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STATE FISCAL PICTURE

The Budget Outlook

- We estimate that even if all the Governor's budget proposals were adopted, the state would still face a shortfall of about $5 billion. This is due to overstated revenues ($3.9 billion) and understated expenditures ($1.1 billion).
- Lower-than-expected receipts of new federal funds would add to the shortfall.
- Thus, although the Governor and Legislature have taken important early steps towards addressing the 2002-03 budget problem, substantial additional actions—beyond those proposed by the Governor—will be needed to bring the 2002-03 budget into balance (P&I "Part I").

Economic and Revenue Outlook

- We agree with the administration that California will begin a recovery from its current recession this spring.
- However, we believe that the recession and stock market weakness are having a more severe adverse impact on stock options and capital gains than assumed by the administration, which in turn is depressing revenues.
- The economic and revenue outlooks are subject to significant downside risks associated with (1) the timing and strength of the economic recovery, and (2) the severity of the decline in stock options and capital gains this year (P&I "Parts II and III").
- In addition, basic revenue volatility has increased in recent years, giving the revenue forecast greater uncertainty (P&I "Part III").

Reliance on Borrowing

- The governor relies on borrowing for $4.8 billion, or well over one-third of his total budget solutions. This includes borrowing from retirement funds, future tobacco settlement revenues, special funds, as well as lease-payment bonds.
- We discuss the Governor's different types of budget balancing borrowing, and the factors that should be focused on by the Legislature in evaluating these proposals and other types of borrowing options (P&I "Part V").

PROGRAM HIGHLIGHTS

EDUCATION

Legislature Should Take Strategic Actions to Address Potential $825 Million Increase in Proposition 98 Requirements

- A crucial issue is posed for the Legislature by a potential General Fund increase needed for Proposition 98 of about $825 million. We discuss ways for the Legislature to act strategically in response to this challenge, in order to minimize impacts on non-Proposition 98 programs, yet still meet important K-14 education priorities.

- These ways include exercising still-viable options to save current-year Proposition 98 monies (an estimated $161 million), substituting monies available from the Proposition 98 Reversion Account for other current-year Proposition 98 funding (saving $535 million), and "moving" certain education expenditures budgeted from non-Proposition 98 sources to Proposition 98 (potentially hundreds of millions of dollars). (*Analysis*, page E-13.)

Reforming Categorical Programs Funding

- We recommend that the Legislature consolidate 51 K-12 programs into five categorical block grants—Academic Improvement, Compensatory Education, Alternative Education, School Safety, and Teacher Support and Development—because greater local flexibility should lead to increased efficiency and effectiveness in meeting specified educational needs. (*Analysis*, page E-77.)

- We further recommend that the Legislature include funding for related mandates in the categorical block grants in order to provide districts with increased funding flexibility and incentives to minimize mandate costs. (*Analysis*, page E-26.)

Governor's "Instructional Materials Realignment Initiative" Too Restrictive

- We recommend that the Legislature redirect $625 million for the "Instructional Materials Realignment Initiative" to our recommended Academic Improvement Block Grant, which encompasses a broader set of purposes and provides school districts increased flexibility. We further recommend that the Legislature deny advance appropriations totaling $1.95 billion for fiscal years 2003-04 through 2006-07 in order to preserve its fiscal flexibility. (*Analysis*, page E-102.)

Challenge Collective Bargaining Mandate

- Given California Supreme Court rulings, school district obligations to bargain with employees over wages and working conditions do not appear to be a constitutionally required "state-reimbursable mandate." Moreover, funding school district bargaining activities through the mandate process does not promote either equity across districts or efficiency. We recommend that the Legislature challenge this budgeting practice and shift the $41.5 million allocated for this purpose to other K-14 education priorities. (*Analysis*, page E-31.)

Provide $78 Million for Revenue Limit Equalization And Public Employees' Retirement System (PERS) Offset

- We recommend that, to the extent resources are available, the Legislature provide budget-year funding for revenue limit equalization ($42 million) and the "PERS offset" to revenue limits ($36 million) because (1) additional general purpose funds enhance the ability of schools to improve student outcomes in ways that suit varying local needs and (2) these programs meet recent legislative priorities. (*Analysis*, page E-75.)

