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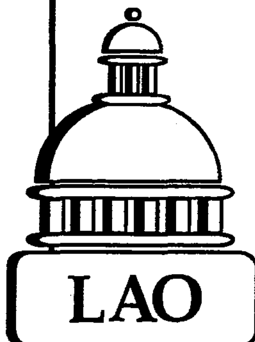
The 1991-92 Budget:
Perspectives and Issues

Strategies for Addressing the State's Budgetary Imablance



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Strategies for Addressing the State's Budgetary Imbalance

INTRODUCTION

As outlined in Part One, the state faces a two-year $9.9 billion funding gap that will have to be addressed prior to the start of the 1991-92 fiscal year. The funding gap consists both of a one-time cyclical component (caused by the economic downturn) and an ongoing *structural* component (due to program requirements that are growing faster than "normal" revenues).

The Governor's Budget provides one plan for addressing the funding gap. It includes proposals that provide short-term relief: one-time revenue enhancements such as accrual accounting changes and accelerated withholding, and near-term expenditure relief through suspension of Proposition 98. In addition, it includes proposals that provide ongoing structural improvement: permanent revenue increases (vehicle license fee increases and the repeal of some sales tax exemptions) and expenditure reductions (such as smaller welfare grants and renters' tax relief payments).

BASIC POLICY CHOICES

In deciding how to address the budget gap, the Legislature will have to resolve two basic issues:

- ***What should be the split between expenditure reductions and revenue increases?*** As noted in Part One, the budget proposes to address much of the funding gap through $5.4 billion in expenditure reductions and $3.1 billion in revenue enhancements. The Legislature will first have to decide how it wants to divide the "solution" between spending reductions and tax increases. In addition, even if the Legislature agrees that the Governor's "split" is reasonable, it might prefer a different set of spending cuts and revenue enhancements based on its assessment of service impacts and tax burden consequences.

- ***What should be the split between one-time and ongoing actions?*** The cyclical component of the budget problem facing the Legislature can be addressed appropriately with *short-term* cuts, adjustments, or revenue increases. Solving the remaining part of the budget problem that is structural and ongoing, however, requires *permanent* spending cuts or revenue increases.

Constraints on Closing the Gap

The Legislature's flexibility in making these two basic policy choices is constrained by the state appropriations limit and by Proposition 98.

- ***The appropriations limit imposes a ceiling on revenue enhancements.*** The Governor's Budget estimates that the state will be approximately $2 billion below its constitutional limit on appropriations in 1991-92 (as discussed in Part Two of this volume). Based on the budget estimate, the Legislature could increase state tax revenues in 1991-92 by up to $2 billion more than the Governor proposes and still remain within the limit. Revenue increases above this level would be possible only to the extent they are spent on *exempt purposes* (such as debt service or unrestricted subventions to local agencies).
- ***Proposition 98 interaction.*** However, such additional increases would be subject to Proposition 98. Additional K-14 appropriations, in turn, would require comparable reductions in non-K-14 programs in order to make "room" for these expenditures under the limit.

LEGISLATURE CAN CHOOSE FROM A VARIETY OF STRATEGIES

The magnitude of the state's budget problem will require the Legislature to make some very difficult choices in the coming months. The specific actions that the Legislature takes to resolve the budget problem undoubtedly will have far-reaching consequences for the provision of public services and for the state's tax structure and economy. Because of this, the Legislature should be aware of the full range of options available to it in addressing the state's budgetary imbalance. Below, we briefly describe the basic strategies that the Legislature could use to balance the budget, offer some considerations regarding the use of each strategy, and provide some examples of specific actions that could be taken to implement each strategy. The examples are offered here not as recommendations, but rather illustrations of how each strategy might be applied. Figure 1 summarizes these basic strategies.

Figure 1

Strategies for Addressing the State's Budgetary Imbalance

INCREASING REVENUES

Modify/Eliminate Tax Expenditures
Expand the Tax Base
Increase Tax Rates

REDUCING EXPENDITURES

Service Reductions
Program Investments
Improved Efficiencies
- Consolidating Programs
- Restructuring Programs
- Management Efficiencies

Funding Shifts
- To Fees
- To Local Governments
- To Federal Government
- To Private Sector

One-Time Adjustments and Deferrals

STRATEGIES FOR INCREASING REVENUES

The Legislature has a wide variety of strategies available to it in order to increase General Fund revenues. Consequently, once the Legislature determines the overall role that revenue increases should play in resolving the budget problem, it will have a large measure of flexibility in fashioning a specific package of revenue increases to achieve that goal.

Within the framework of the existing tax structure, revenue proposals generally can be placed in the following categories:

- Modifying or eliminating tax expenditures.
- Expanding the tax base.
- Increasing tax rates.

Before discussing these specific strategies, we first present several general considerations that should be kept in mind when evaluating revenue strategies.

The Distribution of the State's Tax Burden. Decisions to change the level of revenues can cause changes in the distribution of the state's tax burden (that is, the relative and absolute amount of taxes paid by taxpayers in various income groups). Depending upon the specific revenue strategies employed, the Legislature can alter the distribution to make it *more* or *less* progressive, or leave it essentially the same as it is now. Revenue changes also can alter the relative portions of the tax burden that are directly paid by businesses and individuals.

