to increase staff at the State Warning Center (SWC), which serves as the central information point during state emergencies. The budget proposes increased funding of \$617,000 (General Fund) and nine new positions. The department intends to maintain at least three staff at the center twenty-four hours a day.

## Other Proposals

Although not specifically identified as part of the administration's emergency preparedness package, the Governor's budget includes several

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other proposals that would affect the state's emergency preparedness and response. For instance, the Governor's Strategic Growth Plan would provide bond funding for infrastructure that could help prevent emergencies, such as projects related to flood control. In addition, as part of a \$38 million flood management proposal, the Department of Water Resources (DWR) requests \$2.3 million to improve the department's ability to predict and respond to flood events. Finally, the California Highway Patrol (CHP) proposes a \$491 million multi-year project to modernize its radio system. We review these proposals in detail in the *2006-07 Analysis*.

## PROPOSALS FOCUSED ON SCIENCE ARE REASONABLE

Below, we analyze the Governor's proposals. We find that many of the proposals focused on science are warranted.

***Strengthening Public Health Scientific Expertise.*** Numerous reports and studies have indicated that California's scientific and technical infrastructure in regards to public health preparedness is an area that needs improvement. For example, a Little Hoover Commission report found that California needs to substantially improve and modernize its capacity in disease reporting and laboratory diagnostics. Furthermore, the commission indicated that California's laboratories are understaffed and that their scientific expertise needs to be developed. Given that this is an area of weakness in the state's efforts to prepare for and respond to a disaster (whether it be pandemic influenza, another communicable disease, or an act of terrorism), we find that most of the administration's health proposals categorized as "strengthening scientific expertise and capabilities" are justified.

***Homeland Security Unit.*** Likewise, the administration's proposal to create a science and technology unit within OHS using federal funds appears reasonable. The unit would coordinate information related to scientific and technologic research.

***Purchasing Equipment and Supplies.*** Additionally, we find the following DHS and EMSA proposals to be reasonable: (1) administer three medical assistance teams; (2) purchase and stockpile antivirals, vaccines, and medical supplies; and (3) purchase equipment for ambulance units. These proposals would provide tangible benefits to the state, and the resources generally could be used to address a many types of disasters.

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## MANY OF GOVERNOR'S PROPOSALS ARE FLAWED

While some of the Governor's proposals have merit, most of the proposals suffer from one or more deficiencies—such as the failure to maximize funds other than the General Fund, poorly designed solutions, and a failure to follow state IT policy.

### **Failure to Maximize Use of Other Fund Sources**

The state receives more than \$300 million annually in homeland security and bioterrorism funds from the federal government. With a focus on terrorist threats, the grants have some restrictions on their use. A portion of the funds are required to be allocated to local governments and some activities are ineligible for funding. In addition, the grants are funded on a year-to-year basis.

Despite these limits, the grants provide the state with its largest source of funding for high priority state emergency preparedness activities. To the extent possible, the state should use these funds as its first choice for emergency preparedness activities. Once these funds are exhausted, the state should look to other sources of funds, if appropriate—like state special funds or user funding. Given the state's overall budget situation, the state General Fund should be the funding source of last resort. Yet, as we discuss below, many of the administration's proposals use the General Fund as the funding of *first* resort—missing opportunities for alternative funding sources.

***Overdue Reports Would Assist Legislature.*** As noted earlier, OHS, with DHS's assistance, is required to provide the Legislature a homeland security strategic plan and grant expenditure report. To date, the Legislature has not received those reports. The reports would assist the Legislature in determining how the proposed augmentations fit into the state's overall strategy and whether federal funds are available or are already budgeted for these activities.

***Pandemic Influenza Activities Overlap Bioterrorism.*** As we discussed in the *2005-06 Analysis*, the goal of federal bioterrorism funding is to ensure that all state and local public health organizations are prepared to respond to bioterrorism, outbreaks of infectious diseases, and other public health threats and emergencies. The department claims that most of the federal funding has been directed towards bioterrorism-related activities which are dissimilar to pandemic influenza preparedness and response activities.

Our review, however, finds that some of DHS's proposed General Fund spending this year—particularly as it relates to pandemic influenza planning—appears to fall within the parameters of federal funding. In addition, the requests would allocate General Fund monies using the same

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process that the department has used to allocate federal funds. As noted earlier, this process currently is undergoing an audit due to questions about its effectiveness in getting funds spent in a timely manner. Until the Legislature receives the above-mentioned reports, it will not be in a position to evaluate whether DHS has maximized its use of federal funds for the programs it has identified as having a high priority.

***Most Agriculture Activities Appear Eligible for Federal Funds.*** As noted above, CDFA's current request is an expansion of a proposal rejected by the Legislature last year. One of the reasons that the Legislature rejected the prior request was the department failed to account for the availability of homeland security grant funding. This year, the request references several instances of the receipt of federal funds offsetting the need for General Fund support. The CDFA reports that it exhausted all additional federal funding options.

Our review, however, indicates that most of the department's proposal is consistent with federal funding parameters for the largest grants received by the state. Moreover, the federal government recently placed an emphasis on supporting agricultural-related prevention with its grants. Eligible activities under federal grant guidelines include conducting public education campaigns, promoting business emergency preparedness, conducting vulnerability assessments, and developing security plans. Eligible equipment purchases include agricultural terrorism prevention, response, and mitigation equipment.

The OHS reports that agricultural terrorism is one of the state's 15 funding priorities for the coming year. The OHS is in the process of reviewing and prioritizing state agency funding needs in anticipation of submitting a consolidated grant application to the U.S. Department of Homeland Security. By proposing General Fund spending, the administration has indicated that it deems CDFA's activities to be a spending priority. We find little reason, therefore, why most of CDFA's proposals could not instead be priorities within the federal application.

***New Health Funds Available.*** We also note that after the Governor's budget plan was developed, the federal government awarded California \$9.6 million (including \$2.9 million for Los Angeles County) for pandemic influenza preparation. An additional \$250 million is to be allocated nationally in the future. At the time this analysis was prepared, DHS could not provide information on whether these new federal funds could be substituted for the General Fund resources included in its 2006-07 budget proposals.

***Funding Already Dedicated to Water Security.*** The administration's proposal to assist local agencies in planning, training, and responding to water contamination with \$1.5 million in General Fund resources fails to

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account for funding that is already available for these purposes. Federal bioterrorism funding, a grant from the U.S. Environmental Protection Agency, and Proposition 50 bond funds are already available for purposes outlined in the Governor's budget request. During the last three years, the state has appropriated more than \$37 million from these funding sources for water protection activities, which calls into question whether this separate new program is warranted. Furthermore, \$2 million in Proposition 50 bond funds remain available that could be used in place of General Fund resources proposed in the budget plan.

***Industry Should Contribute to Costs.*** A number of the administration's proposals could be fee-supported in that they are regulatory-based and/or provide direct benefits to industries. For instance, components of DHS's and CDFA's proposals would directly benefit food processors and manufacturers.

Regarding the DHS food contamination proposal (\$1.4 million), the department already inspects, surveys, and oversees food processors and manufacturers for food contaminants on a fee-supported basis. Because the new activities proposed by DHS are an expansion of its current fee-supported duties to prevent food-borne illness and consumer injuries, these new costs should be fee supported.

Similarly, CDFA proposes to conduct security assessments of dairies, farms, ranches, and agricultural production facilities (two components totaling \$1.1 million). The CDFA already assesses regulatory fees on these industries, and the proposed activities are consistent with other inspection activities. In addition, the federal government has already (1) developed model food security plans for producers and (2) funded the development of a course at UCD to enhance agricultural production security. These federal activities may make CDFA's activities unnecessary.

Finally, the DHS request to develop and maintain a \$1.4 million program for the prevention and control of health care infections would directly benefit health care facilities. This new program would help health care facilities reduce the number of costly infections. For example, according to DHS, in California's 450 hospitals, health care-associated infections account for an estimated 300,000 infections, 13,500 deaths, and \$675 million in excess health care costs annually. Therefore, we believe imposing fees on these facilities to support the Governor's new programs in this area is a reasonable approach.

### **Some Proposals Ill-Conceived**

***Media Campaign Is Not Justified.*** The administration is proposing an ongoing DHS public education and information campaign regarding general emergency preparedness and response and pandemic influenza

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preparedness and response. We question the need for this campaign, given that the state already has developed emergency preparedness and influenza media campaigns. For example, OES's "Be Ready!" campaign was launched in April 2005 to address these same issues. In addition, the state already has sufficient public relations staff at DHS and the Health and Human Services Agency (HHS) that could supplement these efforts with free public service announcements.

Finally, based on our discussions with the administration, it is unclear why five new permanent staff positions are needed to implement a campaign, especially given that the proposal includes contract funding for public relations. The department was unable to specify what these positions would do after the media campaign was developed.

***Surveillance Would Be Ineffective.*** The CDFR proposes to establish a program to increase outreach and surveillance in urban and rural areas to detect agricultural diseases and provide education about preventing their spread. The department proposes to visit specialty markets, auctions, swap meets, feed stores, shows, and fairs. Because of the vast number of these venues across the state, we are skeptical that a ten-member surveillance and education team would have even a minimal effect on disease detection. The state already has a network of local agricultural commissioners, public health officials, and UC cooperative extension offices. These entities have an established presence in every county and would be better able to target local efforts.

## **IT Projects Fail to Follow State Policy**

***Agriculture IT Projects.*** Within its proposals, CDFR proposes to fund five IT projects. The department's projects include upgrading communication and data management systems, enhancing notification systems, developing an animal identification and movement tracking system, and developing a database for its emergency response office. In addition, within its proposal to enhance laboratory capacity is funding to develop an IT system. Collectively, these proposed projects total \$2.2 million in 2006-07.

***Required Documents Not Prepared.*** The CDFR has not submitted feasibility study reports (FSRs) for any of these proposed IT projects. Under state policy, FSRs are required for IT projects to ensure that such projects address business needs, contain realistic budget assumptions, and appropriately manage risks. Because of the importance of FSRs for project planning and budgeting, the Legislature stated its intent in the *2005-06 Budget Act* (Control Section 11.05) not to approve funding for information technology projects without FSRs approved at the time of the budget request.

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## Homeland Security and Emergency Services Overlap

The administration has proposed that OHS and OES be separate entities, both reporting directly to the Governor. Although OHS is currently budgeted within OES, the two entities largely have been operating independently of one another. Although homeland security and emergency services can be distinguished from one another in some respects, the activities tend to overlap. For instance, although OHS administers the federal homeland security grants, many grant activities are related to overall emergency planning and response (overseen by OES). Given the current structure, it is likely that federal grant funds allocated by OHS have been used for more narrow homeland security purposes than if OES allocated the grants. The OES would be more likely to integrate the federal funds with existing emergency preparedness activities.

In addition, as noted earlier, the state's emergency response system depends on solid working relationships among participants. Separating grant administration from day-to-day emergency response means that local governments have to forge relationships with two separate state entities.

## Fill Vacancies Before Adding More Positions

In two instances, the administration is proposing adding new positions to offices that have a number of vacant positions for similar duties.

**Homeland Security Slow in Hiring Staff.** The 2005-06 budget provides OHS with a four-fold increase in staffing—bringing total authorized personnel from 13 to 53. These additional staff are intended to handle the office's growing duties, such as administering grants, reviewing dangers to infrastructure, developing the homeland security strategic plan, and related administrative duties. The Governor's budget proposes an additional nine positions for administrative duties within its grant management unit. The administration asserts that the increased positions are justified based on growing workload. Yet, OHS reports that it still has 22 unfilled positions on its existing staff—an overall office vacancy rate of 42 percent.

**Warning Center Staffing.** Similarly, the Governor's budget requests four new emergency services coordinators and four new emergency notification controllers for OES to improve staffing coverage at the SWC. The department already has a total of 51 authorized positions in these two classifications. Yet, according to data from the State Controller's Office, 33 of the existing 51 positions are currently unfilled—a vacancy rate of 65 percent.

## Antiterrorism Fund Should Be Used to Fill Funding Gaps

**Funding for Mass Transit Security.** In 2005-06, California received approximately \$19 million in federal support for transit security. A com-

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parable level of federal funding is expected to be available to the state in 2006-07. Mass transit systems also are eligible recipients under many other federal homeland security grants. In addition to these funds, the administration proposes a new \$5 million grant program for mass transit operators using state monies from the Antiterrorism Fund.

***Program Would Only Make Marginal Improvements.*** Like other local entities, mass transit operators have large security concerns. For example, the Bay Area Rapid Transit (BART) district estimates \$250 million in necessary security improvements. Spread statewide, the proposed \$5 million program would provide only minimal resources to address these demands. In some cases, however, additional funds would help provide some flexibility for activities that are ineligible for federal funding, like minor construction projects.

***Proposal Conflicts With Legislative Intent.*** The Antiterrorism Fund is the state's only dedicated fund source for homeland security activities. The monies can be used to fund activities that are ineligible for federal funding. The proposed use of the Antiterrorism Fund for mass transit security would deplete the fund's resources. When the Legislature established the fund, it specified that one-half of the funds should be used by the Office of Criminal Justice Planning (now part of OES) and the other one-half of funds should be used by other departments. As such, using almost the entire fund balance for a single program is inconsistent with the original intent of the fund—to address multiple departments' homeland security requests.

### **Most Current-Year Proposals Should Wait for Budget**

As noted above, DHS is proposing almost \$12 million in additional current-year funding. The administration intends to introduce legislation to appropriate these funds. Many of the current-year proposals are complex and would have implications for other components of the state's overall emergency preparedness. Given the number of concerns we have raised, we believe the regular 2006-07 budget process would give the Legislature the best opportunity to fully evaluate most of the proposals. (In the section below, we outline our specific recommendations.)

## **LAO RECOMMENDATIONS**

Based on our review, we recommend rejecting many of the administration's proposals. Our recommendations are summarized in Figure 6 and discussed in more detail below. In total, we recommend rejecting \$48 million of the administration's \$61 million budget-year spending. These recommendations would reduce General Fund spending by \$45 million in 2006-07. More than one-half of the amount recommended for rejection could be funded using federal dollars.

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**Figure 6**

**LAO Recommendations on Governor's Proposals**

Proposal	Recommendation
<b>Department of Health Services and Emergency Medical Services Authority</b>	
Strengthen scientific capabilities and expertise.	<ul style="list-style-type: none"> <li>• Reject \$4.3 million for food and water disasters and healthcare infection control program. Other fund sources exist.</li> </ul>
Strengthen state and local preparedness and response.	<ul style="list-style-type: none"> <li>• Reject \$18.6 million related to pandemic influenza. Federal funds are available.</li> </ul>
Public education and media campaign.	<ul style="list-style-type: none"> <li>• Reject \$14.3 million proposal. Campaign overlaps with existing efforts.</li> </ul>
<b>Department of Food and Agriculture</b>	
Increase safety of the state's food supply.	<ul style="list-style-type: none"> <li>• Reject \$7.2 million proposal. Federal and other funds exist. Some components not justified.</li> </ul>
<b>Office of Homeland Security</b>	
Establish office as separate entity.	<ul style="list-style-type: none"> <li>• Establish as division within Office of Emergency Services.</li> </ul>
Grants to mass transit operators.	<ul style="list-style-type: none"> <li>• Reduce by \$2.5 million to allow funding for other departments' homeland security needs.</li> </ul>
Establish science and technology unit.	<ul style="list-style-type: none"> <li>• Approve as budgeted.</li> </ul>
Increase administrative staff	<ul style="list-style-type: none"> <li>• Reject \$0.4 million proposal until vacancies are filled.</li> </ul>
<b>Office of Emergency Services</b>	
Expand staffing at State Warning Center.	<ul style="list-style-type: none"> <li>• Reject \$0.6 million proposal until vacancies are filled.</li> </ul>

**Reject Most Public Health Requests.** We have no objection to DHS’s and EMSA’s requests for current-year funding to purchase vaccines and equipment for ambulance units (\$2.8 million), which would provide equipment and supplies. However, for the reasons outlined above, we recommend that the Legislature reject the remaining \$8.8 million of the current-year request.

