January 20, 2006

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Fiscal Effect on California:

Pending Federal Deficit Reduction Act of 2005

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If enacted by Congress, the Deficit Reduction Act of 2005 would have a significant fiscal impact on California. We project, based on the provisions which we can estimate at this time, that the fiscal impact of this legislation on California would be $3.1 billion—$1.7 billion in reduced federal funds and $1.4 billion in increased state costs—during federal fiscal years 2006 through 2010. These amounts are preliminary estimates and do not reflect potentially significant secondary effects. In this report, we review the major provisions of this legislation, estimate the fiscal impact on federal funds and state funds based on current law, and identify key issues for legislative consideration. ■

Acknowledgments

This report was prepared by Todd Bland, Dan Carson, Steve Boilard, and Jennifer Kuhn. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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STATUS OF FEDERAL LEGISLATION

On December 19, 2005, the U.S. House of Representatives agreed to the conference committee report for S. 1932, the Deficit Reduction Act of 2005, on a vote of 212-206. On December 21, the U.S. Senate removed certain components from the bill pursuant to Senate rules barring provisions not directly related to the budget, and then sent the amended legislation back to the House for further action. The Senate vote was 51-50 (with Vice President Cheney breaking the tie). House action is tentatively scheduled for the first week of February 2006. If enacted, the measure would have a significant fiscal impact on California. Many of the provisions of this bill would be retroactive to October 1, 2005.

SCOPE AND METHODOLOGY FOR ESTIMATING FISCAL IMPACTS

Scope of Our Analysis. The pending legislation includes ten separate titles covering a wide range of topics including health and human services programs, student loans, agricultural research, bank deposit insurance, digital television transition, and pension guarantee premiums. We have limited our analysis to Titles VI (health), VII (human services), VIII (education), and IX (low-income home energy). Although other titles may have significant impacts on California residents and businesses, we have focused our review on changes that are likely to either impact state programs or the individuals served by state programs. The fiscal impact on programs falls into two categories: (1) reduced federal funds or (2) increased state costs.

Estimates Based on Current Law. Our estimates are based on current state law, and therefore we do not assume a state backfill of lost federal funds, unless current federal or state law requires such an expenditure. We have estimated the major direct impacts on state and federal funds based on the best available information at this time. Finally, our estimates do not include potential significant secondary impacts.

Preliminary Estimates. Estimating the impact of major federal changes on state finances is difficult because there is substantial uncertainty with respect to how the changes may be implemented. The estimates in this report are based on many sources including the Congressional Budget Office's (CBO's) nationwide estimates for various provisions. To translate CBO's nationwide estimates into California impacts, we needed to make various assumptions. Additionally, given the complexity of the bill and, in some cases, the absence of firm nationwide estimates, the state estimates presented in this report should be considered preliminary and subject to revision as more information becomes available.

Translating From Federal to State Fiscal Years. Our estimates of changes in state and federal funds are presented on a federal fiscal year (FFY) basis which mostly overlap with the state's fiscal years. For example, the fiscal impact in FFY 2007 (October 2006 through September 2007) would mostly overlap state fiscal year 2006-07 (July 2006 through June 2007).

MAJOR PROVISIONS

Below we summarize by program area the major provisions of the proposed Deficit Reduction Act of 2005.

Higher Education

Existing Law. Currently, the federal government administers various financial aid programs that help students cover college costs. Eligibility for programs is based on financial need as determined by a relatively complicated federal formula. Financial aid includes both grants (such as Pell grants) and loans (such as Stafford loans). Federal loan programs are administered in two ways: direct loans from the federal government, and loans from private lenders that are "guaranteed" by the federal government through a state intermediary agency. The California Student Aid Commission uses an auxiliary agency, EdFund, to process these loan guarantees.