The Division of Revenues Between the State and Local Governments. Local revenues also can play a role in closing the budget gap. For example, the Governor's Budget proposes to shift to the counties the existing state responsibilities for funding local mental health and public health programs. To cover these increased county costs, the budget also proposes to increase state vehicle license fees and allocate the revenue to the counties. There are a number of other ways to "realign" state and local responsibilities that the Legislature may wish to explore, and these options have different implications for both the division of revenues between the state and local governments and the level of government that should be responsible for levying taxes. (For a more extensive discussion of county-state program realignment issues, please see Part Four of this document.)

Interactions with Federal Taxes. Many of the ways available to the Legislature to change state revenues also would affect the *federal* taxes paid by Californians. For many state taxpayers, increases in the amount of state personal income tax that they pay would be partially offset by a reduction in their federal income tax liability. This is because state income taxes are deductible in computing federal income tax liabilities (other state taxes are not generally deductible). Consequently, Californians who itemize their deductions (but not those who take the standard deduction) would have a portion of any increase in their state personal income tax offset by reduced federal taxes. For businesses, this federal interaction is not confined to the state tax on their income because all state taxes can be deducted as expenses against business income.

Interactions with Local Taxes. Some strategies for increasing state sales tax revenues also will increase local revenue from the local share of the sales tax. Under state law, local sales taxes automatically have essentially the same application and exemptions as the state sales tax. Consequently, actions that

eliminate exemptions or that apply the sales tax to additional items or services would increase local, as well as state, revenues. Increasing the *rate* of the state sales tax, however, would not increase local revenues.

We now discuss specific revenue strategies available to help address the state's budgetary funding gap.

STRATEGY: MODIFY/ELIMINATE TAX EXPENDITURES

Tax expenditures refer to the various exclusions, exceptions, preferential tax rates, credits, and deferrals that reduce the amount of revenue collected from the basic structure of the state's taxes. Tax expenditures are very much like regular direct governmental expenditures, except that they are "paid for" by reduced tax collections rather than directly with appropriations.

The underlying rationales for most existing tax expenditure programs fall into three general categories: (1) providing tax relief to specific categories of individuals or businesses, (2) providing economic incentives to encourage certain types of economic activity, or (3) simplifying or reducing the cost of tax administration. Consequently, when the Legislature makes decisions to modify or eliminate tax expenditure programs, the key issues involved are basically the same as those that must be considered when examining the direct expenditure budget:

- Is the objective of the tax expenditure program still valid and achievable?
- Is the tax expenditure cost-effective, both in its own right and relative to other programs that the Legislature could fund with the foregone revenue?

Eliminate Tax Expenditures With No Clear Current Public Purpose

With the passage of time, the original rationale for a tax expenditure may become outdated, and the program may no longer serve any clear public purpose. Repealing these types of tax expenditures can increase state revenue without sacrificing any current policy goals.

Example: Eliminate the Exclusion of Capital Gains on Inherited Assets. Under current personal income tax law, heirs pay taxes only on the appreciation in the value of assets that occurs *after* they inherit them. Any capital gain that occurred during the life of the donor is untaxed. Elimination of this tax expenditure program would tax heirs on the total cumulative capital gains, and increase state revenues by roughly $200 million annually. The most common rationale for the program is

that the property of deceased persons is subject to estate taxes; thus, subjecting the capital gains to income taxation would amount to "double taxation" of the estate. It also is argued that, without this program, heirs might be forced to sell their inherited property in order to pay the tax on the full capital gain. However, these rationales are flawed. Neither the estate tax nor the generation-skipping transfer tax (which are the state taxes imposed upon the property of the deceased) impose any real state tax burden on California taxpayers under current state and federal tax law, because both are merely "pick-up" taxes that collect money that would otherwise go to the federal government. Furthermore, forced sales to pay taxes could be dealt with directly by a tax-deferral program. A tax-forgiveness program is not necessary to address this concern.

Example: Eliminate the Sales and Use Tax Exemption for Printed Advertising Materials. Currently, the purchase of printed advertising materials (such as catalogs, brochures, and the Yellow Pages) is exempt from the sales and use tax if the printer sends the materials directly to potential customers, without charge, on behalf of the advertiser. The original rationale for this tax expenditure program was to eliminate a competitive tax advantage that out-of-state printers had over California printers. As a result of a 1988 U. S. Supreme Court ruling, however, the exemption has become outdated, since California now could apply the tax equitably to both in-state and out-of-state printers. Repealing the exemption would result in revenue gains of up to $50 million annually.

Eliminate Tax Expenditures That Are Ineffective or Not Cost-Effective

Some tax expenditures, although they still have a valid public purpose, are not effective in achieving their goal, or their cost is excessive compared with the public benefit that is achieved. Repealing these types of tax expenditures increases revenues with little or no negative impact on the state's overall goals.

Example: Repeal the Williamson Act. Under the Williamson Act, cities and counties may contract with landowners to restrict the use of property to open-space or agricultural purposes. In return for the restriction, the landowner generally pays a reduced amount of property tax. Prior to the time the program originated (1965), properties were reassessed annually at their current full market value, so that property taxes on land near growing urban areas could increase to the point where the taxes made farming economically unattractive.

