The 2007-08 Budget: Perspectives and Issues

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

Elizabeth G. Hill, *Legislative Analyst*

Staff

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

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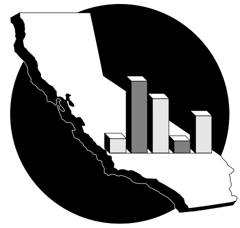


INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2007-08 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 2007-08 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2007-08 Budget Bill*, which contains our review of the *2007-08 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 2007-08 Budget: Perspectives and Issues is divided into five parts:

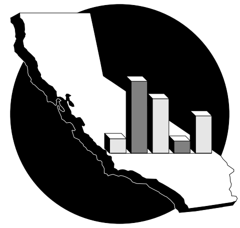
- Part I, "State's Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part II, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part III, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2008-09.
- Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2007-08 and evaluates the major expenditure proposals in the budget.

- Part V, "Major Issues Facing the Legislature," (1) offers a "roadmap" for how the state could spend projected major increases in discretionary Proposition 98 monies over the next five years; (2) assesses the fiscal implications of the Governor's health care coverage proposal; (3) reviews the Legislature's oversight role regarding employee compensation issues; (4) assesses the Governor's proposal to reform the mandate reimbursement process; (5) analyzes two tax proposals the Governor proposes to eliminate in the budget year; and (6) presents steps the state should take to further the adoption of health information technology.

I

State's Fiscal Picture

State's Fiscal Picture



After 2006-07, a year in which state policymakers were able to use surging revenues to significantly increase education spending and prepay budgetary debt, the state faces a challenging outlook. The Governor's budget attempts to bridge a significant shortfall in 2007-08 through a variety of means, including a major redirection of transportation funds, significant reductions in social services, and a substantial increase in tribal gambling revenues from amended compacts.

LAO Bottom Line. Based on our revenue and expenditure projections, we estimate that the adoption of the Governor's budget plan would result in a $726 million deficit in 2007-08 (compared to the administration's January 10th estimate of a $2.1 billion reserve). The difference in these numbers is due principally to our lower estimates of revenue in both the current and budget years, but also due to higher expenditure estimates, primarily related to Proposition 98. Adoption of the plan would also leave the state with large operating shortfalls in future years, unless additional corrective actions are taken. Thus, the Legislature will face major challenges in crafting a budget for the coming year. We believe that the primary focus should be on finding additional budget savings and/or revenues to address the near- and longer-term shortfalls. Should these solutions be insufficient to cover the full magnitude of the budget shortfall, however, the state can also achieve some near-term savings by reducing the amount of supplemental repayments on deficit-financing bonds relative to the $1.6 billion proposed in the budget.

The Budget Proposal

Economic Forecast—Sluggish Growth Through Mid-2007

The U.S. and California economic expansions slowed over the first three quarters of 2006 in response to both the declining real estate market and soaring fuel prices. The budget forecast assumes that the slowdown will persist through the first half of 2007 before stabilizing real estate markets provide support for an upturn beginning in the second half of the year. On an annual average basis, the budget forecasts that U.S. gross domestic product growth will slow from 3.3 percent in 2006 to 2.4 percent in 2007, before partially rebounding to 2.9 percent in 2008. In California, wage and salary employment growth is projected to slow from 1.8 percent in 2006 to 1.2 percent in 2007, before rebounding to 1.6 percent in 2008.

Revenue Forecast—Modest Growth in 2006-07, Larger Increase in 2007-08

The budget forecast is based on economic and revenue trends through November of 2006. Tax receipts during the first five months of the current year fell slightly short of the *2006-07 Budget Act* estimate, which itself assumed only modest growth in 2006-07. The administration's forecast assumes that current trends will improve somewhat in the second half of the current year, but that total revenues and transfers will still increase by only 1.7 percent from the prior year—reaching $95 billion for all of 2006-07. Major taxes are projected to increase by a slightly stronger rate of 2.7 percent. In 2007-08, the budget forecast projects that revenues and transfers will be $102.3 billion, a 7.7 percent increase from the current year. Adjusting for policy-related changes, underlying revenues and transfers are projected to increase a more moderate 6.5 percent during the year.

Revenue-Related Policy Changes. The budget contains no major tax law changes. It does, however, include $506 million in new revenues from amended tribal gambling compacts, and $290 million from tax-related changes and compliance measures. About $165 million of this total is related to the elimination of the teacher tax credit.

Total Budget Spending

The budget proposes total state spending in 2007-08 of $130.8 billion (excluding expenditures of federal funds and bond funds). General Fund spending is projected to increase from $102.1 billion to $103.1 billion (an increase of 1 percent), while special funds spending rises from $24.5 billion to $27.7 billion.

General Fund Condition

Figure 1 shows the General Fund's condition from 2005-06 through 2007-08 under the budget's assumptions and proposals. It shows that:

- ***2005-06.*** The prior year concluded with a reserve of $10.1 billion. The large reserve reflects major increases in revenues in 2004-05 and 2005-06, as well as strong amnesty payments received in 2004-05. It also reflects the proceeds of the deficit-financing bonds issued in 2003-04.
- ***2006-07.*** In the current year, expenditures (at $102.1 billion) are expected to exceed revenues (at $95 billion) by $7.1 billion, leaving $2.9 billion in the reserve.
- ***2007-08.*** In the budget year, projected expenditures increase to $103.1 billion, while revenues are projected to reach $102.3 billion. The resulting $800 million operating shortfall reduces the year-end reserve to $2.1 billion by the close of the budget year.

Figure 1

Governor's Budget—General Fund Condition

(Dollars in Millions)

			Proposed 2007-08	
	2005-06	2006-07	Amount	Change
Prior-year fund balance	$8,981	$10,816	$3,670	
Revenues and transfers[a]	93,427	94,990	102,300	7.7%
Total resources available	$102,408	$105,807	$105,970	
Expenditures	$91,592	$102,137	$103,141	1.0%
Ending fund balance	$10,816	$3,670	$2,830	
Encumbrances	$745	$745	$745	
Reserve	$10,071	$2,925	$2,085[b]	
Budget Stabilization Account	—	$472	$1,495	
Reserve for Economic Uncertainties	$10,071	2,453	590	

Detail may not total due to rounding.

a 2006-07 amount includes $472 million and 2007-08 amount includes $1.023 billion in General Fund revenues transferred to the Budget Stabilization Account, which the administration excludes from its revenue totals. These different treatments do not affect the bottom-line reserve shown.

b As reflected in the *2007-08 Governor's Budget*. Does not account for added costs associated with recent arbitration ruling involving correctional officers' pay, which the administration has acknowledged since the budget's release.

Key Features

Relative to a current-law baseline budget, the Governor proposes about $1.2 billion in additional spending, but also $3.4 billion in various solutions to keep the budget in balance and establish a sizeable reserve. Some of the key programmatic features of the budget are shown in Figure 2.

New Spending. This consists of a $595 million supplemental payment toward retirement of outstanding deficit-financing bonds, $132 million to fund the Governor's compact with higher education, and about $471 million in various other state programs.

Budget Solutions. About one-third of the $3.4 billion in solutions is related to the redirection of $1.1 billion from a transportation special fund to support certain transportation-related General Fund expenditures. The spending is in Proposition 98 home-to-school transportation, general obligation bond debt service, and regional center transportation services in the Department of Developmental Services. The remaining two-thirds of the solutions are related to proposals in a variety of different areas, including:

- $506 million in new revenues from amended tribal gambling compacts;
- $496 million in reductions in the California Work Opportunity and Responsibility to Kids (CalWORKs) program. These are primarily due to (1) the suspension of the July 2007 cost-of-living adjustment (COLA), (2) a proposed full-family sanction eliminating the grant for children in families that are out of compliance with the program, and (3) a five-year time limit for children unless an adult family member meets federal participation requirements;
- $200 million from bond fund proceeds to reimburse the General Fund for flood protection expenditures and $160 million from the elimination of General Fund support for deferred park maintenance;
- $269 million from a shift of CalWORKs childcare to Proposition 98 (thereby reducing General Fund spending in the CalWORKs budget);
- $200 million in revenues from the elimination of the teachers' tax credit and permanent extension of recent changes involving the application of the use tax to out-of-state sales of vessels, aircraft, and vehicles.

Figure 2

Key Programmatic Features of the 2007-08 Budget Proposal

Proposition 98

- Uses $1.9 billion funding increase to cover a 4 percent cost-of-living adjustment (COLA) in K-12 and provides additional support for California Work Opportunity and Responsibility to Kids (CalWORKs)-related child care.
- Rebenches the minimum guarantee.
- Increases community college funding to cover a 4 percent COLA and 2 percent enrollment growth. Leaves fees at current level.

University of California (UC) and California State University (CSU)

- Funds 4 percent base increases and about 2.5 percent enrollment growth. Proposes student fee increases of 7 percent for UC and 10 percent for CSU.
- Reduces state support for outreach programs.

Transportation

- Uses $1.1 billion from the Public Transportation Account to replace General Fund spending in three areas: Proposition 98 funding on home-to-school transportation; transportation services provided by regional centers; and debt service on general obligations bonds issued for transportation projects.

Health and Social Services

- Suspends the July 1, 2007, COLA for CalWORKs grants, and places new time limits and sanctions on children whose parents cannot or will not comply with CalWORKs participation requirements.
- Makes relatively few significant changes in health programs. Does not reflect impacts of Governor's proposed health care reforms.

Criminal Justice

- Provides significant funding increases in the Department of Corrections and Rehabilitation to cover price increases, inmate growth, compliance with various court orders, and a new probation grant program. Includes some offsetting savings from a proposed change in parole policies and shifting certain juvenile offenders to county facilities.

Revenues

- Includes $506 million resulting from amended tribal gambling compacts.
- Proposes permanent elimination of the teachers' tax credit and permanent extension of the recent use tax law changes.

LAO OUTLOOK

In this section, we examine the implications of the *2007-08 Governor's Budget* proposal for the near- and longer-term General Fund condition, using our own revenue forecast and our own estimates of the impacts of the Governor's proposals on revenues and expenditures. Our estimates do not reflect any of the programmatic recommendations that we make in our *Analysis of the 2007-08 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 legal risks associated with the budget proposals, we have generally given the administration the benefit of the doubt, and thus have not included their potential added costs.

2007-08 Budget Would End With Deficit

As indicated in Figures 3 and 4, we estimate that if the Governor's budget were fully adopted, the state would end 2007-08 with its reserves exhausted and a deficit of $726 million. (See box on page 10 for a discussion regarding the Budget Stabilization Account [BSA] in this context.) This

Figure 3

Key LAO Budget Findings

✓ **2007-08 Would Conclude With a $726 Million Deficit**

- Revenues down $2 billion during current and budget years combined, reflecting reductions in personal income taxes and less revenues from tribal gambling and pension obligation bonds.
- Expenditures up by about $825 million, reflecting increases related to Proposition 98 and pension obligation bonds, partly offset by caseload savings in corrections and social services.

✓ **Structural Shortfall Would Continue in Subsequent Years**

- Operating shortfall would be $3.4 billion in 2008-09, before dropping to $2.5 billion in 2009-10.

✓ **State Faces Major Risks and Pressures**

- Potential legal issues with Proposition 98 rebenching.
- Court cases related to CalWORKs, prison health care, and limited liability companies.
- Pressures related to state retiree health care costs.

year-end deficit results from an operating shortfall (that is, an excess of expenditures over revenues in 2007-08) of $2.6 billion, which is only partly covered by the $1.9 billion reserve available from 2006-07.

Our estimate of a year-end deficit contrasts with the administration's forecast of a $2.1 billion reserve. The difference reflects both our lower estimate of revenues and higher estimate of expenditures for the prior, current, and budget years.

Lower Revenues. We forecast that General Fund revenues in 2006-07 and 2007-08 will fall below the budget forecast by a combined total of $2 billion. About $1.4 billion of the difference is related to our lower estimate of revenues from the state's major taxes. A key factor behind our lower tax projections is much weaker-than-expected receipts from year-end personal income tax estimated payments. As indicated in "Part III," we believe that these lower payments are indicative of lower tax liabilities associated with volatile investment income and real estate-related business earnings. The softness in these volatile sources is mitigated somewhat by recent evidence that the economy is emerging from its recent slowdown somewhat earlier than assumed in the budget.

Figure 4

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

(In Millions)

	Actual 2005-06	Estimated 2006-07	Projected 2007-08
Prior-year fund balance	$8,981	$10,693	$2,651
Revenues and transfers[a]	93,427	94,052	101,253
Total resources available	$102,408	$104,745	$103,904
Expenditures	$91,715	$102,094	$103,885
Ending fund balance	$10,693	$2,651	$19
Encumbrances	$745	$745	$745
Reserve	$9,948	$1,906	-$726
Budget Stabilization Account	—	$472	—
Reserve for Economic Uncertainties	$9,948	1,434	—

[a] 2006-07 amount includes $472 million and 2007-08 amount includes $1.023 billion in General Fund revenues transferred to the Budget Stabilization Account, which the administration excludes from its revenue totals. These different treatments do not affect the bottom-line reserve shown.

Detail may not total due to rounding.

The BSA and the Budget

Background

Proposition 58 (approved by the voters in 2004) established a new General Fund budget reserve, called the Budget Stabilization Account (BSA). The measure requires that annual transfers be made to this account totaling 1 percent of revenues in 2006-07 (equivalent to $944 million), 2 percent in 2007-08 (equivalent to $2 billion), and 3 percent thereafter, until the balance of the reserve reaches either $8 billion or 5 percent of General Fund revenues, whichever is greater.

One-half of the annual transfers (or $1 billion in 2007-08) is allocated to a subaccount to make supplemental payments on the outstanding deficit-financing bonds, until they are paid off. The other half is available to support General Fund expenditures (as is the case for the state's other reserve, called the Reserve for Economic Uncertainties).

June 1 Deadline Important. Proposition 58 permits these annual transfers to be suspended by the Governor no later than June 1 preceding the beginning of the fiscal year. This deadline is significant, particularly in the context of balancing the 2007-08 budget. If the transfer is not suspended by June 1, 2007:

- The full transfer ($2 billion) will be made to the BSA.
- Of that amount, $1 billion is immediately allocated for supplemental payments on the deficit-financing bonds, and thus is unavailable to address the 2007-08 budget shortfall.
- Only the remaining $1 billion would still be available for budget-balancing purposes.

Alternatively, if the transfer is suspended, an additional $1 billion would be available for budget-balancing purposes.

BSA and the General Fund Condition

Our display of the General Fund condition for 2007-08 (see Figure 4) reflects the Governor's proposal to make the full $2 billion transfer to the BSA during the year. Thus, our expenditure total includes the one-half of the BSA transfer that would be dedicated to supplemental payments to pay off the deficit-financing bonds ($1 billion).

Given the deficit that we are projecting under the Governor's plan, we assume that the full balances in the BSA and in the Reserve for Economic Uncertainties would be tapped to support the Governor's plan. Thus, in Figure 4, we show zero balances remaining in these reserves. Even after drawing these reserves down to zero, the state would still be short by $726 million in balancing its 2007-08 budget.

The remaining one-fourth of this total is related to our less optimistic assumptions about receipts related to tribal gambling and pension obligation bonds. Specifically, we assume that if the Governor's proposed amended compacts were approved by the Legislature, new tribal gambling revenues would be about $200 million in 2007-08, or more than $300 million less than the administration's forecast. We are also assuming that the $525 million pension obligation bonds assumed by the administration will not be sold due to continued legal problems. These bonds have been invalidated at the lower court level, on the grounds that they constitute debt and therefore must be approved by the voters. About $252 million of the total bonds show up on the revenue side of the budget, while the remaining $273 million shows up as reduced expenditures.

Higher LAO Costs. We estimate that General Fund expenditures under the Governor's budget proposal would exceed the administration's estimate by a net amount of $825 million over the prior, current, and budget years combined. The single largest difference is in the area of Proposition 98, where we estimate that General Fund spending will exceed the budget estimate by $465 million, for two reasons:

- First, we are assuming that the slowdown in real estate activity in California will reduce property tax growth below the administration's forecast, resulting in $204 million less local property tax revenues available to school districts. This is significant because local revenues offset, dollar for dollar, General Fund expenditures for Proposition 98.
- Second, our pattern of General Fund revenue growth (a smaller increase in the current year but a larger increase in the budget year) boosts the Proposition 98 minimum guarantee $261 million above the administration's estimate in 2007-08. This is counterintuitive, given that our revenue estimates are below the budget estimates for both years. It occurs because, while the smaller current-year increase would lower the minimum guarantee relative to the *2006-07 Budget Act* estimate, the actual level of funding will not fall unless the Legislature takes action to reduce the current-year Proposition 98 appropriation level. Absent such a current-year reduction, the year-to-year change in revenues we project would then raise the guarantee above the level proposed in the 2007-08 budget. (This is because Proposition 98 drives off the year-to-year *growth* in General Fund revenues, not the actual *amount* of revenues.)

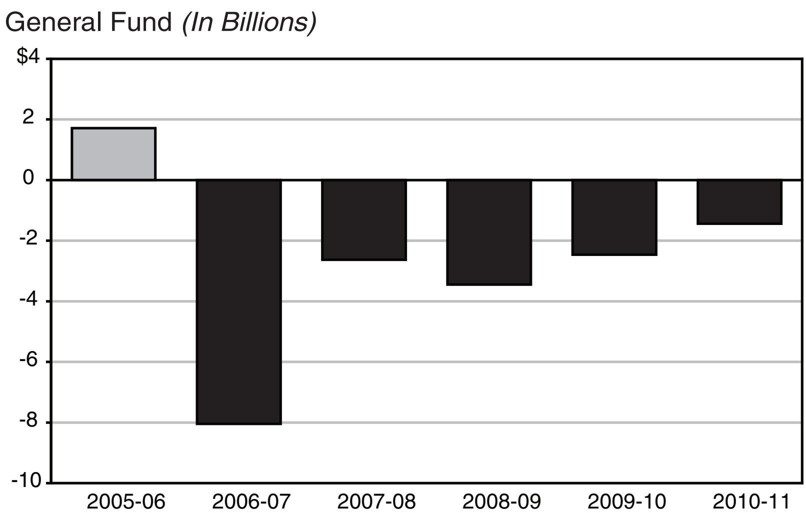
Other factors accounting for our higher expenditure estimate are (1) added pension-related expenses associated with our assumption that the pension obligation bonds will not be sold, (2) added prior-year costs related to a recent arbitration ruling involving correctional officers' pay, and (3) lower savings from unallocated reductions than assumed by the administration. These added costs are partly offset by (1) our higher estimate of savings that would accrue from the Governor's proposals for parole reform and (2) estimates of caseload and COLA savings in social services programs.

Structural Shortfalls Would Persist ...

As shown in Figure 5, the annual operating deficit would expand in 2008-09 under the Governor's budget plan, and remain significant thereafter. Specifically, we estimate that the shortfall would grow to $3.4 billion in 2008-09, before dropping back to about $2.5 billion in 2009-10 and then $1.4 billion in 2010-11 (when there are no deficit-financing bond payments left to make). These estimates assume that the economy and state revenues grow at a moderate pace through 2010-11. They also take into account the out-year revenue and expenditure implications of the Governor's key solutions.

Figure 5

Significant Operating Shortfalls[a] Would Remain



[a]Annual revenues minus expenditures. Legislative Analyst's Office estimate of Governor's revenue and expenditure policies.

… As Would Other Risks and Pressures

The state faces a number of risks and pressures beyond those that we have explicitly accounted for in our near- and long-term fiscal projections. Key risks include:

- Serious legal issues related to the Governor's proposal to reduce the Proposition 98 guarantee by $627 million in 2007-08 to reflect the funding shift for home-to-school transportation to the Public Transportation Account.
- Potential added CalWORKs costs related to the *Guillen* case. In this case, a lower court ruled that the October 2003 COLA (which was tied in statute to reductions in the vehicle license fee) is required by current law. Unless the lower court ruling is overturned at the appellate court or Supreme Court level, the state faces one-time CalWORKs grant costs of over $400 million and potential ongoing costs of over $100 million.
- The state is currently dealing with a variety of federal lawsuits related to its correctional health care system. We have included significant spending, both in 2007-08 and in the out years, to reflect costs associated with these lawsuits. However, the full magnitude of these costs is unknown, and could exceed our estimates by a considerable margin.
- The state is appealing two lower court decisions which found that California's application of the Limited Liability Company fee is unconstitutional. Unless the appellate court overturns the lower court decisions, the state could face potential losses ranging from roughly $100 million to over $1 billion (depending on whether the appellate courts' decisions involved modifying the fee or eliminating it altogether).

Finally, our estimates do not include the added cost pressures associated with retirees, particularly related to health care costs. The state faces an estimated unfunded liability of between $40 billion and $70 billion for retiree health benefits promised to its employees, and local governments and school districts similarly face large obligations. If the state were to prefund its costs for retiree health benefits accruing in 2007-08, it would need to increase annual General Fund spending by over $1 billion. The cost to start paying off past unfunded liabilities would be billions of dollars more each year.

Issues and Considerations

As discussed above, the Governor's budget is based on a number of optimistic assumptions. Using our estimates of revenues and expenditures under the Governor's plan, we estimate that the state would conclude 2007-08 with a $726 million deficit, and would face a continuing structural shortfall thereafter. Beyond this, some of the budget's key proposals raise significant policy issues, and the state faces legal risks that could have substantial impacts on the fiscal picture over the next several years.

In view of these factors, it will be necessary for the Governor and Legislature to find additional solutions in order to bring this budget into balance. Two types of solutions include:

Budgetary Savings. The accompanying *Analysis of the 2007-08 Budget Bill* includes numerous specific recommendations regarding the budget proposal, some of which would produce significant General Fund savings. For example, in Proposition 98, we estimate that current-year K-14 school spending now significantly exceeds the minimum funding guarantee. By selectively reducing current-year Proposition 98 appropriations (with minimal impact on programs), the state could not only achieve 2006-07 savings but also avoid increasing costs above the Governor's proposal for 2007-08. In higher education, we recommend reductions in the Governor's proposal for the University of California and the California State University totaling $138 million, primarily reflecting our estimates of expected inflation and enrollment growth for the coming year.

Reduced Supplemental Repayments Toward Budgetary Debt. If it is not possible to fully restore budgetary balance through program savings and revenues, the state could also reduce the supplemental payments it is making to pay off the deficit-financing bonds. The Governor's budget assumes about $3 billion in repayments of deficit-financing bonds during 2007-08. About one-half of this total is related to annual payments from the quarter-cent sales tax, and the other is from supplemental payments—about $1 billion from the BSA (as required by Proposition 58 unless suspended by the Governor) and $595 million from a proposed separate appropriation. The state could eliminate the proposed $595 million supplemental payment in 2007-08, as well as a portion or all of the $1 billion payment from the BSA. We fully appreciate the administration's goal of paying off these bonds to make room for additional infrastructure borrowing. However, we believe that extending the repayments of these relatively low-cost bonds is preferable to accelerating the payments and then incurring new, higher-cost debt such as the pension obligation bond.

Finally, given the magnitude of the ongoing operating shortfalls, it will be particularly important that the Legislature avoid raising ongoing budget commitments without identifying alternative reductions or new revenues to pay for them.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics

Summary

Both the U.S. and California experienced continued economic expansion with modest inflation in 2006. The pace of growth varied considerably within the year, however. Growth was strongest early on, then slowed as expected, reflecting a sharp decline in real estate activity. The good news is that the softness in housing has not spread to the rest of the economy to any significant degree, as economic growth outside of housing-related industries continued at a moderate pace during 2006. The year ended on a positive note, with preliminary fourth-quarter national growth estimated to be above expectations. Whether this initial estimate will hold up when it is revised in late February and again in late March remains to be seen, however, as many think it is possible that a lower figure is more consistent with other more recent economic data.

For 2007, like most other economists at this time, we forecast that growth will continue but be modest for the nation and California. For the year as whole, 2007 growth will be somewhat less than it was in 2006, with the first half of the year the weakest. Throughout the year, however, growth should accelerate, as the housing sector stabilizes, especially in the second half of 2007. We expect that the state's performance will generally be similar to the nation's.

It should be noted that the current economic expansion has lasted five years and, thus, is comparatively old by historical standards. In addition, past experience tells us that predicting economic turning points is very difficult and expansions do not last forever. It also is important to be aware that there are a number of risks and uncertainties in the outlook, as discussed below. However, despite these considerations, most economists anticipate that the expansion will continue in 2007 and 2008, and think the odds of a pronounced slowdown or outright downturn are relatively low. We share this view.

Recent U.S. Developments

All Major Economic Sectors Except Housing Expanded in 2006

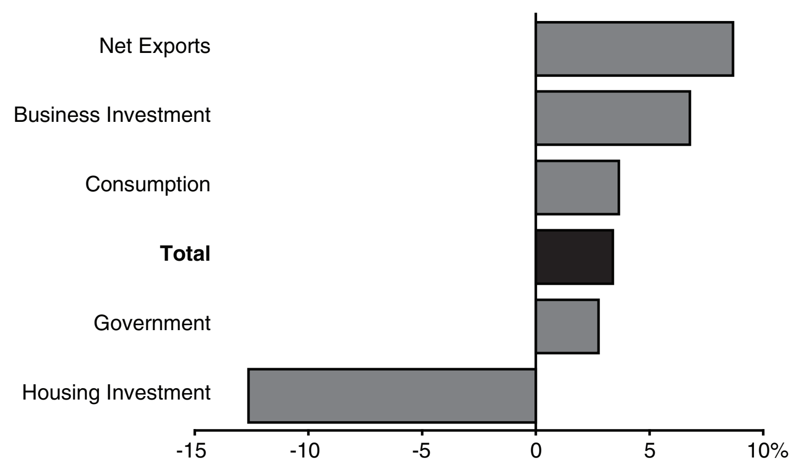
Figure 1 shows that most gross domestic product (GDP) categories experienced moderate to healthy growth in real (inflation-adjusted) terms on a fourth-quarter to fourth-quarter basis during the year. The one exception is residential construction—primarily housing—which fell sharply. Specifically:

- Net exports—which equals exports minus imports—had the greatest percentage improvement and accounted for about one-sixth of GDP growth. Although net exports remain negative, reflecting the nation's trade deficit, they became less negative in the fourth quarter of 2006. This was due to the combination of healthy economic growth abroad (which increases foreign demand for our domestically produced exports), a declining dollar (which also stimulates our exports and discourages imports), and the decline in oil prices. This in turn led to a modest decline in the U.S. trade deficit late in the year and, thus, less of a drag on our economy.

Figure 1

Outside of Home Construction, 2006 Was a Good Year

Percent Change in Real GDP Components Fourth Quarter of 2005 to Fourth Quarter of 2006



- The next-fastest-growing output category was business spending on computers, software, networks, other equipment, and new facilities (referred to as nonresidential investment). This category increased by nearly 7 percent in real terms.
- Consumer spending, driven by good job growth and wage gains, increased 3.7 percent during the year. This moderate increase partly reflects a somewhat better-than-expected holiday shopping season in late 2006.
- Government spending rose 2.8 percent, reflecting modest increases at the federal, state, and local levels.
- On the downside, home construction (technically referred to as residential investment) fell by over 12 percent during 2006, reflecting major declines in single-family home construction and more-moderate declines in construction of apartments.

Reduced Oil Prices Having Positive Economic Impact

World crude oil prices, which rose from around $30 per barrel in early 2004 to a peak of over $75 in mid-2006, began falling in late summer. As shown in Figure 2 (next page), prices retreated from $73 in August to near $60 as of the close of 2006. Prices dropped further during the first three weeks of January, into the low $50s, before returning to about $60 as of mid-February.

Factors contributing to the 2006 decline include: (1) increases in worldwide production and declines in worldwide consumption; (2) fewer-than-expected supply disruptions from hurricanes and other factors; and (3) a mild early winter in the U.S, which depressed demand for heating fuel.

The oil price drop has given a much-needed boost to the U.S. economy. The resulting reduction in prices of gasoline and other energy-related products is boosting disposable incomes and confidence levels of consumers. It has also reduced upward pressures on inflation and reduced the cost of oil imports, thereby improving the nation's trade balance. Finally, the lower energy costs have reduced cost pressures faced by airlines and other energy consuming businesses, leading to stronger profit growth in these sectors.

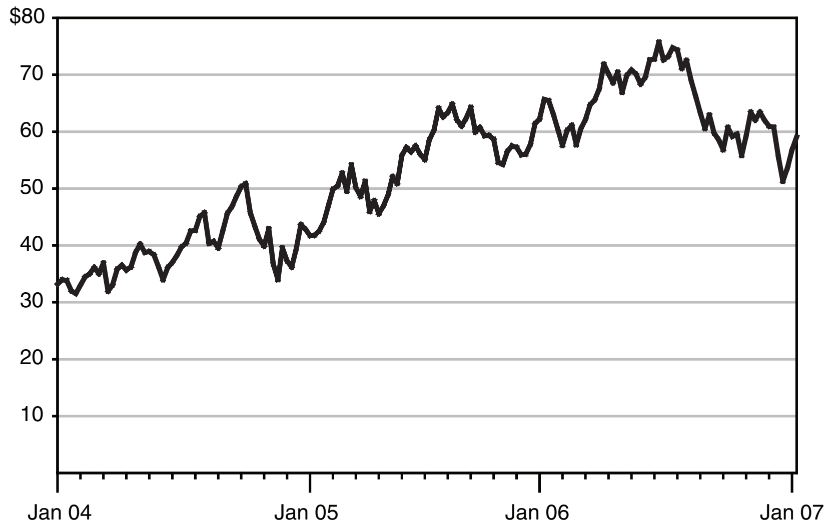
How Long Will 2006 Drop in Oil Prices Last?

Given the recent volatility in the world oil markets, a key question for both the U.S. and California economic outlooks is whether the 2006 oil price decline will be sustained, or whether it will be reversed in the months ahead as economic growth picks up. There is currently a wide range of forecasts for future oil prices. Some energy analysts believe that the recent factors driving prices downward are largely transitory, related

Figure 2

Welcome Decline in Oil Prices After Mid-2006

Weekly Average Price Per Barrel of Oil



to mild weather and temporary slowdowns in consumption. Others, however, believe that the current declines may be related to more fundamental factors, such as sensitivity to high prices and slowing underlying growth in worldwide demand. In 2006, for example, global oil demand grew only 0.6 percent (with reduced demand in most places other than China and the Middle East) compared to 1.5 percent in 2005 and 3.9 percent in 2004. Our forecast takes a middle road. Although short-term oil price volatility is likely throughout the year, we are assuming that prices will average around $60 per barrel, down about 25 percent from the mid-2006 peak.

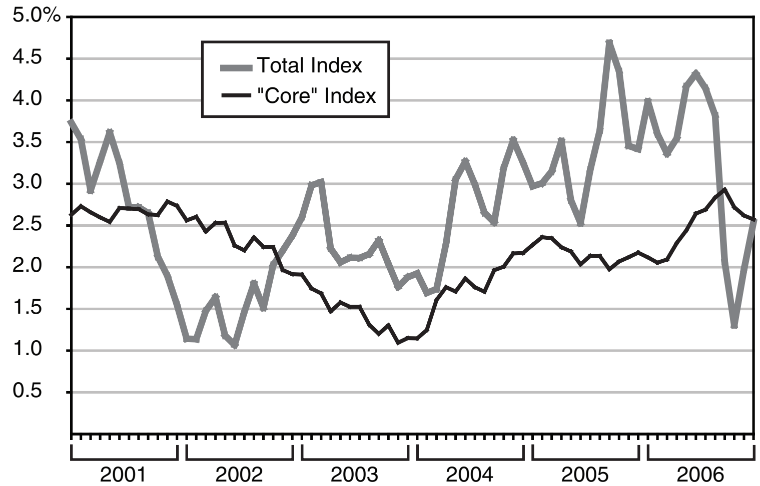
Inflation Eased Late in the Year

One of the major concerns in early 2006 was that the rise in energy prices was beginning to spill over into the rest of the economy. Businesses, no longer able to absorb higher energy costs, were starting to raise the prices of their products and services. Figure 3 shows that "core" inflation (as measured by the Consumer Price Index (CPI) excluding food and energy costs) was accelerating in early 2006, rising from a year-to-year monthly gain of 2.1 percent at the beginning of the year to 2.9 percent as of September. This raised concerns that the Federal Reserve would need to further raise interest rates in order to constrain the economy and thereby hold down inflation, potentially aggravating the economic slowdown that was already occurring.

Figure 3

Drop in Oil Prices Has Reduced Inflationary Pressure

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



The drop in oil prices beginning in mid-summer provided a much-needed respite from rising inflationary pressures. As shown in Figure 3, year-to-year monthly growth in the overall CPI (including food and energy costs) moderated from 4.3 percent in mid-2006 to a low of 1.3 percent in October, before partially rebounding to 2.5 percent at the close of the year. Meanwhile, the core rate fell from 2.9 percent in September to 2.6 percent by the end of the year. This enabled the Federal Reserve to halt interest rate increases late last year.

For the year as a whole, comparing December 2006 to December 2005, overall CPI inflation came in at 2.5 percent, down from 3.4 percent for the prior year. By comparison, core inflation increased 2.6 percent over the same period, versus 2.2 percent for the prior year. The CPI's inflation benefited in 2006 from a slowdown in the medical care component, which normally has been steadily increasing. For example, both physician charges and prescription drug prices experienced very small gains. This slowdown, however, was due to special circumstances, including price cuts by major retailers and several major drugs that came off patent protection during the year, allowing cheaper generic versions to be sold. Thus, medical care inflation will be returning to a higher level in 2007.

Profits Jumped Again in 2006

After soaring 33 percent in 2005, U.S. after-tax profits increased by 19 percent in 2006, reflecting major gains in a wide variety of industries. These gains, which were considerably greater than expected, reflect major increases in oil-related profits, as well as the ongoing benefits of high productivity and sales growth on businesses' bottom-line earnings. As noted in the "Part III" revenue section of this volume, California profits appear to be somewhat less robust than what the national figures would indicate, possibly reflecting the greater negative impact that the housing downturn is having in our state.

Economy Regained Some Momentum in Late 2006

Recent indicators suggest that, after slowing through much of the year, the U.S. economy experienced a modest pick-up late in the year, which appears to have set the stage for continued growth in 2007. For example:

- Preliminary estimates are that real GDP growth in the fourth quarter of 2006 was at an annualized rate of 3.5 percent, which was above expectations. Whether this initial estimate will hold up when it is revised in late February and again in late March, however, remains to be seen, as many economists think it possible that a lower figure is more consistent with other more recent economic data.

- Monthly retail sales jumped by 0.6 percent in November and 0.9 percent in December. The year-end rebound reflected a healthy holiday shopping season—particularly for electronic goods—especially when the delayed tabulation of receipts from December online purchases and gift-cards are counted. Weekly sales reports for January suggest that spending remained healthy into the early weeks of 2007.

- After dropping in both October and November, industrial production rebounded 0.4 percent in December. Manufacturing output rose an even stronger 0.7 percent during the month. For the full year, industrial production was up a moderate 3 percent.

- After declining for much of the year, housing starts jumped 4.5 percent in December, with most regions of the country sharing in the increase. Permits for new construction were also up by 5.5 percent during the month, the strongest gain in over one year.

- Wage and salary employment increased by 206,000 jobs in December, or slightly better than the average gains for 2005 and 2006. The share of the population employed edged up at year-end to over 63 percent, the highest level since late 2001. In a related development, the unemployment rate trended down to 4.5 percent in December. In January, employment growth dropped, however, to 111,000.

- Productivity rose significantly in the fourth quarter of 2006, following a slight decline in the third quarter. Although productivity growth for all of 2006 was only 2.1 percent—the slowest in ten years—the year-end gain was a positive development.

California Trends

Economy Survived a Substantial Real Estate Decline in 2006

Concerns over the impacts of the housing downturn on overall economic growth were of particular importance to California in 2006. This is because the greater-than-average run-up in prices and real estate activity that occurred in California between 2001 and 2005 left this state particularly vulnerable to a dramatic drop in home prices, sales, and construction.

Regarding housing prices, these have been relatively flat statewide thus far, with median prices about the same at year-end 2006 compared to one-year earlier, and down a bit over 3 percent from their 2006 peak in August. There have been certain geographic areas where housing prices have experienced greater softening, however, such as Santa Barbara (down 23 percent over the year).

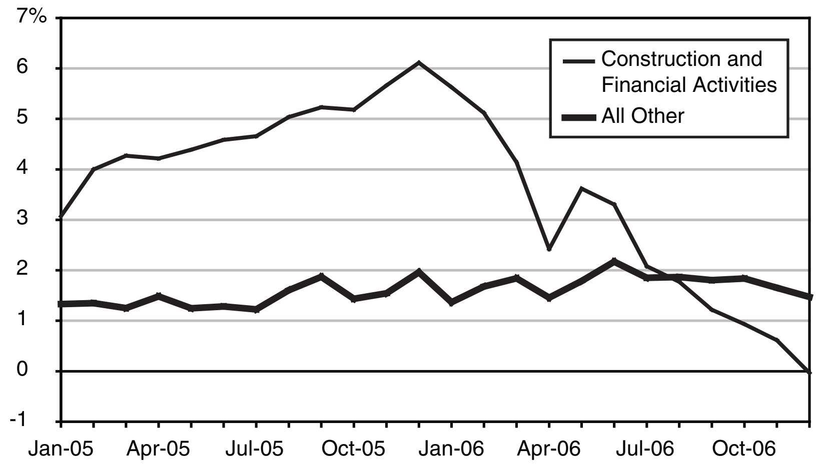
Regarding housing activity, at this point, it appears that the reductions in housing construction and sales, while greater than expected, did not have major adverse impacts on the rest of the economy. As shown in Figure 4 (next page), employment growth in the construction and related finance industries slowed from 6.1 percent in 2005 to near zero by the end of 2006, but growth in all other sectors combined remained relatively steady during this period. Retail spending on automobiles, home furnishings, and other durable goods has been soft (due both to the housing slowdown and high gasoline prices throughout most of the year). However, the majority of the non-real estate sectors of the economy expanded at a solid pace in 2006. The relatively healthy performance reflected a variety of factors, such as:

- Continued growth in California's high-tech and related professional services industry. This high-paid sector includes software development, computer systems and design, biotechnology, and pharmaceuticals.
- Continued strength in information-related industries (including motion pictures, broadcasting, sound recordings, publishing, and Internet service providers).

Figure 4

California Employment Slowdown Confined to Real Estate Industries

California Wage and Salary Employment Year-to-Year Percent Change, by Month



- Solid growth in international trade, which is benefiting California manufacturers and farmers that sell abroad, as well as transportation, warehousing, and distribution activities associated with trade activity passing through California's ports.

As shown in Figure 5, exports of goods produced in California accelerated in 2006, and were up about 13 percent in the third quarter of the year. The third-quarter growth reflected an over-30 percent increase in shipments to China, and more moderate, but still healthy, growth in shipments to other California trading partners.

Is Real Estate Stabilizing?

A key factor in the outlook is whether the real estate downturn has run its course, or whether further reductions are in store. This is the real wild card in the forecast, given that history has shown that housing market corrections have typically lasted a couple of years. The recent news is mixed, but there are some tentative signs that at least the worst of the real estate decline is over. For example, after plunging from over 650,000 (annual rate) in mid-2005 to around 450,000 in mid-2006, sales of existing homes stabilized near the 450,000 range in recent months. Similarly, inventories of unsold homes, while up sharply from 2005 levels, also appear to have

Figure 5

California Exports Accelerated in 2006

Year-to-Year Change in Exports Produced in California, by Quarter

leveled off. Finally, interest rates have stabilized in recent months, while job and income growth continues in the state.

While there may be signs that real estate is bottoming out, we do not expect a significant turnaround any time soon. Affordability remains a major problem, and the large inventory of homes for sale that are on the market means that builders will remain cautious about committing to new developments. The flattening in housing prices will also financially squeeze recent home purchasers that have used variable rate loans with low teaser rates to finance home purchases, as recent reports about foreclosures already indicate. This is of particular concern for the large proportion of homebuyers in 2004 and 2005 that financed the rising costs of homes with nontraditional or "exotic" mortgages, many of which had low initial payments that are scheduled to adjust upward over the next several years. The flattening in home prices implies that homeowners facing large payment increases when these loans reset will not have sufficient equity to refinance their loans and avoid higher monthly payments. Given the considerable dollar size of the mortgages involved, the anticipated rise in applicable interest rates for these particular homeowners implies large monthly payment increases. This suggests that less discretionary income will be left over for other purchases. It also raises the risk of "distress sales" and foreclosures, which in turn will depress home prices and, potentially, new construction activity during the next few years.

The bottom line regarding housing is that, while the worst of the real estate declines may be over, we do not expect the sector to make contributions to economic growth until 2008 or later, and even then the contributions will be only modest. However, even a mere stabilization of activity in this sector implies that it will be less of a drag on the overall economy in 2007 than in 2006.

Other Indicators Are Positive

Nonresidential Construction Is Strong. Although nonresidential construction is only about one-third the size of the residential sector, its positive performance during 2006 offset a significant share of the drop in the residential side of the market. Total nonresidential construction jumped nearly 19 percent in 2006, reaching a total of $20 billion during the year. The increases were widespread, encompassing industrial buildings, office buildings, and hotels. Current indicators, such as strong corporate earnings, falling vacancy rates, and rising office rents, suggest that nonresidential construction activity will remain strong in 2007.

Consumer Confidence Is Up. After falling in each of the prior three quarterly surveys, the index of consumer confidence, as measured by the Survey and Policy Research Institute at San Jose State University, jumped by about 7 percent in January. The increase reflected both rising perceptions about current conditions as well as improved expectations about future conditions. While confidence levels can change rapidly, and are often influenced by transitory factors, such as gasoline price spikes, the recent increase is nevertheless a positive indicator that consumers remain confident and willing to spend.

In summary, California's economy clearly slowed over the course of 2006, but the reduction in growth was primarily concentrated in real estate-related industries. While softness in the real estate sector will continue to drag down growth in early 2007, the overall economy appears to have been in relatively good shape as the new year began.

The Budget's Economic Outlook

The budget's forecast assumes that the recent economic slowdown will persist through the first half of 2007 before stabilizing real estate markets provide support for a mild upturn beginning in the second half of the year. The budget's economic forecast for the nation and state is displayed in Figure 6. On an annual average basis, U.S. GDP growth is projected to slow from 3.3 percent in 2006 to 2.4 percent in 2007, before partially rebounding to 2.9 percent in 2008. The forecast assumes that U.S. inflation, as measured by the CPI, will slow from 3.2 percent in 2006 to annual increases of about 2 percent in both 2007 and 2008.

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—a broad measure of state-level economic activity—will slow from a growth rate of 6.6 percent in 2006, to 5.7 percent in 2007, and further to 5.4 percent in 2008. The annual growth rates for personal income are affected by the administration's assumption that significant one-time bonuses related to the stock market will bolster personal income early in 2007. Absent these one-time bonuses, the growth rate in 2007 would be less and the growth rate in 2008 would thereby be greater than shown. The forecast assumes continued softness in construction-related activity, but solid growth in other sectors of the California economy.

Figure 6

Summary of the Budget's Economic Outlook

		Estimate	Forecast	
	2005	2006	2007	2008
U.S. Forecast				
Percent change in:				
Real gross domestic product	3.2%	3.3%	2.4%	2.9%
Personal income	5.2	7.2	5.4	5.3
Wage and salary employment	1.5	1.4	1.1	1.2
Consumer Price Index	3.4	3.2	2.0	2.1
Unemployment rate (%)	5.1	4.6	4.8	4.9
Housing starts (000)	2,073	1,845	1,586	1,619
California Forecast				
Percent change in:				
Personal income	5.4%	6.6%	5.7%	5.4%
Employment:				
Payroll survey	1.8	1.8	1.2	1.6
Household survey	2.1	0.8	1.2	1.4
Taxable sales	7.4	4.5	3.1	5.4
Consumer Price Index	3.7	3.9	2.6	2.4
Unemployment rate (%)	5.4	4.8	4.9	5.1
Housing permits (000)	209	168	152	165

LAO's Economic Outlook

Our updated economic outlook is for continued expansion in 2007, with the first half of the year the weakest and accelerating as the year progresses.

National Outlook

As shown in Figure 7, we forecast that real GDP growth will ease from 3.4 percent in 2006 to 2.5 percent in 2007, before partially rebounding to 3.1 percent in 2008. The 2007 slowdown reflects large reductions in housing activity, and a slightly slower pace in consumer spending and nonresidential investment activity. Specifically:

- Housing-related investment, after declining by 4 percent in 2006, is projected to fall by 14 percent in 2007, before stabilizing in 2008. On a quarterly basis, this sector has been in decline since late 2005, and is expected to continue declining sharply through the first half of 2007 before steadying itself by year end.
- Real consumer spending is expected to slow from 3.2 percent in 2006, to about 3.1 percent in 2007, and 3 percent in 2008. These increases are slightly less than the projected growth in real disposable income for the same period, reflecting small declines in sales of light vehicles and other durable goods.
- Business-related fixed investment growth is expected to ease from 7.4 percent in 2006 to around 5 percent over the next three years. The forecast reflects steady growth in business spending on structures and computers, but more-moderate increases in telecommunications spending. A key positive factor in the investment outlook is the recent strength in corporate earnings, which have provided businesses with large amounts of cash to support new spending on equipment and buildings. The spending on information technology (IT) equipment is a positive force in California's outlook, because many high-tech products are designed in California.
- The trade deficit is projected to decline in both 2007 and 2008, reflecting the positive impacts of a weaker dollar on exports and lower prices for oil imports. (Nevertheless, despite this improvement, the trade deficit still will remain in the range of $800 billion over the forecast period, suggesting that there will be further downward pressures on the dollar.)

Figure 7

Summary of the LAO's Economic Outlook

	Estimate	Forecast		
	2006	2007	2008	2009
U.S. Forecast				
Percent change in:				
Real gross domestic product	3.4%	2.5%	3.1%	3.4%
Personal income	6.4	5.3	5.5	6.1
Wage and salary employment	1.9	1.2	1.4	1.6
Consumer Price Index	3.0	2.2	2.3	2.5
Unemployment rate (%)	4.6	4.9	4.9	4.6
Housing starts (000)	1,809	1,513	1,613	1,712
California Forecast				
Percent change in:				
Personal income	6.1%	5.6%	5.7%	6.2%
Employment:				
Payroll survey	1.9	1.4	1.7	1.8
Household survey	0.8	1.6	1.2	1.3
Taxable sales	4.8	3.5	5.2	6.2
Consumer Price Index	3.7	2.7	2.5	2.7
Unemployment rate (%)	4.9	4.9	4.8	4.6
Housing permits (000)	164	138	155	170

Inflation and Interest Rates to Decline

We expect that inflation will continue subsiding over the next year from its current pace. The U.S. CPI is projected to slow from slightly over 3 percent in 2006 to slightly over 2 percent in 2007 and 2008. Aside from the expected stabilization in oil prices, factors holding down inflation include continued business productivity growth, moderate wage increases, and intense international competition.

Regarding interest rates, we forecast that short-term rates will remain fairly stable in 2007 and 2008, and long-term rates will drift up by about one-half a percentage point over the two-year period.

California Outlook

We forecast that the recent slowdown in California's economy will continue through the first half of 2007, reflecting ongoing softness in real estate and some sluggishness in retail spending. By mid-year, real estate-related sales and construction are expected to have bottomed out, providing a foundation for a partial rebound in economic growth in the second half of the year. In terms of our specific forecast:

- Personal income growth is projected to slow from 6.1 percent in 2006 to 5.6 percent in 2007, before accelerating slightly to 5.7 percent in 2008. The 2007 slowdown reflects a decline in jobs, wages, and profits related to real-estate activity.
- Wage and salary employment is projected to slow from 1.9 percent in 2006 to 1.4 percent in 2007, in line with overall economic activity, before rebounding to 1.7 percent in 2008. The main factor behind the dip in job growth is slowing construction activity. Growth in most other sectors is expected to remain steady. (A discrepancy continues to exist between the employment pattern associated with the payroll survey that deals with wage and salary employment versus the household survey that deals with civilian employment. This year, the payroll series appears to be more consistent with other economic indicators.)
- Taxable sales are projected to slow from 4.8 percent in 2006 to 3.5 percent in 2007, before rebounding to 5.2 percent in 2008. The dip in sales growth reflects softness in the second half of 2006 and early 2007 related to sales of building-related materials, home furnishings, and light vehicles.
- Housing permits issued in California, a key measure of forthcoming residential construction activity, are expected to decline from 164,000 units to 138,000 units in 2007, before rebounding to 155,000 units in 2008 (see Figure 8).
- We expect dollar value of nonresidential building permits to continue expanding through 2007 and 2008, reflecting continued strength in construction of industrial and office buildings.

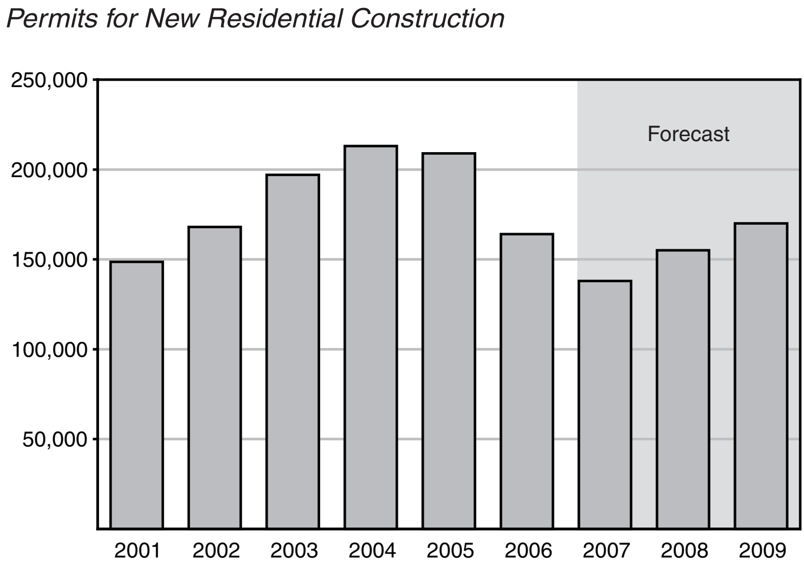
Special Factors Affecting the Outlook

Our forecast takes into account the impacts of both California's recently enacted minimum wage increase and voter passage of the $42.7 billion in infrastructure bonds on the November 2006 ballot.

Minimum Wage Increase. In 2006, the state enacted a two-step increase in the state's minimum wage—from $6.75 to $7.50 per hour effective on January 1, 2007, and further to $8 per hour on January 1, 2008. The increase will raise earnings of workers in a variety of occupations. It will also have a number of other impacts on the California economy, including price increases in restaurants, fast food establishments, and certain other sectors that employ a significant number of low-paid workers, and some

Figure 8

California Home Construction to Bottom Out in 2007



reductions in employment. However, we expect the impacts on overall economic growth and income to be modest (see nearby shaded box).

Bond Package. Our estimates also take into account added spending from the bonds approved by the voters in November 2006 as well as the bonds proposed by the Govenor in the 2007-08 budget. In addition to the long-term benefits from infrastructure related investments—such as improved transportation networks and flood control—spending on construction projects supported by the bond funds will have positive impacts on the economy over the next several years in the form of added employment, income, corporate profits, and taxable sales. However, while the new spending is significant in dollar terms, it is important to remember that (1) it will occur over a decade or more and (2) the annual increases (generally between $5 billion and $10 billion) will be only a modest fraction of California's overall economy. Thus, the added growth that can be expected from this spending is similarly modest—less than one-quarter of 1 percent per year.

The Early-Year Freeze. In January 2007, California experienced extremely cold temperatures throughout much of the state. In many of California's prime agricultural areas, significant damage to a variety of crops and plants occurred, including oranges, lemons, lettuce, asparagus,

California's Minimum Wage Increase

On January 1, 2007, California's minimum wage was raised from \$6.75 to \$7.50 per hour, and on January 1, 2008 it will become \$8 an hour. We estimate that about 7 percent of California workers were probably directly affected by the January 2007 increase, and an additional 2.5 percent could be affected by the additional increase next year.

