RESTRUCTURING THE STATE-LOCAL RELATIONSHIP: MAKING PROGRESS IN 1994-95

How Should the Legislature Begin the Process of Restructuring California's System of State and Local Government?

Summary

The 1994-95 Governor's Budget proposes a major restructuring of the fiscal relationship between the state and California's 58 county governments. This proposal would increase county governments' responsibilities for funding a variety of health and welfare programs, and transfer a corresponding amount of state resources to the counties. Its primary objective appears to be increasing the fiscal incentives for counties to take actions that will improve overall program performance.

The Governor's proposal is similar in many respects to a restructuring proposal offered by this office last year. Both would result in a greater decentralization of responsibility and funding than currently exists. Both recognize the importance of fiscal incentives and program linkages, and attempt to promote collaborative efforts in order to improve the way government delivers services. Most importantly, both proposals stress the importance of outcomes over inputs and process management. The Governor's proposal is a reasonable starting point for the Legislature to use in 1994 as it pursues its state and local government restructuring agenda.

To assist the Legislature in pursuing its restructuring agenda, we outline the elements of the Governor's proposal, and evaluate its fiscal implications. We offer modifications to the proposal to correct the weaknesses we identify. Finally, we suggest that the Legislature needs to consider the state's restructuring needs within a long-term context.

INTRODUCTION

The relationship between the state and its units of local government has come under increasing stress in the last several years. This stress is, in part, a product of the state's continuing recession, which has limited the level of resources available to all levels of government. More fundamentally, however, the stress is a product of tensions inherent to the state's system of government; it reflects a growing dissatisfaction with traditional approaches to government that emphasize top-down control of program operations at the expense of flexibility and results.

In last year's *The 1993-94 Budget: Perspectives and Issues*, we reviewed the problems that characterize California's dysfunctional system of state and local government. We also offered a set of principles to guide the state's efforts to address this problem, and a model for restructuring the state and local government relationship. While we believe that the *Making Government Make Sense* model provides a sound framework for addressing the long-term restructuring needs of the state, there are different ways that progress can be made toward this objective in 1994-95.

The *1994-95 Governor's Budget* contains a major proposal for restructuring the relationship between county governments and the state. Largely structured along the lines of the 1991 state-county program realignment legislation, this proposal increases county shares of cost in existing health and welfare programs, and balances these increased costs with increased revenues transferred to counties from the state. In our view, the Governor's proposal generally moves toward a greater decentralization of programs and funding relative to what exists today, and in this respect is similar to our *Making Government Make Sense* model. Although it contains some fundamental weaknesses, it provides a reasonable starting point for the Legislature's deliberations.

The two key questions facing the Legislature in acting on any restructuring proposal are:

- Exactly what changes should be made in 1994?
- How should the Legislature's efforts to plan for other necessary long-term changes in the state-local relationship influence its choice of short-term actions?

In this report, we review the Governor's proposal and its fiscal implications. In addition, we discuss our concerns with certain portions of the proposal, and recommend some major changes to deal with these concerns. Finally, we provide some discussion of long-term policy choices that should be considered in the context of short-term decision-making.

WHAT IS THE GOVERNOR'S PROPOSAL?

Overview

Figure 1 illustrates the shifts in financial responsibility and funding associated with the Governor's proposal. As the figure shows, the administration's estimates indicate that counties would face increased costs of approximately $3.25 billion in a variety of health and welfare programs, and these costs would be offset by increased county resources of a corresponding amount.

As the figure indicates, the proposal would impose a new county cost share for the Medi-Cal program, increase the county share of cost in most AFDC program areas, and transfer full program and financial responsibility to the counties for certain other programs. In return, the county share of the state sales tax would be doubled, property taxes worth about $1.1 billion would be returned to counties from K-14 school districts, and the state would provide increased trial court-related funding. These elements of the proposal are described in the section that follows.

Elements of the Restructuring Proposal

The approach used by the administration in fashioning it restructuring proposal has three major elements: increased county fiscal responsibilities, increased revenues to offset the costs of these increased responsibilities, and increased flexibility to permit greater local control over programs operated at the local level.

Increased County Responsibilities

New County Medi-Cal Cost Share. County governments would be required to pay an 11.51 percent share of the total cost for Medi-Cal program services provided to county residents. The county share of cost would be based on total Medi-Cal program expenditures for all services with three exceptions. These include expenditures for services provided to state hospital and developmental center clients, for targeted case management services, and for costs associated with matching disproportionate share hospital (DSH) payments. Although the proposal states that each county would pay this share of costs based on services provided to residents of that county, no data systems currently exist to allocate Medi-Cal costs on a county-by-county basis. The administration has not submit-

ted a specific proposal as to how this share of cost is to be allocated to the individual counties.

The administration believes this cost transfer will provide counties a strong fiscal incentive to more effectively control the costs of services provided to Medi-Cal program clients.

Figure 1

Governor's Restructuring Proposal 1994-95 County Fiscal Impact

(In Thousands)	
Expenditure Changes	
Impose new county share of cost:[a]	
11.51 percent share of Medi-Cal	$1,352,903
Change county shares to 50 percent:[b]	
AFDC Grants	$1,126,586
Child Support	-84,812
AFDC County Administration	69,933
Food Stamps Administration	30,252
Staff Development	1,576
Cal-Learn	208
Child Care	2,711
Child Care Administration	663
Transfer financial and program responsibility:	
Alcohol and Drugs	62,258
IHSS/Personal Care	364,460
County Services Block Grant	16,204
Foster Care	323,821
Total, expenditure changes	**$3,266,763**
Revenue Changes	
Transfer state resources:	
Sales Tax	$1,409,000
Property Tax	1,140,000
Mental Health Revenues	15,000
Trial Court Fines and Forfeitures	296,000
Increase state share of cost:	
Trial Court Block Grants	388,359
Total, revenue changes	**$3,248,359**
Net Fiscal Impact	**-$18,404**

[a] Share of total program costs.

[b] Share of non-federal program costs.

Higher County Share of Cost for AFDC. As shown in Figure 1, there are a variety of different AFDC program elements that would be affected by the administration's proposal. In each of these cases, the county share of non-federal program costs would be increased to 50 percent.

