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Highlights of the: 2003-04 Analysis and Perspectives & Issues

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STATE FISCAL PICTURE

The Budget Outlook

- We estimate that the Governor's budget proposal, *if fully adopted*, would eliminate the multibillion dollar budget shortfall facing the state in 2003-04. Its large amount of ongoing savings would also address California's long-term structural imbalance.

- Achieving fiscal balance, however, would require that *virtually all* elements of the plan be adopted and realized, or that alternative real and ongoing solutions of a similar magnitude be found.

- Failure to reach agreements on key budget elements involving taxes, spending reductions, funding shifts, or realignment would cause the fiscal situation to quickly and dramatically deteriorate (P&I, Part I).

Economic and Revenue Outlook

- The United States and California economies continue to struggle in early 2003, due primarily to restrained hiring and investment spending by businesses.

- We assume that stronger economic growth will resume in the second half of 2003, once global uncertainties subside, and business spending picks up.

- Based on this economic forecast, we estimate that revenues will exceed the budget forecast by a net of $1.3 billion in 2002-03 and 2003-04 combined. Our higher estimate assumes a somewhat earlier and stronger economic recovery than does the administration.

- The economic and revenue outlooks are subject to a variety of risks, including (1) weaker personal income tax final payments this spring, (2) a delay in the anticipated acceleration in business spending and hiring, and (3) failure to generate the $1.5 billion in additional revenues assumed from new and renegotiated tribal gaming compacts (P&I, "Parts II and III").

The Governor's Tax Proposal

- The Governor is proposing an $8.3 billion total tax increase, of which $8.2 billion would be used to fund his realignment program and reduce the General Fund's budget shortfall (see next section).

- This proposal involves raising the sales and use tax (SUT) by one percentage point ($4.6 billion), establishing 10 percent and 11 percent high-income tax brackets ($2.6 billion), and raising the cigarette tax by $1.10 per pack ($1.2 billion).

- The proposal would provide a realignment revenue portfolio that is likely to grow at a somewhat lower rate than the programs that are being realigned.

- The SUT proposal would directly affect essentially all Californians, the income tax change would affect a relatively limited number of taxpayers but have large impacts on some, and the cigarette tax proposal raises issues with regard to both consumer behavior and tax evasion that could affect revenues.

- Besides the Governor's tax proposals, a number of other revenue options are available to the Legislature to help address the budget problem, including alternative tax rate proposals, basic tax-base broadening, and modifying or eliminating tax expenditures. (P&I, page 97.)

Realigning Some Programs Make Sense

- Under the administration's plan, the state would increase taxes by more than $8 billion and shift this funding to counties and courts, along with a similar amount of program obligations. Given the size and diversity of California, we think realigning some programs could improve program outcomes.

- To assist the Legislature in its review, we identify factors for it to weigh in considering *which* programs would benefit from realignment. Using these factors, we identify $9.1 billion in programs meriting consideration: $5.1 billion of programs proposed by the administration and $4 billion of programs suggested by our office.

- Given the requirements of the California Constitution and voter-approved measures, enacting realignment will require a broad consensus among many parties. Because realignment plans are difficult to modify over time, we recommend the Legislature take a long-term view in enacting program and funding changes. (P&I, page 123.)

PROGRAM HIGHLIGHTS

K-12 Education

Proposition 98—Education Credit Card Maxed Out

- Assuming enactment of AB 8x (Oropeza) which has passed both houses, the state would start 2003-04 with roughly $2.9 billion in outstanding deferrals—including $1.1 billion of the principal apportionment, almost $900 million in state mandates, and $681 million in categorical programs.

- We believe the Governor's budget is headed in the right direction by relying on ongoing rather than one-time spending reductions, and reducing the level of funding deferrals. (*Analysis*, page E-22.)

K-12 Categorical Program Reform

- The Governor's proposal to combine 58 categorical programs into a K-12 Categorical Block Grant would have many advantages for school districts. It also would create significant problems. Most importantly, the proposed block grant does not adequately address the negative local incentives that led to the initial creation of many categorical programs.