However, since 1978 Proposition 13 has eliminated this reassessment problem and substantially reduced property taxes. As a result, the small benefits this program now provides to landowners do not appear to have a significant effect on their development decisions. Repeal of the program would result in eventual annual state savings of $75 million from reduced school apportionments and open-space subventions. (Please see the *Analysis*, Item 9100, for a detailed discussion of this program).

Example: Repeal the Small Business Health Care Credit. A new tax credit for small businesses that provide health care coverage for their employees will become effective in 1992. This credit, which was originally established by Ch 1521/88 (SB 2260, Keene), was enacted to encourage the provision of health benefits by those small employers who, at the time, did *not* provide such health care coverage. The tax credit equals 25 percent of each covered employee's health insurance costs, up to a yearly maximum of $360 per employee. Subsequently, Ch 797/89 (SB 1207, Keene) expanded the credit to make it available for *all* small employers, regardless of whether they were already providing employee health care coverage.

Approximately 40 percent of employees in small businesses are already covered by health insurance, according to recent estimates. Their employers will receive a windfall benefit from the credit. With regard to the other 60 percent of employees, the level of the credit probably is too small to provide sufficient incentive to result in any dramatic increase in their coverage. Given this, the tax credit is very unlikely to result in an expansion of health coverage that will justify the revenue loss. According to the Department of Finance, repealing the credit would result in revenue gains of $97 million in 1991-92, $400 million in 1992-93, and increasing amounts thereafter. Some portion of these revenues could be directed toward a more targeted approach to providing health care coverage to the uninsured. The Governor's Budget proposes to *delay* the implementation of the credit until 1993, which also would achieve the $97 million revenue gain for 1991-92 cited above.

Example: Modify Home Mortgage Interest Deductions. Under current federal and state law, a taxpayer can deduct up to $1 million for debt associated with acquiring a principal residence and a second residence. In addition, a taxpayer may deduct up to $100,000 for interest paid on a home-equity loan.

The primary rationale for the mortgage interest deduction is that it provides a financial incentive for families to buy homes. However, the tax subsidy made available under this program undoubtedly accrues in many instances simply as a "windfall

benefit" to taxpayers who would have purchased homes anyway, and it encourages the purchase of bigger and more expensive homes, as well as vacation homes, rather than basic housing.

The mortgage interest deduction could be revised to limit windfall gains and to reduce the incentive it currently provides to purchase luxury housing and vacation homes. This could be done by:

- Limiting the total amount of interest deducted each year. If the amount of the deduction were limited to $30,000 for single filers and $60,000 for married and head-of-household filers, the estimated 1991-92 revenue gain would be about $70 million. If the limit were set at $5,000 for single filers, and $10,000 for married and head-of-household filers, the gain would be about $2.8 billion.
- Disallowing interest deductions for second homes. The estimated revenue gain would be from $55 million to $65 million annually.

STRATEGY: EXPAND THE TAX BASE

This strategy extends the reach of existing state taxes to cover economic activities and items that are not presently taxed, or changes the basis on which they are taxed. There is evidence to suggest that some activities that are not now subject to certain taxes are a growing part of the total California economy. Therefore, broadening the base of the state's major taxes could result in significant revenue increases, and base-broadening also could improve the responsiveness of the state's tax system to growth in the state's overall economy. Expanding the base of the state's major taxes also has the advantage that, other things being equal, overall rates can be kept lower to achieve the same level of revenues. In addition, expanding the tax base would, in some cases, allow the state to eliminate existing distortions in the tax structure that favor one type of economic activity over another.

Expanding the Coverage of Taxes

Example: Apply Sales Tax to Selected Services. The sales tax applies to tangible personal property, but not to services. Thus, one option for expanding the sales tax base would be to add services to the base. Below, we show the estimated annual revenue gain from extending the sales tax to selected services:

- Entertainment events (including professional sports events, amusement parks, concerts, and theaters)—$250 million.

- Automobile repairs—$204 million.
- Dry-cleaning services—$86 million.
- Contract janitorial services—$61 million.
- Landscaping services—$48 million.

Example: Conform with Federal Taxation of Social Security and Unemployment Benefits. Currently, the federal government taxes all unemployment benefits. The federal government also taxes a portion of social security benefits, if the taxpayer's other income plus social security benefits exceeds a threshold of $32,000 for married filers or $25,000 for other filers. California does not tax either unemployment or social security benefits. Conforming to federal law in these cases would increase state revenues by $270 million annually in the case of social security benefits and $57 million annually in the case of unemployment compensation.

Changing the Basis of Taxation

Example: Base Excise Taxes on the Product Price. California currently imposes excise taxes on alcoholic beverages, as well as on cigarettes and tobacco products. These taxes are levied on a *unit* basis—the tax is a specified amount per gallon of alcoholic beverage or per pack of cigarettes. Revenue from these taxes, therefore, does not increase with inflation. In the case of alcoholic beverages, the rates have not changed since the 1960s. Changing to a price basis for the alcoholic beverage taxes and the cigarette and tobacco taxes would tend to keep these revenues more in step with inflation. The tax rate could be set to start out generating the existing level of revenue or a higher level. If the tax rates initially were set to generate the current level of revenue, then after one year, revenues would increase by roughly $44 million due to price increases, based on current projections of inflation.