California's minimum wage is now significantly greater than the current federal minimum wage of \$5.15. However, it is not much higher than the increase to \$7.25 currently being contemplated in Congress. Five other states currently have state minimum wages equal to, or greater than, California's, with some scheduled for future increases.

The 18.5 percent total increase in the state minimum wage between 2006 and 2008 is large but far from unprecedented. Over the past 20 years, California has experienced three minimum wage increases of similar or greater magnitude over a period of one year or less. For example, in 1988 the minimum wage increased by almost 27 percent. Likewise, between October 1996 and September 1997, the state's minimum wage was raised by over 21 percent, followed by an additional 12 percent increase in 1998.

One reason why these periodic changes to the minimum wage tend to be large is that inflation significantly erodes the real purchasing power of the minimum wage over time. After adjustment for inflation, California's new minimum wage will have a purchasing power roughly equal to that of the minimum wage in 1988.

Economic theory suggests that a higher minimum wage could cause some increase in certain prices and some reduction in certain types of employment. This will occur if employers are able to incorporate some of their increased wage costs into the prices of the goods and services they sell, and thereby shift these costs to consumers. If this is not possible, some firms may end up cutting back on employment because of reduced sales or other factors, or be forced to absorb the higher costs themselves, thereby realizing fewer profits. The economic effects of these changes would be at least partially offset, however, as workers receiving the increased wages spend them on goods and services.

Although there is some controversy over what the actual effects of previous minimum wage increases have been, the new increases will probably not cause widespread reverberations. However, particularly vulnerable groups—such as teenagers and adult high school dropouts—may see some more significant long-run employment declines, and various businesses will be adversely affected.

strawberries, blueberries, and certain other fruits and vegetables. Initial estimates are that California's farmers have lost in the range of $1 billion in receipts. As of late January, higher prices for many of these items had already started to show up in stores. The cold temperatures also resulted in significantly higher utility bills for heating costs than normal for this time of the year for both residences and businesses.

Although the freeze clearly will have adverse effects on the state's economy, its negative impacts in terms of reducing incomes and jobs will tend to be concentrated in those regions and amongst those individuals and firms most directly affected. For some parties, these losses will be devastating. However, relative to the large size of the overall California economy—over $1.6 trillion—the aggregate losses will be relatively modest. And, in terms of its impact on consumers, increased reliance on imported fruits and vegetables will in some cases help mitigate the effects of limited domestic supplies and higher prices.

To help deal with the adverse impacts of the freeze, Congress is considering adopting a disaster relief package including low-interest farm loans, grants, and other forms of aid. Measures to provide freeze-related tax relief also have been introduced in the Legislature.

Key Forecast Risks

The key risks to our current national and state economic forecasts remain the same as the past two years—housing and energy prices. Although there are some tentative signs that housing is stabilizing, there remains a risk that home sales, construction, and prices will fall considerably further before the market starts to rebound. Similarly, despite recent improvements, world oil markets remain tightly balanced, and supply disruptions or faster-than-anticipated growth in energy demand could result in a more dramatic rebound in oil prices than we are anticipating.

Not all of the risks in the current forecast are on the downside. In particular, our forecast assumes that oil prices will remain near $60 per barrel over the next year as some of the transitory factors depressing demand fade—such as mild early winter weather in the U.S. However, if prices were to return to early January levels (approximately $52 per barrel), we would expect more economic growth, less inflation, and lower interests over the next two years than we are currently predicting.

Comparison to Other Forecasts

Figure 9 (next page) compares our economic forecasts for the nation and California to our November 2006 forecast, 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 2006, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2007), the consensus outlook forecast in the *Western Blue Chip Economic Forecast* (February 2007), and the *2007-08 Governor's Budget* forecast.

Figure 9

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

	Forecast		
	2006	2007	2008
United States Real GDP:			
LAO November	3.3%	2.2%	3.3%
UCLA December	3.2	2.0	3.1
DOF January	3.3	2.4	2.9
Blue Chip "Consensus"[b] January	3.3	2.4	3.0
LAO February	3.4	2.5	3.1
California Payroll Jobs:			
LAO November	1.8%	1.3%	1.6%
UCLA December	1.5	0.5	1.0
DOF January	1.8	1.2	1.6
Blue Chip "Consensus"[c] January	1.5	1.1	1.2
LAO February	1.9	1.4	1.7
California Personal Income:			
LAO November	6.5%	5.4%	5.9%
UCLA December	7.2	4.3	4.6
DOF January	6.6	5.7	5.4
Blue Chip "Consensus"[c] January	5.8	5.3	5.6
LAO February	6.1	5.6	5.7
California Taxable Sales:			
LAO November	4.6%	4.7%	5.8%
UCLA December	6.2	4.2	4.7
DOF January	4.5	3.1	5.4
Blue Chip "Consensus"[c] January	5.3	4.4	5.0
LAO February	4.8	3.5	5.2

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

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

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

Our 2007 projections for most variables shown are slightly more optimistic than our November forecast. The same is true relative to most other forecasts prepared in recent months, except for UCLA, which is significantly below us. To varying degrees, however, all of the projections shown in Figure 9 call for slowing growth in 2007 and a partial rebound in 2008.

One significant difference between our current forecast and most of the other forecasts shown in Figure 9 is that we now estimate less growth in California personal income during 2006. This lower estimate is based on recent historical revisions by the U.S. Department of Commerce to its data on personal income.

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 Exceed 38 Million in 2008

Figure 10 (next page) summarizes our updated state demographic forecast. We project that California's total population will rise from an estimated 37.9 million in 2007 to 38.4 million in 2008, and 38.9 million in 2009. 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 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 slightly upward after having fallen for the past several years.

In numeric terms, the number of new Californians being added each year—about 477,000 people over the forecast interval—is about the size of such cities as Long Beach, Fresno, and Sacramento, and very similar to many smaller states.

Figure 10

Summary of LAO's California Demographic Forecast

(Population in Thousands)

	2007	2008	2009
Total population (July 1 basis)	37,904	38,378	38,876
Changes in population:			
Natural increase (births minus deaths)	315	314	313
Net in-migration (in-flows minus outflows)	145	160	185
Total Changes	**460**	**474**	**498**
Percent changes	1.2%	1.2%	1.3%

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 two-thirds of California's projected annual growth over the forecast period and is assumed to be fairly stable. Net in-migration accounts for the other one-third of the growth over the period, but has historically varied in response to changing economic conditions in the state and, in previous years, has accounted for as much as one-half of the state's annual growth.

Natural Increase. We project that the natural increase component will contribute an average of 314,000 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 145,000 in 2006, due mainly to changes in net domestic migration patterns between California and other states. Specifically, net domestic in-migration from other states fell from a positive 97,000 in 2001 to a *negative* 55,000 in 2006, meaning that in 2006 more people left California for other states than moved into California from them. This reversal 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 net increase in inflows from other states will result in 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 11.

The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 12 (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 801,000 more 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 63 years of age by the end of the forecast period, and thus still are occupants of this age category.

Figure 11

The Age and Ethnic Mix of Californians

July 1, 2007

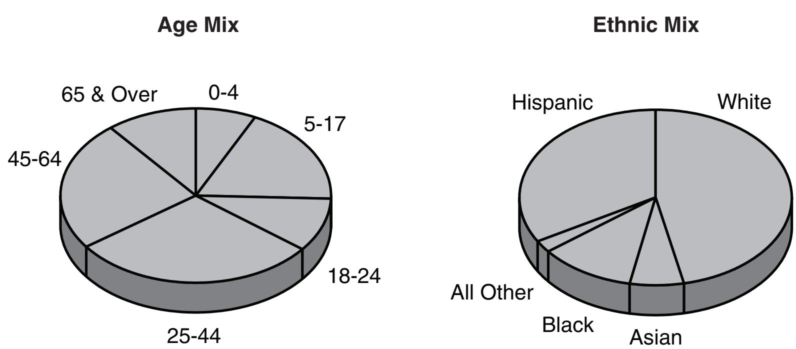
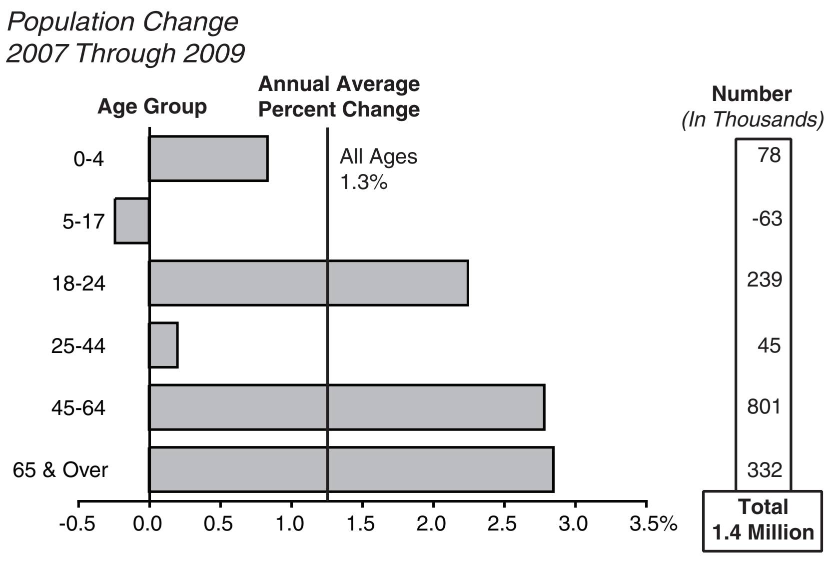


Figure 12

California's Population Outlook by Age Group



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 2007-08 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 eventually place strains on the state's health programs and related services, including the portion of Medi-Cal related to the elderly and disabled.
- The increasing ethnic diversity of the state's population will also mean that many public institutions, especially schools, will serve a population that speaks a multitude of languages and has a wide range of cultural backgrounds. Currently, for example, more than one-third of students in kindergarten and first grade are English-language learners.

III

Perspectives on State Revenues

Perspectives on State Revenues

Following two years of major increases, it appears that revenue growth is slowing sharply in 2006-07, reflecting the impacts of a more moderate economic expansion and a dip in income from capital gains (see Figure 1, next page). The budget assumes that revenue growth will revive somewhat in 2007-08, led by an improving economy beginning later this year. 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

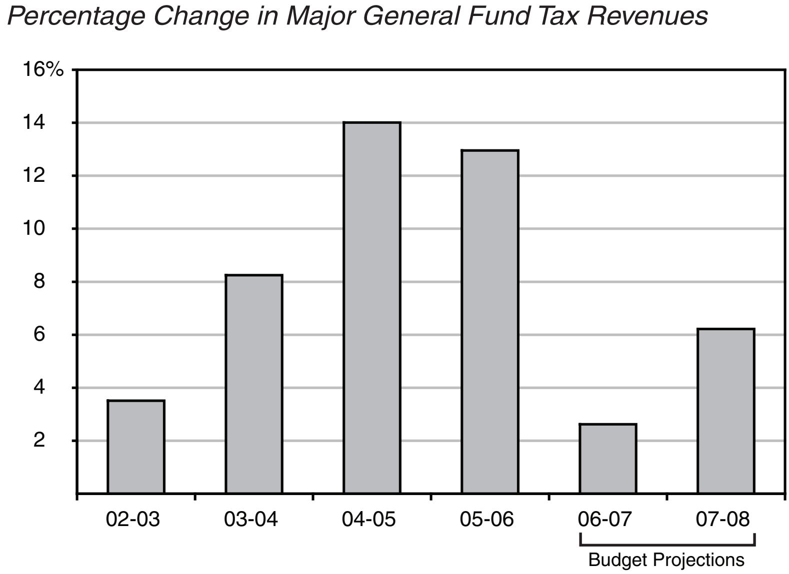
The *2007-08 Governor's Budget* projects that California state government will receive $128 billion in revenues in 2007-08. These revenues are deposited into either the General Fund or a variety of special funds. Figure 2 shows that:

- ***General Fund Revenues.*** About 80 percent of total state revenues are deposited into the General Fund. These revenues are then allocated through the annual budget process for such programs as education, health, social services, and criminal justice.
- ***Special Funds Revenues.*** The remaining roughly 20 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—personal income and sales tax receipts—support both the General Fund and special funds.

Figure 1

After Two Strong Years, Revenue Growth to Subside



Sources of General Fund Revenues. Figure 2 indicates that about 94 percent of total General Fund receipts are attributable to the state's "big three" taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporation tax (CT). The remainder 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

Although the budget does not include any major tax reforms, it does contain several proposals that would have significant impacts on state General Fund revenues. As shown in Figure 3 (see page 46), these proposals would generate $796 million in 2007-08 and include:

- $506 million in new revenues from the approval of five amended gambling compacts with tribes that operate casinos in Southern California.
- $290 million from several proposals affecting the state's major taxes.

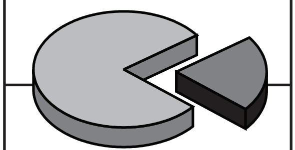
Figure 2

State Revenues in 2007-08[a]

(In Billions)

General Fund Revenues	
Personal Income Tax	$55.6
Sales and Use Tax	29.3
Corporation Tax	10.8
Insurance Gross Premiums Tax	2.4
All Other	4.1
Total	**$102.3**

Total State Revenues $127.8 Billion



Special Funds Revenues	
Motor Vehicle-Related Revenues	$9.1
Sales and Use Tax[b]	5.5
Personal Income Tax[c]	1.7
Tobacco-Related Taxes	1.0
All Other	8.3
Total	**$25.5**

Detail may not total due to rounding.

[a] Governor's budget projections, excluding $1 billion transfer from the General Fund to the Budget Statilization Account.

[b] Includes $3 billion to Local Revenue Fund, $1.5 billion redirected to pay off deficit-financing bonds, $0.7 billion for transportation-related purposes, and $0.3 billion for transportation-related general obligation bond debt service. Excludes $3 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

[c] For mental health services per Proposition 63.

Regarding the latter proposals, the largest is the permanent elimination of the Teacher Retention Tax Credit. This PIT credit is available to credentialed teachers and ranges from $150 to $1,500 per claimant, depending upon their years of experience. The permanent elimination of the credit would result in a net increase in PIT revenues of $165 million in the budget year. This program was adopted in 2000, but has been suspended in each of the past three years and four out of the past six years, primarily due to budgetary considerations. A review of the credit appears in "Part V" of this volume.

The budget would also permanently extend current provisions relating to the application of the use tax on out-of-state purchases of vehicles, vessels, and aircraft. 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 use tax from 90 days to one year. This revised requirement was scheduled to revert back to 90 days on July 1, 2006, but the one-year test was extended through July 1, 2007, by legislation passed along with the *2006-07 Budget Act*. The Governor's proposal would make permanent the one-year test for out-of-state purchases. This proposal is also reviewed in "Part V."

Figure 3

2007-08 General Fund Revenue Changes Proposed in the Governor's Budget

(In Millions)

	Fiscal Impact	
	2007-08	**2008-09**
Personal Income Tax		
Elimination of teacher tax credit	$165	$170
Tax gap enforcement	69	84
Sales and Use Tax		
Make permanent recent changes in treatment of out-of-state purchases of vehicles, vessels, and aircraft	$35	$35
Compliance measures	12	12
Corporation Tax		
Tax gap enforcement	$9	$10
Tribal Gambling		
Amended compacts	$506	$506
Totals, 2007-08 Revenue Measures	**$796**	**$817**

In addition, the administration proposes funding of new auditing positions aimed at reducing the state's tax gap. These proposals, which are reviewed in the General Government section of our *Analysis of the 2007-08 Budget Bill*, are expected to result in increases of $69 million in PIT revenues and $9 million in CT revenues in 2007-08.

The Budget's General Fund Revenue Outlook

The updated budget forecast assumes that revenue growth will slow in 2006-07, and then rebound somewhat in 2007-08. The current estimate for 2005-06 and 2006-07 is up moderately from the *2006-07 Budget Act* projections, mainly reflecting higher PIT collections. The budget's General Fund revenue projections are summarized in Figure 4.

2005-06 Actual. The budget shows that 2005-06 General Fund revenues and transfers totaled $93.4 billion, a 13.6 percent increase from 2004-05. This revised estimate is up $678 million from the 2005-06 revenue forecast contained in the *2006-07 Budget Act.* The increase relative to the *2006-07 Budget Act* is primarily related to the timing of audit payments

Figure 4

Summary of the Budget's General Fund Revenue Forecast

(Dollars in Millions)

		2006-07		2007-08	
	Actual 2005-06	Estimated Amount	Percent Change	Projected Amount	Percent Change
Taxes					
Personal income	$49,877	$52,042	4.3%	$55,598	6.8%
Sales and use	27,581	27,775	0.7	29,347	5.7
Corporation	10,316	10,311	-0.1	10,816	4.9
Insurance	2,202	2,220	0.8	2,354	6.0
Other	467	469	0.4	475	1.1
Other Revenues, Transfers, and Loans					
Other revenues	$2,990	$2,343	-21.6%	$3,073	31.2%
Transfers	-7	-170	—	637	—
Totals	**$93,427**	**$94,990**	**1.7%**	**$102,300**	**7.7%**

Detail may not total due to rounding.

and other receipts, and is partly offset by a lower carry-in balance from 2004-05.

2006-07 Estimate. The administration's forecast assumes that General Fund revenues and transfers will be $95 billion, a 1.7 percent increase from the prior year. The low growth rate reflects both economic factors—such as a slowdown in profits, taxable spending, and capital gains—as well as various one-time factors affecting the 2005-06 and 2006-07 revenue totals. Absent these one-time factors, the underlying growth rate is slightly higher, although still less than 3 percent. The current estimate is up $637 million from the *2006-07 Budget Act*.

2007-08 Forecast. The budget forecasts that General Fund revenues and transfers will be $102.3 billion, a 7.7 percent increase from 2006-07. Adjusting for one-time factors in both the current and budget years, the underlying growth rate is about 6 percent, or slightly faster than the projected growth in the state's economy.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

We Expect Lower Revenues—Down $2 Billion

Figure 5 shows our projections of General Fund revenues for 2006-07 through 2008-09. 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 and budget years combined, we are estimating that General Fund revenues will fall below the budget forecast by $2 billion. We specifically forecast that:

- ***In 2006-07***, General Fund revenues and transfers will total $94.1 billion, a 0.7 percent increase from 2005-06. This is down $939 million from the budget forecast, reflecting a $1.3 billion decline in PIT receipts and a $95 million decline in SUT receipts, partly offset by a $429 million increase in CT revenues.
- ***In 2007-08***, General Fund revenues and transfers will total $101.3 billion, a 7.7 percent increase from the current year. This projected growth rate is affected by certain one-time factors, such as $300 million from an assumed refinancing of tobacco bonds (with the proceeds used to fund the first payment of a Proposition 98 settlement) and the flow and timing of rebate payments related to federal penalties involving child support automation. After adjusting for these effects, the underlying growth in revenues is around 6.5 percent, or modestly higher than personal income growth. Our forecast is down by slightly over $1 billion from the budget projection. A bit over one-half of the reduction is related to our assumptions about pension bonds and tribal gambling compacts, while the remainder is related to our lower forecasts of combined collections from the state's major taxes.
- ***In 2008-09***, revenues and transfers will total $107.5 billion, an increase of 6.2 percent. Excluding various one-time factors, the underlying growth rate is slightly higher than 6.7 percent, or modestly above the projected growth in statewide personal income during the period.

Key Factors Underlying Our Lower Estimates

Soft Year-End Receipts. The budget forecast is largely completed by the administration in early December, prior to when key information about year-end economic and revenue activity becomes available. A key element in the year-end revenue picture is the strength of PIT estimated payments. These payments are due on January 15 of each year, but a significant portion of them are paid in late December in order to take advantage of the federal income tax deduction allowed for state tax payments.

Figure 5

Summary of the LAO's General Fund Revenue Forecast

(Dollars in Millions)

	Estimated 2006-07		Projected 2007-08		Projected 2008-09	
	Amount	Percent Change	Amount	Percent Change	Amount	Percent Change
Taxes						
Personal income	$50,750	1.8%	$54,810	8.0%	$58,660	7.0%
Sales and use	27,680	0.4	29,130	5.2	30,850	5.9
Corporation	10,740	4.1	11,400	6.1	12,140	6.5
Insurance	2,250	2.2	2,351	4.5	2,469	5.0
Other	459	-2.0	461	0.5	463	0.5
Other Revenues, Transfers and Loans						
Other revenues	$2,343	-21.6%	$2,715	15.9%	$2,350	-13.4%
Transfers	-170	—	386	—	550	—
Totals	**$94,052**	**0.7%**	**$101,253**	**7.7%**	**$107,482**	**6.2%**

Detail may not total due to rounding.

Estimated payments are related to volatile nonwage income sources, such as investment earnings and the pass-through of business profits to individuals. These year-end estimated payments have often been an early indicator of the strength of final PIT payments remitted in the forthcoming April.

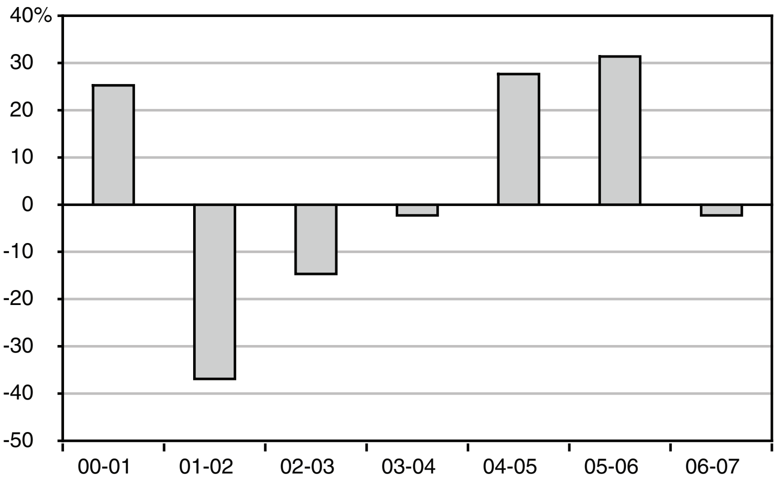
As shown in Figure 6 (next page), these payments soared in 2004-05 and 2005-06. The administration assumed that the strength would continue in 2006-07, estimating a 17 percent increase during the year. However, actual receipts from these estimated payments were down slightly from the 2005-06 level. The actual level of receipts for December 2006 and January 2007 combined was $1.1 billion below the new budget forecast.

The softness in these payments was partly offset by stronger-than-expected year-end corporation taxes, which came in about $350 million above estimates. We also note that the administration's forecast of final payments in April is somewhat conservative relative to last year. Thus, the year-end softness may not translate into a major weakness in April relative to the budget forecast. Nevertheless, the shortfall in year-end estimated payments from individuals is clearly a negative development in the outlook. Even allowing for higher trends in corporation taxes, we expect revenues from the state's major taxes to fall below the administration's updated forecast by over $900 million.

Figure 6

Key Year-End PIT Payments Were Soft in 2006-07

Year-to-Year Percent Change in December and January Receipts
PIT Quarterly Estimated Payments



Lower Estimate for Governor's Tribal Gambling Proposal. As noted earlier, the administration is assuming $506 million in new revenues from the amended tribal gambling compacts. We believe that this estimate is based on optimistic assumptions about both (1) the speed with which new slot machines would be put in place and (2) the amount of revenues generated per machine. We are assuming that, if approved, the compacts would yield no more than $200 million in 2007-08, or $306 million less than projected in the budget.

Pension Bonds Unlikely to Be Sold. The administration is also assuming that the state will sell a $525 million pension obligation bond to cover a portion of California government's annual contribution to the public employment retirement system during the year. About one-half of this total ($252 million) would show up as revenues to the General Fund. (The balance would be reflected as an offset to General Fund expenditures.) We have not included these bond proceeds in our revenue or expenditure estimates for 2007-08 because of previous decisions at the superior court level. These courts have held that the pension obligation bonds violate the State Constitution's prohibition against the creation of debt without voter approval.

THE LAO'S FORECAST FOR MAJOR REVENUE SOURCES

As indicated above, the great majority of General Fund revenues are attributable to the state's three major taxes—the PIT, SUT, and CT. The performance of these taxes will have a dominating 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.

Personal Income Tax

Background

The PIT is, by far, the state's largest revenue source, accounting for 54 percent of total estimated General Fund revenues in 2007-08. In general, the PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Under the PIT, taxable income is subject to marginal rates ranging from 1 percent to 9.3 percent, with the top rate applying to taxable income in excess of about $87,000 for joint returns in 2006 (and one-half of that for taxpayers filing single returns). An additional 1 percent rate is imposed on the portion of 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 in November 2004, are allocated to a special fund to support various mental health programs.

PIT Revenue Forecast

We forecast that PIT receipts will total $50.8 billion in 2006-07, a 1.8 percent increase from the prior year. We also forecast that PIT receipts will increase by 8 percent, to $54.8 billion, in 2007-08 and by an additional 7 percent, to $58.7 billion, in 2008-09. Our revenue estimates assume the Governor's proposal to eliminate the teacher tax credit, as well as the additional collections from audit activities directed at reducing the tax gap. Compared to the budget forecast, our current projection of PIT revenues is down by $1.3 billion in the current year, and by $788 million in 2007-08.

Key Forecast Factors

The main determinants of PIT collections in a given fiscal year are (1) the annual tax liabilities for the two income years falling within the fiscal year, and (2) the timing of the cash payments associated with these income-year liabilities—that is, withholding, quarterly estimated payments, final payments, and refunds. Both of these factors are pointing toward sluggish growth in PIT receipts in 2006-07.

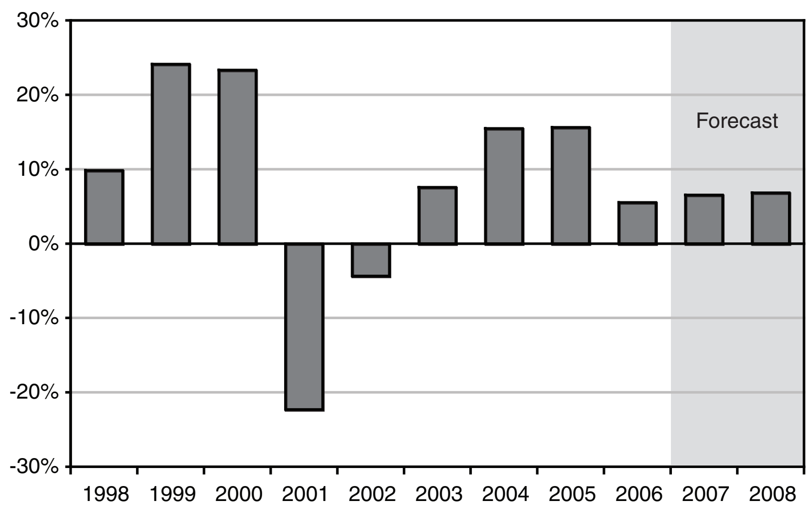
Liability Growth. After growing by more than 15 percent in both 2004 and 2005, we estimate that PIT liability growth eased to 5.5 percent in 2006 (see Figure 7). The more subdued growth rate is consistent with the slowdown in California's economy that occurred during 2006. The economic slowdown took a toll on real estate-related profits and capital gains during the year. Increases and decreases in these volatile earnings sources have a magnified effect on California's income tax liabilities, since business-related profits and capital gains tend to accrue to high-income taxpayers, which are subject to California's top income tax rates. We estimate that, after booming by 40 percent in 2005, capital gains fell by 5 percent in 2006.

We project that PIT liabilities will then increase by 6.5 percent in 2007 and 6.8 percent in 2008. The projected increases are modestly greater than our forecast for personal income growth during these two years. This reflects the interaction of moderate real income growth with California's progressive PIT tax rate structure, where rising incomes are subject to increasingly higher marginal rates. Our forecasts also assume that capital gains will partly rebound during the next two years, growing by 5 percent in 2007 and 8 percent in 2008.

Figure 7

PIT Liability Growth to Be Moderate

Percent Change in Calendar-Year PIT Liabilities



Payment Patterns. Under state law, PIT taxpayers are required to make payments during the year that cover the lesser of (1) 100 percent of their prior-year liabilities or (2) 90 percent of their current-year liabilities. Given these requirements, taxpayers with nonwage income have historically made early quarterly estimated payments based on their prior-year liabilities, knowing that they will avoid penalties if they do so. During periods of significant liability growth, this strategy leads to large payments due when final returns are filed in April. Conversely, when liability growth falls off, taxpayers, basing their early prepayments on the higher prior-year earnings, find themselves with smaller payments due at the end of the year.

In the context of the recent and current PIT outlook, the jump in liabilities in 2005 resulted in a disproportionate increase in payments during 2005-06, since taxpayers with large increases in liabilities found themselves with substantial amounts owed when final payments were due in April 2006. Conversely, we believe that the slowdown in liabilities in 2006 will result in smaller final payments in April 2007 compared to last year.

Sales and Use Tax

Background

The SUT is the General Fund's second largest revenue source, accounting for just under 29 percent of estimated total revenues in 2007-08. 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, such as office furniture and equipment. The largest exemption from the SUT is for most food items consumed at home. The great majority of services are not subject to the sales tax in California.

The second component of the SUT—the *use* tax—is imposed on products bought from out-of-state firms by California residents and businesses for use in this state. With the exception of purchases of automobiles, 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:

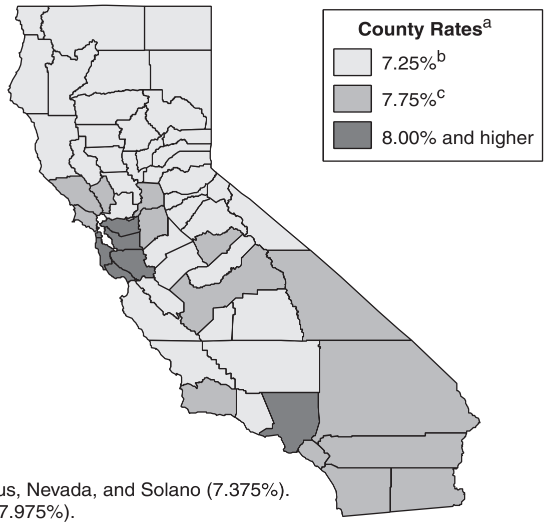
- ***State Rate.*** The basic state SUT rate is currently 6.25 percent. The largest single component is the 5 percent state General Fund rate. Also included in the overall state rate are two half-cent rates whose proceeds are deposited into (1) the Local Revenue Fund, which supports health and social 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. The final component of the state's SUT rate involves Proposition 57. Under that measure, which was approved by the voters in March 2004, 0.25 percent of the Bradley-Burns rate (discussed later) is diverted to a state special fund for purposes of repayment of the deficit-financing bonds. These bonds were issued in 2004 to help deal with the state's budget problem. (The diverted local sales taxes are being 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, which the administration is proposing to do in 2009-10.
- ***Uniform Local Rate.*** This is a uniform local tax rate of 1 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 0.75 percent is allocated to city and county governments for their general purposes. This latter rate will return to 1 percent once the deficit-financing 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

Figure 8

Sales Tax Rates Vary by County

January 1, 2007



[a]Includes Stanislaus, Nevada, and Solano (7.375%).
[b]Includes Fresno (7.975%).

with no optional rates) up to 8.75 percent. On a weighted-average basis calculated using the amount of taxable sales in different counties and their respective SUT rates, the statewide rate is currently 7.94 percent.

SUT Revenue Forecast

We forecast that SUT receipts will total $27.7 billion in 2006-07, a modest 0.4 percent increase from the prior year. Revenues from this source are projected to increase to $29.1 billion in 2007-08 (up 5.2 percent from the current year) and to $30.9 billion in 2008-09 (a 5.9 percent increase). Compared to the budget forecast, our SUT revenue estimate is down $95 million in 2006-07 and by $217 million in 2007-08.

Key Forecast Factors

The key factors behind our forecasted modest current-year growth in General Fund SUT collections are (1) sluggish increases in taxable sales and (2) large "spillover" transfers to transportation-related special funds.

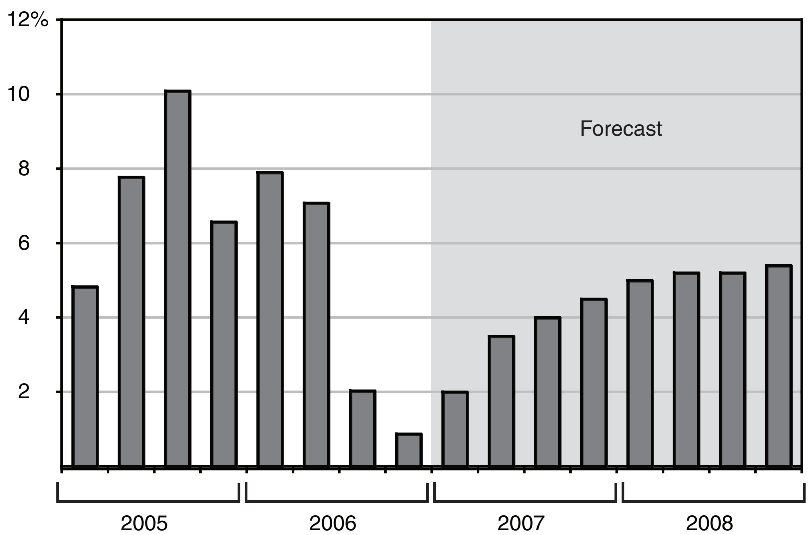
Taxable Sales. This measure generally experienced strong growth in 2005 and early 2006, but then slowed sharply beginning in the third quarter of last year (see Figure 9, next page). We believe that the slowdown has been primarily related to the decline in California's real estate market and its impact on sales of building materials, home furnishings, and related household items. However, it was also related to the negative impacts of higher gasoline prices on consumer spending on big-ticket items, particularly light vehicles sales in the second half of last year. While California appears to have experienced a reasonably healthy holiday shopping season, the strength in this area was not sufficient to offset weakness related to housing and autos. Overall taxable sales increased by just 4.3 percent in 2006, the smallest growth rate since 2002.

We forecast that taxable sales growth will remain subdued in the first quarter of 2007, mainly reflecting softness in housing-related activity. We expect that sales growth will then pick up beginning in the second quarter of 2007. Key factors behind the acceleration are: (1) the stabilization of housing markets, (2) the favorable effects of recent gasoline price declines on consumer confidence and spending on automobiles, and (3) a general improvement in job and income growth over the next year. On an annual basis, we forecast that taxable sales growth will average 3.5 percent in 2007 (with smaller increases in the first half and larger increases in the second half), before accelerating to 5.2 percent in 2008.

Figure 9

Taxable Sales Slowdown to Last Through Early 2007

Year-to-Year Percent Change, by Quarter



Spillover Transfer. A second factor depressing sales tax revenues to the General Fund in the current fiscal year is a larger-than-normal spillover transfer of sales taxes from the General Fund to the Public Transportation Account. This transfer is based on a formula established in the early 1970s that basically compares taxable sales of gasoline to taxable sales of all other products. Under this formula, the transfer increases when the share of total taxable sales that is attributable to gasoline increases. Thus, it is sensitive to both gasoline prices and consumption. In practice, the spillover has tended to increase during periods of high gasoline prices, and decrease or disappear during periods of low gasoline prices. This transfer was suspended in 2005-06 but is expected to be $562 million in the current year. We forecast that the transfer will decline to $454 million in 2007-08 and further to $395 million in 2008-09, based on our forecast for gasoline prices and consumption.

Corporation Tax

Background

The CT is the third largest state revenue source, accounting for 11 percent of total estimated revenues in 2007-08. 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 (LLCs) pay a minimum tax and fee at the corporate level and their income and losses are passed through to their owners, where they are subject to the PIT.

Approximately two-thirds of all CT revenues come from multistate and multinational corporations. These companies have their consolidated U.S. income apportioned to California based on a formula involving the share of their combined property, payroll, and sales that is attributable to this state.

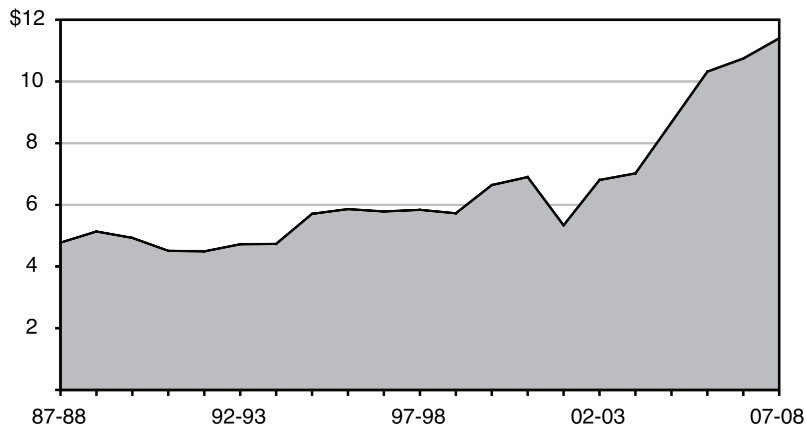
California's CT allows for a variety of exclusions, exemptions, deductions, and credits, many of which are related to, similar to, or identical to those provided under the federal corporate profits tax. Key examples include the research and development tax credit and net operating loss carry forward 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 for losses incurred starting in 2004.

After many years of near-stagnant growth, revenue collections from the CT grew rapidly between 2001-02 and 2005-06 (see Figure 10). These increases are consistent with the rapid growth experienced by other states and at the federal level, and coincide with major growth in reported taxable profits and recent increases in audit collections.

Figure 10

After Two Strong Years, Corporate Tax Growth to Moderate[a]

California Corporate Tax Receipts (In Billions)



[a] 2006-07 and 2007-08 reflect LAO forecast.

CT Revenue Forecast

We forecast that CT receipts will be $10.7 billion in 2006-07, a 4.1 percent increase from the prior year. Thereafter, we forecast that revenues will grow to $11.4 billion in 2007-08 (a 6.1 percent increase), and further to $12.1 billion in 2008-09 (a 6.5 percent increase). Our estimates take into account our projected increases in business profits, as well as factors affecting audit collections. Our CT revenue forecast is above the budget estimate by $429 million for the current year and $584 million for the budget year.

Key Forecast Factors

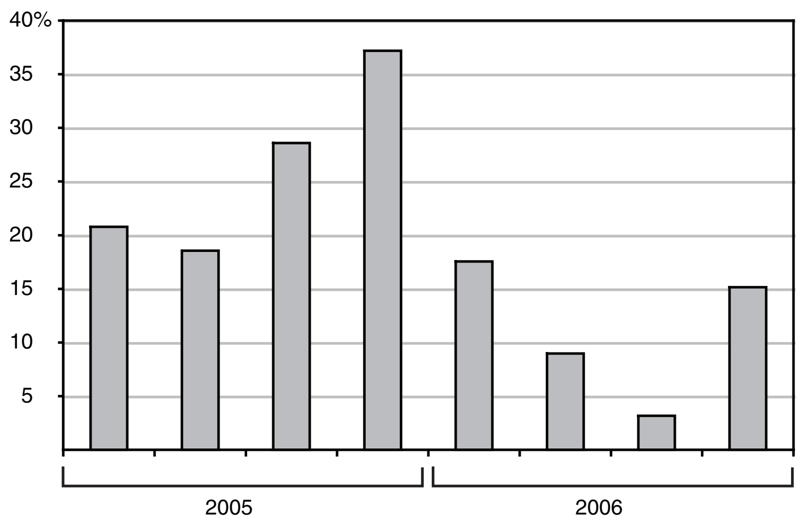
The key determinant of CT tax revenues is California taxable profits. These profits were up 27 percent in 2004 and 32 percent in 2005, reflecting widespread earnings increases.

Recent Evidence Suggests Profits Grew Moderately in 2006. As shown in Figure 11, growth in CT payments subsided during the first three quarters of 2006, suggesting that profits eased during the year. However, as also shown, payments in the final quarter of the year rebounded, increasing by 15 percent from the final quarter of 2005. Based on these payments, we estimate that profits for the full year were up by around 8 percent from 2005. While less robust than for the two prior years, the 2006 performance was reasonably strong, particularly in view of the general economic slowdown that occurred in 2006.

Figure 11

Recent Trends in Corporation Taxes Mixed

Year-to-Year Percent Change in Estimated Payments, by Quarter



Further Slowing Expected. Looking ahead, we forecast that taxable California corporate profit growth will slow significantly to around 4 percent in 2007 before partly rebounding to 7 percent in 2008. The anticipated slowdown in 2007 is related to continued softness in the construction sector, real estate-related finance sectors, and manufacturing sectors related to home construction materials. The partial rebound in subsequent years is related to our assumption that overall sales and output will expand at a moderate pace in 2008 and beyond.

Significant Risk—LLC Fee Litigation

A significant risk to our CT forecast relates to two recent court decisions about California's application of LLC fees. California imposes an annual $800 minimum annual tax plus an annual fee on LLCs doing business in California. The fee is based on a rate structure that takes into account the gross receipts of the business involved from all sources—both inside and outside of California. The state currently collects roughly $300 million from this fee.

During 2006, superior courts in two separate cases ruled that the LLC fee is unconstitutional. The lower courts specifically found that the LLC fee violates the due process and commerce clauses of the U.S. Constitution, because it is based on geographically combined (that is, nonapportioned) receipts of businesses—including receipts derived from their non-California operations. The state is appealing both of these rulings.

Last year, the Legislature passed a measure (AB 1614, Ruskin) which would have revised California's LLC fee structure so that it would be based solely on receipts apportioned to California. The Governor vetoed the measure, however, citing the pending litigation.

Several outcomes to the litigation are possible. For example, under a worst-case scenario, if the state was to lose its appeals and the fee was invalidated, the state would no longer collect those revenues and companies could also file for refunds of fee payments made for 2001 onward. In this event, the revenue loss to the state could be over $1 billion. Alternatively, if the court simply required that the fee be based on apportioned income, the fiscal impacts would be much more modest, roughly $100 million.

Other Revenues and Transfers

The remaining 6 percent of total 2007-08 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 rise from $4.9 billion in 2006-07 to $5.9 billion in 2007-08, before falling slightly to $5.8 billion in 2008-09. These totals are affected by a variety of factors. For example, the increase between the current and budget year reflects (1) $300 million in transfers associated with the refinancing of a tobacco bond, (2) $200 million from the Governor's proposal to amend five existing tribal gambling compacts and double the number of slot machines operated by them, and (3) one-time federal relief payments related to child support automation penalties. The portion of these other revenues related to taxes is expected to grow moderately between the current and budget year.

THE BUDGET'S FORECAST FOR SPECIAL FUNDS REVENUES

Special funds revenues are related to a variety of sources:

- About $9.1 billion (or 35 percent of the budget-year total) is related to motor vehicle-related 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 $5.5 billion is related to the SUT. Of this total, (1) about $3 billion is used to fund health and social services programs that were realigned from the state to local governments beginning in the early 1990s, (2) $1.5 billion is related to the diversion of local sales taxes for deficit-financing bond debt service, and (3) about $1 billion is used for transportation programs.
- Roughly $1.7 billion is related to the high-income PIT surcharge for mental health programs, which was approved by voters as Proposition 63 in November 2004.
- $998 million is from tobacco taxes that have been approved by voters in various elections.
- The remaining special funds revenues are related to a wide variety of sources, including an energy resource surcharge and beverage container redemption fees. The special fund totals are also affected by various transfers and loans between funds.

Modest Underlying Growth Expected

As shown in Figure 12 (next page), the Governor's budget assumes that special funds revenues will total $24.7 billion in the current year (a 0.8 percent decline) and $25.5 billion in 2007-08 (a 3.4 percent increase). A variety of factors are affecting the year-to-year growth rates, including varying amounts of sales tax spillover revenues going to transportation and other transfers between funds. Special funds revenues from ongoing tax sources are projected to increase by roughly 3 percent in 2006-07 and 5 percent in 2007-08. The budget-year growth rate reflects moderate increases in sales taxes, vehicle license fees, and PIT, and modest increases in motor vehicle fuel and tobacco taxes.

Figure 12

Summary of the Budget's Special Funds Revenue Forecast

(Dollars in Millions)

		2006-07		2007-08	
	Actual 2005-06	Estimated Amount	Percent Change	Projected Amount	Percent Change
Motor Vehicle Revenues					
License fees (in lieu)	$2,229	$2,317	4.0%	$2,408	3.9%
Fuel taxes	3,393	3,486	2.7	3,546	1.7
Registration, weight and miscellaneous fees	2,812	2,912	3.5	3,099	6.4
Subtotals	($8,434)	($8,715)	(3.3%)	($9,053)	(3.9%)
Sales and Use Tax					
Realignment	$2,845	$2,854	0.3%	$3,017	5.7%
Deficit-financing bonds	1,420	1,424	0.3	1,511	6.1
Transportation[a]	354	928	162.0	1,016	9.4
Subtotals	($4,619)	($5,206)	(12.7%)	($5,544)	(6.5%)
Other Sources					
Personal income tax surcharge	$1,343	$1,528	13.8%	$1,694	10.9%
Cigarette and tobacco taxes	971	988	1.8	998	1.1
Interest earnings	273	261	-4.5	301	15.2
Other revenues	9,250	7,907	-14.5	8,245	4.3
Transfers and loans	13	98	—	-294	—
Totals	**$24,903**	**$24,702**	**-0.8%**	**$25,540**	**3.4%**

[a] Public Transportation Account, transportation loan repayments, and debt service.
Detail may not total due to rounding.

IV

Perspectives on State Expenditures

Perspectives on
State Expenditures

AN OVERVIEW OF STATE EXPENDITURES

PROPOSED TOTAL SPENDING IN 2006-07 AND 2007-08

The Governor's budget proposes total spending in 2007-08 of $130.8 billion, including $103.1 billion from the state's General Fund and $27.7 billion from its special funds (see Figure 1). This total budget-year spending is $4.2 billion higher than current-year spending—an increase of 3.3 percent. Of total budget-year spending, General Fund spending accounts for about 80 percent. This proposed spending level translates into $3,430 for every man, woman, and child in California, or $358 million per day.

Figure 1

Governor's Budget Spending Totals

(Dollars in Millions)

			Change	
	2006-07	**2007-08**	**Amount**	**Percent**
Budget Spending				
General Fund	$102,137	$103,141	$1,004	1.0%
Special funds[a]	24,509	27,685	3,176	13.0
Totals	**$126,646**	**$130,825**	**$4,180**	**3.3%**

[a] Does not include Local Public Safety Fund expenditures of $2.8 billion in 2006-07 and $3 billion in 2007-08. These amounts are not shown in the Governor's budget.

Detail may not total due to rounding.

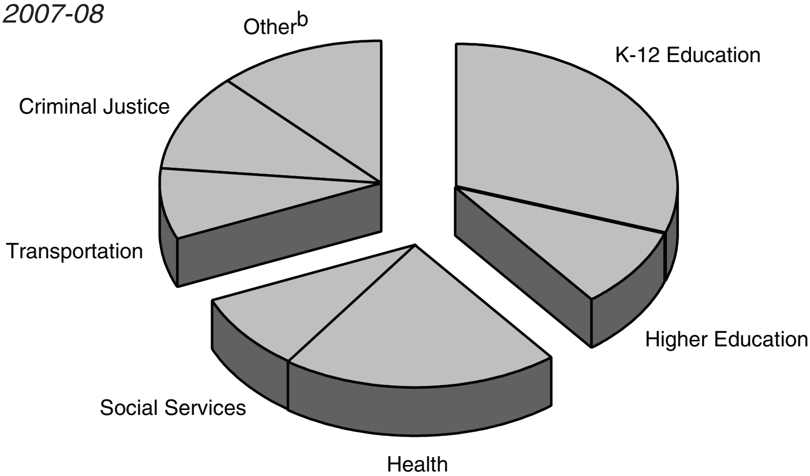
Allocation of Total State Spending

Figure 2 shows the allocation of the proposed $130.8 billion of total state spending in 2007-08 among the state's major program areas. Both General Fund and special funds expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of support in some areas (such as transportation).

Figure 2

Proposed Total State Spending by Major Program Area[a]

2007-08



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

The figure shows that K-12 education receives the largest share of spending—30 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 40 percent. Health and social services programs account for 29 percent of proposed total spending, while transportation and criminal justice together account for roughly 19 percent. The "other" category (12 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, criminal justice programs, as well as tax relief provided through the budget.

Proposed Spending. The Governor proposes General Fund spending of $103.1 billion for 2007-08, an increase of 1.0 percent. As has been the case in recent years, the year-to-year changes in many programs are being affected by special factors, such as transfers of programs, funding redirections, and one-time actions. As shown in Figure 3 (see next page):

- General Fund spending for K-12 Proposition 98 programs is proposed to be $36.9 billion, a 0.5 percent increase from the current year. Total combined state and local funding for K-12 Proposition 98 is proposed to increase by a larger 2.9 percent. The relatively low growth rate for total funding reflects the Governor's proposal to shift $627 million in home-to-school transportation expenditures from Proposition 98 to the Public Transportation Account (PTA). General Fund spending is further depressed by the administration's assumption that local property revenues will increase by 10 percent in 2007-08, despite the real estate slowdown. Local property tax growth offsets, dollar-for-dollar, state General Fund spending for Proposition 98. The budget covers a 4 percent cost-of-living adjustment (COLA) for general apportionment and various categorical programs and provides additional support for the California Work Opportunities and Responsibly to Kids (CalWORKs)-related childcare.
- General Fund Proposition 98 spending for community colleges is proposed to total $4.2 billion, a 4.6 percent increase from the current year. This increase funds a 4 percent COLA and a 2 percent increase in enrollment. It also covers the full-year costs of the student fee reduction that takes place in the middle of 2006-07.
- University of California (UC) and California State University (CSU) combined funding is proposed to be $6.2 billion, a 6 percent increase from the current year. The spending total covers base increases of 4 percent and enrollment increases of about 2.5 percent for both segments.
- Medi-Cal funding is proposed to total $14.6 billion, a 7.2 percent increase from the current year. The increase covers cost and utilization in the program. The potential impact of the Governor's health care reform proposal is not included in the budget totals.

Figure 3

General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 2005-06	Estimated 2006-07	Proposed 2007-08 Amount	Proposed 2007-08 Percent Change
Education Programs				
K-12 Proposition 98	$34,582	$36,658	$36,851	0.5%
Community Colleges Proposition 98	3,670	4,040	4,224	4.6
UC/CSU	5,444	5,895	6,246	6.0
Other	3,939	4,792	5,193	8.4
Health and Social Service Programs				
Medi-Cal	$12,358	$13,649	$14,629	7.2%
CalWORKs	1,963	2,014	1,324	-34.3
SSI/SSP	3,427	3,543	3,893	9.9
In-Home Supportive Services	1,355	1,444	1,471	1.9
Other	7,238	9,170	8,558	-6.7
Criminal Justice	$10,090	$11,924	$12,955	8.7%
Transportation	$1,699	$2,993	$1,558	-47.9%
All Other	$5,827	$6,016	$6,238	3.7%
Totals	**$91,592**	**$102,137**	**$103,141**	**1.0%**

Detail may not total due to rounding.

- CalWORKs spending would decline 34 percent to $1.3 billion in the budget year. The decline reflects a suspension of the January 2007 COLA, the impacts of the Governor's proposals related to time limits and sanctions, and the shift of certain child-care costs to Proposition 98.
- Supplemental Security Income/State Supplementary Payment (SSI/SSP) spending is proposed to total $3.9 billion, an increase of 9.9 percent. The above-average increase primarily results from the half-year effect of funding the statutory January 2008 COLA.
- In-Home Supportive Services (IHSS) spending is proposed to total $1.5 billion, a 1.9 percent increase from the current year. The below-average increase reflects the full-year implementation of quality assurance initiatives and the capping of state participation in provider wages.