The administration believes that giving counties a higher share of program costs will give them a strong fiscal incentive to make program investments in job training, employment services and other services that will contribute to a reduction in welfare dependency.

Counties to Take Over Social Services Programs. Under the administration's proposal, complete financial and program responsibility for the Foster Care and In-Home Supportive Services (IHSS) programs would be transferred to the counties. In addition, funding and operating responsibility for substance abuse programs would be transferred, with the exception that the state would continue to fund perinatal substance abuse projects. The administration indicates that counties would have discretion to determine service levels, approaches to service delivery and control operations, and the involvement of state agencies in these program areas would be limited.

These program transfers reflect a recognition of the linkages that exist between these and other community-based services. By allowing counties greater flexibility in the operation of these programs, the administration expects that more innovative, outcome-based approaches to collaborative service delivery will result.

Increased County Resources

Increased State Funding for Trial Courts. Under the proposal, the state would significantly increase its funding for trial courts under the existing Trial Court Funding Program. The administration proposes that the state funding level be increased to 65 percent of total statewide trial court operations expenses, generally corresponding to the level intended by current statutes.

This portion of the proposal reflects the view that a greater state share of costs is consistent with the statewide interest in promoting the "uniform application of justice throughout the 58 counties" and recognizes that trial court operations are controlled by state laws and regulations.

Court-Related Fine and Penalty Revenues Returned to Counties. The proposal would return the state's share of local trial court-related fine and penalty assessment revenues (about $348 million) to counties and cities. The return of these trial-court related revenues is intended to improve local incentives to collect these funds, which has been a problem over the entire period that counties have been required to remit these funds to the state.

Increased County Property and Sales Tax Allocations. The proposal would increase allocations of property and state sales taxes to the counties. In contrast to the budget actions of the last two years, the proposal would return to counties $1.14 billion of the property taxes now allocated to schools and used to offset state funding obligations under Proposition 98. In addition, the proposal would earmark an additional one-half cent of the state's sales tax to pay for the increased county costs.

The increased revenue allocations are primarily intended to offset the increased county costs resulting from the proposal. In addition, the transfer of property tax revenues is intended, by increasing the overall county share of the property tax, to improve county incentives to adequately support the administration of the property tax. The budget also proposes a one-time $25 million allocation to counties from the General Fund in 1993-94 to provide some temporary assistance in this area.

Return of Mental Health Patient Revenues. Counties also would receive approximately $15 million of state revenues associated with state hospital patients in civil cases. These revenues represent funds paid by Medi-Cal, Medicare and other private sources towards the cost of care provided to these patients. In these cases, counties also pay the state for 100 percent of the costs of the services provided.

The administration intends that the funds be used to help offset the counties' costs for these patients, but no mechanism has been developed to accomplish this.

Increased County Program Flexibility

Goodbye to 1991 Realignment Fund Structure. The proposal would incorporate both the 1991 realignment program and the above changes within a new overall funding structure. Specifically, the multiple accounts of the 1991 program would be eliminated in favor of a new two-account funding structure, as illustrated in Figure 2.

- The *Client Services Fund* would receive the proceeds of the 0.5 percent sales tax rate now dedicated to the Local Revenue Fund for the 1991 realignment program, as well as the proceeds of an existing 0.5 percent sales tax rate that would be shifted from the state's General Fund. The counties would use this fund to pay their increased costs for Medi-Cal and AFDC grants, and the budget indicates that counties would be allowed to transfer surplus funds to their county general funds.
- The *Community Services Fund* would receive the proceeds of the 1991 Vehicle License Fee increase that funded a portion of the increased county costs resulting from the 1991 realignment program. In addi-

tion, this fund would receive the $1.14 billion of property taxes that are proposed to be shifted to the counties. From this fund, counties would pay their increased costs for foster care and the other newly transferred programs. In addition, this fund would help to support the increased county costs associated with the 1991 realignment program.

Figure 2

Proposed Realignment Funding Structure

Client Services Fund	Community Services Fund	County General Funds
Revenues:		
Existing realignment 1/2 cent sales tax	Existing realignment Vehicle License Fee proceeds	Increased state trial court funding block grants
Additional 1/2 cent of state sales tax	Transfer of $1.14 billion from state property tax allocations	Transfer of trial-court-related fine and penalty revenues
		Transfer of mental health patient-related revenues
Expenditures:		
New responsibilities:	*New responsibilities:*	*New responsibilities:*
11.5% share of total Medi-Cal	Foster Care	None
50% share of nonfederal AFDC, including administration, etc.	In-Home Supportive Services	
	Alcohol and Drug Programs	
	County Services Block Grant	
	1991 realignment costs:	*Historical county costs:*
	Foster Care	Foster Care
	In-Home Supportive Services	In-Home Supportive Services
	County Services Block Grant	County Services Block Grant
	Child Welfare Services	Child Welfare Services
	Public Health	Public Health
	Indigent Health	Indigent Health
	Mental Health	Mental Health
	Adoption Assistance	AFDC-FG&U
	GAIN	

County General Fund Contributions Required. Figure 2 also indicates that the restructuring proposal would have a direct impact on county general funds. Specifically, the increased support for the Trial Court Funding Program and the return of fine and forfeiture revenues would increase county General Fund revenues by almost $700 million. The increased trial court support must be used to pay for trial court operating costs, but it is intended to "free up" a like amount of county general funds now used for that purpose.

Under the proposal, the Community Services Fund is intended to pay for the costs of the transferred programs (primarily foster care and IHSS) as well as the costs associated with the 1991 realignment program previously paid for from the Local Revenue Fund. However, because these costs exceed the amount of new revenue to be transferred to the new fund, counties would have to use Client Services Fund surplus revenues and their county general funds to make up the difference. In essence, the additional trial court-related county general fund revenues would be needed to defray the excess costs. Figure 3 illustrates this relationship.