Example: Conform with Federal Limit on Itemized Deductions. Enacting legislation to conform the state personal income tax with federal limits on itemized deductions (3 percent of a taxpayer's adjusted gross income that exceeds $100,000) would bring additional annual revenues to the state of approximately $220 million.

STRATEGY: INCREASE TAX RATES

The most direct way to increase state revenue is by increasing the rate of existing taxes. This is because a rate increase can

be designed to yield a specific amount of revenue, and generally requires less administrative effort to implement than other revenue strategies.

Temporary Tax Increases

Example: Impose a Temporary Surtax on the Income Tax and the Bank and Corporation Tax. This option could be used to address short-term revenue needs by imposing a one-time surtax on 1991 incomes. Surtaxes are easy to administer and, if known far enough in advance, taxpayers can adjust their withholding payments accordingly. Since California's income tax is relatively progressive, imposing a percentage surtax of this kind would increase the progressivity of the state's overall tax system by making personal income taxes a bigger share of the total. For every 1 percent of surtax, the annual revenue gain would be about $200 million.

Permanent Rate Increases

Example: Increase the Top Personal Income Tax Bracket. A new top bracket could either replace the existing 9.3 percent top income tax bracket or be imposed as an additional bracket affecting higher levels of income. If the existing 9.3 percent top rate were raised by 1 percentage point to 10.3 percent, about 2.5 million tax returns would be affected, and the resulting revenue gain would be $1.6 billion in 1991-92. Adding a seventh tax bracket of 11 percent for incomes above $250,000 (single) and $500,000 (joint) would raise $510 million.

Example: Suspend Income Tax Indexing in 1991. The Legislature could effectively suspend the indexing of the personal income tax by establishing new tax brackets for the 1991 income year. Although the suspension would be for only one year, taxes would remain higher permanently.

Proposition 7, approved by the voters at the June 1982 primary election, requires indexing of state income tax brackets and certain tax credits by the percentage change in the California Consumer Price Index (CPI) in order to compensate for the effects of inflation. Although the indexing of tax brackets is required by a voter-approved initiative, Legislative Counsel has opined that the initiative does not prohibit the Legislature from adopting new tax brackets, and these new tax brackets could be identical to the tax brackets that would be in effect if indexing were suspended.

The suspension of indexing would increase the relative tax burden on middle-income taxpayers because they have the great-

est percentage of their taxable income in the middle tax brackets, and these brackets would be those most affected by suspension. Further, suspending indexing would have a smaller relative effect (as a percentage of total taxes paid) on high-income taxpayers because they already have most of their income taxed at the top rate. The revenue gain from a one-year suspension would be approximately $1 billion in 1991-92, $780 million in 1992-93, and similar amounts thereafter.

Example: Increase the State Sales Tax Rate. A sales tax increase would be feasible as either a permanent or temporary revenue strategy. The state sales tax rate is currently set at 4.75 percent. In addition, a uniform local sales tax rate of 1.25 percent is imposed by cities and counties, so that the combined rate is at least 6 percent everywhere in California. Additional local rates may be imposed, but the combined state and local sales tax rate cannot exceed 7 percent. State revenues would increase by approximately $770 million annually for every 0.25 percent increase in the state sales tax rate.

Example: Increase Alcoholic Beverage Taxes. California's alcoholic beverage tax rates are significantly below the national average and have not been changed since the 1960s. Increasing rates to the national average would mean increasing the tax on a six-pack of beer by 14 cents, on a liter of wine by 19 cents, and on a fifth of distilled spirits by 43 cents. This would be expected to generate additional General Fund revenues of approximately $283 million annually.

STRATEGIES FOR REDUCING EXPENDITURES

The Legislature also has a broad range of potential strategies to realize General Fund savings. These strategies generally fall into the following categories:

- Service reductions.
- Program investments for future savings.
- Efficiency improvements.
- Funding shifts to fees, local governments, the federal government, or to the private sector.
- One-time savings and deferrals.

As with revenues, there are some general considerations that should be kept in mind when evaluating spending strategies.

The Distribution of Spending Among State Programs. This question is similar to the consideration of whether revenue

increases should change the tax burden. Spending cuts could be allocated among major program areas in proportion to their current share of the budget, so that overall budget spending priorities would not change. Alternatively, the Legislature could target some program areas for cuts while "protecting" others. This approach would change relative spending priorities. Generally, we have advised the Legislature not to take across-the-board reductions, as that approach treats effective and less effective programs the same. Given the magnitude of the budget funding gap, however, the Legislature will realistically need to consider some reductions in most, if not all, major program areas.

The Division of Spending Between the State and Local Governments. State and local spending are closely linked in many programs. County-operated health and welfare programs, for example, depend on state funds. As a consequence of this linkage, shifting funding responsibility to local governments for programs now supported by the state can generate savings for the General Fund. Because many local governments also face severe budget constraints, however, this approach makes sense only if (1) a new source of funds is provided to cover the shifted costs or (2) the state is willing to let local governments drop the program if the local governments are unwilling to use their existing funds or to approve additional local taxes or assessments to support it.