Guaranty agencies such as EdFund play a central role in the administration of the federal guaranteed student loan program. Most importantly, the guaranty agency underwrites the loan, promising to reimburse the private lender if the student defaults on the loan. (This guarantee reduces lenders' risk and thus encourages participation in the program.) The federal government reimburses the guaranty agency (which, in turn, reimburses lenders) when students default on their loans. In addition, loan guaranty agencies attempt to collect from students on defaulted loans. Guaranty agencies and the federal government share the revenue collected on defaulted loans.

In California, EdFund receives funds (in the form of loan fees and incentive payments) from the federal government to administer the program. These funds are deposited in the Student Loan Operating Fund. In recent years, the Operating Fund has run an annual surplus in the tens of millions of dollars. In some years, the state has used a portion of the surplus to help support the state's own financial aid programs, thus creating one-time General Fund savings in those years.

Fiscal Effects of Title VIII. Title VIII of the act makes significant changes to federal aid programs. The changes with the largest fiscal effects are increased borrower interest rates and reduced lender profits—both of which would significantly reduce the amount of federal funding coming to California. These reductions would be partly offset by an increase in certain federal benefits, described below. Based on preliminary CBO projections, we estimate that the combined effect of the various changes would be a net reduction of about $1 billion in federal outlays over the next five years (2006-2010). Although the state budget would not be affected directly, the changes would affect students and their families, lending institutions, and EdFund. Because there is some flexibility in how the various parties can respond to these changes, we cannot estimate how the net costs would be allocated among the three groups. In general, however, we anticipate the following major changes:

- ***Students Would Be Affected in Various Ways.*** Title VIII contains some changes that would benefit students and other changes that would increase their costs. Most significantly, the act creates a new Academic Competitiveness Grant, which would provide additional aid to low-income undergraduates majoring in science, math, technology, and related fields. We estimate that California students would receive a total of about one-half billion dollars in Academic Competitiveness grants over the five-year period. Title VIII also increases the maximum loan amounts that students could borrow and reduces their loan origination fees. Title VIII would also increase some interest rates, however, which would significantly increase costs for some borrowers.

- ***Profits Retained by Lenders Would Be Reduced.*** Title VIII eliminates a federal bonus payment that effectively supplements the interest payments received by lenders from borrowers. Another change would reduce from 98 percent to 97 percent the amount of reimbursement provided to lenders for defaulted loans.

- ***EdFund's Budget Could Be Affected.*** Title VIII makes various loan program changes that could directly and indirectly affect EdFund's loan volume and revenue. Among the largest changes with a direct effect is a new requirement that EdFund collect a 1 percent "default fee." (EdFund currently waives a comparable fee.) This would increase revenue going into a federal reserve fund. EdFund, however, likely would receive less administrative funding from the federal government. Additionally, EdFund's budget would be indirectly affected by changes that influence borrower behavior, such as higher loan limits and interest rates. EdFund expects the combined effect of these changes would be a net reduction in its operating revenue.

Temporary Assistance for Needy Families (TANF) and Child Care

The federal government provides block grant funds to states for support of cash grants and welfare-to-work services to families whose incomes are not adequate to meet their basic needs. The federal program is known as the TANF program and its state counterpart is the California Work Opportunity and Responsibility to Kids (CalWORKs) program.

Federal Work Participation Rates. Currently, states must meet a work participation rate equal to 50 percent of all cases with adults, minus the percentage point reduction in their caseload since 1995. This percentage reduction is referred to as the "caseload reduction credit." There is a separate 90 percent work participation rate requirement for two-parent families and a corresponding caseload reduction credit.

From 1995 through 2004, California's caseload declined by approximately 46 percent but has been relatively stable since then. Because of this 46 percent reduction, California's currently required participation rate is about 4 percent (the 50 percent requirement, less the 46 percent credit). Beginning in FFY 2006, the proposed legislation resets the base period for the caseload reduction credit to 2005. This change essentially eliminates the value of the credit (because California's caseload has not declined since 2005) thereby setting California's work participation requirements at 50 percent for all families and 90 percent for two-parent families. Currently, California's participation rates are well below these required levels, with the overall rate at 23 percent and the two-parent rate at 32 percent.