Regarding DHS’s budget-year request, we recommend approval of \$7.2 million in General Fund spending for developing scientific expertise, roughly two-thirds of the amount requested. In addition, we recommend approval of the proposals to address the potential for food contamination

and the health care infection control program. However, we would replace the \$2.8 million in General Fund support for these two requests with support from user fees. We also recommend deleting DHS's \$1.5 million General Fund request for water security because these activities likely are eligible for federal and Proposition 50 bond funds.

Regarding preparedness and response activities, we recommend deleting \$18.6 million in General Fund support for two pandemic influenza components of the DHS request because federal bioterrorism funding is already available for these purposes and because forthcoming federal bioterrorism grants could be used in the future for these activities. We recommend approval of EMSA's request for \$1.8 million in reimbursements for medical assistance teams.

Finally, we recommend deleting the proposed \$14.3 million in General Fund resources for a media campaign because it is duplicative of other state efforts.

***Reject Entire Food and Agriculture Request.*** We recommend deleting the entire \$7.2 million request from CDFA. As with last year's proposal, the current request fails to maximize the use of available federal funds. In addition, the surveillance program is unlikely to be effective, required IT planning has not occurred, and industry activities could be funded through fees.

***Homeland Security Should Be Part of OES.*** We recommend rejecting the proposal for a separate budget item for OHS. The OHS and OES have overlapping activities and need to work closely together. The OHS should be established as a division within OES. The Legislature should provide specific statutory authorization for OHS and delineate the office's duties and powers (within OES). Such an approach would make it clear that OES is in charge in case of disaster preparedness and response.

We recommend approving the request for a science and technology unit. We also recommend approving a scaled-down mass transit security funding program of \$2.5 million. The mass transit program should be funded on a one-time basis, so that uses for the Antiterrorism Fund can be evaluated on an annual basis. Consistent with legislative intent, the remaining \$2.5 million could be used to fill in the gaps of departments' requests that are not eligible for federal funding. Given that OHS is still filling positions from last year's significant expansion, it is premature to add additional administrative staff. We therefore recommend deletion of the \$444,000 and nine administrative positions requested.

***Emergency Services Should Fill Vacant Positions.*** Before submitting requests for additional positions, OES should fill existing positions and then reevaluate its workload. Consequently, we recommend deleting the request for increased staff at the SWC.

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## OTHER KEY CONSIDERATIONS

The Governor's proposals described above are aimed largely at two specific potential disaster areas—public health and agriculture. There are a number of other emergency and disaster issues that the Legislature may wish to consider, which we highlight below.

### Federal Funding Trends

Since September 11, 2001, the federal government has provided state and local governments nationally with billions of dollars in homeland security and bioterrorism grant funds. While California has received over \$1 billion from these allocations, many observers have noted that the state has received a proportionately smaller share of funds than other states, based on population. While California has more than 12 percent of the nation's population, a 2004 report by the Public Policy Institute of California found that the state was receiving less than 8 percent of the national homeland security funding. The federal government has since made a number of changes in its funding amounts and allocations—some changes benefiting the state and others reducing state funding. We discuss these changes below.

***Reduced Grant Amounts.*** Due to federal budget reductions, the overall level of federal funding for state and local governments has declined in the past couple of years.

***Emphasis on Risk.*** Partially offsetting the reduction of overall funding, the federal government has increased its emphasis on risk-based allocations. Given California's large size and high-risk targets, this policy change will tend to shift a proportionately larger share of funds to the state. The President's proposed 2006-07 budget (for the federal fiscal year starting in October 2006) would continue this trend.

***Shift to Urban Grants.*** The federal government has also shifted a greater percentage of funds from the State Homeland Security Grant Program to the Urban Area Security Initiative Grant Program. The state program provides funds to the state and all local governments. The urban area program, however, concentrates funding to only the major metropolitan areas deemed to be at the highest risk of terrorism. This change can have mixed effects for California. Those urban areas that are deemed high risk, like Los Angeles and the Bay Area, have received proportionately more funding. Other areas, like Sacramento and San Diego, were recently dropped from the list of high-risk areas.

***Other Funding Considerations.*** To date, the state has played a somewhat passive role in how local governments use their federal funding. Allocations generally are made to counties on a population basis. A local

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committee then determines the use of the grant funds within the county. This system allows local communities to spend the funds on what they deem to be their highest needs. However, this system also may hinder efforts to achieve statewide objectives.

## **Reducing Risks Through Infrastructure**

Investing in infrastructure has been a major component of the state's prevention/mitigation phase of emergency management. For example, most of the state's buildings and bridges have been retrofitted to seismic safety standards. As the Legislature continues to evaluate the Governor's proposed infrastructure plan, it may wish to consider how that plan affects the state's emergency management. We discussed above the infrastructure demands facing mass transit agencies to upgrade their security. Below, we provide two additional examples—flood control and hospital seismic safety—of how infrastructure decisions can affect the state's emergency preparedness.

***Flood Control.*** The state is responsible for the operation and maintenance of the Central Valley flood control system, which contains approximately 1,600 miles of levees. The Central Valley levees were constructed largely by local interests early in the twentieth century to protect agricultural lands. The levees were not constructed to meet modern engineering standards and were not designed to provide protection to the urban areas that have since developed behind them.

In addition to the state's responsibility for flood control in the Central Valley, the state has an important interest in the levee system in the Sacramento-San Joaquin River Delta (although it is not directly responsible for most of this levee system). This is because the operation of the State Water Project, which supplies drinking water to over 20 million people in Southern California, relies on the continued operation of the Delta levee system. If one or more Delta levees were to fail (as occurred in June 2004 at Jones Tract), the State Water Project pumps would have to be shut down to prevent salt water from the San Francisco Bay from being drawn into the drinking water system. The Delta levee system has similar design deficiencies as the Central Valley system, as well as the continuing erosion of Delta islands (which puts increasing pressure on the levees protecting them) and the potential that an earthquake in the Bay Area could cause multiple levee failures.

The DWR has estimated that billions of dollars are necessary to restore and/or upgrade these flood management systems.

***Hospital Seismic Safety.*** Following the 1994 Northridge earthquake, California significantly amended its hospital seismic safety requirements through the passage of Chapter 740, Statutes of 1984 (SB 1953, Alquist).

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Chapter 740 mandates that acute care hospitals classify their buildings into one of five categories according to the risk of damage in an earthquake. By January 2001, hospitals were required to submit to the Office of Statewide Health Planning and Development (OSHPD) evaluations of their buildings' seismic vulnerability and their plans to replace or retrofit each building used for acute care. The next major deadline for hospital seismic compliance is January 2008, when hospitals must ensure that all acute care buildings do not significantly jeopardize life in the event of an earthquake. Hospitals may also apply to OSHPD for an extension of up to five years to meet the 2008 standards.

The evaluations submitted to OSHPD in 2001 placed about 37 percent of the state's acute care hospital buildings in the riskiest category for structural safety. However, there is no data since 2001 regarding how many of the riskiest buildings have been brought into compliance with the 2008 deadlines, nor any existing requirements for hospitals to submit additional information prior to that deadline. Given the lack of information on the progress of hospitals across the state relative to the established deadlines, the Legislature should consider directing OSHPD to survey hospitals' status. A survey could determine the number of hospitals that still have noncompliant buildings and their current stage in the construction, retrofit, or closure process.

### **Reducing Risks Through Land Use Decisions**

By influencing land use decisions, the state may be able to reduce the damages associated with disasters. We discuss two such approaches below.

*Land Use Planning and Flood Control.* As was mentioned above, the state is responsible for the operation and maintenance of the Central Valley flood control system. In addition to the state's financial responsibility for operating and maintaining the state system, the state has been found liable for the flood damage that occurs when a deficient levee fails. While the state system was principally designed to protect agricultural land uses, there has been heavy population growth in the Central Valley in recent decades. Much of this development is protected by levees that are inadequate for urban flood protection.

While the state is ultimately responsible for this risk of catastrophic floods in the Central Valley flood control system, the state has little say in the land use decisions that allow development behind inadequate levees. There have been several proposals made to more closely tie land use decision-making to the public safety and financial risks of future floods, including:

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- Mandating that property owners in all floodplains purchase flood insurance.
- Limiting the availability of state funds for local flood control projects in cases where local jurisdictions are approving development in flood-prone areas.
- Enacting a fee on new development in flood-prone areas to pay for additional flood protection.
- Requiring local governments to certify that new development will be protected by an adequate level of flood control.

While none of these proposals would eliminate future flood risks, they may have the effect of discouraging development in the most flood-prone areas of the Central Valley by making consideration of flood risks a part of land use decision-making.

***Encouraging Fire-Safe Local Planning Decisions.*** The increasing presence of homes in areas of high fire risk is expected to result in the continued increase in state expenditures for wildland fire protection. Although the costs associated with wildland fires are often borne by the state, as with flood risks, the state has little say in the local land use decisions that put these homes in high-risk wildland fire areas.

We think the state should encourage local governments to make fire-safe planning decisions—local planning actions that account for and reduce the risk from wildland fires. These could include making land use decisions that locate development in a way that minimizes the risk of wildland fires, developing fuel management plans, and making sure that building codes and designs address the risk from wildland fires. We discuss in greater detail opportunities to provide incentives for fire-safe planning decisions in our April 2005 report, *A Primer: California's Wildland Fire Protection System* (see pages 20 to 21).

## **Communication During Emergencies**

Immediate and reliable access to information is fundamental to public safety agencies' ability to respond to emergencies and disasters. To effectively manage such incidents, communication systems must allow officers from one public safety agency to communicate with officers from other agencies—known as “interoperability.” Achieving interoperability statewide has been an ongoing effort that has been hindered by both technical and policy considerations. For instance, limited radio frequencies available to public safety agencies has hampered progress. In addition, some safety agencies have been reluctant to cede control over purchasing decisions.

***State Efforts.*** Chapter 1091, Statutes of 2002 (AB 2018, Nakano), assigns the Public Safety Radio Strategic Planning Committee primary

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responsibility for developing and implementing a statewide radio system that facilitates interoperability among all of the state's public safety departments. The committee is also responsible for assessing the need for new or upgraded equipment and establishing a program for equipment purchase. The California State Interoperability Executive Committee, originally established to meet federal communication guidelines, plays a similar role for the state as it relates to communicating between state, local, and federal agencies.

*Buying More Equipment, But Still No Statewide Plan.* It is unclear that the state needs two committees working on similar efforts to establish interoperability plans. Moreover, neither committee has significant authority to direct agencies in their purchasing decisions. While the committees continue their work, public agencies across the state are already using allocations from the homeland security grants and other funds to invest in new communication systems without a statewide plan. (We discuss such a state proposal from CHP in the Transportation Chapter of the *2006-07 Analysis*.)

### **Considering Public Health As a Separate Department**

*Creating a Department of Public Health.* Earlier in this piece, we discuss whether OHS should be a separate entity from OES. The Legislature also may wish to consider other organizational issues to ensure that the state is administratively structured in the best possible way to prepare for and respond to emergencies.

For example, the Little Hoover Commission has recommended creating a new Department of Public Health. The rationale for such an approach includes these concerns: (1) the administration of the Medi-Cal program dominates DHS to the point that other functions such as emergency preparedness receive lower priority; (2) public health functions are disorganized because they are distributed among several departments; and (3) the current fragmentation of public health programs among DHS and other state agencies makes it difficult for the state to monitor health trends and use scientific techniques to diagnose problems and craft solutions. A bill pending before the Legislature, SB 162 (Ortiz), builds upon the commission's recommendations. In order to provide a greater focus to public health programs and emergency preparedness and response activities, the Legislature should further explore a consolidated public health department. Below, we discuss the advantages and disadvantages of such an approach.

*Advantages.* The main advantage of centralizing public health activities is the greater focus it would provide on improving the state's health through public health activities and enhancing public health emergency preparedness. Second, a centralization of public health programs may ex-

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pedite policy and budget decisions. Finally, a centralization of core public health functions in one department may reveal funding opportunities or efficiencies that are not as apparent or achievable when the programs are located in separate departments.

**Disadvantages.** The consolidation of public health programs could also result in disadvantages. First, as proposed by the commission, the department would be outside of HHSA and on par with HHSA and other cabinet-level agencies in the state government organizational structure, with the public health director reporting directly to the Governor. Our assessment is that the location of a public health department outside of HHSA would probably hinder state efforts to coordinate health-related programs and activities. Second, the separation of DHS public health programs from Medi-Cal could lead to missed opportunities for the integration of public health research and information into health care delivery systems (such as Medi-Cal managed care). Finally, reorganizing departments could mean short-term delays in moving ahead with current emergency preparedness activities.

## **Emergency Health and Social Services**

Recent hurricanes brought California an influx of disaster victims from other states, some of whom ended up on California's social services programs. Based on this experience, the Legislature may wish to consider revising the state's social services and health programs for similar circumstances in the future.

**Current Federal Law.** Federal law provided emergency funding to states that gave cash assistance to evacuees from Hurricanes Rita and Katrina. However, to be eligible for this federal funding, states must have already established an emergency program distinct from its regular Temporary Assistance for Needy Families (TANF) program. (California's version of TANF is known as the California Work Opportunity and Responsibility to Kids [CalWORKs] program, and currently the state has not established a distinct program for evacuees.) The federal government also permitted states to accept self-certification of identity, residence, citizenship status, and financial situation for purposes of eligibility for Food Stamps for up to four months. With respect to the TANF program, federal law leaves eligibility rules, including authorization for self-certification, up to the states.

**Current State Law.** The CalWORKs program is designed to help families transition from welfare to work. It has no specific provisions pertaining to displaced disaster victims. (State law does provide for a supplementary benefit program for households affected by *California* disasters.) Consistent with the federal Food Stamps directives, the Department of Social Services allowed hurricane victims to also self-certify eligibility for CalWORKs for up to four months, even though there was no specific statutory authority

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to accept self-certification. Because California had no separate program, the 2,500 evacuees became a state responsibility, with no additional federal funding to cover cash grants and other social services.

*Creating an Emergency CalWORKs Program.* For future disasters, the Legislature may wish to create an emergency CalWORKs program for several reasons. First, by creating a separate program, California could be eligible for future federal reimbursement for cash assistance and other services provided to specified disaster victims or evacuees. Second, in the event of disasters declared by the President and Governor, the Legislature could provide statutory authority to temporarily authorize for up to four months self-certification for certain eligibility requirements. Third, developing a specific short-term assistance program for evacuees to help them obtain shelter and reconnect with their families and assets may better serve the needs of disaster victims, than the current CalWORKs program. Had such a program been in place before Hurricanes Katrina and Rita, California would have been eligible for federal reimbursement for the CalWORKs costs associated with evacuees from these hurricanes.

*Creating Emergency Health Programs.* For similar reasons, the Legislature may wish to explore whether the state should create standby statutory authority so that victims of a major California disaster could more easily access health coverage under Medi-Cal or the Healthy Families Program. Under emergency circumstances, displaced disaster victims requiring health care assistance might encounter difficulties and delays in obtaining coverage because of a lack of access to personal documents that would establish their eligibility for these programs. Federal authorities have permitted individuals to obtain temporary health benefits with self-certification under such circumstances.

## CONCLUSION

Recent events have brought emergencies and disasters to the forefront of public awareness. The state's emergency system is relatively solid, although improvements could be made. The Governor's proposals aim to address some of these weaknesses. However, in most cases, the proposals are flawed. The Legislature should seek how to allocate state and federal emergency-related resources in a more strategic fashion.

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# FUNDING FOR TRANSPORTATION: WHAT THE NEW FEDERAL ACT MEANS FOR CALIFORNIA

***What Are the Implications for California of the New Federal Act for Transportation Funding? What Legislative Actions Are Warranted to Facilitate Implementation of the Act?***

## **Summary**

*In August 2005, Congress reauthorized the federal transportation program through the passage of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU). The act will provide \$23.4 billion in federal funds to California through 2009 for highway, transit, and transportation safety projects. This represents a 40 percent increase in average annual federal funding over the previous transportation program. In addition to increasing federal funding to the state, SAFETEA-LU presents opportunities for financing transportation through nontraditional fund sources and expediting project delivery.*

*There are a number of issues for the Legislature to consider when implementing the act in California. We discuss these issues and make recommendations where further legislative actions are warranted. Specifically, we recommend that the state identify how federally earmarked funds align with statewide funding priorities. In addition, we recommend that the Legislature authorize Caltrans to pursue design-build contracting on a pilot basis and to partner with the private sector in order to take advantage of SAFETEA-LU's innovative finance opportunities.*

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## INTRODUCTION

In October 2003, the Transportation Equity Act for the 21<sup>st</sup> Century (TEA-21) expired. This act had provided federal transportation funding from 1998 through 2003, financing highway and transit projects nationwide through a combination of formula, discretionary, and earmarked funds. The act also allowed transportation agencies to shift formula funds from one grant category to another with few restrictions, thereby providing a flexible source of federal funding for transportation projects.

