# California Spending Plan 2004-05

## The Budget Act and Related Legislation


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Chapter 1

# The 2004-05 Budget—The Problem and The Solution

## Background

The basic challenge confronting lawmakers in crafting a 2004-05 budget was finding a way to once again close a large budget shortfall, which had plagued the state since 2001-02 when expenditures exceeded revenues due to a revenue plunge. At the beginning of the 2004-05 budget cycle—and subsequent to the new Governor's decision to roll back the statutorily triggered vehicle license fee (VLF) increase—we estimated the budget gap to be roughly $15 billion in 2004-05 and beyond, absent corrective actions (see Figure 1 next page). While in subsequent months there were numerous changes to the underlying revenue and expenditure estimates on which this gap estimate was based, the final budget dealt with a 2004-05 shortfall of approximately that same magnitude.

In this chapter, we (1) discuss the factors behind the 2004-05 shortfall, (2) highlight the major budget solutions included in the 2004-05 budget package, and (3) provide initial comments on how the actions taken in the 2004-05 budget will affect the outlook for 2005-06 and beyond.

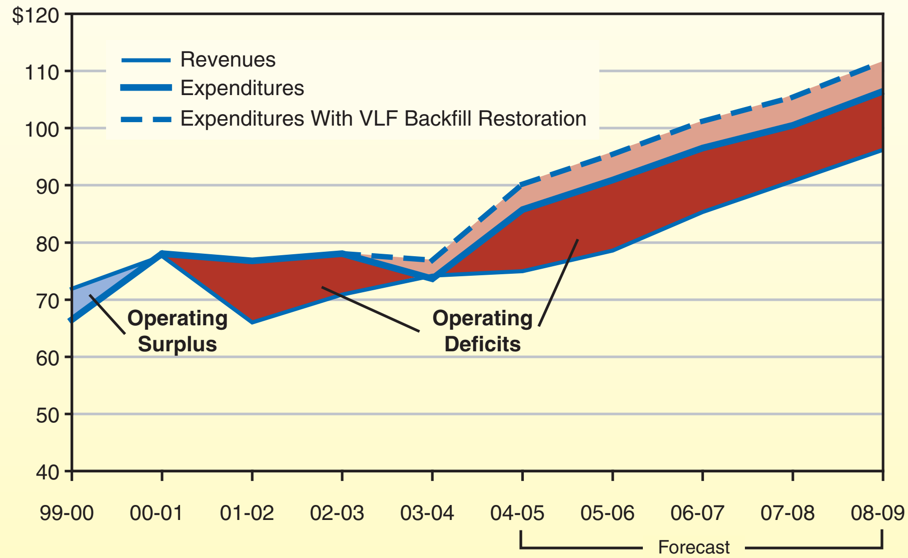
## Factors Behind 2004-05 Shortfall

***2003-04 Budget.*** One year earlier in the 2003-04 budget, the Governor and Legislature had temporarily closed a major cumulative budget shortfall—estimated to be over $30 billion—primarily through substantial borrowing, an assumed triggered increase in the VLF, and program savings. While the plan had a projected reserve of over $2 billion for 2003-04, its heavy reliance on borrowing and other one-time solutions meant that the structural operating shortfall (revenues minus expenditures) was destined to return in 2004-05. At the time of the budget's passage, our office estimated the operating shortfall would be over $10 billion per year even if all of the 2003-04 budget's assumptions held and revenues grew at a moderate pace.

Figure 1

## LAO November 2003 Projection of Revenues and Expenditures

*General Fund (In Billions)*




A key element of the 2003-04 budget was the authorization of a deficit financing bond. The proceeds of this bond were to be used to eliminate the 2002-03 year-end deficit, which at the time was estimated to be $10.7 billion. (In subsequent months, the estimate of the 2002-03 deficit declined, and the maximum amount of bonds authorized to be sold correspondingly fell to $8.6 billion.) Repayment of the bond was tied to one-half cent of the sales tax, and would have cost the General Fund about $2.4 billion annually for about five years beginning in 2004-05.

***Post 2003-04 Budget Developments.*** Following the adoption of the 2003-04 budget, the projected 2004-05 budget shortfall expanded, mainly as the result of two factors:

- First, following the recall election in October 2003, the new administration took office in November and immediately rolled back the statutorily triggered VLF increase which had been assumed as part of the 2003-04 budget. This action resulted in added General Fund costs to replace local revenue losses totaling $2.6 billion in 2003-04 and $4 billion in 2004-05.

- Second, some of the solutions in the 2003-04 budget were adversely affected by court decisions relating to pension obligation bonds and Medi-Cal provider rates.

Although these factors were partly offset by an improving revenue picture, the cumulative shortfall facing policymakers in 2004-05 had climbed to about $17 billion by the time the new budget was introduced in January 2004. This gap consisted of a roughly $2 billion year-end shortfall in the 2003-04 budget and a $15 billion ongoing operating shortfall in 2004-05. Further improvements in the revenue picture between late 2003 and mid-2004 narrowed the gap some. However, the final 2004-05 budget still had to deal with a projected shortfall of roughly $15 billion.

## Budget Solution—Key Components

The budget signed by the Governor on July 31, 2004 contained about $16.1 billion in combined two-year solutions. These solutions enabled the state to eliminate the budget shortfall projected for 2004-05 and build up a modest year-end reserve of $768 million. As shown in Figure 2, these solutions can be divided into six categories—namely, (1) program savings, (2) the use of Proposition 57 bonds, (3) other loans and borrowing, (4) fund shifts, (5) increased revenues and transfers, and (6) diversions of local property taxes.

**Figure 2**

**Allocation of 2004-05 Budget Solutions**

*(In Billions)*

| | 2003-04 | 2004-05 | Two-Year Total |
|---|---|---|---|
| Program savings | $0.4 | $3.4 | $3.8 |
| Proposition 57 bond: | | | |
| Larger proceeds | 0.7 | 2.0 | 2.7 |
| Reduced debt service | | 1.2 | 1.2 |
| Other loans and borrowing | 1.6 | 1.9 | 3.5 |
| Fund shifts | 0.1 | 1.7 | 1.8 |
| Increased revenues, transfers | 0.2 | 1.6 | 1.8 |
| Diversion of property taxes | — | 1.3 | 1.3 |
| **Totals** | **$3.0** | **$13.1** | **$16.1** |

***Program Savings.*** The budget includes about $3.8 billion in program savings. Over half the total is related to a reduction in K-14 education spending related to the suspension of Proposition 98. Other savings include three-month delays in cost-of-living adjustments for California Work Opportunity and Responsibility to Kids and Supplemental Security Income/ State Supplementary Payment grants, reductions in institutional support for the University of California (UC) and California State University (CSU), and unallocated reductions in state operations spending.

***Proposition 57 Bond.*** In December 2003, the Governor and Legislature placed on the March 2004 ballot two measures—namely, Proposition 57, which authorized up to $15 billion in deficit financing bonds, and Proposition 58, which put in the State Constitution an annual budget reserve requirement, an expanded balanced budget requirement, and a prohibition against deficit borrowing in the future. The Proposition 57 bond proceeds were proposed to be used in place of the deficit bond that had been authorized in the 2003-04 budget, and which was being challenged in court. Following voter approval of Propositions 57 and 58, the state sold $11.3 billion in deficit bonds to help with the budget, leaving approximately $3.5 billion in additional bonds available for 2005-06 and subsequent years. Relative to the previously authorized bonds, the Proposition 57 bonds benefited the General Fund in the following two ways:

- ***Higher Borrowing Amounts.*** The $11.3 billion in bonds sold this year was $2.7 billion more than the $8.6 billion that would have been allowed by the previously authorized statutory bond.

- ***Lower Initial Debt-Service Payments.*** As noted above, the repayment of the previously authorized statutory bonds would have been based on the diversion of one-half cent of the sales tax, costing the General Fund about $2.4 billion annually for roughly five years. In contrast, repayment of the Proposition 57 bonds is based on the diversion of one-quarter cent of the sales tax for up to 14 years, for a savings of $1.2 billion in 2004-05.

***Other Loans and Borrowing.*** This category accounts for $3.5 billion in solutions. It includes $929 million related to the use of proceeds from the sale of a pension obligation bond to offset payments to the Public Employees' Retirement System. It also includes a "settle-up loan" of over $1.2 billion related to 2003-04 and prior-year obligations to Proposition 98 education, and a Proposition 42 loan of $1.2 billion from transportation funds.

***Fund Shifts.*** This category totals $1.8 billion, and includes numerous funding redirections and fee increases. It includes $366 million related to increased higher education fees, which are used to offset General Fund support for UC, CSU, and California Community Colleges. It also includes $450 million related to a new law change requiring that 75 percent of court-related punitive damage awards be allocated the state. The budget assumes that these funds will be used to offset General Fund costs for state programs. Finally, this category includes $216 million related to a federal waiver allowing federal financial participation of the state's current state-only In-Home Supportive Services cases.

***Increased Revenues and Transfers.*** This category includes $1.8 billion in total solutions. It includes targeted tax increases related to a two-year suspension of the teachers' tax credit ($210 million) and a two-year rule change related to the use tax on out-of-state purchases of certain large items such as yachts and airplanes ($26 million). It also includes $333 million from a two-month tax amnesty program beginning in the spring of 2005. The budget also includes various transfers from state transportation funds to the General Fund.

***Diversion of Local Property Taxes.*** The budget includes a $1.3 billion annual diversion of local property tax revenues for the benefit of the General Fund in 2004-05 and 2005-06. This diversion is part of a broader agreement that places limits on future state diversions of certain local taxes and "swaps" VLF backfill payments and property taxes.

### Budget Agreements

The final budget includes agreements with K-12 education and local governments. We discuss the detail of these agreements in Chapter 4. However, one element these agreements have in common is a fiscal trade-off. Each entity concedes something in 2004-05—a smaller funding increase in the case of education and a diversion of property taxes in the case of local governments—in return for funding restorations and other commitments in future years.

## Budget Gap to Re-Emerge in 2005-06

The 2004-05 budget includes significant ongoing savings and it makes some progress toward resolving the state's ongoing structural budget shortfall. Nevertheless, like the two prior budgets, the current spending plan (1) contains a significant number of one-time or limited-term solutions and (2) obligates additional spending in future years. As shown in Figure 3 (see next page), major one-time savings include: the use of $2 billion in Proposition 57 bonds to support 2004-05 General Fund program spending, $929 million due to the sale of a pension obligation bond, the deferral of $1.2 billion in Proposition 42 transportation spending, and the postponement of local government mandate payments ($200 million) bringing the total of deferred reimbursements to $1.5 billion. In addition, the savings related to the $1.3 billion diversion of local property taxes and the suspension of the teachers' tax credit will expire after two years. Figure 3 also shows that deferred out-year costs associated with actions taken in 2004-05 and prior-year budgets include: Proposition 98 settle-up payments, Proposition 42 loan repayments, and repayment of the VLF "gap" loan from local governments. (The 2004-05 budget does include early repayment of a $1.4 billion loan from the Traffic Congestion Relief Fund, mostly financed by a tribal gaming bond.)

The combination of these factors suggests that state will continue to face out-year budget shortfalls, absent corrective action. Based on the May Revision budget plan, we had previously estimated these out-year shortfalls to be in the range of $6 billion in 2005-06 and $8 billion in 2006-07. The final actions on the budget—which raised ongoing spending commitments relative to the May Revision in several areas—will likely add to these out-year projected shortfalls. While the remaining Proposition 57 bond authority (about $3.5 billion) is available to offset some of these shortfalls, it appears that substantial additional actions will be needed to bring future budgets into balance. We will be updating our projections of out-year budget shortfalls to reflect both the final budget actions and current economic and revenue developments in our annual publication entitled *California's Fiscal Outlook*, scheduled to be released in November 2004.

**Figure 3**

**Key Factors Contributing to Future Operating Shortfalls**

**Limited-Term Solutions in 2004-05 Budget**

- Deficit bonds ($2 billion)
- Pension bond ($929 million)
- Proposition 42 loan ($1.2 billion)
- Diversion of local property taxes ($1.3 billion annually for two years)
- Suspension of teachers' tax credit (about $200 million annually for two years)
- Postponement of local mandate payments (about $200 million)

**Deferred Out-Year Costs**

- Proposition 98 settle-up payments (about $150 million annually beginning in 2006-07)
- Proposition 42 loan repayments ($1.2 billion in 2007-08, $1 billion in 2008-09)
- VLF "gap" loan repayment ($1.3 billion in 2006-07)

Chapter 2

# Key Features of the Budget Act and Related Legislation

## The Budget Totals

### Total State Spending

The state spending plan for 2004-05 includes total expenditures from all funds of $105.4 billion. As indicated in Figure 1, this total includes budgetary spending of $102.4 billion, reflecting $78.7 billion from the General Fund and $23.7 billion from special funds. In addition, spending from selected bond funds totals $3 billion. These bond-fund expenditures reflect the use of bond proceeds on capital outlay projects in 2004-05. The General Fund costs of these outlays, however, involve the associated ongoing principal and interest payments that must be made until the bonds are retired; thus, for budgetary scoring purposes, these costs show up as General Fund debt-service expenditures.

As Figure 1 shows, total state spending falls by a net of $1.9 billion (1.8 percent) between 2003-04 and 2004-05. This consists of a $1 billion (1.3 per-

**Figure 1**

**The 2004-05 Budget Package Total State Expenditures**

*(Dollars in Millions)*

| Fund Type | Actual 2002-03 | Estimated 2003-04 | Enacted 2004-05 | Change From 2003-04 Amount | Change From 2003-04 Percent |
|---|---|---|---|---|---|
| General Fund | $77,482 | $77,633 | $78,681 | $1,047 | 1.3% |
| Special funds | 18,282 | 19,431 | 23,701 | 4,270 | 22.0 |
| **Budget Totals** | **$95,764** | **$97,065** | **$102,382** | **$5,317** | **5.5%** |
| Selected bond funds | $11,015 | 10,249 | 2,995 | -7,253 | -70.8 |
| **Totals** | **$106,779** | **$107,313** | **$105,377** | **-$1,936** | **-1.8%** |

cent) increase for the General Fund, a $4.3 billion (22 percent) increase in special funds, but a $7.3 billion decline in spending from bond funds.

All three components of spending are affected by special factors. As discussed below, the General Fund spending totals are affected by borrowing, accounting changes, and other deferrals taken to balance the budgets in 2003-04 and 2004-05. The major special funds increase includes new spending associated with the repayment of deficit bonds approved by the voters in March 2004. Finally, over half of the decline in bond fund spending in 2004-05 is related to how education bond expenditures are recorded for budgetary purposes. Specifically, K-12 education bonds are shown as expenditures from bond funds when they are allocated to projects by the State Allocation Board. The 2002-03 and 2003-04 spending totals include allocation of most of the bonds approved by voters in the November 2002 election. However, the 2004-05 expenditure totals do not yet include the allocation of bonds approved in the 2004 election.

## The General Fund Condition

Figure 2 summarizes the estimated General Fund condition for 2003-04 and 2004-05 that results from the adopted spending plan.

***2003-04.*** The budget assumes a prior-year balance of $4.2 billion, revenues and deficit bond proceeds totaling $76.5 billion, expenditures of $77.6 bil-

**Figure 2**

**The 2004-05 Budget Package**
**Estimated General Fund Condition**

*(Dollars in Millions)*

| | 2003-04 | 2004-05 | Percent Change |
|---|---|---|---|
| Prior-year fund balance | $4,178 | $3,127 | |
| Revenues and transfers | 74,570 | 77,251 | 3.6% |
| Deficit Financing Bond | 2,012 | — | |
| Total resources available | $80,760 | $80,378 | |
| Expenditures | $75,621 | $80,693 | 6.7% |
| Deficit Recovery Fund transfer | 2,012 | -2,012 | |
| Total expenditures | $77,633 | $78,681 | |
| Ending fund balance | $3,127 | $1,697 | |
| Encumbrances | 929 | 929 | |
| **Reserve** | **$2,198** | **$768** | |
| Proposition 98 | — | ($302) | |
| Non-Proposition 98 | — | ($466) | |

lion, and a year-end balance of $3.1 billion. After setting aside $929 million for encumbrances, 2003-04 ends with a positive reserve of $2.2 billion. The 2003-04 General Fund condition reflects the sale of $11.3 billion in Proposition 57 deficit bonds. About $9.3 billion of the proceeds were used to eliminate the 2002-03 deficit and to build up a reserve. The remaining $2 billion is reflected for accounting purposes as both revenues and expenditures in 2003-04—as the bond proceeds are first placed into the General Fund but then are subsequently transferred back out of the General Fund to a special fund.

