December 16, 2002

LAO
60 YEARS OF SERVICE

Analysis of Mid-Year Budget Proposal

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On December 6, 2002, the Governor released his current-year plan for partially addressing the enormous General Fund budget shortfall facing California. This plan calls for $10.2 billion in budgetary reductions and adjustments in the current year ($3.4 billion) and budget year ($6.8 billion) combined, as an initial step towards eliminating the shortfall. This report discusses the Governor's proposal, both in the aggregate and by major program area. It also considers its general viability, certain issues associated with some of its specific provisions, and additional options available to the Legislature to use in lieu of or in conjunction with the items in the Governor's plan.

THE BUDGET PROBLEM FACING CALIFORNIA

In our recent report entitled *California's Fiscal Outlook* (November 2002), we indicated that the state's General Fund faces a projected budget-year shortfall of more than $21 billion under the provisions of current law. This amount is comprised of an estimated 2002-03 deficit of roughly $6 billion and a projected 2003-04 operating deficit (that is, expenditures in excess of revenues) of $15 billion. In addition, we indicated that, absent corrective actions, the General Fund would continue to experience large operating deficits into the foreseeable future. Given the above, we advised that very significant spending reductions and/or resource augmentations would be necessary to bring revenues and expenditures back into balance and eliminate the budget shortfall.

Although the administration has not released its own estimate of the size of the budget shortfall, it has indicated that it is even larger than ours—apparently by at least several billion dollars.

APPROACHING THE PROBLEM

In our fiscal outlook report and other recent publications, we have identified for the Legislature a variety of principles, strategies, and tools for dealing with the shortfall. We have noted that the current budget shortfall is much more formidable and challenging than last year's imbalance, due both to the magnitude of the problem and because a number of the one-time solutions heavily relied upon last year are no longer available (such as tobacco securitization). All of this makes it imperative that the Legislature take full advantage of the alternative budget-balancing approaches and options available to it. We especially have cited the need to:

- Undertake current-year actions;
- Put everything "on the table" when considering alternative solutions; and
- Continue to use one-time solutions but realize that significant ongoing actions also will be needed.

With the above in mind, we next discuss the Governor's current-year budget proposal.

THE GOVERNOR'S PROPOSED CURRENT-YEAR ACTIONS

Overview of the Proposal

The $10.2 billion in two-year budgetary reductions and adjustments proposed in the Governor's current-year plan includes $3.4 billion in 2002-03 and $6.8 billion in 2003-04. In contrast to last year's plan, which focused mainly on one-time actions such as deferrals, reversions, and funding redirections, the current plan involves major ongoing reductions to a wide variety of programs.

We believe the focus on ongoing actions is a positive feature of the Governor's proposal, in that it addresses the need for early and significant ongoing actions to address the enormous shortfall. At the same time, however, the current plan merits careful legislative deliberation, since it includes much more substantive proposals than last year's, involving many program reductions and eliminations. Thus, in a very real sense, this year's current-year proposal can be thought of as the first part of the Governor's 2003-04 budget plan, as opposed to just a mid-year correction to the 2002-03 budget.

Three important features of the overall plan are how its solutions are distributed according to (1) type or category of action, (2) major program area, and (3) one-time versus ongoing effects.

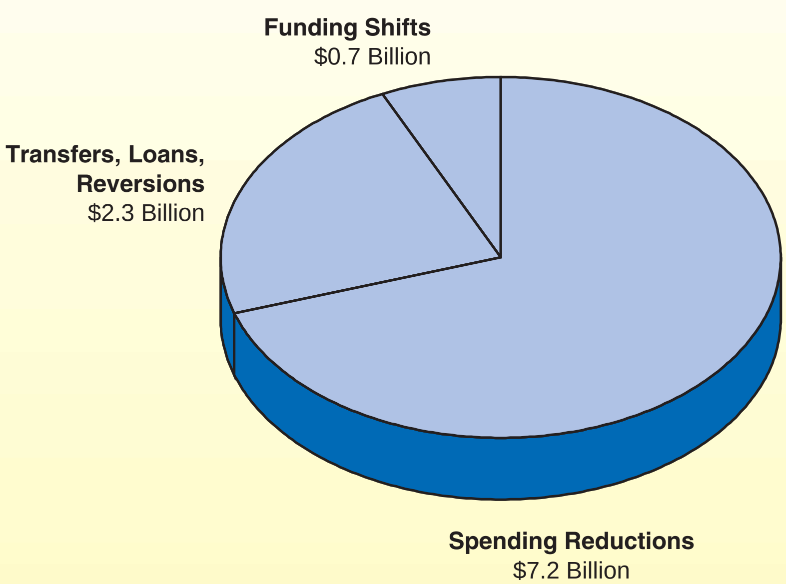
Spending Reductions Account for Majority of Savings

In contrast to last year's current-year plan, which relied heavily on reversions and funding redirections, this year's plan contains major spending reductions. As shown in Figure 1, such reductions account for over two-thirds of the Governor's proposed budget solutions. The remainder consists of funding shifts and transfers, loans, and reversions

Figure 1

Budget Savings Are Primarily From Spending Reductions

Distribution of Two-Year Proposed $10.2 Billion Savings, By Type



Where the Main Spending Reductions Fall. Although the $7.2 billion in program reductions are widespread, the majority of them relate to a relatively few major proposals:

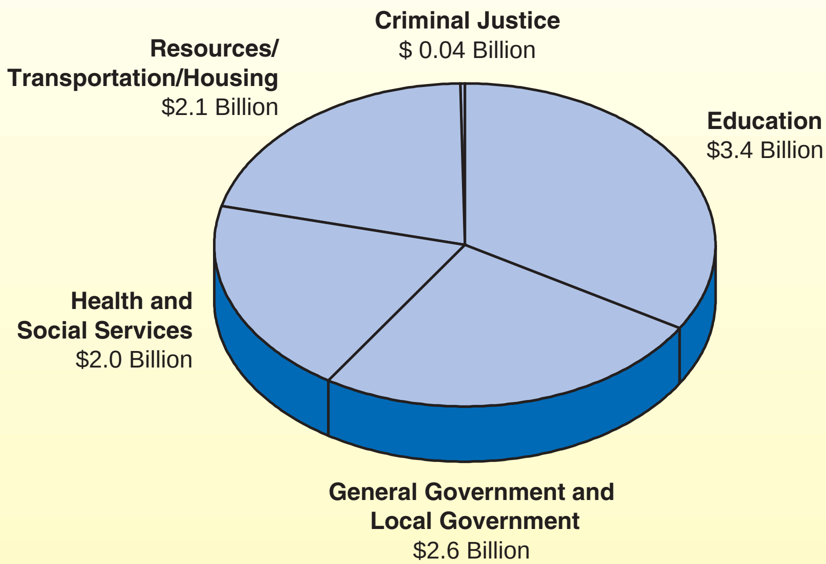
- Across-the-board cuts to K-14 education programs;
- Elimination of social services cost-of-living adjustments (COLAs);
- Elimination of optional benefits and reductions in provider rates in the Medi-Cal program; and
- The reduction in transportation funding.