STRATEGY: SERVICE REDUCTIONS

Service reductions are a direct and immediate means of reducing expenditures. They play a major role in the Governor's Budget proposals, and, given the magnitude of the budget problem facing the Legislature, they will be an important component of the final budget package.

The process of evaluating and selecting service reductions essentially is one of setting priorities—reducing spending on some programs in order to focus the amount of available funds on those programs that are most effective at achieving the state's priorities.

The simplest method of reducing services is to eliminate programs or components of programs. In selecting potential candidates for elimination, the Legislature should consider programs that:

- No longer serve a clear public purpose.
- Do not achieve their stated objective.
- Are not cost-effective.

- Provide services that other parties (such as the private sector or local government) would provide in the program's absence.
- Do not address the state's highest priorities.

Service reductions can take a number of forms in addition to program eliminations. Program eligibility can be restricted in order to reduce the number of people, projects, or organizations that receive benefits—for example, by imposing a needs test for a program that currently has none. Another approach is to reduce the range or size of the benefits provided to recipients. This can be done across the board—for example, by eliminating COLAs—or in a more targeted manner, such as by reducing maximum benefit levels or restricting the menu of services or items that the state provides. The following considerations are useful in evaluating these types of potential program reductions:

- Is there a compelling reason for the current level of service or is the current service level somewhat arbitrary, thereby allowing some type of reduction without fundamentally compromising the program?
- Are some of the services and functions currently included in a program nonessential to accomplishing that program's primary purpose?

Example: Restrict Higher Education Enrollment. Currently, the California Master Plan for Higher Education calls for the University of California (UC) to admit the top 12.5 percent and for California State University (CSU) to admit the top 33.3 percent of all high school graduates in the state. To contain enrollment-related costs, the Legislature could direct—on a one-time or ongoing basis—the UC and the CSU to restrict enrollment by either (1) tightening eligibility requirements or (2) capping the number of students admitted. In the current year, the UC enrolled 22,300 new freshman students and CSU enrolled 29,600. Reducing freshman enrollments by 1,000 students would save $6 million annually at the UC and $3.8 million annually at CSU.

Example: Parole Instead of Prison for Felons with Short Remaining Terms. Currently, thousands of inmates are transferred from county jails to state prisons with very little remaining time to serve (less than four months) prior to their normal parole date. Placing these inmates on parole earlier, instead of transferring them to state prisons, would result in annual savings of about $70 million. This would be accomplished, however, at a potential risk to public safety.

Example: Reduce or Eliminate Arts Council Funding. The legislation that established the council does not specify particular programs or funding levels. The council funds only a minor portion of the total arts activities in the state, most of which are either self-supporting or rely on a combination of private donations, admission fees, and other revenues. Consequently, eliminating or reducing the Arts Council budget would have a minimal impact on the overall level of artistic activities in California. Elimination of the council's funding would save $15 million annually.

STRATEGY: PROGRAM INVESTMENTS

Program investments involve spending additional money now in order to achieve ongoing long-term savings. Because anticipated 1991-92 revenues are much less than the amounts needed to maintain existing service levels, finding money to finance program investments in the coming year will be very difficult. Nevertheless, the Legislature should include program investments among its budget options, recognizing the need to invest now in order to reduce the large ongoing imbalance between the state's revenues and expenditures.

In evaluating potential program investments for 1991-92, the Legislature should keep the following criteria and considerations in mind:

- The expected ongoing savings should be quantified.
- There should be a high degree of confidence that an investment will produce the anticipated savings.
- Investments that do not require large expenditures in 1991-92 or that can be financed over time as savings accrue (by using bond funds, for example) will divert the least funds from current services.

Example: Increase Family Planning Services. A 1989 study by the University of California, San Francisco, found that spending on family planning services generated up to a 12-to-1 return in savings to Aid to Families with Dependent Children (AFDC), Medi-Cal, food stamps, and other programs.

Example: Expand Drug Treatment Services for Parolees. Most of the state's parolees have a history of substance abuse, and positive drug tests or new criminal activity related to drug use often returns parolees to prison. Recent research indicates that drug treatment programs can be effective in reducing the commission of new crimes by many parolees. Furthermore, the cost of typical nonresidential drug treatment programs is

relatively low, so that they would pay for themselves if they reduced the amount of subsequent prison time served by the average parolee by only two months. Currently, however, the state provides only very limited drug treatment programs for parolees. By increasing funding for drug treatment services for parolees, the state potentially could save millions of dollars annually in future incarceration costs. (Please see Items 4200 and 5240 in the *Analysis* for more detailed discussion of this issue.)

STRATEGY: IMPROVED EFFICIENCIES

Improving efficiency is an attractive means of reducing spending because it does not require eliminating programs or services; instead, it involves finding ways of providing services at less expense. Potential savings from this strategy tend to be limited, however, as large savings can occur only in programs that have major inefficiencies.