***2004-05.*** The budget assumes 2004-05 revenues of $77.3 billion, expenditures of $78.7 billion, and an ending balance of $1.7 billion. After setting aside $929 million for encumbrances, the budget reflects a reserve of $768 million. Of the reserve total, $302 million is designated for Proposition 98 purposes, and the remaining $466 million is available for any General Fund purpose.

## Programmatic Spending in 2004-05

As indicated in Figure 3, the 1.3 percent increase in 2004-05 General Fund spending is the net result of sharp increases in some programs and sharp

**Figure 3**

**The 2004-05 Budget Package**
**General Fund Spending by Major Program Area**

*(Dollars in Millions)*

| | Actual 2002-03 | Estimated 2003-04 | Enacted 2004-05 | Change From 2003-04 | |
|---|---|---|---|---|---|
| | | | | Amount | Percent |
| K-12 Education | $27,112 | $29,177 | $32,468 | $3,291 | 11.3% |
| Higher Education | | | | | |
| CCC | 2,738 | 2,281 | 3,050 | 769 | 33.7 |
| UC | 3,176 | 2,908 | 2,721 | -187 | -6.4 |
| CSU | 2,698 | 2,630 | 2,448 | -182 | -6.9 |
| Other | 874 | 985 | 1,098 | 113 | 11.5 |
| Health | 14,254 | 14,012 | 16,320 | 2,308 | 16.5 |
| Social Services | 8,806 | 8,957 | 9,147 | 190 | 2.1 |
| Criminal Justice | 7,855 | 7,399 | 8,455 | 1,056 | 14.3 |
| Vehicle License Fee subventions | 3,797 | 2,689 | — | -2,689 | — |
| Deficit Recovery Fund transfer | — | 2,012 | -2,012 | — | — |
| All other | 6,172 | 4,583 | 4,986 | 403 | 8.8 |
| **Totals** | **$77,482** | **$77,634** | **$78,681** | **$1,047** | **1.3%** |

decreases in others. In many areas of the budget, spending totals have been affected by special factors in either or both 2003-04 and 2004-05. For example:

- The local government agreement results in increased General Fund spending for K-12 education and community colleges, and a decrease in vehicle license fee (VLF) subvention payments. A key element of the agreement—a shift of property taxes from schools to other local governments in return for the elimination of General Fund VLF backfill payments—boosts K-12 and community college payments by $2.8 billion (as the redirected property taxes are replaced with General Fund proceeds). This is more-than-offset by a drop in VLF backfill payments in 2004-05, which decline from $4.1 billion to zero.

- The repayment of Proposition 57 bonds also involves a shift of property taxes from schools to local agencies (to replace the quarter-cent sales tax that is diverted from local governments to a special fund created for the bond's repayment). This results in a corresponding increase in state funding for Proposition 98.

- Medi-Cal spending in 2003-04 was reduced on a one-time basis by two key factors: (1) a one-time increase in federal funds for the program, and (2) an accounting change shifting Medi-Cal payments from an accrual to cash basis. These one-time solutions are not available in 2004-05 and therefore General Fund expenditures increase substantially in that year.

- The major increase in criminal justice spending reflects the use of one-time federal flexible assistance grants in 2003-04 to offset $852 million in state spending for the program.

- The transfer of Proposition 57 bond proceeds to a special fund raised General Fund expenditures by $2 billion in 2003-04. Subsequent expenditures from these funds to support General Fund programs resulted in $2 billion in General Fund savings during 2004-05.

- Finally, the "all other" category is affected by (1) a refinancing of certain debt-service payments in 2002-03 and 2003-04, (2) retirement payment savings in 2004-05 associated with the sale of a pension bond, and (3) the use of punitive damage awards to offset General Fund expenses in 2004-05.

After adjusting for these and related special factors, underlying spending on state programs is estimated to grow at about 3 percent between 2003-04 and 2004-05.

## Evolution of the Budget

In this section, we highlight the major developments in the evolution of the 2004-05 budget, beginning with the Governor's November 2003 proposals and ending in late July 2004, when the budget was signed into law.

### November Proposals

After taking office in November 2003, the new Governor called a special session to place a deficit bond issue and a revised spending limit before the voters in March 2004. After several weeks of negotiations, the administration's initial cap proposal was replaced with a measure that (1) restricted future deficit borrowing, (2) required that budgets passed by the Legislature and signed by the Governor be balanced, and (3) required that, beginning in 2006-07, a portion of annual revenues be set aside into a budget stabilization account. In mid-December, the Legislature passed the deficit-bond proposal and the revised companion measure, which were subsequently placed before the voters as Proposition 57 and Proposition 58, respectively. (These measures were subsequently passed by the voters at the March 2004 election.)

The administration also proposed a variety of mid-year budget reductions in health, social services, and other state programs in late November. No action was taken on these measures, however, and many of the mid-year reductions were subsequently incorporated into the Governor's January budget proposal.

### Governor's January Proposal for 2004-05

In January 2004, the Governor proposed a 2004-05 General Fund budget that addressed a shortfall estimated to be about $17 billion. As indicated in Figure 4 (see next page) and discussed below, it proposed widespread spending reductions, borrowing, a diversion of local property taxes for the benefit of the state, and various funding shifts and transfers from transportation funds.

***Program Savings.*** The plan contained about $7 billion in program savings from most areas of the budget. These included:

- A $2 billion reduction in K-12 Proposition 98 spending (accomplished through a suspension of the minimum funding guarantee).

**Figure 4**

**Key Elements of January Budget Proposal for 2004-05**

✓ **Program Savings From Throughout Budget**
- — Significant reductions in education, health, social services, and transportation
- — Many reductions were ongoing in nature

✓ **Local Property Tax Diversion**

✓ **$12.3 Billion in Proposition 57 Bond Proceeds**

✓ **Other Borrowing, Fund Shifts, Transfers, and Loans**
- — Pension bond
- — Redirection of transportation funds

The suspension was part of an agreement between the Governor and the education community.

- About $700 million in General Fund reductions for the public universities (partly offset by student fee increases).

- A $2.5 billion reduction in health and social services programs. Key proposals included (1) eliminating social services cost-of-living adjustments, (2) imposing a 5 percent reduction in California Work Opportunity and Responsibility to Kids (CalWORKs) grants, (3) imposing a 10 percent reduction in Medi-Cal rates for certain providers, (4) eliminating the in-home supportive services (IHSS) state-only "residual" program, (5) reducing IHSS provider wages, (6) establishing co-payments and standardizing services in developmental services programs, and (7) creating enrollment caps and block grants for certain health and social services programs.

- A $1.2 billion reduction in transportation funding related to the suspension of the Proposition 42 transfer.

- A $400 million unallocated reduction to corrections.

***Proposition 57 Bonds***. The budget also assumed $12.3 billion in proceeds from Proposition 57 bonds, which were proposed to be used in place of the $10.7 billion of statutory bonds that had been authorized in the 2003-04 budget. These previously authorized bonds were facing legal challenges at the time.

***Other Proposals***. The budget's other proposals included: (1) an ongoing $1.3 billion shift of local property taxes from local governments to the benefit of the state; (2) a shift of about $685 million in transportation funds to the General Fund; and (3) a deferral of $1 billion in "settle-up" obligations to Proposition 98 attributable to 2003-04 and prior years. It also proposed significant CalWORKs reforms involving stricter work requirements and greater sanctions, and significant K-12 spending reforms relating to categorical funding.

## May Revision

The May Revision reflected an over-$3 billion increase in available total resources, which it proposed to use to (1) scale back many of the budget reductions proposed in health and transportation, and (2) lower the amount of Proposition 57 bonds used in the 2004-05 budget.

***Improved Revenue Picture.*** The revenue picture improved by about $3.3 billion between January and mid-May, when the Governor released his revised spending plan for 2004-05. The improvement was related to (1) approximately $1.3 billion from stronger-than-expected revenues from an abusive tax shelter amnesty program (2) another $1 billion from an accounting change resulting in accruals of additional revenues, and (3) a $1.3 billion increase in the revenue outlook for the 2003-04 and 2004-05 fiscal years combined.

***Spending Restorations.*** As indicated in Figure 5 (see next page), the Governor used the additional projected revenue proceeds to partially restore reductions that had been proposed in the areas of health, social services, transportation, and education spending and reduced reliance on deficit bonds. Specifically, the administration:

- Dropped the January proposals to eliminate the IHSS state-only residual program, and instead pursued a federal waiver that would result in federal participation in the program.

- Rescinded the proposals to (1) reduce Medi-Cal provider rates by 10 percent, and (2) establish enrollment caps and block grants for various health and social services programs.

- Reduced planned sales of Proposition 57 bonds by $1 billion (from $12.3 billion to $11.3 billion). This preserves a like amount of bonding authority to cover spending in 2005-06 and beyond.

**Figure 5**

**May Revision: Key Changes From January Proposal For 2004-05**

✓ **Spending Restorations in Health and Social Services**
- — Eliminated proposals for provider rate cuts and enrollment caps
- — Restored funding for IHSS residual program, sought federal waiver

✓ **New Proposals**
- — Employee compensation reductions
- — Punitive damage award payments to state
- — Dedication of tribal gaming bond proceeds to transportation loan repayment

✓ **New Agreements**
- — Local government, including limit on property tax diversion to two years
- — UC and CSU compacts

In other areas, the administration eliminated proposals to transfer transportation funds to the General Fund and modified the proposal to suspend Proposition 42 payments. Under the revised plan, the Proposition 42 suspension was replaced by a "loan" from transportation funds. In effect, the amount owed to transportation, along with interest, was proposed to be deferred until 2007-08.

The budget also replaced the $400 million unallocated reduction in corrections primarily with a proposed reduction in employment compensation through renegotiation of existing collective bargaining agreements with correctional officers and other state employees. The administration proposed a law change requiring that 75 percent of court-ordered punitive damage awards be directed to the state's General Fund. Finally, the administration stated its intent that proceeds from bonds related to prospective tribal gaming agreements would be used to repay the loans from the Traffic Congestion Relief Fund (TCRF).

***New Agreements.*** The May Revision embodied the Governor's agreement reached in the spring with local governments, and a compact with University of California (UC) and California State University (CSU). Under the local government agreement, the ongoing $1.3 billion annual property tax shift proposed in January was limited to two years. The agreement also included a complex swap of VLF "backfill" revenues for school district property taxes. In addition, the Legislature was asked to place before the statewide voters in November a constitutional amendment. This amendment would restrict the state's authority to: (1) reduce noneducation local government taxes, except for the $1.3 billion shift of property taxes from these agencies for the benefit of the state budget in 2004-05 and 2005-06 and (2) impose mandates without providing annual reimbursements.

Under the compact with higher education, UC and CSU would receive future funding increases for base support and enrollment increases. The compact also calls for annual increases in student fees, which would be retained by the segments. Finally, it commits the segments to provide annual reports on a variety of activities and outcomes.

## Final Budget

Following the May Revision, the Conference Committee met to reconcile the budget differences of the two houses. Following conference actions and approximately six weeks of negotiations between the Governor and legislative leadership, an agreement was reached in late July. The budget was passed by the Assembly on July 28 and the Senate on July 29. After using his line-item veto authority to delete about $116 million ($80 million General Fund) in spending, the budget was signed by the Governor on July 31, 2004.

***Comparison to the May Revision***. As indicated in Figure 6, the final budget package includes several key provisions from the Governor's May

**Figure 6**

**Final Budget: Comparison to May Revision for 2004-05**

✓ **Key Similarities**

- K-12 education funding
- Higher education fee increases
- Local government agreement, including property tax diversion
- Transportation funding
- Proposition 57 bond amounts and pension bonds
- Punitive damage award payments to state

✓ **Key Differences**

- Targeted restorations for higher education
- CalWorks and SSI/SSP COLAs delayed instead of suspended
- CalWorks grant reduction rejected
- Most employee compensation funding restored
- Teachers' tax credit suspended

Revision. It provides for a two-year $1.3 billion diversion of property taxes and incorporates most of the Governor's earlier agreement with local governments. It includes a roughly $2 billion reduction in Proposition 98 funding relative to the minimum guarantee, and significant fee increases in higher education. It contains the May Revision proposals related to court-ordered punitive damage awards and pension obligation bonds, and it assumes the sale of $11.3 billion in Proposition 57 bonds. It also assumes that proceeds from tribal gaming related bond sales will be used to repay a loan from the TCRF.

At the same time, the final budget differs from the Governor's May Revision proposal in several important ways. For example:

- It rejects funding reductions proposed in social services. In the final budget, the May Revision proposal to suspend COLAs for CalWORKs and Supplemental Security Income/ State Supplementary Payment grants is replaced with a three-month delay in the COLA. Also, the 5 percent reduction in CalWORKs grants was not adopted.

- It restores some of the funding proposed by the administration in the areas of higher education, student financial aid, and outreach programs.

- It restores most of the proposed savings related to state employee compensation. The final budget includes more limited savings related to a delay in the previously negotiated pay increase for correctional officers.

- It includes new revenues from a two-year suspension of the teachers' tax credit, an expanded tax amnesty program, and a rule change related to application of the use tax.

- The final budget does not include the categorical reforms proposed for K-12 education, nor does it include most of the welfare reforms proposed for CalWORKs.

## State Appropriations Limit

***Background.*** Article XIII B of the State Constitution places limits on the appropriation of taxes for the state and each of its local entities. Certain appropriations, however, such as for capital outlay and subventions to local governments, are specifically exempted from the state's limit. As modified by Proposition 111 in 1990, Article XIII B requires that any revenues in excess of the limit that are received over a two-year period be split evenly between taxpayer rebates and increased school spending.

***State's Position Relative to Its Limit.*** As a result of the previous sharp decline in revenues, the level of state spending is now well below the spending limit. Specifically, based on the revenue and expenditure estimates incorporated in the 2004-05 budget, state appropriations were $13.7 billion below the limit in 2003-04 and are expected to be $10.6 billion below the limit in 2004-05.

## Budget-Related Legislation

In addition to the *2004-05 Budget Act*, the budget package includes a number of related measures enacted to implement and carry out the budget's provisions. Figure 7 lists these bills.

**Figure 7**

**2004-05 Budget-Related Legislation**

| Bill Number | Chapter | Author | Subject |
|---|---|---|---|
| SB 1096 | 211 | Budget Committee | Local government—vehicle license fee |
| SB 1097 | 225 | Budget Committee | Technology, Trade, and Commerce technical corrections |
| SB 1098 | 212 | Budget Committee | Transportation financing |
| SB 1099 | 210 | Budget Committee | Transportation—Proposition 42 suspension |
| SB 1100 | 226 | Budget Committee | Taxation |
| SB 1101 | 213 | Budget Committee | Education finance—Proposition 98 suspension |
| SB 1102 | 227 | Budget Committee | General government |
| SB 1103 | 228 | Budget Committee | Health |
| SB 1104 | 229 | Budget Committee | Social services |
| SB 1105 | 214 | Budget Committee | Public employee retirement |
| SB 1106 | 215 | Budget Committee | Pension obligation bonds |
| SB 1107 | 230 | Budget Committee | Resources |
| SB 1108 | 216 | Budget Committee | Education finance |
| SB 1110 | 217 | Budget Committee | State employees: state bargaining unit 6 |
| SB 1111 | 218 | Budget Committee | Veterans Affairs |
| SB 1112 | 219 | Budget Committee | State fire protection fee repeal |
| SB 1119 | 209 | Budget Committee | Ballot measures |
| SB 1120 | 220 | Budget Committee | Deficiency bill: 2003-04 budget |
| SB 1448 | 233 | Alpert | Pupil assessment |
| SB 1809 | 221 | Dunn | Labor Code revisions |
| AB 1554 | 263 | Keene | School finance—emergency apportionments and lease financing |
| SCA 4 | 133[a] | Torlakson | Local government constitutional amendment |

[a] Resolution chapter number.

Chapter 3

# Tax-Related Provisions

The *2004-05 Budget Act* resulted in a number of tax-related changes, although no broad-based tax increases were enacted. The increased revenues from these changes include $333 million from a broad tax amnesty, $210 million from the suspension of the teachers' tax credit, and $26 million from a change in the application of the use tax on certain out-of-state purchases. Another major factor that affects the state's revenue position for 2004-05 is the reinstatement of net operating loss (NOL) carryover deductions.