Examples of Other Savings. About one-third of the $2.3 billion in savings related to transfers, loans, and reversions is due to the proposed deferral of expenditures for local mandate claims. Regarding restructuring, the plan does contain several proposals to restructure programs, mainly in social services. However, the dollar savings associated with these proposals are relatively minor in the near term.

Figure 2

Major Savings Proposed In All Areas Except Criminal Justice

Distributution of Two-Year Proposed $10.2 Billion Savings, By Program



Most—But Not All—Spending Areas Are On the Table

Savings are proposed throughout most areas of the budget. As shown in Figure 2, about one-third of the proposed solutions are in education. Another one-fourth of the total is in the general government and local government category. Health and social services and resources, transportation, and housing each account for about one-fifth of the total. Criminal justice is the one programmatic area that is relatively unaffected by the proposal, accounting for just 0.4 percent of the total proposed savings.

Significant Share of Savings Is Ongoing

Of the $6.8 billion in proposed 2003-04 savings, our review indicates that up to 60 percent ($4 billion) is related to actions which will have ongoing savings. The other 40 percent reflects one-time savings. As indicated above, the large ongoing component will serve to help reduce the multibillion dollar General Fund operating deficit that we project under current law for 2004-05 and thereafter.

LAO Conclusions About the Governor's Plan

The Governor's proposal is an important first step toward addressing the enormous fiscal problem facing California. Since the plan is only a first step (although an ambitious one), it is difficult to evaluate as a complete plan. Such a plan will not be available to the Legislature until the Governor presents his 2003-04 budget proposal on January 10, 2003. Based on what has been presented so far by the administration, however, our preliminary observations are as follows.

➢ ***Credibility.*** We believe that most of the proposals are credible—particularly in the context of the enormous deficit facing the state.

- ➢ ***Programmatic Coverage.*** The proposal achieves savings from a wide range of programs. However, it contains virtually no meaningful reductions in the criminal justice program area, where we believe opportunities for budget solutions exist.

- ➢ ***Achievability and Effectiveness.*** There are several instances, such as the State Teachers' Retirement System (STRS) proposal, where legal issues may be involved. There are also instances—most notably in K-14 education (Proposition 98)—where the proposed plan relies heavily on across-the-board reductions. Such across-the-board reductions may not be the most effective means of achieving savings and also may be difficult to fully achieve, given that the fiscal year is nearly half over. Thus, we believe it would be advisable to look for more focused and targeted cuts (see our alternative proposal for achieving Proposition 98 savings discussed below).

- ➢ ***Balance.*** The plan includes virtually no revenue increases, from either taxes or fees.

PROPOSED ACTIONS BY MAJOR PROGRAM AREA

PROPOSITION 98

Overview

In the December revision, the Governor proposes to reduce Proposition 98 funding for 2002-03 by approximately $1.9 billion. The Governor's proposal would reduce funding to the estimated minimum guarantee of $44.6 billion. Figure 3 summarizes the main components of the proposal. While the Governor's proposal does not identify a total spending level for 2003-04, it does specify savings totaling $1.1 billion in the budget year.

Main Features

The current-year Proposition 98 reduction of $1.9 billion consists of the elimination of the $143 million reserve and the following three components.

- ➢ ***Across-the-Board Reduction ($1.1 Billion).*** The Governor proposes reducing almost all Proposition 98 current-year General Fund appropriations by 3.66 percent. This would result in

Figure 3

**December Revision
Proposed Proposition 98 Savings**

(In Millions)

	2002-03			2003-04		
	K-12	CCC	Total	K-12	CCC	Total
Program Reductions						
Across-the-board	$980.9	$97.5	$1,078.4	—	—	—
Targeted	180.7	117.5	298.2	$191.6	—	$191.6
Reserve elimination	143.0	—	143.0	—	—	—
Fund shifts	349.2	7.6	356.8	—	—	—
Loans/transfers/reversions	—	—	—	870.0	—	870.0
Totals	**$1,653.8**	**$222.6**	**$1,876.4**	**$1,061.6**	**—**	**$1,061.6**

$1.1 billion in savings. Figure 4 shows the impact of the across-the-board cuts on major programs. The across-the-board reduction applies only to the General Fund portion of K-12 revenue limits (not the local property tax portion), so the reduction represents a 2.15 percent cut to total revenue limits. It is our understanding that the revenue limit reduction is a permanent one. The Governor's proposal, however, is ambiguous as to whether the categorical reductions are one-time or permanent. The proposal does not reduce any of the statutory requirements of the categorical programs.

- ***Targeted Reductions ($298 Million).*** The Governor proposes targeted reductions totaling $298 million. Most of this reduction is due to: (1) the elimination of California Work Opportunity and Responsibility to Kids (CalWORKs) Stage 3 child care, effective April 1, 2003 ($99 million) and (2) an adjustment to community colleges funding to account for improper concurrent enrollment of K-12 students ($80 million).

- ***Proposition 98 Reversion Account Swap ($357 Million).*** The Governor proposes reverting funds into the Proposition 98 reversion account from various prior-year appropriations for which the funds were not needed due to implementation delays or underutilization. Prior-year reversions include numerous child care programs ($103 million), the Child Care Facilities Revolving Fund ($22 million), Math and Reading Professional Development ($31.7 million), and various state mandates ($20 million). The proposal would use the reversion account funds to backfill $357 million of the 2002-03 General Fund appropriation for the Regional Occupational Centers and Program. This swap saves the state $357 million. A similar swap for adult education was part of the solution reflected in the *2002-03 Budget Act*.

Governor Proposes to Defer 2003-04 State Mandate Costs. In the *2002-03 Budget Act*, the state provided $125 million for K-14 education mandates and deferred approximately $600 million in payments. The Government Code requires the state to pay interest (at the Pooled Money Investment Account rate) when paying overdue mandate claims. Thus, the current-year mandate deferral is equivalent to a low-interest

Figure 4

Impact of the Governor's Across-the-Board Reduction

(In Millions)

Program	Reduction
K-12 revenue limits	$612.4
Special education	99.3
Community colleges	97.5
K-3 class size reduction	60.8
Adult education	20.8
Targeted instructional improvement grants	20.3
Other programs	167.3
Total	**$1,078.4**

loan from school districts. The Governor proposes to defer payments of K-14 state mandates for the 2003-04 budget and conduct audits of reimbursement claims, which the Governor estimates to be $870 million (we estimate that the cost could exceed $1 billion). The Legislature could reduce budget-year costs by suspending or eliminating specific mandates.