- Criminal justice funding is proposed to increase to $13 billion, an 8.7 percent increase from the current year. The funding covers price increases, inmate growth, compliance with various court orders, and a new program to manage sex offenders.
- Transportation spending from the General Fund is proposed to total $1.6 billion, a decline of 48 percent from the current year. Part of the reason for the decline is that the current-year total includes one-time funding related to large Proposition 42 loan repayments. In addition, the budget-year total reflects a one-time shift of $339 million in debt-service costs from the General Fund to a special fund (the PTA).

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 22 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 2007-08, the Governor proposes special funds spending of $27.7 billion (see Figure 4 on the next page). This is a 13 percent increase from the current-year total. The large increase reflects a variety of funding shifts, some of which were discussed above. The 17.1 percent increase in transportation funding, in part, reflects debt-service payments related to transportation bonds. The large increase in the Department of Mental Health reflects the ramp-up of spending associated with voter approval of Proposition 63 in 2004. The large increase in education is largely related to the use of PTA funds to support General Fund spending in K-12 transportation.

Local Public Safety Funds Not Included in Special Funds Total

It should be noted, that the budget's special funds spending total for 2007-08 excludes expenditures of roughly $3 billion from the Local Public Safety Fund (LPSF). Such spending is also excluded from the current-year and prior-year totals.

Figure 4

Special Funds Spending by Major Program Area

(Dollars in Millions)

	Actual 2005-06	Estimated 2006-07	Proposed 2007-08 Amount	Proposed 2007-08 Percent Change
Transportation	$6,361	$6,489	$7,601	17.1%
Local government subventions	6,168	6,427	6,222	-3.2
Resources related	2,433	3,001	3,102	3.4
Department of Mental Health	168	517	1,511	192.1
Public Utilities Commission	1,230	1,277	1,270	-0.6
Department of Education	45	71	675	851.8
All other	6,311	6,726	7,304	8.6
Totals	**$22,716**	**$24,509**	**$27,685**	**13.0%**

Detail may not total due to rounding.

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 $130.8 billion of proposed 2007-08 spending from the General Fund and special funds, the budget also proposes $58 billion in spending from federal funds and another $12.6 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, proposed 2007-08 spending exceeds $201 billion.

Federal Funds

As noted above, about $58 billion in federal funds are proposed to be spent through the state budget in 2007-08. (This is about one-fourth of the $232 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 $33 billion (57 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 $12.4 billion (22 percent) of the total, and transportation is expected to receive $4.2 billion (7 percent). The remaining $8.2 billion (14 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 2007-08, the budget proposes General Fund debt-service expenditures of $4.7 billion, of which $3.9 billion is for general obligation (GO) bonds and about $780 million is for lease-revenue bonds.

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

Spending of GO Bond Proceeds. The January budget proposal estimates that the state will spend $12.6 billion in GO bond proceeds for capital projects in 2007-08. This includes $6.9 billion for education, $2.8 billion for transportation, and $2.9 billion for resources and other areas. This total is up 32 percent from the $9.5 billion in current-year spending. The comparatively larger amount in the budget year reflects $8.7 billion of spending from the $43 billion of bonds authorized by the voters in November 2006. About $3.5 billion (40 percent) of the spending of new bond monies is for education facilities, $2.8 billion (32 percent) is for transportation projects, and the remaining $2.4 billion (28 percent) is for resources, flood control, and housing.

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 2007-08, the budget proposes $258 million in new spending from lease-revenue bond proceeds for such purposes as the construction of forest fire stations.

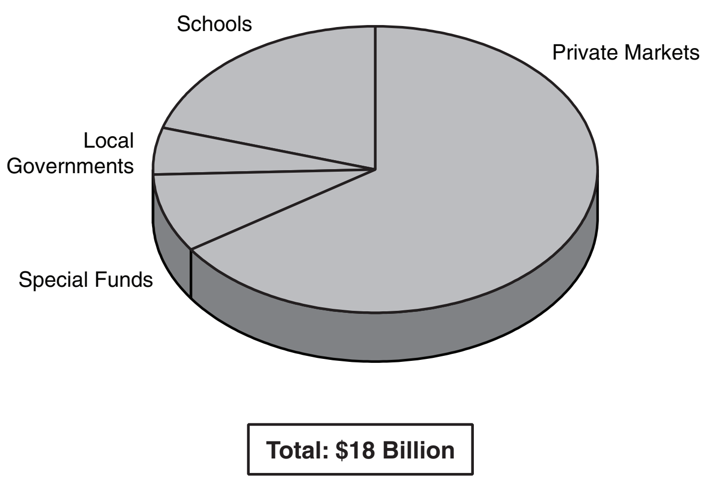
Budgetary Borrowing

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 a total of $1.6 billion in supplemental payments on outstanding deficit-financing bonds). Even after these repayments, however, the state will be left with $18 billion in budget-related debt at the close of 2007-08 (see Figure 5). This consists of:

- About $12 billion from private credit markets, about $5 billion of which result from deficit-financing bonds, with the remainder from tobacco-related bonds and other sources.
- Around $1.5 billion from special funds, about one-half of which is related to deferred Proposition 42 payments.

Figure 5

Budgetary Borrowing Outstanding After 2007-08



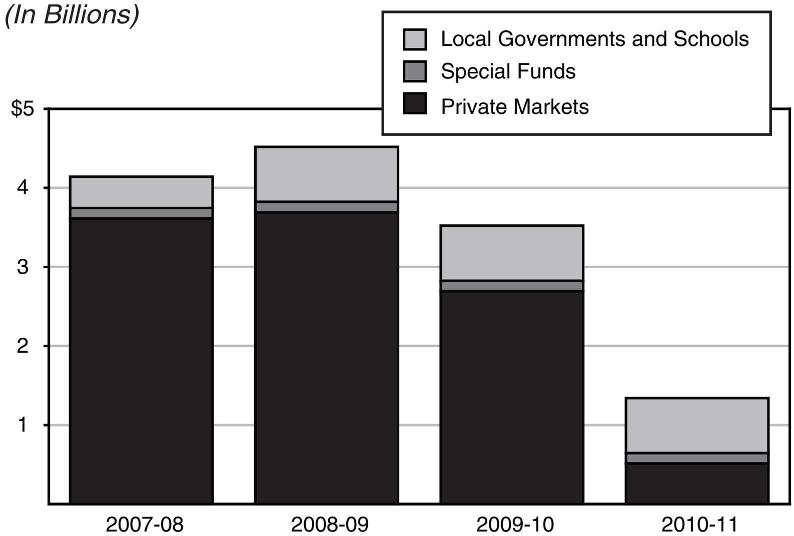
- About $1 billion from noneducation local governments related to deferred mandate payments.
- About $1.1 billion in settle-up payments owed to Proposition 98 education, and another $2.5 billion owed to K-14 education under the terms of the settlement agreement reached last year regarding the 2004-05 suspension of the minimum guarantee.

As shown in Figure 6, scheduled repayments of this budgetary borrowing will result in annual General Fund costs of $4.1 billion in 2007-08, rising to a peak of $4.5 billion in 2008-09. These repayment amounts are included in our projections. The significant decline in payments in 2010-11 is due to the administration's assumption that the Proposition 57 deficit-financing bonds will be paid off in 2009-10.

Figure 6

Annual General Fund Costs Related to Budgetary Borrowing

(In Billions)



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 2006-07, appropriations subject to the limit are $12.1 billion below the limit, and in 2007-08, the gap narrows slightly to $11.9 billion.

COLAs 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, trial courts, and the judiciary. These are generally referred to as statutory COLAs. Other programs receive COLAs on a discretionary basis, through decisions made during the annual budget process. The major General Fund COLAs in the 2007-08 proposed budget are shown in Figure 7. These COLAs are based on a variety of different statutory formulas. For example, the COLAs that are applied to social services programs are related to components of the California Consumer Price Index, COLA adjustments for the trial courts are related to growth in the SAL factor, and general apportionments and some categorical programs in Proposition 98 are linked to the U.S. gross domestic product price deflator for state and local governmental purchases.

Which Programs Receive COLAs in the 2007-08 Budget?

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

- K-12 and community college education, where general apportionments and most categorical programs receive a 4 percent statutory COLA.

Figure 7

General Fund COLAs—*2007-08 Governor's Budget*

Program/Department	COLA Percent	Statutory or Discretionary	Funded	Cost (Millions)
Education				
Proposition 98				
Apportionments	4.04%	Statutory	Yes	$1,384
Categorical programs[a]	4.04	Statutory	Yes	729
Non-Proposition 98 K-12 Education				
Child nutrition programs	4.04	Statutory	Yes	1
Higher Education				
University of California[b]	4.0	Discretionary	Yes	117
California State University[b]	4.0	Discretionary	Yes	109
Judicial Branch				
Trial Courts	5.36%	Statutory	Yes	$147
Health				
Medi-Cal				
County eligibility administration	3.26%	Discretionary	Yes	$18
Long-term care rate adjustments	Various	Statutory	Yes	111
Certain clinics	2.9	Statutory	Yes	18
Managed Care plans	Various	Discretionary	Yes	3
Department of Alcohol and Drug Programs				—
Drug Medi-Cal	3.0	Statutory	Yes	3
Department of Mental Health				
Mental Health Managed Care Program	—	Discretionary	No	—
Department of Developmental Services				
Various regional center vendors	Various	Statutory	No	—
Social Services				
CalWORKs July 2007	3.7%	Statutory	No	—
SSI/SSP January 2008	3.7	Statutory	Yes	$172
Foster Care	3.7	Discretionary	No	—
State Departments				
Operations cost	1.35%[c]	Discretionary	Yes	$57
Total				**$2,869**

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.

b The Governor has a nonbinding compact with higher education that contains specified increases for cost-of-living and enrollment.

c Reflects the administration's January 19th proposal to reduce most departments' operations COLA by one-half. The January 10 budget provided a 2.7 percent COLA for departments at a cost of $103 million.

- UC and CSU, which receive 4 percent COLAs. These base increases are consistent with the Governor's compact with these two higher education segments.
- The trial courts, which receive a 5.4 percent increase, based on the growth in the SAL adjustment factor.
- Selected health programs, particularly long-term care providers and regional center vendors.
- Selected state operations, which receive various price increases to cover nonwage costs. (Subsequent to the release of the January 10 budget, the administration proposed reducing these price increases in order to cover increased employee compensation costs for correctional officers.)

COLAs Not Provided for CalWORKs or Foster Care. While the budget funds the January 2008 COLA for SSI/SSP, it does not include funding for the July 2007 COLA for the CalWORKs program. Funding is also not provided for a foster care COLA.

A Historical Perspective on Spending

Total Spending. Figure 8 shows total state spending over the decade 1997-98 through 2007-08 (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 $67.1 billion to $130.8 billion.

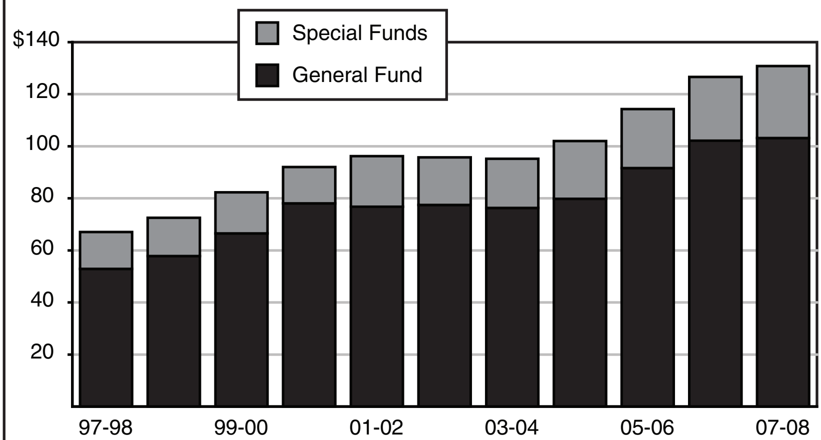
Figure 9 shows cumulative percent changes in various measures of state spending over the past decade. It indicates that total state spending increased by over 43 percent between 1997-98 and 2001-02, reflecting funding increases in education, health, and a variety of other areas in the budget. Spending 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 grew sharply in 2005-06 and 2006-07, reflecting such factors as funding increases in education, the conclusion of a property tax shift, and repayments of budgetary debt. Under the budget plan, funding would increase further in 2007-08, but at a slower pace than the two previous years. Total spending over the entire 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:

Figure 8

Total State Spending Over Time[a]

1997-98 Through 2007-08
(In Billions)

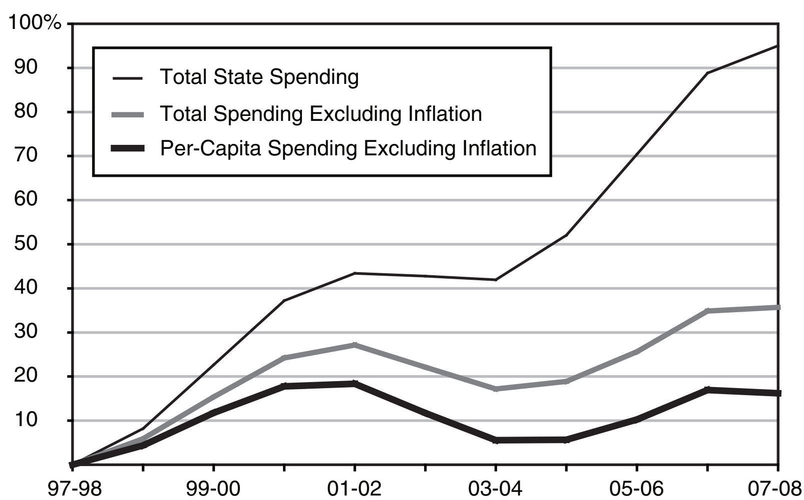


[a] Excludes bond fund expenditures, federal funds, and Local Public Safety Fund expenditures.

Figure 9

Spending Adjusted for Inflation and Population

Percent Increase Since 1997-98



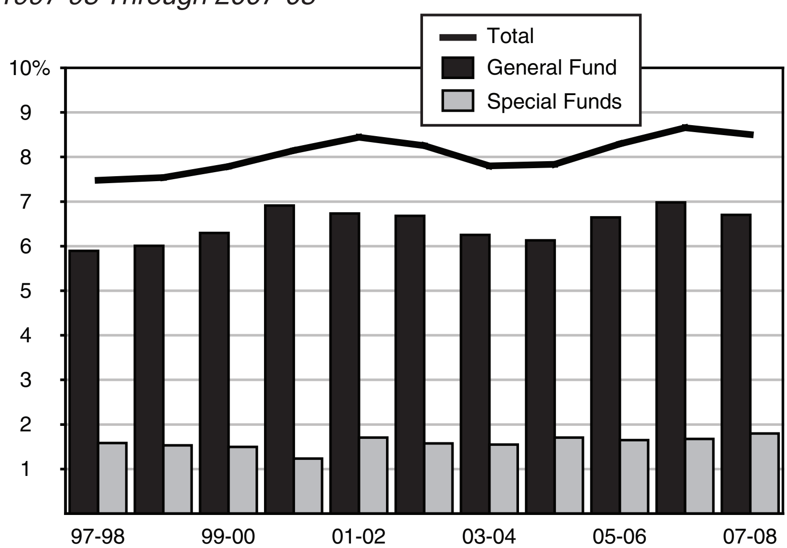
- After adjusting for inflation, real spending has grown by roughly 36 percent over the entire period, or an annual average growth rate of roughly 3.1 percent.
- Real per-capita spending—which adjusts for both inflation and population growth—would increase by about 16 percent over the period under the Governor's plan, for an average annual rate of 1.5 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 1997-98 through 2001-02, total state spending increased steadily as a share of personal income—from 7.3 percent to 8.4 percent. As shown in the figure, growth in General Fund spending accounted for virtually all of this increase.

Figure 10

State Spending as a Percent of Personal Income

1997-98 Through 2007-08



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.

After climbing for the next two years to a peak of 8.7 percent in 2006-07, the ratio of total state spending to California personal income under the Governor's budget plan would decline to 8.5 percent in 2007-08, as personal income in the budget year is projected to rise faster than spending.

Perspectives on
State Expenditures

Major Expenditure Proposals In the 2007-08 Budget

In this section, we discuss several of the most significant spending proposals in the budget. For more information on these spending proposals, and our findings and recommendations concerning them, please see our analysis of the appropriate department or program in the *Analysis of the 2007-08 Budget Bill*.

Proposition 98

Background

California voters enacted Proposition 98 in 1988 as an amendment to the State Constitution. Proposition 98 establishes a minimum annual funding level (or "guarantee") for K-12 schools and the California Community Colleges (CCCs). Typically, it derives this funding level by taking the prior-year funding level and adjusting it by the year-to-year change in K-12 average daily attendance (ADA) and per capita personal income. In any particular year, the Legislature can provide more than the minimum guarantee, though this permanently raises the long-run K-14 funding level. The Legislature also can suspend the guarantee for one year with a two-thirds vote. In the years following a suspension, however, Proposition 98 has built-in mechanisms to ensure K-14 funding is restored to the level it otherwise would have been absent the suspension.

Proposition 98 is funded by a combination of state General Fund and local property tax revenues. It constitutes about three-fourths of total K-12 funding and total CCC funding. In addition, K-14 education receives funding from non-Proposition 98 state General Fund, the state lottery, the federal government, and various other local sources. The community colleges also receive revenue from student fees.

Governor's Proposal

Figure 11 summarizes the Governor's Proposition 98 budget proposal. For 2007-08, it provides $56.8 billion in total K-14 funding ($50.5 billion for K-12 education and $6.3 billion for CCC). This represents a 3.3 percent increase over revised current-year spending.

Figure 11

Governor's Proposed Proposition 98 Funding

(Dollars in Millions)

	2006-07		2007-08	Change From 2006-07 Revised	
	Budget Act	Revised[a]	Proposed	Amount	Percent
K-12 Proposition 98					
General Fund	$37,141	$36,658	$36,851	$193	0.5%
Local property tax revenue	11,973	12,353	13,595	1,242	10.1
Subtotals	($49,114)	($49,011)	($50,446)[b]	($1,435)	(2.9%)
CCC Proposition 98					
General Fund	$4,041	$4,040	$4,224	$184	4.6%
Local property tax revenue	1,853	1,857	2,051	193	10.4
Subtotals	($5,894)	($5,897)	($6,274)	($377)	(6.4%)
Total Proposition 98[c]					
General Fund	$41,295	$40,812	$41,190	$378	0.9%
Local property tax revenue	13,827	14,210	15,645	1,435	10.1
Totals	**$55,122**	**$55,022**	**$56,835[b]**	**$1,813**	**3.3%**

a These dollar amounts reflect appropriations made to date or proposed by the Governor in the current year.

b Reflects Governor's proposal to reduce Proposition 98 funding level by $627 million as part of the Home-to-School Transportation funding shift.

c Total Proposition 98 also includes around $115 million in funding that goes to other state agencies for educational purposes.

Governor Proposes "Baseline Budget." The administration proposes essentially a baseline budget for K-14 education. Specifically, the Governor's budget proposes to increase Proposition 98 expenditures by $1.8 billion over the revised 2006-07 spending level. Figure 12 shows how the new 2007-08 funding would be spent. The budget proposes $2.2 billion in baseline adjustments to pay for growth in the student population ($38 million) and a 4 percent cost-of-living increase ($2.1 billion). These baseline increases are partially offset by a net reduction of $358 million that results from several budget-year policy proposals. The largest of these proposals involves the Home-to-School Transportation program and California Work Opportunity and Responsibility to Kids (CalWORKs) program.

Figure 12

Proposition 98 Expenditure Plan

2007-08 Governor's Budget

Baseline Adjustments	
Cost-of-living adjustment	$2,137.9
Attendance growth	38.2
Subtotal	($2,176.2)
Proposed Increases or Reductions	
Home-to-School Transportation	-$626.8
Child care federal funds shift	269.0
Other K-12 proposals	-29.0
CCC[a] proposals	28.6
Subtotal	(-$358.2)
Total	**$1,818.0**

Detail may not total due to rounding.
[a] California Community College.

Home-to-School Transportation Proposals. The Governor proposes to shift ongoing funding for school transportation ($627 million) from Proposition 98 to the Public Transportation Account (PTA). In a related action, the administration proposes to reduce (or "rebench") the Proposition 98 minimum guarantee by a like amount. Taken together, these actions are intended to achieve ongoing General Fund savings.

Child Care Proposal. The Governor also proposes to achieve $269 million in General Fund savings by shifting the state and federal shares of CalWORKs Stage 2 child care costs. Specifically, the Governor proposes increasing Proposition 98 support by $269 million while reducing federal Temporary Assistance for Needy Families (TANF) support by a like amount. This frees up TANF monies to cover CalWORKs costs that currently are covered by the state General Fund. Unlike the transportation proposal, this proposal does not involve rebenching the Proposition 98 minimum guarantee.

Issues for Legislative Consideration

In 2007-08, the Legislature faces several major issues—some directly related to the Governor's budget proposal, some related to prior-year actions, and some related to our five-year budget outlook.

Rebenching Proposal Risky. We think the Governor's rebenching proposal represents a substantial budget risk and is unlikely to achieve $627 million in General Fund savings. This is because the proposal very likely is unconstitutional and violates the intent of the minimum funding guarantee. The proposal also sets bad policy precedent in that it offers no reasonable explanation as to why a program historically funded from Proposition 98 should now be excluded from it. Under the administration's approach, the state could shift funding for any K-14 program from Proposition 98 to another source and reduce the minimum guarantee anytime it wanted to achieve savings—rendering the guarantee virtually meaningless. In addition to these Proposition 98 issues, the Legislature faces difficult trade-offs in the use of PTA monies and uncertainty whether PTA will have sufficient funds to support the Home-to-School Transportation program in the future.

Other General Fund Challenges. The Legislature also faces other major General Fund threats. We estimate that General Fund tax revenues will be about $1.4 billion lower than the administration estimates (roughly $940 million lower in 2006-07 and $500 million lower in 2007-08). Despite the drop in both years, our estimate of year-to-year revenue *growth* actually is greater, which results in a Proposition 98 minimum guarantee that is about $260 million *higher* than assumed in the Governor's budget. In addition, we believe the administration overestimates property taxes for the budget year by about $200 million. A roughly $200 million drop in property tax revenues increases the Proposition 98 General Fund obligation by a like amount. Together, these factors result in a Proposition 98 General Fund obligation that is roughly $460 million higher than assumed in the Governor's budget. Combined with the school transportation risk, the Legislature could be facing more than $1 billion in additional K-14 Proposition 98 General Fund obligation relative to the Governor's budget.

Reducing Current-Year Spending Could Be Major Part of Budget Solution. Although our estimate of the guarantee is higher than the administration's in 2007-08, the drop in current-year revenues lowers the Proposition 98 minimum guarantee by slightly more than $600 million in 2006-07. Because the budget-year Proposition 98 requirement is based on the current-year spending level, reducing current-year spending can produce major one-time and ongoing savings. Thus, we recommend a package of actions to reduce spending in the current year by slightly more than $600 million. This would reduce the budget year Proposition 98 requirement by about $630 million. As a result, the Legislature could achieve substantial one-time current-year savings while also achieving budget-year savings comparable to the Governor's rebenching proposal. That is, under our set of recommendations, the Legislature could achieve even more savings than under the Governor's plan but without the same risk.

Still Sufficient Funding to Support Baseline Budget. For the budget year, our package of recommendations would ensure the Legislature still could fund a baseline K-14 budget, including growth and cost-of-living adjustments (COLAs). As part of this package, we recommend not increasing the Proposition 98 share of Stage 2 child care costs, as Proposition 98 could no longer accommodate the shift without having to take reductions to K-14 education programs. Our package of recommendations also includes achieving savings from unneeded community college enrollment growth funding.

Changes to Settlement Programs Could Strengthen Reform Efforts. The Legislature faces other major existing K-14 education obligations. The most notable of these is the $2.8 billion obligation stemming from the recent California Teachers Association settlement. Chapter 751, Statutes of 2006 (SB 1133, Torlakson), authorized a seven-year payment schedule for these additional funds. In 2007-08, the state is to provide a total of $300 million in settlement monies ($268 million for a new K-12 education programs and $32 million for community colleges career technical education programs). This payment and the subsequent six annual payments are in addition to otherwise required ongoing Proposition 98 funding.

- ***K-12 Program Has Notable Shortcomings.*** The K-12 funds are designated for a new top-down, one-size-fits-all, highly prescriptive reform program that assumes all low-performing schools can benefit from the same class size reduction initiative. The program also generates large funding inequities, even among those schools serving disadvantaged students. Given serious concerns with this reform approach, we recommend the Legislature maximize the program's potential benefits by running it as a well-structured pilot program.
- ***Career Technical Education (CTE) Program Also Could Be Improved.*** The CCC funds are to be coupled with existing CTE monies and used to improve CTE linkages and pathways between high schools and community colleges. We are concerned the existing CTE plan lacks long-term goals and a way to evaluate effectiveness. We suggest CTE funds would have a greater impact if the Legislature provided more flexibility over the use of the funds while clarifying the goals of the program and establishing performance measures to gauge the effectiveness of the local improvement process.

Developing a Proposition 98 Roadmap. Although our forecast indicates that resources in 2007-08 likely will be able only to support a baseline budget, our out-year forecast shows sizeable Proposition 98 increases are on the horizon. We project Proposition 98 will have significant amounts of new discretionary funds (that is, more than needed to cover baseline cost increases) in each of the next five years. In fact, by 2011-12 Proposition 98 will have a cumulative increase of $6.6 billion in ongoing discretionary funds available for program expansions. We think the possibility of significant and sustained Proposition 98 increases over the next five years makes this an opportune time for the development of a long-term plan, or roadmap. Moreover, the results of a foundation-supported effort to study the issues of funding adequacy and efficiency in K-12 education are expected to be released in the spring of 2007. These studies may help inform the Legislature's discussions about needed investments and the types of policy reforms that should accompany these investments.

Benefits of a Proposition 98 Roadmap. A K-14 roadmap could have a number of significant benefits. Most importantly, it could help the Legislature identify problems in the K-14 system and how best to use available new funding—whenever it becomes available—to address those problems. In our suggested roadmap, we provide data showing the notable achievement gap that continues to persist between K-12 special education, low-income, and English Learner students and other K-12 students. To address these gaps, we offer fiscal reforms and accompanying policy improvements relating to child development and programs for at-risk students. For the community colleges, we provide data showing the large percentage of degree- and transfer-seeking students that fail to graduate or transfer to four-year institutions. To address these issues, we suggest "student success" block grants that would provide incentives to improve while still allowing community colleges flexibility to develop local solutions. For both segments, we also suggest the creation of fiscal solvency block grants to help districts' address the unfunded liabilities related to retiree health benefits.

Higher Education

Background

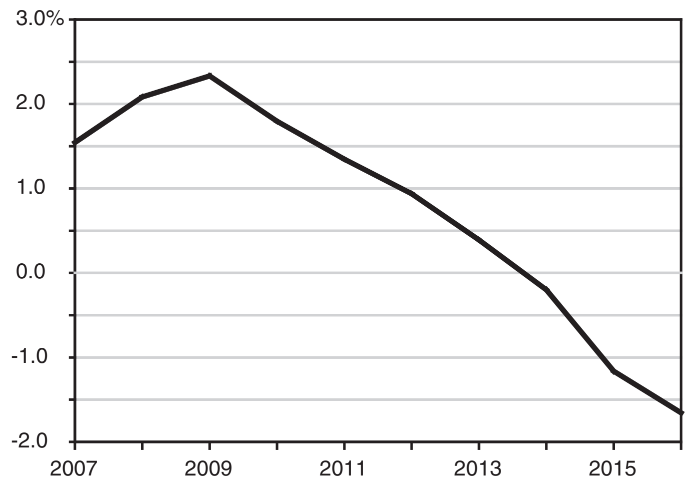
The state's higher education system includes the University of California (UC), the California State University (CSU), and CCC, as well as agencies charged with coordinating higher education policy and administering state financial aid programs. Annual adjustments in the state's cost of providing higher 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 13, 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.

Figure 13

Growth in College-Age Population to Slow Sharply After 2009

Projected Annual Change in 18- to 24-Year-Olds



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 a COLA 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.

Governor's Proposal

UC and CSU. The Governor's budget proposes General Fund support of $6.2 billion in 2007-08 for the state's public universities. This represents an increase of $357 million (6.1 percent) over the current year. This amount would fund enrollment growth of about 2.5 percent, which would accommodate 5,000 additional FTE students at UC and 8,355 additional FTE students at CSU. The proposed enrollment growth funding is based on a marginal cost methodology that the Governor had proposed last year for his 2006-07 budget, and which the Legislature rejected.

The budget also includes General Fund base increases of 4 percent for the segments. In addition, the Governor's budget assumes that student fees would increase by 7 percent and 10 percent at UC and CSU, respectively. The budget is silent on how the segments would use the resulting new revenue, which amounts to $105 million for UC and $97.8 million at CSU, essentially leaving allocation decisions to the segments.

Finally, the Governor's budget would reduce General Fund support for UC and CSU outreach programs by $19.3 million and $7 million, respectively. It would also eliminate $6 million in funding for UC's labor institutes.

CCC. The budget proposes $4.2 billion in General Fund support for CCC, almost all of which counts towards the state's Proposition 98 appropriations. Under the Governor's proposal, General Fund spending would increase by $117 million, or 2.9 percent, from the current year. When student fee revenues and property taxes are also considered, the budget proposal would increase funding for CCC by $271 million, or 4.3 percent. The CCC's share of proposed Proposition 98 appropriations would slightly exceed its statutory share of 10.9 percent. The Governor's budget proposal includes augmentations of $109 million for enrollment growth of 2 percent, $238 million for a 4.04 percent COLA, and $32 million for career technical education. The budget would maintain student fees at $20 per unit.

Issues for Legislative Consideration

As discussed in "Part I," we estimate that the Governor's overall budget proposal would result in a General Fund deficit of over $700 million at the end of the budget year and a $4 billion structural shortfall in 2008-09, absent corrective action. Given this situation, in our *Analysis of the 2007-08 Budget Bill* we recommend several ways that the Legislature could create General Fund savings in higher education relative to the Governor's budget without reducing base programs. We highlight the major issues raised in that analysis below.

Fund Expected Levels of Enrollment Growth. The Governor's proposed base increases for the three segments far exceed our projected 1.1 percent growth in the underlying college-age population. They also exceed the Department of Finance's own projections of increases in the enrollment at the segments. We recommend the Legislature instead fund 2 percent enrollment growth at UC and CSU, and 1.65 percent growth at CCC. We also recommend capturing savings from unspent CCC enrollment funding from the current year.

Fund Cost Increases Caused by Inflation. The Governor proposes 4 percent unrestricted base increases for UC and CSU in 2007-08. We estimate that inflation will cause costs to increase by about 2.4 percent in 2007-08. Accordingly, we recommend base increases of 2.4 percent. Because a statutory formula using a lagged index is customarily used to fund COLAs at the CCCs, we do not take issue with the Governor's proposed augmentation based on that formula.

Maintain Current Share of Cost Covered by Fees. Absent an explicit state fee policy, we recommend that student fees be adjusted in 2007-08 so that they cover the same share of education cost as in the current year. Given our recommendation to fund inflation-based base increases of 2.4 percent at UC and CSU, maintaining the same share of cost in the budget year would require 2.4 percent increases in fee levels. The corresponding increase for student fees at CCC would be less than 50 cents per unit. Given that CCC fees are traditionally charged in whole dollars, and given that current fee levels were adjusted very recently (January 2007), we do not recommend any change to CCC fee levels in 2007-08.

Fund Nursing Programs Using Standardized Approach. The Governor's budget includes augmentations for nursing programs at UC and CSU. While we agree with the need to increase the supply of nursing graduates, we have concerns with several of the Governor's proposals. We recommend a more consistent, simpler way to fund the expansion of nursing enrollment in order to improve outcomes and budgetary transparency.

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 6.7 million persons in the budget year. The Healthy Families Program (HFP), which provides coverage only to children, is assumed in the Governor's budget plan to reach an enrollment of 916,000 by June 2008. 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 programs.

Overall Growth Trend. If the spending levels proposed in the 2007-08 budget are adopted, General Fund spending on health services programs will have grown by $8.3 billion, or 68 percent, from 2000-01 through 2007-08. This represents an average annual growth rate of about 7.7 percent.

Main "Cost Drivers." Much of the increase in General Fund expenditures has been driven by increases in caseload, costs, and utilization of services in Medi-Cal. Increased expenditures for prescription drugs, hospitalization, and long-term care for the aged and disabled have been a significant component of this increase in program costs. Growth in caseloads 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 for Health Care Reform Independent From the Budget. On January 8, 2007, the Governor announced a health care proposal aimed at ensuring that all Californians have health care coverage. This proposal did not provide a timeline for implementation and is not reflected in the budget plan. However, we note that the Governor's proposal would have a significant impact on future funding for state health programs if it were enacted as proposed.

Department of Public Health (DPH). Effective July 1, 2007, the budget plan implements Chapter 241, Statutes of 2006 (SB 162, Ortiz), that creates a new DPH and Department of Health Care Services (DHCS) from the existing Department of Health Services. The DPH will administer a broad range of public and environmental health programs while the DHCS will administer the Medi-Cal Program. This change is intended to result in increased accountability and improvements in the effectiveness of both public health and Medi-Cal by allowing each department to administer a narrower range of programs. The legislation creating the two departments requires that the change be cost neutral to the state.

Governor's Proposal

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

Staffing Expansions. The administration proposes to add about 177 positions for the support of DHCS programs and about 280 positions for the support of DPH programs. Many of the positions proposed by the administration for DHCS and DPH would provide staff to perform activities required by recent legislation. The budget would also add about 151 positions to the state hospital system in the current year and about 508 in the budget year in response to new laws that are expected to increase the number of sexually violent predators committed to state hospitals.

Major Savings Proposals. The Governor's budget plan proposes elimination of the Integrated Services for Homeless Adults with Serious Mental Illness program for savings of almost $55 million General Fund. Increases in General Fund support for regional centers (RCs) that provide services to developmentally disabled individuals would be partly offset by a one-time shift of $144 million in PTA funds to pay the transportation costs of RC clients that previously were paid from the General Fund. The Governor's spending plan also includes a reduction of $44 million General Fund to the RC budget as a result of an initiative to draw down an increased federal funds match for certain residential care facilities. Finally, the Governor's spending plan proposes a reduction of $25 million General Fund for Substance Abuse and Crime Prevention Act (Proposition 36) programs.

Issues for Legislative Consideration

In "Part I" of this volume we discuss our assessment of the significant budget challenge facing the state in 2007-08. Federal policies affecting California's health programs may further aggravate the state's fiscal situation. For example, we project that the state is likely to exhaust its carryover of surplus federal funds for the support of HFP in 2008-09. Without a significant increase in federal funds, it is likely that General Fund support for HFP would have to increase markedly if the present eligibility and benefit levels were to be maintained.

Under these circumstances, the Legislature should carefully consider its opportunities for achieving health program savings in the near term.

For example, we recommend that the Legislature reject some of the DHCS and DPH staffing requests that we found lacked sufficient workload justification. The Legislature should also carefully consider whether the Governor's proposed reduction in funding for Proposition 36 programs would result in savings. Based on our analysis, a reduction in funding for Proposition 36 would probably result in future increased prison costs that are the same or greater than the amount of the reduction.

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 savings in state health program costs. These reform options include the following:

- ***Assist Veterans to Obtain Federal Health Care Benefits.*** We recommend the Legislature explore ways to assist Medi-Cal beneficiaries who are military veterans, and are thus entitled to the comprehensive health coverage offered by the U.S. Department of Veterans Affairs (VA), to apply for and receive those benefits. To facilitate this process, we have identified a federal computer data matching process known as the Public Assistance Reporting Information System that could likely be implemented at a low cost and would allow the state to easily identify veterans enrolled in Medi-Cal. We estimate a shift of veterans from Medi-Cal to the VA health care system could save the state as much as $250 million in General Fund monies.

- ***Shift Emergency Room Patients 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.

- ***Expand Managed Care for Seniors and Other Groups.*** More seniors and persons with disabilities could be placed into managed care where their medical services could be better coordinated and their high costs for hospitalization reduced through greater access to preventive care.

- ***Audit Purchase of Service.*** Weaknesses evident in the fiscal controls for the purchase of services by RCs could be addressed by conducting an audit of this program. We believe such an audit would likely lead to tighter scrutiny and savings expenditures for this program.

- ***Link Provider Rates to Objective Measures.*** Provider rates for state programs are often set on an *ad hoc* basis with increases or decreases depending on the state's near-term fiscal 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.

- ***Monitor HFP Funding.*** If future allocations of federal funds by Congress for HFP remain limited, the state faces the choice as soon as 2008-09 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.

The Governor's proposal for health care coverage expansion is analyzed in more detail in "Part V" of this volume "Major Issues Facing the Legislature." The above proposals for state savings in health care programs are outlined in the "Health and Social Services" chapter of the *Analysis of the Budget Bill* for the years 2005-06, 2006-07, and 2007-08.

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 $9.3 billion in 2007-08, about 9 percent of proposed General Fund expenditures for all purposes.

Overall Growth Trend. From 2000-01 through 2002-03, General Fund spending for social services increased by about $1 billion (16 percent). Since 2002-03, total General Fund spending for social services programs has been essentially flat, rising from $8.8 billion to just over $9.3 billion proposed for 2007-08. The $500 million increase over these five years represents an annual average growth rate of 1.1 percent. In contrast, General Fund spending on all other programs has increased at an average annual rate of 5.9 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 percent.

This relatively flat growth in social services is attributable to many factors. These include additional federal funds (and corresponding General Fund savings) for In-Home Supportive Services (IHSS), periodic suspensions of state COLAs for welfare grants, shifting habilitation services (previously provided in the Department of Rehabilitation) to the Department of Developmental Services, not funding inflationary cost increases for county administration, and the recent cessation of federal penalties for failing to complete a statewide automated child support enforcement system.

Governor's Proposal

The budget provides the 3.7 percent Supplemental Security Income/State Supplementary Program COLA at a cost of $172 million, but suspends the CalWORKs COLA, resulting in a cost avoidance of $124 million. In addition to COLAs, the most significant social services policy proposals in the Governor's budget concern CalWORKs participation sanctions, CalWORKs time limits, and the state share of IHSS provider wage increases.

Increasing CalWORKs Sanctions. Currently, when an able-bodied adult does not comply with CalWORKs participation requirements, the family's grant is reduced by the adult portion, and the children continue to receive a "child-only" grant. The budget proposes a "full family sanction" whereby the reduced grant for the children is eliminated if an adult is out of compliance with participation requirements for at least three months. In response to this increased sanction, the budget estimates that many families will enter employment, resulting in child care and employment services costs of $28 million. In cases where families do not comply, the budget estimates grant and administrative savings of $17 million, so the net cost of this proposal is about $11 million.

Time Limits for Children Receiving CalWORKs. Currently, after five years of assistance, a family's grant is reduced by the adult portion, and the children continue to receive a child-only grant in the safety net program. The budget proposes to eliminate the safety net grant for children whose parents fail to comply with the federal work participation requirements (20 hours per week for families with a child under age 6 or 30 hours per week for families where all children are at least age 6). The budget also proposes to limit assistance to five years for most other child-only cases (such as those with parents who are undocumented or ineligible due to a previous felony drug conviction). These time limit policies are estimated to result in savings of about $336 million in 2007-08.

Limit State Participation in IHSS Provider Wages. Currently, counties negotiate the wages paid to individuals who provide home care services to IHSS recipients. Under current law, the state participates in IHSS provider wages up to $11.10 per hour during 2006-07, rising to $12.10 per hour in 2007-08. (The increase to $12.10 per hour is pursuant to a revenue "trigger" whereby additional state participation is triggered when year-over-year revenues increase by at least 5 percent.) The Governor's budget proposes to freeze state participation in wages to the level provided in each county as of January 10, 2007. The administration now indicates that it will continue to participate in post-January 10 wage increases during 2006-07 until the date when its urgency legislation proposal prospectively limiting state participation in wages is enacted by the Legislature. The budget scores savings of $14.1 million in 2007-08.

Issues for Legislative Consideration

CalWORKs Full-Family Sanction and Time Limit Proposal Not Needed to Meet Federal Work Participation Requirements. The Governor's budget states that increased CalWORKs sanctions and new time limits are necessary to increase the state's work participation rate so that the state can avoid substantial federal penalties. However our review of the Governor's assumptions about the impacts of current law and the ability for the state to obtain a caseload reduction credit indicate that these policy changes are not necessary in order for the state to attain federal compliance by federal fiscal year 2008. We offer an alternative sanction policy which would combine an "up-front engagement" strategy modeled on a sanction prevention program in Los Angeles County with an increased sanction amount if the adult is unwilling to meet participation requirements after three months.

Alternatives to the Governor's IHSS Wage Freeze Proposal. By freezing state participation in provider wages, the budget eliminates the state's exposure of about $350 million from wage increases that counties may grant in future years. Alternatively, the Legislature could eliminate the final revenue trigger, thus limiting future exposure to $225 million. This would provide all counties with an opportunity to increase wages to $11.10 per hour and receive state participation. Finally, the Legislature could delay the final trigger indefinitely.

Budget Faces Substantial Risks From CalWORKs Lawsuit and Reduced Federal Funding for Foster Care/Child Welfare Services. A superior court has ruled in the *Guillen* court case that the October 2003 CalWORKs COLA is required by current law. In December 2006, an appellate court heard the state's appeal and a decision is anticipated in early 2007. Unless the appellate court overturns the prior decision, the state faces one-time CalWORKs grant costs of approximately $434 million. The one-time costs are for 45 months of grant payments (October 2003 through June 2007) owed to recipients on aid during this time period. In addition, the state would face ongoing grant costs of $114 million each year, unless it enacted legislation to reduce grants prospectively.

The state also 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 2000-01. Finally, the state faces potential child welfare penalties of approximately $20 million in 2007-08 unless it substantially improves its performance on three outcome measures.

CRIMINAL JUSTICE

Background

The 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 more than 320,000 offenders, including about 172,000 adult inmates and almost 123,000 adult 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 criminal justice programs represents about 13 percent of total General Fund spending. Since 2000-01, the budget for these programs has grown at an average annual rate of about 8.3 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 to better control spending on staff overtime.

Judicial Branch. Growth in state spending for court operations has resulted primarily from annual adjustments for growth and inflation on certain trial court expenditures provided in accordance with the State Appropriations Limit (SAL). These adjustments are used to fund increases in court employee salaries (excluding judges) and 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

The budget proposes General Fund expenditures of about $13 billion for criminal justice programs. This amount—which includes support for operations, capital outlay, and debt-service for related facilities—represents an increase of about $1 billion, or 8.7 percent, above the revised level of current-year spending for these programs.

Corrections. The Governor's budget proposes to increase spending from all sources for CDCR operations by $607 million, or about 7 percent. The primary causes of this proposed increase are projected increases in the prison and parole populations, salary adjustments, federal court mandates to improve inmate health care, and the implementation of new laws related to the management of sex offenders. In addition, the budget plan includes $10.1 billion in capital outlay projects (funded mainly through lease-revenue bonds) to expand state prison and county jail capacity and to make improvements on the grounds of existing state prisons.

Judicial Branch. Overall, the budget proposes to increase spending for the judicial branch by $196 million, or 5.6 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 overall net increase is primarily the result of annual SAL adjustments for growth and inflation, adjustments for the cost of new or expanded programs, and increases for the cost of implementing recent legislation to increase oversight of conservators and guardians.

Issues for Legislative Consideration

Prison Capacity Package. In order to address a high level of overcrowding of inmates in the state prison system, the administration has presented a 14-part package of proposals that would both build additional capacity to incarcerate offenders at the state and local level and reduce the number of state prison inmates. The Legislature should carefully consider the total impact of all of the components of the proposal on the prison inmate population, including the number of beds relative to the projections in inmate growth, as well as the specific classification levels of offenders affected by the proposal. Our analysis indicates that the administration plan, which includes changes in sentencing laws and parole supervision practices, is more balanced overall than one offered in a special legislative session last summer. However, we find that it goes too far in terms of the total number of beds established and provides the wrong mix of beds. The Legislature should consider alternatives to the Governor's approach, including one we have developed that we believe remedies these problems.

California Prison Receivership. The federal court appointment last year of a Receiver to take over the state's prison medical care system is already resulting in a number of actions intended to improve inmate care. At the same time, there is significant uncertainty regarding the costs and savings likely to result from the Receiver's actions. So far, the Legislature has received only limited information about the fiscal implications of the changes to the medical system that the Receiver is pursuing. Given this situation, it will be important for the Legislature to apply its standard budgetary processes to carefully review and act upon each support and capital outlay budget request submitted to it in behalf of the Receiver. We also believe there are opportunities for legislative oversight of these major changes in the prison medical system. For example, the Receiver is to submit a plan to improve the inmate health care system to a federal court in May 2007. Legislative hearings could be conducted to better understand the fiscal and operational implications of the plan, as well as the metrics to be used to measure progress in improving inmate medical services.

Juvenile Justice System Changes. The budget plan for CDCR's Division of Juvenile Justice reflects administration proposals to (1) shift some offenders from the state to the local level and (2) enact a new state grant program to build county juvenile facilities. As regards the grant program, the budget proposes to provide $400 million in state lease-revenue bond financing to build as many as 5,000 local juvenile beds. The proposed shift in offenders presents an opportunity to mutually benefit the state, counties and the offenders and their families. As the Legislature considers these proposals, it may wish to take into account that a decline in the county juvenile institutional populations and past programs to build additional local juvenile capacity have resulted in about 4,000 beds of excess capacity at the local level.

Courthouse Bond Proposal. The administration is proposing a $2 billion general obligation bond issue for the construction and renovation of courthouses to be placed before voters in November 2008 for their consideration. It is also proposing changes in state law to authorize the Judicial Council to leverage "private-public partnerships" for the construction of court facilities. Such arrangements could be an effective way for the state to attract additional capital and help offset the costs to the state over time of building and operating these facilities. However, the potential benefits are dependent on key aspects of such agreements that are not detailed in the administration proposal. Moreover, if the Legislature does choose to approve such a bond issue, it should consider funding only courthouse projects where responsibility for the facility has been transferred to the state.

TRANSPORTATION

Background

California's state transportation programs are funded by a variety of sources, including special funds, federal funds, and bonds. While state transportation programs have traditionally been funded on a pay-as-you-go basis from taxes and user fees, last year's passage of Proposition 1B provides almost $20 billion in bond funds for state and local transportation programs.

Traditional State Fund Sources. Two special funds—the State Highway Account (SHA) and PTA—have traditionally provided the majority of ongoing state funding for transportation. The SHA is funded mainly by an 18-cent per gallon tax on gasoline and diesel fuel (referred to as the gas tax) and truck weight fees. Generally, these funds have provided a predictable source of funding for transportation.

The PTA is funded by sales tax on diesel fuel and a portion of the sales tax on gasoline. Some PTA revenues come from "spillover"—the amount that gasoline sales tax revenues at the 4.75 percent rate exceed the amount generated from sales tax on all other goods at the 0.25 percent rate. Most PTA revenues are fairly stable; however, spillover can vary greatly from year to year, as it corresponds with fluctuations in gasoline pump prices and the total economy.

More Recent State Fund Sources. In 2002, voters approved Proposition 42, which amended the State Constitution to dedicate revenue from the sales tax on gasoline to transportation. Proposition 42 requires that these revenues fund projects in the Traffic Congestion Relief Program (TCRP) through 2007-08, and on an ongoing basis, fund projects in the State Transportation Improvement Program (STIP), local streets and roads improvements, as well as transit purposes funded by PTA.

When the state faced fiscal difficulties in 2003-04 and 2004-05, Proposition 42 funds were loaned to the General Fund. Proposition 1A, approved by voters in November 2006, restricts the state's ability to borrow these funds and requires that about $750 million in prior-year loans be repaid to transportation by June 30, 2016.

In addition, the recent passage of Proposition 1B at the November 2006 election provides $20 billion in bonds to fund transportation projects over multiple years. The measure creates several new programs to fund a variety of transportation purposes, including highway and transit capital, facilities for goods movement, local road improvements, as well as safety and security enhancements. All funds in the Proposition 1B bond program are subject to appropriation by the Legislature.

Overall Growth Trend. Figure 14 shows expenditures for state transportation programs from state and federal fund sources from 2000-01 through 2007-08. The figure shows that expenditures were relatively stagnate prior to 2004-05, but have grown steadily since. Increased expenditures in 2004-05 reflect a one-time change in accounting methodology. Since then, increased expenditures are due to full funding of Proposition 42 in 2005-06 through 2007-08, proposed expenditure of Proposition 1B bond funds 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 state funding for transportation in California, they have remained relatively flat and therefore do not contribute significantly to the increase.

Figure 14

Expenditures on State Transportation Programs[a]

2000-01 Through 2007-08
(In Billions)

							Estimated	Projected
	00-01	01-02	02-03	03-04	04-05	05-06	06-07	07-08
State funds	$4.2	$3.9	$3.8	$4.0	$4.8	$5.7	$7.2	$8.3
Federal funds	3.4	2.7	2.7	2.3	2.5	3.3	3.5	4.1
Totals	**$7.6**	**$6.6**	**$6.5**	**$6.3**	**$7.3**	**$8.9**	**$10.7**	**$12.3**

a Includes expenditures for the California Transportation Commission, State Transit Assistance, the California Department of Transportation, and the High-Speed Rail Authority.

Governor's Proposals

The 2007-08 budget includes a number of proposals related to transportation funding. In the aggregate, these proposals would increase funding for major transportation programs in 2007-08 compared to estimated current-year funding. Specifically, the budget proposals include:

- ***Fully Fund Proposition 42, Partially Repay Past Loan.*** The budget proposes $1.5 billion, of which $602 million is for TCRP projects, $698 million is for STIP projects, and $175 million is allocated to PTA for transit purposes. The budget also proposes to repay from the General Fund $83 million in past loans.

- ***Begin Using Proposition 1B Funds.*** The budget proposes to appropriate $7.7 billion in Proposition 1B bond money in 2007-08. Of that amount, about $2.8 billion would be for projects in the budget year. The budget also proposes to expend $523 million in bond funds in the current year.

- ***Use Tribal Compact Revenues to Repay Debt, Instead of Bond Funds.*** The budget proposes to use $100 million in tribal compact revenue in each of the current and budget years to repay a portion of a transportation loan to the General Fund. This is in lieu of bond funds, backed by tribal compact revenues, to repay the transportation loans, an approach which is currently the subject of litigation.
- ***Use Transportation Funds to Offset General Fund Expenditures.*** The budget proposes to use $1.1 billion in PTA funds to offset General Fund expenditures, including:
  - ***Debt Service on Transportation Bonds.*** Use the first $340 million in spillover revenues in 2007-08 to pay debt service on outstanding transportation bonds, which has traditionally been paid from the General Fund.
  - ***Home-to-School Transportation and RC Transportation.*** Use $771 million in PTA money to fund transportation purposes generally paid for by the General Fund. Of that amount, $627 million is proposed to fund Home-to-School transportation on an ongoing basis and $144 million is for one-time support of RC transportation.
  - ***Reduce Funding for State Transit Assistance (STA).*** First, the budget proposes to permanently discontinue allocation of spillover revenue to STA, which funds transit operations. Second, the budget proposes to reduce the amount of other PTA revenues that are allocated to STA in 2007-08 to compensate for an overappropriation to STA in 2006-07, relative to the amount required under current law.

Issues for Legislative Consideration

Appropriating Proposition 1B Funds. The budget includes two proposals related to Proposition 1B funds, which would circumvent legislative oversight. First, the budget requests three-year appropriations of Proposition 1B bond funds, totaling $7.7 billion for various transportation programs, even though only $2.8 billion would be spent in the budget year. Second, it proposes budget bill language that would allow the administration to transfer appropriated funds among Proposition 1B programs. These proposals run counter to the bond measure's intent that the Legislature appropriate specific amounts for particular transportation programs. The "power of the purse"—appropriation authority—is one of the Legislature's most powerful tools to ensure accountability. By providing three-year appropriations and allowing the administration to transfer the funds from one purpose to another, as the Governor proposes, this appropriation authority would be circumvented. Accordingly, we recommend that the Governor's proposals be rejected.