## Tax Amnesty

The adopted budget enacts a tax amnesty program that applies to major General Fund taxes—the personal income tax, corporation tax, and sales and use tax. The amnesty program will occur during the period February 1, 2005 through March 31, 2005, and apply to tax years prior to 2003. The program would allow those taxpayers with unreported or underreported tax liabilities to avoid penalties and fees on overdue amounts if they pay such taxes in full or enter into an installment agreement for the payment of them. The amnesty also prevents the Franchise Tax Board (FTB) and the Board of Equalization (BOE) from taking criminal action against program participants. Following the conclusion of the program, penalties for various types of taxpayer noncompliance will be increased. As shown in Figure 1 (see next page), the amnesty program is expected to result in $333 million of additional revenues. (This will be recognized as an increase in the beginning 2003-04 General Fund balance.)

## Tax Expenditure Programs

### *Teachers' Tax Credit Suspended*

Under the budget agreement, the teachers' tax credit will be suspended for tax years 2004 and 2005. The teachers' tax credit was established as part of the 2000-01 budget and provides to credentialed teachers in public and private K-12 schools a credit against their income taxes ranging from $250 (for those with at least four years but fewer than six years of

**Figure 1**

**2004-05 Budget
Tax-Related Provisions**

*(In Millions)*

| | General Fund Revenue Gain |
|---|---|
| **Tax Amnesty** | |
| Personal income tax | $195 |
| Corporation tax | 65 |
| Sales and use tax | 73 |
| Subtotal | ($333) |
| **Tax Expenditure Programs** | |
| Teachers' tax credit suspension | $210 |
| Modified use tax application | 26 |
| Natural Heritage Tax Credit suspension | 11 |
| Subtotal | ($247) |
| **Total** | **$580** |

experience) to $1,500 (for those with 20 or more years of experience). The teachers' tax credit was also suspended for the 2002 tax year. The two-year suspension is estimated to result in additional revenues of $210 million in 2004-05 and $180 million in 2005-06.

### *Use Tax on Out-of-State Purchases Modified*

The budget agreement also changes the application of the use tax on certain out-of-state purchases. Generally, out-of-state purchases made by a California resident and intended for use in California are subject to a use tax (equivalent to the sales tax). However, some major items—such as vessels, vehicles, and aircraft—purchased out of state and kept there for a certain minimum period of time are not considered to be "intended for use in California," and thus are not subject to the use tax. Budget language extends from the current 90 days to 12 months the period that such purchases would need to remain out of state in order to qualify for this use tax exemption. This statutory change would be effective for two years. The estimated General Fund revenue gain from this is $26 million in 2004-05 (partial-year effect) and $35 million in 2005-06.

### *Natural Heritage Tax Credit Suspended*

The Natural Heritage Tax Credit is a program available to income taxpayers and is equal to 55 percent of the market value of certain qualified property approved by the Wildlife Conservation Board that is contributed to the state, a local government, or a nonprofit organization approved by a local government. The 2004-05 budget calls for the suspension of this credit through June 2005 for a 2004-05 revenue gain of $11 million.

As shown in Figure 1, the 2004-05 revenue gain from the above changes is $580 million.

## Tax Administration

In addition to the amnesty program, the Legislature also adopted some additional administrative measures. Specifically:

- The Legislature approved additional staff resources and the redirection of existing staff resources toward revenue generating activities for the state's two major tax agencies. For the FTB, these legislative actions resulted in replacing staff that were redirected from standard audit activity to abusive tax shelter audits in 2004. The augmentations and redirections for the BOE resulted in reinstating positions lost due to the budget's Control Section 4.10 reductions that occurred in 2003-04.

- In addition, the budget calls for the closure of certain field offices maintained by the two tax agencies. As a result of increased Internet development and usage, improved telephone technology, and electronic filing, these closures will not result in any reduction in taxpayer services.

- Finally, the FTB was directed to adopt fees for certain special services that are provided to taxpayers and certain other entities.

## Other Tax Matters

The use of NOL carryover deductions was suspended for tax years 2002 and 2003 as a component of the 2002-03 budget. This deduction will be reinstated and will be available for tax years beginning in 2004. In addition, as part of that year's budget, the NOL carryover percentage, which was formerly 65 percent, has been increased to 100 percent (also effective for the 2004 tax year). The reinstatement of this tax program will result in decreased General Fund revenues in the mid hundreds of millions of dollars.

Chapter 4

# Expenditure Highlights

## Proposition 98

The budget package includes $47 billion in Proposition 98 spending in 2004-05 for K-14 education. This represents an increase of $788 million, or 1.7 percent, from the revised 2003-04 spending level. Figure 1 summarizes the budget package for K-12 schools, community colleges, and other affected agencies. Because of upward revisions in the Proposition 98 minimum funding guarantee in 2003-04, however, this change does not reflect the actual

**Figure 1**

**Proposition 98 Budget Summary**

*2003-04 and 2004-05*
*(Dollars in Billions)*

| | 2003-04 Budget Package | | |
|---|---|---|---|
| | As Enacted | Revised | 2004-05 |
| **K-12 Proposition 98** | | | |
| General Fund | $27.6 | $28.0 | $30.9 |
| Local property taxes | 13.6 | 13.7 | 11.2[a] |
| Subtotals, K-12 | ($41.3) | ($41.7) | ($42.1) |
| *Average Daily Attendance (ADA)* | 5,990,495 | 5,950,626 | 6,006,898 |
| *Amount per ADA (in dollars)* | $6,887 | $7,009 | $7,007 |
| **California Community Colleges** | | | |
| General Fund | $2.2 | $2.3 | $3.0 |
| Local property taxes | 2.1 | 2.1 | 1.8[a] |
| Subtotals, Community Colleges | ($4.4) | ($4.4) | ($4.8) |
| **Other Agencies** | $0.1 | $0.1 | $0.1 |
| **Totals, Proposition 98** | **$45.7** | **$46.2** | **$47.0** |
| General Fund | $30.0 | $30.4 | $34.0 |
| Local property taxes | 15.7 | 15.8 | 13.0 |

[a] Property taxes decline due to changes in the allocation of tax proceeds among local government agencies. See text for further details.

increase in new resources available to K-14 in 2004-05. Thus, the package reflects an increase of $1.3 billion or 2.8 percent from the *2003-04 Budget Act* appropriation level. The budget package also includes an additional $765 million in one-time Proposition 98 funds, including $439 million in 2003-04 settle-up funds and $326 million of prior-year funds from the Proposition 98 Reversion Account.

The 2004-05 spending level is $2.3 billion below the 2004-05 Proposition 98 minimum guarantee, for two reasons. First, Chapter 213, Statutes of 2004 (SB 1101, Committee on Budget and Fiscal Review), suspends the minimum guarantee for 2004-05 and requires the state to provide $2 billion less than the minimum guarantee. Second, the budget creates a $302 million Proposition 98 General Fund reserve—that is, the appropriation level is $302 million less than required by Proposition 98. The reserve reflects an increase in General Fund revenues compared to the Governor's May Revision estimates.

The 2004-05 budget also reflects significant changes in the funding sources for Proposition 98. General Fund support for Proposition 98 increases $3.6 billion, or almost 12 percent from the revised 2003-04 spending level. This large General Fund increase is caused primarily by an 18 percent ($2.8 billion) decrease in property tax revenues for schools resulting from noneducation budget decisions. Changes to property tax collections for K-14 education include:

- A reduction of Educational Revenue Augmentation Fund (ERAF) transfers from local government to schools of $1.1 billion as part of the "triple flip" payment mechanism required by Proposition 57, the Economic Recovery Bond.

- Lower ERAF transfers from local government to schools of $2.8 billion as part of the local government deal in Proposition 1A on the November 2004 ballot. (See our "Local Government" discussion for more details.)

- Higher estimated revenues of $1.1 billion due to natural growth in property tax collections.

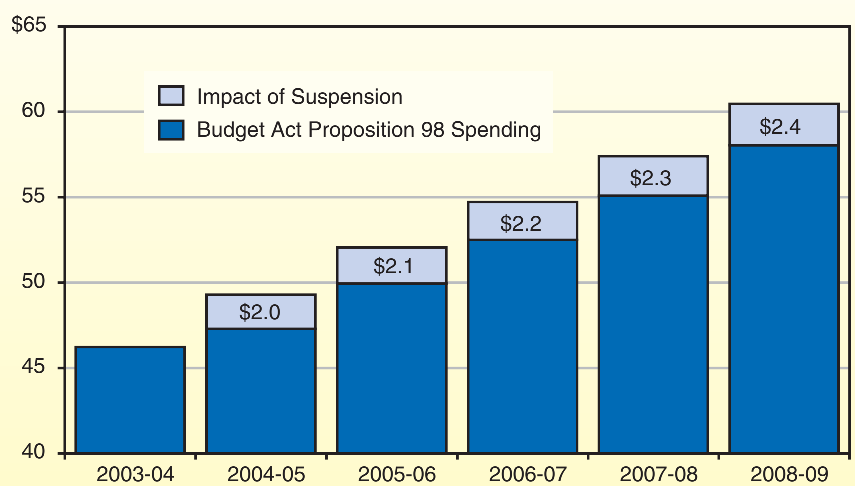
***Long-Run Impact of the Budget Package on K-14 Spending.*** The budget package contains two provisions that will affect future Proposition 98 spending levels. Most importantly, the lower appropriations levels that result from suspending the Proposition 98 guarantee in 2004-05 likely will yield savings to the state in future budgets. Figure 2 shows our estimate of the annual savings to the state from the budget's Proposition 98 suspension (see shaded box). The figure shows that the $2 billion of savings in 2004-05 grows to $2.4 billion by 2008-09. This growth occurs because savings from the 2004-05 suspension increases at the same rate as the annual growth in the minimum guarantee. Annual savings from the suspension will continue until the Proposition 98 maintenance factor is fully paid off.

In addition to the multiyear savings from the Proposition 98 suspension, the budget package delays payment of $969 million in Proposition 98 settle-up obligation for 2002-03 and 2003-04. The delay effectively transforms this obligation into a loan from Proposition 98 to the General Fund. A repayment plan for this loan also is part of the budget package. Chapter 216, Statutes of 2004 (SB 1108, Committee on Budget and Fiscal Review), requires the State Department of Education and the Department of Finance to jointly determine by January 1, 2006, the amount owed under the Proposition 98 minimum guarantee for fiscal years 1995-96 through 2003-04. Chapter 216 also appropriates $150 million from the General Fund beginning in 2006-07 and continuing each year until these prior-year obligations are satisfied. The annual appropriation will be distributed based on enrollment (for K-12) or full-time equivalent students (FTE) (for community colleges). Depending on the amount owed by the state for these years, settle-up payments could continue through 2014-15.

**Figure 2**

**Impact of $2 Billion Suspension on Future Propositon 98 Spending**[a]

*In Billions*




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

### How a Proposition 98 Suspension Works

Over the long run, the Proposition 98 minimum guarantee is determined by the growth in K-12 attendance and growth in per capita personal income (commonly known as the Test 2 factor). The Constitution allows the Legislature to appropriate funding for K-14 education below this "long-term Test 2 level" under two circumstances: (1) the Legislature suspends the requirements of Proposition 98 or (2) per capita General Fund revenues (commonly known as the Test 3 factor) grow more slowly than per capita personal income.

In either of these circumstances, the Constitution directs the state to provide accelerated growth in Proposition 98 funding in future years until the state has "restored" funding to the long-term Test 2 level. During this restoration period, the state calculates the difference between the actual level of spending and the long-term Test 2 level of spending. This difference is referred to as the "maintenance factor" and it is restored in one of two ways:

- When General Fund revenues grow faster than personal income, the state must reduce the maintenance factor by providing additional growth funding for Proposition 98.

- The Legislature can opt to provide funding above the minimum guarantee ("overappropriate")—restoring the maintenance factor faster than required under law.

When the maintenance factor is fully restored, K-14 spending is returned to the long-term Test 2 level. However, the state is *never* required to "pay back" the earlier savings achieved in the years when Proposition 98 funding was below its long-term Test 2 level. These savings, therefore, are not "loans" from prior years, but actual savings. The Department of Finance estimates that absent suspension, the state would have ended the 2004-05 fiscal year with a $1.6 billion maintenance factor (resulting from recent Test 3 years). The proposed suspension creates an additional maintenance factor of $2 billion, resulting in a year-end maintenance factor obligation of $3.6 billion (assuming that settle-up obligations for 2002-03 through 2004-05 are eventually paid).

### Large Education Credit Card Balance Continues

Starting in 2001-02, the Legislature opted to defer significant education program costs to the subsequent fiscal year rather than make additional spending cuts. Figure 3 shows that the budget continues to defer almost $3.5 billion in K-14 costs to the future. As discussed later, the budget provides an additional $270 million to reduce the revenue limit deficit factor. In addition, the budget uses $58 million in one-time 2003-04 settle-up funds to pay outstanding education mandate costs. However, since the budget does not fund the ongoing costs of education mandates (estimated to be about $250 million annually), cumulative deferrals remain at about $3.5 billion in 2004-05.

**Figure 3**

**Update on the K-14 Education Credit Card Balance (Year-End Balances)**

*2001-02 Through 2004-05*
*(In Millions)*

| | 2001-02 | 2002-03 | 2003-04 | 2004-05 |
|---|---|---|---|---|
| **One-Time Costs** | | | | |
| Revenue limit and categorical deferrals | $931 | $2,158 | $1,097 | $1,083 |
| Community college deferral | 116 | — | 200 | 200 |
| Cumulative mandate deferrals | 656 | 958 | 1,266 | 1,524 |
| **Ongoing Costs** | | | | |
| Revenue limit deficit factor | — | — | $883 | $643 |
| **Totals** | **$1,703** | **$3,116** | **$3,446** | **$3,450** |

## K-12 Proposition 98

As shown in Figure 1, spending on 2004-05 K-12 Proposition 98 totals $42.1 billion, an increase of about $400 million (1 percent) from the revised 2003-04 spending level. As discussed above, however, because of upward revisions in the 2003-04 minimum guarantee, this comparison understates the actual increase in resources K-12 schools will receive in 2004-05. Comparing 2004-05 spending to the level included in the *2003-04 Budget Act* shows K-12 spending increasing by $833 million (2 percent).

Growth in Proposition 98 spending also is distorted because numerous expenses have been *deferred* from one fiscal year to another from 2001-02 through 2004-05. These deferrals—which pay districts for program services that were provided in the previous year—make cross-year comparisons difficult. Figure 4 displays the impact of deferrals on per-pupil spending by moving deferred funds into the year in which the district expenditures occur. We refer to this deferral-adjusted funding level as "programmatic" funding because it provides a clearer picture of the actual level of funding and services available to schools and districts each year. Using this calculation, per-pupil spending increased by 2.5 percent ($173 per pupil) over the 2003-04 revised funding level. In contrast, funding actually declined by less than 1 percent ($2 per pupil) between 2003-04 and 2004-05.

**Figure 4**

**K-12 Proposition 98 Spending Per Pupil Adjusted for Funding Deferrals Between Years**

*2001-02 Through 2004-05*

| | Actual 2001-02 | Actual 2002-03 | Revised 2003-04 | Proposed 2004-05 |
|---|---|---|---|---|
| **Budgeted Funding** | | | | |
| Dollar per ADA[a] | $6,608 | $6,597 | $7,009 | $7,007 |
| Percent growth | — | -0.2% | 6.2% | — |
| **Programmatic Funding[b]** | | | | |
| Dollar per ADA | $6,788 | $6,805 | $6,831 | $7,004 |
| Percent growth | — | 0.3% | 0.4% | 2.5% |

a Average Daily Attendance.

b To adjust for the deferrals, we counted funds toward the fiscal year in which school districts had programmatically committed the resources. The deferrals meant, however, that the districts technically did not receive the funds until the beginning of the next fiscal year.

## Major K-12 Funding Changes From the *2003-04 Budget Act*

Figure 5 displays major K-12 funding changes from the *2003-04 Budget Act*. The budget package provides about $2.3 billion in new K-12 expenditures. Funds for these proposals come from three main sources:

- ***Increased Proposition 98 K-12 Spending—$833 Million.*** This is the growth in the total amount of Proposition 98 funding provided for K-12 education.

- ***Reduced Deferral Costs—$1 Billion.*** The budget spends $1 billion in ongoing funding that was freed-up from one-time uses in 2003-04. In 2003-04, the state used over $1 billion to pay off categorical and revenue limit deferrals. Because these costs were one-time in nature in 2003-04, they were available for ongoing purposes beginning in 2004-05.