Congress failed to reauthorize a multiyear transportation program in 2003. Instead, it extended TEA-21 for almost two years to provide continued funding for transportation. However, on August 10, 2005, Congress reauthorized the federal transportation program through 2009 by enacting the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU).

This report summarizes the major provisions of the new federal act, highlights how they differ from TEA-21, and discusses the act's implications for California. The report then identifies the main issues that the Legislature should consider and where further legislative actions are warranted to facilitate implementation of SAFETEA-LU in California.

## MAJOR PROVISIONS OF SAFETEA-LU NATIONWIDE

Figure 1 highlights the major provisions of SAFETEA-LU. This section discusses these provisions in detail and compares national funding levels under SAFETEA-LU and TEA-21. (See a glossary at the end of this report for descriptions of various acronyms and terms used throughout the report).

***Program Structure Relatively Unchanged, but Increases Focus on Safety.*** As with TEA-21, the new act directs federal funding for highways and transit. In the highway program, there continues to be six major formula funding categories—Interstate Maintenance, National Highway System, Congestion Mitigation/Air Quality Improvement (CMAQ), Surface Transportation Program (STP), Bridges, and Equity Bonus (known as Minimum Guarantee under TEA-21). In the transit program, a mixture of formula and discretionary grants is provided through the Urban Formula, Fixed Guideway Modernization, New Starts, and High Priority Bus categories.

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**Figure 1****The Safe, Accountable, Flexible, Efficient  
Transportation Equity Act: A Legacy for Users****Major Provisions****General:**

- Maintains overall structure of previous transportation act (TEA-21), but increases emphasis on safety.
- Continues TEA-21's flexibility allowing up to 50 percent of most program formula funds to be redirected.

**Funding Nationwide:**

- Provides 42 percent increase in average annual funding over TEA-21. Authorization of \$241 billion for fiscal years 2005 through 2009 includes \$190 billion for highways, \$45 billion for transit, and \$5.7 billion for safety enhancements.
- Earmarks over \$26 billion worth of congressionally specified projects, including \$14.8 billion for High Priority Projects and \$1.8 billion for Projects of National and Regional Significance.

**Highways:**

- Guarantees "donor states" a minimum of 90.5 percent return on state fuel tax contributions in 2005 and 2006, 91.5 percent in 2007, and 92 percent in 2008 and 2009.
- Provides incentives for private sector participation in construction of major transportation facilities.
- Pilots include: federal delegation of environmental review responsibilities to states and toll programs on interstate highways.

**Transit:**

- Most discretionary funds remain available for competitive project applications.
- Provides capital funding for smaller transit projects requiring less than \$75 million in federal funds.

The new act differs from TEA-21 by increasing the focus on safety. In addition to augmenting funding levels to previously established safety programs, SAFETEA-LU introduces new discretionary and formula grants aimed at reducing travel-related hazards through increased law enforcement and safety-related planning. The act increases the total authorization for highway safety programs to \$5.7 billion from \$3.3 billion under TEA-21. New federal safety grant programs include Highway Safety Improvement, High Risk Rural Roads, Safety Belt Performance Grants, and Safe Routes to School.

*Overall Funding Level Increases Relative to TEA-21.* The act authorizes \$286 billion nationwide for transportation over the six-year period

from 2004 through 2009. However, due to the delay in reauthorization, about \$45 billion was expended by the time SAFETEA-LU was enacted. Thus, between 2005 and 2009, funding will be closer to \$241 billion with \$190 billion for highways, \$45 billion for transit, and \$5.7 billion for safety improvements. This represents approximately a 40 percent increase in average annual funding over TEA-21, with the ratio of transit to highway funds relatively unchanged.

***Substantial Increase in Earmarks.*** The act earmarks over \$26 billion for more than 6,000 projects nationwide. These projects are specified in various discretionary programs including ones that existed under TEA-21—High Priority Projects (HPP), New Starts, and High Priority Bus—as well as new programs—Projects of National and Regional Significance (PNRS), National Corridor Infrastructure Improvement (NCIIP), and Transportation Improvements (TI). The earmarked amount is a substantial increase over the \$9.3 billion earmarked in TEA-21 for about 1,850 projects exclusively in the HPP program.

***Formula Funds Remain Flexible, Discretionary Funds Less So.*** Similar to TEA-21, the new federal act provides both formula-based funds and discretionary funds. As with TEA-21, SAFETEA-LU provides the state with considerable flexibility in the use of formula funds, which account for 80 percent of total funds authorized in the act. Specifically, state and regional agencies can move up to 50 percent of funds from one formula category to another subject to various restrictions. For example, a state may transfer up to half of its CMAQ apportionment to projects eligible for Interstate Maintenance, National Highway System, STP, Bridges, or Recreational Trails grants. Furthermore, funds provided under STP and Equity Bonus—two of the largest funding categories, making up 30 percent of the \$241 billion distributed through 2009—can be used for a wide variety of projects including transit, highway, local road, bridge, safety, and transportation enhancement projects at states' discretion.

Though formula grants are a flexible source of funding to meet diverse transportation needs, the new act only increases these funds by a modest amount. As Figure 2 shows, total funding to formula grant categories increased by \$10 billion, or 5 percent, over TEA-21 levels.

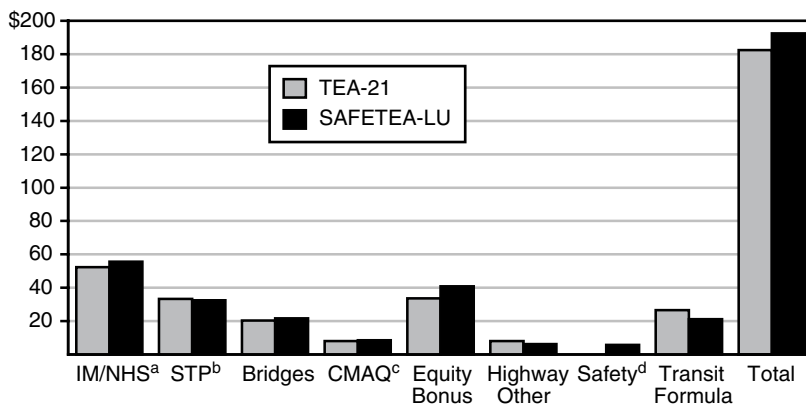
In contrast, Figure 3 shows that SAFETEA-LU provides about \$35 billion in discretionary funding nationwide—about 40 percent more than the amount under TEA-21. In particular, funding for the HPP program increases from \$9.3 billion to \$14.8 billion. The act also creates three new discretionary grant programs for NCIIP, PNRS, and TI.

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**Figure 2**

**Comparison of Formula Funds Nationwide  
TEA-21 Versus SAFETEA-LU**

(In Billions)



<sup>a</sup>IM/NHS = Interstate Maintenance and National Highway System programs.

<sup>b</sup>STP = Surface Transportation Program.

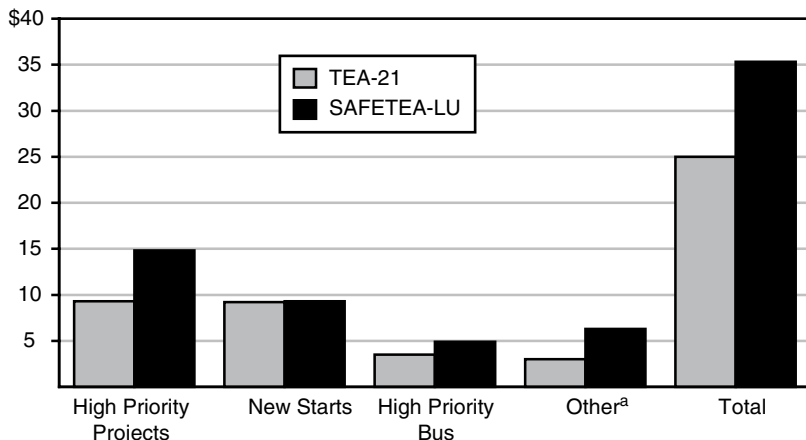
<sup>c</sup>CMAQ = Congestion Mitigation/Air Quality Improvement Program.

<sup>d</sup>Safety funding under TEA-21 was funded primarily through STP funds.

**Figure 3**

**Comparison of Discretionary Funds Nationwide  
TEA-21 Versus SAFETEA-LU**

(In Billions)



<sup>a</sup>Discretionary funds in SAFETEA-LU's "other" category are funds provided through the National Corridor Infrastructure Improvement, Projects of National and Regional Significance, and Transportation Improvements programs.

Compared to formula funds, discretionary grants are considerably less flexible. This is because many discretionary grants are nontransferable among fund categories. For example, HPP funds cannot be applied toward NCIIP projects (included in “other” programs in Figure 3). Further intensifying this rigidity is the fact that four of the major discretionary fund categories (HPP, PNRS, NCIIP, and TI) are *completely* earmarked for specified projects. This means that there are no funds left over in these four categories for additional, nonearmarked projects.

Moreover, for a large number of specifically earmarked projects, the designated funding cannot be redirected to other projects. This further limits states’ ability to direct funding to projects they deem to be of high priority within each fund category.

***Equity Bonus Program Beneficial to Donor States.*** The Equity Bonus program (which is the equivalent to TEA-21’s Minimum Guarantee program) ensures each state a minimum rate of return on its share of fuel tax contributions to the federal highway trust fund. States will receive in 2005 and 2006 a minimum level of funding equivalent to 90.5 percent of their fuel tax contributions—the same rate as guaranteed under TEA-21. The rate will increase to 91.5 percent in 2007 and to 92 percent in 2008. This represents an increase in return for donor states like California, which sends more fuel tax revenues to the federal government than it receives back. Equity Bonus funds may be used for any transportation project eligible for funding under other major highway formula programs.

***Highway and Safety Funds Potentially More Reliable.*** Under TEA-21, funding levels for highway and safety programs were adjusted when revenues to the federal highway trust fund (HTF) fluctuated. Because fuel excise tax revenues to the HTF were lower than projected in 2003, for example, this resulted in a downward fund adjustment to many highway and safety programs. However, under the new federal act, funding to highway and safety programs would not be reduced when tax revenues decline so long as the HTF balance exceeds \$6 billion. This would provide more certainty to states regarding the level of highway and safety funding to be received. However, it is estimated that the trust fund’s balance will be below \$6 billion in the last two years of SAFETEA-LU. As a consequence, highway and safety programs would likely still experience downward fund adjustments if revenues to the HTF are lower than projected. Transit funding is unaffected by this provision, as transit funds have always been exempt from revenue adjustments.

***Other Provisions.*** In addition to changes already discussed, SAFETEA-LU includes a number of provisions that influence the way that transportation facilities are planned, built, and administered. Specifically, the act encourages private investments and partnerships in constructing transporta-

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tion infrastructure, in addition to providing opportunities for environmental streamlining, design-build contracting, and toll road projects.

## IMPLICATIONS OF SAFETEA-LU FOR CALIFORNIA

The new federal act has a number of implications for California's transportation program. The key implications are highlighted in Figure 4, and are further discussed in this section.

**Figure 4**

### **SAFETEA-LU: Key Implications for California**

#### **Funding/Financing**

- ✓ Overall funding to state increases.
- ✓ High level of earmarks a mixed blessing.
- ✓ New program funding benefits goods movement.
- ✓ Innovative finance options expanded, but state law does not provide for use.
- ✓ Toll road project opportunities expanded.

#### **Project Delivery**

- ✓ Design-build restrictions relaxed, but state law requires design-bid-build.
- ✓ Environmental streamlining opportunities offered, but at additional cost and potential state liability.

#### **Programmatic Changes**

- ✓ Regions achieving air quality conformity raise Congestion Mitigation/Air Quality Improvement fund distribution issues.
- ✓ Safety programs provide additional funding, but may be subject to implementation hurdles.
- ✓ Hybrids allowed to utilize high occupancy vehicle lanes.
- ✓ Changes to transit program could benefit state.

**Overall Funding to State Increases.** California’s apportionment of federal transportation funds under SAFETEA-LU will be substantially higher than under TEA-21. This is because of both the increase in the nationwide funding authorization and the higher rate of return to donor states on fuel tax contributions. According to the Department of Transportation (Caltrans) and federal estimates, the act will provide \$23.4 billion in transportation funds to California from 2005 through 2009. Of this amount, about \$18 billion will go to highways, \$5 billion will go to transit, and \$452 million will go to safety improvements. This represents a 40 percent increase in average annual funding over TEA-21. Figure 5 compares average annual funding for California by mode under the two acts. As the figure shows, average annual highway authorizations are 44 percent higher and average annual transit authorizations will grow by a third over the span of SAFETEA-LU.

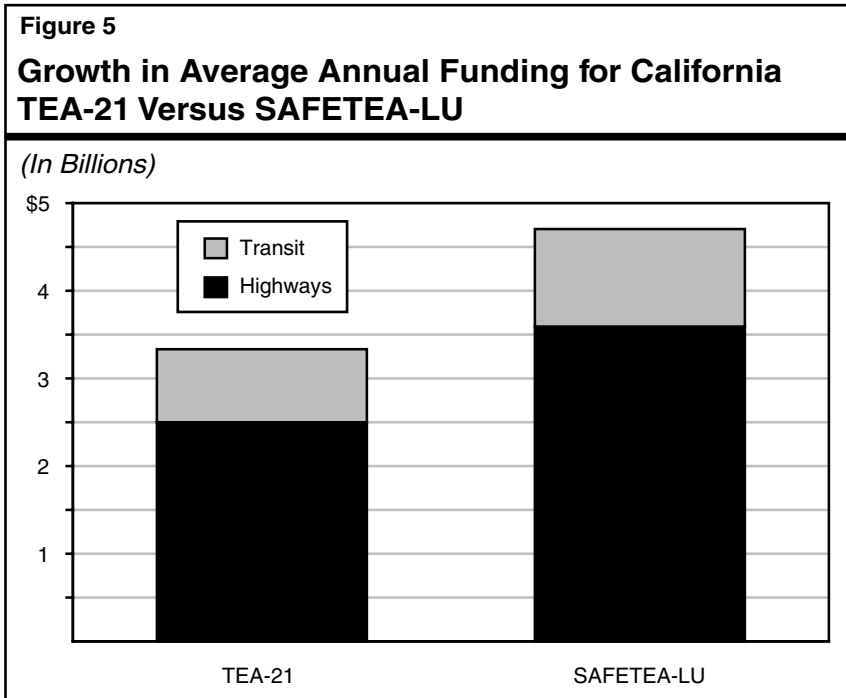


Figure 6 shows California’s authorized funding by program. Funding for highways will account for 76 percent of all funding allocated to California, with six major formula grant programs (including Interstate Maintenance, National Highway System, STP, Bridges, CMAQ, and Equity Bonus) comprising the majority (\$15 billion) of highway funding. Of the remaining \$3 billion in the state’s highway allocation, \$2.4 billion comes from earmarks in the HPP, PNRS, NCIIP, and TI programs with the remainder from smaller highway grants.