LAO Comments

Because the Governor's proposal would lower the Proposition 98 base, the state not only saves money in 2002-03, but also in 2003-04 and beyond. (While a current-year reduction down to the minimum guarantee can generate savings over several years, it does not affect the long-run Proposition 98 spending level.) Given these potential multiyear savings, we believe the Governor's goal of reducing 2002-03 Proposition 98 funding to the minimum guarantee is fiscally prudent. We also generally support the Governor's proposals for targeted reductions, the Proposition 98 reversion account swap, and elimination of the Proposition 98 reserve fund.

We do, however, have concerns with the $1.1 billion across-the-board reduction proposed in the December revision. Specifically, we believe the across-the-board cuts would have an adverse impact on direct services to students and would be difficult for school districts to absorb in the remaining months of the fiscal year. The across-the-board approach assumes that all existing programs have equal value. While relying mainly on an across-the-board reduction appears to allow school districts flexibility to determine how to implement the proposed cuts, this is not really the case. Since the Governor's approach would require school districts to continue to meet all of the program requirements of each of the categorical programs, school districts would have little ability to reduce program costs. For example, while the proposal would reduce funding for K-3 Class Size Reduction (CSR) by $60 million and special education by $99 million, school districts would still have to meet the 20 to 1 student-to-teacher requirement for K-3 CSR and provide all required special education services mandated by state and federal law. In contrast, targeting the reductions at programs that do not have a direct influence on student services would allow school districts to absorb the reductions with the least impact on students. Targeted reductions also allow programmatic requirements to be modified along with the funding.

LAO Alternative Approach. Figure 5 (see page 8) shows an LAO alternative to the Governor's $1.1 billion across-the-board reduction. It includes (1) more targeted reductions, (2) additional reversions, (3) a funding shift for Stage 3 child care, and (4) deferrals. We believe that these alternatives would allow the Legislature to minimize the impact of the reductions on the classroom by eliminating programmatic requirements along with the funding. Our approach would result in over $500 million in additional general purpose funds compared to the Governor's approach. Our approach also takes advantage of additional one-time savings and carry-over funds to generate one-time reductions in Proposition 98 General Fund appropriations.

Budget-Year Decisions. As noted above, a reduction of $1.9 billion in current-year Proposition 98 appropriations also reduces the 2003-04 minimum funding guarantee by a similar amount. However, to achieve these budget-year savings—and additional savings of almost

$800 million—the Legislature would need to repeal specific statutory provisions related to "maintenance factor" repayments and deferrals. The Legislature could also avoid increased education costs in excess of $400 million in 2004-05 by accommodating Proposition 49-required increases in after school spending in 2003-04.

Higher Education

Overview

The Governor's proposal would reduce current-year funding for higher education by $350 million. This represents a reduction of about 3 percent from budgeted levels. The reductions take the form of allocated and unallocated program cuts. The Governor does not propose any fee increases or fund shifts.

Main Features

University of California (UC). The Governor's proposal would reduce current-year General Fund appropriations by $74.3 million, or 2.3 percent. Of this amount, $20 million would come from academic and institutional support, $18 million from research

Figure 5

LAO Alternative to Governor's Across-the-Board Reduction

(In Millions)

Program	Description of Alternative	Fiscal Savings
Instructional Materials One-Time Grants	Delay requirement that all school districts purchase instructional materials aligned to standards.	$150.0[a]
Reduce revenue limit COLA to statutory 1.66 percent	Reduce the COLA to the statutory rate of 1.66 percent from the budget act COLA of 2 percent. This option would have multi-year savings.	95.5
Backfill Stage 3 child care with one-time federal funds	Use one-time federal fund carry-over to backfill Proposition 98 funds for Stage 3 child care.	79.1
Supplemental Instruction—Remedial Programs	Revert unused portion of funds appropriated for supplemental instruction in 1998.	69.9[b]
High Priority Schools Grant Program (HPSGP)	Eliminate second HPSGP cohort. In addition, use 2003-04 Proposition 98 funds to make final 2002-03 payment since the final 20 percent will not be paid to schools until September 2003.	66.2
Math and Reading Professional Development	Delay initiation of program until future years.	63.4[a]
Immediate Intervention/ Underperforming Schools Program	Use 2003-04 Proposition 98 funds to make final 2002-03 payment since the final 20 percent will not be paid to schools until September 2003.	39.6
Reduce categorical COLA to 1.66 percent	Reduce the COLA to the statutory rate of 1.66 percent from the budget act COLA of 2 percent. This option would have multi-year savings.	25.4
CCC Part-Time Faculty	Cut part-time faculty extra compensation (as of February 1, 2003).	24.0
School Library Materials	Temporarily suspend program.	32.7[a]
Miscellaneous	Enact a combination of various reductions and reversions.	115.5[a]
Program funding deferrals	Provide funding for programs administered in 2002-03 in July 2003.	317.0
Total		**$1,078.4**

[a] Savings amount includes a mixture of General Fund and Proposition 98 Reversion Account funds. Additional action necessary to convert reversion funds into General Fund savings.

[b] Additional action necessary to convert reversion funds into General Fund savings.

funding, and $17.3 million would be in the form of smaller cuts to student services and other programs. The remaining $19 million would be an unallocated base reduction.

California State University (CSU). For CSU, the Governor's proposal would reduce current-year General Fund appropriations by $59.6 million, or 2.2 percent. The entire reduction is unallocated.

California Community Colleges (CCC). The Governor's proposal would reduce current-year appropriations (General Fund and local property tax revenue) by $215 million, or 4.3 percent. Of this amount, $97.5 million is an across-the-board reduction to all CCC programs, and $80 million would be targeted at districts that have inappropriately claimed funding for concurrently enrolled high school students. Most of the remaining reductions result from reestimated property tax revenues.

LAO Comments

The Governor's proposal makes relatively modest cuts to the base budgets of all three higher education segments. We believe that cuts of this magnitude are absorbable in the current year. However, we believe additional information is necessary before the Legislature acts on several of the proposals.

Several Significant Base Cuts Are Unallocated. The December revision proposes unallocated base cuts to UC ($19 million) and CSU ($59.6 million). At the time this report was being prepared, the segments were considering backfilling at least a portion of these cuts with student fee increases this spring. They were unable to tell us how they would allocate reductions not covered by fee increases. If these reductions are approved, the Legislature may wish to consider whether further direction to the segments, including perhaps recasting some of the unallocated reductions as specified reductions, is necessary to preserve the Legislature's priorities. (A number of specific reduction options is provided later in this report.)

"Prior-Year Savings" May Not Be Available. The December revision characterizes about $30 million of the higher education reductions as prior-year savings. For UC, the proposal identifies $18 million in 2001-02 funding for three research programs, and another $4 million for the Advanced Placement Online program. However, the status of these funds is unclear because UC informs us that this funding is already committed to specific projects, and may or may not be available.

Estimated Savings From Concurrent Enrollment Proposal Unknown. The Governor's proposal would reduce base apportionment funding by $80 million to community college districts that inappropriately claimed funding for credit instruction of concurrently enrolled high school students. Based on recent discussions with CCC, the Department of Finance (DOF), and others, it appears that abuses have in fact occurred, and that improper payments of a potentially significant magnitude were made. The administration indicates that it intends to conduct an audit "to identify the scope and breadth" of this activity. However, until the audit is completed, the Legislature will not know the extent of the savings that can be achieved.