- We recommend the Legislature consolidate 62 programs into five block grants. Districts would report to the state key fiscal and outcome data on each grant. We believe our proposal would increase district fiscal and program flexibility while increasing district accountability for providing needed services to students. (*Analysis*, page E-43.)

Alternative Spending Plan

- We have identified $427 million of additional Proposition 98 costs for 2003-04 because either (1) the Governor's budget underfunded specific programs or (2) the Legislature increased 2003-04 obligations because of actions taken to date in the First Extraordinary Session. We recommend the Legislature fund these priorities, and make other reductions to stay within the proposed Proposition 98 funding level. (*Analysis*, page E-25.)

State and Federal Accountability Programs

- We recommend that the Legislature take steps to integrate state and federal sanction and intervention programs to send a clear message of expectations to schools and districts. We recommend that state interventions be focused at the school district level and that the state intervene directly at only the lowest-performing schools. (*Analysis*, page E-113.)

Child Care "Realignment" Merits Consideration

- We believe the Governor's proposal to shift responsibility for most child care programs from the state to counties deserves legislative consideration. This realignment would give counties the flexibility to use child care funds as part of an integrated county strategy to serve low-income families and to tailor their child care programs to meet the needs of their communities' working poor. It would also reduce administrative complexity in the state's existing child care system by allowing counties to provide child care under their own set of program rules. (*Analysis*, page E-137.)

Higher Education

Fee Increases Planned for All Public Colleges and Universities

- The Governor's budget assumes student fees will increase at the University of California (UC), the California State University (CSU), and the California Community Colleges (CCC). For the average full-time undergraduate student, fees would increase by $1,065 at UC, $468 at CSU, and $338 at CCC in 2003-04.

- We recommend increases that are about 40 percent smaller at UC and CSU. We also recommend the Legislature adopt an explicit fee policy requiring annual adjustments that are gradual and predictable. (*Analysis*, page E-177.)

- We believe that the level of the proposed CCC fee—which would remain the lowest in the nation—is reasonable. Moreover, we note that all needy students are not required to pay fees at CCC, and many middle-income students can offset their fees through federal tax credits. However, the Governor's proposal misses an opportunity to significantly increase federal financial aid to needy students. This could be achieved by increasing the proposed fee by $1 per unit. (*Analysis*, page E-252.)

Enrollment Growth Funding Does Not Match State Needs

- The Governor's proposal would increase budgeted enrollment at UC and CSU by about 7 percent. It would also *decrease* budgeted enrollment at CCC by 5.7 percent.

- We believe the proposed increase at UC and CSU far exceeds any reasonable projection of demand. Moreover, given the state's fiscal circumstances, we believe growth in student enrollment should be focused at the lower-cost colleges. We therefore recommend that budgeted enrollment at UC and CSU be increased by 4 percent rather than 7 percent. (*Analysis*, page E-188.)

- We believe that some decline in attendance at CCC is to be expected due to the proposed fee increase and other factors. However, we believe the budgeted decline of 5.7 percent may be too drastic. We recommend that the Legislature consider increasing enrollment funding at CCC by up to $100 million, depending on available resources and Proposition 98 considerations. This amount would fund 25,000 additional students. (*Analysis*, page E-259.)

Expansion of Financial Aid Should Serve All Students

- The Governor's budget would increase campus-specific financial aid programs at UC and CSU by $166 million, or about 60 percent, from its level in the enacted 2002-03 budget. The UC and CSU use this money, which is largely derived from student fee revenue, to provide financial aid to their own students.

- Rather than such a large increase in campus-specific aid, we recommend that the state instead provide additional funding for statewide financial aid programs that are open to all students, irrespective of the particular campus or system they select. This would enhance student choice and bolster accountability. (*Analysis*, page E-196.)

Health Services

State Should Restructure Developmental Center System

- As the number of residents of developmental centers (DCs) continues to decline, the cost of care on a per resident basis has continued to grow significantly. The Governor's budget proposes the closure of Agnews DC.

- We recommend that the state initiate the closure of two of the state's five DCs and address key issues pertaining to the future of the DC system. Annual savings starting in 2004-05 would range from $30 million to $75 million, with one-time avoided capital outlay savings and the sale of property totaling several hundreds of millions of dollars. (*Analysis*, page C-99.)