**Figure 6****SAFETEA-LU Program Funding in California  
2005 Through 2009<sup>a</sup>***(In Millions)*

<b>Highways</b>	<b>\$17,834</b>
Surface Transportation	\$3,200
Equity Bonus	3,200
National Highway System	2,800
Interstate Maintenance	2,200
Bridges	1,900
Congestion Mitigation/Air Quality Improvement	1,800
High Priority Projects	1,200
National Corridor Infrastructure Improvement Program	660
Projects of National and Regional Significance	450
Metropolitan Planning	221
Coordinated Border Infrastructure	106
Transportation Improvements	97
<b>Transit</b>	<b>\$5,145</b>
Urbanized Area Formula	\$2,700
New Starts	1,100
Fixed Guideway Modernization	821
Discretionary Bus	195
Jobs Access/Reverse Commute	86
Non-Urbanized Area Formula	85
Metropolitan Planning	54
Elderly and Disabled Operating Assistance	52
New Freedoms	42
State Planning	10
<b>Safety</b>	<b>\$452</b>
Highway Safety Improvement Program	\$384
Safe Routes to School	68
<b>Total</b>	<b>\$23,431</b>

<sup>a</sup> Transit funding authorization estimated by the Federal Transit Administration for 2006 through 2009 only.

California will receive about \$5 billion for transit purposes. This amount includes \$3.9 billion in formula grant programs, including mainly Urbanized Area formula and Fixed Guideway Modernization, and roughly

\$1.3 billion earmarked in discretionary grants. The total transit funding level represents 22 percent of California’s total transportation funding allocation under SAFETEA-LU. This share, however, could increase as the state applies for and receives additional funding for transit projects from discretionary programs like High Priority Bus and New Starts.

While SAFETEA-LU creates and expands safety grant programs, these programs account for a relatively small portion of the total funding authorization to the state. The majority of the state’s safety funds will come from the Highway Safety Improvement Program (HSIP), which provides \$384 million for statewide safety-related data collection, infrastructure improvement, and administration of safety programs. The federal Safe Routes to School Program (SRTS) will provide a total of \$68 million for safety improvements on the transportation network serving schools.

**High Level of Earmarks a Mixed Blessing.** Under SAFETEA-LU, California is a major recipient of earmarked funds from the HPP, PNRS, NCIIP, High Priority Bus, and New Starts programs. Figure 7 shows that \$3.7 billion (16 percent) of California’s \$23.4 billion authorization is earmarked for specific projects. This more than quadruples the total amount of earmarked funds received by the state (\$877 million) under TEA-21.

<b>Figure 7</b>			
<b>Authorized Funding for California</b>			
<i>(In Billions)</i>			
	<b>Formula</b>	<b>Earmarks</b>	<b>Totals</b>
Highway	\$15.4	\$2.4	\$17.8
Transit	3.9	1.3	5.2
Safety	0.4	—	0.4
<b>Totals</b>	<b>\$19.7</b>	<b>\$3.7</b>	<b>\$23.4</b>

Figure 8 shows that \$2.5 billion—about two-thirds—of the state’s earmarked funds are associated with large highway, transit, and goods movement projects. While only three projects in California received more than \$20 million in earmarked funds under TEA-21, SAFETEA-LU authorizes \$20 million or more for each of 24 projects around the state.

## Figure 8 California Earmarked Projects Valued at \$20 Million or More

(In Millions)

Project	County	Source	Earmark Amount
Metro Gold Line Eastside Extension	Los Angeles	New Starts	\$406
Centennial Corridor Loop	Kern	NCIIP <sup>a</sup>	330
BART Extension	San Francisco	New Starts	280
Mission Valley East Extension	San Diego	New Starts	153
Bakersfield Beltway	Kern	PNRS <sup>c</sup>	140
Alameda Corridor East	SCAG <sup>b</sup> Region	PNRS	125
Oceanside Escondido Rail Corridor	San Diego	New Starts	114
SR-178 Bakersfield	Kern	NCIIP	100
Gerald Desmond Bridge	Los Angeles	PNRS	100
I-405 high occupancy vehicle (HOV) lane	Los Angeles	NCIIP	100
Widen a state route between San Luis Obispo County Line and I-5	Kern	HPP <sup>d</sup>	92
Mission Valley East Extension	San Diego	New Starts	89
Widen Rosedale Highway	Kern	NCIIP	60
Inland Empire Goods Movement Gateway	San Bernardino	PNRS	55
Increase capacity on I-80	Placer	NCIIP	50
Golden Gate Bridge	San Francisco	Highway Bridge	50
Widen SR-46	San Luis Obispo	HPP	33
Widen I-405 for HOV lane	Los Angeles	TJ <sup>e</sup>	30
Alameda Corridor East	SCAG Region	TI	30
Transbay Terminal	San Francisco	PNRS	27
Nonmotorized Transportation Pilot Program	Marin	Nonmotorized Pilot	25
Increase capacity on I-80	Placer	HPP	22
SR-4 East Upgrade	Contra Costa	NCIIP	20
Inland Empire Goods Movement Gateway	San Bernardino	HPP	20
<b>Total of earmarks at or exceeding \$20 million each</b>			<b>\$2,452</b>
<b>Total of earmarks less than \$20 million each</b>			<b>\$1,271</b>
<b>Total California earmarks</b>			<b>\$3,723</b>

<sup>a</sup> National Corridor Infrastructure Improvement Program.

<sup>b</sup> Southern California Association of Governments—Region includes Imperial, Los Angeles, Orange, Riverside, San Bernardino, and Ventura Counties.

<sup>c</sup> Projects of National and Regional Significance.

<sup>d</sup> High Priority Projects.

<sup>e</sup> Transportation Improvements.

A number of SAFETEA-LU's earmarked funds assist projects that are high in statewide priority. However, other earmarks are tied to projects that are less crucial from the state's perspective. While earmarked funds infuse the state with federal dollars, these grants are not as flexible as formula funds. Specifically, the state has little discretion to redirect earmarked funds to other projects that it may deem to have higher priority. About 60 percent of California's earmarked funds are devoted to specified projects and cannot be transferred to other priorities. For example, the \$5.8 million provided in HPP funds for a mountain hiking trail may not be used for any other purpose, even if there are alternative projects that can better address the state's transportation needs.

Even in the other 40 percent of cases where earmarked funds can be used for other projects, the act sets limits on the extent of transfers. Specifically, transfers can only be for projects funded by the same discretionary grant program. For instance, TI earmarked funds may only be transferred to other TI earmarked projects. Additionally, there is a limit on the amount of earmarked funding that may be devoted to any given project. As a result of these two conditions, the state's flexibility to transfer earmarked funds is quite limited. Furthermore, this limited flexibility applies primarily to a relatively small number of projects in the PNRS, NCIIP, and TI programs. Consequently, Caltrans has limited leeway in shifting funds among projects to better reflect state priorities.

In addition, earmarked amounts typically do not cover the full costs of projects. As such, state and local agencies must dedicate substantial additional funding from other sources to fully cover project costs. For example, the \$130 million earmarked for carpool lanes on I-405 (in NCIIP and TI funds) does not come close to meeting full project costs, which are estimated at over \$500 million. Moreover, if an earmarked project is not a state priority, dedicating other funding to fully pay for the project would further limit the state's ability to meet higher funding priorities.

***New Program Funding Benefits Goods Movement.*** The act establishes several new programs, including the PNRS and NCIIP programs, which target funding to projects that benefit national and international commerce. The state is a major recipient of these funds. Specifically, California will receive \$450 million from PNRS for high-cost projects that improve the flow of goods and people on the national or regional scale. Major PNRS grants include \$125 million for the Alameda Corridor East in Southern California and \$55 million for the Inland Empire Goods Movement Gateway Project. From NCIIP, which funds projects on highway corridors of importance to national economic growth and trade, California will receive \$660 million for projects in Contra Costa, Kern, and Los Angeles Counties.

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In addition, SAFETEA-LU allocates \$106 million in Coordinated Border Infrastructure (CBI) program funds to California. Prior to 2005, CBI was a discretionary program that provided grants for highway projects near an international border on a competitive basis. The new federal act makes CBI a formula program, allocating funds to border states based on commercial truck and private vehicle volumes, truck cargo volumes (by weight), and the number of land border ports of entry. These funds are intended to provide additional support to mobility improvement projects within 100 miles of the California-Mexico border. For California, this means that CBI funds may only be used in San Diego, Imperial, and parts of Orange and Riverside Counties and thus require a different allocation method than other federal funds flowing into the state.

***Innovative Finance Options Expanded, but Current State Law Does Not Provide for Use.*** The new federal act expands in a number of ways the potential of using innovative financing mechanisms to fund transportation projects. Specifically, it lowers the project cost eligibility threshold for the Transportation Infrastructure Finance and Innovation Act (TIFIA) program. The purpose of the program is to stimulate private investment in nationally or regionally significant surface transportation projects by providing federal credit assistance in the form of direct federal loans, loan guarantees, and lines of credit. Although public agencies can access TIFIA funds, the program's primary mission is to entice private investment. Whereas TEA-21 restricted TIFIA funds to highway projects with costs greater than \$100 million, SAFETEA-LU lowers the cost threshold to \$50 million. Project eligibility has also been expanded to include international bridges and tunnels, as well as intercity passenger bus and rail projects.

The act also allows tax-exempt bonds to be used by the private sector when partnering with a public agency to construct transportation facilities. These bonds, more commonly known as "private activity bonds" (PABs), encourage private investment in transportation infrastructure by making borrowing less expensive (through paying a lower interest rate). The PABs are subject to a national cap of \$15 billion, but there is no limit by state. A variety of public-private partnerships are eligible for PABs—highway, transit, rail freight projects, international bridges and tunnels managed by international entities, as well as intermodal truck-rail transfer projects. Because current state law does not provide general authority to build transportation infrastructure using public-private partnerships, the extent to which these innovative finance provisions can benefit California is limited without state statutory changes.

***Toll Road Project Opportunities Expanded.*** The act provides expanded opportunities to charge tolls on interstate highways. In particular, the act establishes the Express Lanes Demonstration program. This program allows the creation of 15 new toll projects nationwide on existing high

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occupancy vehicle (HOV) lanes and any highway lane opened after SAFETEA-LU's enactment. Once toll revenues cover facility construction and maintenance costs, states may use revenues for other transportation purposes. The program requires that newly tolled HOV lanes include variable pricing structures (tolls vary by time of day or congestion level) and that all toll lanes utilize automatic toll collection technologies, such as FasTrak. Caltrans notes that the I-15 HOV-toll lanes were built under a similar provision in TEA-21 and an I-680 HOV lane could potentially be included in SAFETEA-LU's Express Lanes Demonstration.

***Relaxes Design-Build Restrictions, but State Law Requires Design-Bid-Build.*** The new federal act eliminates the \$50 million floor on the cost of projects that can be constructed using the design-build method, a delivery process that awards both the design and construction of a project to a single entity. The use of design-build to construct public projects is a relatively recent development aimed at reducing project delivery times by streamlining the design and construction processes. Most public agencies in the state have little experience using this delivery process. The new act makes virtually any project eligible to be built using design-build contracting.

With a few exemptions, state law requires public agencies to use the design-bid-build process to deliver capital projects. Under this process, public agencies typically complete the project design before advertising and awarding the construction contract through competitive bidding. Caltrans is not currently authorized to utilize the design-build method. However, SB 371 (Torlakson and Runner) and AB 508 (Richman), if enacted, would permit the department to use this project delivery process.

***Offers Environmental Streamlining Opportunities, but at Additional Cost and Potential Liability.*** The act allows five states, including California, to participate in a pilot program that authorizes the state to assume the Federal Highway Administration's (FHWA's) responsibilities under the National Environmental Policy Act (NEPA). These responsibilities include assessing a highway project's environmental impact, preparing the required federal documentation, and consulting with federal agencies, such as the Fish and Wildlife Service, which are involved in the environmental review process. State transportation officials must decide whether and to what extent they wish to assume these environmental review responsibilities from the federal government. Figure 9 highlights potential levels of NEPA delegation that California could assume.

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**Figure 9**

### **National Environmental Policy Act Options for Delegation of Responsibilities to State**

<b>Option</b>	<b>Description</b>
1	Assume responsibility for both state highway system (SHS) and local assistance projects.
2	Assume responsibility for SHS projects only.
3	Assume responsibility for local assistance projects only.
4	Assume responsibility for preliminary environmental studies only.
5	Assume responsibility for state selected projects only.
6	Assume responsibility only for projects in select geographic areas.

Delegation could streamline the environmental review process, reducing project delivery time. This is because the state would have more control over the pace of the environmental review process and Caltrans would communicate directly with involved federal agencies, instead of doing so indirectly, via FHWA staff. Currently, California has its own environmental review process which parallels the federal process in many aspects. Consequently, Caltrans has indicated that it believes it can assume delegation at any level it chooses, if it has the necessary staff resources to do so. However, no precedent exists for state delegation of NEPA responsibilities, thus there is no experience from which to gauge how much project delivery time could actually be saved or what the new costs to the state would be. Delegation of NEPA responsibilities represents a cost shift from the federal to state government.

Furthermore, the state should choose its level of participation with caution, as delegation means the state could be sued in federal court over its decisions. Under the U.S. Constitution, the state is currently immune from being sued in federal court. In order to participate in the pilot, California would have to waive this constitutional immunity. The additional resources that Caltrans would need to respond to lawsuits in federal court are also unknown.

***Regions Achieving Air Quality Conformity Raise CMAQ Fund Distribution Issues.*** The CMAQ program allocates funds to states based on the severity of air quality problems and the population in air quality nonattainment and maintenance areas. The funds are spent on projects offering air quality or congestion-reduction benefits. In 2005, the federal government replaced one of the measures used in determining whether

localities are in conformity with air quality standards. This change affected the air quality conformity status of four California counties (Santa Cruz, Monterey, San Benito, and Santa Barbara), which were reclassified from maintenance to attainment areas under the new standard. Because these counties are no longer considered maintenance areas, the state's CMAQ funding level would be lower than if these counties were included in the funding calculation. Consequently, they do not contribute to California's apportionment of CMAQ funds under SAFETEA-LU.

Federal law allows the state to continue dispersing CMAQ funds to these counties, as the reclassification reflects more of a change in definition than a measurable improvement in the counties' air quality. Current state law, however, prohibits the expenditure of CMAQ funds in air quality conformity regions. Thus, the state must decide whether it wants to continue dispersing CMAQ funds to these four counties. The level of CMAQ funding previously allocated to these regions was quite low—approximately \$8 million out of the state's \$389 million apportionment in 2004-05. While the amount of CMAQ funds received by the four counties was small, how the state decides to allocate its CMAQ apportionment could set a precedent for future allocations if and when other regions reach air quality conformity.

***Safety Programs Provide Additional Funding, but May Be Subject to Implementation Hurdles.*** The act increases the focus on safety by providing more funding for existing highway safety programs and introducing new programs that support safety improvements. In total, the state will receive about \$452 million from HSIP and SRTS. In order to access all of this funding, the state must address implementation issues associated with expenditure of these funds.

To utilize HSIP funds, SAFETEA-LU requires Caltrans to prepare a Strategic Highway Safety Plan, which identifies dangerous points throughout the state's highway and road network and identifies projects to mitigate these hazards. Caltrans must also report on the effectiveness of the safety programs it implements. Creating these documents could be relatively resource intensive as they require coordination between Caltrans and local transportation authorities. The state must meet these reporting requirements in order to receive a portion of the safety funding beyond 2007.

The act establishes a federal SRTS, a formula-based program providing grants to improve nonmotorized transportation facilities (such as bicycle lanes and sidewalk improvements) used by children traveling to school. Since 1999, the state has funded its own SRTS, using one-third of the state's allocation of federal safety grants. Under current law, the state program will continue through 2008. While the state and federal programs share the same name and general purpose, they each have different funding rules resulting in different allocations. Furthermore, the federal SRTS would

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provide less average annual funding in 2006 through 2009 (about \$17 million) than the state program has historically provided (about \$22 million annually). The state must decide between funding the federal and state SRTSs concurrently, abandoning the state program in favor of the federal program, or adopting an alternative strategy.

***Allows Hybrids to Utilize HOV Lanes.*** The new federal act gives the green light for low-emissions, energy-efficient vehicles with a single occupant to utilize HOV lanes, so long as these vehicles do not cause congestion in the lanes. Although current state law, Chapter 725, Statutes of 2004 (AB 2628, Pavley), has a more detailed definition of HOV lane congestion than does SAFETEA-LU, Caltrans does not perceive a conflict between the state and federal laws.