College Student Fee Policy Needed

- For the eighth straight year, the Governor's budget for higher education proposes no increase in student fees, and the share of educational costs covered by fees continues to decline. However, in a departure from recent practice, the budget does not include an increase in General Fund support to compensate for a lack of a fee increase.

- We recommend that the Legislature enact in statute a consistent fee policy that provides for an appropriate sharing of educational costs between students and the state, and which preserves student access to higher education. (*Analysis*, page E-179.)

Competitive Cal Grant Programs Should Be Expanded

- We recommend expansion of the competitive Cal Grant programs by redirecting state funds from certain financial aid programs at the University of California (UC) and the California State University (CSU). This would help create a statewide financial aid system that is more efficient and objective. A total of $294 million in General Fund monies would be shifted to the competitive Cal Grant programs from UC's and CSU's institutional aid programs. (*Analysis*, page E-202.)

Community Colleges' Categorical Programs Should Be Combined

- The Governor 's budget would reduce funding for several of the California Community Colleges' categorical programs by a total of $121.7 million. We recommend, however, that these reductions be accompanied by a consolidation of 12 categorical programs into two block grants in order to allow greater flexibility in directing available resources where they are the most needed. (*Analysis*, page E-250.)

HEALTH SERVICES

Tobacco Securitization: Is it Good Financial and Budget Policy?

- We find that the administration's proposal to "securitize" the state's future revenues from settlement of litigation with tobacco companies to be in general a feasible and reasonable step for the Legislature to consider as part of a comprehensive solution to the state's budget problems.

- We recommend that the Legislature consider such a transaction only if presented a more detailed proposal and an analysis demonstrating that the net financial outcome would be beneficial to the state. (*Analysis*, page C-27.)

Hospitals Facing Financial Headaches

- Our analysis finds that hospitals face significant financial pressures in the next several years, particularly from recent federal regulations limiting the amount the state can pay public hospitals participating in Medi-Cal. We summarize the role of these hospitals in California, examine their financial status, describe the particular challenges they face, and recommend steps the Legislature could take even in difficult fiscal times to deal with these problems. (*Analysis*, page C-38.)

Assessing the Proposed Medi-Cal Budget Reductions

- We recommend that the Legislature not adopt an administration proposal to reduce provider rates for certain services because of their potential negative impact on patient access to Medi-Cal services, and suggest other options for reducing state health expenditures. (*Analysis*, page C-76.)

- We recommend against the administration's proposal for charging copayments to Medi-Cal beneficiaries. We propose a different copayment approach that would avoid imposing charges on essential medical services while curbing inappropriate use of medical services. (*Analysis*, page C-80.)

- We recommend approval of the Governor's proposal to reduce the cost of Medi-Cal drug purchases and offer some additional approaches that could save the state money on purchases of drugs. (*Analysis*, page C-84.)

Medi-Cal Managed Care: Where Do We Go From Here?

- Ten years after the state began its move to implement managed care, we review options for reform of the medical system that now provides care for a majority of Medi-Cal beneficiaries. We suggest the Legislature consider changing the way managed care rates are set, increasing competition among health plans, and enrolling the elderly and disabled in managed care. (*Analysis*, page C-87.)

Regional Center Mission and Funding Are Misaligned

- Our analysis finds that Regional Center funding has more than doubled since 1995-96, driven up by caseload and cost adjustments for services, a decline in federal waiver support, and an absence of statewide utilization controls. Yet, even with these budget increases, Regional Centers are experiencing financial problems. We propose some initial steps the Legislature could take to achieve significant savings that could either be used to reduce state spending or to reinvest in the Regional Center system. (*Analysis*, page C-126.)

Healthy Families Parent Expansion

- The January budget proposes delaying the implementation of the Healthy Families parent expansion until July 2003. However, following recent approval of a federal waiver, the Governor has indicated support for the expansion in the budget year. Should the Legislature wish to proceed with the expansion in the budget year, we offer an alternative for doing so at a reduced state cost. (*Analysis*, page C-120.)