Slim PTA Balance Could Evaporate; Expenditure Priorities Should Be Established. The budget curtails certain transit expenditures in 2007-08 in order to use $1.1 billion in PTA funds to offset General Fund expenditures. Moreover, it leaves only a small balance of $69 million at the end of the budget year. Because of the volatility of certain revenues, total available PTA funds could be significantly lower than projected, resulting in an account shortfall in 2007-08. Higher than assumed expenditures for transit projects could also bring about a shortfall in PTA. Accordingly, we recommend that the Legislature establish priorities for PTA expenditures in 2007-08, including what expenditures would not be made in the event of insufficient PTA funds.

Reduce PTA Volatility; Increase STA Funding Predictability. The passage of Proposition 42 renders the spillover mechanism unnecessary. This is because Proposition 42 results in all state gasoline sales tax revenues being used for transportation, thus ensuring a total level of funding for transportation from gasoline sales tax that is unchanged by the spillover mechanism. In order to simplify the state's funding structure, we recommend the enactment of legislation to eliminate the spillover mechanism for generating revenue into PTA beginning in 2008-09. This action would leave the total level of state funding for transportation unchanged and would reduce the volatility in PTA. While eliminating spillover would result in less funding for STA in some years, it would increase the predictability and stability of annual program funding. Moreover, additional funds could become available for broader transportation purposes.

If Tribal Bonds Not Issued, Repayment to Transportation Would Span Far Into Future. Because of pending litigation, the state has not yet issued tribal bonds to repay certain transportation loans and probably will not be able to do so in the near future. As a result, the budget proposes to use available tribal compact revenues to repay loans in 2006-07 and 2007-08, rather than issuing bonds. This would provide almost $200 million for highway rehabilitation over the two years. However, if bonds are not issued, it could take another ten years (until 2016-17) to repay all of the loans with tribal compact revenues as they become available on an annual basis. This delayed repayment could impede construction of TCRP projects, which are intended to relieve congestion. We recommend actions the Legislature can take so that congestion relief projects are completed in a timely manner, including setting project deadlines and reverting funds when projects are no longer viable.

Maintenance and Rehabilitation Needs Outpacing Available Funds. As the state's highways age, the costs to maintain and rehabilitate them are increasing. While the Governor's budget proposes more funding for highway maintenance and rehabilitation in 2007-08, it does not address the long-term issue that needs are growing faster than the revenues which pay for these activities. The Legislature should consider actions to ensure sufficient revenues are available to address long-term maintenance and rehabilitation needs. We recommend actions including raising and indexing the gas tax and exploring mileage-based fees.

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, 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 $4.6 billion in 2000-01 to $6.5 billion in 2007-08 (excluding costs of debt service). This reflects a 42 percent increase, or an average annual increase of about 5 percent. The increase mostly reflects growth in expenditures from fee-based special funds and bond funds. General Fund expenditures proposed for 2007-08 are substantially below the 2000-01 spending level—a decrease of $1.3 billion.

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 and two measures (totaling $9.5 billion) approved by the voters in November 2006. These bond measures provide funding for a mix of water, flood control, park, and land acquisition and restoration purposes. While the five 1996 through 2002 resources bond funds are running out—at the end of 2007-08, roughly $700 million will remain available for new projects—the November 2006 bonds provide a substantial influx of funds that will be available for many years.

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 2000-01 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 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, reflecting a major infusion of funding for these purposes from the Propositions 1E and 84 bond measures.

For flood protection, the budget proposes total spending of $725 million (mostly bond funds) in the Department of Water Resources' flood management program in 2007-08—an increase of $510 million, or 70 percent, above current-year funding for this purpose. In addition, the budget proposes to use $200 million of Proposition 1E funds to reimburse the General Fund for flood control expenditures that were incurred prior to bond passage and were made from a $500 million continuous appropriation in Chapter 34, Statutes of 2006 (AB 142, Nuñez).

For water management, the budget includes $473.6 million of state funds (mostly bonds)—spread throughout eight state departments—for the CALFED Bay-Delta Program (CALFED) in 2007-08. This level of expenditure is essentially the same as the current-year level. The program is awaiting the findings of a number of ongoing planning efforts and program assessments that will guide its future direction and funding requirements.

Also as part of water management, the budget requests 78 new positions for the State Water Project (SWP)—the state's main water conveyance system. The SWP is "off budget"—meaning that funds to support the positions, as well as all other functions of SWP, are not appropriated in the annual budget bill.

Resources Bonds. The budget proposes about $2.3 billion in bond funds for various resources programs in the budget year. Of this amount, about $1.8 billion is from the November 2006 bonds—$1.1 billion from Proposition 84 (parks, resource conservation, water management), $624 million from Proposition 84 (flood control), and $98 million from Proposition 1B (transportation and air quality).

The Governor has proposed that a $4 billion water management bond be placed before the voters in 2008. The proposed bond would provide $2.5 billion for surface and groundwater storage projects; $1 billion for conveyance, water quality, ecosystem restoration, and levee improvement projects in the Delta; and, $450 million for water conservation and various restoration projects.

Wildland Fire Protection. About $1.2 billion, or 94 percent, of the California Department of Forestry and Fire Protection's (CDFFP's) proposed expenditures in the budget year is for its fire protection activities. These activities primarily take place on "state responsibility areas (SRA)"—over 30 million acres of primarily *privately-owned* timberlands, rangelands, and watersheds located throughout the state. The vast majority of the funding for the department's fire protection activities comes from the General Fund, with the balance coming from reimbursements (for fire protection services provided to other levels of government) and lease-revenue bonds (for capital outlay projects).

State Parks Maintenance. The state park system includes 278 units, of which about 250 are directly managed by the Department of Parks and Recreation (DPR). These park facilities vary from state beaches to historic parks to off-highway vehicle recreation areas. The budget proposes about $67 million to operate and maintain the state park system, funded mainly from the General Fund and park fee revenues. While the *2006-07 Budget Act* appropriated $250 million from the General Fund to begin addressing a backlog in deferred maintenance projects at state parks, the administration proposes to spend only $90 million of this amount and transfer the remaining balance ($160 million) back to the General Fund. The budget provides no funding for deferred maintenance in 2007-08.

Issues for Legislative Consideration

Flood Protection. Given the substantial infusion of funds for flood management, we think that it is particularly important for the Legislature to be advised of the administration's criteria for selecting projects for funding, and to set its own expenditure priorities. We also find that legislative oversight of would be enhanced by providing for independent review of and reporting on flood-related capital outlay projects, and reporting on expenditures from the $500 million AB 142 appropriation. We think that there is an opportunity to create General Fund savings by transferring unspent funds from the AB 142 appropriation back to the General Fund, replacing these funds with bond funds.

Water Management. Regarding CALFED, we think that the performance measures that CALFED is currently developing would be used more effectively if they were tied to the budget process. We also recommend denying a number of CALFED budget proposals, on the basis that that they either are premature, funded from an inappropriate funding source, or lack matching funds.

As for SWP, we find that its off-budget status complicates the Legislature's capacity to address the state's water policy issues, including Delta issues, in a comprehensive way. This is particularly the case because of SWP's ties to a number of other major on-budget programs, such as CALFED. We therefore recommend that SWP be brought on budget in order to facilitate legislative oversight.

Resources Bonds. We offer a number of recommendations to ensure the effective and efficient implementation of Propositions 1E and 84, consistent with legislative priorities. First, we recommend the enactment of legislation establishing eligibility criteria for new Proposition 84 programs and for bond-funded flood control programs, and to address the funding eligibility of private water companies. Second, the Legislature should establish appropriate state-local cost sharing arrangements for bond-funded flood control projects, and assess the likelihood receiving federal matching funds. Next, the Legislature should consider opportunities to coordinate similar programs across bonds. For example, we recommend consolidating the administration of Propositions 1C and 84 funding for local parks under DPR. Finally, we make a number of recommendations regarding legislative oversight of bond expenditures, including recommendations to hold hearings, establish reporting requirements, and set parameters on bond-funded administrative costs to ensure that they are reasonable.

Wildland Fire Protection. The CDFFP's fire protection budget has increased significantly over the last decade, growing an average of 8 percent annually. We make a number of recommendations to control the department's rising costs. First, we recommend the Legislature clarify the roles of the state and local government for emergency services in SRA. We also recommend the enactment of legislation to levy a fire protection fee on private landowners in SRA, so that the beneficiaries of state fire protection pay a *portion* (50 percent) of its cost. Finally, we recommend that the Legislature consider modifying the current criteria for designating SRA, such that local governments take more responsibility for fire protection on lands where locally-approved development is occurring.

State Parks Maintenance. Despite a growing backlog of deferred maintenance in state parks—totaling around $900 million—the budget proposes no funding for this purpose in the budget year. We make a number of recommendations to address the existing backlog and to slow its growth in the future. Specifically, we recommend appropriating $160 million from Proposition 84 bond funds to backfill the Governor's proposed reversion, requiring the department to develop a strategy to use outside funding sources to help fund deferred maintenance projects, and augmenting the department's ongoing maintenance budget by $15 million from fees.

State Employment and Retirement

Background

Pay for State Employees. The state's costs for paying state employees are determined primarily 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 $28 billion in 2007-08, over one-half of which is supported from the General Fund. Nineteen of the state's 21 bargaining units—all except attorneys and correctional officers—have MOUs that remain in effect until at least the end of 2007-08.

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 (excluding payroll taxes for state employees' Social Security and Medicare benefits) have increased from $1.2 billion in 1998-99 to a projected $4 billion in 2007-08. Key factors explaining 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 during the past decade are summarized in Figure 15 (see next page).

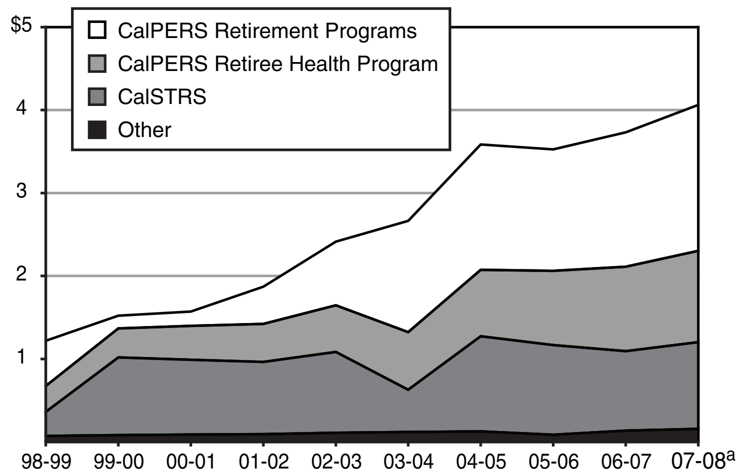
Governor's Proposal

Increased Pay for 19 of 21 Bargaining Units With Current MOUs. The Governor's budget would increase employee compensation by an estimated $1.2 billion in 2007-08, with over one-half of these costs to be paid from the General Fund. The vast majority of these funds address costs related to current labor agreements, court orders, and arbitration decisions. Most state employees will receive an inflation-based salary increase in 2007-08. Over $100 million of the funds—primarily in the budget of CDCR—would increase pay for prison and other state health care personnel as a result of court orders in prison health care cases. The budget plan also includes funds to address a recent arbitration decision awarding $440 million in additional pay to correctional officers. (These funds cover 2005-06, 2006-07, and 2007-08.) There are no funds budgeted for any additional pay increases for correctional officers or attorneys in 2007-08, pending outcomes of the state's negotiations with these bargaining units for new contracts.

Figure 15

Costs for Major State Retirement Programs

(General Fund, In Billions)



[a] Proposed. (CalPERS Retirement Programs amount based on system projections.)

Retirement Costs. The Governor's budget includes three proposals to change the way the state funds retirement benefits. First, the budget proposes to reduce contributions to the California State Teachers' Retirement System's purchasing power account—which protects retired teachers' benefits from being eroded by inflation—by $75 million on an ongoing basis. The reduction in contributions would be implemented in exchange for the state's guaranteeing that teachers' benefits will be maintained at no less than 80 percent of their original purchasing power. In addition, the administration proposes to use the state's $38 million of annual employer drug subsidies under the Medicare Part D program to cover a portion of the state's payments to the California Public Employees' Retirement System (CalPERS) for state retiree health benefits. This proposal would reduce state General Fund costs by a commensurate amount. Finally, on a one-time basis, the administration proposes to offset 2007-08 General Fund contributions to CalPERS by $525 million by issuing debt. Relying on existing state law, the administration proposes to issue pension obligation bonds. Thus far, the state's courts have ruled that such a sale is unconstitutional without voter approval.

Issues for Legislative Consideration

Correctional Officer Salaries. Since state negotiators are currently at the bargaining table with the state's correctional officers union, the Governor's budget includes no funds for a 2007-08 pay raise or increased state contributions to health premiums for the officers. The state's labor agreement with correctional officers expired in July 2006, and under state law, the terms of expired labor contracts continue in effect until a new agreement is approved. Because correctional officers, their supervisors, and managers receive more than 40 percent of the salaries and salary-driven costs paid from the General Fund (over $3 billion per year), a realistic budget plan requires decisions about correctional officer pay. Each 1 percent increase in officer salaries will increase state General Fund costs by about $35 million.

Unfunded Liability for Retiree Health. Under state law, the state pays for most of the costs of health plan premiums for retired state and CSU 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 not set aside 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 discussed in *The 2006-07 Budget: Perspectives and Issues*, this liability will be very large—for the state, some school districts, many local governments, and the UC. We anticipate that the state will receive the draft results of its first retiree health liability valuation during calendar year 2007. We estimate that the state's unfunded liabilities for retiree health benefit will be $40 billion to $70 billion or perhaps more. We recommend that the Legislature begin to set aside funds for these benefits to moderate long-term budgetary pressures.

Pension Unlikely to Be Issued. Due to court rulings to date, we believe it is unlikely that the sale of the pension obligation bonds will occur during the budget year, if ever. Consequently, it is a risky assumption to credit such a sale as helping the state budget's bottom line in 2007-08. Even if the bonds could be sold, however, we would advise on a policy basis not to proceed with a sale. We have consistently recommended against issuing the bonds since they would incur debt for an annual operating expense.

Legislative Oversight of Employee Compensation. Recent agreements with unions, arbitration decisions, and administration actions have all undermined the Legislature's ability to effectively oversee the compensation that is paid to state employees. In "Part V" of this publication, we offer recommendations geared toward the Legislature focusing state employee compensation expenditures within the context of a balanced budget. Among our recommendations are for the Legislature to (1) limit the authority of arbitrators to order large payments based on their interpretation of future labor agreements and (2) end the use of automatic pay raise formulas tied to actions by other governmental employers.

V

Major Issues Facing the Legislature

A Proposition 98 Roadmap

What Are the Implications of Our Five-Year Projection of Proposition 98 Funding Levels? How Can the Legislature Use This Forecast to Improve Its Long-Term Planning for Addressing High Priority K-14 Issues?

Summary

Our most recent forecast projects that, over the next five years, the Proposition 98 minimum guarantee will increase K-14 spending by $6.6 billion more than would be needed to pay for growth and cost-of-living adjustments. This new discretionary money, which will be available on an ongoing basis, provides an opportunity for the Legislature to address critical issues facing schools and community colleges. In this section, we describe the benefits of developing a K-14 roadmap that would help guide the Legislature's fiscal choices to more readily reach its long-term program objectives.

In our suggested roadmap, we provide data showing the notable achievement gaps that persist between K-12 special education, low-income, and English Learner students, and other K-12 students. To address these gaps, we offer fiscal reforms and accompanying policy improvements relating to child development and various programs for at-risk students. For the community colleges, we identify the large percentage of degree- and transfer-seeking students that fail to graduate or transfer to four-year institutions. To address these issues, we suggest "student success" block grants that would provide incentives to improve while still allowing community colleges flexibility to develop local solutions. For both segments, we also suggest the creation of fiscal solvency block grants to help districts address unfunded liabilities related to retiree health benefits. (These liabilities are in the tens of billions of dollars.)

Budgeting—whether for one's personal finances or for state government—entails balancing funding inflows and outflows. In either case, "needs" and "wants" typically exceed resources, which requires choices about how best to use available funds. Budgeting under a short-term perspective often means that any new resources are spent on things that appear important at the time spending decisions are made.

Short-term priorities, however, may be inconsistent with the best long-term use of extra resources. To align short-run budgeting decisions with long-term goals, financial experts counsel people and governments to make explicit their long-term program and financial goals. Once these goals are identified, short-term budget decisions can be structured to support the longer-term goals.

Proposition 98 offers the Legislature a tool for long-term budget planning. Because the minimum guarantee in most years is determined by growth in the economy and K-12 student population, the Legislature can develop a long-term estimate of the amount of new funds that may be available if the economy behaves as expected. Using these revenue projections, the Legislature could develop a long-term expenditure plan that addresses its high-priority uses for new funding. This expenditure plan would serve as a guide to the work of the budget subcommittees in allocating Proposition 98 funds each year.

Many Benefits From Taking a Long-Term Perspective

In this section, we recommend the Legislature develop a roadmap for the use of Proposition 98 funds that we project will become available over the next five years. We call it a roadmap because we think it would help guide the Legislature's fiscal choices so that it would more readily reach its long-term program objectives—despite the unexpected bumps and detours that inevitably occur along the way.

We see many advantages in creating a roadmap for the use of Proposition 98 funds. Figure 1 summarizes these benefits. First, the development of a plan would create a forum for the Legislature to identify its longer-term priorities. We do not see the roadmap as creating binding long-term obligations, but rather an opportunity for the Legislature to assess the progress of students and identify ways that additional funds could further support schools and community colleges in meeting the state's educational goals.

Figure 1

Benefits of a Proposition 98 Roadmap

- ✓ Helps the Legislature Identify Its Long-Term Priorities
- ✓ Strengthens the Legislature's Role in the Budget Process
- ✓ Helps Coordinate Spending Plans With Other Policy and Administrative Actions
- ✓ Facilitates Local Implementation Process

A roadmap also would strengthen the Legislature's role in the budget process. Because growth in the economy and General Fund revenues is hard to predict, the Legislature often faces the task of budgeting hundreds of millions, or even billions, in discretionary dollars at the time of the May Revision. Without a longer-term perspective on the best use of these funds, the Legislature's choices are framed by the Governor's proposals or by other policy issues facing the Legislature at that particular moment. A roadmap would provide a broader range of choices to the budget committees. It also would help members assess the relative importance of immediate needs and longer-term program goals.

A plan also would help the Legislature put in place the other policy structures that might be needed to implement its long-term priorities. Additional money often constitutes only one of several ingredients needed for successful policies or programs. Considerable planning time may be needed, for instance, if new facilities are required to implement the Legislature's policy directives. A long-term plan would allow the Legislature to initiate these changes in coordination with its expenditure plan.

By making the state's policy goals more explicit—and the budget process more predictable—schools and community colleges also would benefit from a roadmap. Just as the Legislature finds itself reacting to last-minute proposals to spend significant new Proposition 98 resources, K-12 and community college districts must implement the resulting new programs under tight timeframes.

The state's experience with implementing K-3 class size reduction (CSR) shows how last-minute budget proposals—particularly ones creating complex new programs that require significant lead time for local planning and implementation—can result in unintended negative consequences. The rapid implementation of CSR in 1996-97 resulted in immediate and severe shortages of credentialed teachers and available classroom space. Studies suggest that the employment opportunities created by the program resulted in credentialed teachers moving from inner-city schools to suburban schools. Perhaps as a result of the implementation challenges created by the very short implementation timelines, evaluations of the class-size program showed little impact on student achievement. Alternatively, a Proposition 98 roadmap could signal future spending directions and give school and community college districts a better chance to implement new programs effectively.

Significant New Revenues in Forecast

The possibility of significant and sustained Proposition 98 increases over the next five years make this an opportune time for the development of a roadmap. Figure 2 displays the LAO Proposition 98 projections of the annual amount of new discretionary funds that will be available from 2007-08 through 2011-12. Discretionary funds represent the growth in year-to-year Proposition 98 funds that is left after providing for baseline costs such as changes in attendance and cost of living. As the figure indicates, the amount of discretionary funds available in 2007-08 and 2008-09 is small—we project about $500 million in each year. (In our *Analysis of the 2007-08 Budget Bill*, we recommend the Legislature use the budget-year funding to help balance the General Fund.) In 2009-10, more than $1.5 billion in new funds is available for new programs (this is the year we project that Proposition 98 begins using Test 1 to determine K-14 funding levels). In 2010-11 and 2011-12, more than $2 billion is available in discretionary funds each year.

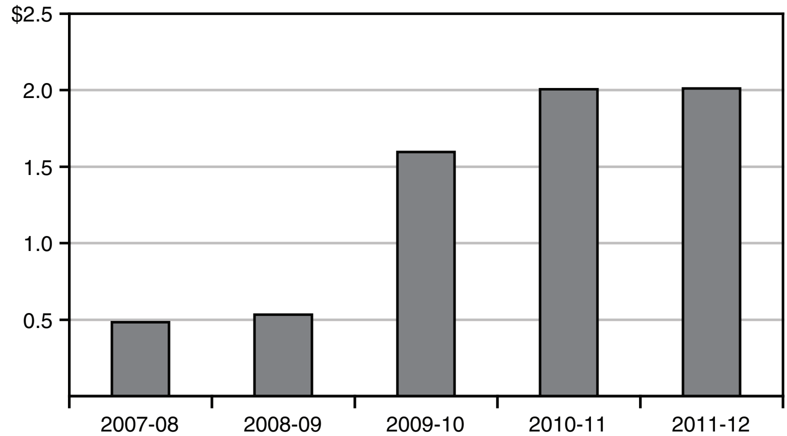
When the incremental annual amounts shown in Figure 2 are cumulated, the state will have $6.6 billion in new discretionary resources available for Proposition 98 by 2011-12. (Using the statutory division of Proposition 98 funds, K-12 education would receive about $5.9 billion of these funds and community colleges would receive about $750 million.) These are permanent, new resources that would substantially boost ongoing per-pupil funding levels for schools and community colleges.

As discussed above, actual annual increases in the minimum guarantee are rarely as orderly as projected. Our five-year projection assumes annual increases based on long-term economic and revenue trends. Since actual annual changes can vary substantially from these long-run averages, the pattern of Proposition 98 increases probably will diverge from our projection. Slower General Fund growth, for instance, could mean that Test 1 would begin determining Proposition 98 spending levels later than we currently project. Despite these caveats, we believe our projections provide a realistic starting point for planning purposes.

Figure 2

LAO Projections of Discretionary Proposition 98 Funds[a]

(In Billions)



[a]Discretionary funds represent available resources under the minimum guarantee after paying for baseline cost increases due to changes in attendance and inflation.

Recent Research Efforts Could Help Inform Planning

The 2007-08 legislative session may represent an opportune time to develop a Proposition 98 roadmap for another reason: the results of a foundation-supported effort to study the issues of funding adequacy and efficiency in K-12 education are expected to be released in the spring of 2007. These studies may help inform the Legislature's discussions about where additional funds are most needed and identify policy changes that should accompany new monies.

At the request of the Assembly Speaker, the Senate Pro Tempore, the Governor, and the Superintendent of Public Instruction, four foundations joined to fund about 20 studies covering a variety of K-12 topics. These studies have two general goals. One is to advise the Governor and legislators whether K-12 schools are "adequately" funded—that is, supported at a level sufficient to ensure that all students can achieve at levels consistent with state achievement standards. The studies will examine funding adequacy for the system as a whole as well as for specific subgroups of students, such as special education and English learner (EL) students.

The second goal is to help state policymakers identify other reforms that would help the K-12 education system operate more efficiently and effectively. Studies include a broad array of topics, including governance, teacher quality and training, and a review of the existing K-12 funding system.

If the studies on California's system conform with the experience of other states that have conducted adequacy studies, the foundation reports will call for substantial increases in support for K-12 education. The reports also are likely to call for programmatic and structural changes to improve the operation of the system. In this event, the reports will provide the Legislature with informed perspectives that can jump-start the discussion over a K-14 roadmap.

A Roadmap Expresses Priorities, Other Program Goals

Creating a long-term roadmap for K-14 expenditures requires an understanding of the critical issues facing the state's education system and how strategic investments can address those issues. Fundamentally, however, it is a priority-setting exercise. While policymakers can disagree about the critical issues in the system, the state's assessment and accountability system puts the Legislature in a much better position than in the past to inform this discussion with data on student success and other outcomes. As a result, the priority-setting discussion establishes an avenue for taking stock of the performance of schools and community colleges and charting the next steps for improvement.

While student success is the most important issue underlying the path outlined in a funding roadmap, a variety of issues may warrant attention. For example, the Legislature has an interest in maintaining the fiscal health of school and community college districts. In addition, the Legislature may want to provide discretionary funds to let local educational agencies pursue critical local priorities.

In considering its high-priority areas, the Legislature should keep in mind some key objectives:

- ***Fix Problems With Current Formulas.*** As the Legislature contemplates adding new funds to existing funding formulas, it may first want to consider using a portion of the funds to eliminate funding disparities and simplify the formulas. In many programs, the current distribution of funding has little analytical basis because it is based on historical factors rather than district "need." Addressing these problems would make the funding system fairer and easier to understand.
- ***Provide Flexibility, but Learn What Works.*** In general, we believe that giving school and community college districts discretion to develop local solutions to specific issues lets districts use funds most effectively. By supporting program evaluations and dissemination of "best practices," the state can help districts learn

how best to use program flexibility to meet the needs of different types of students.

- ***Link New Funds to Improved Performance.*** New investments in K-14 programs may have little impact on student performance without accompanying expectations for improved performance. As we have seen in K-12 education, effective accountability programs significantly sharpen the local focus on creating positive student outcomes. In community colleges, pressure for better performance can be strengthened in a number of ways, including making good measures of program performance easily available to policymakers and the public.

Education research has established that, by itself, additional funding may not result in higher student performance. The above factors, therefore, represent important fiscal and program elements—fairness, transparency, flexibility, accountability—that help create the necessary conditions for schools and community colleges to translate higher funding levels into improved student achievement.

We have identified two major priorities for the LAO roadmap: investing in services to students who are at-risk of low achievement and maintaining the long-term fiscal health of districts. These twin goals emerged from our sense of the major challenges facing school districts in the next five to ten years. We do not suggest, however, that these represent the *only significant* issues facing K-14 education. The critical part of developing a roadmap is for the Legislature to establish *its* priorities.

Major Components of a K-12 Roadmap

Our suggested roadmap would chart two main courses: (1) investing in child development programs and supplemental funding programs for the major subgroups of K-12 students who perform well below state standards, and (2) helping districts address the long-term financial challenge posed by retiree health insurance costs.

Data Reveal Significant Performance Gaps

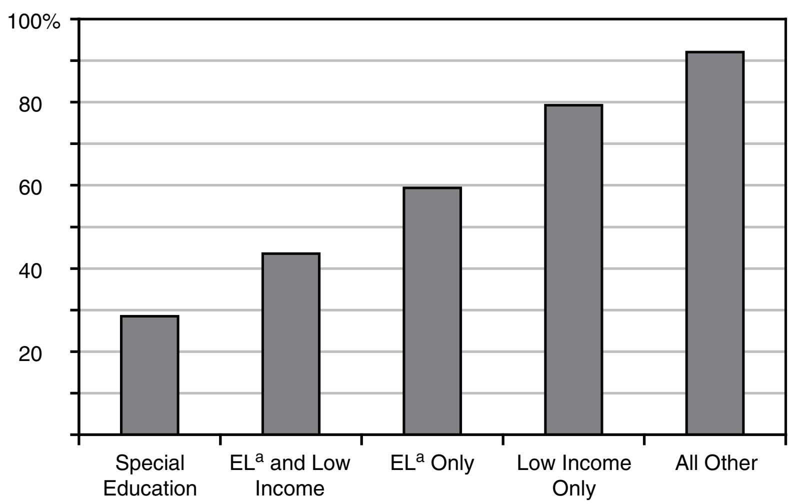
A place to begin the planning process is to assess how students currently fare in our schools. The state's testing programs provide critical data on the achievement of students. This data reveal that major subgroups of our student population struggle to work at levels consistent with graduating from high school. In addition, data also show that schools are not adequately preparing students for the challenges of college and employment after high school.

The state's Standardized Testing and Reporting (STAR) testing program provides a perspective on the achievement of students in grades 2 to 11. Figure 3 displays the proportion of sixth graders that scored at the basic level or above on STAR in English language arts in 2006. The STAR tests report student scores in five performance levels—advanced, proficient, basic, below basic, and far below basic. While the State Board of Education identified the proficient level as the state's goal for all students, the basic performance level roughly equates to the skills needed to pass the high school exit examination.

As Figure 3 illustrates, the average performance of students in the five groups differs markedly. More than 90 percent of the "All Other" group score at basic or higher on STAR. At the other end of the spectrum, only 28 percent of special education students score at these levels. In between these two groups, 44 percent of students who are identified as "EL and Low-Income" and 59 percent of students in the "EL Only" group score at basic or above. Students in the "Low Income Only" group fare relatively well, with more than 80 percent of students scoring at or above the basic level.

Figure 3

Percent of Students Scoring Basic and Above, Sixth Grade STAR English Test, 2006



[a]English learner.

Given the extensive research showing a strong relationship between income and school achievement, however, we are concerned that the current measure of income—eligibility for free or reduced price lunch—may have family income thresholds that are too high to be a good indicator of economic disadvantage. Indeed, the STAR data identify 56 percent of sixth graders as low income.

It is also important to recognize the limitations of these data. Most importantly, students are not permanently assigned to the three "risk" groups. When an EL student becomes fluent in English, for instance, that student leaves the EL category. Similarly, special education students who successfully resolve their disability and low income students whose families move up the economic ladder leave their respective category.

This "group transiency" has a major impact on the accuracy of STAR data over time. Part of the explanation for the low EL and special education scores is that students generally *enter* the categories due to low expected or actual performance and *leave* the category when they begin to achieve at higher levels. Because STAR tracks group scores, not the progress of individual students in the groups, group transiency means that STAR understates the progress of students in these groups. Getting a clearer picture of the progress of these groups will require California to develop measures of achievement growth for individual students.

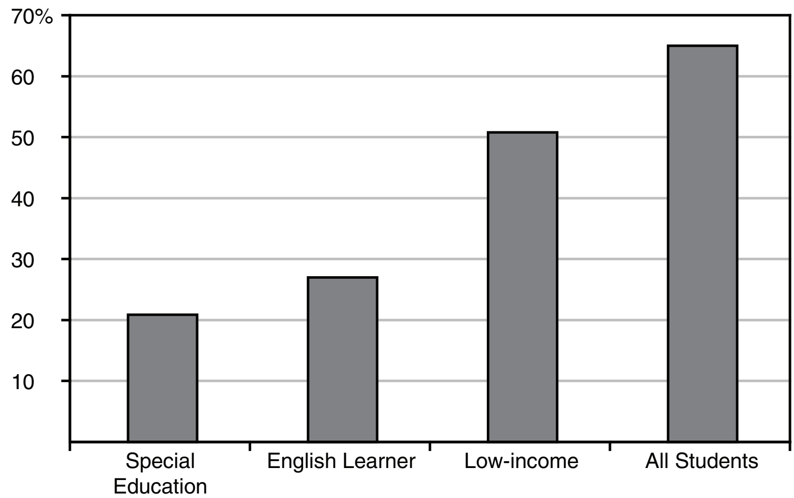
Address Needs of High School Students

The consequences for students of the achievement trends discussed above become most evident when they reach high school. The same groups of students that showed low performance in sixth grade continue to lag in high school. Low achievement contributes to the state's high dropout rate. Data suggest that about 30 percent of 9th grade students do not graduate with their class four years later. While the state's data is unable to reveal what types of students are most likely to drop out, research suggests that low-performing students are most at risk.

Low achievement levels also are evident in pass rates on the California High School Exit Examination(CAHSEE). The test, which students must pass to graduate, is designed to ensure students possess the mathematics and language skills needed for success as adults. Figure 4 (next page) displays the pass rates for the class of 2008. About 65 percent of the class passed the test as 10th graders last spring. Similar to the STAR data, the passing rates of low-income, EL, and special education students are significantly lower than for other students (unlike the STAR data, students may be included in more than one of these groups).

Figure 4

CAHSEE[a] Pass Rates, Class of 2008
10th Grade Test Results



[a] California High School Exit Examination.

Performance problems also affect the transition of students to adult life. Specifically, data show that a significant proportion of high school students are unprepared for the challenge of college or the labor market. For instance, national data show that a quarter of high school graduates remain unemployed six months after graduation. In addition, more than 40 percent of recent high school graduates attending community college need to repeat basic mathematics and English classes. As we discuss in our report *Improving High School: A Strategic Approach* (May 2005), research suggests that the achievement and transition issues are linked. Low-performing students see little advantage to working hard in school, and many choose to drop out. This led us to conclude that upgrading vocational education was a key part of a strategy to give students a greater range of curricular choices that help them connect academics to their post-high school education and employment goals.

Maintain School District Fiscal Health

The second major priority of our roadmap is to secure the long-term fiscal health of school districts. In our *Analysis of the 2006-07 Budget Bill,* we discussed the long-term financial challenge to K-12 districts posed by unfunded retiree health benefits. Because of a new policy adopted by the national Governmental Accounting Standards Board, districts must begin identifying the cost of retiree health care benefits that each district has promised to its current employees and retirees. The accounting requirement will be phased in over a three-year period beginning in 2007-08. Because most districts have not set aside funds to pay for these benefits (as they do with pensions), many districts are expected to report large unfunded liabilities.

About 60 percent of school districts reported providing some amount of health benefits to retirees. Some districts report very large unfunded liabilities. Figure 5 displays selected data from a 2006 survey by the California Department of Education (CDE) on the extent of district liabilities for retiree health benefits. Since only 125 districts reported their liabilities, the cost data is likely to change as more districts conduct their cost studies.

In some cases, the reported liabilities are very large. When translated into per-pupil figures, the largest per-pupil liabilities top $20,000 per student. Unfunded costs of this magnitude pose a major financial threat. To put this into context, the average district receives about $8,000 in state and local funds per student each year. Thus, the health benefit liabilities faced by some districts exceed twice their annual revenues. In the long-run, the financial pressure on districts with very large liabilities may become so severe they eventually will seek financial assistance from the state. Some may even require emergency loans because of this problem.

For most districts, however, liabilities are smaller. As the figure displays, districts that provide lifetime health benefits show average costs of more than $5,500 per student. The average liabilities of districts that end coverage at a specific age—either age 65 (when retirees become eligible for Medicare) or after age 65—are even lower, at about $2,000. Even for

Figure 5

Estimated K-12 Retiree Health Benefits Unfunded Liabilities

(Dollars Per Student Enrollment)

Benefit	Number of Districts	Per-Pupil Liabilities[a] High	Average	Low
Lifetime	76	$23,734	$5,583	$85
Over age 65, not lifetime	116	6,662	1,878	65
Up to age 65	431	27,397	2,302	42

[a] These estimates are based on a subset of districts that provide the given benefit.

these districts, the size of the liabilities remain a concern. Districts with liabilities of $5,000 per student would need to set aside about $350 per student each year to retire this obligation over a 30-year period. In addition these liabilities are growing because the current "pay as you go" method of budgeting followed by most districts does not cover the long-term costs of benefits for current employees.

Information on district liabilities will improve significantly over the next few years as districts comply with the new accounting requirements. We expect, however, that new data will paint a dark fiscal picture for many districts. Because the funding challenge posed by retiree health benefits is so significant, our roadmap allocates funding to address it.

Implementing the Roadmap's K-12 Priorities

Our roadmap would invest new discretionary Proposition 98 funds in three program areas: child development programs, existing programs that support supplementary services to low-performing and at-risk students, funding, and "fiscal solvency" block grants.

Our overview of the K-12 system's most significant issues identified *two* major areas of concern: the achievement of low-income, EL, and special education students and the fiscal threat posed by long-term retiree health benefit liabilities. To address these issues, our plan would direct new discretionary Proposition 98 funds into these areas. In crafting this plan, we have tried to use existing funding streams whenever possible. Our plan also includes complementary policy changes that would improve existing programs, fix problems with current funding formulas, and help make new funds more productive.

Specifically, we would focus a substantial proportion of the anticipated new funds on child development activities for low-income children under the age of five, existing state programs for special education and EL students, support for high school alternative programs and vocational education, and block grants that would protect districts from the fiscal challenge posed by retiree health benefit liabilities. Below, we briefly describe our approach in these areas.

Early Child Development and Preschool

The LAO roadmap allocates a major portion of new discretionary funds for early childhood development programs and preschool. Research shows that early intervention with disadvantaged and disabled students can improve long-term student outcomes. The long-term returns to quality preschool services—higher achievement and graduation rates, fewer referrals to special education, better adult outcomes—have been documented through long-term evaluations. For California, enrolling all EL children in preschool would appear to offer the additional benefit of getting these students earlier exposure to English. Although past studies of preschool were not focused on EL students, we think it is likely that the benefits of providing preschool also extend to this group of children.

Based on research into the cognitive development of infants, however, preschool is now considered to provide support "relatively late" in the lives of children. Evaluations indicate that supporting parents of infants can have positive long-term impacts on children. As a result, other states are beginning to fund programs that promote improved parenting skills. These programs help parents learn about nutrition, health, constructive parenting and discipline techniques, literacy, and educational options. These programs also often provide referrals to other social services.

Given the strong evidence about the long-term benefits of early childhood development programs, our roadmap would set as a goal providing access to preschool classes for all low-income 3- and 4-year olds. In addition, we would include significant funding for a new infant-parent education program that would be modeled after similar programs in other states.

Accompanying this new funding would be several policy changes designed to enhance the impact of the new services. We would dedicate a modest amount of the new funds, for instance, to promote a closer working relationship between preschool providers and K-12 education. These funds would encourage the K-12 system to help preschool programs improve their educational curriculum, identify toddlers who may have disabilities, and provide parents and kindergarten teachers with assessments of student readiness for kindergarten.

We also would place a premium on ensuring high quality preschool services. Consistent with our recent report *Developing Safety and Quality Ratings for Child Care* (January 2007), our plan would include funds to establish a child development quality rating system, which would collect and disseminate information on the quality of state-funded child care programs.

Augment Programs Targeting At-Risk Students

Our roadmap also would dedicate a significant amount of new discretionary resources for programs that support supplemental services to low-performing and at-risk students. Specifically, our plan would increase funding levels for four programs: special education, the Economic Impact Aid (EIA) program (which provides extra support based on the number of EL and low income students), alternative high schools, and vocational education programs:

- ***Special Education.*** Very large disparities in local special education funding rates exist. Our plan would use a portion of the new funds to bring all districts to the current 90th percentile funding level (the state's target for other equalization efforts).
- ***EIA.*** The Legislature streamlined the EIA formula and boosted funding by more than 60 percent in 2006-07. Despite this advance, California spends only about $300 in supplemental funding for each disadvantaged student, about one-half of the $600 per student target established as part of the recent reform.
- ***Alternative High Schools.*** As we discuss in our recent report *Improving Alternative Education in California* (February 2007), we recommend the state revamp its system for funding alternative schools, such as community and continuation schools, which serve primarily high school students. Improving the quality of this system of schools would address a major source of high school dropouts. Given the challenges many of these students face, we think additional funding would also help districts develop better options.
- ***Vocational Education.*** Our roadmap would include new funds to reduce significant local funding disparities among Regional Occupational Centers/Programs and to provide additional funding for introductory and high-level vocational classes.

There are other steps that we would suggest the state take to complement these funding increases. First, data need to be improved. We would require the CDE to explore ways to measure the annual growth of students on the STAR tests. As discussed above, group transiency renders STAR a poor measure of annual student growth, particularly for the subgroups of students most at risk of low performance. Thus, the development of good student growth measures would play a critical role in our plan. Additional work also is needed to refine the state's measure of family income. Our current measure—eligibility for the free and reduced price meals program—may be too broad to reveal important underlying relationships between low income and low achievement.

We also see the need to refine the state's accountability programs. As we discussed in our *Improving High Schools* report, the state needs to reconcile its policy of holding *schools* accountable under the federal No Child Left Behind Act for helping all students reach the *proficient* level of achievement while holding *students* accountable for passing the CAHSEE (which is roughly equivalent to scoring at the *basic* level on STAR). In our report on alternative high schools, we also recommend substantially revising the state's Alternative Schools Accountability System. This system fails to effectively hold alternative schools accountable for meeting the needs of students.

Create Fiscal Solvency Block Grants

Our roadmap would include significant new funding for fiscal solvency block grants. Districts with unfunded retiree health benefit liabilities would be required to use block grant funds for two purposes. First, districts would set-aside an amount in each year's budget equal to the "normal" cost of retiree health benefits—the amount that, if set aside each year over each employee's working life, would pay for all projected benefit costs during retirement. By budgeting for the normal cost of these benefits, the Legislature would ensure that district liabilities would grow no further. Second, any funds remaining would be set-aside to reduce the amount of unfunded liabilities that districts already have accrued. Districts that have no retiree health liabilities could use the block grant funds for any K-12 purpose.

The cost of these block grants will be high. Under our plan, all K-12 districts would receive this new block grant. Although it would be less expensive for the state to target funds only to districts with significant liabilities, we would not suggest this approach. By targeting funding at only problem districts, the state would essentially reward districts whose costs threaten to spiral out of control and penalize districts that have been financially responsible. In general, we think districts should bear responsibility for the consequences of their fiscal decisions. By providing funding to all districts, therefore, districts with significant liabilities would be "penalized" by the requirement to spend the new funds only for those costs. Districts without these liabilities, on the other hand, would be free to spend the funds on program improvements.

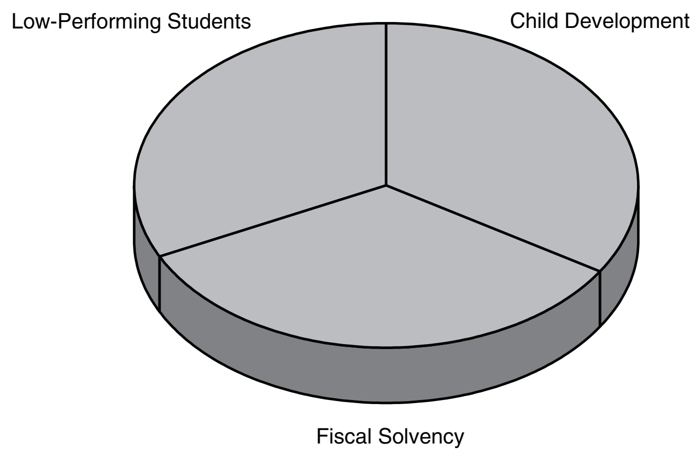
If the state were to provide block grants to all districts, even large grants would translate into relatively small district amounts. For instance, for every $1 billion distributed through the block grants, the state would provide about $175 per student to districts. This amount would fall far short of covering costs in districts with the largest liabilities. Even in districts with moderate liabilities, it might also be insufficient to pay for the unfunded past-year costs and the ongoing normal cost of these services. As a consequence, the roadmap would target a significant percentage of the new discretionary funds for the retiree health issue.

How the LAO Plan Adds Up

Figure 6 (next page) illustrates how our plan would allocate the cumulative $5.9 billion in discretionary funds the we project over the next five years for K-12 education. In rough magnitudes, our roadmap would dedicate: $2 billion of the new funds for child development programs, $1.9 billion to for programs for various at-risk students, and $2 billion for the fiscal block grants.

Figure 6

LAO K-12 Roadmap



Major Components of a CCC Roadmap

Our suggested roadmap would provide new discretionary resources for two new block grants: (1) fiscal solvency grants to help districts address the long-term challenge posed by retiree health insurance costs; and (2) student success grants to help improve student performance.

We base our recommendations for a California Community College (CCC) roadmap on three connected issues: (1) recent improvements in community college funding, (2) a projected slowing of enrollment growth, and (3) continuing performance challenges in the form of low student success rates.

Major Recent Improvements in Community College Funding

In recent years, the Legislature has made major improvements in community college funding. For example, for many years the Legislature has sought to raise the per-student funding rates of many districts in order to "equalize" funding near the level of the highest-funded districts. After adding about $300 million in base funding for this purpose over the past three years, the Legislature's equalization goal has been achieved. In addition, Chapter 631, Statutes of 2006 (SB 361, Scott), revised CCC's apportionment allocation formulas to help ensure that district funding rates remain equalized in the future. Moreover, most of the budget reductions enacted during the budget crisis several years ago (including reductions to matriculation, scheduled maintenance, economic development programs, and base apportionments) have been restored.

Major new investments also have been made in Career Technical Education (CTE) programs, with additional funding totaling more than $400 million planned over the next seven years. (Please see our discussion of these CTE programs in the "Crosscutting Issues" section of this chapter.) Major new augmentations were also recently provided for financial aid services and outreach, with the result that student participation in the Board of Governors waiver program is at an all-time high. Starting in the current year, a new, enhanced funding rate is being provided to high-priority noncredit programs. (Examples include English as a second language and short-term vocational programs.) This new rate is about $500 per student higher than the old noncredit rate and is intended to provide additional resources to districts that offer precollegiate and job-skills courses.

Reversing earlier trends, the Legislature has also addressed longstanding concerns regarding enrollment funding. Specifically, no community college district currently has enrolled more students than it is funded to serve. (During a time of rapid enrollment increase in the late 1990s, some districts experienced enrollment increases that exceeded their budget expectations.) In fact, for the past several years, enrollment growth funding has exceeded actual enrollment growth. Some of this unused enrollment growth funding has been redirected by the Legislature to other CCC priorities, including enhancing basic skills programs and creating a new remediation program for students who fail to pass the high school exit examination.

Moreover, student fees are at their lowest point in several years, with the per-unit rate having dropped by 23 percent in January 2007. Reductions in student fee revenue were backfilled with state funds to ensure that program funding levels were not affected. We also note that under the Governor's budget proposal, the community colleges' share of Proposition 98 resources would actually exceed the statutory "split" of 10.93 percent for the first time since 1990.

Some Funding Needs Still Have Not Been Addressed. To some extent, the recent improvements in community college funding were made possible by delaying payment for some other costs. For example, $200 million in 2003-04 apportionment funding was effectively "borrowed" from future years by continually delaying payment of this amount into the next fiscal year. Paying off this "deferral" would require a one-time cost of $200 million. Similarly, about $100 million in past mandates obligations is owed to community college districts. Some scheduled facility maintenance work also has been delayed as funding was moved to other priorities. And, as with K-12 school districts, community college districts have a substantial unfunded liability for future retiree health care costs. Overall, however, there have been significant funding improvements.

Projected Slowing of CCC Enrollment

As discussed in more detail in the "California Community Colleges" section of this chapter, the size of the traditional college-age population has been growing modestly (between 1 percent and 2 percent) over the past several years. We project this rate will peak at about 2.5 percent in two years, after which it will slow rapidly. We project that by 2013, this population will actually start to shrink.

Assuming constant participation rates, the leveling off of the underlying adult population means that community college enrollment will likewise slow. While some individual districts may continue to experience high growth, the amount of new funding required to accommodate enrollment growth statewide will likely decline from the levels required several years ago.

Community College Performance Challenges

A number of recent studies have highlighted several critical performance challenges facing community colleges. Of particular concern is the large percentage of CCC students who fail to either earn a degree or certificate or transfer to a four-year institution. For example, a recent student by the Institute for Higher Education Leadership and Policy found that about 60 percent of the students entering community colleges seek to earn a certificate or a two- or four-year degree. Of those students, only about one-quarter succeed in their goals within six years. Similarly, the Public Policy Institute of California recently reported that the production of associate's degrees per 100 full-time equivalent (FTE) students at California's two-year colleges is only about three-quarters the rate of the rest of the country. Other reports have made similar findings.

The causes of low rates of student completion are varied and difficult to isolate. However, two points stand out. First, existing funding mechanisms create stronger incentives to increase enrollment than to increase student completion. This is because the allocation of apportionment funding to CCC districts is based almost exclusively on enrollment (as measured in FTE students), with little linkage to student outcomes. For example, community colleges receive apportionment funding based on students being in attendance early on in the semester. The colleges' funding has nothing to do with students completing courses or being successful in them.

Second, various restrictions impinge on districts' ability to allocate resources in a way that best meets their needs. For example, a substantial portion of CCC funding is restricted for certain "categorical" purposes such as providing part-time faculty office hours, funding telecommunications services, or promoting regional economic development. In addition, state law imposes other restrictions on certain aspects of district resource allocation, such as a requirement that at least 50 percent of funding support direct instructional costs.

We believe that districts should be able to allocate financial resources in a way that best serves their students, but categorical and statutory funding restrictions, coupled with fiscal incentives to simply increase enrollment, can often work against those preferred allocation choices.

Investing New Resources to Meet CCC's Challenges

The recent new budgetary investments in the community college system, coupled with the slowing of demographically driven enrollment demand, limits the amount of new resources that will be needed for normal workload increases over the planning period of our roadmap. This creates an opportunity to direct new Proposition 98 funding to paying off outstanding liabilities (such as retiree health benefits) and making improvements in student completion and graduation rates.

Specifically, we recommend that the Legislature consider directing roughly one-half of each year's new, discretionary Proposition 98 funding for CCC outstanding liabilities, including paying off the $200 million deferral, reimbursing local districts for past mandates claims, and helping districts to fund their retiree health benefits liability. The latter liability could be addressed similarly to what we propose for K-12 districts—a fiscal solvency block grant.

We recommend the Legislature use the other half of new, discretionary Proposition 98 funding to improve student performance. In the "California Community Colleges" section of this chapter, we recommend redirecting a small amount of base funding in the budget year for a pilot block grant program to help targeted districts invest in programs that improve student success. In future years, the Legislature could expand this pilot and provide more grant funding to districts that is linked to improvements in student performance. Also, as noted above, we think part of the low student success rates is due to restrictions and disincentives inherent in the way community colleges are funded. Therefore, we recommend that these grants be coupled with relaxing some of these existing restrictions.

How the LAO Plan for the CCC System Adds Up

Our plan would allocate approximately $750 million in discretionary funds for CCC education that are available by the end of our five-year fiscal forecast. Our roadmap would dedicate one-half—$375 million—for "student success" block grants and a similar amount for fiscal solvency block grants. We also suggest that the Legislature set aside funds in the early part of the period to pay off the one-time costs of the deferral and prior-year mandate claims.

Conclusion

This discussion of a K-14 roadmap illuminates the benefits of a long-term legislative plan for the use of Proposition 98 funds that may be available over the next several years. Whether the substantial new discretionary funds actually become available depends primarily on the health of the economy. Even if the flow of new funds is modest, however, we think a roadmap has a number of important benefits. Most importantly, it helps the Legislature identify the problems of the K-14 system and how best to use available new funding—whenever it becomes available—to address those problems.

It is important to remember that these discretionary funds would accumulate over the five years, and that the total $6.6 billion would be realized at the end of this period. Much smaller amounts would be available in the near term. Under our revenue forecast, for instance, only about $500 million in discretionary funds would be available in 2008-09 for K-14 programs. Under our suggested priorities, for example, the Legislature could use a portion of these funds in that year to pay for child care facilities that would be needed to accommodate the proposed expansion of preschool programs. This would pave the way for the ramp up of preschool programs that would occur as the larger sums of discretionary funds became available in later years. Similarly, allocations for low-performing students and fiscal solvency grants would increase over the five years as the new discretionary funds became available. As a result of the roadmap approach the Legislature could ensure that its priorities for new spending were accomplished over the period.