Figure 3

Governor's Restructuring Proposal
Allocation of Revenues and Costs By Fund
1994-95

Client Services Fund	Community Services Fund	County General Funds
+ $2.858 billion sales taxes - $2.5 billion Medi-Cal and AFDC costs	+ $741 million Vehicle License Fees + $1.14 billion local property taxes - $767 million transferred program costs - $2.1 billion existing realignment costs	+ $388 million increased trial court support + $297 million return of trial court revenues + $15 million return of mental health patient revenues
Net +$358 million	**Net -$985 million**	**Net +700 million**

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As Figure 3 shows, the Community Services Fund would have excess costs of $985 million, while the Client Services Fund and county general

funds would have a combined surplus of $1,058 million, or $73 million more than necessary to offset the Community Services Fund deficit. This $73 million, which would accrue to the benefit of the counties, represents the combined impact of the Governor's Budget proposals on the existing realignment program (+$91 million) and the impact of the restructuring proposal discussed earlier (-$18 million). In other words, the Governor's proposals to reduce welfare grants and obtain higher federal cost sharing would reduce the counties' costs under the 1991 realignment program independently of the new restructuring proposal.

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

Our review of the proposal's fiscal implications is primarily intended to address the question of the proposal's fiscal neutrality, both in the immediate 1994-95 time frame and through the remainder of this decade. Although fiscal neutrality is a stated objective of the administration, our analysis indicates that it is by no means guaranteed. We provide a projection of the costs and revenues transferred under two scenarios. We also discuss certain other fiscal issues that may affect the fiscal neutrality of the proposal.

The 1994-95 Outlook

County Impact Depends On Unrelated State and Federal Actions. As shown in Figure 1, the level of costs transferred to the counties in 1994-95 is substantially in balance with the level of increased county resources, given the economic, policy and other assumptions that underlie the *1994-95 Governor's Budget.* As the figure indicates, counties would face increased costs of about $3.25 billion, offset by increased resources of almost the same amount.

From the *county* perspective, this conclusion of initial fiscal neutrality is, however, dependent upon the budget's assumptions that there will be multibillion dollar savings from increased federal funds and the adoption of health and welfare program reductions (please see Part 1 of this volume for a detailed description of these proposals). Specifically, the estimates of increased county shares of cost under the proposal are based upon the budget's estimates of total program costs, which reflect these savings. To the extent that the increased federal funds are not forthcoming, and the health and welfare expenditure reductions are not adopted, we estimate that the level of costs transferred to the counties would be $435 million *higher* than shown above.

Figure 4 summarizes the fiscal impact of the budget's assumptions on county costs in 1994-95. Because it is unlikely that all of these assumptions will be borne out, the proposal's assertion of initial fiscal neutrality is a tenuous one.

Figure 4

County Fiscal Risks in 1994-95 Under Governor's Budget Assumptions[a]

Policy Changes—$267 million

- $208 million to reflect AFDC grant reductions
- $57 million to account for reductions in Medi-Cal optional benefits
- $2 million to reflect capping AFDC maximum family grants

Federal Funds Assumptions—$168 million

- $103 million to reflect FMAP changes
- $46 million to reflect expanded eligibility of relative-providers to receive funding under IHSS
- $19 million to reflect expected additional federal support for refugees on AFDC

[a] Dollar amounts reflect assumed reductions in county expenditures associated with restructuring proposal.

State Impact Must Consider Other Factors. As noted above, the net impact on counties is a loss of $18 million. The net impact on the state, however, is not a net gain of $18 million, for two reasons.

- ***Transfer of Revenues to Cities (-$52 Million).*** Under the proposal, a portion of the fine and forfeiture revenues ($52 million) that would be foregone by the state would be returned to city governments. While this portion of the proposal reduces state revenues, it has no effect on the counties.
- ***Transfer of School Property Taxes (+$31 Million).*** As discussed earlier, the budget proposes that $1.14 billion of existing K-14 school district property taxes be transferred to counties to offset their increased costs under the restructuring proposal. As reflected in the budget, however, state costs for K-14 school apportionments in-

crease by about $31 million *less* than the amount transferred. This is because the budget assumes that a portion of the property taxes transferred are taken from so-called "Basic Aid" school districts that are not entitled to state apportionment funds.

As a result of these factors, the net impact of the restructuring proposal at the state level is a loss of less than $3 million, as opposed to a net county loss of approximately $18 million.

Counties Can Expect Longer-Term Shortfalls

Figure 5 presents our estimates of the proposal's cost/revenue transfers for the period 1994-95 through 1999-2000. The increased county

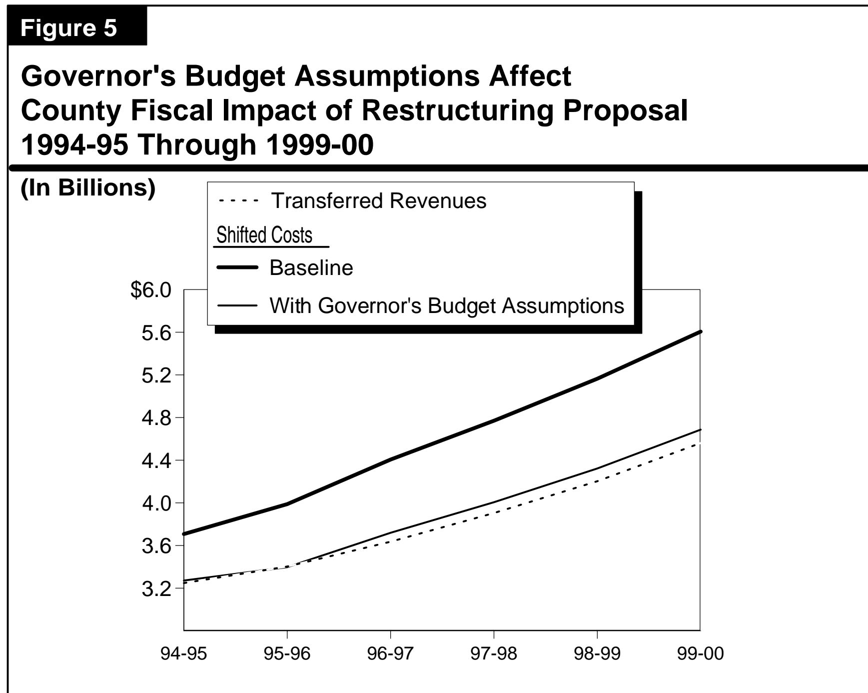

Figure 5

Governor's Budget Assumptions Affect County Fiscal Impact of Restructuring Proposal 1994-95 Through 1999-00

costs are shown both assuming the increased federal funds and program reductions are realized and assuming that they are not realized ("baseline"). In the first case, the figure shows that the increased county resources are in balance with increased costs for 1994-95 and 1995-96, and thereafter a small deficit develops. This deficit reflects an increased cost in the AFDC program stemming from provisions of existing law that require a restora-

tion of prior AFDC grant levels and the provision of annual cost-of-living adjustments.