Missed Opportunities for Savings in California Children's Services

- The state's programs to provide services for some of its most medically fragile children is missing opportunities to control increasing costs and preserve General Fund resources that could help address the state's fiscal problems. Potential General Fund savings would be at least $43 million. (*Analysis*, page C-20.)

Disease Management Could Reduce Medi-Cal Costs

- Poor management of treatment for persons with chronic diseases, such as asthma, diabetes, and heart disease, is driving up the state's costs for Medi-Cal. Our analysis indicates that the implementation of a disease management program could eventually reduce state expenditures by as much as hundreds of millions of dollars annually. (*Analysis*, page C-66.)

Determining Who Is Eligible for Medi-Cal: Options for Savings

- The administration of eligibility rules is one of the most critical functions for the operation of Medi-Cal, but, over the years, the state has had significant concerns about the increasing cost of these activities and the performance of them by the counties. We offer alternative approaches to reforming the eligibility system. (*Analysis*, page C-56.)

State Should Assess Shift to Veterans Administration (VA) Benefits

- Federal survey data suggest that there could be tens of thousands of military veterans who could be receiving comprehensive medical services from the VA health care system but who are enrolled instead in Medi-Cal. If these data proved accurate, it is possible that the state could eventually save as much as $250 million annually by shifting eligible Medi-Cal beneficiaries to the VA system for their medical services. (*Analysis*, page C-63.)

Social Services

Grant Reductions and COLA Suspensions Save $1.6 Billion

- Reducing California Work Opportunity and Responsibility to Kids (CalWORKs) and Supplemental Security Income/State Supplementary Program maximum monthly grants by an average of 6.2 percent results in General Fund savings of $900 million compared to grant levels in 2002-03. Deleting the statutory COLAs in these programs results in further savings of $660 million compared to current law. (*Analysis*, pages C-153 and C-169.)

CalWORKs Grants Overbudgeted by $350 Million

- The Governor's budget projects that the CalWORKs caseload will increase by 2 percent in 2002-03 and by 0.5 percent in 2003-04. However, the most recent data indicate that the CalWORKs caseload continues to decline. We estimate that the Governor's budget overstates CalWORKs costs by $350 million in federal Temporary Assistance for Needy Families (TANF) funds. We present options for the Legislature to convert these TANF savings into General Fund savings. (*Analysis*, pages C-152 and C-156.)

California Fails Federal Foster Care Review

- California has failed all seven child safety, permanency, and well-being outcomes measured by the new federal Child and Family Service Reviews. In order to avoid a loss of federal funds, California will need to improve its performance pursuant to its Program Improvement Plan which must be submitted to the federal government in the near future. (*Analysis*, page C-175.)

State Should Consolidate Aging Programs

- In order to improve the operation of programs serving California's senior citizens, we recommend eliminating the Department of Aging and shifting its functions to the Department of Social Services. Consolidating all aging programs in one department should improve service delivery by making it easier for senior citizens to access a full array of programs. This consolidation would result in administrative savings of $3.4 million and a net reduction of 37 positions. (*Analysis*, page C-36.)

CORRECTIONS

Elderly Inmates Two to Three Times More Expensive, Yet Less Risky

- Elderly inmates are two to three times as costly to incarcerate in state prison as younger inmates. Yet, research shows they are less likely to reoffend and have greater success on parole. For these reasons, we recommend the Legislature adopt legislation requiring that nonviolent elderly inmates be released early to parole. We estimate this would generate General Fund savings of $9 million in the budget year. (*Analysis*, page D-38.)

Work Credits Earn Inmates Early Release

- Inmates who are being processed in the reception centers or who are unassigned to a full-time work or education program due to a shortage of slots earn less than the maximum level of work credits. We recommend enactment of legislation allowing these inmates to earn day-for-day work credit instead of the one-day-for-two-days participation they currently earn thereby saving the state $70 million while reducing the sentence of approximately 29,000 inmates by only 27 days. (*Analysis*, page D-42.)