***Changes to Transit Program Could Benefit State.*** Not only has California's average annual transit funding authorization increased by 33 percent under SAFETEA-LU, but transit provisions in the new federal act are generally favorable to California. For instance, starting in 2007, the discretionary New Starts program will begin awarding grants to smaller transit projects requiring less than \$75 million in federal funds (with total project costs not exceeding \$250 million). Planned bus rapid transit and low-cost trolley projects similar to Los Angeles' Orange Line could benefit from this new source of funds.

Additionally, the new act increases funding to Fixed Guideway Modernization (FGM) and Job Access Reverse Commute (JARC) programs which provide funding for construction and improvement of transit systems. California will receive \$821 million from FGM, up from \$700 million under TEA-21. In addition to increasing funding to the JARC program, SAFETEA-LU makes the program formula-based, significantly improving the reliability of these funds to the state. Prior to reauthorization, California received about \$10 million per year in JARC program grants that were subject to a highly subjective application process. In 2006, the state will receive approximately \$19 million in formula funds from the JARC program, an annual sum that is set to increase slightly each year of SAFETEA-LU's duration.

## ISSUES FOR THE LEGISLATURE TO CONSIDER

Above, we discussed the major implications of the new federal transportation act for California's program through 2009. In this section, we highlight key issues that the Legislature should consider and identify areas where further legislative action is warranted for the state to implement SAFETEA-LU. Recommended legislative actions are summarized in Figure 10 (next page).

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**Figure 10****SAFETEA-LU: Recommended Legislative Actions**

- ✓ Direct California Transportation Commission to (1) estimate nonfederal funds required to fully finance earmarked projects and (2) identify how projects align with state and local priorities.
- ✓ Create new competitive grant program to allocate Coordinated Border Infrastructure funds.
- ✓ Authorize additional public-private partnerships taking into account the state's past experience with such arrangements.
- ✓ Authorize Caltrans to use design-build contracting on a pilot basis.
- ✓ Direct Caltrans to provide a cost-benefit analysis of the National Environmental Policy Act delegation authority.
- ✓ Phase out Congestion Mitigation/Air Quality Improvement funding in counties attaining air quality conformity.
- ✓ Maintain Safe Routes to Schools program at current state funding level.

*How Much Nonfederal Funding Is Needed to Cover Full Project Costs of Federally Earmarked Projects? How Do Earmarked Projects Align With State and Local Priorities?* The new federal act earmarks about 13 percent of the state's highway allocation and a quarter of transit funding for specified projects. In few cases do the earmarked amounts cover the full project costs. To utilize California's allotment of earmarked funds, significant additional nonfederal funding must be made available. While a number of the earmarked projects may be high in statewide priority, others may not be. Providing all of the additional resources necessary to fully fund earmarked projects could skew the state's transportation priorities, resulting in state funds being directed to projects which from a statewide perspective are lower in priority.

We recommend the enactment of legislation that directs the California Transportation Commission (CTC), in cooperation with Caltrans and local transportation agencies, to estimate the nonfederal funds required to fully finance the state's earmarked projects. Additionally, the commission should provide an assessment of which earmarked projects rank higher in state priorities and which earmarks rank lower. With this information,

the state would be able to make better decisions regarding the allocation of state funds for the earmarked projects.

***How Should Coordinated Border Infrastructure Funds Be Allocated?***

The CBI funding category will provide \$106 million to fund projects in four counties (San Diego, Imperial, and parts of Riverside and Orange) within 100 miles of the California-Mexico border. Under current state law, these funds would be pooled and programmed for projects in the State Transportation Improvement Program (STIP) regardless of proximity to the border. Congress, however, required that CBI funds be used exclusively to enhance mobility near international borders, which precludes these funds from being commingled with STIP funds.

To expend CBI funds in a manner consistent with the federal act, we recommend the enactment of legislation specifying that CBI funds are not subject to the current state formula for allocating state and federal funding in the STIP. We further recommend allocating CBI funds in a manner consistent with SAFETEA-LU, by creating a new competitive grant program through which transportation agencies could submit CBI eligible projects for funding to be awarded by CTC. Project selection criteria could include a project's ability to reduce congestion and facilitate goods movement between regions. These measures are already used to select projects for the Interregional Transportation Improvement Program.

***Should the State Promote and Expand Public-Private Partnerships to Encourage Private Investment in Transportation Facilities?***

Public-private partnerships provide a means to generate private investment in the construction of transportation facilities. These partnerships often take the form of a state or local government granting a franchise to a private entity to design, construct, maintain, and operate a facility for an extended period of time. The new federal act allows the use of TIFIA credit assistance and tax-exempt PABs as incentives to induce private sector investments in transportation, by lowering their cost of investing in transportation infrastructure. Both funding sources are finite. As discussed earlier, the act sets a \$15 billion nationwide cap on the total PABs that can be issued for transportation projects.

In general, transportation improvements in California are funded with taxes and user fees. In 1989, the state authorized a pilot program for up to four franchises for privately built transportation facilities under Chapter 107, Statutes of 1989 (AB 680, Baker). To date, only one project (SR-91) is operational and another (SR-125) is under development. The two other franchises authorized by Chapter 107 did not materialize. Thus, the state has limited experience with public-private partnerships.

Current state law does not authorize Caltrans to engage in additional public-private partnerships. Nonetheless, we think there is merit to allow-

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ing Caltrans to engage in public-private partnerships, as they provide a way to generate investment in the state's transportation infrastructure from the private sector. Thus, we recommend enacting legislation to authorize additional public-private partnerships taking into account the state's prior experience. Specifically, before enacting legislation, Caltrans should identify for the Legislature the opportunities and pitfalls the state encountered in its previous experience with public-private partnerships. The Legislature could then take this into account in the new authorization.

For California to take advantage of SAFETEA-LU's innovative finance opportunities, timely action would be needed to provide that authority. This is because other states (such as Texas and Virginia) are already using public-private partnerships to construct large projects and they may be further ahead than California to take advantage of the limited federal financing capacity.

***Should State and Local Transportation Agencies Be Authorized to Construct Projects by Design-Build?*** The new federal act makes virtually any surface transportation project eligible to be built through design-build contracting. As noted earlier, Caltrans is not currently authorized by state law to use design-build, and it does not have experience in using this method to deliver transportation projects. While there are advantages to using design-build, including the potential shortening of project delivery time, there are also potential pitfalls to avoid, including making sure contracts are awarded fairly and competitively such that public accountability is not diminished.

We recognize that there are potential benefits in using design-build to deliver projects. However, because of Caltrans' lack of experience, we recommend that the Legislature provide the department with the authority to use design-build contracting on a pilot basis subject to periodic review and oversight. Accordingly, we recommend that Caltrans be required to report periodically to the CTC and the Legislature on the timeliness of delivery, its process and methodology of contractor selection, and the results of peer review of contracts and projects delivered.

***To What Extent Should Caltrans Participate in the NEPA Delegation Pilot?*** As we noted earlier, allowing Caltrans to assume FHWA's responsibilities under NEPA could potentially shorten the time required for environmental review. However, this would occur only if Caltrans is equipped with the appropriate level and type of staff to take on the tasks. Furthermore, assuming the federal responsibilities by acting in place of FHWA means that the state could be sued in federal court for its decisions. Prior to determining whether and the extent to which Caltrans should be authorized to participate in the delegation pilot, we recommend that the Legislature direct the department to assess the costs (in terms of staffing and risk of

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lawsuits) and benefits (in terms of project review timesavings) that could be realized by accepting various levels of delegated responsibilities.

*Should CMAQ Funds Be Allocated to Regions That Are Reclassified as Air Quality Compliant?* As discussed earlier, a recent federal rule change has resulted in four California counties (Santa Cruz, Monterey, San Benito, and Santa Barbara) being reclassified as air quality attainment areas. As a result, total CMAQ funding to California would be less than otherwise. While the new act allows the state to continue to allocate CMAQ funds to these counties, current state law limits the allocation of these funds only to nonattainment and maintenance regions. Accordingly, we recommend CMAQ funding for these four counties be phased out over a couple of years. This would gradually move CMAQ funds away from attainment areas while refocusing resources on regions with the most serious air quality issues.

*How Should the Safe Routes to School Program(s) Be Structured?* The new federal SRTS program will provide \$68 million to the state through 2009 to fund improvements to nonmotorized transportation facilities in the vicinity of schools. As discussed earlier, this program is similar, but not identical, to an existing state program that is set to continue through 2008.

Currently, the state program is funded at roughly \$22 million annually using one-third of the state's allocation of federal safety grants. We recommend that the Legislature fund the new federal SRTS program at the current state program level. This would free up about \$11 million in other federal safety funds in 2006—an amount equivalent to the federal SRTS funding—for other statewide road safety priorities. As the federal SRTS apportionment to California increases each year of SAFETEA-LU, the annual savings would grow to about \$22 million by 2009.

## CONCLUSION

In addition to increasing funding for transportation, SAFETEA-LU includes a number of provisions that affect the way that transportation facilities are planned, built, and administered. For California, the new act promises an increase in transportation funding and presents opportunities for financing transportation through nontraditional sources and expediting project delivery. There are, however, a number of issues that the Legislature should consider and areas where further legislative actions are warranted to facilitate implementation of SAFETEA-LU in California.

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## GLOSSARY

### **Acronyms:**

**Caltrans:** The California Department of Transportation.

**CTC:** The California Transportation Commission.

**CMAQ:** Congestion Mitigation/Air Quality Improvement is a formula program, established under TEA-21, which funds projects and programs offering transportation related emissions reductions.

**CBI:** Coordinated Border Infrastructure is a new formula program which funds highway mobility improvement projects within 100 miles of an international border.

**FHWA:** The Federal Highway Administration.

**HPP:** High Priority Projects is a discretionary program, established before TEA-21, which provides designated funds to specified projects identified by Congress.

**HSIP:** Highway Safety Improvement Program is a new formula program which provides funding to reduce traffic fatalities and other travel related hazards.

**HTF:** The Highway Trust Fund is the federal account which collects federal fuel excise taxes and funds most of the highway and safety programs in SAFETEA-LU.

**NCIIP:** National Corridor Infrastructure Improvement Program is a new discretionary program which provides funding for construction of highway projects in corridors of national significance to promote economic growth and international or interregional trade.

**NEPA:** The National Environmental Policy Act is a federal environmental review law. It is the federal equivalent of the California Environmental Quality Act.

**PAB:** Private Activity Bonds are tax-exempt bonds issued by private entities when partnering with a public agency to construct transportation facilities. These bonds encourage private investment in transportation infrastructure by making borrowing less expensive (through paying a lower interest rate).

**PNRS:** Projects of National and Regional Significance is a new discretionary program which provides funding for high-cost projects of national or regional significance.

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**SRFS:** Safe Routes to School is a new formula program which provides funding for projects that improve nonmotorized transportation facilities used by children traveling to school.

**SAFETEA-LU:** The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, the federal transportation funding program spanning 2004 through 2009.

**STIP:** State Transportation Improvement Program is California's primary program for construction of new transportation projects.

**STP:** Surface Transportation Program is a formula program, established prior to TEA-21, which provides flexible funding that may be used by states on almost any highway, local road, or transit project.

**TEA-21:** The Transportation Equity Act for the 21<sup>st</sup> Century, the federal transportation funding program that spanned 1998 through 2003.

**TI:** Transportation Improvements is a new discretionary program which provides designated funds to 466 projects identified by Congress.

**TIFIA:** Transportation Infrastructure Finance and Innovation Act program provides federal credit assistance to nationally or regionally significant surface transportation projects, including highway, transit, and rail. Both public and private entities are eligible to receive TIFIA funds.

### **Other Terms:**

**Formula Funds:** Funding apportioned to states based on formula.

**Discretionary Funds:** Grants available on a competitive basis, not apportioned to states by formula.

**Earmarked Funds:** A subset of discretionary funds which are designated to specific projects.

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# REORGANIZING CALIFORNIA'S ENERGY-RELATED ACTIVITIES

***Should the State Reorganize Its Energy-Related Activities? What Is an Appropriate Structure for Energy Policy Making, Regulation, and the Administration of Related Programs?***

## **Summary**

*The Governor has proposed to consolidate several energy-related activities in a new Department of Energy, to be headed by a cabinet-level Secretary of Energy. The Governor's proposal would also transfer the responsibility for permitting new electricity transmission projects from the California Public Utilities Commission to the new department. In this analysis, we describe the existing energy organizational structure in the state, consider concerns raised about the existing structure, examine key points of the Governor's proposal, and raise issues and make recommendations for reorganizing energy-related activities in California.*

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## INTRODUCTION

In May 2005, the Governor submitted to the Legislature a plan to reorganize the state's energy-related activities, known as the Governor's Reorganization Plan 3 ("GRP 3"). Due to legal concerns raised about the use of the GRP process to make certain changes to the California Public Utilities Commission (CPUC), the Legislature rejected GRP 3.

The *2006-07 Governor's Budget* does not contain a proposal to reorganize California's energy-related activities. Rather, the Governor's budget document acknowledges that the administration is sponsoring legislation (AB 1165, Bogh) to reorganize the state's energy-related activities statutorily (hereafter referred to as the "Governor's proposal").

In the following sections, we describe the status of the state's electricity market, identify several problems with the state's existing energy organizational structure, describe the Governor's proposal, identify issues for legislative consideration, and make recommendations for reorganizing energy-related activities in the state.

## STATUS OF THE STATE'S ENERGY MARKET

For most of the past century, California's electricity market (excluding municipal utilities) was fully regulated, with investor owned utilities (IOUs) responsible for generating and delivering electricity, while electricity rates were set by CPUC.

California began the process of restructuring electricity service in the early 1990s by introducing competition into the generation of electricity. The ultimate goal was to lower prices for IOU customers. The plan ultimately adopted in 1996 included a "transition" period during which the IOUs sold off their fossil fuel power plants to independent generators, while retaining their hydroelectric and nuclear power plants. During this transition period, CPUC continued to regulate the IOUs' rates. Eventually, however, electricity purchases and customer rates were to be determined in a competitive market.

The deregulation process was put on hold in response to the energy crisis that arose in 2000 and early 2001. Customers who elected to purchase their electricity from non-IOU providers were allowed to continue this "direct access," but existing individual IOU customers were generally prohibited from switching away from IOU service.

Currently, approximately 10 percent of the state's electricity is delivered through direct access contracts to non-IOU customers. Under existing law, the suspension of direct access will continue until long-term electric-

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ity contracts signed on behalf of the IOUs by the Department of Water Resources (DWR) expire. The last of the contracts expires in 2015.

The energy crisis and its aftermath created considerable instability in the state's electricity market. The IOUs experienced financial problems stemming from the energy crisis and regulatory barriers made it difficult for IOUs to sign long-term power contracts with power plant operators. The lack of long-term power contracts has been seen as a destabilizing factor and an impediment to the construction of new power plants.

Recent developments in the state's electricity market have created a greater level of certainty. For example, Chapter 835, Statutes of 2002 (AB 57, Wright), created a "procurement process," under which IOUs are able to secure long-term electricity supplies through a competitive bidding process. Under this process, IOUs select a mix of electricity supplied by their own power plants and under contract from other generators. The CPUC approved the IOUs' first long-term procurement plans in April 2004. While the market has seen increased stability recently, the Legislature continues to evaluate issues, such as direct access, the resolution of which could result in changes to the market structure in future years.

## CURRENT ENERGY ORGANIZATIONAL STRUCTURE

There are many entities that have a role in the development and implementation of energy policy and the regulation of energy-related activities in the state. These entities also implement energy-related programs, often with overlapping areas of responsibility. These entities include:

*Energy Resources Conservation and Development Commission (CEC).* The CEC is the state's primary entity for implementing energy policy. The CEC is governed by a commission made up of five members, appointed by the Governor and approved by the Senate for fixed terms. The primary duties of CEC are:

- Permitting most new power plants (thermal power plants of 50 megawatts or larger).
  - Forecasting future electricity needs and monitoring energy markets.
  - Promoting energy efficiency and alternative energy technologies, and supporting research and development.
  - Developing and implementing energy efficiency standards for buildings and appliances.
  - Carrying out energy resource planning and policy making.
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**CPUC (Energy Division).** The CPUC regulates the rates of IOUs, including electricity IOUs. The CPUC is governed by a commission of five members, appointed by the Governor and approved by the Senate for fixed terms. The primary duties of CPUC are:

- Regulating the retail rates charged by IOUs.
- Setting service standards and safety rules for IOUs and investigating consumer complaints.
- Overseeing electricity and natural gas markets to protect against anticompetitive behavior.
- Managing or overseeing a variety of energy efficiency programs and rate subsidy programs.