The roadmap also illustrates that, with a long-term perspective, the Legislature can make major investments in school district and community colleges. Because our five-year projection results in so much new discretionary money, our roadmap results in funding allocations on a grand scale. Even smaller amounts, however, accumulate into large sums over time. Later in this chapter, for instance, we review the Governor's proposal on career technical education improvement grants. Our recommendations are based on a long-term perspective—that the program will receive $400 million over the next seven years—rather than the typical short-term budget perspective. Taking a long-term perspective changes the perception of what the program can accomplish.

The process of developing a roadmap also is an important issue. Because the process includes program and funding issues, it would be important to have the budget subcommittees working jointly with the policy committees in each house on the development of a roadmap. The committees also would want to seek input from a variety of sources—including the foundation researchers who are involved in the new studies on adequacy and efficiency. While the task of developing a roadmap represents considerable work, we would hope that the Legislature would see it as an opportunity to take stock of the performance of the K-14 system and chart a long-term course for its improvement.

Potential Fiscal Risks to the State in the Governor's Health Care Coverage Plan

What Are the Major Components of the Governor's Plan to Extend Health Care Coverage to the Uninsured? What Are the Major Risks and Uncertainties That the Legislature Should Consider When Assessing the Plan's Potential Fiscal Impact on the State Budget?

Summary

Numerous stakeholders have raised significant concerns regarding the state's health care system. The Governor proposes to extend health care coverage to California's uninsured population and to implement specific reforms. The Governor's proposal would impose an individual mandate requiring all Californians to maintain a minimum level of health insurance, attempt to contain health care costs so that individuals could afford to purchase coverage, and promote various measures meant to improve the overall health of Californians.

In this analysis, we summarize the major components of the administration's proposal. In addition, we analyze some of the key assumptions the administration's plan is based upon, and identify the major state fiscal risks and uncertainties the Legislature should consider as it reviews the proposal. We conclude that the Governor has presented a comprehensive framework to expand coverage for the uninsured. In addition, the administration has made a serious effort to estimate the programmatic and fiscal impacts of its proposal. We identify a number of legal obstacles and policy issues and conclude that the plan creates fiscal risks to the state potentially reaching several billions of dollars annually.

INTRODUCTION

Various health coverage reform proposals have been introduced in the Legislature in response to concerns regarding California's health care system. In January 2007, the administration announced a proposal to extend health care coverage to California's uninsured population and implement other specific changes to California's health care system.

According to the administration, its plan rests upon three building blocks. First, the proposal, if implemented, would impose an individual mandate requiring all Californians to maintain a minimum level of health care insurance and would enact changes to ensure that everyone would have access to an insurance policy that meets the minimum requirements. Second, the proposal stresses the importance of affordability and cost containment so that individuals would be able to afford to purchase and maintain coverage under the individual mandate. Third, the plan proposes to improve Californian's overall health through an increased emphasis on disease prevention, the promotion of healthy lifestyles and other reforms.

This analysis summarizes the major components of the administration's proposed coverage expansions. We then analyze the key assumptions the administration's plan is based upon, and identify the major fiscal risks and uncertainties to the state that the Legislature should consider when assessing the proposal.

In addition to the coverage expansions, the Governor's proposal also includes a number of changes not directly related to coverage, such as hospital seismic safety reassessment, with far-reaching economic and policy implications. An assessment of the impact of these and other changes not directly tied to health care coverage expansion is beyond the scope of this analysis. Also, the potential impacts of the plan on other health care stakeholders beside the state government, such as consumers, employers, and health care providers, are not addressed in this analysis. Additionally, we do not consider here the question of whether certain components of the plan should be regarded as taxes or fees.

This analysis should be considered a preliminary assessment of the Governor's plan. That is because at the time that this assessment was prepared, the administration had not put its proposal into bill form. As a result, we had to rely upon documents provided by the administration describing its proposal as well as conversations with administration representatives. Our assessment of the plan could change when detailed statutory language implementing the proposal becomes available.

BACKGROUND

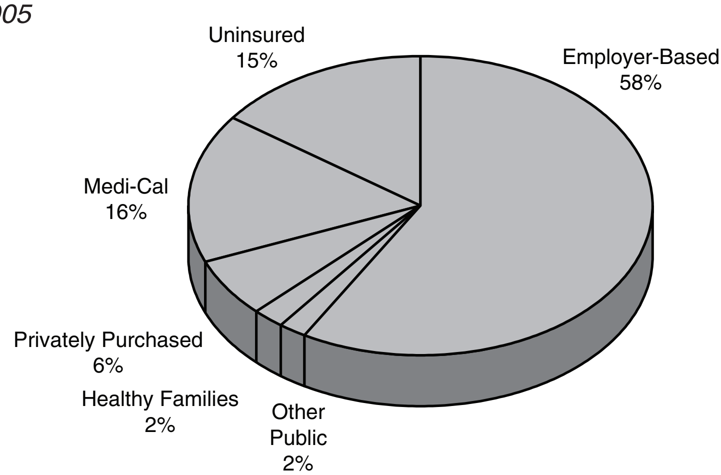
Estimates of the Uninsured Vary. Estimates vary regarding the size of the uninsured population, depending on how the uninsured population is defined. For example, the 2003 California Health Interview Survey (CHIS), conducted by the Center for Health Policy Research at the University of California, Los Angeles, indicates that 4.9 million Californians were uninsured *at any given time*, but that 6.6 million were uninsured *at some point during the year*. However, estimates also vary between different surveys that use the same definition for the uninsured population. For instance, the Survey of Income and Program Participation, administered by the U.S. Census Bureau, estimated the number of Californians uninsured *at any given time* in 2003 to be 6.3 million, which is 31 percent higher than the CHIS estimate. These differences may be partially due to the fact that CHIS obtains its information through telephone interviews rather than in-person interviews, which may increase the possibility of excluding some members of hard-to-reach populations like the uninsured. We discuss these differences in greater detail below.

Fewer Employers Offer Health Care Benefits to Their Employees. Californians currently obtain health care insurance from a variety of sources. As shown in Figure 1, employer-based health care insurance

Figure 1

Californians Obtain Coverage Through a Variety of Sources

2005



Source: 2005 California Health Interview Survey
Percentages do not total 100 percent due to rounding.

provides coverage to most of the insured population in California. The percentage of California's population receiving employer-based coverage has declined over the past two decades, although some recent data suggest this decline may be slowing. The percentage of California's uninsured population under 65 years of age has increased moderately over the same time period, although some recent data suggest that the uninsurance rate has stabilized in the past several years.

Overview of the Governor's Plan

The Governor has broadly outlined a far-reaching plan to expand health care coverage and enact other changes to California's health care system. The administration estimates that once the plan is fully implemented it would cost about $12 billion annually from all government sources, with additional costs of $2.7 billion to individuals and employers. Government funding would be provided by a combination of new and redirected federal, state, and local revenues. However, at the time this analysis was prepared, the administration had not proposed a timeframe for implementing its plan. We note that the Governor's 2007-08 budget plan does not propose any resources for implementation of the health care coverage plan.

Significant Components of the Governor's Plan. The Governor proposes a multifaceted approach to expand coverage to the uninsured, including the following significant components:

- ***Individual Mandate.*** All Californians would be required to maintain a minimum level of health insurance, which the proposal defines as a policy with a $5,000 deductible and maximum out-of-pocket spending limits of $7,500 per person and $10,000 per family. The administration indicates that it would enforce this mandate using health care providers and the state tax withholding and filing processes, although specific information regarding how these enforcement measures would work were unavailable at the time this analysis was prepared.
- ***Employer Mandate.*** All employers with ten or more employees would be required to spend an amount equal to at least 4 percent of their Social Security payroll on employee health benefits or pay the difference into a state health purchasing fund.
- ***Public Health Care Program Eligibility.*** The current Medi-Cal program would be realigned to cover all children and legal resident adults up to 100 percent of the federal poverty level (FPL), currently about $10,000 annually for an individual and about $21,000 annually for a family of four. Eligibility for the current

Healthy Families Program (HFP) would be expanded to include all children between 100 percent and 300 percent of the FPL.

- ***State Health Care Purchasing Program.*** The plan would establish a new state-administered "purchasing pool" to provide health care coverage for adults generally with incomes between 100 percent and 250 percent of the FPL. The pool would seek to use its combined purchasing power to negotiate lower health care premiums than individuals could likely obtain on their own. Legal resident adults would be eligible for state financial assistance through the purchasing pool. A combination of state, federal, and private funds would pay for coverage provided by the pool.
- ***Medi-Cal Provider Rate Increase.*** The plan would generally increase the amounts paid for patient services to certain health care providers up to about 80 percent of the rates paid by the federal Medicare program with the exception of private inpatient rates, which would be set at 100 percent of Medicare.

Few Details on Noncoverage Proposals. Besides expanding coverage, the administration's plan also proposes several general health care changes including the promotion of healthier living among Californians, and the promotion of health care information technology. Figure 2 (next page) summarizes these noncoverage elements of the Governor's plan. The Governor's plan does not identify the costs for these proposals except for certain health promotion programs, estimated to cost $300 million.

How Would the Uninsured Be Covered?

The administration estimates that its plan would provide health care coverage to approximately 4.8 million California residents that currently lack coverage, regardless of their citizenship status. The administration has presented specific estimates for uninsured groups totaling about 4.6 million persons. This difference may be attributable to rounding or other technical data reasons.

Figure 3 (see page 141) summarizes how the various uninsured groups would receive coverage under the Governor's plan. The plan would also shift significant numbers of individuals who currently have health insurance among various coverage sources. Later, we describe how currently insured individuals would receive coverage, as well as describing the shifts in coverage among currently insured persons. Descriptions of certain current state health care programs that would be affected by the coverage plan are included in Figure 4 (see page 142).

Figure 2

**Governor's Health Coverage Plan
Major Noncoverage Elements**

- ✓ ***Health Industry Cost Restrictions.*** Require health insurers and hospitals to spend 85 percent of premium or health spending on patient care.
- ✓ ***Amend Requirements for Health Care Providers.*** Adopt a "worst first" approach to conformity with the state's hospital seismic safety requirements, coordinate workers' compensation with traditional health coverage, and remove legal barriers to retail-based health clinics.
- ✓ ***Encourage Healthy Lifestyles.*** Establish the "Healthy Action Rewards/Incentives" program to promote healthy behaviors with rewards such as gym memberships or reductions in health care premiums.
- ✓ ***Promote Health Information Technology (HIT).*** Appoint a Deputy Secretary of HIT, establish universal electronic prescriptions, and take other steps to expand the use of HIT in the state.
- ✓ ***Combat Diabetes, Obesity, and the Use of Tobacco.*** Expand diabetes management within Medi-Cal, employ a media campaign and other programs to encourage healthy eating, and increase use of smoking cessation programs.
- ✓ ***Amend Regulations for Private Health Coverage Products.*** Review benefit mandates, eliminate unnecessary reporting, and streamline regulatory approval of health care products.

Medi-Cal Would Cover Those Below the FPL. Under the Governor's plan, Medi-Cal would provide coverage to all children (regardless of citizenship status) and to legal resident adults with incomes at or below FPL. Undocumented children would be eligible for the same benefits as citizen children. The administration estimates that 220,000 legal and undocumented children and 630,000 legal resident adults who are currently uninsured would receive coverage through Medi-Cal. The benefits provided to Medi-Cal beneficiaries would remain the same.

HFP Would Cover Low-Income Children. Under the Governor's plan, HFP would provide coverage to all children, regardless of citizenship status, in families with incomes between 100 percent and 300 percent of the FPL. The administration estimates that 250,000 legal and undocumented children who are currently uninsured would obtain coverage through HFP under this plan. Benefits provided to HFP beneficiaries would remain the same.

Figure 3

Governor's Health Coverage Plan
Proposed Sources of Coverage for the Uninsured

		Proposed Source of Coverage					
Currently Uninsured Population	**Total Uninsured**	**Medi-Cal**	**Healthy Families**	**State Purchasing Pool**	**Local Government**	**Employer-Based Coverage**	**Individual Private Insurance**
Children (Regardless of Citizenship Status) In Families:							
Up to 100% of the FPL[a]	220,000	220,000	—	—	—	—	—
Between 100% and 300% of the FPL	250,000	—	250,000	—	—	—	—
Above 300% of the FPL	260,000	—	—	—		210,000	50,000
Total Children	**730,000**	**220,000**	**250,000**	**—**	**—**	**210,000**	**50,000**
Adults:							
Legal residents up to 100% of the FPL	630,000	630,000	—	—	—	—	—
Legal residents between 100% and 250% of the FPL	1,200,000	—	—	1,000,000	—	200,000	—
Legal residents above 250% of the FPL	1,100,000	—	—	—	—	370,000	730,000
Undocumented adults	950,000		—	—	750,000	40,000	160,000
Total Adults	**3,880,000**	**630,000**	**—**	**1,000,000**	**750,000**	**610,000**	**890,000**
Total Uninsured Persons	**4,610,000[b]**	**850,000**	**250,000**	**1,000,000**	**750,000**	**820,000**	**940,000**

a Federal Poverty Level.

b Although the Governor's plan states that it will provide coverage to 4.8 million uninsured persons, the administration has only presented population estimates for these 4.6 million persons. The difference may be attributable to rounding or other technical data issues.

Source: Administration's estimates.

Figure 4

Current State Health Care Coverage Programs

Program	Description	Annual State Funding[a]
Medi-Cal	California's version of the federal Medicaid program. Provides health care coverage generally at no cost for low-income families and aged or disabled adults. Undocumented persons may receive certain limited services.	$14.6 billion General Fund
Share-of-Cost Medi-Cal	Medi-Cal program for persons with higher incomes who must spend a certain amount of their own resources (their "share of cost") before receiving Medi-Cal-provided care.	$112 million General Fund
Healthy Families Program (HFP)	California's version of the federal State Children's Health Insurance Program. Provides health care coverage for children in families earning up to 250 percent of the federal poverty level. Undocumented persons are not eligible for HFP.	$392 million General Fund
Access for Infants and Mothers	Provides health care coverage for low- to moderate-income women throughout pregnancy until 60 days after delivery.	$61 million Proposition 99 funds
Major Risk Medical Insurance Program	Provides comprehensive health coverage for persons who are unable to obtain private individual health insurance or can do so only at a high cost.	$40 million Proposition 99 funds

[a] Figures indicate spending for health care benefits only.

New State Purchasing Pool Would Provide Coverage Options. The Governor's plan would establish a new purchasing pool to be operated by the Managed Risk Medical Insurance Board, which currently administers HFP. The pool would negotiate health insurance premiums with various health care insurers and make the resulting selection of coverage products available to all California adults with incomes between 100 percent and 250 percent of the FPL, including those who work for employers that offer health insurance. Persons at such firms could choose to obtain coverage through the purchasing pool in lieu of the coverage offered by their employers.

Legal resident adults with incomes in this range would be eligible for state financial assistance through the purchasing pool. These beneficiaries would be required to contribute between 3 percent and 6 percent of their incomes toward the cost of their premiums, with the pool paying the remainder. The administration estimates that approximately 1.2 million currently uninsured legal resident adults would be eligible for this subsidized coverage, but that only 1 million of these would actually enroll. The remainder would obtain coverage through their employers. The purchasing pool would also make available to undocumented adults with incomes below 250 percent of the FPL a nonsubsidized insurance product that meets the minimum requirements of the individual mandate.

Some Uninsured Expected to Obtain Private Insurance. The Governor's plan estimates that 820,000 uninsured children and adults will obtain private coverage through an employer, including 210,000 children in families with incomes above 300 percent of FPL, 570,000 legal resident adults, and 40,000 undocumented adults. The plan anticipates that another 940,000 will purchase coverage through the individual market, including 50,000 children in families with incomes above 300 percent of FPL, 730,000 legal resident adults, and 160,000 undocumented adults. The administration believes that the plan's proposed mandates will encourage employers who do not currently offer coverage to begin doing so and that certain proposed regulations, when implemented, would result in insurance companies offering more affordable health care insurance plans.

Counties Would Continue Services for Most Undocumented Adults. The administration estimates that about 1 million undocumented adults are currently uninsured. The text box on the next page discusses how this population currently receives care. Undocumented immigrants would be subject to the individual mandate under the Governor's proposal. The plan anticipates (but does not require) that counties, in cooperation with public hospitals would provide or arrange care for 750,000 of these persons with incomes under 250 percent of FPL. Medi-Cal would continue to provide a limited number of services, such as emergency and prenatal care, to undocumented adults. Of the remaining undocumented adult group without insurance, 40,000 are expected to obtain coverage through employers and 160,000 through the private insurance market.

The Governor's coverage plan would not establish new requirements as to how counties must deliver care or what benefits must be covered. As such, this component of the Governor's plan does not constitute a significant policy shift. However, by providing new options for uninsured persons to obtain coverage, the Governor's plan would likely significantly reduce the numbers of uninsured who may currently rely on obtaining periodic health care services from county-operated programs or facilities.

Some Insured Would Switch Coverage. In addition to providing new health coverage for those currently uninsured, the administration anticipates that certain groups with both public and private health insurance would switch their source of coverage following implementation of the plan. Some of these shifts would result from the Governor's proposed changes to income limits for Medi-Cal and HFP. The administration also estimates that certain persons with private coverage would choose to enter the purchasing pool. Figure 5 (see page 146) summarizes these estimated shifts within insured categories.

Health Care for Undocumented Immigrants

Some Public Programs Currently Treat Undocumented Immigrants

Federal Provisions Affecting Undocumented Immigrants. The federal Emergency Medical Treatment and Labor Act, which requires hospitals to provide emergency care to anyone in need, regardless of ability to pay, effectively allows undocumented persons to obtain health care through hospital emergency rooms. Additionally, California receives over $1 billion in annual federal funding through the federal Disproportionate Share Hospital program, which provides additional compensation to qualifying hospitals that care for Medi-Cal and uninsured patients, including undocumented patients.

Medi-Cal Provides Some Services. Under current law, undocumented immigrants may receive certain Medi-Cal "limited-scope" benefits, which include emergency care, pregnancy-related services, and long-term care. Recent Medi-Cal data indicate that about 800,000 undocumented persons are enrolled for these services, which result in costs of about $700 million General Fund annually.

The state also offers certain services through programs that do not obtain citizenship information when providing care. Children can receive periodic health tests and short-term, full-scope benefits through the Children's Health and Disability Prevention (CHDP) Program, which is intended to encourage the uninsured to apply for Medi-Cal or the Healthy Families Program (HFP). However, most CHDP beneficiaries do not actually submit applications for the broader Medi-Cal and HFP programs. Our discussions with various state and local health program administrators indicate that many of these beneficiaries are believed to be undocumented immigrants.

Most Counties Provide Some Care for Undocumented Immigrants. Most counties provide either emergency-only or broader health care services to undocumented immigrants. For example, 23 counties have implemented Healthy Kids programs, which are similar to HFP but do not receive General Fund support. Recent data suggest

Health Care for Undocumented Immigrants (*continued*)

that about 90,000 children participate in a Healthy Kids program. Our discussions with health care administrators indicate that many of these beneficiaries are thought to be undocumented.

Governor's Plan Would Expand Benefits for Undocumented Immigrants

The Governor's health coverage plan would expand the programs through which undocumented immigrants could access care, as summarized in the table below. Our review indicates that between 300,000 and 600,000 children may be newly eligible for full-scope benefits through Medi-Cal or HFP (some of whom previously received limited-scope Medi-Cal benefits or Healthy Kids coverage).

Undocumented adults would not be eligible for additional benefits through Medi-Cal or HFP under the Governor's plan. However, these individuals could obtain nonsubsidized coverage policies through the purchasing pool. Counties would remain responsible for coordinating care for uninsured, undocumented adult immigrants.

Governor's Health Coverage Plan
Summary of Proposed State Program Changes for Undocumented Immigrants

State Program	Current System	Governor's Coverage Plan
Medi-Cal	Limited-scope benefits for children and adults	Full-scope benefits for *all* children; limited-scope benefits for adults
Healthy Families Program	No benefits for undocumented children	Full-scope benefits for *all* children
State Purchasing Pool	Not applicable	Nonsubsidized coverage available to adults

Figure 5

Governor's Health Coverage Plan Net Effects of Coverage Shifts

	Medi-Cal	Healthy Families	State Purchasing Pool	Local Government	Employer-Based Coverage	Individual Private Coverage
Uninsured persons obtain coverage[a]	850,000	250,000	1,000,000	750,000	820,000	940,000
Coverage Shifts:						
Children shift from Medi-Cal to Healthy Families	-679,000	679,000	—	—	—	—
Children shift from employer coverage to Healthy Families	—	260,000	—	—	-260,000	—
Adult Medi-Cal enrollees shift to purchasing pool	-215,000	—	215,000	—	—	—
Adults shift from employer-based or individual coverage to purchasing pool	—	—	700,000	—	-560,000	-140,000
Net effects of coverage expansion	**-44,000**	**1,189,000**	**1,915,000**	**750,000b**	**—**	**800,000**

a Amounts equal category totals shown in Figure 3.

b The administration indicates that estimates of certain persons who currently receive health care services through county-operated programs or facilities are included in other groups shown.

Source: administration's estimates.

Fiscal Effects of the Governor's Plan

The Governor's plan proposes net new spending of $8.3 billion from government sources to pay for health coverage, including a mix of state, local, and federal funds. Figure 6 displays the plan's estimated expenditure and revenue effects by category.

Spending Under the Governor's Plan

In general, the net new spending results from providing coverage for some populations that are currently uninsured and from shifting some currently insured persons from employer-sponsored insurance to public health care programs. Besides spending for these purposes, the proposal would increase Medi-Cal rates and redirect other funds currently spent for health care programs.

Figure 6

Governor's Health Coverage Plan Combines State, Federal, and Local Spending

Annual Costs and Revenues (In Millions)

	Government			
	State	**Local**	**Federal**	**Total**
Expenditures				
Expand Medi-Cal and Healthy Families	$1,283	—	$1,357	$2,639
State purchasing pool coverage[a]	1,135	—	1,135	2,270
County coverage for undocumented adults	—	$1,000	1,000	2,000
Medi-Cal provider rate increase	2,208	—	1,832	4,040
Health promotion measures	150	—	150	300
Subtotals	$4,775	$1,000	$5,474	$11,249
Less: Redirected funds	$203	$1,000	$1,766	$2,969
Net new expenditures	**$4,572**	**—**	**$3,708**	**$8,280**
Revenues				
Decreased income tax and related revenue	-$900	—	-$7,500[b]	-$8,400
Increased revenue from employers	1,000	—	—	1,000
Increased revenue from hospitals and physicians	3,472	—	—	3,472
Shift of county funds to state	1,000	-$1,000	—	—
Total revenue	**$4,572**	**-$1,000**	**-$7,500**	**-$3,928**
Net Costs	**—**	**$1,000**	**$11,208**	**$12,208**

a Amounts do not include $2.7 billion that the Governor's plan estimates will be contributed by individuals ($1.3 billion) and employers ($1.4 billion) toward the cost of health insurance premiums. The administration does not consider these funds to be state revenues or expenditures.

b The administration estimates that this loss of federal revenue will result from certain components of the Governor's plan, but these funds do not directly affect any aspect of the coverage plan.

Note: Figures may not total due to rounding.

Source: Administration's estimates.

Significant Medi-Cal Rate Increase Proposed. The administration proposes to raise rates paid to certain Medi-Cal providers for health care services. The plan estimates that the new rates would generally be equal to 80 percent of those paid by the federal Medicare program for the same services. For example, Medi-Cal managed care plans would receive an additional $1.35 billion annually ($675 million in state funds) under the Governor's plan, which the administration estimates to be a 24 percent increase. The total Medi-Cal rate increase is the single largest proposed new expenditure, estimated at $4 billion annually.

Plan Redirects Spending by Eliminating Programs. As shown in the figure, the administration estimates that its plan would redirect $203 million in state funds that are currently being spent on other health care programs. This amount represents spending for three programs: the Access for Infants and Mothers program, the Managed Risk Medical Insurance Program, and Medi-Cal Share of Cost. The plan envisions that these programs would be unnecessary because current beneficiaries of these programs would obtain health care coverage from other sources.

Funding Sources for the Governor's Plan

The Governor's coverage proposal would use a mix of funding sources to pay for its anticipated spending. The plan assumes the state would receive new federal funds of $3.7 billion annually to match new state spending, and would redirect $1.8 billion in other current federal expenditures. Additionally, the plan would raise new annual state revenues of $5.5 billion from employers ($1 billion), hospitals and physicians ($3.5 billion), and counties ($1 billion). These new revenues would be offset in part by estimated state revenue losses of $900 million annually resulting from proposed changes to the tax treatment of employee health insurance premiums.

Pay-or-Play Mandate Would Raise Revenue From Employers. As shown earlier in Figure 6, the coverage plan calls for new revenues of $1 billion from employers. These would result from the plan's implementation of a "pay-or-play" mandate in which all employers with ten or more employees must spend at least 4 percent of their Social Security payroll on employee health care benefits or pay the difference into a state fund. For example, a firm that spends 2 percent of its Social Security payroll on health benefits would be required to pay an additional 2 percent to the state (even if it were providing health benefits to its employees). A firm that does not offer health benefits to its employees would need to pay the entire 4 percent to the state. This requirement would not dictate how many of a firm's employees must receive health care benefits, nor would it specify what type of benefits must be provided. The administration estimates that 7.5 percent of California firms would choose to pay the levy under its proposal rather than increase their spending for employee health benefits to the 4 percent level.

Hospitals and Physicians to Pay "Coverage Dividend." The Governor's plan also includes new revenues of $3.5 billion resulting from a levy imposed on hospitals and physicians in the state (referred to by the administration as a coverage dividend). Hospitals would be required to pay 4 percent of their gross revenue to the state, and physicians would be required to pay 2 percent of their gross revenue. The administration estimates that hospitals would pay the state about $2.2 billion, and physicians would pay about $1.3 billion.

Counties Required to Send Funds to State. The Governor's plan would require counties to send about $1 billion in revenue to the state. Counties currently receive "realignment" revenue intended to fund, among other programs, certain health care services for the uninsured and some public health services. These revenues consist of the realignment portion of the state vehicle license fee and a half-cent portion of the state sales tax.

Increased Federal Funds Anticipated. The plan assumes the federal government would match state expenditures with a total of $5.5 billion annually. Of this amount, $3.7 billion would be new matching funds according to the administration, and the remainder would be redirected from federal funds the state already receives for existing programs.

Employer and Individual Contributions for the Purchasing Pool. The Governor's plan permits eligible persons who work for firms that offer health insurance to nonetheless choose to obtain coverage through the purchasing pool. In addition to the individuals' payments to the pool for this coverage, firms whose employees seek such coverage would be required to pay a share of the state costs for the pool. The administration estimates that employers would pay $1.4 billion and that individuals would pay $1.3 billion for this coverage. However, the administration does not consider these funds to be state revenues or expenditures, and they are not reflected in the administration's estimates of total costs for the purchasing pool.

Other Changes Would Lower Tax Revenues. The new plan would make two tax changes that it estimates would lower state income tax revenues by $900 million and federal tax revenues by $7.5 billion. First, the plan would require all employers to establish "Section 125" plans, which allow employees to make tax-sheltered contributions toward the cost of their health care coverage, thereby reducing their tax liabilities. Second, the plan would align California's tax laws with federal provisions that allow individuals to make pretax contributions toward "Health Savings Accounts," which are special savings accounts that allow persons with high-deductible health insurance plans to make tax-free deposits that can later be used to pay for certain health care expenses.

Issues for Legislative Consideration

In this section of our analysis, we examine major legal, fiscal, and policy issues the Legislature should consider in reviewing the Governor's health care coverage expansion plan. The administration has prepared a comprehensive estimate of its plan's fiscal effects, which is based upon several assumptions regarding the resolution of certain legal issues, the availability of additional revenue, the costs of providing services, and the private sector's response to the plan. These fiscal estimates were prepared using a sophisticated economic model, which we describe in the nearby text box (see page 152).

We discuss below the key risks and uncertainties for the state in five areas, which are summarized in Figure 7: (1) potential legal obstacles to implementing the plan, (2) the availability of federal and local funding, (3) economic and demographic assumptions, (4) insurance market factors related to the purchasing pool, and (5) certain potentially understated resources.

Figure 7

LAO Assessment of Major Fiscal Uncertainties

- ✓ ***Potential Legal Obstacles.*** A federal law governing employer health benefit plans could block key features of the Governor's plan.
- ✓ ***Availability of Federal and Local Funds.*** Up to $1.4 billion in federal funds and up to $1 billion in the revenue from counties assumed in the Governor's plan appear to be at risk.
- ✓ ***Economic and Demographic Risks***. Costs of the plan could be higher than forecast to the extent that the uninsured population is larger; growth in costs of medical care outpaces the growth in wages and payrolls; or the cost of providing coverage through the state pool is higher than anticipated. We provide estimates of each of these potential risks.
- ✓ ***Flows From Private to Public Insurance.*** Although the administration's assumptions regarding movements between private insurance and new public coverage generally appear plausible, some uncertainties and potential risks remain.
- ✓ ***Potential Additional Funds.*** The Governor's plan appears to overstate state revenue losses due to the requirement that employers offer Section 125 tax plans. The plan also does not account for some additional funds that could be available due to additional premium payments and the elimination of redundant programs. On balance, we estimate that the plan does not recognize up to $600 million in state resources that may be available.

Potential May Exist for Legal Challenges

The fiscal estimates included in the Governor's plan assume that any possible future legal challenges to enacting and implementing the proposal will be successfully resolved in the administration's favor. As we noted earlier, at the time this analysis was prepared the administration had not proposed legislation to implement its health care coverage plan. However, based on available information, the administration's assumptions regarding the legal implications of the employer mandate merit specific consideration.

Employer Mandate Raises Legal Concerns. The Governor's plan would mandate that employers with ten or more workers spend at least 4 percent of their Social Security payroll on employee health benefits or pay the difference into a state health purchasing pool. This pay-or-play mandate may conflict with a federal law known as the Employee Retirement Income Security Act (ERISA). The ERISA was enacted to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries. We discuss ERISA and a recent federal court case relating to it in more detail in the nearby text box.

Federal ERISA

Federal Law Limits States' Authority Over Employer Health Plans. The federal Employee Retirement Income Security Act (ERISA) was enacted in 1974 as a means of regulating fraud and mismanagement in private-sector employer pension plans. However, the law applies to many other types of employee benefit programs, including plans for health coverage offered by private-sector employers or unions. The ERISA has been interpreted by the courts to generally prohibit the states from requiring employers to provide health insurance coverage to their employees.

Recent Federal Court Decision Finds Maryland Law Violates ERISA. In a recent 2-1 opinion by the 4th U.S. Circuit Court of Appeals, the court found in *RILA v. Fielder* that the Maryland "Fair Share Act" was in violation of ERISA. The Fair Share Act requires employers of 10,000 or more workers that do not spend at least 8 percent of payroll on health insurance costs to pay the difference into a fund that would support the state's Medicaid program. The court ruled that ERISA preempts state law because its effect would require Wal-Mart to incur additional costs for its health plan. It is not clear at this time how this decision may apply to the Governor's plan.

While it is unclear at this time how ERISA and its recent interpretation by the court would affect the pay-or-play provisions of the Governor's proposal, any plan with employer mandates could be subject to legal challenges under ERISA.

Some Federal and Local Funding at Risk

The Governor's plan relies in part on $5.5 billion in federal matching funds ($3.7 billion in new federal matching funds and $1.8 billion in existing federal matching funds) and $1 billion in new revenue from county

Modeling Health Care

The administration estimated many of the outcomes of its proposed policies using a sophisticated forecasting model developed by a professor at the Massachusetts Institute of Technology. (It is our understanding that the Legislature may also use this model for estimating the fiscal effects of other health reform proposals.) The population flows described in Figures 3 and 5 are estimates derived from this model. Many of the fiscal impact estimates shown in Figure 6 and discussed below were also developed using forecasts from this model. The model has both strengths and limitations.

Model Strengths

The model was designed to estimate the responses of individuals and firms to specified changes in the price of insurance created by government policies. For example, the model is well designed to estimate the number of employees who could shift from private into public coverage. Based on our review of the model's methodology and assumptions, we conclude that the model's forecasts of responses to the new incentives created by the Governor's health plan are reasonable and well supported. The projected responses to insurance price changes are based on substantial research work conducted by economists and health experts. The model is thus a useful tool for forecasting the changes in insurance coverage that would result from health reform plans.

Model Limitations

The Legislature should also recognize that this model is not designed or intended to address several issues relevant to broad health reform proposals such as the one the Governor is proposing. For example:

governments. The administration anticipates that these new funds will pay for a substantial portion of the proposed coverage components and the Medi-Cal rate increase. Our review finds that a total of about $1.4 billion in new and some existing federal matching funds and the $1 billion in county funds assumed by the Governor's plan should be considered at risk.

Some Federal Funding for Medi-Cal Program Expansion Uncertain

Most Federal Funds Accessible Under Existing Rules. Our review indicates that about $4.5 billion of the plan's estimated $5.5 billion in an-

Modeling Health Care (*continued*)

- The model's assumptions are derived from current costs in the health care market. No attempt is made to forecast the effects of future health cost changes on state expenditures in future years of the plan.
- The model forecasts impacts of the Governor's health care plan for a single future year once full implementation of the plan has taken place. The issues or costs that might arise during the transition to the new plan are not addressed in the model.
- The model does not address the potential effects of adverse selection. As discussed later in this analysis, adverse selection is a potentially serious fiscal issue that occurs when persons with unusually high medical costs are more likely to enroll in state programs than private coverage. The model does not attempt to forecast impacts of adverse selection.
- The model relies on estimates (inputs) of the size of various uninsured populations. For the administration's plan, these are drawn from the California Health Interview Survey. However, as discussed earlier, estimates drawn from this survey may somewhat undercount the uninsured population. This, in turn, would cause the estimated fiscal effect to be understated.

Summary

The model seems well designed to produce reliable estimates of population responses to health reform efforts. Like all forecasting models, however, this model can produce only approximate estimates of future responses to government policies. The model does not address a number of important issues, including possible future effects of health care inflation.

nual federal matching funds is available without the need for the state to amend its current waivers or obtain new ones. These amounts are likely to be available through the increased flexibility in Medicaid benefit design permitted by the federal Deficit Reduction Act of 2005 or as the standard federal match for Medi-Cal provider rates and coverage expansions allowed under federal law. Nevertheless, there are uncertainties regarding some other federal funds.

New Federal Waiver for Adult Coverage Uncertain. Typically, adults are only eligible for Medi-Cal if they have children or become aged or disabled. The Governor's plan assumes that California will be able to obtain a federal waiver for the state to provide Medi-Cal coverage for childless adults at an annual cost of $250 million in federal matching funds. Generally, federal waivers require budget neutrality, meaning that the state must demonstrate that a proposed change will not result in any additional federal costs. It is unclear how obtaining $250 million in additional federal monies would maintain budget neutrality from the federal perspective. Thus, it is uncertain whether the state will be able to obtain this new federal funding.

Current Federal Hospital Waiver Funding at Risk. California restructured its Medi-Cal hospital financing system under a five-year waiver beginning in 2005-06. This waiver provides increased federal funding for hospitals, including an allotment of about $750 million annually known as the "Safety Net Care Pool" (SNCP), which public hospitals can access to help pay for indigent care costs. California obtained this increased federal funding in part by agreeing to forego the opportunity to implement a "provider tax" on hospitals or physicians. The SNCP includes $180 million annually that must be used toward a "Coverage Initiative" for persons otherwise ineligible for Medi-Cal or HFP. Chapter 76, Statutes of 2006 (SB 1448, Kuehl), established a process to allocate this $180 million to counties annually for locally-based coverage efforts.

The Governor's plan would redirect $542 million in SNCP funds to pay for subsidies offered through the purchasing pool, and designates the remainder for Medi-Cal rate increases for public hospitals. The plan assumes that the state would be able to amend its Medi-Cal hospital waiver to maintain the SNCP funding while levying new charges on hospital and physician revenue. Discussions with the administration indicate that it has not received any preliminary indications that Centers for Medicare and Medicaid Services (CMS) would amend the waiver, and the administration suggested that it would abandon the SNCP if necessary in order to obtain the $3.5 billion in estimated new provider revenue from hospitals and physicians. It is uncertain whether CMS would grant an amended waiver putting this $750 million in SNCP funds at risk.

Federal Funding for HFP Expansion Uncertain

The Governor's proposal assumes that federal funding for the State Children's Health Insurance Program (SCHIP), which California uses to fund HFP, will be reauthorized and that California will receive an increase in its SCHIP allotment to cover both the state's current SCHIP obligations and those citizen children (about 451,000) who would be added to HFP caseload under the Governor's plan.

More Federal Funding Needed to Maintain Current Program. Federal funding for SCHIP has been authorized by Congress only through September 2007. As a result of California's program expansions of HFP and the underlying caseload growth of the program, the current level of SCHIP funds being spent each year exceeds California's annual federal allotment. California is now spending down SCHIP reserves built up during the early years of the program. Therefore, it will be necessary for the state to receive an increase in its SCHIP allotment during the reauthorization in order to continue to support the *existing* HFP caseload. (An analysis of the current shortage of SCHIP funds is included in our *Analysis of the 2006-07 Budget Bill* [see page C-142].)

Governor's Proposal Assumes Significant HFP Funding Increase. The Governor estimates that an additional 1.2 million children will enroll in HFP under his proposal. This includes 250,000 currently uninsured children in families with incomes up to 300 percent FPL and 679,000 children who are currently enrolled in Medi-Cal but would shift to HFP under the revised eligibility rules. The administration also estimates that an additional 260,000 children who currently receive coverage through their parents' employers are expected to shift to HFP. Based on our review, we estimate that this caseload increase would require an increase in federal SCHIP funding allocated to California of about $350 million, or 45 percent, annually and about an additional $270 million annually in state funding.

Governor's Reliance on SCHIP to Fund HFP Expansion Risky. While many observers believe that Congress will reauthorize SCHIP funding, the specific level at which Congress may fund the program would determine whether sufficient federal funds are available to pay for the coverage plan's expansion of HFP. We note that the President's recently announced budget plan proposes to reauthorize SCHIP in the next federal fiscal year only at a level sufficient to fund enrollment at 200 percent of FPL and below. (Children in families with incomes up to 250 percent of FPL are currently eligible for HFP.) Overall, the Governor's reliance on SCHIP funding to expand coverage to children is subject to some risk.

Recapturing County Realignment Funds Uncertain

The Governor's plan anticipates recapturing $1 billion that counties currently receive through realignment funding streams. These revenues are designated for health, mental health, and social services purposes. Use of these revenues is governed by various state statutes and, in some cases, by the State Constitution. The administration has indicated that it intends to work with counties to address any legal changes necessary to implement the coverage plan. However, it is unclear at this time how these issues would be resolved.

Risks and Uncertainties: Economic and Demographic

Uninsured Population Potentially Higher Than Estimated

The projected size and costs of all coverage expansions in the Governor's plan are based on estimates of the uninsured population drawn from the CHIS. The CHIS is very useful as a source of California-specific data. But it has consistently produced estimates of the uninsured population that are up to 30 percent lower than various federal surveys, such as the National Health Interview Survey. This may be partially due to the fact that the CHIS data are based on telephone surveys as opposed to in-person interviews, which may undercount some members of hard-to-reach populations like the uninsured. The CHIS also has lower response rates than comparable federal surveys.

There are valid reasons why different surveys vary. Survey counts offer at best uncertain predictions of the number of uninsured individuals who could apply for coverage under newly expanded state programs. There is reason to believe that other federal surveys may overcount the number of California uninsured. In contrast, it appears likely that CHIS is a moderate undercount of the total uninsured population.

More Uninsured Could Significantly Increase Costs. Should California's actual uninsured population lie close to the higher estimates found in national surveys, additional costs to the state under the Governor's plan could be understated by approximately $500 million. This estimate, however, is at the high end of potential outcomes, and we believe that any actual undercount would be smaller. We believe it would be prudent for the Legislature to obtain budget estimates that factor in the possibility that CHIS is a moderate undercount.

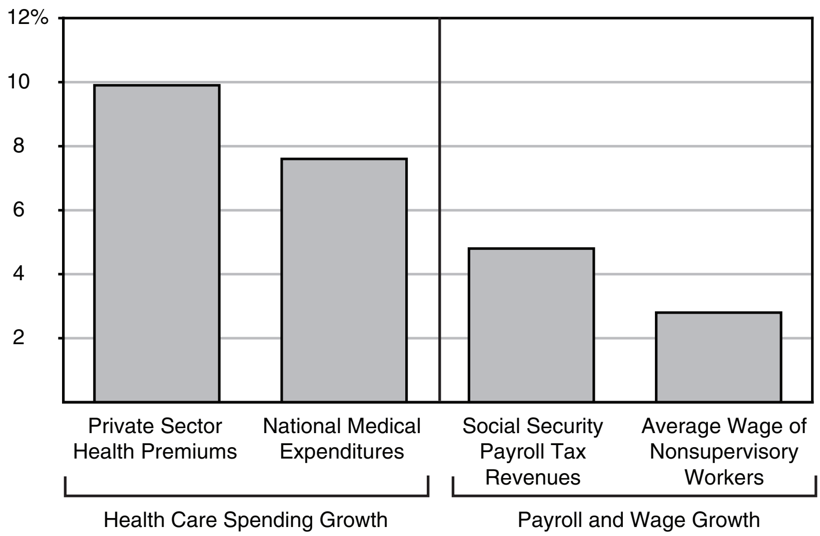
The Issue of Long-Run Health Cost Inflation

Future Health Care Cost Inflation Not Reflected in Plan Estimates. As discussed in the nearby box, the administration did not attempt to model the impact of continuing medical cost inflation on future program costs in the out-years of the plan. Figure 8 shows that growth in medical spending has systematically outpaced growth in wages and salaries. Both of the measures of medical spending growth shown in the figure are significantly greater than the payroll and wage growth rates shown.

Figure 8

Medical Costs Grow Faster Than Payrolls

Average Annual Growth, 1998 Through 2005



The costs under the Governor's plan may grow at a rate similar to medical cost growth, while many of the revenue sources used in the Governor's plan will likely grow at the same rate as wage and salary payroll. For this reason, rapid growth in health costs could create an imbalance between revenues and costs in future years under the Governor's plan.

The reliance on revenues from doctors and hospitals to finance a major share of the plan does create some protection against this outcome. State revenues from medical providers are more likely to increase at the same pace as medical care costs. This would help to protect the state against deficits created by rapid medical cost increases.

However, the cost sharing payments by subsidized workers can be expected to grow more slowly than medical costs, as will the 4 percent of payroll fee levied on employers which do not offer health coverage. As shown in the figure, growth rates in payroll and wages have historically lagged health spending growth. In addition, income growth among the low-income workers making cost-sharing payments to the pool has tended to be particularly slow. The employer premium contributions for subsidized workers may also grow more slowly than health care costs.

How Big Could the Problem Be? As an illustration of the potential future budgetary effects of the gap between revenues and costs, consider the case of the low-income purchasing pool, which will draw major funding from contributions by workers and employers. Suppose the pool is fully funded in its first year, but annual medical cost growth outpaces payroll revenue growth by two to three percentage points (a difference comparable to the gap between overall health expenditure increases and federal payroll tax growth). By the fifth year of program operation, annual pool costs would be approximately $400 million to $500 million greater than revenues. This deficit could be higher if medical cost growth relative to payroll growth is more rapid, or if administration assumptions concerning the federal match for costs in the pool turn out to be low.

But Doesn't the Plan Address Health Cost Inflation? The administration claims that a number of provisions in the plan will act to control health cost inflation. These provisions include various noncoverage prevention initiatives not assessed in this analysis. In addition, the increased coverage funding under the plan is likely to reduce the amount of uncompensated care in the system. This will in turn reduce the "cost shifting" of nonreimbursed care costs to private payers. The administration has claimed that this will reduce health care cost inflation.

However, there are several reasons why a reduction in cost shifting may not reduce health cost growth. For example, reductions in uncompensated care may in some circumstances show up as increases in profits to insurers and health providers, if they decide not to reduce the amount they charge consumers of health services. Second, a reduction in cost shifting might lead to a single one-time reduction in costs, without reducing the underlying rate of future inflation. Finally, increased provider funding under the Governor's plan as a result of rate increases, will be partially offset by new payments they must make due to the provider levy imposed by the plan. This will reduce providers' ability to cut prices. All of these factors make it difficult to predict whether a reduction in uncompensated care funded by this plan will have a lasting impact on medical care inflation.

The bottom line is that it may be difficult to hold down cost growth without direct administrative or regulatory controls. We found two such direct regulatory controls in the Governor's proposal:

- Controls on the price hospitals may charge to insurance plans when insured persons need treatment outside of their network. This provision is likely to reduce health care costs.

- A requirement that health plans, insurers, and hospitals spend at least 85 percent of every dollar in revenues on patient care.

The administration has provided little detail on the 85 percent requirement or how it would be enforced. Such a provision could potentially be used to limit health cost growth, but that would depend on technical regulatory details, such as the exact definition of "patient care" and revenues.

However, given the potential fiscal impacts of rapid inflation, the Legislature may wish to consider how best to address the issue of health care costs.

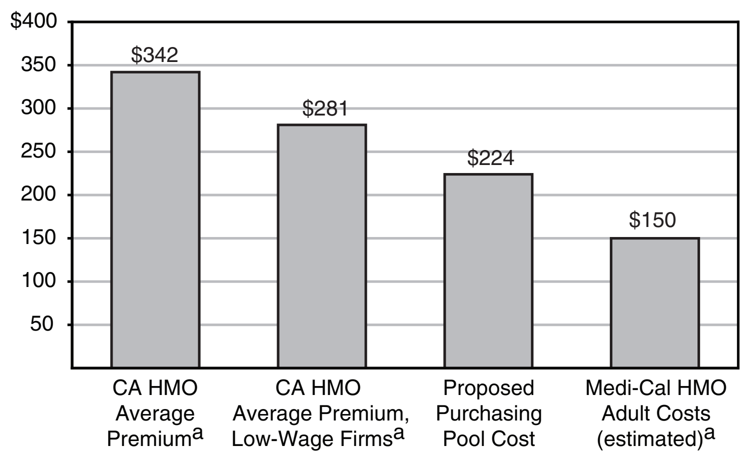
State Coverage Costs in the Purchasing Pool

The cost estimates in the Governor's plan for the purchasing pool assume a per member per month cost of coverage of $224. As shown in Figure 9, this estimated cost is considerably higher than the estimate of current adult Medi-Cal expenditures. However, it is much lower than current (2006) individual premiums for typical private sector plans, such as employer-provided Health Maintenance Organization plans.

Figure 9

Purchasing Pool Costs Per Member Lower Than Private Sector HMO Premiums

Charge Per Month



[a] Based on 2006 data.

According to the California Employer Health Benefits Survey, 85 percent to 90 percent of private sector employers in California pay more than $224 a month for individual premiums under their employer plan. It is likely that the few less expensive plans achieve their low costs either by having an unusually healthy client base or by restricting benefits in various ways.

Not only has the administration projected per member purchasing pool costs lower than the typical private sector plan, but these forecasts are based on a plan that is more generous than the private sector average. Although the administration has not officially committed to offering this plan, the cost estimates are based on a plan similar to the Healthy Families benefit package, with a $500 deductible. This plan would cover roughly 89 percent of total enrollee health costs, while the typical private sector plan covers roughly 82 percent of such costs.

A Failure to Meet Cost Targets Would Have Large Fiscal Effects. Using the administration's assumptions on the final size of the pool, every 10 percent increase in cost over the estimated $224 level would cause state expenditures to fund the new coverage pool to increase by approximately $250 million. (Costs would be even greater if the administration's assumptions about the availability of federal funds to match pool expenditures are mistaken.) Costs equal to the California HMO average individual premium could require additional state expenditures of approximately $1.3 billion annually to fund the purchasing pool.

The Purchasing Pool Cost Target Could Be Difficult to Meet. The administration's relatively low cost estimate is mainly driven by two broad assumptions:

- The purchasing pool will reimburse providers using Medicare rates. These are roughly 80 percent of private levels.
- Enrollees in the purchasing pool will be significantly younger, and also healthier given their age, than the average private-sector enrollee.

It is possible that these assumptions will be borne out, but it is not certain. It may be difficult to pay Medicare rates while still building a strong provider network. Likewise, while the uninsured are younger than the average insured individual, there is also some evidence that they may not be as healthy as other persons their age.

The Administration Also Has a Variety of Options to Hold Down Costs. Administrators of the state pool would be free to offer a plan that has less generous benefits than those used for the initial cost estimate. If the administration wishes to increase bargaining power with providers in order to get lower rates, it would probably also be necessary to restrict all enrollees to a single large plan, rather than offering a range of plan choices in the pool. Finally, the administration could also attempt to provide the plan with access to Medi-Cal drug prices. In general, the state's experience with Medi-Cal shows that per enrollee costs can be held down, but that doing so sometimes requires tradeoffs elsewhere.

Risks and Uncertainties: Flows From Private to Public Insurance

The administration plan attempts to maintain the current system of employer-provided coverage while supplementing it with new public programs to cover the uninsured. Because of this, some workers will simultaneously be eligible for coverage by private employers and by public programs (such as the new state coverage pool). This situation creates the possibility that public coverage will be substituted for private coverage, and persons formerly covered by private insurers will now go on state programs. There are a number of fiscal risks to the state associated with this kind of substitution. Two of these risks, known to economists as "crowd out" and "adverse selection", are defined in Figure 10 (see next page). The figure also defines two forms of insurance regulation—guaranteed issue and community rating—often used as tools to address adverse selection.

Crowd Out

Coverage expansions such as those proposed by the Governor risk crowd out—the movement of large numbers of individuals from private sector health coverage to new government programs. Employers finance health coverage because their employees perceive this fringe benefit to be valuable. The Governor proposes a new state-subsidized pool for low-income workers as an alternative to private coverage. Workers may come to value employer-provided coverage less because of this new coverage option.

The administration forecasts that about 800,000 persons currently covered by employer insurance will move on to public coverage. This is approximately 4 percent of the total population currently estimated to receive employer coverage. In addition, 140,000 persons currently paying for their own coverage in the individual market will shift to the state purchasing pool.

Figure 10

Key Terms in Considering the Potential Outcomes of New State Health Coverage Programs

Term	Definition	Example
Crowd Out	The displacement of private sector health coverage by government-funded programs.	Because of economic incentives created by a new program, a large number of persons move from employer-provided coverage on to programs like Medi-Cal or subsidized coverage.
Adverse Selection	Among persons eligible for both government and private health coverage, less healthy individuals tend to select government coverage, and more healthy individuals find private coverage. This drives up government costs, since it is more expensive to cover less healthy persons.	Individuals with preexisting health conditions find that private insurers charge them unusually high premiums. They therefore switch to a public program, where premiums may be cheaper.
Guaranteed Issue	A requirement that health insurance companies sell coverage to all applicants, regardless of age, pre-existing health condition, or other risk factors.	In the California small business market (2-50 employees), insurers are required to sell coverage to any business that applies.
Community Rating	A general term for rules that limit the degree to which insurers may vary premium prices based on health characteristics. Without this protection, insurers could evade "guaranteed issue" regulation by charging unaffordable prices to applicants with higher health risks.	In the California small business market, insurers must set prices for businesses using standard rates that are based only on employee age, family size, and broad location. They may then vary these rates by no more than 10 percent up or down based on health risk.

According to the administration's forecast, most of these persons will move to the state pool from firms that continue to offer health insurance. Under the Governor's plan, when workers at firms offering health insurance choose state coverage, their employers must help fund them by channeling the employer insurance contribution to the pool. These workers will thus bring their employer contribution with them to help offset state pool expenses. Because of this, there should be limited fiscal impact on the state from this form of crowd out.

The administration predicts that very few firms will drop health insurance entirely due to the new plan. In fact, its forecasts find that under the new plan some employers will now choose to offer health insurance who did not do so before, and more employees will accept coverage at firms who currently offer insurance. Approximately 800,000 uninsured individuals are predicted to find employer coverage under the new plan. On net, then, the administration forecasts that employer provided coverage will not decline due to the new plan.