- ***Fund Shifts and Program Reductions—$468 Million.*** The budget takes advantage of two fund shifts to reduce Proposition 98 funding obligations for K-12. First, the budget uses $218 million in one-time funds in the Proposition 98 Reversion Account (funds appropriated but not spent in prior years) to pay for ongoing program costs for Targeted Instructional Improvement Grants and child care. Second, the budget uses $127 million in federal funds for special education to offset the General Fund cost of special education growth and cost-of-living adjustments (COLAs). In addition, the budget contains net savings of $123 million from numerous other changes.

The budget uses the $2.3 billion in available funds to provide growth, COLAs, and other funding increases. Major spending changes include:

- ***Growth and COLA—$509 Million and $980 Million.*** The budget fully funds both statutory and discretionary growth and COLA. Specifically, the budget provides $509 million for a 0.95 percent growth adjustment ($413 million for revenue limits and $96 million for categorical programs) and $980 million for a 2.41 percent COLA ($741 million for revenue limits and $239 million for categorical programs).

- ***Deficit Factor Reduction—$270 Million.*** To balance the *2003-04 Budget Act*, the state "deficited," or reduced, revenue limits by $894 million by not providing a COLA (1.9 percent) and reducing revenue limits by 1.2 percent from the 2002-03 levels. This budget includes $270 million to partially restore the deficit. In addition, Chapter 216 also amends existing law to delay full restoration of the revenue limit from 2005-06 to 2006-07.

- ***Instructional Materials and Deferred Maintenance—$188 Million and $173 Million.*** The budget provides $363 million for standard-aligned instructional materials (a $188 million increase) and $250 million for deferred maintenance (an augmentation of $173 million). Both of these augmentations were related to issues raised in the *Williams v. State of California* lawsuit. The budget package also contains funding specifically to satisfy the settlement, including an additional $138 million in one-time funds for instructional materials for students in schools ranked in deciles one or two of the Academic Performance Index and a $50 million set-aside of one-time funds for other Williams lawsuit settlement costs.

- ***Unemployment Insurance Costs—$120 Million.*** The budget reflects an additional $120 million for school district and county offices of education unemployment insurance costs due to an increase in unemployment insurance rates from 0.3 percent in 2003-04 to 0.7 percent in 2004-05.

- ***Equalization—$110 Million.*** The budget provides $110 million to equalize school district revenue limits. The equalization funding is distributed using the current base revenue limits (as adjusted for excused absences).

In addition to the increase in state funds, the budget includes major increases in federal funds. Specifically, the federal funding for special education increases by $140 million (most of which is used to provide for special education growth and COLA). Title I funding increases by $120 million (most of which was passed through to districts). In addition, the budget sets-aside $67 million in federal support for low-performing school districts pending legislation creating a school district accountability system.

**Figure 5**

**Major Adjustments to K-12 Proposition 98 Funding**

*Changes From the 2003-04 Budget Act*
*(In Millions)*

| Program | Amount |
|---|---|
| Growth | $508.5 |
| Cost-of-living adjustments | 979.9 |
| Deficit factor | 270.0 |
| Instructional materials | 188.0 |
| Deferred maintenance | 173.0 |
| Unemployment insurance | 120.1 |
| Equalization | 109.9 |
| Net reduction of deferral costs[a] | -1,048.3 |
| Reversion Account funds used for ongoing program[b] | -218.1 |
| Special education federal fund offset | -126.6 |
| Other changes | -123.4 |
| **Total Changes** | **$833.0** |

[a] In 2003-04, the state used over $1 billion to pay off categorical and revenue limit deferrals. These costs were one-time in nature, and the funds can be used for ongoing purposes beginning in 2004-05. The budget takes advantage of these freed-up one-time funds to support other K-14 priorities.

[b] The state used $119.5 million of Proposition 98 reversion account funds to cover ongoing child care costs and $98.6 million for the Targeted Instructional Improvement Grants.

### Trailer Bills and Related Legislation

The education trailer bills and related legislation made the following major changes:

- ***Assessment Reauthorization.*** Chapter 233, Statutes of 2004 (SB 1448, Alpert), reauthorizes the Standardized Testing and Reporting program until 2011. Second grade testing, however, is reauthorized only until 2007. The bill also requires the development of a primary language test aligned to the state's academic content standards in language arts and mathematics to the extent federal funds are provided in the budget for that purpose.

- ***Nonpublic School Funding.*** Chapter 216 revises the way the state funds special education services for foster care students attending nonpublic, nonsectarian schools. Nonpublic schools are specialized private schools that serve students with severe disabilities. The prior funding formula provided 100 percent of the additional cost of services for these students. Because this formula violated federal law by encouraging placements in nonpublic schools, the new formula provides the same amount of funds no matter whether a student is placed in a public or nonpublic school. The budget package also includes $38.7 million from the General Fund to partially fund the higher cost of the new formula.

- ***Financing School District Emergency Loans Through the State Infrastructure Bank.*** Chapter 263, Statutes of 2004 (AB 1554, Keene), establishes a process for refinancing three emergency loans to districts through the State Infrastructure Bank (SIB). This will benefit the General Fund by over $140 million in 2004-05. The state will hold these three districts (Oakland, West Contra Costa, and Vallejo) harmless by subsidizing the interest expense of the SIB loans.

## Higher Education

The 2004-05 budget provides a total of $8.9 billion in General Fund support for higher education. As shown in Figure 6, this is $361 million, or 4.2 percent, more than the amount provided in 2003-04. This net change results from the combined effect of a $769 million increase in General Fund support for the California Community Colleges (CCC) and a $408 million reduction for the University of California (UC), the California State University (CSU), Hastings College of the Law, and the California Student Aid Commission (CSAC).

**Figure 6**

**General Fund Appropriations for Higher Education**

*(Dollars in Millions)*

| | 2003-04 (Revised) | 2004-05 | Change Amount | Change Percent |
|---|---|---|---|---|
| University of California | $2,907.8 | $2,721.0 | -$186.8 | -6.4% |
| California State University | 2,630.1 | 2,448.0 | -182.1 | -6.9 |
| California Community Colleges | 2,281.2 | 3,050.2 | 769.0 | 33.7 |
| Student Aid Commission | 672.8 | 636.8 | -36.0 | -5.4 |
| California Postsecondary Education Commission | 2.0 | 2.0 | — | — |
| Hastings College of the Law | 11.1 | 8.1 | -3.0 | -26.7 |
| **Totals** | **$8,505.0** | **$8,866.1** | **$361.1** | **4.2%** |

## UC and CSU

Although the Legislature approved some of the Governor's proposals for reductions at UC and CSU, it also significantly modified a few of them (as described below). Further, although the May Revision referenced "compacts" whereby the Governor has committed to include various funding increases for the segments in future budget proposals (beginning in 2005-06), these commitments are not binding on the Legislature, and the 2004-05 budget makes no reference to them.

***Student Fees.*** All three public higher education segments increased student fees for 2004-05. Figure 7 shows the change in student fees from 2003-04 to 2004-05. As the figure shows, UC and CSU increased resident undergraduate fees by 14 percent and CCC's resident fees increased by $8 per unit, or 44 percent. Graduate fee increases ranged from 20 percent for UC academic graduate students and CSU teacher education students to 37 percent for UC optometry and pharmacy students. (Nursing students at UC did not experience any systemwide fee increase.) The UC and CSU also increased nonresident tuition by about 20 percent. These higher fees will generate $358 million in additional revenue to backfill a General Fund reduction of the same amount. (About $15 million of this amount was in jeopardy at the time this report was being prepared, due to a superior court injunction preventing UC from imposing the fee increase on continuing professional school students.) Despite the Governor's proposal to enact a long-term fee policy, no such policy was adopted as part of this budget package. However, the Legislature subsequently passed a bill (AB 2710, Liu) directing UC and CSU to develop policies that would result in more predictable and moderate changes in student fees.

**Figure 7**

## Student Fees

*(Systemwide Tuition and Fees for Full-Time Students)*

| | | | Change From 2003-04 | |
|---|---|---|---|---|
| | 2003-04 | 2004-05 | Amount | Percent |
| **University of California (UC)** | | | | |
| **Resident Fees** | | | | |
| Undergraduate students | $4,984 | $5,684 | $700 | 14% |
| Graduate students | 5,219 | 6,269 | 1,050 | 20 |
| Professional school students[a] | | | | |
| Optometry | $10,339 | $14,139 | $3,800 | 37% |
| Pharmacy | 10,339 | 14,139 | 3,800 | 37 |
| Dentistry | 13,524 | 18,024 | 4,500 | 33 |
| Veterinary medicine | 12,029 | 16,029 | 4,000 | 33 |
| Medicine | 14,013 | 18,513 | 4,500 | 32 |
| Business administration | 14,824 | 19,324 | 4,500 | 30 |
| Theater, film, and television | 8,649 | 11,249 | 2,600 | 30 |
| Law | 15,313 | 19,113 | 3,800 | 25 |
| Nursing | 8,389 | 8,389 | — | — |
| **Nonresident Tuition and Fees** | | | | |
| Undergraduate students | $19,194 | $22,640 | $3,446 | 18% |
| Graduate students | 17,709 | 21,208 | 3,499 | 20 |
| **California State University** | | | | |
| **Resident Fees** | | | | |
| Undergraduate students | $2,046 | $2,334 | $288 | 14% |
| Teacher education students | 2,256 | 2,706 | 450 | 20 |
| Graduate students | 2,256 | 2,820 | 564 | 25 |
| **Nonresident Tuition and Fees** | | | | |
| Undergraduate students | $10,506 | $12,504 | $1,998 | 19% |
| Graduate students | 10,716 | 12,990 | 2,274 | 21 |
| **California Community Colleges** | $540[b] | $780[c] | $240 | 44% |

[a] A preliminary injunction in August 2004 prevented UC at least temporarily from imposing the 2004-05 fee increase on continuing professional school students.

[b] Reflects per unit fee of $18.

[c] Reflects per unit fee of $26.

In addition, the budget assumes UC and CSU will begin to phase in surcharges on students who take "excess" units (those beyond 110 percent of the units required for a baccalaureate degree). These surcharges are supposed to eventually result in students being charged the full cost of instruction for excess units. For 2004-05, UC and CSU are expected to receive an additional $25 million in student fee revenue as a result of this new surcharge.

***Allocated Reductions.*** The budget achieves $244 million in General Fund savings—$107.9 million at UC and $136.3 million at CSU—by reducing funding for research and academic support, increasing student-faculty ratios, and imposing other allocated reductions. The allocated reductions include those associated with the excess unit surcharge.

***Enrollment***. In adopting the 2004-05 budget, the Legislature rejected the Governor's proposal to redirect 7,000 eligible freshmen from UC and CSU to the community colleges. While it did not restore the associated $24.8 million reduction to UC's enrollment funding, the budget package anticipates that UC will accommodate all eligible students with existing funds. For CSU, the budget fully restores the Governor's associated reduction of $21.1 million, and further augments General Fund support by $12.2 million to fund an additional 2,155 FTE students. However, as explained in the shaded box, CSU will actually serve about 11,000 *fewer* students in 2004-05 than the previous year.

***K-14 Outreach Programs***. The budget maintains funding for UC and CSU's outreach programs at their 2003-04 levels. For UC, the budget provides the full $29.3 million in General Fund support. For CSU, the budget provides $7 million in General Fund support and assumes CSU will redirect funding from other programs to add another $45 million in outreach funding, thus matching total outreach funding at its 2003-04 level of $52 million. As discussed in the accompanying box, CSU plans to shift funds away from enrollment to support its outreach programs.

## CCC

General Fund support for CCC increases by $769 million (or 34 percent) from 2003-04 to 2004-05. However, this overstates the increase in CCC's overall financial resources because some of the increase simply offsets reductions in local property tax revenue and some is earmarked to pay for costs incurred in 2003-04. Adjusting for these factors, and including new revenue from a student fee increase, reveals a year-to-year increase in available resources of $288 million, or 5.9 percent. Major augmentations are identified below.

***Proposition 98 Funding.*** General Fund support and local property tax revenues used by local community college districts are counted as Proposition 98 appropriations. The CCC's total Proposition 98 funding increases by $412 million, or 9.4 percent. The 2004-05 budget provides CCC with 10.2 percent of total Proposition 98 appropriations.

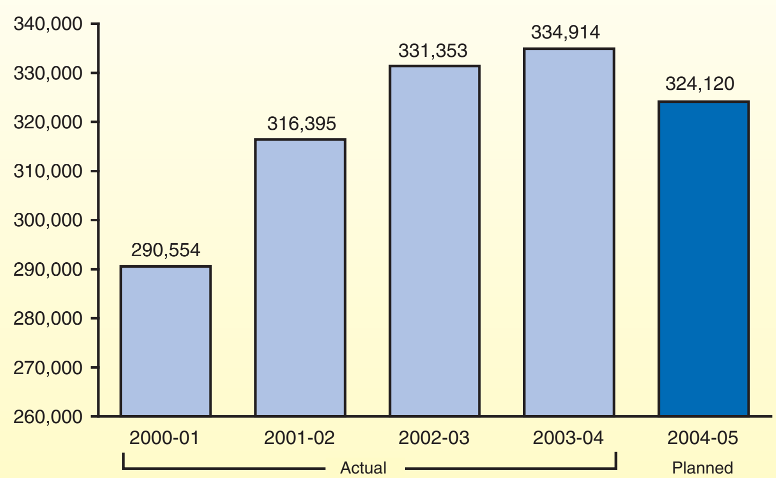
### CSU Plans to Serve About 11,000 Fewer Students

As part of last year's (2003 04) budget package, the Legislature expressed its intent that no new funding be provided for enrollment growth at the University of California (UC) and the California State University (CSU) in 2004-05. Accordingly, the Governor's budget proposal for 2004-05 included no new enrollment growth funding. In fact, the Governor proposed to reduce new freshman enrollment by 10 percent, with the forgone enrollment redirected to the community colleges in order to achieve $45.9 million in General Fund savings—$24.8 million at UC and $21.1 million at CSU. The Legislature, however, rejected the Governor's redirection proposal. Instead, the budget plan anticipates that UC and CSU will admit all eligible freshman applicants.

For CSU, the budget not only protects base enrollment funding, but it actually *increases* available enrollment funding by $12.2 million. The budget directs the university to enroll a total of 324,120 full-time equivalent (FTE) students. However, as indicated in the figure, this amount is roughly 11,000 FTE students *fewer* than the number of students served in the prior year. This is because CSU plans to shift enrollment funding away from serving students in order to "backfill" General Fund reductions in other program areas. For example, as noted above, CSU has committed to provide $45 million in existing funds to backfill a General Fund reduction to outreach.

**California State University Enrollment**

*2000-01 Through 2004-05*
*Full-Time Equivalent Students*



***Deferrals***. The 2004-05 budget continues to defer $200 million in Proposition 98 spending into the next fiscal year. Because the 2004-05 budget also includes $200 million for spending that was deferred from the 2003-04 fiscal year, these two amounts cancel each other out and thus do not affect the overall appropriation level for 2004-05.

***Major Augmentations***. The Legislature approved major augmentations proposed by the Governor, including $80 million for progress in equalizing the per-student funding among CCC districts, $106 million for a 2.41 percent COLA for apportionments and some categorical programs, and $134 million for a statewide enrollment increase of 3 percent (about 33,300 FTE students). In addition, the Legislature added $27 million in enrollment funding to pay for some of the existing, unfunded enrollment at districts that have exceeded their enrollment caps.

### CSAC and Financial Aid

The budget includes $808 million for CSAC. Of this amount, $759 million is for the Cal Grant programs. This is $104 million, or 16 percent, more than Cal Grant expenditures in 2003-04. Of total Cal Grant funding, $602 million is General Fund, $147 million is Student Loan Operating Fund (SLOF) monies, and $10 million is federal funds. As part of a short-term budget solution, SLOF monies are being used for the first time to support Cal Grant costs. Because of this shift of some costs to the SLOF, General Fund support actually declines from 2003-04 to 2004-05 by $42 million, or 7 percent.

The Cal Grant budget includes funding for 66,000 new high school entitlement awards, 3,000 new transfer entitlement awards, and, as specified in law, 22,500 new competitive awards. It also increases the Cal Grant award for UC and CSU students by 14 percent, sufficient to fully offset the undergraduate fee increase. The budget decreases the Cal Grant award for students attending private colleges and universities by 14 percent, from $9,708 to $8,322. In addition, the budget raises the Cal Grant income ceilings by the percent change in per capita personal income from 2003.