Source of Budget-Year Savings Is Not Clear. The December revision projects both current-year and budget-year savings to be achieved from the various proposals. For higher education, some of the budget-year estimates seem unlikely to be achieved merely by the annualization of the base reductions proposed in the December revision. For example, while the $19 million unallocated current-year reduction for UC is scheduled to save an additional $19 million in the budget year, the $59.6 million current-year reduction for CSU is projected to more than double to $152 million in the budget year. As another example, the $3.3 million cut to UC's outreach programs is projected to grow tenfold to $33.2 million in the budget year. Overall, it appears that much of the projected budget-year savings could be achieved only if significant *additional* cuts were made to the segments' base budgets in 2003-04. The Governor's proposal does not provide an explanation as to the source or nature of these assumed budget-year reductions.

HEALTH SERVICES

Overview

The Governor's December revision package includes significant program reductions, funding shifts, and reversions affecting various health programs, particularly Medi-Cal and state programs serving individuals with a mental illness or a developmental disability. According to the administration's estimates, the adoption of the December revision proposal would reduce General Fund expenditures for health programs by almost $375 million in 2002-03 and $1.1 billion in 2003-04. Figure 6 summarizes the fiscal impact of the Governor's proposal on health services. As the figure indicates, program reductions account for the largest share of savings in both the current and budget years. The largest program reductions are in the Medi-Cal Program, as discussed below.

Figure 6

December Revision
Proposed Health Services Savings[a]

General Fund (In Thousands)

Type of Savings	2002-03	2003-04
Program reductions	$191,874	$1,129,216
Fund shifts	2,562	10,062
Loans/transfers/reversions	180,550	—
Restructuring/reorganization	—	38
Totals	**$374,986**	**$1,139,316**

[a] Totals do not include additional savings in health programs proposed through deferral of payments for state-mandated programs.

Main Features

Medi-Cal. The biggest and most significant savings would come from program reductions in the Medi-Cal Program. The expenditure reduction package includes proposals for:

- A selective 10 percent reduction in provider rates, primarily affecting nursing homes and physicians.
- The elimination of certain optional benefits provided to adult beneficiaries, including dental care and medical supplies.
- Tightening of eligibility rules, including rescinding the 1931(b) expansion of Medi-Cal eligibility to working poor families and reinstatement of requirements that parents file quarterly reports to reaffirm their eligibility.

Also, a new state assessment would be imposed on intermediate care facilities for the developmentally disabled (ICF/DDs) to draw down additional federal Medicaid funds.

Developmental Services. Several of the Governor's proposals affecting the Department of Developmental Services (DDS) involve efforts to secure additional federal funds. For example, his plan would revert to the General Fund larger than expected federal revenues from prior years from community-based programs for persons with developmental disabilities. Some components affecting DDS do involve making program reductions. Specifically, the Governor's plan proposes to save $100 million in General Fund costs for community programs by establishing new statewide standards for the purchase of such services.

Mental Health. Department of Mental Health programs would be reduced primarily through program reductions, including making a 10 percent rate cut in community treatment programs comparable to the reductions affecting other Medi-Cal programs. The Governor also proposes to initially trim, and eventually eliminate, General Fund support for certain school-based mental health services.

Public Health. Several public health programs face program reductions. Prostate cancer treatment programs; state-sponsored research into cancer and valley fever; and grant programs to address such problems as domestic violence, teenage pregnancy, and gynecological cancers would also face General Fund cuts.

Restructuring. The most significant program restructuring proposal affecting health services involves the proposed consolidation of the Emergency Medical Services Authority into the Department of Health Services.

LAO Comments

Some Corrections Needed. The Governor's proposals are reasonable options for the Legislature to consider, along with other approaches to resolving the state's fiscal problem, that would probably achieve most of the estimated savings. Our analysis indicates that the Legislature would have to act in a timely manner in order to achieve the significant savings proposed in Medi-Cal, but could probably act in conjunction with passage of the budget bill on the proposal to establish statewide standards for services for the developmentally disabled.

When it does act, the Legislature should consider making technical corrections to the statutory language needed to implement some of the proposals in order to clarify which Medi-Cal services would be affected. Also, at the time this analysis was prepared, we were not able to resolve technical questions about some aspects of the proposals, such as the assessments proposed to be levied on ICF/DDs.

Other Alternatives. The Legislature may wish to consider some cost-cutting alternatives to the Governor's proposals. For example, it could impose a broader new assessment than the one contained in the Governor's plan for ICF/DDs that would include other types of long-term care facilities. Additional tens of millions of dollars in state revenues that could be raised in this fashion could be used to help offset the cost of such long-term care to the state.

Social Services

Overview

For 2002-03, the Legislature appropriated $8.6 billion from the General Fund to support the state's social services programs. The

Governor's December revision proposes to reduce social services expenditures by $64 million in 2002-03 and $450 million in 2003-04. Figure 7 summarizes the proposed savings for each year.

In the current year, about half of the proposed savings result from early reversion of unspent funds ($10.4 million) or by using previously unanticipated federal funds to offset program costs ($22.2 million). Deletion of the June Supplemental Security Income/State Supplementary Program (SSI/SSP) COLA ($24.1 million) accounts for most of the $31.5 million in program reductions in 2002-03.

For the budget year, nearly all of the program reduction savings of $447 million are achieved by deleting the statutory COLAs and rate adjustments (combined savings of $420 million). The remainder of the savings come from various program reductions, eliminations, and restructurings in the Departments of Aging, Rehabilitation, and Community Services and Development.

Major Features

Most Savings Are From COLA and Rate Adjustment Deletions. The vast majority of the budget year savings come from COLA deletions ($328 million for SSI/SSP and $80 million for CalWORKs) and suspending the statutory rate adjustment for the Work Activity Program through 2005-06 (resulting in a $12 million savings in 2003-04).

Two Restructuring/Reorganization Proposals. First, the Governor proposes to delete the naturalization assistance and mentoring programs at the Department of Community Services and Development (resulting in combined savings of $3.9 million) and to move all remaining functions to the Department of Social Services (DSS). Second, the December revision proposes to shift the Habilitation Services Program from the Department of Rehabilitation (DOR) to the Regional Centers operated by the DDS, resulting in a net savings of $2.2 million.

Other Major Proposals. The Governor proposes to eliminate several programs and reduce others at the Department of Aging (DOA) for a combined savings of about $8 million in 2003-04. The December revision also proposes to reduce Work Activity Program and Supported Employment Program provider reimbursement rates by 5 percent effective April 1, 2003, resulting in savings of $1.5 million in 2002-03 and $6.3 million 2003-04.