In the latter (baseline) case, however, we project that counties would face substantial annual deficits over the entire forecast period, beginning in 1994-95. The magnitude of the annual deficit would more than double over the forecast period. From the state perspective, this annual deficit translates into annual savings of a corresponding magnitude.

Clearly, the budget's assumed federal funds and health and welfare program reductions both reduce the initial costs of the transaction, and limit the rate of growth in transferred programs over time.

Achieving Fiscal Neutrality Will Be Difficult

As a result of the factors discussed above, it will be extremely difficult for the Legislature to ensure that a restructuring proposal of this type actually achieves the goal of fiscal neutrality. Certainly, the Legislature can make adjustments in the level of resources it provides to the counties to account for the policy decisions it makes in acting on the state's budget. However, in the case of the anticipated federal funds, it is unlikely to have any firm basis on which to proceed because federal budget actions will not be finalized until September or October of this year.

Certain other considerations also are important in evaluating the fiscal impacts and overall neutrality of the Governor's restructuring proposal. These are discussed below.

Potential Mandate Liabilities

Because in the aggregate, the administration's proposal provides additional resources sufficient to offset the mandated county costs, the administration contends that it has avoided any potential mandate reimbursement implications. To the extent that the budget's assumptions regarding federal funds and program reductions are not borne out, however, or if revenue growth in future years is not sufficient to offset program cost growth, the state could be liable for reimbursement of the excess costs faced by the counties.

Another issue in this regard concerns the ability of the state to use local property tax revenues as a way of reimbursing counties for mandated costs. The state Constitution allows the state to disclaim responsibility for reimbursement of state-mandated costs under certain circumstances. In some cases, the Legislature has disclaimed this responsibility on the basis that it has provided "self-financing" authority—that is, the legislation provides sufficient revenue or revenue authority to offset the increased

costs. Certainly, the Governor's proposal provides roughly sufficient authority to offset its increased costs, but according to Legislative Counsel, *a self-financing disclaimer is not valid where the revenue authority is local proceeds of taxes*. This is a highly technical legal issue, but it would appear to argue that the state could be liable for mandate reimbursement. Some sort of a county "election", such as was used for purposes of the Trial Court Funding Program, may be required to eliminate this vulnerability.

Allocation Formula Issues

The administration intends that its proposal be fiscally neutral, both on a statewide basis *and* on a county-by-county basis. Because the administration has provided no details as to how the Medi-Cal cost shares, increased Trial Court Funding support and property tax transfers would be allocated among counties, we are not currently able to evaluate the proposal on this basis. However, the design of these allocation formulas will have to take into account a number of factors if the proposal is to meet this county-by-county neutrality goal. These include the treatment of "equity" based allocations under the existing realignment program, and potential imbalances between the levels of Community Services Fund expenditures and the level of Trial Court-related revenues and property taxes that are available to offset these costs in some counties.

Trial Court Spending Levels

The budget proposes to increase the level of state support for the Trial Court Funding Program, but as noted above, it anticipates that the county funds "freed up" by this transaction will be available to defray other county costs associated with the proposal. However, because of the existing "judicial sign-off" provisions of the Trial Court Funding Program, it is possible that some portion of these funds will be retained by the trial courts in each county.

Another issue concerns the recent estimates of trial court expenditures released by the Trial Court Budgeting Commission, which are substantially higher than those used by the DOF in preparing the budget proposal. Our review of these figures indicates that they are a more reasonable estimate of expenditures than that used in the budget, so that reaching the 65 percent funding goal would require additional funding of up to $108 million in 1994-95 and higher amounts thereafter. (For purposes of the projections discussed above, we have not incorporated these new estimates of expenditures because they have not been accepted by the administration.)

Administrative Cost Changes Not Reflected

The budget acknowledges that both the state's and the counties' expenditures for program administration will be affected by the proposal. In fact, the budget anticipates that net cost *savings* will be achieved at both levels of government. With regard to the impact on governmental administrative expenditures, we think that it is important for the state to take an aggressive role in the development of program outcome measures and in the development of statewide data processing systems. This role implies the expansion of state agency duties in some cases that will at least partially offset the savings from elimination of existing control functions. The administration has provided no details as to how this elimination of functions will be accomplished, nor are any savings reflected in the budget.

At the county level, we agree that counties may experience some cost savings, to the extent that the state reduces its monitoring, data reporting and other requirements. However, counties are likely to experience increased costs to carry out new responsibilities, for example to establish and regulate foster care rates. Depending upon the specifics of the state's actions to reduce requirements, county administrative costs may increase or decrease.

HOW CAN THE PROPOSAL BE IMPROVED?

The Governor's restructuring proposal reflects a clear statement of the problems that plague the existing state-county relationship, and its statement of principles for restructuring has some commonality with the principles that we offered in last year's *Making Government Make Sense* model. The primary thrust of the proposal toward solving those problems also is positive, in that it seeks to refocus important parts of the state-county relationship towards achievement of better outcomes. It attempts to improve those outcomes through reliance on fiscal incentives to motivate greater program performance. It also recognizes the need for more flexible approaches to service delivery, and promotes collaborative efforts among programs in delivering services to clients.

As a short-term or initial step towards making the longer term changes that are needed in the relationship between the state and all units of local government, the general approach is a workable one. The underlying logic of this approach seeks to increase the role of counties in setting policy goals for a wider range of locally provided programs and in making resource allocation decisions. The proposal takes the existing assignment of responsibilities as a given, and seeks to better align program operations with operating realities and the state's fiscal interests. The shifting of state funding responsibilities and the increased county revenues are the methods by which this is accomplished.