State Should Shift OCJP Programs to Other Departments

- Given the Office of Criminal Justice Planning's (OCJP's) poor performance in the administration of its programs, and the significant overlap of its mission and programs with those of other departments, we recommend that OCJP programs be shifted to other departments. This would improve the efficiency and service delivery of state government, save $1.5 million General Fund, and free up $3.7 million in federal funds for other programs. (*Analysis*, page D-67.)

State Could Close Three Youth Authority Institutions

- In response to legislative direction, the Youth Authority has submitted a plan to close three institutions: the male portion of the Ventura Youth Correctional Facility and the DeWitt Nelson Youth Correctional Facility (in Stockton) would close by the end of the budget year, and the Fred C. Nelles Youth Correctional Facility (in Whittier) would close by the end of 2005-06. We recommend that the Youth Authority report at budget hearings on the time frame for implementing the closures and the feasibility of closing Fred C. Nelles before DeWitt Nelson. (*Analysis*, page D-52.)

Capital Outlay

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 utilization standards, and based on year-round operations. (*Analysis*, pages G-84, G-93, and G-99.)

- Existing University of California research space exceeds both legislative standards and the proportion of research space at comparable research institutions. As a result, we recommend deletion of state funding for new research space. (*Analysis*, page G-87.)

California State University (CSU)—Plans at Brawley Site Unclear

- The CSU San Diego campus plans to accept a gift of 200 acres of land outside Brawley (Imperial County) as a site for a future off-campus center. The size of the site and the initial master plan documents prepared by the campus, however, suggest something more than an off-campus center.

- We believe the Legislature should have complete information about CSU's plans and intentions before commitments are made that could require major funding by the state. (*Analysis*, page G-96.)

➢ Proposed "Death Row" Facility at San Quentin

- The budget proposes $220 million to construct a new condemned inmate facility at San Quentin. While the state needs to address the existing conditions for this population, this proposed project is not ready to proceed.

- We recommend that the Legislature direct the Department of Corrections to either prepare a more complete proposal for a facility at San Quentin or, if it is willing to consider other locations, study alternative sites for the facility. (*Analysis*, page G-77.)

TRANSPORTATION

➢ General Fund Relief Means Traffic Congestion

- The Governor's proposal to use about $1.7 billion in transportation funds to aid the General Fund would delay projects in the Traffic Congestion Relief Program (TCRP) and makes the program's future funding uncertain. We recommend that the California Transportation Commission (CTC) provide an updated status on all TCRP projects. The Legislature should also act quickly and decisively to determine the state's funding commitment to the program. We provide several options for legislative consideration. (*Analysis*, pages A-14 through A-21.)

➢ Truck Weight Fee Numbers Do Not Add Up

- The State Highway Account's balance has decreased due to several factors, including a decline in weight fee revenue. In order to avoid a shortfall, the budget proposes to reduce expenditures and increase truck weight fees. However, we find that the fee proposal is based on inconsistent revenue estimates and that better information is needed to assess the proposal. We recommend that the Departments of Finance (DOF) and Motor Vehicles (DMV) reconcile the difference in the estimates prior to budget hearings. (*Analysis*, page A-24.)

➢ Extensive Project Rescheduling Diminishes Value of STIP

- In recent years, the Caltrans has consistently rescheduled the delivery of many State Transportation Improvement Program (STIP) projects to later years. This reduces the value of the STIP as a scheduling tool and renders

Caltrans' annual capital outlay and capital outlay support budgets meaningless. As a result, legislative oversight of Caltrans' performance is seriously compromised. We recommend that Caltrans and CTC report on the reasons for the high levels of project rescheduling. We further recommend budget bill language requiring CTC to identify in its next annual report strategies to reduce this level of rescheduling. (*Analysis*, page A-65.)

Proposals to Save Motor Vehicle Account May Not Be Enough

- The Motor Vehicle Account (MVA), which primarily funds the California Highway Patrol (CHP) and DMV, faces a significant deficit in the budget year without corrective actions. The budget proposes a number of solutions, including raising fees on vehicle registration and driver licenses. However, these measures may not go far enough if things do not "break right" for the account. In order to ensure that the MVA remains in a healthy fiscal condition, the Legislature will have to either increase fees further or reduce expenditures for the departments it supports. (*Analysis*, page A-30.)