LAO Comments

Feasibility and Timing. We believe all of the proposed reductions in social services are

Figure 7

December Revision
Proposed Social Services Savings

General Fund (In Thousands)

Type of Savings	2002-03	2003-04
Program reductions	$31,535	$447,687
Fund shifts	22,153	121
Loans/transfers/reversions	10,413	31
Restructuring/reorganization	—	2,200
Totals	**$64,101**	**$450,039**

feasible in that the savings can be achieved if the Legislature passes the proposed urgency legislation package. With the exception of certain COLA deletions, the savings proposals need action by late January. We believe that the restructuring proposals for the Department of Community Services and Development/DSS and DOR/DDS are workable and may lead to service delivery efficiencies.

CalWORKs Maintenance-of-Effort (MOE) Requirement Limits Savings. The Governor's December revision proposal to delete the June 2003 COLA ($146 million in 2003-04) and the October 2003 COLA ($89 million) results in total savings of $235 million in 2003-04. However, only $80 million of these savings benefit the General Fund. This is because under the CalWORKs program, General Fund savings are limited to the amount by which estimated General Fund expenditures would exceed the MOE requirement of $2.7 billion. The administration believes that providing both of these COLAs would push state spending about $80 million above the MOE requirement. Accordingly, the plan's General Fund savings from these COLA deletions are limited to $80 million and the remaining savings of $155 million would be in federal Temporary Assistance to Needy Families funds that would be used to fund other CalWORKs program costs (child care, employment services, and administration). Alternatively, the Legislature could provide the COLAs and hold CalWORKs spending at the MOE floor by making other CalWORKs program reductions.

Relatively Deep Reductions for Aging Programs. We note that the proposed $8 million reduction at the DOA represents a 20 percent reduction in General Fund support compared to the 2002-03 appropriation of $40 million.

Judiciary and Criminal Justice

Overview

In the judiciary and criminal justice area, the Governor proposes total current-year reductions of $99.3 million, including $65.8 million in program reductions, $31.5 million in reversions, and $2 million through program restructuring. This represents about 1.4 percent of the 2002-03 General Fund budget for these programs. These savings increase to $235.3 million in the budget year, almost all of which are program reductions, as shown in Figure 8.

Figure 8

December Revision
Proposed Judiciary and Criminal Justice Savings

General Fund (In Millions)

Type of Savings	2002-03	2003-04
Program reductions	$65.8	$230.2
Loans/transfers/reversions	31.5	—
Restructuring/reorganization	2.0	5.1
Totals	**$99.3**	**$235.3**

Main Features

Judiciary. The Governor proposes to reduce current-year funding for the courts by $60 million, including unallocated reductions of $10 million for the Judicial Council, and $50 million for the trial courts. These unallocated reductions would increase in the budget year to $29 million and $200 million, respectively.

Criminal Justice. In criminal justice, the Governor proposes General Fund reductions totaling $39.3 million in the current year. Over half of this amount ($21 million) is from the reversion of funds budgeted for capital projects in the California Department of Corrections (CDC), and the Office of Criminal Justice Planning (OCJP). Other significant proposals in this area include shortening the correctional officer training academy from 16 weeks to 12 weeks ($1.3 million), and reducing victims' services and public safety grant programs administered by OCJP ($3.6 million). The proposal also includes numerous other minor reductions in state operations for OCJP, Youth Authority, Board of Prison Terms, Youthful Offender Parole Board, and the Commission on Peace Officer Standards and Training.

LAO Comments

Most of the proposed reductions are in the judiciary budget. We believe the Governor's proposals for the *current year* are feasible, and are not likely to severely impact the delivery of court or criminal justice services. Based on our discussions with Judicial Council, it will likely allocate the Governor's proposed $50 million unallocated reduction by requiring each court to cut its budget by 1 percent to 2 percent. The local courts will likely reduce expenditures by implementing hiring freezes, reducing professional information technology consulting services, reducing major equipment purchases, and reducing the use of temporary help. However, based on conversations with Judicial Council staff, the *budget-year* reductions proposed for the courts may require reductions in staffing and programs intended to improve access, such as the Court Appointed Counsel, Equal Access, and Court Interpreter programs, as well as reduced hours of court operation.

In contrast, the Governor proposes relatively minor reductions in CDC. Most of the Governor's corrections proposals would generate one-time savings. Consequently, the criminal justice (including corrections) savings decrease from $39.3 million in 2002-03 to $6.2 million in 2003-04.

Resources and Environmental Protection

Overview

The Governor's December revision proposes a total of $257.7 million of General Fund savings in resources and environmental protection programs, of which $156.1 million is from the current year and $101.6 million from the budget year. A majority of the savings in both years is derived from shifting funding to other fund sources, primarily bond funds. The balance of the savings in the current year comes largely from reverting unspent funds from prior-year appropriations, mainly for local flood control subventions. Finally, the Governor proposes various program reductions across a number of resources and environmental protection departments, totaling $12.4 million in the current year and $30.8 million in the budget year. Most of the current-year reductions are proposed to be ongoing. Figure 9 summarizes the fiscal impact of the Governor's proposal on resources and environmental protection programs.

Main Features

Current Year. For the current year, the Governor proposes three sets of actions to create most of the savings: (1) reverting $58.1 million for local flood control subventions, (2) shifting $44.1 million for restoration and other capital projects in the Wildlife Conservation Board to Proposition 40 bond funds, and (3) shifting $22.4 million for the CALFED Bay-Delta Program and other water-related programs to Proposition 50 bond funds. The Governor also proposes one fee-related change—an increase in state park fees of $4.5 million in the current year. Finally, most of the proposed individual program reductions are significantly under $1 million. The largest program reductions proposed for the current year are $2 million (one-time) for zero-emission vehicle incentives and $1.6 million for enforcement in the Department of Fish and Game (DFG).

Budget Year. For the budget year, the Governor proposes two sets of actions that create much of the savings: (1) shifting $43.7 million for the CALFED Bay-Delta Program and other water-related programs to Proposition 50 bond funds and (2) raising state park fees by $20 million. The largest program reductions for the budget year are $6.8 million for water quality trend monitoring, $3.3 million for water rights regulation, and $2.9 million for enforcement in the DFG.

LAO Comments

Feasibility. For the most part, the savings proposed by the Governor appear to be achievable. However, lacking details about the proposed funding shift to Proposition 50 bond funds in the CALFED Bay-Delta Program, we are unable to determine whether the proposed bond-funded expenditures fit within the eligible uses of these bond funds. Finally, as noted above, the Governor's savings proposal largely relies on shifting funding for a number of programs and projects to bond funds. The Legislature should consider whether the Governor's proposed use of the bond funds is consistent with its funding priorities for the bonds.