**Electricity Oversight Board (EOB).** The EOB acts as a market monitor, overseeing the state's electricity market. According to statute, EOB is to be governed by a board made up of three appointees of the Governor and one member appointed from each of the California Senate and Assembly. Currently, there is no quorum and EOB staff report to the Governor's office. The primary duties of EOB are:

- Monitoring electricity markets to prevent manipulation and anti-competitive behavior.
- Initiating proceedings at the Federal Energy Regulatory Commission (FERC) regarding anticompetitive behavior and market manipulation.
- Representing the state in ongoing litigation at FERC and in the courts related to the 2000-01 energy crisis.

**California Power Authority (CPA).** The CPA was created to assist in the development of new electricity resources in the state, by providing revenue-bond supported financing. The CPA has not financed any electricity generation projects and is currently inactive; CPA's bonding authority will expire in January 2007.

**Division of Oil, Gas, and Geothermal Resources (DOGGR).** The DOGGR, located in the Department of Conservation, regulates the drilling, operation, maintenance, plugging and abandonment of oil, natural gas, and geothermal wells in the state, and is responsible for preventing damage to the state's natural resources from such operations.

**California Energy Resources Scheduling Division (CERS).** The CERS is a division within DWR, that was delegated the responsibility for purchasing electricity on behalf of IOUs during the 2000-01 energy crisis. At that time, with the financial stability of IOUs in question, the state stepped in to purchase power on the spot market and through long-term contracts.

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The CERS is no longer permitted to sign new power contracts, but it will continue to manage the existing power contracts through 2015, although the majority of the contracts will expire by 2011.

**Independent System Operator (ISO).** While not considered a state agency, ISO is a not-for-profit entity, created by the state to oversee the electricity transmission system. The primary duties of ISO are:

- Oversight and operation of the electricity transmission system in the state.
- Planning for transmission needs and ensuring the reliability of the system.
- Operation of a “spot” market for electricity (the market where electricity providers can buy electricity in the short term to supplement existing resources).

Figure 1 summarizes selected activities and responsibilities of the state’s energy-related entities and ISO. As the figure shows, and as discussed below, there is significant overlap among these entities.

<b>Figure 1</b>							
<b>Selected Activities and Responsibilities of the State's Energy-Related Entities</b>							
<b>Activities/Responsibilities</b>	<b>CEC</b>	<b>CPUC</b>	<b>EOB</b>	<b>CPA</b>	<b>CERS</b>	<b>DOGGR</b>	<b>ISO<sup>a</sup></b>
Representing state at FERC <sup>b</sup>		✓	✓		✓		
Promoting energy conservation/efficiency	✓	✓		✓			
Forecasting electricity demand	✓						✓
Licensing generators	✓					✓	
Promoting renewable resources	✓	✓		✓			
Planning natural gas infrastructure	✓	✓		✓			
Planning transmission infrastructure	✓	✓	✓	✓			✓
Integrated resource planning	✓	✓		✓			
Monitoring the electricity market	✓	✓	✓				
Monitoring/planning system reliability		✓	✓				✓
<sup>a</sup> The Independent System Operator (ISO) is not considered a state agency. <sup>b</sup> Federal Energy Regulatory Commission.							

## PROBLEMS WITH THE CURRENT ORGANIZATIONAL STRUCTURE

There have been a number of concerns raised in recent years about the organization of the state's energy entities and the ability of these entities to work cooperatively to implement the state's energy policies. These problems include multiple policy-making entities within the administration, duplicative and overlapping responsibilities, and limited accountability for policy decisions.

### Multiple Policy-Making Organizations Within the Administration

The simple question, "What is the administration's energy policy?" is not easily answered, because there are several entities within the administration that make energy policy. Moreover, some of these policy makers are in quasi-autonomous commissions that are not directly accountable to the Governor. For example, CEC is required to adopt an Integrated Energy Policy Report every two years and periodically prepares an Energy Action Plan, in conjunction with CPUC. These documents are adopted by their respective commissions, but do not necessarily reflect the Governor's policy positions. Additionally, CPUC regularly adopts General Orders which promulgate general policy positions, but do not necessarily represent the Governor's official policy positions. Because policy is formulated and articulated by the Governor's office, CEC, and CPUC, it is sometimes uncertain which policy represents the energy policy of the administration *as a whole*.

Some industry observers have noted that the current decentralization of the policy-making role of the state's energy-related entities means that the state does not always present a "unified front" when working with the federal government and other parties regarding energy-related issues. It is argued that this, in turn, inherently can hinder the state's ability to be effective in achieving its energy-related objectives.

### Duplicative and Overlapping Responsibilities Among Organizations

In several areas, the state's energy entities perform similar or overlapping duties. This has resulted in duplication of effort—which is inefficient—and problems with coordination—which impedes program effectiveness.

**Nonrenewable Energy Use.** Both CEC and CPUC currently administer programs designed to reduce nonrenewable energy use. Specifically, CPUC oversees incentive programs designed to increase the adoption of energy efficiency measures, while CEC develops standards to promote energy efficiency. The CPUC is also responsible for ensuring that the state's IOUs purchase electricity from renewable sources (according to the Renewables Portfolio Standard), while CEC is responsible for providing the subsidies that make these renewable resources competitive with other sources of energy.

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**Electricity Transmission Planning.** In this area, overlapping and redundant permitting jurisdictions have been blamed for delaying investment in new infrastructure. According to CEC's Strategic Transmission Investment Plan, multiple permitting processes have created duplication among local, state, and federal entities, often resulting in a failure to consider the long-term benefits of transmission from a *statewide* perspective. According to CEC, these multiple jurisdictions have resulted in delayed approvals and denial of needed projects. This is of particular concern because the recently enacted federal Energy Bill of 2005 stipulates that the federal Secretary of Energy can preempt state permitting responsibility for transmission projects that are in the national interest, if he or she finds that there are congestion or capacity constraints that need to be addressed. While such federal involvement might speed up infrastructure development, the potential shift in responsibility for permitting new transmission infrastructure from the state to the federal government could prevent the state from determining which new projects are in the state's best interest.

**Energy Market Representation.** Several entities appear before FERC on matters relating to California energy markets, including EOB, CPUC, CERS, the Attorney General, and the Division of Ratepayer Advocates (within CPUC). It is not clear which entity, if any, is the lead in representing the state's interest in these proceedings or which entity represents the administration's official energy policy.

### **Limited Accountability for Policy Decisions**

The current structure of California's energy entities reduces accountability by diffusing responsibility for policy making and regulatory decision making across multiple entities. In addition, the structure places policy-making decisions in the hands of commissioners who are not directly accountable to the administration or the Legislature.

Because there are many areas in which the responsibilities of the state's energy entities overlap, it is difficult for the Legislature and the public to determine which entities are responsible for decision making and to hold each one accountable for performance. In the area of electricity transmission permitting, for example, the actions of several entities can delay or reject a specific project, but no single entity is responsible for ensuring that there is adequate investment in new infrastructure.

The current energy organizational structure includes a mix of department and commission structures, and this mix creates its own set of accountability problems. The independence of a commission can be beneficial under circumstances in which decision makers should be insulated from outside pressure, such as ratemaking. However, because commissioners are generally appointed to fixed terms and cannot easily be dismissed by

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the Governor or the Legislature, the independence of commissions can also reduce accountability to the Governor and the Legislature. To some extent, this allows commissions to make policy independent of the policy-making processes of the Legislature and the administration.

For example, under a decision recently adopted by CPUC, the state will use \$2.8 billion of ratepayer funds over the next decade to subsidize the installation of solar energy systems. The policy was adopted by CPUC without authorizing legislation, despite the fact that such legislation is currently under review by the Legislature (SB 1, Murray).

## REORGANIZATION PROPOSALS

*Governor's Reorganization Plan.* As his initial plan to reorganize the state's energy-related activities, the Governor submitted GRP 3 to the Legislature in May of 2005. The plan would:

- Create a single Department of Energy, with a department head referred to as the "Secretary" who would be a member of the Governor's cabinet.
- Abolish CEC, EOB, CPA, and CERS, and transfer their functions, as well as some other minor programs, to the new department.
- Create a new California Energy Commission within the new department, with responsibilities limited to permitting new power plants, permitting electricity transmission and natural gas infrastructure (responsibilities transferred from CPUC), and approving energy efficiency standards.
- Make the Secretary also chair of the new California Energy Commission.
- Designate the new department as the exclusive representative of the state before FERC.

Due to legal issues concerning proposed changes involving CPUC—a constitutionally created body—through the GRP process, the Legislature rejected GRP 3.

*Revised Governor's Proposal (AB 1165, Bogh).* To address issues regarding reorganization, the Governor resubmitted his proposal to the Legislature in bill form last summer, including certain policy changes made in response to issues raised during hearings on GRP 3 held by the Little Hoover Commission. The Governor's proposal was substantially the same as GRP 3 with three primary exceptions. It:

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- Makes the Secretary a member (not the chair) of the new California Energy Commission.
- Retains natural gas permitting functions at CPUC.
- Makes the new department the lead state entity to appear before FERC, while allowing other state entities to also appear.

**Other Legislative Proposal.** In addition to the Governor's proposal, AB 1190 (Canciamilla), also introduced last session, addressed the issue of energy organizational structure. The bill proposed to create a new Energy Agency, headed by a cabinet-level Secretary, and required the Governor to submit a detailed plan for reorganization that would accomplish the general goals of consolidating energy-related functions within the new agency and transferring all policy-making responsibility from CPUC to the new agency. This bill is currently inactive.

## ISSUES FOR LEGISLATIVE CONSIDERATION

When evaluating the Governor's and other proposals to reorganize the state's energy-related activities, there are a number of issues that the Legislature should consider. These issues, which we discuss in the following sections, include:

- Timing of Reorganization—Is it Premature?
- Creating Clear Lines of Accountability.
- Deciding Who Should Make Policy.
- Deciding the Placement and Structure of Regulatory Functions.
- Deciding the Placement and Structure of Nonregulatory Programs.

### Timing of Reorganization—Is it Premature?

***Evolving Nature of California's Electricity Market.*** One of the concerns raised in the hearings held by the Little Hoover Commission on GRP 3 was that it may be premature to reorganize the state's energy-related activities, given that the long-term market structure for electricity in the state has not been settled.

While the state is still evaluating elements of the electricity market—such as direct access—we note, as discussed earlier, that recent developments have brought increased stability to the market.

***State Will Benefit From a More Accountable and Efficient Organizational Structure, Even if the Market Structure Changes.*** While we recognize

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the inherent uncertainty in the structure of the state's electricity market, we think that a well-designed reorganization can improve accountability and efficiency, regardless of the market structure. Whether a future electricity market is fully regulated, completely open to competition, or something in between, the state will still make and implement statewide policies and operate programs in the energy area. The potential for gains in accountability and efficiency are largely independent of the larger debate about market structure. Therefore, in our view, it is not premature for the Legislature to proceed with a reorganization of the state's energy entities at this time.

### **Creating Clear Lines of Accountability**

*Current Organizational Structure Reduces Accountability.* As discussed previously, the current energy organizational structure—in which multiple state entities have responsibility for policy making and program implementation—reduces accountability by spreading responsibility for the success or failure of these activities across multiple organizations.

*Consolidated Energy Department Would Improve Accountability.* A department, into which functions from multiple entities are consolidated and headed by a Secretary, would provide a single point of contact for many energy-related activities. (We do not take a position on whether the head of a new department should or should not be a cabinet-level secretary; for simplicity, we follow the terminology of the Governor's proposal.) This would improve accountability within the administration, by integrating the development of policy and the implementation of programs in one entity that would answer directly to the Governor. It would also improve accountability to the Legislature by creating a single point of contact through which to focus legislative oversight of policy development and program implementation. Both the Governor's proposal and AB 1190 adopt the consolidated department approach. We recommend the Legislature adopt this organizational structure.

### **Deciding Who Should Make Policy**

*Policy-Making Decisions Currently Reside With Commissions.* Currently, policy making responsibilities at both CEC and CPUC reside with commissioners who are appointed to fixed terms and have little direct accountability to the Governor or the Legislature for their decisions. In addition, because these commissions make decisions collectively, individual commissioners are not easily held to account for decisions made by the commission as a whole.

*A Secretary Would Be More Accountable.* A Secretary, as head of the department, would answer directly to the Governor, and can be required to explain policy decisions to the Legislature much more easily than can the

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multiple members of a commission. We recommend that the Legislature adopt a structure that includes an individual department head, either a Secretary or department director.

While the Governor's proposal would consolidate policy making with the Secretary of the new department, we note that there is no specific provision in his proposal requiring CPUC (which would still retain energy-related functions under his proposal) to abide by those policy decisions. On the other hand, AB 1190 contemplated that CPUC would base its regulatory decision making on the policies developed by a new Energy Agency.

We think that any proposal to reorganize the state's energy entities should explicitly address CPUC's policy-making role. This is because CPUC has interpreted its duty to protect ratepayers broadly, and has made significant energy-related policy decisions under this authority.

### **Deciding the Placement and Structure of Regulatory Functions**

When deciding where to place and how to structure the state's energy-related regulatory functions, it is important to consider the special requirements for independence and public involvement of regulatory decision making. Therefore, we recommend that most regulatory functions be carried out under a commission structure. We also recommend that the Legislature reevaluate the state's regulatory system for planning and permitting new transmission infrastructure, to address concerns about existing impediments to transmission infrastructure investment. We discuss these recommendations in detail below.

***Responsibility for Energy-Related Regulation Is Spread Over Many Entities.*** Currently there are energy related *regulatory* functions spread over several entities, including CEC (permitting new power plants, adopting efficiency standards), CPUC (rate setting, permitting new transmission projects), EOB (market monitoring and initiating regulatory proceedings at FERC), and DOGGR (regulating oil, gas, and geothermal wells). In some cases (CEC and CPUC), these regulatory functions are invested in commissions. In other cases (EOB and DOGGR), these duties are not performed by commissions. The Governor's proposal would move several regulatory functions to the new department, including transmission permitting (from CPUC) and electricity market oversight (from EOB).

***Most Regulatory Activity Should Remain Under a Narrowly-Focused Commission, With Potential for Consolidation.*** In many cases, regulatory decisions can be controversial and therefore it can be useful to insulate them from outside pressures that may threaten the independence of the decision makers and thus the objectivity of their decisions. Hence, it is appropriate for these decisions to be made by commissioners who are appointed to fixed terms and are not easily removed from their position

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by the Governor or the Legislature. For example, CPUC—in addition to having a long history and considerable expertise in the regulation of utility rates—is governed by commissioners who are appointed to fixed terms. We believe that this gives the commissioners a degree of independence that is useful for the regulation of utility rates. We therefore recommend that utility rate-setting regulatory authority be retained in CPUC, under its commission, in any energy reorganization plan.

Currently, CEC's appointed commissioners oversee all activities of the commission, including developing and adopting policy, presiding over regulatory functions, and implementing nonregulatory programs. We recommend that under a reorganized department, the duties of a new California Energy Commission be limited to making regulatory decisions, namely the permitting of new power plants and the adoption of energy efficiency standards. We would also recommend that the development and adoption of policy and the oversight of the implementation of nonregulatory programs be the responsibility of the Secretary.

Under this recommendation—and similar to the Governor's proposal—the new California Energy Commission would reside within the department and would have access to department staff to support its regulatory activities. However, because members of the new commission would be appointed by the Governor, confirmed by the Senate, and would not answer directly to the Secretary, the commissioners would be able to make regulatory decisions relatively independently of outside interference. In addition, the commission structure provides significant opportunity for public participation in regulatory proceedings, which allows the public to be sure that regulatory decisions are made impartially.