Under this approach, county fiscal incentives—given effect through changes in cost-sharing ratios and program transfers—are used to bring about increased achievement of desirable program outcomes by the counties. We agree that counties *are* likely to respond to changes in fiscal incentives by changing county decisions as to how available local resources are allocated among programs. For example, the Governor's proposal to transfer funding responsibility for foster care is likely to result in counties focusing additional resources on efforts to serve abused or neglected children and their families. Counties would invest more in *preventive* services, such as mental health or substance abuse service, in order to avoid the higher share of cost they would pay under the proposal for *reactive* services, such as foster care.

Modifications Are Needed

Although there are generally positive aspects to the proposal, we do not recommend that the Legislature adopt it as proposed. Specifically, we believe that even within the approach outlined by the Governor, better policy choices are available that more appropriately match fiscal incentives with the ability of counties to control program costs. In addition, the Legislature should consider some policy choices that are consistent with the overall approach but are not addressed by the Governor's proposal.

More specifically, our review indicates that the Governor's proposal has two major flaws. These relate to the broad cost-sharing proposed for Medi-Cal and AFDC, and the inconsistent treatment of fiscal incentive problems. In addition, the Legislature will need to fill in several policy "gaps" in the proposal, such as how the state's interest in maintaining minimally adequate levels of public health programs will be ensured if counties are given broad discretion over program levels as proposed.

Broad Cost-Sharing Undermines Goals of Restructuring

The administration's proposal takes too broad an approach to the application of fiscal incentives, in that it assigns a share of cost that in many cases is not commensurate with county control of program activities. In the AFDC and Medi-Cal programs, for example, we are concerned that the administration's proposal is premised on an unrealistic view of county control over these programs. The bulk of expenditures for both of these programs is driven by economic and demographic factors which counties have limited ability to influence. This is not to say that counties have no ability to influence program costs, but that their influence is of a far more marginal nature than that assumed by the Governor's proposal. The high sharing ratios proposed by the Governor for Medi-Cal and AFDC could pose a significant threat to counties' financial stability, particularly during economic downturns. Under such circumstances, the counties' ability to allocate resources to "preventive" programs could be seriously undermined.

Inconsistent Fiscal Incentives Reduce Efficiency Potential

The proposal does not adequately deal with counter-productive fiscal incentives - situations where a fiscal incentive operates to encourage an inappropriate local decision from an overall program perspective. For example, the proposal may exacerbate the existing problem of some counties using Youth Authority placements as a less-expensive alternative to foster care placements. There are a number of situations where the proposal fails to correct existing problems of this type, or introduces new ones.

What Types of Modifications Are Appropriate?

We believe that these and certain other, less serious, flaws pose a significant threat to the workability of the Governor's proposal. If the Legislature decides to proceed with the Governor's proposal as an initial step toward restructuring the state-county relationship, we suggest that it consider a number of modifications to the *specifics* that will correct for these problems. This section discusses the general types of modifications that we believe are appropriate within the essentially short-term approach of the Governor's proposal. It then provides specific recommendations for improvements within the different program areas affected by the proposal.

Our recommendations for modifications generally fall into four categories, as illustrated in Figure 6. The first two categories directly correspond to the major flaws identified above. In the first category, we recommend that targeted fiscal incentives be used in place of the broad cost-sharing

proposed by the Governor. In the second category, we recommend specific changes to ensure that the fiscal incentives that are present in the relationship work in a uniformly positive manner. The third category has to do with limiting the potential for actions taken by one county to adversely affect the citizens of other counties. In the last category, we recommend that the Legislature adopt changes or additions to the proposal that will further the goal of achieving greater efficiency and control of costs in these program areas.

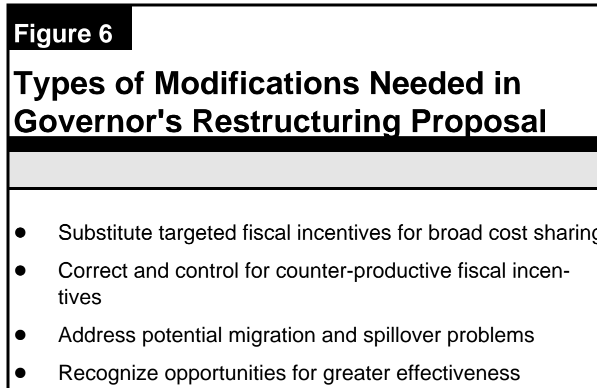

Figure 7 summarizes the specific changes that we recommend to improve the overall effectiveness of the Governor's proposal for restructuring the state-county fiscal relationship. In the remainder of this section, we describe these specific recommendations for changes in the Governor's proposal, focusing on each individual program area in turn.

Medi-Cal

In general, we believe that the administration's goal of encouraging greater efficiency is more appropriately and effectively addressed through direct state action as opposed to increased county shares of cost. We provide specific recommendations for such actions in our *Analysis of the 1994-95 Budget Bill*. These include the modification of "disproportionate share payments" to reduce county incentives to extend the hospitalization of Medi-Cal patients, and the expansion of the capitated rate reimbursement system (managed care) to cover additional Medi-Cal recipients (please see our review of the proposed Medi-Cal budget in the *Analysis*—Item 4260). However, there are certain situations where, because of the linkage to other county-operated programs, we believe that a share of cost is appropriate. Our recommendations for changes in this area are discussed below.

Figure 7

Summary of Changes to Governor's Restructuring Proposal
Recommended by Legislative Analyst's Office

Medi-Cal

Use targeted incentives rather than total program cost-sharing

- 50 percent county cost share for Medi-Cal long-term care and IHSS
- 100 percent county cost share for Medi-Cal mental health and substance abuse services
- Impose "outcome-based" sanctions, such as cost-sharing for substance-abused infants

Improve Efficiency by Direct State Actions

- Modify Disproportionate Share Payments to "per-discharge" formula
- Expand Capitated Reimbursements to non-AFDC clients

AFDC

Use targeted incentives rather than total program cost-sharing

- Rewards for transitioning recipients to employment
- County shares of cost based on time on aid

Youth Authority and Parole

- Improve fiscal incentives by imposing county share of cost for CYA admissions
- Reinforce incentives for preventive programs by assigning parole responsibilities to counties

Child Welfare Services

- Develop outcome-based fiscal incentives to reduce recidivism rates

Realignment Funding Structure

- Limit county flexibility to reduce funding for public health programs

Medi-Cal Long-Term Care and IHSS. The budget proposes to give counties an 11.51 percent share of the total cost of Medi-Cal (including federally funded costs) and increase the county share of IHSS to 100 percent of nonfederal costs. Because nursing home care (on a *total* cost per case basis) is significantly more expensive than IHSS, it is fiscally appropriate to encourage greater use of IHSS in those cases where it is an effective substitute from a treatment perspective. Under the Governor's proposal,

the county share of cost in this area is intended to give them a “financial reward” for using IHSS in lieu of long-term care where appropriate.