Work Participation Penalties. Under current law, if a state fails to meet the work participation rates, it is subject to a penalty equal to a 5 percent reduction of its federal TANF block grant. For each successive year of noncompliance, the penalty increases by 2 percent to a maximum of 21 percent. For California, the 5 percent penalty would be approximately $185 million annually. States that fail to meet their work participation requirements are required to (1) backfill their federal penalty with state funds and (2) increase their maintenance-of-effort (MOE) spending by 5 percent.

Child Care. The proposed measure increases national child care funding by $200 million each year from FFY 2006 through FFY 2010. California is likely to receive about 13 percent of this increased funding.

Child Support

The child support enforcement program helps custodial parents obtain child support from noncustodial parents regardless of the custodial parents' income or whether the custodial parents receive welfare payments. Thus, child support enforcement services are available to both welfare and nonwelfare (nonassistance) families. The program is supported with state and federal funds.

No Federal Match for Reinvestment of Incentive Funds. Under current federal law, child support program costs are shared—66 percent federal and 34 percent state. Also, states compete for federal incentive funds based on the performance of their child support enforcement system. States must use the incentive funds for child support enforcement activities or a closely related activity such as fatherhood programs. Currently, states count the federal incentive funds towards the states' 34 percent match. Effective October 1, 2007, states would no longer be able to use their incentive funds as matching funds, thereby resulting in a loss of federal funds.

Loss of State Revenues for Assistance Collections. To the extent the state does not backfill behind the matching funds (described above), total funding for child support collection activities would decline by about 9 percent beginning in FFY 2008. This reduction in administrative funding would likely result in lower assistance and nonassistance child support collections, due to reduced enforcement efforts. Because most assistance collections are retained by the state as General Fund revenue, there would be a reduction in revenue for California.

Mandatory Fee for Nonassistance Cases. This measure would assess an annual fee on California equal to $25 for most nonassistance child support cases. This fee would be deducted from California's federal funds for program administration regardless of whether California elects to collect this fee from the affected nonassistance families.

Federal Participation in Pass-Through of Child Support to Welfare Recipients. Currently, California passes through to welfare families the first $50 per month collected from the noncustodial parent. California must reimburse the federal government for its 50 percent share of the amount passed through to the family. Beginning in FFY 2009, California would no longer have to reimburse the federal government for its share of the child support that is passed through to welfare families. This would result in a state savings.

Other Changes. Title VII of the proposed measure makes many other changes to the child support program including a mandatory review/adjustment of child support orders every three years and changes in the way child support is collected and distributed. These changes will result in increased state administrative costs. Because these costs are difficult to estimate with precision and are likely to be at least partially offset by increases in child support collections, they have not been included in our fiscal estimates.

Foster Care

Children removed from their homes due to abuse or neglect receive a foster care grant to support their needs in a foster home or group setting. The program is funded by federal, state, and county governments.

Certain Children Federally Ineligible for Foster Care (Reversal of* Rosales*). Pursuant to the 2003 *Rosales v. Thompson* federal court case, a child removed from his/her home as a result of abuse or neglect, may be eligible for federal foster care assistance regardless of whether the child's "home of removal" was eligible for aid under federal income guidelines. Children most frequently affected by this decision were those who were removed from their homes and then placed with relatives who subsequently sought financial assistance. As a result of this court ruling, a relative could receive a foster care grant rather than a CalWORKs child-only grant payment. The proposed measure amends federal law so as to effectively reverse the *Rosales* decision.

The proposed measure would reduce federal funds coming to California in two ways. First, the foster children affected by the federal change would revert back to being CalWORKs child-only cases, where the federal government does not share in these grant costs. Second, the proposal would shift some nonrelative caregiver cases from federally funded foster care to a program that is state- and county-funded only. These changes would be retroactive to October 1, 2005.