Finally, we think that the permitting of new oil, gas and geothermal wells—currently the responsibility of DOGGR and not proposed for transfer under the Governor's proposal—should be made the responsibility of the new California Energy Commission within the new department. These activities are regulatory in nature, and are similar to the permitting activities currently undertaken by CEC.

*Activities Currently Performed by EOB Can Be Overseen by a Secretary.* On the other hand, we think that the unique duties of EOB, while regulatory in nature, can be performed by staff who answer directly to the new Secretary. Under current law, EOB acts as a market monitor and exercises this responsibility by initiating proceedings at FERC when it finds there has been illegal market manipulation or anticompetitive behavior. The EOB is not a decision making body. Rather, EOB presents evidence to FERC or the courts, and these bodies make the ultimate decision on the issue at hand. Because EOB does not make regulatory decisions itself, it is appropriate for EOB's duties to be transferred to the new department, to be overseen by the Secretary.

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***Department Should Be Designated as the Lead Entity Before FERC.***

In many instances, several state entities appear before FERC in the same proceeding. In order to avoid confusion over which entity represents the administration's official position, the department should be designated as the state's official lead representative, as proposed by the Governor. This would allow the administration to ensure that the state's interests, as a whole, are represented in proceedings at FERC and in the courts. However, as also proposed by the Governor, we recommend that other state entities be allowed to continue to appear before FERC as necessary for them to address issues corresponding to their particular area of technical expertise.

We note that there are some relatively minor activities that would be performed by the new department under our recommendation and the Governor's proposed reorganization that may, under FERC rules, create a conflict of interest with market monitoring activities. This would occur in cases where the department could be considered a market participant. For example, CEC currently provides subsidies to certain renewable energy providers, such as solar or wind power generators. This financial relationship could potentially make it a market participant. If these programs and the responsibilities of EOB (as a market monitor) were consolidated in a new department, this could create a potential conflict of interest. Accordingly, if the responsibilities of EOB were consolidated in the new department, it may be necessary to create a system of procedural firewalls to prevent any potential conflicts of interest between market monitoring activities and other programs in the department.

***Legislature Should Consider Reorganizing the State's Electricity Transmission Permitting Process.*** The Governor's proposal would transfer the authority to permit new electricity transmission projects from CPUC to the new California Energy Commission in the new department. This component of the Governor's proposal is an attempt to address concerns that the state's current system for planning and permitting new transmission projects (which can involve multiple entities at the local, state, and federal levels) is substantially impeding investment in this type of infrastructure. However, the Governor's proposal does not comprehensively address this issue.

Addressing problems with the transmission permitting process is a particularly complex one, as it involves not only multiple state entities but also multiple levels of government. While we make no recommendation on this issue, we believe that the Legislature should determine a policy that explicitly lays out each entity's responsibilities. Such a policy would need to address the fundamental issue of allocating responsibilities, including system wide planning, determination of the system reliability and economic need of a project, permitting, environmental review, and the allocation of costs to ratepayers.

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## Deciding the Placement and Structure of Nonregulatory Programs

***Both CEC and CPUC Operate Nonregulatory Energy Programs.*** As was mentioned above, there are energy-related programs that are nonregulatory in nature currently performed by several entities. As the state's primary energy entity, CEC operates several programs, such as supporting new investment in renewable energy (including providing subsidies for solar energy). On the other hand, CPUC also administers several nonregulatory programs, some of which are similar in purpose to CEC programs. Specifically, CPUC's new California Solar Initiative appears duplicative of an existing solar energy program at CEC.

***Program Consolidation Can Potentially Improve Program Efficiency and Effectiveness.*** To the extent that similar programs are operated by different entities, this can create inefficiencies, for example, by increasing the cost it takes to advertise multiple programs to consumers. Additionally, several small programs are often less effective than a consolidated program, because program beneficiaries may not be aware of all the overlapping programs and may not take advantage of existing programs. Finally, the operation of duplicative programs in different entities can result in unnecessary administrative costs. While the Governor's proposal does not consolidate these solar energy programs, we recommend that CPUC's California Solar Initiative and CEC's existing solar energy program be consolidated in the new department.

***Consolidation Problematic for Some Programs or Functions.*** On the other hand, there are some existing programs or functions that are proposed for consolidation under the Governor's proposal where consolidation would create limited benefits and could create organizational problems. First, the Governor's proposal would move the functions of CPA and CERS into the new department. We think this would produce little benefit and generate problems by creating potential conflicts of interest within the new department.

Given that CPA has not financed any new power plants and its bonding authority expires at the end of the year, it is unlikely that the department would finance any new power plants using CPA's existing authority. If the department did use this authority to finance new power plants, however, it could conflict with other department duties, including market monitoring. Therefore, we recommend that CPA's bonding authority be left out of the new department and be allowed to expire.

Similarly, CERS' current participation in the electricity market, as the manager of multimillion dollar energy contracts, could create a potential conflict of interest with the new department's market monitoring responsibility. Because CERS is not signing any new power contracts and the existing contracts that it manages will expire over the next several years,

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there is little benefit from including it in a new department. Therefore, we recommend that CERS remain in DWR.

Finally, the Governor's proposal would consolidate certain functions or programs from the Department of General Services and the Office of the State Architect in the new department. For the most part, the activities of these programs are limited to procuring energy for state agencies and implementing energy efficiency measures in state buildings. There does not seem to be any significant benefit from moving these programs into a consolidated energy department. Therefore, we recommend against transferring these functions to the new department as proposed by the Governor. The Governor also proposes to transfer a nonoperational energy program from the Office of Planning and Research to the new department. Because this program is no longer in operation, this transfer is unnecessary.

## CONCLUSION

While some uncertainty remains surrounding the structure of California's electricity market, we think that the time is right for the Legislature to create a more efficient and accountable organizational structure. Our proposed reorganization does not depend on a particular electricity market structure and provides enough flexibility to allow the state to respond to changing market conditions. With or without our recommended reorganization, the state still faces many energy challenges. For example, in the coming years, the state will have to ensure that adequate electricity production and transmission infrastructure is developed to accommodate a growing population, while at the same time ensuring that energy efficiency and renewable energy production goals and standards are met. We think that our recommendations to create a more accountable and efficient organizational structure should improve the state's ability to address these challenges in a comprehensive manner, while allowing enough flexibility to adapt to new challenges as they arise.

We summarize our recommendations for a reorganized structure and contrast these with the Governor's proposal in Figure 2 (see next page).

A consolidated department reflecting a reduced number of separate entities developing and implementing policy would improve accountability. We recommend that energy policy-making responsibility rest with a department head who is directly answerable to the administration and the Legislature, while regulatory functions should largely continue under a commission structure within the new department. We recommend that the Legislature adopt a process to comprehensively address the system for planning and permitting new transmission. Finally, we find that opportunities exist to consolidate energy program activities, thereby creating

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efficiencies. However, we recommend leaving other programs specified in the Governor's proposal out of a consolidated department due to limited benefits or problems which would be created by doing so.

**Figure 2**  
**Energy Reorganization Proposals**

Function/Structural Issue	Governor's Proposal	LAO Alternative
Organizational structure	Department of Energy.	Same.
Organizational head	Cabinet-level "Secretary."	Secretary or director.
Energy policy development	Responsibility of department head.	Same.
CEC	Abolish entity, transfer duties to new department, some of which would be handled by new commission.	Same.
Duties of new commission within new department	Limited to regulatory functions: permitting new power plants, approving energy efficiency standards, and permitting new electricity transmission projects.	Limited to regulatory functions: permitting new power plants, approving energy efficiency standards.
EOB	Abolish entity, transfer duties to new department.	Same.
CPA	Abolish entity, transfer duties to new department.	Allow authority to expire.
CERS	Transfer duties to new department.	Leave as is.
DOGGR	Leave as is.	Transfer duties to new commission within new department.
CPUC	Retain rate regulation responsibility and California Solar Initiative; responsibility for permitting electricity transmission projects transferred to new department.	Retain responsibility for rate regulation and electricity transmission permitting. Transfer California Solar Initiative to new department.
Electricity transmission permitting	Transfer permitting authority from CPUC to new commission within new department.	No recommendation; Legislature needs to determine allocation of responsibilities.
FERC representation	New department would appear before FERC as the lead representative of California energy policy. Other state entities could appear as needed.	Same.
Other nonregulatory programs	Transfer energy programs in Office of Planning and Research, Office of the State Architect, and Department of General Services to new department.	Leave as is, no transfer.



# MENTAL HEALTH MANDATES CONTINUE TO POSE CHALLENGES

***Should the Legislature Restructure Mental Health Services for Special Education Children to Address Major Fiscal and Policy Concerns With These State Mandates?***

## **Summary**

*State costs for reimbursing counties for two state-mandated programs to provide mental health services for school children have grown significantly in recent years. Moreover, serious weaknesses are evident in the system for delivering these services for children in special education programs. To help guide legislative policy-making in this area, we provide background information on these two mandates, assess the Governor's budget and policy proposals relating to them, and outline the Legislature's options for addressing these issues.*

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## INTRODUCTION

Costs for mental health services under two state-mandated programs that provide mental health services for special education students have grown significantly in recent years, and recent developments suggest that this trend is likely to continue. Moreover, we have identified problems with the ongoing implementation of these mandates involving weak fiscal controls, the lack of accountability for ensuring the quality of services, weak linkages to education, and the failure of some counties to provide these services at all to students.

In this analysis, we comment on the level of funding provided in the Governor's 2006-07 budget plan for these two mandates, examine in detail why the mandates are not an effective approach to operating such a large mental health services program, and outline two options for program reform in this area.

## BACKGROUND

*Federal Mandate Becomes a State Mandate.* In 1976, Congress passed what is now known as the Individuals with Disabilities Education Act (IDEA) to guarantee handicapped children the right to receive a free appropriate public education. This included special education and related services, such as mental health care, necessary for the child to benefit from his or her education.

Initially, local educational agencies were responsible for providing all of the necessary services to special education children under this federally mandated program. However, Chapter 1747, Statutes of 1984 (AB 3632, W. Brown) and related legislation shifted the responsibility for providing mental health services to counties. Also, subsequent state legislation shifted responsibility for mental health services for students placed in out-of-state residential facilities to the counties. These local mental health programs, in turn, have become known collectively as the "AB 3632" mandates.

Even though the requirements stem from a federal IDEA mandate, the Commission on State Mandates (CSM) has determined that, by obligating county mental health systems to provide these services to eligible children, AB 3632 and its related legislation constitute reimbursable state mandates for counties. Article XIII B, Section 6 of the State Constitution generally requires the state to reimburse claims filed by local agencies, such as counties, for costs they have incurred when the state has required them by legislation or regulation to establish a new program or a higher level of service.

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For several years, due to the state's fiscal problems, the state delayed making appropriations for the payment of these claims to counties, with the result that more than \$350 million in reimbursements are now owed by the state to counties for AB 3632 services. However, the state no longer has the option of avoiding or delaying such appropriations if it wishes a mandate to remain in effect. This is because Proposition 1A, a constitutional amendment approved by the voters in November 2004, generally requires the state to either fund or suspend local government mandates each year. The measure also allows the state to pay off its past mandate obligations over a set period of time (subsequent legislation established the repayment period at 15 years).

*Varied Sources of Funding Provided Over Time.* Like other special education programs, AB 3632 is structured as an entitlement program, meaning that it is available free of charge to all children eligible for services. The most recently available Department of Mental Health (DMH) data indicate that about 30,000 children receive services under the provisions of AB 3632. This program has been supported mainly from the following funding sources:

- ***DMH Categorical Program.*** Until 2002-03, DMH budgeted about \$12 million annually for a categorical program that provided "up-front" funding to counties for these services. Since 2002-03, this funding has been discontinued.
  - ***Medi-Cal and Other Health Coverage.*** The state's Medi-Cal health care program has been relied upon on an ongoing basis to help pay for AB 3632 services for about one-half of the children served by the program. The most recently available data suggest that state and federal Medi-Cal funding for AB 3632 children probably exceeds \$60 million annually. The state's Healthy Families Program and private insurance have also helped to pay for these services, although to a much lesser degree than Medi-Cal.
  - ***Realignment Funding.*** Sales tax and vehicle license fee funding that was provided to counties through the state-local realignment of mental health services enacted in 1991 has been used by some counties to help support AB 3632 services. In some cases, it has been used as a match to draw down part of the federal Medi-Cal funds identified above.
  - ***Federal Special Education Funds.*** Beginning in 2003-04, the budget for the California Department of Education (CDE) included about \$69 million in federal special education funds each year that were required to be passed through to counties for AB 3632 services.
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- **Mandate Reimbursements.** Counties have filed claims with the state to be reimbursed for their costs for carrying out state-mandated programs. With the exception of the realignment funds, these claims are generally for costs that are not paid for from the other funding sources we have identified above. For three years—2002-03 through 2004-05—the state budget did not include any funding to pay these county claims. However, following voter enactment of Proposition 1A, the 2005-06 Budget Act appropriated \$120 million to reimburse county mandate claims for AB 3632 services provided by counties during 2004-05 and 2005-06.

The mix of funding sources actually used for the support of these services has varied over time. The \$12 million DMH categorical program has not been in operation for four years and, as noted above, payments of reimbursements for mandates had been delayed for three successive years because of the state's fiscal problems. However, reimbursement payments to counties are now beginning to resume, with further support for the program now coming mainly from federal special education funds, Medi-Cal and other public and private insurance coverage, and county realignment allocations.

**SELPA Funding.** In addition to these resources, recent state budgets have also appropriated \$31 million annually from the General Fund to Special Education Local Plan Areas (SELPA), regional educational agencies that are responsible for the planning of special education services. These funds, which are counted as part of the Proposition 98 funding guarantee for schools, are to be used by SELPAs and schools to provide early intervention services for children who are experiencing mental health problems before they require special education services.

This program operates separately of AB 3632 and the \$31 million allocation is not available to county mental health agencies for the purpose of complying with the AB 3632 mandates.

## **ADMINISTRATION STILL SEEKING TO REVISE THE AB 3632 PROGRAM**

**2005-06 Actions.** Due to a number of fiscal and programmatic concerns about AB 3632 that we discuss in more detail below, the administration had proposed legislation last year to repeal the state laws mandating county mental health systems to provide these services to special education children. The administration further proposed legislation to return the responsibility for complying with federal IDEA special education mandates to the schools, but to also authorize SELPAs to contract with county mental

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health systems so as to minimize any disruption in the delivery of these services to children.

The Legislature rejected the administration's proposal to repeal the mandates, keeping the responsibility for providing these special education services with county mental health agencies. The Legislature also approved an appropriation of \$120 million from the General Fund to resume reimbursement of claims filed by counties for providing these services.

At the time he signed the *2005-06 Budget Act*, the Governor issued a written statement indicating that he was approving the \$120 million on a one-time basis. The Governor also directed DMH, in collaboration with CDE, to develop a plan to shift AB 3632 services from a state-mandated program to a categorical program in 2006-07.

**2006-07 Budget Proposal.** The administration's January budget does not include a specific proposal for a redesigned AB 3632 program. Instead, the administration indicates that it intends to submit these changes to the Legislature in time for the May Revision. The administration indicates that, while consultations with education and mental health agencies and others on such changes had begun, additional work was necessary before a comprehensive plan to implement its proposed approach would be ready for legislative consideration.

Despite the lack of a specific plan, the administration reiterated its intention to eliminate the AB 3632 mandates and to establish a categorical program for the same purposes in their place. It has also indicated its willingness to consider proposals providing categorical program funding for either mental health agencies or for the schools.

Finally, the January budget plan:

- Continues the \$31 million in Proposition 98 General Fund support for SELPAs for early intervention mental health services;
  - Maintains the transfer of \$69 million in federal special education funding to county mental health agencies for AB 3632 services;
  - Sets aside \$50 million from the General Fund (that is not counted toward Proposition 98) in the CSM budget for the proposed new AB 3632 categorical program; and
  - Allocates about \$98 million from the General Fund to begin reimbursing local governments for various unpaid mandate claims, of which about a third are unpaid past claims by counties relating to AB 3632 services.
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## BUDGET PLAN MAY NOT FULLY FUND AB 3632 SERVICES

**Budget May Provide Insufficient Funding.** Our analysis of the Governor's budget plan indicates that it would provide insufficient funding in the current year and budget year combined to fully fund the costs of the program under existing law. Depending on the design of the still-developing administration plan, additional funds beyond those now included in the budget plan may be needed for a new AB 3632 categorical program.