Even though we agree that a fiscal incentive is appropriate in this area, we find that the intent of the Governor's proposal does not square with the relative costs that it would impose on the counties. We estimate that, under the proposed sharing ratios, counties would find it advantageous *from a fiscal perspective* to place in nursing homes all IHSS recipients who require more than 100 hours of service per month—nearly one in five current IHSS recipients. Furthermore, these generally are the cases for which nursing home placement is a relevant consideration, due to the relatively high levels of care needed.

In lieu of the administration's proposal, we recommend that the Legislature provide for the same county share of both IHSS and Medi-Cal long-term care costs. If the counties were given responsibility for a relatively large share (say, 50 percent) of both Medi-Cal long-term care and IHSS costs, the cost differential between the two programs would provide the fiscal incentive to use the lower-cost “preventive” program. In order to further strengthen the incentive to minimize inappropriate institutionalization, we also recommend that counties be given a share of costs for non-medical residential facility care provided to SSI/SSP recipients.

Mental Health and Substance Abuse Services in Medi-Cal. The Governor proposes that counties assume responsibility for funding alcohol and drug programs, and continue their responsibility under the 1991-92 realignment legislation for mental health programs. We believe this proposal, in general, has merit. However, it does relatively little to reduce the existing incentive for counties to shift the costs of county mental health and substance abuse services to the Medi-Cal program, where possible. In order to correct this, we recommend that counties be assigned 100 percent of the nonfederal costs for these services in the Medi-Cal Program, thereby eliminating the county incentive to shift these individuals to the Medi-Cal program. This proposal would further have the benefit of effectively consolidating funding and programmatic control for the full range of mental health and substance abuse services—both within and outside the Medi-Cal Program—at the county level. In addition, because counties have more experience with monitoring psychiatric inpatient services in particular, they may prove more effective in controlling utilization of these services than the Medi-Cal field offices.

Outcome-Based Sanctions. Finally, we believe the Legislature should explore the use of “outcome-based sanctions” that would assign county financial responsibility for certain Medi-Cal expenses on a per-case basis. For example, counties could be assessed a significant share of cost for low-birthweight and substance-exposed infants. This would create a fiscal

incentive for counties to avert such poor programmatic outcomes, and encourage them to target resources to activities such as alcohol and substance abuse programs that might prevent them.

Aid to Families With Dependent Children

In order to give counties a greater incentive to pursue strategies that keep people off of AFDC, the budget proposes to increase the counties' share of the nonfederal costs of the program from 5 percent to 50 percent. Rather than increasing the overall share of costs, we recommend that the Legislature adopt a more targeted approach that focuses the fiscal incentives to better achieve this objective.

Rely on Incentives and Sanctions. As we indicated in *Making Government Make Sense,* we recommend that a system of incentives and sanctions be established to encourage counties to get AFDC recipients off of aid. For example, the budget is proposing—and we think it is a good idea—to provide fiscal incentives to counties based on their ability to increase terminations from AFDC by Greater Avenues for Independence (GAIN) recipients. Similarly, a county's share of costs could increase to the extent that recipients remain on aid more than a specified period of time.

Promote Linkages. There are various programs that can have an effect on reducing the need for individuals and families to rely on income maintenance programs such as AFDC. Included among these "preventive" programs are job training and education efforts, such as the GAIN Program, and substance abuse programs. The budget proposes to retain the existing cost sharing ratio of the GAIN Program (counties have 30 percent of nonfederal costs) and to transfer all state funded alcohol and drug programs (except perinatal substance abuse) to the counties. We believe that this is appropriate in the case of GAIN, as keeping the cost share low encourages counties to make the needed program investments.

Youth Authority and Parole

As noted above, recognizing the linkages between related programs helps to ensure that fiscal incentives are consistently structured in a positive fashion. We believe that two changes are needed to improve the consistency of the fiscal incentive package with regard to criminal offenders.

Add Parole Supervision Cost Share. Although the Governor's proposal recognizes in several cases the linkages that exist among different programs, the proposal ignores the significant linkage that exists between alcohol and drug abuse and the occurrence of criminal offenses. In order to strengthen the fiscal incentive to allocate resources for substance abuse and other preventive programs, we recommend that counties be given a significant share of the funding responsibility for the supervision of persons paroled from state prisons. Success in such efforts could also help in controlling the costs of incarceration.

Increase Youth Authority Placement Fees. The Governor's proposal also ignores fiscal incentive problems associated with two of the major treatment choices for juveniles offenders - foster care and the Youth Authority. In fact, the Governor's proposal may significantly worsen an existing counter-productive fiscal incentive. This is because it would increase the counties' cost for foster care placements while maintaining an extremely low county share of cost for Youth Authority placements. There are currently 5,500 juveniles on probation who have been placed in foster care, most of whom are placed in group homes costing an average of $3,100 per month. Counties can now place these probationers instead into the Youth Authority, for which the counties are charged *$25 per month* per ward. The Governor's proposal contains no provisions requiring the maintenance of these juvenile probationers in their existing placements, nor does it otherwise constrain a county's ability to transfer these persons to the CYA. By making such transfers, counties could avoid foster care placement costs ,while shifting costs to the state.