Consolidating Programs

Consolidating or combining programs and departments that have overlapping or related functions or clientele can reduce duplication and make more effective use of personnel and other resources. Consolidations also can enhance the delivery of services to the public by providing "one-stop shopping" for related programs. In evaluating potential consolidations, the following considerations should be kept in mind:

- Consolidating programs or departments often imposes up-front costs in order to realize longer-term savings.
- Combining *large* programs or departments may not result in any additional economies of scale and could even *increase* costs if programs or organizations became unwieldy.

Example: Combine the State's Tax Agencies. The state maintains two separate agencies to administer and collect its primary taxes. The Franchise Tax Board (FTB) administers the personal income tax and the bank and corporation tax, and the Board of Equalization (BOE) administers the sales tax, gasoline tax, and various other excise taxes. Consolidating the two agencies could result in ongoing long-term savings and revenue gains to the state in two ways (after some initial expenses to accomplish consolidation). First, operating costs could be reduced by sharing functions, such as collections, data processing, communications, and administrative services, as well as by sharing field facilities. Second, consolidation would enhance

cooperation and information sharing among the tax programs in order to reduce tax evasion and strengthen collection of delinquent taxes. Furthermore, combining the FTB and the BOE could provide more convenient and better service to taxpayers.

Example: Consolidate Economic Development Activities. The state currently has at least 20 separate agencies engaged in a multitude of economic development programs, at an annual cost of more than $500 million. Combining these programs in one or two agencies probably could reduce administrative costs significantly, reduce duplicative program efforts, and increase the effectiveness of state economic development efforts.

Restructuring Programs

Another way of improving efficiency is to restructure programs. This involves making fundamental changes in the way a program tries to achieve its objectives. For example, many state regulatory agencies try to "control" behavior through extensive, detailed rules and regulations. As an alternative, they could rely on market-based approaches (pricing, penalties, incentives) to achieve the desired results, thereby reducing regulatory costs and allowing the regulated parties more flexibility in complying with program requirements.

As with consolidations, there may be up-front costs to achieve some restructurings. In addition, restructurings can take time to achieve, so savings may not be immediate.

Example: Coordinate Funding for Desegregation and Compensatory Education. The focus of school desegregation programs has been shifting from moving students among schools to providing additional educational resources to overcome the harmful effect of racial and cultural isolation. As a result, the ways in which many school districts are using state desegregation aid are not very different from the uses of funding provided under the state compensatory education program (also known as Economic Impact Aid—EIA). EIA provides funds to enhance programs for districts with high proportions of disadvantaged students. By requiring school districts to give first priority for the use of EIA funds to desegregation programs, and by limiting state desegregation aid only to allowable desegregation costs in excess of EIA funds, the Legislature could slow the rapidly growing costs of desegregation aid. Coordinating the two programs in this way also would provide a more equitable distribution of state aid among *all* school districts with high concentrations of minority students. Annual savings could be tens of millions of dollars.

Example: Market Approach to Setting Rates for Foster Care Group Homes. Payments to group homes that provide foster care to children cost the General Fund roughly $500 million annually. These payments are based on a statutory schedule designed to cover the costs of operating the various types of homes. As an alternative, the state could adopt more of a market approach to rate setting. This could involve monitoring the supply of group home beds available at each of the 14 levels of care and raising or lowering rates in response to shortages or surpluses of beds. This approach would ensure that the state pays only as much as needed to ensure an adequate supply of beds, given a desired level of service. The potential savings from this change could be tens of millions of dollars annually.

Example: Encouraging Innovation in Social Service Delivery. Counties must comply with state regulations and funding limitations in providing many social services. While these state requirements attempt to address a variety of concerns, they are inherently rigid, and counties generally are not free to try alternative approaches that may lead to more efficient programs and more effective results. For example, our report *Child Abuse and Neglect in California: A Review of the Child Welfare Services Program* (January 1991) notes that allowing counties to "borrow" foster-care funding from future years to pay up-front costs to reunite families can prevent foster care placements and result in a net savings. There also may be opportunities for innovation in the In-Home Supportive Services (IHSS) Program, which helps the elderly and disabled poor to remain safely in their homes. Allowing counties, on a pilot basis, to use IHSS funds to provide equipment, make special modifications to client's homes, or to provide meals in a congregate setting could determine whether a more flexible approach is more cost-effective than restricting the use of IHSS funds to in-home care by an attendant, as is currently the case.

Example: Increase Penalties to Reduce Enforcement Costs. State personnel in a number of agencies enforce a wide variety of laws and regulations to protect the state's environment and its natural resource base. The state also provides funds for some local enforcement functions. Generally, there has been no attempt to systematically balance the size of fines and penalties with enforcement costs. If fines and penalties were larger, and the state continued to have some level of visible enforcement presence, it could shift some of the burden it currently shoulders for environmental and resource protection to private parties. Presumably, individuals and businesses would be more careful to comply with these laws and regulations if the cost of violations

were increased. The state could reduce its enforcement costs while maintaining current levels of overall compliance.

Management Efficiencies

These types of efficiency improvements involve making better use of existing personnel, facilities, and equipment to achieve the state's program goals.