No Federal Administrative Funding for Certain Placements. The proposed legislation explicitly places limits on the claiming of federal administrative funds for children placed in ineligible facilities, such as those residing in unlicensed relative homes, detention centers, or hospitals. Currently, the state may receive federal reimbursement for certain administrative costs while children are in these settings.

Increased Funding for Child Abuse Prevention and Court Improvements. The proposed legislation increases national funding for child abuse prevention (Safe and Stable Families Funds) by $200 million over five years. California is likely to receive roughly 20 percent of these funds. The bill also provides $100 million nationally over five years for juvenile court improvements. California is likely to receive roughly 10 percent of these funds.

Supplemental Security Income/State Supplementary Program (SSI/SSP)

The SSI/SSP provides cash assistance to eligible aged, blind, and disabled persons. The SSI component is federally funded and the SSP component is state funded.

Limit Retroactive Lump Sum Payments. In order to receive SSI/SSP, a nonaged individual must prove that he/she is disabled and cannot work. This process for establishing eligibility for SSI/SSP often takes many months. Under current law, once an individual is determined to be disabled and therefore eligible for SSI/SSP, he/she may receive a lump sum payment to cover the period back to when he/she first applied for assistance. The amount of the lump sum payment of their retroactive benefit may not exceed one-year's worth of benefits, with any additional retroactive payment amounts prorated and paid out subsequently. Under the proposed measure, payment of the lump sum amount would be limited to three months worth of benefits. Recipients entitled to more than three months worth of retroactive benefits would receive the remaining obligation spread over the remainder of the year.

The measure also requires more frequent redeterminations of eligibility, potentially resulting in some individuals being found ineligible. These changes will result in federal savings for the federally funded SSI portion of the grant and state savings in the state funded SSP portion of the grant.

Low-Income Home Energy Assistance Program (LIHEAP)

The LIHEAP provides financial assistance to eligible low-income households to offset the costs of heating and/or cooling dwellings, payments for weather-related energy emergencies, and weatherization services to improve home energy efficiency. The program is federally funded.

On a one-time basis, the measure increases LIHEAP funding during FFY 2007 by $1 billion. California is likely to receive about 5 percent of this funding.

Medicaid

The federal Medicaid program (known as Medi-Cal in California) provides health care coverage to low-income families and children, and the aged, blind, and disabled. The program is funded by the federal and state governments.

The pending federal measure would make extensive changes in funding, benefits, and eligibility rules for the Medicaid program. Some of the changes would be mandatory on states, while other changes would provide states, at their option, with the authority to modify their programs. The changes would have various and complex fiscal impacts on the federal government and the state, as some provisions would likely reduce state revenues, increase state administrative and benefit costs, and in some cases reduce state benefit costs. In some cases these changes would also have fiscal effects on California counties.

We discuss the major provisions affecting Medicaid below and also assess their fiscal impact on the state and the federal government. In most cases we were able to determine the likely direction of the fiscal impact (that is, net costs or savings), but we were not able to quantify the direction because of lack of data or because the changes could be implemented in a wide variety of ways by future government actions. However, in the case of quality improvement fees, we were able to estimate the revenue loss to the state.

Quality Improvement Fees. Federal law now allows California and other states to establish so-called "quality improvement fees" on various categories of medical providers. The objective of these fees is both to increase state revenues and to finance rate increases for providers by drawing down additional federal funds. This measure would impose new rules for such fees when they are imposed on Medicaid managed care plans. Beginning in October 2009, California would have to impose such a fee on all managed care plans—not just those serving Medi-Cal beneficiaries—or eliminate the fee entirely. We have reflected this provision as resulting in a loss in revenue to the state (see Figure 2) because current state law does not permit the fee to be collected from all managed care plans.