## Local Government

The 2004-05 budget package makes major changes to local government revenues and proposes a constitutional amendment to greatly restrict future state authority over local finance. Specifically, the package:

- ***Places a Constitutional Amendment Before the State's Voters.*** The Legislature approved Proposition 1A for the November ballot, which would greatly reduce future legislative authority to reduce or reallocate local revenues from the sales tax, property tax, or vehicle license fee (VLF). The Legislature approved Proposition 1A as an alternative to Proposition 65 (placed on the ballot through the initiative process). The accompanying shaded box provides information on these competing measures.

- ***Eliminates the Statutory VLF Trigger and Backfill***. The budget package sets the VLF rate at 0.65 percent of vehicle value and eliminates the trigger mechanism that increases the VLF rate in the event that the state's General Fund has insufficient funds to make the required backfill payments to cities and counties. The budget package permanently replaces city and county VLF backfill revenues with an equal amount of property taxes shifted from schools and community colleges. (All education agency property tax reductions are offset by increased state aid.)

- ***Shifts Property Taxes to K-14 Districts.*** The budget package shifts $1.3 billion of property taxes from cities, counties, special districts, and redevelopment agencies to K-14 district schools in 2004-05 and 2005-06 for the fiscal benefit of the state. Figure 8 provides more information on this property tax shift.

- ***Provides No Funding for Most Mandates***. Similar to 2003-04, the 2004-05 budget package provides no funding to reimburse local governments for most state-mandated local programs. We estimate that these deferred reimbursements total over $1.5 billion, including more than $200 million for local agency compliance with mandated requirements in 2004-05.

- ***Reduces Booking Fee Authority and Reimbursements.*** The budget package prohibits counties from increasing their booking fees in 2004-05. Beginning in 2005–06, counties may impose booking fees to offset one-half (rather than all) of their administrative costs associated with booking and processing of arrestees. In 2004-05, cities and special districts continue to receive $38.2 million in booking fee reimbursements through a continuous appropriation. The budget package eliminates this continuous appropriation effective July 1, 2005.

## Proposition 65 and Proposition 1A

Proposition 65 and Proposition 1A both amend the State Constitution to achieve three similar objectives regarding state and local government finance. Proposition 65 was sponsored by statewide local government associations and qualified for the ballot through the initiative process. Proposition 1A was placed on the ballot by the Legislature (SCA 4, Torlakson).

As part of the budget agreement, the local government associations agreed to support Proposition 1A instead of Proposition 65. Proposition 1A specifies that if it is approved by a greater number of votes, Proposition 1A's provisions shall prevail over Proposition 65's provisions.

### Both Measures Significantly Limit State Authority To Change Major Local Tax Revenues for the State's Fiscal Benefit

***Effect on 2004-05 State Budget***

- Proposition 65's restrictions apply retroactively, and thus would prevent a major part of the 2004-05 budget plan from taking effect (the two-year, $1.3 billion annual property tax shift). This property tax shift could occur in the future, if approved by the state's voters.
- Proposition 1A's restrictions apply to future state actions only, and would allow the planned $1.3 billion property tax shift to occur.

***Effect on Future State Budgets***

- Proposition 65 allows the state, upon approval of the state's voters, to modify major local tax revenues for the fiscal benefit of the state.
- Proposition 1A prohibits such state changes, except for limited, short-term shifting of local property taxes.

### Both Measures Greatly Reduce State Authority to Reallocate Tax Revenues Among Local Governments to Address Policy Concerns

***Effect on Revenue Allocation***

- Proposition 65 requires state voter approval before the state can reduce any individual local government's revenues from the property tax, uniform local sales tax, or vehicle license fee (VLF), without the consent of the local government.
- Proposition 1A prohibits the state from reducing any local government's revenues from the uniform local sales tax or optional sales tax, but maintains some state authority to alter the allocation of property tax revenues, VLF revenues, and other taxes with the consent of the local government. Proposition 1A does not include a voter approval requirement.

***Types of Local Governments Affected***

- Proposition 65's restrictions apply to cities, counties, special districts, and redevelopment agencies.
- Proposition 1A's restrictions do not apply to redevelopment agencies.

### Both Measures Restrict State Authority to Impose Mandates On Local Governments Without Reimbursement

- Proposition 65 authorizes individual local governments, schools, and community college districts to decide whether or not to comply with a state requirement if the state does not fully reimburse local costs.
- Proposition 1A provisions do not include schools and community colleges. If the state does not fund a mandate, the state must pass a law temporarily eliminating every local government's obligation to implement it.

**Figure 8**

**Major Provisions of the Property Tax Shift**

The budget package shifts $1.3 billion of property taxes from cities, counties, special districts, and redevelopment agencies to K-14 districts in 2004-05 and again in 2005-06. This tax shift reduces state General Fund education spending obligations by a commensurate amount. Local shift amounts are as follows:

***Cities—$350 Million.*** Each city's shift is based on a statutory formula. In general, the formula sets each city's shift at an amount equal to at least 2 percent, but not more than 4 percent, of city general purpose revenues.

***Counties—$350 Million.*** Each county's shift is specified in statute. In general, each county's shift reflects its proportionate share of 2003-04 county vehicle license fee allocations.

***Special Districts—$350 Million.*** Each special district's shift will be determined pursuant to a statutory formula.

- ***Nonenterprise Districts.*** Fire, police, hospital, library, veterans' memorial, and mosquito/vector control districts are exempt from the shift. Other nonenterprise special districts contribute 10 percent of their property tax revenues, or about $60 million.
- ***Enterprise Districts.*** The shift from transit and certain public utility enterprise districts is limited to 3 percent and 10 percent, respectively, of their property tax revenues. All other enterprise special districts contribute property taxes so that the total shift from special districts reaches $350 million. No shift from an enterprise district may exceed 10 percent of its total revenues.

***Redevelopment Agencies—$250 Million.*** Similar to the 2003-04 redevelopment property tax shift, the 2004-05 budget plan:

- Requires each agency to make a payment to its county Educational Revenue Augmentation Fund in 2004-05 and 2005-06.
- Allows agencies to extend the life of their plans by up to two years.

The amount of each agency's payment reflects both its proportionate share of: (1) gross tax increment and (2) net tax increment (which accounts for amounts passed-through to other local agencies). If an agency has insufficient funds to make its payment, it may borrow up to half of the amount from its Low and Moderate Income Housing Fund or request its host city or county to make the payment. If a redevelopment agency (or its host city or county) fails to make the required property tax contribution, the county auditor will transfer property taxes from the host city or county to cover the payment.

## HEALTH

The *2004-05 Budget Act* provides about $16.3 billion from the General Fund for health services programs, about a $2.3 billion or 16.5 percent increase compared to the revised prior-year level of spending as shown in Figure 9. This increase is primarily the result of one-time adjustments in the Medi-Cal Program that we discuss below. Several significant aspects of the budget package are summarized in Figure 10 and discussed below.

## Provider Rates

***Various Rate Changes.*** The budget plan adopts an administration proposal to achieve savings of $31 million by reducing by 10 percent the interim amount initially paid to certain hospitals that serve Medi-Cal patients. The budget also includes a modified version of an administration proposal that would achieve net state savings of $52 million through a reduction in Medi-Cal pharmacy reimbursements.

The budget provides that certain managed care plans, known as county organized health systems, would receive a 3 percent rate increase to improve their financial stability at a state cost of about $15 million.

The spending plan rejects an administration proposal to save $28 million by modifying the reimbursement rates for certain clinics that serve Medi-Cal patients.

***Ten Percent Rate Reduction Withdrawn.*** The budget plan does not include a proposed 10 percent rate cut in provider reimbursement rates for Medi-Cal and various public health programs that would have been in addition to the 5 percent reduction enacted as part of last year's budget act. The administration withdrew the proposal, which was intended to save the state about $620 million in 2003-04 and 2004-05, at the May Revision.

***Prior Rate Reductions.*** No longer assumes a 5 percent reduction in the rates paid to certain Medi-Cal providers had been enacted as part of the

**Figure 9**

**Health Services Programs General Fund Spending**

*(Dollars in Millions)*

| | | | Change | |
|---|---|---|---|---|
| | **2003-04** | **2004-05** | **Amount** | **Percent** |
| Medi-Cal (local assistance only) | $9,947 | $11,916 | $1,969 | 19.8% |
| Department of Developmental Services | 1,975 | 2,231 | 256 | 13.0 |
| Department of Mental Health | 895 | 943 | 48 | 5.4 |
| Healthy Families Program (local assistance only) | 291 | 319 | 28 | 9.7 |
| Department of Alcohol and Drug Programs | 233 | 237 | 4 | 1.7 |
| All other health services | 671 | 674 | 3 | 0.4 |
| **Totals** | **$14,012** | **$16,320** | **$2,308** | **16.5%** |

2003-04 budget. However, the spending plan no longer assumes about $248 million in savings in 2003-04 and 2004-05 from rate reductions that have been blocked by still-pending litigation. In addition, the spending plan reverses the 5 percent reduction ($4.2 million) that was largely unaffected by the court case for the California Children's Services, the Genetically Handicapped Persons Program, the Child Health and Disability Prevention Program, the Breast and Cervical Cancer Early Detection Program, and the Multipurpose Senior Services Program.

**Figure 10**

**Major Changes in General Fund Spending For State Health Programs**

*2004-05*
*(Dollars in Millions)*

| | |
|---|---|
| **Medi-Cal** | |
| Backfill one-time accounting and federal cost-share savings | $1,613 |
| Assume no savings from 2003-04 5 percent provider rate reduction | 248 |
| Increase county organized health system rates by percent | 15 |
| Delay checkwrites to providers | -288 |
| Reduce pharmaceutical reimbursements | -52 |
| Rescind adjustments for nursing home wages | -46 |
| Adjust caseload for reconciliation of Los Angeles County eligibility records | -33 |
| Reduce interim rates paid to certain hospitals by 10 percent | -31 |
| Control costs for county administration of Medi-Cal eligibility | -10 |
| Impose quality improvement fee for managed care plans | -9 |
| Expand auditing of hospitals | -3 |
| **Department of Developmental Services** | |
| Augment community programs to facilitate closure of Agnews | $11 |
| Recognize federal funds from recertification of regional center | -30 |
| Make unallocated reduction in regional center services and operations | -18 |
| **Department of Mental Health (DMH)** | |
| Adjust for EPSDT[a] spending growth (DMH reimbursements) | $135 |
| Reduce Children's System of Care local assistance | -20 |
| Delay and reduce beds activated at Coalinga State Hospital | -10 |
| **Public Health** | |
| Reverse 5 percent provider rate reduction for various programs | $4 |
| Suspend state contribution to CMSP[b] | -20 |

a Early and Periodic Screening, Diagnosis and Treatment Program.

b County Medical Services Program.

## Medi-Cal Program

The budget act provides about $11.9 billion from the General Fund ($33 billion all funds) for local assistance provided under the Medi-Cal Program. This amounts to almost a $2 billion or 20 percent increase in General Fund support for Medi-Cal local assistance discussed in more detail below.

***One-Time Adjustments.*** A General Fund backfill of two major one-time technical funding changes accounted for about $1.6 billion of the increase in spending. These are: (1) the inclusion in 2003-04 of a program accounting change ("accrual to cash") that reduced program costs on a one-time basis, and (2) the expiration in the budget year of a temporary increase in federal support for the program that required an increase in state support for Medi-Cal local assistance. Absent these technical changes, the year-over-year increase in Medi-Cal spending would be about $350 million, or 3.5 percent, in the spending plan signed by the Governor.

***Checkwrite Delays.*** The single largest Medi-Cal savings in the spending plan are one-time savings due to delaying checkwrites by two weeks for reimbursements to providers. This means some payments to providers that would otherwise have occurred in 2004-05 will actually occur in 2005-06. This results in savings of about $288 million in 2004-05.

***Medi-Cal Reform.*** The budget plan does not include staffing and funding sought by the administration to develop a federal waiver that would allow the Medi-Cal Program to be structured to achieve as much as $400 million a year in future state savings. The Legislature determined that any such resources should be provided as part of subsequent policy legislation (now anticipated to be introduced in January 2005) for this purpose.

***Quality Improvement Fee.*** The Legislature approved with modifications an administration proposal to levy a quality improvement fee on certain managed care health plans. The fee, which would take effect in January 2005 subject to federal approval, would result in a net savings to the state General Fund of $9 million in 2004-05 that would grow to $53 million in 2005-06.

***Antifraud and Other Activities.*** The budget plan adopts a series of proposals to combat fraud and overspending in the Medi-Cal Program, including the addition of 20 new auditor positions to examine the claims of hospitals serving Medi-Cal beneficiaries. The state savings from the additional audits are projected to be $3.1 million in 2004-05 and $8.8 million in 2005-06. A proposed change in state law to prevent middle-income persons from disposing of their assets to become eligible for Medi-Cal was not adopted as part of the budget.

***Wage Adjustment Rate Program.*** The budget rescinds the Wage Adjustment Rate Program (WARP) that had been established (but never implemented) to use state funds to augment the wages of personnel working in nursing facilities. The General Fund savings in 2003-04 from rescinding WARP were $46 million. These savings will continue through 2004-05 and beyond.

***Caseload Adjustment.*** The budget plan assumes that the state will achieve more than $33 million in savings in the budget year from a reduction in the Medi-Cal caseload that will result from a comparison of Medi-Cal eligibility records kept by the state and Los Angeles County. The Medi-Cal caseload is expected to decline by a monthly average of 58,000 persons as a result of this reconciliation of eligibility files.

***County Administration of Eligibility.*** The budget reduces county allocations for administration of Medi-Cal eligibility by counties by $10 million in General Fund support to reflect cost-control efforts that are to be initiated in 2004-05.

## Healthy Families

The budget provides about $319 million from the General Fund ($872 million all funds) for local assistance under the Healthy Families Program during 2004-05. This reflects a General Fund increase of about $28 million or 9.7 percent for the program. Part of the growth in spending is due to the projected continued increases in program caseload to about 774,000 children by June 2005. As noted, proposals to cap program enrollment and to shift part of the program into a county block grant were not adopted. The Legislature also rejected administration proposals for staff resources and contract funding to restructure the program into two tiers that would vary in their benefits and level of family premiums. However, the budget plan increases premiums for higher-income families whose children are participating in the program starting in 2005-06 to achieve annual state savings of about $5.4 million.

## Population Caps and Block Grants

The administration withdrew—following legislative action to reject the proposals—two proposals offered in January to achieve savings of about $66 million in certain health programs (as well as social services programs) through the imposition of enrollment limits and the establishment of a county block grant. The block grant proposal would have affected the Healthy Families Program. The enrollment cap would have affected Healthy Families as well as the Medi-Cal Program, state hospitals, the AIDS Drug Assistance Program, California Children's Services, the Genetically Handicapped Persons Program, and the Breast and Cervical Cancer Treatment Program.

## Department of Developmental Services

The budget provides more than $2.2 billion from the General Fund ($3.5 billion all funds) for services to individuals with developmental disabilities in developmental centers and regional centers. This amounts to an increase of about $256 million, or 13 percent, in General Fund support over the revised prior-year level of spending.

***Community Programs.*** The 2004-05 budget includes a total of $1.8 billion from the General Fund ($2.8 billion all funds) for community services for the developmentally disabled, an increase in General Fund resources of about $236 million over the prior fiscal year. In enacting this budget plan, the Legislature rejected an administration proposal to save about $12 million by establishing statewide standards for the purchase of certain services. It strengthened the auditing of regional center vendors and imposed additional unallocated reductions of more than $18 million to regional center operations and services. The budget implements copayments for families of developmentally disabled children with incomes above 400 percent of the federal poverty level ($73,600 for a family of four). Finally, the budget recognizes about $30 million in additional federal funds, that will be used to offset General Fund costs, from the recertification of the South Central Los Angeles Regional Center for the Home and Community-Based Waiver program.

***Developmental Centers.*** The budget provides about $390 million from the General Fund for operations of the developmental centers and related activities (about $715 million all funds). This represents about a $19 million increase above the revised level of General Fund support provided to the centers in 2003-04. Part of the spending increase is due to an $11 million augmentation to assist in the closure of Agnews Developmental Center. Specifically, the Legislature rejected a proposal to make improvements at Sonoma Developmental Center to accommodate residents moved out of Agnews and instead redirected the funds to expand community programs for the same purpose.

## Department of Mental Health

The budget provides about $943 million from the General Fund ($2.6 billion all funds) for mental health services provided in state hospitals and in various community programs by the Department of Mental Health. This amounts to about a $48 million, or 5.4 percent, increase in General Fund support overall over the 2003-04 level of spending.