After examining the methodology and assumptions of the forecasting model, we believe that the administration's forecasts are plausible, although like all forecasts they are not without risks. The findings are driven by several elements of the administration plan that act to minimize crowd out. The most important elements are:

- Workers earning over 250 percent of the poverty level are not eligible for public coverage. In most firms, this group constitutes a majority of the workforce. Employers will maintain an incentive to provide coverage for these workers.
- The requirement that employers who do not offer insurance pay a 4 percent fee, provides a new incentive for employers to maintain coverage.
- The individual mandate will make employer-provided health insurance coverage a more valuable fringe benefit for employees.

There are also a number of more subtle provisions in the plan designed to minimize the extent to which employers can substitute public subsidies for their own health insurance contributions. The most important of these is that employers will not be permitted to make different levels of premium contributions for different types of employees. Without this provision, employers could require larger premium contributions from those employees who are eligible for subsidies. This would drive more employees on to the purchasing pool, and reduce employer contributions to fund the pool.

Are There Additional Crowd Out Risks? Although the administration's forecasts are generally reasonable, there are potential risks created by the fact that the forecasting model does not forecast the impacts of future health cost inflation. Health cost inflation could lead to increased crowd out in future years of the program. If premiums in the private market continue to increase rapidly, private-sector premiums may become less affordable relative to state pool contributions. At this point, more employees may reject private coverage and choose the public pool, and more employers may be tempted to drop coverage. It is difficult to estimate the size of this fiscal risk.

Adverse Health Selection

Adverse Selection Has Potentially Large Fiscal Effects. Adverse health selection occurs when the people who choose to enter a public plan are systematically less healthy than the average insured individual.

A few patients with chronic or expensive illnesses account for a large fraction of health care costs in any one year. In 2002, 5 percent of the United States insured population accounted for approximately one-half of all health care costs, while the least expensive 50 percent of the insured population accounted for only 3 percent of total health care costs. Private health insurance plans or employers can therefore benefit greatly from transferring responsibility for the most expensive patients to the government.

There is pressure towards adverse selection whenever individuals or groups with higher medical costs (for example, persons with chronic diseases) find it cheaper or easier to obtain public coverage than they do private coverage. The existence of a state pool that guarantees coverage at a set cost to all applicants between 100 percent to 250 percent of poverty could make this possible. Any situation in which less healthy individuals must pay more for their coverage could then create pressures toward adverse selection into the state pool. Employers could also face some incentives or pressure from insurance providers to try to channel their least healthy employees into the state pool.

The Administration Plan Attempts to Address Adverse Selection. Insurance regulations that require guaranteed issue and community rating are typical tools used to prevent adverse selection from affecting government-offered insurance programs. Guaranteed issue and community rating rules prevent private insurers from rejecting unhealthy applicants or setting prohibitively high prices for them. Such actions tend to drive less healthy applicants to state funded programs. California currently has only a limited degree of this type of insurance market regulation, and it is limited to the small group market (2-50 employees).

The Governor's plan includes a recommendation to require guaranteed issue and community rating in the individual insurance market. There are many motivations for this recommendation, but one positive benefit is that it will reduce possibilities for adverse selection into the state pool.

The administration has also chosen not to allow persons with incomes over 250 percent of the poverty line to buy in to the state pool. This will also help to minimize possibilities for adverse selection into the new state pool.

However, Adverse Selection Could Be a Continuing Concern. The administration coverage model does not attempt to forecast any fiscal impacts of adverse selection. Should adverse selection occur, the costs of coverage in the new public pool could be significantly higher than the administration's estimates. The Legislature may wish to consider further protections against adverse selection into the state-funded pool.

Some Additional Funds Available

Our analysis indicates that the Governor's plan does not recognize up to $600 million in state resources that may be available. These additional resources could be used to offset some of the potential fiscal risks identified above.

Section 125 Revenue Losses Likely Overstated

The Governor's plan includes a requirement that all California businesses offer a Section 125 plan. These plans provide a vehicle for employees to purchase health insurance coverage using pretax dollars, at little cost (a small administrative amount) to the employer. This is an important element of the plan, since it would significantly reduce the costs of complying with the individual insurance mandate.

However, our analysis indicates that the administration has likely overestimated the state revenue losses associated with requiring Section 125 plans. Discussions with administration officials suggest that this estimate did not incorporate certain significant details of the administration's final plan. We believe the estimated $900 million loss of state revenue incorporated in the Governor's plan may be overstated by $300 million to $500 million annually.

Some Fiscal Effects Omitted From Governor's Plan

Our review indicates that net resources totaling up to $100 million in state funds are not included in the Governor's plan. These include premium revenue associated with certain new enrollees expected to join HFP. Additionally, the proposed coverage expansions would likely eliminate much of the need for the Children's Health and Disability Prevention Program, which the Governor's 2007-08 budget estimates will cost the state $65 million General Fund. However, the Governor's plan has not included in its fiscal estimate the administrative costs that would be necessary to establish the proposed purchasing pool and expand HFP. These costs would partially offset the omitted savings components.

Summary of Fiscal Risks and Uncertainties in the Governor's Plan

Figure 11 summarizes our initial estimates of the fiscal impacts associated with the issues described above. These net fiscal impacts imply additional annual costs to the state, *beyond* those identified in the Governor's estimates, of $150 million and potentially $3.2 billion or more annually. Costs could grow beyond the higher estimate if certain risks related to health cost inflation and the costs of coverage in the state pool turn out to be particularly unfavorable to the state.

Figure 11

LAO Assessment of Major Fiscal Uncertainties

(Dollars in Millions)

	Potential Annual Additional State Costs	
	Low Estimate	**High Estimate**
Potential Additional Costs, Annual Basis		
Some federal matching funds unavailable	—	$1,350
Medi-Cal coverage for childless adults	—	(250)
Hospital Safety Net Care Pool	—	(750)
SCHIP funding	—	(350)
Revenue from counties unavailable	—	1,000
Higher number of uninsured persons	$100	500
Health care cost inflation (by fifth year of plan)	400	Unknown above 400
Higher cost of coverage in purchasing pool	250	Unknown above 250
Subtotal Costs	$750	$3,500 or more
Potential Additional Funds		
Lower state revenue losses	$500	$300
Additional resources possible	100	50
Subtotal Revenues	$600	$350
Total Net Costs	**$150**	**$3,150 or more**

Conclusion

Any plan to reform the state's health care system, by the nature of its complexity, will involve financial risk over the long term. Many of the risks discussed above would be shared by any health reform plans that attempt to maintain the current system of employer-provided coverage while expanding public programs to cover the uninsured. The administration plan represents a comprehensive attempt to address problems that the Governor has identified in our current health care system. We find that the administration has made a serious and thorough attempt to identify fiscal costs to state government that would result from the plan

While there are risks to reform, risks also exist in continuing the current health care system. In many cases, fiscal risks under the current system do not fall directly on the state government. But they do lead to costs for Californians, such as private businesses who pay increasing health care premiums, or low-income individuals who are or may become uninsured. We have not attempted to compare the costs of the Governor's proposal to the costs of continuing the current system.

LEGISLATIVE OVERSIGHT OF STATE EMPLOYEE COMPENSATION

What Is the Process for Setting Compensation Levels for State Employees? What Are the Roles of the Legislature and the Administration in This Process? How Can the Legislature Use Its Powers to Improve State Employee Compensation Policies?

Summary

The delivery of state government services to the public ultimately depends on state employees. Pay and benefit levels for state employees play a major role in recruiting and retaining a talented workforce, but also in determining whether departments are successful in meeting their responsibilities. Employee compensation also drives a significant portion of the state's operating costs. The Legislature plays the central role in setting employee compensation levels, but certain provisions in the state's labor contracts—as well as administration actions—sometimes undermine the Legislature's ability to oversee employee compensation policies.

In this piece, we focus on the process *for setting compensation and recommend the Legislature improve the state's employee compensation policies. Our recommendations are geared toward the Legislature focusing state employee compensation expenditures within the context of a balanced budget. Among our recommendations are for the Legislature to (1) limit the authority of arbitrators to order large payments under their interpretation of future labor agreements and (2) end the use of automatic pay raise formulas tied to actions by other governmental employers.*

Pay and benefit levels for state employees often play a central role in determining whether departments are successful in meeting their responsibilities. Employee compensation also drives a significant part of the state's operating costs. Accordingly, the Legislature has a significant interest in state employee pay and benefits.

In this piece, we discuss the processes for setting compensation levels for state executive branch employees. The Legislature possesses broad powers—through budget appropriations, oversight, and legislation—to determine salary levels and benefits for these employees and to review the application of these policies. Nevertheless, some labor agreements negotiated by the current administration and prior administrations contain provisions that make it difficult for lawmakers to use these powers effectively. In addition, the executive branch has taken actions that have undermined the Legislature's central role in setting employee compensation. We recommend the Legislature use its powers to improve the state's employee compensation policies so that employee pay and benefits can be managed within the context of a balanced budget. While this piece focuses on the *processes* for legislative approval and oversight of employee compensation policy, we acknowledge that there are other significant issues confronting the state's personnel system including: (1) inefficiencies associated with the civil service hiring and promotion process and (2) the competitiveness of pay offered to some groups of employees with that offered by similar employers in the public and private sector. These other issues have likely contributed to some of the process issues we have identified.

The Processes for Setting Employee Pay and Benefits

In this section, we discuss the historical and current processes for setting employee compensation. First, we discuss how pay and benefit levels were set prior to the 1982 implementation of collective bargaining for most state employees. Then, we discuss the current processes of setting employee compensation for two broad groups: (1) unionized civil service employees and (2) civil service employees who are excluded from collective bargaining (excluded employees) or those who are exempt from civil service laws under the State Constitution (exempt employees). These three groups of employees are further defined in the nearby box.

The Employee Compensation Process Prior to 1982

The Legislature significantly changed public employment laws in the 1960s and 1970s, culminating at the state level with the passage of the state's collective bargaining law (now known as the Ralph C. Dills Act) in 1977. Collective bargaining began for state employees in 1982 after the

California Supreme Court rejected a claim that the Dills Act was unconstitutional. (University employee labor relations are governed by a separate law.) Prior to 1982, the State Personnel Board (SPB)—a five-member board created by the State Constitution to administer the civil service system—played a significant role in setting employee pay and benefits. The method for setting compensation levels during this period was different for civil service employees (including managers and supervisors) and exempt employees.

Definitions of Employee Groups

Following are descriptions of the employee groups discussed in this piece.

- ***Civil service employees*** are part of the civil service system, which is administered principally by the State Personnel Board. Under the State Constitution, all state employees are part of the civil service system, unless explicitly exempted. Appointments and promotions in the civil service are made "under a general system based on merit ascertained by competitive examination." In 1934, the voters approved the civil service system to prevent political motivations from influencing appointments and promotions. There are about 200,000 state civil service employees, of which about 83 percent are rank-and-file employees (nonsupervisory and nonmanagerial personnel).
- ***Excluded employees*** are those civil service personnel that do not have collective bargaining rights. They include managers and supervisors, as well as employees involved with certain budgetary and labor management functions of state government. There are about 35,000 excluded employees.
- ***Exempt employees*** include state officials appointed by the Governor—with or without confirmation by the Senate—and members of boards and commissions. Under the Constitution, these employees are not in the civil service. There are about 600 of this type of exempt state employees. Legislative, judicial, and university system employees are also exempt under the Constitution.

Civil Service Employees. The process for civil service pay setting evolved over time. By the mid-1970s, SPB staff conducted semiannual surveys of salaries and benefits paid by other public and private employers in the state. The SPB annually presented a report to the Legislature and the Governor in December containing its salary and benefit increase recommendations. This report described the prevailing salaries among other employers and estimated the "state salary lag," the percentage amount by which state employees' pay was lower than that of comparable employees elsewhere in the public and private sectors. Typically, civil service classifications across state government were recommended to receive the same percentage increase. The Governor's budget in January included proposals for salary and benefit increases in light of SPB's recommendations. After considering the proposals and SPB's update of its survey results each spring, the Legislature then appropriated funds for salary adjustments in the budget act (and, if necessary, approved accompanying legislation for benefit increases). Of the 24 budget acts passed between 1955 and 1978, only 12 of them incorporated all of SPB's salary recommendations without amendments. In many instances when the Legislature deviated from SPB recommendations, it included funds in the budget act for larger pay increases than had been recommended by SPB for some groups of employees.

Exempt Employees. The Department of Finance (DOF) generally set pay levels for exempt employees prior to the Dills Act. Departments paid for exempt employee salaries from their appropriations approved by the Legislature in the annual budget act.

Current Process for Unionized State Employees

State Employee Bargaining Units. About 83 percent of the executive branch's employees are members of one of the state's 21 employee bargaining units. Each unit is represented in the collective bargaining process by a union chosen by employees. The current list of bargaining units is shown in Figure 1 (see page 174). Members of the unit either are dues-paying members of the union or, as provided in the unit's agreement with the state, have "fair share fees" deducted from their paychecks to cover the union's costs for representing them.

Collective Bargaining Under the Dills Act. Under the Dills Act, the Department of Personnel Administration (DPA) represents the Governor in negotiations with unions concerning state employee labor contracts. After DPA and unions reach a tentative agreement—known formally as a memorandum of understanding (MOU)—the administration presents the MOU to the Legislature for ratification. The Dills Act was crafted to be consistent with the Legislature's constitutional "power of the purse." Specifically, the act provides that *any* provision of an MOU requiring the expenditure of funds may not become effective unless approved by the Legislature in the annual budget act. (Over time, this provision has been interpreted to allow other statutes—including those that amend the annual budget act—to represent the Legislature's approval of MOU provisions that require expenditures.) In addition, if any provision of the MOU requires a statutory amendment—related to pension benefits, for example—those provisions generally do not take effect unless approved by the Legislature.

The Legislative Process for Proposed MOUs. In the past, some MOUs were presented to the Legislature very late during its annual sessions, and occasionally, they were passed with little debate or opportunity for legislators to obtain information about the fiscal and policy ramifications of compensation increases included in the MOU. In recent years, legislative actions have given Members and staff some additional time to consider the potential effects of proposed MOUs. In 2003, the Senate approved SR 29 (Burton), which amended Senate rules to prohibit passage of a bill approving an MOU until the final version of the proposed agreement has been available for Members to review for at least seven legislative days. Chapter 499, Statutes of 2005 (SB 621, Speier), clarifies the requirements for DPA to disclose side letters, appendices, or addenda to MOUs to the Legislature, as well as to the public on its Web site. Chapter 499 also provides that MOUs shall not be subject to legislative ratification until either (1) the Legislative Analyst's Office (LAO) has presented a fiscal analysis of the proposed MOU or (2) ten calendar days have elapsed since the proposed MOU was received by LAO. (We began preparing MOU fiscal analyses for the Legislature in 2006 pursuant to the provisions of Chapter 499.) Typically during the legislative process, a bill is sponsored by DPA to ratify the MOU, make any needed statutory changes to implement the agreement, and appropriate additional funds needed to implement its provisions in the budget year. The Legislature may approve or reject the bill. When the Legislature approves a MOU bill, the MOU takes effect after the bill has been signed by the Governor and the agreement has been approved by the bargaining unit's membership.

What if the Legislature Rejects the MOU? If the Legislature does not approve funds needed to implement any provision of an MOU, that provision may not take effect. The Dills Act provides that, in this scenario, either DPA or the union "may reopen negotiations on all or part" of the MOU. The DPA and the union, however, may agree to implement provisions of the MOU that do *not* require the expenditure of funds. (The MOUs contain many provisions not tied to pay or benefit levels directly, such as procedures for employees to request vacation time.) If, however, the parties do not implement any provisions of the proposed MOU and the unit's prior MOU has expired, then another section of the Dills Act takes effect.

Figure 1

State Employee Bargaining Units and Employee Groups

Bargaining Unit or Employee Group	Percent of State Workforce	Collective Bargaining Representative
1—Administrative, Financial, and Staff Services	20.4%	• Service Employees International Union (SEIU), Local 1000
2—Attorneys	1.7	• California Attorneys, Administrative Law Judges, and Hearing Officers in State Employment
3—Educators and Librarians (Institutional)	1.2	• SEIU Local 1000
4—Office and Allied	13.7	• SEIU Local 1000
5—Highway Patrol	2.9	• California Association of Highway Patrolmen
6—Correctional Peace Officers	14.0	• California Correctional Peace Officers Association
7—Protective Services and Public Safety	3.1	• CAUSE—Statewide Law Enforcement Association
8—Firefighters	2.1	• CDF Firefighters
9—Professional Engineers	4.8	• Professional Engineers in California Government
10—Professional Scientific	1.2	• California Association of Professional Scientists
11—Engineering and Scientific Technicians	1.2	• SEIU Local 1000

Continued

This section provides that when an MOU has expired, the provisions of the *prior* agreement (including "no strike" and arbitration provisions) remain in effect until an impasse is reached in negotiations. At impasse, the state may implement its "last, best, and final offer" to the bargaining unit if the Legislature approves expenditures and statutory changes associated with this offer.

Current Process for Excluded and Exempt Employees

Within Available Appropriations, Administration Has Some Flexibility. In statute and in practice, the Legislature has granted DPA the general authority to establish salary and benefit schedules for essentially all excluded and exempt employees. (The main exception is for certain exempt appointees—principally departmental directors—whose salaries are governed by statute, as described later.) Departments' expenditures—

Bargaining Unit or Employee Group	Percent of State Workforce	Collective Bargaining Representative
12—Craft and Maintenance	5.0	• International Union of Operating Engineers (IUOE), Locals 3, 12, 39, and 501
13—Stationary Engineers	0.4	• IUOE Locals 39 and 501
14—Printing Trades	0.2	• SEIU Local 1000
15—Allied Services (Custodial, Food, Laundry)	1.9	• SEIU Local 1000
16—Physicians, Dentists, and Podiatrists	0.7	• Union of American Physicians and Dentists
17—Registered Nurses	1.8	• SEIU Local 1000
18—Psychiatric Technicians	3.2	• California Association of Psychiatric Technicians
19—Health and Social Services/Professional	1.9	• American Federation of State, County, and Municipal Employees, Local 2620
20—Medical and Social Services	1.0	• SEIU Local 1000
21—Education and Libraries (Noninstitutional)	0.3	• SEIU Local 1000
Subtotal	(82.6%)	
Excluded and Exempt Employees	17.4%	• None
Total	**100.0%**	

including personnel costs for excluded, exempt, and other employees—are limited by the amounts, terms, and conditions of their appropriations in the annual budget act.

Pay Differential for Supervisors and Managers. Typically, when DPA extends pay raises to a broad range of excluded and exempt employees, it requests funding for this purpose in the budget bill or in a separate bill containing an appropriation. (Chapter 240, Statutes of 2006 [AB 2936, Ridley-Thomas], for example, ratified a new MOU for California Highway Patrol [CHP] officers and also included funds for pay raises for most excluded state employees.) The DPA's current policy establishes a guideline for a minimum pay differential—now 5 percent—between the top pay available for senior rank-and-file employees and the top pay available for excluded managerial and supervisory classes.

Broad New Administration Authority for Certain Exempt Appointees. Chapter 240 also grants the administration broad new authority to increase the pay of 53 specified exempt appointees—principally agency secretaries and departmental directors. State law specifies that these employees will receive the same general salary increase as provided for state employees in any fiscal year. Chapter 240 gives DPA the power to "set and adjust, as needed," the annual compensation of these employees. The law requires DPA to consider the size of the agency or department that the employee heads, the scope of responsibility of the position, and "other factors appropriate to the determination of compensation necessary to recruit and retain qualified employees in leadership positions for the state." Chapter 240 limits these appointees' compensation to no more than 125 percent of compensation that the California Citizens Compensation Commission sets for the Governor. Currently, the Governor is eligible for an annual salary of $206,500. Therefore, these appointees may not receive an annual salary of more than $258,125. The law requires DPA to notify the Legislature of increased compensation levels after the adjustments have been made.

Some MOUs Make It Difficult for Legislature to Oversee Employee Pay

As described above, the Legislature must approve any expenditure provided for by an MOU. Nevertheless, some MOUs negotiated by the current administration and prior administrations contain provisions that make it difficult for lawmakers to assess their long-term fiscal implications and provide effective oversight for the state's employee compensation policies. In this section, we discuss several examples of these problems.

Automatic Pay Raise Formulas Compromise Legislature's Power of the Purse

Several MOUs tie the pay of groups of state employees to that received by groups of comparable employees of other public agencies in the state. These formulas make the Legislature's job more difficult because they provide significant pay raises that are beyond the state's control. Examples of such agreements follow.

CHP Pay Raise Formula. Chapter 723, Statutes of 1974 (AB 3801, Brown), implemented the first CHP pay formula, which required SPB to survey pay levels for officers in specified urban police departments in making its recommendations for CHP salaries. Currently, the law specifies that DPA will survey the "total compensation" (including both base salaries and some other categories of compensation) provided to officers employed by Los Angeles County and the Cities of Los Angeles, San Diego, San Francisco, and Oakland annually.

In applying this formula, Chapter 1, Statutes of 2002 (SB 65, Burton), amended the law to provide that failure of DPA and the CHP officers' union to agree to an MOU "shall not relieve the state of the duty" to provide the average compensation levels indicated in the annual survey for the five urban police departments. Absent an explicit agreement of the CHP officers' union to the contrary, this means that CHP officers receive a raise virtually every year regardless of whether their MOU is current or has expired. The CHP officers are the only group of state rank-and-file employees with this type of statutory pay raise formula.

Correctional Officers Pay Raise Formula. Chapter 290, Statutes of 1986 (SB 1373, Keene), states legislative intent that, in order to address recruitment and retention difficulties in the state's prison system, "salaries must be improved and maintained" for correctional officers and requires DPA to "take into consideration the salary and benefits of other large employers of peace officers in California." The DPA noted in its responses to a State Auditor's report that one purpose of the correctional officer labor agreement it presented to the Legislature in 2001 was to bring the state into compliance with Chapter 290. The 2001 correctional officer MOU, which was ratified by the Legislature in January 2002 and remained in effect (with subsequent amendments) until July 2006, increased correctional officer compensation each year between 2003 and 2006. Under the 2001 MOU, the officers' pay and specified benefits were to be raised to a level of $666 per month less than CHP officers by the end of the contract. (The $666 monthly amount has been described as the "historic salary relationship" between CHP and correctional officers.) In June 2004, the correctional officers' union agreed with the administration to defer portions of raises scheduled under the 2001 MOU for one to two years—giving the state the benefit of short-term budget savings in exchange for other changes in the MOU. In ratifying the renegotiated MOU, the Legislature continuously appropriated funds to bring correctional officers' salaries up to the originally agreed $666 differential by July 1, 2006.

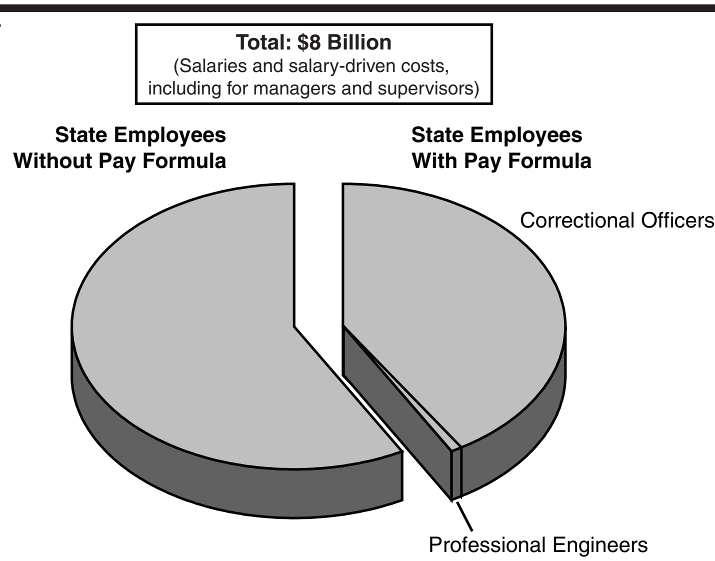
Engineers' Pay Raise Formula. Chapter 616, Statutes of 2003 (AB 977, Diaz), ratifies a five-year agreement reached between DPA and the state's professional engineer union. This MOU provides several consecutive annual raises based on the results of an annual salary survey comparing pay of state engineers with those employed by other public agencies in the state. Under the MOU, engineers will receive a pay raise on July 1, 2008 (one day before expiration of the agreement). This raise will eliminate any pay lag between state engineers and the weighted average salaries of the various public agencies surveyed.

Formulas Drive Significant Expenditures and Are Difficult to Predict. Personnel costs drive a significant percentage of the state's operating expenditures. Under MOUs and statutes described above, a significant portion of these costs is governed by annual pay raise formulas. This is particularly true for the General Fund. Figure 2 shows that in 2005-06, 42 percent of General Fund salary and related expenses—$3.4 billion in total—was for employees (including supervisors and managers) whose compensation was covered by one of the pay raise formulas. The vast majority of these expenses relate to correctional officers, the costs for which are paid from the General Fund. All CHP salaries and most professional engineer salaries are paid from various special funds, although, in some cases, particularly for CHP officers, agencies with General Fund expenditures reimburse CHP for services provided (such as security). Moreover, the amount of the formula pay raises included in the agreements with these three groups of employees cannot be predicted in advance. Generally, the amount of the raise is not known until the May Revision or later due to when the local government salary surveys for peace officers and engineers are completed. Accordingly, these formula pay raises make it more difficult for the Legislature to plan, establish priorities, and balance the budget during the annual budget process.

Figure 2

Salaries Determined by Pay Formulas–Nearly One-Half of General Fund Personnel Expenditures

2005-06



Other Automatic Pay Raise Formulas Have Been Proposed. On several occasions, lawmakers have considered other proposals to institute automatic pay increase formulas for employee groups. Chapter 926, Statutes of 1999 (AB 1639, Committee on Public Employees, Retirement, and Social Security), states that the "policy of the state" is to consider prevailing salaries and benefits of local fire departments when considering compensation provided to the state's wildland firefighters. Recently, legislative committees have discussed requiring the administration to tie salaries of Fish and Game wardens to those of CHP officers and tie salaries of state firefighters to local firefighters.

Formulas Difficult to Change. Under the Dills Act, the Legislature must approve expenditures for any provision of an MOU. This means that, while MOUs often have effective dates spanning two years or more, the Legislature must appropriate the funds necessary for agreed-upon pay raises each year (during the budget process). If, in any given year, the Legislature does not approve the funds necessary to implement any provision of an MOU, the union has a right to reopen negotiations on all or part of the agreement. In practice—due to the expectations of state employees that they will receive scheduled raises—the Legislature has not opted to disapprove funds for an MOU even when the state faced significant revenue shortfalls. Instead, in these years the Legislature sometimes has approved amended MOUs—negotiated between DPA and unions—that modify terms of bargaining units' original agreements. Historically, these MOU amendments have allowed the state to forego paying a planned pay raise in a fiscal year in exchange for something else—enhanced health benefits, for example—that may have less of a cost in the near term but more of a cost over the longer term.

Formulas Not Tied to Actual Recruitment and Retention Trends. Historically, the Legislature has approved compensation increase formulas for employee groups because of concerns about employee recruitment and retention. (Chapter 290 specifically mentions recruitment and retention issues among correctional officers, and the current version of the CHP pay formula statute mentions similar issues among CHP officers.) Despite this legislative intent, the current employee pay formulas do not contain any factor that adjusts pay increases based on the success or failure of departments in actually recruiting and retaining employees. The CHP officer compensation increase under the pay formula, for example, remains the same each year even if officer vacancies or recruitment problems decline.

Long-Term Agreements Lock in Spending

Several Units Have Had Long-Term Agreements Recently. The now-expired correctional officers' labor agreement took effect in 2001 and expired in 2006, as did the prior agreement between the state and the

CHP officers' union. The current CHP officers' MOU took effect in 2006 and expires in 2010. The professional engineers' contract was approved in 2003 and expires in 2008. By contrast, most other state bargaining units currently have contracts of two years in length.

Agreements Lock in State Expenditures for Many Years. As discussed above, it is difficult for the Legislature to modify pay raise provisions of MOUs once the agreements are in place, even though the Legislature has the power to do so. Given the volatility of the economy and the state's revenue structure, this can mean the Legislature faces pay raise commitments in more dire fiscal conditions than when MOUs were approved.

MOUs Have Given Arbitrators Enormous Power in Agreements

Binding Arbitration Often Is a Dispute Resolution Mechanism. Many bargaining unit MOUs include provisions directing certain disputes between employees and the state over the interpretation of the agreement to grievance mechanisms and, in some cases, binding arbitration. Binding arbitration is intended to provide an alternative forum to the courts to resolve disputes. State law governs many of the rules and procedures related to arbitration proceedings.

Recent Ruling Had Major Fiscal Impact. In November 2006, an arbitrator ruled that the state had miscalculated pay increases and health benefits that he decided were owed to correctional officers beginning in 2005-06 under the terms of their 2004 renegotiated MOU. The arbitrator decided that correctional officers were entitled to an extra 3.125 percent pay raise and an increase in state contributions to their health premiums under the MOU. In January 2007, DOF announced that the arbitrator ordered the state to pay $280 million of expenditures attributable to 2005-06 and 2006-07. In addition, the Governor's budget proposes $160 million of costs in 2007-08 to continue paying officers the compensation levels ordered by the arbitrator. In total, the effect of this decision was to increase state expenditures by $440 million.

Arbitrators' Ruling Relied on Information Not Available to Legislature. The arbitrator's decision cited certain sections of the correctional officers' MOU in reaching his decision—including a vague section implying that the state had obligations to limit the differences between CHP and correctional officers for other types of compensation not even listed in the agreement. Nevertheless, a large portion of the opinion was devoted to detailed accounts of oral exchanges between DPA negotiators and union officials. The arbitrator relied extensively on the oral understandings that these parties had about what the pay raise formula meant and how it was to be calculated. It seems that these oral agreements—not the written documents presented to the Legislature for consideration—were the key factors behind the arbitrator's ruling. Thus, the information that ultimately determined the compensation awarded was not information available to the Legislature when it made its appropriation decisions. This is because the Legislature could not possibly have known about the extensive set of oral understandings between the administration and the officers' union when it approved the 2001 MOU, the 2004 renegotiated MOU, or the 2006-07 budget.

MOUs Are Long and Complex Documents

Hundreds of Pages That Drive Costs and Departmental Operations. The state's 21 MOUs are significant documents because they (1) drive the state's personnel-related costs and (2) influence departmental operations. Under the Dills Act, the provisions of MOUs are intended to deal only with wages, hours, and other terms and conditions of employment. Nevertheless, the terms of MOUs—typically 100 or more pages in length—often control key aspects of how state departments function. Under the terms of the correctional officers' agreement, for example, overtime costs have tended to increase, and a specific provision of this agreement—known as the "entire agreement clause"—requires state officials to meet and confer with the officers' union in certain instances when proposed changes in operations affect the working conditions of a "significant number" of officers. According to DPA, the entire agreement clause "requires the state employer to negotiate continuously" with the union "over the impact of matters within its management discretion." This type of provision may allow rank-and-file employees to exert significant influence over the management direction of affected state departments. This, in turn, may undermine the ability of managers to execute policies of the administration and the Legislature.

Outdated References, Errors, and Vague Phrases Surprisingly Common. In 2006, our office released fiscal analyses of each proposed MOU to the Legislature. We have been struck by the frequency of typographical errors, outdated references, and vague phrases in the proposed MOUs. For example, in our analysis of the Unit 10 professional scientists MOU, we noted that the text of the tentative agreement presented to the Legislature did not define a term central to administering one pay raise provision of the agreement. (In that case, DPA and the union produced summaries of the agreement that had similar descriptions of what negotiators meant to say.) As discussed above, vague references in the 2001 correctional officers' agreement were among the passages cited in the recent arbitrator's decision concerning correctional officers.

Administration Actions Have Undermined Legislature's Role

In the previous section, we discussed how some administration-negotiated MOUs contain provisions that limit the ability of the Legislature to assess their long-term fiscal implications. In addition, we have found that certain administration actions undermine the Legislature's ability to oversee, set, and change employee compensation levels. There are two key issues in this regard. First, the administration claims to have a great deal of authority to raise employee pay without explicit legislative approval through the budget or MOU process. Second, the administration—particularly in exercising its significant authority to set supervisor and manager salaries—sometimes has not provided the Legislature with regular, consistent information on compensation issues for these groups of employees. In this section, we discuss these administration actions.

Administration Claims Broad Authority to Raise Pay

Chapter 499 Clarifies Administration's Disclosure Responsibilities. Chapter 499—which took effect in 2006—clarifies existing requirements for DPA to present labor agreements to the Legislature. Specifically, Chapter 499 makes explicit the requirement that DPA submit to the Legislature side letters, appendices, or other addenda to previously ratified MOUs. Those MOU amendments requiring the expenditure of $250,000 or more are submitted to the Joint Legislative Budget Committee (JLBC) for review to determine if they make substantial changes not reasonably within the parameters of the MOU approved by lawmakers. Those not requiring the expenditure of funds also must be identified by DPA. (Chapter 499 does not explicitly address MOU amendments requiring annual expenditures of less than $250,000, but current law already prohibits implementation of any MOU fiscal provision without the provision of funding.)

Administration Claims Broad Authority to Raise Pay. In 2006, DPA began complying with the provisions of Chapter 499. From its submissions to the Legislature under the new law and from discussions with administration officials, we have found that the new disclosure requirements mark a big change for DPA. In the past, we understand that DPA frequently took actions to raise employee pay without legislative funding approval, since the department asserted that it had authority to do so under existing statutes and MOUs. The administration's claims that it possesses this type of authority were discussed in communications from DPA or DOF to the JLBC between July and November 2006. In one case, DOF informed JLBC that the administration intended to approve a new pay differential for a group of attorneys in order to reduce the differential between their pay and that of their supervisors. This was presented despite explicit legislative action earlier in 2006 to set that differential at a *higher* level. In another case, DPA informed JLBC that even though it had not included a provision to increase mileage reimbursements in one MOU that was ratified by the Legislature earlier in the year, it now planned to provide this reimbursement to the group of employees. The department characterized the action as "non-fiscal" (seemingly in an attempt to avoid the requirement for legislative ratification), despite the fact that the reimbursement would require tens of thousands of dollars of state expenditures. (Upon the JLBC's recommendation, DPA later submitted this provision to the Legislature for approval, which was granted.)

In some cases, DPA seems to assert that provisions of approved MOUs giving it the authority to implement pay differentials to address recruitment, retention, or similar problems are the basis for its actions. In other cases, DPA seems to believe that if the administration is not asking for an additional appropriation (by requiring a department to "absorb" the increased costs), no legislative approval is required for the pay raises it wishes to implement unilaterally. Finally, the administration claims authority to raise pay when a department's recruitment and retention problems rise to the level of an emergency that affects public health, safety, or essential departmental operations.

The Problem With the Administration's Claims of Authority. The problem with the administration claiming the authority to raise pay unilaterally without legislative review during the budget process is simple: *pay raises are not free*. Pay raises—no matter what they are called (salary increases, pay differentials, or bonuses) or how they are implemented—require the expenditure of funds, and under both the Constitution and the Dills Act, the decisions about how the state expends funds are made by the Legislature—*not* the executive branch. The nearby box (next page) discusses an example of the problems with the administration raising pay without legislative review.

Administration Needs to Pay Attention to Manager and Supervisor Pay Annually

Eroded Pay Differentials for Supervisors and Managers. The administration has broad authority over supervisory and managerial salaries, as described earlier. The state—as well as other public and private employers—generally establishes a guideline for a minimum pay differential between senior rank-and-file employees and supervisory personnel. At times, this minimum pay differential has been eroded when DPA does not give comparable raises to supervisors that rank-and-file personnel receive. This gives rise to "compaction," a situation in which salaries of rank-and-file personnel rise to a level close to or even above that of supervisory and management personnel. Compaction is a problem because

An Example:
How These Pay Raises Undermine Legislative Authority

The annual budget process involves the Legislature making decisions concerning administration proposals about how much money and how many staff to allocate to each program in each department. As an example, assume that the Legislature approves a new administration-proposed initiative in a public safety department that includes spending authority for a dispatcher and two peace officers. After the end of the legislative session, the department is having a difficult time recruiting dispatchers. In the contract for the bargaining unit representing the dispatchers, there is general language about the department having the authority to implement pay differentials to address recruitment problems. The Legislature did not provide funds to implement any such differential during the budget process, but the administration decides to institute a 10 percent pay differential for dispatchers anyway in order to help address the recruitment problems. The administration probably would claim that the department will be able to use its salary savings (the money saved from not filling the dispatcher position for part of the year) to cover costs of this new pay increase. Under this reasoning, since no additional appropriation is needed during the fiscal year, the administration might claim that no legislative action is required to approve expenditures of funds for the pay raise.

We believe this justification for implementing pay raises runs counter to the letter and spirit of the Dills Act. First, pay raises *always* require the expenditure of funds, and the budget process involves a department-by-department consideration of personnel expenditures, including pay increases. Second, these unilateral increases of pay by the administration leave the next year's Legislature with unnecessarily difficult choices. If the dispatcher position is filled by the time the next fiscal year begins, salary savings will not be available to fund the costs of the new 10 percent pay differential. The next Legislature may face these unpalatable choices in this example: (1) increase funding to the department to continue the differential implemented during the prior year, (2) stop funding for the differential and hope the dispatcher stays with the program, or (3) remove funding for one of the peace officers in the program in order to fund the costs of the dispatcher pay differential. It is also possible that the administration will not call this particular problem to the Legislature's attention the next year; in this case, it may cut funds from other programs to continue funding the differential and thereby reduce the department's overall services to the public.

it reduces incentives for employees to seek promotion to supervisory positions, and it encourages supervisors to demote to highly paid rank-and-file positions.

No Consistent Method for Administration to Inform Legislature. In 2006, the administration proposed and the Legislature approved a set of pay increases for all excluded state employees that included funds to address many of the key departmental problems with compaction. Nevertheless, there has not been a consistent, coordinated process for the administration to analyze these issues and inform the Legislature where such problems exist. In the past, the Legislature has often learned of compaction problems from labor groups or individual departments. Also, it appears that sometimes DPA has not considered the effects of rank-and-file employees' nonsalary compensation (including pay differentials and overtime payments) in contributing to compaction problems.

Recommendations to Enhance Legislative Oversight of Employee Compensation

In this section, we make several recommendations to improve the state's compensation policies and enhance legislative oversight of employee compensation.

End Automatic Pay Raise Formulas

We recommend that the Legislature not approve any new automatic pay raise formulas in future memoranda of understanding and repeal the statutory formula for California Highway Patrol officers when that bargaining unit's current labor agreement expires.

Implementing this recommendation would require the Legislature to (1) reject any proposed MOUs that include an automatic pay raise formula tied (for example) to growth in local government salaries and (2) pass legislation repealing the CHP statutory pay formula to take effect no later than the expiration of that bargaining unit's current MOU in 2010. This action would give the Legislature more flexibility to consider the appropriate pay raises—whether smaller or larger than those under the previous pay formulas—for each group of state employees. So that the Legislature can consider the pay and benefits of comparable employees elsewhere in the public or private sector, DPA should present salary survey information for key MOUs.

Arbitrators' Authority to Order Unanticipated State Spending Should Be Curbed

We recommend that the Legislature amend the Dills Act or the state's arbitration laws to limit the authority of arbitrators to order large payments without legislative involvement.

Most arbitration decisions interpreting MOUs result in minor costs for state departments. The recent correctional officers' arbitration award was a notable exception. We believe that binding arbitration often is an appropriate method to address differences in interpretations of MOUs. In our view, however, arbitrators should not have the authority to approve the expenditure of funds to implement a provision of an MOU. To prevent this problem from becoming more significant in the future, we recommend that the Legislature enact legislation to limit the authority of arbitrators to impose payment obligations on the state based on their interpretation of provisions of any future MOU. (We do not propose to change arbitrators' authority in current or prior MOUs.) The Legislature has several options in this area. For example, it could limit arbitrators' authority to order payments over a given amount—$10 million, perhaps, in one-time or annualized costs. Alternatively, the Legislature could require that (1) such large settlements be approved by lawmakers before they are finalized and paid from state funds or (2) arbitrator orders of this type will have a legal force and effect only if some amount of time (perhaps six months) passes without the Legislature enacting a bill to overturn the order. These measures would ensure that the Legislature's interpretation of the expenditures it approved for MOUs takes precedence over those of an arbitrator.

Approve One-Year or Two-Year MOUs

We recommend that the Legislature not approve any proposed memoranda of understanding in the future that have a term of more than two years.

Given the state's volatile revenue structure, we believe that it is not advisable for the Legislature to give an implicit commitment to groups of employees that the state will be able to raise their pay by a given amount more than one or two years in advance. As we have discussed, the Legislature actually has the authority under the Constitution and the Dills Act to set the compensation levels of each employee each year during the budget process. In practice, however, employees expect to get the pay raises included in an MOU, and the Legislature has few attractive options when state fiscal constraints make it difficult to actually fund these raises. We believe that shorter-term MOUs give the Legislature more budgeting flexibility, and we believe they represent a firmer commitment to state employees about the level of compensation the state will be able to afford in the future.

Joint Hearings on Selected MOUs With Major Fiscal or Policy Impacts

We recommend that the Legislature convene joint hearings with members of policy and fiscal committees to consider the fiscal and policy ramifications of some proposed memoranda of understanding prior to approving or rejecting the labor agreements.

The state's 21 MOUs drive a significant portion of state operating costs and significantly affect departments' capacities to meet their statutory responsibilities. Given the importance and complexity of these documents, we believe that joint policy and fiscal hearings on some MOUs—those with the most significant fiscal and policy effects—would be helpful for the Legislature in evaluating the merits of proposed agreements. These hearings could consider the estimated costs of the agreements, as well as how each agreement addresses staffing and operational problems at affected departments. Such hearings would be a way for members of the Legislature to suggest changes to MOUs if appropriate.

More Time Before Voting on MOUs

We recommend that the Legislature—either formally (through changes in law or legislative rules) or informally—decide to take at least three weeks to consider and review memoranda of understanding presented by the administration.

Given the length and complexity of the MOUs, we have found it challenging to provide analyses to the Legislature within the ten-day time frame established for LAO review in Chapter 499. Given our own difficulties, we believe it is very difficult for legislators, committees, and interested parties to consider all of the issues associated with this type of a document within a short time frame. For instance, the Legislature approved $1.2 billion for increased pay and benefits for state employees in 2006-07. For the agreement involving the Service Employees International Union, the documents totaled 1,729 pages. While the Legislature often took several weeks to consider agreements presented to it in 2006, it did not in some cases. Given the magnitude of the policy and fiscal issues at stake, a minimum of three weeks for legislators to consider these lengthy documents, receive public comments, and consider our findings would be advisable.

Require Administration to Submit Excluded and Exempt Pay Proposal Annually

We recommend that the Legislature enact legislation to require the administration to submit their proposed increases (if any) for all excluded and exempt employees each year by the time of the May Revision.

While the Legislature has granted the administration broad authority to increase excluded and exempt employees' pay, we have found that the administration's actions for these groups often have been an afterthought, as compared with the higher-profile MOU process used to determine rank-and-file employees' pay raises. This is one reason why the compaction problems we discussed earlier have persisted. It has also made it difficult to consider (1) issues concerning supervisor and manager compensation, recruitment, and retention, and (2) the budgetary ramifications of pay increases for these groups. The administration has stated that the timing of its release of the excluded employee pay package so late in the legislative calendar results from the need to conclude MOU negotiations first. By the May Revision, however, the administration should know the general proposals it is discussing with unions on pay raises (and, in other cases, does know the pay raises to be provided to unionized employees in current MOUs). Moreover, even if the administration presents such a plan prior to May Revision, it may amend this plan later when it submits proposed MOUs to the Legislature. The administration should include with this annual pay plan any proposals to increase departmental directors' compensation under Chapter 240.

Administration's Flexibility to Increase Pay Should Be Limited

We recommend that the Legislature adopt budget bill language clarifying that budgeted funds may be used only for compensation levels approved in bargaining unit memoranda of understanding or other legislative measures.

Limiting Administration Flexibility. Under the Dills Act, the Legislature's authority to control expenditures used for employee compensation is clear. The administration needs to seek and receive explicit legislative approval for implementing pay raises—except in cases of emergency or court orders, when the budget act and applicable laws already provide the administration with separate funding options. To end any confusion about what existing law is, we recommend that the Legislature adopt the following budget bill language as part of the budget item (Item 9800) that appropriates money for the administration to distribute to departments to address the costs of each year's employee compensation increases:

> The funds appropriated in this item and in other items of this act may be spent to increase the compensation of various classifications of state employees after the date of passage of this act only in accordance with: (1) memoranda of understanding that are approved by the Legislature either before or after passage of this act; (2) side letters or other amendments to memoranda of understanding that are approved by the Legislature either before or after passage of this act; (3) regular adjustments in employee pay

> based on tenure, years of service, employee performance, promotions, or similar factors (including, but not limited to, merit salary adjustments) that were authorized prior to passage of this act; (4) pay actions that were instituted prior to passage of this act or approved by the Legislature as a part of this act; (5) pay differentials that were instituted prior to passage of this act or approved by the Legislature as a part of this act; (6) pay differentials explicitly authorized by an act of the Legislature after passage of this act; (7) binding judicial, grievance, or arbitration decisions; and (8) the provisions of Item 9840 of this act, which provides funds to address state contingencies and emergencies.

In our opinion, this language would clarify the meaning of existing law and limit the ability of the administration to unilaterally grant pay increases that infringe on the Legislature's authority to control the expenditure of state funds.

Summary

The recommendations discussed above—summarized in Figure 3—would enhance the Legislature's leadership role in determining the pay and benefits provided to state employees. They also would assist the Legislature in focusing state employee compensation expenditures within the context of a balanced budget.

Figure 3

LAO Recommendations:
Legislative Oversight of State Employee Compensation

- ✓ End automatic pay raise formulas.
- ✓ Curb arbitrators' authority to order unanticipated state spending.
- ✓ Limit length of memoranda of understanding (MOUs) to no more than two years.
- ✓ Hold joint hearings on selected MOUs with major fiscal or policy impacts.
- ✓ Have more time before voting on MOUs.
- ✓ Require administration to submit excluded and exempt pay proposal annually.
- ✓ Limit administration's flexibility to increase pay without legislative approval.

IMPROVING THE MANDATE PROCESS

How Could the Legislature Expedite the Process of Making Mandate Determinations and Reduce the Complexity of Filing Reimbursement Claims?

Summary

The California Constitution requires the state to reimburse local governments for certain state mandates. The process for determining the existence of state mandates and providing local government reimbursements, however, has significant shortcomings. "Test claims" filed by local governments (alleging the existence of a mandate) typically take over five years to be resolved by the Commission on State Mandates. During this time, state fiscal liabilities mount and local governments carry out mandates without reimbursement. Local governments devote considerable resources to mandate record keeping, but the State Controller's Office disallows about one-third of local government mandate claims because they do not comply with the commission's complex guidelines. Local governments often appeal these claim reductions to the commission, causing further delays in the mandate determination process.

The administration's proposal to reform this mandate process provides a good starting point for discussion. In this analysis, we review the administration's proposal and offer the Legislature a similar, but more extensive, proposal that includes three significant changes to the mandate process:

(1) Simplify the process for local governments to file reimbursement claims by placing greater emphasis on unit cost methodologies.

(2) Allow mandate payment methodologies to be developed through negotiations between local government and the Department of Finance.

(3) Establish an alternate process to provide early settlement of mandate disputes and bypass the commission entirely.

The California Constitution generally requires the state to reimburse local governments when it mandates that they provide a new program or higher level of service. State law assigns the Commission on State Mandates the authority to (1) resolve disputes over the existence of state mandates and (2) develop methodologies (called parameters and guidelines, "Ps&Gs") that local governments follow to calculate the amount they may claim as reimbursements.

Figure 1 summarizes the full mandate process—from imposition of a state requirement (box 1) to payment of and adjustments to reimbursement claims (boxes 10-12). The steps in box 2 to box 9 commonly are referred to as the "mandate determination process," because these are the steps in which the commission determines whether a requirement constitutes a state-reimbursable mandate and defines how the state requirement will be reimbursed.

Concerns With the Process

Over the last several years, state and local officials have expressed significant concerns about the mandate determination process, especially its length and the complexity of the reimbursement claiming methodologies.

Lengthy Process Poses Difficulties for State and Local Governments

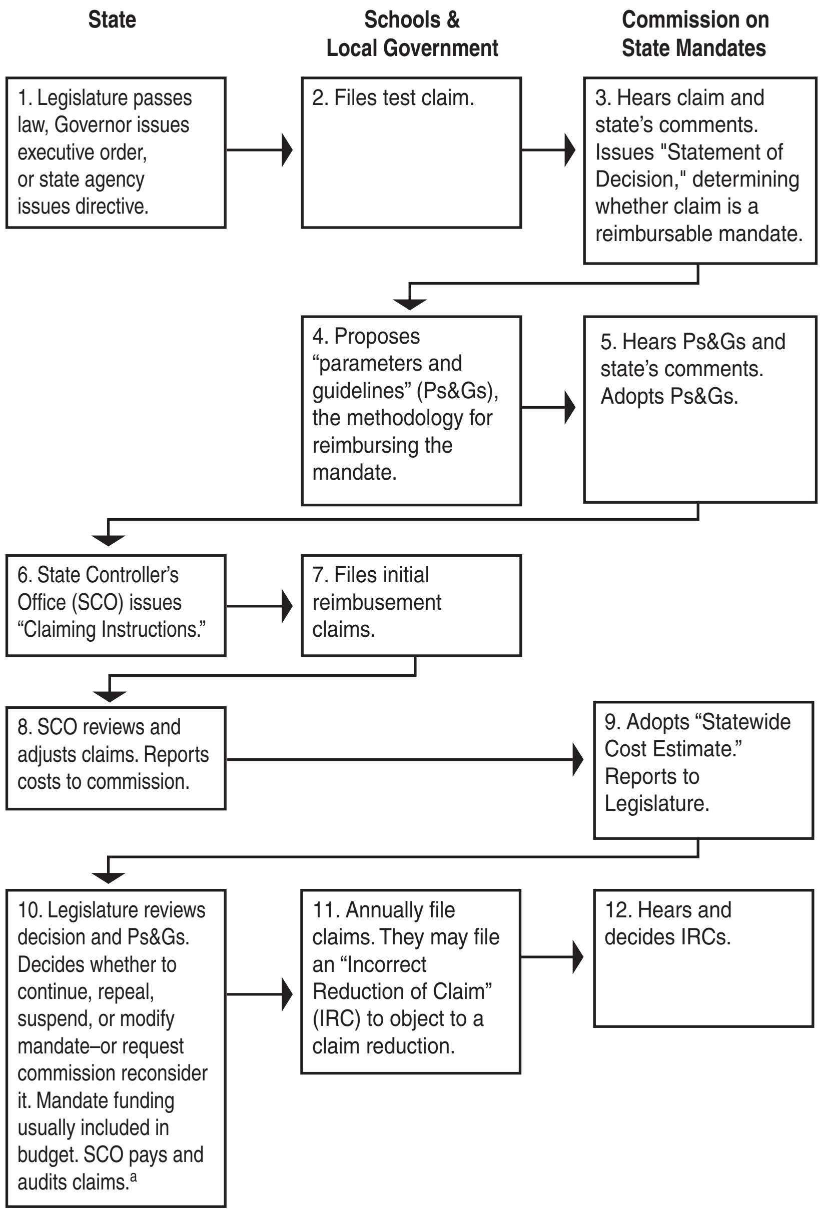
It currently takes the commission over five years to complete the mandate determination process for a successful local government test claimant. Specifically, our review of new mandates claims reported to the Legislature in 2004 through 2006 found that the commission took almost three years from the date a test claim was filed (box 2 in Figure 1) to render a decision as to the existence of a state-reimbursable mandate (box 3). The commission took more than another year to adopt the mandate's claiming methodology or Ps&Gs (box 5) and almost another year to estimate its costs and report the mandate to the Legislature (box 9).