Prescription Drug Prices. Federal law currently requires drug manufacturers to offer their lowest prices to federal agencies and programs, including the Medicaid program. Also, drug manufacturers are required to discount their prices through the provision of rebates on drugs provided to Medicaid beneficiaries.

This measure would make a number of changes to tighten the federal law regarding rebates, and includes provisions that:

- Establish a new upper limit on payments for certain generic drugs.

- Require greater efforts to collect rebates on drugs administered by physicians.

- Provide additional data to states and the public on the prices drug makers are paid for their drugs. States would also receive additional data on the retail prices being paid for drugs.

- Require states to report annually to the federal government on the rate they paid for drugs, so payments among all states could be compared.

- Make children's hospitals eligible for discount prices currently available under federal law to certain other providers.

Collectively, these provisions are likely to result in savings to federal and state governments.

Asset Eligibility Rules. Persons applying for Medicaid long-term care, such as nursing home care, are currently ineligible if they transferred certain income and assets to others for less than their value within the last three years. This measure lengthens this "look-back" period from three to five years. It also expands the types of asset transfers that can disqualify such individuals for Medicaid benefits. For example, a state could choose to exclude new Medicaid applicants with more than $500,000 of equity in their home (unless their spouse, for example, still lived there). Under current rules, homes generally are not counted as assets that affect Medicaid eligibility. These changes would likely result in administrative costs and benefit savings, with a resulting net savings to the state and federal governments.

Eligibility and Benefit Changes. This measure contains a number of provisions that modify the array of services provided under Medicaid, including changes that would likely result in an expansion of some services and constraint of certain others. Some of the most significant effects of the federal measure are discussed below.

The measure contains several provisions that would allow states to expand home and community-based services for elderly and disabled beneficiaries. Other provisions expand self-directed personal care services and psychiatric services for children, allow states to offer "health opportunity accounts" partly controlled by beneficiaries, and continue for another year transitional coverage for families who would otherwise lose eligibility due to increased work hours and income. Severely disabled children in families with incomes up to 300 percent of the federal poverty level (FPL) would be permitted to enroll in Medicaid subject to paying premiums. However, case management and targeted case management services would face tighter restrictions under the new federal measure. States would be permitted to provide some beneficiaries "benchmark" coverage plans (similar in scope to California's Healthy Families Program) in lieu of more comprehensive standard Medicaid coverage.

These various changes would increase or decrease federal, state, and county costs, with their net fiscal effect depending largely on which options to modify Medi-Cal were selected by the state.

Copayments and Premiums. Current federal law generally limits to $3 the copayment that can be charged to a Medicaid beneficiary for receipt of a medical service. Current law also does not allow providers to deny services to beneficiaries who indicate they are unable to pay them. Strict limits also exist on charging premiums to beneficiaries.

This measure changes federal law to allow states to establish higher copayments for beneficiaries in a few eligibility categories—such as parents with incomes greater than 150 percent of the FPL—and permits providers to deny services if they are not paid at that time. The total amount of copayments paid (as calculated either monthly or quarterly) would be limited to 5 percent of a family's income. Special copayment rules, including applicability to more eligibility groups, would apply for prescription drugs and the use of emergency rooms for nonemergency care. Premiums could not be charged to most eligibility groups, including families with incomes lower than 150 percent of the FPL, pregnant women, and aged or disabled beneficiaries. The proposed changes, if adopted, could reduce federal and state benefit costs.

Verification of Immigration Status. Current federal law generally only permits citizens and qualified aliens to receive full-scope Medicaid benefits, although others, such as undocumented persons, may receive emergency medical services through the program. Individuals must file a written certification under penalty of perjury as to their immigration status, but states are not now required to obtain and verify documentation of citizenship, such as a passport or birth certificate. This measure would require state Medicaid programs to verify specified documents, for both new applications and redeterminations of eligibility for full-scope benefits. These changes would likely result in administrative costs and benefits savings.