Potential to Shift to Fees. Our review finds that there are a number of missed opportunities to create additional General Fund savings by shifting funding to fees or bond funds. Additionally, some of the Governor's proposed reductions from the General Fund could potentially be backfilled (partially or fully) by fee or bond revenues. We list these options at the end of this report. Our fee-based options include revising the existing fee structure in the state's water rights, dam safety, air quality, water quality, and pesticide regulatory programs, as well as enacting new fees to cover state agency costs to review and enforce timber harvest plans and to pay a portion of the

Figure 9

December Revision
Resources and Environmental Protection Savings

General Fund (In Millions)

Type of Savings	2002-03	2003-04
Program reductions	$12.4	$30.8
Fund shifts	80.8	70.8
Loans/transfers/reversions	62.9	—
Totals	**$156.1**	**$101.6**

state's firefighting expenditures that benefit private landowners.

TRANSPORTATION

Overview

The Governor's proposed revision to the 2002-03 budget includes several transportation-related actions to benefit the General Fund. The largest of these is a cumulative reduction of $1.7 billion in the Traffic Congestion Relief Program (TCRP) in the current and budget years. Of this total, the current year reduction in the TCRP would be $100 million, with the remaining $1.6 billion reduction occurring in the budget year. The proposal also provides $25.3 million in transfers and reversions from transportation funds to the General Fund in the current year. The largest of these is a $15 million transfer from the State Highway Account (SHA) to recover Statewide Cost Allocation Plan money.

In addition, the proposal attempts to address a low cash balance in the SHA by eliminating an estimated $90 million in current-year SHA payments for local street and road maintenance. This action would have no General Fund effect.

Main Features

TCRP to Provide Significant General Fund Relief. The TCRP-related action to assist the General Fund includes several components:

- ➢ Suspension of an approximately $1.1 billion transfer from the General Fund to the Transportation Investment Fund (TIF) in the budget year, which would otherwise occur under Proposition 42.
- ➢ Forgiveness of a planned $500 million loan repayment from the General Fund to the Traffic Congestion Relief Fund (TCRF) in the budget year.
- ➢ The transfer of an additional $100 million from the TCRF to the General Fund in the current year.

Proposition 42, passed by the voters in March 2002, constitutionally requires the transfer into the TIF of General Fund revenues generated from the sales tax on gasoline, estimated to be about $1.1 billion annually. From 2003-04 through 2006-07, $678 million of the transferred funds would be used annually for TCRP projects. In 2007-08, $602 million would be used for these projects. The remaining funds in each year would be allocated as follows: 40 percent for the State Transportation Improvement Program (STIP), 40 percent for local street and road maintenance, and 20 percent for the Public Transportation Account (PTA). Beginning in 2008-09, all funds transferred into the TIF would be allocated among the STIP, local streets and roads, and the PTA according to the same percentage shares.

The TIF transfer may be suspended if (1) the Governor proclaims that making the transfer would result in a significant negative fiscal impact to the General Fund, and (2) the Legislature passes, by a two-thirds majority, legislation suspending the transfer. The Governor's proposal includes a trailer bill to implement the suspension, and the Governor issued the required proclamation on December 9.

LAO Comments

Proposal Will Delay Transportation Projects. The administration's proposal removes funding for TCRP projects that would otherwise be expended in the current and budget years, thereby delaying these projects. If project expenditures were to occur in the current and budget years as Caltrans estimated in spring 2002, about $1.2 billion worth of TCRP projects would be delayed over the two-year period. In addition, as part of the suspension of the General Fund transfer to the TIF in the budget year, STIP funding would be reduced by about $150 million, local street and road funding by about $150 million, and PTA funding by about $75 million.

Also, discussions with the DOF indicate that the administration intends to create a process whereby entities that are responsible for TCRP projects may use STIP funding for TCRP projects, even if that funding is currently programmed for other projects. If this process is created and utilized, the proposal will delay an unknown number of STIP projects.

In addition to losing TCRP funding, local entities would lose about $90 million in SHA funding in the current year for street and road maintenance. Under current law, the SHA was to provide the local maintenance funding in 2001-02 and 2002-03, and in return would receive cities' and counties' share of TIF funding in 2006-07 and 2007-08. The Governor's December proposal would stop the last three quarters of the SHA transfer to locals in the current year, but would not provide offsetting funding to the locals in later years.

Trailer Bill Does Not Contain Necessary Statutory Change. Current law allows TCRF money to be loaned to the General Fund. Any such loans must be repaid no later than June 30, 2006, or earlier as needed to ensure that TCRP projects are not delayed. To make the proposed $100 million transfer and forgive repayment of $500 million in the budget year, existing law must be changed to allow *transfers* from the TCRF to the General Fund, rather than just loans. The administration's proposed trailer bill does not make this change.

Proposal Is One-Time, But May Be Extended. The administration's proposal uses current-year and budget-year TCRP funding to assist the General Fund, creating a one-time reduction in transportation funding. However, the administration's position regarding funding for TCRP projects over the long term is unknown.

General Government

Overview

The Governor's December revision makes numerous spending reductions across many state departments. Proposals in the general government area account for over $1.2 billion in General Fund savings over the current and budget years combined. As discussed in more detail below, the two largest components of these savings relate to employee compensation and the STRS.

Main Features

Allocation of Statewide Reductions. The 2002-03 budget package provided DOF the authority to implement up to $750 million in unallocated reductions in state operations budgets. The mid-year proposal identifies $321 million in specific reductions throughout state government.

Employee Compensation. The Governor proposes a reduction in overall state employee compensation for the budget year of $470 million—the equivalent of about an 8 percent reduction in salaries.

STRS Benefit Payment. Current law requires funds to be annually appropriated to STRS to ensure that retired teachers' benefits are not eroded by inflation. The Governor proposes to reduce the required 2003-04 appropriation to STRS by $500 million.

LAO Comments

Allocation of Statewide Reductions. While the Governor counts the allocation of $321 million in state operations reductions as part of his $10.2 billion in proposed solutions, this proposal actually *worsens* the state's bottom line by $429 million compared to existing law (since the enacted budget assumed the full $750 million in savings).

Employee Compensation. The Governor's employee compensation proposal depends on the state successfully negotiating such a reduction with employee unions through the collective bargaining process. The Legislature likely will not know whether such negotiations are fruitful until late in the budget process. Furthermore, in evaluating any negotiated agreement, the Legislature will have to be aware of the magnitude of any out-year costs (from potential increased future benefits negotiated) in exchange for the deferral of compensation in 2003-04.

STRS Benefit Payment. The intent of the STRS proposal is not to affect the ability of the system to provide its retirees with the statutorily required inflation protection. For instance, the administration has proposed a statutory provision to repay any funds if they are needed to maintain benefits. While these provisions may prove adequate, the state has encountered legal difficulties in implementing similar types of retirement-related actions in the past. At this point, the legal issues raised by the proposed appropriation reduction have not been fully explored.

Local Government

Overview

The administration proposes actions that would reduce local government resources by over $1.5 billion.

Main Features

The December revision contains three main proposals affecting local government.