Example: Use Existing Inmate Fire Crews for Initial Attack of Forest Fires. Inmates from the Department of Corrections' conservation camps make up about 220 fire crews managed by the California Department of Forestry and Fire Protection (CDFFP). These inmate crews generally perform firefighting duties, such as clearing fire lines and digging trenches only *after* CDFFP's regular fire engine and bulldozer crews have completed their initial attack on a fire with water or retardant. Nevertheless, the inmate fire crews generally arrive at a fire at the same time as the regular fire crews, and they could, with proper training, perform initial attack functions. Using the existing inmate fire crews to perform initial attack, as well as other, firefighting functions could save the state up to $2 million annually.

Example: Automating Welfare Administration. The state currently pays a substantial portion of county welfare administration costs. Merced and Napa Counties have implemented their portion of a new Statewide Automated Welfare System (SAWS). Preliminary indications are that savings from reduced payment errors and enhanced productivity of eligibility workers will pay for the system in three to five years and generate ongoing savings to the counties and the state. If implemented statewide, SAWS could generate annual state savings of more than $100 million.

Example: Change Child Care Staffing Ratios. The state subsidizes a number of child development programs that provide child care for children from needy families or with special needs. Studies indicate that the ratio of staff to children for these preschool children could be changed from the current 1:8 to 1:10, with no significant detrimental effect on the behavior or development of the children. The "leaner" staffing ratio, however, would save the state up to $19 million annually. (Please see the *1989-90 Analysis*, page 761, for a detailed discussion.)

Example: Offer Low-Enrollment Classes Less Frequently. The potential exists for more cost-effective scheduling of course offerings by the UC and the CSU. Some courses with a low average enrollment could be offered on a less frequent basis. For example, a graduate seminar now given twice a year with an

average enrollment of five students could be given once each year to 10 students. Consolidating course offerings in this manner would allow affected faculty to teach additional courses without increasing their total course load.

Example: Eliminate Year-Round School Incentives. We have found that these payments to school districts are of little value in achieving their intended purpose—decreasing demand for state school construction aid by promoting year-round use of existing facilities (please see Item 6110 of the *Analysis*). Accordingly, the Legislature could eliminate these incentives for a savings of $78 million, with little or no impact on the number of pupils attending year-round schools.

Example: Higher Education Year-Round Operations. The CSU has operated summer quarters successfully at four campuses (Hayward, Los Angeles, Pomona, and San Luis Obispo) for a number of years. The CSU currently is preparing a cost-benefit study of year-round operation in response to a legislative directive. Expanding year-round operations at CSU and implementing them at UC campuses as well has the potential to reduce future capital outlay costs by tens of millions of dollars.

STRATEGY: FUNDING SHIFTS

By shifting the funding for programs to other sources, where appropriate, the Legislature can reduce General Fund spending while maintaining services.

Shifting to Fees

State programs that provide specific benefits to individuals or businesses often can be shifted to funding from fees charged to the beneficiaries. Programs that regulate or mitigate activities that can adversely affect others also can be supported by fees charged to the parties responsible for those activities. As budget constraints have become tighter in recent years, the state and local governments have looked more to fees as a funding source for both existing and new programs.

Fees can take several forms, ranging from direct charges for specific services (such as park admission fees), to more generally imposed fees similar to excise taxes (such as the recycling fee imposed on tires). In addition to imposing new fees, the Legislature can increase existing fees that currently do not fully offset program costs. The following points should be considered in evaluating proposals to shift funding to fees:

- There should be a clear relationship between the fee and the services that it funds.

- It must be practical to identify those who should pay the fee and to collect it from them in a cost-effective manner.
- Those on whom fees are imposed must have the ability to pay.
- Imposing partial fees or copayments (even if the fee revenue is relatively small) may also provide incentives for the better utilization of services. In other cases, however, charging fees may be counter to the purpose of some programs, such as programs that seek to increase the use of preventive services.

Example: Water Quality and Water Rights Fees. The State Water Resources Control Board will spend a total of $40.3 million from the General Fund in 1991-92 on its water quality regulation program ($32 million) and its water rights program ($8.3 million). These funds could be replaced in whole or in part by new fee revenue. Water quality fees could be linked to services provided by the board's permitting, monitoring, enforcement, and standards setting activities, because without these activities dischargers would be prohibited from using the state's waters for waste disposal. The fee payers could be identified and assessed easily (please see the *Analysis*, Item 3940, for a detailed discussion). Similarly, water rights fees could be charged to holders of water rights to cover the board's costs of permitting, protecting, and regulating water rights.

Example: Dam Safety Fees. The Department of Water Resources currently charges only a nominal fee for its dam safety inspections and certifications. Raising fees to cover 70 percent of program costs, consistent with other state safety inspection programs, would raise up to $3.5 million annually to offset General Fund costs. (Please see the *Analysis*, Item 3860, for a detailed discussion.)

Shifting Costs to Local Governments

State funding for programs or projects with primarily local benefits could be shifted to local governments. The potential for state savings from this strategy is limited, however, because of the constitutional requirement that the state reimburse local governments for any new mandated costs. In addition, local governments must have a funding source available to support costs shifted from the state if they are to continue these programs without curtailing existing local programs. (For a detailed discussion of the fiscal relationship between the state and the counties, please see our piece in Part Four of this document.)