***Community Programs.*** The 2004-05 budget includes about $304 million from the General Fund ($1.8 billion all funds) for local assistance for the mentally ill, about a $2.2 million decrease in General Fund support. The budget plan does not include proposals made by the administration to achieve $40 million in General Fund savings by reducing the maximum rates allowable for services, to save $13 million by increasing the county share of growth in costs for the Early and Periodic Screening, Diagnosis and Treatment program, or to save $5 million by continuing to phase out the school-based Early Mental Health Initiative.

The Governor vetoed almost all of the remaining $20 million in state funding provided by the legislature for the Children's System of Care program. Finally, about $100 million in state and federal funds were allocated in the State Department of Education (SDE) budget to pay for mental health services for special education children in 2004-05.

***State Hospitals.*** The budget provides more than $587 million from the General Fund for state hospital operations (about $733 million all funds). The increase of about $46 million in General Fund resources was due primarily to adjustments for growth in caseload and operating expenses. The budget plan does not incorporate various administration proposals that would have saved the state about $13 million by, among other actions, redirecting persons who are in the process of being considered for commitments to the hospital system as Sexually Violent Predators from the state hospital system to counties and allowing indeterminate commitments to state hospitals. About $9.5 million in state savings would be achieved by delaying the opening of a new state hospital in Coalinga by one month and reducing the number of beds initially activated.

## Public Health

***Community Challenge Grants.*** The administration eventually withdrew a proposal to eliminate $20 million in federal funding to support the Community Challenge Grant program, which provides grants to community-based organizations for programs intended to reduce the number of teenage and unwed pregnancies and to promote responsible parenting. Full funding for the program was included in the budget.

***County Medical Services Program.*** The budget suspends for another year the annual contribution by the state to the County Medical Services Program (CMSP) in order to achieve $20 million General Fund savings. Thirty-four participating small counties pool resources under CMSP to provide medical and dental care to low-income adults between 21 and 64 years of age who are not eligible for Medi-Cal.

***Newborn Screening Program Expansion.*** The budget allocates $2.7 million from the Genetic Disease Testing Fund to expand the existing state program to screen newborns for certain genetic diseases. The expansion will permit use of tandem mass spectrometry technology to allow early identification and treatment of an additional 30 diseases.

## Social Services

The 2004-05 budget increases General Fund support for social services programs by $190 million (2.1 percent) to a total of $9.1 billion, as shown in Figure 11. After adjusting for one-time increases in federal fiscal relief and program transfers to other departments, General Fund spending on social services is essentially flat.

Figure 11 summarizes the changes in General Fund spending by major program. In brief, substantial increases in the Supplemental Security Income/State Supplementary Program (SSI/SSP) ($328 million) and the California Work Opportunity and Responsibility to Kids (CalWORKs) program ($134 million) were partially offset by savings in the Department of Child Support Services (-$180 million) and other social services programs (-$175 million).

Figure 12 lists the major budget changes in social services programs, resulting in a net savings of $498 million compared to the requirements of prior law. Two proposals—deferral of the federal child support automation penalty and increased federal funds for In-Home Supportive Services (IHSS)—account for about 85 percent of the General Fund reduction.

**Figure 11**

**Social Services Programs General Fund Spending**

*(Dollars in Millions)*

| | | | Change | |
|---|---|---|---|---|
| | 2003-04 | 2004-05 | Amount | Percent |
| Supplemental Security Income/State Supplementary Program | $3,157 | $3,485 | $328 | 10.4% |
| California Work Opportunity and Responsibility to Kids | 1,996 | 2,131 | 134 | 6.7 |
| In-Home Supportive Services | 1,117 | 1,158 | 41 | 3.7 |
| Children's Services/Foster Care/Adoptions Assistance | 1,359 | 1,418 | 59 | 4.4 |
| Department of Child Support Services | 467 | 287 | -180 | -38.5 |
| County administration/automation | 423 | 405 | -18 | -4.2 |
| Other social services programs | 437 | 262 | -175 | -40.3 |
| **Totals** | **$8,957** | **$9,147** | **$190** | **2.1%** |

**Figure 12**

**Major Changes—Social Services Programs 2004-05 General Fund**

*(In Millions)*

| Program Issue | Change From Prior Law |
|---|---|
| **California Work Opportunity and Responsibility to Kids[a]** | |
| Limit General Fund child care expenditures countable toward federal requirement | $153 |
| Augment employment services | 50 |
| Permit counties to retain unspent block grant funds from 2003-04 | 40 |
| Reduce county block grant allocation (Governor's veto) | -40 |
| Suspend July 2004 cost-of-living adjustment (COLA) for three months | -25 |
| Adopt work participation reforms | -12 |
| Adopt tribal Temporary Assistance for Needy Families (TANF) reforms | -15 |
| Replace TANF support for juvenile probation with General Fund in Board of Corrections | -134[b] |
| **Supplemental Security Income/State Supplementary Program** | |
| Delay state January 2005 COLA until April 2005 | -$37 |
| Make certain state-only noncitizen cases federally eligible | -3 |
| **In-Home Supportive Services** | |
| Increase in federal funds due to federal waiver | -$216 |
| Adopt quality assurance initiatives | -11 |
| **Programs for Children** | |
| Reduce child welfare services funding (Governor's veto) | -$17 |
| Implement annual (rather than semiannual) redetermination of federal eligibility | -5 |
| **Community Care Licensing** | |
| Increase licensing fees | -$6 |
| Continue fingerprint fee for one year | -3 |
| **Child Support** | |
| Defer payment of federal child support automation penalty | -$220 |
| **Community Services and Development** | |
| Reinstate naturalization assistance program | $2 |
| **Total** | **-$498** |

a General Fund and/or federal TANF funds.

b Identical offsetting General Fund cost in Board of Corrections.

## CalWORKs

The budget includes $2.1 billion from the General Fund in the Department of Social Services (DSS) budget for the CalWORKs program in 2004-05. This is an increase of about 7 percent compared to the prior year. Below are some of the key changes in the CalWORKs area.

***Work Requirements.*** Budget-related legislation includes a requirement that CalWORKs recipients must participate in at least 20 hours of "core" work activities once they have signed a welfare-to-work plan. Core work activities have been expanded to include vocational education and training for up to 12 months. Budget-related legislation also requires nonexempt CalWORKs recipients to have a welfare-to-work plan no more than 90 days after eligibility is determined or 90 days after the date the recipient is required to begin participating in welfare-to-work activities. The budget assumes these reforms will result in grant savings of $86.2 million, with substantially offsetting costs in employment services ($6.6 million), automation ($2.5 million), and child care ($65.6 million) for a net savings of about $12 million.

***Tribal Temporary Assistance for Needy Families (TANF).*** The budget reduces funding to the tribal TANF program by $30.5 million. However, this reduction is partially offset by the redistribution of $15.5 million in unspent tribal TANF funds from 2003-04. The net reduction of $15 million will be proportionately distributed across all tribal TANF programs. In addition, beginning July 1, 2005, tribal TANF funding allocations for programs in existence for at least three years will be based on current caseloads, including both assistance and service only cases, rather than on federal fiscal year 1994 caseload figures.

***CalWORKs Grants.*** The budget suspends the CalWORKs July 2004 COLA for three months. This delay results in a cost avoidance of $25.3 million in 2004-05. When the COLA does go into effect, the maximum monthly grant for a family of three in a high-cost county will rise by about $19 to a total of $723, and the maximum monthly grant for a family of three in a low-cost county will increase by about $18 to a total of $671. The Legislature rejected the Governor's proposed 5 percent grant reduction.

***County CalWORKs Allocations.*** The budget passed by the Legislature provided $90 million more for county CalWORKs block grants (a $50 million augmentation and $40 million in rollover funds from 2003-04) than the Governor's May Revision. The Legislature provided the additional funding because counties indicated that administrative savings attributed to the implementation of quarterly reporting were substantially overestimated. However, the Governor vetoed $40 million in the CalWORKs basic administrative block grant, so that the net increase available to counties is $50 million.

***Juvenile Probation.*** The budget replaces $134 million in federal TANF funding with General Fund monies in the Board of Corrections for juvenile probation programs. Previously, TANF funds were allocated by DSS to support county juvenile probation programs.

***CalWORKs Maintenance-of-Effort (MOE) Requirement.*** The budget limits the type of child care expenditures within the SDE that may count toward the CalWORKs MOE. Specifically, the state will only count toward the CalWORKs MOE those SDE child care expenditures made for children in families receiving CalWORKs, rather than expenditures for all children who are eligible for CalWORKs, but who may not be receiving cash assistance. As a result, countable spending in SDE was reduced by about $153 million. This reduction in countable MOE in SDE necessitates a corresponding increase in the General Fund appropriation for CalWORKs within DSS. The Legislature took this action in order to prioritize limited CalWORKs resources on CalWORKs grants and employment services.

## SSI/SSP

The budget includes $3.5 billion from the General Fund for the program, an increase of $328 million (10.4 percent). Most of this increase is attributable to replacing one-time federal fiscal relief funds with General Fund monies ($238 million) and funding caseload growth ($71 million), partially offset by delaying the state COLA to April 2005 ($37 million).

***Grant Payments.*** Budget trailer bill legislation delays the January state COLA until April 2005. This results in General Fund savings of $37 million. The Legislature rejected the Governor's proposal to not pass through the federal SSI COLA. Figure 13 shows the maximum monthly SSI/SSP grant for individuals and couples during 2004, including the federal COLA (January 2005) and the state COLA (April 2005).

**Figure 13**

**SSI/SSP[a] Grant Levels**
**January Federal COLA and April State COLA**

*(Maximum Monthly Grants)*

| | January 2004 | January 2005 | April 2005 |
|---|---|---|---|
| **Individuals** | | | |
| SSI | $564 | $576 | $576 |
| SSP | 226 | 226 | 236 |
| **Totals** | **$790** | **$802** | **$812** |
| **Couples** | | | |
| SSI | $846 | $865 | $865 |
| SSP | 553 | 553 | 572 |
| **Totals** | **$1,399** | **$1,418** | **$1,437** |

[a] Supplemental Security Income/State Supplementary Program.

***SSI Advocacy.*** Under current law, approximately 8,300 legal noncitizens receive state-only SSI/SSP benefits through the Cash Assistance Program for Immigrants (CAPI). However, as some of these noncitizens increase in age, they may become eligible for federal SSI/SSP grants based on the development of a qualifying disability. Budget trailer bill legislation requires counties with more than 70 CAPI recipients to create advocacy programs to assist certain recipients in becoming federally eligible. Based on a similar program in Los Angeles County, this advocacy initiative is estimated to result in net savings of $3.1 million.

***Enrollment Cap and Block Grant Proposals Dropped.*** The May Revision abandoned the January budget proposal to cap enrollment and create county block grants to replace the CAPI, discussed above. (The May Revision also dropped similar proposals for legal immigrants receiving state-only food stamps and/or CalWORKs.)

### IHSS

The budget increases General Fund support for the IHSS program by $41 million (3.7 percent) to a total of almost $1.2 billion. The spending growth is mostly attributable to increases in caseload and workload ($153 million), replacing one-time federal funds with General Fund monies ($102 million), and administrative cost increases ($13 million), substantially offset by savings associated with the anticipated infusion of federal funds pursuant to the federal IHSS Plus Waiver discussed below ($216 million).

***Medicaid Waiver to Increase Federal Funding.*** At the May Revision, the administration (1) withdrew its proposal to eliminate the state-only funded "residual" IHSS program for federally ineligible individuals and (2) announced its intent to pursue a Medicaid Section 1115 demonstration waiver in order to obtain federal financial participation for approximately 75,000 individuals currently served in the residual program. The Legislature approved trailer bill legislation authorizing the administration to pursue and negotiate the IHSS Plus Waiver. When approved, the new federal funds would result in General Fund savings of $216 million. The U.S. Department of Health and Human Services approved nearly all aspects of the waiver in August 2004.

***Quality Assurance.*** Budget trailer bill legislation makes a series of reforms intended to standardize the authorization of service hours, prevent fraud and overpayments, and reduce program costs. These changes include standardizing assessment procedures and forms, allowing counties to vary the timeframe for reassessment based on the likelihood of change in the need for service, formally defining the term "fraud" with respect to the IHSS program, and requiring the state and counties to conduct various quality assurance initiatives (such as case reviews, error rate studies, and audits). These reforms are estimated to result in net savings of $11.4 million in 2004-05.

### Children's Programs

The budget provides a combined total of $1.4 billion from the General Fund for Foster Care, Children's Services, and Adoptions Assistance. This is an increase of $59 million (4.4 percent) compared to 2003-04.

***Veto of Child Welfare Services (CWS) Funding.*** Since 1998, the state has provided counties with additional federal and state funds (known as the CWS "augmentation") in order to reduce the number of cases per social worker. The January budget included $91 million for the augmentation, identical to the 2003-04 appropriation. Unlike the base allocation of funding for CWS, counties were not required to put up some of their own money in order to access the augmentation so long as they (1) matched their entire base share of child welfare services funding and (2) fully utilized the CWS automation system.

In the May Revision, the Governor proposed that counties share in the cost of the augmentation, resulting in county costs of $17 million and an identical General Fund savings. The Legislature rejected this proposal and backfilled the General Fund reduction. In the final budget, the Governor vetoed the General Fund backfill as well as the related language (Provision 12) that set out the criteria to be met.

The final budget, therefore, reduces support for CWS by $17 million from the General Fund. The budget assumes, however, that counties will use their own funds to backfill that reduction, thereby avoiding a reduction in federal funds. Should counties be unwilling or unable to backfill the funding, the state will lose $10.3 million in federal funds. At the time this report was prepared, the administration indicated that, despite the veto of Provision 12, it has the authority to allocate the remaining augmentation funds without a county share of cost.

Following the adoption of the *2004-05 Budget Act*, the Legislature enacted SB 1612 (Speier) related to child welfare services. At the time this report was prepared, the bill was awaiting action by the Governor. Should the Governor sign the bill, the $17 million in General Fund support for this program will be restored using prior-year unspent funds and the language previously included in Provision 12 of the *2004-05 Budget Bill* will be added to the Welfare and Institutions Code.

***Foster Care Reforms.*** The budget reflects a General Fund savings of $4.7 million due to a reduction in the frequency of federal eligibility redeterminations for foster care children, and elimination of the policy of reimbursing small group home and foster family agency providers for the costs associated with financial audits. The Legislature rejected other foster care reform proposals from the administration including reducing grant levels for nonrelated legal guardians and standardizing foster family home rates.

***CWS Program Improvements.*** The budget includes $31 million in funding ($6.7 million General Fund) to further develop two CWS initiatives. First, $19 million in state and federal funding is allocated for the implementation of the federally required program improvement plan designed to improve the state's performance on certain federal outcome measures. This funding will be used for such things as safety assessments and permanency planning. The remaining funding ($12 million) will be used for the county self-assessments and peer reviews required by the California Child Welfare Outcomes and Accountability System pursuant to Chapter 678, Statutes of 2001 (AB 636, Steinberg).

***Dependency Drug Courts.*** The budget provides $2 million in federal funds to expand the dependency drug court program. These funds are a combination of Promoting Safe and Stable Families funding and Substance Abuse Prevention Treatment funds. This program is designed to provide substance abuse treatment for parents who have lost or are at risk of losing their children due to abuse or neglect.

***Inflation Adjustments.*** Due to the continuing weakness in the General Fund condition, the budget for 2004-05 follows the practice of 2002-03 and 2003-04 of not providing a discretionary COLA for Foster Care or the Adoptions Assistance program. The budget also follows the 2002-03 and 2003-04 practice of not providing inflationary, cost-of-doing-business adjustments to cover county administrative costs for Foster Care or Child Welfare Services.

## Child Care

The Governor's 2004-05 budget proposed changes in child care eligibility and reimbursement rates. The Legislature rejected the Governor's proposals, but adopted some policy and fiscal integrity reforms discussed below.

***Policy Reforms.*** The budget states legislative intent that preferred placement for 11- and 12-year-olds is in after school care, rather than in child care programs. However, in order to ensure funding for all 11- and 12-year-olds who need child care, the budget creates a set-aside of $36.2 million, intended to be allocated only to the extent that 11- and 12-year-olds do not obtain care in after-school programs. The budget also allocates $20 million to after-school programs to expand enrollment caps to accommodate any additional 11- and 12-year-olds and directs that $61.8 million in new 21st Century federal funds be prioritized on 11- and 12-year-olds. Finally, budget trailer bill legislation limits priority eligibility and fee exemptions for children referred to child care services by Child Protective Services or considered at risk for abuse and neglect and referred by another organization.