Redevelopment Low- and Moderate-Income Housing Fund Shift. Current law generally requires local redevelopment agencies to deposit 20 percent of their property tax revenues (commonly referred to as "tax increment" revenues) into designated funds for the development of local low- and moderate-income housing. For more than a decade, the state has expressed concern regarding the failure of some agencies to spend these monies on affordable housing. The administration proposes to shift $500 million of unencumbered funds from these housing funds to the state General Fund.

Deferral of Non-Education Mandates. The California Constitution requires the state to reimburse schools and local agencies for the costs of implementing certain "state mandates." In 2002-03, the state deferred reimbursement for current-year non-education mandate costs, newly identified mandates, and mandate deficiencies from prior years. The Government Code requires the state to pay interest (at the Pooled Money Investment Account rate) when paying overdue mandate claims. Thus, the current-year mandate deferral is equivalent to a low-interest loan from local government. In its mid-year spending reduction plan, the administration proposes to continue deferring reimbursement of non-education mandates. The administration projects this deferral will save $769.4 million in 2003-04.

Vehicle License Fee (VLF) Reserve Fund. Legislated reductions in the VLF paid by motorists resulted in establishing a special reserve fund to provide rebates during the first phase of the reduction. The Governor's proposal would eliminate the reserve fund and shift the $33 million currently in the fund to the General Fund.

LAO Comments

Redevelopment. Our review of the housing fund shift indicates that the administration's proposal could serve as a reasonable "starting point" for discussions regarding revenue transfers from redevelopment agencies, but that the proposal may not realize its goals due to various legal and constitutional constraints. In addition, we note that information regarding the amount of unencumbered funds in local housing funds is dated. Thus, funding available for transfer may be more or less than the $500 million identified. Finally, we note that the administration's proposal does not modify redevelopment agency housing obligations to reflect their reduced housing revenues.

Mandates. Given the cost of existing mandates and new mandates approved by the Commission on State Mandates, we estimate that the administration's mandate deferral represents a much larger deferral of non-education mandate costs—about $1.2 billion in 2003-04. Instead of simply postponing mandate payments, the Legislature could reduce mandate costs by suspending or repealing certain mandates.

VLF Reserve Fund. Since almost all VLF rebates have been paid, we believe the transfer of moneys remaining in the reserve to the General Fund is a reasonable proposal. The General Fund, however, will be responsible for any future rebates. As a result, the net savings for the current year will be somewhat less than $33 million.

ADDITIONAL LAO OPTIONS

In addition to the proposals in the Governor's plan, there are a variety of additional budget-balancing options that we have identified that the Legislature may wish to consider, either in lieu of or to supplement those of the Governor. These alternatives include both additional spending options and revenue-related solutions.

Figure 10 (see page 20) itemizes these additional current-year options along with their estimated fiscal effects in 2002-03 and 2003-04. As with the Governor's proposals, these alternatives fall into a variety of categories including program reductions and eliminations, spending deferrals, funding shifts, fee increases, and reversions of unspent appropriations to the General Fund. We believe these options merit current-year consideration either because of the savings they can generate in 2002-03, or because they will facilitate the state's ability to achieve savings in 2003-04.

Figure 10

Selected LAO Current-Year Budget Options

(In Millions)

		Savings	
Department/Program	**Description/Option**	**2002-03**	**2003-04**
Spending Reductions			
Health Services/Medi-Cal	Exclude coverage of over-the-counter cough and cold drugs.	$1.9	$7.6
Health Services/Medi-Cal	Suspend wage adjustment rate program for nursing facilities.	21.0	21.6
Health Services/Medi-Cal	Enroll disabled persons in managed care in counties where plans now exist.	—	1.1
Health Services/Medi-Cal	Impose a moratorium on new adult day health centers.	7.3	30.1
Health Services/Medi-Cal	Temporarily suspend continuous eligibility for children.	—	192.6
Health Services/Medi-Cal	Temporarily suspend optional services beyond those proposed by administration, excepting prescription drugs.	22.5	93.1
Social Services/ child welfare	Reduce frequency of group home visits.	1.9	7.6
Social Services/Foster Care	Suspend supplemental clothing allowance for two years.	0.8	3.2
Social Services/IHSS	Suspend state participation in future providers' wage increases.	4.0	13.0
Youth Authority	Suspend Gang Violence Reduction Grants for two years.	0.5	1.7
Youth Authority	Close one facility.	—	4.0
Corrections	Close Northern California Women's Facility.	—	11.4
Corrections	Release nonviolent elderly inmates to parole.	0.9	3.4
Corrections	Discharge nonviolent parolees early	12.6[a]	50.4[b]
Agency Secretaries	Eliminate General Fund support for agency secretaries.	—	7.8
Fair Employment and Housing	Eliminate department and commission, leaving federal law and remedies for violations.	—	13.4
Health and Human Services and Teale Data Centers	Consolidate administrative functions.	—	4.0
Technology, Trade, and Commerce Agency	Revert General Fund support for various programs.	11.7	23.5
Various	Eliminate nonessential commissions and departments.	—	8.3
Franchise Tax Board (FTB)	Require E-filing for certain tax practitioners.	2.0	2.5
Tax Agencies (FTB and BOE)	Consolidate various district office activities.	1.1	3.5
UC	Eliminate funding for Dual Admissions program.	2.5	2.5
UC and CSU	Reduce funding for administration (5 percent in CY and 10 percent in BY).	34.0	67.9
CSU	Revert faculty compensation funding carried over from 2001-02.	17.2	—
Student Aid Commission (SAC)	Recognize current-year savings in statewide financial aid programs.	46.5	—
SAC	Raise minimum GPA requirement by one-third point for Cal Grant Entitlement programs.	—	30.3
SAC	Reduce income ceilings by $5,000 for Cal Grant Entitlement programs.	—	15.8
UC and CSU	Eliminate need-based institutional financial aid programs.	—	103.3
Scholarshare	Defund Governor's Scholars Program and Governor's Distinguished Math and Science Scholars Program.	28.0	128.0
Water Resources	Defer funding for state flood control projects.	3.0	—