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

Foster Care and Child Welfare Services

Although the counties would assume full financial responsibility for foster care, no change is proposed to Child Welfare Services (CWS), in which nonfederal costs are shared 70 percent state, 30 percent counties. The proposed shift of foster care funding responsibility would give the counties a strong fiscal incentive to focus on activities designed to reduce the need to place children in foster care arrangements. Similarly, giving counties a relatively small share of CWS would encourage them to allocate resources to the “preventive” components of that program, such as family preservation and family reunification.

We would note that there are circumstances under which the Legislature might decide to increase the county share of CWS costs. The reason that child welfare services are needed in the first place relates largely to adult behavior problems. Giving counties a larger fiscal stake in CWS, for example, would give counties an incentive to pursue activities, such as mental health and substance abuse programs, that are designed to address problems leading to the need for child welfare programs.

While we do not suggest changing the cost-sharing ratios for CWS at this time, we do recommend that outcome-based fiscal incentives be developed for the program. Successful efforts in this area could permit transferring all funding responsibility for CWS to the counties while still maintaining a strong incentive for counties to focus on activities that reduce the need for foster care placements. For example, counties could be given a fiscal sanction tied to the percentage of "recidivism cases" in CWS—cases where the program clearly resulted in an unsuccessful outcome.

County Flexibility in Allocating Funds

As explained above, the budget proposes to replace the existing Local Revenue Fund—the depository for realignment revenues—with two new funds. Because the Local Revenue Fund has numerous accounts, and counties have only limited ability to redirect funds among the accounts, the budget proposal should provide counties with added flexibility in allocating resources among programs. In addition, the budget proposes to give counties unrestricted control over unexpended monies remaining in the funds at the end of a fiscal year.

Counties would not have complete control over program costs because several of the programs involved in the restructuring proposal are entitlement programs under federal law. These include AFDC grants, Medi-Cal, Foster Care, and IHSS (to the extent that persons are receiving personal care services supported by federal Medicaid funds). Because the entitlement programs essentially have first call on realignment revenues, their generally faster rates of growth will constrain the amount of funds available for other programs, many of which are preventive in nature. The Governor's proposal suggests that counties would be given significantly more latitude than they now have to control costs in nonentitlement programs.

County flexibility has the advantage of facilitating innovative efforts at the local level and adaptation to local conditions. Experience with the 1991 realignment and certain other pilot projects indicates that counties will exercise a substantial amount of initiative when given the opportunity, and that they can implement successful innovations. Conversely, increased county flexibility may result in a lack of uniformity in the provision of services, leading to adverse incentives for inter-county migration. It also may

result in potential "spillover" effects to the extent that counties "underspend" for needed programs. Underspending for local public health programs in one county, for example, can lead to increased transmission of diseases such as tuberculosis to residents of other counties. As we discussed in *Making Government Make Sense*, these conditions indicate that in a number of program areas there is a statewide interest in ensuring adequate minimum levels of service in each county. This interest can be served by state operation of these programs, as we proposed, or by state laws to set minimum standards for counties.

The Legislature faces a significant dilemma in determining how much control over levels of service the counties should be allowed in each of these program areas. The budget proposes that counties be given "broad authority to determine service and funding levels" for programs funded from the proposed Community Services Fund, including public health and indigent health programs. In these areas especially, we believe there is a compelling state interest in ensuring at least some minimum levels of service statewide, due to the potential for migration and "spillover" problems discussed above. Although Proposition 99 established a "maintenance of effort" requirement for certain health-related county services, it does not specifically require maintenance of effort for public health services in particular. We recommend that the Legislature consider establishing some constraints on county flexibility in this areas, for example, by maintaining the existing separate account for public health program funding.

THE INFLUENCE OF LONG-TERM CONSIDERATIONS

The Governor's proposal focuses on specific changes to be made in the 1994-95 fiscal year, and is silent on further changes that may be necessary in subsequent years. The proposal does, however, raise some questions about how some of the long-term policy choices facing the Legislature should be reconciled with the short-term actions that need to be taken in 1994.

In reviewing the Governor's proposal, we believe the Legislature should consider its own preferences for long-term policy directions. At a minimum, this would allow the Legislature to avoid taking short-term actions that will be difficult to reverse when it later seeks to implement those longer-term preferences. Consideration of longer-term choices also allows the development of strategies for implementation of restructuring choices over time, and the consideration of short-term actions in that longer-term context. From our perspective, there are several specific issues that the Legislature will ultimately need to address, and these are summarized in Figure 8.

Figure 8

Longer-Term Issues May Influence Short-Term Restructuring Choices

Issue	Implications
Trial Court Funding:	
What is state's ultimate objective for funding and operation of the courts?	Greater state control of court spending is consistent with higher state funding State operation of trial courts is consistent with full state funding
General Assistance/Indigent Health Care:	
How can control and funding responsibilities in this area be linked?	Greater flexibility over service levels is consistent with continued county funding responsibility Integration into state system is consistent with continued state control
Growth and Development:	
How can the state ensure that local development incentives are consistent with state policy goals?	Increased city and county allocations of property taxes will improve incentives for appropriate types of development Reduced influence of retail sales taxes can mitigate incentives for inappropriate development choices
County Fiscal Capacity:	
How can the Legislature ensure that counties are able to make preventive investments and be effective program partners?	Actions which result in lower levels of fiscal capacity are incompatible with effective partnerships Greater access to discretionary revenues facilitates local efforts to make preventive investments
Accountability:	
How can the public be reconnected with its government institutions?	Further jumbling of responsibilities is inconsistent with improved accountability

Trial Court Funding

As discussed earlier, the Governor's proposal would significantly increase the state's share of funding for the trial courts, consistent with Ch 90/91, the Trial Court Realignment and Efficiency Act of 1991 (AB 1297, Isenberg). That act expressed legislative intent to increase state support of the trial courts each year, to 65 percent in 1994-95 and to a maximum of 70 percent by the 1995-96 fiscal year.

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

However, the proposal leaves open the question of what the state's ultimate objective is for funding and operation of the trial courts. This question has important implications for the Legislature. Specifically, we are concerned that increased state funding for the trial courts, *without greater state involvement and control over trial court expenditures,* will create a new source of uncontrollable costs in the state budget. Thus, to the extent that the Legislature wishes to avoid becoming involved in exercising control over the costs of trial court operations, it makes little sense to purchase an increased share of trial court costs.