***Fiscal Integrity.*** Budget trailer bill legislation requires SDE, in consultation with DSS, to do an error rate study to determine the extent of overpayments and fraud in the state's child care program, establish best practices in ensuring program fiscal integrity, and to make recommendations on how to achieve these goals by April 1, 2005. Beginning in July 2005, all child care contracts with SDE would be required to include measures that implement the identified best practices. The budget includes an appropriation of $1 million in SDE for expenses necessary for local welfare fraud investigators and district attorneys to consult with SDE to develop and implement the error rate study.

### Community Care Licensing (CCL)

The budget provides a total of $21 million from the General Fund for CCL. This is a decrease of 41 percent ($14 million) compared to 2003-04. This decrease is primarily due to the shifting of licensing revenues to the Technical Assistance fund from the General Fund ($20.8 million). This shift allows the Legislature to better monitor the amount of revenue generated by licensing fees and ensure that any fee increases are not outpacing the cost of the program. Finally, the budget provides about $6 million for additional staff to process increased workload.

***Fee Increases for Licensing.*** By increasing existing fees and establishing new fees, the budget generates additional revenues of $5.8 million for CCL. This brings the estimated fee revenue to a total of $20.8 million for 2004-05.

***Continue Fee Requirement.*** The budget continues the requirement for providers working in facilities serving six or fewer individuals to pay fingerprint fees ($24 for fingerprint processing and an additional $16 for live scan fingerprint imaging). This continuation results in a General Fund savings of $2.8 million.

### Department of Child Support Services (DCSS)

The budget includes $287 million in General Fund support for the DCSS, a decrease of $180 million (38 percent) compared to 2003-04. This decrease is primarily a result of the deferral of the federal automation penalty, partially offset by the increased cost of the statewide child support automation system.

***Child Support Automation Penalty Deferral.*** The federal government has allowed California to defer paying the $220 million child support automation penalty that would be due during 2004-05 until the 2005-06 state fiscal year. The state is being assessed this penalty due to its continued failure to implement a single, statewide automation system for the collection of child support.

### Department of Community Services and Development

***Naturalization Program.*** The Governor sustained a legislative augmentation of $1.5 million from the General Fund for the Naturalization Services Program, which provides grants to community-based organizations to help legal, permanent residents become United States citizens.

## Judiciary and Criminal Justice

The *2004-05 Budget Act* contains $10.1 billion (all funds) for judicial and criminal justice programs, including $8.4 billion from the General Fund. The total amount is a decrease of $2.7 million, or less than 1 percent, from 2003-04 expenditures. The General Fund total represents an increase of $1 billion, or 14 percent.

Figure 14 shows the changes in expenditures in some of the major judicial and criminal justice budgets. Below, we highlight the major changes in these budgets.

### Court-Related Funding

The budget includes $2.3 billion for support of trial courts. This amount includes $1.2 billion from the General Fund; $475 million transferred from counties to the state; and $627 million in fine, penalty, and court fee revenues. The General Fund amount is $125 million, or 11.5 percent, higher than 2003-04 expenditures. The single largest component of the General Fund increase consists of $94 million to support higher spending for court employee salaries and benefits.

The budget also includes an unallocated reduction of $75 million. Finally, the budget loans $30 million from the State Court Facilities Construction Fund to the General Fund.

**Figure 14**

**Judicial and Criminal Justice Budget Summary General Fund**

*(Dollars in Millions)*

| Program/Department | 2003-04 | 2004-05 | Change Amount | Change Percent |
|---|---|---|---|---|
| Trial Court Funding | $1,083 | $1,208 | $125 | 11.5% |
| Department of Corrections | 4,860 | 5,657 | 797 | 16.4 |
| Department of Youth Authority | 369 | 329 | -40 | -10.8 |
| Board of Corrections | 23 | 137 | 114 | 495.7 |
| Board of Prison Terms | 25 | 60 | 35 | 140.0 |
| Citizens' Options for Public Safety | 100 | 100 | — | — |
| Juvenile Justice Grants | 100 | 100 | — | — |
| Other corrections programs | 820 | 845 | 25 | 3.0 |
| **Totals** | **$7,380** | **$8,436** | **$1,056** | **14.3%** |

## Punitive Damages

The budget amends state law to require that 75 percent of punitive damage awards in civil lawsuits be deposited into a newly established Public Benefit Trust Fund administered by the Department of Finance. The budget allocates $450 million from this fund to offset General Fund expenditures in 2004-05.

## Corrections

The budget contains $5.7 billion from the General Fund for support of the California Department of Corrections (CDC), a net increase of $797 million, or 16 percent, above the 2003-04 level. The single largest component of this increase is $853 million to replace one-time federal funds that do not continue in 2004-05. The remaining significant changes—including both increases and decreases in expenditures—are discussed below.

***Population.*** The budget provides full funding for the projected inmate population. The budget assumes that the inmate population will be about 157,000 by the end of 2004-05, a decrease of 6,000 inmates from the end of 2003-04. The parole population is projected to reach about 117,000 parolees at the end of the budget year, an increase of 4,000 parolees from the end of 2003-04. These projected changes in the inmate and parole populations are due primarily to the implementation of parole reforms adopted in 2003-04.

***Fiscal Accountability and Efficiencies.*** The *2004-05 Budget Act* provides funds to address areas of CDC's budget that have contributed to the department's annual budget deficiencies. This includes funding to (1) backfill correctional officers during time off ($99.5 million), (2) fund staff for medical guarding and transportation ($18.2 million), (3) support additional staff for administrative segregation units ($16.8 million), and (4) fund the Business Information System ($4.6 million). In addition, the department will be required to annually report to the Legislature on projected expenditures, by prison facility. The budget also assumes savings of $35.3 million from efficiencies achieved through various reductions, including elimination of headquarters positions, and reduced energy expenditures.

***Parole Reforms.*** The budget expands the use of intermediate sanctions, and certain programs to reduce the number of parole violators returned to prison. In particular, it provides funding to expand the use of (1) prerelease planning to prepare inmates for release, (2) community substance abuse treatment services, and (3) electronic monitoring devices for parole violators. As a result of these changes, the budget assumes additional reductions in the prison population, as well as the parole population, for a net savings of $87 million. The parole population reduction results from making mandatory a currently discretionary policy that discharges from state supervision parolees who have completed a year on parole without returning to prison. In addition, the budget provides $57 million for CDC and the Board of Prison Terms to implement the *Valdivia v. Schwarzenegger* settlement agreement to reform the parole revocation process. The elements of the implementation plan that drive these costs include the addition of a probable cause hearing, provision of attorneys, and an expedited timeframe for conducting the revocation process.

***Inmate Health Care.*** The budget assumes implementation of several cost-saving measures in the inmate health care program. These measures include switching to the generic version of a few high utilization prescription drugs, adopting protocols related to treatment of Hepatitis C, auditing hospital billings, and more effectively managing and negotiating health care contract costs. As a result of these changes, the budget assumes savings of $36 million in the inmate health care program.

### Department of the Youth Authority

The budget provides $329 million from the General Fund for support of the Youth Authority, an 11 percent reduction in comparison to 2003-04. This decrease primarily results from the closure of the Fred C. Nelles Youth Correctional Facility in Whittier, and the Mount Bullion Conservation Camp in Mariposa County.

### Assistance to Local Law Enforcement

***Probation Block Grant.*** The budget provides $134 million (General Fund) to backfill for the loss of the TANF Block Grant support for probation services which sunsets in October 2004. The funds, administered by the Board of Corrections, will be allocated consistent with the previous TANF Block Grant.

***Citizens' Options for Public Safety (COPS).*** The budget includes $100 million to continue the COPS program. The program provides discretionary funding on a per capita basis, for local police departments and sheriffs for front line law enforcement (with a minimum guarantee of $100,000), sheriffs for jail services, and district attorneys for prosecution.

***Other Grants to Local Law Enforcement.*** The budget includes approximately $38 million for a variety of other local law enforcement programs, including the High Technology Theft Apprehension and Prosecution ($13.5 million), War on Methamphetamine ($9.5 million), and Vertical Prosecution ($8.2 million) programs. The budget also restores funding ($18.5 million) for the Rural County Sheriff's Grant program, which was not funded in 2003-04.

### Assistance for Local Juvenile Justice Programs

***Juvenile Justice Grants.*** The budget provides $100 million for juvenile justice grants. These grants go to county level juvenile justice coordinating councils to support locally identified needs related to juvenile crime.

## TRANSPORTATION

### Department of Transportation

The 2004 budget provides total expenditures of $9.3 billion from special funds and federal funds for the Department of Transportation (Caltrans). This is 26 percent above the 2003-04 expenditure level. The increase is primarily due to higher anticipated expenditures for transportation capital outlay. However, while the budget provides a higher level of expenditure authority to Caltrans, much of this authority depends on uncertain funding sources. These sources include $1.2 billion from tribal gaming bonds (described below), $800 million in bonds to be repaid with future federal revenues, and $300 million that is dependent on the federal government raising the tax on ethanol fuel to match the current federal tax on other motor fuel. To the extent that some of this funding does not materialize, Caltrans' expenditures could be significantly lower than budgeted. As a consequence, less money would be available for projects in the State Transportation Improvement Program and the Traffic Congestion Relief Program (TCRP).

Of the amount provided in the budget, approximately $8.4 billion is for highway transportation expenditures. The budget also provides $228 million for Caltrans' mass transportation program, and about $600 million for the transportation planning program and departmental administration.

Funding for the highway transportation program includes $5 billion for capital outlay, $1.4 billion for capital outlay support, $955 million for local assistance, and $813 million for highway maintenance. The amount provided for capital outlay support includes funding for 10,653 personnel-years in state staff, 699 personnel-year-equivalents of cash overtime, and 1,070 personnel-year-equivalents in contracted services.

### Transportation Loans and Repayment

Since 2001-02, various amounts of transportation funds have been borrowed to aid the state General Fund condition. The 2004 budget includes additional borrowing of transportation funds. At the same time, the budget provides for the early repayment—in 2004-05—of loans that were due to be repaid in 2005-06. Figure 15 summarizes the loans and repayments detailed below.

**Figure 15**

**Transportation Loans and Repayments[a]**

*(In Millions)*

| | To General Fund[b] | | | To TCRF[c] | |
|---|---|---|---|---|---|
| Year | From SHA | From TCRF | From TIF | From SHA | From PTA |
| 2000-01 | — | — | — | $2 | — |
| 2001-02 | $173 | $238 | — | 41 | $180 |
| 2002-03 | -173 | 1,145 | — | 520 | 95 |
| 2003-04 | — | — | $862 | -100 | — |
| 2004-05 | — | -1,383[d] | 1,207 | -463[e] | -275[e] |
| 2005-06 | — | — | — | — | — |
| 2006-07 | — | — | — | — | — |
| 2007-08 | — | — | -1,207 | — | — |
| 2008-09 | — | — | -862 | — | — |

SHA = State Highway Account; TCRF = Traffic Congestion Relief Fund; TIF = Transportation Investment Fund; PTA = Public Transportation Account.

a Amounts do not include interest.

b Positive numbers are amounts payable *to* the General Fund, negative numbers are payable *from* the General Fund.

c Positive numbers are amounts payable *to* TCRF, negative numbers are payable *from* TCRF.

d Amounts include $43 million from the General Fund, $140 million in "spillover" revenue, and $1.2 billion from bonds backed by tribal gaming revenue.

e Amounts are to be repaid from the $1,383 million transferred to TCRF in 2004-05.

***Proposition 42 Suspended, to Be Repaid in 2007-08.*** Under Proposition 42, approved by voters in March 2002, revenue from the sales tax on gasoline that previously went to the General Fund is to be transferred into the Transportation Investment Fund (TIF) for transportation purposes, beginning in 2003-04. However, Proposition 42 allows the transfer to be suspended in years in which the transfer would have a significant negative fiscal impact on the General Fund. The 2003 budget partially suspended the transfer for 2003-04, and required that suspended amount ($862 million) to be transferred to TIF with interest by June 30, 2009. The 2004 budget, on the other hand, fully suspends the Proposition 42 transfer, allowing about $1.2 billion to remain in the General Fund in 2004-05. This amount is to be repaid with interest for transportation purposes by June 30, 2008.

***Repayment of Transportation Loans.*** The 2004 budget repays to the Traffic Congestion Relief Fund (TCRF) $183 million that had been loaned to the General Fund. Of this amount, $43 million will be paid from the General Fund, and $140 million is "spillover" revenue resulting from high fuel prices, which would otherwise go to the Public Transportation Account (PTA). Of the $183 million:

- $163 million will be used for expenditure on TCRP projects.

- $20 million will go to the State Highway Account (SHA) to partially repay an outstanding loan from the account to TCRF.

***Tribal Gaming Revenue to Be Used for Transportation.*** Chapter 91, Statutes of 2004 (AB 687, Nuñez), provides in 2004-05, $1.2 billion in bonds to repay with interest transportation loans that would otherwise be due in 2005-06. These bonds will be backed by tribal gaming revenues as specified in newly approved tribal gaming compacts. The money will be distributed in the following priority order:

- $457 million will be used to repay with interest an outstanding loan from the SHA.

- $290 million will be used for TCRP projects.

- $275 million will be used to repay an outstanding loan from PTA.

- $192 million will be used in 2004-05 to repay money owed for local street and road maintenance that is due by 2008-09.

If any additional money is available beyond the anticipated $1.2 billion, the funds would first be used to repay $47 million owed to the State Transit Assistance program that is due by 2008-09. Any remaining funds would then be used to repay TIF suspensions that are payable from the General Fund in 2007-08 and 2008-09.

### California Highway Patrol (CHP) and Department of Motor Vehicles (DMV)

The 2004 budget provides about $1.2 billion to support the CHP, about 2 percent higher than the level of 2003-04. About 90 percent of this support will come from the Motor Vehicle Account (MVA).

With regard to the DMV, the budget provides $715 million in departmental support, about the same level as in 2003-04. Of this amount, about $390 million will come from the MVA with the remainder coming from the SHA and vehicle license fee revenues.

## Resources and Environmental Protection

The 2004-05 budget provides about $4.8 billion from various fund sources for natural resources and environmental programs administered by the Resources and California Environmental Protection Agencies, respectively. This is a reduction of about $2.9 billion, or 37 percent, when compared to 2003-04 expenditures. This reduction is mainly the result of a decrease in bond fund expenditures for park and water projects due to the one-time nature of these expenditures. In addition, the budget reflects a slight net increase in General Fund expenditures of about $12 million. The most significant General Fund augmentation is a $50 million General Fund backfill resulting from the budget's repeal of an existing fire protection fee that would have partially funded state fire protection services provided to private landowners.

Figures 16 and 17 compare expenditure totals for resources and environmental protection programs in 2003-04 and 2004-05. As the figures show, the largest changes in funding for these programs are generally in local assistance and capital outlay due to a reduction in available bond funds.

The following sections summarize the major features of the 2004-05 budget for natural resources and environmental protection programs. We also include a summary of energy and telecommunications-related spending highlights, including programs both within and outside the Resources Agency.

**Figure 16**

## Resources Programs: Expenditures and Funding

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

| | | | Change | |
|---|---|---|---|---|
| **Expenditures** | **2003-04** | **2004-05** | **Amount** | **Percent** |
| State operations | $2,984.4 | $3,018.6 | $34.2 | 1.1% |
| Local assistance | 1,251.0 | 368.0 | -883.0 | -70.6 |
| Capital outlay | 1,830.3 | 311.0 | -1,519.3 | -83.0 |
| **Totals** | **$6,065.7** | **$3,697.6** | **-$2,368.1** | **-39.0%** |
| **Funding** | | | | |
| General Fund | $986.0 | $1,019.6 | $33.6 | 3.4% |
| Special funds | 1,487.8 | 1,655.4 | 167.6 | 11.3 |
| Bond funds | 3,337.3 | 860.9 | -2,476.4 | -74.2 |
| Federal funds | 254.6 | 161.7 | -92.9 | -36.5 |
| **Totals** | **$6,065.7** | **$3,697.6** | **-$2,368.1** | **-39.0%** |

**Figure 17**

## Environmental Protection Programs: Expenditures and Funding

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

| | | | Change | |
|---|---|---|---|---|
| **Expenditures** | **2003-04** | **2004-05** | **Amount** | **Percent** |
| State operations | $857.7 | $927.2 | $69.5 | 8.1% |
| Local assistance | 800.8 | 212.1 | -588.7 | -73.5 |
| Capital outlay | 0.9 | — | -0.9 | -100.0 |
| **Totals** | **$1,659.4** | **$1,139.3** | **-$520.1** | **-31.3%** |
| **Funding** | | | | |
| General Fund | $90.8 | $68.9 | -$21.9 | -24.1% |
| Special funds | 713.8 | 823.8 | 110.0 | 15.4 |
| Bond funds | 693.8 | 85.1 | -608.7 | -87.7 |
| Federal funds | 161.0 | 161.5 | 0.5 | 0.3 |
| **Totals** | **$1,659.4** | **$1,139.3** | **-$520.1** | **-31.3%** |

## Overall Budget Solution: Fund Shifts, Fund Transfers, and Program Reductions

Resources and environmental protection programs assisted in the state's overall budget solution through: (1) shifting some General Fund costs to fee-based special funds, (2) making transfers from a special fund to the General Fund, and (3) adopting General Fund program reductions. Unlike recent years, the budget does not include any loans from resources-related special funds to the General Fund. We discuss each of the components of the budget solution in the sections that follow.