Example: Eliminating State Funding for Local Flood Control Projects. Under current state law, the state pays 70 percent of the nonfederal share of local flood control projects, with local agencies paying the remaining 30 percent. Eliminating this state funding would shift all of the nonfederal costs onto local agencies in the areas served by these projects. Local agencies have a number of financing options to cover these costs, including bonds and fees. Eliminating state funding for local flood control projects would save the state $42.5 million in 1991-92.

Example: County Match for Use of Institutions for Mental Diseases. Under current law, counties pay 15 percent of the net treatment costs of mentally ill persons in most types of 24-hour care facilities (the state pays the other 85 percent). *All* of the costs of treatment in Institutions for Mental Diseases (IMDs), however, are paid by the state. This approach results in a substantial incentive for counties to place patients in IMDs, whether or not they require the skilled nursing care that IMDs provide. Requiring a 15-percent match by counties for IMD treatment would reduce state costs by almost $12 million at existing utilization levels. Ultimately, the fees should result in even larger state savings by reducing inappropriate use of IMDs. (Please see the *Analysis*, Item 4440, for a detailed discussion of this issue.)

Example: Eliminate State Subsidy for Driver Training. The primary beneficiaries of driver training programs provided by schools are the students who receive free driver trainer subsidized by the state. If state funding were eliminated, school districts would have to decide whether to continue subsidizing the program themselves from their own general-purpose revenues. If driver training programs were discontinued, students who wished to drive prior to age 18 (or their families) would have the choice of paying for driver education themselves. Eliminating funding for driver training would save the state $21 million in 1991-92.

Example: Lower the Vote Requirement for Local General Obligation Bonds. The state has increasingly become the source of funds for major local capital outlay projects, such as the construction of schools, parks, and jails. A constitutional amendment lowering the voter approval requirement for local general obligation bonds from two-thirds to a majority (the same as the vote requirement for state bonds) would increase the ability of local governments and schools to finance capital outlay projects by themselves, thereby reducing the state's future debt service costs to finance these types of local projects.

Shifting Costs to the Federal Government

In some cases, the state currently does not take full advantage of potential federal funding to offset its program costs. This can occur through oversight or because of a state preference to operate these programs in a manner that does not qualify for federal funding. In these cases, state spending could be reduced by shifting costs to available federal funding. These funding shifts would involve the following considerations:

- Are the added federal funds worth the accompanying loss of state control?
- Will federal funds continue to be available long enough to justify the cost and effort required to revise existing programs to meet federal requirements?

Example: Shift Qualifying State Costs to the Medi-Cal Program. Currently, the state pays the full cost of several types of health-related services that could be financed as "optional benefits" under the Medi-Cal program, thereby qualifying them for partial federal funding. These services include rehabilitative services provided by the Department of Mental Health, and personal care and case management services provided by the Department of Developmental Services. Funding these programs through Medi-Cal has the potential to save the state millions of dollars annually by using federal funds. In order to qualify for this funding, however, these programs may have to meet additional requirements which could increase program costs. Accordingly, a study to determine the amount of net savings to the state should be done before any of these services are placed under Medi-Cal.

Shifting Costs to the Private Sector

This strategy goes further than shifting programs to fee support because it shifts the provision of services, in addition to their funding, to businesses and individuals. By imposing requirements directly on businesses and individuals (for example, in their roles as employers or landlords), the state can sometimes achieve public purposes without collecting or spending public funds.

Example: Requiring Employers to Provide Health Benefits. One way to reduce the state's very substantial indigent health care costs is to require some or all employers to provide health insurance to their employees (or pay a fee to the state to provide health coverage in lieu of directly insuring their employees). The amount of the net savings would depend on the extent to which (1) very small businesses are included, (2) part-time and

intermittent workers are covered, and (3) revenue losses from existing state tax credits for health benefits provided by small employers offset health care cost savings.

STRATEGY: ONE-TIME ADJUSTMENTS AND DEFERRALS

This strategy involves stop-gap measures that, like one-time revenue gains, help the state address the near-term cyclical portion of its current budget shortfall. Deferring expenditures, however, will make balancing *future* budgets even more difficult.

Example: Postpone Flood Control Subventions. State flood control subventions, which are the state's contribution to the nonfederal share of local flood control projects, could be postponed to future years. The *1991-92 Governor's Budget* proposes to spend a total of $57.4 million from the Special Account for Capital Outlay for these subventions (including $14.9 million for Delta levees projects). Instead, the money could be transferred to the General Fund and used for other purposes. In most cases, deferring the payment of the subventions would not significantly delay project construction, although it *may* increase local financing costs somewhat.

Example: Tahoe Conservancy Projects. The budget proposes to spend a total of $7 million in 1991-92 from the state's share of federal offshore oil revenues for additional projects of the California Tahoe Conservancy to control soil erosion, increase public access and recreational facilities, and to protect and restore watersheds in the Tahoe Basin. Some or all of these projects could be deferred to future years, and the savings could be transferred to the General Fund.

This analysis reflects the collective efforts of the Legislative Analyst's staff. It was coordinated by Dan Rabovsky, under the direction of Mac Taylor. For information concerning this analysis, please contact the authors at (916) 445-6511.