- The state is at risk of losing $750 million in unspent federal State Children's Health Insurance Program funds over the next two years in the absence of congressional action. We suggest the Legislature work with the congressional delegation regarding the availability of these funds. We also present examples of options to minimize this potential loss of federal funds. (*Analysis*, page C-122.)

Proposal to Abolish the Child Health and Disability Prevention Program Needs Work

- We agree in concept with the Governor's plan to eliminate the Child Health and Disability Prevention (CHDP) program because it could result in more comprehensive health care for children in the Medi-Cal and Healthy Families programs at a lower cost to the state. However, we note that there are problems with the proposal that need to be addressed such as its impact on community health clinics and access to care for children previously served by CHDP. (*Analysis*, page C-106.)

Guidance on CalWORKS Five-Year Time Limit Needed

- By June 2003 about 100,000 adult recipients (20 percent of caseload) will lose their cash aid because of the CalWORKs five-year time limit. The CalWORKs statute does not provide counties with clear guidance on the number of recipients that should be exempted from the time limit or the circumstances under which employment services should continue to be provided after an individual reaches the time limit.

- We (1) present options for establishing guidelines for counties in providing exemptions and (2) recommend enactment of legislation providing transportation assistance to former recipients who are working at least 20 hours per week. (*Analysis*, page C-190.)

Welfare-to-Work Component of CalWORKs Underfunded in 11 Counties

- County welfare-to-work block grants in 11 counties are not sufficient to provide all recipients with the services they require to become self-sufficient prior to reaching their five-year time limit. Absent legislative action, funding for CalWORKs' welfare-to-work component will continue to erode.

- In developing a long-term budget plan for CalWORKs (including its welfare-to-work component), the Legislature faces difficult choices. We suggest that the Legislature consider (1) whether to increase funding above the minimum federal requirement, (2) the relative importance of grant payments versus welfare-to-work services, and (3) reallocating block grant funds among counties. (*Analysis*, page C-203.)

Work Participation in the CalWORKs Program

- Although California has consistently exceeded the federal work participation requirement and thus avoided federal penalties, only 26 percent of single-parent cases in federal fiscal year 2000 were participating in CalWORKs in accordance with state law. Further, 22 percent of single-parent cases were "disengaged" from the program—that is, they were neither participating, exempt, nor sanctioned for noncompliance.

- We examine the advantages and disadvantages of various approaches the Legislature could take to improve program participation in light of the state's fiscal condition. (*P&I*, "Part V")

California Currently Falls Below Federal Standards for Foster Care

- Federal Foster Care performance reviews will be conducted in California beginning in the fall of 2002. Preliminary analysis of the most recent data (1998) indicates that California may fail to meet national standards on a number of performance measures which could result in the loss of federal funds. We review California's record compared to other large states and make recommendations for improving California's performance. (*Analysis*, page C-226.)

Judiciary and Criminal Justice

State Could Close Women's Prison

- The female inmate population has declined for the past two years. Between June 30, 1999 and June 30, 2000, the female population dropped by 771 inmates, or 7 percent. The California Department of Corrections (CDC) projects the female inmate population will decline by an additional 950 inmates by the end of the budget year. This decline provides the state the opportunity to close one of its smaller women's prisons.

- We recommend that CDC report at budget hearings on the feasibility and costs and benefits of closing the Northern California Women's Facility, as well as on other potential current and future uses for the prison facility in the event it were closed. (*Analysis*, page D-35.)

CDC Budget Deficiencies Likely to Continue

- The CDC has had several consecutive years of budget deficiencies. Although some significant efforts have been made to control spending, there continue to be ongoing budget problems that will likely result in significant General Fund deficiencies in the current and budget years. (*Analysis*, page D-33.)

Risky Assumptions in Criminal Justice and Judiciary Budget

- The budget assumes the state will receive a $50 million increase in federal funds for undocumented prisoners. We believe there is considerable uncertainty in this assumption given that the President's budget proposes to eliminate federal reimbursements to the states for housing undocumented felons. (*Analysis*, page D-32.)