Costs for CHP Staff Continue to Soar

- Costs for CHP staff could be over $100 million more than budgeted in order to fund required benefits and scheduled salary increases. We recommend that the DOF and CHP report on the magnitude of these unfunded costs and present the administration's plan to pay for them. (*Analysis*, page A-76.)

Loose Connection Between New Telephone Surcharge and Protective Services

- The budget proposes to pay for CHP's enhanced protective and security programs with a new surcharge on intrastate telephone calls even though there is not a sufficient linkage between the proposed surcharge and the activities it would fund. If the Legislature deems the surcharge an appropriate funding source, we recommend that CHP not be authorized to set the surcharge rate, and that the use of surcharge revenue be limited to specific, non-transportation-related activities. (*Analysis*, page A-80.)

Hard to Get "On Board" With Consolidation Plan for High-Speed Rail Authority

- The administration's proposal to consolidate the High-Speed Rail Authority (HSRA) into Caltrans would result in some savings, but would not improve the effectiveness and efficiency of the state's efforts to develop and implement a high-speed rail system. We recommend the restoration of HSRA's funding and an offsetting reduction in Caltrans' budget. (*Analysis*, page A-73.)

Resources

Governor's Fee Proposals Can Go Further

- The budget proposes various fee increases for resources programs. We offer additional fee proposals to shift funding from the General Fund to fees, totaling $214 million. We propose to shift to fees services provided directly to beneficiaries (such as fire protection), or costs to regulate the activities of individuals or businesses that degrade public resources. The additional opportunities that create General Fund savings include:

  - ***Fire Protection—***$170 million savings if property owners who benefit from state fire protection services pay $6 per acre in order to offset one-half of the state's proposed General Fund costs to provide fire protection services largely to private landowners. (*Analysis*, page B-88.)

  - ***Timber Harvest Plan (THP) Review—***$22.1 million savings by having timber operators fully cover the costs incurred by state agencies in their review and enforcement of THPs. (*Analysis*, page B-60.)

  - ***Water Rights—***$7.2 million savings by increasing fees on applicants for new water rights and establishing an ongoing fee on all water rights holders, since they are direct beneficiaries of the State Water Resources Control Board's water rights program. (*Analysis*, page B-123.)

  - ***Dam Safety—***$5.4 million savings by increasing existing fees on dam owners regulated by the Department of Water Resources' dam safety program, since they are direct beneficiaries of the department's activities that ensure the safe operation of dams. (*Analysis*, page B-106.)

  - ***Air Quality "Stationary Source" Regulation—***Additional $4.4 million savings beyond the Governor's fee proposal by having fees replace a portion of the General Fund support remaining in the Air Resources Board's stationary source program for activities related to air quality permitting. (*Analysis*, page B-111.)

  - ***Pesticide Regulation and Risk Assessment—***$2.9 million General Fund savings in various state departments by extending the coverage of pesticide fees to include the costs of state departments outside of the

Department of Pesticide Regulation (DPR) that conduct work related to pesticide regulation. We also offer an alternative structure to the Governor's fee proposal for DPR. (*Analysis*, page B-116.)

- ***Power Plant Siting and Compliance Activities.*** We also recommend that the Legislature establish fees on power plant developers and generators to cover a portion of the power plant siting and related compliance costs of the Energy Resources Conservation and Development Commission (California Energy Commission). If this action were taken, electricity ratepayers (who currently cover most of the siting program's costs) would pay less for this activity. (*Analysis*, page B-79.)

Large Amount of Bond Expenditures in Need of Legislative Oversight

- The Governor's budget proposes over $2.1 billion of bond funds for resources programs. Many of these proposals lack detail; others are inconsistent with legislative direction. (*Analysis*, pages B-26, B-48, B-76, B-96, and B-101.)

- We offer recommendations to improve legislative oversight of bond expenditures of the Wildlife Conservation Board (WCB). In the current and budget years combined, over $1 billion of WCB expenditures would not be reviewed by the Legislature, unless the Legislature steps in to make these expenditures part of the budget bill review process. (*Analysis*, page B-93.)