### Fee-Based Funding Shifts

The 2004-05 budget increases existing fees in a few of the resources and environmental protection programs. These fee-based funding shifts result in General Fund savings of about $24 million in 2004-05, relative to prior-year expenditures. In contrast, as discussed later, the budget also assumes the repeal of an existing resources-related fee pertaining to fire protection, resulting in a General Fund cost of $50 million in 2004-05.

Figure 18 details the General Fund savings resulting from the increases in existing fees.

### Transfers

The budget includes a transfer of $12 million to the General Fund from the Energy Resources Program Account, an account administered by the Energy Resources Conservation and Development Commission (Energy Commission).

**Figure 18**

**Resources and Environmental Protection Fee Increases**

*2004-05*
*(In Millions)*

| Fees | General Fund Savings |
|---|---|
| State park | $15.0 |
| Air quality | 3.3 |
| Water quality | 3.0 |
| Toxics | 1.4 |
| Conservation | 1.0 |
| Coastal development | 0.3 |
| **Total** | **$24.0** |

## Other Spending Highlights

Other spending highlights, including expenditures from Proposition 40 and Proposition 50 bond funds, are summarized below.

## Resources and Environmental Protection Expenditures

- ***Proposition 40.*** Proposition 40 is a $2.6 billion resources bond measure approved by the voters in March 2002. The measure provides funds to conserve natural resources (land, air, and water); acquire and improve state and local parks; and preserve historical and cultural resources.

  The budget includes about $273 million in expenditures from Proposition 40 in 2004-05, leaving less than $100 million available for projects and programs in future years. Figure 19 shows the breakdown of 2004-05 Proposition 40 expenditures by programmatic area.

**Figure 19**

### Proposition 40 Bond Expenditures

*2004-05*
*(In Millions)*

| Program Area | Budgeted Expenditures |
|---|---|
| State conservancies—acquisition, development, restoration | $79 |
| Local parks | 78 |
| State parks—acquisition, development, deferred maintenance | 76 |
| Farmland Conservancy Program | 13 |
| Department of Fish and Game, grants for salmon restoration | 8 |
| Fuel reduction efforts in the Sierra Nevada | 7 |
| Grants to local conservation corps | 4 |
| Cultural and historical resources | 2 |
| Other | 6 |
| **Total** | **$273** |

- ***Proposition 50.*** Proposition 50 is a $3.4 billion resources bond measure approved by the voters in November 2002. The measure provides funds for various water-related programs, and allocates the majority of the funds to coastal protection and the CALFED Bay-Delta Program. The budget includes about $480 million in expenditures from Proposition 50 in 2004-05, leaving about $1 billion for projects and programs in future years. Figure 20 (see next page) shows the breakdown of these expenditures by programmatic area.

- ***CALFED Bay-Delta Program.*** The CALFED Bay-Delta Program is a consortium of 24 state and federal agencies created to address a number of interrelated water problems in the state's Bay-Delta region. The budget provides a total of about $420 million from various state and federal funds for the CALFED Bay-Delta Pro-

**Figure 20**

**Proposition 50 Bond Expenditures**

*2004-05*
*(In Millions)*

| Program Area | Budgeted Expenditures |
|---|---|
| CALFED Bay-Delta Program | $207 |
| Safe drinking water | 98 |
| Clean water and water quality, including river parkways | 58 |
| Coastal watershed and wetland protection | 50 |
| Wildlife Conservation Board—acquisition, development, restoration | 25 |
| Colorado River management | 14 |
| Groundwater monitoring | 10 |
| Water security | 10 |
| Other | 8 |
| **Total** | **$480** |

gram in 2004-05. This amount reflects a decrease of about $114 million in state funds for CALFED from estimated 2003-04 expenditures. This reduction is mainly the result of a decrease in bond fund expenditures for water projects due to the one-time nature of these expenditures. Proposition 50 bond funds are by far the largest source of support for the program, providing about $207 million of the program's funding in 2004-05. The General Fund provides $12 million of the program's support.

- ***Carl Moyer Program.*** The Air Resources Board and local air districts administer the Carl Moyer Air Quality Standards Attainment Program (Carl Moyer Program). The main object of the Carl Moyer Program is to reduce oxides of nitrogen ($NO_X$) emissions from diesel-fueled engines.

  The Governor's proposal, as adopted by the Legislature, provides $30.5 million in fee revenues in 2004-05 (half-year of revenues) from a revised smog check program to support the Carl Moyer Program. Specifically, the air quality fee assessed at the time of registration for new cars exempted from smog check will increase by $6—from $6 to $12. To offset this fee adjustment, owners of new cars will be exempt from getting their vehicles smog checked for up to six years, instead of the previous four years. These changes will provide a dedicated funding source of $61 million annually for the Carl Moyer Program.

- ***Electronic Waste Recycling Program.*** The budget provides $73.4 million from fees for the first year of an electronic waste recycling program administered jointly by the California Integrated Waste Management Board and the Department of Toxic Substances Control. The program is funded by a fee assessed at the point of sale of certain electronic equipment, with the fee ranging from $6 to $10 depending on the size of the screen of the electronic device. Retailers will be required to begin collection of the e-waste fee on November 1, 2004, pursuant to Chapter 84, Statutes of 2004 (AB 901, Jackson).

- ***Allocation of Tidelands Oil Revenues.*** The budget dedicates $500,000 of tidelands oil revenues to activities related to the Marine Life Protection Act. In addition, $26 million of tidelands oil revenues will be provided to various resources-related purposes if tidelands revenues are collected in excess of the $165.5 million amount assumed by the budget. These purposes include ocean protection projects, salmon and steelhead trout restoration projects, fish hatchery operations, and local parks.

- ***Repeal of Fire Protection Fees.*** The budget package includes the repeal of a previously authorized fire protection fee levied on private landowners in areas (referred to as "State Responsibility Areas") where the state provides fire protection services. This fee—not yet collected because it was only enacted in 2003-04—would have partially supported the state's fire protection services provided to these landowners in 2003-04 and 2004-05. The budget provides $50 million from the General Fund to backfill the loss of revenue from the fee for 2004-05—the fee level originally anticipated in the Governor's January budget proposal.

- ***Fuel Reduction Partnership.*** The budget earmarks funds totaling about $1.5 million (federal funds, bond funds, and reimbursements) for a partnership between the California Department of Forestry and Fire Protection and the California Conservation Corps (CCC). The partnership will provide fire suppression training for about 80 corpsmembers and give priority to bond-funded fuel reduction projects involving the CCC.

- ***Health Care Benefits for CCC Corpsmembers.*** The budget includes $1.8 million from the General Fund to fund 80 percent of health care benefit costs for CCC corpsmembers, with corpsmembers covering 20 percent of the benefit costs.

## Energy and Telecommunications Expenditures

- ***Energy Commission.*** The budget includes about $350 million from special funds and federal funds for support of the Energy Commission in 2004-05, a 16 percent increase from 2003-04. The increase mainly reflects an increase in Renewable Resource Trust Fund expenditures to increase renewable energy production.

- ***California Public Utilities Commission.*** The budget includes $1.2 billion from special funds for support of the California Public Utilities Commission in 2004-05. This is a 5 percent reduction from estimated 2003-04 expenditures, mainly due to lower expenditures in funds that support various universal service telecommunications programs. In particular, the budget eliminates funding for the California Teleconnect Fund program. This program provides discounts to schools, libraries, and qualifying hospitals and community-based organizations on telephone service and other advanced telecommunications services that provide access to the Internet. Although the budget eliminated funding in 2004-05 for this program, legislation—Chapter 227, Statutes of 2004 (SB 1102, Committee on Budget and Fiscal Review)—was enacted that provides policy direction for this program for future years.

- ***California Energy Resources Scheduling Program (CERS).*** The budget includes about $46 million from the Department of Water Resources (DWR) Electric Power Fund for the administration of the CERS program within DWR. This program was established in 2001 to purchase electricity on behalf of the state's three largest utilities. While the CERS program no longer purchases electricity, it continues to be financially responsible for managing a multibillion dollar portfolio of electricity contracts and overseeing the repayment of over $11 billion of ratepayer-supported revenue bonds.

- ***Elimination of California Consumer Power and Conservation Financing Authority (Power Authority).*** The *2004-05 Budget Act* reduces funding for the Power Authority to $424,000 in 2004-05, an amount consistent with the Governor's January budget proposal to eliminate the authority as a first step to reorganizing the state's energy agencies. This level of funding will provide the authority with funding through September 30, 2004 for purposes of winding down the agency, including finishing remaining work and terminating existing contracts.

# Capital Outlay

The 2004 budget includes almost $1.8 billion for capital outlay (excluding highways and transit), as shown in Figure 21. About 95 percent of total funding is from bonds (either general obligation or lease-revenue bonds).

The major state capital outlay projects and programs funded in the budget include:

## Resources

About $269 million in capital outlay expenditures planned for 2004-05 will be for resources programs.

- ***Coastal Conservancy***—A total of $75.5 million including $68.6 million from Propositions 12, 40, and 50 bond funds for various coastal conservation and restoration projects.

- ***Department of Parks and Recreation***—A total of $71 million including $55.5 million from Propositions 12 and 40 bond funds, and $11.7 million from special funds for 26 capital outlay projects.

- ***Wildlife Conservation Board***—About $45.8 million, including $45.2 million from bond funds, for habitat conservation.

- ***Department of Forestry and Fire Protection***—About $17 million including $11.9 million from bond funds and $3.3 million from the General Fund for the acquisition and construction of 17 major capital outlay projects.

**Figure 21**

**2004-05 Capital Outlay Programs by Funding Source**

*(In Thousands)*

| | Bonds | General | Special | Federal | Totals |
|---|---|---|---|---|---|
| Legislative, Judicial, and Executive | $8,098 | — | $619 | — | $8,717 |
| State and Consumer Services | 4,653 | — | — | — | 4,653 |
| Business, Transportation, and Housing | — | — | 10,551 | — | 10,551 |
| Resources | 236,239 | $3,626 | 21,668 | $7,409 | 268,942 |
| Health and Human Services | — | 629 | — | — | 629 |
| Youth and Adult Corrections | 2,000 | 26,990 | — | — | 28,990 |
| Education | 73,260 | — | — | — | 73,260 |
| Higher Education | 1,360,765 | — | — | — | 1,360,765 |
| General Government | 12,824 | 6,415 | 6,828 | 7,449 | 33,516 |
| **Totals** | **$1,697,839** | **$37,660** | **$39,666** | **$14,858** | **$1,790,023** |

### Higher Education

About $1.4 billion (or 76 percent) in nontransportation capital outlay expenditures planned for 2004-05 will be for higher education programs.

- ***California Community Colleges***—$627 million from bond funds for 92 projects at 65 campuses and off-campus centers.

- ***California State University***—$321 million from bond funds for 22 projects at 15 campuses.

- ***University of California***—$413 million from bond funds for 35 projects at nine campuses.

### Other

- ***Department of Education***—About $73.3 million including $69.9 million from lease-revenue bonds to replace a dormitory and chiller at the California School for the Deaf in Riverside.

- ***Department of Corrections***—$24.2 million from the General Fund for nine capital outlay projects at various state correctional facilities.

- ***Department of Food and Agriculture***—$19.6 million, including $12.8 million from lease-revenue bonds and $6.4 million from the SHA, to complete construction of a new agricultural inspection station in Truckee.

## State Administration

### Employee Compensation and Retirement

***Employee Compensation.*** The budget provides $405 million from the General Fund for 2004-05 salary and benefit costs associated with collective bargaining agreements. This amount includes $26 million for newly authorized pay increases for certain nurses, teachers, and psychiatric technicians.

In addition, the budget package includes a revision of a multiyear agreement with correctional officers. The revision defers 6 percent of a scheduled 11 percent pay increase, reducing General Fund costs by $63 million in 2004-05. Of the deferred amount, 5 percent will go into effect on January 1, 2005, and 1 percent will go into effect in 2006-07. Officers will receive an additional raise in 2005-06 based on raises provided to local law enforcement agencies (the raise is currently estimated at more than 5 percent). By the end of the agreement, correctional officers' salaries will be at the same level as under the original agreement. As such, the savings generated are one-time in nature. Unlike other collective bargaining agreements, the costs for this revised agreement will be paid through a continuous appropriation—rather than through an appropriation in the budget act.

***Retirement.*** The budget package authorizes the issuance of pension obligation bonds to pay $929 million in 2004-05 state retirement costs. These bonds would be paid off over 20 years. The budget further reduces General Fund retirement costs by $32 million through a delay in state payments for new employees. Under the plan, the state will not make retirement contributions for new employees for two years. The new employees will contribute 5 percent of their salary to a retirement account. After the two-year period, these employees will then choose whether to (1) transfer the funds in their account to the Public Employees' Retirement System (PERS) or (2) cash out their account. If an employee chooses to transfer the proceeds to PERS, that employee would receive retirement service credit for the two years. The state will bear any additional financial liability (beyond the transferred funds) for the retirement costs associated with the two years of service. This increased liability would be paid through increases in future employer contribution rates. If an employee instead opts to cash out the account, that employee would not receive the two years of service credit. In this case, the state would not owe payments for the two-year period. After the initial two-year period, these employees will be treated the same as existing employees.

## Statewide Issues

***Indian Gambling Revenues.*** The budget assumes $300 million in new General Fund revenues from Indian tribes. Chapter 91 approved agreements with five tribes, which will provide a portion of these revenues. In addition, the state is authorized to issue over $1 billion in bonds (with proceeds dedicated to transportation purposes) backed by additional payments from tribes. The Legislature recently approved SB 1117 (Burton), which provides agreements with four additional tribes. Under the measure, these four tribes would contribute revenues to the state based on the level of gaming activity.

***Unallocated Reductions.*** The budget provides the administration with the authority to make $150 million in General Fund reductions during the fiscal year. State operations appropriations could be reduced by as much as 20 percent, and local assistance appropriations could be reduced by as much as 5 percent. The budget assumes an additional $150 million in savings from efficiencies due to the future reorganization of state government.

***Procurement Savings.*** The budget assumes $96 million in General Fund savings from improved state purchasing and contracting practices. The administration has signed a contract with a private vendor to help generate these savings.

***Elimination of Deficiency Spending.*** The budget package eliminates Section 27.00 of the budget act and the related authorizations for departments to engage in deficiency spending. The deficiency process allowed departments to commit the state to spending prior to an appropriation by the Legislature. In place of deficiency spending, the budget appropriates $50 million from the General Fund to be used throughout the year for unanticipated expenses. Under specified conditions, the administration will be able to transfer these funds to a department's budget to address an unanticipated expense. For any additional unanticipated expenses, the administration will need to seek supplemental appropriations from the Legislature *prior to* the expenditure of funds.

## Department Issues

***Federal Election Reform.*** The budget appropriates $264 million in federal funds for the Secretary of State (SOS) to implement election reform changes required by the federal Help America Vote Act of 2002. Prior to the expenditure of these funds, the SOS will provide the Legislature with a spending plan for review.

***Data Center Consolidation.*** Under current law, the Health and Human Services Data Center and the Stephen P. Teale Data Center were scheduled to consolidate their operations on July 1, 2004. The budget assumes $3.5 million in General Fund savings from improved efficiencies in 2004-05 as a result of this consolidation. On August 24, 2004, the Governor issued an Executive Order to begin planning for the consolidation.