ESTIMATED IMPACT ON FEDERAL FUNDS

Figure 1 shows the estimated major impacts of the proposed Deficit Reduction Act on federal funds flowing to California. The negative numbers represent reductions in federal funds to California and the positive numbers represent increases. As the figure shows, we estimate that California will lose a total of nearly $1.7 billion over the five FFYs from 2006 through 2010. The single largest reduction is nearly $1.5 billion from the provisions pertaining to federal student loans. Because of the way the federal government accounts for these loan-related savings, the estimate overstates the near-term impact on California. Students, lending institutions, and EdFund would experience these impacts more gradually as loans are paid off.

The second largest loss in federal funds is due to federal penalties for failing to meet TANF work requirements. Even though California is likely to be out of compliance as soon as FFY 2007, there is typically a two-year lag between the year a state is found out of compliance and when penalties are actually assessed. Although it is possible that California could avoid the penalties through program changes, many such changes would require amending current state law and accordingly are not reflected in our scoring. The figure does not include potential federal losses due to Medicaid changes because they cannot be estimated at this time.

Finally, this figure quantifies direct fiscal impacts and does not include potential significant secondary impacts. We have not included such impacts in our analysis primarily because they depend on policy choices pertaining to how the proposed changes may be implemented, whether the state would backfill for any loss in federal funding, and how individuals may respond to implementation of the various provisions.

Figure 1

Pending Deficit Reduction Act of 2005
Major Impacts on Federal Funds to California

(In Millions[a])

	Federal Fiscal Year					
Program Area/Description	**2006**	**2007**	**2008**	**2009**	**2010**	**Totals**
Higher Education[b]						
Net federal savings from loan program changes[c]	-$335	-$285	-$280	-$280	-$275	-$1,455
New Academic Competitiveness Grants	90	100	105	110	115	520
TANF and Child Care						
Penalties for failing to meet work participation target	—	—	—	-$185	-$260	-$445
Increased funding for child care	$25	$25	$25	25	25	125
Child Support						
Mandatory fee on nonassistance cases	—	-$5	-$5	-$5	-$5	-$20
No federal match for reinvested incentive funds	—	—	-90	-90	-90	-270
Foster Care						
Certain children federally ineligible (*Rosales*)	-$5	-$5	-$5	-$5	-$5	-$25
No federal administrative funding for certain placements	-15	-15	-20	-20	-20	-90
Increased funding: child abuse prevention and court improvements	10	10	10	10	10	50
SSI/SSP						
Limits on lump sum payments and disability redeterminations	-$40	-$20	-$10	-$20	-$20	-$110
Low-Income Home Energy Assistance Program (LIHEAP)						
One-time augmentation for 2007	—	$45	—	—	—	$45
Totals	**-$270**	**-$150**	**-$270**	**-$460**	**-$525**	**-$1,675**

[a] Rounded to nearest $5 million.

[b] Based on preliminary Congressional Budget Office estimates.

[c] The 2006 estimate reflects upfront the total value of the loan program changes over the life of all outstanding loans. The same approach is used for new loans in each year thereafter.

ESTIMATED IMPACT ON STATE GENERAL FUND

Based on current state law, Figure 2 shows the direct impacts on the state General Fund over the next five fiscal years. Costs and lost revenues are shown as positive numbers and savings are reflected as negative numbers. As the figure shows, state costs are estimated to increase by almost $1.4 billion. The single largest cost is $720 million for the increase in the state TANF MOE requirement because, based on current performance, the state is likely to be out of compliance with federal work participation mandates beginning in FFY 2007. Another significant cost is the loss of approximately $250 million in Medi-Cal quality improvement fee revenue beginning in 2010. The estimates in Figure 2 only include costs required under current law and do not include any discretionary backfills. Finally, the figure shows how annual costs rise to nearly $700 million by 2010. These costs are likely to continue at least at this magnitude in the out years.