Eliminate Funding for Unspecified State Park Acquisitions

- The budget provides $35 million (Proposition 50) for statewide park acquisitions. Because the budget provides minimal information on how these funds will be spent and because these acquisitions may result in future unfunded General Fund obligations to support new and expanded state parks, we recommend the proposal be denied. (*Analysis*, page B-102.)

Governor Reduces Pesticide Risk Assessment Effectiveness

- The Governor's proposal to move the scientific peer review of pesticide risk assessments from the Office of Environmental Health Hazard Assessment (OEHHA) to a panel coordinated by the Secretary for the California Environmental Protection Agency would reduce the effectiveness of the state's pesticide risk assessment. We offer an alternative funding proposal to support this and other functions in OEHHA, while reducing General Fund expenditures. (*Analysis*, page B-129.)

➢ Legislative Oversight Needed of Electricity Settlement Funds

- The state has received cash and assets from settlements resulting from the renegotiation of energy contracts entered into by the state during the "energy crisis." Future settlements are also likely. We recommend that the Legislature hold hearings to consider uses for the settlement funds. Additionally, we recommend the establishment of a special fund from which the settlement monies would be appropriated by the Legislature. (*Analysis*, page B-64.)

➢ Future of State's FERC Representation Depends on State's Energy Agency Organization

- Several state agencies represent the state before the Federal Energy Regulatory Commission (FERC) on similar energy-related issues.
- The current organization of the state's energy agencies, including the structure of the state's representation before FERC, should be evaluated after key decisions have been made that will dictate what the future structure of the state's electricity market will itself look like. For the interim, we recommend ways the Legislature can ensure coordination among the multiple agencies appearing before FERC. (*Analysis*, page B-68.)

➢ Environmental Protection Indicators—Good Idea, But Legislature Should Be a Player

- The administration has embarked on a new initiative—Environmental Protection Indicators for California (EPIC)—to track changes that are taking place in the environment. We think that this "results based" approach to environmental protection has merit. We recommend the enactment of legislation to guide EPIC and to ensure that data generated by it is sufficiently linked to the budget development process. (*Analysis*, page B-30.)

General Government

➢ Incurring Debt for Retirement Costs Is Ill-Advised

- To reduce budget costs, the administration proposes to finance up to $2.5 billion in scheduled retirement contributions to the Public Employees' Retirement System and the State Teachers' Retirement System. The majority of these costs are for the ongoing operating expenses of the retirement systems.

- Incurring decades worth of debt to avoid an annual operating expense as a budget-balancing tool is poor fiscal policy. We recommend rejecting the administration's proposal. (*Analysis*, page F-13.)

Risky Assumption of $1.5 Billion, but Existing Gaming Revenue Can Help Budget Shortfall

- The budget assumes $1.5 billion in new revenues to the General Fund from the renegotiation of revenue-sharing agreements with Indian tribes. The agreements are voluntary, and the proposed amount is ten times what tribes currently pay. The realization of the full amount, therefore, is unlikely.

- The administration does not propose a spending plan for $88 million in the Indian Gaming Special Distribution Fund. We recommend using these funds for gambling-related expenses currently paid by the General Fund, such as public safety and mental health funding for local governments. (*Analysis*, page F-63.)

Effectiveness of Film Subsidies and Trade Offices in Doubt

- While making cuts in most other Technology, Trade, and Commerce Agency programs, the budget proposes to continue funding for a film permit subsidy program and the foreign trade offices. Both of these programs have questionable effectiveness. We recommend deleting the $12 million proposed for these programs. (*Analysis*, page F-103.)

Better Choices Than Deferring Mandates

- As with the 2002-03 budget, the administration proposes to defer the costs of all general government mandates on local governments. By the end of the budget year, the state would owe over $1.2 billion to noneducation local governments. Instead of this approach, we recommend the Legislature adopt the general policy of either funding its mandate obligations—or eliminating the state's liability for the mandate. We recommend that funding for some mandates be consolidated within the state-county realignment proposal and that all other mandates be repealed, modified, or suspended for the budget year. (*Analysis*, page F-17.)