- The budget assumes that a proposed increase in criminal fines (20 percent) and civil filing fees (10 percent) will generate $61 million in General Fund revenue. This is a risky assumption given the level of local discretion in setting criminal fines and the downward trend in court civil filings. (*Analysis*, page D-18.)

County Sliding Fee for Youth Authority Commitments Should Be Adjusted

- Counties are currently required to share in the cost of housing wards at the Youth Authority. The amount the counties pay is based upon a sliding scale that provides counties the incentive to send the most serious juvenile offenders to the Youth Authority and retain less serious offenders in county-based services. However, the fees are capped which over time erodes the fiscal incentive built into the sliding scale fee structure.

- We recommend the enactment of legislation to adjust the sliding scale fees annually for the effects of inflation. This would maintain the fiscal incentive for counties to send their most serious offenders to the Youth Authority and partially offset the yearly inflationary cost increase incurred by the Youth Authority. (*Analysis*, page D-48.)

Capital Outlay

California Infrastructure Plan

- The administration was required to submit in January 2002 a plan on the state's infrastructure. The plan, however, has not yet been issued. We recommend the Legislature defer approval of new capital outlay projects (except those addressing fire and life safety) until the infrastructure plan has been submitted and reviewed by the Legislature.

- We also recommend the Legislature establish a select committee to address procedural changes that could be adopted to allow the Legislature to proactively address California's infrastructure needs and respond to the Governor's future infrastructure plans. (*Analysis*, page G-17.)

Project Management Fees

- The Department of General Services (DGS) is responsible for project and construction management of most state capital outlay projects. Our review of DGS project fees reveals a lack of justification and accountability for the methods used to calculate the fees included in project cost estimates. We recommend that the Bureau of State Audits conduct a performance audit of

DGS capital outlay project cost estimates in order to evaluate (1) the appropriateness of fees charged, (2) the method of determining fee levels, and (3) the quality control process in place for budget development. (*Analysis*, page G-21.)

Funding Higher Education Capital Outlay

- As in previous years, we recommend the Legislature provide funding for higher education capital outlay based on statewide priorities and criteria, using reasonable construction cost guidelines, and based on year-round operation. (Please see *Analysis*, pages G-55, G-65, and G-77 for specific issues with each segment.)

- We recommend the Legislature direct the segments to use their facilities at least as intensively as required by current utilization standards, and that California State University and the community colleges report their actual utilization at least biennially.

- Because of limited state resources for capital outlay, we recommend the Legislature authorize the University of California (UC) to use Garamendi bonds (revenue bonds backed by UC research revenue) to fund the construction of research space. This would allow state resources to be used for improvements to instructional facilities. (*Analysis*, page G-27.)

Transportation

Additional Transportation Funds Available to Loan to General Fund

- The budget proposes to loan $672 million from the Traffic Congestion Relief Fund (TCRF) to the General Fund, and to shift other transportation funds in order to prevent a shortfall in TCRF. We find that TCRF expenditures will likely be lower than projected. We recommend budget bill language to (1) allow a larger TCRF transfer to the General Fund if necessary and (2) limit the transfer of State Highway Account (SHA) funds to TCRF. (*Analysis*, page A-15.)

SHA Balance Likely to Be Much Higher Than Projected

- The budget projects a 2002-03 SHA cash balance of $84 million, due in part to a large increase in projected capital outlay expenditures. However, over the past seven years, the Department of Transportation (Caltrans) has consistently overestimated capital outlay expenditures. We find it unlikely that capital outlay expenditures will grow at the projected rate, and therefore the SHA balance could be hundreds of millions of dollars higher than the budget projects. (*Analysis*, pages A-17 and A-43.)

Public Transportation Account (PTA) Shortfall Can Be Avoided

- Lower gasoline prices and declining diesel fuel sales have combined to substantially reduce projected PTA revenues. A recent tax regulation would further reduce revenues and cause a shortfall in the account in 2002-03. We recommend that a planned loan of $100 million from PTA to the TCRF be reduced in order to avoid the projected shortfall. (*Analysis*, pages A-22 through A-25.)