This lengthy period presents several difficulties. Local governments must carry out the mandated requirements without reimbursements for five years, *plus* the additional time associated with development of the mandate test claim and waiting for the reimbursement funds to be appropriated and checks issued. Altogether, it is not uncommon for mandate funding to lag mandate enactment by six to seven years.

The lengthy mandate determination period also poses difficulties on the state. Specifically, state mandate liabilities accumulate throughout

Figure 1

Mandate Determination Process



[a] Legislature may modify Ps&Gs and fund a lower amount, but not deny local agencies' right to reimbursement.

the determination period, making the amount of state costs reported to the Legislature (box 9) higher than would be the case if the process were completed on a more expedited basis. The delays also complicate state policy review of mandates because the Legislature receives a mandate's cost information years after the debate regarding its imposition has concluded.

The commission's large backlog of claims (it currently has over 100 claims under review) commonly is cited as a reason for the time delays. While commission staff suggests that they are reducing this backlog, workload data do not show significant progress. We note, for example, that local governments *filed* the same number of claims (46) over the last three years as the commission *closed* during this time (claims are closed when the commission reports a mandate's costs to the Legislature or rejects the claim, or the claims is withdrawn or consolidated). We also note that the commission has yet to render its decision for 86 claims (14 of which were filed by local governments more than five years ago), and that the commission seldom decides more than 20 test claims in a year. From this, we conclude that the large backlog of claims is not likely to disappear in the near future, absent action by the Legislature and administration to change the mandate process.

Complicated Claiming Methodologies

The Legislature created the seven-member commission in 1984 as a quasi-judicial body and instructed it to act deliberatively in resolving the complex legal questions associated with determinations of state mandated costs. (Figure 2 shows the membership of the commission.) The work of the commission to render mandate decisions usually meets these legislative expectations as its decisions are well reasoned and typically withstand judicial challenges.

Figure 2

The Commission on State Mandates—Membership

- Director of the Department of Finance
- State Treasurer
- State Controller
- Director of the Office of Planning and Research
- Two local government members (from a school district, city council, or county board of supervisors)[a]
- One public member[a]

[a] Appointed by the Governor.

After the commission issues its Statement of Decision, however, the commission's work products do not serve the state as well. Specifically, the reimbursement methodologies adopted by the commission (the Ps&Gs, box 5) typically are too complicated to be usable by local governments or be easily reviewed by the State Controller's Office (SCO). The problem with the commission's reimbursement methodologies stem from (1) the inherent difficulties in quantifying mandate costs and (2) the commission's tendency to link reimbursement methodologies specifically to the legal description of the mandated activities specified in its Statement of Decision.

Inherent Difficulties in Estimating Mandated Costs

Few state mandates establish completely new local programs. Rather, state mandates usually modify elements of preexisting local programs or procedures—and indirectly trigger other changes to local programs or procedures (such as additional training or facility costs).

Local accounting and workload data systems typically report information on the cost of programs as a whole, as well as program and policy variables important to the local government. Local data systems seldom are designed to measure the marginal additional costs of new requirements. While local governments can modify their data systems to collect such information, making these changes can be difficult and frustrating if the data has limited usefulness from a local point of view.

Linking Payment Methodology to Legal Description of Mandate

Despite the practical limitations discussed above, the commission commonly adopts mandate reimbursement methodologies that delineate pages of highly specific activities for which local governments may claim costs. These activities frequently are described using the same legal description that the commission used in its Statement of Decision.

The problem with focusing on the legal definition of claimable costs is that the specified activities seldom are complete local government programs that are easy for a local government to quantify and document.

Example: POBOR Mandate. The Peace Officer Procedural Bill of Rights (POBOR), Chapter 465, Statutes of 1976 (AB 301, Keysor), provides a series of enhanced rights and procedural protections to peace officers who are subject to interrogation or discipline by their employer. In 1999, the commission found to be a mandate those procedural requirements of POBOR that *exceeded* the rights provided all public employees under the due process clause of the United States and California Constitutions. For example, POBOR requires local governments to hold an administrative hearing when they (1) transfer a peace officer as punishment or (2) deny a promotion for reasons other than merit. The due process clause in the State and U.S. Constitutions do not require such a hearing. Thus, local costs to provide administrative hearings under these specific circumstances are reimbursable. The costs to provide administrative hearings under many other circumstances, in contrast, are not.

The reimbursable activities specified in the commission's 14-page POBOR Ps&Gs require detailed new record keeping by local governments. For example, the Ps&Gs permit local governments to claim costs to tape record and transcribe certain police officer interviews, but only if the peace officer commenced his or her own tape recording *first*. Similarly, local governments may send employees to training to learn about POBOR's requirements. If the training covers other personnel issues, however, the local government only may file for reimbursement for the number of minutes of the training in which POBOR is discussed.

Complexity Causes State-Local Friction and Delays

Given the complexity of the claiming methodologies, it is not surprising that the SCO finds that local governments' claimed costs frequently (1) are not supported by source documents showing the validity of such costs or (2) are not allowable under the mandate's reimbursement methodology. Accordingly, SCO has disallowed over one-third of all reimbursement claims over the last few years. (Some claims have been reduced by as much as 90 percent.)

Local governments appeal many of these audit reductions to the commission (see boxes 11 and 12), frequently claiming that the level of documentation required by the auditors is impractical or that the reimbursement methodology is unclear. These local appeals, in turn, further delay the mandate determination process. Currently, 118 audit appeals are pending before the commission. The commission estimates that each appeal takes staff about 100 hours to review and process. Thus, the commission currently has over six staff years of work to resolve these appeals, a workload that is notable given that the commission only has 14 staff.

Past Legislative Action

The problems identified above are not new and the Legislature has taken steps to address them over the last few years. Specifically, the Legislature provided additional staff to the commission and Department of Finance (DOF) to assist them in reviewing and responding to mandate claims. The Legislature also enacted a one-year statute of limitations on local government mandate test claim filings. This statute of limitations was intended to reduce the problems the commission was experiencing researching test claims when the facts were dated.

Seeking to simplify the mandate claiming process and reduce the number of mandate audits, the Legislature enacted Chapter 890, Statutes of 2004 (AB 2856, Laird), with every member of the Assembly Special Committee on State Mandates serving as a coauthor. (The special committee met for over a year and reviewed the mandate process in depth.) Chapter 890 authorized the commission to adopt a "reasonable reimbursement methodology" for mandates, a methodology that places greater emphasis on the use of unit costs and other approximations of local costs, rather than detailed documentation of actual local costs.

Unfortunately, although DOF and local agencies have proposed reasonable reimbursement methodologies, the commission has not adopted one. A significant obstacle to use of this approach has been the commission's legal interpretation that it must review *actual* local government cost data from *all* claimants—a requirement that has proved impossible to meet.

Administration's Proposal

Seeking to address the problems discussed above, the Governor's budget proposes to significantly change the mandate process. It has two main features. First, it creates an alternative dispute resolution process whereby DOF and local governments (except schools and community college districts) may jointly determine if local agencies are entitled to mandate reimbursement. Under this process:

- The DOF would notify the Legislature of a joint determination and the amount to be subvened.
- The Legislature could approve the joint determination and appropriate the funds—or suspend the mandate.
- Local agencies must withdraw any related mandate test claim if the Legislature provides the proposed funding.

Second, the proposal would use simple, unit-based methodologies to reimburse mandates found under the alternative dispute process. It would also repeal the statute authorizing the commission to adopt reasonable reimbursement methodologies.

The administration's proposal provides a good starting point for discussion. Unlike California's civil and criminal courts, the existing mandate determination process does not provide for alternative dispute resolution or negotiated settlements. Instead, all mandate test claims follow the lengthy process shown in Figure 1. The administration's proposal acknowledges the potential to expedite the mandate process through the development of an "out of commission" negotiated process.

The administration also acknowledges the need to adopt simpler mandate reimbursement methodologies and indicates that payment for negotiated claims would be based on unit costs and other easy to administer approaches. The administration further indicates that it will encourage the commission to adopt simpler claiming methodologies for mandates under its review, drawing upon the commission's existing legal authority to do so. The administration specifies that its intent in proposing repeal of the reasonable reimbursement methodology statute is to eliminate a statute that has not worked as intended.

Concerns With Proposal

While the administration's general approach is on target, its mandate reform proposal would benefit from legislative review and modification because it:

- ***Diminishes the Legislature's Information and Policy Options Regarding Mandates.*** Under current law, the Legislature receives a legal decision and proposed methodology regarding each mandate (box 10) and may direct the commission to reconsider these documents if it believes the commission did not consider important information. The Legislature also may modify the reimbursement methodology and/or reduce funding for a mandate, as long as its actions do not interfere with local government's constitutional right to reimbursement. Under the administration's proposal, in contrast, the Legislature's role is reduced to reviewing the agreement negotiated between the administration and local governments—and accepting or rejecting it.
- ***Does Not Acknowledge the Legal Alternatives Available to Local Governments That Disagree With a Proposed Settlement.*** The administration's proposal appears to assume that a mandate settlement, negotiated between DOF and some local governments, would be the sole form of mandate reimbursement available to local governments. Given that the California Constitution entitles local governments to reimbursement of their mandated costs, we think it is likely that the courts would allow local governments that are not satisfied with the funding provided under this negotiated settlement to file court actions for additional reimbursement.
- ***Expedites and Simplifies Few Mandates.*** The administration indicates that it wishes to focus its efforts on those claims that are subject to the annual mandate payment requirement of Proposition 1A, approved by the voters in November 2004. This measure provided exceptions for mandates affecting educational agencies and pertaining to employee rights. Such an approach greatly reduces the potential effectiveness of the administration's proposal.

Specifically, we note that 55 of the 86 mandate test claims pending before the commission are from educational agencies and 5 others relate to employee rights, both exempt from Proposition 1A's annual payment requirement. Thus, less than a third of these 86 test claims potentially could be expedited under the administration's proposal.

To address these concerns, we outline below a three-part mandate reform package that is similar to the administration's proposal, but (1) maintains the Legislature's policy control regarding mandates, (2) acknowledges the rights of local governments that disagree with the negotiated settlement, and (3) strives to expedite and simplify many mandate claims.

LAO Three Part Mandate Reform Package

Building on the Governor's proposal, we offer a reform package to expedite and simplify the mandate determination process without altering local rights or state responsibilities under the Constitution's mandate reimbursement requirement. Given the variation in local government mandates, no single change would improve the process for all claims. Accordingly, our reform package includes three elements that we recommend the Legislature enact as optional alternatives to the existing process:

- ***Amend the Existing Reasonable Reimbursement Methodology Statute.*** Our proposal clarifies the type of easy-to-administer reimbursement methodology that the Legislature envisioned when it enacted this statute. While we would encourage the commission to use this approach to the greatest extent possible, the commission could adopt Ps&Gs using the existing approach (documented actual costs) if it were appropriate for a specific claim.
- ***Modify the Existing Mandate Process to Allow Reimbursement Methodologies and Estimates of Statewide Costs to Be Developed Through State-local Negotiations, With Minimal Commission Oversight.*** This option would replace the existing adversarial process (shown in boxes 4, 5, 7, 8, and 9) with a single negotiated step, expediting the existing process by at least a year. Because the negotiated Ps&Gs would be based on the reasonable reimbursement methodology approach described above, this negotiated process also simplifies the claiming process.
- ***Create an Alternative Dispute Resolution Process That Bypasses the Commission Process Entirely.*** This alternative would resolve mandate claims in about a year, thus offering the greatest potential for expediting the mandate process. While this alterna-

tive probably would be used for only a small number of claims (where there is a wide agreement between local governments and the administration), any reduction in the number of claims would improve the commission's processing time for other claims.

We discuss these three elements in more detail below.

Amend the Reasonable Reimbursement Methodology Statute

Given the difficulties parties have encountered trying to use the reasonable reimbursement methodology statute, we understand the administration's frustration and its resulting proposal to repeal it. We also acknowledge that the commission's broad underlying authority allows it to adopt unit-based and other easy-to-administer reimbursement methodologies without the reasonable reimbursement methodology statute. We observe, however, that the commission rarely has used this authority to adopt simple claiming methodologies and that the problems associated with the current claiming process are significant. We also find that there are significant policy advantages to the Legislature defining the type of easy-to-administer reimbursement methodologies that it wants to encourage. Accordingly, our proposal calls for amending the reasonable reimbursement methodology statute to facilitate its use, as opposed to repealing the statute as the administration proposes.

Based on discussions with state and local representatives, we think the reasonable reimbursement methodology statute could assume the role the Legislature intended if the Legislature made two changes. First, the commission should be authorized to consider cost information submitted by a representative sample of eligible claimants, associations of affected local governments, and other projections of local costs—rather than reviewing actual cost data from *all* claimants. Second, the commission should be authorized to approve a reasonable reimbursement methodology if it meets *one* of the two threshold criteria specified in current law (rather than both criteria). These criteria are: (1) total state mandate reimbursements are equal to total estimated local costs and (2) the methodology would fully reimburse the costs of at least 50 percent of all local claimants. While the commission should strive to adopt a methodology that satisfies *both* criteria, it would not be required to do so.

How Would This Approach Improve the Mandate Process?

Amending the reasonable reimbursement methodology statute in this fashion would facilitate the commission's ability to adopt easy-to-administer reimbursement methodologies and highlight a type of claiming methodology that would provide major benefits to state and local governments.

Specifically, greater reliance on unit-based and other simple claiming methodologies would reduce local government costs to file claims. (Due to the complexity of the current system, most local governments hire consultants who specialize in the preparation of mandate claims. Consultants sometimes deliver these claims, along with their voluminous required documentation, to the SCO's office in forklifts.) Simplifying the claiming methodology would allow local governments to use local personnel to prepare their claims, and do so with minimal effort.

State government, in turn, also would experience considerable savings because it would take fewer state staff to process and audit mandate reimbursement claims. Under the current documentation-intensive approach to mandate claiming, it takes the SCO's office over a month to simply file and tally annual mandate claims. Another 35 SCO staff are dedicated exclusively to auditing mandate claims. If mandate claiming were simplified, processing incoming mandate claims would be a minor task and many mandate auditors could be redirected to other high priority state program purposes.

Finally, we note that amending the reasonable reimbursement methodology statute would have an indirect, but very positive effect on the length of the mandate determination process. This is because greater use of unit-cost and other simple reimbursement methodologies would reduce the potential for disagreements in the mandate claiming process and lead to fewer audit appeals. Reducing audit appeals would free up commission time to focus on mandate determinations.

Allow Methodologies to Be Developed Through Negotiations

Under the current mandate determination process, it takes about two years to develop Ps&Gs and a statewide cost estimate. The reason this takes so long is because:

- Local governments and DOF (representing the state) work in an adversarial manner to develop Ps&Gs, frequently filing and responding to legal drafts of proposed Ps&Gs and seldom reviewing cost data together.
- The adopted Ps&Gs typically cannot be used to estimate statewide costs. As a result, the SCO sends the Ps&Gs (along with claiming instructions) to all eligible local government claimants to file initial claims. Estimates of statewide costs, in turn, are based on the initial claims filed by these local governments. (Ironically, although this process was developed to provide accurate statewide cost estimates, it inevitably understates costs significantly. This is because local governments seldom have the documentation read-

ily available to complete the complex claims and do not file them immediately.)

The mandate determination process could be expedited by at least a year and claiming methodologies made more workable by establishing a process for *negotiated* development of Ps&Gs. This process would consolidate much of the work in boxes 4, 5, 7, 8, and 9 of Figure 1.

Under this proposal, shortly after the commission determined that a test claim was a reimbursable mandate (box 3), a local government claimant and DOF could notify the commission of their interest in developing negotiated Ps&Gs pursuant to the reasonable reimbursement methodology described above. To ensure that the process considers local costs from a broad range of local governments (not just the test claimant), the parties would be required to propose a plan to ensure that costs from a representative sample of eligible local government claimants are considered.

The local government claimant and DOF would review data together and jointly develop a reasonable reimbursement methodology. To ensure that the methodology remains useable over time, the methodology would specify a date upon which DOF and test claimant agree to reconsider it and propose amendments to the commission.

Prior to submitting the negotiated methodology to the commission, the local government test claimant and DOF would be responsible for ensuring that it is supported by a wide range of local governments. This support could be demonstrated in different ways, including securing letters of support from affected local governments, statewide associations of local governments, or a representative sample of affected local governments.

Based on the information reviewed, the local government claimant and DOF would estimate the statewide cost of the proposed reimbursement methodology. Because the methodology would be based on relatively simple factors (such as unit costs), the quality of the statewide cost estimate is likely to be significantly better than the estimates provided currently.

Under our approach, the commission's review of the negotiated Ps&Gs and estimate of statewide cost would be largely procedural. The commission would review the parties' proposed methodology to ensure that they took steps to consider costs from a sample of local governments and that the methodology is supported by a wide range of local governments. The commission also would review the methodology for general consistency with the underlying Statement of Decision.

How Would This Improve the Mandate Process?

This approach offers all of the state and local government saving and other benefits associated with the reasonable reimbursement methodology described in the previous section.

In addition, this negotiated settlement process would:

- Expedite the mandate determination process, trimming at least one year from the existing five-year process.
- Improve the accuracy of estimates provided to the Legislature regarding a mandate's statewide costs, giving it greater ability to review the mandate's costs and benefits.
- Give local governments and DOF opportunities to work together on mandate matters, potentially building trust and experience that would allow the parties to work together under the alternative dispute resolution process described below.

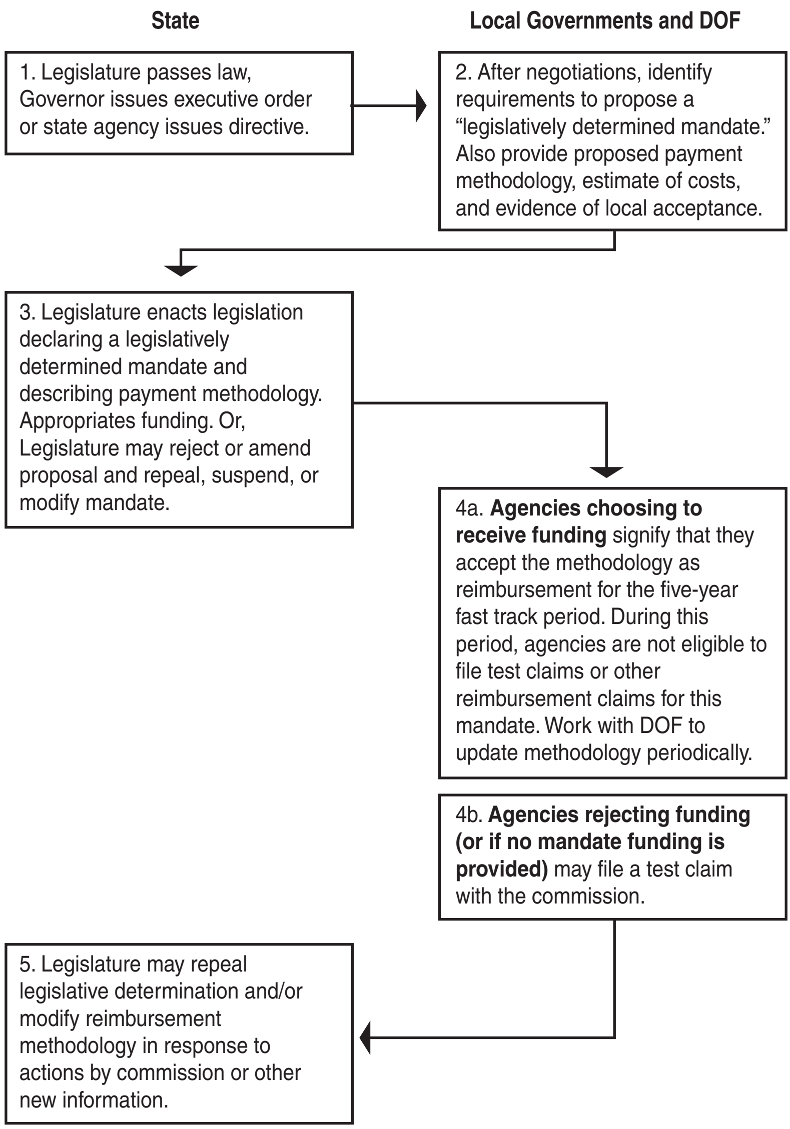
Create an Alternative Dispute Resolution Process

The third component of our mandate reform package, an alternative dispute resolution process, is the most wide sweeping. Although this process probably is suitable for only those mandate claims where there is significant consensus, use of this process would free significant time for the commission to focus on more complicated claims.

Figure 3 (next page) summarizes our proposed "fast track" process, and the responsibilities of the administration, local governments, and the Legislature. As can be seen, our alternative dispute resolution proposal is very similar to the administration's proposal. Both allow for swift (possibly less than one year) settlement of mandate claims by bypassing the usual commission process. Both begin with negotiations between local governments and DOF—and culminate with the Legislature receiving a mandate identification proposal and simple payment methodology. Both proposals make the identified mandates subject to the payment requirements of Proposition 1A and allow them to be suspended by the Legislature pursuant to provisions of existing law. Finally, both approaches require local governments to withdraw any related mandate test claim if the Legislature provides the proposed funding.

Figure 3

LAO Proposal for Fast Track Mandate Identification and Payment



The key differences between the administration and our alternative dispute resolution proposals pertain to our proposal's: (1) emphasis on maintaining legislative policy control over mandates, (2) recognition of the legal recourse of local governments that do not accept the outcome of the alternative dispute resolution process, and (3) inclusion of education and employee rights mandate claims in our recommended process. Below, we discuss the issues relating to legislative policy control and options for local governments that disagree with the proposed settlement.

Legislative Policy Control Over Mandates

Under our approach, the information provided to the Legislature regarding mandates and the Legislature's policy control over mandates would not be diminished. The Legislature would identify the mandate and specify its reimbursement methodology in statute. In future years, the Legislature could modify or repeal this determination. The Legislature also could reject a proposed mandate determination without suspending the mandate. (Under the administration's proposal, the Legislature's only choices are to approve a mandate proposal or suspend the mandate.)

Local Governments Disagreeing With the Proposed Resolution

Our approach acknowledges the legal alternatives available to local governments that disagree with the outcome of the alternative dispute resolution process. Given that this process entails intergovernmental negotiations, not judicial review, we assume that the courts would allow local governments to file separate actions with the commission (or courts) if they are not satisfied with the proposed resolution.

Our approach seeks to minimize the likelihood of this occurring and to reduce any resulting difficulties by:

- Requiring the administration and local government negotiators to (1) use information from a wide range of local governments to develop their proposed reimbursement methodologies and (2) assess and verify local support for any methodology before it is proposed to the Legislature. In addition, under our approach, the Legislature could reject a proposal and request that it be renegotiated to secure a higher level of local acceptance.
- Specifying that local governments that object to the proposed settlement may not receive the negotiated reimbursements (box 4b in Figure 3). Instead, these local governments must file a test claim with the commission and proceed through the regular mandate determination process.
- Promoting stability in the negotiated settlement by specifying that local governments that accept funding must remain under

this reimbursement system and not file a test claim related to this mandate for five years. (This restriction would not apply, however, if the Legislature changed the reimbursement methodology or the funding amount so as to reduce the funding to which the local government was entitled.)

- Specifying that if a court or the commission later finds that the state's reimbursement amounts were not sufficient, any state funding provided to local agencies pursuant to the alternative dispute resolution process counts as an offset to the state's overall liability.

How Would This Approach Improve the Mandate Process?

This approach offers all of the state and local government saving and other benefits of the reasonable reimbursement methodology described earlier and provides for very fast (probably less than one year) resolution of mandate claims. Overall, this approach would cut about four years from the existing mandate determination process.

While this process probably is appropriate for only a small number of claims where there is significant consensus, our review finds that even these less controversial claims currently require considerable commission time and attention. Redirecting some claims to this fast track process, therefore, would reduce the commission's caseload and free up time for it to focus on more complicated claims.

Conclusion

The mandate determination process has been a mounting source of friction between state and local governments. The administration's mandate reform proposal acknowledges the key sources of this friction—the undue complexity of the claiming methodologies and the extraordinary length of the mandate determination process—and can serve as a good starting point for legislative consideration.

In our view, the problems state and local governments are facing regarding the mandate process are amenable to legislative solutions and substantial improvements in the near term are possible. The mandate determination process could be expedited significantly and the claiming process made more manageable by (1) amending an existing provision of law that authorizes easy-to-administer claiming methodologies, (2) replacing a portion of the existing mandate determination process with state-local negotiations, and (3) establishing an alternative dispute resolution process that would bypass the commission process and provide swift resolution to mandate disputes.

The Governor's Tax Proposal

Should the Legislature Adopt the Governor's Proposed Tax Changes Involving the Teachers' Retention Tax Credit and the Taxation of Out-of-State Purchases of Vessels, Vehicles, and Aircraft?

Summary

The budget contains two tax-change proposals. The first is to permanently repeal the existing teacher retention tax credit, which was adopted in 2000 but was temporarily suspended in four of the past six years. The second is to make permanent a temporary change made in 2004 to extend, from 90 days to one year, the time that vessels, vehicles, and aircraft recently purchased out of state must be kept outside of California in order to avoid the state's use tax. We provide background on these two proposals, discuss their economic and fiscal impacts, and identify issues associated with them. Based on our review, we recommend that the Legislature adopt both proposals.

Proposal to Eliminate the Teacher Retention Tax Credit

Background

Off-and-on since January 1, 2000, California has made available a teacher retention tax credit (TRTC) providing benefits to those teaching in kindergarten through 12th grade (K-12) classes. The stated intent of the TRTC is to encourage the state's experienced K-12 teachers to remain in the profession, as well as compensate teachers for their unreimbursed expenses related to professional development and classroom instruction.

The credit is available to any qualifying teacher and is not associated with their actual expenses incurred. Rather, the amount of the credit is based upon years of service as a credentialed teacher at a qualifying institution in California. The California TRTC increases from $250 for teachers with four or five years of service to a maximum of $1,500 for teachers with 20 years of service. California's credit is offered in addition to a federal "above the line" deduction of $250 for qualified out-of-pocket expenses. Also, educators with out-of-pocket expenses larger than the allowable California credit or federal above-the-line deduction may claim expenses over these amounts as a miscellaneous itemized deduction. The TRTC is nonrefundable, which means that a claimant cannot receive more in credits than his or her tax liability. In addition, any unused credit cannot be carried forward and used to offset liabilities in future tax years.

Credit Features and Eligibility

In order to qualify for the credit, an individual must: (1) hold a California preliminary or professional teaching credential, (2) teach K-12 in an educational institution located in California, and (3) have completed at least four years of service as a fully credentialed teacher at a public or private educational institution (services performed as a credentialed teacher in another state may also count toward determining the years of service).

The credit amount is limited to the lesser of 50 percent of the total tax imposed on the individual's wages and salaries for services as a credentialed teacher or:

- $250 for at least four years but less than six years of service.
- $500 for at least 6 years but less than 11 years of service.
- $1,000 for at least 11 years but less than 20 years of service.
- $1,500 for 20 years or more of service.

Use of the TRTC

Figure 1 shows the use of the credit since its inception in 2000—including tax years 2000, 2001, and 2003 (the credit was suspended for tax years 2002, 2004, 2005, and 2006, due to budgetary considerations). As shown, the credit has been claimed by over 200,000 teachers each year, with a revenue loss of over $150 million annually. The figure also shows that the number of taxpayers claiming the credit fell somewhat in 2003, which may be attributed to the inconsistent availability of the credit to taxpayers. The average claim during the period shown increased from $737 in 2000 to $773 in 2001, and then fell to $748 in 2003.

Figure 1

History of TRTC[a] Claims

Tax Year[b]	Number of Returns	Amount of Credit Claimed (*In Millions*)	Average Credit Claimed
2000	213,610	$157.3	$737
2001	214,850	166.0	773
2003	204,881	153.3	748
Totals	**633,341**	**$476.6**	**$752[c]**

[a] Teacher retention tax credit (TRTC).
[b] The TRTC was suspended in tax years 2002, 2004, 2005, and 2006.
[c] Average claim over the period shown.

The use of the TRTC by income class in 2003 is shown in Figure 2 (next page). About 9 percent of total taxpayers claiming the credit earned more than $150,000, and these claims accounted for 15 percent of the total cost to the state of the credit. The figure also shows that 87 percent of the teachers that claimed the credit in 2003 had incomes greater than $50,000, and that 94 percent of the cost of the credit is attributable to claims by these taxpayers. (As a reference point, in 2004 the median adjusted gross income in California was about $35,000.)

Figure 2

Usage of the TRTC[a] by Income Class in Tax Year 2003

Adjusted Gross Income	Share of Total: Number of Claims	Share of Total: Amount of Claims	Average Claim Amount
$0 to $50,000	13%	6%	$351
$50,000 to $70,000	28	22	588
$70,000 to $100,000	23	21	683
$100,000 to $150,000	27	36	998
Over $150,000	9	15	1,247

[a] Teacher retention tax credit.

What Has the Credit Accomplished?

The state has spent almost $500 million on the TRTC since its inception. A key consideration for the Legislature is whether it has accomplished its intent. For that reason, our review focuses on two questions:

- *First*, has the program resulted in fewer or later retirements or job shifts on the part of teachers?
- *Second*, has the program effectively and efficiently reimbursed teachers for out-of-pocket classroom expenditures?

Effects on Retention Hard to Identify but Likely Are Limited

Unfortunately, it is difficult to provide hard evidence as to the program's effects on work-related decisions made by TRTC beneficiaries. There is some basis, however, for concluding that these effects likely have been limited.

Evaluation of the credit's ability to achieve the goal of improved retention (particulary among more experienced teachers) involves such steps as: (1) examining retirement patterns of teachers in years when the credit was available as compared to years when the credit was not available, and (2) examining retention of all staff—not just those of retirement age.

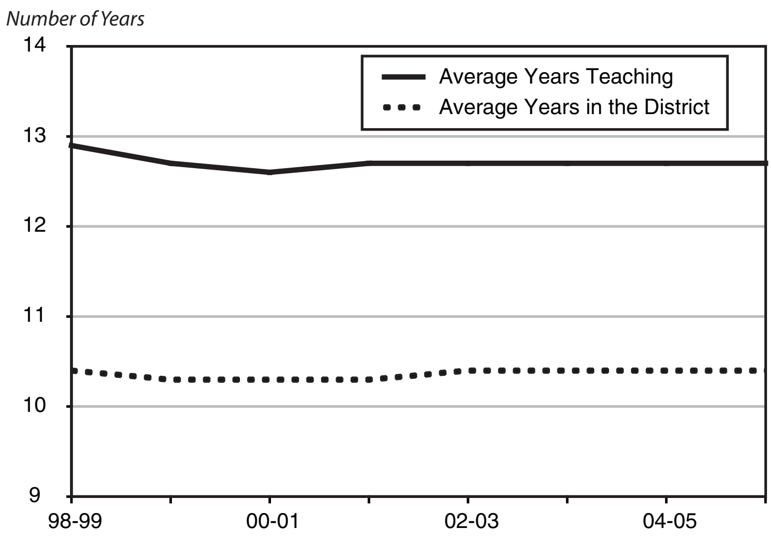
Minimal Effect on Retirements. While no data on the credit's particular impact on retirements is available, examination of retirement rates in years that the credit was available suggests that the credit had no significant positive effect on retention among the most experienced teachers—that is, those teachers eligible for retirement. This finding is not surprising given that the credit is such a small amount relative to a teacher's total annual compensation. A more direct way to affect retention rates of experienced teachers is through the retirement system. In fact, the state recently took such actions:

- In 2001, the state provided increased benefits (known as the "longevity bonus") to members retiring with 30 or more years of service earned by 2011.
- Also beginning in 2001, retirees with 25 or more years of service became eligible for a benefit based on their highest 12 consecutive months of salary, instead of the highest 36 months used for members with fewer years of service.

Minimal Effect on Teacher Retention Rates. Figure 3, which shows the retention of all public teaching staff in the state over recent years, suggests that the TRTC has had little to no effect on overall retention of teachers. The figure shows that the average number of years teaching and the average years in a particular district has remained virtually flat over the period.

Figure 3

California Teacher Retention Is Stable[a]



[a] Statewide years of service for K-12 teachers in public schools.

Issues Concerning Reimbursement of Classroom Expenditures

Credit Not Tied to Actual Out-of-Pocket Expenditures. The TRTC's stated intent is, in part, to reimburse certain teachers for out-of-pocket classroom expenses. However, as currently structured, the amount of the credit is dependent only upon years of credentialed service as a teacher, rather than actual out-of-pocket expenses incurred. Hence, rather than a reimbursement for expenses, the program represents a direct wage subsidy for certain teachers. Because of this disconnect, there is no data available on the amount of instructional materials actually reimbursed through this credit.

Credit Does Not Reimburse Expenses of Many Teachers. New teachers are excluded from the current program since they do not have at least four years of credentialed teaching. This is so even though newer teachers may arguably incur the greatest out-of-pocket expenses for gathering supplies for their students, since these new teachers do not have supplies accumulated from years past. The same argument applies to preschool teachers, who are not currently eligible for the TRTC.

State Provides Significant Direct Instructional Materials Spending. The budget includes significant funds for instructional materials in classrooms. Specifically, for 2007-08, it sets aside $419 million in an instructional materials block grant and $109 million in an arts and music block grant. Lottery moneys from Proposition 20, which usually amount to between $150 million and $200 million each year, are also available for instructional materials. Taken together, the administration proposes more than $680 million for instructional materials in the budget year. This is a significant increase in targeted state funding on instruction materials compared to the start of the decade. This increased spending may have reduced significantly the level of unreimbursed spending by teachers.

LAO Bottom Line

As noted above, we find there to be a lack of evidence that the TRTC has materially encouraged teacher retention. Rather than use the tax system, we think it is much more appropriate and effective for the state and school districts to use their pay and retirement systems to address any retention concerns. We also were unable to identify evidence that the TRTC materially affects the amount of instructional materials and supplies that teachers contribute to their classrooms. This is not surprising given that the credit is not linked to teacher spending on these materials. For these reasons, we recommend that the Legislature adopt the Governor's proposal to eliminate the TRTC on the grounds that it is not an effective and cost-efficient means of achieving its stated objectives. Elimination of the credit would result in annual savings to the state of $165 million beginning in 2007-08 and increasing amounts thereafter.

Proposal Involving Out-of-State Purchases of Vessels, Vehicles, and Aircraft

Background

California imposes a sales and use tax (SUT) on the final sale of tangible personal property, where the term "final sale" applies when the purchaser is determined to be a property's ultimate consumer. The main component of the SUT is the *sales* tax, which is collected by retailers on most purchases made in California. The second component, the *use* tax, is applied to nonretail sales occurring inside of California, as well as to purchases made outside of California involving goods which are then brought into California for storage or use in this state. The SUT is administered by the California State Board of Equalization (BOE).

The Key Issue—What Does "Use" Mean?

The single most important issue involved in administering the use tax when out-of-state purchases are involved is: *What criteria should be employed to determine whether an item has been purchased for use in California versus for out-of-state usage, and thus whether it is or is not subject to California taxation.*

Past and Current Criteria

Past Criteria. California had a given set of rules in place for many years to make this determination regarding taxability. Prior to October 2004, any vessel, vehicle, or aircraft purchased out of state was generally subject to the SUT if it was either purchased in California or if it was brought into California within 90 days of its purchase date (the so-called "90-day test"). Property held outside of California for the initial 90-day period was presumed to have been purchased for out-of-state use, and thus was exempt from taxation. In addition, if the property was brought into California before the 90-day period was up, it could still be exempt if it was subsequently used and stored outside of California at least one-half of the time during the six-month period immediately following its initial entry into the state (the so-called "principal-use test").

But Problems Emerged. Over time, the state increasingly found itself experiencing difficulties under these original rules in effectively enforcing the spirit of the law regarding the use taxation of out-of-state purchases of vessels, vehicles, and aircraft. What occurred was that a growing number of purchasers—particularly of yachts and recreational vehicles (RVs)—used the 90-day test to claim the out-of-state usage exemption. In the case of vessels, this often involved taking possession more than three miles offshore, sailing the vessel directly to Ensenada or other sites near the U.S. border, and then storing it for 90 days or more before returning to California. In the case of RVs, it often involved taking possession in Arizona, Nevada, or Oregon, then using or storing the vehicle outside of California for at least 90 days before returning to the state.

Current Criteria. These problems led to the enactment of Chapter 226, Statutes of 2004 (Senate Bill 1100, Committee on Budget and Fiscal Review), which temporarily tightened up on the rules. The enactment of Chapter 226 was in response to concerns about growing usage of the exemption and the belief that this involved assets that would subsequently be used on an ongoing basis in California instead of outside of the state. Figure 4 summarizes the changes temporarily made by Chapter 226 that the Governor's proposal would make permanent. As shown, the main one is the "one-year test," under which property is subject to the use tax if it is brought into California within one year after its purchase (except when this is done simply for repair, retrofit, or modification).

LAO Report Requirement

Chapter 227 also required the LAO to evaluate and report on the economic and fiscal effects of the new rules. In our report—*Out-of-State Purchases: California's Taxation of Vessels, Vehicles, and Aircraft* (April 2006)—we concluded that it would be preferable to make these rule changes permanent, and this is what the Governor is proposing.

LAO Report Findings

General Approach and Considerations

By lengthening the time that purchasers need to keep vessels, vehicles, and aircraft out of state in order to fulfill the requirements for an out-of-state usage exemption, Chapter 226 was expected to result in fewer exempt sales and an increase in SUT revenues to California. At the same time, however, industry representatives asserted that the law changes would have negative impacts on California business activities and profitability. These concerns were most notable with respect to the yachting industry, where it was argued that Californians would be put at a competitive economic disadvantage with those in other yachting regions, such as the northwest and Florida. Given these concerns, our analysis focused first and foremost on the impacts of Chapter 226 on the yachting industry, although we also evaluated impacts on vehicles (mostly RVs) and aircraft.

Figure 4

Use Tax Changes Made by Chapter 226

Vessels, Vehicles, and Aircraft Purchased Prior to October 2004

- ✓ Out-of-state purchases subject to the use tax if brought into California within 90 days of purchase.
- ✓ Use tax does not apply if vessel, vehicle, or aircraft is used outside of California more than one-half the time during the six-month period following its entry into California.
- ✓ Provisions apply to both residents and nonresidents.

Vessels, Vehicles, and Aircraft Purchased Between October 1, 2004 and June 30, 2006

- ✓ ***Residents.*** Out-of-state purchases subject to use tax if brought into California within one year of purchase.
- ✓ ***Nonresidents.*** Out-of-state purchases subject to use tax if used or stored in California for more than six months of the first year of ownership.
- ✓ ***Presumptions.*** Use tax presumed to apply if:
  - Owner is a California resident.
  - Purchase is subject to California registration fees (in case of vehicle) or property taxes (in case of vessel or aircraft).
  - Purchase is used or stored in California more than one-half of the time during the first 12 months of ownership.
- ✓ ***Repair Exemptions.*** Exemption for purchases brought into state for repair, retrofit, or modification (RRM) so long as not used by owner for more than 25 hours during each RRM period.

In considering the impacts of Chapter 226, it was important to assess the extent to which its provisions can be avoided through the use of other tax code provisions. That is, can purchasers who no longer qualify for the out-of-state usage exemption still find other means to avoid the use tax? If this were to occur frequently, the added revenue from the limits placed on the out-of-state usage exemption by Chapter 226 might be largely or even entirely negated. This could potentially occur through two avenues: (1) the use of an alternative exemption or (2) utilizing certain other provisions of the tax law, such as changing the organizational form of a business.

Other Exemptions Available to Buyers of Vessels, Vehicles, and Aircraft. Altogether, there are 13 exemptions in the use tax law, including that for out-of-state usage and others ranging from purchases between family members to transfers between related businesses. In addition to the out-of-state usage exemption, there are three exemptions of major relevance to purchasers of vessels, vehicles, and aircraft. These are the exemptions for (1) commercial fishing, (2) interstate commerce, and (3) being a common carrier. We determined that there definitely is potential for taxpayers to substitute other exemptions for the out-of-state exemption in the case of aviation-related purchases, but less opportunity for substitution in the case of vessels and vehicles.

Economic and Fiscal Effects Involving Vessels

Our analysis of Chapter 226's economic and fiscal effects was based on such factors as our assessment of the industry's structure, the mix of vessels marketed to Californians, industry sales data, and assumptions about the likely mix of different behavioral responses of purchasers to the law change.

Regarding these behavior responses, individuals would be faced with four different options: (1) buying the same vessel and paying the use tax in California, (2) purchasing a smaller vessel and paying the use tax in California, (3) complying with the one-year test and keeping the vessel out of state so as to avoid the use tax, and (4) canceling their purchase altogether. At one extreme, if the great majority of buyers simply went ahead and purchased the vessel in California, then the measure would result in a large increase in revenues and a modest increase in economic activity. At the other extreme, if the main effect was a cancellation of buyer's plans, then Chapter 226 would result in fewer revenues and reduced economic activity. The actual mix of behaviors would depend on such factors as the sensitivity of buyers and sellers to changes in after-tax vessel prices, and the mobility of buyers—that is, their ability to shift purchases and usage of a vessel from California to other regions.

The Evidence to Date. Based on the data available so far, it appears that the measure has resulted in major declines in the out-of-state usage exemption, an increase in sales subject to California's SUT, and thus a roughly $20 million annual increase in SUT receipts from vessel-related purchases.

Overall Fiscal and Economic Effects

Fiscal Effects. After conducting similar analyses for vehicles and aircraft and combining the results with those for vessels, we estimated that the combined impact of Chapter 226 on SUT revenues was a revenue increase of about $45 million in 2005-06. The General Fund share of this total was about $28 million, with the remaining portion going to state special funds and localities.

Economic Effects. In terms of economic effects, we concluded that it is likely that the extended one-year test has had some adverse effects on California's yachting and RV industries. In instances where the state is competing with other states and countries for business, the Chapter 226 changes could also have adverse effects on California's competitiveness. The initial data we have observed, however, suggest that these effects have not been particularly large.

Legislative Issues and Considerations

In considering the Governor's proposal to extend Chapter 226 permanently, the main question facing the Legislature is: *Which tax test is most appropriate both from (1) a tax policy perspective and (2) in terms of making practical sense?*

The One-Year Test Is Preferable

Determining the best approach from a tax policy perspective can be a complicated issue for vessels, vehicles, and aircraft, as they have long lives, are mobile, and thus may be used in numerous places over their lifetimes. While, in theory, use taxes could be apportioned to various different taxing jurisdictions over time based on where the assets are used, such a process would, in practice, be virtually impossible to administer and enforce by the state's taxing agencies. It is for this reason that California, like other states, has adopted tests that are rough approximations for determining whether property that is being purchased is, in fact, for use in California. The basic tax policy question regarding Chapter 226 is thus whether the one-year test is a more appropriate measure for determining usage than the 90-day test. Although neither test is perfect, the striking decline in claims for the out-of-state usage exemption for vessels and RVs that occurred when the test was expanded to one year strongly suggests that the majority of the 90-day exemptions were made for assets that were purchased for use in this state. In this regard, we believe the one-year test is a better approximation of actual usage than is the 90-day test. As such, we recommend that the Legislature adopt the Governor's proposal to make Chapter 226's change permanent.

But Other Changes Also May Merit Consideration

If the Legislature does choose to permanently extend the one-year test, it may also wish to consider changes to Chapter 226 that we believe would address some legitimate concerns about the measure raised by the affected industries and which would not weaken the basic intent of Chapter 226.

These changes involve:

- ***Connection of the Use Tax to the Property Tax Lien Date.*** Under Chapter 226, a nonresident owner of a vessel or aircraft is exempt from the use tax if the property is used outside of the state for more than six months during the first year. However, the vessel or aircraft is also presumed to be for use in California (and thus subject to the use tax) if it is subject to the property tax during the first 12 months of ownership. Thus, if a vessel owned by a nonresident is within a county on the January lien date, it would be subject to both the personal property tax and the use tax. While this linkage may help BOE establish use tax liabilities, we believe it creates a conflicting standard that could seriously disadvantage nonresidents that have fully met the out-of-state usage test, and yet find themselves subject to the use tax. Given this, the Legislature may wish to eliminate the provision in Chapter 226 which links the application of the use tax to the property tax.
- ***Exemption for Fueling and Emergencies.*** Chapter 226 includes an exemption from the use tax for vessels and aircraft for repair, retrofit, or modifications. The Legislature may wish to add similar exemptions for refueling and emergencies, since such activities do not necessarily imply regular usage in California.

A State Policy Approach: Promoting Health Information Technology in California

What Is Health Information Technology (HIT), and How Can HIT Tools Benefit Health Care? What Efforts Are Underway to Develop HIT in Government and in the Private Sector? What Practical Steps Should the State Take to Develop HIT in California?

Summary

Persistent increases in health care spending and deficiencies in health care quality are attributable in part to the continued reliance by many health care providers on archaic, paper-based methods of storing and communicating health information. Health information technology (HIT) offers the potential to improve health care delivery and quality, but adoption of these tools by health care providers has been slow. Our review assesses the potential for HIT tools such as electronic health records (EHRs) and regional health information organizations (RHIOs) to meet these challenges, and provides an overview of HIT development efforts in government and the private sector. We conclude that the state should take steps to promote widespread adoption of HIT, and we outline several strategies to achieve that goal.

Introduction

Rising Health Costs Challenge Government and Business. Over the past four decades, national health expenditures have more than tripled as a percentage of the country's gross domestic product. More recently, since 1990, per capita health expenditures have more than doubled, routinely outpacing overall inflation by significant margins each year.

In California, state spending for health programs reflects similar trends. State expenditures for health benefits provided to low-income persons through the Medi-Cal Program rose by over 35 percent between 2000-01 and 2005-06. We project that Medi-Cal spending will grow faster than overall state General Fund spending through at least 2011-12. Also, health coverage premiums for state employees and retirees enrolled in the California Public Employees' Retirement System (CalPERS) rose by an average of 14 percent annually from 2001 to 2006.

The persistent rise in health care spending presents challenges across the spectrum of stakeholders. Fewer businesses are providing health insurance to their employees than before, as reported in a 2006 Kaiser Family Foundation survey that found a decline from 68 percent in 2001 to 61 percent in 2006 in the number of firms nationwide that offer health coverage. The same survey also reported that health coverage premiums increased by 7.7 percent in 2006, an improvement over the 9.2 percent premium increase seen in 2005, but still more than twice the annual employee wage increase of 3.8 percent. Governments at the federal and state levels are looking for ways to maintain or expand publicly-funded health care available through programs such as Medicaid while meeting budget restrictions.

Health Care Lagging in Information Technology. Another recent trend is the growing recognition of the discrepancy between the limited use of information technology in health care versus its more extensive use in some other industries. A person can use the same bank card to withdraw money from automated teller machines all over the world, but their potentially life-saving medical information is often accessible to only a few medical office staff who shuffle through paper files.

One consequence is that patients today often must provide their medical information repeatedly to different care providers and specialists in the course of receiving treatment. Doctors frequently do not have access to the medical information they need, such as the prescriptions a patient is currently taking, increasing the risks of complications during treatment. Patients themselves often lack sufficient knowledge of their medications, instead perhaps telling the doctor that they take a blue pill for a heart condition and a red one for blood pressure.

Under a worst-case scenario, a doctor in an out-of-town emergency room trying to treat an unconscious patient would have no idea what other medical conditions the patient might have or which medications he or she might be taking. This lack of data increases the risks of adverse reactions to treatment or medication that threaten the patient's safety and drive health care costs higher. Awareness of these sorts of problems increased notably with a 2000 study by the Institute of Medicine, a nonprofit research institution established by Congress. The study reported that medical errors cause between 44,000 and 98,000 preventable deaths in hospitals annually, surpassing motor vehicle accidents, breast cancer, and AIDS as causes of death. These errors result in wasted resources of an estimated $17 billion to $29 billion each year, over one-half of which are for health care costs.

Health Information Technology Shows Promise. Against this backdrop, health care providers and payers have recently begun to turn their attention to HIT as a means to improve the quality of health care while holding costs down. Electronically stored personal health information, known as EHRs, show promise of improving the efficiency of health care delivery by providing quicker access to health records and reducing duplicative administrative and care procedures. Greater use of electronic pharmacy prescriptions could help providers avoid administrative delays experienced when a pharmacist is unable to read the doctor's handwriting on a prescription. Eventually, health information networks (which we discuss in more detail later in this report) may link the data systems of all providers in a region or state together, establishing a seamless network of information across the health care community that enables providers to immediately access a patient's comprehensive health history at the point of care.

This report provides background information on HIT tools, describes current policies at various government levels, assesses the potential for HIT to address certain health challenges in California, and offers recommendations on how to help realize HIT's potential to improve patient care and control health care costs for the state's citizens.

BACKGROUND: HIT LANDSCAPE

In this section, we describe (1) the basic terminology for discussion of HIT; (2) potential quality and efficiency benefits of HIT; (3) significant barriers to HIT expansion, such as financing, proprietary ownership of technology, and security and privacy issues; (4) the common data and technology standards being used by HIT systems; and (5) how RHIOs are being organized and sharing information.

Basic Terminology

Health information technology is a broad phrase intended to capture a wide range of technologies and processes related to the electronic generation, storage, and transmission of health information. These include electronically stored information about an individual's health history; electronic networks for transmitting health data between health care providers; and electronic processing of physicians' orders, including drug prescriptions and laboratory tests. The nearby box provides a more complete listing and description of terms used in this report.

Common Health Information Technology Terms

In this report, we use the term health information technology (HIT) to encompass all of the following technologies:

- ***Electronic Health Records (EHRs).*** These records consist of electronically stored information about an individual's health history, treatments, and other related information held by a health care provider. An EHR may include information in a variety of forms such as X-rays or computerized scan results, and EHRs of varying sophistication are possible. Some capabilities offered by EHRs include viewing patient medical histories, ordering prescriptions and lab work, and treatment advisory functions. These records are sometimes also referred to as electronic medical records or EMRs.

- ***Personal Health Records (PHRs).*** These electronic records are similar to EHRs but are often limited to information on an individual's health conditions and treatment history. They may be maintained by the individual, who likely also controls access to the record.

- ***Health Information Exchange (HIE).*** Data transfer known as HIE is the electronic communication of health information between separate health care entities, such as between a physician's office and a medical laboratory.

- ***Regional Health Information Organizations (RHIOs).*** A RHIO is a group of health care entities, often confined to a particular geographic area, in which the members typically establish

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Potential Quality and Efficiency Benefits of HIT

The movement toward establishing new HIT systems has been motivated in large part by expectations that these new technologies will improve the quality of patient care and help contain health care costs. When implemented successfully, the use of HIT should help physicians and other providers make decisions about patient care in ways that improve the quality and efficiency of care. Some examples of the benefits afforded by HIT applications are the following:

(1) an electronic network for communicating multiple types of health information using standardized information formats and transmission conventions, and (2) rules governing various aspects of the group's operation, including financing. Such groups may include hospitals, clinics, pharmacies, laboratories, and other health care providers.

- ***Electronic Prescribing (eRx).*** With this technology, electronic devices are used to create, process, and communicate prescriptions for medication. These eRx tools can incorporate functions of varying sophistication. In their most basic form, physicians write and manage prescriptions using a computer instead of a paper prescription pad. More sophisticated varieties can include treatment advice and communication across organizations. This software can be a stand-alone product or may be incorporated into a package of EHR systems or software.
- ***Computerized Physician Order Entry (CPOE).*** These products are clinical information technology tools that physicians and other providers can use to enter orders, such as prescription drugs or lab tests, into a computer system for further patient action. These products are most frequently used in hospitals. Similar to eRx technology, CPOE products were sold as stand-alone tools in the past but are now often incorporated into EHR packages.
- ***Clinical Decision Support Systems.*** These are software tools that assist care providers by offering advice or "best practice" recommendations for a patient's situation, using information about the individual patient and a database of recommended procedures. These capabilities are now frequently incorporated into EHR, CPOE, and eRx products.