Figure 2

Pending Deficit Reduction Act of 2005
Major Impacts on California General Fund

(In Millions[a])

	Federal Fiscal Year					
Program Area/Description	**2006**	**2007**	**2008**	**2009**	**2010**	**Totals**
Medicaid						
Loss of quality improvement fee revenue	—	—	—	—	$250	$250
Child Support						
Federal participation in pass-through of child support	—	—	—	-$15	-$15	-$30
Loss of revenue for assistance collections	—	—	$10	15	15	40
TANF and Child Care						
Increase in state maintenance of effort	—	$180	$180	$180	$180	$720
Required backfill of federal penalty	—	—	—	185	260	445
SSI/SSP						
Limits on lump sum payments and disability redeterminations	-$20	-$10	-$10	-$10	-$15	-$65
Totals	**-$20**	**$170**	**$180**	**$355**	**$675**	**$1,360**

[a] Rounded to the nearest $5 million.

KEY ISSUES FOR THE LEGISLATURE

If enacted, the Deficit Reduction Act poses many challenges for state policy makers. Below we identify key issues for the Legislature to consider in responding to the proposed federal changes.

Examine Options to Offset State Costs and Lost Revenues

As noted earlier, this proposed federal measure contains a number of provisions that could result in significant state costs and losses of revenues. Given these circumstances, we believe the Legislature should carefully examine the options it has under other provisions which would allow the state, at its discretion, to access additional federal funds and other revenues for state health programs. For example, the new federal measure would allow the state to more effectively impose copayments for certain Medi-Cal beneficiaries (particularly for costly emergency rooms and prescription drugs); access additional federal funding for services for developmentally disabled and mentally ill beneficiaries now supported mainly with state funds in order to expand home and community-based services; and obtain more accurate information that could be useful in establishing the prices it will pay for prescription drugs. We will continue to review some of these potential opportunities more closely.

Consider CalWORKs Program Changes To Avoid/Reduce Penalties

Noncompliance with federal TANF work participation rates results in substantial penalties and an increase in the MOE requirement. There are many strategies for increasing participation so as to potentially avoid or reduce these costs. These strategies involve policy changes and investments in welfare-to-work services as well as certain technical changes. Our upcoming *Analysis of the 2006-07 Budget Bill* will provide the Legislature with a range of options for increasing work participation.

Monitor Impact on California's Loan Guaranty Agency

As noted earlier, some of the changes to the federal loan programs would affect EdFund. EdFund officials expect that the changes could dampen its growth in new loans and reduce the total revenue it otherwise would collect. These effects could reduce total funding contained in the Operating Fund in future years, and thus reduce funds potentially available to help support some of the state's grant programs. If the bill passes, we recommend the Legislature carefully monitor EdFund's budget to assess the effect of these changes and determine if any state fiscal response might be needed.

Study Interaction of Federal Changes With State Aid Programs

The changes proposed in the act also could have significant effects on students. The higher loan limits, for example, might help to promote access to higher education, but they might also increase loan indebtedness and default rates. It is unclear how these federal changes would interact with state and college financial aid programs. For example, the various changes in financial aid for first- and second-year students could influence decisions to enroll in community colleges. New loans available for graduate students could affect how the state's university systems package their aid. The higher loan limits could lead campuses to increase the work-loan requirements for students receiving financial aid. Given the uncertainty about the effects of these various changes, we recommend the Legislature direct the Student Aid Commission to assess these effects and examine their interaction with state and college aid programs.

CONCLUSION

If enacted by Congress, the Deficit Reduction Act would result in substantial state costs, as well as pressures to backfill for losses in federal funds. The Governor's budget, prepared prior to Congressional action, does not recognize these potential impacts. As discussed in this report, there are steps which the Legislature could take to mitigate some of the impacts. To the extent they are not addressed, these costs and pressures would aggravate the state's projected structural budget problem.