Ongoing Funding for Stormwater Management Needs Justification

- The budget requests $23.4 million for Caltrans to manage stormwater runoff. We find that several aspects of the proposal are either not adequately justified or do not have workload estimates to justify ongoing funding at this time. We recommend deletion of $838,000. We further recommend that $13.5 million of the request be granted on a one-time basis until Caltrans can provide better workload justification. (*Analysis*, page A-47.)

Extensive Rescheduling Reduces Number of Projects Delivered

- In 2000-01, Caltrans delivered 97 percent of programmed State Transportation Improvement Program (STIP) projects, and almost 100 percent of programmed expenditures. This high delivery rate was achieved, however, by rescheduling into future years, projects that originally were supposed to be delivered in 2000-01. Thus, in terms of the sheer number of STIP projects delivered, it dropped 62 percent between 1999-00 and 2000-01 due to extensive rescheduling of projects by Caltrans. (*Analysis*, page A-51.)

New Funding System Needed for Ongoing Security Programs

- Increased costs for security activities will result in a Motor Vehicle Account (MVA) shortfall in the budget year unless corrective actions are taken. We find the MVA is not appropriate as the sole fund source for ongoing protective services. We recommend a new system for funding ongoing security costs that combines MVA with General Fund and reimbursements. (*Analysis*, pages A-26 through A-31.)

Antiterrorism Programs Not Fully Developed

- The administration expects to receive $350 million in federal funds for antiterrorism security activities, but the budget allocates only $164 million for specific security measures. (*Analysis*, page A-32.)

- We withhold recommendation on $89.6 million requested for the California Highway Patrol until the levels of federal reimbursement are better known in the spring. We also recommend development of an expenditure plan that sets priorities for the use of the remaining $176 million in anticipated additional federal funds. (*Analysis,* pages A-32 through A-39.)

RESOURCES

➢ Using Fees to Save the General Fund

- Several opportunities exist to create additional General Fund savings by shifting funding for resources programs from the General Fund to fees. Fees are an appropriate funding source in these cases, either because the state is providing a service that directly benefits an identifiable person or business (such as fire protection services), or administering a pollution control program that should be funded on a "polluter pays" basis. Specifically, these opportunities include:

  - ***Fire Protection—***$141 million savings if, for example, fees levied on property owners replace 50 percent of proposed General Fund expenditures for the California Department of Forestry and Fire Protection's fire protection services provided largely to private landowners. (Analysis, page B-60.)

  - ***Water Quality Regulation***—$22.5 million savings by levying fees on dischargers of waste into waters in order to fully replace proposed General Fund expenditures in the State Water Resources Control Board's "core regulatory" program—permitting, inspections, and enforcement. (*Analysis*, page B-94.)

  - ***Timber Harvest Plan Review***—$21.5 million savings by having timber operators fully cover the costs of multiple state agencies to review and enforce timber harvest plans. (*Analysis*, page B-50.)

  - ***Air Quality "Stationary Source" Regulation***—$18.7 million savings by levying fees on stationary sources of pollution (such as petroleum refineries) in order to replace funding from the General Fund for activities related to air quality permits. (*Analysis*, page B-80.)

CALFED and Tahoe EIP: Big Dollars and Long Implementation—Legislative Oversight Needed

- The budget proposes $519 million in state funds for the CALFED Bay-Delta Program. This program—established to address water problems in the Bay-Delta—involves 24 state and federal agencies, is anticipated to last 30 years, and is estimated to cost $8.5 billion for its first seven years (through 2006-07). We find that the CALFED budget proposal is based on risky assumptions about federal and bond funding.
- The budget proposes $26.6 million in state funds for the Tahoe Environmental Improvement Program (EIP). This program—created to meet environmental standards in the Lake Tahoe region—involves over 50 state, federal, local, and private interests, is planned to last 20 years (through 2016), and is estimated to cost at least $1.5 billion.
- Legislative review of both of these programs could be enhanced by holding joint policy and budget committee hearings. (*Analysis*, pages B-17 and B-43.)