We acknowledge that it might be possible to achieve some reduction in the cost of AB 3632 services were they to be restructured from two mandates into a categorical program. However, the gap between existing county costs for the program in its current form and the amount of funding set aside in the Governor's budget plan for a new categorical program is significant.

Specifically, based on our review of preliminary data on county mandate claims for 2004-05 compiled by the State Controller's Office (SCO), we estimate that at least \$180 million would be needed for each of the 2005-06 and 2006-06 fiscal years to support AB 3632 services. Figure 1 shows the amount of funds appropriated in the 2005-06 *Budget Act* for these mandates and the amount of resources the administration has proposed for them in 2006-07. Absent the appropriation of additional state resources, the funding gap that remains to be addressed if AB 3632 remains a state mandate could exceed \$50 million in the current year and \$60 million in the budget year, for a potential combined shortfall of more than \$110 million over the two fiscal years.

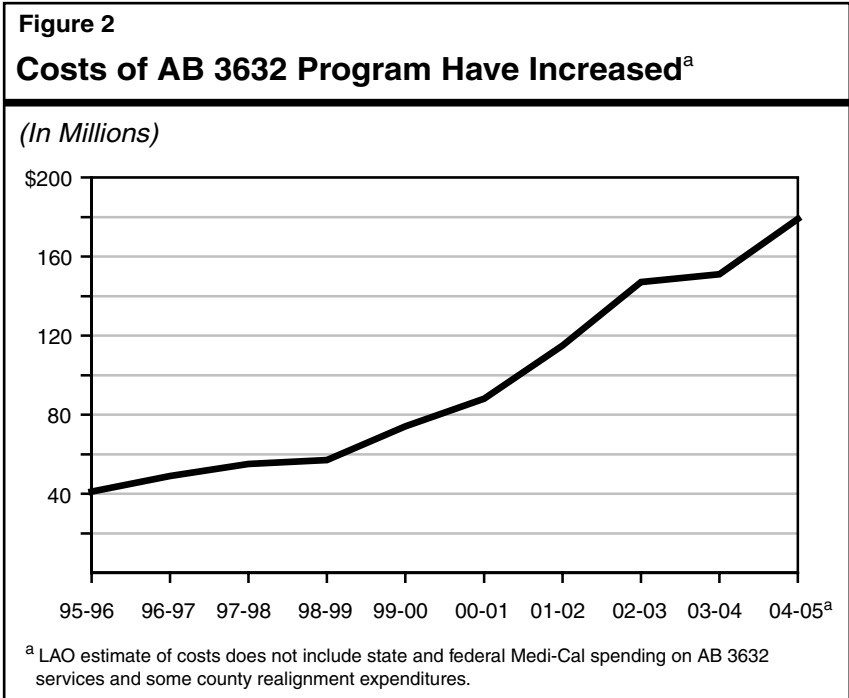
**Figure 1**

### LAO Estimate of Costs for AB 3632 Services

(In Millions)

	2005-06	2006-07
<b>Estimated Cost of County Services</b>	\$180	\$180
<b>Funding in Budget Act</b>		
Federal special education	\$69	\$69
Mandate appropriation in the Department of Mental Health budget	60	—
Set-aside in Commission on State Mandates budget	—	50
<b>Total Funding Available</b>	<b>\$129</b>	<b>\$119</b>
<b>Estimated Funding Gap</b>	<b>\$51</b>	<b>\$61</b>

**Funding Gap Could Be Greater.** The AB 3632 funding shortfall could be tens of millions of dollars greater than we have identified, especially if the Legislature decides to maintain them in the form of a state-mandated program. The SCO data upon which we have based our estimate is preliminary and more complete data could well document higher total costs for AB 3632 services than we are now projecting. As shown in Figure 2, past trends have demonstrated steady and significant growth in AB 3632 costs.



Recent changes in circumstances also suggest higher costs are likely for AB 3632 services. For example, considerable as the spending has been for AB 3632 services in recent years, it appears likely that county spending for AB 3632 services might have been even greater had not the state repeatedly delayed payments of any such claims to an undetermined date. Previously, some counties might have experienced cash flow problems before they received reimbursement from the state, but now the lag in payments of claims is likely to be reduced.

Another factor likely to significantly increase program costs is recent legislation and CSM actions broadening the scope of the mental health services and administrative costs that are subject to reimbursement by the state under AB 3632. These legislative and CSM actions clarified that

some services—such as case management, medication management, and psychotherapy—are now to be considered state-reimbursable costs. Retroactive claims for reimbursement for services that had been disallowed by state auditors for these services will be paid to counties, and future claims can also include these added services.

Similarly, counties have now been assured that they can use the realignment funds they receive under state law to help pay for AB 3632 services without having to reduce their mandate claims against the state to reflect these amounts. This includes realignment funds counties have used in the past to draw down federal Medi-Cal funding. These and other changes could increase the claims filed by counties against the state.

***Shortfall Probably Requires General Fund Solution.*** Our analysis indicates that the shortfall in funding for AB 3632 that we have identified will probably have to be addressed using state General Fund resources. For example, we have concluded that, under federal rules, additional federal special education funds are not available for the support of AB 3632 services beyond the \$69 million already proposed for this purpose in the education budget.

## **EXISTING MANDATES A POOR PROGRAM MODEL**

In our 2005-06 *Analysis* (please see page E-76), we discussed some of the problems with the state's existing approach to the delivery of AB 3632 services through the two state mandates on county mental health agencies. In this analysis, we focus on four key issues: (1) weak fiscal controls, (2) the lack of accountability for ensuring the provision of quality services, (3) weak linkages to education, and (4) the failure of some counties to provide these services at all. We discuss these issues below.

### **Weak State Mechanisms to Control Costs**

Our analysis indicates that the existing approach to delivery of AB 3632 services, by which the state reimburses counties for the provision of mental health services after-the-fact in response to claims, does not provide strong cost-control mechanisms or guarantee that state funds are well spent. As with all state-mandated programs, the state reimburses 100 percent of the allowable county administration and service costs that are claimed by counties. This reduces the incentive for cost management by local agencies.

This potential for costs to escalate is particularly significant in the case of AB 3632 because of the significant and unresolved disagreements that have arisen regarding which particular types of mental health services are necessary to fulfill the requirements of IDEA. The lack of a traditional

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categorical program structure, in which the costs and specific services that are authorized are spelled out clearly in statute and regulations, has sometimes left school agencies and counties confused as to which services and administrative costs are reimbursable under the two mandates.

A series of audits conducted by SCO since 2002 have disallowed almost \$39 million in AB 3632 claims based on audits of \$220 million in claims from counties. A large portion of the disallowances related to audit findings that medication management services could not be claimed under AB 3632—a decision that has now been reversed by legislation and CSM rulings. However, the CSM rulings did uphold audit findings that claims for reimbursement for crisis intervention services are not permissible.

The audits also found other evidence of weak fiscal controls in the provision of these services, such as claims for reimbursement for services provided by other programs as well as over-billing and data entry errors. Similarly, education agencies have reported finding counties providing AB 3632 services to students who are ineligible for special education services or to students who later cannot be found in any school district within that county. Some education agencies also have questioned whether, in some cases, the rates counties charged for AB 3632 services were higher than those charged for other county mental health programs.

### **A Lack of Accountability for Ensuring the Quality of Services**

Our analysis indicates that the existing mandate approach also does not create an accountability mechanism to encourage the delivery of effective mental health services. The goal of AB 3632 is to help special education students do better in school. The existing program structure simply provides funds to counties for services rendered without (1) a program element to measure how well counties achieve the program's goals or (2) a requirement to provide basic data on services provided to students in the program.

### **Weak Linkages to Education**

Existing law assigns county mental health agencies the responsibility to provide AB 3632 services to help students succeed in school. To carry out this responsibility, county mental health agencies assess the needs of students who may need mental health services, develop the treatment plan for students who need these services, and deliver and pay for those services. Existing statute, however, does not (1) ensure that mental health and education agencies collaborate to design effective local programs, (2) require counties to consult with K-12 education agencies regarding the delivery of services, or (3) provide an accountability mechanism to assess the extent to the programs are working to resolve the mental health problems of special education students. As a consequence, the existing AB 3632

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mandate can foster an inappropriate separation between local K-12 and county mental health agencies.

This separation can make it difficult for educators to have input over the design and quality of AB 3632 services. For example, some educators indicate that counties do not provide important information regarding the status and progress of students receiving AB 3632 services. Other educators indicate that they would prefer that counties provide AB 3632 services at or near school sites in order to minimize travel costs and a student's time away from the classroom. Under the existing program, however, educators have no formal authority to get needed information or to ensure that the provision of mental health services does not supplant teaching time during the regular school day.

The separation of program responsibilities also leads some educators to believe that they have *no* role in the AB 3632 program. Because the state has assigned most responsibilities to local mental health, some educators believe that issues regarding program accountability or effectiveness should be addressed by counties and the state. These mental health services, however, support a student's individual *education* plan. As such, we think educators should be directly involved in the development of local AB 3632 programs as a way of maximizing the impact of services on each student's educational opportunities.

### **No Services Provided in Some Instances**

Federal special education law makes schools responsible for providing all special education services, including mental health services. Thus, if counties do not provide services, the responsibility falls to the schools to do so.

At least three local education agencies in California now administer all or some of the required AB 3632 services. These education agencies must provide the mental health services without access to AB 3632 funds or other available funding sources. The current program does not contemplate these situations, which can leave education agencies with the task of developing and funding a network of services without an adequate funding mechanism to pay for them.

## **ISSUES FOR LEGISLATIVE CONSIDERATION**

The issues discussed above reveal the kinds of problems that are created by using a state mandate to administer and finance a complex program that requires close coordination between the K-12 education and county mental health systems. State-mandated local programs provide only a

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source of funds. The existing AB 3632 mandate does not establish guidance about eligible services, accountability for ensuring the delivery of effective services, or the responsibilities of state agencies for program oversight.

To address these issues, we recommend that the Legislature initiate steps to restructure the way the state provides AB 3632 services to improve the way these services are provided to children and to avoid future fiscal problems.

### **Mandates Should Be Eliminated**

Any restructuring, in our view, begins with the repeal of the existing AB 3632 mandates. To us, the evidence is strong that the current approach of relying on state mandates does not ensure the delivery of quality services for the children who need them. Moreover, under the current approach, the state is already experiencing significant increases in costs in this program, and faces difficulty in ascertaining whether these services are being provided in a cost-effective manner.

The Legislature also will have to address the funding shortfall for AB 3632 services that is likely to occur under the Governor's budget proposal. We see few reform options that would reduce AB 3632 costs by the roughly \$60 million (about one-third of current estimated program costs) that would align the program with the level of resources that would be available under the Governor's budget plan.

The Legislature thus faces significant programmatic issues in the design of AB 3632 services and an immediate fiscal issue because the amount of funding proposed by the administration is likely to fall short of the amount needed to maintain the existing level of services. We believe the administration has an obligation to provide the Legislature with a policy proposal for modifying AB 3632 services that is in alignment with the funding that it proposes for these purposes.

### **Insist on Early Review of Administration Proposal**

As noted earlier, the administration announced last July that it intended to prepare a proposal for a categorical program that would take the place of the AB 3632 mandates. Seven months after declaring its intention to prepare a plan for a categorical program, no such proposal has been presented to the Legislature and the administration now plans to present its completed proposal at the time of the May Revision. This proposed schedule, coming very late in the budget process, would not provide the Legislature sufficient time to assess the merit of such a plan.

Accordingly, we recommend that the administration be directed to present its preferred approach to the Legislature by April 1. If the Legislature is interested in restructuring AB 3632 services and repealing the two mandates, we recommend that it convene early legislative policy hearings

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to examine the administration proposal and the alternative approaches we discuss below.

### **Options for Reform of AB 3632**

As discussed above, the absence of fiscal, program, and accountability measures for these services means that reforming the AB 3632 program requires developing these program components to guide the delivery of mental health services for special education students.

We see at least four major issues that any reform of AB 3632 should address:

- **Lead Administrative Agency.** The choice of lead local agency (county mental health agencies or the SELPAs) would affect the program's orientation towards mental health or education.
- **Funding Mechanism.** A new AB 3632 program would require a funding formula that balances incentives for efficient delivery of services with the federal mandate that all special education students who need mental health services must receive them. While there are a range of options, we would recommend the Legislature avoid the use of state mandates to finance this program.
- **Local Coordination of Services.** The state needs to create better mechanisms and incentives for joint planning between county mental health agencies and SELPAs in the design of services. A new program also should provide flexibility over which local agency delivers services.
- **Accountability and Oversight.** So long as the state maintains fiscal responsibility for AB 3632 services, it also needs accountability mechanisms to ensure that local programs are effectively addressing student mental health needs. In addition, the state agencies should play a larger role in encouraging local collaboration between the two systems.

Below, we briefly describe two options that address these major program issues.

**Option: Shift Program Responsibility to K-12 Education.** In our *Analysis of the 2005-06 Budget Bill*, we recommended shifting responsibility for AB 3632 services to a K-12 education categorical program, which we believe would alter the financing and governance for mental health services sufficiently to address most of the shortcomings of the current system. We continue to prefer this approach, under which special education programs would be provided a block grant of funds with which to support mental health services, thereby creating strong incentives for educators to operate efficient programs.

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Our recommended approach would mend the separation between education and mental health services by making the education system responsible for the program, with the likely result of a greater focus on providing effective services to students. Because the responsibility for providing both special education and related mental health services would clearly rest with the schools, school accountability for student education outcomes would also be clarified. Moreover, there is no reason why this governance change should disrupt the delivery of these services to children, since, under our preferred approach, local education agencies could contract with county mental health agencies for the delivery of services.

Under our model, mental health and education agencies could nonetheless collaborate in providing mental health services to special education students. As noted earlier, counties in many cases would continue to serve as the main provider of these services under a contract relationship with school agencies. As with the current system, making the two systems work together—despite different governance structures, goals, and cultures—could present challenges.

***Option: Mental Health Categorical Program.*** While we continue to believe our recommendation for a K-12 categorical program represents the best option available to the state, we believe the Legislature should also examine the alternative of creating a new AB 3632 categorical program operated by county mental health agencies.

This approach has some advantages. For example, it would keep all county mental health services for children in one county mental health system. This would allow schools to take advantage of existing expertise and economies of scale in the county-operated programs. It would also allow counties to identify and meet the mental health needs of special education students other than those services that are required for a student's educational program. We discussed this possibility in our *Analysis of the 2002-03 Budget Bill*. (Please see page C-159.) One disadvantage of this model is that, if a county agency failed to fully carry out its responsibilities, school agencies would continue to remain financially and programmatically at risk under the federal IDEA mandate to provide these services.

A new program, however, could be designed to take advantage of the strengths of the county mental health agencies while also recognizing the shared responsibility for these services. For instance, the state could require joint planning of county AB 3632 programs in order to promote closer working relationships between education and mental health. Local accountability mechanisms also could be included in a new county program as an avenue to improving the quality of services to students. Even the funding mechanism could recognize the shared responsibility for AB 3632 services by requiring both education and mental health to support program costs when they exceed the amount provided by the state.

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## CONCLUSION

The 2006-07 *Governor's Budget* proposes a significant change in the existing AB 3632 program but does not yet provide a specific approach for the Legislature to consider. In addition, the budget proposal could be more than \$110 million short of fully funding the program for 2005-06 and 2006-07, combined. In our view, the reform of AB 3632 that is contemplated by the administration is unlikely to generate enough savings to bring its proposal into alignment with the level of funding it has included in the 2006-07 budget plan.

We agree, however, with the underlying assumption in the Governor's proposal that the state needs to find a better mechanism for financing AB 3632 services than the existing state-mandates. Moreover, the current program raises a number of policy issues that warrant the Legislature's attention. By addressing both the policy and fiscal issues together, we see an opportunity for the Legislature to place this program on a path that could result in more efficient and effective services at the local level.