On the other hand, there are a variety of ways that the Legislature could begin to exert its influence to control trial court expenses and bring about operational efficiencies. For example, the Legislature could provide for the allocation of trial court funds based on performance criteria, such as their ability to meet administrative cost-reduction goals and the implementation of efficiency measures. These include allowing superior, municipal and justice court judges to hear matters irrespective of jurisdiction. The achievement of these efficiencies was, in fact, one of the original goals of the Trial Court Funding Program.

General Assistance and Indigent Health Care

County governments are now required by state law to provide services to indigent persons not covered by other state programs, such as Medi-Cal and AFDC. In last year's budget debate, a great deal of attention was focused on how counties might be provided some relief from the burdens of these programs, and an agreement was reached to allow the most financially "distressed" counties to seek state approval for reductions in General Assistance payments. In addition, the state has reduced the procedural requirements that apply when counties attempt to close local health facilities. Although the Governor's Budget asserts that counties would be provided "broad authority to determine service and funding levels" for indi-

gent health programs, the Department of Finance has informed us that no specific changes in general assistance or indigent health care are proposed or contemplated.

The Legislature will continue to face considerable pressure to achieve consistency in the state's current policies as regards services for the indigent population. Specifically, there is a significant lack of correspondence between program control and funding responsibilities in this area. State law generally controls service levels, while counties provide the bulk of the funds. In the long run, the state probably will come under increasing pressure to take a primary role in funding for these programs, or to allow counties greater flexibility in determining service levels. We believe it makes greater sense in the long run to begin to integrate these programs into the state's other programs for the needy, and for the state to assume a primary funding role.

The implications of such a decision for the Legislature in considering its short-term realignment options are several. First, this would argue against allowing counties greater flexibility in determining funding levels for indigent health, as may or may not be intended by the Governor's proposal, because funding reductions could impair integration efforts. Second, such a decision may argue for state participation in the costs of the general assistance and indigent health programs as a transition mechanism pending integration.

Growth and Development

The state has a broad interest in local economic development decisions, as these decisions have a substantial influence on the overall health of the state's economy, the availability of jobs for citizens, and the quality of life in this state. In recent years, the Legislature has increasingly directed its attention to these issues of economic development, and in 1993 enacted several measures designed to improve the state's business climate. The shift of property taxes away from cities and counties to schools that has taken place in the last two years, however, has reduced city and county incentives to approve new developments. In combination with the long-standing incentives that encourage these entities to favor retail over other forms of development, it is clear that the existing incentives do not favor the types of development needed to further the state's economic growth.

In this context, the Governor's proposal to return a portion of the property taxes previously shifted away from counties makes sense. However, we do not believe that this action by itself is sufficient to correct the problem. In the longer run, the Legislature will need to consider the changes in the mix of revenues that support all local governments, as well as alternative methods of allocating these revenues.

Most importantly, the Legislature will need to evaluate whether a relatively high dependence upon the retail sales tax by local agencies is conducive to the balanced pursuit of economic development in this state. To the extent that this high dependence is viewed as problematic, the Legislature should consider substituting higher allocations of property taxes for the transfer of sales taxes proposed by the Governor. It also will need to address the question of how the development incentives faced by cities can be brought into line with the state's goals, because most development occurs within city boundaries.

County Fiscal Capacity

Current constraints on county fiscal capacity—that is, the ability of counties to meet the public service needs of their communities with available resources—place limits on the extent to which counties can enter an effective program partnership with the state under the Governor's restructuring proposal. While fiscal capacity varies significantly across counties, it has declined statewide over the last several years as the state has transferred increasing shares of property tax revenues from counties for support of local schools. In this context, it should be noted that most counties have not yet implemented the full amount of spending reductions required by the 1993-94 property tax transfers. This is because they were allowed to take a credit against the required transfer in 1993-94 for the additional property taxes accruing to schools if they elected to participate in the so-called “Teeter Plan” for allocation of property taxes.

In the long run, the Legislature needs to consider changes to improve the fiscal capacity of county governments. Because of their weak fiscal condition, counties will face pressure to make program investment decisions based more on short-term fiscal considerations as opposed to the potential for improved long-term outcomes. Even as the economy improves, counties as a whole are unlikely to have adequate fiscal capacity to be effective partners with the state in the administration of shared program responsibilities.

As we discussed earlier, the administration's assumptions concerning program reductions and federal funds are *not* likely to be fully realized, so that county fiscal capacity will likely suffer another setback in 1994-95 if the Governor's proposal is adopted. Notwithstanding such a conclusion, we believe that the Legislature should recognize the importance of adequate local fiscal capacity, both for the achievement of the state's programmatic goals in partnership programs and for the effective functioning of the state's system of government generally. Aside from avoiding actions which worsen existing levels of local fiscal capacity, the Legislature should consider acting to minimize the erosion of county resources associated with

existing state-controlled programs and providing counties with greater access to discretionary revenue sources.

Accountability

In our view, any broad attempt at restructuring the state and county relationship, or more broadly, government in general, needs to strengthen the connection between governmental institutions and the public they serve. Our current system of overlapping and duplicative responsibilities is not working, partly because people do not know who to hold accountable for failures, or who to credit for successes. Consequently, separating state and local government duties to the *maximum extent possible* is an important component of restoring program accountability and, ultimately, public confidence in government. We agree with the administration that *complete* separation is difficult to achieve, but from our perspective, the state should not ignore the accountability problems created by disproportionately structured program control and funding arrangements. Even where areas of shared interest and responsibility exist, it still is important to assign primary responsibility to one level of government, and to ensure that the levels of assigned program funding responsibility are commensurate with the levels of actual program control.

CONCLUSION

The need to begin serious efforts to restructure California's dysfunctional system of government is a critical one, and it is important that steps be taken during 1994 towards achieving this objective. The Governor's Budget proposal lays the foundation for progress in this area. Further steps will be required, and a certain amount of experimentation will probably be needed to determine which options are the most effective. For these reasons, it is less critical that this first step be perfectly balanced and comprehensive, and more critical that it be a step in the right direction. But, only by examining its long-term policy preferences can the Legislature ensure that its first step is taken on the right track.