Budget Substantially Cuts Back Fish and Game's Review of CEQA Documents

- The budget proposes a $2.1 million reduction for the Department of Fish and Game's review activities under the California Environmental Quality Act (CEQA)
- This reduction would result in the department reviewing very few CEQA documents to assess a proposed project's impact on fish and wildlife. We offer alternative funding sources should the Legislature wish to increase funding for this purpose. (*Analysis*, page B-64.)

Past State Park Acquisitions Create Unfunded Future Costs

- The Department of Parks and Recreation projects that it will have increased its land holdings for state parks by more than 75,000 acres, at a cost of $328 million in the current and prior year.
- We find that many of these acquisitions will result in future development and operating costs that have not been provided for or identified. We make a number of recommendations to ensure that future costs resulting from land acquisitions are better accounted for in the budget process. (*Analysis*, page B-68.)

➢ Emergency Fire Suppression Budget Not Realistic

- The budget proposes eliminating most funding for emergency fire suppression.
- Since the department's actual costs for emergency fire suppression have averaged over $70 million annually over the last ten years, budgeting almost nothing for emergency fire suppression is not realistic. We offer options to provide the funding for a more realistic budget. (*Analysis*, page B-58.)

➢ Brownfields Program Substantially Reduced; Alternative Funding Exists

- The budget proposes no funding for the Department of Toxic Substances Control (DTSC) to provide *new* loans and grants to clean up contamination at abandoned or underutilized sites known as "brownfields." Instead, the department is budgeted to administer existing loans and grants.
- We find that DTSC and the California Pollution Control Financing Authority have overlapping statutory authority to provide financial assistance for brownfields redevelopment. We make recommendations to reduce the potential for programmatic overlap, and offer a source of funding should the Legislature wish to increase funding for cleanup loans and grants in the budget year. (*Analysis*, page B-104.)

General Government

➢ Proposed Deferral of Retirement Contributions Has High Price Tag

- To increase the state's fiscal flexibility, the budget proposes to defer $2 billion in state retirement contributions to the Public Employees' Retirement System and the State Teachers' Retirement System, including $1.6 billion from the General Fund, over three fiscal years. In exchange for lowering the state's contribution rates earlier than scheduled, the state would provide additional retirement benefits to the members of the two systems.
- In present value terms, this fiscal flexibility would cost the state well over $4 billion. In view of the high costs, we recommend that the deferral proposals be rejected. (*Analysis*, page F-15.)

➢ Industry Should Contribute to Medfly Control

- Controlling the medfly population reduces agricultural damage. As such, the state's consumers benefit and so do certain agricultural industries. Consequently, the cost of medfly control should be shared by the state (General Fund) and the agricultural industries. We recommend the enactment of legislation that directs the Department of Food and Agriculture to assess the agricultural industry for half the cost of medfly control. (*Analysis*, page F-110.)

"Peace Officer Procedural Bill of Rights" Mandate Costs More Than Anticipated

- The state's costs to reimburse local governments for providing procedural protections for peace officers involved in disciplinary actions will be about the same as the state's costs to operate all peace officer training programs. We recommend that the Legislature delete $50 million proposed to reimburse local governments and refer the matter to the Bureau of State Audits for review. We further recommend that the Legislature place this mandate on "pause" in the budget year. (*Analysis*, page F-54.)

DOIT: Limited Success Justifies Limited Reauthorization

- The Department of Information Technology (DOIT) is scheduled to sunset on June 30, 2002. Based on our review, DOIT's overall performance of its legislative mandates is one of limited success. Therefore, we recommend a two-year reauthorization of DOIT and a Bureau of State Audits review of DOIT's progress in meeting its mandated responsibilities. (*Analysis*, page F-29.)

Reorganization and Coordination of Energy-Related Agencies and Activities

- California has a number of different boards, commissions, and departments involved in implementing, overseeing, and managing the state's various energy-related policies and responsibilities.

- This multiplicity of agencies, and evidence of certain duplicative activities and other problems, suggest that it is time for the state to "stand back" and assess how these entities are organized and interacting (*P&I*, "Part V").