Continued

Department/Program	Description/Option	Savings 2002-03	Savings 2003-04
Federal Funds			
Developmental Services	Assume higher Medicaid waiver enrollment cap.	$46.1	$72.1
Health Services/Public Health	Move Indian Health Program to Managed Risk Medical Insurance Board (MRMIB).	—	4.0
Health Services/Public Health	Move Seasonal, Agricultural and Migratory Worker program to MRMIB.	—	4.0
Developmental Services	Draw down federal funding for regional center services provided to ICF/DD residents.	—	48.8
Fees			
Developmental Services	Establish a share-of-cost for regional center services provided to children under 18.	—	$30.5
Air Resources	Increase fees to more fully cover stationary source program.	—	15.4
Pesticide Regulation	Increase fees to fully cover costs of the department's programs.	—	16.9
Water Resources Control Board (WRCB)	Increase fees to fully support core regulatory program.	—	16.3
WRCB	Increase fees to fully support water rights program.	—	11.5
Water Resources	Increase fees to fully support dam safety program.	—	7.8
Forestry and Fire Protection	Enact fees to cover a portion of department's firefighting expenditures that benefit private landowners.	—	195.0
Various resources departments	Enact fees to fully support timber harvest plan review and enforcement.	—	21.0
FTB	Establish fee for tax practitioner hotline.	$0.5	0.8
Youth Authority	Increase county fees to reflect inflation.	2.1	3.5
Justice	Charge counties a fee for use of state forensic labs.	4.0	16.0
UC and CSU	Increase systemwide fees by 5 percent for spring 2003.	21.9	53.6
UC and CSU	Increase systemwide fees by 10 percent effective fall 2003.	—	151.4
UC and Hastings	Increase fees for law and professional schools by 15 percent effective fall 2003.	—	8.8
Fund Shifts			
Alcohol and Drugs	Redirect state and federal asset forefeiture proceeds.	$2.5	$10.0
Water Resources Control Board	Shift funding for groundwater monitoring to Proposition 50 bond funds.	0.7	2.8
Various resources departments	Shift funding for North Coast Watershed Assessment to Proposition 40 bond funds.	1.0	3.0
Forestry and Fire Protection	Shift funding for Sudden Oak Death activities to Proposition 40 bond funds.	0.5	—
Parks and Recreation	Shift funding for ADA compliance activities to Proposition 40 bond funds.	2.0	7.8
Loans/Transfers			
Caltrans/Rental Property	Transfer rental property revenues from the State Highway Account (SHA) to General Fund.	$35.0	$35.0
Caltrans/Interest Income	Transfer interest income from SHA to General Fund.	17.8	17.8
Toxic Substances Control	Transfer fund balance in Illegal Drug Lab Account to General Fund.	7.6	—

[a] Savings range from $5.9 million to $12.6 million.

[b] Savings range from $23.4 million to $50.4 million.

Tax-Related Options

As noted previously, the Governor's current-year plan includes virtually no revenue increases. Given the severity of the shortfall, we have suggested revenue options be on the table for legislative deliberation. In considering tax-related options, the Legislature could follow several alternative approaches. These include:

- ***Rate Changes.*** Here, the basic definition and coverage of the tax base would remain unchanged but more revenues would be generated. One example would be a restoration of the VLF to its 1998 level. Such an increase would result in a budget savings (to backfill local revenue losses) of $820 million in 2002-03 (assuming an April 1, 2003 effective date) and $3.9 billion in 2003-04. Another example would be the temporary imposition of high-income tax brackets (10 percent and 11 percent), as was done in the early 1990s' fiscal crisis ($2.5 billion in 2003-04). Another might be a 5 percent surcharge on existing income tax liabilities ($1.8 billion in 2003-04). Finally, a half cent sales tax rate increase would yield about $2.5 billion in revenues annually.

- ***Base Broadening.*** This would involve expanding the basic tax base to include elements that are currently untaxed. For example, subjecting amusement and recreation services to the sales tax would generate revenues of $475 million in 2002-03 and $2 billion in 2003-04.

- ***Changes to Tax Expenditures.*** This would involve modifying or eliminating certain tax exemptions, exclusions, deductions, and credits. Although having the practical effect of base broadening, the focus would be on limiting the current loss in revenues from the existing tax system. Examples might include eliminating the teacher tax credit that currently is suspended for 2002 ($180 million in 2003-04), and temporarily suspending or reducing either the research and development credit or the manufacturers' investment tax credit (roughly $500 million annual revenue gain).

ADDITIONAL COMMENTS AND CONSIDERATIONS

Timely Action Is Crucial

Taking timely actions on current-year proposals is important if the full amount of the potential savings identified is to be achieved.

Potential Benefits Can Be Lost Forever. One reason is that as the months "tick by" and action is delayed, the time left becomes shorter and shorter over which savings can be generated. In some cases, delays in action up to a certain point will not reduce the achievable savings. This would be the case for statewide standards for purchase of services for the developmentally disabled, as well as the suspension of the Proposition 42 transfer. However, in certain other cases, delays will result in potential benefits being lost. For example, in the case of the VLF, if a decision were made to increase the rate, each month of delay would reduce the General Fund savings by roughly $300 million.

Changes Take a Certain Amount of Time to Implement. Another reason for timely action involves the various administrative and technical lead times necessary to implement different budget-balancing options. In the above case of a VLF rate restoration, for example, there must be ample time given for the updating of computer programs and forms, the notification to vehicle owners of the change, and allowing adequate time for the new assessments to be paid. The Department of Motor Vehicles indicates that it would need at least three months to implement an increase in the VLF rate. Attempting to implement changes without adequate lead times will hamper their successful implementation.

Tax Options Must Consider Proposition 98

Education Would Get the Majority of Any New State Tax Monies. The constitutional provisions that govern Proposition 98 determine how increases in state tax revenues increase the K-14 minimum funding guarantee and its so-called "maintenance factor" repayments. Our current calculations indicate that if state taxes were increased to help address the state's budget shortfall and Proposition 98 was not suspended, somewhat over one-half of the first $5 billion collected annually would be required to go to Proposition 98 for funding K-14 education.

Although this does not imply that increased taxes should not be put on the table for consideration as part of a comprehensive solution to the budget problem, it does make it important for the Legislature to carefully evaluate what the best approach might be to considering any tax-related changes.

What About Suspending Proposition 98? Current law allows the state to suspend Proposition 98 in an urgency bill other than the budget bill. In this case, the entire amount of any new tax revenues could be used for budget-balancing purposes.

Are There Other Options? Another means by which the Legislature can use new revenues to address the budget problem is to make changes to special fund taxes or local revenues, which would not have Proposition 98 interactions. For example, any increased VLF amounts are automatically exempted, since the state funds these through payments to localities to compensate them for their reduced VLF collections. The state could also raise special fund sales taxes to support state-local realignment of program expenditures ($2.5 billion for a half-cent rate increase). Finally, the state could increase local property taxes—through, for example, statutory changes in business assessment practices or through the elimination of exemptions. Increases in local property taxes would result in General Fund savings by reducing state spending requirements for schools. It would also raise revenues to local governments, which would enable the state to reduce certain other forms of local assistance without necessarily affecting services to the public.

Major Challenges Lie Ahead

As indicated earlier, the Governor's current-year plan represents a good first step toward dealing with the budget shortfall. Its submission gives the Legislature the opportunity to begin determining early-on how some of its own budget-balancing priorities stack up against those that the Governor has identified thus far. Likewise, our current-year options provide the

Legislature with additional opportunities for taking actions early-on to help address the budget problem.

Given the enormity of the budget shortfall, however, the current-year actions proposed by the administration and identified by our office are necessarily a first step—and even larger actions will be needed to supplement them. These additional actions will be especially challenging, given that the current-year proposals contain some of the "easier" options available, and many of those yet to come will be even more difficult. This makes it all the more important that timely action be taken.

Acknowledgments

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