- Fewer unnecessary medical tests.
- Higher quality patient care.
- Improved emergency care outcomes.
- More efficient prescription drug processing.
- Fewer patient burdens, such as repetitive paperwork.
- Better disaster preparation.
- Increased public health monitoring.

Potential Benefits of Health Information Technology

- ***Fewer Medical Tests.*** Access to a patient's electronic health records (EHR) at the point of care through a regional health information organization (RHIO) network would reduce the possibility that a physician would order redundant medical tests. Without such access, a physician would not know whether another physician had ordered a similar test recently. Also, paper records that are lost or located at another facility can result in tests being needlessly repeated at increased cost and inconvenience to the patient.
- ***Higher Quality Patient Care.*** Clinical decision support tools incorporated into electronic prescribing, EHR, or computerized physician order entry systems can alert physicians to potential treatment risks—such as adverse drug interactions, avoiding costly and potentially harmful medical errors. Physicians could receive electronic reminders to take certain standard actions in caring for patients—such as indicating that a diabetes patient is due for a blood test.
- ***Improved Emergency Care Outcomes.*** A hospital emergency room that is linked to a RHIO can quickly access a patient's medical history to inform decisions at the point of care. Accounting for this information helps the physicians avoid potentially dangerous adverse treatment reactions.
- ***More Efficient Prescription Drug Processing.*** When prescriptions are issued electronically to pharmacies, the pharmacist receives the order almost immediately and can begin filling

(continued on next page)

These potential benefits are described in greater detail in the nearby box.

Various Barriers Have Slowed Adoption of New Technologies

Despite the acknowledged potential benefits of HIT systems, adoption so far has been limited. Only an estimated 15 percent of physicians nationally use EHRs, and small medical practices are less likely to have implemented EHRs than larger practices, as illustrated in Figure 1 (see next page). Communities with RHIOs under development or in operation number perhaps in the low hundreds nationally, with most of these in some stage of development short of actually implementing a health information exchange (HIE).

it prior to the patient's arrival. Possible confusion resulting from a doctor's illegible handwriting, a common administrative hurdle with paper prescriptions, can be avoided.

- ***Fewer Patient Burdens.*** Patients in a hospital would not need to repeatedly describe their situation to different doctors and nurses who come to check on them. Instead, up-to-date information in EHR would be available nearby the patient, possibly through a wireless laptop or handheld computer. Also, patients would only need to provide their personal and family medical history once to establish an EHR. From then on, the primary care physician, or other care providers, could access the record through a RHIO and update it, maintaining a comprehensive medical history in one file, rather than in numerous paper files scattered around doctor's offices, laboratories, hospitals, and other locations.

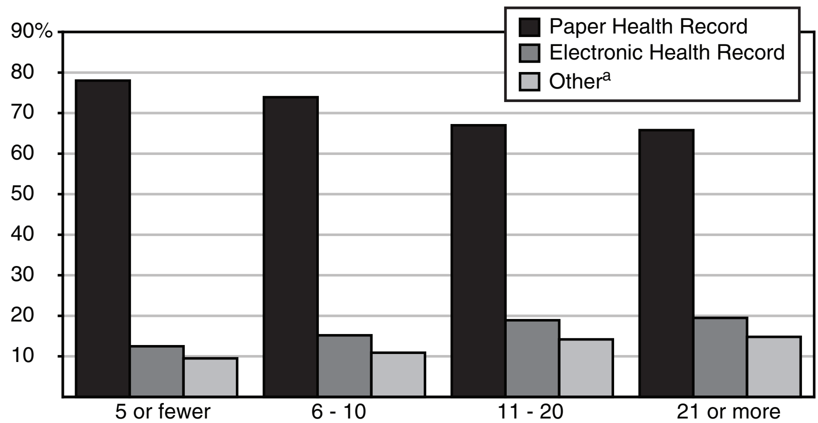
- ***Better Disaster Preparation.*** Medical histories stored on EHRs would be less likely to be lost during a natural disaster in any particular area, assuming that appropriate precautions were taken to back up electronic records. For instance, a fire or earthquake that destroyed a physician's office might not result in the loss of that practice's records if that physician participated in a RHIO. If the practice kept all its records onsite in paper folders, all records could be lost in such an event.

- ***Increased Public Health Monitoring.*** Public health monitoring would be improved by the ability to review diagnostic information on a confidential basis from a wide variety of patients. Trends in disease and other medical conditions could be detected faster and, thus, addressed more rapidly.

Figure 1

Electronic Health Records Least Common Among Small Physician Groups

Percent Using Each Type of Record (2005)



Source: Gans, et al: "Medical Groups' Adoption of Electronic Health Records and Information Systems," Health Afffairs Volume 24, No. 5, September/October 2005.

[a]Includes scanned images, dictation, and transcription.

A variety of factors have slowed the wider adoption of HIT. Lack of financial resources is one frequently cited barrier to greater implementation of these new systems, but other notable factors include the challenge of transitioning to an EHR-based practice as well as proprietary and privacy concerns. We discuss each of these barriers to HIT in more detail below.

Financing Remains Elusive. The relatively high cost of implementation has inhibited the adoption of both EHRs and HIE. According to a 2005 survey conducted by the eHealth Initiative (eHI), a nonprofit organization that promotes HIT nationwide, 32 percent of groups seeking to establish HIE indicated that securing start-up funding was a moderately difficult challenge, with 59 percent reporting this as a very difficult challenge. Establishing a "sustainable" business model (in which business revenues or savings from use of the new technology would be sufficient to offset its additional cost) was described in this survey as either very difficult or moderately difficult by 84 percent of groups seeking to establish HIE. We discuss the costs of EHRs for individual practices later in this report.

Transition to EHRs Presents Challenges. Use of EHRs as an integral part of a medical practice typically requires different administrative processes than those associated with paper records. In addition, new hardware and software could require comprehensive rearrangement of operating procedures. At a minimum, patients' medical histories have to be entered into the EHR system, at least to some extent, creating additional workload. As physicians and administrative staff learn to incorporate EHRs and possibly RHIOs into their business, they temporarily may be unable to care for as many patients. For some providers, this decrease in patient volume could result in a loss of revenue in addition to the stress of changing familiar patterns of work. One detailed account of EHR adoption by a small primary care practice reported decreased patient scheduling, longer patient wait times, and high levels of workplace stress for about three months following implementation. However, the practice ultimately achieved improved patient wait times and improved staff morale.

Lack of Interoperable Products Prevents Sharing of Health Data. A significant barrier to establishing HIE partnerships and RHIOs has been a general lack of interoperability among the variety of HIT products that have been available. These products were developed with proprietary formats by competing vendors, which means that an EHR created in one software program may not be easily accessed through a different software program. Although some technology standards are emerging now, as discussed in the nearby text box (see next page), marketplace conditions and incentives generally have not emerged to create widespread standardization of HIT tools. As a result, even the relatively few health care providers who now have EHRs might need to commit significant additional resources to be able to share EHRs with other organizations in their health care community. According to a report by the technology research firm Forrester Research, the costs to integrate computer systems across organizations will be substantially greater than the costs to purchase those HIT software and hardware systems.

Information Security and Privacy—Significant Concerns. Concern over the security and privacy of health information is also regularly cited by experts in news and research reports as a key challenge for the development of HIT systems.

Holding a large volume of personal information in an electronic format inherently creates a risk that one breach of information security could generate widespread risk or damage to the privacy of patients. The recent well-publicized incident involving a security breach of personal records maintained by the U.S. Department of Veterans Affairs (VA) demonstrates the high level of public concern about such security and privacy issues. In that case, a laptop computer with millions of veterans' personal identification information was stolen. While the incident did not specifically involve EHRs or RHIOs, and no health information was lost, these new HIT technologies plausibly create similar risks.

In a 2005 national survey of American consumers funded by the California HealthCare Foundation (CHCF), a philanthropy that supports health care improvement through a variety of projects, two-thirds of respondents reported being very concerned or somewhat concerned about the privacy of their personal medical records. A majority of those surveyed thought that computerization would benefit the health care industry, but they were modestly less confident in the security of electronic health information relative to paper records (although a majority felt that each would be secure).

The federal government has established some requirements for the security and privacy of electronic health information as part of a 1996 law known as the Health Insurance Portability and Accountability Act (HIPAA). The HIT systems must be developed in compliance with HIPAA privacy and security rules. Generally, HIPAA permits information to be shared among providers for purposes of rendering care, implying that

Some Data and Technology Standards in Place

Various data and technological standards currently in use are proving integral in the development of "interoperable" health information systems capable of effectively sharing health data included in electronic health records and electronic prescribing. We highlight below two main types of standards.

Terminology Standards. One main type of standard lays out a common set of medical terminology for a particular area of health care, in order to help ensure that all information users understand one another. An example of this type of standard is called the Logical Observation Identifiers Names and Codes (LOINC), which provides uniform terms and codes for laboratory testing procedures. The 2005 eHealth Initiative (eHI) survey mentioned earlier reported that 41 percent of health information exchange respondents that had begun implementation were using LOINC terminology to share information on laboratory tests.

Computer Standards. Another main type of standard spells out the uniform technical specifications that allow different computer systems to communicate accurately among one another. One popular standard in this category is known as Health Level Seven (HL7), a "messaging" standard that allows users to know who is sending and receiving the information and which patient the information describes. The eHI survey reported that 76 percent of respondents that had begun implementation used HL7.

many HIE activities are permissible. However, it is not yet clear how the HIPAA rules apply to some of the potential new data-sharing practices associated with these systems.

How RHIOs Are Being Governed And Sharing Information

The RHIOs can differ significantly in how they are organized and governed, and in how they share information. We discuss some of these key differences below.

Governance Increasingly Formal. Some RHIOs are developing as informal collaborations among participating health care entities within a region. At the other end of the spectrum are formal, legally established RHIOs organized as either nonprofit or for-profit corporations.

The eHI's 2005 survey mentioned earlier indicates that groups operating RHIOS are tending to become more formally organized. For example, the 2005 survey reports that 44 percent of survey respondents indicated that their RHIOs are incorporated, up from 29 percent of those who responded to eHI's 2004 survey.

Approaches Vary for Sharing Information. The RHIOs also differ in regard to how their information is shared with other appropriate entities, such as medical providers. Four main categories used to describe systems for sharing medical data are:

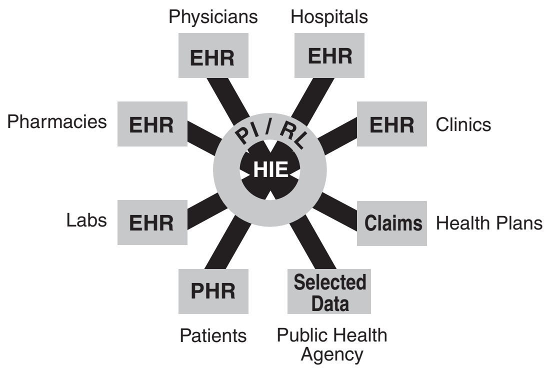
- ***Point-to-Point Systems.*** In this category, health care providers share patient data with one another on an *ad hoc* basis as agreed by the parties. There is generally no shared database or established network among multiple entities for this purpose. This is how much of the health industry operates today, using paper medical records.

- Federated Systems. Under this approach to sharing medical data, each participating health entity, such as a doctor's office, hospital, or lab, stores the data pertaining to its patients on its own separate computer systems. These individual systems are then linked by a computer network that allows users to search for health records on each of the other systems using patient indexing and record locator software. Each participating health entity can maintain different computer programs at its own location as long as those programs can communicate with each other. An example of a hypothetical federated RHIO is shown in Figure 2 (see next page).

- ***Centralized Systems.*** Under this approach, all patient and clinical data is stored on one central database that is accessible to all participants. Individual health entities would "upload" patient information to the central database. Each participating entity

Figure 2

Regional Health Information Organization Federated System Example



EHR - Electronic health record. Data is stored at each provider location, not in a central location.
PHR - Personal health record. Enables individuals to access their health records.
PI/RL - "Patient Index" and "Record Locator" software. These tools guide data requests through the network to the relevant information about the correct patient.
HIE - Health information exchange network. Information technology structure that enables health data transfer.

would have to adopt computer programs that were technically compatible with the central database.

- ***Hybrid Systems.*** This approach combines the advantages of the federated and centralized systems. Some patient data would be stored on a centralized database that integrates information from participants into a uniform format at a central location. Some information would continue to be stored on the computer systems of participants, which could still be linked as in the federated model.

Federal Efforts to Promote Health Technology Systems

Various federal efforts to promote broader use of HIT and the development of RHIOs have been initiated in the past two years. These include (1) administrative actions by the U.S. Department of Health and Human Services (HHS) and (2) legislative proposals now being considered by Congress. We discuss these activities in more detail later. Additionally, the federal government has achieved what many experts consider to be a highly successful EHR system in the VA, which we discuss in more detail in the nearby text box.

Federal Administrative Actions

The current federal administration issued a call in 2004 for the development of a national health information infrastructure within ten years. Since then, the Bush administration has launched a variety of projects to develop a comprehensive HIT policy approach and to assist health care providers in adopting their own HIT systems. Below are several key examples of such actions.

Veterans Affairs Health System a Leader in HIT Adoption

The U.S. Department of Veterans Affairs (VA) health system is the largest single health care system in the country. Its 1,400 hospitals and other health facilities participate in a network that allows clinicians to access patient electronic health records (EHRs) available from other VA facilities. Images including X-rays, photos, and other documents are available through the network. Adoption of HIT has been credited with playing a significant role in the transformation of the VA from a provider of substandard care in the early 1990s to an institution that outperforms most private hospitals in HIT adoption and, by some measures, in general care quality and efficiency.

VA Leading in Quality. For six years in a row, VA hospitals have outperformed private facilities in quality of care, according to a patient survey conducted annually by the University of Michigan. A 2004 RAND Health study comparing the VA with other health providers concluded that VA patients were more likely to receive recommended care and that quality of care for VA patients exceeded that of other patients in 14 out of 15 categories of assessment.

VA's EHR System Mitigated Effects of Natural Disaster. The VA's EHR system demonstrated its advantage in coping with natural disasters. Hurricane Katrina destroyed the VA Medical Center in Gulfport, Mississippi, and caused the evacuation and closure of the New Orleans VA Medical Center. Nonetheless, health records for the 40,000 veterans in the area were quickly available at other VA health facilities around the country due to the VA's HIT capabilities.

VA Software Now Available to Physicians. In September 2005, the VA made available to physicians a version of its EHR software, VistA, that had been redesigned to work in private physicians' offices. Physicians must pay licensing and installation costs to use VistA-based products, but the software is potentially less expensive than commercial alternatives.

New Entities Established to Set Policy Direction. In 2004, the Bush administration established the Office of the National Coordinator for Health Information Technology (ONCHIT) within HHS. The ONCHIT is intended to lead HHS's HIT activities and coordinate the administration's overall approach to HIT policy. Additionally, HHS convened a new federal advisory committee called the American Health Information Community (AHIC), comprised of leaders from government and industry, to provide input on HIT implementation issues.

Regulatory Changes to Facilitate HIT Adoption. The federal Centers for Medicare and Medicaid Services (CMS), the lead federal agency for those two major health care programs, and the HHS Office of the Inspector General issued new regulations in August 2006 that are intended to facilitate HIT sharing among health care organizations. Currently, federal antikickback laws seek to prevent improper compensation arrangements between physicians and other providers, such as hospitals. The new regulations establish or clarify "safe harbors" in which sharing HIT does not violate these laws. For example, one exception established by CMS sets up certain conditions under which a hospital could provide electronic prescribing (eRx) hardware or software to a physician who could refer patients to the hospital without running afoul of the antikickback rules.

Health Agency Grants for HIT Development. In 2005, HHS funding awards included about $36 million in grants to public and private organizations to focus on four specific areas of HIT development.

- ***"Harmonizing" HIT Standards.*** A grant of $3.3 million to the American National Standards Institute will support efforts to develop and evaluate a process for harmonizing existing standards for HIT in order to permit systems to share information much more easily and more widely.

- ***Certification of HIT Systems.*** A wide variety of HIT products are available in the marketplace, but there are limited means for certifying what these products can do or how well they can communicate with one another. The Certification Commission for Health Information Technology (CCHIT), a voluntary certification body created by three private HIT industry associations, received a grant of $2.7 million from HHS to help put such a certification system in place. Specifically, CCHIT is developing criteria to evaluate EHRs and the networks that can connect HIT systems. In July 2006, CCHIT issued its first round of certifications, announcing that over 20 EHR products met its criteria for outpatient clinic EHRs. The CCHIT also intends to develop certification standards for hospital and health plan inpatient EHRs and the networks through which HIT products can share information.

- ***Health Information Privacy and Security.*** Health care providers and other organizations have adopted additional policies and standards to protect the privacy and security of health records. The HHS awarded a grant of $11.5 million to RTI International, a nonprofit research organization, to assess the health information privacy and security laws and practices of different states and business organizations and how they vary. In California, the nonprofit organization CalRHIO and the California Office of HIPAA Implementation (CalOHI), which is part of the state Health and Human Services Agency, are leading this project.

- ***Nationwide Health Information Network.*** The HHS has awarded $18.6 million in contracts to develop four prototype RHIOs connecting disparate areas of the country. We provide more detail on the status of this effort later in this report.

Additional Administration Activities to Promote HIT. A variety of other federal administration efforts are underway. For example, the National Institutes for Health, the primary federal agency for conducting medical research, is also operating grant programs related to HIT systems. Additionally, grant funds totaling $150 million over two years have been made available for innovative improvements in state Medicaid programs (known as Medi-Cal in California). The funds were made available under the recently enacted federal Deficit Reduction Act, which specifically cites HIT as a permissible use for the funds.

Further, the U.S. Agency for Healthcare Research and Quality (AHRQ), a research arm within HHS that focuses on improving health care, is also providing grant funding and expertise to promote the development and adoption of new HIT systems. California organizations have received AHRQ grants for projects including establishing an Internet-based diabetes registry in Santa Cruz County and evaluating the usefulness of HIT in rural settings.

Congressional Activities

Members of Congress proposed a number of bills during the 109th Congress to promote the adoption of improved HIT systems for general care delivery, although none were passed into law. These included measures to provide additional funding for HIT development or to promote uniform standards for HIT systems.

Of these bills, S. 1418 and H.R. 4157 were each approved by a full vote in one of the houses. The Senate passed S. 1418 in late 2005, and the House of Representatives approved H.R. 4157 in July 2006. Both bills would have set up HIT subsidy programs, established ONCHIT and AHIC in federal statute, and enacted a variety of other similar provisions. However, H.R. 4157 also included a requirement not strictly related to HIT adoption, namely, the establishment of a significantly expanded set of medical billing codes. The Congress did not reconcile the differences in these two bills before the legislative session ended.

Development of Health Data Networks Progressing

Some estimates indicate that there are more than 100 RHIOs around the country. However, reports to date suggest that the vast majority of these are still in the planning stages, and that relatively few RHIOs have actually commenced the full-scale practice of sharing health information electronically. In this section, we discuss private and government-supported efforts to establish RHIOs and the success of these efforts to date.

Private RHIOs Taking the Lead So Far

Many RHIOs at this time rely on grant funds to cover operating costs. However, some RHIOs that have focused more narrowly on certain types of HIE capabilities are now able to support their operations with their own revenue instead of grant funds. We provide information below on some notable efforts supported mainly by the private sector to adopt EHRs and eRx and to develop RHIOs and HIE.

Indiana Health Information Exchange (IHIE). The IHIE is a nonprofit corporation that started in February 2004 from a collaboration of 13 health care organizations, including hospitals, providers, public health organizations, and researchers. The first available service through IHIE was a messaging system by which doctors could receive the results of patients' tests like X-rays or laboratory tests electronically. Health providers and other organizations that generate the data, such as laboratories, pay fees to send these clinical reports electronically at about one-half the cost of sending paper-based messages. Physicians receive the electronic messages free of charge.

The IHIE also operates an EHR system that links 18 different hospitals within Indianapolis. This means emergency room physicians can gain immediate electronic access to the medical histories of a patient who may appear in the emergency room, regardless of which hospital in the city may have previously served that patient. This access to EHRs is reported to be particularly useful in the treatment of patients who arrive in an emergency room unconscious or unable to speak.

HealthBridge. Based in Cincinnati, the HealthBridge information network links together 18 hospitals connecting thousands of physicians, nursing homes, independent laboratories, and radiology centers in its community. HealthBridge provides clinical messaging services in which laboratory, radiology, transcription, and health information can be transmitted. Some hospital inpatient records can also be accessed via the HealthBridge network. HealthBridge is notable in part because of its longevity and independence—it began in 1997 with virtually no government funding.

Prescription Drug Networks Have High Participation. Two networks specifically targeted to the prescription drug market have emerged with high rates of participation among pharmacists. Although they share data for only one type of service (prescription drugs), these networks demonstrate that HIE can be established in a form that includes many participants. SureScripts, founded by two major national pharmacy associations, claims that up to 85 percent of pharmacies nationwide are linked to its network and that 45 percent of its participants accept electronic prescriptions. The other network, RxHub, is a joint venture of the country's three largest pharmacy benefit managers (PBMs). RxHub transmits eligibility, benefit, and medical history information from these three PBMs to physician offices at the point of care. Physicians also can use RxHub to send electronic prescriptions to the PBMs' mail-order pharmacies.

Some Government-Supported RHIOs Developing

While privately organized HIE efforts are the furthest along in development to date, a few government-organized efforts supported by federal agencies and some states are also now underway. We discuss these efforts later.

Federal Prototypes to Test Cross-Country Networks. As noted earlier, the HHS has provided federal grant funding for the development of four prototype RHIOs through its National Health Information Network project. Each group will establish prototype networks among hospitals, laboratories, pharmacies, and physicians. Additionally, the four prototype networks are intended to establish systems that can communicate with one another. Once the projects are completed, the design for these networks is to be made public to stimulate further innovation and development of such electronic systems.

Among the health care markets selected to participate in these projects are Mendocino, which is to participate in a network with providers in Indiana, Massachusetts, and Santa Cruz, which has been included in an effort with Cincinnati and Cleveland, Ohio.

Some State Government Programs Under Way. A few state governments are also playing a more significant role in funding or organizing RHIOs. In its most recent survey, eHI found that at least ten governors have issued an executive order related to HIT promotion and that 22 state legislatures have passed bills related to using HIT for health care improvement. Some examples of these state activities are shown in Figure 3.

Figure 3

Selected State Government Efforts to Fund HIT Development

State	Activity	Funding Level
Florida	Administers grant program to award funds in three categories: Assessment & Planning, Operations & Evaluation, and Training & Technical Assistance.	$3.5 million over two years
New York	Provided grant funding to support 26 regional health network projects.	$53 million
Rhode Island	Most recent state budget includes bond funds to help develop a statewide health care information system.	$20 million
Tennessee	Provided start-up capital to develop a three-county HIE under the Volunteer eHealth Initiative launched in July 2004.	$10 million

Early Results Show Promise for Health Care Quality

Because so few private and public organizations have completed the process of adopting and implementing these new HIT systems, only limited information is available on the results of these efforts to date. What information is available suggests that, while the results to date are not unanimous, HIT has a clearly demonstrated capability to deliver improvements in health care quality in some health care settings.

In 2003, the U.S. Government Accountability Office (GAO) reported improvements in the quality of care such as shorter hospital stays, quicker communication of test results, and better management of chronic diseases for patients. For example, one provider realized a 20 percent increase in the number of diabetes patients whose conditions were under a high level of control. A survey published in the health journal *Annals of Internal Medicine* reviewed more than 250 studies of various HIT efforts (conducted primarily at four academic health care institutions), finding support for three different types of quality benefits: improved adherence to recommended care guidelines, improved surveillance and monitoring of patient conditions, and reduced medication errors. A leading nonprofit hospital in Brooklyn, New York, reported a 30 percent decrease in average inpatient length-of-stay and decreases of 41 percent to 49 percent for certain diagnostic laboratory tests following implementation of an internal EHR system.

Financial Benefits of HIT Show Promise

Studies of the financial effects of HIT indicate that savings can result from adoption of various HIT tools. However, the financial benefits do not accrue evenly to all participants in the health care delivery process. Payers such as health care plans appear to reap most of the financial benefits, while care providers, such as hospitals or physicians, typically bear most of the costs of HIT implementation. Even so, health care providers have seen financial rewards, but these results are more inconsistent.

Potential for Nationwide Savings. Some researchers have estimated that the United States health system as a whole, including both public and private sectors, would yield better care at lower costs if supported by networks of health information. A 2005 report by RAND, a nonprofit research institution, estimated that the U.S. could establish a comprehensive network of EHRs over 15 years. RAND projected that the average annual implementation costs over this period of $8 billion would be more than offset by average savings of $42 billion each year, resulting in average annual net savings of $34 billion. RAND estimates gross savings would be $77 billion annually following implementation, with additional savings possible by using such a network for preventive care and management of chronic conditions. Some critics contend that such predictions rely on possibly unrealistic assumptions about the ability of health care organizations to incorporate HIT into their operations. They also note that the estimated savings amount to less than two percent of the nation's annual projected health spending in 15 years.

HIT Efforts Show Fiscal Benefits for Some Hospitals. There are some preliminary indications that use of EHRs is providing net financial benefits to some hospitals that have implemented them. For example, Brigham and Women's Hospital in Boston, Massachusetts, estimated it achieved net savings of $5 million to $10 million per year following installation of a computerized physician order entry system that reduced serious medication errors by 55 percent. The GAO review previously mentioned described a variety of financial benefits realized by the entities in the study. A large hospital included in the report generated about $8.6 million in annual savings by replacing paper medical charts with EHRs for outpatients and about $2.8 million annually by establishing electronic access to laboratory results and reports. However, the GAO report focused on organizations that were successful in implementing HIT; it did not analyze results for any entities that may have attempted to adopt HIT without success.

Some Positive Effects for Small Providers. Some evidence regarding the experience of smaller health care entities with EHRs is also available. A study of the effects of EHRs in primary care settings published in the *American Journal of Medicine* estimated net benefits from EHR use of over $86,000 per provider over a five-year period. A case study of small physician practices by the University of California, San Francisco, reported an initial investment for computer training, software, and hardware for these groups ranging from $37,000 up to $64,000 per physician. The study reported that most of these medical practices experienced net financial benefits within several years, primarily as a result of efficiency gains and increased billing. The time needed to recover the initial expenditure for the EHRs averaged two and one-half years, although 2 of the 14 practices studied appeared unlikely to ever recover their initial investment. Practices with less pre-EHR technical experience tended to have higher implementation costs, reducing their net financial benefits.

The Status of HIT in California

In California, a variety of HIT activities are now underway, comprised so far mostly of local and private efforts. However, state officials have recently begun to take steps to promote and develop HIT systems in the state.

Nonprofit Organizations Providing Leadership. Various nonprofit organizations in California are currently promoting the adoption of EHRs and the development of RHIOs by providing grants, coordinating stakeholders, and developing standards for such systems. Notable examples of these efforts include the following:

- ***CalRHIO.*** CalRHIO is a nonprofit organization seeking to develop HIE and RHIOs in California primarily through coordination, research, and education. Among its various projects is an effort to establish HIE among the state's emergency rooms.

- ***Lumetra.*** Lumetra is a nonprofit health consulting organization that provides a range of services to clients in the public and private sectors. Under a contract with CMS, Lumetra led a pilot project involving four states to make HIT training resources available free of charge to Medicare providers. Through this program, which CMS expanded nationwide in 2006, Lumetra provides online training and personal assistance to teach California physicians how to select and use EHR software.

- ***CHCF.*** The CHCF supports a wide variety of health care projects in California through research, education, and funding. Among its various HIT development activities, CHCF is leading an effort to promote the adoption of its laboratory data exchange standard called ELINCS.

Some HIE Development Underway. Various efforts to develop HIE among members of a health care provider community are underway around California. These differ in planned scope and organization, but none yet represents a fully operational RHIO. Three such efforts are the Securing Health Access and Record Exchange in Mendocino County, the Santa Cruz RHIO, and the Santa Barbara County Care Data Exchange, which we discuss further in the nearby box.

Corporate HIT Activities. Several large California health care plans and hospital chains are also in the process of implementing EHRs or HIE within their organizations. The health care plan WellPoint has reported plans to make personal health records (PHRs) available to members and to provide electronic access to clinical data on WellPoint members for emergency departments. Blue Shield is reportedly establishing PHRs for its own employees as a pilot program to evaluate the possibility of making such records available for members. Kaiser Permanente, a comprehensive health plan and care delivery system, has already implemented EHRs and eRx at many of its care facilities as part of an ongoing project to employ such tools throughout its network.

Governor Issues Executive Order for HIT. In July 2006, the Governor issued an executive order with the stated goal of achieving full information exchange

Santa Barbara County Care Data Exchange (SBCCDE)

The SBCCDE consists of nine regional health care entities, including hospitals, health plans, clinics, labs, pharmacies, and the county public health department. The SBCCDE relies on the federated model of data sharing, which it believes will hold costs lower than a centralized model and better ensure the security of medical records. However, SBCCDE also employs a central "patient index" to provide easier access to patient records.

Part of the original funding for SBCCDE was provided by the California Healthcare Foundation in the late 1990s, but various legal and organizational issues have delayed full implementation of this regional health information organization. Physicians are now being trained on how to use the system, but data sharing had begun at only a few larger care facilities at the time this report was prepared. Additionally, recent discussion with some SBCCDE participants indicates that ongoing funding for the project is now uncertain as a result of the various delays.

between health care providers and stakeholders within ten years. The order (1) directs administration officials to allocate at least $240 million for this purpose to certain health care organizations, (2) calls for the development of public-private financing alternatives to expedite HIT adoption, and (3) establishes an "eHealth Action Forum" to develop a statewide agenda and comprehensive HIT program by July 2007. The eHealth Action Forum, a meeting of experts convened by the secretaries of the Health and Human Services Agency; the Business, Transportation, and Housing Agency; and the State Chief Information Officer, met in October 2006 to discuss ideas for the state's HIT policy.

The $240 million discussed in the executive order is held by UnitedHealth Group, a major operator of health care plans. (We discuss these funds further below.) UnitedHealth acquired PacifiCare Health Systems, a health care plan, in December 2005. In order to obtain regulatory approval for this merger from the California Department of Insurance (CDI) and the state Department of Managed Health Care (DMHC), UnitedHealth agreed to spend $250 million for various projects to improve health care in California. Under the terms of the merger agreement, UnitedHealth must spend the funds in consultation with CDI, DMHC, and members of an advisory committee. The agreement does not provide a direct role for the Legislature in allocating the funding.

The UnitedHealth funds consist of two pools of money: First, $50 million was available for various grant or subsidy purposes including technology improvements for safety net providers, medical education programs in underserved areas. Second, the remaining $200 million was limited to investment-grade uses benefiting entities that care for underserved populations and have difficulty accessing capital. Over $10 million of the smaller pool has already been spent, primarily for medical education purposes. The administration has not provided a specific proposal for using the remaining $240 million to expand HIT efforts in California.

Governor's Health Coverage Expansion Plan Promotes HIT. In January 2007, the Governor announced a multifaceted plan to provide health insurance to California's uninsured. This package of proposals lists a number of strategic directions to promote HIT adoption, including the following:

- Establishing a Deputy Secretary of HIT and a State HIT Financing Advisory Committee to coordinate the state's HIT-related efforts and develop financing mechanisms.
- Implementing universal eRx by 2010.
- Developing a standardized PHR within the public and private sectors.

- Implementing a county-level pilot electronic medical record system for mental health patients within the requirements of Proposition 63, the Mental Health Services Act, which California voters approved in the November 2004 general election.

Administration Seeking Federal HIT Grant. The California Department of Health Services (DHS) indicates that it is applying for a grant under the federal Deficit Reduction Act to help develop the state's HIT capabilities. The department indicates that, with assistance from CalRHIO, it sought $11 million over two years to support a pilot project for certain community clinics and hospital emergency rooms serving Medi-Cal patients in three selected areas of the state. This project would grant these providers access through the Internet to the Medi-Cal prescription data held by the pharmaceutical networks SureScripts and RxHub, described above, as well as diagnostic laboratory data. The DHS did not receive any funds in the first round of grant awards, announced in January, but can apply for a second round of funding to be awarded later in 2007.

State Legislature Has Considered Several HIT Bills. Lawmakers considered several HIT bills during the 2005-06 legislative session, including one that was signed into law.

Chapter 698, Statutes of 2006 (AB 225, Negrete McLeod) conforms state statute to federal law by establishing safe harbors for the sharing of electronic prescribing technology between certain health care providers. These provisions would be limited to drugs covered under Medicare Part D, the prescription drug benefit for Medicare participants.

Other measures that were considered but not approved by the Legislature were:

- ***SB 1338 (Alquist)***—Would have required the California Health and Human Services Agency, in conjunction with certain other state departments, to develop a strategic plan to foster the adoption of HIT. This plan would have included, among other provisions, HIT standards and identifying incentives to promote the use of EHRs and PHRs.

- ***SB 1672 (Maldonado)***—Would have established a low-interest loan program to assist nonprofit healthcare organizations in purchasing HIT. The loan program would have been administered by the California Health Facilities Financing Authority

- ***AB 1672 (Nation, Richman)***—In an early version, would have established deadlines for various health care entities to adopt EHRs, provided enhanced Medi-Cal reimbursement for EHR adoption, and provided state funding to promote HIT development.

CalPERS Considering HIT Issues. This system purchases health care for more than 1.2 million state and local government employees, or about 4 percent of insured Californians. Annual health care premiums for CalPERS members total $4.3 billion. Discussions with CalPERS staff indicate that it has begun to consider means by which it could help its members benefit from HIT, but at this stage it has not developed any specific strategies to do so.

Medi-Cal Would Likely Benefit From HIE. Currently, the Medi-Cal Program does not include any mechanisms to directly finance or encourage its network of medical providers to undertake HIE efforts. Our review of the benefits of HIE indicates that Medi-Cal, California's version of the Medicaid program, would benefit significantly from the broad development of HIE networks. Roughly 70 percent of its costs to the state are for fee-for-service care, in which beneficiaries may seek care from Medi-Cal providers of their choosing with no coordination through a primary care physician. Fee-for-service thus has a high potential for duplicative testing and poor access to patients' health history among different providers. The point-of-care access to health information available through RHIOs could equip physicians to provider better care while eliminating the need for Medi-Cal beneficiaries to repeatedly complete medical paperwork. Savings to the state would be possible across a variety of services, including hospital inpatient and outpatient, pharmacy, laboratory, and disease management services. For example, a reduction in Medi-Cal's average hospital stay of 15 percent, or one-half the 30 percent reduction in length-of-stay in the Brooklyn hospital example noted previously, would generate General Fund savings of nearly $300 million annually. If certain other savings results could be replicated by the program, savings or cost avoidance to state health programs could eventually reach the hundreds of millions of dollars annually.

Other State Programs Also Stand to Benefit. In addition to Medi-Cal, the state provides health care and related services through several other programs that would likely benefit from widespread HIT adoption. For example, the Healthy Families Program, operated by the Managed Risk Medical Insurance Board (MRMIB) contracts with various health care plans to provide coverage for over 800,000 low-income children. The state Department of Mental Health (DMH) provides for the delivery of mental health services through a state-county partnership: A broad array of treatment and rehabilitative services are provided for clients with mental illness, and children and youth with serious emotional disturbance. Mentally ill would, in some cases, benefit from the comprehensive approach to health care that would result from enabling mental health care providers to access health data held by their patients' physical health care providers, and vice versa. Additionally, access to EMRs could help reduce health care costs for the California Department of Corrections and Rehabilitation (CDCR), whose inmates transfer from receiving care in the private sector to the prison system often with delayed access to medication history and other information.

Recommended Strategies to Promote HIT Adoption

Adoption of HIT has demonstrated benefits to health care quality and efficiency within numerous individual organizations, and the broad exchange of health information through RHIOs promises additional improvements. Although risks accompany HIT implementation efforts, our review indicates that Medi-Cal and CalPERS would likely benefit eventually from the broad development of RHIOs and HIE around the state.

However, it remains unclear which specific HIT systems and approaches will ultimately improve the quality of health care and prove to be cost-effective. Given this situation, we recommend that the state's role, at this time, be to support the development of HIT in the state without imposing restrictions that prematurely promote the development of particular technologies or products, instead leaving those matters to be resolved by competition in the HIT marketplace. For this reason, we also recommend, at this time, against requiring health care providers to adopt HIT in order to participate in the state's major health care programs, such as Medi-Cal or CalPERS. Doing so at this early stage creates a risk that the state might discourage providers from continuing to participate in Medi-Cal or force them to undertake HIT projects that might prove unsuccessful.

We believe a better approach for the state now is to provide incentives to encourage voluntary expansion and experimentation with HIT within California generally and within the state's major health care programs. We believe such a voluntary approach would work in partnership with health care providers and would involve less risk to the state. Should policies to encourage voluntary HIT adoption eventually prove to be insufficient, the Legislature could consider additional policies at a later date. These could include mandating that providers share their health care data with an available local HIE organization or adopting selected data-sharing formats and requiring their use by providers in the state's major health care programs.

Below we outline more specific strategies for the Legislature to consider that are consistent with the approach discussed previously to foster the development and expansion of HIT within California.

Financing HIT Development

As discussed earlier, financing is a major obstacle for health care organizations interested in adopting EHRs. Smaller medical practices in particular tend to lack the funding to purchase EHRs and the operational flexibility to make the transition to operating an EHR system. Our analysis indicates that Medi-Cal and other state health programs could be used as vehicles to support HIT development through a combination of loans, grants, training, and innovative reimbursement methods. Given the General Fund shortfall facing the state over the next few years, the state should first seek funding sources other than the General Fund to support these strategies, as we discuss further below. For instance, although the UnitedHealth funds are not under direct legislative control at this time, the Legislature could pass legislation directing CDI and DMHC how to proceed in their roles as advisors to UnitedHealth on the use of those funds.

Establish Loan Program for Medi-Cal Providers. In our view, SB 1672 (Maldonado), considered but not passed during the 2005-06 legislative session, offers a sound approach for using low-interest loans to reduce EHR acquisition costs for health care providers. As proposed in SB 1672, these loans would come from an existing revolving fund operated by the California Health Facilities Financing Authority (CHFFA). Thus, additional state General Fund resources would not be needed for such a program. The CHFFA reports that the balance available for loans through a similar existing loan program had grown to $22 million as of November 2006.

The state should target HIT loans to Medi-Cal providers under a selected size in order to serve those least able to obtain financing on their own. Appropriate limits on the size of loans would help to manage the size of the program. Also, loans should be limited to a certain set percentage of the acquisition costs and first-year service costs of the EHR package (perhaps two-thirds of the total) in order to ensure that only committed providers obtain loans. We recommend that any such loan program be limited to financing of HIT systems that would be widely interoperable and meet standards or product certification to ensure this result. Some portion of the $200 million pool of UnitedHealth funds allotted for investment purposes may also be available for this purpose, depending on UnitedHealth's investment criteria.

Create New Medi-Cal HIT Reimbursement Methods. Physicians who implemented EHRs have reported significant disruptions to work processes and patient volumes during transition to the new systems, resulting in loss of revenue. In order to mitigate the one-time financial burden associated with the transition to new HIT systems, we recommend that the Legislature authorize Medi-Cal to establish short-term rate augmentations to reimburse providers for HIT implementation activities. Under this method, providers that implement targeted HIT capabilities, such as eRx or electronic sharing of laboratory results, would receive a certain percentage increase in the rates paid for selected services. We recommend that these increased reimbursement rates be available only to providers that meet certain minimum requirements, similar to those discussed previously for loans.

By compensating providers for HIT adoption through Medi-Cal billing rates, the state would obtain Medi-Cal's standard dollar-for-dollar federal funding match, which would not likely be available by using the funds for grants. A portion of the $40 million in UnitedHealth funds could be transferred to the General Fund to provide the state match necessary to draw down the federal funds.

Provide Grants for RHIO Development. Significant benefits from HIT will only be realized once communities of health care providers in a region enable broad and efficient sharing of patient information. Accordingly, we recommend that the Legislature establish a program to provide one-time grants to organizations seeking to develop RHIOs or other forms of HIE. Several features of a grant program operated by the State of Florida would appear likely to benefit California. Florida provides such grants only to projects that agree to establish HIE between at least two competing provider organizations. Florida also requires a 50 percent funding match by the grantee, which would ensure that the grantees were invested in the success of the project. A portion of the $40 million pool of UnitedHealth funds available for grants could be employed in this manner, and it may be possible to obtain federal grant funds for this purpose as well.

Develop Training Opportunities for Providers. The lack of resources and experience to support a HIT implementation project can be a significant obstacle for providers, particularly smaller providers who tend to lack dedicated information technology staff. Training in the use of EHRs could help to reduce this challenge. As noted earlier, the California nonprofit organization Lumetra provides free EHR training to Medicare providers as part of its federal contract. While Medi-Cal providers are likely to also serve Medicare patients, Lumetra's program is limited to a few hundred physician practices and is already at capacity. Additionally, the American Medical Informatics Association, a nonprofit organization that promotes the use of health technology, has established partnerships with universities to provide short-term Internet-based training courses in HIT. We recommend that the state establish a contract with organizations such as these that would be targeted at Medi-Cal providers in smaller practices. A portion of the $40 million pool of UnitedHealth funds available for grants could be used for this purpose, and federal grant funds may be available as well.

Employ State's Purchasing Power To Promote HIT Development

The state could use its influence as a significant purchaser of health care services to promote the use of HIT.

Seek HIT Marketplace Discounts for Medi-Cal Providers. As a further means to reduce the financial barriers to HIT adoption, particularly among small providers, we recommend that the Legislature direct Medi-Cal to seek bulk discounts on EHR products for its providers. Medi-Cal provides health care for 6.6 million beneficiaries, or 22 percent of Californians with health coverage. Using its power in the health care marketplace, the state could obtain significant discounts for individual medical practices that otherwise would be left paying full price for new HIT systems.

In order to avoid "picking a winner" among the HIT marketplace competitors, the state should seek discount commitments from a range of vendors, all of whom would need to meet certain thresholds for data interoperability. Medi-Cal providers would still purchase HIT tools directly from vendors; the key role for the Medi-Cal Program is to negotiate on their behalf. Our proposed approach allows the state to reduce some of the fiscal barriers to HIT adoption without directly spending its own funds.

Monitor HIT Activities of CalPERS. The CalPERS represents another opportunity for the state to use its influence in the marketplace to promote the development and expansion of HIT systems. Specifically, we recommend that the Legislature require CalPERS to report by May 1, 2008, on its efforts with respect to HIT and on the costs and efficacy of requiring its contracting health plans to make PHRs available to CalPERS members.

Additionally, the Legislature should eventually require health plans contracting with CalPERS to make PHRs and EHRs available to CalPERS members and to participate in RHIOs where available. A recently proposed (but not enacted) bill in Congress, H.R. 4859, would require plans contracting with the Federal Employees Health Benefits Program (the federal equivalent of CalPERS) to make EHRs and PHRs available to their members. House Resolution 4859 would also require these contracting health plans to establish incentives for their health care providers to adopt EHRs, subject to the availability of federal grant funds for that purpose. Initially, however, for the reasons discussed previously, we recommend a voluntary approach that encourages, rather than requires, such actions by health care plans.

Adopt Policy Coordination Role

The HIT marketplace continues to develop at a rapid pace, and the efforts to establish HIE networks still have not demonstrated which are the best and most sustainable operating models for sharing health information. In order to maintain a state HIT policy that can adapt to possible marketplace innovations, we recommend that the state take an active role in partnership with the private sector to coordinate HIT policy.

Establish Advisory Body. First, we recommend that the Legislature enact legislation to expand CalOHI's role to include leadership of an ongoing public-private body to assess the progress of RHIO development in the state and make recommendations for additional actions to coordinate data sharing efforts. Such a body could play a role similar to that proposed by SB 1338 for the California Health and Human Services Agency, which would have led a stakeholder group in developing a strategic plan to promote HIT adoption in California. This new role should also include assessing how DMH, MRMIB, and CDCR might incorporate HIT.

This advisory body should represent the interests of various stakeholders in the health care community. As noted earlier in this report, CalOHI and CalRHIO have been collaborating on a federally funded project to evaluate the effect of state laws on the development of HIT. CalOHI, which is an office within the California Health and Human Services Agency, should be tasked with leading the ongoing advisory body, which should also include representatives from DMHC, CDI, DHS, DMH, MRMIB, and CDCR. Private-sector members should include CalRHIO, and additional members could be drawn from the Governor's eHealth Action Forum or from the nonprofit organizations that have shown leadership in HIT. Our discussions with stakeholders indicate that the independence of such a group would be important in encouraging acceptance and participation by private sector stakeholders.

We recommend that the Legislature direct the advisory body to include on its agenda, potential future actions the state could take if a voluntary approach to RHIO development proves to be ineffective. Our review indicates that at some point, in the absence of reasonable progress, it could become necessary to take other steps. These could include requiring health care providers to share data with available RHIOs or assessing charges on private health care plans and health insurers in order to finance some of the costs to operate a common health information network. The advisory body should evaluate how long the state should allow the private sector before taking a more proactive role.

Remove Possible Statutory Barriers to HIT Adoption. We also recommend that the Legislature direct the new advisory body to review various antikickback and consumer protection laws in California and to recommend any revisions that would be warranted to foster the development of HIT. In considering changes to the law, this review should seek to balance the privacy protections now provided to consumers by existing statute against the consumer benefits that could result from the more widespread use of HIT systems.

Our review indicates that there is merit in evaluating and possibly updating some of these laws to reflect new uses of information in HIT systems. As noted previously, Chapter 698 conforms California law to federal eRx rules to accommodate HIT. However, additional technologies and practices could require additional statutory changes. The findings stemming from the joint research project by CalRHIO and CalOHI should provide information on additional ways that the Legislature can revise current statutes for HIT to remove barriers to the development of HIT without undermining appropriate consumer protection laws.

Conclusion

In this report, we have outlined basic HIT concepts and how they can work to improve the quality and efficiency of health care in California. Our analysis indicates that various financial and organizational barriers are impeding broader implementation of HIT. Even so, a number of HIE efforts have developed around the country and in California. The results to date indicate that these efforts offer promise to improve the quality of health care and reduce health care costs.

The federal government and some state governments have begun to take various steps to further promote such HIE endeavors. We recommend that the Legislature also take steps now to encourage the development and expansion of HIT in California. Figure 4 summarizes our recommendations, which could be implemented individually or as a package.

Figure 4

Summary of LAO Recommendations

✓ **Seek Non-General Fund Resources to Promote Health Information Technology (HIT) Adoption**

- Establish low-interest loan program to assist Medi-Cal providers with the costs of HIT systems.
- Create new Medi-Cal reimbursement policies that compensate providers on a limited-term basis for transitioning to electronic health records (EHR)-based operations.
- Establish grant program to support the development of regional health information organizations in the state.
- Set up a contract to provide training opportunities for Medi-Cal practitioners to prepare them for the implementation of HIT in their practices.

✓ **Use the State's Health Care Purchasing Power to Encourage EHR Adoption**

- Authorize Medi-Cal to negotiate with HIT vendors to obtain discounted prices for Medi-Cal care providers on EHRs that meet selected criteria.
- Require the California Public Employees' Retirement System (CalPERS) to report on its activities to develop EHRs for its members and the costs of requiring health plans that contract with CalPERS to promote the availability of EHRs for their members.

✓ **Promote Policy Coordination Role**

- Authorize the California Office of HIPAA Implementation to lead a public-private advisory body to coordinate state HIT policy with health care stakeholders.
- Require the new advisory body to recommend changes to state privacy laws and other health care statutes that would remove impediments to HIT adoption while maintaining consumer protections.

Appendix: Glossary of Acronyms

AHIC (American Health Information Community)—A federally chartered advisory body that provides recommendations to HHS regarding how to make health records electronic and interoperable.

AHRQ (U.S. Agency for Healthcare Research and Quality)—An agency within the HHS that operates various research programs aimed at improving the nation's health care.

CalOHI (California Office of HIPAA Implementation)—State body that operates within the California Health and Human Services Agency and is responsible for coordinating the state's efforts to implement HIPAA.

CalPERS (California Public Employees' Retirement System)—State agency responsible for administering retirement and health benefits for state employees and retirees.

CalRHIO (California Regional Health Information Organization)—A non-profit organization seeking to develop health information exchange and regional health information organizations in California primarily through coordination, research, and education.

CCHIT (Certification Commission for Health Information Technology)—A voluntary organization created by three health technology organizations to verify that various health information products meet certain standards.

CDCR (California Department of Corrections and Rehabilitation)—State department responsible for operating the state prison system.

CDI (California Department of Insurance)—California state department responsible for regulating and overseeing insurance companies.

CHCF (California HealthCare Foundation)—An independent philanthropy whose goal is to improve health care delivery and financing in California.

CHFFA (California Health Facilities Financing Authority)—Entity within the State Treasurer's Office that manages several health care financing programs.

CMS (Centers for Medicare and Medicaid Services)—Federal agency responsible for administering the Medicare and Medicaid programs.

CPOE (Computerized Physician Order Entry)—Clinical health information technology tools that physicians and other providers can use to enter orders, such as prescription drugs or laboratory tests, into a computer system for further patient action.

DHS	(Department of Health Services)—California state department responsible for administering a variety of public health and health care programs, including management of the Medi-Cal Program. As of July 2007, DHS will split into the Department of Health Care Services and the Department of Public Health.
DMH	(Department of Mental Health)—California state department responsible for overseeing or providing care for mentally ill children an adults.
DMHC	(Department of Managed Health Care)—California state department responsible for overseeing and regulating health care service plans.
eHI	(eHealth Initiative)—A national nonprofit organization whose mission is to improve the quality, safety, and efficiency of health care through information and information technology.
EHR	(Electronic Health Record)—Electronically stored information about an individual's health history, treatments, and other related information held by a health care provider.
eRx	(Electronic Prescribing)—Use of electronic devices to create, process, and communicate prescriptions for medication.
GAO	(Government Accountability Office)—Nonpartisan Congressional organization responsible for evaluating the programs and expenditures of the federal government.
HHS	(U.S. Department of Health and Human Services)—Federal agency responsible for administering a wide variety of health programs, including other federal departments such as the Centers for Medicare and Medicaid Services.
HIE	(Health Information Exchange)—Electronic communication of health information over a network between separate health care entities, such as between a physician's office and a medical laboratory.
HIPAA	(Health Information Portability and Accountability Act)—A 1996 federal law that establishes a variety of standards for the security and privacy of health care information.
HIT	(Health Information Technology)—Any of a variety of information technologies that health care organizations can use to generate, process, and exchange health information during the delivery and administration of health care.
Medi-Cal	California's version of the federal Medicaid program, which provides health insurance to low-income persons.

ONCHIT	(Office of the National Coordinator for Health Information Technology)—An office established within the HHS to oversee the federal government's policies for promoting health information technology.
PHR	(Personal Health Record)—Electronically stored information similar to electronic health records but often maintained by an individual and limited to information on the individual's health conditions and treatment history.
RHIO	(Regional Health Information Organization)—A group of health care entities in which the members typically establish (1) an electronic network for communicating multiple types of health information using standardized information formats and transmission conventions, and (2) rules governing various aspects of the group's operation, including financing.
SBCCDE	(Santa Barbara County Care Data Exchange)—A regional health information organization launched in Santa Barbara County in the late 1990s.
VA	(U.S. Department of Veterans' Affairs)—Federal agency responsible for administering a variety of programs for veterans and their families.